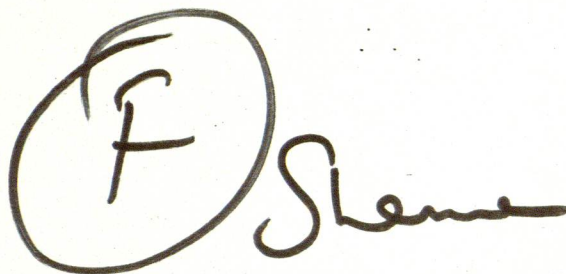


MEMORANDUM



To: Prime Minister

From: Alfred Sherman

AMICUS PLATO, SED MAGIS AMICA VERITAS

(Aristotle)

The budget has been received with warm acclaim in many friendly quarters. I wish I could share their optimism, but I cannot. On the contrary, I think we are on a path to disaster. It is not for me to say how far our friends' optimism stems from loyalty, good will, hope - all admirable sentiments. But I have learned from experience to trust my own judgment, while heeding what everyone else has to say with an open mind, and treating it on its merits.

As I see it, the present weight of state expenditure is already more than the economy can bear. Yet government policy is to increase it further both absolutely and even more as a proportion of the measured private GDP which is due, according to Treasury forecast, to shrink. This attempt, combined with the wholly unrealistic obligation to link a high proportion of government spending to the RPI is bound to intensify the hyper-inflationary treadmill. (I define hyper-inflation not in numerical terms, but as a situation in which inflation feeds on itself, which indexation invariably produces.)

Hyper-inflation, in turn, is bound to intensify "confrontation" and waste of resources, thereby retarding the growth of real investment and self-financing and sustaining employment. As a result, two years hard slog will not take us nearer the promised land, but further away, leaving no time for new policies before the election run-up.

The key to abating inflation is cutting government expenditure. As KJ said in 1976 in a booklet which still carries your imprimatur, "cuts means cuts", not cutting projected increases. If that was true in 1976, when the snaffle-bit of the IMF restrained expenditure, a fortiori in 1979/80, after two years of all out electioneering-economics by the Callaghan government, the need to amputate in order to save the patient is commensurately greater.

Nor can I honestly share the belief that NSO revenues will obviate the need to grasp nettles. On the contrary, the NSO revenues and balance-of-payments contribution are a two-edged sword. They reinforce a healthy economy and undermine a sick one, as several oil-producing states have discovered. I agree with Hayek and Macchiavelli that inflation is easier to squeeze out quickly than slowly. Experience in several "success story" countries confirms this, politically and economically.

As we have seen, NSO's impact on the value of Sterling makes exporting more difficult and import-penetration stronger, thereby weakening our industrial base. This need not be inevitable. Were it accompanied by a decrease in domestic cost-levels, then competitiveness could be maintained and enhanced, while we enjoyed the benefits of a high exchange rate too. An open economy like ours (i.e. an economy which must have a high foreign-trade quotient) does better by attending to its cost levels than being dominated by its exchange rates.

But in an economy like ours, cost levels are decided primarily by government expenditure-levels - whether you measure them in terms of taxation or of resources-use - and secondly by labour-costs, of which, of course, wage levels are only one component. Given high taxation (including NI and inflation-tax), trade union opposition to productivity, and the way in which labour is made scarcer and more costly by generous wages and lax demands in nationalised work-simulation centres, and generous indexed unemployment and supplementary benefits, industry's competitive position is undermined, while NSO pushes up Sterling's value.

Please allow me to leave you with the orders of magnitude. GDP is of the order of £120 billion, inflation is running at 20%. This means that there is £24 billion excess purchasing power in the economy. This is generated primarily by government sale of paper to the banks, who then tend to multiply it by using it as a monetary base.

The effect of inflation is to accommodate this discrepancy between monetary demand and real supply. But insofar as the government is obliged to make good the 20% difference for a high proportion of the £80 billion in the state sector (whether by indexing benefits or adjusting cash-limits) more money has to be printed. In this context, £600 million is less than the statistical error. And insofar as the private sector is actually shrinking, the additional burden placed on it is even more killing.*

* I enclose two recent articles of mine. I also commend to you Hayek's recent lecture.

This may seem pessimistic, but it is realistic, and I think my loyalty is best expressed by telling you what I really believe, rather than relaying wishful thinking. As I said earlier, after nearly twenty years of matching my vision against that of KJ, the Treasury and the rest of the establishment, I have learned to rely on my own judgment. I do not trust the Treasury's (Keynesian) model, nor have I a high opinion of their reasoning. Needless to say, I should be happy to defend my views in any forum.

28 March 1980