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TO IMMEDIATE F C O

TELEGRAM NUMBER 1380 OF 24 APRIL

INFO PARIS, BONN, ROME, TOKYO, OTTAWA, UKREP BRUSSELS, UKMIS GENEVA,  
UKDEL NATO, UKDEL OECD,

INFO SAVING OTHER EC AND NATO POSTS, CG'S IN USA, UKMIS NEW YORK.

MY TWO IPTS: BONN SUMMIT: US ECONOMY AND ECONOMIC POLICIES

## SUMMARY

1. THE GROWTH OF THE US ECONOMY HAS SLOWED DOWN TO A CRAWL. A FINAL BUDGET DEAL IS STILL SOME WAY OFF AND WILL PROBABLY NOT BE ON THE ADMINISTRATION'S TERMS. THEIR TAX REFORM PROPOSALS REMAIN IN THE WINGS, AND MAY NOT GET TO CENTER-STAGE SOON ENOUGH FOR A BILL TO PASS THIS YEAR.
2. AT THE SUMMIT BAKER WILL PROBABLY SEEK TO KEEP ALIVE HIS SUGGESTION FOR AN INTERNATIONAL MONETARY MEETING AT LEAST UNTIL AGREEMENT ON A DATE FOR THE START OF A NEW GATT ROUND IS ASSURED, WHILE TRYING TO MINIMISE THE SCOPE OF THE SUGGESTION. HIS VIEWS ON INTERNATIONAL ECONOMIC POLICY ARE STILL FORMING, AND THE BEST STATEMENT OF THE ADMINISTRATION'S POSITION REMAINS SHULTZ'S PRINCETON SPEECH OF 11 APRIL.

## THE DOMESTIC US ECONOMY

3. THE MAIN ECONOMIC FIGURES ARE GIVEN IN MY FIRST IPT. WHILE THE US ECONOMY HAS BEEN EXPANDING OVER THE PAST TWO YEARS, IT HAS ENCOURAGED CAPITAL INFLOWS FROM ABROAD AND THE DEFICIT HAS BEEN FINANCED WITHOUT LARGE INCREASES IN INTEREST RATES. IF THE ECONOMY SLOWS DOWN, IT MUST BE QUESTIONABLE WHETHER VOLUNTARY CAPITAL INFLOWS WILL CONTINUE ON THE SAME SCALE WITHOUT AN INCREASE IN INTEREST RATES. THE HEAVY INDEBTEDNESS OF MAJOR SECTORS OF THE US ECONOMY, THE DUBIOUS VALUE OF MANY OF THE ASSETS ON THE BOOKS OF THE US BANKS, THE DECLINE OF SEVERAL MAJOR INDUSTRIES AND US AGRICULTURE, HAVE ALL RAISED ADDED DOUBTS ABOUT THE SUSTAINABILITY OF THE DOLLARS 100 BILLION CAPITAL INFLOW. EVEN IF REAL DEMAND RESPONDED TO FASTER GROWTH IN THE MONEY SUPPLY BY ITSELF GROWING MORE QUICKLY, THIS MIGHT ONLY LEAD TO A WORSENERD TRADE DEFICIT AND VERY LITTLE INCREASE IN GNP GROWTH.

4. THE FEDERAL RESERVE IS NOW BEING TORN BETWEEN SEVERAL FACTORS INFLUENCING MONETARY POLICY. THE M1 INCREASE IN THE FIRST QUARTER WAS ABOVE THE TOP OF ITS TARGET 'CONE'. THE LATEST INFLATION FIGURE (A RISE OF 0.5 PERCENT IN THE CONSUMER PRICE INDEX IN MARCH). ALTHOUGH RELATED TO THE PRICE OF PETROL, IS ALSO A SOURCE OF DISCOMFORT. BUT CONCERN ABOUT THE FRAGILITY OF US FINANCIAL INSTITUTIONS AND THE ECONOMY WILL MILITATE AGAINST A RAPID CUTTING BACK OF MONETARY GROWTH. FEARS OF SUSTAINED HIGH INTEREST RATES HAVE TENDED IN RECENT DAYS TO DRIVE THE DOLLAR BACK UP. VOLCKER IS THEREFORE IN A TOUGH POSITION, BUT PAST PERFORMANCE WOULD INDICATE THAT HE MAY CONTINUE WITH HIGH MONETARY GROWTH.

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5. IF RECOVERY IS TO CONTINUE SUSTAINABLY THE BUDGET DEFICIT MUST BE CUT. THE SPENDING REDUCTION PLAN AGREED BETWEEN THE PRESIDENT AND SENATE REPUBLICAN LEADERS ON 4 APRIL AIMS TO ACHIEVE SAVINGS OF DOLLARS 52 BILLION IN FY86, AND TO REDUCE THE FEDERAL DEFICIT TO ABOUT DOLLARS 100 BILLION IN FY88. THE NEXT FEW DAYS WILL DETERMINE ITS FATE IN THE REPUBLICAN SENATE, BUT ITS CHANCES OF SURVIVING INTACT IN THE DEMOCRATIC HOUSE OF REPRESENTATIVES ARE VERY LOW. THE FY86 TOTALS MAY BE ATTAINABLE, BUT THE MIX SEEMS VIRTUALLY CERTAIN TO CHANGE, WITH THE PROPOSED 3 PERCENT REAL INCREASE IN DEFENCE SPENDING PARTICULARLY VULNERABLE. AND EVEN IF THE TOTALS ARE ACHIEVED, THE DEFICIT PROJECTION WOULD REMAIN DOLLARS 175 BILLION IN FY86, AND THE TARGET OF A DEFICIT OF FOLLARS 100 BILLION IN FY88 LOOKS VERY OPTIMISTIC, ESPECIALLY IF THE ECONOMY SLOWS DOWN SIGNIFICANTLY, AUTOMATICALLY REDUCING TAX REVENUES AND MEANS-TESTED EXPANDITURE PROGRAMMES, AND INCREASING THE POLITICAL DIFFICULTY, IN THE RUN-UP TO THE MID-TERM ELECTIONS, OF CUTS IN DISCRETIONARY EXPENDITURE ON AGRICULTURE, PUBLIC WORKS AND OTHER EMPLOYMENT SUPPORT

#### TAX REFORM

6. SECRETARY BAKER HAS SAID THAT THE ADMINISTRATION'S PLAN FOR REVENUE-NEUTRAL TAX REFORM WILL BE PUT TO CONGRESS IN EARLY MAY, AND WILL REMAIN BROADLY AS IN THE ORIGINAL REGAN PROPOSALS. THIS WOULD MEAN A SUBSTANTIAL INCREASE IN THE PROPORTION OF TOTAL TAX PAID BY CORPORATIONS COMPARED TO INDIVIDUALS - BASICALLY BECAUSE THEIR ACCELERATED DEPRECIATION ALLOWANCES WOULD BE REDUCED - AND A REDUCED TOP RATE OF INCOME TAX FOR INDIVIDUALS, PERHAPS AS LOW AS 35 PERCENT.

7. THE DEBATE WILL BE LONG AND DIFFICULT. ROSTENKOWSKI (CHAIRMAN OF THE HOUSE WAYS AND MEANS COMMITTEE) IS ALREADY EXAMINING ALTERNATIVE IDEAS, AND MAY CHOOSE TO TAKE HIS COMMITTEE DOWN ITS OWN PATH, PERHAPS ALONG THE LINES OF THE IDEA OF A MINIMUM TAX FAVOURED BY DEMOCRATS SUCH AS REPRESENTATIVES RUSSO AND SCHUMER AND SENATOR METZENBAUM. A MINIMUM TAX WOULD ENSURE THAT AN INDIVIDUAL OR CORPORATION WOULD PAY AT LEAST SOME PERCENTAGE OF NET INCOME, WITH CERTAIN DEDUCTIONS AND ALLOWANCES ADDED BACK INTO NET INCOME FOR THE PURPOSES OF CALCULATING THE MINIMUM TAX BASE. SUCH AN IDEA WOULD BE OPPOSED BY THE ADMINISTRATION AS INIMICAL TO TRUE REFORM, BUT IT MIGHT BE MORE ACCEPTABLE TO THE GROUPS MAINLY AFFECTED THAN SECRETARY REGAN'S ORIGINAL PROPOSALS.

#### THE SUMMIT

8. THE PRESIDENT GOES TO BONN AGAINST A WEAKER DOMESTIC ECONOMIC BACKGROUND THAT AT ANY TIME SINCE 1982. THE ADMINISTRATION'S MAIN DOMESTIC ECONOMIC POLICIES, EXPENDITURE REDUCTION AND TAX REFORM, ARE NOT YET SAFELY LAUNCHED AND MAY UNDERGO FURTHER RADICAL CHANGE. THE US BANKING SYSTEM FACES SERIOUS SOLVENCY DIFFICULTIES OF ITS BORROWERS IN SEVERAL DOMESTIC SECTORS (ENERGY, REAL ESTATE, AGRICULTURE), AS WELL AS INTERNATIONALLY. AND THE US IS ON THE ROAD TO BECOMING A NET DEBTOR FOR THE FIRST TIME SINCE WORLD WAR I.

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9. THE TEMPTATION FOR THE PRESIDENT WILL BE TO ARGUE IN BONN THAT THE US ECONOMY HAS PULLED THE WORLD ECONOMY A LONG WAY IN THE PRESENT RECOVERY: THAT IT IS NOW TIME FOR OTHER COUNTRIES BOTH TO EXPAND THEIR ECONOMIES AND REDUCE THEIR TRADE BARRIERS TO ALLOW BETTER ACCESS FOR US PRODUCTS. THERE WILL BE A TEMPTATION TO ECHO VOLCKER'S REPEATED HINTS THAT A MORE RESPONSIBLE FISCAL POLICY IN THE US SHOULD BE THE OCCASION FOR SOME LOOSENING IN OTHER COUNTRIES. BUT THE PROOF OF GREATER FISCAL RESPONSIBILITY HERE HAS YET TO BE DEMONSTRATED IN PRACTICE.

10. THERE ARE TWO VIEWS IN THIS TOWN ON THE MOTIVATION FOR BAKER'S SUGGESTION FOR A HIGH-LEVEL MEETING TO DISCUSS INTERNATIONAL MONETARY REFORM. THE FIRST IS THAT IT IS SIMPLY A GAMBIT TO GET THE FRENCH TO AGREE TO A STARTING DATE FOR A NEW GATT ROUND, AND TO DEAL WITH DOMESTIC PRESSURE FROM US INDUSTRY. I AM NOT SURE THAT THIS INTERPRETATION IS RIGHT. THERE HAVE BEEN RECENT SIGNS (PUBLIC STATEMENTS BY BAKER AND SHULTZ'S 11 APRIL SPEECH) THAT THE US WISHES TO REGAIN ECONOMIC LEADERSHIP AMONGST THE SUMMIT SEVEN. BAKER HAS ALSO SHOWN SIGNS OF WANTING MONETARY REFORMS MORE FUNDAMENTAL THAN THOSE RECOMMENDED IN THE G10 REPORT, ALTHOUGH HE DOES NOT APPEAR TO BE CLEAR ABOUT WHAT THEY SHOULD BE. I BELIEVE HIM TO BE MORE OPEN-MINDED ON THIS ISSUE THAN HIS PREDECESSOR, AND HE WILL ALSO BE AWARE THAT THERE IS GROWING ENTHUSIASM FOR MONETARY REFORM ON THE HILL.

11. FCO PLEASE ADVANCE TO POWELL (NO.10), PPS/S OF S, PPS/CHANCELLOR, HATFIELD (CABINET OFFICE), LITTLER (HMT), HAYES (DTI), BRAITHWAITE (FCO) AND LOEHNIS (BANK).

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