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TELEGRAM NUMBER 2023 OF 2 JULY

INFO SAVING PARIS, BONN, UKREP BRUSSELS, UKDEL OECD, ALL CG'S IN USA.

PRESIDENT REAGAN'S ECONOMIC RECOVERY PROGRAMME: THE PRESENT POSITION

1. THE 4 JULY CONGRESSIONAL RECESS PROVIDES THE OPPORTUNITY TO TAKE STOCK OF HOW FAR PRESIDENT REAGAN'S FOUR-PART ECONOMIC RECOVERY PROGRAMME HAS PROGRESSED TOWARDS IMPLEMENTATION AND THE PRESENT PROSPECTS FOR THE UNITED STATES ECONOMY.

2. IT IS NOW JUST 3 MONTHS UNTIL FY 1982 BEGINS ON 1 OCTOBER. ACCORDING TO THE TIMETABLE IN THE 1974 BUDGET ACT, THE LEGISLATION IMPLEMENTING REAGAN'S EXPENDITURE AND TAX CUTS SHOULD BE IN PLACE BY THEN. THIS IS NORMALLY A TIGHT TIMETABLE, BUT REAGAN APPEARS LIKELY TO BE SUCCESSFUL IN ADHERING TO IT.

EXPENDITURE

3. PRESIDENT REAGAN ACHIEVED A MAJOR PERSONAL VICTORY ON 26 JUNE (SEE WASHINGTON TELEGRAM NO 1987 OF 29 JUNE) WHEN THE HOUSE OF REPRESENTATIVES PASSED THE ADMINISTRATION-BACKED OMNIBUS BUDGET RECONCILIATION BILL, LARGELY BECAUSE OF HIS INTENSIVE LOBBYING OF CONGRESSMEN. WHILE IT IS CONCEIVABLE THAT THE BILL COULD RUN INTO DIFFICULTIES DURING THE CONFERENCE PROCEDURE TO ELIMINATE DIFFERENCES BETWEEN THE HOUSE AND SENATE VERSIONS, THIS SEEMS UNLIKELY. IT ALSO SEEMS UNLIKELY THAT MANY OF THE CUTS WILL BE RESTORED WHEN INDIVIDUAL VOTES ARE TAKEN TO APPROPRIATE FUNDS. THE UPSHOT IS THAT REAGAN IS NOW ALMOST CERTAIN TO GET ALL HIS DESIRED BUDGET REDUCTIONS FOR FY82.

4. AS REGARDS FY83 AND BEYOND, THERE IS STILL SOME ROOM FOR DOUBT ABOUT WHETHER ALL THE ADMINISTRATION'S TARGETS FOR PUBLIC EXPENDITURE REDUCTIONS WILL BE MET. THESE INCLUDE SUBSTANTIAL AMOUNTS TO BE OBTAINED BY FURTHER CUTS AS YET UNSPECIFIED, AND THE ADMINISTRATION WILL NEED TO SPELL THESE OUT IF IT IS TO MEET ITS GOALS. RECENT REDUCTIONS IN THE PRESIDENT'S POPULARITY IN THE PUBLIC OPINION POLLS MAY REFLECT THE INCIPIENT RECOGNITION OF THE IMPACT WHICH FURTHER REDUCTIONS WILL HAVE ON PARTICULAR GROUPS WITHIN THE COMMUNITY. FOR INSTANCE, THE RECENT PROPOSALS TO REDUCE SOCIAL SECURITY RETIREMENT EXPENDITURE RAN INTO A SOLID WALL OF OPPOSITION EVEN IN THE REPUBLICAN-CONTROLLED SENATE, AND FURTHER PROGRESS ON THIS FRONT IS GOING TO BE DIFFICULT. IT ALSO SEEMS DOUBTFUL WHETHER STATE AND LOCAL - ADMINISTERED PROGRAMMES WILL BE TRANSFORMED INTO BLOCK GRANTS TO THE EXTENT THAT THE ADMINISTRATION WOULD WISH. THIS WOULD BE INTENDED BOTH TO LIMIT THE FEDERAL GOVERNMENT'S FINANCIAL RESPONSIBILITY AND TO INCREASE THE DISCRETION OF THE STATES.

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TAXATION

5. ON TAXATION, REAGAN WILL NOT GET ALL THAT HE ORIGINALLY SOUGHT. HE HAS ALREADY COMPROMISED ON THE TIMING AND SIZE OF THE PROPOSED THREE-STAGE REDUCTION IN PERSONAL TAXATION. THIS REDUCTION HAS BEEN PRUNED TO 25 PERCENT OVERALL FROM THE ORIGINAL 30 PERCENT, AND IT IS NOW SCHEDULED TO BEGIN ON 1 OCTOBER 1981 RATHER THAN ON 1 JULY. MOREOVER, HIS ORIGINAL TAX STRATEGY WAS FOR AN INITIAL, SIMPLE BILL COVERING PERSONAL AND BUSINESS TAX CUTS THAT COULD BE IMPLEMENTED QUICKLY, WITH MORE DETAILED PROPOSALS LEFT FOR A SECOND TAX BILL IN THIS SESSION OF CONGRESS. BUT HE NOW PROPOSES THAT THE FIRST BILL SHOULD INCLUDE SEVERAL DETAILED PROVISIONS, INCLUDING INCENTIVES FOR RESEARCH, ABATEMENT OF THE MARRIAGE PENALTY, SAVINGS INCENTIVES, EXCLUSIONS OF FOREIGN EARNED INCOME, REDUCED ESTATE AND GIFT TAX, AND A REDUCTION IN THE WINDFALL PROFITS TAX ON CRUDE OIL. THIS MAY ENCOURAGE OTHERS TO PRESS FOR THEIR PET SCHEMES ALSO TO BE INCLUDED. THE ACCELERATED DEPRECIATION PROPOSALS FOR COMPANIES HAVE COME UNDER SCRUTINY IN THE HOUSE WAYS AND MEANS COMMITTEE. IT NOW LOOKS LIKELY THAT THE COMMITTEE WILL RECOMMEND AN ALTERNATIVE SYSTEM UNDER WHICH INVESTMENTS WOULD BE FULLY WRITTEN OFF IN THE YEAR IN WHICH THEY ARE MADE (ALTHOUGH THIS ARRANGEMENT WOULD BE PHASED IN OVER A PERIOD), AND THAT THEY WILL PROPOSE SOME REDUCTION IN THE RATES OF COMPANY TAX AS WELL AS AT LEAST SOME DEGREE OF CONDITIONALITY FOR THE THIRD YEAR OF THE PERSONAL TAX CUT.

6. THE PRESIDENT HAS SAID THAT HE WANTS BOTH THE EXPENDITURE RECONCILIATION BILL AND A TAX BILL TO HAVE CLEARED THE CONGRESS BY 1 AUGUST. NOW THAT HE IS VIRTUALLY CERTAIN OF ACHIEVING THE FIRST OF THESE AIMS, THE SECOND WILL PROBABLY BECOME THE MAIN DOMESTIC POLITICAL ISSUE HERE IN THE COMING WEEKS.

DEREGULATION

7. THERE HAS BEEN VERY LITTLE PUBLICITY ABOUT DEREGULATION, THE THIRD ELEMENT IN THE PRESIDENT'S PROGRAMME. THIS MAY BE BECAUSE THE MAIN EFFORT SO FAR HAS BEEN DIRECTED AT DELAYING OR STOPPING THE INTRODUCTION OF NEW REGULATIONS, RATHER THAN ABOLISHING OLD ONES. SOME MAJOR CHANGES IN PROSPECTIVE SAFETY REQUIREMENTS HAVE BEEN MADE FOR CARS, BUT EVEN THIS - WHICH MIGHT HAVE BEEN EXPECTED TO DRAW SOME PROTESTS FROM THE CONSUMER MOVEMENT - HAS ATTRACTED LITTLE ATTENTION.

MONETARY POLICY

8. THE FEDERAL RESERVE BOARD HAS CONTINUED TO PURSUE THE GENERAL POLICY THAT CHAIRMAN VOLCKER ANNOUNCED IN OCTOBER 1979. GROWTH IN THE MONETARY AGGREGATES HAS, FOR THE MOST PART, BEEN WITHIN THE TARGET RANGES. HIGH NOMINAL INTEREST RATES GOING WELL ABOVE 20 PERCENT HAVE BEEN ACCEPTED ON OCCASION IN PURSUANCE OF THIS POLICY. AND

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INTEREST RATES ARE WELL ABOVE THE CURRENT RATE OF INFLATION. INTEREST RATES HAVE BECOME A FOCUS OF ATTENTION NOT ONLY BECAUSE OF THEIR IMPORTANCE FOR THE DOMESTIC ECONOMY, EXCHANGE RATES AND INTERNATIONAL FINANCIAL RELATIONS, BUT ALSO BECAUSE THEY ARE AN INDICATOR OF MARKET CONFIDENCE IN THE ADMINISTRATION'S DETERMINATION AND ABILITY TO GET INFLATION DOWN.

9. AT THIS MOMENT THE PRIME RATE IS ABOUT 20 PERCENT. OTHER RATES ARE MOVING ERRATICALLY, BUT ARE TENDING TO RISE AGAIN AFTER A RECENT DECLINE. LONG TERM BOND YIELDS IN JUNE HAVE BEEN LOWER THAN IN MAY, BUT THIS MAY PARTLY HAVE REFLECTED TECHNICAL FACTORS CONNECTED WITH THE TIMING OF PUBLIC BORROWING. THEY HAVE RISEN AGAIN OVER THE LAST WEEK OR SO. THERE IS SOME CONSENSUS THAT THE TREND OF SHORT TERM RATES MAY DRIFT DOWNWARDS IN THE NEXT COUPLE OF MONTHS, MAINLY BECAUSE OF INCREASING INDICATIONS THAT THE ECONOMY HAS LEVELLED OFF. BEYOND THAT, THERE IS NO CONSENSUS AND THE PROSPECT IS FAR FROM CLEAR.

THE CONGRESSIONAL CONTEXT

10. IT IS PREMATURE TO SUGGEST THAT REAGAN HAS BUILT A LASTING, NEW COALITION OF REPUBLICANS AND CONSERVATIVE DEMOCRATS. HE HAS HOWEVER SUCCEEDED IN CREATING AN EFFECTIVE CONSERVATIVE MAJORITY IN THE HOUSE, AS WELL AS IN THE SENATE, ON EXPENDITURE ISSUES. HE WILL HAVE TO WORK TO SUSTAIN IT AND EXTEND IT TO HIS TAX PROPOSALS. IT WILL BE VULNERABLE TO ANY SWING IN THE POPULAR MOOD. BUT, FOR THE TIME BEING AT LEAST, THE DEMOCRATS IN CONGRESS ARE EVEN MORE DEMORALISED THAN THEY WERE IN THE IMMEDIATE AFTERMATH OF REAGAN'S ELECTION. THE IMAGE OF THE DEMOCRATIC PARTY AS A WHOLE IS NOT OF CHAMPIONS OF THE UNDER-PRIVILEGED, BUT OF LAST DITCH DEFENDERS OF A LOST CAUSE. DEMOCRATS MUST NOW HOPE THAT THE PRESIDENT'S VICTORY WILL PLACE RESPONSIBILITY FOR SUCCESS OR FAILURE UNEQUIVOCALLY ON HIS SHOULDERS AND THAT THEY WILL REAP THE BENEFIT OF POPULAR DISCONTENT AS THE SPENDING CUTS BEGIN TO MAKE THEIR MARK.

11. F C O PLEASE PASS TO BOTTRILL (TREASURY) AND HAYWARD (BANK OF ENGLAND).

F C O PASS SAVING BONN, UKREP BRUSSELS, PARIS, UKDEL OECD.

THOMAS

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HAVE BEEN PROVIDED FOR IN THE FIRST BUDGET RESOLUTION (FOR FY 83 AND BEYOND, MANY OF THESE ARE AS YET UNSPECIFIED BY THE ADMINISTRATION). THE ADMINISTRATION HAS NOW REPORTEDLY AGREED TO DISCUSS COMPROMISE PROPOSALS WHICH WOULD SECURE ITS OBJECTIVE OF PREVENTING THE INSOLVENCY OF THE SOCIAL SECURITY TRUST FUND, INCLUDING THE OPTION OF REDUCTIONS IN FUTURE COST-OF-LIVING INCREASES FOR SOCIAL SECURITY RECIPIENTS, TO WHICH PRESIDENT REAGAN HAS HITHERTO BEEN OPPOSED.

4. ON THE TAX SIDE NOT A GREAT DEAL OF PROGRESS HAS BEEN MADE. THERE HAVE BEEN SEVERAL INFORMAL CONSULTATIONS BETWEEN TREASURY SECRETARY REGAN AND ROSTENKOWSKI (DEMOCRAT CHAIRMAN OF THE HOUSE WAYS AND MEANS COMMITTEE) AND BETWEEN REGAN AND SENATOR DOLE (REPUBLICAN CHAIRMAN OF THE SENATE FINANCE COMMITTEE) ABOUT A POSSIBLE COMPROMISE ON REAGAN'S PROPOSALS FOR REDUCTIONS IN PERSONAL TAXATION. IT HAS BEEN REPORTED THAT BOTH CHAIRMEN HAVE SAID THAT THE ADMINISTRATION'S PROPOSALS AS THEY STAND DO NOT ENJOY MAJORITY SUPPORT IN THEIR COMMITTEES. A COMPROMISE BETWEEN THE ADMINISTRATION AND CONGRESS IS THEREFORE POSSIBLE. THIS MIGHT TAKE THE FORM OF A DELAY IN THE INTRODUCTION OF THE CUTS IN PERSONAL INCOME TAX RATES BEYOND THE 1 JULY 1981 DATE PROPOSED BY THE ADMINISTRATION, IN ORDER TO HOLD DOWN THE FY 82 BUDGET DEFICIT. ON THE PERIOD OVER WHICH THE TAX CUTS ARE INTRODUCED, THE ADMINISTRATION'S POSITION HAS NOW REPORTEDLY BEEN SOMEWHAT MODIFIED TO INSISTENCE ON A QUOTE MULTI-YEAR UNQUOTE TAX CUT (INSTEAD OF A THREE-YEAR ONE). THIS MAY REFLECT CONCERN ABOUT DEVELOPMENTS IN FINANCIAL MARKETS (SEE BELOW) AS WELL AS IN CONGRESS. WHILE CHAIRMAN ROSTENKOWSKI HAS NOT FORMALLY ABANDONED HIS PROPOSAL FOR A ONE YEAR TAX CUT, IT COULD BE THAT A COMPROMISE MIGHT BE REACHED UNDER WHICH REDUCTIONS IN PERSONAL TAXATION WERE AGREED FOR TWO YEARS AND NOT THREE. FORMAL CONGRESSIONAL CONSIDERATION OF SPECIFIC TAX PROPOSALS HAS NOT YET BEGUN.

5. IN THE MEANTIME, AMERICAN INTEREST RATES REMAIN TOO HIGH FOR POLITICAL COMFORT, WITH BANKS' PRIME RATES AT 20 PERCENT. ON PROSPECTS FOR INTEREST RATES, PRESIDENT REAGAN IS REPORTED TO HAVE REASSURED CHANCELLOR SCHMIDT (DURING THE LATTER'S VISIT HERE) THAT AMERICAN INTEREST RATES WOULD SOON FALL AFTER THE ADMINISTRATION'S ECONOMIC RECOVERY PROGRAMME IS INTRODUCED AND

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THE RATE OF INFLATION COMES DOWN. BUT TREASURY SECRETARY REGAN IS REPORTED IN THE WASHINGTON POST OF 22ND MAY AS HAVING PREDICTED THAT INTEREST RATES WILL STAY HIGHER THAN ASSUMED EARLIER BY THE ADMINISTRATION, AND THAT HE DID NOT EXPECT INTEREST RATES TO GO BELOW THE 15 PERCENT RANGE FOR SOME TIME. THERE SEEMS NO PROSPECT OF INTEREST RATES ON 91-DAY TREASURY BILLS DECLINING TO THE AVERAGE 11.1 PERCENT ASSUMED FOR CALENDAR 1981 IN THE ADMINISTRATION'S ECONOMIC SCENARIO. IF REGAN IS RIGHT, THIS WILL HAVE CLEAR IMPLICATIONS FOR THE DOLLAR EXCHANGE RATE WHICH UNDER SECRETARY SPRINKEL HAS SAID WILL NOT BE THE SUBJECT OF INTERVENTION BY THE AMERICAN AUTHORITIES EXCEPT IN A DISORDERLY MARKET.

6. FCO PLEASE PASS TO POLE, DHSS AND BOTTRILL AND BUTLER, TREASURY.

FCO PASS SAVING PARIS, BONN, UKREP BRUSSELS AND UKDEL OECD.

HENDERSON

THIS TELEGRAM
WAS NOT
ADVANCED

(REPEATED AS REQUESTED)

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