

CONFIDENTIAL

GR 1300

C O N F I D E N T I A L

FM WASHINGTON 231645Z NOV 82

TO PRIORITY F C O

TELEGRAM NUMBER 3790 OF 23 NOVEMBER

INFO SAVING PARIS, BONN, TOKYO, OTTAWA, UKREP BRUSSELS, UKDEL OECD,
CGS USA

PROSPECTS FOR US ECONOMIC POLICY

1. THE LAME DUCK SESSION OF THE 97TH CONGRESS CONVENES ON 29 NOVEMBER. DURING THE CONGRESSIONAL ELECTION CAMPAIGN, PRESIDENT REAGAN SAID THAT HE WANTED THIS SESSION TO ADDRESS SEVERAL MAJOR POLICY ISSUES. BUT IT SEEMS UNLIKELY THAT THE DEMOCRATS WILL SIMPLY ACCEPT HIS AGENDA NOW THAT THEY KNOW THAT THEY WILL BE STRONGER IN THE NEW CONGRESS IN JANUARY. THE MAIN FOCUS OF ATTENTION IS LIKELY TO BE UNEMPLOYMENT, GIVEN THE MAJOR INFLUENCE WHICH THIS APPEARS TO HAVE HAD ON VOTERS' ATTITUDES DURING THE ELECTION.

2. UNEMPLOYMENT NOW STANDS AT OVER 10 PERCENT, AND THE PROSPECTS OF GETTING THIS FIGURE DOWN SOON REMAIN POOR. WHILE INFLATION HAS BEEN FALLING TO AROUND 5 PERCENT, INTEREST RATES ARE STILL HIGH IN REAL TERMS, AND INVESTMENT INTENTIONS AND CONSUMER CONFIDENCE ARE LOW. SOME EXPANSION OF THE ECONOMY IS EXPECTED IF ONLY BECAUSE PENT-UP DEMAND IS CONSIDERABLE BUT RELEASE OF THIS DEMAND AWAITS THE RETURN OF CONFIDENCE AND WILL PROBABLY NOT GET UNDER WAY UNTIL NEXT YEAR. UNLESS THIS EXPANSION REACHES 4 PERCENT (AND THIS IS TOWARDS THE OPTIMISTIC END OF THE RANGE) UNEMPLOYMENT IS UNLIKELY TO DECLINE SIGNIFICANTLY IN 1983, AND HARD-PRESSED FIRMS IN THE MID-WEST AND ELSEWHERE MAY FACE ANOTHER TOUGH YEAR.

3. THE CONGRESS STILL HAS TO ACT ON 10 OF THE 13 APPROPRIATIONS BILLS FOR THE 1983 FISCAL YEAR WHICH BEGAN LAST MONTH. SOME OF THESE MAY NOT BE PASSED BY CHRISTMAS, IN WHICH CASE SOME FEDERAL SERVICES WILL AGAIN NEED TO DEPEND ON CONTINUING RESOLUTIONS. BUT THERE WILL BE PLENTY OF MANOEUVRING IN PREPARATION FOR THE NEXT CONGRESS WHICH WILL START IN JANUARY. IN PARTICULAR, THERE IS LIKELY TO BE CONTINUING DISPUTE BETWEEN THOSE WHO FEEL THAT UNEMPLOYMENT SHOULD BE TACKLED NOW BY PUBLIC EXPENDITURE OR TAX PROPOSALS TENDING TO INCREASE THE BUDGET DEFICIT, AND THOSE WHO WOULD GIVE PRIORITY TO REDUCING THE DEFICIT IN ORDER TO AVOID RECOVERY BEING CHOKED OFF BY RISING INTEREST RATES.

4. ON THE TAX SIDE, TREASURY SECRETARY REGAN HAS BEEN CONSIDERING A PROPOSAL TO BRING FORWARD TO JANUARY THE 10 PERCENT PERSONAL TAX CUT NOW SCHEDULED FOR JULY. ITS SUPPORTERS ARGUE THAT, AS THE TAX CUT IS DUE TO TAKE PLACE ANYWAY, THE PROPOSAL WOULD INJECT SOME EXTRA CONSUMER SPENDING JUST WHEN IT IS NEEDED TO HELP THE RECOVERY TO TAKE OFF. WHILE IT WOULD INCREASE THE FY83 BUDGET DEFICIT, IT IS ARGUED THAT IT MIGHT SOMEWHAT REDUCE THE PROJECTED DEFICIT IN FY84 WHEN PRIVATE DEMAND FOR CREDIT COULD BE PICKING UP AND COMPETING WITH THE BIG TREASURY BORROWING REQUIREMENT. HOWEVER, THE PROPOSAL IS OPPOSED BY BUDGET DIRECTOR STOCKMAN AND CEA CHAIRMAN FELDSTEIN, WHO ARE CONCERNED TO GET THE BIG BUDGET DEFICIT DOWN AS SOON AS POSSIBLE. THERE ARE FEARS THAT THE IMMEDIATE EFFECT ON

CONFIDENTIAL

MARKET

CONFIDENTIAL

MARKET SENTIMENT WOULD BE TO RAISE INTEREST RATES, SO THAT ITS NET EFFECT WOULD BE TO PROLONG THE RECESSION. REPUBLICAN CONGRESSIONAL LEADERS HAVE TOLD REAGAN THAT IT WOULD NOT GET SUFFICIENT SUPPORT IN THE CONGRESS. INDEED SOME DEMOCRATS WOULD PREFER TO CANCEL THIS TAX CUT ALTOGETHER.

5. AS REGARDS EXPENDITURE PROPOSALS, PRESIDENT REAGAN HAS EXPRESSED HIS OWN OPPOSITION TO JOBS PROGRAMMES WHICH MERELY QUOTE MAKE WORK UNQUOTE. HE HAS COMMENTED MORE FAVOURABLY ON THE IDEA OF PUTTING A 5 CENTS INCREASE ON THE TAX ON GASOLINE AND USING THE PROCEEDS TO REPAIR ROADS AND BRIDGES. SUCH A PROPOSAL HAS SOME MERIT FROM THE STANDPOINTS OF ENERGY CONSERVATION AND IMPROVING INFRASTRUCTURE, BUT IF THE SCHEME WERE MERELY SELF-BALANCING IT WOULD NOT OF COURSE MAKE A NET CONTRIBUTION TO SOLVING THE BUDGET PROBLEM.

6. THE DEBATE ON THE BUDGET IS BOUND TO RETURN SOONER OR LATER TO WAYS OF ATTACKING THE STRUCTURAL DEFICIT. EVEN IF RENEWED ECONOMIC GROWTH REDUCES THE CYCLICAL ELEMENT OF THE DEFICIT, THE UNDERLYING PROBLEM WOULD REMAIN SINCE IN THAT SITUATION PRIVATE DEMAND FOR CREDIT WOULD TEND TO INCREASE. SOONER OR LATER, THEREFORE, THE ADMINISTRATION AND THE CONGRESS WILL HAVE TO RESOLVE CONFLICTING AIMS ON TAXATION, DEFENCE EXPENDITURE, AND CIVIL EXPENDITURE (INCLUDING SOCIAL SECURITY). THE BIPARTISAN COMMISSION ON SOCIAL SECURITY CHAIRED BY ALAN GREENSPAN, WHICH WAS TO HAVE REPORTED THIS MONTH, HAS NOW POSTPONED ITS REPORT FOR A FEW MORE WEEKS. ACTION ON THIS POLITICALLY INTRACTABLE ISSUE HAS THUS YET AGAIN BEEN POSTPONED, AND LEFT TO THE NEXT CONGRESS. ON BUDGET POLICY GENERALLY, THERE ARE CLEAR DIFFERENCES OF VIEW BETWEEN THE ADMINISTRATION AND THE REPUBLICAN LEADERSHIP IN THE CONGRESS. SENATORS DOLE (CHAIRMAN, FINANCE COMMITTEE) AND DOMENICI (CHAIRMAN, BUDGET COMMITTEE) AND THE REPUBLICAN MINORITY LEADER IN THE HOUSE, MR MICHEL, HAVE INDICATED THAT THEY MIGHT BE WILLING TO TRADE CUTS IN DEFENCE EXPENDITURE FOR FEWER CUTS, OR SOME INCREASES, IN CIVIL PROGRAMMES. DOMENICI HAS DESCRIBED UNEMPLOYMENT AS HAVING REACHED A POINT WHERE IT IS POLITICALLY UNACCEPTABLE TO THE AMERICAN PEOPLE, AND HAS COMMENTED THAT THE BUDGET SHOULD AIM MORE AT DEFENCE BUDGET FROM ANY SPENDING CUTS WHICH NEED TO BE MADE.

7. THE ADMINISTRATION MUST RESTATE ITS OWN BUDGET POSITION IN JANUARY WHEN IT INTRODUCES THE FY84 BUDGET. THERE IS CONSIDERABLE ARGUMENT WITHIN THE WHITE HOUSE AND THE CABINET ABOUT THE RIGHT COURSE. PRESIDENT REAGAN IS ON RECORD AS FAVOURING A BALANCED BUDGET BUT, ON STOCKMAN'S OWN ASSESSMENT, PRESENT ADMINISTRATION POLICIES WOULD YIELD A DEFICIT OF ABOUT DOLLARS 150 BILLION TO DOLLARS 180 BILLION IN EACH OF THE NEXT TWO OR THREE YEARS, AND FELDSTEIN HAS PUBLICLY MENTIONED A FIGURE OF AS MUCH AS DOLLARS 200 BILLION FOR FY84 IF NO CORRECTIVE ACTION IS TAKEN. THE PRESIDENT WILL NEED TO PROPOSE SHARP CUTS IN EXPENDITURE PROGRAMMES IN ORDER TO MAKE SIGNIFICANT PROGRESS TOWARDS A BALANCED BUDGET, WHILE STICKING TO HIS OTHER AIM OF HOLDING DOWN THE TAX BURDEN. THERE /IS NO

CONFIDENTIAL

CONFIDENTIAL

IS NO SIGN YET THAT HE WILL VOLUNTEER TO MAKE RADICAL CUTS IN THE GROWTH OF THE DEFENCE PROGRAMME IN THE FY84 BUDGET. THERE ARE THUS THE MAKINGS OF QUITE AN ARGUMENT WITHIN THE ADMINISTRATION, AND OF QUITE A ROW BETWEEN THE ADMINISTRATION AND THE NEXT CONGRESS, BEFORE SOME COMPROMISE IS PAINFULLY HAMMERED OUT.

8. ON MONETARY POLICY, THERE IS SOME PUBLIC CONFUSION ABOUT WHAT THE FEDERAL RESERVE BOARD IS TRYING TO DO. SOME NEW YORK OBSERVERS HAVE ASSUMED THAT RECENT FED STATEMENTS, TO THE EFFECT THAT THE MONETARY AGGREGATES ARE BEING SERIOUSLY DISTORTED BY SPECIAL FACTORS, WERE A WAY OF GETTING OFF THE HOOK OF PARTICULAR MONETARY TARGET FIGURES WHICH PRESENT CIRCUMSTANCES HAVE MADE UNREALISTIC. THE RAPID GROWTH IN BANK RESERVES AND IN THE MONETARY BASE HAS ALSO BEEN INTERPRETED AS AN INDICATOR THAT THE FED HAS EASED UP IN RECENT WEEKS. ON THE OTHER HAND, THE FED HAS NOT REDUCED THE DISCOUNT RATE AS FAST AS MIGHT HAVE BEEN EXPECTED IF IT HAD DECIDED TO FOLLOW A CLEARLY STIMULATORY MONETARY STANCE. FOLLOWING THE LATEST CUT IN THE DISCOUNT RATE TO 9 PERCENT ON 19 NOVEMBER, THE MAJOR BANKS HAVE REDUCED THEIR PRIME RATES TO 11.5 PERCENT AND THE TREASURY BILL RATE FELL TO AROUND 8 PERCENT, BUT THE YIELD ON LONG-TERM TREASURY BONDS ROSE SLIGHTLY TO REMAIN AROUND 10 AND ONE HALF PERCENT.

9. THE LATEST STATEMENT BY VOLCKER ON 16 NOVEMBER INDICATED THAT WHILE, FOR THE PRESENT, THE GROWTH OF MONEY AND CREDIT HAS HAD TO BE INTERPRETED IN THE LIGHT OF ALL THE EVIDENCE AVAILABLE WITH RESPECT TO THE ECONOMY, PRICE DEVELOPMENTS, INTEREST RATES AND FINANCIAL PRESSURES, THE FED DO NOT INTEND TO ABANDON BROAD GUIDELINES FOR MONETARY AND CREDIT GROWTH AS A MEANS OF JUDGING POLICY OVER A PERIOD OF TIME. HE ADDED THAT THE DANGER OF CREATING EXCESS LIQUIDITY WAS NOT SO MUCH IMMEDIATE WHEN THERE IS SO MUCH SURPLUS CAPACITY AND UNEMPLOYMENT, BUT RATHER WHEN THE ECONOMY BEGINS TO REGAIN FORWARD MOMENTUM. THE CONCLUSION TO BE DRAWN FROM THIS SEEMS TO BE THAT THE FED WILL DO WHAT THEY CAN TO ASSIST RECOVERY DURING THE NEXT FEW MONTHS EVEN IF THIS MEANS ALLOWING M1 AND M2 TEMPORARILY TO MOVE ABOVE THEIR TARGET RANGES, BUT WITHOUT ABANDONING THE

BASIC DIRECTION OF THEIR POLICIES. AS VOLCKER HAS FREQUENTLY INDICATED, THE FED'S TASK WOULD OF COURSE BE MADE MUCH EASIER IF THERE WAS A CREDIBLE PROSPECT OF REDUCTIONS IN THE FEDERAL BUDGET DEFICIT.

10. FCO PLEASE ADVANCE TO PS/CHANCELLOR OF THE EXCHEQUER, COUZENS, XOTTRILL (TREASURY), AND WATSON (BANK OF ENGLAND).

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

WRIGHT

[ADVANCED/REPEATED AS REQUESTED]

FCO/WHITEHALL
NAD

3
CONFIDENTIAL