PRIME MINISTER 1 May 1985

ECONOMIC SUMMIT

Locomotive Reflation: Should the Non-US Economies Expand?

If US interest rates start to come down because the US Government decides to cut its Budget deficit, it would be damaging for the other Western nations then to expand their Budget deficits. It would limit reductions of interest rates.

On Treasury figures for 1984, the UK general government financial deficit was 3.25% of GDP, and the US one 3.5%. In 1985, the UK deficit is scheduled to fall, whereas the US deficit will rise; but, allowing for the sale of public sector assets (counted as negative public spending, but in practice a way of financing a deficit) the UK Budget deficit remains very similar to that of the US. France, Canada and Italy also have high deficits; whereas Japan and Germany - which have much lower rates of unemployment - have substantially lower general government deficits. Hardly evidence that bigger deficits lower unemployment.

The major Western countries are growing quite healthily - 5.25% on average in 1984, and another 3.5% forecast for 1985. The Western European countries are markedly slower than Japan, the States and Canada. The backdrop for concerted action to bring together monetary policies and currencies is not favourable. The table on Annex 7 of the

Treasury's Economic Brief shows just how widespread the variations are in the growth of money: from Italian money growth of 19.5% in the second half of 1984, to a decline in Canada.

Following the surge of the dollar, no-one can have any confidence that, at the current level of exchange rates, we have a viable reflection of long-term values which international central banks ought to defend for any length of time. The Japanese yen still looks very undervalued, as measured by the Japanese trade account and the underlying strength of the Japanese economy. Unless the US is going to tighten and tighten again its money policy and put rates up, the US currency still looks expensive - particularly against the yen. The German currency looks cheap against some of its weaker Western European neighbours.

Against such a background, you cannot peg the rates for any length of time by expensive intervention; nor should you believe that any international agreement on desirable rate bands would produce anything other than a set of political problems.

<u>GATT Round</u>

In contrast, the idea of a new GATT round is extremely attractive, and should be encouraged at every convenient turn. There is a growing mass of evidence to suggest that

tariffs and other barriers to trade destroy jobs around the world, and tend to make international economies poorer rather than richer.

A major stumbling block is that France and Italy may insist on "international monetary reform" as a condition for a new GATT round. Our tactics have been to separate the two issues and play down the exchange rate question. You might argue that it is not the overvalued dollar per se which harms the world economy, but excessive American borrowing, which pulls up interest rates and harms growth. The undervalued yen exposes manufacturing sectors to excessive Japanese competition.

The right answer is not to try to manipulate exchange rates - this would be expensive and unsuccessful - but to remove distortions in capital markets which contribute to the exchange rate problem. There are two in particular - tax relief on interest in the USA, and banking "caution" towards consumer borrowing in Japan.

The other difficulty in concerting a Summit position on the GATT round is the French and German insistence that the round must not tamper with the CAP. Since the CAP is an afront to a liberal trading system, with its variable import levies and massive dumping policies, the round won't make progress unless the CAP is open to discussion. The CAP problem can only be solved by switching its emphasis away

from price support for all and towards direct "social" income support for small, uneconomic farms. This must imply an alignment of prices towards world levels and a greater exposure to free trade.

The United States

The crucial battle is that over the Budget. The table beneath summarises the proposals before the Senate Budget Committee:

Projected Budget Deficit:	1985/6	1986/7	1987/8
	$bn	$bn	$bn
(a) No action projection by Office of Management and Budget:	227	245	244
(b) President's Budget proposal:	180	165	144
(c) Senate/White House compromise Budget:	175	145	99
(Cuts under Senate/White House compromise):	(52)	(100)	(145)

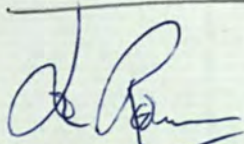
Over one-third of the total expenditure reductions planned in the so-called "compromise" now involves halving the planned real growth in defence spending. Other cutbacks will be in Medicare, Medicade and Social Security. If US economic growth falls significantly below the 4% per annum rate assumed in these figures, then the Budget arithmetic

will look even worse. The Senate has now passed the Administration/Senate Budget Committee compromise proposal, but some Republicans will impose individual measures during the later stages & the proposals are likely to be watered down -

At the same time, the state of the American financial industry is not getting any better. The savings and loans industry now has a tangible net worth of less than 0.5% of its total assets. Nine savings and loans failed last year, and more failures are likely in the future. Simultaneously, there is a high level of bank failures, which have risen from an annual average of less than 10 in 1977-81, to 34 in 1982, 45 in 1983, and 78 in 1984. Some 800 banks under the surveillance of the Office of the Controller of the Currency now require special supervisory attention - a fourfold increase in 5 years. (Source: N M Rothschild's Monthly Newsletter.) This background is always there, and at any time can force the US authorities into easier money as they flare up.

Conclusion

The world background still remains difficult. Locomotion will not help. A new GATT round can. Given the enormous swings possible in the US banking, monetary and currency position, any concerted effort to intervene or control exchange rates would be doomed to failure at considerable political and financial cost.



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