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TO IMMEDIATE FCO

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## THE SECOND REAGAN ADMINISTRATION AND THE APPROACH TO THE BONN SUMMIT

## SUMMARY

1. WITH THE RE-ELECTION HONEYMOON OVER, THE ADMINISTRATION IS IN A BAD PATCH. THE ECONOMIC SLOW-DOWN CAUSES CONCERN, AND THE WHITE HOUSE SEEMS TO HAVE LOST ITS TOUCH, AT LEAST FOR THE MOMENT. REAGAN'S PERSONAL APPEAL REMAINS STRONG, BUT HE NEEDS A GOOD SUMMIT, AS THE 1986 MID-TERM ELECTIONS BEGIN TO CAST A LONG SHADOW.

## DETAIL

2. THE PRESIDENT HAS FOUND HIS OWN LANDSLIDE VICTORY LAST NOVEMBER A DIFFICULT ACT TO FOLLOW. LITTLE HAS SINCE BEEN ACHIEVED: THE POLITICAL CLIMATE HAS CHANGED APPRECIABLY SINCE YOU AND THE PRIME MINISTER WERE HERE IN FEBRUARY; AND THE ADMINISTRATION HAS IN RECENT WEEKS LOOKED MORE EMBATTLED THAN AT ANY TIME FOR TWO YEARS. IT IS GLAD CONFIDENT MORNING NO MORE.

3. VERY LITTLE HAS GONE RIGHT. ECONOMIC PERFORMANCE IN THE FIRST QUARTER, WITH GNP UP ONLY 1.3 PERCENT AND DOMESTIC PRODUCTION UP 3. PERCENT LESS THAN TOTAL DEMAND, HAS CALLED INTO QUESTION THE ADMINISTRATION'S PROJECTION OF 3-4 PERCENT GROWTH THIS YEAR, AND INDIRECTLY CAST DOUBT ON THE WHOLE MESSAGE OF GROWTH AND PROSPERITY ON WHICH THE ELECTION SUCCESS WAS BASED. THIS MAY TAKE SOME TIME TO PERCOLATE THROUGH TO PUBLIC ATTITUDES, BUT THERE IS ALREADY EVIDENCE OF A FALL IN CONSUMER CONFIDENCE, AND CONSUMER SPENDING WAS SHARPLY DOWN IN MARCH. CONTINUING GOOD NEWS - LOWER INTEREST RATES (7 3/4 PERCENT ON A THREE-MONTH TREASURY BILL AND 11.3 PERCENT ON A 20-YEAR US BOND), AND LOW (3.7 PERCENT) INFLATION - HAS BEEN MORE THAN OUTWEIGHED BY A WEAK TREND IN INDUSTRIAL PRODUCTION, STAGNANT CAPACITY UTILISATION (80.8 PERCENT) AND UNEMPLOYMENT (7.3 PERCENT). LOWER INTEREST RATES AND INFLATION ARE INCREASINGLY SEEN PARTLY AS SIGNS OF WEAKENING ECONOMY, RATHER THAN AS UNAMBIGUOUS INDICATORS OF THE SCOPE FOR FURTHER GROWTH. MOREOVER, WITH MONEY SUPPLY (M1) GROWTH OF NEARLY 10 PERCENT IN THE FIRST QUARTER, SOME NOW SEE LOWER INTEREST RATES AS A HARBINGER OF INFLATIONARY PRESSURES TO COME.

4. THE ADMINISTRATION IS NOT DISGUIISING ITS DISAPPOINTMENT. DON REGAN, THE NEW WHITE HOUSE CHIEF OF STAFF HAS SAID BLUNTLY THAT THE ECONOMY WAS QUOTE NOT HEALTHY UNQUOTE AT PRESENT. THE ECONOMIC NEWS, INCLUDING THE TROUBLES IN THE BANKING SECTOR IN

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OHIO, AND THE DOLLAR'S RECENT FALL, HAVE REINFORCED CALLS FOR EFFECTIVE DEFICIT REDUCTION MEASURES, BUT WITHOUT MAKING THEIR ACHIEVEMENT ANY EASIER: AND THE SLOW PROGRESS OF THE BUDGET NEGOTIATIONS BETWEEN THE ADMINISTRATION AND THE HILL IS GENERALLY BEING BLAMED ON A LACK OF DIRECTION IN THE WHITE HOUSE. THE PRESIDENT NOW FINDS HIMSELF CRITICISED FOR BEING READY TO BREAK HIS PROMISE TO AVOID CUTS IN SOCIAL SECURITY UPGRADINGS, BUT STILL FAR FROM ACHIEVING HIS TARGET OF DOLLARS 50 BILLION REDUCTIONS IN FY 86 EXPENDITURE. HIS GRUDGING CONCESSION OF CUTTING THE RISE IN DEFENCE SPENDING TO ONLY 3 PERCENT IS WIDELY SEEN AS TOO LITTLE, TOO LATE: MORE WILL HAVE TO BE PAINFULLY SQUEEZED OUT. AND WHILE THE BUDGET BATTLE RAGES IN WASHINGTON, THERE IS A REAL DISCONTENT THROUGHOUT THE FARM BELT, EVEN THOUGH THE PRESIDENT'S DECISION TO VETO THE FARM AID PACKAGE IN FEBRUARY WILL HAVE BEEN GENERALLY POPULAR IN NON-AGRICULTURAL AREAS. PROTECTIONIST PRESSURES CONTINUE TO GROW, NOT LEAST ON THE HILL, AND THE ADMINISTRATION IS DANGEROUSLY CLOSE TO LOSING CONTROL OVER THEM.

5. PERSONAL CHANGES AT THE WHITE HOUSE PARTIALLY EXPLAIN THE CURRENT ECLIPSE. THE REPLACEMENT OF THE BAKER-MEESE-DEAVER TRIUMVIRATE BY REGAN (AND BUCHANAN) MEANS SUBSTITUTING DRIVE AND ACTION FOR JUDGEMENT AND REFLECTION: MORE STICKS BRANDISHED, FEW CARROTS DISCREETLY OFFERED. INSTEAD OF BAKER'S BEHIND-THE-SCENE MANOEUVRING AND CONSENSUS BUILDING, PARTICULARLY ON THE HILL, A MORE CONFRONTATIONAL, HARD-CHARGING, LESS PRAGMATIC APPROACH HAS DEVELOPED OVER THE PAST COUPLE OF MONTHS. IT HAS BEEN A TIME FOR TAKING ENTRENCHED POSITIONS, AND FOR THE INCREMENTAL UPPING OF THE RHETORICAL ANTE.

6. IT WORKED ON MX: IT HAS FAILED ON NICARAGUA, OVER WHICH THE WHITE HOUSE'S DISCOMFITURE IS SO STRIKING PRECISELY BECAUSE IT CHOSE TO RAISE THE STAKES SO HIGH. THE RESULT IS A SERIOUS BLOW TO THE CREDIBILITY OF ITS POLICIES TOWARDS CENTRAL AMERICA: IT IS FAR FROM CLEAR HOW BEST TO RESTORE IT, GIVEN THAT THE PRESIDENT HAS ACKNOWLEDGED THAT HIS AIM IS TO OVERTHROW THE SANDINISTAS, AND CONGRESS HAVE SHOWN UNAMBIGUOUSLY THAT THEY DO NOT INTEND TO GIVE HIM THE MEANS TO DO SO. HARDLY LESS DAMAGING TO THE PRESIDENT IS THE BITBURG/BELSEN CATALOGUE OF BLUNDERS, FOR WHICH DEAVER MUST TAKE PRIME RESPONSIBILITY, BUT IN WHICH THE PRESIDENT'S OWN REPEATED GAFFES HAVE BEEN REMINISCENT OF HIS SHAKY PERFORMANCE IN THE EARLIEST DAYS OF THE ADMINISTRATION.

6. OF COURSE, THE WASHINGTON HOT-HOUSE EXAGGERATES THE BAD NEWS FOR THE ADMINISTRATION: THERE STILL IS GOOD NEWS ABOUT. DESPITE THE CONFUSED US SIGNALS ON A SUMMIT WITH GORBACHEV, AND SIGNS OF NERVOUSNESS THAT MOSCOW TOO MAY HAVE FOUND A QUOTE GREAT COMMUNICATOR, UNQUOTE A SERIOUS US/SOVIET POLITICAL DIALOGUE HAS BEEN RE-ESTABLISHED AT A SENIOR LEVEL, AND THE GENEVA TALKS HAVE GOT UNDERWAY REASONABLY UNEVENTFULLY. THE PRESIDENT'S OPPOSITION TO TAX INCREASES IS NO DOUBT STILL POPULAR, AND THE LATEST (22 APRIL) ABC PUBLIC OPINION POLL STILL GAVE HIM A 54 PERCENT OVERALL JOB APPROVAL RATING (DOWN FROM 68 PERCENT IN JANUARY).

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9. THE PRESIDENT'S ADVISERS MAY ALSO TAKE IRONIC COMFORT FROM THE FACT THAT RECENT FAILURES HAVE BEEN VERY MUCH OF THE ADMINISTRATION'S OWN MAKING: NOT THE RESULT OF ANY PERCEPTIBLE RISE IN DEMOCRAT PARTY FORTUNES. ON THE CONTRARY, THE DEMOCRAT PARTY REMAINS DIS-ORGANISED AND ON THE DEFENSIVE, LACKING LEADERSHIP AND A CLEAR POLICY IDENTITY. BOTH PARTIES STILL HAVE 18 MONTHS TO REGROUP BEFORE THE NEXT CONGRESSIONAL ELECTIONS: WE CAN EXPECT VICE PRESIDENT BUSH, ALREADY RECRUITING STAFF AND SEEKING HIGHER VISIBILITY, TO ACT ON HIS PERSONAL INTEREST IN ENSURING THAT REAGAN'S SECOND TERM IS A SUCCESS: BUT WE MUST ALSO EXPECT THE 22 REPUBLICAN SENATORS UP FOR RE-ELECTION IN 1986 TO BECOME INCREASINGLY LESS WILLING TO BE ASSOCIATED WITH WHITE HOUSE FUMBLING.

9. AND AT THIS STAGE, THE JUDGEMENT MUST BE THAT THE TEFLON IS BEGINNING TO WEAR THIN. THE PRESIDENT BADLY NEEDS TO RECOVER HIS LEGISLATIVE AND POLITICAL FINESSE: HE WILL BE ANXIOUS FOR A SUMMIT SUCCESS. FOR THE LINE HE IS LIKELY TO TAKE IN BONN, SEE MY TWO IFTS.

10. ADVANCE COPIES TO POWELL (NO 10), PPS/S OF S, PPS/CHANCELLOR, HATFIELD (CABINET OFFICE), PS/PUS, LITTLER (TREASURY), HAYES (DTI), BRAITHWAITE (FCO).

FCO PLEASE PASS SAVING TO ANKARA LUXEMBOURG THE HAGUE ATHENS COPENHAGEN BRUSSELS LISBON OSLO REYKJAVIK UKDEL VIENNA DUBLIN.

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MR. MAUD .

COPIES TO .

MR. POWELL - No. 10 D. SE.  
PS | CHANCELLOR } H.M. TREASURY  
MR. LITTLER }  
MR. HATFIELD - CAB OFF.  
MR. HAYES - DTI

(ADVANCED AS REQUESTED)

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