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Prime Minister

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Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

PRIME MINISTER

PRESIDENT REAGAN AND THE US BUDGET DEBATE

I am sorry to go on about this. I do so because I am convinced of its importance to our own national interest and political fortunes.

2. We both know how much the prospects for renewed growth, and our chance of turning the tide of unemployment, depend on the outlook for lower interest rates - achieved in a responsible fashion. They depend too on the prospects of renewed growth in the US.

3. But because of the World role of the dollar there is a limit to what we (or other like-minded countries like Germany) can do to get our own interest rates down. And only the US itself can affect its own rates. They have made striking progress in reducing their inflation rate. But markets are not yet convinced that this is permanent. There is no doubt that in this they are powerfully influenced by what they see as the prospect for the US budget deficit.

4. So far the markets remain unconvinced that the deficit is likely to follow the right downward path. And no wonder: in March 1981 the 1983 deficit was expected to be \$23 billion; in February of this year the uncorrected "baseline" prospect was \$146 billion; by April that had risen to \$182 billion - with the prospect of higher figures in later years. The "deal" agreed between the President and Republican Senators aimed to reduce the \$182 billion to \$116 billion, but has so far been rejected by the House of Representatives.



5. The very real risk is that no agreement will be reached before the Summer Recess, which would mean that interest rates would be likely to remain high until at least November. And no-one can be sure that the outcome of the mid-term elections will make it any easier to secure the necessary reductions after November.

6. I know from my talks with Don Regan and Paul Volcker that they are desperately aware of the need to make progress before then. They have both been most appreciative of the restrained but persistent way in which I have pressed the case. You may remember how Schmidt told us at Chequers that Regan was as good as urging him to press the case upon the President. But Schmidt feels, as I do, that you are better placed than anyone else to give the necessary encouragement to President Reagan: for he can be in no doubt about the identity of your views and his on the main economic issues. And you are able, of course, to draw upon our own experience. It was only because of our own willingness to "bite the bullet" in our 1981 Budget that we were able to turn the tide of expectations in this country.

7. I entirely agree with you, of course, that it is not for us to tell the President how to put his own act together. But I am sure that we should leave him in no doubt about the importance, for the political and economic prospects of all the industrial countries, of his displaying firm determination to secure a convincing prospect of declining US deficits.

8. It is above all because of the strong reasons of UK national interest which I have mentioned that I hope you will feel able to speak to the President about this. I

PERSONAL AND CONFIDENTIAL



..... attach a possible speaking note, which has been agreed with Alan Walters. You will see that it in no way involves you in urging tax increases or going into detail on how the President achieves the right result on the deficit problem. But it does stress the urgency of his doing so.

(G.H.)

3 June 1982

CONFIDENTIAL

1. We continue to stand four square behind the efforts of the U.S. Administration to reduce inflation and believe the success of those efforts will be of the first importance for the United States, for the Alliance and for the whole of the free world. We applaud the notable progress which is being achieved in reducing the U.S. inflation rate. We shall continue to express our support publicly for U.S. policy on this.

2. We support your methods as well as your objectives. We approve whole-heartedly your determination to maintain tight control of the growth of the money supply; to cut public expenditure; and to reduce progressively the federal budget deficit.

3. We wish you success in your efforts in Congress to secure agreement on federal budgets showing a declining rate of deficits over the next 3 fiscal years. We very much sympathise with your wish to achieve this to the largest extent possible through public expenditure reductions, and with the smallest possible public sector. But we cannot try to tell you what is or is not possible in these matters.

4. What we do feel is that it is urgent to settle the question of the deficits as soon as possible. We believe that a settlement on the kind of declining path you have been seeking would reassure markets and opinion generally, and would help reduce interest rates. We know that you, like we, want lower interest rates. At this stage in our counter-inflation policies we can be

powerfully helped by a belief that inflation is coming down for good, and greatly hindered by continued doubts about whether our achievements will endure. And we want people to believe that declining deficits will free resources within the monetary targets for an expansion of the private sector, which has always shown so much vigour in the United States.

5. We don't suggest that reducing the deficits will end all the problems. Nor do we suggest that it would remove all the interest rate problems of other countries, which may be attributable to their own national policies. We all have our own responsibilities. But we do believe it would help substantially to improve the chance of a lasting victory over inflation both in the United States and elsewhere.