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25 February 1983
ALAN WALTERS

PRIME MINISTER

US ECONOMY: CHANCELLOR'S MEMORANDUM 24 FEBRUARY

Monetary Policy

It is important to be clear that the Fed's policy has turned from being disinflationary to one that is markedly inflationary. Over 1982 the monetary base was expanding at 8% per annum. This will be consistent with inflation rate in the region of 8%-10% per annum in 1984. All the discussion and argument about interpreting monetary conditions and indicators are largely irrelevant.

In cyclical terms the Fed has been doing what it always tended to do in the past, that is to say contract the rate of growth of the money supply during a slump and expand it as the economy emerges into a boom. The money supply was squeezed hard until the middle of last year, and has subsequently expanded in the last three months of the year at 15% rate pa.

Because of the tremendous political pressures and the timing of the election, I cannot see the Fed doing any significant tightening before the latter part of 1984. This means that we must expect the United States will enter into a long run inflationary surge similar to that we have seen so often in the 1970s. I therefore expect that the present low inflation rate will last for little more than another year. Then inflation will pick up again to the region of 8% or more.

Interest Rates

The ostensible objective of the recent expansionary monetary policy was to keep interest rates down. It is true that this has had the effect of maintaining low short run interest rates. However, long run interest rates have increased by one or even two percentage points. This implies first that the market believes that the inflation rate is going to rise - and somewhere round about 8% is clearly their expectation in view of the fact that long term bonds are 10½% or 11%. Secondly, the fact that the spread of short and long rates has increased means that the market expects much higher short term interest rates in future years. These expectations are entirely consistent with a large budget deficit claiming some 70% of the available funds for investment.

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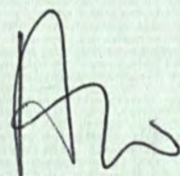
Conclusion

The signs of a future inflation in the United States are sufficiently clear for us to consider what our policies should be under these conditions. It might be worthwhile at some stage convening a group to consider our policy. It may well be that we are in sight of Europe needing to provide the lynchpin reserve currency to replace the dollar. This would have momentous consequences.



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