Confidential + Personal

Washington DC
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Prime Minister

Economic Policy

My absence here in Washington prevents me from being involved in the budget discussions. I shall be in London on 27th for a week so that I will be able to advise you then in more detail. But I thought it might be useful to set out my general thoughts here.

First I think it is important that in this budget the government be seen to be initiating its programme for reducing inflation to zero. The government needs to convince the sceptical public that it will not rest on its achievment of 5 per cent as "acceptable". (Shrewd market men know that an inflationary floor at 5 per cent will soon see the rate surging again up to 10 per cent or so. And market expectations reflect an inflation rate of more than 7 per cent.) I believe that the distressingly high increase in average earnings in manufacturing last year (to December) at 9.7 per cent reflected inflationary expectations exceeding 7 per cent. These expectations probably reflect the more relaxed budgetary and monetary conditions last year; a modest but unmistakable correction is called for this year.

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In principle I would like to see the PSBR fall to 2 per cent of GDP or roughly £6 bn. (This would still be ½ per cent over the 1980 MTFS figure for 1983/4) It would be much tighter than anyone at present expects - and for that reason would be quite powerful in revising expectations. The implicit tightening that is already absorbed in the increased contingency allowance will work in the right direction. This will be offset, however, by the fact that ~~much~~ some £1.5 Bn of the increase in revenue is from the sale of assets. On balance I think £7 bn should be regarded as an upper limit.

Secondly, you are aware, I am sure, of the ambient view that the "government seems to have no real policy for this second term". This view was put to me - albeit in a friendly way - by the leader of the IMF team to the U.K., Mr P. de Fonteney.* He agreed that the policy had been generally successful so far, but there seemed to be no clear policy of reforms ahead. While I know that this is far from true, there is a case for considering whether you could defuse this cause for concern. I believe that a suitable budget, that clearly showed there was no more drift, would help. But there is a long list of other reforms where a clear statement of policy would be of considerable benefit, both economically and I suspect politically.

In the United States, the publication of the budget and economic report of the President has changed nothing. I continue to think that nothing will be done about the deficit until 1986. Meanwhile there are signs that opinion is becoming less sanguine about the continuation of the boom. The stock market, often a very useful early indicator, turned sharply down, interest rates have crept up higher - but nevertheless the shine has gone off the dollar. And there is anecdotal evidence of a rise in the inflation rate. I continue to believe that the marked turndown will come later this year - and this seems to be the way opinion is veering.

Although our recovery in Britain is much more firmly based than that in the United States, the backwash from a marked turndown in the United States would be serious. There is little to be done except continue to ensure that our financial strategy is right for us.

AW

A.A. Walters

* I believe Andrew Turnbull knows him quite well.