



10 DOWNING STREET

*From the Private Secretary*

12 February 1981

*Dear John,*

As you know, Mr. Paul Volcker, Chairman of the Federal Reserve System, called on the Prime Minister at 0900 hours on Wednesday, 11 February. The Chancellor of the Exchequer and Sir Kenneth Couzens, and Mr. Ahmerman from the U.S. Embassy, were also present.

Mr. Volcker described the current economic situation in the US as he saw it. In his view, some of President Reagan's advisers were being overly optimistic on the tax front. Unless there were early and substantial public expenditure cuts, he doubted whether there would be scope for tax reductions on the scale which they envisaged. The President should be giving the American people greater warning of the difficulties that lay ahead. It was very unlikely that the acceleration in GNP growth in the fourth quarter of 1980 could continue, as was being suggested in some quarters. For if the current monetary targets were to be hit, there was little or no scope for any real growth in the economy. The money supply had been rising at a rate slightly faster than the target range, and they had taken steps to curb it. But the consequence was high interest rates, and even now this was putting a damper on economic expansion. With a big budget deficit in prospect, pressure on the money markets was likely to continue. He feared the prospect of some sizeable bankruptcies, which in turn could put some of the financial institutions at risk. In addition, there were the uncertainties about future oil prices, and the possibility of a bad winter wheat crop because of insufficient rain. If there was to be a real recovery, inflation had to be reduced. It would be better for the new Administration to "hit hard and fast" in order to achieve this. The question which everybody in the US was asking was whether a turn-around in inflation was possible without the economic squeeze which the UK had experienced.

The Prime Minister said that she thought the scope for achieving reduced inflation without a major squeeze was better in the case of the US than it had been for the UK. Here, our difficulties had been aggravated by the world recession and by the high exchange rate; but also, wage inflation was more built in to the system. Years of incomes policies, and the assumption of automatic annual pay increases, made it more difficult to curb the growth of earnings. Mr. Volcker said on the latter point, that the US was having its difficulties too.

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The existence of three-year pay contracts was a mixed blessing at a time when the Government was trying to disinflate. For example, the auto workers had just signed a contract which would give them 40 per cent over three years. Also, in those sectors of the economy such as the defence and energy industries which were booming, wages were going up very fast. On the other hand, the public utility unions were probably less strong than their counterparts in the UK.

There was some discussion of monetary control issues. Mr. Volcker said that the financial markets were much more complex and erratic than existing theories suggested, and therefore they were harder to protect. But the FED had done a great deal of work in trying to improve their understanding of these matters and their techniques of market management. They were now reasonably confident that they could hit their monetary targets on a quarterly basis two-thirds of the time with a margin of plus or minus 10 per cent. But it was doubtful whether the interest rate consequences could always be borne. Control had been improved as a result of the auction system for debt which he had introduced. Auctions allowed the Treasury to sell the amount of debt that they desired, and he did not believe that they had been greatly responsible for the recent interest rate volatility. The latter was primarily due to other forces. There were some disadvantages - for example, the authorities could no longer give signals to the market in the way that the Bank of England was able to. But the advantages outweighed the disadvantages. The Prime Minister said that she thought the US experience with auctions could be very relevant for the UK, though we would be concerned if we had as much volatility as the US bond market appeared to display.

Finally, Mr. Volcker reported on some conversations he had had in London and in Europe over the previous day or two. He had found a scepticism in the City which he had not found previously about the different measures of the money supply, the setting of targets and the authorities' ability to meet them. Businessmen to whom he had spoken in London seemed to be getting pretty nervous: they had sympathy for what the Government was trying to do, but they now wanted a little hope - particularly on the exchange rate and interest rate front. In his conversations with bankers in Zurich and Barcelona, he had found increasing concern that the world was moving into deeper recession; and there appeared to be an increasing number of people who were advocating reflation. Even in Germany, people were beginning to take this line. He had also found growing concern about the problems of the LDCs. Many LDCs were in fact facing a very difficult situation because of higher oil prices and because of the very high interest rates which they were paying on their external debt. Countries such as Brazil had not reckoned on interest rates staying high and world inflation moderating when they took on their debt.

I am sending a copy of this letter to Tim Allen (Bank of England) and George Walden (Foreign and Commonwealth Office).

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H.M. Treasury.

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*Tim Lambert*  
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