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THE US ECONOMY

The US economy is rushing forward on the back of easy money and a traditional Keynesian stimulus to the economy.

The balance of payments is diving into deficit. The US is likely to reveal a \$75,000 m. trade deficit for 1983. 1984 will see a deficit approaching \$100,000 million on trade account. This is only possible because the American banking system is busy repairing the ravages of the world debt crisis and has stopped selling dollars to lend overseas. Conventional wisdom says that the dollar is unnaturally strong because there has been a flight into quality (ie dollars) by international investors. Many commentators have predicted the collapse of the dollar for a year or more. This paper explains why it hasn't fallen so far.

The Banking Crisis

In 1981, American banks lent \$84.5 billion of new money to countries and multinationals around the world. Against this, only \$41 billion of new dollars were deposited with US banks from external sources. This imbalance continued in 1982 with a further \$107 billion increase in US banks' assets overseas (lendings to countries and companies) offset by only \$63 billion of new foreign deposits with US banks.

The difficulties in making more lending available to bankrupt Third World countries and impecunious international companies has reduced the rate of new lending to only \$11.5 billion in the first half of 1983. Against this, there have been new deposits of \$11.7 billion for US banks. These movements in the international banking world have been the dominant influences upon the US capital account, and have enabled the US to carry on with its spending spree on imports from other countries. American banks' reluctance to lend largely explains the strength of the dollar.

In 1984 we would expect there to be some modest increase in the rate of new lending to Third World countries and international companies, if only to help them pay their interest bills. Companies will be more prosperous next year as a result of some upturn in world trade, and may use this as collateral for further borrowing. Meanwhile, the forced restructuring of Third World country debt is likely to

entail some small increase in lending to Third World countries as part of the price of preserving the liabilities of those countries as assets on the banks' balance sheets. There may also be some increase in outward portfolio investment by US institutions which will also need matching. Not until there is a flight of capital outwards will the dollar fall sharply.

The US Budget Deficit

The background to the fast money growth in the States in the last 12 months has been the persistent high budget deficit. This is running at a near \$200 billion per annum level, and even allowing for a satisfactory rate of economic growth and some upturn in tax revenues in 1984, the deficit is still likely to be running at \$175 billion per annum one year out. This makes the conduct of tight money policies difficult. In the post-Election period, whoever is elected (and we assume that Reagan is the most likely) will have to tighten money policy and this will mean both taking some tough action on the budget itself, and raising interest rates.

The Status of Sterling

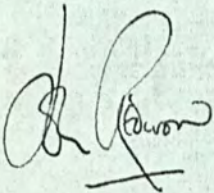
The future of sterling depends very much upon the state of play in the Gulf. If the Iraqis use their Exocet weapons to attack shipping around Kharg Island, and if they succeed in preventing the flow of oil along the Gulf routes, or if the Iranians retaliate by blocking the Gulf, then sterling will rise sharply as oil prices rise. Outside such an apocalyptic result, we believe that sterling will remain in the trading range 80-85 on the trade-weighted. The plight of the dollar is more problematic. Although the budget and trade deficits point to a sharp correction of an over-valued currency occurring sooner rather than later, the international banking crisis and the interest rate structure point in the other direction. It is too early to say when the dollar will crack: it will hinge on when US investors panic about the trade problem.

Conclusions

The US economy will continue to grow for another year. The dollar has not weakened on cue to correct the trade balance for the reasons outlined above. Inflation will pick up. International adjustments will remain slow, as:

- (a) investors world-wide are extremely nervous about the international background; and
- (b) the banking system is going to remain very cautious about taking on new commitments to growing but illiquid areas.

Currencies will remain volatile, and any attempt to embark on new stabilisation proposals now would be disastrous. The only way for currencies to move in line is if countries are prepared to pursue common monetary policies, and there is absolutely no evidence that they are ready to do this. The US economy remains with enormous structural weaknesses and imbalances, but we suspect that it will be able to muddle through for a bit longer. Our best strategy is to tighten a little now and await further progress in making the world debt burden more stable. The banking situation is the biggest constraint on world growth and the largest single worry besetting financial markets. We need to persevere with tough words to discourage default coupled with some sensible modest short-term accommodation through the international agencies as we have been doing.



JOHN REDWOOD