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FM WASHINGTON 230040Z FEB 82  
TO ROUTINE FCO

TELEGRAM NUMBER 587 OF 22 FEBRUARY 1982.

INFO SAVING TO PARIS BONN UKREP BRUSSELS TOKYO AND OTTAWA.

U S ECONOMY: THE POLITICAL CONTEXT, THE ECONOMIC OUTLOOK  
AND THE ROLE OF THE FEDERAL RESERVE.

1. THE ECONOMIC OUTLOOK HAS TO BE SEEN IN ITS POLITICAL CONTEXT. THIS WILL NO DOUBT KEEP CHANGING BUT OVER THE LAST TWO WEEKS THERE HAS BEEN SOMETHING APPROACHING A PHONEY WAR ON THE BUDGET. THE PRESIDENT CHALLENGED HIS CONGRESSIONAL CRITICS QUOTE TO PUT UP OR SHUT UP UNQUOTE. A NUMBER OF DEMOCRATS (AND ONE OR TWO REPUBLICANS) HAVE RESPONDED WITH ALTERNATIVE PROPOSALS. BUT STOCKMAN TOOK THE LINE IN CONGRESSIONAL TESTIMONY LAST WEEK THAT NO SERIOUS ALTERNATIVE TO THE ADMINISTRATION'S OWN BUDGET HAD YET BEEN PUT FORWARD. WITH STOCKMAN HIMSELF UNDER FIRE ON THE HILL (SENATOR HELLINGS CALLED HIM A PATHOLOGICAL FINAGLER - AND OTHERS WERE LESS COMPLIMENTARY) AND HIS CREDIBILITY SERIOUSLY IN DOUBT, THE ADMINISTRATION HAVE NO OBVIOUS SPOKESMAN TO WORK THE MAGIC THAT ENABLED REAGAN TO CARRY MUCH OF HIS PROGRAMME LAST YEAR. THEY HOPE THAT WHEN CONGRESS HAS DONE ITS SUMS IT WILL CONCLUDE THAT THERE IS NO VIABLE ALTERNATIVE TO THE REAGAN BUDGET BUT ADMINISTRATION SPOKESMEN ARE ALSO BEING FORCED TO ACKNOWLEDGE PUBLICLY THAT A MESSY FIGHT IS IN PROSPECT. CONGRESSMEN RETURNING FROM LAST WEEK'S RECESS REPORT WHAT THE OPINION POLLS ALSO SHOW - DIMINISHING PUBLIC CONFIDENCE IN THE PRESIDENT'S ECONOMIC PROGRAMME. AGAINST THIS BACKGROUND, SOME OF THE RECENT ECONOMIC FIGURES MAKE FOR PREDICTABLY GLOOMY READING.

2. U S INDUSTRIAL PRODUCTION FELL BY 3 PERCENT IN JANUARY TO STAND 10 PERCENT BELOW ITS LEVEL IN JULY (WHEN THE CURRENT RECESSION BEGAN). THE DECLINE HAS BEEN WIDESPREAD, WITH THE HOUSING AND CAR INDUSTRIES PARTICULARLY HARD HIT. THESE INDUSTRIES, BOTH VERY SENSITIVE TO THE LEVEL OF INTEREST RATES, HAVE BEEN OPERATING AT BELOW 50 PERCENT OF CAPACITY FOR SOME MONTHS.

3. MARKET INTEREST RATES, WHICH FELL SHARPLY IN OCTOBER AND NOVEMBER, HAVE REBOUNDED SINCE THE BEGINNING OF THE YEAR TO A LEVEL 5 PERCENT OR MORE ABOVE THE RATE OF INFLATION. WHILE THIS RISE PARTLY REFLECTS THE REACTION OF THE MARKET TO THE PROSPECT OF HIGHER FEDERAL BUDGET DEFICITS, AND UNCERTAINTIES ABOUT CONGRESSIONAL REACTIONS TO PRESIDENT REAGAN'S BUDGET PROPOSALS, THE SURGE IN THE MAIN MONETARY AGGREGATE (M1) IN JANUARY HAS ALSO EVOKED QUFSTIONS BOTH WHETHER THE FEDERAL RESERVE BOARD'S FUNDAMENTAL STRATEGY IS RIGHT AND WHETHER IN PRACTICE THE FED CAN CONTROL THE GROWTH OF THE MAIN MONETARY AGGREGATES.

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4. SUPPLY-SIDERS OUTSIDE THE ADMINISTRATION SUCH AS CONGRESSMAN JACK KEMP HAVE OVER RECENT WEEKS CALLED FOR FED CHAIRMAN VOLCKER'S RESIGNATION, AND (ACCORDING TO A REPORT IN TODAY'S WASHINGTON POST) FOR A FUNDAMENTAL CHANGE IN THE FED'S STRATEGY, SO THAT ITS DISCOUNT RATE WOULD BECOME THE MAIN INSTRUMENT OF MONETARY CONTROL RATHER THAN INFLUENCING THE GROWTH OF THE MAIN MONETARY AGGREGATES AS AT PRESENT BY MEANS OF OPEN-MARKET OPERATIONS AIMED AT CONTROLLING THE GROWTH OF THE RESERVES OF THE COMMERCIAL BANKS. SOLOMON (CHAIRMAN OF THE FEDERAL RESERVE BANK OF NEW YORK) HAS ALSO PUBLICLY CALLED INTO QUESTION THE RELEVANCE OF CONTROLLING SPECIFIC AGGREGATES SUCH AS M1 AND M2 AT A TIME WHEN A RAPID-RATE OF FINANCIAL INNOVATION HAS MEANT THAT RECORDED MOVEMENTS IN SPECIFIC AGGREGATES MAY GIVE A MISLEADING INDICATION OF CREDIT CONDITIONS.

5. MOST PRIVATE FORECASTERS NOW CONSIDER THAT THE PROSPECTS FOR THE U S ECONOMY IN 1982 HAVE BECOME GLOOMIER SINCE THE TURN OF THE YEAR. FOR 1982 AS A WHOLE, THEY ARE NOW PROJECTING A FALL OF 0.7 PERCENT IN REAL ACTIVITY, WHEREAS THREE MONTHS AGO THEY WERE PROJECTING A GROWTH OF 0.8 PERCENT. THEY ALSO EXPECT THAT THE RECENT PATTERN OF HIGH AND VARIABLE INTEREST RATES IS LIKELY TO CONTINUE DURING 1982. THE PRESIDENT HAS SO FAR GIVEN NO SIGN THAT HE IS PREPARED TO CHANGE THE BUDGET HE ANNOUNCED ON 8 FEBRUARY ENOUGH TO REDUCE THE DEFICITS MUCH BELOW THE PUBLISHED ESTIMATES, AND THEREBY TO TAKE SOME PRESSURE OFF INTEREST RATES.

6. THE PRESIDENT ALSO REJECTED A FUNDAMENTAL CHANGE IN MONETARY STRATEGY, AT HIS PRESS CONFERENCE ON 18 FEBRUARY WHEN HE SUPPORTED THE FED'S POLICIES. BUT CHAIRMAN VOLCKER IS NOW UNDER PRESSURE TO MAKE HIS STRATEGY WORK AND IN PARTICULAR TO GAIN BETTER CONTROL OF WEEK-TO-WEEK FLUCTUATIONS IN THE AGGREGATES. THE MOST RECENT MONEY SUPPLY FIGURES (FOR THE WEEK TO 10 FEBRUARY) SHOW A DOLLARS 3.1 BILLION DECLINE, WHICH SHOULD STEM CRITICISM OF THE EARLIER BULGE, AND POSSIBLY ALLOW ENOUGH SCOPE FOR THE FED TO EASE CREDIT CONDITIONS TO PREVENT THE RECENT INCREASE IN SHORT-TERM INTEREST RATES FROM CONTINUING. BUT IF INTEREST RATES CONTINUE TO RISE WHILE THE MONEY SUPPLY MOVES ERRATICALLY, EVEN BUDGET DIRECTOR STOCKMAN MAY HAVE SECOND THOUGHTS ABOUT SUPPORTING VOLCKER WITHIN THE ADMINISTRATION, AND TREASURY SECRETARY REGAN AND CHAIRMAN WEIDENBAUM OF THE COUNCIL OF ECONOMIC ADVISERS ARE LIKELY TO REVERT TO THEIR OPEN CRITICISMS OF ERRATIC MOVEMENTS IN THE MONEY SUPPLY. FOR HIS PART, VOLCKER IS UNLIKELY TO REFRAIN FROM COMMENTING IN PUBLIC THAT FISCAL POLICY IS MAKING AN INSUFFICIENT CONTRIBUTION IN THE FIGHT AGAINST INFLATION. THE PRESIDENT'S WORDS AT HIS PRESS CONFERENCE SHOULD THEREFORE BE REGARDED AS MARKING NOT SO MUCH AN ACCORD WITH THE FED, AS A TEMPORARY AND UNEASY TRUCE WHICH WILL HOLD ONLY SO LONG AS THERE IS NO FURTHER RISE IN INTEREST RATES OR DETERIORATION IN THE ECONOMY.

7. FCO PLEASE PASS TO BATTRILL (TREASURY) AND WATSON (BANK OF ENGLAND).  
FCO PASS SAVING TO PARIS BONN UKREP BRUSSELS TOKYO AND OTTAWA [NOT ADVANCED]

THOMAS  
FINANCIAL  
NAD

[REPEATED AS REQUESTED]

2  
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MR BATTRILL TREASURY  
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