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CM(76) 35th Conclusions

COPY NO 77

CABINET

CONCLUSIONS of a Meeting of the Cabinet held at 10 Downing Street on

WEDNESDAY 1 DECEMBER 1976

at 10.30 am

PRESENT

The Rt Hon James Callaghan MP
Prime Minister

[The] Rt Hon Michael Foot MP
[Lo]rd President of the Council

The Rt Hon Lord Elwyn-Jones
Lord Chancellor

[The] Rt Hon Denis Healey MP
[Chan]cellor of the Exchequer

The Rt Hon Anthony Crosland MP
Secretary of State for Foreign and Commonwealth Affairs

[The] Rt Hon Merlyn Rees MP
[Secr]etary of State for the Home Department

The Rt Hon Shirley Williams MP
Secretary of State for Education and Science and Paymaster General

[The] Rt Hon Anthony Wedgwood Benn MP
[Secr]etary of State for Energy

The Rt Hon Eric Varley MP
Secretary of State for Industry

[The] Rt Hon Peter Shore MP
[Secr]etary of State for the Environment

The Rt Hon Roy Mason MP
Secretary of State for Northern Ireland

[The] Rt Hon Bruce Millan MP
[Secre]tary of State for Scotland

The Rt Hon John Morris QC MP
Secretary of State for Wales

[The] Rt Hon Fred Mulley MP
[Secre]tary of State for Defence

The Rt Hon Albert Booth MP
Secretary of State for Employment

[The R]t Hon David Ennals MP
[Secre]tary of State for Social Services

The Rt Hon Edmund Dell MP
Secretary of State for Trade

[The R]t Hon Lord Peart
[Lord] Privy Seal

The Rt Hon John Silkin MP
Minister of Agriculture, Fisheries and Food

The Rt Hon Roy Hattersley MP
Secretary of State for Prices and Consumer Protection

The Rt Hon William Rodgers MP
Secretary of State for Transport

The Rt Hon Stanley Orme MP
Minister for Social Security

The Rt Hon Harold Lever MP
Chancellor of the Duchy of Lancaster

The Rt Hon Reginald Prentice MP
Minister for Overseas Development

ALSO PRESENT

The Rt Hon Michael Cocks MP
Parliamentary Secretary, Treasury

SECRETARIAT

Sir John Hunt
Mr D le B Jones
Mr J A Marshall

SUBJECT

IMF NEGOTIATIONS

IMF NEGOTIATIONS

Previous Reference: CM(76) 34th Conclusions, Minute 3

The Cabinet discussed the negotiations with the International Monetary Fund. Their discussion is recorded separately.

Cabinet Office

1 December 1976

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CABINET

LIMITED CIRCULATION ANNEX

CM(76) 35th Conclusions

Wednesday 1 December 1976 at 10.30 am

IMF NEGOTIATIONS

Previous Reference: CM(76) 34th Conclusions, Minute 3

The Cabinet had before them four papers on the alternative courses which were open to the Government - a memorandum by the Chancellor of the Exchequer (CP(76) 123), a memorandum by the Secretary of State for Foreign and Commonwealth Affairs (CP(76) 118), a memorandum by the Secretary of State for Energy (CP(76) 117) and a memorandum by the Secretary of State for the Environment (CP(76) 124); together with three memoranda by the Chancellor of the Exchequer (CP(76) 111, 122 and 125) and a note by the Central Policy Review Staff (CP(76) 116) which were also relevant.

THE PRIME MINISTER said that the formal position of the United States and West German Governments was that the negotiations over the loan were for the International Monetary Fund (IMF) to handle; and although no doubt they both had their contacts with the IMF, it seemed that they were not prepared to bring pressure to bear on the Fund on the United Kingdom's account. The West German Chancellor was, however, impressed with the gravity of the situation, and fearful of the possibility that the world might start moving down the trade restriction route. He reminded the Cabinet that the loan negotiations were only one element in the situation, and there were good grounds for believing that others might be negotiable, eg an international arrangement to cover the sterling balances. Without an agreement with the IMF over the loan, there was however no question of covering those balances, and no question of any other bilateral borrowing. He had talked privately and separately to Mr Len Murray and to Mr Jack Jones but there were difficulties in any wider consultation with the Trades Union Congress (TUC) in view of the need for complete secrecy. He suggested that at that day's meeting they should concentrate on the broad strategic options open to the Government, leaving more detailed consideration till their meeting the following day.

TOP SECRET

THE SECRETARY OF STATE FOR ENERGY said that the Cabinet had to reach a political judgment on the situation. The West German Chancellor had shown himself unsympathetic; the present United States administration was a lame duck; and President-elect Carter was an unknown quantity. All of this pointed to the need for self-reliance. The country was in the depths of a slump which would deepen. With $1\frac{1}{4}$ million unemployed the Government must go for reflation in order to move towards their target of getting unemployment down to 700,000 by 1979. They must expand the manufacturing base; and they must safeguard social security benefits. The Cabinet had to choose between two alternative strategies; that which he proposed, and that which was put forward by the Chancellor of the Exchequer which, with its deflationary impact, was a departure from, not a continuation of, the existing strategy. In his view deflation was unacceptable. The expansion which was needed could only be achieved through protection, which was legal both under the General Agreement on Tariffs and Trade (GATT) and under the rules of the European Economic Community (EEC). The Government should seek international support for a protectionist strategy which would involve both import controls on manufactures and, at least for an interim period, exchange controls to check speculative outflows and facilitate a differential rate of interest for official holders of sterling, together with control of bank advances and reserve powers to introduce planning agreements. Not to have even attempted to agree such a set of policies internationally would be inexplicable to the Labour movement. If the Government deflated, undermined the industrial strategy, cut back social security benefits and accepted international control of the country's economic affairs, their political stance would be impossible. Under his proposals the Government would be seen to be defending the national interest, and in his view in this situation the IMF might well be prepared to make the loan available; but if they did not, the Government would have a tough self-reliant strategy to follow. He saw no prospect of survival for the Government if they allowed unemployment to increase in order to meet the demands of international bankers. The effect of the policies he proposed would be to bring about a more rapid recovery of employment than the other proposals before Cabinet.

THE SECRETARY OF STATE FOR THE ENVIRONMENT agreed that the choice before the Cabinet was deflation or some alternative strategy. The Chancellor of the Exchequer was proposing a reduction of £1 billion in public expenditure in 1977-78 - which would increase unemployment - to be followed by a further cut of £1 billion in 1978-79. This would be a political tomb for the Government. In response to such measures the IMF would issue the loan in tranches to enable them to police the United Kingdom's economic behaviour and would require a Letter of Intent ruling out import controls. In his view the heart of the country's present problems was that we were running a deficit on our current account and had exhausted all possible sources of borrowing. It was therefore necessary to close the trade gap and get into surplus as quickly as possible, and the best and speediest way of doing this would be by imposing controls on imports. He did not share the views of those who wanted such controls for a prolonged period, since he did not believe that British industry would achieve the necessary regeneration behind protective barriers. All he wanted was to get into current balance as soon as possible. It had been objected to this course that it would provoke retaliation; but he pointed out that under Article XII of the GATT, paragraphs 1 and 2 (a) (i) and (ii) of which he quoted _in extenso,_ such action by the United Kingdom was fully justified and there was no provision for retaliation by other members (unlike the position under Article XIX, which dealt with selective controls, and which did concede such a right). The trade pledge entered into by members of the Organisation for Economic Co-operation and Development, which the Government had twice reaffirmed, contained the reservation that it was dependent upon the surplus countries behaving in such a way as to stimulate world trade, and the failure of the surplus countries in this respect removed any inhibition on account of that pledge. It was true that there was some risk of emulation by those in a similar position to the United Kingdom. Italy would undoubtedly follow suit, and just possibly France and perhaps such countries as Australia, New Zealand and Canada, who were all in balance of payments difficulties; but the major surplus countries - the United States, West Germany and Japan - would have no right to do so. In his view it should be possible to adopt import controls and to persuade other countries that it was sensible for us to do so. This would lead to a surplus of £4 billion on current account in 1978. Admittedly there remained the short term problem of obtaining the necessary financial assistance to cover the immediate period of difficulty, but it should be possible to bridge this gap, perhaps by introducing import deposits. The IMF could not afford to refuse help to a major democracy, but if this should happen one alternative possibility would be to seek to roll forward to a later date the repayment of the short term standby credit, at present due to be repaid on 9 December. Another possibility would be to arrange for the mobilisation of the country's capital assets and arrange for their orderly release until the current account deficit was closed.

THE FOREIGN AND COMMONWEALTH SECRETARY said that neither of the strategies proposed by the Secretary of State for Energy or the Secretary of State for the Environment were necessary on economic merit. The Government's present economic strategy was working and the case had not been made out either for import restrictions or for a further deflation of £1 billion. In his view expenditure cuts on such a scale would be disastrous. If the IMF pushed the Government that far, it would become necessary for the Prime Minister to state publicly that the only alternative to such a course would be a siege economy. The reaction to such a threat would be that the United States and Germany would ensure that the IMF would act in such a way as to avert that possibility. The question was: what deal would be tolerable with the IMF. In his view it would be acceptable to cut the public sector borrowing requirement (PSBR) by £1 billion as long as this was done mainly by non-deflationary measures, such as the sale of the British Petroleum shares. Quota restrictions would be wholly inconsistent with the IMF's attitude; but it might be possible to do something about import deposits. Taken with £1 billion of other cuts, the PSBR would go below £8½ billion in 1977-78, and this would appear the more acceptable as being part of a larger strategy. The deflationary effects of import deposits were very much less than those of comparable expenditure cuts. When the announcement of an agreement with the IMF was made, the Government should at the same time announce the cuts which they had recently agreed but not yet made public - although he accepted that this was a presentational point only, since the cuts were policy changes needed to keep expenditure within planned limits.

In the course of discussion the following points were made:-

a. It was by no means clear, given the limited scale of the United Kingdom's foreign exchange reserves, that if a policy of import controls were adopted it would be possible to finance the external deficit, which would inevitably persist for some time, without having to resort to such steps as drastic rationing. It might be, as the Secretary of State for the Environment had suggested that, faced with proposed action under Article XII of the GATT, the IMF would make the loan available; but if this proved wrong the country could be facing a bankrupt situation. It had been argued that it would be necessary to impose exchange controls at the same time as import controls in order to stop a capital outflow; but it was pointed out that the United Kingdom in fact enjoyed a net inflow of capital, since much of what was scored as an outflow was in fact capital investment overseas from retained profits.

b. It was suggested that if, as part of the price of a loan, the IMF required an undertaking that import controls would not be introduced, then a decision against them now could not be reversed; but it was pointed out that the Letter of Intent would only specify the need for prior consultation. The IMF would wish to monitor the United Kingdom's progress over a two-year period and they would propose to spread the release of the loan over that time - although it was hoped to get a large part of the loan as soon as the agreement was signed.

c. It would be a mistake for those who regarded it as of great importance that the United Kingdom should have the loan to underestimate the negotiating power which this need placed in the IMF's hands. Furthermore, the IMF view was that the present exchange rate was too high rather than too low, so that they might well be prepared to go to the absolute limit in negotiation.

d. There must be doubt about the Foreign and Commonwealth Secretary's proposal that, if the IMF pushed for large expenditure cuts, the Prime Minister should state publicly that a seige economy was the inevitable alternative. Such a move could lead to a collapse of confidence which made it an extremely risky procedure.

e. A go-it-alone policy was not viable, since the country would be unable to finance the needs of her basic industries. Import deposits were not a painless alternative, and it was recalled that the import surcharge scheme of 1964 had provoked strong opposition in the countries of the European Free Trade Area and a withdrawal of their co-operation in wider fields. Action on imports was contrary to the interests of a country which, like the United Kingdom, traded world-wide. The reaction of the EEC would need to be considered, particularly on such otherwise unrelated issues as the Green Pound, through which the United Kingdom was at present enjoying a subsidy of some £500 million a year.

f. Rising unemployment was inevitable under any of the policies before the Cabinet. The rationalisation of industries such as shipbuilding, aircraft and the motor car industry, as well as coal and steel, was all aimed at improving productivity and thus - at least in the short term - increasing unemployment. It had to be remembered that, thanks to the Labour Government, the worst of the misery had been taken out of unemployment by the payment of reasonable levels of benefit.

g. It would be important to avoid making the mistake of doing too little - even if that were enough to get the loan - and then having to do more and worse at a later stage. It was by no means clear that £1 billion off the PSBR by means which would not affect employment would create the necessary market confidence; while import deposits involved grave disadvantages in the second year when their effects were reversed.

h. If it proved possible later to reduce personal direct taxation, this would release a considerable fund of goodwill among Labour Party supporters. It might be worth considering the possibility of differential taxation in favour of those who worked in specified sectors such as manufacturing industry. More immediately, the possibility of an increase in Value Added Tax should not be ruled out, since the effects of this on the retail price index would probably be less damaging than that of a fall in the value of the pound.

i. All the main schemes put before Cabinet had three aims in common: first, the desirability of obtaining the IMF loan if this were possible; second, the need to cut imports, whether by controls or by higher unemployment; and third, the survival and improvement of British industry. These three ends would be best served by adoption of the scheme put forward by the Secretary of State for the Environment.

j. It was argued that although the morale of the Party was very low, it would hold together to put through the Chancellor of the Exchequer's proposals. Against this the view was taken that it was too much to ask the Government's supporters to stomach a third package in a year, including cuts in the social security field which required legislation.

THE CHANCELLOR OF THE EXCHEQUER said that the Cabinet must decide which of the courses before them was the least disagreeable. His proposals had been condemned as deflationary, but he reminded Cabinet that the large PSBR in prospect was inflationary and a cut in it would simply modify the degree of inflation. The under use of capacity in the country was part of a world phenomenon. In his view the right adjustment to make to such a situation must take full account of the monetary and financial factors and the effect they had upon the real economy. The PSBR had to be cut because it was impossible to finance it at the prospective high level save by printing money or maintaining excessive interest rates. Without the IMF loan the external deficit could not be financed, there would be no safety net for the sterling balances, no acquiescence by other countries in a scheme of import deposits, and no bilateral lending. He reminded Cabinet that if, in the event, the PSBR looked like being lower than now forecast, it was always possible to feed demand into the economy through cuts in taxation in the Budget, a course which would prove extremely popular. In his view failure to reach agreement with the IMF would cause unemployment to rise very rapidly. A siege economy of the kind envisaged by the Secretary of State for Energy implied also a command economy, which was contrary to the maintenance of the mixed economy to which the Government was committed. The Secretary of State for the Environment's alternative would not cut unemployment, and being a short term policy designed to last only until the balance of payments was in surplus, it involved all the short term disadvantages without any of the longer term prospects of improvement. He reminded Cabinet that effectively action had already been taken on imports since the depreciation which had taken place in the exchange rate since 1975 had been equivalent to a tariff of 25 per cent.

THE PRIME MINISTER, summing up the discussion, said the Cabinet had now reached a point at which it should be possible to reach a conclusion on the general economic strategy to be adopted. It was clear that the majority were not in favour of adopting a strategy which would involve quota restrictions on imports; and that they would support the continuation of efforts to reach agreement with the IMF on the loan - although some members of Cabinet who favoured this course would wish to reconsider the alternative, protectionist strategy if the terms of an IMF loan proved to be too arduous. No agreement had however yet been reached on the question of the size or composition of the package which the Cabinet would endorse either on its own merits or in order to obtain the loan. At their meeting on the following day they would need to decide the amount by which the PSBR should be reduced, and, in very broad terms, how such a reduction should be achieved. Further detailed discussion would of course be necessary subsequently in order to settle the precise make-up of the package; but the Cabinet needed to settle without further delay what proposal to put to the IMF. He indicated that he would be seeing certain members of the TUC that evening and would listen to their views and inform them, as far as he properly could, of the situation. He observed that in his view the state of the Labour Party was not, perhaps, as bad as some had suggested, and that there was a growing understanding of the situation which had to be faced and an increasing will to come together in a closer unity.

The Cabinet -

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

Cabinet Office

1 December 1976