

GRS 900A

CONFIDENTIAL

CONFIDENTIAL

AMENDED DISTRIBUTION 6 DECEMBER 1984

FM WASHINGTON 052347Z DEC 84

TO PRIORITY F C O

TELEGRAM NUMBER 3625 OF 5 DECEMBER

INFO UKREP BRUSSELS, UKDEL OECD, UKMIS GENEVA.

INFO SAVING PARIS, BONN, ROME, TOKYO, UKMIS NEW YORK, US CONSULATES GENERAL.

MIPT (NOT TO ALL)

SHULTZ AT CHEVENING: US TRADE POLICY

1. THE LAKER ISSUE, ON WHICH I AM REPORTING SEPARATELY, DOMINATES THE US/UK TRADE FIELD. BUT OTHER IMPORTANT DEVELOPMENTS SINCE THE ELECTION ARE WORTH NOTHING.

2. THE US EXTERNAL ACCOUNT HAS CONTINUED TO DETERIORATE. THE TRADE DEFICIT IN OCTOBER WAS DOLLARS 9.2 BILLION (A FALL OF DOLLARS 3.5 BILLION FROM THE RECORD MONTHLY DEFICIT REACHED IN SEPTEMBER), MAKING A TOTAL DEFICIT FOR THE FIRST TEN MONTHS OF DOLLARS 105.5 BILLION. SOME ECONOMISTS ARE NOW FORECASTING A TRADE DEFICIT IN 1985 AS HIGH AS DOLLARS 150 BILLION. IN ANNOUNCING THE FIGURES FOR OCTOBER, SECRETARY BALDRIGE NOTED THAT "THESE CONTINUING PROBLEMS UNDERSCORE THE NEED TO CUT THE BUDGET DEFICIT TO REDUCE INTEREST RATES FURTHER TO LOWER THE DOLLAR".

3. ALREADY THERE ARE SIGNS THAT THE ADMINISTRATION FEELS THAT IT MUST RESPOND BY BEING SEEN TO PROMOTE US TRADE INTERESTS MORE AGGRESSIVELY THAN IN THE PAST. HAVING WRESTED RESPONSIBILITY FOR INTERNATIONAL STEEL NEGOTIATIONS FROM SECRETARY BALDRIGE, USTR BROCK IS NOW UNDER GROWING PRESSURE TO CONCLUDE A SERIES OF VOLUNTARY RESTRAINT ARRANGEMENTS WITH THIRD WORLD SUPPLIERS WITHIN THE 90 DAYS ALLOWED IN THE PRESIDENT'S S201 DECISION. HIS FRUSTRATION AT THE LACK OF PROGRESS IN THESE TALKS MAY ACCOUNT FOR THE EXTRAORDINARY MANNER IN WHICH HE FIRST APPEARED TO HAVE DONE A DEAL WITH COMMISSION

ER DAVIGNON OVER EC EXPORTS OF PIPES AND TUBES, AND THEN RENEGED IN THE FACE OF PRESSURE FROM THE US STEEL INDUSTRY. GIVEN THE COMMUNITY'S RECORD OF INABILITY TO RESTRAIN ITS EXPORTS OF PIPE AND TUBE TO THE 5.9 PERCENT LEVEL ENVISAGED IN THE 1982 EXCHANGE OF LETTERS, IT WOULD HAVE BEEN DIFFICULT TO HAVE BLAMED THE AMERICANS FOR TAKING UNILATERAL ACTION TO RESTRAIN IMPORTS AT AN EARLIER STAGE. THE COMMUNITY SHARE OF THE MARKET HAD REACHED 14 PERCENT AND WAS STILL GROWING. BUT, BY WAITING UNTIL THE EC COUNCIL OF MINISTERS HAD, WITH GREAT DIFFICULTY, AGREED A MANDATE TO SETTLE THE ROW, THE US HAVE PUT THEMSELVES IN THE WRONG. THIS MAY WELL ACCOUNT FOR THE PRESIDENT'S REPORTED WILLINGNESS DURING CHANCELLOR KOHL'S VISIT TO ENCOURAGE A RE-OPENING OF NEGOTIATIONS BETWEEN BROCK AND DAVIGNON. I AM HOWEVER DOUBTFUL WHETHER IT IS REALISTIC TO

CONFIDENTIAL

/ENVISAGE

CONFIDENTIAL

ENVISAGE A US CLIMB-DOWN.

4. ANOTHER FACTOR WHICH MAY HELP TO EXPLAIN BROCK'S MALADRONT HANDLING OF THE ISSUE, WAS THE REPORT THAT SECRETARY BALDRIGE HAS REVIEWED HIS PREVIOUS SUGGESTIONS THAT THE OFFICE OF THE USTR AND THE DEPARTMENT OF COMMERCE SHOULD BE MERGED IN A NEW DEPARTMENT OF INTERNATIONAL TRADE AND INDUSTRY. WITHOUT GREATER PRESIDENTIAL SUPPORT THAN HE RECEIVED DURING REAGAN'S FIRST TERM, THIS SUGGESTION IS UNLIKELY TO MAKE MUCH PROGRESS. NEVERTHELESS, HE MAY ACCOUNT FOR THE CLEAR SIGNS THAT BROCK AND HIS STAFF INTEND TO ACT MORE FORCEFULLY TO DEAL WITH "UNFAIR" FOREIGN COMPETITION.

5. A FURTHER ILLUSTRATION OF THIS CURRENT MOOD CAME AT THE GATT CONTRACTING PARTIES (CPS) SESSION IN GENEVA BETWEEN 26-30 NOVEMBER WHERE, BY ALL ACCOUNTS, THE US DELEGATION SHOWED CONSIDERABLE LACK OF FINESSE. NEVERTHELESS THE OUTCOME WAS PROBABLY NOT TOO BAD FROM THEIR POINT OF VIEW OR OURS, AND AT THE VERY LEAST, WILL NOT HAVE DISCOURAGED THEIR EFFORTS TO GET A NEW GATT ROUND GOING.

6. THE PRESENT INDICATIONS ARE THAT THE RECENT CHANGES IN CONGRESSIONAL LEADERSHIP WILL NOT MAKE A SIGNIFICANT DIFFERENCE TO THE MOOD IN CONGRESS. SENATOR DANFORTH'S ASSUMPTION OF THE CHAIR OF THE SENATE COMMERCE COMMITTEE HAS STRENGTHENED HIS HAND, AND WE SEEM CERTAIN TO HEAR MORE NEXT YEAR ABOUT RECIPROCIITY IN TRADE (PARTICULARLY IN TELECOMMUNICATIONS) BUT, WITH THE IMPORTANT EXCEPTIONS OF THE EXPORT ADMINISTRATION ACT AND THE FARM BILL, WE ARE UNLIKELY TO SEE MUCH SIGNIFICANT TRADE LEGISLATION IN THE NEXT SESSION. WE SHALL BE REPORTING SEPARATELY ON US/EC AGRICULTURAL TRADE RELATIONS AFTER WE HAVE SEEN SECRETARY BLOCK ON 6 DECEMBER.

7. FINALLY, OUR PROBLEMS OVER US EXTRATERRITORIALITY CONTINUE TO COMPLICATE THE BILATERAL RELATIONSHIP. ALTHOUGH THE PRESIDENT'S DECISION TO DROP THE PROCEEDINGS IN THE LAKER CASE WAS WELCOME, ITS FALL-OUT, IN THE FORM OF THE RELUCTANCE OF THE AMERICANS IN LAST WEEK'S TALKS TO PROCEED WITH MEANINGFUL DISCUSSIONS ON ARRANGEMENTS TO DO AWAY WITH TREBLE DAMAGE ANTI-TRUST LIABILITY IN THE AVIATION FIELD, MAKES A RESOLUTION OF THIS DISPUTE EVEN MORE DIFFICULT. SIMILARLY, WHILE THE CONFIDENTIAL EXCHANGE OF LETTERS BETWEEN SECRETARY BALDRIGE AND MR TEBBIT ESTABLISHING A BILATERAL ARRANGEMENT FOR NOTIFICATION AND CONSULTATION IN THE AREA OF EXPORT CONTROLS CONSTITUTES A SIGNIFICANT STEP FORWARD, THE RESULTANT

2

CONFIDENTIAL

1 PUBLICITY

CONFIDENTIAL

PUBLICITY (FOR WHICH THE AMERICANS ARE AT LEAST PARTLY TO BLAME) HAS STIMULATED PRESSURES FOR SIMILAR ARRANGEMENTS FROM OTHER US ALLIES (AND CURIOSITY FROM THE EC DELEGATION HERE) WHICH MAY MAKE SIMILAR DEALS MORE DIFFICULT IN THE FUTURE.

B. IT IMAGINE YOU WILL WANT TO BE VERY CRITICAL OF THE RECENT DECISION OVER STEEL. IT IS IMPORTANT THAT THE AMERICANS ARE LEFT IN NO DOUBT THAT THERE IS NO WAY TO DO BUSINESS BETWEEN ALLIES AND PARTNERS. ON THE POSITIVE SIDE IT SEEMS EVEN MORE DESIRABLE TO PROMOTE THE CASE FOR GETTING ON WITH OR SERIOUS PREPARATION OF OF A NEW TRADE ROUND, AMONG OTHER THINGS AS A PROPHYLACTIC TO THE RISING PROTECTIONISTS PRESSURES HERE.

FCO PLEASE PASS SAVING: PARIS, BONN, ROME AND TOKYO.

WRIGHT

(REPEATED AS REQUESTED)

FCO(PALACE)/WHITEHALL
NAD

-3-
CONFIDENTIAL

CONFIDENTIAL

AMENDED DISTRIBUTION 6 DECEMBER 1984

CONFIDENTIAL

FM WASHINGTON 052338Z DEC 84

TO PRIORITY FCO

TELEGRAM NUMBER 3624 OF 5 DECEMBER

INFO PARIS, BONN, TOKYO, ROME, UKDEL OECD, UKREP BRUSSELS,
UKDEL NATO.

SAVING US CONSULATES-GENERAL, UKMIS NEW YORK.

MJPT (NOT TO ALL):

SHULTZ AT CHEVENING: THE US ECONOMY AND THE FEDERAL BUDGET DEFICIT

SUMMARY

1. IT IS NOW GENERALLY RECOGNISED IN THE ADMINISTRATION AND ON THE HILL THAT DEFICIT REDUCTIONS IS THE NO 1 DOMESTIC PRIORITY. THERE IS NOT YET THE OUTLINE OF A DEAL ON HOW TO HANDLE IT, SLOWER US GROWTH, AND GREATER ECONOMIC UNCERTAINTIES. A SENATE MORE INDEPENDENT OF THE WHITE HOUSE, AND OPPOSITION FROM DEMOCRATS SMARTING FROM THE ELECTIONS, WILL MAKE IT HARD TO GET THE DEFICIT SUBSTANTIALLY DOWN BY EXPENDITURE CUTS ALONE. BUT THAT IS WHAT THE PRESIDENT WILL PROBABLY PROPOSE IN JANUARY AND HIS PROPOSED CUTS WILL BE SUBSTANTIAL. HE WILL BE RELUCTANT TO ACCEPT TAX INCREASES, BUT MAY BE DRIVEN TO DO SO IN THE END. THE TREASURY'S TAX REFORM PROPOSALS, THOUGH ATTRACTIVE TO SENIOR CONGRESSMEN OF BOTH PARTIES, WILL NEED TO HAVE THE PRESIDENT'S SUPPORT IF THEY ARE TO HAVE ANY CHANCE OF SUCCESS. NOT CLEAR THAT THEY WILL GET IT.

DETAIL

ECONOMIC BACKGROUND

2. THE PRESIDENT TOOK CREDIT DURING THE ELECTIONS FOR AN EXPANDING AND HEALTHY AMERICAN ECONOMY. THE ATMOSPHERE HAS SINCE CHANGED, WITH CONCERN ABOUT DECELERATING GROWTH (10.1 PERCENT, 7.1 PERCENT AND 1.9 PERCENT RESPECTIVELY IN THE FIRST THREE QUARTERS), AND GREATER UNCERTAINTY ABOUT ECONOMIC PROSPECTS. THE CURRENT QUARTER ALSO SEEMS TO BE WEAK, PERHAPS REFLECTING TEMPORARY INVENTORY ADJUSTMENT. THE FED IS CLEARLY EASING ITS STANCE AND, BY REDUCING ITS DISCOUNT RATE, HAS RECENTLY SIGNALED THAT IT WOULD LIKE EASIER MONETARY CONDITION. GROWTH MAY THEREFORE PICK UP SOMEWHAT EARLY NEXT YEAR TO, SAY 3 PERCENT, IN 1985 AS A WHOLE. EVEN SO, THERE IS INCREASING TALK ABOUT DOWNSIDE RISKS. WALL STREET DOES NOT KNOW WHAT TO MAKE OF IT ALL.

3. INFLATION IS NOW RUNNING AT 4.2 PERCENT, AND THERE IS LITTLE RISK OF A RESURGENCE NEXT YEAR. WAGE INCREASES HAVE BEEN MODERATE AND PRODUCER PRICES WEAK. INTEREST RATES ARE NOW FALLING. AND MOST FINANCIAL MARKET FORECASTERS DO NOT PREDICT MUCH MOVEMENT IN THE TREND FOR THE COMING MONTHS. THE HIGH LEVEL OF THE DOLLAR REMAINS AN ENIGMA, GIVEN THE LARGE AND GROWING TRADE DEFICIT. SOME DEPRECIATION STILL SEEMS LIKELY; BUT IT HAS DONE FOR SOME TIME.

CONFIDENTIAL

CONFIDENTIAL

4. VOLCHER HIMSELF REMAINS REASONABLY OPTIMISTIC. HE WAS IN A
OPTIMISTIC MOOD WHEN I CALLED ON HIM ON 4 DECEMBER. HE THOUGHT THE
SUCCESS OF THE CHRISTMAS SELLING SEASON WOULD BE AN IMPORTANT
INDICATOR OF WHAT WOULD HAPPEN TO GROWTH, AND TO CONFIDENCE.
HE WAS WORRY WAS THE LEVEL OF IMPORTS, WITH THE IMBALANCE
BETWEEN EXPANSION OF DEMAND AND OF PRODUCTION WHICH THIS IMPLIED.

BUDGET PROPOSALS

5. IT IS AGAINST THIS BACKGROUND THAT THE ADMINISTRATION IS
FORMULATING ITS BUDGET PROPOSALS (MY LETTER OF 3 DECEMBER TO
MIDDLETON). THEY ARE SAID TO BE CONSIDERING PROPOSING EXPENDITURE
MEASURES TO REDUCE THE DEFICIT TO DOLLARS 100 BILLION, OR 2 PER
CENT OF GNP, BY 1982. THIS WOULD BE ENOUGH TO STABILISE THE DEBT/GNP
RATIO, AND COULD BE DONE BY A SERIES OF SPECIFIC EXPENDITURE
PROPOSALS, A SPENDING FREEZE IN NOMINAL TERMS, OR A COMBINATION
OF BOTH. THE SQUEEZE IS LIKELY TO BE THE MOST DRACONIAN EVER
ATTEMPTED BY THE ADMINISTRATION: THE TARGET FOR YEAR 1 CUTS IS
DOLLARS 42B, AND THERE HAVE BEEN REPORTS THAT TENTATIVE AGREEMENT
HAS BEEN REACHED ON SAVINGS OF SOME DOLLARS 34B, WITH DEFENCE NOT
YET INCLUDED - NO AREA EXCEPT SOCIAL SECURITY WOULD BE EXEMPT
FROM THE CUTS, AND EVEN SENIOR PENTAGON OFFICIALS EXPECT THEIR
BID FOR 13 PERCENT REAL GROWTH IN THE DEFENCE BUDGET TO BE CUT
DOWN TO 5 PERCENT OR BELOW. WEINBERGER WILL RESIST THIS VERY STRONGLY

BUT IT IS CLEAR THAT HE WILL HAVE A MAJOR FIGHT ON HIS HANDS
WHEN HE RETURNS FROM HIS CURRENT TRAVELS.

6. THE BUDGET PROPOSALS WILL BE BATTED ABOUT WITHIN THE
ADMINISTRATION FOR SOME TIME, AND NEED NOT BE FINALISED UNTIL
END-JANUARY, WHEN THEY HAVE TO GO TO CONGRESS. BUT THE DEMOCRATS,
STILL SMARTING FROM THEIR MASSIVE ELECTION DEFEAT, ARE UNLIKELY
TO COOPERATE IN CUTTING SPENDING UNLESS THE PRESIDENT ACTUALLY
PROPOSES SOME TAX INCREASES. THIS IS OF COURSE WHAT HE HAS SAID
THAT HE WILL NOT DO: AND TREASURY SECRETARY REGAN IS STILL SAYING
THAT TAX INCREASES ARE NOT NEEDED. THE NEW SENATE MAJORITY LEADER,
DOLE, IS UNLIKELY TO WORK AS MUCH IN HARNESS WITH THE WHITE HOUSE
AS DID HIS PREDECESSOR, BAKER. THE SENATE IS ALSO LIKELY TO BE
LESS SYMPATHETIC TO SWINGING SPENDING CUTS THAN WAS ITS
PREDECESSOR, EVEN THOUGH DOLE HIMSELF FAVOURS A SPENDING FREEZE.
AND THE HOUSE WILL CONTAIN THIRTY-TWO NEW REPUBLICANS WHO CAN BE
EXPECTED TO HAVE PRO-GROWTH, SUPPLY-SIDE SYMPATHIES, AND MAY BE
RELUCTANT TO VOTE FOR DEFICIT REDUCTION, PARTICULARLY BY TAX-HIKES,
IF GROWTH IS SLOW.

7. WITH A PRESIDENT UNWILLING TO REVERSE HIS ATTITUDE TO TAX
INCREASES, AN UNCOOPERATIVE CONGRESS, AND A LESS BUOYANT ECONOMY,
THE PROGNOSIS FOR THE DEFICIT IS STILL NOT GOOD. VOLCHER SAID IT
WAS HARD TO SAY WHERE THINGS WERE GOING. BUT IT IS EARLY DAYS YET,
AND THE REALISATION THAT DOLLARS 300 MILLION A DAY IS NOW NEEDED
TO SERVICE THE FEDERAL DEBT MAY DAWN ON ALL CONCERNED, AND CHANGE
THE PICTURE.

8. THE US TREASURY'S TAX REFORM PROPOSALS ARE EFFECTIVELY A SIDE-ISSUE. IT IS NOT CLEAR WHETHER THE PRESIDENT WILL ADOPT THEM, OR CONGRESS TAKE THEM UP SERIOUSLY. THE PROPOSAL FOR A MODIFIED FLAT TAX, REDUCING THE NUMBER OF BRACKETS FROM FOURTEEN TO ONLY THREE (15 PERCENT, 25PERCENT AND 35PERCENT), WHILE CLOSING MAJOR LOOPHOLES, IS LONG OVERDUE. BUT IT WILL BE FIERCELY RESISTED BY THE SPECIAL INTEREST GROUPS, AND ALSO PERHAPS BY SENATOR PACKWOOD, THE NEW CHAIRMAN OF THE SENATE FINANCE COMMITTEE. THE PROPOSAL FOR A DROP IN THE RATE OF CORPORATION TAX FROM 42 PERCENT TO 33 PERCENT, COMBINED WITH LESS GENEROUS DEPRECIATION PROVISIONS IS DESIRABLE (AND A REPLICA OF THE 1984 UK FINANCE ACT.) BUT CONGRESSMAN KEMP AND OTHERS CAN BE EXPECTED TO RESIST TAMPERING WITH THE ACCELERATED COST RECOVERY SYSTEM INTRODUCED IN 1981, WHICH THEY SEE AS THE KEYSTONE OF THE INVESTMENT BOOM, AND THE RECOVERY. THE TAX REFORM PROPOSALS WOULD, IF IMPLEMENTED, TEND TO REDUCE US INTEREST RATES, SINCE THEY WOULD HAVE THE EFFECT OF EASING THE DEMAND FOR CREDIT.

THE WHITE HOUSE ROLE

9. THE PROSPECTS FOR DEFICIT REDUCTION, AND TAX REFORM, DEPEND ON THE PRESIDENT'S ATTITUDE. IF HE CAN BRING HIMSELF TO AGREE, OR PREFERABLY TO PROPOSE, TAX INCREASES, THEN THE EFFORTS TO REDUCE THE DEFICIT MAY HAVE A REAL CHANCE IN THE CONGRESS. IF HE SHOULD SUPPORT THE TREASURY'S TAX REFORM PROPOSALS, INSTEAD OF REMAINING CONSPICUOUSLY ALOOF FROM THEM, THEY TOO MIGHT HAVE SOME PROSPECT OF SUCCESS. BUT SO FAR HE HAS SHOWN NO SIGNS OF BEING WILLING TO ADMIT EITHER THAT THE STAGE OF LAST RESORT HAS BEEN REACHED ON THE DEFICIT (AND THAT HE MUST THEREFORE AGREE TO INCREASE TAXES), OR THAT TAX REFORM PER SE IS GOOD.

RECOMMENDED LINE TO TAKE

10. OUR TASK IS NO LONGER TO CONVINCING THE ADMINISTRATION THAT SOMETHING MUST BE DONE ABOUT THE BUDGET DEFICIT. THAT POINT IS NOW WELL TAKEN. IT IS RATHER A QUESTION OF PROBING THEIR WILLINGNESS TO PRESS ON TO THE END OF THE ROAD EVEN IF THE DESIRED HARVEST FROM EXPENDITURE CUTTING DOES NOT, AS IT WILL NOT, FULLY MATERIALISE.

WRIGHT

CO(PALACE)/WHITEHALL