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FROM WASHINGTON

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TO SAVING FCO TELNO 11 OF 29 FEBRUARY

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US ECONOMIC PROBLEMS

1. There has been a significant change in economic opinion in recent weeks, culminating in the statement by the President that inflation has reached a "crisis stage".

2. The present situation arises less than five months after the last major policy change. On 6 October 1979 the Federal Reserve Board (FRB) was forced to take strong action, leading to a 3% increase in bank lending rates, following rapid growth in the money supply, a serious decline in the dollar and a wave of speculation on the commodity markets. This package was widely approved at the time as an adequate response to the situation and two months ago Mr Volcker, Chairman of the FRB, seemed to be preparing the markets for a decline in interest rates as the economy weakened. As an indication of the change of outlook, the FRB hurriedly raised the discount rate on 15 February from 12% to 13%, triggering an increase of over 1% in bank lending rates.

3. The causes of the present concern are different from those in the autumn. The dollar is not weak, the money supply figures are within the targets, and the gold boom has subsided. There are four main factors causing the present situation - the recession that never was, the President's budget proposals (and in particular his support for increased defence spending following the invasion of Afghanistan), doubts about FRB policy, and the rate of inflation itself.

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4. The economy defied economists' predictions throughout 1979. After an exceptionally long period of growth from 1975 there was a wide expectation, even hope, that 1979 would see a recession because the economy was operating at near full capacity, and further pressure would be inflationary. While in the second quarter of 1979 the economy did decline substantially, in the third quarter it more than recovered. Initial estimates for the fourth quarter suggested growth and not decline, and the revised figures for that quarter published on 20 February showed quite substantial growth (annual rate of 2.7%).

5. The Administration's economic forecast, published with its budget proposals at the end of January, assumed a mild recession in the first half of 1980 but after the events of 1979 there was bound to be scepticism about the accuracy of the forecast. This scepticism was increased by the budget itself. Two aspects in particular raised doubts about the Administration's economic policy. First, the deficit for the fiscal year beginning October 1979 (FY 80) was revised from $29 billion (approved by Congress only three months earlier) to $40 billion. This was a reversal of the trend of declining deficits through the Carter years. Changed economic assumptions played their part in this, but also there was a substantial increase in defence spending, and total spending was projected to show a 14% increase on FY 79. Also, these estimates did not allow for other known increases, eg effects of the latest oil price increase. Second, the $16 billion deficit proposed for FY 81 looked an underestimate. Many believed that Congress would increase the rate of defence spending and would balk, in an election year, at the real reductions in other programmes, and at several of the President's legislative proposals which would cut spending. A deficit of at least $30 billion seemed likely, against widespread feeling that the inflation prospects argued for a balanced budget.

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6. Confidence was not helped by the tone of the Administration's economic report published in January, which said that it would take several years to get inflation down to 5%. The pay guidelines for 1980 were bogged down. In October 1979 the President had enlisted the unions in a new pay board. Asked to report within a month the board, in January, proposed new guidelines, significantly higher than those in 1979, and the President has not yet said whether he accepts them.

7. At the same time, confidence in Mr Volcker has declined. Although the money supply is within the targets, credit still seems to be readily available to industrial borrowers and the financial markets have been confused by the FRB's operations.

8. The most recent event creating the "crisis" has been the publication in the middle of February of the consumer price index for January showing an increase of 1.4% (an annual rate of 18% - the highest for six years, compared with 13% for most of 1979). The figures for the next few months are expected to be almost as bad.

9. The Administration is reviewing its economic policies, reportedly looking at further budget cuts in FY 80 and FY 81, including possibly deindexing social security payments, setting a ceiling for federal spending as a percentage of GNP, an additional tax on petrol, and controls on consumer credit. The Administration has repeatedly rejected mandatory pay and price controls although these are now supported by some experts as well as a majority of the public. The voluntary pay guidelines are in difficulty because to raise them significantly would be an admission of defeat but not to raise them, given current inflation, would make them unrealistic and they would be ignored. Unlike October 1979 when the FRB alone took action, it is the Administration that is now expected to play the main part.

10. The other Presidential candidates have argued that once economic issues regained prominence over foreign policy issues, the President would be vulnerable, but although the economy has hit the headlines the President seems so far to have suffered very little. The Republican candidates have proposed only a confusing mixture of tax cuts and cuts in the budget deficit. Senator Kennedy has proposed an across the board six month freeze on prices, wages, interest rates, profits, dividends, and rents, together with petrol rationing. But after the New Hampshire results, the President may feel little constrained by his opponent's position on economic issues. He may see virtue in tough measures, showing firm leadership. One fact seems unavoidable - substantial policy changes are needed now to restore confidence and dampen inflationary expectations.

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