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CABINET

ECONOMIC STRATEGY - THE IMF

Memorandum by the Secretary of State for Foreign and
Commonwealth Affairs

1. It is now widely agreed that there is no economic case for further deflationary cuts in public expenditure:
 - a. Resources. No one seriously suggests that, given the prospective level of unemployment and spare capacity under existing policies, we need still more deflation to make room for exports and investment.
 - b. Inflation. Far from improving matters, further cuts would, by their probable effect on rents and other prices and on relations with the Trades Union Congress (TUC) seriously threaten the Social Contract and the prospects for wage stability next year.
 - c. Investment. Further cuts, involving another increase in unemployment and a rate of growth in 1977-78 of, say, $1\frac{1}{2}$ per cent, would still further depress the profit expectations of industry. Whatever the rate of interest, industrialists will invest only if they can see the future demand for their products; and a yet greater degree of deflation would kill our industrial strategy stone-dead.
 - d. Balance of Payments. This, the traditional argument for public spending cuts, is not being advanced in the present controversy; in any event we are likely to move into a healthy surplus in 1978 (Treasury) or mid-1977 (National Institute).
 - e. Financing the Deficit. It is sometimes argued that we cannot easily finance a public sector borrowing requirement (PSBR) of £10½ billion. There is much scepticism about this argument; moreover other estimates of the likely PSBR are much lower (eg National Institute £8.2 billion). The uncertainty here is far too great to justify cuts which could torpedo the Social Contract and threaten the future of the Government.

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2. The argument therefore boils down to the confidence factor. On this, I would make the following points:-

a. We have to consider the likely effects on confidence of a possible breakdown in the Social Contract caused by further cuts.

b. Informed opinion, both nationally and internationally, is turning strongly against the policy of further deflation (eg statements by leading economists, the recent statement of the Confederation of British Industry (CBI), editorials in the *Washington Post* and the *Herald Tribune*, the sympathetic response of President Ford and Chancellor Schmidt to the Prime Minister's message, etc.).

c. Provided we secure the IMF loan, we shall get the safety net for the sterling balances. The market will then see that we have the means to regain control of our currency. For the first time in years we shall be seen to have the money to finance our deficit until it is turned into surplus and to remove the sterling balances' threat to the stability of sterling. Our new ability to defend the sterling rate will be a crucially important factor which has hitherto been absent.

d. The fact that our partners have agreed to the IMF loan and safety net will show the market that international opinion wants us to have a stable currency on the basis of which we can pursue our economic policies and are willing to organise important co-operation in support.

e. The market will see the £1 billion PSBR cut which I am proposing for 1977-78 as the precursor of further cuts going with higher economic activity.

3. Our bargaining position with the IMF is in my view stronger than people realise. For if they push us to the point of a siege economy and the full panoply of import controls, this would gravely threaten the cohesion of the EEC, dangerously stimulate a move towards world protectionism, and bring into question the British contribution to the military defence of the West. Our very weakness brings us strength. If we keep our nerve, we shall find that the IMF cannot afford not to give us the loan.

4. I make one final point. It is still sometimes said that the British people are not living within their means and need to be taught a sharp lesson about the reality of our condition. But on present policies we shall be living within our means by late 1977 or early 1978. Meanwhile the British people are enduring 1½ million unemployed, a loss of potential production on an enormous scale, and an actual fall in their real standard of living. There is no canon of morality or economics of social democracy which demands from them a further and needless sacrifice.

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Foreign and Commonwealth Office

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