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BRITISH EMBASSY,
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FROM THE AMBASSADOR

6 November 1984

The Right Honourable
Sir Geoffrey Howe QC MP
Secretary of State for Foreign
and Commonwealth Affairs
Foreign and Commonwealth Office
London SW1

Sir,

1984 US PRESIDENTIAL ELECTION RESULT: WHAT WILL REAGAN DO?

1. It was certainly a famous victory: the question is how Ronald Reagan will use it.

2. He has a remarkably free hand, for the result was a resounding vote of confidence, not for the Republican Party, or even for the policies of the first Reagan Administration, but for Reagan the man. Of course the separation of powers means that Congress can, and no doubt will, hedge him in. The 1986 Congressional elections, where far more Republican than Democrat seats will be vulnerable, will cast a long shadow, almost certainly tying him down still further in the second half of his term. And Reagan, prevented by the 22nd Amendment from running again, will be a lame duck well before

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November 1988, even if his health holds out. But this is his moment, and to a considerable extent he can use it as he wishes. There is a "window of opportunity" in 1985.

3. Will he therefore continue with the policies of the last four years, or shall we see something new? In this despatch I address what are for us the four key areas of policy - the domestic economy, international trade, the problems of the developing world, and foreign (and particularly East/West) policies - and assess the prospects. My best overall guess is that we shall see more continuity than change.

4. Partly, this is, I believe, because Reagan genuinely believes - and with some reason, - that America is stronger today than it was in 1980, and because of his policies. The extraordinary upsurge of patriotism over the Olympics, though skillfully exploited by the Republicans, was genuine enough; and it appealed to Reagan for the very reasons that he appeals to Americans. Partly it is because I doubt if he has himself focussed on the economic dangers underlying the present boom, and its proximate cause, the budget deficit, or is likely to do so until events so compel him. He is older as his second term starts than any previous President was on leaving Office, and his reluctance to grapple with new ideas, or master and retain detail, seems bound to grow. And partly it is because I judge that he feels comfortable with the team around him, and will make few Cabinet changes. Shultz and Regan, probably the two key Cabinet

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Secretaries, and Meese and Clark, the Californian praetorians, seem certain to stay on, at least for the present; Baker, the key White House adviser, seems likely to move up rather than out of government; and only Donovan (Labour) and French-Smith (Attorney General) seem very likely to go, though a question-mark hangs over Weinberger. It will remain a Cabinet of good team players, with few in-house critics. And criticism from the Party is more likely to come from the far-Right than from those Centrists who expressed doubts about the policies of the Mark I Administration.

5. In some ways, this is good news for us. Reagan has been, and will remain, a staunch defender of the overall Western interest vis-a-vis the East; but continuity in East/West relations as such will now mean a continuing search for improved dialogue with Moscow. For the Reagan of 1984 is already distinctly different from the Reagan of 1981, in playing up the need to improve the atmosphere, and the content, of the super-power dialogue. Cynics impute merely electoral motives: I do not; and in the concluding section of this despatch I risk a guess at what this particular form of continuity might mean in concrete terms. Having devoted his first term to making America strong, he will wish to devote the second to promoting peace, democracy and prosperity.



6. But on the central issue of economic policy, which arguably dwarfs all others in importance, it is perhaps rather bad news; for continuity means only half-hearted efforts to control the federal deficit, a risk that the boom will end with a bang, and continuing high US interest rates and an over-mighty dollar. And it is to this issue that I turn first.

US ECONOMIC POLICY

7. Reagan has ridden back to the White House on a surging US economic recovery. In the short-term growth is expected to continue at a still satisfactory rate, and the outlook for inflation continues to be good. But there are many even here who are alarmed about the high level of real interest rates, which is beginning to penalise some sectors of the economy (eg housing), about the strength of the dollar, which is penalising some farmers and large parts of industry, about the soundness of parts of the financial system, and about the sustainability of an economic policy dependent on the richest country in the world sucking in capital to finance a current account deficit running at over \$100 billion each year.

8. The financial markets believe that a reduction in the budget deficit is the key to the solution of these problems; and an Administration that believes in the magic of the markets cannot therefore deny for ever the link between the deficit and the level of interest rates. Nor can an Administration that preaches



sound finance for ever remain unconcerned about huge additions to public debt. The authoritative Congressional Budget Office (CBO) suggests that some \$1,460 billion in new public debt will, on current trends, be added between January 1984 and the end of 1989 to the end-1983 outstanding stock of public debt of \$1,142 billion, and that net interest payments will take 21% of tax revenues by 1989.

9. But private concern about the budget deficit is one thing: public action is another.

10. Current - and probably temporary - good news on the economy, especially the decline in interest rates, will not impress upon the President or Congress any urgency for deficit reduction. The dire forecasts of the pundits have still not come to pass; and Treasury Secretary Regan may go on cheerfully saying "So far, so good", like the man who fell off the Empire State Building, and enjoyed much of the trip down. The Republican Right will continue to believe, as an act of faith, that buoyant growth and lower interest rates will validate the Administration's forecast for the 1989 deficit of \$140 billion, and invalidate the CBO's estimate of \$263 billion.

11. In any event action to reduce the deficit raises decisions of considerable political difficulty. All the "easy" expenditure cuts have been made, and the new Congress will not be much more



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willing than the old one to deliver new cuts. The Office of Management and Budget, who should be wielding the axe, and did so with some effect in 1981, now have only a minor technical role. And the pressures of the campaign forced the President into promises, for example on social security, which will not help him to find savings.

12. So scope for early and substantial expenditure reductions, for announcement in the State of the Union Address and the 1986 Budget, looks strictly limited, unless the President is willing to strike out in bold new directions. Medicare, Medicaid, cost of living pensions adjustments, farm support, and some defence programmes, are the obvious candidates. But the political problems are no less obvious.

13. Nor will the President readily swallow his campaign pledges to avoid tax increases except as a last resort. (Towards the end of the campaign he was inclined to drop the "last resort" formula when out on the hustings and away from cautious Washington advisers: instead he spoke of increases being "over my dead body".) Certainly there may be proposals for revenue-neutral tax reform, with a reduction in tax rates offset by limitations of some of the more blatant tax breaks. Various "flat tax" approaches already have bipartisan support in Congress, but the Administration will need clever footwork if they are to avoid becoming hooked on a lower tax rate before securing agreement to the

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to the closing of the loopholes. The appointment of Senator Packwood to the Chairmanship of the key Senate Taxation Committee would make the task harder.

14. So, the immediate prospect is for talk about tax reform and expenditure cuts, but precious little real action on the deficit. If the financial markets remain sure that the necessary action will follow in due course, confidence may hold. And they may give the President the benefit of the doubt for some time. But if the markets come to believe that only the pressure of events will force the necessary political compromises, then the dire warnings of the pundits may at last come to pass. When is anyone's guess. One possibility being canvassed here is a bi-partisan commission on the deficit. We shall see.

15. America's friends, who have played down their concern about the deficit at and since the London Summit, may face a choice. Should they, while privately recognising the risks, tacitly accept the White House line - now lent some support by Larosiere - that the US is playing its proper role as the motor of world recovery; that the US trade deficit provides golden opportunities for British and other exporters; and that the benefits to the debtor nations of the US recovery exceed the disbenefits of high US interest rates; and thank God for that? Or should they now revert to the line taken up to and at the



1983 Williamsburg Summit, and seek to persuade the President that Volcker is right, and Regan wrong, and that for 1985 and after the health of the world economy requires a better balance between US fiscal and monetary policies? If we adopt the latter strategy, the domestic background here strongly suggests that private consultation will be more productive than public ful-
mination.

US TRADE POLICY

16. US trade policy during the first Reagan Administration was inevitably dominated first by the depth of the 1981-82 recession, and then by the dramatic surge in the value of the dollar. Although most US industries rapidly recovered, many of those heavily involved in or exposed to international trade, - but not those in high technology which seem impervious to the strength of the dollar, - inevitably suffered. While an over-valued dollar, and the consequences of the debt crisis in some of their major traditional markets, meant that US exporters struggled, importers had a field day. In the last three months before the election, imports of manufactured goods grew at an annual rate of some 78%; and the US trade balance for the first nine months of 1984 was in deficit to the tune of \$100 billion. Protectionist pressures, particularly on steel and textiles, have mounted, while public confidence in the virtues of a liberal multilateral trading system has declined. This will continue, for industry and Congress will find it easier to blame foreigners than a popular President.

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17. The President has tried, and will I believe continue to try, to hold the line. The 1984 Trade Bill was not a bad one. Where he felt forced to take protectionist action (as in the case of his decision in September to grant greater relief for the steel industry) he cloaked the decision in the language of free trade. Where he took steps to liberalise trade (by pressing Congress for renewal of the US GSP and for authority to negotiate a free trade agreement with Israel) he made judicious but limited concessions to the proponents of tougher trade laws. But he is bound to be sensitive to the size of the US trade deficit. If domestic demand tapers off in 1985, the business community's commitment to free trade will lessen. The Administration will come under pressure to throw the existing law-book at "unfairly" traded imports, and to force open foreign markets, if necessary by exploiting the new reciprocity powers in the 1984 Trade and Tariffs Act.

18. The litmus test will be the Administration's approach to GATT. The President reaffirmed his commitment to a new GATT round in his IMF speech only two months ago. In theory, he is now in a strong position to extract from Congress negotiating authority for the concessions the US must itself make if it is to secure the removal of foreign barriers to US exports of services, agricultural products and high technology. In practice, it is by no means certain that the new Administration will take the risk, or that the Congress will grant him the



authority to offer quids pro quo. There may well be a temptation instead to seek further trading opportunities through new bilateral arrangements. This is not to say that the 99th Congress is more likely than its predecessors to pass protectionist legislation. Consumer groups have recently shown an encouraging willingness to lobby against, or challenge in the courts, measures which affect their interests; and the press, for the most part, is still anti-protectionist. Much will depend on the approach of America's main trading partners, the European Community and Japan, and whether all three can find a way of opening up the markets of the newly industrialised countries. One thing is clear. A grudging and defensive EC approach to further multilateral trade negotiations, including agriculture, would play into the hands of the protectionist forces here.

19. Moreover the new Congressional focus of attention in the trade field, in 1985 at least, is likely to be agriculture, for Congress is obliged to pass a Farm Bill renewing or modifying existing support arrangements. It is still far from clear how that will turn out. While the rapid increase in Federal expenditure on agriculture in the last four years has attracted much criticism, high real interest rates mean that many farmers, particularly in the mid-West, now face debts they cannot service, declining land values and poor export prospects. The temptation to find a scapegoat makes the EC vulnerable to criticism. As a

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result, the Congressional debate will deal not only with domestic farm support programmes, but also with how to restore export competitiveness. There will be strong pressure for a major programme of new export subsidies to win back markets "lost" to the EC; and the Administration may find - or declare - it irresistible, particularly if support prices have to be cut.

20. Bilateral Anglo-American trade policy discussion will in any case remain bumpy, not least because there will continue to be attempts to enforce a wide definition of US jurisdiction beyond US shores. The gas pipeline crisis, and the current row over attempts to apply US anti-trust laws to bilateral air services, will not be the end of the story. We shall need to continue to combine vigorous and vigilant defence of UK interests with willingness to work out practical solutions. It is difficult to reconcile opposing principles; it may be possible to work out pragmatic answers.

US THIRD WORLD POLICIES

21. The area of Reagan external policy where Mondale's criticisms were perhaps most justified was in relation to the Third World. But this was also the area of least interest to US public opinion. The attack cut no ice, and the policies seem unlikely to change.



22. Overseas aid policy will probably continue to be fashioned largely by Congressional pressures. And if a real attack on the deficit develops, US Aid, already low by European standards, will probably fall further. The Administration are likely to increase the emphasis placed on bilateral, rather than multi-lateral programmes, and on strategic, rather than development concerns. Israel, Egypt, and Central America will continue to absorb the bulk of the funds. And we may expect a continuing firm line on the International Fund for Agricultural Development (IFAD), and a reluctance to move quickly to a major capital increase for the International Bank for Reconstruction and Development (IBRD), or to provide new funding for the International Development Association (IDA).

23. Conceivably, the harshness of the Administration's anti-Third World rhetoric may be muted in the second term. And conceivably a President looking not for re-election but to his place in the history books may be more prepared to take on a Congress and public still hostile to Aid. There is a task for diplomacy here, pointing out that economic stagnation and social deprivation are the most fertile ground for Communist subversion, but it will remain an uphill task.



24. On debt the problem is rather different. Global solutions to the international debt problem will continue to find few supporters here. The Administration will certainly go on sharing our view that the salvation of countries in trouble lies in the pursuit of sustainable non-inflationary growth through sound monetary and fiscal policies, competitive exchange rates, and the opening up of economies to market forces, and in particular to private direct investment flows. That is what US spokesmen will continue to say.

25. But what America will do is another question. They will have a continuing solicitude for the larger debtor countries - Argentina, Brazil and Mexico - where a "default" could affect the American banking system. Where they see a direct US strategic interest they will be ready to give a particular debtor special treatment, including favourable credit and grants, and the exercise of discreet US pressure on the International Monetary Fund. We will need to be alive to the risk that, by practising alone what we both preach, the UK might be manoeuvred into appearing tougher on friendly debtors than is the US.

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US FOREIGN POLICY

26. The Reagan Administration of 1981, reflecting the deeply anti-Communist attitudes of middle America, began by viewing all issues through an East/West prism. It was convinced that its main task was to reverse the West's decline: it saw the democracies threatened by psychological defensiveness, deceived by detente into ignoring the threat of Soviet expansionism, militarily weakened, and economically corroded by inflation. Real dialogue with the Soviet Union, though much talked about even at the outset, was only seriously attempted quite recently. There were no summits, no major agreements with the Soviet Union, and tidal waves of hostile rhetoric ensured that at times there was barely any civil communication at all.

27. The Reagan of 1984 has persuaded America that his primary objectives have been achieved. With the good fortune of like-minded governments in Europe, the Alliance has held together. INF is being deployed. The word from the bridge is that there have been no Soviet advances, as in Afghanistan, on Reagan's watch; and the Grenada success has made Americans feel safer. He has drawn the sting of the American peace and freeze movements, and lifted American eyes from the gloomy introspection of the 1970s. Mondale fairly questioned whether these achievements and this approach was



enough to solve complex problems in the Third World, or make the world safer. What about the risks of an arms race in outer space, or of involvement in Central America? But the inability of the Democrats to score points off Reagan on foreign policy demonstrated the remarkable public confidence he enjoys. America genuinely feels stronger and more confident. It is this psychological change which leads me to believe that better East/West relations may now be possible.

28. The Administration's underlying attitude to the Soviet Union will not change. As Shultz said in his recent speech in Los Angeles, there are no illusions about the repressive Soviet system and the incompatibility of aims and values between the super-powers. Nonetheless, there has been a clear evolution in the Administration's policy, brought about not only by the electoral campaign, but also by learning from past mistakes, talking to allies, and, above all, feeling stronger. The motto is still "peace through strength", but there is now more emphasis on patience, quiet diplomacy, and the search for common ground. I have no doubt that the message which the President gave to Gromyko in September will be reiterated in the next few days, and that openings for progress will be sought. There will also be pressure from within and without the Administration to try for a Summit Meeting quite soon. And I believe that the President, feeling that he has recouped American strength, now wants to go down in history in his second term as a man of peace.

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29. Whether he can is another question. It takes two to tango. It will depend on how the Soviet Union chooses to behave - another KAL disaster would kill the momentum of the moment - and on whether the Kremlin leadership are capable of responding to American initiatives, and doing business with a man they must cordially loathe. No less important will be the cohesiveness of the team he appoints: internecine bickering here can produce paralysis, or agreement only on negotiating positions so extreme as to be unnegotiable. Some strengthening of the NSC staff at senior levels, and some personnel changes in the Pentagon, may be needed.

30. But the biggest immediate problem is how the two sides can translate public rhetoric about the need for arms control negotiations into practical agreement to sit down and negotiate. In his UN General Assembly speech the President talked of a possible "umbrella" which would spread over the whole arms control process: this might permit some re-ordering of the existing negotiating furniture and thus a finessing of entrenched positions. The question is where the Russians will see an interest in negotiating. I believe that the faint outline of a deal is just discernible. It would involve trading the US desire to constrain the proliferation of Soviet offensive nuclear systems against the Soviet desire to constrain US developments in space and defensive systems. There are obvious difficulties, including that for the President

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of having to decide whether to accept some constraint on his cherished Strategic Defence Initiative, but an interim agreement, which might avoid these problems by involving only a temporary moratorium on the testing of ASAT systems, matched by interim constraints on strategic nuclear systems, could conceivably take rather rapid shape in 1985. Other arms control issues, including chemical weapons and MBFR, remain intrinsically intractable; it will be hard to generate major movement on either.

31. Nor will the Administration have any truck with arguments for appeasing the Russians in other areas - Europe, Asia, the Middle East or Central America - in the hope that this might help secure arms control agreements. On the contrary. The President will remain wholly committed to Europe's defence, and the maintenance of the Alliance. Indeed, the new Administration will now see the arrival of a new NATO Secretary General and the dawning of the post-INF era as an excellent opportunity to press for the strengthening of the Alliance's conventional defences. And Congressional pressures for greater European efforts will grow. While real rates of increase in the US defence budget will certainly be slower during the second Reagan term, it seems unlikely that they will fall below 3%. Institutional innovations, such as the strengthening of WEU, are no substitute in US eyes for improved defence effort on the ground. The US will support efforts to give NATO 'more bang for each buck'; but they will not see this as an argument for fewer bucks.



32. Talk of the US turning its back on Europe has been greatly exaggerated. Europe is where the main Soviet threat lies and the main focus of American interest. But the interest in Asia of an Administration with its roots in California will remain real. Troubles in the Philippines, or greater instability in the sub-continent (with post-Gandhi sectarian strife, Pakistani nuclear ambitions, Soviet irritation at the Afghan quagmire, and communal trouble in Sri Lanka) could provide major distractions, but the thrust of US policy will be to aim to deny the Pacific to the Russians, by consolidating the recent improvement in relations with China, and by encouraging Japan's emergence as a political actor in the region. We should not react too defensively, though we must be watchful for developments in this policy which might be at our commercial expense. The Americans will continue to try to develop political and defence cooperation within the Summit Seven, not least because it brings in Japan.

33. Denial will also remain the watch word in Central America. Reagan's first objective will still be to ensure that the guerrillas in El Salvador are kept at bay, and the Nicaraguans on the defensive. Further US financial support for the Contras seems certain to be an Administration objective, and a Congressional battle-ground, and may well prove a lost cause. But some clandestine encouragement of their activity will probably continue. Congress willing, the White House will go ahead with the massive



Kissinger aid programme to the area. The efforts to bring the Contadora process to meaningful fruition will continue. But the containment versus intervention debate over Nicaragua, described in my despatch of 6 September, has yet to be resolved. Pressure on Nicaragua will continue, and some of it may prove unpalatable to America's allies. If it led to the internal collapse of the Sandinistas, the White House would be delighted. Direct US military involvement will be no more attractive a proposition for a US President looking for his place in history than it was for one seeking re-election. But much more unattractive would be the further spread of communism in America's backyard. The Sandinistas and their friends must be aware that what happens next is largely up to them. Provocations, such as the introduction of MIGs, would attract direct retaliation, and pressure on the President to go all the way. I suspect that the President would reluctantly accept containment, if it works, but that it suits him well enough that he is able to begin his second term in an ambiguous position, with the ball to all intents and purposes in the Nicaraguan court. Meanwhile the threat is seen as a useful deterrent.

34. Policy in the Middle East will continue to be distorted by the relationship with Israel, and the super-power dimension (my despatch of 14 March). Bruised by their experiences in Lebanon, the Administration are increasingly preoccupied with the terrorist threat there and across the world. And if the Shultz doctrine on pre-emptive and retaliatory action becomes Presidential doctrine, -



and it is not yet - difficult foreign policy problems will arise. While President Reagan remains publicly committed to the search for a wider Middle East peace, based on the positions set out in his 1 September 1982 speech, the Americans see no hope at present of re-launching this initiative, given the composition of the Israeli government and continuing disarray on the Arab side. Shultz's strong preference is for low profile diplomatic activity, focussing initially on the generally agreed objective of Israeli withdrawal from Southern Lebanon. The Americans will also try to promote better Egyptian/Israeli relations and to encourage the Israelis to improve the living conditions and economic prospects of Palestinians in the occupied territories.

35. Despite the intractability of these and other regional problems, and regular US offers to Moscow to consult about them, I see no likelihood that the Americans will encourage the Russians to play an active role in their solution. Conversely the pursuit of better relations with Moscow will probably not be seen as a significant constraint on US policies in particular regions: Afghanistan will not be forgotten, and the effort to secure a Southern African settlement which ensures the withdrawal of Cuban forces from Angola will, I believe, continue. Linkage, while recognised recently by Shultz as a fact of life in international relations, will not take precedence over holding the line worldwide against communist encroachment, and pursuing American interests and responsibilities forcefully and forthrightly. And the



confidence to defend those interests on all fronts, while at the same time pursuing a new dialogue with Moscow, is there in abundance.

CONCLUSION

36. In short, I predict little change in domestic and international economic policies; and I foresee further squalls ahead on trade issues. More seriously, I fear that Reagan Mark II will exhibit all Reagan Mark I's reluctance to get to grips with the fundamental problem of the mounting budget deficit, despite all the damage high interest rates and an over-mighty dollar plainly do to the world economy. Continuity of policy on East/West issues may, on the other hand, bring progress on arms control, for Reagan has already changed, and Shultz is setting a climate of opinion very different from that of the extreme Reaganauts on their arrival in Office in 1981. But there will be squalls ahead on foreign policy issues too, with Central America perhaps the most immediate of American preoccupations. Anglo-American relations should lose none of their complexity - and, I would hope, none of their closeness - over the next four years. Your invitation to Shultz to join you at Chevening after the NATO Ministerial Meeting at Brussels could not be more timely: it seems to me to be essential to ensure that we not only share the American objectives for a peaceful, democratic and prosperous world, and recognise their pre-eminent role in achieving it, but are also in agreement about the means to bring it about.

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37. I am sending copies of this despatch to HM Representatives at the UN, NATO and the EC, in NATO and Community Capitals, and at Moscow, New Delhi, Canberra and Tokyo.

I have the honour to be,
Sir,
Your obedient Servant,

A handwritten signature in black ink, appearing to read 'Oliver Wright', with a long, sweeping flourish extending to the right.

Oliver Wright



SUMMARY

THE 1984 US PRESIDENTIAL ELECTION: WHY REAGAN WON

1. The expected personal triumph for Reagan the man; for a Sun Belt against a Rust Belt Presidential ticket; and for conservative rather than liberal policies.

(Paragraphs 1 - 3)

2. But the Democrats fare better in Congressional races, and should not be written off for 1988, provided they too can bring their ethos up to date. (Paragraphs 4 - 6)

3. Mondale's mistakes; efficient White House campaign management; a carping press; but a result that fairly reflects America's mood. (Paragraphs 7 - 9).