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MY TELNO 2854: US ECONOMIC RECOVERY PROGRAMME

1. PRESIDENT REAGAN'S ECONOMIC RECOVERY PROGRAMME CAME INTO EFFECT ON 1 OCTOBER. FROM THIS DATE ONWARDS DEVELOPMENTS IN THE US ECONOMY WILL INCREASINGLY BE CREDITED TO OR BLAMED ON HIM, RATHER THAN ATTRIBUTED TO THE POLICIES OF CARTER. WHILE HE MIGHT BE ABLE TO REST FOR A TIME ON THE PLEA THAT IT WILL TAKE SOME TIME FOR HIS POLICIES TO SUCCEED, THIS WILL TEND TO SOUND A LAME EXCUSE, GIVEN THE CLAIMS OF SOME OF HIS LIEUTENANTS THAT ENACTMENT OF THE LEGISLATION WOULD ITSELF HAVE AN IMPACT ON EXPECTATIONS. TACTICAL VICTORIES IN CONGRESS ON EXPENDITURE CUTS WILL NO LONGER SUFFICE TO CONVINCE THE AMERICAN PEOPLE THAT HE IS ON TRACK. HE MUST SOON DELIVER THE GOODS IN TERMS OF ECONOMIC PERFORMANCE. RECENT ATTENTION HAS FOCUSED ON WHETHER HE CAN SECURE THE REDUCTION THAT HE HAS PROMISED IN THE PRESENT HIGH LEVEL OF MARKET INTEREST RATES BY REDUCING THE BUDGET DEFICIT. BUT IN THE LONGER TERM HE MUST ALSO MAKE FURTHER PROGRESS IN REDUCING INFLATION AND ACHIEVING SUSTAINED GROWTH.

2. PRESIDENT REAGAN'S TERM OF OFFICE HAS ALREADY SEEN A DECLINE IN THE RATE OF INFLATION. SOME OF THIS HAS BEEN FORTUITOUS, DUE TO A SOFTENING IN THE PRICES OF FOOD AND ENERGY BUT THE UNDERLYING RATE OF INFLATION HAS NONETHELESS BEEN REDUCED FROM ABOUT 12 PERCENT AT THE TURN OF LAST YEAR TO ABOUT 10 PERCENT NOW. WHILE THE ECONOMY HAS BEEN SLUGGISH IN THE SECOND AND THIRD QUARTERS OF THIS YEAR, IT HAS PROBABLY DECLINED ONLY SLIGHTLY FROM THE HIGH LEVEL REACHED IN THE FIRST QUARTER, WHEN GROWTH WAS AT A RECORD ANNUAL RATE OF 8.6 PERCENT. SHORT-TERM INTEREST RATES ARE ALSO DOWN ABOUT 2 PERCENT FROM THEIR PEAKS IN JULY. BUT INTEREST RATES REMAIN STRONGLY POSITIVE IN REAL TERMS - WITH LONG-TERM REAL RATES ON CORPORATE BONDS NOW ABOUT 6 - 7 PERCENT. THERE IS NO CLEAR TREND IN THE LEVEL OF UNEMPLOYMENT: AT PRESENT IT STANDS AT 7.5 PERCENT.

3. CHAIRMAN VOLCKER OF THE FEDERAL RESERVE BOARD, WHILE BELIEVING THAT THE BURDEN OF FIGHTING INFLATION SHOULD NOT BE PLACED ON MONETARY POLICY ALONE, SHOWS EVERY SIGN OF WANTING TO STICK TO HIS MONETARY TARGETS. THE 1982 TARGET RANGE THAT HE HAS SET FOR M1-B IS 2 1/2 - 5 1/2 PERCENT, FOR M2 6 - 9 PERCENT AND M3 6 1/2 - 9 1/2 PERCENT. THE ADMINISTRATION'S TARGET FOR REAL GROWTH DURING 1982 (FOURTH QUARTER 1981 TO FOURTH QUARTER 1982) IS 5.2 PERCENT AND FOR INFLATION ABOUT 7.3 PERCENT (GNP DEFLATOR).

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GNP IN NOMINAL TERMS IS PROJECTED TO GROW BY 12.9 PERCENT. SUCCESS IN REDUCING THE GROWTH OF PUBLIC EXPENDITURE WILL REDUCE PRESSURE ON CREDIT MARKETS ONLY IF PRIVATE DEMAND FOR CREDIT DOES NOT SHOW A CORRESPONDING INCREASE. BUT PRESIDENT REAGAN'S OPTIMISTIC FORECASTS FOR THE REAL ECONOMY MUST BE PREDICATED ON A RAPID EXPANSION OF PRIVATE BORROWING, SINCE THE PRESENT LIQUIDITY OF AMERICAN COMPANIES IS NOT SUCH THAT A MAJOR EXPANSION COULD BE FINANCED SOLELY WITH INTERNALLY-GENERATED FUNDS, EVEN AFTER ALLOWING FOR THE CONCESSIONS TO COMPANIES IN THE NEW TAX BILL. AN ANALYSIS BASED ON CREDIT DEMAND AND SUPPLY, THEREFORE, LEADS TO THE CONCLUSION THAT INTEREST RATES ARE LIKELY TO REMAIN HIGH DURING ANY FORTHCOMING ECONOMIC EXPANSION SO LONG AS VOLCKER'S RESTRICTIVE MONETARY TARGETS ARE IN PLACE. RECENT REMARKS BY TREASURY SECRETARY REGAN THAT THE FED MIGHT BE ABLE TO EASE UP A BIT, WITHOUT CHANGING THE BROAD THRUST OF MONETARY POLICY, INDICATES THAT THE ADMINISTRATION MAY BE GROWING ANXIOUS ON THIS SCORE.

4. THE ABOVE ARGUMENT WOULD NEED TO BE MODIFIED IF IT WERE BELIEVED THAT EXISTING LEVELS OF INTEREST RATES CONTAINED A PREMIUM FOR INFLATIONARY EXPECTATIONS THAT WOULD BE RAPIDLY ELIMINATED ONCE MARKETS WERE CONVINCED OF THE ADMINISTRATION'S DETERMINATION TO GET INFLATION AND THE FEDERAL DEFICIT DOWN. DEVELOPMENTS IN FINANCIAL MARKETS DURING THE SUMMER, WITH INTEREST RATES HIGH AND NEW YORK STOCK EXCHANGE PRICES DEPRESSED, WERE OFTEN ATTRIBUTED TO MARKET SCEPTICISM ABOUT WHETHER THE ADMINISTRATION COULD BRING DOWN THE BUDGET DEFICIT, AND ALSO REFLECTED CONCERN AT THE TREASURY'S LARGE BORROWING NEEDS DURING THE SECOND HALF OF THIS YEAR. PRESIDENT REAGAN'S STATEMENT OF 24 SEPTEMBER WAS OBVIOUSLY AIMED AT IMPROVING CONDITIONS IN THE FINANCIAL MARKETS. BUT IT IS POSSIBLE THAT, WHILE INTEREST RATES ARE SENSITIVE TO PROSPECTIVE CONDITIONS IN THE CREDIT MARKETS (INCLUDING THE ADMINISTRATION'S BORROWING NEEDS), PRICES ON THE NEW YORK STOCK EXCHANGE HAVE ALSO BEEN REACTING TO THE IMMEDIATE PROSPECTS FOR THE US ECONOMY. SOME MEMBERS OF THE ADMINISTRATION THEMSELVES DO NOT SEE FURTHER GROWTH COMING MUCH BEFORE THE MIDDLE OF 1982 AND THERE ARE DIFFERENCES OF VIEW ABOUT HOW STRONG GROWTH WILL BE THEREAFTER. INFLATIONARY EXPECTATIONS MAY BE ALREADY REDUCED BECAUSE INFLATION HAS COME DOWN. IN THAT CASE LOWER INTEREST RATES MAY ONLY COME ABOUT WITHIN THE EXISTING MONETARY TARGETS IF THE ECONOMY CONTINUES TO BE SLUGGISH FOR A FAIRLY PROLONGED PERIOD. WHILE COMBINED RAPID GROWTH AND HIGH REAL INTEREST RATES COEXISTED IN THE FIRST QUARTER OF THIS YEAR, SUCH A SITUATION SEEMS UNSUSTAINABLE FOR A PROLONGED PERIOD. A REASONABLE CONCLUSION SEEMS TO BE THAT UNLESS THE MONETARY TARGETS ARE RELAXED, THE ADMINISTRATION WILL NOT ACHIEVE ITS GROWTH OBJECTIVES UNLESS THERE IS A MUCH GREATER FALL IN THE PRICE LEVEL THAN IT ITSELF PREDICTS. GIVEN THAT WAGE SETTLEMENTS ARE CURRENTLY RUNNING AT ABOUT 10 PERCENT, THIS SEEMS AN UNLIKELY OUTCOME.

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5. TO PREVENT INCREASED PRESSURE ON CREDIT MARKETS, CONTINUING SUCCESS IN CUTTING GOVERNMENT BORROWING IS ESSENTIAL. BUT THE ADMINISTRATION MAY BE CHASING A RECEDING TARGET. ON 17 SEPTEMBER CONGRESSIONAL BUDGET OFFICE DIRECTOR RIVLIN ESTIMATED THAT THE ADMINISTRATION WOULD NEED TO FIND DOLLARS 100 BILLION OF CUTS (ADDITIONAL TO THE FIRST ROUND OF BUDGET CUTS) BY FY84 TO ACHIEVE ITS OBJECTIVE OF BALANCING THE FEDERAL BUDGET. THIS FIGURE IS DOLLARS 40 BILLION MORE THAN THE ADMINISTRATION'S ESTIMATE. ON 24 SEPTEMBER, THE PRESIDENT CLAIMED THAT DOLLARS 35 BILLION OF ADDITIONAL CUTS HAD BEEN IDENTIFIED FOR THAT YEAR (INCLUDING DOLLARS 6 BILLION OF DEFENCE CUTS). THE NATURE OF THESE CUTS IS STILL RATHER HAZY, BUT EVEN IF THEY WERE ALL IDENTIFIED AND ENACTED THEY WOULD BE A LONG WAY SHORT OF DOLLARS 100 BILLION, A FIGURE WHICH ITSELF COULD INCREASE. BUDGET DIRECTOR STOCKMAN IS NO LONGER EMPHASISING THE NEED TO ACHIEVE BUDGET BALANCE BY FY84, BUT SIMPLY THE NEED TO DEMONSTRATE PROGRESS TOWARDS REDUCING THE BUDGET DEFICIT IN FY82, BY ACHIEVING A CLEAR REDUCTION IN THE DEFICIT FROM FY81 (A REDUCTION FROM ABOUT DOLLARS 56 BILLION TO DOLLARS 43.1 BILLION). HE IS ALSO REPORTED TO HAVE SAID THAT, IF A WEAK ECONOMY CAUSED FEDERAL REVENUES TO FALL SHORT OF FORECASTS, HE WOULD NOT SEEK ADDITIONAL SPENDING CUTS TO PREVENT THE BUDGET DEFICIT FROM GROWING.

6. NEITHER PRESIDENT REAGAN'S RECENT ANNOUNCEMENT OF HIS STRATEGIC ARMS PROGRAMME NOR HIS OTHER RECENT STATEMENTS SEEM CONSISTENT WITH FURTHER MAJOR DEFENCE EXPENDITURE CUTS BEFORE FY84, UNLESS THESE ARE IMPOSED ON HIM BY CONGRESS. IT IS DIFFICULT AT THE MOMENT TO JUDGE WHETHER THE ADMINISTRATION WILL, WHEN IT COMES TO THE CRUNCH BEFORE THE LEGISLATIVE ELECTIONS NEXT YEAR, ACQUIESCE IN CONSIDERABLE DEFENCE CUTS. I DO NOT THINK IT IMPOSSIBLE GIVEN THE POLITICALLY UNATTRACTIVE ALTERNATIVES. THE CONGRESS HAS EXPRESSED A CLEAR AVERSION TO SOCIAL SECURITY CUTS, AND PRESIDENT REAGAN (WHILE INVITING CONGRESS TO STUDY THE POSSIBILITY) HAS NOT MADE ANY NEW PROPOSALS. INTEREST PAYMENTS ON THE NATIONAL DEBT ARE ENESCAPABLE. THIS MEANS THAT THE REMAINING 40 PERCENT OR SO OF PUBLIC EXPENDITURE ON WELFARE PROGRAMMES ETC WILL NEED TO BEAR THE ENTIRE BRUNT OF FURTHER REDUCTIONS. SINCE STATE GOVERNMENT FINANCES HAVE ALREADY BEEN SQUEEZED BY THE FIRST ROUND OF CUTS (RESULTING IN LOUD COMPLAINTS BY STATE GOVERNORS), PUTTING A GREATER BURDEN ON THEM IS NOT GOING TO BE AN EASY OPTION.

7. ANOTHER WAY OUT OF THE QUANDARY IS SOMETIMES SEEN AS RAISING SIGNIFICANT INDIRECT TAXATION AT THE FEDERAL LEVEL, BUT PRESIDENT REAGAN HAS OPPOSED THIS COURSE (WHICH COULD CHANGE THE BALANCE OF THE US TAX SYSTEM AS BETWEEN THE STATES AND THE FEDERAL GOVERNMENT). WHILE A DOLLARS 3 BILLION REDUCTION IN OBSOLETE INCENTIVES ETC WAS INCLUDED IN THE MEASURES ANNOUNCED ON 24 SEPTEMBER (RISING TO DOLLARS 11 BILLION BY FY84), THERE ARE NO OBVIOUS POLITICALLY ACCEPTABLE WAYS IN WHICH THE BUDGET GAP COULD BE CLOSED SOLELY BY RAISING TAXATION. THE DEFERMENT OF THE RECENTLY ENACTED INCOME TAX CUTS WOULD BE A BIG POLITICAL REVERSE AND WOULD SEEM THE LEAST ACCEPTABLE TO THE ADMINISTRATION AT THIS STAGE.

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8. IT IS GOING TO BE AN UPHILL STRUGGLE FOR THE ADMINISTRATION TO CONVINCED MARKETS THAT IT WILL TAKE ACTION TO REDUCE THE BUDGET DEFICIT SUFFICIENTLY TO MAKE ROOM FOR CORPORATE BORROWING AND ECONOMIC EXPANSION. A DOLLARS 13 BILLION REDUCTION IN THE DEFICIT IN FY82 COMPARED WITH FY81 ALMOST CERTAINLY WILL NOT BE ENOUGH BY ITSELF. TO SUCCEED, THEY WILL HAVE TO HOLD OUT THE REALISTIC PROSPECT OF A CONTINUING REDUCTION IN FY83 AND BEYOND SO THAT SUSTAINED PRIVATE SECTOR GROWTH CAN BE ACCOMMODATED.

9. FCO PLEASE PASS TO BOTTRILL (TREASURY) AND HAYWARD (BANK OF ENGLAND).

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