



Prime Minister,

For information, you are due
to have dinner with Schultz
tomorrow evening.

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

J.P. Collins
16/12/82

PRIME MINISTER

As you know, I saw George Shultz tonight. The problem of the US deficit - the latest estimates for the year October 1982-83 suggest figures of \$180 - 195 billion, equivalent to 5 - 6 per cent of GDP - came up, and I mentioned our concern that a deficit of such a size could lead to a renewed rise in interest rates as private credit demand recovers in the United States. If, of course, the deficit were financed by printing money it would undermine progress in reducing inflation. Either development would have serious consequences both for the US and the world economy.

2. Tonight, as when I spoke to him in Washington in September, Shultz tended to ascribe the deficit largely to the recession and hence to see it as self-correcting. He sees little link between the deficit and interest rates, citing this year's experience when interest rates have fallen despite the rise in the deficit. It occurred to me that you might like some advice, before you see him, on how to handle this argument.

3. It is of course right to take some account of the effect of the recession on budget deficits, and we have done so to a modest extent ourselves. But this does not remove the need to put deficits on a firmly declining path in the medium-term. The Shultz view is too short-sighted.

4. The Administration's commitment to a very large increase in defence spending, the President's adherence to his tax cuts package, and the entrenched opposition to any cutback in the growing burden of entitlement programmes are all factors tending to increase the deficit irrespective of any recovery in the economy.



5. It is disturbing that OECD estimates that US policy measures have added the equivalent of 1 per cent of GDP to the deficit this year in addition to the increase due to the recession. It is also a source for concern that the deficit seems set to rise again steeply next year when the Administration claims the economy will be recovering strongly.

6. It is wrong in my view to read too much into this year's experience when the recession has reduced private credit demand so that interest rates have been able to fall despite the budget deficit. As the US economy recovers, so will private credit demand; and the competition between public and private sectors for funds could well drive up interest rates.

7. None of this will be news to you, but I hope that you won't let him get away with the cyclical argument.

8. Incidentally, he asked for my views on the reasons for the strength of the dollar. He seemed himself to place weight on the US as a source of refuge for funds at a time of uncertainty in the world economy. There may well be something in this, but the fact is that the dollar has already shown signs of weakening in the face of a prospective large external deficit next year. Feldstein - the Chairman of the Council of Economic Advisers - is reported this week as mentioning a \$75 billion trade deficit next year. Of course we would not mind the dollar falling a bit, but a precipitate fall, as a result of failure to control the deficit, would jeopardise all that we have been trying to do to create a more stable international monetary framework as the basis for resumed non-inflationary growth.

A handwritten signature in dark ink, appearing to be 'G.H.'.

G.H.

16 December 1982