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ECONOMIC RECONSTRUCTION GROUP

Note by the Chairman

1. The task of the Group is to establish an economic strategy for the Party both for the present and the future. For obvious reasons we have for the time being concentrated on a small number of issues of central importance. This note sets out the issues we have considered, indicates the directions in which the Group's thinking is developing and suggests priorities for further work.

FOUR MAJOR PROBLEMS

2. There are four related problems which dominate economic policy:

(a) Inflation;

(b) Imbalances in the way national output is allocated, in particular the excessive size of the public sector and the consequent downward pressure on exports, investment and private spending and the rate of economic growth;

(c) Imbalances in monetary policy - above all stemming from the enormous public sector deficit.

(d) Defects of the labour market and collective bargaining.

We have devoted most of our attention to inflation.

INFLATION

3. The current inflation has many causes - unions, their monopoly, power and militancy, excess demand, monetary policy, expectations, and the size and growth of the public sector. Each factor is a necessary condition for inflation and the presence of all or several of them is sufficient to ensure that the situation will continue to deteriorate. Each needs to be given careful consideration in analysing what has happened in the past. Policies to deal with each are needed in any programme to master inflation today and tomorrow. If some of the causes are ignored or aggravated, the programme will be ineffective and may sow the seed of its own destruction.

4. The acceleration of wages and prices under this Government has been so abrupt that the Group came to question an important unspoken promise of past counter-inflationary policies, that the programme should suppress inflation by sustained and relatively mild de-escalation over a number of years. It also become clear to us that there would be immense problems involved in mastering inflation Whatever approach was adopted significant and by post war standards unprecedented deflation is inevitable in the short run. This fact and the particular policies adopted would strain the bounds of consent to the limits, and constitute a a standing challenge and open invitation to attack from the militant left. These lines of thinking emerged from an assessment of some of the alternatives open to us.

Alternative Policies

A 'gradualist' monetary approach

5. As proposed by Professors Friedman, Parkin, Laidler and others, one would follow for four or five years a programme of steady reduction in the rate of growth of the money supply. The target for monetary growth would be consistently set at a lower rate of increase than that of prices. The policy would thus bear down on rather than accommodate wage and price increases. The Group tended to the view that there would be several serious problems involved in this course of action. A very high level of unemployment would probably be required for, say, four or five years. In the private sector capital expenditure, confidence and growth would be damaged. The need to sustain the policy throughout the life of a Parliament would raise obvious political difficulties.

6. **A dramatic monetary approach**

If a gradualist strategy is ruled out because it would be too slow and too painful to sustain, one might instead consider halting the growth of the money supply abruptly in order to get the necessarily messy process of killing the inflation over quickly. The Group felt that not merely was this strategy politically impossible, but also that it would do lasting and probably unacceptable economic damage to the economy. There would be appalling dislocation in the public sector and simultaneous crises in financial institutions, the stock exchange and productive industry.

7. **Indexation**

Systems of indexation have been proposed both as ways of making it possible to adjust our economic and social life to the continuation of high rates of inflation, and as a device for restoring confidence and efficiency to the market place in a way which would bring the rate of inflation down. Neither alternative has much attraction in the present context. In the first case the basic objective is unacceptable. In the second case there are grounds for doubting whether indexation will of itself be an effective way of dealing with the many causes of inflation referred to earlier. Indeed there are grounds for arguing that in this country it might make inflation worse rather than better. As normally proposed, wage-indexing would only bring results slowly at best, perhaps too slowly to meet the urgency of our current situation. We felt that this approach needed further examination before one could conclude that it might have a useful role to play.

8. **An 'ideal' programme**

The chief difficulty with the solutions so far mentioned is that all of them involve dampening the growth of inflationary expectations through the *indirect* pressures of the market mechanism. Many of the devices suggested are slow to take effect and all are politically painful and ecomically costly. When expectations of inflation are as firmly embedded as they are today, the strains and costs of such policies become excessive. It follows therefore that some means must be found of operating directly on expectations as well. We were therefore led to ask whether there were ways in which one could reduce the costs and increase the feasibility of such policies by taking direct action to reduce expectations. It was suggested that there might be a case for doing so as part of a wider package of policies, which might take the following form.

9.
(a) A much tighter monetary policy with the growth of money supply reduced to a rate consistent with no growth in money wages;

(b) Action to reduce the public sector's financial deficit in the short run and the level of public spending in the longer run, to release resources for exports, investment and private spending;

(c) A scheme to ensure that much of the resources released from the public sector are transfered into profits, investment, jobs and growth;

(d) Abolition of price controls, de facto if not de jure;

(e) Labour market reforms to blunten militancy to restore some of the order to collective bargaining which has been destroyed in recent years.

(f) A total wage freeze lasting for at least one wage round.

10. The consequences of a programme such as this would be:

(a) The inevitable short-run deflation would be reduced to a minimum and offset before long by investment and export led expansion;

(b) The company sector would be strengthened rather than weakened by the counter-inflationary policy and the foundations would be relaid for resumption of a high rate of economic growth.

(c) After 6 months of acute difficulties, the second six months would see price inflation almost diminished and inflationary expectations severely checked, both before the psychological advantage of the shock tactics adopted has worn off.

Of all the alternatives considered this appears to be the quickest to achieve results and least impossible to pursue.

THE GOVERNMENT'S ATTACK ON INFLATION

11. The Group has not had the opportunity to form a systematic view about the Government's new proposals, but a number of basic weaknesses in it are immediately apparent over and above the obvious inadequacies of the £6 flat rate pay limit and the semantics of the status of the policy:

(a) The objective of 10 per cent inflation in a year may be too modest and the Government's proposals for a period of sustained controls lasting several years follow necessarily. But the pursuit of a policy of extended restraint will expose the Government to dangerous and powerful challenges before inflation has been adequately checked. There are also profound political objections to the indefinite continuation and extension of the wide range of controls and intervention on which the Government will have to depend.

(b) The Government has still shown no signs of having any strategy for the revival of the private sector; and is in effect condemning the country to an extended period of deflation and stagnation of unpredictable severity and duration.

(c) The Chancellor's limited, belated and vaguely spelt out intention to reduce public spending in the longer term, while doing little about the public sector deficit in the short term exposes the economy to three risks:

(i) To the extent that the deficit is not covered by proper borrowing, there is likely to be an accumulation of near liquid assets which could well magnify and dangerously accelerate any natural or Government-induced expansion of demand.

(ii) To the extent that the public sector deficit is covered by proper borrowing, the money thus obtained will be diverted from investment in industry and housebuilding with socially unpleasant and economically harmful consequences.

(iii) To the extent that private spending is depressed in favour of public, individuals will be spurred on to greater militancy in wage-bargaining.

PUBLIC EXPENDITURE PRICES POLICY AND THE LABOUR MARKET

12. We have briefly discussed a number of problems which stem from inadequacies of the labour market and the weaknesses of the framework for collective bargaining:

(a) Any counter-inflationary policy is likely to provoke militant challenges. The authority of Government and Parliament will be questioned in confrontations either when it reestablishes control over public spending and the money supply through existing laws, executive or court decisions or, if that forms part of the programme, over statutory powers to regulate wages in some way. How best can these challenges be met? How far can they be localised and defeated by contingency planning. How far can and should we aim to curb the collective or individual rights of strikers and the financial support they obtain from social security?

(b) To avoid the recurrence of inflation in the future, is it necessary to construct an institutional framework wihtin which wage claims are negotiated and settled - for example synchronisation of pay settlements and a contractual basis for bargains between Unions and employers.

We have not yet formulated definite answers to these questions. In addition we shall naturally need to keep in close touch with other groups which are considering the same problems.

13 The working out of strategies for taxation, resource, allocation and reduction of public expenditure has been left in the hands of the Public Spending and Taxation groups, whose preliminary reports are already circulated. (We have not yet had time to give consideration to either). Since colleagues involved in other policy groups will need to know the basic economic assumptions and targets with which their own proposals must be reconciled, it is my intention to provide them with the necessary guidance as soon as possible.

14 We have briefly considered a number of aspects of prices policy. In general terms we are agreed that de facto price control should be eliminated as quickly as possible. However there are obvious political problems involved in the total abolition of machinery concerned with prices. Fruthermore we recognise the case for bodies concerned with monopolies, restrictive practices, and the information and protection of the consumer. In particular we have discussed and will further consider the case for a body acting in the consumer interest in relation to Nationalised Industries.

PRIORITIES FOR FURTHER WORK

15. Our priorities are:

(a) To further develop a counter-inflationary policy.

(b) To link that more closely with policies for restoring the health of the company sector.

(c) To consider in greater detail monetary policy both in its own right and in relation to a and b.

(d) To establish a strategy for the labour market consistent with our other central economic policies.

We shall also need to give some thought to what line we take in public on these subjects at this year's Party Conference, in the coming Parliamentary year and next summer.

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