Prime Minister

USA

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A. J. C. 27/1

FCS/82/20

CHANCELLOR OF THE EXCHEQUER

US Economic Policy and the Alliance

1. I share the anxiety you express in your letter of 22 January on this subject. American economic policies are putting an increasing strain on relations between the United States and Europe. This makes it much more difficult to deal with other transatlantic pressures, for example over Poland or the Middle East.

2. I agree too that we should convey our worries to the Americans through a variety of channels. You are the best placed to argue the case with authority and I am sure you did so at the last meeting of the G5. The preparation for the Versailles Economic Summit, which will get underway next month, would provide further opportunities. As you know, I myself shall be away in South-East Asia until mid-February. But on my return, I will do what I can to help. I should say, however, that I am not sure that I would be able to help very much by raising the question with Al Haig. In talking about these problems his background is very much strategic rather than economic and I doubt whether he has much influence on economic policy. I should also have to be very careful to avoid any suggestion that we disapprove of the increase in American defence spending; this could only have an adverse effect on him.

3. You raised the question of a message from the Prime Minister to President Reagan on this subject as a possibility, after he has given his State of the Union speech. I agree that this is an idea worth considering very seriously. But both the timing and the presentation would need to be handled very carefully. The Americans seem to me more than usually sensitive at the moment to any sort of criticism from their European allies, however expressed. I would prefer to wait and see how we emerge from the next few weeks exchanges with the Americans over Poland before we tackle them at the highest level over economic policy.

4. I am copying this to the Prime Minister.

C

Foreign and Commonwealth Office (CARRINGTON)

27 January 1982

CONFIDENTIAL

Prime Minister ②

USA

MLS 5/2

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

5 February 1982

B J P Fall Esq.
Foreign and Commonwealth Office

MS

Dear Brian,

US ECONOMIC POLICY AND THE ALLIANCE

The Chancellor has seen your Secretary of State's minute of 27 January, and accepts that it would be better not to pursue immediately Chancellor Schmidt's suggestion that the Prime Minister should send a message to President Reagan about US economic policy and interest rates.

However, as the Chancellor mentioned in Cabinet yesterday, the prospect for US interest rates is a matter for continuing concern: President Reagan's State of the Union message represented in this context a significant disappointment. The Chancellor's conclusion is that it is essential to keep up a steady pressure on the US authorities. Secretary Regan had sent a letter about the State of the Union Message: replying to him provided a natural opportunity for the Chancellor to set out our concerns in some detail. I attach a copy of the letter which he has accordingly sent.

I am copying this letter and the attachment to Michael Scholar at No. 10 and to Tim Allen at the Bank.

Yours ever,

John Kerr

J.O. KERR
Principal Private Secretary

Treasury Chambers, Parliament Street, SW1P
01-233 3000

4 February 1982

The Honorable Donald T. Regan,
Secretary of the US Treasury,
WASHINGTON

Dear Don

Thank you for your message of 26 January about the President's State of the Union Address. I was very interested to read both the full text of the Address and an excerpt from your testimony to the Joint Economic Committee of Congress on 27 January, and I look forward to seeing next week your detailed budget proposals.

I am grateful to you for noting my concern about your Budget deficit and its impact. It has occurred to me that it might be useful if I were to set out my position fairly fully. In spite of G5 meetings we do not for long spells get an opportunity to talk these things out in any detailed way, although you and we are pursuing broadly analogous policies with very similar objectives.

You know that the United Kingdom Government supports fully the President's efforts, and yours, to reduce inflation, public expenditure and the size of the public sector; to improve national productivity; to reward savings and encourage investment; and to exercise firm control over monetary growth. Our policies are in many respects parallel to yours. We greatly wish your policies to succeed: indeed we believe that success is essential to the strength of the free economies.

As I see it, to win the fight against inflation one requires a firm monetary stance supported by an adequate control of the Budget deficit. If fiscal policy does not adequately underpin monetary policy, one of two outcomes can occur. The first is that one may be compelled, because interest rates became intolerable, to slacken monetary policy to match budgetary policy. The second is that interest rates remain very high.

The first would have far reaching consequences for the health of the dollar, and is certainly not an outcome which your friends on this side of the Atlantic would wish to see. But the second would have a very severe impact on interest rates and exchange rates over here: that in turn would produce resentment and strains in the Alliance. Either way the free world would suffer.

/I welcome

I welcome the President's efforts to reduce the estimated Budget deficits for future years. I know, however, that you must be disappointed - as I am - that this year's deficit is likely to be so much larger than your original target, and that the prospects for reducing the deficits in later years now appear less good.

I know that a number of arguments can be advanced to support the proposition that even a rising pattern of deficits can be consistent with success against inflation and lower interest rates. The first is that this year's increased deficit is mainly the product of recession and that in a recession some increase should be tolerated. In 1980-81 our own public borrowing requirement exceeded our target for similar reasons. There is force in the point, provided that the downward trend really is convincingly resumed thereafter. We took action to bring this about in 1981-82, and have achieved it.

A second argument is that excessive preoccupation with Budget deficits is a European phenomenon which does not fit US circumstances, where the federal deficit is a more modest proportion of GDP and the private bond market plays a much larger role. But off-Budget borrowing on public credit ought, I would think, to be added to federal deficits when making comparisons, e.g. with our UK PSBR. More important still, the US savings ratio is well under half that in the UK and other West European countries. I know that you hope to increase savings through your income tax relief programme. But it may be optimistic to rely on much sustained increased in savings from tax reliefs which are modest in real terms.

A third argument is that resumed growth will reduce the deficit, and it may. I see you gave Congress an example of the impact of growth at 4 to 5 per cent. The US economy has certainly achieved growth at that rate at times in the 1970s. But in the 1970s that rate of growth, when long sustained, seems to have been associated with quite a lot of inflation. We worry about the impact on interest rates of a sharp revival of demand for private credit, linked with a rising deficit.

A fourth argument is that the deficit doesn't matter if the money supply is controlled. But it is a good deal more difficult to control money in the face of a rising deficit. We are back to the size of the deficit relative to the pool of savings, and to the competition of private (and international) credit demands as the economy recovers.

I see that general government borrowing accounted for about 30 per cent of the total demand for credit in the United States in both 1980 and 1981, and is likely to account for at least the same proportion in 1982. I believe that this is similar to the Carter Administration's credit demands in the period 1975-77, but as I recall these were accompanied by a strong rise in private credit at the same time. These demands were only accommodated with a sharp upsurge in the monetary aggregates - with inflationary consequences later.

/Policy here,

Policy here, in West Germany, and elsewhere in Europe has been directed to reducing or at least stabilising budget deficits. This has involved sacrifices in the interests of reducing inflation and achieving a better balance in the economy. In our case, and probably in others, I believe the basis of a sound recovery has been laid. That recovery could however be retarded by a renewed rise in interest rates or a resurgence of inflation. The course of your policies and of the US economy is of the greatest importance for both.

Hence my concern, widely shared in Europe, that you should succeed in establishing a downward trend in the US deficit, and in convincing the markets that your counter-inflation policy will bring success. I know it is part of your philosophy, as it is of ours, that markets cannot lightly be disregarded and are critically important indicators, including indicators of inflationary expectations. When they are convinced, I am sure we may all look for relief on interest rates. I very much hope that your forthcoming Budget will be an important step in that direction.

Knowing you as I do, I am sure that you will not take this unsolicited advice amiss. I appreciate only too well the difficulties you face in administering a courageous policy, and I recognise that the post-war history of the British economy is not a particularly good advertisement for the quality of advice from London. I also fully understand - because I share them - the problems created by the burden imposed by a major defence effort. I have warmly welcomed the progress you have made, as we have, in reducing inflation. I write - I hope without presumption - as a friend; but also because your policies have so much more impact on us than ours can ever have on you.

As you say, let's continue to keep in touch.

With warm good wishes

Yours

Geoffrey

GEOFFREY HOWE

USA

Ref. A07319

PRIME MINISTER

Cabinet

I understand that the Chancellor of the Exchequer thinks that it might be helpful if at tomorrow's Cabinet he were to give his colleagues a short explanation of the present state of play on US interest rates. The decision of some of the large US banks to increase their prime rates to $16\frac{1}{2}$ per cent seems to have provoked a crisis between the Federal Reserve and the White House with the Administration seeking to imply that the increase should only be a temporary phenomenon and the Federal Reserve implying that the Government's high budget deficit is to blame.

2. The Chancellor only wishes to speak briefly, and I would suggest that you might ask him to do so as part of the Foreign Affairs item.

RtA

ROBERT ARMSTRONG

3 February 1982