

010
In Cabinet folder

CONFIDENTIAL

Prime Minister



Relevant to Public
Expenditure Cabinet.

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

MU 14/7

PRIME MINISTER

THE INTERNATIONAL ECONOMIC SCENE AND OUR OWN POLICIES

In view of their implications for our own policies, it may be useful to bring to your attention some recent impressions of the international economic scene.

2. There were opportunities in Washington and Paris last week to hear the latest US views on interest rates. In Washington there were Versailles follow-up discussions, which Ken Couzens attended, on the proposed study of exchange rate intervention; and on the Group of Five consultations about convergence of policies in the interests of greater exchange rate stability, which Larosiere is to attend. (There will be meetings of Finance Ministers in Toronto on these subjects during the IMF Annual Meeting in September, but it would be wrong to expect rapid developments.) There were also OECD discussions last week on US interest rates, on international financing through the banking system and on prospects for recovery in the light of the recent OECD half-yearly forecast.

3. Perhaps the most authoritative view on US interest rates was that of Henry Wallich of the Federal Reserve. He told Ken Couzens that he expected rates to decline gently over the next year or so because of falling inflation but could not exclude "blips" around this trend. However US officials generally remained puzzled about the high level of real US interest rates and, because of the constitutional relationships and the aspects of the Budget which the Administration have excluded from change, gave an impression of

CONFIDENTIAL



powerlessness and uncertainty. In addition to concern about financing the Budget deficit now forecast, US interest rates clearly contain a premium for uncertainty: about budget overruns, about risks of corporate failures, about the true prospect for inflation. Confidence is lacking.

4. I found in Brussels on Monday that Community Finance Ministers shared many of these impressions of the US scene. They, like me, are concerned to secure what independence we can from US interest rates. The German view, which is clearly the most important, is that some independence is possible, but within limits. That is our own experience.

5. This situation suggests an unfavourable international economic climate with a slow OECD recovery attended by an unusual degree of risk. Against this background I am sure we are right to continue our policy of gradual reduction of interest rates as the situation permits, and yesterday's $\frac{1}{2}$ per cent reduction in base rates is a move in the right direction. But we cannot risk a break in confidence which could rapidly oblige us to reverse the interest rate gains we have made and the negative differential against US rates we now enjoy.

6. That is why it is particularly important to avoid the wrong outcome on public expenditure this year. If, against a very uncertain international background, the announcement - or even rumours - of big public expenditure increases were to undermine market confidence, that could prove very damaging to interest rates and so to the prospects of growth.

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

A handwritten signature in black ink, appearing to be 'G.H.' with a flourish.

G.H.

July 1982