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PREM 19/941

Economic Situation

USA

PART 1.

May 1979

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~15.5.79~~		2.7.81		~~2.8.82~~			
~~6.6.79~~		~~13.7.81~~		~~20.8.82~~			
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10.12.79		~~12.10.81~~					
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PART 1 ends:-

MCS to Industry 30/9

PART 2 begins:-

Washington tel. 3320 12/10

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Gov anywhere suitable for this?
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30 September 1982

Thank you for your letter of 6 September with which you enclosed a copy of a report from Business Week, which Mr. Sterling thought the Prime Minister would be interested to read.

She was indeed interested to see this and has asked me to pass her thanks on to Mr. Sterling.

M. C. SCHOLAR

Kevin Tomlin, Esq.,
Department of Industry.

GRS 434

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IMMEDIATE

RECEIVED 24 SEP 1982

FM F.C.O. 231819Z SEP 82

TO IMMEDIATE PEKING

TELEGRAM NUMBER 440 OF 23 SEPTEMBER

FOLLOWING TELEGRAM NOW REPEATED TO YOU FOR P.M'S PARTY AT REQUEST OF PRIVATE OFFICE WAS RECEIVED FROM WASHINGTON TELEGRAM NUMBER 3118 OF 22 SEPTEMBER

INFO SAVING PARIS BONN OTTAWA TOKYO AND CGS USA.

US ECONOMY : RECENT DEVELOPMENTS

1. THE MOST RECENT STATISTICS ABOUT THE US ECONOMY, AND PRONOUNCEMENTS ON THEM BY SOME SENIOR MEMBERS OF THE ADMINISTRATION, HAVE STRUCK A RATHER OPTIMISTIC NOTE. THE COMMERCE DEPARTMENT HAS NOW REVISED UPWARDS ITS ESTIMATE OF THE GROWTH IN REAL GNP IN THE SECOND QUARTER FROM 1.3 TO 2.1 PERCENT (BOTH AT ANNUAL RATES). THEIR FIRST INDICATION IS THAT THERE HAS BEEN SOME FURTHER GROWTH IN THE THIRD QUARTER (1.5 PERCENT AT AN ANNUAL RATE). THE INDEX OF LEADING INDICATORS HAS ALSO RISEN FOR FOUR SUCCESSIVE MONTHS.

2. WITH BOTH THE RATE OF INFLATION (NOW AT 6.5 PER CENT) AND INTEREST RATES FALLING, THE NEW YORK STOCK MARKET HAS CONTINUED ITS RALLY, AND ON 21 SEPTEMBER CLOSED WITH THE DOW JONES INDUSTRIAL AVERAGE AT OVER 934, THE HIGHEST FOR OVER A YEAR. THE YIELD ON A 3 - MONTH TREASURY BILL IS BELOW 8 PERCENT, AND ON A LONG-TERM TREASURY BOND BELOW 12 PERCENT.

3. IN RESPONSE TO THE LATEST DEVELOPMENTS, SPEAKES (WHITE HOUSE SPOKESMAN) HAS SAID THAT ''THE SIGNS ARE UNMISTAKABLE. THE MOMENTUM FOR RECOVERY IS BUILDING, EVEN IF IT IS BUILDING SLOWLY''. TREASURY SECRETARY REGAN SAID YESTERDAY THAT ''THE WORST IS BEHIND US'' AND (ON UNEMPLOYMENT, NOW AT 9.8 PERCENT) THAT THE ADMINISTRATION WAS ''OPTIMISTIC THAT A STEADY, SUSTAINABLE RECOVERY WILL REFLECT ITSELF IN NEW HIRING'' BY YEAR-END.

4. PRIVATELY, FELDSTEIN (CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS) HAS BEEN SAYING THAT THE US ECONOMY IS STILL FLAT. THIS VIEW IS SHARED BY MOST ECONOMIC COMMENTATORS OUTSIDE THE ADMINISTRATION, WHO BELIEVE THAT THE US ECONOMY IS STILL WEAK,

AND THAT THIS HAS BEEN ONE OF THE FACTORS LYING BEHIND THE DECLINE IN INTEREST RATES. THEY ALSO BELIEVE THAT THE FEDERAL RESERVE BOARD MAY SOON RE-TIGHTEN MONETARY POLICY TO RESTRICT RECENT RAPID GROWTH IN THE MAIN MONETARY AGGREGATE, M1, AND THIS COULD HALT THE DECLINE IN INTEREST RATES. FURTHER INCREASES IN UNEMPLOYMENT ARE ALSO CLEARLY POSSIBLE, AND THE CAR AND HOUSING INDUSTRIES REMAIN DEPRESSED. BUT, AS THE MID-TERM CONGRESSIONAL ELECTIONS APPROACH, THE ADMINISTRATION CAN NOW CLAIM WITH SOME CREDIBILITY THAT A SLOW RECOVERY IS BEGINNING AND THAT THE LATEST US ECONOMIC DEVELOPMENTS ARE AT LEAST IN THE RIGHT DIRECTION.

5. FCO PLEASE PASS TO BOTTRILL (TREASURY). WATSON (BANK OF ENGLAND) AND BROADBENT (ESID).

FCO PASS SAVING PARIS BONN OTTAWA AND TOKYO.

PYM

NNNN

SECRET Prime Minister (2) 21 September 1982
ALAN WALTERS
MS 21/9

PRIME MINISTER

UNITED STATES MONETARY POLICY

Conclusions

In view of all the press speculation that monetary policy has changed and become more expansive, I thought that I ought to carry out a brief analysis and put press comment in its place. My conclusions are:

(a) Since 1979, US monetary policy has been carried out consistently with the objective of getting inflation down from 10-12% to less than 5% by 1984, and this policy is still being pursued.

(b) The effects which one would expect of this policy of reduced monetary growth have been broadly those which the United States has experienced, namely a reduction in growth rate, an increase in unemployment and an appreciation of the dollar against the mark and the yen.

(c) Recent expansion of the rate of growth of M1 is not inconsistent with the counter-inflation strategy, just as our expansion from March 1981 was consistent with the MTFS.

(d) Although the Fed has been criticised by Friedman, Brunner and others for allowing the monetary growth rate to "yo-yo", this has not affected the basic thrust of the counter-monetary strategy, but it may have added to real interest rates. (As we know from our experience, considerable monthly or even quarterly instability in the growth rates is inseparable from a mechanism whereby the Authorities control interest rates rather than the reserve requirements of the banking system.)

Recent Monetary Growth

In Figure 1 I have plotted the actual growth of the money supply compared with that required for a smooth disinflationary path from over the five year period to the end of 1984. This assumes the

/trend rate of

SECRET

trend rate of growth of velocity of 3% per annum, and anticipates that there will be a 5% growth rate of GNP by the end of the period (this is roughly the same as 3% inflation). As you can see from the diagram, the stock of money supply is still below the trend path. (Rather like ours during this past year.) There is some room for expanding at a faster rate in order to bring the money supply back onto its appropriate path.

There is an even more compelling reason for allowing more relaxed monetary growth. I have assumed in the diagram that velocity increases 3% a year. But over the winter of 1981/82 there was in fact a sharp fall in velocity. It is difficult to present a convincing reason for this fall; I conjecture that it was associated with the perceived threats to various fringe financial institutions and the flight to quality. If this is the case, then the fall is unlikely to persist, and is likely to be reversed in the course of time. Meanwhile, however, it does provide a good argument for Volcker expanding the money supply to get back on course and, indeed, a reasonable argument for an interim overshoot. It is vitally important, however, for the Fed to carry conviction that it will stick to the disinflationary path. More overt toughness than is statistically necessary may be needed to carry conviction. Last Friday's money supply figures and the recent behaviour of the Federal Funds rates suggest that the Fed realises still that it has not won the confidence battle.

Erratic Money Growth and Economic Activity

Granted the average rate of growth of the money supply has been right over the past 2½ years, there has, however, been very considerable criticism that the erratic rate of growth from year to year, and especially the slow-down in the third and fourth quarters of 1981, have contributed considerably to the slump in economic activity which we have seen in the United States from the winter of 1981/82 onwards. (We followed more or less the same policy and saw the same broad effect. You will no doubt recall the difficulty we had in changing our monetary stance, in particular interest rates, from November 1981 onwards.) These oscillations in monetary growth are inevitably part and parcel of the mechanism of monetary control - through interest rate variations instead of through reserve or base money. I am sure Friedman is right in believing that a lot of the oscillations in demand are

/generated

generated by the underlying oscillations in monetary growth; and that the money supply will be stabilised only when we get onto a monetary base system.

Friedman also confirmed that the reaction of US economic activity to a change in monetary growth now takes place after a lag of only three months compared with 6-9 months some years ago. We have seen some signs of a shortening of the lag in the UK - but it is difficult to quantify it yet.

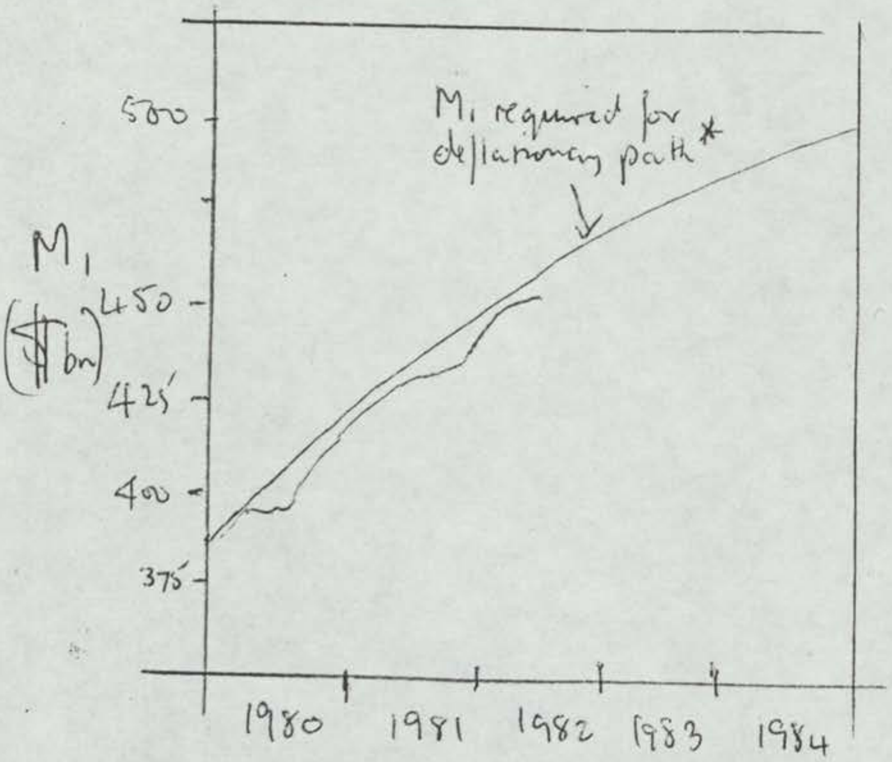
Future United States Interest Rates and Inflation

In conversation today, Friedman said he feared that both interest rates and inflation in the United States would not proceed on their downward course. He believes that inflation will stabilise over the next year or two at about 8%, and that interest rates will be correspondingly round about 10-11%. I was not convinced on the arguments he gave in support of this claim. But I have learned that one dismisses Friedman's arguments at one's peril, so I asked him if he would send me the statistical support for his predictions. For my own part I believe that the American inflation rate is heading, albeit unsteadily, downwards and that interest rates will fall along with it. This depends crucially, however, on the Government convincing markets that the Federal spending programmes are under control. The members of the new economics team say that the President will tackle this in earnest after the November elections. The unthinkables - such as cutting eligibility and indexing of Social Security - will then be pursued. Of course this may be the usual pap fed to markets to bolster confidence, but in this case I suspect that they are right.

21 September 1982

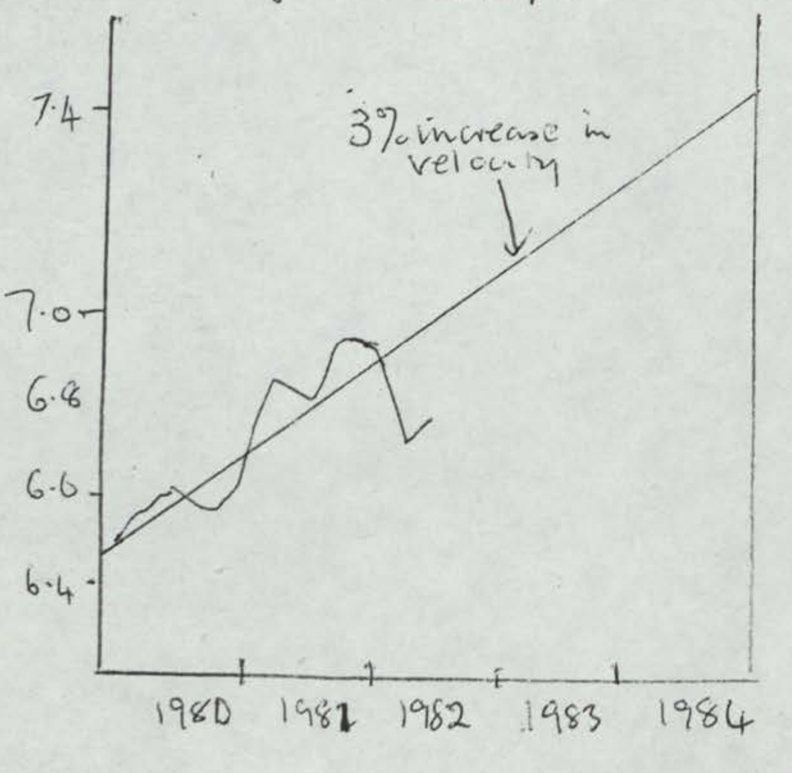
ALAN WALTERS

Fig 1 M₁ (bn of $)



* Assuming a 3% trend in Velocity

Fig 2 Velocity (ie M₁/GNP)



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Jeffrey Sterling CBE
Special Adviser

6 September 1982

(2)

Michael Scholar Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

Prime Minister

MCS 14/9

Dear Mr Scholar

USA ECONOMY

Mr Sterling thought that the Prime Minister may be interested, if she has not seen it already, in the attached report from Business Week on the "built in deficit" in the USA economy.

No 8/9

Have R

MCS 17/9

Yours

Kevin Tomlin

wr us 17/9

GR/CF

KEVIN TOMLIN
PS/Mr Sterling

Have I ach'd?

MCS 17/9

THE BUILT-IN DEFICIT

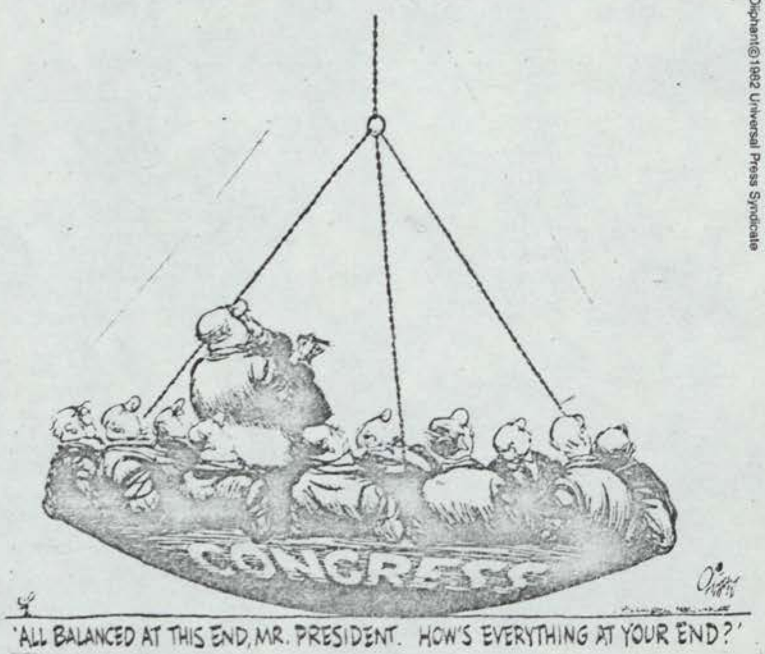
What it is doing to the economy | Why federal spending outpaces revenues | The trouble is Congress

Deficits are hardly new in the U. S. economy. There have been 10 in the past decade, 19 in the past 20 years, 32 since World War II, and 45 since the New Deal swept the government in 1932. But now, for the first time in its history, the U. S. economy is suffering from a built-in deficit, one that will remain astronomically high even if no new spending programs or tax reductions are enacted. And the shortfalls will stay unprecedentedly huge even if there is a solid recovery. From 1982 to 1985 the U. S. will add almost $500 billion to the national debt, more than it had in the preceding 30 years.

Launching a successful attack on the structural deficit is the most critical political task of this decade. This deficit has taken root despite 10 years of lip service to a balanced budget; despite passage of the Budget Control Act of 1974, which was supposed to get expenditures into line with receipts; and despite the revolutionary results of the 1980 election, which seemed to mandate a shrinking role for the government.

Whether the U. S. will be able to break the shackles of the built-in deficit—after a decade in which the moves that were supposed to balance the budget have only succeeded in creating a bigger imbalance—will depend on whether executives, Washington policymakers, and the American public have a clear understanding of the true origins of the deficit and its debilitating economic effects. It is now apparent that Washington's failure to capitalize on strong public sentiment in favor of scaled-down government following the 1980 Presidential election was a monumental political malfunction, one for which the nation is paying a high price today—the most miserable and baffling economic environment that business has seen since the Depression:

■ Business sales are stagnant. Whatever their long-run inflationary consequences, deficits used to help spur economic growth. Now the built-in deficit is a major barrier to economic recovery and to a return to long-term prosperity.



'ALL BALANCED AT THIS END, MR. PRESIDENT. HOW'S EVERYTHING AT YOUR END?'

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■ Real interest rates are at record levels. Reduced inflation used to usher in lower interest rates, particularly on long-term bonds. Market rates have, in fact, declined somewhat in the past year. But inflation has fallen much faster, leaving real interest rates, particularly long-term ones, at record levels. And the Federal Reserve cannot do anything about it. Until now easy-money policies traditionally helped bring down interest rates. Today, at almost any sign of ease by the Fed, rates shoot up. Investors interpret a move toward ease as a sign that the Fed has embarked on an inflationary policy of fast money growth to finance the deficit.

■ The U. S. is deindustrializing. Cuts in corporate taxes used to tilt the economy away from consumption and toward investment. But the Economic Recovery Tax Act of 1981 has had the opposite effect. The U. S. is becoming more dependent than ever on consumer spending. The nation's industrial plant and equipment are deteriorating, and more companies are being forced to sell off or close down businesses in basic industries.

■ Export markets are shrinking. The reduction in inflation that the U. S. has experienced should have improved international competitiveness and spurred exports. Instead, the built-in deficit is keeping U. S. interest rates high and the dollar strong, offsetting the competitive gains from lower inflation. As a result, the U. S. is expected to run huge trade deficits into the mid-1980s.

■ Uncertainty over economic policy is rife. In the middle of a severe recession, neither economists nor politicians would have advised raising taxes or cutting spending. Now, however, many economists are recommending just that. And the politics of deficits have become so absurd that Congress, barely one year after passing the largest tax cut in history, has done an about-face and is proposing the biggest tax increase in history.

It is not so much the 1982 deficit that is wrecking the economy; it is the prospect of huge deficits out to 1985 or even 1987. The U. S. has lost long-term control over the balance between expenditures and revenues. Spending as a percent of gross national product will average an unprecedentedly high 23% from now until 1985, while revenues' percentage will decline steadily to less than 20%. In the past two decades, spending averaged 20% and revenues 19%. As a percent of GNP, the deficit will rise to a historic high of 4% the coming fiscal year and next before gradually declining to 2% by 1985. In past recoveries, deficits dropped sharply to well below 1% of GNP in just a few years.

In dollars, the deficits from fiscal 1982 through 1985 are staggering. According to the Office of Management & Budget's midsession review, released on July 30, the deficit will jump from this year's $109 billion to $115 billion in fiscal 1983 before falling to $74 billion in fiscal 1985. That forecast, however, was the cause of a bitter internal debate within the Administration—a debate many observers believe was the reason Chairman Murray L. Weidenbaum and member Jerry Jordan of the Council of Economic Advisers recently resigned. And OMB Director David A. Stockman conceded on Aug. 3 in testimony before Congress that his office's 1983 estimate could easily be understated by $20 billion.

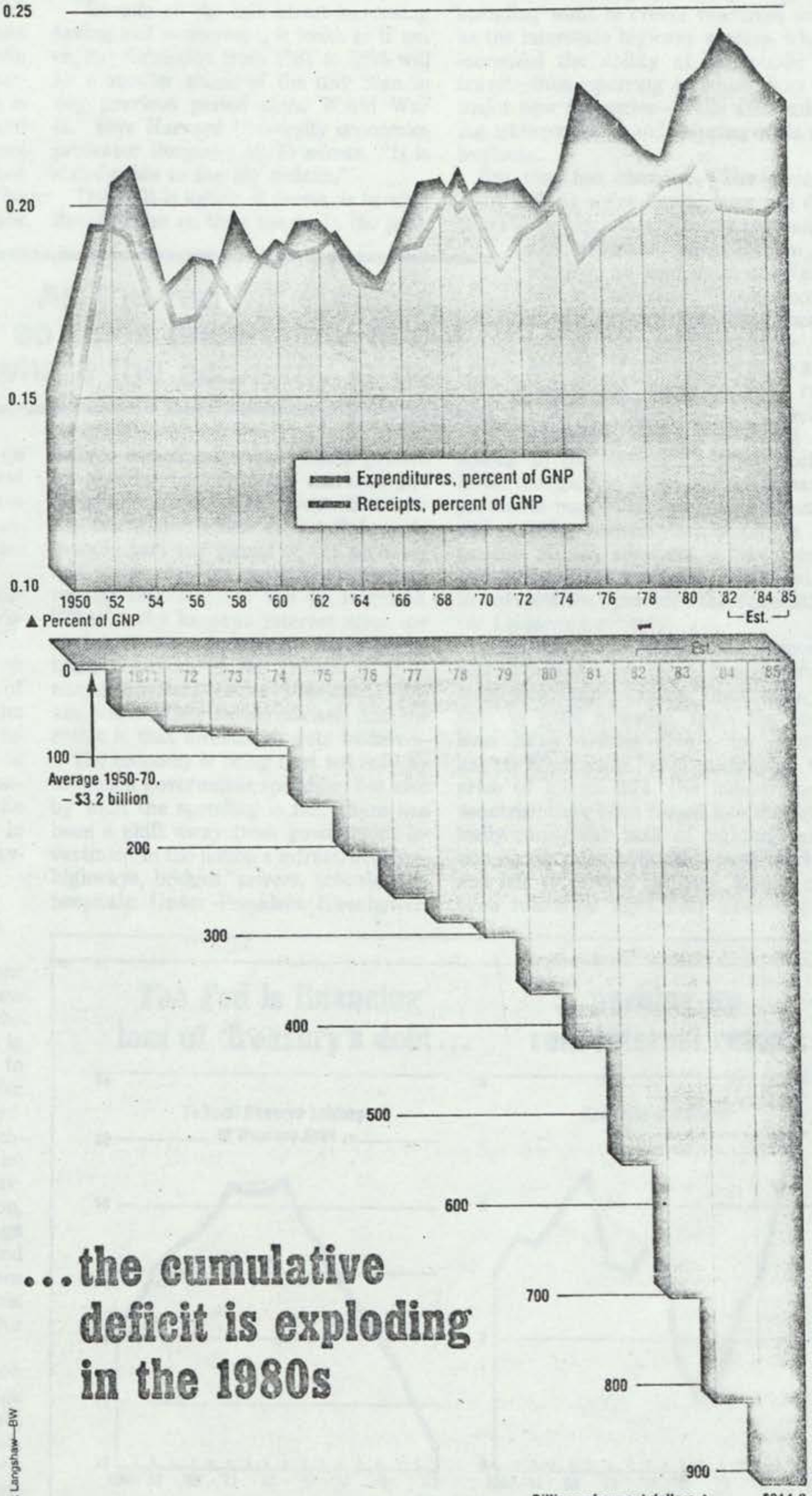
Even before Stockman's public concession, most observers believed that the best estimates of the deficit are not those of the Administration, but those made by the Congressional Budget Office. CBO Director Alice M. Rivlin has estimated that the deficit for 1982 would be approximately $125 billion and that it would stay within a range of $140 billion to $160 billion through 1985. Federal Reserve Board Chairman Paul A. Volcker concurs.

'Not the same kick'

The change in the short-run impact of budget deficits is one of the most surprising features of the new economic environment. Ever since Congress passed the deficit-creating tax cut in the summer of 1981, forecasters in and out of government have been predicting economic recovery. But company order books have become thinner and thinner. "Deficits do not have the same expansionary kick they had back in the '40s, '50s, or '60s," concedes the first U. S. Nobel laureate in economic science, Paul A. Samuelson of the Massachusetts Institute of Technology, a leading Keynesian.

In an economy in which deficits have become chronic, Samuelson explains, the stimulative effect of this year's estimated $125 billion deficit is muted. As the deficit estimates escalate, uncertainty about future economic policy increases, and this gets reflected in interest rates. Therefore, Samuelson says, "you lose in

With federal receipts stuck below expenditures...



Data: Commerce Dept., Data Resources Inc.; BW

Derrick Langshaw—BW

action, slowing economic growth. But the politicians have tried to cushion the impact of that slow growth with a constantly widening safety net of social programs that has pushed deficits up as a proportion of GNP.

In the U. S., the clash between tight monetary policy and loose fiscal policy has become particularly intense this year. "When related to potential GNP, the fiscal 1983 budget is among the two or three most expansive in the postwar period," calculates Goldman Sachs's Wenglowski. In that situation, the Fed can either accommodate the large deficits by boosting its purchases of government securities—thus increasing money and credit—or it can allow those securities to hit the private markets and, therefore, keep money and credit growth within its targets. Up to this point the Fed has clearly chosen the latter course (chart). The result has been the highest real interest rates in history and the sharpest recession since World War II.

Fed Chairman Volcker maintains that a tighter fiscal policy is a precondition to sustained ease on the monetary side. "A credibly firmer budgetary posture would permit us a degree of greater flexibility. Specifically, by dampening concern about a resurgence of inflation or credit-market pressures, fiscal restraint also lessens fears that short-run increases in the money supply might presage a continuing inflationary monetization of the debt," Volcker contends.

But changing the fiscal-monetary mix that forces monetary policy to carry the fight against inflation might be more difficult to achieve than even the Fed chairman may care to admit. The combination of tight money and easy fiscal policy has been intellectually justified by economist Robert Mundell of Columbia University. In the early 1970s, Mundell argued that the mix was just what is needed to fight inflation and stimulate economic growth.

In his view, the key to growth is holding down inflation and eliminating the distortions and inefficiencies it creates in the markets. If government can maintain a tight money policy and guarantee the value of its currency, it will break inflationary expectations, he contended. A loose fiscal policy, he added, is no real danger, since lower taxes mean greater incentives, which will lead to accelerating real economic growth and, therefore, more savings in the private sector.

Mundell's theory was adopted to varying degrees in the major industrial countries because it provided a justification for what politicians really wanted to do anyway to fight the inflation caused by OPEC. So while governments—including Washington—ran up big deficits, they instituted restrictive monetary policies to damp inflation.

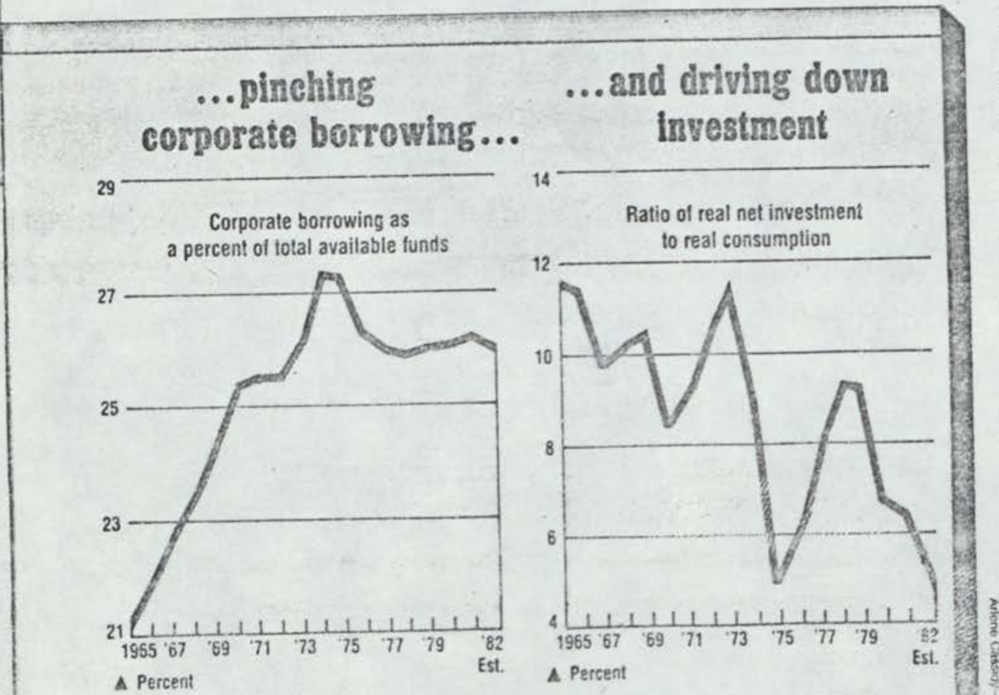
Indeed, in the U. S., Mundell's theory became the linchpin of the supply siders, who went one step further and argued that cutting taxes would stimulate economic growth so quickly that the deficit would fast disappear. Clearly, that supply-side promise has not materialized. And although the Fed may have eased its tight grip on credit conditions in recent weeks, the structural deficit means that monetary policy still has to carry the burden of containing inflation.

The No. 1 villain: Runaway entitlements

The structural deficit was made in Washington, particularly on Capitol Hill. It is the end product of 20 years of economic myopia, political greed, and legislative recklessness. Its origins lie in the thinking that characterized the go-go 1960s, when Washington operated on three highly optimistic premises: that economic growth would continue strong enough to make all things possible, that inflation would continue to push an unprotesting public into higher and higher tax brackets, and that the U. S. was rich enough to redistribute income through a series of entitlement programs without doing any damage to the nation's productive or financial capacity.

But the harsh lesson of the 1970s, which Congress still chooses to ignore, is that none of these premises was valid in the longer run. Economic growth slowed, the public revolted against being milked of tax dollars by bracket creep, and political chicanery caused the cost of income redistribution through entitlement programs to grow beyond any nation's financial capacity (page 91). In addition, the U. S. public recognized that the decline in defense spending's share of GNP—with the ratio tilted to finance the growth of social programs—left the country dangerously vulnerable.

In the second half of the 1970s, inflation made the ultimate consequences of the politicians' mistakes difficult to see. "The structural deficit is largely the product of the disinflation process," says OMB Director David A. Stockman. "The spending programs were built up during the '60s and '70s, and temporarily the surge in inflation financed the spending commitments that had built up without apparent strain. The problem is that the inflationary source of financing was unsustainable. The disinflation process unmasked the structural deficit." Adds Van Ooms, chief economist for the House Budget Committee: "Many pro-



Data: Data Resources Inc., BW estimates

grams were greatly expanded during the '60s when it appeared that strong economic growth would go on forever."

The popular view is still that huge deficits are caused largely by pork-barrel legislation. It is true that legislators, sometimes with executive branch urging, waste a lot of money supporting each other's favorite water projects, farm-price supports, shipbuilding subsidies, or job-training programs. But all legislation of this kind is so-called discretionary spending, which is both a relatively small part of the budget (19.5% in fiscal 1982) and relatively easy to control. The Administration, in fact, has had its greatest successes in cutting just this sort of expenditure.

What has become increasingly clear in recent years, especially since Reagan took office, is that the really big bucks are in the "entitlement programs." By definition, an entitlement is a federal benefit to which any qualified citizen has a right by law, and the money for such outlays does not have to be appropriated each year. These programs just grow automatically as demand for the benefits grows. Entitlements—including Social Security, medicare, medicaid, aid to families with dependent children, civil service pensions, and disability insurance—accounted for 48% of the budget in 1981.

The untouchables

In Washington, entitlement programs are generally regarded as the major part of the budget's "uncontrollable spending" portion. But the only truly uncontrollable budget cost is interest, since the government must pay its debt. What makes entitlement spending uncontrollable is that the programs' constituencies are so large and politically powerful that until last year politicians have been almost unwilling even to discuss touching them seriously.

The history of entitlement programs can be dated from the New Deal, when the biggest, most costly, and most politically potent of them—Social Security—was begun. The Social Security system made it politically acceptable to believe that the government had a responsibility for maintaining some level of well-being for its citizens. That idea was greatly expanded in President Johnson's Great Society as such programs as medicare and Head Start were adopted to attempt to deal with poverty and racial discrimination. And the big spur to entitlements came in the last decade, when eligibility for—and benefits from—almost all programs were vastly increased. As William Greider notes in his forthcoming book, *The Education of David Stockman and Other Americans*: "[Stockman's complaint has been that] liberal politics in its later stages had lost its ability to judge claims and so yielded to all of them .... As Stockman saw it, this process did not ameliorate social inequities; it created new ones by yielding to powerful interest groups."

Stockman: Inflation temporarily financed spending programs of the '60s and '70s.

It is generally accepted that the biggest factor making the budget deficit unmanageable was the 1972 move boosting Social Security benefits 20% and then indexing the system to increases in the consumer price index. That event vividly demonstrates the devastating effect of playing politics with entitlements, something Washington has done over and over again. The powerful chairman of the House Ways & Means Committee at that time, Wilbur Mills, believed that a big increase in Social Security benefits would greatly support his Presidential bid in the 1972 elections. As it turned out, nothing could help Mills, but President Nixon, who initially opposed the benefits increase, changed his mind as the election drew near and went along with the move.

Congress has played politics with spending while counting on the Fed to control inflation

After Nixon's victory, however, House Republicans initiated the idea of indexing Social Security, in the hope that the politicization of benefit increases could be eliminated. The idea was that if levels were adjusted automatically, politicians could not curry favor with the voters by bidding up benefits. Just how vain that hope has turned out to be emerged clearly in the past year, as Congress and the White House jockeyed over how to tackle Social Security's runaway costs.

Everyone agrees that something must be done to stem the rise in the program's spending, which went up from $64 billion in 1975 to $155 billion this year. By 1990 the cost of the Social Security system will double to $310 billion. But when Reagan proposed in May, 1981, that costs be lowered by reducing early retirement benefits, cutting welfare payments, and raising the amount of money retirees could earn so that their Social Security benefits could be trimmed, the Senate, in a nonbinding resolution, rejected key elements of the plan by a 96-to-0 vote. And that fall, Reagan turned down a bipartisan Senate plan sponsored by Senator Pete V. Domenici (R-N. M.) to trim Social Security by capping cost-of-living adjustments.

While Social Security is by far the biggest, it is not the only major entitlement program where costs are running away. Almost all of them, including medicare and medicaid, were indexed in the '60s and '70s. With inflation soaring, the costs of such indexed programs rose by staggering amounts. From 1975 to 1982 the tab for medicare jumped $15 billion, to $46 billion, and the medicaid bill rose $10 billion, to $17 billion.

And indexing is not the only problem. In keeping with the philosophy that growth and inflation could finance everything, Washington also encouraged states to raise benefits and expand eligibility for many programs. The cost of aid to families with dependent children has soared, largely because the number of people becoming eligible for assistance increased enormously. Similarly, while food stamps are not legally an entitlement program, they have become a quasi-entitlement, because Congress until last year automatically boosted the amount of money available as demand rose. And it rose dramatically in the '70s when President Carter substantially increased benefits. From 1975 through fiscal 1982, the cost of the program will have doubled, from $4.6 billion to an estimated $10.3 billion.

Demographic changes, too, are driving up expenses. As the elderly portion of the population grows larger, the costs of Social Security, medicare, and medicaid are pushed higher and higher. Veterans' pensions have become dramatically more expensive, and though their costs will level off, veterans' medical benefits will continue to go up sharply, growing by about 30% by 1985. Civil service pensions increased to $20 billion in 1982, almost three times their 1975 level, and they are expected to rise $27 billion by 1985.

The spending side cannot be blamed entirely for the built-in deficit. The enormous tax cuts enacted last year are slashing revenues and will continue to do so in the years ahead, at the same time that disinflation will depress the government's income. Unless it is changed, the Christmas-tree tax bill that Congress finally passed will, by 1986, increase the federal revenue loss by an estimated $42 billion more than the Administration's original proposal. Reagan's plan would have cut receipts by $225 billion; the congressional bill raised that figure to $267 billion. If the $99 billion tax increase recently proposed by Senator Robert J. Dole (R-Kan.) is accepted, however, the tax loss by 1986 will drop to an estimated $209 billion.

Cures for congressional paralysis

Because the built-in deficit is so large and the pressures from Congress to maintain programs are so strong, stemming the red ink will not be easy. Until now all the best-intended strategies—such as capping revenues to cap spending (the Reagan ploy), impounding government funds (the Nixon ploy), and improving budgetary control procedures (the congressional ploy)—have failed miserably. What is even more disheartening is that Congress did not manage to close the budget gap when the shortfall was minuscule, compared with the deficits that the U. S. will be facing in the years ahead.

Everyone recognizes that it will be impossible to put all the deficit-closing eggs in one basket. Instead, the realistic choice is some compromise among a number of menus attractive to political coalitions that have substantial constituencies. These alternatives are:

- The pure-growth option. Advocates believe that the supply-side tax cuts will eventually work and the economy will stage a vigorous recovery. Since that recovery will wipe out the deficit, they

Red ink engulfs Europe, too

The U. S. is not the only country wrestling with swelling structural deficits. Expanding deficit spending to meet everything from a rising tide o. unemployment claims—10.6 million are now jobless in Europe—to 1981's $34 million loss on the Concorde is a way of life on the other side of the Atlantic as well.

Until now the U. S. has done better in the budget sweepstakes than have other industrialized countries. American officials still take comfort from the fact that the U. S. deficit takes a smaller share of the economy than European deficits do. And while the U. S. deficit grows out of huge tax cuts, European deficits came from massive social spending on top of already high levels of taxes.

But the prospect of a U. S. deficit of more than $150 billion by 1984—4% of the gross national product—would dramatically change that. Only Italy, whose deficit may exceed 14% of GNP this year, and West Germany, where it will hit 4.5%, would be in worse shape among the major industrial countries. That U. S. deficit would exceed the relative size of Britain's 1.9% shortfall, France's 3%, and it would be heading toward the levels of such welfare states as Sweden and Denmark.

For Europeans, the prospect of a sustained U. S. deficit is a financial nightmare. By driving up interest rates in the New York money market, U. S. borrowing has already pushed interest rates sharply higher in Europe, too. That has helped weaken their economies. But if Europe were to adopt Japan's strategy and not follow U. S. interest rate increases, its currencies would weaken drastically, leading to even more transatlantic trade friction and imported inflation for European countries.

Europeans also worry about the psychological effect of a U. S. structural deficit. "Like it or not, the U. S. is the world's economic leader as well as its political leader," says Paul Van Den Bempt, director of the National Economies Section of the European Community. "If the U. S. shows it cannot control its deficit, what kind of hope does that leave for other countries?"

Up to now, European governments have shielded their financial markets from the stress of their own deficits by financing the shortfalls through central banks and international capital markets. When France decided to boost its deficit from about 1.5% of GNP in 1980 to the current 3%, it announced that the Banque de France would buy more than 50% of the debt. Germany's federal and state governments sold an estimated $18 billion in debt to foreign buyers last year, to finance their budget and balance-of-payments deficits. Officials also note that while their shortfalls are relatively large, Europeans save much more of their income than do Americans, thus easing the strain on their financial markets.

No tax increases. Because European governments feel they can borrow as much as they need without driving up interest rates, they do not share U. S.-type concerns about big deficits crowding out private borrowers. But some European governments are worried about crowding private initiative out of the economy. Government spending among the 10 EC countries, for instance, now accounts for about 49% of GNP, up from 32% in 1960. And state and federal taxes have risen to 45% of GNP from 32% in 1960.

European economists say it would be foolish to raise taxes any more. "Heavier taxation leads to more evasion, is a disincentive to professional effort, and puts people on low incomes at a disadvantage," the EC warned in a recent report to finance ministers.

Spending limits instead. Eschewing tax increases leaves spending reductions as the only route to controlling deficits, and the British, in particular, are taking a hard line there. Prime Minister Margaret Thatcher has stopped deficits from going up by imposing cash limits, which halt inflation-indexed cost overruns. Britain is now the only European country to show a declining deficit despite the recession. In Belgium, the government used emergency powers to stop indexed social security payments.

Germany and the Netherlands are requiring consumers to pay small users' fees for socialized medical services that had been free. German hospitals now charge about $2 per day.

Still, huge government spending and deficits seem intractable. Economists at Germany's Kiel Institute say that Bonn will do well to trim government spending from nearly a 50% share of the economy today to some 44% by 1990. That reduction will take so long, they note, largely because Europe's normal unemployment rate is now closer to 8% than to the 3% level of the 1960s. With such high joblessness, governments will continue to fund generous unemployment programs in the hope of maintaining political stability.

maintain, it is unnecessary to cut any social programs or raise any new taxes. "The deficit this year is due to the recession, and those projected deficits by Stockman are just tools to get new taxes and cut programs," says Jude Wanniski, president of Polyconomics Inc. and a supply-side spokesman. This, of course, is the supply-side solution, and Wanniski admits that its theorists no longer have the President's ear. "Reagan is now acting like Nixon, Ford, and Carter," he says. The most prominent politician among the supply siders, Representative Jack F. Kemp (R-N. Y.), is attempting to kill the Dole tax bill in the House.

- The modified-growth option. Most supporters of this idea are in the Administration. They want to leave all of last year's tax cuts in place to stimulate growth, but they also believe that the budget cannot be balanced unless entitlements are cut sharply. The only areas that are untouchable are defense and the third year of Reagan's personal tax cut.
- The orthodox conservative option. Proponents of this course believe that the supply-side experiment has failed and that budget-balancing will have to come from both the expenditure and revenue sides of the ledger. They are resigned to keep the third year of the tax cut but want to eliminate the income-tax indexing scheduled for 1985 and, most important, raise revenues by broadening the tax base, primarily by doing away with loopholes. They would also scale back entitlements, especially Social Security, and cut defense spending somewhat.
- The liberal option. Most liberals believe that major cuts should be made in defense spending. They want to close tax loopholes, from a budget-balancing perspective as well as an equity standpoint, and they advocate eliminating indexation and the third year of the tax cut. They also concede that changes must be made in Social Security.
- The conservation option. The budget could be balanced, advocates argue, if the U. S. taxed energy use much as the Europeans do. In particular, they want a massive tax on gasoline.

Clearly, these various proposals cannot be fully reconciled. But what is also clear is that there is broad-based agreement on a number of key areas that hold some real promise for finally coming to grips with the built-in deficit:

PRUNE SOCIAL SECURITY AND MEDICARE. Social Security, which has almost doubled in cost over the past six years, faces very serious long-term funding problems as the nation's population ages and the number of workers supporting each retiree continues to decline. As a consequence, the government must act now to scale back the benefits that are currently locked in for future retirees. At the same time, Washington should avoid any permanent reduction in benefits for those already in retirement or about to retire. Because people plan for retirement years in advance, such a move would be a serious breach of faith. However, since indexation of Social Security in recent years has provided beneficiaries with protection against inflation unavailable to the workers whose taxes pay for the program, a one-year suspension of the cost-of-living increase or a cap at several percentage points below the consumer price index for a few years should be considered.

Medicare faces different problems. Medical care inflation is running at 15% and will bankrupt the program in three years or less. The government must also consider whether the share of expenses

Dennis Brack/Black Star

Domenici: Reagan rejected his plan to trim Social Security cost-of-living increases.

borne by the beneficiary should be increased. Medicare was never intended to absorb the full cost of medical treatment, and the country probably cannot afford even the existing share.

ELIMINATE TAX INDEXATION. The government got into its current fiscal straitjacket largely because Congress indexed spending programs. The idea behind indexing tax brackets was to deprive Congress of the money generated by inflation to fund its spending spree. But clearly, not having the revenues in hand has not stopped Congress from spending. All indexing will do is add $23 billion to the deficit in 1986.

IMPOSE AN ENERGY TAX. Putting a tax on imported oil or taxing gasoline at the pump will have a double-barreled effect. It will raise considerable revenue; a 10¢ gasoline levy brings in $8 billion. It also puts pressure on OPEC and thus in the long run brings down the rate of inflation. That, in turn, allows policy to be more stimulative, thus raising GNP and indirectly generating more tax dollars.

SLOW DEFENSE SPENDING. Congressional Republicans and Democrats, as well as some Administration officials, want to slow the rate of growth of Reagan's defense spending program. Few dispute the President's goal of boosting outlays, but lawmakers on both sides of the aisle believe that such programs as the B-1 bomber, the MX missile, and the Navy's 600-ship fleet should be carefully examined to see if costs can be cut or even some aspects eliminated.

Unfortunately, Washington is very far from seriously addressing the built-in deficit. Although a working consensus is clearly needed, the differences between Republicans and Democrats and between Congress and the White House over who is responsible and what changes are necessary are so great that the political process is paralyzed. Reagan, who still defends his economic program, says the recession that has caused this year's deficit is the fault of Congress, which forced him to scale back and postpone his original three-year tax cut. He also holds that the massive outyear deficits are the responsibility of a Congress that caved in to lobbyist pressures by loading up the tax cut with extra goodies and, most important, refused to attack spending seriously.

Power struggle

Most congressional Republicans and Democrats do not accept final responsibility for the built-in deficit, although they concede that they bear some of the blame for past and present programs that have caused the red ink to become unmanageable. A number of Democrats and most Republicans initially supported Reagan's program, yet many now argue that the tax cut was too big and compressed into too short a time, given the simultaneous rapid increase in defense spending. That is why Senator Dole pushed his tax bill through the Senate and why many Democrats and Republicans, especially the Senate leadership, are furious that Reagan has waffled on what seemed to be a commitment to defense cuts in fiscal 1984 and 1985.

In fact, deep down, Congress—especially its Republican members—is inclined to blame much of the problem with the structural deficit on the President's refusal to capitalize on his political popularity to launch an attack on entitlement programs. They believe that Reagan could have done it last October, when Senator Domenici put together his plan to set a cap on cost-of-living increases for Social Security. Now, says Domenici: "I'm not sure you can solve the deficit problem all at once. We may have to sit down and look at what spending cuts are realistically achievable and then look at defense spending from the view of how big the deficits will be if we have achieved all we can in other areas with a tax base that has been cut back."

It is widely accepted that for more than a decade, congressional control over spending has increased at the expense of the executive. The Reagan Administration had hoped to wrest control back. Its strategy was to use multiyear tax cuts and indexation of the tax code to starve the legislative branch of the revenue needed to finance expenditures. But the tactic is obviously not working.

Political gutlessness

The bottom line is whether or not politicians have the will to make political decisions that could prove costly. The failure of the Congressional Budget Act to enforce fiscal discipline on Capitol Hill shows clearly that no amount of procedural reform can ever substitute for sheer political willpower. But political guts are a scarce commodity, as demonstrated by House Speaker Thomas P. O'Neill Jr.'s abdication of his responsibility even to draft tax legislation to try to cope with the mounting deficits.

That is a major reason interest is rapidly growing in amending the Constitution to force Congress to adopt a balanced budget and to increase the powers of the President to veto expenditures program by program or to impound spending allocations. In fact, the Senate on Aug. 4 approved a bill that would generally require Congress to produce a balanced budget. But many observers worry that the lawmakers would find a way around any constitutional amendment. And Administration officials admit that the legislators are unlikely to approve a big increase in the President's authority to control the budget directly. "It is not just the Democrats," says a top Reagan aide. "The Senate Republican subcommittee chairmen are as jealous of their prerogatives as the College of Cardinals is of its."

History does not give much hope that Congress will do what is necessary to deal with the built-in deficit. But never in history has it been more imperative that Congress not pursue business as usual. Failing to deal with the deficit will preordain that the U. S. will never get back on the road to prosperity. ■

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GRS 780 CONFIDENTIAL Prime Minister

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TO PRIORITY F C O

TELEGRAM NUMBER 2796 OF 20 AUGUST

INFO SAVING UKMIS NEW YORK, CG'S IN USA.

USA

MY TELNO 2757: PRESIDENT REAGAN: TAX INCREASE

1. CONGRESS YESTERDAY PASSED MR REAGAN'S DOLLARS 98.3 BILLION TAX BILL. THE VOTE WAS 226 TO 207 IN THE HOUSE AND 52 TO 47 IN THE SENATE. IN THE HOUSE, WHERE THE VOTE WAS IN DOUBT UP TO THE LAST MINUTE, 103 REPUBLICANS VOTED FOR THE BILL AND 87 AGAINST. THE PRESIDENT THUS HAD TO DEPEND ON A LARGE NUMBER OF DEMOCRATIC VOTES TO GET THE MEASURE THROUGH. IN THE SENATE, THERE WERE LESS REPUBLICAN DEFECTIONS BUT, EVEN HERE, THE PRESIDENT HAD TO RELY ON LIBERAL DEMOCRATS SUCH AS SENATOR KENNEDY TO GET HIS BILL.

2. OVER THE PAST FEW DAYS, THE PRESIDENT HAS HAD TO GRIN AND BEAR IT AS, ONE AFTER THE OTHER, LIBERAL DEMOCRATS SUCH AS KENNEDY, O'NEILL AND GOVERNOR JERRY BROWN OF CALIFORNIA, HAVE PUBLICLY ENDORSED THE BILL. CONSERVATIVE REPUBLICANS, TO WHOM THESE MEN ARE ANATHEMA, SAW THIS LIBERAL DEMOCRATIC SUPPORT AS FURTHER EVIDENCE THAT THE PRESIDENT HAD MADE A HORRIBLE MISTAKE IN EMBRACING THIS PIECE OF LEGISLATION. BEFORE THE VOTE WAS TAKEN TIP O'NEILL MADE AN EMOTIONAL APPEAL TO THOSE REPUBLICANS WHO HAD WON THEIR SEATS ON MR REAGAN'S COAT-TAILS NOT TO DESERT HIM NOW THAT HE WAS MAKING A CHANGE OF POLICY IN THE NATIONAL INTEREST. THIS DID LITTLE TO RALLY THE WAVERERS BUT SKILFULLY EXPLOITED REPUBLICAN UNEASE.

3. MR REAGAN MOUNTED AN UNPRECEDENTED LOBBYING OPERATION IN SUPPORT OF THE BILL, MEETING, TELEPHONING AND CAJOLING HIS SUPPORTERS UP TO THE LAST MINUTE. HE WOULD HAVE SUFFERED A SERIOUS BLOW TO HIS PRESTIGE IF HE HAD LOST. EVEN SO, REPUBLICANS WILL NOW FACE AN AWKWARD NOVEMBER CAMPAIGN, EITHER HAVING TO CONCEDE THAT LAST YEAR'S MEASURES HAVE NOT WORKED OR, IN THE CASE OF THOSE WHO VOTED AGAINST THE PRESIDENT, HAVING TO CLAIM THAT THEY ARE NOW THE ONLY ONES STILL IN STEP. HAVING FOUGHT TOOTH AND NAIL AGAINST THE BILL THEY CAN HARDLY PRETEND TO BELIEVE THAT ALL WILL BE WELL WITH THE ECONOMY NOW THAT IT HAS PASSED. AT THE SAME TIME, THEY HAVE TURNED THEIR BACK ON THE PRESIDENT AND DAMAGED HIS CREDIBILITY ON WHICH THEY STILL DEPEND FOR RE-ELECTION.

4. ALTHOUGH THE TAX BILL ITSELF IS CAREFULLY BALANCED IT CONTAINS A NUMBER OF MEASURES THAT WILL AFFECT THE CONSUMER: A 100 PERCENT INCREASE IN THE TAX ON CIGARETTES (WHICH HAD NOT HOWEVER BEEN ADJUSTED SINCE): A 1 PERCENT TO 3 PERCENT RISE IN TELEPHONE EXCISE TAX AND A SMALL INCREASE (TO 8 PERCENT) ON THE TAX ON AIR TICKETS. SPENDING ON THE MEDICARE PUBLIC MEDICINE PROGRAMME IS TO BE CUT BY DOLLARS 13 BILLION OVER THREE YEARS. ONE SPECIAL MEASURE - THE EXTENSION OF UNEMPLOYMENT PAY FROM 26 WEEKS TO A MINIMUM OF 39 WEEKS - IS ITSELF A PAINFUL REMINDER THAT UNEMPLOYMENT IS AT A POSTWAR RECORD OF NEARLY 10 PERCENT.

/5.

CONFIDENTIAL

5. THE PASSAGE OF THE TAX BILL IS BEING BRAVELY PRESENTED BY ADMINISTRATION SPOKESMEN AS ANOTHER VICTORY FOR MR REAGAN. AND IN TERMS OF HIS PERSISTENCE AND POWERS OF PERSUASION ON THE HILL, SO IT IS. BUT THE PRESIDENT HIMSELF HAS SCARCELY CONCEALED THAT THE TAX BILL REPRESENTED A VERY PAINFUL DECISION FOR HIM AND IT MUST BE A DISAPPOINTING SEQUEL TO HIS SUCCESS A YEAR AGO IN SECURING THE ADOPTION OF HIS BUDGET. THIS YEAR, FEW NEED REMINDING THAT THE TAX BILL WILL MAKE AT BEST A SMALL DENT IN THE FEDERAL BUDGET DEFICIT WIHICH IS STILL EXPECTED TO AMOUNT TO SOME DOLLARS 115 BILLION IN FY 1983 ALONE.

6. THIS WEEK'S STOCK EXCHANGE BOOM HAS BROUGHT A LITTLE CHEER. BUT IT IS WIDELY RECOGNISED THAT THE MAIN UNDER-LYING CAUSE FOR THE FALL IN INTEREST RATES WHICH BROUGHT ON THE BOOM IS THE FACT THAT THERE IS NO LONGER ANY EARLY PROSPECT OF THE ECONOMY PICKING UP SIGNIFIC-ANTLY.

THOMAS

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TO ROUTINE FCO
TELEGRAM NUMBER 2638 OF 2 AUGUST

U S TAX INCREASES

SUMMARY

1. THE HOUSE OF REPRESENTATIVES INDICATED IT'S WILLINGNESS TO INCREASE TAXES ON 28 JULY WHEN IT VOTED TO GO TO CONFERENCE ON A BILL PASSED EARLIER BY THE SENATE. THE BILL, KNOWN AS THE TAX EQUITY AND FISCAL RESPONSIBILITY BILL OF 1982, INCLUDES SOME 100 CHANGES IN LAW THAT WILL INCREASE REVENUES SOME DOLLARS 21BN AND REDUCE EXPENDITURE DOLLARS 4BN IN FY83. THE HOUSE ACTION SUBSTANTIALLY INCREASES THE CHANCES THAT CONGRESS WILL PASS A TAX INCREASE PACKAGE THIS SESSION. THE PRESIDENT IS EXPECTED TO APPROVE THE BILL IF IT IS SENT TO HIM FOR SIGNATURE.

DETAIL

2. THE TAX BILL, ACCORDING TO ITS AUTHOR SENATE FINANCE COMMITTEE CHAIRMAN DOLE, WAS DESIGNED TO INCREASE REVENUE WHILE AT THE SAME TIME INTRODUCING GREATER EQUITY INTO THE TAX SYSTEM, REMOVING SOME ECONOMIC DISTORTIONS AND MOVING TOWARDS ECONOMIC PRICING FOR GOVERNMENT SERVICES. THE LARGE NUMBER OF CHANGES IS CLEARLY A TACTICAL MEASURE INTENDED TO INCREASE THE CHANCES OF CONGRESSIONAL APPROVAL.

3. THE FOLLOWING ARE ITS MAIN PROVISIONS (FY83 PRELIMINARY REVENUE/EXPENDITURE EFFECTS IN BRACKETS).

A. INCREASING BUSINESS TAXES IN SUCH AREAS AS DEPRECIATION, SAFE HARBOUR LEASING, AND THE OVERSEAS DEPRECIATION ALLOWANCES FOR U S OIL COMPANIES (DOLLARS 0.2BN)

B. INCREASING INDIVIDUAL INCOME TAX REVENUES BY RAISING TO 7 PERCENT OF INCOME THE THRESHOLDS BEFORE MEDICAL AND CASUALTY COSTS CAN BE DEDUCTED FROM TAXABLE INCOME, WHILE REDUCING THE CAPITAL GAIN HOLDING PERIOD TO SIX MONTHS (DOLLARS 5.9BN).

C. CHANGES DESIGNED TO REDUCE THE INCIDENCE OF TAX EVASION, INCLUDING THE WITHOLDING AT SOURCE OF 10 PERCENT OF INTEREST AND DIVIDENDS INCOME (DOLLARS 6.7BN).

D. CHANGES IN THE RULES GOVERNING THE TAX TREATMENT OF PENSION PLANS AND LIFE INSURANCE COMPANIES (DOLLARS 1.7 BN)

E. HIGHER EXCISE TAXES ON CIGARETTES, AIRLINE OPERATIONS, AND TELEPHONES (DOLLARS 2.5BN).

/ F. OVER 50

F. OVER 5Ø DETAILED CHANGES IN THE OPERATION OF FEDERAL ENTITLEMENT PROGRAMMES (DOLLARS 4.2BN IN SAVINGS).

4. IT WAS UNUSUAL FOR THE DEMOCRAT CONTROLLED HOUSE TO ACCEPT THE SENATE VERSION OF THE TAX BILL RATHER THAN WRITING ITS OWN VERSION. THIS WAS POSSIBLE BECAUSE THE SENATE IN FACT TACKED THIS BILL ON TO AN EARLIER SMALL TAX BILL THAT HAD ORIGINATED IN THE HOUSE. EVEN SO, SOME HOUSE MEMBERS FELT THAT THEY HAD ABROGATED THEIR CONSTITIONAL DUTY TO ORIGINATE TAX LEGISLATION. BUT THE DEMOCRAT MAJORITY, MINDFUL OF THE NOVEMBER CONGRESSIONAL ELECTIONS, SAW POLITICAL ADVANTAGE IN GIVING THE PRESIDENT WHAT HE HAD ASKED FOR SO THEY COULD PUT THE BLAME FIRMLY ON HIM LATER ON FOR WHAT THEY CONFIDENTLY EXPECT WILL BE THE FAILURE OF HIS ECONOMIC POLICY. HOUSE REPUBLICANS ON THE OTHER HAND WERE UNHAPPY AT THE BILL PASSED BY THE REPUBLICAN CONTROLLED SENATE BECAUSE IT TOOK THE PRESSURE OFF DEMOCRATS TO VOTE FOR REDUCTIONS IN EXPENDITURE.

5. THE HOUSE/SENATE CONFERENCE COMMITTEE IS EXPECTED TO ADDRESS THE TAX BILL TOMORROW. THERE ARE BOUND TO BE SUSBTANTIAL PRESSURES FROM THE SPECIAL INTEREST GROUPS TO REDUCE THE BURDEN OF THE BILL EG THE TOBACCO INDUSTRY AND LARGE OIL COMPANIES AND SOME FURTHER CHANGES SEEM LIKELY. IF THE CONFERENCEES CAN AGREE, A REVISED BILL WILL BE SENT BACK TO THE HOUSE AND SENATE FOR A FINAL VOTE, PROBABLY BEFORE THE START OF THE SUMMER RECESS ON 19 AUGUST.

6. FCO PLEASE PASS TO BOTTRILL (TREASURY) AND WATSON (BANK OF ENGLAND)

THOMAS

[ADVANCED AS REQUESTED]

FINANCIAL

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GRS 670
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FM WASHINGTON 022302Z AUG 82
TO ROUTINE FCO
TELEGRAM NUMBER 2639 OF 2 AUGUST
INFO SAVING PARIS, BONN, UKDEL OECD, UKREP BRUSSELS

ADMINISTRATION'S MID-YEAR BUDGET REVIEW

SUMMARY

1. THE ADMINISTRATION'S MID-YEAR REVIEW OF THE FY83 BUDGET, PUBLISHED TODAY, SHOWS A SLOWER RECOVERY FROM ECONOMIC RECESSION AND HIGHER BUDGET DEFICITS THAN IT HAD INDICATED EARLIER. MANY PRIVATE FORECASTERS BELIEVE THESE OFFICIAL ESTIMATES OF THE BUDGET DEFICIT ARE STILL TOO LOW AND THAT ON CURRENT POLICIES THERE IS UNLIKELY TO BE A SUBSTANTIAL REDUCTION IN THE DEFICIT IN THE COMING YEARS.

DETAIL

2. THE ADMINISTRATION'S MAIN ECONOMIC ASSUMPTIONS ARE AS FOLLOWS (CALENDER YEARS):

	1981	1982	1983
GNP (0/0 ANNUAL CHANGE)			
- CURRENT PRICES	11.4	5.6	11.2
- 1972 PRICES	2.0	-0.7	4.4
CONSUMER PRICE INDEX (0/0 ANNUAL CHANGE)	10.3	5.9	6.7
UNEMPLOYMENT RATE (0/0)	7.6	9.2	8.4
INTEREST RATE (3 MONTH TREASURY BILLS 0/0)	14.1	12.0	10.7

3. IN ITS LATEST BUDGET CALCULATIONS, THE OFFICE OF MANAGEMENT AND BUDGET (OMB) ESTIMATES A DEFICIT OF DOLLARS 108.9BN IN FY82 (COMPARED WITH A FORECAST DOLLARS 100.5BN IN APRIL) FOLLOWED BY DOLLARS 115BN IN FY83 (COMPARED WITH DOLLARS 101.9BN FORECAST EARLIER). THE INCREASE IN THE FORECAST DEFICIT IS MAINLY DUE TO A DOLLARS 18.6BN REDUCTION TO DOLLARS 646.5BN IN REVENUES. THIS RESULTS MAINLY FROM CHANGES IN ECONOMIC ASSUMPTIONS: A MORE RAPID REDUCTION IN INFLATION AND A DELAY IN THE RECOVERY FROM RECESSION. THE REVENUE CALCULATIONS TAKE INTO ACCOUNT THE TAX EQUITY AND FISCAL RESPONSIBILITY BILL NOW BEFORE CONGRESS AND OTHER TECHNICAL RE-ESTIMATES. FY83 BUDGET OUTLAYS ARE SOME DOLLARS 5.5BN LOWER AT DOLLARS 751.5BN.

4. THE OMB PROJECTS THE DEFICIT WILL DECLINE FROM DOLLARS 115BN IN FY83 TO DOLLARS 92.6BN IN FY84 AND TO DOLLARS 73.6BN IN FY85. THIS WOULD BRING THE DEFICIT DOWN FROM A PROJECTED 3.6 PERCENT OF GNP IN FY83 TO 1.8 PERCENT IN FY85.

COMMENT

5. MOST PRIVATE ECONOMISTS EXPECT THE RECOVERY WILL BE LESS ROBUST THAN THE REAL ANNUAL RATE OF 4.5 PERCENT ASSUMED BY THE OMB FOR THE SECOND HALF OF 1982 AND FOR 1983. FOR EXAMPLE, THE BLUE CHIP CONSENSUS OF PRIVATE FORECASTERS IS FOR REAL GROWTH AT A 3.8 PERCENT ANNUAL RATE FOR THE SECOND HALF OF 1982 AND 3.5 PERCENT IN 1983.

6. ON THE BASIS OF LESS OPTIMISTIC ECONOMIC ASSUMPTIONS, THE CONGRESSIONAL BUDGET OFFICE (CBO) ESTIMATED LAST WEEK THAT THE FY83 DEFICIT WOULD BE BETWEEN DOLLARS 141BN AND DOLLARS 151BN. CBO DIRECTOR ALICE RIVLIN ALSO SAID THAT THE FEDERAL BUDGET DEFICIT WOULD BE LIKELY TO REMAIN IN THE RANGE OF DOLLARS 140-160BN FOR THE NEXT THREE YEARS, EVEN IF ALL THE SPENDING CUTS AND TAX INCREASES CALLED FOR IN THE CURRENT BUDGET RESOLUTIONS WENT INTO EFFECT. RIVLIN ALSO NOTED THAT DEFICITS OF THIS SIZE WOULD KEEP PRESSURE ON FINANCIAL MARKETS, HOLD INTEREST RATES HIGH AND PREVENT A VIGOROUS RECOVERY FROM THE RECESSION. FED CHAIRMAN VOLCKER SUBSEQUENTLY COMMENTED TO A SENATE COMMITTEE THAT THE CBO ESTIMATES QUOTE CAME AS NO SURPRISE TO US. THEY ARE IN THE GENERAL AREA OF WHAT THE MARKETS THINK IS PROBABLE UNQUOTE.

7. FOR THESE REASONS, THE ADMINISTRATION UNDERSTANDABLY RELEASED THE REVISED ESTIMATES WITH LITTLE FANFARE THOUGH THIS HAS NOT PREVENTED PRESS COMMENT FROM REFLECTING THE DEEP SCEPTICISM OF THE MAJORITY OF OUTSIDE COMMENTATORS.

8. FCO PLEASE PASS TO BOTTRILL (TREASURY) AND WATSON (BANK OF ENGLAND).

FCO PASS SAVING PARIS BONN UKDEL OECD AND UKREP BRUSSELS.

THOMAS

[ADVANCED & REPEATED AS REQUESTED]

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GRS 850
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FM WASHINGTON 290430Z JUL 82
TO IMMEDIATE FCO
TELEGRAM NUMBER 2591 OF 29 JULY

PRESIDENT REAGAN'S PRESS CONFERENCE.

1. THE PRESIDENT HELD A PRESS CONFERENCE THIS EVENING (28 JULY): MAIN THEMES WERE THE ECONOMY AND THE MIDDLE EAST.

2. THE ECONOMY.

THE PRESIDENT REITERATED HIS STRONG SUPPORT FOR A CONSTITUTIONAL AMENDMENT TO BALANCE THE FEDERAL BUDGET. HE URGED PASSAGE OF THE AMENDMENT IN HIS OPENING STATEMENT, NOTING THAT CONSISTENT BUDGET DEFICITS THROUGH THE YEARS HAD QUOTE BROUGHT THE ECONOMY TO ITS KNEES UNQUOTE. HE BELIEVED THAT CONGRESSIONAL APPROVAL WOULD IMPROVE THE CLIMATE OF OPINION ABOUT PROSPECTIVE BUDGET DEFICITS AND THAT THIS WOULD HELP BRING INTEREST RATES DOWN.

3. THE PRESIDENT VIGOROUSLY DEFENDED HIS SUPPORT OF THE AMENDMENT WHILE SIMULTANEOUSLY SUBMITING TO CONGRESS A BUDGET FOR FY 1983 WITH A RECORD DEFICIT. HE BLAMED THE DEMOCRATS FOR FAILING TO GIVE HIS ADMINISTRATION ALL THE BUDGET REDUCTIONS THAT HE HAD SOUGHT. MOREOVER HE WAS QUOTE NOT THROUGH WITH CUTS IN SPENDING UNQUOTE AND WOULD BE PROPOSING MORE NEXT YEAR.

4. ON THE STATE OF THE ECONOMY, THE PRESIDENT INSISTED THAT THE RECESSION WAS BOTTOMING OUT AND THAT THERE WOULD BE AN IMPROVEMENT IN THE SECOND HALF OF THIS YEAR. THIS RECOVERY WOULD BE SUSTAINED AND WOULD BE BASED ON SOLID GROWTH RATHER THAN THE QUICK AND ILLUSORY SOLUTIONS EMPLOYED BY PREVIOUS ADMINISTRATIONS. HE REJECTED CRITICISM THAT THE ADMINISTRATION'S ECONOMIC FORECASTS HAD BEEN CONSISTENTLY OPTIMISTIC. FOR EXAMPLE INFLATION HAD BEEN REDUCED MUCH MORE RAPIDLY THAN HAD BEEN FORECAST LAST YEAR: INDEED THE EFFECT OF REDUCED INFLATION ON TAX REVENUE WAS ONE OF THE FACTORS THAT HAD LED TO A HIGHER BUDGET DEFICIT.

5. THE PRESIDENT SAID THAT HE WAS DISTRESSED BY THE TIME IT WAS TAKING TO PUT RIGHT THE DAMAGE DONE BY PAST ADMINISTRATIONS: BUT THE TASK WAS SLOWLY AND SURELY BEING DONE AND MANY AMERICANS WERE ALREADY BENEFITTING FROM THE ADMINISTRATION'S SOUNDER ECONOMIC POLICIES.

6. REAGAN WAS IMPRECISE ON THE MIDDLE EAST. HE EXPRESSED OPTIMISM THAT HABIB WOULD FIND A SOLUTION TO THE CRISIS IN THE LEBANON WHICH WOULD INVOLVE THE REMOVAL OF ARMED PLO FORCES TO THIRD COUNTRIES AND THE WITHDRAWAL OF ALL FOREIGN TROOPS, INCLUDING THE ISRAELIS AND SYRIANS, FROM LEBANON. THE US WANTED LEBANON ONCE AGAIN TO BE UNDER A CENTRAL GOVERNMENT WITH UNITED ARMED FORCES. HABIB WAS DOING AN EXCELLENT JOB: THE PRESIDENT REFUSED TO GO INTO DETAILS, PARTICULARLY REGARDING US/ISRAELI CONTACTS.

/7.PRESIDENT

7. PRESIDENT REAGAN SAID THAT IT WOULD BE A STEP FORWARD IF THE PLO DROPPED ITS REFUSAL TO RECOGNIZE ISRAEL'S RIGHT TO EXIST AND ACKNOWLEDGED UNSCR 242 AND 338: HE ADDED THAT THE RECENT CALL BY US CONGRESSMEN ON ARAFAT WAS NOT WELL TIMED. ASKED IF HE SUPPORTED THE IDEA OF A PALESTINIAN STATE, HE REPLIED THAT THE US WAS ESSENTIALLY AN INTERMEDIARY AND WOULD NOT IMPOSE ITS VIEWS: IT WAS UP TO THOSE DIRECTLY INVOLVED TO DECIDE. HE ADDED THAT THE AUTONOMY TALKS, WHICH WERE RELEVANT, WERE A CASUALTY OF THE LEBANON CRISIS.

8. ALLIANCE. THE PRESIDENT CLAIMED THAT DISAGREEMENT OVER THE PIPELINE WAS A FAMILY QUARREL: EACH SIDE KNEW IN ADVANCE THE POSITION OF THE OTHER. HE HAD NO SECOND THOUGHTS ABOUT HIS ADMINISTRATION'S ACTIONS, ALTHOUGH HE INSISTED THAT HE WOULD REVIEW THE POSITION WITH REGARD TO THE PIPELINE IF THE POLISH MILITARY GOVERNMENT WOULD QUOTE SOFTEN OR RELEASE ALL THE PEOPLE INCLUDING LECH WALESA, IF THEY SHOULD REOPEN CONVERSATIONS WITH SOLIDARITY UNQUOTE. HE DENIED THAT US GRAIN SALES TO THE SOVIET UNION WERE INCONSISTENT WITH AMERICAN ACTION ON THE PIPELINE. GRAIN WAS AVAILABLE FROM MANY SOURCES, AND A U.S. EMBARGO SUCH AS CARTER'S AFTER AFGHANISTAN HAD HURT AMERICAN FARMERS MORE THAN THE RUSSIANS: PIPELINE TECHNOLOGY, ON THE OTHER HAND, WAS ESSENTIALLY AMERICAN, AND THE RUSSIANS WOULD BE HURT BY ITS WITHDRAWAL. FURTHERMORE THE SOVIET UNION HAD TO DEPLETE ITS SCARCERESERVES OF FOREIGN RESERVES TO BUY AMERICAN GRAIN, WHILE THE PIPELINE PROJECT WOULD ACTUALLY EARN THEM HARD CASH.

9. CHINA. THE PRESIDENT SAID THAT HE WANTED TO DEVELOP RELATIONS WITH THE PEOPLES REPUBLIC: BUT HE WOULD NOT ABANDON AMERICA'S LONG TERM ALLIES ON TAIWAN. THE US HAD A MORAL OBLIGATION TO THE TAIWANESE. HE WOULD ABIDE BY THE TERMS OF THE TAIWAN RELATIONS ACT.

10. EL SALVADOR. PRESIDENT REAGAN CONCEDED THAT ABUSES CONTINUES: NEVERTHELESS, THE SALVADORAN GOVERNMENT WAS DOING ITS BEST TO CURB THEM. STATE DEPARTMENT WITNESSES WOULD TESTIFY BEFORE CONGRESS SHORTLY THAT CONTINUED US AID WAS JUSTIFIED . THE FALSE PROPAGANDA AND DIFINFORMATION ON EL SALVADOR HAD BEEN EXPOSED BY THE MASSIVE TURN-OUT DURING THE RECENT ELECTIONS.

11. THE PRESIDENT REFUSED TO CRITICIZE THE INTERIOR SECRETARY, JAMES WATT, FOR RECENT INDISCRETIONS. HE USED UP SEVERAL MINUTES DEALING WITH AN IMPORTUNATE LADY JOURNALIST ON AN OBSCURE QUESTION ABOUT WOMEN'S RIGHTS.

HENDERSON

FCO/WHITEHALL
NAD

USA

CONFIDENTIAL

Prime Minister (2)

CAW

MCS 22/7

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

21 July 1982

Michael Scholar Esq
No.10 Downing Street

Dear Michael,

VOLCKER'S STATEMENT: 20 JULY

The Chancellor thought the Prime Minister might like to .... see the attached brief note about the testimony given yesterday to the US Senate Banking Committee by Paul Volcker, Chairman of the US Federal Reserve Board. It was an important statement on US economic policy, and also showed some striking similarities with our own experience and policies. It has been well received in the markets.

Yours ever,

John Kerr.

J O KERR

CONFIDENTIAL

MR VOLCKER'S STATEMENT, 20 JULY

The testimony given to the US Senate Banking Committee yesterday by Mr Volcker, Chairman of the Federal Reserve Board, was an important and balanced statement on US economic policy. It has been widely reported in the press.

2. The main strands in what he said were as follows:-

(i) The US inflationary tide seems to have turned in "a fundamental way". There is an opportunity to achieve lasting progress towards price stability, to provide the basis for many years of economic recovery. With this success in sight it would be quite wrong to relax policy now.

(ii) Interpretation of the monetary evidence is complicated. Partly for technical reasons to do with financial innovation, and partly because at a time of recession and uncertainty peoples' desire to hold monetary assets may increase for precautionary reasons, strong efforts to reduce monetary growth further would be inappropriate. Growth around the top of the Fed's target ranges would therefore be "fully acceptable", and bulges above the target range could be tolerated for a time.

(iii) The principal threat to policy lies in the fiscal deficit. "Considerably more remains to be done to bring the deficit under control as the economy expands". A "credibly firmer budget posture" would greatly relieve strains in the financial markets and help bring interest rates down.

3. There are, of course, striking parallels with UK experience and the policies we have been pursuing: sticking to the strategy against inflation; continued but not excessive downwards pressure on the monetary aggregates, making allowance for changes that affect the significance of the numbers; and the need to control the budget deficit. What is also striking is that the Volcker statement is a more authoritative survey of both the monetary and fiscal situation in the US than any recent statement by the Administration itself. Volcker's message about the Budget deficit is the one we have been urging on the US administration.

4. The statement was taken well in the markets, though much of its impact seems to have been anticipated and discounted in advance. It was preceded by a cut in the Fed's discount rate. The detailed comments about monetary policy (paragraph 2(ii) above) could imply less instability in interest rates in future.

5. The US money supply figures for the last two weeks have also been helpful, with M1 back within its target range for the year for the first time for many months. Three-month eurodollar interest rates fell around 3% from 16½% in the last week of June to around 13½% before Volcker's statement. Since then they have fallen a little further, to a little under 13¼% at the close of business in London on 21 July. US prime interest rates have also started to come down. This fall it if is sustained is likely to be very important for the development of the world economy.

6. These developments have proved helpful for UK interest rates in recent weeks. Mr Volcker's testimony in itself will not necessarily bring any further early fall in US rates, but it may help to consolidate the fall that has already taken place.

HM Treasury
21 July 1982

PERSONAL AND CONFIDENTIAL

9AW ①

Prime Minister

A.J.C. 3/6

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

PRIME MINISTER

PRESIDENT REAGAN AND THE US BUDGET DEBATE

I am sorry to go on about this. I do so because I am convinced of its importance to our own national interest and political fortunes.

2. We both know how much the prospects for renewed growth, and our chance of turning the tide of unemployment, depend on the outlook for lower interest rates - achieved in a responsible fashion. They depend too on the prospects of renewed growth in the US.

3. But because of the World role of the dollar there is a limit to what we (or other like-minded countries like Germany) can do to get our own interest rates down. And only the US itself can affect its own rates. They have made striking progress in reducing their inflation rate. But markets are not yet convinced that this is permanent. There is no doubt that in this they are powerfully influenced by what they see as the prospect for the US budget deficit.

4. So far the markets remain unconvinced that the deficit is likely to follow the right downward path. And no wonder: in March 1981 the 1983 deficit was expected to be $23 billion; in February of this year the uncorrected "baseline" prospect was $146 billion; by April that had risen to $182 billion - with the prospect of higher figures in later years. The "deal" agreed between the President and Republican Senators aimed to reduce the $182 billion to $116 billion, but has so far been rejected by the House of Representatives.

5. The very real risk is that no agreement will be reached before the Summer Recess, which would mean that interest rates would be likely to remain high until at least November. And no-one can be sure that the outcome of the mid-term elections will make it any easier to secure the necessary reductions after November.

6. I know from my talks with Don Regan and Paul Volcker that they are desperately aware of the need to make progress before then. They have both been most appreciative of the restrained but persistent way in which I have pressed the case. You may remember how Schmidt told us at Chequers that Regan was as good as urging him to press the case upon the President. But Schmidt feels, as I do, that you are better placed than anyone else to give the necessary encouragement to President Reagan: for he can be in no doubt about the identity of your views and his on the main economic issues. And you are able, of course, to draw upon our own experience. It was only because of our own willingness to "bite the bullet" in our 1981 Budget that we were able to turn the tide of expectations in this country.

7. I entirely agree with you, of course, that it is not for us to tell the President how to put his own act together. But I am sure that we should leave him in no doubt about the importance, for the political and economic prospects of all the industrial countries, of his displaying firm determination to secure a convincing prospect of declining US deficits.

8. It is above all because of the strong reasons of UK national interest which I have mentioned that I hope you will feel able to speak to the President about this. I

PERSONAL AND CONFIDENTIAL

.... attach a possible speaking note, which has been agreed with Alan Walters. You will see that it in no way involves you in urging tax increases or going into detail on how the President achieves the right result on the deficit problem. But it does stress the urgency of his doing so.

G.

(G.H.)
3 June 1982

1. We continue to stand four square behind the efforts of the U.S. Administration to reduce inflation and believe the success of those efforts will be of the first importance for the United States, for the Alliance and for the whole of the free world. We applaud the notable progress which is being achieved in reducing the U.S. inflation rate. We shall continue to express our support publicly for U.S. policy on this.

2. We support your methods as well as your objectives. We approve whole-heartedly your determination to maintain tight control of the growth of the money supply; to cut public expenditure; and to reduce progressively the federal budget deficit.

3. We wish you success in your efforts in Congress to secure agreement on federal budgets showing a declining rate of deficits over the next 3 fiscal years. We very much sympathise with your wish to achieve this to the largest extent possible through public expenditure reductions, and with the smallest possible public sector. But we cannot try to tell you what is or is not possible in these matters.

4. What we do feel is that it is urgent to settle the question of the deficits as soon as possible. We believe that a settlement on the kind of declining path you have been seeking would reassure markets and opinion generally, and would help reduce interest rates. We know that you, like we, want lower interest rates. At this stage in our counter-inflation policies we can be

powerfully helped by a belief that inflation is coming down for good, and greatly hindered by continued doubts about whether our achievements will endure. And we want people to believe that declining deficits will free resources within the monetary targets for an expansion of the private sector, which has always shown so much vigour in the United States.

5. We don't suggest that reducing the deficits will end all the problems. Nor do we suggest that it would remove all the interest rate problems of other countries, which may be attributable to their own national policies. We all have our own responsibilities. But we do believe it would help substantially to improve the chance of a lasting victory over inflation both in the United States and elsewhere.

GR 470
UNCLASSIFIED
FM WASHINGTON 010305Z APR 82
TO IMMEDIATE F C O
TELEGRAM NO 1054 OF 31 MARCH
INFO PARIS, BONN, TEL AVIV (FOR S OF S PARTY)

PRESIDENT REAGAN'S PRESS CONFERENCE

PRESIDENT REAGAN GAVE A NATIONALLY TELEVISED PRESS CONFERENCE THIS EVENING. IN THE PAST, HE HAS HELD SUCH CONFERENCES IN THE EARLY AFTERNOON. BUT THE AUDIENCE AT THAT HOUR IS SMALL AND MOST PEOPLE HAVE SEEN ONLY THE BRIEF EXTRACTS SHOWN ON THE EVENING NEWS. ON THIS OCCASION, THE PRESIDENT DECIDED TO TAKE PRIME VIEWING TIME TO REACH A LARGER AUDIENCE, IN THE BELIEF THAT HE COULD GET HIS MESSAGE ACROSS IF HE TALKED DIRECTLY AND UNEDITED TO THE AMERICAN PEOPLE.

2. THE PRESIDENT OPENED WITH A STATEMENT ON NUCLEAR ARMS POLICY (SEE MIFT NOT TO ALL). MUCH OF THE SUBSEQUENT QUESTIONING WAS DEVOTED TO THE ECONOMY. I AM REPORTING SEPARATELY THE PRESIDENT'S COMMENTS ON EL SALVADOR AND ON THE MIDDLE EAST.

3. DENYING THAT HE WAS ''A GREAT STONE FACE'', THE PRESIDENT SAID THAT HE WAS PREPARED TO LISTEN TO SUGGESTIONS FOR CHANGES IN HIS PROPOSED BUDGET FOR FY 1983. THE BEST WAY OF REDUCING THE BUDGET DEFICIT WAS TO CUT FEDERAL SPENDING. HIS RECENTLY APPOINTED CITIZENS TASK FORCE WOULD BE LOOKING AT THE DEFENCE DEPARTMENT TO TRY TO FIND SAVINGS BUT HE COULD NOT ACCEPT REDUCTIONS WHICH WOULD SET THE US BACK IN THE DEFENCE FIELD.

4. ASKED WHETHER HE COULD CLAIM THAT AMERICANS WERE BETTER OFF NOW THAN UNDER THE CARTER ADMINISTRATION, THE PRESIDENT SAID THAT HE SHOULD BE JUDGED OVER HIS ENTIRE TERM, NOT HIS FIRST FIFTEEN MONTHS. INTEREST RATES HAD, HOWEVER COME DOWN FROM 21 AND HALF PERCENT TO 16 PERCENT AND INFLATION HAD DROPPED FROM 12 PERCENT TO 4 AND A HALF PERCENT ON THE LATEST FIGURES. THE KEY TO DEALING WITH THE PROBLEMS OF UNEMPLOYMENT WAS NOT SHORT TERM EMERGENCY MEASURES, WHICH INVOLVED AN ARTIFICIAL AND INFLATIONARY STIMULUS ULTIMATELY DAMAGING TO THE POOR, BUT A CONSISTENT ECONOMIC STRATEGY WHICH

/ WOULD WIN

WOULD WIN THE CONFIDENCE OF BUSINESS AND THE MONEY MARKETS. INTEREST RATES WERE NOT TOO HIGH BECAUSE OF ADMINISTRATION OR FED POLICY, BUT BECAUSE THE MONEY MARKETS, AFTER YEARS OF BITTER EXPERIENCE, DID NOT YET BELIEVE THAT GOVERNMENT WOULD HAVE THE CONFIDENCE IN ITS OWN POLICIES TO STAY THE COURSE.

5. THE PRESIDENT WENT TO SOME LENGTHS TO TRY TO DISPEL THE IMPRESSION THAT HIS GOVERNMENT WAS TRYING TO BALANCE THE BUDGET ON THE BACKS OF THE POOR, POINTING TO INCREASED SPENDING ON A WIDE RANGE OF SOCIAL PROGRAMMES. HE MADE IT PLAIN THAT HE WAS NOT PREPARED TO GO BACK ON HIS TAX CUT PACKAGE, ARGUING THAT HAD CONGRESS APPROVED HIS ORIGINAL PROPOSAL FOR A 30 PERCENT CUT, THE CURRENT RECESSION MIGHT HAVE BEEN AVERTED. THE PRESIDENT SAID THAT, WHILE HE SUPPORTED THE IDEA OF A CONSTITUTIONAL AMENDMENT TO REQUIRE A BALANCED BUDGET, IT WOULD BE ESSENTIAL TO ENSURE THAT ANY PROPOSAL INCLUDED A STATUTORY LIMIT ON TAX INCREASES TO PREVENT GOVERNMENT USING SUCH INCREASES AS AN EASY WAY TO A BALANCED BUDGET.

HENDERSON

FCO/WHITEHALL

NAD

CONFIDENTIAL [CULL]
FM WASHINGTON 290110Z MAR 82
TO ROUTINE FCO
TELEGRAM NO 1013 OF 28 MARCH
INFO SAVING PARIS, BONN, UKREP BRUSSELS, TOKYO, OTTAWA,
CONSUL GENERALS IN USA

PRESIDENT REAGAN, CONGRESS AND THE ECONOMY

1. THE REPUBLICAN LEADERS IN THE HOUSE AND THE SENATE HAVE PUBLICLY WARNED THE PRESIDENT THAT TIME IS RUNNING OUT FOR A BUDGET COMPROMISE AND THAT, UNLESS THE WHITE HOUSE IS PREPARED TO START NEGOTIATING BEFORE THE EASTER RECESS (WHICH STARTS ON 2 APRIL) CONGRESS MAY GO AHEAD AND TRY TO DRAW UP A BI-PARTISAN BUDGET OF ITS OWN.

2. THE PRESIDENT'S OPPOSITION TO ANY CHANGES IN HIS PROPOSED BUDGET HAS HITHERTO SEEMED TO BE SET IN CONCRETE, BUT MR REAGAN IS NOW UNDER PRESSURE NOT ONLY FROM HIS OWN PARTY IN CONGRESS, BUT ALSO FROM INDUSTRIALISTS, MEMBERS OF HIS CABINET AND FROM HIS OWN STAFF TO SUPPORT A COMPROMISE. LAST YEAR, FACED WITH CONGRESSIONAL DIFFICULTIES, THE PRESIDENT APPEALED DIRECTLY TO THE NATION FOR SUPPORT AND RECEIVED AN OVERWHELMING RESPONSE. THIS YEAR, THINGS LOOK DIFFERENT. THE PRESIDENT CANNOT COUNT ON THE UNQUALIFIED SUPPORT OF HIS OWN PARTY OR OF CONSERVATIVE DEMOCRATS. THE PUBLIC, TO JUDGE FROM THE OPINION POLLS, ARE NOW ALSO ANXIOUS THAT CHANGES SHOULD BE MADE. FOR THE FIRST TIME, THE POLLS SHOW MAJORITY SUPPORT FOR A CUTBACK IN PROJECTED DEFENCE SPENDING.

3. THE ELEMENTS OF A COMPROMISE MOST LIKELY TO HAVE A CHANCE OF ENACTMENT INCLUDE

(A) HIGHER TAXES THAN ORIGINALLY PROPOSED BY THE PRESIDENT, PERHAPS INCLUDING CHANGES IN THE TIMING OR AMOUNT OF THE 10 PER CENT CUT IN INDIVIDUAL INCOME TAX RATES SCHEDULED TO TAKE PLACE ON 1 JULY 1983:

(B) A SMALLER INCREASE IN DEFENCE SPENDING THAN THE PRESIDENT ORIGINALLY PROPOSED: AND

(C) A LIMIT ON THE AUTOMATIC ANNUAL ADJUSTMENT IN ENTITLEMENT PROGRAMMES, INCLUDING SOCIAL SECURITY.

4. THE PRESIDENT AND THE DEMOCRATS HAVE BEEN PLAYING A CAT-AND-MOUSE GAME. THE PRESIDENT WOULD LIKE TO PUT THE ONUS FOR CHANGING THE BUDGET ON THE DEMOCRATIC LEADERSHIP IN THE HOUSE OF REPRESENTATIVES THEREBY MAKING THEM RESPONSIBLE FOR UNPALATABLE PROPOSALS (HIGHER TAXES) AND AVOIDING A PAINFULLY PUBLIC DEMONSTRATION THAT HIS BUDGET DOES NOT HAVE THE SUPPORT OF HIS OWN PARTY IN THE SENATE, WHERE THE REPUBLICANS ARE IN THE MAJORITY. SPEAKER O'NEILL HAS SAID THAT HE IS WILLING TO DISCUSS A COMPROMISE BUT IS DETERMINED THAT THE PRESIDENT SHOULD CARRY AT LEAST EQUAL RESPONSIBILITY FOR WHATEVER CHANGES EMERGE.

5. IF THE OUTLINE OF A COMPROMISE DOES NOT EMERGE BEFORE EASTER, THE ADMINISTRATION WILL HAVE ITS ARM EVEN MORE FIRMLY TWISTED IN MAY OR JUNE WHEN IT HAS TO SEEK AN INCREASE IN THE PUBLIC DEBT CEILING. IT IS AT THAT POINT THAT CONGRESS WILL HAVE MAXIMUM LEVERAGE ON THE ADMINISTRATION TO PROPOSE ITS OWN PROPOSALS.

6. CONGRESS FURTHERMORE HAS YET TO ADOPT A BUDGET RESOLUTION INCORPORATING THE SECOND ROUND OF BUDGET CUTS IN FY1982. GOVERNMENT SPENDING IS BEING MAINTAINED ON THE BASIS OF A CONTINUING RESOLUTION WHICH EXPIRES AT THE END OF MARCH. SPENDING AUTHORITY WILL THEREFORE HAVE TO BE RENEWED BY CONGRESS IF THE FEDERAL GOVERNMENT IS TO BE FINANCED BEYOND THE END OF THIS MONTH. THE HOUSE OF REPRESENTATIVES HAS PASSED A RESOLUTION EXTENDING SPENDING AUTHORITY UNTIL THE END OF SEPTEMBER. BUT A SIMILAR STOP-GAP MEASURE MAY RUN INTO DIFFICULTIES IN THE SENATE WHERE SOME REPUBLICANS ARE CONSIDERING CONTROVERSIAL AMENDMENTS DESIGNED TO USE BUDGET AUTHORISATION TO PURSUE SOCIAL GOALS EG TO LIMIT THE BUSING OF PUPILS TO STATE SCHOOLS.

7. IN SHORT, THE PRESIDENT AND CONGRESS ARE AT LOGGERHEADS AND THE BUDGETARY PROCESS IS AT A STANDSTILL. THE ADMINISTRATION HAS BEGUN BELATEDLY TO REALISE THAT A FAILURE TO TAKE ACTION SOON TO TRY TO BREAK THE DEADLOCK IS UNLIKELY TO WORK TO ITS ADVANTAGE. THE MAIN BLOCKAGE HAS BEEN THE PRESIDENT'S OWN RESISTANCE TO INCREASING INDIRECT TAXES, OR TAMPERING WITH THE DIRECT TAX CUTS WHICH ARE AN INTEGRAL PART OF HIS PROGRAMME. THE FIRST SIGNS OF GIVE HAVE NOW APPEARED IN THE ADMINISTRATION'S POSITION. THE WHITE HOUSE CHIEF OF STAFF, BAKER, HAS BEEN AUTHORIZED TO HOLD PRELIMINARY TALKS WITH THE DEMOCRATS ON WHERE THEY WOULD LIKE TO SEE CHANGES MADE. MEESE ACKNOWLEDGED YESTERDAY THAT CHANGES WOULD BE NECESSARY BECAUSE OF THE GROWTH IN ESTIMATES OF THE PROBABLE DEFICIT: THE ADMINISTRATION WOULD BE LOOKING FOR QUOTE AREAS OF AGREEMENT UNQUOTE WITH CONGRESS.

FCO PASS SAVING PARIS, BONN, UKREP BRUSSELS, TOKYO, OTTAWA

HENDERSON

THIS TELEGRAM WAS NOT ADVANCED

FINANCIAL
NAD

[REPEATED AS REQUESTED]

USD

SAVING TELEGRAM

BY BAG

FROM WASHINGTON

[CULL]

TO FCO TELNO 5 SAVING OF 12 MARCH 1982

UNITED STATES MONTHLY ECONOMIC REPORT FOR FEBRUARY 1982

SUMMARY

1. Senate Republican leaders have indicated the President's FY83 budget proposals are unlikely to pass Congress in their current form. Senate Budget Committee Chairman Domenici is working for a bi-partisan consensus on alternative proposals. These might include lower growth in defence expenditure, a freeze on federal pay and entitlement payments in FY83, a freeze in most other programmes for 3 years, and closing tax loopholes. Other Congressmen have proposed postponing the third instalment of the 3 year personal tax cut enacted last year. Should a bi-partisan consensus be reached, the Congress might seek to impose it on the Administration as a condition of approving an increase in the federal debt limit which will be needed in April or May. On 9 March President Reagan said that he was prepared to work with Congress on the budget issue, but he studiously avoided comment on specific alternative proposals.

2. The Congressional Budget Office (CBO) published a report on 25 February on the President's FY83 budget proposals. The CBO have estimated that the Administration's budget would produce higher deficits than the Administration projects. They have used less optimistic economic assumptions, and expect significantly higher outlays. The CBO estimate that, if the Administration's measures are passed, the FY83 budget deficit would be $121bn, rising to $129bn in FY84 and $140bn in FY85 (compared with the Administration's forecast of $91.5bn, $82.9bn and $71.9bn respectively).

3. The US recession is continuing. Industrial production fell by 3% in January to stand 10% below its level in July 1981 (when the recession began). The decline has been widespread;

/WITH

with the car and housing industries remaining depressed. The unemployment rate rose to 8.8% in Janaury, compared with 7.2% in July 1981. Most private forecasters consider that the prospects for the US economy in 1982 have become gloomier since the beginning of the year. Many forecast a postponement of the end of the recession to mid-year, and are scaling down their predictions of the strength of the recovery.

4. An encouraging trend is the moderation in inflation. The January Consumer Price Index stood 8.4% above its level of a year earlier. The rate of increase in the housing component continues to ease, while lower petrol prices have contributed to a decline in the transportation component. Average earnings per hour in the private sector were 7.5% higher in February than a year earlier.

5. Market interest rates have eased from the middle of February, partly because of the prolongued weakness of the economy. At the end of the month, rates on 3-month Treasury Bills stood at 12.8% and on 20-year Government bonds at 14.1%.

(See MIFT for Full Report)

HENDERSON

FINANCIAL
NAD

THIS TELEGRAM
WAS NOT
ADVANCED

PRINCIPAL INDICATORS

Quarterly Data (1981 - Q 4)

	% change on	
	Previou Quarter	Year earlier
GNP	-1.2	0.8
Exports of Goods & Services	-3.7	-2.0
Imports of Goods & Services	-0.2	7.2

	Actual Level	
	Latest Quarter	Previous Quarter
Balance of Payments Current Account (Q_3)	\$2.1bn	\$1.1bn

Monthly Data

	% change on	
	Previous Month	Year earlier
Consumer Price Index (JAN)	0.3	8.4
Money Stock M1B(JAN)	1.5	7.0
M2 (New) (JAN)	1.0	10.5
Dollar Effective Exchange Rate (FEB) nsa	3.2	12.4

	Actual Level	
	Latest Month	Year earlier
Banks Prime Rate % (FEB) nsa	16.6	19.4
Unemployment Rate % (FEB)	8.8	7.3

Note: all figures are seasonally adjusted unless otherwise noted.

GR 320

UNCLASSIFIED [CULL]

FM WASHINGTON 042144Z MAR 82

TO ROUTINE FCO

TELEGRAM NUMBER 737 OF 4 MARCH

INFO SAVING BONN, PARIS, UKREP BRUSSELS, TOKYO.

M T
USA

US BUSINESS OPINIONS ABOUT PRESIDENT REAGAN'S FY83 BUDGET PROPOSALS

1. THE U.S. PRESS TODAY CARRIES REPORTS THAT THE BUSINESS ROUND TABLE, A PRESTIGIOUS ASSOCIATION OF 200 MAJOR CORPORATIONS, HAS CONCLUDED THAT PRESIDENT REAGAN'S PROJECTED BUDGET DEFICITS ARE UNACCEPTEDLY LARGE. THE ROUND TABLE'S 46-MEMBER POLICY COMMITTEE IS REPORTED TO SUPPORT DEFERRAL OF THE SCHEDULED 10 PERCENT TAX CUT FOR INDIVIDUALS FOR 1983 AND MODIFICATION OF THE DISPUTED TAX LEASING PROVISIONS ENACTED LAST YEAR. THEY HAVE ALSO INVITED CONGRESS TO REDUCE PRESIDENT REAGAN'S PROPOSED DEFENCE EXPENDITURE. SIMILAR POSITIONS HAVE BEEN TAKEN BY THE UNITED STATES CHAMBER OF COMMERCE AND THE NATIONAL ASSOCIATION OF MANUFACTURERS.

2. IN A FULL PAGE NEWSPAPER ADVERTISEMENT APPEARING IN MAJOR NEWSPAPERS YESTERDAY (COPY BY BAG), THE AMERICAN BANKERS' ASSOCIATION AND SERVERAL OTHER ASSOCIATIONS OF AMERICAN FINANCIAL INSTITUTIONS ISSUED A STATEMENT SAYING THAT THERE WAS NO ALTERNATIVE BUT TO SLOW DOWN GROWTH OF PUBLIC EXPENDITURE NOT EXCLUDING DEFENCE AND ENTITLEMENT PROGRAMMES AND, IF NECESSARY, DEFERRING PREVIOUSLY ENACTED TAX REDUCTIONS OR ENACTING INCREASES IN TAXES. THE AMERICAN BANKERS' ASSOCIATION CALLED FOR A BI-PARTISAN APPROACH IN CONGRESS TO DEVELOP EFFECTIVE SOLUTIONS.

3. THESE DEVELOPMENTS ADD YET MORE WEIGHT TO THE INCREASINGLY WIDELY HELD VIEW THAT PRESIDENT REAGAN'S BUDGET PROPOSALS FOR FY 83 WILL NOT GET THROUGH CONGRESS WITHOUT SUBSTANTIAL ALTERATION. PUBLIC STATEMENTS BY BUSINESS ASSOCIATIONS WHICH EXPLICITLY OR IMPLICITLY CRITICSE PRESIDENT REAGAN'S PROPOSALS ARE A NEW DEVELOPMENT. THEY ILLUSTRATE HOW FAR OPINION HAS MOVED SINCE THE BUDGET PROCESS LAST YEAR WHEN MOST OF THE ADMINISTRATION'S PROPOSALS WERE ENACTED.

4. FCO PLEASE PASS TO BOTTRILL (TREASURY) AND WATSON (BANK OF ENGLAND).

FCO PASS SAVING BONN, PARIS, UKREP BRUSSELS, TOKYO.

HENDERSON

[REPEATED AS REQUESTED]

FINANCIAL
NAD
WED

COPIES TO:-
MR BOTTRILL TREASURY
MR WATSON BANK OF ENGLAND

RESTRICTED

GR 680

mr Schofar

To see

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RESTRICTED [CULL]
FM WASHINGTON 270110Z FEB 82
TO ROUTINE FCO
TELEGRAM NUMBER 652 OF 26 FEBRUARY
INFO SAVING PARIS BONN UKREP BRUSSELS TOKYO OTTAWA

US BUDGET DEFICITS

1. IN A REPORT RELEASED YESTERDAY, THE CONGRESSIONAL BUDGET OFFICE (CBO), WHICH IS CHARGED WITH PROVIDING NON-PARTISAN BUDGET ADVICE TO CONGRESS, SAID THAT THE ADMINISTRATION HAD UNDERESTIMATED THE BUDGET DEFICIT FOR FISCAL YEAR 1983 BY SOME DOLLARS 29BN, AND WARNED OF QUOTE CONTINUING LARGE AND GROWING DEFICITS INTO THE FORESEEABLE FUTURE UNQUOTE.

2. THE ECONOMIC FORECASTS OF BOTH THE ADMINISTRATION AND THE CBO ARE IN CLOSE AGREEMENT IN 1982. BUT IN 1983 THE ADMINISTRATION'S FORECAST IS MORE OPTIMISTIC THAN THE CBO'S. THE ADMINISTRATION LOOK FOR REAL GNP TO GROW BY 5.2 PERCENT OVER THE FOUR QUARTERS OF 1983 AND INFLATION (AS MEASURED BY THE GNP DEFLATOR) TO BE 5.5 PERCENT. THE CBO EXPECTS REAL GNP TO GROW BY ABOUT 3.7 PERCENT IN 1983 AND INFLATION TO BE 7.0 PERCENT. THE ADMINISTRATIONS ECONOMIC ASSUMPTIONS FOR 1984 AND BEYOND ARE ALSO MORE OPTIMISTIC THAN THE CBO'S.

3. THE CBO'S ANALYSIS FINDS THAN REVENUES ARE LIKELY TO BE SLIGHTLY LOWER AND OUTLAYS SIGNIFICANTLY HIGHER THAN PROJECTED BY THE ADMINISTRATION. THE REVENUE DIFFERENCES RESULT MAINLY FROM ESTIMATED EFFECTS OF THE ECONOMIC RECOVERY TAX ACT OF 1981. ON THE OUTLAY SIDE, THE MAIN DIFFERENCES ARE IN ESTIMATES OF THE COST OF FARM PRICE SUPPORT, THE RATE OF SPENDING FOR DEFENCE PROCUREMENT, LIKELY RECEIPTS TO BE DERIVED FROM THE PROPOSED ACCELERATED SALE OF OFF-SHORE OIL LEASES, AND NET INTEREST COSTS.

4. THE UPSHOT IS THAT THE CBO ESTIMATES THE BUDGET DEFICIT (ASSUMING THE ADMINISTRATION'S BUDGET MEASURES ARE ENACTED) TO BE DOLLARS 111BN IN FY82, DOLLARS 120BN IN FY83, DOLLARS 129BN IN FY84 AND DOLLARS 140BN IN FY85. THIS COMPARES WITH ADMINISTRATION ESTIMATES OF DOLLARS 98BN IN FY82, DOLLARS 92BN IN FY83, DOLLARS 83BN IN FY84 AND DOLLARS 72BN IN FY85. THE CBO WARN THAT THE BUDGET DEFICIT COULD BE EVEN LARGER, IF TIGHT CREDIT CONDITIONS PRODUCE A WEAKER ECONOMY THAN ASSUMED.

5. EARLIER THIS WEEK, SENATOR DOMENICI (REPUBLICAN CHAIRMAN OF THE SENATE BUDGET COMMITTEE) SAID THAT THE PRESIDENT'S FY83 BUDGET PROPOSALS WOULD NOT PASS CONGRESS IN THEIR CURRENT FORM BECAUSE OF CONGRESSIONAL CONCERN OVER THE SIZE OF PROJECTED DEFICITS. THE CBO REPORT WILL ADD IMPETUS TO CONGRESSIONAL ATTEMPTS TO REDUCE THE DEFICIT. HOUSE MINORITY LEADER MICHEL (REPUBLICAN, ILLINOIS) TOLD REPORTERS YESTERDAY THAT THE BILL TO INCREASE THE DEBT CEILING THAT THE ADMINISTRATION WILL NEED IN APRIL OR MAY CANNOT PASS THE HOUSE IN THIS ELECTION YEAR UNLESS IT IS LINKED

TO A QUOTE BUDGET RESOLUTION THAT INDICATES WE ARE NARROWING THE DEFICIT SOMEWHAT UNQUOTE BELOW THE DOLLARS 92 BILLION FORECAST BY THE PRESIDENT FOR FY83. (THE STATUTORY LIMIT ON THE DEBT CEILING GIVES THE CONGRESS A LEVER TO GET WHAT IT WANTS FROM THE ADMINISTRATION PROVIDED A BIPARTISAN PACKAGE CAN BE PUT TOGETHER.) MICHEL SAID THE WAY TO CUT THE DEFICIT WAS TO TRIM THE PRESIDENT'S PLANNED DEFENCE INCREASES, REDUCE COST OF LIVING INCREASES UNDER CERTAIN ENTITLEMENT PROGRAMMES, AND DEFER THE FINAL ROUND OF THE REAGAN INCOME TAX CUT NOW SCHEDULED FOR JULY 1983. THESE SUGGESTIONS PARALLEL RATHER SIMILAR PROPOSALS PUT FORWARD IN RECENT DAYS BY LEADING SENATE REPUBLICANS, INCLUDING BUDGET CHAIRMAN DOMENICI. IT IS POSSIBLE THAT A BIPARTISAN PACKAGE WILL EMERGE FROM THE SENATE BUT LESS LIKELY THAT ONE WILL EMERGE FROM THE HOUSE OF PREPRESENTATIVES, WHERE THE DEMOCRATS HAVE A MAJORITY.

6. THE ADMINISTRATION HAVE NOT SO FAR REACTED TO THESE DEVELOPMENTS OTHER THAN TO DESCRIBE SENATOR DOMENICI'S PROPOSALS AS QUOTE INTERESTING AND WORTH FURTHER STUDY UNQUOTE. OFFICIALS CONTINUE TO EMPHASISE THE NEED TO PERSEVERE WITH THE PRESIDENT'S ECONOMIC PROGRAMME. THE ADMINISTRATION HAVE BEEN POINTING TO TWO BRIGHT SPOTS - THE RECENT DECLINE IN INTEREST RATES AND THE DECLINE IN THE RATE OF INFLATION, WHICH ROSE BY ONLY 0.3 PERCENT IN JANUARY TO STAND 8.4 PERCENT ABOVE ITS LEVEL OF A YEAR EARLIER.

7. FCO PLEASE PASS TO BOTTRILL (TREASURY) AND WATSON (BANK OF ENGLAND) AND ALL SAVING ADDRESSEES.

FCO PASS SAVING TO ALL SAVING ADDRESSEES.

REPEATED AS REQUESTED

THOMAS

FINANCIAL

NAD

COPIES TO
MR BOTTRILL, TREASURY
MR WATSON, B/ENGLAND

THIS TELEGRAM
WAS NOT
ADVANCED

J.S.A.

GRS 1000 CONFIDENTIAL

CONFIDENTIAL [CULL]

FM WASHINGTON 230040Z FEB 82

TO ROUTINE FCO

TELEGRAM NUMBER 587 OF 22 FEBRUARY 1982.

INFO SAVING TO PARIS BONN UKREP BRUSSELS TOKYO AND OTTAWA.

U S ECONOMY: THE POLITICAL CONTEXT, THE ECONOMIC OUTLOOK AND THE ROLE OF THE FEDERAL RESERVE.

1. THE ECONOMIC OUTLOOK HAS TO BE SEEN IN ITS POLITICAL CONTEXT. THIS WILL NO DOUBT KEEP CHANGING BUT OVER THE LAST TWO WEEKS THERE HAS BEEN SOMETHING APPROACHING A PHONEY WAR ON THE BUDGET. THE PRESIDENT CHALLENGED HIS CONGRESSIONAL CRITICS QUOTE TO PUT UP OR SHUT UP UNQUOTE. A NUMBER OF DEMOCRATS (AND ONE OR TWO REPUBLICANS) HAVE RESPONDED WITH ALTERNATIVE PROPOSALS. BUT STOCKMAN TOOK THE LINE IN CONGRESSIONAL TESTIMONY LAST WEEK THAT NO SERIOUS ALTERNATIVE TO THE ADMINISTRATION'S OWN BUDGET HAD YET BEEN PUT FORWARD. WITH STOCKMAN HIMSELF UNDER FIRE ON THE HILL (SENATOR HELLINGS CALLED HIM A PATHOLOGICAL FINAGLER - AND OTHERS WERE LESS COMPLIMENTARY) AND HIS CREDIBILITY SERIOUSLY IN DOUBT, THE ADMINISTRATION HAVE NO OBVIOUS SPOKESMAN TO WORK THE MAGIC THAT ENABLED REAGAN TO CARRY MUCH OF HIS PROGRAMME LAST YEAR. THEY HOPE THAT WHEN CONGRESS HAS DONE ITS SUMS IT WILL CONCLUDE THAT THERE IS NO VIABLE ALTERNATIVE TO THE REAGAN BUDGET BUT ADMINISTRATION SPOKESMEN ARE ALSO BEING FORCED TO ACKNOWLEDGE PUBLICLY THAT A MESSY FIGHT IS IN PROSPECT. CONGRESSMEN RETURNING FROM LAST WEEK'S RECESS REPORT WHAT THE OPINION POLLS ALSO SHOW - DIMINISHING PUBLIC CONFIDENCE IN THE PRESIDENT'S ECONOMIC PROGRAMME. AGAINST THIS BACKGROUND, SOME OF THE RECENT ECONOMIC FIGURES MAKE FOR PREDICTABLY GLOOMY READING.

2. U S INDUSTRIAL PRODUCTION FELL BY 3 PERCENT IN JANUARY TO STAND 10 PERCENT BELOW ITS LEVEL IN JULY (WHEN THE CURRENT RECESSION BEGAN). THE DECLINE HAS BEEN WIDESPREAD, WITH THE HOUSING AND CAR INDUSTRIES PARTICULARLY HARD HIT. THESE INDUSTRIES, BOTH VERY SENSITIVE TO THE LEVEL OF INTEREST RATES, HAVE BEEN OPERATING AT BELOW 50 PERCENT OF CAPACITY FOR SOME MONTHS.

3. MARKET INTEREST RATES, WHICH FELL SHARPLY IN OCTOBER AND NOVEMBER, HAVE REBOUNDED SINCE THE BEGINNING OF THE YEAR TO A LEVEL 5 PERCENT OR MORE ABOVE THE RATE OF INFLATION. WHILE THIS RISE PARTLY REFLECTS THE REACTION OF THE MARKET TO THE PROSPECT OF HIGHER FEDERAL BUDGET DEFICITS, AND UNCERTAINTIES ABOUT CONGRESSIONAL REACTIONS TO PRESIDENT REAGAN'S BUDGET PROPOSALS, THE SURGE IN THE MAIN MONETARY AGGREGATE (M1) IN JANUARY HAS ALSO EVOKED QUFSTIONS BOTH WHETHER THE FEDERAL RESERVE BOARD'S FUNDAMENTAL STRATEGY IS RIGHT AND WHETHER IN PRACTICE THE FED CAN CONTROL THE GROWTH OF THE MAIN MONETARY AGGREGATES.

4. SUPPLY-SIDERS OUTSIDE THE ADMINISTRATION SUCH AS CONGRESSMAN JACK KEMP HAVE OVER RECENT WEEKS CALLED FOR FED CHAIRMAN VOLCKER'S RESIGNATION, AND (ACCORDING TO A REPORT IN TODAY'S WASHINGTON POST) FOR A FUNDAMENTAL CHANGE IN THE FED'S STRATEGY, SO THAT ITS DISCOUNT RATE WOULD BECOME THE MAIN INSTRUMENT OF MONETARY CONTROL RATHER THAN INFLUENCING THE GROWTH OF THE MAIN MONETARY AGGREGATES AS AT PRESENT BY MEANS OF OPEN-MARKET OPERATIONS AIMED AT CONTROLLING THE GROWTH OF THE RESERVES OF THE COMMERCIAL BANKS. SOLOMON (CHAIRMAN OF THE FEDERAL RESERVE BANK OF NEW YORK) HAS ALSO PUBLICLY CALLED INTO QUESTION THE RELEVANCE OF CONTROLLING SPECIFIC AGGREGATES SUCH AS M1 AND M2 AT A TIME WHEN A RAPID RATE OF FINANCIAL INNOVATION HAS MEANT THAT RECORDED MOVEMENTS IN SPECIFIC AGGREGATES MAY GIVE A MISLEADING INDICATION OF CREDIT CONDITIONS.

5. MOST PRIVATE FORECASTERS NOW CONSIDER THAT THE PROSPECTS FOR THE U S ECONOMY IN 1982 HAVE BECOME GLOOMIER SINCE THE TURN OF THE YEAR. FOR 1982 AS A WHOLE, THEY ARE NOW PROJECTING A FALL OF Ø.7 PERCENT IN REAL ACTIVITY, WHEREAS THREE MONTHS AGO THEY WERE PROJECTING A GROWTH OF Ø.8 PERCENT. THEY ALSO EXPECT THAT THE RECENT PATTERN OF HIGH AND VARIABLE INTEREST RATES IS LIKELY TO CONTINUE DURING 1982. THE PRESIDENT HAS SO FAR GIVEN NO SIGN THAT HE IS PREPARED TO CHANGE THE BUDGET HE ANNOUNCED ON 8 FEBRUARY ENOUGH TO REDUCE THE DEFICITS MUCH BELOW THE PUBLISHED ESTIMATES, AND THEREBY TO TAKE SOME PRESSURE OFF INTEREST RATES.

6. THE PRESIDENT ALSO REJECTED A FUNDAMENTAL CHANGE IN MONETARY STRATEGY, AT HIS PRESS CONFERENCE ON 18 FEBRUARY WHEN HE SUPPORTED THE FED'S POLICIES. BUT CHAIRMAN VOLCKER IS NOW UNDER PRESSURE TO MAKE HIS STRATEGY WORK AND IN PARTICULAR TO GAIN BETTER CONTROL OF WEEK-TO-WEEK FLUCTUATIONS IN THE AGGREGATES. THE MOST RECENT MONEY SUPPLY FIGURES (FOR THE WEEK TO 1Ø FEBRUARY) SHOW A DOLLARS 3.1 BILLION DECLINE, WHICH SHOULD STEM CRITICISM OF THE EARLIER BULGE, AND POSSIBLY ALLOW ENOUGH SCOPE FOR THE FED TO EASE CREDIT CONDITIONS TO PREVENT THE RECENT INCREASE IN SHORT-TERM INTEREST RATES FROM CONTINUING. BUT IF INTEREST RATES CONTINUE TO RISE WHILE THE MONEY SUPPLY MOVES ERRATICALLY, EVEN BUDGET DIRECTOR STOCKMAN MAY HAVE SECOND THOUGHTS ABOUT SUPPORTING VOLCKER WITHIN THE ADMINISTRATION, AND TREASURY SECRETARY REGAN AND CHAIRMAN WEIDENBAUM OF THE COUNCIL OF ECONOMIC ADVISERS ARE LIKELY TO REVERT TO THEIR OPEN CRITICISMS OF ERRATIC MOVEMENTS IN THE MONEY SUPPLY. FOR HIS PART, VOLCKER IS UNLIKELY TO REFRAIN FROM COMMENTING IN PUBLIC THAT FISCAL POLICY IS MAKING AN INSUFFICIENT CONTRIBUTION IN THE FIGHT AGAINST INFLATION. THE PRESIDENT'S WORDS AT HIS PRESS CONFERENCE SHOULD THEREFORE BE REGARDED AS MARKING NOT SO MUCH AN ACCORD WITH THE FED, AS A TEMPORARY AND UNEASY TRUCE WHICH WILL HOLD ONLY SO LONG AS THERE IS NO FURTHER RISE IN INTEREST RATES OR DETERIORATION IN THE ECONOMY.

7. FCO PLEASE PASS TO BATTRILL (TREASURY) AND WATSON (BANK OF ENGLAND).
FCO PASS SAVING TO PARIS BONN UKREP BRUSSELS TOKYO AND OTTAWA.

[NOT ADVANCED]

THOMAS
FINANCIAL
NAD

[REPEATED AS REQUESTED]

COPIES TO
MR BATTRILL TREASURY
MR WATSON BANK OF ENGLAND

GR 500

UNCLASSIFIED
FM WASHINGTON 190105Z FEB 82
TO ROUTINE F C O
TELEGRAM NUMBER 539 OF 18 FEBRUARY

PRESIDENT REAGAN'S PRESS CONFERENCE 18 FEBRUARY: THE ECONOMY.

1. PRESIDENT REAGAN GAVE A PRESS CONFERENCE THIS AFTERNOON. THE PRINCIPAL ISSUE COVERED WAS THE U S ECONOMY. POINTS ON CENTRAL AMERICA, THE MIDDLE EAST AND POLISH DEBT ARE BEING REPORTED IN SEPARATE TELEGRAMS.

2. IN AN OPENING STATEMENT, THE PRESIDENT SAID THAT HE HAD UNDERTAKEN A YEAR AGO, TO CONTROL THE UNCONTROLLABLE IE GOVERNMENT SPENDING WHICH HAD REACHED AN INTOLERABLE AND INCOMPREHENSIBLE LEVEL. AS PART OF THIS TASK HE WOULD NOW ESTABLISH A PRIVATE SECTOR SURVEY ON COST CONTROL IN THE FEDERAL GOVERNMENT. A HIGH-POWERED, INDEPENDENT TEAM WOULD UNDERTAKE AN IN-DEPTH REVIEW OF THE ENTIRE EXECUTUVE PRANCH OF THE FEDERAL GOVERNMENT IN ORDER TO ROOT OUT WASTE AND INEFFICIENCY. THE TEAM WOULD REPORT DIRECT TO THE PRESIDENT AND WOULD BEGIN THEIR REVIEW WITH THE DEPARTEMENTS OF DEFENSE, HEALTH AND HUMAN SERVICES AND HOUSING AND URBAN DEVELOPMENT.

3. REVIEWING HIS ECOMOMIC PROGRAMME, THE PRESIDENT SAID THAT THE U S ECONOMY WAS NOT YET OUT OF THE WOODS BUT WAS HEADING TOWARDS A CLEARING. HE HIMSELF REMAINED CONCERNED AT THE LEVEL OF INTEREST RATES BUT THE ADMINISTRATION AND THE FEDERAL RESERVE BOARD WOULD BE BETTER EQUIPPED TO BRING DOWN INTEREST RATES AND THE RATE OF INFLATION IF THEY WORKED TOGETHER. HE HAD CONFIDENCE IN THE ACCOUNCED POLICIES OF THE FED AND SUPPORTED THE FED'S 1982 MONEY GROWTH TARGETS WHICH WERE FULLY CONSISTENT WITH THE ADMINISTRATION'S ECONOMIC PROJECTIONS FOR THE COMING YEAR. A RESPONSIBLE FISCAL POLICY WAS NEEDED TO COMPLEMENT A FIRM, ANTI-INFLATIONARY MONETARY POLICY. HE WOULD DEVOTE THE RESOURCES OF HIS PRESIDENCY TO KEEPING DEFICITS DOWN. BY PURSING A PRUDENT COURSE OF SOUND FISCAL AND MONETARY POLICIES INFLATION WOULD CONTINUE TO DECLINE, INTEREST RATES WOULF FALL AND THE U S WOULD ONCE AGAIN ENJOY SUSTAINED ECONOMIC GROWTH.

4. ANSWERING QUESTIONS, THE PRESIDENT SAID THAT, WHILE THE ADMINISTRATION WOULD CONTINUE TO TRY TO CLOSE TAX LOOPHOLES, TO ABANDON ITS BASIC TAX CUT POLICY WOULD BE TO GIVE UP A VITAL INGREDIENT IN THE EXPANDING ECONOMY AND IN ADDING TO GOVERNMENT REVENUES WITHOUT PENALISING THE TAX PAYER. IT WOULD BE VERY FOOLISH TO TURN AWAY FROM THE TAX PACKAGE WHICH WOULD BE THE STRONGEST ELEMENT IN AN IMPROVING ECONOMY. SIMILARLY, THE U S COULD NOT BACK AWAY FROM INCREASES IN NATIONAL DEFENCE SPENDING WITHOUT SENDING

/A VERY

A VERY UNWISE MESSAGE WHICH WOULD CAUSE DISMAY TO AMERICA'S ALLIES AND SATISFACTION TO POTENTIAL ADVERSARIES. THE PREISDENT ENDORSED REMARKS MADE BY STOCKMAN IN CONGRESS YESTERDAY TO THE EFFECT THAT WHILE THE ADMINISTRATION WERE PREPARED TO LOOK AT PROPOSED CHANGES IN THE BUDGET, NO SERIOUS ALTERNATIVE HAD YET BEEN PUT FORWARD. THE PRESIDENT BELIEVED THAT HE AND HIS ADVISERS HAD ALREADY LOOKED AT ALL THE AVAILABLE OPTIONS IN DETAIL AND HAD COME UP WITH THE BEST PACKAGE IN THE CIRCUMSTANCES.

5. THE PRESIDENT DECLINED TO ENDORSE EARLIER ADMINISTRATION STATEMENTS LOOKING FORWARD TO ECONOMIC RECOVERY BY LATE SPRING. HE WOULD SAY NO MORE THAN THAT IN THE MONTHS, AND THE YEAR, AHEAD, THE RECESSION WOULD BOTTOM OUT, INTEREST RATES WOULD FALL AND SIGNS OF ECONOMIC RECOVERY WOULD BE APPARENT. HE DENIED THAT HE WAS LESS CONFIDENT NOW THAN HE HAD BEEN A MONTH AGO ABOUT THE PACE OF ECONOMIC RECOVERY, MAINTAINING THAT HE WAS CAUTIOUSLY OPTIMISTIC AND THAT ECONOMIC INDICATORS WERE POINTING IN THE RIGHT DIRECTION.

F C O PASS TO THE TREASURY.

HENDERSON

FCO/WHITEHALL
NAD

NOT ADVANCED

USD

CONFIDENTIAL [CULL]
DESKBY 080900Z
FM WASHINGTON 060039Z FEB 82
TO IMMEDIATE FCO
TELEGRAM NO 385 OF 5 FEBRUARY
AND TO PRIORITY PARIS, BONN, UKDEL NATO, UKREP BRUSSELS,
KUALA LUMPUR (FOR PRIVATE SECRETARY)

UNITED STATES: BUDGET FOR FY83

1. PRESIDENT REAGAN WILL ON MONDAY 8 FEBRUARY PRESENT HIS FY83 BUDGET TO THE CONGRESS. WE HAVE OBTAINED A COPY OF HIS PROPOSALS IN ADVANCE. THESE ARE EMBARGOED UNTIL 12 NOON LOCAL TIME AND SHOULD NOT BE MADE PUBLIC BEFORE THEN. PROJECTIONS FOR THE BUDGET TOTALS AND THE DEFICIT UNTIL 1985 ARE AS FOLLOWS:-

	1982	1983	1984	1985
	(BILLIONS OF DOLLARS)			
RECEIPTS	626.8	666.1	723.0	796.6
OUTLAYS	725.3	757.6	805.9	868.5
DEFICIT	- 98.6	- 91.5	- 82.9	- 71.9

THE BUDGET DOCUMENTS ALSO INDICATE THE SENSITIVITY OF THE DEFICIT PROJECTIONS TO VARIOUS CHANGES IN ECONOMIC ASSUMPTIONS. THIS ANALYSIS INCLUDES, FOR EXAMPLE, A QUOTE HIGHER GROWTH/LOWER INFLATION UNQUOTE SCENARIO WHICH LEADS TO A BALANCE BY 1986, AND A QUOTE LOWER GROWTH/HIGHER INFLATION UNQUOTE SCENARIO WHICH LEADS TO DEFICITS RISING TO DOLLARS 131 BILLION IN THAT YEAR.

2. THE MAIN ECONOMIC ASSUMPTIONS ARE AS FOLLOWS:-
(CALENDAR YEARS)

	1981	1982	1983	1987
NOMINAL GNP (PERCENT INCREASE)	11.3	8.1	11.5	9.0
GNP (CONSTANT 1972) DOLLARS (PERCENT INCREASE)	2.0	0.2	5.2	4.3
CONSUMER PRICE INDEX (PERCENT INCREASE)	10.3	7.3	6.0	4.5
UNEMPLOYMENT RATE (PERCENT)	7.6	8.9	7.9	5.3
INTEREST RATE (91 DAY T.BILL) (PERCENT)	14.1	11.7	10.5	5.5

3. IN TOTAL, DOLLARS 55.9 BILLION IN BUDGET REDUCTION MEASURES ARE PROPOSED FOR FY83, CONSISTING OF DOLLARS 11.7 BILLION IN SAVINGS IN ENTITLEMENTS EXPENDITURE, DOLLARS 2.5 BILLION IN USER FEE INCREASES, DOLLARS 20.3 BILLION IN WHAT ARE DESCRIBED AS QUOTE MANAGEMENT INITIATIVES UNQUOTE, DOLLARS 14.2 BILLION IN SAVINGS ON DISCRETIONARY AND OTHER PROGRAMMES, AND DOLLARS 7.2 BILLION IN REVENUE GAINS FROM TAX REVISIONS. THE PHRASE QUOTE MANAGEMENT INITIATIVES UNQUOTE INCLUDES SUCH ITEMS AS AN AGRESSIVE CAMPAIGN TO COLLECT DELINQUENT DEBTS OWED TO THE FEDERAL GOVERNMENT, A REDUCTION OF A FURTHER 75,000 CIVIL FEDERAL EMPLOYEES IN THE PERIOD 1985-87 AND RESTRAINT ON THEIR PAY INCREASES, THE SALE OF FEDERAL PROPERTY, THE ACCELERATION OF LEASING ON THE OUTER CONTINENTAL SHELF, AND IMPROVED TAX COLLECTION AND ENFORCEMENT.

4. REDUCTIONS IN MEDICAL ENTITLEMENTS ACCOUNTS FOR DOLLARS 5.1 BILLION OF THE ENTITLEMENTS SAVINGS OF DOLLARS 11.7 BILLION, AND REDUCTIONS IN CASH ASSISTANCE AND NUTRITION ANOTHER DOLLARS 4.6 BILLION. THE DOLLARS 14.2 BILLION OF SAVINGS IN DISCRETIONARY PROGRAMMES ARE WIDELY SCATTERED.

5. THE TOTAL OBLIGATIONAL AUTHORITY FOR DEFENCE SPENDING IS EXPECTED TO BE DOLLARS 258 BILLION IN FY83 AND DEFENCE OUTLAYS OF DOLLARS 215.9 BILLION ARE PROPOSED. THE AVERAGE ANNUAL REAL INCREASE IN DEFENSE SPENDING FROM 1981 TO 1987 IS PUT AT 7.9 PER CENT, ENTITLEMENT EXPENDITURE 1.5 PER CENT AND OTHER CIVIL PROGRAMMES MINUS 7.6 PER CENT.

6. ON FIRST SIGHT IT APPEARS THAT THE ADMINISTRATION IS RELYING ON THE SUCCESS OF MANAGEMENT INITIATIVES FOR A SUBSTANTIAL PART OF THE SUCCESS OF ITS FY83 BUDGET STRATEGY. THIS TACTIC COULD BE INTENDED TO AVOID HAVING TO OBTAIN SPECIFIC LEGISLATION, WHICH WOULD NEED CONGRESSIONAL APPROVAL IN ORDER TO ACHIEVE CUTS IN EXPENDITURE. IT COULD ALSO MEAN THAT THE BOTTOM OF THE BARREL HAS BEEN REACHED IN CANVASSING FOR CANDIDATES FOR POLICY CUTS FROM SPENDING DEPARTMENTS.

7. RECENT PRESS COMMENT HAS REMAINED SCEPTICAL ABOUT WHETHER PRESIDENT REAGAN'S FY83 BUDGET PROPOSALS, AS OUTLINED BY THE PRESIDENT IN HIS STATE OF THE UNION ADDRESS ON 26 JANUARY, WILL BE SUFFICIENT TO RELIEVE THE PRESSURES ON FINANCIAL MARKETS AND

INTEREST RATES ARISING FROM HIGH FEDERAL BUDGET DEFICITS. THERE IS ALSO DOUBT ABOUT WHETHER ALL THE FY83 BUDGET PROPOSALS WILL GET AS SMOOTH A RIDE IN CONGRESS AS THOSE FOR FY82, ESPECIALLY THOSE FOR REDUCING PUBLIC EXPENDITURE ON ENTITLEMENT PROGRAMMES. REAGAN'S PROPOSALS FOR A NET TRANSFER OF FUNCTIONS FROM THE FEDERAL GOVERNMENT TO THE INDIVIDUAL STATES HAS SO FAR FAILED TO DIVERT ATTENTION FROM THE BASIC CONDITION OF THE US ECONOMY, WITH UNEMPLOYMENT AT 8.5 PERCENT AND INTEREST RATES REMAINING PERSISTENTLY HIGH. COMMENTATORS MAY ALSO FOCUS ATTENTION ON THE LESS ATTRACTIVE SCENARIOS MENTIONED IN PARAGRAPH 1 ABOVE AS WELL AS ON THE ADMINISTRATION'S CENTRAL PROJECTIONS.

8. FURTHER COMMENTS ON THE FY83 BUDGET AND AN ASSESSMENT OF INITIAL CONGRESSIONAL AND MEDIA REACTIONS WILL FOLLOW BY SEPARATE TELEGRAM.

9. FCO PLEASE ADVANCE TO PS/SIR KENNETH COUZENS AND BOTTRILL (TREASURY), AND WATSON (BANK OF ENGLAND).

HENDERSON

FINANCIAL
NAD

[ADVANCED AS REQUESTED]

CONFIDENTIAL

Prime Minister ②

USA

MLS 5/2

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

5 February 1982

B J P Fall Esq.
Foreign and Commonwealth Office

MS

Dear Brian,

US ECONOMIC POLICY AND THE ALLIANCE

The Chancellor has seen your Secretary of State's minute of 27 January, and accepts that it would be better not to pursue immediately Chancellor Schmidt's suggestion that the Prime Minister should send a message to President Reagan about US economic policy and interest rates.

However, as the Chancellor mentioned in Cabinet yesterday, the prospect for US interest rates is a matter for continuing concern: President Reagan's State of the Union message represented in this context a significant disappointment. The Chancellor's conclusion is that it is essential to keep up a steady pressure on the US authorities. Secretary Regan had sent a letter about the State of the Union Message: replying to him provided a natural opportunity for the Chancellor to set out our concerns in some detail. I attach a copy of the letter which he has accordingly sent.

I am copying this letter and the attachment to Michael Scholar at No. 10 and to Tim Allen at the Bank.

Yours ever,

John Kerr

J.O. KERR
Principal Private Secretary

5 FEB 1982

Treasury Chambers, Parliament Street, SW1P
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

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
CC(82) 4th Conclusions, minute 2	4.2.82

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed OWayland Date 1 November 2012

PREM Records Team

USA

Ref. A07319

PRIME MINISTER

Cabinet

I understand that the Chancellor of the Exchequer thinks that it might be helpful if at tomorrow's Cabinet he were to give his colleagues a short explanation of the present state of play on US interest rates. The decision of some of the large US banks to increase their prime rates to $16\frac{1}{2}$ per cent seems to have provoked a crisis between the Federal Reserve and the White House with the Administration seeking to imply that the increase should only be a temporary phenomenon and the Federal Reserve implying that the Government's high budget deficit is to blame.

2. The Chancellor only wishes to speak briefly, and I would suggest that you might ask him to do so as part of the Foreign Affairs item.

RtA

ROBERT ARMSTRONG

3 February 1982

Prime Minister

USA ②

A. J. C. 27/1

FCS/82/20

CHANCELLOR OF THE EXCHEQUER

US Economic Policy and the Alliance

1. I share the anxiety you express in your letter of 22 January on this subject. American economic policies are putting an increasing strain on relations between the United States and Europe. This makes it much more difficult to deal with other transatlantic pressures, for example over Poland or the Middle East.

2. I agree too that we should convey our worries to the Americans through a variety of channels. You are the best placed to argue the case with authority and I am sure you did so at the last meeting of the G5. The preparation for the Versailles Economic Summit, which will get underway next month, would provide further opportunities. As you know, I myself shall be away in South-East Asia until mid-February. But on my return, I will do what I can to help. I should say, however, that I am not sure that I would be able to help very much by raising the question with Al Haig. In talking about these problems his background is very much strategic rather than economic and I doubt whether he has much influence on economic policy. I should also have to be very careful to avoid any suggestion that we disapprove of the increase in American defence spending; this could only have an adverse effect on him.

3. You raised the question of a message from the Prime Minister to President Reagan on this subject as a possibility, after he has given his State of the Union speech. I agree that this is an idea worth considering very seriously. But both the timing and the presentation would need to be handled very carefully. The Americans seem to me more than usually sensitive at the moment to any sort of criticism from their European allies, however expressed. I would prefer to wait and see how we emerge from the next few weeks exchanges with the Americans over Poland before we tackle them at the highest level over economic policy.

4. I am copying this to the Prime Minister.

C

Foreign and Commonwealth Office (CARRINGTON)

27 January 1982

27 JAN 1982

CONFIDENTIAL

USA cc AN

(2)

Prime Minister

Timely for Thursday's Cabinet.

MCS 26/1

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

PRIME MINISTER

M.T

US INTEREST RATES

On 8 October last I minuted you and other Cabinet colleagues about the implications of US budgetary and interest rate policy for our own fiscal and monetary policies. American policy will continue to have major implications for our own situation, especially for our interest rates and exchange rate throughout 1982. Colleagues may like to have an up-to-date assessment of the position in the light of my recent meetings with other Finance Ministers and Central Bank Governors.

2. During much of 1981 we were able to shield British industry from the full impact of high US interest rates. Fiscal restraint in the 1981 Budget contributed substantially to this. Taking 1981 as a whole our interest rates fell relative to US rates: our average for the year was 3 per cent below US rates whereas in 1980 it was 2½ per cent above them.

3. Although US interest rates fell in October and November as the US economy moved into recession, they have already gone up again, and there is now a widely held fear that they will rise further later in the year. The main reason for this fear is the large emerging US budget deficit. If a recovery of the US economy late in 1982 coincided with the need to fund a sharply growing deficit, interest rates could hardly fall and might rise again. In the 1981 US fiscal year, which ended on 30 September last, the budget deficit was $55/60 billion. The original forecast for fiscal 1982 (ending 30 September 1982) was $43 billion, but the latest forecast is over $100 billion. For 1983 and 1984 still higher figures are forecast. This prospect may be improved

/by President Reagan's

by President Reagan's State of the Union message expected on 26 January; or by some later budget statement. But a great deal would have to be done (and major congressional battles fought and won) greatly to change the thrust and direction of this deficit.

4. The implications of this for interest rates in the UK and in Europe generally are not attractive. In recent discussions with members of the US Administration I have, as you know, urged that every effort be made to reduce the deficit, and have reminded them of the potential impact on European economies. It is possible that the impact of the US deficit on US and therefore European interest rates could be reduced, e.g. by continued recession in the US. But continued US recession would itself be damaging to the European economies.

5. The progress we have already made with our own public deficit and with our inflation has improved our ability to withstand risks like those which the US situation may produce. However I think the existence of these external risks to our interest rates and exchange rate do have a very real bearing on our discussion on 28 January about our own budget.

6. I am copying this minute to our Cabinet colleagues and to Sir Robert Armstrong.

G.H.

26 January 1982

CONFIDENTIAL

Prime Minister

I doubt if Haig will be effective on this subject.

2. A message to President Reagan after the State of the Union speech may be too late if he commits himself in it on the size of the budget deficit etc. But it is now too close for you to influence its contents.

3. If you want to send a message to Reagan we ought to explore the timing more carefully. Agree that I should pursue this?

A.J.C. 22/1

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

Let us first see what the State of the Union Speech contains.
MT

22 January 1982

The Rt. Hon. The Lord Carrington, KCMG MC
Secretary of State for Foreign and
Commonwealth Affairs

Dear Peter

US ECONOMIC POLICY AND THE ALLIANCE

I know you are well aware that the way in which the United States conducts its economic policy has important political as well as economic implications for the Alliance, and particularly for relations between the US and Europe. I believe it is of great importance to the free world that the US should bring its inflation under control and that the dollar, which is the international currency of the free world, should enjoy strength and stability. It is probably inevitable that achieving this will impose some burdens on the rest of us as well as on the US itself. The US economy is too large a part of the free world to avoid that. But while accepting this and supporting the objective of US policy, I believe we are entitled to ask our American friends to apply a balance of policies which avoids throwing an undue part of the burden of American adjustment on other members of the Alliance; and which also avoids imposing burdens in ways which are both obvious, and which suggest indifference to their interests.

Present US policy looks like leading to levels of budget deficit which are either not at all compatible with moderate interest rates, or are compatible only while the US economy is in recession. There is a reluctance to pay for greatly increased defence expenditure by increased taxation when it becomes apparent that even substantial expenditure cuts elsewhere are not enough to finance it. This threatens the counter inflation programme itself: it was after all the failure to pay for defence expenditure by increased taxation in the 1960s which contributed to dollar depreciation and the end of the Bretton Woods exchange rate system. More immediately it leads to high interest rates and the prospect that they may continue.

/This in turn

This in turn has imposed on Europe in a direct and striking way a choice between similar high interest rates and currency depreciation. Germany faced this choice most acutely in February last; we faced it in September. The United States, for reasons which are understandable, has not wished to vary its monetary or exchange rate policy in response to European representations. Some of our partners have been quick to see this reaction as uncaring. And anti-Americanism in Europe is provided with a ready-made grievance which it can exploit. The French Finance Minister Delors stressed this point in discussion with me early this week.

As you know, I have, with other Community Finance Ministers, taken every opportunity since last summer to urge on American colleagues the need to reduce the growing budget deficit, if necesssary by increasing taxation.

The deficit outturn for the US fiscal year 1981, which ended on 30 September last, was $55/60 billion. The original forecast for fiscal 1982 (ending 30 September 1982) was $/43 billion. The latest forecast is for an outturn over $100 billion, with even higher deficits in fiscal 1983 and 1984. These figures may be improved somewhat if new measures are included in President Reagan's State of the Union message next week; or in a subsequent statement about the budget. However, a great deal would have to be done to alter the direction of the deficit.

You may have seen that Chancellor Schmidt recently suggested to the Prime Minister that she might send a message to the President on this subject, and the Prime Minister may wish to consider that when the State of the Union speech is available; we are rather too near that speech to approach him now. However, given the political implications of a policy which could lead to sustained or recurrent high US interest rates, I hope that you would feel able, as opportunity offers, to represent to Secretary Haig and other American friends that everything possible should be done to reduce the emerging deficits. We may find that sustained discreet pressure from as many quarters as possible is needed to achieve a better outcome.

I am sending a copy of this letter to the Prime Minister.

GEOFFREY HOWE

CONFIDENTIAL
FM WASHINGTON 180230Z
TO ROUTINE F C O
TELNO 3848 OF 17 DECEMBER 1981,
INFO PARIS, BONN, TOKYO, ROME, OTTAWA, UKDEL OECD, UKREP BRUSSELS.

THE US RECESSION AND PRESIDENT REAGAN'S ECONOMIC RECOVERY PROGRAMME.

1. THE US ECONOMY IS NOW RECOGNISED TO BE IN RECESSION. IN NOVEMBER INDUSTRIAL PRODUCTION DECLINED BY 2.1%, THE FOURTH SUCCESSIVE MONTHLY DROP. THE RECESSION IS UNDOUBTEDLY AFFECTING THE CREDIBILITY OF PRESIDENT REAGAN'S MEASURES TO STRENGTHEN THE ECONOMY BY REDUCING THE ROLE OF THE FEDERAL GOVERNMENT. WHATEVER THE LONG-TERM MERITS OF THE ADMINISTRATION'S POLICIES, IT BECAME INCREASINGLY EVIDENT DURING THE LAST WEEKS OF THE 1981 CONGRESSIONAL SESSION THAT EXPENDITURE CUTS ARE BECOMING PROGRESSIVELY MORE DIFFICULT FOR THE CONGRESS TO SWALLOW. THE MAIN FACTOR IS THE PRESENT LEVEL OF UNEMPLOYMENT OF 8.4%, WHICH IS SPREAD UNEVENLY BETWEEN LOCALITIES AND RACIAL GROUPS. WHEN THE OFFICIAL FORECASTS OF PROSPECTIVE BUDGET DEFICITS RANGING FROM DOLLARS 100 BILLION TO DOLLARS 163 BILLION FOR FY82-FY84 WERE LEAKED, UPWARD PRESSURE ON US INTEREST RATES WAS AGAIN EVIDENT, REVERSING THE DECLINE THAT BEGAN IN THE SUMMER. THIS COMBINED WITH EVENTS IN POLAND, HAS ALSO INCREASED THE EXTERNAL VALUE OF THE DOLLAR. THE UNDERLYING RATE OF INFLATION IS DECLINING AND IS EXPECTED TO CONTINUE TO DECLINE NEXT YEAR, BUT THE LATEST PUBLISHED LEVEL OF THE CONSUMER PRICE INDEX (10.2% IN OCTOBER OVER OCTOBER OF LAST YEAR) IS STILL HIGH ENOUGH BY HISTORICAL US STANDARDS TO KEEP IT IN THE PUBLIC CONSCIOUSNESS.

2. THE RECESSION STARTED IN THE CAR AND HOUSING INDUSTRIES AND HAS SPREAD FROM THOSE AREAS TO THE REST OF THE ECONOMY. CAR PRODUCTION IS AT A VERY LOW LEVEL, WITH NOVEMBER SALES ABOUT 18% BELOW EVEN THE DEPRESSED LEVEL OF NOVEMBER 1980. CAR IMPORTS ARE NOW REGULARLY CAPTURING ABOUT 25 TO 30 PERCENT OF THE DOMESTIC MARKET. HOUSING STARTS IN 1981 WILL PROBABLY BE AT THE LOWEST LEVEL SINCE 1959 WHEN STATISTICS BEGAN TO BE RECORDED. WHILE INTEREST RATES HAVE COME DOWN, THEY HAVE NOT DONE SO SUFFICIENTLY TO MAKE MORTGAGES (NOW TYPICALLY AT 16%) ATTRACTIVE TO HOME BUYERS OR TO ALLEVIATE THE VERY SERIOUS SOLVENCY PROBLEMS OF THE SAVINGS AND LOAN ASSOCIATIONS.

3. THE REACTION OF THE ADMINISTRATION TO THESE RECENT UNFAVOURABLE ECONOMIC DEVELOPMENTS HAS BEEN TO CLAIM THAT THEY DID NOT FORESEE THE SEVERITY OF THE PRESENT RECESSION OF THE DEGREE TO WHICH HIGH INTEREST RATES HAVE BECOME ENTRENCHED BECAUSE OF THE POLICIES OF THE PREVIOUS ADMINISTRATION. AT HIS PRESS CONFERENCE ON 17 DECEMBER, PRESIDENT REAGAN DECLARED HIMSELF OPPOSED TO TAX INCREASES

/AND

AND EVEN TO ''IRRESPONSIBLE'' EXPENDITURE REDUCTIONS, AND DID NOT COMMIT HIMSELF TO BALANCING THE FEDERAL BUDGET BY ANY SPECIFIC DATE. THERE IS THEREFORE LITTLE HOPE THAT THE COUNTER-INFLATIONARY BURDEN OF MONETARY POLICY WILL BE TRANSFERRED IN ANY SIGNIFICANT DEGREE TO FISCAL POLICY. IF THE US ECONOMY EXPANDS AGAIN AS EXPECTED IN THE SECOND HALF OF 1982, THERE IS THE OBVIOUS RISK THAT EXTREMELY HIGH INTEREST RATES WILL RE-EMERGE.

4. PROSPECTS FOR GROWTH IN 1982 ARE FOR A RISE IN REAL GNP OF 1% OR LESS. THE REPUBLICAN PARTY IS EVIDENTLY RELYING ON THE PROSPECT OF SHARPLY INCREASED GROWTH AFTER MID-1982 TO RETRIEVE THE SITUATION AND THEY ALSO DOUBTLESS HOPE FOR A CONTINUING DECLINE IN THE RATE OF INFLATION AND INTEREST RATES. BUT IF THE ADMINISTRATION CONTINUE THEIR PLANS FOR NO INCREASES IN TAXATION, HIGH DEFENCE EXPENDITURE, AND ONLY MODERATE REDUCTIONS IN EXPENDITURE ON CIVIL PROGRAMMES, THEIR STRATEGY IS CLEARLY A RISKY ONE. IT APPEARS TO BE BASED ON THE ASSUMPTION THAT HIGH INTEREST RATES WILL NOT RE-EMERGE IN TIME FOR THE RECOVERY TO BE CHOKED OFF, AN ASSUMPTION WHICH IS BY NO MEANS SELF-EVIDENT.

HENDERSON

FCO|WH
NAD

THIS TELEGRAM
WAS NOT
ADVANCED

USA

US INTEREST RATES: EFFECT ON UK ECONOMY

Factual

(i) UK short-term interest rates were below US rates from last November until September this year. For some time (in spring/early summer) they were 4-5 percantage points below US rates (see attached graph).

(ii) In September UK rates rose sharply; weakness of sterling and rapid pace of bank lending were the principal factors.

(iii) Between end-September and end-November US rates fell by about around five percentage points, as depth of US recession became apparent (see graph). UK rates also fell, but by less. In the light of the continued rapid growth of bank lending, cautious conduct of domestic monetary policy argued against a more rapid fall in rates.

(iv) In December US rates have firmed, in part because markets have begun to show renewed concern about the Federal borrowing requirement. UK market rates have also firmed, by about 1 percentage point since mid-November. On 17 December one US bank raised its prime rate by $\frac{1}{4}$ per cent, reversing the downward trend of recent weeks. But so far no further increase in UK base rates (which stand at 14$\frac{1}{2}$ per cent compared with October peak of 16 per cent).

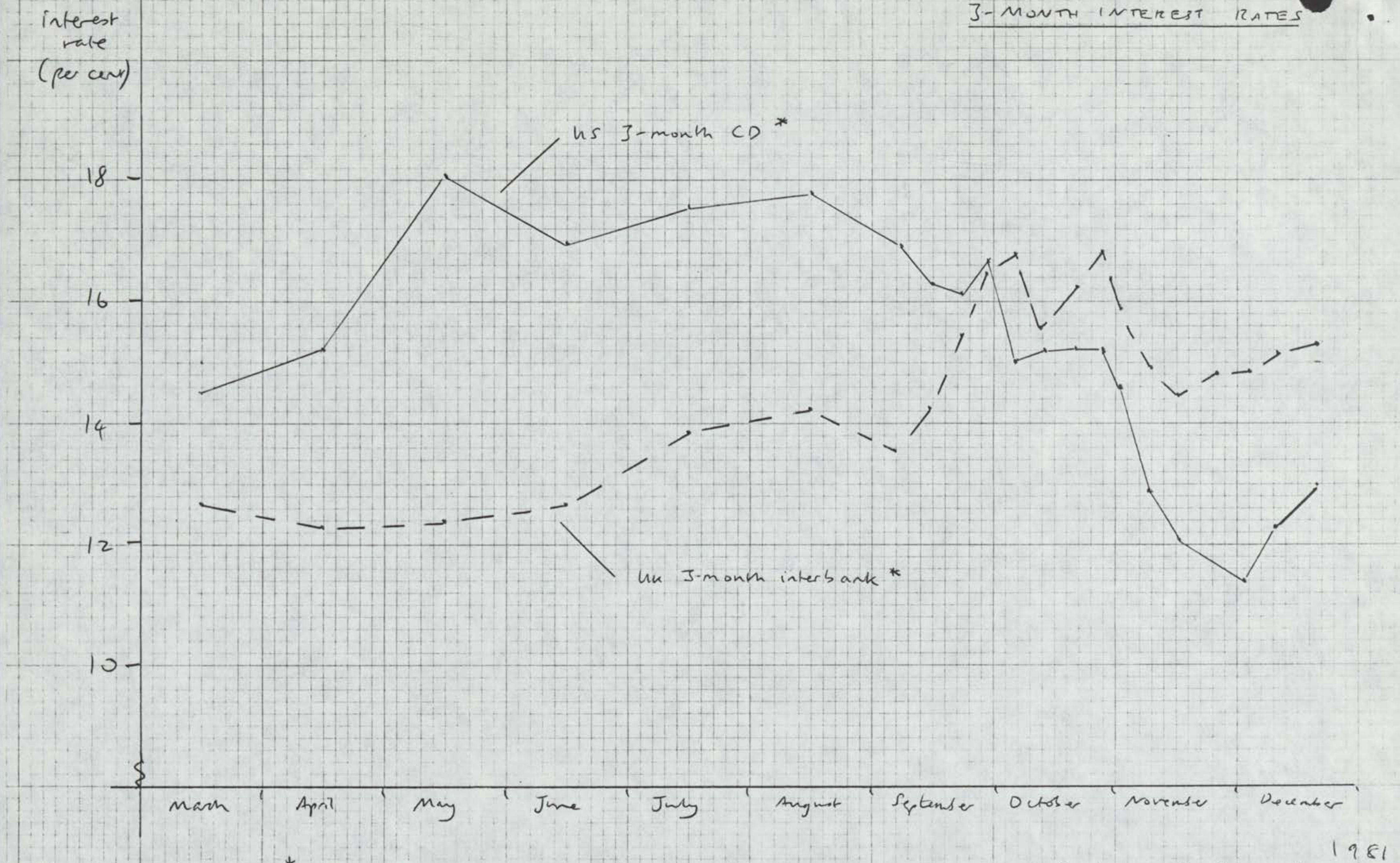
Line to take

(i) UK rates were pulled up by US rates?
Stress that there is no automatic relationship between UK and US rates. For a large part of the year UK rates were little affected by rising US rates. In September UK rates rose sharply, in part as a result of the weakness of sterling and in part as a result of the acceleration in bank lending. Both posed a dangerous inflationary threat.

(ii) Why have UK rates not fallen as far as US rates?
/No automatic relationship between UK and US rates/.
Can not answer for US Administration's interest rate policy. But a more rapid fall in UK rates would have been inconsistent with our domestic monetary objectives - the maintenance of steady but not excessive downward pressure on monetary growth and inflation.

(iii) Join EMS exchange rate mechanism in order to insulate UK rates from swings in US rates?
Will participate when the time is right for ourselves and the system. But EMS participation would not insulate us from external pressures. Other EMS members were not insulated from effects of high US interest rates which put pressure on EMS band as a whole. /If asked about idea of a "ring fence" of exchange controls around Europe, to insulate from US interest rate movements: this is impracticable and would not succeed. Exchange controls did not avert the sterling crisis of 1976./

MOVEMENTS IN UK AND US
3-MONTH INTEREST RATES



*Note: The US 3-month Certificate of Deposit rate is considered to be the most representative 3-month rate. The US has no rate precisely equivalent to the UK 3-month interbank rate.

E.R.

Prime Minister

Some background briefing on the US economy

UK AND EC VIEWS ON US ECONOMIC POLICY

1. - The considerable decline of US short-term interest rates and the US dollar since their summer peak has led most EC governments to take a more relaxed view of UK economic policy.

2. At their informal meeting at Lancaster House on 30-31 October, the consensus among EC Finance Ministers favoured intervention by the US authorities in the foreign exchange market to smooth fluctuations but no one expressed a wish to see massive intervention against market forces*.

3. There is general recognition among Community governments of the importance of the US bringing down the rate of inflation, but there is less than complete confidence that this can be achieved with present policies. Scepticism has centred on the US Administration forecasts of GNP growth and reduction in the federal deficit. On both matters the US Administration's view has moved towards that of Europe.

* <u>Confidential - not to be used</u>
The US Treasury Secretary had earlier sent messages to some Finance Ministers which implied that he stood ready to intervene if events in Poland caused markets suddenly to lose confidence.

ECONOMY : RECENT DEVELOPMENTS

Federal expenditure: At his 10 November press conference Presdient Reagan reaffirmed his broad economic strategy but deferred his request for Congress to ait on his September proposals for reduction in planned expenditure on entitlement programmes by $2.6bn and to enhance revenues by $3bn in FY 82, until January of next year. When the Democratic leaders of Congress tried on 24 November to defy him over the other $8.4bn cuts he called for in September the President faced them down and many Democratic Congressmen deserted their leaders to vote for lower expenditure; the outcome will force Congressto face the issue again in mid-December.

2. The President has said he remains committed to the goal of a balanced budget but that he no longer regards it as likely that this will be achieved by FY 84.

3. Real GNP declined in the second and third quarters and recent indications suggest a further steeper fall is coming in the fourth quarter.

4. The balance on external account has deteriorated as a result of the strong dollar. The effective exchange rate of the dollar has however declined almost 9½ per cent since August.

5. Short-term interest rates continue their decline: three-month Treasury bills are now at 10.29 per cent compared to their peak of 16.4 per cent and on 24 November Chase Manhattan took the lead in the downward movement of prime rates by cutting its rate to 15¾ per cent. Other banks were expected to follow. Reflecting fears of a reversal of this decline, rates on longer-term borrowing are now higher than on short-term.

6. Consumer prices rose only 0.4 per cent in October compared to substantially higher rises in preceding months.

7. Unemployment rose to 8 per cent in October.

BULL POINTS <u>As at 30.11.81</u> (Tape 455)

(i) Evidence that the fall in output is now over

- Total output (GDP) rose by ¼ per cent in 3Q according to preliminary estimates.

- Industrial and manufacturing output increased ¾ and 1½ per cent respectively between 2Q and 3Q.

- Short time working in manufacturing fallen to ¼ of January peak; total hours worked have stabilised.

- 3Q figures for manunfacturing, distribution and wholesalers show rate of destrocking reduced by well over half compared with 1H 1981.

- Volume of engineering and construction orders this year up about 20 and 10 per cent respectively on 2H 1980.

- Private sector housing starts up over 40 per cent in year to 3Q 1981.

- Most recent major independent forecasts (LBS, St James, NIESR, P&D, CBI) assess low point in activity reached in 1H 1981; prospect of some recovery in coming year.

(ii) <u>Earnings and settlements.</u> Increases halved in 1980-81 pay round. <u>CBI pay data bank</u> shows manufacturing settlements in 1980-81 averaging 8-9 per cent, with about two-thirds in single figures. Public sector in line.

(iii) <u>Productivity</u>. Indications that productivity increasing. Output per head in manufacturing in 1981 2Q almost 6 per cent higher than in 1980 4Q. Investment in plant and machinery holding up.

(iv) <u>Competitiveness</u>. Pay moderation and increases in productivity have led to very little rise in manufacturers' unit wage costs this year. Combined with exchange rate fall implies a recovery in UK competitiveness (up some 10 per cent this year) and alleviation in intensity of squeeze on profit margins.

(v) <u>Unemployment</u>. Rate of increase in unemployment in 3 months to November less than half that of the last quarter of 1980. [NB some commentators conclude that trend is now accelerating.] Some increase in number of <u>vacancies</u> over recent months. Short-time working in manufacturing sharply cut - just ¼ of January level in September. <u>Overtime working</u> has increased by 10 per cent in 3 months to September over previous 3 months. Total <u>hours worked</u> in manufacturing have now broadly stabilised.

(vi) <u>Special employment measures</u>. In July Government announced further provision for special measures, worth (gross) £700 million in 1981-82. A large part of this was for young people, including the new Young Workers Scheme. Special employment and training measures currently cover 700,000 people at a cost of over £1100 million this year.

(vii) Industrial relations. Number of stoppages over period since July 1980 lowest in any comparable period since 1940s.

(viii) Retail prices. Inflation almost halved since peak in second quarter of last year. 12 monthly increase in October of 11.7 per cent. [NB Progress will for a while remain affected by lower exchange rate and higher interest rates.] UK's now much closer to average year-on-year consumer price inflation in major competitors (around 10¾ per cent).

(ix) Public sector borrowing. Underlying position in line with Budget time forecast for 1981-82.

(x) International consensus that control of monetary aggregates and public expenditure essential to curb inflation, improve 'supply side' and lay foundations for renewed, sustainable growth. US, Canada and Germany have announced lower monetary targets for this year than last. Most major countries (US, Japan, Italy, Germany, Netherlands, Sweden, Norway and Australia) have recently announced measures to cut planned public spending.

(xi) Loan Guarantee Scheme. Off to a very good start. Nearly 1200 guarantees issued so far on loans totalling over £41 million. Over half of loans going to new businesses.

(xii) Enterprise Zones. 10 out of 11 zones already in operation. Much interest shown; eg announced that at Dudley new high technology project will provide 300 jobs by 1985. At Corby, a good proportion of sites already allocated for development and on designation day 32 factories were already under construction. At Clydebank, 45 companies with potential for 600 new jobs have either moved in or are expanding existing operations.

(xiii) British export successes. September trade figures show that exports holding up better than many feared. Specific successes reported in the Press include: STC has won contract worth £170 million for telephone cable across Pacific from Australia to Canada: Davy Corporation have won £330 million contract for steel plate mill in Mexico and are in lead in international consortium to build £1250 million steelworks in India; Foster Wheeler working on £140 million petro-chemical complex in Greece.

(xiv) Locations in Britain selected by international companies. Texas Instruments, Hewlett Packard and Motorola and demonstrating confidence in Britain by selecting sites in UK for expanding their operations.

Economic Briefing Division, HM Treasury, 01-233 3364/5809

PROSPECTS FOR EC DEVELOPMENT

Points to make

1. Constant well-publicised arguments in Community tend to distract attention from underlying common purpose of free, democratic Europe, towards which steady progress is being made.

2. European Council last week tackled the most difficult issues of reform - CAP and budget. No overall agreement possible, but even so much progress made, and an excellent atmosphere. Essence of Community is achieving compromises which reconcile different national interests.

3. [If asked] Difference in political philosophy between Governments in Member States not necessary. Our obstacle to Community development: e.g. French Socialist Government has stressed need to tackle economic and social problems at a Community level.

Copy to Alan Walters.

Prime Minister

USA 2

CONFIDENTIAL

You may be interested to read this note by Terry Burns on his recent visit to the US.

MCS 19/10

VISIT TO UNITED STATES: 21-30 SEPTEMBER 1981

1. I spent 4 days in Washington prior to the World Bank/IMF meetings. I gave two speeches, one to the National Economists Club (September 22) and one to the National Association of Business Economists (September 24). With Mr Dow I saw a variety of people in Washington (list attached). I was also present when the Chancellor met Mr Stockman and Mr Regan.

2. I was impressed by the degree of uncertainty about the reasons for recent developments and the prospects for the future. Not surprisingly, the failure of almost everyone to predict recent events has left analysts struggling to produce explanations for recent levels of interest rates. Sharp differences of view still exist but I sensed a greater degree of humility in some quarters than earlier reports have indicated.

3. Although there are differences of view within Washington and within the Administration the sharpest differences are between Wall Street and Washington. The bankers at the lunch given by Mr Anson were very pessimistic and showed a substantial lack of confidence in the Administration's policies. At the same time several members of the Administration are blaming higher interest rates upon the short sighted view and lack of sophistication of Wall Street and the press.

Underlying Position

4. The underlying growth potential of the US economy appears to be reasonably high. This is the major difference between the US and the UK. The demands that are being made on the economy for defense expenditure, energy investment, and high technology are important. So is the ability of the economy to begin to adjust itself towards these new demands and the changed pattern of relative prices following the oil price shock. This underlying strength of the economy is

possibly responsible for the strong underlying demand for credit. In the absence of monetary restraint some observers were speaking of a potential growth rate of up to 4% per annum.

5. At the same time the US faces a persistent inflation problem. The upward trend of inflation is becoming strongly entrenched with each cycle. So far this acceleration has not been anything like as serious as in the UK although in part this may reflect the sluggish behaviour of US wages. However, the opposite side of this coin is that the same sluggishness of wage response could make it that much more difficult to get inflation down again. Recently US inflation has been improved by lower energy and food prices - possibly reflecting a stronger exchange rate although it has not been recognised as such. Excluding cyclical influences, the underlying US inflation rate is probably about 10%.

6. The combination of 4% potential growth and 10% underlying inflation points to a growth of nominal GDP of up to 14% per annum in the absence of monetary restraint. The implication of the monetary targets and the Administration's overall strategy is that this needs to be brought back to about 10% per annum.

7. Two major issues emerge from this. The first is the appropriate fiscal/monetary balance. What should be the relative balance of fiscal and monetary policy in bringing about this deceleration of nominal GDP; what part should be played by the federal deficit and what part by higher interest rates? The second issue is whether this deceleration of nominal GDP inevitably implies a recession. Alternatively is it possible that the tax cuts can simultaneously stimulate output and reduce inflation within a profile of lower nominal GDP growth?

Fiscal Policy

8. There is a broad consensus that fiscal policy - at least from FY82 - would be expansionary. Instead of contributing to a reduced growth of nominal GDP, on present plans fiscal policy will

be a force for some expansion. For FY 1984 the combination of tax cuts and defense and social security commitments were generally thought to be inconsistent with the objective of a balanced budget. There are a number of ways in which the picture might change. Despite the tax bill there could be a postponement of some of the reductions. In addition a VAT, an oil import fee and a natural gas windfall profits tax were mentioned as possible starters. Political pressures are likely to prevent any such innovations before the 1982 election. The recent abortive attempt to cut social security spending is disappointing from the point of view of longer term public expenditure control and there seems little desire to raise this again quickly.

9. In the short run the US budget deficit is being increased much as ours was in 1980-81 by changed economic assumptions. Lower oil and food prices have damaged tax collection and increased farm price support. With some programmes additional numbers claiming benefit have more than offset earlier cuts in the benefit rate, and it is difficult to prevent agents exploiting cheap lines of credit or credit guarantees as economic pressure increase.

Monetary Policy

10. This fiscal stance means that monetary policy has to bear a large part of the burden of reducing the growth of nominal GDP. The resulting pressure on velocity implies high real interest rates. This seems to be at the heart of the concern of the financial markets who see it as a conflict of demand for credit between the private and public sectors.

11. It is difficult to judge the level of nominal interest rates that this implies. Already housing, autos and some small businesses are in trouble as a result of the high interest rates. But some parts of the economy are relatively immune. If deflation is to come entirely from monetary policy it could mean a severely unbalanced economy.

12. Whether this pressure on velocity can wholly account for the continuing high level of interest rates is an unresolved matter. Based on broadly the same information as is available now few analysts expected present interest rates to continue. There was some discussion of unusually high risk premiums being necessary because of uncertainty about the continuation of present policies and whether inflation can be brought down; but much of it merely reflects an absence of any other explanation.

13. Persistent slow growth of output or even recession could bring some temporary interest rate reductions; and declining inflation would reduce nominal interest rates. But over the period of the Administration as a whole the outlook is for a continuing high level of real interest rates.

14. The US is having similar problems to ourselves in interpreting the significance of the various monetary aggregates. The narrow aggregate M1B is growing below target whilst the wide aggregates are either at the top of or above the target range. It was argued to us that this may be appropriate because of an acceleration in narrow money velocity that may not be easily reversed. At the same time it was argued that the wide aggregates include interest sensitive components which might be affected by any rise in savings following the tax cuts as well as high interest rates themselves. This would produce a tendency for the wide measures to overstate the underlying stance of monetary policy. This was reminiscent of many discussions here on the role of various aggregates. The US is moving from a concentration on narrow aggregates towards taking account of the wide aggregates just as we are moving in the opposite direction. Maybe we will meet somewhere in the middle.

15. The difficulty involved in interpreting the significance of the various aggregates is producing something of a backlash against monetary targets. This is where the interest in gold seems to emerge. This.....

was discussed more frequently than I had expected. No consideration seems to have been given to the implications of any proposal for other countries or exchange rates. I can see nothing of importance coming from this, although it will ruffle some feathers. From our point of view, it may be one way into the general case for greater exchange rate stability between the dollar and elsewhere but that is a very long shot.

16. An important difference between the UK and US is the response to exchange rate appreciation and loss of international cost competitiveness. In the US few people show any interest in exchange rates. There were some reports of pressure on profit margins and volumes but in general it was not an important policy issue. The reverse of this is that the US will not get the same anti-inflation benefit as the UK did. And it is another way in which monetary policy can influence the economy apart from those sectors clearly influenced by high interest rates. Because of the exchange rate, the pressure of anti-inflationary policy in the UK has been spread beyond construction and autos ~~more~~ than is likely to be the case in the US.

Prospects for Output and Inflation

17. Despite the strong potential underlying growth of output most of those consulted expect output to be stagnant for several more months. Two groups then expect to see a rapid upturn. One of these groups is the 'supply siders' in the Administration. They argue that inflation will fall rapidly and provide room within the growth of nominal GDP for a rapid growth of output. Their basic approach is to argue that nominal GDP will be determined by the monetary targets. The division between price and output will depend upon supply side considerations and in particular will be affected by the fiscal changes. Those taking this approach reject the notion of a sluggish price response and argue that it has been possible on previous occasions to have a sharp

reduction in inflation, led by lower interest rates, lower mortgage costs and lower increases in housing costs.

18. A second group expecting rapid growth from mid-82 are the conventional large model forecasters such as Lawrence Klein of Wharton. They argue that the effect of fiscal expansion will outweigh any efforts towards restraint by the monetary authorities. They expect real interest rates to fall back somewhat and in any case do not expect them to offset the effect of the fiscal expansion. They expect velocity to rise to accomodate the higher level of output.

19. Those looking for slower growth see it as the inevitable result of the Fed's effort to restrain monetary growth. The Fed themselves are looking for output stagnation until the end of 1982 and no sharp recovery until inflation comes down. One view is that they will intensify the monetary squeeze until inflation does improve substantially.

Conclusions

20. As in the UK a lot will depend on the speed of adjustment of inflation to the monetary squeeze. I would be relatively pessimistic of the chances of a sharp break given the sluggish response of US wages. It was argued to us that the next wage round was crucial. A number of important wage settlements were due in 1982 - cars, tyre manufacturing, and transport - which would be conducted against a difficult economic background. If there is a major change in wage behaviour in these sectors that quickly spreads to other less depressed sectors the outlook would be much better. But the UK experience does not suggest that this can be achieved so easily. Despite the smoother operation of the US labour market, I would expect that getting inflation down will be a painful business. In recession some progress will be made but it will be difficult to sustain.

20. This points to high and fluctuating real and nominal interest rates over the cycle. One possible resolution could stem from the burden this will place upon certain parts of the economy which

in turn is likely to produce constant pressure for a change in the fiscal stance. In the early stages of any recovery when impatience is at its highest it could also lead to considerable pressure for some relaxation of the monetary targets.

21. My interpretation is that the longer term success of the Reagan policy is likely to depend upon the ability of the Administration to control the level of public spending. Without further progress, the pressure on certain sectors could be intense and then the inflation objective would be in doubt. If expenditure is reduced, the prospects must be better. Even so, we would be unwise to count on a rapid move to lower inflation and faster growth, although the likelihood of the policy being sustained would be greater.

TERRY BURNS
October 1981

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LIST OF PEOPLE TALKED TO:

Administration

Treasury - Beryl Sprinkel
Norman Ture
Paul Gray Roberts

Department of Commerce - Bob Dederick

Council of Economic Advisers - Murray Weidenbaum
Jerry Jordon

Federal Reserve - Governor Partee
Michael Prell (Asst Director; Director of Research & Statistics)

Others in Washington

Lawrence Klein (University of Pennsylvania)

National Association of Manufacturers - Larry Fox (Vice President)

Brookings Institution - Joe Pechman
Charlie Schultze
Other senior fellows

American Enterprise Institute - Tom Johnson
William Fellner
Rudolph Penner

Congressional Budget Office - Alice Rivlin

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VLB

FILE

cc: Mr Walters
Vereker
Hoskyns

12 October 1981

In Stats file

Building Societites Mortgage Interest Rate

The Prime Minister has seen and noted the Chancellor's minute of 8 October.

I am sending a copy of this letter to David Wright (Cabinet Office).

MICHAEL SCHOLAR

John Kerr, Esq.,
H.M. Treasury.

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cc Alan Walters
A Duguid
J Vereker

see by MS
see letter 12/10

1

SECRET

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

PRIME MINISTER

The current economic instability in the Western world has its origins in the United States. On my recent visit there I talked to all the key figures. The following are my considered reactions.

2. The United States is trying simultaneously to complete its adjustment to the two oil shocks; to increase defence spending sharply; and to make a major reduction in the inflation which has rooted itself deeply in its economy; and at least to reduce, and eventually eliminate, deficit spending. Success by the US would benefit all of us. At present however the strains of this multiple effort are transmitting themselves to other countries via interest rates and exchange rates, for the dollar remains the principal reserve and trading currency (including the currency of oil) and the principal financial markets are dollar markets.

3. The root of the problem is that US Administration has not yet convinced markets in the US that its anti-inflation programme will succeed. It has not yet convinced them that it can control and eliminate the budget deficit as far and as fast as necessary. As a result US interest rates remain very high (prime rate 19 per cent; 3 month money 15-15½ per cent; government long bonds 15 per cent; with an inflation rate of 11 per cent in consumer prices). The President's targets have been a budget deficit of $43 billion in fiscal year 1982, reducing to nil by 1984. After enacting a major expenditure cutting programme in the summer, he put forward further proposals on 24 September for additional savings of $16 billion, in order to get back on target for 1982 but it is not at all

certain that he will get his way. Furthermore, the markets, and the US bankers with whom I spoke, clearly feel that the Administration is not sufficiently single-minded about reducing the deficit it has to finance. They note that the Administration has not found it possible to make economies in indexed social security pensions; or to scale back significantly its planned increase in defence expenditure; or to forgo tax reductions; or to increase indirect taxes.

4. US interest rates may well remain high (and volatile) until there is a more convincing picture on the deficit, promising a reduction in US government borrowing and a substantial fall in the inflation rate. A weakening dollar could delay any fall in the rates.

5. None of this means that we should fail to support President Reagan's efforts to beat inflation. There are great and continuing risks to the world economy if he fails. They do mean however that in private we should continue to urge on him and his US government colleagues the need to control the US budget deficit. Some - e.g. Stockman - need no urging, but the President's position is ambivalent. He seems anxious to avoid fiscal action in advance of the 1982 congressional elections, and it is not yet clear that control of the deficit is the objective to which he attaches the highest priority - as for Europe's sake it should be.

6. For we face a harsh environment so long as we are exposed to high US interest rates. Fortunately British industry has had the benefit of a better wage round, of improvements in productivity, and of interest rates below those in the United States. Interest rates would have gone up much sooner, and now be much higher, but for the action we took at the time of the Budget.

7. But this environment makes it all the more necessary for us to avoid getting out of line, and pursuing policies softer than those adopted by other countries, as we did in 1974-76. The UK is still particularly exposed to international monetary and trading developments. It is more than ever necessary that we should strictly control our PSBR and our monetary framework if we are to come through safely.

8. This is the lesson Chancellor Schmidt drew from the prospect of continuing high US interest rates after the Ottawa Summit. He returned home to organise budgetary savings. The French did the opposite. The latest US developments suggest that Chancellor Schmidt was right. The French have been forced to devalue and are now using the latest US signals, in and at the time of the IMF meetings, as the reason - or excuse - to prune back their budgetary growth.

9. In Opposition we took the view that the policies of restraint which the IMF urged on the Labour Government were right. In his address to the recent Meetings, the Managing Director of the IMF emphasised to member countries that it was "essential not to relax the efforts to combat inflation". ..... Colleagues may be interested to see the attached extract from his speech.

10. The IMF prescription, now as in 1976, is in line with our own. I am clear that we must continue to follow it.

11. Copies of this minute go to Cabinet colleagues, and to Sir Robert Armstrong.

G.H.

(G.H.)

8 October, 1981

EXTRACT FROM STATEMENT BY J. DE LAROSIERE, CHAIRMAN OF THE EXECUTIVE BOARD AND MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND IN PRESENTING THE THIRTY-SIXTH ANNUAL REPORT OF THE EXECUTIVE DIRECTORS TO THE BOARD OF GOVERNORS OF THE FUND

"At this stage in our progress, it is essential not to relax the efforts to combat inflation, but rather to press on with determination. Experience has amply demonstrated that sustained, sound growth requires that inflation first be brought under control. In some conditions, it is possible to increase economic activity temporarily through demand-stimulating policies. But an economy in the grip of inflation cannot be permanently revived by printing more money. The need today is to enable our economies to produce more, and at less cost.

The policy effort must be intensified along two basic lines: more effective demand management and measures to improve supply.

Let us look at demand management first. I observed a moment ago that the industrial countries have the growth of their monetary aggregates under better control today. Nevertheless, the burden being placed on monetary policy is undoubtedly excessive. To be effective, monetary policy must be supported by a coherent, sound fiscal policy. But it is evident that the fiscal policies of a number of industrial countries have been excessively expansionary since the early 1970s. The combined budget deficit of the industrial countries is about twice as large, in terms of GNP, as it was in 1973. A third of the industrial countries recorded a budgetary surplus in 1973; all of them are in deficit today. This weakness in public finance has stimulated demand-pull inflation and reduced the share of financing available to the private sector.

It is not possible to generalize in this area, of course, since the effects of a budget deficit can be assessed only in the context of the particular economy concerned. But it is certain that when credit demand is still strong, and the rate of saving is inadequate, a budget deficit, even if relatively moderate, can intensify competition among borrowers and push interest rates upward. I might add that, beyond these direct economic effects, fiscal management is often rightly seen by the public as a test of a government's seriousness and determination in fighting inflation.

In view of the importance of the US economy and the effects of US policy on the rest of the world, a few words on the United States are in order at this point. From an international standpoint, the sharp increase of US interest rates and - at least until recently - their great volatility, as well as the dollar's appreciation on the exchange markets, have become the subject of much controversy. These developments have had repercussions on many other countries, and in some cases have given rise to policy dilemmas. In the United States itself, the persistence of high interest rates has become a source of widespread dissatisfaction and disappointment. Whatever the criticisms and pressures in this area, however, I think it would be a great mistake to surrender to them by raising the monetary targets. Reduction of the rate of US inflation is crucial to world economic stability; it must be achieved, and it can only be achieved if monetary policy holds firmly to its course and is consistently applied. The effort thus far to combat inflation has been encouraging, monetary targets have been set, and deep budget cuts have been made. The fact remains, however, that a decisive and sustained effort to reduce the budget deficit is necessary if inflationary expectations are to be broken and the pressure of government demands on the financial markets are to be eased.

But, vital as it may be, the control of overall demand cannot by itself eliminate inflation. The causes of inflation are rooted in our societies, and stem from a multitude of habits, attitudes, and rigidities which also demand remedy and correction. This is a long-range task, to be moulded in each case by the characteristics and policies of the country concerned. But, however different the situations, the necessary structural reforms all hinge on a few simple ideas. Incentives to work and save must be strengthened. Unnecessary, paralysing regulations must be abolished. Flexibility, a capacity to react, and a willingness to take risks - characteristics which too often have given way to rigidity, protection and privilege - must be restored to our economies. There are no magic responses to the challenges we face; rather, we must persevere in a combination of convergent, consistently applied measures.

The analysis I have just made may appear conservative to some. But I believe it is wholly realistic. It is true that unemployment is reaching alarming levels. Who could underestimate the importance of this problem? Yet it seems certain that we can never hope to solve it by weak financial management. On the contrary, the unemployment problem was exacerbated by the inflationary policies of the years 1973 to 1979. Productive investment, the basis of all growth, can be revived not by distributing additional means of payment, but by strengthening investor confidence in the health of the economy. This, in turn, requires monetary stability above all; it is the prerequisite for increased saving. This leads me to state forcefully, as the Executive Board asked me to do a few weeks ago, that the fight against inflation must be waged courageously and with determination. This is undeniably a priority if the unemployment problem is to be attacked with any chance of lasting success.

Premature relaxation of the restraints on demand in countries experiencing severe inflation would only aggravate the inflation, jeopardise the currency, and hamper growth. Perseverance is therefore required in the struggle against inflation. In the present social environment, this calls for difficult decisions; in the short term, in fact, they will probably aggravate the economic slowdown. But they are vital if we are to overcome the stagflation that has characterised the industrial economies for too long."

29 September 1981

8 OCT 1981

Prime Minister 4

WSA ww 8/10

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TO ROUTINE FCO

TELEGRAM NUMBER 2990 OF 7 OCTOBER

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MT.

MY TELNO 2854: US ECONOMIC RECOVERY PROGRAMME

1. PRESIDENT REAGAN'S ECONOMIC RECOVERY PROGRAMME CAME INTO EFFECT ON 1 OCTOBER. FROM THIS DATE ONWARDS DEVELOPMENTS IN THE US ECONOMY WILL INCREASINGLY BE CREDITED TO OR BLAMED ON HIM, RATHER THAN ATTRIBUTED TO THE POLICIES OF CARTER. WHILE HE MIGHT BE ABLE TO REST FOR A TIME ON THE PLEA THAT IT WILL TAKE SOME TIME FOR HIS POLICIES TO SUCCEED, THIS WILL TEND TO SOUND A LAME EXCUSE, GIVEN THE CLAIMS OF SOME OF HIS LIEUTENANTS THAT ENACTMENT OF THE LEGISLATION WOULD ITSELF HAVE AN IMPACT ON EXPECTATIONS. TACTICAL VICTORIES IN CONGRESS ON EXPENDITURE CUTS WILL NO LONGER SUFFICE TO CONVINCE THE AMERICAN PEOPLE THAT HE IS ON TRACK. HE MUST SOON DELIVER THE GOODS IN TERMS OF ECONOMIC PERFORMANCE. RECENT ATTENTION HAS FOCUSSED ON WHETHER HE CAN SECURE THE REDUCTION THAT HE HAS PROMISED IN THE PRESENT HIGH LEVEL OF MARKET INTEREST RATES BY REDUCING THE BUDGET DEFICIT. BUT IN THE LONGER TERM HE MUST ALSO MAKE FURTHER PROGRESS IN REDUCING INFLATION AND ACHIEVING SUSTAINED GROWTH.

2. PRESIDENT REAGAN'S TERM OF OFFICE HAS ALREADY SEEN A DECLINE IN THE RATE OF INFLATION. SOME OF THIS HAS BEEN FORTUITOUS, DUE TO A SOFTENING IN THE PRICES OF FOOD AND ENERGY5 BUT THE UNDERLYING RATE OF INFLATION HAS NONETHELESS BEEN REDUCED FROM ABOUT 12 PERCENT AT THE TURN OF LAST YEAR TO ABOUT 10 PERCENT NOW. WHILE THE ECONOMY HAS BEEN SLUGGISH IN THE SECOND AND THIRD QUARTERS OF THIS YEAR, IT HAS PROBABLY DECLINED ONLY SLIGHTLY FROM THE HIGH LEVEL REACHED IN THE FIRST QUARTER, WHEN GROWTH WAS AT A RECORD ANNUAL RATE OF 8.6 PERCENT. SHORT-TERM INTEREST RATES ARE ALSO DOWN ABOUT 2 PERCENT FROM THEIR PEAKS IN JULY. BUT INTEREST RATES REMAIN STRONGLY POSITIVE IN REAL TERMS - WITH LONG-TERM REAL RATES ON CORPORATE BONDS NOW ABOUT 6 - 7 PERCENT. THERE IS NO CLEAR TREND IN THE LEVEL OF UNEMPLOYMENT: AT PRESENT IT STANDS AT 7.5 PERCENT.

3. CHAIRMAN VOLCKER OF THE FEDERAL RESERVE BOARD, WHILE BELIEVING THAT THE BURDEN OF FIGHTING INFLATION SHOULD NOT BE PLACED ON MONETARY POLICY ALONE, SHOWS EVERY SIGN OF WANTING TO STICK TO HIS MONETARY TARGETS. THE 1982 TARGET RANGE THAT HE HAS SET FOR M1-B IS 2 1/2 - 5 1/2 PERCENT, FOR M2 6 - 9 PERCENT AND M3 6 1/2 - 9 1/2 PERCENT. THE ADMINISTRATION'S TARGET FOR REAL GROWTH DURING 1982 (FOURTH QUARTER 1981 TO FOURTH QUARTER 1982) IS 5.2 PERCENT AND FOR INFLATION ABOUT 7.3 PERCENT (GNP DEFLATOR).

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/GNP

GNP IN NOMINAL TERMS IS PROJECTED TO GROW BY 12.9 PERCENT. SUCCESS IN REDUCING THE GROWTH OF PUBLIC EXPENDITURE WILL REDUCE PRESSURE ON CREDIT MARKETS ONLY IF PRIVATE DEMAND FOR CREDIT DOES NOT SHOW A CORRESPONDING INCREASE. BUT PRESIDENT REAGAN'S OPTIMISTIC FORECASTS FOR THE REAL ECONOMY MUST BE PREDICATED ON A RAPID EXPANSION OF PRIVATE BORROWING, SINCE THE PRESENT LIQUIDITY OF AMERICAN COMPANIES IS NOT SUCH THAT A MAJOR EXPANSION COULD BE FINANCED SOLELY WITH INTERNALLY-GENERATED FUNDS, EVEN AFTER ALLOWING FOR THE CONCESSIONS TO COMPANIES IN THE NEW TAX BILL. AN ANALYSIS BASED ON CREDIT DEMAND AND SUPPLY, THEREFORE, LEADS TO THE CONCLUSION THAT INTEREST RATES ARE LIKELY TO REMAIN HIGH DURING ANY FORTHCOMING ECONOMIC EXPANSION SO LONG AS VOLCKER'S RESTRICTIVE MONETARY TARGETS ARE IN PLACE. RECENT REMARKS BY TREASURY SECRETARY REGAN THAT THE FED MIGHT BE ABLE TO EASE UP A BIT, WITHOUT CHANGING THE BROAD THRUST OF MONETARY POLICY, INDICATES THAT THE ADMINISTRATION MAY BE GROWING ANXIOUS ON THIS SCORE.

4. THE ABOVE ARGUMENT WOULD NEED TO BE MODIFIED IF IT WERE BELIEVED THAT EXISTING LEVELS OF INTEREST RATES CONTAINED A PREMIUM FOR INFLATIONARY EXPECTATIONS THAT WOULD BE RAPIDLY ELIMINATED ONCE MARKETS WERE CONVINCED OF THE ADMINISTRATION'S DETERMINATION TO GET INFLATION AND THE FEDERAL DEFICIT DOWN. DEVELOPMENTS IN FINANCIAL MARKETS DURING THE SUMMER, WITH INTEREST RATES HIGH AND NEW YORK STOCK EXCHANGE PRICES DEPRESSED, WERE OFTEN ATTRIBUTED TO MARKET SCEPTICISM ABOUT WHETHER THE ADMINISTRATION COULD BRING DOWN THE BUDGET DEFICIT, AND ALSO REFLECTED CONCERN AT THE TREASURY'S LARGE BORROWING NEEDS DURING THE SECOND HALF OF THIS YEAR. PRESIDENT REAGAN'S STATEMENT OF 24 SEPTEMBER WAS OBVIOUSLY AIMED AT IMPROVING CONDITIONS IN THE FINANCIAL MARKETS. BUT IT IS POSSIBLE THAT, WHILE INTEREST RATES ARE SENSITIVE TO PROSPECTIVE CONDITIONS IN THE CREDIT MARKETS (INCLUDING THE ADMINISTRATION'S BORROWING NEEDS), PRICES ON THE NEW YORK STOCK EXCHANGE HAVE ALSO BEEN REACTING TO THE IMMEDIATE PROSPECTS FOR THE US ECONOMY. SOME MEMBERS OF THE ADMINISTRATION THEMSELVES DO NOT SEE FURTHER GROWTH COMING MUCH BEFORE THE MIDDLE OF 1982 AND THERE ARE DIFFERENCES OF VIEW ABOUT HOW STRONG GROWTH WILL BE THEREAFTER. INFLATIONARY EXPECTATIONS MAY BE ALREADY REDUCED BECAUSE INFLATION HAS COME DOWN. IN THAT CASE LOWER INTEREST RATES MAY ONLY COME ABOUT WITHIN THE EXISTING MONETARY TARGETS IF THE ECONOMY CONTINUES TO BE SLUGGISH FOR A FAIRLY PROLONGED PERIOD. WHILE COMBINED RAPID GROWTH AND HIGH REAL INTEREST RATES COEXISTED IN THE FIRST QUARTER OF THIS YEAR, SUCH A SITUATION SEEMS UNSUSTAINABLE FOR A PROLONGED PERIOD. A REASONABLE CONCLUSION SEEMS TO BE THAT UNLESS THE MONETARY TARGETS ARE RELAXED, THE ADMINISTRATION WILL NOT ACHIEVE ITS GROWTH OBJECTIVES UNLESS THERE IS A MUCH GREATER FALL IN THE PRICE LEVEL THAN IT ITSELF PREDICTS. GIVEN THAT WAGE SETTLEMENTS ARE CURRENTLY RUNNING AT ABOUT 10 PERCENT, THIS SEEMS AN UNLIKELY OUTCOME.

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5. TO PREVENT INCREASED PRESSURE ON CREDIT MARKETS, CONTINUING SUCCES IN CUTTING GOVERNMENT BORROWING IS ESSENTIAL. BUT THE ADMINISTRATION MAY BE CHASING A RECEDING TARGET. ON 17 SEPTEMBER CONGRESSIONAL BUDGET OFFICE DIRECTOR RIVLIN ESTIMATED THAT THE ADMINISTRATION WOULD NEED TO FIND DOLLARS 100 BILLION OF CUTS (ADDITIONAL TO THE FIRST ROUND OF BUDGET CUTS) BY FY84 TO ACHIEVE ITS OBJECTIVE OF BALANCING THE FEDERAL BUDGET. THIS FIGURE IS DOLLARS 40 BILLION MORE THAN THE ADMINISTRATION'S ESTIMATE. ON 24 SEPTEMBER, THE PRESIDENT CLAIMED THAT DOLLARS 35 BILLION OF ADDITIONAL CUTS HAD BEEN IDENTIFIED FOR THAT YEAR (INCLUDING DOLLARS 6 BILLION OF DEFENCE CUTS). THE NATURE OF THESE CUTS IS STILL RATHER HAZY, BUT EVEN IF THEY WERE ALL IDENTIFIED AND ENACTED THEY WOULD BE A LONG WAY SHORT OF DOLLARS 100 BILLION, A FIGURE WHICH ITSELF COULD INCREASE. BUDGET DIRECTOR STOCKMAN IS NO LONGER EMPHASISING THE NEED TO ACHIEVE BUDGET BALANCE BY FY84, BUT SIMPLY THE NEED TO DEMONSTRATE PROGRESS TOWARDS REDUCING THE BUDGET DEFICIT IN FY82, BY ACHIEVING A CLEAR REDUCTION IN THE DEFICIT FROM FY81 (A REDUCTION FROM ABOUT DOLLARS 56 BILLION TO DOLLARS 43.1 BILLION). HE IS ALSO REPORTED TO HAVE SAID THAT, IF A WEAK ECONOMY CAUSED FEDERAL REVENUES TO FALL SHORT OF FORECASTS, HE WOULD NOT SEEK ADDITIONAL SPENDING CUTS TO PREVENT THE BUDGET DEFICIT FROM GROWING.

6. NEITHER PRESIDENT REAGAN'S RECENT ANNOUNCEMENT OF HIS STRATEGIC ARMS PROGRAMME NOR HIS OTHER RECENT STATEMENTS SEEM CONSISTENT WITH FURTHER MAJOR DEFENCE EXPENDITURE CUTS BEFORE FY84, UNLESS THESE ARE IMPOSED ON HIM BY CONGRESS. IT IS DIFFICULT AT THE MOMENT TO JUDGE WHETHER THE ADMINISTRATION WILL, WHEN IT COMES TO THE CRUNCH BEFORE THE LEGISLATIVE ELECTIONS NEXT YEAR, ACQUIESCE IN CONSIDERABLE DEFENCE CUTS. I DO NOT THINK IT IMPOSSIBLE GIVEN THE POLITICALLY UNATTRACTIVE ALTERNATIVES. THE CONGRESS HAS EXPRESSED A CLEAR AVERSION TO SOCIAL SECURITY CUTS, AND PRESIDENT REAGAN (WHILE INVITING CONGRESS TO STUDY THE POSSIBILITY) HAS NOT MADE ANY NEW PROPOSALS. INTEREST PAYMENTS ON THE NATIONAL DEBT ARE ENESCAPABLE. THIS MEANS THAT THE REMAINING 40 PERCENT OR SO OF PUBLIC EXPENDITURE ON WELFARE PROGRAMMES ETC WILL NEED TO BEAR THE ENTIRE BRUNT OF FURTHER REDUCTIONS. SINCE STATE GOVERNMENT FINANCES HAVE ALREADY BEEN SQUEEZED BY THE FIRST ROUND OF CUTS (RESULTING IN LOUD COMPLAINTS BY STATE GOVERNORS), PUTTING A GREATER BURDEN ON THEM IS NOT GOING TO BE AN EASY OPTION.

7. ANOTHER WAY OUT OF THE QUANDARY IS SOMETIMES SEEN AS RAISING SIGNIFICANT INDIRECT TAXATION AT THE FEDERAL LEVEL, BUT PRESIDENT REAGAN HAS OPPOSED THIS COURSE (WHICH COULD CHANGE THE BALANCE OF THE US TAX SYSTEM AS BETWEEN THE STATES AND THE FEDERAL GOVERNMENT). WHILE A DOLLARS 3 BILLION REDUCTION IN OBSOLETE INCENTIVES ETC WAS INCLUDED IN THE MEASURES ANNOUNCED ON 24 SEPTEMBER (RISING TO DOLLARS 11 BILLION BY FY84), THERE ARE NO OBVIOUS POLITICALLY ACCEPTABLE WAYS IN WHICH THE BUDGET GAP COULD BE CLOSED SOLELY BY RAISING TAXATION. THE DEFERMENT OF THE RECENTLY ENACTED INCOME TAX CUTS WOULD BE A BIG POLITICAL REVERSE AND WOULD SEEM THE LEAST ACCEPTABLE TO THE ADMINISTRATION AT THIS STAGE.

8. IT IS GOING TO BE AN UPHILL STRUGGLE FOR THE ADMINISTRATION TO CONVINCE MARKETS THAT IT WILL TAKE ACTION TO REDUCE THE BUDGET DEFICIT SUFFICIENTLY TO MAKE ROOM FOR CORPORATE BORROWING AND ECONOMIC EXPANSION. A DOLLARS 13 BILLION REDUCTION IN THE DEFICIT IN FY82 COMPARED WITH FY81 ALMOST CERTAINLY WILL NOT BE ENOUGH BY ITSELF. TO SUCCEED, THEY WILL HAVE TO HOLD OUT THE REALISTIC PROSPECT OF A CONTINUING REDUCTION IN FY83 AND BEYOND SO THAT SUSTAINED PRIVATE SECTOR GROWTH CAN BE ACCOMMODATED.

9. FCO PLEASE PASS TO BOTTRILL (TREASURY) AND HAYWARD (BANK OF ENGLAND).

FCO PASS SAVING UKREP BRUSSELS, UKDEL OECD, BONN, PARIS, ROME, TOKYO AND OTTAWA

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FOLLOWING PERSONAL FOR PRIME MINISTER FROM CHANCELLOR OF THE EXCHEQUER.

THE STATE OF POLICY IN THE UNITED STATES

1. I PROMISED A FURTHER REPORT ABOUT THE US SCENE. I HAVE NOW SEEN PRESIDENT REAGAN'S BROADCAST AND THE REACTION TO IT. I HAVE ALSO SEEN STOCKMAN, VOLCKER AND REGAN AND HAD OTHER OPPORTUNITIES TO APPRAISE THE SITUATION. SO HAS TERRY BURNS, WHO IS HERE AT PRESENT.

2. ON THE BUDGET DEFICIT, THE DOLLARS 16 BILLION IMPROVEMENT NOW SOUGHT BY THE PRESIDENT IS A DETERMINED FURTHER EFFORT WHICH WE MUST APPLAUD. IT WILL NOT BE EASY TO DELIVER IN FULL. EVEN SO, IT LEAVES THE DEFICIT FOR FISCAL YEAR 1982 AT DOLLARS 43.1 BILLION COMPARED WITH THE ORIGINAL FORECAST OF DOLLARS 42 BILLION. SO THE BALANCE BETWEEN FISCAL AND MONETARY POLICY WILL NOT HAVE BEEN IMPROVED, BUT ONLY AT BEST PREVENTED FROM GETTING WORSE. THERE IS AS YET NO CONVINCING PATH TO THE BUDGET BALANCE IN 1984 WHICH THE PRESIDENT SAYS IS HIS OBJECTIVE. THE CUTS ON THE ENLARGED DEFENCE BUDGET WERE RELUCTANT AND MODEST, AND 7 PERCENT REAL GROWTH IS STILL ENVISAGED. YOU WILL RECALL (WASHINGTON TELNO 2859) THAT STOCKMAN SAW LITTLE CHANCE OF FURTHER SOCIAL SECURITY REDUCTIONS, OR OF EARLY INCREASES IN TAXATION. THERE IS A RISK THAT THE TIDE OF PUBLIC AND CONGRESSIONAL OPINION MAY TURN AGAINST FURTHER BUDGET CUTS AND MAKE THEM MORE DIFFICULT.

3. PERHAPS IT IS NOT SURPRISING THAT THE MARKETS HAVE NOT BEEN REASSURED AND REMAIN UNCERTAIN. FEARS REMAIN OF CONTINUING HIGH INTEREST RATES AND FOR THE PRESENT THAT HAS AGAIN STRENGTHENED THE DOLLAR AGAINST EUROPEAN CURRENCIES: RATHER MORE AGAINST THE EMS THAN AGAINST STERLING. THE UNCERTAINTIES OF US MARKETS ARE COMMUNICATING THEMSELVES TO LONDON MARKETS, ESPECIALLY THE EQUITY MARKET.

4. VOLCKER'S ACCOUNT WAS AS FOLLOWS. THERE WAS A MODEST EASING OF SHORT-TERM RATES REFLECTING SOME FALL IN DEMAND FOR BANK CREDIT, BUT THE BOND MARKET (LONG RATES) WAS FOCUSSING ON THE DEFICIT. THE DEFICIT WAS LARGE AND WOULD NEED BIG CUTS TO HOLD IT DOWN. MARKETS WOULD BE AFFECTED BY A BIG FINANCING DEMAND FROM THE TREASURY IN THE NEXT THREE MONTHS. HE EXPECTED SLUGGISH OUTPUT IN THE NEXT TWO QUARTERS. THERE WAS A CHANCE THAT INFLATION WOULD FALL AND REDUCE INTEREST RATES. BUT THE DOWNWARD TREND IN INFLATION WAS NOT YET CLEARLY ESTABLISHED OR REFLECTED IN WAGES. HE SAW THE GAME AS BEING QUOTE WON OR LOST WITHIN THE NEXT 12 MONTHS UNQUOTE.

5. ECONOMISTS (INCLUDING FRIEDMAN) CALLED IN BY THE ADMINISTRATION WERE SAYING THEY DID NOT KNOW WITH ANY CERTAINTY WHY INTEREST RATES WERE SO HIGH. VOLCKER SAW TWO MAIN EXPLANATIONS: A BASIC CHANGE IN INFLATIONARY EXPECTATIONS IN THE US AND THE IMPACT OF HOLDING MONETARY GROWTH SUBSTANTIALLY BELOW THE NOMINAL GROWTH OF GNP. REGAN BROADLY AGREED WITH VOLCKER'S ASSESSMENT BUT ADDED THAT IF THE RECENT CONTROL OF MONETARY AGGREGATES WAS MAINTAINED, INFLATION WAS BOUND TO COME DOWN. HE EXPECTED NO REVIVAL IN THE ECONOMY BEFORE LATE 1982 OR EARLY 1983.

6. THERE ARE OBVIOUS PARALLELS, AS WELL AS MANY DIFFERENCES, BETWEEN THIS PHASE OF AMERICAN POLICY AND OUR OWN EXPERIENCE. THEY MAY NOW FOLLOW US IN GETTING A SIGNIFICANT REDUCTION IN INFLATION, BETTER WAGE PERFORMANCE BUT, AS VOLCKER INDICATED, NONE OF THIS IS SURE. THEY EXPECT TO SEE THEIR CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS WEAKEN AND THEY MIGHT THEN GET A WEAKER DOLLAR (THOUGH OTHER DEVELOPMENTS, EG POLAND, PROLONGED HIGH INTEREST RATES COULD RETARD THIS). THEY HAVE OF COURSE GREAT ADVANTAGES COMPARED WITH US BUT ALSO HANDICAPS - DEFENCE COSTS, THEIR RELUCTANCE TO CHANGE COURSE ON TAX, A CONGRESS WHICH HAS TO BE PERSUADED RATHER THAN CONTROLLED, MID-TERM ELECTIONS. AND, FOR THE PRESENT, THEY HAVE NOT CONVINCED THEIR MARKETS OR MADE ENOUGH IMPACT ON INFLATIONARY EXPECTATIONS.

7. THERE ARE TWO MAJOR IMPLICATIONS FOR US. THEIR SUCCESS OR FAILURE IS OF THE GREATEST IMPORTANCE BOTH FOR THE WORLD ECONOMY AND FOR US POLITICALLY. WE OUGHT NOT TO IDENTIFY OURSELVES SLAVISHLY WITH EVERY ASPECT OF THEIR POLICIES: QUITE THE CONTRARY. BUT STRONG PARALLELS ARE BOUND TO BE DRAWN. THERE ARE, SECONDLY, THE DIRECT EFFECTS OF THEIR SITUATION ON US. WE ARE NOW MORE EXPOSED TO CONTINUING HIGH US INTEREST RATES THAN WE WERE WHEN THE OIL FACTOR WAS MOVING IN OUR FAVOUR AND OUR CURRENT ACCOUNT WAS AT ITS STRONGEST. WE HAVE TO FACE THE POSSIBILITY THAT US RATES WILL CONTINUE STRONG, AND COULD FLUCTUATE AS THE STRUGGLE OVER THE BUDGET DEFICIT CONTINUES. RELIEF FROM THEIR IMPACT COULD BE DELAYED FOR US AND OTHER EUROPEAN COUNTRIES UNTIL US INFLATION FALLS: OR UNTIL THE DOLLAR WEAKENS (PERHAPS, FOR EXAMPLE, BECAUSE THE US CURRENT ACCOUNT GOES INTO SUBSTANTIAL DEFICIT).

8. WE HOPE TO CONTINUE PRESSING THE AMERICANS AT EVERY REASONABLE OPPORTUNITY TO REDUCE THEIR BUDGET DEFICIT AND TO OPEN THEIR MINDS TO TAX ACTION IF NECESSARY. THERE MAY BE OPPORTUNITIES AT CANCUN. LIKE CHANCELLOR SCHMIDT AFTER OTTAWA, WE HAVE TO TAKE WHATEVER ACTION WE CAN IN OUR OWN FIELD TO INCREASE OUR INDEPENDENCE IN THE MARKETS FROM US INTEREST RATES. THAT MEANS DOING OUR UTMOST ON PUBLIC EXPENDITURE, AND OF COURSE ON PAY. I THINK IT ALSO MEANS THAT WE MUST EXPECT TO GO ON PAYING ATTENTION TO THE EXCHANGE RATE IN OUR OWN INTEREST RATE DECISIONS, BECAUSE WE (LIKE THE EMS) WILL BE EXPOSED TO ANY CONTINUING VOLATILITY IN US INTEREST RATES.

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TO ROUTINE F C O

TELEGRAM NUMBER 2565 OF 1 SEPTEMBER

INFO SAVING OTTAWA EC POSTS TOKYO UKDEL OECD

PRESIDENT REAGAN AND THE ECONOMY

1. PRESIDENT REAGAN WAS RIDING HIGH WHEN HE LEFT WASHINGTON FOR A CALIFORNIA HOLIDAY A MONTH AGO. AS HE RETURNS TO WASHINGTON THIS WEEK IT IS BECOMING INCREASINGLY RECOGNISED THAT HIS TACTICAL VICTORY IN SWEEPING HIS BUDGET AND TAX CUT LEGISLATION THROUGH CONGRESS TEMPORARILY MASKED THE UNDERLYING ECONOMIC PROBLEMS WITH WHICH THE ADMINISTRATION MUST NOW GRAPPLE.

2. THE ADMINISTRATION ARE COMMITTED TO CONTINUING THE FIGHT AGAINST INFLATION AND VOLCKER (CHAIRMAN OF THE FEDERAL RESERVE BOARD) HAS PUBLICLY DEFENDED THE FED'S COMMITMENT TO FIGHTING INFLATION BY A REDUCTION IN THE GROWTH OF MONEY AND CREDIT DESPITE A STATEMENT BY REAGAN LAST WEEK THAT HIGH INTEREST RATES WERE QUOTE HURTING US IN WHAT WE'RE TRYING TO DO AS MUCH AS THEY'RE HURTING ANYONE UNQUOTE. IF THE ADMINISTRATION'S POSTURE IS TO CARRY CONVICTION (AND THEY'RE RELYING HEAVILY ON CREATING THE RIGHT EXPECTATIONS) THEY HAVE TO FIND A WAY OF MEETING THEIR COMMITMENT TO BALANCE THE BUDGET BY FY 1984 AT A TIME WHEN THE DEFICIT, FUELLED BY LOW GROWTH AND SLOWLY RISING UNEMPLOYMENT, MAY BE DOLLARS 20 BILLION OR MORE OVER THE CURRENT ESTIMATE OF DOLLARS 42.5 BILLION FOR FY 1982. THE ADMINISTRATION ARE COMMITTED TO FINDING A FURTHER DOLLARS 30 BILLION IN BUDGET SAVINGS FOR FY 1983 AND DOLLARS 44 BILLION FOR FY 1984. SINCE THE BUDGET FOR FY 1983 MUST BE PRESENTED TO CONGRESS IN JANUARY OF NEXT YEAR, THE INESCAPABLE CONCLUSION IS THAT FURTHER DRASTIC BUDGET CUTS MUST BE FOUND IN THE VERY NEAR FUTURE. OTHERWISE ANY RETURN OF BUSINESS CONFIDENCE GENERATED BY THE TAX CUT MAY BE LARGELY OFFSET BY THE HIGH LEVEL OF INTEREST RATES AND FEARS OF THE CONSEQUENCES OF A GROWING BUDGET DEFECIT.

3. THE IMPACT OF THE PUBLIC SPENDING CUTS ALREADY MADE BY THE ADMINISTRATION HAS YET TO BE FELT SINCE THEY HAVE NOT AS YET TAKEN EFFECT. BUT THE CUTS WERE SWINGING, EG THE ELIMINATION OF THE DOLLARS 122 MINIMUM MONTHLY PAYMENT TO ALL NEW RECIPIENTS OF SOCIAL SECURITY: AXING 300,000 PUBLIC SERVICE JOBS UNDER THE CETA PROGRAMME: REDUCING MEDICAL AID BY ABOUT 1 BILLION A YEAR AND TAKING AT LEAST 1 MILLION PEOPLE OFF THE FOOD-STAMP PROGRAMME. IT WILL BE DIFFICULT TO TRIM MAJOR CIVIL PROGRAMMES SUCH AS SOCIAL SECURITY FURTHER WITHOUT CREATING A CONTROVERSY WHICH WILL STRAIN CONGRESSIONAL LOYALTY TO THE PRESIDENT EVEN FROM CONGRESSMEN REPRESENTING REPUBLICAN DISTRICTS, SINCE THIS WOULD AFFECT NOT ONLY THE POOR

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AND DISADVANTAGED BUT THE GENERAL POPULATION AS WELL. NOR WILL IT BE EASY TO TRANSFER FURTHER EXPENDITURE POSSIBILITIES TO THE INDIVIDUAL STATES: STATE GOVERNORS ARE ALREADY SMARTING FROM THE REDUCTION IN FEDERAL AID WHICH THEY HAVE RECEIVED UNDER THE CUTS ALREADY PASSED BY CONGRESS, AND WILL NOT READILY AGREE TO FURTHER REDUCTIONS.

4. PRESIDENT REAGAN HAS ALREADY BROKEN HIS HOLIDAY TO HAVE MEETINGS WITH WEINBERGER, STOCKMAN AND MEESE TO TAKE A PRELIMINARY LOOK AT WHERE CUTS MIGHT BE MADE IN THE DEFENCE BUDGET WHICH HAD BEEN DUS TO RISE BY 7 PER CENT PER ANNUM FROM DOLLARS 180 BILLION IN FY 1981 TO DOLLARS 333 BILLION IN FY 1985. ALREADY MEESE HAS BEEN QUOTED AS SAYING THAT THE 7 PER CENT GROWTH FIGURE WAS A ROUGH TARGET FOR PLANNING PURPOSES, NEVER AN ABSOLUTE FIGURE. WEIDENBAUM (CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS) SAID IN A TELEVISION INTERVIEW AT THE WEEKEND THAT CURRENT PROPOSED DEFENCE SPENDING INCREASES WERE QUOTE EXTREMELY GENEROUS UNQUOTE: LESS RAPID EXPANSION MIGHT BE IN ORDER. HE WENT ON TO SUGGEST CHANGES IN THE YARDSTICK USED FOR INDEXING SOCIAL SECURITY BENEFITS IE MOVING AWAY FROM THE CONSUMER PRICE INDEX TO SOME OTHER INDEX LESS DISTORTED BY FACTORS SUCH AS THE COST OF HOME OWNERSHIP.

5. WHILE THERE IS NO DOUBT, THEREFORE, THAT THE ADMINISTRATION WILL AGAIN COMB THROUGH ALL OTHER PROGRAMMES FOR POSSIBLE SAVINGS, IT IS INCREASINGLY CLEAR THAT THEY HAVE NOW REACHED THE POINT WHERE TO ACHIEVE THEIR OBJECTIVES THEY WILL HAVE TO LOOK HARDER AT THE DEFENCE PROGRAMME AND THE SOCIAL SECURITY SYSTEM. CUTS IN THE PROJECTED GROWTH OF DEFENCE SPENDING MAY BE MORE PALATABLE POLITICALLY THAN MAJOR CHANGES IN THE SOCIAL SECURITY SYSTEM (WHICH WOULD BE ATTACKED BY THE DEMOCRATS AS AN ASSAULT ON AN ENTITLEMENT FOR WHICH AMERICANS HAVE PAID). BUT IT WILL NOT BE EASY FOR AN ADMINISTRATION COMMITTED TO MASSIVE INCREASES IN DEFENCE SPENDING TO BACK OFF AFTER LESS THAN A YEAR IN OFFICE.

FCO PASS SAVING TO OTTAWA TOKYO UKDEL OECD ATHENS BONN BRUSSELS COPENHAGEN DUBLIN LUXEMBOURG PARIS ROME THE HAGUE UKREP BRUSSELS.

THOMAS

F.C.O | WH/
NAD

[REPEATED AS REQUESTED]

THIS TELEGRAM WAS NOT ADVANCED

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vb

USA

17 August 1981

The Prime Minister has seen and noted the Chancellor's minute of 11 August, about United States economic policy.

MAP

Peter Jenkins, Esq.,
H.M. Treasufy.

My

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CONFIDENTIAL

Prime Minister

cc Mr Walters

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

PRIME MINISTER

US ECONOMIC POLICY

President Reagan's success in gaining a large majority in the US Congress for his tax and budget measures, without major concessions on their scope or character, has launched his programme with as much political momentum as he could have wished. We all hope it will achieve its goals. But, as you yourself said recently to the Prime Minister of Singapore, there are some grounds for concern that US interest rates may remain at a high level, particularly if heavy public borrowing competes with a heavy demand for credit from the private sector when monetary growth is, very properly, being restrained. I share your concern that this could have a severe impact on our own prospects for economic recovery.

2. Exchanges at the Ottawa Summit and in other forums will have brought home to the US Administration at the highest levels the anxiety which we and others feel on this score. There is little to be gained by saying anything more at this stage. But September will bring the IMF/IBRD joing annual meeting, and I shall want to give careful thought to what I might then say in my bilateral meetings with Americans in its margins. I should like to discuss with you before leaving for Washington

/the line I might

the line I might take with them. Meantime, I shall avoid being drawn - at any rate in private discussion with the Americans - into any explicit endorsement of this aspect of their programme.

(G.H.)

11 August 1981

2

THE U.S. ECONOMY

Reaganomics: so far, so good

By Reginald Dale, U.S. Editor in Washington

PRESIDENT REAGAN'S success in laying the foundations of his economic programme has left many Americans, including some of his most ardent supporters, gasping in astonishment. Against almost every expectation he has done precisely what he said he was going to do, and he has done it on time.

As he starts his four-week Californian holiday, he can look back on a series of smashing congressional victories in which he not only firmly laid the two main planks of his economic policy — a \$36bn (£20bn) spending cut next year and a \$750bn tax cut between this autumn and 1986—but consigned the Democratic opposition to demoralised disarray.

His programme can no longer be discussed only as a hypothesis. America, and the world, are about to find out if Reaganomics work in practice.

It is worth remembering what the pundits were saying in February, when he first unveiled the details of his plans. The conventional wisdom was that he might get some of his Budget cuts, but certainly not all. There would be a long drawn out fight on the tax cuts which might last until the end of the year and still not result in a Reagan victory.

Deregulation of industry, the third plank in the platform, would have to wait until well

David Stockman: already looking forward to the next round of spending cuts.

into 1982. Economists were seriously worried about what would happen if the spending cuts fell into place and the tax cuts did not.

As it has turned out, the conventional wisdom was badly mistaken. Mr Reagan has not got 100 per cent of what he asked for, but he has probably come as near as he could possibly have hoped. The \$5bn difference between the \$41bn he originally sought in spending cuts next year and the \$36bn he has actually got is not going to cause him to lose much sleep.

There is a greater difference with the tax cuts—instead of three annual 10 per cent cuts in income tax starting on July 1 this year, he has got a 5 per cent cut on October 1 and two 10 per cent cuts in July 1982 and July 1983.

This will obviously delay—and weaken—the initial impact. But the important point is that he has a three-year commitment from Congress (the Democrats wanted the third cut to be conditional on the state of the economy at the time).

Moreover, the indexation of tax brackets to the cost of living index from 1985 means that Mr Reagan's tax cuts are now built into the structure of the tax system. That, taken together with his determination to balance the Budget by 1984, means he is well on the way to establishing a strict budgetary regime which will last him through the four years of his term of office.

Mr David Stockman, his energetic budget director, is already looking forward enthusiastically to the next round of spending cuts.

Deregulation of industry—"getting Government off its back"—has suffered some setbacks in the Supreme Court, which has ruled, for example, that workers are entitled to the maximum possible protection from health and safety hazards. The court has not bought the original Reagan line that the costs to industry must be taken into account alongside the benefits to the workers.

However, that will not fatally undermine Mr Reagan's deregulation drive, much of which can be accomplished by administrative fiat and a start is already being made.

One area in which the Administration's plans are behind schedule is monetary policy. Interest rates have not come down as forecast—they are still at near record levels. The financial markets are still worried about the size of the likely Budget deficit.

And it is not only the European economies which are suffering, as President Reagan pointed out at last month's Ottawa summit, many American businesses are hurting, too — and the American thrift (mortgage and savings) institutions *are screaming*.

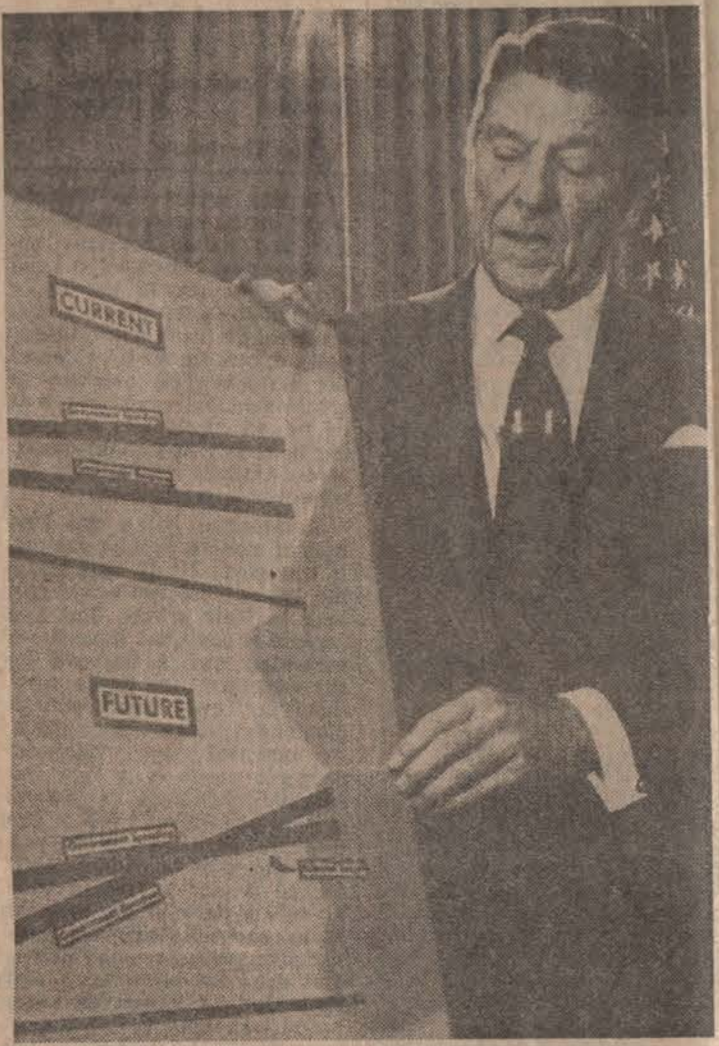
The Treasury is not too happy with the Federal Reserve's management of the money supply. But even here there is no wavering in the Administration's conviction that interest rates will come down as soon as the financial markets fully understand that it really is going to "stay the course."

How has Mr Reagan got this far, apparently against all the odds? In the first place, he has shown far greater political skill than most people gave him credit for. His handling of Congress is now being compared, respectfully, with that of the old master, Lyndon Johnson.

He has grabbed the initiative and left the Democrats struggling to catch up, and he has shrewdly identified individual Democratic congressmen who he needed to draw into his camp to overcome the Republicans' minority in the House of Representatives.

In enticing them on to the bandwagon he has had to make deals which may turn out to be hostages to fortune. He has made promises ranging from an undertaking to modify his plan to eliminate minimum social security payments to a commitment to help Georgia peanut farmers.

But above all he has won the



Explaining the theory: Mr Reagan appears to have struck a chord which echoes strongly and clearly around the country . . .

key congressional votes by convincing the majority that his economic plan is the one the American people want.

In this, at least for the time being, he is almost certainly right. Of course, he is not going to please everyone, and it is not hard to make out a case that cuts in spending on welfare, health and education may cause genuine hardship. But Mr Reagan appears to have struck a chord which echoes strongly and clearly around the country when he argues that the old ways simply have not worked.

The poor are still poor, despite massive spending on welfare, and many blacks are still in desperate straits despite all the government programmes over the years. There is a widespread feeling that a new approach should at least be given a try.

The same goes for defence spending, which Mr Reagan wants to increase by a massive 11 per cent a year in real terms at the same time that he is cutting everything else. Many Americans are startled and confused by the discovery that their country is in danger of *slipping into the position of* number two superpower, and they want something done about it. In many parts of the country, the two things ordinary people will agree on are the need to reduce inflation —and increase defence spending. It is neither here nor there if this defies certain schools of economic thought.

Above all, Mr Reagan, like a successful Napoleonic marshal, has managed to enshroud himself with an aura of good luck, of being a natural winner. It may be physically painful, but it does no harm politically to survive a point blank assassination attempt. He is even lucky in the timing of the latest slowdown in the economy. It has taken the wind from the sails of those who once argued that a major tax cut would be far too inflationary.

ADMINISTRATION PROJECTIONS OF ECONOMIC ACTIVITY

	1980	1981*	1982*
GNP	\$2,626bn	\$2,951bn	\$3,296bn
Real growth	−0.2%	+2.6%	+3.4%
Inflation (CPI)	+13.5%	+9.9%	+7.0%
Unemployment rate	7.2%	7.5%	7.3%
Interest rate, 91-day treasury bills	11.5%	13.6%	10.5%

* Estimate.

What then can go wrong? Two things, at least, say his opponents. First, the American people will wake up with a jolt when they realise the full practical consequences of the Budget cuts for their everyday lives. Second, the whole programme simply will not work.

The Reagan economic programme is meant to square the circle. Tax cuts provide the incentive for people to work harder and save more. The money saved goes into investment in modern equipment industries where the workers are working harder because of the tax cuts.

Productivity increases, the price of American-produced goods becomes more competitive and inflation comes down —helped on its way by the progressive reduction of the budget deficit, a crackdown on the growth of the money supply and a strong dollar. As business becomes more profitable, it makes more sense for people to invest their tax cut savings in it, and the cycle starts again.

Looked at like that, the programme is open to criticism from two opposite directions. A prime element in the equation is to ensure that the money people save in tax cuts is invested in the right way and not merely spent on increased consumption.

Some of the more purist supply-siders would argue that only the rich can be trusted to invest their money sensibly and that they should, therefore, get an even bigger tax break than that already contained in the President's across the board tax cut. Mr Reagan's Democratic opponents argue that the package already favours the rich and big business, far too much.

It is true that for many Americans the tax cuts will not mean very much more money in their pockets overnight. The *main effect* will be to stop them paying more than they would have otherwise. As venerable an authority as the International Monetary Fund's staff, while endorsing the overall direction of the Reagan plan, made it clear in a recent report that it believed the Administration had over-estimated the likely supply side effects of the tax cuts—or at least the speed with which they would come about. In its annual economic outlook, the Fund predicted a real growth rate of only 1.25 per cent in U.S. GNP next year, against the Administration's 3.4 per cent.

A key factor will be how far the Administration succeeds in reducing inflation. It is now confidently predicting that the year-on-year rate for 1981 will be in single figures and that the economy is on course for the target of around 5 per cent inflation by the end of 1984. If, however it has got its figures wrong, a key link in the chain will be broken. Interest rates will stay high, further endangering the thrift institutions which are meant to be encouraging savings, and any extra money stemming from the tax cuts will be more likely to go on consumption than investment.

Many of President Reagan's critics would argue that, whatever he may say, his programme is inflationary. Firstly, they would point to the Budget deficit, which, at a projected \$55bn this year and \$42bn next year, is far higher than Mr Reagan originally intended.

Secondly, they take issue with his view that a vast increase in defence spending can be achieved without inflationary spin-off. (Some of them also claim there will not be enough money in the budget to finance the defence build-up after the tax cuts.)

The Administration rejects comparisons, frequently made, with the Johnson Vietnam build-up, now generally admitted to have injected a massive dose of inflation into the system.

Mr Stockman likes to point out that at the time of Vietnam the U.S. domestic budget was expanding at an extremely rapid real rate, whereas today it is declining. The Vietnam build-up also pushed up defence spending from 7 per cent to 9 per cent of GNP, he says, whereas under the Reagan plan it will rise from its current level of 5 per cent to a maximum of 6.8 per cent—less than the Vietnam starting point.

The other answer to any doubts which may be expressed about inflation is the monetarist one. Dr Beryl Sprinkel, the administration's arch monetarist, insists that provided the

Beryl Sprinkel: insists that inflation will be squeezed out of the economy

money supply is kept under control, and the Budget deficit is not financed irresponsibly, inflation will be squeezed out of the economy.

He, like everyone else in the Reagan team, is convinced that Reaganomics can be made to work. For Washington, there is a rare unanimity at all the highest levels of the Administration about where the economy should be heading, and confidence it will get there.

Outside the Administration, as Mr Reagan's triumphs in Congress have shown, there is a widespread feeling that the programme should be given the chance to prove itself one way or the other. Senator Howard Baker of Tennessee, the Republican leader in the Senate, openly admits it is a gigantic "riverboat gamble." But he is putting his money on it, together with a great deal of the Republican Party's political capital.

THE ARTS

Lyttelton

Translations by MICHAEL COVENEY

Any sceptic who feared that the absorption of Brian Friel's *Translations*, the best Irish play for years, by the National Theatre would soften it down or diminish its impact is in for a surprise. It was premiered last year by the Field Day Company in Derry and moved triumphantly on to the Dublin Festival, where I first saw it. Hampstead Theatre gave it a new production earlier this year and it is that version, directed by Donald McWhinnie and designed by Eileen Diss, with costumes by Lindy Hemming, that has now opened in the Lyttelton.

Although set in a Donegal hedge school of the 1830s, there is nothing remote about the dramatic investigation of Anglo-Irish relations. Indeed, for someone like myself, a London Irishman thanks to the potato famine, the play, even after three viewings, sets off strange and complicated feeling of dislocated patriotism, a sharp sense of loss for a world and a way of life to which I can really lay no claim.

This is not maudlin speculation. Nor are these feelings prompted by the exact and highly detailed observation of a vanished rural community. It is with real wonder that this higgledy-piggledly world of casual erudition and fierce communal loyalties is realised by the author, conveyed in a beauifully structured text.

Even in Ireland, it was resonantly ironical that a play about the obliteration of the Irish language was delivered in English. The scene where a young English lieutenant makes love to a bright and romantically ambitious colleen in his language while she responds in hers is struck through with the stuff of real dramatic poetry.

That scene is played unforgettably by Shaun Scott and Bernadette Shortt. His infatuation with the mythology of place names develops in the call of duty, which is the drawing up of a new map. To this end, the Army has hired the services as go-between and interpreter of Owen, elder son of the hedge school master.

Owen has been in Dublin for six years and is moving with the tide of progress. Only when the lieutenant goes missing and the area is threatened with retaliatory eviction and clearance does he realise the folly of his ways. The younger brother, Manus (Gabriel Byrne, an excellent newcomer to the cast), loses his girl to the lieutenant and *sets off, a smouldering*, lame reject, to trudge along the coast.

The show has transferred very well to the large stage, with one remarkable elaboration among the cast. This is the performance of Ian Bannen as Hugh, the bibulous master whose glorious speech, a tapestry of Latin tags, remembered heroism, savage perception and lip-smacking phraseology is now incorporated in a characterisation on the grand scale. Whether offering hospitality as he struggles helplessly around the book-cluttered desk, or bullying reflex responses out of his eager class, this kindly Squeers of Ballybeg is both a celebration of a trust in language and a warning about ignoring its application.

In no way, however, does the performance overshadow the top class work of either Tony Doyle as Owen or Ron Flanagan and Anna Keaveney as tremulous pupils with the countryside on their boots and faces.


Leonard Burt

Ron Flanagan, Anna Keaveney, Ian Bannen and Maire ni Ghrainne

Cinema

Hey ho Silver . . . th

by NIGEL ANDREW

The Legend of the Lone Ranger (U) Odeon Marble Arch
John M Stahl and Shohei Imamura National Film Theatre
In For Treatment ICA

Hurling across the Western landscape its masked white man and Red Indian constant-companion—plus horses—*The Lone Ranger* was one of the staple series of 1950s television. It had a surreal dash and a beguilingly dotty dynamism as it subjected the *William Tell* overture to *prestissimo* extremes and sent its two wrong-righters scampering fearlessly and anonymously across America seeking injustice wherever it might lurk.

Exhumation being the keynote of modern popular cinema, it was never likely that, come the 1980s, these two would rest long in their graves. But *The Legend of the Lone Ranger*, co-presented and co-financed by our very own Lord Grade, turfs them out even more unceremoniously than it might. Accompanied by voiced-off doggerel verses of a rare and ruthless awfulness, it follows our quaintly-matched duo through banally-scripted boyhood years as 'blood-brothers' in and around an indian tribe up to and beyond the moment when the Lone Ranger—hitherto known plainly as John Reid—first dons his black mask and buckskin and hoists his horse up on two legs.

At the point of mask-donning and horse-hoisting, alas, the film advances from the merely asinine to the terminally grotty: with the appearance of the villain, one "Butch" Cavendish (Christopher Lloyd), the kidnapping by Mr Cavendish of President Ulysses S. Grant (Jason Robards) and the shoot-'em-out rescue of this dignitary by you-know-whom. William Fraker, promoted from photographing that high-carat shambles *1941*, directs. But he has brought with him his stock-in-trade diffusion effects, here so exaggerated as to suggest that the film was shot through lubricated sackcloth. Acted with a wondrous woodenness to boot by Klinton Spilsbury in the name role, this appalling aberration is the closest to a Hara-kiri act yet committed by Lord Grade's production company.

★

Two excellent seasons claim your attention at the National Film Theatre this month. "The Romantic Image" celebrates John M. Stahl, a Hollywood director of a stylish and equal aptitude for comedy and melodrama, whose best-known films were Mark-1 models of the "women's pictures" later remade by more famous weepie-maestro Douglas Sirk in the 1950s. Although Stahl was first in the field with *Imitation of Life, Magnificent Obsession* and *When Tomorrow Comes* (remade by Sirk as *Interlude*), Sirk's work has attracted more critical limelight in recent years. But that Stahl had his own grandeur is proved by the long-running liveliness of his career and by at least one unique and magnificent movie that one doubts anybody could remake—so delicately does it tightrope-walk over absurdity—without falling sheer to his doom.

Leave Her to Heaven, showing at the NFT on August 18, is a bubbling brew of jealousy, murder and frustrated passion involving Cornel Wilde, Gene Tierney, much palatial scenery and many mythopoeic sunsets. This astonishing *danse macabre* of familial ferocity—Tierney's possessive love as Wilde's wife prompts her to do away with all who come near, competing for his affection—is filmed in a bronzy, rich-textured Technicolor the like of which you will seldom have seen: fulminous colours, swirling shadows, a sumptuous minuteness of detail.

Shohei Imamura, to whom the National Film Theatre devotes a concurrent season, is a spikily original talent from Japan and one of the small handful of directors who have successfully stormed into the breach left by the (virtual) retirement of Kurosawa and Ichikawa. His strong, caustic pictures of Japanese society range from the black-comedy brio of *The Pornographer* via the grainy documentary style of *Post-War History of Japan as Told by a Bar Hostess* to the stark pessimism of *Vengeance Is Mine*, his latest film to be seen in this country and a fearsome assault-course through the life and mind of a multiple murderer, and the brackish embattled society from which he springs. Imamura holds joint sway with Stahl at the NFT until the end of August.

★

"Het Werkteater" is a Dutch drama group who specialise, so their Press handout vouchsafes to us, in "performing plays to audiences whose daily life involves contact with people suffering from serious illnesses."

Erik van Zuylen's *In For Treatment*, a powerful film version of one of their plays, can hardly be more comforting to the sick and their friends and relatives than a terminal diagnosis. It follows the grim fortunes of a middle-aged market-gardener (played by Helmert Woudenberg) who after being detained for long and mysterious weeks in hospital for "tests" and "examinations" finally discovers he has a malignant brain tumour. This after nurses have bustled briskly about, batting away his anxieties, and doctors, saying "This won't hurt," have inserted tubes and thermometers into nameless regions and planted oil-derricks in his chest to pump for blood. By the middle of the film your stomach has taken up almost permanent residence in the back of your mouth.

Fortunately the film has the kindness to go on and cast a slightly more optimistic light, if not on the patient's chances of recovery at least on the deportment and good will of the hospital staff. *In For Treatment* is

Greenwich

The Killing Game

by B. A. YOUNG

Lieutenant - Colonel Guy Holden, DSO, MC, commanding the London Regiment (which has changed since I served in it) plays games with his batman, like pretending to shoot him or knife him. He does this even when his wife Clarissa is there, or her father, a retired general, once Colonel of the Regiment. His second-in-command, George Bradley, newly appointed from the Cheshires, disapproves of his CO; he openly avers that the DSO was won for massacring Irish teenage boys and a woman.

Clarissa's trouble is that she

court-martial by the general and the colonel and his wife, ending in a death sentence which only turns out to be another of those games.

A few points for the attention of Thomas Muschamp, author, and Derek Martinus, director. Majors don't call colonels "sir" in their homes, or colonels generals. A brigadier is not a general. Bradley couldn't have been appointed to command the London Regiment when he has openly shown his disloyalty to the colonel. Senior officers don't discuss intimate matters in the presence of their wives

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TELEGRAM NUMBER 2354 OF 6 AUGUST 1981,

INFO OTTAWA, PARIS, BONN, ROME, TOKYO, AND UK DEL O E C D.

U S ECONOMIC PROGRAMME: BUDGETARY LEGISLATION

1. CONGRESS HAVE PASSED AND SENT TO THE PRESIDENT FOR SIGNATURE THE TAX AND BUDGET RECONCILIATION BILLS. (SEE MY TELNO 2303 OF 31 JULY). PRESIDENT REAGAN IS EXPECTED TO SIGN THEM SHORTLY.

2. THE TAX BILL SUBSTANTIALLY ALTERS THE U S FEDERAL TAX STRUCTURE. ITS MAIN FEATURES ARE (A) REDUCTIONS ON 25 PERCENT IN PERSONAL INCOME TAX RATES IN THREE STAGES OVER 33 MONTHS STARTING ON 1 OCTOBER 1981 AND (B) ACCELERATED DEPRECIATION ALLOWANCES FOR U S BUSINESS INVESTMENT BASED MAINLY ON STANDARD DEPRECIATION PERIODS OF 10, 5 OR 3 YEARS FOR DIFFERENT CATEGORIES OF INVESTMENT. THE PERSONAL INCOME TAX CUTS WILL REDUCE THE TOP MARGINAL RATE TO JUST OVER 50 PERCENT, AND THE MAXIMUM TAX ON LONG TERM CAPITAL GAINS TO JUST OVER 20 PERCENT. THE BILL ALSO INCLUDES A LARGE NUMBER OF SMALLER MEASURES THAT WERE ADDED DURING CONGRESSIONAL CONSIDERATION TO ATTRACT SUPPORT FROM DEMOCRATS. THESE INCLUDE TAX RELIEF FOR OIL PRODUCERS: DIRECT TAX INCENTIVES FOR SAVING: REDUCTIONS IN GIFT AND ESTATE TAXES: AND INDEXATION OF ALL PERSONAL INCOME TAX BRACKETS FROM FY85 ONWARDS.

3. THE NET EFFECT OF THE TAX CHANGES WILL BE TO REDUCE REVENUES, COMPARED WITH PREVIOUS PROJECTIONS, BY US DOLLARS 37.7BN IN FY82, RISING TO US DOLLARS 149.9BN IN FY84. OF THE TOTAL CUTS IN FY82, THE PERSONAL TAX CHANGES ACCOUNT FOR SOME US DOLLARS 26.9NB, BUSINESS TAX CHANGES US DOLLARS 10.7NB, ENERGY-RELATED PROVISIONS US DOLLARS 1.3BN, AND SAVINGS INCENTIVES US DOLLARS 0.3BN. ELIMINATION OF MOST COMMODITY TAX STRADDLES INCREASE REVENUE BY SOME US DOLLARS 0.6BN. ON THE ADMINISTRATION'S ECONOMIC ASSUMPTIONS, FEDERAL REVENUES ARE NOW FORECAST TO DECLINE FROM 21.1 PERCENT OF G N P IN 1981 TO 19.0 PERCENT IN FY84.

4. THE BUDGET RECONCILIATION BILL REDUCES THE SCOPE OF A NUMBER OF FEDERAL EXPENDITURE PROGRAMMES AND WILL PROVIDE EXPENDITURE SAVINGS OF SOME US DOLLARS 35BN IN FY82 RISING TO US DOLLARS 55.6BN IN FY-84. IT AFFECTS A NUMBER OF SENSITIVE AREAS OF FEDERAL EXPENDITURE, INCLUDING FOR EXAMPLE THE REPEAL OF THE MINIMUM SOCIAL SECURITY BENEFIT FOR BOTH NEW AND EXISTING BENEFICIARIES, AND CUTS IN THE PUBLIC SERVICE EMPLOYMENT PROGRAMME, IN THE FOOD STAMP PROGRAMME AND IN TRADE ADJUSTMENT ASSISTANCE FOR THE UNEMPLOYED. THE BROAD PROVISIONS OF THE BILL WILL NOW NEED TO BE TRANSLATED, AFTER THE SUMMER RECESS, INTO DETAILED APPROPRIATIONS FOR EACH SERVICE FOR FY82.

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5. THE PASSAGE OF THE TAX AND BUDGET RECONCILIATION BILLS REPRESENTS A VERY SIGNFICANT POLITICAL ACHIEVEMENT FOR PRESIDENT REAGAN, AND GIVES HIM MOST OF THE ECONOMIC MEASURES WHICH HE SOUGHT FOR FY82. THERE ARE, HOWEVER, SOME SIGNFICANT DIFFERENCES FROM THE PROGRAMME WHICH HE ORIGINALLY PRESENTED. ON THE TAX SIDE, THE 30 PERCENT CUT WHICH HE ORIGINALLY PROPOSED IN PERSONAL TAX RATES, IN 3 EQUAL INSTALMENTS OVER 3 YEARS, HAS NOW BEEN SCALED BACK TO 25 PERCENT, WITH THE FIRST INSTALMENT REDUCED TO 5 PERCENT AND DEFERRED TO 1 OCTOBER 1981. THE BUSINESS TAX MEASURES WENT THROUGH BROADLY AS PROPOSED. THE LARGE NUMBER OF EXTRA TAX MEASURES CONCEDED TO GAIN CONGRESSIONAL SUPPORT ARE NOT FULLY CONSISTENT WITH THE STATEMENT IN HIS INAUGURAL ADDRESS QUOTED IN MY DESPATCH OF 16 APRIL, THAT THE TAX SYSTEM QUOTE MUST NOT BE USED TO REGULATE THE ECONOMY NOR BRING ABOUT SOCIAL CHANGE UNQUOTE. ON THE EXPENDITURE SIDE, HE HAS GOT THE BULK OF THE SAVINGS WHICH HE SOUGHT, BUT THE CONGRESS DID NOT FULLY IMPLEMENT HIS PROPOSALS TO COMBINE NUMEROUS SPECIFIC GRANTS TO THE STATES AND CITIES INTO BROADER BLOCK GRANTS. THE REJECTION BY CONGRESS OF HIS FIRST PROPOSALS TO REFORM THE SOCIAL SECURITY SYSTEM ALSO DOES NOT AUGUR WELL FOR OBTAINING THE FURTHER SPECIFIC SPENDING CUTS WHICH ARE STILL REQUIRED FOR YEARS AFTER FY82.

6. IN THE LONGER TERM, A NUMBER OF QUESTION MARKS REMAIN OVER THE SUCCESSFUL IMPLEMENTATION OF THE ECONOMIC RECOVERY PROGRAMME. THESE INCLUDE:

A. THE EXPENDITURE SAVINGS INCLUDED IN THE RECONCILIATION BILL ONLY ACHIEVE ABOUT HALF OF THE SAVINGS WHICH THE ADMINISTRATION CALCULATE TO BE REQUIRED TO BALANCE THE FEDERAL BUDGET BY FY84. SAVINGS OF AT LEAST US DOLLARS 33BN IN FY83 AND US DOLLARS 44BN IN FY84 REMAIN TO BE FOUND. THE ADMINISTRATION WILL THUS NEED TO IDENTIFY OVER THE NEXT SIX MONTHS SUBSTANTIAL FURTHER SAVINGS THAT ARE ACCEPTABLE TO CONGRESS (AND ADDITIONAL TO ITS PLANNED SOCIAL SECURITY REFORM) IF ITS TARGETS ARE TO BE MET.

B. FROM THE START, EXPERTS FROM ALL POINTS ON THE POLITICAL SPECTRUM HAVE QUESTIONED WHETHER THE CLAIMED EFFECTS OF THE PERSONAL INCOME TAX CUTS ON SAVINGS AND WORK INCENTIVES WILL MATERIALISE . THE PRUNING OF THE TOTAL CUT FROM 30 TO 25 PERCENT MEANS THAT IT NOW DOES LITTLE MORE THAN OFFSET INFLATIONARY QUOTE BRACKET CREEP UNQUOTE AND HIGHER SOCIAL SECURITY TAXES. THE U S ADMINISTRATION CONTINUE TO ARGUE IN REPLY THAT THE BENEFIT WILL BE FELT BECAUSE PEOPLE WILL HAVE THE ASSURANCE THAT THE TAX BURDEN WILL NOT FURTHER INCREASE, AND BECAUSE MARGINAL TAX RATES FOR HIGHER INCOME EARNERS ARE BEING REDUCED. THEY HAVE, HOWEVER, ADVANCED LITTLE EMPIRICAL EVIDENCE FOR THIS VIEW.

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C. MANY OBSERVERS, INCLUDING THE O E C D AND I M F, HAVE QUESTIONED WHETHER THE ADMINISTRATION WILL BE ABLE TO GET THE SIMULTANEOUS QUICK RETURN TO RAPID ECONOMIC GROWTH AND LOW INFLATION ASSUMED IN ITS ECONOMIC PROJECTIONS. IF THE ECONOMY FAILS TO MATCH UP TO THESE ASSUMPTIONS, THE FISCAL DEFICIT WILL TEND TO BE WIDENED, AND AS THE TAX REDUCTIONS ARE NOW IN PLACE, FURTHER SPENDING CUTS BEYOND THOSE MENTIONED IN (A) ABOVE WOULD BE REQUIRED TO BALANCE THE BUDGET BY FY84. THIS COULD IMPERIL THE PROPOSED RAPID BUILD-UP IN DEFENCE SPENDING.

D. IN PARTICULAR, DOUBTS HAVE BEEN EXPRESSED WHETHER THE POLICY ENDORSED BY THE ADMINISTRATION CAN BE CONSISTENT WITH ITS ASSUMPTION OF STRONG ECONOMIC GROWTH NEXT YEAR. THE MID-SESSION BUDGET REVIEW USES ECONOMIC ASSUMPTIONS THAT IMPLY SUSTAINED RAPID INCREASES IN MONEY VELOCITY, IN EXCESS OF HISTORICAL EXPERIENCE, AT A TIME WHEN INTEREST RATES ARE PROJECTED TO DECLINE. THE FEDERAL RESERVE BOARD ALSO BELIEVE THAT THE TAX CUTS WILL PLACE AN ADDITIONAL BURDEN ON MONETARY POLICY, AND MAINTAIN AN UPWARD PRESSURE ON INTEREST RATES. IF INTEREST RATES DO REMAIN HIGH, THIS COULD HAVE AN ADVERSE IMPACT ON THE THRIFT INSTITUTIONS AND HEIGHTEN EUROPEAN CONCERN ABOUT THE EFFECTS OF HIGH INTEREST RATES ON THEIR ECONOMIES, AS WELL AS HELPING TO SUSTAIN THE VALUE OF THE DOLLAR. A FURTHER YEAR OF SLUGGISH GROWTH IN 1982 WOULD ALSO MEAN THAT UNEMPLOYMENT WOULD REMAIN HIGH IN THE RUN UP TO THE NEXT CONGRESSIONAL ELECTIONS IN THAT YEAR.

7. F C O PLEASE PASS TO BOTTRILL (TREASURY), HAYWARD BANK OF ENGLAND) AND BROADBENT (F C O).

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MRS GILMORE

Prime Minister

To glance.

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... I attach a statement by Mr Paul Volcker, Chairman, Board of Governors of the Federal Reserve System before the Joint Economic Committee on July 16 1981.

2. The Chancellor has commented that this is a characteristically robust, clear and perceptive speech, well worth propagating and using where we can. He has in mind particularly some of the UK economic press. He has also commented that the point in the first paragraph of page 5 maybe useful for briefing of Cabinet colleagues.

3. I am copying the speech to Tim Lankester in No 10.

P.S. JENKINS
3 August 1981

I appreciate the opportunity to appear before this Committee to present the Federal Reserve's views on the international implications of U.S. macro-economic policies, and particularly monetary policy.

Inevitably questions arise abroad, as they do in this country, about particular techniques and implications of U.S. ecomomic policies. After all, nearly all of the nations represented at the Ottawa Summit, and most others, are faced with difficult problems and choices in developing economic policy, and external influences on their interest rates and exchange rates inevitably raise new complications for some -- just as at times external developments complicate our own policy-making. However, the expression of such concerns should not be taken as disagreement with the basic intent or thrust of our policies, certainly not among those most closely concerned with financial policy. I base that judgment on my own discussions with central bankers and finance ministers abroad as well as on the conclusions reached in May at the meeting of the IMF's Interim Committee in Gabon and more recently at the OECD Ministerial meeting.

Accordingly, I expect that the President will hear a general endorsement of the broad purposes and objectives of U.S. economic policies when he meets next week with other heads of state and governments. Specifically, I believe that the priority the United States has attached to the fight against

With The Compliments
Of

Paul A. Volcker

For release on delivery
9:00 A.M., E.D.T.

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

July 16, 1981

A characteristically robust, clear
+ perceptive speech, which
others may like to see
(incl. perhaps No.10 – + some of
the UK economic press?)

(The point on p.5 also pertinent for
our ~~[illegible]~~ briefing of Cabinet colleagues)
Also worth emulation by our
own speech-writers

inflation is widely appreciated. Indeed, the leaders of these very nations, along with many others, have long urged us to adopt rigorous and convincing anti-inflation policies, and I do not believe they will change that attitude now.

Foreign officials do rightly stress that, in our interdependent world, U.S. economic developments and policies have ramifications for the policies and performance of other economies. Our weight in the world economy, while relatively smaller than in the early postwar years, is still very significant, and leaders abroad have to take U.S. economic policies into account when they formulate their own programs. They do want us to be aware of the external implications of high dollar interest rates and a rising dollar, as we should be. The short-run effects -- abroad as well as at home -- can indeed be discomforting. But we should also have a sense of proportion about those effects.

The United States should not and can not assume the responsibility for all the economic difficulties of particular countries. In some instances -- for example, countries with sizable balance-of-payments deficits -- some depreciation of their currencies relative to the dollar may have been natural, and a number of countries have internal reasons for following firm monetary policies. Changes in exchange rate relationships within Europe have been relatively small recently, and most of the trade of those countries is not affected by the substantial appreciation of the dollar. The point is often made in the context of the dollar's appreciation that oil and other commodities are priced in dollars, but it should also be pointed out that monetary restraint in the United States has contributed importantly to squeezing out inflationary excesses in those markets.

FS? has done so

In general, it is rarely easy to trace through the relative weight of different forces impacting on the economic policy problems of different countries. We all -- certainly including the United States -- must guard against a temptation to assign undue responsibility to external forces. I would remind you that any exchange rate involves two national currencies; a change in that exchange rate may reflect policies or developments in either country, or more likely both at the same time. The recent "strength" of the dollar vis-a-vis some currencies headlined in the press has been relative; it may be -- indeed has been -- influenced by conditions abroad, as well as in the United States. I would note that short-term interest rates in the United States are a bit lower today than at the turn of the year, and interest rate differentials are narrower with respect to continental European currencies. Yet the dollar has appreciated substantially against those currencies over the past six months.

Because of the potential for misunderstanding, and because developments and policies here do have effects on other countries whose leaders face difficult economic problems and choices, we have a clear responsibility to listen closely to their views, to explain our policies carefully, and to respond to constructive, substantive criticism. Prolonged misunderstanding is always dangerous, for economic and political friction could impair the fabric of the open international economy that serves us all. My perception is that, fortunately, there is broad understanding of our objectives and policies -- combined, of course, with a good deal of impatience in awaiting results, just as is sometimes the case at home.

The essential point about U.S. economic policies -- monetary, fiscal and other -- is our commitment to reducing inflation. Most of the foreign leaders with whom I have talked readily agree that it is in their countries' fundamental interest, as well as ours, that the United States make significant progress against inflation. Because of the dollar's role in world financial markets and because of the U.S. prominence in the world economy, a necessary condition for the restoration of stability in currency markets and for the resumption of sustained, worldwide economic growth is the restoration of greater price stability in the United States.

Obviously, they, as we, would like to see lower and more stable U.S. interest rates and less variation in exchange rates. Everyone would agree that reduced inflation and a clear sense of movement toward price stability must be the basis for maintaining such stability over time. Against that background, international discussions raise questions of means, not ends.

As you know, Federal Reserve monetary policy has been directed at restraint in the rate of growth of the monetary aggregates. Some observers -- and they are not confined to those outside our borders -- believe we are following a policy deliberately directed at achieving high interest rates and dollar appreciation. Such views are mistaken; the Federal Reserve has neither an interest rate nor an exchange rate objective. We do take the view that persistent restraint in the growth rates of the monetary aggregates is necessary to ensure lower inflation -- and therefore lower interest rates -- over time. I find no disposition among my colleagues abroad to question that necessity.

In the short run, interest rates are a function of the many factors that influence the demand for money and credit, including the budgetary position of the government, the strength of business activity, and the inflationary momentum. So long as actual and expected inflation and nominal demand remain strong, high interest rates should not be surprising. Only when inflation slackens significantly, and markets believe the slowdown will be sustained, can we look forward to meaningful, sustained declines in dollar interest rates, consistent with growth in real activity.

Relative interest rates can and do influence exchange markets. But that influence has to be judged in the context of other influences working at the same time. As I have already suggested, it would be a mistake to attribute the roughly 20 percent weighted-average appreciation of the dollar since December of last year primarily to the behavior of nominal interest rates on dollar assets. The differential between U.S. interest rates and short-term interest rates on average in foreign industrial countries has declined about 2-1/2 percentage points since the end of 1980. U.S. short-term interest rates are now about 1 percentage point less than their December average. Interest rates on the continent of Europe are appreciably higher, yet their currencies have depreciated substantially relative to the dollar. Interest rates in two of the Summit countries -- Japan and the United Kingdom -- have declined so far this year, and in one of those countries -- Japan -- the depreciation of its currency relative to the dollar has been smaller than that of the continental European currencies. The yen, as well as the Canadian dollar, has experienced a weighted-average appreciation so far this year.

Obviously, one must look beyond absolute or relative interest rates to explain the dollar's appreciation this year. Among the other relevant factors in the United States have been the first signs of some improvement in our relative inflation performance, a continuation of a relatively favorable U.S. current-account position, and favorable assessments of the potential of the new Administration's economic program. On the other side of the Atlantic, balance-of-payments deficits have been large, and there has been a sense of greater political change and uncertainty.

A number of foreign observers, while not questioning the need for monetary restraint in the United States have suggested that monetary policy should not carry so much of the burden of the stabilization effort either here or in their own countries. As you know, I have also often emphasized the importance of fiscal restraint and regulatory and other policies, alongside firm restraint on the money supply, in a comprehensive program to reduce U.S. inflation. At the same time, we all have to recognize the difficulties in changing these policies dramatically and quickly. We are in fact making progress in reducing the strong upward trend in government expenditures -- and I would remind you that the Administration has emphasized that more will need to be done in future years, particularly if we are to reap the benefits of tax reduction in a context of reduced budget deficits. The closer the budget is to balance, all else equal, the less pressure will be felt in financial markets, the lower interest rates will be, and the danger of abnormal exchange rate pressures will be lessened. But it would be unreasonable to expect a balanced budget overnight, and I believe there is a growing understanding abroad, as at home, that fiscal policy cannot easily be shifted in the short run. After all, most other governments are grappling with fiscal problems at least as difficult as our own.

It is equally important to recognize that there are no "quick fixes" available through monetary policy to lower or fine tune interest rates. If the Federal Reserve, for example, were to deviate from its policy of monetary restraint in an effort to lower interest rates, any seeming short-run relief would have to be balanced against the substantial risk -- for the United States and the rest of the world -- of excessive credit growth, a further hardening of inflationary expectations, and still greater interest rate pressures in the future.

"Like others, I shall applaud lower interest rates in the United States any day if they signal success in the battle against inflation. But I would look upon lower rates with mixed feelings if they promised more inflation and hence higher interest rates for the future." Those words are not mine, but those of a central bank colleague in Europe.* It seems to me they capture the essence of our policy problem.

Of course, as I suggested earlier, there is impatience for results. Monetary restraint is painful, and it cuts unevenly, at home as well as abroad. Moreover, the burdens are not restricted to the industrial economies; developing countries are affected as well. Some are experiencing slower growth in their exports because of slack demand in the industrial world. They are all facing much stiffer borrowing terms in international markets than those to which they have been accustomed. It may be of little comfort to suggest that, in some cases, those terms may well have been too easy in the past -- internationally as well as domestically nominal interest rates have frequently

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*Remarks by Karl Otto Pohl, President of the Deutsche Bundesbank, June 12, 1981, before the Roundtable of the International Banking Institute in Cannes.

been exceeded by actual inflation rates, encouraging excessive indebtedness and the postponement of needed adjustments. What we would all like to see is a reasonable middle ground, and more stability and predictability; we will not succeed unless we keep at it.

If we cannot promise instantaneous and easy results -- the answers do not lie in "fine tuning" fiscal or monetary policies -- we can and must make the effort necessary to explain our policies, formally and informally, in all the forums available to us, and to consider carefully the views of others. In that connection, I have long felt that the economic summits can help assure that our mutual economic concerns are fully discussed and addressed at the highest level, and the success of those meetings over time can be measured less by any concrete agreements than by the degree of understanding reached about our mutual problems and purposes.

Certainly we must all avoid the temptation to become inward looking during this difficult period. Intensification of trade restrictions would be damaging to the interest of all countries. Together we must seek effective ways to help developing countries cope with their own serious adjustment problems, not the least by maintaining and strengthening our commitment to cooperation and dialogue in the IMF and World Bank.

Most of all, it is crucial that we not fail in our basic purpose of restoring stability and laying the base for sustained growth. One wise foreign official, widely experienced in international affairs, recently put it to me roughly as follows: You cannot expect us to be enthusiastic about the effects of your policies; we will all have different opinions about just how you are going about it; but the fact is we have no agreed better alternatives to offer you. We can only wish you success.

I would only add that with success the present international concerns will fade in memory. We would do no one a service, at home or abroad, if we were to take actions that would jeopardize the prospects for that success.

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FM WASHINGTON 312230Z JUL 81
TO ROUTINE F C O
TELEGRAM NUMBER 2303 OF 31 JULY

US ECONOMIC PROGRAMME: BUDGETARY LEGISLATION.

1. THE HOUSE OF REPRESENTATIVES AND SENATE HAVE DECIDED TO TRY TO COMPLETE WORK ON THE TAX BILL AND THE BUDGET RECONCILIATION BILL BEFORE THE SUMMER RECESS, ORIGINALLY SCHEDULED FOR TOMORROW. CONGRESSIONAL LEADERS EXPECT THIS PROCESS TO TAKE UNTIL THE MIDDLE OF NEXT WEEK.

2. ON THE TAX SIDE, IT WILL BE NECESSARY TO RESOLVE THE DIFFERENCES BETWEEN THE HOUSE AND SENATE VERSIONS OF THE TAX BILL (SEE MY TELNO 2286 OF 29 JULY). THIS IS NOT EXPECTED TO PRESENT GREAT DIFFICULTY, THOUGH A NUMBER OF SENATORS ARE KNOWN TO BE CONCERNED ABOUT THE GENEROUS TREATMENT WHICH HAS BEEN GIVEN TO OIL PRODUCERS IN THE HOUSE BILL.

3. BOTH HOUSE AND SENATE VERSIONS CONTAIN THE KEY ELEMENTS OF THE PRESIDENT'S REVISED PROPOSALS: A 25 PER CENT CUT IN PERSONAL INCOME TAX RATES TO BE INTRODUCED IN 3 STAGES OVER 33 MONTHS STARTING NEXT OCTOBER, AND AN ACCELERATED (10 : 5 : 3) DEPRECIATION SCHEDULE FOR BUSINESS INVESTMENT. THESE PROVISIONS THEREFORE SEEM CERTAIN TO EMERGE IN THE FINAL VERSION.

4. ON THE EXPENDITURE SIDE, A HOUSE/SENATE CONFERENCE COMMITTEE RECOMMENDED ON 29 JULY A COMPROMISE RECONCILIATION BILL THAT IS EXPECTED TO BE ACCEPTABLE TO BOTH THE HOUSE AND SENATE. (SEE MY TELNO 1983 OF 29 JUNE). THIS BILL PROVIDES FOR REDUCTIONS IN THE SCOPE OF A NUMBER OF FEDERAL PROGRAMMES, AND WHEN PASSED IT WILL PROVIDE MOST OF THE EXPENDITURE SAVINGS CALLED FOR IN THE PRESIDENT'S ECONOMIC PROGRAMME FOR FY82. PASSAGE OF THE RECONCILIATION BILL BEFORE THE RECESS WILL LEAVE RELATIVELY LITTLE BUDGETARY BUSINESS TO BE CONSIDERED WHEN CONGRESS RE-ASSEMBLES ON 8 SEPTEMBER.

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TELEGRAM NUMBER 2126 OF 13 JULY
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PROSPECTS FOR THE U.S. ECONOMY.

1. AT THE OTTAWA SUMMIT, PRESIDENT REAGAN WILL HAVE THE FIRST OPPORTUNITY PERSONALLY TO EXPLAIN HIS ECONOMIC PROGRAMME TO THE HEADS OF GOVERNMENT AS A GROUP. THE ADMINISTRATION HAS BEEN SHOWING SIGNS OF GROWING AWARENESS OF THE CONCERN EXPRESSED BY OTHER COUNTRIES ABOUT THE INTERNATIONAL EFFECT OF U.S. ECONOMIC POLICIES. REAGAN WILL WISH TO CONVINCE OTHER LEADERS OF THE MERITS OF HIS PROGRAMME OR AT LEAST (E.G. IN THE CASE OF MITTERRAND) TO CONVINCE THEM THAT ANY DIFFICULTIES CAUSED BY TEMPORARILY HIGH INTEREST RATES ARE ESSENTIAL FOR EVENTUAL SUCCESS IN REVITALISING THE AMERICAN ECONOMY.

2. THE BACKGROUND IS SET OUT IN MY TELNO 2023. ONE OF REAGAN'S PROBLEMS IS THAT IT IS NOT CLEAR THAT THE U.S. ECONOMY IS GOING TO GROW AS FAST AS THE ADMINISTRATION PREDICT. THE ADMINISTRATION POSTULATE IN THEIR ECONOMIC SCENARIO THAT THERE WILL BE REAL GNP GROWTH OF 4.2 PERCENT IN 1982 (THEY NOW EXPECT A SLACKENING OFF FOR MUCH OF THE REMAINDER OF 1981). THERE IS A LARGE GAP BETWEEN 4.2 PERCENT AND THE OECD SECRETARIAT FORECAST OF 1 PERCENT. MOST PRIVATE FORECASTERS HERE ARE PREDICTING AN OUTCOME RATHER NEARER THE ADMINISTRATION'S THAN THE OECD'S. BUT DOUBTS ARE FREQUENTLY EXPRESSED EVEN HERE ABOUT WHETHER REAGAN'S MEASURES CAN SHARPLY REDUCE INFLATION WITHOUT RESTRAINING OUTPUT, PARTICULARLY SINCE THE ADMINISTRATION IS ENCOURAGING THE FEDERAL RESERVE BOARD TO CONFINE MONETARY GROWTH STRICTLY WITHIN THE TARGETS.

3. REAGAN'S PROPOSED EXPENDITURE REDUCTIONS FOR FY82 SHOULD BE PASSED BY CONGRESS BEFORE THE START OF FY82 IN OCTOBER. NONETHELESS, IF SUFFICIENT GROWTH DOES NOT OCCUR IN 1982, THIS WOULD ALMOST CERTAINLY PUSH UP THE ADMINISTRATION'S FORECAST DOLLARS 45 BILLION BUDGET DEFICIT IN FY82, AS A RESULT OF THE REDUCTION IN TAX RECEIPTS AND THE INCREASE OF SOCIAL WELFARE PAYMENTS. THIS WOULD IMPOSE AN EVEN GREATER BURDEN ON MONETARY POLICY FOR CONTAINING INFLATION. CONTINUING HIGH INTEREST RATES WOULD ALSO WORSEN THE BUDGET DEFICIT BECAUSE OF HIGHER THAN EXPECTED DEBT INTEREST PAYMENTS. THE ADMINISTRATION CLAIM THAT U.S. INTEREST RATES SHOULD COME DOWN ONCE INFLATION IS REDUCED, BUT BOTH SHORT AND LONG-TERM RATES HAVE QUITE RECENTLY TURNED UP AGAIN DESPITE EVIDENCE THAT THE RATE OF INFLATION IS NOW EDGING DOWN. REGAN TOLD THORN THAT HE EXPECTED INTEREST RATES TO COME DOWN BY THE END OF THIS YEAR.

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4. THE RECENT DECLINE IN THE RATE OF INFLATION TO ABOUT 10 PERCENT MAINLY REFLECTS A MODERATING TREND IN FOOD AND ENERGY PRICES. THE PROSPECTS FOR SUBSTANTIAL CONTINUED SUCCESS IN REDUCING THE INFLATION RATE DEPEND ON LOWER WAGE SETTLEMENTS AS THE PRICE LEVEL COMES DOWN, AND THERE IS NOT YET MUCH EVIDENCE OF THIS. A GOOD ASSESSMENT OF THESE PROSPECTS WILL NOT BE POSSIBLE UNTIL NEXT YEAR WHEN SEVERAL MAJOR NEW PAY AGREEMENTS ARE DUE TO BE NEGOTIATED. THE ADMINISTRATION'S ASSUMPTION OF A RISE IN CONSUMER PRICES OF 8.3 PERCENT IN 1982 THEREFORE SEEMS TO BE ONE OF THE MORE PLAUSIBLE ELEMENTS IN THEIR SCENARIO, PROVIDED INFLATIONARY EXPECTATIONS DO NOT DETERIORATE ON ACCOUNT OF THE SIZE OF THE BUDGET DEFICIT.

5. AS REGARDS THE ''SUPPLY SIDE'' EFFECTS OF REAGAN'S PROGRAMME, THE MAIN CURRENT CONCERN ABOUT INVESTMENT PROSPECTS IS THE PRESENT HIGH LEVEL OF REAL INTEREST RATES, WHICH THE PROGRAMME MAY DO LITTLE TO REDUCE. DOUBTS ARE ALSO EXPRESSED WHETHER THE PROPOSED PHASED PERSONAL TAX REDUCTION WILL PROVIDE MUCH GENERAL INCREASE IN PERSONAL INCENTIVES FOR SAVING AND WORK, SINCE ON AVERAGE IT WILL DO LITTLE MORE THAN OFFSET THE INCREASED TAX BURDEN DUE TO THE EFFECT OF INFLATION ON THE REAL LEVEL OF THE TAX BRACKETS. THE EFFECTS WILL DEPEND ON THE EXACT SHAPE OF THE TAX LEGISLATION WHICH EMERGES FROM CONGRESS, WHICH IS STILL UNCLEAR. IF THE REPUBLICANS SUCCEED IN CONCENTRATING TAX REDUCTIONS IN THE UPPER BRACKETS, AND IF THE TOP RATE OF INCOME TAX IS IMMEDIATELY REDUCED THIS OCTOBER FROM 70 PERCENT TO 50 PERCENT (AND OF CAPITAL GAINS TAX FROM 28 PERCENT TO 20 PERCENT) AS REAGAN NOW PROPOSES, THERE MAY BE SOME FAVOURABLE INCENTIVE EFFECTS. ANY SUCH EFFECTS WILL HOWEVER TAKE TIME TO FEED THROUGH INTO INCREASED INVESTMENT AND GROWTH, AND MAY NOT MUCH AFFECT THE PROSPECTS FOR 1982. THIS IN TURN HAS IMPLICATIONS FOR HOW SOON THE ADMINISTRATION CAN ACHIEVE THE GRADUAL DECLINE IN UNEMPLOYMENT WHICH IS ALSO INCLUDED IN THEIR ECONOMIC SCENARIO.

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TELEGRAM NUMBER 2023 OF 2 JULY
INFO SAVING PARIS, BONN, UKREP BRUSSELS, UKDEL OECD, ALL CG'S IN USA.

PRESIDENT REAGAN'S ECONOMIC RECOVERY PROGRAMME: THE PRESENT POSITION

1. THE 4 JULY CONGRESSIONAL RECESS PROVIDES THE OPPORTUNITY TO TAKE STOCK OF HOW FAR PRESIDENT REAGAN'S FOUR-PART ECONOMIC RECOVERY PROGRAMME HAS PROGRESSED TOWARDS IMPLEMENTATION AND THE PRESENT PROSPECTS FOR THE UNITED STATES ECONOMY.

2. IT IS NOW JUST 3 MONTHS UNTIL FY 1982 BEGINS ON 1 OCTOBER. ACCORDING TO THE TIMETABLE IN THE 1974 BUDGET ACT, THE LEGISLATION IMPLEMENTING REAGAN'S EXPENDITURE AND TAX CUTS SHOULD BE IN PLACE BY THEN. THIS IS NORMALLY A TIGHT TIMETABLE, BUT REAGAN APPEARS LIKELY TO BE SUCCESSFUL IN ADHERING TO IT.

EXPENDITURE

3. PRESIDENT REAGAN ACHIEVED A MAJOR PERSONAL VICTORY ON 26 JUNE (SEE WASHINGTON TELEGRAM NO 1987 OF 29 JUNE) WHEN THE HOUSE OF REPRESENTATIVES PASSED THE ADMINISTRATION-BACKED OMNIBUS BUDGET RECONCILIATION BILL, LARGELY BECAUSE OF HIS INTENSIVE LOBBYING OF CONGRESSMEN. WHILE IT IS CONCEIVABLE THAT THE BILL COULD RUN INTO DIFFICULTIES DURING THE CONFERENCE PROCEDURE TO ELIMINATE DIFFERENCES BETWEEN THE HOUSE AND SENATE VERSIONS, THIS SEEMS UNLIKELY. IT ALSO SEEMS UNLIKELY THAT MANY OF THE CUTS WILL BE RESTORED WHEN INDIVIDUAL VOTES ARE TAKEN TO APPROPRIATE FUNDS. THE UPSHOT IS THAT REAGAN IS NOW ALMOST CERTAIN TO GET ALL HIS DESIRED BUDGET REDUCTIONS FOR FY82.

4. AS REGARDS FY83 AND BEYOND, THERE IS STILL SOME ROOM FOR DOUBT ABOUT WHETHER ALL THE ADMINISTRATION'S TARGETS FOR PUBLIC EXPENDITURE REDUCTIONS WILL BE MET. THESE INCLUDE SUBSTANTIAL AMOUNTS TO BE OBTAINED BY FURTHER CUTS AS YET UNSPECIFIED, AND THE ADMINISTRATION WILL NEED TO SPELL THESE OUT IF IT IS TO MEET ITS GOALS. RECENT REDUCTIONS IN THE PRESIDENT'S POPULARITY IN THE PUBLIC OPINION POLLS MAY REFLECT THE INCIPIENT RECOGNITION OF THE IMPACT WHICH FURTHER REDUCTIONS WILL HAVE ON PARTICULAR GROUPS WITHIN THE COMMUNITY. FOR INSTANCE, THE RECENT PROPOSALS TO REDUCE SOCIAL SECURITY RETIREMENT EXPENDITURE RAN INTO A SOLID WALL OF OPPOSITION EVEN IN THE REPUBLICAN-CONTROLLED SENATE, AND FURTHER PROGRESS ON THIS FRONT IS GOING TO BE DIFFICULT. IT ALSO SEEMS DOUBTFUL WHETHER STATE AND LOCAL - ADMINISTERED PROGRAMMES WILL BE TRANSFORMED INTO BLOCK GRANTS TO THE EXTENT THAT THE ADMINISTRATION WOULD WISH. THIS WOULD BE INTENDED BOTH TO LIMIT THE FEDERAL GOVERNMENT'S FINANCIAL RESPONSIBILITY AND TO INCREASE THE DISCRETION OF THE STATES.

CONFIDENTIAL

/TAXATION

TAXATION

5. ON TAXATION, REAGAIN WILL NOT GET ALL THAT HE ORIGINALLY SOUGHT. HE HAS ALREADY COMPROMISED ON THE TIMING AND SIZE OF THE PROPOSED THREE-STAGE REDUCTION IN PERSONAL TAXATION. THIS REDUCTION HAS BEEN PRUNED TO 25 PERCENT OVERALL FROM THE ORIGINAL 30 PERCENT, AND IT IS NOW SCHEDULED TO BEGIN ON 1 OCTOBER 1981 RATHER THAN ON 1 JULY. MOREOVER, HIS ORIGINAL TAX STRATEGY WAS FOR AN INTITIAL, SIMPLE BILL COVERING PERSONAL AND BUSINESS TAX CUTS THAT COULD BE IMPLEMENTED QUICKLY, WITH MORE DETAILED PROPOSALS LEFT FOR A SECOND TAX BILL IN THIS SESSION OF CONGRESS. BUT HE NOW PROPOSES THAT THE FIRST BILL SHOULD INCLUDE SEVERAL DETAILED PROVISIONS, INCLUDING INCENTIVES FOR RESEARCH, ABATEMENT OF THE MARRIAGE PENALTY, SAVINGS INCENTIVES, EXCLUSIONS OF FOREIGN EARNED INCOME, REDUCED ESTATE AND GIFT TAX, AND A REDUCTION IN THE WINDFALL PROFITS TAX ON CRUDE OIL. THIS MAY ENCOURAGE OTHERS TO PRESS FOR THEIR PET SCHEMES ALSO TO BE INCLUDED. THE ACCELERATED DEPRECIATION PROPOSALS FOR COMPANIES HAVE COME UNDER SCRUTINY IN THE HOUSE WAYS AND MEANS COMMITTEE. IT NOW LOOKS LIKELY THAT THE COMMITTEE WILL RECOMMEND AN ALTERNATIVE SYSTEM UNDER WHICH INVESTMENTS WOULD BE FULLY WRITTEN OFF IN THE YEAR IN WHICH THEY ARE MADE (ALTHOUGH THIS ARRANGEMENT WOULD BE PHASED IN OVER A PERIOD), AND THAT THEY WILL PROPOSE SOME REDUCTION IN THE RATES OF COMPANY TAX AS WELL AS AT LEAST SOME DEGREE OF CONDITIONALITY FOR THE THIRD YEAR OF THE PERSONAL TAX CUT.

6. THE PRESIDENT HAS SAID THAT HE WANTS BOTH THE EXPENDITURE RECONCILIATION BILL AND A TAX BILL TO HAVE CLEARED THE CONGRESS BY 1 AUGUST. NOW THAT HE IS VIRTUALLY CERTAIN OF ACHIEVING THE FIRST OF THESE AIMS, THE SECOND WILL PROBABLY BECOME THE MAIN DOMESTIC POLITICAL ISSUE HERE IN THE COMING WEEKS.

DEREGULATION

7. THERE HAS BEEN VERY LITTLE PUBLICITY ABOUT DEREGULATION, THE THIRD ELEMENT IN THE PRESIDENT'S PROGRAMME. THIS MAY BE BECAUSE THE MAIN EFFORT SO FAR HAS BEEN DIRECTED AT DELAYING OR STOPPING THE INTRODUCTION OF NEW REGULATIONS, RATHER THAN ABOLISHING OLD ONES. SOME MAJOR CHANGES IN PROSPECTIVE SAFETY REQUIREMENTS HAVE BEEN MADE FOR CARS, BUT EVEN THIS - WHICH MIGHT HAVE BEEN EXPECTED TO DRAW SOME PROTESTS FROM THE CONSUMER MOVEMENT - HAS ATTRACTED LITTLE ATTENTION.

MONETARY POLICY

8. THE FEDERAL RESERVE BOARD HAS CONTINUED TO PURSUE THE GENERAL POLICY THAT CHAIRMAN VOLCKER ANNOUNCED IN OCTOBER 1979. GROWTH IN THE MONETARY AGGREGATES HAS, FOR THE MOST PART, BEEN WITHIN THE TARGET RANGES. HIGH NOMINAL INTEREST RATES GOING WELL ABOVE 20 PERCENT HAVE BEEN ACCEPTED ON OCCASION IN PURSUANCE OF THIS POLICY. AND

INTEREST RATES ARE WELL ABOVE THE CURRENT RATE OF INFLATION. INTEREST RATES HAVE BECOME A FOCUS OF ATTENTION NOT ONLY BECAUSE OF THEIR IMPORTANCE FOR THE DOMESTIC ECONOMY, EXCHANGE RATES AND INTERNATIONAL FINANCIAL RELATIONS, BUT ALSO BECAUSE THEY ARE AN INDICATOR OF MARKET CONFIDENCE IN THE ADMINISTRATION'S DETERMINATION AND ABILITY TO GET INFLATION DOWN.

9. AT THIS MOMENT THE PRIME RATE IS ABOUT 2Ø PERCENT. OTHER RATES ARE MOVING ERRATICALLY, BUT ARE TENDING TO RISE AGAIN AFTER A RECENT DECLINE. LONG TERM BOND YEILDS IN JUNE HAVE BEEN LOWER THAN IN MAY, BUT THIS MAY PARTLY HAVE REFLECTED TECHNICAL FACTORS CONNECTED WITH THE TIMING OF PUBLIC BORROWING. THEY HAVE RISEN AGAIN OVER THE LAST WEEK OR SO. THERE IS SOME CONSENSUS THAT THE TREND OF SHORT TERM RATES MAY DRIFT DOWNWARDS IN THE NEXT COUPLE OF MONTHS, MAINLY BECAUSE OF INCREASING INDICATIONS THAT THE ECONOMY HAS LEVELLED OFF. BEYOND THAT, THERE IS NO CONSENSUS AND THE PROSPECT IS FAR FROM CLEAR.

THE CONGRESSIONAL CONTEXT

1Ø. IT IS PREMATURE TO SUGGEST THAT REAGAN HAS BUILT A LASTING, NEW COALITION OF REPUBLICANS AND CONSERVATIVE DEMOCRATS. HE HAS HOWEVER SUCCEEDED IN CREATING AN EFFECTIVE CONSERVATIVE MAJORITY IN THE HOUSE, AS WELL AS IN THE SENATE, ON EXPENDITURE ISSUES. HE WILL HAVE TO WORK TO SUSTAIN IT AND EXTEND IT TO HIS TAX PROPOSALS. IT WILL BE VULNERABLE TO ANY SWING IN THE POPULAR MOOD. BUT, FOR THE TIME BEING AT LEAST, THE DEMOCRATS IN CONGRESS ARE EVEN MORE DEMORALISED THAN THEY WERE IN THE IMMEDIATE AFTERMATH OF REAGAN'S ELECTION. THE IMAGE OF THE DEMOCRATIC PARTY AS A WHOLE IS NOT OF CHAMPIONS OF THE UNDER-PRIVILEDGED, BUT OF LAST DITCH DEFENDERS OF A LOST CAUSE. DEMOCRATS MUST NOW HOPE THAT THE PRESIDENT'S VICTORY WILL PLACE RESPONSIBILITY FOR SUCCESS OF FAILURE UNEQUIVOCALLY ON HIS SHOULDERS AND THAT THEY WILL REAP THE BENEFIT OF POPULAR DISCONTENT AS THE SPENDING CUTS BEGIN TO MAKE THEIR MARK.

11. F C O PLEASE PASS TO BOTTRILL (TREASURY) AND HAYWARD (BANK OF ENGLAND).

F C O PASS SAVING BONN, UKREP BRUSSELS, PARIS, UKDEL OECD.

THOMAS

FCO/WHITEHALL
NAD

[ADVANCED & REPEATED AS REQUESTED]

HAVE BEEN PROVIDED FOR IN THE FIRST BUDGET RESOLUTION (FOR FY 83 AND BEYOND, MANY OF THESE ARE AS YET UNSPECIFIED BY THE ADMINISTRATION). THE ADMINISTRATION HAS NOW REPORTEDLY AGREED TO DISCUSS COMPROMISE PROPOSALS WHICH WOULD SECURE ITS OBJECTIVE OF PREVENTING THE INSOLVENCY OF THE SOCIAL SECURITY TRUST FUND, INCLUDING THE OPTION OF REDUCTIONS IN FUTURE COST-OF-LIVING INCREASES FOR SOCIAL SECURITY RECIPIENTS, TO WHICH PRESIDENT REAGAN HAS HITHERTO BEEN OPPOSED.

4. ON THE TAX SIDE NOT A GREAT DEAL OF PROGRESS HAS BEEN MADE. THERE HAVE BEEN SEVERAL INFORMAL CONSULTATIONS BETWEEN TREASURY SECRETARY REGAN AND ROSTENKOWSKI (DEMOCRAT CHAIRMAN OF THE HOUSE WAYS AND MEANS COMMITTEE) AND BETWEEN REGAN AND SENATOR DOLE (REPUBLICAN CHAIRMAN OF THE SENATE FINANCE COMMITTEE) ABOUT A POSSIBLE COMPROMISE ON REAGAN'S PROPOSALS FOR REDUCTIONS IN PERSONAL TAXATION. IT HAS BEEN REPORTED THAT BOTH CHAIRMEN HAVE SAID THAT THE ADMINISTRATION'S PROPOSALS AS THEY STAND DO NOT ENJOY MAJORITY SUPPORT IN THEIR COMMITTEES. A COMPROMISE BETWEEN THE ADMINISTRATION AND CONGRESS IS THEREFORE POSSIBLE. THIS MIGHT TAKE THE FORM OF A DELAY IN THE INTRODUCTION OF THE CUTS IN PERSONAL INCOME TAX RATES BEYOND THE 1 JULY 1981 DATE PROPOSED BY THE ADMINISTRATION, IN ORDER TO HOLD DOWN THE FY 82 BUDGET DEFICIT. ON THE PERIOD OVER WHICH THE TAX CUTS ARE INTRODUCED, THE ADMINISTRATION'S POSITION HAS NOW REPORTEDLY BEEN SOMEWHAT MODIFIED TO INSISTENCE ON A QUOTE MULTI-YEAR UNQUOTE TAX CUT (INSTEAD OF A THREE-YEAR ONE). THIS MAY REFLECT CONCERN ABOUT DEVELOPMENTS IN FINANCIAL MARKETS (SEE BELOW) AS WELL AS IN CONGRESS. WHILE CHAIRMAN ROSTENKOWSKI HAS NOT FORMALLY ABANDONED HIS PROPOSAL FOR A ONE YEAR TAX CUT, IT COULD BE THAT A COMPROMISE MIGHT BE REACHED UNDER WHICH REDUCTIONS IN PERSONAL TAXATION WERE AGREED FOR TWO YEARS AND NOT THREE. FORMAL CONGRESSIONAL CONSIDERATION OF SPECIFIC TAX PROPOSALS HAS NOT YET BEGUN.

5. IN THE MEANTIME, AMERICAN INTEREST RATES REMAIN TOO HIGH FOR POLITICAL COMFORT, WITH BANKS' PRIME RATES AT 20 PERCENT. ON PROSPECTS FOR INTEREST RATES, PRESIDENT REAGAN IS REPORTED TO HAVE REASSURED CHANCELLOR SCHMIDT (DURING THE LATTER'S VISIT HERE) THAT AMERICAN INTEREST RATES WOULD SOON FALL AFTER THE ADMINISTRATION'S ECONOMIC RECOVERY PROGRAMME IS INTRODUCED AND

/THE

THE RATE OF INFLATION COMES DOWN. BUT TREASURY SECRETARY REGAN IS REPORTED IN THE WASHINGTON POST OF 22ND MAY AS HAVING PREDICTED THAT INTEREST RATES WILL STAY HIGHER THAN ASSUMED EARLIER BY THE ADMINISTRATION, AND THAT HE DID NOT EXPECT INTEREST RATES TO GO BELOW THE 15 PERCENT RANGE FOR SOME TIME. THERE SEEMS NO PROSPECT OF INTEREST RATES ON 91-DAY TREASURY BILLS DECLINING TO THE AVERAGE 11.1 PERCENT ASSUMED FOR CALENDAR 1981 IN THE ADMINISTRATION'S ECONOMIC SCENARIO. IF REGAN IS RIGHT, THIS WILL HAVE CLEAR IMPLICATIONS FOR THE DOLLAR EXCHANGE RATE WHICH UNDER SECRETARY SPRINKEL HAS SAID WILL NOT BE THE SUBJECT OF INTERVENTION BY THE AMERICAN AUTHORITIES EXCEPT IN A DISORDERLY MARKET.

6. FCO PLEASE PASS TO POLE, DHSS AND BOTTRILL AND BUTLER, TREASURY.

FCO PASS SAVING PARIS, BONN, UKREP BRUSSELS AND UKDEL OECD.

HENDERSON

THIS TELEGRAM
WAS NOT
ADVANCED

(REPEATED AS REQUESTED)

FCO WHITEHALL
NAD

COPIES TO

COPY ADDRESSEES

SUMMARY

THE REAGAN ADMINISTRATION'S ECONOMIC POLICY - AN INITIAL ASSESSMENT

1. Since he took office on 20 January, President Reagan has given overriding priority to his economic programme. His Administration has not yet focussed on international economic policy to the same extent (paragraphs 1 and 2).

2. He aims to reduce the Federal Government's interference in the economic life of the nation, arguing that government is not the solution to the nation's problems but that it is the problem. The election result shows that this theme struck a responsive chord throughout the United States (paragraphs 3-5).

3. He has proposed a four-part economic programme: spending cuts; reductions in personal tax rates and in business taxes; reductions in Federal regulations; and a commitment to a stable monetary policy. The Administration have set out an optimistic scenario for the US economy which they aim to achieve with their programme (paragraphs 6 and 7).

4. The Administration claim that the main effects of their programme will be to raise savings; to increase work effort; to stimulate investment and to reduce inflation. However, they recognise the risk that strong growth could be choked off by monetary restraint imposed by the independent Federal Reserve Board. There is also some room for doubt that the claimed effects will materialise, at least in the short run. The programme is unlikely to provide much immediate help to the traditional industries at present in difficulty, such as cars and steel (paragraphs 8-13).

/5.

5. The President has effectively deployed his skills as a communicator in selling his economic programme, but these do not now look like being decisive in Congress. Many are concerned that the programme will not lead to a balanced budget by fiscal year 1984 and so are reluctant to grant the full 30% tax cut over 3 years. But, although Democrats are unhappy about the impact of the programme on the less well-off, the President may still get the bulk of his expenditure cuts approved (paragraphs 14-17).

6. The economic team under the President has now yet entirely settled down but the key figure below the President so far has been Mr David Stockman, Director of Management and Budget (paragraphs 18-19).

7. Some provisional conclusions are drawn in paragraph 20 of this despatch.

BRITISH EMBASSY,
WASHINGTON, D.C. 20008
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FROM THE AMBASSADOR

16 April 1981

The Rt Hon The Lord Carrington KCMG MC
Secretary of State for Foreign and
Commonwealth Affairs
Foreign and Commonwealth Office
London SW1

My Lord,

THE REAGAN ADMINISTRATION'S ECONOMIC POLICY - AN INITIAL ASSESSMENT

Introduction

1. Since he took office on 20 January, President Reagan and his close associates have given overriding priority to formulating and presenting their economic prescription for the United States. The programme which the President announced to the Congress on 18 February, and presented in detail on 10 March, reflects the economic philosophy which he expounded during the election campaign last autumn. This was that the economic troubles of the United States - and indeed of the western world - stem from too much government, whether this takes the form of extravagant social programmes, high taxation stifling initiative, or over-regulation of industry and commerce. The purpose of this despatch, primarily the work of Mr H G Walsh, Economic Counsellor in the Embassy, is to describe the main elements of the Administration's programme for the domestic economy and the thinking which underlies it; and to offer some preliminary thoughts about its prospects of approval by the Congress, and of achieving the goals which the Administration have set.

/2.

2. The Administration has not yet focussed its attention on international economic policy to the same extent as on domestic policy. On relations with the developing countries, an indication of their approach is contained in the paper they have circulated on a framework for cooperation between the industrial and developing countries in preparation for the Ottawa Summit. This indicates that the Administration's approach will be tough and market-oriented, with bilateral aid and other assistance related to political and security objectives. An increased role will be sought for the private sectors in achieving flows of resources to promote development. Multilateral aid, including that given through the World Bank, will be given a low priority and will be subject to a thorough scrutiny of its effectiveness. Outside the aid field, the alignment of interest rates on export credit with market rates will probably be pursued even more vigorously than under the Carter Administration, since the Administration propose to cut the funding of the Ex-Im Bank. Their economic philosophy makes it unlikely that they will be amenable to an international approach to synchronise reductions in interest rates and their approach to the dollar exchange rate will be to allow it to find its market equilibrium. They will be disposed to foster free trade and to accept its domestic consequences provided that it is also fair.

<u>The Domestic Economy</u>

3. It is clear from the election result that the general theme of President Reagan's economic strategy struck a responsive chord throughout the United States. The general principle that the Federal Government's role in economic life should be reduced is popular even in areas such as the northern industrial states which stand to lose most from reductions in Federal expenditure. The proposed change of basic philosophy can perhaps best be gauged from the following extracts from the President's address to the Congress on 18 February and his

/Inaugural

Inaugural Address on 20 January:

> "The taxing power of government must be used to provide revenues for legitimate government purposes. It must not be used to regulate the economy or bring about social change. We have tried that and surely we must be able to see it does not work".

> "In this present crisis, government is not the solution to our problem; government is the problem."

4. The President's statements refer to widespread discontent with a welfare system that reflects the values of the eastern liberal establishment and tends to provide little incentive for those on welfare to return to or take up work, with interference at local level such as busing programmes for school children to meet social rather than educational objectives, with a food stamps programme believed to be subject to widespread abuse, with artificially created public sector jobs to "make work", and with a welfare bureaucracy which has a vested interest in providing services at a higher level than the "safety net" ensuring minimum standards for the poor. The Administration point out that, in order to finance increased public expenditure, the level of Federal income tax has been allowed to rise surreptitiously through the effect of inflation in causing so-called "bracket creep" (there is no provision for automatic indexation of the tax brackets in US tax legislation). The extent of this "bracket creep" is illustrated by the fact that in 1965 only 6% of US taxpayers faced marginal income tax rates of 25% or more. This proportion has now risen to about 30%. The combined effects of low productivity growth, high inflation and increased taxation have meant that the real take-home pay of the typical US production worker is now no higher than it was in the early 1960s. (Family income has

/risen

risen mainly because of the increased participation of women and other members of households in the labour force.)

5. President Reagan does not claim that the US has reached a higher degree of collectivism and regulation in economic affairs than has been reached in other Western countries. He is appealing to the general feeling that for too long America had been moving in the wrong direction: away from the fundamental individual economic freedoms of the past and towards regulation and an emphasis on consumption and safe investments which have left little room for creativity and innovation. Part of the hope that he holds out for a reversal of this trend is that economic policies in the United States have not been inimical to wealth creation for as long as in some other countries such as the UK, and that the damage is not irreversible provided that some of the trends in American economic and social life are themselves reversed. He now proposes to revert to increased reliance on the market mechanism to achieve the main economic goals.

The Programme for National Economic Recovery

6. To achieve his objectives and deal with the problems of the American economy, President Reagan has proposed a four-part economic programme consisting of:

(i) spending cuts and other measures to reduce the budget deficit;

(ii) reductions in personal tax rates over three years and in business taxes;

(iii) reductions in the burden and intrusiveness of federal regulations; and

(iv) a new commitment to a stable monetary policy.

This programme is described in more detail in the Appendix.

/The Economic Scenario

The Economic Scenario

7. The Administration have set out an economic scenario for the American economy for the period up to 1986, which they aim to achieve be securing the implementation of their programme. The main targets are for steady annual real growth of around 4% by 1986, combined with a reduction in inflation to 4% and unemployment to 5½%. For 1982 the scenario assumes real GNP growth of 4.2%, a rise in consumer prices of 8.3% and unemployment at 7.2%. The average interest rate on a 91-day Treasury bill is forecast to decline from about 11% on average in 1981 to 9% in 1982 and gradually thereafter to 6% in 1986.

The Main Questions

8. Two main questions arise at this stage. First, what effects the proposals would have, if fully implemented; and second, what are the prospects of the tax and expenditure cuts being enacted by the Congress?

The effects of the programme

9. On the first question, the Administration have said that they do not regard as relevant assessments of their programme based on whether it adds to, or subtracts from, aggregate demand. The expansionary impact of their programme on the American economy is supposed to come not from extra demand but from the removal of artificial restraints imposed by the Government. In formulating their scenario they have relied on four main macro-economic effects:

(i) a recovery of savings from their present historically low levels on the assumption that at least part of the money saved from public expenditure reductions, and passed on in tax reductions, will not be diverted to consumption;

/(ii)

(ii) an increase in the supply of labour brought about by the effect of the income tax reductions in increasing the net returns to extra work effort;

(iii) a stimulation of investment brought about by the reductions in business and capital gains taxation and the elimination of over-regulation;

(iv) a reduction in inflation brought about by the reduction in the rate of growth of the money supply (which is assumed to have no, or few, adverse effects on real output).

The Administration are relying on the multiplier effects of confidence. Their forecasts of declining prices and interest rates are put forward with the intention that economic decision-takers should adjust their plans accordingly, so that pay demands will be moderated and financial markets stabilised.

10. President Reagan is fortunate to be taking office at a time when there is no immediate shortage of energy supplies, or the imminent prospect of large real increase in the price of oil. There is still room however for scepticism about his economic scenario. In particular, the assumption that restraining the growth of the moeny supply will reduce inflation but not output is clearly at the extreme of a range of possible outcomes. If there is strong growth in 1982 as the Administration predict, there is at least a risk that it will be choked off by monetary restraint, since the independent Federal Reserve Board's policy of reducing the rate of growth of the money supply, to which Chairman Volcker is firmly committed, could well cause a recurrence of the high interest rates of much of 1980 (with possible recurring effects on the dollar exchange rate against other major currencies). Most

/outside

outside forecasts for real GNP are in the range $2\frac{3}{4}$ - $3\frac{3}{4}$ for 1982 (following $1\frac{1}{2}$ - $2\frac{1}{4}$ for 1981); those at the lower end typically are based on the assumption that interest rates will be higher than predicted by the Administration. Even ignoring inconsistency with monetary policy, most commentators think that it will be very difficult to achieve a deceleration of the rise in consumer prices to 8.3% combined with 4.2% real growth in 1982. The Administration's forecasts do not seem to have taken adequate account of rising costs such as indexed pay agreements, and most outside price forecasts are higher. But the general prospect is for at least some resumption of growth and decline in inflation in 1982, which should be helpful to the prospects for recovery in other industrialised countries.

11. Setting aside the Administration's detailed forecasts, will the proposals produce a much more dynamic American economy without unpleasant side effects? Again, there is room for some scepticism, especially in the short run. Even under the Administration's assumption of greatly reduced inflation, most of the tax cuts will be offset because there will be no indexation of tax brackets during the period of their implementation. Because some of the public expenditure cuts could place an increased burden on the States if services are to be maintained, some of the Federal tax reductions might be offset by local tax increases, reducing their incentive effect. To the extent that extra incentives are created by the programme, the effects on the economy could well be felt in 1983 and beyond, since it may take some time for work habits to adjust and for extra output to be generated from additional saving and investment.

/12.

12. The specific prescriptions of tax reductions aimed at providing incentives, public expenditure cuts aimed at a balanced budget through reduced waste and inefficiency, a reduction of the federal regulatory burden and reducing the growth of the money supply to counter inflation are not new. President Carter had already embarked on economic policies, or had made proposals, not dissimilar to some of Reagan's. President Reagan's main departure from the policies of recent Presidents seems to be in the distributional impact of his programme. If it is put fully into operation, better-off Americans and the already expanding regions of the sun belt will almost certainly benefit. California, and other States with a large concentration of defence industries, would seem especially likely to be net gainers. The less well-off and the northern cities, on the other hand, seem likely to be the main losers from the programme. With the general level of unemployment now about 7%, and that for black male youths above 30%, its main effects could well turn out to be social rather than economic. This is particularly likely to be true if rapid economic growth is not in fact achieved as soon as the Administration intend, and if a high rate of unemployment (especially amongst blacks) persists.

13. Since the main purpose of the programme is to influence the environment within which the free market operates, its effect on investment and productivity will come through mainly in the medium to long term. It will not provide much immediate help to the traditional industries at present in difficulty, such as cars and steel. The car industry particularly, whose present decline has put half a million people out of work, has just suffered its largest losses in history, and Japanese imports have reached almost 25% of the US market. The Administration will face continued demands from such industries for help of one kind or another to enable

/them

them to recover their stride and meet the technological challenge from outside - a challenge no longer confined to the traditional industries. Problem areas like this will chafe uncomfortably against the Administration's fundamental free market philosophy.

Prospects in the Congress

14. The annual Congressional budget process normally breeds temporary alliances of Congressmen across party boundaries to achieve specific objectives in the expenditure and tax fields. This means that, although the President has the formal power to reject Congressional legislation, the package of expenditure and tax measures eventually enacted is usually a compromise and may bear little relationship to what was originally proposed by the Administration. To avoid this, President Reagan has made a major effort to speak personally to as many Congressmen as possible about the need to maintain the integrity of his economic programme. He has made the programme's promotion the overriding priority of his Presidency to date, assiduously deploying those skills as a communicator which are reckoned to be his principal asset. He is also in a position to exert pressure, since Republican Congressmen will be looking for his support in the 1982 elections.

15. The President's efforts have no doubt made some favourable impact, but do not now look like being decisive. The Republicans have a majority in the Senate and therefore a majority on all Senate committees. But despite this even in the Senate the programme has now, after initial smooth progress, run into difficulties. The Senate Budget Committee has so far refused to forward a draft resolution embodying the complete programme including the tax proposals to the Senate as a whole. Three Republicans on the Committee joined the Democrats to vote

/against

against this because they were reluctant to agree to tax reductions for individuals extending over three years while a large part of the scheduled public expenditure reductions in the second and third years remain to be identified.

16. The House of Representatives is expected to vote on a budget resolution in late April or early May which, as at present drafted, is inconsistent with the Administration's proposals in a number of respects. Although it would achieve the total amount of public expenditure savings desired by the Administration, it would also restore some outlays on social programmes which the Administration wishes to cut and compensate by holding back defence spending. More importantly, it embodies a proposal for a one-year tax cut for individuals which is smaller (and less regressive) than the Administration's. President Reagan has said that the Administration sees no need for a compromise at the present stage.

17. What is likely to be the final outcome? While the Senate might eventually agree to the multi-year tax cut for individuals proposed by the Administration if conservative Senators were sufficiently certain that public expenditure cuts beyond FY82 would actually be achieved, such an outcome seems unlikely in the House. The Administration will therefore probably have to compromise on their tax proposals if their programme is to be in place before FY82, which begins in October 1981. This might be done by their agreeing to only a one-year cut for individuals in the first instance. Their proposals for cuts in business taxes should however be enacted broadly as originally outlined. On the expenditure side, most guesses by Congressmen of the proportion of the Administration's budget cuts that will be enacted in FY82 place the figure at

/about

about three-quarters. Substitute cuts will probably be hard to find in FY82, and the identification of sufficient cuts to meet expenditure targets for later years may require radical proposals in the medical, social security and welfare fields. The Administration recognise that they will need to take a much more searching look at these programmes than they could do in the few weeks after the inauguration. Now that targets have been published, any failure to enact expenditure cuts of the size proposed would clearly not augur well for inflation or interest rates, and it would have a harmful effect on confidence.

Personalities

18. Unquestionably, the key figure below the President so far has been Mr David Stockman, Director of Management and Budget. Without his drive and detailed knowledge of public expenditure programmes (acquired during a decade as a Congressional aide and Congressman) the Reagan programme could not have been put together in such a short space of time, and vital impetus would have been lost by the time it was assembled.

19. The Treasury team, however, have not made such a good initial impression. Secretary Regan has not yet managed to imprint his views on economic policy, and is hampered because two of his Under-Secretaries (Mr Beryl Sprinkel and Mr Norman Ture) firmly hold disparate views. Mr Sprinkel believes that the economy is best controlled through control of the money supply, while Mr Ture places greater emphasis on reducing the tax burden on individuals and on minimising the role of the Federal Government. Chairman Volcker of the Federal Reserve Board (who has responsibility for monetary policy under the Federal Reserve Act) is just as committed to a

/reduction

reduction in the rate of monetary growth as a way of getting down inflation as the Administration, but beneath the surface there are signs of disagreement between him and Mr Sprinkel both on monetary techniques and on policy. Mr Sprinkel, an advocate of monetary base control, suspects Mr Volcker of paying too much regard to the level of interest rates, and of an excessive tolerance to short-term fluctuations in monetary growth. Mr Weidenbaum, the Chairman of the Council of Economic Advisers, appears to have acted as an effective binding agent despite having been appointed late. In the discussions leading to publication of the Administration's scenario, it was reportedly he who played a key role in reaching a compromise.

Provisional Conclusions

20. (i) President Reagan has widespread public support for the direction which he now proposes for the domestic economy, and for the general thrust of his programme for national economic recovery.

(ii) Even if implemented in full, the programme may not produce the 4.2% growth in GNP and inflation rate of 8.3% in 1982 predicted in the Administration's economic scenario. There should however be some real growth in 1981 and 1982, together with a gradual decline in the rate of inflation. Success will depend on confidence which in turn will be geared to the complicated cog-wheels of Congress, as well as to the hard-headed judgements of the business and financial community.

(iii) According to the normal timetable for US budgetary procedure, that part of the Reagan programme which requires legislation to give it effect should have passed through all the necessary Congressional stages by next October. But present difficulties in Congress indicate that, if it is to be enacted

/on schedule,

on schedule, there will have to be some modification of the proposal for a full 30% reduction in personal tax rates over three years. The President is however likely to get the bulk of his expenditure cuts through Congress, and also the proposed reduction in taxes on businesses.

(iv) There could well be social and regional repercussions from the distributional effects of the Administration's policies if rapid economic growth is not achieved so that the present high level of unemployment (especially for blacks) persists, and if adequate measures are not taken to assist or protect industries facing special difficulties.

21. I am sending copies of this despatch to HM Representatives at Paris, Bonn, Rome, The Hague, Brussels, Luxembourg, Copenhagen, Dublin, Athens, UKREP Brussels, UKDEL OECD, UKDEL NATO, UKMIS New York, UKMIS Geneva, Tokyo, Ottawa, Canberra and Mexico City, as well as to HM Consuls-General in the United States.

I have the honour to be,
My Lord,
Your obedient Servant,

Nicholas Henderson

APPENDIX

1. The Administration's proposals listed in paragraph 7 are described in more detail below.

(i) Reducing the Budget deficit

2. The aim is to balance the budget by the fiscal year 1984 (October 1983 - September 1984). Massive cuts are proposed in the previous Administration's plans for public expenditure. These cuts rise from $48.6 billion in FY82 to $201.7 billion in FY86. The savings in FY82 have all been identified, but in the years FY83-86 a further $30-$45 billion per year in savings are required that have not yet even been ascribed to individual programmes. The intention is to increase defence expenditure (compared with existing plans) by $6.2 billion in 1982 to $63.1 billion in 1986, and to maintain a "safety net" of social benefits for the poorest. To allow budgetary provision for safeguarded "safety net" and defence expenditure to increase, all other expenditure (including the unidentified savings) is proposed to be reduced by about one-quarter (in money terms) as early as 1984. The average annual growth in total Federal spending has been about 16% (in money terms) in recent years, and it is proposed to reduce this to about 5.5%. Even on the Administration's optimistic assumptions about inflation, this means an overall reduction in volume terms, and a much bigger volume reduction in programmes other than defence and those in the "safety net".

3. The budget cuts proposed extend over a wide area, including expenditure on social programmes outside the "safety net"; on public employment programmes; on Federal aid to public transport; on energy "R and D"; on assistance for workers

/especially

especially affected by imports; on natural resources and the environment; and on support for the arts. It is also proposed to consolidate nearly 100 grant programmes to the States, under which Federal aid is disbursed provided State expenditure falls into certain approved "categories", into a few multi-purpose block grants for State support of education, health and social services. The aim is to allow the States more flexibility to adopt their own approaches in providing these services. Federal subsidies for synthetic fuels, the Ex-Im Bank, the dairy industry and capital projects are also to be sharply cut back. Increased user fees are to be imposed on airway system users, barge operators and commercial and recreational vessels. Reductions are also proposed in off-budget outlays, rising from $4.7 billion in 1982 to $11.6 billion in 1986. These include reductions in loans for rural electrification and home purchase, for low-rent public housing and for students in higher education.

4. A freeze has been placed on hiring to fill Federal Government posts, and restrictions have been imposed on expenditure on office furniture, consultancy fees and travel by Federal employees. Employment in non-defence agencies is proposed to be 63,000 fewer than existing policies would imply by 1982 (but 20,000 more in the Department of Defense).

(ii) Reductions in taxation

5. The proposals for tax reductions for businesses are that, for the purpose of calculating taxes, company assets should be written off within certain specified periods instead of (as at present) being fairly closely related to the actual useful life of the equipment concerned. The main periods would be 3 years for vehicles and machinery and equipment used for "R and D", 5 years for most common factory equipment and 10 years for factory buildings. It is proposed that these arrangements

/should

should be retrospectively made effective from 31 December 1980. It is also proposed to reduce personal income tax rates by one-tenth each year for 3 years, effective from 1 July 1981, 1 July 1982 and 1 July 1983. The cumulative effect of this would be a 5% reduction in the income tax rates in the calendar year 1981, a 15% reduction in 1982, a 25% reduction in 1983 and a 30% reduction in 1984. The highest marginal tax rate, both for earned and unearned income, would be 50% after the 1983 change. The top rate of capital gains tax would be reduced from 28% to 20% by 1984. No change is at present proposed in the brackets to which these rates apply, which are fixed in money terms and <u>not</u> automatically indexed to inflation. Taking this into account, Federal revenues are expected to rise by 50% by 1986.

6. The objectives of the tax reductions for individuals are to encourage saving and to create more output by encouraging work at the expense of leisure. They are not designed to boost demand. They will especially benefit high earners and, because of this, it is hoped that a large part of the reductions will go into savings while the additional income created by their incentive effect will generate extra tax revenue to at least partially finance the reductions in tax rates.

(iii) <u>Reducing the burden of Federal regulations</u>

7. The third element in the programme is a reduction in the burden and intrusiveness of government regulations. Complying with existing regulations is estimated to cost the private sector approximately $100 billion a year. Their administration costs a further $20 billion, so that at present 4.5% of GNP is taken up in meeting Federal regulations. The reforms will not however (at least at first) reduce this enormous burden

/significantly.

significantly. The main intention is to delay or cancel new regulations which would, if implemented, impose a further cost. A temporary freeze has been placed on all new regulations to permit them to be reviewed before they are implemented. Federal agencies will no longer be able to promulgate new regulations without satisfying a task force led by Vice-President Bush.

(iv) Monetary Policy

8. The fourth element in the Administration's programme is the commitment to a firm and stable monetary policy. This was included after consultation with the independent Federal Reserve Board, which has not however expressed explicit approval of the published version. The Administration's objective is to reduce the rate of growth of money and credit by 1986 to half that in 1980, but without any annual targets for that period in between. While the absence of a published path for the main monetary aggregates makes the policy difficult to assess, it seems clear that the Administration would prefer a steadier growth than was achieved by the Federal Reserve Board in 1980.

The Stockman Express

HOW A 34-YEAR-OLD FORMER ANTIWAR ACTIVIST AND DIVINITY STUDENT HIGHBALLED HIS WAY TO COMMAND OF THE FEDERAL BUDGET

BY WALTER SHAPIRO

Eight days before the inauguration, Ronald Reagan's cabinet hosted a black-tie dinner at the F Street Club to honor the transition teams. Donald Regan, the new treasury secretary, was sick, but he sent a toast to be read in his name.

According to a participant, Regan's dinner toast read like this: "No one has made greater use of the transition teams than I have. Only by totally working my whole transition team 15 hours a day could I keep Dave Stockman under control."

The secretary of the treasury had reason to be worried about David A. Stockman, the new director of the Office of Management and Budget. At age 34, after two terms as a Michigan congressman, Stockman is the youngest person to hold Cabinet rank in more than 150 years. He comes to power with a controversial agenda to transform American economic policy and a young man's faith in the potency of his own ideas.

For starters, Stockman wants to mount a frontal assault on the federal budget. He isn't cowed by the congressional appropriations process. Nor is he frightened by the special interests nor liberal bleeding-hearts who defend their favorite sections of the budget with the ferocity of junkyard dogs.

The OMB post may be his battle station, but budget-cutting is only part of his ambitious strategy.

Stockman, who believes in free market economics, wants to declare holy war on the kind of federal regulations that businessmen curse over their martinis. Unlike the more cautious Regan, he is a zealous advocate in the Reagan cabinet of across-the-board, permanent Kemp-Roth tax cuts.

If tax-cut strategy works, Stockman believes that the energies of America will be unleashed in an orgy of productive frenzy. And, if it fails, Stockman will have to defend the largest budget deficits in American history. Either way, Stockman promises to be at the center of the firestorm that will swirl around Reagan economic policy.

Walter Shapiro is a staff writer with The Washington Post Magazine.

In the early scrimmages among the Reagan team, Stockman has already broken away for long yardage. Alan Greenspan, a key outside adviser to Reagan, said, "Among those going into government, Stockman has the most conceptual input right now. Dave deserves the status that he has achieved. He's done an extrordinary job. He's the brightest guy around."

There are many bright, intensely driven, 34-year-old whiz kids in Washington. But Dave Stockman is different. At a time when many of his contemporaries are bucking for regional sales manager or worrying if they are partnership material, Stockman is trying to impose discipline on an unwieldy $739 billion budget.

His meteoric rise is a tale of raging ambition. Stockman himself concedes that at times, it makes him "appear to be the most conniving character in history."

The Stockman saga illustrates that, even in an age of falling expectations, America is still a meritocracy, ready to reward bright Midwestern farmboys who work hard, cultivate their betters and keep their eye squarely on the main chance.

It was just 14 years ago that Ronald Reagan, pledging to get tough with campus demonstrators, was sworn in as governor of California. That same year, 1967, Stockman was an antiwar activist on the sprawling East Lansing campus of Michigan State University. In the spring, he came to Washington for an antiwar rally. That summer, between his junior and senior years in college, Stockman worked as the only full-time organizer in the Lansing area for Vietnam Summer, arguing that Vietnam was an internal civil war.

Today, Stockman remembers Vietnam Summer as "pretty much of a bust." But he also fondly recalls 1967 as the the first summer that he didn't have to return to his family's 150-acre fruit farm outside of St. Joseph, Mich., "to pick berries and haul tomatoes."

Stockman was reluctant to discuss whether he agrees with Ronald Reagan that Vietnam was "a noble cause." But the OMB director gave a revealing answer when asked what stayed with him from that period as an antiwar crusader: "I suppose the same curiosity. It was more intellectual than anything

else. The only thing that has changed is my view of the world. I'm still trying to figure out the world, even now."

The first thing you notice about Dave Stockman are the aviator glasses and the thatch of graying hair swept back in a $25 haircut from a unisex barber. His face is generally impassive, but occasionally in conversation a small smirk will play across his features. Whether it's at his Senate confirmation hearing or in his office early on a Saturday morning, Stockman wears the same conservative uniform—a dark suit from Britches, a white shirt and a sincere red tie.

Much of the surface polish is the work of Jennifer Blei, his 26-year-old girlfriend. She is one of the top computer salespeople for IBM. Two years ago, at the age of 32, Stockman did not own a pair of jeans. "I got him to buy a pair," Blei said, "but they shrank in the first washing so they ended above his ankles. But he kept wearing them. They weren't really a pair of jeans, they were more like a long pair of shorts."

Outside of his work, Stockman's life is about as riveting as the opening pages of Proust's *Remembrance of Things Past*. He and Jennifer Blei occasionally play chess. They go out to dinner at homes of friends like Rep. Jack Kemp (R-N.Y.) and Richard Straus, editor of a newsletter on Middle East affairs. But as Blei put it, "If this is going to be a personal piece about Dave Stockman, it will be a really short article."

Small towns in the Midwest breed high achievers. More top-ranking corporate executives are born there than anywhere else. The harsh farm life and the lack of other diversions instill the work ethic. The flat, unchanging landscape inspires among the brightest a desperate urge to escape.

This environment molded Dave Stockman. He grew up on a southwestern Michigan farm that has been in his mother's family since the 1890s. He even went to a one-room school.

The living room of the family farmhouse looks like it was lifted from an old Saturday Evening Post cover, complete with a couch covered in chintz, simulated wood-grain paneling, and a recliner for Stockman's father, Al.

His mother, Carol, said that Dave, the oldest of five, "is the least emotional of the children." That comment triggered a reprise of all the old family arguments that Al Stockman, too, isn't emotional. The OMB director's father finally sat up in his recliner and said, "It's just that I don't let it show." Carol Stockman had the last word: "But you can't keep it all inside you; you'll get an ulcer."

While Dave was at Michigan State, where he originally went to study agriculture, the Stockman family was the scene of many heated debates over Vietnam. Al Stockman, a strong supporter of the war, remembers that "I felt pretty lonely at times."

Fourteen years later, with his son in the Reagan cabinet, Al Stockman finally feels vindicated. "The things Dave is preaching now," Stockman said, "were the things that I was saying back in the days when I was so out of it. College professors always know more about things than the old man at home."

There are college professors and, then, there are Harvard professors. The Stockman saga demonstrates the opportunities that can fall into your bookbag in Harvard Yard.

At Michigan State, one of Stockman's principal interests was religious philosophy. His road to the antiwar movement began at the activist Edgewood United Church of Christ in Lansing, where he also taught Sunday school.

In 1968, Stockman accepted a fellowship to Harvard Divinity School—though he had no intention of entering the clergy. Stockman attributes this decision to his "fascination" with the writings of theologian Reinhold Niebuhr. "I was trying to find a way intellectually out of the radical thicket I was in," Stockman said. "Niebuhr was sort of a bridge back to a more conventional view of the world."

Divinity school conveniently brought with it a 4-D draft deferment. Stockman denies that he was a draft dodger. But some who knew him well during this period have their suspicions.

MORRISON SAID HE'D 'BE WILLING TO SURMISE' THAT STOCKMAN KNEW DIVINITY SCHOOL WOULD 'KEEP HIM OUT OF THE DISTASTEFUL SPECTACLE THAT WAS VIETNAM.'

Truman Morrison, Stockman's minister in college, wrote one of his recommendations to Harvard. Morrison said he'd "be willing to surmise" that Stockman knew divinity school would "keep him out of the distasteful spectacle that was Vietnam."

Morrison was one of many interviewed for this article who commented on Stockman's self-absorption: "David was always thinking about David a great deal of the time. He is very narcissistic. David has always been very intent on his own personal advancement."

Nothing that Stockman did before or since was more calculated than his campaign to win Sen. Daniel Patrick Moynihan (D-N.Y.) as his mentor. Moynihan was then commuting from Harvard to his job in the Nixon White House.

At Harvard, Stockman recognized the upward mobility of the babysitter. He plotted for months to get a job as the live-in au pair student for the Moynihan family. Before his job interview, the methodical Stockman read all of Moynihan's published writings.

Stockman tended bar, carried groceries, emptied the garbage and looked after the three Moynihan children. The year left an imprint on many of his attitudes toward the federal budget.

Moynihan—along with Harvard professors James Q. Wilson and Nathan Glazer, who also influenced Stockman—were in the forefront of a group of Great Society liberals rethinking the effects of the social programs they had shaped during the Johnson years. Their novel notion was to look hard at the results of social programs instead of merely praising their goals.

Moynihan recalls that it would have been easy for Stockman to become another Harvard radical of the era. "There was something in him that said that this is not as interesting, or if you will, as promising a way to spend your life," Moynihan said. "He chose to be a nonconformist."

Others at Harvard pursued nonconformity by trashing campus buildings; Stockman became a liberal Republican.

It was a shrewd move. In those days, prominent Democrats were awash in Ivy League resumés. Meanwhile, the Republican Party was a geriatric enterprise filled with blue-haired old ladies and corpulent Rotarians.

Another helpful mentor, Washington Post associate editor David S. Broder, brought Stockman together with Rep. John Anderson (R-Ill.), the soul of moderate Republicanism.

Broder was teaching a course at Harvard and Stockman was one of his brightest students. Anderson, newly elected chairman of the House Republican Conference, needed another staffer. Broder mentioned Stockman; Moynihan took Anderson aside after a White House meeting to sing the praises of his young protegé.

Stockman borrowed $50 from his mother to fly to Washington for the interview. Anderson hired him on the spot, and the dream of a divinity degree died forever.

Eighteen months later, 25-year-old Dave Stockman became director of the House Republican Conference, with a private office and a personal staff. In three years, Stockman transformed the conference from an intellectual backwater into one of the best research factories on Capitol Hill.

Stockman calls these years "my formative period." During this period, he developed his "rabid" affinity for free-market economics. It was a conversion that was, in part, dictated by political necessity.

Anderson's liberal social views were alienating orthodox

Republicans. Stockman feared for Anderson's leadership position—and his own job. So he began reading reams of material from the American Enterprise Institute and other conservative think tanks. He was searching for free-market issues on which Anderson could appear to be a mainstream Republican.

Anderson and Stockman were extremely close. At various points, the congressman found staff jobs for two Stockman brothers. When Anderson made speeches in southwestern Michigan, he stayed with Stockman's parents. It was the kind of father-son relationship you see occasionally on Capitol Hill. But it was a relationship eventually doomed by the son's rebellion against the liberal views of his surrogate father.

Anderson himself refused to be interviewed about Stockman. But his wife, Keke, remembered Stockman as "a workaholic. I've never seen a young man so obsessed with work."

Stockman blames his rift with Anderson on his decision not to support the congressman's recent presidential ambitions. "That disappointed him a lot," Stockman said. "Understandably so."

Keke Anderson believes the falling-out happened earlier. "John began to sense," she said, choosing her words carefully, "that there was just too much drive and not enough human aspects there."

'DAVE WAS WEARING HIS HAIR LONG IN THOSE DAYS, SORT OF OF A PRINCE VALIANT HAIRCUT, AND THAT DIDN'T HELP . . . AND HE GAVE VERY LONG ANSWERS TO QUESTIONS.'

There comes a time in every successful young man's life when he wants to do something on his own. Most resist the temptation because of mortgage payments or children. A few start their own businesses or law firms. Dave Stockman, 29, ran for Congress in 1976.

It was a bold gamble. Despite an uninspiring record, Republican incumbent congressman Edward Hutchison was fully in tune with the conservatism of Stockman's home district in southwestern Michigan and showed no intention of retiring. Moreover, virtually no one in the district knew Stockman, who hadn't lived at home since 1964.

Stockman also had to bridge a difficult political and social chasm. His grandfather had been Republican county treasurer for 30 years and his family was prominent among the farmers in the area. However, Stockman came from a different social class than the local gentry, with their big houses on Lake Michigan.

But Stockman had been prepping for a race against the hapless Hutchison for a long time. He had long earnest talks with a local judge, Chester Byrns, who helped introduce him to the first families of the area. Byrns describes Stockman in those days as "not very sophisticated" with "much of the farmboy still in him."

In 1974, Stockman got his mother, who was a spear-carrier in local Republican politics, elected county chairman. She worked with such intensity on her son's campaign that a congressional aide to Stockman later compared her to "Rose Kennedy or maybe Joe Kennedy."

Meanwhile Stockman stole his young campaign manager from the Republican Conference. David Gerson, now 27, has been Stockman's alter ego as he has moved from administrative assistant to an aide at OMB. Together, back in 1975, they put together the first modern campaign in the history of the sleepy congressional district—a $110,000 primary challenge to Hutchison.

During this time, Stockman somehow found time to write his first article, "The Social Porkbarrel," which appeared in early 1975 in The Public Interest, a small neo-conservative magazine.

The article fused Moynihan's skepticism about social programs with Stockman's knowledge of the hidden byways of Capitol Hill. Social programs, the future OMB director argued passionately, had acquired a constituency that used the same porkbarrel politics as the military-industrial complex.

"That article is how I got to Congress," Stockman said with a laugh. Irving Kristol, the editor of The Public Interest, found occasion to praise it effusively in a long commentary in the Wall Street Journal.

Kristol's column caught the eye of the most influential newspaper publisher in the district. The publisher wrote an editorial suggesting that the Hutchinson era had passed — and that the Stockman era was dawning. "That editorial launched our campaign and things just started to build after that," Stockman said.

Judge Byrns recalls a meeting in his home in the fall of 1975 to introduce Stockman to the local corporate elite centered around Whirlpool, the dominant corporation in the area.

"Dave knew that the dozen or so people I had invited could be financially helpful to him," Byrns said. "But they were skeptical. Dave was wearing his hair long in those days, sort of a Prince Valiant haircut, and that didn't help. He was very hesitant because he knew who these people were. Lord, how he had studied them. He had a nervous habit of stroking his mouth as he talked. And he gave very long answers to questions."

But Stockman's intellect and his knowledge of Washington overcame his social awkwardness. "Stockman fascinated those people because he was a walking computer," Byrns said. "He was using facts and figures that these business leaders could look up. And they did, and they were impressed."

On Groundhog Day 1976, Stockman sprang from his hole and formally announced his congressional candidacy. Two days later, Hutchison announced his retirement from Congress.

Humility was not Dave Stockman's strong suit when he arrived in Congress in early 1977.

At the orientation session for new GOP freshmen, everyone introduced himself, usually with a bit of personal biography. When it was Stockman's turn, he got up and said, "My name is Dave Stockman. I have a great deal of experience on Capitol Hill. My staff and I will be glad to help any of you freshmen get adjusted."

"As you can imagine," said one of his colleagues, "Dave's remarks went over like a lead balloon."

But Stockman had too much on his mind to worry about congressional protocol. He wangled a seat on the commerce committee and was in the forefront of the Republican opposition to Carter's energy programs. He became a self-taught expert on health care and helped lead the fight against Carter's hospital cost containment program.

Beginning in 1977, Stockman put together alternative conservative budget proposals. In March 1980, speaking for a group of 60 House members, he proposed $26 billion in cuts. At a House Budget Committee hearing, Stockman said that he personally wanted to cut $34 billion more.

Blessed with a safe district, Stockman could pursue his ideological interests free from much cant and hypocrisy. He voted against farm subsidies in an agricultural district. He was the only member of the Michigan delegation to oppose the Chrysler bailout.

Meanwhile, Stockman kept writing, churning out more than 20 articles on policy issues, particularly energy, regulation and economics. A third of these pieces, which helped solidify Stockman's reputation as a thinking man's conservative, appeared in the pages of The Washington Post.

At his Senate confirmation hearing, after listening to liberal senators read back some of his more controversial sentences, Stockman said ruefully, "If I do manage to get confirmed for this job, I think I'm going to stop writing."

Perhaps Stockman's shrewdest move in Congress was cementing an alliance with Jack Kemp, the former football quarterback turned tax-cut advocate.

Kemp describes their relationship as "Mr. Inside and Mr. Outside." But a more accurate assessment would be that Stockman provided the brains and Kemp provided, if not the brawn, at least, the public stage presence.

Despite Stockman's self-confidence, he acknowledged that there was a gaping hole in his economic thinking when he arrived in Congress. He had strong views on the budget and oppressive federal regulations, but he lacked an overall economic theory—a macroeconomic philosophy in the jargon of the trade.

"I believed in free-market economics," Stockman said, "but that doesn't tell you anything about macroeconomic policy. I needed a macro philosophy and I didn't have one. Except for a knee-jerk Hooverite view that most Republicans had at the time. But I was a little too sophisticated for that. I knew the budget couldn't be balanced every year."

Kemp's gospel, called supply-side economics, contends that the government went wrong by stimulating consumer demand. What it should have been doing, Kemp argued, was encouraging America to increase production. One policy remedy was a massive tax cut, the Kemp-Roth bill, that would set off a new American industrial revolution.

With Kemp directing his reading, Stockman became a true believer. Up to now, Stockman's strength was his skepticism about well-intentioned social welfare programs and the government's tinkering with the free market. But Stockman seized on supply-side economics with the same zeal that young intellectuals once brought to the writings of Herbert Marcuse.

A week after the 1980 election, before Reagan had picked his OMB director, Stockman and Kemp collaborated on a memo that outlined how the new administration could avoid an "economic Dunkirk." The origins of this memo explain how the dynamic duo of Kemp and Stockman worked.

Kemp, not Stockman, had been invited to the first meeting of Reagan's economic advisers in mid-November in Los Angeles. The former quarterback for the Buffalo Bills felt a bit inadequate in this august company: "There would be all these big-name economists—George Schultz, Alan Greenspan, Arthur Burns—and me, Jack Kemp, sitting around a table. I felt a tremendous sense of responsibility."

Continued on page 13

So Kemp turned to Stockman, his junior partner. "Dave," he said, "we've got to decide on the type of approach I'm going to take at that meeting." Stockman wrote most of the memo and Kemp carried the ball in Los Angeles.

There are signs that Kemp is bristling over Stockman's new prominence. David Gerson recalls a recent half-joking phone call from Kemp. "I'm getting tired of Dave Stockman pushing me off the front pages," Kemp said. "The next thing, I'll be seeing him on the cover of a sports magazine with his arm cocked back ready to throw a pass."

Even as a junior congressman, Dave Stockman had a lean and hungry look. He was toying with running for the Senate in 1982 or 1984. Fred Matthews, his chief congressional fund-raiser, wanted to enter him in the Iowa presidential caucuses in 1984. In the fall of 1979, Stockman tried to get Matthews, an optometrist from Dowagiac, Mich., to raise some money for an exploratory presidential campaign for Kemp.

"What's in it for you?" Matthews said he asked Stockman.

"That way I could be director of OMB," Stockman said.

Kemp never ran for president, but Stockman got to be OMB director by impersonating two presidential candidates. Before Reagan's debate with Anderson, the former California governor practiced by debating the 33-year-old two-term congressman.

Stockman had only met Reagan at large formal meetings, but he was an obvious choice to play Anderson, his former mentor. He was so good he was asked to come back for a second performance in late October as the stand-in for Carter.

The reviews were glowing. Reagan, a former actor, knew talent when he saw it. Alan Greenspan was so impressed by Stockman's impersonation of Carter that he said, "If we had the capacity to give something like an Academy Award, Stockman would have gotten it." Sen. Paul Laxalt (R-Nev.), one of Reagan's closest advisors, said the mock debates were "near-indispensable" for Stockman's unanimous selection for the OMB job.

It is said that some of the most disappointed people in life are those who achieve their dreams too early.

The director of OMB, with its far-reaching responsibilities that cut across the entire government, has always been Stockman's dream job.

"Dave has always been in awe of that position," said Jennifer Blei. "It was the place where he could implement all of his ideas. But it's always been almost like a dream to him. I always felt he'd be an OMB director. But not in 1980."

Two flames have lighted Dave Stockman's charmed life as he has moved from antiwar crusader to OMB director. One is his burning ambition and the other is his glowing faith that his ideas can shape political events.

But Stockman's idealism has always been curiously devoid of compassion. He has described the federal budget as "a coast-to-coast soupline." But he lacks the empathy also to see the budget as people to be served, instead of inflated numbers on a page.

Perhaps this lack of compassion is related to the way Stockman has used his obsession with work to keep people at arm's length.

Nothing in Stockman's career has prepared him to compromise his vocal confidence in his own opinions. An intellectual lone wolf could stand out among the Republican minority in the House. But now Dave Stockman is playing on someone else's team.

As OMB director, Stockman will win some battles in the Reagan White House, but he will lose some as well. In victory or defeat, Stockman will have to defend the administration's policies to Congress, the press and the public.

Will he bear defeat gracefully, and defer to others more powerful—but not necessarily more intelligent—than he? It is a problem that worries the Reagan team. According to corridor gossip during transition, Edwin Meese III, Reagan's closest adviser, personally selected the man who will be Stockman's deputy at OMB, Edwin L. Harper.

His mission is the same as Donald Regan's. To keep Dave Stockman under control. ■

ut reductions in these areas would allow Congress to take credit for evenhandedness: it would not be sparing the Joffrey Ballet while cutting back its assistance to food-stamp recipients.

By the end of last week Stockman was considering a number of additional proposals that seemed sure to offend groups that Congress has traditionally deemed sacred. The most controversial plan involved ending the twice-yearly indexation of Federal employee pension benefits, leaving government workers with a single annual cost-of-living increase in their pensions. Similarly, the law-and-order lobby was bound to oppose any proposal to reduce aid to local police. Even the Pentagon did not seem safe from Stockman's surgery. Last week he suggested that through such measures as closing bases and canceling some aircraft purchases, he could hold the increase in military spending for fiscal 1982 to $10 billion over the Carter Administration's budget, rather than the originally estimated $25 billion. "We are asking every part of the political system to act against their short-term interests," says a White House political operative.

'Yea': That request is likely to be ignored unless the Republicans strengthen their newly acquired leadership of the Senate. Last week, for example, it was only with great difficulty that Republican committee chairmen managed to gain support from their own party members for Reagan's request for an increase in the debt ceiling. When Democratic administrations made such requests in the past, Republicans routinely rejected them as "fiscally irresponsible." Last week, with the shoe on the other foot, the Democrats were balking, forcing what one committee chief called "a very difficult and embarrassing decision for so many conservative Republicans." The finally 73-to-18 vote to raise the ceiling counted North Carolina's Jesse Helms in the "yea" column for the first time in his political career.

Helms may be an important litmus in the battle of the budget. As chairman of the Senate Agriculture Committee, he is committed to a drastic reduction in the food-stamp program—and his position on tobacco subsidies is equally clear. "In North Carolina," he told The Washington Post, "tobacco isn't a commodity, it's a religion." But Helms's biggest test will involve the $1 billion-a-year dairy subsidy that encourages high milk prices and artificial surpluses. In the last Congress, only 70 House members were willing to offend the powerful dairy lobby by voting to eliminate the subsidy. Helms's reaction may determine whether a committed conservative can really fight the special interests.

Every member of Congress will feel similar pressures, but Stockman is prepared to offer them a substantial reward for persistence. According to a new set of eco-

Meet David Stockman

The briefing, held on Capitol Hill one afternoon last week, was a Daniel-in-the-lion's-den encounter between the wily Democratic leadership of the House and the Reagan Administration's boy wonder, budget director David Stockman. On the job less than a month, Stockman, 34, made an earnest pitch for sweeping cutbacks in Federal spending—and in the end even the skeptical barons were impressed. "Every time a Cabinet Secretary comes up here, he brings a battery of assistants and refers everything to them," said House Speaker Thomas P. (Tip) O'Neill. "This guy comes in all by himself and ticks them off boom, boom, boom. I've never seen anybody who knows the operation like this kid—he's something else, believe me."

For a neophyte conservative whose reputation rested largely, until recently, on two short terms in the House, Stockman is fairly dazzling political Washington these days. His frail good looks and boyish charm are potent catalysts for celebrity (although he is now avoiding interviews), and his buzz-saw intellect has helped him stage a series of bravura performances before Congress. Republicans are vying for superlatives to describe his brilliance, and even Democrats concede his formidable command of the budget. "I grasp things quickly, but I'm not even in his league," said one awed liberal, Rep. Thomas Downey of New York. During his whirlwind debut, Stockman has parlayed his appointment as director of the Office of Management and Budget into what is arguably the second biggest job in government—quarterbacking the economic policy on which Ronald Reagan has staked his Presidency.

Eclipse: So completely has Stockman taken control that the economic-policy council formulating the grand strategy Reagan will propose next week is called simply the "Stockman committee." Treasury Secretary Donald T. Regan, who was supposed to be the Administration's chief economic spokesman, has been almost totally eclipsed by Stockman—and doesn't even attend most of the policy group's meetings. That leaves Stockman free to pursue his two economic goals: the supply-side belief that big tax cuts are needed fast, and the firm conviction that the budget can be amply cut by going after programs that subsidize the well-to-do. His aides speak constantly of "safety nets" for the poor and of their ability to trim government while remaining "compassionate." "My political theme," Stockman said recently, "is cutting off the undeserving." Yet many of his proposed cuts seem likely to affect low-income families (page 26).

White House aides say the President's faith in a young man he barely knew six months ago stems from Stockman's role in the campaign. Last summer Stockman was drafted to serve as a stand-in for John Anderson (for whom he once worked) while Reagan practiced for his first Presidential debate. Stockman's blowtorch brilliance in their first session left the candidate stunned. One Reagan aide says he was "amazed at how brazen" Stockman was when, podium to podium in the garage at Reagan's rented estate in Virginia, he excoriated Reagan as a tool of the rich,

John Ficara—NEWSWEEK

Stockman: 'Cutting off the undeserving'?

the scourge of the poor, "heartless" and "ignorant."

Fortunately for Reagan, the real debate was more polite. Reagan himself has since joked that "I lost every debate to Dave Stockman," and he recognized, one senior hand says, that the young congressman "wasn't just another yes guy." Stockman was called back to help Reagan warm up for Jimmy Carter in October and by then, insiders say, Reagan sensed that Stockman was just the sort of bright, tough man he wanted to ride herd on the budget.

Stockman began pushing his ideas well before the Inauguration with a white paper, co-signed by Rep. Jack Kemp, entitled "Avoiding a GOP Economic Dunkirk."

His intent was to warn Reagan of the political risks of inflation and to urge an economic blitz in the first 100 days. After his dire view was backed by economist Alan Greenspan, Stockman went to chief of staff Jim Baker to lobby for the job of budgetary axman. Reagan quickly agreed. Stockman had his entire staff in place and the cuts identified before other Cabinet members had time to set their own agendas. His proposed cuts in foreign aid led to a confrontation with Secretary of State Alexander Haig, and Energy Secretary James Edwards was rankled by Stockman's pre-emptive announcement of the decision to decontrol oil prices. But Reagan doesn't seem to mind. "We're talking about taking on 40 years of spending practices," says a top White House aide. "We couldn't do it unless somebody honchoed it from the beginning."

'Comet': Stockman, a bachelor, honchos the budget eighteen or nineteen hours a day, seven days a week—a regimen that he concedes to be "certifiable" workaholism. He lives modestly—aside from his salary, his assets last year were not more than $50,000—and rises at 5 a.m. He reads for an hour and then, still reading, is chauffeured to work. On a typical day last week he arrived at his office by 7 for interviews with prospective OMB staffers, drove to Capitol Hill for a meeting with Senate Republicans at 8:45, went back to the White House for a 10 o'clock session on regulatory reform and a 10:30 Cabinet meeting, then doubled back to the Hill for a working lunch. At 1:15 he joined Reagan in the Capitol to woo Congressional leaders, went to the Department of Health and Human Services at 3 for a budget huddle and got back to his office by 4. At 5:30 he was back on the Hill and at 7 he arrived at a dinner honoring Congress. He has little time to see his girlfriend, IBM representative Jennifer Blei, and a Reagan aide who sees him as "a bright comet in the sky," is already praying that he "doesn't burn out."

Stockman learned the work ethic early on, as a farm boy in southwestern Michigan—rolling, handsome country dotted with farms and small towns, as broadly Protestant as it was traditionally Republican. The oldest of Allen and Carol Stockman's five children, David helped with chores, studied hard and, his mother recalls, read anything he could get his hands on. At Lakeshore High in nearby Stevensville, he was president of the student council, an honors student and an undersized football and basketball player who always, his coach says, "gave 100 per cent." He worked for Barry Goldwater's ill-fated Presidential campaign in 1964—then went off to Michigan State University, where he suddenly was transformed into a campus radical. As the leader of a summer-long protest against the war in Vietnam, Stockman championed draft avoidance on campus and wound up under surveillance by the Michigan State Police. Their assessment, according to the State Journal of Lansing: "Dark, long brown hair, but clean and very good looking."

'Skepticism': His flirtation with the left only barely survived his graduation from Michigan State. He enrolled at Harvard Divinity School—partly to avoid the draft, friends say—and rediscovered conservatism. Sociologist Nathan Glazer and political scientist James Q. Wilson, two of his professors, remember him as a brilliant student who quickly followed their lead toward neoconservatism. Daniel Patrick Moynihan took Stockman into his household as a boarder. ("He may be the deputy assistant to the President," Moynihan says, "but to my daughter, he'll always be 'the babysitter'.") They spent hours talking, and Moynihan inculcated "a certain skepticism" about the left-liberal certitudes Stockman was spouting. Finally, Stockman recalls, "I had to reconstruct my whole philosophy and ideology"—which led him at last to a profound skepticism toward Big Government.

He also caught the political bug. When Illinois Congressman John Anderson showed up at Harvard for a public-affairs seminar, he offered Stockman a job on his Washington staff. Stockman quickly accepted, left Harvard without getting a degree and spent the next eighteen months in Anderson's office. But he was moving right, while Anderson was moving left. "I found the job fascinating," Stockman says, "although I couldn't support most of his positions by the time I left." He spent three years as director of the House Republican Conference, which was at that time chaired by Anderson, and in 1975 went home to Michigan to run successfully for Congress.

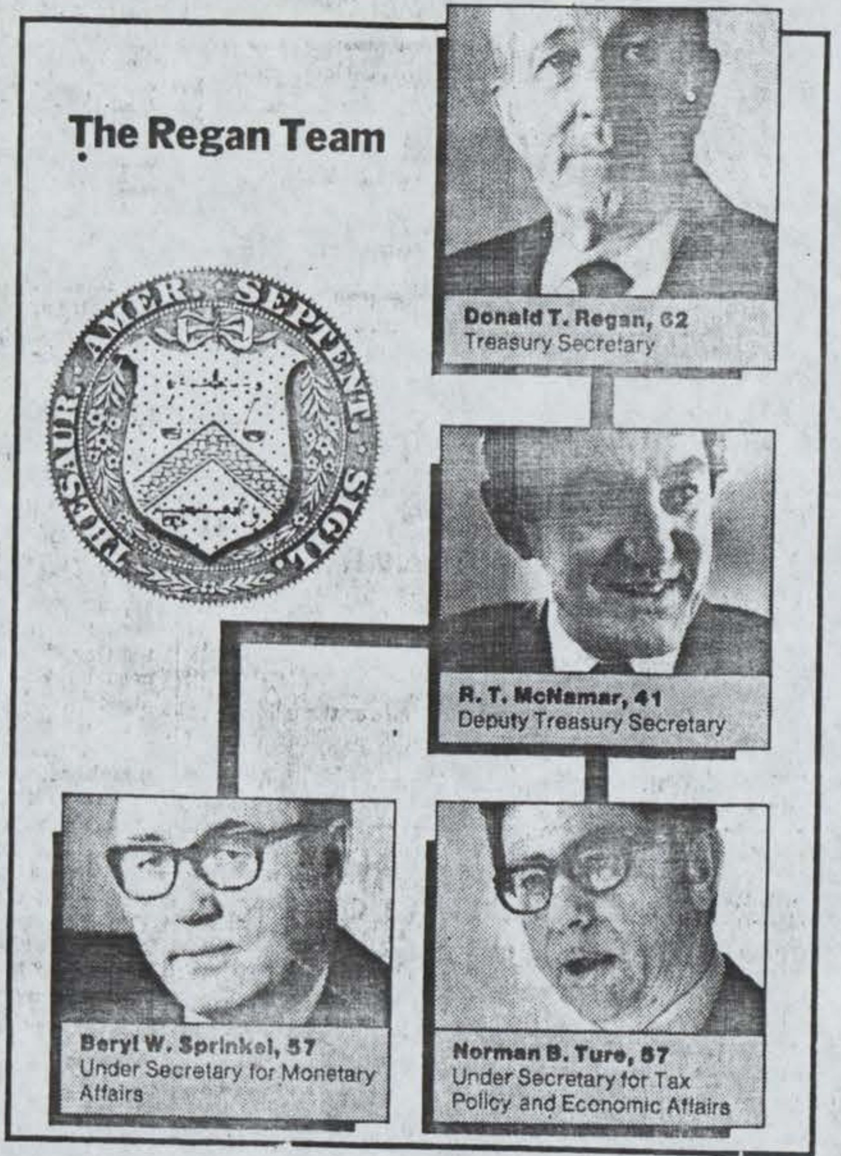
He was quickly recognized as a forceful young conservative—brash to some, arrogant to others, but unmistakably on the rise within the ranks of House Republicans. "He intimidated some of the older guys," says one GOP staffer. Taken in tow by Rep. Robert Michel, then Minority Whip, Stockman gradually learned to rein in his impatience and, during his second term, to win votes for his neoconservative views. He fought the windfall-profits tax, synfuels subsidies and the Chrysler loan guarantees, but lost on all. He joined conservative Democrats in defeating the hospital-cost-containment bill, and his trenchant critique of Jimmy Carter's first gasoline-rationing plan led to its surprise defeat. For all his zeal, Stockman proved himself to be "more pragmatic than ideological," Michel says.

'Rough Edges': When he left Congress for OMB, Stockman tried to pick his own successor—angering some Michigan Republicans who view him as arrogant, even ruthless. There are still, a friend concedes, "some rough edges with David, as there would be with anybody who has this much authority at the age of 34"—but his rapid rise to power rests on the confidence he has inspired in the Reagan White House. Stockman must make the most of the new Administration's honeymoon if he is to succeed in dramatically cutting the budget. By taking the lead, he has volunteered for the risks of failure along with the rewards of success—and his ambitious gamble is Reagan's as well.

TOM MORGANTHAU with ELEANOR CLIFT, THOMAS M. DeFRANK, RICH THOMAS and ELAINE SHANNON in Washington and TONY FULLER in Michigan

Work ethic: With grandparents after 1976 win, as divinity student, in high school

The Ferment in Regan's Treasury



The new Secretary seems to shift positions on tax and spending. Will supply-siders overwhelm him?

By STEVEN RATTNER

WASHINGTON

TO the casual eye, little has changed in the Treasury Department. The portraits of past Secretaries still stare down from the walls in a corner of the second floor. Bureaucrats bustle through the marble-floored corridors. Even the offices of the top officials remain unchanged — redecorating has been banned for budget reasons.

Yet all is not quiescent in this house of finance. Already, as rarely in the past, the Treasury Department has emerged as a seat of intellectual ferment.

How the new Treasury will function — and whether ferment will become turmoil — depends on how easily men representing a variety of economic viewpoints mesh their different outlooks and how well the new Secretary will be able to bring an intellectual discipline to men who in the past have mostly been free spirits.

The new Secretary, Donald T. Regan, is himself at issue. Widely expected to be a voice of pragmatism and restraint in an Administration heavily populated with economic ideologues, he has delivered himself of a variety of remarks — sometimes ambiguous, sometimes conflicting, but always impressive in style and force — that have left the distinct impression that he will not fill his anticipated role.

The varying statements illustrate both the multiplicity of viewpoints now at work in the Treasury and the task the 62-year-old former chairman of Merrill Lynch faces in overcoming his lack of Washington experience. David A. Stockman, director of the Office of Management and Budget, has already shown signs of usurping the preeminent role in economic policy usually filled by the Treasury Secretary.

"I don't understand his latest public statements which do not coincide with his previous public and private statements," said Representative James R. Jones, Democrat of Oklahoma and chairman of the House Budget Committee, of Mr. Regan. "My only concern is whether he is fully in the decision-making loop."

Take, for example, the matter of budget cuts and tax reduction. All of the senior Administration officials argue publicly that both are needed and that they should occur as simultaneously as possible. But in the practical world, simultaneity is unlikely and the Reagan Administration has been pressed on whether it would accept tax cuts passed before budget reductions are voted.

At his confirmation hearing on Jan. 6, Mr. Regan described the reduction of projected Federal spending and the easing of government regulation as "the more important parts" of the Reagan program. "Then we cut taxes," he said.

Exactly three weeks later, Mr. Regan told the Senate Appropriations Committee that the "tax program cannot wait until budget outlays are reduced." And he maintained, "We must not make the mistake of assigning a higher priority to balancing the budget than to revitalization of the economy."

He took much the same stance in a luncheon last week, rejecting suggestions that the tax cut be made contingent on achieving spending restraint. But the next day, a senior White House official pointedly disputed the Regan remark, insisting that the two proposals were

Continued on Page 15

THE NEW YORK TIMES, SUNDAY, FEBRUARY 8,

The Ferment in Regan's Treasury

Some feel David Stockman is seeking control of tax policy.

Continued from Page 1

linked. Privately, senior Administration officials concede that Mr. Regan's conflicting statements reflect in part the fluctuating influences of Mr. Regan's senior aides. Within the group, the conflicts seem to result less from philosophical differences than from differences in emphasis, as in the case of the timing of tax cuts. All of the officials emphatically endorse the need for the entire program of tax cuts, budget cuts, tight control over the rate of growth of money and credit and reductions in regulation.

"What the Secretary started out to do consciously from the beginning was to put together a team bringing various perspectives to the Treasury," said R. T. (Tim) McNamar, the new deputy secretary. "We've got an economic situation to which there is no one answer."

Dominant at least in terms of numbers are the supply-side economists, a loose term for a group that stresses the positive effects of tax cuts, particularly on industry. The most senior exponent of that concept is Norman B. Ture, the Under Secretary for Tax and Economic Policy and formerly a Washington economic consultant. Mr. Ture, who was viewed as a liberal in the 1950's, has gradually become more conservative and in recent years has been touting an economic model showing that the 30 percent, three-year tax cut known as Kemp-Roth would result in major increases in employment by stimulating demand and, therefore, industrial activity.

WITHIN the Administration, Mr. Ture, who is known for holding strong views, has forcefully advocated that the tax cuts take effect as soon as possible and that a large "capital cost recovery" provision be enacted that would allow business to write off new investments faster. Mr. Ture is also arguing that other tax changes such as the marriage penalty should be placed in a separate package.

In Mr. Ture's economic shop are two men of like views: Paul Craig Roberts, the Assistant Secretary for Economic Policy, who was part of the group that worked on the Kemp-Roth proposal, and his deputy, Steve Entin, who was a staff member of the Joint Economic Committee for Senator William V. Roth, Republican of Delaware and cosponsor of Kemp-Roth. (Two other former Roth aides are directing legislative affairs at the Treasury.)

But on the tax side, Mr. Ture's assistant secretary is John E. Chapoton, a Houston lawyer who served as tax legislative counsel in the Treasury. Among the first things Mr. Ture did when his subordinate arrived was to give him some reading materials on supply-side economics. Reports of tension have already filtered out.

Meanwhile, the Under Secretary for Monetary Affairs is Beryl W. Sprinkel, a principal advocate of monetarism, which emphasizes the need for the Federal Reserve to make the money supply grow more slowly and less erratically.

"We're not going to be reluctant to suggest to the Federal Reserve the kind of monetary policies we think they should be following," said Mr. Sprinkel. "We don't have to wait to balance the budget to get inflation under control."

But in the past, most of the Under Secretary's job has involved international monetary matters, in which the 57-year old former chief economist for the Harris Trust and Savings Bank in Chicago has comparatively little experience. "There are some areas in which I'm well informed and some in which I'm not well informed," he said.

Before Mr. Regan's recent pronouncements, Treasury watchers felt that he and Mr. McNamar would constitute a third group with a more even-handed view of the various policy alternatives.

Mr. McNamar, an energetic and engaging 41-year-old lawyer and businessman, who was most recently executive vice president and chief financial officer of the Beneficial Standard Corporation in Los Angeles, describes himself as an "orthodox Republican," by which he means that he relies on no one solution. "We need a variety of actions," said Mr. McNamar, who was executive director of the Federal Trade Commission from 1973 to 1977.

Although Mr. Regan rejects the notion that he is possessed of a traditional Republican economic philosophy, and although he was known on Wall Street as something of a mavarick, his few public statements on economic policy before his appointment suggested a different emphasis.

Back in July, Mr. Regan called for a tax cut and talked of the need for incentives, much as he is doing now. But then, his priorities were a little different. First came accelerated depreciation, second, lower capital gains taxes and, third, protecting taxpayers against being pushed into higher tax brackets by inflation, a change that would give proportionately more relief to middle- and lower-income taxpayers than would Kemp-Roth.

Mr. Regan was also viewed as suspect by the most conservative Republicans for having supported wage-price controls in 1971 and for having lent at least tacit support to Democratic candidates, including Jimmy Carter.

While his statements have sometimes caused concern, Mr. Regan's manner of delivery has won universal praise. In meetings, the native of Boston has impressed even hardened Washingtonians with his crisp responses, steady gaze and sharp mind.

"He comes across as strong and forceful but with a sense of humor," said Charls E. Walker, a former Treasury Deputy Secretary under former President Richard M. Nixon, after a breakfast session. "He made his points and made them very clearly."

Mr. Walker also praised Mr. Regan for assembling a Treasury team quickly, probably second only to Alexander M. Haig Jr. in the State Department in speed. But other Treasury watchers also question whether Mr. Regan actually chose the team, virtually none of whom he had met before their job interviews, or whether it was pushed onto him.

Mr. Ture, for example, was reportedly at the head of a list prepared by the "kitchen cabinet," the group of California businessmen that President Reagan relied on in the early stages after his election. Mr. Regan's principal selection has been his New York public relations aide, John Kelly, who also lacks Washington experience, to fill a similar post here.

And officials such as Representative Jones wonder about the extent to which Mr. Regan is shaping Administration policy in view of the highly visible role taken by Mr. Stockman. At the outset, Mr. Regan's lesser role was attributed to his lack of experience; now, questions are being raised. "Tax policy has always been the domain of the Treasury, but now it looks like Stockman's grabbing for that too," said one concerned Treasury official.

For his part, Mr. McNamar argues that the Treasury has been trying to keep a low public profile in part because only Mr. Regan has won Senate confirmation and that "Treasury has been at every budget-cutting meeting." In addition, the economic policy council, which replaces President Carter's economic policy group, has not yet started up.

"You're talking about the first 30 days," said Mr. McNamar. "The Administration is not speaking with one consistent economic view yet, and when it does it will be Donald Regan's." ■

Epic Political Struggle Looming, Washington Officialdom Realizes

POLITICS, From A1

address Thursday night was the first display of these tactics.

But the budget process takes Congress most of the year to complete, and it is beyond the power of the White House to accelerate that schedule. Reagan can win some quick skirmishes, for example in his effort to reduce the current budget by about $14 billion, but the truly revolutionary cuts he seeks in fiscal 1982 and beyond won't be voted on until much later.

This unavoidable delay will give the special-interest groups — from welfare mothers to dairy farmers to Exxon and Boeing — ample time to mobilize their political forces to try to frustrate the administration's proposed cuts. "There are probably 35 meetings along the K Street corridor right now, trying to plan how to stop this," one White House official said with evident relish for the battles ahead.

The outcome of this contest remains unpredictable, not least because unforeseeable events can easily prove decisive. For example, the White House is hoping to keep national attention focused on the budget issue until it is resolved, but an international crisis — a Soviet invasion of Poland, say — could distract both the country and the White House, opening up new maneuvering room to the interest groups.

But there is widespread agreement on this point: Reagan seems to have an opportunity for success which his predecessors lacked, a sense of political readiness and nervousness that simply was not present in previous seasons of much-heralded budget cutting. Two dozen interviews with White House officials, members of both houses of Congress and professional lobbyists suggest both why Reagan could win his crusade, and what might tear it apart.

Administration officials and their allies in Congress suggested these elements are necessary ingredients in a winning strategy:

• A demonstrably fair plan for budget cuts, in which all special interests are seen to share in the sacrifices. This has been Stockman's objective all along, though some Republican members of Congress fault him for leaning too heavily on poor people in his initial planning. Stockman even hopes to surprise Congress by proposing some cuts in the Pentagon's budget, though these will be more than matched by new increases.

The theory of a balanced package of cuts was summed up neatly by Tom Korologos, a prominent Washington lobbyist who is close to the White House.

"If the Business Roundtable isn't furious when this is over," Korologos said, referring to the group that represents the sentiment of America's biggest corporations, "it will have failed. Everybody has got to scream equally — a loud outcry. Then it might fly."

Of course, fairness of this kind is much easier to describe than to achieve. Some of the oxen that will be gored by Reagan's budget cuts will never believe that they are suffering "fairly," and will fight back accordingly.

One key White House official who asked that his name not be used said at the end of the week that after the first leaks of the Reagan cuts he was "really surprised at the reaction on the Hill." People he expected to be fiercely opposed to the cuts are accepting them with unexpected equanimity, this official said.

• Preservation of the post-election political mood in Washington, which is clearly favorable to Reagan's cause. Politicians from liberal Democrats to arch-conservative Republicans agree that November's surprising results — both Reagan's large margin of victory, and the Republicans' unexpected gains in Congress — have intimidated even the House Democrats who remain in control of that body.

Rep. Thomas S. Foley (D-Wash.), the new majority whip in the House, said last week that "there's a consensus growing in the Congress" in favor of less government spending, fewer government regulations and simplified government programs. "The inflation level is the most serious issue facing the country," Foley said.

If even liberal Democrats are talking like that, Reagan clearly has an advantage. "I think the climate is somewhat intimidating," said Rep. Barber Conable (N.Y.), the ranking Republican on the Ways and Means Committee. "Of course, the conventional wisdom is that this climate won't last long."

• The evolution of shifting coalitions of budget-cutting members of both houses to head off the pet projects of key members. Sen. Jesse Helms (R-N.C.) is a convinced budget cutter, but he doesn't want to touch the tobacco subsidies so important in his home state. If he can protect them — or if the dairy industry's many friends in Congress can protect dairy subsidies, or if the western senators and representatives preserve all the expensive water projects — the spell of unity Reagan hopes to cast will be broken. Other interests will pursue their pet projects with renewed indignation. The Stockman plan will be plucked and pulled from every direction at once. White House officials say they are keenly aware of this problem.

• Top-flight lobbying work all year. After last week's vote to raise the debt ceiling in the House, when three-fourths of the Republicans were persuaded by the White House to support a measure they had all but unanimously opposed in the past, Rep. Richard Bolling (D-Mo.), chairman of the Rules Committee, observed: "The day of the amateur [president] is passed . . . These guys are really going to be playing legitimate, effective hard ball."

These same people see many different ways that the new president's crusade could be frustrated, too. Among them:

• A loss of nerve among Republicans who can't stomach cuts of the programs that many of their constituents depend on. Sen. Bob Dole (R-Kan.) said last week that he has repeatedly reminded the White House that six of the Republicans on the Finance Committee he now chairs will be up for reelection in 1982, and thus will have to answer for whatever the Republican-controlled Senate has done in the interim.

If a united front is broken, several Republicans in both houses said, the whole plan could quickly unravel.

• A changed atmosphere on Capitol Hill. A serious economic downturn, for example, could revive traditional congressional instincts and promote a new round of pump-priming through the federal budget. "You've got 100 senators each holding one finger up in the air to see which way the wind is blowing," said an aide to a prominent Senate liberal, who admitted that today's wind is favorable to budget cuts.

• An outbreak of regional warfare in Congress. Many of today's big government programs — all of which Reagan will try to trim — were the product of elaborate regional compromises. For example, food stamps and price supports and subsidies for farmers have traditionally been seen as a trade-off between rural and urban members of the House. Northern members made trades to win Sun Belt support for the fuel-aid program to help poor people pay for their heating oil or gas. Western members traded votes on matters of interest to northern and eastern colleagues to win support for their water projects.

If the budget-cutting process destroys any of these explicit and implicit arrangements, "there's a real danger of sectionalism dividing the Congress," said Sen. Patrick J. Leahy (D-Vt.).

• Squabbling between members whose first interest is tax cuts and those who are more anxious about spending cuts.

So far, Stockman has held the two camps together by allying the new administration with both of them. But there are members of both parties who would be perfectly willing to vote tax cuts before spending cuts are agreed on, and others who will fight such a move bitterly.

In the end Reagan's most formidable foe may be the traditions of politics as usual that have governed Capitol Hill for so long. The new president wants a revolution in bread-and-butter politics, but many in Congress can be expected to offer him half a loaf.

Epic Political Struggle Looms

Official Washington Realizing Reform Crusade Is Not Business-as-Usual

By Robert G. Kaiser
Washington Post Staff Writer

David A. Stockman's big black book of budget cuts, 145 pages of numbers and fine print, makes tangible what official Washington was already beginning to grasp: the Reagan crusade for federal reform is not business-as-usual. It promises, instead, to produce a year of epic political struggle unlike anything seen before in modern Washington.

When President Reagan presents his detailed economic proposals 10 days from now, the struggle will begin in earnest. In the meantime, the budget-cutting prospectus prepared by budget director Stockman and obtained yesterday by The Washington Post will be the best-read official document in the capital, widely circulated and scrutinized in Congress and in lobbyists' offices.

The sum of its details is breath-taking: enormous reductions proposed for long-familiar and popular federal programs. Stockman proposes to cut scores of billions: in some cases he would cut the benefits that significant elements of the population depend on for their survival.

In the first days of his presidency Reagan has apparently settled easily into the idea of fighting this radical crusade, which in fact is closer to the apocalyptic rhetoric of his early political career than the soothing reassurances of last year's presidential campaign. Candidate Reagan often seemed to be saying that the only thing that had to be cut was federal taxes in order to restore the country's economic well-being. Now President Reagan predicts "an economic calamity of tremendous proportions" unless radical surgery is performed on the federal budget.

The difference between the campaign rhetoric and the new budget-cutting crusade is one of the political problems that the administration will have to conquer to prevail. "The candidate in 1980 who asked for sacrifice," recalled Rep. James R. Jones (D-Okla.), chairman of the House Budget Committee, "lost the election." But now the man who won will be asking for literally unprecedented sacrifices from individual Americans and some formidable interest groups.

Many in the White House, including Stockman, who is the principal architect of the budget-cutting plan, believe speed and momentum are crucial to their success. The idea is a political blitzkrieg backed by a persuasive president's direct appeals to the nation for support. Reagan's televised

See POLITICS, A20, Col. 1

Reagan Budget Team Proposes Cuts Across Broad Spectrum

8/2/81

By Ward Sinclair and John M. Berry
Washington Post Staff Writer

President Reagan's budget architects have put together an extraordinary package of proposed budget cuts touching every level of American society and dismantling dozens of popular federal aid programs that support everything from school lunches to airports, public television and welfare.

The sweeping nature of the spending cuts being considered by the Reagan administration is outlined in documents prepared as prelude to presentation of the president's economic policy program Feb. 18 and obtained yesterday by The Washington Post.

The budget documents, prepared by David A. Stockman, director of the Office of Management and Budget in the Reagan White House, were circulated confidentially last week among key senators and House members who will preside over the budget and appropriations action this spring.

For example, the Stockman budget book proposes for fiscal 1982:

• A massive revamping and rewriting of federal school aid policy, with a consolidation of at least 57 programs into a scheme of block grants that would go to the states to spend as they see fit. But the school aid would be reduced by 20 percent from what the states receive.

• A $990 million reduction in child nutrition programs on top of at least a $400 million cut proposed by the Carter administration.

• The abolition of the Economic Development Administration, including all its $425 million in loan guarantees, an end to the $3.7 billion public service jobs (Comprehensive Education and Training Act) program, and shutdown of the Appalachian Regional Commission and nine other sister regional commissions.

• A $1.3 billion reduction in highway, rail, airport and mass transit aid that would doom completion of the full 101-mile Washington Metro subway system.

House Democrats tomorrow will get, by courtesy of the Democratic Study Group (DSG), a first look at these probable budget slashes totaling $26.2 billion. Another $10 billion to $20 billion worth of reductions are anticipated before Reagan formally sends his unprecedented budget changes to Capitol Hill.

The early delivery of the detailed cuts — obtained independently by the DSG — seems certain to set the tone for what will be a knock-down, drag-out brawl over Reagan's efforts to scuttle dozens of aid programs that have acquired forceful advocates during the last two decades. Even in the Senate, now controlled by the Republicans, a melee is assured. "We don't interpret Reagan's victory last fall as a mandate to scuttle all these programs," said an aide to a key tax-writing Democrat.

While some of the details of the budget proposals have filtered out

See CUTS, A14, Col. 1

Excerpts from 145-page OMB document on budget cuts. Page A15.

President's Budget Team Readies Broad, Deep Cuts

CUTS, From A1

sporadically in recent days, the full scope of the sharp alteration in federal support for so many activities — and the pain they are certain to cause — leaps from the pages of Stockman's catalogue of cuts.

Stockman yesterday declined to comment on the specifics of OMB's proposals, saying only, "It's all still in the option stage, but the options are firming very quickly."

President Reagan, who has approved many elements in the program already, must clear these and other issues this week in order to meet his timetable for his economic message to Congress in 10 days.

Another unusual side to the Stockman proposals is the "probable reaction" assessments sketched out by OMB draftsmen as part of the presentation and defense of the projected slashes. On most proposals, the OMB foresees stiff opposition from Congress, state and local governments, as well as from labor, business and social welfare organizations.

Even at that, however, the GOP White House apparently is counting on support from friendly Democrats to carry through with the swing of the cleaver. In contemplating a $671 million chop of aid to families with dependent children (AFDC), for example, OMB says the likelihood of winning "seems good," with leadership expected from Sen. Russell B. Long (D-La.), who until this year was chairman of the Finance Committee.

The sweeping changes proposed in the energy area total $6.4 billion, with the budding synthetic fuels program virtually wiped out. Support for solar energy and energy conservation are more than cut in half.

The reduction of $712 million in synthetic fuels money in 1982, and much larger reductions in loan guarantees, is justified on the grounds that the private sector can do the job and that it is not up to the federal government to build synfuels plants.

As for an assessment of the probable backlash, the OMB documents state: "The proposed actions would be strongly opposed by project sponsors and the array of business and labor interest that would benefit from [a] government-subsidized construction program (architect engineers, constructors, suppliers, labor unions, and development interests in areas where plants are to be built).

"Also," the document continues, "the popular perception that synfuels are a way of reducing dependence on imported oil and holding down OPEC prices would produce negative public and media reaction. Congressional delegations from West Virginia, Kentucky, Ohio, Alabama and Illinois would be affected."

Similar arguments are made for cutting back money for energy conservation activities: "Supported by existing tax credits, individuals and businesses are already making substantial conservation efforts, which will be accelerated by oil and gas decontrol. In light of these trends, much current federal activity is superfluous or imposes too great a regulatory burden on the public."

It's not just private business and individuals that are in many cases to be left to their own devices, but so are quasi-public organizations such as the Tennessee Valley Authority.

Financially, TVA will fight its own battles, with 1982 outlays cut $762 million. OMB suggests TVA should borrow money on its own, not through the Federal Financing Bank, and that it should scale back its planned construction of generating plants, including deferral of three nuclear plants.

The nation's rural electric and telephone cooperatives, who collectively constitute the biggest borrowers for whom the Treasury Depoartment's Federal Financing Bank raises money, would also be left to their own devices in the capital markets.

In keeping with the administration's avowed aim of looking at all federal programs, the OMB proposals also go after some of the "silk-stocking" outlays of government spending.

The national endowments for the arts and the humanities would be ticketed for an $85 million reduction in their grant-awarding programs, while public broadcasting would see its support shorn by $43 million. In both cases, Stockman's aides acknowledge the sensitivity of their assault, predicting an outcry from constituencies they describe as "articulate and politically active."

But in another sense, the proposals seem destined to provoke cries of anguish from traditionally less articulate sectors — children, for one; the poor and the sick, for another. The OMB master plan, despite frequently stated administration commitments to protecting programs for the "truly needy," touches them nonetheless.

As an example, the plan envisions a saving of $1 billion through placement of a cap on federal spending for Medicaid, the health program for the poor. OMB projects an annual saving of $5 billion within three years if Congress goes along with the cuts.

Pages From Budget Director

THE WASHINGTON POST Sunday, February 8, 1981 ... R 1

Stockman's 'Black Book'

Following are excerpts from the 145-page document listing the Reagan administration's contemplated spending cuts. In most cases the budget cutters have set forth the rationales for their proposals and forecast the likely reactions in Congress and among affected interest groups. Listed cuts are from the so-called current services budget, which sets forth what spending would be in fiscal 1981 and 1982 under current law and economic assumptions, absent any changes in policy. All figures are in millions of dollars and in projected outlays — money the government is expected actually to spend.

Medicaid

	1981	1982
Current Estimate	16,483	18,215
Proposed Savings	100	1,013

Current Program: Medicaid is a program of grants to States to assist them in providing medical insurance coverage to the poor.

Potential Change: The savings identified above could be achieved if an interim cap were imposed on federal Medicaid spending while proposals for fundamental program reforms are developed. The cap would limit federal grants a level $100 million below the 1981 spending estimate, and allow a 5 percent increase in 1982, $1 billion below the current spending estimate. After 1982, federal spending would be allowed to rise only with inflation. States would be given additional flexibility to adjust payment rates for providers, to organize more cost-effective systems of care, to change covered services, and to adjust eligibility in order to live within their allocated share of the expenditure cap.

Medicaid spending has risen faster than 15 percent annually over the last five years. Only capping federal payments can produce significant budget restraint under present conditions.

The interim cap will allow each state to maintain its current real share of total federal Medicaid spending. The effects of the cap however, vary from state to state, depending on projected rates of expansion and the methods adopted to reduce program costs. Based on current state projections for 1982, all but 3 states will have reimbursements limited as a result of the cap. Nine states now consume 55 percent of all federal Medicaid dollars. New York and California alone generate 27 percent of all federal Medicaid costs. The increased state flexibility proposed . . . will enhance states' ability to improve the cost-effectiveness of the program and to make appropriate adjustments in eligibility. Nevertheless, some states are likely to respond to the cap by withdrawing needed services from the poor and by excessively constraining payments to providers.

Probable Reactions: Most states will object strongly to imposition of a federal cap on Medicaid, although welcoming the proposed increases in flexibility. In addition, provider groups, especially hospitals, may balk at limited payment rate reductions stimulated by the cap. These groups might add their voices to the normal welfare constituency in the Congress. In view of the current inequities in the program, it will be important to emphasize that the cap is a temporary measure while proposals for fundamental reforms are developed.

Disability Insurance

	1981	1982
Proposed Savings	125	600

Current Program: Disability Insurance (DI) benefits are paid to disabled workers and their families. The costs of disability insurance have grown by leaps and bounds.

Potential Changes: (1) Improve administration to reduce payments to ineligibles — Unpublished Social Security Administration (SSA) Pilot quality Control studies indicated a 15-20 percent DI error rate, with most of the misspent funds going to individuals misclassified as disabled.

A top-flight management team, starting immediately and operating under current law, could produce sizeable savings starting in FY 82.

(2) Institute a "megacap" — A megacap would limit related disability benefits so that they do not exceed a worker's prior after-tax earned income. The rationale is simply that individuals should not receive more while disabled than they were paid for working. The largest federal program offsetting DI benefits would be veterans compensation benefits.

Excluding veterans compensation benefits would markedly reduce the savings associated with a megacap.

Excluding state worker's compensation or private disability insurance benefits also would reduce the savings from a megacap. Reducing DI benefits for private insurance payments could be seen as taking private property from individuals who chose to insure themselves.

Provide a stricter recency-of-work test: Workers who had social security covered earnings up to 5 years ago but not since are eligible for social security disability benefits.

Opponents to this change would make emotional appeals about vulnerable people being excluded from benefits, such as the disabled, widows mothers and dependent children.

Probable Reaction: Congress may be reluctant to again reform disability insurance. The 1980 DI reforms focused on eliminating excessive benefits for the disabled. Seeking major cuts in disability benefits might be viewed by advocates as an assult on America's social insurance "safety net."

Social Security Student Benefits

	1981	1982
Proposed Savings	100	700

Current Program: Full time students age 18-21 are entitled to social security benefits as dependents of retired, disabled or deceased workers. Approximately 800,000 students now receive benefits from this program. The average social security student benefit is $255 per month and ranges from a low of $20 to a high of $700.

Potential Changes: The students benefits program should end. New recipients should be prevented from entering the program, and existing recipients' benefits should be reduced by 25 percent over the next four years.

Arguments for Ending Program:

The benefit is inapporopriate for the social security program — Social security protects against loss in income from risks (old age, disability and death) which are beyond the worker's control. Continuing the child's benefits past age 18 because of their choice to go to school ahould not be an insurable risk.

The benefit is poorly designed as educational assistance expenses.

Educational assistance is provided more equitably and efficiently under other programs

The social security trust system can no longer afford this drain on its funds.

Program participation rates and costs have exploded since 1965 enactment.

Probable Reactions: Recommemdations by the Carter administration to reduce or abolish these benefits have not even gained serious consideration on Capitol Hill. Severe opposition by present and future beneficiary families, Social Security advocacy groups and the higher education establishment can be anticipated.

The new Congress may be more responsive to trimming this program on merit, particularly when the savings are needed to maintain the overall soundness of the social security system.

Minimum Social Security Benefits

	1981	1982
Proposed Savings	200	1,000

Current Program: A minimum initial benefit of $122 per month is given to social security recipients who otherwise earned a lesser amount.

Potential Changes: Both GAO and various social security advisory councils concluded that the minimum benefit has outlived its usefulness and generates undesirable windfalls. It was originally adopted to assure that benefits paid to retired workers were larger than welfare payments.

The original rationale for the minimum benefit makes no sense today. The Supplemental Security Income (SSI) program, enacted in 1972 for the needy aged, blind and disabled pays benefits which are about double the social security minimum benefit ($240/month).

Because SSI benefits would be increased by the amount social security benefits were reduced, eliminating the minimum benefit would not affect truly needy recipients. Of the 3 million minimum beneficiaries, less than half would lose a single dollar if the minimum benefit were eliminated.

According to GAO, 74 percent of minimum income recipients do not "depend primarily" on social security benefits. This includes 15 percent who have federal government pensions averaging $900 per month and 10 percent whose working spouses earn at least $14,000 per year. Eliminating the minimum benefit tends to even out the income distribution among retirees by reducing incomes among the better-off without affecting incomes among the worst-off.

Probable Reactions: Doing away with the minimum benefit makes programmatic sense and has been recommended by GAO. However, those recipients who would lose a portion of their income would lobby fiercely against minimum benefit elimination. Eliminating the minimum could be painted as a first step toward dismantling social security, resulting in heightened resistance to other social security reforms.

Unemployment Insurance Extended Benefits

	1981	1982
Proposed Savings	568	2,162

Current Program: The regular unemployment insurance system pays benefits for up to 26 weeks (in most states) to experienced workers. Up to 13 more weeks of extended benefits become available ("trigger on") when either individual state unemployment rates or the national rate exceed certain levels. The national trigger has been on since summer 1980, and under current assumptions would remain on through three quarters of FY 1982.

Potential Changes: (1) Eliminate the national extended benefit trigger. When the national insured unemployment rate (the ratio between unemployment claimants and the number of workers covered under the program) exceeds 4.5 percent, extended benefits become available to workers in all 50 states, regardless of the unemployment rate in a particular state. Eliminating the national trigger would restrict extended benefits to states with high unemployment rates and demonstrated need.

(2) Change the method of calculating the trigger rate.

(3) Increase state trigger levels. Currently a state must pay extended benefits when its insured unemployment rate is at least 4 percent and at least 120 percent of its experience in the prior two years. A state, if it wishes, can pay them when its insured unemployment rate exceeds 5 percent. These limits could be raised to 5 percent and 6 percent.

(4) Strengthen and enforce the work test. Unemployment insurance recipients are supposed to be available for and seeking work at all times. However, state enforcement of this requirement is very uneven.

Potential Reaction: The first three changes would require congressional action on substantive legislation; the fourth would require appropriations action. Lobbying against the proposals, particularly by organized labor, would be intense. Eliminating the national trigger and changing the trigger rate calculation have been discussed on the Hill before and do enjoy support, particularly in the Senate, which in the last session passed legislation eliminating the national trigger.

Trade Adjustment Assistance

	1981	1982
Proposed Savings	—	1,000

Current Program: The Trade Adjustment Program pays benefits in addition to unemployment insurance to workers when increases of imports "contribute importantly" to their losing their jobs. Benefits are liberal (70 percent of prior gross earnings — up to the average weekly manufacturing wage, now $269) and extend to 52 weeks. Workers over age 60 or in approved training can draw 26 additional weeks. TAA was enacted to gain approval of a less restrictive international trade policy by those concerned with the effect of imports on jobs.

Potential Changes: Implement GAO recommendations to limit TAA to people who have exhausted their unemployment insurance (UI) benefits; cap TAA benefits at UI benefit levels; and limit the duration of TAA and UI benefits combined to 76 weeks.

Or, same as above, but limit duration to 52 weeks. The hardship felt by workers eligible for TAA is no worse than for other unemployed workers, who are now subject to a 39-week benefit limit. For those with permanent problems, 52 weeks of TAA should provide sufficient time to get training, relocate, or find adequate new jobs.

Potential Reaction: Organized labor, particularly the Steelworkers and the UAW, will strongly oppose attempts to curtail TAA, particularly to reduce benefits for current claimants. Last year the House passed a bill expanding the TAA program. There is, however, considerable sentiment that something must be done to control this program which has grown far beyond expectations.

Food Stamps

	1981	1982
Proposed Savings	—	2,600

Current Program: Food stamps subsidize the food purchases of low-income households. Each household meeting eligibility requirements — an income test, an asset test and a work requirement — receives stamps redeemable for food purchases. Stamp allotments vary by household size and net income level. Allotments are annually indexed based upon changes in the Thrifty Food Plan, USDA's lowest cost plan for a nutritionally adequate diet.

Potential Changes: Savings would be achieved by adopting the following package of proposals:

- Food stamp benefits would be reduced 35 cents rather than 30 cents for every dollar earned and gross income limits would be set on eligibility. Using gross household income instead of net income improves the low-income targeting of the program. Participation would decline by 2 to 3 million persons from these changes.
- Liberalizing amendments scheduled to take effect in FY 1982 relating to adjustments and deductions would be repealed. Current recipients would not lose any of their present benefits and no recipients would be dropped due to this change. Food allotments for families with school age children would be reduced to take into account free school meals. Approximately 43 percent of food stamp households (3 million) would be affected.
- Require income eligibility to be based on income in the prior quarter.

Probable Reaction: Enactment of the complete package is highly unlikely. Repeal of the scheduled 1982 liberalizations and increasing the benefit reduction rate with gross income limits are the most likely. Other proposals (school lunch offset, and quarterly retrospective accounting) may be more difficult.

Aid to Families With Dependent Children

	1981	1982
Proposed Savings	—	671

Current Program: AFDC is often viewed as the primary federal welfare program (although SSI spends as much, and food stamps 50 percent more, for the poor). AFDC is administered by the states with federal matching funds ranging from 50 percent to 83 percent.

Potential Changes: Advance payment of the Earned Income Tax Credit (EITC) — which goes to families with low-income earnings — would be assumed and counted against a family's monthly AFDC payment.

The income of step-parents would be counted in determining a child's elegibility and benefits for AFDC, in contrast to current requirements which do not assume any financial responsibility on behalf of step-parent. This proposal would eliminate the anomalous situation of a child being an integal part of a household that should be expected to support her/him and at the same time being a public charge.

States would be required to determine each month's AFDC benefits based on the family's income and circumstances in the previous month. This would replace the current prospective procedure of estimating future income and family circumstances to calculate benefits, which can result in overpayments and undetected ineligility.

Currently, an AFDC family's earned income may be offset by an unlimited amount of reasonably attributed work-related expenses, including child care, in determining AFDC benefits. Standardizing disregards would encourage greater economy by AFDC recipients in their work expenses, which could efectively increase their income available for other expenditures ($86-plus million savings).

AFDC payments below $10 per month would be prohibited.

Probable Reaction: The likelihood of congressional passage of AFDC items in this package seems good, with leadership expected on most items from Senator Long and the Senate Budget Committee. Opposition from the welfare lobbies can be expected on all AFDC items and, with regard to the retrospective reporting requirements, will focus on up-front administrative costs associated with the proposed change.

Health Planning

	1981	1982
Current Estimate	172	184
Proposed Savings	-20	-75

Current Program: The health planning program provides support for 213 local health systems agencies (HSAS) and 57 state health planning and development agencies (SHPDAS). The program has a dual charge: to assure equal access to quality medical care and to control costs; in practice, however, emphasis has been toward cost containment. The program's three primary methods of controlling costs are: 1) certificate of need review for new facilities construction or equipment purchase; 2) appropriateness review for existing facilities, and 3) proposed utilization of federal funds review for federal grant application.

Potential Change: This proposal would phase out federal support for the entire planning program over the 1981-1983 period. This policy action would be consistent with a two-year administration timetable for development and implementation of a pro-competitive bill for health financing reforms.

This proposal reflects three basic deficiencies of the current planning program:

- Inappropriate regulation. The health planning program is intended to restrain costs by limiting the supply of facilities and services. However, this approcach also inhibits market forces which are needed to strengthen competition and provide less costly services.
- Lack of effectiveness. The planning program has functioned under serious liabilities of attempting to impose a federal structure incompatible with many state and local political processes and attempting to restrain costs without altering the financing system which is the main contributor to excess costs.
- Federal/state/local responsibilities. The planning program is a highly visible example of the federal government seeking to impose national program, in exhaustive detail, on states and local areas. Continued support for the current planning program would thus appear to be a low priority in view of this administration's approach to returning responsibilities to appropriate levels of government.

Probable Reaction: Some dissatisfaction with the present planning program is evidenced by the 15 percent reduction in 1981 funding for local health planning. Nevertheless, absent a viable pro-competition alternative to cost containment, the current planning/regulatory approach has continued to maintain support. The strongest opposition to elimination of this program will come from the local health planning agencies and congressional supporters of a strenghened federal role in health care regulation. Some provider groups and Blue Cross, with stakes in the present non-competitive system, as well as states, may also oppose a complete end of funding. Most providers, however, will probably support program elimination.

Comprehensive Employment And Training Act

	1981	1982
Proposed Savings	946	3,708

Current Programs: Prior to 1973, a number of categorical, federally controlled programs were authorized by the Manpower Development and Training Act (MOTA) and the Economic Opportunity Act (EOA). In 1973, CETA combined most of these programs into a single block grant and transferred responsibility for their administration to state and local governments.

Potential Change: The savings above reflect total elimination of CETA subsidies for regular jobs in the public sector, by the end of FY 1981. Because CETA funds are available for obligation for two years and may be expended for up to two years after the date of obligation, maximum savings in outlays in 1981 and 1982 require phasing out the program in 1981.

Probable Reaction: State and local governments can be expected to oppose phase-out. Termination will diminish services in most jurisdictions, and in communities which engaged in heavy substitution, considerable problems could result. Organized labor can be expected to argue against any reduction, citing PSE as a way to reduce the unemployment rate, preserve, and enhance job skills provide valued output, and prevent a decline in public services. Strong opposition can be expected from minority groups since virtually all PSE participants are disadvantaged and almost half are minorities. Recycling some of the PSE savings into training programs could ameliorate the criticism, but would reduce overall savings.

Public Health Service Hospitals

	1981	1982
Current Estimate	158	161
Proposed Savings	-40	-100

Current Program: The federal government operates a system of eight general hospitals and clinics primarily to provide free medical care for merchant seamen.

Potential Changes: This proposal would eliminate the merchant seamen entitlement, the general hospitals and the clinic system on the following grounds:

The merchant seamen entitlement to free medical care at public expenses is inequitable and unwarranted.

Only 40 percent of the PHS system's patient care is now for primary beneficiaries (merchant seamen).

Occupancy rates of the hospitals have been hovering at 60 percent since 1978 compared to national minimum standards of 80 percent occupancy.

All of the hospitals are located in overbedded areas; and

All affected cities have at least one other federal facility operating at less than 80 percent occupancy to care for non-merchant seamen patient load entitled to federal care.

Probable reaction: There will be strong reaction from members of Congress whose constituency is affected by reduction of 5,000 federal jobs, but objection is not likely from other areas. Former senator Magnuson and former congressman Murphy . . . were primarily responsible for continuance of the system. The remaining hospitals are in Seattle, San Francisco, Galveston (Nassau Bay), New Orleans, Norfolk, Baltimore, Staten Island and Boston.

National Health Services Corps Scholarship, Placement Programs

	1981	1982
Current Estimate	151	187
Proposed Savings	-3	-14

Current Program: The NHSC provides federally employed physicians and other professionals to areas classified by HHS as health manpower shortage areas (HMSAS).

Potential Change: This proposal would eliminate all new scholarship awards in 1981 and 1982 on the following grounds:

- Rapidly diminishing access problems. Currently available data indicate that serious remaining problems of access to adequate primary care are rapidly being reduced and will probably be virtually eliminated within the next few years.

In addition, recent data indicate that physicians in general, and primary care physicians in particular, are voluntarily locating in smaller communities and that specialists in rural areas spend 30 percent or more of their time on primary care.

- Costs — Total program costs are very high. Federal costs now average $100,000 per physician for each year of scholarship obligated service. Alternative aid program would be more cost effective.

Probable Reaction: This proposal has a very good chance of gaining support from both Appropriations committees. The House committee has been highly critical of the NHSC placement process in recent years. There has been a higher and higher proportion of assignees placed with HHS grantees in urban areas as opposed to rural areas where the eventual establishment of a private practice is more likely.

National Endowment For Arts, Humanities

Humanities

	1981	1982
Proposed Savings	—	39

Arts

	1981	1982
Proposed Savings	—	46

Program: The National Endowment for the Arts and the National Endowment for the Humanities were first authorized in 1965. Most recently, the endowments were reauthorized in December 1980 for a five-year period, through FY 1985.

Potential Change: Reduce the budget authority of the arts and humanities endowments by 50 percent. The proposed savings reflect a 50 percent reduction in funding for arts and humanities programs beginning in Fiscal Year 1982. From Fiscal Year 1984 on for the arts and Fiscal Year 1985 on for the humanities, the endowments would be held level at $100 million.

Reductions of this magnitude are premised on the notion that the administration should completely revamp federal policy for arts and humanities support. For too long, the endowments have spread federal financing into an ever-wider range of artistic and literary endeavor, promoting the notion that the federal government should be the financial patron of first resort for both individuals and institutions engaged in artistic and literary pursuits. This policy has resulted in a reduction in the historic role of private individual and corporate philanthropic support in these key areas. These reductions would be a first step toward reversing this trend.

Moreover, even in those areas where federal financing does not wholly supplant private philanthropic means of support, it constitutes a low priority item. Given the need for fiscal retrenchment across the full range of human federal programs that meet more basic human needs, low priority items must bear a greater differential burden if fiscal restraint is to be achieved in a balanced and compassionate way.

Probable Reaction: The arts and humanities endowments have broad and articulate public constituencies, ranging from university presidents to museum directors to individual artists and scholars. In addition, most artistic and cultural institutions maintain strong ties to business and corporations through honorary appointments on boards of directors. A proposal to halve the budgets of the endowments could generate strong opposition.

Corporation for Public Broadcasting

	1981	1982
Proposed Savings	—	43

Program: The Corporation for Public Broadcasting is the primary vehicle for providing federal financial assistance to the 217 radio and 170 television stations that currently compose the non-commercial broadcasting system.

Potential Change: Sixty percent of CPB's budget is comprised of block grants to local stations, [and] 24 percent of CPB's budget goes to national program production. The CPB board would have to decide how any cut would be distributed among CPB activities. If a 25 percent reduction in fiscal year 1982 was directed primarily at administrative costs and national program production, support to local stations could be held relatively constant. Given the necessity for funding restraint and the need to cut out low priority items in the budget, a 25 percent cut is reasonable for 1982. Additional reductions would be made in 1983 and 1984 so that the funding for CPB would level out at $100 million in 1985.

Potential Reaction: CPB support goes to 387 non-commercial radio and television stations. These will probably object to a reduction in CPB funding since their non-federal support is barely keeping up with inflation. In addition, public broadcasting has millions of viewers, many of whom are articulate and politically active.

Child Nutrition

	1982	1983
Proposed Savings	-990	-1,200

Current Program: The child nutrition (CN) appropriation finances a variety of programs: school lunches and breakfasts, child care meals, summer meals, nutrition education, equipment assistance, and state administrative expenses. The lunch, breakfast and child care programs subsidize all meals served, but the subsidies vary in three tiers by household income level.

Restructure CN Subsidies: The Omnibus Reconciliation Bill made several changes to CN meal subsidies — some permanently, others only for FY 81. The Carter FY 82 budget assumes that the FY 81 reductions will be made permanent.

Additional legislative savings that should be proposed are:

- Reduce the base meal subsidy from an estimated 19.2 cents/meal to 9 cents in FY 82 and freeze it.
- Reduce the commodity subsidy for all meals from 15.9 cents/meal to 8 cents in FY 82 and freeze it.
- Reduce the special subsidy for students between 125 percent and 185 percent of poverty by 25 percent (from 74 cents to 55 cents in FY 82).
- Eliminate subsidies for snacks served in child care and summer meal progams.
- Require schools to verify the income eligibility of students on a 10 percent sample basis.
- Eliminate meal subsidies to private schools where yearly tuition exceeds $1,500.

Probable Reactions: Outlook for continuation of the FY 81 Reconciliation Act reductions is good. Further reductions will be difficult but not impossible to achieve.

CN advocates have had strong bipartisan support in the House Education and Labor Committee. If other cuts are not sought in their areas of interest, agriculture and education interest groups may coalesce to oppose these cuts.

Social/Community Services; Health Program Consolidation

	1981	1982
Proposed Savings	—	1,827

Current Program: The federal government finances a multitude of social and community services and health programs. These programs often serve narrow target groups and finance duplicatory services (e.g., family planning is financed by more than one HHS health program and in the Title XX social services program).

Potential Change: The programs listed are potential candidates for consolidation into one block grant to the states for 1982 and subsequent years, with funding at 80 percent of the sum of 1981 current services amount for each program.

Probable Reactions: States will generally support consolidation of several of these programs but will oppose major reductions in total funding (in fact, they will probably seek automatic indexing of federal funding — some states may also seek redistribution of funds among states). Specific interest group (e.g., vocational rehabilitation), in addition to opposing the overall funding reduction, will strongly oppose the discontinuance of specific funding for services to themselves. They will fear states will not give them the same funding priority they had by having a separate categorical federal program. Those receiving direct federal grants (e.g., localities, community action agencies, community health centers, and other non-profit groups) will oppose this proposal since they would fear that other entities might receive grant funds that they themselves now have. Hill reaction will be mixed given the various committee jurisdictions covering the proposed programs to be consolidated.

Elementary, Secondary Grants Consolidation

	1981	1982
Proposed Savings	—	1,258

The proposal is to consolidate the purpose of all or part of 57 separate federal elementary and secondary education programs — one-third of all Education Department programs — into two "block grant" programs, which would be funded in FY '82 at 80 percent of the level represented by the sum of the components in FY '81.

Accompanying this consolidation, and offsetting the reduction in federal funding, would be a great increase in state/local flexibility with respect to the uses of the federal funds, and slicing away of numerous regulations and requirements that create costs for state and local education agencies.

In particular, it is planned to seek changes in the Education for Handicapped Children Act (P.L. 94-142) and in Section 504 of the Rehabilitation Act of 1973, that would narrow the group of handicapped persons (with respect to whom federal requirements are imposed and funds made available) to those with severe disabilities and to limit the "related services" that must provided.

Residual programs not included in either of the two block grants are of three kinds:

1. Several large programs are (e.g., Impact Aid, Vocational Education) where separate legislative initatives are planned.
2. Programs and activities that are not suitable to inclusion in a state or local block grant. These include Indian education, assistance to the Virgin Islands, evaluation activities, media services, "deaf-blind" centers, educational research and dissemination, and the gathering of statistics.
3. Programs and activities not fundamentally related to elementary and secondary education, such as rehabilitation services and all of the postsecondary programs.

Probable Reaction: This proposal sketches a nearly-complete overhaul of federal elementary and secondary education policy. It will be popular with many, especially those who believe that the federal role is to supply resources, not to specify what must be done with those resources. It will also appeal to school boards and others now laboring under the burden of detailed regulations, service requirements, maintenance-of-effort clauses, and the like.

Disapproval can be expected from each separate group or interest that now has one or more separate programs it identifies as "its own" and that under this proposal would have to compete for resources with other groups at the state or local level. The proposal would be characterized by opponents at a backing-away from the "historic" federal responsibility for assisting each group and meeting each need separately. Civil rights groups can also be expected to be disquieted.

The reception will further be dampened by the reduction in aggregate funding for a set of activities that have experienced little or no increase (hence a decrease in real terms) in the past two years.

The proposal will also be analogical to President Nixon's 1973 proposal for "special revenue sharing" in the field of education, which met a swift death in the 93rd Congress, and to President Ford's 1976 consolidation proposal, which fared no better.

Student Loans And Pell Grants

	1981	1982
Proposed Savings	-89	-914

Current Program: The Guaranteed Student Loan (GSLs) program facilitates borrowing from private lenders by graduate and undergraduate students (and their parents).

The National Direct Student Loan (NDSL) program provides participating institutions with capital contributions for student loan funds which the institution must match with 10 percent from non-federal funds. These institutional loan funds then make 4 percent loans to needy tested students.

The Pell Grant (formerly BEOG) program is authorized, under the new law, to provide a maximum award of $1,900 in 1981 and $2,100 in 1982. The percentage of educational costs covered increases from 50 to 60 percent when the maximum award reaches $2,100 in 1982. The grant a student receives takes into account the family income less specified deductions and a student's educational costs.

Potential Change:

- Provide student GSLs only for need remaining after other sources of aid counted, eliminate the in-school interest subsidy, and charge market rate on parent loans.
- Reduce the funding of NDSL Federal Capital Contributions by 25 percent per year. This approach will phase-out new federal capital in this program in four years. However, schools' revolving funds totaling approximately $3.5 billion would continue to provide loans to eligible students.
- Impose a $25,000 income limiation for participation in the Pell Grant program. Limiting participation in this program to families with the median national income or less (projected to 1981 this would be approximately $25,000) would reduce the number of participants by an estimated 286,000 in both 1981 and 1982.

Probable Reaction: College costs are a major concern to middle-income families, who would react negatively to any reduction in federal support for higher education. Higher education institutions whose students receive substantial amounts of federal student assistance benefits would also protest strongly.

Rural Electrification Administration

	1981	1982
Proposed Savings	699	1,945

Current Program: The Rural Electrification Administration of USDA makes direct and guaranteed loans to advance the construction and operation of electric and telephone utilities in rural areas. Direct loans are made on highly favorable terms. Since the mid-70s, the REA has increasingly relied on the Federal Financing Bank as the originator of many of these guaranteed loans.

Potential Change: The savings projected above would result from a major retrenchment in REA activity designed to (1) increase the reliance of REA borrowers on private sources of capital and (2) focus REA activity on those areas truly requiring federal support.

The changes are:

- Effective April 1, 1981, stopping further FFB originations of REA-guaranteed loans.
- Elimination of 2 percent loans for electrification and telephone construction programs.
- Elimination of all loans for power supply purchases. The REA was intended to facilitate utility construction, not to provide operating subsidies.
- A 25 percent reduction in the principal amount of direct loans disbursed annually.

This last proposal, as well as all the others, is based on the premise that the REA has largely accomplished its purpose — to provide the investment capital necessary to construct electric and telephone infrastructure nationwide. The bulk of lending is now for

power

power generation and system upgrading, functions that should be borne by system users.

In the absence of restraint, REA would continue to expand the reliance of rural utility companies on federally provided and sponsored credit.

Probable Reaction: The affected utilities, of course, will not be pleased to have to bear financing costs more reasonably related to the true cost of funds. The need for short-term rate hikes to support private borrowing market rates will also offend customer of REA-financed utilities. Congressional delegations from the regions in which these utilities operate will be sensitive to these concerns.

Export-Import Bank

	1981	1982
Proposed Savings	155	560

Current Program: The Export-Import Bank provides a wide range of credit support activities on behalf of sales of American goods and services ovverseas.

Potential Change: The savings estimate . . . reflects three major changes in the bank's level of operations:

- A 25 percent reduction in new direct loan originations below levels planned for the five-year period;
- A prohibition against interest subsidies in guaranteed loan transactions.
- Elimination of discount loans.

Probable Reaction: The Boeing Corp., which consumes the lion's share of the 42 percent of Export-Import Bank direct loans that support aircraft sales, might lose sales in those instances (roughly 20-30 percent of Bank/Boeing activity) where Boeing comes head to head with subsidized foreign producers. Other major bank users, among them many Business Roundtable members, will be forced to find buyers with access to private credit. While the opinion of the business community is divided on the Export-Import Bank due to the heavy emphasis it places on overseas aircraft sales and construction projects, both present and potential users would feel constrained to object strenuously.

Farmers Home Administration

	1981	1982
Proposed Savings	30	105

Current Program: As the agency's title suggests, the Farmers Home Administration (FmHA) was started as a means of providing credit assistance for family farm operations and the construction of housing in rural areas, which were left after the rash of bank failures in the early 1930s with severe credit shortages.

Since that time, FmHA has been expanded to the point where it duplicates virtually every other federal lending and lending assistance effort. Through three major funds, the FmHA now makes loans for housing, community dvelopment, farm operation, hospital construction, sewer and waste treatment facilities, ad infinitum. In FY 1981, in addition to far-flung loan guarantee operations, FmHA will make $14 billion in direct loans from these three funds.

Proposed Changes: The savings estimates contemplate a 25 percent across-the-board reduction in new direct lending by the agency.

Probable Reaction: The FmHA is a favorite means of dispensing largesse to constituents in rural areas, and congressional offices are heavily involved in the process of securing FmHA grants and loans for local farms, businesses and government subdivisions. While funding reductions would not prohibit congressionally assisted grantsmanship, they would severely restrict its scope, particularly if the reductions were achieved, as suggested above, by targeting remaining funds to lowest-income borrowers.

Can Thatcherism Survive British Slump?

By WILLIAM BORDERS

LONDON

WHEN Prime Minister Margaret Thatcher discusses the very serious economic recession that Britain is experiencing, she often employs homely metaphors to explain her conviction that better times must follow, if only the course is held true.

"It's like a nurse looking after a patient," she said recently, in a characteristic explanation of why the Government thinks it has to be tough and austere in the face of soaring unemployment and industrial decline.

"Which is the better nurse," the Prime Minister asked, "the one who smothers the patient with sympathy and says, 'Never mind, dear, there, there, lie back and I'll look after you,' or the nurse who says, 'Now come on, shake out of it. It's time you put your feet to the ground and took a few steps. Now get back and take a few more tomorrow.' "

As no one in Britain needs to be told, Mrs. Thatcher is the firm nurse in that metaphor. But her political problem, of course, is that the patient can always get another nurse.

As this particular nurse nears the midpoint in her tenure at 10 Downing Street, the British economy is in worse shape, by most measures, than it has been in years. Unemployment stands at nearly 9 percent and is increasing so relentlessly that The Sunday Times began publishing a weekly listing, headlined "Jobless Britain," of factories that have closed and the number of jobs were lost at each. The number unemployed, now well over two million, increased by 900,000 in 1980.

Industrial production has been declining more sharply than at any time in years, and inflation is 15 percent. That is lower than the peak reached last summer but still above the 10 percent when Mrs. Thatcher took office 21 months ago.

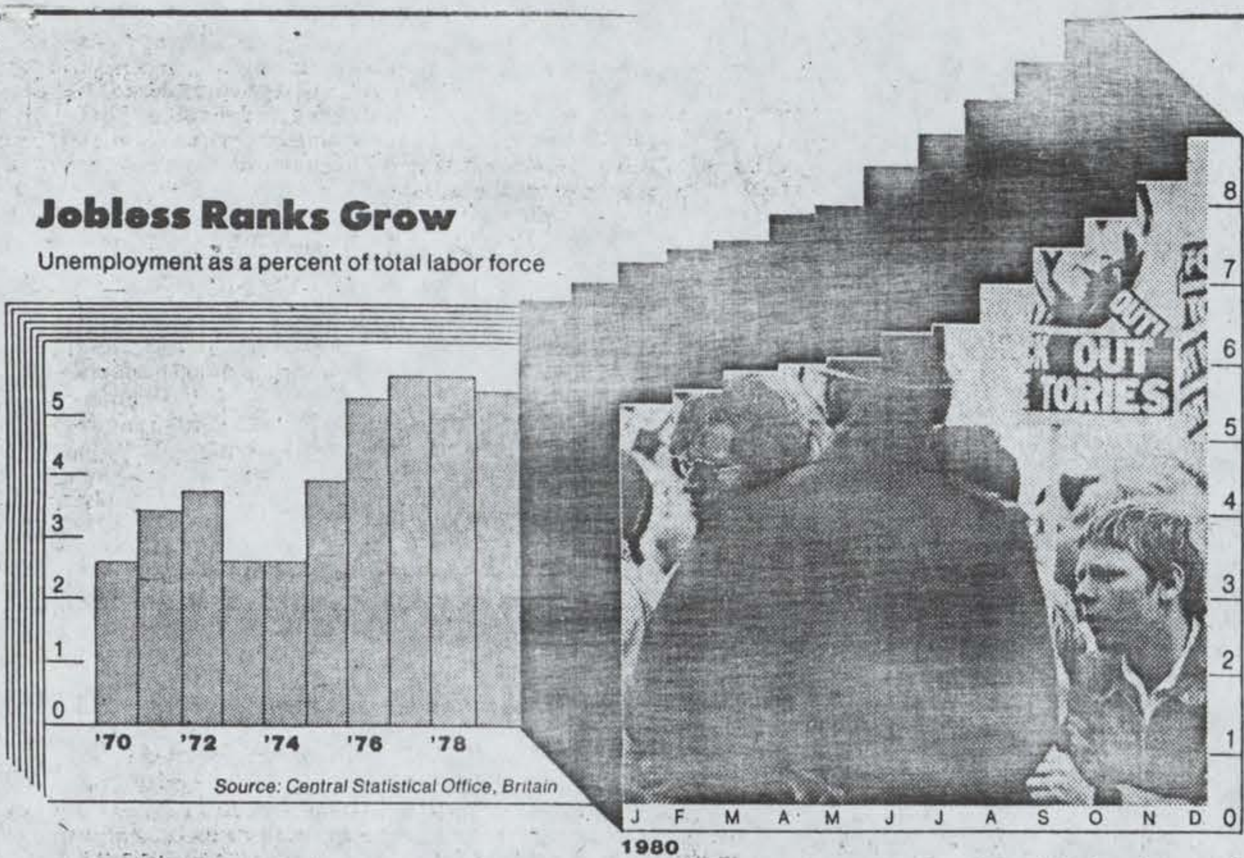
Millions of people, including the newly unemployed and their families, feel directly aggrieved by the Conservative Government, and the party — and Mrs. Thatcher in particular — are slipping steadily behind the opposition Labor Party in the public opinion polls.

"Maggie, Maggie, Maggie — out, out, out," the

Continued on Page 50

Jobless Ranks Grow

Unemployment as a percent of total labor force



Can Thatcherism Survive?

Continued From Page 33

marchers chanted at a huge unemployment protest in Liverpool one cold day last fall. Within the Conservative Party, and even within the Cabinet, there is growing concern that that could become a rallying cry for the whole country.

With its comfortable majority in the House of Commons, the Conservative Government will not have to call an election before 1984. But that date, which looked so far away at the beginning of Prime Minister Thatcher's term, looks closer now. As one of her advisers said, "It could be disastrous if our policies haven't begun to show some good by the time we have to go to the voters."

Even by some within her own party, the Prime Minister is increasingly being urged to relent a bit on her strict austerity program and to increase — instead of cut — public spending, step up help for ailing industry and rely less on firm monetarism as the ultimate weapon against inflation.

To Mrs. Thatcher's great irritation, even former Prime Minister Edward Heath, also a Conservative, has described her economic policy as "catastrophic." Nonetheless, every time she is asked about it, she replies like the firm nurse.

"Our goal must be to bring down inflation and to build a realistically strong economy in which productive, well-based industry can prosper," she said recently. "For years, we have been paying ourselves more than we produced. This must stop."

The economic pressures of the past year have forced some companies to become leaner and more efficient and some labor unions to moderate their demands. Defenders of the Government say this will happen more and more, and the result will be a stronger, more competitive Britain.

They also like to point to the one bright spot on the economic horizon: the steadily swelling flow of oil from the North Sea. With current production of 1.7 million barrels a day, exceeding such giants as Indonesia and Kuwait, Britain has become self-sufficient in oil, saving billions in import bills.

"It gives us a cushion against shortages and supply fluctuations, not to mention a great income to apply elsewhere in the economy," said an oil executive here.

But even that good news has a dark side. The oil production has been a major factor in the appreciation of sterling, which is now trading at a level 50 percent higher than in 1976. This has had a devastating effect on exporters, making their goods more expensive abroad.

Such traditional exporting industries as textiles have been particularly hard hit, and so has the automobile business, which suffers from competition with cheaper imports. Well over half the cars now sold in Britain are foreign made.

Sir Michael Edwardes, the chairman of BL Ltd., the automobile company that used to be called British Leyland, expressed a widely held view among industrialists when he declared in exasperation that, if the Government could not figure out a way to keep the oil from hurting big business, it should "leave the bloody stuff in the ground." □

USA

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GRS 800

[CULL]

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FM WASHINGTON 281848Z AUG 80

TO PRIORITY FCO

TEL NO 3869 OF 28 AUGUST 1980.

AND TO ROUTINE TOKYO, OTTAWA, EC POSTS.

Prime Minister

You may like to glance at the details of Pres. Carter's package

MAP 29/8

ECONOMIC PACKAGE. MY TELEGRAM 3847 (NOT TO ALL)

AT BRIEFING ATTENDED BY MINISTER (ECONOMIC) THIS MORNING, DETAILS OF THE ECONOMIC PACKAGE WERE GIVEN BY SCHULTZE (CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS) AND OTHER CEA REPRESENTATIVES. WHITE HOUSE FACT SHEET FOLLOWS IN TOMORROW'S BAG FOR TURNBULL (TREASURY).

2. MAIN MEASURES ARE AS FOLLOWS:-

(A) MEASURES ORIENTED TOWARDS INVESTMENT

(1) TAX DEPRECIATION ARRANGEMENTS TO BE LIBERALISED AND SIMPLIFIED.

(2) PART (30%) OF THE 10% INVESTMENT TAX CREDIT TO BE GIVEN IN CASH TO FIRMS WITH NO TAXABLE EARNINGS.

(3) A NUMBER OF MISCELLANEOUS EXPENDITURE MEASURES, INCLUDING EXPANDED FEDERAL SUPPORT FOR SCIENTIFIC RESEARCH AND TECHNOLOGICAL DEVELOPMENT, INCREASED PUBLIC SECTOR INVESTMENT IN TRANSPORTATION, AND ENERGY CONSERVATION.

(B) REDUCING TAX BURDENS

(1) A TAX CREDIT TO OFFSET THE JANUARY 1981 RISE IN EMPLOYERS AND EMPLOYEES SHARE OF SOCIAL SECURITY TAX.

(2) INCREASE IN THE EARNED INCOME TAX CREDIT (WHICH IS REFUNDABLE TO NON-TAX PAYERS) TO OFFSET THE RISE IN SOCIAL SECURITY TAXES FOR THOSE FAMILIES WHO PAY SOCIAL SECURITY BUT EARN TOO LITTLE TO PAY INCOME TAX.

(3) A SPECIAL TAX DEDUCTION TO OFFSET THE QUOTE MARRIAGE PENALTY UNQUOTE ON MARRIED COUPLES BOTH OF WHOM EARN.

(C) OTHER MEASURES

(1) AN EXTRA 10% INVESTMENT TAX CREDIT FOR INVESTMENT IN AREAS SUFFERING A DECLINING INDUSTRIAL BASE AND HIGH UNEMPLOYMENT. THIS WILL BE DISCRETIONARY: CERTIFICATES OF NECESSITY WILL BE ISSUED BY THE DEPARTMENT OF COMMERCE FOR UP TO DOLLARS 10 BILLION OF QUALIFYING INVESTMENTS.

(2) EXTENSION FROM 39 WEEKS TO 52 WEEKS OF UNEMPLOYMENT BENEFITS PAID TO WORKERS IN HIGH UNEMPLOYMENT STATES.

(3) EXPANSION OF PROGRAMMES TO IMPROVE WORKER MOBILITY, INCLUDING JOB TRAINING AND RETRAINING.

(4) A NEW ECONOMIC REVITALISATION BOARD WILL ADVISE THE PRESIDENT ON THE ESTABLISHMENT OF AN INDUSTRIAL DEVELOPMENT AUTHORITY TO CREATE JOBS IN AREAS OF HIGH UNEMPLOYMENT.

RESTRICTED

/3. SCHULTZE

3. SCHULTZE AND OTHER CEA REPRESENTATIVES STRESSED THE FOLLOWING POINTS:

(1) THE PROPOSALS WERE REGARDED AS RELATIVELY CAUTIOUS, OFFSETTING ONLY PART OF THE ADDITIONAL TAX REVENUE ACCRUING IN 1981 FROM THE INCREASE IN SOCIAL SECURITY TAX, WINDFALL PROFITS TAX, AND THE EFFECT OF INFLATION PUSHING PEOPLE INTO HIGHER TAX BRACKETS. THEY HAD ALSO BEEN CONCERNED TO AVOID BUILDING UP EXCESSIVE DEFICITS IN LATER YEARS.

(2) THE PACKAGE HAD BEEN ORIENTED AS FAR AS POSSIBLE TOWARDS STIMULATING INVESTMENT, AND IMPROVING PRODUCTIVITY. BUT THERE WAS ALSO SOME NEED TO OFFSET PART OF THE PROSPECTIVE RISE IN THE PERSONAL TAX BURDEN.

(3) THE ADMINISTRATION HAD NO ILLUSION THAT THE PACKAGE WOULD HAVE A MARKED IMMEDIATE IMPACT ON INFLATION, WHICH AFTER THE RECENT ABERRANT IMPROVEMENT WAS LIKELY SOON TO CLIMB BACK UP TO THE UNDERLYING RATE OF 9-10 PER CENT. THEIR AIM HAD BEEN TO SPEED AN OTHERWISE SLUGGISH ECONOMY IN 1981 WITHOUT ACTUALLY REKINDLING INFLATION, AND TACKLE THE INFLATION PROBLEM BY IMPROVING PRODUCTIVITY IN THE LONGER TERM.

(4) MANY OF THESE PROPOSALS REQUIRED CONGRESSIONAL ENACTMENT. ADMINISTRATION HOPED THIS WOULD FOLLOW THE ELECTION. A TAX CUT ENACTED BEFORE THE ELECTION WOULD BE LIKELY TO END UP TOO LARGE AND WRONGLY ORIENTED.

(5) THEY WERE ASSUMING THAT INTEREST RATES WOULD QUOTE DRIFT UPWARD UNQUOTE IN 1981, BUT NOT TO AN EXTENT WHICH WOULD IMPEDE THE RECOVERY.

(6) THE TAX AND EXPENDITURE MEASURES TOGETHER WOULD COST ABOUT DOLLARS 30 BILLION IN CALENDAR 1981, BUT CONSIDERABLY LESS THAN THAT IN FISCAL 1981 BECAUSE THE MEASURES WOULD ONLY AFFECT PART OF THAT YEAR. THEY ESTIMATED THAT BY THE END OF 1982 THE MEASURES WOULD INCREASE INVESTMENT BY 10 PER CENT, AND DECREASE UNEMPLOYMENT RATE BY 0.8 PERCENTAGE POINTS, COMPARED WITH WHAT THESE WOULD OTHERWISE HAVE BEEN.

4. FURTHER COMMENT FOLLOWS.

FCO PLEASE ADVANCE SIR K COUZONS AND TURNBULL, TREASURY, AND GILCHRIST, BANK.

FRETWELL

FINANCIAL
NAD

[NOT ADVANCED]

Prime Minister

MAP 27/8.

GRS220

[CULL]

RESTRICTED

FM WASHINGTON 262145Z AUG 80

TO PRIORITY FCO

TELEGRAM NO 3847 OF 26 AUGUST

ECONOMIC PACKAGE

1. THE PRESIDENT'S PROGRAMME TO PROVIDE JOBS AND TO STIMULATE THE ECONOMY IS DUE TO BE ANNOUCED AT 2.00 P.M. (LOCAL TIME) ON THURSDAY 28TH AUGUST.

2. TODAY'S EAST COAST PRESS CARRIES ARTICLE QUOTING ADMINISTRATION SOURCES ON THE CONTENTS OF THE PACKAGE. MAIN FEATURES ARE EXPECTED TO BE:

(I) A PROPOSED TAX CUT OF AROUND DOLLARS 30 BILLION TO TAKE EFFECT IN 1981, EMBRACING BOTH PERSONAL TAX (TO OFFSET THE INCREASE IN SOCIAL SECURITY CONTRIBUTIONS DUE NEXT YEAR) AND SOME FORM OF ACCELERATED DEPRECIATION ALLOWANCES FOR COMPANIES, POSSIBLY BIASED IN FAVOUR OF AREAS OF HIGH UNEMPLOYMENT:

(II) A PUBLIC WORKS PROGRAMME WITH POSSIBLE EMPHASIS ON TRANSPORT, INFRASTRUCTURE AND DISTRESSED AREAS:

(III) OTHER MEASURES TO ASSIST INDUSTRY, RETRAINING AND AREAS OF URBAN DECAY.

3. MINISTER (ECONOMIC) HAS BEEN INVITED TO TO A BRIEFING FOR QUOTE SUMMIT UNQUOTE COUNTRIES BY AMBASSADOR OWEN ON THE MORNING OF THE ANNOUNCEMENT. WE SHALL REPORT FURTHER AFTER THIS BRIEFING AND THE PUBLICATION OF THE THE DETAILS.

FRETWELL

THIS TELEGRAM WAS NOT ADVANCED

FINANCIAL

NAD

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SAVING TELEGRAM

Interest Sit.

Prime Minister

To glance

MAP 11/8

BY BAG
FM WASHINGTON
RESTRICTED [CULL]
TO FCO TEL NO. 42 SAVING OF 7 AUGUST 1980

UNITED STATES MONTHLY ECONOMIC REPORT FOR JULY 1980

SUMMARY

1. The decline in US economic activity is continuing, but at a slower pace than during the second quarter. The unemployment rate, now 7.8%, failed to show the further increase expected in July, but this pause is probably only temporary. The rise in consumer prices, although less rapid than in the first quarter, still continues close to the underlying rate of inflation at about 10% a year.

2. The full extent of the steep fall in economic activity in the second quarter is now known. GNP fell by 2.2%, mostly due to lower sales of US cars and to a lesser extent housing. The reduction in demand was caused by a squeeze on real incomes and by the failure of the US car industry to produce sufficient small cars, as well as high interest rates and credit controls. The initial impact of the latter is now recognised to have been much more substantial than originally envisaged.

3. President Carter sent to Congress on 21 July his mid-session review, including a new official economic forecast and revised budget estimates for FY 1981. The forecast accepts that the economy is experiencing a deeper recession than thought likely earlier this year. It expects the economic recovery to begin around the end of the year, but to proceed slowly in 1981, with unemployment remaining at 8.5% in the absence of policy changes. The rate of inflation is forecast to be only slightly lower in 1981 than 1980 (though for technical reasons the consumer price index may show a temporary improvement later this year).

/ 4.

4. No new tax or expenditure initiatives are proposed in the revised budget estimates. On that basis, the budget is projected to be in deficit in 1981-82 by $28.9 bn, instead of the surplus of $16.5 bn estimated in March. The balance of risk is that the deficit could be higher than this.

5. President Carter continues to be criticised by Governor Reagan and others for his failure to table a tax cut at this stage, but these views are not universally held. He has responded by stressing the importance of following through in the fight against inflation and the need to address long term economic objectives, both of which point to deciding the amount and form of a tax cut nearer the time. Although it seems almost certain that Congress will eventually enact a tax cut to come into effect in early 1981, it is not clear that this will be done before the November elections.

6. The Federal Reserve Board, in their mid-year policy report to Congress, have re-emphasised the importance of curbing inflation. Mr Volcker, in subsequent testimony, came out against a general tax cut in 1981, although he did not rule out a cut targeted to encouraging business investment. The Board have also published provisional target ranges for growth of the main monetary aggregates in 1981, consistent with a modest further tightening of monetary policy.

(See MIFT for full REPORT)

THIS TELEGRAM
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ADVANCED

FRETWELL

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US MONTHLY ECONOMIC SITUATION REPORT

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PRINCIPAL INDICATORS

Quarterly Data (1980 - Q2)

	% change on	
	Previous Quarter	Year earlier
GNP	-2.2	-0.8
Exports of Goods & Services	-2.3	10.9
Imports of Goods & Services	-6.8	-3.4

	Actual Level	
	Latest Quarter	Previous Quarter
Balance of Payments Current Account (Q1)	-2.6	-1.8

Monthly Data

	% change on	
	Previous Month	Year earlier
Consumer Price Index (Jun)	1.0	14.3
Money Stock M1B(Jun)	1.2	4.4
M2 (New) (Jun)	1.4	8.2
Dollar Effective Exchange Rate (Jly)	-0.6	-1.3

	Actual Level	
	Latest Month	Year earlier
Banks Prime Rate % (Jly)	11.25	11.5
Unemployment Rate % (Jly)	7.8	5.7

USA 2

RESTRICTED
SAVING TELEGRAM

Prime Minister

BY BAG
FM WASHINGTON
RESTRICTED [CULL]
TO FCO TEL NO.32 SAVING OF 10 JUNE 1980

MAP 13/vi

MONTHLY ECONOMIC REPORT FOR THE UNITED STATES FOR MAY 1980

SUMMARY

1. There are growing signs that the recession will be quite deep. The unemployment rate has risen rapidly from 6.2% in March to 7.8% in May. There are however some indications that increases in consumer prices may be moderating from recent high levels, although the underlying inflation rate remains close to 10%

2. Industrial production fell sharply in April by 1.9%, following smaller declines in both February and March. The largest declines in April occurred in the production of motor vehicles and in construction supplies.

3. Retail sales fell by 1.0% in April, following a 1.3% fall in March (nominal terms). Durable goods contributed most to this decline. Housing starts fell 2% in April, following a 22% fall in March and are now close to the level reached at the bottom of the 1974/5 recession, and car sales fell 10.6% following a 18.5% fall a month earlier.

4. The US merchandise trade deficit improved further in April, mainly due to another reduction in oil imports. The level of oil imports is being held down by the healthy state of US oil stocks, itself a product of the mild winter and lower gasoline consumption.

5. The increase in the consumer price index (CPI) slowed in April to 0.9%, less than the 1.4% increases that occurred in January, February and March. The CPI now stands 14.7% above the level of a year ago. Producer prices rose only 0.3% in May, the smallest increase for some two years.

6. Growth in the main monetary aggregates has been weak. The most closely watched aggregate, M1-B, has fallen 1.6% between its peak in early February and the middle of May, and is now below the target range. Consumer instalment credit, after rising rapidly in

/the second

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the second half of 1979, has been declining since the turn of the year. Commercial and industrial loans which continued to increase early this year, fell back slightly in April.

8. Interest rates continued to decline in May. Six-month Treasury bills stood at 8% at the end of May, down from 16% at their peak in early April. Banks' prime rates, which reached 20% at about the same time, declined to about 14%. The falls in interest rates caused further pressure on the US dollar, which at the end of May stood 9% below its peak at the beginning of April (trade weighted basis).

9. The Federal Reserve Board (FRB) on 22 May started to dismantle the specific credit controls it introduced on 14 March. The FRB's imposition of these controls on top of its policy of restraining the growth in the monetary aggregates has been criticised from some quarters for aggravating the economic recession.

10. Congress has failed to meet its 31st May deadline for passing the first budget resolution that sets ceilings on Federal expenditure. The failure reflects conflicting views about the priorities that should be given to defence and social programmes and to reducing taxes, within the context of a balanced budget. The budget process is likely to be placed under further strain in the months ahead as a result of Congress's action overturning the President's oil import fee proposals; the prospect that the recession will be more severe than assumed in the budget calculations; and the growing pressure for a tax cut. These developments make it very unlikely that the budget for FY81 will, in the event, be balanced.

(See MIFT for full REPORT)

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PRINCIPAL INDICATORS

Quarterly Data (1980 - Q1)

	% change on	
	Previous Quarter	Year earlier
GNP	0.2	0.8
Exports of Goods & Services	4.6	11.1
Imports of Goods & Services	1.4	5.6

	Actual Level	
	Latest Quarter	Previous Quarter
Balance of Payments Current Account (1979 Q4)	-$0.9 bn.	$1.1 bn.

Monthly Data

	% change on	
	Previous Month	Year earlier
Consumer Price Index (Apr)	0.9	14.7
Money Stock M1B(Apr)	-1.2	4.8
M2 (New) (Apr)	-0.2	7.5
Dollar Effective Exchange Rate (May)	-5.0	-1.1

	Actual Level	
	Latest Month	Year earlier
Banks Prime Rate % (May)	16.25	11.75
Unemployment Rate % (May)	7.8	5.8

JH

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USA

SUBJECT.

10 DOWNING STREET

THE PRIME MINISTER

26 March 1980

cc ~~Master~~ set
Dept

PRIME MINISTER'S
PERSONAL MESSAGE
SERIAL No. T 66/80

Thank you for your message of 14 March about your economic policy decisions. I am grateful to have had advance notice of these important measures.

I share your conviction that we must give overriding priority to getting inflation down. I know how difficult the decisions can be in this field. I therefore appreciate very much your determination in taking these painful, but necessary measures. Your resolute actions will give encouragement and support to other governments who are grappling with similar problems, and contribute greatly to the restoration of a more stable world economy. Geoffrey Howe made a point of including a favourable reference to your measures in his budget speech earlier today.

I particularly welcome the action you have taken to reduce gasoline consumption. This will be a signal contribution to our common efforts to reduce oil consumption and dependence on oil imports. I agree that reductions in domestic demand for oil must be part of a wider pattern. We shall readily join with you in developing appropriate concerted or national action, when this is discussed internationally. I believe that, for this year at least and possibly beyond, market forces are likely to maintain a reasonable balance between supply and demand for oil and our preference is to allow them to do so. Nevertheless, we must keep a careful watch on the situation, in case further action is needed. I expect that the next Ministerial meeting of the International Energy Agency will consider these matters, but I hope they will look at longer term measures rather than concentrate primarily on the short term.

/I hope

I hope we can keep in close touch on both economic and energy policies. Geoffrey Howe is writing to Bill Miller separately about the contents of his budget.

(SGD) MARGARET THATCHER

The President of the United States of America.

vb

Foreign and Commonwealth Office

London SW1A 2AH

Type for wire

26/3

26 March 1980

Dear Michael,

US Economic Policy

Your letter of 14 March to John Wiggins enclosed a message from President Carter to the Prime Minister giving advance notice of his anti-inflation package. The Treasury have suggested that we should coordinate a suitable reply.

Oil Import Ceilings

Apart from a description of the measures, the only point of substance in the message is a request for support in seeking tight oil import ceilings for 1981 to which the Department of Energy wish to reply.

Assessment of the Measures

The Treasury's preliminary assessment of the measures is that the Carter Administration has been forced into them by continued high inflationary expectations in the United States combined with doubts about the credibility of the earlier budget proposals. They are probably what the situation now requires, but there is a risk that they may be too severe. Apart from their effect on expectations, the measures will fall mainly in 1981. If a budget deficit of $40 billion is indeed to be brought down to close to zero (and particularly if this should coincide with an increase in the Domestic Savings Ratio) this could exacerbate the expected weakening of the US economy in 1981. Perhaps for this reason, the Administration have subsequently left open the possibility of a tax cut next year.

Reactions to the Package

The measures have had a mixed reception in the United States. The budget cuts have been criticised as illusory and the 'gasoline conservation charge' has been attacked as inflationary. Internationally, the only official reaction of which we are aware is a statement by Count Lambsdorf that the measures 'seem capable of fighting effectively against inflation in the US'. Informal soundings

/in Bonn

in Bonn indicate that the Germans are privately doubtful about congressional acceptance and wonder also whether the package will have sufficient effect on inflationary expectations.

You will be aware that the Americans have asked that Summit countries should 'not be bashful' in stating publicly their approval of these measures (paragraph 8 of Washington Tel No 1107). Neither the Prime Minister nor the Chancellor have been questioned in the House of Commons about the American measures but we have suggested the inclusion of a suitable reference in the Budget speech.

/ I enclose a draft reply, agreed with the Treasury and the Department of Energy.

I am sending copies of this letter to John Wiggins, Bill Burroughs (Department of Energy) and David Wright (Cabinet Office).

Yours ever

GW

(G G H Walden)
Private Secretary

M O'D B Alexander Esq
10 Downing Street
London

DSR 11

Registry No.

DRAFT LETTER

Type 1 +

SECURITY CLASSIFICATION

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.... In Confidence

To:–
President Carter

From
The Prime Minister
Telephone No. Ext.

Department

Thank you for your message of 14 March about your economic policy decisions. I am grateful to have had advance notice of these important measures.

I share your conviction that we must give overriding priority to getting inflation down. I know how difficult the decisions can be in this field. I therefore appreciate very much your determination in taking these painful, but necessary measures. Your resolute actions will give encouragement and support to other governments who are grappling with similar problems, and contribute greatly to the restoration of a more stable world economy. Geoffrey Howe made a point of including a favourable reference to your measures in his budget speech earlier today.

I particularly welcome ~~your measures~~ the action you have taken to reduce gasoline consumption. This will be a signal contribution to our common efforts to reduce oil consumption and dependence on oil imports. I agree that reductions in domestic demand for oil must be part of a wider pattern. We shall readily join with you in developing appropriate concerted or national action, when this is discussed internationally. I believe that, for this year at least and possibly beyond, market forces are likely to maintain a reasonable balance between supply and demand for oil and our preference is to allow them to do so. Nevertheless, we must keep a careful watch on the situation, in case further action is needed. I expect that the next Ministerial meeting of the International Energy Agency will consider these matters,

/but

Dd 0532000 800M 5/78 HMSO Bracknell

but I hope they will look at longer term measures rather than concentrate primarily on the short term.

I hope we can keep in close touch on both economic and energy policies. Geoffrey Howe is writing to Bill Miller separately about the contents of his budget.

[COLL]

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~~MR THOMAS~~ MR EVANS
MR HAYES
GEOG DUS ..SIR A. ACLAND..
GEOG AUS ..LORD BRIDGES..
HEAD FRD (2)
HEAD ~~GEOG~~ N AM D
HEAD EID (2)
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MR G. M. GILL
(7) OVERSEAS SECTION
MR ...

BANK OF ENGLAND

MR McGILLIVRAY
MR S.W. PAYTON
MR C.W. McMAHON
~~MR P. ...~~

DEPT OF TRADE 1 VICTORIA ST

PS/S OF S TRADE
MR W.M. KNIGHTON
MR S. ABRAMSON

MR COOPER

ADVANCE COPY

GR 600
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FM WASHINGTON 210435Z MAR 80
TO IMMEDIATE F C O
TELEGRAM NUMBER 1190 OF 21 MARCH

Read in full.

OUR TELNO 1097: PRESIDENT CARTER'S ANTI-INFLATION PACKAGE: INITIAL PRESS REACTION.

1. INITIAL PRESS REACTION TO PRESIDENT CARTER'S ANTI-INFLATION PACKAGE HAS BEEN MIXED, WITH MOST COMMENTATORS SAYING THAT IT WILL DO LITTLE TO REDUCE INFLATION IN THE SHORT TERM.

THE BUDGET

THE BUDGET

2. THE BUDGETARY PROPOSALS HAVE RECEIVED THE GREATEST ATTENTION. THE WALL STREET JOURNAL HAS BEEN PARTICULARY CRITICAL CHARGING THAT THE CUTS ARE MISLEADING BECAUSE THEY HAVE BEEN SUPERIMPOSED ON REVISED ESTIMATES OF EXPENDITURE AND REVENUE. ON THE EXPENDITURE SIDE, NEW INFLATION ASSUMPTIONS HAVE RAISED THE FY81 TOTAL BY DOLLARS 9.5 BN SINCE THE PRESIDENT'S JANUARY PROPOSALS. THE PROPOSED CUTS OF DOLLARS 13.5 BN THEREFORE ONLY REDUCE NOMINAL EXPENDITURE BY DOLLARS 4 BN. ON THE REVENUE SIDE, REVISOIONS SINCE JANUARY HAVE RAISED THE TOTAL BY DOLLARS 11.5 BN, WHILE THE NEW INTEREST WITHOLDING PROPOSAL AND OIL IMPORT FEE TOGETHER ARE EXPECTED TO RAISE A FURTHER DOLLARS 13 BN. THESE CALCULATIONS LEAD THE WALL STREET JOURNAL TO CONCLUDE THAT PRESIDENT CARTER'S BUDGET CUTS ARE IN FACT QUOTE A TAX INCREASE UNQUOTE.

3. THERE HAS ALSO BEEN SOME SPECULATION AS TO THE REASONS WHY PRESIDENT CARTER DECIDED AGAINST PROVIDING FULL DETAILS OF HIS BUDGET PROPOSALS BEFORE THE END OF MARCH. THE MOST FREQUENTLY MENTIONED ARE THAT IT WAS POLITCALLY ADVANTAGEOUS TO WAIT UNITL AFTER THE IMPORTANT ILLINOIS AND NEW YORK PRIMARIES AND ALSO THAT THE DETAILS OF THE PROGRAMME HAD YET TO BE WORKED OUT.

MONETARY AND CREDIT MEASURES.

4. THE FEDERAL RESERVE MEASURES ARE INCREASINGLY SEEN BY THE PRESS AS HAVING THE GREATEST POTENTIAL IMPACT ON THE ECONOMY. THE CONSUMER CREDIT MEASURES HAVE RECEIVED THE GREATEST ATTENTION SO FAR, THOUGH THIS IS PROBABLY IN PART BECAUSE THEY ARE THE EASIEST TO REPORT.

VOLUNTARY WAGE AND PRICE GUIDELINES

5. THE NEW YORK TIMES HAS DESCRIBED THE PRESIDENT'S NEW PROPOSALS AS QUOTE TOOTHLESS JAWBONING UNQUOTE.
THE PAPER SAYS THAT PRESIDENT CARTER'S MOST IMPORTANT ERROR WAS IN FAILING TO ASK FOR DIRECT RESTRAINTS ON WAGES AND PRICES. IT FEELS WITHOUT CONTROLS OF SOME SORT, THE PROSPECTS FOR REPAIRING THE ECONOMY QUICKLY ARE VERY POOR. THE LIKELYHOOD OF FURTHER MANDATORY CONTROLS IS MENTIONED IN OTHER PAPERS.

OIL IMPORT FEE

6. THERE HAS BEEN REMARKABLY LITTLE COMMENT SO FAR ON THE PRESIDENT'S IMPOSITION OF AN OIL IMPORT FEE OR ON THE CONSEQUENT INCREASE IN GASOLINE PRICES.

GENERAL REACTIONS.

7. THE PRESS HAS GIVEN PROMINENCE TO THE REACTIONS OF THE FINANCIAL ... THE DECLINE OF THE STOCK MARKET HAS BEEN GENERALLY

GENERAL REACTIONS.

7. THE PRESS HAS GIVEN PROMINENCE TO THE REACTIONS OF THE FINANCIAL MARKETS. THE DECLINE OF THE STOCK MARKET HAS BEEN GENERALLY REPRESENTED AS A QUOTE THUMBS DOWN UNQUOTE TO THE PRESIDENT'S PACKAGE (ALTHOUGHT THE WASHINGTON POST REPORTED MORE POSITIVELY THAT THIS REFLECTED EXPECTATIONS OF LOWER CORPORATE PROFITS AND HIGHER INTEREST RATES).
IN MOST PAPERS THIS RESPONSE HAS BEEN CONTRASTED WITH THE QUOTE APPROVAL UNQUOTE SHOWN BY THE FOREIGN EXCHANGE AND GOLD MARKETS AS THE VALUE OF THE DOLLAR INCREASED AND THE PRICE OF GOLD DECLINED. THE SLIGHT INCREASE IN BOND PRICES HAS RECEIVED LITTLE ATTENTION.

8. THE OVERALL EDITORIAL REACTION TO THE PACKAGE SO FAR IS THAT IT DOES NOT CONTAIN ENOUGH STRONG MEASURES IMMEDIATELY TO REDUCE INFLATION OR TO DAMPEN INFLATIONARY EXPECTATIONS.
THE MAIN EFFECT ON INFLATION IS INCREASINGLY RECOGNISED AS RESULTING FROM A SLOW DOWN IN THE ECONOMY LATER IN THE YEAR.

9. F C O PLEASE ADVANCE TO A TURNBULL (TREASURY) DESKBY 210900Z AND PASS TO P HAYWARD (BANK OF ENGLAND)

HENDERSON

NNNN

USA

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JS

10 DOWNING STREET

From the Private Secretary 14 March 1980

U.S. ECONOMIC POLICY

I enclose a copy of a message to the Prime Minister from President Carter which has just been delivered here by the American Embassy. The contents of the message are embargoed until 9.30 p.m. this evening when President Carter will be announcing the new measures in Washington.

I am sending copies of this letter, and its enclosure, to George Walden (FCO), Bill Burroughs (Department of Energy) and David Wright (Cabinet Office).

M. O'D. B. ALEXANDER

John Wiggins, Esq.,
HM Treasury.

GB

EMBASSY OF THE UNITED STATES OF AMERICA
LONDON

March 14, 1980

MO FAX to Chequers

B 14/3

MO

Dear Prime Minister:

I have been asked to deliver the enclosed message to you from President Carter, which was just received at the Embassy.

The President has asked that you hold this information in confidence until his announcement, which will be at 9:30 p.m. London time.

Sincerely,

Kingman Brewster

Kingman Brewster
Ambassador

Enclosure
(CONFIDENTIAL)

The Rt. Hon. Margaret Thatcher, M.P.,
Prime Minister,
London.

PRIME MINISTER'S PERSONAL MESSAGE SERIAL No. T57/80.

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SUBJECT.

March 14, 1980

Dear Prime Minister:

I am writing to let you know of the decisions that I have made and will shortly announce regarding U.S. economic policy. These decisions have been prompted by recent increases in inflation and a consequent greater rise in inflationary expectations. They are intended to make clear our determination to do whatever is required to control inflation. We have consulted extensively about these steps with Congressional leaders, and I am confident that their support will be forthcoming.

The basic thrust of my decisions is restraint:

1. Restraint in the federal budget. I will soon submit to the Congress a revised and balanced budget for 1981. I will freeze Federal civilian employment and reduce on-going programs in every civilian agency of government. I will nonetheless fulfill my commitment to a continued growth in real spending on defense, and will maintain an effective foreign aid program, including a large contribution to the multilateral banks.

2. Restraint in borrowing and lending. I will authorize the Federal Reserve to impose a limited range of credit controls. The Federal Reserve will also act in other ways, under its own authorities, to moderate the expansion of credits. And it will launch a major voluntary program for banks and other lenders to limit the growth of credit. These actions will increase the prospects for reducing the tremendous strains in financial markets during recent weeks.

3. Restraint in setting private wages and prices. I am firmly determined not to impose mandatory wage and price controls. The Council on Wage and Price Stability has just issued revised voluntary pay standards and confirmed an extension of voluntary price standards, which were developed from the recommendation of a tri-partite advisory committee, with members from business, labor, and the public. I will substantially expand the government's capability to monitor and report to the public on any violation of these voluntary wage and price standards.

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4. Restraint in the use and importation of oil. I am using the powers of the President to impose a gasoline conservation charge on imported oil. The charge will be allocated solely to gasoline at a rate of 10 cents a gallon. It should reduce imports about 100,000 barrels a day after a year, and as much as 250,000 barrels a day after three or four years. I will also submit to the Congress a request for enactment of a permanent gasoline tax. The conservation charge will be removed as soon as the tax is enacted.

I am imposing this import charge in the expectation that it will be part of an internationally agreed demand restraint program, involving additional actions by all the major industrial oil importing countries. Reductions in U.S. demand, alone, will not solve the global energy problem. Indeed, it will be difficult for me to secure sustained public support for these reductions unless they are seen as part of a wider program to the same end. I trust that my action will pave the way for agreement on such a program, involving tight 1981 oil import ceilings and substantial cuts in oil consumption between now and 1985, if estimates of future oil supply and demand indicate that this is needed. My Government will be making specific proposals in this sense at appropriate international meetings. I hope for your support.

These are hard decisions. They will involve substantial sacrifice by the American people. The threat that we face requires nothing less. In meeting this threat, the United States will be making a large contribution to world economic health. The more these actions are taken, and appear to be taken, as part of concerted action by all the industrial countries, the more effective they will be, over the substantial period required for success.

Sincerely,

Jimmy Carter

President Carter, after consulting widely with Congress, has just completed an intensive review of measures which can be taken to arrest inflationary pressures in the U.S. economy. The President has decided that, as a critical part of the resulting strengthened domestic economic program, the price of gasoline needs to be increased in the interest of encouraging conservation in the discretionary use of petroleum; this is a course of action that has been urged upon the U.S. repeatedly in the IEA, by oil producing nations publicly, and in bilateral discussions. Such measures both will encourage more rapid progress toward conservation of energy and will raise additional revenues to bring the budget into balance, thereby working against inflation.

The revenues raised by this measure, together with new budget reductions, will help achieve a balance between expenditures and receipts.

The President does not have, at present, the authority to impose an increase in the federal ad valorem tax on gasoline. Therefore, concurrently with submitting to the Congress legislation to enact an increased gasoline ad valorem tax, the President will use his existing authority under the Trade Expansion Act to impose a gasoline conservation charge on all crude oil imports of $4.62 per barrel; through the mechanism of an entitlements program authorized by the Trade Expansion Act and the E.P.A.A., the full impact of this charge will be allocated against gasoline prices. This temporary charge will be lifted as soon as Congress enacts the proposed increase in the gasoline ad valorem tax.

In explaining this program, which will have the same effect as a gasoline tax, it is important to emphasize that the temporary fee approach is the only option the President has available to take immediate action to increase gasoline prices -- as all European and other Western industrialized countries have already done for some time. This temporary action is necessary to move immediately; the basic objective is to achieve conservation in gasoline consumption. The fee will bridge the time gap until legislation for an increase in the gasoline excise tax can be passed. It will thus meet the need for increased revenues on a more immediate basis than the legislative process will allow, in order to achieve a balanced budget and thus maximize the Administration's efforts to bring inflation under control as rapidly as possible. This is consistent with conservation policy measures in other industrialized consuming nations. It is important to stress that the charge will be removed when the tax is enacted by Congress.

By providing a more stable U.S. economy, these measures will strengthen the world economic and trading system. World oil markets will also benefit from the reduction in U.S. import demand resulting from additional gasoline conservation. In addition, the program will promote stability for the dollar in the exchange markets and therefore a more stable international monetary system.

It should be stressed that the expected conservation effects of this immediate import charge which will be shifted to gasoline are a critical part of the President's anti-inflation package.

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FM WASHINGTON 052347Z MAR 80

TO PRIORITY F C O

TELEGRAM NUMBER 968 OF 5 MARCH

US ECONOMIC PROBLEMS

1. OUR SAVINGRAM 11 OF 29 FEBRUARY REPORTED THE MARKED DETERIORATION IN THE CLIMATE OF ECONOMIC OPINION HERE AND INDICATED THAT THE ADMINISTRATION ARE CONDUCTIONG A WIDE-RANGING ECONOMIC POLICY REVIEW.

2. TWO FURTHER DEVELOPMENTS THIS WEEK HAVE INTENSIFIED THE PRESSURE ON THE ADMINISTRATION'S ECONOMIC POLICIES.

(I) INTEREST RATES HAVE RISEN EVEN HIGHER WITH MOST MAJOR BANKS RESETTING THEIR PRIME RATES AT 17 AND A QUARTER PERCENT ON 4 MARCH AND THE TREASURY PAYING RECORD YIELDS ON NEW BILLS.

(II) THE BUDGET DEFICIT FOR CURRENT YEAR (FY80), ORIGINALLY SET AT DOLLARS 29.9 BN. IN THE SECOND BUDGET RESOLUTION LAST OCTOBER AND RAISED TO DOLLARS 40 BN BY PRESIDENT CARTER IN HIS CONGRESSIONAL BUDGET MESSAGE ON 28 JANUARY, IS NOW GENERALLY EXPECTED TO TURN OUT EVEN HIGHER.

3. THE MAIN POLICY OPTIONS UNDER CONSIDERATION ARE REPORTED TO INCLUDE THE FOLLOWING.

(I) A TIGHTENING OF FISCAL POLICY INVOLVING A REDUCTION IN FEDERAL EXPENDITURE DESIGNED TO BALANCE THE BUDGET FOR THE FISCAL YEAR BEGINNING IN OCTOBER (FY81). AT PRESENT THE BUDGET PROPOSALS CALL FOR A DEFICIT OF DOLLARS 15.8 BN, ALTHOUGH MANY COMMENTATORS BELIEVE IT WOULD TURN OUT HIGHER. ALL GOVERNMENT DEPARTMENTS EXCEPT DEFENCE HAVE BEEN ASKED TO PROVIDE OPTIONS FOR REDUCING EXPENDITURE.MEASURES UNDER CONSIDERATION REPORTEDLY INCLUDE DE-INDEXING SOCIAL SECURITY PAYMENTS AND CURTAILMENT OF JOB CREATION PROGRAMMES. SMALLER REDUCTIONS IN FY80 EXPENDITURE ARE ALSO UNDER CONSIDERATION. THESE ARE LIKELY TO BE DIRECTED AT OFFSETTING RECENT INCREASES IN THE EXPENDITURE ESTIMATES OF SOME PROGRAMMES, SO THAT THE PRESIDENT CAN STILL ACHIEVE THE BUDGET DEFICIT OF DOLLARS 40 BILLION HE PROJECTED IN HIS CONGRESSIONAL BUDGET MESSAGE.

(II) A SECOND AREA OF POSSIBLE ACTION IS ON MONETARY POLICY. THERE IS MUCH TALK OF THE ADMINISTRATION PROPOSING CREDIT CONTROLS. THE FED, WHO WOULD BE RESPONSIBLE FOR OPERATING ANY CONTROLS, HAVE IN THE

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PAST MADE CLEAR THEIR DISLIKE OF ANY GENERAL SYSTEM OF CONTROLS NOT LEAST BECAUSE THEY WOULD/ BE A NIGHTMARE TO ADMINISTER. IT WOULD NOT BE SURPRISING, HOWEVER, IF THEY WERE LOOKING FOR MORE SELECTIVE WAYS TO RESTRAIN CREDIT, FOR EXAMPLE IN THE AREAS OF CONSUMER OR BUSINESS LOANS, OR TO RESTRICT THE MARKETS IN THOSE INSTRUMENTS WHICH HAVE HELPED TO FINANCE THE CONTINUING CREDIT EXPANSION BUT WHICH ARE NOT INCLUDED IN THE MAIN MONETARY AGGREGATES. WE HAVE HEARD, INTER ALIA, THAT THE FED HAVE INCREASED THEIR SURVEILLANCE OF THE COMMERCIAL PAPER MARKET LEADING AT LEAST ONE BANKER TO INFER THAT SOME DEVICE MAY BE UNDER CONSIDERATION WITH THE OBJECT OF CONSTRAINING SUCH SOURCES OF FINANCE. OTHER OPTIONS REPORTEDLY BEING DISCUSSED INCLUDE INCREASED MINIMUM PAYMENTS ON CREDIT CARD BALANCES OUTSTANDING AND LIMITING BANK LOANS FOR CORPORATE TAKEOVERS, THOUGH MOST RECENT REPORTS SUGGEST THESE ARE NOT FAVOURED BY THE ADMINISTRATION. A FURTHER POSSIBILITY WOULD BE FOR THE FED TO AGREE TO ANOTHER INCREASE IN THE DISCOUNT RATE.

(III) ACTION IS ALSO UNDER CONSIDERATION ON THE ENERGY FRONT. THE MOST COMMONLY MENTIONED OPTIONS ARE TO RAISE OIL IMPORT DUTIES AND TO INCREASE GASOLINE TAXES. NEITHER OF THESE IS LIKELY TO BE POLITICALLY APPEALING TO THE PRESIDENT AT THIS TIME.

(IV) INTEREST IN MANDATORY WAGE AND PRICE CONTROLS HAS RECENTLY REVIVED. HOWEVER, ANY MOVE IN THIS DIRECTION SEEMS LIKELY TO RELEASE A SURGE OF ANTICIPATORY PRICE INCREASES WHILE CONGRESS WAS CONSIDERING WHETHER TO GRANT THESE POWERS. FOR THIS AND OTHER REASONS THE ADMINISTRATION HAVE REPEATEDLY RULED OUT CONTROLS, FOR EXAMPLE AT THE TIME SENATOR KENNEDY PROPOSED THESE ON 7 FEBRUARY, AND MOST RECENTLY LAST WEEKEND IN A TELEGRAM ON INFLATION FROM THE PRESIDENT'S INFLATION ADVISER, KAHN, AND TREASURY SECRETARY MILLER TO THE 500 LARGEST CORPORATIONS IN THE US. THE PRESIDENT COULD NONETHELESS SEEK TO STRENGTHEN THE REPORTING REQUIREMENTS UNDER THE EXISTING VOLUNTARY WAGE AND PRICE GUIDELINES.

4. THE PRESIDENT'S RECENT STATEMENT THAT INFLATION HAS REACHED A QUOTE CRISIS STAGE UNQUOTE AND THE SIEDLY REPORTED POLICY REVIEW HAVE NOW BUILT UP EXPECTATIONS TO SUCH AN EXTENT THAT ONLY SUB-STANTIAL PACKAGE IN THE NEAR FUTURE WILL BE SEEN AS ADEQUATE. THE RESULTS OF THE NEW HAMPSHIRE PRIMARY ALSO SUGGEST THAT SENATOR KENNEDY HAS MADE SOME HEADWAY ON ECONOMIC ISSUES AND THAT INFLATION HAS AGAIN RETURNED TO CENTRE STAGE AS A POLITICAL ISSUE. IN THESE CIRCUMSTANCES, THE PRESIDENT IS LIKELY TO FEEL OBLIGED TO TAKE THE LEAD, RATHER THAN LEAVING THE FED TO MAKE THE RUNNING AS HITHERTO.

OF THE VARIOUS MEASURES DISCUSSED ABOVE, THE MOST LIKELY OUTCOME SEEMS TO BE A PACKAGE OF EXPENDITURE CUTS, BUT THIS ALONE MAY NOT BE ENOUGH TO QUELL INFLATIONARY EXPECTATIONS. SELECTIVE ACTION ON THE MONETARY FRONT IS COMMONLY QUOTED AS THE NEXT MOST LIKELY COMPONENT OF ANY PACKAGE.

5. THERE HAS BEEN LITTLE OFFICIAL INDICATION OF HOW SOON ANY PROPOSALS MIGHT BE ANNOUNCED. CLEARLY, THE CURRENT INTEREST IN THE REVIEW AND THE PROXIMITY OF THE IMPORTANT ILLINOIS PRIMARY (MARCH 18) POINT TO SOME TIME FAIRLY SOON. A CONTACT AT THE OFFICE OF MANAGEMENT AND BUDGET HOWEVER HAS INFORMED US THAT THE GENERAL INTENTIONS IS FOR A NUMBER OF DETAILED OPTIONS FOR BUDGET CHANGES TO BE PUT TO THE PRESIDENT LATER THIS WEEK, ENABLING HIM TO ANNOUNCE GENERAL PROPOSALS AROUND THE END OF NEXT WEEK - THE TIME OF YEAR BUDGET REVISIONS ARE CUSTOMARILY SENT TO CONGRESS.

6. FCO PLEASE PASS TOTURNBULL (TREASURY) AND HAYWARD (BANK OF ENGLAND) AND ALSO TO COUZENS (TREASURY) REF. TELECON ANZON/COUZENS OF 4 MARCH.

FRETWELL [THIS TELEGRAM WAS NOT ADVANCED]

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FROM WASHINGTON

CONFIDENTIAL [CULL]

TO SAVING FCO TELNO 11 OF 29 FEBRUARY

AND INFO SAVING TO: BONN, PARIS, TOKYO, ROME, UKREP BRUSSELS, UKDEL OECD

US ECONOMIC PROBLEMS

1. There has been a significant change in economic opinion in recent weeks, culminating in the statement by the President that inflation has reached a "crisis stage".

2. The present situation arises less than five months after the last major policy change. On 6 October 1979 the Federal Reserve Board (FRB) was forced to take strong action, leading to a 3% increase in bank lending rates, following rapid growth in the money supply, a serious decline in the dollar and a wave of speculation on the commodity markets. This package was widely approved at the time as an adequate response to the situation and two months ago Mr Volcker, Chairman of the FRB, seemed to be preparing the markets for a decline in interest rates as the economy weakened. As an indication of the change of outlook, the FRB hurriedly raised the discount rate on 15 February from 12% to 13%, triggering an increase of over 1% in bank lending rates.

3. The causes of the present concern are different from those in the autumn. The dollar is not weak, the money supply figures are within the targets, and the gold boom has subsided. There are four main factors causing the present situation - the recession that never was, the President's budget proposals (and in particular his support for increased defence spending following the invasion of Afghanistan), doubts about FRB policy, and the rate of inflation itself.

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4. The economy defied economists' predictions throughout 1979. After an exceptionally long period of growth from 1975 there was a wide expectation, even hope, that 1979 would see a recession because the economy was operating at near full capacity, and further pressure would be inflationary. While in the second quarter of 1979 the economy did decline substantially, in the third quarter it more than recovered. Initial estimates for the fourth quarter suggested growth and not decline, and the revised figures for that quarter published on 20 February showed quite substantial growth (annual rate of 2.7%).

5. The Administration's economic forecast, published with its budget proposals at the end of January, assumed a mild recession in the first half of 1980 but after the events of 1979 there was bound to be scepticism about the accuracy of the forecast. This scepticism was increased by the budget itself. Two aspects in particular raised doubts about the Administration's economic policy. First, the deficit for the fiscal year beginning October 1979 (FY 80) was revised from $29 billion (approved by Congress only three months earlier) to $40 billion. This was a reversal of the trend of declining deficits through the Carter years. Changed economic assumptions played their part in this, but also there was a substantial increase in defence spending, and total spending was projected to show a 14% increase on FY 79. Also, these estimates did not allow for other known increases, eg effects of the latest oil price increase. Second, the $16 billion deficit proposed for FY 81 looked an underestimate. Many believed that Congress would increase the rate of defence spending and would balk, in an election year, at the real reductions in other programmes, and at several of the President's legislative proposals which would cut spending. A deficit of at least $30 billion seemed likely, against widespread feeling that the inflation prospects argued for a balanced budget.

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6. Confidence was not helped by the tone of the Administration's economic report published in January, which said that it would take several years to get inflation down to 5%. The pay guidelines for 1980 were bogged down. In October 1979 the President had enlisted the unions in a new pay board. Asked to report within a month the board, in January, proposed new guidelines, significantly higher than those in 1979, and the President has not yet said whether he accepts them.

7. At the same time, confidence in Mr Volcker has declined. Although the money supply is within the targets, credit still seems to be readily available to industrial borrowers and the financial markets have been confused by the FRB's operations.

8. The most recent event creating the "crisis" has been the publication in the middle of February of the consumer price index for January showing an increase of 1.4% (an annual rate of 18% - the highest for six years, compared with 13% for most of 1979). The figures for the next few months are expected to be almost as bad.

9. The Administration is reviewing its economic policies, reportedly looking at further budget cuts in FY 80 and FY 81, including possibly deindexing social security payments, setting a ceiling for federal spending as a percentage of GNP, an additional tax on petrol, and controls on consumer credit. The Administration has repeatedly rejected mandatory pay and price controls although these are now supported by some experts as well as a majority of the public. The voluntary pay guidelines are in difficulty because to raise them significantly would be an admission of defeat but not to raise them, given current inflation, would make them unrealistic and they would be ignored. Unlike October 1979 when the FRB alone took action, it is the Administration that is now expected to play the main part.

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10. The other Presidential candidates have argued that once economic issues regained prominence over foreign policy issues, the President would be vulnerable, but although the economy has hit the headlines the President seems so far to have suffered very little. The Republican candidates have proposed only a confusing mixture of tax cuts and cuts in the budget deficit. Senator Kennedy has proposed an across the board six month freeze on prices, wages, interest rates, profits, dividends, and rents, together with petrol rationing. But after the New Hampshire results, the President may feel little constrained by his opponent's position on economic issues. He may see virtue in tough measures, showing firm leadership. One fact seems unavoidable - substantial policy changes are needed now to restore confidence and dampen inflationary expectations.

29/2

HENDERSON

Distribution: Chancery

[THIS TELEGRAM WAS NOT ADVANCED]

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BY BAG

FM WASHINGTON

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TO FCO TEL NO. 7 SAVING OF 12 FEBRUARY 1980

MONTHLY ECONOMIC REPORT FOR THE UNITED STATES

SUMMARY

1. The long awaited US recession has still not arrived. The economy grew by 0.3% in the fourth quarter of 1979, following a strong performance in the third. This brings to 2.3% the rate of growth for 1979 as a whole.

2. The rise in economic activity was mainly associated with higher real personal consumption, financed by a further decline in the household savings ratio. This now stands at 3.3% -- the lowest level since 1950. Fixed investment was slightly lower, and net imports virtually unchanged.

3. Industrial production is also consistent with a relatively buoyant economy, with total production slightly higher in December, following small declines in November and October. There are, however, some signs of weakness in cyclically sensitive sectors. Although privately owned housing starts were unchanged in December, the level was 26% down on a year earlier. Sales of US produced motor vehicles were also 24% down in the first half of January, compared with a year earlier. Generally inventories were higher, with the inventory/sales ratio rising to 1.42 in November from 1.41 a month earlier. The unemployment rate, which has remained in the range of 5.6% to 6.0% for over a year, increased to 6.2% in December.

4. The rate of inflation continues to be a major cause of concern. The consumer price index rose by 1.2% in December (seasonally adjusted) and now stands 13% higher than a year earlier. As anticipated, house prices and mortgage costs rose sharply, but other components also contributed to the overall rise. The implicit GNP price deflator rose by 2.1% in the fourth quarter of 1979.

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5. The growth in the monetary aggregates M1 and M2 continues to be within the target ranges. The credit aggregates (total loans and business loans) appear to be growing at a slower pace than in the period immediately preceding the Fed's October 6 measures. Growth in bank reserves in recent weeks has been faster than that of the monetary aggregates. Although this is causing some concern in financial circles the Fed seem content provided growth in the main monetary and credit aggregates remains satisfactory. Interest rates in the long term bond markets rose sharply at the end of January, in response to a more pessimistic view of inflation prospects and the banks' prime rates remain in a range of about 15¼%.

6. The strong growth in US exports over the last 18 months appears to be tapering off. Total exports were only 1.4% higher in the fourth quarter. In December the trade deficit increased to $3.08 bn, in part a result of a higher oil import bill and lower gold exports.

7. January saw a number of economic policy announcements. The President sent his budget proposals to Congress (see our Telegram No. 415) and published his economic report (our Telegram No. 548). The Administration decided against proposing a tax cut at this time, although they indicated that a tax cut would be considered if economic conditions and prospects were significantly to worsen. The Administration's forecasts were notable for their pessimism about the prospects for US inflation and labour productivity growth over the next 18 months. As a response to these problems, Senator Kennedy has called for a statutory 6-month freeze on prices, wages and dividends, to be followed by an incomes policy.

(SEE MIFT FOR FULL REPORT)

HENDERSON

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U.S. MONTHLY ECONOMIC SITUATION REPORT

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PRINCIPAL INDICATORS

Quarterly Data (1979 - Q4)

	% change on	
	Previous Quarter	Year earlier
GNP	0.3	0.8
Exports of Goods and Services	1.4	8.9
Imports of Goods and Services	1.1	2.2

	Actual Level	
	Latest Quarter	Previous Quarter
Balance of Payments Current Account (Q3)	$ 0.8 bn	$-1.1 bn

Monthly Data

	% change on	
	Previous Month	Year earlier
Consumer Price Index (Dec)	1.2	13.3
Money Stock M1 (Dec)	0.4	5.7
M2 (Dec)	0.5	8.4
Dollar Effective Exchange Rate	-0.8	1.2

	Actual Level	
	Latest Month	Year earlier
Banks Prime Rate % (Jan)	15.3	11.8
Unemployment Rate % (Jan)	6.2	5.8

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USA 2

Prime Minister
Public reaction to US budget
MAP 11/2

FM WASHINGTON Ø82145Z FEB 8Ø

TO ROUTINE F C O

TELEGRAM NUMBER 642 OF 8 FEBRUARY, 198Ø,

INFO BONN, PARIS, ROME, TOKYO, UKREP BRUSSELS, AND UKDEL OECD.

REACTIONS TO THE U S BUDGET FOR FY 1981.

1. THERE HAS BEEN LITTLE ENTHUSIASM AND A SUBSTANTIAL AMOUNT OF CRITICISM OF THE BUDGET.

2. FIRST REACTIONS AMONGST POLITICAL LEADERS WERE ON PREDICTABLE LINES. REPRESENTATIVE JIM WRIGHT, THE DEMOCRATIC MAJORITY LEADER IN THE HOUSE, SAID IT WAS A GOOD, TIGHT, AUSTERE BUDGET, THE BASIC FRAMEWORK OF WHICH WOULD BE ACCEPTABLE TO CONGRESS. WITH THE EXCEPTION OF SENATOR JAVITS, REPUBLICAN SPOKESMEN CONDEMNED THE BUDGET AS INFLATIONARY. THE DEFICIT WAS LOWER NOT BECAUSE OF CUTS IN SPENDING, BUT BECAUSE OF HIGHER TAXES. BOTH SENATOR KENNEDY AND GEORGE BUSH CRITICISED THE PRESIDENT FOR BREAKING HIS ELECTION PROMISE TO BALANCE THE BUDGET, AND RECALLED THAT IN HIS 1976 CAMPAIGN, THE PRESIDENT MADE MUCH OF HIS QUOTE MISERY INDEX UNQUOTE (THE SUM OF THE INFLATION AND UNEMPLOYMENT RATES). IT WAS THEN 13 PER CENT WHEREAS, ON THE BASIS OF ADMINISTRATION FORECASTS IT WILL BE 18 PER CENT AT THE END OF THIS YEAR. SENATOR KENNEDY CLAIMED THAT THE TOTAL DEFICIT IN THE CARTER YEARS WERE AN ALL TIME RECORD. THE CONGRESSIONAL BLACK CAUCUS COMPLAINED THAT THE BUDGET IGNORED THE NEEDS OF THE POOR.

3. THE SENATE AND HOUSE BUDGET COMMITTEES HAVE BEGUN THEIR CONSIDERATION OF THE BUDGET, AND IT HAS ATTRACTED LITTLE PRAISE BUT CONFLICTING CRITICISM. SENATOR MUSKIE, SENATOR BUDGET COMMITTEE CHAIRMAN, APPROVED OF THE CANDOR OF THE ADMINISTRATION IN FORECASTING A RECESSION, BUT EXPRESSED DISAPPOINTMENT THAT THE BUDGET DID NOT BALANCE. REPUBLICANS ON THE COMMITTEE ASKED FOR EVEN HIGHER DEFENCE SPENDING, BUT ALSO A TAX CUT. THERE WAS GENERAL UNEASE THAT THE BUDGET DID NOT ADDRESS THE PROBLEM OF INFLATION, WHICH THE ADMINISTRATION SEEMED TO BLAME TOO EASILY ON OPEC. IN THE HOUSE BUDGET COMMITTEE SEVERAL MEMBERS CLAIMED THAT THE BUDGET WAS BASED ON OPTIMISTIC ASSUMPTIONS, AND THE DEFICIT COULD BE SUBSTANTIALLY ABOVE DOLLARS 16 BN. THERE WAS AT THE SAME TIME PRESSURE FOR TAX CUTS.

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4. AMONG THE NEWSPAPERS THE WALL STREET JOURNAL'S EDITORIAL, HEADED QUOTE IMPRUDENT AND IRRESPONSIBLE UNQUOTE SAID THAT THE BUDGET WAS INFLATIONARY AND LARDED WITH ELECTION PORK. COMPARED WITH THE ORIGINAL EXPENDITURE TARGETS FOR FY80, THE FIGURE FOR FY81 REPRESENTED A 16 PERCENT INCREASE. INCOME TRANSFERS, WHICH ARE NOW 45 PER CENT OF THE BUDGET, ERODE SAVINGS AND CAPITAL FORMATION. AS REGARDS THE PORK BARREL, HOUSING SUBSIDIES WILL BE UP 12 PER CENT AND THE EXPENDITURE ON EMPLOYMENT AND TRAINING SCHEMES UP 18 PER CENT. ANOTHER ARTICLE POINTED OUT THAT MANY OF THE PRESIDENT'S LEGISLATIVE PROPOSALS, WHICH WOULD REDUCE EXPENDITURE, WERE UNLIKELY TO BE APPROVED BY CONGRESS.

5. IN THE WASHINGTON POST, UNDER THE HEADLINE QUOTE A BUDGET WRAPPED IN RED WHITE AND BLUE UNQUOTE HOBART ROWAN SAID THAT THIS WAS A WHOLLY POLITICAL BUDGET. THE PRESIDENT HAD NOT PRODUCED HIS PROMISED BALANCED BUDGET, OR PROGRAMMES TO DEAL WITH INFLATION AND UNEMPLOYMENT. TAXES WOULD NOT BE CUT, AND IN CONTRAST TO HIS ELECTION PROMISE, DEFENCE SPENDING WOULD BE INCREASED. ALL THIS HAS BEEN MADE POSSIBLE BY BREZHNEV AND KHOMEINI. WHEN THE PUBLIC FOCUSSES ON POCKET BOOK ISSUES, HE SAID, DON'T BE SURPRISED IF CARTER APPROPRIATES MUCH OF THE KENNEDY PROGRAMME.

6. ROBERT SAMUELSON, IN THE NEW YORK TIMES, SAID THAT THE BUDGET SHOWED THAT THE WHITE HOUSE WAS DRIFTING, ACCOMMODATING THE CONSTITUENCIES WHICH SEEM NEAREST AND MOST VISIBLE. SAMUELSON SAID THAT THE PRESIDENT STILL LACKED AN UNDERLYING VISION OF HOW ECONOMIC POLICY NEEDS TO BE REORIENTATED TO ADJUST TO THE LONG TERM PROBLEMS - PRODUCTIVITY, REDUCED WORLD ECONOMIC POWER, AND EXCESSIVE DEMANDS FOR LIMITED RESOURCES, THAT UNDERLY THE INFLATION. CARTER'S POLICIES WOULD CREATE MORE PROBLEMS THAN THEY SOLVED. SYMBOLIC WAS THE ABSENCE OF MEASURES, E.G. A GASOLINE TAX, TO REDUCE OIL DEMAND. THE PRESIDENT HAD ABANDONED HIS PLEDGE TO REDUCE GOVERNMENT SPENDING

/TO

TO 21 PER CENT OF GNP - IT WILL BE 22 PER CENT IN FY81. CONGRESS AND THE WHITE HOUSE HAD CREATED THESE PROBLEMS OVER THE YEARS BY FINANCING NEW PROGRAMMES FROM THE REDUCTION IN DEFENCE SPENDING. THE PRESIDENT HAD EVADED THE PROBLEM THIS YEAR BY ALLOWING TAX REVENUE TO RISE, BUT THIS WOULD REDUCE INCENTIVES AND INVESTMENT.

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TELEGRAM NUMBER 343 OF 22 JANUARY 80.
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TREASURY UNDER SECRETARY SOLOMON.

IT HAS BEEN ANNOUNCED THAT ANTHONY SOLOMON, TREASURY UNDER SECRETARY FOR MONETARY AFFAIRS IS LEAVING ON 1 APRIL TO BECOME PRESIDENT OF THE NEW YORK FEDERAL RESERVE BANK. THAT POST HAS BEEN VACANT SINCE VOLCKER LEFT TO BECOME CHAIRMAN OF THE FEDERAL RESERVE SYSTEM IN WASHINGTON AT THE END OF JULY 1979.

SOLOMON'S APPOINTMENT HAS BEEN APPLAUDED IN THE EAST COAST PRESS. THE NEW YORK FED. IS THE MOST IMPORTANT OF THE FEDERAL RESERVE BANKS LOCATED AROUND THE U.S.A., AND IS THE OPERATIONAL ARM OF THE RESERVE SYSTEM IN THE DOMESTIC AND INTERNATIONAL MARKETS.

A SUCCESSOR TO SOLOMON AT THE TREASURY HAS NOT BEEN ANNOUNCED. HE TAKES UP HIS NEW YORK POST ON 1 APRIL, AND WE HAVE HEARD UNOFFICIALLY THAT HE IS LEAVING THE TREASURY ON THE 1 MARCH. AS THE SPECIALIST ON INTERNATIONAL MONETARY AFFAIRS, HIS DEPARTURE WILL LEAVE A SERIOUS GAP, UNLESS HE IS REPLACED QUICKLY.

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TELNO 223 OF 14 JAN 80
US ECONOMY

1. WHEN ECONOMIC MINISTER PAID A COURTESY CALL ON SECRETARY MILLER AT THE US TREASURY TODAY, MILLER MADE A NUMBER OF COMMENTS ON THE ECONOMIC PROSPECTS.

2. MILLER THOUGHT RECESSION HAD IN FACT BEGUN, ALTHOUGH NOT YET REFLECTED IN UNEMPLOYMENT FIGURES. THE SIGNS WERE THERE IN EG. THE AUTOMOBILE INDUSTRY AND HOUSING. BUT HE EXPECTED THE RECESSION TO BE MODERATE, POSSIBLY LASTING FOR THE FIRST TWO OR THREE QUARTERS OF 1980: IT WOULD NOT BE ON THE SCALE OF THE 1974 RECESSION.

3. HE DID NOT THINK IT WOULD PROVOKE CONGRESSIONAL PRESSURE FOR REFLATIONARY ACTION ON THE BUDGET THIS YEAR. HE THOUGHT THE TIMETABLE ON THESE MATTERS WAS OFTEN MISUNDERSTOOD. IF THE PRESIDENT HAD WANTED TO FOLLOW THAT COURSE, HE WOULD HAVE NEEDED TO START LAST SUMMER. BUT HE HAD GIVEN PRIORITY TO THE FIGHT AGAINST INFLATION, AND HAD NOT EVEN ALLOWED A TAX CUT TO BE EXAMINED WITHIN THE ADMINISTRATION. REPUBLICAN PRESIDENTIAL CANDIDATES WOULD OBVIOUSLY NOT WANT TO BE MORE EXPANSIONARY THAN THE PRESIDENT. THE CONGRESS WAS MORE QUOTE SKITTERISH UNQUOTE. BUT THE PRESENT DEMOCRATIC LEADERSHIP IN CONGRESS HAD SUPPORTED THE PRESIDENT'S APPROACH. UNLESS THE RECESSION WAS MUCH MORE MARKED THAN HE ENVISAGED, MILLER DID NOT THEREFORE SEE MUCH LIKELIHOOD OF CONCERTED CONGRESSIONAL PRESSURE FOR FISCAL RELAXATION.

4. ON EARNINGS, HE CONFIRMED THE PAY BOARD WERE LIKELY TO RECOMMEND A RANGE OF 7 1/2 - 9 1/2 PER CENT FOR SETTLEMENTS, ON THE BASIS THAT SETTLEMENTS SHOULD ONLY BE ABOVE THE MID-POINT OF THE RANGE IF THEY HAD BEEN BELOW THE NATIONAL AVERAGE IN THE PAST (AND VICE VERSA). HE THOUGHT THIS WAS A REASONABLE APPROACH, BUT HE WAS CAUTIOUS ABOUT HOW FAR IT WOULD BE COMPLIED WITH.

5. ON THE PROSPECTS FOR SAVINGS, HE SAID THAT AS THE US HAD NO RECENT EXPERIENCE OF SUSTAINED INFLATION AT PRESENT LEVELS, ANY ANALYSIS WAS LIABLE TO BE BASED MAINLY ON GUESSWORK. THE REASON FOR THE PRESENT LOW SAVINGS RATE WAS PARTLY DEMOGRAPHIC, REFLECTING THE LARGE NUMBERS IN THE YOUNG MARRIED AGE GROUP WHICH HAD LARGE DEBT COMMITMENTS. ALSO THE PUBLISHED FIGURE FOR THE SAVINGS RATIO DID NOT INCLUDE EQUITY INVESTMENT IN HOUSING, WHICH WAS INCREASINGLY BEING SEEN AS THE BEST INFLATION HEDGE. FUNDS FOR NEW HOUSING WHICH HAD PREVIOUSLY ALMOST DRIED UP WERE NOW PLENTIFUL FOLLOWING THE MEASURES TAKEN IN THE LAST TWO YEARS. WHILE HE EXPECTED SOME INCREASE IN THE SAVINGS RATIO FROM THE PRESENT LOW LEVEL, HE DID NOT THEREFORE EXPECT ANY SHARP SHIFT.

6. FCO PLEASE PASS ADVANCE COPY TO A. TURNBULL (HMT).

HENDERSON

FCO/WHITEHALL DISTN. [ADVANCED AS REQUESTED]

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TO IMMEDIATE F.C.O.

TELEGRAM NUMBER 4134 OF 10 DECEMBER.

[CULL]

Prime Minister

11.12.

FOR TURNBULL HMT FROM DADD

BEGINS:

SUMMARY OF MONTHLY ECONOMIC REPORT FOR THE U.S.

1. RECENT STATISTICS HAVE CONFIRMED THAT THERE WAS A CONSIDERABLE RECOVERY IN THE THIRD QUARTER, GROWTH NOW BEING ESTIMATED AT A 3.5 PERCENT ANNUAL RATE. THE RESILIENCE OF THE U.S. ECONOMY IN THE THIRD QUARTER APPEARS TO HAVE BEEN DUE TO THREE MAIN FACTORS. THESE ARE THAT U.S. CONSUMERS WERE OFFSETTING THE FALL IN REAL INCOMES BY SAVING LESS: THAT U.S. BUSINESS DID NOT REDUCE INVENTORIES BY AS MUCH AS MIGHT HAVE BEEN EXPECTED AND HOUSE BUILDING HELD UP WELL COMPARED WITH PREVIOUS CYCLES. THERE MAY ALSO HAVE BEEN SOME POSTPONEMENT OF CONSUMER EXPENDITURE FROM THE SECOND QUARTER DUE TO THE EFFECTS OF THE PETROL SHORTAGE.

2. HOWEVER, THE LATEST ECONOMIC AND FINANCIAL INDICATORS ARE AGAIN BEGINNING TO POINT MORE STRONGLY TO THE POSSIBILITY OF A RECESSION. FOR CARS AND HOUSING, TRADITIONALLY THOSE SECTORS MOST AFFECTED BY AN ECONOMIC RECESSION, SALES AND HOUSING STARTS WERE WELL DOWN IN OCTOBER. FOR CARS, SEASONALLY ADJUSTED SALES WERE 17 PERCENT DOWN AND SEASONALLY ADJUSTED HOUSING STARTS WERE 8 PERCENT DOWN COMPARED WITH SEPTEMBER. CAR SALES WERE ALSO LOW DURING THE FIRST HALF OF NOVEMBER. RETAIL SALES ALSO DECLINED 1 1/2 PERCENT IN OCTOBER THOUGH THE UNEMPLOYMENT RATE IMPROVED MARGINALLY TO 5.8 PERCENT. THE GROWTH IN MONEY SUPPLY HAS SLOWED SHARPLY OVER THE PAST 2 MONTHS, PARTIALLY DUE TO THE FED'S MEASURES, AND IS NOW WITHIN THE TARGETS. BUSINESS LOAN DEMAND WHICH HAD BEEN RISING VERY FAST IN THE THIRD QUARTER IS NOW DECLINING. AND INTEREST RATES HAVE DECLINED SOMEWHAT FROM THE PEAKS REACHED IMMEDIATELY AFTER THE ANNOUNCEMENT OF THE FED PACKAGE.

3. THE MERCHANDISE TRADE DEFICIT NARROWED TO DOLLARS 2.02 BN SEASONALLY ADJUSTED IN OCTOBER. THE IMPROVEMENT HAS BEEN DUE MAINLY TO HIGHER AGRICULTURAL AND MANUFACTURED GOODS EXPORTS. THE VALUE OF OIL IMPORTS ROSE 7.8 PERCENT TO DOLLARS 6.8 BN. THE U.S. DOLLAR HAS FALLEN BACK SOMEWHAT ON FOREIGN EXCHANGE MARKETS OVER THE LAST MONTH.

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4. THE CONSUMER PRICE INDEX ROSE BY ANOTHER 1.Ø PERCENT IN OCTOBER, HOUSING SHOWING THE HIGHEST RATE OF INCREASE. AS THE EFFECTS OF THE INCREASE IN MORTGAGE RATES COME THROUGH, THE CPI WILL RISE MORE SHARPLY SINCE THE INDEX ASSUMES THAT ALL HOUSEHOLDERS REMORTGAGE THEIR PROPERTY EACH MONTH. THE CPI HAS INCREASED AT ABOUT A 13 PERCENT ANNUAL RATE SO FAR THIS YEAR, COMPARED WITH AN INCREASE IN THE IMPLICIT GNP DEFLATOR AT A 8.Ø PERCENT RATE IN THE THIRD QUARTER.

5. SOME BANKS HAVE REDUCED THEIR PRIME RATES FROM THE HIGH LEVELS REACHED A FEW WEEKS AGO. THESE NOW STAND AT BETWEEN 15 1/4 - 15 3/4 PERCENT. SHARP DROPS HAVE ALSO OCCURRED IN THE RATES ON FEDERAL FUNDS AND BANK CERTIFICATES OF DEPOSIT. MANY ANALYSTS NOW BELIEVE THAT INTEREST RATES HAVE PEAKED, ALTHOUGH THERE IS NO CONSENSUS OF HOW QUICKLY THESE WILL FALL.

6. THE ECONOMIC IMPLICATIONS OF THE IRANIAN CRISIS ARE WIDELY DEBATED ALTHOUGH THERE REMAIN MORE QUESTIONS THAN ANSWERS. OF CONCERN ARE THE POSSIBLE EFFECTS OF HIGHER OIL PRICES ON INFLATION AND THE IMPLICATIONS FOR THE DOLLAR OF THE BLOCKING OF IRANIAN ASSETS (WHICH WAS WIDELY SUPPORTED IN THE U.S.) AND POSSIBLE CHANGES IN THE METHOD OF PAYMENT FOR OIL. RELATIVELY LITTLE PUBLIC ATTENTION TO DATE HAS BEEN GIVEN TO ASSESSING THE EFFECTS OF POSSIBLE OIL SHORTAGES ON ECONOMIC ACTIVITY AND WHAT POLICY MEASURES MIGHT BE APPROPRIATE. THE ADMINISTRATION ARE HOWEVER WORKING ON CONTINGENCY PLANS TO REDUCE CONSUMPTION.

7. ECONOMIC FORECASTERS ARE UNUSUALLY RELUCTANT TO COMMIT THEMSELVES ON THE COURSE OF U.S. ECONOMY OVER THE NEXT 2 TO 3 QUARTERS IN THE ABSENCE OF A CLEAR UNDERSTANDING OF WHETHER OR NOT THE ECONOMY HAS PASSED A CYCLICAL TURNING POINT. THOSE FACTORS CAUSING PARTICULAR DIFFICULTY INCLUDE THE NEW MONETARY CONDITIONS, THE OIL PRICE AND SUPPLY SITUATION IN THE LIGHT OF THE IRANIAN CRISIS, AND THE SAVING AND BORROWING PATTERNS OF CONSUMERS IN FACE OF CONTINUING INFLATION. HOWEVER THE CONSENSUS VIEW IS FOR A SOMEWHAT MORE PRONOUNCED RECESSION THAN PREVIOUSLY ANTICIPATED IN THE FIRST HALF OF 198Ø, THOUGH STILL CONSIDERABLY LESS SEVERE THAN THAT EXPERIENCED IN 1974/75. THE RATE OF INFLATION IS NOT EXPECTED TO MODERATE BEFORE THE LATTER PART OF 198Ø.

8. FULL REPORT WILL FOLLOW BY WEDNESDAY BAG.

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TELEGRAM NO 2948 OF 1 OCTOBER
INFO EEC POSTS, BELGRADE (FOR UK DELEGATION TO IMF/IBRD ANNUAL MEETINGS)

Prime Minister

Ans. Rut

U.S. WAGE AND PRICE POLICY.

THE ADMINISTRATION HAS ANNOUNCED CERTAIN CHANGES IN THE GUIDELINES FOR THE SECOND YEAR OF THE PROGRAMME STARTING 1 OCTOBER 1979, AND THE CREATION OF PAY AND PRICE COMMITTEES.

PAY

2. THE PAY GUIDELINE FOR THE COMING YEAR WILL ALLOW A ONE PER CENT CATCH-UP FOR THOSE WORKERS WHOSE PAY INCREASE DID NOT EXCEED 7 PER CENT IN THE PREVIOUS YEAR. THIS IS DESIGNED TO COMPENSATE WORKERS WHO HAVE NOT BENEFITTED FROM COST OF LIVING ALLOWANCES (C.O.L.A.) WHICH, LEGITIMATELY UNDER THE GUIDELINES, HAVE TAKEN THE PAY INCREASE OF OTHER WORKERS OVER 7 PER CENT.

3. A PAY COMMITTEE IS TO BE ESTABLISHED. IT WILL HAVE 15 MEMBERS, 5 FROM EACH OF BUSINESS, LABOUR AND THE GENERAL PUBLIC. JOHN DUNLOP, WHO RAN THE COST OF LIVING COUNCIL UNDER NIXON, AND WAS LABOUR SECRETARY UNDER FORD WILL BE CHAIRMAN. THE AFL-CIO WHICH IS CURRENTLY COMMITTED TO PARTICIPATE WILL PROVIDE PROBABLY 3 MEMBERS. NO REPRESENTATIVES OF BUSINESS HAVE YET BEEN NAMED.

4. THE DUTIES OF THE COMMITTEE ARE (A) TO SUBMIT BY 31 OCTOBER 1979 RECOMMENDATIONS FOR MODIFICATIONS, IF ANY, TO THE PAY STANDARD, THE INFLATION ASSUMPTION FOR C.O.L.A., THE THRESHOLD FOR THE LOW PAY EXCEPTION, AND THE ADJUSTMENT FOR WORKERS NOT COVERED BY COLA.
(B) GENERALLY TO COMMENT ON INTERPRETATION OF THE PAY STANDARDS AND NON COMPLIANCE DECISIONS OF THE COUNCIL ON WAGES AND PRICES.

5. THE CHARTER OF THE COMMITTEE SUGGESTS THAT IT WILL BE A CONTINUING BODY BUT OUR DISCUSSION WITH THE RELEVANT WHITE HOUSE STAFF (WHERE THE COMMITTEE IDEA HAS BEEN DEVELOPED) INDICATE THAT THE BATTLE OVER THE POWERS OF THE COMMITTEE IS NOT YET OVER, AND WILL BE CONTINUED WITHIN THE COMMITTEE ITSELF. ITS CONTINUING ROLE (IF ANY) WILL BE PART OF THE RECOMMENDATIONS TO BE MADE BY 31 OCTOBER. AS YET THE COMMITTEE IS ADVISORY, AND THE PRESIDENT WILL HAVE DISCRETION TO REJECT OR ACCEPT THE RECOMMENDATIONS. UNTIL THE PRESIDENT HAS TAKEN THAT DECISION THE PAY GUIDELINES FOR THE COMING

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YEAR ARE UNDECIDED.

6. BEHIND THE PAY COMMITTEE DEVELOPMENT LIE WEEKS OF INTENSE NEGOTIATIONS BETWEEN THE ADMINISTRATION AND THE AFL-CIO, AND A FURTHER RESULT OF THIS IS A QUOTE NATIONAL ACCORD BETWEEN THE ADMINISTRATION AND THE AFL-CIO LEADERSHIP UNQUOTE. THE PURPOSE OF THE ACCORD IS TO ESTABLISH PROCEDURES FOR CONTINUING CONSULTATIONS, GIVEN BASIC AGREEMENT THAT FIGHTING INFLATION IS TOP PRIORITY. THE TERMS OF THE AGREEMENT ARE FULL OF GENERALISED VIRTUE, E.G. NEED FOR DISCIPLINED FISCAL POLICY, RESPONSIBLE BEHAVIOUR WITH RESPECT TO PAY AND PRICES, REDUCED DEPENDENCE ON IMPORTED OIL. THE MORE PARTICULAR INTERESTS OF THE AFL-CIO PRESUMABLY SHOW THROUGH IN THE ITEM WHICH SAYS THAT IF THE RECESSION DEEPENS WE MUST BE PREPARED WITH APPROPRIATELY SCALED RESPONSES THAT HAVE BOTH ANTI-INFLATION AND ANTI-UNEMPLOYMENT CHARACTERISTICS. BUT THIS IS SURROUNDED BY CAUTIONARY REMARKS, E.G. RECOGNISING OPERATIONAL LIMITS AND CONGRESSIONAL CONCERNS.

7. OF ITSELF THEREFORE THE ACCORD APPEARS TO BE LITTLE MORE THAN A GESTURE, THOUGH MARKING SUBSTANTIAL EFFORT BY THE ADMINISTRATION TO GET CLOSER TO ORGANISED LABOUR.

PRICES

8. THE ADMINISTRATION HAVE PROMULGATED PRICE STANDARDS, COVERING THE TWO YEAR PERIOD STARTING 1 OCTOBER 1978. COMPANIES ARE ASKED TO LIMIT THEIR PRICE INCREASES IN THAT PERIOD TO THE PRICE INCREASE IN THE 1976-77 BASE PERIOD. THUS THOSE COMPANIES WHICH COMPLIED WITH THE EXPIRING GUIDELINE AND HELD PRICES ONE HALF PER CENT BELOW THE AVERAGE INCREASE OF THE BASE PERIOD WILL BE ALLOWED IN EFFECT A ONE PERCENTAGE POINT CATCH UP. THERE ARE ALSO PROVISIONS TO TIGHTEN UP ON THE PROFIT MARGIN STANDARD WHICH IS AN ALTERNATIVE WHICH COMPANIES CAN USE INSTEAD OF THE PRICE BASED STANDARD.

9. A PRICE COMMITTEE IS TO BE ESTABLISHED WITH FIVE MEMBERS, REPRESENTING QUOTE THE GENERAL PUBLIC UNQUOTE, AND CHOSEN BY THE PRESIDENT. THE COMMITTEE IS INTENDED TO CONSIDER MODIFICATIONS TO, OR REVISED INTERPRETATIONS OF, THE PRICE STANDARDS. NO APPOINTMENTS HAVE BEEN ANNOUNCED.

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Prime Minister

You may like to look at the (not very encouraging) summary.

BY BAG
FM WASHINGTON
RESTRICTED
TO FCO TELNO. 46 SAVING OF 10 SEPTEMBER 1979

MONTHLY ECONOMIC REPORT FOR THE UNITED STATES
SUMMARY

1. It is generally accepted that the US economy has entered a period of recession. GNP is estimated to have fallen at a rate of 2.4% p.a. in the second quarter and we expect a further fall during the remainder of this year. Growth in 1980 will probably be very slow. The unemployment rate rose to 6.0% in August after a long period at around 5.7%. It seems likely to reach the 7% - 8% range during 1980.

2. The inflation rate still shows no sign of moderating. Consumer prices rose by 1% in July and in August producer prices at the finished goods stage increased by 1.2%. These figures probably exaggerate the underlying inflation rate because of the particularly large short-run effects of recent increases in energy and housing prices, but we do not expect consumer price increases to fall below 10% p.a. for some time.

3. Wage increases have lagged behind prices so far this year. The Administration will soon announce new wage standards for the second year of the voluntary anti-inflation programme. These are expected to be slightly looser than the 7% standards (with exceptions) which attained reasonable compliance in the programme's first year, but maintaining adherence in the face of recent losses in real income is likely to prove considerably more difficult. Much may depend on the current negotiations in the automobile industry, which is already suffering severely from declining sales and Chrysler's financial problems.

4. Monetary policy has tightened significantly over the past six weeks. Against the background of a poor inflation picture, an acceleration in the growth of the monetary aggregates and higher interest rates abroad, the discount rate has been raised in two steps from 9½% to 10½%. The Fed has raised the key Federal Funds

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/ RATE

rate over $11\frac{1}{4}\%$ compared with the range of $10\% - 10\frac{1}{4}\%$ which it had maintained for much of the year. The steeper part of this increase came soon after Paul Volcker took over as Chairman of the Fed, encouraging the markets to believe that he would exert a stronger control over the aggregates than his predecessor, William Miller. Prime rates at some major commercial banks have now risen to $12\frac{3}{4}\%$, considerably higher than the previous record level reached in 1974.

5. The merchandise trade deficit fell to $1.1 billion in July, despite an increase of $0.5 billion in the month in the cost of fuel imports. In the first seven months of the year, the trade deficit has cumulated to nearly $13 billion compared with over $20 billion in the same period in 1978, mainly because of much improved export volumes. Even after allowing for the higher cost of oil imports in the remaining months of the year, the deficit on the current account of the balance of payments may fall to $5 billion compared with $14 billion in 1978. If economic activity remains depressed and oil prices do not rise further in real terms, the current account could show a surplus in 1980.

6. Congress is scheduled to pass this month a second, binding Budget resolution for the fiscal year 1980, which starts in October. Although momentum in favour of fiscal stimulus is growing, the resolution seems likely to endorse the President's original proposal of no tax cuts and a tight ceiling on Federal expenditure. Nevertheless, the actual Federal deficit in 1980 is likely to be well above the President's recommendation of around $30 billion because of rising unemployment and the tax cut issue could be reopened at any time during the fiscal year.

/ Principal

Principal Monthly Indicators

		% change (annual rate)		
		On Previous Month	Last 3 months on previous 3 months	Last 3 months on 3 mths yr earlier
Industrial Production	Jul	-1.6	1.1	4.3
Retail Sales (current prices)	Jul	4.4	1.1	8.8
Consumer Prices	Jul	12.7	13.3	11.0
Average Hourly Earnings	Aug	3.2	7.5	7.7
Index of Leading Indicators	Jul	-4.2	-5.8	-1.4
Money Stock (M1)	Jul	10.6	8.9	4.5
S & P Index of "500" shares	Jul	12.2	5.1	4.1

		Latest Month	Average of latest 3 months	Average of 3 mths yr earlier
Unemployment Rate (%)	Aug	6.0%	5.7%	5.9%
Merchandise Trade Balance	Jul	-\$1.1b	-\$1.8b	-\$2.3b
Interest Rate on CD's	Aug	10.7	10.2	8.0

Quarterly National Expenditure Data

	% change (annual rate)	
(1979Q2)	On 1 qtr earlier	On 1 year earlier
GNP	-2.4	1.9
Consumers' Expenditure	-3.0	2.2
Business Fixed Investment	-3.5	4.0
Government Expenditure	-3.4	0.4
Exports of goods and services	-2.7	6.4
Imports of goods and services	11.7	6.1

Balance of Payments

	Latest quarter	Previous quarter
(1979Q1)		
Current Account (\$ billion)	0.2	-0.3

Exchange Rate

		Actual % Change	
		On Previous Month	On Year Earlier
Dollar effective rate	Jul	-2.2	-2.3

/ ECONOMIC ACTIVITY

ECONOMIC ACTIVITY

7. Virtually all parts of the economy exhibited discernible weakness in the first half of 1979. Consumers expenditure rose - compared with the second half of 1978 - at only 1% p.a., while government expenditure dropped by 1% p.a. and housing by nearly 10% p.a. Even the 7% p.a. rise in exports was significantly offset by continued import growth. An increase in production for inventories, probably largely involuntary, and an encouraging amount of business fixed investment helped to produce a 1% p.a. increase in GNP but it is clear that towards the end of the period output was dropping significantly. Disruptions caused by the petrol shortage probably explain a significant part of this decline (as did weather and labour problems earlier in the period) but the principal factor seems undoubtedly to have been the squeeze in real incomes which is unlikely to be quickly reversed.

8. Industrial production rose by 2% p.a. between the half-years, although as with other parts of the economy this disguised a virtually flat performance between December and June. The business equipment sector was the only one to run counter to this trend, even though a definite slowdown compared with 1978 was evident. July showed a small drop in overall industrial output. A substantial fall in production in the automobile industry was again the major component.

9. Declining automobile sales were also the main identifiable feature in the weak consumers expenditure figures. The drop of nearly $2 billion in 1972 prices in the second quarter was equal to the entire fall (3% p.a.) in personal consumption in the quarter although some of this expenditure was presumably diverted to other goods. Despite extensive marketing campaigns by the industry and large financial bonuses to customers, car sales continued weak into July and August. Retail sales as a whole declined in July in volume terms and it does not look as if there was the bounce-back in consumers expenditure in the third quarter that seemed possible when the petrol shortage first eased. Some department stores have nevertheless reported encouraging preliminary figures for August sales.

10. The personal savings ratio rose to 5.4% in the second quarter despite a fall of over 1% p.a. in real personal disposable income. This was its highest level for over two years, and nearly ½% above average 1978 levels (on revised data). Part of this rise may have been an involuntary result of petrol problems, but the recent sharp drops registered in indices of consumer confidence (the Conference Board survey, for example, showed falls in virtually every month this year) and the reductions in real financial wealth caused by high inflation rates suggest that this could be followed by further increases. Consumer debt outstanding rose at an appreciably slower rate in June.

11. Housing is still showing unexpected resilience to higher interest rates and declining real incomes. Starts fell only to a 1.8 million annual rate in July and revised data for the second quarter show activity only 5% below peak 1978 levels. Net inflows into the thrift institutions were weak in July, but

the net outflow of April (not seasonally adjusted) has not threatened to reoccur. Mortgage rates have now risen above $11\frac{1}{4}\%$ with large regional disparities (causing occasional severe supply problems) because of usury ceilings in some States.

12. Business fixed investment is finally showing signs of impending weakness. Rates of growth this cycle have been disappointing but nevertheless very steady, with construction latterly showing a lot of strength. New building contracts have now however started to ease and orders figures for equipment are showing sizeable reductions. New orders for nondefence capital equipment (in money terms) fell nearly 7% in July to their lowest point this year. The steel industry, which was surprisingly buoyant in 1978 and early 1979, is now beginning to suffer. Although the latest BEA survey of capital spending plans for 1979 showed some increase from the previous survey, it still pointed to a weak performance in the final two quarters of the year in volume terms.

13. Much has been written about the inventory situation in this cycle, but the position is still not particularly clear. The automobile sector was already overstocked even before the petrol crisis occurred because of failures (particularly by Ford and Chrysler) to match production to the current pattern of demand. Desperate attempts are now being made to clear 1979 model cars to make room for the 1980 models (although production has also been maintained at higher levels than necessary because of an excess of components which will not fit the new models).

14. Outside the automobile sector, there are as yet few visible problems, but its ripples are nonetheless certain to spread. Retail stores will also not long be able to sustain their financial position in the face of declining sales without some retrenchment. The largely involuntary increase in inventory accummulation in the second quarter was worth $\frac{1}{2}\%$ of GNP (2% p.a.).

EXTERNAL ACCOUNT

15. The deficit on merchandise trade fell to $1.1 billion in July, about half the size of the average deficit recorded in the first half of the year. Apart from a steep, $0.5 billion rise in the cost of fuel imports, imports dropped sharply. The improved competitiveness which the US attained through dollar depreciation in 1977 and 1978 seems to have had a significant impact on import volumes, whose rate of growth has recently moderated appreciably. Together with the effects of the slowdown in aggregate activity, it looks as if this might lead to a drop in volumes in the current quarter. Exports have meanwhile been growing very strongly, the main rise having been registered through 1978 but apparently consolidated in the first half of 1979.

16. The President committed the US, in his major energy speech in July, to keep net oil imports below 8.2 million barrels per day in 1979. Although gross imports are now running at slightly above this level, the low rate of imports recorded during the spring and the continued export of over 0.2 mbd mean that the target over the year in net terms should be easily met. Similarly, with an extra 0.2mbd of oil expected from Alaska next year, mandatory conservation measures (reinforced now by price increases) and low final demand in

/ the

the economy, a ceiling of 8.5 mbd net for 1980 would be attained without difficulty or the need for quota schemes.

17. The dollar had a generally quieter period after the beginning of August following falls in June and July. Interest rate differentials are now being restored and the slowdown in the US economy, together with the reduced trade deficit, has improved confidence. Worries nevertheless persist in the markets about the underlying inflation rate and the political climate in the US. The authorities spent about \$5½ billion net in foreign exchange (nearly all Deutschmarks) in the May-July quarter to support the dollar. This necessitated a re-activation of the swap lines with the West German and Swiss authorities.

FINANCIAL MARKETS

18. Short-term interest rates rose substantially during August and early September, with the Fed pushing the key Federal Funds rate apparently into the 11¼% - 11½% range compared with levels of below 10½% in July. The first major increases came during the period of uncertainty in the foreign exchange markets when the Cabinet changes were being formulated, but these were soon followed by further rises after Paul Volcker took over as Chairman of the Federal Reserve Board. The discount rate was raised in the middle of August, for the second time in a month, to a new record rate of 10½%.

19. Since his nomination by the President, Volcker has made several public statements in which he has reiterated a Fed Chairman's traditional resolve to combat inflation and maintain a sound dollar. The fact that these statements have been followed by Fed action to raise interest rates significantly when the monetary aggregates have not been unambiguously getting out of hand and whilst the economy has been visibly slowing has reinforced their credibility. But it is not yet clear whether these latest moves were designed mainly with this psychological effect in mind or whether they represented the start of what will be a consistently tighter line by the Federal Open Market Committee. Clearly the strength of the dollar is still an important consideration. Although there are fears that further increases in interest rates are likely to make the recession more severe, there has been little evidence to date of a traditional "credit crunch" developing. Not even the housing sector has yet experienced a serious shortage of funds.

20. Prime rates at all the major commercial banks were raised to a record 12¼% at the end of August and some again to 12¾% in early September after further Fed tightening, release of worse data on wholesale prices and evidence of some renewed strength in business borrowing at the New York banks. The stock market lost some of the ground it had gained in the July-August period, the Dow Jones Industrial Average index falling back below 870.

/ LABOUR

LABOUR MARKET AND PRICES

21. The unemployment rate rose sharply in August to 6.0% after nearly a year around the 5.7% level. Although changes in unemployment normally lag changes in output there had been some surprise that the unemployment rate had not shown signs of increasing earlier, a phenomenon attributed partly to a slowing in the rate of growth of the labour force (perhaps itself associated with the form of the activity slowdown) and partly to a growing tendency towards labour hoarding in the major cyclical industries. However, the size of the August increase may have been exaggerated by seasonal measurement problems.

22. Wage negotiations between the Union of Automobile Workers and the automobile industry seem to be proceeding towards a settlement near to the contract date of 14 September, although there are reported to be considerable problems over union pressure for an automatic indexing arrangement for pensions of existing retirees. If a strike results, the UAW have announced that General Motors, the largest and financially by far the healthiest of the companies involved, would be the target.

23. Consumer prices rose by a further 1% in July, taking the level 11.3% above that of a year earlier. Energy prices continued to be the main proximate cause. There was more disturbing news on the wholesale side, with producer prices of finished goods rising 1.1% in July and 1.2% in August. The latter figure included a surprising reacceleration in food prices. Forecasts of a moderation in inflation rates later this year had previously depended to a considerable extent on an expected flat or declining path for food prices.

ECONOMIC PROSPECTS

24. The sluggishness which the economy has shown since the beginning of this year seems certain to continue well into 1980. We expect to see GNP showing a decline for the last three quarters of 1979 and probbly the beginning of 1980, although of course there may be occasional fluctuations in this path. Some recovery seems possible in the second half of 1980, particularly if tax cuts are implemented fairly soon, but this will probably not prevent the unemployment rate from rising to around 8% by the end of the year.

25. Because activity levels at the beginning of 1979 were considerably higher than 1978, GNP should show a growth rate between the years of about 1½%. Between 1979 and 1980 there is not likely to be much net growth. The inflation rate as measured by the Consumer Price Index may start to ease within the next few months and into 1980, but this is more a result of the particular way in which the index is constructed and the short-term effect of recent increases in energy and housing prices than it is a symptom of a deceleration in the underlying rate of inflation. We expect the CPI to increase by nearly 12% through the year 1979 and about 10% between 1979 and 1980 with some signs of deceleration being evident through the year. The deceleration in 1980 should bring CPI increases more nearly in line with trend increases in unit labour costs which have recently been in the 8% - 9% p.a. range. Some temporary acceleration in wage costs is expected over the next year as employees seek to recover recent losses real earnings, but the combination of a weak economy,

/ tight

tight monetary policy and the Administration's anti-inflation standards are expected to prevent this becoming too sizeable.

26. The trade balance may deteriorate over the next few months as the full effects of the oil price increases and the recovery of oil import volumes is felt, but the underlying position seems definitely to be improving. For the year as a whole, we expect to see a decline in the merchandise trade deficit, measured on a census basis, from $28.5 billion in 1978 to around $24 billion in 1979. This estimate is of course still subject to a wide margin of error, but it would imply a current account deficit of the order of $5 billion for 1979 compared with $14 billion in 1978. Looking ahead to 1980, the current account deficit should improve further as import demand slackens and exports maintain the levels they have gained as a result of recent improvements in competitiveness. Much depends on movements in the terms of trade, particularly with respect to oil, and on how much world growth slows next year, but we expect that the current account will probably be in rough balance in 1980.

27. The risks to this forecast seem mostly on the negative side. High interest rates and continuing high rates of inflation threaten to raise the personal savings ratio even higher than we have assumed and to cut further into the housing sector and business investment. This would cause a much deeper and perhaps prolonged recession. The inflation rate continually seems to exceed predictions and there is a far higher probability of wages accelerating above the levels assumed than of their moderating from this year's rates. However, the balance of risk on the current account seems to be in the direction of a substantial surplus appearing in 1980. Should the recession prove to be severe, and particularly if import volumes plummet the way they did in the 1975 recession, a surplus of the order of $10 billion would seem quite possible unless oil prices rise much faster than the general rate of inflation.

POLICY OUTLOOK

28. The main topic of interest at the moment is whether a tax cut will be put in place during the fiscal year 1980, which starts this October. Congress is scheduled to complete work on the second Budget Resolution towards the end of this month, and in the limited time available it does not seem likely that there will be any change from the policy proposed by the President in January and adopted provisionally by the Congress in May. This held tax rates at essentially their present levels and put a tight ceiling on Federal expenditure. However, the issue can be raised again any time during the financial year and speculation centres on whether the President will withdraw his recently repeated rejection of a tax cut and propose in his January Budget message that Congress act speedily to make major reductions in personal, business or pay-roll taxes.

29. The tax cuts most widely discussed would provide relief of the order of $20-$25 billion in calendar 1980. These would not be much larger than necessary simply to offset fiscal drag and other previously legislated changes, but they would clearly make the balanced-budget target in fiscal 1981 impossible to achieve. The

/ administration

administration is particularly concerned about the psychological and political costs of what would be seen as a softening of its resolve to reduce inflation if it were to propose significant tax cuts.

30. The Administration is also facing major questions of principle over the handling of Chrysler's difficulties. The company has severe structural and managerial problems which predate, but have been magnified by, the current low level of demand in the automobile industry and an acute shortage of cash. Chrysler lost over $200 million in the second quarter of the year and expect losses for the whole year to exceed $700 million. They are about to present a detailed request for Federal aid, probably in the form of advance tax credits and loan guarantees, and have already disposed of some of their assets and laid off workers to show their determination to deal with the crisis. Treasury Secretary, Miller, has, however, already reiterated his opposition to cash help and has put limits on the size of loan guarantee he might be prepared to recommend to Congress.

31. The Senate failed to complete work on the Windfall Profits Tax on oil companies before the Congressional recess and there are few signs of speedy passage of the measure now that Congress has resumed. Interest is focussed mainly on the way in which proceeds from the tax might be spent in order to promote domestic production or conservation.

32. The Administration has published preliminary proposals for the second year of its voluntary anti-inflation programme. Final details will be made public in the middle of the month, but the Administration has already confirmed that the reference period will continue to be an October-September year. It is likely that the new wage and price standards will cover both years of the programme taken together but at a slightly higher rate than the first year standards. This will give more flexibility to those who complied fully with the standards during the first year. Efforts are still being made to find some formula which will gain acceptance by organised labour.

/ Expenditure

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penditure on GNP (quarterly data)
(1972 prices $b sa annual rate)

	1979(2)	% pa change over last qtr		% pa change over same qtr yr earlier	
GNP	1422.1	-2.4		1.9	
Personal Consumption	914.8	-3.0		2.2	
durables	144.5	-14.3		-2.2	
nondurables	344.0	-4.6		1.4	
services	426.3	2.7		4.6	
Business fixed investment	145.9	-3.5		4.0	
Housing investment	57.2	-3.4		-6.1	
Change in business inventories	18.5	12.3	(A)	15.6	(A)
Govt purchases of goods & services	272.3	-3.4		0.4	
Federal	98.2	-11.0		1.7	
State & Local	174.1	1.2		-0.3	
Net exports of goods & services	13.4	17.0	(A)	12.3	(A)
Exports	116.2	-2.7		6.4	
Imports	102.8	11.7		6.1	
Price deflator (1972=100)	163.8	9.2		8.6	
GNP (current prices)	2329.4	6.7		10.7	
Net exports (current prices)	-7.6	-4.0	(A)	-7.6	(A)

B Monthly indicators

	Month		% pa change over 1 mth earlier	% pa change over 3 mths earlier	% pa change over year earlier
Industrial production	Jul	152.1	-1.6	3.5	3.4
Capacity utilisation mfg	Jul	85.6	-5.4	1.4	0.9
Retail Sales ($b current prices)	Jul	71.7	4.4	2.1	8.3
Car Sales (m units pa)	Jul	10.5	228.4	-19.7	-4.1
Housing Starts (m units pa)	Jul	1.8	-58.3	12.9	-14.5
Merchandise exports ($b)	Jul	15.7	63.8	62.3	34.4
Merchandise imports ($b)	Jul	16.8	-10.8	19.8	15.3
Civilian employment (Hsehld Svy)	Aug	96.9	-3.8	2.4	2.3
Unemployment Rate (%)	Aug	6.0	5.7 (A)	5.8 (A)	5.9 (A)
Consumer Price Index (1) (2)	Jul	218.9	12.7	12.8	11.3
Producer Price Index (2)					
finished products	Aug	217.3	15.4	11.7	11.1
all commodities	Aug	238.1			13.2
Average hourly earnings (pnf adj)	Aug	231.0	3.2	6.5	7.6
Average hourly earnings (pnf)	Aug	6.2	0	4.7	7.7
Composite indices					
12 leading indicators	Jul	139.3	-4.2	-1.7	-1.3
4 coincident indicators defl	Jul	145.0	-0.8	2.2	3.2
6 lagging indicators	Jul	166.0	12.3	10.2	15.7
Inventory levels ($b cur prices)	Jun	$406.7b (A)	$401.7b (A)	$391.7b (A)	$360.4b (A)

(1) All urban consumers

(2) % changes are seasonally adjusted; levels are not seasonally adjusted.

(A) Implies actual value in the period specified NOT percentage change.

/ Monetary

Monetary indicators

	Latest Month		% change at annual rate over previous 4 wks	13 wks	52 wks
Federal reserve credit outstanding $b sa (1)	Aug	131.3	-0.7	9.0	0.7
Monetary base $b (1)	Aug	149.5	12.9	11.5	8.5
M1 $b	Jul	372.1	10.6	8.8	4.9
M2 $b	Jul	914.0	13.5	11.3	7.7
Total bank reserves (1) $b	Aug	41.1	9.2	6.5	8.4
Consumer instalment credit	Jun	292.5	22.4	21.9	17.1
Commercial & industrial loans by all commercial banks	Jul	259.9	5.7	20.6	17.7

	Latest Month		Previous Month	3 mths Previous	Year Previous
Commercial bank prime rate (1)	Aug	11.88	11.50	11.75	9.10
3 mth Treasury bills	Aug	9.51	9.26	9.62	7.08
Corporate Aaa bonds	Aug	9.23	9.20	9.50	8.69
3 mth CD rate	Aug	10.67	10.14	10.17	8.04
US Govt bond rate (20-yr)	Aug	8.96	8.94	9.21	8.45
Federal Funds rate	Aug	10.92	10.50	10.24	8.03

(1) Average of latest 4 weeks

USA

Prime Minister

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MIPT.
US DEFENCE BUDGET
1. IN THE COURSE OF HIS TESTIMONY ON 3Ø JULY TO THE SENATE ARMED SERVICE COMMITTEE ON SALT II, VANCE CONFIRMED THAT, OWING TO HIGHER INFLATION LEVELS THAN ORIGINALLY ESTIMATED AND TO CONGRESSIONAL CUTBACKS IN ADMINISTRATION REQUESTS FOR DEFENCE FUNDING, THE US WOULD NOT MEET THE 3% TARGET FOR FY1979 OR 198Ø QUOTE UNLESS MORE IS ADDED UNQUOTE. VANCE ADDED THAT IT WAS QUOTE ESSENTIAL THAT WE CARRY OUT UNQUOTE THE 3% PLEDGE TO THE ALLIANCE: QUOTE WE WILL PLAN FOR IT ... AND WE WILL MEET IT UNQUOTE.
2. THE ADMINISTRATION'S MID-SESSION BUDGET REVIEW PUBLISHED LAST MONTH OF THE PROSPECTS FOR 198Ø RAISED THE INFLATION ESTIMATE FOR THAT CALENDAR YEAR TO 9%. THE FY198Ø (WHICH STARTS IN OCTOBER 1979) INFLATION RATE FOR WEAPONS PROCUREMENT AND R AND D HAD ORIGINALLY BEEN CALCULATED AT 7%, RESULTING IN A DEFENCE BUDGET REQUEST FOR THAT FINANCIAL YEAR OF DOLLARS 122.7 BILLION FOR OUTLAYS WHICH WOULD HAVE MEANT A 3% INCREASE IN REAL TERMS (OUR TELNO 263). UNDER THE 9% INFLATION ESTIMATE, THE ADMINISTRATION'S FIGURE FOR FY198Ø WOULD NOW HAVE TO BE INCREASED BY SOME DOLLARS 2.Ø BILLION TO MAINTAIN THE 3% TARGET.
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MONTHLY ECONOMIC REPORT FOR THE UNITED STATES

SUMMARY

1. It now seems clear that GNP fell in the second quarter of this year after having risen only marginally in the first quarter. The further increases in oil prices announced at the Geneva meeting of OPEC and the President's commitment at the Tokyo summit to set a limit on oil imports mean that the chances of the economy recovering quickly from the current sluggishness seem very slight. The Administration is now talking more openly of the likelihood of recession this year.

2. The energy situation is already having a crucial impact on the economy. Fuel shortages have been directly responsible for some disruption to spending patterns and production but they also, more importantly, provoked independent truck drivers to organise widespread dislocation of deliveries of fuel and freight. The automobile sector, generally considered the most important determinant of cyclical changes in industrial activity, has been suffering from a sharp drop in demand accentuated by a strong swing towards the more fuel-efficient imported models. And the loss in consumer purchasing power caused by the 20% rise in retail petrol prices between December and May has contributed significantly to the slowdown in retail sales.

3. The Department of Commerce's preliminary estimate for the April to June quarter (based on only two months' figures) reportedly suggests that GNP fell at an annual rate of 2.4%. Retail sales in April and May were provisionally estimated to have fallen below the average level of the first quarter in money terms, industrial production was on average little changed and the merchandise trade balance deteriorated on a dollar basis. Employment failed to grow between March and June and total hours worked suffered a declin[e]. The unemployment rate of 5.6% in June was nonetheless the lowest in nearly five years.

4. Consumer prices in May rose by a further 1.1%, taking the level to nearly 11% above that of a year earlier. Food and home-purchase

/COSTS

costs no longer stand out as having experienced an appreciably worse rate of increase than other parts of the consumer price index, but all fuel-related items have grown at two or three times the rate attributed to other goods. The eventual passing-through of the latest round of crude oil price increases and the high rates of inflation recently experienced at the wholesale level for finished goods other than food suggest that significant improvements in the CPI are unlikely to be sustained over the next few months. Although, as recently as March, Administration officials were keeping to their forecast of a rise of only 7.4% in the CPI through 1979, officials are now unofficially conceding that it is more likely to be in the region of 10%; some private-sector economists are expecting the 13% annual rate to continue throughout this year.

5. The dollar suffered its worst period this year on the foreign exchanges in the run-up to the OPEC and Tokyo summits. It fell over 4% against the Deutschemark, despite support from the Fed and the Bundesbank. The merchandise trade figures for May were viewed as rather disappointing. The deficit widened to $2.5 billion, largely on account of a failure by manufactured exports to sustain their recently sharply improved trend. However, the current account of the balance of payments went into surplus in the first quarter for the first time in over two years.

6. Short-term market interest rates softened in June as evidence accumulated of a slowdown in the economy. Three-month Treasury bill rates were particularly weak, with yields falling from over 9½% p.a. to 8¾% through the month. The Fed however kept their key operating rate, the Federal Funds rate, at or above the 10¼% level and the recent narrowing of differentials between US and other countries' interest rates has revived expectations that there might be a further rise in US rates in advance of a very gradual reduction later this year.

7. The weakness in the economy has already produced calls in Congress for tax cuts next year aimed particularly at offsetting the effects of fiscal drag and providing supply-side incentives. The Administration has so far resisted such initiatives, apparently preferring to wait until there is definite evidence of a sustained increase in unemployment before changing its policy stance. A major reappraisal of energy and economic policies is currently being undertaken by the President at Camp David.

PRINCIPAL

Principal Monthly Indicators

		% change (annual rate) On Previous Month	Last 3 months on previous 3 months	Last 3 months on 3 mths yr earlier
Industrial Production	May	16.3	1.3	6.1
Retail Sales (current prices)	May	-1.8	2.8	10.8
Consumer Prices	May	14.0	13.5	10.5
Average Earnings (adjusted)*	Jun	4.9	6.6	7.8
Index of Leading Indicators	May	4.3	-3.9	0.4
Money Stock (M1)	May	0.7	3.1	4.4
S & P Index of "500" shares	May	-24.3	6.2	2.4

		Latest Month	Average of latest 3 months	Average of 3 mths yr earlier
Unemployment Rate (%)	Jun	5.6%	5.7%	5.9%
Merchandise Trade Balance	May	-$2.5b	-$1.8b	-$2.7b
Interest Rate on CD's	Jun	9.8 %	10.0%	7.4%

Quarterly National Expenditure Data

(1979Q1)	% change (annual rate) On 1 qtr earlier	On 1 year earlier
GNP	0.8	4.7
Consumers' Expenditure	0.7	4.6
Business Fixed Investment	5.1	9.6
Government Expenditure	-4.2	1.6
Exports of goods and services	13.1	16.2
Imports of goods and services	5.2	6.9

Balance of Payments

(1979 Q1)	Latest quarter	Previous quarter
Current Account ($ billion)	0.2	-0.3

Exchange Rate		Actual % Change On Previous Month	On Year Earlie
Dollar effective rate	May	0.8	-4.4

* Average hourly earnings of production or nonsupervisory workers in the private nonfarm economy adjusted for interindustry employment shifts and for overtime in manufacturing.

ECONOMIC ACTIVITY

8. An unusual leak of the Department of Commerce's "flash" estimate of GNP for the second quarter of 1979 showed a decline at an annual rate of 2.4% from the previous period. The estimate was based only on partial data for the first two months of the quarter (apart from some gloomy indicators of automobile sales in early June) but data since then have served if anything to push the estimate down even further.

9. The second-quarter figures have been widely heralded as evidence that the expected recession is now under way and that activity may well carry on declining for the rest of this year. Although it does seem likely that the economy will stay very sluggish or decline this year, it is rather early to draw a definite conclusion about the profile of activity from current data alone. The particularly high rate of inflation experienced in the second quarter and the disruptions to conventional buying patterns induced by the petrol shortage produced a significant fall in retail sales in real terms in the quarter. As discussed further in para. 29 et seq real personal disposable incomes can be expected to stay tightly squeezed this year but there is no reason to expect the rate of decline to be as fast as that experienced in the second quarter.

10. Analysis of retail trade figures since January demonstrates the extent to which fluctuations in the gasoline situation have dominated the overall consumption picture. Sales of automobiles and associated products fell by over 7% in money terms between January and May and preliminary reports suggest that the June drop could be much sharper. Meanwhile, total expenditure on gasoline etc. rose by 10%. Full figures are given in the table below, although April and May data are subject to substantial revision and the seasonal adjustment used is not necessarily very reliable.

Retail sales (current dollars, millions)

	Jan.	Feb.	March	April	May
Automobiles and accessories	15010	14930	14970	14180	13900
Other durable goods	10240	10100	10480	10360	10240
Gasoline service stations	5350	5570	5560	5680	5850
Other non-durable goods	40250	40520	41030	41000	41120
Total retail trade	70850	71120	72040	71220	71110

11. Whilst petrol shortages, occasional dislocations caused by action taken by independent truckers and measures to conserve energy usage have already caused considerable changes to be made in vacation and other expenditure plans, it does not seem likely that the resultant temporary increase in savings of households will not eventually find some alternative spending outlet. The final effect of the energy crisis (allowing for the impact on the overalll price level) may therefore turn out to be far more critical to the

PATTERN

pattern of consumption this year than its level and sluggish aggregate figures for the early summer months are not necessarily a good guide to later developments. On the other hand, the recent substantial falls in indices of consumer confidence suggest that an abrupt and uncompensated increase in the savings ratio of the sort which occurred at the beginning of 1975 could happen again, so that the risk of further sharp falls in personal consumption cannot be completely discounted.

12. The only other major element of final expenditure to have shown the weakness evident in personal consumption has been housing but figures so far this year have indicated less of a slow-down than had been widely expected. Housing starts rose just above 1.8 million p.a. in May to produce an average so far this year of about 1.7 m. starts compared with 2 million p.a. in 1978. However, average mortgage rates are still climbing and the thrift institutions are suffering an unusual net outflow of funds. Some of the institutional impediments to housing finance (such as usury ceilings) have recently been softened, but price factors now seem to be exerting an influence both through demand for mortgages and the willingness of thrifts to compete for funds.

13. Business fixed investment still seems to be growing at a reasonable rate. The latest BEA survey of capital spending plans, taken in late April and May, showed that some further real increase was expected in the second quarter of this year and construction activity was reported fairly strong. The survey was also less pessimistic than previous ones had been about prospects for the rest of 1979, indicating a total increase for the year of about 4½% in real terms. Orders for non-defence capital goods in May recovered some of the sharp fall experienced the previous month and machine tools were particularly strong. The impact of the oil price increases and the likelihood of the economy proving to be very weak this year may however soon start to have an effect on purchasing plans.

14. The ratio of inventories to sales rose sharply in April as inventories increased at their fastest rate (1.4% in the month) for a year. Much of this rise may have been an unintentional response to the decline in final sales in the month but there is still little evidence outside the automobile sector that stocks are in danger of becoming excessive.

15. Industrial production rebounded in May to its March level, implying that the size of the drop recorded in April may have been exaggerated by the particular hours-worked index that was used as well as the Teamsters dispute. However, even allowing for these factors, the index has risen by less than 1% so far this year.

EXTERNAL ACCOUNT

16. The merchandise trade deficit widened in May to $2.5 billion compared with a monthly average so far this year of $1.8 billion. Most categories of exports showed some decline, as they had in April, and imports of consumer and intermediate manufactured goods rose significantly. However, the general picture on manufactured trade this year remains fairly encouraging and the improvement of $17 billion expected by the Administration for all non-fuel trade between 1978 and 1979 still looks comfortably attainable.

| 17.

17. The improvement in non-fuel trade will nevertheless probably be swamped from the second half of this year by the extra cost of fuel imports. Imports of fuel amounted to roughly \$42 billion in 1978 and now seem likely to rise above \$55 billion this year. Even in the absence both of any further increases in OPEC prices and any significant restocking by the oil companies, the fuel import bill for 1980 could exceed over \$65 billion as the full effect of the latest round of price increases come through. Some additional exports to OPEC countries can be expected to be achieved by the US, but with growth elsewhere likely to slow appreciably, the likelihood of the US being able to maintain the recent rate of improvement in the balance of payments on current account seems fairly small. In the first quarter of the year the current account went into surplus for the first time since the beginning of 1977.

18. The dollar suffered its first major period of weakness this year in the run-up to the OPEC meeting and Tokyo summit. It declined through June nearly 2½% in effective (trade-weighted) terms and over 4% against the Deutschemark in spite of apparently substantial intervention by the Fed and the Bundesbank. Uncertainty about what proposals the President would recommend following the Tokyo commitment to restrain oil imports to the 1977 level of 8½ mbd contributed to some further hesitancy at the beginning of July.

FINANCIAL MARKETS

19. The monetary aggregates are continuing to show a confusing picture. M1 grew by an exceptionally large \$6.9 billion in the first week of June but has since steadied at a level about 1% above that of May. M2 has now been accelerating perceptibly since the basically flat October-February period. Its rate of growth since the end of March has accelerated to 10% p.a., including the strong April period.

20. The Federal Reserve Board has meanwhile been keeping Federal Funds rates fairly steady. Since the small upward adjustment at the end of April to 10¼% there have been occasional periods when the Fed has seemingly been content to see rates approaching 10½% for a while but this never seems to have developed into a new target. Other short-term rates have meanwhile dropped significantly as the markets have perceived signs of slackness in the real economy. Yields on 3-month Treasury Bills fell from 9½% at the beginning of June to 8¾% by the end. Expectations that bond prices may have passed their low point for the cycle have however receded somewhat as the view has strengthened that dollar weakness might force the Fed to tighten policy at least temporarily in the near future.

LABOUR MARKET AND PRICES

21. Employment in June as measured by the household survey returned roughly to its March level at 96.8 million, whilst the establishment survey showed a further slight increase. Average hours worked failed to return to their March peak, so that there seems to have been a net reduction in total labour input through the second quarter.

/22.

22. The unemployment rate fell marginally in June to 5.6% of the labour force, but the drop was wholly accounted for by a fall in teenage unemployment. As June is the first month of the summer vacation there was in fact a large rise in reported teenage unemployment during the month but the seasonal adjustment factor, somewhat unreliably, more than offset it. Unemployment has stayed very close to 5.8% for nearly a year.

23. Consumer prices again rose by 1.1% in May, boosted in particular by a 1.8% increase in transport costs. Food prices have begun to moderate, but the falls which have been registered in the producer price index for finished goods have not yet been reflected at the consumer stage. Producer prices for foods fell by 1.2% in June, following a 1.3% drop in May and a 0.3% drop in April. Other elements of the finished goods price index have continued to increase at rates in excess of 1% per month and at the crude goods stage there has been a significant acceleration. The price of non-food materials is now over 20% above the level of a year ago.

24. There are no indications yet of an acceleration in labour costs to match these price movements. Poor productivity growth has meant that unit labour costs have been rising at rates approaching 10% p.a. for the last year but earnings do not seem to have shown any tendency to accelerate. In fact the adjusted hourly earnings index rose by only 0.4% in June leaving the level 7.6% above that of a year earlier. It appears likely that this moderate performance is almost totally attributable to restraint in the majority, non-union sector - with the Administration's wage guidelines being generally kept - because details of settlements made by the major bargaining units and the effects of existing cost-of-living adjustment clauses suggest that rather higher rates of increase are being attained in the unionised sectors.

25. There have recently been several large wage settlements which have severely stretched or broken the wage standards. A detailed assessment made by a former officials of the Council on Wage and Price Stability of the Teamsters' April agreement suggests that it may have been worth about 29 % over three years compared with the base line (before exceptions) of 22½% set by the Administration. The costly settlement made by United Airlines with its machinists was determined by COWPS to have exceeded both comparable agreements made by other airlines before the policy was put in place and the Administration's formal standards. A "finding of non-compliance" has now been filed by the Administration, which is the first stage in instituting any action against the company. Similar moves have been started against the major rubber companies, whose recent settlement appears likely to cost 38% in three years if the rate of inflation averages 9% p.a.

26. The way is now theoretically clear for the Administration to start denying Federal contracts to companies who have broken their wage or price guidelines. The lower court ruling which declared unconstitutional the President's right to invoke selective sanctions has now been overturned by the appeals court and the Supreme Court has to date not chosen to hear plaintiffs on the issue. Action has already been started against Amerada Hess and Ideal Basic for violating the price guidelines. There are however further difficulties on the wages side because, of the two major violators to date, United Airlines does not hold large Federal contracts and any action against the Rubber Companies would probably necessitate the Administration turning to foreign sources. General Electric may find themselves the first company to face serious sanctions following

/THEIR

their tentative settlement worth apparently over 30% over three years with the electrical workers.

ECONOMIC PROSPECTS

27. The recent further increase in oil prices has made a recession this year (in the technical sense of six months of declining output) by far the most likely prospect for the US economy. It also means that there is even less chance than previously thought that there will be a recovery in the earlier part of 1980. If, as now seems probable, GNP at the end of 1979 is little changed from the end of 1978 and there is only very slow growth through 1980, the year-over-year growth rates will probably register about 2% for 1979 and well under 1% for 1980. The Administration's mid-year Budget review timed for release on Friday, 13 July is likely to show only a slightly less gloomy prospect.

28. The inflation outlook is critical to the forecast for the real side of the economy. Although the upsurge in inflation at the beginning of the year could in large part be attributed to special circumstances in food and housing, it is now energy which is the dominant proximate influence. A large part of recent increases in oil prices has yet to be passed through to the consumer (although there is evidence that margins in the wholesaling and retailing petroleum sectors have recently risen unsustainably fast) and, year-on-year, consumer prices (the CPI) may well rise by 11% between 1978 and 1979 and nearly as fast again in 1980. The CPI is a rather biassed measure of changes in the actual cost-of-living because of its weighting system, particularly on the housing side, but even the implicit deflator for consumer expenditure may increase by nearly 10% this year and next. It grew at an annual rate of 10½% in the first quarter of this year and will probably significantly exceed this rate in the second.

29. There are no signs yet that earnings are beginning to accelerate to match this rise in the inflation rate, so that households' purchasing power is being rapidly eroded. The tax cut in January provided some temporary relief, but offsets since then from the effects of inflation and fiscal drag have probably cut real disposable incomes to levels well below those of the end of 1978. Increases in employment have also been small. Although it seems likely that wage increases will eventually start to respond to the recent movements in prices (despite slacker demand and the existence of the wage standards) little growth can be expected this year or next in real personal disposable incomes unless large tax cuts are instituted. As consumers also seem more likely in current circumstances to react to the increased uncertainty about inflation and unemployment by raising their rates of saving rather than maintaining their consumption patterns, the outlook for consumers expenditure is rather bleak. The recent extreme weakness in retail sales may exaggerate this tendency because of the particularly disruptive effect on automobile and other sales of the energy situation, but a sustainable recovery seems unlikely.

30. The main question is still whether the general slowdown foreseen for the economy will turn into a severe recession. There are certainly few sectors of demand which would seem to be strong enough to offset the effects of the expected deceleration in consumers expenditure. Housing seems likely to weaken further this year and government purchases will probably show little growth in real terms although business fixed investment and the

/TRADE

trade balance should continue to provide some small stimulus. The main uncertainties seem to relate to business inventories and personal savings. In the last recession, in 1974/75, particularly sharp movements in these areas were responsible for a contraction in demand that surprised most observers by its severity. There are as yet no indications that a similar phenomenon will happen again but the inflation rate and interest rates have already returned to similar levels and the risks of some substantial drop in demand are therefore in theory clearly present again.

31. Prospects for a sustained improvement in the current account of the balance of payments have been further eroded by the oil price increases. Although the deficit in 1979 may still be in the region of $10 billion there could be a sizeable deterioration in 1980 unless the recession does turn out to be very severe.

POLICY OUTLOOK

32. The Administration held firmly in the first few months of this year to the view that the economy was unlikely to go into recession this year and that any fiscal stimulus would be inappropriate. They hoped that the economy would gradually slow down and allow their anti-inflation programme to take effect without their having to risk particularly large increases in unemployment. This position has now been forced into a substantial change by the oil price increases and the Administration is beginning to accept publicly that a recession is likely. Furthermore, it is now privately reconsidering whether any policy response should after all be proposed.

33. One of the constraints which previously prevented the Administration from recommending any tax cuts in 1980 was the perceived political need to reduce the size of the Federal deficit. The intention was to bring the deficit down from an estimated $37 billion in the current fiscal year to below $30 billion in fiscal 1980 and hopefully towards balance in 1981. Buoyant tax receipts so far this year have however made it probable that this year's deficit could turn out to be well below $30 billion and the 1980 deficit, helped by the first receipts from the proposed windfall profits tax on oil, could fall comfortably below $20 billion (if unemployment does not rise significantly). This would then leave a certain amount of room for tax cuts to be made for at least part of the fiscal year without immediately implying abandonment of the cause of fiscal conservatism.

34. The economic case for granting a tax cut in 1980 is also now becoming more generally accepted. The oil price increase is frequently likened to an untoward excise tax on the economy which it might, in some circumstances and to some degree, be appropriate to offset by fiscal means. And it is appreciated that the resultant squeeze on real incomes could (in spite of restrained demand management policies) lead to defensive demands for much higher nominal wage increases if no other compensation is offered. Perhaps most significantly, arguments in favour of a tax cut on supply-side grounds are providing a respectable justification for measures which might otherwise be rejected because of their short-term implications for the Federal deficit.

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35. The Administration is therefore privately conceding the advantages of granting some tax cuts next year but it seems likely that they will not choose to acknowledge it publicly for some time because of its possible effects on confidence and the Administration's image of inconsistency on economic policy. In Congress, the running is at the moment being made by the Chairman and ranking minority member of the Joint Economic Committee, Senator Bentsen and Congressman Clarence Browne, with Russell Long, Chairman of the Senate Finance Committee adding powerful support for a sizeable tax cut. In addition, many Republicans sympathetic to Jack Kemp's arguments for increasing incentives by making significant reductions in tax levels, could be expected to approve a tax package of appropriate composition. If they were to form a coalition with liberal Democrats, concerned to provide a stimulus to the economy, it is possible that momentum for a tax cut could build up very quickly.

36. There seems to be less scope for change on the monetary side. Although Fed Chairman Miller has up until now, like the Administration and most influential parts of Congress, publicly expressed support for the view that any pronounced weakening of the economy should be offset by monetary changes rather than enlargement of fiscal deficits, the Fed's freedom of manoeuvre currently seems very limited. Interest rate differentials compared with other countries have recently narrowed significantly and the dollar is clearly vulnerable to speculative moves because of underlying pressures associated with the worsening in the cost-competitive position of the US and fears about the consequences of the oil price increases. Some easing of monetary policy could be achieved by speeding up the process of deregulation (thus, for instance, providing cheaper and more plentiful funds for the housing sector) but a generalised reduction in short-term interest rates seems unlikely in the absence of a really severe recession. In fact, some small (and temporary) upward movement over the next few months seems possible if the dollar does come under pressure.

37. The immediate policy discussions in the economic field at the moment are anyway centred on the energy question. The short-term commitments on oil imports made by President Carter at the Tokyo summit should not be difficult to achieve provided that the rate of economic growth stays slow and there are steady oil flows from Alaska, but in the medium-term some radical changes will be needed. A very sizeable programme to produce synthetic fuels is under consideration, together with some relaxation of environmental standards and a set of emergency measures. Some of the finance for a synthetic fuels programme would be provided by receipts from the windfall profits tax, legislation for which has passed the House in slightly tougher form than originally proposed by the Administration.

38. The bold moves being contemplated on energy clearly threaten to undermine other current objectives of domestic economic policy. Restraints on energy usage could potentially impede activity levels even below those currently expected and most would further aggravate domestic inflation rates. The latter is bound to worsen the climate in which further changes to the Administration's voluntary anti-inflation programme can be considered. But the pressures on the Administration and Congress to be able to demonstrate some action to promote significant improvements in the economy during the election year of 1980 are becoming increasingly urgent and the general reappraisal which the President is currently making at Camp David could well produce some major changes in direction.

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Expenditure on GNP (quarterly data).
('972 prices $b sa annual rate)

	1979(1)	% pa change over last qtr		% pa change over same qtr yr earlier	
GNP	1417.6	0.8		4.7	
Personal Consumption	913.5	0.7		4.6	
durables	148.7	-3.7		7.9	
nondurables	345.3	-3.6		3.6	
services	419.5	6.3		4.2	
Business fixed investment	146.7	5.1		9.6	
Housing investment	58.0	-14.4		-2.5	
Change in business inventories	10.6	8.2	(A)	12.3	(A)
Govt purchases of goods & services	276.4	-4.2		1.6	
Federal	102.0	-1.9		0.8	
State & Local	174.4	-5.5		2.1	
Net exports of goods & services	12.5	10.2	(A)	2.9	(A)
Exports	115.2	13.1		16.2	
Imports	102.8	5.2		6.9	
Price deflator (1972=100)	159.9	8.9		8.7	
GNP (current prices)	2267.3	9.8		13.8	
Net exports (current prices)	-3.7	-7.6	(A)	-24.1	(A)

Monthly indicators

	Month		% pa change over 1 mth earlier	3 mths earlier	year earlier
Industrial production	May	152.1	16.3	2.9	5.7
Capacity utilisation mfg	May	85.6	13.5	-1.4	2.0
Retail Sales ($b current prices)	May	71.1	-1.8	-0.1	10.7
Car Sales (m units pa)	Jun	9.6	-85.6	-66.6	-19.1
Housing Starts (m units pa)	May	1.8	85.9	206.3	-10.3
Merchandise exports ($b)	May	13.9	-1.8	10.9	17.6
Merchandise imports ($b)	May	16.3	25.5	48.4	16.7
Civilian employment (Hsehld Svy)	Jun	96.8	5.6	-0.4	2.0
Unemployment Rate (%)	Jun	5.6	5.8 (A)	5.7(A)	5.7(A)
Consumer Price Index (1) (2)	May	214.1	14.0	13.6	10.8
Producer Price Index (2)					
finished products	Jun	213.4	6.2	7.4	9.7
all commodities	Jun	233.1			11.3
Average hourly earnings (pnf)	Jun	6.1	6.1	6.1	8.1
Average hourly earnings (pnf adj)	Jun	228.4	4.9	5.6	7.6
Composite indices					
12 leading indicators	May	141.2	4.3	-4.7	-0.4
4 coincident indicators defl	May	144.6	3.4	-0.8	3.7
6 lagging indicators	May	162.2	-0.7	9.1	15.9
Inventory levels ($b cur prices)	Apr	$397.1b(A)	$391.7b(A)	$383.0b(A)	$350.5b(A)

(1) All urban consumers

(2) % changes are seasonally adjusted; levels are not seasonally adjusted.

(A) Implies actual value in the period specified NOT percentage change.

/MONETARY

Monetary indicators

	Latest Month		% change at annual rate over previous 4 wks	13 wks	52 wks
Federal reserve credit outstanding \$b sa (1)	Jun	128.8	2.2	8.7	5.9
Monetary base \$b (1)	Jun	146.7	10.4	7.7	7.8
M1 \$b	May	364.5	0.7	6.7	4.0
M2 \$b	May	893.8	5.5	8.0	6.8
Total bank reserves (1) \$b	Jun	40.4	-0.9	-3.6	7.2
Consumer instalment credit	Apr	282.4	19.1	10.7	18.7
Commercial & industrial loans by large banks		NOT	AVAILABLE		

	Latest Month		Previous Month	3 mths Previous	Year Previous
Commercial bank prime rate (1)	Jun	11.63	11.75	11.75	8.62
3 mth Treasury bills	Jun	9.09	9.62	9.49	6.71
Corporate Aaa bonds	Jun	9.25	9.50	9.36	8.75
3 mth CD rate	Jun	9.78	10.17	10.15	7.81
US Govt bond rate (20-yr)	Jun	8.93	9.21	9.09	8.52
Federal Funds rate	Jun	10.27	10.24	10.09	7.57

(1) Average of latest 4 weeks

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USA

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Prime Minister

(Summary only)

MONTHLY ECONOMIC REPORT FOR THE UNITED STATES

SUMMARY

1. There is now firmer evidence that the US economy is entering a sustained period of slower growth. The growth rate of GNP for the first quarter is estimated to have been only 0.4% p.a. and output probably declined during April. Special factors, such as unusually severe weather conditions, have been partly responsible for the recent poor performance, but real incomes have been so severely squeezed by the recent high rate of inflation that they seem unlikely to be able to support any significant growth in personal consumption this year. The housing sector has already begun to decline.

2. Retail sales increased only marginally in April in money terms. So far this year they have probably declined in real terms by over 3%. Industrial production, which was particularly heavily affected by the effect of the Teamsters' dispute on the automobile industry, fell by 1% in April and total hours worked in the economy failed in April and May to maintain the steady expansion of previous months. Unemployment has stayed at roughly 5.8% of the labour force since last August.

3. There is little good news on inflation. Consumer prices rose by 1.1% in April, taking the average annual rate of increase so far this year to roughly 13%. Although there has been some moderation in price increases recently at the crude goods stage, the energy situation threatens to delay any further improvement and prices of wholesale finished goods have continued to rise at well over 12% p.a. These rates of increase have not so far been matched by wages. Average earnings increased by only 7½% in the year to May, compared with over 8% the year before and a short period in excess of 8½% p.a. Some of this small deceleration was evident before the most recent phase of the anti-inflation programme was announced in October, but the fact that few settlements have recently been made at rates approaching the current rate of inflation may be taken as a sign that the wage guidelines have had at least a temporary effect on earnings. However, their continued effectiveness has been put in further doubt by the probable psychological impact of the recent Court ruling that use of Federal procurement sanctions to support the guidelines is illegal.

4. The monetary aggregates have slowed down in recent weeks since the

/sudden

sudden strong burst recorded in April, which followed a long period of zero growth. There are still wide differences of opinion about the implications of these movements in the monetary indicators, but the Federal Reserve Board seem to be holding to a policy of keeping interest rates fairly steady. The key short-term interest rate - the Federal Funds rate - remained at about 10¼% throughout May. Much of the change in behaviour of the monetary aggregates can be explained by moves towards deregulation of the financial system. The momentum of these changes has been recently maintained by allowing better terms to small savers and endorsement in principle by the Administration of proposals designed to allow interest rates on all deposits to adjust, in time, to market levels.

5. The merchandise trade deficit widened in April to $2.2 billion, but overall the performance of manufactured trade so far this year has nevertheless been very encouraging. The Administration expect the current account deficit for 1979 to fall to about $10 billion compared with $16 billion in 1978. This forecast assumes that the fuel import bill will rise by about 25% between the years, but for each additional increase in the price of oil of 5% the trade balance is expected to worsen by over $2½ billion in a full year. The dollar fell slightly on news of the worse-than-expected trade deficit but it is still over 5% above the level of the beginning of the year in effective (trade-weighted) terms.

6. With the continuing uncertainty about the depth of the slowdown in the economy through the remainder of this year and into 1980, fiscal and monetary policies are very much in the balance. The energy issue seems likely to be crucial. The sharp increases in oil prices have worsened the already worrying outlook for inflation and there is little scope for the effect of these increases on the level of domestic demand to be offset by fiscal action. The Federal Reserve Board has shown a reluctance to tighten monetary policy further in case it should precipitate a recession, but it seems equally unwilling to lower interest rates because of inflationary risks.

7. Congress has now completed work on the First Budget Resolution for fiscal year 1980, which starts this October, and the targetted deficit of $23 billion is even lower than the President proposed in January. It allows for less real growth in Federal expenditure and does not include the small tax cut which the President intended to give through his Real Wage Insurance scheme. In fiscal 1981, both the Administration and Congress are aiming for a balanced budget target. No thought is being given to ways in which a stimulus might be given to the economy in this period, although the position may change if unemployment starts to rise sharply.

/Principal

Principal Monthly Indicators

		% change (annual rate) On Previous Month	Last 3 months on previous 3 months	Last 3 months on 3 mths yr earlier
Industrial Production	Apr	-11.2	1.9	7.2
Retail Sales (current prices)	Apr	5.9	9.5	11.9
Consumer Prices	Apr	14.0	12.7	10.2
Average Earnings (adjusted)*	May	1.6	7.2	7.9
Index of Leading Indicators	Apr	-33.5	-4.4	0.8
Money Stock (M1)	Apr	18.4	-0.2	4.7
S & P Index of "500" shares	Apr	26.2	14.3	11.1

		Latest Month	Average of latest 3 months	Average of 3 mths yr earlier
Unemployment Rate (%)	May	5.8%	5.8%	6.1%
Merchandise Trade Balance	Apr	-$2.2 b.	-$1.4 b	-$3.4 b
Interest Rate on CD's	May	10.2 %	10.1 %	7.1 %

Quarterly National Expenditure Data

(1979Q1)	% change (annual rate) On 1 qtr earlier	On 1 year earlier
GNP	0.4	4.6
Consumers' Expenditure	0.3	4.5
Business Fixed Investment	5.3	9.7
Government Expenditure	-4.2	1.6
Exports of goods and services	11.2	15.7
Imports of goods and services	6.0	7.1

Balance of Payments

(1978Q4)	Latest quarter	Previous quarter
Current Account ($ billion)	-1.3	-3.7

Exchange Rate

		Actual % Change On Previous Month	On Year Earlier
Dollar effective rate	Apr	1.2	-3.9

* Average hourly earnings of production or nonsupervisory workers in the private nonfarm economy adjusted for interindustry employment shifts and for overtime in manufacturing.

ECONOMIC ACTIVITY

8. GNP is now estimated to have risen at an annual rate of only 0.4% in the first quarter of the year. Final domestic demand fell in the period and only a slight increase in the rate of inventory accumulation and an improving trade balance produced the positive overall growth rate. It is clear that unusually severe weather conditions contributed to the slowdown in the quarter, with construction in the residential, business and local government sectors particularly severely hit, but personal consumption was also weak throughout the quarter and some of the build-up of inventories may have been an involuntary reflection of this.

9. Industrial production increased at an annual rate of 4½% in the first quarter according to Federal Reserve Board data, though this figure does not seem to be consistent with the expenditure-based estimates of activity. Some compensating statistical adjustment in April or May was therefore to be expected, but the extent of the decline (1%) in April seems mainly to have been due to special factors operating during the month. The sharp decline in the output of the automobile industry alone contributed ½% to the measured drop and a significant proportion of this can probably be attributed to the effect of the Teamsters' dispute which prevented components being delivered to the assembly lines There is however evidence to suggest that the automobile manufacturers were not unhappy to interrupt their production because of inventory problems. A further difficulty with the industrial production index was its reliance on employment data which were seriously affected by the timing of the survey in April which coincided both with religious holidays and the Teamsters' dispute.

10. Even allowing for the fall in April, the growth of industrial production in this cycle has been impressively strong. The output of business equipment rose by 7.2% in the year to April and of total industrial output by 5.1%. Capacity utilisation in manufacturing in March was 86.1% on the FRB index compared with a peak of 88% in the last boom period of 1973.

11. The slowdown in consumers expenditure reflects in large part the effect of an accelerating inflation rate on consumer purchasing power. Even after a sizeable tax cut in the first quarter of the year, real personal disposable income grew at an annual rate of under 3% compared with increases of 4.3% in 1978. The tax cut was effectively worth about 1% of income in the first quarter and, since it was implemented, real personal disposable income has declined significantly. The savings ratio is estimated to have risen to 5.4% in the first quarter compared with an extremely low figure of 4.8% at the end of 1978, but is still historically very low.

12. There was considerable concern towards the end of 1978 about the growing reliance on consumer credit and fears that households would become over-extended. Consumer credit outstanding rose by over 25% during 1978. This increased credit nevertheless seemed to be concentrated amongst households with two earners and few dependents and there have been no signs of, for instance, increases in delinquency rates or significant extensions in repayment periods which might indicate severe pressure on household finances. The rate of expansion of consumer credit seems to have slowed somewhat in the first few months of this year. Similarly, the apparent use of mortgage credit to finance expenditure on durable goods is less

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likely to be a problem now that housing finance is becoming less easy to obtain.

13. Retail sales increased marginally in April to a level about 11% above that of a year earlier in money terms, at a time when prices had been increasing at roughly the same rate (depending on which price indicator is being used). There has been very little change in nominal retail sales since the end of 1978. However, this was the culmination of a very brisk period and itself followed a period of six months in the middle of the year when there were no indications from the data of any increases at all. Sales of domestic cars fell very heavily in the first half of May, although the importance of this may have been exaggerated in many accounts because the reference level normally specified was the comparable period for 1978, when sales were exceptionally strong, and the impact of scares on the energy side have been to raise the attractiveness of the smaller, imported cars and not necessarily so far on the total volume of purchases being made.

14. The effect of the increases in oil prices and the shortage of gasoline on consumers expenditure is difficult to assess. Apart from the loss in purchasing power which the increased prices undoubtedly imply and the incentive to switch purchases of cars towards more fuel-efficient models, there may be some apparently perverse behaviour because of an increase in general inflationary expectations and an observable tendency to advance purchases of new cars in order to benefit from their apparently higher efficiency. By analogy with last winter's experience of the effect of disruptions to travel, one effect may however be simply to lower total expenditure on all goods temporarily.

15. The strong recovery in <u>housing starts</u> which characterised the period immediately following the severe winter of 1978 has not been repeated this year. Although increasing somewhat from the very low level of 1.4 million per annum in February, the March and April figures do begin to provide some confirmation that the housing sector has already begun a significant decline. The March level of 1¾ million per annum starts was nearly 15% below the average of 1978 and most observers expect the average for the rest of this year to be even lower than this. Activity in the housing sector is estimated to have fallen at an annual rate of over 16% in the first quarter and it seems likely that the total fall between 1978 and 1979 could be in the region of 10%. There was a net outflow of money from savings and loan institutions in April, the first time deposits have failed to keep up with net advances since monetary policy began to be tightened last year.

16. The strength of <u>business fixed investment</u> in the last six months has been a matter of some surprise. Expenditure on equipment rose at an annual rate of nearly 12% in the first quarter of 1979 and 9% at the end of 1978, compared with a rise of less than 7% in 1978 as a whole. Although the dramatic fall of over 13% in new orders for non-defence capital goods in April was the steepest monthly decline since 1971, the series grew very strongly in previous months and individual figures are frequently subject to large revision. There are no signs yet of manufacturers beginning to cancel recent orders and informal reports suggest that investment plans are staying strong in spite of the growing indications of the slowdown in the economy and more reports that this slowdown could be extended for a significant period. First

reports suggest that the next survey of investment intentions conducted by BEA should confirm a strong first quarter and point to steady growth through the year.

17. Manufacturing inventories rose by 1.6% in April to $208.7 billion. This was in line with the behaviour of inventories in the first part of the year where some continued build-up in stock levels in real terms was evident. There has been considerable concern about the possibility that excess inventory levels, encouraged by good business liquidity and precautionary buying ahead of expected price increases, could lead to a large adjustment when the slowdown gathers pace, but the overall ratio of both manufacturing and trade inventories to final sales is still low in historical terms. There are some industries where excesses are certainly apparent, the most obvious being in the automobile sector other than General Motors, but these are so far leading only to moderate changes in production schedules.

18. The Federal Budget went into surplus in April, registering a positive balance of $11½ billion, largely because of the annual surge of income tax receipts. So far this fiscal year the deficit has accumulated to $33 billion, broadly the same as officially forecast for the whole of the financial year. Nevertheless, because of the recent unexpected buoyancy of tax receipts, it looks as if the Federal budget will register some further surpluses and the deficit for the whole fiscal year may be no more than $25 billion. On a national income basis, the Federal deficit has declined steadily since the beginning of 1978, from an annual rate of over $50 billion to only $18 billion in the first quarter of 1979.

EXTERNAL ACCOUNT

19. The merchandise trade deficit widened sharply in April to nearly $2.2 billion. Some worsening from the surprisingly low deficits of February and March was expected, but the size of the monthly change gave rise to some pressure on the dollar. Exports declined across the board from their high March level, but they were still nearly 20% above the level of a year earlier. On the imports side, most of the increase between March and April can be explained by higher volumes of imports of petroleum and products and of imported cars. The latter rose in value terms by nearly $0.4 billion between March and April, perhaps partially reflecting restocking as dealers accommodated to the increase in demand for more fuel-efficient vehicles. The US trade deficit with Japan widened to over $1 billion in April, back to last year's levels.

20. The Administration has recently released some detailed forecasts for the trade and current account positions in 1979. They foresee an improvement in the current account balance from a deficit of just over $16 billion in 1978 to between $10 and $11 billion in 1979. The trade deficit, measured on a balance of payments basis rather than the census definition used in the monthly release, is expected to decline from $34 billion in 1978 to $27 billion in 1979 (although Commerce Assistant Secretary Weil has suggested the improvement may in fact be slightly smaller than this). Imports of petroleum products are expected to increase by about 25% in value terms, to $52 billion, but the oil price assumptions on which this is based (a 25% average price increase between the years) may be optimistic. The major offset comes through a sharp rise in the value of non-agricultural exports from $112 billion to over $140 billion. The

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latter forecast is based on an increase in volume of over 12%, which is historically an exceptionally strong performance, but which is at the lower end of the range of estimates available to the Administration. There is clearly a wish not to present over-optimistic forecasts for the current account because of the possibility of much higher fuel imports resulting from further increases in oil prices and concern about creating further pressure on the dollar.

21. Ratification of the trade pact between the US and the People's Republic of China has been complicated by the issue of unimpeded textile imports from China. The US has now imposed quotas on five critical categories of textiles. The question of protection for other vulnerable industries from elsewhere in the world is also of crucial importance in advance of the Administration's plans to obtain accord from Congress for the main elements of the Multilateral Trade Negotiations recently completed in Geneva. The House has approved extra funds for "adjustment assistance" to industries which are being significantly affected by import competition. At present, affected companies receive loans and technical aid to change to other products and employees receive training and larger unemployment compensation. The new funds would extend benefits to workers who manufacture components which are used in products which have been hit by import competition.

22. The dollar has stayed generally firm, apart from worries caused by the increase in the trade deficit. Indicators of a slowing in the economy have generally proved beneficial. The dollar ended May 23% higher against the Yen than the trough reached last October and 9% against the German deutschemark. So far this year it has appreciated 5% in effective (trade-weighted) terms against other major currencies. Nevertheless, the price of an ounce of gold has risen in dollar terms to 280 compared with about 220 at the beginning of the year.

23. The greater strength of the dollar in recent months has allowed the Federal Reserve Board and the Treasury to repay all their outstanding "swap" agreements and to add about a billion dollars to their foreign exchange reserves. In all, about $7 billion of foreign exchange was obtained during the February-to-April quarter, compared with sales of over $9 billion in the previous two quarters.

FINANCIAL MARKETS

24. The rapid spurt in the growth of M1 which caused considerable concern in April has given way to a decline, according to the weekly figures, through the month of May. The series has now dropped to the floor of the long-run target range set for the one-year period from the fourth quarter of 1978. It is clear, however, that data for M1 are particularly vulnerable to incorrect seasonal adjustment on top of the other distorting factors associated with regulatory changes which have made the last eight months' figures exceedingly difficult to interpret. M2 has been subject to similar seasonal problems and has also been affected by some of the technical changes, but it continued to increase steadily through May.

/25. Because

25. Because of these uncertainties, the Federal Reserve do not seem to be critically affected by the measured movements in the money supply in determining interest-rate policy. The recently-released minutes of the April meetings of the Federal Open Market Committee have been interpreted as providing evidence that the action to raise interest rates during the month was directly dictated by changes in the monetary aggregates, but the fact that a special session was needed to endorse the interest-rate change signifies that these changes on their own might not have been sufficient. Signs of general ease in monetary conditions and further adverse data on prices were probably crucial factors. The FOMC have been divided for much of the year on the direction which policy should take and discussion has focussed more on the general economic and financial situation than on the aggregates themselves.

26. The Fed has kept its key operating rate, the Federal Funds rate, at about 10¼% since the end of April. This has opened up an unusually large differential for member banks between market rates on their conventional sources of funds and the current discount rate of 9½% with a consequential increase in use of the discount window. This is expected to be countered soon by a small increase in the discount rate.

27. The steep rise in short-term interest rates during 1978 led to the emergence of very large differentials between market rates and those payable to small savers at commercial banks and thrift institutions. Interest rates on small time and savings deposits are still subject to Regulation Q ceilings which, for example, limit rates on passbook savings at the thrifts to 5¼%. The introduction of the six-monthly money market certificates last June eased the situation considerably, but the minimum denomination of these is $10,000. Small increases in the ceilings have now been announced (¼% for passbook savings) and four-year certificates paying near to market rates are to be allowed. In a further move towards liberalisation of the regulations covering the terms which can be offered by financial institutions, the Administration has presented to Congress an outline of proposals to phase out all ceilings on interest rates, including those on checking accounts. Details of the proposals have however not yet been drafted.

28. The Federal Reserve Board has been operating with only five members since the death of StephenGardner last November and the resignation of Philip Jackson. The first of the Presidential nominees for the two Board vacancies, a black Washington banker named Emmett Rice, is currently being vetted by the Senate Banking Committee and his appointment is expected to be confirmed shortly. The second nominee, Frederick Schulz, has a long history of involvement in the Florida State legislature and has strong ties with Carter aides and the Carter Presidential campaign. It is possible that his confirmation hearings, which have not yet been set in motion, may produce some difficulties for the Administration. If both appointments are confirmed, four of the seven Governors will have been nominated by President Carter.

/LABOUR MARKETS.

LABOUR MARKETS

29. The confusing picture on employment and hours presented by April data has been slightly clarified by the figures for May. Although the timing of the April survey undoubtedly produced an exaggerated estimate of the fall in hours worked, average hours in May were still 1% below those in March and employment, as measured by both establishment and household surveys, was little changed. It therefore now appears increasingly likely that the slowdown in activity has begun, making a strong contrast with the rapid expansion of employment which has characterised the latter stages of this upturn. Even allowing for the slack figures in April and May, employment in May was over 3% above the level of a year earlier.

30. Unemployment remained at 5.8% of the labour force in May. There has been little change in the measured unemployment rate since last August, although in the previous year the rate had dropped dramatically from 7%. The fall in the overall rate was not however shared by all demographic groups. Black teenage unemployment is still well over 30%, little lower than it was in 1977.

31. Hourly earnings, as measured by the adjusted index for private non-farm employees, barely changed between April and May. In the year to May, earnings increased by only 7.6%. This represents a marginal decceleration from the previous year and, at a time when price increases have been accelerating, indicates a certain measure of success for the Administration's voluntary anti-inflation policy announced last October. There have not yet been any significant breaches of the guidelines, which call for increases in annual compensation averaging no more than 7%, but the rules have been bent significantly, particularly for the Teamsters. The Administration has not yet given its verdict on the settlement between United Airlines and its machinists, which ended a six-week stoppage of the airline. The terms of the settlement are clearly well above the quantative guidelines, but they are not formally binding because associated bargaining units obtained large increases before the policy came into effect.

32. The environment in which the dispute between the Union of Rubber Workers and Uniroyal Inc is taking place has been significantly changed by a recent court decision on the use of Federal procurement sanctions. The Rubber Workers were a party to the lawsuit, which successfully claimed that the President's denial of Government contracts to firms in violation of the guidelines has the effect of making the controls mandatory and thereby exceeds the President's current constitutional powers. The Administration has said that it intends to appeal the decision, but the employers' side in the Rubber Work ers' dispute has lost one of its major arguments and the psychological effect of the loss, at least temporarily, of the only real weapon in the anti-inflation programme may be severe.

/ECONOMIC

ECONOMIC PROSPECTS

33. All the signs now point to a sluggish performance for the US economy for the rest of this year and perhaps early into 1980. The crucial questions are whether the economy will slip into a deep recession rather than simply a period of slow growth and how long such an eventuality might last. The outcome on inflation which itself is crucially dependent on the energy situation and possible policy responses will probably be the crucial factors determining the outcome.

34. Much emphasis has been placed by economic analysts on the fact that the economy is apparently much better balanced than has been normal at comparable stages in previous cycles. There are few indications of excessive inventory levels, the housing sector is turning down in quite a smooth fashion, households do not seem to have overstretched their debt position and the trade balance is moving in a favourable direction. Business fixed investment has grown fairly modestly so that it does not seem likely that wide margins of spare capacity will emerge. These are factors which should prevent any recession from becoming too deep. However, the strains on personal income caused by accelerating inflation (and so far unmatched by earnings increases) are already leading to a slow-down in personal consumption expenditure. Without further falls in the savings ratio from its already historically extremely low level there is not much likelihood of significant growth in this area for the remainder of this year. With both personal consumption and housing weak, aggregate demand in the economy is unlikely to show much growth and unemployment can be expected to start rising again. Until inflation starts to ease or the housing sector revives, it is difficult to see any likely source of significant growth in the US economy. This is why the consensus now is that the economy will stay weak for at least a year from now and is unlikely to show any sizeable recovery before the end of 1980 without some additional stimulus, perhaps through tax cuts or significant easing of monetary policy.

35. On the important provisos that wage settlements do not re-accelerate strongly and the energy situation does not deteriorate further, it is possible that inflation rates will peak very shortly and could decline to rates of 8% p.a. by the beginning of 1980. However, real earnings have been so severely squeezed over recent months that most observers expect some catch-up in settlements starting later this year, which would then feed through onto the prices side. The weakening of final demand is expected to prevent this from becoming too serious a factor, but there are doubts about whether monetary policy has really been tight enough to exert a significant moderating influence.

36. The slowdown in the economy should however improve the trade balance, to add to the beneficial effects of the depreciation of the dollar in late 1977 and 1978. Nevertheless, the rise in oil prices and the loss of exports to Iran are expected to provide considerable offsets this year and, once the effects of depreciation have peaked, the current account may well begin to deteriorate again. Although Treasury Secretary Blumenthal has spoken of the current account deficit declining from $10 billion in 1979 to $6 billion at an annual rate at the beginning of 1980, a reversal can be expected to follow unless there is a further significant widening in the differential of growth rates between the US and the rest of the world or further improvements in competitiveness.

/POLICY

37. It has been widely accepted since the end of last summer that the economy needed to be slowed down in order to avoid capacity constraints and reduce inflationary pressures. The outlook for real activity described above is therefore one which would broadly be thought satisfactory by policy-makers in the Administration, Federal Reserve Board and Congress. However, there are as always differences in view about the seriousness of the risks on inflation. Concern about energy prices and supplies has reduced hopes that a deceleration of inflation might be achieved at the same time as a recession is avoided.

38. One important consequence of recent data confirming the slowdown in activity is that senior Administration officials have stopped worrying that the economy might be about to undergo a final excessive burst of growth and have apparently stopped pressuring the Fed to raise interest rates further. Their assessment of the likely course of the economy through the rest of this year now seems to be very similar to that of the Fed, which shows a generally weak economy that might be pushed into recession if monetary policy were to be squeezed too hard.

39 The desire to keep the economy running at a fairly low level of activity, together with pressure from all quarters for a balanced Federal budget, has led Congress to endorse the broad stance of the President's Budget proposals for fiscal year 1980, which starts this October. The First Budget Resolution calls for a target deficit of $23 billion in the year, to be achieved by limiting outlays to $532 billion and ensuring that revenues will exceed $509 billion. The expenditure level is the same as the President originally recommended but, because of more pessimistic assumptions on inflation and unemployment, it implies more stringent real cuts in controllable programmes than the President proposed. The only significant change in policy terms on the revenue side is the removal of the Administration's proposed scheme for Real Wage Insurance, the balance of extra revenue simply reflecting higher assumptions about inflation and average tax rates. Because of this uncertainty about estimating assumptions it is difficult to assess precisely whether this Budget, if it is finally passed into law, will represent a significant tightening of fiscal policy between the financial years. The Federal deficit in the current fiscal year may just turn out to be below the $23 billion total targetted for 1980, but it has benefitted from relatively low unemployment figures and some apparently over-buoyant tax receipts.

40. It has been the case in the previous three years of the current budgetary process that policy incorporated in the First Budget Resolution has been confirmed in the legally-binding Second Budget Resolution, which will not be passed until September. The expectation is that this will be true this year as well. However, several influential members of Congress, particularly Senator Muskie, the Chairman of the Senate Budget Committee, have made it clear that they may need to reassess their attitudes towards the Budget later on in the fiscal year if unemployment begins to rise significantly. There are also likely to be electoral pressures next year to provide some tax relief to middle-income earners who will have suffered a significant increase in their average tax burden because of inflation and who will be facing the prospect of sizeable increases in social security contributions in January 1981.

/If tax relief

If tax relief were to be granted during 1980 it would mean that the possibility of obtaining a balanced Federal Budget in fiscal 1981 would be extremely remote. However, a severe slowdown in the economy would probably anyway swell the deficit significantly so that when the President presents his 1981 Budget to Congress in January 1980, the prospect of achieving a balanced budget by holding firm on tax cuts may prove impossible. The President's recent restatement of his commitment to balance the Federal Budget in 1981 assumed that the economy would not go into a recession.

These considerations about macro-economic policy may nevertheless be swamped by measures to deal with the energy situation. The President's proposals to enact a standby gasoline rationing plan have already been rejected by Congress and only limited conservation measures have so far been approved. The President's decision to phase out controls on oil prices has proved to be very unpopular with the Democratic Party in Congress, although there has as yet been no serious challenge to his authority in this area. It is widely recognised that more measures are needed but political problems considerably limit the Administration's scope for action. There is, however, less reluctance now to rule out possible measures solely because of their direct consequences for domestic inflation.

The Administration's voluntary anti-inflation programme has been dealt a severe blow by the recent Court decision declaring unconstitutional the President's use of sanctions in the granting of Federal procurement contracts. An appeal is being lodged by the Administration, but public confidence in the effectiveness of the programme seems at present to be very low. Although there is apparently a large measure of public support for making the controls legally enforceable, the President does not at present have any statutory powers for implementing such a move and the Administration has consistently ruled out the use of mandatory controls.

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A Expenditure on GNP (quarterly data)
(1972 prices $b sa annual rate)

	1979(1)	% pa change over last qtr	% pa change over same qtr yr earlier
GNP	1416.3	0.4	4.6
Personal Consumption	912.4	0.3	4.5
durables	148.6	-3.9	7.8
nondurables	345.4	-3.5	3.6
services	418.4	5.2	4.0
Business fixed investment	146.8	5.3	9.7
Housing investment	57.7	-16.2	-3.0
Change in business inventories	11.2	8.2 (A)	12.3 (A)
Govt purchases of goods & services	276.4	-4.2	1.6
Federal	102.0	-1.9	0.8
State & Local	174.5	-5.3	2.2
Net exports of goods & services	11.7	10.2 (A)	2.9 (A)
Exports	114.7	11.2	15.7
Imports	103.0	6.0	7.1
Price deflator (1972=100)	159.9	8.8	8.7
GNP (current prices)	2264.8	9.3	13.7
Net exports (current prices)	-5.3	-7.6 (A)	-24.1 (A)

B Monthly indicators

	Month		% pa change over 1 mth earlier	% pa change over 3 mths earlier	% pa change over year earlier
Industrial production	Apr	150.1	-11.2	-1.6	5.1
Capacity utilisation mfg	Apr	84.9	-15.5	-5.0	1.4
Retail Sales ($b current prices)	Apr	72.2	5.9	7.8	10.8
Car Sales (m units pa)	Apr	11.1	-76.3	5.5	-10.9
Housing Starts (m units pa)	Apr	1.7	-22.2	17.7	-19.6
Merchandise exports ($b)	Apr	13.9	-38.2	24.9	19.4
Merchandise imports ($b)	Apr	16.0	79.5	-4.7	10.7
Civilian employment (Hsehld Svy)	May	96.3	1.2	-1.4	2.3
Unemployment Rate (%)	May	5.8	5.8 (A)	5.7 (A)	6.1 (A)
Consumer Price Index (1) (2)	Apr	211.5	14.0	13.9	10.4
Producer Price Index (2)					
finished products	Apr	211.2	11.4	12.1	10.3
all commodities	Apr	229.7			11.3
Average hourly earnings (pnf)	May	6.1	10.4	4.7	8.0
Average hourly earnings (pnf adj)	May	227.1	1.6	5.8	7.6
Composite indices					
12 leading indicators	Apr	138.7	-33.5	-12.0	-2.0
4 coincident indicators defl	Apr	145.2	-10.1	0.6	4.2
6 lagging indicators	Apr	161.4	18.8	10.6	17.1
Inventory levels ($b cur prices)	Apr	$392.3b	$387.4b (A)	$379.4b (A)	$349.2b (A)

(1) All urban consumers

(2) % changes are seasonally adjusted; levels are not seasonally adjusted.

(A) Implies actual value in the period specified NOT percentage change.

/C Monetary

C Monetary indicators

	Latest Month		% change at annual rate over previous 4 wks	13 wks	52 wks
Federal reserve credit outstanding \$b sa (1)	May	128.5	10.2	8.1	7.6
Monetary base \$b (1)	May	145.5	6.0	4.8	7.9
M1 \$b	Apr	364.1	18.4	4.7	4.7
M2 \$b	Apr	889.8	14.5	6.7	7.2
Total bank reserves (1) \$b	May	40.4	-5.2	-3.5	8.4
Consumer instalment credit	Mar	278.3	11.6	5.0	19.0
Commercial & industrial loans by large banks	NOT AVAILABLE				

	Latest Month		Previous Month	3 mths Previous	Year Previous
Commercial bank prime rate (1)	May	11.75	11.75	11.75	8.25
3 mth Treasury bills	May	9.62	9.47	9.35	6.43
Corporate Aaa bonds	May	9.50	9.38	9.30	8.69
3 mth CD rate	May	10.17	10.07	10.18	7.43
US Govt bond rate (20-yr)	May	9.21	9.10	9.04	8.46
Federal Funds rate	May	10.24	9.98	10.06	7.36

(1) Average of latest 4 weeks

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Prime Minister
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MONTHLY ECONOMIC REPORT FOR THE UNITED STATES

SUMMARY

1. There is still great uncertainty about the course which the US economy is likely to follow over the next year. After four years of expansion a slowdown now seems likely but its severity and timing remain matters of considerable dispute. GNP apparently grew at an annual rate of less than 1% in the first quarter of the year, with the housing sector particularly weak, but there are still some signs of strength in personal consumption. The balance of opinion now is that there will be little growth, or perhaps some decline in output, in the second half of the year resulting in an increase in real GNP between 1978 and 1979 of about 2½%. But few would dismiss the possibility that growth will continue more strongly during much of 1979 and that this will be followed by a full recession during the election year 1980.

2. The evidence on inflation is clearer, but uniformly disappointing. Consumer prices rose at an annual rate of nearly 12% in the first quarter, taking the price level over 10% above that of a year earlier. At the wholesale stage, prices of finished goods accelerated to an annual rate of increase of over 14% in the first quarter. These may however represent peaks for the year as far as published price indices are concerned. On the wages side, settlements have so far been fairly modest, and increases in earnings have been slightly below last year's rates of 8½% p.a. It is difficult to assess how far this moderation is due to the wage standards set in the anti-inflation programme and how long it will continue. The recent bending of wage standards to facilitate a settlement for the Teamsters and the prospects for several other key settlements suggest that the chances of earnings continuing to increase at rates considerably below the current rate of price inflation are not very high.

3. The dollar has been strong despite news on inflation. This seems to have been due mainly to the change in financial policies last November, but the actual and expected improvement in the current account of the balance of payments relative to other major economies has also probably been a major factor. In the first quarter of this year, the deficit on merchandise trade fell to an annual rate of $21 billion compared with an average of $28 billion in 1978. The monthly deficit of less than $1 billion in March was the lowest for nearly two years, with the trend

/GROWTH

RESTRICTED

growth in manufactured exports looking particularly strong. Forecasts for the rest of this year suggest that the deficit on current account may drop to about $10 billion compared with $16 billion in 1978.

4. The monetary picture is still difficult to interpret. After more than six months of virtually no net growth, the main monetary aggregates accelerated sharply during April. This may perhaps have marked the end of a period of severe distortion in the monetary aggregates during which technical changes in cash management induced by new monetary regulations and higher interest rates gave a misleading impression of monetary tightness. In fact, borrowing continued to increase fairly steadily through the period and seems to have strengthened considerably recently. Credit conditions have not generally been perceived to be tight. After several months of keeping interest rates steady, the Federal Reserve Board have now moved to firm slightly the rate for Federal Funds - the key short-term rate - to take their target level to apparently about 10¼%.

5. Although it is widely accepted that combatting inflation is the top economic priority, differences in view about prospects for economic activity this year have produced varying policy prescriptions. Some senior members of the Administration have hitherto shown concern that further rises in interest rates might tip the economy into recession this year. But they now see risks that growth could actually turn out to be too fast for at least part of this year and consider that increases in interest rates now have less effect on activity than they used to. They have therefore been suggesting that a further tightening of monetary policy might be appropriate. The Federal Reserve Board, on the other hand, faced with a forecast of a weaker economy this year and mixed evidence on the monetary aggregates have up until now chosen a more restrained posture. Their latest moves to increase interest rates came only after pressure had been put on them and the adjustment could turn out to be mainly symbolic.

6. Congress is nearing completion of its first Budget Resolution for fiscal year 1980, which starts in October. An apparently tighter fiscal policy than the President requested in January looks likely, with the projected Federal deficit reduced well below $30 billion in fiscal 1980, despite an assumption of a weaker economy.

/PRINCIPAL

Principal Monthly Indicators

		% change (annual rate)		
		On Previous Month	Last 3 months on previous 3 months	Last 3 months on 3 mths yr earlier
Industrial Production	Mar	10.0	4.6	8.5
Retail Sales (current prices)	Apr	5.9	9.5	11.9
Consumer Prices	Mar	12.7	11.0	9.8
Average Hourly Earnings	Apr	0	6.9	8.7
Index of Leading Indicators	Mar	-5.7	-2.2	2.2
Money Stock (M1)	Apr	18.4	-0.2	4.7
S & P Index of "500" shares	Apr	26.2	14.3	11.1

		Latest Month	Average of latest 3 months	Average of 3 mths yr earlier
Unemployment Rate (%)	Apr	5.8	5.7	6.1
Merchandise Trade Balance	Mar	-$0.8 b	-$1.7 b	-$3.5 b
Interest Rate on CD's	Apr	10.1	10.1	6.9

Quarterly National Expenditure Data

(1979 Q1)	% change (annual rate) On 1 qtr earlier	On 1 year earlier
GNP	0.7	4.7
Consumers' Expenditure	1.7	4.8
Business Fixed Investment	2.8	9.0
Government Expenditure	-3.4	1.8
Exports of goods and services	2.5	13.4
Imports of goods and services	7.7	7.5

Balance of Payments

(1978Q4)	Latest quarter	Previous quarter
Current Account ($ billion)	-1.3	-3.7

Exchange Rate

		Actual % Change On Previous Month	On Year Earli
Dollar effective rate	Apr	1.2	-3.9

/ECONOMIC

ECONOMIC ACTIVITY - CURRENT TRENDS

7. As we expected, provisional estimates for GNP growth in the first quarter of the year showed a considerable deceleration from the 7% annual rate that had been achieved in the last quarter of 1978 (for a breakdown of 1979Q1 figures, see previous Table). The extent of the slowdown, to 0.7% p.a., was nevertheless even greater than had been anticipated and the official estimates may well be revised upwards when later data are incorporated. The preliminary GNP figures did not make adequate allowance for the improvement in the real trade balance which actually occurred through the quarter and industrial production is estimated to have grown at an annual rate of 4½% in the period.

8. It would anyway be premature to interpret the figures as solid evidence of an underlying deceleration in the economy. Particularly severe winter weather delayed construction activity in the residential and road-building areas much more than seasonal adjustment would normally allow for, so that the drops recorded in Housing and in State and Local Government expenditure almost certainly exaggerate the trend. And there has recently been a considerable volatility in quarterly estimates of final demand which have provided confusing pointers to the short-term outlook.

9. There are nevertheless some important features of recent data which do strongly suggest that the economy is beginning to slow down. The housing sector is conventionally the trigger to large cyclical developments and it had been expected since the middle of last year that it would start declining as the effects of rising interest rates and declining mortgage extensions worked through. It was actually protected for some time by the strong liquidity of the thrift institutions on the one hand and, on the other, by a powerful underlying demand built mainly on demographic trends and expectations of large capital gains. These forces now seem to be being moderated, although it is possible that the recent slowdown in housing activity, and in mortgage extensions, could turn out to be purely, rather than merely partly, seasonal. On the consumption side, and particularly in durables, there are also signs of moderation. Not only is the trend of retail sales now flattening, but the further falls in the savings ratio from already very low levels which would be needed to offset future low or negative rates of increase in disposable income in real terms, do not seem to be materialising. This is not to say, however, that consumption is yet weak and it would probably require some significant increase in personal savings this year to produce a large enough effect to induce a recession.

10. The other most widely-referenced pointers to a slowdown this year are the official "leading indicators" series, which has now (on revised data) shown three successive months of decline, and also some signs of volatility in inventory behaviour. Neither of these provide particularly reliable evidence. Movements in the indicators have been dominated by the sluggishness of the monetary aggregates and these have probably been grossly distorted over the last six months. And inventories are certainly not wildly out of balance, although there may be some sectoral problems.

DEVELOPMENTS BY SECTOR

11. The growth in retail sales has slowed down considerably

/SINCE

since the spurt recorded during the last quarter of 1978. There was little change reported in the level of sales between March and April and from December to April the rate of increase was only about 7% p.a. in money terms, rather less than the current rate of inflation. Automobile sales have held up fairly well despite (or in some cases because of) the uncertainty about fuel prices and availability. March was a record month, with unit sales of 12.6 million at an annual rate compared with an average of 11.3 million in 1978, although there was a subsequent fall in April. Expenditure on consumer services has been rather stronger, partly because of higher weather-induced demand for power and preliminary estimates put growth during the first quarter at 5% p.a.

12. The major question at the moment concerns the behaviour of personal savings. The data in this area are notoriously unreliable and fluctuations in the savings ratio can be expected to mirror changes in the growth rate of personal income because of the time it takes for consumption to adjust to new levels of income, but the outturns on personal savings during 1978 were, on any basis, surprisingly low. There is a little evidence from surveys to support the view that this reflected some anticipatory buying of durables against the expectation of high rates of inflation but this does not seem to afford a complete explanation. It also contrasts strongly with behaviour in previous inflationary periods in the US and in recent years in Europe and Japan when savings have risen markedly to protect the real value of financial balances.

13. Consumer confidence surveys carried out by the Conference Board, Citibank and by the National Family Opinion Survey in Michigan report a sizeable drop in recent months in householders' optimism about their personal economic prospects and in buying plans. This is widely expected to herald a significant rise in the personal savings ratio from the 5.2% level recorded both in the first quarter of 1979 and in most of 1978. Whether the ratio will return to the 6% - 7% range which was prevalent in the 1960's remains uncertain.

14. Housing starts rose to 1.8 million p.a. in March (seasonally adjusted) after two very low weather-affected months at the 1.5 million p.a. level. This is however less of a recovery than occurred during last year's exceptionally severe winter and looks like the start of a significant decline in the housing sector from the situation where a rate of 2 million p.a. starts had been maintained for well over a year. The rate of mortgage closure at S & L is currently 15% below last year's rates and the rate of inflow of deposits into the thrift institutions is at last showing some signs of moderation. Nevertheless the liquidity position of the thrifts is still very good (much of their cash being invested in short-term financial investments such as CD's because of the relatively very high yields being obtained compared with mortgage advances). The less attractive yields they are now constrained to provide on six-monthly money-market certificates has probably reduced their deposit inflows but does not yet seriously seem to have affected their ability to raise finance from this source as needed.

15. Although the growth of business fixed investment this

/CYCLE

cycle has never accelerated to the rates traditionally experienced, it has proved to be a steady source of expansion to the economy. It grew by 9% in 1977 and 8% in 1978 and in the first quarter of 1979 it is estimated to have risen by nearly 3% p.a. despite a sizeable weather-induced fall in construction. Expenditure on equipment rose at an annual rate of 8%.

16. Forward indicators for business fixed investment present a mixed picture. Orders for durable goods and contracts for new construction have been exceptionally strong recently. They point to vigorous growth over the next six months at least. But direct surveys of capital spending plans suggest little further growth in real terms. Even the latest McGraw-Hill survey, which on first reading pointed to a rise of 16% in spending in nominal terms between 1978 and 1979 in fact suggests a rise nearer 11% when adjusted for normal reporting biasses and baseline errors.

17. A build-up of inventories in the first quarter was the only net source of GNP growth identified in the provisional GNP data. There were some signs in the quarter of anticipatory buying ahead of expected increases in price and possible delivery delays, but much of the rise seems to be explained by the unexpectedly low level of final sales. Inventory levels are being carefully monitored for the sort of excesses which magnified the depth of the 1975 recession, but in general manufacturers, and to a lesser extent distributors, seem to be keeping them under a tight reign. The strong liquidity position of the private business sector means however that there is potential for an unhealthy movement into stocks at any time and it is this possibility which is the main concern of those Administration economists who have been advocating a further tightening in monetary policy.

18. The drive towards a reduced Federal deficit and the impact on a local level of initiatives like Proposition 13 have probably contributed to the recent slowdown in Government purchases of goods and services, but much of the decline in the first quarter seems to have been weather-related. Road repair work and construction were particularly badly affected. There are also considerable regional disparities, with the demand for services growing very rapidly in the newly-expanding areas despite tax-reducing moves.

EXTERNAL ACCOUNT

19. The merchandise trade balance improved dramatically in March to record a deficit of $0.8 billion compared with a monthly average (on a census basis) of $2.4 billion in 1978. Agricultural exports were particularly strong, but all categories of manufactured exports rose significantly. Rising fuel imports provided some offset.

20. Compared with a year earlier, manufactured exports (categories 5-8) had risen 32% by the first quarter in money terms. The comparable rise in imports was only 12½%. Although the first quarter of 1978 was itself a particularly bad period for the trade balance, the rate of improvement seems to confirm the fact that the depreciation of the dollar in 1977 and early 1978 had the effect of restoring much of the competitiveness of US goods which had been lost in 1975 and 1976.

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21. It is too early however to be confident that this improved performance of the trade balance will be sustained throughout the remainder of this year. The rapidity of the turnaround in both import and export performance may be a reflection simply of a faster speed of adjustment of volumes to the changes in competitiveness, plus recent advantageous price movements. If this is so, the total effect attributable to the depreciation may be no larger than would have been assumed on the basis of previous estimates and the worsening of competitiveness which has occurred since the dollar strengthened last November may produce some deterioration in the trade balance by the end of the year. The full effects of the increases in oil prices have also yet to work their way through.

22. If an optimistic interpretation of recent trade performance were to be taken (i.e. that the underlying trend has strengthened) it is possible that the current account deficit for the US could drop as low as $5 billion this year (even with further oil price increases to come) compared with $16 billion in 1977 and 1978. A more central projection would however still probably suggest a deficit of around $10 billion for 1979 involving some deterioration on the trade side towards the end of the year.

23. This visible and projected improvement in the current account has contributed significantly to the restored health of the dollar in recent months. Relative to Germany, Japan and most other industrialised countries the increases in oil prices can also be expected to have a smaller direct effect on the US economy because roughly half of US oil consumption is still provided from domestic sources. But relative interest rates and the joint resolve shown by the Central Banks over the winter months to defend the dollar has almost certainly played the major role in turning around the performance of the dollar to the point at which indicators of worsening inflation have seemed to have little adverse impact on the exchange rate.

24. In effective (trade-weighted) terms the dollar had appreciated 9½% by the end of April from its low point at the end of last October. It has gained 5% so far this year, including a maximum appreciation of 16% against a rather volatile yen.

FINANCIAL MARKETS

25. Uncertainty in financial markets about the interpretation of the monetary aggregates over the previous six months was increased during April by a sudden change in M1 behaviour, signs of an unusually directed policy rift between the Administration and the Fed and apparent contradictions between statements by the Fed Chairman and actions actually taken by the Fed. At the heart of these problems seems to be the genuine difficulty being experienced in assessing what statistical effect new changes in cash management procedures have had on various components of the money supply and hence in estimating what has been the underlying state of financial conditions and what the implications are for the economy.

26. M1 grew by 2% during the month of April alone according to the (normally rather unreliable) weekly figures issued during the month and 1½% in the month on the basis of provisional monthly figures. This performance contrasted strongly with that of the

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previous six months when there was actually a net downward movement in the narrow aggregate. Seasonal factors may afford a partial explanation for this apparent change in behaviour, but it had anyway been expected that, once the discrete shift in money balances induced by the advent of automatic transfer between savings and chequing accounts and the swift rise in use of repurchase agreements on commercial paper and money market mutual funds was over, M1 would again resume a more positive growth path. The speed of the increase during April nevertheless gave support to those who had been contending that underlying monetary conditions had in fact been rather loose, a viewpoint further supported by the spurt in commercial and industrial borrowing during the month.

27. Against this unfolding background of evidence of considerable liquidity in the economy which might be further fuelling inflation, senior officials and economists in the Administration increased their (previously internal) pressure on the Fed to start raising interest rates. This, and the reaction of the Fed Chairman, attracted a certain amount of publicity as did a subsequent instruction by the President to his advisers to soften their criticism of the Fed's moderate stance. The Fed Chairman then confused the markets further by repeating his view, just in advance of a Federal Open Market Committee meeting, that short-term interest rates need not be pushed any higher, only to be followed two weeks later by a clear move by the Fed to raise rates, if only by a small amount. The immediate triggers to this action seem to have been higher-than-expected monetary figures during those two weeks and disappointing data on consumer prices, but there is an impression that the Administration's view has now prevailed on the Fed, at least to the extent that it has shown the will not to relax monetary policy. Federal Funds rates seem to have been moved up from their previous target range of 10% - 10 % to about 10¼%, with all the major banks' prime rates now set at 11¾%.

28. Uncertainty about the policy direction the Federal Reserve Board is taking has helped impede the recovery of the stock market and the Dow Jones Industrial Average index fell from about 830 at the beginning of April to around 830 in the first week of May.

LABOUR MARKET AND PRICES

29. Employment and hours data for April presented a confusing picture. The monthly survey of households showed a massive drop of 670,000 (0.7%) in employment in the month after eight months of very strong growth during which gains averaged 0.3% per month. There was also a very sizeable drop of ½ hour (1.4%) in the recorded average work-week. On the other hand, employment as measured by the monthly survey of establishments was shown to be virtually unchanged over the month and, because of a large drop in the labour force as measured by the household survey, there was only a small rise - to 5.8% - in the unemployment rate.

30. Most commentators have chosen to disregard these data because of their internal inconsistency and the fact that the collection routines were significantly disrupted by religious holidays, the weather and the effects of the Teamsters dispute in

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the trucking industry. There is nevertheless a possibility that the unusually strong growth of employment which characterised the latter part of the recovery is now beginning to moderate. The disparities between different demographic and occupational groups remain. The average unemployment rate in the black population is reported to be nearly 12%, with male black adults just under 9% and black teenagers well over 30%. In the white population, the average unemployment rate is just below 5%, with adult males down to about 3½% and teenagers about 14%. White-collar workers are estimated to have an unemployment rate of about 3½% and blue-collar workers over 6½%.

31. The most reliable indicator of underlying movements in earnings is normally the hourly earnings index for production or nonsupervisory workers on private non-agricultural payrolls. This excludes from other earnings data both the effects of fluctuations in overtime premiums in manufacturing and the consequences of changes in the proportion of workers in high- to low-paid industries. The index (seasonally adjusted) showed that increases in earnings during 1978 averaged just under 8½% p.a. with some acceleration at the beginning of the year and moderation later on. This moderation seems to have continued into 1979 and increases compared with a year earlier are currently averaging just over 8% (the April figure in fact declined to 7.8%). However, it is not possible to determine the extent to which this might be a reflection of the wage guidelines, which only came into being in October 1978, nor whether the moderation will continue if inflation stays at current rates.

32. The earnings index does not in any case tell the whole story. Non-wage benefits are making up an increasingly important share of total labour compensation and provisional data for the first quarter show that there was a rise of 9½% in total hourly compensation over a year earlier. Furthermore, the wording of the wage standards provides some incentive to postpone a part of agreed wage increases to future periods by loading them into cost-of-living adjustments. The standard has also been shown to be a good dea[l] more flexible on fringe benefit increases than on cash earnings. There were several concessions on pensions inserted into the original wage guidelines with the aim of facilitating a settlement in the negotiations between the Teamsters and the haulage industry and further changes (including some on the wages side) were made during the talks themselves and the short lockout which followed. The rubber workers indicated they were interested in pursuing similar loopholes in their current negotiations and the electrical and automobile workers, who are due to settle later this year, may follow similar lines. Meanwhile, United Airlines have been grounded for over six weeks by a dispute with the machinists' union. Even if there are no dramatic breaks in the guidelines this year, labour compensation increases are likely to stay in the region of 9% p.a.

33. Consumer prices rose by 1% in March, taking the quarterly rate to the region of 12% p.a. and the rate compared with a year earlier above 10% for the first time since 1974/75. In March, 1978 consumer prices had been less than 7% above those of a year earlier. Much of the acceleration in the index can be attributed to food, fuel and costs of house purchase but there are signs

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from the producer (or wholesale) price index that there are significant rises in processed goods that have yet to be passed through to the consumers. At the finished goods stage, prices rose by 1.3% during April having increased at an annual rate of 14% in the first quarter. At the crude goods stage prices rose at over 20 % p.a. in the six months to March 1979 although there was a fall of 0.4% in April.

ECONOMIC OUTLOOK

34. Beyond the next few months, the outlook for the economy is very uncertain. The consensus amongst economic forecasters, and apparently also in parts of the Administration, is that there will probably be a decline in activity rates for at least one or two quarters before the economy starts a very slow recovery in 1980. There is, however, a fair measure of support for the view that the economy will remain reasonably strong for the remainder of this year (although growing at a significantly slower rate than in 1978) and will then dip into a perhaps severe recession during 1980. This prospect is normally thought to be conditional on a continuation this year of high rates of inflation and a monetary policy forced eventually into producing restrictively high rates of interest.

35. Because of the strong growth of the economy through 1978 and the maintenance of the relatively high level of activity in the first quarter of 1979, GNP will show a growth rate between 1978 and 1979 of over 2% even if there is no growth from now on. The Administration are still officially projecting an increase of about 3¼% between the years, while most economic analysts who do not see a recession developing in 1979 are projecting a growth rate of just over 2½%. Consumer prices are expected to rise by about 9% through 1979, with some commentators foreseeing the possibility that the inflation rate will not in fact dip below 10%.

36. One brighter aspect of recent developments is the fast improvement in the trade account and the renewed health of the dollar. It is however not certain how long these circumstances will continue. The relatively high rates of inflation currently being experienced in the US compared with most of its competitors in the developed world suggest that a significant proportion of the competitiveness which was recovered during 1978 is being erroded. Although the relatively slower growth now expected for the US this year and next will help the trade position, these developments suggest that overall the improvement in the current account will probably be short-lived so that renewed pressure may be felt on the dollar.

POLICY PROSPECTS

37. Congress is currently completing work on the first Budget Resolution for fiscal 1980 which starts this October. The Resolution is not at this stage binding on Congress but provides normally a good indication of the direction in which fiscal policy will be determined. The Senate has proposed a Federal deficit of $29 billion on the assumption of a somewhat weaker econom[y] than the Administration specified when originally recommending the same target deficit. The House on the other hand have opted

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for a target of $21 billion but on the basis of economic assumptions which themselves reduce the projected deficit by $10 billion. The situation is further complicated by latest calculations e.g. of tax yield being made by the Administration (but not timely enough to be processed into the Congressional Resolution) which suggest that even the House estimates could over-state the likely deficit under the policies currently being debated. A conference committee is now charged with reconciling the two sets of proposals to produce a "concurrent" Resolution for adoption by both Houses.

38. Despite these doubts about the basis on which the forecasts ought to be made, the mood of Congress is fairly clear. A strict rein will be kept on projected expenditure programmes and at the moment there is no support for any tax cuts. This policy has the full support of the Administration and there do not appear to be signs of any serious consideration being given to possible changes in fiscal policy should the economy in fact turn down as most people are predicting. This means that there is considerable uncertainty about how fiscal policy might actually develop during the election year of 1980. It is possible for Congress to revise its budget Resolution at any time during the financial year and the possibility of a change in direction, precipitated by electoral concerns about unemployment and the rise in tax burden on middle-income earners, cannot be ruled out. The prospect of achieving a balanced Federal budget in 1981 seems, however, to be conditional both on a strong economy and on no large changes in tax rates from present law being permitted.

39. The major tax measures currently under consideration by Congress are associated with the President's efforts to clawback part of the expected windfall gains to the oil companies which would follow his decision to move towards decontrol of oil prices. The regional and sectoral conflicts which characterised Congressional consideration of the President's energy programme in 1977 and 1978 are again of vital importance.

40. With very little scope for further fiscal changes within the current year and some evidence that the state of liquidity in the corporate sector might be excessive, there has been a tendency in the Administration to think of monetary policy as providing the appropriate instrument for economic management at the present time. The Federal Reserve Board, on the other hand, have been less certain that the tightening in monetary policy which they had already instituted had not already gone far enough to bring about a serious slowdown in the economy this year. As data on the monetary side and for the economy at large become more coherent, there could be a rather firmer decision by the Fed on whether to proceed with another round of monetary tightening.

41. Most of the components of the Administration's anti-inflation programme are still in place despite some bending of the rules to allow a settlement in the Teamsters dispute and the loss in Congress of the Real Wage Insurance Programme. However, there is considerable scepticism about the effectiveness of the prices standards and little prospect, because of cost pressures already in the pipeline, that price inflation can be measurably reduced. One aspect currently being considered is whether Federal regulations affecting industry can be eased, for a short period at least, in order to mitigate some of the costs they would otherwise impose.

Expenditure on GNP (quarterly data)
(1972 prices $b sa annual rate)

		% pa change over	
	1979(P)	last qtr	same qtr yr earlier
GNP	1417.3	0.7	4.7
Personal Consumption	915.7	1.7	4.8
durables	150.1	0	8.9
nondurables	347.1	-1.6	4.1
services	418.5	5.3	4.0
Business fixed investment	145.9	2.8	9.0
Housing investment	58.1	-13.8	-2.4
Change in business inventories	11.8	8.2 (A)	12.3 (A)
Govt purchases of goods & services	277.0	-3.4	1.8
Federal	102.1	-1.6	0.9
State & Local	174.9	-4.4	2.4
Net exports of goods & services	8.9	10.3 (A)	2.9 (A)
Exports	112.4	2.5	13.4
Imports	103.4	7.7	7.5
Price deflator (1972=100)	159.9	8.7	8.7
GNP (current prices)	2265.6	9.5	13.7
Net exports (current prices)	-10.3	-7.6 (A)	-24.1 (A)

Monthly indicators

			% pa change over		
	Month		1 mth earlier	3 mths earlier	year earlier
Industrial production	Mar	152.2	10.0	3.5	8.0
Capacity utilisation mfg	Mar	86.3	5.7	0	4.4
Retail Sales ($b current prices)	Apr	72.2	5.9	7.8	10.8
Car Sales (m units pa)	Apr	11.1	-76.3	5.5	-10.9
Housing Starts (m units pa)	Mar	1.8	2135.3	-44.1	-10.8
Merchandise exports ($b)	Mar	14.5	125.1	40.1	29.6
Merchandise imports ($b)	Mar	15.3	45.2	6.6	9.1
Civilian employment (Hsehld Svy)	Apr	96.2	-8.0	-0.5	2.6
Unemployment Rate (%)	Apr	5.8	5.7(A)	5.8(A)	6.0(A)
Consumer Price Index (1) (2)	Mar	209.1	12.7	13.0	10.2
Producer Price Index (2)					
finished products	Apr	211.2	11.4	12.1	10.3
all commodities	Apr	229.7			11.3
Average hourly earnings (pnf)	Apr	6.0	0	4.1	7.7
Average hourly earnings (pnf adj)	Apr	226.6	7.1	7.0	7.8
Composite indices					
12 leading indicators	Mar	142.3	-5.7	-4.9	1.4
4 coincident indicators defl	Mar	145.5	6.8	-0.5	6.3
6 lagging indicators	Mar	158.8	-3.7	8.0	15.7
Inventory levels ($b cur prices)	Apr	$392.3b(A)	$387.4b(A)	$379.4b(A)	$349.2b(

(1) All urban consumers

(2) % changes are seasonally adjusted; levels are not seasonally adjusted.

(A) Implies actual value in the period specified NOT percentage change.

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C Monetary indicators

	Latest Month		% change at annual rate over previous 4 wks	13 wks	52 wks
Federal reserve credit outstanding $b sa (1)	Apr	127.5	14.1	-5.3	9.4
Monetary base $b (1)	Apr	144.8	6.9	4.5	8.3
M1 $b	Apr	364.1	18.4	4.7	4.7
M2 $b	Apr	889.8	14.5	6.7	7.2
Total bank reserves (1) $b	Apr	40.6	-4.6	-6.9	10.1
Consumer instalment credit	Mar	278.3	11.6	5.0	19.0
Commercial & industrial loans by large banks	NOT AVAILABLE				

	Latest Month		Previous Month	3 mths Previous	Year Previous
Commercial bank prime rate (1)	Apr	11.75	11.75	11.75	8.25
3 mth Treasury bills	Apr	9.47	9.49	9.35	6.29
Corporate Aaa bonds	Apr	9.38	9.36	9.26	8.56
3 mth CD rate	Apr	10.07	10.15	10.46	7.01
US Govt bond rate (20-yr)	Apr	9.10	9.09	8.98	8.32
Federal Funds rate	Apr	9.98	10.09	10.05	6.85

(1) Average of latest 4 weeks

FINANCIAL DIST:

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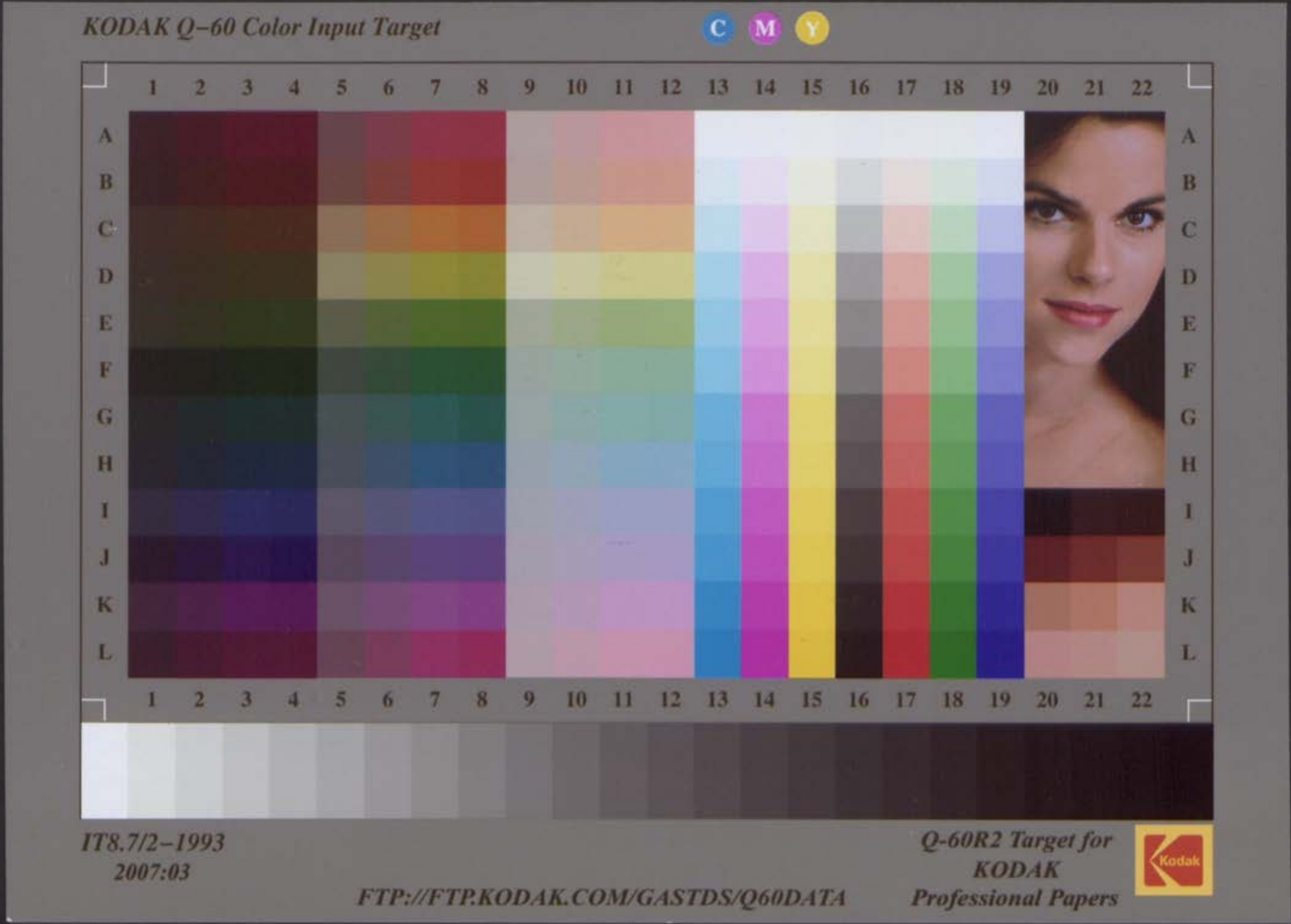
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