10 DOWNING STREET

Prime Minister

Peter Tapsell handed the to Michael Alison. For as many as support him, I am sure there are as many, if not more, who welcome your remarks.

AT

21/12

economy
US ^ future

15/12/83

I have had a good many letters on the subject of U.S. deficits. The P.M. might possibly be interested to read an extract from a typical reply I have sent, since exchanges at Question Time necessarily have to be conducted in short-hand.

Peter Tapsell

Obviously, the "technicians" will wish to distinguish between cyclical deficits and structural deficits, but for the immediate purposes of the "neo-Keynesian" argument I think we can fairly confine the discussion to the cyclical deficit.

If your thesis of last March (which I strongly support as a generally helpful approach) is still valid the dramatic increase in U.S.production - probably 6% up end-quarter 1983 over end-quarter 1982 - should be producing a desirable result: and, indeed, it has so far.

As a proportion of GNP, the U.S. budgetary deficit fell from around 7% at the worst(end-1982) to what I expect to be around 5½%

in fiscal 1984 (which, as you know, started on 1st October).

Moreover, in the past two months there has been a substantial drop in the unemployment rate (by almost 1%) in the U.S. and this will certainly have a beneficial impact on the deficit.

I know that the "gloomsters" (who are mostly"monetarists" terrified of being discredited by the possible success of Reagonomics) tell us that the American economy will soon over-heat or even go back into recession. No doubt there will have to be periodic touches on the brake pedal. However, I hope you will agree that there is a very good chance that the 6% growth rate in 1983 can be averaged out at around your magic figure of 5.2% in the period up to 1986. I accept that most economists would regard such an estimate as on the high side, but even if the actual growth is lower than this it must have a restraining effect on the deficit.

So it is at least arguable that the spectre of future U.S. budgetary deficits has been exaggerated while the greatly beneficial effect on world trade of their trading deficit is often overlooked, as is the extent to which the recovery in the U.S. economy is acting as the"locomotive"to pull the whole world out of slump,

Although I naturally accept the argument that world interest rates might be lower if the U.S. budgetary deficit was smaller, it does not follow (as the history of the Thirties surely proves) that those lower international rates would generate a recovery elsewhere,while we do know that the U.S. budgetary deficit has been a major contributory factor to the recovery of the U.S. economy which is evidently working through to the rest of the world (e.g. Japan).

Richard Ryder made a valid point in his centre page article in The Daily Telegraph yesterday when he said that it might be misleading to draw a direct analogy between the U.S. and U.K. economies. I accept that. However, as the "monetarists" have been telling us for years that they are propagating absolute and universal truths,applicable to Taiwan and Chile as much as to a western industrialised society, it is hardly now open to them to apply a policy of strict intellectual selectivity where economies are concerned !

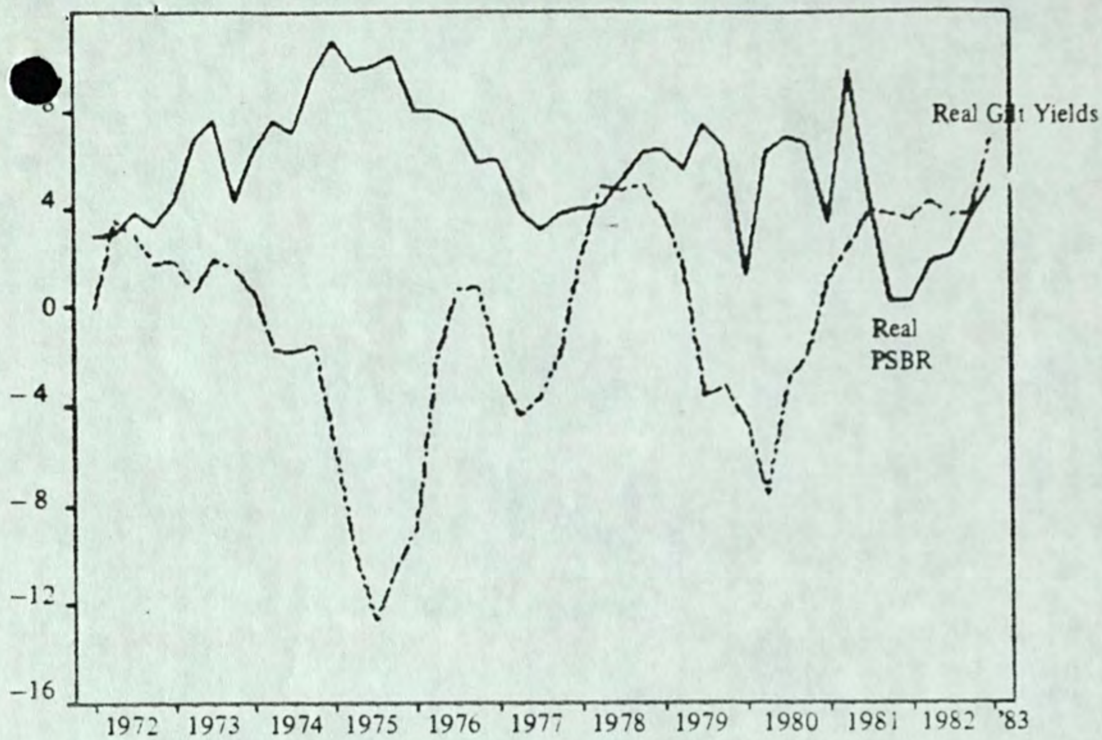
I am sure that Donald Regan was right when he told the EEC Finance Ministers last week that there is no direct causal link between deficits and interest rates (as a former bond dealer and a former chief executive of Merrill Lynch he is better equipped to make this judgment than most civil servants and academics). What he said about the U.S. is demonstrably true of the U.K. as the attached graph comparing Real PSBR and Real Gilt Yields over the past decade clearly shows.

Finally, there is a wider political consideration which is often overlooked. Three years ago we were all desperately worried about the military preponderance that the Soviet Union was expected to enjoy over the U.S. in the mid-1980's. The U.S. budgetary deficit, to a considerable extent, is a consequence of the President's heroic efforts to close that gap on behalf of us all. It is ironic that his severest critics now are precisely those who used to clamour most loudly about this danger.

Happy Christmas,

Yours ever, Peter

THE REAL PSBR AND REAL GILT YIELDS



Uncle Sam's overdraft may cut Britannia's housekeeping

Differences between the British and American economies outweigh the similarities, believes RICHARD RYDER, MP, so we should be wary of their attitude towards budget deficits

A GLORIOUS incident endures from the 1960s film, "The Graduate," when Dustin Hoffman, in the title role, is taken aside at his 21st birthday party by a business associate of his father's. "I want to give you some advice, boy," whispers the businessman, "just one word, plastics."

Three years ago an earnest American, out of the same sort of stable, and now in President Reagan's Administration, gave me advice at a conference in Switzerland. Gripping one of my elbows, and guiding me into breakfast, he confided: "Watch your deficit, boy, keep it low, keep it low."

It was far too soon in the day to be flippant and so I refrained from quoting about the only words of Oscar Wilde's known to me by heart: "It is always a silly thing to give advice, but to give good advice is absolutely fatal."

With the American deficit having doubled since then, despite President Reagan's professed fiscal conservatism, and the British deficit, as a percentage of the gross national product, halved by Mrs Thatcher, I wonder whether the good advice could prove fatal for anyone? I wonder, too, whether President Reagan's loose approach has greater merit than Mrs Thatcher's resolute approach? After all, if the American economy grows in real terms at five per cent. in 1984, as forecast, contrasted with, say, three per cent. here, then surely, the argument runs, the British Government should relax its anorexic obsession with the deficit — the resolute approach — and opt for expansion along American lines despite the near certainty of even higher interest rates.

While this view—to be examined later—partially depends on the existence of similarities between the two economies, it also supposes that the longer term American, and general world, recovery is not being threatened by the podgy Reagan deficit.

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ON that score, sharp differences have surfaced at the top of the American Administration. The chairman of the President's Council of Economic Advisers, Mr Martin Feldstein, has bravely warned, against President Reagan's wishes, that the deficit is a major threat to world recovery. In fact, in a recent speech, Mr Feldstein reckoned that the President should raise taxes, at once, because further inaction on revenue to reduce the deficit endangered longer term recovery.

On the same day, Mr Donald Regan, the Treasury Secretary, whose presence in London last week ignited exchanges in Parliament, advanced the President's line that the perils of the deficit have been exaggerated. There is no direct link between big deficits and high interest rates, Mr Regan claimed, adding that the deficits, and the economic controversy generated by them, will disappear as recovery strengthens.

If Mr Reagan is correct, then the American economy is motoring as smoothly as a Cadillac, with perfect brakes, and no perils lurk for longer-term world recovery. According to Mr Feldstein's prognosis, the American economy is motoring along like a Cadillac, with defective brakes, and the consequences for longer-term world recovery could be shocking to behold.

Disaster can be avoided, he asserts, by checking expenditure or increasing taxes. Yet neither option is worth betting on with the Presidential election less than a year ahead. Besides, the President's protective attitude towards defence and the Congress's towards welfare hardly encourages the careful husbandry prevalent in most major Western nations. Indeed the President may even cut taxes, at last satisfying his old "supply side" friends, who contend that lower taxes create incentives and produce additional revenue.

Mr Regan and Mr Feldstein have British fan clubs or, as they are more grandly called sometimes, appreciation societies. No matter, many of Mr Regan's British fans, such as Mr Peter Tapsell, MP, imply that Mrs Thatcher's resolute approach is rather pointless. Whereas Mr Feldstein's cheer her to the echo and warn of rising inflation and interest rates, if she softens. Yet, are not similarities between the two economies sometimes misleading?

To start with, the American economy is more resilient than Britain's. American firms adapt more easily and expand output faster to meet demand. Despite difficulties, such as Japanese competition, loss of national self confidence, and the declining steel industry—inefficient production is rare, and firms in trouble, like Chrysler and Pan-am, recover faster. By contrast Britain, due to the fragility of its international competitiveness at the current exchange rate, is vulnerable to import penetration after a demand upsurge at home.

In fact, imports count for less in America than Britain. So much so that in 1982 imports of goods and services were equivalent to 11 per cent. of gross national product in America, contrasted with 25 per cent. in Britain. Consequently, improvements in the American economy lead to fewer import penetrations than here.

The pound is high—perhaps too high—and exposed to a loss of confidence and sudden depreciation. So, if Britain nourished a podgy deficit, the impact on the international value of sterling could be dramatic, the more so in future with oil revenues peaking.

Confidence could, also, be shaken in Britain if the Government followed the American example by selling debt in the City, where expectations of a high deficit resulting in rising interest rates could be self-justifying. In other words the City, scared of higher interest rates, might refuse to buy the Government debt. This could lead to looser money supply figures, and, if the Government persisted, to steeper interest rates, whatever the City's desires.

So America's experience with its deficit, if repeated here, could be perilous. Contrasts between the two economies outweigh the comparisons. Yet events across the Atlantic next year could significantly affect the course and speed of Britain's recovery.

President Reagan's re-election campaign has begun. When the bell sounds for the primaries in the New Year, his Democratic rivals, their hats already in the ring, will be wrestling for dominance in the snow of New England.

Gradually, during 1984, they—and the President—will be forced to elaborate their views on the deficit and whether it should be ignored or checked. Either way, Britain's economic recovery in the 1980s could be grazed by the American deficit, the sore aggravated by protectionist pressures, still building up despite good intentions and the international banking crisis which, far from solution, is being intensified by agencies such as the International Monetary Fund.

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BACK to that conference in Switzerland, three years ago, where I was rebuked, after breakfast, by the American for predicting that the E E C's determination to develop an autonomous foreign policy would cause friction between it and President Reagan.

The American took me to pieces, for several minutes, before proudly concluding his assault by declaiming from Cicero: "Rashness attends youth, as prudence does old age." "Does that apply to foreign or domestic policy?" I inquired, in all innocence. "Both," he retorted. Now, he should know.