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29th May 1975

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I have only now finished checking the attached note of the discussions I held a couple of week's ago about the central issues of economic policy. It may seem a modest output from an all-day discussion but it did help to clear our minds and you may find it useful. I am sending a copy to Keith Joseph as well as to David Howell, John Nott and Research Department.

The obviously missing part of the argument (which we discussed inconclusively because we were near the end of the day) is what, if anything, should be done towards altering the effective balance of power as between Government and collectively organised labour. This will have to be one of the main subjects for discussion in our central economic policy study group.

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The Rt. Hon. Margaret Thatcher MP

NOTES ON AN ALL-DAY DISCUSSION ON ECONOMIC POLICY

HELD AT 61 PENTIMAN ROAD on SUNDAY 18th MAY 1975

Present: Geoffrey Howe
David Howell
John Mott
Adam Ridley
Michael Niblock
Anne Bulloch.

R. Lawson / *de*

1. Recognise the necessity for living with a floating exchange rate, not least because it would be impossible to replace it with any other system in the foreseeable future. Moreover it is technically desirable. But it does not solve any of the underlying domestic political problems. It makes their solution more urgent and carries the threat of adding to them if they are not solved. It brings them to the surface more quickly. For example:
 - a. It poses the threat of higher interest rates, with the consequent difficulty of "dealing with" the mortgage situation.
 - b. It makes plain, but not plain enough, the impact of continuing devaluation on living standards BUT
 - c. Does not prevent the wrong people protecting themselves against the consequences.
 - d. The fact that the exchange rate is floating will not exclude the necessity of day-to-day decisions being made as to the kind of money that you had to use to support the rate.
 - e. The floating rate regime does make the crunch - and therefore the moment of necessary decision - so much less likely that it is extremely unwise to expect such an event to produce a manifest occasion for action. It should be one of our main political tasks to try to focus the consequences into such a moment.

2. Probably the most important political and practical constraint on monetary policy, particularly in the context of a floating rate, is the housing mortgage market. A stabilisation scheme that would have the effect of insulating this is an essential concept to have on hand. In order for this to march alongside housing policy generally, it needs to be selective. It should best take its place in the context of increasing "privatisation" of the housing market. The question arises whether this two-tier interest rate structure needs to be extended in other directions.
 3. We are against balance-of-payments-type regulation of imports whether in the form of specific controls or subsidies or surcharges or quotas of anything of that kind. On the other hand, we recognise the legitimacy of anti-dumping action; but should confine that to importing which is not merely painful but fair, but manifestly painful and unfair.
 4. Proper monetary control involves, for the private sector, exposure of that sector to the impact of higher interest rates. Insofar as that involves a high cost of borrowing notably for industry, compensation can only come from allowing industry to charge the cost of such borrowing. In addition to such control (through the mechanism of the price of money) of the private sector, one should need to have available at least agencies like hire purchase control. There is a need to consider whether other special controls might be necessary, including the corset; and re-examination of the overdraft system.
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5. The problems of managing monetary policy in the private sector are made infinitely more difficult by the current condition of the public sector. This has got to be tackled by reduction of the PSBR. This must itself be implemented against the background of a sensible flow of funds analysis. There are really two objectives:-

- i. To reduce the underlying weakness of "a government living beyond its income".
- ii. To secure a switch of the resources currently being over-borrowed into essentially the corporate sector. We want to make it clear that this long-term reduction of the PSBR can and should be achieved only over a period of several years. The objective could be attractively presented in terms of getting back towards a situation where we may balance our budget. Insofar as the immediate consequences of rapid reduction in the PSBR - without further consideration of the consequences - can be unacceptable unemployment, the scale and manner of reduction must be adjusted in light of plausible expectations as to where the resources should and would flow in the alternative.

6. The need to cut the PSBR - two complementary arguments:

- i. If the PSBR continues to grow, we will be moving further and further towards the Weimar mechanism of hyperinflation.
- ii. In order to have a sensible monetary policy, you have to ^{reduce} the public sector's outside borrowing requirement.

7. Cut the real level of public spending

- i. We have to do this first because we are living beyond our means and we have to reduce the total of resources consumed domestically.
- ii. We have to get the allocation of the resources we do consume domestically right as between the different sectors, public and private, investment and consumption, exports and home.

Social Contract

8. We can neither cut the PSBR nor do much about the real level of public spending if we continue with the most obnoxious feature of the social contract which is its automatic compensation for price and tax increases.
9. Cutting the PSBR should and would involve the elimination of subsidies. Insofar as that contributes to a rise in the RPI, it should not be allowed to deflect us from that strategic course. There may, however, be a case for regulating the timing of subsidy elimination so as to prevent it all taking place in one provocative peak.
10. The dominant problem is the reduction of the level of pay settlements. This problem must be tackled most directly in the public sector. A literal freeze of incomes whether or not accompanied by a freeze of prices is unacceptable, because it could not work save for a very short time, and would only defer the real problem. Anything resembling a freeze of prices or tightening of price control is wholly unacceptable because of its impact on profitability, unemployment and nationalised industry deficits and so the PSBR.

11. The possibility of across the board indexation of pay settlements deserves consideration as a policy objective. It is in fact a sensible identification of what should be the next step to a still lower level of pay settlements. Statutory enforcement even of this would be unacceptable because of the consequent rigidity and scope for institutionalised confrontation.

12. The method of achieving such downward indexation would be two-fold:
 - i. Willingness to discuss in such bodies as a souped-up NEDC (or other early consultation with the world at large) the propositions that real living standards would have to be reduced and that pay increases could not substantially compensate for more than the rise in prices of essentials. From such discussion a more realistic understanding of the economic position should emerge by way of replacement of the misleading social contract.

 - ii. By the setting of cash limits for the growth from year to year of public sector budgets, at an over-all percentage figure significantly below the current rate of inflation; with which pay and job bargaining in each sector would have to take place. This approach would not involve displacing the measurement of pay parities along something like Priestley lines but would alter the consequences in terms of actual pay settlements and job security because of the need to reconcile the strict comparability with the strict limits of cash available. It is worth considering the possibility of making capital sums available within the public sector, specifically designed to encourage people to move out of employment in that sector (by early retirement or the active voluntary seeking of other employment (the golden quill-shake)

13. What has been said so far makes clear our policy preference in relation to freezes of various kinds. We should certainly not propose such things; but should be prepared to display a constructively sceptical willingness to consider such proposals, well illustrated by the practical considerations set out above.