3.23

CONFIDENTIAL

FROM: J O KERR

DATE: 17 January 1984

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Unwin
Mr Lavelle
Mr Bottrill
Mr Graham

Sir Oliver Wright: Washington
Mr Bone: FCO
Mr Coles: No 10
Mr Appleyard: FCO

MR LITTLER

A.J.C. 18/1

AMBASSADOR PRICE

The US Ambassador called, at his request, on the Chancellor for 40 minutes tonight. Four subjects were discussed.

US Deficit

2. The Ambassador said that he was very much afraid that the Budget proposals would show no reduction in the US deficit. He had spent an hour alone with the President at the New Year, and had formed the strong impression that "revenue enhancement" was, for the present, ruled out. He hoped, but without any great confidence, that this might be a tactical position, and that some concession on tax increases might be offered in exchange for agreement by the Democrats to cuts in spending on social programmes. But he feared that effective action to rein in the deficit would in practice be postponed until after November. He well remembered Mr Regan complaining to him, on 2 January 1981, about the deficit, then thought to be \$45 billion, and subsequently discovered to be \$65 billion, which he and the President were inheriting from the Carter era: Regan had seen it as absurdly, and damagingly high. He had agreed with all Regan said then, and he had not changed his tune, though Regan had had to change his.

3. The Chancellor agreed that, while the US success against inflation, and the current high levels of output growth, were a cause for congratulation, current and prospective high

deficits, and interest rates, were a cause of grave concern, and not just to the US itself. It was important to remember that the effect of high deficits was cumulative, as the debt service burden piled up. And private sector investment could be crowded out by the requirement to fund Government debt, while US industry must already be suffering from the high imports occasioned by the strong dollar. For the developing world, and for countries in debt, no single step would be more beneficial than a reduction in US interest rates.

UK Economy

4. The Ambassador suggested that UK economic performance was currently good, but that some commentators thought the recovery might run out in 1985 or 1986.

5. The Chancellor said that recovery was at present steady, with output growth in 1983 and 1984 likely to come out at just below 3 per cent. Inflation would stick at around 5 per cent for most of the year, and might fall further in 1985. Unemployment, though not yet coming down, had levelled off. Manufacturing productivity was steeply up; service-industries were expanding quite rapidly, and the labour market situation had been transformed since 1979, with management reasserting its authority, and the trade unions now in a very different mood. The 1983 surplus on the current account balance of payments would be some £1.5b; a further, though lower, surplus was forecast for 1984.

6. As for the possibility of the recovery running out in 1985 or 1986, long term forecasting was always dangerous, and to be avoided if possible. But provided that a consistent framework of financial policy was maintained, as it would be, and public spending kept firmly under control, as it should be, he saw no reason to expect a setback. The same commentators who now saw clouds on the horizon had in 1981 argued that recovery was impossible without a change of policy, had maintained in 1982 that the evident recovery was an illusion, had moved on in 1983 to predict a downturn in 1984, and were now obliged to postpone the date of Doomsday still further. One day they might be right, but the fact was that the prospects still looked good.

Unitary Taxation

7. The Chancellor asked whether Secretary Regan's commission on unitary taxation would still report, as planned, in February. The Ambassador had no new information, but thought that nothing had changed. He was inclined to doubt whether unitary taxation would be a long-term problem. It would not spread to every State, and the multi-national corporations

would move to those States which eschewed it. So the market would solve the problem by itself. The Chancellor thought this very plausible, but pointed to the present difficulties faced by foreign companies, and the very great concern about the issue both in this country and among our European partners. He had left Secretary Regan in no doubt about the pressures on HMG on the issue.

Relations with the Embassy

8. The Ambassador said that he would like to see closer links between his Embassy and HMT. A close and satisfactory working relationship existed between the US Treasury representative and officials in HMT, but he would like to see such contacts broadened to embrace the Embassy as a whole. And periodic meetings with the Chancellor would be particularly useful for him.

9. The Chancellor welcomed the idea of such meetings. His impression was that while there might on occasion be major disagreements between the Administration and HMG over economic and financial issues - eg the effects of a high Budget deficit, and the principle and practice of unitary taxation - the channels of communication were very good, and each side understood the other's position without difficulty. It was very useful that he saw Secretary Regan regularly, not just on bilateral visits, but in the framework of G5; and these meetings were under-pinned by regular meetings of G5 deputies. He could recall no recent parallel in the economic sphere to the problems in transatlantic political relations in late 1983: perhaps Foreign Ministers should form their own G5.

9. Incidentally, the Ambassador seemed 100 per cent confident that President Reagan would run again, and hardly less confident that he would win.

JOK.

J O KERR