

GRS 750
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FM WASHINGTON 240014Z MAR 84
TO IMMEDIATE FCO
TELEGRAM NUMBER 1009 OF 23 MARCH
AND TO SAVING BONN, PARIS, TOKYO, OTTAWA, ROME.
INFO SAVING ALL CONSULATES-GENERAL.

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US file

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A.S.C. 26/3

US ECONOMY: HIGHER INTEREST RATES

SUMMARY

1. INTEREST RATES HAVE BEEN RISING STEADILY. THE RATE ON THREE MONTH TREASURY BILLS IS NOW 9.8 PERCENT. THE RISE IS DUE:
 - (A) TO THE CONTINUED STRENGTH OF THE RECOVERY AND THE ASSOCIATED INCREASE IN THE PRIVATE DEMAND FOR CREDIT;
 - (B) TO THE MARKET'S CONCERN THAT MONETARY POLICY MAY BE TIGHTENED AND THAT PLANS TO REDUCE BUDGET DEFICIT WILL ONLY HAVE A MODEST IMPACT ON THE GOVERNMENT'S BORROWING REQUIREMENT.

DETAIL

2. INTEREST RATES IN MOST MARKETS HAVE RISEN IN RECENT WEEKS. THE RESULTING DECLINE IN MARGINS LED TO AN INCREASE IN THE PRIME RATE FROM 11.0 TO 11.5 PERCENT. CONCERN OVER INFLATION HAS ALSO RAISED YIELDS ON LONGER-TERM BONDS WITH 20 YEAR BONDS UP TO 12.5 PERCENT. IN RECENT DAYS SHORT TERM RATES HAVE MOVED HIGHER WITH TREASURY BILLS CLOSE TO 9.8 PERCENT.
3. THE ECONOMY HAS CONTINUED TO GROW STRONGLY. AFTER REAL GNP GROWTH OF 5.0 PERCENT (ANNUAL RATE) IN THE FOURTH QUARTER OF 1983, THE DEPARTMENT OF COMMERCE'S FLASH ESTIMATE OF GROWTH IN THE FIRST QUARTER THIS YEAR IS 7.2 PERCENT (ANNUAL RATE). THIS IS MUCH HIGHER THAN THE EARLIER FORECASTS OF BOTH THE ADMINISTRATION AND MOST OTHER ANALYSTS. DURING FEBRUARY THE EXPANSION WAS REFLECTED IN FURTHER INCREASES IN PERSONAL INCOME AND INDUSTRIAL PRODUCTION, A SURGE IN HOUSING STARTS AND A FURTHER DECLINE IN THE RATE OF UNEMPLOYMENT TO 7.8 PERCENT.
4. THE EXPANSION HAS RESULTED IN A STRONG GROWTH IN THE PRIVATE DEMAND FOR CREDIT. DURING THE FOURTH QUARTER 1983 THERE WAS HIGHER DEMAND FOR MORTGAGE FINANCE AND CONSUMER INSTALMENT CREDIT, THE LATTER REFLECTING HIGHER PURCHASE OF CARS AND OTHER CONSUMER DURABLES. THESE TRENDS HAVE CONTINUED IN EARLY 1984, ACCOMPANIED BY AN ESTIMATED 15 PERCENT (ANNUAL RATE) INCREASE IN BUSINESS DEMAND FOR SHORT TERM CREDIT. THE STRENGTH OF THIS DEMAND, AGAINST THE BACKGROUND OF THE LARGE FEDERAL GOVERNMENT BORROWING REQUIREMENT AND THE LOW HOUSEHOLD SAVINGS RATE OF 5 PERCENT, HAS RESULTED IN UPWARD PRESSURE ON INTEREST RATES.
5. ALL THE MONETARY AGGREGATES HAVE GROWN STRONGLY SINCE THE BEGINNING OF THE YEAR. IN FEBRUARY THE BROAD AGGREGATE M3 WAS CLOSE

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TO THE TOP OF ITS RANGE, AND IN MID-MARCH M1 WAS CLOSE TO THE UPPER LIMIT OF ITS 4-8 PERCENT GROWTH TARGET. THIS GROWTH, AND THE GREATER EMPHASIS THE FEDERAL RESERVE NOW PLACES ON MOVEMENTS IN M1 HAS LED SOME ANALYSTS TO SPECULATE THAT THE FEDERAL RESERVE MAY HAVE RECENTLY TIGHTENED MONETARY POLICY, CONTRIBUTING TO THE RISE IN INTEREST RATES.

6. IT IS UNCERTAIN WHETHER THE FEDERAL RESERVE HAS TIGHTENED MONETARY POLICY. BUT THE NEXT MEETING OF THE FEDERAL OPEN MARKET COMMITTEE (FOMC) ON 26/27 MARCH WILL BE IMPORTANT. THE ECONOMY IS GROWING FASTER THAN THE FOMC'S CENTRAL FORECAST OF ECONOMIC GROWTH IN 1984 BETWEEN 4.0 - 4.75 PERCENT. THEY ALSO REMAIN CONCERNED OVER THE STRENGTH OF INFLATIONARY EXPECTATIONS. ALTHOUGH THE CONSUMER PRICE

INDEX IN FEBRUARY WAS ONLY 4.6 PERCENT ABOVE ITS LEVEL OF A YEAR AGO, THE FOMC IS LIKELY TO BE CONCERNED THAT THE RISE IN THE RATE OF CAPACITY UTILIZATION IN THE MANUFACTURING SECTOR TO 81 PERCENT IN FEBRUARY MAY BEGIN TO GENERATE COST PRESSURES. THE FOMC WILL ALSO BE AWARE OF THE IMPLICATIONS OF A FURTHER RISE IN INTEREST RATES, ESPECIALLY FOR THE DEBT BURDEN OF SOME DEVELOPING COUNTRIES.

7. THE FINANCIAL MARKETS REMAIN CONCERNED OVER THE SIZE OF THE FEDERAL GOVERNMENT'S PROJECTED BUDGET DEFICIT. THEIR INITIAL RESPONSE TO THE RECENTLY ANNOUNCED AGREEMENT BETWEEN THE PRESIDENT AND REPUBLICAN LEADERS IN CONGRESS TO REDUCE THE DEFICIT BY DOLLARS 150 BILLION BETWEEN FY 1985-87 WAS POSITIVE. SINCE THEN THERE HAS BEEN INCREASING REALIZATION THAT THE ADDITIONAL SAVINGS TO THOSE ANNOUNCED IN THE BUDGET FOR FY 1985 MAY BE SMALL, ARE LIKELY TO BE CONCENTRATED TOWARDS THE END OF THE THREE YEAR PERIOD AND TO BE IMPLEMENTED WILL REQUIRE THE AGREEMENT OF THE DEMOCRATS IN CONGRESS, WHO HAVE THEIR OWN PROPOSALS TO LOWER THE DEFICIT.

8. USING THEIR MORE PESSIMISTIC ASSUMPTION OF ECONOMIC GROWTH AND INTEREST RATES, THE CONGRESSIONAL BUDGET OFFICE HAVE ESTIMATED THAT THE PRESIDENT'S RECENT PROPOSALS WOULD YIELD DEFICITS OF DOLLARS 181 BN IN FY 1985, RISING TO DOLLARS 198 BN IN FY 1987. THIS COMPARES WITH THE PROJECTED FALL IN THE DEFICIT FROM DOLLARS 169 BN IN FY 1985 TO DOLLARS 143 BN IN FY 1987 UNDER THE PRESIDENT'S PLAN.

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9. BOTH THE STRENGTH OF THE ECONOMY IN THE FIRST QUARTER AND THE RISE IN INTEREST RATES HAS SURPRISED THE ADMINISTRATION, ALTHOUGH A WHITE HOUSE SPOKESMAN CLAIMED THE RISE WILL NOT SLOW THE RECOVERY. BUT VOLCKER, SPEAKING IN CONGRESS, HAS POINTED OUT THE DANGER THAT CROWDING OUT WILL PREVENT A BALANCED RECOVERY. THE RATIONING MECHANISM IS THE INTEREST RATE. MUCH DEPENDS ON SOME MODERATION IN THE GROWTH IN THE ECONOMY AND FURTHER PROGRESS IN DISCUSSIONS BETWEEN CONGRESS AND THE ADMINISTRATION TO LOWER THE DEFICIT IN FY 1985 AND BEYOND.

FCO PASS SAVING: BONN, PARIS, TOKYO, OTTAWA, ROME.

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