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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

THE US ECONOMY

In my minute of 14 February about the Interim Committee meeting I promised a separate note on the US economic scene. My visit to Washington provided an opportunity for discussions with Secretary Regan and a number of US officials and advisers.

2. Monetary policy appears to be in some disarray. The Fed argue that the apparent faster monetary growth towards the end of 1982 reflects institutional change and inter-mediation, while the stricter monetarists see it as expansionary and hence inflationary. I am inclined to accept a good part of the Fed argument, which implies that the change in the money/GDP relationship last year resulted in US monetary policy being tighter than intended. The difficulties of interpreting monetary conditions when the chosen indicators are subject to distortions is familiar from our own experience but, unlike us, the US authorities also have to contend with the problems caused by large budget deficits.

3. Paul Volcker recently announced higher and rebased monetary targets, but the markets must doubt if they will be maintained - despite his confirmation of the Fed's goals on defeating inflation. The credibility of monetary policy will be further strained if inflation picks up again. For the moment however the Fed will be particularly keen to avoid any significant or lasting increase in short-term interest rates.

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4. I found a markedly greater and more widespread buoyancy of opinion about short-term prospects for recovery than before Christmas, although there is a range of opinion over the precise timing and likely strength. The Fed is hopeful of lower inflation this year, in the 3-4 per cent range, with help from lower energy prices and lower labour costs. US productivity growth has been unexpectedly good - rather reminiscent of our own experience. But while the prospects for output and inflation look bright there is a risk of instability of both interest rates and the dollar if the recovery is too rapid. We will be watching for any signs of this developing.

5. Prospective budget deficits at around 6 per cent of GDP in the current fiscal year remain a major source of concern because they could damage current activity by raising real interest rates still further. This could also strengthen the exchange rate, reducing the competitiveness of exposed mature industries and reinforcing demands for increased protectionism. While all agree on the need to tackle high deficits, as yet there is no consensus on how to do so.

6. We also discussed the growing pressure on the major low inflation countries (Japan, Germany, the UK and the US) to adopt expansionary policies and pull the world out of recession. We explained that in terms of our own MTFs lower inflation, by itself, should leave room for higher growth and that it would be wrong to add artificial reflationary action. There will of course be pressure at the Summit for such action, and it will be important before Williamsbury to reduce
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expectations that the Summit will produce reflationary initiatives. To this end we need to get across the message that recovery will emerge within a framework of prudent financial policies. There will be opportunities, eg. The May OECD Ministerial meeting, to put across in advance our views on how best to secure a sustainable recovery.

7. Copies of this minute go to the Foreign and Commonwealth Secretary and Sir Robert Armstrong.

G.H.
24 February 1983