PRIME MINISTER'S VISIT TO WASHINGTON :
ECONOMIC INDUSTRIAL LUNCH : 26 FEBRUARY

1. The Amabassador opened the discussion by suggesting that it should concentrate on three areas. He would first invite the Prime Minister to give her prognosis for the UK economy. He would then welcome a contribution from the American guests, and particularly Secretary Regan, on the Administration's programme for the US economy and particularly on the time-scale within which they expected to see results. Thirdly, he thought it would be interesting to discuss how far governments should or should not take steps, outside the area of fiscal policy, to deal with industrial problems, particularly at a time of economic instability and of increasing competition from the newly industrialising countries.

2. The Prime Minister began by underlining three elements in the US economy which made it different from the UK. These were first that it had great underlying strength, based on free enterprise and risk-taking. Second, that it was not overburdened with nationally owned industry. Third, that the trade union factor in the US was quite different.

3. But there were a number of factors in common. Both economies had in recent years suffered an endemic tendency to inflation. If their politicians had been more strong-minded in carrying out their chosen policies, this inflation could have been avoided. But in Britain, the underlying rate of inflation had increased steadily from the 1960s onwards, and during the last Parliament had reached an average annual rate of 15%. This was partly because politicians had given way to pressures which had made it necessary to raise taxes beyond reasonable levels and to borrow above reasonable interest rates.

4. The answer to this was to return to sound money. The Prime Minister did not propose to discuss the technicalities. The basic point was that no money supply policy could be made to work properly with high borrowing by the public sector forcing up high interest rates. The single most important step to be achieved was to cut public spending. Money supply policies would then fall into their proper place and risk-taking could resume. In Britain, we had pursued a tight monetary policy and inflation was coming down. It was now running at an annual rate of below 9% which was good.

5. There were other problems. First, there was a very strong pound as a result of high interest rates and North Sea oil. This left industry less competitive than it would otherwise be. Even more difficult was the problem of high unemployment which resulted partly from squeezing out inflation and partly from reductions in over-manning. This was a problem which should have been tackled years ago and delay in tackling it had made it worse.

/6.

6. But there was a bright side as well. Pay settlements had been very much more reasonable and were now mostly in single figures. The balance of payments had been very strong, not simply because of North Sea oil, but because British companies were operating in a more dynamic way. There had been a real sea change in attitudes. The Prime Minister believed that once we had got through the present period of high unemployment, and given our independence from the rest of the world for resources of energy, Britain would be a very formidable competitor.

7. The Secretary of the Treasury acknowledged that the US economy was relatively strong, but at present it was growing weaker. Turning at once to the budgetary problem, he said that the figures available when the new Administration's economic policy was being drawn up, had turned out to be radically wrong. The revised figures on which they were now working made the problems much more difficult to solve within the time frame they had chosen.

8. Mr Regan continued that there were four parts to US economic policy. First, strict fiscal policy. This meant large budget cuts, starting with a reduction of $41½ billion, or 8%, in the first year and rising to $50 billion. Second, an enormous tax cut. Mr Regan admitted that there was some discussion even within the Administration about whether this would be inflationary. Third, deregulation. A task force had been set up to deal with the problem of excessive regulation. The new Chairman of the Council of Economic Advisers, Mr Weidenbaum, was an expert in this field. The aim of this part of the policy was to achieve substantial increases in productivity. Fourth, a tight monetary policy. This was the independent responsibility of the Federal Reserve, but Mr Regan commented that the line which Mr Volcker was proposing to take was in full accord with the Government's general purpose.

9. Mr Regan said that all the four elements in the programme were closely interwoven. There had been some criticism that the new Administration had not acted fast enough. But within the first thirty days, they had proposed the largest budget cuts, the largest tax reductions, and the most sweeping dismantling of regulations that had ever been put forward.

10. As far as the political acceptability of the programme was concerned, the Republican Party had a majority of three in the Senate, but games would be played in the House. It was difficult to predict the outcome. The Administration could propose, but others could dispose. Mr Regan was himself confident that the President's skill as a communicator would enable the Administration to carry their policies through.

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11. As to results, the Administration expected to reduce the GNP price deflator from 9½% to 5% by 1985. An important factor in achieving this would be the incentive effect of tax cuts, both on businesses and on individuals. Reduction in capital gains tax should help to restore the level of savings. The proposed changes in depreciation allowances should encourage industrial investment and improve productivity. This should help to increase exports and lead to a stronger dollar. Mr Regan believed that this programme would succeed.

12. Mr Weidenbaum, Chairman of the Council of Economic Advisers drew on the theme of innovation in the new Administration's economic policies. They had looked not for any particular doctrine, but for what would work in this nation.

13. Congressman Reuss commented that we were all now monetarists and supply-siders, and observed that the IMF and the World Bank also had a part to play in dealing with world economic problems.

14. The Secretary for Energy in a brief general intervention, commented on the importance of getting the energy equation right. This would need to include a renewed emphasis on the development of nuclear power: the US Government was looking forward to collaborating with the UK on nuclear breeder reactors. He went on to emphasise the importance of movements in the price of oil in the struggle against inflation.

15. The Prime Minister commented that inflation could not be blamed on movements in the price of oil. The Germans and the Swiss had not suffered from inflation as a result of the oil price explosions of the 1970s. They had refused to print money to pay for the increase. In countries where this had not happened, the politicians had a heavy responsibility. When the price of oil increased, expenditure on something else had to be reduced in order to make room for it. This was the only way to achieve sound money. There was no inflation in a barter society. In her view, monetarism was like gravity. It was not a doctrine. It was there.

16. The Secretary of Commerce suggested that it would be unwise to put exclusive emphasis on monetary policy as the weapon for conquering inflation. We should not ignore the importance of pursuing responsible fiscal policies as well. Otherwise interest rates would rise to the point where it was impossible for industry to compete.

17. Mr Rohatyn (Lazards) commented on the strength which the UK derived from its energy resources. For the US, energy was an Achilles heel. He pleaded for a gasoline tax as the only means of curbing US consumption of energy and helping to balance the budget. As a Democrat, he supported the Administration's programme. There was no alternative.

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18. Mr Greenspan (Economic Consultant) welcomed the universal recognition round the table that none of us could any longer live with inflation. There could be no solution of our economic problems without controlling inflation. This was an absolutely fundamental goal and he was encouraged to hear the Prime Minister say that the UK would not compromise on this.

19. Mr Wriston (Citicorp) said that enormous intellectual capital had been invested in economic systems which had not worked. But a change in attitude was now taking place across the country. People were ready to try something else.

20. Congressman Evans welcomed President Reagan's emphasis on working with Congress. The US people were tired of politics as usual. There was strong support for change. He thanked the Prime Minister for the courage she had shown and for setting an example to the rest of the world. He also expressed support for the work of the IMF and the World Bank.

21. The Ambassador asked when results might be expected from the Administration's economic policies. Mr Weidenbaum forecast that 1981 would be a mediocre year. But results might begin to be expected in 1982. The US economy had taken decades to get to the position it was now in. It would take some time to get it straight. He asked in return what the Prime Minister thought.

22. The Prime Minister replied that, as she had already said, the US was starting from a different point. Americans were still in the business of risk-taking. In the UK, incentives to take risks had all but disappeared with tax levels of 83% on earned income and 98% on savings. Her first step had had to be to reduce those disincentives.

23. She was confident that the US economy would come through the present recession. But she warned that it would be rough going for the first year. The Administration would be criticised as hard and flinty-faced. In the UK, she had remained hard and flinty-faced because she cared about pulling the country through. The UK was still in for a difficult year or 15 months. She had said at the beginning that it would take three years for her policies to bear fruit.

24. Mr Lewis Preston (Morgan Guaranty) said that he thought present policies were running high risks. Expenditure should be cut first. Tax reductions should wait. Mr Regan replied that unless tax levels were reduced, fiscal drag ("bracket creep") would destroy incentives completely. The savings rate was already down to 5%. Historically it had been 7 to 8%. How could the US economy become more productive if no encouragement was given to industry to modernise?

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25. At the end of the discussion Mr Greenspan said that in his view, it was not a question of how much time the new policies would take to work, but how much time we had got. While interest rates remained at their present level, long term assets were being funded by short term liabilities. Measures were needed to reduce inflationary pressures quickly so that interest rates could come down. Otherwise he foresaw a serious threat to the strength of the financial system.

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cc: PS/No 10
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