

CONFIDENTIAL

FM WASHINGTON 252030Z MAY 83
TO PRIORITY F C O
TELEGRAM NUMBER 1470 OF 25 MAY

THE US ECONOMY BEFORE THE WILLIAMSBURG SUMMIT

1. THE US ECONOMY IS NOW GROWING SHARPLY WITH SOME PRIVATE FORECASTERS SUGGESTING THAT GNP GROWTH IN THE SECOND QUARTER WILL BE BETWEEN 5-6 PERCENT AT AN ANNUAL RATE. FOR 1983 AS A WHOLE MOST PRIVATE ANALYSTS (AND THE ADMINISTRATION) FORECAST GNP GROWTH WITHIN THE RANGE 2.8 PERCENT - 3.0 PERCENT.
2. THE FIGURE FOR THE ANNUAL RATE OF GROWTH OF GNP IN THE FIRST QUARTER HAS BEEN REVISED DOWNWARDS FROM 3.1 PERCENT TO 2.5 PERCENT. MOST OF THE GROWTH EARLY IN THE YEAR WAS CONFINED TO A REDUCTION IN THE RATE AT WHICH STOCKS WERE DRAWN DOWN AND A RECOVERY IN HOUSING. CONSUMER SPENDING HAS NOW ALSO REVIVED. RETAIL SALES INCREASED BY 1.7 PERCENT IN MARCH AND 1.6 PERCENT IN APRIL. THE LATEST ESTIMATES OF INDUSTRIAL PRODUCTION SHOW A SUBSTANTIAL AND WIDESPREAD RECOVERY, ALTHOUGH EXPORTS AND INVESTMENT REMAIN WEAK. THE INDEX OF INDUSTRIAL PRODUCTION ROSE BY 2.1 PERCENT IN APRIL, FOLLOWING A 1.2 PERCENT INCREASE IN MARCH, WITH GAINS AMONG BOTH DURABLE AND NON-DURABLE GOODS. THE RATE OF UNEMPLOYMENT IN APRIL FELL SLIGHTLY TO 10.2 PERCENT.
3. THE INCREASE OF THE CONSUMER PRICE INDEX OVER THE 12 MONTHS TO APRIL WAS 3.9 PERCENT, REFLECTING THE EFFECTS OF TIGHT MONETARY POLICY IN THE PERIOD UP TO MID-1982 AND LOWER OIL PRICES. THE PROSPECTS FOR INFLATION OVER THE NEXT 12 MONTHS ARE ALSO FAVOURABLE. WHILE THE LOW POINT IN THE MONTHLY ANNUAL INFLATION INCREASE FIGURES MAY NOW HAVE BEEN PASSED, IT IS UNLIKELY THAT THERE WILL BE A STRONG RESURGENCE OF INFLATION. CONTINUING WAGE MODERATION SHOULD ENSURE THAT IT REMAINS BETWEEN 4-5 PERCENT.
4. THE CHIEF THREAT TO THE RECOVERY REMAINS HIGH INTEREST RATES. IN RECENT DAYS FINANCIAL MARKETS HAVE RESPONDED ADVERSELY TO JUMPS IN THE WEEKLY FIGURES FOR THE MONETARY AGGREGATE M1, AND THE YIELD ON A 3-MONTH TREASURY BILL HAS RISEN TO 8.4 PERCENT. THERE HAS ALSO BEEN A MOVEMENT IN LONGER RATES WITH LONG-TERM TREASURY BONDS CURRENTLY YIELDING ALMOST 11 PERCENT, IMPLYING A REAL RATE OF RETURN AFTER ALLOWING FOR THE CURRENT INFLATION RATE OF ALMOST 7 PERCENT.
5. THE ADMINISTRATION ARE OBVIOUSLY CONCERNED ABOUT THE RISE IN SHORT TERM MARKET INTEREST RATES IMMEDIATELY BEFORE THE SUMMIT. INTEREST RATES ROSE AS THE MARKET ANTICIPATED SOME TIGHTENING OF MONETARY POLICY, FOLLOWING THE LARGE INCREASE IN M1 IN THE FIRST TWO WEEKS OF MAY TO A LEVEL WELL ABOVE THE UPPER END OF ITS 4-6 PERCENT GROWTH RANGE FOR 1983. THERE IS THEREFORE NO SIMPLE COURSE

OF ACTION OPEN TO THE FEDERAL RESERVE WHICH COULD REVERSE THE INCREASE OF INTEREST RATES. FURTHER RAPID EXPANSION OF THE MONEY SUPPLY COULD WELL LEAD TO HIGHER INTEREST RATES, WHILE TIGHTENING CONTROL WOULD HAVE THE SAME EFFECT. TREASURY SECRETARY REGAN, WHO HAS RECENTLY AGAIN ADOPTED A CRITICAL TONE ABOUT THE FED, HAS SUGGESTED THAT ITS AIM SHOULD NOW BE 6 PERCENT GROWTH IN THE MONEY SUPPLY FOR THE REMAINDER OF THE YEAR. WHILE THE FED HAS REPEATEDLY SAID THAT IT NOW TARGETS M2 AND M3 (WHICH ARE WITHIN THEIR TARGET RANGES), RECENT DEVELOPMENTS HAVE SHOWN THAT STRONG MOVEMENTS IN M1 ARE STILL CAPABLE OF DISRUPTING FINANCIAL MARKETS AND AFFECTING INTEREST RATES.

6. THE RISE IN INTEREST RATES HAS AFFECTED THE DOLLAR EXCHANGE RATE, WHICH ON 25 MAY STRENGTHENED AGAINST MOST EUROPEAN CURRENCIES EXCEPT THE POUND. THE DOLLAR ROSE TO A SIX-MONTH HIGH AGAINST THE GERMAN MARK, AND SET ANOTHER RECORD AGAINST THE FRENCH FRANC. THE HIGH VALUE OF THE US DOLLAR, AS AFFECTED BY HIGH US INTEREST RATES, WAS THE SUBJECT OF COMPLAINT BY FRENCH FOREIGN MINISTER CHEYSSON LAST SUNDAY IN AN AMERICAN TELEVISION BROADCAST.

7. THE US FY84 BUDGET PROCESS REMAINS IN A CONFUSED STATE. THE HOUSE OF REPRESENTATIVES AND THE SENATE WILL NEXT WEEK BEGIN THE CONFERENCE PROCEDURE TO RECONCILE THEIR SEPARATE VERSIONS OF THE FIRST CONCURRENT BUDGET RESOLUTION. THE SENATE VERSION PROVIDES FOR AN FY84 FEDERAL DEFICIT OF DOLLARS 179 BILLION AND THE HOUSE VERSION FOR DOLLARS 175 BILLION (THE ADMINISTRATION BUDGET PROVIDES FOR A DEFICIT OF DOLLARS 192 BILLION). THE BALANCE OF THE TWO VERSIONS IS DIFFERENT, WITH THE HOUSE PREFERRING MORE CIVIL AND LESS MILITARY EXPENDITURE AND MORE TAX INCREASES, THAN THE SENATE. THE PRESIDENT HAS SAID THAT HE WILL VETO LEGISLATION ENACTING EVEN THE DOLLARS 9.9 BILLION IN TAX INCREASES PROPOSED IN THE SENATE VERSION, MAKING THE FINAL OUTCOME FOR THE DEFICIT UNCERTAIN.

8. F C O PLEASE PASS TO PS/CHANCELLOR, LITTLER AND BOTTRILL (TREASURY) AND WATSON (BANK).

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