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Prime Minister

Timely for Thursday's Cabinet.

MCS 26/1

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PRIME MINISTER

M.T

US INTEREST RATES

On 8 October last I minuted you and other Cabinet colleagues about the implications of US budgetary and interest rate policy for our own fiscal and monetary policies. American policy will continue to have major implications for our own situation, especially for our interest rates and exchange rate throughout 1982. Colleagues may like to have an up-to-date assessment of the position in the light of my recent meetings with other Finance Ministers and Central Bank Governors.

2. During much of 1981 we were able to shield British industry from the full impact of high US interest rates. Fiscal restraint in the 1981 Budget contributed substantially to this. Taking 1981 as a whole our interest rates fell relative to US rates: our average for the year was 3 per cent below US rates whereas in 1980 it was 2½ per cent above them.

3. Although US interest rates fell in October and November as the US economy moved into recession, they have already gone up again, and there is now a widely held fear that they will rise further later in the year. The main reason for this fear is the large emerging US budget deficit. If a recovery of the US economy late in 1982 coincided with the need to fund a sharply growing deficit, interest rates could hardly fall and might rise again. In the 1981 US fiscal year, which ended on 30 September last, the budget deficit was \$55/60 billion. The original forecast for fiscal 1982 (ending 30 September 1982) was \$43 billion, but the latest forecast is over \$100 billion. For 1983 and 1984 still higher figures are forecast. This prospect may be improved

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by President Reagan's State of the Union message expected on 26 January; or by some later budget statement. But a great deal would have to be done (and major congressional battles fought and won) greatly to change the thrust and direction of this deficit.

4. The implications of this for interest rates in the UK and in Europe generally are not attractive. In recent discussions with members of the US Administration I have, as you know, urged that every effort be made to reduce the deficit, and have reminded them of the potential impact on European economies. It is possible that the impact of the US deficit on US and therefore European interest rates could be reduced, e.g. by continued recession in the US. But continued US recession would itself be damaging to the European economies.

5. The progress we have already made with our own public deficit and with our inflation has improved our ability to withstand risks like those which the US situation may produce. However I think the existence of these external risks to our interest rates and exchange rate do have a very real bearing on our discussion on 28 January about our own budget.

6. I am copying this minute to our Cabinet colleagues and to Sir Robert Armstrong.

G.H.

26 January 1982