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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

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Andrew Turnbull Esq
10 Downing Street
LONDON SW1

Dear Andrew

VISIT OF PAUL VOLCKER

The FCO are preparing, in consultation with the Treasury, briefing on the world economy and US economic prospects for the Camp David talks. More immediately you may like to have, as background for the Volcker meeting, the attached summary note on the US economy.

In recent days, as you may have seen, Volcker has made two major speeches - on debt and the US growth. The attached excerpts may also be of interest. For completeness I am also attaching Oliver Wright's recent despatch on the US prospects as seen by the Embassy.

The Chancellor is himself seeing Chairman Volcker later today, and I will let you know any major points of interest that come up.

Yours ever
David

D L C PERETZ
Principal Private Secretary

PROSPECTS FOR THE US BUDGET DEFICIT

1. Summary

(i) The US Federal budget deficit in Fiscal Year 1984 was about $175 billion, and could on present policies rise to $260 billion (remaining at 5% of GNP) by FY 89. The structural budget deficit may rise from about $110 billion (2.9% of GNP) to about $250 billion (4.6% of GNP) in the same period. The budget deficit is not out of control, but has been exacerbated by the 1981 tax reductions, the defence build up, and rising debt service costs. (Paragraphs 2 and 4.)

(ii) The amount of public debt outstanding in the US on present policies could double between 1983 and 1989, and interest payments, now at $300 million a day, could reach over 20% of tax receipts by FY 89. (Paragraph 2.)

(iii) Recent economic and political developments have made it harder to form a deficit-reducing coalition. The vital relationship between the President and the Republican Senate leadership may not be as close as before. Cooperation from the Democrats on budget issues is unlikely, since they are still smarting from the effects of their election defeat. (Paragraphs 3-7.)

(iv) The President is likely, in his FY 86 budget proposals, to concentrate almost exclusively on expenditure reductions, perhaps with the objective of reducing the deficit to $100 billion or 2% of GNP by 1988. (Paragraphs 8 and 9.)

(v) The possible outcomes include no action until 1986, or a freeze on expenditure increases this year. The actual outcome will depend on whether the Congress are galvanised into action. (Paragraphs 10 and 11.)

(vi) The Treasury Department's proposals for tax reform are an attractive package, but their prospects are dubious,for they would harm important special interests, and are irrelevant to the main budget issue. The proposals if implemented would probably tend to reduce US interes rates. (Paragraphs 12-15.)

(vii) The Congressional budget process will probably not be reformed this year, but dissatisfaction with the present procedure is growing. (Paragraphs 16 and 17.)

(viii) We should continue to put firmly on record our view that the Federal budget deficit is too large. But we also need in private to suggest to the Administration, and especially influential Congressmen, that the US should adopt a medium-term financial strategy similar to ours, with targets for a phased reduction of the deficit. (Paragraphs 18 and 19.)

(ix) If a consensus for firm action develops, and entrenched positions are relaxed, progress could be rapid. Butthe firm commitment of the President to any compromise would be essential, and there is no sign at this stage that he is willing to make one. (Paragraph 20.)

Economic and Fiscal Background

2. The table below provides the latest Congressional Budget Office projections for the main budget aggregates up to FY 89 if no corrective action is taken. The economic growth assumptions underlying the figures are: 6.6% in 1984, 2.8% in 1985 and 3.1% thereafter. The deficits forecast are high but do not seem to be unrealistic. The CBO budget deficit forecast for FY 85, at $178 billion, is well below the Administration's latest forecast of $205-210 billion; the Administration forecast for later years will probably not be known until the budget is published in January.

/...

US BUDGET: CBO AUGUST BASELINE

(Fiscal years, $ Billion or %)

	Actual	Projected				
	1984	1985	1986	1987	1988	1989
Revenues	666.5	751	811	881	965	1042
Outlays	841.8	929	1006	1097	1203	1305
Deficit	175.3	178	195	216	238	263
Cyclical Deficit	67	32	28	20	17	17
Structural Deficit *	108	146	167	195	221	246
Per cent of GNP:						
Revenues	18.6	19.1	19.1	19.2	19.4	19.4
Outlays	23.5	23.7	23.7	23.9	24.2	24.3
Deficit	4.9	4.5	4.6	4.7	4.8	4.9
Cyclical Deficit	1.9	0.8	0.7	0.4	0.3	0.3
Structural Deficit	2.9	3.6	3.9	4.2	4.4	4.6
Debt in Hands of Public	1,308	1,497	1,706	1,936	2,189	2,466
Net Interest on Debt	111.1	133.5	149.6	168.6	194.1	213.9
Net Interest as % of Revenues	16.6	17.8	18.4	19.1	20.1	20.5

* at 6% unemployment

3. There seems to be a consensus - probably now extending to President Reagan - that the structural budget deficit is a serious problem. Financiers are concerned at the deficit's implications for US Treasury borrowing, and the resulting crowding-out of the credit markets. Farmers and producers of tradeable manufactures recognise high interest rates as the main cause of the high dollar and low exports, and are consequently generally sympathetic to deficit-reduction measures. There is a traditional Republican concern to see the country back on a sound fiscal basis, and a new Republican desire to put an end to big government. Insiders such as Niskanen, of the Council of Economic Advisers, and Penner, of the CBO, fear most the recent explosive rise in public debt, since the Federal Government now pays $300 million a day in debt service, and the number is rising fast. But the consensus that a high deficit is bad news falls a long way short of agreement on how to remedy it.

4. Part of the problem is that the causes of the deficit are not widely understood. In the last ten years, the rise in the deficit correlates with the rapid rise in non-means-tested entitlement spending from about 7% to 10% of full-employment GNP. But such expenditure is financed by Social Security taxes which are regarded by most Americans not as taxation but as insurance premia. These insurance premia have fully financed the increase in entitlement expenditure, and have not directly contributed to the deficit. Growth in discretionary

expenditure and expenditure on "welfare" (ie means-tested social programmes) has not grown disproportionately, especially since this expenditure was severely cut in 1981. Income tax, to be indexed only in this tax year, has been a buoyant source of revenue because of the combined effects of inflation and a progressive rate structure. There has been a significant decline in the contribution to revenue of the corporate income, estate and gift taxes (5.6% of revenue in 1970; an estimated 3.0% in 1984). But, especially from the perspective of the period since 1980, the growth of the defence budget and the tax reductions of the 1981 Economic Recovery Act (ERTA) have been the main causes of the deficit. To that extent the deficit reflects specific acts of policy and (aside from debt interest) is not "out of control". But it is obviously not easy for the Administration either to reverse previous policies or to withdraw benefits from millions of Americans.

The Congress

5. The situation in the Congress is also more difficult than before. The significant point is not that the election brought net gains of two for the Democrats in the Senate and fifteen or sixteen for the Republicans in the House of Representatives. The Senate before the elections already contained a handful of Republicans who regularly voted with the Democrats on economic issues. The new Senate could well be considerably more centrist and less conservative than its

predecessor and the new majority leader, Senator Dole, will be significantly less inclined to take his instructions from the White House than was his predecessor, Howard Baker. This could mean more consensus within the Senate, but also that the vital relationship between the President and the Republican leadership will be weaker. But Dole has said that he wants to give precedence to the deficit issue and seems to favour a spending freeze.

6. The House will still contain a substantial Democratic majority, but may be rather more conservative than its predecessor. The thirty-two new Republicans who have entered on Reagan's coat-tails could join up with the other Young Turks led by Jack Kemp of New York. If so, compromises between the Democrats and the Republicans in the House will be difficult to achieve and the mere existence of so many advocates of supply-side economics could lead the President to be cautious in agreeing to compromises embodying tax increases. The minority Republican leadership in the House could therefore have a difficult balancing act to maintain a common Republican front while attempting to reach a budget compromise with uncooperative Democrats.

7. The prospects for early action on the budget deficit are not likely to be helped by developments in the economy. If the low (1.9%) annualised rate of growth of the third quarter of 1984 continues and unemployment should begin to rise, then old-fashioned Keynesians and supply-siders in Congress could

form an unholy alliance to block a deficit-cutting compromise. Measures to increase expenditure on countering unemployment might even have some chance of being passed. If growth resumes at a non-inflationary rate of 3% next year, then the Congress will have little incentive to take any action, particularly if interest rates remain constant or continue to fall. If strong growth resumes, then the recorded deficit will not be below forecast, and no action would be likely unless interest rates also rose sharply. Congress might be galvanised into action by a crisis, such as a collapse of confidence in the US dollar or a large fall in stock or bond prices and a rise in interest rates. But these would be chance events, and there is no certainty about whether or when they might arise.

Expenditure Reductions

8. The FY 86 Budget (for the year beginning in October 1985) has not yet been finalised by the President, but on the basis of the usual leaks, and discussions with officials and Congressional staffers, it is possible to speculate about the expenditure reduction propoals it will contain. During the election campaign the President appeared to rule out tax increases (by degrees ranging from "only as a last resort" to "over my dead body"), and this undertaking will certainly apply to his own budget proposals. Therefore the budget to be published next January will be largely confined to proposals for expenditure reductions. To use the words of Administration

insiders, they are likely to be Draconian. Since only about 18% of Federal expenditure is on non-defence discretionary items, any substantial proposals for cuts will have to make inroads into controversial entitlement areas such as Medicare. But it is not expected that the Administration will again attempt to make major cuts in means-tested programmes, which affect the poor, as it did in 1981. The main areas now being canvassed for cuts include:

- Civil Service retirement benefits
- Grants to State and local governments
- Veterans' benefits
- Medicare and Medicaid
- Tax deductions for medical expenditure
- Agricultural support
- Perhaps, abolition of the Department of Education or even the Ex-Im Bank.

The above is not an exhaustive list, and areas such as defence are likely also to be targeted by Budget Director Stockman. There seem to be signs of a possible consensus that Weinberger's budget request will be cut back to 5% real growth. The only expenditure programme likely to be immune, because of the President's campaign promises, is Social Security.

9. The Administration's objective is likely to be to reduce the budget deficit to $100 billion, or 2% of GNP, by 1988. This would also stabilise the public debt/GNP ratio, and

prevent interest costs from soaring. To do this by expenditure reductions alone would require a remarkable success in Congress, since proposals for cuts in the target areas will obviously evoke strong protests. The precedent of 1981 is often cited, and the President then secured $35 billion of expenditure cuts. But the 1981 tax reductions were greater, so the analogy is imprecise. In the end, the President may reject Budget Director Stockman's advice, and simply propose that expenditure be frozen at current nominal levels. Senator Dole is said to favour such a scheme, and it would avoid some of the conflicts about particular areas for cuts, but it would still constitute a Draconian proposal.

10. The support of at least some Democrats would be necessary to enact any programme of expenditure reductions. But the Democrats are at present not inclined to be co-operative. As they see it, President Reagan minimized the importance of the deficit during the election campaign, and claimed that the deficit would be reduced by recovery, whereas they took what they regard as a more responsible approach and recommended a tax increase; lost in consequence. They now regard the deficit as the President's problem: let him either cure it by delivering on his promises of growth, or admit his mistake, and go for tax increases.

Budget proposals for FY 86, focusing on expenditure cuts alone, may therefore not get very far in a Congress that shows no more signs of being tougher on expenditure than was its predecessor.

11. The Democrats will have to be mollified by tax increases, and it is not clear that many of the new Republicans in the House of Representatives will wish to compromise with them. As noted in paragraph 6, a compromise might therefore depend on skilful leadership within the Republican caucus in the House before the Democrats are even approached. Optimists here say that there could be negotiations next July or August for a package to supplement the "down-payment" that was finally agreed in October of this year. But the majority view is that such a compromise will be difficult to reach, short of a financial emergency. If an emergency were to occur, it would make it more probable that agreement could be reached on a spending freeze at current levels.

Tax Reform

12. The President has now received a report containing proposals from the US Treasury for a revenue-neutral package of tax reforms. The proposals as they stand are strictly irrelevant to the budget deficit, being revenue-neutral. They will probably not be seriously considered for passage by the Congress until after the first attempt at passing a Budget Resolution (due by 15 May).

13. The Treasury's tax proposal that finds favour with both Republicans and Democrats, and which is given most emphasis in the tax reform package, is a modified flat tax on income. This is very similar to that proposed by Congressmen Kemp-Kasten (Republicans) and Bradley-Gephardt (Democrats). It would reduce the existing fourteen-rate structure to three rates (15%, 25% and 35%), and eliminate many loopholes. It retains only really essential or politically necessary deductions such as those for mortgage interest on the first home, and severely restricts deductions for charitable contributions and for State and local taxation. Even more controversially, a separate proposal reduces provision for the depreciation of plant and equipment owned by businesses in exchange for a reduction in the rate of corporation tax to 33% (a move, like several elements of the Treasury proposals, towards a system similar to the UK's). There are no more tenacious lobbyists in Washington than those whose field is taxation, and there is an obvious danger that reductions in individual and corporate tax rates will go through, but that the unpopular closure of loopholes will not. What sets out as revenue-neutral may end up rather different. The US Treasury, who greatly admire the Chancellor's 1984 budget, wish they too could move budget resolutions on budget day, and be sure of a Finance Act by the autumn.

14. Not only will lobbyists for groups of individual tax-payers be against loophole-closing, but some supply-siders will oppose as a matter of principle any major reductions in the depreciation

provisions for businesses, and may find an ally in Senator Packwood (the new Chairman of the powerful Senate Finance Committee) who likes the tax system as it is. But having proposals for tax reform on the table may eventually provide the Administration with an opportunity to gain more revenue by raising the nominal rates of tax above those proposed and below present nominal rates, while closing some loop-holes. But they are in no mood to seize such an opportunity yet. A more likely outcome would be a complete standoff on tax reform, particularly if the President retains his present aloofness from the Treasury proposals.

15. If the tax reform package could be passed, this would have the effect of tending to reduce US interest rates. The limitation of personal interest relief to mortgages on a first home, the indexation of interest relief, and the lowering of tax rates would reduce the incentive to borrow, easing the demand for credit. The increased tax incentive for saving and the indexation of interest receipts would tend to increase the supply of savings. This would all be beneficial from our point of view.

Procedural Reform

16. There are hardly any signs now that the Administration intend vigorously to pursue a constitutional requirement for a balanced budget as part of their FY 86 budget proposals. This would be irrelevant to deficit reduction in the next

five years because it would take so long to ratify by the States; the proposal for a line-item veto seems also to have dropped out of everyone's but the President's sight. But there is widespread discontent with the 1974 Budget Act and Representative Obey (D-Wisconsin) has recently made a proposal that is receiving considerable attention. Congress at present spends about one-quarter of its time on a budget process which includes a non-binding Budget Resolution that is ineffectual because it is not taken seriously as an expenditure (or taxation) limit. It then has no time to pass the tax and (especially) the appropriations provisions which do have legal effect. The result is that at the end of each fiscal year there is usually an undignified scramble to pass a Continuing Resolution to fund Government programmes during the next year.

17. Obey's proposal is to have the Appropriations and Tax Committees report their recommendations for the following fiscal year to the floor of the House of Representatives by June of each year which, when coordinated by the Budget Committee and approved on the floor, would have immediate legal effect. This would have the merit of forcing Congressmen to vote the tax and expenditure sides of the budget at the same time, and hence to support a specific deficit. The Obey idea is also intended to get the budget out of the way

to free the Congress for other activities. It has some chance of being adopted, but the timetable which it envisages (ie agreement on a comprehensive budget proposal by June of each year) is thought to be extremely tight in terms of the Congressional calendar. Because it would upset the balance of power within the existing House committee structure, this proposal is not likely to be adopted this year.

Conclusion

18. The prospects for early progress towards reducing the US budget deficit look to be poor, and the outlook for tax reform in 1985 is also dim because of the difficulties of closing tax loopholes and Senator Packwood's appointment as Senate Finance Committee Chairman. The Democrats in Congress and the President have taken positions too far apart for early progress to be made on the deficit without a catalyst, for example a major financial crisis such as the collapse of the dollar or a sharp rise in interest rates. The continuation of the American economic recovery does not seem as secure as it looked several months ago and, if growth continues to slacken, corrective action on the deficit will be both more politically difficult and more necessary.

19. We shall need to continue to put on public record our view that the deficit is far too high. But there also seems much to be said for privately advocating a phased programme

of structural deficit reduction, similar to that in our own Medium-Term Financial Strategy. Given the separation of powers, the Administration would of course be unable to control the Congress and so impose continuity. But at least performance could be checked against a plan containing specific targets. Some degree of discipline might result. We might do well to advocate privately to the Administration, and especially to influential Congressmen, the merits of an MTFS. It would be helpful if this could be done in conjunction with our EC partners.

20. The outlook for the deficit is not entirely one of gloom. The American system, while not designed for efficiency, can be expeditious once a political consensus develops on individual issues. Even without an economic or financial emergency, it is quite possible that, say, pressure from the public and the media about the rising tide of public debt, could force some action. If so, a deficit reduction programme could be quickly put in place. But any compromise seems likely to require the President to move considerably from his present position and to accept the need for revenue increases. This will be difficult for him: the Prime Minister's visit to Camp David on 22 December is very important.

LOBBYISTS

TAX REFORM

BY AUTH FOR THE PHILADELPHIA INQUIRER

OFFICIAL TEXT

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UNITED STATES INFORMATION SERVICE, U.S. EMBASSY, 55/56 UPPER BROOK STREET, LONDON W1A 2LH

VOLCKER OPTIMISTIC ABOUT U.S. GROWTH
(Excerpts: Volcker on the U.S. economy)

Washington -- A slowdown in growth such as the United States experienced during the third quarter of 1984 is typical of recovery periods and there are "reassuring signs for the future," according to Federal Reserve Board Chairman Paul Volcker.

In a speech last week in New York City, Volcker said such slowdowns are typically related to temporary imbalances in inventories, which seems to have been the case in the third quarter. He pointed to "continuing growth in income and employment and relatively strong investment plans" as indications that growth will resume. In addition, "the decided decline in interest rates as the growth rate has slowed should help support both housing and investment, and the related easing of pressures on bank reserve positions by the Federal Reserve will help keep money and credit growing."

Other points made by Volcker:

-- The Federal Reserve has the responsibility to support orderly growth in demand, in line with potential, and "we intend to meet that responsibility." Moreover, "with the dollar so strong internationally, and with inflationary trends more favorable, I believe we have more flexibility in the conduct of policy than for some time, without raising alarms about a new inflationary surge."

-- While the "inflationary dragon" has not yet been slain, "it is fair to suggest that, for the first time in a long while, it's on the defensive." Confidence that inflation will remain low is one of the basic prerequisites for a decline in interest rates.

-- The high level of U.S. imports "has been a crucially important contribution to world economic health at a time of high unemployment and halting recovery in Europe and when many Latin American countries have been struggling to get their own finances and external accounts in order," but running such a large trade deficit is not sustainable indefinitely.

-- For the moment, the United States is "addicted to foreign borrowings" to reconcile its budget deficit and investment needs with its limited propensity to save, and the constructive approach is "to act to end the addiction by moving promptly and effectively to reduce the budget deficit."

Following are excerpts from Volcker's speech:

This decade, economically speaking, started in a discouraging -- even frightening -- way. As a nation, we had come to expect that

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inflation had become a way of life. As we did so, it predictably began to accelerate. People preoccupied with how to beat inflation began to worry more about how to trade their houses for capital gains and about the price of gold than about how to do their jobs a little better. And in that environment, it is not so surprising that productivity growth practically stopped, and so did real increases in income. Once price increases threatened to get out of hand, even the textbook axiom that there was a "trade-off" between a little more inflation and a little less unemployment didn't seem to work. We ended up with more of both....

I'm not going to argue...that we have, as yet, slain the inflationary dragon. But it is fair to suggest that, for the first time in a long while, it's on the defensive. And I think that once we got down to the serious business of controlling inflation, the gains have been greater -- and come faster -- than many thought possible. Measured by consumer prices, inflation has been running at a rate of little more than four percent a year, still far from satisfactory, but lower than in more than a decade. Wholesale prices of goods have been rising very little -- not at all for six months. That is a good omen that, for the time being, prices at the retail level will remain under control.

The first progress toward lower inflation occurred during a deep recession. There was a natural inclination to be skeptical. We had seen that before; it would be only a cyclical phenomena; just wait, inflation would, like arthritis pain, come back with a change in the weather.

In that light, the most encouraging news is that, after two years of strong expansion, the trend has remained better. And as it has, there have been signs that success can help breed further success.

For instance, as expectations of inflation have slowly diminished, labor doesn't have to fight so hard for increasing wage settlements simply to stay ahead of the game. That helps keep costs under control, and in turn reinforces the disinflationary process.

As prospects for greater price stability have improved, the chronic weakness of the dollar internationally during much of the 1970's has been dramatically reversed, indeed to the point of concern that the competitive pressure of imports on some of our most important manufacturing industries may be excessive. Whatever the precise optimum level of the dollar in relation to other currencies, the message is clear that the renewed emphasis on productivity and efficiency born in the adversity of recession must be maintained and reinforced.

And, as confidence gradually strengthens in our ability to restore reasonable price stability -- a confidence that can be earned and kept only by sustained performance -- we will have put in place one of the basic prerequisites for interest rates returning to, and staying at, the much lower levels we have enjoyed historically.

All of this, as you know, has been accompanied over the past two years by the strongest peacetime economic expansion in many years. Both employment -- with 6.5 million new jobs created over the past two years -- and average real incomes have gained. Consumption has been high, but investment has also surged. After-tax profits, relative to GNP, are as high as in some time.

But, of course, all this started from a low level. With unemployment still well above seven percent, we still have a considerable distance to go before we can be satisfied that we are operating at levels close to our true potential. With continued

sizable increases in investment, we should be able to keep our physical capital in line with needs. And more competitive markets will help keep prices under control.

But I would fail to be in character, as a central banker and practitioner of what has been called the dismal science, if I did not emphasize to you that, despite all these recent gains, all is not right in the economic state of the United States. We face some tough policy choices -- tough politically and tough economically. Unless they are resolved soon, and resolved satisfactorily, all those bright prospects will be in jeopardy.

The current economic news has been full of reports of a sharp slowing in the rate of economic growth during the summer and early fall. In one sense, that is not surprising; the pause comes hard upon an exceptionally sharp rate of increase in the GNP, at a rate of some 8.5 percent, during the first half of the year. The barrage of attention, in this media age, to every twist and turn in the economy should not obscure the simple fact that it's not in the nature of the economic beast to move forward, quarter by quarter, with military precision.

A sharp slowing in growth for a time during an expansion period is in fact historically common, typically related to temporary imbalances in inventories following a period of rapid accumulation and temporary fluctuations in consumption. Something of that sort seems to be at work this fall.

Continuing growth in income and employment and relatively strong investment plans are reassuring signs for the future. The decided decline in interest rates as the growth rate has slowed should help support both housing and investment, and the related easing of pressures on bank reserve positions by the Federal Reserve will keep money and credit growing.

But the question persists -- is that all there is to it? Is something more fundamental at work that could lead to more serious difficulties?

We don't have to look far for a possible culprit. Fed mainly by an enormous increase in imports, our international trade deficit reached a new high of about 130,000 million dollars at an annual rate during the summer.

Throughout the expansion period, the trade balance has been deteriorating, and so has, in parallel, our overall external current account, which measures imports and exports of all goods and services. Since late 1982, the current account deficit has increased by almost 100,000 million dollars to an annual rate in the neighborhood of 120,000 million dollars during the third quarter.

When we import more goods and services than we export, we must pay for it in the only way we can -- by borrowing capital from abroad in the same amount. For the time being, that has not been difficult. Relatively high interest rates, growing confidence in our economic prospects, and political stability have all acted as a magnet for foreign funds. But I must also point out that the United States is importing capital so fast that the largest and richest country in the world is well on its way to becoming the largest international debtor as well.

The growing trade deficit, and the related capital inflow, have some highly significant implications. For one thing, we as a country have been consuming significantly more than we have been producing. The GNP -- a measure of production -- has risen by about twelve percent in real terms over the past two years. Domestic spending has

ri[illegible] appreciably faster, by more than 15 percent. In essence, a lot of demand generated in this country has flowed abroad, generating production and income in other countries. We didn't feel it much, in overall terms, while our own production was expanding so rapidly. But it made a very noticeable impact last quarter, when domestic demand continued to expand at the relatively rapid rate of more than 5.5 percent, while GNP growth slipped to a rate of only about two percent.

Both industrialized and developing countries abroad have benefited from our growing markets. That has been a crucially important contribution to world economic health at a time of high unemployment and halting recovery in Europe and when many Latin American countries have been struggling to get their own finances and external accounts in order. From our own standpoint, the ample supply of foreign goods in our markets has certainly benefited the consumer and helped to keep inflation under control. What may be less understood is that the massive capital inflow has, directly or indirectly, helped enormously in maintaining a reasonable balance in our capital markets during a period of record Federal budget deficits.

The simple fact is demands on our savings -- from business investment, from housing, and from the Federal deficits -- currently exceed what American individuals, businesses, and state and local government pension funds are willing to save by an amount equivalent to about three percent of the GNP. That shortfall is, in effect, being covered by drawing on the savings of other countries; the net financial inflow in the third quarter appeared to be running at a rate of some 120,000 million dollars a year.

Let me put the point another way. I am sure many people, worried about the budget deficit a year or more ago, feared that deficits would "crowd out," as the phrase goes, domestic housing and investment as economic recovery took hold. There was understandable concern that interest rates would be under very strong pressure -- that there wouldn't be enough money to finance both rising investment needs and a Federal deficit in the range of 175,000-200,000 million dollars the same time. "Something" would have to give.

Well, yes and no. That analysis, focused primarily on the U.S. potential to save, failed to take account of the sharp increase in the inflow of capital from abroad. Interest rates have indeed been high, relative to most other industrialized countries, and foreign capital has freely flowed into our markets in amounts adequate to enable us to maintain rapid growth in business investment and reasonable levels of housing. That capital inflow was, at the same time, necessarily accompanied by a growing trade deficit. That deficit reflects lost markets for our exporters or manufacturers competing with imports. Those internationally oriented businesses have been the ones "crowded out" -- but that process was not recognized so clearly simply because those industries are widely dispersed, because the chain of causation is indirect, and because the economy has been expanding so rapidly. And, of course, we will have to pay interest on those foreign borrowings for many years.

Given all the apparent advantages -- the stimulus to world growth and adjustment, lower interest rates domestically than would otherwise have been possible, and the benefits to consumers of relatively low priced foreign goods -- why it might be asked, should we be so concerned?

For a simple reason. Strong as the United States is, and encouraging as is our progress toward price stability and greater

productivity, borrowing so much abroad, and running so large a trade deficit, is not sustainable indefinitely.

For one thing, there is a political as well as economic dimension. So large a deficit understandably intensifies, among affected industries, the already strong pressures for protection. A lot rides on the ability of the administration and the Congress to contain those pressures, for yielding here will certainly be matched, and more, by retaliation abroad. I can think of no scenario more conducive to undermining world economic growth, and more particularly the prospects for the poor countries already struggling with debt problems. And at the same time, it would provide as strong inflationary impetus.

Economically, protectionist measures are a diversion from the underlying problem. Suppose we somehow succeeded, in short order, in sharply reducing the trade deficit and its counterpart, our borrowing from abroad? Then, how would we finance our Federal deficit? What would be the implications for interest rates -- and thus for housing and investment?

The hard reality is that, for the moment, we are addicted to foreign borrowings to reconcile our deficit and our investment needs with our limited propensity to save at home. Yet, we can't count indefinitely on the capital inflow -- among other things, growth needed in other countries requires that they employ more of their savings at home. At some point, as our debts rise, confidence could be undermined. Surely, the constructive approach is to act to end the addiction by moving promptly and effectively to reduce the budget deficit, restoring better balance to our domestic capital markets, encouraging lower interest rates, and reducing the pressures on internationally oriented business....

My thesis...is a simple one. We have come a long way toward restoring the prospects for price stability and for sustained growth. The benefits have flowed throughout the world, not just to the United States. But we have already delayed too long in facing up to a fundamental imbalance -- reflected in those related budgetary and trade deficits -- that left untended, poses a great threat for the future.

The current pause in economic growth need be no more than that. But it should be warning enough that this is no time to bask idly in the warmth of past progress, at the plain risk that, instead of controlling our own economic destiny, we fall prey to crisis and dislocations.

There are responsibilities aplenty for others: for business and labor to continue working together to improve efficiency, to contain costs, and to innovate; for other nations, in Europe and elsewhere, to stimulate their own growth so that so much of the responsibility for maintaining a healthy world economy does not fall on the United states alone; for heavily indebted countries to build upon the progress they have made to get their own finances more completely in order. And there are encouraging signs in all those areas.

But there is simply no escape for appropriate action by the United States as well -- too much rests upon our ability to conduct prudent and disciplined monetary and fiscal policies.

The record of the past two years seems to me to provide dramatic evidence of the benefits that flow from facing up to the problems that once seemed almost insurmountable. With the same exercise of will and foresight, we will be able to look back upon the current pause as simply part of the transition to more stable and sustained growth.

OFFICIAL TEXT

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DEBT PROBLEM MANAGEABLE, VOLCKER SAYS

(Excerpts: Volcker speech on the debt situation)

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Washington -- The international debt problem is manageable, and with effort should remain so, according to Federal Reserve Board Chairman Paul Volcker.

Speaking to the American Swiss Association in New York November 29, Volcker said success will depend on sustained growth by industrialized countries, avoidance of excessive real interest rates and maintenance of open competitive markets, both in the industrialized and developing worlds.

Other points made by Volcker:

-- Federal Reserve analysis supports the conclusion of others that "trend growth by the industrializing developing countries of five percent or more annually can be restored in the years ahead consistent with significantly falling debt burdens," while at the same time the banks with loans to these countries can reduce their exposure relative to their capital.

-- Hard analysis does not support the pessimistic earlier view of some that substantial increases in official aid or across-the-board writedowns of debt by the banks would be needed to avoid financial breakdown.

-- The most important contribution the industrial world can make to further improvement in the debt situation is "to maintain orderly economic expansion, with the important by-product of a favorable external economic environment for developing countries seeking to expand exports."

-- All industrialized countries have to resist protectionist pressures, but this is not a matter to be addressed by them alone. "Protectionism...can be as much or more of a handicap to growth and development when practiced by the developing countries themselves."

-- "A thicker layer of equity risk capital (in debtor countries) would be the best possible base for encouraging a restoration of normal bank lending." The return of confidence in these countries implied by a surge in private investment, both domestic and foreign, would provide the strongest possible evidence that debt problems are over.

Following are excerpts from Volcker's speech:

(begin excerpts)

It's a particular honor and delight for me to receive your award today. Central bankers, even more than others, are bound to admire and respect the success of the Swiss both in maintaining so large a

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measure of monetary and economic stability internally over the years and in contributing so importantly to world financial affairs. What a demonstration of the tangible benefits of financial discipline and common sense Switzerland is.

I am tempted to hypothesize that Swiss success reflects the fact that Switzerland maintains a strong and independent central bank.

Now, I'm not about to reject that thought entirely. But I am ready to acknowledge that something even deeper may be at work as well -- a matter of national character and experience and enlightened self-interest of those living in what is, after all, a small country poorly endowed with natural resources.

The career of my good friend Fritz Leutwiler, who will soon be retiring from his responsibilities at both the Swiss National Bank and the Bank for International Settlements, has been squarely in the Swiss financial traditions, and he has brilliantly added to it. All of us in other countries who have worked closely with him during these turbulent recent years are bound to sorely miss his practical leadership and wise counsel. In no area will that be more true than in dealing with the continuing problems of international debt.

Fritz brought to the days of crisis from the earliest tremors in Eastern Europe an understanding, a willingness to act and to lead, and a personal influence that were indispensable to managing the situation. That job is still far from complete -- by its nature it will be the work of years. But I also think it is fair to say that today, for all the obstacles still ahead, we can see that the earlier sense of hopelessness expressed by some is plainly not justified, that the main avenues to success can be more clearly identified and more broadly understood, and that strong cooperative efforts by borrowers and lenders alike can be elicited, in their mutual interest, to help manage the situation.

Before substantiating those points, a sense of the origins and nature of the problem seems to me essential. It's often explained in terms of specific events -- the successive oil crises, the impact of historically high interest rates in the early 1980's coinciding in part with a prolonged recession, and errors by lenders or in economic management by particular borrowers. Obviously, those particular events and circumstances were significant. But there have been broader forces and attitudes at work.

The international debt problem -- important as it is quantitatively and in terms of its impact on so many countries, so many people, and so many financial institutions -- is only one symptom of a larger challenge: a transition from a highly inflationary environment to restoration of the financial underpinning of sustained, non-inflationary growth.

Bank lending to a whole tier of important developing countries -- those moving rapidly toward industrialization -- got its initial strong impetus in the early 1970's when the first oil crisis greatly added to financing needs at a time when strong growth patterns and rising commodity prices had greatly improved confidence in the basic outlook of the borrowing countries. The ability of the banking system to respond flexibly and vigorously to those needs itself reinforced confidence. But the expotential further rise in bank lending through the 1970's, and the second 1979-80 oil crisis, can only be fully explained, in my judgment, in the context of other, more fundamental, developments and attitudes. There was a common perception of continuing and even accelerating inflation and exceptionally low real interest rates, a sense that government would nonetheless be able and willing to maintain relatively strong growth in the world as a whole,

and an implicit assumption that the kind of financial crises experienced by our fathers and grandfathers were more a relic of history than a future threat.

So long as new loans flowed freely, rapid growth could be maintained in many developing countries, and inflation seemed to wash away much of the increased debt burden. It was also true that both interest payments and debt maturities were, in effect, being made only with the proceeds of new loans. That is not, in itself, an unusual or necessarily disturbing circumstance -- it is, in fact, a normal part of the growth cycle for a company or country. But it is sustainable only when the debt is maintained, and seen to be maintained, in some manageable relationship to real growth and productivity, with a liquidity or borrowing cushion against inevitable periods of recession and disturbance.

Looking back, it's much easier now than in the 1970's to see the warning signs that the process was not in fact sustainable for some countries, and that it had become dependent on accelerating inflation and exceptionally low real interest rates. Lending banks had permitted their own capital ratios and liquidity to erode, increasing their own potential vulnerability. And, perhaps most ominously, late in the 1970's and at the start of the 1980's accelerating capital flight from a number of borrowing countries signaled deteriorating prospects for productive investment; at the same time, larger amounts of external, public borrowing were required to finance the outflow.

The implicit assumption of rising inflation, low real interest rates, and sustained world growth were abruptly undermined in the early 1980's. When the crisis erupted in Mexico, reflecting a particular combination of political and economic circumstances, the simple fact is much of the continent of South America, as well as some other important borrowers, had become vulnerable to even a temporary change in circumstances and market psychology. One clear danger was that self-protective instincts of individual lenders to cut risks and exposures by suddenly curtailing new loans would not only grievously impair the stability of their borrowing customers but also pose large risks for all creditors with large loan exposures -- a category including most of the major international banks.

Happily, there was not only prompt recognition on all sides of that danger to the international financial system but a strong willingness to participate in a collective approach to deal with it. I will not review the details of that cooperative effort. Suffice it to say it had several critical ingredients.

The efforts of the borrowing countries themselves to reduce external needs -- an effort that initially inevitably required emphasis on curtailing swollen imports -- and to become more competitive and productive over time were absolutely critical. But those efforts would have been fruitless without recognition by banks of their own interest in orderly refinancing of old loans and the provision of enough new money to maintain the viability of the adjustment programs undertaken by borrowers. The role of the International Monetary Fund (IMF) in the process has, of course, been essential. It could, as it was designed to do, provide a critical margin of new money. I sense more important, if less measurable, has been its ability -- as an internationally respected, competent, and neutral financial (and intellectual) intermediary -- to seize the initiative in coordinating the effort, country by country, and to maintain surveillance over the entire process.

The founders of the IMF could hardly have foreseen this role, and few of us, even a few years ago, could have appreciated the importance it would assume. Of course, it has had to be supported, with

resources and otherwise, by governments and central banks of the leading countries....

Now, more than two years after Mexico had to declare a temporary standstill on its debt repayments, we can take some satisfaction from the fact that the crisis facing major developing countries and the system has been contained and kept manageable. For some of the most important borrowers -- notably Mexico, Venezuela and Brazil -- more can be claimed. They have made unexpectedly rapid progress in external adjustment, and have succeeded in rebuilding significant financial reserves. Two of them have negotiated long-term debt restructurings on terms that they should realistically be able to meet, and the third has plans to do so.

It's equally obvious that points of vulnerability remain, and to some extent, problems can remain contagious. Argentina, for instance, only now is at a critical point in negotiating with its creditors for a sizable amount of needed new money and debt rollovers, following prolonged consultations by the new and democratic government on an appropriate adjustment program with the IMF. Other smaller Latin American countries, as well as a few elsewhere, remain in a very difficult position, economically and financially.

Under the circumstances, it's still too soon to close the book on what might be thought of as "stage one" of handling the LDC (less developed country) debt problem -- urgent crisis management. But it's not too soon to begin work on stage two -- the transition to renewed growth and stability. I suggested at the start that the broad prerequisites for success can be identified, and at a general level command a broadening degree of agreement as consistent with realistic and reasonable assumptions.

In essence, econometric and other analysis at the IMF and World Bank, as well as among some private analysts, suggest trend growth by the industrializing developing countries of five percent or more annually can be restored in the years ahead consistent with significantly falling debt burdens and much reduced exposure relative to capital or lenders. Our own work in the Federal Reserve supports these conclusions.

The assumptions typically made in these studies do not strike me as heroic: growth averaging about three percent a year among the industrialized countries, well within historical experience; real dollar interest rates within the range of those experienced over the past year or so (an assumption which could well be unduly pessimistic); and no large change, up or down, in oil prices. Projections for individual countries made by both borrowers and lenders in developing longer-terms restructuring programs, such as for Mexico, lend credence to the more general analysis.

I am well aware that econometric projections are not the same as reality; the real world has more surprises, and more fluctuations, than can ever be captured in a series of equations averaging past relationships. But I believe the work does demonstrate effectively that all the effort on crisis management has not led us into a blind alley, only postponing an inevitable day of reckoning. Hard analysis simply does not support the pessimistic earlier view of some that such extreme and unlikely measures as substantial new official aid programs or across-the-board writedowns of debt would inexorably become necessary to avoid financial breakdown.

But, conversely, there should be no presumption that favorable results are assured and automatic. All those who have cooperated in crisis management will have important continuing roles to play. That sounds as though the patience of all could be sorely tested -- except that the actions needed are basically consistent with the individual interests of the several parties, debt problems or no.

For example, the most important need for the industrialized world to maintain orderly economic expansion, with the important by-product of a favorable external economic environment for developing countries seeking to expand exports. For the past 18 months, the United States has played a particularly large role in supporting world growth. Our huge and growing trade deficit and the much slower rate of U.S. growth for some months -- while not in itself exceptional during an expansion period -- should also be reminders enough that the responsibility for encouraging growth should not fall on one country alone. Indeed, looking ahead, the historically high levels of unemployment that have persisted in Europe for some time, and the progress that has been made against inflation, suggest the potential for above-average growth rates in that key industrial center for a while.

To me, it is obvious as well that prospects for balanced growth with more moderate interest rates in this country would be greatly enhanced by a strong and early attack on our now chronically large budget deficit. Given our weight in the world economy, that deficit not only overstrains our capacity to save domestically, it absorbs too much of the limited supply of capital abroad.

All the industrialized countries will have to work hard and in concert to resist protectionist pressures. There is no doubt that rapid increases in imports from the developing world pose difficult adjustment problems for long-established industries here and elsewhere; temptations to curtail imports become well nigh irresistible when markets in other countries are closed. But there is also no doubt that the ability of the developing world to grow and service its debt is dependent on rising exports -- and that their development will also stimulate a comparable flow of exports from the industrialized world. In the end, the productivity and standard of living of all countries is at stake.

The question should not be addressed to industrialized countries alone. Protectionism, or what amounts to the same thing -- a network of subsidies, controls, and artificial pricing -- can be as much or more of a handicap to growth and development when practiced by the developing countries themselves. Far too often, a few favored industries are supported and pampered at great cost, budgetary or otherwise, sacrificing the competition that spurs efficiency and harming other sectors -- often including agriculture -- operating far below their potential.

That lost "potential" may have appeared less urgent when bank loans from abroad seemed abundantly available on easy terms. But the only prudent assumption today is that those days of lenders aggressively "selling" loans to the most heavily indebted are gone, certainly for years ahead. Realistically, given the scars of recent experience, the relative exposure of a number of large banks to particular countries is likely to remain larger than they would desire for some time. Many smaller banks, attracted to foreign business beyond their normal market areas, may wish to retrench. I do not suggest that when conditions justify -- including satisfactory performance with respect to IMF-sponsored adjustment programs -- long-term restructuring of existing debts at reasonable spreads should not be expected in more countries, or that cooperative efforts to raise essential amounts of new money will not be successful. In appropriate circumstances, the common interest in those efforts remains compelling. But truly spontaneous lending by individual institutions to countries with serious debt servicing difficulties may be confined largely to trade credits for a time, and even as confidence more fully returns, new lending is likely to remain moderate by the standards of the 1970's for years to come.

There can be, in fact, no common interest in simply resuming the lending patterns of earlier years -- lending that would ultimately again threaten the stability of lenders and borrowers alike. Banking and supervisory agencies here and elsewhere will themselves want to guard against that eventuality.

All of that emphasizes the need to make more effective use of savings generated internally as well as externally -- the former in any event will always be the most important source of capital for any country. That is a difficult and politically sensitive area in which every country will have to find its own solutions, suited to its own traditions and philosophies. But having said that, I cannot refrain from making several observations on the current scene.

A number of heavily indebted countries have made the strongest kind of effort, under crisis conditions, to make fundamental adjustments in their economies, often at the expense initially of cutting already low standards of living and aggravating structural problems of unemployment. The results in their external accounts have been remarkable. Internally, progress has typically been more difficult. Inflation in a number of countries is still rising, or falling more slowly than anticipated. For a variety of reasons, business and agriculture have been delayed in reorganizing and enhancing efficiency, and many incentives seem to remain perverse.

As the immediate crisis recedes, there will be strong and legitimate demands for renewed growth and employment. That will need to be done without counting on such large injections of new bank lending as in the past or much more rapid expansion of officials lending from abroad to make up for an inability to generate usable domestic savings.

I would like to be able to say with confidence that many foreign companies or other potential foreign investors are poised today to support those needs by means of large new equity investments -- either as active managers, as partners in local enterprises, or as portfolio investors. Potentially, I believe such investors do exist, and in large numbers, given the local opportunities for profit in expanding domestic markets and international markets. But, with a few significant exceptions, potential investors are hesitant and reluctant. Many seem less concerned with creditworthiness than with -- as they see it -- a history of distrust about private and foreign business, a perceived absence of security for private capital, and excessive controls.

One does not have to look to foreign capital to make the point. In country after country, debt problems were greatly aggravated by massive capital exports by their own citizens -- capital that once exported is likely to provide little or no earning for use of the country as a whole. When a nation is unable to attract and efficiently employ the capital of its own citizens, prospects for attracting the equity participation of others is slim. Yet, that is precisely the kind of fund -- whether in the hands of their own entrepreneurs or from businesses abroad -- that could spark and sustain the growth and the productivity that is so sorely needed. And, not so incidentally, in financial terms, a thicker layer of equity risk capital would be the best possible base for encouraging a restoration of normal bank lending.

These are not theoretical propositions -- there are obvious examples around the world of developing countries with an hospitable climate for investment that have managed to maintain their growth and attract foreign capital in the midst of the debt crisis affecting so many other countries. I realize that habits and attitudes built up over many years, whether by foreign investors or within a country, are

ard to change, and the prevailing cautious attitudes of foreign investors may no longer be fully justified by objective facts in some countries. But one senses that, with attention, greater opportunities can be developed in the mutual interest. Certainly, the return of confidence implied by a surge in private investment, domestic and foreign, would provide the strongest possible evidence that the debt problems are indeed behind us, and that hard-pressed borrowing countries can confidently again look forward to sustained growth and raising standards of living.

Let me summarize my thesis in a few sentences. The debt problem is, and with effort should remain, manageable. While the particular conditions and circumstances differ widely among them, a number of developing countries, working with the IMF, have made striking progress toward achieving external balance without heavy dependence on new bank lending. In that context cooperative efforts by lending banks -- again typically in the context of IMF programs -- will remain justified and essential for some time to achieve realistic repayment scheduled for existing loans and to raise amount of new funds essential to finance adjustment.

As we look ahead, these efforts should be consistent with renewed strong growth by the borrowers, and with significantly reduced debt servicing burdens of borrowers and reduced exposure by lending banks (relative to their capital or assets). Indeed, ultimate success, from the viewpoints of borrowers, lenders and the world at large, is dependent upon reaching those results. Reasoned analysis strongly suggests those results can and will be reached, provided growth by industrialized countries is sustained, excessive real interest rates are avoided, and open competitive markets are maintained, both in the industrialized and developing worlds.

Viewed in that light, the basic policy requirements for success in resolving the problems of international indebtedness are the same as those for meeting our economic problems more generally.

So far as the United States is concerned, the message seems to me very clear. All the arguments for maintaining progress toward price stability, for dealing with the budget deficit, for resisting protectionism, for encouraging productivity, are reinforced and made more urgent.

I am sure there are pointed lessons for others as well. If we succeed even moderately well in acting upon those lessons -- and that is certainly well within our several capacities -- I see no reason why this debt crisis, as so many crises before, cannot in the end be turned to constructive opportunity.

US ECONOMY

ESSENTIAL FACTS

US output growth slowed to an unexpectedly low 2 per cent (annual rate) in the third quarter following growth of 10 and 7 per cent in the first and second quarters respectively. Flat consumption together with a large rise in imports account for most of the slowdown - stockbuilding rose sharply. In October industrial production barely changed but both orders and other leading indicators continued to fall again.

2. Debate continues as to whether the recent slowdown is a 'pause' in growth or marks the start of a recession. In a recent speech Volcker was optimistic and argued that the slowdown partly reflected stock imbalances and pointed to some encouraging signs such as the continuing rise in employment and bullish investment plans. Most forecasters see the US economy growing by 3-3½ per cent next year though the Administration has yet to revise its own assumption of 4 per cent growth. Prospects thereafter are less clear.

3. Unemployment fell in November to 7¼ per cent compared to the last peak of almost 11 per cent at the end of 1982. Over the same period civilian employment has risen by over 6 million.

4. Inflation remains modest at 4¼ per cent with settlements still low. Consumer price inflation could rise a little next year but any sharp fall in the dollar could worsen prospects considerably.

5. US interest rates have fallen by over 2½ points since the summer but seem to have firmed more recently. Short rates now stand at 9 per cent with long rates at 11½ per cent - slightly lower than at the start of the year with inflation broadly the same.

6. The dollar rose to a new peak in mid October. Since then it has eased but more recently it has been rising again. The trade deficit declined slightly to $9bn in October making a

cumulative total this year of $106bn. Most expect a trade (current account) deficit of $130bn ($100bn) this year as a whole and some further increase next.

7. In September the Federal Open Market Committee decided to ease its <u>monetary stance</u> because of the slow growth in some of the monetary aggregates, weakness in the economy and lack of any clear inflationary pressures. Discount rate was cut by ½ point to 8½ per cent in November as the Fed became increasingly concerned over the slowdown in growth. After negligible growth in recent months M1 has risen sharply in the last few weeks to stand in the middle of its target range. Last summer Volcker announced the Fed's provisional monetary targets for 1985 when he lowered the M1 and M2 targets slightly. He will confirm or change them in February.

Aggregate	1984		1985
	Target	Latest	Target (prov)
M1	4-8	6 (mid Nov)	4-7
M2	6-9	7 (Oct)	6-8½
M3	6-9	9¾ (Oct)	6-9

8. The Administration now estimates the US <u>Federal deficit</u> as $205/210bn in fiscal 1985 which, on our own forecasts of 3½ per cent growth next year, is equivalent to almost 5½ per cent of GNP. Without further cuts outstanding government debt could virtually double between 1983 and 1989 rising from under 35 to almost 50 per cent of GDP. Interest payments could reach over 20 per cent of revenues in five years time.

9. Many argue that the fiscal deficit position is ultimately unsustainable. Some also hold that the scale of expenditure cuts likely to be agreed is inadequate and see tax increases as necessary to reduce the deficit to sustainable levels.

10. President Reagan is considering an expenditure freeze for fiscal 1986 and a range of expenditure cuts in non-defence, non-social security areas with the objective of lowering the deficit to $100bn or 2 per cent of GDP by 1988. Reports suggest he has agreed to selective cuts of $34bn for fiscal 1986 and further reductions in later years but these do not touch social security. As yet no reductions in defence plans have been finalised. Full details will not be known until the President announces the budget towards the end of January next year.

11. The US Treasury's tax reform is presented as revenue-neutral though it shifts the burden away from consumption and towards the corporate sector. Tax increases are not being considered but without extra revenue there is no real possibility of the deficit being reduced to sustainable levels.