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FM WASHINGTON 271830Z SEP 81  
TO IMMEDIATE KUWAIT  
TELEGRAM NUMBER 2 OF 27 SEPTEMBER  
INFO PRIORITY MELBOURNE

ps/pm plus  
covering sl.p  
28/9

FOLLOWING PERSONAL FOR PRIME MINISTER FROM CHANCELLOR  
OF THE EXCHEQUER.

THE STATE OF POLICY IN THE UNITED STATES

1. I PROMISED A FURTHER REPORT ABOUT THE US SCENE. I HAVE NOW SEEN PRESIDENT REAGAN'S BROADCAST AND THE REACTION TO IT. I HAVE ALSO SEEN STOCKMAN, VOLCKER AND REGAN AND HAD OTHER OPPORTUNITIES TO APPRAISE THE SITUATION. SO HAS TERRY BURNS, WHO IS HERE AT PRESENT.
2. ON THE BUDGET DEFICIT, THE DOLLARS 16 BILLION IMPROVEMENT NOW SOUGHT BY THE PRESIDENT IS A DETERMINED FURTHER EFFORT WHICH WE MUST APPLAUD. IT WILL NOT BE EASY TO DELIVER IN FULL. EVEN SO, IT LEAVES THE DEFICIT FOR FISCAL YEAR 1982 AT DOLLARS 43.1 BILLION COMPARED WITH THE ORIGINAL FORECAST OF DOLLARS 42 BILLION. SO THE BALANCE BETWEEN FISCAL AND MONETARY POLICY WILL NOT HAVE BEEN IMPROVED, BUT ONLY AT BEST PREVENTED FROM GETTING WORSE. THERE IS AS YET NO CONVINCING PATH TO THE BUDGET BALANCE IN 1984 WHICH THE PRESIDENT SAYS IS HIS OBJECTIVE. THE CUTS ON THE ENLARGED DEFENCE BUDGET WERE RELUCTANT AND MODEST, AND 7 PERCENT REAL GROWTH IS STILL ENVISAGED. YOU WILL RECALL (WASHINGTON TELNO 2859) THAT STOCKMAN SAW LITTLE CHANCE OF FURTHER SOCIAL SECURITY REDUCTIONS, OR OF EARLY INCREASES IN TAXATION. THERE IS A RISK THAT THE TIDE OF PUBLIC AND CONGRESSIONAL OPINION MAY TURN AGAINST FURTHER BUDGET CUTS AND MAKE THEM MORE DIFFICULT.
3. PERHAPS IT IS NOT SURPRISING THAT THE MARKETS HAVE NOT BEEN REASSURED AND REMAIN UNCERTAIN. FEARS REMAIN OF CONTINUING HIGH INTEREST RATES AND FOR THE PRESENT THAT HAS AGAIN STRENGTHENED THE DOLLAR AGAINST EUROPEAN CURRENCIES: RATHER MORE AGAINST THE EMS THAN AGAINST STERLING. THE UNCERTAINTIES OF US MARKETS ARE COMMUNICATING THEMSELVES TO LONDON MARKETS, ESPECIALLY THE EQUITY MARKET.
4. VOLCKER'S ACCOUNT WAS AS FOLLOWS. THERE WAS A MODEST EASING OF SHORT-TERM RATES REFLECTING SOME FALL IN DEMAND FOR BANK CREDIT, BUT THE BOND MARKET (LONG RATES) WAS FOCUSSING ON THE DEFICIT. THE DEFICIT WAS LARGE AND WOULD NEED BIG CUTS TO HOLD IT DOWN. MARKETS WOULD BE AFFECTED BY A BIG FINANCING DEMAND FROM THE TREASURY IN THE NEXT THREE MONTHS. HE EXPECTED SLUGGISH OUTPUT IN THE NEXT TWO QUARTERS. THERE WAS A CHANCE THAT INFLATION WOULD FALL AND REDUCE INTEREST RATES. BUT THE DOWNWARD TREND IN INFLATION WAS NOT YET CLEARLY ESTABLISHED OR REFLECTED IN WAGES. HE SAW THE GAME AS BEING QUOTE WON OR LOST WITHIN THE NEXT 12 MONTHS UNQUOTE.

5. ECONOMISTS (INCLUDING FRIEDMAN) CALLED IN BY THE ADMINISTRATION WERE SAYING THEY DID NOT KNOW WITH ANY CERTAINTY WHY INTEREST RATES WERE SO HIGH. VOLCKER SAW TWO MAIN EXPLANATIONS: A BASIC CHANGE IN INFLATIONARY EXPECTATIONS IN THE US AND THE IMPACT OF HOLDING MONETARY GROWTH SUBSTANTIALLY BELOW THE NOMINAL GROWTH OF GNP. REGAN BROADLY AGREED WITH VOLCKER'S ASSESSMENT BUT ADDED THAT IF THE RECENT CONTROL OF MONETARY AGGREGATES WAS MAINTAINED, INFLATION WAS BOUND TO COME DOWN. HE EXPECTED NO REVIVAL IN THE ECONOMY BEFORE LATE 1982 OR EARLY 1983.

6. THERE ARE OBVIOUS PARALLELS, AS WELL AS MANY DIFFERENCES, BETWEEN THIS PHASE OF AMERICAN POLICY AND OUR OWN EXPERIENCE. THEY MAY NOW FOLLOW US IN GETTING A SIGNIFICANT REDUCTION IN INFLATION, BETTER WAGE PERFORMANCE BUT, AS VOLCKER INDICATED, NONE OF THIS IS SURE. THEY EXPECT TO SEE THEIR CURRENT ACCOUNT OF THE BALANCE OF PAYMENTS WEAKEN AND THEY MIGHT THEN GET A WEAKER DOLLAR (THOUGH OTHER DEVELOPMENTS, EG POLAND, PROLONGED HIGH INTEREST RATES COULD RETARD THIS). THEY HAVE OF COURSE GREAT ADVANTAGES COMPARED WITH US BUT ALSO HANDICAPS - DEFENCE COSTS, THEIR RELUCTANCE TO CHANGE COURSE ON TAX, A CONGRESS WHICH HAS TO BE PERSUADED RATHER THAN CONTROLLED, MID-TERM ELECTIONS. AND, FOR THE PRESENT, THEY HAVE NOT CONVINCED THEIR MARKETS OR MADE ENOUGH IMPACT ON INFLATIONARY EXPECTATIONS.

7. THERE ARE TWO MAJOR IMPLICATIONS FOR US. THEIR SUCCESS OR FAILURE IS OF THE GREATEST IMPORTANCE BOTH FOR THE WORLD ECONOMY AND FOR US POLITICALLY. WE OUGHT NOT TO IDENTIFY OURSELVES SLAVISHLY WITH EVERY ASPECT OF THEIR POLICIES: QUITE THE CONTRARY. BUT STRONG PARALLELS ARE BOUND TO BE DRAWN. THERE ARE, SECONDLY, THE DIRECT EFFECTS OF THEIR SITUATION ON US. WE ARE NOW MORE EXPOSED TO CONTINUING HIGH US INTEREST RATES THAN WE WERE WHEN THE OIL FACTOR WAS MOVING IN OUR FAVOUR AND OUR CURRENT ACCOUNT WAS AT ITS STRONGEST WE HAVE TO FACE THE POSSIBILITY THAT US RATES WILL CONTINUE STRONG, AND COULD FLUCTUATE AS THE STRUGGLE OVER THE BUDGET DEFICIT CONTINUES RELIEF FROM THEIR IMPACT COULD BE DELAYED FOR US AND OTHER EUROPEAN COUNTRIES UNTIL US INFLATION FALLS: OR UNTIL THE DOLLAR WEAKENS (PERHAPS, FOR EXAMPLE, BECAUSE THE US CURRENT ACCOUNT GOES INTO SUBSTANTIAL DEFICIT).

8. WE HOPE TO CONTINUE PRESSING THE AMERICANS AT EVERY REASONABLE OPPORTUNITY TO REDUCE THEIR BUDGET DEFICIT AND TO OPEN THEIR MINDS TO TAX ACTION IF NECESSARY. THERE MAY BE OPPORTUNITIES AT CANCUN. LIKE CHANCELLOR SCHMIDT AFTER OTTAWA, WE HAVE TO TAKE WHATEVER ACTION WE CAN IN OUR OWN FIELD TO INCREASE OUR INDEPENDENCE IN THE MARKETS FROM US INTEREST RATES. THAT MEANS DOING OUR UTMOST ON PUBLIC EXPENDITURE, AND OF COURSE ON PAY. I THINK IT ALSO MEANS THAT WE MUST EXPECT TO GO ON PAYING ATTENTION TO THE EXCHANGE RATE IN OUR OWN INTEREST RATE DECISIONS, BECAUSE WE (LIKE THE EMS) WILL BE EXPOSED TO ANY CONTINUING VOLATILITY IN US INTEREST RATES.

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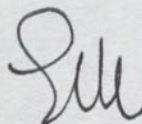
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WASHINGTON TEL No 2 TO KUWAIT.

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Delegation Office

28/9/81