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TO PRIORITY FCO

TELEGRAM NUMBER 3803 OF 19 DECEMBER

INFO IMMEDIATE HONG KONG (FOR PRIME MINISTERS PARTY), ROUTINE PARIS,
BONN, TOKYO, ROME, UKDEL OECD, UKREP BRUSSELS, UKDEL NATO, MODUX
(FOR DS1 AND DS12)
INFO SAVING CO'S IN USA, UKINS NEW YORK

pre prep

THE US ECONOMY, THE FEDERAL BUDGET DEFICIT AND US DEFENCE SPENDING:
LATEST DEVELOPMENTS
SUMMARY

1. ACCORDING TO A PRELIMINARY ESTIMATE, THE US ECONOMY RESUMED
SOMEWHAT FASTER GROWTH IN THE FOURTH QUARTER, WHEN THE ANNUALISED
GROWTH RATE WAS 2.8 PERCENT. US INTEREST RATES ARE NOW FALLING.
PRESIDENT REAGAN HAS NOW CONSIDERED DEFENCE SECRETARY WEINDERGER'S
AND BUDGET DIRECTOR STOCKMAN'S ALTERNATIVE PROPOSALS FOR DEFENCE
CUTS, AND HAS DECIDED IN FAVOUR OF CUTS IN OUTLAYS OF DOLLARS
8.7 BILLION IN FY86, DOLLARS 9 BN IN FY87 AND DOLLARS 10 BN IN
FY88, OR ABOUT DOLLARS 28 BILLION IN TOTAL, COMPARED TO THE DOLLARS
58 BN TOTAL SOUGHT BY STOCKMAN.

DETAIL

2. THE **FLASH** GNP FIGURES (SUBJECT TO REVISION) RELEASED TODAY
BY THE DEPARTMENT OF COMMERCE INDICATE THAT US ECONOMIC GROWTH
IN THE FOURTH QUARTER RECOVERED SOMEWHAT TO AN ANNUAL RATE OF
2.8 PERCENT, FOLLOWING GROWTH (REVISED DOWNWARDS) AT 1.6 PERCENT
IN THE THIRD QUARTER. THIS WOULD BRING REAL GROWTH IN THE US
ECONOMY FOR 1984 OVER 1983 TO 6.7 PERCENT. THE EXPECTED GAIN IN
FOURTH-QUARTER REAL OUTPUT REFLECTS A SUBSTANTIAL INCREASE IN
FINAL SALES PARTLY OFFSET BY A DECREASE IN BUSINESS INVENTORY
INVESTMENT.

3. INTEREST RATES ARE DECLINING FURTHER, WITH THE YIELD ON 3-MONTH
TREASURY BILLS NOW BELOW 8 PERCENT. MANUFACTURERS HANOVER TRUST
REDUCED ITS PRIME LENDING RATE TO 10 3/4 PERCENT (FROM 11 AND 1/4
PERCENT) ON 17 DECEMBER. BANKERS TRUST COMPANY FOLLOWED WITH A
SIMILAR MOVE ON 19 DECEMBER, AND OTHER BANKS ARE EXPECTED TO
REDUCE THEIR RATES SOON.

4. SECRETARY OF DEFENCE WEINDERGER ANNOUNCED ON 18 DECEMBER THAT
THE ADMINISTRATION HAS NOW DECIDED ON ITS PROPOSALS FOR THE
DEFENCE BUDGET, WHICH ARE FOR ABOUT DOLLARS 28 BN IN CUTS OVER
THREE YEARS (DOLLARS 8.7 BN IN FY86, DOLLARS 9 BN IN FY87
AND DOLLARS 10 BN IN FY88) RATHER THAN THE DOLLARS 58 BN SOUGHT BY
STOCKMAN (DOLLARS 8 BN, DOLLARS 20 BN AND DOLLARS 30 BN).
THE ANNOUNCED FIGURES, EXPRESSED AS CUTS FROM FUTURE PROGRAMMES,
DISGUISE SUBSTANTIAL INCREASES IN OUTLAYS IN THE THREE YEARS.
OUTLAYS ON DEFENCE (IN NOMINAL TERMS) ARE PROPOSED TO BE DOLLARS
277.5 BN, DOLLARS 324.3 BN AND DOLLARS 359.8 BN RESPECTIVELY.
IN TERMS OF TOTAL BUDGET AUTHORITY, THE AMOUNTS PROPOSED ARE
DOLLARS 313.7 BILLION, DOLLARS 362.6 BILLION, AND DOLLARS 411.5
BILLION, EQUIVALENT TO REAL GROWTH ESTIMATED AT 6.4 PERCENT,
5.1 PERCENT AND 3.3 PERCENT. SENIOR CONGRESSMEN FROM BOTH PARTIES
HAVE SAID THAT THE PROPOSED CUTS ARE INADEQUATE. FURTHER CUTS WILL
UNDOUBTEDLY BE PROPOSED DURING THE FY86 CONGRESSIONAL BUDGET
PROCESS.

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COMMENT

7. IT IS POSSIBLE THAT THE ADMINISTRATIVE PROPOSED DEFENCE SAVINGS HAVE BEEN DELIBERATELY TARGETED ON THE LOW SIDE TO LEAVE ROOM FOR BARGAINING WITH THE CONGRESS ABOUT FURTHER SAVINGS ON DEFENCE. THE RELATIVELY MODEST DEFENCE TARGETS CONTRAST SHARPLY WITH THE DRACONIAN DOLLARS 34 BN IN CUTS PROPOSED FOR DOMESTIC PROGRAMMES IN FY86. FOR INSTANCE, THE PROPOSALS INCLUDE PROVISION FOR A TOTAL OF 7 PERCENT IN MILITARY PAY INCREASES IN FY85 (FOLLOWED BY A 15-MONTH FREEZE). BUT, AS SENATOR CONNICK (CHAIRMAN OF THE SENATE BUDGET COMMITTEE) SAID ON 10 DECEMBER, IT IS MUCH TOO EARLY IN THE BUDGET PROCESS TO SAY HOW MUCH REDUCTION IN THE BUDGET DEFICIT WILL BE ACHIEVED THIS YEAR. THIS APPLIES PARTICULARLY TO THE BALANCE BETWEEN DOMESTIC AND DEFENCE EXPENDITURE, WHICH IS USUALLY ONE OF THE FIAL ITEMS TO BE AGREED BETWEEN THE REPUBLICANS AND THE DEMOCRATS IN THE BUDGET NEGOTIATIONS DURING THE SUMMER.

8. FCO PLEASE ADVANCE TO BROADBENT (ECONOMIC ADVISERS, FCO), SHIELDS (TREASURY) AND SPEEN (BANK).

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