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Prime Minister

I doubt if Haig will be effective on this subject.

2. A message to Reagan after the State of the Union speech may be too late if he commits himself in it as the size of the budget deficit etc. But it is now too late for you to influence its contents.

3. If you want to send a message to Reagan we ought to explore the timing more carefully. Agree that I should pursue this?

A.J.C. 22/1

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

Let us first see what the State of the Union speech contains.

22 January 1982

The Rt. Hon. The Lord Carrington, KCMG MC
Secretary of State for Foreign and
Commonwealth Affairs

Dear Peter

US ECONOMIC POLICY AND THE ALLIANCE

I know you are well aware that the way in which the United States conducts its economic policy has important political as well as economic implications for the Alliance, and particularly for relations between the US and Europe. I believe it is of great importance to the free world that the US should bring its inflation under control and that the dollar, which is the international currency of the free world, should enjoy strength and stability. It is probably inevitable that achieving this will impose some burdens on the rest of us as well as on the US itself. The US economy is too large a part of the free world to avoid that. But while accepting this and supporting the objective of US policy, I believe we are entitled to ask our American friends to apply a balance of policies which avoids throwing an undue part of the burden of American adjustment on other members of the Alliance; and which also avoids imposing burdens in ways which are both obvious, and which suggest indifference to their interests.

Present US policy looks like leading to levels of budget deficit which are either not at all compatible with moderate interest rates, or are compatible only while the US economy is in recession. There is a reluctance to pay for greatly increased defence expenditure by increased taxation when it becomes apparent that even substantial expenditure cuts elsewhere are not enough to finance it. This threatens the counter inflation programme itself: it was after all the failure to pay for defence expenditure by increased taxation in the 1960s which contributed to dollar depreciation and the end of the Bretton Woods exchange rate system. More immediately it leads to high interest rates and the prospect that they may continue.

/This in turn

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This in turn has imposed on Europe in a direct and striking way a choice between similar high interest rates and currency depreciation. Germany faced this choice most acutely in February last; we faced it in September. The United States, for reasons which are understandable, has not wished to vary its monetary or exchange rate policy in response to European representations. Some of our partners have been quick to see this reaction as uncaring. And anti-Americanism in Europe is provided with a ready-made grievance which it can exploit. The French Finance Minister Delors stressed this point in discussion with me early this week.

As you know, I have, with other Community Finance Ministers, taken every opportunity since last summer to urge on American colleagues the need to reduce the growing budget deficit, if necesssary by increasing taxation.

The deficit outturn for the US fiscal year 1981, which ended on 30 September last, was $55/60 billion. The original forecast for fiscal 1982 (ending 30 September 1982) was S/43 billion. The latest forecast is for an outturn over $100 billion, with even higher deficits in fiscal 1983 and 1984. These figures may be improved somewhat if new measures are included in President Reagan's State of the Union message next week; or in a subsequent statement about the budget. However, a great deal would have to be done to alter the direction of the deficit.

You may have seen that Chancellor Schmidt recently suggested to the Prime Minister that she might send a message to the President on this subject, and the Prime Minister may wish to consider that when the State of the Union speech is available; we are rather too near that speech to approach him now. However, given the political implications of a policy which could lead to sustained or recurrent high US interest rates, I hope that you would feel able, as opportunity offers, to represent to Secretary Haig and other American friends that everything possible should be done to reduce the emerging deficits. We may find that sustained discreet pressure from as many quarters as possible is needed to achieve a better outcome.

I am sending a copy of this letter to the Prime Minister.

GEOFFREY HOWE

USA

US INTEREST RATES: EFFECT ON UK ECONOMY

Factual

(i) UK short-term interest rates were below US rates from last November until September this year. For some time (in spring/early summer) they were 4-5 percantage points below US rates (see attached graph).

(ii) In September UK rates rose sharply; weakness of sterling and rapid pace of bank lending were the principal factors.

(iii) Between end-September and end-November US rates fell by about around five percentage points, as depth of US recession became apparent (see graph). UK rates also fell, but by less. In the light of the continued rapid growth of bank lending, cautious conduct of domestic monetary policy argued against a more rapid fall in rates.

(iv) In December US rates have firmed, in part because markets have begun to show renewed concern about the Federal borrowing requirement. UK market rates have also firmed, by about 1 percentage point since mid-November. On 17 December one US bank raised its prime rate by $\frac{1}{4}$ per cent, reversing the downward trend of recent weeks. But so far no further increase in UK base rates (which stand at $14\frac{1}{2}$ per cent compared with October peak of 16 per cent).

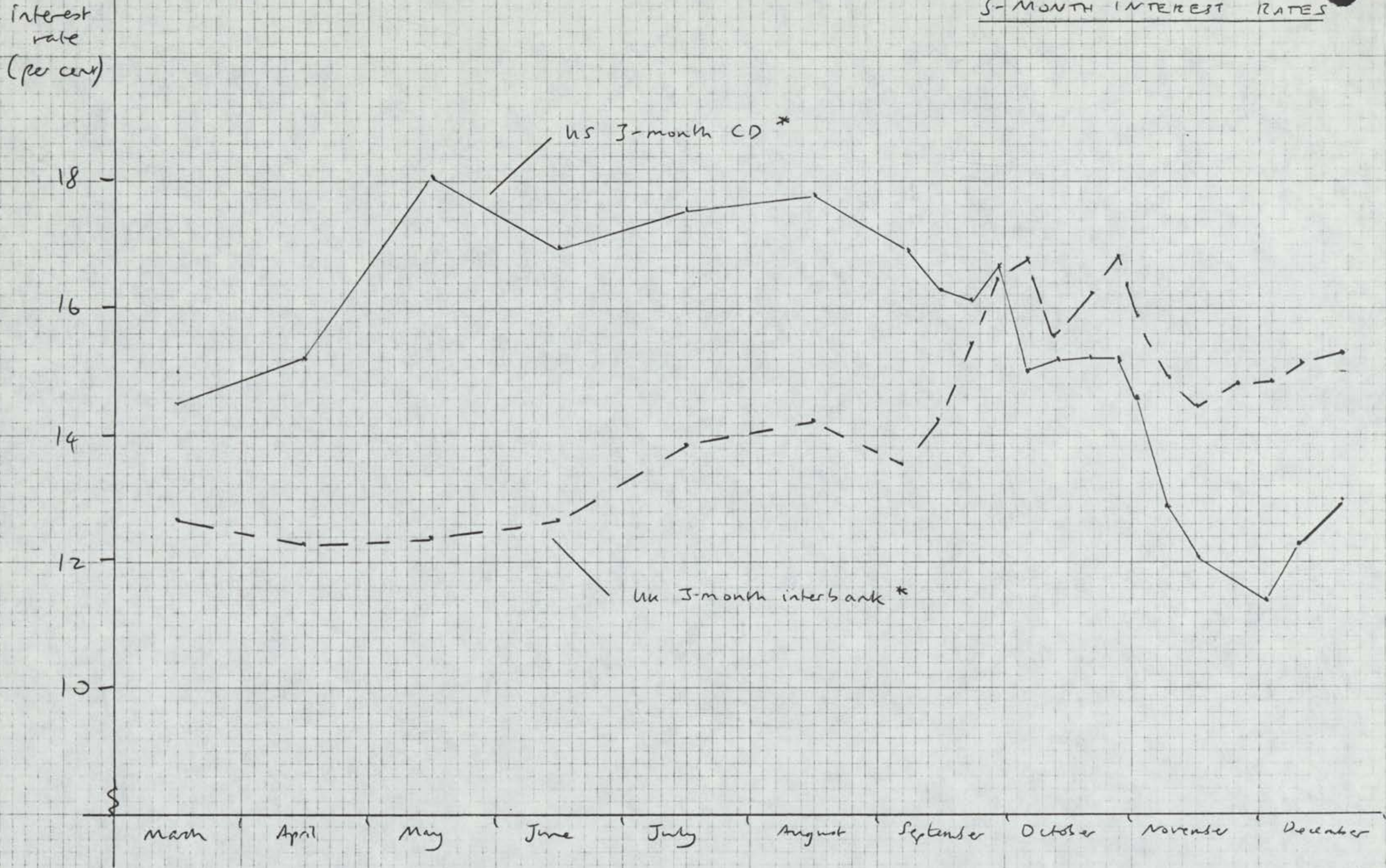
Line to take

(i) UK rates were pulled up by US rates?
Stress that there is no automatic relationship between UK and US rates. For a large part of the year UK rates were little affected by rising US rates. In September UK rates rose sharply, in part as a result of the weakness of sterling and in part as a result of the acceleration in bank lending. Both posed a dangerous inflationary threat.

(ii) Why have UK rates not fallen as far as US rates?
/No automatic relationship between UK and US rates/.
Can not answer for US Administration's interest rate policy. But a more rapid fall in UK rates would have been inconsistent with our domestic monetary objectives - the maintenance of steady but not excessive downward pressure on monetary growth and inflation.

(iii) Join EMS exchange rate mechanism in order to insulate UK rates from swings in US rates?
Will participate when the time is right for ourselves and the system. But EMS participation would not insulate us from external pressures. Other EMS members were not insulated from effects of high US interest rates which put pressure on EMS band as a whole. /If asked about idea of a "ring fence" of exchange controls around Europe, to insulate from US interest rate movements: this is impracticable and would not succeed. Exchange controls did not avert the sterling crisis of 1976./

MOVEMENTS IN UK AND US 3-MONTH INTEREST RATES



1981

*Note: The US 3-month Certificate of Deposit rate is considered to be the most representative 3-month rate. The US has no rate precisely equivalent to the UK 3-month interbank rate.

E.R.

Prime Minister

Some background briefing on the US economy

UK AND EC VIEWS ON US ECONOMIC POLICY

1. The considerable decline of US short-term interest rates and the US dollar since their summer peak has led most EC governments to take a more relaxed view of UK economic policy.

2. At their informal meeting at Lancaster House on 30-31 October, the consensus among EC Finance Ministers favoured intervention by the US authorities in the foreign exchange market to smooth fluctuations but no one expressed a wish to see massive intervention against market forces*.

3. There is general recognition among Community governments of the importance of the US bringing down the rate of inflation, but there is less than complete confidence that this can be achieved with present policies. Scepticism has centred on the US Administration forecasts of GNP growth and reduction in the federal deficit. On both matters the US Administration's view has noved towards that of Europe.

* Confidential - not to be used

The US Treasury Secretary had earlier sent messages to some Finance Ministers which implied that he stood ready to intervene if events in Poland caused markets suddenly to lose confidence.

S ECONOMY : RECENT DEVELOPMENTS

Federal expenditure: At his 10 November press conference Presdient Reagan reaffirmed his broad economic strategy but deferred his request for Congress to ait on his September proposals for reduction in planned expenditure on entitlement programmes by $2.6bn and to enhance revenues by $3bn in FY 82, until January of next year. When the Democratic leaders of Congress tried on 24 November to defy him over the other $8.4bn cuts he called for in September the President faced them down and many Democratic Congressmen deserted their leaders to vote for lower expenditure; the outcome will force Congressto face the issue again in mid-December.

2. The President has said he remains committed to the goal of a balanced budget but that he no longer regards it as likely that this will be achieved by FY 84.

3. Real GNP declined in the second and third quarters and recent indications suggest a further steeper fall is coming in the fourth quarter.

4. The balance on external account has deteriorated as a result of the strong dollar. The effective exchange rate of the dollar has however declined almost 9½ per cent since August.

5. Short-term interest rates continue their decline: three-month Treasury bills are now at 10.29 per cent compared to their peak of 16.4 per cent and on 24 November Chase Manhattan took the lead in the downward movement of prime rates by cutting its rate to 15¾ per cent. Other banks were expected to follow. Reflecting fears of a reversal of this decline, rates on longer-term borrowing are now higher than on short-term.

6. Consumer prices rose only 0.4 per cent in October compared to substantially higher rises in preceding months.

7. Unemployment rose to 8 per cent in October.

BULL POINTS — <u>As at 30.11.81</u> (Tape 455)

(i) Evidence that the fall in output is now over

- Total output (GDP) rose by ¼ per cent in 3Q according to preliminary estimates.

- Industrial and manufacturing output increased ¾ and 1½ per cent respectively between 2Q and 3Q.

- Short time working in manufacturing fallen to ¼ of January peak; total hours worked have stabilised.

- 3Q figures for manunfacturing, distribution and wholesalers show rate of destrocking reduced by well over half compared with 1H 1981.

- Volume of engineering and construction orders this year up about 20 and 10 per cent respectively on 2H 1980.

- Private sector housing starts up over 40 per cent in year to 3Q 1981.

- Most recent major independent forecasts (LBS, St James, NIESR, P&D, CBI) assess low point in activity reached in 1H 1981; prospect of some recovery in coming year.

(ii) <u>Earnings and settlements.</u> Increases halved in 1980-81 pay round. <u>CBI pay data bank</u> shows manufacturing settlements in 1980-81 averaging 8-9 per cent, with about two-thirds in single figures. Public sector in line.

(iii) <u>Productivity</u>. Indications that productivity increasing. Output per head in manufacturing in 1981 2Q almost 6 per cent higher than in 1980 4Q. Investment in plant and machinery holding up.

(iv) <u>Competitiveness</u>. Pay moderation and increases in productivity have led to very little rise in manufacturers' unit wage costs this year. Combined with exchange rate fall implies a recovery in UK competitiveness (up some 10 per cent this year) and alleviation in intensity of squeeze on profit margins.

(v) <u>Unemployment</u>. Rate of increase in unemployment in 3 months to November less than half that of the last quarter of 1980. [NB some commentators conclude that trend is now accelerating.] Some increase in number of <u>vacancies</u> over recent months. Short-time working in manufacturing sharply cut - just ¼ of January level in September. <u>Overtime working</u> has increased by 10 per cent in 3 months to September over previous 3 months. Total <u>hours worked</u> in manufacturing have now broadly stabilised.

(vi) <u>Special employment measures</u>. In July Government announced further provision for special measures, worth (gross) £700 million in 1981-82. A large part of this was for young people, including the new Young Workers Scheme. Special employment and training measures currently cover 700,000 people at a cost of over £1100 million this year.

(vii) Industrial relations. Number of stoppages over period since July 1980 lowest in any comparable period since 1940s.

(viii) Retail prices. Inflation almost halved since peak in second quarter of last year. 12 monthly increase in October of 11.7 per cent. [NB Progress will for a while remain affected by lower exchange rate and higher interest rates.] UK's now much closer to average year-on-year consumer price inflation in major competitors (around 10¾ per cent).

(ix) Public sector borrowing. Underlying position in line with Budget time forecast for 1981-82.

(x) International consensus that control of monetary aggregates and public expenditure essential to curb inflation, improve 'supply side' and lay foundations for renewed, sustainable growth. US, Canada and Germany have announced lower monetary targets for this year than last. Most major countries (US, Japan, Italy, Germany, Netherlands, Sweden, Norway and Australia) have recently announced measures to cut planned public spending.

(xi) Loan Guarantee Scheme. Off to a very good start. Nearly 1200 guarantees issued so far on loans totalling over £41 million. Over half of loans going to new businesses.

(xii) Enterprise Zones. 10 out of 11 zones already in operation. Much interest shown; eg announced that at Dudley new high technology project will provide 300 jobs by 1985. At Corby, a good proportion of sites already allocated for development and on designation day 32 factories were already under construction. At Clydebank, 45 companies with potential for 600 new jobs have either moved in or are expanding existing operations.

(xiii) British export successes. September trade figures show that exports holding up better than many feared. Specific successes reported in the Press include: STC has won contract worth £170 million for telephone cable across Pacific from Australia to Canada: Davy Corporation have won £330 million contract for steel plate mill in Mexico and are in lead in international consortium to build £1250 million steelworks in India; Foster Wheeler working on £140 million petro-chemical complex in Greece.

(xiv) Locations in Britain selected by international companies. Texas Instruments, Hewlett Packard and Motorola and demonstrating confidence in Britain by selecting sites in UK for expanding their operations.

Economic Briefing Division, HM Treasury, 01-233 3364/5809

PROSPECTS FOR EC DEVELOPMENT

Points to make

1. Constant well-publicised arguments in Community tend to distract attention from underlying common purpose of free, democratic Europe, towards which steady progress is being made.

2. European Council last week tackled the most difficult issues of reform - CAP and budget. No overall agreement possible, but even so much progress made, and an excellent atmosphere. Essence of Community is achieving compromises which reconcile different national interests.

3. [If asked] Difference in political philosophy between Governments in Member States not necessary. Our obstacle to Community development: e.g. French Socialist Government has stressed need to tackle economic and social problems at a Community level.

Copy to Alan Walters.

Prime Minister

USA 2

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You may be interested to read this note by Terry Burns on his recent visit to the US.

MCS 19/10

VISIT TO UNITED STATES: 21-30 SEPTEMBER 1981

1. I spent 4 days in Washington prior to the World Bank/IMF meetings. I gave two speeches, one to the National Economists Club (September 22) and one to the National Association of Business Economists (September 24). With Mr Dow I saw a variety of people in Washington (list attached). I was also present when the Chancellor met Mr Stockman and Mr Regan.

2. I was impressed by the degree of uncertainty about the reasons for recent developments and the prospects for the future. Not surprisingly, the failure of almost everyone to predict recent events has left analysts struggling to produce explanations for recent levels of interest rates. Sharp differences of view still exist but I sensed a greater degree of humility in some quarters than earlier reports have indicated.

3. Although there are differences of view within Washington and within the Administration the sharpest differences are between Wall Street and Washington. The bankers at the lunch given by Mr Anson were very pessimistic and showed a substantial lack of confidence in the Administration's policies. At the same time several members of the Administration are blaming higher interest rates upon the short sighted view and lack of sophistication of Wall Street and the press.

Underlying Position

4. The underlying growth potential of the US economy appears to be reasonably high. This is the major difference between the US and the UK. The demands that are being made on the economy for defense expenditure, energy investment, and high technology are important. So is the ability of the economy to begin to adjust itself towards these new demands and the changed pattern of relative prices following the oil price shock. This underlying strength of the economy is

possibly responsible for the strong underlying demand for credit. In the absence of monetary restraint some observers were speaking of a potential growth rate of up to 4% per annum.

5. At the same time the US faces a persistent inflation problem. The upward trend of inflation is becoming strongly entrenched with each cycle. So far this acceleration has not been anything like as serious as in the UK although in part this may reflect the sluggish behaviour of US wages. However, the opposite side of this coin is that the same sluggishness of wage response could make it that much more difficult to get inflation down again. Recently US inflation has been improved by lower energy and food prices - possibly reflecting a stronger exchange rate although it has not been recognised as such. Excluding cyclical influences, the underlying US inflation rate is probably about 10%.

6. The combination of 4% potential growth and 10% underlying inflation points to a growth of nominal GDP of up to 14% per annum in the absence of monetary restraint. The implication of the monetary targets and the Administration's overall strategy is that this needs to be brought back to about 10% per annum.

7. Two major issues emerge from this. The first is the appropriate fiscal/monetary balance. What should be the relative balance of fiscal and monetary policy in bringing about this deceleration of nominal GDP; what part should be played by the federal deficit and what part by higher interest rates? The second issue is whether this deceleration of nominal GDP inevitably implies a recession. Alternatively is it possible that the tax cuts can simultaneously stimulate output and reduce inflation within a profile of lower nominal GDP growth?

Fiscal Policy

8. There is a broad consensus that fiscal policy - at least from FY82 - would be expansionary. Instead of contributing to a reduced growth of nominal GDP, on present plans fiscal policy will

be a force for some expansion. For FY 1984 the combination of tax cuts and defense and social security commitments were generally thought to be inconsistent with the objective of a balanced budget. There are a number of ways in which the picture might change. Despite the tax bill there could be a postponement of some of the reductions. In addition a VAT, an oil import fee and a natural gas windfall profits tax were mentioned as possible starters. Political pressures are likely to prevent any such innovations before the 1982 election. The recent abortive attempt to cut social security spending is disappointing from the point of view of longer term public expenditure control and there seems little desire to raise this again quickly.

9. In the short run the US budget deficit is being increased much as ours was in 1980-81 by changed economic assumptions. Lower oil and food prices have damaged tax collection and increased farm price support. With some programmes additional numbers claiming benefit have more than offset earlier cuts in the benefit rate, and it is difficult to prevent agents exploiting cheap lines of credit or credit guarantees as economic pressure increase.

Monetary Policy

10. This fiscal stance means that monetary policy has to bear a large part of the burden of reducing the growth of nominal GDP. The resulting pressure on velocity implies high real interest rates. This seems to be at the heart of the concern of the financial markets who see it as a conflict of demand for credit between the private and public sectors.

11. It is difficult to judge the level of nominal interest rates that this implies. Already housing, autos and some small businesses are in trouble as a result of the high interest rates. But some parts of the economy are relatively immune. If deflation is to come entirely from monetary policy it could mean a severely unbalanced economy.

12. Whether this pressure on velocity can wholly account for the continuing high level of interest rates is an unresolved matter. Based on broadly the same information as is available now few analysts expected present interest rates to continue. There was some discussion of unusually high risk premiums being necessary because of uncertainty about the continuation of present policies and whether inflation can be brought down; but much of it merely reflects an absence of any other explanation.

13. Persistent slow growth of output or even recession could bring some temporary interest rate reductions; and declining inflation would reduce nominal interest rates. But over the period of the Administration as a whole the outlook is for a continuing high level of real interest rates.

14. The US is having similar problems to ourselves in interpreting the significance of the various monetary aggregates. The narrow aggregate M1B is growing below target whilst the wide aggregates are either at the top of or above the target range. It was argued to us that this may be appropriate because of an acceleration in narrow money velocity that may not be easily reversed. At the same time it was argued that the wide aggregates include interest sensitive components which might be affected by any rise in savings following the tax cuts as well as high interest rates themselves. This would produce a tendency for the wide measures to overstate the underlying stance of monetary policy. This was reminiscent of many discussions here on the role of various aggregates. The US is moving from a concentration on narrow aggregates towards taking account of the wide aggregates just as we are moving in the opposite direction. Maybe we will meet somewhere in the middle.

15. The difficulty involved in interpreting the significance of the various aggregates is producing something of a backlash against monetary targets. This is where the interest in gold seems to emerge. This.....

was discussed more frequently than I had expected. No consideration seems to have been given to the implications of any proposal for other countries or exchange rates. I can see nothing of importance coming from this, although it will ruffle some feathers. From our point of view, it may be one way into the general case for greater exchange rate stability between the dollar and elsewhere but that is a very long shot.

16. An important difference between the UK and US is the response to exchange rate appreciation and loss of international cost competitiveness. In the US few people show any interest in exchange rates. There were some reports of pressure on profit margins and volumes but in general it was not an important policy issue. The reverse of this is that the US will not get the same anti-inflation benefit as the UK did. And it is another way in which monetary policy can influence the economy apart from those sectors clearly influenced by high interest rates. Because of the exchange rate, the pressure of anti-inflationary policy in the UK has been spread beyond construction and autos ~~more~~ than is likely to be the case in the US.

Prospects for Output and Inflation

17. Despite the strong potential underlying growth of output most of those consulted expect output to be stagnant for several more months. Two groups then expect to see a rapid upturn. One of these groups is the 'supply siders' in the Administration. They argue that inflation will fall rapidly and provide room within the growth of nominal GDP for a rapid growth of output. Their basic approach is to argue that nominal GDP will be determined by the monetary targets. The division between price and output will depend upon supply side considerations and in particular will be affected by the fiscal changes. Those taking this approach reject the notion of a sluggish price response and argue that it has been possible on previous occasions to have a sharp

reduction in inflation, led by lower interest rates, lower mortgage costs and lower increases in housing costs.

18. A second group expecting rapid growth from mid-82 are the conventional large model forecasters such as Lawrence Klein of Wharton. They argue that the effect of fiscal expansion will outweigh any efforts towards restraint by the monetary authorities. They expect real interest rates to fall back somewhat and in any case do not expect them to offset the effect of the fiscal expansion. Theyexpect velocity to rise to accomodate the higher level of output.

19. Those looking for slower growth see it as the inevitable result of the Fed's effort to restrain monetary growth. The Fed themselves are looking for output stagnation until the end of 1982 and no sharp recovery until inflation comes down. One view is that they will intensify the monetary squeeze until inflation does improve substantially.

Conclusions

20. As in the UK a lot will depend on the speed of adjustment of inflation to the monetary squeeze. I would be relatively pessimistic of the chances of a sharp break given the sluggish response of US wages. It was argued to us that the next wage round was crucial. A number of important wage settlements were due in 1982 - cars, tyre manufacturing, and transport - which would be conducted against a difficult economic background. If there is a major change in wage behaviour in these sectors that quickly spreads to other less depressed sectors the outlook would be much better. But the UK experience does not suggest that this can be achieved so easily. Despite the smoother operation of the US labour market, I would expect that getting inflation down will be a painful business. In recession some progress will be made but it will be difficult to sustain.

20. This points to high and fluctuating real and nominal interest rates over the cycle. One possible resolution could stem from the burden this will place upon certain parts of the economy which

in turn is likely to produce constant pressure for a change the fiscal stance. In the early stages of any recovery when impatience is at its highest it could also lead to considerable pressure for some relaxation of the monetary targets.

21. My interpretation is that the longer term success of the Reagan policy is likely to depend upon the ability of the Administration to control the level of public spending. Without further progress, the pressure on certain sectors could be intense and then the inflation objective would be in doubt. If expenditure is reduced, the prospects must be better. Even so, we would be unwise to count on a rapid move to lower inflation and faster growth, although the likelihood of the policy being sustained would be greater.

TERRY BURNS
October 1981

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LIST OF PEOPLE TALKED TO:

Administration

Treasury - Beryl Sprinkel
Norman Ture
Paul Gray Roberts

19 OCT 1981

Department of Commerce - Bob Dederick

Council of Economic Advisers - Murray Weidenbaum
Jerry Jordon

Federal Reserve - Governor Partee
Michael Prell (Asst Director; Director of Research & Statistics)

Others in Washington

Lawrence Klein (University of Pennsylvania)

National Association of Manufacturers - Larry Fox (Vice President)

Brookings Institution - Joe Pechman
Charlie Schultze
Other senior fellows

American Enterprise Institute - Tom Johnson
William Fellner
Rudolph Penner

Congressional Budget Office - Alice Rivlin