MEMORANDUM OF CONVERSATION

DATE AND TIME: Thursday, February 14, 1985

LOCATION: Dr. Mulford's Office

PARTICIPANTS:

Barclays Bank: Sir Timothy Bevan, Chairman
Mr. Brian Pearse, Chief Executive for North America

Treasury: Assistant Secretary Mulford
James E. Ammerman
Douglas C. Kruse

SUBJECTS: Sterling/dollar exchange rate, OECD structural adjustment exercise, LDC debt situation

DISTRIBUTION: Dr. Mulford, Messrs. Dallara, DeFalco, Escoube, Fauver, Newman and Springborn; Ms. Walsh

Mr. BEVAN began by asking how the United States viewed the weakness of sterling against the dollar. Dr. MULFORD responded that the exchange markets were reflecting the strong performance of the United States economy and that a key factor in making European currencies stronger would be for Europe to adopt policies fostering stable prices and sustainable growth. It was generally recognized that intervention would not be successful in changing exchange rate levels. As far as the deficit was concerned, the Administration was committed to reducing the growth of government spending. A modest beginning had been made last year, despite the upcoming elections, and much greater improvement should be possible in 1985.

Mr. BEVAN felt that sterling was undervalued at $1.10, just as he had felt that $2.40 was unrealistic, and Mr. PEARSE added that present exchange rate levels did not reflect purchasing power. Mr. BEVAN characterized the feeling in the British banking community as one of helplessness. Interest rates had little effect on sterling, and while intervention could smooth the edges, it could not influence sterling's performance in the exchange market. Dr. MULFORD added that raising interest rate levels had negative effects on economic growth. Mr. BEVAN agreed but felt that the political impact could be offset by a cut in rates at budget time. Perhaps the problem with sterling was that the government, confident in its secure majority, had not done a good job selling its economic policies. When the "Wets" had pressed for some relaxation, this had been interpreted in some quarters as possibly signalling a weakening in the government's resolve. The rise in interest rates was thus important not in and of itself but as a demonstration of the government's commitment to restraining money supply growth and inflation.

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Dr. MULFORD noted there seemed to be an assumption in Britain, especially in the newspapers, that there was a trade-off between stable prices and strong economic growth. On the contrary, by making the appropriate structural changes, improvements on both fronts were possible. In the United States, some 7 million jobs had been created during the Reagan Administration while in Europe 1.8 million had been lost. Structural rigidities in European economies were one of the main factors. Unemployment compensation was higher and generally lasted longer than in the United States. In England, labor mobility was further impeded by such practices as the council house system.

Mr. BEVAN agreed that British firms tended to pay overtime or upgrade equipment rather than hire new workers, but he felt that the collapse of the miners' strike, which he expected in a matter of weeks, had changed the environment in Britain. Eliminating or reducing benefits was difficult, but perhaps now the political will existed.

Dr. MULFORD rejoined that eliminating structural rigidities, while perhaps painful in the short-term, was in the best interests of the European countries. The European Coal and Steel Community and the European Investment Bank had borrowed vast amounts of money to try to preserve declining industries for social reasons. The attempt had been doomed to failure because it defied economic reality, and the result had been to postpone and aggravate the problem. In the United States, we had allowed the necessary adjustment to take place. The U.S. steel industry now employed less than a quarter of a million people, while more than a million worked in the electronics field. Most of the growth in employment over the past decade had come in firms employing less than twenty people.

Mr. BEVAN pointed out that such changes, while desirable, could be painful in the short term. With elections now looming on the horizon, the government might be reluctant to act. Dr. MULFORD emphasized that structural adjustment was in Europe's own best interests. A growing European economy with stable prices would have favorable repercussions on foreign economies, but the main benefits would be higher standards of living for Europeans. The United States was urging such change primarily because we wanted Europe to enjoy the economic improvements, just as we were trying to reduce the budget deficit mainly because of the threat it posed to the U.S. economy.

Dr. MULFORD asked about the outlook for the LDC debt situation. Mr. BEVAN responded that it was now a problem, not a crisis. There had been some disappointing news recently, especially about Brazil, but it might not be a bad thing to show that countries not pursuing appropriate adjustment policies did not receive the same favorable terms as, for example, Mexico. Of

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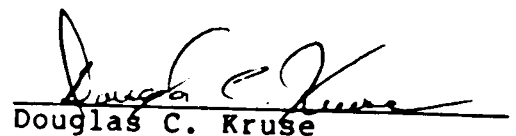
course the major debtors were still vulnerable to changes in OECD demand, oil prices, interest rates, and (with growing currency diversification in their loans) exchange rates. Some were trying to protect themselves by holding reserves in a mix of currencies, but this could not offset the potential risk.

Dr. MULFORD asked about the changes that had taken place in the foreign exchange markets: ten years ago, buying or selling $10 million was enough to move the markets; now transactions of $100 million were handled routinely. Mr. BEVAN said it was his impression that professional trading, i.e. position-taking by dealers, had become the most important factor. Commercial trading reflecting trade and investment flows had not grown as rapidly as the market. The size of inflows and outflows associated with portfolio investment, in particular, was greatly exaggerated. Most British institutional investors, for example, were near their limit in foreign currency investments, and they were simply not active buyers or sellers of sterling.

As a matter of policy, Barclays did not take positions in the foreign exchange markets, but many of its competitors did. Even at Barclays, though, Mr. BEVAN believed that dealers took sizeable intra-day positions. The result was that the market had almost become a pool reflecting dealers' views on how rates would move. Although this was not a dangerous business practice per se because the banks had developed elaborate internal controls, it was unhealthy for the foreign exchange markets. Interest rates no longer necessarily had much effect on rates, as the recent British experience had shown, and the resources available to central banks were not sufficient to enable them to be a major influence on the markets. Dr. MULFORD wondered what steps could be taken to remedy this situation. Mr. BEVAN responded that he had diagnosed the problem but could propose no cure.

February 15, 1985



Douglas C. Kruse

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