PREM 19/1654

PART 2

Confidential Filing

Economic Situation

USA

Part 1: May 1979
Part 2: October 1982

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~5.10.82~~		~~21.12.83~~		~~27.11.84~~			
~~28.10.82~~		~~17.1.84~~		~~5.12.84~~			
~~24.11.82~~		~~27.1.84~~		~~10.1.85~~			
~~3.12.82~~		~~23.2.84~~		~~2.2.85~~			
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~~21.1.83~~		~~29.3.84~~		~~18.2.85~~			
~~7.2.83~~		~~16.4.84~~		~~20.2.85~~			
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~~.12.83~~							

PART 2 ends:-

British Embassy, Washington to HMT 28.2.85

PART 3 begins:-

Statement Paul Volcker 6.3.85

→ Mr Turnbull No.10

US file

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P Wynn Owen Esq
PS/Chancellor of the Exchequer
HM Treasury

Your reference

Our reference

Date 28 February 1985

Dear Phillip,

As discussed, I attach copies of Paul Volcker's testimony before (a) the House Banking Committe and (b) the Senate Foreign Relations Committee this week.

Yours ever,
Harry
H G Walsh

c. with attachments

R G Lavelle Esq
HM Treasury

T Lankester Esq
HM Treasury

CH/EXCHEQUER
REC. 11 MAR 1985
MR LITTLER
MR UNWIN
MR TURNBULL (NO. 10)

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Subcommittee on Domestic Monetary Policy

of the

Committee on Banking, Finance and Urban Affairs

House of Representatives

February 26, 1985

I appreciate this opportunity to appear before you to present the Federal Reserve's monetary policy objectives for 1985. In accordance with the Humphrey-Hawkins Act, the semi-annual report of the Federal Reserve was transmitted to you earlier. That report reviews in detail economic developments and monetary policy in 1984, and sets forth for 1985 the plans for policy by the Federal Open Market Committee. This morning I would like to discuss the Committee's decisions and the outlook for the economy in the context of some important unfinished business facing all of us responsible for economic policy.

The Economic Setting

The familiar objective of monetary policy is to foster sustained economic growth and employment in a context of reasonable price stability. Stated so generally, that objective can hardly be challenged; it indeed encompasses the broad goals of economic stabilization policy generally.

Measured in those terms, there is clear reason for satisfaction in the performance of the economy last year. In summary, with real gross national product up by 5-1/2 percent over the year, and by about 12 percent in two years, we have enjoyed the strongest expansion since the Korean War period. On top of the gains in jobs in 1983, employment increased by over 3 million last year. The unemployment rate fell one full percentage point to 7.2 percent at year-end. Real incomes for the average American are up.

Prospects for sustained growth and productivity over time rest importantly on success in achieving and maintaining an environment of greater stability of prices and financial markets. In that light, it is encouraging that, contrary to widespread earlier expectations, the strong growth of 1984 took place without inflation increasing appreciably from the sharply reduced levels of 1982 and 1983. Specifically, the consumer price index increased around 4 percent last year, little changed from the previous two years, and prices of most goods (in contrast to services) at the wholesale and retail levels rose by less than that. While the evidence is less tangible, there are also encouraging signs that chronic expectations of future inflation have been damped.

The behavior of actual prices and nominal wages, which by some measures rose more slowly in 1984 than in 1983 despite expanding demands for labor, may in some part reflect those changes in attitude. Businessmen and workers no longer seem so preoccupied with a need to anticipate inflation in their pricing and wage decisions. And declines in bond yields after midyear seemed to reflect, to some degree, less fear of future inflation.

To be sure, a number of factors that may not be lasting have helped to hold price increases down. The continuing appreciation of the dollar and strong competition from imports have placed strong pressures on prices and wages in some manufacturing and mining industries. Widespread declines in commodity prices cannot persist indefinitely. Unemployment is still higher than we would like to see. But it is also true that progress against inflation, as it is prolonged, can potentially feed on itself by encouraging restrained price and wage behavior.

As we start 1985, the immediate economic outlook appears reasonably favorable in these respects. Projections of Federal Open Market Committee members that I will be reviewing later in my testimony broadly parallel those of the Administration, the Congressional Budget Office, and many other observers; economic growth is expected to remain strong enough in 1985 to produce some further decline in unemployment, with little if any pickup in inflation.

But we must not be beguiled by those tranquil forecasts into any false sense of comfort that all is well. If the enormous potential of the American economy for growth and stability -- not just for 1985 but for the years beyond -- is to become reality, we need a sense of urgency, not of relaxation.

For one thing, with the general price level still rising in the neighborhood of 4 percent a year -- and with prices of services that today account for so much of the economy rising more rapidly than that -- we should not confuse evidence of progress against inflation with ultimate success. Indeed, the more favorable price expectations I noted a few moments ago could prove fragile -- highly vulnerable to any indications that public policy is prepared to accept and accommodate to inflationary forces. That must be of particular concern in the conduct of monetary policy.

Perhaps more immediately, despite the strength of the overall expansion, some important areas of the economy are under strain and there have been recurrent international and domestic credit problems. Those strains and pressures are aggravated by underlying imbalances that, unless dealt with effectively, will undercut the long-term outlook.

One of those imbalances was highlighted by the slowdown in GNP growth we experienced in the third quarter. Such a "pause" is not an unusual feature of an expansion period. Demand does not grow smoothly, and occasional inventory imbalances will develop that require production adjustments. What was unusual last summer was that the slowing of demand growth was accompanied by a surge in imports, magnifying the effects on domestic producers. That summer import surge was reversed by year-end, but the underlying trend toward higher imports is clear. Our trade deficit increased to about
(1) $110 billion in 1984, far higher than ever before, and the entire external current account deficit -- counting both goods and services -- has deteriorated by about $100 billion since 1982. The sustainability of that trend, politically as well as economically, is, to say the least, questionable.

The rising trade deficit helps account for the failure of a number of important sectors to participate at all fully in the expansion. Agriculture, heavy capital equipment producers, and the metals industry, all of which face difficult structural problems in any event, are examples. They are further pressed by interest rates that, as you know, remain historically high, both in nominal terms and relative to recent inflation.

Looking abroad, growth in many industrial countries remains sluggish amid continuing high levels of unemployment, and depreciation of their currencies vis-a-vis the dollar seems to be one factor inhibiting more expansionary policies. Important developing countries are still struggling to restore stability and maintain growth while laboring under heavy debt burdens. In this interdependent world, these difficulties feed back on our own prospects.

(ii) It is no coincidence that the record external imbalance and continued high interest rates have been accompanied by large federal budget deficits -- deficits that according to projections of both the Administration and the Congressional Budget Office will only deepen in the years ahead in the absence of decisive corrective action.

Government deficits can be relatively benign and even useful in boosting incomes and purchasing power in the slough of recession and when private investment and credit demands are weak. It is also true that our growing volume of imports

(A)

over the last two years has provided an impetus for growth in other countries when other expansionary forces were weak. Moreover, the kind of obvious squeeze on, or "crowding out" of, domestic housing and investment that many anticipated as the expansion has developed has not been apparent.

We have been able to reconcile high deficits, sharply rising imports, and strong investment mainly for one reason: we have been able to attract an enormous amount of savings from abroad to supplement our own. The net capital inflow approached $100 billion last year, and it will probably need to be still larger this year. Domestic net savings -- by individuals, businesses, and state and local governments -- are running at about $325 billion, so the supplement from abroad adds close to a third to net savings generated internally. The net capital inflow was equivalent last year to more than half of the budget deficit.

(iii)

That same inflow of funds has encouraged a very strong dollar. The strong dollar, in turn, contributes importantly to the huge and growing trade deficit. Our policy dilemma is simple but perhaps not fully understood. We cannot logically welcome the capital inflow from abroad in one breath and complain about the trade deficit in the next. They are two sides of the same coin.

We are managing to finance the deficit and maintain housing and investment expenditures with the help of imported capital. At the same time, the exporter, those competing with imports, and the farmer are being "crowded out."

Looking ahead, the stability of our capital and money markets is now dependent as never before on the willingness of foreigners to continue to place growing amounts of money in our markets. So far, they have been not only willing but eager to do so. (iii) But we are in a real sense living on borrowed money and time.

It is up to all of us to make constructive use of both the money and the time. In essence, that is the challenge for all of us -- for monetary and fiscal policy, and for all the other policies that can contribute to a productive, growing economy.

Monetary Policy in 1984

As you will recall, the economy was expanding particularly rapidly during the early part of 1984, and demands for money and credit -- and for bank reserves to support monetary growth -- were also strong. By early spring, data available at the time showed M1 increasing at rates well into the upper portion of its range for the year, which targeted growth at 4-8 percent.* At the same time, driven by the financing needs generated by rising levels of private spending and by the Federal Government,

*The data in this testimony for the monetary aggregates reflect recent seasonal and benchmark revisions. While the changes for the year as a whole were small, the revised data for M1 for the first half of the year are lower, and the second half higher, than reported earlier.

M3 and non-financial credit were expanding around or above the upper end of their long-term ranges.

The strong expansionary forces in the economy were reflected in some limited upward movements in interest rates in February and March, and early in the spring the Federal Reserve began to exert some additional restraint on reserves being supplied through open market operations. Consequently, depository institutions were forced to rely increasingly on borrowing at the discount window to satisfy demands for reserves. With credit demands and the economy continuing to expand strongly, and with markets concerned about the possibility that inflationary forces might reassert themselves as the period of strong expansion lengthened, interest rates moved noticeably higher in the spring. In April the Federal Reserve increased its discount rate 1/2 of a percentage point to 9 percent to bring this rate into better alignment with market rates and to discourage reserve adjustment at the discount window.

In May, a liquidity crisis developed in one of the largest commercial banks in the country, growing out of continuing concerns over weaknesses in its loan portfolio. The Federal Reserve, the FDIC, and the primary supervisor of the bank, the Comptroller of the Currency, worked closely together to support the orderly functioning of the institution while more permanent recapitalization and other elements of a long-term solution could be developed. Nonetheless, that incident, together with continuing concerns about international debt problems, for a time contributed to uneasiness in banking markets, and interest rates on short-term private credit instruments rose appreciably above those on government securities.*

Demands for money slackened after midyear as the economic expansion slowed. Long-term interest rates began to drop from the higher levels reached in the spring as inflation concerns moderated. With the problems of the Continental Illinois Bank contained and progress made toward restructuring the debts of some important developing countries, the abnormal interest rate spreads began to narrow, but the money markets as a whole remained under some pressure. By late August and September, with M1 growth moving toward the midpoint of its range and M3 expansion slowing toward the upper end of its range, and with some evidence that economic growth had slowed, the Federal Reserve began to ease pressures on reserve positions.

That process continued through the fall, and borrowing at the discount window fell steadily from September through January. Late in the year, total and nonborrowed reserves began to grow rapidly. Short-term interest rates declined between 2-1/2 and 3-1/2 percentage points over the last four months of the year. Reacting to these declines, and to an extent facilitating them, the Federal Reserve in two half-point steps reduced the discount rate to 8 percent, the lowest level since 1978.

*Attachments I & II summarize these and related developments, and the Federal Reserve response, more fully.

Several additional factors influenced judgments about the appropriate degree of easing of reserve positions during the fall. The dollar remained exceptionally strong in foreign exchange markets, potentially increasing pressures on some sectors of the American economy and a source of growing concern among some of our trading partners experiencing depreciating currencies vis-a-vis the dollar. At the same time, relatively favorable incoming data about prices and wages tended to allay concerns about actual and potential inflationary pressures. In fact, prices of many sensitive commodities were falling appreciably. In these circumstances, reserves could be provided more liberally, and growth in the money supply more actively supported without providing a basis for a destructive rise in inflation expectations.

The fall in interest rates and the more generous provision of reserves in the context of some increases in economic activity led to a rather strong revival of M1 and M2 growth around year-end, bringing both aggregates relatively close to the mid-points of their respective ranges. As monetary and credit growth continued at a relatively rapid pace into January, the easing process came to an end.

Unlike the pattern during much of 1982 and 1983, when M1 grew more rapidly than nominal GNP (that is "velocity" slowed), the income velocity of M1 rose 4 percent last year. That is broadly in line with cyclical experience in the past, taking into account both the pattern of interest rate movements and income growth. M2 velocity also increased, rising around 1-1/2 percent following two yearly declines.

These developments provide some support for the view that velocity trends over time, as well as cyclical changes for these aggregates, may be returning to patterns more along the lines of earlier experience. In contrast, in 1982 and 1983, during a period of rapid transition to deregulation of deposit interest rates and substantial economic uncertainty, those earlier patterns had been disrupted and velocity had declined appreciably.

The rise in M3 and credit during 1984 exceeded expectations at the start of the year, and both measures exceeded by a considerable margin the upper limits of their ranges over the year as a whole. In fact, credit increased at its most rapid pace over the entire post-World War II period, both in absolute terms and relative to nominal GNP. Debt growth of this magnitude would appear to be much faster than consistent with the long-run health of our economy and financial system. It reflects to some degree the imbalances in our economy I emphasized earlier.

For example, the budget deficit led to expansion of federal debt of 16 percent, an unprecedented rate of growth in the second year of a business cycle. The growth of the debt of non-federal sectors, at nearly 13 percent, also was high relative to past experience. A portion of this growth in private debt -- perhaps around 1-1/2 percentage points -- can be attributed to a huge volume of mergers, leveraged buyouts, and stock repurchases by businesses which had the effect of substituting debt for equity. Despite some sizable sales of new stock, non-financial corporations on balance retired about $70 billion of stock last year.

Whatever the circumstances and justification for the particular companies involved, a financial structure that tends toward more debt (and shorter debt) relative to equity becomes more vulnerable over time. More cash flow must be dedicated to debt servicing, exposure to short-run increases in interest rates is magnified, and cushions against adverse economic or financial developments are reduced. These are factors that prudent lending institutions should take into account in evaluating new credits, and reports suggest that some banks did in fact review their policies toward mergers and leveraged buyout financing as the year wore on.

While the effect cannot be isolated, the rapid growth of debt relative to GNP may also reflect the fact that domestic <u>spending</u> increased appreciably faster than domestic production, which is what the GNP measures. A new machine, for instance, will require financing, whether purchased at home or abroad, and sharply increasing amounts of capital equipment have in fact been imported. As I indicated earlier, directly or indirectly, that financing may be supplied from abroad, alleviating the pressures on our market. But the debt burden inevitably rests with the borrower.

Monetary Policy in 1985

At its meeting last week the FOMC agreed to some small changes in some of the ranges for the monetary and debt aggregates tentatively set out last July. The modifications are in response to analysis of information now available and do not represent any change in policy intentions. As shown on the attached table, for M1, the Committee reaffirmed the lower tentative range it adopted last July of 4 to 7 percent growth from the fourth quarter of 1984 to the fourth quarter of 1985. M2 is targeted to grow between 6 and 9 percent, the same range as used in 1984. The upper end of that range was increased by 1/2 percent from the tentative range for 1985 set in July. That small adjustment reflects a technical judgment -- based on assessment of recent developments -- that M2 could expand more in line with income growth this year, in keeping with the historic record of little trend growth in its velocity.

The upper end of the new M3 range of 6 - 9 1/2 percent was also set 1/2 percent higher than tentatively agreed in July. The associated monitoring range for credit was set at 9 to 12 percent, a percentage point above the 1984 range. Adjustments in both target ranges still contemplate a considerable slowing in these two aggregates from what actually occurred in 1984. Even so, credit growth, fueled in part by the budget deficit, is expected to be quite strong, significantly exceeding the rate of expansion of GNP for the third consecutive year.

The Committee does not anticipate that growth of debt within the targeted range would necessarily pose significant new risks for the economy or the financial system in the year immediately ahead. However, a healthy financial structure will in time require more restraint on borrowing relative to the economic growth that, in the last analysis, provides the wherewithal to service the debt. One continuing problem in that respect is the extent to which the current tax structure tends to favor debt rather than equity financing, a point addressed in the Administration's reform proposals.

The ranges for growth in money and credit are expected by FOMC members and non-voting Reserve Bank Presidents to support another year of satisfactory economic expansion without an acceleration of inflation. Forecasts of real GNP growth centered around rates of 3-1/2 to 4 percent from the fourth quarter of 1984 to the fourth quarter of 1985 -- rates anticipated to be sufficient to reduce the unemployment rate to around 6-3/4 to 7 percent by year-end. Inflation, as measured by the GNP deflator, was expected most frequently to be in a range of 3-1/2 to 4 percent over the year, about the same rate as prevailed in 1984.*

*These projections, now regularly set out in our Humphrey-Hawkins Reports, should not be interpreted as indicating "targets" for real growth or inflation in the short or longer run. As discussed in Attachment III, the Committee does not target a specific long-range growth path for the economy.

In view of the necessarily tenuous nature of any judgment about the outlook for exchange rates, FOMC members in preparing their projections assumed that the dollar would fluctuate in a range encompassing its level of recent months. They also assumed that the federal budget deficit would be reduced significantly in fiscal 1986 relative to base line projections, a development that would help damp both interest rate and inflationary expectations. Obviously, those assumptions suggest some of the important risks inherent in the outlook.

As I indicated in discussing 1984 developments, we entered 1985 with the various monetary aggregates growing relatively rapidly. The targets for this year take, as usual, the actual average for the fourth quarter of the previous year as a starting point (or "base"). Consequently, we are starting the year with the levels of the aggregates above the target ranges as they have been conventionally illustrated -- that is by so-called "cones" starting at a point late the previous year and widening through the current year. (See Charts I to IV.)

That conventional and widely used "picture" is essentially arbitrary. Interpreted rigidly (and wrongly), the narrowness of a cone in the early part of the year -- literally narrower than some <u>weekly</u> fluctuations in the money supply -- would attach policy importance to levels or movements in the various aggregates that in fact have no significance.

We have sometimes considered, and others have suggested, a better "pictorial" approach would be to illustrate the targets by a different (but also necessarily arbitrary) convention -- parallel lines drawn back from the outer bounds of the specified fourth quarter target ranges to the base period, as shown in the charts attached. The target range is then portrayed as maintaining the same width throughout the year. The current levels of the aggregates, as you can see on the charts, are within such parallel lines.*

As a matter of economics and policy, rather than graphics, the Committee is not disturbed by the present level of M1 and M2 relative to its intentions for the year. It contemplates that, as the year progresses, growth will slow consistent with the target ranges.

Consistent with that approach, as I indicated earlier, the progressive process of easing reserve positions undertaken in the latter part of 1984 ended. The provision of reserves through open market operations is currently being conducted a bit more cautiously to guard against inadvertent "overshoots" in supplying reserves. Any further change in approach will, as always, depend upon assessments of the trend of monetary growth in the period ahead, evaluated in the context of the flow of information on the economy, on prices, and on domestic credit and exchange markets.

The annual target ranges for M1 and M2 assume that trends in velocity are returning to a more normal and predictable

*Attachment IV addresses the different but related questions of the appropriate "base" used in setting and illustrating targeted growth ranges.

pattern. However, there is some analysis that suggests the trend of velocity over time may be a little lower than the trend of 3 percent or so characteristic of much of the postwar period when interest rates were trending higher. Should developments during 1985 tend to confirm that somewhat lower velocity growth, and provided that inflationary pressures remain subdued, the Committee anticipates that those aggregates might end the year in the upper part of their ranges. The lower part of the M1 range would be consistent with greater cyclical growth in velocity than now thought likely. As usual, these ranges will be reviewed at mid-year, in accordance with Humphrey-Hawkins Act procedures.

The Challenge Ahead

The approach toward monetary policy that I have outlined for 1985 is designed to promote, as best we can, our common objectives of sustained growth and stability. We can build on the strong progress of 1983 and 1984. There is forward momentum in the economy. The public at large seems to sense a greater degree of control over inflation than for many a year -- and I sense some chance of further progress toward price stability this year even as the economy grows.

Happily, despite the strength of the economic advance and the financing of a huge deficit, interest rates are today little above those of two years ago. The threats of financial dislocation growing out of the debt problems of much of the developing world, or from more purely domestic financial pressures, have been well contained. Points of strain will, without doubt, require continuing attention this year. But, in the context of a healthy economy, they are capable of resolution.

By encouraging appropriate growth in money and credit, in discharging our supervisory responsibilities, in performing when necessary the essential functions of lender of last resort, and in our general surveillance of the financial system, the Federal Reserve can help build on that progress. We aim to do so.

But it is equally important to understand clearly what monetary policy and the Federal Reserve cannot do.

The progress against inflation, the strength of the dollar and the competition from abroad, and some margins (if diminishing) of capacity and manpower have provided a certain degree of flexibility in the conduct of monetary policy. But that limited flexibility would be abused at our collective peril. Credibility in the effort to deal with inflation is a precious thing. The lesson here and abroad, now and through history, is that, once a sense of price stability is lost, it can be restored only with pain and suffering.

The Federal Reserve can theoretically run the modern equivalent of the printing press -- we can create more money. But more money is not the same as correcting the gross imbalance between our ability to generate real savings and the demands for those savings posed by housing, by investment and by the federal deficit.

To create money beyond that needed to sustain orderly growth would be to invite renewed inflation -- damaging incentives to save in the process. In contrast, to encourage savings from income would be to provide more of the real resources we need for future growth -- and it would help spur productivity and reduce price pressures in the process.

If that route isn't open to us -- and as a practical matter we probably can't do much right now to change ingrained savings behavior -- then the only constructive alternative is to attack the problem from the other side of the ledger by reducing the federal deficit.

For the time being, capital from abroad has been readily available to close the growing gap between our domestic savings and the demands upon them, moderating pressures on interest rates. Indeed, the money attracted partly by perceptions of our strength has come so freely we have an exceptionally strong dollar. But that same strong dollar contributes to a massive trade deficit that strains key sectors of industry and our agriculture, aggravating structural problems.

No doubt bad monetary policy could drive the dollar down -- a monetary policy that aroused inflationary expectations, undermined confidence, and drove away foreign capital.

But then, how would we finance our investment and our budget deficit?

Nor is the process of money creation adapted to relieving particular sectoral strains within our economy. We can and will, in our administration of the discount window and in our actions as lender of last resort, protect the essential financial fabric by supporting credit-worthy depository institutions faced with extraordinary needs.

But the evident problems of particular sectors, in the last analysis, will yield only to measures that support their efficiency and broaden their markets. That in itself is a large agenda, for government and those involved alike. And the process will be much easier if we at the same time address the basic imbalance between our capacity to save and our need to invest and to finance the government that I have emphasized today.

Conclusion

I fully appreciate the difficulties of the decisions before you as you collectively approach those excruciating budgetary choices. As you do so, I know that you are aware of the priority that progressive reduction of the deficit deserves. That, indeed, would provide the most fundamental kind of reassurance that growth can be sustained in an environment of greater stability.

For our part, in the conduct of monetary policy, we in the Federal Reserve will be sensitive to both the opportunities and the dangers before us. We believe the approach I have outlined with respect to the monetary targets and our implementation of policy sensibly reflects and balances the concerns I am sure we share.

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Chart 1

M1 Target Ranges and Actual

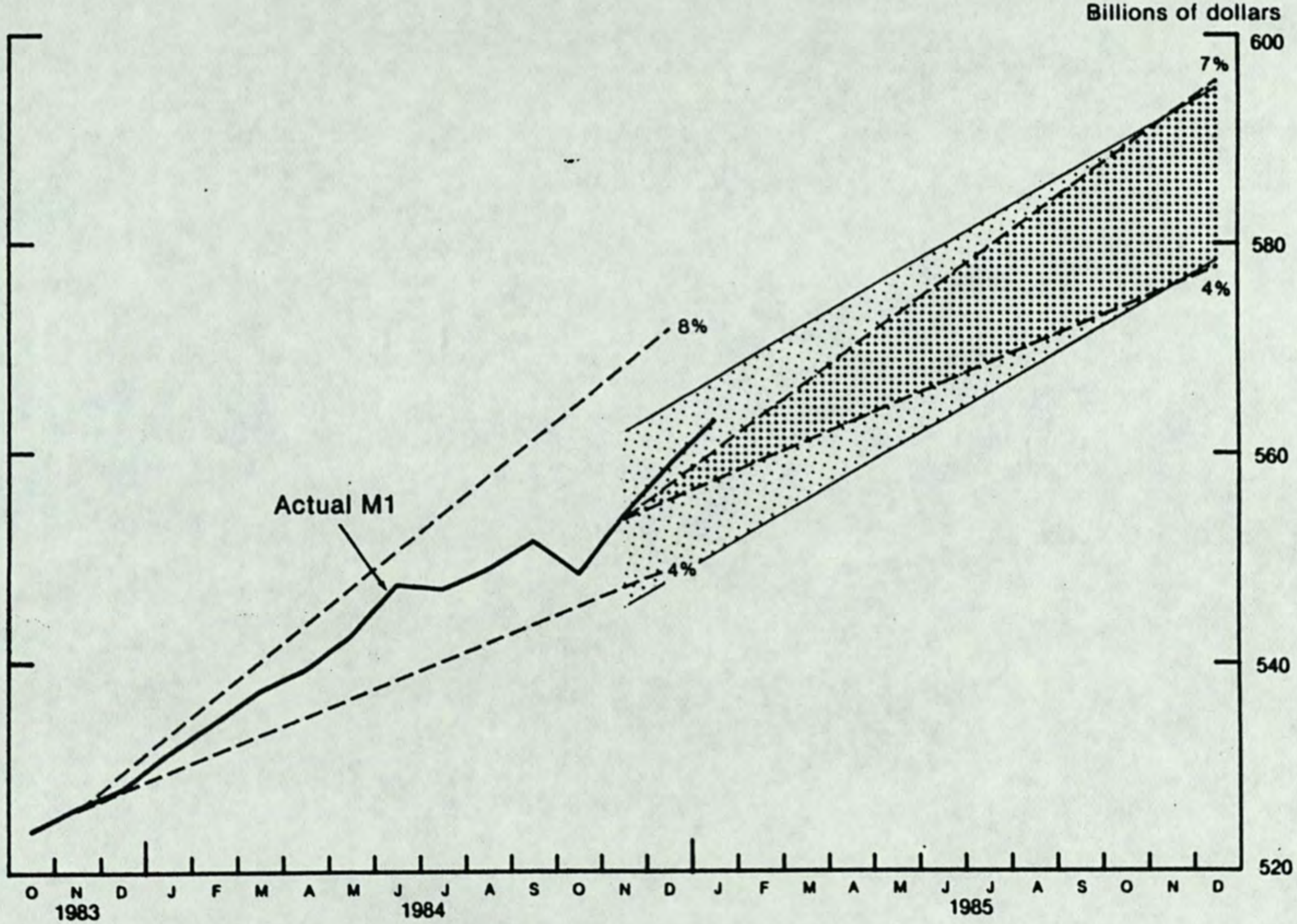


Chart 2

M2 Target Ranges and Actual

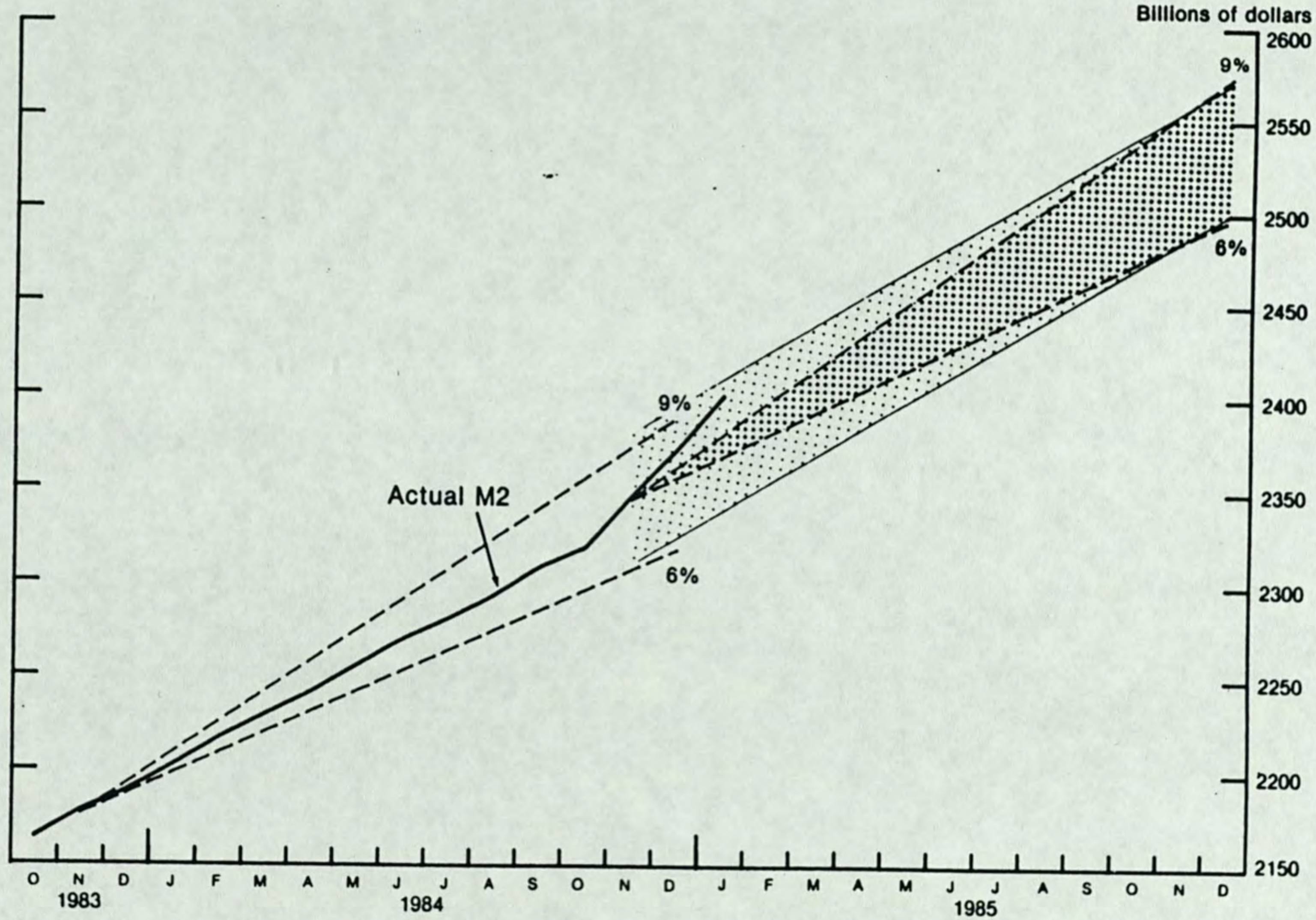


Chart 3

M3 Target Ranges and Actual

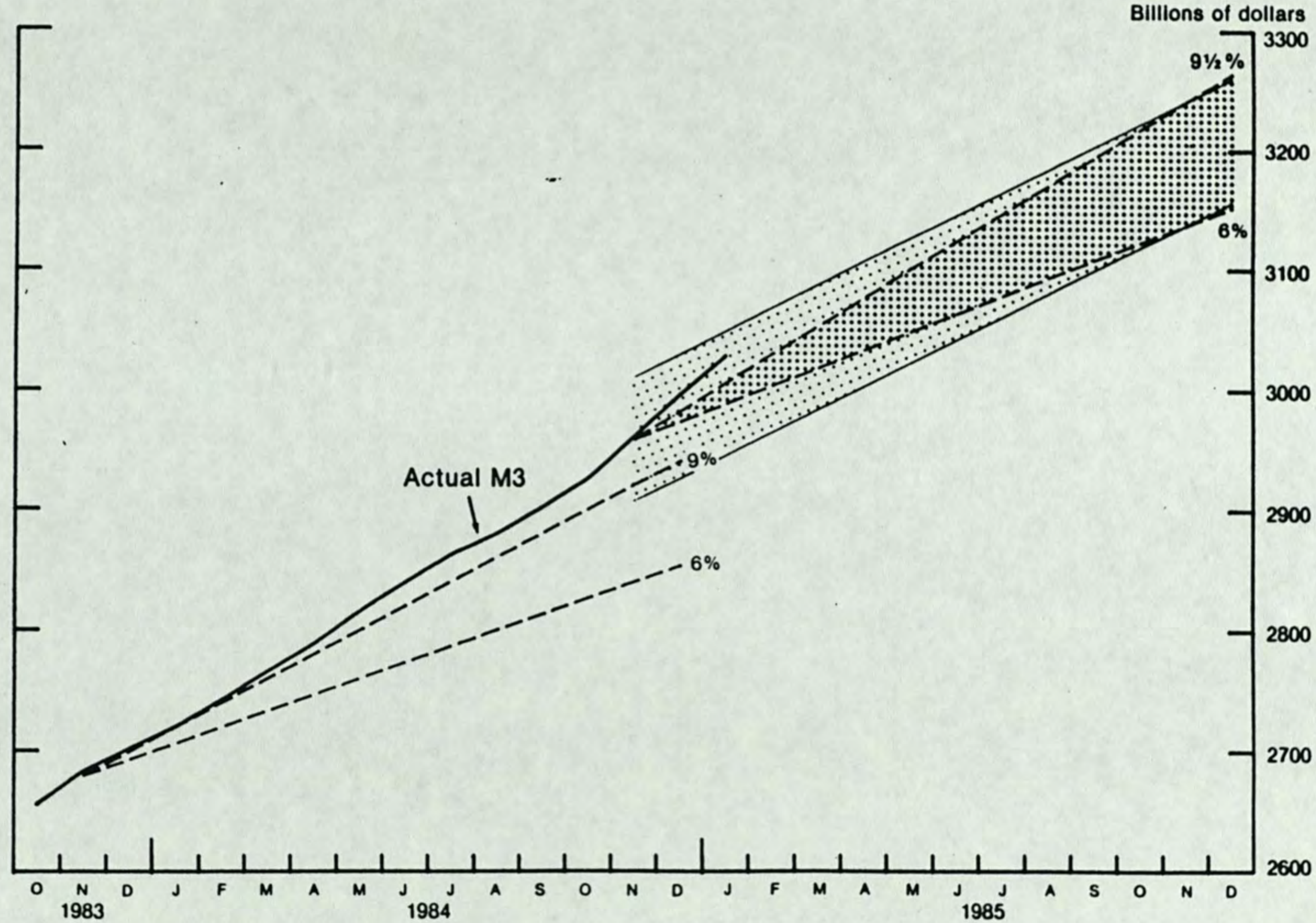
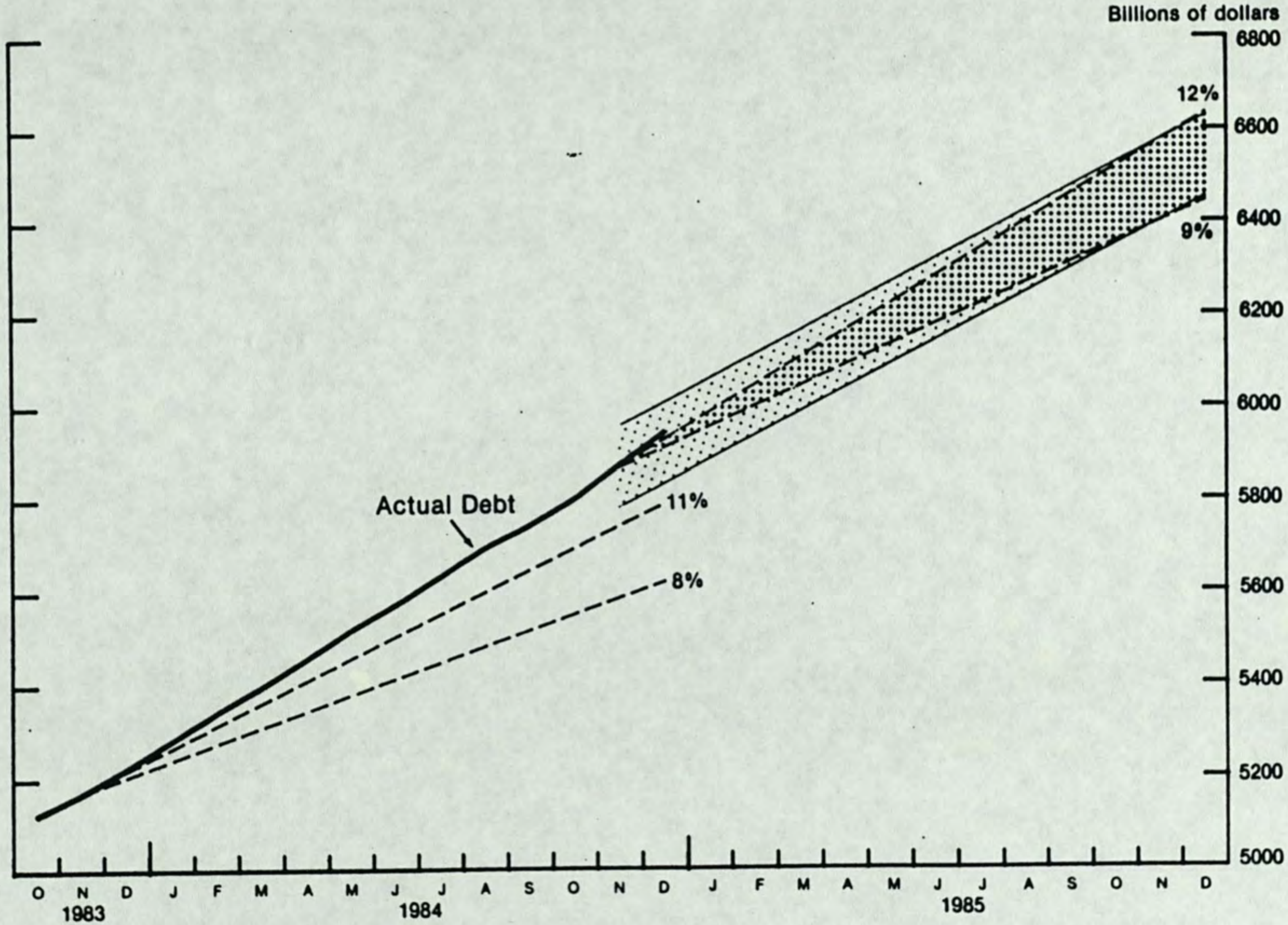


Chart 4

Debt Monitoring Ranges and Actual



Attachment I
The Implications for Monetary Policy of the Near Failure of the Continental Illinois Bank

The condition of the Continental Illinois Bank -- the seventh largest in the United States at the beginning of 1984 -- had been a matter of concern to regulatory authorities and market participants for some time, particularly after the failure of the Penn Square Bank in the middle of 1982 brought to light large loan losses and weaknesses in credit policy. Continuing profit and loan problems culminated in rumors of possible impending failure and a liquidity crisis in May 1984, involving withdrawal or failure to renew billions of dollars of deposits in the bank over a few days.

The FDIC, the Federal Reserve, and the Comptroller of the Currency, with the cooperation of a group of major banks, developed arrangements to provide temporary capital and liquidity support pending more permanent solutions and reorganization. The Federal Reserve -- acting as lender of last resort -- provided large amounts of funds through the discount window to maintain the bank's liquidity. That lending rose irregularly from around $3 billion during most of May to a peak of more than $7 billion in August. During the autumn the amount of outstanding loans declined to much reduced levels.

Provision of funds through the discount window has the effect of expanding total bank reserves, and unless otherwise offset, the lending to the bank would have had the effect of expanding the money supply well beyond targeted ranges. To maintain consistency of reserve provision with FOMC intentions, essentially equivalent amounts of reserves were absorbed by open market operations. While the large borrowings necessarily involved some added technical difficulties and uncertainties in the conduct of open market operations, the Committee was able to achieve its reserve objectives.

At the same time, however, the liquidity crisis of Continental Illinois Bank, particularly in an environment in which international debt and other credit problems were attracting attention, generated concern about possible threats to the stability of other financial institutions. As a result, interest rates on banking liabilities rose appreciably relative to interest rates on Treasury securities during the spring. More cautious funding and lending policies by a number of banks appeared to have some effect on maintaining short-term interest rates at higher levels than might otherwise have been the case.

The extraordinary concerns in the marketplace dissipated as the year wore on, reflecting some sense of progress in dealing with both the international debt situation and points of domestic financial strain. Strong liquidity pressures at one of the largest savings and loan organizations during the late summer and fall, requiring sizable liquidity support by the Federal Home Loan Bank System, had lesser effects on market attitudes.

The experience of 1984, together with supervisory efforts and the strong continuing pressures on some sectors of the economy have underscored for depository institutions the importance of adequate capital and prudent lending policies, and other means of assessing and controlling risk. Substantial efforts have been made by many of the larger banking organizations to increase capital ratios and to review credit standards. In time, in the environment of a growing economy, these efforts should be reflected in stronger institutions and a reinforced banking system.

Attachment II
The International Debt Situation in 1984

At times during 1984, concerns about the external debt problems of key borrowing countries continued to be an important factor affecting attitudes in financial markets. As the year began, markets had substantial doubts about the viability of the Brazilian adjustment program, the programs of the new Venezuelan and Argentine governments were unknown, and there was some sense of weariness among the borrowing countries and their creditors. Tensions were aggravated by increases in dollar interest rates in the spring and early summer.

Subsequently, concerns in financial markets receded somewhat as interest rates moved lower, clear progress was recorded in narrowing some countries' external imbalances, and plans for long-term debt restructuring were developed for some of the largest borrowers.

The improvements in external accounts in Mexico and Venezuela in Latin America, and in Yugoslavia and Hungary in Eastern Europe, produced current account surpluses last year. Brazil's current account deficit was essentially eliminated, and a number of other countries had reduced deficits.

This progress was faciliated in many cases by significant increases in exports, particularly to the United States, and in most cases was accompanied by a recovery -- or at least a slower rate of decline -- of imports. Such developments, coupled with continued moderate capital inflows, contributed to sizable increases in the international reserves of many of these countries and to the prospects of reduced demands for extraordinary external financing in the future. At the same time, most of those countries managed to achieve domestic growth.

Against this background, several of the major borrowing countries were able to move on to a second phase in their adjustment and financing programs. One important iniative, when warranted by progress in adjustment, has been planning for longer-term or multi-year restructuring of outstanding debts on terms that reflect stronger creditworthiness and permit planning on a more assured basis for the future. Such arrangements have been agreed in principle between the commercial banks and Mexico and Venezuela; serious negotiations have begun with Brazil and Yugoslavia; and the financing package prepared for Argentina contains some longer-term elements.

However, it is also evident from developments in 1984 and the first months of 1985 that the process of adjustment which began in 1982 is far from complete, particularly on the internal side. Financial markets will remain sensitive to indications of progress or the lack thereof. Cooperation among borrowing countries, commercial banks, multilateral institutions, and creditor countries will continue to be required. The need for imaginative and constructive solutions to the problems faced by individual countries is not over.

Attachment III
Targeting Real Growth

Questions sometimes arise as to whether the Committee's forecasts for real GNP growth or prices are in the nature of short-run targets toward which the Federal Reserve "fine tunes" policy, or whether the Committee has preconceptions about just how rapidly the economy can and should grow over the medium or longer run.

The answer to those questions is no. Monetary policy is, of course, broadly directed toward sustaining the growth process in a non-inflationary environment. But the Committee as a group has no preconceived notion as to just how rapid growth can or should be over a particular period of time, without straining our resources or giving rise to price pressures and imbalances that would make it ultimately unsustainable.

Our capacity for growth over time depends on such variables as the trends in productivity, in the labor force, in incentives to save and invest, and in other factors over which monetary policy has essentially no direct or long-run influence. There are other policies, public and private, quite outside the purview of monetary policy that will influence both our growth potential and actual growth paths over time. There are debates in and outside the Federal Reserve as to some of these factors that affect economic growth, but annual monetary targets and operational decisions do not, and need not, rest on such assumptions for the long run.

For instance, the Committee would presumably welcome faster growth than predicted for 1985 if that proved consistent with moderating inflationary forces, and indeed, less inflation than anticipated would tend to encourage greater growth, consistent with our monetary targets. Indeed, the relationship between money and economic growth at any point in time is sufficiently loose that many other factors bear upon actual performance.

In sum, policies are periodically reassessed in light of incoming information about prices, output, exchange rates and other variables bearing on our growth potential and prospects for inflation. In practice there is sufficient flexibility in our targeting procedures to accommodate information that might suggest greater or lesser growth potential over time.

Attachment IV
The Base for Monetary Target Ranges

Some questions have been raised concerning the "base" used by the Open Market Committee in deciding on targets for the monetary and credit aggregates for the calendar year. Consistent with the Humphrey-Hawkins Act procedures, the Committee's target ranges are specified each February as a range of growth from the fourth quarter of the previous calendar year to the fourth quarter of the current calendar year.

The convention that is usually used, is that the beginning point -- or "base" from which growth is measured -- is taken to be the fourth quarter average growth of a particular monetary or credit aggregate. Other "bases" could be used -- and occasionally have been used -- if the conventional base period is seriously distorted, by institutional change or otherwise.

During its recent meeting the Committee, as it has from time to time, discussed the issue of the desirability of choosing a base for 1985 for one or more of the aggregates other than the conventional one. It concluded that none of the fourth quarter averages for the targeted aggregates were distorted in a manner that strongly suggested the desirability of departing from the usual convention, and that such a departure might indeed confuse communication of the Committee's intentions. It also noted that the average level of both M1 and M2 during the fourth quarter of 1984 was reasonably close to the mid-point of the previous year's range, an alternative base suggested by some. M3 and credit ran significantly above the 1984 ranges. Rebasing those aggregates at the mid-point of the 1984 ranges would thus have implied a wrenching adjustment in the levels of those aggregates, a result that would be contrary to the Committee's intentions. Essentially, such a change would have implied a substantial tightening to bring the growth of those aggregates into the new ranges, or, alternatively, a specification of ranges of growth for 1985 that would have been extraordinarily high and quite out of keeping with longer range intentions.

More broadly, a decision to regularly target growth from the mid-point of a previous year's range would seem to imply the continuing validity of a judgment made a year earlier that the mid-point of a previous range is in some sense a uniquely "correct" level of a monetary aggregate. The Committee does not share such a conviction. Instead, it believes that the appropriate trend of each aggregate needs to be judged in the light of evidence as to velocity changes and other factors as they emerge over time.

In setting targets for any year, the Committee is, of course, aware of the base level of the aggregate. Adjustments in the new target ranges themselves, or in the conduct of policy within those ranges, can take account of any modest distortions in the base. Such considerations are reflected in the discussion of policy in the testimony.

Growth Ranges for the Aggregates for 1984
in Comparison with Actual Growth
(QIV to QIV)

	Percent Increases	
	Ranges	Actual Growth
M1	4 to 8	5.2
M2	6 to 9	7.7
M3	6 to 9	10.5
Domestic Nonfinancial Debt	8 to 11	13.4

Growth Ranges for the Aggregates Adopted for 1985
in Comparison with Tentative Ranges and Those for 1984
(QIV to QIV)

	Percent Increases		
	Adopted Ranges for 1985	Tentative Ranges for 1985 Set in Mid-1984	Ranges for 1984
M1	4 to 7	4 to 7	4 to 8
M2	6 to 9	6 to 8-1/2	6 to 9
M3	6 to 9-1/2	6 to 9	6 to 9
Domestic Non-financial Debt	9 to 12	8 to 11	8 to 11

For release on delivery
10:00 A.M., E.S.T.
February 27, 1985

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Senate Foreign Relations Committee

United States Senate

February 27, 1985

I am pleased to discuss with you this morning the role of the United States in the global economy. That role, of course, has many dimensions, and I can only touch upon a few of them this morning -- specifically on the relationships between our expansion and growth in the world generally, certain aspects of trade and exchange rate policy, and the problem of developing country debt.

As you know, we have enjoyed a strong recovery for more than two years, with the real Gross National Product rising by some 12-1/2 percent from the fourth quarter of 1982 to the fourth quarter of 1984.

GNP is a measure of production. Throughout this period, domestic demand has increased faster than the GNP. In essence, a significant fraction of demand currently generated here -- more than 2-1/2 percent -- is now flowing abroad, providing stimulus to production overseas. Put another way, U.S. purchases of goods and services have increased by about 15 percent over the past two years, as compared to the 12-1/2 percent increase in production.

With strong stimulus absent in the rest of the world, the growth of demand in the United States represented 70 percent of the total growth of demand in the OECD area from 1982 to 1984, even though we accounted for only 40 percent of OECD GNP in 1982. Moreover, countries outside the OECD area, including importantly many countries in Latin America, have similarly benefitted from the vigor of U.S. recovery.

The difference in economic performance over this period has been starkly evident in employment figures. In the United States, jobs increased by 7 million since the end of 1982. In contrast, there has been virtually no increase in employment in the rest of the OECD area as a whole, and in many of those countries unemployment rates have continued to fluctuate around their post-World War II highs.

At the same time, the growth and relative dynamism of the American economy have helped attract a flow of funds from abroad, strengthening the dollar even as our external trade and current accounts have moved into deep deficit. The growing net capital inflow -- now supplementing net domestic savings of individuals, businesses and state and local governments by nearly a third -- has been a critically important factor in enabling us to finance both rising investment and the enormous Federal deficit. The strength of the dollar and the ready availability of goods from abroad have also been potent factors restraining price increases for manufactured goods in the United States.

(1) From one perspective, those results are gratifying for us, and our trading partners have benefitted as well. But there are, of course, serious flaws -- flaws that unless dealt with constructively, will undermine all the progress. Strains and distortions are evident, for instance, in pressures on our farmers, miners, and producers of heavy capital equipment. There have been exceptionally high levels of unemployment in many

other industrialized countries, and, looking ahead, too few signs of significant improvement in that respect. Moreover, the financial position of the heavily indebted developing countries remains vulnerable. Those difficulties feed back on prospects for our exports and our financial system. Interest rates remain high relative both to historical experience and to recent rates of inflation.

Those strains have specific causes and potential remedies. But it is also true they are all aggravated by underlying imbalances in our trade and budgetary accounts. U.S. trade

(ii) and overall current account deficits reached levels of almost $110 billion and $100 billion, respectively, during 1984. Such deficits seemed almost unimaginable a few years ago, yet the present prospect is that those external deficits could rise still further. And it is not a coincidence that those external deficits are accompanied by internal budget deficits of unprecedented size during a period of prosperity, deficits that, according to both Administration and Congressional Budget Office estimates, will tend to grow further in the absence of corrective action even assuming healthy U.S. economic growth.

(iii) Economic analysis and common sense coincide in telling us that the budgetary and trade deficits of the magnitude we are running are not sustainable indefinitely in a framework of growth and prosperity. They imply a dependence on foreign borrowing by the United States that, left unchecked, will sooner or later undermine the confidence in our economy essential to a strong currency and to prospects for lower interest rates. But the hard fact is that we have come to rely on that foreign borrowing to finance the combination of a budget deficit and the private investment demands generated by a growing economy. The largest and richest economy in the world has perforce been required for the time being to draw on savings that might otherwise have been invested abroad. Indeed, the inflow of savings from abroad is equal to something on the order of 15 percent of net savings (or about 8 percent of gross savings) in all other OECD countries combined. And, the related exchange rate pressures, trade imbalances and financial strains generate political as well as economic pressures toward economic nationalism and protectionism.

(iv)

It seems to me essential that those pressures be resisted. There are powerful reasons why such an approach is not in our economic interest whatever the response abroad.

For instance, we have encouraged developing countries to adopt policies that will enable them to service their debts, to enhance over time their productive capacity, and to grow. Success is dependent upon their ability to increase exports -- and as their exports grow they will also import, from the United States and other industrialized countries. But that success will be denied if the United States and other industrial countries protect their own markets from fair competition by developing countries.

Even if we could somehow shield developing countries from broad protectionist measures -- and it is not clear that in practice we could do so -- there are other high economic costs from widespread protectionism. Quotas, new tariffs, or import surcharges all act directly to raise prices, and the problem would not be temporary if the effect would be to refuel inflationary expectations -- just at a time when so much progress has been made in changing that psychology. Other things equal, protectionist measures that actually had the effect of appreciably reducing some imports would presumably be reflected in still further upward pressures on the dollar, hurting exporters and industries not protected.

Beyond those specifics there are potentially much more damaging risks of a breakdown in a world trading order built up so laboriously after the chaos of the 1930s.

Consider, for example, the proposals now being discussed for a temporary import surcharge. Those proposals are sometimes coupled with other measures to reduce our budget deficit. Such proposals are offered as a relatively painless means of raising government revenue while simultaneously addresing the trade deficit.

One attraction is that an import surcharge effectively taxes foreign exporters as well as domestic residents. But it is also clear that any benefits, either for trade or for the budget, would be temporary. More lasting favorable consequences of the proposals would be derived not from the temporary surcharge but from the accompanying budget measures.

I would question whether the imposition of a surcharge makes those accompanying measures easier, or more difficult, to enact. In any event, so attractive a tax to the United States would certainly be attractive to others as well. Most countries have budget deficits larger than they would like, and with high unemployment would not be averse to reducing imports. If the surcharge approach is, in effect, legitimized by the United States, wouldn't others find almost irresistible temptations to emulate our example? Would not that eliminate any net benefits and also have destructive implications for world trade -- upon which our hard-pressed farmers, among others, are so dependent?

At a more fundamental level, we cannot logically take actions to reduce our trade deficit and at the same time welcome the associated capital inflows from abroad. The trade deficit and our capital inflow are two sides of the same coin. Unless we reduce our budget deficit, success in improving our trade balance, and thus reducing the capital inflow, will only threaten stronger pressures on our domestic financial markets, jeopardizing housing and investment.

(v) In essence, a lasting solution to the problem of our external imbalance rests on simultaneously restoring internal financial equilibrium. I know of no approach to that problem that promises success other than straightforward measures to reduce our budget deficit over time. Approaches that obscure that basic need will, in the end, be counterproductive.

I do not want in any way to suggest that, important as action with respect to the budget deficit is, that approach will somehow deal with all the problems of the global economy. In particular, other industrial countries have clear responsibility and opportunity to take actions themselves to enhance their economic prospects. The importance of policies to deal with structural rigidities in their economies has often been noted. Moreover, in some important countries where inflationary pressures have been successfully contained, and where credible long-term anti-inflationary monetary policies are firmly in place, there may be scope for action to stimulate their growth by constructive measures to speed tax reductions or otherwise.

Certainly, much remains to be done to restore sustainable growth patterns in much of the developing world. Over the past two years or more, a number of the more advanced and largest developing countries, particularly in Latin America, have made serious efforts to implement appropriate adjustment programs in conjunction with IMF and private financing arrangements. Clear progress -- in some cases, spectacular progress -- has been made in eliminating or narrowing external imbalances. Mexico and Venezuela in Latin America, and Yugoslavia and Hungary in Eastern Europe, have produced current account surpluses. Brazil's current account deficit was essentially eliminated last year. Happily, most of those countries have also managed to restore a measure of domestic growth. All of that progress was facilitated by access to foreign markets, most importantly in the United States.

In some instances, the progress in adjustment has encouraged and justified longer-term or multi-year restructuring of outstanding debts on terms that reflect stronger credit-worthiness and permit planning on a more assured basis for the future. Such arrangements have been agreed in principle between the commercial banks and Mexico, Venezuela and Ecuador, and serious negotiations are underway with Brazil and Yugoslavia.

However, these signs of progress do not mean that the "debt problem" is behind us -- or that, more broadly, the borrowing countries are firmly on a path of sustained strong growth in a context of political and economic stability. Indeed, some of the more fundamental adjustments necessary to that end are still absent, or only partially in place. Inflation, for instance, remains disturbingly high in many of the countries, and in some is still rising to new peaks. Spontaneous new investment by either domestic firms or from abroad has often been slow to develop, reflecting in considerable part concern in some countries about the role for private investment and the degree of controls and market distortions. Moreover, on the more purely financial side, cooperation among borrowing countries, commercial banks, multilateral institutions, and creditor countries will continue to be required despite the protracted and tedious nature of the process. Rather than impatience, the need remains for energetic and constructive approaches to the longer-term problems faced by individual countries.

I will conclude with a few words about the dollar. Few if any anticipated the degree of strength that the dollar has displayed persistently for some time, nor can it fully be explained by such factors as relative interest rates or differences in inflation rates. No doubt, relative confidence in our economic prospects, in our political stability, and in our business climate have played a part, as has a sharp diminution in our bank lending abroad. At the same time, the widening gap in our trade position suggests that our basic competitive position cannot support so high a dollar indefinitely.

(✓)

The policy question is what measures can be taken to encourage a reasonably competitive equilibrium over time. I suggest that the general approach I have alluded to today would work in that direction.

Credible measures to reduce the U.S. budget deficit would alleviate one source of inflationary concern and encourage lower real interest rates than would otherwise be the case. In that environment, some other important industrial countries might find it easier to undertake more stimulative policies at home. If they managed at the same time to deal more effectively with some structural rigidities, the perceived contrast between the opportunities in the U.S. economy and the relative sluggishness of European economies could constructively be diminished. If developing countries could reduce inflation and restore more confidence in their own business climate, their own citizens would then employ more of their savings in their own countries, and funds could again be attracted in greater volume from the United States or elsewhere.

(vii) At times, forceful official intervention in exchange markets could have a useful role to play. But that role has to be complementary and subsidiary to more basic measures to have lasting impact. That is why measures to deal with the fundamental imbalances in our own financial requirements are so important.

Over the near term, prospects for the economic performance of the United States, and to a lesser extent the rest of the world, appear to be favorable. We want to build sensibly on those strengths and to deal in a lasting way with the imbalances. Purely symptomatic treatment is not adequate -- and, in the form of protectionism, will be counterproductive. The more basic approaches necessarily take time, and we have let too much time pass already. But fortunately we can still proceed from a position of strength. I trust we will make the most of the opportunity before us.

****

Prime Minister ④

Confirmation that Volcker for one does not regard the trade deficit / high dollar as sustainable and that a lower budget deficit is part of the solution. AT 13/3

RECENT TESTIMONY BY MR. PAUL VOLCKER, HOUSE BANKING COMMITTEE,

26 FEBRUARY, 1985

(i) Our trade deficit increased to about $110 billion in 1984, far higher than ever before, and the entire external current account deficit - counting both goods and services - has deteriorated by about $100 billion since 1982. The sustainability of that trend, politically as well as economically, is, to say the least, questionable.

(ii) It is no coincidence that the record external imbalance and continued high interest rates have been accompanied by large federal budget deficits - deficits that according to projections of both the Administration and the Congressional Budget Office will only deepen in the years ahead in the absence of decisive corrective action.

(iii) The net capital inflow approached $100 billion last year, and it will probably need to be still larger this year. Domestic net savings - by individuals, businesses, and state and local governments - are running at about $325 billion, so the supplement from abroad adds close to a third to net savings generated internally. The net capital inflow was equivalent last year to more than half of the budget deficit.

/ (iv) But we

(iv) But we are in a real sense living on borrowed money and time.

SENATE FOREIGN RELATIONS COMMITTEE: 27 FEBRUARY, 1985

(i) But there are, of course, serious flaws - flaws that unless dealt with constructively, will undermine all the progress. Strains and distortions are evident, for instance, in pressures on our farmers, miners, and producers of heavy capital equipment.

(ii) US trade and overall current account deficits reached levels of almost $110 billion and $100 billion, respectively, during 1984. Such deficits seemed almost unimaginable a few years ago, yet the present prospect is that those external deficits could rise still further. And it is not a coincidence that those external deficits are accompanied by internal budget deficits of unprecedented size during a period of prosperity, deficits that, according to both Administration and Congressional Budget Office estimates, will tend to grow further in the absence of corrective action even assuming healthy US economic growth.

(iii) Economic analysis and common sense coincide in telling us that the budgetary and trade deficits of the magnitude we are running are not sustainable indefinitely in a framework of growth and prosperity. They imply a dependence

/on

on foreign borrowing by the United States that, left unchecked, will sooner or later undermine the confidence in our economy essential to a strong currency and to prospects for lower interest rates.

(iv) The largest and richest economy in the world has perforce been required for the time being to draw on savings that might otherwise have been invested abroad. Indeed, the inflow of savings from abroad is equal to something on the order of 15 per cent of net savings (or about 8 per cent of gross savings) in all other OECD countries combined. And, the related exchange rate pressures, trade imbalances and financial strains generate political as well as economic pressures toward economic nationalism and protectionism.

(v) In essence, a lasting solution to the problem of our external imbalance rests on simultaneously restoring internal financial equilibrium.

(vi) At the same time, the widening gap in our trade position suggests that our basic competitive position cannot support so high a dollar indefinitely.

/ (vii) At times,

(vii) At times, forceful official intervention in exchange markets could have a useful role to play. But that role has to be complementary and subsidiary to more basic measures to have lasting impact.

NBPM
US ~~Energy~~ file

House of Lords · Westminster

Dear David —

For your boss!

They're absolutely right ...

James

Reply to: The Lord Hanson, 180 Brompton Road, London SW3 1HF

REVIEW & OUTLOOK

How Not to Save the Pound

It is always possible to debate what messages the market is sending when it pushes the pound down toward parity with the dollar. But it's not plausible to interpret the current market as suggesting that British taxes are too low. Yet–incredibly–that seems to be the interpretation gaining currency in Britain.

Our man Peter Truell delivered news of this in a dispatch from London earlier this month. And over the weekend London's Telegraph newspaper reported Mrs. Thatcher had returned from her talks in Washington more convinced that caution was needed in the budget to be introduced in three weeks. The paper said "it was acknowledged in Whitehall" that the chancellor would have to shelve plans for a bold tax reform in favor of a strategy to save the pound. At Whitehall they probably make their soup out of water and phosphorous.

The thinking behind this idea seems to be that a tax cut could ignite inflation and further undercut an already battered pound. Somebody seems not to have told the British that the U.S. has managed to cut both taxes and inflation without denting the dollar. The idea also seems to be that a tax cut would boost the government's borrowing requirement–British lingo for its deficit–at a time when the government is determined to hew as close as possible to a balanced budget. Here too someone seems to be overlooking the American record, which suggests that carefully constructed tax cuts in high marginal rates lead to revenue increases.

More important than this is the fact that it was the enormous tax cut President Reagan pushed through in his first term that kicked off the American boom and sent the dollar on its way. The boom is being propelled by the mandate, delivered in the 1984 election, for more of the same. Mr. Reagan clearly was trying to do Mrs. Thatcher a favor when, in his press conference Friday, he brushed off her complaints about the deficit and the dollar and declared that the problem is that America's trading partners haven't caught up with the U.S. recovery.

Britain–and the rest of Europe, for that matter–seems to resist this notion. In recent weeks, for example, the British have been trying to halt the pound's plunge by jacking up interest rates. Rates have been boosted more than *four points* since Jan. 1. Yet this hasn't pulled the pound out of its dive. The currency may lose its tail-section altogether and head for the ocean unless someone gets more power to the engines.

Tax cuts would be precisely the thing to supply that power. Mrs. Thatcher and her chancellor, Nigel Lawson, seemed to be thinking along the right lines a few months ago, when their aides started talking about a new round of tax cuts. Government spokesmen were hinting at the time that personal taxes might be cut by between $1.5 billion and $3.25 billion in the coming fiscal year. Our sources suggest these cuts would bite at the margins and provide some of the increased incentives to work that Britain needs to start catching up with America. So now is a time not to abort the tax cuts but to be bold.

Wall Street

URNAL.

25/2/85

RIVERSIDE, CALIFORNIA

The Outlook

High Unemployment Is Likely to Linger On

NEW YORK

Does the rise in unemployment to 7.4% of the civilian labor force last month indicate that we have already seen the lows in joblessness for the current business expansion? Do we face a rerun of the 1970s and early 1980s, when the low achieved in each succeeding business cycle was consistently higher than in the previous one?

Most economists don't expect much improvement in unemployment figures anytime soon. The latest consensus forecast by the four dozen analysts surveyed monthly by Blue Chip Economic Indicators, a Sedona, Ariz., newsletter, envisioned unemployment averaging 7.1% this year and 7.0% next year.

However, Audrey Freedman, a senior research associate at the Conference Board, notes that her own prediction that unemployment "will sit around 7.2% this year" isn't a prediction that nothing will be going on. Far from it. Just to keep unemployment from rising, she says, "you will have to create 1.5 million jobs" to match the growth in the labor force. She expects those jobs to be created, but not many more—not enough to reduce unemployment further—because "the recovery is aging and flattening out."

So far in this cycle, the unemployment rate hit its low, 7.1%, last June and again last November. That may well be as far down as it gets; unemployment tends to be a leading indicator at cyclical peaks. Moreover, that low substantially exceeds the highest monthly rate, 6.1%, during the 1969-70 recession.

Here is how the unemployment-rate lows have been trending higher during the four previous business expansions:

Cycle Peak	*Lowest Rate*	*Month*
Dec. '69	3.4%	Jan.-May '69
Nov. '73	4.6	Oct. '73
Jan. '80	5.6	May '79
July '81	7.2	Apr. '81

Analyzing such trends, economists try to filter out cyclical joblessness from the unemployment lingering on even during booms—often called the natural rate of unemployment. That unemployment, which can't be reduced without unleashing steep inflation, is divided into frictional unemployment—the 3% or so of workers voluntarily between jobs—and structural unemployment—workers with inadequate skills.

During the 1970s, most economists believe, the natural rate of unemployment rose. Michael Wachter of the University of Pennsylvania cites three reasons:

—**Unfavorable demographics.** Baby-boomers and women flooded into the labor force, and jobs couldn't be created fast enough. Moreover, youths and women tend to be less attached to the labor force, and as they float in and out of jobs, frictional unemployment rises.

—**Rising government transfer payments.** As unemployment compensation, welfare and Social Security benefits increased, the unemployed could be choosier about jobs.

—**Inflationary shocks.** Surges in oil and food prices hit when many labor and commodity markets were already tight, and the government felt forced to clamp down and fight inflation more quickly—at the cost of jobs—than it would in a slack economy.

Now, Prof. Wachter estimates, the natural rate of unemployment probably has dropped to about 5¾% from perhaps 6¼% in the late 1970s. He notes that the surge of new job-seekers has slowed, and in the future "the demographics will continue to be favorable." So they will. According to the Bureau of Labor Statistics, the labor force aged 16 and over, which grew 1.3% a year in 1950-60, 1.7% in 1960-70 and 2.6% in 1970-80, is rising only 1.6% in 1980-90 and will increase just 1% annually in 1990-95.

Furthermore, President Reagan has halted the increase in inflation-adjusted transfer payments. And inflation is down, although Prof. Wachter notes the danger posed by steep federal budget deficits.

Other factors also may be paring the natural rate of unemployment. Prof. Wachter observes that the minimum wage, often said to inhibit hiring of low-skilled workers, has been eroded by inflation since its last increase, to $3.35 an hour, in January 1981. If the minimum had kept up with the 16.5% gain in nonsupervisory production workers' average pay since then, it "would now be $3.90," he adds.

Meanwhile, the youths and women who earlier swamped the labor market have acquired wider job skills and now presumably could, if laid off, find new jobs more quickly. And as actual unemployment drops, their increasing skills may reduce the natural rate.

Moreover, as Mrs. Freedman noted in a recent paper, "Union power to set industrywide wage rates has clearly decreased during the past four years." Unions thus have lost some of their ability to keep real wages from falling enough to enable employers to hire most of the jobless.

But tending to raise the natural rate of unemployment has been rapid technological change, which forces more job switching. In fact, a study by Michael Podgursky of the University of Massachusetts found that by the late 1970s, the primary source of structural unemployment had shifted from youths to prime-age males; unions couldn't halt surging imports, factory automation or the decline of smokestack industries. High-tech industry can't replace lost basic-industry jobs and, by lifting productivity, it enables output to rise faster than employment.

Economists figure that the economy must grow about 3% annually merely to provide jobs for new labor-force entrants, but the Blue Chip group, on the average, expects growth only slightly above that this year and below that next year. Without a new surge of growth, we may be stuck with 7%-plus unemployment for some time.

—HENRY F. MYERS

PREM 19/1654

Senate Confirms Meese to Head Justice Agency

Vote on Attorney General Was 63-31; He's Slated To Be Sworn In Today

By DAVID ROGERS and ANDY PASZTOR
Staff Reporters of THE WALL STREET JOURNAL

WASHINGTON – The Senate, after a year of controversy, voted 63-31 to confirm Edwin Meese as attorney general.

The number of votes against Mr. Meese was the largest against any cabinet nominee since Earl Butz was confirmed as Richard Nixon's agriculture secretary in 1971. Democrats accounted for all of the opposition, and final action was delayed by four days of partisan maneuvering over farm legislation.

"I think that politics played a very big part in what took place, but that's all behind us," said Mr. Meese, who will be sworn in today to succeed retiring Attorney General William French Smith. "I am committed to the fair, compassionate and forward-looking policies the department should have," Mr. Meese said.

Mr. Meese, a former county prosecutor from California and one of President Reagan's most outspoken conservative aides, is expected to advocate tougher sentences, including the death penalty, for some violent crimes. He also is likely to support expanded police authority to seize and use evidence in prosecuting criminals, and to call for increased compensation to victims of violent crime. Mr. Meese is expected to continue the Reagan administration's opposition to the use of racial quotas in school-desegregation plans and in affirmative-action hiring cases brought against companies and municipalities.

Edwin Meese

While serving in the White House, Mr. Meese has sought to ease antitrust constraints as a way to make U.S. industries more competitive with foreign concerns. He also has advocated legislation supporting prayer in public schools.

Although Mr. Meese hasn't said what his priorities will be in the new job, he will have an opportunity to place his stamp on the department by picking appointees for 11 of the top policy-making slots in the department. Some lawmakers and administration officials expect that Mr. Meese will be a more active administrator and a more vocal advocate of tougher anti-crime laws than was Mr. Smith, his predecessor.

Last month, Mr. Meese told the Senate Judiciary Committee he didn't see any reason for major increases in federal expenditures for anti-crime programs, but he urged states and cities to provide more financial and moral support for such programs. Officials familiar with Mr. Meese's plans for the department also expect that he will push for tougher anti-drug enforcement efforts by relying more heavily on the U.S. military to fight drug smuggling.

Mr. Meese was caught up in a swirl of controversy over ethical issues almost immediately after his nomination was announced 13 months ago. He was accused of using his White House position as counselor to the president to get federal jobs for individuals who helped him in personal financial matters.

A special prosecutor, Washington lawyer Jacob Stein, found last year that there was "no basis" for charges that Mr. Meese had violated federal law. He declined to comment, however, on "Mr. Meese's ethics and the propriety of his conduct for office."

The issue was revived last month when it was disclosed that a staff report by the Office of Government Ethics had concluded that Mr. Meese's financial transactions appeared in two instances to conflict with his official duties. After reviewing the matter and meeting with Mr. Meese's attorneys, the office's director, David Martin, decided against recommending any action. But disclosure of the staff analysis added to the bitterness that often marked the confirmation proceedings.

Within the Senate, Mr. Meese's confirmation was an important victory for the new majority leader, Robert Dole (R., Kan.), but it proved more of a struggle than expected. Democrats mounted a filibuster, delaying action until they were

24-7

US file

US TRADE AND CURRENT ACCOUNTS ($bn)

	Trade (balance of payments)-basis	Current Account	
1983	-61	-42	
1984	-108	-102	
1984 Q1	-26	-20	
Q2	-26	-24	
Q3	-33	-33	
Q4	-23	-25	(Bank estimate)

Forecasts

	Trade	Current Account
1985 Wharton	-130	-115
OECD	-135	-130

Prime Minister (2)

This indicates that the improvement in the US current balance in Q4 1984 may be temporary. Outside forecasters expect the deficit in 1985 to be greater than in 1984.

AT
26/2

Prime Minister.

PPS.
The Prime Minister may wish to be aware of this, before tomorrow's economic meeting.

c. Mr. Butler
PS/HMA
Head of C

Mr. Wicks

N.C.W.
20.2.

1. I attach a note on Federal Reserve Chairman Volcker's statement to the Senate Banking Committee on monetary policy in 1985.

No need for PM to read.

2. You also asked whether Treasury Secretary Baker had referred to US policy on intervention in foreign exchange markets during recent testimonies before Congress. Baker testified both today and yesterday. His statement (same for both occasions) is attached and contains no reference to intervention. I understand from the US Treasury that in response to questions at today's hearing Baker would only say that some intervention had occurred, US policy was to intervene to calm disorderly markets, but there had been a slight softening of policy as revealed in the G5 Statement. He refused to give details on the amount of intervention, the factors which led to a decision to intervene and whether this recent move(s) had been co-ordinated with other G-5 countries.

3. I attach a copy of your telegram reporting Baker's comments over the weekend on this issue, as requested.

Julian Exeter

J. Exeter

20 February, 1985

US MONETARY POLICY

1. In a statement on monetary policy to the Senate Banking Committee, Federal Reserve Chairman Volcker announced small increases to the growth ranges for M2, M3 and the credit aggregate for 1985 compared to the ranges which had been provisionally set for 1985 last July, but added that they did not represent any change in policy intentions. The new ranges and performance in 1984 (from a fourth quarter base) are as follows:-

	Ranges for 1985	Ranges for 1984	Actual Growth in 1984
	(	Percent Growth	)
M1	4-7	4-8	5.2
M2	6-9	6-9	7.7
M3	6-9.5	6-9	10.5
Domestic Non-Financial Debt	9-12	8-11	13.4

2. Volcker stated that growth of money and credit of this order would support another year of satisfactory economic expansion without an acceleration of inflation. It was consistent with the Federal Open Market Committees (FOMC) forecast for 1985 of growth of nominal and real GNP growth centered around 7.5-8.0 percent and 3.5-4.0 percent respectively (fourth quarter on fourth quarter), inflation at 3.5-4.0 percent and unemployment falling to 6.75-8.0 per cent by the year end. This forecast is similar to that of both the Administration and the CBO.

3. With strong growth of the money supply at present, Volcker acknowledged that all the aggregates would start above the target ranges, but was confident that growth, especially for M1 and M2, would slow during the year consistent with the growth ranges. The upward revision of the broader aggregates appears to reflect a recognition that credit growth will continue to be strong in 1985, partly reflecting the size of the budget deficit.

4. On monetary policy Volcker said that the progressive easing of reserve conditions had come to an end and open market operations were being conducted more cautiously. Referring to the decisions to ease policy in late 1984 Volcker said that both the strength of the dollar and the success in lowering inflation were contributing factors.

5. During his statement Volcker stressed the link between trade and budget deficits, arguing that high deficits, rising imports and strong investment had been reconciled by a growing volume of net capital inflows, amounting to nearly $100 bn in 1984. Volcker stated that "the stability of our capital and money market is now dependent as never before on the willingness of foreigners to continue to place growing amounts of money in our markets" and "we are in a real sense living on borrowed money and time." The resulting strength of the dollar had caused imbalances within the economy, especially among exporters and farmers. As on previous occasions, Volcker urged the Congress to lower the budget deficit. In response to a question Volcker repeated his view that the deficit for FY 86 should be cut by some $50 bn.

.../2

6. During a discussion on the credit problems of farmers in the mid west, Volcker said he believed there would be heavy pressures on some banks, but he believed these could be contained without affecting the financial system.

7. Volcker welcomed the reduction in inflation and a probable decline in inflationary expectations. But he warned that some of those factors contributing to the decline in inflation might not be lasting. In addition Volcker stressed on several occasions his firm resolve not to succumb to any potential pressures to monetize the debt. In response to a question Volcker acknowledged they might arise if there were only modest cuts in the deficit. But an expansionary monetary policy under these conditions would lower growth and raise inflation.

8. In response to further questions Volcker said several factors were responsible for the strength of the dollar including US interest rates and favourable growth prospects. To date intervention in foreign exchange markets had been limited and was only undertaken when both the Treasury and the Federal Reserve agreed it would be desirable.

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TO IMMEDIATE F C O

TELEGRAM NUMBER 598 OF 20 FEBRUARY

AND TO PARIS, BONN, TOKYO, OTTAWA, ROME, UKDEL OECD

File

Mr Turnbull

US MONETARY POLICY

SUMMARY

1. IN A STATEMENT TO THE SENATE BANKING COMMITTEE, VOLCKER ANNOUNCED THE GROWTH RANGES FOR M3 AND THE DEBT AGGREGATE FOR 1985 HAD BEEN RAISED COMPARED TO THEIR 1984 LEVELS. VOLCKER STATED THAT THE PROGRESSIVE EASING OF MONETARY POLICY HAD NOW ENDED. VOLCKER WARNED OF THE RISKS OF THE US ECONOMY'S GROWING DEPENDENCE ON FOREIGN CAPITAL. HE AGAIN URGED CUTS IN THE BUDGET DEFICIT FOR FY 86 OF SOME DOLLARS 50 BN.

DETAIL

2. FEDERAL RESERVE CHAIRMAN VOLCKER TESTIFIED BEFORE THE SENATE BANKING COMMITTEE TODAY. HE ANNOUNCED SMALL INCREASES TO THE GROWTH RANGES FOR M2, M3 AND THE CREDIT AGGREGATE FOR 1985 COMPARED TO THE RANGES WHICH HAD BEEN PROVISIONALLY SET FOR 1985 LAST JULY, BUT ADDED THAT THEY DID NOT REPRESENT ANY CHANGE IN POLICY INTENTIONS. THE NEW RANGES AND PERFORMANCE IN 1984 (FROM A FOURTH QUARTER BASE) ARE AS FOLLOWS:-

	RANGES FOR 1985	RANGES FOR 1984	ACTUAL GROWTH IN 1984
	(	PERCENT GROWTH	)
M1	4-7	4-8	5.2
M2	6-9	6-9	7.7
M3	6-9.5	6-9	10.5
DOMESTIC NON-FINANCIAL DEBT	9-12	8-11	13.4

3. VOLCKER STATED THAT GROWTH OF MONEY AND CREDIT OF THIS ORDER WOULD SUPPORT ANOTHER YEAR OF SATISFACTORY ECONOMIC EXPANSION WITHOUT AN ACCELERATION OF INFLATION. IT WAS CONSISTENT WITH THE FEDERAL OPEN MARKET COMMITTEES (FOMC) FORECAST FOR 1985 OF GROWTH OF NOMINAL AND REAL GNP GROWTH CENTERED AROUND 7.5-8.0 PERCENT AND 3.5-4.0 PERCENT RESPECTIVELY (FOURTH QUARTER ON FOURTH QUARTER), INFLATION AT 3.5-4.0 PERCENT AND UNEMPLOYMENT FALLING TO 6.75-8.0 PERCENT BY THE YEAR END. THIS FORECAST IS SIMILAR TO THAT OF BOTH THE ADMINISTRATION AND THE CBO.

4. WITH STRONG GROWTH OF THE MONEY SUPPLY AT PRESENT, VOLCKER ACKNOWLEDGED THAT ALL THE AGGREGATES WOULD START ABOVE THE TARGET RANGES, BUT WAS CONFIDENT THAT GROWTH ESPECIALLY FOR M1 AND M2, WOULD SLOW DURING THE YEAR CONSISTENT WITH THE GROWTH RANGES. THE RANGES FOR M1 AND M2 ASSUME A RETURN TO A MORE NORMAL AND PREDICTABLE PATH OF VELOCITY: THE RANGE FOR M1 IS JUDGED SUFFICIENTLY WIDE

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/ SHOULD

SHOULD VELOCITY GROWTH FALL SLIGHTLY BELOW TREND. THE NEW RANGES FOR THE BROADER AGGREGATES, ALTHOUGH RAISED, ASSUME A CONSIDERABLE SLOWING IN THE GROWTH OF BOTH M3 AND THE DEBT AGGREGATE. VOLCKER WARNED OF THE IMPLICATIONS OF CONTINUED STRONG GROWTH OF THE DEBT AGGREGATE, WHICH HE ARGUED PARTLY REFLECTED THE TAX STRUCTURE WHICH FAVOURED DEBT RATHER THAN EQUITY FINANCING.

5. ON MONETARY POLICY VOLCKER SAID THAT THE PROGRESSIVE EASING OF RESERVE CONDITIONS HAD COME TO AN END AND OPEN MARKET OPERATIONS WERE BEING CONDUCTED MORE CAUTIOUSLY. (SEPARATELY THE RECENTLY RELEASED MINUTES OF THE FOMC'S DECEMBER MEETING SHOWED THAT THE FOMC VOTED TO EASE POLICY FURTHER AT THAT TIME). REFERRING TO THE DECISIONS TO EASE POLICY IN LATE 1984 VOLCKER SAID THAT BOTH THE STRENGTH OF THE DOLLAR AND THE SUCCESS IN LOWERING INFLATION WERE CONTRIBUTING FACTORS.

6. DURING HIS STATEMENT VOLCKER STRESSED THE LINK BETWEEN TRADE AND BUDGET DEFICITS, ARGUING THAT HIGH DEFICITS, RISING IMPORTS AND STRONG INVESTMENT HAD BEEN RECONCILED BY A GROWING VOLUME OF NET CAPITAL INFLOWS, AMOUNTING TO NEARLY DOLLARS 100 BN IN 1984. VOLCKER STATED THAT QUOTE THE STABILITY OF OUR CAPITAL AND MONEY MARKET IS NOW DEPENDENT AS NEVER BEFORE ON THE WILLINGNESS OF FOREIGNERS TO CONTINUE TO PLACE GROWING AMOUNTS OF MONEY IN OUR MARKETS QUOTE AND UNQUOTE WE ARE IN A REAL SENSE LIVING ON BORROWED MONEY AND TIME UNQUOTE. THE RESULTING STRENGTH OF THE DOLLAR HAD CAUSED IMBALANCES WITHIN THE ECONOMY, ESPECIALLY AMONG EXPORTERS AND FARMERS. AS ON PREVIOUS OCCASIONS, VOLCKER URGED THE CONGRESS TO LOWER THE BUDGET DEFICIT. IN RESPONSE TO A QUESTION VOLCKER REPEATED HIS VIEW THAT THE DEFICIT FOR FY 86 SHOULD BE CUT BY SOME DOLLARS 50 BN.

7. VOLCKER WELCOMED THE REDUCTION IN INFLATION AND A PROBABLY DECLINE IN INFLATIONARY EXPECTATIONS. BUT HE WARNED THAT SOME OF THOSE FACTORS CONTRIBUTING TO THE DECLINE IN INFLATION MIGHT NOT BE LASTING. IN ADDITION VOLCKER STRESSED ON SEVERAL OCCASIONS HIS FIRM RESOLVE NOT TO SUCCUMB TO ANY POTENTIAL PRESSURES TO MONETIZE THE DEBT. IN RESPONSE TO A QUESTION VOLCKER ACKNOWLEDGED THESE MIGHT ARISE IF THERE WERE ONLY MODEST CUTS IN THE DEFICIT. BUT AN EXPANSIONARY MONETARY POLICY UNDER THESE CONDITIONS WOULD LOWER GROWTH AND RAISE INFLATION.

8. IN RESPONSE TO FURTHER QUESTIONS VOLCKER SAID SEVERAL FACTORS WERE RESPONSIBLE FOR THE STRENGTH OF THE DOLLAR INCLUDING US INTEREST RATES AND FAVOURABLE GROWTH PROSPECTS. TO DATE INTERVENTION IN FOREIGN EXCHANGE MARKETS HAD BEEN ~~LIMITED~~ AND WAS ONLY UNDERTAKEN WHEN BOTH THE TREASURY AND THE FEDERAL RESERVE AGREED IT WOULD BE DESIRABLE.

COMMENT

9. THE UPWARD REVISION TO THE RANGES FOR THE BROADER AGGREGATES APPEARS TO REFLECT A RECOGNITION THAT CREDIT GROWTH WILL CONTINUE

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/ TO BE

TO BE STRONG IN 1985, PARTLY REFLECTING THE SIZE OF THE BUDGET DEFICIT, EVEN THOUGH THE FOMC FORECAST ASSUMES A SUBSTANTIAL CUT IN THE DEFICIT FOR FY 86. THE EASING OF MONETARY POLICY HAS NOW ENDED, BUT THE GROWTH OF THE MONETARY AGGREGATES IS LIKELY TO REMAIN STRONG OVER THE NEXT FEW WEEKS. IN THE FEDERAL RESERVE'S SEPARATE MONETARY POLICY REPORT TO CONGRESS, IT IS STATED THAT DURING THE YEAR M1 WOULD BE EXPECTED TO MOVE GRADUALLY TOWARDS AND INTO ITS TARGET RANGE. IN RESPONSE TO QUESTIONS AS TO WHETHER HE WOULD SERVE HIS FULL TERM, VOLCKER WAS, AS USUAL, NON-COMMITAL. BUT HE MADE IT CLEAR THAT MONETARY POLICY WOULD REMAIN ANTI-INFLATIONARY AS LONG AS HE WAS CHAIRMAN OF THE FEDERAL RESERVE.

10. COPIES OF VOLCKER'S STATEMENT AND THE FED'S MONETARY REPORT TO CONGRESS FOLLOW BY BAG.

11. FCO PLEASE ADVANCE TO SHIELDS (HMT), BROADBENT (EA), TAIT (ERD) AND GREEN (BANK).

WRIGHT

(ADVANCED AS REQUESTED)

FINANCIAL
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COPIES TO:
MR SHIELDS, TREASURY
MR GREEN, BANK OF ENGLAND

TREASURY NEWS
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For Release Upon Delivery
Expected at 2:00 p.m.
February 19, 1985

Testimony of the Honorable
James A. Baker, III
Secretary of the Treasury
Before the Senate Appropriations Committee
February 19, 1985

Mr. Chairman and Members of the Committee:

It is a pleasure to meet with you today to discuss our fiscal affairs and the tasks that lie ahead. The economy has done very well in the past year and the outlook for the future is promising. But we are faced with the need to reduce what has become an excessive rate of Federal spending. Because of that Federal spending, the prospective budget deficits that would develop in the absence of any offsetting action are far too large for our long-run economic health. We must place the Federal budget deficit on a declining path and keep it there. With your help and a bipartisan Congressional effort, I am sure that meaningful reductions in the growth of Federal spending can be achieved. Legislative action along the lines recommended in the President's Budget proposals will provide a fiscal framework within which the economy can continue to prosper.

These past four years have been marked by truly dramatic improvement in the performance of the U. S. economy. Four years ago, it was the increasingly held belief that we had lost the ability to control our economic destiny -- that inflation was out of control, that dwindling availability of natural resources would put a cap on growth; and, most worrisome of all, we were told that we had lost the innovative spirit that had propelled this economy to world leadership.

Now, confidence in our ability to meet the challenges of the future is being restored by the implementation of an economic program designed specifically to:

-- bring inflation under control,

-- free markets from the burden of unnecessary government interference,

-- restore incentives for productivity and growth,

-- and, thereby, increase opportunity for all.

That program has been remarkably successful by almost every measure of economic performance.

-- Real growth for 1984 was the highest since 1951. During the first two years of the current expansion, at a 6.0 percent annual rate, real growth has been the strongest for any expansion since the economy pulled out of the strike-depressed recession trough of late-1949 into the Korean War boom.

-- Growth of real business capital spending during this expansion has far outpaced gains during any previous postwar recovery.

-- Our economy has shown itself to be a remarkable job-creating machine. Spurred by formation of new business and by technological innovation, more than 7.3 million jobs have been created during this recovery and expansion.

-- And even as the economy has shown this remarkable growth, inflation has stayed under control. For each of the past three years, it has not exceeded 4%. Last year, as measured by the GNP deflator, it was the lowest since 1967. And the trends of wages, oil prices, and world raw material prices all remain favorable.

I have made a promise to myself that I know I may not be able to keep. But I shall try. While I will of course contribute to the development of economic forecasts that we use for purposes of planning and analysis, I shall try to resist the temptation to offer specific, detailed, numerical economic forecasts of my own.

The economic projections underlying the budget assume continued real economic growth and a steady decline in unemployment, inflation, and interest rates.

Consistent with my promise to myself, let me say only this about the overall economic outlook. Prospects are excellent for sustained economic growth without inflation -- provided that we act promptly and responsibly to continue what we have begun. And by "we" I should emphasize that I mean to include both Houses of the Congress, as well as the Executive Branch.

There is still much unfinished business.

We must not rest with the tax rate reduction we enacted in 1981. That simply adjusted for the hyper-inflation that the economy had been experiencing before. Now we must go on, as the President has directed, to overhaul the whole tax system -- to increase fairness, simplicity, and economic growth. This element of our program is, as the President has said, of equal priority with spending control.

The printed budget document includes a number of revenue-related measures -- most of which have been submitted before. These range from tuition tax credits to enterprize zone incentives to technical provisions related to certain trust funds. The budget does not include the proposals for comprehensive overhaul of the tax system -- for, as you know, those proposals, made public on November 27, remain under review. But we believe that -- with constructive effort by all parties -- a comprehensive restructuring of the tax system could be enacted this year. And I will be having a good deal more to say about this in other contexts.

The focus of today's discussion is principally upon our printed budget, however.

Immediate steps must be taken to narrow the deficit.

Just as important as closing the deficit is the manner by which it is closed. It would be wrong to go back to our old ways of pushing up taxes, either legislatively or by bracket creep in a nonindexed system. In our view, the tax reductions of the past several years have been largely responsible for the turnaround in economic performance. This means that deficit reduction must be accomplished from the spending side.

The large deficits that we face during the remainder of the decade are due to an excessive rate of Federal spending. The American people do not feel they are undertaxed. They want government spending brought under control.

Between 1964 and 1979, Federal outlays averaged 20-1/2 percent of GNP. Now they are in the 24 to 25 percent range. Federal outlays have virtually been living a life of their own. The President's budget proposals would restrain the rate of growth of outlays below that of the economy and shrink the outlay-GNP ratio down to the 21 percent range by the end of the decade. This would leave a deficit of less than $100 billion by 1990.

The President's budget proposes a combination of freezes, reforms, user fees, program cuts and terminations that will achieve savings for fiscal year 1986 of a little more than $50 billion. This is calculated from the "baseline" path that spending would take if we did nothing. These reductions are sufficient to hold total spending on government programs -- that is, everything but debt service -- no higher in 1986 than in 1985. It is an ambitious target, but is achievable, without damaging the social safety net, or our continued defense rebuilding, or any essential government function.

Achievement of our target of $50 billion in reductions would accomplish two things. The deficit in 1986 would be about $40 billion less than in 1985. And, even more important, the actions taken this year will have an amplified effect in later years, resulting in annual savings of more than $100 billion by 1988. This will set the deficit on a declining path -- both in absolute dollars and, even more significantly, as a share of GNP. Under our economic assumptions, the deficit would drop from over 5 1/2 percent of GNP this year to less than 3 percent by 1988 -- on down to less than 1 1/2 percent by 1990. The exact percentages are not the issue; the important thing is the trend.

The deficit has been accommodated thus far without damage to the expansion, and interest rates have declined considerably. But "real" interest rates remain too high. We need monetary policies that will allow us to continue strong economic growth without inflation. Such policies will help get interest rates down further. At the same time, a firm, convincing policy of deficit reduction will also help keep us on a course to still lower interest rates -- while insuring that the Government, in financing the deficit, does not absorb such a large share of the nation's savings as to impair private productive investment.

Our budget proposal represents a "freeze" in total program spending. That is something that is easy for most to understand -- and to most, I think, it makes sense. There will, we know, be disagreements about what we propose specifically for one program or another. But we believe our specific proposals are thoroughly defensible on the merits. And we look forward to working with the Congress to develop a comprehensive package that will bring the budget under control -- by freezing overall program spending for fiscal year 1986.

With good will, we believe this can be done. We are sure it is what the American people want to be done.

File

18 February 1985

PRIME MINISTER

REAGANOMICS

Many Tory MPs think that Reagan is ruining the world economy. Yet with inflation very low, employment rising, growth continuing at a reasonable rate, and the US continuing to attract the money it needs to pay for its expansion, why should the President worry?

The points he and his advisers should be thinking about are:

The Federal Budget Deficit

In 1981, the Budget deficit was a little under $60 billion. It rose to $110 billion in 1982; $195 billion in 1983; and is estimated to stay between $175 billion and $210 billion between 1984 and 1986 (Simon & Coates figures). If you adjust the deficit for the state of the economic cycle, it has been steadily rising throughout his Presidency. This requires financing, and means an ever-bigger burden of debt.

The trade balance has also deteriorated markedly from around $4 billion a month in 1981 to over $10 billion a month, and still seems to be going up. This too requires financing.

E.R.

The US has probably become a net debtor country, bringing to an end many decades of American dollar exports to finance growth and investment around the world.

As the trade balance deteriorates, US manufacturing industry is being forced onto the defensive. In 1970, imported manufactures accounted for 9.3% of total manufactures. By 1984, it is estimated this figure had reached almost 23%, and it is rising sharply (Simon & Coates). As this process is under way, the pain of the manufacturing sector will become more obvious in Washington, and there will be arguments for import controls and other measures to alleviate the pressures on the US manufacturing base.

The very high interest rates which the States has had to impose are also furthering strains in the world financial system, making adjustment to the world debt crisis more difficult. Yet because there are tax breaks at home against interest payments, but not for those who have borrowed from overseas, the very high real interest rates are making adjustment that much more difficult. Nor is the adjustment process proceeding that smoothly. The 8 February Wall Street Journal pointed out that in Argentina prices rose by 25% in January alone; and in Bolivia prices are now rising at 80% a month. At this level, normal commercial relationships start to break down.

The message of all countries forced into adjustment by the IMF or the world banking crisis in recent years must surely be the same to the USA. It is better to adjust while you still have the chance to do it yourself in your own time and in your own manner.

Conclusion

Asking the President to cut his deficit because high real rates are hurting the other Western world currencies and economies is unlikely to move him. And the strong dollar and rapid US growth does bring us benefits as well as agonies - a much bigger potential market. But appealing to his own political sense on what high real rates and large deficits are doing to his own domestic manufacturing base, and to the US banking system, may bring the message home in a more direct way and encourage him to plan a little more for the longer term. Otherwise the inexorable logic of compound interest on his debts will catch up with him.

John Redwood

JOHN REDWOOD

P12

PERSONAL AND SECRET

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

PRIME MINISTER

US ECONOMIC POLICY

Since we may not have a chance to discuss your forthcoming trip to Washington before you leave, I thought I should briefly record for you my personal views on the foreign exchange issue and the US deficit.

2. I believe it would be desirable for you to go a little further on the strength of the dollar and intervention arrangements than your briefing suggests. The US authorities do not like to appear to criticize free market developments and they hate any suggestion that they should talk their own currency down. But they are saying privately that at present levels the dollar is uncomfortably high, and they do see the effect on trade and protectionist pressures. It is right of course for you to make clear, as necessary, that you are leaving detailed intervention arrangements to the practitioners. But you might wish to say to the President that you think it a matter of great importance that the Washington G5 commitment is carried forward effectively and that it is recognised by the market that all parties are operating, and operating together, to this end. With Baker you might wish to express appreciation for the helpful tone of his recent comments on Fed' intervention, and ~~add~~ that dollar strength has been a factor which has been operating in combination with others to contribute to pressure on sterling and hence UK interest rates.

3. You may also like to suggest to President Reagan that it is not very clever of his people to ascribe the succession of

rises in the dollar to real and justified causes (as against speculation and similar market phenomena), since one day - during his Presidency - the dollar will fall and he will not want that ascribed to a well-merited verdict on the US economy.

4. I attach, by way of background, a telegram recording the G5 communique on intervention and a short factual note on what has actually been said and done since the G5.

5. We must not, of course, let up on the Administration of Congress about the Federal budget deficit. Although the recent Washington telegram (No.511, 13 February) may be right about European criticism of the US economy being regarded as whingeing, the sustainability of the world recovery and our own freedom of manoeuvre on domestic policy is threatened by historically high US interest rates and the strong dollar. The telegram sensibly suggests that you could point out to the President that on current policies he will not only leave office with the level of Federal debt at record levels, but with the US economy actually in hock to the rest of the world. It is a time when painful decisions must be made - it is not enough to rely on high growth rates to eliminate the deficit problem. They won't.

NL.

N.L.
18 February 1985

WASHINGTON STATEMENT: SUBSEQUENT DEVELOPMENTS

The Washington Agreement was reached at a time of considerable dollar strength.

2. Following the Agreement markets initially took a cautious attitude which helped to restrain further surges in the dollar. Sterling was significantly insulated thereafter by the second interest rate increase on 28 January. In the last few days the dollar has moved forward again to reach new record levels although the end of the week has seen some profit taking and rates have currently eased. Since the agreement the $ effective rate has increased by some 2½%.

3. During this period US comments (including public comments by Volcker and Macnamar) appear to have left doubt in the market about the strength of the US commitment to the G5 Agreement. This reinforced sentiment that the Fed may not have changed its intervention policy and that concerted action had little impact. President Reagan has rationalised the dollar's strength as reflecting the moderate pace of European growth. Poehl, the President of the Bundesbank, has been reported as having reservations about the effectiveness of intervention.

4. The US have interpreted the G5 Agreement as very much a reaffirmation of Williamsburg rather than breaking any new policy ground. In practice they have been prepared to contemplate intervention only in the context of strong upward speculative pressure. They have been reluctant to intervene on days where there has not been earlier intervention in Europe. In general the extent of US intervention has not matched that of the Bundesbank. German intervention has been a little predictable, though markets may have been surprised that the Bundesbank has not stepped in more heavily of late.

5. The recent Basle meeting reviewed the operation of the intervention arrangements and concluded that a further effort should be made to concert it more effectively and to be tactically more imaginative. There was a disposition to give evidence of renewed determination by the authorities. Some suggestion was reported that the US Treasury felt that the most recent Fed interventions had not been adequately appreciated and followed through in Europe. Stoltenberg, the German Finance Minister, has subsequently spoken to Baker. These contacts may have contributed to the more positive statements by Baker in Washington at the weekend which referred to the Fed intervening 'more readily' in recent weeks and a 'moderation of the tone' of previous US intervention policy.

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TO IMMEDIATE FCO
TELEGRAM NUMBER 152 OF JANUARY

FROM LITTLER FOR NO. 10 DUTY CLERK

FOLLOWING IS TEXT OF ANNOUNCEMENT ISSUED TO PRESS BY DON REGAN IMMEDIATELY AFTER G5 MEETING THIS AFTERNOON.
BEGINS

THE MINISTERS OF FINANCE AND CENTRAL BANK GOVERNORS OF FRANCE, GERMANY, JAPAN, THE UNITED KINGDOM, AND THE UNITED STATES ANNOUNCED TODAY THAT THEY HAD MET TO DISCUSS A RANGE OF INTERNATIONAL ECONOMIC AND FINANCIAL ISSUES. THE MEETING, PART OF A REGULAR SERIES OF CONSULTATIONS AMONG THESE COUNTRIES ON ECONOMIC AND FINANCIAL MATTERS OF MUTUAL INTEREST, ALSO INVOLVED IMF MANAGING DIRECTOR DE LAROSIERE FOR A DISCUSSION OF THE ECONOMIC POLICIES AND PROSPECTS OF THE MAJOR INDUSTRIAL COUNTRIES.

THE MINISTERS AND GOVERNORS, NOTING THE RECENT DEVELOPMENTS IN THE EXCHANGE MARKETS, EXPRESSED THEIR COMMITMENT TO WORK TOWARD GREATER EXCHANGE MARKET STABILITY. TOWARD THIS END, THE MINISTERS AND GOVERNORS:

—REAFFIRMED THEIR COMMITMENT TO PURSUE MONETARY AND FISCAL POLICIES THAT PROMOTE A CONVERGENCE OF ECONOMIC PERFORMANCE AT NON-INFLATIONARY, STEADY GROWTH;

—STRESSED THE IMPORTANCE OF REMOVING STRUCTURAL RIGIDITIES IN THEIR ECONOMIES TO ACHIEVING THE OBJECTIVES OF NON-INFLATIONARY, STEADY GROWTH AND EXCHANGE MARKET STABILITY, AND EXPRESSED THEIR INTENT TO INTENSIFY EFFORTS IN THIS AREA; AND

—IN LIGHT OF RECENT DEVELOPMENTS IN FOREIGN EXCHANGE MARKETS, REAFFIRMED THEIR COMMITMENT MADE AT THE WILLIAMSBURG SUMMIT TO UNDERTAKE COORDINATED INTERVENTION IN THE MARKETS AS NECESSARY.

THE MINISTERS AND GOVERNORS BELIEVE THAT THIS APPROACH WILL PROVIDE A SOLID FRAMEWORK FOR SUSTAINING RECOVERY, REDUCING INFLATION, INCREASING EMPLOYMENT, AND ACHIEVING GREATER EXCHANGE RATE STABILITY.

ENDS

FCO PLEASE PASS IMMEDIATE DESKBY 04.45Z TO NO. 10 DUTY OFFICER AND TO PS/FOREIGN SECRETARY.

AND DESKBY 08.00Z TO PS/CHANCELLOR, SIR P. MIDDLETON, MR. CASSELL, MR. LAVELLE (HM TREASURY), PS/GOVERNOR, MR. LOEHNIS, MR. GAILL AND MR. BYATT (BANK OF ENGLAND)

WRIGHT

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TO IMMEDIATE F C O
TELEGRAM NUMBER 511 OF 13 FEBRUARY
INFO SAVING C G NEW YORK, UKREP BRUSSELS, BONN, PARIS.

M.I.P.T.: (NOT TO ALL): PRIME MINISTER'S VISIT - ECONOMIC ASPECTS

1. FEW HERE IN WASHINGTON QUESTION THAT IN HIS FIRST TERM THE PRESIDENT WROUGHT AN ECONOMIC MIRACLE. EVEN THE DEMOCRATS CANNOT GAINSAY THE ANNUS MIRABILIS OF 1984 WHEN AT 6.8 PERCENT ECONOMIC GROWTH WAS THE FASTEST SINCE 1951 (AND THE FIGURES ARE LIKELY TO BE REVISED UPWARDS, FOR GROWTH IN THE LAST QUARTER WAS ABOVE THE ORIGINAL 3.9 PERCENT ESTIMATE), AND INFLATION, AT 4 PERCENT, HAD BEEN KEPT LOW FOR FOUR CONSECUTIVE YEARS - TWO FACTORS WHICH MATERIALLY HELPED TO DELIVER A MASSIVE PRESIDENTIAL ELECTION VICTORY. THE ADMINISTRATION BELIEVE THAT THE ECONOMY IS SET FAIR THROUGH 1985.

2. TRUE, THERE IS A LOT OF TALK ABOUT THE PERILS OF THE BUDGET AND TRADE DEFICITS. BUT THERE IS NO SENSE IN THE ADMINISTRATION'S TOP ECHELONS OF EMERGING CRISIS OR NEED FOR URGENT ACTION. THE PERILS, IF PERILS THEY BE - AND SOME INFLUENTIAL VOICES EVEN DISPUTE THAT - ARE THOUGHT TO ARISE ONLY IN THE MEDIUM TERM. THUS, NISKANEN, MEMBER OF THE COUNCIL OF ECONOMIC ADVISERS, LIKENS THE BUDGET DEFICIT TO QUOTE A SLOW-ACTING BUT POTENTIALLY LETHAL CANCER UNQUOTE. EVEN THE ORTHODOX CONGRESSIONAL BUDGET OFFICE COUCHES ITS WARNINGS IN TERMS OF QUOTE THE LONG RUN CONSEQUENCES OF SUSTAINED DEFICITS UNQUOTE WHERE THE LONG RUN MEANS QUOTE INTO THE NEXT DECADE UNQUOTE. TRUE TO FORM, VOLCKER IS STILL PUBLICLY MAINTAINING THE CALL FOR EARLY ACTION, THOUGH HE HAD ADMITTED TO ME PRIVATELY THAT HE DOES NOT THINK HIS WARNINGS HAVE MUCH IMPACT.

3. THE CURRENT STRENGTH OF THE DOLLAR DOES NOW GIVE RISE TO SOME CONCERN IN THE ADMINISTRATION, BUT NOT, APPARENTLY, TO THE EXTENT OF STIMULATING REMEDIAL ACTION. ITS RISE IS ASCRIBED TO THE BELIEF THAT UNITED STATES ECONOMY OFFERS INVESTORS A SAFE AND PROFITABLE HAVEN, OR AS MCNAMAR WOULD HAVE IT QUOTE THE BEST AFTER TAX RETURN AND THE LEAST SOVEREIGN RISK UNQUOTE. EQUALLY THE SLUMP IN THE EUROPEAN CURRENCIES IS, TO A LARGE EXTENT, SEEN IN THE ADMINISTR-

ATION AS A REFLECTION OF THE WEAKNESS OF THE EUROPEAN ECONOMIES, FLOWING FROM OVER-UNIONISATION, MARKET RIGIDITES, AND LACK OF OPPORTUNITY FOR ENTREPRENEURIAL TALENT. (THEY HAVE A DIFFERENT EXPLANATION FOR THE WEAKNESS OF THE YEN EXCLAM). INSTEAD OF GRUMBLING ON ABOUT THE DOLLAR, THE ADMINISTRATION BELIEVE THAT WE SHOULD BE GRATEFUL FOR THE OPPORTUNITIES WHICH THEIR TRADE DEFICIT AFFORDS OUR EXPORTERS. THERE IS AN INCLINATION TO REGARD ANY CRITICISM AS WHINGEING AND WHINGEING WON'T WORK IN THE EBULLIENT WASHINGTON OF 1985. IN ANY CASE, THEY SUSPECT THAT IF THE DOLLAR FELL WE SHOULD FIND OTHER THINGS TO COMPLAIN ABOUT: INCREASED COMPETITION FROM U.S. EXPORTS, E.G.

4. CERTAINLY THE HIGH DOLLAR AND HIGH REAL INTEREST RATES ARE PUSHING MANY FARMERS, AND THEIR LOCAL BANKS, INTO DEEP TROUBLE. AND THE SAME IS HAPPENING TO THOSE OTHER PARTS OF THE AMERICAN ECONOMY FACING FOREIGN COMPETITION. BUT THE ADMINISTRATION DEALS WITH THESE INDUSTRIES' PROBLEMS BY PROGRAMMES DIRECTED TO THEIR PARTICULAR NEEDS, SUCH AS HELP TO FARMERS STRUGGLING WITH INDEBTED-NESS (WHILE TRYING TO REDUCE FARM SUPPORT GENERALLY) AND EVEN SPECIFIC MEASURES OF PROTECTION (E.G. STEEL AND TEXTILES) RATHER THAN BY AN EARLY CHANGE IN OVERALL ECONOMIC POLICIES WHICH WOULD ENABLE INTEREST RATES AND THE DOLLAR TO COME DOWN.

5. SO THE PRIME MINISTER WILL BE GREETED BY AN ADMINISTRATION SATISFIED WITH ITS PAST ECONOMIC SUCCESSES, CONFIDENT IN ITS PRESENT POLICIES, AND OPTIMISTIC ABOUT FUTURE SUCCESS.

6. THE PRIME MINISTER'S APPROACH IN ANY DISCUSSION WITH THE PRESIDENT AND SECRETARY BAKER ABOUT THE TURBULENCE IN THE EXCHANGE MARKETS WILL NEED TO BE JUDGED IN THE LIGHT OF UP-TO-DATE MARKET EVENTS.

7. MORE GENERALLY, I SUGGEST THAT, WHILE RECOGNISING THE IMPRESSIVE AMERICAN ECONOMIC PERFORMANCE, AND ITS ROLE IN STIMULATING EUROPEAN GROWTH, AND ENABLING THE INTERNATIONAL BANKING SYSTEM TO MANAGE 3RD WORLD DEBT, SHE SHOULD SEEK TO REINFORCE AND QUICKEN THE PRESIDENT'S RESOLVE IN DEALING WITH THE BUDGET DEFICIT. THE PRIME MINISTER MIGHT POINT TO THE DANGERS OF PROTECTIONISM, ARISING FROM THE TRADE DEFICIT: AND THE RISK TO THE ECONOMY OF THE FREE WORLD IF THEY WERE NOT SUCCESSFULLY RESISTED. VOLCKER TOLD ME LAST NIGHT THAT HE TAKES VERY SERIOUSLY THE THREAT OF AN IMPORT SURCHARGE (IN TRUTH, A TAX ON IMPORTS), WHICH I WARNED ABOUT IN MY TELNO 414. IT IS ALWAYS BETTER HERE TO ACCENTUATE THE POSITIVE: WE SHOULD KEEP THE ADMINISTRATION COMMITED TO A NEW G.A.T.T. ROUND AS THE BEST METHOD OF STAVING OFF PROTECTIONIST MEASURES.

8. BEYOND THIS, THE HIGH DOLLAR, AS WELL AS BRINGING ENORMOUS PROBLEMS FOR THE PRESIDENT'S ALLIES IN THE MANAGEMENT OF THEIR OWN ECONOMIES, WILL BRING A SUBSTANTIAL PENALTY IN THE LONGER TERM FOR THE UNITED STATES. SHE MIGHT POINT OUT THAT THE U.S. ECONOMY IS INCREASINGLY BEING KEPT AFLOAT ONLY BY CURRENCY INFLOWS FROM ABROAD, FINANCING THE U.S. DOLLARS 100 BN CURRENT ACCOUNT DEFICIT. HOW LONG WILL THE FINANCIAL MARKETS BE WILLING TO OBLIGE - AND AT WHAT COST IN INTEREST RATES? IT WOULD BE A TRAGEDY IF THE PRESIDENT, WHO HAS DONE SO MUCH TO RESTORE HIS COUNTRY'S, AND THE ALLIANCE'S, MILITARY SECURITY, WERE TO GO DOWN IN THE HISTORY BOOKS AS THE PRESIDENT WHO HAD UNDERMINED HIS COUNTRY'S ECONOMIC SECURITY BY PUTTING THE UNITED STATES INTO HOCK WITH THE REST OF THE WORLD.

US net debts

AS THE PRESIDENT WHO HAD UNDERMINED HIS COUNTRY'S ECONOMIC SECURITY BY PUTTING THE UNITED STATES INTO HOCK WITH THE REST OF THE WORLD.

9. I BELIEVE THAT SUCH AN APPROACH WOULD PROVIDE THE FRAMEWORK IN WHICH THE PRIME MINISTER COULD MAKE, AT THE VARIOUS MEETINGS, THE POINTS ON PROTECTIONISM AND OTHER TRADE AND ECONOMIC ISSUES IN MY TELNO 414. SHE MIGHT INVITE THE PRESIDENT TO WORK TOGETHER TO STRENGTHEN FREE TRADE. MOVES TO INCREASE PROTECTION, SUCH AS THE CONSULTATIONS WITH THE E.C. ON SEMI-FINISHED STEEL, WHICH THE U.S. HAVE DEMANDED, AND THE NEW TEXTILE ORIGIN RULES WHICH ARE PUNITIVE TO HONG KONG, ARE HARDLY COMPATIBLE WITH THIS.

10. IT IS PERHAPS A LITTLE SANGUINE TO BELIEVE THAT WE CAN BRING AN EARLY SHIFT IN U.S. ECONOMIC PRIORITIES. BUT I HOPE THE PRIME MINISTER WILL TAKE THIS OPPORTUNITY TO BRING HOME TO THE PRESIDENT, AS ONLY SHE CAN, THE LIKELY ECONOMIC AND POLITICAL CONSEQUENCES, FOR THE UNITED STATES AND ITS ALLIES, OF THIS ECONOMY'S GROWING DEBT. WITHDRAWAL FROM ANY DEPENDENCY ALWAYS REQUIRES DIFFICULT DECISIONS. BUT IF THE UNITED STATES ECONOMY REALLY BECOMES HOOKED, THE PROSPECTS ARE DIRE. IT WOULD, I SUGGEST, BE BETTER TO EXPRESS CONCERN ABOUT THE EFFECTS ON AMERICA THAN ABOUT THE DEFICIT'S CONSEQUENCES FOR US, AND AMERICA'S OTHER TRADING PARTNERS. FOR THE LATTER COULD BE CONSTRUED AS WHINGEING, AND COULD PROVOKE REMINDERS THAT THE U.S. HAS IN THE LAST 3 YEARS FULFILLED ITS TRADITIONAL ROLE AS MOTOR OF THE FREE WORLD'S ECONOMIES. WE CAN ACKNOWLEDGE THAT IT HAS PLAYED THIS ROLE: WHILE WARNING THAT THE FUTURE LOOKS LESS ROSY. AND WE CAN ALSO REMIND THE PRESIDENT OF THE BENEFITS WE HAVE GAINED FROM THE TOUGH MEASURES OF THE 1981 U.K. BUDGET.

11. IN ADDITION, I STRONGLY RECOMMEND THAT, IN CONTACTS WITH THE ADMINISTRATION AND ON THE HILL, AND IN PRESS AND TELEVISION INTERVIEWS, THE PRIME MINISTER SET LONDON'S RECENT FINANCIAL TURBULENCE IN ITS PROPER LONGER TERM CONTEXT. SCARGILL AND THE DOLLAR ARE THE CURRENT FLAVOURS OF THE MONTH AND AS A RESULT OUR RECORD ON GROWTH, INFLATION, AND - NOT LEAST - BORROWING NOW GETS LESS ATTENTION HERE THAN IT DESERVES. IT WOULD DO MUCH GOOD - IF THE PRIME MINISTER COMES WITH A CONFIDENT MESSAGE ON THE FUTURE OF BRITAIN. AMERICANS ADMIRE SUCCESS AND SELF-CONFIDENCE, SO A LITTLE PRIDE IN OUR ACHIEVEMENTS, WHICH ARE MANY, WILL GO DOWN WELL HERE, AT THE WHITE HOUSE ON THE HILL AND WITH THE MEDIA.

12. ADVANCE COPIES TO POWELL (NO. 10): PS/S OF S, PS/PUS, BRAITHWAITE, MARSHALL (NAD), FCO: PS/S OF S, MOD: PS/CHANCELLOR, LITTLER, LAVELLE, (HM TREASURY): PS/S OF S, DTI: HADFIELD, CARTLEDGE (CABINET OFFICE).

F.C.O. PASS SAVING: UKREP BRUSSELS, BONN, PARIS.

WRIGHT

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ACTION COPY

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DESKBY 190800Z
FM WASHINGTON 190410Z FEB 85
TO IMMEDIATE FCO
TELEGRAM NUMBER 564 OF 18 FEBRUARY

THE DOLLAR

WEEKEND PRESS REPORTS INDICATE THAT TREASURY SECRETARY BAKER HAS SOME DISQUIET ABOUT THE RECENT RISE IN THE DOLLAR. BUT HE SUGGESTS THAT INTERVENTION IS BEST CONFINED TO QUOTE DISORDERLY MARKETS. UNQUOTE

DETAIL

BAKER IS REPORTED IN THE WASHINGTON POST AND NEW YORK TIMES TO HAVE CALLED THE RECENT G5 MINISTERS' AGREEMENT A QUOTE MODERATION OF TONE UNQUOTE OF THE INTERVENTION GUIDELINES. HE BELIEVED THAT REDUCING THE FEDERAL BUDGET DEFICIT WOULD BE MORE EFFECTIVE IN THE LONG RUN IN SLOWING THE DOLLAR'S RISE THAN INTERVENTION. QUOTE I THINK THE POSITION IS BASICALLY THAT IT'S OUR VIEW THAT OPEN SQUARE BRACKET INTERVENTION IS CLOSE SQUARE BRACKET BEST DONE AND MORE PROPERLY DONE ONLY IN THE CASE OF DISORDERLY MARKETS. UNQUOTE AT THE JANUARY 17 MEETING QUOTE WE AGREED TO TAKE A LOOK AT IT WHEN TO DO SO WOULD BE HELPFUL. THAT'S A RATHER VAGUE STANDARD. WE HAVE DONE THAT SINCE THEN. WITHOUT GETTING INTO MORE DETAIL, WE HAVE INTERVENED, AND WE HAVE IN FACT DONE SO SINCE I'VE BEEN HERE. UNQUOTE IN ANSWER TO QUESTIONS ABOUT THE SUCCESS OF THE INTERVENTIONS, BAKER REPLIED QUOTE I THINK THAT THERE WAS SOME EFFECT BUT THE DOLLAR CONTINUED TO RISE NOTWITHSTANDING THOSE INTERVENTIONS. WHAT I CAN'T TELL YOU IS HOW MUCH MORE IT WOULD HAVE RISEN IF WE HAD NOT INTERVENED. UNQUOTE AN UNNAMED SENIOR OFFICIAL IS REPORTED AS SAYING QUOTE THERE'S BEEN SOME INTERVENTION IN CASES, NOT LIMITED TO DISORDERLY MARKETS. UNQUOTE ACCORDING TO THE NEW YORK TIMES, BAKER INDICATED THAT THE REAGAN ADMINISTRATION IS MUCH LESS CHEERED BY THE RISE OF THE DOLLAR THAN IT WAS A MONTH OR TWO AGO AND WAS PARTICULARLY CHAGRINED BY THE RECENT STRETCH DURING WHICH THE DOLLAR GAINED DAY AFTER DAY.

FCO PLEASE ADVANCE TO PS/PRIME MINISTER, PS/CHANCELLOR, LITTLER AND LAVELLE (HMT), BRAITHWAITE (FCO), LOEHNIS (BANK).

WRIGHT

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RESTRICTED [CULL]
FM WASHINGTON 112352Z FEB 85
TO PRIORITY F C O
TELEGRAM NUMBER 463 OF 11 FEBRUARY
INFO ROUTINE PARIS, BONN, TOKYO, ROME, UKREP BRUSSELS, UKDEL OECD, UKDEL NATO, ALL CGS IN THE U.S.

Summary only
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U S FY86 BUDGET: LATEST DEVELOPMENTS.

REF: OUR TELNOS 360 AND 412.

SUMMARY

1. JUDGING FROM A HOST OF RECENT PUBLIC STATEMENTS AND CONGRESSIONAL TESTIMONIES, IT SEEMS CLEAR THAT THE PRESIDENT'S FY 86 BUDGET PROPOSALS ARE IN FOR A ROUGH RIDE AND WILL BE SUBSTANTIALLY ALTERED BY THE CONGRESS. TREASURY SECRETARY BAKER HAS NOW SAID THAT HE WOULD RULE OUT TAX INCREASES EVEN AS A LAST RESORT IF NO PROGRESS IS MADE ON THE ADMINISTRATION'S EXPENDITURE REDUCTION PROPOSALS DURING THE BUDGET PROCESS THIS YEAR. MOST COMMENTATORS BELIEVE THAT THE ADMINISTRATION WILL FIND IT DIFFICULT TO ACHIEVE ITS TARGET OF DOLLARS 50 BILLION IN EXPENDITURE SAVINGS IN FY86.

DETAIL

2. IN HIS 6 FEBRUARY STATE OF THE UNION ADDRESS THE PRESIDENT GAVE THE REFORM AND SIMPLICATION OF THE U S TAX SYSTEM A HIGH PRIORITY AND DID NOT ELABORATE MUCH ON HIS BUDGET PROPOSALS BEYOND STRESSING THE NEED FOR A FREEZE ON SPENDING IN FY86 AND FOR CONSTITUTIONAL REFORMS TO GIVE HIM INCREASED BUDGETARY POWERS. PUTTING HIS FAITH IN INCREASED ECONOMIC GROWTH TO REDUCE THE DEFICIT, THE PRESIDENT MENTIONED A TOP RATE OF INCOME TAX OF 35 PERCENT AS THE TARGET OF A BIPARTISAN TAX BILL, WITHOUT ALSO STRESSING THAT THIS COULD ONLY BE ACHIEVED IF THE TAX BASE WERE BROADENED ENOUGH. IN A SUBSEQUENT INTERVIEW WITH THE WALL STREET JOURNAL, HE ALSO SAID THAT HE WOULD HAVE TO BE CONVINCED OF THE NEED TO CHANGE THE ACCELERATED DEPRECIATION PROVISIONS FOR COMPANIES INTRODUCED IN THE 1981 ECONOMIC RECOVERY TAX ACT AND IMPLIED THAT THE ONLY GROUPS WHO SHOULD PAY MORE UNDER TAX REFORM WOULD BE THOSE WHO WERE TAKING CONVOLUTED STEPS TO AVOID IT UNDER THE PRESENT TAX CODE, ALTHOUGH HE ALSO MADE THE SAVING REFERENCE THAT TAX REFORM WOULD BE REVENUE-NEUTRAL. TREASURY SECRETARY BAKER THEN TOLD THE HOUSE APPROPRIATIONS COMMITTEE THAT THE ADMINISTRATION WOULD NOT PROPOSE A TAX INCREASE EVEN IF CONGRESS FAILS TO MAKE PROGRESS IN REDUCING THE BUDGET DEFICIT THIS YEAR.

3. ON EXPENDITURE, THE MOST SIGNIFICANT DEVELOPMENT IS THAT SENATOR DOLE HAS ABANDONED HIS ATTEMPT PERSONALLY TO CO-ORDINATE A DRAFT OF AN ALTERNATIVE SET OF PROPOSALS TO THOSE OF THE ADMINISTRATION AND THAT THE PROPOSALS TO BE PUT TO THE SENATE WILL BE PROCESSED THROUGH THE NORMAL (AND SLOWER) CHANNEL OF

SENATOR DOMENICI'S BUDGET COMMITTEE. IT SEEMS LIKELY THAT THIS COMMITTEE WILL PROPOSE TO REDUCE THE PRESIDENT'S PROPOSALS FOR THE FULL INDEXATION OF SOCIAL SECURITY AND FOR MUCH HIGHER DEFENCE EXPENDITURE. SENATOR DOLE WISHES (VERY AMBITIOUSLY) TO HAVE A BINDING VOTE ON THE BUDGET SPENDING CUTS AS EARLY AS THE END OF MARCH, AFTER WHICH THE ADMINISTRATION'S TAX REFORM BILL WOULD BE PRESENTED. THIS WOULD USE THE EXPERIENCE IN 1981 AS A PRECEDENT (WHEN THROUGH THE SO-CALLED RECONCILIATION PROCEDURE A BINDING BUDGET FOR FY82 WAS PASSED IN LATE JULY INCORPORATING DOLLARS 35 BN IN EXPENDITURE CUTS). BUT THE DEMOCRATS ACQIESCED TO AN ABBREVIATED PROCEDURE IN 1981, WHEREAS THIS YEAR SPEAKER O'NEILL CLAIMS THAT THEY WILL SCRUTINISE EACH PROPOSED CUT.

4. ON THE AMOUNT OF THE PROPOSED EXPENDITURE CUTS, MOST OUTSIDE COMMENTATORS BELIEVE THAT DOLLARS 50 BN WILL BE A DIFFICULT TARGET TO REACH. EVEN BUDGET DIRECTOR STOCKMAN TOLD THE SENATE BUDGET COMMITTEE THAT THE FY86 ADMINISTRATION BUDGET PROPOSALS ''MAY WELL CONSTITUTE THE BULK OF WHAT IS FEASIBLE, WHAT IS PRACTICAL AND JUSTIFIABLE TO DO IN THIS DECADE''. WHILE FED CHAIRMAN VOLCKER TOLD THE JOINT ECONOMIC COMMITTEE THAT THERE WOULD BE AN ADVERSE IMPACT ON FINANCIAL MARKETS, LEADING TO HIGHER INTERESTS RATES, IF CONGRESS FAILED TO CUT THE DEFICIT BY AT LEAST DOLLARS 50 BN, C B O DIRECTOR PENNER (HAVING PREDICTED THAT THE DEFICIT COULD RISE TO AS HIGH AS DOLLARS 400 BN BY 1990 IF THERE WERE A RECESSION) SAID THAT DOLLARS 50 BN WAS AMBITIOUS AND THAT A MORE REALISTIC AND RELEVANT OBJECTIVE WOULD BE TO STOP THE AMOUNT OF PUBLIC DEBT GROWING AS A PERCENTAGE OF GNP BEYOND FY88.

5. IN TERMS OF INDIVIDUAL EXPENDITURE AREAS, BUDGET DIRECTOR STOCKMAN HAS ACKNOWLEDGED TO THE CONGRESS THAT IN HIS VIEW DEFENCE SPENDING SHOULD HAVE BEEN CUT FURTHER THAN HAS BEEN PROPOSED BY THE ADMINISTRATION, AND HAS GONE SO FAR AS TO REFER TO THE GROWTH OF MILITARY RETIREMENT BENEFITS AS ''A SCANDAL AND OUTRAGE'', DRAWING SHARP RESPONSES FROM VETERANS' GROUPS. SENATOR DOLE HAS STATED THAT HE WOULD LIKE TO SEE A 3 PERCENT REAL INCREASE IN DEFENCE SPENDING INSTEAD OF THE 5.9 PERCENT SOUGHT BY THE ADMINISTRATION AND HOUSE MAJORITY LEADER WRIGHT HAS SUGGESTED THAT HE ALSO WOULD BE ABLE TO ACCEPT 3 PERCENT.

6. ON AGRICULTURE, BUDGET DIRECTOR STOCKMAN HAS OFFERED TO THE CONGRESS A COMPACT UNDER WHICH, IF THE CONGRESSMEN FROM FARM STATES ACCEPTED THE ADMINISTRATION'S FARM BILL, THE ADMINISTRATION IN RETURN WOULD PROVIDE SHORT-TERM CREDIT TO FARMERS IN FINANCIAL DIFFICULTIES. THIS OFFER WAS ANGRILY TURNED DOWN BY FARM STATE CONGRESSMEN AND IN THE END HAK

CONGRESSMEN AND IN THE END THE ADMINISTRATION HAD TO MAKE A FIRM OFFER OF A FARM CREDIT PACKAGE WITHOUT RECEIVING ANY ASSURANCES IN RETURN. MOREOVER, THIS PACKAGE MAY HAVE TO BE

AUGMENTED TO MEET VARIOUS CRITICISMS OF ITS INADEQUACY. THE ADMINISTRATION'S PROPOSALS TO CUT FARM SUBSIDIES ARE CLEARLY IN FOR A ROUGH RIDE AND IT WOULD BE SURPRISING IF THEY WERE NOT SCALED DOWN DURING THE BUDGET PROCESS BECAUSE OF THE STRENGTH OF FEELING IN THE FARM STATES.

COMMENT

7. TAX INCREASES HAVE APPARENTLY BEEN RULED OUT OF COURT BY THE TREASURY SECRETARY ALTOGETHER FOR THIS YEAR AND THE PRESIDENT HAS COME CLOSE TO ATTACHING HIMSELF TO THE OBJECTIVE OF A 35 PERCENT TOP RATE OF INCOME TAX. THERE IS A LONG WAY TO GO BEFORE EXPENDITURE REDUCTIONS ARE WITHIN SIGHT. THE SUCCESS OF EVEN A MORE MODEST PACKAGE OF SPENDING REDUCTIONS THAN PROPOSED WILL DEPEND ON THE WILLINGNESS OF THE ADMINISTRATION TO COMPROMISE AND AGREE TO CUT DEFENCE EXPENDITURE FURTHER. C B O DIRECTOR PENNER IS PROBABLY RIGHT WHEN HE STATES THAT A REALISTIC TARGET WOULD BE TO STABILISE THE DEBT/GNP RATIO BY FY88, BUT EVEN THIS WILL BE DIFFICULT TO ACHIEVE. AS REAL CUTS BECOME INCREASINGLY HARD TO MAKE, SOME OF THE EXPENDITURE REDUCTIONS THAT EVENTUALLY EMERGE MAY NOT REFLECT TRUE REDUCTIONS IN PUBLIC SECTOR CLAIMS ON THE FINANCIAL MARKETS, E.G. THE PROPOSAL THAT EX-IM BANK SHOULD ABANDON DIRECT LENDING FOR EXPORT CREDIT AND INSTEAD ONLY GUARANTEE PRIVATE SECTOR LOANS FOR EXPORTS.

8. F C O PLEASE ADVANCE TO SHIELDS (TREASURY), GREEN (BANK) AND BROADBENT (ECONOMIC ADVISERS).

WRIGHT

ADVANCED AS REQUESTED

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GR 1700
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FM WASHINGTON 030205Z
TO IMMEDIATE FCO
TELEGRAM NUMBER 360 OF 2 FEBRUARY 1985
AND TO IMMEDIATE PARIS, BONN, TOKYO, ROME, UKREP BRUSSELS, OTTAWA, UKDEL NATO, ALL C.G'S IN THE US.

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THE UNITED STATES FY86 BUDGET

SUMMARY
1. PRESIDENT REAGAN'S FY86 BUDGET CONTAINS FEW SURPRISES. APPROXIMATELY DLRS 50 BILLION OF EXPENDITURE REDUCTIONS ARE PROPOSED FOR FY86, RISING TO DLRS 105 BILLION BY FY88 SO THAT THE DEFICIT IS REDUCTED TO DLRS 144 BILLION (2.8 PERCENT OF GNP). THE BUDGET STRATEGY CONSISTS OF A ONE YEAR FREEZE IN TOTAL SPENDING OTHER THAN DEBT SERVICE, WITH DEFENCE SPENDING GIVEN PREFERRED STATUS AND NON-DEFENCE EXPENDITURE SEVERELY CUT BACK. THIS BALANCE IS ALMOST CERTAIN TO BE READJUSTED SOMEWHAT IN THE CONGRESS DURING THE BUDGET PROCESS THIS YEAR.

DETAIL
2. PRESIDENT REAGAN WILL PRESENT HIS FY86 BUDGET TO CONGRESS ON 4 FEBRUARY. IT IS EMBARGOED UNTIL 1.30 P.M. LOCAL TIME. UNTIL THEN, THE INFORMATION IN THIS TELEGRAM, BASED ON AN ADVANCE COPY, SHOULD BE TREATED AS CONFIDENTIAL.

3. THE BUDGET SUMMARY IS AS FOLLOWS (IN BILLIONS OF DOLLARS):

	BUDGET RECEIPTS AND EXPENDITURES				
	FY 85	86	87	88	90
BASELINE DEFICIT	224	230	246	248	224
RECEIPTS	737	794	862	950	1108
(PERCENT OF GNP)	19.0	18.9	18.9	19.3	(NA)
OUTLAYS	959	974	1027	1095	1190
(PERCENT OF GNP)	24.8	23.2	22.6	22.2	(NA)
BUDGET DEFICIT	218	180	165	144	82
(PERCENT OF GNP)	5.7	4.3	3.5	2.8	(NA)

4. THE BASELINE BUDGET DEFICITS ARE CONSIDERABLY ABOVE THOSE ESTIMATED BY THE ADMINISTRATION LAST AUGUST IN ITS MID-SESSION REVIEW OF THE BUDGET. THE FY86 BUDGET DEFICIT WAS THEN PROJECTED AT DOLLARS 174 BN. THE MAIN REASONS FOR THE INCREASE IN THE ESTIMATES OF THE BASELINE DEFICIT ARE THE EFFECTS OF SLOWER THAN EXPECTED GROWTH IN THE SECOND HALF OF 1984, AN INCREASE IN OUTLAYS, AND A DECISION TO INCLUDE THE OFF-BUDGET ITEMS.

CONFIDENTIAL

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5. THE BUDGET DOCUMENTS EMPHASIZE THE NEED TO CUT GOVERNMENT SPENDING IN FY 86 BY SOME DLRS 50 BN TO LOWER THE PROJECTED DEFICIT TO DLRS 180 BN. IF THE PROPOSED CUTS ARE ENACTED, TOTAL SPENDING WOULD RISE BY 1.5 PERCENT IN NOMINAL TERMS ABOVE THE FY85 LEVEL. THIS INCREASE IS ALMOST WHOLLY ACCOUNTED FOR BY THE RISE IN DEBT SERVICE PAYMENTS. THE CUTS INCLUDE DLRS 21 BILLION FROM DISCRETIONARY PROGRAMMES, DLRS 14 BILLION FROM ENTITLEMENT PROGRAMMES, AND A LOWER INCREASE IN THE RATE OF GROWTH OF DEFENCE SPENDING TO YIELD A SAVING OF DLRS 8.9 BILLION. MINOR CHANGES IN OFFSETTING RECEIPTS AND A DECLINE IN DEBT SERVICE PAYMENTS BECAUSE OF THE SAVINGS ACCOUNT FOR DLRS 6.7 OF THE TOTAL REDUCTION. THE PROJECTED DEFICIT FOR FY88 OF DLRS 144 BN, SOME 2.8 PERCENT OF GNP, IS WELL ABOVE THE OMB'S INITIAL TARGET OF LOWERING THE DEFICIT TO DLRS 100 BN BY FY88, SOME 2 PERCENT OF GNP. THE FAILURE TO MEET THIS TARGET MAINLY REFLECTS THE ADMINISTRATION'S DECISION TO ACCEPT SMALLER CUTS IN THE GROWTH OF DEFENCE SPENDING BETWEEN FY86-88 THAN WAS ORIGINALLY PROPOSED BY THE OMB.

6. THE BUDGET ESTIMATES (AS IS CUSTOMARY) ARE BASED ON AN OPTIMISTIC ECONOMIC FORECAST FOR FY86 AND ASSUMPTIONS FOR THE LATER YEARS. GNP GROWTH IS FORECAST AT SOME 4 PERCENT P.A. THROUGHOUT THE PERIOD TO FY88, ACCOMPANIED BY A SLOW DECLINE IN INFLATION, FALLING UNEMPLOYMENT AND A REDUCTION IN INTEREST RATES. THE MAIN DIFFERENCE COMPARED TO THE PREVIOUS OFFICIAL FORECAST (AUGUST 1984) IS THE REDUCTION IN INTEREST RATES IN FY85 AND FY86. THE MAIN FIGURES ARE AS FOLLOWS:-

2 3

ECONOMIC ASSUMPTIONS

CALENDAR	85	86	87	88	90
NOMINAL GNP (PERCENT YR ON YR)	7.8	8.5	8.3	8.1	7.1
REAL GNP (PERCENY YR ON YR)	3.9	4.0	4.0	4.0	3.6
CONSUMER PRICE INDEX (PERCENT YR ON YR)	4.1	4.3	4.2	3.9	3.3
UNEMPLOYMENT (PERCENT ANNUAL AVERAGE)	7.0	6.9	6.6	6.3	5.8
91 DAY T-BILL (PERCENT)	8.1	7.9	7.2	5.9	5.0
10-YEAR TREASURY NOTE	11.0	10.3	9.3	7.3	5.5

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OUTLAYS

7. THE BUDGET PROPOSES SHARP CUTS IN A NUMBER OF DOMESTIC PROGRAMMES IN FY 86. THESE INCLUDE DLRS 5 BILLION IN AGRICULTURE AS THE FARM PRICE SUPPORT SYSTEM IS BROUGHT MORE IN LINE WITH MARKET PRICES AND CREDIT PROGRAMMES ARE CUT.THE BUDGET OF THE ENERGY DEPARTMENT IS PROPOSED TO BE CUT BY NEARLY HALF, MAINLY BECAUSE OF AN INDEFINITE MORATORIUM ON FILLING THE STRATEGIC PETROLEUM RESERVE. IT IS PROPOSED THAT THE SMALL BUSINESS ADMINISTRATION'S DIRECT LOAN PROGRAMMES SHOULD BE TERMINATED. FROM FY86, IT IS PROPOSED THAT THE EX-IM BANK SHOULD NOT BE ABLE TO ENTER INTO NEW DIRECT LENDING OBLIGATIONS, ALTHOUTH IT WILL BE ABLE TO CONTINUE TO GUARANTEE PRIVATE SECTOR EXPORT LOANS. A SPECIAL FUND OF DLRS 1.3 BILLION HAS BEEN PROPOSED FOR EX-IM INTEREST RATE SUBSIDIES IN FY86.

8. EXPENDITURE ON MEDICARE AND MEDICAID IS PROPOSED TO RISE BY LESS THAN THE RATE OF INFLATION TO SAVE DLRS 5.1 BILLION. MAJOR SAVINGS OF DLRS 1.3 BILLION ARE ALSO TO BE ACHIEVED BY A PROPOSED 5 PERCENT CUT FOR FEDERAL EMPLOYEES IN FY86 WITH SEVERE RESTRAINT THEREAFTER.

9. DEFENCE SPENDING IS PROJECTED TO RISE THROUGHOUT THE BUDGET PERIOD. DEFENCE OUTLAYS ARE PLANNED TO INCREASE 12.6 PERCENT IN NOMINAL TERMS TO DLRS 277.5 BN IN FY86 RISING TO DLRS 348.6 BN BY FY88. DEFENCE BUDGET AUTHORITY (THE AUTHORITY TO MAKE FUTURE SPENDING COMMITTMENTS) IS PLANNED TO RISE 10.1 PERCENT IN NOMINAL TERMS IN FY86 TO DLRS 313.7 BN (OR 5.9 PERCENT IN REAL TERMS).

10. INTEREST CHARGES ON THE DEBT ARE PROJECTED TO RISE FROM DLRS 143 BN IN FY86 TO DLRS 159 BN BY FY88, ON THESE ASSUMPTIONS THE SHARE OF INTEREST COSTS IN TOTAL OUTLAYS WOULD REMAIN THE SAME UP TO FY88 AT ABOUT 15 PERCENT. THE PROPORTION OF FEDERAL DEBT HELD BY THE PUBLIC IS PROJECTED TO RISE FROM 39.1 PERCENT OF GNP IN FY85 TO 40.7 PERCENT IN FY87 BEFORE FALLING TO 38.4 PERCENT BY FY90. IN THE ABSENCE OF CORRECTIVE ACTION, THIS PROPORTION WOULD RISE TO 47.2 PERCENT IN FY90.

RECEIPTS

11. TAX REVENUES ARE PROJECTED TO INCREASE FROM DLRS 794 BN IN FY86 TO DLRS 950 BN IN FY88, REFLECTING CONTINUED ECONOMIC GROWTH AND PREVIOUSLY ENACTED TAX LEGISLATION, AND ALSO NEW PROPOSALS FOR INCREASED USER FEES AND TRUST FUND REFORMS.

12. THERE IS A SENSITIVITY ANALYSIS IN THE BUDGET DOCUMENTS WHICH SHOW HOW THE DEFICIT WOULD VARY ACCORDING TO ALTERNATIVE ASSUMPTIONS. A ONE PERCENTAGE POINT LOWER ANNUAL GROWTH RATE FROM JANUARY 1986 WOULD RAISE THE DEFICIT BY DLRS 33 BN BY FY88. INFLATION AND INTEREST RATES WHICH WERE ONE PERCENT HIGHER WOULD REDUCE THE DEFICIT BY DLRS 7 BN BY FY88. THE CONGRESSIONAL BUDGET OFFICE WILL PUBLISH ITS OWN ESTIMATES OF THE EFFECTS OF THE PRESIDENT'S BUDGET SHORTLY. WITHOUT ANY DEFICIT REDUCTION MEASURES THE CBO IS REPORTED TO PROJECT THE BASELINE DEFICIT RISING FROM DOLLARS 215 BN IN FY86 TO DOLLARS 296 BN BY FY90 ON ITS OWN ECONOMIC ASSUMPTIONS.

COMMENT

13. THE BUDGET NUMBERS ARE VERY MUCH AS EXPECTED, HAVING BEEN EXTENSIVELY LEAKED IN RECENT WEEKS. WHEN CONGRESS CONSIDERS THE BUDGET, IT IS LIKELY TO HAVE A NUMBER OF PROPOSALS TO DISCUSS ASIDE FROM THE ADMINISTRATION'S. THE SENATE REPUBLICANS ARE CURRENTLY WORKING ON THEIR OWN PROPOSALS TO PRESENT TO CONGRESS LATER IN THE MONTH: THE HOUSE DEMOCRATS MAY ALSO PROPOSE THEIR OWN PACKAGE. THERE IS A BROAD MEASURE OF AGREEMENT OVER THE DESIRABILITY OF REDUCING THE BUDGET DEFICIT BY SOME DOLLARS 50 BN IN FY86, BUT A WIDE DIFFERENCE OF VIEW OVER THE COMPOSITION OF THE SAVINGS. MANY IN CONGRESS BELIEVE THERE WILL BE LITTLE CHANCE OF SECURING SAVINGS

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OF THIS MAGNITUDE WITHOUT LARGER CUTS IN THE GROWTH OF DEFENCE SPENDING. THE SENATE REPUBLICANS ARE LIKELY TO PROPOSE THIS, COMBINED WITH LIMITATIONS ON COST OF LIVING INCREASES FOR SOCIAL SECURITY BENEFIT PAYMENTS. HOUSE DEMOCRATS ARE UNLIKELY EITHER TO ACCEPT SUCH LIMITATIONS OR MANY OF THE OTHER PROPOSED CUTS IN DOMESTIC SPENDING PROGRAMMES WITHOUT FURTHER CUTS IN THE GROWTH OF DEFENCE SPENDING.

14. NOTWITHSTANDING THE CONGRESSIONAL DIFFICULTIES, IT SEEMS LIKELY THAT AT LEAST SOME EXPENDITURE REDUCTIONS WILL BE ACHIEVED THIS YEAR. BUT THEIR MAGNITUDE COULD WELL BE LESS THAN THE DOLLARS 50 BILLION PROJECTED FOR FY86. IF ONLY DOLLARS 30 BILLION OF SAVINGS WERE ACHIEVED (AS SOME COMMENTATORS PREDICT) THEN THE FY86 BUDGET DEFICIT WOULD STILL BE IN THE REGION OF DOLLARS 200 BILLION (EQUIVALENT TO 4.8 PER CENT OF PROJECTED GNP).

15. FURTHER COMMENTS ON THE FY86 BUDGET AND AN ASSESSMENT OF CONGRESSIONAL AND OTHER REACTIONS WILL FOLLOW WHEN THEY ARE AVAILABLE. COPIES OF BUDGET DOCUMENTS FOLLOW BY BAG.

16. FCO PLEASE ADVANCE TO LITTLER AND SHIELDS (HMT), TAIT (ERD) BROADBENT (EA), GREEN (BANK), AND TWYFORD (ECGD).

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US BUDGET DEFICIT: LATEST DEVELOPMENTS

SUMMARY

1. THE PRESIDENT'S BUDGET, DUE TO BE PRESENTED TO CONGRESS IN EARLY FEBRUARY, WILL CONTAIN PROPOSALS SUFFICIENT TO RESTRICT OVERALL NOMINAL PUBLIC EXPENDITURE IN FY 86 TO FY 85 LEVELS BUT WILL NOT INCLUDE BUDGET DIRECTOR STOCKMAN'S OBJECTIVE OF REDUCING THE DEFICIT TO DOLLARS 100 BN (2 PER CENT OF GNP) BY FY 88. THE ADMINISTRATION IS CONCERNED MAINLY ABOUT THE STRENGTH OF THE RECOVERY BUT THE DEFICIT IS THE TOP ITEM ON THE CONGRESSIONAL AGENDA. SENIOR REPUBLICAN SENATORS NOW SAY THAT THEY WILL PRODUCE THEIR OWN SERIES OF DEEP-CUTTING BUDGET OPTIONS, PROBABLY EXTENDING TO DEFENCE AND SOME DE-INDEXATION OF SOCIAL SECURITY. THE DEMOCRATS HAVE NOT YET DECLARED THEIR HAND AS THE ANNUAL BUDGET STRUGGLE IS ABOUT TO GET UNDER WAY.

DETAIL

2. THE ADMINISTRATION, HAVING EXTENSIVELY LEAKED THEIR BUDGET PROPOSALS, FACE THE PROSPECT OF PRESENTING A BUDGET DEAD ON ARRIVAL IN CONGRESS. THE REPUBLICANS IN THE SENATE HAVE NOW MADE A BID FOR THE LEAD ON THE BUDGET DEFICIT PROBLEM. DOLE (MAJORITY LEADER) AND DOMENICI (BUDGET COMMITTEE CHAIRMAN) HAVE INTRODUCED A MARKER BILL CALLING FOR THE DEFICIT TO BE REDUCED TO DOLLARS 100 BN (2 PER CENT OF GNP) BY FY 88, BUT INTEND TO ACHIEVE SAVINGS BY THEIR OWN MEANS. THEY HAVE SAID THAT THEY WILL ANNOUNCE THEIR OWN DETAILED PROPOSALS BEFORE THE PRESIDENT'S ARE AVAILABLE. THE DEMOCRATS ALSO CLEARLY REGARD THE DEFICIT AS THE TOP DOMESTIC ISSUE: SPEAKER O'NEILL HAS SAID THAT IT IS THE TOP PRIORITY ITEM ON HIS AGENDA. THE NEW DEMOCRAT CHAIRMAN OF THE HOUSE BUDGET COMMITTEE (GRAY - PENNSYLVANIA) HAS IMPLIED THAT HE WOULD NOT RULE OUT A CUT IN SOCIAL SECURITY IN CERTAIN CIRCUMSTANCES.

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3. AS DISCUSSED WITH THE SENATE REPUBLICAN LEADERSHIP (DOLE, DEMENICI AND MAJORITY WHIP SIMPSON OF WYOMING), THE PROPOSALS ORIGINALLY ENVISAGED BY THE ADMINISTRATION WERE TOO NARROWLY BASED. THEY INCLUDED A FREEZE ON ALL COST-OF-LIVING ADJUSTMENTS IN ENTITLEMENT PROGRAMMES EXCEPT SOCIAL SECURITY AND A FREEZE ON DISCRETIONARY CIVILIAN PROGRAMMES. BUT THEY ALSO INCLUDED A LONG LIST OF MORE SEVERE CUTS OR QUOTE MAJOR PROGRAMME REFORMS UNQUOTE INCLUDING A 5 PER CENT CIVIL SERVICE PAY CUT AND CONTROVERSIAL CUTS IN CHILD NUTRITION ETC. A NUMBER OF PROGRAMMES (E.G. THE JOB CORPS, THE SMALL BUSINESS ADMINISTRATION AND DIRECT LENDING BY THE EXIM BANK) WERE SCHEDULED FOR OUTRIGHT TERMINATION. MANY REPUBLICANS FELT THAT, BECAUSE HE HAD EXCLUDED SOCIAL SECURITY AND DEFENCE SPENDING FROM THE SCOPE OF HIS CUTS, SOME OF BUDGET DIRECTOR STOCKMAN'S PROPOSALS WERE MORE DRACONIAN THAN THEY NEEDED TO BE, WITH LITTLE CHANCE OF BEING ENACTED INTO LAW.

4. REPUBLICAN SENATORS REQUESTED STOCKMAN TO PREPARE FIGURES FOR A COMPREHENSIVE FREEZE ON ALL SPENDING INCLUDING DEFENCE AND SOCIAL SECURITY, SO THAT THERE WOULD BE APPROXIMATE EQUALITY OF MISERY. THEY HAVE SINCE DEVELOPED A MENU OF OPTIONS WHICH WOULD, IN THE UNLIKELY EVENT OF BEING ADOPTED WHOLESALE, REDUCE THE DEFICIT TO DOLLARS 78 BILLION BY FY 88. THE OUTCOME OF THESE EXERCISES, COMPARED WITH THE ADMINISTRATION'S PROPOSALS, IS SHOWN IN THE TABLE BELOW.

	FY 86	FY 87	FY 88
DOLLARS BILLION (INCLUDING ITEMS FORMERLY OFF-BUDGET)			
DEFICIT (NO ACTION)	225	240	235
DEFICIT TARGET	168	136	98
DEFICIT (ADMIN PROPOSALS)	178	167	139
DEFICIT (COMPREHENSIVE FREEZE)	186	171	140
DEFICIT (SENATE OPTIONS TOTAL)	156	126	78

REDUCTIONS IN DEFENCE BUDGET

DEFENCE SAVINGS (ADMIN PROPOSALS)	8.7	9	10
DEFENCE SAVINGS (COMPREHENSIVE FREEZE)	20	35	51

THE IMPLICATIONS FOR THE DEFENCE BUDGET OF A FREEZE ON DEFENCE ARE CLEARY SUBSTANTIAL, AND SECRETARY WEINBERGER AT LEAST WOULD NOT WISH TO GIVE UP ANY BARGAINING CHIPS THAT COULD BE USED DURING THE ARMS CONTROL NEGOTIATIONS. SENATE DEFENCE APPROPRIATIONS CHAIRMAN STEVENS AND SENATOR GOLDWATER HAVE ALSO RAISED OBJECTIONS. MEETINGS ARE STILL BEING HELD DURING WHICH ONE OF THE ADMINISTRATION'S OBJECTIVES IS TO DRAW THE REPUBLICAN SENATE BUDGET LEADERSHIP ACROSS MORE TO THE PRESIDENT'S PROPOSALS.

5. THE PRESIDENT'S PERSONAL STAND ON THE BUDGET IS THAT HE WELCOMES THE EFFORTS OF REPUBLICAN CONGRESSMEN TO DRAFT THEIR OWN PROPOSALS. DESPITE ELECTION PROMISES, HE HAS EXPRESSED A WILLINGNESS EVEN TO CONSIDER PROPOSALS TO FREEZE THE INDEXATION OF SOCIAL SECURITY PAYMENTS PROVIDED THAT THEY ARE AGREED FIRST IN THE CONGRESS ON A BI-PARTISAN BASIS. HE REMAINS ADAMANTLY OPPOSED TO PROPOSALS FOR TAX INCREASES BECAUSE OF THEIR POSSIBLE EFFECT ON THE RECOVERY, BUT THE FACT THAT HIS OWN PROPOSALS WILL ALMOST CERTAINLY FALL SHORT OF THE FY 88 TARGET OF A DOLLARS 100 BN DEFICIT COULD INVITE SUCH PROPOSALS FROM ELSEWHERE. ON TAX REFORM, HE HAS NOW SAID THAT HE INTENDS TO PURSUE TAX SIMPLIFICATION THIS YEAR ON A SEPARATE TRACK FROM THE BUDGET. HE WILL HAVE REGAN IN THE WHITE HOUSE TO HELP HIM WITH THE NECESSARY CONSULTATIONS WITH CONGRESS AND INDUSTRY LOBBYISTS.

6. THE AMENDMENTS TO THE PROPOSALS ON TAX REFORM THAT ARE NOW BEING DISCUSSED ARE CONCESSIONS IN THE FIELDS OF THE ACCELERATED COST RECOVERY SYSTEM (DEPRECIATION ALLOWANCES) SEMICLN INDEXATION OF INTEREST SEMICLN TREATING CAPITAL GAINS AS INCOME SEMICLN AND CHARITABLE CONTRIBUTIONS. MIXED VIEWS ARE ALSO EMERGING AS TO WHETHER THE PERSONAL EXEMPTION SHOULD, AS PROPOSED, BE DOUBLED FROM DOLLARS 1,000 TO DOLLARS 2,000. BUT SO FAR TREASURY OFFICIALS RESPONSIBLE FOR TAX POLICY HAVE INDICATED THAT THEY WISH THE TAX REFORM PACKAGE TO HOLD TOGETHER AS LONG AS POSSIBLE. THE CHIEF DANGER OF MAKING COSTLY CONCESSIONS ON DEPRECIATION ALLOWANCES WOULD BE TO DESTROY THE BALANCE OF A PACKAGE WHICH, ALTHOUGH REVENUE NEUTRAL OVERALL, FAVOURS HOUSEHOLDS AND REQUIRES COMPANIES TO CONTRIBUTE MORE TO THE NATIONAL FISC. ANY ALTERATION IN THIS BALANCE MIGHT MAKE IT POLITICALLY LESS ATTRACTIVE. BAKER MAY BE MORE SYMPATHETIC TO CHANGES THAN REGAN.

7. SINCE BOTH THE ADMINISTRATION'S PLAN AND THE COMPREHENSIVE FREEZE WOULD STILL LEAVE A LARGER DEFICIT THAN DOLLARS 100 BN IN FY 88, THE QUESTION ARISES HOW SUCH A GAP MIGHT BE MET IF DOLLARS 100 BN REMAINED THE TARGET. THERE ARE A FEW PROPOSALS WHICH, ALTHOUGH RUNNING AT STAFFER LEVEL ON THE HILL, HAVE NOT YET RECEIVED POLITICAL SUPPORT. AMONGST THE MOST OBJECTIONABLE OF THESE ARE PROPOSALS FOR AN IMPORT SURCHARGE OR POSSIBLY EVEN A LEVY ON CAPITAL INFLOWS. THERE IS SOME SUPPORT IN THE MEDIA FOR A FEDERAL EXCISE TAX ON PETROLEUM PRODUCTS SUCH AS GASOLINE. LAST, STILL VERY MUCH IN THE BACKGROUND, ARE PROPOSALS FOR MORE GENERAL TAX INCREASES. ANY OF THESE COULD SURFACE DURING THE BUDGET PROCESS BUT AT PRESENT THEY ARE ONLY PART OF THE UNDERCURRENT.

COMMENT

8. THE BUDGET PROCESS HAS NOT FORMALLY BEGUN BUT ALREADY THE ADMINISTRATION HAS HAD TO ABANDON ITS INITIAL OBJECTIVE. DISCUSSIONS IN CONGRESS COULD WELL BE BASED ON THE SENATE REPUBLICANS' PROPOSALS RATHER THAN THE ADMINISTRATION'S. THE INITIATIVE HAS PASSED TO THE SENATE, WHERE 22 REPUBLICANS

ARE

ARE ALL TOO CONSCIOUS THAT THEY WILL BE UP FOR RE-ELECTION IN 1986. THE WHITE HOUSE SEEMS TO BE CONTENT THAT THIS SHOULD BE SO, SINCE THE PRESIDENT HAS PAINTED HIMSELF INTO A CORNER BY HIS CAMPAIGN PLEDGE NOT TO CUT SOCIAL SECURITY AND HIS FAILURE TO GET WEINBERGER TO AGREE TO SUBSTANTIAL DEFENCE CUTS.-

9. THIS WOULD IN MOST OTHER COUNTRIES REPRESENT AN ABDICATION OF RESPONSIBILITY AND A SHAMBLES. BUT THE FLAVOUR EMERGING HERE IS MORE ONE OF PRESIDENTIAL OPEN-MINDEDNESS I.E. GETTING THE PRESIDENT OFF THE HOOK OF HIS OWN DEVISING SUBJECT TO A BAN ON TAX INCREASES WHICH MIGHT KILL THE RECOVERY. IT IS TRUE THAT THE PROPOSED CUTS THAT WERE ORIGINALLY LEAKED WERE SO NARROWLY BASED THAT IT SHOULD HAVE BEEN ANTICIPATED THAT THEIR EFFECTS ON THE PROGRAMMES THAT WOULD HAVE TO BEAR MOST OF THEIR BRUNT WOULD BE POLITICALLY UNACCEPTABLE. IT IS IRONIC THAT WEINBERGER, A FORMER BUDGET DIRECTOR, PLAYED SO LARGE A ROLE IN THEIR DOWNFALL. BUT NO ONE IS TALKING YET OF A MAJOR DISASTER.

10. IN MAKING THEIR PROPOSALS PUBLIC SO EARLY, THE ADMINISTRATION HAVE AT LEAST MANAGED TO PUT THE DEFICIT ISSUE HIGH ON THE POLITICAL AGENDA, PERHAPS HIGHER THAN THEY WOULD WISH. THE PRESIDENT, IN BACKING AWAY FROM HIS OWN DETAILED PROPOSALS BEFORE THEY ARE EVEN FORMALLY PRESENTED, WILL BE KEEPING HIS OPTIONS OPEN TO ACCEPT WIDER-BASED CUTS, INCLUDING THOSE IN DEFENCE AND SOCIAL SECURITY, ALTHOUGH THE LOSS OF BAKER FROM THE WHITE HOUSE MAY MAKE IT MORE DIFFICULT FOR HIM TO CONDUCT DELICATE NEGOTIATIONS WITH THE CONGRESS. (BEWARE MIRROR-IMAGING: THE US TREASURY HAS NO RESPONSIBILITY FOR THE BUDGET EXCEPT FOR TAXATION). WE ARE NOW IN THE POSITION THAT BAKER OF THE TREASURY WILL BE RESPONSIBLE FOR THE TAX REFORMS PROPOSED BY REGAN: AND REGAN AS CHIEF OF STAFF AT THE WHITE HOUSE WILL BE RESPONSIBLE FOR NEGOTIATING BAKER'S BUDGET WITH THE CONGRESS.-

11. THE CONGRESS WILL NOW HAVE TO GET DOWN TO GRIPS WITH DETAILS AND SUCCESS WILL DEPEND ON GETTING THE DEMOCRATS INTO THE ACT AT SOME STAGE. AT THE MOMENT THEY ARE NOT DECLARING WHERE THEY STAND UNTIL THEY HAVE EXPLOITED ALL THE OPPORTUNITIES FOR BLAMING THE REPUBLICANS FOR THE BUDGET CRISIS AND FOR PROPOSING THE NASTY MEASURES THAT WILL HAVE TO BE TAKEN TO DEAL WITH IT. SATISFACTORY PROGRESS WILL NOT BE MADE UNTIL THIS STAND-OFF IS RESOLVED SEMICLN A LONG AND DIFFICULT CONGRESSIONAL BUDGET PROCESS LOOKS TO BE IN PROSPECT AGAIN THIS YEAR, BUT I STAND BY MY PREDICTION THAT THE BUDGET DEFICIT WILL IN FACT BE REDUCED. IT IS, AS YOU WILL SEE, ALL VERY DIFFERENT FROM THE WAY WE ORDER THESE THINGS AT HOME.

12. FCO PLEASE ADVANCE TO PPS/CHANCELLOR OF THE EX CHEQUER, LITTLER AND SHIELDS (HMT), PS/GOVERNOR AND GREEN (BANK) AND BROADBENT (ESID).

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FROM: DAVID PERETZ
DATE: 17 December 1984

N 18/12

MR LAVELLE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
PS/Minister of State
Sir P Middleton
Sir T Burns
Mr Littler
Mr Unwin
Mr Cassell
Mr Lankester
Mr Shields

VISIT BY CHAIRMAN OF THE FED

Chairman Volcker came to see the Chancellor at No 11 Downing Street on 12 December. Sir T Burns, and Mr Newman from the US Embassy, were also present.

US Economy

2. Chairman Volcker said he was reasonably certain that the current slowdown in the US would be permanent: he saw growth as running at no more than 3 to 4 per cent next year. The main question was how long the current fiscal imbalance, and payments deficits were sustainable. At some point, he believed, the dollar would fall. A modest fall in the dollar would not concern him, so long as - and he thought this important - other industrial countries were to respond by allowing their policies to become more expansionary.

3. The Chancellor felt that if US interest rates came down, and the dollar fell, then European rates would fall as well. Chairman Volcker said he feared the Germans, in particular, might not be prepared to move quickly enough.

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US Deficit

4. Chairman Volcker was not optimistic about the chances of early action. He believed the Administration would propose expenditure savings (although proposed savings in defence spending might turn out to be "nominal" cuts only); but that it would be very hard to get Congress to agree. The President, however, would not be prepared to look at the alternative of raising taxes until it was clear that progress on spending cuts was blocked. The President himself was less concerned, intuitively, about the deficit than about the scale of government spending.

US Banking System

5. Chairman Volcker said he was less concerned than he had been about the state of the US banking system. Banks now had a much better attitude. But it would take some years for them to get their balance sheets right. Meanwhile many banks remained exposed to the risks of a sharp fall in the oil price. The best combination would be a gentle fall in the oil price and a gentle fall in the dollar, but he was concerned, in both cases, that the fall might turn out to be too sharp.

DLCP

D L C PERETZ

Circulation:

Mr Turnbull (No 10)
Mr Appleyard (FCO)
PS/Governor

- Sir P. Middleton.
You may find some of this of interest!
AR 13/12/84

cc. Sir T Burns
Mr Littler
Mr Cassell

US file

NOTE OF THE MEETING OF THE BACKBENCH FINANCE COMMITTEE
TUESDAY 11 DECEMBER 1984

The meeting was addressed by Federal Reserve Chairman Paul Volcker.

2. Mr Volcker made some introductory remarks on the US and world economy. After a period in which the US had seen the most rapid growth since the Korean War the rate of expansion has now slowed down. Throughout the upswing there had been a very rapid increase in imports which had helped to fuel other economies, particularly those of the developing world, Canada and to a lesser extent Europe. American demand was now likely to slow down but next year Japanese expansion would be a partial substitute.

3. In spite of the trade deficit the dollar had appreciated as capital flowed into the US. Domestic saving had been insufficient to fund the federal deficit on top of other demands for funds, and capital inflows from abroad had made up the difference.

4. There was good news on the debt crisis in the developing world but the problem had not yet been fully solved. Large borrowers, in particular Mexico and Brazil, had done a lot to put their houses in order. It was to be hoped that the developing world could resume growth of about 5% .

5. Terence Higgins asked what were the risks of a rapid reversal of the inflow of capital into the US and a consequent fall in the dollar. Mr Volcker said that while the US continued to run a current account deficit there would have to continue to be an inflow of capital. The questions were at what exchange rate and what interest rate. The sooner steps were taken to reduce the domestic deficit the better protected the US would be against a possible

change in sentiment. Any attempt to pump up demand would lead to a still bigger current account deficit. Monetary policy could not by itself maintain inflows, fiscal policy was crucial. He had, however, worried about a drop in the dollar a year ago and it hadn't happened.

6. Roger Freeman asked what lessons UK policy makers should learn from the US. Mr Volcker said he would not offer any precise advice. All nations had been struggling with similar problems, trying to get the psychological presumption of inflation out of the system. In these circumstances stimulation could be dangerous. The UK had made a lot of progress on the fiscal side and in structural terms the UK deficit did not exist.

7. Brian Mawhinney asked whether we were resolving the debt problem or merely postponing it. Mr Volcker said that the future of the developing countries depended on the success they had in making adjustments at home. A number of them had taken stronger measures than one could reasonably have expected. They would have to open up their economies more and at the same time put less of their own money in Miami or New York. The banks' lending practices had been looser than one would have liked.

8. George Walden asked how great the pressure would be on the US Defence Budget. Mr Volcker said that he did not think the cuts the President would like to see could be achieved by simply cutting the civil side of the budget. There would have to be a reduction in the planned rate of growth of defence spending.

9. Anthony Beaumont-Dark asked whether the banks weren't going to need support while the debt problem was being sorted out. Mr Volcker said that the banks would have to continue their co-operative efforts for some time.

10. Lord Jock Bruce-Gardyne asked what was the Fed's attitude to the exchange rate and to intervention. Mr Volcker said that there was no official policy towards the exchange rate but it was difficult to repress the thought that it was pretty darned high now. He did not think one could rely on intervention to counter fundamental economic forces.

11. Sir Michael Shaw asked Mr Volcker's view of Africa. Mr Volcker replied that, bluntly, the African market wasn't big enough economically to matter.

12. Lord Eccles asked whether the US trade deficit wasn't more important to the UK than the level of interest rates. Mr Volcker agreed but queried the trade deficit could be sustained.

13. Tim Yeo asked whether confidence that the Third World would continue to solve its debt problem was compatible with the assumption that the US would cut its trade deficit. Mr Volcker replied that as both projections had come out of an econometric model they must be internally consistent.

14. Edwina Curry asked if the US wasn't missing a trick in world political terms by being lukewarm on multilateral aid. Mr Volcker replied that the US was keener on multilateral aid than it had been five or six years ago but that it was not popular domestically. As an example, the US copper industry had suffered very strong competition from developing countries.

15. Peter Hordern asked about the reaction to the President's tax proposals. Mr Volcker replied that they had been quite heavily criticised initially but he would not underestimate the President's ability to get something through Congress if he wanted to.

16. Alan Howarth asked if it wouldn't be necessary to have a crisis to deal with the US deficit. Mr Volcker said that he would like to avoid crisis.

17. Nigel Forman asked what should be top of the agenda at the next economic summit. Mr Volcker said that in his opinion summits didn't make much difference.

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MIPT (NOT TO ALL)

SHULTZ AT CHEVENING: US TRADE POLICY

1. THE LAKER ISSUE, ON WHICH I AM REPORTING SEPERATELY, DOMINATES THE US/UK TRADE FIELD. BUT OTHER IMPORTANT DEVELOPMENTS SINCE THE ELECTION ARE WORTH NOTHING.

2. THE US EXTERNAL ACCOUNT HAS CONTINUED TO DETERIORATE. THE TRADE DEFICIT IN OCTOBER WAS DOLLARS 9.2 BILLION (A FALL OF DOLLARS 3.5 BILLION FROM THE RECORD MONTHLY DEFICIT REACHED IN SEPTEMBER), MAKING A TOTAL DEFICIT FOR THE FIRST TEN MONTHS OF DOLLARS 105.5 BILLION. SOME ECONOMISTS ARE NOW FORECASTING A TRADE DEFICIT IN 1985 AS HIGH AS DOLLARS 150 BILLION. IN ANNOUNCING THE FIGURES FOR OCTOBER, SECRETARY BALDRIGE NOTED THAT ''THESE CONTINUING PROBLEMS UNDERSCORE THE NEED TO CUT THE BUDGET DEFICIT TO REDUCE INTEREST RATES FURTHER TO LOWER THE DOLLAR''.

3. ALREADY THERE ARE SIGNS THAT THE ADMINISTRATION FEELS THAT IT MUST RESPOND BY BEING SEEN TO PROMOTE US TRADE INTERESTS MORE AGGRESSIVELY THAN IN THE PAST. HAVING WRESTED RESPONSIBILITY FOR INTERNATIONAL STEEL NEGOTIATIONS FROM SECRETARY BALDRIGE, USTR BROCK IS NOW UNDER GROWING PRESSURE TO CONCLUDE A SERIES OF VOLUNTARY RESTRAINT ARRANGEMENTS WITH THIRD WORLD SUPPLIERS WITHIN THE 90 DAYS ALLOWED IN THE PRESIDENT'S S201 DECISION. HIS FRUSTRATION AT THE LACK OF PROGRESS IN THESE TALKS MAY ACCOUNT FOR THE EXTRAORDINARY MANNER IN WHICH HE FIRST APPEARED TO HAVE DONE A DEAL WITH COMMISSION -ER DAVIGNON OVER EC EXPORTS OF PIPES AND TUBES, AND THEN RENEGED IN THE FACE OF PRESSURE FROM THE US STEEL INDUSTRY. GIVEN THE COMMUNITY'S RECORD OF INABILITY TO RESTRAIN ITS EXPORTS OF PIPE AND TUBE TO THE 5.9 PERCENT LEVEL ENVISAGED IN THE 1982 EXCHANGE OF LETTERS, IT WOULD HAVE BEEN DIFFICULT TO HAVE BLAMED THE AMERICANS FOR TAKING UNILATERAL ACTION TO RESTRAIN IMPORTS AT AN EARLIER STAGE. THE COMMUNITY SHARE OF THE MARKET HAD REACHED 14 PERCENT AND WAS STILL GROWING. BUT, BY WAITING UNTIL THE EC COUNCIL OF MINISTERS HAD, WITH GREAT DIFFICULTY, AGREED A MANDATE TO SETTLE THE ROW, THE US HAVE PUT THEMSELVES IN THE WRONG. THIS MAY WELL ACCOUNT FOR THE PRESIDENT'S REPORTED WILLINGNESS DURING CHANCELLOR KOHL'S VISIT TO ENCOURAGE A RE-OPENING OF NEGOTIATIONS BETWEEN BROCK AND DAVIGNON. I AM HOWEVER DOUBTFUL WHETHER IT IS REALISTIC TO

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ENVISAGE A US CLIMB-DOWN.

4. ANOTHER FACTOR WHICH MAY HELP TO EXPLAIN BROCK'S MALADROIT HANDLING OF THE ISSUE, IS THE REPORT THAT SECRETARY BALDRIGE HAS REVIVED HIS PREVIOUS SUGGESTIONS THAT THE OFFICE OF THE USTR AND THE DEPARTMENT OF COMMERCE SHOULD BE MERGED IN A NEW DEPARTMENT OF INTERNATIONAL TRADE AND INDUSTRY. WITHOUT GREATER PRESIDENTIAL SUPPORT THAN IT RECEIVED DURING REAGAN'S FIRST TERM, THIS SUGGESTION IS UNLIKELY TO MAKE MUCH PROGRESS. NEVERTHELESS, IT MAY ACCOUNT FOR THE CLEAR SIGNS THAT BROCK AND HIS STAFF INTEND TO ACT MORE FORCEFULLY TO DEAL WITH ''UNFAIR'' FOREIGN COMPETITION.

5. A FURTHER ILLUSTRATION OF THIS CURRENT MOOD CAME AT THE GATT CONTRACTING PARTIES (CPS) SESSION IN GENEVA BETWEEN 26-30 NOVEMBER WHERE, BY ALL ACCOUNTS, THE US DELEGATION SHOWED CONSIDERABLE LACK OF FINESSE. NEVERTHELESS THE OUTCOME IS PROBABLY NOT TOO BAD FROM THEIR POINT OF VIEW OR OURS, AND AT THE VERY LEAST, WILL NOT HAVE DISCOURAGED THEIR EFFORTS TO GET A NEW GATT ROUND GOING.

6. THE PRESENT INDICATIONS ARE THAT THE RECENT CHANGES IN CONGRESSIONAL LEADERSHIP WILL NOT MAKE A SIGNIFICANT DIFFERENCE TO THE MOOD IN CONGRESS. SENATOR DANFORTH'S ASSUMPTION OF THE CHAIR OF THE SENATE COMMERCE COMMITTEE HAS STRENGTHENED HIS HAND, AND WE SEEM CERTAIN TO HEAR MORE NEXT YEAR ABOUT RECIPROCITY IN TRADE (PARTICULARLY IN TELECOMMUNICATIONS) BUT, WITH THE IMPORTANT EXCEPTIONS OF THE EXPORT ADMINISTRATION ACT AND THE FARM BILL, WE ARE UNLIKELY TO SEE MUCH SIGNIFICANT TRADE LEGISLATION IN THE NEXT SESSION. I SHALL BE REPORTING SEPARATELY ON US/EC AGRICULTURAL TRADE RELATIONS AFTER I HAVE SEEN SECRETARY BLOCK ON 6 DECEMBER.

7. FINALLY, OUR PROBLEMS OVER US EXTRATERRITORIALITY CONTINUE TO COMPLICATE THE BILATERAL RELATIONSHIP. ALTHOUGH THE PRESIDENT'S DECISION TO DROP THE PROCEEDINGS IN THE LAKER CASE WAS WELCOME, ITS FALL-OUT, IN THE FORM OF THE RELUCTANCE OF THE AMERICANS IN LAST WEEK'S TALKS TO PROCEED WITH MEANINGFUL DISCUSSIONS ON ARRANGEMENTS TO DO AWAY WITH TREBLE DAMAGE ANTI-TRUST LIABILITY IN THE AVIATION FIELD, MAKES A RESOLUTION OF THIS DISPUTE EVEN MORE DIFFICULT. SIMILARLY, WHILE THE CONFIDENTIAL EXCHANGE OF LETTERS BETWEEN SECRETARY BALDRIGE AND MR TEBBIT ESTABLISHING A BILATERAL ARRANGEMENT FOR NOTIFICATION AND CONSULTATION IN THE AREA OF EXPORT CONTROLS CONSTITUTES A SIGNIFICANT STEP FORWARD, THE RESULTANT

 I PUBLICITY

PUBLICITY (FOR WHICH THE AMERICANS ARE AT LEAST PARTLY TO BLAME) HAS STIMULATED PRESSURES FOR SIMILAR ARRANGEMENTS FROM OTHER US ALLIES (AND CURIOSITY FROM THE EC DELEGATION HERE) WHICH MAY MAKE SIMILAR DEALS MORE DIFFICULT IN THE FUTURE.

8. I IMAGINE YOU WILL WANT TO BE VERY CRITICAL OF THE RECENT DECISION OVER STEEL. IT IS IMPORTANT THAT THE AMERICANS ARE LEFT IN NO DOUBT THAT THAT IS NO WAY TO DO BUSINESS BETWEEN ALLIES AND PARTNERS. ON THE POSITIVE SIDE IT SEEMS EVEN MORE DESIRABLE TO PROMOTE THE CASE FOR GETTING ON WITH OR SERIOUS PREPARATION OF OF A NEW TRADE ROUND, AMONG OTHER THINGS AS A PROPHYLACTIC TO THE RISING PROTECTIONISTS PRESSURES HERE.

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(REPEATED AS REQUESTED)

WRIGHT

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MIPT (NOT TO ALL):
SHULTZ AT CHEVENING: THE US ECONOMY AND THE FEDERAL BUDGET DEFICIT

SUMMARY

1. IT IS NOW GENERALLY RECOGNISED IN THE ADMINISTRATION AND ON THE HILL THAT DEFICIT REDUCTIONS IS THE NO 1 DOMESTIC PRIORITY: THERE IS NOT YET THE OUTLINE OF A DEAL ON HOW TO HANDLE IT, SLOWER US GROWTH, AND GREATER ECONOMIC UNCERTAINTIES.
A SENATE MORE INDEPENDENT OF THE WHITE HOUSE, AND OPPOSITION FROM DEMOCRATS SMARTING FROM THE ELECTIONS, WILL MAKE IT HARD TO GET THE DEFICIT SUBSTANTIALLY DOWN BY EXPENDITURE CUTS ALONE. BUT THAT IS WHAT THE PRESIDENT WILL PROBABLY PROPOSE IN JANUARY AND HIS PROPOSED CUTS WILL BE SUBSTANTIAL: HE WILL BE RELUCTANT TO ACCEPT TAX INCREASES, BUT MAY BE DRIVEN TO DO SO IN THE END. THE TREASURY'S TAX REFORM PROPOSALS, THOUGH ATTRACTIVE TO SENIOR CONGRESSMEN OF BOTH PARTIES, WILL NEED TO HAVE THE PRESIDENT'S SUPPORT IF THEY ARE TO HAVE ANY CHANCE OF SUCCESS. NOT CLEAR THAT THEY WILL GET IT.

DETAIL

ECONOMIC BACKGROUND

2. THE PRESIDENT TOOK CREDIT DURING THE ELECTIONS FOR AN EXPANDING AND HEALTHY AMERICAN ECONOMY. THE ATMOSPHERE HAS SINCE CHANGED, WITH CONCERN ABOUT DECELERATING GROWTH (10.1 PERCENT, 7.1 PERCENT AND 1.9 PERCENT RESPECTIVELY IN THE FIRST THREE QUARTERS), AND GREATER UNCERTAINTY ABOUT ECONOMIC PROSPECTS. THE CURRENT QUARTER ALSO SEEMS TO BE WEAK, PERHAPS REFLECTING TEMPORARY INVENTORY ADJUSTMENT. THE FED IS CLEARLY EASING ITS STANCE AND, BY REDUCING ITS DISCOUNT RATE, HAS RECENTLY SIGNALLED THAT IT WOULD LIKE EASIER MONETARY CONDITION. GROWTH MAY THEREFORE PICK UP SOMEWHAT EARLY NEXT YEAR TO, SAY 3 PERCENT, IN 1985 AS A WHOLE. EVEN SO, THERE IS INCREASING TALK ABOUT DOWNSIDE RISKS. WALL STREET DOES NOT KNOW WHAT TO MAKE OF IT ALL.

3. INFLATION IS NOW RUNNING AT 4.2 PERCENT, AND THERE IS LITTLE RISK OF A RESURGENCE NEXT YEAR: WAGE INCREASES HAVE BEEN MODERATE AND PRODUCER PRICES WEAK. INTEREST RATES ARE NOW FALLING. AND MOST FINANCIAL MARKET FORECASTERS DO NOT PREDICT MUCH MOVEMENT IN THE TREND FOR THE COMING MONTHS. THE HIGH LEVEL OF THE DOLLAR REMAINS AN ENIGMA, GIVEN THE LARGE AND GROWING TRADE DEFICIT. SOME DEPRECIATION STILL SEEMS LIKELY: BUT IT HAS DONE FOR SOME TIME.

14.

4. VOLCHERE HIMSELF REMAINS RESONABLY OPTIMISTIC. HE WAS IN A ...USTIC MOOD WHEN I CALLED ON HIM ON 4 DECEMBER. HE THOUGHT THE SUCCESS OF THE CHRISTMAS SELLING SEASON WOULD BE AN IMPORTANT INDICATOR OF WHAT WOULD HAPPEN TO GROWTH, AND TO CONFIDENCE. HIS MAIN WORRY WAS THE LEVEL OF IMPORTS, WITH THE IMBALANCE BETWEEN EXPANSION OF DEMAND AND OF PRODUCTION WHICH THIS IMPLIED.

BUDGET PROPOSALS

5. IT IS AGAINST THIS BACKGROUND THAT THE ADMINISTRATION IS FORMULATING ITS BUDGET PROPOSALS (MY LETTER OF 3 DECEMBER TO MIDDLETON). THEY ARE SAID TO BE CONSIDERING PROPOSING EXPENDITURE MEASURES TO REDUCE THE DEFICIT TO DOLLARS 100 BILLION, OR 2 PER CENT OF GNP, BY 1988. THIS WOULD BE ENOUGH TO STABILISE THE DEBT/GNP RATIO, AND COULD BE DONE BY A SERIES OF SPECIFIC EXPENDITURE PROPOSALS, A SPENDING FREEZE IN NOMINAL TERMS, OR A COMBINATION OF BOTH. THE SQUEEZE IS LIKELY TO BE THE MOST DRACONIAN EVER ATTEMPTED BY THE ADMINISTRATION: THE TARGET FOR YEAR 1 CUTS IS DOLLARS 42B, AND THERE HAVE BEEN REPORTS THAT TENTATIVE AGREEMENT HAS BEEN REACHED ON SAVINGS OF SOME DOLLARS 34B, WITH DEFENCE NOT YET INCLUDED - NO AREA EXCEPT SOCIAL SECURITY WOULD BE EXEMPT FROM THE CUTS, AND EVEN SENIOR PENTAGON OFFICIALS EXPECT THEIR BID FOR 13 PERCENT REAL GROWTH IN THE DEFENCE BUDGET TO BE CUT DOWN TO 5 PERCENT OR BELOW. WEINBERGER WILL RESIST THIS VERY STRONGLY :

BUT IT IS CLEAR THAT HE WILL HAVE A MAJOR FIGHT ON HIS HANDS WHEN HE RETURNS FROM HIS CURRENT TRAVELS.

6. THE BUDGET PROPOSALS WILL BE BATTED ABOUT WITHIN THE ADMINISTRATION FOR SOME TIME, AND NEED NOT BE FINALISED UNTIL END-JANUARY, WHEN THEY HAVE TO GO TO CONGRESS. BUT THE DEMOCRATS, STILL SMARTING FROM THEIR MASSIVE ELECTION DEFEAT, ARE UNLIKELY TO COOPERATE IN CUTTING SPENDING UNLESS THE PRESIDENT ACTUALLY PROPOSES SOME TAX INCREASES. THIS IS OF COURSE WHAT HE HAS SAID THAT HE WILL NOT DO: AND TREASURY SECRETARY REGAN IS STILL SAYING THAT TAX INCREASES ARE NOT NEEDED. THE NEW SENATE MAJORITY LEADER, DOLE, IS UNLIKELY TO WORK AS MUCH IN HARNESS WITH THE WHITE HOUSE AS DID HIS PREDECESSOR, BAKER. THE SENATE IS ALSO LIKELY TO BE LESS SYMPATHETIC TO SWINGING SPENDING CUTS THAN WAS ITS PREDECESSOR, EVEN THOUGH DOLE HIMSELF FAVOURS A SPENDING FREEZE. AND THE HOUSE WILL CONTAIN THIRTY-TWO NEW REPUBLICANS WHO CAN BE EXPECTED TO HAVE PRO-GROWTH, SUPPLY-SIDE SYMPATHIES, AND MAY BE RELUCTANT TO VOTE FOR DEFICIT REDUCTION, PARTICULARLY BY TAX-HIKES, IF GROWTH IS SLOW.

7. WITH A PRESIDENT UNWILLING TO REVERSE HIS ATTITUDE TO TAX INCREASES, AN UNCOOPERATIVE CONGRESS, AND A LESS BUOYANT ECONOMY, THE PROGNOSIS FOR THE DEFICIT IS STILL NOT GOOD. VOLCHEK SAID IT WAS HARD TO SAY WHERE THINGS WERE GOING. BUT IT IS EARLY DAYS YET, AND THE REALISATION THAT DOLLARS 300 MILLION A DAY IS NOW NEEDED TO SERVICE THE FEDERAL DEBT MAY DAWN ON ALL CONCERNED, AND CHANGE THE PICTURE.

8. THE US TREASURY'S TAX REFORM PROPOSALS ARE EFFECTIVELY A SIDE-ISSUE. IT IS NOT CLEAR WHETHER THE PRESIDENT WILL ADOPT THEM, OR CONGRESS TAKE THEM UP SERIOUSLY. THE PROPOSAL FOR A MODIFIED FLAT TAX, REDUCING THE NUMBER OF BRACKETS FROM FOURTEEN TO ONLY THREE (15 PERCENT, 25PERCENT AND 35PERCENT), WHILE CLOSING MAJOR LOOPHOLES, IS LONG OVERDUE. BUT IT WILL BE FIERCELY RESISTED BY THE SPECIAL INTEREST GROUPS, AND ALSO PERHAPS BY SENATOR PACKWOOD, THE NEW CHAIRMAN OF THE SENATE FINANCE COMMITTEE. THE PROPOSAL FOR A DROP IN THE RATE OF CORPORATION TAX FROM 42 PERCENT TO 33 PERCENT, COMBINED WITH LESS GENEROUS DEPRECIATION PROVISIONS IS DESIRABLE (AND A REPLICA OF THE 1984 UK FINANCE ACT.) BUT CONGRESSMAN KEMP AND OTHERS CAN BE EXPECTED TO RESIST TAMPERING WITH THE ACCELERATED COST RECOVERY SYSTEM INTRODUCED IN 1981, WHICH THEY SEE AS THE KEYSTONE OF THE INVESTMENT BOOM, AND THE RECOVERY. THE TAX REFORM PROPOSALS WOULD, IF IMPLEMENTED, TEND TO REDUCE US INTEREST RATES, SINCE THEY WOULD HAVE THE EFFECT OF EASING THE DEMAND FOR CREDIT.

THE WHITE HOUSE ROLE

9. THE PROSPECTS FOR DEFICIT REDUCTION, AND TAX REFORM, DEPEND ON THE PRESIDENT'S ATTITUDE. IF HE CAN BRING HIMSELF TO AGREE, OR PREFERABLY TO PROPOSE, TAX INCREASES, THEN THE EFFORTS TO REDUCE THE DEFICIT MAY HAVE A REAL CHANCE IN THE CONGRESS. IF HE SHOULD SUPPORT THE TREASURY'S TAX REFORM PROPOSALS, INSTEAD OF REMAINING CONSPICUOUSLY ALOOF FROM THEM, THEY TOO MIGHT HAVE SOME PROSPECT OF SUCCESS. BUT SO FAR HE HAS SHOWN NO SIGNS OF BEING WILLING TO ADMIT EITHER THAT THE STAGE OF LAST RESORT HAS BEEN REACHED ON THE DEFICIT (AND THAT HE MUST THEREFORE AGREE TO INCREASE TAXES), OR THAT TAX REFORM PER SE IS GOOD.

RECOMMENDED LINE TO TAKE

10. OUR TASK IS NO LONGER TO CONVINCE THE ADMINISTRATION THAT SOMETHING MUST BE DONE ABOUT THE BUDGET DEFICIT. THAT POINT IS NOW WELL TAKEN. IT IS RATHER A QUESTION OF PROBING THEIR WILLINGNESS TO PRESS ON TO THE END OF THE ROAD EVEN IF THE DESIRED XXXXXXX HARVEST FROM EXPENDITURE CUTTING DOES NOT, AS IT WILL NOT, FULLY MATERIALISE.

WRIGHT

FCO(PALACE)/WHITEHALL

CONFIDNETIAL

PRIME MINISTER ② Agree to raise with Chancellor at next bilateral? AT 27/11

A BANKING CRISIS IN THE UNITED STATES

The balance sheets of US banks, particularly the Money Centre Banks, are in a parlous state and cannot be quickly recapitalised (especially at P/E ratios of 4 to 6!). If I am correct in the judgement that the United States is entering a slowdown to stagnation or worse in 1985, then the loan portfolios will deteriorate markedly. (Recall that Continental Illinois went bust in one of the most vigorous expansions in post war history!)

It would be wise for the Bank to prepare contingency plans for the event of perhaps three or four big (MCB) failures and the consequential Fed-FDIC reaction. One needs to know the amount of exposure of our banks and corporations, the effects of the Fed selling Treasuries to finance deposit-support, the likely widening of spreads in the "flight to quality" and so on.

E

The Bank may protest that such a scenario is quite "unthinkable". But that is why we must think it out and take whatever preventative measures seem prudent. I have already spoken to Sir Peter Middleton about my fears and have made similar suggestions. I think it would be best to make it clear to the Chancellor that such failures should be viewed as alarming but by no means impossible contingencies, and that we should do what we can to avoid the fallout.

I must have more time with Alan to discuss this.

MT

AW

ALAN WALTERS
27 November 1984

CONFIDENTIAL

US file.
Extract for Sir A Walters Book

almost 80% from 1981.1 to 1983.4, in gross trading profits for non-North-Sea corporations - a real increase of around 50 percent. And in March 1984 corporate profits had increased 25 percent over March 1983.[1/] The CBI 1984 forecast was for a net pretax rate of return of non North Sea industsrial and commercial corporations of 8.5 percent compared with less than 4 percent in 1981. These data are evidence of a strong increase in aggregate demand from 1981 to 1983. It was increasingly profitable to produce more goods and services - but, alas, not to employ more labour. The number of jobs fell, from 1981 to 1984, and the rate of unemployment increased and remained high and is widely expected to stay at around 3 million for some time.[2/]

Additional plausibility for this wage-cost explanation of high

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1/ See Hansard 12th July 1984 Chancellor's Question Time.

2/ This is a stark contrast to the United States where, from the end of 1982 onwards there has been a sharp recovery of profits, similar to that in the UK, but also a very large reduction in the rate of unemployment. Many observers of a Keynesian pursuasion have attributed this recovery to the striking increases in the federal deficit. But these increases in the deficit began in mid 1979 to mid 1980 - over which the deficit increased about $70 bn - and again another increase in almost $60 bn at the end of 1980 through to 1982.2. The increase in the deficit from 1979 to mid 1981 was about $100 bn. Yet there was a sharp contraction in 1981-2 - gross investment fell precipitously from mid 1981 to the end of 1982 and unemployment rose to nearly 11 percent. The addition to the deficit of another $70 to $80 m in the last half of 1982 was thought by Keynesians to be the cause of the great recovery from December 1982 or January 1983 onward. If the 1982 increase in the deficit were the stimulant of the economy in 1983 why did the $100 bn not work its wonders in 1981-2 rather than lead to the down turn to one of the deepest slumps of the post war years? On the other hand, monetarists such as Professor Karl Brunner correctly predicted the recovery on the basis of the sharp expansion in M_1 and M_0 which began in mid 1982 and persisted through the middle of 1983.

AT

BY BAG [CULL]

FROM WASHINGTON

TO FCO TEL NO. 29 SAVING OF 1 OCTOBER 1984

UNITED STATES MONTHLY ECONOMIC REPORT FOR SEPTEMBER

(SEE MIPT FOR SUMMARY)

1. The main economic developments reported in September were:-

(a) Real GNP is estimated to have risen by 3.6% (saar) in the third quarter, according to the flash estimate from the Department of Commerce.

(b) Consumer spending (in current dollars) grew at an annual rate of 1.8% between June and August.

(c) Housing Starts fell by 12.8% in August to 1.54 million units annual rate.

(d) Interest Rates fell during September. Commercial banks lowered the Prime Rate from 13.0 to 12.75% at the end of the month.

(e) The Dollar surged by over 2% against most major currencies in September, though eased back towards the end of the month.

(f) The Administration decided to limit the share of steel imports in the US to some 20% through voluntary restraint agreements to be negotiated with major steel exporters.

(g) General Motors and the Auto Workers Union agreed a new 3 year contract providing wage increases of 2.25%, plus COLA's, and a $1 bn fund for workers displaced through automation.

ECONOMIC ACTIVITY

2. Real GNP is estimated to have grown by 3.6% at a seasonally adjusted annual rate (saar) in the third quarter, according to the flash estimate from the Department of Commerce. Growth in the third quarter contrasts with the (revised) estimate of GNP growth in the second quarter of 7.1% (saar), which contributed to growth of 8.6% at an annual rate in the first half of the year. The Department of Commerce acknowledged that the flash estimate showed lower than expected growth, due mainly to a sharp slowing in the growth of final sales. Although there are no estimates of the growth of final sales, most components are expected to show weak growth, especially personal consumer expenditures. Fixed investment and government spending may contribute much of the increase in final sales which did occur. Higher business inventories are expected to have offset some of the weakness in the contribution of final sales to growth, although some of this probably reflects involuntary stock building as demand fell. This is in contrast to the second quarter when final sales rose by 10.3% (saar), partly offset by a negative contribution of stockbuilding to growth.

.../2

3. Inflation is estimated to have risen at only moderate rates according to the broad estimates of inflation. In the third quarter, the implicit price deflator (which reflects changes in prices and the composition of output) is estimated to have risen by 2.9% (saar), and the fixed weight deflator by 3.4% (saar). The latest estimates for GNP growth in the second and third quarters are as follows:

US GNP 1984

	Level	Percent change from previous quarter (annual rate)	
	1984 Q3	1984 Q2	1984 Q3
Nominal GNP ($bn)	3704	10.7	6.6
Real GNP (1972 $bn)	1653	7.1	3.6
GNP implicit price deflator (1972 = 100)	224.0	3.3	2.9

4. Personal Income rose by 0.5% in August, following a revised 0.7% gain in July. The lower increase was due to a smaller increase in wages and salaries, which account for some 60% of total income. No change from the July levels of both hours worked and the hourly wage rate was partly responsible for the slower growth in wages. For the third consecutive month consumer spending in current dollars has grown well below the increase in incomes. In both July and August consumer spending rose by 0.1% (the estimate for July was revised downwards from the figure reported last month). This represented a decline in spending of 0.4% in real terms during July and although no estimates are available for real consumer spending in August, it is probable that spending fell again. The weak growth in expenditure is due to a reduction in spending on both durable and non-durable goods, offset by increased spending on services. The lower rate of spending has contributed to a rise in the savings ratio now estimated at 6.1% for July.

5. The weakness of consumer spending was reflected in a fall in retail sales of 0.8% in August, following a revised 2.0% decline in July. Most of the fall in both months was due to lower sales of both cars and clothing. The value of car sales, which represented some 20% of the value of total retail sales in August, declined by 4.0% in both July and August. There was a larger fall in the number of cars sold, down 5.6% in August to 10.0 million units at an annual rate. The fall was concentrated among domestically produced cars, which fell to 7.7 million units at an annual rate, owing to a shortage of inventories and model changeovers in some plants. The continuing demand for larger cars has ensured that the average price per vehicle has tended to rise, thus limiting the fall in the value of cars sold.

6. Industrial Production rose by 0.2% in August, following gains of 0.9% in both June and July. Although the growth of output remained strong among producers of business equipment and defence and space products, total production of durable goods fell by 1% in August. Most of this was due to 3.2% fall in car production. Production of primary metals also fell, mainly due to a 2.5% decline in steel production. In August the index of capacity utilization remained at 82.6% for total industry and 82.8% in the manufacturing sector.

7. Inventories rose by 0.8% in July to $551.3 bn. Sales by manufacturers, retailers and wholesalers declined by 0.8%, resulting in a rise in the inventory to sales ratio to 1.34. Some of the growth in inventory investment is thought to be involuntary as demand fell more sharply than expected. Most analysts expect firms will remain cautious about adding to stocks much above the current stock/sales ratio in view of the current level of financing costs.

8. Housing Starts fell by 12.8% in August to 1.54 million units annual rate. The decline followed a revised 6.1% fall in starts in July. Starts of single family houses declined for the fourth consecutive month. This fall was accompanied by a sharp fall in the number of starts for apartments. Most analysts believe the slowdown in housing activity due to the rise in mortgage rates in recent months. But some 80% of the August fall in starts was concentrated in the South, suggesting there may have been some overbuilding in earlier months and that much of the August decline reflects an adjustment to the recent surge in apartment building. Building permits also fell in August by 4% to a rate of 1.57 million units.

9. The composite Index of Leading Economic Indicators increased by 0.5% in August, following revised declines of 1.8% in July and 1.1% in June. Four of the ten indicators available for August contributed to the increase, including stock prices, net business formation, claims for state unemployment insurance and new orders for consumer goods and materials. The index of coincident indicators, which measures current economic activity rose by 0.2% in August, following a 0.1% gain in July.

EMPLOYMENT, PRODUCTIVITY AND PRICES

10. The civilian unemployment rate was 7.5% in August and has been at this level for three of the last four months. The two major surveys of employment showed contrasting movements in August. According to the household survey employment fell by 425,000 in August. Since most of the decline was due to a fall in employment of those under 25, it is believed the large fall may simply reflect students leaving jobs prior to returning to college. The payroll survey of employment registered an increase of 159,000 in August. Both measures of employment now record similar total gains in employment since the trough of recession in November 1982 - 5.9 million jobs under the payroll survey and 5.8 million according to the household survey. The average workweek of production workers on private non-agricultural payrolls was 35.2 hours in August, unchanged from the revised July figure. Seasonally adjusted average hourly and weekly earnings were both unchanged in August.

11. The consumer price index (CPI) rose by 0.5% in August due to higher food prices, and an increase in housing costs. The index is now 4.2% above its level of a year ago. The producer price index of finished goods declined by 0.1% in August and was 2% above its level of a year ago. The decline was mainly due to a 2.5% fall in energy prices, nearly offset by higher costs in other consumer and capital goods.

MONEY, CREDIT AND INTEREST RATES

12. The growth of the monetary aggregates remained slow in August, although domestic non-financial credit continued to grow well above the top of its target range. In August M1 rose by 0.1% and M2 by 0.4%, keeping both aggregates well within their respective target ranges.

The broader aggregate M3 also rose by 0.4%, bringing it back to the top of its target range. Some analysts believe M3 will move back within its target range during the remainder of the year. Much of the strong growth in the first half of the year, when M3 grew at an annual rate of 10.0% compared to its fourth quarter average in 1983, can be explained by the growth of large time deposits. These in turn reflected the sizeable increase in Certificates of Deposits issued by banks, to finance the surge in loan growth from the business and personal sector. There are now some signs (see below) that the growth in loan demands is moderating. The broad credit aggregate rose by 1% in July and has grown at an annual rate of 14% compared to its fourth quarter 1983 base.

13. The slowdown in the growth of the money supply over the last 12 months has meant that all the monetary aggregates are growing well within the interim targets established by the FOMC at its meeting in mid July. These are shown below:-

AUGUST 1984 GROWTH IN THE MONETARY AGRREGATES

	Growth Rate June to August (annual rate)	June-September Interim Target	Growth Rates from QIV 1983	1984 Target Range
M1	0.2%	5.5%	5.9%	4-8%
M2	4.7%	7.5%	6.6%	6-9%
M3	6.7%	9.0%	9.2%	6-9%

14. Most analysts believe the Federal Reserve has recently eased monetary policy. The rationale is thought to be the moderate rate of growth of the money supply and the indications of a slowdown in the real economy. During September the Federal Reserve, through its open market operations, appear to have supplied member banks with sufficient reserves to reduce their borrowing from the discount window to $750 million per day from the $1 billion which had been the average level since March. Although some of this intervention in recent weeks reflects the Federal Reserves desire to offset seasonal reserve shortages caused by rising Treasury balances, as tax receipts have increased, some analysts argue the scale of open market operations is consistent with a borrowing target for member banks in the region of $750 million per day. This, and the absence of any upward pressure on the Federal Funds Rate, has led analysts to conclude there has been a slight easing of monetary policy. Other analysts believe it is too soon to judge. They argue the FOMC is unlikely to have eased policy so quickly in view of the conclusion in the most recently published minutes of the FOMC that members would respond to an economic and monetary slowdown only after it was well established. In addition some analysts believe that GNP growth will rebound in the fourth quarter, making any easing of policy unnecessary.

15. There are some indications that the increase in the demand for loans is now slowing. Following a 20% annual rate rise in the first half of 1984, <u>Commercial and Industrial loans</u> rose at an 8.4% annual rate in August. Since June these loans have risen at an annual rate of 8.9%, the slower rate thought to reflect in part a reduction in the number of business acquisitions and leveraged buy outs. <u>Consumer installment credit</u> continues to grow rapidly. It rose by $7.1 bn in July, an increase of 19.8% at an annual rate, compared to growth of 22% annual rate during the first half the year.

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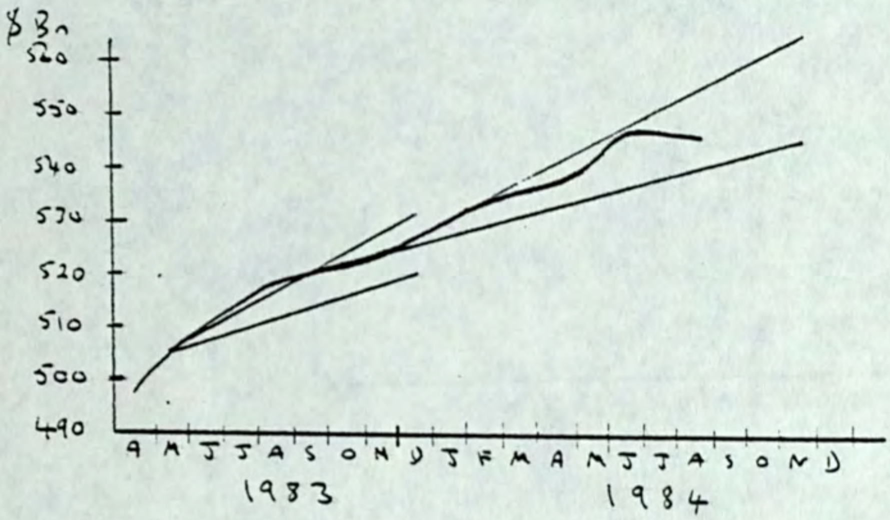
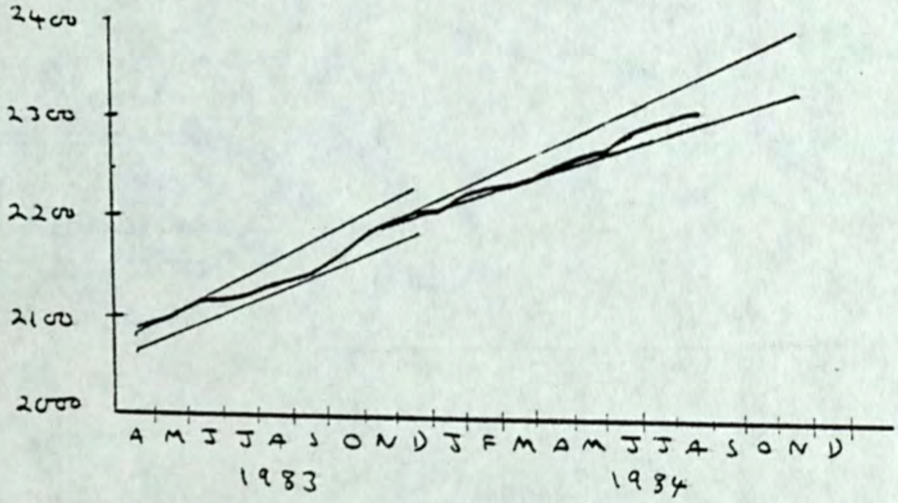
RESTRICTED

GROWTH OF MONETARY AGGREGATES



M1

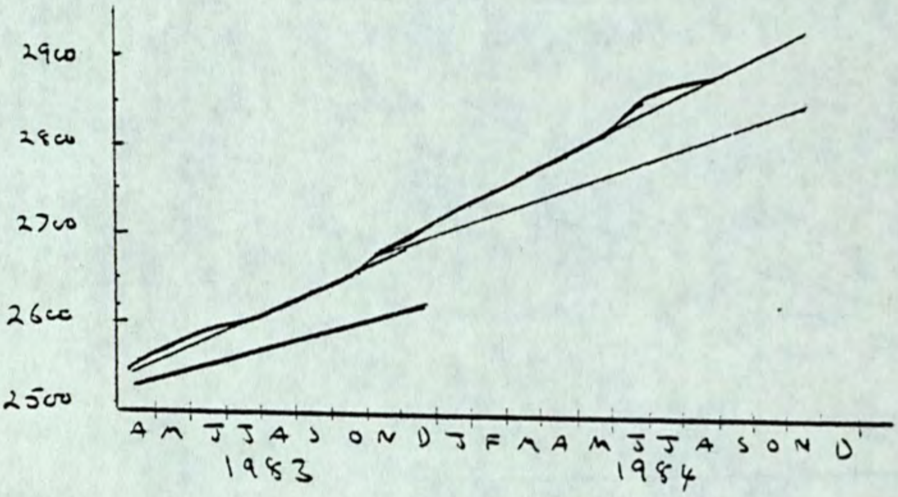
Fed Target
IVQ/83 to IVQ/84
4-8%



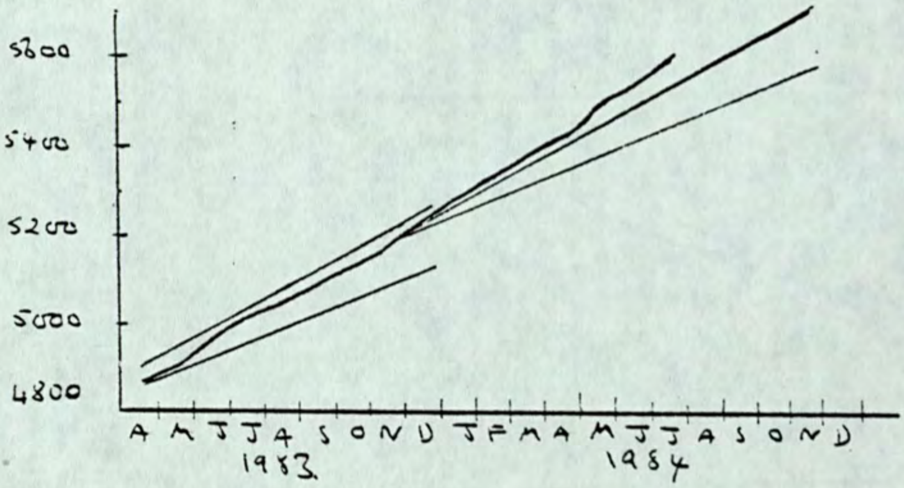
M2

Fed Target
IVQ/83 to IVQ/84
6-9%

RESTRICTED



M3
Fed Target
IVQ/83 to IVQ/84
6-9%



Domestic Non-
Financial Credit
Fed Range
IVQ/83 to IV Q/84
8-11%

16. Interest rates fell slightly during September in response to some reduction in the rate of increase in loan demand and some analysts' expectations that the Federal Reserve had eased monetary policy. Towards the end of September the Federal Funds rate had fallen below 11.5%, compared to 11.6% in August, and the rate on three month Treasury Bills had declined to 10.3% (10.5%). The declines prompted a reduction in the Prime Rate by most major banks from 13.0 to 12.75% at the end of September, the first reduction in the Prime Rate in more than a year and a half. Longer term rates continued to fall with the yield on 20 year Treasury bonds falling to 12.2%, compared to 12.7% in August.

EXTERNAL TRADE

17. Following the record merchandise trade deficit of $14.1 bn in July, the trade deficit amounted to $9.9 bn in August, bringing the cumulative deficit to $83.7 bn during the first 8 months of the year. The value of imports amounted to $27.9 bn, compared to $33.5 bn in July, with reductions in both the value of petroleum imports, manufactured goods and some agricultural commodities contributing to most of the decline. Exports amounted to $18.0 bn in August, a fall of $1.4 bn compared to the July figure due mainly to a decline in exports of manufactured goods.

18. During September the value of the dollar surged against most currencies, especially the European currencies. By mid September the effective rate for the dollar had risen 2.3% above its August level. Despite the fall in US interest rates, the markets perception of the relative strength of US economic performance appeared to be the main reason for the strong increase. Towards the end of the month the dollar eased, mainly as a result of limited intervention by some European central banks.

19. The US current account deficit rose to a record $24.4 bn in the second quarter, from a revised $19.7 bn in the first. Although the trade deficit was largely responsible for the total deficit on current account, the increase in the deficit was primarily due to a sharp decline in net service receipts from $8.3 bn in the first quarter to $3.4 bn in the second quarter. The decline was more than accounted for by a decrease in income on US direct investment abroad, due to capital loss largely related to the appreciation of the dollar. On the capital account, there was a marked decline in US direct investment abroad, reflecting lower reported earnings from US companies abroad as the dollar rose, and some inflows of equity capital. There was a sharp increase in capital inflows. These included an increase in direct investment in the US, up $7.6 bn compared to a rise of $2.4 bn in the first quarter, and a large increase in the purchase of Treasury securities up $6.5 bn compared to $1.4 bn in the first quarter, reflecting higher US interest rates and the strong demand for funds to finance domestic expansion. The statistical discrepancy rose from $6 bn in the first quarter to $13 bn in the second. The main results are recorded below (in $bn):

US CURRENT ACCOUNT

	1983 Year	1984 Quarter 1	1984 Quarter 2
Merchandise exports	200.3	53.9	54.6
Merchandise imports	261.3	79.8	80.3
Balance on trade	-61.0	-25.9	-25.7
Invisible exports	132.0	36.8	34.1
Invisible imports	103.8	28.4	30.7
Invisible balance	28.2	8.4	3.4
Unilateral transfer	-8.6	-2.1	-2.1
Current Account	-41.6	-19.7	-24.4
Net US purchases of foreign assets (capital outflow)	-49.5	-1.9	-24.9
Net foreign purchase of US assets (capital inflow)	81.7	15.7	35.9
Statistical Discrepancy	9.3	6.0	13.3

THE REGIONS: CALIFORNIA

20. The Californian economy has grown strongly during 1984 and the prospects are that the states' real gross product will increase by 4-5% in 1985, faster than the consensus forecast for the US as a whole. In 1984 industrial production has grown steadily, especially in the aerospace sector, and in the machine tools and computer industries; construction activity has been strong in both residential and non-residential sectors; retail sales have risen by over 8% compared to a year ago, similar to the national average. In the Los Angeles area it is estimated that retail sales fell by some 20% during the period of the Olympic Games in July. Part of this may reflect the third quarter weakness in sales evident in the national economy, but it was also accentuated by declining sales in the Los Angeles area as tourists were deterred by predictiions of limited hotel accommodation and congestion.

21. It is estimated employment in the state will grow by 500,000 during 1984, which will be the largest increase since 1978. The state unemployment rate was 7.5% in June. Much of the increase in employment has been in the aerospace industry, which is the states' second largest manufacturing industry, with almost 80% of the industry concentrated in southern California. Although California's relative share of US aerospace employment (currently about one-third) is declining, this has been offset by several factors including continued increases in defence spending, some improvement in the prospects for the commercial airline industry; the success of the Space Shuttle programme and the growth of private outlays on satellites.

22. Prospects for 1985 are for relatively strong growth of between 4-5% in state GNP, further increases in production from the aerospace and electronics industries and continued growth of employment. The chief restraint is reported to be the relatively high rate of inflation,

currently estimated at 6.8%, compared to the national average of over 4%. Approximately half of California's increase in inflation has reflected higher housing costs, especially rents, utility costs and insurance. In southern California the high cost of land and housing may be acting as a disincentive to further expansion. One large enterprise, Hughes Helicopter, recently decided to move it corporate headquarters and workforce from southern California to Arizona.

ECONOMIC PROSPECTS

23. There is now some disagreement among analysts over the immediate prospects for the economy. Some analysts believe consumer confidence remains strong and this will enable the economy to rebound in the fourth quarter, growing at between 4.5 - 6.0% at an annual rate. Much of the expected increase in consumer expenditure would reflect an increase in car sales since these analysts believe car sales in the third quarter were artificially depressed by the lack of inventories. Other analysts believe the third quarter flash estimate is an indication that the economy will now moderate, chiefly because they believe consumers have satisfied their demand for the purchase of durables and will now attempt to rebuild savings. The Blue Chip Consensus of Private Forecasters estimate the economy will grow at 7.3% in 1984 and 3.5% in 1985 (the same forecast for 1985 as reported last month).

24. The majority of the Blue Chip forecasters expect inflation to remain moderate during 1985. The average forecast is for the GNP deflator to rise by 4.9% in 1985, compared to 3.8% in 1984. For 1985 these inflation forecasts are in a range of 3.9 - 6.1%. Those arguing that inflation will grow towards the top of this range believe some weakening of the dollar and pressures on the Federal Reserve to monetize part of the budget deficit will be significant. The forecasters who expect inflation to remain at the lower end of the range believe food and oil prices will remain stable and anticipate continued moderation of wage claims.

25. One sector of the economy which is expected to maintain steady growth through the remainder of the year is fixed investment. The latest survey of Business Capital Spending Plans from the Department of Commerce indicates real capital outlays will rise by 13.3% in 1984. The cyclical upswing in business fixed investment has contributed significantly to the growth of real GNP. Since the trough of the recession in the fourth quarter 1982, real fixed investment has grown by over 25%. Much of the increase has been in investment in equipment, which have risen more strongly than the average of previous recoveries. Outlays on investment in plant are closer to the average of recent recoveries, chiefly because investment continued to fall once the recovery was underway. Investment in plant then rose from mid 1983, especially in the retail and service sectors, and among some utilities. Much of the gain in equipment spending has been recorded among relatively few sectors including cars and trucks, and hightechnology equipment such as computers.

26. A number of reasons have been put forwards for the surge in investment spending at a time when interest rate levels have remained at high levels. Most analysts are agreed that the accelerated depreciation allowances of the 1981 Tax Act provided a strong incentive, especially for investment in equipment with relatively short lives. There may

also have been some pent up demand, a need to improve competitiveness and a need to increase capacity in certain sectors. Most analysts believe capital spending will moderate in 1985, as the economy slows, but will nevertheless make an important contribution to growth. A slower rate of investment spending would also ease the pressure on interest rates.

POLICY DEVELOPMENTS

27. In early September the US Trade Representative, Brock, announced that the President had decided to reject a request for import relief, submitted by the US copper mining industry. The Administration believed that import restraints would have raised copper prices and led to job losses in the domestic copper fabricating industry.

28. On 18 September the President announced he had decided against giving relief to the US steel industry in the S 201 carbon steel case. The President rejected the recommmendations of the International Trade Commission to impose tariffs and quotas covering some 70% of steel imports. Instead the Administration has said it will seek voluntary restraints agreements with steel exporting countries in the hope of reducing the share of imports from its current level of 25% to the 1983 level of some 20%. Excluding imports of semi-finished steel the Administration hoped to reduce imports to 18.5%. In further elaboration of the Administration's decision, USTR Brock said that the Administration would seek voluntary limits on steel imports from Brazil and Spain, and hold talks with Japan and Korea about their diversion of steel exports to the US to fill gaps left by steel exporting countries already subject to restraint. He would report to the President within 90 days on the progress made in implenting the President's decision. Although the decision enabled the Administration to claim that it was consistent with its anti-protectionist policies, the decision was also welcomed by major US steel companies, including Bethlehem Steel, which initiated the original 201 case. This has raised speculation that the steel copanies interpret the decision as a firm commitment by the Administration to limit steel imports to 18.5% (20.5% including imports of semi finished steel). USTR Brock described the 18.5% figure as "an estimate of what the Administration hopes to attain".

29. The Administration announced a programme of Federal loan guarantees and temporary interest subsidies to alleviate the debt problems of the farm community. The programme is in response to the sharp rise in the value of farm debt in recent years, following a period of weak commodity prices and declining land values. It also follows the ending of the Payment-In-Kind Programme (PIK). The main elements of the new programme are: the Farmers Home Administration (FHA) will guarantee up to 90% of the value of bank loans to farmers, if the banks reduced the value of loans to farmers facing default by 10%; the FHA will grant a 5 year grace period on interest payments on 25% of the loans up to the value of $100,000 to farmers in financial difficultuies; provide financial advice to farmers to restructure their finances.

30. Following the decision to repeal the 30% withholding tax - the 30% tax on portfolio interest paid to foreign investors (and subsequently included in the Tax Reform Act of 1984), Congressional concern over tax evasion led the US Treasury to announce in mid September it was banning new issues of US bearer bonds. The Senate in particular were concerned that American citizens or residents could evade US taxes by purchasing

bearer bonds, which allow the bond holder to remain anonymous. Instead the Treasury will issue registered bonds. Although these keep the identity of the bond holder secret, the financial institutions which sell them must certify that the purchasers are not Americans. In a report to Congress reviewing recent decisions in this area, Treasury Secretary Regan indicated that the Treasury had to strike a balance between the need to avoid tax evasion and the legislation's objective of facilitating efficient access to international financial markets by US borrowers.

31. Two important wage negotiations were concluded in September. The United Auto Workers Union (UAW) reached an agreement with General Motors (GM) on a three year contract to replace the one which expired on September 14. The contract provides for an average 2.25% wage increase in each of the three years plus cost of living adjustments. Although much attention had been focused on the size of the eventual wage settlement, and the extent to which it could be regarded as inflationary, the main problem in the negotiations was over job security. In the face of increasing competition from Japanese imports, GM were concerned to increase their automation to cut costs, while the UAW was concerned with preserving jobs. The agreement provides for a $1 bn programme lasting six years to enable GM to retrain, transfer and support workers who will be displaced as a result of increased automation. Most analysts believe the agreement is non-inflationary and will enable GM to speed up its automation process, thus improving productivty. The agreement has to be ratified by the union members. The United Mine Workers (UMW) reached a tentative agreement with the coal mine operators on a new 40 month contract to replace the one which expired on September 30. The main provisions include a total wage increase of 10.25% over the life of the contract, higher pensions and enhanced job security. The agreement was subsequently ratified by miners at the end of the month. The main significance of this contract is that it is the first peaceful wage settlement in the industry for many years.

32. The Democratic Presidential Candidate, Walter Mondale, published his proposals to reduce the budget deficit. Compared to the CBO baseline deficit, Mondale's plan would reduce the deficit by a total of $177 billion by FY 1989, leaving the deficit at $86 bn. The main elements of the programme, which assumes GNP growth of 3.5% a year, are:

Mondale's Deficit Reduction Plan FY 85-89 ($bn)

Tax increases	85
Spending Cuts	54
of which defence	25
health care	12
Additional federal spending	-30
Revenue from higher economic growth	17
Savings on interest payments on the federal debt	51
Total deficit reduction	177

33. On the spending side Mondale would cut back the growth of defence expenditure to between 3-4% per year in real terms, partly by cancelling the MX and B-1 bomber programme, and propose a cost containment programme for the health costs. His proposals also call for additional spending on certain discretionary programmes which have been cut by the Reagan Administration. Mondale's tax proposals are more specific and include a 15% minimum corporate tax; modified tax indexation for individuals; a limit on the third year of the Reagan tax cut for high income earners and a 10% tax surcharge on married couples with incomes over $100,000 and for single people with incomes over $70,000. The balance of the savings are made up of reduced interest charges on the debt reflecting the implementation of the proposals to lower the deficit and an assumption that interest rates would fall to 7.5% by 1989 as the Federal demand for credit is reduced.

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ECONOMIC INDICATORS

(All figures are seasonally adjusted unless otherwise noted)

.. ECONOMIC ACTIVITY

xpenditure on GNP (Quarterly data bn 1972 prices at annual rate)	Latest Quarter 1984 (Q2)	% change at annual rate over: last Quarter	same quarter year earlier
. GNP	1638.8	7.1	7.5
Personal Consumption	1064.2	7.9	5.8
. Durables	178.6	11.8	14.3
. Non-durables	396.6	10.2	5.8
. Services	488.9	4.6	2.9
. Business fixed investment (non-res)	202.9	21.4	22.7
Housing investment	56.8	21.5	18.1
Change in business inventories	20.3(A)	31.6 (A)	-6.1 (A)
. Government Purchases of Goods & Services	302.1	18.6	3.3
0. Federal	123.2	45.4	5.1
1. State and Local	178.9	3.7	2.1
2. Net Exports of Goods and Services	-11.4 (A)	-8.3 (A)	13.6 (A)
3. Exports	144.7	-0.6	5.6
4. Imports	156.2	8.1	26.6
5. Price Deflator (1972 = 100)	222.4	3.3	3.8
6. GNP (Current Prices)	3644.7	10.7	11.6
.7. Net Exports (Current Prices)	-58.7 (A)	-51.5 (A)	-6.5 (A)

Ionthly Indicators	Month	Level	% change at annual rate over: previous month	3 months earlier	one year ago
8. Retail Sales ($bn current prices)	AUG	106.2	-9.7	-17.0	8.1
9. Car Sales (m. units pa)	AUG	10.0	-50.3	-34.1	12.6
0. Industrial Production	AUG	166.2	2.9	8.6	9.5
1. Capacity Utilization mfg	AUG	82.8	0	5.5	7.1
2. Inventory Levels ($bn current prices)	JULY	551.3 (A)	546.8 (A)	541.1(A)	501.4
3. Housing Starts (m units pa)	AUG	1.5	-80.7	-46.1	82.0
4. Index of 10 Leading Indicators nsa	AUG	164.5	6.0	-9.3	3.5
5. Index of 4 Coincident Indicators nsa	AUG	156.0	2.3	5.5	10.9
6. Index of 6 Lagging Indicators nsa	AUG	119.9	13.9	14.1	8.2

B. EMPLOYMENT, PRICES AND PRODUCTIVITY

		Month	Level	% change at annual rate over previous month	3 months earlier	one year ago
27.	Civilian Employment (millions)	AUG	105.0	-4.7	-1.2	3.4
28.	Unemployment (%)	AUG	7.5 (A)	7.5 (A)	7.5 (A)	9.5
29.	Average Weekly Hours (pnf nsa)	AUG	35.2	0	-1.1	0.6
30.	Average Hourly Earnings (pnf nsa)	AUG	160.6	-1.5	2.5	3.3
31.	Consumer Price Index (1)(2)	AUG	313.0	5.1	4.3	4.2
32.	PPI (3) finished products (nsa)	AUG	291.8	-3.2	0.4	2.0
33.	Productivity (4)	Quarter 2 84	106.4	n/a	4.6	2.7
34.	Unit Labour Costs (5)	Quarter 2 84	158.0	n/a	-0.8	1.3

C. MONEY, CREDIT AND INTEREST RATES

Monetary Aggregates		Month	Level ($bn)	% change at annual rate over previous 4 weeks	13 weeks	52 weeks
35.	M1	AUG	546.4	1.7	4.0	5.6
36.	M2	AUG	2289.6	4.5	5.4	7.2
37.	M3	AUG	2867.9	3.9	10.8	10.3
38.	Domestic Non-Financial Debt	JULY	5626.0	16.1	15.1	12.4
39.	Monetary Base	AUG	196.1	8.3	8.6	8.5
40.	Total Reserves	AUG	38.5	6.4	11.1	6.6
41.	Non-Borrowed Reserves + Ext. credit	AUG	37.5	3.2	37.9	6.8
42.	Discount Window Borrowing nsa ($ million)(6)	AUG	974	916(A)	2951(A)	1055(A)
43.	Consumer Instalment Credit	JULY	437.2	21.7	26.8	19.3
44.	Commercial and Industrial Loans by all Commercial Banks	AUG	459.7	7.6	11.3	14.2

Interest Rates		Month	Rate (%)	Actual Rates (%) previous month	3 months ago	1 year ago
45.	Federal Funds	SEPT	11.5	11.6	11.1	9.4
46.	3 Month Commercial Paper	SEPT	11.0	11.2	11.0	9.3
47.	3 Month CDs	SEPT	11.3	11.5	11.3	9.4
48.	3 Month Treasury Bills	SEPT	10.3	10.5	9.9	9.0
49.	US Govt. Bond (20 year)	SEPT	12.2	12.7	13.5	11.9
50.	Prime Rate	SEPT	13.0	13.0	12.5	11.0
51.	Corporate AAA Bonds	SEPT	12.4	12.9	13.5	12.3

D. EXTERNAL SECTOR

			Value ($bn) in		
		Latest Month/Quarter	previous months	3 months earlier	1 year ago
52.	Merchandise Exports	AUG 18.0	19.4	17.9	17.4
53.	Merchandise Imports (cif)	AUG 27.9	33.5	26.8	23.8
54.	Trade Balance Quarter 2	-25.7	n/a	-25.8	-14.9
55.	Current Account Quarter 2	-24.4	n/a	-19.7	-9.6

A Actual value in period specified, NOT percentage change

1 All urban consumers

2 Level and % changes are not seasonally adjusted

3 Producer Price Index

4 Output per hour, 1977 = 100, all persons, non-farm business sector

5 Unit labour costs, 1977 = 100, all persons, non-farm business sector

6 Excluding extended credit

BY BAG

[CULL]

FROM WASHINGTON

AT/No 10 AM

TO FCO TEL NO. 28 OF 1 OCTOBER 1984

UNITED STATES MONTHLY ECONOMIC REPORT FOR SEPTEMBER

SUMMARY

1. There is now firmer evidence that the pace of the recovery is slowing, following growth in the first half of the year at an 8.6% annual rate. The Department of Commerce's flash estimate of GNP growth in the third quarter was 3.6%. Much of the slowdown was due to weak growth in consumer spending, which declined in real terms in July and probably in August as well, and to a further decline in net exports.

2. Most of the August economic indicators reflected this slowdown. Consumer spending rose by only 0.1% in current dollars, following a similar increase in July. The weakness in consumer spending was reflected in a 0.8% fall in retail sales, mianly owing to lower car sales. Housing starts declined by 12.8%, following a 6.1% fall in July. The growth of industrial production slowed to 0.2%, following 0.9% gains of June and July. The unemployment rate remained at 7.5% and has been at that level for three of the last four months. However the index of leading economic indicators rose by 0.5%, reversing the decline of the previous two months.

3. Inflation remains moderate, although the Consumer Price Index rose by 0.5% in August owing to higher food and housing costs: the index is 4.2% above its level of a year ago. General Motors and the United Auto Workers Union reached agreement on a new 3-year contract which provides for wage increases averaging 2.25%, plus cost of living adjustments in each year. The main issue in the negotiations was job security, rather tahn the level of the union's pay claim. GM agreed to a $1 bn programme to assist workers displaced through automation. Most commentators believe the agreement is non-inflationary and will enable the company to improve its competitiveness.

4. The growth of the money supply slowed during August: the narrow aggregates M1 and M2 grew by 0.1% and 0.4% respectively and the growth of M3 also slowed. All the monetary aggregates remained well within the interim target ranges for the June-September period set by the Federal Open Market Committee in July. But the total non-financial credit aggregate continued to grow at a rate well above its 8-11% growth range.

5. Market interest rates fell during September, resulting in a decision by most major banks to cut the Prime Rate from 13.0% to 12.75%. The rate on three month Treasury bills fell to below 10.3% in September, from 10.5% in August. This may have reflected some moderation in the demand for credit by the business sector, but it also reflected a slight easing of monetary conditions by the Federal Reserve in response to the weaker than expected growth in the real economy in the third quarter, and the absence of inflationary pressures. The yield on longer term bonds continued to fall - the yield on 20-year Government bonds declined to 12.2% by mid-September from 12.7% in August.

6. Despite the fall in interest rates, the dollar surged against most major currencies in September but eased back towards the end of the month following intervention by several European central banks. The strength of the dollar during September was thought to reflect the market's perception of the relative attractiveness to investors of the US economy, and in particular the sustained success in containing inflation. The trade deficit in August was $9.9 bn, bringing the cumulative deficit for the year to $83.7 bn.

7. During September the President announced two decisions on trade which the Administration claimed were consistent with its anti-protectionist policy. Requests for import relief from the US copper mining industry and the US steel industry were rejected. In the case of steel, although the Administration rejected the request for tariffs and formal quotas for imports, they agreed to seek voluntary restraint agreements with major steel exporting countries in the hope of reducing imports from the current level of 25% of the market to the 1983 level of 20%. US Trade Representative Brock will report to the President within 90 days on the outcome of these negotiations. Since the decision was welcomed by the US Steel industry, some uncertainty surrounds the exact nature of the commitment that was given to the steel producers by the Administration.

8. Details follow by bag.

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SUMMARY: ECONOMIC INDICATORS

(All figures are seasonally adusted unless otherwise noted)

Quarterly Data (1972 prices)	(1984 - Q2)	% change on Previous Quarter	% change on 1 Year Earlier
GNP		1.7	7.5
Personal Consumption		1.9	5.8
Exports of Goods and Services		-0.1	5.6
Imports of Goods and Services		2.0	26.6

	Actual Level Latest Quarter	Actual Level Previous Quarter
Current Account (1984 - Q2) $bn	-24.4	-19.7

Monthly Data		% change on Previous Month	% change on 1 Year Earlier
Retail Sales	AUG	-0.8	8.1
Industrial Production	AUG	0.2	9.5
Consumer Price Index	AUG	0.5	4.2
M1	AUG	0.1	5.6
M2	AUG	0.4	7.2
Dollar Effective Exchange Rate nsa	SEPT	2.3	8.9

		Actual Level Latest Month	Actual Level 1 Year Earlier
Unemployment Rate (%)	AUG	7.5	9.5
3 Month Treasury Bill nsa (%)	SEPT	10.3	10.5

Ack'd 20/9

10 DOWNING STREET

From the Private Secretary

20 September 1984

I enclose a copy of a letter which the Prime Minister has received from Mr. Harry Hooper, President of the Society of Motor Manufacturers & Traders Ltd.

I should be grateful for a draft reply for the Prime Minister's signature by Friday, 5 October.

(DAVID BARCLAY)

Miss Ruth Thompson,
Department of Trade and Industry.

FROM THE PRESIDENT

SMMT THE SOCIETY OF MOTOR MANUFACTURERS & TRADERS LTD.

FORBES HOUSE · HALKIN ST.
LONDON SW1X 7DS
TELEPHONE 01-235 7000

The Rt Hon Margaret Thatcher MP
10 Downing Street
London SW1

20 September 1984

R20

Dear Prime Minister,

Selective Distribution Block Exemption

The major vehicle manufacturers in this country have written directly to yourself or the Secretary of State for Trade and Industry over the motor industry's deep concern on this issue. The replies they have had have not led them to believe that the Government understands the seriousness of the proposal and its likely effect on the motor industry in the United Kingdom. Decisions as to the final regulation are due by the end of October and entry into effect for 1 January 1985. Time is therefore short and I have been asked to write to you to express our concern, a concern which is shared by all the motor industries in Europe and all Governments with vehicle manufacturing industries other than yours.

The detailed argument need not concern us here. It is two issues of principle I wish to bring directly to your attention. Your administration has urged industry to become more competitive and to gain a larger share of domestic and foreign markets. Within our industry a major tool in achieving increased market share is pricing. The draft regulation will remove or severely reduce our ability to employ this weapon. This is extremely serious but not as serious as the other issue of principle.

The regulation will place in the hands of bureaucrats in Brussels the right to be judge and jury over prices and to determine what prices shall be charged in national markets. Moreover price control mechanisms introduced by national governments will, through the full line availability clause, ensure that the lowest price for a model in Europe obtains throughout the community. This will either destroy the major part of European manufacturing, which is not profitable now at present price levels, or will cause European industry to withdraw to a few markets leaving the rest to the products of Japan, COMECON, Russia and South Korea.

We have understood it to be one of the basic tenets of your Government's philosophy that competition must be open and market forces effective. We also understood you to be against a socialist measure such as price controls. May I urge you to explain to us, preferably in person, why UK officials involved in this issue are not upholding these principles ? I am copying this letter to the Ministers concerned.

HARRY HOOPER

cc The Rt Hon Norman Tebbit,MP
Norman Lamont MP,Alex Fletcher MP

USA : Economic Situation Pt 2.

20 SEP 1984

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GRS 1500
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DESKBY 180900Z [CULL]
FM WASHINGTON 171637Z SEP 84
TO IMMEDIATE FCO
TELEGRAM NUMBER 2750 OF 17 SEPTEMBER

Summary only.

U S ECONOMY: PROSPECTS FOR DEFICIT REDUCTION AND TAX REFORM

MS

SUMMARY

1. DURING HIS VISIT ON 13-14 SEPTEMBER, THE FINANCIAL SECRETARY SPOKE TO REPRESENTATIVES OF THE ADMINISTRATION AND THE CONGRESS INVOLVED IN THE BUDGET PROCESS AND WITH PROPOSALS FOR TAX REFORM. THE CONSENSUS VIEW WAS THAT THE EXPENDITURE COMPONENT OF THE FY85 QUOTE DOWNPAYMENT PACKAGE UNQUOTE OF DEFICIT REDUCTIONS WOULD BE ENACTED, BUT THAT FURTHER DEFICIT REDUCTION NEXT YEAR WOULD BE VERY DIFFICULT TO ACHIEVE. THE ADMINISTRATION WOULD FOCUS ON EXPDENDITURE REDUCTIONS IN ITS FY86 BUDGET, BUT THE DEMOCRATS IN CONGRESS WOULD INSIST ON AT LEAST SOME TAX INCREASES IF FURTHER BUDGET SAVINGS WERE TO BE AGREED. IMPOSING TAX INCREASES BY CLOSING LOOPHOLES WOULD BE DIFFICULT TO ACHIEVE SINCE MANY HAD ALREADY BEEN CLOSED BY LEGISLATION IN 1982 AND 1984, WHILE THE PRESIDENT WAS IMPLACABLY OPPOSED TO INCREASES IN TAX RATES. ONE WAY OUT OF THE IMPASSE WAS A DEAL UNDER WHICH SOCIAL SECURITY BENEFIT
S
AND INCOME TAXATION WOULD BOTH BE PARTIALLY DE-INDEXED. CHANGES IN THE POLITICAL COMPOSITION OF THE CONGRESS WOULD BE AN IMPORTANT FACTOR AFFECTING DEFICIT REDUCTION PROSPECTS.

2. THE PROSPECTS FOR FUNDAMENTAL TAX REFORM NEXT YEAR WERE JUDGED TO BE HIGHLY PROBLEMATICAL SINCE THERE WAS NEITHER ENOUGH LEEWAY IN THE BUDGET TO COMPENSATE LOSERS FROM THE REFORM NOR ENOUGH SUPPORT IN THE ADMINISTRATION FOR RAISING TAXES SUBSTANTIALLY AND THUS NECESSITATE REFORM TO AVOID AN EXCESSIVE RISE IN TAX RATES. IN THE CONGRESS THERE WAS TWO ALTERNATIVE TAX REFORM BILLS IN CONTENTION FOR PASSAGE: BOTH WOULD INTRODUCE MODIFIED VERSIONS OF A FLAT TAX. THE U S TREASURY CONTINUES TO BE INTERESTED IN A VALUE-ADDED TAX (SEE PARAGRAPH 8).

DETAILS

3. ON 13-14 SEPTEMBER, THE FINANCIAL SECRETARY PAID CALLS ON MCNAMAR, PEARLMAN AND MCLURE (US TREASURY), NISKANEN (COUNCIL OF ECONOMIC ADVISERS), CONGRESSMAN JACK KEMP, PENNER (CONGRESSIONAL BUDGET OFFICE) AND SALMON (CHIEF COUNSEL, WAYS AND MEANS COMMITTEE) TO DISCUSS THE PROSPECTS FOR DEFICIT REDUCTION AND TAX REFORM IN THE UNITED STATES. HE ALSO SPOKE TO REPRESENTATIVES OF THE OFFICE OF MANAGEMENT AND BUDGET, THE FEDERAL RESERVE BOARD, THE JOINT COMMITTEE ON TAXATION AND THE SENATE FINANCE COMMITTEE.

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/DEFICIT

DEFICIT REDUCTION

4. SINCE THE FY85 BUDGET PROCESS REMAINS INCOMPLETE, THE IMMEDIATE ACTION ON DEFICIT REDUCTION IS IN THE CONGRESS ON THE DOLLARS 142 BILLION ''DOWNPAYMENT PACKAGE'' OF SAVINGS DURING FY85-87, ONLY DOLLARS 63 BILLION OF WHICH (MAINLY TAX INCREASES) WAS CONTRIBUTED BY THE 1984 DEFICIT REDUCTION ACT THAT HAS BEEN SIGNED INTO LAW. THE REMAINING SAVINGS ON DISCRETIONARY PROGRAMMES WILL HAVE TO BE FOUND DURING THE CURRENT APPROPRIATION PROCESS. THE KEY TO THE SUCCESSFUL PASSAGE OF THE SAVINGS IS A COMPROMISE ON DEFENCE EXPENDITURE WHICH NOW APPEARS TO BE ON THE POINT OF BEING AGREED.

5. FURTHER REDUCTIONS IN THE BUDGET DEFICIT WILL PROBABLY HAVE TO AWAIT THE FY86 BUDGET PROCESS, BEGINNING WITH THE FY86 BUDGET SUBMITTED TO THE CONGRESS BY THE PRESIDENT IN JANUARY OR EARLY FEBRUARY. NISKANAN TOLD THE FINANCIAL SECRETARY THAT THE PRESIDENT'S BUDGET WILL NOT CONTAIN ANY PROPOSALS FOR SIGNIFICANT TAX INCREASES BUT WILL PROPOSE ONE ''LAST PUSH'' TO REDUCE THE DEFICIT BY EXPENDITURE REDUCTIONS - PROBABLY DOLLARS 100 BILLION OF THEM OVER TWO YEARS. IN REJECTING THE IDEA OF TAX INCREASES, HE SAID THAT ''WE NOW LIVE IN A HIGH REAL INTEREST RATE AND HIGH DOLLAR WORLD, AND I WOULD NOT RECOMMEND ANYTHING TO THE PRESIDENT THAT WOULD CHANGE THAT''.

6. PENNER SAID THAT THE OUTLOOK FOR DEFICIT REDUCTION WOULD BE VERY DIFFICULT NEXT YEAR EVEN IF A CONGRESS WAS RETURNED WITH BROADLY THE SAME POLITICAL COMPOSITION AS NOW. IT WAS POSSIBLE THAT THE SENATE COULD CONTAIN MORE REPUBLICANS OR RIGHT-WING DEMOCRATS FOLLOWING A REAGAN LANDSLIDE, BUT IT WAS MORE LIKELY THAT THERE WOULD BE ONE OR TWO EXTRA LOYAL DEMOCRATS. WHEN ADDED TO THE FIVE OR SO REPUBLICANS WHO NORMALLY VOTE WITH THE DEMOCRATS ON ECONOMIC MATTERS, THIS COULD REDUCE OR ELIMINATE THE EFFECTIVE CONTROL OF THE REPUBLICANS OVER THE UPPER CHAMBER. IT ATTEMPTS TO REDUCE EXPENDITURE FAILED AND THE PRESIDENT WERE WILLING TO TOLERATE TAX INCREASES AS A LAST RESORT, IT WAS ESSENTIAL THAT THE CHAIRMAN OF THE SENATE FINANCE COMMITTEE SHOULD BE SYMPATHETIC. THE PRESENT CHAIRMAN (DOLE) WOULD COOPERATE, BUT IF DOLE WERE TO REPLACE BAKER AS SENATE MAJORITY LEADER SENATOR PACKWOOD WOULD REPLACE HIM AS CHAIRMAN OF THE COMMITTEE AND PACKWOOD FAVOURED MORE TAX LOOPHOLES RATHER THAN FEWER.

7. BALLENTINE (OMB) AND SALMON (A REPUBLICAN AND A DEMOCRAT RESPECITIVELY) ENVISAGED A SCENARIO UNDER WHICH THE PRESIDENT'S PROPOSALS FOR EXPENDITURE REDUCTIONS WOULD BE REJECTED BY THE HOUSE OF REPRESENTATIVES. IN THIS CASE, THEY THOUGHT THERE MIGHT BE A DEAL NEGOTIATED UNDER WHICH THE DEMOCRATS AGREED TO SOME DE-INDEXING OF SOCIAL SECURITY BENEFITS WHILE THE REPUBLICANS AGREED TO SOME DE-INDEXING OF INCOME TAX. SALMON BELIEVED THAT THAT ISSUE MIGHT BE FORCED BY THE DEMOCRATS WHO, IN RESPONSE TO

THE PRESIDENT'S PROPOSAL FOR A BALANCED-BUDGET AMENDMENT TO THE CONSTITUTION, COULD COMPEL THE ADMINISTRATION TO COOPERATE IN ACTUAL DEFICIT REDUCTION BY REFUSING TO AGREE NEXT YEAR ON AN INCREASE IN THE FEDERAL DEBT LIMIT. (PENNER POINTED OUT HOWEVER THAT A DE-INDEXING SOLUTION MIGHT BE DEEMED TO BREACH THE PRESIDENT'S COMMITMENT NOT TO INCREASE TAX RATES NEXT YEAR).

TAX REFORM

8. PEARLMAN AND MCLURE CONFIRMED THAT THE TREASURY'S RECOMMENDATIONS FOR TAX REFORM, INCLUDING A STUDY OF A FLAT TAX, A TAX ON CONSUMPTION , A NATIONAL SALES TAX AND A VALUE-ADDED TAX (VAT), WILL BE SUBMNITTED TO THE PRESIDENT ON SCHEDULE ON 1 DECEMBER. IT HAD NOT BEEN DECIDED WHEN OR IF THEY WOULD BE PUBLISHED. WHILE TREASURY OFFICIALS WERE UNWILLING TO DIVULGE THEIR RECOMMENDATIONS, THEY EXHIBITED A FAIRLY STRONG INTEREST IN A VAT AND, AFTER THE FINANCIAL SECRETARY HAD EXTOLLED THE MERITS OF A VAT TO MCNAMAR, MCLURE COMMENTED THAT IT WOULD BE USEFUL IF THE CHANCELLOR WERE TO DO THE SAME TO SECRETARY REGAN DURING THE IMF/IBRD MEETINGS.

COMMENT

9. IT SEEMED AS IF U S TREASURY INTEREST IN VAT STEMS FROM THE WISH TO ACHIEVE A LOW RATE WITH A FLAT INCOME TAX WHILE RETAINING CERTAIN LOOPHOLES INCLUDING THOSE TO ENCOURAGE SAVING. VAT WOULD BE USED AS A SUPPLEMENTARY TAX TO MAINTAIN BUOYANCY IN THE REVENUE. WHILE A NORMAL VAT WOULD DRAW OBJECTIONS FROM THE INDIVIDUAL STATES AS POACHING ON THEIR INDIRECT TAX BASE, THE LEADING TAX LOBBYIST IN WASHINGTON (CHARLS E WALKER) HAS PROPOSED A VAT THAT APPLIES TO THE WHOLE-SALE STATES OF PRODUCTION ONLY, AND NOT THE RETAIL STAGE. THIS WOULD LEAVE THE STATES A CLEAR FIELD FOR IMPOSING SALES TAXES.

10. CONGRESSIONAL STAFFERS TOLD THE FINANCIAL SECRETARY THAT TAX REFORM PROPOSALS HAVE NOW FOCUSSED ON TWO BILLS: KEMP-KASTEN (REPUBLICAN) AND BRADLEY-GEPHARDT (DEMOCRAT). BOTH INVOLVE VERSIONS OF A FLAT INCOME TAX (ALTHOUGH BRADLEY-GEPHARDT ENVISAGES TWO HIGHER TAX RATES FOR THE TOP 20 PERCENT OF INCOMES). THE MAIN OBSTACLE TO THEIR ENACTMENT IS THE AMOUNT OF BASE-BROADENING THAT WOULD BE REQUIRED AND THE STRONG OPPOSITION OF THE SPECIAL INTEREST GROUPS WHO WOULD BE DIVESTED OF LONG-STANDING TAX BENEFITS. PEARMAN CONFIRMED TO THE FINANCIAL SECRETARY THAT EVEN SLIGHT MODIFICATION OF RELIEF ON MORTGAGE INTEREST FOR UPPER INCOME GROUPS WOULD BE VIRTUALLY IMPOSSIBLE. NISKANEN SAID THAT AS PART OF ANY TAX REFORM THE ADMINISTRATION WOULD WISH TO RETAIN TAX INCENTIVES FOR SAVING, SO THAT A MOVE COULD BE MADE TOWARDS USING CONSUMPTION AS THE TAX BASE RATHER THAN INCOME. IN THE CONGRESS, TAX REFORM PROPOSALS ARE NOT CLEARLY SEPARATED FROM PROPOSALS FOR TAX INCREASES, AND THERE IS AN AWARENESS THAT EITHER OF THE CONTENDING REFORM PROPOSALS COULD EASILY BE MODIFIED SO AS TO GENERATE EXTRA REVENUE.

/11. NONE

11. NONE OF THE FINANCIAL SECRETARY'S INTERLOCUTORS THOUGHT THAT THERE WOULD BE A MAJOR TAX REFORM IN 1985. THIS WAS BECAUSE MOST OF THEM THOUGHT THAT A PRECONDITION FOR TAX REFORM WAS EITHER THAT THERE HAD TO BE SCOPE FOR COMPENSATING LOSERS IN THE REFORM (I.E. A STRUCTURAL BUDGET SURPLUS) OR THE ADMINISTRATION HAD TO WANT TO GENERATE EXTRA TAX REVENUE AND NEEDED REFORM TO DO THIS WITH A MINIMUM EFFECT ON TAX RATES AND INCENTIVES. THERE WAS NO SCOPE FOR THE FORMER AND THE ADMINISTRATION WOULD WISH TO FOCUS ON EXPENDITURE REDUCTIONS NEXT YEAR RATHER THAN TAX INCREASES. BUT THE ADMINISTRATION WAS NONETHELESS EXPECTED TO TRY TO INFLUENCE THE FY86 BUDGET PROCESS IN A WAY THAT WAS CONSISTENT WITH THE BROAD THRUST OF REFORM: SIMPLICATION, BASE-BROADENING, MAINTAINING INCENTIVES FOR SAVING, AND KEEPING MARGINAL INCOME TAX RATES AS LOW AS POSSIBLE.

12. FCO PLEASE ADVANCE TO PS/CHANCELLOR OF THE EXCHEQUER, PS/FINANCIAL SECRETARY, MONGER AND BOTTRILL (TREASURY), AND TAYLOR THOMPSON (INLAND REVENUE).

WRIGHT (ADVANCED AS REQUESTED)

FINANCIAL
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From Kleinwort Benson Quarterly International Review Sept '84

→ US file

AT 19/4

DOLLARS AND DEFICITS

A Personal View of the United States Economy at Election Time

by

Alan Walters

I

One tries not to think about the deficit. It is just too distressing. But it is a comfort to know that the President is also very concerned about the deficit. In fact it is reported that as a consequence of worrying about the federal deficit, he has suffered many sleepless afternoons.

The prospect is heavy with irony. A Republican President, committed to constitutional amendments requiring a "balanced budget" (whatever that may mean in 1984), presiding over this ballooning deficit; the economy taking off at an explosive pace with stable prices to a mixture of cheers and boos from dyed-in-the-wool Keynesians, Socialists and the neo-Keynesian "sound finance" revisionists; and an election, too! In this year of 1984 the Administration predicts that by 1990 there will be a balanced budget!

In 1981, the President also projected a balanced budget for fiscal year 1985 ($5 billion surplus). In 1984 however, the Administration forecasts the fiscal year 1985 budget to be $180 billion in deficit. Accidents do happen. But a slip of $185 billion is more than a little accident; it has all the appearance of carelessness. The sad reality is roughly as follows:

$43 billion	-	expenditure cuts planned but not delivered.
$105 billion	-	revenues deficiency, some due to lower output, some to lower inflation than was thought likely.
$38 billion	-	expenditure increases, mainly the interest on the debt which is projected, assuming interest rates on Treasury Bills at 6% in 1985.

Oddly enough there is no warrant for the widespread view that the Pentagon is to be blamed. On the contrary, defence spending is less (by about $12 billion real Dollars) than had been projected in 1981. But there are many other items that are greater by a few billion Dollars (e.g. Medicare by $10 billion). And as my colleague Herb Stein puts it, a billion here, a billion there - it soon adds up to real money.

The future for the deficit is ultimately determined by the future of the economy - and vice versa. The Administration projects falling deficits to 1989 by assuming that there will be no recession for the next five years, that growth will be about four per cent per annum and that interest rates decline to five per cent in 1989. I suppose it is just possible, but at what odds; am I offered 100 to 1? We have seen the slumps of 1974/5 and 1981/2 increasingly boost the deficit, and more and more of the deficit has hung on through the recovery. It is a sort of ratchet that becomes very painful to reverse. (The British reader may find some parallels with the U.K. economy in 1979. A soaring deficit, interest rates and exchange rate at the top of a boom. But, and here the analogue breaks down, unlike Britain in 1979 there appears to be little incipient inflation.)

II

Meanwhile the deficit is credited with such effects that men may marvel. Many Keynesians have claimed that the deficit produced the recovery of 1983-84 - but oddly enough many also claim that the deficit will abort that recovery. There is nothing like having it both ways - how can you lose!

Try as I might I find it difficult to agree with either of these interpretations. After all the budget deficit started to increase rapidly (by about $70 billion) from mid-1979 to mid-1980 - and by yet another $60 billion from late 1980 through the first quarter of 1982. Yet in spite of this massive budgetary stimulus there was a sharp contraction in 1982 to give one of the deepest depressions of the post-war years. The deficit appeared to be not a stimulant, but a depressant. However, yet another sharp increase ($75 billion) in the deficit in the second half of 1982, and presto, the economy turned upwards at the end of 1982. At last, after two occasions when it all went wrong, the deficit stimulant finally appeared to work in the right way.

One may be forgiven for being unenthusiastic about a control system that appears to steer in the right direction only fitfully. Most important of all, this ignores the behaviour of the Federal Reserve Board. The evidence shows that the Fed, which had been squeezing the monetary growth from the first quarter of 1981 (5% for M1) suddenly relented in the summer of 1982. The rate of growth of M1 shot up to fourteen per cent. (This change in the rate of monetary expansion (plus nine per cent) is comparable to that which the Heath Government inflicted on poor Britain in 1971/2.) With such a monetary boost it is hardly surprising that the money national income responded as one would expect about six months later.

Perhaps the only really surprising feature of the rapid rise of money income was the fact that virtually all of it took the form of increases in real income (and one may add also increases in employment); inflation remained at the low level of 1982. One would not expect the inflation to appear until mid-1984 (just as the Heath expansion of 1971/2 appeared in the inflation of 1974), but there is, as yet, little or no sign of a reignition of inflation in the United States. For political polemics this is truly a splendid prospectus to promote at the hustings. The Administration boasts that the bogey of inflation has at last been laid. The President forecasts that inflation in 1989 will be still down at three to four per cent or so.

Nobody believes him. The Treasury has been selling ten year and twenty year bonds with a near fourteen per cent yield - so they clearly do not trust the President's forecasts. And with good reason. History and experience suggest that persistent high deficits are eventually inflated away. In the long run, with the

traditional low savings rates in the United States there seems to be no other way. At some stage even the United States Government will be unable to persuade people to increase the fraction of their wealth held in U.S. Treasury bonds. The process must stop long before the stock of United States public debt exceeds total private wealth.

III

Meanwhile the deficit exacts its tribute. At first sight all seems too good to be true. There are no signs yet of the "crowding out" of private investment; indeed gross capital formation has been at as high or even higher a level than one would expect at this stage of the cycle. No doubt much of the investment buoyancy is explained by the response to the Economic Recovery Tax Act (ERTA) 1981 and the Tax Equity and Fiscal Responsibility Act (TEFRA) 1982 - the effective average corporate tax rate fell from 46.6 per cent in 1980 to 36.5 per cent in 1983. This certainly helped fight investment crowding out. But the "crowding out" appears most poignantly - and alarmingly - in the export industries.

The fears that were originally expressed that the United States would be unable to achieve a sufficiently large current account deficit to enable large capital inflows have proved to be groundless. About a third to a half of the increase in the deficit has been financed by net borrowing from foreigners, which is now probably running at $100 billion or so - that is, at two per cent of GNP. The current account balance of payments deficit for 1983 was $41.5 billion and is likely to be $80 to $90 billion in 1984, and still rising. The most striking effect has been the reduction in U.S. bank lending abroad. Overall, perhaps as early as 1985, the United States will become a net debtor to the rest of the world. (Of casual interest is the fact that Britain has already probably become a more substantial creditor nation with net assets rising to over £55 billion in 1983).

U.S. Net Foreign Assets (Year end: Billions of current Dollars)

1979	1980	1981	1982	1983
94.4	120.6	156.4	149.5	105.9

It is simple to conclude that the persistent high federal deficit has been the main cause of the high interest rates and the high Dollar. Nevertheless the Administration has argued that any connection between high U.S. deficits and Dollar interest rates is "not proven". Somehow they must persuade us that as the supply of Treasury bonds expands so must there be a matching demand for bonds at the same level of interest rates. The foreign demand for Treasuries has indeed moderated the rise in interest rates but it has not eliminated it. The supply of bonds is just too large. Similarly, supply-siders have embraced the view that lower tax rates will stimulate activity and so induce savings to provide the needed demand for bonds. There are some, primarily cyclical, increases in gross corporate and state savings, but not enough to keep interest rates down.

The rise in interest rates however has undoubtedly kept the exchange rate of the Dollar much higher than its purchasing power parity. Thereby it has contributed to the restraint of inflation in the United States, just as it has provided the "locomotive" for growth in the West. It is a moot point whether the other industrialised countries have lost more from the high interest rates than they have gained from such "locomotion" of the United States.

IV

The deficit and the Dollar cannot remain high and inflation low forever. Similarly the current balance of payments deficit and the high real interest rates must eventually fall. We may be agreed on the outcome; but everyone has been badly wrong on the question "when?". Similarly, some think it will end with a crash; others see it in terms of a gentle, moderate but sustained subsidence. I conjecture it will be a crash but for no good reason except the observation that currency markets always seem to overdo things. But "when?" - your guess is as good as or better than mine.

One main worry is the growing protectionism largely stimulated by the rise of the Dollar in the United States. Like the plague, protectionism is infectious. It is much easier to impose import quotas and raise tariffs than to abolish or even reduce them. (Unfortunately protectionism is preached with a fervour, even fanaticism, by the still influential Cambridge economists and their acolytes). The other main concern is the possibility of more exchange rate intervention and controls. Nostalgia for the myths of Bretton Woods, even for the old Gold Standard, stirs in the breast of many a romantic statesman. It is rumoured that Representative Jack Kemp will promote a resolution supporting the return to a Gold Standard - albeit at an inflationary value per fine ounce. They yearn for the imposed order of executive decisions rather than what they regard as the chaotic mess of market outcomes. All such attempts will fail. But there is much potential for mischief in such measures.

I am, however, still optimistic - though the reader is entitled to wonder why. I suppose that the main reason has been the behaviour of the United States over the most distressing industrial decline in 1981-1982. In spite of the political furor, there was only a modest increase in protectionism (all of it rather silly, but never mind), and virtually no attempts to manipulate the Dollar exchange rate or to interfere in free convertibility. Was this not an acid test of principle over pragmatism? We shall soon see.

The other main prop to my optimistic view is the essential competitive vitality of the United States economy. The growth of the United States (2.2 per cent) has been greater than that in all major European countries (1.7 per cent being the average for the EEC) in the post-OPEC decade 1973-84. Employment in the United States has increased by one fifth whereas in the Common Market it has declined over this last decade.

With such micro-virtue, there <u>must</u> be some consolation for such macro-vice. One also suspects that the great conservative electorate will eventually - perhaps not until 1986 or 1987 - insist on action to match the rhetoric.

GRS 380

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FM WASHINGTON 312245Z AUG 84

TO ROUTINE F C O

TELEGRAM NUMBER 2590 OF 31 AUGUST

THE US ECONOMY: MOVEMENTS IN THE LEADING INDEX OF ECONOMIC INDICATORS

1. THE INDEX OF LEADING ECONOMIC INDICATORS, WHICH IS DESIGNED TO PREDICT MONTHLY MOVEMENTS IN AGGREGATE ECONOMIC ACTIVITY, DECLINED BY 0.8 PERCENT IN JULY, FOLLOWING A REVISED 1.3 PERCENT IN JUNE. THE LARGEST CONTRIBUTION TO THE DECLINE WAS IN BUILDING PERMITS, AND NEW ORDERS FOR PLANT AND EQUIPMENT FELL FOR THE SECOND MONTH IN A ROW. THE LAST TIME THE INDEX DECLINED FOR TWO CONSECUTIVE MONTHS WAS IN DECEMBER/JANUARY 1981/2.

2. A WHITE HOUSE SPOKESMAN SAID THE FALL IN THE INDICATORS QUOTE SIGNALS SOME MODERATION AHEAD IN ECONOMIC ACTIVITY WHICH SHOULD HELP IN DIMINISHING PRESSURE ON INTEREST RATES UNQUOTE. MOST ANALYSTS ARE AGREED THAT AT LEAST THREE CONSECUTIVE MONTHS OF DECLINE IN THE INDEX ARE REQUIRED BEFORE ONE CAN SAFELY PREDICT AN ECONOMIC DOWNTURN. THE LAG BETWEEN SUCH CONSISTENT DECLINES IN THE INDEX AND THE PEAKS OF THE BUSINESS CYCLE HAS VARIED BETWEEN 3 AND 23 MONTHS IN THE POST-WAR ERA, BUT IN THREE OF THE LAST FOUR BUSINESS CYCLES (1970, 1974 AND 1980) THE INDEX FELL SOME 8-10 MONTHS BEFORE THE ACTUAL PEAK.

3. OTHER RECENT ECONOMIC INDICATORS PROVIDE MIXED SIGNALS. IN JULY INDUSTRIAL PRODUCTION, AND PERSONAL INCOME ROSE SHARPLY. BUT THE PACE OF CONSUMER SPENDING SLOWED, HOUSING ACTIVITY FELL, AND A RECORD TRADE DEFICIT WAS RECORDED. IN THE FIRST HALF OF 1984, REAL GNP GREW AT AN ANNUAL RATE OF 8.8 PERCENT, IE FASTER THAN THE GROWTH RATE IN THE FIRST YEAR OF THE RECOVERY, WHICH IS UNUSUAL. MOST ANALYSTS EXPECT SOME MODERATION IN ACTIVITY DURING THE NEXT 12 MONTHS. THE LATEST FORECAST FROM THE BLUE CHIP CONSENSUS OF PRIVATE FORECASTERS SHOWS GNP GROWING AT ABOUT A 4 PERCENT ANNUAL RATE DURING THE SECOND HALF OF THE YEAR, AND AT 3.4 PERCENT IN 1985 OVER 1984.

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4. THE INDEX OF LEADING INDICATORS WILL BE PUBLISHED TWICE MORE BEFORE NOVEMBER, AND MUCH ATTENTION WILL OBVIOUSLY FOCUS ON THESE LATER FIGURES. THOUGH IT WOULD NOT IN FACT CONSTITUTE FIRM EVIDENCE OF AN EARLY DOWN-TURN, DEMOCRAT SPOKESMEN WOULD HIGHLIGHT ANY FURTHER FALL. AND IT WOULD BECOME MORE DIFFICULT FOR THE PRESIDENT TO MAINTAIN CONVINCINGLY DURING THE CAMPAIGN THAT THE ECONOMY WAS SET FIRMLY ON A COURSE OF SUSTAINED ECONOMIC GROWTH DURING A SECOND TERM.

5. FCO PLEASE PASS TO BOTTRILL (TREASURY), GREEN (BANK), TAIT (ERD) AND ROLLO (ESID).

WRIGHT [REPEATED AS REQUESTED]

FINANCIAL
ERD
NAD
ESID

COPIES TO:
MR BOTTRILL - TREASURY
MR. GREEN - B/ENGLAND

RESTRICTED

GRS 950
RESTRICTED
FM WASHINGTON 260125Z JUL 84
TO IMMEDIATE FCO
TELEGRAM NUMBER 2271 OF 25 JULY
AND SAVING TO PARIS, BONN, ROME, OTTAWA, UKREP BRUSSELS AND
TOKYO

US MONETARY POLICY

MS

SUMMARY

1. VOLCKER TESTIFIED BEFORE CONGRESS TODAY. THE TOP END OF THE GROWTH RANGES FOR M1 AND M2 FOR 1985 WERE REDUCED. ALL MONETARY AGGREGATES TO BE GIVEN EQUAL WEIGHT IN THE IMPLEMENTATION OF POLICY. FOMC FORECAST SLOWER GROWTH OF THE ECONOMY IN 1985. HIGHER INTEREST RATES HAVE CONTRIBUTED TO FINANCIAL STRAINS AND IMBALANCES IN THE ECONOMY. IMPORTANT TO LOWER THE BUDGET DEFICIT.

DETAIL

2. FEDERAL RESERVE CHAIRMAN VOLCKER ANNOUNCED A REDUCTION IN THE TOP END OF THE GROWTH RANGE FOR THE MONETARY AGGREGATES M1 AND M2 FOR 1985. VOLCKER PRESENTED THE FEDERAL RESERVE'S MID YEAR REPORT ON MONETARY POLICY AND THE FEDERAL OPEN MARKET COMMITTEE'S (FOMC'S) RECOMMENDATIONS FOR THE GROWTH OF THE AGGREGATES TO THE SENATE BANKING COMMITTEE TODAY. THE FIGURES FOR THE RECENT GROWTH OF THE AGGREGATES AND TARGET RANGES (FOURTH QUARTER '84 TO FOURTH QUARTER '85) ARE AS FOLLOWS:-

	EXISTING TARGET RANGES (PRCENT)	ACTUAL GROWTH QIV '83 TO JUNE '84 (PERCENT)	TARGET RANGES FOR 1985 (PERCENT)
M1	4 TO 8	7.5	4 TO 7
M2	6 TO 9	7.0	6 TO 8.5
M3	6 TO 9	9.7	6 TO 9
DOMESTIC NON-FINANCIAL DEBT	8 TO 11	13.1	8 TO 11

3. VOLCKER SAID THAT THE FOMC HAD DECIDED TO LOWER THE RANGE FOR THE NARROWER AGGREGATES SINCE M1 AND M2 HAD GROWN WITHIN THEIR EXISTING RANGES DURING 1984. INDICATIONS OF THE RETURN OF A MORE NORMAL GROWTH OF M1 VELOCITY HAD LED THE FOMC TO GIVE EQUAL WEIGHT TO THE GROWTH OF ALL THE MONETARY AGGREGATES IN 1985. THE GROWTH OF THE BROADER AGGREGATES IN 1984 REMAINED IN EXCESS OF THE MONITORING RANGES, REFLECTING THE STRONG GROWTH OF CONSUMER CREDIT (UP 18.4 PERCENT SINCE END 1983) AND THE SPATE OF MERGER ACTIVITY AND CORPORATE FINANCIAL RE-ORGANIZATIONS. THUS NO CHANGE HAD BEEN MADE TO THE RANGES FOR THESE AGGREGATES.

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4. VOLCKER STATED THAT MONETARY POLICY WOULD CONTINUE TO SUPPORT SUSTAINABLE GROWTH WHILE ENCOURAGING GREATER PRICE STABILITY. DURING THE FIRST HALF OF 1984 RAPID ECONOMIC GROWTH HAD BEEN FINANCED BY INCREASES IN THE VELOCITY OF MONEY AND LARGE INCREASES IN CREDIT. VOLCKER HINTED THAT THERE HAD BEEN NO FURTHER CHANGE IN MONETARY POLICY FOLLOWING THE RISE IN THE DISCOUNT RATE TO 9 PERCENT IN APRIL. THE RISE IN INTEREST RATES IN 1984 REFLECTED THE EXCESSIVE DEMANDS ON SAVINGS AND CONCERN OVER FUTURE LEVELS OF INFLATION.

5. IN THE REMAINDER OF HIS COMMENTS VOLCKER DEALT WITH THE IMPORTANCE OF FINANCIAL STABILITY. ACKNOWLEDGING THE STRENGTH OF THE RECOVERY, ACCOMPANIED BY LOW INFLATION TO DATE, VOLCKER STRESSED THE STRAINS AND IMBALANCES THAT WERE EMERGING. HIGH INTEREST RATES HAD CONTRIBUTED TO THE DETERIORATION OF THE U S TRADE ACCOUNT AND STRENGTHENED PROTECTIONIST PRESSURES. THESE INCREASED THE DIFFICULTIES FOR DEVELOPING COUNTRIES IN MEETING DEBT SERVICE PAYMENTS. WITHIN THE U S, HIGHER INTEREST PAYMENTS HAD ADVERSELY AFFECTED THE FINANCIAL POSITION OF THE FARM SECTOR, THE THRIFTS AND ACCENTUATED THE PROBLEMS OF CONTINENTAL ILLINOIS. SOME RECENT MERGERS HAD ALSO REDUCED THE AMOUNT OF EQUITY AVAILABLE TO THE RESULTING COMPANY. VOLCKER REPEATED HIS WARNINGS OF THE NEED FOR AN EARLY REDUCTION IN THE BUDGET DEFICIT TO LOWER INTEREST RATES.

6. MUCH OF THE RESULTING DISCUSSION WITH COMMITTEE MEMBERS CONCENTRATED ON THE BUDGET DEFICIT, THE DOLLAR AND CONTINENTAL ILLINOIS. VOLCKER SAID HE BELIEVED THERE WAS A RELATIONSHIP BETWEEN BUDGET DEFICITS AND INTEREST RATES. A SHARP FALL IN THE DOLLAR, IF IT OCCURRED, WOULD COMPLICATE MONETARY POLICY SINCE BOTH INFLATION AND INTEREST RATES WOULD TEND TO RISE. IN RESPONSE TO SOME CRITICAL COMMENTS ON THE FEDERAL RESERVE'S ROLE IN THE DEALING WITH CONTINENTAL ILLINOIS, VOLCKER SAID HE THOUGHT THE EPISODE SHOWED THE SUPERVISORY SYSTEM WAS CAPABLE OF DEALING WITH SUCH CASES, BUT HE ACKNOWLEDGED THERE WERE IMPORTANT ISSUES SUCH AS LEVELS OF DEPOSIT INSURANCE TO DISCUSS. A NUMBER OF SENATORS STRESSED THE NEED FOR EARLY HEARINGS ON BANK SUPERVISION.

COMMENT:

7. THE SMALL REDUCTION IN THE GROWTH RANGE FOR M1 AND M2 WAS NOT UNEXPECTED. IT REFLECTS THE FOMC'S DESIRE TO AVOID ANY RESURGENCE OF INFLATION AND THEIR FORECAST OF SLOWER ECONOMIC GROWTH IN 1985. THEY FORECAST REAL GNP TO GROW BETWEEN 2 TO 4 PERCENT IN 1985 COMPARED TO 6-7 PERCENT THIS YEAR. VOLCKER LAID MORE STRESS ON FINANCIAL STRAINS, BOTH DOMESTIC AND EXTERNAL, THAN IN EARLIER TESTIMONIES. BUT THE MAIN CONCLUSION - THE NEED TO LOWER THE BUDGET DEFICIT TO EASE THE PRESSURE ON MONETARY POLICY AND INTEREST RATES REMAINED THE SAME.

8. A COPY OF VOLCKER'S STATEMENT AND THE FEDERAL RESERVE'S REPORT TO CONGRESS WILL BE SENT BY BAG.

9. FCO PLEASE PASS TO BOTTRILL (HMT), GREEN (BANK) AND ROLLO (ESID).

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

HANNAY

FINANCIAL
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(ADVANCED AS REQUESTED)

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FM WASHINGTON 141535Z JUL 84

TO ROUTINE FCO

TELEGRAM NUMBER 2151 OF 14 JULY 1984.

AND TO UKDEL OECD, CG'S IN USA, BIS NEW YORK.

MYTEL NO 2065 OF 6 JULY: 1984 DEMOCRATIC PLATFORM: ECONOMIC GROWTH, PROSPERITY AND JOBS.

1. THE ECONOMIC PROGRAMME IN THE 1984 DEMOCRATIC PLATFORM (COPY BY BAG TO NAD) IS AIMED AT ATTRACTING ALL SHADES OF OPINION IN THE PARTY. THE DOCUMENT IS THEREFORE OF AN ''ALL THINGS TO ALL MEN'' NATURE AND HARDLY SETS OUT A COHERENT, LET ALONE COSTED, ECONOMIC PROGRAMME. SOME OF THE COMMITMENTS CONFLICT AND THE PLATFORM GIVES LITTLE IDEA OF WHAT A DEMOCRATIC PRESIDENT'S ECONOMIC PROGRAMME WOULD BE IN PRACTICE.

2. WHILE THERE IS A COMMENDABLY STRONG UNDERTAKING TO PURSUE OVERALL ECONOMIC POLICIES THAT SHARPLY REDUCE DEFICITS, THERE IS AN UNDERSTANDABLE LACK OF CLARITY ABOUT MEANS. THE PROGRAMME INCLUDES A STRING OF COMMITMENTS TO INCREASED EXPENDITURE ON CHILD CARE, EDUCATION, TRAINING - AS PART OF ''A COMMITMENT TO FULL EMPLOYMENT '' - INFRASTRUCTURE, HOUSING AND SO ON. THERE ARE UNDERTAKINGS TO ''REASSESS'' DEFENCE SPENDING (WHICH ELSEWHERE IN THE PLATFORM BECOMES TO ''REDUCE THE RATE OF INCREASE IN DEFENCE SPENDING''): CREATE A TAX SYSTEM THAT IS ADEQUATE AND FAIR: CONTROL SKY-ROCKETING HEALTH COSTS WITHOUT SACRIFICING QUALITY OF CARE: AND ELIMINATE OTHER UNNESESSARY EXPENDITURE. ''THROUGH EFFICIENCY AND TOUGHNESS WE WILL RESTORE SANITY TO OUR FISCAL HOUSE.'' SOCIAL SECURITY IS EXPRESSLY PROTECTED FROM CUTS AND THE INTERESTS OF HEALTH CARE BENEFICIARIES ARE ALSO TO BE PROTECTED THOUGH THERE WILL BE STRICT CONTROL ON THE LEVEL OF HEALTH CARE REIMBURSEMENT AVAILABLE FROM MEDICARE.

3. THOUGH THE PLATFORM IS WELL LARDED WITH REFERENCE TO THE IMPORTANCE OF THE FREE MARKET AND THE PRIVATE SECTOR, THIS IS BALANCED BY AN INTERVENTIONIST STANCE - ''WE ARE COMMITTED TO PURSUING INDUSTRIAL STRATEGIES THAT EFFECTIVELY AND IMAGINATIVELY BLEND THE GENIUS OF THE FREE MARKET WITH VITAL GOVERNMENT PARTNERSHIP AND LEADERSHIP''. THE RADICAL INTERVENTIONIST INDUSTRIAL POLICY, SO FASHIONABLE IN DEMOCRATIC PARTY CIRCLES A YEAR AGO, FINDS ONLY ECHOES IN THE PROPOSALS TO CREATE A NATIONAL ECONOMIC COOPERATION COUNCIL (RATHER LIKE OUR NEDC), TO ESTABLISH A NATIONAL RECONSTRUCTION FUND, AND TO NEGOTIATE ''INDUSTRIAL MODERNISATION AND GROWTH AGREEMENTS'' COMMITTING MANAGEMENT TO NEW INVESTMENT, HIGHER EMPLOYMENT AND TRAINING AND THE UNIONS TO THE INTRODUCTION OF NEW TECHNOLOGY. IT ALSO PROMISES A RETURN TO USE OF QUOTES OLD-FASHIONED ANTI-TRUST POLICY UNQUOTES WHICH DOES NOT AUGUR WELL FOR OUR EFFORTS TO PERSUADE THE ADMINISTRATION TO CURB THE SCOPE AND REMEDIES AVAILABLE UNDER US ANTI-TRUST LAWS.

WRIGHT

(REPEATED AS REQUESTED)

FCO/WH (PALACE)
NAD

RESTRICTED

US Eco Policy

Prime Minister ④

AT 16/7

D. A. S. PLASTOW

VICKERS P.L.C.
VICKERS HOUSE,
MILLBANK TOWER,
MILLBANK,
LONDON, SW1P 4RA
TELEPHONE: 01-828 7777

The Rt. Hon. Mrs Margaret Thatcher, MP,
The Prime Minister,
10, Downing Street,
London, S.W. 1.

So nice to be thanked! MT

13th July, 1984.

Dear Prime Minister,

This morning I heard from both our Rolls-Royce North American management and our advisers the final details of the new tax legislation affecting business use of cars in America.

There is no doubt that your personal intervention with President Reagan was crucial in achieving amendments to the draft proposals which would have been extremely damaging to our business.

All the employees in our car factories join me in saying how grateful we are for your support.

Yours sincerely,

David Plastow

cc NO

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
TELEPHONE DIRECT LINE 01-215 5422
SWITCHBOARD 01-215 7877

JF6893

PS/
Secretary of State for Trade and Industry

10 July 1984

NBPM
AT 11/7

Andrew Turnbull Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1

Dear Andrew,

US TAX TREATMENT OF IMPORTED CARS

Thank you for your letter of 28 June with which you sent a copy of the US response to our Aide Memoire which was given to White House officials during the London Summit last month.

2 The US Note confirms the reports which we have had from our Embassy in Washington about the compromise which was reached in Congress on changes in the tax treatment of passenger cars used for business purposes.

3 The outcome seems reasonably satisfactory. We no longer have any obvious grounds for criticism on the basis of discrimination against imported cars. Taken as a whole, the US provisions do not seem markedly out of line with those of the UK.

4 While the UK manufacturers who were most concerned about the original proposals, Jaguar and Rolls Royce, would naturally have preferred the status quo if this had been a real possibility, I understand that they are reasonably satisfied with this result. In the circumstances, we see no need for any further action.

5 I am copying this letter to David Peretz (HM Treasury) and Peter Ricketts (FCO).

Yours ever,
Ruth

RUTH THOMPSON
Private Secretary

USA : Economic Situation Pt 2.

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET

CONFIDENTIAL

US file

US/Econ Sit

AT 11/7

PRIME MINISTER

FELDSTEIN'S PARTING SHOTS

Interview July 8, Washington Post

1. Understandably, Marty Feldstein's "forecasts" are not very different from those which he gave you in ~~March~~ April 27 (?) of this year. His explanation of the speed of GNP growth over the last two quarters is, I think, correct. Inventory accumulation has accounted for much of the bounce back. However, for this reason I would argue that the recovery is likely to peter out and slide into a decline certainly by 1985. Feldstein is more optimistic - perhaps for good political reasons.

2. The remarkable feature is what he did not say. Not a word about the high dollar, protectionism, the current account deficit, the state of the balance sheets of US banks, debt repudiation, etc. I was surprised he did not say that the federal deficit is crowding out US export industries and enabling imports to erode the advantage of domestic producers.

3. As we feared a year or more ago, interest rates are rising quite sharply - and over the last six months most of the forecasters have reversed their previous expectations of lower interest rates and the general feeling is that prime may go up another two percentage points before the end of the year. (That is predicated on the recovery continuing but rather more slowly than the first half of 1984.)

4. How long can this awful trinity of high deficit, dollar and interest rates continue? No-one has any good basis for making a judgement. [The demand for dollars, fuelled by the debt crisis and the collapse of confidence in many countries and corporations, has burgeoned with interest rate differentials.] My guess continues to be that the break is more likely to come in the next six months than in 1985 - but I cannot demonstrate that my guess is more plausible than others.

5. I suspect that events will take the form of an outbreak of inflation and a collapse of the dollar. But other scenarios are not easily dismissed; for example the break might take the form of a debt repudiation (by Peru, Bolivia, for example) and more bank liquidity runs - leading to even higher interest rates, and, through the decline of interest-sensitive investment such as housing, a sharp inflationary recession.

&. As always, the only sensible policy for the UK is to conduct our domestic policies consistent with the MTFS. Commodity prices are still falling, even in terms of sterling in the month of June. We cannot insulate ourselves completely, as the increase of base rates on Friday testified, but we must persuade the markets (and I think they are tentatively so persuaded) that we shall not defend sterling against either an appreciation of a depreciation of the US dollar. Domestic financial stability is our overriding goal.

AW

ALAN WALTERS
9 July 1984

The Washington Post BUSINESS & FINANCE

Sunday, July 8, 1984

Q&A
Martin S. Feldstein

Martin Feldstein will leave Washington this week after two sometimes stormy years as chairman of the president's Council of Economic Advisers. He looks back on his tenure in an interview with staff writer John M. Berry.

Q: On several occasions, White House and Treasury officials have made very unflattering remarks about your forecasts and your analyses. Last year some of them rejected your analysis of the economic situation both for political and economic reasons. You have had substantial public disagreements with the secretary of the Treasury, or he with you.

Given those experiences, as you go away from office, what are your thoughts personally about your two years here and more broadly about the role of the chairman of the Council of Economic Advisers?

A: Well, let me start with the simplest question, and that is how do I go away thinking about the experience as a personal thing. In a word, positively, despite those distractions, which are kind of a sideshow to the real substance of the job. I think it's a position which any economist who has broad interests in economic policy and has the opportunity to serve in should do. It is a chance to practice economics in a way that you cannot in any other position in the world, and to learn a lot in the process.

So I have no regrets . . . . I felt very confident about my own view—not about forecasts, that's really irrelevant. Officials at Treasury and the White House knew all along that that forecast of a 4 percent real growth last year was part of a forecast that showed 4 percent for five years, an above-average growth rate for the five years. They tried to discredit the forecasting process as part of a political, internal power struggle.

The process of making anonymous statements to the press is a form of not very subtle attempts at intimidation and trying to get you to change your position. I can't see any reason to succumb to that kind of intimidation.

Q: During these controversies, most of which centered on the question of whether one should turn to tax increases if necessary to try to reduce budget deficits, did the president at any time ever suggest to you, think what you want to think but don't continue to think it in public?

A: No. And I think that's very important, because behind a lot of backbiting and personalities there really have been some fundamental differences in policies. There are clearly people on the Treasury staff who are firmly committed to the view that no tax increase is ever justifiable under any economic circumstances. And starting with a strong ideological position that leads them to that conclusion, they opposed the attempt to raise revenue in 1982 before I got here, they opposed a contingency tax in 1983 and they opposed the idea of added revenue in the compromise package this year.

There are also political people in the White House who claim that substantively they believe we need more tax revenue but that it's the wrong time. And you discover that it's always the wrong time to raise revenues. They were reluctant to accept the contingency tax idea, they were firmly opposed on having anything in the '84 deficit reduction down payment as the wrong thing to do in an election year.

> **"So I have no regrets . . . I felt very confident about my own view."**

By Ray Lustig—The Washington Post

Obviously, to the extent that they can discredit the economic arguments about the importance of doing something, last year, this year, that would help them deal with this as a purely political matter.

Now the interesting thing and, to me, the important thing . . . is that that was not the president's position. It was not the president's position last year, and it was not the president's position this year.

Last year the president supported a contingency tax. White House officials, Treasury officials were quick to announce that it was dead and that there was no point in pursuing it. I think they did him a disservice, and that, if it had been pursued and negotiated, we could have had that in 1983, it would have removed the deficit issue from the election and it also would have put the economy on a sounder economic basis for 1985 and beyond.

But that was not their judgment, and they tried to undermine it. When it came to this year, they also tried to block any serious talk about a budget strategy that would actually lead to an active deficit reduction in 1984. But it was the president again who said no; he was prepared to go along with it—the Blair House negotiations—with the clear understanding that that was a package that involved early reductions in defense spending and significant additional tax revenue, with the proviso that it did not lead to higher tax rates.

We saw the controversy in a different area within the last few months, where the same White House officials who were attacking my position on the budget deficits attacked the position on monetary policy that I've held and that they have held. They were very critical about the Fed, arguing that Fed policy is too tight—[measuring it by a weekly money supply figure] if it happened to be low that week—and that it was likely to halt the recovery. The president put an end to that within about three days . . . .

But at no time have I felt that the policy that I was advocating was at variance from administration policy or from the president's own position . . . . The main thing that I was accused of by some of the White House political people during 1983 was supporting the president on the budget proposals more aggressively than they would.

Q: Do you have anything in mind, any way of improving the policy process?

A: I don't think so. The process works well in the sense that the president has heard the different points of view. He gets to make the decisions on all the issues where there are serious disagreements among his senior Cabinet-level officials.

I don't know what can be done to avoid the debates about how the economy operates. I felt those debates were counterproductive before I came here, not the debates so much as statements . . . debates about whether tax cuts could be self-financing. Debates about whether savings could rise so much that the deficits would have no effect on interest rates, I think have been counterproductive in the sense that they have frightened financial markets, made interest rates higher than they otherwise

See FELDSTEIN, G2

MTV Hoping Its Stock Will Be 'Thriller' for Investors

VSL

10 DOWNING STREET

From the Private Secretary 28 June 1984

Thank you for sending the aide memoire setting out the position on the tax reform measures currently before Congress as they relate to imported cars.

I will pass this to other Government departments for further consideration.

ANDREW TURNBULL

Mr. Timothy E. Deal

dl vsz

10 DOWNING STREET

From the Private Secretary 28 June 1984

US Tax Treatment of Imported Cars

In the margins of the Prime Minister's bilateral with President Reagan on 5 June, an aide memoire prepared by your Department on the tax treatment of imported cars was handed to White House officals. Mr. Timothy Deal of the US Embassy has transmitted the attached aide memoire in response. I have sent him a holding reply.

I would be grateful if you could examine the note to see whether any further action needs to be taken.

I am copying this letter to David Peretz (HM Treasury) and Peter Ricketts (FCO).

(ANDREW TURNBULL)

Miss Ruth Thompson,
Department of Trade and Industry.

AIDE MEMOIRE

The position of Her Majesty's Government on a possible tax on luxury automobiles contained in the Aide Memoire of June 5, 1984, which was handed to United States officials in London, has been conveyed to appropriate officials in Washington.

The United States Administration has, of course, been following closely the negotiation in the House-Senate conference on tax reform measures, including the provisions to limit overstatement of tax deductions for cars used for business purposes. As Her Majesty's Government is aware, the Administration opposed the proposals to set specific caps on the value of a car which could be claimed for tax credits or depreciation, and worked instead for stricter reporting and substantiation requirements as well as a percentage business use threshold before

Embassy of the United States of America,

London, June 26, 1984.

accelerated depreciation and tax credits are available. In the process, the Administration pointed out the concern expressed particularly by the Governments of Great Britain and West Germany over the impact such a value cap would have on imported vehicles.

On June 18, the Congressional conferees reached a compromise agreement on revised provisions governing use of luxury vehicles for business purposes. They abandoned the cap approach and provided instead that taxpayers may recover the cost of an automobile at the rate of six thousand dollars per year (four thousand dollars the first year). In addition, the conferees generally limited the investment tax credit available for automobiles to one thousand dollars. The conferees also agreed on other provisions, including a business use threshold.

It is unlikely that these provisions will undergo further change in conference. However, we would underline that these new depreciation rules for automobiles are not discriminatory in relation to imports, since they allow taxpayers to recover the full cost of any automobile used for business purposes. The Administration believes the attempt to tighten the provisions on the business deductibility of vehicles is an appropriate effort by the Congress to restrict what has been a seriously abused loophole in the existing tax code, an effort which is only a part of the process aimed at reducing the federal deficit.

bD

Mr Young
to see X and return
M AT 26/2

Mr Turnbull

AT - noted, with thanks. R.J. 26/6.

GRS 670
[CULL]
UNCLASSIFIED
FM WASHINGTON 252145Z JUN 84
TO PRIORITY FCO
TELEGRAM NUMBER 1974 OF 25 JUNE

US DEFICIT REDUCTION PACKAGE: TAX BILL

SUMMARY
1. THE HOUSE/SENATE CONFERENCE ON THE TAX BILL COMPLETED ITS WORK ON 23 JUNE AND AGREED ON A PACKAGE OF MEASURES TO REDUCE THE US BUDGET DEFICIT BY DLRS 61 BILLION OVER THREE YEARS. THE PACKAGE INCLUDES DLRS 11 BN IN SPENDING CUTS, MAINLY ON MEDICARE, AND MEDICAID, AND THE REMAINDER OF THE PACKAGE CONSISTS OF A NET INCREASE IN REVENUE FROM A LONG SERIES OF TAX CHANGES. WHILE THE AGREEMENT ON THE TAX BILL STILL NEEDS TO BE RATIFIED BY THE HOUSE OF REPRESENTATIVES AND THE SENATE, THIS IS EXPECTED TO BE A FORMALITY. THE DRLS 140 - DLRS 180 BILLION DEFICIT REDUCTION PACKAGE NOW NEEDS TO BE COMPLETED BY THE ACHIEVEMENT OF SAVINGS IN APPROPRIATED EXPENDITURE.

DETAIL
2. THE CONFERENCE OUTCOME ON THE MAIN TAX MEASURES AFFECTING THE UK WAS:
1) INSURANCE OR REINSURANCE PREMIUMS PAID TO UK INSURANCE COMPANIES IN RESPECT OF US RISKS WILL CONTINUE TO BE EXEMPT FROM FEDERAL EXCISE TAX.
2) THE CONFERENCE MODERATED THE PROVISIONS FOR WITHHOLDING TO ENFORCE THE FOREIGN INVESTMENT IN REAL PROPERTY TAX ACT FROM A WITHHOLDING RATE OF UP TO 28% TO ONE OF 10%, ALONG THE LINES OF A COMPROMISE THAT WAS PROPOSED BY THE FLORIDA BAR ASSOCIATION.
X
3) THE HOUSE AND SENATE PROVISIONS AFFECTING THE ALLOWABLE DEPRECIATION ON LUXURY CARS USED FOR BUSINESS PURPOSES WERE MODERATED SO THAT, INSTEAD OF A CEILING ON THE TOTAL AMOUNT OF DEPRECIATION ALLOWABLE, A CEILING HAS BEEN PLACED ONLY ON THE ANNUAL AMOUNT OF DEPRECIATION WITH NO LIMIT IMPOSED ON TOTAL DEPRECIATION. THE EFFECT OF THIS IS THAT THE MORE EXPENSIVE CARS HAVE TO BE DEPRECIATED OVER LONGER PERIODS THAN LESS EXPENSIVE ONES (SEE MY TELNO 1907 OF 19 JUNE). A LIMIT OF DOLLARS 1,000 WAS HOWEVER PLACED ON THE AMOUNT OF INVESTMENTS TAX CREDIT THAT IS PAYABLE.
4) THE CONFERENCE ALSO DECIDED TO RAISE THE EXCISE TAX ON LIQUOR BY ABOUT 35 CENTS A BOTTLE (FIFTH), WITH NO INCREASE ON WINE OR BEER. THIS WILL OBVIOUSLY ADVERSELY AFFECT UK SCOTCH WHISKY PRODUCERS ALONG WITH THE DOMESTIC MANUFACTURERS OF WHISKY. NO DISCRIMINATION IS INVOLVED AS TO THE NATIONALITY OF MANUFACTURERS TO WHOM THE TAX APPLIES.

/5) THE

5) THE CONFERENCE DECIDED ON THE ABOLITION OF THE WITHHOLDING TAX ON INTEREST PAID TO TO FOREIGNERS ON NEW ISSUES OF TREASURY AND CORPORATE BONDS. THIS ABOLITION EXTENDS TO ALL REGISTERED CORPORATE AND TREASURY BONDS, AND NOT SIMPLY TO SPECIAL ISSUES AIMED AT FOREIGNERS, AND WILL TAKE EFFECT IMMEDIATELY AFTER THE LEGISLATION IS SIGNED INTO LAW. WITHHOLDING WILL BE RETAINED FOR BEARER BONDS.

3. OTHER IMPORTANT DECISIONS TO EMERGE FROM CONFERENCE WERE THAT IT REFUSED TO ENDORSE LEGISLATION INTRODUCING ENTERPRISE ZONES, EVEN THOUGH SUCH LEGISLATION WAS SUPPORTED BY THE ADMINISTRATION. IT ALSO DECIDED TO LIMIT THE AMOUNT OF TAX-EXEMPT INDUSTRIAL DEVELOPMENT BONDS (IDBS) WHICH A STATE CAN ISSUE TO DLRS 150 PER STATE RESIDENT OR DLRS 200 MILLION PER STATE PER YEAR, WHICHEVER IS THE HIGHER.

4. WHILE THE CONFERENCE REPORT HAS TO BE APPROVED ON THE FLOOR OF THE HOUSE AND THE SENATE, IT IS UNLIKELY THAT THERE WILL BE ANY SUPPORT FOR RE-OPENING A CAREFULLY NEGOTIATED COMPROMISE. THE INCREASES IN REVENUE THAT HAVE BEEN SECURED BY THE TAX INCREASES HAVE BEEN VERY HARD WON, AND THE MISCELLANEOUS LEGISLATION THAT WAS CONSIDERED BY THE CONFERENCE COVERED OVER 1,000 PAGES. IT IS UNKNOWN WHETHER THE PRESIDENT WILL SIGN THE TAX LEGISLATION AFTER IT IS APPROVED ON THE FLOOR OF EACH HOUSE, OR WHETHER HE WILL WAIT UNTIL THERE IS AGREEMENT ON THE COMPLETE DOWN PAYMENT PACKAGE OF DLRS 140 - DLRS 180 BN BEFORE SIGNING THE TAX LEGISLATION INTO LAW.

5. TEXT OF CONFERENCE REPORT WILL FOLLOW BY BAG WHEN AVAILABLE.

6. FCO PLEASE PASS TO BOTTRILL AND R I G ALLEN (TREASURY), SPENCE AND GRAY (INLAND REVENUE), OLDHAM HILTON AND BESTON (DTI) HOLLIS (MAFF) SNOXELL (ERD) AND GREEN (BANK).

WRIGHT

(ADVANCED AS REQUESTED)

FINANCIAL
ERD
NAD

COPIES TO:
ADVANCE ADDRESSEES.

US file

The Atlanta Journal and Constitution
June 10, 1984

Nick
Poulos

Briton offers U.S. deficit prescription

Alan Arthur Walters, who for three years served as personal economic adviser to British Prime Minister Margaret Thatcher, almost cancelled out on a long-standing commitment to speak to Atlanta business leaders last week.

The British economist explained at a dinner sponsored by the Federal Reserve Bank of Atlanta last Thursday that he thought he might be obliged to attend the economic summit conference which opened the same day in London.

"As it turned out, my presence was not required," he said dryly. "Besides, I've always wanted to see where Sherman marched."

Walters, currently a resident scholar at the American Enterprise Institute in Washington, acknowledged that he was the economist who persuaded Mrs. Thatcher to adopt the unconventional measures to right the falling British economy back in 1981.

"With unemployment rising to new peak rates and output falling, the conventional economic wisdom was to expand the fiscal deficit, which was already very large," he said.

"My advice to the prime minister was to do the very opposite: reduce the deficit sharply and massively by cutting back government spending as much as possible and raising taxes.

Great moral courage

"It took great moral courage for the prime minister to adopt such a program. Most economists asserted that such a policy would prove disastrous; that the British economy would descend into a 'black hole.' "

Walters recalled that the economic community was so outraged by the proposed economic program that 365 leading economists signed a letter of protest which was published in an ad in the Financial Times.

"But economists had fallen into such disrepute in England that their outcry was taken as affirmation that the government probably was on the right track," said Walters.

"You know, bankers are very reluctant to write down the assets in their portfolios when loans go awry. Like bankers, economists are very reluctant to depreciate their intellectual capital notwithstanding the fact it has become completely worthless."

At any rate, said Walters, the program worked; the economy turned around, and the British recovery is now in its fourth year.

Walters asserted that public confidence is the most important element of economic policy.

Keynes recognized it

"Keynes (British economist John Maynard Keynes) recognized that a long time ago," Walters said. "But he noted that economists didn't pay much attention to it because they couldn't quantify it.

Walters went on to explain that continuing high budget deficits upset the markets, creating all kinds of problems for the economy. That's the effect of a lack of confidence, he said.

Walters said he would prescribe the same medicine for the U.S. economy as Mrs. Thatcher did for the British economy.

Walters said congressional action to reduce the U.S. budget deficit with a "down payment" is quite inadequate to revive market confidence.

"I recognize it is terribly difficult to reduce spending, so the only alternative is to raise taxes sufficiently to greatly reduce the deficit," he said. "It's got to be done sooner or later, and it's better to do it right away to restore confidence in the markets."

Asked about economist Milton Friedman's argument that it does no good to raise taxes because Congress will simply spend more money, Walters replied:

"That wouldn't and didn't happen in Britain, but if that did happen here, then there wouldn't be any point in raising taxes. It would simply be a treadmill. But I don't know whether the Congress would, as Milton Friedman suggests, spend the additional revenue."

Nick Poulos is business editor of The Atlanta Constitution and The Atlanta Journal.

CONFIDENTIAL

US file

NOTE OF A DISCUSSION IN NO 11 DOWNING STREET AT 4.15PM ON THURSDAY 7 JUNE 1984 BETWEEN THE CHANCELLOR AND MR TAKESHITA, FINANCE MINISTER OF JAPAN

Unitary Tax

After an initial exchange of courtesies, the Chancellor asked Mr Takeshita what line he would be taking on unitary tax in the forthcoming discussions between Finance Ministers. Mr Takeshita said that he thought the "waters-edge" solution proposed by the US Working Group seemed sensible, but added that there were some important details, that were now under discussion between the Japanese and US in Washington, about which he was worried. The Chancellor said he felt it important not to divert the US attention from getting the report of the Working Group signed and implemented. The UK view was that it would be possible to live with the "waters-edge" solution, subject to certain minor changes which could be made; but that seeking to make major changes ran the risk of deadlock and inaction.

US Deficit

2. Mr Takeshita asked whether it was right to focus too much on the US deficit at the forthcoming meetings. In reply the Chancellor said that he agreed it was wrong to take too agressive a tone; or to insist on the linkage between interest rates and the deficit (even though there clearly was one). But the US deficit clearly had to be on the agenda: to ignore it altogether could be bad for markets and confidence, and in any case the US would expect the point to be pressed.

3. Mr Takeshita said he fully shared these views.

CONFIDENTIAL

International Debt

4. The Chancellor and Mr Takeshita agreed that their views and approach were basically very similar.

Japanese Capital Markets

5. Mr Takeshita stressed that although the recent Japanese moves had resulted from bilateral Japan/US discussions, the results were multi-lateral. He also accepted that further follow-up action was needed in Japan.

6. The Chancellor welcomed what had been done as an important first step; he stressed that UK financial firms would be interested in opening up in Japan. He suggested it would be useful for the Bank of England to have talks with the Japanese authorities about this. [Mr Takeshita did not respond]

IDA Supplementary

7. Mr Takeshita said that the Japanese position was that, while the Diet was generally very understanding on participation in multi-lateral agencies, it would be impossible to get ratification of Japanese participation without that of the US.

D L C PERETZ
11 June 1984

Circulated to:

PS/CST	Mr Lavelle
PS/FST	Mr R Allen
PS/EST	PS/IR
Sir P Middleton	Mr Spence (IR)
Mr Littler	Mr Appleyard (FCO)
Mr Unwin	Mr Turnbull (No 10)

cc MASTER

1

SUBJECT FILED ON: USA: Visit of Pres. Reagan A3

10 DOWNING STREET

From the Private Secretary

5 June 1984

Dear Peter,

Talks with the President of the United States

The Prime Minister had a tête-à-tête conversation with President Reagan this evening from 1810-1915 hours. No notetakers were present. The Prime Minister gave me a general account of the conversation afterwards.

With regard to the Economic Summit, Mrs. Thatcher said that she was determined not to countenance an attack on American economic policy. But it would clearly be necessary to consider the sustainability of recovery and the problem of the present level of interest rates - and in this context the US deficit was significant. The Prime Minister also discussed with the President the general approach which the Summit might adopt to the problem of international debt.

No mention was made in this conversation of the handling by the Summit of the question of terrorism or of the UK environment initiative.

The Prime Minister decided not to discuss with the President the US proposals for amendments to the draft Declaration on Democratic Values (Sir Robert Armstrong's minute of 5 June). But I was able to discuss this matter with various members of the President's party and I have minuted separately to Sir Robert Armstrong on this point.

The Prime Minister discussed East/West relations with the President in general terms. She emphasised that we took a global view of East/West relations and were not limited in our thinking to the problems presented for Europe by the current state of the relationship. Mrs. Thatcher's general impression was that the US Government was rather at a loss as to how to proceed in the field of East/West relations.

There was some discussion of the situation in the Gulf

/and

and in particular of the new development today involving the shooting down of an Iranian aircraft by the Saudis over their own territorial waters. Mr. Shultz told the Prime Minister later that, contrary to some reports, it appeared that there had been no attack on a vessel in Saudi waters but that an Iranian aircraft which had entered the area had simply been shot down.

The Prime Minister told President Reagan that we had decided to maintain the British garrison in Belize for at least two years unless circumstances changed (and I rather believe that the Prime Minister conveyed the impression that the effect of this decision was that the garrison would remain indefinitely unless there was a radical change in the situation). She emphasised that we did not intend to make this decision public. It was an example of our commitment to the US policy of promoting stability in Central America. The President expressed gratitude for this decision. On Central America more generally, the Prime Minister emphasised that we appreciated the global significance of US efforts in the area.

The Middle East was also discussed. The Prime Minister said that she was anxious that, following the US elections, there should be a new American initiative in the area. President Reagan said that this was his intention - and confirmed, in answer to the Prime Minister's question that she could so inform King Hussein. The prospect of the West Bank being included in a confederation with Jordan was also discussed. President Reagan apparently said that if Arafat would recognise Israel's right to exist the situation would be much easier. The Prime Minister gave it as her view that Arafat's present situation was difficult.

With regard to the President's visit to Ireland, the Prime Minister thanked him for his public references to the evils of terrorism and the US policy of non-intervention in the problem of Northern Ireland.

There was little time to raise bilateral trade problems. However, the Prime Minister mentioned the question of luxury cars and said that we would be handing a paper to the President's party. I gave to Mr. Sommer of the National Security Council a copy of the aide memoire enclosed with Ruth Thompson's letter of 4 June to Andrew Turnbull and I attach a copy of this for ease of reference. I also discussed the problem in general terms with Mr. Sommer and Mr. Baker.

The Prime Minister also told the President, with regard to the Laker case, that we could not accept that US law should be unilaterally applied to matters which should properly be dealt with in the US/UK Bilateral Aviation

/Agreement

Agreement and that we much hoped that officials would be able to find a workable solution soon.

I am copying this letter and enclosure to David Peretz (HM Treasury), Richard Mottram (Ministry of Defence), John Lyon (Northern Ireland Office), Callum McCarthy (Department of Trade and Industry) and Richard Hatfield (Cabinet Office). The contents of the letter should be closely protected.

Yours ever

John Coles.

Peter Ricketts Esq
Foreign and Commonwealth Office.

MFJAAV

MF J

bc N.O.

10 DOWNING STREET

From the Private Secretary

4 June 1984

Dear Ruth,

US Proposal to Limit Tax Benefits on Company Cars

The Prime Minister has seen your letter to me of 1 June. She agrees that she should register her concern over this issue with the President but doubts whether, in the time available, it will be possible to raise this orally at the bilateral. She has agreed, however, that if a suitable note is prepared, it could be handed to the President's staff. I would be grateful if you could send us the text of such a note. The letters to Sir Austin Bide and Mr. Plastow have been sent, more or less as drafted by your Department.

I am copying this letter to David Peretz (HM Treasury) and Peter Ricketts (Foreign and Commonwealth Office).

Yours sincerely

Andrew Turnbull

Andrew Turnbull

Miss Ruth Thompson
Department of Trade and Industry.

MFJAAN

JR

original
cc. L.E.S.
ECON. POL. Pt 16.

DEPARTMENT ... STREET
1-19 VICTORIA STREET
LONDON SW1H 0ET

Telephone (Direct dialling) 01-215) 5422
GTN 215)
(Switchboard) 215 7877

JF6630

Secretary of State for Trade and Industry

4 June 1984

G/2.
Please type note + 2 and return to me.
AT 4/6.

Andrew Turnbull Esq
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1

Dear Andrew

US PROPOSALS TO LIMIT TAX BENEFITS ON LUXURY CARS

... As requested in your letter of 4 June, I enclose a note which might be handed over to one of the White House staff in the margins of tomorrow's bilateral discussions with President Reagan on the above subject.

2 I am sending a copy of this letter and enclosure to Peter Ricketts at the Foreign Office and David Peretz at the Treasury.

Yours ever,

Ruth

RUTH THOMPSON
Private Secretary

Encl

AIDE MEMOIRE

HMG are greatly concerned at legislative proposals now before Congress to limit the tax benefits on passenger cars used for business. The provisions of a bill adopted by the House of Representatives would set the limit at $21,000; under a similar bill adopted by the Senate the limit would be set at $15,000.

Whether or not these provisions are protectionist in intent, it is quite certain that they would be discriminatory in effect. Almost all cars costing over $21,000 are imported. Most such cars are exported to the United States from the United Kingdom and the FRG. Even the lower limit of $15,000 exceeds the average retail price of a US car. It follows that, in either case, the potential loss of tax benefits would bear more heavily upon imported cars.

HMG understand that the US Treasury Department has opposed the provisions on grounds of tax policy, preferring stricter rules for personal use of business assets generally, which, in addition, would be free of objection on grounds of discrimination.

HMG would welcome advice on the steps which the US Administration proposes to take to secure amendments to the bills to remove their discriminatory provisions.

File

8A

cc: DTI
FCO
HMT

10 DOWNING STREET

THE PRIME MINISTER

4 June, 1984

Dear Mr. Plastow,

Thank you for your letter of 23 May about the effect that tax proposals now before the US Congress could have upon sales of Rolls Royce cars in the United States. I can well understand your concern.

We must of course be cautious in making representations to other Governments about matters of domestic taxation; and limits on tax benefits allowable on company cars are not exclusive to the USA. But we have every right to express objection to taxation proposals which would clearly discriminate against imported vehicles.

Both Norman Tebbit and Paul Channon have raised the issue with the US Administration in recent weeks; and we have of course supported other representations by the European Community. I hope, also, to have an opportunity to express these concerns during the London Summit next week.

Yours sincerely

Margaret Thatcher

D.A.S. Plastow, Esq.

84

FCE

DA

cc: DTI
FCO
HMT

10 DOWNING STREET

THE PRIME MINISTER

4 June, 1984

Dear Sir Austin

Thank you for your letter of 24 May.

I well understand your concern about the impact the tax proposals now before Congress could have upon sales of Jaguar cars to the United States.

We must of course take care in making representations to other Governments about matters of domestic taxation; and limits on the tax benefits allowable on company cars are not exclusive to the USA. But there does seem to be at least a measure of protectionist feeling behind these proposals and we have every right to express objection to measures which would discriminate against imported vehicles.

The US Administration can have little doubt about HMG's views on the proposals. Both Norman Tebbit and Paul Channon have expressed our concern in recent weeks. I hope, also, to have an opportunity to reiterate this during the London Summit next week.

Yours sincerely

Margaret Thatcher

Sir Austin Bide

E.R.

1

PRIME MINISTER cc Mr. Owen

US Proposals to Limit Tax Benefits on Company Cars

Mr. Plastow (Rolls Royce) and Sir Austin Bide (BL/Jaguar) have both written urging you to intervene with President Reagan about the tax proposals now before the US Congress. In the attached letter from DTI it is recommended that you should not send a message but should raise the matter in bilateral discussions with the President next week. I suspect that this item, though important for the companies, may not come high enough in your priorities to be raised orally during the discussions. Furthermore, if there is no notetaker it is not clear how far raising it orally will produce the desired result.

An alternative, hinted at in the letter, is that your interest should be made known to White House staff by handing them a note and making it clear that we expect a reply.

There are good reasons for not being too heavy handed:

(i) This is not our highest priority in discussions with the US Administration and Congress on taxation. Both unitary taxation and the impact of Federal Excise Tax on insurance are more important.

(ii) We should be encouraging the US Administration to raise more revenue by cutting down on unnecessarily generous allowances. Our interest is to see that this is done in a way which is not discriminatory.

(iii) The taxation of car benefits as it relates to employees is similar in the US and the UK. The difference relates to the costs allowable to the company which are much more generous in the US.

/ Nevertheless,

Nevertheless, to keep faith with Jaguar and Rolls Royce we need to ensure that the legislation is not discriminatory.

Agree -

(i) that a note be handed to President Reagan's staff with a request for a reply? Yes mt

(ii) you write to Sir Austin Bide and Mr. Plastow as drafted?

AT

1 June 1984

CCNO

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
Telephone (Direct dialling) 01-215) 5422
GTN 215)
(Switchboard) 215 7877

Secretary of State for Trade and Industry

1 June 1984

Andrew Turnbull Esq
Private Secretary to the
Prime Minister
10 Downing Street
London SW1

Dear Andrew,

US PROPOSALS TO LIMIT TAX BENEFITS ON COMPANY CARS

Thank you for your letters of 24 and 29 May.

2 The letters from Mr Plastow (Rolls Royce) and Sir Austin Bide (BL/Jaguar) urge the Prime Minister to intervene with President Reagan about tax proposals now before the US Congress. The proposals, which form part of a 1600-page Deficit Reduction Bill, would put a ceiling on the tax benefits allowable on the purchase and use for business purposes of cars. The House of Representatives has proposed a ceiling of $21,000; the Senate a figure of $15,000. A compromise will be sought in a House/Senate Conference early in June.

3 Rolls Royce and Jaguar are concerned at the adverse impact that a ceiling - which effectively discriminates against imported luxury cars - could have upon their US sales. A ceiling of $21,000 would be particularly discriminatory since nine out of ten cars affected would be imports. Mercedes have been prominent in public lobbying against the proposals; and, earlier this month, Chancellor Kohl telephoned President Reagan on the issue.

4 For the UK, both my Secretary of State and the Minister for Trade have made representations at a high level in the US Administration. My Secretary of State put our point of view very clearly to Commerce Secretary Baldrige on 21 May. The European Community has expressed concern both to the US Administration and to members of Congress who are looking at the proposals, and we have associated ourselves with their representations.

5 The US Administration have made clear that they understand our concern and do not themselves favour the tax proposals. But the initiative now lies with Congress, and the influence of the Administration on the progress of the proposals is limited. There are also other bilateral issues (including at least one in the

JH3AJP

Deficit Reduction Bill itself) with the US where the implications for the UK could be even more serious. For these reasons, we would not recommend a formal message from the Prime Minister to President Reagan on the issue of tax benefits on luxury cars. In view of the importance of the matter to Rolls Royce and Jaguar, however, my Secretary of State believes the Prime Minister should seek an opportunity to raise the matter in bilateral discussions with the President during his visit to London next week. Suitable material has already been provided for inclusion in the bilateral briefing which the FCO is putting together. My Secretary of State has suggested that the Prime Minister should make sure the President's staff register her interest, and know that we expect an answer on the point.

6 Suggested replies to Mr Plastow and Sir Austin Bide accompany this letter.

7 I am copying this letter to David Peretz (HM Treasury) and Peter Ricketts (FCO). I understand that the Treasury will be advising separately on the current tax position in the UK and the US.

Yours ever,

Ruth

RUTH THOMPSON
Private Secretary

JH3AJP

6.63

NBPM AT CG ~~ASO~~ 4/6

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

1 June 1984

Andrew Turnbull Esq
10 Downing Street
LONDON
SW1

Dear Andrew,

US PROPOSALS TO LIMIT TAX BENEFITS ON COMPANY CARS

You sent David Peretz a copy of your letter of 24 May to Ruth Thompson at the Department of Trade and Industry.

I understand that the Secretary of State's Office will be letting you have information about the background to this issue and advice on how the Prime Minister might handle the matter in relation to President Reagan. We endorse any recommendation that the Prime Minister should not send a formal message to President Reagan but that, if she feels unable to raise the matter orally with the President, it should be brought to the attention of the White House staff.

I am attaching a note which outlines the present UK and American systems for taxing company cars and describes the proposals being put forward by Congress. The note brings out the fact that the American proposals would introduce into their system the sort of restrictions which are already found in our own. This is an added reason for the Prime Minister taking a relatively low-key approach.

I am copying this letter to Ruth Thompson (DTI) and Peter Ricketts (FCO).

Yours ever
Judith

MISS J C SIMPSON
Private Secretary

TAXATION OF BUSINESS CARS : DRAFT US LEGISLATION

Present US treatment of business cars

1. An American taxpayer acquiring a car for business use is entitled to the following tax deductions:

i. an investment tax credit (ie an investment incentive)

ii. annual depreciation allowances which write off the cost of the vehicle over 3 years

iii. relief for normal operating and maintenance costs.

2. The investment credit is 6 per cent of cost. If this is taken in full, the depreciation allowances are given on 97 per cent of the cost. But the taxpayer may elect a reduced investment credit of 4 per cent, in which case the depreciation allowances are given on the full 100 per cent of cost.

American proposals

3. In April, the Senate passed a Tax Bill containing a provision limiting the investment tax credit and the depreciation allowances to the first $15,000 of the vehicle's cost. The Bill also contained a provision under which relief is available only for cars (and boats and aircraft etc) which are used at least 90 per cent for business purposes.

4. The House of Representatives had earlier passed a Bill which would impose a similar limit, butof $21,000.

5. The proposals are said to derive partly from a wish to raise more revenue ($500 million over the next 3 years has been mentioned) and partly from a Democratic party objective of restricting the advantages of the better off.

6. The next stage in the legislative process is a House/Senate conference to produce a compromise version. This is presumably the Conference Committee referred to in paragraph 2 of the telex message annexed to Mr Plastow's letter.

UK treatment of business cars

7. In the UK, our capital allowances are the equivalent of their investment tax credits and depreciation allowances.

8. Even before the recent Budget, no first year capital allowances (ie investment incentive) were normally given on ordinary business cars. Only writing down allowances at 25 per cent of the reducing balance can be claimed. This applies to all used cars - at the bottom of the price range as well as the top.

9. We do, however, impose a limit on the amount of the capital allowances which can be given in any one year. In effect, annual allowances are not available in respect of the excess of cost over £8,000. An upper limit has existed since 1961. So we do discriminate against more expensive vehicles.

10. Moreover, if a car is blatently excessive in relation to its alleged use (eg a Bentley for a farm,) the Revenue can seek to limit still further the allowances, in accordance with normal tax principles, by arguing that part of the cost was a reflection of personal rather than business choice.

11. Where a car is used by a self-employed person for his personal transport as well as for business, a restriction in the allowances is normally made to reflect the non-business mileage.

12. The personal "benefit" that employees and directors earning £8,500 a year or more receive from the private use of cars provided by their employers or companies is taxable in their hands as part of used income.

Treatment elsewhere in Europe

13. We have no immediate knowledge of how Germany treats business cars for depreciation purposes, but in France only the first 3,500 Francs (about £3,000) qualifies for relief.

Assessment

14. On the taxation of the private benefit accruing to an employee from his use of a car provided by his employer, we and the Americans appear to take very much the same approach.

15. But the treatment of the costs of the car in the business accounts is rather different. The present US system of investment tax credits

and depreciation allowances is a lot more generous than ours in its treatment of business cars. There appears to be no limit to the deductions in respect of expensive cars. Nor does there appear to be any restriction to take account of either the element of personal choice or private mileage.

16. The current American proposals may have been inspired in part by an underlying element of protectionism - imported cars will be the most affected. But they appear to be of general application, and are moving in the direction of our own system - reflecting the view that expenditure on a luxury car reflects personal preference rather than business needs and that it is therefore appropriate to limit the tax relief available for the cost of such a vehicle. It is said that, of the 840,000 cars which would be affected if there were an upper limit of $15,000, only a few are US-built, and of the rest over 200,000 are German.

17. The UK motor industry has campaigned for a long time for a lifting of the restrictions here on relief. Whatever view Ministers might take on that issue in future years, the fact is that at the present time the UK is not in a position to argue against the American proposals, unless somehow they can be shown to discriminate directly against imported cars.

Inland Revenue
May 1984

E.R.

NBPM AT 1/6

1 June 1984

MR TURNBULL

US PROPOSALS ON COMPANY CARS

The DTI are right to recommend that representations be made on the US proposals to put a ceiling on the tax benefits on business cars.

Although we wish to see the US budget deficit reduced, and should not wish to intervene in the balance between expenditure reduction and tax increases, this particular measure is protectionist. As the DTI point out, 9 out of 10 cars affected would be imports.

The measure is especially damaging to Rolls Royce, and would also be adverse to Jaguar in the run-up to privatisation. It should be raised as a matter of urgency and importance in the bilateral discussions with the President.

JOHN REDWOOD

LATABE

File

DSS

10 DOWNING STREET

From the Private Secretary

29 May 1984

I enclose a copy of a letter to the Prime Minister from Sir Austin Bide, the subject matter of which is relevant to the letter from Mr. Plastow which Andrew Turnbull sent you on 24 May. I should be grateful for urgent advice on how you think this letter should be handled.

I am sending a copy of this letter and its enclosures to David Peretz (HM Treasury) and Peter Ricketts (Foreign and Commonwealth Office).

David Barclay

Miss Ruth Thompson
Department of Trade and Industry.

JR

File

085

10 DOWNING STREET

From the Private Secretary 29 May 1984

I am writing on behalf of the Prime Minister to thank you for your letter of 24 May.

I have placed your letter before her, and a reply will be sent to you as soon as possible.

David Barclay

Sir Austin Bide.

JP

file

24 May 1984

You will wish to know that the Prime Minister has received a letter from Mr. Plastow of Rolls Royce on the impact of European car exports of US legislation for the taxation of benefits in kind. This is receiving attention.

Andrew Turnbull

John Egan, Esq.

10 DOWNING STREET

2

Prime Minister

You should be aware of this problem. I am seeking advice on how you should reply

AT
24/5

MT

GR Acte / Reply asap

SNO

BL Public Limited Company
35-38 Portman Square
London W1H 0HQ
Telephone: 01-486 6000
Telex: 263654
Cables: Leymotors London W1 Telex

BY HAND

24th May 1984

Dear Prime Minister,

I feel that I must bring to your attention the legislation pending before the United States Congress which will limit the potential size of the United States luxury car market largely dominated by imports from the U.K. and Germany. My understanding is that critical moves are imminent.

We believe that we are now the leading exporter from the U.K. into the United States and perceive this legislation as protectionist against the U.K.; notwithstanding we are one of the United States most loyal trading partners.

We are mobilizing public opinion among United States owners and dealers who support our position and many are contacting their congressional representatives. We have communicated our views to the President's Special Trade representative, Ambassador Brock, as well as to Secretary Baldridge and the Administration appears to believe that approaches directly to President Regan would be appropriate and helpful.

I hear that Chancellor Kohl has telephoned the President expressing his concern in respect of Mercedes Benz and BMW.

I could hardly exaggerate the importance of this matter in relation to BL/Jaguar plans and I wonder if I can prevail upon you to intervene personally.

If I or my colleagues can assist with further information we shall be happy to do so.

My apologies for being a bother but I know you will understand my anxiety.

Sincerely
Austin Bide

Sir Austin Bide
Chairman

The Rt. Hon. Margaret Thatcher, MP,
The Prime Minister,
10 Downing Street,
London SW1

cc The Rt. Hon. Norman Tebbitt, MP
Mr. Norman Lamont, MP

Registered Office:
35-38 Portman Square, London W1H 0HQ
Registered in England No. 1213133.

CONFIDENTIAL

√6

cc Mr Young.

10 DOWNING STREET

From the Private Secretary

24 May 1984

US Legislation on Taxation of Car Benefits

I attach a letter from Mr. Plastow of Rolls Royce, with which Mr. Egan of Jaguar wishes to be associated. I would be grateful for early advice on how the Prime Minister should respond. Although President Reagan is arriving in London on 4 June, the letter suggests that any intervention from here would need to be before that. Although the letter suggests the Prime Minister should telephone President Reagan, you should consider the alternative of a message. If you believe this would be preferable, could you supply a draft.

I am copying this letter to David Peretz (HM Treasury) and Peter Ricketts (Foreign and Commonwealth Office).

Andrew Turnbull

Miss Ruth Thompson
Department of Trade and Industry

MFJAAH

CONFIDENTIAL

610

D.A.S. PLASTOW

VICKERS P.L.C.
VICKERS HOUSE,
MILLBANK TOWER,
MILLBANK,
LONDON, SW1P 4RA
TELEPHONE: 01-828 7777

The Rt. Hon. Mrs Margaret Thatcher,
The Prime Minister,
10, Downing Street,
London, S.W. 1.

23rd May, 1984.

Dear Prime Minister,

Attached is a copy of a telex from one of our tax attorneys in the United States, which is self-explanatory.

More than half the Rolls-Royce cars we manufacture are shipped to North America and we are faced with proposed U.S. tax legislation which would clearly discriminate against higher priced imported cars.

When I was in Washington ten days ago I explained to Ambassador Brock, the US Trade Representative, that whilst we accept readily the principle of taxing benefits in kind, we were strongly opposed to legislation which would have a severe impact only upon imported products. I also told him that there was evidence of the American domestic manufacturers supporting this legislation as a protectionist move.

In the case of Rolls-Royce Motors, if the legislation as proposed is enacted, the business would suffer losses and redundancies would have to be declared at our Crewe and London factories.

John Egan of Jaguar Cars joins me in hoping that you will be able to telephone President Reagan on this crucial issue.

Yours sincerely,

David Plastow

Registered in London under No. 3543 Registered Office: PO Box 177 Vickers House Millbank Tower Millbank London SW1P 4RA

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[illegible]ore Message 008   1325 Words Left

WU
27921 VICLON G

EASYLINK 244403A001 21MAY84 17:03/17:08 EST
PRIORITY MESSAGE
FROM: TLX 703729 MUDGEA UD
      MUDGE ROSE GUTHRIE ALEXANDER
TO: 85127921

TO: DAVID PLASTOW
    LONDON, ENGLAND

FROM:J. ROGER MENTZ

DATE:MAY 21, 1984

DEAR DAVID:

I AM PLEASED TO CONFIRM THAT I HAVE BEEN ADVISED BY OUR CLIENT, MERCEDES-BENZ, THAT CHANCELLOR KOHL OF WEST GERMANY PLACED A TELEPHONE CALL TO PRESIDENT REAGAN ON WEDNESDAY, MAY 16TH IN THE COURSE OF WHICH HE EXPRESSED THE CONCERN OF HIS GOVERNMENT ABOUT THE PENDING U.S. TAX LEGISLATION THAT WOULD LIMIT THE TAX BENEFITS FOR AUTOMOBILES USED IN BUSINESS TO A FLAT DOLLAR AMOUNT OF COST -- EITHER DOLLARS 15,000 OR DOLLARS 21,000. WE HAVE RECEIVED INDEPENDENT CONFIRMATION THAT THE CALL DID TAKE PLACE FROM THE SECRETARY OF THE U.S. CABINET. MR. KOHL DESCRIBED THE SEVERE ANTICIPATED IMPACT OF THE PROPOSED LEGISLATION ON GERMAN AUTOMOBILE EXPORTS (MERCEDES-BENZ, B.M.W., PORSCHE AND AUDI), AND REQUESTED THAT THE ADMINISTRATION MAKE AN EFFORT TO HAVE THIS PROVISION DELETED FROM THE LEGISLATION.

IT WOULD BE EXTREMELY HELPFUL IN MOTIVATING THE ADMINISTRATION IF PRIME MINISTER THATCHER WOULD PLACE A SIMILAR TELEPHONE CALL TO THE PRESIDENT. THE CONFERENCE COMMITTEE, WHICH WILL RESOLVE THIS ISSUE, WILL BE CONVENING ON MAY 23RD AND 24TH, BUT THIS ISSUE WILL PROBABLY NOT BE RESOLVED UNTIL AFTER THE CONGRESS RETURNS FROM ITS MEMORIAL DAY RECESS, WHICH WILL BE THE WEEK OF JUNE 4TH. THUS THE CALL SHOULD BE PLACED AS SOON AS POSSIBLE TO PERMIT THE ADMINISTRATION TIME TO COMMUNICATE INTERNALLY AND TO ESTABLISH ITS POSITION.

WARM REGARDS.

J. ROGER MENTZ

MMMM

WU
27921 VICLON G

6

10 DOWNING STREET

From the Private Secretary

24 May 1984

I am writing on behalf of the Prime Minister to thank you for your letter of 23 May with which you enclosed a copy of a telex from Mr. J. Roger Mentz.

Your letter is receiving attention and a reply will be sent to you as soon as possible.

Andrew Turnbull

D.A.S. Plastow, Esq.

6

10 DOWNING STREET

From the Private Secretary

24 May 1984

The Prime Minister has received a letter from Mr. Plastow of Rolls Royce and this is receiving attention.

Andrew Turnbull

John Egan, Esq.

10 DOWNING STREET

From the Private Secretary

Prime Minister

Kit McMahon phoned to say that the reaction to the Continental Illinois rescue had been better than expected. There was no detectable reaction in the foreign exchange markets where the Gulf was the dominant factor. Nor were there signs yet of any contraction in the inter bank market, though a more cautious attitude to deposits is to be expected. Our clearers have been asked to behave "responsibly".

Kit McMahon's view is so far so good but problems with other banks may yet emerge.

AT

18/5

10 DOWNING STREET

Prime Minister

We understand the Continental Illinois is likely to be after the close of banking business, but this could often be close on the West Coast i.e. 1 a.m. UK time. I have arranged for a message to be sent here first thing tomorrow morning.

AT
15/5

Prime Minister (2)
To be aware of these developments
AT 10/5

CC/B1

FROM: J.G.LITTLER
DATE: 10 MAY, 1984

CHANCELLOR

cc Economic Secretary
Sir Peter Middleton
Sir Terence Burns
Mr.Unwin
Mr.Battishill
Mr.Lavelle
Mr.Mountfield
Mr.Bottrill
Mr.Kelly

NEW YORK MEETING OF BANKERS

There has been a good deal of (mainly misleading) publicity of a meeting held during the last few days by the New York FED, which was attended by a number of central bank representatives (including the Deputy Governor, Mr.Loehnis and Mr. Cooke from the Bank of England), by representatives of a couple of major United States commercial banks and, for part of the time, by the IMF Managing Director and an IBRD representative.

2. Mr.Loehnis has promised me a fuller account by tomorrow, but has given me orally the following summary.

3. From the outset the meeting was designed, and was carried through, on the basis of general talk about current problems, and not on the basis of seeking early decisions. No Finance Ministry representatives were involved, and the meeting was not discussing ways of bringing in Government support.

4. Discussion focussed heavily on problems of management of the maturities and interest costs of commercial debt. Two ideas or families of ideas were particularly favoured:-

(a) Rescheduling: there was a broad measure of agreement that very short-term rescheduling could not go on and that efforts should be made to induce commercial banks to think in terms of multi-year rescheduling to achieve better overall maturity profiles.

(b) Interest rates: everybody was expressing concern about already high, and possibly even higher dollar interest rates, and there was a widespread disposition to look for ways of "capping". Outright capitalisation of interest was unpopular, but there was much discussion of varieties of schemes to defer some "top slice" or "excess element" - however defined - in the total nominal interest rate. One idea which attracted a good deal of interest was something akin to the British mortgage arrangements under which standard payments are made by the debtor, with the proportion of capital and interest varying in response to interest rate changes.

5. No specific follow-up action has been agreed. The participants will continue to think over these ideas, and individual central banks are likely to discuss them with their own commercial banks. Mr. Loehnis believes - and thinks that others take the same view - that what is needed is an initiative arising from the commercial banks themselves. But encouragement may be needed from central banks and - as we have seen elsewhere - American supervision requirements have a rigidity which could stand in the way of some sensible ideas and action on the part of the US authorities on this front might be needed.

6. On the face of it, I think this sounds to have been a sensible discussion. I had the opportunity of a talk yesterday with Sir Alan Walters to go over some possibilities in this field. We agreed that moves by commercial banks themselves to limit or ease the burdens of excessively high interest rates could be welcomed (a step on the road to recognition by the banks that they cannot go on expecting full value on all parts of their balance-sheets). But he agreed strongly with my view that we should resist any proposals by commercial banks to seek compensation or guarantees from central banks, governments, or international institutions.

7. In view of the publicity which the meeting aroused, it is possible ...... you might face a question in Parliament this afternoon. I attach a short note.

(J.G.LITTLER)

Q. Recent meeting of bankers in New York.

A. Understand this was a private meeting of bankers, mainly central bank representatives, to exchange ideas about international commercial debt problems.

I welcome such discussions, which understandably focussed on the unwelcome impact on these problems of rising dollar interest rates.

Notes for Supplementaries

1. Governments were not represented at the meeting.

2. Governments are playing a full part in tackling the management of international debt problems - through the International Monetary Fund and through rescheduling of official and officially-guaranteed debt.

3. I see no case for Government financial support to relieve commercial banking debt.

U S file

Fact and Comment II

By M.S. Forbes Jr., Deputy Editor-in-Chief

THE NEW ECONOMIC MIRACLE?

LONDON—No one could have conceived of this question a few years ago: Is Britain becoming the economic powerhouse of Western Europe, if not of the industrial world?

Last year the United Kingdom's growth rate exceeded everyone else's. When adjustments and revisions are made, Britain will have outperformed not only our European partners, but the U.S. and Japan as well. Since the late 1970s, Britain's income per capita growth has topped the industrial rankings. Productivity has grown phenomenally. Inflation remains low. New business starts are at a record.

The brilliant new Chancellor of the Exchequer, Nigel Lawson, could, with a bit of courage and imagination, become the 20th-century Gladstone. His first budget was bold, at least by British standards. Recognizing the importance of services, he is phasing out the overly generous incentives to buy new plant and equipment, and instead is cutting the corporate income tax from 52% to 35% over a four-year period. He removed a 15% surcharge on investment income, reduced capital transfer taxes and eliminated a payroll tax surcharge, which was a job destroyer.

The reaction to the Chancellor's budget: The stock market boomed and interest rates fell. For the first time in decades, long-term U.K. interest rates in 1983 fell below those of the U.S. The gap is widening in 1984.

Not that all is milk and honey. Unemployment remains appallingly high (over 12%), though it is better than that of most Western European countries. Britain's performance is relative. Fifteen years ago the U.K.'s current growth rate would have been regarded as pitiful. Thanks to the recession, government spending as a percentage of GNP has grown sharply. Many government bureaucracies, especially health services, remain bloated.

Much remains to be done. Nigel Lawson must make the major moves. He should significantly reduce the rates of Britain's personal income tax, which are far too high. The capital gains tax, currently 30%, must also be cut substantially.

With changes like that, Britain's performance will truly be outstanding.

THERE'S A WAY

for the U.S. to save several billion dollars a year in servicing the national debt. Current outlays for interest now come to more than $120 billion a year. The method: indexing government bonds, both for principal and interest.

The British under Mrs. Thatcher have done this for three years, and the system has worked well. Most new government bonds issued in the sceptered isle are indexed.

Historically, the "real" interest rate on government debt has been 2 1/2% to 4%. Thanks to investor uncertainty about inflation, real long-term interest rates are abnormally high, both here and in the U.K.

For instance, though inflation is rising at a 3%-to-5% rate (depending upon which measure one uses), the U.S. Treasury's new 20-year bond issue has a coupon of 12⅜%.

These high rates cost Washington plenty. Wouldn't it be nice if the interest coupon could be, say, 3%? In Britain, that's what the government pays on new bond issues.

With indexing, investors know their income and principal are protected. They don't need a stiff premium in interest rates to cover fears about inflation. (In the U.K. the extra income is taxed; the additional principal is not).

Even though the bond's principal is indexed to keep up with deflation, the government could save a bundle if it holds inflation down. Alan Walters, formerly Prime Minister Thatcher's economic adviser and now a professor of economics at Johns Hopkins University, points out in a paper for the American Free Enterprise Institute that a five-year indexed debt instrument could save the government more than $200 in overall outlays for each $1,000 bond. Longer term, the savings could be even greater.

The arguments against indexing government bonds—such as hurting the market for securities from the private sector—have been refuted by Britain's experience.

The U.K. has shown the way on this. Too bad we don't have a Treasury Secretary strong enough to do the same thing on this side of the Atlantic.

US file

AT to see

SAVING TELEGRAM

BY BAG [CULL]

FROM WASHINGTON

TO FCO TELEGRAM No.11 SAVING OF 25 APRIL 1984

OUTLOOK FOR THE US BUDGET DEFICIT: CHIEF SECRETARY'S VISIT TO WASHINGTON

Summary

1. During his visit to Washington on 17-18 April, the Chief Secretary had discussions with US officials about the prospects for reductions in the US budget deficit. The consensus was that this year's deficit reduction package, aimed at saving $150 bn over three years, would pass through the Congress but that the Administration would still face the prospect of $175-$200 bn deficits after the November elections. The outlook for further deficit-cutting measures in 1985 depended on the outcome of the elections, but the most likely source of savings was some reduction in the planned growth of defence expenditure. The prospects for radically increasing taxes or substantially reducing entitlement expenditure would probably continue to be difficult, or at best uncertain, in 1985.

Detail

2. On 17-18 April Mr Rees had a number of discussions with US officials about various aspects of the Federal budget during calls on Stockman (Director, Office of Management and Budget), Sprinkel (Under Secretary for Monetary Affairs at the US Treasury), Davis (Administrator of Health Programmes at HHS), Devine (Director, Office of Personnel Management), Chapoton (Assistant Secretary for Tax Policy, US Treasury), Penner (Director, Congressional Budget Office) and Bowsher (Comptroller General).

3. Stockman frankly stated that, even if this year's deficit reduction package of $150 bn in savings over three years were fully implemented, a re-elected Administration would still be faced with $200 bn deficits running throughout the next five years. The main reason for this pessimistic view was that the Administration's official forecasts had almost certainly under-estimated the average level of interest rates, and over-estimated GNP growth, over the five-year budget period. While Penner believed that the successful enactment of the deficit reduction package would have a major psychological impact on attitudes in the Congress, and would save a considerable amount of debt interest, he too saw deficits staying in the $175-$200 bn range even after its passage.

4. All the Chief Secretary's interlocutors agreed that it was probable that the deficit reduction package would be passed, although most pointed out that there was a sizeable gap to be bridged between the Democratic House and the Republican Senate on the desirable rate of growth of defence spending. The most

/plausible

plausible explanation for the apparent cooperativeness of the Democratic Party on the package was given to the Chief Secretary by Mr Art Pine of the Wall Street Journal at his lunch with financial journalists: the Democrats had decided that it would improve their electoral prospects if they did not treat the deficit as a divisive or party-political issue.

5. The convergence of opinion about the prospects for the deficit reduction package was however not paralleled by any consensus about the post-election prospects for deficit reduction. Sprinkel, who was optimistic, saw these mainly in terms of legal or Constitutional reforms that would give the President the power to veto individual items of expenditure voted by the Congress and that would require a balanced budget except in national emergencies. He was not keen to raise taxes as it could, by taking the deficit pressure off, encourage the Congress to spend more and anyway his own objective was to reduce the public expenditure/GNP ratio rather than the deficit itself..

6. Stockman, on the other hand, made no reference to legal devices and was under no illusion that it would be easy to make massive cuts in social entitlement programmes, and both he and Penner pointed to the high amount of defence expenditure in the next few years that was already contractually committed. Some progress might be made towards partially de-indexing social benefits or delaying their payment, but this would only reduce the budget deficit marginally. By implication, Stockman obviously thought tax increases were necessary to make a major difference, but stopped short of openly advocating them.

7. Davis pointed out that cash expenditure on the Medicare programme was growing at the alarming annual rate of 15-16% and Penner said that total health expenditure was growing at an annual rate of 12%, and that there was stiff political resistance to reforms. Penner was also concerned about the rising burden of debt interest and had little confidence about the permanence of efforts to contain agricultural support expenditure. He did however apparently believe that the will shown by the Congress to do something about the deficit this year might extend beyond the elections. Devine gave the impression that his attempts to reform the US Civil Service pension, health, and life insurance systems would be opposed in the Congress - and these he thought were some of the major potential sources of savings in administrative expenditure. No official gave any indication that it would be possible - as Secretary Regan suggested it would to the Chancellor of the Exchequer in the previous week - to reduce the deficit, mainly through expenditure reductions, to 1/2% of GNP by 1990.

8. No officials said that they expected tax increases after the elections.

Comment

9. The US will still be faced with $175 - $200 bn deficits after the November electiions. There is traditionally a brief period - perhaps the first six months after a President is re-elected - when

/he

he can be expected to have the sympathy of the Congress and the benefit of the doubt concerning his proposals. But even so, proposals for the de-indexation of Social Security benefits or significant savings in health care programmes (as are being advocated by some Republicans in Congress) could only pass through a Congress that was much more Republican than the present one, and the general expectation is for a more Democratic Congress after November. Reductions in the growth of defence expenditure are much more likely, but this will be limited by what the President can accept and the extent to which defence expenditure is already contractually committed. Defence savings would build up over a period of years. It has been estimated by Pechman of Brookings that savings of $50 bn might be feasible in 1989, although in FY86 the potential savings would be far smaller. The constitutional and legal reforms to control expenditure mentioned by Sprinkel would be exceedingly difficult to implement.

10. On the tax side, tax reform is being considered, but not in the context of raising revenue - though as the US Treasury privately admit, it would not be technically difficult to convert the measures now under consideration in that Department from revenue neutrality to revenue raising. The President is against raising the rates of existing taxes, and his objections might well extend to introducing new taxes to raise revenues. He has said however that he is ready to contemplate closing tax loopholes. While some thought is being given in Congress and in the Treasury to a flat-rate income tax, a consumption tax and a VAT, there are no signs that detailed studies are under way in the Treasury about how to close major tax loopholes. The major Federal tax expenditures that could be reduced - interest relief for individuals, deductions for State taxes and charitable contributions, exemption of Social Security payments from income tax - all have special interest groups waiting to pounce should the Administration propose changes affecting them. The prospects for the closing of loopholes seem to depend largely on developments in the Congress next year, which are highly uncertain.

WRIGHT

THIS TELEGRAM WAS NOT ADVANCED

FINANCIAL

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NAD

FILE

Ru/

10 DOWNING STREET

From the Private Secretary

16 April, 1984

The Prime Minister has asked me to thank you warmly for your letter of 5 April and the speech which you enclosed on "The American Trade Deficit in Perspective". Mrs. Thatcher has commented that your speech applies your customary clarity and wisdom to the enormous issues that face us.

The Prime Minister sends you every good wish.

A. J. COLES

His Excellency Mr. Arthur F. Burns.

NK

Prime Minister (4)

A.J.C. 5/4.

EMBASSY OF THE
UNITED STATES OF AMERICA

Bonn, Germany
April 5, 1984

R 11

Dear Madam Prime Minister

I am enclosing a recent speech of mine that deals with economic issues that have excited interest in Europe as well as the United States.

With kind regards.

Sincerely,

Arthur F. Burns

Reply

Thanking so very much
for letting me see this
speech. It shows
your continuing clarity
& wisdom to ~~the~~ the
enormous [illegible]
that [illegible] us.
Everybody [illegible]

The Right Honorable Margaret Thatcher
Prime Minister
London, England

THE AMERICAN TRADE DEFICIT IN PERSPECTIVE

Arthur F. Burns
Ambassador of the United States
to the Federal Republic of Germany

Presented at
The Industrie Club
Duesseldorf, Federal Republic of Germany
April 5, 1984

THE AMERICAN TRADE DEFICIT IN PERSPECTIVE

by

Arthur F. Burns

I very much appreciate the opportunity to address this distinguished audience today. The topic I have chosen to discuss with you is the merchandise trade of the United States with other countries. My reasons for focusing on this subject are not parochial. In the first place, it is important for Europeans to understand that the strong recovery in America's over-all production and employment has been accompanied by further deterioration in its foreign trade. Secondly, the poor trade performance of the United States in recent years reflects a disequilibrium in the world economy as well as in our domestic economy. Widespread political strains have been the inevitable result. The promises of last year's Williamsburg Summit with regard to international trade and finance have not been fulfilled. If anything, international tensions arising from economic issues have increased during the past year.

Let me begin by reciting some of the essential facts about the foreign trade of the United States. Until 1970, my country enjoyed a surplus in its merchandise trade with the rest of the world. Since then, with oil prices higher and competition from our trading partners keener, trade deficits have been the rule. For a time this served a constructive international role in view of America's surplus on other items in its international accounts. But the trade deficit took a quantum jump towards the end of the 1970's when it reached a rate of about 30 billion dollars per year--a rate that was maintained through the first half of 1982. More recently, the trade deficit has grown by leaps and bounds. It reached an annual rate of 75 billion dollars in the final quarter of 1983, and is expected to exceed 100 billion dollars this calendar year.

To be sure, the deterioration in America's merchandise trade is still being offset by our traditional surplus on trade in services and on investment income from abroad. Even so, the deficit in our international current account--which allows for these items--reached over 40 billion dollars during 1983, and ran at a much higher annual rate in its final quarter. The counterpart of this dramatic current account deficit has been a huge flow of funds from abroad to the United States combined with a sharp contraction in our traditional capital exports. That is hardly a welcome development for a nation with the largest and richest economy in the world.

There is a widespread belief in American circles that many of our industries can no longer compete against more efficient Japanese firms. There is worry as well that American producers are being victimized by unfair competition from low-wage producers in developing countries and subsidized products of European and other foreign enterprises. Such explanations of our foreign trade deficit contain an element of truth, but hardly more than that. The principal causes of America's recent trade deterioration are to be found elsewhere--in the high value of the dollar in foreign exchange markets, in the faster rebound from recession in the United States than in Western Europe or Japan, and in the unavoidable need of debt-ridden developing countries to practice austerity.

The strength of the dollar in foreign exchange markets in the past few years is well known in Europe. Between late 1980 and early this year the dollar appreciated about 30 per cent against the Swiss franc, 40 per cent against the British pound, 50 per cent against the German mark, 100 per cent against the French franc. The dollar's appreciation against the Japanese yen and Canadian currency was much less. Nevertheless, taking the currencies of the ten major industrial countries together, the dollar appreciated on the average about 50 per cent during that period. The high cost of the dollar obviously has made American goods less attractive to foreign buyers, while the low cost of foreign currencies has made foreign products more attractive to Americans. Although the dollar has weakened since the start of this year, it still retains the greater part of the appreciation against other currencies that occurred after 1980.

Another major cause of America's trade deterioration is the difficulty that many developing countries have been experiencing during the past two to three years in borrowing abroad. By 1982 an increasing number of commercial bankers and other suppliers of credit finally realized that they had been less than prudent in accommodating--in fact, often even encouraging--the eagerness of developing countries to pile up indebtedness. Once lending to these countries was curtailed, one after another of them found it impossible to meet its scheduled debt repayments or even the interest due on its indebtedness. To prevent outright bankruptcy, their governments had to plead for financial assistance from the International Monetary Fund, other governments, and the private financial community; but such help could not remove the need to practice austerity--particularly, to cut imports and expand exports. The nations of Latin America, which have especially close commercial ties with the United States, were foremost among those suffering a shortage of foreign exchange. Not surprisingly, the dollar value of our exports to Latin America was cut almost in half between the first quarter of 1981 and the final quarter of 1983.

A third factor in America's trade deterioration is the uneven cyclical development of the major industrialized countries. Economic recovery began in the United States towards the end of 1982 and gathered momentum rapidly. The economy of Canada recovered about the same time and advanced almost as rapidly. Other industrial countries did not do as well. Japan's economy continued to advance but at a diminished rate. Great Britain and Germany recovered more gradually than the United States, while the rest of Western Europe continued to experience stagnation or recession. Because of the lag of the recovery process outside the United States, our exports to Europe and Japan became very sluggish while our imports soared--as always happens during the expansion phase of the business cycle.

In addition to the several major causes of America's trade deficit on which I have dwelt--namely, the strong dollar, the distress of developing countries, and the rapid rebound of the American economy--a host of other factors played some part. Two of them deserve special mention: first, the world-wide drop in oil demand which forced OPEC members to cut back their imports; second, recent developments in world agriculture--a subject to which I will need to return--which also contributed to the deterioration of America's foreign trade.

The piling up of these unfavorable trade developments has become a matter of widespread concern in the United States. Farm income was already depressed during the late 1970's; and with foreign sales declining, it has plummeted since 1980. Moreover, the shrinkage in exports of our manufactured products resulted in a reduction of both jobs and profits in numerous firms--particularly those engaged in producing machinery, civil aircraft, and other capital goods. Meanwhile, the rise in imports kept adding to the displacement of workers involved in the manufacture of various consumer as well as capital goods.

Professional economists often look upon such vicissitudes of trade as normal workings of a competitive market, and they are apt to express confidence that the difficulties will eventually be corrected through the marketplace. In principle, there is considerable justification for such views.

As the economy of the United States continues to expand, its rate of expansion is bound to moderate. Meanwhile, signs of economic recovery in Western Europe, which have been gradually reemerging, are likely to multiply. With the gap in economic performance between Europe and the United States narrowing, America's trade deficit will tend to diminish. On balance, Latin American developments should also be less damaging to our foreign trade. During the past year, the heavily indebted countries of Latin America have experienced significant improvement in their current account balances with the rest of the world. Hence, the recent sharp reduction in their imports from the United States can hardly be expected to become still larger. Moreover, since the purchasing power of the dollar over commodities appears to be appreciably overvalued relative to other currencies, it would not be at all surprising if the decline in the foreign exchange value of the dollar that has occurred since its January peak were moderately extended over the next year or two. In short, one can reasonably argue that the marketplace is already releasing forces that before long will diminish the American trade deficit.

Relaxed thinking along these lines, however, is rarely shared by American businessmen, farmers, and workers who happen to have been adversely affected through foreign trade. Nor is it shared by politicians -- particularly in an election year. Of late, American advocates of restrictive trade policies have become bolder, and their complaints about trade practices of other countries have become more strident. Their calls for new import barriers are being echoed by similar calls in Europe. After all, numerous European industries have also experienced an economic setback in recent years, and unemployment is now extensive throughout Western Europe. With the virus of protectionist sentiment spreading, the need for economic statesmanship both in the United States and in Europe has become urgent.

America's foreign trade problem is also Europe's problem, and it is important for both Europeans and Americans to try to see from an international viewpoint the trade and financial issues that have caused political tensions among us. In the process of doing that, we are all bound to find that what Americans regard as their special problem involves common international concerns that require better mutual understanding--and often also corrective measures--on both sides of the Atlantic.

One of the problems that has been especially troublesome in the relations between the United States and Western Europe involves agricultural trade. Americans have long complained about the protectionist thrust of the European Community's agricultural policy--a policy that relies heavily on price supports to maintain the income of its farmers. Each year the Community's member governments fix common prices of various agricultural products. These prices run above world prices. The domestic market of the Community is then protected by variable levies that tend to keep out lower-priced imports. In part as a result of this policy, the Community's share of America's total agricultural exports has tended to decline.

The decline would have been sharper if the Community's restrictions had also been applied to soybeans and soybean products--which loom large in American exports. This has been precluded by prior international agreements that permit soybeans and their derivatives to be shipped duty-free into the Community. That access has recently been threatened by the proposal of the European Commission to impose a consumer tax on vegetable oils. Quite obviously, such a tax would have much the same effect as an explicit import barrier.

The American government is also troubled by the commission's proposal to restrict imports of corn gluten--a product used in animal feeds -- which now also enters the Community duty-free on the basis of previous agreements. Since American farmers have not shared in the recent economic recovery, concern over restrictive measures against corn gluten and soybeans has become acute in the United States.

These new European proposals have thus intensified a perennial complaint of the United States--namely, that our market is far more open to agricultural imports than the Community's market. There can be no denying, however, that Europeans have some legitimate complaints about

American agricultural policies. The United States, for example, has long maintained import quotas on dairy products--a protectionist measure that has hurt European farmers. Again, American wine producers have recently been seeking Congressional limitation on wine imports.

The deplorable clamor for increasing protectionism in agriculture is not only interfering with the efficient use of labor and capital. It may also release new inflationary pressures--directly by raising food prices, indirectly by repercussions on labor markets. Nor is this all. Agricultural policies in Europe and the United States are becoming a heavy burden on governmental budgets. Programs for supporting farm prices and incomes cost the American government 28 billion dollars in fiscal year 1983 --an enormous increase over the preceding two years. The cost of supporting agriculture has also increased rapidly in the European community, reaching over 13 billion dollars in 1983. Indeed, the member governments of the Community are now engaged in an anxious search for ways of limiting the impact of agricultural expenditures on their budgets--a search that has caused severe political strains in Europe.

Foreign trade in agricultural products is thus an intra-European problem as well as a problem involving the United States and Western Europe -- for that matter, much of the rest of the world as well. A basic cause of this common problem is the tendency toward excessive production of various agricultural products. Here the Europeans have perhaps been more at fault than Americans, for the agricultural support programs of the United States have usually included some incentives to cut back production while European support programs have not. In fact, the Community's disposal of its surpluses through subsidized sales on world markets has been a source of considerable friction between the United States and the Community.

As we look ahead, the problem of oversupply may become more acute because of continuing advances in agricultural technology--especially in the grain and dairy sectors. This is clearly a problem that Community and American farmers have in common. Although our several governments recognize this, they have not yet tackled together the challenge posed by world overproduction. Fortunately, both the American government and the Community have of late moderated their rhetoric on agricultural trade issues, restrained their actions, and tried quietly to resolve their outstanding differences. The German government, in particular, has expressed firm opposition to a European consumer tax on vegetable oils. It should be a source of some comfort to both Americans and Europeans that powerful voices of reason are being heard at a time when pressures on goverments from agricultural interests have become so insistent.

Trade in steel products is another perennial irritant in relations between the United States and the European Community. Problems in this area have recently become more troublesome, largely as a result of declining demand for steel products during the recession, but partly also because of larger production and exports by some developing countries. In view of these changed market conditions, steel firms on both sides of the Atlantic have been forced to curtail production, close some entire plants, and release many workers.

In the early 1980's, American steelmakers petitioned our government for protection against rising steel imports from the European Community. The Americans argued that European firms were benefiting unfairly from export subsidies and that some of their products were being sold in the United States below their fair value. If their complaint had run the full course permitted by American law, the result would certainly have been a sharp reduction in European exports of carbon steel products. Fortunately, mutual good will prevailed over legal contests. After long and difficult negotiations, involving both steel producers and governments, an agreement was reached in October 1982, under which the Community undertook to limit moderately its exports of certain steel products to the United States through the end of 1985.

This agreement has worked reasonably well thus far, but it has by no means quieted the steel trade issue. The specialty steel branch of the American industry, which was not covered by the 1982 agreement, has also suffered declines in profits and employment in recent years. Its urgent appeal for relief under American law led in July 1983 to the President's approval of temporary quotas and extra tariffs for specialty steel imports. This action was severely criticized in Europe -- in part, no doubt, because it came so soon after the Williamsburg Summit. At any rate, the European Community responded, as it had the right to do under GATT rules, by limiting certain imports of equivalent value from the United States. At times during the past year, the specialty steel problem threatened to provoke a serious rift in the relations between the United States and Western Europe. Once again, however, the matter was settled amicably thanks to the willingness of the concerned parties to make the necessary compromises. Unfortunately, both American producers and their organized workers have now joined in fresh appeals for restricting imports of steel generally. Difficulties over steel trade thus remain with us.

In view of the restlessness that continues to afflict international steel trade, there can be no escape from the conclusion that arrangements such as Americans and Europeans have recently succeeded in working out are merely temporary expedients. The critical fact is that both the United States and Europe face a common problem of overcapacity in their respective areas -- a problem that is being accentuated by rising imports from the more advanced of the developing countries. It is only by addressing together these broader issues that we can have a reasonable chance of finding lasting solutions to our perennial problems in steel trade.

Because of limitations of time, as well as of my own knowledge, I shall not comment on other specific trade issues -- as in the case of copper, footwear, machine tools, and wines -- that are being accorded public attention in this election year. But in view of my past involvement in central banking, I do want to make a few observations about financial questions surrounding America's trade deficit that have stirred wide interest and controversy.

Let us take first the case of the dollar's appreciation. It has served to reduce inflationary pressures in the United States, but it has had the opposite effect in Europe -- since a very large part of Europe's imports is denominated in dollars. On the other hand, the dollar's appreciation has severely hurt America's foreign trade, while it has benefited the trade of other countries -- including those in Western Europe. Discerning Europeans recognize that the trade deficit of the United States has served, in effect, to drive the world economy forward. They have not, however, rejoiced over their trade advantage, since they realize that the dollar's strength will not last indefinitely and therefore fear that the industrial structure of their countries could become distorted in the process of responding to a temporary trade advantage.

Europeans naturally prefer a stable dollar to one that oscillates in buying power, and so for that matter do Americans. But neither Europeans nor Americans have as yet found an acceptable method of returning to the kind of stability in exchange rates that existed before the abandonment of the Bretton Woods system. In a world in which capital movements often overshadow trade movements and in which inflation rates of individual countries diverge widely, central bank intervention in foreign exchange markets--a remedy that is still popular in some political circles--cannot accomplish anything beyond smoothing out the very short-run fluctuations of exchange rates.

To be sure, many Europeans feel that the appreciation of the dollar has been largely due to the relatively high interest rates in the United States. Their argument typically runs as follows: first, high American interest rates are damaging European economies by attracting to the United States funds that otherwise would be directed to capital investment at home. Second, European interest rates are also higher than they would be in the absence of the outflow of capital to the United States. Third, the gigantic debt burden of developing countries is being compounded by the high American interest rates. Fourth, the United States could correct these difficulties by bringing down its interest rates, and this could best be accomplished by reducing the enormous deficits in the American government's budget. Finally, the American economy as well as the entire international economy would benefit in the process.

This line of reasoning has not been confined to Europeans. Many Americans have shared it -- which is not surprising since the above argument does embody a substantial element of truth. I must nevertheless point out that the above argument is incomplete. It overlooks the fact that the dollar is a haven of safety for Europeans and others in times of international political turmoil such as we have experienced in recent years. It overlooks the fact that there are causes of high interest rates beyond budget deficits. It overlooks the fact that the high American interest rates have not proved an obstacle to a robust recovery in the United States, including a revival of both residential construction and business investment in fixed capital. More important still, the European argument overlooks the fact that profit opportunities in the United States have become distinctly more favorable than in Western Europe. Even with American interest rates remaining as they are, if European governments moved more boldly to improve prospects for business profits in their countries, the chances are that the flow of capital to the United States would be materially checked--indeed, that American capital on balance might well start moving to Europe.

The American goverment can surely be helpful to the European economy as well as to its own by proceeding resolutely to reduce its projected budget deficits. That is fully recognized by now both by the Reagan Administration and the Congress. I am entirely confident that a significant budgetary correction will be accomplished before long -- perhaps even by this summer, but certainly by next spring. As awareness of this forthcoming development spreads through financial markets, current pressures on interest rates will tend to be eased and financial investments in the United States may thus become less attractive to foreigners. But Europe can also do its part -- namely, by improving the environment for business risk-taking, innovation, and capital investment. In short, European governments as well as the American government could take actions -- as indeed some are already doing -- to reduce the many difficulties that have been caused by high interest rates and the strong dollar. To some degree, with prospective profits in Europe beginning to improve, a wholesome process of economic revitalization may already be getting under way.

While the United States will have to emphasize one set of policies in dealing with the dollar's strength and Europe quite another, their approaches can and should be similar in dealing with the indebtedness of the developing countries -- again a problem that the United States and Western Europe have in common. Fortunately, this has been recognized on both sides of the Atlantic. Indeed, speedy action by the International Monetary Fund and the Bank for International Settlements, working in concert with the governments of the leading industrial countries as well as with their central and commercial bankers, has staved off what might otherwise have been an international financial collapse. These constructive rescue missions have not, however, solved the underlying debt problem of the developing countries, since the debtors are being burdened with interest charges that some--perhaps many--of them may find it impossible to meet.

All concerned parties have some further contribution to make. As governments of the industrial countries continue to work at fostering sustainable growth of their economies, the developing countries will gain opportunities to increase their exports. That, along with efforts to bring down interest rates and curb protectionist impulses, is fundamental. For their part, commercial banks -- especially the large institutions that play a leadership role in international finance -- need in their self-interest, as well as for the sake of stability in the international financial system, to do more than they have yet done to ease the payments problem of debtor countries.

Typically, of course, when commercial bankers run into a debt problem of one of their business customers, they devise means of scaling down the size of the debt or the interest on it, and at times even accept the debtor company's stock in place of all or part of the outstanding debt. That business approach is suggestive of actions that could be taken in handling the indebtedness of some of the more necessitous developing countries.

One possibility would be for a dozen or so of the major international banks to proceed on their own to cut substantially the interest rates charged to those of the less developed countries that have run into insuperable difficulties in complying with the financial program worked out in their behalf by the International Monetary Fund. Such voluntary interest-rate reductions could not in practice be generalized to cover all banks, since many of the smaller banks would balk at following the initiative of the major banks. That, however, is not a fatal objection, since the relief granted by the major international banks would of itself reduce appreciably the financial burden facing necessitous debtors.

In any event, leadership by the major international banks in interest-rate reductions is not the only possible route to relief. For example, near-term interest payments due from seriously troubled countries could be transformed into debt obligations that extend sufficiently into the future to provide the debtors essential breathing space.

Moreover, the governments of the United States and Western Europe can play a more direct role in helping the less developed countries to reestablish their credit worthiness and resume economic growth. Legislation calling for renewal of our system of trade preferences for developing countries that is now before the Congress is important in this regard. The European Community is likewise involved in renegotiating the Lome Convention which permits duty-free access of raw materials from developing countries. The existing European and American systems of general trade preference deserve extension and some further liberalization.

The developing countries must, nevertheless, be constantly reminded that it is decisively to their own benefit to expose their economies in greater degree to market forces. Continued reliance on preferential treatment is a dead-end policy, and one that will not be accepted indefinitely by the industrial nations. Developing countries must be particularly encouraged to pursue financial policies that will attract foreign investors, besides enticing back some of the enormous amounts of capital that their own frightened citizens and businesses had moved abroad. However difficult such policies may be, there is no other way for the developing countries to achieve the full partnership that they seek in the investment and trading system of the modern world.

In bringing this address to a conclusion, I want -- even at the cost of some repetition -- to leave several basic thoughts with you. First of all, it is well to keep in mind that prior to last year, the biggest current account deficit that any country had ever experienced in a single year was about 15 billion dollars. The 70 to 80 billion dollar shortfall that my country is headed for this year is awesomely different from anything experienced in the past. Since America's trade problem involves Europe deeply, it is essential that Europeans and Americans seek better understanding of their mutual economic concerns and work together toward their resolution.

Second, as previously suggested, the United States can best contribute to easing the trade and debt problems that now confront the world by moving decisively toward greater fiscal discipline. This needs to be combined with a skilful monetary policy that tempers the robustness of economic growth and thus guards against inflationary pressures. In Europe the foremost need is for confidence-building measures that foster job creation, so that Europe can contribute more significantly to the recovery of world trade.

Third, since the problem of international indebtedness is also without precedent -- either as to dimension or disruptive potential -- it is highly important to seek ways of enlarging upon the progress that has been achieved in the current phase of crisis management. We need, in particular, constructive initiatives that will enable the world to ride out difficulties even if economic developments in the years ahead should prove disappointing.

Fourth, the danger of protectionism has been growing despite some improvement in the condition of the international economy. In that regard, both Americans and Europeans must be concerned about the effects of protectionism on the developing world as well as about the weakening of our own economies through further protectionist actions. Even more important than that, we need to keep in mind that enmities created by trade restrictions at times spill over into the political arena, and may even affect the capacity of the partners in the North Atlantic Alliance to cooperate as effectively as they should in meeting challenges to their common security.

Fortunately, the several dangers and needs that I have emphasized are increasingly recognized on both sides of the Atlantic. Indeed, some have already been dealt with or are at present being considered constructively. I see, therefore, ample basis for hope of a better economic future than has been our lot in the past few years.

In the course of my life, I have seen many crises come and go. I have also seen crises that were widely anticipated fail to materialize. It is always unwise to underestimate the capacity of human ingenuity and good will to resolve economic problems -- whether they be domestic or international. Let us not underrate that capacity now. As Americans and Europeans we know in our hearts that the ethical, political, and cultural values that we share in common are overwhelmingly more important than the trade or financial issues that now and then excite us.

RESTRICTED

US file

Mr. Turnbull.

A.J.C. 26/3.

GRS 750
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FM WASHINGTON 240014Z MAR 84
TO IMMEDIATE FCO
TELEGRAM NUMBER 1009 OF 23 MARCH
AND TO SAVING BONN, PARIS, TOKYO, OTTAWA, ROME.
INFO SAVING ALL CONSULATES-GENERAL.

US ECONOMY: HIGHER INTEREST RATES

SUMMARY

1. INTEREST RATES HAVE BEEN RISING STEADILY. THE RATE ON THREE MONTH TREASURY BILLS IS NOW 9.8 PERCENT. THE RISE IS DUE:

(A) TO THE CONTINUED STRENGTH OF THE RECOVERY AND THE ASSOCIATED INCREASE IN THE PRIVATE DEMAND FOR CREDIT:

(B) TO THE MARKET'S CONCERN THAT MONETARY POLICY MAY BE TIGHTENED AND THAT PLANS TO REDUCE BUDGET DEFICIT WILL ONLY HAVE A MODEST IMPACT ON THE GOVERNMENT'S BORROWING REQUIREMENT.

DETAIL

2. INTEREST RATES IN MOST MARKETS HAVE RISEN IN RECENT WEEKS. THE RESULTING DECLINE IN MARGINS LED TO AN INCREASE IN THE PRIME RATE FROM 11.0 TO 11.5 PERCENT. CONCERN OVER INFLATION HAS ALSO RAISED YIELDS ON LONGER-TERM BONDS WITH 20 YEAR BONDS UP TO 12.5 PERCENT. IN RECENT DAYS SHORT TERM RATES HAVE MOVED HIGHER WITH TREASURY BILLS CLOSE TO 9.8 PERCENT.

3. THE ECONOMY HAS CONTINUED TO GROW STRONGLY. AFTER REAL GNP GROWTH OF 5.0 PERCENT (ANNUAL RATE) IN THE FOURTH QUARTER OF 1983, THE DEPARTMENT OF COMMERCE'S FLASH ESTIMATE OF GROWTH IN THE FIRST QUARTER THIS YEAR IS 7.2 PERCENT (ANNUAL RATE). THIS IS MUCH HIGHER THAN THE EARLIER FORECASTS OF BOTH THE ADMINISTRATION AND MOST OTHER ANALYSTS. DURING FEBRUARY THE EXPANSION WAS REFLECTED IN FURTHER INCREASES IN PERSONAL INCOME AND INDUSTRIAL PRODUCTION, A SURGE IN HOUSING STARTS AND A FURTHER DECLINE IN THE RATE OF UNEMPLOYMENT TO 7.8 PERCENT.

4. THE EXPANSION HAS RESULTED IN A STRONG GROWTH IN THE PRIVATE DEMAND FOR CREDIT. DURING THE FOURTH QUARTER 1983 THERE WAS HIGHER DEMAND FOR MORTAGE FINANCE AND CONSUMER INSTALMENT CREDIT, THE LATTER REFLECTING HIGHER PURCHASE OF CARS AND OTHER CONSUMER DURABLES. THESE TRENDS HAVE CONTINUED IN EARLY 1984, ACCOMPANIED BY AN ESTIMATED 15 PERCENT (ANNUAL RATE) INCREASE IN BUSINESS DEMAND FOR SHORT TERM CREDIT. THE STRENGTH OF THIS DEMAND, AGAINST THE BACKGROUND OF THE LARGE FEDERAL GOVERNMENT BORROWING REQUIREMENT AND THE LOW HOUSEHOLD SAVINGS RATE OF 5 PERCENT, HAS RESULTED IN UPWARD PRESSURE ON INTEREST RATES.

5. ALL THE MONETARY AGGREGATES HAVE GROWN STRONGLY SINCE THE BEGINNING OF THE YEAR. IN FEBRUARY THE BROAD AGGREGATE M3 WAS CLOSE

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TO THE TOP OF ITS RANGE, AND IN MID-MARCH M1 WAS CLOSE TO THE UPPER LIMIT OF ITS 4-8 PERCENT GROWTH TARGET. THIS GROWTH, AND THE GREATER EMPHASIS THE FEDERAL RESERVE NOW PLACES ON MOVEMENTS IN M1 HAS LED SOME ANALYSTS TO SPECULATE THAT THE FEDERAL RESERVE MAY HAVE RECENTLY TIGHTENED MONETARY POLICY, CONTRIBUTING TO THE RISE IN INTEREST RATES.

6. IT IS UNCERTAIN WHETHER THE FEDERAL RESERVE HAS TIGHTENED MONETARY POLICY. BUT THE NEXT MEETING OF THE FEDERAL OPEN MARKET COMMITTEE (FOMC) ON 26/27 MARCH WILL BE IMPORTANT. THE ECONOMY IS GROWING FASTER THAN THE FOMC'S CENTRAL FORECAST OF ECONOMIC GROWTH IN 1984 BETWEEN 4.0 - 4.75 PERCENT. THEY ALSO REMAIN CONCERNED OVER THE STRENGTH OF INFLATIONARY EXPECTATIONS. ALTHOUGH THE CONSUMER PRIC
E
INDEX IN FEBRUARY WAS ONLY 4.6 PERCENT ABOVE ITS LEVEL OF A YEAR AGO, THE FOMC IS LIKELY TO BE CONCERNED THAT THE RISE IN THE RATE OF CAPACITY UTILIZATION IN THE MANUFACTURING SECTOR TO 81 PERCENT IN FEBRUARY MAY BEGIN TO GENERATE COST PRESSURES. THE FOMC WILL ALSO BE AWARE OF THE IMPLICATIONS OF A FURTHER RISE IN INTEREST RATES, ESPECIALLY FOR THE DEBT BURDEN OF SOME DEVELOPING COUNTRIES.

7. THE FINANCIAL MARKETS REMAIN CONCERNED OVER THE SIZE OF THE FEDERAL GOVERNMENT'S PROJECTED BUDGET DEFICIT. THEIR INITIAL RESPONSE TO THE RECENTLY ANNOUNCED AGREEMENT BETWEEN THE PRESIDENT AND REPUBLICAN LEADERS IN CONGRESS TO REDUCE THE DEFICIT BY DOLLARS 150 BILLION BETWEEN FY 1985-87 WAS POSITIVE. SINCE THEN THERE HAS BEEN INCREASING REALIZATION THAT THE ADDITIONAL SAVINGS TO THOSE ANNOUNCED IN THE BUDGET FOR FY 1985 MAY BE SMALL, ARE LIKELY TO BE CONCENTRATED TOWARDS THE END OF THE THREE YEAR PERIOD AND TO BE IMPLEMENTED WILL REQUIRE THE AGREEMENT OF THE DEMOCRATS IN CONGRESS, WHO HAVE THEIR OWN PROPOSALS TO LOWER THE DEFICIT.

8. USING THEIR MORE PESSIMISTIC ASSUMPTION OF ECONOMIC GROWTH AND INTEREST RATES, THE CONGRESSIONAL BUDGET OFFICE HAVE ESTIMATED THAT THE PRESIDENT'S RECENT PROPOSALS WOULD YIELD DEFICITS OF DOLLARS 181 BN IN FY 1985, RISING TO DOLLARS 198 BN IN FY 1987. THIS COMPARES WITH THE PROJECTED FALL IN THE DEFICIT FROM DOLLARS 169 BN IN FY 1985 TO DOLLARS 143 BN IN FY 1987 UNDER THE PRESIDENT'S PLAN.

/ COMMENT

COMMENT

9. BOTH THE STRENGTH OF THE ECONOMY IN THE FIRST QUARTER AND THE RISE IN INTEREST RATES HAS SURPRISED THE ADMINISTRATION, ALTHOUGH A WHITE HOUSE SPOKESMAN CLAIMED THE RISE WILL NOT SLOW THE RECOVERY. BUT VOLCKER, SPEAKING IN CONGRESS, HAS POINTED OUT THE DANGER THAT CROWDING OUT WILL PREVENT A BALANCED RECOVERY. THE RATIONING MECHANISM IS THE INTEREST RATE. MUCH DEPENDS ON SOME MODERATION IN THE GROWTH IN THE ECONOMY AND FURTHER PROGRESS IN DISCUSSIONS BETWEEN CONGRESS AND THE ADMINISTRATION TO LOWER THE DEFICIT IN FY 1985 AND BEYOND.

FCO PASS SAVING: BONN, PARIS, TOKYO, OTTAWA, ROME.

WRIGHT

[REPEATED AS REQUESTED]

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FM WASHINGTON 170115Z MAR 84
TO IMMEDIATE FCO
TELEGRAM NUMBER 923 OF 16 MARCH

Mr Turnbull

US BUDGET DEFICIT: PRESIDENTS PROPOSALS

1. SUMMARY
THE PRESIDENT, WITH THE SUPPORT OF REPUBLICAN LEADERS IN THE SENATE, HAS ANNOUNCED REVISED BUDGET PROPOSALS, INCLUDING SIGNIFICANT CUTS IN THE PROPOSED DEFENCE BUDGET, TO REDUCE THE FEDERAL DEFICIT. THE PACKAGE HAS STILL TO OBTAIN THE AGREEMENT OF THE DEMOCRATIC HOUSE.

2. THE PRESIDENT ANNOUNCED YESTERDAY A PACKAGE TO LOWER THE BUDGET DEFICIT BY DOLLARS 150 BN BETWEEN FY85-87, FOLLOWING AGREEMENT BETWEEN THE ADMINISTRATION AND SENIOR REPUBLICANS IN CONGRESS. IT PROVIDES FOR SOME ADDITIONAL CUTS OVER AND ABOVE THOSE PROPOSED IN THE PRESIDENT'S FY85 BUDGET. THE BUDGET PROVIDED FOR CUTS OF DOLLARS 72 BN IN SPENDING AND INCREASES IN REVENUE OF DOLLARS 34 BN BETWEEN FY85-87, YIELDING DEFICITS IN THE REGION OF DOLLARS 180 BN IN EACH OF THOSE YEARS. THE LATEST PROPOSALS WOULD CUT THE DEFICIT TO DOLLARS 169 BN IN FY85, DOLLARS 150 BN IN FY86 AND DOLLARS 143 BN IN FY87.

3. THE PACKAGE CONSISTS OF WHAT IS TERMED QUOTE A DEFENCE COMPROMISE UNQUOTE, ALLOWING FOR SAVINGS IN THE RATE OF INCREASE OF DEFENCE OUTLAYS, AMOUNTING TO DOLLARS 40.2 BN: CUTS IN NON-DEFENCE SPENDING OF DOLLARS 43.2 BN, INCREASES IN TAX REVENUES OF DOLLARS 48 BN AND RESULTING SAVINGS THROUGH LOWER INTEREST COSTS ON THE DEBT OF A FURTHER DOLLARS 18 BN. MOST OF THE SAVINGS WOULD BE REALISED IN THE SECOND AND THIRD YEAR OF THE FY85-87 PERIOD. FURTHER DETAILS ARE BEING SENT TO LONDON BY BAG.

4. THE COMPROMISE AGREEMENT ON DEFENCE REPRESENTS AN IMPORTANT SHIFT IN THE ADMINISTRATION'S VIEW OF THE APPROPRIATE RATE OF INCREASE IN DEFENCE SPENDING. FOR FY85 DEFENCE SPENDING IN REAL TERMS IS PLANNED TO RISE BY 5.1 PER CENT, CLOSE TO THE TARGET FIGURES ADOPTED LAST YEAR BY CONGRESS IN ITS BUDGET RESOLUTION FOR 1984, WHICH PROVIDED FOR REAL INCREASES OF 5 PER CENT IN DEFENCE BUDGET AUTHORITY FOR FY84 AND 85. COMPARED TO THE AMOUNT ACTUALLY APPROPRIATED IN 1984, THE REAL INCREASE IN DEFENCE SPENDING IS OVER 7 PER CENT. BUT IT REMAINS SUBSTANTIALLY BELOW THE 13 PER CENT REAL INCREASE ORIGINALLY SOUGHT BY THE ADMINISTRATION. IN ADDITION THE ADMINISTRATION HAS MADE NO SPECIFIC PROPOSALS FOR CUTS IN ANY PARTICULAR PROGRAMME, WHICH IT HAD EARLIER ARGUED WAS NECESSARY BEFORE IT COULD AGREE TO LOWERING THE INCREASE IN DEFENCE SPENDING. THE MAIN PROPOSALS OF THE THREE YEAR AGREEMENT ON DEFENCE SPENDING ARE:-

/1985.

	1985	1986	1987
BUDGET AUTHORITY (DLS BN)	299.0	333.7	372.0
BUDGET OUTLAY (DLS BN)	266.0	294.6	330.4
REAL GROWTH RATE (PER CENT)	5.1	5.0	4.9

5. THE TAX MEASURES COVER A LARGE NUMBER OF SMALL REVENUE-RAISING PROPOSALS, MANY OF WHICH AIM TO CLOSE TAX-LOOPHOLES, AND ARE REPORTED TO HAVE THE SUPPORT OF TREASURY SECRETARY REGAN. OF THE DOLLARS 48 BN OF TAX REVENUES, THE ADMINISTRATION HOPE THAT OVER DOLLARS 38 BN WILL BE DERIVED FROM MEASURES INCLUDED IN THE SIMILAR BILLS CURRENTLY UNDER CONSIDERATION BY THE HOUSE WAYS AND MEANS COMMITTEE AND APPROVED YESTERDAY BY THE SENATE FINANCE COMMITTEE. THE DOMESTIC SPENDING CUTS AFFECT A NUMBER OF ENTITLEMENT PROGRAMMES, OTHER DISCRETIONARY PROGRAMMES, AND PROVIDES FOR A FREEZE ON FARM TARGET PRICES.

6. HOUSE DEMOCRATS HAVE NOTED THE PRESIDENT'S PROPOSAL, BUT HAVE STATED THEY WILL PRESS FOR FURTHER CUTS IN DEFENCE SPENDING. CONGRESS HAS UNTIL 15 MAY TO REACH AGREEMENT ON ITS FIRST BUDGET RESOLUTION.

7. THE INITIAL MARKET REACTION TO THE NEWS WAS POSITIVE. BUT THE LONGER TERM ECONOMIC SIGNIFICANCE OF THE MEASURES DEPENDS ON THE AMOUNT OF ADDITIONAL SAVINGS THAT ARE EVENTUALLY AGREED AND THEIR PHASING OVER THE THREE YEAR PERIOD. THE CONCERN OF MANY, INCLUDING FEDERAL RESERVE CHAIRMAN VOLCKER, IS THAT ADDITIONAL CUTS OF ONLY SOME DOLLARS 10 BN IN FY85, OVER AND OBOVE THE ORIGINAL BUDGET PROPOSALS, MAY NOT BE SUFFICIENT TO OFFSET THE PRESSURE ON INTEREST RATES FROM THE SIGNS OF GROWING PRIVATE SECTOR DEMAND FOR CREDIT. INTEREST RATES HAVE RISEN IN RECENT WEEKS. HIGHER INTEREST RATES THAN ASSUMED BY THE ADMINISTRATION IN ITS BUDGET CALCULATIONS, LEADING TO HIGHER INTEREST CHARGES ON THE DEBT, WOULD OFFSET SOME OF THESE SAVINGS.

8. THE PRESIDENT'S DEFICIT REDUCING PACKAGE HAS RETURNED THE POLITICAL INITIATIVE TO THE ADMINISTRATION. IF THE DEMOCRATIC HOUSE TURNS IT DOWN, THE REPUBLICANS CAN ACCUSE THE DEMOCRATS OF FISCAL IRRESPONSIBILITY. THOUGH INITIAL MARKET REACTION HAS BEEN POSITIVE, IT IS TOO SOON TO JUDGE WHETHER THE DEFICIT REDUCTION, IF AGREED, WOULD CARRY THE ECONOMY THROUGH THE REST OF THIS YEAR WITHOUT FURTHER PERTURBATIONS IN THE EXCHANGE AND MONEY MARKETS. BUT IT DOES SHOW THAT THE ADMINISTRATION AND ITS SUPPORTERS IN THE SENATE CAN ACT QUICKLY TO PUT TOGETHER A USEFUL PACKAGE WHEN GOADED BY BAD NEWS FROM THE FINANCIAL MARKETS. IT REMAINS TO BE SEEN WHETHER THE HOUSE OF REPRESENTATIVES WILL BUY IT SO THAT THE REDUCED BUDGET CAN PASS INTO LAW.

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FM WASHINGTON 230436Z FEB 84

TO ROUTINE FCO

TELEGRAM NUMBER 614 OF 22 FEBRUARY

MT

PRESIDENT'S PRESS CONFERENCE: ECONOMIC ISSUES.

1. IN HIS FIRST PRESS CONFERENCE OF 1984 THE PRESIDENT WAS CRITICAL OF THE DEMOCRATS FOR THEIR FAILURE TO NEGOTIATE SO FAR ON HIS BIPARTISAN PROPOSAL FOR A DOWN PAYMENT OF DOLLARS 100 BILLION TO LOWER THE BUDGET DEFICIT. HE HAD PROPOSED THE IDEA OF A DOWN PAYMENT IN THE STATE OF THE UNION ADDRESS IN RESPONSE TO CALLS FOR ACTION TO LOWER THE DEFICIT. THE PRESIDENT STATED IT WAS IRONIC THAT THOSE WHO HAD DEMANDED NEGOTIATIONS WERE NOW PROVING RELUCTANT TO ENTER INTO THEM.

2. THE PRESIDENT REPEATED HIS CONCERN OVER THE SIZE OF THE BUDGET DEFICIT AND THE NEED TO LOWER IT. BUT HE HELD OUT LITTLE PROSPECT FOR TAX INCREASES OR REDUCTIONS IN DEFENSE SPENDING BEYOND THOSE PROPOSED IN THE BUDGET FOR FY 1985. HIGHER TAXES WOULD NOT REDUCE THE DEFICIT, BUT MERELY LEAD TO MORE GOVERNMENT SPENDING. THE PRESIDENT STATED THE ADMINISTRATION HAD ALREADY LOWERED THE RATE OF INCREASE OF GOVERNMENT SPENDING, AND MORE COULD BE DONE TO REDUCE SPENDING. BUT ON DEFENCE SPENDING THE PRESIDENT SAID THE ADMINISTRATION'S PROPOSALS WERE REASONABLE, ESPECIALLY IN THE LIGHT OF SEVERAL YEARS DECLINE IN DEFENCE SPENDING PRIOR TO 1980. THE LEVEL OF DEFENCE SPENDING SHOULD REFLECT THE COST OF THOSE MEASURES REQUIRED TO ENSURE NATIONAL SECURITY. ANY PROPOSALS TO LOWER THE RATE OF INCREASE OF DEFENSE SPENDING SHOULD BE CONSIDERED IN THIS LIGHT.

3. ON THE ECONOMY THE PRESIDENT DOUBTED THAT THE SCALE OF BORROWING BY THE FEDERAL GOVERNMENT AND THE PRIVATE SECTOR WOULD THREATEN THE RECOVERY, PARTLY BECAUSE OF THE INCREASE IN COMPANY PROFITABILITY WHICH ENABLED FIRMS TO FINANCE INVESTMENT FROM THEIR OWN SOURCES. HE ACKNOWLEDGED THAT INTEREST RATES REMAINED HIGH. THIS REFLECTED THE MARKETS CONCERN THAT INFLATION MIGHT INCREASE. THE PRESIDENT BELIEVED INTEREST RATES COULD FALL PROVIDING THE ADMINISTRATION REMAINED FIRM IN ITS POLICY OF LOWERING INFLATION. HE SAID THE FEDERAL RESERVE WAS PURSUING A MONETARY POLICY WHICH WAS CONSISTENT WITH A SOUND RECOVERY WITHOUT RAISING INFLATION.

4. FCO PLEASE PASS TO BOTTWELL (HMT), ROLLA (ESID) AND GREEN (BANK).

WRIGHT

FINANCIAL

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THIS TELEGRAM WAS NOT ADVANCED

10 DOWNING STREET

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Prime Minister

Apart from avoiding mention of a specific time, the Volcker analyses of the US position is couched in very similar terms to your own.

AT

10/2

Fed signals concern at twin deficit threat

BY PAUL TAYLOR IN WASHINGTON

Mr Paul Volcker, the Federal Reserve Board chairman, yesterday testified before the U.S. House of Representatives Banking, Finance and Urban Affairs Committee on the state of the U.S. economy, the prospects for continued non-inflationary growth and Fed policy. The following are excerpts from his remarks.

A year ago in appearing before you on this occasion I emphasised that after too many years of pain and instability, we had an enormous opportunity to sustain growth for years ahead in an environment of much greater price stability. Today, after a year of strong recovery, that sense of the opportunities before us has only been reinforced.

What we have not done in this past year is to face up to other hazards to our prosperity and to our stability, hazards that are new to our actual experience but which have been long identified. I am referring of course to our twin deficits: the structural deficit in our federal budget and the deficit in our external account, both at unprecedented levels and getting worse. Both of those deficits carry implications for the prospects of reducing our still historically high levels of interest rates.

So far, the strains have been masked by other factors of strength and by the rapidity of growth from the depths of recession. But with the passage of time and full recovery, the predictable effects have become more obvious. They pose a clear and present danger to the sustainability of growth and the stability of markets, domestic and international. We still have time to act—but in my judgment, not much time.

Over the past year, our needs have been increasingly met by savings from abroad in the form of net capital inflow. That money has come easily amid world economic and political uncertainty, the U.S. has been a highly attractive place to invest. But part of the attraction for investment in dollars has been relatively high interest rates. In effect, the growing capital inflow has, directly or indirectly, helped to finance the internal budget, by the same token helping to moderate the pressures of the budget deficit on the domestic financial markets.

At the same time, the flow of funds into our capital and money markets pushed the dollar higher in the exchange markets even in the face of growing trade and current account deficit—and the dollar appreciation in turn undercut our worldwide trading position further.

We simply cannot afford to become addicted to drawing on increased amounts of foreign savings to help finance our internal economy. Part of our domestic industry—that part dependent on exports or competing with imports—would be sacrificed. The stability of the dollar and our domestic financial markets would become hostage to events abroad. If the recovery is to proceed elsewhere, as we want, other countries will increasingly need their own savings. While we don't know when, at some point the process would break down.

We recognise that the battle against inflation has not yet been won—that scepticism about our ability, as a nation, to maintain progress towards stability is still evident. That is one of the reasons why longer-term interest rates have lingered so far above current inflation levels. After so many false starts in the past, the scepticism is likely to remain until we can demonstrate that, in fact, the recent improvement is not simply a temporary matter—that the Federal Reserve is not prepared to accommodate a new inflationary surge.

The doubts are reinforced by concerns that the pressures of the huge budget deficit on financial markets may, willy nilly, push us in that direction.

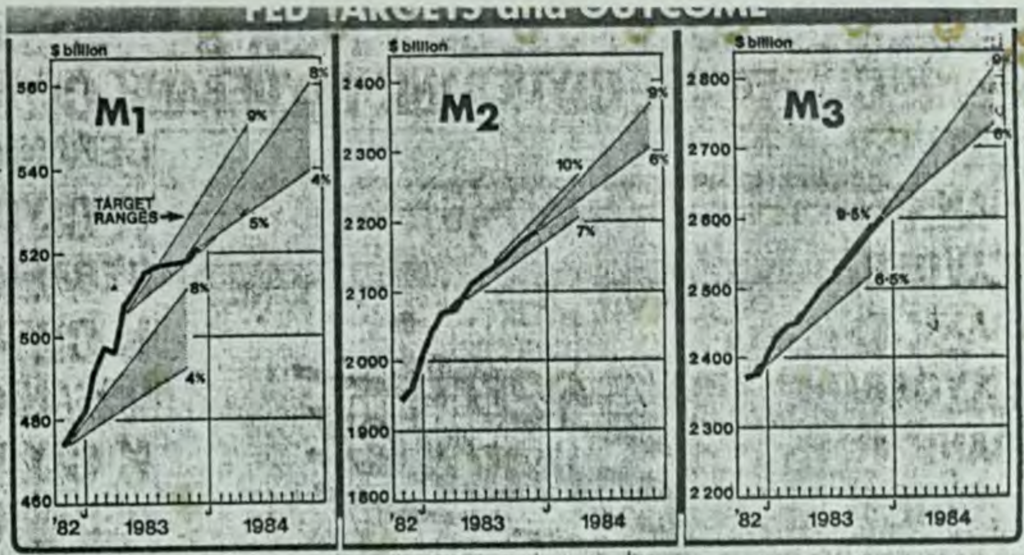
The desire to see interest rates lower, or to avoid increases, is natural. But attempts to accomplish that desirable end by excessive monetary growth could soon be counterproductive. By feeding concerns about inflation, the implications for interest rates themselves would be in the end be perverse—and likely sooner rather than later.

As things stand, credit markets are already faced with potential demands far in excess of our capacity to save domestically; to add renewed fears of inflation to the outlook would only be to reduce the willingness to commit funds for long periods of time and for productive investment. Inflationary policies would also discourage the continuing flow of funds from abroad upon which for the time being, we are dependent.

In setting the targets for the various monetary and credit aggregates for 1984 as a whole, the Fed Open Market Committee had to remain alert to the danger of renewed inflation as well as to the need for growth.

Certainly, a kind of demonstration that we are beginning to face up to our budgetary problems would make it easier for monetary policy to do its necessary work. And, in the larger scene, it would be tangible evidence to our own people that we can do what is necessary to seize the bright opportunities before us.

Feature, Page 19



Congressional Budget Office adds voice of concern

MR RUDOLF PENNER, director of the Congressional Budget Office, warned yesterday that Federal budget deficits could soar to $326bn by 1989 if there are no changes in current budget policies, Stewart Fleming writes from Washington.

The CBO warns that the deficit could hit $267bn in 1986 and $390bn by 1989. In an anlysis of the budget outlook based on more pessimistic economic assumptions in line with the U.S. economy's 3 per cent real growth path in the 1970s but including a "moderate recession" in 1986 involving a 0.9 per cent decline in real economic output.

The CBO's figures differ widely from those which the Reagan adminstration put in its budget message to Congress. The administration projected deficits of $177bn in 1986, falling to $123bn in 1989.

The CBO warned that deficits of this magnitude are unprecedented since World War Two. Many analysts believe they could have severely depressing effects on interest and trade sensitive sectors of the economy and could lead to increased instability in overall economic activity.

Commenting on the difference between the central projection of the CBO calling for a deficit of $326bn in 1989, Mr Penner said the CBO assumption of a 3.4 per cent real growth rather than the 4 per cent the Administration assumes and less optimistic interest rates assumptions appear to account for a large part of the gap.

Prime Minister 4

To note

AT

Mr. Turnbull.

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FM WASHINGTON 312358Z

TO IMMEDIATE FCO

TELEGRAM NUMBER 352 OF 31 JANUARY 1984

AND TO ROUTINE PARIS, BONN, TOKYO, ROME, UKREP BRUSSELS, OTTAWA, UKDEL NATO.

THE UNITED STATES FY85 BUDGET

1. PRESIDENT REAGAN WILL PRESENT HIS FY 85 BUDGET TO CONGRESS TOMORROW. IT IS EMBARGOED UNTIL NOON LOCAL TIME. UNTIL THEN THE INFORMATION IN THIS TELEGRAM, BASED ON AN ADVANCE COPY, SHOULD BE TREATED AS CONFIDENTIAL

2. THE BUDGET SUMMARY IS AS FOLLOWS:

	BILLIONS OF DOLLARS			
	FY84	FY85	FY86	FY89
RECEIPTS	670	745	815	1060
(PERCENT OF GNP)	18.8	19.2	19.3	19.8
OUTLAYS	854	925	992	1184
(PERCENT OF GNP)	24.0	23.8	23.4	22.1
DEFICIT	184	180	177	123
(PERCENT OF GNP)	5.2	4.6	4.2	2.3

3. THE MAIN OUTLINE OF THE RATHER OPTIMISTIC BUDGET ECONOMIC FORECAST IS FOR STRONG GROWTH IN 1984 (5.3 PER CENT YEAR-ON-YEAR) WITH STEADY GROWTH AT ABOUT 4 PER CENT THEREAFTER. INFLATION IS FORECAST TO PEAK AT ABOUT 4.6 PER CENT IN 1985 AND TO DECLINE SLOWLY THEREAFTER. THE MAIN FIGURES ARE AS FOLLOWS:

	ECONOMIC ASSUMPTIONS: CALENDAR YEARS				
	84	85	86	87	89
NOMINAL GNP (YEAR-ON-YEAR PER CENT INCREASE	10.1	9.1	8.7	8.4	7.6
REAL GNP YEAR-ON-YEAR PER CENT INCREASE)	5.3	4.1	4.0	4.0	3.9
CONSUMER PRICE INDEX (PER CENT INCREASE)	4.4	4.6	4.5	4.2	3.6
UNEMPLOYMENT (PER CENT ANNUAL AVERAGE)	7.8	7.6	7.3	6.8	5.7
INTEREST RATE 91 DAY T-BILL (PERCENT)	8.5	7.7	7.1	6.2	5.0

MESSAGE CLEARLY INDICATES THAT HE WOULD NOT SUPPORT MAJOR TAX INCREASES AT LEAST UNTIL SECRETARY REGAN HAS CONDUCTED HIS REVIEW OF THE TAX SYSTEM, DUE AT THE END OF THE YEAR.

10. FURTHER COMMENTS ON THE FY 85 BUDGET AND AN ASSESSMENT OF CONGRESSIONAL AND OTHER REACTIONS WILL FOLLOW BY SEPARATE TELEGRAM.

11. FCO PLEASE PASS TO LITTLER AND BOTTRILL (TREASURY), GREEN (BANK OF ENGLAND), AND ROLLO (ESID).

WRIGHT

FINANCIAL
NAD

(ADVANCED AS REQUESTED)

Prime Minister ②

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DESKBY 270900Z

FM WASHINGTON 262347Z JANUARY, 1984

TO IMMEDIATE F C O

TELEGRAM NUMBER 306 OF 26 JANUARY

INFO PRIORITY PARIS, UKDEL OECD, BONN, UKREP BRUSSELS, TOKYO AND ROME.

MT 27/1

MY TELS NOS 295 AND 296: STATE OF THE UNION ADDRESS: PRESIDENT REAGAN AND THE US BUDGET DEFICIT

SUMMARY

1. THE PRESIDENT'S ADDRESS INVITES THE CONCLUSION THAT HE DOES NOT WISH TO MAKE HARD ECONOMIC CHOICES IN AN ELECTION YEAR. THE PUBLIC OPINION POLLS SHOW THAT THE CHIEF REASON FOR HIS PRESENT POPULARITY IS THE PERFORMANCE OF THE ECONOMY, FOR WHICH HE SENSIBLY TOOK CREDIT, AND THAT THE VAST MAJORITY OF AMERICANS DO NOT WISH TO HAVE TO PAY EARLY TAX INCREASES, OR EVEN TO BE PSYCHOLOGICALLY CONDITIONED FOR TAX INCREASES AT A LATER DATE BY THE ANNOUNCEMENT OF SOME FORM OF CONTINGENCY TAX INCREASE SUCH AS THE ONE IN LAST YEAR'S BUDGET. HIS SPECIFIC PROPOSALS HAVE TO BE SEEN AGAINST THAT BACKGROUND.

DETAIL

2. THERE ARE A NUMBER OF PROPOSALS, NONE VERY CONVINCING FOR DEALING WITH THE BUDGET DEFICIT. SOME OF THEM WILL NO DOUBT APPEAR IN THE FY85 BUDGET, WHICH IS TO BE SENT TO THE CONGRESS ON 1 FEBRUARY, BUT OTHERS ARE LONGER-TERM AND PROVIDE A GENERAL INDICATION OF THE DIRECTION OF THE PRESIDENT'S THINKING FOR THE FUTURE BEYOND THE NOVEMBER ELECTIONS.

3. THERE IS AN IMPLICIT ADMISSION IN THE ADDRESS THAT THE PRESENT LEVEL OF THE STRUCTURAL BUDGET DEFICIT IS UNSATISFACTORY, BUT THAT SIGNIFICANT TAX INCREASES WOULD IN THE LONG-RUN MAKE THE STRUCTURAL DEFICIT EVEN WORSE. THE PRESIDENT SAID HE WISHED TO REDUCE THE ROLE OF THE GOVERNMENT IN THE OVERALL ECONOMY, WHICH MEANT REDUCING PUBLIC EXPENDITURE AND NOT INCREASING TAXES. BUT HE DID NOT IDENTIFY THE SPECIFIC AREAS IN WHICH EXPENDITURE CUTS COULD BE ACHIEVED. THE OUTLOOK FOR ACHIEVING PUBLIC EXPENDITURE SAVINGS IS NOT BRIGHT. STOCKMAN HAS PUBLICLY EXPRESSED THE VIEW THAT THEY ARE GOING TO BE VIRTUALLY IMPOSSIBLE. THE FINANCIAL MARKETS MUST DOUBT THE ABILITY AND DETERMINATION OF THE PRESIDENT TO DEAL WITH THE DEFICIT EVEN BEYOND THE NOVEMBER ELECTIONS.

4. ONLY MINOR PUBLIC EXPENDITURE REDUCTIONS ARE LIKELY TO BE PROPOSED FOR THE FY85 BUDGET, POSSIBLY REDUCING THE DEFICIT BY ONLY DOLLARS 5.6 BILLION IN FY85. THE TAX PROPOSALS WILL PROBABLY REDUCE MINOR LOOPHOLES AND MAKE TECHNICAL CORRECTIONS. THE PROPOSAL FOR A CONTINGENCY TAX SEEMS VIRTUALLY CERTAIN NOT TO REAPPEAR. THE TAX MEASURES MIGHT EVEN INCLUDE THOSE INTRODUCED LAST SESSION IN THE TAX REFORM ACT OF 1983 (HR 4170), AFFECTING TAX-EXEMPT

CONFIDENTIAL

/ENTITY

ENTITY LEASING PROVISIONS, INSURANCE TAX PROVISIONS, MINOR TAX SIMPLIFICATION, FRINGE BENEFIT PROVISIONS AND POSSIBLY MORE CONTROVERSIAL PROPOSALS SUCH AS A FURTHER TIGHTENING UP ON INDUSTRIAL REVENUE BONDS. BUT THESE WOULD INCREASE REVENUE BY ONLY DOLLARS 2.5 BILLION IN FY85. TECHNICAL RE-ESTIMATES MIGHT ADD TO THE FY85 BUDGET SAVINGS SO THAT THEY MIGHT TOTAL DOLLARS 12 BILLION IN ALL.

5. THE PRESIDENT'S SUGGESTION THAT CONGRESSIONAL AND ADMINISTRATION REPRESENTATIVES SHOULD MEET TO AGREE A BIPARTISAN DEFICIT REDUCTION PLAN TO ACHIEVE A BUDGET REDUCTION OF DOLLARS 100 BILLION OVER THE NEXT THREE YEARS IS NOT A NEW APPROACH. BUT WHEN THIS PLOY HAS BEEN TRIED IN PAST YEARS, IT HAS BEEN AFTER THE PRESIDENT'S BUDGET HAS BEEN INTRODUCED AND DIFFICULTIES HAVE DELAYED ITS PROGRESS IN CONGRESS. THE PRESIDENT REFERRED TO THE 2,500 RECOMMENDATIONS OF THE GRACE COMMISSION ON COST CONTROL IN GOVERNMENT AS A CONTRIBUTION OTO THE REDUCTIONS. THE COMMISSION CLAIMS TO HAVE IDENTIFIED A POTENTIAL DOLLARS 400 BILLION IN SAVINGS OVER THREE YEARS. BUT MOST OF ITS RECOMMENDATIONS CARRY LITTLE CONVICTION EITHER WITH THE OFFICE OF MANAGEMENT AND BUDGET OR ON THE HILL.

6. THERE HAVE FOR SOME TIME BEEN INFORMAL PROPOSALS FOR A PRESIDENTIAL COMMISSION TO MAKE RECOMMENDATIONS FOR CUTTING THE BUDGET DEFICIT IN THE MEDIUM-TERM. THE PRESIDENT DID NOT REFER TO THIS IDEA BUT INSTEAD PROPOSED THAT THE BIPARTISAN GROUP TO CONSIDER SAVINGS OVER THE NEXT THREE YEARS SHOULD ALSO EXPLORE HOW TO MAKE STRUCTURAL REFORMS. IT IS DIFFICULT TO SEE HOW SUCH A GROUP, THAT WILL BE HARD-PRESSED TO REACH AGREEMENT ON SHORT-TERM ISSUES, COULD REACH AGREEMENT ON A LONGER-TERM PLAN.

7. THE PRESIDENT'S BID FOR LINE-ITEM VETO POWER IN THE BUDGET PROCESS IS DESIGNED TO REPLACE THE PRESENT ALL OR NOTHING VETO WHICH IS A VERY BLUNT INSTRUMENT. ADOPTION OF A LINE-ITEM VETO POWER COULD IN THEORY BE ACHIEVED EITHER WITH LEGISLATION OR (MORE EFFECTIVELY) BY A CONSTITUTIONAL AMENDMENT. BUT IN PRACTICE IT IS DOUBTFUL WHETHER CONGRESS WOULD ACCEPT EITHER, SINCE SUCH A MEASURE WOULD GIVE THE PRESIDENT POWER TO CUT OUT SPECIFIC ITEMS THAT HE DID NOT LIKE WHILE LEAVING THE REST. HOWEVER A LINE-TERM PROCEDURE, IF ADOPTED, WOULD BE LIMITED IN EFFECT. IT COULD NOT GIVE THE PRESIDENT A VETO OVER THE BASIC PROVISIONS OF PUBLIC LAW. IT WOULD NOT FOR EXAMPLE TOUCH THOSE PROVISIONS WHICH GIVE CITIZENS ENTITLEMENTS UNDER PROGRAMMES SUCH AS SOCIAL SECURITY AND MEDICARE WHERE THE SCOPE FOR PUBLIC EXPENDITURE REDUCTIONS IS THE GREATEST. SUCH A VETO WOULD ALSO HAVE THE DISADVANTAGE OF IMPEDING BIPARTISAN DEALS, SUCH AS THE ONE SOUGHT BY REAGAN THIS YEAR, UNLESS THE PRESIDENT PROMISED NOT TO APPLY HIS VETO TO THE RESULT. BUT THE PRESIDENT HAS EVIDENTLY ADOPTED THE LINE-ITEM VETO AS HIS MAIN OBJECTIVE IN CHANGING THE BUDGET PROCESS: IT WAS NOTICEABLE THAT LAST NIGHT HE DOWN-PLAYED HIS LONG-STANDING ADVOCACY OF A CONSTITUTIONAL AMENDMENT REQUIRING A BALANCED BUDGET. 8.

8. THE MAJOR NEW ELEMENT IN THE SPEECH WAS THAT THE PRESIDENT HAS ASKED TREASURY SECRETARY REGAN TO REFORM AND SIMPLIFY THE ENTIRE US TAX CODE AND TO REPORT BACK IN DECEMBER 1984. THIS WILL BE A MONUMENTAL TASK. THE PRESIDENT TALKED IN TERMS OF LOWER TAX RATES ENCOURAGING TAX COMPLIANCE BY THE ILLEGAL UNDERGROUND ECONOMY, TO INCREASE THE TAX BASE, WHEREAS SECRETARY REGAN HAS RECENTLY BEEN ADVOCATING THE REMOVAL OF LEGITIMATE TAX LOOP-HOLES WITH THE SAME OBJECTIVES AS THE PRESIDENT - ENABLING MARGINAL INCOME TAX RATES (AND PROGRESSIVITY) TO BE REDUCED WITHIN THE US TAX SYSTEMS. BUT THE MAJOR AMERICAN PERSONAL TAX DEDUCTIONS - INTEREST PAYMENTS, CHARITABLE CONTRIBUTIONS, AND MEDICAL EXPENSES - WOULD BE DIFFICULT TO REDUCE. THE PRESIDENT MOREOVER DID NOT ADD TO THE CREDIBILITY OF ANY PROGRAMME TO CLOSE PERSONAL TAX LOOPHOLES BY REITERATING HIS SUPPORT FOR TUITION TAX CREDITS FOR PRIVATE SCHOOL EDUCATION.

9. FCO PLEASE PASS TO BOTTRILL (TREASURY), GREEN (BANK) AND BROADBENT (ESID).

WRIGHT

ADVANCED AS REQUESTED

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CONFIDENTIAL

OE

FROM: J O KERR

DATE: 17 January 1984

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Unwin
Mr Lavelle
Mr Bottrill
Mr Graham

Sir Oliver Wright: Washington
Mr Bone: FCO
Mr Coles: No 10
Mr Appleyard: FCO

MR LITTLER

A.J.C. 18/1

AMBASSADOR PRICE

The US Ambassador called, at his request, on the Chancellor for 40 minutes tonight. Four subjects were discussed.

US Deficit

2. The Ambassador said that he was very much afraid that the Budget proposals would show no reduction in the US deficit. He had spent an hour alone with the President at the New Year, and had formed the strong impression that "revenue enhancement" was, for the present, ruled out. He hoped, but without any great confidence, that this might be a tactical position, and that some concession on tax increases might be offered in exchange for agreement by the Democrats to cuts in spending on social programmes. But he feared that effective action to rein in the deficit would in practice be postponed until after November. He well remembered Mr Regan complaining to him, on 2 January 1981, about the deficit, then thought to be $45 billion, and subsequently discovered to be $65 billion, which he and the President were inheriting from the Carter era: Regan had seen it as absurdly, and damagingly high. He had agreed with all Regan said then, and he had not changed his tune, though Regan had had to change his.

3. The Chancellor agreed that, while the US success against inflation, and the current high levels of output growth, were a cause for congratulation, current and prospective high

deficits, and interest rates, were a cause of grave concern, and not just to the US itself. It was important to remember that the effect of high deficits was cumulative, as the debt service burden piled up. And private sector investment could be crowded out by the requirement to fund Government debt, while US industry must already be suffering from the high imports occasioned by the strong dollar. For the developing world, and for countries in debt, no single step would be more beneficial than a reduction in US interest rates.

UK Economy

4. The Ambassador suggested that UK economic performance was currently good, but that some commentators thought the recovery might run out in 1985 or 1986.

5. The Chancellor said that recovery was at present steady, with output growth in 1983 and 1984 likely to come out at just below 3 per cent. Inflation would stick at around 5 per cent for most of the year, and might fall further in 1985. Unemployment, though not yet coming down, had levelled off. Manufacturing productivity was steeply up; service-industries were expanding quite rapidly, and the labour market situation had been transformed since 1979, with management reasserting its authority, and the trade unions now in a very different mood. The 1983 surplus on the current account balance of payments would be some £1.5b; a further, though lower, surplus was forecast for 1984.

6. As for the possibility of the recovery running out in 1985 or 1986, long term forecasting was always dangerous, and to be avoided if possible. But provided that a consistent framework of financial policy was maintained, as it would be, and public spending kept firmly under control, as it should be, he saw no reason to expect a setback. The same commentators who now saw clouds on the horizon had in 1981 argued that recovery was impossible without a change of policy, had maintained in 1982 that the evident recovery was an illusion, had moved on in 1983 to predict a downturn in 1984, and were now obliged to postpone the date of Doomsday still further. One day they might be right, but the fact was that the prospects still looked good.

Unitary Taxation

7. The Chancellor asked whether Secretary Regan's commission on unitary taxation would still report, as planned, in February. The Ambassador had no new information, but thought that nothing had changed. He was inclined to doubt whether unitary taxation would be a long-term problem. It would not spread to every State, and the multi-national corporations

would move to those States which eschewed it. So the market would solve the problem by itself. The Chancellor thought this very plausible, but pointed to the present difficulties faced by foreign companies, and the very great concern about the issue both in this country and among our European partners. He had left Secretary Regan in no doubt about the pressures on HMG on the issue.

Relations with the Embassy

8. The Ambassador said that he would like to see closer links between his Embassy and HMT. A close and satisfactory working relationship existed between the US Treasury representative and officials in HMT, but he would like to see such contacts broadened to embrace the Embassy as a whole. And periodic meetings with the Chancellor would be particularly useful for him.

9. The Chancellor welcomed the idea of such meetings. His impression was that while there might on occasion be major disagreements between the Administration and HMG over economic and financial issues - eg the effects of a high Budget deficit, and the principle and practice of unitary taxation - the channels of communication were very good, and each side understood the other's position without difficulty. It was very useful that he saw Secretary Regan regularly, not just on bilateral visits, but in the framework of G5; and these meetings were under-pinned by regular meetings of G5 deputies. He could recall no recent parallel in the economic sphere to the problems in transatlantic political relations in late 1983: perhaps Foreign Ministers should form their own G5.

9. Incidentally, the Ambassador seemed 100 per cent confident that President Reagan would run again, and hardly less confident that he would win.

JOK.

J O KERR

10 DOWNING STREET

Prime Minister

Peter Tapsell handed the to Michael Alison. For as many as support him, I am sure there are as many, if not more, who welcome your remarks.

AT

21/12

econony

US fete

15/12/83

I have had a good many letters on the subject of U.S. deficits. The P.M. might possibly be interested to read an extract from a typical reply I have sent, since exchanges at Question Time necessarily have to be conducted in short-hand.

Peter Tapsell

Obviously, the "technicians" will wish to distinguish between cyclical deficits and structural deficits, but for the immediate purposes of the "neo-Keynesian" argument I think we can fairly confine the discussion to the cyclical deficit.

If your thesis of last March (which I strongly support as a generally helpful approach) is still valid the dramatic increase in U.S.production - probably 6% up end-quarter 1983 over end-quarter 1982 - should be producing a desirable result: and, indeed, it has so far.

As a proportion of GNP, the U.S. budgetary deficit fell from around 7% at the worst(end-1982) to what I expect to be around 5½%

in fiscal 1984 (which, as you know, started on 1st October).

Moreover, in the past two months there has been a substantial drop in the unemployment rate (by almost 1%) in the U.S. and this will certainly have a beneficial impact on the deficit.

I know that the "gloomsters" (who are mostly "monetarists" terrified of being discredited by the possible success of Reagonomics) tell us that the American economy will soon over-heat or even go back into recession. No doubt there will have to be periodic touches on the brake pedal. However, I hope you will agree that there is a very good chance that the 6% growth rate in 1983 can be averaged out at around your magic figure of 5.2% in the period up to 1986. I accept that most economists would regard such an estimate as on the high side, but even if the actual growth is lower than this it must have a restraining effect on the deficit.

So it is at least arguable that the spectre of future U.S. budgetary deficits has been exaggerated while the greatly beneficial effect on world trade of their trading deficit is often overlooked, as is the extent to which the recovery in the U.S. economy is acting as the "locomotive" to pull the whole world out of slump.

Although I naturally accept the argument that world interest rates might be lower if the U.S. budgetary deficit was smaller, it does not follow (as the history of the Thirties surely proves) that those lower international rates would generate a recovery elsewhere, while we do know that the U.S. budgetary deficit has been a major contributory factor to the recovery of the U.S. economy which is evidently working through to the rest of the world (e.g. Japan).

Richard Ryder made a valid point in his centre page article in The Daily Telegraph yesterday when he said that it might be misleading to draw a direct analogy between the U.S. and U.K. economies. I accept that. However, as the "monetarists" have been telling us for years that they are propagating absolute and universal truths,applicable to Taiwan and Chile as much as to a western industrialised society, it is hardly now open to them to apply a policy of strict intellectual selectivity where economies are concerned !

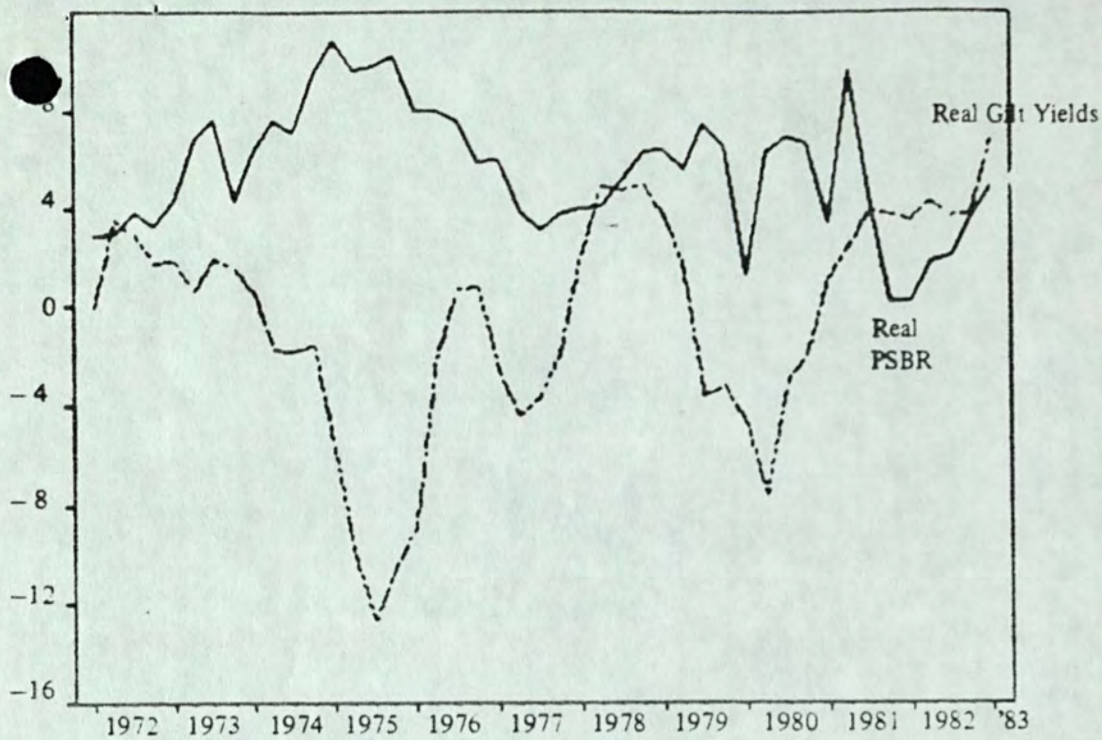
I am sure that Donald Regan was right when he told the EEC Finance Ministers last week that there is no direct causal link between deficits and interest rates (as a former bond dealer and a former chief executive of Merrill Lynch he is better equipped to make this judgment than most civil servants and academics). What he said about the U.S. is demonstrably true of the U.K. as the attached graph comparing Real PSBR and Real Gilt Yields over the past decade clearly shows.

Finally, there is a wider political consideration which is often overlooked. Three years ago we were all desperately worried about the military preponderance that the Soviet Union was expected to enjoy over the U.S. in the mid-1980's. The U.S. budgetary deficit, to a considerable extent, is a consequence of the President's heroic efforts to close that gap on behalf of us all. It is ironic that his severest critics now are precisely those who used to clamour most loudly about this danger.

Happy Christmas,

Yours ever, Peter

THE REAL PSBR AND REAL GILT YIELDS



Uncle Sam's overdraft may cut Britannia's housekeeping

Differences between the British and American economies outweigh the similarities, believes RICHARD RYDER, MP, so we should be wary of their attitude towards budget deficits

A GLORIOUS incident endures from the 1960s film, "The Graduate," when Dustin Hoffman, in the title role, is taken aside at his 21st birthday party by a business associate of his father's. "I want to give you some advice, boy," whispers the businessman, "just one word, plastics."

Three years ago an earnest American, out of the same sort of stable, and now in President Reagan's Administration, gave me advice at a conference in Switzerland. Gripping one of my elbows, and guiding me into breakfast, he confided: "Watch your deficit, boy, keep it low, keep it low."

It was far too soon in the day to be flippant and so I refrained from quoting about the only words of Oscar Wilde's known to me by heart: "It is always a silly thing to give advice, but to give good advice is absolutely fatal."

With the American deficit having doubled since then, despite President Reagan's professed fiscal conservatism, and the British deficit, as a percentage of the gross national product, halved by Mrs Thatcher, I wonder whether the good advice could prove fatal for anyone? I wonder, too, whether President Reagan's loose approach has greater merit than Mrs Thatcher's resolute approach? After all, if the American economy grows in real terms at five per cent. in 1984, as forecast, contrasted with, say, three per cent. here, then surely, the argument runs, the British Government should relax its anorexic obsession with the deficit — the resolute approach — and opt for expansion along American lines despite the near certainty of even higher interest rates.

While this view—to be examined later—partially depends on the existence of similarities between the two economies, it also supposes that the longer term American, and general world, recovery is not being threatened by the podgy Reagan deficit.

★

ON that score, sharp differences have surfaced at the top of the American Administration. The chairman of the President's Council of Economic Advisers, Mr Martin Feldstein, has bravely warned, against President Reagan's wishes, that the deficit is a major threat to world recovery. In fact, in a recent speech, Mr Feldstein reckoned that the President should raise taxes, at once, because further inaction on revenue to reduce the deficit endangered longer term recovery.

On the same day, Mr Donald Regan, the Treasury Secretary, whose presence in London last week ignited exchanges in Parliament, advanced the President's line that the perils of the deficit have been exaggerated. There is no direct link between big deficits and high interest rates, Mr Regan claimed, adding that the deficits, and the economic controversy generated by them, will disappear as recovery strengthens.

If Mr Reagan is correct, then the American economy is motoring as smoothly as a Cadillac, with perfect brakes, and no perils lurk for longer-term world recovery. According to Mr Feldstein's prognosis, the American economy is motoring along like a Cadillac, with defective brakes, and the consequences for longer-term world recovery could be shocking to behold.

Disaster can be avoided, he asserts, by checking expenditure or increasing taxes. Yet neither option is worth betting on with the Presidential election less than a year ahead. Besides, the President's protective attitude towards defence and the Congress's towards welfare hardly encourages the careful husbandry prevalent in most major Western nations. Indeed the President may even cut taxes, at last satisfying his old "supply side" friends, who contend that lower taxes create incentives and produce additional revenue.

Mr Regan and Mr Feldstein have British fan clubs or, as they are more grandly called sometimes, appreciation societies. No matter, many of Mr Regan's British fans, such as Mr Peter Tapsell, MP, imply that Mrs Thatcher's resolute approach is rather pointless. Whereas Mr Feldstein's cheer her to the echo and warn of rising inflation and interest rates, if she softens. Yet, are not similarities between the two economies sometimes misleading?

To start with, the American economy is more resilient than Britain's. American firms adapt more easily and expand output faster to meet demand. Despite difficulties, such as Japanese competition, loss of national self confidence, and the declining steel industry—inefficient production is rare, and firms in trouble, like Chrysler and Pan-am, recover faster. By contrast Britain, due to the fragility of its international competitiveness at the current exchange rate, is vulnerable to import penetration after a demand upsurge at home.

In fact, imports count for less in America than Britain. So much so that in 1982 imports of goods and services were equivalent to 11 per cent. of gross national product in America, contrasted with 25 per cent. in Britain. Consequently, improvements in the American economy lead to fewer import penetrations than here.

The pound is high—perhaps too high—and exposed to a loss of confidence and sudden depreciation. So, if Britain nourished a podgy deficit, the impact on the international value of sterling could be dramatic, the more so in future with oil revenues peaking.

Confidence could, also, be shaken in Britain if the Government followed the American example by selling debt in the City, where expectations of a high deficit resulting in rising interest rates could be self-justifying. In other words the City, scared of higher interest rates, might refuse to buy the Government debt. This could lead to looser money supply figures, and, if the Government persisted, to steeper interest rates, whatever the City's desires.

So America's experience with its deficit, if repeated here, could be perilous. Contrasts between the two economies outweigh the comparisons. Yet events across the Atlantic next year could significantly affect the course and speed of Britain's recovery.

President Reagan's re-election campaign has begun. When the bell sounds for the primaries in the New Year, his Democratic rivals, their hats already in the ring, will be wrestling for dominance in the snow of New England.

Gradually, during 1984, they—and the President—will be forced to elaborate their views on the deficit and whether it should be ignored or checked. Either way, Britain's economic recovery in the 1980s could be grazed by the American deficit, the sore aggravated by protectionist pressures, still building up despite good intentions and the international banking crisis which, far from solution, is being intensified by agencies such as the International Monetary Fund.

★

BACK to that conference in Switzerland, three years ago, where I was rebuked, after breakfast, by the American for predicting that the E E C's determination to develop an autonomous foreign policy would cause friction between it and President Reagan.

The American took me to pieces, for several minutes, before proudly concluding his assault by declaiming from Cicero: "Rashness attends youth, as prudence does old age." "Does that apply to foreign or domestic policy?" I inquired, in all innocence. "Both," he retorted. Now, he should know.

NOTE FOR THE RECORD

Prime Minister's Comments on US Budget Deficit

i) Why did the Prime Minister criticise US deficit so strongly?

Both the Prime Minister and the Chancellor have made public their concern about the US deficit on many occasions. There is nothing new in this.

ii) But wasn't the Prime Minister going further in saying US economic policy could "cause great trouble within 12 months"?

In questioning whether the US budget deficit was consistent with a sustained recovery, the Prime Minister was doing no more than the Chairman of the Federal Reserve, Mr. Volker, has done in his testimony to the Joint Economic Committee of Congress in October.

iii) In what sense had capital outflows to the US damaged investment in the UK?

The Prime Minister was doing no more than restating the fact that high interest rates in the US are damaging to the world recovery. As far as the UK is concerned we do not worry about investment overseas since, with a current account surplus, there must be a net outflow of capital. The point is, however, particularly relevant to the developing world. Nothing would be more helpful to them than a reduction in US interest rates.

8 December 1983

ANDREW TURNBULL

The Prime Minister: I refer the right hon. Gentleman to the reply that I gave some moments ago.

Mr. Ashley: Will the Prime Minister agree that she has been arguing in Europe for the principle that the poorest members should not pay the heaviest burden. If that is so, how about applying that principle at home where she can implement it? We have 1,068,000 people who are long-term unemployed and who are being denied long-term supplementary benefit. That means that married couples are being robbed of £11 a week—a quarter of their income. Unless the Prime Minister acts on that principle, is she aware that she can be accused of double standards?

The Prime Minister: No I do not agree with right hon. Gentleman's accusation. The unemployed receive, in the first instance, unemployment benefit from their insurance. Over and above that, they receive, as the right hon. Gentleman says, supplementary benefit. The two in total amount to about £5 billion. I think that the two are reasonable under the circumstances.

Mr. Kinnock: Has the Prime Minister yet had a chance to look at this morning's figures, which, sadly, confirm the fact that the 25 per cent. annual rate of increase in business failures is continuing? Can the right hon. Lady say which policies she will change to reverse this sad trend?

The Prime Minister: Unemployment, as the right hon. Gentleman knows, appears to have peaked. The number of vacancies are not increasing as fast as we would wish. There is very considerable interest in the new enterprise allowance. As he will have seen from "Social Trends", a record number of people are self-employed. This means that there is a great deal of interest in enterprise. The success or failure of a business depends not upon what the right hon. Gentleman or I say, but upon whether the business produces goods and services which people will buy.

Mr. Kinnock: I would be very glad to have further good news. I at least agree with the Prime Minister's view on competitiveness. Does she not concur with me when I say that it is extremely sad that, in the four years in which she has been Prime Minister, competitiveness has gone down by 30 per cent. and investment has gone down by 20 per cent? Given the recovery about which she talks, is she aware that if the present "rate of progress" were sustained it would take 160 years to get back to the level that we enjoyed in 1979? Will the Prime Minister answer my original question and say whether the 160-year wait is part of a medium or long-term strategy?

The Prime Minister: As the right hon. Gentleman is referring to 1979 and to industrial effort, I point out that output per head and output per hour now are 11 per cent. and 14 per cent. respectively above the previous cyclical peak of 1979. May I, on investment, refer the right hon. Gentleman to the Chancellor of the Exchequer's speech in the last full day's debate that we had on this subject when he gave full details on capital and current expenditure and pointed out that when one has a true definition of capital expenditure it is about the same now as it was during the year 1978-79.

Mr. Finsberg: Will my right hon. Friend find time today to talk to the Law Officers to see whether they can find a way to prevent authorities such as the GLC and Camden from spending ratepayers' money on Labour party propoganda?

The Prime Minister: I think that would probably be, as my right hon. Friend indicates, a matter for the district auditors or the Law Officers. I think that we would all deplore the expenditure of ratepayers' money on party political propoganda, particularly those hard-pressed ratepayers of London, including small businesses who want rates to go down, not up.

Q4. **Mr. Winnick** asked the Prime Minister what are her official engagements for 8 December.

The Prime Minister: I refer the hon. Gentleman to the reply that I gave some moments ago.

Mr. Winnick: While recognising that hardly anything has gone right for the Prime Minister in the past few weeks —I am sorry about that—was it not unjust to deprive the Lord Privy Seal and Leader of the House of Commons of his job of co-ordinating Government policy? Why does not the Prime Minister, like the Secretary of State for Northern Ireland and the Secretary of State for Energy, in their coded ways, recognise the fact that it is the Government's policies that are so damaging to Britain, not their co-ordination?

The Prime Minister: I note that the hon. Gentleman thinks that getting inflation down is very damaging for Britain—although our record is far better than his—and that the record of output per head is very damaging for Britain, although I think that it is very good. We have done far better on the National Health Service than the Labour Government—*[Interruption.]* The Labour Government actually reduced provision for the National Health Service in real terms in two of the five years—1976-77 and 1977-78—that they were in office. The fact is that the Conservative Government have been very good for Britain, as was recognised at the last general election.

Mr. Tapsell: When, later today, my right hon. Friend receives the United States Secretary of the Treasury, Mr. Donald Regan, will she discuss with him the reasons why economic policies which can broadly, but fairly, be described as at least neo-Keynsian, seem to have brought such beneficial effects to the United States economy? Before our next Budget is finalised could the principles of British economic policy be rigorously re-examined with an open mind?

The Prime Minister: In spite of what my hon. Friend said, a budget deficit of this kind is causing high interest rates, which are extremely damaging to this and other European countries. Further it is preventing us from getting the amount of investment that we should have in this country because much capital is withdrawing to the United States. The United States also has a fantastic balance of trade deficit in contrast to the figures for this country, where we have a £1·2 billion surplus so far this year. I would rather be in our position, which is sustainable, than in that of United States which, I believe, will cause great trouble within 12 months.

Dr. Owen: Has the Cabinet yet been able to make up its collective mind on the question of breaking the solicitor's monopoly on house conveyancing? If it has not, will the Government continue merely to talk about competition policy while creating private monopolies and maintaining professional monopolies?

The Prime Minister: An announcement will be made when the matter comes before the House shortly.

CHANCELLOR'S MEETING WITH MR REGAN, 8 DECEMBER

US ECONOMY

Points to make

(i) Welcome strong recovery in US economy since the beginning of this year. Important for US and rest of world that this is consolidated into durable growth for the years ahead.

(ii) Recovery so far has depended heavily on increased private consumption, residential construction and a turnround in stock-building. These have benefitted from the reduction in inflation and interest rates as well as the temporary boost from tax cuts and lower savings.

(iii) Note that falls in both inflation and interest rates appear to have come to an end.

$65-70 billion trade deficit, $40 billion current account deficit this year.

(iv) Disturbing that deterioration in trade balance has been so large - reflects partly of course the US lead in the recovery but probably more significantly the dollar's strength.

(v) Important now that balance of recovery should be shifted if it is to be sustainable with investment playing a full part and the deterioration in the external balance curbed.

(vi) Cannot disguise own view that budget deficit is the key. Unless it is put on a convincing declining path it is likely to pose an increasing threat to both internal and external financial stability.

(vi) Domestically, competition between government and private sector for funds is likely to put upward pressure on interest rates and make Fed's task of monetary control harder. Believe Mr Volcker right to adhere to counter-inflation policy. Monetisation of the deficit would be worse.

around $200 million and expected to remain there.

(vii) Externally, budget deficit has its counterpart in current deficit. Risk that foreigners will become increasingly reluctant to add further dollar assets to their portfolios, implying either pressure on the dollar or need for higher US interest rates.

(viii) Recognise pressures on Administration in run-up to next year's elections, but fear that delays in tackling budget deficit could prove high risk strategy economically (and politically?).

(ix) Confidence among markets in a reduction of the budget deficit would help keep down interest rates improving the prospects domestically for a recovery in investment and externally for an orderly dollar decline which would help correct the US trade balance.

(x) Countries outside US have a strong interest in US development and policies because of the impact on their own interest rates and exchange rates. What are Mr Regan's views on European policies for recovery? Hope we can take forward G5 multi-lateral surveillance process with IMF Managing Director.

INTERNATIONAL DEBT

The general outlook for the international debt scene is still uncertain. The longer term prospects have been improved to some extent by the economic recovery which is now under way in some major industrial countries but there are still difficulties to be faced in the short term.

General debt policy

2. Any durable solution to country debt problems must depend above all on economic adjustment by debtor countries. It is up to them to regain the confidence of commercial banks and other creditors by pursuing sound adjustment policies.

3. Developed countries' best contribution would be to secure non-inflationary growth and avoidance of protectionism.

4. Support the role of the IMF and World Bank by ensuring they have the necessary resources and by supporting such policies in the Board.

5. Governments stand ready to contribute through the IMF, World Bank, official rescheduling and BIS bridging operations as appropriate. They should not normally be expected to make further contributions to the financing burden. To do so could weaken the normal market disciplines on debtors and private creditors and involve unacceptable increases in Government spending or financial exposure.

6. Generally debtor countries are not a homogenous group. Their difficulties are best dealt with on a case-by-case basis, not by generalised and costly schemes. (The flexibility of this approach is already allowing the timescale to lengthen; some of the commercial bank facilities for Brazil run for 9 years.)

Brazil

7. The largest single problem has been Brazil whose difficulties may well extend several years into the future.

8. The recent round of negotiations passed successfully through the critical period at the end of last month, at which time

a. the IMF Board approved the revised economic programme enabling drawings to be resumed

b. a substantial part of the commercial banks $6.5 billion syndication had been achieved

c. the Paris Club agreed debt restructuring in respect of official debts of some $3.8 billion rather than the $2 billion which had earlier been anticipated by the IMF. (The UK share was $331 million, rather than $180 million.)

d. the IMF were satisfied on the availability of the $2.5 billion package of new export credits.

9. The British contribution generally has been substantial, but HMG has not made any commitment on the export credit package. No other G10 countries (apart from the US) have made commitments either, but all have some contribution in mind. The US commitment of $1.25 billion now seems likely to be mostly short-term, and therefore of lower quality than had originally been assumed. This apparently came as a surprise to the French and Germans at a recent meeting of G5 officials. The US response was to say that we (the UK) might count our own continuing short term cover. But this is not the point. We are under no pressure to alter our present position, except in the reports from Brazil itself and even this now seems to have been settled.

10. One of the immediate problems - of particular importance to the US - is the completion of the commercial bank syndication. If, as seems possible, it is not completed in time to allow disbursement of the first tranche before 31 December, arrears will remain outstanding and US banks may be required to declare certain assets as non-performing.

11. Even if the immediate hurdles can be cleared, Brazil faces a long difficult period of adjustment. The IMF seem to regard the present programme as no more than a holding operation for the next 9-12 months. A series of programmes may therefore be necessary to sustain the economic adjustment. The problem for the Brazilian authorities will be to maintain these policies in the face of the likely domestic political reactions.

Argentina

12. The IMF programme continues to deteriorate. There have been no drawings since last May, partly because of Argentine financial discrimination to the UK but also, now that this has been removed, by continuing arrears. Argentina was meeting performance criteria comfortably early in the year, but no longer seems to be doing so. The IMF will need to renegotiate the programme with the new government, which takes office on 10 December. They do not expect to finalise this before next March.

13. Despite great last minute confusion the first $500 million of the commercial banks $1.5 billion medium term loan was advanced last week on 2 December. It comes straight back to the banks in settlement of an overdue instalment on an earlier bridging loan and other arrears. This was particularly important to the American banks who might otherwise have had to classify their outstanding loans as non-performing assets.

14. Because the banks get the money back we have some assurance that it cannot be used for arms purchases.

In addition, it seems clear that military expenditure will not be a high priority of the new government. We would expect them to cut existing levels of spending, both to accommodate their own policies and to distance themselves from the previous military regime.

15. The US nevertheless intend to reinstate the certification of Argentina as eligible to receive US arms sales, to take effect from 10 December when the new Government takes office. The certification was originally withdrawn on human rights grounds. The return to democracy makes reinstatement almost automatic. We have nevertheless protested at this action in the aftermath of the Falklands conflict. We want to be sure that it will not lead to significant arms sales and that any applications will be properly vetted. We have US assurances on these points, and confidential assurances that they will consult us in particular cases as appropriate.

16. Certification is now scheduled to be announced at the regular US State Department press conference at midday (Washington time) on Thursday 8 December. This is roughly the same time as the meeting with Mr Regan.

Mexico

17. The Mexican economic recovery appears to be progressing well. The detailed application of debt rescheduling is being negotiated and implemented and the Mexican authorities are confident that their financial requirements have been covered in 1983. Requirements for 1984 remain at some $4 billion, but this is as originally expected.

Venezuela

18. Venezuela's debt service difficulties continue. Venezuela is heavily dependent on oil exports and the US is a major customer. Problems were caused by falls in oil prices and demand. The Venezuelan Authorities have allowed things to drift during 1983, rather than take unpopular economic measures

before the elections on 4 December. The results of the elections are now clear. The Christian Democrat Government has been defeated by the Social Democrat opposition, who will take office next February. We would hope that this will end the hiatus in debt rescheduling negotiation, and enable proper negotiations to resume with the IMF.

Philippines

19. This is building into a particularly difficult case. External debt amounts to some $25 billion. A 90 day moratorium on repayments of principal to banks is already in force. There will have to be negotiations with the banks, creditor governments in the Paris Club, and with the IMF.

20. The preliminary IMF view suggests a financing gap of some $4.3 billion up to mid-1985 and the IMF would look to Governments for some $1 billion over and above any contribution through debt rescheduling. In preliminary discussions at official level we have made it clear that the Fund should not take such a contribution for granted and should explore the alternative of a tighter programme. But we are bound to come under some pressure. In terms of bank exposure at the end of 1982, the US is in the front line with some 45%, Japan has 23% and the UK is third with 14%. It will be important for the Fund to keep in touch with all concerned.

Poland

21. Official talks on Polish debt relief were broken off after martial law was declared in 1981. The commercial banks continued with their own negotiations and they continue to press ahead. Agreements have already been reached for the years up to and including 1983. A meeting in Vienna has already been arranged for 16 December to discuss banking debt in 1984 and perhaps 1985 as well. The bulk of the banks' exposure has already been restructured and the amounts due in these and subsequent years are relatively small.

22. Official talks have just restarted, at a meeting in Paris last month. It made no progress. The Poles opened with unacceptable conditions about IMF membership and new credits, and talks very nearly broke down. Nevertheless it has been agreed that there will be a further meeting in the new year. The negotiations are bound to be long and difficult (not least because the commercial banks have had first go at the available resources) but we would hope to secure some net repayments and properly negotiated agreements for the future.

23. It is in Western financial interests to get the debt negotiations back on the road. It was good that the US Authorities were able to relax their political objections enough to allow last month's meeting to take place. It is disturbing that subsequently, following the strengthening of Polish internal controls, the American political conditions now seem to be back in place. This may mean that, even if the Poles come to the next meeting prepared to negotiate sensibly, we may nevertheless still be baulked by the US.

Yugoslavia

24. Western creditor countries met in Geneva last month (18 November) with the IMF and the Yugoslavs. The purpose was to review progress on the 1983 support package and to look forward to 1984. Two working groups are being set up, one to consider debt restructuring and the other to examine overall prospects for 1984. We expect the 1984 package to be smaller than this year's and for the official element to concentrate more directly on debt service payments due. As before the commercial banks will also be expected to make their own contribution to the final package. They are meeting this week.

25. We hope the IMF programme for 1984 will require Yugoslavia to make realistic economic adjustment themselves, keeping

to a minimum the need for external finance, and hopefully removing the need for any further support in 1985. The IMF currently still envisage a financing gap of more than \$2 billion of which they expect Governments to contribute some \$200 million in new export credits (on top of rescheduling). But a good deal of further scrutiny of these figures will be required. An IMF team is currently in Yugoslavia. The programme is unlikely to be settled before the end of this year.

PRIME MINISTER

Visit of Treasury Secretary Regan

Secretary Regan is calling on you on his way to Brussels where, together with Shultz, Block, Brock and Baldridge, he is having meetings with Thorn and other leading members of the European Commission. The background to this is set out in the telegram at Annex A.

Attached are the briefs for this visit. There are likely to be three issues:

(i) US Economy - see brief at Annex B.
The paradox is that inflation is low and the economy is still growing, so why worry? The disturbing signs are that despite strong growth, the budget deficit remains high at around $200bn. This is keeping interest rates up, the exchange rate up, and weakening the trade balance. The trade deficit could reach £65-70bn this year and more next.

As John Redwood's note indicates, this could all be a lull before the storm. The solution is, of course, to reduce the budget deficit.

You should express our worries about the balance of policy and probe for signs of any movement on the budget deficit.

(ii) International Debt, Brazil - see brief at Annex C.
You could ask Secretary Regan how he sees the prospects on international debt and seek his view of the Brazilian package. He might press you on export credit. You can reply that the UK has done a great deal in relation to its improvements in trade with Brazil. The extra export credit seems to have been secured. What is the point of offering more medium-term export credit when it is proving necessary to reschedule the existing credits. You could go over to the attack and say that you understand the £1.25bn of

/ US export credit

US export credit is short-term, and therefore of lower quality than had originally been assumed. Brazil still has access to US short-term credits.

(iii) Unitary Taxation - see brief at Annex D which sets out the background and line to take.
The main objective should be to register no lessening in our concerns and to establish from Secretary Regan the prospects for his working group.

AT

7 December 1983

GR 1200 RESTRICTED for Regan folder, (6.15 pm, 8/12)

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FM WASHINGTON 052254Z DEC 83
TO PRIORITY F C O
TELEGRAM NUMBER 3660 OF 5 DECEMBER.

U.S. ECONOMY: LATEST DEVELOPMENTS

1. THE LATEST INDICATORS CONTINUE TO SHOW THAT THE U.S. ECONOMY IS UNDERGOING A RAPID EXPANSION. REAL GNP ROSE AT AN ANNUAL RATE OF 7.7 PERCENT IN THE THIRD QUARTER, MAINLY AS A RESULT OF AN INCREASE IN FIXED INVESTMENT AND IN STOCK BUILDING. INDUSTRIAL PRODUCTION CONTINUES TO RISE, AND UNEMPLOYMENT FELL TO 8.4 PERCENT IN NOVEMBER, ALMOST A FULL 1 PERCENT BELOW THE 9.3 PERCENT SEPTEMBER LEVEL. RETAIL SALES ARE RISING, MAINLY REFLECTING THE STRONG RISE IN CAR SALES WHICH IN OCTOBER WERE 22 PERCENT ABOVE THE LEVEL OF A YEAR AGO.

2. THERE IS NO SIGN OF AN INFLATIONARY SURGE. THE CONSUMER PRICE INDEX IN OCTOBER WAS 2.9 PERCENT HIGHER THAN IN OCTOBER 1982 AND PRODUCER PRICES HAVE BEEN RISING ONLY MODERATELY. UNIT LABOUR COSTS HAVE RECENTLY BEEN RISING ONLY MODERATELY - AT AN ANNUAL RATE OF 1.8 PERCENT IN THE THIRD QUARTER SO THAT THEY ARE ONLY 0.8 PERCENT ABOVE A YEAR AGO. AT THIS STAGE THERE ARE NO SIGNS THAT PAY SETTLEMENTS ARE MOVING TOWARDS A MORE INFLATIONARY PHASE.

3. IN RECENT MONTHS THE GROWTH OF THE MONEY SUPPLY HAS SLOWED DOWN AND IN OCTOBER ALL THE MONETARY AGGREGATES WERE WITHIN THEIR TARGET OR MONITORING RANGES. M1 HAS BEEN INCREASING AT AN ANNUAL RATE OF ONLY ABOUT 1.7 PERCENT SINCE JULY, WHICH HAS GIVEN RISE TO SOME APPREHENSION WITHIN THE ADMINISTRATION THAT MONETARY GROWTH IS NOW TOO SLOW. FED CHAIRMAN VOLCKER HAS HOWEVER CLAIMED THAT THE STANCE OF MONETARY POLICY IS APPROPRIATE IN ORDER TO REDUCE THE CHANCES OF REKINDLING INFLATION AS THE ECONOMY CONTINUES TO GROW. IT IS WIDELY EXPECTED THAT FEDERAL RESERVE POLICY, WHICH IS NOW HIGHLY JUDGEMENTAL RATHER THAN MECHANISTIC, MAY RESPOND IF THERE IS ANY SIGNIFICANT SLOWING DOWN OF THE ECONOMY IN THE FOURTH QUARTER. INTEREST RATES, ESPECIALLY ALLOWING FOR INFLATION, REMAIN VERY HIGH AND THE NOMINAL RATE ON A THREE-MONTH TREASURY BILL IS NOW ABOUT 9 PERCENT AND, ON A TWENTY-YEAR GOVERNMENT BOND, ABOUT 12 PERCENT.

4. THERE WAS A RECORD DOLLARS 9 BILLION TRADE DEFICIT IN OCTOBER, AND CUMULATIVE TRADE DEFICITS FOR THE FIRST TEN MONTHS OF THIS YEAR AMOUNT TO DOLLARS 56 BILLION. IT IS WIDELY EXPECTED THAT THE TRADE DEFICIT MAY AMOUNT TO DOLLARS 65-70 BILLION FOR 1983 AS A WHOLE, RISING TO CLOSE TO DOLLARS 100 BILLION IN 1984. HIGH U.S. INTEREST RATES CONTINUE TO KEEP THE DOLLAR EXCHANGE RATE STRONG.

RESTRICTED /5.

5. THE PROSPECTS ARE ENCOURAGING AND THE BLUE CHIP CONSENSUS OF PRIVATE FORECASTS PREDICTS REAL GNP TO GROW BY 5.3 PERCENT IN 1984, FOR INFLATION TO INCREASE AT A RATE OF 5 PERCENT, AND FOR UNEMPLOYMENT TO AVERAGE 8.5 PERCENT FOR THE YEAR AS A WHOLE. THERE IS VIRTUAL UNANIMITY AMONGST COMMENTATORS THAT THE RECOVERY WILL CONTINUE AT LEAST UP UNTIL THE NOVEMBER 1984 PRESIDENTIAL ELECTIONS. WHILE HOUSING STARTS ARE DECLINING, MOST OTHER LEADING INDICATORS ARE RISING AND THE INDEX OF LEADING INDICATORS HAS RISEN IN EVERY MONTH SINCE SEPTEMBER 1982.

6. EFFORTS IN THE CONGRESS TOWARDS THE END OF THE LAST SESSION TO MAKE PROGRESS IN REDUCING THE U.S. BUDGET DEFICIT DID NOT SUCCEED, MAINLY BECAUSE THE PRESIDENT THREATENED TO VETO TAX LEGISLATION. CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS FELDSTEIN HAS RECENTLY MADE PUBLIC COMMENTS INCONSISTENT WITH THE PRESIDENT'S VIEW OF THE CAUSES OF THE DEFICIT AND OF THE APPROPRIATE MEANS OF DEALING WITH IT. FELDSTEIN HAS FOCUSED ON HIGH DEFENCE EXPENDITURE AND THE NEED FOR TAX INCREASES, HARKING BACK TO THE PROPOSAL IN THIS JANUARY'S FY 84 BUDGET FOR A CONTINGENCY TAX INCREASE IN FY 86. THIS HAS EMBARRASSED THE ADMINISTRATION (WHO PROBABLY INTEND TO DROP THE PROPOSAL IN THE FY 85 BUDGET) AND HAS ENDANGERED FELDSTEIN'S PERSONAL POSITION AS CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS.

7. THE ADMINISTRATION WOULD CLEARLY LIKE TO REDUCE PUBLIC EXPENDITURE BUT THEY HAVE NOT MADE DETAILED PROPOSALS FOR SO DOING, IN AN ATTEMPT TO STEER THE DIFFICULT DEFICIT ISSUE BEYOND THE 1984 NOVEMBER ELECTIONS. THEY WILL HAVE TO PRESENT THE FY 85 BUDGET TO CONGRESS IN EARLY 1984, BUT THEY MAY HOPE THAT ATTENTION WILL FOCUS ON THE UNADJUSTED BUDGET DEFICIT RATHER THAN THE STRUCTURAL BUDGET DEFICIT IMPLIED BY THE FIGURES.

8. ON THE LAST DAY OF THE CONGRESSIONAL SESSION, A BILL WAS PASSED ENABLING THE U.S. TO CONTRIBUTE DOLLARS 8.4 BILLION TO THE I.M.F. QUOTA INCREASE AND INCORPORATING BOTH AUTHORISATION AND APPROPRIATION LEGISLATION. CONGRESS ALSO HAS APPROVED AN INCREASE IN THE PUBLIC DEBT CEILING FROM DOLLARS 1.389 TRILLION TO DOLLARS 1.49 TRILLION. IT IS ESTIMATED THAT THE NEW CEILING WILL ENABLE THE GOVERNMENT TO CONTINUE FUNDING ITS PROGRAMMES UNTIL APRIL 1984.

9. LATEST DATA ARE GIVEN BELOW:-

SUMMARY: ECONOMIC INDICATORS

(ALL FIGURES ARE SEASONALLY ADJUSTED UNLESS OTHERWISE NOTED)

QUARTERLY DATA (1972 PRICES) (1983 - Q3)	PERCENT CHANGE ON PREVIOUS QUARTER	1 YEAR EARLIER
GNP	1.9	4.6
PERSONAL CONSUMPTION	0.7	4.8
EXPORTS OF GOODS AND SERVICES	3.2	-4.0
IMPORTS OF GOODS AND SERVICES	5.1	6.4

ACTUAL LEVEL

2

RESTRICTED /CURRENT

RESTRICTED

		LATEST QUARTER	PREVIOUS QUARTER
CURRENT ACCOUNT (1983 - Q2) DOLLARS BN		-9.7	-3.6
MONTHLY DATA		PERCENT CHANGE ON	
		PREVIOUS MONTH	1 YEAR EARLIER
RETAIL SALES	OCT	1.1	10.2
INDUSTRIAL PRODUCTION	OCT	0.8	14.1
CONSUMER PRICE INDEX	OCT	0.4	2.9
M1	OCT	0.1	10.4
M2	OCT	0.7	12.0
DOLLAR EFFECTIVE EXCHANGE RATE NSA	NOV	1.5	2.4
		ACTUAL LEVEL	
		LATEST MONTH	1 YEAR EARLIER
UNEMPLOYMENT RATE	NOV	8.4	10.7
3 MONTH TREASURY BILL NSA	NOV	8.7	8.1.

10. F C O PLEASE PASS TO LITTLER (FOR WICKS) AND BOTTRILL (TREASURY), GREEN (BANK) AND BROADBENT (ESID).

WRIGHT

FINANCIAL D
ESID
NAD

COPIES TO
MR LITTLER
MR BOTTRIL } TREASURY

MR GREEN
BANK OF ENGLAND

RESTRICTED

2 December 1983

USA - Econ Sit.

PRIME MINISTER

THE US ECONOMY

The US economy is rushing forward on the back of easy money and a traditional Keynesian stimulus to the economy.

The balance of payments is diving into deficit. The US is likely to reveal a $75,000 m. trade deficit for 1983. 1984 will see a deficit approaching $100,000 million on trade account. This is only possible because the American banking system is busy repairing the ravages of the world debt crisis and has stopped selling dollars to lend overseas. Conventional wisdom says that the dollar is unnaturally strong because there has been a flight into quality (ie dollars) by international investors. Many commentators have predicted the collapse of the dollar for a year or more. This paper explains why it hasn't fallen so far.

The Banking Crisis

In 1981, American banks lent $84.5 billion of new money to countries and multinationals around the world. Against this, only $41 billion of new dollars were deposited with US banks from external sources. This imbalance continued in 1982 with a further $107 billion increase in US banks' assets overseas (lendings to countries and companies) offset by only $63 billion of new foreign deposits with US banks.

The difficulties in making more lending available to bankrupt Third World countries and impecunious international companies has reduced the rate of new lending to only $11.5 billion in the first half of 1983. Against this, there have been new deposits of $11.7 billion for US banks. These movements in the international banking world have been the dominant influences upon the US capital account, and have enabled the US to carry on with its spending spree on imports from other countries. American banks' reluctance to lend largely explains the strength of the dollar.

In 1984 we would expect there to be some modest increase in the rate of new lending to Third World countries and international companies, if only to help them pay their interest bills. Companies will be more prosperous next year as a result of some upturn in world trade, and may use this as collateral for further borrowing. Meanwhile, the forced restructuring of Third World country debt is likely to entail some small increase in lending to Third World countries as part of the price of preserving the liabilities of those countries as assets on the banks' balance sheets. There may also be some increase in outward portfolio investment by US institutions which will also need matching. Not until there is a flight of capital outwards will the dollar fall sharply.

The US Budget Deficit

The background to the fast money growth in the States in the last 12 months has been the persistent high budget deficit. This is running at a near $200 billion per annum level, and even allowing for a satisfactory rate of economic growth and some upturn in tax revenues in 1984, the deficit is still likely to be running at $175 billion per annum one year out. This makes the conduct of tight money policies difficult. In the post-Election period, whoever is elected (and we assume that Reagan is the most likely) will have to tighten money policy and this will mean both taking some tough action on the budget itself, and raising interest rates.

The Status of Sterling

The future of sterling depends very much upon the state of play in the Gulf. If the Iraqis use their Exocet weapons to attack shipping around Kharg Island, and if they succeed in preventing the flow of oil along the Gulf routes, or if the Iranians retaliate by blocking the Gulf, then sterling will rise sharply as oil prices rise. Outside such an apocalyptic result, we believe that sterling will remain in the trading range 80-85 on the trade-weighted. The plight of the dollar is more problematic. Although the budget and trade deficits point to a sharp correction of an over-valued currency occurring sooner rather than later, the international banking crisis and the interest rate structure point in the other direction. It is too early to say when the dollar will crack: it will hinge on when US investors panic about the trade problem.

Conclusions

The US economy will continue to grow for another year. The dollar has not weakened on cue to correct the trade balance for the reasons outlined above. Inflation will pick up. International adjustments will remain slow, as:

(a) investors world-wide are extremely nervous about the international background; and

(b) the banking system is going to remain very cautious about taking on new commitments to growing but illiquid areas.

Currencies will remain volatile, and any attempt to embark on new stabilisation proposals now would be disastrous. The only way for currencies to move in line is if countries are prepared to pursue common monetary policies, and there is absolutely no evidence that they are ready to do this. The US economy remains with enormous structural weaknesses and imbalances, but we suspect that it will be able to muddle through for a bit longer. Our best strategy is to tighten a little now and await further progress in making the world debt burden more stable. The banking situation is the biggest constraint on world growth and the largest single worry besetting financial markets. We need to persevere with tough words to discourage default coupled with some sensible modest short-term accommodation through the international agencies as we have been doing.

<u>JOHN REDWOOD</u>

② CONFIDENTIAL

PRIME MINISTER ~~/~~ AT 9/11

US ECONOMY AND INFLATION IN 1984

My prognosis for the US economy is the same as I reported in my minute of 24 June. I am fairly certain that by the end of 1984 the inflation rate will reach 6% and might even be as high as 9%.

In the 12 months from July 1982 to July 1983 the monetary growth (M1) has been 13½%. The rise in the two years ending July 1983 was larger than any earlier two year period. I cannot see how this substantial monetary expansion cannot be reflected in the rate of inflation in 1984. That expansion has already produced a rapid "recovery" of the American economy over the past three quarters. It has had its effect on quantities; the consequences on prices must follow.

Since July 1983, however, there has been a sharp decline in the monetary growth rate. From July to October 1983 it has run at an annual rate of about 2½%. (This slow down was forecast as a likely outcome in the June memorandum.) It is likely that this will cause a marked decline in the rate of growth of the American economy probably beginning early next year.

I suspect as soon as this happens, Paul Volcker will come under pressure to expand. The taps will be open once again. We shall see again the familiar policy of switching between feast and famine.

We cannot entirely dismiss the possiblity that there will be some return to wages and price controls. Nixon introduced them under similar circumstances in 1981. If the democrats win the presidency, then wages/price regulations are a virtual certainty. But even with a Reagan victory I would judge that there is a 50-50 chance of controls being introduced.

All these thoughts, together with the seemingly permanent large ($200bn) federal deficit, suggest that 1984/85 will be quite a rough ride for the world economy. The best policy for Britain is to continue to pursue our programme of sound finance. This will ensure that we are as robust as we can be in all the turbulence around us.

AW

ALAN WALTERS
9 November 1983

CONFIDENTIAL

GPO

US fin

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

21 October 1983

Andrew Turnbull Esq
10 Downing Street

Dear Andrew

MR KINNOCK AND THE US BUDGET DEFICIT

I enclose, as promised, a short note on which you might draw in response to Mr Kinnock's suggestion that we should emulate the US budget deficit in pursuit of growth. As you will see, this refers to Mr Volcker's outspoken remarks to the Joint Economic Committee yesterday. We do not have a full text of Mr Volcker's speech but you will have seen it reported in the FT and we have checked the particular references with Washington.

Yours sincerely,

Margaret O'Mara

MISS M O'MARA
Private Secretary

~~Higher US budget deficits and economic recovery~~

Background

Mr Neil Kinnock has claimed in a speech to the Newspaper Press Fund in Glasgow that increases in public spending and borrowing, as in the United States, provide a route to economic recovery. It is true thatthe US economy is growing strongly but if this recovery is to prove durable and not be dissipated in rising inflation and interest rates, the US budget deficit will need to be curbed, and the Administration is committed to doing just that.

2. On the same day that Mr Kinnock was making his speech, Mr Paul Volcker, the respected chairman of the US Federal Reserve - who has more experience in these matters than Mr Kinnock has or is ever likely to have - told Congress in Washington that the huge Federal budget deficits were a threat to economic expansion and 'a major factor propping up interest rates.'

3. Mr Volcker pointed out that there were already signs, for example, in the housing sector, of private investment being crowded out by high interest rates. He also cited the poor US external trade performance as being one of the problems created in part by high interest rates which have helped keep the dollar artificially high.

SPECIAL NOTE

THE NEXT PAGES ARE GLUED TOGETHER CAPTURED IMAGE AS SEEN IN ORIGINAL

Growth in U.S. exceeds forecast

By Stewart Fleming in Washington

THE U.S. economy grew more strongly than expected in the third quarter, according to figures for real gross national product issued yesterday. The surge raised hopes that output will show a further significant increase in the closing months of the year.

Mr Donald Regan, the Treasury Secretary, predicted that the GNP could grow in the fourth quarter by more than 6 per cent. Yesterday's seasonally adjusted figure for the July-September period was 7.9 per cent.

The advance dispelled earlier fears that the U.S. economic upswing was in danger of petering out after the 9.7 per cent growth recorded in the second quarter.

Greeting the announcement, however, Mr Paul Volcker, chairman of the Federal Reserve Board, repeated his warnings that the huge Federal budget deficits were a threat to sustained economic expansion and were "a major factor propping up interest rates." Mr Volcker was addressing a congressional hearing.

Mr Malcolm Baldrige, the Secretary for Commerce, said the economy could grow at 4 to 5 per cent next year.

Mr Volcker said growth had been more rapid than expected and noted progress in the fight against inflation. In the latest quarter, inflation as measured by the broad "price deflator," was 3.3 per cent compared with 3.4 per cent in the second quarter.

But Mr Volcker went on to give a warning that some of the factors behind the impressive inflation performance in the first half of 1983, when prices were virtually stable, were temporary. Echoing Mr Baldrige, Mr Volcker said he expected inflation of 4½ per cent to 5 per cent next year.

Mr Volcker again saved his sharpest criticism for the policies which have resulted in budget deficits.

"It is an illusion," he said, "to believe that the deficit can be handled by (economic) growth."

There were already signs in, for example, the housing sector, of private investment being crowded out by high interest rates, which he saw as being directly related to the scale of the expected budget deficits. He cited the poor U.S. export performance as being one of the problems created in part by high interest rates and foreign currency inflows which had contributed to keeping the dollar artificially high.

Extracts from Mr Paul Volcker's testimony to the Joint Economic Committee of Congress, 20 October 1983.

' . . . Moreover, there are obvious potential obstacles in the path to sustained progress. Most importantly the current prospect that Federal budget deficits will remain exceptionally large into the indefinite future is a major factor propping up interest rates and continues to pose a serious risk to the stability of financial markets in the future threatening the balance and ultimate sustainability of the recovery itself.'

' . . . . It is an illusion to believe that the deficit can be handled by (economic) growth.'

SENT 20 OCT 1983

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TELEGRAM NUMBER 3036 OF 19 OCTOBER

PRESIDENT REAGAN'S PRESS CONFERENCE, : THE U S ECONOMY.

PRESIDENT REAGAN GAVE ONE OF HIS REGULAR TELEVISED PRESS CONFERENCES ON 19 OCTOBER. HE BEGAN WITH A STATEMENT IN WHICH HE SAID THAT, 1000 DAYS INTO HIS ADMINISTRATION A STRONG RECOVERY WAS UNDER WAY. INTEREST RATES AND INFLATION WERE DOWN: 400,000 NEW JOBS HAD BEEN FOUND LAST MONTH, AND MOST INDUSTRIAL SECTORS WERE NOW EXPANDING. THE KEY TO CONSOLIDATING THIS SUCCESS WAS KEEPING TAXES DOWN AND REDUCING GOVERNMENT EXPENDITURE, AND HE APPEALED TO CONGRESS TO COOPERATE IN ACHIEVING THIS DURING THE REMAINING WEEKS OF THE SESSION. IN REPLY TO A QUESTION ABOUT FALTERING INDICATORS IN THE HOUSING INDUSTRY, HE DENIED THAT HIGH INTEREST RATES WERE TO BLAME. THE LATEST FIGURES QUOTED, IF CONFIRMED, WERE PROBABLY AFFECTED BY SEASONAL FACTORS AND BY PEOPLE WAITING IN ANTICIPATION OF A FURTHER DROP IN INTEREST RATES.

2. FOR THE PRESIDENT'S ANSWERS ON ARMS CONTROL, IRAN/IRAQ AND LEBANON, SEE MY 3 IFT'S.

WRIGHT

010

ECONOMIC SECRETARY TO THE TREASURY

NBPM

MCS 9/9

Treasury Chambers, Parliament Street, SW1P 3AG

M C Scholar Esq
10 Downing Street
Whitehall
LONDON

5 September 1983

Dear Michael,

The Prime Minister may be interested in the attached notes on the series of meetings the Economic Secretary had in Washington and New York at the end of July. I apologise for not letting you have this before now.

I am sending a copy of this letter and the enclosure to Brian Fall (FCO).

Yours sincerely,

Andrew Hudson

A P HUDSON

CONFIDENTIAL

NOTE OF MEETING WITH DR MARTIN FELDSTEIN

Tuesday 26 July, at 10.00 am

Present

Dr Martin Feldstein, Chairman, Council of Economic Advisers

Economic Secrerary
Mr Wicks
Mr Hudson

1. The Economic Secretary began by explaining the purpose of his visit to the USA. US economic prospects had a major influence on the decisions which he and his Treasury colleagues would have to take over the coming months. He was concerned about the potential impact on the UK economy of the high American budget deficit and of a possible rise in interest rates, and wanted to explore the economic outlook at first hand.

2. Dr Feldstein said that he agreed with the general view that the high deficit had a serious impact on the rest of the US economy. He noted that Congress was beginning to see sense on spending levels, and thought this might make it possible for an agreement on the approach to controlling future deficits to be reached by the end of 1983. If this could be done, it would be important to convey to the markets that there was an agreed approach between the Administration and Congress, even if there was no action until 1985.

3. The Economic Secretary explained the way in which the decision to de-index certain benefits and to raise indirect taxes in the spring of 1981 had been crucial, in political as well as economic

terms, to turning round the economy. It had brought public borrowing under control, and had promoted an earlier fall in interest rates than would otherwise have been possible. Politically, although there had been a lot of opposition at the time, it had convinced the public of the Government's determination to stick to its strategy. Dr Feldstein expressed an interest in this. He thought it would be very useful to pass the message widely in the Administration, where similar tough decisions might have to be faced, and where the success of the British Government was much admired.

4. The Economic Secretary registered the Government's concern at the recent Supreme Court decision on unitary taxation.

APH

A P HUDSON
27 July 1983

CONFIDENTIAL

NOTE OF MEETING WITH MR JACQUES DE LAROSIÈRE

Tuesday 26 July, at 11 am.

Present

Mr Jacques de Larosiere, Managing Director, IMF
Mr Bill Dale, Deputy Managing Director

Economic Secretary
Mr Wicks
Mr Alan Whittome, Counsellor, IMF
Mr Hudson

1. Mr de Larosière began by saying that he thought the continued fight against inflation was the most important policy for a healthier world economy. The recession had in fact helped the real underlying strength of the economy: the need now was to build on this strength, and not to refuel inflation. The Economic Secretary said there need be no doubt about the British Government's commitment to the elimination of inflation: the measures announced on 7 July demonstrated this.

2. Mr de Larosière saw two main threats to the improving world economy: the size of the US deficit, with its implications for interest rates; and the international debt problem.

The US position

3. Mr de Larosière was concerned that the size of the deficit would inhibit recovery, because the US Treasury and the private sector would be competing for finance. Although the actual deficit would come down from the $200 billion projected for the current year, he saw no attack being made on the structural $100 billion deficit which was at the core of this.

4. Mr Dale also did not think this structural problem would be tackled. The Economic Secretary said that, although tough decisions would be required, the British experience over 1981 had shown that these could be politically advantageous in demonstrating the Government's commitment to its strategy.

5. Mr de Larosière said that Secretary Regan, speaking at a meeting recently, had not denied the link between the deficit and interest rates. Mr Regan had acknowledged that the size of the deficit would have to be tackled, though this could not be done through increasing taxes, which would merely give Congress more money which it would turn into extra spending. Mr de Larosiere feared that this approach was tantamount to saying that nothing would be done. His own view was that the best prospect of reducing the deficit would be through a combination of indirect tax increases and cuts in non-defence spending. The UK experience in 1981 could be useful in demonstrating the viability of such a measure to the Administration. Action was needed soon: measures for the 1984 Budget could be very helpful as a signal to the markets of the Administration's resolve.

The International Debt Problem

6. Mr de Larosière said that steady progress was being made in tackling the problem and monitoring the position of countries in trouble. Some people had suggested radical approaches, such as "internationalising" all the large sovereign debt. He was sure that such approaches would not be viable, because there would be a lack of political support in eg the United States, nor desirable, because it was vital to maintain the direct link between countries and their creditors.

7. Of the major programmes, that for Mexico was on track, as was that for Argentina, apart from a problem on wage levels and the UK's particular problem (paragraph 8 below). The position on Brazil was more worrying: it was critical to successful recovery that the 1984 Budget should build on recent moves in the right direction. The

letter of intent which the Fund had recently been given did not promise this - it merely covered the most immediate problems of 1983 - so his staff would be seeking a more satisfactory programme.

8. Mr de Larosière had made it clear to the Argentines that the Fund management would not support continued eligibility to draw if the discriminatory restrictions against UK banks and companies were not lifted. The Argentines said that they could not make such a move for political reasons. This meant there was a risk of the IMF programme, and with it the commercial bank programme, being stopped, and Argentina going into practical default.

9. The Economic Secretary stressed how critical an issue this was for the UK Government in political terms. Much of the difficulty in getting the International Monetary Arrangements Bill through Parliament had resulted from the objections of MP's to loans to Argentina, and the military uses to which they could be put. The Government had supported the IMF programmes as the best route for the debtor countries back to normal economic and political relations; and the decision to take the IMA Bill early, when it would have been easier to delay, was a part of this. He said that the Government was very grateful for the Managing Director's help to date in standing firm on the non-discrimination conditions attached to the IMF programme for Argentina.

10. Mr de Larosière said that the Fund would be absolutely firm. He thought some gesture from the UK on the exclusion zone would help the Argentines. The Argentines might try to play on the general fear of a country defaulting, but he thought it would be against their interests to do so.

APH

A P HUDSON
27 July 1983

NOTE OF MEETING WITH MR C FRED BERGSTEN

Tuesday 26 July, at 12.15 pm.

Present

Mr C Fred Bergsten, Director, Institute for International Economics

Economic Secretary
Mr Walsh
Mr Hudson

1. The Economic Secretary raised with Mr Bergsten two subjects of concern to the UK in the international field, unitary taxation, and the extraterritoriality of some US legislation. He stressed the strength of feeling on both issues.

2. On unitary taxation, Mr Bergsten agreed that the effects would be damaging to the US. He thought that a constitutional problem would emerge, with states trespassing on the remit of the Federal government. He thought that the sense of repugnance generated by extraterritoriality would only be realised by American opinion if another country retaliated.

3. Mr Bergsten asked about the economic effects flowing from the high pound between 1979 and 1981. The Institute for International Economics were studying methods of exchange rate management, and would be publishing something in the autumn. The Economic Secretary explained the basis of the UK stance. Mr Bergsten said that the US Administration had not become more pragmatic on the value of intervention in the exchange markets, in contrast to its positions on other subjects.

APH

A P HUDSON

27 July 1983

ECONOMIC SECRETARY TO THE TREASURY

NOTE OF LUNCH AT IMF

Tuesday 26 July, at 1.00 pm

Present

[See attached list]

1. Much of the lunch was taken up, rather surprisingly, with explanations of the methods by which the UK Treasury monitors and controls public expenditure. The lead-in to this came from the Economic Secretary stressing the importance the UK Government attach to public expenditure control. He and Mr Wicks explained the cash limit system, and its importance as a discipline on Departments planning future spending.

2. Otherwise, discussion covered the overall economic picture. Dr Penner made the point that the US deficit problem was more serious than the UK had faced not only because the deficit was higher as a proportion of GNP but also because this was true although the scope of US Federal Government activity was narrower than in the UK.

APH

A P HUDSON
27 July 1983

Lunch given by Mr Nigel Wicks at the IMF on Tuesday, 26 July, at 1.00 p.m. in Dining Room No. 1

'To meet Mr John Moore, MP, Economic Secretary to the Treasury.'

Guest List

Host

Mr John Moore, MP	Economic Secretary to the Treasury
Mr Andrew Hudson	Private Secretary to Mr Moore
Mr Edwin M (Ted) Truman	Director, Division of International Finance, Federal Reserve
Mr Raymond Seitz	Executive Assistant to Secretary Shultz, Department of State
Mr Bruce Bartlett	Executive Director Joint Economic Committee
Mr William Cline	Institute for International Economics
Mr Shahid Husain	Vice President, Operations Policy World Bank
Dr Rudolph Penner	American Enterprise Institute
Mr Derek Smith	UK Alternate World Bank

ECONOMIC SECRETARY TO THE TREASURY

NOTE OF MEETING WITH SENATOR JAKE GARN

Tuesday 26 July, at 3.00 pm.

Present

Senator Jake Garn, Chairman, Senate Banking Committee
2 staff members

Economic Secretary
Mr Walsh
Mr Hudson

1. There was some discussion of the IMF Bill, which Senator Garn had steered through the Senate. He was not optimistic about the Bill's getting a speedy passage through the House. Even if it did, it would emerge so heavily amended that the conference between the 2 chambers to sort out the differences would be very difficult.

2. The Economic Secretary referred to the UK Government's concern at both unitary taxation and the extraterratoriality in some legislation. On the latter, Senator Garn said that it resulted from very strong feelings in Congress and the Administration about aspects of the involvement of American or their subsidiaries with the Eastern bloc. The Economic Secretary saw this point of view, and undertook to pass it on to the Secretary of State for Trade and Industry, but he stressed the repugnance felt in the UK for extraterritoriality.

3. Senator Garn blamed the problem of the high Budget deficit solely on Congress. If the President's proposals had been passed in every detail, without amendment, there would be no problem. But Congress did not show the courage needed to implement spending cuts.

APH

A P HUDSON
27 July 1983

RESTRICTED

NOTE OF MEETING WITH DR BERYL SPRINKEL

Tuesday 26 July, at 3.45 pm

<u>Present</u>

Dr Beryl Sprinkel, Under Secretary for Monetary Affairs, US Treasury

Economic Secretary
Mr Wicks
Mr Hudson

1. The <u>Economic Secretary</u> began by explaining the purpose of his visit, and his interest in the prospects for the US economy over the next year, against the background of the high budget deficit, and fears of an increase in interest rates.

2. <u>Dr Sprinkel</u> said that he thought there was a shortage of evidence of a link between budget deficits and interest rates. His own view was that there was such a link.

3. However, he thought that monetary policy was also very important. The Administration had been urging the Fed for the past six months to cut the rate of growth of the money supply, but to do so without putting a brake on the recovery. They would continue to press this approach on the Fed.

4. The <u>Economic Secretary</u> explained the purpose, and successful outcome, of the measures introduced by the UK Government in the spring 1981 Budget. <u>Dr Sprinkel</u> said that if these measures were tried in the US, the deficit would not fall - Congress would merely spend more. The Treasury had calculated that of \$100 extra tax revenue, 60-70 went in extra spending, and only 30-40 in reducing the deficit.

5. If the recovery was maintained, prospects were good for a fall in the deficit, because growth prospects were good. The President would contribute to the fall by vetoing spending increases. If monetary growth could be contained, there would be scope for interest rates to fall. But this did depend on a number of variables all working out well. At the moment, the markets did not believe inflation would stay as low as it was at present, and Dr Sprinkel tended to agree.

[6. The Economic Secretary's judgement on Dr Sprinkel's - relative - optimism is that it is in large measure the product of his views not having been heeded, and his having lost his former control and influence. What he is now doing is seeking an intellectual defence for the President's inability to act to restrain spending, and unwillingness to hold back on tax cuts.]

7. Dr Sprinkel was very interested in the Government's privatisation programme.

8. The Economic Secretary registered with him the concern felt in the UK about unitary taxation.

9. At the time of the meeting, Dr Sprinkel was heavily involved in lobbying Congressmen on the IMF Bill. He was confident that it would pass in more or less its existing form.

APH

A P HUDSON
28 July 1983

RESTRICTED

NOTE OF MEETING WITH MR ROBERT DEDERICK

Tuesday 26 July, at 5.00 pm

Present

Mr Robert G Dederick, Under Secretary for Economic Affairs, Commerce Department

Economic Secretary

Mr Walsh

Mr Hudson

1. Mr Dederick's responsibilities were in the Commerce Department, but his views were of considerable interest on general economic questions. The Economic Secretary began by asking how Mr Dederick saw the general economic outlook.

2. Mr Dederick said that the crucial question for him was why short-term rates had not fallen further at a time of recession. His own explanation was that the Fed had not reduced the rates further because it feared this would fuel inflation.

3. He did not see long-term interest rates as particularly high. He noted that the difference between this and previous large deficits was that these had always come about at times when private sector credit demand was weak.

4. The large deficits resulted from having indexation of personal tax reliefs, while not removing indexation of spending programmes.

5. Nothing was likely to be done about this in 1983 or 1984; there might be changes before the end of 1985. In the longer run, he thought there would be some form of consumption tax in the USA.

6. He saw dangers to inflation and eventually to interest rates in an over rapid recovery. There was no chance of fiscal action to put downward pressure on rates. Some move now to increase the rates slightly would increase the chance of the recovery not being too rapid. Such a move would be politically more feasible now than in 1984.

7. The Economic Secretary registered the concern in the UK at unitary taxation. He pointed out the danger to the USA, above all other countries, if other countries, particularly l.d.c.s introduced unitary taxation. Mr Dederick said that he had not previously thought very hard about unitary tax, because of his commitment to States' rights. He recognised now that he would have to think seriously about this difficult problem.

8. On the international trade picture, Mr Dederick thought it was now impossible for the USA to be an island of growth, because of its dependence on other markets and its relationship to the l.d.c.s and OPEC. The Economic Secretary stressed the UK's concern at trends towards isolationism and protectionism. He did not think was in the US's best long-term interets. Protectionism for steel was of particular concern. Mr Dederick mentioned agriculture as an area of concern to him: the US needed to export its surplus production, but faced subsidies, especially in the EC.

9. Mr Dederick acknowledged that if the $ fell to a more reasonable level, a lot of the pressures on US firms would disappear. Some major firms were in trouble.

APH

A P HUDSON
28 July 1983

NOTE OF MEETING WITH SENATOR JAMES McCLURE

Wednesday 27 July, at 9.30 am

1. During his visit to Washington, the Economic Secretary had a private meeting with Senator McClure, the Chairman of the Senate Committee on Energy and Natural Resources.

2. Senator McClure thought there was no possibility of action being taken on taxes or spending to reduce the high budget deficit before January 1985.

3. He thought that there would be another fast-breeder package later this year.

4. He added an interesting insight to the question of unitary taxation, by saying it was partly a debate between "producer" states and "consumer" states. Producer states were in favour of it, as a way of increasing their revenue-raising capacity; consumer states were very antagonistic, because it would make it much harder for them to attract industries.

APH

A P HUDSON

28 July 1983

ECONOMIC SECRETARY TO THE TREASURY

NOTE OF MEETING WITH MR RAY SEITZ

Wednesday 27 July, at 10.30 am

1. During his visit to Washington, the Economic Secretary had a private meeting with Mr Ray Seitz, Executive Assistant to Secretary of State Schulz, whom he knew very well from the time when Mr Seitz was a First Secretary in London.

2. The Economic Secretary put Mr Seitz fully in the picture on the UK position on the question of further IMF help to Argentina while discriminatory restrictions against UK banks and companies were still in place. He stressed that this was an issue of the highest political sensitivity in London. Mr Seitz said he would pass this on to Secretary of State Schulz. He thought there need be no worry that the USA would wobble in its support for the UK's and the Fund's position. He had not been aware previously that the existence of discriminatory restrictions was not generally known in Parliament.

3. In conjunction with this, the Economic Secretary explained to Mr Seitz that the Government had decided to take the International Monetary Arrangements Bill through Parliament earlier than was necessary - and at the cost of using up considerable political credit - in order to demonstrate its commitment to the IMF as the route back to normalcy for debtor countries.

4. Mr Seitz raised the subject of Lebanon, which he said was not taking up 50% of the Secretary of State's time. He said that the presence of the British troops in the Lebanon peace-keeping force was critical.

A P HUDSON
28 July 1983

NOTE OF MEETING WITH MR STEPHEN BOSWORTH

Wednesday 27 July, at 11.00 am

Present

Mr Stephen Bosworth, Director, Policy Planning Staff, State Department

Mr Paul H Boeker

Economic Secretary
Mr Walsh
Mr Hudson

1. The Economic Secretary began by raising the issue of unitary taxation. He said it puzzled MPs and others in the UK, who did not think the Administration was putting sufficient effort into getting rid of it. He pointed out the dangers for the USA if l.d.c.s adopted this method of taxation. Mr Bosworth said this was an issue he had not gone into very deeply. Mr Boeker pointed out that national legislation would be needed to eliminate unitary tax, and this could take two years. The Economic Secretary was concerned at this: he said unitary taxation was the most serious single issue between the two countries; if resolving it took two years, there would be severe pressure for retailiation of some sort. Mr Walsh point out that in that time, more states might adopt unitary taxation: this was not a problem which would lessen or disappear if nothing were done.

2. Mr Bosworth explained that in his role as Director of the Policy Planning Staff at the State Department, his task was to challenge some of the conventional wisdoms there. There was a difference of view in the US Government as to whether high budget deficits mattered. Some thought that the capital markets were not

suffering, and that high interest rates were caused not by the high deficit but by expectations about inflation. His own view was that the high deficit did matter, leading to high interest rates, which had an adverse effect on the whole economy. He saw a link with the high dollar, and was concerned at the impact of this on the trade position.

3. Mr Bosworth thought there would be no action on the deficit until 1985. The scope for cutting spending had reached its limit in political terms. There would therefore be no spending cuts to reduce the structural deficit, so any changes would have to be on the revenue side, and he did not see the President changing his position. After 1985, something would have to be done to restore the revenue base. He thought the structural deficit was moving towards $130 billion. The Economic Secretary asked whether the high deficit would affect the quality and durability of the recession before then. Mr Bosworth thought there was a chance that favourable external factors, such as a fall in energy prices, might mean the recovery remained bouyant until 1985. A key point on oil prices was how far Saudi Arabia would accept the erosion of her market share over some years. Cuts in government spending would be resisted there as elsewhere.

4. Mr Boeker pointed to some of the other variables. The expectation that the value of the dollar would be sustained had led to investment in the USA. A change in, for example, the expectations for inflation could have a significant effect on this, and if the dollar began to fall it might fall fast. Certain commodity prices might rise: he noted that the US faced the possibility of a very bad feed grain harvest. There were a lot of variables, and if none went badly awry, action on the deficit early in 1985 might be soon enough.

5. Mr Bosworth asked about the position of the British economy. The Economic Secretary explained that the deficit and inflation were under control, the Medium Term Financial Strategy had been

reaffirmed, and that the recovery was a little way ahead of most of Western Europe. Major policy objectives for the next five years included reducing the burden of taxation and switching it further from direct to indirect taxes, and making progress on privatisation.

6. Mr Bosworth asked about the prospects for the EEC countries. The Economic Secretary was not optimistic in some cases. He noted that the pound had gone up quite markedly against some of the softer European currencies. Mr Bosworth thought there was a growing perception in Germany of a shift in relative prosperity against the Germans and in favour of the British. He thought German self-confidence was falling. The Economic Secretary agreed, and thought that the UK was benefitting from having taken tough decisions which had not yet been addressed elsewhere.

APH

A P HUDSON
29 July 1983

NOTE OF MEETING WITH MR RICHARD McCORMACK

Wednesday 27 July at 11.45 am

Present

Mr Richard McCormack, Assistant Secretary for Economic and Business Affairs, State Department

Economic Secretary
Mr Walsh
Mr Hudson

1. The Economic Secretary began by explaining the UK's concern about unitary taxation. Mr McCormack was very position in response. He said that the Administration was well aware of all the arguments against unitary tax, including the danger to the USA of l.d.c.s adopting the method. He realised that other States were likely to follow the 13 who used it at the moment. The subject had been discussed at a recent Cabinet Council of Economic Affairs, and no member had had anything to say in favour of the method. A working group had been set up to look into the problem urgently.

2. Mr McCormack thought the question of the deficit was absolutely essential to the prosperity of the USA. He thought there was no chance of action on it before the election, unless something tangible came up which threatened to abort the recovery, and could convince the Administration as a whole, and Congress, of the urgency of the problem. Public debate was not yet sufficiently compelling. But he thought the problem would be tackled early in January 1985 at the latest.

3. Mr McCormack said that he and most of his colleagues expected some downward pressure on oil prices next spring, for perhaps a $2 fall, unless there was a hard winter. This might come from a desire on the part of the Saudis to sell more oil. Otherwise, the Americans expected prices to be relatively stable over the next 5-10 years. The Economic Secretary said he would be interested in future indications of US views on this subject, particularly on the timing of changes.

4. The Economic Secretary explained the UK's position on exterritoriality. He did not think that otherwise well informed and influential American opinion appreciated fully the repugnance felt in the UK over this. Mr McCormack said he realised certain US actions had touched a sensitive nerve. But the UK had done similar things occasionally. The aim should be to remove the real irritants to good relations. The Economic Secretary said he understood this, but stressed that the American extention of control over overseas subsidiaries was a very sore point.

APH

A P HUDSON
29 July 1983

ECONOMIC SECRETARY TO THE TREASURY

LUNCH AT WORLD BANK

Wednesday 27 July, at 1.00 pm

Present

(see list attached)

US Economy

1. Mr Wicks began by asking Mr van Doorn Ooms for his view on the familiar question of the US deficit.

2. Mr van Doorn Ooms said that he saw very little chance of any action to reduce spending. There was also a lack of enthusiasm in the Administration for any move forward on a revenue Bill. This meant that the deficit was likely to remain roughly its present level at least until the election.

3. Governor Wallich admitted to being perplexed at the behaviour of the monetary aggregates. His view of the fiscal outlook was the same as that of Mr van Doorn Ooms. His own view was that it might be possible to achieve tighter monetary targets if there were a smaller budget deficit. But he did not think Congress would share this view: they would expect some relaxation of monetary discipline as a quid pro quo for a tigher fiscal stance. Given present circumstances, the view of the monetarists was that when interest rates fell, they would fall only slowly.

4. Governor Wallich said that he thought the large trade deficit might not have its expected effect of downward pressure on the dollar. In any case, the strong dollar was not necessarily a bad thing for the rest of the world. Commodity prices were measured in dollars, so a strong dollar had some advantages for l.d.c.s.

Other countries could decouple from the dollar, allowing their currency to fall against the dollar, and becoming able to reduce their interest rates. The USA stood to suffer, as it was already suffering, in its trading position. Mr Wicks thought that the most important and inescapable thing for the debtor countries was that their debt was denominated in dollars, and they suffered from the high (dollar) interest rates which they had to pay on the debt.

World Economy

5. Mr Habermeier wondered whether some of the current international economic problems could be eased by an expansion of the international money supply. The Economic Secretary said that this was not an approach which appealed to the UK Government; Mr Wicks put the argument that it would merely fuel inflation. Mr Habermeier did not think this was necessarily the case, but his view had little support in discretion.

6. There was some discussion of the pros and cons of the proposition that the IMF should borrow more from commercial banks, and particularly of whether this would lead to more or less lending direct from banks to individual countries. There was no great enthusiasm for more IMF borrowing, though nobody sought to suggest it would be wrong under all circumstances. Mr Qureshi made the point that the IMF would not want to duplicate the role of the World Bank in the financing of longer-term programmes, and all agreed with this. Mr Habermeier confirmed that any borrowing would be short-term.

APH

A P HUDSON
2 August 1983

Lunch given by Mr Nigel Wicks at the World Bank on Wednesday, 27 July, at 1.00 p.m. in Dining Room No. 3

'To meet Mr John Moore, MP, Economic Secretary to the Treasury

Guest List

Host

Mr John Moore, MP	Economic Secretary to the Treasury
Mr Andrew Hudson	Private Secretary to Mr Moore
Mr Alan Granwell	International Tax Counsel US Treasury
Mr Van Doorn Ooms	Chief Economist, Economic Analysis House Budget Committee
Mr Richard McCormack	Assistant Secretary Economic and Business Affairs Department of State
Mr Moeen Qureshi	Senior Vice President, Finance World Bank
Mr Walter Habermeier	Treasurer, IMF
Mr Alan Whittome	Counsellor, IMF
~~Mr Marc Leland~~	~~Assistant Secretary for International Affairs, US Treasury~~
Mr Harry Walsh	Counsellor (Economic), British Embassy
Governor Henry C Wallich.	Federal Reserve Board

NOTE OF MEETING WITH REPRESENTATIVE STEPHEN NEAL

Wednesday 27 July, at 3.00 pm

Present

Representative Stephen Neal, Chairman, Sub-Committee on International Trade, Investment and Monetary Policy

Economic Secretary

Mr Walsh

Mr Hudson

1. The main topic of discussion at this meeting was the IMF Bill, which was being debated in the House that week. Mr Neal was responsible for the Bill, as Chairman of the relevant sub-committee of the House Banking Committee.

2. Mr Neal did not think that the Bill could be passed that week - there were simply not enough votes behind it. He was confident that a version of the Bill would pass eventually - the measure at the heart of it was simply too important not to prevail. However, perception of that was not sufficiently wide-spread at the moment.

3. The Administration was fairly confident that the Bill would pass in the current week, as the Economic Secretary had gathered from earlier meetings. But they had not "counted noses". They underestimated the depth and breadth of feeling against the Bill, and hence the amount of lobbying that would be required, particularly of the Administration's own natural supporters, for the measure to command a majority. Such lobbying as had taken place had been too little and, for a vote in the current week, too late. Opposition was coming from a number of angles: from those who thought it was merely a measure to bail out the banks; from those who thought

money would be better spent on social programmes at home; from those who thought extra facilities for the IMF were simply wasted; and from some Democrats who were disinclined to vote for an Administration measure when the Administration had not mustered its own forces in support.

4. The <u>Economic Secretary</u> explained that, under a very different Parliamentary system, it had been difficult to steer the comparable Bill through the House of Commons. Opposition had come similarly from all sides, with the added particular complication of loans to Argentina. Nonetheless, the Government had felt it important to take the Bill early, although this was not politically the best time, because an early passage would demonstrate commitment to the IMF as the best route for debtor countries back to normalcy, and would, it was hoped, help other countries to secure early passage of their Bills. The Chancellor had written to Treasury Secretary Regan with this in mind. The Economic Secretary mentioned to Mr Neal two of the main arguments he had used in getting the Bill through: that the IMF was the best route back to normalcy; and that a default would have very serious consequences for banks in the USA or the UK with, for example, a threat to the jobs of employees in the banking sectors.

[5. The Economic Secretary judged Representative Neal to be a thoroughly competent and able man. He thought Neal's explanation of the reasons why the Bill was running into trouble were right. Neal himself had done all could.]

APH

A P HUDSON

2 August 1983

CONFIDENTIAL

NOTE OF MEETING WITH CHAIRMAN VOLCKER

Wednesday 27 July, at 4.00 pm

Present

Mr Paul Volcker, Chairman, Federal Reserve Board

Economic Secretary
Mr Walsh
Mr Hudson

US Economy

1. Chairman Volcker did not depart from the broad consensus that no action would be taken to reduce the US structural deficit before 1985. Indeed, he feared that once the Budget for FY 1984 had been considered in Congress and in the Administration, and in negotiations between the two, it was unlikely that the figure for the deficit envisaged in the Conference Resolution of Congress ($179.3 billion) could be achieved.

2. This would make it very difficult for interest rates to come down. The current slight shading upwards might prevent a larger rise later. But Congress would only act on the deficit if there were a sharp increase which they saw as stemming from the budget deficit and threatening the recovery.

International Issues

3. There was not very much discussion of the international trade picture. But Chairman Volcker accepted that the dollar was currently at a very high level, and was aware of the fears that if it began to fall it might fall rapidly and sharply.

4. On the Brazilian situation, Chairman Volcker said that the Government's decision to begin to take the necessary tough measures on the economy (beginning the de-indexation of wages) had come as a considerable relief. The situation would, of course, have to be monitored with care , and it was particularly important to ensure that the recent progress was build upon in 1984. For the present, financial assistance should be maintained and if IMF assistance were delayed the necessary bridging operation should take place. He hoped that the UK would agree.

5. On the IMF Bill, Chairman Volcker confirmed that the President had become involved in the process of securing support for the Bill. The Economic Secretary explained that the pattern of opposition in the UK Parliament had been fairly similar to that in Congress. The Government had decided to take the Bill early to show its support for the IMF as the route back to normalcy for the debtor countries. Chairman Volcker was sure that this would be a useful point for the Administration to pray in aid in rallying support.

APH

A P HUDSON
3 August 1983

CONFIDENTIAL

NOTE OF MEETING WITH CHAIRMAN VOLCKER

Wednesday 27 July, at 4.00 pm

Present

Mr Paul Volcker, Chairman, Federal Reserve Board

Economic Secretary
Mr Walsh
Mr Hudson

US Economy

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APH

A P HUDSON

3 August 1983

ECONOMIC SECRETARY TO THE TREASURY

NOTE OF ECONOMIC SECRETARY'S VISIT TO NEW YORK,
28-29 JULY 1983

1. This note records the main points emerging from the Economic Secretary's visit to New York, which followed straight after the visit to Washington (recorded in a series of separate notes).

2. The Economic Secretary had meetings with the following:

(a) Mr Henry Fowler, Chairman, Goldman Sachs and Co, and former Secretary to the US Treasury;

(b) Mr Lewis Preston, Chairman, and Mr Rimmer de Vries, Morgan Guaranty Trust;

(c) (Lunch) Mr Ralph Peters, Chairman, Discount Corporation, and colleagues;

(d) Mr Sam Cross, Executive Vice-President, Federal Reserve Bank of New York;

(e) Mr Gary Wenglowski, Chief Economist, Goldman Sachs and Co;

(f) Mr Thomas Theobald, Vice Chairman, Citicorp;

(g) Mr P P Kuczynski, President, First Boston International.

3. The Economic Secretary also had private meetings with Board Members from Dean Witter Reynolds Inc, and with Mr Henry Kaufman of Salomon Brothers.

4. The purpose of the visit was, in short, to test out the conclusions drawn from the Washington meetings on people working in the financial markets.

5. The core of all the meetings was therefore discussion of the general outlook for the US economy. The Economic Secretary began by explaining the structure of the new Treasury team, and the purpose of his visit. He was interested in the US economy because of its significance for the decisions which would have to be taken in the UK over the coming months, and for the worldwide implications of movements in American interest rates and the dollar. His overwhelming impression from his meetings with members of the Administration, in Congress, and with Chairman Volcker, was that it was most unlikely that any action would be taken to reduce the high structural deficit before the Presidential election at the end of 1984. Congress would not agree to any spending cuts; and the President would brook no tax increases. The deficit would therefore continue at a very high level, and most people thought this would put upward pressure on interest rates, although this was not a unanimous conclusion. The outlook for the economy was thus not very auspicious: the high deficit might put a brake on recovery if it led to higher interest rates, and might also lead to inflation.

6. None of the people we met in New York disagreed with these conclusions. There was no suggestion that the deficit problem would be addressed, unless a particular event - the obvious possibility being a sharp rise in interest rates - forced Congress and the Administration to address it. And there was a general expectation that interest rates would go up rather than down, though nobody forecast a rapid increase. There was some concern at how long the dollar could be sustained at its present level, given the large trade deficit; and the fears outside the USA that this would lead to more protectionism were acknowledged.

7. The person who came nearest to departing from this consensus was Mr Theobald (of Citicorp). His immediate response to the Economic Secretary's summary of the position was to say that interest rates were not necessarily high, in historical terms, or measured against the market's expectations of future inflation. He also questioned whether the level of interest rates was inhibiting business behaviour in any way. There was certainly no shortage of venture capital in the USA - he quoted some madcap schemes which had found substantial financial backing and then, predictably, failed. Indeed, Citicorp had decided recently to expand their venture capital activities in the UK, where there was unfulfilled demand.

8. Mr Fowler though that the deficit could not be tackled without tackling two elements in it: firstly, the revenue side as a whole; and secondly, the indexed flat-rate entitlements (benefits), where demographic changes were increasing the costs, and where he thought the case for some form of means-testing was overwhelming. He did not think the political will existed to tackle these problems now. But it was not impossible; as Treasury Secretary, he had presided over the last US budget surplus (in 1968), and he had achieved this by pushing through some unpopular tax increases. He was thus interested in the Economic Secretary's explanation of the purpose and consequences of the spring 1981 Budget, when indirect taxes had been increased and certain benefits de-indexed against strong opposition at the time, but with the result of demonstrating to the public the Government's resolute determination to keep the deficit down and get rid of inflation, and hence some gain in political terms. Mr Fowler hoped the message had been heard in Washington.

9. Mr Fowler thought it was very important for international understanding that Ministers, and particularly heads of Government, should meet regularly. He believed this was the only real way better international cooperation could be achieved.

10. Mr Wenglowski (of Goldman Sachs) was concerned about the "crowding out" resulting from the high deficit. The very substantial Government borrowing was making funds harder to come by for other potential borrowers: the l.d.c.s and the private sector. He thought, however, that the Fed was likely to be forced to temporise and to delay rises in interest rates because of the political pressure the "crowded out" could apply.

11. Mr Wenglowski said he thought the high deficit would lead to inflationary pressures. But it was the interaction of the high deficit with the desire for a tight monetary policy which caused the problem of heavily indebted l.d.c.s.

12. Mr Eddie Hanlon, of the Discount Corporation, shared the general expectation that interest rates would go up. But he could not see any point in the Fed's present policy of "gradualism" - allowing rates to shade up gradually, in the hope of avoiding a major increase later. This had been tried before, and had never worked.

13. Discussion with Mr Preston and Mr de Vries at Morgan Guaranty concentrated on international economic issues. They were interested in the UK's policy on intervention and the exchange rate: Mr de Vries had heard reports that the UK was now pursuing a policy of managing rates to keep them within specific target zones. The Economic Secretary said that there had been no change in policy. Clearly, the extent of intervention would fluctuate from time to time dependent on circumstances, but such fluctuations should not be misinterpreted as a change of policy. This reassured Mr de Vries, who had been surprised by the suggestion that the UK had target zones.

14. Both Mr Preston and Mr de Vries were very concerned about the problem of debtor countries. They thought that the present approach was right. Brazil was particularly worrying: it was vital here to link the 1983 and 1984 programmes to try to ensure progress was maintained.

15. They wondered what could be done about the valuation of the dollar against the yen. The Economic Secretary saw this as part of a wider question for the West of how to get on in economic terms with Japan.

16. They thought there would be some weakening of oil prices in the spring. Internal pressure would make Saudi Arabia, and possibly other OPEC countries, want to sell more oil.

17. On the privatisation programme, they were optimistic that a proportion of the shares in the various companies could be sold in the US markets.

18. Mr Kuczynski and his colleagues at First Boston (Mr Donnelly and Mr Batten) were similarly optimistic about the prospects for share sales.

APH

A P HUDSON

3 August 1983

pm

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GRS 600
CONFIDENTIAL [CULL]
DESKBY 080900Z
FM WASHINGTON 052355Z AUG 83
TO IMMEDIATE FCO
TELEGRAM NUMBER 2211 OF 5 AUGUST
INFO BONN, PARIS, TOKYO, ROME, UKREP BRUSSELS AND OTTAWA

US INTERVENTION IN FOREIGN EXCHANGE MARKETS

1. WICKS AND EXETER CALLED ON DALLARA (DEPUTY ASSISTANT SECRETARY FOR INTERNATIONAL MONETARY AFFAIRS, U S TREASURY) AND AXILROD (STAFF DIRECTOR FOR MONETARY AND FINANCIAL POLICY, FED) TODAY TO DISCUSS THE U S INTERVENTION IN EXCHANGE MARKETS, AND TO ASCERTAIN WHETHER THIS MARKED A CHANGE OF POLICY.

2. THEIR CONVERSATIONS INDICATED THAT THE INITIAL REASON FOR THE INTERVENTION IN EXCHANGE MARKETS ON FRIDAY, 29 JULY WAS THE DESIRE TO SMOOTH THE VOLATILITY OF THE DOLLAR/DEUTSCHEMARK RATE AND TO A LESSER EXTENT THE DOLLAR/YEN RATE. IN ADDITION, DALLARA MENTIONED THAT TREASURY SECRETARY REGAN FELT IT A SUITABLE OPPORTUNITY TO SHOW THE ADMINISTRATIONS COMMITMENT TOWARDS THE UNDERSTANDING ON INTERVENTION AND EXCHANGE MARKETS REACHED AT WILLIAMSBURG FOLLOWING THE CIRCULATION OF THE JURGENSEN REPORT. IT HAD ALSO BEEN CONCLUDED THAT INTERVENTION MIGHT BE MORE SUCCESSFUL IF IT WERE CO-ORDINATED WITH OTHER COUNTRIES WHOSE CURRENCIES WERE UNDER PRESSURE, AND IF THE CO-ORDINATED INTERVENTION WERE WELL PUBLICISED.

3. IT APPEARS MOST UNLIKELY THAT THIS INTERVENTION MARKS ANY CONSIDERED CHANGE OF POLICY BY THE ADMINISTRATION. THE OBJECTIVES OF THE ACTION APPEAR TO HAVE BEEN LIMITED TO STEMMING THE RISE IN THE DOLLAR AND TO CALMING DISORDERLY MARKETS. ALTHOUGH THE ADMINISTRATION REMAINED CONCERNED OVER THE LEVEL OF THE DOLLAR, THERE WAS NO SUGGESTION THAT THEY WERE ATTEMPTING TO LOWER THE RATE.

4. AXILROD EXPLAINED THAT DURING THE FIRST PART OF THIS WEEK, MARKETS HAD CONTINUED TO BE UNSTABLE DESPITE THE INTERVENTION, MAINLY IN RESPONSE TO THE LARGE U S TREASURY FUNDING REQUIREMENTS AND SOME INCREASE IN THE FEDERAL FUNDS RATE, THE LATTER FOR REASONS WHICH COULD NOT WHOLLY BE EXPLAINED. PARTLY FOR THESE REASONS, THE INTERVENTION HAD BEEN LARGER AND MORE FLEXIBLE THAN ON PREVIOUS OCCASIONS WHEN THE ADMINISTRATION HAD INTERVENED. AXILROD CONFIRMED THAT THE INTERVENTION WAS STERILISED SO THAT IT HAD NO EFFECTS ON THE MONEY SUPPLY. IT IS CLEAR THE INTERVENTION IS BEING CARRIED OUT AS A DAY-TO-DAY OPERATION. BOTH AXILROD AND DALLARA WERE MODERATELY PLEASED WITH THE WEEK'S WORK.

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5. OUR ASSESSMENT IS THAT THE DECISION TO INTERVENE SEEMS TO HAVE RESULTED FROM A NUMBER OF SPECIFIC FACTORS PARTICULARY THE VOLATILITY OF THE DOLLAR/DEUTSCHEMARK RATE, AND DOES NOT MARK ANY CHANGE OF POLICY BY THE ADMINISTRATION. BUT IN VIEW OF BOTH THE TREASURY'S AND THE FED'S COMMENTS ON THE COMPARATIVE SUCCESS OF THE OPERATION, IT MAY MAKE IT EASIER FOR THOSE MORE IN FAVOUR OF INTERVENTION TO ARGUE THEIR CASE ON SUBSEQUENT OCCASIONS SHOULD THE DOLLAR CONTINUE TO RISE AND IF U S INTEREST RATES WERE TO RISE FURTHER. THERE IS NO CHANGE IN THE VIEW THAT INTERVENTION CAN AT BEST HAVE ONLY A LIMITED EFFECT IN THE FACE OF STRONG CAPITAL FLOWS. NOR IS THERE ANY INDICATION THAT THE WEEK'S EVENTS HAVE PERSUADED THE ADMINISTRATION TO RE-EXAMINE THE FUNDAMENTALS OF ECONOMIC POLICY AS IT EFFECTS INTEREST RATES AND THE BUDGET DEFICIT.

6. FCO PLEASE ADVANCE TO LITTLER AND PERETZ (HMT) AND GILCHRIST (BANK OF ENGLAND).

THOMAS

FINANCIAL
ERD
NAD

COPIES TO
MR LITTLER } TREASURY
MR PERETZ }
MR GILCHRIST B/ENGLAND

Chancellor of the Duchy of Lancaster

Prime Minister

Odd.

MLS 20/7

NO

PRIME MINISTER

1. May I draw attention to the following:

The United States

? ? G.D.P ? 1. Has a massive budget deficit - currently estimated at $170 billion to $179 billion or well over £100 billion;

No higher than ours. 2. Has very high rates of interest.

Nevertheless

1. The US economy is recovering very rapidly: growth by Q4 1983 more than double that in the UK - 5½% compared with 2½% in the UK.

2. Unemployment lower - 10% compared with 13.7% in the UK. Increase since 1979 much less than in the UK.

3. Inflation lower - 3.5% compared with 3.7%.

2. We have always taken the view that a high deficit means high interest rates. The President has challenged this view. Official discussions have been inconclusive. There is another strand of thought suggested by the current performance of the American economy. It may well be that what really matters is not so much the size of the deficit - or the PSBR - but its composition. That a deficit due to a high level of expenditure is damaging. But a deficit due to a low level of taxation may not be. The difference lies in the fact that in the first case Government expenditure is pre-empting an increasing share of the national resources. While in the second case it is the private sector which is given the opportunity and impetus to expand. If this thesis is true it would go a long way to explain the apparent irrational policy the President is pursuing and the even more irrational success it is achieving. ? – Time lag to renewed inflation?

3. The implications for our own policy are profound. I do not propose raising the matter in our discussion on public expenditure tomorrow. It might well confuse the argument - even though in fact it powerfully supports the case for reducing expenditure. Nevertheless we shall need to return to the matter before the Budget strategy is settled. And as getting the economy moving is of the essence in relation to unemployment it is relevant also to the Chequers discussions.

A.C.

COCKFIELD

20 July 1983

20 JUL 1983

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CF/ PA please mcs 14/7

CF/ Chancellor, the Treasury:

GR 650
CONFIDENTIAL [CULL]
FM WASHINGTON 072254Z JUL 83
TO ROUTINE FCO
TELEGRAM NUMBER 1903 OF 7 JULY

CALL ON SECRETARY REGAN

1. I CALLED ON SECRETARY REGAN TODAY AS PART OF THE PREPARATIONS FOR YOUR VISIT NEXT WEEK AND TO INTRODUCE MINISTER (ECONOMIC), LELAND (ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, US TREASURY) WAS ALSO PRESENT.

2. THE US TREASURY WERE CLEARLY MUCH AGITATED THIS MORNING BY TODAY'S ARTICLE IN THE WASHINGTON POST REPORTING THAT ''FEDERAL RESERVE OFFICIALS, FACED WITH AN ECONOMIC RECOVERY THEY BELIEVE COULD SPEED OUT OF CONTROL, WILL TIGHTEN CREDIT CONDIDTIONS NEXT WEEK AND LET INTEREST RATES RISE''. SECRETARY REGAN SIAD THAT THE SAW NO CASE FOR COOLING DOWN THE ECONOMY WHEN IT HAD NOT YET HAD A CHANCE TO HOT UP. THERE WAS STILL A LOT OF SLACK IN THE US ECONOMY SO THAT EARLY ACTION WOULD BE PREMATURE.

3. I SAID THAT YOU WOULD NO DOUBT WELCOME A DISCUSSION ON THIS AS WELL AS ON PROSPECTS FOR REDUCING FUTURE BUDGET DEFICITS.

We must enquire what action the Treasury is taking.

4. REGAN THEN ASKED ABOUT REACTION IN THE UNITED KINGDOM TO THE SUPREME COURT'S RECENT DECISION ON UNITARY TAX. I TOLD HIM ABOUT THE CONSIDERABLE CONCERN WHICH THAT DECISION HAD CREATED AND I SAID THAT YOU MIGHT WELL WISH TO RAISE THE SUBJECT WITH HIM. LELAND SAID THAT THE JUSTICE DEPARTMENT WERE CONSIDERING ASKING THE SUPREME COURT FOR A RETRIAL ON THE GOUNDS THAT THEY HAD NOT CONSIDERED THE ADMINISTRATION'S CASE. REGAN THOUGHT THAT THE MORE PROBABLE COURSE WOULD BE FOR THE ADMINISTRATION TO PROPOSE REMEDIAL LEGISLATION. HE FORESAW CONSIDERABLE DIFFICULTIES IN CONGRESS WITH SUCH LEGISLATION, ESPECIALLY AS THE AFFECTED STATES WOULD NO DOUBT DEMAND FINANCIAL COMPENSATION FROM THE US TREASURY.

5. REGAN REPORTED THAT THE ADMINISTRATION'S IMF BILL WOULD BE FACING CRITICAL VOTES IN THE HOUSE ON EITHER JULY 15 OR 19. IF THE VOTES WERE LOST, THE BILL WOULD NOT BE KILLED BUT WOULD CERTAINLY BECOME ''COMATOSE''. THE ADMINISTRATION, INCLUDING THE PRESIDENT, WERE THEREFORE ENGAGED IN MASSIVE LOBBYING EFFORTS WITH REPRESENTATIVES. WE SAID THAT THE UK LEGISLATION AUTHORISING OUR HIGHER CONTRIBUTION TO THE GENERAL ARRANGEMENTS TO BORROW AND OUR CONTRIBUTION TO THE EIGHTH QUOTA INCREASE OUGHT, ON PRESENT PLANS, TO BE PASSED BY PARLIAMENT WITHIN THE NEXT WEEK. SECRETARY REGAN SAID THAT IT WOULD BE HELPFUL IF THE CHANCELLOR OF THE EXCHEQUER WERW ABLE TO INFORM HIM OFFICIALLY OF THE LEGISLATION'S PASSAGE AT THE EARLIEST OPPORTUNITY. THIS WOULD HELP THE ADMINISTRATION WITH THE CONGRESS.

CONFIDENTIAL

/6. I SAID

6. I SAID THAT YOU MIGHT WELL WISH TO RAISE NEXT WEEK THE STILL OUTSTANDING ARGENTINE DISCRIMINATORY RESTRICTIONS. REGAN WAS NOT SURPRISED. LELAND SAID THAT IT WAS NO SECRET THAT THE ARGENTINE ECONOMIC MINISTERS WANTED THE RESTRICTIONS REMOVED, AND MANY IN THE MILITARY WOULD PROBABLY NOT, IN THE EVENT, OBJECT. BUT AN INFLUENTIAL ELEMENT IN THE ARMED FORCES WERE DEMANDING THAT THE UK SHOULD MAKE SOME GESTURE FIRST.

We have - ie UK first - loan and ie unfreezing Argentine assets in London.

7. ON THE INTERNATIONAL DEBT SITUATION, SECRETARY REGAN SAID THAT WHILE THERE WAS NOT YET A PERMANENT SOLUTION, MEXICO'S DEBT PROBLEM WAS RELATIVELY BETTER THAN IT HAD BEEN A YEAR AGO. THE ARGENTINE SITUATION HAD ALSO IMPROVED. BUT THE POSITION IN BRAZIL WAS STILL UNRESOLVED. PRESIDENT FIGUEIREDO'S DEPARTURE NEXT WEEK TO THE UNITED STATES FOR HEART TREATMENT WAS LIKELY TO MAKE IT MORE DIFFICULT TO DEVISE A SOLUTION WHICH WOULD MEET IMF REQUIREMENTS.

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[CULL]

UNCLASSIFIED

FM WASHINGTON 292200Z JUN 83

TO PRIORITY FCO

TELEGRAM NUMBER 1813 OF 29 JUNE

INFO SAVING PARIS BONN ROME TOKYO UKREP BRUSSELS UKDEL OECD

US ECONOMY: HIGHER GROWTH FORECASTS

1. FOLLOWING PRESIDENT REAGAN'S APPEARANCE ON TELEVISION LAST NIGHT (OUR TELNO 1805), THE ADMINISTRATION HAVE NOW RELEASED THE MAIN DETAILS OF THEIR MID-YEAR FORECASTS, REVISING UPWARDS THE LAST OFFICIAL GROWTH FORECASTS MADE IN APRIL. GROWTH IN 1983 (4TH QUARTER TO 4TH QUARTER) IS NOW FORECAST AT 5.5% (4.7% IN APRIL) AND GROWTH IN 1984 AT 4.5% (4% IN APRIL.). (THEIR FORECASTS OF INFLATION REMAIN THE SAME AS IN APRIL.)

2. THE MAIN FIGURES ARE AS FOLLOWS:

CALENDAR YEAR	GROWTH IN GNP IN 1972 DOLLARS YEAR ON YEAR	4TH QUARTER ON 4TH QUARTER	UNEMPLOYMENT RATE (4TH QUARTER)
1982	-1.7	-0.9	10.5
1983	3.1	5.5	9.6
1984	5.2	4.5	8.6
1985	4.2	4.0	8.0
1986	4.0	4.0	7.3

3. ACCORDING TO FELDSTEIN, CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS, THE INCREASE IN THE GROWTH RATE WOULD REDUCE THE PROJECTED DOLLARS 190 BILLION FEDERAL BUDGET DEFICIT FOR FY84 BY DOLLARS 10-15 BILLION AND WOULD REDUCE THE FY85 DEFICIT BY THE SAME AMOUNT.

4. IN A SPEECH TO THE NATIONAL PRESS CLUB TODAY (COPIES BY BAG), SECRETARY REGAN REHEARSED THE MAIN RECENT FAVOURABLE ECONOMIC DEVELOPMENTS LEADING TO THE REVISED FORECAST. ON THE BUDGET, HE SAID THAT FOR THE TIME BEING THE ADMINISTRATION EXPECTED TO BE ABLE TO FINANCE THE DEFICIT WITHOUT CROWDING OUT PRIVATE INVESTMENT, AND THAT THE PSYCHOLOGICAL IMPACT OF DEFICITS HAD LARGELY BEEN DISCOUNTED BY THE MARKET. THE SOLUTION TO THE BUDGET PROBLEM IN THE LONGER TERM WOULD BE SHIFTING RESOURCES BACK INTO THE PRIVATE SECTOR. HE WAS STRONGLY AGAINST EVEN A SMALL INCREASE IN TAXES NOW, WHICH WOULD ENDANGER THE RECOVERY.

/5.

5. THE SENATE THIS MORNING REJECTED BY A VOTE OF 45-55 THE DEMOCRATIC PROPOSAL TO PUT A LIMIT ON THE BENEFIT INDIVIDUALS COULD DERIVE FROM THE 10% CUT IN INCOME TAX RATES DUE ON 1 JULY. THIS MEANS THAT THE LEGISLATION TO DO THIS, ALREADY PASSED IN THE HOUSE, WILL NOT PROCEED. ALTERNATIVE MEANS WILL HAVE TO BE FOUND IF THE DOLLARS 12 BILLION INCREASE IN TAX REVENUES IN FY84 PROVIDED FOR IN THE BUDGET RESOLUTION IS TO BE FOUND. BUT THERE IS WIDESPREAD DOUBT, GIVEN THE THREAT OF A PRESIDENTIAL VETO, THAT ANY BILL TO INCREASE TAXES WILL BE PASSED THIS YEAR.

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

FCO PASS SAVING PARIS BONN ROME TOKYO UKREP BRUSSELS UKDEL OECD

REPEATED AS REQUESTED

WRIGHT

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NAD

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UNCLASSIFIED
FM WASHINGTON 290205Z JUN 83
TO PRIORITY FCO
TELEGRAM NUMBER 1805 OF 28 JUNE

MT

PRESIDENT REAGAN'S PRESS CONFERENCE OF 28 JUNE : US ECONOMY

IN AN OPENING STATEMENT AT HIS PRESS CONFERENCE ON 28 JUNE, PRESIDENT REAGAN RECALLED THE CRITICAL STATE OF THE ECONOMY WHEN HE CAME INTO OFFICE AND NOTED THE HEADWAY HE HAD MADE SINCE. THE ECONOMY WAS NOW STRONG AND ALL THE KEY SIGNS (PRODUCTIVITY, CAR SALES, HOUSING STARTS) WERE GOOD. THESE WERE SOLID SIGNS OF HOPE. THE US ECONOMY WAS BEGINNING TO SPARKLE. THE ADMINISTRATION HAD BEEN ABLE TO REVISE UPWARDS ITS GROWTH FORECAST FOR THE COMING YEAR FROM 4.7% TO 5.5%.

2. THE PRESIDENT REAFFIRMED HIS COMMITTMENT TO THE 10% PER CENT TAX CUT TO BE FOLLOWED BY INDEXATION IN 1985. HE CALLED FOR A BIPARTISAN APPROACH TO THE BUDGET, SAYING THAT THE ANSWER TO HIGH INTEREST RATES WAS NOT TO RAISE TAXES BUT TO REDUCE SPENDING. HE VOWED TO PREVENT THE CAP ON BENEFITS FROM THE TAX CUT WHICH HAD BEEN PROPOSED BY THE DEMOCRATS (AND PASSED BY THE DEMOCRATICALLY CONTROLLED HOUSE) FROM BECOMING LAW. HE WAS NOT LOOKING FOR A CONFRONTATION WITH CONGRESS BUT WOULD VETO BUDGET BUSTING APPROPRIATIONS BILLS.

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

WRIGHT

FINANCIAL

NAD

P.F. Pt 2

CONFIDENTIAL

Prime Minister ②

MCS 24/6

PRIME MINISTER

UNITED STATES ECONOMY

The United States economy grew strongly in the second quarter of the year. To many observers the recovery seems well established. But appearances are deceptive. Two-thirds of the recent increase has been due to cessation of the inventory decumulation. And there is virtually no new net investment taking place at all.

The fiscal monetary situation is doubly dangerous. The monetary aggregates increased substantially from last July onwards. There have been only the most hesitant signs of them being arrested. A minor industry has sprung up trying to explain them away as being irrelevant, misleading etc. But the current growth in the economy is ample evidence of that monetary stimulus some nine months to a year before. Any attempt sharply to arrest that monetary growth in the next few months will have a sharp effect on growth during the 1984 election year. If, on the other hand, it is not arrested then it will feed through into inflationary expectations and inflation itself again starting just some months before the vote in November 1984.

In the long run the massive federal budget deficit overhangs everything. There was no serious disagreement with my analysis of the consequences of this deficit. (The only outrageously wrong analyses came from a small "unimportant" group in the Treasury under Manuel Johnson. They continue to argue that reductions in tax rates will so increase output and savings that the deficit will dissolve in a wave of unprecedented growth. But I am told we can ignore their ravings.)

All agreed that the underlying structural deficits had to come down. But the policies for getting the deficit under control seem to have given way to a vacant sort of Micawberism.

George Shultz said that the deficit was no problem at the moment, since there was so little demand by the private sector for funds (that is to say there is no net investment taking place). He was very concerned, however, about the cumulation of future expected deficits. But he continued to back the President in ruling out tax increases. He believed that the President was right in

/insisting

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insisting on a reduction in public spending. But he was not specific on precisely what public spending should be cut - certainly not defence. Shultz said that the real problem was that there was no powerful political pressure to deal with the deficit. He said it took some time for Americans to get round to recognising that inflation was a problem; similarly, he thought it would take some time to realise the deficit was a problem. Then they would deal with it.

Feldstein disagreed with Shultz on one important issue. He believed the only really effective way to reduce the deficit, and politically he did not think this was possible until after 1985, was by increasing tax. He argued that the "cuttable" part of the deficit, excluding defence, entitlements, social security, medicare etc, had been pretty much cut down already. There was very little to be obtained from further cuts. He also believed that Shultz had not interpreted public opinion correctly; there was, he thought, a powerful constituency for balanced budgets.

In my view Feldstein was much closer to the truth than Shultz. But, of course, Shultz is closer to the President. The policy, therefore, is much more likely to be closer to Shultz than to Feldstein. This is an additional worry since Shultz at least talked to me about the likelihood of the American economy passing through a period of sustained high growth. (Broadly an extra 1% of growth in the United States reduces the deficit by about \$25-\$30billion.) However, no great growth prospects can be entertained when there is so little net private investment.

Feldstein is much less optimistic about growth; he recognises the crucial role of new technology and new investment. He believes that tax increases in late 1985 or 1986 are the only solution. In my view, however, they will be too little and too late.

The scene is set for:

a. a marked retardation in recovery in 1984;

b. a marked increase in inflation beginning probably in 1984; and

c. a debt crisis of considerable magnitude, the timing of which is very uncertain.

/In this

E.R.

In this scenario, a. and b. are substitutes in timing only; this depends upon how the Federal Reserve Board behaves over the next few months. The debt problem, however, will be with us for some time. The general situation in the United States is very reminiscent of many Latin American countries. There is the same incoherence, incompatability of objectives, impossible pay-offs to political constituents, and the same paralysis of policy. I know it is "unthinkable" that the great American economy could so degenerate. But the evidence is clear and we should not on our part be Micawber-like because we cannot face the consequences.

AW

ALAN WALTERS
24 June 1983

CONFIDENTIAL

ALAN WALTERS
17 May 1983

Prime Minister

MLS 17/5

PRIME MINISTER

WILLIAMSBURG: THE THEMATIC PAPER (REVISED) 12 MAY 1983

Exchange Rates and Intervention

Under III on page 3 it is argued that there should be intervention in exchange markets in a "coordinated manner" in instances "where we agree such intervention would be helpful". This also appears again under IV for the longer term where there is a reference to "our agreement on exchange market intervention".

The basic idea behind this can be illustrated with the dollar/yen situation now. Assume that the US and Japan agree that the dollar is high relative to the yen. The US should both increase the number of dollars and use them to buy yen ("unsterilised intervention"). Reciprocally, the Japanese Government would undertake to decrease the quantity of yen. The Central Bank would use their stock of dollars to buy yen - thus decreasing the number of yen in the hands of Japanese residents. (Coordination means that the Japanese would reinforce the American intervention rather than "sterilise" it.)

The net result of such unsterilised intervention would be an increase in the American money supply and an increase in American inflation. Yet we know the high dollar is generated by high US interest rates which are themselves the product of an expected increase in inflation which is in turn due to the Federal deficit. Such coordinated intervention would confirm market expectations of more US inflation. The Japanese inflation, already low, would be reduced further. In my view, this makes the international financial system more, rather than less, unstable.

[Similarly, had we in Britain agreed at the end of 1980 and early 1981 to a coordinated intervention with other developed countries, we would not have the low inflation rate that we have today. We would have reflated.]

We should return to our basic position that intervention is useful for day-to-day smoothing - and no more.

A New Bretton Woods

This is being pressed by the French, mainly by Jacques Attoli. I believe that the Americans are strongly opposed to even the idea of a new Bretton Woods, even at some time in the distant future. It is

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largely a way for the French to blame the sad plight of the French economy on the international monetary system rather than their own policies. And if we accede to the idea of a new Bretton Woods this does suggest that the international monetary system is in something of a crisis state. I do not think we should admit that.

AID, the IMF, SDRs and IDA Replenishments

Throughout the paper there is a commitment to "strengthen world economic institutions" and specifically to ratify the increase in IMF resources and "to provide more official assistance for developing countries" and to ensure "agreed funding levels for IDA" (the World Bank) and other banks.

In part this reflects the US Administration's desire to put pressure on Congress to ratify the new IMF and GAB agreement and to authorise funds for the 6th IDA replenishment. But this commitment in the thematic paper is much more embracing and far reaching - well beyond to the next IMF quota increase and IDA 7.

ALAN WALTERS
17 May 1983

RESTRICTED

MR

GPS 840
RESTRICTED [CULL]

FM WASHINGTON 141840Z

TO PRIORITY F C O

TELNO 1345 OF 14 MAY 1983,

INFO SAVING PARIS, ROME, BONN, TOKYO, UKREP BRUSSELS, UKDEL OECD.

PROSPECTS FOR REDUCING THE US BUDGET DEFICIT:

LATEST DEVELOPMENTS IN CONGRESS.

SUMMARY.

THE ANNUAL US BUDGET BATTLE IS PROVING IF ANYTHING MORE THAN USUALLY DIS-ORDERLY. THE CONGRESSIONAL CALENDAR REQUIRES THE PASSAGE OF AN AGREED FIRST BUDGET RESOLUTION BY 15 MAY. AS OF THE END OF LAST WEEK, SUCH A RESOLUTION WAS NOWHERE IN SIGHT. THE SENATE HAD HAD TO ADMIT FAILURE TO REACH A COMPROMISE. WITH THE PRESIDENT DUG IN AGAINST EFFECTIVE TAX INCREASES AND IN FAVOUR OF A SUBSTANTIAL INCREASE IN DEFENCE SPENDING, THE PESSIMISTS WERE BEGINNING TO TALK OF THE POSSIBILITY OF FAILURE TO GET A 1984 BUDGET AT ALL AND OF HAVING TO OPERATE ON THE BASIS OF CONTINUING RESOLUTIONS. IT IS TOO EARLY TO REACH THAT CONCLUSION YET, OR ANYTHING LIKE IT. BUT THE PRESENT POSITION IS CERTAINLY A MESS.

2. FOR THOSE WHO NEED IT, A FULLER PICTURE OF WHERE THE PROCESS HAS GOT TO AND WHAT THE PROSPECTS ARE IS SET OUT BELOW.

DETAIL.

1. THE SENATE, ON 12 MAY REJECTED BY A VOTE OF 52-48 A COMPROMISE FIRST BUDGET RESOLUTION BACKED BY THE ADMINISTRATION. PRESIDENT REAGAN'S INSISTENCE THAT PROVISION SHOULD BE MADE FOR FY84 MILITARY EXPENDITURE TO RISE AT LEAST 7.5% IN REAL TERMS AND THAT TAX INCREASES IN THAT YEAR SHOULD BE LIMITED TO DOLLARS 2.6 BILLION WERE KEY FACTORS IN THE DEFEAT OF THE ADMINISTRATION COMPROMISE. AN ALTERNATIVE COMPROMISE PROPOSED BY MODERATE REPUBLICAN SENATORS, PROVIDING FOR GROWTH IN DEFENCE SPENDING OF 6% AND REVENUE INCREASES OF DOLLARS 9 BILLION WAS ALSO DEFEATED. AS A RESULT OF THIS IMPASSE THE RESOLUTION HAS BEEN REFERRED BACK TO THE SENATE BUDGET COMMITTEE WITH INSTRUCTIONS THAT THE COMMITTEE SHOULD REPORT A FRESH RESOLUTION BY 17 MAY.

2. PRESIDENT REAGAN ALLOWED HIS CHIEF BUDGET LIEUTENANTS IN THE SENATE (MAJORITY LEADER BAKER AND CHAIRMAN OF THE BUDGET COMMITTEE DOMENICI) TO INCORPORATE DOLLARS 11 BILLION MORE IN DOMESTIC FY 84 SPENDING IN THE ADMINISTRATION COMPROMISE THAN HAD BEEN PROVIDED FOR IN HIS ORIGINAL BUDGET. THIS WAS HOWEVER INSUFFICIENT TO BREAK DEMOCRATIC SOLIDARITY WHICH, SUPPLEMENTED BY THE VOTES OF THE REBEL REPUBLICANS, CAUSED THIS COMPROMISE TO BE DEFEATED.

3. DOMENICI AND BAKER LOBBIED ON BEHALF OF THE PRESIDENT AGAINST THE REPUBLICAN MODERATES' ALTERNATIVE DRAFT RESOLUTION. THE DOLLARS 9 BILLION OF REVENUE INCREASES INCLUDED IN THAT RESOLUTION MIGHT HAVE MEANT A LIMIT ON THE AMOUNT EACH INDIVIDUAL COULD SAVE FROM THE 10% CUT IN INCOME TAX RATES SCHEDULED FOR JULY, AND ALSO CONTAINED PROVISIONS FOR FY 85 AND BEYOND THAT COULD HAVE IMPLIED THE REPEAL OF LEGISLATION INDEXING TAX RATES TO INFLATION. THUS THE MODERATES PLAN WAS AN ATTACK ON THE TAX REDUCTIONS WHICH PRESIDENT REAGAN BELIEVES ARE AN ESSENTIAL PART OF HIS ECONOMIC PROGRAMME.

4. WHETHER OR NOT THE SENATE PASSES THE FIRST BUDGET RESOLUTION NEXT WEEK, THE PROSPECTS FOR A US BUDGET COMPROMISE LOOK CLOUDED. THE BUDGET RESOLUTION PASSED BY THE HOUSE OF REPRESENTATIVES ON 23 MARCH, PROVIDING FOR FY 84 REVENUE INCREASES OF DOLLARS 30 BILLION AND A REAL INCREASE IN DEFENCE SPENDING OF 5% (COMPARED WITH 10% REQUESTED BY THE PRESIDENT AND THE 7.5% FOR WHICH HE WAS PREPARED TO SETTLE), APPEARS TO BE A NON-RUNNER IN THE SENATE AND WOULD BE UNACCEPATABLE TO THE ADMINISTRATION.

5. THE PRESENT POSITION THEREFORE IS THAT THE PRESIDENT IS INSISTING (A) ON THE IMPLEMENTATION OF HIS TAX REDUCTIONS: (B) ON A REAL INCREASE IN DEFENCE SPENDING OF AROUND 7% AND (C) THAT THERE CAN BE NO SIGNIFICANT INCREASE IN TAXATION TO ALLOW FOR MORE CIVIL SPENDING AND SOME REDUCTION IN THE BUDGET DEFICIT, PROJECTED AT DOLLARS 190 BILLION FOR FY84.

6. THE WHITE HOUSE SPOKESMAN SAID THIS WEEK THAT THE PRESIDENT WOULD RATHER SEE CONGRESS PASS NO BUDGET AT ALL THAN ONE THAT SIGNIFICANTLY INCREASED TAXES IN FY84. IN THOSE CIRCUMSTANCES, THE ADMINISTRATION WOULD HOPE, BY A COMBINATION OF CONTINUING RESOLUTIONS AND SPECIAL APPROPRIATIONS BILLS, TO SECURE MAJOR ITEMS WHICH THEY WANT (PARTICULARLY DEFENCE SPENDING) WHILE PREVENTING THE DEMOCRATS FROM IMPLEMENTING THEIR OWN PET MEASURES. THERE IS A LARGE TACTICAL ELEMENT IN APPROACH,WITH THE ADMINISTRATION AFFECTING TO IGNORE THE CONSEQUENCES OF FAILURE TO AGREE A BUDGET, IN TERMS OF GROWTH OF THE BUDGET DEFICIT AND THE IMPACT THAT COULD HAVE ON US ECONOMIC RECOVERY. IN PRACTICE, IT CANNOT IGNORE THE GROWING DEFICIT, NOT LEAST BECAUSE REPUBLICANS IN THE SENATE, (GLANCING NERVOUSLY OVER THEIR SHOULDERS AT LAST NOVEMBER'S ELECTION RESULTS AND LOOKING FORWARD WITH SOME APPREHENSION TO 1984), ARE CONCERNED ABOUT THE IMPLICATIONS. THE PRESIDENT CAN AFFORD TO PLAY HAND BALL WITH THE DEMOCRATS BUT CANNOT THUMB HIS NOSE AT THE LEADERS OF HIS OWN PARTY IN THE SENATE, ALL OF WHOM WANT TO REACH A COMPROMISE. THE THE ODDS ARE THEREFORE STILL IN FAVOUR OF SOME DEAL AT THE LAST MINUTE. WHAT IS CERTAIN IS THAT THE ''REFORMED'' BUDGET PROCEDURE, WHICH WAS DESIGNED TO ENABLE CONGRESS AND THE ADMINISTRATION TO SET OVERALL SPENDING TARGETS BEFORE GETTING DOWN TO THE BUSINESS OF APPROPRIATIONS, IS PROVING WELL NIGH IMPOSSIBLE TO OPERATE. COMPREHENSIVE BUDGETS HAVE HARDLY EVER BEEN ADOPTED SINCE THE NEW PROCEDURE WAS INTRODUCED IN 1974.

7. FCO PLEASE PASS TO BROADBENT (ESID), BOTTRILL (TREASURY) AND WATSON (BANK).

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

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FM WASHINGTON 222340Z APR 83
TO PRIORITY FCO
TELEGRAM NUMBER 1099 OF 22 APRIL 1983
INFO PARIS, BONN, TOKYO, UKREP BRUSSELS, UKDEL OECD

US ECONOMY: RECENT DEVELOPMENTS

1. THERE IS NOW CONFIRMATION THAT A US ECONOMIC RECOVERY IS UNDER WAY. PRELIMINARY ESTIMATES INDICATE THAT REAL GNP GREW AT A 3.1 PER CENT ANNUAL RATE IN THE FIRST QUARTER OF 1983, FOLLOWING A 1.7% DECLINE IN 1982. THIS FIRST QUARTER RISE WAS SOMEWHAT LESS THAN THE 4 PER CENT EXPECTED EARLIER, AND SOME ADMINISTRATION OFFICIALS DO NOT EXPECT INCREASED MOMENTUM TO GATHER UNTIL THE SECOND HALF OF THE YEAR. THE FIRST QUARTER RECOVERY WAS NARROWLY-BASED AND DOMINATED BY INCREASES IN HOUSING CONSTRUCTION AND A DECLERATION IN THE DRAWDOWN OF INVENTORIES. A SUBSTANTIAL RECOVERY WILL DEPEND UPON A REVIVAL IN CONSUMER SPENDING, WHICH IS NOT YET FIRMLY ESTABLISHED, ALTHOUGH CONSUMER CONFIDENCE IMPROVED SHARPLY IN MARCH. CAR SALES WERE ESPECIALLY DISAPPOINTING IN THE FIRST QUARTER.

2. INFLATION (CONSUMER PRICE INDEX) IN MARCH WAS ONLY ABOUT 3.5 PER CENT ABOVE A YEAR AGO. THE YIELD ON A 3-MONTH TREASURY BILL IS CURRENTLY ABOUT 8 PER CENT AND, ON A LONG-TERM GOVERNMENT BOND, 10.5 PER CENT. ADJUSTED FOR INFLATION, THERERFORE, INTEREST RATES REMAIN HISTORICALLY HIGH ESPECIALLY FOR THE EARLY STAGE OF A RECOVERY. THE FEDERAL RESERVE CLEARLY WANTS A FURTHER DECLINE, NOT AN INCREASE, IN INTEREST RATES TO SUPPORT THE RECOVERY AND HIGHLY RESTRICTIVE ACTION TO BRING THE MONETARY AGGREGATES BACK WITHIN THE TARGET RANGES SEEMS UNLIKELY AT THIS POINT.

3. THE ADMINISTRATION IS NOT CURRENTLY ENJOYING A HIGH SUCCESS RATE ON DOMESTIC ECONOMIC ISSUES IN THE CONGRESS. THE FY 84 FEDERAL BUDGET PROCESS IS IN A CONFUSED STATE, WITH THE DEMOCRATS SO FAR EXHIBITING BETTER PARTY DISCIPLINE THAN THE REPUBLICANS. ON 23 MARCH THE HOUSE OF REPRESENTATIVES PASSED A DEMOCRATIC BUDGET RESOLUTION WHICH PROVIDED FOR A DEFICIT OF DLRS 175 BILLION, INCLUDING AN INCREASE IN REAL DEFENCE EXPENDITURE OF LESS THAN 5 PER CENT AND THE CANCELLATION OF THE 10 PER CENT CUT IN INCOME TAX RATES SCHEDULED FOR JULY. THIS RESOLUTION WAS UNACCEPTABLE TO PRESIDENT REAGAN. THE SENATE HAS YET TO VOTE ON A BUDGET RESOLUTION, BUT THE SENATE BUDGET COMMITTEE YESTERDAY APPROVED A DEMOCRATIC RESOLUTION SIMILAR TO THE ONE PASSED IN THE HOUSE INCLUDING A PROVISION FOR THE CANCELLATION OF THE JULY TAX CUT. REPUBLICANS ON THE COMMITTEE WERE SPLIT BETWEEN THOSE WHO DID NOT WANT EVEN THE LIMITED FY 84 TAX REVENUE INCREASES PROPOSED BY THE PRESIDENT AND THOSE WHO WERE IN FAVOUR OF SUBSTANTIAL INCREASES, SO THAT THE VOTE IN FAVOUR OF THE RESOLUTION WAS 13 TO 4. THIS UNDOUBTEDLY CAME AS A DISAPPOINTMENT TO THE PRESIDENT, WHO HAD EARLIER AUTHORISED SENIOR WHITE HOUSE OFFICIALS TO TRY TO NEGOTIATE A COMPROMISE ACCEPTABLE TO HIM.

4. THE VOTE IN THE SENATE BUDGET COMMITTEE DEMONSTRATES HOW LITTLE CONTROL THE ADMINISTRATION NOW HAS OVER THE CONGRESSIONAL BUDGET PROCESS. THE PRESIDENT'S PREROGATIVE, THE VETOING OF LEGISLATION, DOES NOT APPLY TO BUDGET RESOLUTIONS SINCE THESE DO NOT COME TO HIM FOR APPROVAL. IN ORDER TO AVOID A BUDGET RESOLUTION IMPLYING THE CANCELLATION OF THE SCHEDULED JULY TAX REDUCTION, THE PRESIDENT NOW HAS TO GAIN A VICTORY IN THE VOTE ON THE SENATE FLOOR. THE DEBATE WILL PROBABLY BEGIN AT THE END OF NEXT WEEK AND THE VOTE ON TAXATION COULD WELL BE CLOSE. THE PRESIDENT COULD HOWEVER VETO ANY ATTEMPT TO ENACT THE CANCELLATION OF THE TAX REDUCTION IF HE LOSES THE VOTE IN THE SENATE AND THE DEMOCRATS DO NOT APPEAR TO HAVE ENOUGH VOTES TO OVERTURN THIS. AT THIS STAGE IT APPEARS THAT IF A CONGRESSIONAL COMPROMISE WERE REACHED ON THE FY 84 BUDGET, IT WOULD RESULT IN A SOMEWHAT LOWER DEFICIT THAN THAT PROPOSED BY THE PRESIDENT (DLRS 190 BILLION), BUT WITH (PERHAPS) SOMEWHAT HIGHER TAXATION AND (ALMOST CERTAINLY) HIGHER SOCIAL EXPENDITURE AND LOWER DEFENCE EXPENDITURE THAN THE PRESIDENT WOULD LIKE. BUDGET DIRECTOR STOCKMAN, IN A LEAKED MEMORANDUM, HAS INDICATED THAT HE FEARS THAT THE FY84 BUDGET PROCESS WILL NOT SUCCESSFULLY BE COMPLETED SO THAT DLRS 200 BILLION DEFICITS WOULD EXTEND INTO THE FUTURE. SO FAR, HOWEVER, THE PRESIDENT HAS NOT GIVEN UP HOPE OF REACHING AN ACCEPTABLE FY 84 BUDGET COMPROMISE IN THE CONGRESS.

5. THE ADMINISTRATION SUFFERED A MINOR DEFEAT YESTERDAY WHEN THE SENATE APPROVED A MEASURE THAT WOULD DELAY FOR FOUR YEARS THE INTRODUCTION OF A WITHHOLDING TAX ON DIVIDEND AND INTEREST INCOME DUE TO TAKE EFFECT FROM 1 JULY. RELIANCE IS INSTEAD PROPOSED TO BE PLACED ON BETTER COLLECTION AND ENFORCEMENT OF THIS TAX. THE HOUSE MAY ALSO SUPPORT THIS MOVE AND IT LOOKS AS IF THE PRESIDENT COULD NOT SUSTAIN A VETO. THE LOBBYISTS FOR THE BANKS THUS SEEM TO HAVE ACHIEVED A MAJOR VICTORY IN HAVING A SIMPLE ANTI-EVASION MEASURE POSTPONED. THE LOSS OF REVENUE IS ESTIMATED AT ABOUT DLRS 5 BILLION A YEAR.

6. THERE IS A CONTINUING WAVE OF SPECULATION ABOUT THE POSSIBLE SUCCESSOR TO FEDERAL RESERVE CHAIRMAN VOLCKER. IT WAS REPORTED EARLIER THIS WEEK THAT SENIOR WHITE HOUSE ADVISERS HAD RECOMMENDED TO THE PRESIDENT THAT HE SHOULD NOT RE-APPOINT VOLCKER WHEN THE LATTER'S TERM OF OFFICE ENDS IN AUGUST. BUT AT THE END OF THE MEETING OF REAGAN'S ECONOMIC POLICY ADVISORY PANEL ON 20 APRIL, REAGAN TOOK VOLCKER ASIDE AND TOLD HIM THAT HE HAD NOT YET ADDRESSED THIS ISSUE. IT IS GENERALLY BELIEVED THAT, IF ASKED, VOLCKER WOULD STAY FOR ANOTHER TERM. HIS RE-APPOINTMENT IS SUPPORTED NOTABLY BY FELDSTEIN (CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS) AND GREENSPAN (ONE OF THE CHIEF OUTSIDE CANDIDATES). RECENT EDITORIALS IN THE WASHINGTON POST AND THE WALL ST JOURNAL HAVE ALSO SUPPORTED HIS RE-APPOINTMENT. THE PRESIDENT IS HOWEVER KEEPING HIS OPTIONS OPEN FOR THE TIME BEING.

7. FCO PLEASE PASS TO PS/CHANCELLOR, PS/LITTLER, BOTTRILL (TREASURY) AND WATSON (BANK OF ENGLAND).

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PRIME MINISTER

UNITED STATES ECONOMIC POLICY

There is some evidence that the Fed is reducing the very rapid rate of monetary growth that began in July 1982. Over the past five weeks the rate of growth appears to have slowed down somewhat. This has been reflected in quite sharp increases in short term interest rates and very modest increases at the long end.

The main hope, and I am afraid it is only hope, is that the Fed will continue gradually to rein in the outrageous monetary growth of the last nine months. Their record in this respect has been quite dismal since the policy changes of October 1979. For example, after the massive expansion at an annual rate of 22% from February to April 1981, they then dramatically reduced the rate to -8½% for the next ten weeks. If this performance is repeated then we are likely to have a replay of mid-1981.

Fortunately, there is a good chance that an erratic monetary policy may be bailed out by a fall in the price of oil or a resuscitation of European growth. Similarly, there is a chance that the temporary decline in velocity will be reversed, and so any sharp monetary contraction may be offset by a rise in velocity.

There is, however, a real possibility of a renewal of recession in the United States in 1984. If that results in a Democratic victory in the Presidential elections, there is every reason to believe the inflation will take off once more.

I am sorry that I cannot be more precise about potential outcomes. But I thought you ought to know where the analysis and evidence lead - for there are important implications for us.

ALAN WALTERS
14 April 1983

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DESKBY 140900Z
FROM WASHINGTON 131720Z APR 83.
TO IMMEDIATE F C O
TELEGRAM NUMBER 970 OF 13 APRIL
AND TO ROUTINE BONN, PARIS, UKDEL OECD, UKREP BRUSSELS, ROME, TOKYO, OTTAWA.

US MONETARY POLICY

FOR PS TO CHANCELLOR AND LAVELLE (TREASURY).

1. IN HIS TESTIMONY BEFORE THE HOUSE BANKING COMMITTEE ON 12 APRIL, FED CHAIRMAN VOLCKER CONFIRMED THE GROWTH RATES FOR THE MONETARY AGGREGATES PRESENTED TO CONGRESS IN FEBRUARY, (4-8 PER CENT FOR M1, 7-10 PER CENT FOR M2 OVER A FEBRUARY MARCH BASE AND 6.5 - 9.5 PER CENT FOR M3). IN ADDITION HE STATED THAT IN VIEW OF THE VARIOUS INSTITUTIONAL DEVELOPMENTS WHICH HAD AFFECTED MONETARY RELATIONSHIPS, QUOTE WE HAVE PUT A GREATER PREMIUM ON JUDGEMENT AND LESS ON AUTOMATACITY IN OUR OPERATIONAL DECISIONS IN RESPONDING TO MOVEMENTS IN THE AGGREGATES IN RECENT MONTHS UNQUOTE.

2. THE MONETARY AGGREGATES, ESPECIALLY M2 HAD GROWN STRONGLY IN THE FIRST FEW MONTHS OF THE YEAR, MAINLY DUE TO INFLOWS INTO THE NEW MONEY MARKET ACCOUNTS. BUT THE FED BELIEVED THAT THE GROWTH OF THE BROADER AGGREGATES MAY BE SLOWING AND THAT MONETARY POLICY WAS CONSISTENT WITH THE OBJECTIVES SET OUT IN FEBRUARY. VOLCKER ADDED THAT THIS IMPLIED AN EXPECTATION THAT MONETARY GROWTH, ESPECIALLY M1 AND M2 WOULD SUBSIDE IN THE COMING MONTHS. PROLONGED GROWTH OF THE AGGREGATES AT HIGH LEVELS WOULD BE A CAUSE FOR CONCERN.

3. ON THE PROSPECTS FOR THE ECONOMY VOLCKER INDICATED THAT THE FED BELIEVED A MODERATE RECOVERY WAS UNDERWAY. BUT THERE WERE STILL RISKS AND UNCERTAINTIES IN THE MEDIUM TERM OWING TO THE UPWARD PRESSURE ON INTEREST RATES FROM THE LARGE BUDGET DEFICITS. IN SUBSEQUENT QUESTIONING. VOLCKER IS REPORTED TO HAVE SAID THAT LONG TERM INTEREST RATES WERE TOO HIGH FOR A SUSTAINED ECONOMIC RECOVERY, ESPECIALLY AS INFLATION HAD FALLEN.

4. MUCH OF VOLCKER'S TESTIMONY AND THE SUBSEQUENT DISCUSSION IN THE COMMITTEE CONCERNED THE SENSE OF CONGRESS PROVISION INCLUDED IN THE HOUSE VERSION OF THE FIRST BUDGET RESOLUTION REQUIRING THE FED TO ESTABLISH OBJECTIVES FOR THE MAIN ECONOMIC VARIABLES. VOLCKER INDICATED THAT SUCH A MOVE WAS INAPPROPRIATE SINCE IT IMPLIED A DEGREE OF FINE TUNING IN MONETARY POLICY WHICH COULD PROVE COUNTER-PRODUCTIVE.

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5. THE MINUTES OF THE FEBRUARY MEETING OF THE FEDERAL OPEN MARKET COMMITTEE AT WHICH IT ESTABLISHED THE RANGE FOR THE GROWTH OF THE MONETARY AGGREGATES FOR 1983 HAVE JUST BEEN RELEASED. FOUR OF THE 12 COMMITTEE MEMBERS DISSENTED FROM THE COMMITTEES RECOMMENDATION, AN UNUSUALLY HIGH DEGREE OF DISAGREEMENT. THOSE DISSENTING WERE CONCERNED THAT WITH THE NUMBER OF TARGETS ADOPTED (RANGES FOR THE 3 AGGREGATES AND BANK CREDIT) AND THAT THE DECISION TO GIVE LESS WEIGHT TO M1 WOULD MAKE IT MORE DIFFICULT TO CONTROL THE GROWTH OF THE MONEY SUPPLY.

6. THE MINUTES MAKE CLEAR THAT THE MAJORITY OF THE COMMITTEE CONCLUDED THEY HAD NO OPTION BUT TO ADOPT A MORE JUDGEMENTAL APPROACH TO THE INTERPRETATION OF MOVEMENTS IN THE AGGREGATES. THEIR ASSESSMENT OF THE APPROPRIATE GROWTH RANGES WAS CLEARLY COMPLICATED BY THE UNCERTAINTY OVER THE EFFECT OF THE NEW MONEY MARKET ACCOUNTS ON THE AGGREGATES, THE BEHAVIOUR OF VELOCITY IN 1983 FOLLOWING ITS SHARP FALL IN 1982, AND WHETHER THE NEW ACCOUNTS, EXPECIALLY THE SUPER-NOWS WITH THEIR SAVINGS ELEMENT WHICH ARE INCLUDED IN M1, WOULD ALTER THE RELATIONSHIP BETWEEN MOVEMENTS IN M1 AND GNP. THE DECLINE IN VELOCITY IN 1982 WAS ATTRIBUTED TO A STRONG PRECAUTIONARY DEMAND FOR MONEY AT A TIME OF ECONOMIC UNCERTAINTY. THE COMMITTEE ALSO CONCLUDED THAT AS A RESULT OF THE DECLINE IN VELOCITY, RIGID ADHERENCE TO THE 1982 TARGETS WOULD HAVE RESULTED IN A MUCH MORE RESTRICTIVE POLICY THAN HAD BEEN INTENDED.

FCO PLEASE PASS TO BOTTRILL (HMT), BROADBENT (FCO) AND WATSON(BANK).

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FM WASHINGTON 131715Z APR 83

TO IMMEDIATE F C O

TELEGRAM NUMBER 969 OF 13 APRIL

AND TO ROUTINE BONN, PARIS, UKREP BRUSSELS, ROME, TOKYO, OTTAWA AND UKDEL OECD

US BUDGET DEFICIT

1. THE US BUDGET DEFICITS FOR FY 1983 AND FY 1984 ARE FORECAST TO BE SLIGHTLY ABOVE THE LEVELS ESTIMATED IN JANUARY WHEN THE BUDGET WAS PRESENTED TO CONGRESS, ACCORDING TO THE ADMINISTRATION'S LATEST ESTIMATES. IN THEIR APRIL REVISION OF THE BUDGET, THE OFFICE OF MANAGEMENT AND BUDGET HAVE ESTIMATED THE DEFICIT AT DOLLARS 210 BN IN FY 1983 AND DOLLARS 190 BN IN FY 1984, DOLLARS 2.5 BN AND DOLLARS 1.5 BN HIGHER THAN THE PREVIOUS ESTIMATES FOR RESPECTIVE YEARS. BUT THE BUDGET DEFICITS WILL BE LOWER IN FY 1985-88 THAN PREVIOUSLY CALCULATED.

2. THE REVISED ESTIMATES OF THE DEFICITS FOR FY 1983 TO FY 1988 FOLLOWS (WITH FIGURES PUBLISHED IN JANUARY IN BRACKETS).

BUDGET DEFICIT (DOLLARS BN)

1983	1984	1985	1986	1987	1988
-210.2	-190.2	-185	-145	-137	-102
(-207.7)	(-188.8)	(-194)	(-148)	(-142)	(-117)

3. THE REVISIONS REFLECT THE PREVIOUSLY ANNOUNCED CHANGES TO THE FORECAST OF ECONOMIC GROWTH FOR 1983, TECHNICAL ADJUSTMENTS AND POLICY CHANGES - IN PARTICULAR THE ENACTMENT OF BOTH THE JOBS BILL AND THE BILL ON SOCIAL SECURITY REFORM WHICH WERE PASSED BY CONGRESS JUST BEFORE THE EASTER RECESS.

4. THE REVISED FORECASTS FOR ECONOMIC GROWTH FOR CALENDAR YEARS 1983 AND 1984 ARE AS FOLLOWS:

	1983	1984
REAL GNP (YEAR ON YEAR)	2.9	4.3
GNP DEFLATOR	4.4	4.8
UNEMPLOYMENT	10.0	9.1

THERE WAS NO CHANGE TO THE PROJECTIONS FOR THE PERIOD 1985-88 COMPARED TO THOSE PUBLISHED IN JANUARY, ALTHOUGH UNEMPLOYMENT IS NOW PROJECTED TO FALL AT A SLIGHTLY FASTER RATE TO 6.2 PERCENT IN 1988 AS A RESULT OF THE STRONGER RECOVERY IN 1983.

5. IN FY 1983 THE HIGHER DEFICIT IS THE RESULT OF A NET INCREASE IN OUTLAYS, MAINLY DUE TO HIGHER EXPENDITURE UNDER THE JOBS BILL. THE HIGHER OUTLAYS ARE PARTIALLY OFFSET BY HIGHER TAX RECEIPTS OWING TO AN INCREASE IN THE LEVEL OF ECONOMIC ACTIVITY. IN FY 1984 BOTH OUTLAYS AND RECEIPTS ARE PROJECTED TO FALL BELOW THE LEVEL FORECAST IN JANUARY, BUT RECEIPTS FALL FASTER. LOWER RECEIPTS IN FY 1984 ARE PARTLY DUE TO DIFFERENCES IN THE TIMING OF SOCIAL SECURITY CONTRIBUTIONS: THE NET FALL IN OUTLAYS IS MAINLY DUE TO

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LOWER UNEMPLOYMENT COMPENSATION. HIGHER RECEIPTS BETWEEN FY 1985-88 ARE THE MAIN REASON FOR THE LOWER DEFICITS IN THESE YEARS. THESE CHANGES ARE THE NET EFFECT OF HIGHER INCOME TAXES REFLECTING HIGHER NOMINAL INCOMES, PARTIALLY OFFSET BY LOWER WINDFALL PROFITS TAX DUE TO LOWER OIL PRICES. THE ADMINISTRATION RECOMMEND THAT HIGHER EXPENDITURE UNDER THE JOBS BILL IN FY 1983 AND 1984 IS OFFSET BY LOWER EXPENDITURE ON OTHER PROGRAMMES BETWEEN FY 1985-88.

6. COPIES OF THE REPORT FOLLOW BY BAG.

FCO PLEASE PASS TO BOTTRILL (HMT) AND WATSON (BANK).

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TO PRIORITY FCO

TELEGRAM NUMBER 721 OF 22 MARCH 1983

SAVING TO PARIS, BONN, TOKYO, OTTAWA, UKREP BRUSSELS.

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US ECONOMY: GNP GROWTH IN THE FIRST QUARTER OF 1983.

1. THE US ECONOMY HAS BEEN GROWING AT 4 PER CENT ANNUAL RATE IN THE FIRST QUARTER OF 1983 ACCORDING TO THE QUOTE FLASH UNQUOTE ESTIMATE FROM THE DEPARTMENT OF COMMERCE. THIS IS CLOSE TO THE LATEST BLUE CHIP CONSENSUS OF PRIVATE FORECASTS WHICH IS FOR 4.4 PER CENT GROWTH AT AN ANNUAL RATE DURING THE FIRST QUARTER, AND AT THE BOTTOM END OF THE COMMERCE DEPARTMENT'S EARLIER PREDICTIONS.

2. THE ESTIMATES OF HIGHER ACTIVITY, BASED ON PRELIMINARY DATA FOR JANUARY AND PROJECTIONS FOR FEBRUARY/MARCH, REFLECT HIGHER PRODUCTION OF CARS, STEEL AND HOME APPLIEANCES (FOLLOWING THE HEAVY DRAWDOWN OF STOCKS IN THE FORTH QUARTER OF 1982) AND CONTINUED IMPROVEMENT IN RESIDENTIAL CONSTRUCTION. THERE WERE HOWEVER DECLINES IN THE NET EXPORT OF GOODS AND SERVICES, AND IN GOVERNMENT EXPENDITURE. BUSINESS FIXED INVESTMENT SHOWED LITTLE CHANGE, AND THERE WAS PROBABLY ONLY A MODERATE INCREASE IN CONSUMERS' EXPENDITURE. THE MAIN FACTORS BEHIND THE RECOVERY SO FAR SEEM THEREFORE TO BE A DECELERATION IN INVENTORY DRAWDOWN AND THE RECOVERY IN HOUSING.

3. TREASURY SECRETARY REGAN, COMMENTING ON THE NEW GNP ESTIMATES, SAID THAT GROWTH COULD EXCEED AN ANNUAL RATE OF 4 PER CENT IN THE FIRST QUARTER AND INCREASE TO 5 PER CENT BY THE THIRD QUARTER PROVIDED THAT INTEREST RATES DO NOT RISE. THE PRESIDENT SAID THAT THE RECOVERY QUOTE LOOKS LIKE IT WILL BE LONG AND STRONG UNQUTOE. UNTIL THERE ARE SIGNS OF A HIGHER RATE OF INCREASE IN CONSUMER SPENDING, HOWEVER, MOST MAJOR FORECASTING ORGANISATIONS BELIEVE THAT THE RECOVERY WILL BE GRADUAL, AND WELL BELOW THE AVERAGE FOR POST-WAR BUSINESS CYCLES.

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

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TELEGRAM NUMBER 620 OF 14 MARCH

U.S. ECONOMY: VIEWS OF PRIVATE FORECASTERS

1. VIEWS OF PRIVATE U.S. FORECASTERS ABOUT THE PROSPECTS FOR THE U.S. ECONOMY HAVE BECOME MORE OPTIMISTIC DURING THE PAST MONTH. THE AVERAGE FORECAST OF THE 46 FORECASTING SERVICES INCLUDED IN THE SO-CALLED BLUE CHIP CONSENSUS IS FOR A 2 POINT 7 PERCENT GROWTH RATE IN 1983 OVER 1982. THE AVERAGE FOR THE SIX LARGEST ECONOMETRIC SERVICES IS 2 POINT 4 PERCENT. THESE FIGURES COMPARE WITH AVERAGES FOR THE PREVIOUS MONTH OF 2 POINT 5 PERCENT AND 2 POINT 0 PERCENT RESPECTIVELY, WHICH WERE QUOTED IN OUR MONTHLY ECONOMIC REPORT FOR FEBRUARY (MY TELNO 5 SAVING).

2. ON A QUARTERLY BASIS, THE AVERAGE OF ALL THE FORECASTING SERVICES INDICATES GROWTH AT AN ANNUAL RATE OF OVER 4 PERCENT IN THE FIRST AND SECOND QUARTERS OF 1983 AND OF AROUND 5 PERCENT IN THE THIRD AND FOURTH QUARTERS. ON UNEMPLOYMENT, THE AVERAGE FORECAST IS NOW FOR A LEVEL OF 10 POINT 1 PERCENT FOR 1983 AS A WHOLE, BUT FALLING BELOW DOUBLE DIGITS IN THE FOURTH QUARTER OF 1983.

3. ON INFLATION, THE AVERAGE FORECAST FOR THE GNP DEFLATOR IN 1983 OVER 1982 IS 4 POINT 6 PERCENT, AND FOR THE CONSUMER PRICE INDEX 4 POINT 0 PERCENT. THE SIX LARGEST FORECASTING SERVICES ARE MORE OPTIMISTIC - 4 POINT 3 PERCENT AND 3 POINT 1 PERCENT RESPECTIVELY. FOR BOTH INDICES, THE AVERAGE FORECAST FOR 1984 IS RATHER HIGHER THAN FOR 1983, AT AROUND 5 PERCENT.

4. F C O PLEASE ADVANCE TO BOTTRILL (TREASURY), WATSON (BANK OF ENGLAND) AND BROADBENT (ESID).

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US ECONOMY: SHORT-TERM PROSPECTS

1. THE INDEX OF LEADING ECONOMIC INDICATORS ROSE BY 3.6% IN JANUARY, PROVIDING FURTHER EVIDENCE THAT AN ECONOMIC RECOVERY IS UNDER WAY. THIS INCREASE IN THE REVISED INDEX (THE LARGEST FOR OVER 30 YEARS) FOLLOWS A 0.8% INCREASE IN DECEMBER AND A 0.4% INCREASE IN NOVEMBER. THE INDEX HAS NOW RISEN FOR 9 OUT OF THE LAST 10 MONTHS. WHILE MUCH OF THE INCREASE WAS BECAUSE OF THE GROWTH IN THE MONEY SUPPLY (M2), LARGE INCREASES WERE ALSO RECORDED IN THE AVERAGE WORK WEEK, NEW ORDERS AND BUILDING PERMITS. FELDSTEIN, CHAIRMAN OF THE COUNCIL OF ECONOMIC ADVISERS, IS REPORTED AS SAYING THAT THE LATEST FIGURE FOR THE INDEX SHOWS THAT THE RECOVERY BEGAN IN JANUARY.

2. THE BLUE CHIP CONSENSUS OF PRIVATE FORECASTERS IS THAT IN 1983 GNP GROWTH WILL BE 2.5% OVER 1982, COMPARED TO THE ADMINISTRATIONS BUDGET FORECAST OF 1.4%. COMMERCE UNDER SECRETARY DEDERICK HAS SAID THAT REAL OUTPUT COULD BE GROWING AT AN ANNUAL RATE OF 4% OR MORE IN THE FIRST QUARTER OF THIS YEAR AND THAT THE RECOVERY IS QUOTE CLEARLY GOING TO BE FASTER THAN THE FORECAST UNDERLYING THE BUDGET DOCUMENT UNQUOTE. HE FORECASTS GROWTH OF 5 PER CENT BETWEEN THE FOURTH QUARTERS OF 1982 AND 1983.

3. FELDSTEIN HAS SAID THAT THE ADMINISTRATION WILL REVISE UPWARDS ITS ECONOMIC FORECASTS FOR 1983. DISCUSSIONS WITH SENIOR OFFICIALS IN THE COUNCIL OF ECONOMIC ADVISERS HAVE CONFIRMED THAT THEY EXPECT THE REVISED GROWTH RATE TO BE WITHIN THE RANGE OF 2.0 - 2.5% OVER 1982. THE NEW ESTIMATE WILL REFLECT THE COMMENCEMENT OF THE RECOVERY IN JANUARY, RATHER THAN LATER DURING THE FIRST QUARTER AS WAS ORIGINALLY ASSUMED, AND THE FALL IN OIL PRICES. LOWER OIL PRICES WILL REDUCE INFLATION FURTHER AND ARE THEREFORE EXPECTED TO RAISE CONSUMERS' REAL DISPOSABLE INCOME AND SPENDING.

4. THE MAIN CONCERN CONTINUES TO BE THE NEED FOR LOWER INTEREST RATES TO SUSTAIN THE GROWTH IN OUTPUT INTO THE SECOND HALF OF THE YEAR. DEDERICK HAS ACKNOWLEDGED THAT LARGE BUDGET DEFICITS COULD BE A MAJOR PROBLEM IN ACHIEVING A SUSTAINED AND BALANCED RECOVERY.

5. FCO PLEASE PASS TO BOTTRILL (HMT) AND WATSON (BANK).

FCO PASS SAVING:- PARIS BONN TOKYO UKREP BRUSSELS

(REPEATED AS REQUESTED)

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FM WASHINGTON 282050Z FEB 83

TO PRIORITY F C O

TELEGRAM NUMBER 484 OF 28 FEBRUARY

AND TO HMY BRITANNIA (FOR SIR O WRIGHT).

US ECONOMY

1. A GRADUAL US ECONOMIC RECOVERY APPEARS NOW TO BE UNDER WAY. MOST ANALYSTS BELIEVE THAT GROWTH COULD BE 2-2.5 PERCENT BETWEEN 1982 AND 1983, AND THEREFORE THAT THE ADMINISTRATION FORECAST OF 1.4 PERCENT IS TOO CAUTIOUS. INDUSTRIAL PRODUCTION ROSE BY NEARLY 1 PER CENT IN JANUARY, THE INCREASE BEING WELL SPREAD AMONGST CONSUMER GOODS AND DEFENCE INDUSTRIES. HOUSING STARTS ROSE SHARPLY TO AN ESTIMATED 1.7 MILLION UNITS (ANNUAL RATE) IN JANUARY, ALSO BENEFITING ANCILLARY INDUSTRIES SUCH AS FURNITURE AND APPLIANCES. THE DECLINE IN INVENTORIES SLOWED IN DECEMBER AND IT IS EXPECTED THAT STOCKBUILDING WILL CONTRIBUTE TO MUCH OF THE GROWTH IN THE FIRST QUARTER.

2. DURING 1982, INFLATION (THE CONSUMER PRICE INDEX) ROSE BY LESS THAN 4 PER CENT, THE SMALLEST ANNUAL INCREASE SINCE 1972. THE OUTLOOK ON INFLATION CONTINUES TO BE FAVOURABLE AND IT COULD BE BELOW THE ADMINISTRATION'S FORECAST OF 5 PERCENT IN 1983. THE CONTINUATION OF LOW RATES OF INFLATION WILL DEPEND ON FURTHER PRODUCTIVITY IMPROVEMENTS WHICH, COMBINED WITH WAGE MODERATION, SHOULD RESULT IN RELATIVELY LOW INCREASES IN UNIT LABOUR COSTS. THE PROSPECT FOR LOWER ENERGY PRICES IS ALSO FAVOURABLE.

3. THE FIRMNESS OF INTEREST RATES SINCE EARLY JANUARY IS THE MAIN REASON FOR DOUBT ABOUT THE STRENGTH OF THE RECOVERY, ALTHOUGH MANY BANKS' PRIME RATES WERE REDUCED TO 10 AND HALF PERCENT ON 25 FEBRUARY. THIS FIRMNESS REFLECTS LARGER THAN EXPECTED US TREASURY BORROWING, UNCERTAINTIES OVER THE GROWTH RATE OF MONEY SUPPLY AND THE CONCERN OVER THE SIZE OF THE STRUCTURAL BUDGET DEFICITS AFTER 1984. REAL INTEREST RATES REMAIN HIGH. THUS CAPITAL SPENDING MAY REMAIN WEAK, ESPECIALLY AS CAPACITY UTILISATION IS LOW (ONLY 67.8 PERCENT IN JANUARY). MOST ANALYSTS FORECAST ONLY A SLIGHT DECLINE IN UNEMPLOYMENT FROM THE JANUARY LEVEL OF 10.4 PERCENT DURING THE YEAR.

4. FEDERAL RESERVE BOARD CHAIRMAN VOLCKER HAS INDICATED THAT MONETARY POLICY WILL CONTINUE TO BE FLEXIBLE ENOUGH TO ACCOMMODATE RECOVERY WITHOUT BEING INFLATIONARY. VOLCKER HAS FREQUENTLY STRESSED THE DIFFICULTY OF PURSUING A FLEXIBLE MONETARY POLICY ULTIMATELY TO LOWER INTEREST RATES WHEN LARGE BUDGET DEFICITS ARE TENDING TO PUSH UP MARKET RATES. ACTION TO LOWER THE BUDGET DEFICIT IS LIKELY TO BE ESSENTIAL IF INTEREST RATES ARE TO FALL.

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5. IN COMMENTING YESTERDAY ON THE SHORT-TERM PROSPECTS FOR INTEREST RATES, SENIOR MEMBERS OF THE ADMINISTRATION AND FEDERAL RESERVE CHAIRMAN VOLCKER ALL EXPECTED A FURTHER DECLINE IN AT LEAST SOME INTEREST RATES IN LINE WITH THE DECLINE IN INFLATION. THIS DECLINE WAS, THEY POINTED OUT, BEING GIVEN FURTHER IMPETUS BY THE DECLINE IN OIL PRICES. SECRETARY REGAN WENT SO FAR AS TO SUGGEST THAT THE PRIME RATE CHARGED BY THE BANKS COULD FALL TO THE RANGE 6-9 PER CENT.

6. THE ADMINISTRATION'S INCREASED CONFIDENCE ABOUT PROSPECTS FOR US ECONOMIC RECOVERY, AND THEIR AGREEMENT TO A JOBS BILL PACKAGE WORTH DOLLARS 4.6 BILLION (TOGETHER WITH OTHER MEASURES TO ALLEVIATE UNEMPLOYMENT), HAS FOR THE TIME BEING IMPROVED RELATIONS WITH CONGRESS. THE FISCAL YEAR 1984 BUDGET PROCEDURE IS STILL AT AN EARLY STAGE, AND THERE ARE GOING TO BE SUBSTANTIAL DIFFERENCES BETWEEN THE ADMINISTRATION AND CONGRESS ON WHAT AMENDMENTS ARE ACCEPTABLE TO THE ORIGINAL ADMINISTRATION PROPOSALS. THE DEMOCRATS ARE LIKELY TO OPPOSE THE PROPOSED SPENDING FREEZE (IN REAL TERMS) IN FY84 SINCE IT IN FACT CONSISTS OF A STRONG INCREASE IN REAL DEFENCE EXPENDITURE AND A DECLINE IN REAL NON-DEFENCE EXPENDITURE. THE ADMINISTRATION IS ASKING FOR A FURTHER SEVEN PER CENT REAL INCREASE IN DEFENCE SPENDING: CONGRESS WILL BE TRYING TO HOLD THIS DOWN TO BETWEEN THREE AND FIVE PER CENT. THE CONGRESS IS ALSO UNLIKELY TO ACCEPT THE ADMINISTRATION'S CONTINGENCY TAX PROPOSAL. UNLESS AN ALTERNATIVE TO THIS CAN BE FORMULATED, THERE WOULD BE THE UNACCEPTABLE PROSPECT OF CONTINUING BUDGET DEFICITS OF ABOUT DOLLARS 200 BILLION BEYOND FISCAL YEAR 1985. THERE IS THEREFORE PLENTY OF SCOPE FOR SHARP DIFFERENCES BETWEEN THE ADMINISTRATION AND CONGRESS TO RE-EMERGE ON BUDGET ISSUES DURING THE SPRING AND SUMMER.

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25 February 1983
ALAN WALTERS

PRIME MINISTER

US ECONOMY: CHANCELLOR'S MEMORANDUM 24 FEBRUARY

Monetary Policy

It is important to be clear that the Fed's policy has turned from being disinflationary to one that is markedly inflationary. Over 1982 the monetary base was expanding at 8% per annum. This will be consistent with inflation rate in the region of 8%-10% per annum in 1984. All the discussion and argument about interpreting monetary conditions and indicators are largely irrelevant.

In cyclical terms the Fed has been doing what it always tended to do in the past, that is to say contract the rate of growth of the money supply during a slump and expand it as the economy emerges into a boom. The money supply was squeezed hard until the middle of last year, and has subsequently expanded in the last three months of the year at 15% rate pa.

Because of the tremendous political pressures and the timing of the election, I cannot see the Fed doing any significant tightening before the latter part of 1984. This means that we must expect the United States will enter into a long run inflationary surge similar to that we have seen so often in the 1970s. I therefore expect that the present low inflation rate will last for little more than another year. Then inflation will pick up again to the region of 8% or more.

Interest Rates

The ostensible objective of the recent expansionary monetary policy was to keep interest rates down. It is true that this has had the effect of maintaining low short run interest rates. However, long run interest rates have increased by one or even two percentage points. This implies first that the market believes that the inflation rate is going to rise - and somewhere round about 8% is clearly their expectation in view of the fact that long term bonds are 10½% or 11%. Secondly, the fact that the spread of short and long rates has increased means that the market expects much higher short term interest rates in future years. These expectations are entirely consistent with a large budget deficit claiming some 70% of the available funds for investment.

/Conclusion

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Conclusion

The signs of a future inflation in the United States are sufficiently clear for us to consider what our policies should be under these conditions. It might be worthwhile at some stage convening a group to consider our policy. It may well be that we are in sight of Europe needing to provide the lynchpin reserve currency to replace the dollar. This would have momentous consequences.

ALAN WALTERS
25 February 1983

Top copy filed on
Econ Pol: Williamsburg
Summit Pt 11

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

PRIME MINISTER

THE US ECONOMY

In my minute of 14 February about the Interim Committee meeting I promised a separate note on the US economic scene. My visit to Washington provided an opportunity for discussions with Secretary Regan and a number of US officials and advisers.

2. Monetary policy appears to be in some disarray. The Fed argue that the apparent faster monetary growth towards the end of 1982 reflects institutional change and inter-mediation, while the stricter monetarists see it as expansionary and hence inflationary. I am inclined to accept a good part of the Fed argument, which implies that the change in the money/GDP relationship last year resulted in US monetary policy being tighter than intended. The difficulties of interpreting monetary conditions when the chosen indicators are subject to distortions is familiar from our own experience but, unlike us, the US authorities also have to contend with the problems caused by large budget deficits.

3. Paul Volcker recently announced higher and rebased monetary targets, but the markets must doubt if they will be maintained - despite his confirmation of the Fed's goals on defeating inflation. The credibility of monetary policy will be further strained if inflation picks up again. For the moment however the Fed will be particularly keen to avoid any significant or lasting increase in short-term interest rates.

/4. I found a

4. I found a markedly greater and more widespread buoyancy of opinion about short-term prospects for recovery than before Christmas, although there is a range of opinion over the precise timing and likely strength. The Fed is hopeful of lower inflation this year, in the 3-4 per cent range, with help from lower energy prices and lower labour costs. US productivity growth has been unexpectedly good - rather reminiscent of our own experience. But while the propsects for output and inflation look bright there is a risk of instability of both interest rates and the dollar if the recovery is too rapid. We will be watching for any signs of this developing.

5. Prospective budget deficits at around 6 per cent of GDP in the current fiscal year remain a major source of concern because they could damage current activity by raising real interest rates still further. This could also strengthen the exchange rate, reducing the competitiveness of exposed mature industries and reinforcing demands for increased protectionism. While all agree on the need to tackle high deficits, as yet there is no consensus on how to do so.

6. We also discussed the growing pressure on the major low inflation countries (Japan, Germany, the UK and the US) to adopt expansionary policies and pull the world out of recession. We explained that in terms of our own MTFS lower inflation, by itself, should leave room for higher growth and that it would be wrong to add artificial reflationary action. There will of course be pressure at the Summit for such action, and it will be important before Williamsbury to reduce

/expectations that

expectations that the Summit will produce reflationary initiatives. To this end we need to get across the message that recovery will emerge within a framework of prudent financial policies. There will be opportunities, eg. The May OECD Ministerial meeting, to put across in advance our views on how best to secure a sustainable recovery.

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

G.H.
24 February 1983

E.R.

CONFIDENTIAL

11 February 1983
ALAN WALTERS

PRIME MINISTER

(2)

Prime Minister

MARTIN FELDSTEIN'S VIEWS ON THE US ECONOMY

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1. The Recovery

Feldstein's judgement that the recovery has begun is based on fairly firm foundations. The two main indicators are, as I reported in November, new housing starts and the automobile industry. These real signs are buttressed by increases in order books.

But what we do not know is whether the recovery will persist. Will it merely peter out after a few months, as ours did in 1981, and the US economy stagnate yet again? He was arguing that this would not occur and that there would be a recovery faster than the 3½% or so which was incorporated in the estimates of the future budget deficits. (Traditionally the bounce back of the American economy from a slump tends to be quite rapid - about 5% growth is the normal rate of recovery in the post war years. But this is not a normal slump, nor will there be a normal recovery.)

These arguments for a more rapid recovery, circa 5%, are supported by the monetarists such as Karl Brunner. They argue that there has been such a monetary stimulus from the late summer of last year that there is bound to be a very rapid increase in real output followed a year or so later by a resumption of inflationary pressure. Feldstein, on the hand, argues that the monetary stimulus since the summer has been a once and for all response to the increase in the demand for money caused by the reduction in the rate of inflation. Although there has been 15% p.a. increase in M1 over the last two or three months, this will not be reflected, he argues, in a long run increase in inflation. In the next three years he anticipates that inflation will be of the order of 5% or so.

2. Money and the Federal Deficit

The surge in M1 can be explained in terms of the sharp change in velocity associated with a reduction in inflation. As short term interest rates and inflation falls, people will wish to hold more money of the non-interest bearing kind. This is what we are now experiencing and is quite consistent with continuation of progress in reducing inflation. What is a cause for alarm, however, is the

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fall in the velocity also of M2. In terms of the historical record, one would certainly not experience a fall in velocity of M2 under circumstances of falling inflation. This would then suggest that there has been a real relaxation of monetary conditions and that inflation up to 8% or so is likely to ensue.

Feldstein is clearly very worried about this fall in the velocity, or undue expansion, of M2. He and Volcker both believe it may be due to the change in banking regulations such that accounts which were in the M3 magnitude have shifted recently into M2. They are inclined, therefore, to explain it away as being simply a consequence of a change in the banking structure. Unfortunately, they have no evidence to back their conjecture since the statistics of M3 are only reported at much less frequent intervals, about three months, and the data are not yet available to check their conjecture. Feldstein drew some comfort from the fact that our statistics are behaving in a consistent way - that is to say the increase in velocity of M1 is associated with a fall in the velocity of both M2 and M3, as has appeared in recent months.

3. Conclusion

I can find no reason to disagree with both Feldstein and Karl Brunner that there will be a fairly rapid recovery in the United States over the next months. But I am afraid that the recovery will not continue for very long. The monetary expansion has brought down short term interest rates circa 8%-9%, but the long term bond rates remain stubbornly high at about 11%. The high long term interest rates mean that either the recovery will be short and soon aborted, or that inflation will rise again to levels of about 8% or so which will disappoint anticipations of low inflation and recovery. The presistent budget deficits and the belief that Congress and the administration do not have the political courage to bring them down will simply reaffirm the market's view that the accumulated debt will be monetised. All this suggests, therefore, that there will be a fairly rapid recovery which will peter out in 1984. Short interest rates will remain low for a while but will increase towards the end of this year, and long rates are likely to be little changed. If there is any dramatic progress on the deficit, however, the prognostication could change remarkably but in a predictable way.

ALAN WALTERS

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TO ROUTINE FCO

TELEGRAM NUMBER 268 OF 2 FEBRUARY

INFO SAVING: PARIS, BONN, UKREP BRUSSELS, UKDEL NATO, TOKYO.

MYTELNO 243 OF 31 JANUARY: INITIAL REACTIONS TO PRESIDENT REAGAN'S FY84 BUDGET PROPOSALS

SUMMARY

1. INITIAL REACTIONS TO PRESIDENT REAGAN'S FY84 BUDGET PROPOSALS IN CONGRESS, THE PRESS AND AMONGST ECONOMIC COMMENTATORS HAVE BEEN MIXED. THE MORE REALISTIC FORECASTS FOR ECONOMIC GROWTH WERE WELCOMED. THERE IS ALSO AGREEMENT ON ALL SIDES THAT THE BUDGET DEFICIT NEEDS TO BE REDUCED. BUT THERE ARE DOUBTS ABOUT WHETHER THE PROPOSALS FOR REDUCING THE DEFICIT REFLECT ANY MAJOR CHANGE IN THE ADMINISTRATION'S PRIORITIES. THE CONGRESSIONAL BUDGET PROCESS WILL IN ANY CASE TAKE 9 MONTHS AND NO CLEAR BATTLE LINES HAVE YET BEEN DEFINED. BUT SUCCESSFUL PASSAGE OF MEASURES FOR REDUCING THE DEFICIT WILL PROBABLY DEPEND ON HOW MUCH GROUND THE ADMINISTRATION IS PREPARED TO GIVE IN STRIKING A BALANCE BETWEEN REDUCING EXPENDITURE AND RAISING TAXATION AND BETWEEN REDUCING CIVIL AND CURBING THE GROWTH OF MILITARY EXPENDITURE.

DETAIL

2. IT IS TOO EARLY TO PREDICT HOW CONGRESS WILL DIVIDE ON THE MAIN ISSUES DURING THE PROCESS OF TRYING TO GET THE BUDGET THROUGH CONGRESS, WHICH WILL TAKE AT LEAST 9 MONTHS (FY84 STARTS ON 1 OCTOBER 1983). WITH THE INCREASED DEMOCRATIC MAJORITY IN THE HOUSE FOLLOWING THE CONGRESSIONAL ELECTIONS IN NOVEMBER 1982, THE BUDGET PROPOSALS WILL NOT PASS AS THEY STAND, AND NO DOUBT THERE IS MUCH WHEELING AND DEALING TO COME. THE FIRST FORMAL CONGRESSIONAL PROCEDURES RELEVANT TO THE FY84 BUDGET ARE TAKING PLACE IN THE BUDGET COMMITTEES OF EACH HOUSE, WHO ARE UNDER A STATUTORY OBLIGATION TO REPORT BUDGET PROPOSALS BY 15 MARCH, WITH A VIEW TO A FIRST BUDGET RESOLUTION TO ESTABLISH A COMMON TARGET FOR TOTAL RECEIPTS AND EXPENDITURE BEING AGREED BY 15 MAY. THEREAFTER THE PROPOSALS HAVE TO GO THROUGH THE MILLS OF AUTHORISATIONS AND APPROPRIATIONS COMMITTEES BEFORE THE WHOLE PROCESS CAN BE COMPLETED, THEORETICALLY IN SEPTEMBER.

3. CONGRESS IS LIKELY TO ACCEPT THE NEED FOR ACTION TO REDUCE THE SIZE OF BUDGET DEFICITS OVER THE BUDGET PERIOD. BUT HE DEMOCRATS ARE UNLIKELY TO AGREE WITH THE PRESIDENT'S ASSERTION THAT THE DEFICITS OWE NOTHING TO HIGHER PLANNED DEFENCE SPENDING OR TO THE PROGRAMME OF PHASED CUTS IN INCOME TAX, BUT RATHER THE RAPID GROWTH OF ENTITLEMENT EXPENDITURE ON INCOME SUPPORT, HEALTH CARE AND WELFARE PAYMENTS. THEY POINT TO THE DISPARATE COMPONENTS OF THE PROPOSED ''EXPENDITURE FREEZE'' FOR FY84, WHICH CONSISTS OF A GROWTH IN DEFENCE SPENDING OF OVER 10 PERCENT IN REAL TERMS AND A DECLINE IN

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OTHER SPENDING (EXCLUDING INTEREST PAYMENTS) OF OVER 5 PERCENT IN REAL TERMS. THEY ARE LIKELY TO OPPOSE THE PRESIDENT'S PROPOSALS TO RESTRAIN THE GROWTH OF MEDICARE BENEFITS, ENTITLEMENT PROGRAMMES SUCH AS FOOD STAMPS AND FARM PRICE SUPPORTS, SINCE THEY REGARD IT AS INAPPROPRIATE TO CONCENTRATE SPENDING CUTS IN SECTORS AFFECTING THOSE WHO ARE BEARING THE WORST EFFECTS OF THE RECESSION.

4. THE ADMINISTRATION'S PROPOSALS TO FREEZE FEDERAL CIVILIAN AND MILITARY PAY AND PENSIONS WILL BE RESISTED BY STRONG PRESSURE GROUPS AND THERE WILL BE INSISTANCE THAT ANY SAVINGS ON MILITARY EXPENDITURE MUST BE FOUND ELSEWHERE (E.G. SENATOR WARNER'S PROPOSAL FOR A 5 PERCENT REDUCTION IN MILITARY MANPOWER LEVELS.) BUT THE GREENSPAN COMMISSION PROPOSALS FOR SOCIAL SECURITY REFORM MAY RECEIVE MORE SUPPORT IN VIEW OF THE URGENT NEED TO TACKLE THE FINANCIAL PROBLEMS OF THE TRUST FUNDS.

5. THE DEMOCARTIC ALTERNATIVE APPROACH HAS BEEN DESCRIBED BY TIP O'NEILL (D.-HOUSE SPEAKER) AS SUPPORT FOR ''A BUDGET THAT WILL INCLUDE A MAJOR COMMITMENT TO CREATING JOBS AND STIMULATING THE ECONOMY''. THE DEMOCRATS HAVE CRITICISED THE BUDGET FOR ITS LACK OF NEW JOBS PROGRAMMES AND ARE LIKELY TO PROPOSE NEW PROGRAMMES TO EXPAND EMPLOYMENT IN THE PUBLIC SECTOR. BUT THE PRESIDENT HAS STATED THAT IN PRINCIPLE HE REMAINS OPPOSED TO TEMPORARY MAKE-WORK JOBS PROGRAMMES.

6. THE PRESIDENT'S PROPOSALS FOR A CONTINGENCY TAX INCREASE TO TAKE EFFECT IN OCTOBER 1985 HAVE COME IN FOR HEAVY CRITICISM. THERE IS LITTLE SUPPORT IN CONGRESS FOR THE PRINCIPLE OF A STANDLY TAX IF THIS IS INTENDED TO LIMIT ITS FUTURE DISCRETIONARY POWER OVER TAXATION. INSTEAD, THE DEMOCRATS HAVE SUGGESTED ELIMINATING OR REDUCING THE AMOUNT OF THE CUT IN INCOME TAX SCHEDULED TO TAKE EFFECT THIS JULY, AND/OR AMENDING THE LEGISLATION PROVIDING FOR INDEXATION OF INCOME TAX THRESHHOLDS IN JANUARY 1985. THE PRESIDENT OPPOSES THESE COUNTER-PROPOSALS. IF BOTH THE CONTINGENCY TAX PLAN AND REDUCING THE SCHEDULED INCOME TAX CHANGES ARE DOUBTFUL STARTERS, THEN IT IS UNCERTAIN WHERE ADDITIONAL REVENUES WILL COME FROM.

7. THE MAJORITY OF ECONOMIC COMMENTATORS REMAIN CAUTIONS ABOUT THE ADMINISTRATION FORECAST OF 4 PERCENT ECONOMIC GROWTH BEGINNING IN 1984. ALTHOUGH SUCH A GROWTH RATE IS BY PAST STANDARDS NOT IMPLAUS-IBLE, IT IS THOUGHT THAT MUCH DEPENDS ON WHETHER FINANCIAL MARKETS WILL BE CONVINCED THAT FUTURE BUDGET DEFICITS WILL BE REDUCED. THE PRINCIPAL CONCERN IN THE MARKETS IS THAT LARGE DEFICITS WILL CROWD OUT THE PRIVATE DEMAND FOR CREDIT AS THE RECOVERY PROCEEDS, OR WILL BE INFLATIONARY IF THE FED ACCOMMODATES THEM. SOME COMMENTATORS,E.G. RUDOLPH PENNER OF THE AMERICAN ENTERPRISE INSTITUTE, ARGUE THAT THE ADMINISTRATION'S FORECASTS ARE UNDULY PESSIMISTIC AND THAT THE RECOVERY WILL BE MORE BUOYANT, LEADNING TO LOWER DEFICITS. BUT

/ EVEN

EVEN PENNER ACCEPTS THAT THE DEFICIT WILL NOT FALL SIGNIFICANTLY UNLESS SOME ACTION IS TAKEN. FINANCIAL MARKETS WILL BE INFLUENCED HEAVILY BY ANY INDICATION OF WHETHER OR NOT THE CONGRESS IS WILLING TO TAKE THE NECESSARY ACTION. SO FAR THEY APPEAR NOT TO HAVE BEEN CONVINCED, SINCE INTEREST RATES HAVE BEEN EDGING UPWARDS IN THE PAST WEEK OR SO.

8. FCO PLEASE PASS TO PS/CHANCELLOR OF THE EXCHEQUER, PS/LITTLER AND BOTTRILL (TREASURY) AND WATSON (BANK OF ENGLAND)

FCO PASS SAVING PARIS, BONN, UKREP BRUSSELS, UKDEL NATO AND TOKYO.

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TO PRIORITY FCO 251 OF 1 FEBRUARY 1983
SAVING TO UKMIS NEW YORK, UKMIS GENEVA, NATO POSTS AND
CONSULS-GENERAL IN THE USA

MY TELEGRAM NO 79: WHICH REAGAN?

1. THE PRESIDENT'S SECOND STATE OF THE UNION ADDRESS (MY TELNO 213) HAS LEFT A QUESTION MARK IN WASHINGTON'S POLITICAL FIRMAMENT. WAS THE PRESIDENT'S WIDELY-NOTICED CONCILIATORY TONE MERELY COSMETIC? OR DID IT REPRESENT THE BEGINNING OF A SUBSTANTIVE CHANGE IN REAGAN'S POLITICAL STANCE? THE BUDGET, PRESENTED TO CONGRESS YESTERDAY (MY TELNO 243) HAS LED MOST PEOPLE TO CONCLUDE THAT IT WAS COSMETIC. REPUBLICAN SUPPORTERS ARE OBVIOUSLY UNWILLING TO ADMIT THAT THERE WAS ANY NEED FOR A CHANGE OF SUBSTANCE. DEMOCRATIC OPPONENTS FOR EQUALLY OBVIOUS REASONS, PREFER TO DEPICT THE PRESIDENT AS STUBBONLY SET IN CONCRETE. EITHER WAY, THE BUDGET DOES NOT SHOW MUCH SIGN OF CHANGING PRIORITIES.

2. IN PARTICULAR, THE PROPOSAL TO REDUCE THE PENTAGON'S BUDGET BY DOLLARS 55 BILLION OVER FIVE YEARS IS SEEN BY THE DEMOCRATS AND EVEN BY SOME REPUBLICANS, AS DERISORY. AND THERE IS LITTLE SIGN THAT ANYONE IS TAKING THE PROSPECT OF A CONDITIONAL STANDBY TEX IN THREE YEARS TIME AS ANYTHING BUT A GIMMICK. THE ONE IMPORTANT CHANGE OF SUBSTANCE IS THE GREATER REALISM OF THE ECONOMIC FORECASTS AND THE RECOGNITION OF THE SIZE OF THE PROJECTED BUDGET DEFECIT. THIS REVISION HAS RECEIVED A WIDESPREAD WELCOME. NEVERTHELESS, THERE IS STILL BOUND TO BE A CONSIDERABLE BATTLE IN CONGRESS, PARTICULARLY OVER DEFENCE SPENDING, THE PROPOSED REDUCTIONS IN SOCIAL PROGRAMMES AND ALTERNATIVE METHODS OF REDUCING THE HUGE PROSPECTIVE DEFICITS THROUGH TAXATION ADJUSTMENTS OR REFORMS.

3. THE CONVENTIONAL VIEW SEEMS TO BE THAT AT MOST THE PRESIDENT HAS TONED DOWN HIS RHETORIC IN AN UNDERSTANDABLE ATTEMPT TO COURT HIS CRITICS. (THERE IS A COMPARABLE CHANGE OF TUNE IN HIS ATTITUDE TO THE SOVIET UNION). THIS JUDGMENT WAS PUT AT ITS MOST ASTRINGENT BY WILLIAM SAFIRE (RIGHT WING REPUBLICAN) WHO CALLED THE STATE OF THE UNION ADDRESS A QUOTE THEMELESS PUDDING .....A SERIES OF BANALITIES DESIGNED TO INGRATIATE THE PRESIDENT WITH HIS POLITICAL OPPOSITION UNQUOTE.

4. I AM NOT SO SURE. THERE IS NO DOUBT THAT REAGAN IS A SHREWD POLITICIAN. I BELIEVE THAT HE HAS READ THE RESULTS OF THE MID-TERM ELECTIONS AND OF RECENT PUBLIC OPINION POLLS AS A CLEAR INDICATION THAT IF THE REPUBLICANS ARE TO STAND A CHANCE AT THE 1984 ELECTIONS, SOMETHING NEEDS TO BE DONE TO RESTORE HIS IMAGE.

IN THE FIRST YEAR OF HIS PRESIDENCY, HE SCORED HEAVILY BY BEING SEEN AS A DECENT MAN WITH STRONG BELIEF IN TRADITIONAL AMERICAN VALUES, WHO WAS ABLE TO WORK WITH CONGRESS SO AS TO GET SENSIBLE THINGS DONE. IN RECENT MONTHS, NOT ONLY HAS HIS DECENCY COME UNDER QUESTION (QUOTE THE FAIRNESS ISSUE UNQUOTE) BUT HE HAS LOST HIS EARLIER REPUTATION FOR BEING ABLE TO GET HIS POLICIES ACCEPTED BY CONGRESS, NOT LEAST BECAUSE WITNESS THE BUDGET DEFICIT, REAGONISM HAS FAILED. AT THE VERY LEAST THEREFORE THE NEW EMPHASIS ON AN ATTEMPT AT BI-PARTISANSHIP SEEMS DESIGNED AT ONCE TO REACH OUT TO A WIDER POLITICAL AUDIENCE AND, IF SUCCESSFUL, TO RE-ESTABLISH HIS STANDING AS A STRONG PRESIDENT WHO CAN GET THINGS DONE.

5. I BELIEVE THERE MAY BE A LITTLE MORE TO IT THAN THAT. REAGAN CHOSE THIS VERSION OF THE ADDRESS FROM A NUMBER OF TOUGHER ALTERNATIVES THAT WERE SUBMITTED TO HIM. THE ONLY PHRASE WHICH BROUGHT CONGRESS TO ITS FEET (QUOTE WE WHO ARE IN GOVERNMENT MUST TAKE THE LEAD IN RESTORING THE ECONOMY UNQUOTE) WAS A DELIBERATELY FAR CRY FROM THE ANTI-GOVERNMENT POSITION WHICH HE HAS PURSUED OVER MOST OF HIS POLITICAL CAREER AND WHICH HE EXPRESSED SO CLEARLY DURING HIS INAUGURAL ADDRESS (QUOTE IN THIS PRESENT CRISIS, GOVERNMENT IS NOT THE SOLUTION TO OUR PROBLEM: GOVERNMENT IS THE PROBLEM. UNQUOTE) WAS THIS PERHAPS REAGAN THE PRAGMATIST DISTANCING HIMSELF CONSCIOUSLY FROM REAGAN THE IDEOLOGUE? AND THUS RESPECTING THE EXPERIENCE OF HIS CALIFORNIA GOVERNORSHIP.

6. IT IS TOO SOON YET TO JUDGE. THE ANSWER WILL BECOME CLEARER AS THE BATTLE OVER THE BUDGET PROCEEDS AND WE SEE WHAT CONCESSIONS THE PRESIDENT IS PREPARED TO MAKE. HIS RELATIONSHIP WITH THE 98TH CONGRESS, LIKE THE PERFORMANCE OF THE ECONOMY, WILL BE ONE OF THE KEY FACTORS IN HIS MIND WHEN HE COMES TO MAKE HIS DECISION ABOUT RUNNING FOR A SECOND TERM. IF HE WANTS TO RUN IN 1984 AND TO WIN, HE HAS TO FIND A DIFFERENT CONSTIUENTCY FROM THE ONE WHICH SUPPORTED HIM TO VICTORY IN 1980.

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FM WASHINGTON 312300Z JAN 83
TO PRIORITY FCO
TELEGRAM NUMBER 246 OF 31 JANUARY
INFO SAVING PARIS, BONN, UKREP BRUSSELS, UKDEL NATO, UKDEL OECD

US ECONOMY: BACKGROUND BRIEFING ON THE BUDGET AND THE ECONOMIC REPORT OF THE PRESIDENT

1. FELDSTEIN (CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS) BRIEFED OECD EMBASSIES TODAY ON THE ECONOMIC BACKGROUND TO THE FY84 BUDGET AND THE ANNUAL CEA REPORT.

2. IN OPENING THE SESSION, FELDSTEIN EMPHASISED THE INTERNATIONAL CONTEXT OF THE ECONOMIC MEASURES PROPOSED BY THE ADMINISTRATION. FELDSTEIN NOTED THAT HE WOULD BE ACCOMPANYING VICE PRESIDENT BUSH ON HIS TRIP TO EUROPE AND SAID THAT THIS WAS AN INDICATION OF THE AWARENESS WITHIN THE ADMINISTRATION OF THE INTERDEPENDENCE OF THE OECD ECONOMIES. ONE OF THE ASSUMPTIONS UNDERLYING THE ADMINSTRATION'S LATEST FORECASTS WAS THAT THE OECD COUNTRIES WOULD HAVE A GRADUAL RECOVERY AND THAT THERE WOULD BE NO MAJOR DEFAULTS OF HIGH-DEBT COUNTRIES.

3. FELDSTEIN SAID THAT THE ADMINISTRATION'S SHORT-TERM FORECAST WAS INTENDED TO BE REALISTIC AND WAS NOT SIMPLY A GOAL. HE THOUGHT THAT IT WAS TREMENDOUSLY IMPORTANT THAT THE FORECAST SHOULD BE CREDIBLE WITHIN THE FINANCIAL COMMUNITY. GROWTH IN REAL GNP FROM THE FOURTH QUARTER OF 1982 TO THE FOURTH QUARTER OF 1983 WAS EXPECTED TO BE 3.1 PERCENT. THIS FIGURE REPRESENTED A BALANCE OF PROBABILITIES. IF THE RECOVERY HAD BEGUN IN JANUARY HE WOULD HAVE FORECAST SOMETHING MORE LIKE 5 PERCENT INSTEAD OF 3.1 PERCENT. BUT THE STARTING POINT FOR THE RECOVERY WAS STILL UNKNOWN: WHILE THE LEADING INDICATORS POINTED TO A RECOVERY IN THE MONTHS AHEAD, THE LATEST COINCIDENT INDICATORS (FOR DECEMBER), SUCH A INDUSTRIAL PRODUCTION, SHOWED THAT IT HAD NOT YET BEGUN. IF RECOVERY DID NOT BEGIN UNTIL MAY HE THOUGHT THAT THE GROWTH BETWEEN THE FOURTH QUARTER OF 1982 AND THE FOURTH QUARTER OF 1983 COULD BE AS LOW AS 2 PERCENT.

4. FOR THE LONGER TERM, FELDSTEIN EMPHASISED THAT THE ADMINISTRATI-ION'S OBJECTIVE WAS SUSTAINABLE GROWTH. THIS WAS FORECAST AT A STEADY 4 PERCENT FROM THE SECOND HALF OF 1983. THE OBJECTIVE WAS NOT TO ALLOW THE RECOVERY TO ADD SIGNIFICANTLY TO INFLATION, AND THE ADMINISTRATION WERE NOT TRYING TO DRIVE UNEMPLOYMENT DOWN TO THE LOW TARGET LEVELS OF THE EARLY 1970S. FOR INSTANCE, THE SO-CALLED HIGH EMPLOYMENT DEFICIT ESTIMATES IN THE BUDGET DOCUMENTS HAD BEEN MADE ON THE BASIS OF 6 1/2 PERCENT UNEMPLOYMENT. WHILE THE GROWTH IN THE GNP DEFLATOR WAS PUT AT 5.4 PERCENT IN 1983 COMPARED TO 4.6 PERCENT 1982, THIS INCREASE WAS LARGELY RELATED TO THE FALL IN AGRICULTURAL PRICES IN 1982 WHICH WOULD NOT NECESSARILY BE REPEATED.

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5. IN ANSWER TO A QUESTION ABOUT MONETARY POLICY, FELDSTEIN SAID THAT THE FORECAST OF NOMINAL GNP GROWTH DURING 1983 OF 8.8 PERCENT WAS INTENDED TO BE CONSISTENT WITH A GROWTH OF THE MONETARY AGGREGATE M2 WITHIN THE UPPER PART OF THE FEDERAL RESERVE BOARD'S PRESENT TARGET RANGE OF 6-9 PERCENT. HE GAVE A WARNING HOWEVER THAT THE ACTUAL FIGURES FOR M2 IN THE FIRST FEW MONTHS OF 1983 COULD BE CONSIDERABLY ABOVE THE TARGET RANGE BECAUSE OF INSTITUTIONAL FACTORS, PARTICULARLY RE-INTERMEDIATION FOLLOWING THE INTRODUCTION OF MONEY MARKET INTEREST RATES ON SOME BANK ACCOUNTS. HE MENTIONED POSSIBLE MONTHLY FIGURES WHICH COULD BE TRANSLATED INTO ANNUAL M2 GROWTH RATES OF AS HIGH AS 15-20 PERCENT. THE LARGEST PART OF THIS HE SAID WOULD REPRESENT AN UPWARD SHIFT IN M2, NOT EXCESSIVE GROWTH. THE BUDGET DOCUMENTS CONTAINED A FORECAST OF DECLINING SHORT-TERM MARKET INTEREST RATES AND HE ACKNOWLEDGED THAT THIS WAS AGAINST THE LATEST MARKET MOVEMENTS. BUT ONCE MARKETS CAME TO REALISE THAT SOMETHING WAS GOING TO BE DONE ABOUT FUTURE BUDGET DEFICITS, HE THOUGHT THAT THE DOWNWARD TREND IN THESE RATES SINCE MID-1982 WOULD CONTINUE.

6. ON THE FUTURE EXTERNAL VALUE OF THE DOLLAR, FELDSTEIN DID NOT GIVE ANY FORECASTS BUT MENTIONED TWO OPPOSING FORCES. HE THOUGHT THERE WOULD BE A HIGH MERCHANDISE TRADE DEFICIT IN 1983 (AMOUNTING TO 2 PERCENT OR MORE OF GNP) AND ALSO A LARGE CURRENT ACCOUNT DEFICIT. THIS WOULD TEND TO DRIVE THE DOLLAR DOWN. BUT HE SAW A CONTINUATION OF HIGH LONG-TERM REAL INTEREST RATES, WHICH WOULD TEND TO HOLD THE DOLLAR UP. THE AVERAGE NOMINAL RATE OF INTEREST ON A 10-YEAR TREASURY NOTE WAS FORECAST AT 10.2 PERCENT IN 1983, WHICH WAS ABOUT 5 PERCENT ABOVE THE RATE OF INFLATION.

7. COPIES OF THE BUDGET DOCUMENTS AND THE ECONOMIC REPORT OF THE PRESIDENT (WHEN THE LATTER BECOMES AVAILABLE) FOLLOW BY BAG TO BOTTRILL (TREASURY), BROADBENT (FCO) AND WATSON (BANK OF ENGLAND).

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

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TELEGRAM NUMBER 243 OF 31 JANUARY
AND TO ROUTINE PARIS, BONN, TOKYO, UKREP BRUSSELS, UKDEL NATO.

UNITED STATES: BUDGET FOR FY84

1. PRESIDENT REAGAN WILL PRESENT HIS FY84 BUDGET TO THE CONGRESS ON JANUARY 31. WE HAVE OBTAINED A COPY OF HIS PROPOSALS IN ADVANCE. THESE ARE EMBARGOED UNTIL NOON LOCAL TIME AND SHOULD NOT BE MADE PUBLIC BEFORE THEN. PROJECTIONS FOR THE BUDGET TOTALS AND THE DEFICIT UNTIL FY88 ARE AS FOLLOWS:-

	FY83	FY84	FY85	FY86	FY88
	(BILLIONS OF DOLLARS)				
RECEIPTS	598	660	724	842	1010
RECEIPTS/GNP (PERCENT)	18.7	18.9	19.0	20.3	N.A.
OUTLAYS	805	849	918	990	1127
OUTLAYS/GNP (PERCENT)	25.2	24.3	24.1	23.9	N.A.
DEFICIT	207	189	194	148	117
DEFICIT/GNP (PERCENT)	6.5	5.4	5.1	3.6	N.A.

2. THE BUDGET DOCUMENTS ESTIMATE THAT ABOUT 69 PERCENT OF THE UNCORRECTED BUDGET DEFICIT IN FY 83 IS STRUCTURAL AS DISTINCT FROM CYCLICAL, WHEREAS BY FY86 THIS INCREASES TO 85 PERCENT AND TO 97 PERCENT BY FY88.

3. THE MAIN OUTLINE OF THE BUDGET ECONOMIC FORECAST IS FOR SOME RECOVERY IN ECONOMIC ACTIVITY IN THE FIRST HALF OF 1983 WITH GREATER MOMENTUM GATHERING IN THE SECOND HALF. UNEMPLOYMENT IS FORECAST AT ABOVE 10 PERCENT ON AVERAGE IN 1983, WHILE INFLATION IS PUT AT BELOW 5 PERCENT.

4. THE ECONOMIC ASSUMPTIONS ARE AS FOLLOWS:-
(CALENDAR YEAR)

	1982	1983	1984	1985	1986	1988
NOMINAL GNP (PERCENT INCREASE)	4.1	6.7	9.3	9.1	8.8	8.6
GNP (CONSTANT 1972) DOLLARS (PERCENT INCREASE)	-1.8	1.4	3.9	4.0	4.0	4.0
CONSUMER PRICE INDEX (PERCENT INCREASE)	6.0	4.9	4.6	4.6	4.6	4.4
UNEMPLOYMENT RATE (PERCENT)	9.5	10.7	9.9	8.9	8.1	6.9
INTEREST RATE (91 DAY T.BILL) (PERCENT)	10.7	8.0	7.9	7.4	6.9	6.1

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5. THE MAIN PROPOSALS FOR REDUCTIONS IN CIVIL EXPENDITURE INCLUDE A 6 - MONTH DELAY IN SOCIAL SECURITY COST-OF-LIVING ADJUSTMENTS AS PROPOSED BY THE BIPARTISAN COMMISION, ITS EXTENSION TO OTHER BENEFIT PROGRAMMES, A ONE-YEAR FREEZE ON OTHER NON-DEFENCE DOMESTIC EXPENDITURE, (INCLUDING THE FEDERAL PAYROLE AND PENSIONS), MEASURES TO CONTROL THE GROWTH OF AUTOMATIC ENTITLEMENT PROGRAMMES, AND HEALTH CARE REFORM. PROVISION FOR DEFENCE INCREASES, IN REAL TERMS THROUGHOUT THE BUDGET PERIOD. REAL DEFENCE OUTLAYS ARE PROJECTED TO INCREASE BY ABOUT 10 PERCENT IN FY84 OVER FY83 AND REAL NON-DEFENCE OUTLAYS TO DECLINE BY ABOUT 3 PERCENT.

RECEIPTS

6. THE BUDGET PROPOSALS FOR INCREASING RECEIPTS INCLUDE A MAJOR INNOVATION, A CONTINGENCY TAX PLAN IF ECONOMIC GROWTH SUFFICIENT TO LIMIT THE FY86 DEFICIT TO 2 AND ONE HALF PER CENT GNP (AS FORECAST IN JULY 1985) DOES NOT MATERIALISE. THE CONTINGENCY TAXES CONSIST OF A 1 PER CENT SURCHARGE ON THE TAXABLE INCOME OF INDIVIDUALS AND CORPORATIONS AND A 5 DOLLAR PER BARREL EXCISE TAX ON OIL.
THE MAIN REVENUE INCREASES ARE AS FOLLOWS:

	BILLIONS OF DOLLARS		
REVENUE INCREASES	FY84	FY85	FY86
BIPARTISAN SOCIAL SECURITY PLAN	8.2	5.8	8.9
CIVIL SERVICE RETIREMENT CONTRIBUTIONS	1.2	2.3	2.1
TAXATION OF HEALTH INSURANCE PREMIUMS	2.3	4.4	6.0
CONTINGENCY TAX PLAN	-	-	4.6
TOTAL	11.2	11.3	61.3

(THERE ARE SOME MINOR REVENUE DECREASES NOT LISTED BUT TAKEN INTO ACCOUNT IN THE TOTAL)

7. THE PRESIDENT CLEARLY HOPES THAT A BIPARTISAN SPIRIT WILL PREVAIL IN CONGRESS SO THAT A COMPROMISE CAN BE REACHED ON THE OVERALL BUDGET SIMILAR TO THE ONE REACHED ON THE SOCIAL SECURITY COMMISSION'S REPORT. BUT THE RECOMMENDATIONS OF THE COMMISSION AND THE OTHER BUDGET PROPOSALS WILL RECEIVE THE USUAL SCRUTINY AND COULD WELL BE ALTERED AS THEY PASS THROUGH THE CONGRESS. IN PARTICULAR, THE DEMOCRATS WILL PROBABLY WISH TO REDUCE PROVISION FOR DEFENCE EXPENDITURE AND INCREASE THAT FOR CIVIL PROGRAMMES, PARTICULARLY FOR THOSE THAT CREATE JOBS.

8. FURTHER COMMENTS ON THE FY84 BUDGET AND AN ASSESSMENT OF CONGRESSIONAL AND OTHER REACTIONS WILL FOLLOW BY SEPARATE TELEGRAM.

9. FCO PLEASE ADVANCE TO PS/LITTLER AND BOTHRILL (TREASURY) AND WATSON (BANK OF ENGLAND).

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TELNO 86 OF 13 JANUARY 1983

INFO MODUK (DS1 AND DS12), UKDEL NATO, BONN, PARIS, MOSCOW,

INFO SAVING CONSULS GENERAL IN THE U.S.A.

REAGAN ADMINISTRATION: THE BUDGET

1. THE IMMEDIATE CAUSE OF THE BAD PRESS PRESIDENT REAGAN HAS BEEN RECEIVING IN RECENT DAYS (MY TELNO 79) HAS BEEN THE DEBATE ON THE BUDGET WHICH HAS BEEN GOING ON WITHIN THE WHITE HOUSE AND HAS BEEN EXTENSIVELY AIRED IN THE COLUMNS OF THE PRESS AS A RESULT OF UNAUTHORISED WHITE HOUSE LEAKS.

2. AT HIS PRESS CONFERENCE A WEEK AGO, THE PRESIDENT SOUGHT TO CONVEY THE IMPRESSION THAT, WHILE NO DECISIONS HAD BEEN TAKEN, ON THE BUDGET FOR FY84 WHICH IS TO BE PRESENTED TO CONGRESS AT THE END OF THIS MONTH, HE WAS NONETHELESS CONFIDENT THAT HE COULD CONTINUE TO SET THE ECONOMIC AGENDA AS IN THE PAST (NO TAX INCREASES: REDUCTION IN SOCIAL SPENDING AND MAINTAINING PLANNED INCREASES IN DEFENCE SPENDING). THE GROUND WAS IMMEDIATELY CUT FROM UNDER THE PRESIDENT'S FEET FIRSTLY BECAUSE IT WAS WELL KNOWN THAT HIS ADVISERS WERE ALL TELLING HIM THAT HE MUST TAKE STEPS TO CUT THE BUDGET DEFICIT (PROJECTED AT DOLLARS 200 BILLION FOR FY84): AND SECONDLY BECAUSE A SUCCESSION OF REPUBLICAN LEADERS IN CONGRESS, MOST NOTABLY THE PRESIDENT'S ALTER-EGO ON CAPITOL HILL, SENATOR LAXALT, TOLD THE PRESIDENT AND THE PRESS THAT THERE WOULD BE NO SUPPORT WITHIN CONGRESS FOR REDUCTIONS IN SOCIAL SPENDING, THAT THE DEFICIT MUST BE REDUCED AND THAT THOSE REDUCTIONS MUST ENCOMPASS SOME DECREASE IN PROJECTED DEFENCE SPENDING.

3. ALL THE SIGNALS FROM THE WHITE HOUSE OVER THE LAST FEW DAYS INDICATE THAT THE PRESIDENT HAS COMPROMISED, BUT THE TURN-AROUND HAS NOT BEEN SKILFULLY HANDLED AND IT IS CLEAR THAT THE STATE OF THE ECONOMY IS DICTATING POLICY RATHER THAN THE OTHER WAY AROUND. THE LATEST INDICATIONS FROM THE WHITE HOUSE AND FROM WEINBERGER HIMSELF ARE THAT THE PRESIDENT AIMS TO FIND CUTS OF AROUND DOLLARS 11.3 BILLION IN THE DEFENCE BUDGET AND A FURTHER DOLLARS 6 BILLION IN THE CIVIL BUDGET BY IMPOSING A PAY FREEZE ON FEDERAL OFFICIALS AND SERVING MEMBERS OF THE ARMED FORCES. IN ADDITION, THE PRESIDENT IS BELIEVED TO BE CONTEMPLATING AN INCOME TAX SURCHARGE WHICH WOULD ONLY COME INTO AFFECT IN TWO YEAR'S TIME IF THE DEFICIT HAD NOT BEEN REDUCED BEYOND A CERTAIN POINT IN THE MEANTIME. THE PROPOSAL FOR A FREEZE ON PLANNED PAY INCREASES FOR FEDERAL OFFICIALS AND THE ARMED FORCES IS LIKELY TO PROVOKE A FURORE IN CONGRESS PARTICULARLY IF, AS EXPECTED, THE PRESIDENT GOES ON TELEVISION IN THE NEAR FUTURE TO SEEK PUBLIC SUPPORT FOR THE MEASURE OF A SACRIFICE IN THE NATIONAL INTEREST.

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/SPEAKER

SPEAKER O'NEILL'S STAFF HAVE TOLD US THAT THE DEMOCRATS IN CONGRESS WOULD ''RAISE HELL'' OVER THE PROPOSAL, NOT ONLY BECAUSE IT WOULD MAKE ONLY A SMALL DENT IN THE BUDGET BUT BECAUSE IT WOULD UNDERMINE THE CONSIDERABLE PROGRESS WHICH HAS BEEN MADE IN THE LAST TWO YEARS IN IMPROVING THE MORALE AND READINESS OF AND THE QUALITY OF RECRUITMENT TO THE ARMED FORCES, WHILE SEEKING TO PRESERVE ALL EXISTING WEAPONS PROGRAMMES.

5. WEINBERGER FOUGHT HARD TO MAINTAIN SOME INCREASE IN ARMED FORCES PAY IN THE COMING YEAR I.E. A 4% INCREASE COMPARED WITH A PROJECTED INCREASE OF 7.6%, BUT WAS NOT PREPARED TO CUT BACK EQUIPMENT PROGRAMMES. IN DECIDING TO OPT FOR A COMPLETE FREEZE, THE PRESIDENT IN EFFECT IS SAYING THAT IF CONGRESS WANT CUTS IN THE DEFENCE BUDGET THEY WILL HAVE TO ACCEPT THEM IN THIS PAINFUL AND UN-PALATABLE FORM. BUT THE PRESIDENT DOES NOT HAVE THE POWER TO DICTATE TO CONGRESS THE FORM WHICH CUTS MUST TAKE. THERE WILL BE STRONG CONGRESSIONAL DEMANDS FOR CUTS IN PROGRAMMES RATHER THAN IN PAY AND REDUCTIONS.

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TELEGRAM NUMBER 4039 OF 23 DECEMBER
INFO BONN, UKDEL NATO
INFO SAVING PARIS, MOSCOW, TEL AVIV AND CG'S IN USA

MY TELNO 4002: CONGRESS: THE LAME DUCK SESSION

1. THE LAME DUCK SESSION OF CONGRESS HAS FINALLY ENDED. ON TUESDAY, THE PRESIDENT SIGNED INTO LAW THE CONTINUING RESOLUTION WHICH, AS FINALLY ADOPTED, WILL FUND THE FEDERAL GOVERNMENT UNTIL THE END OF SEPTEMBER 1983 IE. UNTIL THE END OF THE CURRENT FINANCIAL YEAR. THIS MORNING, THE SENATE, AFTER A MAMMOTH FILLIBUSTER BY SENATOR HELMS AND A HANDFUL OF HIS CONSERVATIVE COLLEAGUES, ADOPTED THE FIVE CENT A GALLON INCREASE IN GASOLINE TAX WHICH WILL FUND HIGHWAY REPAIRS THROUGHOUT THE COUNTRY. THE HOUSE HAD ADOPTED THE LEGISLATION AND PACKED ITS BAGS EARLIER THIS WEEK.

2. IN SIGNING THE BILL CONTAINING THE CONTINUING RESOLUTION, THE PRESIDENT MADE A STATEMENT EXPRESSING HIS RESERVATIONS ABOUT A NUMBER OF FEATURES, NOTABLY THE FAILURE TO PROVIDE FUNDS FOR MX PRODUCTION AND THE LACK OF FULL PRODUCTION FUNDING FOR THE PERSHING II MISSILE. HE EMPHASISED THAT THE PERSHING MISSILE WAS BEING DEVELOPED IN ORDER TO MEET AN ALLIED REQUEST FOR LAND-BASED SYSTEMS IN EUROPE THAT WOULD HELP MAINTAIN DETERRENCE. THE ADMINISTRATION REMAINED STEADFAST IN ITS DETERMINATION TO MEET THESE ALLIANCE COMMITMENTS AND INTENDED TO MEET SCHEDULED DEPLOYMENT OF PERSHING MISSILES IN DECEMBER 1983.

3. THE PRESIDENT HAS CLAIMED THAT THE LAME DUCK SESSION HAS ACHIEVED HIS PRINCIPAL PURPOSE OF COMPLETING ACTION ON A BUDGET FOR THE FOLLOWING FISCAL YEAR AT LEVELS CONSISTENT WITH THE BUDGET RESOLUTION ADOPTED EARLIER IN THE SESSION. HE WAS WARNED BY THE REPUBLICAN CONGRESSIONAL LEADERS THAT, IF HE CALLED CONGRESS INTO LAME DUCK SESSION AFTER THE ELECTIONS, HE WOULD FACE A QUERULOUS AND INDECISIVE SESSION. THOSE WARNINGS HAVE BEEN AMPLY BORNE OUT. IN POLITICAL TERMS THE MOST IMPORTANT SET-BACK WAS THE REFUSAL OF FUNDING FOR PRODUCTION OF THE MX. OVERALL CONGRESS APPROVED DOLLARS 17 BILLION LESS IN MILITARY SPENDING THAN THE PRESIDENT HAD ASKED FOR, THOUGH THE MILITARY BUDGET STILL REPRESENTS A REAL INCREASE IN DEFENCE SPENDING OF 6 PERCENT PER ANNUM. MAJOR ITEMS OF LEGISLATION INCLUDING REVISIONS TO IMMIGRATION LAW, A NEW CRIMINAL CODE AND THE CARIBBEAN BASIN INITIATIVE ALL GOT LOST IN THE HAGGLING OF THE LAST FEW WEEKS AND WILL HAVE TO BE REINTRODUCED IN THE NEW CONGRESS. THE DOLLARS 11.2 BILLION WORTH OF FOREIGN AID INCLUDED IN THE CONTINUING RESOLUTION WAS SLIGHTLY LESS THAN THE SUM REQUESTED BY THE PRESIDENT THOUGH AID FOR ISRAEL

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/ WAS

WAS INCREASED (AGAINST THE PRESIDENT'S WISHES) TO AN ANNUAL TOTAL OF ALMOST DOLLARS 2 1/2 BILLION (DOLLARS 2 BILLION FOR EGYPT). THE PRESIDENT HIMSELF COMMENTED ON THE FACT THAT AID FOR MANY DESERVING COUNTRIES HAD BEEN DENIED QUOTE IN ORDER TO FURTHER INCREASE AID TO A NATION ALREADY RECEIVING 28 PERCENT OF OUR TOTAL FOREIGN AID IN ADDITION TO A DOLLARS 300 MILLION CREDIT INCREASE I PROPOSED THIS FISCAL YEAR UNQUOTE.

4. THE PRESIDENT CAN DRAW COMFORT FROM HAVING HEADED OFF THE PROPOSED HOUSE AND SENATE JOBS BILLS TOTALLING DOLLARS 6 1/2 BILLION. BUT HE HAS LOST MUCH OF THE INITIATIVE IN SETTING SPENDING PRIORITIES TO A CONGRESS WHICH IN TURN IS BESET BY DISPUTES BETWEEN CONFLICTING INTERESTS. THIS IS MAKING IT DIFFICULT FOR EITHER THE ADMINISTRATION OR REPUBLICAN CONGRESSIONAL LEADERS TO ESTABLISH NATIONAL PRIORITIES WITH ANY CERTAINTY OF SEEING THEM CARRIED INTO LAW. FOR TWENTY-FOUR HOURS THE GOVERNMENT WAS THREATENED WITH A SHUTDOWN BECAUSE CONGRESS HAD NOT VOTED THE MONEY TO KEEP IT GOING. CONGRESS ITSELF MAY BE THE PRINCIPAL LOSER IN TERMS OF PUBLIC OPINION. BUT THE PRESIDENT HAS NOT EMERGED UNSCATHED FROM A BATTLE WHICH HAS DENTED HIS REPUTATION AS A MAN WHOSE AUTHORITY WAS HITHERTO THOUGHT SUFFICIENT TO CARRY MOST OF HIS POLICIES THROUGH THE LEGISLATIVE. WITH TWENTY SIX MORE DEMOCRATS IN THE HOUSE AND PLENTY OF SCOPE FOR GUERRILLA WARFARE OVER THE BUDGET DEFICIT AND DEFENCE PROGRAMMES, THE PRESIDENT IS LIABLE TO FIND THE NEW CONGRESS, WHICH GETS UNDER WAY ON 25 JANUARY WITH THE STATE OF THE UNION ADDRESS, AN EVEN MORE UNCOMFORTABLE PARTNER.

FCO PASS SAVING PARIS, MOSCOW AND TEL AVIV

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24 November 1982

ALAN WALTERS

PRIME MINISTER

UNITED STATES ECONOMIC POLICY

Prime Minister

MCS 24/11

Interpretation

From all my interviews and discussions, the predominant feeling was one of uncertainty, loss of confidence, confusion and flux. Except for the strictly technical people, all those with political appointments were anxious to keep their options open. I attribute this largely to the palpable change in the political atmosphere and alignment.

The elections, although giving rise to the result which was broadly expected, have opened up seams of doubt and they have exposed a hitherto latent dissatisfaction with the policy, so that those who were firm adherents are now to be counted as suspect supporters or even back-sliders. Although the ostensible complexion of the Senate has not changed, the political realities have. And the change in the House is far more significant than the switch of 26 seats.

Monetary Policy

There has, undoubtedly, been a change in the stance of the Fed. To some extent the change is justified by the transformations in the institutions of the banking system. The aggregate M1 has become distorted and the Fed are now targeting on M2. But behind this technical facade there are a large number of opportunities for surreptitious changes.

In my judgement, there has been a considerable easing of monetary policy in the last month or two. The Fed has been blamed by the populists in Congress, who always become more vociferous during the last two years of an administration, and by many of the President's supporters. But apart from the political pressure, there is also the genuine belief that the recovery is so stymied that a small monetary push would do little harm, and might offset some of the political criticism (see interviews with Secretary Regan, Chairman Volcker and David Lindsey).

/If the Fed

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If the Fed is thinking along these lines, and I believe there is considerable evidence that it is, then the expansion must be taken back, preferably gradually, during the course of next year in order to deliver a feasible non-inflationary policy.

There is some evidence that the markets may believe that Volcker has such a policy in train. Long term interest rates have behaved quite well in the last two months. There has been no obvious outburst of inflationary expectations, in spite of more and more gloomy news on the budget front.

There is good reason, however, to fear that Volcker may not be able to draw in the expansion of the latter part of 1982. Pressures can be brought on the Fed to keep it going. I think that Volcker will do everything in his power to resist such pressures, but I am not sure that he will win. If he does not, then it is difficult to see how the United States can avoid drifting up to an 8%-10% rate of inflation once again.

The Budget Deficit

None of this policy for stability will be helped by the burgeoning budget deficit. There are no immediate plans that have a hope of reducing it to a non-inflationary size in the years ahead.

However, I did detect a marked shift in the Treasury, in the person of the Under Secretary, Beryl Sprinkel. He admitted that he was changing his mind about the need for a considerable and obvious reduction in the budget deficit - mainly for psychological reasons. This is a marked change, and since Sprinkel is the main brains behind the Treasury Department, it is quite significant. Secretary Donald Regan merely huffed and puffed and went through well-known defensive strategies to suggest that the US budget deficit was not large, no larger than the Japanese or ours, etc. He clearly displayed some of the pressure he was feeling.

All this is promising, but we have yet to see any concrete measures. The proposal to advance the tax cut six months is ludicrous and quite inconsistent with reducing the budget deficit. It is fine tuning of a clumsy, Keynesian kind.

In my view, there will be no firm policy initiative until the President is convinced. Both Sprinkel and Martin Feldstein, the Chairman of the Council of Economic Advisers, suggested to me that you were the only person who could convince the President of the desperate need of the world for a reduction in their future budget deficits.

The Effect On Us

Although all is in a state of flux in the United States, the range of feasible policies that are likely to emerge should not inhibit our policy to any great extent. Provided we do not attempt to peg the dollar exchange rate, we can easily accommodate to a somewhat more expansionary policy by the United States. In the short run it may well be of some assistance to us, in the run up to the election.

In the long run, if Volcker substantially reverses his policy, and the United States inflates at around 10%, then we shall find ourselves in a position similar to that of Germany and Switzerland during the great American inflation of 1978/79. However, I think we have learned enough to deal with that situation if it arises.

24 November 1982

ALAN WALTERS

GR 1300 CONFIDENTIAL

C O N F I D E N T I A L

FM WASHINGTON 231645Z NOV 82

TO PRIORITY F C O

TELEGRAM NUMBER 3790 OF 23 NOVEMBER

INFO SAVING PARIS, BONN, TOKYO, OTTAWA, UKREP BRUSSELS, UKDEL OECD, CGS USA

PROSPECTS FOR US ECONOMIC POLICY

1. THE LAME DUCK SESSION OF THE 97TH CONGRESS CONVENES ON 29 NOVEMBER. DURING THE CONGRESSIONAL ELECTION CAMPAIGN, PRESIDENT REAGAN SAID THAT HE WANTED THIS SESSION TO ADDRESS SEVERAL MAJOR POLICY ISSUES. BUT IT SEEMS UNLIKELY THAT THE DEMOCRATS WILL SIMPLY ACCEPT HIS AGENDA NOW THAT THEY KNOW THAT THEY WILL BE STRONGER IN THE NEW CONGRESS IN JANUARY. THE MAIN FOCUS OF ATTENTION IS LIKELY TO BE UNEMPLOYMENT, GIVEN THE MAJOR INFLUENCE WHICH THIS APPEARS TO HAVE HAD ON VOTERS' ATTITUDES DURING THE ELECTION.

2. UNEMPLOYMENT NOW STANDS AT OVER 10 PERCENT, AND THE PROSPECTS OF GETTING THIS FIGURE DOWN SOON REMAIN POOR. WHILE INFLATION HAS BEEN FALLING TO AROUND 5 PERCENT, INTEREST RATES ARE STILL HIGH IN REAL TERMS, AND INVESTMENT INTENTIONS AND CONSUMER CONFIDENCE ARE LOW. SOME EXPANSION OF THE ECONOMY IS EXPECTED IF ONLY BECAUSE PENT-UP DEMAND IS CONSIDERABLE BUT RELEASE OF THIS DEMAND AWAITS THE RETURN OF CONFIDENCE AND WILL PROBABLY NOT GET UNDER WAY UNTIL NEXT YEAR. UNLESS THIS EXPANSION REACHES 4 PERCENT (AND THIS IS TOWARDS THE OPTIMISTIC END OF THE RANGE) UNEMPLOYMENT IS UNLIKELY TO DECLINE SIGNIFICANTLY IN 1983, AND HARD-PRESSED FIRMS IN THE MID-WEST AND ELSEWHERE MAY FACE ANOTHER TOUGH YEAR.

3. THE CONGRESS STILL HAS TO ACT ON 10 OF THE 13 APPROPRIATIONS BILLS FOR THE 1983 FISCAL YEAR WHICH BEGAN LAST MONTH. SOME OF THESE MAY NOT BE PASSED BY CHRISTMAS, IN WHICH CASE SOME FEDERAL SERVICES WILL AGAIN NEED TO DEPEND ON CONTINUING RESOLUTIONS. BUT THERE WILL BE PLENTY OF MANOEUVRING IN PREPARATION FOR THE NEXT CONGRESS WHICH WILL START IN JANUARY. IN PARTICULAR, THERE IS LIKELY TO BE CONTINUING DISPUTE BETWEEN THOSE WHO FEEL THAT UNEMPLOYMENT SHOULD BE TACKLED NOW BY PUBLIC EXPENDITURE OR TAX PROPOSALS TENDING TO INCREASE THE BUDGET DEFICIT, AND THOSE WHO WOULD GIVE PRIORITY TO REDUCING THE DEFICIT IN ORDER TO AVOID RECOVERY BEING CHOKED OFF BY RISING INTEREST RATES.

4. ON THE TAX SIDE, TREASURY SECRETARY REGAN HAS BEEN CONSIDERING A PROPOSAL TO BRING FORWARD TO JANUARY THE 10 PERCENT PERSONAL TAX CUT NOW SCHEDULED FOR JULY. ITS SUPPORTERS ARGUE THAT, AS THE TAX CUT IS DUE TO TAKE PLACE ANYWAY, THE PROPOSAL WOULD INJECT SOME EXTRA CONSUMER SPENDING JUST WHEN IT IS NEEDED TO HELP THE RECOVERY TO TAKE OFF. WHILE IT WOULD INCREASE THE FY83 BUDGET DEFICIT, IT IS ARGUED THAT IT MIGHT SOMEWHAT REDUCE THE PROJECTED DEFICIT IN FY84 WHEN PRIVATE DEMAND FOR CREDIT COULD BE PICKING UP AND COMPETING WITH THE BIG TREASURY BORROWING REQUIREMENT. HOWEVER, THE PROPOSAL IS OPPOSED BY BUDGET DIRECTOR STOCKMAN AND CEA CHAIRMAN FELDSTEIN, WHO ARE CONCERNED TO GET THE BIG BUDGET DEFICIT DOWN AS SOON AS POSSIBLE. THERE ARE FEARS THAT THE IMMEDIATE EFFECT ON /MARKET

CONFIDENTIAL

MARKET SENTIMENT WOULD BE TO RAISE INTEREST RATES, SO THAT ITS NET EFFECT WOULD BE TO PROLONG THE RECESSION. REPUBLICAN CONGRESSIONAL LEADERS HAVE TOLD REAGAN THAT IT WOULD NOT GET SUFFICIENT SUPPORT IN THE CONGRESS. INDEED SOME DEMOCRATS WOULD PREFER TO CANCEL THIS TAX CUT ALTOGETHER.

5. AS REGARDS EXPENDITURE PROPOSALS, PRESIDENT REAGAN HAS EXPRESSED HIS OWN OPPOSITION TO JOBS PROGRAMMES WHICH MERELY QUOTE MAKE WORK UNQUOTE. HE HAS COMMENTED MORE FAVOURABLY ON THE IDEA OF PUTTING A 5 CENTS INCREASE ON THE TAX ON GASOLINE AND USING THE PROCEEDS TO REPAIR ROADS AND BRIDGES. SUCH A PROPOSAL HAS SOME MERIT FROM THE STANDPOINTS OF ENERGY CONSERVATION AND IMPROVING INFRASTRUCTURE, BUT IF THE SCHEME WERE MERELY SELF-BALANCING IT WOULD NOT OF COURSE MAKE A NET CONTRIBUTION TO SOLVING THE BUDGET PROBLEM.

6. THE DEBATE ON THE BUDGET IS BOUND TO RETURN SOONER OR LATER TO WAYS OF ATTACKING THE STRUCTUAL DEFICIT. EVEN IF RENEWED ECONOMIC GROWTH REDUCES THE CYCLICAL ELEMENT OF THE DEFICIT, THE UNDERLYING PROBLEM WOULD REMAIN SINCE IN THAT SITUATION PRIVATE DEMAND FOR CREDIT WOULD TEND TO INCREASE. SOONER OR LATER, THEREFORE, THE ADMINISTRATION AND THE CONGRESS WILL HAVE TO RESOLVE CONFLICTING AIMS ON TAXATION, DEFENCE EXPENDITURE, AND CIVIL EXPENDITURE (INCLUDING SOCIAL SECURITY). THE BIPARTISAN COMMISSION ON SOCIAL SECURITY CHAIRED BY ALAN GREENSPAN, WHICH WAS TO HAVE REPORTED THIS MONTH, HAS NOW POSTPONED ITS REPORT FOR A FEW MORE WEEKS. ACTION ON THIS POLITICALLY INTRACTABLE ISSUE HAS THUS YET AGAIN BEEN POSTPONED, AND LEFT TO THE NEXT CONGRESS. ON BUDGET POLICY GENERALLY, THERE ARE CLEAR DIFFERENCES OF VIEW BETWEEN THE ADMINISTRATION AND THE REPUBLICAN LEADERSHIP IN THE CONGRESS. SENATORS DOLE (CHAIRMAN, FINANCE COMMITTEE) AND DOMENICI (CHAIRMAN, BUDGET COMMITTEE) AND THE REPUBLICAN MINORITY LEADER IN THE HOUSE, MR MICHEL, HAVE INDICATED THAT THEY MIGHT BE WILLING TO TRADE CUTS IN DEFENCE EXPENDITURE FOR FEWER CUTS, OR SOME INCREASES, IN CIVIL PROGRAMMES. DOMENICI HAS DESCRIBED UNEMPLOYMENT AS HAVING REACHED A POINT WHERE IT IS POLITICALLY UNACCEPTABLE TO THE AMERICAN PEOPLE, AND HAS COMMENTED THAT THE BUDGET SHOULD AIM MORE AT

DEFENCE BUDGET FROM ANY SPENDING CUTS WHICH NEED TO BE MADE.

7. THE ADMINISTRATION MUST RESTATE ITS OWN BUDGET POSITION IN JANUARY WHEN IT INTRODUCES THE FY84 BUDGET. THERE IS CONSIDERABLE ARGUMENT WITHIN THE WHITE HOUSE AND THE CABINET ABOUT THE RIGHT COURSE. PRESIDENT REAGAN IS ON RECORD AS FAVOURING A BALANCED BUDGET BUT, ON STOCKMAN'S OWN ASSESSMENT, PRESENT ADMINISTRATION POLICIES WOULD YIELD A DEFICIT OF ABOUT DOLLARS 150 BILLION TO DOLLARS 180 BILLION IN EACH OF THE NEXT TWO OR THREE YEARS, AND FELDSTEIN HAS PUBLICLY MENTIONED A FIGURE OF AS MUCH AS DOLLARS 200 BILLION FOR FY84 IF NO CORRECTIVE ACTION IS TAKEN. THE PRESIDENT WILL NEED TO PROPOSE SHARP CUTS IN EXPENDITURE PROGRAMMES IN ORDER TO MAKE SIGNIFICANT PROGRESS TOWARDS A BALANCED BUDGET, WHILE STICKING TO HIS OTHER AIM OF HOLDING DOWN THE TAX BURDEN. THERE /IS NO

IS NO SIGN YET THAT HE WILL VOLUNTEER TO MAKE RADICAL CUTS IN THE GROWTH OF THE DEFENCE PROGRAMME IN THE FY84 BUDGET. THERE ARE THUS THE MAKINGS OF QUITE AN ARGUMENT WITHIN THE ADMINISTRATION, AND OF QUITE A ROW BETWEEN THE ADMINISTRATION AND THE NEXT CONGRESS, BEFORE SOME COMPROMISE IS PAINFULLY HAMMERED OUT.

8. ON MONETARY POLICY, THERE IS SOME PUBLIC CONFUSION ABOUT WHAT THE FEDERAL RESERVE BOARD IS TRYING TO DO. SOME NEW YORK OBSERVERS HAVE ASSUMED THAT RECENT FED STATEMENTS, TO THE EFFECT THAT THE MONETARY AGGREGATES ARE BEING SERIOUSLY DISTORTED BY SPECIAL FACTORS, WERE A WAY OF GETTING OFF THE HOOK OF PARTICULAR MONETARY TARGET FIGURES WHICH PRESENT CIRCUMSTANCES HAVE MADE UNREALISTIC. THE RAPID GROWTH IN BANK RESERVES AND IN THE MONETARY BASE HAS ALSO BEEN INTERPRETED AS AN INDICATOR THAT THE FED HAS EASED UP IN RECENT WEEKS. ON THE OTHER HAND, THE FED HAS NOT REDUCED THE DISCOUNT RATE AS FAST AS MIGHT HAVE BEEN EXPECTED IF IT HAD DECIDED TO FOLLOW A CLEARLY STIMULATORY MONETARY STANCE. FOLLOWING THE LATEST CUT IN THE DISCOUNT RATE TO 9 PERCENT ON 19 NOVEMBER, THE MAJOR BANKS HAVE REDUCED THEIR PRIME RATES TO 11.5 PERCENT AND THE TREASURY BILL RATE FELL TO AROUND 8 PERCENT, BUT THE YIELD ON LONG-TERM TREASURY BONDS ROSE SLIGHTLY TO REMAIN AROUND 10 AND ONE HALF PERCENT.

9. THE LATEST STATEMENT BY VOLCKER ON 16 NOVEMBER INDICATED THAT WHILE, FOR THE PRESENT, THE GROWTH OF MONEY AND CREDIT HAS HAD TO BE INTERPRETED IN THE LIGHT OF ALL THE EVIDENCE AVAILABLE WITH RESPECT TO THE ECONOMY, PRICE DEVELOPMENTS, INTEREST RATES AND FINANCIAL PRESSURES, THE FED DO NOT INTEND TO ABANDON BROAD GUIDE-LINES FOR MONETARY AND CREDIT GROWTH AS A MEANS OF JUDGING POLICY OVER A PERIOD OF TIME. HE ADDED THAT THE DANGER OF CREATING EXCESS LIQUIDITY WAS NOT SO MUCH IMMEDIATE WHEN THERE IS SO MUCH SURPLUS CAPACITY AND UNEMPLOYMENT, BUT RATHER WHEN THE ECONOMY BEGINS TO REGAIN FORWARD MOMENTUM. THE CONCLUSION TO BE DRAWN FROM THIS SEEMS TO BE THAT THE FED WILL DO WHAT THEY CAN TO ASSIST RECOVERY DURING THE NEXT FEW MONTHS EVEN IF THIS MEANS ALLOWING M1 AND M2 TEMPOR-ARILY TO MOVE ABOVE THEIR TARGET RANGES, BUT WITHOUT ABANDONING THE BASIC DIRECTION OF THEIR POLICIES. AS VOLCKER HAS FREQUENTLY INDICATED, THE FED'S TASK WOULD OF COURSE BE MADE MUCH EASIER IF THERE WAS A CREDIBLE PROSPECT OF REDUCTIONS IN THE FEDERAL BUDGET DEFICIT.

10. FCO PLEASE ADVANCE TO PS/CHANCELLOR OF THE EXCHEQUER, COUZENS, XOTTRILL (TREASURY), AND WATSON (BANK OF ENGLAND).

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

WRIGHT [ADVANCED/REPEATED AS REQUESTED]

FCO/WHITEHALL
NAD

NOTE OF A VISIT BY PROFESSOR ALAN WALTERS TO THE US TREASURY
FRIDAY 19 NOVEMBER 1982 AT 4.00PM

Present:

Mr Beryl Sprinkel, Under Secretary for Monetary Affairs
Professor Alan Walters, No 10
Mr Mark Dadd, British Embassy

Monetary Policy

1. Mr Sprinkel said that he was most concerned at the irregular growth of M1. For example, there had been a sharp squeese on M1 during 1981. The Treasury would much have preferred to have had a gradual reduction which would in turn have had a less adverse effect on the real economy. The irregularity primarily resulted from 2 factors. First the Fed did not try very hard to counter short run movements in the aggregates because it honestly believed fluctuations over a 6 month period did not matter (perhaps because most of these reflected movements in money demand). Second, the Fed had a very loose mechanism for controlling growth in the aggregates. In particular its lagged reserve accounting procedures, which are not now due to change until the Spring of 1984, meant that, in a sense, money determined reserves rather than the other way around. Also its practice of making infrequent discount rate changes created distortions between borrowed and non-borrowed reserves. The Fed is not likely to change these procedures until there is a new Chairman.

2. Professor Walters asked whether the recent spike in M1 was due to the maturing of all-saver certificates. Mr Sprinkel said that he might believe this explanation except that the monetary base and reserves were also rising rapidly at the present time. He therefore suspected that this was not the only or main explanation.

Interest Rate Volatility

3. The Treasury is putting final touches to a study which shows that volatility in the growth of M1 had raised interest rates by 2-3% on average. (The report is to be published soon.) The Fed, who initially dismissed this conclusion, have come around to the view that higher volatility might increase interest rates by 1%. Another reason for high US interest rates was that markets simply did not believe the President's budget estimates.

Independence of the Fed

4. A paper had just gone to Secretary Regan on the future structure of the Federal Reserve Board. Mr Sprinkel said he had recommended that it remain independent, mainly because any attempt to bring it into the Administration would involve a difficult fight and the outcome could not be reliably predicted. It was however possible to make some changes to improve the Fed's effectiveness, eg the President should be able

to appoint his own Chairman when he enters office. Congress is now considering legislation that would constrain monetary policy by forcing the Fed to target on interest rates.

Cmd

20 November 1982

British Embassy
Washington DC

NOTE OF A VISIT BY PROFESSOR ALAN WALTERS TO THE FEDERAL RESERVE BOARD AT 3PM ON FRIDAY 19 NOVEMBER 1982

Present:

Mr Paul Volcker, Chairman, Federal Reserve Board
Professor Alan Walters, No 10
Mr Mark Dadd, British Embassy

The Monetary Aggregates

1. Mr Volcker said that it was becoming increasingly difficult to interpret the monetary aggregates. One could rationalise why the aggregates were growing so rapidly and accept in principle that some of this growth sould be accommodated. The main problem was estimating precisely what adjustment to make. Moreover, if this were possible, the financial markets tended not to believe you if you said there were good reasons for accommodating some of the growth.

2. Mr Volcker said that the Fed had in the past set the path for non-borrowed reserves primarily with reference to the M1 target. The Fed was now giving more weight to M2 and to a limited extent M3. The changes taking place in the demand for money were clearly dramatic: M1 velocity was going to drop this year for the first time since the War and M2 velocity is expected to decline by a record amount. There were many factors responsible for these changes including the decline in interest rates and an increase in liquidity preference. It would not be possible to go back to setting the path of non-borrowed reserves in the basis of M1 for about a year.

3. Professor Walters responded that the UK had had a similar experience in 1980. The monetary aggregate Sterling M3 was growing very rapidly whilst other indicators pointed to monetary tightness eg the high foreign exchange rate, high interest rates and the low growth in the monetary base and M1. Mr Volcker agreed that the Fed's recent procedural changes were in some ways analogous to the 1980 situation in the UK. If M2, now only just above its target range, came down a bit, it would greatly help the Fed. The Fed had a difficult problem: it wanted to keep interest rates coming down but did not wish to indicate to the markets that this was to the detriment of its overall strategy.

International Situation

4. Professor Walters was particularly concerned about the German economy. Manufacturing output had declined 6.8% in the 2nd Quarter of 1982 and unemployment was now rising very rapidly. It was difficult to see how the German economy would pull out of recession any time soon since major structural problems remain eg in the chemical and steel industries.

5. Mr Volcker said that he was currently spending a great deal of time on the Mexican debt situation. Mexico would need further new money at the end of this year. It was going to be very difficult to bring the 1600 or so banks involved on board by that time. Argentina also presented a serious problem though in many ways its economy was in much better shape than Mexico's. It would however be a messy business. Brazil was also a real problem. His objective was to hold off addressing the Brazilian problem until Mexico was well on the way to being dealt with, so that they were not both in the headlines together.

20 November 1982

British Embassy
Washington DC

NOTE OF A VISIT BY PROFESSOR ALAN WALTERS TO THE US TREASURY ON THURSDAY 18 NOVEMBER 1982 AT 2PM.

Present:

Mr Don Regan, Secretary US Treasury
Mr Beryl Sprinkel, US Treasury
Mr Marc Leland, US Treasury
Professor Alan Walters, No 10
Mr Mark Dadd, British Embassy

International Criticism of US Policies

1. Secretary Regan said that the US had done everything asked of it at recent economic summits. It had been asked at Ottawa to get inflation under control, and it had. It had been asked at Versailles to get interest rates down, and it had. Now, the US was being told to get its deficits under control. He was not sure how reducing the US deficit would help get the world economy out of recession, indeed it might make matters worse.

2. Secretary Regan asked why the US budget deficit was a problem for Europe and noted that the Japanese budget deficit expressed as a percentage of GNP was larger. Professor Walters said there were a number of reasons. First, the US deficit was in fact larger than the estimates currently quoted because of the off-budget items. Second, it was not so much the size of the budget deficit that was important but the need to ensure that it was trending downwards. For example, in the UK the decision to raise taxes in order to reduce the deficit in the 1981 budget had had a very good effect on UK financial markets. Evidence for this included the relatively flat yield curves on UK government securities and the fact that UK interest rates had been lower than US rates over the last year, in spite of the UK's higher inflation rate. The reason that it was important to convince the market that there would be a downward trend in the budget deficit was the risk that the monetary authorities would monetise the debt (either during the current Administration or future Administrations). In 1981 the UK Government had adopted a restricitve budget in order to reduce the budget deficit. Some 364 economists had subsequently signed an open letter claiming that this budget would cause the economy to go deeper into recession. In fact the recovery virtually started from that point.

Fiscal Policy

3. Secretary Regan said that unemployment was now the most serious problem for Congress. If the private sector did not show signs of early recovery then Congress would act to stimulate activity through the public sector. Congress was in no mood to raise taxes in a recession. The Administration, for its part, would not raise income taxes, though it might increase the gasoline tax and some other indirect taxes

which were user fees. The net result was that it would not be possible to do much this year to reduce the deficit, but the Administration would act to reduce it after the recovery got under way. Professor Walters noted that the UK Government still held a 10 point lead in the polls in spite of high unemployment. This was not just a result of the Falklands conflict.

4. Secretary Regan said that the President's budget for FY84 would show the deficit declining over the next few years. For FY83 the deficit was forecast at $150-$160bn, declining to $130bn in FY84 and to less than $75bn in FY87. These estimates included proposed policy changes and was based on very modest increases in real GNP (about 3-4% annually). They were also consistent with slow growth in the monetary aggregates. Professor Walters said that the UK experience showed that credible budget estimates that included a declining trend in the deficit could have very beneficial effects on financial markets and lead to lower interest rates.

Monetary Policy

5. Secretary Regan said that the political realities of the current situation were that if interest rates did not come down within the next two months "the Fed would no longer exist in its current form". This was Congressional reality rather than an Administration position. Most Congressmen who had supported the Fed's tight monetary policy had lost in the November elections and both left and right were determined to get interest rates down. At present the opponents of the Fed's policy were not well organised. The Fed was being told of this now. The Fed will therefore by trying to operate within its policy to get interest rates down, though it was not clear whether this would result in a small or large interest rate reduction.

Protectionism

6. Secretary Regan said that protectionism was becoming a big issue in domestic US politics. There was a lot of pressure for a move in this direction. He felt that the US was not getting much help from its EC partners in its objectives for the upcoming GATT Ministerial. Professor Walters said that the UK also wanted to prevent a move towards protectionism. Nonetheless it was concerned at some of the disparities in tariff rates eg in trade between Spain and the UK in cars. Secretary Regan said that the US was similarly disadvantaged in its car trade with Japan through their use of import regulations.

Conclusion

7. Secretary Regan said that he wished to leave with Professor Walters the message that the Administration was mindful of the size of US budget deficits and was attempting to keep them under control. With an anaemic economy it would be difficult to make rapid progress but the Administration intended to keep up the fight.

Cmd

20 November 1982

British Embassy
Washington DC

NOTE OF A VISIT BY PROFESSOR ALAN WALTERS TO THE AMERICAN ENTERPRISE INSTITUTE, 11.45AM, THURSDAY 18 NOVEMBER 1982

Present:

Dr T Johnson, Director of Economic Studies, AEI
Dr H Stein, AEI, + Guest (Israeli Central Bank)
Dr W Fellner, AEI
Dr A Broida, AEI
Dr M Foss, AEI
Dr J Weicker, AEI
Professor A Walters, No 10
Dr M Dadd, British Embassy

The Disinflationary Process

1. Dr Fellner asked whether, in Western countries, the disinflationary process took 4-5 years to work its was through the economy. Professor Walters replied that it would take at least 4 years for the necessary structural adjustment to take place. One had to remember real interest rates had been negative for some 15 years and real wages in many industries and groups of workers had got out of line. It was bound to take time.

Unemployment

2. The increase in UK unemployment was not simply the result of the recession. Another problem was that as real wages were going down, unemployment benefits were rising with inflation, thereby compressing the income differential between those in and out of work. Indeed, in the UK, 1½m of the unemployed were receiving more than 85% of the income that they would receive in work. Another problem was that UK unemployment benefits remained at the same level indefinitely, whereas French and German benefits, for example, dropped sharply after a certain period of time increasing the incentive to return to work. Professor Walters noted that it was surprising how many professional economists believed that unemployment was unrelated to the real wage.

3. Dr Stein estimated the natural rate of unemployment in the US to be between 6% and 6½%. Professor Walters noted that estimates of the natural unemployment rate in the UK had risen from ½-3/4m in the 1970s to 1½m now. Dr Weicker commented that he was not sure whether this represented a change in the natural rate or merely a perception of the natural rate. Professor Walters said that there were particular problems posed by high unemployment amongst young people. Employers were increasingly reluctant to take on young people who had been unemployed for an extended period. The problem of youth unemployemt was also more politically sensitive. The key issue was that wages of young people were too high relative to more experienced and therefore more productive workers. Dr Fellner asked whether the UK Government had attempted to get across the message that the unemployment rate did not truly reflect the number of unemployed. Professor Walters replied that it had not.

The Banking System

4. Professor Walters said that a lot of change was taking place in the UK financial system. For example the widespread corporate practice of purchasing the paper of other corporations was diminishing. These funds were increasingly being routed through the banking system. Banks had also entered the residential mortgage business. Dr Stein said the US financial system was also experiencing institutional change though the net trend seemed to be towards dis-intermediation ie business formerly conducted in the banking system was now increasingly being done elsewhere. Professor Walters noted that British banks were in not too bad shape: they had a much higher capital base in relation to liabilities and a somewhat better spread amongst countries than US banks.

5. Professor Walters thought there was unlikely to be a collapse of bank liquidity - partly because of the central bank agreements following the 1974 banking crisis. He recognised however that the current agreement may not be water-tight, for example in the Ambrosario affair. The Italian Central Bank had not supported Ambrosario's Luxembourg branch as many bankers initially assumed it would. Dr Broida said that he believed there was a role for a new international monetary agency, not unlike the IMF, to take over some of the sovereign loans now held by commercial banks and to issue its own debt instruments. Professor Walters said that the IMF was certainly not suited for such a role in its current form. Indeed, he believed that a convincing intellectual case had not been made for increasing the IMF quotas.

20 November 1982

British Embassy
Washington DC

NOTE OF A VISIT BY PROFESSOR ALAN WALTERS TO THE FEDERAL RESERVE BOARD AT 9.40AM ON THURSDAY 18 NOVEMBER 1982

Present:

Mr Stephen Axilrod, Staff Director for Monetary Policy, Fed
Professor Alan Walters, No 10
Mr Mark Dadd, British Embassy

Recent Developments

1. Mr Axilrod said that there had been substantial drops in velocity in both M1 and M2 over the last year. The reduction in M2 velocity was more spectacular since historically it had been more stable. The reduction in short term interest rates was partly responsible for this but even if the interest rate effect was removed one would still have seen a reduction in velocity. This was because, in technical terms, the IS curve had shifted backwards as private sector confidence and spending collapsed. This had not been fully offset by increases in government purchases, even though the budget deficit had increased some $30bn between the first and second halves of 1982 on a high employment basis. In sum, the US experience was that an expansionary fiscal policy combined with a tight monetary policy had adverse implications for the financial markets which in turn held down consumer and business confidence. It had made the recession worse than otherwise would have been the case. Personally he would prefer to have seen a tighter fiscal policy and a weaker monetary policy. This would help the financial sector, confidence, and encourage investment and consumer purchases. Unfortunately US policy was not headed this way.

Changes in Fed Procedure

2. Mr Axilrod said that in October the Fed had started calculating the non-borrowed reserves path that it uses for operational purposes on the growth of M2 rather than on M1. This was because M1 had been growing very rapidly and unpredictably in recent months. In October the increase was particularly rapid, due to the large number of all-saver certificates maturing (this accounted for perhaps a half of the October increase). Moreover, the Fed recognised that it did not know what the effects of various other technical changes were going to be over the next month or two, eg the introduction of a new money market type fund at banks and thrifts. Unfortunately M2 was a "mushy" aggregate. It was insensitive to short-run economic changes and the demand for it with respect to interest rates was inelastic. In spite of its undesirable characteristics, it was uncertain when it might be possible to return to setting the non-borrowed reserves path with reference to M1.

3. It was not clear that this change should be interpreted as an easing of monetary policy. The decision to reduce the discount rate at the last FOMC meeting had been in response to earlier movements in market interest rates. There had been no change since in the discount rate. In other words, there had been no abandonment of monetary targetting or of policy since the October FOMC meeting.

The Outlook

4. The Fed's current forecast was for there to be no significant recovery until late 1983. There had already been a sharp reduction in investment. The inventory reduction was probably still not yet over, given recent declines in industrial production. The only strong signs were in construction and defence and perhaps the wealth effects of the recent stock market rise and improvements in household liquidity. Professor Walters pointed out that lower tangible asset values, particularly in housing, would offset some of the wealth effect in household financial assets.

5. Since confidence in the economy was very poor, real interest rates would have to go lower before the recovery could get under way. Reducing taxes, the approach proposed by some, would probably not work in practice because the beneficial effects on aggregate demand would be more than offset by an adverse financial market reaction and lower confidence. Professor Walters noted that the UK Government introduced a restrictive 1981 budget that many believed would make the recession worse. In practice, however, it was followed by recovery (at least until UK interest rates rose later in the year in response to the rise in US rates). Mr Axilrod noted that recent proposals to bring forward the US July tax cut might lead to higher interest rates and the postponement of the recovery. For the Fed, the big dilema in the coming months was whether it should relax monetary policy to help the economy or hold with the targets adjusted for some of these special factors.

6. Professor Walters noted that this recession was substantially unlike previous ones since the War. Over the last 15 years real interest rates had been negative whereas they were now positive. Real wages had also had to adjust. This was bound to take time. Economists were tending to look at the US position in cyclical terms but there was in fact a lot of structural adjustment going on. Mr Axilrod said that there had already been some progress in the US. Wage costs were now rising at about 6.0% annually and with productivity growing at about 1.0% pa, prices next year might only be rising at 5%. Presuming a faster cyclical rebound of 2-3% in labour productivity, one might even get price increases in the order of 3% next year.

Cms

19 November 1982

British Embassy
Washington

NOTE OF A VISIT BY PROFESSOR ALAN WALTERS TO THE FEDERAL RESERVE BOARD AT 9.00AM ON THURSDAY 18 NOVEMBER 1982

Present:

Mr Dave Lindsey, Associate Director of Research, Fed
Mr David Howard, International Economist, Fed
Professor Alan Walters, No 10
Mr Mark Dadd, British Embassy

The Demand for Money

1. Mr Lindsey said that there had been an increase in the demand for M1 in 1982 as inflation declined but the econometric equations had underpredicted its extent. There was evidence of a higher precautionary demand for liquidity than they had earlier expected. This was particularly manifest in the first quarter of 1982 but this effect had clearly carried on after that period. Some had also been associated with the introduction of "NOW" accounts and some with the reduction in interest rates. He nonetheless thought that not all the effect of lower interest rates had yet come through on the aggregates. Professor Walters said that there were many similarities with the UK experience. There had been substantial change in UK money velocity as a result of the sharp reduction in inflation. Retail prices had hardly moved at all over the last few months and there were some further good figures in the pipeline.

Recent Changes in Fed Procedure

2. Mr Lindsey noted that Mr Volcker had announced at Hot Springs on 9 October that the Fed would be giving less emphasis for the time being to the monetary aggregate M1 and more to M2 (and to some extend M3). In practice, this meant that the Fed was now targetting its non-borrowed reserves path on M2 rather than on M1. (It was not clear at this stage when or even whether the Fed would be able to go back to targetting on M1). Volcker had mentioned 2 reasons for making this change. First, many all-saver certificates were maturing and these funds were being placed in transactions accounts included in M1, which had increased sharply in October. There had been a lot of uncertainty about the extent of this effect at the October FOMC meeting. Second, a new account at banks and thrift institutions similar to money market mutual fund accounts was to be introduced on 14 December. This was likely to cause further distortions. Draft regulations for these accounts called for a $2500 minimum average balance, and a maximum of 3 automatic transfers and 3 cheques a month. No cheque size limitations and no limit on telephone transfers had been proposed. The account therefore had properties of both transactions and savings balances and was logically somewhere between M1 and M2. The Fed

had not made any decision on how to incorporate this account into the aggregates. Nor was it clear how soon a more stable relationship would re-emerge between the aggregates and nominal GNP. The eventual relationship would depend on how banks priced this new account and how the reserve requirements were set.

The Recovery

3. Mr Lindsey noted that many economists were concerned that the recent reduction in interest rates had not been sufficient to get the recovery going. Indeed the Fed staff currently forecast no recovery until the second half of 1983. The business forecasters he had talked to recently had become much more pessimistic about the real outlook. Professor Walters noted that forecasters performance had been very poor over the last few years. For example, in the UK most private forecasters had predicted the result of the 1981 budget would be a further decline in activity whereas the economy had in fact grown somewhat.

4. Mr Lindsey said that, in his view, an acceleration of monetary growth from current levels was not inconsistent with a further decline in inflation over the next couple of years. This was because the structural changes now taking place were increasing the amount of money demanded. Moreover, the current rate of unemployment was well above the natural rate (some 6½%). In other words, if one was disposed to attempt to fine tune monetary policy, this was the time for doing so. Mr Lindsey noted that if there were to be a strong recovery there would still be time to retighten monetary policy before inflation was rekindled.

Cms

20 November 1982

British Embassy
Washington DC

2.39

Top Copy on Japan, Nov '79, Internal Situation

Prime Minister

A useful list.

MCS 11/11

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

10 November 1982

R Bone Esq.
Foreign and Commonwealth Office

Dear Roger,

OTHER COUNTRIES FISCAL POLICIES

The Chancellor thought that Cabinet colleagues might, in addition to other briefing material being circulated this week, find it helpful to have a background note containing examples of fiscal measures that have been taken or are in prospect in other countries.

I attach a short paper that has been prepared here with some illustrative material of this kind.

I am sending copies of this letter to Michael Scholar (No. 10) and to the Private Offices of other Cabinet members.

Yours sincerely,

Jill Rutter

JILL RUTTER
Private Secretary

OTHER COUNTRIES' FISCAL POLICIES

Budget plans for 1983 have now been announced in most countries. It is clear that governments are determined to restrain borrowing even if this involves hard decisions to cut spending or raise taxes.

2. In the wake of the first oil price increase many industrial countries allowed public expenditure to rise. Following the second increase countries recognised that they faced large deficits which would not disappear in the foreseeable future. Subsequently the main emphasis of policy has been to reduce these deficits, cut national cost overheads and seek to improve market efficiency. Within tightly controlled expenditure limits governments are also trying to change the balance of expenditure from current to capital expenditure, and to switch the burden of taxation from industry. Any increase in expenditure has generally taken the form of aid to industry or employment programmes.

3. Some illustrations of measures taken or in prospect are set out below:

Social Security benefits

(i) The French government intends to index social benefits to the inflation target rather than the inflation outturn. Pension increases are to be delayed by 6 months.

(ii) The German government is to introduce means-testing for child benefits as well as delaying pension increases for 6 months.

(iii) The Belgian government intends to reduce family allowances. Unemployment benefit has also been reduced for some groups.

(iv) The Danish government is to de-index social security payments.

Social security contributions

(i) The French government plans to raise the contributions of people who have taken early retirement and levy a 1 per cent contribution from some civil servants (previously they were exempted).

(ii) The Danish government is increasing employees and employers contributions.

(iii) The Belgian government intends to increase personal contributions.

Health expenditure

(i) The French government intends to introduce a "hotel" charge for some hospital patients, of 20 Francs per day.

(ii) The German government plans to make patients contribute to the cost of in-patients' hospital treatment for the first 14 days.

(iii) The Belgian government has banned further hospital building.

(iv) The American government has cut $13 billion from planned expenditure on its Medicare programme.

Public sector pay and numbers

(i) The German government will be limiting pay increases for public servants to 2 per cent.

(ii) Japanese public servants are to receive no cost of living adjustment this year.

(iii) The Belgian government has stopped recruitment and intends to reduce the numbers employed by 1½ per cent.

(iv) The Danish government intends to impose a ceiling of 4 per cent for public sector wages increases in 1983-85.

Income tax

(i) The German government plans to raise a special levy from higher tax payers.

(ii) The French government will raise the top rate of tax on earned income from 60 per cent to 65 per cent.

c/c HMA Bonn

Original filed on Germany Pt 4
PM's Mtgs with Chanc Kohl in Germany

NOTE OF A DISCUSSION BETWEEN THE PRIME MINISTER AND AMBASSADOR BURNS AT THE RESIDENCE ON THURSDAY 28 OCTOBER, 10.30 PM

1. The Prime Minister started by asking Ambassador Burns what was happening in American economic policy.

2. Ambassador Burns said that there had been a real change in the direction of American monetary policy. The FED had been trying out the market since July and had found that they had more room for manoeuvre in reducing interest rates than they had expected. There had been recent disappointment because the FED had not made a further reduction in the discount rate, but Ambassador Burns believed that this was because the FED did not want to appear to be acting politically in advance of an election. He was in no doubt that there had been a real change of policy in the interests of stimulating the real economy.

3. On the prospects for the US economy, Ambassador Burns said that it had bottomed out and there would be some slight growth in the coming year. House building had already begun to turn up, but business investment was still declining. The real surprise was that consumer expenditure had not so far risen more: this appeared to be because high unemployment levels were causing people to hold back from spending, and this was reflected in an increase in the savings ratio.

4. Turning to the pipeline, Ambassador Burns said that the President very much wanted to remove the sanctions. He disliked regulations of this sort, but had been obliged to take action because of his political constituency. America had been subsequently rethinking its foreign policy and had reflected that it had not been logical, when the West was spending vast sums on defence, to make available to Russia foreign exchange which bolstered the Russian defence effort.

5. Turning to the banking system, Ambassador Burns said that the commercial banks had over-lent since the mid-1970s and were now feeling the effects of having been more concerned with quantity than with quality. In some ways, they had acted as

/imprudently

imprudently as investment banks in the United States in the 1920s. But Britain, Germany and the United States had good mechanisms for supporting their banking systems, and he was optimistic that there would not be a major collapse. However, as the banks drew in their horns, it would have a depressing effect on the world trade system, which in his opinion was likely to produce a sluggish period of international trading activity for the next two years.

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TELEGRAM NUMBER 12 OF 25 OCTOBER

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US ECONOMY

1. YOUR INTERESTING TELNO 27 OF 22 OCTOBER REINFORCES OUR IMPRESSIONS (WASHINGTON TELNO 3320 OF 12 OCTOBER) THAT THE IMMEDIATE PROSPECTS FOR THE US ECONOMY MAY BE LESS OPTIMISTIC THAN THE RECENT BEHAVIOUR OF THE NEW YORK STOCK EXCHANGE MIGHT INDICATE, AND THAT THE FEDERAL RESERVE BOARD'S MORE RELAXED ATTITUDE STEMS IN PART BECAUSE IT IS CONCERNED ABOUT ECONOMIC PROSPECTS. GROWTH OF 3-4 PER CENT IN 1983 OVER 1982 WOULD REPRESENT ONLY A WEAK RECOVERY COMPARED TO NORMAL, AND STILL LEAVE UNEMPLOYMENT VERY HIGH. IT SHOULD NOT ALTOGETHER BE RULED OUT AT THIS STAGE, BUT THE STATE OF CONSUMER CONFIDENCE, WHICH YOU MENTION, WILL BE AN IMPORTANT FACTOR IN DETERMINING HOW STRONG THE RECOVERY WILL BE. FOR WHAT IT IS WORTH, THE SO-CALLED BLUE CHIP CONSENSUS FORECAST, WHICH IS THE AVERAGE OF LEADING PRIVATE FORECASTS, AND IS USUALLY FAIRLY ACCURATE BY THIS STAGE IN THE YEAR, CURRENTLY SHOWS A GROWTH OF GNP IN 1983 OF 3.2 PER CENT.

2. THE POLICIES OF THE FED HAVE ATTRACTED MORE INTEREST RECENTLY THAN THE SIZE OF THE BUDGET DEFICIT AS A DETERMINANT OF US INTEREST RATES. BUT IF ADMINISTRATION PROPOSALS FOR THE FY84 BUDGET (TO BE PRESENTED IN EARLY 1983) WERE TO REPRESENT CLEARLY INADEQUATE PROGRESS TOWARDS THE ADMINISTRATION'S EXPRESSED AIM OF EVENTUALLY BALANCING THE BUDGET, THIS COULD ONCE AGAIN HAVE A SIGNIFICANT AND EARLY ADVERSE EFFECT ON FINANCIAL MARKETS, AND COULD AFFECT LONG-TERM INTEREST RATES IN PARTICULAR.

3. LIKE YOU, WE ARE RATHER SURPRISED BY THE COMMENT OF YOUR INFORMANTS RECORDED IN THE LAST SENTENCE OF YOUR PARAGRAPH 7. OPINIONS ON THIS POINT DO OF COURSE DIFFER, DEPENDING PARTLY ON THE EXPOSURE OF DIFFERENT BANKS TO COUNTRIES CURRENTLY IN THE NEWS. BUT THE MAJOR BANKS REPRESENTED AT THE CHANCELLOR'S LUNCH IN TORONTO DID NOT GIVE THE IMPRESSION THAT THEY HAD BEEN TAKEN BY SURPRISE BY THE SITUATION WHICH WAS BEING DISCUSSED THERE. INDEED, HAVING COME WITH A FEELING WHICH ONE OF THEM DESCRIBED AS QUOTE WORRED BUT NOT ALARMED UNQUOTE, THEY GAVE THE IMPRESSION THAT THEY HAD BEEN, IF ANYTHING, SOMEWHAT REASSURED BY THEIR TALKS IN TORONTO.

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4. WE AGREE GENERALLY WITH YOUR ASSESSMENT OF THE PROTECTIONIST MOOD IN THE US. US EXPORTERS, OF COURSE, FACE PRESSURE FOR IMPORT RESTRICTIONS IN OVERSEAS MARKETS NOT ONLY BECAUSE OF BALANCE OF PAYMENTS DIFFICULTIES THERE, BUT ALSO BECAUSE OF UNEMPLOYMENT PROBLEMS OVERSEAS.

WRIGHT

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ECD (E)
MR THOMAS
CABINET OFFICE

COPIES TO
H. M. TREASURY

COPIES SENT TO
No. 10 DOWNING STREET

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USA

OFFICIAL TEXT

Thursday, October 14th, 1982

UNITED STATES INFORMATION SERVICE, U.S. EMBASSY, 55/56 UPPER BROOK STREET, LONDON W1A 2LH

PRESIDENT REAGAN'S ADDRESS ON THE ECONOMY

Foundation Laid For Lasting Recovery

Washington, Wednesday, October 13th, 1982

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IN RECENT DAYS ALL OF US HAVE BEEN SWAMPED BY A SEA OF ECONOMIC STATISTICS -- SOME GOOD, SOME BAD, AND SOME JUST PLAIN CONFUSING. THERE ARE TIMES WHEN I THINK THAT THE PAPER TRAFFIC THAT CROSSES MY DESK IN A WEEK COULD FILL A BIG-CITY PHONE BOOK, AND THEN SOME.

THE VALUE OF THE DOLLAR IS UP AROUND THE WORLD. INTEREST RATES ARE DOWN BY 40 PERCENT. BUYING POWER IS GOING UP. SOME ECONOMIC INDICATORS ARE DOWN. OTHERS ARE UP. BUT THE DARK CLOUD OF UNEMPLOYMENT HANGS OVER THE LIVES OF 11 MILLION OF OUR FRIENDS, NEIGHBORS AND FAMILIES.

AT TIMES, THE SHEER WEIGHT OF ALL THESE FACTS AND FIGURES MAKES THEM HARD FOR ANYONE TO UNDERSTAND. WHAT DO THEY REALLY MEAN, AND WHAT CAN WE DO TO MAKE THEM BETTER?

WELL, THE FIRST STEP IS TO UNDERSTAND WHAT THEY MEAN IN HUMAN TERMS -- HOW THEY ARE AFFECTING THE EVERYDAY LIVES OF OUR PEOPLE. BECAUSE BEHIND EVERY ONE OF THOSE NUMBERS ARE MILLIONS OF INDIVIDUAL LIVES -- YOUNG COUPLES STRUGGLING TO MAKE ENDS MEET, TEENAGERS LOOKING FOR WORK, OLDER AMERICANS THREATENED BY INFLATION, SMALL BUSINESSMEN FIGHTING FOR SURVIVAL, AND PARENTS WORKING FOR A BETTER FUTURE FOR THEIR CHILDREN.

ALL OF THEM HAVE ONE THING IN COMMON. THEY'RE AMERICANS WHO LOVE THIS COUNTRY OF OURS AND WANT TO MAKE IT A BETTER PLACE. THEY'RE BRAVE, HARD-WORKING PEOPLE WHO KNOW THAT AMERICA TODAY FACES SERIOUS PROBLEMS THAT WERE LONG YEARS IN THE MAKING. AND THEY'RE DESPERATELY TRYING TO MAKE SENSE OUT OF ALL THE STATISTICS, SLOGANS, AND POLITICAL JARGON FILLING THE AIRWAVES IN THIS ELECTION YEAR. ABOVE ALL, THEY'RE CONCERNED CITIZENS WHO ARE LOOKING FOR GUIDEPOSTS ON THE ROAD TO RECOVERY -- FOR WAYS TO HELP SEE OUR COUNTRY THROUGH TO BETTER TIMES.

I KNOW BECAUSE I HEAR FROM HUNDREDS OF THEM EVERY DAY, IN MEETINGS HERE AT THE WHITE HOUSE, ON VISITS TO SCHOOLS, MEETING HALLS, FACTORIES AND FAIRGROUNDS ACROSS THE COUNTRY, AND IN THOUSANDS OF PHONE CALLS AND LETTERS. I ONLY WISH I COULD SHARE WITH YOU TONIGHT ALL THAT THEY

HAVE TO SAY -- THEIR HOPES, THEIR FEARS, THEIR CONCERNS AND, MOST OF ALL, THEIR QUIET, PATIENT COURAGE.

LET ME JUST GIVE ONE EXAMPLE THAT SPEAKS FOR SO MANY OF YOU, A LETTER FROM A WIFE AND MOTHER NAMED JUDITH, WHO LIVES IN SELMA, ALABAMA.

"DEAR MR. PRESIDENT," SHE WRITES. "IT'S 3:45 AM, AND FOR OVER AN HOUR I HAVE BEEN UNABLE TO SLEEP...THIS MORNING I NEED VERY MUCH TO BELIEVE IN SOMETHING ....I AM NOT WRITING SO MUCH AS AN INDIVIDUAL, BUT AS A REPRESENTATIVE OF SO MANY. WE NEED TO TALK WITH YOU -- TO BELIEVE THAT YOU HEAR US...

"AFTER YEARS OF TRAINING AND EXPERIENCE, WE CAN'T FIND JOBS. NATIONAL UNEMPLOYMENT FIGURES SOUND ALMOST HEALTHY NEXT TO THE ALMOST 19 PERCENT WE ARE ENDURING IN SELMA.

"THE COSTS FOR BASIC SURVIVAL ARE NEARLY BEYOND BELIEF ...THERE MAY NEVER BE A HOUSE -- HOME OF OUR OWN -- THAT DREAM WE HAVE WORKED FOR, FOR SO MANY YEARS...WE HAVE SAID 'NO' TO SO MANY THINGS...WE'RE AFRAID AND CONFUSED. WE'VE WORKED SO HARD -- WE CONSERVED -- WE PLANNED -- WE WERE FRUGAL -- CAREFUL. WE FEEL SO OUT OF CONTROL. WE DON'T WANT A HANDOUT -- WE JUST WANT TO HELP MAKE THE SYSTEM WELL AGAIN.

"WE MUST KNOW THAT IN THE TONS OF BUREAUCRACY... WE HAVE NOT BEEN LOST...WE WANT TO HELP. WE WANT A BETTER LIFE, AND WE ARE WILLING TO WORK FOR IT. WE BELIEVE. WE MUST -- IT IS ALL WE HAVE."

JUDITH, I HEAR YOU. YOU AND MILLIONS OF OTHER MEN AND WOMEN LIKE YOU STAND FOR THE VALUES OF HARD WORK, THRIFT, COMMITMENT TO FAMILY AND LOVE OF GOD THAT MADE THIS COUNTRY SO GREAT, AND WILL MAKE US GREAT AGAIN. AND YOU DESERVE TO KNOW WHAT WE ARE DOING IN THESE DIFFICULT TIMES TO BRING YOUR DREAM, "THE AMERICAN DREAM", BACK TO LIFE AGAIN AFTER SO MANY YEARS OF MISTAKES AND NEGLECT.

TONIGHT, IN HOMES ACROSS THIS COUNTRY, UNEMPLOYMENT IS THE PROBLEM UPPERMOST ON MANY PEOPLE'S MINDS. GETTING AMERICANS BACK TO WORK IS AN URGENT PRIORITY FOR ALL OF US -- AND ESPECIALLY FOR THIS ADMINISTRATION.

BUT REMEMBER, YOU CAN'T SOLVE UNEMPLOYMENT WITHOUT SOLVING THE THINGS THAT CAUSED IT - THE OUT-OF-CONTROL GOVERNMENT SPENDING, THE SKY-ROCKETING INFLATION AND INTEREST RATES THAT LED TO UNEMPLOYMENT IN THE FIRST PLACE. UNLESS YOU GET AT THE ROOT CAUSES OF THE PROBLEM -- WHICH IS EXACTLY WHAT OUR ECONOMIC PROGRAM IS DOING -- YOU MAY BE ABLE TO TEMPORARILY RELIEVE THE SYMPTOMS, BUT YOU'LL NEVER CURE THE DISEASE. YOU MAY EVEN MAKE IT WORSE.

I HAVE A SPECIAL REASON FOR WANTING TO SOLVE THIS PROBLEM IN A LASTING WAY. I WAS 21 AND LOOKING FOR WORK IN 1932, ONE OF THE WORST YEARS OF THE GREAT DEPRESSION, AND I CAN REMEMBER ONE BLEAK NIGHT IN THE THIRTIES WHEN MY FATHER LEARNED ON CHRISTMAS EVE HE HAD LOST HIS JOB. TO BE YOUNG IN MY GENERATION WAS TO FEEL THAT YOUR FUTURE HAD BEEN MORTGAGED OUT FROM UNDER YOU -- AND THAT'S A TRAGIC MISTAKE WE MUST NEVER ALLOW OUR LEADERS TO MAKE AGAIN. TODAY'S YOUNG PEOPLE MUST NEVER BE HELD HOSTAGE TO THE MISTAKES OF THE PAST.

THE ONLY WAY TO AVOID MAKING THOSE MISTAKES AGAIN IS TO LEARN FROM THEM.

THE POUNDING ECONOMIC HANGOVER AMERICA IS SUFFERING FROM DIDN'T COME ABOUT OVERNIGHT AND THERE IS NO SINGLE,

INSTANT CURE. IN RECENT WEEKS, A LOT OF PEOPLE HAVE BEEN PLAYING WHAT I CALL THE "BLAME GAME." THE ACCUSING FINGER HAS BEEN POINTED IN EVERY DIRECTION OF THE COMPASS AND A LOT OF TIME AND HOT AIR HAVE BEEN SPENT LOOKING FOR SCAPEGOATS.

WELL, THERE'S PLENTY OF BLAME TO GO AROUND. THE PROBLEMS WE FACE ARE BIGGER THAN ANY ONE PARTY OR GROUP OF PEOPLE. THEY'RE THE RESULT NOT OF WEEKS OR MONTHS, BUT OF YEARS- EVEN DECADES - OF PAST MISTAKES. THE PROBLEM ISN'T WHO TO BLAME -- IT'S WHAT TO BLAME. SO TONIGHT, LET'S FORGET ABOUT PARTY POLITICS AND TAKE A LOOK AT HOW OUR COUNTRY GOT INTO THIS FIX AND WHAT WE CAN DO TO GET HER OUT OF IT.

WHEN I SAID THIS PROBLEM WAS YEARS IN THE MAKING, I WASN'T JUST USING A FIGURE OF SPEECH. THIS CHART SHOWS YOU WHAT I MEAN.

YOU SEE THAT RED LINE. IT REPRESENTS THE RATE OF UNEMPLOYMENT FROM 1968 THROUGH THE PRESENT AND IT TELLS US TWO IMPORTANT THINGS. FIRST OF ALL, IT'S A JAGGED LINE, REPRESENTING RISES AND DIPS IN UNEMPLOYMENT AS OUR ECONOMY PASSED THROUGH BOOM PERIODS AND BAD PERIODS OVER THE PAST DECADE. THIS REMINDS US THAT THE CURRENT RECESSION IS PART OF A LONG SERIES -- A SERIES THAT HASN'T STOPPED BECAUSE, IN THE PAST, WHEN THE CRUNCH CAME, TOO MANY IN GOVERNMENT RESORTED TO QUICK FIXES INSTEAD OF GETTING TO THE ROOT CAUSE

EACH TIME THEY APPLIED THE QUICK FIXES, UNEMPLOYMENT DIPPED FOR A WHILE,ONLY TO TAKE OFF AGAIN. IN THAT SENSE, YOU COULD SAY THAT WE'VE BEEN ON A DECADE-LONG ROLLER COASTER RIDE.

THE ONLY DIFFERENCE IS THAT, ON A ROLLER COASTER, YOU END UP ON SOLID GROUND ONCE THE RIDE IS OVER. AS YOU CAN SEE FROM THE CHART, WHILE UNEMPLOYMENT ZIG-ZAGGED FROM YEAR TO YEAR, ITS LONG-TERM DIRECTION KEPT NOTCHING UPWARD. NOTICE THAT EACH SO-CALLED RECOVERY LEFT UNEMPLOYMENT HIGHER THAN BEFORE THE RECESSION.

IN 1968, UNEMPLOYMENT STOOD AT 3.5 PERCENT. IN 1971, IT SHOT UP TO 5.9 PERCENT. THEN IT STARTED COMING DOWN AGAIN, BUT INSTEAD OF GOING ALL THE WAY BACK TO 3.5 PERCENT, IT BOTTOMED OUT AT 4.9 PERCENT. IN 1974, IT STARTED SHOOTING UP AGAIN, AND THE SAME THING HAPPENED. IT BOTTOMED OUT AT A HIHER LEVEL THAN BEFORE. IN OTHER WORDS, FOR ALL ITS SHORT-TERM UPS AND DOWNS, THE UNEMPLOYMENT ROLLER COASTER WAS REALLY AN ESCALATOR, EDGING ITS WAY UP THE CHARTS THROUGHOUT THE LAST DECADE. UNLESS WE REVERSE THAT TREND, IT CAN ONLY GET WORSE NOT JUST FOR US, BUT FOR OUR CHILDREN AND GRANDCHILDREN.

NOW LET'S LOOK AT WHAT'S BEHIND THIS BAD TREND IN UNEMPLOYMENT. WHAT'S BEEN CAUSING IT FOR OVER DECADE?

A SECOND CHART TELLS MUCH OF THE STORY, BUT BEFORE WE LOOK AT IT, I'LL BET MANY OF YOU HAVE ALREADY COME UP WITH THE ANSWER.

IT'S A PHENOMENON THAT, LAST YEAR, A MAJORITY OF AMERICANS CORRECTLY IDENTIFIED AS OUR SINGLE MOST PRESSING LONG-TERM PROBLEM -- INFLATION.

INFLATION, AND THE HIGH INTEREST RATES IT LEADS TO, ARE THE REAL CULPRITS. THEY CREATE THE ECONOMIC CLIMATE THAT LEADS TO UNEMPLOYMENT.

THIS BLUE LINE REPRESENTS INFLATION. LIKE UNEMPLOYMENT INFLATION HAS ZIG-ZAGGED OVER THE LAST DECADE, BUT, YOU CAN SEE THAT, UP TO NOW, THE LONG-TERM TREND HAS BEEN UPWARDS. AGAIN, AS WITH UNEMPLOYMENT, THE

OLD QUICK FIXES SIMPLY DID NOT WORK. EACH TIME THEY WERE APPLIED, THEY GAVE A LITTLE TEMPORARY RELIEF TO THE PATIENT, BUT LEFT HIM WEAKER THAN HE WAS BEFORE.

IT'S A CONSISTENT PATTERN. EACH TIME INFLATION HAS SHOT UP SINCE 1969 THERE HAS BEEN A DEADLY, DELAYED REACTION OF RISING UNEMPLOYMENT. INFLATION IS LIKE A VIRUS IN THE ECONOMIC BLOODSTREAM, SOMETIMES DORMANT AND SOMETIMES ACTIVE BUT LEAVING THE PATIENT WEAKER AFTER EVERY NEW ATTACK.

MY FELLOW AMERICANS, WE'VE GOT TO STOP THESE TRENDLINES TO DISASTER.

TO DO THAT WE HAVE TO UNDERSTAND WHAT CAUSES THEM. WELL, FOR STARTERS, OUR FEDERAL GOVERNMENT HAS BEEN LIVING BEYOND ITS MEANS FOR MORE THAN A GENERATION. ONE OF THE WISEST OF OUR FOUNDING FATHERS, THOMAS JEFFERSON, WARNED THAT THE PUBLIC DEBT IS "THE GREATEST OF DANGERS TO BE FEARED." HE BELIEVED THAT IT WAS WRONG FOR ONE GENERATION TO FOREVER BURDEN THE GENERATIONS YET TO COME, AND, FOR THE FIRST 150 YEARS OF OUR HISTORY, OUR LEADERS HEEDED JEFFERSON'S WARNING.

BUT NOT LATELY. IN OUR LIFETIMES WE HAVE SEEN GOVERNMENT SPENDING RAGE OUT OF CONTROL. WE'VE ONLY HAD ONE BALANCED BUDGET IN THE LAST 22 YEARS.

SO NOW, WE'RE STAGGERING UNDER A TRILLION DOLLAR DEBT. THIS YEAR, BEFORE GOVERNMENT CAN SPEND ONE DIME TO FEED THE HUNGRY, CARE FOR THE SICK, OR PROTECT OUR FREEDOM, IT MUST PLAN TO SPEND 110,000 MILLION DOLLARS JUST TO PAY INTEREST ON THAT DEBT. AND STILL THE BIG SPENDERS WONDER WHY THE AMERICAN PEOPLE WANT WHAT A STUBBORN MINORITY IN THE HOUSE OF REPRESENTATIVES DENIED THEM JUST 12 DAYS AGO -- A CONSTITUTIONAL AMENDMENT TO BALANCE THE BUDGET.

ALL OF THIS GOVERNMENT SPENDING AND RED INK CAN ONLY SPAWN HIGHER TAXES AND WHOPPING DEFICITS WHICH, FOR NEARLY TWO DECADES, LED TO INFLATIONARY INCREASES IN THE MONEY SUPPLY. INFLATION AND MASSIVE GOVERNMENT BORROWING DRIVE UP INTEREST RATES. THAT MAKES IT DIFFICULT OR IMPOSSIBLE FOR FAMILIES TO GET THE CREDIT THEY NEED TO BUY HOMES, CARS AND APPLIANCES, OR FOR BUSINESSES TO INVEST IN GREATER PRODUCT-IVITY. AND, ULTIMATELY, INFLATION LEADS TO RECESSION AND UNEMPLOYMENT. WE'VE HAD EIGHT RECESSIONS SINCE WORLD WAR TWO.

AT THE BOTTOM OF IT ALL IS INFLATION -- GOVERNMENT-CAUSED INFLATION. OVER THE YEARS, OUR LEADERS ADOPTED SOMETHING CALLED THE "NEW ECONOMICS" BASED ON A BELIEF THAT A LITTLE INFLATION EACH YEAR CREATED PROSPERITY. BUT, EACH TIME THE ECONOMIC DISRUPTION CAUSED BY INFLATION TRIGGERED ANOTHER ROUND OF RECESSION AND HIGH UNEMPLOYMENT, THE GOVERNMENT REACTED, NOT LIKE YOUR FAMILY WOULD -- BY PUTTING ITS OWN HOUSE IN ORDER -- BUT BY SPENDING, BORROWING AND PRINTING MORE MONEY.

UNEMPLOYMENT WOULD DIP FOR A TIME, BUT THE SAME QUICK FIX THAT TEMPORARILY EASED UNEMPLOYMENT WAS SENDING INFLATION BACK THROUGH THE CEILING.

IT WAS A VICIOUS CYCLE. TOO MANY PEOPLE PLAYED POLITICS WITH THE ECONOMY FOR TOO LONG, AND THOSE TWIN DISASTER LINES KEPT INCHING OMINOUSLY UPWARD, BRINGING OUR SOCIETY CLOSER AND CLOSER TO CATASTROPHE.

IN A WAY, I GUESS I CAN UNDERSTAND WHY SO MANY OF OUR POLITICAL LEADERS FELL INTO THIS TRAP. I AM SURE THEY DID IT WITH THE BEST OF INTENTIONS. IT IS EASY TO LOSE TOUCH WITH REALITY WHEN IT IS OTHER PEOPLE'S MONEY THAT YOU ARE SPENDING AND THERE ARE SO MANY THINGS YOU WANT TO DO FOR THIS OR THAT

SPECIAL INTEREST GROUP-- SO MANY PROBLEMS, MANY OF THEM QUITE ATTRACTIVE AND WELL-MEANING, THAT CAN ONLY BE SUBSIDIZED BY MORE GOVERNMENT TAXING, SPENDING AND BORROWING. I CAN UNDERSTAND HOW IT HAPPENED. INDEED, LIKE MANY OTHERS, FOR A TIME I ACCEPTED GOVERNMENT'S CLAIM THAT IT WAS SOUND ECONOMICS, BUT THERE CAME A DAY WHEN I, AND MILLIONS OF OTHER AMERICANS, BEGAN TO REALIZE THE TERRIBLE CONSEQUENCES OF ALL THOSE YEARS OF PLAYING POLITICS AS USUAL WHILE THE ECONOMIC DISASTER LINES CREPT HIGHER AND HIGHER.

WELL, AT MY AGE, I DID NOT COME TO WASHINGTON TO PLAY POLITICS AS USUAL. I DID NOT COME HERE TO REWARD PRESSURE GROUPS BY SPENDING OTHER PEOPLE'S MONEY. AND, MOST OF ALL, I DID NOT COME HERE TO FURTHER MORTGAGE THE FUTURE OF THE AMERICAN PEOPLE JUST TO BUY A LITTLE SHORT-TERM POLITICAL POPULARITY. I CAME TO WASHINGTON TO TRY TO SOLVE PROBLEMS -- NOT TO SWEEP THEM UNDER THE RUG AND LEAVE THEM FOR THOSE WHO WILL COME LATER.

A PRESIDENT'S GREATEST RESPONSIBILITY IS TO PROTECT ALL OUR PEOPLE FROM ENEMIES, FOREIGN AND DOMESTIC. HERE AT HOME, THE WORST ENEMY WE FACE IS ECONOMIC -- THE CREEPING EROSION OF THE AMERICAN WAY OF LIFE AND THE AMERICAN DREAM THAT HAS RESULTED IN TODAY'S TRAGEDY OF ECONOMIC STAGNATION AND UNEMPLOYMENT.

NOW I DO NOT PRETEND FOR A MOMENT THAT, IN 21 MONTHS, WE HAVE BEEN ABLE TO UNDO ALL THE DAMAGE TO OUR ECONOMY THAT HAS BUILT OVER MORE THAN 20 YEARS. THE FIRST PART OF OUR PROGRAM HAS BEEN ON THE BOOKS ONLY ONE YEAR AND 13 DAYS. MUCH OF THE LEGISLATION WE NEED HAS STILL NOT BEEN ENACTED. WE HAVE STILL GOT A LONG WAY TO GO BEFORE WE RESTORE OUR PROSPERITY. BUT WHAT I CAN REPORT TO YOU TONIGHT, MY FELLOW AMERICANS, IS THAT, AT LONG LAST, YOUR GOVERNMENT HAS A PROGRAM IN PLACE THAT FACES OUR PROBLEMS AND HAS ALREADY STARTED SOLVING THEM.

TWENTY-ONE MONTHS AGO, WE FACED FIVE CRITICAL PROBLEMS: HIGH TAXES, RUNAWAY GOVERNMENT SPENDING, INFLATION, HIGH INTEREST RATES AND UNEMPLOYMENT.

GETTING TO THE ROOTS OF UNEMPLOYMENT MEANT FIGHTING INFLATION AND HIGH INTEREST RATES CAUSED BY RUNAWAY GOVERNMENT SPENDING AND TAXING BECAUSE WE KNOW THAT, WHEN INFLATION SHOOTS UP, IT TRIGGERS A DELAYED-ACTION RISE IN UNEMPLOYMENT; NOW INFLATION IS BEING DRIVEN BACK DOWN, AND LOWER UNEMPLOYMENT WILL FOLLOW.

SO WE STARTED BY WINNING THE FIRST REAL TAX CUT FOR THE AMERICAN PEOPLE IN NEARLY TWO DECADES. OUR PROGRAM BRINGS DOWN INCOME TAX RATES 25 PRECENT. AT THE SAME TIME, WE HAVE BEEN CUTTING COSTLY, WASTEFUL GOVERNMENT REGULATIONS AND THE RATE OF INCREASE IN GOVERNMENT SPENDING. WE HAVE REDUCED THE RATE OF GOVERNMENT SPENDING GROWTH BY NEARLY TWO-THIRDS.

INFLATION, WHICH REGISTERED 12.4 PERCENT IN 1980, IS DOWN TO JUST 5.1 PERCENT SO FAR THIS YEAR.

INTEREST RATES, WHICH HAD CLIMBED AS HIGH AS 21.5 PERCENT BENORE WE TOOK OFFICE, HAVE THIS WEEK FALLEN TO 12 PERCENT -- NOT LOW ENOUGH, BUT CERTAINLY HEADING IN THE RIGHT DIRECTION.

UNEMPLOYMENT, ALWAYS A LAGGING INDICATOR IN TIMES OF RECESSION, HAS NOT YET STOPPED ITS UPWARD DRIFT.

BUT IN 21 MONTHS, WE HAVE ALREADY BROUGHT TAX RATES DOWN BY A QUARTER, WITH THE THIRD INSTALLMENT COMING NEXT JULY, AND BROUGHT DOWN THE RATE OF INCREASE IN GOVERNMENT

SPENDING BY NEARLY TWO-THIRDS. THAT HAS HELPED US TO BRING DOWN THE RATE OF INFLATION BY MORE THAN HALF, AND THAT HAS HELPED US TO BRING DOWN INTEREST RATES BY 40 PERCENT.

SO, ON FOUR OUT OF FIVE PROBLEMS THAT FACED US IN 1980, WE HAVE MADE IMPORTANT PROGRESS. WE HAVE NOT SOLVED THEM ALL, BUT WE ARE MAKING HEADWAY. JUST LAST WEEK, THE FEDERAL RESERVE BANK DECIDED TO LOWER ITS DISCOUNT RATE TO 9.5 PERCENT -- THE FIRST TIME THIS KEY INTEREST RATE HAS GONE BELOW TWO DIGITS SINCE 1979, AND THE FIFTH REDUCTION IN JUST FOUR MONTHS. THIS DEMONSTRATES THE FED'S CONFIDENCE THAT INFLATION AND MARKET RATES WILL CONTINUE COMING DOWN -- AND ITS CONFIDENCE THAT WE CAN WORK TOGETHER FOR A HEALTHY, NON-INFLATIONARY RECOVERY. ALL OF THIS LAYS THE GROUND WORK FOR A RECOVERY THAT WILL MEAN MORE JOBS AND MORE OPPORTUNITY FOR ALL OUR PEOPLE -- BUT IT IS A DELAYED REACTION.

REMEMBER THE TRENDLINES. JUST AS SURELY AS SKYROCKETING INFLATION CREATED A NEGATIVE REACTION THAT DROVE UP UNEMPLOYMENT, BRINGING DOWN INFLATION AND INTEREST RATES IS CREATING A POSITIVE REACTION THAT WILL BOOST EMPLOYMENT. I WISH THERE WERE A QUICKER, EASIER WAY -- SOME MAGIC SHORT CUT -- BUT UNEMPLOYMENT IS ALWAYS ONE OF THE LAST THINGS TO TURN AROUND AS AN ECONOMY HEADS INTO RECOVERY.

AND MAKE NO MISTAKE, AMERICA IS RECOVERY-BOUND AND THE WORLD KNOWS IT. THE AMERICAN DOLLAR, BEATEN DOWN AND DISTRUSTED IN THE LATE 1970'S, IS SHOWING NEW STRENGTH. RECENTLY, WE HAVE BEEN SEEING A SURGE OF INVESTMENT IN OUR STOCK AND BOND MARKETS. THIS IS NO FLASH IN THE PAN. MARKETS WILL GO UP AND THEY WILL COME DOWN, BUT THE TREND IN THE UNITED STATES IS UP.

WHAT'S MORE, THIS INVESTMENT IS COMING FROM ALL OVER -FROM HOME, FROM ABROAD, FROM SMALL INVESTORS ON MAIN STREET, TO THOSE WHO MANAGE MILLIONS OF DOLLARS--INCLUDING OUR WORKERS' PENSION FUNDS.

WHY AREN'T THESE PEOPLE HEEDING THE DRUMBEAT OF DOOM AND GLOOM COMING FROM WASHINGTON? BECAUSE THEY HAVE BEEN WATCHING THIS COUNTRY'S INFLATION AND INTEREST RATES DROPPING FOR MONTHS. THEY REALIZE THIS ADMINISTRATION MEANS BUSINESS IN THE BATTLE AGAINST INFLATION.. THEIR DECISION TO PUT CASH ON THE LINE IS A STRONG VOTE OF CONFIDENCE IN THE FOUNDATION BEING LAID FOR AMERICA'S OPPORTUNITY RECOVERY -- HEALTHY, STABLE GROWTH THAT WILL BRING NEW JOBS AND OPPORTUNITY FOR OUR PEOPLE WITHOUT RETURNING US TO RUNAWAY INFLATION AND INTEREST RATES.

THAT'S THE ONE BIG DIFFERENCE BETWEEN THE RECOVERY AMERICA IS HEADED FOR TODAY, AND THE SHAKY, TEMPORARY RECOVERIES OF THE RECENT PAST -- THIS ONE IS BUILT TO LAST.

WITH YOUR SUPPORT WE CAN SHOW THE WORLD THAT WE HAVE LEARNED OUR LESSON AND THAT, THIS TIME WE ARE GOING TO GET THE JOB DONE AND GET IT DONE RIGHT. THIS TIME WE ARE GOING TO KEEP INFLATION, INTEREST RATES AND GOVERNMENT SPENDING, TAXING AND BORROWING DOWN -- AND GET AMERICANS BACK ON THE JOB.

MUCH OF THE WORK THAT REMAINS TO BE DONE REQUIRES CONGRESSIONAL COOPERATION. AS YOU KNOW, CONGRESS ADJOURNED OCTOBER 2ND FOR THE ELECTION CAMPAIGN, BUT IT LEFT BEHIND A LOT OF UNFINISHED BUSINESS. FOR THIS REASON, I URGED THE CONGRESS TO RECONVENE, AFTER THE ELECTIONS, SO THAT IT CAN DO ITS PART, AS QUICKLY AS POSSIBLE, TO CONTINUE THE WORK OF

RECOVERY. WE SIMPLY CANNOT AFFORD TO WAIT UNTIL NEXT YEAR WHEN SOMETHING AS VITAL AS THE ECONOMIC HEALTH OF AMERICA IS AT STAKE.

THE CONGRESS WILL RETURN ON NOVEMBER 29TH. IT WILL FACE FIVE TOP ECONOMIC PRIORITIES -- PRIORITIES THAT MUST BE ADDRESSED.

-- FIRST, THE CONGRESS MUST DO ITS PART TO CONTROL GOVERNMENT SPENDING. BEFORE ADJOURNING, IT SENT ME ONLY TWO APPROPRIATIONS BILL. ELEVEN MORE REMAIN TO BE PASSED, AND I WILL USE THE VETO IF NECESSARY TO KEEP THEM WITHIN THE BUDGET. WHEN THE CONGRESS PASSED THE TAX PACKAGE THIS SUMMER, IT PLEDGED TO SAVE THREE DOLLARS IN OUTLAYS FOR EVERY ONE DOLLAR IN NEW REVENUES. I INTEND TO HOLD THE CONGRESS TO ITS WORD.

-- SECOND, I URGE THE CONGRESS TO RECONSIDER THE CONSTITUTIONAL AMENDMENT TO BALANCE THE BUDGET. THIS CRUCIAL MEASURE WAS PASSED BY THE SENATE AND SUPPORTED BY A CLEAR MAJORITY IN THE HOUSE OF REPRESENTATIVES. IT WAS ONLY DEFEATED BECAUSE OF THE HARD CORE OPPOSITION OF A MINORITY OF REPRESENTATIVES WHO PREFER CONTINUED BIG SPENDING.

-- THIRD, THE CONGRESS SHOULD ACT ON REGULATORY REFORM TO HELP MAKE GOVERNMENT MORE ECONOMICAL AND EFFICIENT, AND THE PRIVATE SSECTOR MORE PRODUCIVE. REGULATORY REFORM LEGISLATION WAS PASSED UNANIMOUSLY BY THE SENATE, BUT WAS BOTTLED UP IN COMMITTEE IN THE HOUSE.

-- FOURTH, THE TIME HAS COME FOR PASSAGE OF THE ENTERPRISE ZONES INITIATIVE TO REVIVE DECLINING INNER CITY AND RURAL COMMUNITIES BY PROVIDING NEW INCENTIVES TO DEVELOP BUSINESSES AND JOBS. THIS PROGRAM WAS APPROVED BY THE SENATE FINANCE COMMITTEE BUT STILL AWAITS ACTION ON THE SENATE FLOOR AND IN THE HOUSE.

--AND, FIFTH, WE NEED TO PASS THE CLEAN AIR BILL WHICH, WHILE PROTECTING THE ENVIRONMENT, WILL MAKE IT POSSIBLE FOR INDUSTRY TO REBUILD ITS PRODUCTIVE BASE AND CREATE MORE JOBS.

IT IS NOT AN EASY JOB, THIS CHALLENGE TO REBUILD AMERICA AND RENEW THE AMERICAN DREAM. AND I KNOW IT CAN BE TEMPTING, LISTENING TO SOME WHO WOULD GO BACK TO THE OLD WAYS AND THE QUICK FIX. BUT CONSIDER THE CHOICE. A RETURN TO THE BIG SPENDING AND BIG TAXING THAT LEFT US WITH 21.5 PERCENT INTEREST RATES IS NO REAL ALTERNATIVE. A RETURN TO DOUBLE-DIGET INFLATION IS NO ALTERNATIVE. A RETURN TO TAXING AND TAXING THE AMERICAN PEOPLE-- THAT'S NO ALTERNATIVE. THAT IS WHAT DESTROYED MILLIONS OF AMERICAN JOBS. TOGETHER WE HAVE CHOSEN A NEW ROAD FOR AMERICA. IT IS A FAR BETTER ROAD. WE NEED ONLY COURAGE TO SEE IT THROUGH. I KNOW WE CAN. THROUGHOUT OUR HISTORY, WE AMERICANS HAVE PROVEN AGAIN AND AGAIN THAT NO CHALLENGE IS TOO BIG FOR A FREE, UNITED PEOPLE.

TOGETHER WE CAN DO IT AGAIN. WE CAN DO IT BY SLOWLY BUT SURELY WORKING OUR WAY BACK TO PROSPERITY THAT WILL MEAN JOBS FOR ALL WHO ARE WILLING TO WORK AND FULFILLMENT FOR ALL WHO STILL CHERISH THE AMERICAN DREAM.

WE CAN DO IT, MY FELLOW AMERICANS, BY STAYING THE COURSE.

FROM: J GRAHAM
DATE: 20 October 1982

MR SALVESON - cc Mr Bottrill
(For transmission to Mr Coles
at No 10)

PRESIDENT REAGAN'S SPEECH ON THE ECONOMY

In your letter of 18 October 1982 to Mr Fall on the debate on the address of the Queen's speech you mentioned that the Prime Minister would like to read the full text of President Reagan's recent speech on the American economy.

2. I enclose a transcript, taken from the New York Times of October 14, supplied by our Embassy in Washington.

J Graham

J GRAHAM

US Economy file
N.Y.T. 14.10.82.

Transcript of Reagan's Speech to Nation on G.O.P. Policy and the Economy

My fellow Americans, in recent days all of us have been swamped by a sea of economic statistics, some good, some bad, and some just plain confusing. There are times when I think that the paper traffic that crosses my desk in a week could fill a big city phone book, and then some.

The value of the dollar is up around the world. Interest rates are down by 40 percent. The stock and bond markets surge upward. Inflation is down 59 percent. Buying power is going up. Some economic indicators are down. Others are up. But the dark cloud of unemployment hangs over the lives of 11 million of our friends, neighbors and family.

At times, the sheer weight of all these facts and figures makes them hard for anyone to understand. What do they really mean, and what can we do to make them better?

Well, the first step is to understand what they mean in human terms, how they're affecting the everyday lives of our people. Because behind every one of those numbers are millions of individual lives: young couples struggling to make ends meet, teen-agers looking for work, older Americans threatened by inflation, small-business men fighting for survival, and parents working for a better future for their children.

'Want to Make It a Better Place'

All of them have one thing in common. They're Americans who love this country of ours and want to make it a better place. They're brave, hard-working people who know that America today faces serious problems that were long years in the making. And they're desperately trying to make sense out of all the statistics, slogans and political jargon filling the airwaves in this election year. Above all, they're concerned citizens who are looking for guideposts on the road to recovery, for ways to help see our country through to better times.

I know because I hear from hundreds of them every day, in meetings here at the White House, on visits to schools, meeting halls, factories and fairgrounds across the country, and in thousands of phone calls and letters. I only wish I could share with you tonight all that they have to say — their hopes, their fears, their concerns and, most of all, their quiet, patient courage.

Letter From Selma, Ala.

But let me just give you one example that speaks for so many of you, a letter from a wife and mother named Judith, who lives in Selma, Ala.

"Dear Mr. President," she writes. "It's 3:45 A.M., and for over an hour I've been unable to sleep ... this morning I need very much to believe in something ... I'm not writing so much as an individual, but as a representative of so many. We need to talk with you — to believe that you hear us ...

"After years of training and experience, we can't find jobs. National unemployment figures sound almost healthy next to the almost 19 percent we're enduring in Selma.

"The costs for basic survival are nearly beyond belief ... there may never be a house — home of our own — that dream we've worked for for so many years .... We have said 'no' to so many things ... we're afraid and confused. We've worked hard — we conserved — we planned — we were frugal — careful. We feel so out of control. We don't want a handout — we just want to help make the system well again.

"We must know that in the tons of bureaucracy ... we've not been lost ... we want to help. We want a better life, and we're willing to work for it. We believe. We must — it's all we have."

The American Dream

Well, Judith, I hear you. And millions of other men and women like you stand for the values of hard work, thrift, commitment to family and love of God that made this country so great, and will make us great again.

And you deserve to know what we're doing in these difficult times to bring your dream — the American dream — back to life again after so many years of mistakes and neglect.

Tonight, in homes across this country, unemployment is the problem uppermost on many people's minds. Getting Americans back to work is an urgent priority for all of us — and especially for this Administration.

But remember, you can't solve unemployment without solving the things that caused it — the out-of-control government spending, the sky-rocketing inflation and interest rates that led to unemployment in the first place. Unless you get at the root causes of the problem — which is exactly what our economic program is doing — you may be able to temporarily relieve the symptoms, but you'll never cure the disease. You may even make it worse.

I have a special reason for wanting to solve this problem in a lasting way. I was 21 and looking for work in 1932, one of the worst years of the Great Depression, and I can remember one bleak night in the Thirties when my father learned on Christmas Eve that he'd lost his job. To be young in my generation was to feel that your future had been mortgaged out from under you — and that's a tragic mistake we must never allow our leaders to make again. Today's young people must never be held hostage to the mistakes of the past.

The only way to avoid making those mistakes again is to learn from them.

The pounding economic hangover America's suffering from didn't come about overnight and there's no single, instant cure. In recent weeks, a lot of people have been playing what I call the "blame game." the accusing finger has been pointed in every direction of the compass and a lot of time and hot air have been spent looking for scapegoats.

Well, there's plenty of blame to go around. The problems we face are bigger than any one party or group of people. They're the result not of weeks or months, but of years — even decades — of past mistakes. The problem isn't who to blame — it's what to blame. So tonight let's forget about party politics and take a look at how our country got into this fix and what we can do to get her out of it.

When I said this problem was years in the making, I wasn't just using a figure of speech. This chart shows you what I mean.

You see that red line. It represents the rate of unemployment from 1968 through the present and it tells us two important things. First of all, it's a jagged line, representing rises and dips in unemployment as our economy passed through boom periods and bust periods over the past decade. This reminds us that the current recession is part of a long series — a series that hasn't stopped because, in the past, when the crunch came, too many in government resorted to quick fixes instead of getting to the root cause.

Each time they applied the quick fixes, unemployment dipped for awhile, only to take off again. In that sense, you could say that we've been on a decade-long roller coaster ride.

The only difference is that, on a roller coaster, you end up on solid ground once the ride is over. As you can see from the chart, while unemployment zigzagged from year to year, its long-term direction kept notching upward. Notice that each so-called recovery left unemployment higher than before the recession.

In 1968, unemployment stood at 3.6 percent. In 1971, it shot up to 5.9 percent. Then it started coming down again, but instead of going all the way back to 3.6 percent, it bottomed out at 4.9 percent. In 1974, it started shooting up again, and the same thing happened. It bottomed out at a higher level than before. In other words, for all its short-term ups and downs, the unemployment roller coaster was really an escalator, edging its way up the charts throughout the last decade.

Unless we reverse that trend, it can only get worse, not just for us, but for our children and grandchildren.

Now let's look at what's behind this bad trend in unemployment. What's been causing it for over a decade?

A second chart tells much of the story, but before we look at it, I'll bet many of you've already come up with the answer.

It's a phenomenon that, last year, a majority of Americans correctly identified as our single most pressing long-term problem — inflation.

Inflation, and the high interest rates it leads to, are the real culprits. They create the economic climate that leads to unemployment.

This blue line represents inflation. Like unemployment, inflation has zigzagged over the last decade, but, you can see that, up to now, the long-term trend has been upwards. Again, as with unemployment, the old quick fixes simply did not work. Each time they were applied, they gave a little temporary relief to the patient, but left him weaker than he was before.

It's a consistent pattern. Each time inflation has shot up since 1969 there has been a deadly, delayed reaction of rising unemployment. Inflation is like a virus in the economic bloodstream, sometimes dormant and sometimes active, but leaving the patient weaker after every new attack.

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My fellow Americans, we've got to stop these trendlines to disaster. To do that we have to understand what causes them. Well, for starters, our Federal Government has been living beyond its means for more than a generation. One of the wisest of our founding fathers, Thomas Jefferson, warned that the public debt is "the greatet of dangers to be feared." He believed that it was wrong for one generation to forever burden the generations yet to come, and, for the first 150 years of our history, our leaders heeded Jefferson's warning.

But not lately. In our lifetimes we've seen Government spending rage out of control. We've only had one balanced budget in the last 22 years.

So now, we're staggering under a trillion dollar debt. This year, before Government can spend one dime to feed the hungry, care for the sick or protect our freedom, it must plan to spend $110 billion just to pay interest on that debt. And still the big spenders wonder why the American people want what a stubborn minority in the House of Representatives denied them just 12 days ago, a Constitutional amendment to balance the budget.

All of this Government spending and red ink can only spawn higher taxes and whopping deficits which, for nearly two decades, led to inflationary increases in the money supply. Inflation and massive Government borrowing drive up interest rates. That makes it difficult or impossible for families to get the credit they need to buy homes, cars and appliances, or for businesses to invest in greater productivity. And, ultimately, inflation leads to recession and unemployment. We've had eight recessions since World War II.

Impact of Inflation

At the bottom of it all is inflation — Government-caused inflation. Over the years, our leaders adopted something called the "new economics" based on a belief that a little inflation each year created prosperity. But, each time the economic disruption caused by inflation triggered another round of recession and high unemployment, the Government reacted, not like your family would — by putting its own house in order — but by spending, borrowing and printing more money.

Unemployment would dip for a time, but the same quick fix that temporarily eased unemployment was sending inflation back through the ceiling.

It was a vicious cycle. Too many people played politics with the economy for too long, and those twin disaster lines kept inching ominously upward, bringing our society closer and closer to catastrophe.

In a way, I guess I can understand why so many of our political leaders fell into this trap. I'm sure they did it with the best of intentions. It's easy to lose touch with reality when it's other people's money that you're spending and there are so many things you want to do for those or this or that special-interest group — so many programs, many of them quite attractive and well-meaning; that can only be subsidized by more Government taxing, spending and borrowing. I can understand how it happened. Indeed, like many others, for a time I accepted Government's claim that it was sound economics, but there came a day when I, and millions of other Americans, began to realize the terrible consequences of all those years of playing politics as usual while the economic disaster lines crept higher and higher.

Well, at my age, I didn't come to Washington to play politics as usual. I didn't come here to reward pressure groups by spending other people's money. And, most of all, I didn't come here to further mortgage the future of the American people just to buy a little short-term political popularity. I came to Washington to try to solve problems — not to sweep them under the rug and leave them for those who will come later.

Worst Enemy Is Economic

A President's greatest responsibility is to protect all our people from enemies, foreign and domestic. Here at home, the worst enemy we face is economic — the creeping erosion of the American way of life and the American dream that has resulted in today's tragedy of economic stagnation and unemployment.

Now I don't pretend for a moment that, in 21 months, we've been able to undo all the damage to our economy that has built up over more than 20 years. The first part of our program has been on the books only one year and 13 days. Much of the legislation we need has still not been enacted. We've still got a long way to go before we restore our prosperity. But what I can report to you tonight, my fellow Americans, is that, at long last, your Government has a program in place that faces our problems and has already started solving them.

Twenty-one months ago, we faced five critical problems: high taxes, runaway Government spending, inflation, high interest rates and unemployment.

Getting to the roots of unemployment meant fighting inflation and high interest rates caused by runaway Government spending and taxing because we know that, when inflation shoots up, it triggers a delayed-action rise in unemployment; now inflation is being driven back down, and lower unemployment will follow.

So we started by winning the first real tax cut for the American people in nearly two decades. Our program brings down income tax rates 25 percent. At the same time, we've been cutting costly, wasteful Government regulations and the rate of increase in Government spending. We've reduced the rate of Government spending growth by nearly two-thirds.

Cites Decline in Interest

Inflation, which registered 12.4 percent in 1980, is down to just 5.1 percent so far this year.

Interest rates, which had climbed as high as 21½ percent before we took office, have this week fallen to 12 percent, not low enough, but certainly heading in the right direction.

Unemployment, always a lagging indicator in times of recession has not yet stopped its upward drift.

But in 21 months, we've already brought tax rates down by a quarter, with the third installment coming next July, and brought down the rate of increase in Government spending by nearly two-thirds. That's helped us to bring down the rate of inflation by more than half, and that's helped us to bring down interest rates by 40 percent.

So, on four out of five problems that faced us in 1980, we've made important progress. We haven't solved them all, but we're making headway. Just last week, the Federal Reserve Bank decided to lower its discount rate to 9.5 percent, the first time this key interest rate has gone below two digits since 1979, and the fifth reduction in just four months. This demonstrates the Fed's confidence that inflation and market rates will continue coming down, and its confidence that we can work together for a healthy, noninflationary recovery. All of this lays the ground work for a recovery that will mean more jobs and more opportunity for all our people, but it's a delayed reaction.

'Remember the Trendlines'

Remember the trendlines. Just as surely as skyrocketing inflation created a negative reaction that drove up unemployment, bringing down inflation and interest rates is creating a positive reaction that will boost employment. I wish there were a quicker, easier way, Some magic short cut, But unemployment is always one of the last things to turn around as an economy heads into recovery.

And make no mistake, America is recovery-bound and the world knows it. The American dollar, beaten down and distrusted in the late 1970's, is showing new strength. Recently, we've been seeing a surge of investment in our stock and bond markets. This is no flash in the pan. Markets will go up and they will come down, but the trend in the United States is up.

What's more, this investment is coming from all over, from home, from abroad, from small investors on Main Street, to those who manage billions of dollars, including our workers' pension funds.

'This One Is Built to Last'

Why aren't these people heeding the drumbeat of doom and gloom coming from Washington? Because they've been watching this country's inflation and interest rates dropping for months. They realize this Administration means business in the battle against inflation. Their decision to put cash on the line is a strong vote of confidence in the foundation being laid for America's recovery, Healthy, stable growth that will bring new jobs and opportunity for our people without re-

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turning us to runaway inflation and interest rates.

That's the one big difference between the recovery America is headed for today, and the shaky, temporary recoveries of the recent past — this one is built to last.

With your support we can show the world that we've learned our lesson and that this time we'e going to get the job done and get it done right. This time we'e going to keep inflation, interest rates and government spending, taxing and borrowing down, and get Americans back on the job.

Much of the work that remains to be done requires Congressional cooperation. As you know, Congress adjourned Oct. 2 for the election campaign, but it left behind a lot of unfinished business. For this reason, I urged the Congress to reconvene, after the elections, so they can do its part, as quickly as possible, to continue the work of recovery. We simply can't afford to wait until next year when something as vital as the economic health of America is at stake.

The Congress will return on Nov. 29. It will face five top economic priorities — priorities that must be addressed.

He Lists the Priorities

First, the Congress must do its part to control Government spending. Before adjourning, it sent me only two appropriationbills. Eleven more remain to be passed, and I will use the veto if necessary to keep them within the budget. When the Congress passed the tax package this summer, it pledged to save $3in outlays for every $1in new revenues. I intend to hold the Congress to its word.

Second, I urge the Congress to reconsider the Constitutional Amendment to balance the budget. This crucial measure was passed by the Senate and supported by a clear majority in the House of Representatives. It was only defeated because of the hard core opposition of a minority of Representatives who prefer continued big spending.

Third, the Congress should act on regulatory reform to help make Government more economical and efficient, and the private sector more productive. Regulatory reform legislation was passed unanimously by the Senate, but was bottled up in committee in the House.

Fourth, the time has come for passage of the Enterprise Zones Initiative to revive declining inner city and rural communities by providing new incentives to develop businessand jobs. This program was approved by Senate Finance Committee but still awaits action on the Senate floor and in the House.

And, fifth, we need to pass the Clean Air Bill which, while protecting the environment, will make it possible for industry to rebuild its productive base and create more jobs.

'It Is Not an Easy Job'

But it isn't an easy job, this challenge to rebuild Ameerica and renew the American dream. And I know it can be tempting, listening to some who would go back to the old ways and the quick fix. But consider the choice. A return to the big spending and big taxing that left us with 21½ percent interest rates is no real alternative. A return to double-digit inflation is no alternative. A return to taxing and taxing the American people, — that's no alternative. That's what destroyed millions of American jobs. Together we've chosen a new road for America. It's a far better road. We need only the courage to see it through. I know we can. Throughout our history, we Americans have proven again and again that no challenge is too big for a free, united people.

Together we can do it again. We can do it by slowly but surely working our way back to prosperity that will mean jobs for all who are willing to work, and fulfillment for all who still cherish the American dream.

We can do it, my fellow Americans, by staying the course.

Thank you, good night and God bless you.

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PRESIDENT REAGAN'S SPEECH TO THE NATION: THE US ECONOMY

1. PRESIDENT REAGAN SPOKE TO THE NATION LAST NIGHT ABOUT THE US ECONOMY. HIS NATIONALLY TELEVISED SPEECH, LASTING NEARLY HALF-AN-HOUR, WAS BILLED AS NON-PARTISAN. BUT IT WAS PROMPTED BY THE PRESIDENT'S ANXIETY ABOUT THE MID-TERM ELECTIONS ON 2 NOVEMBER (MY TELEGRAM NO. 3314) AND WAS NON-PARTISAN ONLY TO THE EXTENT THAT THE PRESIDENT MADE NO DIREREFERENCE TO THE DEMOCRATS. IT WAS OTHERWISE THE CAMPAIGN SPEECH HE HAS BEEN MAKING ACROSS THE COUNTRY IN RECENT DAYS. IT PROVOKED AN OUTCRY FROM THE DEMOCRATS WHO URGED THE TV NETWORKS EITHER NOT TO CARRY THE ADDRESS OR TO CHARGE FOR IT AS PAID ADVERTISING. IN THE END, ONLY ABC DECLINED TO BROADCAST THE SPEECH. IT WAS SHOWN AT PRIME VIEWING TIME AND WAS FOLLOWED, BY A DEMOCRATIC RIGHT OF REPLY (EXERCISED, BECAUSE OF THE RIVALRIES AMONG THE DEMOCRACTIC PRETENDERS TO THE PRESIDENCY BY THE SCARCELY KNOWN SENATOR REIGLE OF MICHIGAN).

2. SPEAKING IN HIS BEST FIRESIDE STYLE AND APPEALING FREQUENTLY TO QUOTE MY FELLOW AMERICANS UNQUOTE, THE PRESIDENT PORTRAYED HIMSELF AS A MAN NOT INTERESTED IN PARTY IN-FIGHTING (QUOTE AT MY AGE I DIDN'T COME TO WASHINGTON TO PLAY POLITICS AS USUAL UNQUOTE) AND AS THE CHAMPION OF THE PEOPLE AGAINST GOVERNMENT. WITHOUT IDENTIFYING HIS TARGETS HE MADE IT VERY CLEAR THAT HE WAS LAYING THE BLAME FOR THE COUNTRY'S ECONOMIC PROBLEMS AT THE DOOR OF PREVIOUS ADMINISTRATIONS AND OF PREDOMINANTLY DEMOCRATIC CONGRESSES, SPEAKING OF YEARS IN WHICH THE FEDERAL GOVERNMENT HAD LIVED BEYOND ITS MEANS, OF GOVERNMENT-CAUSED INFLATION AND OF A MINORITY IN THE HOUSE OF REPRESENTATIVES, IE THE DEMOCRATS, WHO REFUSED TO GIVE THE PEOPLE THE BALANCED BUDGET WHICH THEY WANTED.

3. AT THE OUTSET, THE PRESIDENT SAID HIS ADMINISTRATION HAD FACED FIVE CRITICAL PROBLEMS: HIGH TAXES, RUN-AWAY GOVERNMENT SPENDING INFLATION, HIGH INTEREST RATES AND UNEMPLOYMENT. USING A CHART ON THE TV SCREEN, THE PRESIDENT TICKED OFF ONE BY ONE HIS SUCCESSES IN FOUR OUT OF FIVE OF HIS MAIN GOALS:
(A) INCOME TAX RATES WERE DOWN 25 PER CENT.
(B) THE RATE OF GROWTH IN GOVERNMENT SPENDING HAD BEEN CUT BY NEARLY TWO-THIRDS.
(C) INFLATION WAS DOWN FROM 12.4 TO 5.1 PER CENT.
(D) INTEREST RATES WERE DOWN FROM 21-1/2 PER CENT TO 12 PER CENT.
ONLY UNEMPLOYMENT, ALWAYS A LAGGING INDICATOR IN TIMES OF RECESSION,

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/HAD NOT

HAD NOT YET STOPPED ITS UPWARD DRIFT. BUT MILLIONS OF AMERICANS HAD ALREADY REALISED THAT IT WAS INFLATION WHICH LED TO RECESSION AND UNEMPLOYMENT. THE SHORT TERM QUICK REFLATIONARY FIX, THE RESORT OF PREVIOUS GOVERNMENTS, HAD PROVOKED ONLY SHORT-TERM BURSTS OF ACTIVITY, ULTIMATELY LEAVING BOTH INFLATION AND UNEMPLOYMENT AT HIGHER LEVELS THAN BEFORE.

4. THE PRESIDENT SAID THAT GETTING AMERICANS BACK TO WORK WAS HIS PRINCIPAL GOAL. BUT IT COULD ONLY BE ACHIEVED THROUGH NATIONAL RECOVERY. MAKE NO MISTAKE, HE SAID , AMERICA WAS RECOVERY-BOUND AND THE WORLD KNOWS IT. THE NEW STRENGTH OF THE DOLLAR AND THE BOOM ON WALL STREET WERE CLEAR SIGNALS. INVESTMENT WAS COMING FROM THE INDIVIDUAL ON MAIN STREET AS WELL AS BIG BUSINESS. THE AMERICAN PEOPLE WERE NO LONG HEEDING THE DRUMBEAT OF DOOM AND GLOOM COMING FROM WASHINGTON.

5. THE PRESIDENT CONCLUDED HIS ADDRESS BY SETTING OUT AN AGENDA FOR CONGRESS, WHICH RETURNS FOR A LAME DUCK SESSION AT THE END OF NOVEMBER.

CONGRESS MUST:

(A) DO ITS PART TO CONTROL GOVERNMENT SPENDING, INCLUDING ADOPTING THE ELEVEN OUTSTANDING APPROPRIATIONS BILLS. THE PRESIDENT WOULD USE HIS VETO TO KEEP SPENDING WITHIN THE BUDGET OUTLINE.

(B) RECONSIDER THE CRUCIAL CONSTITUTIONAL AMENDMENT TO BALANCE THE BUDGET.

(C) ACT ON REGULATORY REFORM TO MAKE GOVERNMENT MORE ECONOMIC AND EFFICIENT, AND THE PRIVATE SECTOR MORE PRODUCTIVE.

(D) ADOPT THE ENTERPRISE ZONES INITIATIVE SO FAR APPROVED ONLY BY COMMITTEE.

(E) PASS THE CLEAN AIR BILL TO PROTECT THE ENVIRONMENT AND ENABLE INDUSTRY TO REBUILD ITS PRODUCTIVE BASE AND CREATE MORE JOBS.

REITERATING THE APPEAL HE HAS BEEN MAKING UP AND DOWN THE COUNTRY MR REAGAN URGED AMERICANS TO REJECT THE OLD WAYS AND TO JOIN WITH HIM IN STAYING THE COURSE.

COMMENT

6.A POLL TAKEN BEFORE THE SPEACH AND PUBLISHED IN TODAY'S WASHINGTON POST SHOWS THAT A MAJORITY OF THOSE SURVEYED NATIONWIDE BELIEVE THEY ARE WORSE OFF NOW THAN WHEN MR REAGAN TOOK OFFICE. THIS IS A MEASURE OF THE PRESIDENT'S PROBLEM IN THE PRESENT CAMPAIGN.

CONFIDENTIAL

DESPITE HIS SUCCESSES, AMERICANS THINK THAT THINGS ARE GOING BADLY FOR THEM AND ARE UNLIKELY TO GET BETTER QUICKLY. INDIVIDUALS HAVE NOT YET BEGUN TO FEEL THE BENEFIT OF REDUCED INFLATION AND/LOWER INTEREST RATES. THEY DO NOT SEE AN END TO THE RECESSION AND HAVE INTERPRETED THE UNEMPLOYMENT FIGURES AS CONFIRMING THE GLOOMY PROSPECTS. THE PRESIDENT SET OUT LAST NIGHT TO CONVINCE THE VOTERS THAT, IF ONLY THEY WILL STICK WITH HIM THEY WILL REAP THE REWARDS OF THE PAINFUL MEASURES HE HAS HAD TO TAKE. TO JUDGE BY POLLING AT A NATIONAL LEVEL, IT LOOKS AS IF THE ELECTORATE IS GROWING WEARY OF GIVING REPUBLICANS THE BENEFIT OF THE DOUBT. BUT THE DEMOCRATS HAVE NOT THEMSELVES BEEN ABLE TO COME UP WITH ANY VERY CONVINCING ALTERNATIVES. MID-TERM ELECTIONS ARE A SERIES OF INDIVIDUAL RACES IN EACH STATE AND DISTRICT: AND IT IS NOT YET CLEAR WHETHER THERE IS A STRONG ENOUGH ANTI-REPUBLICAN TIDE IN THOSE INDIVIDUAL DISTRICTS WHERE THE DEMOCRATS MUST WIN THE 30 OR MORE SEATS IN THE HOUSE THAT THEY WOULD NEED TO INFLICT A SIGNIFICANT POLITICAL DEFEAT ON THE PRESIDENT AND HIS PARTY.

FCO PASS SAVING: MOSCOW UKREP BRUSSELS UKDEL NATO.

WRIGHT (REPEATED AS REQUESTED)

FCO/WHITEHALL
NAD

FOR RELEASE WEDNESDAY A.M.'S, OCTOBER 13, 1982

NATIONAL CITY BANK
OF MINNEAPOLIS

October 13, 1982

U.S. ECONOMIC POLICY AND OUTLOOK

by

WALTER W. HELLER AND GEORGE L. PERRY

For 3½ years the American economy has been kept under wraps. Output today is lower than in early 1979, a performance that has added 5 million to the ranks of the unemployed and brought factory operating rates to their post-war low. It is hard to see the forces that will pull us out of this dismal swamp and push output above the early-1979 levels before 1983. This is by all odds our worst economic experience since World War II. We have traded double-digit inflation for double-digit unemployment.

We come to this bleak appraisal reluctantly. The recession we projected in this letter a year ago has already been deep and costly. But the second-half recovery we foresaw is simply not materializing. Policies that kept real interest rates at record levels in the teeth of a sustained recession have overwhelmed the stimulus of tax cuts, defense boosts, and lower inflation. The net impact is still unfolding in economic weakness in sector after sector of the U.S. economy. Before turning to those sectoral prospects, we examine the major source of that weakness: monetary policy.

MONETARY POLICY

The Federal Reserve's tight monetarist strategy of the past 3 years has kept real interest rates extraordinarily high at every stage of the cycle. This has not only pushed us into the present recession but could well prolong it. What we need now is more than just the letup in monetary stringency that comes naturally from a listless and financially fragile economy. We need an active pursuit of lower rates before things get worse.

True, we have had a welcome drop in rates since mid-year. Treasury bill rates are down 5 to 6 points, commercial paper rates are off by 4 to 5 points, and the prime rate has fallen 3½ points. The stickier interest rates on long-term bonds have fallen 2 points and mortgage rates about 1 point since mid-year.

The sense of relief these lower rates bring is offset by the apprehension that they are too little and too late to avoid a further softening of the economy. By any test of past experience, monetary policy is still far too restrictive for this stage of the business cycle. A simple comparison of *real* interest rates – market rates minus the inflation rate – drives this home:

- In the early years of previous post-war recoveries, real interest rates have averaged between 1½% and 2%.
- Today, with inflation running at about 5% and interest rates in the private sector running from 10% to 14% and more, real rates are 3 to 4 times as high as in the typical post-war recovery.
- Given present money-supply targets and the huge federal deficits facing us, the prospects for sharp cuts in real rates are poor.

Both theory and experience teach that aggressive action by the Fed in an economy with huge unemployment and excess capacity can bring real rates down without reigniting inflation. Such a policy, without abandoning the commitment to stem inflation, would at long last remove the major risk of a further economic decline and a string of financial failures.

The stock market has clearly been anticipating the further letup in Fed policy that would clear the track for economic recovery. But this is still in the realm of tomorrow's hope. Our projections are based on today's reality of repressively high real interest rates.

DELAYED RECOVERY

By rights, we should be in a cyclical recovery. Consumers have enjoyed a sizable tax cut, defense spending is on the move, inventories have been cut, inflation is down, interest rates have softened, and the upsweep in stock and bond prices has added $250 billion to people's assets.

But these economic pluses have been no match for the continued sources of weakness. Consumers are cowed by double-digit unemployment and growing layoffs. Manufacturers and distributors are still cutting inventories. State-local governments are retrenching. High mortgage costs continue to burden housing. Auto production schedules for the current quarter have been cut significantly. Business capital spending is reeling under the impact of weak markets and low-capacity utilization. And the combination of our strong dollar and weak economies abroad is sharply cutting net exports.

Barring unforeseen strength in consumer purchases or a sharp turn in Federal Reserve policy, we now expect recovery to be delayed until 1983. This will keep the official unemployment rate above 10% for months to come and will bring the comprehensive unemployment rate, embracing both part-time and discouraged workers, to 15% or more.

This grim job outlook will be paralleled by further declines in output, operating rates, and profits. Average operating rates in manufacturing will drop to only two-thirds of capacity. Profits, after declining 27% this year, will suffer further declines in the first part of 1983.

Signs of strength are hard to find as one looks across the individual sectors of the economy:

Consumer spending has not responded to the mid-year tax cut. One can hope that a delayed reaction to the tax cut, combined with lower consumer debt and the spectacular rally in security values, would still bring a recovery in consumer spending. But the worsening job market and stubbornly high borrowing costs have undermined consumer confidence and discouraged spending.

Housing starts recovered to an annual rate of a little over 1 million units during the summer. But until mortgage interest rates fall considerably further, the gains in home building will be very modest. One of the imponderables in the housing outlook is the impact of new legislation permitting savings institutions to compete with money market funds. The new law, coupled with the redeployment of funds from maturing All Savers' Certificates, is expected to increase the flow of funds into the mortgage market. If the more optimistic expectations of participants in residential financing are realized, a more vigorous housing revival may be in the cards.

Most discouraging is the snowballing weakness in *business investment*. Each survey of business investment intentions has been worse than the last. New orders for business capital equipment declined nearly 20% during the past year, and orders are still declining as sales and operating rates continue to fall short of expectations. Capital goods production is still falling at a 15% annual rate. Weakness in nonresidential building will become progressively worse in 1983 as present projects are completed and vacancies in commercial and office buildings discourage new construction.

The *net export balance*, after holding up remarkably well during the first half of this year – partly because recession reduced the demand for imports – declined sharply in the summer. The strong dollar makes U.S. goods less competitive and at the same time makes imported goods less expensive. Weakness in foreign economies will further cut into U.S. export demand. In particular, the financial crisis afflicting the Latin American economies will cut exports to this region. During the past four quarters, our merchandise trade balance with this region declined by $6 billion. It will decline substantially further in coming quarters as the Latin American nations are forced to limit their imports in order to meet the interest burden on their foreign debts.

The overdue *inventory* turnaround – from liquidation to accumulation – is not yet in sight. With orders, output, backlogs, and retail sales all falling well below expectations, business still finds itself with more inventories than it needs. The rate at which inventories were liquidated dropped from $36 billion in the first quarter to $16 billion in the second and still further in the third. This slowdown has two significant consequences:

- First, when businesses rely less on drawing down inventories to supply their customers, output grows even in the face of a drop in final sales. When businesses cut back their rate of inventory sell-off by $20 billion from the first to the second quarter, that translated into an automatic plus of $20 billion in the quarter-to-quarter change in GNP. This was the major factor in the posting of a 2.1% real GNP gain in the second quarter. A similar slowing of inventory liquidation also plays a major role in the Commerce "flash report" of a 1.5% real growth rate in the third quarter (which we believe will convert into a minus when the final numbers are in).
- Second, it means that businesses still have to work off unwanted inventories, thereby serving as a drag on output in the current quarter.

Inventory behavior is notoriously difficult to predict. If consumers snap out of their lethargy and the Fed aggressively eases credit, businesses will raise their target inventory levels thus requiring added output to satisfy their customers.

INFLATION

The miserable state of the economy has its counterpart in a brighter outlook for inflation. The tradeoff between unemployment and inflation still lives. Economic policies that have generated what will soon be 4 years of no-growth – nothing like it has been seen since the Great Depression of the 1930s – have also ground down the rate of inflation. No wonder. Even if we assume that our capacity to produce, our GNP potential, has been growing at only a bit over 2% per year – and many would put it at 2½% to 3% – actual output is running between $250 and $300 billion a year below our potential. This huge overhang of excess labor and plant capacity – together with the competitive pressure of falling import prices – has forced moderation in both wage and price behavior.

Add to this the impact of large crops on food prices, the impact of worldwide economic weakness on energy prices, the impact of deregulation on transportation prices and wages, and the impact of Federal Reserve policy on housing prices and now on mortgage rates, and it is not surprising that the overall picture is one of continued quiet on the inflation front.

The improvement shows up both in actual and in underlying rates of inflation. During the first 8 months of this year, average hourly earnings have been rising at a 6½% rate, the underlying rate of inflation in the CPI has dropped to 6%, and increases in the actual CPI have averaged 5.4%. Compared with the previous 12 months, these represent slowdowns of 1½, 2½, and 3½ percentage points, respectively. And inflation is still heading downward.

The critical question is whether the moderation in price and wage behavior will survive recovery. Rising demand, by definition, increases pressures for price increases. In the early stages of recovery, the hunger for increased profit margins can be satisfied from a drop in unit costs as more goods and services are produced with the existing capital equipment and labor force. But what about later on?

Much depends on whether consumers and workers recognize the full extent of the reduction in inflation to date and adjust their expectations of inflation downward. Survey after survey shows consumers still believing that inflation is significantly higher than it really is. And the combination of bulging federal deficits, painful past experience, and a certain cynicism has induced pessimism about the future course of inflation. Nevertheless, a number of factors suggest a sustained period of relief from a new round of inflation:

- Workers no longer have to play catch-up with the cost of living.
- Many of the industries with the strongest unions — for example, autos and steel — are subject to foreign competition and other structural pressures that are likely to bring wage and price increases in those industries to more moderate levels.
- Excess capacity and unemployment throughout the industrial world suggest a substantial cushion against renewed inflation as well as a muted rise in raw materials prices.
- With an oil glut abroad and a natural gas glut at home, energy prices are likely to be better behaved than had been anticipated.

THE FISCAL POLICY DILEMMA

Fiscal policy faces an uncomfortable dilemma of timing in 1983. On one hand, further budget trimming and tax boosts are clearly needed to put the budget on a steady course toward balance or surplus at high employment, that is, to eliminate the present "structural" deficit that would run to about $75 billion at high employment by 1985. (We use 5.6% unemployment as the definition of high employment, rather than the Congressional Budget Office's 5.1%. If Secretary Regan's 6% to 6½% range were accepted as the definition, the 1985 high-employment deficit would run over $100 billion.)

On the other hand, as the foregoing review of economic prospects has shown, an economy that continues to sputter and operates nearly $300 billion below its potential well into 1983 can ill afford a sharp restriction in fiscal stimulus. The objective is gradually to take the foot off the fiscal gas as the economy expands, not to slam on the fiscal brakes at the first sign of recovery. The best policy mix would be a decisive easing of monetary policy coupled with fiscal steps to reduce the out-year deficits.

Under the leadership of Senators Dole and Domenici, the Congress and White House compromised on a substantial tightening of budget policy last summer. These changes will boost revenues $40 billion by 1985, thus offsetting one-fifth of the 1981 tax cut. They will cut projected spending by a good deal more. Even though the total advertised spending cuts of $130 billion for 1985 — including such questionable items as $16 billion of unspecified "management savings" and $56 billion of savings from lower interest payments — appear exaggerated, the compromise was significant. It will bring about a substantial reduction in the 1984-85 deficits. Equally important, it represents a significant retreat by President Reagan from his previous adamant opposition to tax increases and modest cuts in the defense buildup. As modified by Congress, real defense purchases are now scheduled to rise just under 6% this year, about 6½% next year, and 7% in 1984.

With these changes factored in, what are the near-term prospects for the budget deficit?

- For fiscal 1982, just ended, the budget deficit will turn out to be slightly above the $105 billion we projected in this letter last February.
- For fiscal 1983, CBO projects the deficit at $155 billion, or $51 billion more than Congress had estimated. Part of the CBO adjustment comes from a more realistic assessment of likely expenditure savings from the recent budget compromise. About half of the difference comes from less optimistic assumptions about the path of the economy and interest rates.
- Given our even more pessimistic economic assumptions than those of CBO, we expect the 1983 deficit to be over $175 billion.

To gain more perspective on the fiscal policy dilemma and the budget-tightening moves that President Reagan will undoubtedly recommend in his budget message early next year, we should sort out how much of the deficit is a product of economic weakness, how much of it would persist at high employment, and what year-to-year changes are taking place.

- The bulk of the fiscal 1983 deficit is a child of the recession. If the economy were humming along at high employment, the deficit would be running, not at $175 billion, but at $40 billion, or 1% of GNP.
- If high employment were defined as 6.5% unemployment rather than the 5.6% we use, the 1983 high-employment deficit would be about $65 billion. It is worth noting, however, that the particular definition of high employment is not of great significance for measuring the impact of fiscal policy. It is the *swing* toward higher or lower deficits rather than the *level* of those deficits that measures the degree of fiscal stimulus or fiscal restriction.
- The swing toward deficits now projected for fiscal 1984 and 1985 after adjustment for the recent budget compromise is no longer very dramatic. The high-employment deficit moves up from 1% of GNP this year to 1.7% in those years.

How does this swing compare with other major swings toward high-employment budget deficits in the past 20 years?

- The first swing occurred with the buildup in Vietnam War spending under President Johnson. From a high-employment surplus averaging 0.7% of GNP in 1962-64, the budget moved into a high-employment deficit of 1.7% in 1967-68, a swing of 2.4 percentage points. This stimulated an economy already at full employment and is a well-documented example of perverse and inflationary fiscal policy.
- The next big swing, under President Nixon, was from a 0.1% surplus in 1969-70 to a 0.9% deficit in 1971-72, a shift that helped pull the economy back to full employment from a mild recession.
- The third swing, under President Ford, was a shift from a 0.6% high-employment deficit in 1973-74 to a 1.3% deficit in 1975-76. Again, this was a response to the steep recession that followed the first OPEC oil price explosion, a response that helped initiate recovery. It was a move in the right direction and was followed by a return to virtual high-employment balance in the budget under President Carter in fiscal 1979.

The swing we now project is no greater than those in the early and mid-seventies. It is scheduled to occur in an economy characterized by huge excess capacity and unemployment. While hewing to the goal of eliminating the high-employment deficit in the longer run, the White House and Congress should take care not to do too much too soon. As implied earlier, we do not want to slam on the brakes just when the economy is beginning to move again.

CONCLUSION

As our reappraisal of economic prospects makes clear, we believe that the odds on an economic recovery starting in the second half of this year have dropped considerably and that the odds on recession continuing into 1983 have correspondingly risen. To some extent, we are in uncharted waters, for the combination of a deep slump and high real interest rates has no precedent since the start of the Great Depression of the 1930s (when prices declined). All in all, then, there is considerable uncertainty and unease surrounding today's economic outlook.

But even if our best estimates prove too pessimistic, the balance of risks clearly favors policies to fight recession and support expansion. Even the rosy forecasts by the White House and Treasury project only a weak recovery and stubbornly high unemployment. And real progress has been made in bringing inflation to heel. So the case for shifting policy, especially Federal Reserve policy, to an expansionary stance now seems airtight.

As this is written, the indications are that the Fed has decided not to constrain the money supply during the current period of churning among various money market instruments. This could be just a short-term adjustment. But a number of observers believe that it may signify that the Fed is backing away from its exclusive emphasis on the monetary aggregates and shifting to a more accommodative posture. If this were to bring interest rates down substantially from current levels, we would project a considerably less bleak outlook for the U.S. economy.

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M I P T: U.S. MONETARY POLICY

FOLLOWING ARE EXCERPTS FROM MR VOLKER'S INFORMAL TALK TO THE BUSINESS COUNCIL ON 9 OCT 1982. BEGINS:

AS YOU KNOW, YESTERDAY WE MADE A FURTHER REDUCTION IN THE DISCOUNT RATE TO 9-1/2 PERCENT. AS IS USUALLY THE CASE, THAT CHANGE WAS, IN AN IMMEDIATE SENSE, DESIGNED TO MAINTAIN AN APPROPRIATE ALIGNMENT WITH SHORT-TERM MARKET RATES. IT WAS, OF COURSE, ALSO TAKEN AGAINST A BACKGROUND OF CONTINUED SLUGGISHNESS IN BUSINESS ACTIVITY, THE EXCEPTIONAL RECENT STRENGTH OF THE DOLLAR ON THE EXCHANGE MARKETS, AND INDICATIONS OF STRONG DEMANDS FOR LIQUIDITY IN SOME MARKETS.

IN THE LIGHT OF ALL THE POTENTIALLY CONFUSING COMMENT IN THE PRESS IN RECENT DAYS, WHICH SEEMED TO BE BASED ON A COMBINATION OF PARTIAL INFORMATION AND REPORTORIAL SPECULATION, IT MAY BE DESIRABLE TO REITERATE WHAT SEEMS TO ME OBVIOUS: THE SMALL REDUCTION IN THE DISCOUNT RATE - AS IN THE CASE OF THE FOUR CHANGES OF SIMILAR MAGNITUDE IN JULY AND AUGUST - REPRESENTS NO CHANGE IN THE BASIC THRUST OF POLICY.

IN ASSESSING ECONOMIC AND FINANCIAL DEVELOPMENTS OVER RECENT MONTHS, I WOULD ALSO POINT OUT AGAIN WHAT I HAVE SAID ON A NUMBER OF OCCASIONS BEFORE: THERE IS GROWING EVIDENCE THAT THE INFLATIONARY MOMENTUM HAS BEEN BROKEN. INDEED, WITH APPROPRIATE POLICIES, THE PROSPECTS APPEAR GOOD FOR CONTINUING MODERATION OF INFLATION IN THE MONTHS AND YEARS AHEAD. CONTINUING PROGRESS TOWARD RESTORING PRICE STABILITY IS AN ESSENTIAL PART OF BUILDING A SOLID BASE, NOT JUST FOR RECOVERY BUT FOR SUSTAINING EXPANSION OVER A LONG PERIOD. CONCERN ABOUT INFLATION, AND MONETARY DISCIPLINE, IS NOT SOMETHING WE CAN TURN ON AND OFF: IT WILL BE A CONTINUING PRIORITY CONCERN OF POLICY.

WHAT DOES INEVITABLY CHANGE IS THE FINANCIAL AND BUSINESS ENVIRONMENT IN WHICH WE OPERATE. UNFORTUNATELY FROM THE STANDPOINT OF REPORTING AND COMMUNICATION, THE CONTINUING THRUST OF MONETARY POLICY CANNOT BE ADEQUATELY MEASURED BY ANY SINGLE OR SIMPLE SYMBOL. HEADLINES CAN BE MISLEADING.

/I HOPE

I HOPE WE HAVE ALL LEARNED THAT THE LEVEL OR DIRECTION OF INTEREST RATES IS NOT, BY ITSELF, A RELIABLE TEST OF ''EASE'' OR ''RESTRAINT'' - IT ALL DEPENDS UPON THE CIRCUMSTANCES. LOWER INTEREST RATES IN AN ECONOMY IN RECESSION ARE NOT UNUSUAL, AND ARE CONSISTENT WITH THE NEED FOR RECOVERY. BUT LOWER INTEREST RATES DO NOT IN THEMSELVES INDICATE A CHANGE IN BASIC POLICY APPROACH. OVER LONGER PERIODS OF TIME, ACHIEVING AND MAINTAINING THE LOWER LEVEL OF INTEREST RATES WE WOULD ALL LIKE TO SEE MUST, IN A SENSE, BE A REWARD FOR SUCCESS IN DEALING WITH INFLATION: ARTIFICIALLY FORCING THE PROCESS WOULD IN THE END BE COUNTER-PRODUCTIVE. WHAT IS NEEDED IS MARKET CONVICTION THAT THE FUNDAMENTALS ARE CONSISTENT WITH LOWER INTEREST RATES, AND I BELIEVE THAT IS WHAT WE HAVE BEEN SEEING FOR SOME MONTHS.

THE EMPHASIS ON MONETARY AND CREDIT AGGREGATES IN CONDUCTING AND INTERPRETING POLICY DURING RECENT YEARS IS, OF COURSE, USEFUL IN PART BECAUSE OF THE UNRELIABILITY OF INTEREST RATE MEASURES IN GAUGING THE NECESSARY DEGREE OF RESTRAINT. WE EXPRESS POLICY IN TERMS OF BROAD TARGETS FOR THE VARIOUS DEFINITIONS OF MONEY ON THE BASIC THESIS THAT, OVER TIME, THE INFLATIONARY PROCESS IS RELATED TO EXCESSIVE GROWTH IN MONEY AND CREDIT. BUT YOU HAVE ALSO HEARD ME REPEATEDLY EXPRESS CAUTION ABOUT THE VALIDITY OF ANY SINGLE MEASURE, OR EVEN ALL THE MEASURES IN THE SHORT RUN. WE HAVE TO BE ALERT TO THE POSSIBILITY THAT RELATIONSHIPS MAY BE DISTURBED BY TECHNOLOGICAL OR REGULATORY CHANGES IN BANKING, OR MORE BROADLY BY SHIFTS IN LIQUIDITY PREFERENCES AND VELOCITY.

WE FACE OVER THE NEXT FEW MONTHS, NOT JUST THE POSSIBILITY BUT THE VIRTUAL CERTAINTY OF DISTORTIONS -- DISTORTIONS GROWING OUT OF LEGISLATION AND REGULATION - IN THE M1 NUMBER THAT IS SO WIDELY FOLLOWED IN THE MARKETS.

(TECHNICAL SENTENCES ON DISTORTIONS OMITTED. SEE PARAGRAPH 4 OF MIPT)

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IN THE CIRCUMSTANCES, I DO NOT BELIEVE THAT, IN ACTUAL IMPLEMENTATION OF MONETARY POLICY, WE HAVE ANY ALTERNATIVE BUT TO ATTACH MUCH LESS THAN USUAL WEIGHT TO MOVEMENTS IN M1, OVER THE PERIOD IMMEDIATELY AHEAD. WE WILL, OF COURSE, ANALYZE THE DATA CAREFULLY TO ASSIST US IN ASSESSING UNDERLYING TRENDS, BUT IT IS LIKELY TO TAKE SOME MONTHS BEFORE NEW RELATIONSHIPS CAN BE JUDGED WITH ANY DEGREE OF RELIABILITY IN A WORLD OF RADICALLY NEW DEPOSIT INSTRUMENTS WITH TRANSACTIONS CAPABILITY.

FORTUNATELY, WHILE THE M2 AND M3 AGGREGATES MAY ALSO BE AFFECTED BY THE NEW DEPOSIT INSTRUMENTS, THE IMPACT SHOULD BE RELATIVELY MUCH LESS. THOSE AGGREGATES ARE NOT ONLY MUCH LARGER, BUT MOST OF THE SHIFTS AMONG FINANCIAL INSTRUMENTS ARE EXPECTED TO TAKE PLACE WITHIN THOSE LARGE AGGREGATES.

(TECHNICAL SENTENCES ON DISTORTIONS OMITTED).

/ THE FACT

THE FACT THAT, FOR THE TIME BEING, UNDERLYING MONETARY GROWTH AND RESERVE PROVISION CANNOT SENSIBLY BE GAUGED BY DIRECTLY OBSERVING MOVEMENTS IN M1 - UP OR DOWN - IS A TECHNICAL FACT OF LIFE: IT HAS NO BROADER POLICY SIGNIFICANCE.

IT IS TRUE THAT FOR SOME TIME (BEFORE THE NEW DISTORTIONS THAT WILL BE INDUCED BY LEGISLATION AND REGULATION) THE VARIOUS MONETARY AGGREGATES HAVE IN GENERAL BEEN SOMEWHAT ABOVE THE GROWTH PATHS TARGETED FOR THE YEAR. I WOULD ALSO POINT OUT, THOUGH, THAT INDICATIONS SUGGEST AN APPRECIABLE RECENT SLOWING IN GROWTH OF BOTH M2 AND M3, AND IT SO HAPPENS -- PERHAPS FORTUITOUSLY -- THAT LAST WEEK'S M1 FIGURE IS VERY CLOSE TO TARGET. THAT IS PART OF THE SETTING OF THE DISCOUNT RATE CHANGE.

YOU MAY RECALL THAT, WHEN REITERATING OUR ANNUAL TARGETS IN JULY, I EMPHASIZED THAT ''GROWTH SOMEWHAT ABOVE THE TARGETED RANGES WOULD BE TOLERATED FOR A TIME IN CIRCUMSTANCES IN WHICH IT APPEARED THAT PRECAUTIONARY OR LIQUIDITY MOTIVATIONS, DURING A PERIOD OF ECONOMIC UNCERTAINTY AND TURBULENCE, WERE LEADING TO STRONGER THAN ANTICIPATR DEMANDS FOR MONEY. WE WILL LOOK TO A VARIETY OF FACTORS IN REACHING THAT JUDGEMENT, INCLUDING SUCH TECHNICAL FACTORS AS THE BEHAVIOR OF DIFFERENT COMPONENTS IN THE MONEY SUPPLY, THE GROWTH OF CREDIT, THE BEHAVIOR OF BANKING AND FINANCIAL MARKETS, AND MORE BROADLY, THE BEHAVIOR OF VELOCITY AND INTEREST RATES.'' I BELIEVE REASONED ASSESSMENT OF RECENT DEVELOPMENTS IN THE LIGHT OF THOSE FACTORS DOES SUGGEST THAT PREFERENCES FOR LIQUIDITY HAVE GENERALLY BEEN RELATIVELY STRONG, REFLECTED IN PART IN SOME ABNORMAL PRESSURES IN PARTS OF THE PRIVATE CREDIT MARKETS. IN THAT LIGHT, THE FACT THAT SOME OF THE AGGREGATES HAVE TENDED TO RUN SOMEWHAT ABOVE THEIR TARGET RANGES HAS BEEN FULLY ACCEPTABLE TO THE FEDERAL OPEN MARKET COMMITTEE.

I BELIEVE I CAN SPEAK FOR ALL MEMBERS OF THE COMMITTEE IN SAYING THAT THOSE JUDGMENTS HAVE BEEN REACHED, AND WILL CONTINUE TO BE REACHED, IN FULL RECOGNITION OF THE NEED TO MAINTAIN THE HEARTENING PROGRESS TOWARD PRICE STABILITY. ENDS.

SOURCE: THE FEDERAL RESERVE BOARD.

F C O PL ADVANCE TO BOTTRILL (TREASURY) AND TO WATSON (BANK OF ENGLAND).

(ADVANCED AS REQUESTED)

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COPIES TO:-
MR BOTTRILL - TREASURY
MR WATSON - B/ENGLAND

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A SHIFT IN US MONETARY POLICY?

SUMMARY

1. FINANCIAL MARKETS AND COMMENTATORS HERE HAVE INTERPRETED THE OUTCOME OF LAST WEEK'S MEETING OF THE FEDERAL RESERVE'S MAIN POLICY COMMITTEE (THE FEDERAL OPEN MARKET COMMITTEE), AND THE REDUCTION IN FEDERAL RESERVE BOARD'S DISCOUNT RATE FROM 10 PER CENT TO 9 1/2 PER CENT, AS A SIGNIFICANT RELAXATION IN US MONETARY POLICY, AT LEAST IN THE SHORT RUN. HOWEVER, OPINION IS DIVIDED ON THE IMPORTANCE OF THE CHANGE FOR THE MEDIUM TERM. CHAIRMAN VOLCKER, IN A SPEECH LAST SATURDAY, SAID THAT NO CHANGE IN THE BASIC THRUST OF POLICY HAS BEEN MADE, BUT THAT TECHNICAL FACTORS MADE IT APPROPRIATE TO ATTACH ''MUCH LESS THAN USUAL WEIGHT'' TO THE MAIN MONETARY AGGREGAT M1 IN THE PERIOD AHEAD AND TO MOVE TO A WIDER RANGE OF INDICATORS, ESPECIALLY M2 AND M3, IN JUDGING THE STANCE OF MONETARY POLICY. IT APPEARS TO MANY COMMENTATORS AS IF THE FED, AT LEAST IN THE WEEKS RUNNING UP TO THE 2 NOVEMBER CONGRESSIONAL ELECTIONS, AND PERHAPS UNTIL AN ECONOMIC RECOVERY GETS UNDER WAY, WILL CHOOSE TO ERR ON THE SIDE OF ACCOMMODATING UPWARD MOVEMENTS IN THE MONETARY AGGREGATES RATHER THAN RISK A SIGNIFICANT REVERSAL OF THE RECENT DECLINES IN INTEREST RATES.

DETAIL

2. DURING HIS ANNUAL HUMPHREY-HAWKINS TESTIMONY TO CONGRESS LAST JULY, CHAIRMAN VOLCKER SAID THAT MONETARY GROWTH ''SOMEWHAT ABOVE THE TARGETED RANGES WOULD BE TOLERATED FOR A TIME IN CIRCUMSTANCES IN WHICH IT APPEARED THAT PRECAUTIONARY OR LIQUIDITY MOTIVATIONS, DURING A TIME OF ECONOMIC UNCERTAINTY OR TURBULENCE, WERE LEADING TO STRONGER THAN ANTICIPATED DEMANDS FOR MONEY''. SUBSEQUENTLY, THE MAIN MONETARY AGGREGATE M1 ROSE ABOVE ITS TARGET RANGE, AND THERE WAS A GENERAL DECLINE IN INTEREST RATES, ESPECIALLY IN SHORT-TERM MARKET RATES. THERE HAS RECENTLY BEEN SPECULATION ABOUT WHETHER AND WHEN THE FED WOULD ADOPT A MORE RESTRICTIVE STANCE TO BRING MONETARY GROWTH IN LINE WITH THE TARGET RANGES.

RESTRICTED

/3.

3. AT LAST WEEK'S FEDERAL OPEN MARKET COMMITTEE (FOMC) MEETING, A DECISION APPARENTLY WAS TAKEN TO CONTINUE TO IMPLEMENT MONETARY POLICY IN LINE WITH VOLCKER'S JULY STATEMENT, DESPITE RECENT MONETARY GROWTH ABOVE THE TARGET RANGES. THE EFFECT OF THE LEAKS FOLLOWING THE MEETING WAS TO CONTRIBUTE TO A FURTHER DECLINE IN INTEREST RATES. INTEREST RATES ON 3-MONTH TREASURY BILLS ARE NOW ABOUT 8 PER CENT AND ON LONG-TERM TREASURY BONDS LESS THAN 11 PER CENT. THE BANKS' PRIME RATES WERE REDUCED LAST WEEK FROM 13 1/2 PER CENT TO 13 PER CENT. THERE HAS BEEN A DRAMATIC UPSWING IN THE EQUITY MARKETS, AND THE DOW-JONES INDUSTRIAL AVERAGE ON THE NEW YORK STOCK EXCHANGE HAS RISEN ABOVE 1000. CHAIRMAN VOLCKER HAS BEEN ABLE TO EXPLAIN THE REDUCTION IN THE FED'S DISCOUNT RATE LAST FRIDAY FROM 10 PER CENT TO 9 1/2 PER CENT AS ''MAINTAINING AN APPROPRIATE ALIGNMENT WITH SHORT-TERM MARKET RATES''. AT LEAST SOME PART OF THE DECLINE IN MARKET RATES WAS ITSELF BECAUSE OF MARKET SPECULATION ABOUT THE OUTCOME OF TUESDAY'S FOMC MEETING.

4. AS WELL AS THE DECLINE IN US INFLATION: THERE WERE TWO TECHNICAL REASONS FOR THE FOMC DECISION THAT WERE CITED BY VOLCKER IN HIS SPEECH TO THE BUSINESS COUNCIL AT HOT SPRINGS ON 9 OCTOBER (EXCERPTS FROM THE SPEECH ARE CONTAINED IN MIFT). FIRST, THE MATURATION OF DOLLARS 31 BILLION IN ''ALL SAVERS'' CERTIFICATES ISSUED BY THE SAVINGS AND LOANS ASSOCIATIONS LAST YEAR, A LARGE PART OF THE PROCEEDS FOR WHICH WILL TEND ARTIFICIALLY TO INCREASE THE GROWTH OF M1. SECOND, THE INTRODUCTION IN A COUPLE OF MONTHS' TIME OF MONEY MARKET-TYPE DEPOSITS AT BANKS AND SAVINGS AND LOANS ASSOCIATIONS, WHICH WILL ALSO HAVE A DISTORTING EFFECT (ALTHOUGH WHETHER THIS WILL INCREASE OR DECREASE M1 IS UNKNOWN).

5. COMMENTATORS HERE HAVE WIDELY INTERPRETED THE FOMC DECISION AS GOING BEYOND A TECHNICAL ADJUSTMENT. THEY POINT OUT THAT SOME FED GOVERNORS, INCLUDING VOLCKER, HAVE REPEATEDLY VOICED THEIR CONCERN ABOUT THE CONTINUING SOFTNESS OF THE US ECONOMY, THE FINANCIAL WEAKNESS OF US COMPANIES AND FINANCIAL INSTITUTIONS, AND THE POTENTIAL INSTABILITY OF THE WORLD FINANCIAL SYSTEM. THE IMMINENCE OF THE CONGRESSIONAL ELECTIONS ON 2 NOVEMBER IS ALSO ADDUCED AS A FACTOR WHICH MIGHT HAVE MADE THE FOMC DECIDE TO ERR ON THE SIDE OF ACCOMMODATION RATHER THAN TIGHTNESS IN THE COMING WEEKS.

6. SOME COMMENTATORS APPEAR TO EXAGGERATE THE CHANGE. THERE IS NO INDICATION THAT THE FED HAS DEPARTED FROM THE POLICY INTRODUCED IN OCTOBER 1979 OF TARGETING THE MONETARY AGGREGATES RATHER THAN INTEREST RATES. NOR DOES IT SEEM TO BE ENGAGED IN AN AGGRESSIVE CAMPAIGN TO BRING DOWN INTEREST RATES AT ALL COSTS. BUT THE FED MAY FIND IT DIFFICULT TO REVERSE ITS RELAXED STANCE UNTIL THERE ARE MORE DEFINITE INDICATIONS OF AN UPTURN IN THE US ECONOMY. ITS MONETARY STANCE WILL PROBABLY CONTINUE TO EVOLVE IN THE LIGHT OF DEVELOPMENTS IN THE ECONOMY AND FINANCIAL MARKETS.

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

WRIGHT

[ADVANCED AS REQUESTED)

MONETARY
NAD
ERD
NEWSD

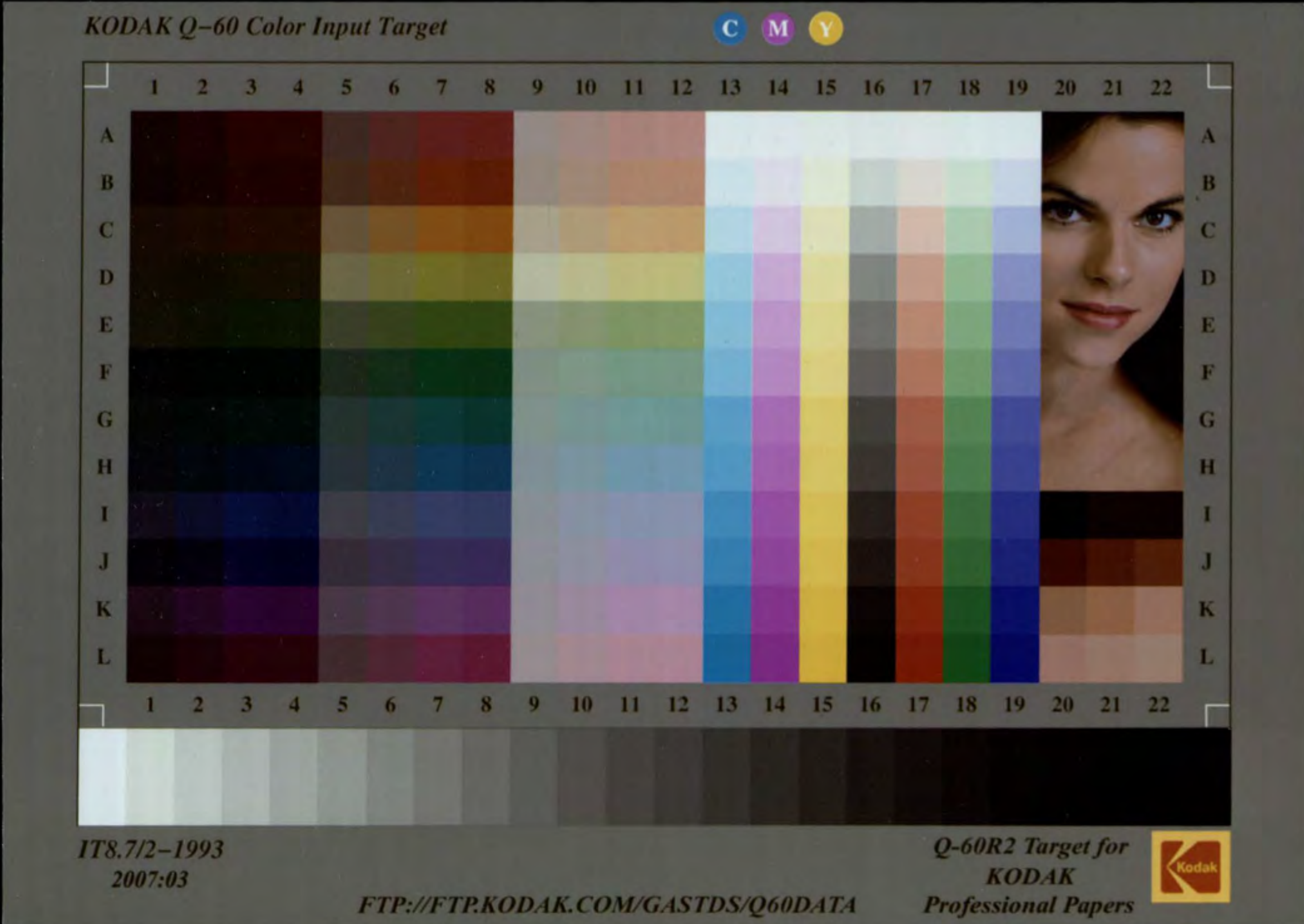
COPIES TO:-
MR BOTTRILL - TREASURY
MR WATSON - B/ENGLAND

PART 1 ends:-

mes to Industry 30/9

PART 2 begins:-

Washington tel: 3320 12/10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