Part. A.

CONFIDENTIAL

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Begins: 4/2/82
Ends: 11/5/82.

PO -CH /GH/0065

PART A

~~Talks with~~

Chancellor's (Howe) Papers:

TALKS WITH UNITED STATES OF AMERICA FINANCE MINISTER REGAN ON THE BRITISH AND AMERICAN ECONOMIES

Disposal Directions: 25 Years

D Anderson
25/7/95.

PO -CH /GH/0065
PART A

CONFIDENTIAL

U.S. file

cc CST
FST
EST
MST(C)
MST(L)
Sir D Wass
Sir K. Couzens
Mr Middleton
Mr Burns
Mr Littler
Mr Lavelle
Mr Bottrill
Mrs Gilmore
Mr Peretz
Mr Ridley

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

4 February 1982

The Honorable Donald T. Regan,
Secretary of the US Treasury,
WASHINGTON

Dear Don

Thank you for your message of 26 January about the President's State of the Union Address. I was very interested to read both the full text of the Address and an excerpt from your testimony to the Joint Economic Committee of Congress on 27 January, and I look forward to seeing next week your detailed budget proposals.

I am grateful to you for noting my concern about your Budget deficit and its impact. It has occurred to me that it might be useful if I were to set out my position fairly fully. In spite of G5 meetings we do not for long spells get an opportunity to talk these things out in any detailed way, although you and we are pursuing broadly analogous policies with very similar objectives.

You know that the United Kingdom Government supports fully the President's efforts, and yours, to reduce inflation, public expenditure and the size of the public sector; to improve national productivity; to reward savings and encourage investment; and to exercise firm control over monetary growth. Our policies are in many respects parallel to yours. We greatly wish your policies to succeed: indeed we believe that success is essential to the strength of the free economies.

As I see it, to win the fight against inflation one requires a firm monetary stance supported by an adequate control of the Budget deficit. If fiscal policy does not adequately underpin monetary policy, one of two outcomes can occur. The first is that one may be compelled, because interest rates became intolerable, to slacken monetary policy to match budgetary policy. The second is that interest rates remain very high.

The first would have far reaching consequences for the health of the dollar, and is certainly not an outcome which your friends on this side of the Atlantic would wish to see. But the second would have a very severe impact on interest rates and exchange rates over here: that in turn would produce resentment and strains in the Alliance. Either way the free world would suffer.

/I welcome

I welcome the President's efforts to reduce the estimated Budget deficits for future years. I know, however, that you must be disappointed - as I am - that this year's deficit is likely to be so much larger than your original target, and that the prospects for reducing the deficits in later years now appear less good.

I know that a number of arguments can be advanced to support the proposition that even a rising pattern of deficits can be consistent with success against inflation and lower interest rates. The first is that this year's increased deficit is mainly the product of recession and that in a recession some increase should be tolerated. In 1980-81 our own public borrowing requirement exceeded our target for similar reasons. There is force in the point, provided that the downward trend really is convincingly resumed thereafter. We took action to bring this about in 1981-82, and have achieved it.

A second argument is that excessive preoccupation with Budget deficits is a European phenomenon which does not fit US circumstances, where the federal deficit is a more modest proportion of GDP and the private bond market plays a much larger role. But off-Budget borrowing on public credit ought, I would think, to be added to federal deficits when making comparisons, e.g. with our UK PSBR. More important still, the US savings ratio is well under half that in the UK and other West European countries. I know that you hope to increase savings through your income tax relief programme. But it may be optimistic to rely on much sustained increased in savings from tax reliefs which are modest in real terms.

A third argument is that resumed growth will reduce the deficit, and it may. I see you gave Congress an example of the impact of growth at 4 to 5 per cent. The US economy has certainly achieved growth at that rate at times in the 1970s. But in the 1970s that rate of growth, when long sustained, seems to have been associated with quite a lot of inflation. We worry about the impact on interest rates of a sharp revival of demand for private credit, linked with a rising deficit.

A fourth argument is that the deficit doesn't matter if the money supply is controlled. But it is a good deal more difficult to control money in the face of a rising deficit. We are back to the size of the deficit relative to the pool of savings, and to the competition of private (and international) credit demands as the economy recovers.

I see that general government borrowing accounted for about 30 per cent of the total demand for credit in the United States in both 1980 and 1981, and is likely to account for at least the same proportion in 1982. I believe that this is similar to the Carter Administration's credit demands in the period 1975-77, but as I recall these were accompanied by a strong rise in private credit at the same time. These demands were only accommodated with a sharp upsurge in the monetary aggregates - with inflationary consequences later.

/Policy here,

Policy here, in West Germany, and elsewhere in Europe has been directed to reducing or at least stabilising budget deficits. This has involved sacrifices in the interests of reducing inflation and achieving a better balance in the economy. In our case, and probably in others, I believe the basis of a sound recovery has been laid. That recovery could however be retarded by a renewed rise in interest rates or a resurgence of inflation. The course of your policies and of the US economy is of the greatest importance for both.

Hence my concern, widely shared in Europe, that you should succeed in establishing a downward trend in the US deficit, and in convincing the markets that your counter-inflation policy will bring success. I know it is part of your philosophy, as it is of ours, that markets cannot lightly be disregarded and are critically important indicators, including indicators of inflationary expectations. When they are convinced, I am sure we may all look for relief on interest rates. I very much hope that your forthcoming Budget will be an important step in that direction.

Knowing you as I do, I am sure that you will not take this unsolicited advice amiss. I appreciate only too well the difficulties you face in administering a courageous policy, and I recognise that the post-war history of the British economy is not a particularly good advertisement for the quality of advice from London. I also fully understand - because I share them - the problems created by the burden imposed by a major defence effort. I have warmly welcomed the progress you have made, as we have, in reducing inflation. I write - I hope without presumption - as a friend, but also because your policies have so much more impact on us than ours can ever have on you.

As you say, let's continue to keep in touch.

With every good wish

Yours

Geoffrey

GEOFFREY HOWE

215/3

Mr Gatarde US file.

THE SECRETARY OF THE TREASURY

WASHINGTON

March 8, 1982

Mr Lavelle
CST, FST, EST,
Sir D Wass,
Sir K Couzens
Sir A Rawlinson
Mr Byatt
Mr Ryrie
Sir Littler
Mr Middleton
Mr R Allen
Mr Peretz
Mr Bottrill
Mr Kroll

Dear Sir Geoffrey:

Thank you for your thoughtful letter sharing your views on U.S. fiscal policy. I appreciate both your concern and your candor, and I read your comments in the spirit in which they were offered.

In the process of preparing our proposed budget for Fiscal Year 1983, we considered a number of possible approaches for bringing the budget deficit down more rapidly. The budget proposal we produced on February 6 embodies a number of strong, politically-difficult measures designed to put the deficit on a declining trend.

But when all was said and done, we simply saw no good economic reason to abandon the President's program for economic recovery. It was decided that higher taxes were likely to snuff out the recovery. We are succeeding in getting inflation under control; now we will push ahead with the rest of our agenda. We are all too well aware of the difficult transition problems inherent in returning to a healthy long-run growth path after decades of economic mismanagement. But the job must be done, and will be done.

? I take a more optimistic view of near-term economic prospects than you do. Interest rates appear to have resumed the downward course of last fall. Measures of inflation have been slowing markedly, and this should be reflected in future reductions in interest rates. Additionally, the uncertainty premium, which has been keeping real interest rates at extraordinary levels, should narrow as both the Administration and the Federal Reserve continue to demonstrate their resolve in pursuit of a policy of monetary restraint. We have attempted to make a careful assessment of the flows of saving which will be available to the economy over the next several years. We believe these flows will be sufficient to finance needed improvements in the nation's stock of productive capital as well as Federal borrowing needs.

Your suggestion that we see more of one another is a good one. The next time we are both in the same city, let's make an effort to get away for a private chat.

With best wishes.

Sincerely,

Don

Donald T. Regan

The Right Honorable
Sir Geoffrey Howe
Chancellor of the Exchequer
London

P.S Looking forward to seeing you in Paris and Helsinki - if not sooner

DTR

JU164

7/4/82. C

EXCHEQUER
-7 APR 1982
Mr Lavelle
Sir K Couzens
Mr Littler

CONFIDENTIAL

PRIME MINISTER

US VISIT - MARCH 22 - APRIL 2, 1982

This 10-day visit was primarily to promote inward investment by US companies. I also took the opportunity to have a day in Washington when I met members of the Administration, and of Congress, the Chairman of the Council of Economic Advisers and members of the Federal Communications Commission. As well as Washington, the tour covered the New York area, Pittsburgh, Boston and the San Francisco Bay area. I visited 14 companies, had 8 speaking engagements and had 6 sessions with the media, including an interview on CBS radio which was carried coast-to-coast.

Our Economy

2 I found a good awareness of the improvement in our economic prospects; this was particularly strong among firms with successful UK subsidiaries. Many of those with whom I spoke contrasted, a little ruefully, the success of the British Government in bringing the UK budget deficit under control with the difficulties currently being experienced by the Administration in Washington. There was a particular welcome for the improvements in industrial productivity in Britain, for our improving industrial relations record and for our increasing competitiveness. A number of the firms approached are contemplating new investment in Britain or expanding existing operations.

The Washington Scene

The US Economy

3 My main purpose was to form a view of the likely development of the budgetary impasse between the White House and Congress.

No clear view emerged except that the uncertainty is likely to persist for some little while.

4 Discussions with the Secretary for Commerce (Mr Baldrige) and with the Deputy Special Trade Representative (Mr David Macdonald) showed that the Administration wanted to play down the difficulties. It was suggested that it did not matter too much if Congress took some time to become reconciled to the President's budget proposals, and that anxieties about the Administration's projected budget deficit were misplaced. "I think the Treasury's forecasts are exaggerated and that there is not too much to worry about", said one. On this view, interest rates would tend to fall over the next few months and, hopefully, would not rise in the autumn.

5 In Congress, I met Henry Reuss (Dem) and John Dingell (Dem) who expressed a very different view. They were deeply worried about high interest rates and the prospect that rates could go still higher. They believed that the Administration would have to modify its budget proposals and they also believed that Congress would be prepared to agree to some expenditure cuts (e.g on entitlements) provided the President stretched out his defence programme over a longer timescale, postponed the 1983 tax cut and made other changes. It was ironic but true that a Republican President had put forward proposals involving a budget deficit of nearly $100 million for the coming year and rising in the years ahead, while Democrats in Congress were arguing for changes to reduce the prospective deficits.

6 I discussed this whole question with bankers, industrialists and others during my tour. They were much closer to the views expressed by the Congressmen, and were unanimous that deficits had to be reduced so that interest rates could be brought down and stay down. I found very few who were optimistic that this in fact would happen. The general thrust of the views given to me were that interest rates would come down in the short term, but

would rise towards the end of the calendar year. This was, for instance, the view expressed by senior managers at Manufacturers Hanover, by the Chairman and board members of the First National Bank of Boston and by the Chief Economist of the Bank of America.

7 In all these discussions, I made it clear that rising American interest rates towards the end of 1982 would be very bad news indeed for Europe in general and Britain in particular.

The Buckley Mission

8 I discussed the Buckley Mission briefly with Mr Baldrige. He was at great pains to emphasise that the purpose of the Mission had been widely misunderstood in Europe and that it was aimed primarily at securing agreement on reducing or ending concessionary credit to the Soviet Union and other Comecon countries. I suggested that many European governments had seen the Mission as a further attempt by the US Administration to secure support for its measures of 29 December. Mr Baldrige admitted that Mr Buckley had had to explain his precise purpose to each government he saw. Mr Baldrige went on to say that he fully understood the reluctance of European governments to contemplate the abrogation of outstanding commercial contracts. It had not been the purpose of the Buckley Mission to secure this outcome. (I understand that there has since been a telegram from Washington spelling out this point.)

Steel

9 I discussed the steel anti-dumping cases with Mr Baldrige and Mr Macdonald. While sympathetic to the British case, they saw no option but for the suits to run their course at least for the time being. Both spoke highly of the responsibility shown by BSC and of the case which had been made by Ian MacGregor, but they could not prevail on the US industry to narrow their sights on the real culprits. Both, however, believed that later on this

year the way might be open to some kind of settlement.

Protectionism

10 In response to my anxieties that America might be going down a protectionist road, both members of the Administration made it clear that they were aiming primarily at Japan. Although they talk about "reciprocity", they mean reciprocity with Japan. They appeared to welcome the Community's Article XXIII application but agreed with me that it would be a long hard battle to make any real impact on Japan's imports.

Telecommunications

11 A good discussion was held with the Federal Communications Commission (FCC) on liberalisation, broadband cable, satellites, regulatory mechanisms etc. Two points of interest: first, Congress is attempting to legislate to bring the regulatory agencies under congressional control. Clearly, their free-standing, non-political role has become an embarrassement. Second, the FCC saw Britain as having a unique opportunity to advance cable TV etc., and telecommunications in parallel and perhaps in an integrated way that had not been open to the United States. We agreed that there should be closer official contacts between my Department and the Commission.

The Rest of the Talk

i) US Investment in Britain

12 Although most of the firms contacted acknowledged the improvements taking place in our economy, there were still anxieties about UK industrial relations, about the delays in getting projects off the ground, about public sector strikes and so on. The baggage handlers strike at Heathrow had obviously disrupted one or two key visits to Britain and may actually have lost us one particular investment project which in the event has gone to Holland.

13 For high technology, high growth companies, the UK is seen as a good location for US subsidiaries - for example the recent decision by Hewlett Packard to make a major new investment in Bristol. On the other hand, the point was strongly made to me that it remains difficult for us to develop our own home grown high technology, high growth companies from scratch, because, despite the improvements that have been made, we do not give enough encouragement to venture capital and we do not offer an attractive regime for stock options. I will be discussing with the Chancellor of the Exchequer what further changes we need to make if we are really to emulate the Silicon Valley phenomenon in this country.

14 On all these company visits I was accompanied by the relevant Consul-General or by a member of their staffs. It is obvious that they have built up admirable relationships with many of the firms in their areas. They did, however, stress very strongly the desirability of the best possible co-ordination between the various UK agencies engaged in promoting inward investment.

ii) Industry and Education

15 My programme included visits to the Massachusetts Institute of Technology and Stanford University. I was briefed by senior academics on the admirable relationships those institutions have established with industry in their areas and was able to recognise how enormously important a strong technological university can be in promoting faster industrial growth in its locality. Though we have made a start on this in Britain, we have a long way to go; and even in the USA, the number of institutions which have successfully emulated MIT and Stanford is evidently quite small.

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Conclusion

16 I would like to thank the Foreign and Commonwealth Office and our Posts in the United States for arranging programmes which were full of interest and value. I was particularly impressed with the calibre of the guest lists for dinner parties arranged by the Ambassador in Washington and the Consuls-General in New York and San Francisco. I warmly appreciate the trouble that was taken to make my tour really worthwhile, and I hope that Francis Pym will pass this on to the Posts concerned.

17 I am copying this minute to Geoffrey Howe, Francis Pym, Keith Joseph, Jim Prior, George Younger, Nicholas Edwards, Peter Rees, and to Mr John Sparrow.

P.J.

P J

7 April 1982

Department of Industry
Ashdown House
123 Victoria Street

CONFIDENTIAL

pmp

cc: PS/Chief Secretary
Mr. Ryrie
Mr. Burns
Mr. Quinlan
Mr. Dixon
Mr. Lovell

without attachement
Sir Kenneth Couzens
Mr. Lavelle
Mr. Littler

PS/MR. WAKEHAM

SECRETARY OF STATE FOR INDUSTRY'S VISIT TO THE UNITED STATES

The Chancellor has seen the Secretary of State for Industry's minute to the Prime Minister of 7 April.. (Copies attached to those who not already received it.)

2. The Chancellor was particularly in Mr. Jenkin's point in paragraph 13 about the difficulty in developing "own our home grown high technology, high growth companies from stratch". He notes that Mr. Jenkin proposes to discuss this with him in due course.

3. The Chancellor would be most grateful if your Minister could consider the implications of Mr. Jenkin's point and how we should react to it.

JKR

JILL RUTTER
8 April 1982

JU164

CONFIDENTIAL

EXCHEQUER
-7 APR 1982
Mr Lavelle
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PJ

P J

7 April 1982

Department of Industry
Ashdown House
123 Victoria Street

EXTRACT FROM

FINANCIAL TIMES

DATE 16-4-82

PAGE 1

Reference A/1

Regan says budget compromise needed to end 'steep recession'

BY ANATOLE KALETSKY IN WASHINGTON

MR DONALD REGAN, the U.S. Treasury Secretary, yesterday pronounced the U.S. economy "dead in the water" as the Federal Reserve Board published another set of gloomy economic statistics.

He implied that the Administration and Congress will have to agree to curb expected federal deficits to get the economy moving again.

The economy is "in very steep recession" and is "not going anywhere—it's not going down much; it's not going up any; it's just dead," Mr Regan said on ABC Television just before the publication of industrial production figures for March. These showed a 0.8 per cent decline.

This was the seventh fall in the past eight months, and leaves current production 8.3 per cent below the level of last July.

Yesterday's figures showed that the production increase recorded in February was a statistical freak. The February increase, originally estimated as 1.6 per cent, has now been revised to 1.2 per cent and Administration economists concede that it was a largely meaningless blip, due almost entirely to recovery after the unprecedented cold weather experienced in much of the country in January.

Mr Regan conceded that the long-awaited economic upturn, which he had earlier characterised as the economy "roaring back" in the spring, would begin only late this summer.

Even this would depend on a compromise between the Congress and President Reagan over the 1983 Budget to reduce the expected deficit of \$102bn (£58bn) Mr Regan implied.

"High interest rates have brought this economy to its knees," he said on television. "To get it going we have to let business know we are cutting deficits. That will be the signal business wants."

Asked if the Administration still believed that the economy would recover by the late summer, he replied that it did, "if we get this compromise (on the Budget) and get these deficits down."

The Administration's official view, forcefully put by Mr Regan since the beginning of the controversy over the 1983 Budget, had been that the size of the projected budget deficit was compatible with an economic recovery this summer.

But yesterday he conceded that this recovery would be at best short-lived unless interest rates could be reduced.

The key question exercising the Administration is whether such a reduction in interest rates can be achieved on the basis of President Reagan's Budget. Mr Regan's statements yesterday may suggest that he is beginning to accept the Wall Street view that budget deficits of more than \$100bn are incompatible with lower interest rates.

Mr Malcolm Baldrige, the U.S. Commerce Secretary, also said yesterday that an economic recovery will depend largely on interest rates, although he said that "all the tools are in place for a recovery to begin in June."

The Commerce Department's Chief Economist, Mr Robert Ortner, said that the March industrial production figures suggested that "maybe the recession is not going to end sharply like it has in the past. Maybe like an old soldier it will just fade away."

Reagan hint of budget compromise, Page 6
Editorial Comment, Page 18

THE SECRETARY OF THE TREASURY
WASHINGTON

April 22, 1982

Dear Sir Geoffrey:

Our representatives will be meeting in Paris again May 6 and 7 to consider revisions in the arrangement on guidelines for officially supported export credits. These revisions are badly needed to reduce the element of subsidy in officially supported export financing.

The adjustments in interest rates last November initiated the long overdue process of reducing and eventually eliminating export credit subsidies. Nevertheless, they represent only a first step and, indeed, offer no significant reduction, but only a rollback to the subsidy-level prevailing in 1980 when it was already recognized that there was a need to sharply reduce these subsidies.

The May meeting should make a major effort to increase interest rates toward market levels, making allowance for those special cases with low market rates of interest. At a time when we are all struggling with the problem of budget deficits, it is inappropriate to continue costly export credit subsidies. They are a major drain on the budgets of many countries and their advantages are doubtful since they are usually matched by foreign competition.

In addition to increasing the interest rate, we should also seek to rationalize the classification of borrowing countries under the arrangement. The United States has long favored a unitary rate structure in the belief that export credits are a trade promotion measure, not an aid mechanism. We should agree to reclassify borrowing countries so that their status under the arrangement better reflects their economic situation. It is most unfortunate that the OECD countries continue to provide subsidized export financing even where it is inappropriate, such as among arrangement participants and to the USSR, a major industrial and military power.

I hope that I can count on your support on this extremely important matter.

Sincerely,

Donald T. Regan

Rt. Hon. Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
H M Treasury
Parliament Street
London SW1P 3AG

FROM: A C S ALLAN pup
DATE: 27 April 1982

1. MR LOVELL
2. MINISTER OF STATE (REVENUE)

cc Chancellor —
Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (c)
Mr Ryrie Mr Quinlan
Mr Middleton
Mr P Dixon
Mr D Moore
Mr Chivers
Mr Gordon
Mr Robson
Mr Andren
Mr F Martin
Mr Potter
PS/Inland Revenue

SECRETARY OF STATE FOR INDUSTRY'S VISIT TO THE US

The Chancellor asked you to consider the implications of Mr Jenkin's comments about the difficulties of developing "our own home grown high technology, high growth companies from scratch." This comment was made in his minute to the Prime Minister on 7 April about his trip to the US on March 22 to April 2.

2. Mr Jenkin has since written to the Chancellor on 16 April about one specific point on taxation of share options. The Inland Revenue will be providing advice on this. Mr Jenkin also indicates he will be writing separately about "improvements which I see as necessary if we are to tap the potential sources of venture capital on the scale needed to generate the kind of format of innovation which we seek." It seems likely that this will primarily cover tax points too.

3. There may, however, also be some points on the expenditure side which will emerge. You may be interested to see the attached note which Mr Quinlan put to the Chancellor on 18 February. This note doubted whether there was an across-the-board problem which might be susceptible to any new general measures by Government, but wondered whether there might be a specific problem for high-risk investment in innovative activities where some action by Government might help. This is something which we are pursuing informally with DOI and the Bank of England, though we are not convinced that the scope for action is at all large.

4. More generally, the Budget package of extra expenditure on innovation will have provided some small boost. One of the measures to be taken by DOI is to raise grant rates for most R&D schemes from 25% to 33½% for a limited period; this in itself reduces the risk and the financing cost of investing in innovation.

5. The development of public purchasing policy aimed at "public purchasing policy aimed at "pulling through" new British products and processes should also help in this direction. The Government has welcomed the general thesis of the ACARD report on R&D for publich purchasing, that the private sector should undertake a greater share of the R&D which supports public purchasing. This should lead to greater attention being given to the needs of export markets when new products and services are being developed for the public sector, and should improve the private sector's technological capacity.

6. You may like to know that the Treasury's Policy Coordinating Committee, chaired by Sir Douglas Wass, will be discussing Government support for innovation at a meeting early next month. In the light of that discussion we shall be considering whether there are any further points or proposals we should put to Ministers.

for A C S ALLAN

M/2

CONFIDENTIAL

From: M E QUINLAN
18 February 1982

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (C)
Minister of State (L)
Sir Douglas Wass
Mr Burns
Mr Ryrie
Mr Middleton
Mr Byatt
Mr Battishill
Mr Britton
Mr Christie
Mr Kemp
Mr Lovell
Mr Monck
Mr Chivers
Mr Gordon
Mr Robson
Mr Turnbull
Mr Andren
Mr Seebohm
Mr Isaac (IR)

FINANCE FOR PRIVATE-SECTOR INDUSTRIAL INVESTMENT

Alongside our consideration of the particular proposals by Mr Grylls, on which Mr Middleton's minute to you of 14 December last gave our conclusions, we have been doing some work on the reality and nature of the underlying issue which the Grylls Group was seeking to address. I attach a short note giving the outcome.

2. As you will see, the note is sceptical of whether there is an across-the-board problem of a type susceptible (within macro-economic policy) to non-selective aid in the sort of way the Grylls ideas envisage; the most important aid to sound investment will be to improve the general condition of the economy.

3. You will however see that two particular points are noted as worth further thought. The first (paragraphs 12 and 14(a)) is the possibility of fostering - preferably by explanation rather than any new intervention technique - the wider use of index-linked borrowing; this chimes with a possible line of enquiry identified by the Financial Secretary's meeting last might. The second (paragraphs 13 and 14(b)) relates to the possible use of a partial-guarantee concept to encourage innovatory investment by small to medium sized firms. We

cannot yet conclude with certainty that action on such lines would fill any significant real gap in current arrangements, and I see no way in which we could prudently regard it as a candidate for very early action. But if you find it interesting, we would explore matters further on a non-committal basis with the Department of Industry and the Bank of England.

MEQ.

M E QUINLAN

WALL STREET JOURNAL

3 May 1982

U.S. Suggests Panel Of Trade Partners On Economic Policy

By a WALL STREET JOURNAL *Staff Reporter*

WASHINGTON—The Reagan administration is proposing that the U.S. and its major trading partners set up a new high-level international panel to help coordinate economic policies.

The plan, a response to European complaints that the U.S. is "insensitive" to the effect of its policies on other countries, is being discussed with officials of major European powers, Japan and Canada.

U.S. officials hope to win agreement on details of the proposal during a series of meetings over the next few weeks, in time to announce the initiative publicly at a seven-nation economic summit in Versailles June 4 to 6.

The plan calls for creating a permanent working group of top government finance officials and central bankers from a handful of large countries. The panel would meet several times a year to discuss economic policies.

U.S. officials emphasized that the group wouldn't have any powers to alter individual economic policies, and said the U.S. wouldn't change its policy of refusing to intervene in world currency markets.

The proposal is being offered as a gesture to meet European complaints that the U.S. has failed to consult its trading partners sufficiently on the effect of its economic policies. Europe is particularly concerned about high interest rates in the U.S.

The U.S. also wants to head off a move by some European countries to abandon their anti-inflation policies in favor of new economic stimulus measures designed to help bring down Europe's high unemployment rates.

And Washington hopes to squelch European demands that the U.S. and Japan, whose inflation rates are relatively low, begin to spur their economies faster. Some Europeans say such measures would help pull Europe back on its feet.

The Reagan administration contends that any of these moves would only refuel worldwide inflation pressures. Europeans have complained that high U.S. interest rates are forcing them to keep their own rates high, quelling any recovery.

U.S. officials said it still isn't clear how many countries would participate in the coordinating group. The seven attending the Versailles summit are the U.S., Japan, West Germany, Britain, Canada, France and Italy.

b/f with Regan brief on Friday
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PRESIDENT REAGAN AND THE FY83 U.S. BUDGET
(MY TELNO 1530 OF 30 APRIL)

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HENDERSON

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COPIES TO.

PS/~~CHANCELLOR~~ OF ~~THE~~ EXCHEQUER
MR BOTTRILL
TREASURY

MR WATSON
BANK OF ENGLAND

COPIES SENT TO
No. 10 DOWNING STREET

(ADVANCED AS REQUESTED)

FROM: N J ILETT
DATE: 6 May 1982

FALKLANDS

UK restrictions

We have frozen Argentine assets, but our restrictions fall short of a total block on payments to Argentina. We have taken pains to minimise the impact on the international banking system, by limiting restrictions to banks inside UK jurisdiction and allowing "entrepot" (management) business with existing Argentine loans to continue.

Attitude of banks outside the UK

Argentina's apparent inability to raise new medium and long term finance in the USA or elsewhere in consequence of the crisis and the UK freeze is a powerful factor in the pressure on the junta. Argentina is pretty well isolated in the international financial markets. It is important that this pressure is maintained. The banks' prudential instincts should make forceful representations by the authorities unnecessary.

Possible Argentine default

The UK's present belief is that the problems for the international banking system that could follow an Argentine default outweigh any advantages that default might have for the immediate negotiating situation. Mr Regan can be given private assurances to this end (there is no harm in letting the Argentines sweat on this point by refraining from public comment). We would not ask the US to freeze Argentine assets (even supposing they could or would do this) because of the risk to the international financial system.

US economic sanctions (background)

The US have suspended new export credit guarantees and commodity credit corporation guarantees (main impact psychological), as well as military exports (interpreted broadly). The Prime Minister has asked President Reagan to introduce a complete ban on imports, but it appears that the US is unwilling to do this.

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1. MR LAVELLE
2. CHANCELLOR

FROM: A R H BOTTRILL
DATE: 6 May 1982

c c Mr Littler
Mr Garside

CHANCELLOR'S MEETING WITH MR DONALD REGAN, 7 MAY 1982

I attach a brief for the Chancellor's meeting with Mr Regan, together with supporting material, namely, the exchange of letters earlier this year, the Washington embassy's latest assessment of the position on the budget negotiations and a recent Press cutting on Mr Regan's own attitude. The Chancellor may also find this useful for this weekend's lunch with Mr S~~c~~hultz.

A. Bottrill

A R H BOTTRILL

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CHANCELLOR'S MEETING WITH US TREASURY SECRETARY MR DONALD REGAN, 7 MAY 1982

POINTS TO MAKE

(i) Applaud US policies aimed at reducing inflation, including strict monetary control. For the benefit of the whole free world that US should succeed in these policies. Largest free economy. Dominant role of dollar in world trade and monetary system.

(ii) Glad that US achieving major reduction in inflation. Impressive contribution from realistic pay settlements.

(iii) But still worried about balance between US fiscal and monetary policy. (Refer to letter to Regan, 4 February).

(iv) Declared US policy is to reduce, then eliminate budget deficits. Instead, they are set to rise - more than $100 billion for two years running. Result is that financial markets are not convinced about future of the policy and interest rates remain high.

(v) High US interest rates damage US industry and business. They could defeat US's own counter-inflation and recovery policies. Note that Mr Regan has said just this.

(vi) But high US interest rates also damage the rest of the world. Everybody faced with choice between letting their currency depreciate or accepting high interest rates also. US has a responsibility to rest of free world to avoid this damage.

(vii) Only way to lower interest rates is convincing improvement in prospects for deficit and evidence of determination by Administration and Congress to tackle them. Better done by reducing expenditure. But better partly by higher taxation than not at all. Must reduce interest rates.

(viii) No answer to say that $100 billion plus deficits not large in relation to US GNP (perhaps 3-4 per cent). US savings ratio much lower than in Europe or Japan. Deficits are large by US standards and above all, need is to put in place policies which convince market that the trend for budget deficits is clearly downwards, ie the equivalent of our MTFs.

BACKGROUND

The Chancellor wrote to Mr Regan on 4 February (copy attached) making most of the same points as those above. Mr Regan's reply on 8 March (also attached) said the US budget measures were designed to put the deficit on a declining path and took a relatively optimistic view of the prospects for financing the deficit and for getting lower interest rates.

2. The situation in the US economy has worsened in several ways in recent months as have the prospects for the budget deficit. The pressures on the Administration therefore have increased and doubts about its strategy have risen.

3. GDP fell by about 1 per cent in the first quarter of this year after a similar fall in the last quarter of 1981. Industrial production is about 7 per cent below its level a year ago. Unemployment is rising and is now about 9 per cent of the labour force. Retail sales are flat. The leading indicators in February fell for the tenth month running.

4. The most encouraging development has been a sharp slowdown in inflation with wholesale prices falling in February and March, and consumer prices rising at an annual rate of less than 2-3 per cent in the first three months of this year. These almost certainly understate the underlying rate of inflation which is probably closer to 5-6 per cent, but this is still a sharp improvement on the rate of about 11 per cent a year ago. There has been some hard wage bargaining with Ford and General Motors' workers accepting new contracts worth about 6½ per cent a year over the next 2½ years.

10%?

5. Interest rates fell from May to December last year but have since risen. The prime lending rate is now about 16½ per cent. The fall in inflation implies that real interest rates are now at historically very high levels - much higher than those of Europe or Japan. Consequently the dollar has appreciated 5 per cent since the end of last year despite a growing trade deficit. The current account is close to balance but may soon move into deficit unless the economy continues depressed enough to hold down imports.

6. Little, if any, recovery in output seems likely in the current quarter. The OECD, together with most outside forecasters, expects a modest recovery in the latter half of this year followed by growth of around 3 per cent next year. This is less optimistic than the Administration's own projections. The OECD sees no fall in US unemployment before the end of next year. Inflation, however, should level out at about 6 per cent. Views about the US current balance differ but Administration officials have spoken of a deficit of $20-$40 billion emerging next year, accompanied by some fall in the dollar.

Monetary Policy

7. The Federal Reserve's target growth for M1 during 1982 is 2½ to 5½ per cent though both the Administration and the Fed have said that growth should be in the upper third of the range. In the period between December and mid-April, however, growth has been around 8 per cent at an annual rate. This implies that the recent growth rate must be broadly halved for the rest of the year if the target is not to be breached. A recovery in real output, coupled with the underlying inflation rate, therefore, will imply the need for a further sharp rise in velocity with corresponding pressure on interest rates.

Fiscal Policy

8. The latest position on the negotiations between the Administration and the Congress over next year's budget is described in the attached telegram from our Washington embassy. The Administration's own latest published estimates put the likely Federal deficit for the current

year (FY 1982) and next year (FY 1983) both at slightly over $100 billion - about $10 billion higher than the February projections. These latest Administration figures, however, still use February's optimistic economic assumptions and unofficial estimates put next year's deficit as high as $180 billion if further measures are not taken.

9. Mr Regan in a now celebrated phrase described the US economy a fortnight ago as 'dead in the water', and implied that the Administration would have to cut the budget deficit to get the economy moving again. He said:

> "High interest rates have brought this economy to its knees. To get it going we have to let business know we are cutting deficits. That will be the signal business wants."
>
> (Financial Times, 16 April, attached).

10. The Democrats have tried to persuade the President to abandon the third tranche of his income tax cuts package so that they can claim credit for cutting the deficit without cuts in social security benefits. Some Senators have argued for higher indirect taxes. The President has offered instead a possible income tax surcharge and lower defence spending in return for cuts in social programmes.

11. We shall be interested to have Mr Regan's own assessment of the likely size of any compromise package and the resulting level of next year's deficit. If the unofficial estimates are anywhere near correct, then a very substantial package, of say more than $50 billion, will be needed merely to keep the deficit to $100 billion. This would still represent about 3 per cent of GDP and would be likely to present financing difficulties in view of the low US savings propensity. This is forecast to rise to perhaps around 7 per cent of personal incomes next year, but would still be only about half that in the major European economies and a third that in Japan.

EF2 Division
HM Treasury
6 May 1982

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(1) Critical appraisal of D.R. reply to my letter.

(2) Can we point, skeptically, to the continuing bad ways in which a US example on military ... can encourage / is leading other countries to act similarly to disadvantage of US ways – i.e. endure their self-interest?

FROM: R G LAVELLE

DATE: 6 May 1982

CHANCELLOR

cc: Sir D Wass
Sir K Couzens o/r
Mr Littler
Mr Carey
Mr Bottrill
Mr Peretz

(3) Is the fall in OPEC surpluses making it difficult for US (etc?) to finance their deficits?

Falklands points to get across to him?

MEETINGS WITH MR REGAN

(4) Important non-economic

You are dining with Mr Regan on Friday, 7 May and giving him breakfast at No 11 on Saturday 8 May. You will of course also both be attending the OECD Ministerial, G-5, G-10 and IMF Interim Committee meetings next week. Your meeting with the Governor tomorrow morning provides an opportunity to compare notes on the line to take in these contacts.

(5) A summary of points to make on a "prompt card"?

2. We are intending to submit briefing for the Paris and Helsinki meetings to you separately this evening. This material will speak for itself (and will not contain any surprises). In the short time available for bilateral exchanges, you will probably not wish to anticipate next week's discussions. However you might conceivably like to glance at the brief, in the Helsinki bundle, on the suggestion of a possible new initiative at Versailles on international monetary co-operation: this is a new talking point which Mr Regan might bring up. There is also a G-5 brief on Eastern European issues, which might warrant a glance. The only other point you might like to have in mind is that Mr Regan is the current G-10 Chairman. This should not be too onerous a task this time. (We have incidentally not yet seen a draft of the communiqué, but an outline has been mentioned to Deputies which sounded innocuous.)

These briefs are not yet ... need to ... back ...

3. Your discussions will have the US economy as their principal focus. There is attached a note of the line we suggest you might take here plus background factual material.

(6) Exchange controls: I need a simple set of principles to defend – and find it difficult to derive principle from D.R.'s letter of 22.iv. But how, otherwise, do they (US) compete with our jobs?

(7) Latest US Budget "deal"

(8) Group of 30 proposals

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4. There are three other topics on which briefing is also attached.

5. The first is a short note on the Falklands and US sanctions.

6. The second is unitary taxation about which you have written to Mr Regan in the past. This subject seems worth raising again with him, if only to be able to say that this has been done.

7. The third is the export credit consensus. AEF will send forward to you tomorrow a note of the line you might take following key discussions which will have been taking place in Paris in the course of that day. However since the subject is complex, it may be helpful to have the attached background briefing in advance.

8. There is one final point. In the course of the last Versailles Summit Preparatory Meeting the Americans (Mr Sprinkel) said that there had been four occasions when the US had been prepared to intervene in the foreign exchange markets - but found that they had quietened down by themselves. We understand in great confidence (and not from a Treasury source) that one of those occasions was the initial flurry in the markets after the Falklands invasion. Sterling has in fact proved remarkably robust in subsequent weeks. We should also probably not reveal knowledge of our understanding of the US position. But it might be worth saying innocently that some months ago you recall that Mr Regan said he would be prepared to receive telephone calls if colleagues looked for US help in some specific disturbance. Is this offer still open?

Too interrogative: a simple reminder shown in?

R G LAVELLE

pl. attach Mr Jenkin's minute of 7/4

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FROM : MINISTER OF STATE (R)
DATE : 6 May 1982

CHANCELLOR OF THE EXCHEQUER

Arr discussion early + action; Chancellor, PCC + [illegible]; MST(R), FST + MR etc — with a view to [illegible] early action in this year's Fin Bill, NEDC etc

cc Chief Secretary
Financial Secretary
Sir Kenneth Couzens
Mr Ryrie
Mr Burns
Mr Littler
Mr Quinlan
Mr Lavelle
Mr Dixon
Mr Lovell
Mr R Martin - IR
PS/IR

SECRETARY OF STATE FOR INDUSTRY'S VISIT TO THE UNITED STATES

You asked for my views on Patrick Jenkin's minute of 7 April arising out of his recent visit to the United States. You will by now have seen Mr Allan's minute of 17 April which deals with the industrial dimensions. The Inland Revenue are considering the fiscal aspects and we await their comments. However my initial views on this are that the two areas where progress might be possible are share options and the Business Start-Up Scheme. I have always felt that the key to the Business Start-Up Scheme is to get financial institutions interested in promoting the scheme by both putting together package deals to attract investors and finding companies who are at the right stage in their development to take advantage of outside equity capital. We might press Patrick Jenkin on what the DoI think of the prospects here and what steps we can jointly take to promote this form of business expansion.

Of the various points in Mr Allen's minute, I think we should make far more of our public purchasing policy. Far too frequently this is looked upon as a negative tool to enable us to place

orders with an ailing British company, which we would otherwise not do, in the hope that the additional orders will help to keep it going.

We should look upon our public purchasing policy as a positive means of promoting and developing what is good in British industry by placing orders with companies able to use the business as a stepping stone to useful expansion. I wonder if this aspect of our policy is properly considered and indeed whether our purchasing people are sufficiently aware of the full scope of the policy. I understand the reluctance particularly in the Treasury over this policy but much of the evidence points to the fact that the most progressive companies want orders from Government rather than aid.

I also believe the Industry/Education area is vital and still neglected. I would like to see much more emphasis on wealth creation in our education system, and much more public debate - could we not take initiatives in NEDC and similar forums to raise the level of discussion?

My experiences in the DoI made me worry a great deal about the DES and the UGC. We will urgently need more electronic engineers if we are to take advantage of the technology growth that will be satisifed by imports if we don't create the climate and the opportunities here. Some imaginative steps are needed such as creating or possibly transforming Cranfield into a Royal Institute of Technology as a permanent reminder of Information Technology year We need to persuade the young that engineering and wealth creating is a career for the most able of their generation.

JOHN WAKEHAM

CONFIDENTIAL

FROM: P.S. JENKINS
11 May 1982

pwp

cc: Chief Secretary
Financial Secretary
Sir Kenneth Couzens
Mr. Ryrie
Mr. Burns
Mr. Littler
Mr. Quinlan
Mr. Lavelle
Mr. Dixon
Mr. Lovell

PS/Inland Revenue

MINISTER OF STATE (R)

SECRETARY OF STATE FOR INDUSTRY'S VISIT TO THE UNITED STATES

The Chancellor read with interest your minute of 6 May on points arising out of Mr. Jenkin's recent visit to the United States.

2. He agrees that the points you have identified - share options, the Business Start-Up Scheme, public purchasing policy and the industry/education area all need to be actively pursued, and some of these points may turn out to justify early action (even in this year's Finance Bill).

PSJ

P.S. JENKINS

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