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PERSONAL AND SECRET

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PRIME MINISTER

US ECONOMIC POLICY

Since we may not have a chance to discuss your forthcoming trip to Washington before you leave, I thought I should briefly record for you my personal views on the foreign exchange issue and the US deficit.

2. I believe it would be desirable for you to go a little further on the strength of the dollar and intervention arrangements than your briefing suggests. The US authorities do not like to appear to criticize free market developments and they hate any suggestion that they should talk their own currency down. But they are saying privately that at present levels the dollar is uncomfortably high, and they do see the effect on trade and protectionist pressures. It is right of course for you to make clear, as necessary, that you are leaving detailed intervention arrangements to the practitioners. But you might wish to say to the President that you think it a matter of great importance that the Washington G5 commitment is carried forward effectively and that it is recognised by the market that all parties are operating, and operating together, to this end. With Baker you might wish to express appreciation for the helpful tone of his recent comments on Fed' intervention, and add that dollar strength has been a factor which has been operating in combination with others to contribute to pressure on sterling and hence UK interest rates.

3. You may also like to suggest to President Reagan that it is not very clever of his people to ascribe the succession of

rises in the dollar to real and justified causes (as against speculation and similar market phenomena), since one day - during his Presidency - the dollar will fall and he will not want that ascribed to a well-merited verdict on the US economy.

4. I attach, by way of background, a telegram recording the G5 communique on intervention and a short factual note on what has actually been said and done since the G5.

5. We must not, of course, let up on the Administration of Congress about the Federal budget deficit. Although the recent Washington telegram (No.511, 13 February) may be right about European criticism of the US economy being regarded as whingeing, the sustainability of the world recovery and our own freedom of manoeuvre on domestic policy is threatened by historically high US interest rates and the strong dollar. The telegram sensibly suggests that you could point out to the President that on current policies he will not only leave office with the level of Federal debt at record levels, but with the US economy actually in hock to the rest of the world. It is a time when painful decisions must be made - it is not enough to rely on high growth rates to eliminate the deficit problem. They won't.

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18 February 1985

WASHINGTON STATEMENT: SUBSEQUENT DEVELOPMENTS

The Washington Agreement was reached at a time of considerable dollar strength.

2. Following the Agreement markets initially took a cautious attitude which helped to restrain further surges in the dollar. Sterling was significantly insulated thereafter by the second interest rate increase on 28 January. In the last few days the dollar has moved forward again to reach new record levels although the end of the week has seen some profit taking and rates have currently eased. Since the agreement the $ effective rate has increased by some 2½%.

3. During this period US comments (including public comments by Volcker and Macnamar) appear to have left doubt in the market about the strength of the US commitment to the G5 Agreement. This reinforced sentiment that the Fed may not have changed its intervention policy and that concerted action had little impact. President Reagan has rationalised the dollar's strength as reflecting the moderate pace of European growth. Poehl, the President of the Bundesbank, has been reported as having reservations about the effectiveness of intervention.

4. The US have interpreted the G5 Agreement as very much a reaffirmation of Williamsburg rather than breaking any new policy ground. In practice they have been prepared to contemplate intervention only in the context of strong upward speculative pressure. They have been reluctant to intervene on days where there has not been earlier intervention in Europe. In general the extent of US intervention has not matched that of the Bundesbank. German intervention has been a little predictable, though markets may have been surprised that the Bundesbank has not stepped in more heavily of late.

5. The recent Basle meeting reviewed the operation of the intervention arrangements and concluded that a further effort should be made to concert it more effectively and to be tactically more imaginative. There was a disposition to give evidence of renewed determination by the authorities. Some suggestion was reported that the US Treasury felt that the most recent Fed interventions had not been adequately appreciated and followed through in Europe. Stoltenberg, the German Finance Minister, has subsequently spoken to Baker. These contacts may have contributed to the more positive statements by Baker in Washington at the weekend which referred to the Fed intervening 'more readily' in recent weeks and a 'moderation of the tone' of previous US intervention policy.