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Meeting with Marty FELDSTEIN, Chairman of Council of ECONOMIC Advisers in Washington.

PRIME MINISTER

March 1984.

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~14.3.84~~ ~~26.4.84~~ ~~27.4.84~~ 11.1.88							

PREM 19/2416

Tessa

5/00 pm.

Fixed with Feldstein's office for 5.00 pm.

PAG 12/1

PRIME MINISTER

POSSIBLE MEETING WITH MARTIN FELDSTEIN

Alan Walters rang this evening to say that Martin Feldstein would be in London this Thursday, 14 January, and recommending that you might arrange to see him during the day. Apparently Feldstein's views on U.S. policy tally closely with those which Alan gave you on Saturday.

Thursday is, of course, a difficult day for you.* Do you want to fit in a very short meeting, say in late afternoon, or would you prefer me to ring Feldstein and say that, regrettably, Thursday is extremely difficult for you?

Yes not

* Alan had not realised the House had returned.

PAG.

Paul Gray

11 January 1988

DG2CMQ

SUBJECT
cc Master.

CONFIDENTIAL

1 cc ~~Dw Mells~~
2 US file

NOTE OF A MEETING BETWEEN THE PRIME MINISTER AND DR. FELDSTEIN HELD AT 10 DOWNING STREET ON 27 APRIL 1984 AT 1100 HOURS

The Prime Minister asked Dr. Feldstein for his assessment of the current position on the US federal deficit. The US had many advantages - it was a haven of last resort for world currencies, it had no socialist party, the enterprise culture was still strong and its geographical position favourable - which meant a deficit of this size might be less damaging.

Dr. Feldstein said the prospects for the federal deficit had turned round remarkably in the last few months. He was unable to date this change in climate precisely but Congress had returned after Christmas with a greater sense of urgency and had responded to the President's state of the union message. There was now all-party agreement that a package of deficit reducing measures should be implemented and it was possible this could even be agreed before the Summit. The President had proposed a package of $150b. over the next three years. The Democrats' package was similar in size, the only difference being the distribution of savings between defence and non-defence expenditure.

Dr. Feldstein thought the package would make a significant contribution to the problem. It was not simply $50b. each year but comprised $25b. in 1985, $50b. in 1986, $70b. in 1987, rising to $90b. by the end of the decade. If the objective were to reduce the deficit to near zero these figures would contribute one-third to one-half of the change needed. It was helpful that the package was referred to as a "down payment" as this implied a commitment to more in 1985. He thought that financial markets had not fully taken account of the improved prospects and that, in consequence, there was still some improvement in sentiment still to come.

Though this should help to bring down long rates, Dr. Feldstein thought that in the near term, short-term rates could still rise. This would have implications for international indebtedness since foreign borrowings were priced in relation to short-term interest rates. At the moment the international debt situation was delicately balanced. The position of Brazil and Mexico was improving, and this would set an example to Argentina. Countries were prepared to accept the process of adjustment so long as they appeared to be making progress. A sharp rise in interest rates could set this back. For example, a 1 per cent rise in interest rates would cost Brazil $700m. a year. If debtor countries lost heart they could be tempted to default. He suggested establishment of an automatic mechanism which would provide additional lending if interest rates rose. This would be rather like the provision for extending the repayment of mortgages.

The Prime Minister said that the sale of assets and the encouragement of inward investment had been proposed as a way of easing the debt crisis. She doubted whether this could make a large contribution as there would be the delicate problem of political control to be overcome. She regarded the proposal under which banks would sell part of their loan portfolio as a way of putting a value on the rest, as more promising. If the value of a country's debt were very low the debtor would have an incentive to redeem it.

Dr. Felstein said that monetary control was being maintained in the United States and inflation being held down. Interest rates were being allowed to rise, thereby avoiding monetisation of the debt. The Prime Minister mentioned that HMG had introduced index-linked bonds. Although they were not selling well at present because inflationary expectations were low they provided a useful protection should expectations deteriorate. Dr. Felstein said he had advocated such bonds in the US.

/The Prime Minister

The Prime Minister said she had welcomed the details produced by OECD on the burden of social expenditure in the industrial countries, but felt the response at the seminar had been disappointing. Dr. Feldstein thought that four or five of the Summit countries might be prepared to acknowledge the existence of this problem.

The discussion then turned to fiscal policy. Dr. Feldstein said the President had asked for radical proposals to be put to him after the election. These would include a VAT which would operate in addition to the sales taxes levied by the states. There were two objections. First, that VAT was a very effective tax and would weaken the defence against proposals for higher expenditure. Secondly, it would be seen as pre-empting the revenue base of the states. The Prime Minister recounted the history of VAT in the UK. She felt that the current rate of 15 per cent was close to the maximum and that while there was some scope for extending the coverage this could not go too far before hitting the difficult problem of food.

Dr. Feldstein observed that UK policy was directed towards raising the threshold of income tax. While there were arguments in favour of this there were arguments against as it created a class of people for whom all public services appeared to be free. The Prime Minister accepted this but pointed out that national insurance contributions still provided a close link with the value of benefits.

Dr. Feldstein noted that the divorce of responsibility for finance from the point of delivery in health care had contributed to the soaring costs in the US. The difficulty lay with hospital costs rather than the salaries of physicians. 90 per cent of hospital bills were now covered by public or

 /private

private insurance. He mentioned two measures to constrain the cost to the Government which were unlikely to be enacted in the near future but which might be returned to after the election. The first was to impose a small hotel charge in hospitals, the second was to treat insurance benefits over $175 a month as taxable income.

The Prime Minister asked about progress of unitary taxation. Dr. Feldstein thought that a so-called "water's edge" solution would be reached though the deadline of 1 May might be missed. The problem was that the states felt themselves vulnerable to the power of multinational companies to manipulate the location of profits. One possible solution was for the federal authorities to assist the states in identifying local profits.

The Prime Minister asked about President Reagan's prospects for re-election. Dr. Feldstein said these were good; the economy was doing well, consumer sentiment was the best since the middle '60s, Mr. Mondale was not an attractive candidate and had no campaign issue and the President's rating was good. The only possible obstacles would be trouble in Central America or rumours about the President's health. He thought a big win was essential for the President in order to give him a mandate to face what would inevitably be a Democrat controlled House.

The Prime Minister reported on the progress made in tackling the problems of the CAP. While the recent settlement was hailed as a major advance it, too, was only a down payment as surpluses remained for many products. The problem of the sharing of budget costs remained to be settled.

/The Prime Minister

The Prime Minister and Dr. Feldstein agreed that if asked publicly about their meeting they would say they had spoken about developments in the US economy. The US Government was now tackling the problem of the deficit and the prospects for an agreed deficit reduction package were now good. This would restore confidence in markets and be helpful in restraining interest rates in the US and abroad.

AT

27 April 1984

Prime Minister

AT 26/4

26 April 1985

MR ~~TURNBULL~~

MARTY FELDSTEIN'S VISIT

Dr Marty Feldstein, Chairman of the President's Council of Economic Advisers since August 1982, is calling on the Prime Minister at 10.45am tomorrow. (A personality note is at Annex A.) He is also calling on John Moore in the Treasury, and visiting the Bank of England.

1. The US Economy - the Good News

The recovery is continuing. GDP has grown 7.5 per cent over the past 12 months. After a surge at the beginning of the year, the rate of growth may now be easing off. The Administration expects growth of 5.5 per cent during 1984 and 4 per cent next year.

The main impetus for the recovery came at first from consumers' expenditure. Consumers are still better off. Late in 1982 and in 1983, shares and house prices went up. Increased wealth encourages more spending. The series of personal income tax cuts have increased their spending power, and more jobs have boosted total incomes. Business investment began to recover late last year as companies responded to this increase in private consumption. Increased tax allowances also helped. This should sustain the recovery.

Inflation is now down to 4.5 per cent compared with 10 per cent in 1981 (and having fallen as low as 2.5 per cent late last year because of special factors). But the decline in inflation may now be over.

The jobs market has performed much better in the US than here or in the rest of Europe. An extra 4 million jobs have been created in the past year, with unemployment falling from 11 per cent in late 1982 to 7.75 per cent now. These jobs have emerged because real wages have been held down, matching the poor performance of productivity in the US. And the labour market is now flexible in other ways - workers are more willing to move to the sunbelt areas, where the jobs are, unionisation, at 25 per cent, is very low by OECD standards, and there is no pronounced benefit unemployment trap.

2. The US Economy - the Bad News

The budget and trade deficits are both massive.

The budget deficit almost doubled last fiscal year to $195 billion, or 6 per cent of GDP. This year, the Administration expects it to be about $184 billion, or 5.5

LARAAO

E.R.

per cent of GDP. And on the Administration's own optimistic assumptions, the deficit stays at about $200 billion a year (slowly falling to 4.5 per cent of GDP) over the rest of the decade. The Congressional Budget Office, which is pretty impartial, forecasts a deficit up to $325 billion by 1989 using less optimistic assumptions about growth and interest rates. In particular, if interest rates do not fall as much as the Administration hopes, spiralling debt service costs will mean that the deficit feeds on itself. Annex B describes the current state of the Budget negotiations.

The federal deficit holds up interest rates, especially when combined with rising private sector credit demand, because of strong growth. Interest rates have risen by over 1.5 per cent in the year to end March, and now stand at about 10.5 per cent. Long bond yields are now over 12.5 per cent. We are now in the virtually unprecedented position where UK interest rates are lower than in the US. There are indications that the Fed is willing to run a firm monetary policy and accept higher rates, possibly causing the recovery to slow down rather than rising. So far this year, M1 and M2 have grown at an annual rate of around 6 per cent compared to their targets of 4-8 per cent and 6-9 per cent respectively. M3 is towards the top of its 6-9 per cent target.

The trade deficit stood at $70 billion in 1983, and is officially projected to be $110 billion this year. The simplest explanation of the deficit is that it reflects the over-valuation of the dollar, which is in turn attributable to high interest rates and capital flows.

3. Points for Discussion

The Federal Deficit. The Prime Minister may not want to be too harsh a critic of President Reagan's policies, either in public or in private, during his election year. On the other hand, Marty Feldstein is more sympathetic to European worries about the deficit than other members of the Administration, and should not be discouraged. It is important to get the right balance between fiscal and monetary policy in the US, otherwise interest rates will remain high and possibly rise further. What result does Marty Feldstein expect to emerge from the current Budget negotiations? What does he expect to happen to US interest rates? Is he worried about impact of rising US rates on international debt problem?

Labour Market. The performance of the US labour market has been impressive. What lessons are there for the UK?

Economic Summit. Sherpas are hard at work preparing for the Summit discussions? Will the US assist in the removal of Summit. But does he have any particular suggestions for the

LARAAO

tariff and non-tariff barriers to trade, a vital matter for world prosperity? It might be an opportunity to reaffirm the UK's strong line on this matter.

Tax Reform. This is a topical issue in the US Administration at present, and Dr Feldstein might raise it. Mr Regan is supposed to be reporting to the President by the end of this year on possible reform, particularly a move towards more indirect taxation. This would match the UK approach, but there are considerable differences in the approach to corporate taxation. The US has recently increased capital allowances - the opposite of Nigel Lawson's measures. This difference is probably best explained in terms of the special features of the two economies. In the US, the labour market performs well, and the worries are about iniadequate capital investment and very sluggish productivity. In the UK, we have been giving tax subsidies to labour-saving capital investment, regardless of its profitability, when we have a major employment problem.

DLW

DAVID WILLETTS

LARAAO

ANNEX A

PERSONALITY NOTE ON DR MARTIN FELDSTEIN, CHAIRMAN OF THE PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

Dr Martin Feldstein was born in 1939 in New York. He graduated from Harvard in 1961. Dr Feldstein was a research fellow and lecturer at Nuffield College Oxford where he received his D. Phil in 1967. Since then he has been a Professor of Economics at Harvard. He has taken a two year leave of absence. He was President of the National Bureau of Economic Research a highly respected, private, non-partisan research body from 1977-1982.

2. Dr Feldstein was nominated to be a member and subsequently Chairman of the Council of Economic Advisers in August 1982 following the resignation of Murray Weidenbaum. Dr Feldstein appears to have had rather more impact within the Administration than the previous Chairman. But his public disagreements with Treasury Secretary, Regan over the effects of fiscal deficits on interest rates and other subjects have lessened his influence.

3. He has written extensively on taxes, the social security system, unemployment and the role of Government in the economy. In his book The American Economy In Transition, published in 1980 Feldstein attributed many of the problems of the deteriorating performance of the economy to government mismanagement of monetary and fiscal policies. Dr Feldstein has been a strong supporter of efforts to control and reduce Federal spending. More recently he has advocated tax increases as a way of reducing the Federal deficit.

25 April 1984

E.R.

ANNEX B

THE FEDERAL DEFICIT: CURRENT STATE OF NEGOTIATIONS

1. The Administration's draft budget to fiscal 1985 proposed \$100 billion cuts over the 3 years 1985-87 as a "down payment". This has been overtaken. Attention is now on two separate deficit reduction packages, one from each side of Congress.

2. The President and Republican Congressmen have now agreed a bigger package worth \$150 billion over 3 years which significantly allows for lower defence spending than planned in the budget, combined with larger cuts in non-defence expenditure and tax increases. Most of the savings, however, occur in fiscal years 1986-87. There is a disagreement simmering between Regan, who believes there is scope for further large cuts in non-defence expenditure, and Feldstein, who does not and has argued for tax increases (indexation of tax brackets starts in January 1985).

3. The Democrats' rival \$182 billion plan has greater defence cuts, but smaller reductions in other expenditure. Its other main feature is to tie increases in expenditure on defence, social security and automatic benefit entitlement programmes above 3.5 per cent in real terms, to additional tax increases.

4. A series of tax measures has already been passed by both Houses of Congress, and the Administration expects there to be a reconciliation soon. The legislative timetable dictates that Congress should agree a first budget resolution by 15 May. Despite the good intentions represented by these deficit reductions packages, the danger remains that pre-election pressures may still inhibit the necessary agreement. If none emerges, the next Administration's budget for fiscal 1986 may need to take much tougher measures and some form of major tax increase may be inevitable.

LARAAN

BF 22/3 AT

GR

PPS pte

(Linda's note)

D 15/3

1. MR. TURNBULL AT 14/3

2. PRIME MINISTER

Sir Alan Walters has telephoned to say that Mr. Marty Feldstein will be in London at the end of April. Sir Alan thinks that you might well like to see him. You could do so on Friday 27 April.

Agree I arrange for Mr. Feldstein to come in on that day?

Yes MT

Dmb

14 March 1984

Caroline

Could you please arrange this - ask AT if we shd invite the Chancellor.

Andrew.

Please let me know when you have fixed things up I need to tip off US Embassy. AT

10.45 - 11.45 FRI 27 April.

Dmb 16/3

a.w. will get.

ROSE

Alan rang on Friday. Can you:

1. Marty Feldstein, Chairman of Council of Economic Advisers in Washington, will be visiting London on April 26 pm and on 27th (all day). Alan thinks the PM would like to see him. Please set things in motion.

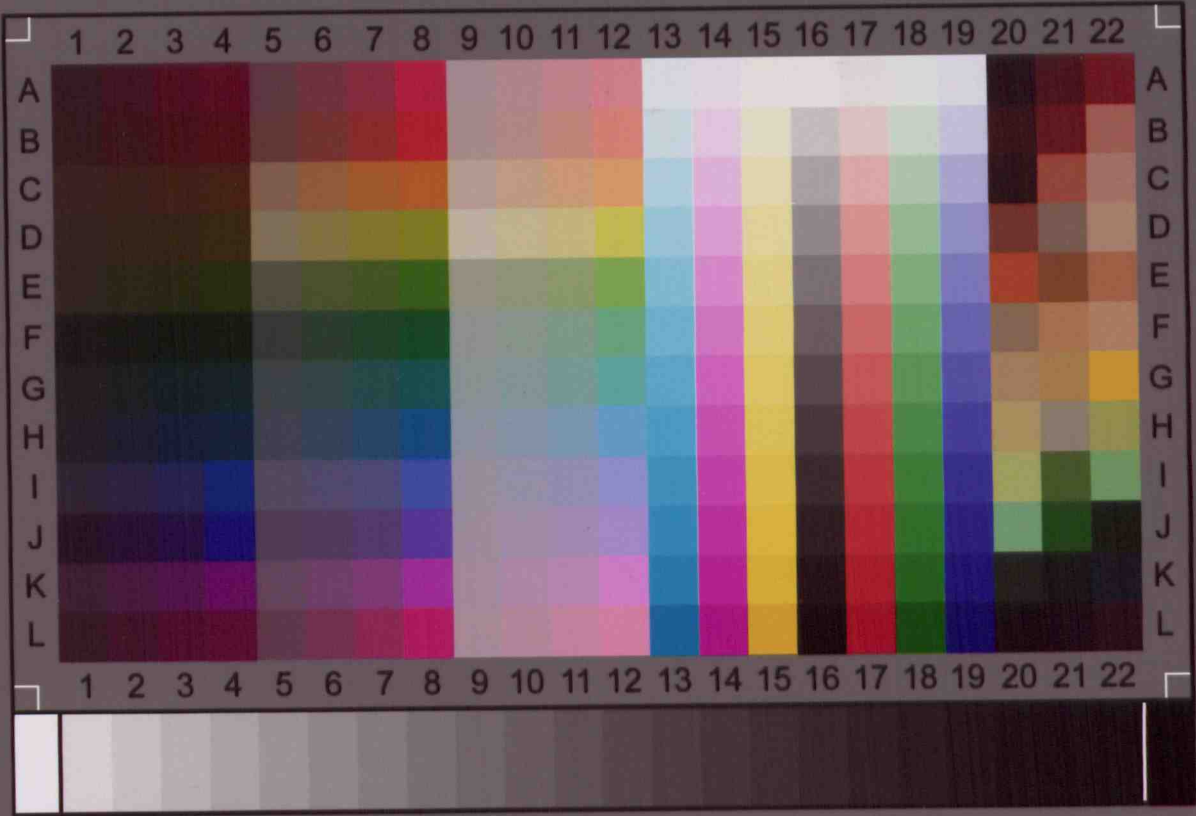
2. Ring his daughter and tell her to send Mr Horn, the accountant, details of her earnings.

LINDA

Andrew

I have agreed with Rose that you will put the proposition in 1 to the PM. She could do 1 hour at 11 am, or at 3 or 4 pm on Friday 27th.

Dave
14/3



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