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MRS THATCHER

The Chancellor's Package

I have foreborne from bombarding you with paper about this since the newspapers have done their best to keep us fed up with a steady flow of ever-changing information. However, you may find it helpful to have the attached background notes from George Cardona and the following more general comments before the Chancellor makes his statement and before the Shadow Cabinet considers what he has done.

Economic Appraisal

I start off by assuming that the Chancellor will, as widely foreshadowed, propose for the financial year 1976-7:

(a) spending cuts of some £1 billion or so;

(b) financial savings of £250-750 million, composed partly of sales of BP shares, higher charges (e.g. for council houses) and higher indirect taxes - or a selection from these;

(c) some larger cuts in 1977-8;

(d) adherence to targets for DCE, and possibly the money supply or borrowing requirement as well.

I would furthermore assume that he will announce that talks will take place in the new year about arrangements for re-deploying the sterling balances, but that he will not be able to promise any firm commitment from our allies towards the introduction of a new scheme.

from the economic point of view

We have to ask ourselves first whether such a package is likely to be adequate. Given that the outside world wishes us to pursue a tough monetary policy and to get on top of inflation as quickly as possible, the smaller the spending cuts the greater the crowding out pressures in the financial markets.

On the whole the outside experts seem to think that money savings of the order of £1½ billion net or so should not bring about undue competition for personal savings next year. But this is, of course, largely because borrowers have been so badly crowded out already that they are unlikely to seek further punishment and will limit their demands for funds severely. I conclude therefore that there is no great inconsistency or incoherence between the likely size of the monetary targets and the spending cuts which the Chancellor and IMF will have agreed together; but that these targets will together go hand in hand with a very depressed rate of economic expansion as a result of the errors of past years.

The next question is how far the size of the spending cuts (as opposed to increases in revenue) is adeq uate. At this point it is important to stress how little we know about the size of the relevant magnitudes next year. My own suspicion, oft repeated, is that we shall only be told about a proportion of the total reductions which the Government has effected in the plans it laid down in February and July of this year. If the cuts in reality amount to something in the region of £1½ billion, then I think we can be reasonably satisfied. Clearly the more effectively the Chancellor takes action to resuscitate the private sector at the same time as he restrains the public sector the greater the case for public sector restraint.

If past experience is anything to go by the composition of the Chancellor's economies will certainly afford us grounds for complaint. We are already well aware of what he intends to do to the defence budget. In all probability he will already compound the errors of the July measures of this year by making still further economies in capital investment rather than restraining expenditure on current account.

Confidence

The crucial question in the short to medium run is not whether on any objective analysis the measures are sufficient – in reality there is a wide margin within which they could meet that criterion. What is far more important is the extent to which they affect international confidence. Here my belief is that – accidents apart – the package will be well received initially. The principal reason will be that the rest of the world sees us at last in the hands of the International Monetary Fund and unable to pursue an economic policy of our own for some time. However, this reaction could be quite short lived. If the response of the Labour Party is one of hostile or growing disunity, then external opinion will naturally turn sour before long. If, furthermore, it should become apparent that the Government's policies, and developments in the economy should make it impossible for us to meet the IMF's targets, then one can expect confidence to ebb. Finally, the announcement of a series of discussions about sterling balances can only help. Whether it will account for much by now is difficult to say, but my own feeling is that it will have been largely allowed for already. There could easily be little more joy to be extracted from this story until or unless a genuine renewal of something like the Bale agreement of 1968 can be agreed with other countries.

The greatest threats to any lasting strengthening of confidence must be:

(a) the fact that the Chancellor never seems to do as much in any mini-budget as he knows he ought to do;

(b) the quite technical problem of sustaining or (already) improving on the present exchange rate when ~~a~~ our monetary policy* acts as a very strong attraction to overseas lenders.*

Since the costs of yet another failure must be very high while the costs of erring on the side of "over kill" are small, we can certainly criticise the package for its modest scope if it is anything like it is expected to be at the moment. In general terms I think it would be unwise to assume that the public reaction will definitely be bad - qualified anxiety should be the keynote.

<u>What line we might take in Parliament</u>

My own feeling is that our reaction to the package should be based on the following six points, three positive and three negative.

We welcome (i) the fact that the economy has returned to the embrace of the IMF. That was the only way that Labour economic policy could be made to work at all under Mr Wilson last time. It remains the only hope while Labour are in power today.

(ii) The further conversion of Mr Callaghan and a few of his Ministers to our views on the importance of restraining public spending, preserving a disciplined monetary policy while avoiding crowding out (or at least the extremer forms of it).

* This point [illegible] figures

[illegible]

Mrs Thatcher 14th December, 1976.

(iii) The publicly announced - and the hidden - cuts in public spending on which the Government are embarking.

But we deplore

(iv) The absence of the degree of "over kill" needed to ensure that the country does not plunge yet again into a sterling crisis within a month or two.

(v) The composition of the economies which the Chancellor has proposed.

(vi) The almost total absence of any effective measures to resusciatate the private sector.

I have a strong feeling that we would be ill-advised to formally oppose the Government in the economic debate next week. I sense that to do so so shortly after your recent speech on devolution will seem excessively aggressive and will imply rather strongly to some people that we in practice will oppose whatever we can whenever we can rather than adhering to the admirable principle of backing the Government when it carries out the right policies.

AR.

Adam Ridley

Copy to: Sir Geoffrey Howe