12 December 1984

PRIME MINISTER

VOLCKER MEETING
US DEFICIT AND THE TREASURY'S "PROPOSALS"

The Stockman spending cuts of $240bn over three years will surely be mangled by Congress and departments. I doubt if more than $100-130bn will emerge - and then they will not be effective before 1986 at the earliest. The annual effect - say $40bn a year - will not offset the increase in the forecast deficit due to slower growth.

Supply siders (eg Paul Craig Roberts) blame the larger deficits on Volcker's slow monetary growth in the last five months, which has dampened down the expansion from 8% in 1983-4 (ii) to 1½ to 2 percent in the second half of 1984. (Volcker is likely to say that the M1 aggregate is very distorted by regulation changes etc.)

Increases in taxes (the "last resort") are now being openly discussed even in the White House, but again even if sanctioned by President and Congress it will be a long time before it falls on pocket books - 1986 at the earliest. And if a downturn or even slow growth has occurred the reluctance to increase taxes will be increased.

In my view there is as yet insufficient commitment and momentum to secure credibility of any programme produced by either the Administration or Congress. The President still hopes that Congress will yield to the expenditure cuts. A possible compromise would be for the President to accept a one-for-one tax increase and expenditure cut provided that Congress agrees to a constitutional amendment to provide for a balanced budget.

Monetary Policy

The Fed is not trying to maintain interest rates mainly because of their fears of a slower growth rate and the accusation that it was Fed-induced. In effect there has been a decline in the demand for credit by the private sector as the investment boon, induced by the tax remissions of 1981/2, has begun to peter out, and interest rates have declined up to two percentage points.

The Fed board has become rather more expansion and supply-side minded with the appointment of Martha Seger. She joins Preston Martin, Volcker's deputy, and another Reagan appointee, to give the expansionist group more voting power. Conjectures are rife about the possible resignation of Volcker in 1985 and the promotion of Martin. (This would be quite devastating to confidence in the Fed, but I am not sure that the President is receiving such advice. An acceptable alternative would be Alan Greenspan but he is disliked by the supply-siders, who influence the President.)

The Debt Problem

i. International

As we feared, the short term liquidity rescue has lulled many into a false sense of security. There has been very little action on the institutional side with long term reforms to put matters right.

We have wasted time - and now time may waste us.

[Fritz Leutwieler was present at the Argentine negotiations and was infuriated by the behaviour of the Central Banks, the Fed, the IMF and the Bank in the arm-twisting. The Argentinians made noises as usual.]

The trade surpluses of the debtor countries hinge entirely on the US current account deficit of $120bn or so, which is quite unsustainable both politically (through protectionist pressures) and economically.

These transitory surpluses have given excuses for delaying the painful long term adjustment process and the western banks have used them as excuses for more credit to pursue the fiction that the loans are "performing".

ii. Domestic bank debt in the United States

As we saw in Continental, the domestic porfolios are even more worrying - especially in energy, agriculture and heavy industry. A downturn in the economy will give cruel exposure of their fictions. Too little has been done to liquify and rebuild their balance sheets.

In sum, I fear a major collapse - say of two money centre banks such as Manufacturers and Chase. How will Volcker (or Martin, God forbid!) handle this massive loss of confidence? Are they prepared for such a contingency? The depressing effect of a flight from bank deposits could be horrendous.

A warning note appeared in the Continental case when the FDIC's promise (probabbly unconstitutional) to bail out all depositors did not stem the attrition at all.

We know the lessons of the 1931 collapse, but now the size of the problem is so much larger and the international linkages so much more complex.

The massive supply of liquidity needed to offset such bank runs will have to be withdrawn quickly as the situation is restored - otherwise we will find the unsavoury combination of inflation and depression overtaking events.

ALAN WALTERS

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.)