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10 DOWNING STREET

From the Private Secretary

14 April 1983

CALL UPON THE PRIME MINISTER BY MR. PAUL VOLCKER

Mr. Paul Volcker called upon the Prime Minister this afternoon. Mr. Newman from the US Embassy was also present.

The Prime Minister referred to the half per cent reduction in base rates in the UK this afternoon. Mr. Volcker said that he, too, had been under pressure to reduce interest rates, with six months of very low inflation figures, but the rapid monetary growth of recent months and the prospect of higher inflation in 1984 was an inhibition. He believed that the United States' recovery was set fair in the short run, with a considerable inventory turn-around and surprisingly good housing figures, given how high real interest rates were. The tax cut at the end of June would also boost consumption. His principal worry was the budget deficit, with total savings at around 7 per cent and the budget deficit at around 6½ per cent of GNP. The Federal Government was borrowing $¾ billion per day. The problem would come if the recovery proceeded too quickly and if there were no reduction in the budget deficit. The Prime Minister said that an increase in the taxes on gasolene, alcohol and tobacco would, surely, make a considerable impact on the deficit. Mr. Volcker replied that tax increases on their own would be inadequate: what was needed was, say, a $30 billion defence cut, a $30 billion cut on other spending, and $30 billion in higher taxes.

The Prime Minister spoke of her concern about the international banking situation. There was too much emphasis on the role of the IMF and IBRD, too ready a recourse by debtor countries to these institutions, and too small an impact by IMF and IBRD conditionality on the imprudent and profligate. Mr. Volcker said that this was not the moment to persuade commercial banks to draw back from foreign lending. The risk was the other way, that the banks were drawing their horns in too suddenly and too far. He would not himself criticise the IMF and the IBRD. The sums which they were putting forward were small, and under their aegis debtor countries were being obliged to impose severe economic regimes, with sharply falling GNP and GNP per head in some cases. He was hopeful about the future in Mexico,

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although he believed she had not quite reached the nadir yet. The Brazilians talked well, and were good on paper, but their actions back home were causing a continuing deterioration in Brazil's situation. The Prime Minister enquired whether the assistance the Fed had been giving to Mexico had been a large factor in the growth of US money supply in recent months. Mr. Volcker said that the growth had not been deliberate. He would have preferred a lower growth rate, but one should not become too worried: he did not believe that the growth which had occurred would necessarily lead to higher inflation several years hence.

Mr. Volcker said that it would be important to put in place a proper system of surveillance and control for commercial banks, to prevent a repetition of their present situation in the future. He expressed appreciation of the Prime Minister's support for the British involvement in the measures to deal with Argentina's indebtedness, and spoke of the difficulties for the international monetary system were the Argentinians to repudiate their debts. Chile was currently seeking large-scale support from the United States, and it might be that they would give this support if they could be persuaded that the Chileans would pursue a sensible policy. He was much encouraged by Venezuela's recent decision to go to the IMF; they had long been unwilling even to admit that they were in difficulty, notwithstanding a long-term and ruinous outflow of capital to the United States.

In a brief discussion of oil prices, Mr. Volcker agreed that the price appeared to be stabilised for the time being, and referred to criticisms he had faced in Congress for not supporting a much reduced oil price. For his own part, he believed that another $1, $2 or $3 reduction would not be too disruptive, but that a further fall would be difficult to accommodate. The Prime Minister said that in her view a $3 fall now would be very damaging.

Mr. Volcker enquired what prospects the Prime Minister saw for moves towards greater exchange rate stability, particularly at Williamsburg. The Prime Minister replied that there would not be greater stability until the major countries followed prudent financial policies. She would argue on these lines at Williamsburg, and she believed that such arguments would be still better received this year than in earlier years. Mr. Volcker commented that sticking to a well-conceived financial policy was becoming increasingly difficult since there had been growing restlessness as the recession went on and on. But he believed that within the last three months or so the restlessness had abated somewhat, as the prospect for recovery became clearer. He was facing considerable pressure in Congress to set his monetary policy so as to facilitate recovery. He sought, as always, to add to this formula a requirement that he should do nothing which would re-ignite inflation. But he was not confident that he would secure the inclusion of this essential rider. The Prime Minister said that it would be important that Williamsburg was absolutely clear on this point. Mr. Volcker agreed, and added that he was confident that,

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with the Prime Minister and President Reagan there, the Summit would give the right message.

I am sending a copy of this letter to Brian Fall (Foreign and Commonwealth Office), and Richard Hatfield (Cabinet Office).

John Kerr, Esq.,
H.M. Treasury.