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SECRET

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NOTE OF THE DISCUSSION AT THE PRIME MINISTER'S LUNCH FOR PRESIDENT
GISCARD D'ESTAING ON 19 NOVEMBER AT 10 DOWNING STREET

Present:

Prime Minister	President Giscard d'Estaing
Foreign and Commonwealth Secretary	Monsieur Francois-Poncet
Lord President of the Council	Monsieur Giraud
Secretary of State for Industry	HE, Monsieur Jean Sauvagnargues
Sir Reginald Hibbert	Monsieur Patrick LeClerc
Mr. C.A. Whitmore	

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United States

Following a discussion on the prospects of the various United States Presidential candidates, in the course of which there was general agreement that Senator Kennedy was unlikely to be successful, President Giscard remarked that it would be a pity for the western world if the re-election of President Carter meant that we were deprived of what he called the United States presence. The West did not need American leadership but it did need the steadying influence of the United States. The prospects for the global balance of power in the next few years were not good. Although the Soviet Union would continue to be militarily strong they were not in a sound ideological and economic position. Their system was not a good one for the future. If the West now adopted a strong policy, it would be "on the winning side" but the present erratic United States approach was worrying. It was impossible for the West to be politically effective without an American contribution. The United Kingdom was acting boldly in Southern Africa and France was doing the same in Central Africa, but they were doing so separately.

Monsieur Francois-Poncet added that what happened in Iran might well affect President Carter's chances of re-election. It was possible that things there would knock him out of the race.

Britain and the international scene

President Giscard said that he was glad to see Mrs. Thatcher confirming the position and influence of the United Kingdom in world affairs. He welcomed the British contribution to international

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3. ON INFLATION, THE RECORD SO FAR THIS YEAR HAS BEEN INTENSELY DISAPPOINTING FOR THE ADMINISTRATION. OVER THE FIRST 9 MONTHS, THE CONSUMER PRICE INDEX ROSE AT AN ANNUAL RATE OF MORE THAN 13 PERCENT IT IS TRUE THAT THERE HAVE BEEN A NUMBER OF TEMPORARY FACTORS AT WORK, ESPECIALLY THE RISE IN OIL PRICES EARLY IN THE SUMMER, BUT THE RATE OF INFLATION CANNOT BE WHOLLY EXPLAINED IN TERMS OF TEMPORARY FACTORS AND THERE SEEMS TO BE AN UNEXPLAINED ELEMENT. HOWEVER IT IS SIGNIFICANT THAT WAGE PRESSURES HAVE NOT BEEN A PRIMARY SOURCE OF INFLATION. OVER THE PAST YEAR WAGE INCREASES HAVE LAGGED BEHIND INFLATION.

4. THE ADMINISTRATION AND THE FEDERAL RESERVE STILL HOPE THAT, AS THE TEMPORARY FACTORS WORK THEMSELVES OUT, INFLATION CAN BE BROUGHT BACK INTO SINGLE FIGURES BY THE EARLY PART OF NEXT YEAR, BUT THIS IS VERY OPTIMISTIC. ALFRED KAHN, CHAIRMAN OF THE PRESIDENT'S COUNCIL ON WAGE AND PRICE STABILITY HAS JUST ADMITTED AS MUCH. ONE DANGER IS THAT WAGE EARNERS, REALISING THAT THEY HAVE SUFFERED A FALL IN REAL EARNINGS, WILL BEGIN TO INSIST ON CATCHING UP AND THAT WAGES WILL BECOME AN INFLATIONARY FORCE. THE PRESIDENT'S WAGE GUIDELINE FOR THE YEAR ENDED LAST SEPTEMBER MAY HAVE HAD SOME MODERATING INFLUENCE, BUT NO NEW GUIDELINE HAS YET TAKEN ITS PLACE. A PAY BOARD HAS BEEN APPOINTED, WITH UNION PARTICIPATION, BUT IT IS REPORTED STILL TO BE IN DISAGREEMENT ABOUT WHAT ADVICE IT SHOULD GIVE THE PRESIDENT FOR THE COMING YEAR. ANOTHER OBVIOUS DANGER IS A FURTHER RISE IN THE PRICE OF OIL, WHICH COULD EASILY PREVENT THE INFLATION RATE FROM FALLING BACK.

5. THUS, IT IS VIRTUALLY CERTAIN THAT 1980 WILL BE A BAD YEAR FOR THE ECONOMY IN TERMS OF BOTH UNEMPLOYMENT AND INFLATION SEMI COLON AND IT IS QUITE ON THE CARDS THAT IT MAY BE A NEAR-DISASTROUS ONE. EVEN THE MORE OPTIMISTIC FORECASTS ASSUME A SUBSTANTIAL RISE IN UNEMPLOYMENT AND IT IS NOW VERY OPTIMISTIC TO EXPECT INFLATION TO RETURN TO SINGLE FIGURES AT ANY RATE IN THE EARLY PART OF THE YEAR. A PESSIMISTIC BUT QUITE PLAUSIBLE VIEW IS THAT THE ECONOMY WILL MOVE INTO A FAIRLY DEEP RECESSION OR THAT THE RECESSION, IF NOT DEEP, WILL BE PROLONGED WITHOUT THE BEGINNINGS OF ANY RECOVERY IN 1980, AND THAT INFLATION WILL BE IN THE MID-TEENS. THIS WOULD MAKE 1980 THE SECOND CONSECUTIVE YEAR OF RECORD INFLATION IN THE UNITED STATES AND THE THIRD YEAR OF QUOTE DOUBLE DIGIT UNQUOTE INFLATION IN AMERICAN POST-WAR HISTORY. CONFIDENTIAL / CURRENT POLICIES

CURRENT POLICIES

6. WITH THE DETERIORATING OUTLOOK, THERE HAS RECENTLY BEEN A SHARP CHANGE IN THE MONETARY POLICY, BUT NOT IN FISCAL POLICY. THE CHANGES INTRODUCED BY THE FEDERAL RESERVE AT THE BEGINNING OF OCTOBER INVOLVED A SWITCH TO MORE DIRECT CONTROL OF BANK RESERVES, ALLOWING INTEREST RATES TO BE DETERMINED MORE FREELY BY THE MARKETS. AT THE SAME TIME THE FEDERAL RESERVE HAS SHOWN THAT IT WILL BE MORE DETERMINED IN PURSUING ITS MONEY SUPPLY TARGETS. THE EFFECT HAS BEEN MUCH HIGHER INTEREST RATES AND THIS IS POTENTIALLY AS SENSITIVE A SUBJECT HERE AS ANYWHERE ELSE. BANK PRIME RATES HAVE RISEN FROM ABOUT 12 PERCENT TO OVER 15 IN THE LAST MONTH AND MORTGAGE RATES HAVE RISEN FROM ABOUT 11 AND ONE HALF TO ABOUT 14 AND ONE HALF PERCENT. MORTGAGES ARE NOW DIFFICULT TO OBTAIN. THE NEW POLICY MEANS THAT INTEREST RATES WILL FLUCTUATE MORE AND IT IS DIFFICULT TO PREDICT THEIR LEVEL. BUT IT IS WIDELY ASSUMED THAT THEY WILL RISE FURTHER BEFORE FALLING AS RECESSION SETS IN. SOME THINK THEY MAY PEAK BY THE END OF THE YEAR, BUT MANY BELIEVE THE TURN WILL NOT COME UNTIL MID-1980. THE TIGHTENING OF MONETARY POLICY HAS ALREADY INCREASED THE CHANCES THAT THE RECESSION WILL BE A SUBSTANTIAL ONE SEMI COLON AND A CONTINUATION OF HIGH INFLATION WOULD ENCOURAGE THE FED TO HOLD TO A TOUGH POLICY. A COMBINATION OF TIGHT MONEY POLICIES AND HIGH INFLATION IN THE FIRST HALF OF 1980 COULD MAKE FOR A DEEP AND PROLONGED RECESSION.

7. FISCAL POLICY CANNOT ADJUST SO QUICKLY TO CHANGING CIRCUMSTANCES. THE BUDGET FOR FY80 (BEGINNING OCTOBER 1979), JUST APPROVED, PROVIDES FOR A FEDERAL DEFICIT OF DOLLARS 30 BN, WHICH IS WHAT THE PRESIDENT PROPOSED LAST JANUARY. CARTER HAS CLAIMED THAT IT IS AN QUOTE AUSTERE BUDGET UNQUOTE AND THE DEFICIT AT THIS LEVEL WOULD AMOUNT TO BARELY MORE THAN 1 PERCENT OF GNP, DOWN FROM 4 PERCENT THREE YEARS AGO. THE NEXT MOVE ON FISCAL POLICY WILL BE MADE WHEN THE PRESIDENT PRESENTS HIS BUDGET FOR FY81 IN JANUARY AND IT IS NOT CERTAIN AT THIS STAGE WHETHER HE WILL PROPOSE A TAX CUT TO TAKE EFFECT SOME TIME EITHER IN FY80 OR FY81 SEMI COLON AND IF SO WHETHER IT WILL BE DESIGNED ONLY TO OFF-SET THE EFFECT OF INFLATION ON THE TAX BURDEN, PARTIALLY OR WHOLLY, OR WHETHER IT WILL GO FURTHER.

THE POLITICAL IMPLICATIONS

8. AS IN OTHER COUNTRIES, INFLATION IS NOW GENERALLY THOUGHT TO BE OF GREATER CONCERN TO THE ELECTORATE THAN UNEMPLOYMENT. THIS IS NO DOUBT ONE REASON FOR THE STRENGTH OF THE QUOTE CONSERVATIVE UNQUOTE INFLUENCE IN AMERICAN POLITICS RECENTLY. THE POINT TO MAKE, HOWEVER, IS THAT UNEMPLOYMENT, ALTHOUGH HISTORICALLY HIGH, IS NOT A MAJOR POLITICAL CONCERN AT THE MOMENT AND THIS MAY WELL CHANGE AS 1980 PROCEEDS. ASSUMING THAT 1980 WILL BE A YEAR OF BOTH RISING UNEMPLOYMENT AND HIGH INFLATION, SEVERE TENSIONS WILL ARISE IN THE DEMOCRATIC PARTY, MUCH MORE THAN IN THE REPUBLICAN PARTY WHOSE CANDIDATES FOR THE PRESIDENCY AND THE CONGRESS WILL BE LESS CONCERNED ABOUT UNEMPLOYMENT AND WILL TAKE A FIRMER STAND AGAINST INFLATION.

9. IN THE DEMOCRATIC PARTY, QUESTION ARISE ABOUT THE ATTITUDES OF THE PRESIDENT, KENNEDY AND DEMOCRATIC MEMBERS OF CONGRESS.

10. CARTERS POLITICAL INSTINCTS LIE MORE IN THE CONSERVATIVE DIRECTION THAN KENNEDY'S. CONTRASTING HIS APPROACH WITH KENNEDY'S, HE SAID RECENTLY: QUOTE I BELIEVE IN TIGHT MANAGEMENT... IN MAKING THE EXISTING PROGRAMMES EFFICIENT... IN SAVING MONEY... IN TRYING TO HAVE FISCAL RESPONSIBILITY UNQUOTE. HIS CLAIM THAT BEATING INFLATION IS HIS ADMINISTRATION'S NUMBER ONE PRIORITY IS NO DOUBT SINCERE. BUT HE IS NO LESS CONSCIOUS OF THE NEED TO PROTECT HIS POSITION WITH HIS NATURAL CONSTITUENCY OF BLACKS AND OTHER ETHNIC GROUPS, THE UNDER PRIVILEGED AND ORGANISED LABOUR AGAINST THE STRONG APPEAL WHICH KENNEDY WILL MAKE TO THEM. THE AMBIGUITY OF HIS POSITION IS REFLECTED IN HIS RECENT PROMISE TO AN AUDIENCE OF CONSTRUCTION WORKERS NOT TO QUOTE 'FIGHT INFLATION WITH YOUR JOBS' UNQUOTE.

11. THE CARTER ADMINISTRATION HAS ENDORSED THE RECENT FED MEASURES, BUT WITH A DEGREE OF DETACHMENT SUGGESTING THAT THEY WERE GRATEFUL NOT TO HAVE TO ASSUME THE RESPONSIBILITY FOR SUCH MEASURES THEMSELVES. IN THE MAIN AREA FOR WHICH THE PRESIDENT IS RESPONSIBLE,

NAMELY FISCAL POLICY, NO ONE EXPECTS ANY POLICY MOVE BEFORE THE BUDGET IN JANUARY: AND THE PRESIDENT COULD THEN LEAVE ROOM FOR HIMSELF TO PROPOSE CHANGES LATER IN THE YEAR, IF HE FINDS HIMSELF DOING POORLY IN THE EARLY KEY PRIMARIES, AND IF UNEMPLOYMENT IS RISING AT THE TIME, HE COULD MAKE SOME MOVE, SUCH AS A TAX CUT PROPOSAL, EARLY IN THE SPRING. BUT MUCH WILL DEPEND ON HIS READING OF THE REASONS FOR A POOR POLITICAL PERFORMANCE. IF HE AND HIS ADVISERS TAKE THE VIEW THAT INFLATION IS THE MORE IMPORTANT REASON, THIS WOULD POINT TO DIFFERENT CONCLUSIONS SEMI COLON BUT THERE ARE NO POLICIES AVAILABLE TO HIM WHICH CAN BE EXPECTED TO BRING THE RATE OF INFLATION DOWN QUICKLY.

12. KENNEDY WILL FACE SIMILAR DILEMMAS AND WILL HAVE TO DECIDE IN THE COMING MONTHS WHETHER TO MAKE A DETERMINED EFFORT TO MODIFY HIS IMAGE AS A BIG SPENDING LIBERAL AND HOW CREDIBLY HE CAN DO THIS. KENNEDY HAS CHOSEN TO CHALLENGE THE PRESIDENT ON HIS ECONOMIC POLICIES, BUT HE HAS BEEN CAREFUL SO FAR TO COUCH HIS CRITICISM IN GENERAL TERMS AND TO PRESENT THE ISSUE AS A FAILURE OF LEADERSHIP. HE HAS ATTACKED THE PRESIDENT ON INFLATION BUT HIS ONLY SPECIFIC PROPOSAL HAS BEEN TO CONTINUE TO CONTROL OIL PRICES. HE WILL BE UNDER PRESSURE TO BE MORE SPECIFIC AS THE CAMPAIGN HEATS UP AND HE IS ALREADY VULNERABLE TO CHARGES OF INCONSISTENCY ON ECONOMIC ISSUES (E.G. ADVOCATING EXPANDED SOCIAL SPENDING BUT VOTING FOR BUDGET CUTS). SOME OF THE ACADEMIC ECONOMISTS FROM WHOM KENNEDY WILL TAKE ADVICE ARE NOW CONVINCED OF THE NEED FOR CONSERVATIVE FISCAL AND MONETARY POLICIES AND KENNEDY WILL PRESUMABLY BE ALERT TO THE DANGER OF BEING REGARDED AS INDIFFERENT TO INFLATION. ON BALANCE HOWEVER KENNEDY WILL PROBABLY CONTINUE TO STAND SOMEWHAT TO THE QUOTE LEFT UNQUOTE OF CARTER ON ECONOMIC ISSUES GENERALLY. THIS IS CERTAINLY THE IMPRESSION GIVEN BY HIS STATEMENT OF 7TH NOVEMBER ANNOUNCING HIS CANDIDACY.

13. IT IS HARD TO SAY HOW INFLATION WILL AFFECT THE BATTLE BETWEEN KENNEDY AND CARTER, AS THE INCUMBENT, CARTER MUST EXPECT TO BE BLAMED FOR THE CURRENT RATE OF INFLATION BUT IT IS AN OPEN QUESTION WHETHER KENNEDY WILL BE ABLE TO PERSUADE VOTERS THAT HE HAS ANY MORE EFFECTIVE ANSWER TO IT.

14. THE TENSIONS WITHIN THE DEMOCRATIC PARTY ON THESE ISSUES WILL ALSO BE SEEN IN THE CONGRESS WHERE THE MAJORITY WILL PROBABLY FIND ITSELF CONFUSED AND DIVIDED IN THE COMING MONTHS. SOME DEMOCRATS ARE VERY READY TO RESPOND TO A RISE IN UNEMPLOYMENT QUICKLY BY SUPPORTING TAX CUTS AND PERHAPS JOB CREATION PROGRAMMES. BUT THERE ARE OTHER FORCES AT WORK TOO. A SIGN OF THE QUOTE CONSERVATIVE UNQUOTE INFLUENCE AT WORK IN THE DEMOCRATIC MAJORITY HAS BEEN THAT NEITHER HOUSE OF CONGRESS HAS BEEN WILLING TO VOTE FOR A BUDGET DEFICIT EXCEEDING THE ONE THE PRESIDENT PROPOSED. WITH THE DEMOCRATIC MAJORITY DIVIDED IT IS NOT TO BE ASSUMED THAT THE MAJORITY OF THE CONGRESS AS A WHOLE WILL AGREE QUICKLY ON MEASURES TO COUNTER RISING UNEMPLOYMENT.

15. FOR REPUBLICANS, INFLATION WILL CERTAINLY BE A BIG ISSUE IN THE ELECTION, PERHAPS THE MAJOR ISSUE, AND THEY WILL NATURALLY BLAME IT ON THE DEMOCRATIC ADMINISTRATION AND CONGRESS. THIS APPROACH CHIMES IN WITH THEIR GENERAL DESIRE, ON OTHER GROUNDS, TO SEE BOTH GOVERNMENT EXPENDITURE AND TAXES REDUCED, (ALTHOUGH THEY WILL WANT TO INCREASE DEFENCE EXPENDITURE) THERE IS A MINORITY WHICH BELIEVES IN CUTTING TAX REGARDLESS OF LEVELS OF EXPENDITURE, BUT THE MAIN REPUBLICAN CASE WILL BE FOR CUTTING BOTH, AND FOR ACCEPTING HIGH INTEREST RATES AND ANYTHING ELSE WHICH WILL HELP TO BEAT INFLATION. THERE ARE UNLIKELY TO BE SIGNIFICANT DIFFERENCES BETWEEN THE MAIN REPUBLICAN CANDIDATES ON THESE ISSUES, AND THE CHOICE OF A NOMINEE BY THE REPUBLICANS WILL NOT BE SIGNIFICANTLY INFLUENCED BY THEM. THERE IS THEREFORE LESS TO BE SAID ABOUT THE REPUBLICAN SIDE AT THIS STAGE, BUT, TO THE EXTENT THAT THE ELECTORATE IS PRIMARILY CONCERNED ABOUT INFLATION AND INFLATION REMAINS HIGH THIS MUST TEND TO STRENGTHEN THE HAND OF ANY REPUBLICAN CANDIDATE FOR THE WHITE HOUSE AND OF CONGRESSIONAL CANDIDATES TOO. THE DIFFICULT QUESTION TO JUDGE IS HOW FAR THE AMBIGUITIES AND CONFUSION IN THE THINKING OF THE DEMOCRATIC PARTY REFLECT AMBIGUITIES AND CONFUSION IN THE MIND OF MOST OF THE ELECTORATE.

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16. AT THIS STAGE IT IS HARD TO AVOID THE CONCLUSION THAT THERE IS IN THIS COUNTRY SO FAR NO OVERWHELMING DETERMINATION TO DEAL WITH INFLATION EFFECTIVELY. AMERICA IS BEWILDERED AND ANGRY ABOUT THE INFLATION IT IS SUFFERING BUT THERE IS NO CONSENSUS ABOUT WHAT SHOULD BE DONE, AND MANY BELIEVE THAT INFLATION IS BEYOND THE POWER OF POLITICIANS TO CONTROL. AT THE SAME TIME THERE ARE SIGNS THAT AMERICANS ARE GETTING MORE USED TO HIGH INFLATION. THERE IS LESS HORROR AND INDIGNATION ABOUT DOUBLE DIGIT INFLATION NOW THAN WHEN AMERICA FIRST EXPERIENCED IT IN 1974. THE ADMINISTRATION SAYS THAT IT IS TREATING INFLATION AS ENEMY NUMBER ONE. BUT IT DOES NOT DO SO UNAMBIGUOUSLY. A CASE COULD BE MADE OUT FOR TOUGHER FISCAL POLICIES THAN AT PRESENT, COMBINED WITH CONTINUED FIRM MONETARY POLICIES FOR A LONG PERIOD. A REALLY DETERMINED EFFORT TO BEAT INFLATION WOULD ALSO HAVE TO INVOLVE OTHER THINGS, (INCLUDING PERHAPS A MUCH MORE SERIOUS EFFORT TO REDUCE THE IMPACT OF GOVERNMENT REGULATION ON AMERICAN BUSINESS). 1980 MAY HOLD SURPRISES, BUT AT THE MOMENT IT DOES NOT SEEM LIKELY THAT THE POLITICAL DEBATE NEXT YEAR WILL PRODUCE A STRONG CONSENSUS ON HOW TO DEAL WITH AMERICA'S MOST SERIOUS ECONOMIC PROBLEM.

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