

Prime Minister



I doubt if Haig will be effective on this subject.

2. A message to ~~begin~~ begin after the state of the Union speech may be too late if he commits himself in it on the size of the budget deficit etc. but it is now too close for you to influence its contents.

3. If you want to send a message to Reagan we ought to explore the timing more carefully. Agree that I should phrase this?

Treasury Chambers, Parliament Street, SW1P 3AG
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22 January 1982

The Rt. Hon. The Lord Carrington, KCMG MC
Secretary of State for Foreign and Commonwealth Affairs

Let us first see what the speech contains.

State of the Union

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Don Peter

A.J.C. 24/1

US ECONOMIC POLICY AND THE ALLIANCE

I know you are well aware that the way in which the United States conducts its economic policy has important political as well as economic implications for the Alliance, and particularly for relations between the US and Europe. I believe it is of great importance to the free world that the US should bring its inflation under control and that the dollar, which is the international currency of the free world, should enjoy strength and stability. It is probably inevitable that achieving this will impose some burdens on the rest of us as well as on the US itself. The US economy is too large a part of the free world to avoid that. But while accepting this and supporting the objective of US policy, I believe we are entitled to ask our American friends to apply a balance of policies which avoids throwing an undue part of the burden of American adjustment on other members of the Alliance; and which also avoids imposing burdens in ways which are both obvious, and which suggest indifference to their interests.

Present US policy looks like leading to levels of budget deficit which are either not at all compatible with moderate interest rates, or are compatible only while the US economy is in recession. There is a reluctance to pay for greatly increased defence expenditure by increased taxation when it becomes apparent that even substantial expenditure cuts elsewhere are not enough to finance it. This threatens the counter inflation programme itself: it was after all the failure to pay for defence expenditure by increased taxation in the 1960s which contributed to dollar depreciation and the end of the Bretton Woods exchange rate system. More immediately it leads to high interest rates and the prospect that they may continue.

/This in turn



This in turn has imposed on Europe in a direct and striking way a choice between similar high interest rates and currency depreciation. Germany faced this choice most acutely in February last; we faced it in September. The United States, for reasons which are understandable, has not wished to vary its monetary or exchange rate policy in response to European representations. Some of our partners have been quick to see this reaction as uncaring. And anti-Americanism in Europe is provided with a ready-made grievance which it can exploit. The French Finance Minister Delors stressed this point in discussion with me early this week.

As you know, I have, with other Community Finance Ministers, taken every opportunity since last summer to urge on American colleagues the need to reduce the growing budget deficit, if necessary by increasing taxation.

The deficit outturn for the US fiscal year 1981, which ended on 30 September last, was \$55/60 billion. The original forecast for fiscal 1982 (ending 30 September 1982) was \$/43 billion. The latest forecast is for an outturn over \$100 billion, with even higher deficits in fiscal 1983 and 1984. These figures may be improved somewhat if new measures are included in President Reagan's State of the Union message next week; or in a subsequent statement about the budget. However, a great deal would have to be done to alter the direction of the deficit.

You may have seen that Chancellor Schmidt recently suggested to the Prime Minister that she might send a message to the President on this subject, and the Prime Minister may wish to consider that when the State of the Union speech is available; we are rather too near that speech to approach him now. However, given the political implications of a policy which could lead to sustained or recurrent high US interest rates, I hope that you would feel able, as opportunity offers, to represent to Secretary Haig and other American friends that everything possible should be done to reduce the emerging deficits. We may find that sustained discreet pressure from as many quarters as possible is needed to achieve a better outcome.

I am sending a copy of this letter to the Prime Minister.

GEOFFREY HOWE

