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FROM: R G LAVELLE

DATE: 13 April 1983

MR KERR

cc: Mr Burns
Mr Bottrill

DISCUSSIONS WITH MR VOLCKER

As background for this visit, I attach a copy of the latest World Economic Prospects brief. US material is sidelined.

2. As you suggested, I have asked the Embassy to send us in the course of the day a summary appraisal of Mr Volcker's testimony yesterday to the House Banking Committee, to supplement the attached FT report.

R G LAVELLE

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FINANCIAL TIMES WEDNESDAY 13 APRIL 1983 (front page)

Volcker stresses need for lower U.S. interest rates

BY PAUL TAYLOR IN NEW YORK

MR PAUL VOLCKER, U.S. Federal Reserve Board chairman, said yesterday that U.S. interest rates were still too high to support a long-term economic recovery, and that if he were a private banker he would be inclined to reduce his loan rates.

Mr Volcker's comments, which had been eagerly awaited by U.S. stock and bond markets, contained few if any surprises. He was testifying before the House Banking Committee on the Fed's monetary policy.

He told Congressmen that interest rates were abnormally high considering the low rate of U.S. inflation and the outlook for inflation in the future.

"If the inflation outlook is as good as I think it is, interest rates are high relative to what is necessary and desirable to sustain a long, healthy recovery. But I would not make the case that in the short run the level of interest rates is incompatible with a business recovery."

Mr Volcker said the markets saw inflationary factors becoming more acceptable but that there was still a "residual concern" that the improvement in the inflation rate might be temporary. This was reflected in longer-term interest rates.

He said interest rates were also affected by the yawning budget deficit which had resulted in the Treasury issuing an average of $750m (£487m) in new securities every day.

In addition, U.S. interest rates were being buffeted by the various changes resulting from financial deregulation.

In spite of these uncertainties, Mr Volcker rejected suggestions that the Fed should establish short-term monetary objectives. Such a move would encourage a "degree of fine tuning" that could be counterproductive to basic economic goals.

With one eye on the markets and economists' concerns about the recent rapid growth in some of the money supply aggregates, Mr Volcker emphasised again that M2 had been distorted by the introduction of new bank accounts.

He said that considering somewhat slower growth in March, M2's growth was very near the upper end of its projected targets and a 7 to 10 per cent annual range still "appears reasonable." The March M2 figure is due to be published on Friday.

Mr Volcker said M1, the narrowest money supply measure, had also been affected by the new accounts and was difficult to assess. M1 had clearly been growing faster than its annual 4 to 8 per cent target range, but he repeated that the degree of uncertainty over interpreting the figures had led to the Fed to place less emphasis on M1 in its short-term monetary policy.

Nevertheless, prolonged growth of M1 at high levels "would be cause for concern."

Summarising the Fed's view of monetary policy, Mr Volcker said: "Taking account of credit as well as monetary behaviour, and some indications that the burst of growth in at least the broader monetary aggregates may be subsiding, we believe our monetary posture has been broadly consistent with the specific objectives we set out in February."

PERSONAL REPRESENTATIVES' MEETING 16-18 APRIL 1983

WORLD ECONOMIC PROSPECTS

Points to make

ECONOMIC OUTLOOK

i. Recovery in world activity not yet fully established. Increase in US GDP and leading indicators, together with revived confidence in Germany, are encouraging but recent firmness in US interest rates and patchy nature of rise in demand emphasise tentative character of recovery so far.

ii. Lower oil prices should, on balance, improve world growth and reduce inflation. Some oil exporting debtors may suffer, more so if prices fall further but benefits to oil-importing countries should outweigh these difficulties.

iii. International financial scene still requires close monitoring. Adjustment process must continue. Most major debtors now have stabilisation programmes with the IMF. Case by case approach is required as blanket solutions would undermine global counter-inflationary strategy. Useful that IMF giving positive lead to commercial banks.

POLICIES

iv. Monetary policy should be flexible but firm enough to prevent any renewed upsurge in inflation. Fiscal policy should aim to achieve a prudent and sustainable structural budget position in the medium term.

v. Policies need to sustain recovery but Williamsburg should resist calls for excessive reflation. Within the framework of prudent financial policies those countries who achieve lower inflation will have greater room for real output growth.

vi. Major countries, especially SDR group, should pursue convergent policies to achieve non-inflationary growth. Only way to exchange rate stability. Welcome recent French recognition.

vii. All countries, particularly Summit partners, need to resist protectionism. Developing countries need access to industrial markets. Trade restrictions inhibit growth and impoverish us all.

Background

ECONOMIC OUTLOOK

Early signs of the modest <u>recovery</u> (1-2 per cent growth in output) forecast for the major industrial economies in 1983 are accumulating. In the US real GDP is estimated to have risen by 1 per cent in the first quarter but so far much of this is attributed to a slower rate of destocking. Industrial production and housing starts have continued rising while in Europe and particularly in Germany business confidence may have turned round. Lower inflation and lower interest rates should help promote the recovery in activity. The fall in oil prices should also increase activity.

2. The US Administration has revised upwards its 1983 projection of growth between the end of 1982 and the end of 1983 from 3 per cent to over 4½ per cent. In Germany private forecasts of GDP growth this year have recently been increased to around 1-2 per cent. But the government while expecting some recovery in 1983 has so far left unchanged its own forecast for zero growth on average in 1983. The French government is now expecting no real growth this year following the recent austerity package.

3. Output growth in the non-oil developing countries (NODCs) after falling last year is also forecast to pick up slightly in 1983 to around 3 per cent though this remains below the 5 per cent growth achieved earlier. World trade is expected to recover only slowly growing by around 1 per cent after falling sharply last year the first fall since 1975.

4. <u>Unemployment</u> is likely to exceed 9 per cent for the major OECD economies by the end of 1983. With the pick-up in activity the rate of increase in unemployment at least may however start to decline towards the end of the year.

5. The year-on-year rate of inflation has fallen faster than expected. For the major countries it has come down from 12 per cent on average in 1980 to 5 per cent this February. Some further fall is likely in the early part of the year but thereafter higher activity may push inflation up somewhat.

6. Nominal interest rates fell markedly late in 1982. In the US three month market rates fell from around 16½ per cent last summer and bottomed out at 8½ per cent by the end of 1982. Since then rates have been broadly flat but over the last month or so they have edged up and now stand above 9 per cent. Elsewhere interest rates recently have generally fallen further (Germany) or remain unchanged (Japan). Although real interest rates have eased slightly they remain high compared to past experience.

7. The OPEC agreement in mid-March to cut prices by 15 per cent to a new marker of $29 pb has held up so far. OPEC's current account may now move into deficit. Lower oil prices should help many sovereign debtors but hurt those who are also oil exporters (Mexico) and may create some extra problems (eg Venezuela, Nigeria, Indonesia, Egypt). A further fall would aggravate these difficulties. On balance the agreed oil price reduction should however improve economic prospects.

8. The large prospective US current account deficit (over $20 bn) dominates the increase in deficits expected this year for the major countries in aggregate. The Japanese current account surplus is running at around $1 bn a month which is higher than the last quarter of 1982 while in Germany January's surplus was over $½ bn. The French deficit improved slightly in February but is already well over a quarter of the government's target for 1983 with only two months' figures available. The Japanese and German surpluses, of $7½ bn and $3½ bn last year, are expected to increase this year.

9. Non-oil developing countries' (NODCs) adjustment last year cut imports sharply thereby reducing their current account deficit from $100 bn to $90 bn. Net new bank lending to NODCs contracted sharply last year - growing by only 9 per cent compared to over 20 per cent in previous years.

10. Financing constraints on NODCs are likely to persist. The IMF expects net new bank lending to grow by only 8 per cent or so in 1983. Import growth may remain depressed but the up-turn in the OECD area should allow some recovery in export growth and some further and sustained improvement in commodity prices. Together with the benefits of lower interest rates this should help NODCs to reduce their current account deficits further to around $70 bn. The recent fall in oil prices should also help.

Exchange rates have remained volatile. After rising sharply last year the effective dollar rate depreciated by around 8 per cent between November 1982 and February this year. But more recently the dollar has strengthened recouping most of this loss as US interest rates have firmed and interest differentials narrowed. As a result of the EMS realignment the DM appreciated by 8 per cent against the French franc ($5\frac{1}{2}$ per cent from the DM revaluation and $2\frac{1}{2}$ from the franc devaluation). Despite the strong appreciation since last November which has reversed the losses in 1982 the yen remains undervalued.

12. Most major debtors including Mexico, Brazil and Argentina are now implementing stabilisation programmes with IMF assistance. Although the imminent threat of major international defaults has receded financing difficulties still persist. The $47\frac{1}{2}$ per cent increase in quotas (from SDR 61 bn to SDR 90 bn) agreed at the IMF's February Interim Committee together with the increase in the General Arrangements To Borrow and its greater availability should enable the Fund to play an effective role in helping countries to adjust their economies. The World Bank needs its resources replenished (See Annex on IDA).

13. Several new initiatives have been proposed to ease the banks' present difficulties with sovereign lending. Some of the schemes involve a new international institution taking over responsibility for some country lending by banks. All involve public money without reinforcing conditionality and none so far has attracted support from other major countries. The arguments for a new SDR allocation will need to be carefully considered. The IMF will be studying them later this year (July). The UK has an open mind but doubts if an unduly large allocation will be justified.

POLICIES

14. The operation of monetary policy last year was complicated by institutional change and shifting liquidity demands. Last year US monetary growth overshot the targets partly due to distortions. In February the Fed announced higher targets for 1983, but stressed its counter-inflationary goal.

15. Reports of the February FOMC meeting suggest the Committee was divided over monetary policy with some arguing for a tighter stance. Earlier this year all the monetary aggregates were growing rapidly well above their respective target ranges. But there are signs that the expected slowdown in growth may be occurring. M3 growth slowed in February and is now just slightly above its $6\frac{1}{2}$-$9\frac{1}{2}$ per cent target. More recently the level of M1 has actually fallen and growth has contracted sharply. Despite this the latest figures indicate M1 grew at around 15 per cent pa over the period since Q4 1982 as a whole which is considerably in excess of its 4-8 per cent target.

16. Last year monetary growth (CBM) in Germany at around 6 per cent was towards the top end of the 4-7 per cent target range. The same target has been set for 1983 despite lower inflation. In the first two months of the year CBM has grown at over 10 per cent pa, well above target, partly as a result of temporary factors. In France although domestic credit expanded rapidly in 1983 the external deficit enabled the monetary target to be met. The government has announced a tighter target for 1983. It has moved to a single figure objective which has just been reduced from 10 per cent to 9 per cent. Italian monetary control last year was wrecked by the high public sector deficit. No new target has been set for 1983.

17. As regards fiscal policy, since 1979 despite most government's attempts to achieve firm public expenditure control, general government deficits have risen, mostly due to the recession, from 2 per cent of GDP in 1979 to over 4 per cent in 1982. Only Japan and the UK have secured a reduction in their deficits while of the remaining major countries Germany has made the greatest efforts to keep deficits down. Mildly expansionary policies in France and the US have, along with the recession, tended to increase budget deficits.

18. Last December OECD estimated that deficits for the major economies this year would remain at 4 per cent of GDP despite the expected recovery. The new French measures to accompany the devaluation are designed to keep the central government budget deficit in 1983 and 1984 to 3 per cent of GDP. The restrictive 1983 budget introduced by the Japanese Government has been tempered but only slightly by the concession of income tax cuts later this year, the financing of which has yet to be decided, and the acceleration of public works programmes.

19. The US Administration estimates that the budget measures for FY1984 should reduce the Federal deficit from 6½ per cent of GDP in FY1983 to 3½ per cent by FY1986. But these deficits would still be high compared with past experience and depend on rapid growth being achieved. The budget measures are still being debated and have yet to be passed by Congress. So far at least the budget has not entirely satisfied concern over the Administration's future fiscal stance.

PROCEDURE

20. We share the hopes for a relatively informal discussion at Williamsburg concentrating on a few key economic issues. But there is already considerable pressure notably from the French and the Scandanavians, for some co-ordinated reflation by the major low inflation countries. Such expectations need to be defused in advance of the Summit. Lower inflation should, within the bounds of prudent counter-inflation policies, allow greater real growth. But there is scope for a better policy mix to ensure a more balanced and sustainable recovery. In particular the US should be encouraged in its efforts to reduce its budget deficit while there is a need for high inflation countries such as Italy and France to bring their performance into line with that of their Summit partners.

21. As yet there has been no call for a macro-economic assessment paper examining prospects and policies similar to the one produced for Versailles. It might however be useful to consider whether there should be a short note on the latest position which could be prepared after the OECD Ministers' meeting.

12 April 1983

ANNEX

INTERNATIONAL DEVELOPMENT ASSOCIATION (IDA)

Points To Make

Prospects for Congressional approval of US contributions to IDA 6 in FY 83 and FY 84 are causing anxiety. Hope that US Administration will make major effort to secure approval. Failure would have serious implications for future of IDA and would damage developed countries' position in North-South dialogue. Would be particularly unfortunate in context of UNCTAD VI.

2. Hope also that US will be flexible on the size of its contribution to IDA 7. Important for all donors to contribute in accordance with their economic strength.

INTERNATIONAL DEVELOPMENT ASSOCIATION

ESSENTIAL FACTS

IDA was established in 1960 as an affiliate of the World Bank. Its credits are provided on near grant terms to the poorest countries in the world.

IDA 6

The Sixth Replenishment (IDA 6) was originally intended to provide $12 billion for commitments in three fiscal years beginning 1 July 1980 (FY 81), but the Carter Administration was unable to obtain Congressional authorisation for the US contribution ($3.24 billion - 27%). The present US Government decided to accept the commitment but to phase payment over 4 years instead of three (ie to FY 84). Only $1.9 billion has so far been authorised by Congress and there is a serious risk that the US contribution will not be complete until the fifth year (FY 85). Other IDA donors have agreed to provide IDA with additional commitment authority over the extended 4 year period - first by advancing their first year's IDA 6 instalments, then by delinking their second and third year's instalments from the level of the US contribution, and finally by agreeing special funding for FY 84.

The Reagan Administration is seeking supplementary appropriation of $245 million for FY 83 and the $1095 million balance in FY 84. It is common ground that every opportunity should be used to persuade them to make a major effort to secure Congressional approval for these appropriations. Resulting from a UK initiative, the German Ambassador in Washington delivered a European Community demarche of 1 March. IBRD President (Mr Clausen) in London 12-15 April will ask Prime Minister to raise this with Reagan personally at Williamsburg.

IDA 7

Negotiations on the seventh replenishment began in Washington last year with the intention of reaching agreement by the time of the September 1983 Annual Meeting of the IMF and World Bank. Meaningful negotiations cannot begin until the US position under IDA 6 is clarified, and the size of the US contribution to IDA 7 is known.

UK Interest

The UK has been a strong supporter of IDA under successive Governments and our interest is probably to work for a continuing high level of resources for IDA, but towards an IDA 7 replenishment target that is realistic and includes full US participation. It would be futile to fix an overall volume which the US Administration could not meet or to start IDA 7 without the US. At the present time the US Administration is thought to be considering contributions of around $750 million a year which would produce an IDA 7 total of $9 billion over 3 years or $12 billion over 4 years - substantially less in nominal terms than the agreed total for IDA 6.

On burden sharing, we have already made clear our intention of reducing our share from the very high level of 10.1 per cent for IDA 6, and from the 7.6 per cent for the special funding for FY 84, to one more in line with UK's relative economic strength.