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From the Private Secretary

18 November 1988

MEETING BETWEEN THE PRIME MINISTER AND DR. GREENSPAN, CHAIRMAN OF THE FEDERAL RESERVE BOARD, AT BLAIR HOUSE, WASHINGTON DC, 16 NOVEMBER 1988

The Prime Minister had a meeting, lasting forty-five minutes with Dr. Alan Greenspan, Chairman of the Federal Reserve Board. Dr. Greenspan was accompanied by Mr. E. Truman (Federal Reserve Board). H.M. Ambassador, Washington and Mr. Frank Cassell (Minister for the Economy) were also present.

After touching briefly on the latest US trade figures (released that morning), the Prime Minister asked Dr. Greenspan for his view on the current state of the financial markets which, she said, seemed to be intent on trying to talk the dollar down, and generating a follow-up to Black Monday. Dr. Greenspan said that market people hated inactivity; they were intent on encouraging activity, irrespective of its direction. With sophisticated telecommunication systems, any news or statement made anywhere in the world could be in the market within seconds. This created problems for those wanting to keep markets calm. It was no longer enough for policy makers to make appropriate adjustments in their instruments (interest rates, intervention etc), they had also to devise a means of saying something that would be soothing to the market but would not be seen as intended simply to do that.

Asked how he saw prospects for the American economy, Dr. Greenspan replied that it was doing very well: investment, consumption and exports were all growing strongly. It was difficult to find any real elements of weakness. As in the United Kingdom, the problem was that the recent growth of the economy was too good for the total capacity of the system. The authorities were therefore trying to restrain growth, and thereby to prolong it. This was a difficult exercise. Marginal changes in interest rates would have only very modest effects on expenditure. There was no firm evidence that inflation was accelerating but there were pressures against capacity, and a risk that this could lead to an acceleration in wages and prices. If it did, it would endanger the money supply suppression that the Fed had achieved that year. The

Fed was intent on maintaining a degree of pressure in the markets that was just ahead of expectations.

Dr. Greenspan continued that the low level of saving in the American economy worried him. The Prime Minister said that in an international context there was a difficult cultural problem. The Japanese and the Germans expected not to buy, because they preferred to save; but they expected everybody else to buy. Dr. Greenspan said that he saw signs that Japanese saving might be beginning to crumble. However, the Japanese economy was growing rather rapidly - and at capacity: in these circumstances, he did not see great scope for getting the Japanese to spend more.

He attached great importance to getting the US budget deficit down. This would lead to "much lower" real interest rates, which in turn should bring higher capital expenditure. Looking back to the early 1980s, it was clear that real interest rates had risen sharply as the budget deficit had opened out, and that these real interest rates in turn had led to a fall in net investment as a share of GNP.

The Prime Minister asked whether he expected a reduction in the US budget deficit to be reflected in an improvement in the trade deficit (recalling that Britain had now moved into large budget surplus while the current account had gone sharply into the red). Dr. Greenspan said that the linkage was not simple. The pattern in the 1980s had been that the higher real interest rates had pulled the dollar higher and worsened America's international competitiveness. But it did not follow that that sequence would work in reverse if the budget deficit were cut. The economy was now at or near full capacity. Higher investment would, in time, enable domestic output to be substituted for imports and also help competitiveness. And what happened to the exchange rate would depend on whether the confidence generated by the reduction in the budget deficit led to an increase in foreigners' propensity to hold dollars.

It was crucial to increase total saving. He had come to the conclusion that the only way of doing this in the US economy was by improving the fiscal balance. He did not believe that lower real interest rates would discourage private saving (the US evidence suggested that saving was not very responsive to interest rates).

Cutting the budget deficit would help to prevent any reacceleration of inflation. In a brief discussion of recent UK experience, it was noted the differences between the UK and US economies lay not only in their fiscal stance but also in the structure of their labour markets: so far the high demand pressures in the US had not fed into pay settlements.

The Prime Minister explained UK experience in getting the budget into surplus and the resultant need to buy back gilt-edged. This had far-reaching implications for the pattern of domestic capital flows. Pension funds had become used to investing a high proportion of their incoming funds

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each year in gilt-edged. Now the stock of gilts was falling. In time, this should lead to a revival of the corporate bond market. Dr. Greenspan commented that he was very suspicious of any argument that said it was necessary to continue to supply a certain amount of a particular debt instrument in order to meet the needs of particular investors. By removing an instrument that was no longer needed you were forcing an efficiency process in the market. It was clear that the US was now seeing excessive amounts of debt. Treasury issues had increased rapidly in recent years: the amount outstanding implied a degree of potential liquidity that could become very difficult to handle.

For all these reasons it was important to get the budget deficit down. He knew of no adverse consequence of lowering the deficit, or of lowering it too quickly. There was a potential backlog of capital investment that could offset any fiscal drag arising from the reduction in the deficit. The problem was not economic but political. He thought that there was a resonably good chance with a new Congress in place (or even before that) that some significant progress might be made towards the longer-term solution of the budget problem. The Fed could hold the fort for a while, but it could only operate on the edges. Without a rebalancing of supply and demand in the economy there was a very serious problem.

The Prime Minister then raised the question of the savings and loan institutions. Dr. Greenspan said that this was extremely serious and would have to be tackled urgently. 100 per cent protection for depositors meant that there was no run on these institutions; in that sense the problem was not a financial one. It could quickly become a fiscal problem because the bailing out of the unsolvent thrifts would far exceed the resources of the regulatory bodies. The Prime Minister remarked that if you saved people from the consequences of irresponsibility they will be irresponsible.

Concluding the meeting, the Prime Minister complimented Dr. Greenspan on his handling of the financial markets after Black Monday. He replied that it had certainly been right immediately to put new liquidity into the markets, but he had taken the first opportunity to withdraw it again.

I am copying this letter to Stephen Wall (Foreign and Commonwealth Office) and to Trevor Woolley (Cabinet Office).

C. D. POWELL

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H.M. Treasury.