Conservative and Unionist Central Office

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Memorandum from: Sir Harry Boyne

To: The Chairman
The Chief Whip
Mr Ian Gow, MP
Mr Alan Howarth

Date: 5th October, 1981

I enclose a text of a speech which Ted Heath is to make to the FCS at Manchester University at lunchtime tomorrow, Tuesday 6th October. We obtained the text at our request from Mr Heath's Research Assistant who told us it was already issued to selected correspondents and that we were at liberty to issue it through our Press Office although he quite understood that we might decide against doing so.

Having read the text with care I have decided not to make our facilities available for its issue and distribution. My reason for this decision is that the speech amounts to a sustained attack on the Government's economic policy which I do not consider it is the business of Conservative Central Office to disseminate to the obvious disadvantage of the Conservative Government.

HBoyne

There is another way

In this speech Mr Heath calls for 'a complete reassessment of Conservative Economic Policy'.

He describes the vicious circle of rising interest rates, increased costs, lower production and higher unemployment with the consequent impact on the public sector borrowing requirement to which Britain is now bound.

We must break our chains or continue into deeper depression.

Mr Heath analyses the consequences of present policies and then proceeds to set out his proposals.

Britain and the other members of the European Community need to do two things. First to free themselves from the competitive race in interest rates led by the United States in what it believes to be its own interests, and secondly to achieve the stabilisation of its currencies. In these Britain and the other members of the Community have the same interests in common.

To do this requires the EEC to ring itself round with a fence inside which it can be freed from the wild economic fluctuations of the world outside, organise its own interest rates - which are always relative - and stabilise its currencies.

It will require Britain to use again its exchange controls as part of the EEC exchange controls and to regulate the Euro currency markets which are the American Trojan Horse in Europe.

Mr Heath will deal with further details of this in his speech in Newcastle-upon-Tyne next Friday evening.

Breaking the vicious circle will enable the British Government to reduce interest rates, reduce the burden of interest payment on the Government and on businesses, allow profits and investment to increase, reduce unemployment and the cost of that to the Government and to reverse the present vicious circle of events. Mr Heath also outlines action that should be taken domestically to assist this process.

Mr Heath sets out some of the questions the man in the street is asking himself today and answers them by saying

There is another way

Release time: 1300 hours/TUESDAY 6 October 1981

Extract from a speech by The Rt Hon Edward Heath MBE MP (Bexley, Sidcup) speaking to the Federation of Conservative Students at the University of Manchester, Oxford Road, Manchester on Tuesday 6 October 1981

THERE IS ANOTHER WAY

The imperative need for a completely fresh assessment of Conservative economic policy

It is imperative in our present economic circumstances, both national and international, that we should make a completely fresh assessment of Conservative economic policy. This is necessary not only in the interests of our country, about which we must all be deeply concerned, but also in the interests of the Conservative Party for which some of us have worked throughout our political lives. Many of us have remained almost silent for a long time on these matters, perhaps for far too long, in order that the dire consequences of the present dogmatic policies could be more widely recognised. We were hoping that they would bring about a more pragmatic approach to economic affairs, greater flexibility in handling and a wider use of all the available techniques of economic management. Together these would have produced a better balance in the economy as well as in our society.

Recent events, however, have shown that this is not to be. The reversal of the downward trend in interest rates, the subsequent 4 points rise with the prospect of yet more to come, the still further increase in unemployment and the numbers of liquidations which are bound to follow the rise in mortgage rates together with the hardship and personal bankruptcies associated with them, all indicate that the situation is getting worse, not better, and that the policy has become more dogmatic not less so. In the political sphere, the Government reshuffle only confirms what is economically obvious. A fresh assessment can no longer be delayed. The time has come to speak out.

The vicious circle we must break

Britain is now locked in a vicious circle of spiralling interest rates. We are bound to the killing treadmill of their consequences. It is this vicious circle we must break.

Higher interest rates mean increased expenditure by the Government on all variable interest loans and on all new financing to cover its budget deficit. The recent rise of 4 points in interest rates will raise the cost of its new financing by at least £400 million to which has to be added considerable extra expenditure on existing variable interest loans.

Higher interest rates mean more unemployment and consequently more Government expenditure. For every extra 100,000 unemployed the Government has to find £340 million, not allowing for the resultant loss in production and the further consequential loss in revenue. The three million people unemployed today cost the Government about £10.5 billion - exactly the size of this year's public sector borrowing requirement. Reducing unemployment to what it was when the Conservative Government left office in 1974, namely just under 600,000 would save about £8.4 billion.

Higher interest rates in the public sector mean higher costs and higher prices. This then needs to be covered by either increased Government spending or increased inflation or both. Higher interest rates for the private sector also mean higher prices, lower profits, still further reductions in investment and lower tax revenue for the Government. Higher interest rates also mean that the banks have to lend more to those firms they are prepared to allow to survive. We are long past the point where any businessman in his senses will borrow for productive investment for he knows full well that in today's circumstances it is impossible for him to carry on his business financially in a way which will enable him to cover the cost of borrowing together with the actual rate of inflation and still make a profit on his capital. Those who borrow do so because they are desperate to survive. In these cases the banks lend them more money so that they can pay the higher interest charges on all their borrowings. The result is that the money supply is increased rather than reduced. Far from interest rates at the present level reducing inflation, Government expenditure and the money supply the tendency is to increase all three.

The net result of completing the vicious circle is that prices have increased, the rate of inflation has gone up, the money supply has increased unemployment has gone up, the rate of bankruptcies has increased, the industrial base has been further eroded, the Government's borrowing requirement has increased and as a result there is more pressure to raise interest rates yet again - to be followed inevitably by the same vicious circle. It is this which must be broken. The Government has made one attempt at doing so. It has proved unsuccessful because of the competitive race internationally for higher interest rates. It is from this that we must disengage ourselves. It will require drastic action which I will later outline.

Five years of monetarism - the methods and the mistakes

This country's economy has now been governed by monetarist policies not just for two-and-a-half years of Conservative Government, but for five years, in fact ever since the Labour Government was forced to call in the International Monetary Fund. Surely that is sufficient time in which to judge the merits or demerits of attempting to run a complicated, sophisticated economy purely by monetary means. The present Government has tried to manage the economy solely by the use of interest rates combined with attempts to limit Government expenditure. Let no one scoff at the difficulties encountered by a Government endeavouring to cut its spending. Every administration must continuously try to achieve greater efficiency at a lower real cost. After that cuts in orders for capital goods involve massive sums in compensation and do lasting harm not only to the public sector which requires the goods but also to the private sector which supplies them. Cuts in services, whether to businessmen or to citizens reach a point where they become totally unacceptable. These facts must be faced. A further attempt is about to be made to run the economy in this way, although contrary to these dogmas the Government has now been forced to intervene in the exchange market and to formulate an incomes policy for the public sector.

What have been the consequences?

Britain has suffered from a widely fluctuating Sterling currency. Sterling rose from \$2.08 to \$2.43 between May'79 and January'81, a percentage increase of 16% in 20 months. It then fell to \$1.78, a percentage fall of 26% in 8 months. Both movements were exacerbated by the decision not to use exchange controls, though fortunately these remain on the statute book. As a result of the first rocket-like rise many firms found their profits disappeared and their export markets lost, never to be regained. Some have gone into liquidation, not because they were over-staffed or inefficient but because the Sterling rate made it impossible for them any longer to compete. As a result of this currency instability no businessman today can make any sound judgement as to what the future holds for him in the world's export markets. The consequences are a loss of confidence in general and timidity in salesmanship in particular. Both are bound to damage our long-term export prospects. The recent severe fall in the level of Sterling will, it is calculated, add some 3% to our rate of inflation through the higher cost of our imports of food and raw materials.

The higher interest rates drove many small firms, in particular the family businesses, into liquidation. 1980 saw a record number of company liquidations, up by more than 50% on 1979. The situation has since become worse. In the first quarter of 1981 there was 74% more such liquidations than in the first quarter of 1980.

It is not surprising that last year the United Kingdom was at the bottom of the growth table in the West. In 1980 our Gross Domestic Product was actually 3% below what it was in 1979. There were shortfalls in particular in the production of textiles, leather, clothing and chemicals last year and the output of metal manufactures fell by about 30%. The only increase came from outside the industrial sector, namely in agriculture the only sector in which an unrestrained market mechanism is not allowed to govern, which rose by over 8%. As a further consequence, profits last year were badly down. For companies not involved in North Sea oil, they declined by 4½% and the fall is continuing this year. The impact on investment is clear.

On Friday 25 September 1981, The Times summed it up by saying, 'prices are today rising faster than when the Government took office. Unemployment is within a whisker of 3 million (up by 1.7 million since May 1979)' - it is of course above 3 million now. 'National output is 7¾% below its peak in the early summer of 1979. Manufacturing industry alone is producing 16% less' - and they might have added that is 15% less that in February 1974 despite the three-day week. It concluded, 'no Government for half a century has presided over such a fearsome economic deterioration.'

The myths of the 70's

Can anyone now doubt the need to make a complete reassessment of British and European policy?

Yet many commentators and politicians are reluctant to embark on this, either because they became hooked at an earlier stage on a simple poli of so-called pure monetarism, from which they cannot release themselves, or because they gave foolish promises to make major increases in defence expenditure, continuously slash taxes and produce a balanced budget all at the same time. Others cry that the only alternative is unrestrained sociali

All these groups have been influenced by their ignorance of the history of the last fifty years and by their acceptance of the pernicious myths spread about the twenty-five years from 1950 to 1975. These were assiduously spread by those naively believing that there is a simple formula that will somehow defeat inflation, create jobs and restore expansion. They do so in ignorance of the fact that inflation in the middle 70s was begun by the massive and rapid increase in world commodity prices, which for Britain amounted to nearly 200%, and by the 400% increase in oil prices imposed by OPEC in the Autumn of 1973. None of the doctrinaire monetarists has ever attempted to explain how inflation caused by a rise in external commodity prices on this scale can be dealt with purely by internal monetary policies. Nor do they explain how a further increase in OPEC prices at a time of world economic expansion will be dealt with by these means alone. In fact Britain, using all the techniques of economic management available succeeded in keeping the rate of inflation down in the early 7o's more successfully than any other Western country, and below that of any period during the succeeding seven years. As the Conservative Policy Document, "The Right Approach to the Economy" asked, 'Is there really such a simple formula?' It answered its own question with the reply, 'Of course not'.

New directions - the international position

When we look at the world economic situation we find it equally alarming. The present American administration is endeavouring to run its own economy on a similar monetarist basis. It is doing so regardless of its impact on Europe or on the rest of the world. Its high interest rates are leading a competitive race which is ruinous not only to Britain and to the rest of Europe but also to so many of the developing countries. The administration's attempts to reduce its enormous budget deficits can only succeed, if at all, over a long period of time. For how many years therefore is this policy going to be continued and for how many more years must Europe suffer? It cannot be other than long drawn out. There was a time when the United States could drag Europe out of a recession. The reverse now seems to be the case. Washington is indifferent to the fact that it is dragging Europe deeper and deeper into the mire.

How to regain control of our situation

The need to detach ourselves from the American-led pressure for ever higher interest rates is combined with a need to re-establish the stability of our currency. It can do us no good to see it rush up once again to a much over-valued position nor to see it come crashing down to the point where it is undervalued and inflationary.

We are not alone in this. The same applies to the other members of the European Community. They do not need interest rates at the American level for their national economies. Indeed their economies have been damaged by them already as well as by the inflationary impact of the increased cost of their oil imports brought about by the high level of the over-rated dollar. They need just as much to increase the stability of their currencies inside the European Monetary System. At the moment Britain is a cause of instability because, while we are not a member of the European Monetary System, the pound is in the European Currency Unit which is disturbed by these wide variations in Sterling. The interests of Britain and the other members of the European Communtiy are thus in line, to obtain lower interest rates and to achieve stability in their currencies.

The members of the Community must now be prepared to act as one in order that inside the Community they can adjust and co-ordinate their interest rates without having to elevate them to the American levels, and can stabilise their currencies with the use of the admustment mechanisms which make the EMS far more flexible than any of its predecessors. The resources available to the Community should enable them to achieve this.

Action by the European Community

Europe will have to put a ring fence round its money and capital markets to enable it to disengage itself more effectively from aberations in the rest of the world. It will require speedy action and firm leadership within the Community. We in Britain should resume the use of our powers of exchange control as part of a Community exchange control system vis-a-vis third countries. This could be used in either direction, to prevent hot money pouring in and pushing up our currency to an undesirable level as happened eighteen months ago, or to prevent capital flowing out to centres of higher interest rates and thus reducing our currency to the level where it is undervalued.

It is yet another myth to say that Bank of England exchange controls were ineffective. After 1931, they were well organised and highly efficient and we have much experience to give to the Community in setting up a system of co-ordinated intervention by the central bank vis-a-vis the dollar and the yen. The EMF would not intervene in non-community currencies. Instead the Community exchange rate intervention would be carried out by the member states in Community currencies.

The Community should also link Euro-currency markets to Community controls, for example by establishing reserve requirements. The Euro-currency markets are an ever-increasing and substantial factor in the disposition of the world's money, providing easy substitutes to nationally controlled money. This in itself can defeat the objectives of any government's policy. In Europe the shifting balances are a massive Trojan horse conveying United States monetary conditions into our own markets. The United States itself has a long-term interest in carrying out such an operation jointly with the Community in case the dollar again collapses. It would be best if this were done in unison. If we cannot do it together Europe must do it alone. That is what the European Community is all about. If the Community cannot reach agreement on this we ourselves must use our well tried and oft proven system on our own.

Major, indeed dramatic, changes in policy

The measures I have outlined would involve major, indeed, dramatic changes in policy. This would bring about basic changes in the position both of ourselves and of the rest of Europe. To the fearful I would say that the only alternative is to drag on down the dreary path of ever deepening recession. The reduction in interest rates could be the first stage of turning the vicious circle into a virtuous one. By the effects on the cost of servicing Government debt, by the increase in Government revenue consequent upon increased economic activity, and by lightening the burden on industry and small businesses, the scene could be set for increased investment, reduced corporate taxation and more jobs.

The effect of reduced interest rates would clearly be to improve corporate finance and profits. This is an essential precondition of economic recovery. This process could be assisted by the reduction and final abolition of the National Insurance Surcharge (NIS).

The surcharge is a tax on employment and on production. Its reduction and abolition would have the advantage of reducing the costs o goods produced for export without reducing the price of imported goods. It would therefore also assist manufacturers producing for the home mar While the surcharge is expected to raise £3.8 billion this financial ye much of which is paid by the public sector, its abolition would not cos as much as that. It would be in part offset by the reduction in payments of unemployment benefit and by the revenues from increased economic activity.

Creating the demand

It is not enough, however, just to make it easier for firms to invest. While abolition of the National Insurance Surcharge will encourage exports and produce a shift towards home-produced goods, further measures will be needed to provide sustainable demand at home and overseas.

As far as British Industry is concerned, there is a substantial and continuing reluctance to become involved with new investment and with research and development until an available market is clearly seen. This is one of the lessons of the past thirty-five years which we have to learn. It is not enough, therefore, just to provide a more efficient 'supply side' of the economy - the demand side also has an important part to play. This can be assisted by a Government by means of selective capital investment, the need for which is all too plainly obvious, some of it for productive purposes, some for the improvement of social conditions and the environment.

continues

World demand and international trade

International demand, in particular for capital goods can come from the developing world, either from OPEC countries with surpluses or from investment by the international institutions supplied with funds by the surplus holding countries. It is here that the British Government should be giving wholehearted support to the proposals being discussed at the Cancun Summit. It is a shortsighted measure to deter overseas students from coming to this country when they would otherwise be trained on British equipment and become ambassadors for it in their own countries. Similarly it is shortsighted to limit the provision of expertise to the developing world when so much of it could be later reflected in orders for British equipment. Britain cannot possibly pull herself out of this recession on her own. She needs the trade which comes from an effective demand in the developing world.

Sustaining the recovery

In trying to create the conditions in which the descent into deeper and deeper depression can be reversed there is another lesson which has to be learned. On every occasion since the War when Britain has been staging a recovery three major problems have emerged. First, the demand for raw materials for our industrial processes has resulted in an increase in our imports which has brought about a deficit on our balance of payments before the manufactured products, especially capital goods, could be exported. This has led to a weakness in Sterling. For the first time since the war, however, our position is stronger because of the effect of North Sea oil on our balance of payments. It can be made stronger still by membership of the EMS and the joint resources which support it.

Secondly, because of the overvalued level of our currency we have been prone to overlarge imports of consumer goods. This position should be improved with our currency in the EMS at a satisfactory level.

But neither of these problems have been as deep-seated as the third, namely the shortage of skilled manpower with which to carry through our industrial recovery. On every occasion the improvement has been halted by employers finding themselves short of both trained management and skilled manpower, particularly those who could adapt themselves to a fast-changing technology. Whenever it is possible to bring about the next recovery that problem will prove to be greater then ever. The shorta of all skills is bigger than ever before.

The moral is clear. What this nation requires is a massive training and retraining programme, not just in order to alleviate the impact of unemployment on young people but to provide a sound basis for the expansion of industry and services in the future. At present we lack both an effective system and the resources such as those possessed by our major industrial competitors. It is essential that the Government should advance speedily in this respect over a broad front. At the same time there will be an absence of volunteers unless it can be clearly shown how their skills are going to be profitably used in the future. There must be a light at the end of the tunnel. This we can show them once we break the vicious circle.

Consensus politics

Progress in these policies can only be brought about if a considerable degree of consensus exists within our country. I have heard some doubt expressed as to what consensus means. Lest this doubt continue let me endeavour to describe it. Consensus means deliberately setting out to achieve the widest common measure of agreement about our national policies, in this particular case about our economic activities, in the pursuit of a better standard of living for our people and a happier and more prosperous country. If there be any doubt about the desirability of working towards such a consessus let us recognise that every successful industrialised country in the modern world has been working on such a basis. Japan has probably achieved the highest position in this respect, Germany closely follows and among the smaller countries, Austria is foremost. Sweden, despite changes of government adheres to its consensus in financial and industrial affairs. France's success over the last thirty years has been based on a commonly accepted programme which has enabled it to overtake the United Kingdom and to advance swiftly on Germany. There was a time when the rest of the world admired the British because we appeared to have a capacity for compromise and for working together far beyond the reach of most other countries. Alas, this is no longer the case. That is no reason for not setting out to regain that which we once had and which has proved of such value to our friends and competitors.

Consensus is not created by signed agreements or solemn undertaking. It is created by a continuing process of consultation and discussion in which government demonstrates its determination to tackle the problems which cause tension within society - among them unemployment, inner city decay, racial discrimination.

No-one will ever convince the exponents of the singular doctrine of monetarism that it is now inadequate. The answer will always be that it has not been tried hard enough or long enough or that interest rates did not go high enough or that government spending was not cut savagely enough or that the action should have been taken more quickly to produce the desired economic results or more slowly to avoid the undesirable political and social reactions. These may long remain matters for academic discussion.

What the businessman and trade unionist, the ordinary citizen and his family are now rapidly realising is that if such a policy requires to be perpetuated for an even longer period and even more stringent measures such as are proposed at the moment are needed then the price which as individuals and as a community they are being asked to pay is too high to be acceptable.

This is a perfectly justifiable conclusion for any citizen to reach. He is entitled to make his own judgement on the costs and benefits of any government policy and then to act accordingly when he is given the opportunity.

The answer to the man in the street

What the man in the street is asking himself is this. Why does the Government arbitrarily fix the rate of increase in the money supply in a bracket between two particular figures? Why does it then find that the supply has doubled despite its decree and how does it come to the conclusion that a certain budget deficit would be justified but another would not? And then find that the deficit is £5 billion more than it decreed. And if the Government is determined to squeeze inflation out of the system why does it deliberately increase it by an increase in indirect taxation and other means? And if as a result of high interest rates, increased taxation and high Sterling rates, production falls dramatically, how can any increase in the money supply be justified? And how dare those who run the biggest budget deficit in history reproach others with the heinous crime of 'printing money'? And if more than three million unemployed are necessary to get inflation down to a level higher than it was two-and-a-half years ago, how many more millions of unemployed will be required to bring it down - to what level? - to a level which has never been revealed? And what level of interest rates and how many millions of unemployed will be required to keep it there? Indeed how can any recovery be started without Government investment at a time when interest rates are too high even to allow businesses to start stocking up? And finally, have we now moved into a money-conscious society which is only concerned with the high interest rates it can get on monetary deposits and not in the least with earning its income on the return from productive capital investment?

These are the questions the man in the street is now asking himself.

To which the insistent reply is that 'there is no other way'. To this the man in the street is more and more responding 'then there has got to be another way'.

And there _is_ another way. And one the Conservative party must pursue.