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PRIME MINISTER

See record of P.N.'s  
meeting with President

THE US DEFICIT

A.S.C. 20/5

In my minute of 4 May I suggested that it would be valuable if, during our forthcoming US visit, you could have a word with the President, in private, about the US deficit. I then had in mind that this might be best done during our visit to Washington just before the Williamsburg Summit; though that is no longer possible, I still think it well worth doing during your bilateral talk with Reagan at Williamsburg. I see from Washington telegram No 1363 that Sir Oliver Wright takes the same view.

2. I don't need to spell out the message which we want to get across: you have already conveyed it to Shultz and Volcker, as indeed I have done with Feldstein, Meese, and of course regularly with Don Regan. But it is getting it across to the President that counts; and you might like to glance at the attached short brief and charts. The brief picks up a suggestion, put to me by Feldstein last month, that the President would be interested in an account of our 1981 Budget, and its effects; and the first of the charts is an improved version of one which I showed Meese during his recent visit.

3. Copies of this minute and enclosures go to Francis Pym and Sir Robert Armstrong.

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

(G.H.)

24 May 1983



MEETING BETWEEN THE PRIME MINISTER AND PRESIDENT REAGAN

Points to make on US economic policy

(i) It is not only in the United States that there is great concern about high US real interest rates. Many of us fear that if they remain high, even more if they rise still further, they will cause enormous damage both to the US and the rest of the world:

- world recovery will be lopsided and difficult to sustain. Because of the damaging effect to investment longer term growth rates will suffer;
  
- interest rates in other industrial countries will be higher than they might otherwise be because of the importance of the dollar in the world capital markets and the competitive attraction of current dollar rates;
  
- the resulting high interest rates are a very large part of the immediate pressure on debtor countries;
  
- by increasing the trade deficit, interest rates and the exchange rate, the high budget deficit means that capital is being attracted to the US. The high exchange rate in turn is causing protectionist pressures in the US and the capital outflow to the US is causing resentment elsewhere at a time when the world needs more efficient long term investment;

(ii) We fear that markets will hold interest rates high unless the US can demonstrate its ability to maintain anti-inflationary monetary policy in a balanced way without distorting capital markets. This requires that the US authorities demonstrate their determination and ability to get a better control - over time - of the structural budget deficit.



(iii) The contrast between recent British and American experience shows the importance of budget deficits for interest rates. We have aimed to reduce our budget deficit (relative to GDP) in each of the last three budgets and the trend is unmistakably downward. At the same time the American deficit has been rising - and is now much larger than ours, an unusual state of affairs, particularly as the UK typically has a higher savings ratio than the US (Chart 1). As a result British long term interest rates were lower than American ones in 1982 for the first time in the post-war period (Chart 2). This is not only because of UK success on inflation which has been matched by similar progress in the US but must also reflect the balance of saving and borrowing in our respective countries.

(iv) The turning point for us came early in 1981, when we were faced with the choice between reducing the budget deficit and raising interest rates to keep monetary conditions under control. Domestic demand had been weak; the budget deficit had risen in the previous year; the exchange rate and interest rates were high. Despite rising unemployment and warnings from many commentators that it would intensify recession, we cut our budget deficit, mainly by raising taxes. The real burden of personal income tax was raised (by failing to increase allowances and thresholds by the inflation rate of 15%); real excise duties were raised (on alcoholic drinks, hydrocarbon oils and tobacco); and a supplementary petroleum duty and a special tax on bank deposits were introduced. The impact on inflationary expectations was as important as the direct financial effects; the message was that the Government was determined to stick to its course of reducing deficits. Since then the exchange rate has fallen to a more sustainable level; after some further upward pressure due to world interest rate levels, long term interest rates have fallen sharply; and domestic demand has been rising at about 3% per annum (Chart 3).

#### Background

(see also brief on World Economy, especially paragraphs 15-17)

There is some danger of overplaying the link between large budget deficits and high interest rates; other factors, particularly inflationary expectations, also have an important role. Nevertheless, if inflation is to be kept under control over the long-term, the budget deficit should not be monetised and high - perhaps rising - interest rates would be required to raise the necessary long-term finance.



2. Part of the explanation for the high interest rates in the US may be high inflationary expectations. These may in turn derive from the large present and prospective budget deficits and the fear that they may eventually be monetised. Mr Volcker said in Brussels on 19 May that the prospects for future deficits are a major part of the problem of reducing US interest rates in the long term: "This is not a problem that can be solved by pure monetary policy. I am looking ahead rather than at the current situation".

3. The administration argue that it is total world budget deficits that have caused high interest rates rather than just the US one, because the capital markets from which governments borrow are well integrated. There is some truth in this, but the US is a greater culprit (in terms of both the level of and the increase in the budget deficit) than Japan, Germany or the UK (but lesser than France and Italy). The administration's figures for the US Federal deficit are:

Fiscal year	Deficit (£ bill)	GNP (£ bill)	Deficit/GNP (per cent)
1981	80	2872	2.8
1982	128	3033	4.2
1983	225	3194	7.0
1984	203	3489	5.8
1985	205	3807	5.4

There are reasons to believe that the estimates for 1984 and 1985 may be optimistic: the administration has always revised their estimates upwards in the past, and the Congressional Budget Office - probably more impartial - show a rising deficit (in £) rather than a falling one from 1983 onwards. The largest general government deficits expected elsewhere in 1983 are about \$40 bn (in Italy and Japan).

4. There is little controversy about the adverse effects of high interest rates.

5. The presentation of the British experience by the Prime Minister should impress the President. It benefits from avoiding a too-direct criticism of American policy. A full interpretation of what happened would involve some qualifications to the simple "points to

make" above. In particular, some of the fall in UK interest rates in 1981-82 is attributable to the fall in US rates rather than to the reduced PSBR. Another strong point to be made is that the UK at the time was just as concerned as the President now is to ease the burden of taxation and give incentives to industry and people; we judged - and have been confirmed in that judgment since - that the rise in taxes in 1981 is not inconsistent with the fundamental target of reducing taxation over the medium term.



CHART 1

US and UK Government Deficits as a percentage of Gross National Product

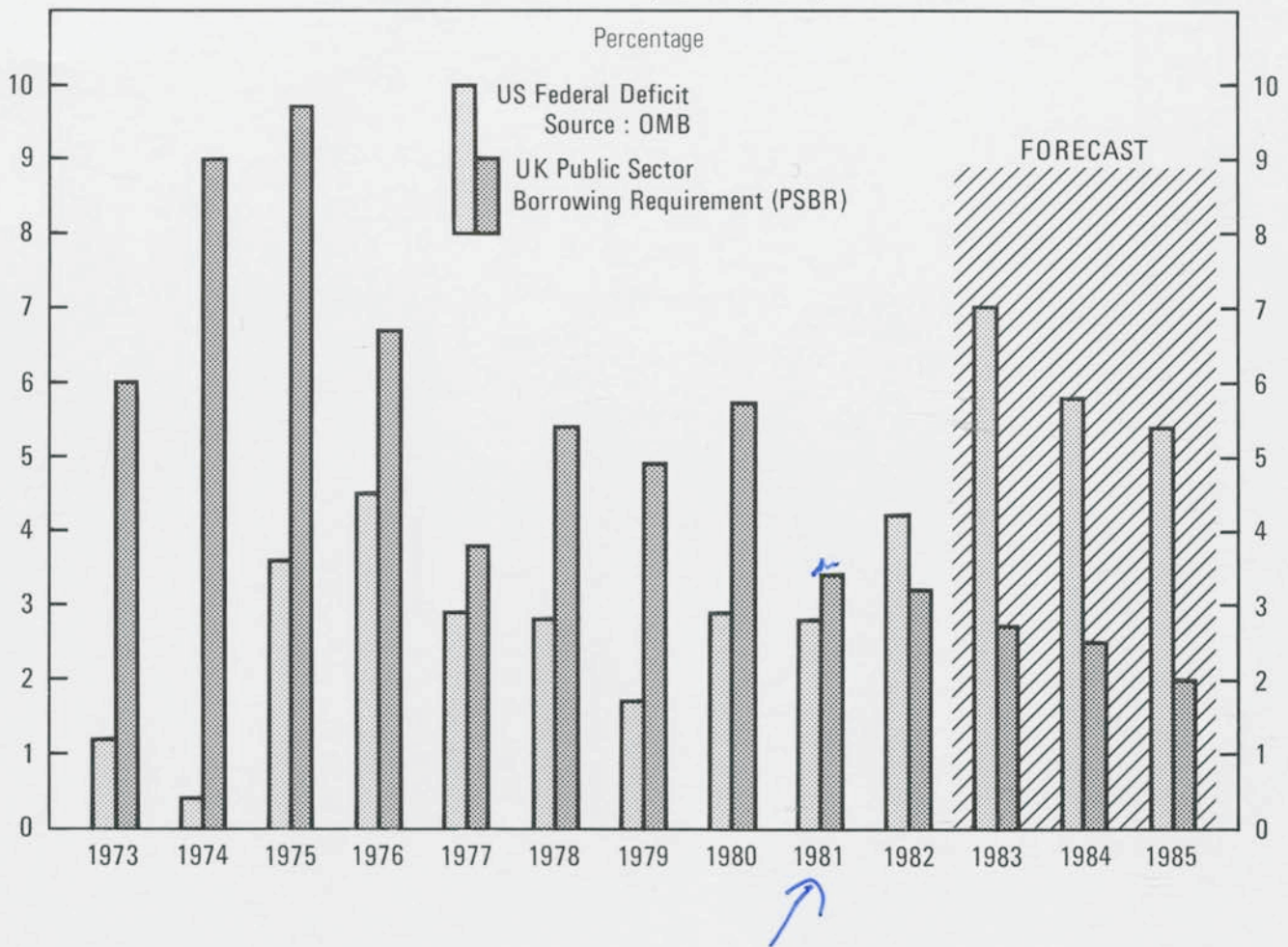
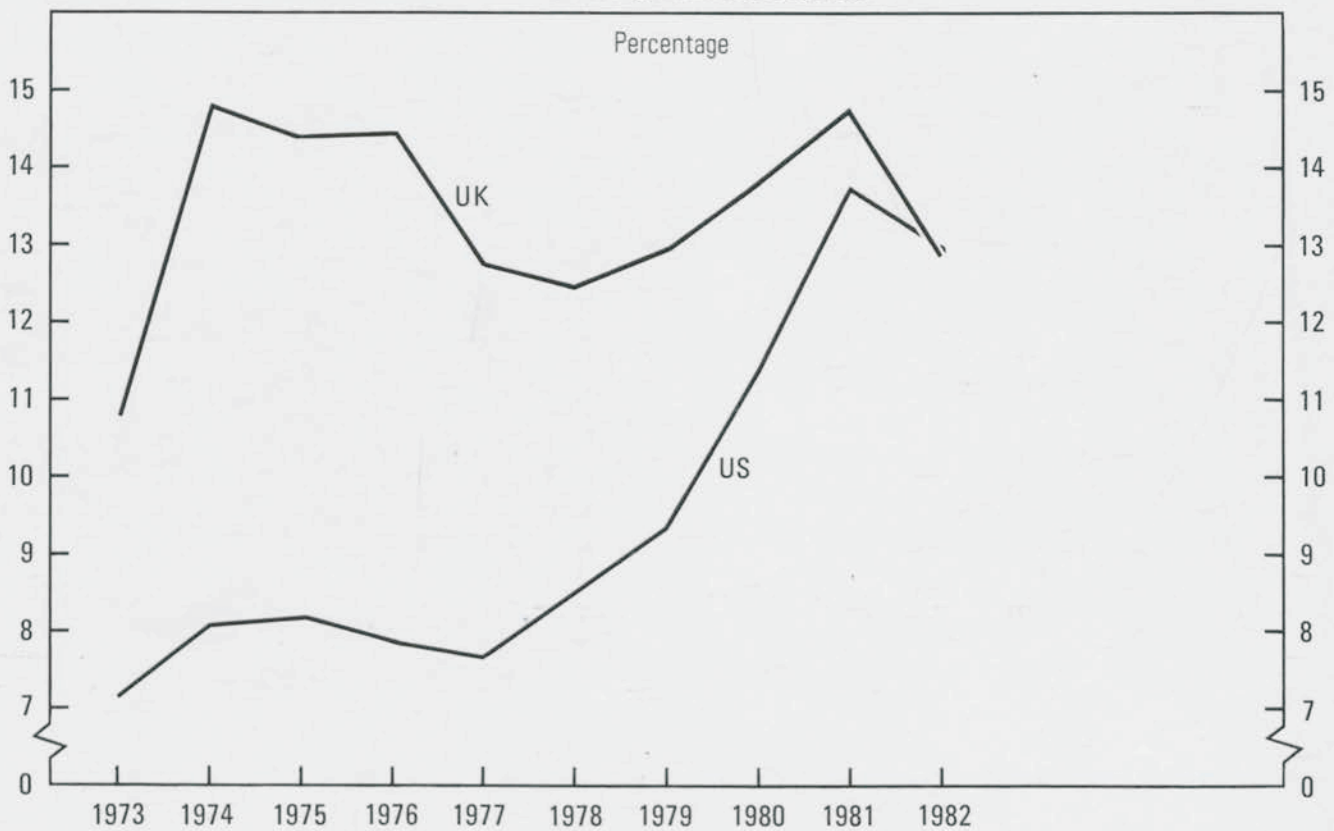
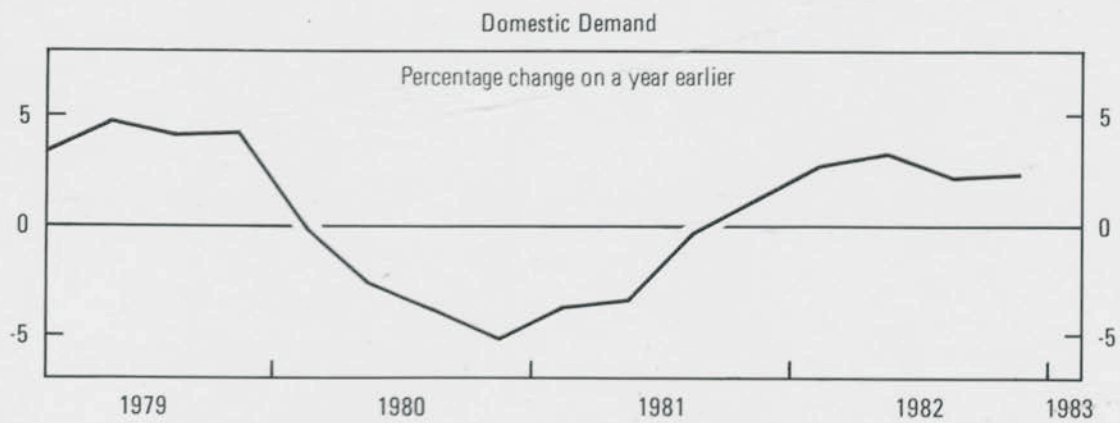
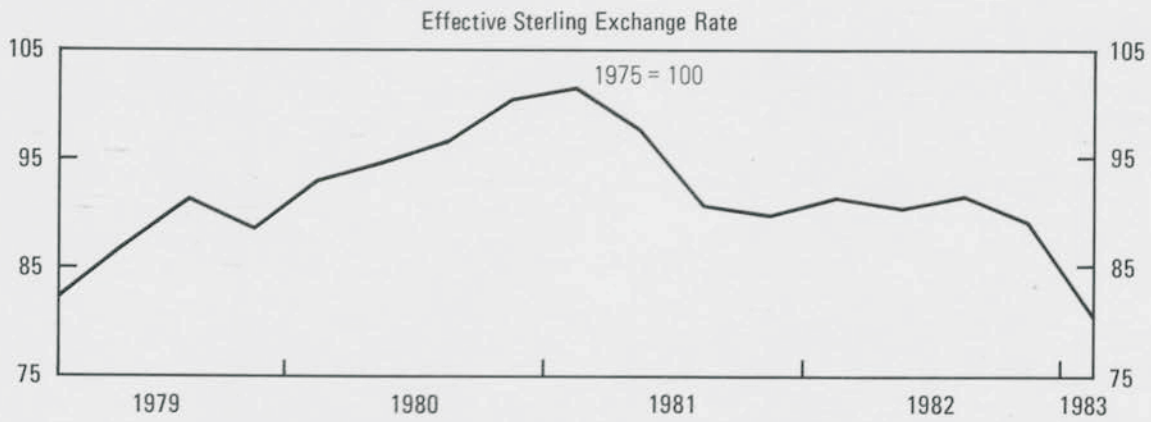
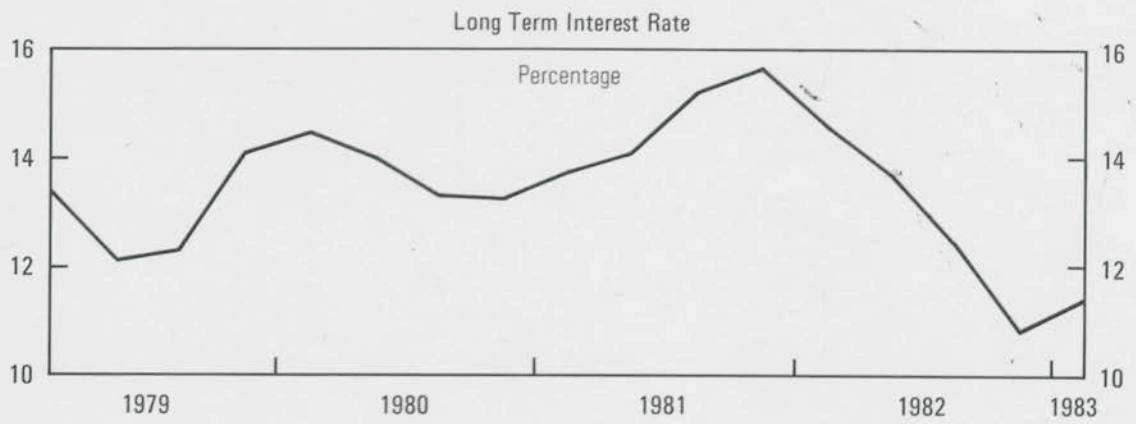
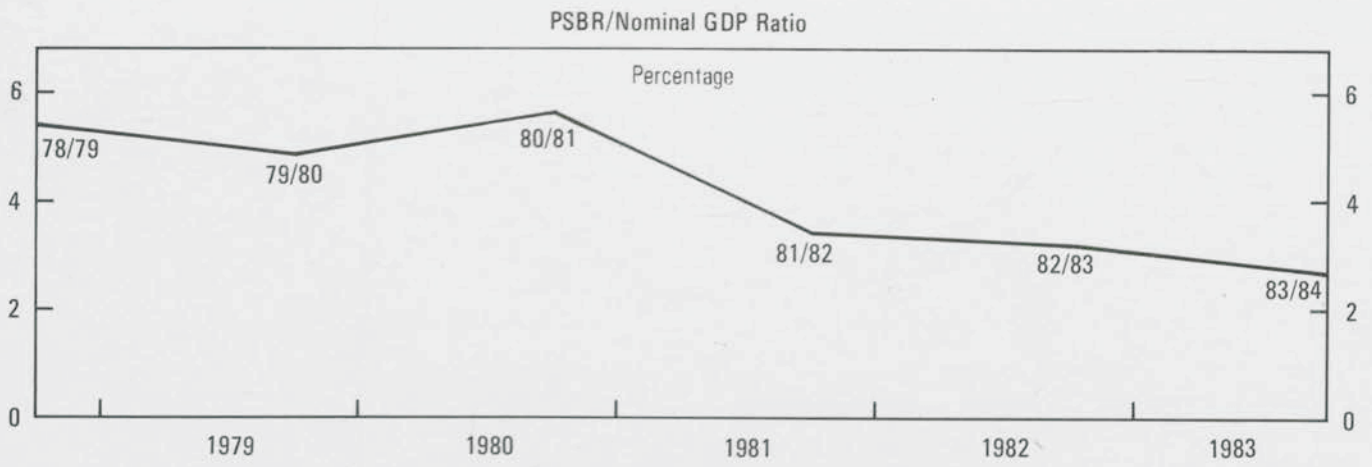


CHART 2

US and UK Long Term Interest Rates



UK PSBR, Interest Rate, Exchange Rate and Domestic Demand





WILLIAMSBURG SUMMIT

CHANCELLOR'S PRESS BRIEFING, WEDNESDAY, 25 MAY, 11AM, HM TREASURY

CHANCELLOR'S OPENING STATEMENT

MY LAST BRIEFING ON 26 APRIL

SIR GEOFFREY: ... SINCE WE'VE HAD THE WASHINGTON MEETINGS OF THE DEVELOPMENT COMMITTEE AND THE G7 MEETING ENDORSED THE CONCLUSIONS OF THE JURGENSEN REPORT; O.E.C.D., NOW WE'VE GOT THE SUMMIT COMING UP ON SATURDAY. AS YOU ALL KNOW THE PRIME MINISTER WILL HAVE TO LEAVE ON THE SUNDAY EVENING BUT WILL HAVE BEEN THERE FOR THE MAIN MEETINGS INCLUDING DISCUSSIONS ON THE CENTRAL ISSUES OF THE WORLD ECONOMY. FRANCIS PYM AND I WILL STAY ON UNTIL THE END OF THE MEETINGS ON MONDAY AFTERNOON. I DON'T THINK ANY OF YOU NEED ME TO SAY THAT YOU SHOULDN'T EXPECT THE FORTHCOMING SUMMIT TO RESULT IN A SERIES OF SPECIFIC NEW DECISIONS BECAUSE THAT'S NOT WHAT SUMMITS ARE ABOUT, IT'S NOT THE RIGHT FORUM FOR TAKING IMPORTANT WORKING DECISIONS OF THAT KIND. MANY OF THEM DEPEND IN ANY EVENT ON THE DECISIONS OF INDIVIDUAL GOVERNMENTS OR ACTIONS BY ESTABLISHED INTERNATIONAL BODIES OF WIDER REPRESENTATION. SO THAT XDOESN'T MEAN THAT I'M ONE OF THOSE WHO ARE CYNICAL ABOUT THE VALUE OF SUMMITS: HAVING BEEN NOW AT FOUR STARTING WITH TOKYO IN 1979 I DO BELIEVE THEY HAVE A REAL VALUE IN PROVIDING AN OPPORTUNITY FOR THOSE CONCERNED TO REACH A BETTER UNDERSTANDING WITH EACH OTHER AND OF EACH OTHER AND TO APPRECIATE MORE FULLY THE IMPACT UPON EACH OTHER'S ECONOMIES OF THEIR POLICIES. AS YOU KNOW THIS OCCASION'S GOING TO HAVE AS MUCH TIME AS POSSIBLE ALLOWED FOR INFORMAL DISCUSSION AMONG THE SUMMIT LEADERS AND PRESIDENT REAGAN'S MADE A DETERMINED ATTEMPT TO ACHIEVE THAT. THERE ARE BOUND TO BE DIFFERENCES OF PERCEPTION AND EMPHASIS AMONGST THEM BUT I BELIEVE THERE WILL EMERGE VALUABLE SHARED UNDERSTANDING FOR SOME OF THE IMPORTANT PROBLEMS THAT CONFRONT THE WORLD ECONOMY AND A STRENGTHENING OF THE WILL TO CO-OPERATE IN TACKLING THEM. THE OBJECT OF THE EXERCISE IS TO INCREASE THAT KIND OF COMMON PERCEPTION AND I BELIEVE WILLIAMSBURG WILL CONTRIBUTE TOWARDS THAT. AS FOR THE MAIN THEMES, DURING THE LAST SIX MONTHS WE HAVE SEEN AN IMPORTANT CHANGE OF CLIMATE IN THE WORLD ECONOMY. THE ATMOSPHERE AND THE EVIDENCE OF RECOVERY HAVE BECOME STRONGER AND A LITTLE WIDER AND THE PROSPECTS FOR THE CONTINUATION OF THAT RECOVERY WILL BE AT THE HEART OF THE SUMMIT DISCUSSIONS, BUT THE MAIN THREADS OF DISCUSSION WON'T BE A SEARCH FOR MEANS OF PROMOTING RECOVERY, I BELIEVE IT WILL BE A CONSUMMATION OF THE STRATEGY TO MAINTAIN THE RIGHT KIND OF RECOVERY AND A STUDY OF SOME OF THE STILL WORRYING POSSIBILITIES IN THE WAY OF SUCCESS. OBVIOUSLY AFTER THIS DEEP AND PROLONGED RECESSION AND WITH PROSPECTS OF GRADUAL RECOVERY, THAT WON'T ENABLE US RAPIDLY TO REDUCE HIGH LEVELS OF UNEMPLOYMENT. IT'S NOT SURPRISING THERE HAVE BEEN DEMANDS FOR MEASURES TO STIMULATE MORE RAPID GROWTH OF ACTIVITY BUT I BELIEVE THAT TO GIVE WAY TO DEMANDS OF THAT KIND WOULD BE A PROFOUND MISTAKE THAT WOULD PUT AT RISK THE LONGER TERM BENEFITS OF THE ADJUSTMENTS THAT SO MANY COUNTRIES HAVE BEEN PAINFULLY MAKING. THE BELIEF THAT RECOVERY ON A DURABLE BASIS IS OBTAINABLE ONLY IF THE CONTINUING FIGHT AGAINST INFLATION IS SUCCESSFUL, WHICH WAS ALREADY EXPRESSED AT VERSAILLES LAST YEAR, HAS BEEN REINFORCED SINCE THEN. THE FACT THAT THE BEST RECOVERY PROSPECTS ARE BEING SHOWN IN THE COUNTRIES WHICH HAVE ACHIEVED THE LOWEST RATES OF



INFLATION, IS BOUND TO CARRY GREAT WEIGHT AND MEASURES TAKEN DURING THE LAST YEAR IN FRANCE REPRESENT AN IMPORTANT COMMITMENT TO THE COUNTER-INFLATIONARY STRATEGY. BELIEVE THE SUMMIT IS LIKELY TO ENDORSE THAT STRATEGY AND NOTE THAT THERE IS NOW AN OPPORTUNITY FOR SUSTAINABLE NON-INFLATIONARY GROWTH OVER COMING YEARS. OF COURSE THERE ARE STILL FORMIDABLE PROBLEMS WHICH FACE. I THINK THERE ARE PROBABLY FOUR THAT DESERVE SOME SPECIAL

ATTENTION. FIRST OF ALL THE HIGH INTEREST RATE/BUDGET DEFICIT PROBLEM. HIGH REAL INTEREST RATES, PARTICULARLY IN THE UNITED STATES WHICH IS BOUND TO SET A PATTERN FOR OTHER COUNTRIES, ARE G TROUBLESOME FOR SEVERAL REASONS. THEY MUST INHIBIT THE SCALE OF RECOVERY OF NEW INVESTMENT WHICH IS A VITAL NEED IF WE'RE TO HAVE SUSTAINED FUTURE ECONOMIC GROWTH. THEY REPRESENT A VERY SIGNIFICANT PART OF THE COSTS OF DEBT WHICH ARE WEIGHING SO HEAVILY ON SOME OF THE DEVELOPING COUNTRIES, PARTICULARLY SOME OF THE MORE ADVANCED ONES AND *THEY* ARE CONTRIBUTING TO A HIGH DOLLAR EXCHANGE RATE WHICH IN TURN IS HARMING THE UNITED STATES EXTERNAL TRADE AND ENCOURAGING PROTECTIONIST PRESSURES IN THAT COUNTRY. NOW OBVIOUSLY THERE'S ROOM FOR ARGUMENT ABOUT THE MECHANISM THROUGH WHICH THESE HIGH REAL INTEREST RATES HAVE COME ABOUT BUT IT'S PRETTY WIDELY FELT, AND I CERTAINLY AGREE, THE MOST IMPORTANT SINGLE ACTION WHICH WOULD IMPROVE THE SITUATION WOULD BE FOR THE UNITED STATES AUTHORITIES THAT'S TO SAY THE ADMINISTRATION AND CONGRESS, TO DEMONSTRATE THEIR ATTENTION - DETERMINATION AND ABILITY TO BRING DOWN OVER THE NEXT FEW YEARS THE PRESENT VERY LARGE UNITED STATES FISCAL DEFICIT THEN THERE'S THE INTERNATIONAL DEBT PROBLEM. AGAINST THE SUBDUED BACKGROUND, OBVIOUSLY THAT'S BOUND TO BE A WORRY THAT'S GOING TO BE DISCUSSED, THE PROBLEM OF EXCESSIVE DEBTS OF PARTICULAR COUNTRIES, IMPORTANT ACTION HAS ALREADY BEEN TAKEN, WE HAVE MOUNTED APPROPRIATE RESPONSES SPEEDILY FOR SEVERAL COUNTRIES, BASED ON ADJUSTMENT PROGRAMMES THAT HAVE BEEN WORKED OUT WITH AND APPROVED BY THE IMF, WHICH PLAYS AN IMPORTANT CATALYTIC ROLE IN THESE CASES. INCREASES IN THE RESOURCES POTENTIALLY AVAILABLE TO THE IMF HAVE BEEN AGREED AND IT'S IMPORTANT THAT THOSE SHOULD BE NOW RATIFIED PROMPTLY AND WE'VE DEVELOPED PRINCIPLES FOR HANDLING DIFFICULT CASES.

THIRDLY OTHER DEVELOPING COUNTRY PROBLEMS, THE DOMINANCE OF THESE PROBLEMS OF SOVEREIGN DEBT SHOULDN'T DISTRACT ATTENTION FROM THEIR OTHER PROBLEMS, THE POORER COUNTRIES IN PARTICULAR, WHICH HAVE IN DIFFERENT WAYS SUFFERED SEVERELY FROM THE RECESSION AND I'M SURE THAT SUMMIT LEADERS WILL HAVE VERY MUCH IN MIND THE FORTHCOMING UNCTAD MEETING, WILL WANT TO RESPOND TO THE MODERATE AND REALISTIC *STATEMENTS OF THE* DEVELOPING COUNTRIES IN THE RECENT PAST, PARTICULARLY FROM THE NEW DELHI AND BUENOS AIRES MEETINGS. RECOVERY OF ECONOMIC GROWTH BY INDUSTRIAL COUNTRIES WILL BE A NECESSARY AND VALUABLE CONDITION FOR RECOVERY IN THE DEVELOPING COUNTRIES. THE SUMMIT LEADERS WILL OBVIOUSLY WANT AS WELL TO CONSIDER THE IMPORTANCE OF KEEPING OPEN TRADING MARKET BOTH WAYS AND OF MAINTAINING ADEQUATE AID FLOWS. THEN PROTECTIONIST



PRESSURES HAVE BEEN GROWING IN THAT DIRECTION IN SUMMIT COUNTRIES, AS ELSEWHERE, YET THERE'S NO DOUBT THAT MORE OPEN MARKETS SHOULD BE AN AID TO WORLD ECONOMIC RECOVERY AND THAT MORE PROTECTIONISM WOULD THREATEN TO RESTRICT THAT. SO I EXPECT THE LEADERS OF THE SUMMIT TO DISCUSS HOW TO ENCOURAGE MOVEMENT IN THE RIGHT DIRECTION, MORE OPENNESS AS THE RECOVERY GATHERS PACE, RATHER THAN THE OTHER.

THEN, FUTURE CO-OPERATION. I THINK THAT'S LIKELY TO BE A STRONG THEME AND I CERTAINLY WELCOME THAT PERSONALLY MYSELF. IN OUR RECENT MEETING FINANCE MINISTERS OF THE SUMMIT COUNTRIES HAVE BEEN DEVELOPING THEIR THINKING AND PRACTISING CO-OPERATION WITH EACH OTHER IN TWO IMPORTANT DIFFERENT WAYS. THEY BOTH ACTUALLY STEM FROM DECISIONS TAKEN AT AND FOLLOWING THE VERSAILLES SUMMIT. FIRST - EXCHANGE RATES. YOU'VE SEEN... THE JURGENSEN REPORT AND THE STATEMENT WE MADE IN WASHINGTON ABOUT THAT, THAT WAS CONCERNED WITH THE RELATIVELY NARROW QUESTION OF INTERVENTION IN FOREIGN EXCHANGE MARKETS TO INFLUENCE EXCHANGE RATES, BUT THERE WAS SOME CONVERGENCE OF VIEWS ON THE ROLE OF SUCH OPERATIONS AND A RECOGNITION THAT THEY CAN HAVE A BENEFICIAL EFFECT IN SOME LIMITED CIRCUMSTANCES AND THAT'S A USEFUL ADVANCE. IN FACT OUR DISCUSSIONS AS FINANCE MINISTERS DID GO WIDER THAN THAT, INTO A MORE GENERAL RECOGNITION WITH WHICH WE ALL AGREED THAT THE EXCHANGE RATE IS AN IMPORTANT ASPECT OF A COUNTRY'S ECONOMY, IMPORTANT FOR ITSELF AND IMPORTANT FOR OTHERS AND THAT THE AUTHORITIES OF ANY ONE COUNTRY SHOULD HAVE REGARD TO THEIR EXCHANGE RATE IN CONSIDERING DOMESTIC POLICIES AND THEIR EFFECTS AND THAT'S AN IMPORTANT FOUNDATION FOR FUTURE DEVELOPMENT. IN FACT THE SUMMIT LEADERS MAY WANT TO REFLECT ON POSSIBLE DEVELOPMENTS FROM THERE ON.

YOU'VE SEEN THAT THE THOUGHT OF A NEW BRETTON WOODS CONFERENCE HAS BEEN SUGGESTED. I WOULD MYSELF THINK THAT THAT

KIND OF IDEA IS CERTAINLY PREMATURE AT THIS STAGE, I THINK WE LIVE IN A DIFFERENT WORLD WHERE INSTITUTIONS NOW EXIST WHICH DIDN'T EXIST THEN, WHICH MAY THEMSELVES PROVIDE THE FORUM IN WHICH BRETTON WOODS TYPE QUESTIONS CAN BE CONSIDERED BUT I CERTAINLY WOULDN'T WANT TO RULE OUT THE IDEA OF ADVANCE IN THAT DIRECTION ON THE BASIS OF WELL PREPARED WORK. THERE'S ANOTHER LINE OF CO-OPERATION WHICH I, I THINK FIRST SUGGESTED IN MY WASHINGTON IMF SPEECH IN SEPTEMBER '81, AND WHICH WAS LAUNCHED, AS IT WERE OFFICIALLY AT VERSAILLES, NAMELY THE IDEA THAT CERTAIN COUNTRIES, PARTICULARLY THE FIVE WHOSE CURRENCIES MAKE UP THE SDR+, SHOULD TRY TO ACHIEVE PARTICULARLY CLOSE CO-OPERATION WITH THE HELP OF THE IMF MANAGING DIRECTOR, IN ANALYSING THEIR OWN POLICIES AND THEIR IMPACT ON EACH OTHER AND THE REST OF THE WORLD. THERE HAVE, AS YOU KNOW, SINCE BEEN A NUMBER OF MEETINGS OF FINANCE MINISTERS TO DO JUST THAT, THE MOST RECENT WAS IN WASHINGTON AT THE END OF APRIL, THEY HAVE INVOLVED A VERY THOROUGH AND CRITICAL ANALYSIS AND MUCH FRANK AND VALUABLE DISCUSSION AND THOSE WHO'VE BEEN TAKING PART IN THEM FEEL THAT THEY ARE MAKING PROGRESS AND WE ARE DETERMINED TO CONTINUE AND INTENSIFY THOSE ARRANGEMENTS. WE SHALL BE REPORTING ON THAT WORK TO THE SUMMIT AND I THINK THEY'LL WELCOME THAT AS A PROMISING DEVELOPMENT FOR THE FUTURE. BY WAY OF SUMMING UP, ALL THESE THINGS ARE OBVIOUSLY CLOSELY RELATED TO EACH OTHER AND IF WE MAKE HEADWAY ON ALL OF THEM THAT REPRESENTS THE BEST PROSPECT OF ACHIEVING A SUSTAINABLE NON-INFLATIONARY RECOVERY.

DO 'T EXPECT ANY PANACEAS FROM WILLIAMSBURG, ANY MORE THAN FROM ANYWHERE ELSE. THERE AREN'T ANY. BUT PLEASE DON'T UNDER-RATE THE IMPORTANCE OF HEADS OF THE SUMMIT COUNTRIES AND THEIR FINANCE MINISTERS AND FOREIGN MINISTERS, COMING TOGETHER IN THIS WAY, COMMITTING THEMSELVES TO THE OBJECTIVE OF SUSTAINABLE NON-INFLATIONARY RECOVERY AND TO THE KIND OF DISCUSSIONS THAT ARE NECESSARY, THE KIND OF DISCUSSIONS THAT THE WORLD WOULD EXPECT FROM THE LEADERS OF THE LEADING ECONOMIES IF WE'RE TO GET OUR VIEWS COMING CLOSER TOGETHER ON THE IMPORTANT ISSUES AND I THINK THAT'S THE OBJECT OF WILLIAMSBURG AND I HOPE WE SHALL MAKE A SIGNIFICANT HEADWAY TOWARDS IT.

END