

From the Rt. Hon. Harold Macmillan, O.M.

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By hand

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*Dear Private Secretary,*

When Mr. Macmillan was staying at Chequers at the beginning of August, he promised to send the Prime Minister his views on the present economic situation.

I now enclose a Memorandum which Mr. Macmillan would be grateful if you could hand to Mrs Thatcher.

*Yours sincerely,*  
*Rosemary Aisneith*  
Personal Secretary

The Private Secretary  
to The Prime Minister

MEMORANDUM

From: The Rt. Hon. Harold Macmillan, O.M.

1. The world economic situation is dominated by the gap between the sums paid by the oil purchasing countries (chiefly the West) and the oil producing countries (chiefly Arab). This is a classic example of the imbalance between the rate of saving and the rate of investment analysed by Keynes fifty years ago. The scale, however, is far beyond anything that could have been conceived by former economists. After making allowance for genuine investment by the oil producers there is estimated to be some 200 billion dollars, which is known in technical language as 'inrequitable'. In other words, this sum is not turned into goods and services by the oil countries but remains held mainly on short term in the international banking system.

So long as this gap remains there is inevitably world recession, and it is by far the greatest problem which besets the civilised world to-day in the economic field.

2. This gap has been to some extent, dealt with from 1974 by what is called the process of 'recycling'. This really means a desperate effort by the international banking system to find credit-worthy borrowers all over the world. This process cannot be pursued much longer. Already the banking system especially American is at risk

and any further attempt to force money upon unsound borrowers may lead to disaster. There is, therefore, this dilemma. Yet if the money is not re-lent in terms of goods and services (chiefly capital goods) the world recession will continue. If it is re-lent beyond what sound banking practice would allow, there is danger of a liquidity crisis overcoming the international banking system similar to, but on a much greater scale than, that of 1931. It only needs another Credit Anstaldt to start it off.

3. Short of occupying the oil producing countries by force, which seems both immoral and impractical, there is no method except by persuasion or compelling the Arab countries to allow this huge surplus to be invested fruitfully. What is really required is a massive investment in non oil producing countries, especially the so-called Third World, similar to the Marshall Aid for Europe in 1947. It is clear that this is a difficult task needing long and skilful negotiation. It cannot be solved by the sudden appearance of international officials for a few days in this or that Arab country. It needs a long and patient negotiation headed by trusted American and European figures. Meanwhile every effort should be made to increase the production of oil all over the world and the production of energy by atomic power as rapidly as possible. But since all this will take a long time the fact of the tendency towards constant recession must be taken into account.

4. All the circumstances, therefore, would demand at the present time not restriction and deflation, but powerful reflationary measures largely on capital account throughout all the countries of the West.

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5. What is it that prevents the adoption of the natural remedy of reflation? It is the phenomenon which has developed in all the market economies certainly of the West and more particularly in Britain, of inflation caused by excessive wage increases without corresponding increases in production in industry and commerce, accompanied by equal or even greater increases in the administrative classes.

6. The situation in Great Britain has been worse than other Western countries because of the almost negligible rise in productivity. To the extent that the British disease has become more serious than the Continental, our competitive position had fallen in world markets even before 1974.

7. Faced with this situation most countries have taken restrictive action of various degrees of intensity. Only in Britain has this taken the severe form of the last year.

8. Here in Britain a combination of high Bank Rate (to a point which would have been regarded as sheer usury in any other age) and the consequent attraction of foreign money (mostly in the form of hot money) into Britain, by rates

higher than those prevailing in other countries and a corresponding increase in the value of the pound against the dollar, has seriously increased the competitive difficulties of British exporting industry without so far producing any marked effect upon the inflation of prices.

9. The so-called 'money supply' policy may be useful as a guide to what is happening just as a speedometer is in a car; but like the speedometer it cannot make the machine go faster or slower. In the first year of this Government the whole concentration of effort to squeeze wages down or to prevent excessive rises has fallen naturally upon that part of industry and commerce which, whether publicly or privately controlled, has to compete in the market. It has affected equally British Leyland, the Steel and the Coal Industries which are Government owned; but it has fallen more particularly upon private enterprise in its true sense, that is to say that part of the economy which is still operating independently of Government ownership or support. It must not, however, be forgotten that so-called private enterprise depends in many cases largely on the purchases by central or local government (for instance local authorities are the largest buyers of furniture in the country). Hence the squeeze upon public expenditure whether central or local both in capital and consumer goods coupled with the high rate of interest and the over-valuation of the pound (which is based partly upon British oil production and partly upon the attraction of high interest rates) have combined to put British production

industry, whether public or private, in an increasingly precarious position with little corresponding relief. It is, of course, true that in the private sector these processes are likely to result in smaller wage concessions this autumn (10% or less). This is partly due to the actual inability to pay any increase without bankruptcy and partly through the fear of trades unionists seeing the rapid growth of unemployment and their corresponding willingness to accept more reasonable terms.

10. Nevertheless, the picture is a serious one. For even if firms may be able to remain in business, either by drawing on existing liquid assets or by the sale of other assets, or by borrowing from the banks, many of them will be forced to reduce their output and to abandon their investment projects with a corresponding reduction in their competitive power in the future.

11. What then can be said to have been gained? Certainly a shock has been given by the Government's policies to the nation as a whole, and even a sense of exhilaration amongst those who believe that steady continuance of these deflationary policies will achieve the desired result. (Incidentally, Mr. Biffin one of the protagonists of 'monetarism' has admitted that the effect of this policy on inflation may be negligible). The main visible pressure has fallen on private competitive enterprise. The high value of the pound, the excessive interest rates, and the postponement of capital investment by the central government, local governments and

industry, are together threatening not merely an alarming increase of unemployment (which so far as it is a result of reducing over-manning may be healthy economically, although dangerous socially). But in due course it threatens a serious blow to the balance of payments through the collapse of parts of certain important industries (e.g. textiles, paper making, etc.)

12. Meanwhile it is quite true that the Government have tried to bring similar pressures in the public sector whether in that of the producing side or the purely administrative side. Unhappily, they entered the campaign with apparently little knowledge of what powers they really have. They have little if any control of the wages paid either by central government or by local government. The powerful bureaucratic system which has taken away the central powers of the Treasury over state employment and much reduced the power of Ministers over their own departments, makes it almost impossible for the Government to fix the wages of its own employees, since they are now controlled by a whole series of committees and mechanisms which have become rooted in the system. (Even with the teachers, which is a solitary case where the Government has statutory control, subject to Parliament, it was found impossible to set aside an arbitration). On local authorities the only instrument which the Government can bring to bear is to reduce the grant. But the local authorities can retaliate in three ways. In spite of a reduced grant they can increase rates. Secondly, they can postpone capital projects, even the most essential and worth-

while. Thirdly they can cut their purchases of various commodities greatly to the injury of private enterprise and to that of the public as a whole. There is no way by which the Government can stop this nor is there any way in which the Government can force the local bureaucracy to reduce its own numbers or remuneration. Thus both locally and centrally the tendency is the other way, (just as it used to be said, perhaps jokingly, that the fewer ships the Navy had, the greater the number of Admirals).

13. It must be admitted that the troubles of the last fifteen years are largely due to the refusal of the trades unions to accept any curb upon their monopoly position, and their determination to force up the wages in terms of money rates without regard to productivity.

Conservative and Labour Governments in turn have made an attempt at a so-called 'wages policy', sometimes by voluntary method, sometimes by statutory control, and sometimes by a mixture of both. It was, of course, part of Conservative policy at the last General Election, that a Conservative Government would not attempt a wage policy but would only exercise control by 'monetary' means. That is to say, by squeezing productive enterprise, especially private enterprise, by putting cash limits upon public industries or services, and by restricting the cash available to local authorities. In fact, this amounts just as much to a wage policy as formerly, but by other means. Can it be said to have succeeded so far? Will it succeed if continued,



or will the cost be too high?

14. These are the questions which must now be faced. It is clear that a very considerable amount of success has been reached in the sense of giving a severe shock to the nation. Nor would it be wise to make a sudden change of policy, thus losing the confidence of the Party and of the people and creating a sense of confusion. There are, however, many adjustments that can be made, the most vital of which are

- (a) to reduce the rate of interest to a reasonable figure.
- (b) to try to repel rather than attract foreign hot money, again by reducing interest rates and thus reach a more realistic value of sterling.

15. It will be argued that the reduction of interest rates would force the Government from its policy of funding the public requirements rather than living on Treasury bills. I believe it will be found on examination that little of the foreign hot money goes into buying long term Government securities. These are the result of internal saving. My experience over a great number of years is that the mass of the public save out of habit or prudence. The only budget which I introduced as Chancellor of the Exchequer in 1955 was called 'the savings budget' and we raised enormous sums when money was 5% or less. The story of the Building Societies has

been the same. It may be argued that reduction in the rate of interest would not automatically reduce the excessive value of the pound. Nevertheless it can be tried and if it fails normal open market measures can be taken. If these remedies were applied they could be claimed as a success of the policy rather than a failure or change of direction. If they are not, the Government will be gradually forced either to further nationalisation of industries fallen into bankruptcy and/or to protective measures with all that this implies to world trade.

16. Wage policies as such have failed both Labour and Conservative Governments. Is there any way out other than a reversion to voluntary or statutory wage control? It would appear that the only course now is to try to divert attention from the excessive emphasis of wages to the problem which we all know to be basic - that of productivity.

17. British wages are not high compared to Continental or American, but British productivity is lamentably low. We all know the problem. We all know its roots. We all know its history and we all know what should be its solution. But in spite of some progress in various industries, we are lagging behind. The new industrial revolution is upon us, and we are not taking advantage of its opportunities.

18. It must be remembered that as civilisation proceeds the base on which it depends becomes, proportionately to the whole community, continually smaller. In a primitive society the whole population except perhaps the King or Chief, and a

few magicians or medicine men, are employed on production of wealth - ploughing the land, tending the cattle and so forth. Such a society is like a pyramid with a very small top and a very large base. As civilisation progresses the structure turns into something more like a pillar; we have now reached the point that a modern society is more like a pyramid upside down. The top is very large and the base upon which it depends is proportionately smaller. This has been made possible by the introduction of the machine in all its various forms, with great potential benefit. Yet all the benefits of civilised life, religion, the arts, education and the like depend ultimately upon the producers of wealth. I do not know what is the true proportion now: but let us say that one man at work supports three or four employed in defence or in the social services, or in the various evidences of civilised life including administrations. But this man can only sustain the burden if his productive capacity is steadily increased. You can, of course, try to reduce the burden by cutting down the burden on the producer. This, up to a point, is sound. But it soon becomes regressive. The right course is to increase the power of the one man through the proper use of the machine so that he can exercise the creation of wealth of say  $1\frac{1}{2}$  men or  $1\frac{1}{4}$  men.

19. If this be the true way out, as I am convinced it is, surely the full effort should be made now to organise a real campaign in favour of productivity. This must be combined of course with some relaxation upon the pressure of investment

but it should be accepted as the main task of Government to preach to industry.

20. We should organise nationally, locally and industrially, possibly through the existing NEDDY's, or possibly by some other organisation for the purpose. Churchill was always hankering after some kind of industrial parliament for he realised the extraordinary system whereby political matters are debated fully and openly while the decisions which effect a whole nation are taken by employers and trades unions without any clear picture being given to the public for the reasons actuating their decisions. If much of the restrictive practices were argued out fully in public the whole situation might well be changed and the pressure put upon the acceptance of modern methods of production and the best use of modern machinery.

21. It is by trying to switch the controversy on to productivity and the benefits in terms of wages, hours of work, holidays and the like that can follow the adoption of modern methods, that we may hope to obtain by a return to 'consensus' politics, sneered at by some, but the essence of Tory democracy. Devisive politics in a democratic system are not likely to be applied for sufficient length of time to become effective even if such methods were desirable. Nor can permanent deflation be a credible solution to the threat of national and international recession.

H.M.

20th August 1980