

BACKGROUND NOTE

DEFICIT AND INTEREST RATES

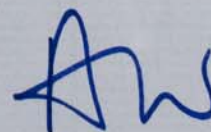
1. The argument of many commentators is that the high US deficits causes high US interest rates which in turn cause interest rates to be high in the rest of the world. In other words, our interest rates are determined by the US deficit.
2. The argument that US deficits cause high US interest rates is probably correct, but has been disputed because it is argued that the real deficits as a fraction of GNP are much lower than they appear and are not historically high. (Friedman, Kagan and Sprenkel.) They argue that high interest rates are largely due to erratic monetary policy and high inflationary expectations.
3. The belief that reducing the deficit through increases in taxation would bring down American interest rates is disputed since many would argue that the increased taxes would be paid primarily from people's savings. The supply of credit would be reduced parallel with the demand for it. There is some truth in this proposition.
4. A powerful group of advisers to the President argue that interest rates are high because there is a widespread belief that the Federal Reserve Board will be "forced" to adopt a more expansionary monetary policy as the slump deepens. Although the rate of inflation has declined dramatically in the United States, as a consequence of the Federal Reserve Board's squeeze, the experience of the seventies is being projected into the future. "When the going gets rough governments give up". The President's advisers argue that interest rates have come down and will decline further as markets become convinced that this administration will not give up.
5. It is much more difficult, however, to argue that high US interest rates require high interest rates in the rest of the world. The Americans will point to Japanese interest rates of about 6 per cent and German interest rates currently at about 8 or 9 per cent - both of these imply real interest rates of the order of 3 per cent, not at all high by long historical standards. The Americans may powerfully argue that Britain has successfully reduced and indeed can continue to reduce interest rates provided it does not at the same time wish to defend a high exchange rate against the dollar (cf Japan and Germany). Freedom of exchange rates implies substantial freedom

from the hegemony of American interest rates. Americans may also argue that, quite properly, we should fix our interest rates according to our domestic monetary policy, and not worry about the exchange rate.

The Political Factors

6. The President is known to his enemies as a very stubborn man and to his admirers as a man of principle. I doubt very much whether preaching to him that he ought to increase taxes, even if he thought the case was being put in good faith, would have any effect on his policy. It would be seen, however, as providing ammunition for the enemies of his policy, particularly in the House. It may do harm to the Alliance and it is very doubtful whether it would do any good. The President has been told by many eminent authorities that he cannot reduce federal spending any more. But this has been the message on each occasion when he has substantially reduced it. In that respect he has a better record than the UK Government.
7. It would be very damaging if, as was suggested at last Thursday's meeting, you tell the President that he should follow the example of Britain: when we found that we could not reduce public spending, we increased taxes in 1981. In the President's circles this is regarded at best as some sort of regrettable necessity in political terms. Britain accommodated the enlarged public sector instead of persisting in reducing it. He believes he must reduce it.
8. The President might properly reject advice on how to reduce his deficit as being uninformed and unwarranted interference. It will be recalled that in 1976 the IMF asked the Government to reduce the Budget deficit; it did not specify whether that was to be done by cutting spending or increasing taxes. And at that time the IMF were lending us money! In any case, we should not prejudge the sort of compromises which the President might reach in his battles with Congress.

1 June 1982



ALAN WALTERS

CONFIDENTIAL

PA. Mus 10/6

BRIEFING NOTE FOR THE PRIME MINISTER ON THE UNITED STATES DEFICIT  
INTEREST RATES AND TAXES

1. Wholehearted approval of the UK Government for the President's policy to:
  - (a) maintain tight control of the rate of growth of the money supply; and
  - (b) progressively reduce the federal budget deficit.

Reducing the rate of growth of the money supply will reduce inflation to the great benefit of the United States and the rest of the free world. Reducing the federal deficit, if it is achieved by reducing the rate of growth of federal spending, will provide capital and manpower for an expansion of the vigorous private sector in the United States - again to the great benefit of the rest of the world.

2. Only the President and his advisers can determine which is the best way in which to reduce the federal government deficit. The precise mixture of policy must be determined by the President's view of the economic, political, legal and constitutional needs of the United States. However, we do believe that the President is entirely correct in insisting that the best method of reducing the deficit is to reduce rate of growth of federal spending.

1 June 1982

ALAN WALTERS

CONFIDENTIAL