

COMBER

10 DOWNING STREET

From the Principal Private Secretary

13 December, 1984.

Dear David,

The Prime Minister met Chairman Paul Volcker this evening. He was accompanied by the US Ambassador and Mr. Jerry Newman.

The Prime Minister started off by asking Mr. Volcker about the banking situation in the US, including the possibility of further problems for the US banks if growth slowed down in the US economy. Mr. Volcker said that the US banks had assumed that inflation would last for ever, and were staffed by people who had not the experience of the late '20s and '30s. There could be further difficulties. He would not let major banks go under without a struggle, but believed that the stockholders should suffer as they had done in the case of Continental Illinois.

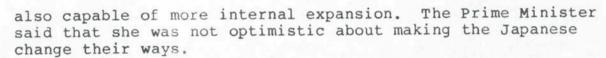
The Prime Minister commented that she had heard that recent appointments to the Fed Board were not proponents of such strict monetary discipline as Mr. Volcker himself.

Mr. Volcker said that he would confine himself to the comments that the last two appointees had been known to dissent from recent decisions on the side of easier money. He also said that, while he had been in Europe, he had read a report in the New York Times that the Secretary of the US Treasury had criticised the Fed for pursuing an "irresponsibly tight" monetary policy. The Prime Minister commented that she saw Mr. Volcker's personal role at the Fed as vital.

The Prime Minister then asked Mr. Volcker how he saw the prospects for US growth. Mr. Volcker said that he saw a risky period ahead. Part of the problem was a "blip" which was natural after recent rapid growth as inventories got out of line. But the real problem he saw was the rapid rise of imports. This was partly due to rapid growth and partly to the high dollar. But the consequence was that US manufacturers were being undercut, and there was much greater uncertainty and reluctance to undertake investment. Another consequence was that too much of the income generated by US economic growth was taking place abroad. He thought that there would be a slowing down in the US economy next year, and he hoped that Europe and Japan would take up the running. Prime Minister Nakasone was visiting Washington in January, and a Japanese banker had urged that he should be put under as much pressure as possible to expand the Japanese domestic economy. Germany was probably

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The Prime Minister said that she thought one of the main reasons for the strength of the dollar was that the US was a reliable free enterprise economy. She wondered therefore why the US had to pay such high interest rates for its borrowings. Mr. Volcker said that, unlike the Swiss, the US did not have 20 years of sound monetary policy behind them, although he hoped that as a result of their performance in the last 5 years they now had more flexibility than 3 years ago. But the main problem was that total savings were 8½% of national income, whereas borrowing was 11%.

The Prime Minister then asked about the US deficit. She was concerned at the rate at which the proportion of revenue represented by debt interest was growing, and she understood that the US was about to become a debtor nation. It had been suggested to her that the President might do a deal with Congress by which he agreed to equivalent increases in revenue in return for Congress's agreement to cuts in public expenditure and a constitutional amendment for a balanced budget. Mr. Volcker said that he had not heard this particular suggestion before. The President was not far from being able to get an amendment for a balanced budget through Congress - it would probably already pass through the Senate - but he did not think that it would have particular significance. The US was already a debtor nation on some counts, and in the next 2 years would beome much more so. Nothing could be done about the internal deficit for at least a year. The US growth had so far been beneficial both to the rest of the world, and to the US itself: the problem was that the combination of external and internal deficits could not last.

The Prime Minister asked Mr. Volcker his views on the international banking situation. Mr. Volcker said that there were many new faces among the central bankers, particularly in the major countries. He would miss Fritz Leutweiler very much. As regards the international situation, he hoped that the Prime Minister would be sympathetic over Argentina. He accepted her view that the Argentines might have got an easier deal than they should have done, but it was still essential that support should continue. He thought that Brazil had done particularly well in improving its balance of payments, and he had some hopes for Venezuela. But he was worried that Mexico was showing signs of lapsing into old ways: certainly there was no opening up of the Mexican economy.

The Prime Minister said that the only course forward that she could see was to try to run things prudently, and to go in the right direction slightly faster than people thought that they could accept. Mr. Volcker said that it was vital that the Government should not be defeated by the

mineworkers' strike: the action which President Reagan had taken over air traffic controllers early in his first Administration had been crucial in changing attitudes throughout the US economy.

I am sending a copy of this letter to Len Appleyard (Foreign and Commonwealth Office).

Your evar,

Robin Buttar

David Peretz, Esq., HM Treasury.

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