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THE WHITE HOUSE ~~SECRET~~

WASHINGTON

MEMORANDUM

Date: March 25, 1978

FOR ACTION:

✓Eizenstat
Moore
Watson
McIntyre concur by phone
Schultze— attached
Secretary Schlesinger — attached

FOR INFORMATION:

Vice President

FROM: Rick Hutcheson, Staff Secretary

SUBJECT: SECRET Blumenthal memo re Inflation, Energy and the dollar

YOUR RESPONSE MUST BE DELIVERED TO THE STAFF SECRETARY BY:

TIME: 9:00 a.m.

DAY: Monday

DATE: March 27

ACTION REQUESTED:

_X_ Your comments

Other:

STAFF RESPONSE:

____ I concur. ____ No comment.

Please note other comments below:

PLEASE ATTACH THIS COPY TO MATERIAL SUBMITTED.

If you have any questions or if you anticipate a delay in submitting the required material, please telephone the Staff Secretary immediately. (Telephone, 7052)

THE WHITE HOUSE
WASHINGTON

	FOR STAFFING
	FOR INFORMATION
	FROM PRESIDENT'S OUTBOX
	LOG IN/TO PRESIDENT TODAY
	IMMEDIATE TURNAROUND

ACTION	FYI	
	/	MONDALE
		COSTANZA
/		EIZENSTAT
		JORDAN
		LIPSHUTZ
/		MOORE
		POWELL
/		WATSON
/		McINTYRE
/		SCHULTZE

		ENROLLED BILL
		AGENCY REPORT
		CAB DECISION
		EXECUTIVE ORDER

Comments due to Carp/Huron within 48 hours; due to Staff Secretary next day

		ARAGON
		BOURNE
		BRZEZINSKI
		BUTLER
		CARP
		H. CARTER
		CLOUGH
		FALLOWS
		FIRST LADY
		HARDEN
		HUTCHESON
		JAGODA
		GAMMILL

		KRAFT
		LINDER
		MITCHELL
		MOE
		PETERSON
		PETTIGREW
		POSTON
		PRESS
		SCHLESINGER
		SCHNEIDERS
		STRAUSS
		VOORDE
		WARREN

3/24/78

Department of the Treasury

Office of the Secretary

to: Mr. Rick Hutcheson

Mike Blumenthal asked whether the President might see this Monday, before his trip. It is an information memo, and Mike has no objection to it being staffed routinely--so long as the President gets to see it before his trip.

Curt

Curt A. Hessler
Executive Assistant
to the Secretary
room 3407
phone 566-5901

URGENT INFORMATION

~~SECRET~~/GDS

THE SECRETARY OF THE TREASURY
WASHINGTON 20220

March 24, 1978

MEMORANDUM FOR THE PRESIDENT

FROM: W. Michael Blumenthal WMB

SUBJECT: Inflation, Energy, and the Dollar

I want to summarize for you a series of recent developments that, taken together, heighten my concern about the inflation, energy, and dollar situations.

Inflation

All the recent statistics are very troubling.

- Treasury and CEA now estimate that the CPI will rise 7.0-7.1% between the fourth quarter of 1977 and the fourth quarter of 1978. As recently as January, our published estimate was 6.1%.

- Early indications suggest that the GNP deflator will rise at an annual rate of 7.8% in the first quarter of 1978, as opposed to only 5.9% in the fourth quarter of 1977.

- In January, the CPI rose 0.8%, i.e. an annual rate of 9.6%. The February numbers will likely be equally discouraging.

- The wholesale prices of consumer foods increased by 2.9% in February, foreshadowing sharp retail food price increases.

As statistics like this accumulate in the next few weeks, they will fuel inflationary expectations throughout the private sector and will impart a new, upward thrust to the wage-price spiral.

Budget

Inflationary expectations may be further aggravated by the budgetary situation.

~~SECRET~~/GDS Jg 5/14/90

In January, we proposed a $60 billion deficit for FY 1979. We defended this figure as being smaller than the FY 1978 deficit. Since then, however, we have re-estimated the FY 1978 deficit at $53 and our proposed FY 1979 deficit at $59 (due in each case to spending shortfalls). This has put us in the very awkward position of arguing that the deficit should grow substantially between FY 1978 and FY 1979--even though by 1979, unemployment will have fallen further, capacity and labor markets will be tighter, and inflation will be higher. What's worse, there are enormous pressures, at every program point, to enlarge the FY 1979 deficit beyond our January figure.

A few examples:

Urban program	$1 - 3 billion
Farm legislation	$1 - 3 billion
Elimination of some tax reforms	$2 - 4 billion (at minimum)
Tuition Tax credit	$1 - 2 billion
Total	$5 -12 billion

Unless we exercise a very firm hand, the FY 1979 deficit will almost certainly balloon--despite shortfalls and contingencies--to $63 - 65 billion, i.e. at least a $10 billion increase over FY 1978.

Against this inflationary background, financial markets will inevitably tighten, either spontaneously or through a more restrictive monetary policy by the Federal Reserve.

Energy

The Energy Conferees have recessed for another 10 days, with no action in sight on COET. For this bill, the end is always in sight, but never in hand.

There are gathering signs that OPEC will not long hold back from price-raising action. King Khalid's letter to you is one straw in the wind. The Kuwaiti-led drive for a 5% price rise is an equally serious portent.

Dollar

Given this environment, the foreign exchange markets remain nervous. The pressure has momentarily subsided on the German mark and Swiss franc but demand for the Japanese yen is especially strong. The dollar has depreciated against the yen by 4.4% so far this month, despite intervention by Japanese authorities totaling $4.1 billion. We are seeing signs that central banks as well as private firms are shifting financial reserves into yen; our information is incomplete and sensitive but the amounts appear to be quite substantial.

Private bankers are telling me that capital is continuing to flow out of the U.S., following an estimated fourth quarter 1977 net outflow of almost $10 billion.

I am very concerned about the impact on the market of next week's release of the CPI and leading indicators for February. The leading indicators may be down due to a decline in money supply and to weather and coal strike effects, following on the heels of a decline in January of 1.9%. It is unlikely that this and the inflation figures for February will be well received, especially after we just this week revised upward our estimate for the 1977 current account deficit to $20.2 billion.

These trends seem to me to dictate three conclusions:

1. Immediately after your trip, we should inform the Congress that, absent prompt passage of COET, circumstances will require imposition of an oil import fee. This would not be intended as a threat but as a step necessary to our economic and political security.

2. The anti-inflation program you announce after your trip must be tough and credible. I have asked the EPG to review the plan submitted this week with this in mind: we may propose additional options to you.

3. In light of the economic and political risks of accelerating inflation and continuing weakening of the dollar, we should review our economic goals and the fiscal policies designed to achieve them.

We still have time to master these related threats to our prosperity, but not much time. If we shy from taking difficult actions now, we may face almost impossible difficulties in the future.

~~SECRET~~

Re:
Blumenthal Memo re Inflation, Energy & the Dollar

CONGRESSIONAL LIAISON:

Premature imposition of oil import fees will almost certainly kill chances for passage of both natural gas and energy tax bills. Import fees are important for what they signal -- a national resolve to deal with energy problem -- and the same signal could be sent by a positive movement on COET by Congress. (DT & BC)

Department of Energy
Washington, D.C. 20585

March 25, 1978

MEMORANDUM FOR THE PRESIDENT

FROM: James R. Schlesinger JRS

SUBJECT: Mike Blumenthal's March 25 Memo

"Steady as you go" would appear to be the appropriate guide for policy. Our position would be embarrassing if policy decisions acquired the characteristics of stop and go.

The Administration has opted for a policy of expansion, recognizing that expansion entails the risk of a somewhat greater rate of inflation. In the course of pursuing its policy of expansion, the Administration has recently recommended a $25 billion tax cut to stimulate the economy. Having recommended such a cut, we would be in an awkward public position if we were perceived to be wringing our hands about the prospective size of the deficit. If the deficit should increase in the way that Mike has suggested (it will undoubtedly be restrained by shortfalls in outlays), it would be about five percent above that projected by the Administration in January. Approximately one-third of the projected deficit is based upon the Administration's recommendations for a tax cut. For us to be in a posture of hand-wringing about a small projected increase in the budget deficit -- subsequent to the Administration proposals to stimulate the economy through an expanded budget deficit -- would raise the question of our own steadiness, indeed, whether or not we know what we are doing.

On energy matters -- we have finally forged what appears to be the basis of a settlement on natural gas after an embittered history of 25 years of debate and substantial differences between the positions of the two houses. With natural gas prospectively to be settled, the COET issue should be resolved one way or the other shortly thereafter. In fact, it is not accurate to indicate that there is no action in sight on COET. Recent public indications by

Senator Long of his willingness to support COET, the growing interest in the Social Security option for COET revenues and meetings planned for next week involving Congressmen Ashley and Ullman with key producers to explore a workable COET and oil incentive program are all positive signs that contribute to a growing feeling that COET can be enacted following settlement of the natural gas issue.

In the midst of these Congressional deliberations, it would seem ill-advised to impose fees and thus raise a divisive issue. Import fee imposition may be desirable, but <u>must</u> be approached carefully. If the natural gas issue is resolved, careful soundings can be made regarding Congressional reactions to the imposition of such fees. One must also bear in mind the very small impact on oil imports that would come in the short term from such an imposition, and carefully avoid creating the impression that we would expect a major impact. Exaggeration on our part in itself would rightly become a focus of debate.

The dollar is indeed in trouble. Its difficulties will not be resolved until we get the steadily growing deficit in the balance of trade under control. That deficit -- putting aside energy costs -- has increased dramatically. This year it will grow still more even though the foreign exchange costs for energy will fall. If we are approaching a crisis, we should accept the full implications. We should examine all those measures that might deal effectively with the crisis -- rather than palliatives. To deal effectively with a balance of trade deficit of this magnitude should imply consideration of an import surcharge and restraint of tourist expenditures and the cost of maintaining dependents overseas. Indeed, we may ultimately face a dilemma whether continued expansion <u>plus</u> continuing trade liberalization are consistent with a successful effort to preserve the dollar's international value.

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

March 27, 1978

MEMORANDUM FOR THE PRESIDENT

FROM: Lyle E. Gramley LEG by Peter Gould

Subject: Blumenthal memo on Inflation, Energy and the Dollar

I share Secretary Blumenthal's concern over recent developments in the domestic economy and their potential for adverse impact on the strength of the dollar abroad. There is time, however, to shape the course of budgetary policy in response to these developments with deliberation. The recent worsening in the outlook for inflation in 1978 is due in large measure to increasing food prices and the effects of the depreciation of the dollar. These effects on overall prices are likely to be transitory, and confined to 1978. The food price runup is likely to have run its course by mid year.

Some worsening in the underlying rate of inflation may also be underway, and that is a more serious concern for 1979 and beyond. We will need to think through carefully what implications that may have for our overall economic policy strategy.

While you are away, the CEA will be undertaking a careful review of the outlook for economic activity and prices and its implications for the appropriate course of budgetary policy. We will be in a better position to assess the situation and advise you when you return.

THE WHITE HOUSE
WASHINGTON

4/3

Withdrawn –

New memo to be
Submitted,

per Curt Hessler.