E. R.

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Policy Unit

PRIME MINISTER

I attach a copy of an article in yesterday's Guardian by Peter Jenkins.

Peter Jenkins is no friend of course, but the article is not a bad summary of the position as it must appear to neutral or hostile observers

The main omission in the article is the real joker in the pack - the very rapid rise in oil prices and thus the completely unforeseen combination of excessively steep recession and an excessively high pound; this whole structural adjustment being forced at tremendous speed on the least competitive, most under-invested and historically trade union-ridden segment of the economy. It is this change, on top of the huge growth in earnings over our first year, that has really pushed us off course.

We must now be approaching the point - probably about the time of the March Budget - when we have to choose between one of two routes. On the one side, we can start to move increasingly towards what is "politically possible" but simply inadequate for solving the problem. On the other, we will have to find ways of doing things which appear to be "politically impossible" but which are essential if we are to have the slightest chance of getting back onto our strategic course.

We are at present keeping 8 and 9 January free to do a reappraisal of the position and our strategy, with Alan Walters (at Chequers). I have already had some discussion with him on this and we have been communicating on different aspects of the problem. We shall be giving you a paper, with copies to Geoffrey and Keith, shortly before the Christmas Recess in preparation for that January session (whether or not you decide that you would like Geoffrey and Keith to attend it). The aim of the paper will be to ensure that we see the wood for the trees while there is still time left to think it through. There's no point in putting it to you earlier, because I don't think there's time to digest that type of paper except during the Recess.

JH

JOHN HOSKYNS

The collapse of confidence

Peter Jenkins

THERE IS as yet no major change in Government policy. The new session of Parliament opens tomorrow with Mrs Thatcher as determined as ever to solve the problems of Britain through control of the money supply.

In the course of the public expenditure review, which the Cabinet is supposed to finalise this morning, the Treasury ministers have suffered some reverses and the "wets" — for the first time — scored some points. But what the Treasury failed to obtain in spending cuts it intends to claw back in tax increases in the Budget next spring. In other words, the recession will be made still worse by policies of deflation in pursuit of the Government's monetary targets.

The Prime Minister has rejected an early reduction in interest rates. They are to come down only as the money supply is brought under control. She is more favourably disposed to a devaluation of the pound if only she knew how. This debate continues in Whitehall but there doesn't seem to be much which can be done about the pound for as long as the Government sticks to its monetary strategy.

So there has been no change of direction during the last two or three weeks, in spite of all the leaks, in spite of the divisions within the Cabinet and the screams from industry. Nevertheless, something important has happened and Mrs Thatcher's Government, after 18 months in office, has perhaps entered a new phase.

The first thing that has happened is a collapse of confidence in the Chancellor of the Exchequer and his Treasury team. This applies to Number 10, the Cabinet and official Whitehall, although for somewhat different reasons. The Prime Minister's loss of confidence in her Chancellor has chiefly to do with his failure to control the money supply. That, in her simple view, is what he is there to do.

The Cabinet has lost patience with the Treasury because it is sick of forecasts and figures which either turn out to be wrong or seem to be irrelevant; moreover, it has little remaining confidence that Sir Geoffrey Howe knows where he is heading, except for trouble. Whitehall's lack of confidence has to do with the lack of confidence which Treasury officials (or most of them) themselves have in the Chancellor's policies.

The second important change to have occurred is an erosion of confidence in the Government's policy in a wider sense. The Prime Minister herself, or so it is said, is becoming afflicted with mild scepticism about at least the timing of the dawning of the entrepreneurial renaissance which is supposed to be the result of her monetarist stringency. But that hasn't yet diminished her enthusiasm for the monetarism.

Sir Keith Joseph, who is charged with the benign neglect of British industry, is said to be down in one of his dumps; something has gone wrong, the country is failing to respond to the Government's logic.

Industry's lack of confidence in the Thatcherite policies is having a powerful impact on the Government and, no less significantly, on backbench Conservative MPs. Sir Terence Beckett's political ineptitude ought not to obscure the importance of this. The concern focuses not primarily upon the alarming trend in unemployment but upon the exchange rate, and on interest rates primarily because of their connection with the over-valued pound. How much punishment of this kind can industry take and — still more to the point — what good will it do in the end? Those are the questions Ministers and MPs are increasingly asking.

The trouble is nobody can pretend to see light at the end of the tunnel. All those who peer into the future without the aid of blue-tinted spectacles are becoming rapidly convinced that it doesn't work. This is the third important change in the atmosphere brought about by the mind-concentrating public expenditure review of the past few weeks. For there seemed to be no end to the remorseless logic of the Treasury. Where would it lead the country — and the Government — in, say, two years' time? To three million unemployed? Disorder on the streets? Suppose inflation bottoms out at 8 or 9 per cent in 1982 — would that be a sufficient basis for a competitive surge by British industry? And how long before unions and employers between them eroded whatever advantage has been so painfully gained?

These realisations have produced what is not yet a change of direction in the Government's policies but the beginnings at least of a crisis of confidence. There are too many Ministers now who know in their hearts that Thatcherism doesn't work and this dawning of disbelief is of far greater potential importance than any observable shifts of emphasis which are likely to emerge from the recent round of Cabinet battles.

Although the "wets" inflicted some humiliating blows against the Treasury it would be wrong to suppose that the rival faction in the Cabinet has gained the upper hand or that the counter-revolution has begun. All that has happened so far is that some commonsensical Ministers — mostly from outside the great spending departments — have prevented the Treasury from pushing its logic to its looney extreme.

The overshoot in public spending has three chief causes. One is the cost of the nationalised industries. For example, each man employed in the steel industry is currently costing the exchequer £7,000 a year.

Another is the cost of the recession. For example, every man unemployed costs the tax payer more than £4,000 a year. Thirdly, defence spending has gone over the top this year for the perverse reason that weaponry is being delivered in advance of time, that also due to the recession. These three items alone add a gigantic sum — in excess of £3 billion to Government spending.

The Treasury — determined to stay within the borrowing limits dictated by its monetary strategy — sought off-setting economies in the narrowing base of controllable public expenditure. That would have meant rubbishing election promises, deepening the recession and exacerbating social distress. The Cabinet, in the end, prevented the Treasury Ministers pushing their policies to such dangerous political extremes, but no coherent alternative strategy for combatting inflation is as yet in sight.

A fundamental change in the direction of Government policy is not yet in prospect. One reason for this is that Mrs Thatcher still has time on her side. The prospects for the coming wages round are good; the retail price index (which measures inflation) is the only one flashing an encouraging sign; workers are behaving cautiously and household incomes have not yet felt the impact of the recession. Mrs Thatcher has at least one more winter of her honeymoon.

The hue and cry about spending cuts, the alarming trend in unemployment, and the headlines of economic gloom and doom have between them obscured an important fact about the present state of Britain. This is that real living standards are only now beginning to be hit by the recession. During 1978 and 1979 real disposable income (that is money to spend after tax, deductions and price increases) rose by a cumulative 12 per cent. Only in the third quarter of this year did a decline set in. North Sea oil and inflationary wage bargaining have so far cushioned the British standard of living against the effects of the sharp increase in world energy costs.

It is no great wonder therefore that the Government is less unpopular than might be supposed, that many groups of workers are prepared to accept modest wage settlements, and that there is as yet no general sense in the country of the impending crisis which is beginning to grip Ministers and their senior officials.

The unemployment time bomb already has some time to tick. With more than two million out of work already the total, according to official forecasts, could rise to 2.7 million by this time next year and — perhaps — three million by 1982. Yet it is misleading still to talk about "mass" unemployment just as it was in the Thirties;

So Mrs Thatcher has some leeway yet. What is worrying many of her Ministers is not so much the immediate consequences of her still-determined persistence but rather where it may have led her in a year or two's time. The recession in Britain is worse than anywhere else because of the greater underlying weakness of the British economy. Persistent slow growth combined with inflationary wage pressures and resistance to structural change have progressively enfeebled the British economy. Without North Sea oil the crisis would by now be deep and fundamental.

In such an atmosphere it was never likely that the Thatcherite free market magic would bring about the rapid change in attitudes and performance expected of it. What at the time of her election seemed like an innocent enthusiasm now seems like a risible delusion. Mrs Thatcher being Mrs Thatcher she intends to press on.

But how will the damage done to British industry be repaired? How will the economy climb out of a recession so deep? Who seriously supposes that the sustained wage restraint necessary to restore British competitiveness will be forthcoming? Who can believe that a spontaneous industrial regeneration will result from the policy of squeeze, squeeze and squeeze again?

In the last few weeks an apparition has appeared at the end of the tunnel. It is not the glimmer of light but rather the dark spectre of failure. It has been a chilling experience for those who have seen it.