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TELEGRAM NUMBER 2126 OF 13 JULY

INFO PARIS, BONN, ROME, OTTAWA, TOKYO, UKREP BRUSSELS.

PROSPECTS FOR THE U.S. ECONOMY.

1. AT THE OTTAWA SUMMIT, PRESIDENT REAGAN WILL HAVE THE FIRST OPPORTUNITY PERSONALLY TO EXPLAIN HIS ECONOMIC PROGRAMME TO THE HEADS OF GOVERNMENT AS A GROUP. THE ADMINISTRATION HAS BEEN SHOWING SIGNS OF GROWING AWARENESS OF THE CONCERN EXPRESSED BY OTHER COUNTRIES ABOUT THE INTERNATIONAL EFFECT OF U.S. ECONOMIC POLICIES. REAGAN WILL WISH TO CONVINCE OTHER LEADERS OF THE MERITS OF HIS PROGRAMME OR AT LEAST (E.G. IN THE CASE OF MITTERRAND) TO CONVINCE THEM THAT ANY DIFFICULTIES CAUSED BY TEMPORARILY HIGH INTEREST RATES ARE ESSENTIAL FOR EVENTUAL SUCCESS IN REVITALISING THE AMERICAN ECONOMY.

2. THE BACKGROUND IS SET OUT IN MY TELNO 2023. ONE OF REAGAN'S PROBLEMS IS THAT IT IS NOT CLEAR THAT THE U.S. ECONOMY IS GOING TO GROW AS FAST AS THE ADMINISTRATION PREDICT. THE ADMINISTRATION POSTULATE IN THEIR ECONOMIC SCENARIO THAT THERE WILL BE REAL GNP GROWTH OF 4.2 PERCENT IN 1982 (THEY NOW EXPECT A SLACKENING OFF FOR MUCH OF THE REMAINDER OF 1981). THERE IS A LARGE GAP BETWEEN 4.2 PERCENT AND THE OECD SECRETARIAT FORECAST OF 1 PERCENT. MOST PRIVATE FORECASTERS HERE ARE PREDICTING AN OUTCOME RATHER NEARER THE ADMINISTRATION'S THAN THE OECD'S. BUT DOUBTS ARE FREQUENTLY EXPRESSED EVEN HERE ABOUT WHETHER REAGAN'S MEASURES CAN SHARPLY REDUCE INFLATION WITHOUT RESTRAINING OUTPUT, PARTICULARLY SINCE THE ADMINISTRATION IS ENCOURAGING THE FEDERAL RESERVE BOARD TO CONFINE MONETARY GROWTH STRICTLY WITHIN THE TARGETS.

3. REAGAN'S PROPOSED EXPENDITURE REDUCTIONS FOR FY82 SHOULD BE PASSED BY CONGRESS BEFORE THE START OF FY82 IN OCTOBER. NONETHELESS, IF SUFFICIENT GROWTH DOES NOT OCCUR IN 1982, THIS WOULD ALMOST CERTAINLY PUSH UP THE ADMINISTRATION'S FORECAST DOLLARS 45 BILLION BUDGET DEFICIT IN FY82, AS A RESULT OF THE REDUCTION IN TAX RECEIPTS AND THE INCREASE OF SOCIAL WELFARE PAYMENTS. THIS WOULD IMPOSE AN EVEN GREATER BURDEN ON MONETARY POLICY FOR CONTAINING INFLATION. CONTINUING HIGH INTEREST RATES WOULD ALSO WORSEN THE BUDGET DEFICIT BECAUSE OF HIGHER THAN EXPECTED DEBT INTEREST PAYMENTS. THE ADMINISTRATION CLAIM THAT U.S. INTEREST RATES SHOULD COME DOWN ONCE INFLATION IS REDUCED, BUT BOTH SHORT AND LONG-TERM RATES HAVE QUITE RECENTLY TURNED UP AGAIN DESPITE EVIDENCE THAT THE RATE OF INFLATION IS NOW EDGING DOWN. REAGAN TOLD THORN THAT HE EXPECTED INTEREST RATES TO COME DOWN BY THE END OF THIS YEAR.

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4. THE RECENT DECLINE IN THE RATE OF INFLATION TO ABOUT 10 PERCENT MAINLY REFLECTS A MODERATING TREND IN FOOD AND ENERGY PRICES. THE PROSPECTS FOR SUBSTANTIAL CONTINUED SUCCESS IN REDUCING THE INFLATION RATE DEPEND ON LOWER WAGE SETTLEMENTS AS THE PRICE LEVEL COMES DOWN, AND THERE IS NOT YET MUCH EVIDENCE OF THIS. A GOOD ASSESSMENT OF THESE PROSPECTS WILL NOT BE POSSIBLE UNTIL NEXT YEAR WHEN SEVERAL MAJOR NEW PAY AGREEMENTS ARE DUE TO BE NEGOTIATED. THE ADMINISTRATION'S ASSUMPTION OF A RISE IN CONSUMER PRICES OF 8.3 PERCENT IN 1982 THEREFORE SEEMS TO BE ONE OF THE MORE PLAUSIBLE ELEMENTS IN THEIR SCENARIO, PROVIDED INFLATIONARY EXPECTATIONS DO NOT DETERIORATE ON ACCOUNT OF THE SIZE OF THE BUDGET DEFICIT.

5. AS REGARDS THE "SUPPLY SIDE" EFFECTS OF REAGAN'S PROGRAMME, THE MAIN CURRENT CONCERN ABOUT INVESTMENT PROSPECTS IS THE PRESENT HIGH LEVEL OF REAL INTEREST RATES, WHICH THE PROGRAMME MAY DO LITTLE TO REDUCE. DOUBTS ARE ALSO EXPRESSED WHETHER THE PROPOSED PHASED PERSONAL TAX REDUCTION WILL PROVIDE MUCH GENERAL INCREASE IN PERSONAL INCENTIVES FOR SAVING AND WORK, SINCE ON AVERAGE IT WILL DO LITTLE MORE THAN OFFSET THE INCREASED TAX BURDEN DUE TO THE EFFECT OF INFLATION ON THE REAL LEVEL OF THE TAX BRACKETS. THE EFFECTS WILL DEPEND ON THE EXACT SHAPE OF THE TAX LEGISLATION WHICH EMERGES FROM CONGRESS, WHICH IS STILL UNCLEAR. IF THE REPUBLICANS SUCCEED IN CONCENTRATING TAX REDUCTIONS IN THE UPPER BRACKETS, AND IF THE TOP RATE OF INCOME TAX IS IMMEDIATELY REDUCED THIS OCTOBER FROM 70 PERCENT TO 50 PERCENT (AND OF CAPITAL GAINS TAX FROM 28 PERCENT TO 20 PERCENT) AS REAGAN NOW PROPOSES, THERE MAY BE SOME FAVOURABLE INCENTIVE EFFECTS. ANY SUCH EFFECTS WILL HOWEVER TAKE TIME TO FEED THROUGH INTO INCREASED INVESTMENT AND GROWTH, AND MAY NOT MUCH AFFECT THE PROSPECTS FOR 1982. THIS IN TURN HAS IMPLICATIONS FOR HOW SOON THE ADMINISTRATION CAN ACHIEVE THE GRADUAL DECLINE IN UNEMPLOYMENT WHICH IS ALSO INCLUDED IN THEIR ECONOMIC SCENARIO.

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