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CABINET

IMF NEGOTIATIONS

Memorandum by the Chancellor of the Exchequer

BACKGROUND

1. In this paper I put before my colleagues my considered assessment of the prospect before us, and of the measures which that prospect requires us to take.

2. It is clear from the latest short-term forecasts that at the present planned levels of expenditure and taxation we shall face very severe financing problems over the next year or two, both at home and abroad. The latest forecast for the public sector borrowing requirement (PSBR) in 1977-78 is between £10½ billion and £11 billion; and the forecast deficit on the current account of the balance of payments next year is £1.6 billion to which we must add the deficit of £1.4 billion on capital account, making a total of about £3 billion. Unless we take action to deal with this situation, we face a further slide in the sterling parity and an uncontrolled growth of the money supply - and both of these would refuel the engine of inflation. Furthermore, domestically, we should face the continuing prospect of high interest rates, restrictions on bank lending and continuing damage to our industrial policy.

3. At present we are holding our own well in both the foreign exchange and the gilt-edged markets. This owes much to the fact that people know we have the International Monetary Fund (IMF) team here - and to the expectations which that has created. However, we cannot expect confidence to continue unchecked, if we do not act fairly soon to meet those expectations. The reserves at end-November will be just over $5 billion of which $1.6 billion in gold and Special Drawing Rights is not liquid. Of the remaining $3.4 billion, $1.6 billion has to be repaid on 9 December, leaving $1.8 billion. This is why we must reach agreement with the IMF. If we fail or if there is what the markets regard as ominous delay, the exchange rate will slide - perhaps plunge - and we will not have the reserves to stop it.

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4. Having considered all the possibilities, I am convinced that we need to make a significant adjustment in fiscal policy, to meet the situation. And it is clear from my discussions with them that the IMF team here share that judgment.

IMF DISCUSSIONS

5. In all discussions so far the Fund have emphasised that their overriding concern is to see a marked improvement in the United Kingdom's export performance and a sustained programme for economic recovery over the next two years. They have been at pains to point out that they see it as no part of their function to dictate policies to the United Kingdom Government. Given the limited scope of our negotiating authority, however, they have, at our request, indicated a number of objectives which they believe we should need to adopt in order to persuade the Board and our main creditors that our policies are viable; and have expressed preferences about the most effective means of achieving those objectives.

6. The Fund team accept that, given the social and political strains involved in a too rapid adjustment, the present imbalance in the economy cannot be eliminated in less than two years. This is to be welcomed. They are convinced, however, that if confidence is to be restored, our aims should be to work towards targets for <u>1978-79</u> of £5 billion for domestic credit expansion which leads to £6½ billion for the PSBR. Provided early action was taken to validate a credible path to those figures, and provided the mix of policies was such as to sustain confidence, they would envisage that we then had a good prospect of achieving an output growth rate of about 1½ per cent in 1977-78 and 4 per cent in 1978-79. On these assumptions, and assuming that confidence will allow interest rates to come down, they see the need for a fiscal adjustment for 1978-79 of £3-£4 billion at 1976 Survey prices. Their confidence that we shall achieve a 4 per cent growth rate in 1978-79 after such a substantial fiscal adjustment rests on an expectation that, by allowing the exchange rate to depreciate in line with our present state of competitiveness, we shall achieve a large expansion in our net exports that year, and that industrial investment will be rising strongly. To the extent that these expocations are not realised, the Fund would be prepared to contemplate some demarcation from the PSBR target.

7. In discussion with officials, the Fund team originally argued that, to have maximum effect, this adjustment should be achieved solely through savings on public expenditure. They acknowledge that this is a matter for the Government to decide, but argue that the adjustment would need to be more severe if public expenditure were not the <u>main</u> source of savings.

8. For <u>1977-78</u> the Fund team believe strongly that we should not risk losing the chance to restore confidence by doing too little. They argue that there would be disproportionate benefits if we set a target below the level of

£9 billion which I announced in July. They are, therefore, looking for a PSBR of about £8½ billion to be achieved primarily by means of public expenditure savings.

ASSESSMENT

9. The scope of action required must inevitably be a matter of judgment. I have already persuaded the IMF team to reduce its initial demand for public expenditure cuts in the coming year and will continue to negotiate very toughly on the scale of the action required now to affect the outcome in 1978-79.

10. In my judgment, however, the broad scale of the action they now suggest is about right if we accept their view of the pattern of growth in the next two years. In any case we need to take action on this scale to restore confidence and re-establish control of our currency. The bulk of this action should be taken through reductions in public expenditure, but these might need to be supplemented by some further increases in taxation, particularly for 1978-79, if the forecasts the IMF have accepted as a basis for their suggestions prove to be correct. If on the other hand the PSBR predictions which have been taken as a base prove to be too pessimistic, it may be possible to make some reductions in direct taxation without missing the new PSBR targets. Moreover, the IMF staff have agreed that if the growth of national output in 1978-79 were to prove lower than they assume, a larger PSBR target for that year could be envisaged.

PUBLIC EXPENDITURE

11. In considering how big the public expenditure component of a package should be, my colleagues will naturally wish to know what would be involved. As agreed earlier on, work has been carried out by officials of the Treasury and the Departments concerned on reductions which might be technically possible, starting in the period immediately ahead. This can be completed and circulated in the light of our discussion. Meanwhile I will indicate briefly the kind of options involved.

12. The full list of possibilities which has been drawn up, from which a specific set of measures could be constructed, could produce savings of about £3 billion in a full year if all of them were adopted. This would involve a moratorium for a full year of all public sector construction projects not already committed, excluding the nationalised industries but including housing. This would account for about one-third of the £3 billion. It would also require the total cancellation of upratings of social security benefits and public sector pensions next year, and in addition it would require further specific savings in a wide range of programmes including health, education, aid, defence and industrial support. Such measures would be technically feasible but politically very difficult to accept.

13. We cannot be sure in advance of a detailed negotiation how far we may have to go on public expenditure to meet the Fund's objectives, but I think we must in any case be prepared to make savings of £1½ billion in 1977-78, rising by a further £½ billion to £2 billion in 1978-79 at 1976 Survey prices. In my judgment savings of this size are the minimum necessary to give us a reasonable prospect of carrying through the Fund negotiations to a successful conclusion, and to re-establish confidence in the markets. My officials have already done some work on illustrative packages of different magnitudes, the largest of which would meet this requirement. Any of these illustrative packages would involve some action, but less drastic, on all the items which I have already mentioned, eg some pause in new construction commitments, but falling short of a 12 months moratorium across the board, and some saving on benefits and public service pensions, but not a total cancellation of the next upratings. The higher level of savings in the second year would largely be secured by the carry-through of the first-year measures, some of which would have an increasing effect; but some of the other first-year measures would not carry through in full, so that some additional action would be required to achieve the larger total in 1978-79.

14. Thus, among other options, we should have to consider substantial further economies in the housing programme for that year, probably by a reduction in the level of new council house construction and/or legislation to allow for a marked real increase in local authority rents. Another possible source of savings would be a further substantial reduction in defence expenditure beyond that in the illustrative packages; this would require another Defence Review and reconsideration of our defence commitments. But the need for such additional savings in these programmes in 1978-79 will be significantly reduced if my colleagues accept my proposals, which I intend shortly to bring to Cabinet, for encouraging a shift to foreign currency financing of export credit by arrangements which would include a raising of interest rates for sterling-financed export credit.

15. Changes in the planned level of benefits and public sector pensions would require legislation. In the former case the required provisions could be added to the Social Security (Miscellaneous Provisions) Bill which is due to be introduced this week. The basic idea put forward for our consideration is that the statutory requirement for mandatory upratings should be repealed or suspended, and replaced by a discretionary power. The same approach would be adopted to public service pensions and would affect not only the Civil Service but also local authorities, the Health Service, the police, the armed forces, Members of Parliament and the judges. The implications for the nationalised industries would also have to be examined.

16. A decision on this legislation will be crucial to the package as a whole. We need to consider action on these lines not merely for the sake of the expenditure reductions involved but also in order to deal with the

situation in which real living standards of those on benefit or pensions are being maintained or even increased while the real wages of those at work are being squeezed.

NEXT STEPS

17. We must take decisions on the main issues without further delay. Drawings under the June $5.3 billion standby have to be repaid by 9 December. It is not necessary for us to draw money from the Fund by that date, but it is of vital importance that we should be able to indicate by then at least that we have reached a firm understanding with the Fund. There are further stages of consultation to be carried out, mainly with the Group of Ten countries who will be asked to put up the money for the Fund drawing, after the talks in London are completed. Progress in the talks has been slow largely because of our own inability until now to make concrete proposals. If we are to meet the timetable it is now essential that we should come to an understanding with the Fund this week on the main elements of a programme.

18. Details of the agreement with the Fund can be filled out later, but this week's decisions will have to cover the size of the PSBR and the growth of the money supply in both 1977-78 and 1978-79 (although both would be contingent on economic circumstances in those years and subject to review) and the size of the public expenditure element in the adjustment.

CONCLUSION

19. I recognise that I am facing my colleagues with extremely difficult decisions, but I believe we also have an opportunity to establish a viable path to recovery over a two-year period. Moreover, if negotiations with the IMF are successfully concluded, we shall have obtained international endorsement of the validity of our policies and of the recovery at which they aim. This endorsement in itself should provide an invaluable boost to confidence both at home and abroad.

20. It is in this belief that I make the following recommendations:

i. I should be authorised forthwith to discuss with the Fund, without commitment, packages designed to meet their PSBR requirements, with a public expenditure component of £1½ billion in 1977-78, rising by a further £½ billion to £2 billion in 1978-79; and an appropriate tax component. At the same time work should be carried forward on the preparation of documents for an agreement with the Fund.

ii. The Lord Privy Seal should be invited to bring before us as a matter of urgency a paper dealing with the question of an amendment to the Pensions (Increase) Act.

iii. I should be invited to arrange, in consultation with the Secretary of State for Social Services, for a more detailed paper to be prepared on the implications of amending the existing social security legislation. This paper would also indicate the problems involved in taxing short-term benefits.

iv. The Secretary of State for the Environment, in consultation with the Chief Secretary, Treasury, should be invited to bring forward a paper on policy options arising from the Housing Policy Review.

The papers under ii., iii. and iv. should be available for our next meeting.

D W H

Treasury Chambers

22 November 1976