CONFIDENTIAL

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FROM: DAVID PERETZ
DATE: 17 December 1984

N 18/12

MR LAVELLE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Mr Littler
Mr Unwin
Mr Cassell
Mr Lankester
Mr Shields

VISIT BY CHAIRMAN OF THE FED

Chairman Volcker came to see the Chancellor at No 11 Downing Street on 12 December. Sir T Burns, and Mr Newman from the US Embassy, were also present.

US Economy

2. Chairman Volcker said he was reasonably certain that the current slowdown in the US would be permanent: he saw growth as running at no more than 3 to 4 per cent next year. The main question was how long the current fiscal imbalance, and payments deficits were sustainable. At some point, he believed, the dollar would fall. A modest fall in the dollar would not concern him, so long as - and he thought this important - other industrial countries were to respond by allowing their policies to become more expansionary.

3. The Chancellor felt that if US interest rates came down, and the dollar fell, then European rates would fall as well. Chairman Volcker said he feared the Germans, in particular, might not be prepared to move quickly enough.

USR / Volcker

US Deficit

4. Chairman Volcker was not optimistic about the chances of early action. He believed the Administration would propose expenditure savings (although proposed savings in defence spending might turn out to be "nominal" cuts only); but that it would be very hard to get Congress to agree. The President, however, would not be prepared to look at the alternative of raising taxes until it was clear that progress on spending cuts was blocked. The President himself was less concerned, intuitively, about the deficit than about the scale of government spending.

US Banking System

5. Chairman Volcker said he was less concerned than he had been about the state of the US banking system. Banks now had a much better attitude. But it would take some years for them to get their balance sheets right. Meanwhile many banks remained exposed to the risks of a sharp fall in the oil price. The best combination would be a gentle fall in the oil price and a gentle fall in the dollar, but he was concerned, in both cases, that the fall might turn out to be too sharp.

DLCP

D L C PERETZ

Circulation:

Mr Turnbull (No 10)
Mr Appleyard (FCO)
PS/Governor

- Sir P. Middleton.
You may find some of this of interest!
AR 13/12/84

cc. Sir T Burns
Mr Littler
Mr Cassell

US file

NOTE OF THE MEETING OF THE BACKBENCH FINANCE COMMITTEE
TUESDAY 11 DECEMBER 1984

The meeting was addressed by Federal Reserve Chairman Paul Volcker.

2. Mr Volcker made some introductory remarks on the US and world economy. After a period in which the US had seen the most rapid growth since the Korean War the rate of expansion has now slowed down. Throughout the upswing there had been a very rapid increase in imports which had helped to fuel other economies, particularly those of the developing world, Canada and to a lesser extent Europe. American demand was now likely to slow down but next year Japanese expansion would be a partial substitute.

3. In spite of the trade deficit the dollar had appreciated as capital flowed into the US. Domestic saving had been insufficient to fund the federal deficit on top of other demands for funds, and capital inflows from abroad had made up the difference.

4. There was good news on the debt crisis in the developing world but the problem had not yet been fully solved. Large borrowers, in particular Mexico and Brazil, had done a lot to put their houses in order. It was to be hoped that the developing world could resume growth of about 5% .

5. Terence Higgins asked what were the risks of a rapid reversal of the inflow of capital into the US and a consequent fall in the dollar. Mr Volcker said that while the US continued to run a current account deficit there would have to continue to be an inflow of capital. The questions were at what exchange rate and what interest rate. The sooner steps were taken to reduce the domestic deficit the better protected the US would be against a possible

change in sentiment. Any attempt to pump up demand would lead to a still bigger current account deficit. Monetary policy could not by itself maintain inflows, fiscal policy was crucial. He had, however, worried about a drop in the dollar a year ago and it hadn't happened.

6. Roger Freeman asked what lessons UK policy makers should learn from the US. Mr Volcker said he would not offer any precise advice. All nations had been struggling with similar problems, trying to get the psychological presumption of inflation out of the system. In these circumstances stimulation could be dangerous. The UK had made a lot of progress on the fiscal side and in structural terms the UK deficit did not exist.

7. Brian Mawhinney asked whether we were resolving the debt problem or merely postponing it. Mr Volcker said that the future of the developing countries depended on the success they had in making adjustments at home. A number of them had taken stronger measures than one could reasonably have expected. They would have to open up their economies more and at the same time put less of their own money in Miami or New York. The banks' lending practices had been looser than one would have liked.

8. George Walden asked how great the pressure would be on the US Defence Budget. Mr Volcker said that he did not think the cuts the President would like to see could be achieved by simply cutting the civil side of the budget. There would have to be a reduction in the planned rate of growth of defence spending.

9. Anthony Beaumont-Dark asked whether the banks weren't going to need support while the debt problem was being sorted out. Mr Volcker said that the banks would have to continue their co-operative efforts for some time.

10. Lord Jock Bruce-Gardyne asked what was the Fed's attitude to the exchange rate and to intervention. Mr Volcker said that there was no official policy towards the exchange rate but it was difficult to repress the thought that it was pretty darned high now. He did not think one could rely on intervention to counter fundamental economic forces.

11. Sir Michael Shaw asked Mr Volcker's view of Africa. Mr Volcker replied that, bluntly, the African market wasn't big enough economically to matter.

12. Lord Eccles asked whether the US trade deficit wasn't more important to the UK than the level of interest rates. Mr Volcker agreed but queried the trade deficit could be sustained.

13. Tim Yeo asked whether confidence that the Third World would continue to solve its debt problem was compatible with the assumption that the US would cut its trade deficit. Mr Volcker replied that as both projections had come out of an econometric model they must be internally consistent.

14. Edwina Curry asked if the US wasn't missing a trick in world political terms by being lukewarm on multilateral aid. Mr Volcker replied that the US was keener on multilateral aid than it had been five or six years ago but that it was not popular domestically. As an example, the US copper industry had suffered very strong competition from developing countries.

15. Peter Hordern asked about the reaction to the President's tax proposals. Mr Volcker replied that they had been quite heavily criticised initially but he would not underestimate the President's ability to get something through Congress if he wanted to.

16. Alan Howarth asked if it wouldn't be necessary to have a crisis to deal with the US deficit. Mr Volcker said that he would like to avoid crisis.

17. Nigel Forman asked what should be top of the agenda at the next economic summit. Mr Volcker said that in his opinion summits didn't make much difference.

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