

CONFIDENTIAL

USA



CAW

Prime Minister

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MLS 22/7

Treasury Chambers, Parliament Street, SW1P 3AG

01-233 3000

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Michael Scholar Esq  
No.10 Downing Street

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Dear Michael,

VOLCKER'S STATEMENT: 20 JULY

The Chancellor thought the Prime Minister might like to  
..... see the attached brief note about the testimony given  
yesterday to the US Senate Banking Committee by  
Paul Volcker, Chairman of the US Federal Reserve Board.  
It was an important statement on US economic policy, and  
also showed some striking similarities with our own  
experience and policies. It has been well received in the  
markets.

Yours ever,  
J O Kerr

J O KERR

MR VOLCKER'S STATEMENT, 20 JULY

The testimony given to the US Senate Banking Committee yesterday by Mr Volcker, Chairman of the Federal Reserve Board, was an important and balanced statement on US economic policy. It has been widely reported in the press.

2. The main strands in what he said were as follows:-

(i) The US inflationary tide seems to have turned in "a fundamental way". There is an opportunity to achieve lasting progress towards price stability, to provide the basis for many years of economic recovery. With this success in sight it would be quite wrong to relax policy now.

(ii) Interpretation of the monetary evidence is complicated. Partly for technical reasons to do with financial innovation, and partly because at a time of recession and uncertainty peoples' desire to hold monetary assets may increase for precautionary reasons, strong efforts to reduce monetary growth further would be inappropriate. Growth around the top of the Fed's target ranges would therefore be "fully acceptable", and bulges above the target range could be tolerated for a time.

(iii) The principal threat to policy lies in the fiscal deficit. "Considerably more remains to be done to bring the deficit under control as the economy expands". A "credibly firmer budget posture" would greatly relieve strains in the financial markets and help bring interest rates down.

3. There are, of course, striking parallels with UK experience and the policies we have been pursuing: sticking to the strategy against inflation; continued but not excessive downwards pressure on the monetary aggregates, making allowance for changes that affect the significance of the numbers; and the need to control the budget deficit. What is also striking is that the Volcker statement is a more authoritative survey of both the monetary and fiscal situation in the US than any recent statement by the Administration itself. Volcker's message about the Budget deficit is the one we have been urging on the US administration.
4. The statement was taken well in the markets, though much of its impact seems to have been anticipated and discounted in advance. It was preceded by a cut in the Fed's discount rate. The detailed comments about monetary policy (paragraph 2(ii) above) could imply less instability in interest rates in future.
5. The US money supply figures for the last two weeks have also been helpful, with M1 back within its target range for the year for the first time for many months. Three-month eurodollar interest rates fell around 3% from 16½% in the last week of June to around 13½% before Volcker's statement. Since then they have fallen a little further, to a little under 13¼% at the close of business in London on 21 July. US prime interest rates have also started to come down. This fall if it is sustained is likely to be very important for the development of the world economy.
6. These developments have proved helpful for UK interest rates in recent weeks. Mr Volcker's testimony in itself will not necessarily bring any further early fall in US rates, but it may help to consolidate the fall that has already taken place.