E.R. Pt 2

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Prime Minister (2)

MLS 24/6

PRIME MINISTER

UNITED STATES ECONOMY

The United States economy grew strongly in the second quarter of the year. To many observers the recovery seems well established. But appearances are deceptive. Two-thirds of the recent increase has been due to cessation of the inventory decumulation. And there is virtually no new net investment taking place at all.

The fiscal monetary situation is doubly dangerous. The monetary aggregates increased substantially from last July onwards. There have been only the most hesitant signs of them being arrested. A minor industry has sprung up trying to explain them away as being irrelevant, misleading etc. But the current growth in the economy is ample evidence of that monetary stimulus some nine months to a year before. Any attempt sharply to arrest that monetary growth in the next few months will have a sharp effect on growth during the 1984 election year. If, on the other hand, it is not arrested then it will feed through into inflationary expectations and inflation itself again starting just some months before the vote in November 1984.

In the long run the massive federal budget deficit overhangs everything. There was no serious disagreement with my analysis of the consequences of this deficit. (The only outrageously wrong analyses came from a small "unimportant" group in the Treasury under Manuel Johnson. They continue to argue that reductions in tax rates will so increase output and savings that the deficit will dissolve in a wave of unprecedented growth. But I am told we can ignore their ravings.)

All agreed that the underlying structural deficits had to come down. But the policies for getting the deficit under control seem to have given way to a vacant sort of Micawberism.

George Shultz said that the deficit was no problem at the moment, since there was so little demand by the private sector for funds (that is to say there is no net investment taking place). He was very concerned, however, about the cumulation of future expected deficits. But he continued to back the President in ruling out tax increases. He believed that the President was right in

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insisting on a reduction in public spending. But he was not specific on precisely what public spending should be cut - certainly not defence. Shultz said that the real problem was that there was no powerful political pressure to deal with the deficit. He said it took some time for Americans to get round to recognising that inflation was a problem; similarly, he thought it would take some time to realise the deficit was a problem. Then they would deal with it.

Feldstein disagreed with Shultz on one important issue. He believed the only really effective way to reduce the deficit, and politically he did not think this was possible until after 1985, was by increasing tax. He argued that the "cuttable" part of the deficit, excluding defence, entitlements, social security, medicare etc, had been pretty much cut down already. There was very little to be obtained from further cuts. He also believed that Shultz had not interpreted public opinion correctly; there was, he thought, a powerful constituency for balanced budgets.

In my view Feldstein was much closer to the truth than Shultz. But, of course, Shultz is closer to the President. The policy, therefore, is much more likely to be closer to Shultz than to Feldstein. This is an additional worry since Shultz at least talked to me about the likelihood of the American economy passing through a period of sustained high growth. (Broadly an extra 1% of growth in the United States reduces the deficit by about $25-$30billion.) However, no great growth prospects can be entertained when there is so little net private investment.

Feldstein is much less optimistic about growth; he recognises the crucial role of new technology and new investment. He believes that tax increases in late 1985 or 1986 are the only solution. In my view, however, they will be too little and too late.

The scene is set for:

a. a marked retardation in recovery in 1984;

b. a marked increase in inflation beginning probably in 1984; and

c. a debt crisis of considerable magnitude, the timing of which is very uncertain.

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In this scenario, a. and b. are substitutes in timing only; this depends upon how the Federal Reserve Board behaves over the next few months. The debt problem, however, will be with us for some time. The general situation in the United States is very reminiscent of many Latin American countries. There is the same incoherence, incompatability of objectives, impossible pay-offs to political constituents, and the same paralysis of policy. I know it is "unthinkable" that the great American economy could so degenerate. But the evidence is clear and we should not on our part be Micawber-like because we cannot face the consequences.

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