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## ECONOMIC POLICY AND THE IMF CREDIT

Memorandum by the Chancellor of the Exchequer

1. During our discussions last week some of our colleagues doubted the wisdom of making any substantial measure of fiscal adjustment in 1977-78 - and still more in 1978-79 - on the lines which I have advocated in general terms. The decisions which we have to take are among the most important, and most difficult, which a British Government has had to face in many years. I am anxious that those of my colleagues who are disposed not to accept my advice should fully understand the case for the adjustment and the consequences, in terms of alternative policies to the one I put forward, of not making it. In this memorandum I set out the arguments for an adjustment, my recommendation on its quantum and my judgment of the options open to us - and their implications - if my advice is not accepted.
2. The case for a fiscal adjustment (or, to put it more bluntly, a cut in the prospective Public Sector Borrowing Requirement (PSBR) in the two financial years 1977-78 and 1978-79 is not simply that this is what the International Monetary Fund (IMF) require as a condition of a standby credit, important as that is as an argument; there is a more fundamental reason, which would apply even if we did not require the Fund's money both to repay the \$1.6 billion swap facility due to our Central Bank creditors on 9 December and to finance our external deficit over the next few months. The argument is partly about finance, and particularly external finance, and partly about the general direction of the economy and the pace at which it is progressing to our declared goals.
3. The external finance argument is this. We have, certainly on the basis of our economic forecast and to a more limited but still significant extent on the basis of independent forecasts, a continuing substantial deficit on current account. After an encouraging recovery in the first half of 1976, we have had several months of deficits each over £200 million, giving an annual rate of about £2½ billion. To the finance required to cover this we have to add a requirement of about £1 billion per annum to cover the structural element of our capital account - particularly export credit. Finally we have to be prepared at present to finance any continuing tendency for sterling holders to want to convert their assets into foreign currencies.

4. Whether on present policies we eliminate our current deficit in the course of 1977 as the National Institute predict, or whether we do not do so until 1978 as the Treasury expect, we shall have to borrow abroad on a substantial scale for at least a year and probably more. Unless we can do this, we shall not be able to cover the deficit at anything like the present exchange rate. Our only course then would be to hope to achieve equilibrium by allowing the rate to fall to levels at which there might be some chance of foreigners stepping in to buy sterling so as to acquire a lot of United Kingdom assets - British firms and property, as well as financial assets - very cheaply. This, despite the effect that the fall in the exchange rate would have on our own cost of living, is still an optimistic scenario. The pessimistic scenario is one of continuous and probably accelerating depreciation, leading to South American-style inflation, with higher import prices feeding through to wages and vice versa.

5. Our future turns critically therefore on our ability to mobilise external credit on a scale which will enable us to fill the gap - presently of about £3 billion per annum - until we are in the black. Over the three years since the onset of the oil crisis, in addition to earlier IMF borrowings, we have managed to raise something like £6 billion of external credit, whether by receiving a sterling inflow from the Organisation of Petroleum Exporting Countries (OPEC) or by direct market borrowing by public sector bodies and by private institutions. Why do we now suppose that our credit has run out? The answer is that the market remains a potentially large source of further credit, but our creditworthiness has become dangerously undermined. The market and OPEC who together have sustained us since 1973 have both become very sceptical about the viability of our policies, in particular about our determination to move into surplus and about our ability to manage our domestic finance in such a way that we will not see a dangerous monetary expansion undermining, if not destroying, the success of our counter-inflation programme. The experience of this year, when our progress on inflation has been visibly checked, when our balance of payments has deteriorated, when the money supply has begun to expand at an alarming rate, and when PSBR seems to remain obstinately high has not been reassuring. There is no doubt that unless we take decisive action to improve the balance of payments and to get the monetary expansion under firm control, we shall not raise the funds we need to maintain stability at home and abroad.

6. We need in this context to keep the role of the IMF in perspective. Quantitatively it is not as important as the market itself. But it is seen by the market as the bellwether. If the Fund accepts that our policies are credible, the market is virtually certain to follow suit, and the amounts potentially available to us are large. Per contra, if we fail to reach agreement with the Fund, we are unlikely to be able to raise funds on any significant scale in the market.

7. In domestic financial terms, the prospective PSBR - now estimated to be £10½ billion in 1977-78 - presents a huge internal financing problem. To contain monetary expansion to a level which would not have adverse repercussions on the exchange rate, we should both have to continue to sell gilts on a massive scale and have to contain the growth of bank credit to the private sector: we cannot be certain of achieving the first, even with high interest rates.

8. If we succeeded in containing monetary expansion by action on these two fronts we would in both ways be depriving industry of some of the external funds it needs if we are to regenerate the industrial base on which the future of the economy depends. The continuing high interest rates would also put at risk other policies, notably housing. If we failed in controlling the growth of the money supply, we should forfeit the prospect of recovery in domestic growth, inflation and the balance of payments.

9. Even on the basis of the present prospect we cannot be certain that the predicted improvement in the external balance will come about. There is a risk that, instead of achieving equilibrium in 1978, we shall continue in deficit for some considerable time. In my view this is a risk which we simply cannot afford to take. Too often in the past we have taken risks with the external balance and this has been our undoing.

10. My judgment therefore, which I have reached independently of the Fund - is that there is a powerful case for a fiscal adjustment, and more-over one which would extend over the two years 1977-78 and 1978-79. On present policies both of these years are likely to show substantial fiscal deficits and it is necessary to contemplate measures which run through and indeed have greater effect in the second year than the first. This is mainly because it is in the second year that the growth of the economy is likely to be stronger as the expansion of exports and investment gets under way.

11. The size of the adjustment required involves a difficult exercise of judgment. My own view is that it should be such as to reduce the PSBR to something like £8½ billion in 1977-78 and perhaps to a similar figure the following year, though the latter figure should be thought of more tentatively because of the many uncertainties which surround estimates for a period so far ahead. I believe that, if we make the necessary moves now, we should safeguard our future, secure agreement with the Fund and decisively re-establish our market creditworthiness. We should establish firm conditions for the exchange rate to stabilise and enable us to plan for a secure industrial revival untroubled by the destabilising and unsettling effects on our economy which have thrown us so badly off course this year.

12. As to the nature of the adjustment, I consider that this should be largely, if not predominantly, through reductions in public expenditure. There are two reasons for this. First, I believe that tax increases would

be regarded by the Trades Union Congress (TUC) as a breach of the understanding we reached with them in May under which, in return for a pay agreement based on £2.50/5 per cent/£4 we agreed certain income tax reductions. I have already been warned by the National Economic Development Council (NEDC) Six that an increase in tax, whether direct or indirect, would be very badly received by the union rank and file. In practice the only tax increases I could propose would be in the indirect field, and these would impinge immediately on the Retail Price Index. To the extent that, through Government action, we add significantly to prices in the next few months, we shall jeopardise the current pay round and make agreement less likely on a third round pay policy on any basis which offers some prospect of the rate of inflation being brought down in 1977-78. We also give concern to those abroad who judge us primarily by our rate of inflation. The second reason is that, for good or ill, the market undoubtedly places greater weight on expenditure cuts than on tax increases as a measure of reducing the fiscal deficit; and if the package contains tax increases, will look for a greater total reduction in the PSBR for any given impact on confidence. We may as a Party deplore this and write it off as political prejudice. But we cannot ignore it. And we would be unwise to suppose that what the market expects is irrational. It is far from clear that the mass of the public, including our own supporters, would not prefer to see its take-home pay protected than see the social wage kept inviolate. In terms of incentive to effort I am sure that it is the pay packet which counts, not the size of our public programmes, important as these are to the society we want to create.

13. In my paper (CP(76) 111) last week I said that I believed that the size of the fiscal adjustment required was £1½ billion in 1977-78 rising to £2 billion in 1978-79. Since then, further calculations carried out by the Treasury, in which credit is taken for the lower interest rates which a package could achieve, suggest that the PSBR targets at which I was aiming could be secured by adjustments of £1 billion rising to about £2 billion in the second year. These adjustments would be supplemented by the sale of the equivalent of the ex-Burmah holding of British Petroleum (BP) shares. I believe that we could secure agreement with the Fund with such a programme. Although for the reasons I have given the programme should consist mainly of expenditure cuts I would not rule out a small tax component, preferably for the second year, given the great difficulties we should have with the TUC in indirect tax increases now before the negotiation of a third pay round.

14. To the extent that in the next few months the economy develops more favourably than we presently expect and the actual PSBR looks like being lower, I would hope to make some income tax reductions in the 1977 Budget to restore at least part of the demand lost by the cuts. If there is scope for this within the programme we shall be committing ourselves to, it would provide us with a valuable inducement for the unions to agree a third year of pay restraint. It is not impossible that if President Carter leads the major countries in a more expansionary policy, this too would create scope for cuts in income tax in Britain.

15. It is important that the package of measures we announce should not be wholly negative but should have a component which deliberately supports the industrial strategy, which is at the centre of our economic policy. There are a number of instruments which have been suggested for this purpose, but the most fruitful is the new Selective Investment Scheme which builds on the success of the Accelerated Project Scheme which we have now brought to an end. Advance indication that we were about to introduce a Selective Investment Scheme was given at last month's meeting of NEDC but we have deliberately held back its formal announcement for inclusion in a package. We earlier had in mind that the Scheme should have a limit of £100 million. By no means all of this will be spent in 1977-78 and 1978-79; it is not therefore the overall financial limit of the Scheme, so much as the annual rate of spend, which will determine its impact in the next two crucial years. I therefore suggest that, when we announce this Scheme, we should make it clear that, so long as good cost-effective projects are coming forward in support, they will not be allowed to fail for lack of resources on our part; and that, when the £100 million limit is reached, we shall be prepared to look favourably at its extension. We should also indicate that selective assistance to industry under the Industry Acts will also have a high claim on resources, although the limitation here is as much one of administration as of money. We cannot, however, be so forthcoming about schemes of assistance for employment. Indeed, if we were to adopt schemes of the size advocated by the Secretary of State for Employment - which would cost over £750 million gross - we could do so only at the expense of seeking comparable cuts elsewhere.

16. A programme on the lines set out would I think be all we would need for a stable and financially sound economy. It is right that we should consider whether any valuable role could be played by a temporary (12 months) scheme of import deposits, designed to induce a significant financial inflow to the United Kingdom during the critical period when the balance of payments was still in deficit and to reduce marginally the volume of imports. In considering this possibility, we must of course remember that the initial helpful effects of an import deposit scheme are inevitably reversed when the scheme ends, and that there would be very strong international pressure for such a scheme to end after 12 months at the most.

17. If our position were that we could foresee ways of making really dramatic reductions of public expenditure and/or increases in taxation in 1978-79, but not before, there could be great advantage in an import deposit scheme to bring forward some of the effects and create a smoother path of financial improvement. But in fact, I believe we should take fiscal action to reduce the prospective PSBR in both years, although this will require rather larger cuts in 1978-79 than next year. So the profile of the effects of an import deposit scheme would not suit us. To add an import deposit scheme to measures on the lines I have described would have its main impact on the PSBR in the current year; would have a relatively marginal impact on 1977-78, taken as a whole; and would have a strongly adverse impact in

1978-79, when the deposits would have to be repaid. They would therefore generally distort the pattern of change we should be seeking. On the other hand if we used an import deposit scheme as a substitute for expenditure cuts affecting 1977-78, this would be ill-received by our international partners (who might well in some cases be induced to retaliate) and would leave us with an even more difficult problem in 1978-79. In either case an import deposit scheme would greatly reduce company liquidity and might stop the investment recovery in its tracks. It has therefore been strongly opposed in a public statement by the Confederation of British Industry (CBI). For these reasons I doubt the economic value of an import deposit scheme at the present time, although it might have political value in helping to sell the package at home if that package were acceptable abroad without import deposits.

18. I realise that the programme I have outlined would mean that unemployment and, to some extent, prices would rise above their forecast levels in the year or so ahead. Unemployment might be 30,000 higher than in the National Income Forecast (NIF) by the fourth quarter of 1977, but the prospects beyond then would depend very much on the way other elements in the economy were moving. We might well be able to relax the rigour of the programme in late 1977 or early 1978 if the economy was then set fair. We would have overcome the worst of our financial problems and the constraints on our freedom would be greatly reduced.

19. However, it would be misleading to compare the prospect after this fiscal action with the figures suggested by the basic NIF. The NIF forecast of output, employment, balance of payments, etc, was (like the National Institute forecasts) entirely predicated on the assumption of internal financial stability and on a sufficiency of external credit. In practice and on present policies neither of these conditions is likely to be fulfilled. And, if they are not fulfilled, the whole basis of the forecast disintegrates. A failure to adjust present policies could well produce a collapse of the sterling rate, an accelerating rate of inflation and a sharply worsening balance of trade. These developments would produce an employment and price prospect far worse than the one envisaged under the proposed programme.

20. I realise that the proposals I am putting to my colleagues are not agreeable and will be difficult to sell to the Party and the TUC. If there were a better or more viable set of policies I should propose them. But I do not believe that any of the alternatives, all of which would mean abandoning negotiations with the Fund, is preferable to my proposals, or indeed is viable in practice. Three broad alternatives have been suggested, although some elements in each might be combined with others:

- i. A programme involving drastic import controls and supporting exchange control measures.

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ii. A programme involving little or no fiscal change. It has been suggested that this could be coupled with an attempt to finance our deficit by large-scale credits and the sale abroad of financial assets which would have no effect on the level of activity.

iii. A programme involving minimal cuts in expenditure, a wage/price freeze and a scheme of import deposits designed to raise the external finance.



21. In giving the proper consideration to these policy alternatives we must recognise that the present - still very fragile - state of confidence could be disturbed once again, if there were to be an ominous delay in reaching agreement with the Fund or, worse still, if the discussions were broken off without our having reached agreement. In that event the markets would almost certainly take the timing of decisions out of our hands.

22. I will not go into i. in any detail, for the arguments against it are well set out in the paper by the Central Policy Review Staff (CP(76) 116). This programme would involve a complete reversal of everything we have sought to achieve as a government. We should have to withdraw from the European Community (although whether we would secure the legislation required to permit this seems to me uncertain). We should invite retaliation which would damage those parts of British industry which have been most successful in world markets and we should foster and protect those very industries which are least competitive. It would be a complete reversal of our industrial strategy. At the end of the day we could well be weaker and less able to compete than we are now. The expansion of investment which it would be a main purpose of the programme to promote, would be forthcoming, only if businessmen thought it was likely to endure. But against the likelihood that the Opposition would promise to abandon it as soon as it won office, businessmen would not take the decisions essential to the programme's success. Our manufacturing base would therefore tend to contract, rather than to expand.

23. The programme at ii. appears to be much more attractive and to have fewer long term disadvantages. But is it realistic? To be effective it would require external credit on a vast scale, sufficient in fact not only to finance the deficit but also to allow for the withdrawal of the sterling balances, which would not be underwritten by the safety net arrangements which only agreement with the Fund can secure. I can see no grounds whatever for supposing that this credit would be forthcoming. The market would certainly not supply it, and the Prime Minister's recent exchanges with President Ford and Chancellor Schmidt make it clear that bilateral official borrowing from the strong countries, notably the United States and Germany, is not an option if we fail to agree a programme with the Fund (and we must not forget that these countries have their own domestic political constraints). Nor do I consider that we could obtain sufficient funds by the sale abroad of some of our national assets. We could in theory dispose of the whole of the 70 per cent of the official holdings of BP (valued at £1½ billion), but it would be a difficult operation to mount because of its size and would take a good deal of time. There may be a few other assets which we hold and might hope to sell. But the proceeds would still be well short of our requirements; and, even if they were not, I cannot think that the Government's reputation and credibility would be enhanced by the wholesale disposal of our patrimony at knock-down prices. Is it really in our interests to sell off our industrial base when the equity index is (even now) at 300 - or to sell off the whole of BP, just before the company begins to accumulate massive profits from the North Sea?

24. There remains the theoretical option iii. of seeking to establish our credit and viability by some smaller fiscal adjustment than I have proposed, supported by a wage/price freeze and/or by a scheme of import deposits. I regard this as less impracticable than the other two options but it is nevertheless open to a number of powerful objections.

25. First, as CP(76) 125 points out, a "freeze" can be interpreted in more than one way. In its simplest form, it presumably means no increase in wages and no increase in prices for a stated period. Thus, industry (in both the public and private sectors) would have to absorb the full impact of increases in import costs and any other increases in domestic non-wage costs. As a consequence, it would (by comparison with our present strategy) imply a massive switch of resources from industry to personal consumption - comparable in some ways with the indexing of real take-home pay. It would spell catastrophe for industry, whose cash flow would be gravely interrupted within a matter of months.

26. In a less extreme form, the "freeze" could mean no increase in wages and an increase in prices limited to the effects of import and other domestic non-wage costs. But this would in practice involve much of the hardship of my recommended course, without the benefits of the Fund's money and the Fund's certificate of approval. It might have the presentational advantage of being "our" programme since it would not have been agreed with the Fund. But the wage freeze would require much greater sacrifices from the trade union movement, whose acquiescence would be highly doubtful. Unless postponed until August next year, the freeze would wreck existing horizontal relativities and run the risk of making certain groups, eg the miners, openly defiant. In those circumstances, we certainly could not count on the continued co-operation of the TUC and the CBI on which the success of our economic and industrial policies depends. At the same time, we should still have the problem of external finance (because of the break with the Fund) and the exchange rate would remain vulnerable. Its vulnerability would be intensified by each statement by union leaders questioning or rejecting the pay freeze.

27. I am driven by these considerations to the conclusion that, of all the courses open to us, the one I have put forward is the least damaging and, indeed, more positively, is the only one which is likely to put us in a reasonably strong position when, as a Government, we have to face the electorate. I believe that we must use the remaining international credit available to us, to remove the structural imbalance in our economy, once and for all and so re-establish control of our own affairs. I do not believe the Government would survive yet another policy review under the pressure of the markets and the glare of hostile publicity.

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28. I realise that many of our supporters will not like what I propose; but I believe that both in Parliament and outside they can be brought to recognise the realities of our situation. I do not believe they would risk our survival as a Government, when they know what is the only alternative.

D W H

Treasury Chambers

30 November 1976

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