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PRIME MINISTER

(2) The analyses of the US deficit is especially worth noting

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INTERNATIONAL DEBT

The London Economic Summit backed the UK's view that there should be no grand scheme. It supported the softly-softly approach, trying to tempt countries and other borrowers back into the ways of solvency and prudence, easing the transition by encouraging more equity and rescheduling of debt.

Since 1981, the markets have quietly and steadily been sorting out the problems of the 25 major country borrowers. Pressures upon these countries has reduced their current account deficit from $79 billion to $31 billion[1], and the trend is still downwards.

Improvement in their balance of payments is crucial. Over the last 2 years, imports have fallen relative to the foreign currency reserves there to pay for them, and exports now bear a slightly better relationship to the costs of meeting the interest charges on their international borrowings.

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1 All figures come from Simon & Coates' useful Economics Compendium

The necessary rescheduling of debt has gone on apace. The total short-term debt of the 25 countries has fallen from $140 billion in 1982 to $91 billion in 1984. Their long-term debt has been rising steadily: $300 billion in 1979; $436 billion in 1982; and $549 billion by 1984.

The figures do not show that we are yet out of the wood. The system remains fragile and accident-prone. A false step at any point by one of the major borrowers or, more importantly, by the major lenders, could disrupt the whole structure. But we should draw modest encouragement from the quiet processes of the marketplace that are rescheduling the debts, and from the improvement in the countries' trade performance.

The US

Meanwhile, the new large international borrower, the US, is still proceeding on its spendthrift course. A Federal deficit of $180 billion per annum means that simply paying the interest on the growing stock of debt guarantees a further major increase in the total debt outstanding. **The Congressional Budget Office is forecasting net interest on US Government debt rising from $134 billion in 1985 to well over $200 billion by 1989.** The impact of compound arithmetic is remorseless. A drop in foreign confidence would be reflected in a lower dollar and higher interest rates - a combination which would start to correct the balance of payments deficit at the expense of reduced activity.

<u>What is wrong with Sir James Goldsmith's view of the US deficit in the Observer of 4 November</u>? (Figures from N M Rothschild/OECD; not checked with official sources)

Sir James Goldsmith said: "If you compare (the US Budget deficit) with that of European countries, it is - in net OECD terms - $110 billion and not $175 billion . . . Every decline of 1 per cent in interest rates saves $12-$15 billion in the financing of the deficit. I expect a 3-4 per cent decline in interest rates. The deficit is the red herring of the experts".

His lower deficit must result from deducting the surplus of state and local government budgets. Yet the financial surplus of the US state of local governments is only $40 billion per annum, and not the $65 billion the quotation suggests.

He should then add back the off-budget outlays in the US which are currently running at around $15 billion, ie a deficit of $150 billion, not $175 billion or $110 billion.

He ignores the distinction between cyclical and structural budget deficits. The US budget deficit is a problem because it is so large at a point in the economic cycle when it ought to be small.

The effect of a 1% decline in US interest rates on the deficit is not as stated. Because of the maturity structure of the US federal debt, the effect would take time to build up, rising from, say, $7 billion in Year 1 to $18 billion by Year 6.

If rates do fall, it will probably be because the US economy is slowing down. For each year the US growth falls one percentage point below the Treasury's target (of 4 per cent) an additional $12 billion would be added to the US budget deficit, thereby offsetting the benefit of lower interest charges.

The OECD indicate that they will be anticipating a US current account deficit next year in the region of $130 billion! This must begin to slow the US economic recovery. US manufacturing industry is already experiencing order shortfalls (through import penetration) and rising stock levels.

Financing UK economic activity and Government borrowing

Insurance companies and pension funds have stopped placing new investment overseas. Between 1979 and 1983, they invested £10 billion overseas. The first half of 1984 saw a small net disinvestment of £23 million. This important turn-round is likely to continue; more cash will be available for UK companies and the gilt market.

The prospect for next year, if public expenditure can be held to the targets, is for a relatively easy task on financing the deficit, compared with previous years. This reflects the growing cash surpluses in UK institutions; the growing disinclination to invest overseas; the attractive returns currently available on gilts and equities; and the satisfactory state of the corporate sector.

The message is clear for the UK. Companies have every opportunity to expand and to create jobs: they have an embarrassment of cash; the problem is encouraging them to use it in the right ways. And interest rates should fall as a requirement for net Government gilt sales of some £4 bn is quite modest, compared with previous years. A strong equity market, well underpinned by institutional cash, is ideal for a large denationalisation programme.

The recent rally in the pound against the dollar, coupled with the drop in interest rates and good levels of funding, illustrate the wisdom of benign neglect of the markets in the period of difficulty a few weeks ago. Further interest rate falls would be a welcome stimulus all round, and would be an added incentive in building a policy that creates more jobs. Long live the policy of no sterling target.

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