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②
1) Mr. Scholes
2) Prime Minister.

RECORD OF A DISCUSSION BETWEEN THE CHANCELLOR
AND THE CHAIRMAN OF THE FEDERAL RESERVE,

AT 10am ON 28 JUNE in NO 11

Mr Volcker agreed that the position on the US deficit was very worrying. He saw no chance that the Administration would voluntarily take effective action. The President probably did not accept the estimates of future deficits of some \$200B a year, and certainly attached a higher priority to increasing defence expenditure and reducing taxes than to eliminating the risk of deficits on that scale. Congress was more concerned, but disliked tax increases even more than increased deficits. Interest rates were however likely to rise, and fairly soon, and this might conceivably cause Congress to recognise how damaging the current and prospective deficits were. But of course it would be the Fed which would take most of the blame, when interest rates rose.

2. The Chancellor asked whether interest rates would rise sharply; what exchange rate movements were expected; and to what extent the dollar was taken into account in assessing monetary conditions. Mr Volcker said that the exchange rate was not taken into account in a regular or systematic manner, though from time to time it was necessary to agonise about it. If the dollar had been weaker in the last six months, domestic policy would undoubtedly have been tighter. The dollar certainly ought to weaken soon - but he had been saying that for six months. The fall could be quite sharp, when market sentiment changed, and there were perhaps indications that it was already changing, for the dollar had not strengthened in recent days, though interest rates had edged up. Monetary growth was now rather rapid, and the economy was expanding faster than had been expected. The tax cut due on 1 July was 'absolutely



not required'. On domestic policy grounds there was no doubt that interest rates should rise, and perhaps quite sharply, if only for a short period. But the external and international arguments went the other way. Debtor countries badly needed lower world interest rates.

3. Mr Volcker then said that he had been asked by the Argentine Central Bank Governor to make it plain in London that in the Argentine view a gesture from the UK over the exclusion zone was required before Argentina could lift the remaining restrictions on UK non-banking firms operating there. The Chancellor took note, pointing out that all discriminatory restrictions would have to be lifted before Argentina's July IMF drawing could go ahead.

4. Mr Volcker warned that the situation over the US legislation on the IMF quota increase was far from satisfactory. The Bill which had emerged from the Senate caused no problems; but new amendments being tabled to the House version were highly unsatisfactory. It was not clear either that the Bill would go through - certainly strong Administration pressure would be required - or that it would emerge without damaging amendments attached. The Bretton Woods Act prevented government lending to the IMF in any form without Congressional approval. It was important to keep the issue of IMF market borrowing under wraps until the quota increase was through Congress, for Congress might see market borrowing as an alternative to the quota increase, and block the latter.

5. The Chancellor asked about the exposure of US banks in developing countries now experiencing financial difficulties; and about the possible need for improved surveillance and supervision arrangements by central banks world-wide. Mr Volcker thought that the position of the US banking sector was less volatile than it had been in mid-82. But he warmly agreed that progress on improved, and coordinated, surveillance had been halting and unsatisfactory.

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The Ambrosiano case was a graphic illustration of a problem not yet solved. It was of course difficult to argue at the same time that the banks must give greater weight to prudential considerations and that they should maintain current lending levels to countries in difficulty. But both points were in fact essential.

6. The meeting ended at 10.50 am.

A handwritten signature in dark ink, appearing to be 'J O Kerr'.

J O KERR
28 June 1983

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