1. SIR KENNETH COUZENS
2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Ryrie
Mr Middleton
Mr Hancock
Mrs Hedley-Miller
Mr Bottrill
Mr Turnbull
Mr Whitmore(No.10)

MEETING WITH MR VOLCKER

Together with the Prime Minister you are seeing Mr Volcker on 11 February. Two briefs are attached. The first covers U.S. economic and monetary policies; the second deals with UK financial policies.

2. The meeting provides an opportunity to seek Mr Volcker's views on:-

(i) the policies of the new Administration (Mr Volcker has said that tax reductions in advance of public spending cuts might not be consistent with reduced pressure on financial markets).

(ii) U.S. economic prospects (the U.S. inflation rate, now on the way up again, might soon meet the UK inflation rate on the way down).

(iii) the operation of U.S. monetary policy.

3. Although methods of monetary control differ between the U.S. and the UK there are similarities in overall approach. It is jointly recognised that no one monetary aggregate can be an adequate guide to policy. And that short-term deviations from trend, or in the relationship between money supply and other economic variables need not be harmful.

4. In each country the interpretation of monetary policy has been complicated: in the UK by the corset, and in the U.S. by the growth of new banking facilities which are blurring the distinction between various types of money.

5. Mr Volcker is likely to ask about UK policies. You may wish to administer an antidote to recent criticism in the U.S. press and elsewhere.

6. You will be supported at the meeting by Sir Kenneth Couzens.

M. C. Mercer

M C MERCER
10 FEBRUARY 1981

KEC 10/2

US ECONOMIC INDICATORS

GNP in 1980 fell by around 0.1 per cent. The decline in the second quarter (9.9 annual rate) was a post-war record. Some recovery in second half of the year, but chance of a renewed fall in activity in first half of 1981 remains.

Consumer prices accelerated sharply at the end of 1980 with a rise in the last quarter of over 12 per cent (annual rate). Higher mortgage rates were only partly responsible. Earnings growth is now starting to pick up. Hourly Earnings in December were 10.5 per cent higher than a year earlier.

Unemployment has been fairly steady at around 7.5 per cent for the last year or so but is officially expected to reach 8 per cent in the first half of 1981.

The current account was almost certainly in surplus last year for the first time since 1976. Compared with 1979 the improvement was almost entirely on trade account with a 17 per cent or so reduction in the volume of oil imports more than offsetting higher oil prices.

PRIME MINISTER'S AND CHANCELLOR'S MEETING WITH MR VOLCKER

DRAFT BRIEF NO.1 : US DEVELOPMENTS AND POLICIES

1. i. What are prospects for US output (can recent recovery be sustained?); and inflation (UK rates may well now be falling below US rates).

ii. Might US tax cuts boost government borrowing before public spending cuts begin to bite? Effect on interest rate if this happens and inflation accelerates.

iii. Interested in US experiment with monetary base control. Has it led to higher/more volatile rates than necessary? Effect of volatility on inflationary expectations, business confidence? European complaints about effects on EMS currencies?

iv. What have been main operational problems in setting targets and controlling bank reserves?

BACKGROUND

Policies of new Administration

2. Main economic measures proposed by Reagan are : 10% personal tax cut in each year 1981-83; corporate tax concessions; 2% cut in federal outlays in 1981.

3. Growing concern about timing and impact of tax and public expenditure proposals. Policy statement expected mid-February. Volcker has urged "concrete action" on public spending before taxes are cut. Others, notably Stockman, say early tax cuts are imperative to stimulate economy and help reduce budget deficit through higher economic activity. Expenditure cuts will not be easy. A 2% reduction implies a 16% cut in those programmes that can be trimmed (ie those that are not demand determined or bound by statute).

4. Federal deficit for 1981 officially forecast at $55 billion (around 2% of GNP); with federally backed loans etc it could reach over $70 billion. Reagan's proposed tax cuts would cost around $30 billion in 1981 (about half of expected fiscal drag); a 2% public expenditure cut would save some $15 billion. Danger of fiscal/monetary imbalance as large federal financing needs compete with private credit demands. And economy grew fast (5% annual rate) in Q4 of 1980.

<u>US Monetary policy: Techniques and problems</u>

5. New techniques introduced in October 1979 seek to control growth of monetary aggregates by restricting supply of reserves to the banking system. Not pure monetary base control. Interest rates not completely free but allowed to fluctuate within wide margins.

6. Techniques applied through open-market operations. Fed buys and sells securities to provide volume of non-borrowed reserves thought consistent with money targets. If money supply moves above target banks need to top up reserves. They are encouraged to use Fed discount window only as a last resort and to look for other sources of funds first. In this way reserve pressure pushes up money market interest rates (the Fed funds rate is the trigger) and so affects bank lending and money supply growth. If money supply fails to come back on course the Fed can squeeze the supply of non-borrowed reserves further.

7. Two main problems in practice: what targets to choose and how to define them; and how to react when relationships between bank reserves and money supply appear to shift.

a. <u>Choice of target</u>

8. Trade-off between Fed's ability to control a given aggregate and influence of that aggregate on overall demand. Monetary base easiest to control but weak relationship to overall demand. Broad aggregate such as M2 has more stable relationship but hard to control. Narrower aggregates fall inbetween.

9. Problems of definition a further complication. US financial system evolving rapidly. Growing availability of new instruments and banking facilities blurring distinction between various forms of money. Fed has opted for flexibility. Family of targets:

MIA - Currency plus demand deposits

MIB - MIA plus other checkable deposits (eg recently authorised "Negotiable Order of Withdrawal" accounts which are interest bearing).

M2 - MIB plus banks' overnight repurchase agreements, savings and small time deposits.

Volcker recently said "No single monetary measure should be emphasised to the exclusion of others, nor should undue weight be placed on short-term changes or small deviations from targets, particularly when those deviations are not consistent from one measure to another."

b. <u>Relationship between bank reserves and money supply</u>

10. Fed nonetheless has problem of distinguishing between self-correcting money supply fluctuations and more fundamental shifts. It periodically sets short-term (1-2 months) targets during the year and manages reserves on day-to-day basis. Procedure designed to avoid unnecessary market disruption (many say it has failed in this): while responding early to serious money supply slippage.

11. One difficulty has been unpredictable relationship between reserves and money stock. Different money stock components have different reserve requirements: some have none at all; many banks have left the Federal Reserve system to avoid requirements. Uniform requirements are being applied to all deposit taking institutions but this will take 8 years.

12. Another difficulty has been Fed's limited ability to achieve reserves targets. Forecasting errors and faulty or erratic management of the discount window have been blamed. Reforms to increase Fed's control over reserves are being considered.

## Recent monetary developments

13. Partly for these reasons, new techniques have had teething problems. But Volcker attributes last year's volatility of interest rates and money supply mainly to parallel volatility in the overall economic environment (cf GDP fall in Q2 1980 at 10% annual rate, rise in Q4 at 5%).

14. US interest rates (3 month CD rates) rose from 10% in February 1980 to 18% in April, fell to 6% in June, rose to 20% in mid-December and have since fallen back to around 17%. Money supply (MIB) fell in the second quarter of last year and grew rapidly for much of the second half. For the year as a whole MIA and MIB grew at the upper end of target ranges (3½-6% and 4-6½% respectively); M2 slightly exceeded its 6-9% range.

15. Europeans complain about the effects of high and volatile US interest rates on the German mark and other European currencies. They see US monetary policy as adding to their inflation by weakening their currencies, and to their unemployment by keeping up European interest rates. But they can hardly complain about US determination in fighting inflation.

## Prospects

16. All targets for 1981 provisionally cut by ½%. Fed to reassess them in mid-February. Early interest rate decline might be limited by several factors:

i. Heavy Treasury financing requirements - estimated at about $25 billion in first quarter.

ii. Probable Fed unwillingness (even if economy goes into recession again) to see repeat of rapid interest rate decline of last spring.

iii. Prospect of double figure inflation persisting through most of 1981.

PRIME MINISTER'S AND CHANCELLOR'S MEETING WITH MR VOLCKER

BRIEF NO.2 : UK FINANCIAL POLICIES

Introduction

1. Mr Volcker may seek to establish where the UK Government stands on its financial policies. He could ask:

i. What caused the overshoot of £M3?

ii. Why had the Government nevertheless felt able to reduce interest rates?

iii. Does the Government intend to continue its monetary strategy or is it veering towards some kind of exchange rate objective?

iv. What problems are the Government experiencing in reconciling fiscal and monetary policy?

Points to make

2. The Government remains fully committed to its monetary strategy by which inflation will be reduced by a progressive reduction in the growth of money. Intend to stick to monetary targets - no intention of switching to an exchange rate regime or modulating monetary targets according to the level of the exchange rate.

3. Government accepts that, if allowed to continue for long, rapid growth of £M3 would have serious consequences. Relationship between money and prices well established over an extended period. But after a burst of growth in the late summer, rate of increase of sterling M3 has been falling back. Short term variations need not have harmful effects. Programme for reducing inflation is a medium term one and in that timescale it remains our intention to reduce the growth of the money supply.

4. Special factors have inflated growth of £M3. Problem of corset similar to problem of changing financial structure in US - see Brief 1, para.9. Other factors have been:

i. high PSBR, reflecting recession (nationalised losses, faster procurement spending, more benefit payments, lower-tax yields);

ii. imbalance between personal and company sectors; three excessive pay rounds plus a high exchange rate, high interest rates and a sharp recession produced heavy company bank borrowing and a 17% personal savings ratio. Unprecedented extent to which personal savings and company borrowings channelled through the banking system probably added to demand for £M3 and inflated figures.

5. Notwithstanding high growth of £M3, Government have felt able to make some reduction in interest rates in view of evidence of monetary tightness from many other indicators (rapidly falling inflation, strong exchange rate, slow growing narrower aggregates, general state of economy). But formulation of monetary objectives for coming period now under consideration as part of March 10 Budget.

6. Government intends to continue using £M3 as its main target variable, but agree with Volcker's remarks (Brief No 1, para 9) that no one aggregate can be adequate as sole guide to policy. While we do not intend to adopt multiple targets, Government will take account of narrower aggregates alongside £M3 in conduct of policy.

7. Acutely aware of potential conflict between fiscal and monetary policy. This is heightened by use of broad aggregate as principal target variable - indeed that is an important argument for continuing with £M3. Fiscal measures were taken in November, and Budget will provide further opportunity to bring borrowing requirement into line with needs of monetary policy.

8. Seen some tendency in US press to say "Thatcher experiment failed". Maybe some saying it because would <u>like</u> it to be true. But it isn't. Policy very much alive and inflation falling faster than in other major countries. Is being pursued with determination.

<u>Background</u>

9. A separate note will be submitted on the provisional money supply figure for banking January, which will be published on Tuesday, 10 February.