CONCLUSIONS of a Meeting of the Cabinet
held at 10 Downing Street on
TUESDAY 1 JULY 1975
at 9.30 am

PRESENT
The Rt Hon Harold Wilson MP
Prime Minister

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<td>The Rt Hon Harold Lever MP</td>
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<td>Chancellor of the Duchy of Lancaster</td>
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The Cabinet discussed counter-inflation policy. Their discussion and the conclusions reached are recorded separately.

Cabinet Office

1st July 1975
CABINET

CONFIDENTIAL ANNEX

CC(75) 31st Conclusions

Tuesday 1 July 1975 at 9.30 am

COUNTER-INFLATION POLICY

THE PRIME MINISTER explained that a small group of Ministers had met the previous day to consider what action might be needed in the light of the very serious turn of events in the foreign exchange markets. They had agreed that if confidence were to be maintained in sterling it was essential that a short statement be made in the House that afternoon, saying that the Government's counter-inflation measures were in an advanced state of preparation, outlining what these might be and making clear that firm proposals would be published within the next few days.

THE CHANCELLOR OF THE EXCHEQUER said that the Cabinet had recognised at its meeting on 20 June that a counter-inflation policy had to be prepared quickly, but they had always been aware that events might overtake even the rapid timetable to which they had been working. Sterling was now crumbling, and the Government would have to take decisions and announce them that day if a further, rapid, deterioration in the situation were to be avoided. The rate of exchange against a 'basket' of other currencies had been slipping gradually ever since the last quarter of 1974, but recently the decline had accelerated. In April and May it fell by 4 per cent; in the first three weeks of June it fell by a further 4 per cent; and on the previous day alone it had fallen by 1 per cent. Up to the end of 1974 its fall had been with the dollar; and this had meant that the oil producing countries had no incentive to transfer their funds from London to New York. Now the rate was going down against the dollar, and at 9.15 that morning the dollar rate stood at 2.1740 compared with a rate of 2.2248 on the previous Friday. Among the big sterling holders, Nigeria had indicated a month previously that they were planning to diversify their holdings; the Kuwait Government had said that they would begin to move funds when the rate fell below 2.20; and the Saudi Arabian Government had said that they would start to move funds once the rate was below 2.17. The Government was therefore faced with the risk of a massive withdrawal of funds and if action were not taken the rate would drop further still. This would have an adverse effect upon
inflation, since every 5 percentage points depreciation in the rate of exchange led to an increase of about 1 per cent in domestic prices - especially food - about six months later. There were $6,000 million in the reserves, of which $5,000 million were needed for current liabilities. Any further drain would mean borrowing from the International Monetary Fund, who, after the first, limited, tranche, would certainly require not only an effective incomes policy but also deflationary action and heavy cuts in public expenditure as the price of further assistance. Cuts in public expenditure would not help the inflationary situation, but would certainly lead to additional unemployment. It was therefore imperative to announce that afternoon how the Government proposed to deal with cost inflation and incomes.

Enormous progress had been made with the Trades Union Congress (TUC). Although the General Council had so far only asked the Economic Committee to consider the proposals in the paper circulated as C(75) 67, both Mr Len Murray and Mr Jack Jones had committed themselves to getting inflation down to a level which was roughly the same as that which the Government had in mind and also to relating pay increases to that target. Such a policy would probably get a two-to-one endorsement on the General Council. It would be possible to demonstrate to the TUC that such an inflation target required keeping pay increases down to 10 per cent, or about £6 at a flat rate. The problem was how to convince opinion both at home and abroad that such a "norm" would be observed, the TUC having the previous year committed themselves to easier guidelines which many of their constituent members had ignored. This year the situation was even worse in that some unions had already rejected the idea of pay restraint at all. How then could compliance be achieved? He had considered various sanctions. In the public sector it would be possible to establish cash limits for nationalised industries and local authorities, and require the cost of any excessive pay settlement to be offset by cuts in other expenditure. This might require legislation. For the private sector, it would be possible to amend the Price Code so as to disallow for price increase purposes the cost of any excessive pay settlement; but this was likely to have little or no effect on capital intensive industries and on those engaged primarily in exports. He doubted whether a voluntary policy, coupled with financial sanctions of this kind, would carry the conviction needed to stop further loss of confidence in sterling. He considered therefore that it would be essential for the Government to say that they proposed to take action to make it illegal for employers to pay more than the norm. If this were done the overwhelming majority of employers would comply with the law. He was not proposing legal sanctions on the workers. His impression was that, while the TUC could hardly be expected to approve such a policy, they would wish to see the Labour Government survive, and, in spite of criticising them, would do their best to make the policy work.
In discussion it was argued that the proposal put forward by the Chancellor of the Exchequer presented great difficulties. Making any norm into a legal limit was something which would be strongly opposed by the whole trades union movement. It bore all the hallmarks of a policy thought up hurriedly and without adequate consideration of all the difficulties and anomalies to which it could give rise. It was not proposed to use criminal sanctions against workers; but once started on the statutory road, no-one could be sure how things would develop. If there were a legal limit, and the coal miners went on strike against it, it would in effect be a strike in defiance of the law. Furthermore there would be grave difficulties over the transitional period, not only with the seamen who were awaiting the results of arbitration, but other groups, such as the police, who had already made a settlement above 10 per cent to start in September, and post office workers who had a forward indexation provision in their last settlement. It was not in fact possible to draw a clear distinction between the two pay rounds. Any anomaly could lead to industrial action in a situation where the Government would have no sympathy from the TUC, who would certainly be opposed both to the general policy and to the particular level of wage increase contemplated. If negotiations with the TUC could continue, there was a chance that agreement might be reached on, say, a 12½ per cent norm, which would not in practice be so much different from a 10 per cent one as to justify putting at risk all the goodwill and co-operation that might be lost by going for a statutory policy. In effect, the proposal was that there should be a wage cut, with no discussions and no advance preparation. Such a policy might collapse in the outcry which it would provoke. It was essential to continue discussing the problem with the TUC.

Against this it was strongly argued that, desirable as an agreement with the TUC would be, there was no prospect of getting one since the Government would not be able to concede the quid pro quo which the TUC, judging by the document circulated as C(75) 67, would be likely to demand. There had been a considerable change in the mood in the country, and the overwhelming weight of opinion amongst the general public and amongst ordinary trades union members was by no means identified with that of the TUC and the union activists. In favour of making an early statement it was argued that the situation was extremely serious - more so than in 1966-67 - and unless control was re-established the Government might be destroyed. Indeed the hyper-inflation that would follow a collapse of sterling could lead to the total destruction of the value of the currency and of society itself. Even if the support of the TUC could be obtained - and this was by no means certain - there simply was not time. What was needed to stop the slide on the foreign exchange markets was an unambiguous statement of the Government's determination to control pay increases. This would provoke a strong challenge from the trades union movement, and the Government would have to face a very difficult period. Nevertheless, to delay the statement till later could precipitate an irretrievable situation. It had to be recognised however that the worst
situation would be a statement which failed to stop the outflow, so that the Government were then compelled to return within days to make a further, and much tougher, statement.

Against making a statement that day it was argued that it was not yet clear that such a move was in fact necessary. If it were, it was questionable whether anything which the Government could say would in fact hold the rate. Alternative courses which might be examined included the possibility of giving sterling guarantees to the major holders, a possibility which should certainly be examined before adopting an incomes policy which would divide the Labour movement. Such guarantees would, however, be likely to be extremely costly, and it was improbable that they could be confined to the major holders only. Another alternative course was to allow the rate to continue to fall until it found the level at which market forces would push it up again. It was accepted that this could involve a very difficult period for the country, but equally so the proposal by the Chancellor of the Exchequer was in effect to put into reverse the whole strategy and philosophy of the Government just at the moment when responsible trades union leaders were making dramatic moves to achieve a voluntary incomes policy.

In further discussion it was argued that, if there were to be a statement that afternoon, it was important that it should say clearly that 10 per cent or equivalent was the maximum pay increase which the Government had in mind, together with some reference to prices and price control, although the latter would need to be touched on only lightly in view of the need to avoid a further squeeze on profits and a consequential adverse effect on investment prospects. On the question of sanctions, it could be said that the Government had a formidable battery of sanctions, some financial and some statutory, already at its disposal, and would be prepared to take further powers if necessary. While the statement would make it clear that excess settlements in the public sector would mean cuts in other expenditure, it should not be ruled out that the available wages fund might be allowed to be higher if genuine productivity could be achieved or reductions in overmanning. It was important that the statement should make an impact on foreign opinion, but it was suggested that it might avoid detail on either prices or wages and take the form of a general statement of intention and determination. The inflation target could be given, together with an assurance that the Government would take all appropriate measures to achieve it, and was even now discussing the problems of wages and prices with both sides of industry. Precision about objectives and targets rather than about means would avoid giving hostages to fortune. Against this it was suggested that such studied vagueness could be both ineffective in helping the exchange rate and arouse the worst suspicions of the trades unions. In fact both the Chancellor of the Exchequer and the Prime Minister had already, in public speeches, referred to the inflation target, without any visible effect on foreign opinion. It
might be possible to say that the Government were determined to control pay increases, and explain in general terms how this might be done, but to add that the Government would seek to achieve this by voluntary means, but would take reserve powers for use in case this failed. Another possibility might be to say that the Government would discuss the possibility of a voluntary policy further with the TUC, but that if they could not show within a matter of days that an effective agreement could be reached, then the Government would be prepared to take legislative powers. On the other hand, there was much to be said for the view that if there were a statement containing some reversal of present policy, that reversal should be total and complete, since a partial retreat would only provoke pressures which would eventually force the Government further along the same road. Whatever the formula adopted it should be made clear that a major purpose of the policy was to remove the disabling effect of inflation on the Government's ability to stem the increase in unemployment. The statement should also emphasise the importance of a policy of this kind in protecting those least able to fend for themselves.

In the course of discussion the following further points were made:–

a. Any question of imposing criminal sanctions against workers should be completely ruled out. Not only would this provoke strong opposition from the trades union movement, but it would also be quite impracticable to operate.

b. The use of the Prices Code to discourage excessive wage settlements, for example by disallowing the cost of the excess for price increase purposes, would have little effect upon capital-intensive industries, where wage costs were a small proportion of total expenditure or in exporting industries, where the Prices Code did not apply. This meant that such industries would have little incentive to resist excessive settlements, and once they had been made comparable workers in other industries would seek parity of treatment. This argued for legislative controls over employers. One possibility would be to use the Prices Code as a sanction by allowing no price increase for 6 months (compared with the usual 3 months) where an excessive settlement had been agreed.

c. Rents presented a difficult problem, and the right solution might be to relate rent rises to the wages norm.

d. It should be possible to restrict assistance under Sections 7 and 8 of the Industry Act to those firms who observed the pay policy, and to refuse it to others.
e. One possible alternative course would be to impose a total freeze on prices and wages for a limited period, thus buying time to think out the details of a longer term policy. The disadvantage of this was that it would not restore foreign confidence since it would imply that the Government had not yet found a solution.

f. There would no doubt be pressure from some quarters for a further cut in public expenditure designed to reduce the size of the public sector borrowing requirement. This should be met by referring to the cash limits which it was proposed to impose upon the nationalised industries and local authorities, and to the extension of the system of cash control for public expenditure where this was appropriate. It might also be possible to indicate that the stringency applied to public sector spending in 1976-77 would be extended to later years.

g. The comparisons which had been made with 1966 and 1972 were not apt. The true comparison was with 1931. What was now contemplated was a real cut in wages, a policy which would not command TUC support. No policy could be made to work without trade union goodwill. The policy which had been proposed would be profoundly damaging to the Labour movement. A 10 per cent norm would be difficult to justify to low-paid groups of workers, such as the National Health Service ancillaries. They would have suffered 25 per cent erosion of the value of their pay since their last settlement, and over the coming 12 months might suffer a further erosion of 12½ per cent. Against this total erosion of 37½ per cent, they were to be offered compensation of only 10 per cent. The only answer to this was that they would have received a considerable boost at their last settlement, so that their subsequent decline was from a high point.

h. A 10 per cent norm would, if fully applied, and assuming no large-scale withdrawal of savings, lead to a deflationary effect of some £300 million, equivalent to an addition to unemployment of some 30,000. However, in such a situation drawing on savings was likely to occur; and success with the inflation rate could increase exports and investment and thus add to employment, perhaps sufficiently to offset the adverse effects.

THE PRIME MINISTER, summing up the discussion, said that the strong balance of opinion in the Cabinet was in favour of a statement being made that afternoon. They were more evenly divided on what such a statement should contain. But if an early statement was to be made it was essential that it should be framed to have the best possible chance of dealing with the crisis of confidence in the foreign exchange markets and also of keeping open the possibility of reaching an
agreement with the TUC. It should therefore begin by stating firmly the complete determination of the Government to deal with the situation, indicating that the Government's target was to get the rate of domestic inflation down to 10 per cent by the third quarter of 1976, and down into single figures by the end of 1976. The importance of this for the housewife and for social security beneficiaries should be stressed. Furthermore, it should indicate that this would require that pay increases be kept within a maximum of 10 per cent (or its equivalent) for the whole of the coming pay round. The statement would say the Government had reached an advanced stage in working out a policy to deal with the situation, and that consultations had begun with the TUC and CBI. The policy would have to cover the range of sanctions open to the Government, including the use of the Prices Code, the imposition of cash limits on nationalised industries and local authorities to ensure that the cost of any excessive pay settlements had to be met from expenditure cuts elsewhere and not from additional subsidies, increased borrowing or higher charges; and the limitation of dividends. It should be made clear that, while the Government would greatly prefer to proceed on the basis of a voluntary policy agreed with the Confederation of British Industry (CBI) and the TUC, if an effective agreement could not be obtained on the basis of the Government's targets by a very early date, then the Government would be obliged to legislate to impose a requirement on both public and private sector employers to comply with the 10 per cent limit on wage increases.

He proposed that the Cabinet Secretariat should be instructed to prepare a draft on these lines, which could then be considered immediately after lunch by a small group of Ministers consisting of himself, the Lord President, the Chancellor of the Exchequer and the Secretaries of State for the Environment, Employment, Prices and Consumer Protection and Trade. After the statement had been made, work should proceed rapidly to draft both the legislation which would be necessary if agreement could not be reached with the TUC, and the White Paper which would be needed in any event.

The Cabinet -

1. Took note, with approval, of the Prime Minister's summing up.

2. Instructed the Secretary of the Cabinet to prepare a draft of the statement on the lines indicated in the summing up.

Cabinet Office

2 July 1975
The Rt Hon Harold Lever MP
Chancellor of the Duchy of Lancaster

The Rt Hon Fred Mulley MP
Secretary of State for Education and Science

The Rt Hon Robert Mellish MP
Parliamentary Secretary, Treasury

The Rt Hon Lord Shepherd
Lord Privy Seal

The Rt Hon Reginald Prentice MP
Minister for Overseas Development

The Rt Hon John Silkin MP
Minister for Planning and Local Government

THE FOLLOWING WERE ALSO PRESENT

The Rt Hon Edmund Dell MP
Paymaster General (Item 4)

Mr Alan Williams MP
Minister of State, Department of Prices and Consumer Protection (Item 4)

SECRETARIAT

Sir John Hunt
Sir Patrick Nairne (Item 2)
Mr P Benner (Items 1, 3 and 4)
Mr T F Brenchley (Item 2)
Mr E J G Smith (items 1 and 2)
Mr A D Gordon-Brown (Item 4)

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