OD(80)63
29 October 1980

COPY NO. 44

CABINET

DEFENCE AND OVERSEA POLICY COMMITTEE

OUR ECONOMIC STRATEGY AND PRICE POLICY FOR AGRICULTURE

Note by the Chancellor of the Exchequer

At OD on 13 October we discussed agriculture prices in the context of the need for CAP reform, Community Budget restructuring and the situation of our own agricultural industry. We ought also to relate our approach to these managed agricultural prices to our basic economic strategy.

2. We are determined to adhere to our medium term financial strategy, to gear down the growth of the money supply and to achieve a progressive and permanent reduction in the rate of inflation. The inevitable transmission mechanisms of this policy mean incomes rising more slowly than the rate of inflation, a squeeze on profits producing a squeeze on costs, and the squeeze on costs leading in turn to limitation of wage increases. In time, as price increases slow down, employment and living standards will benefit.

3. Given our targets, if one section of the economy is protected from this painful mechanism, their share of the burden has to be added to the burden of the unprotected sectors. We have been all too well aware of the imbalances in the economy created by the personal sector helping itself to excessive wage increases and

thus transferring all the burden to the corporate sector; and by the public sector insulating its pay and its programmes and transferring the burden to the private sector. We have also been conscious of the insulation enjoyed by those on indexed state benefits. For good reasons of economic pricing, elimination of subsidies and long term fuel management we have had to allow the nationalised fuel industries to raise their prices as fast or faster than the general inflation. The effect of all this is that the private corporate sector, especially private manufacturing, is the residual legatee of economic hardship. It is thus forced into heavy bank lending which adds to its problems and which could put our policy at risk. We hope to see these imbalances redressed by much lower pay increases, especially in the public sector; by better productivity and reduction of costs generally; by reducing the demands of the public sector; and by reviewing indexation of benefits.

4. The very nature of the CAP protects agriculture from price competition and the discipline of the market. This has two major implications:

(i) It has created expectations that the Government accepts an obligation to maintain the living standards of farmers. To the extent that this principle is followed, farm prices are determined irrespective of the demand for the final products and the underlying basis for them is production costs - wages, fertilisers and other inputs, interest rates and so on.

(ii) As a result farm output tends to rise from one year to the other producing unwanted surpluses. This is in contrast to manufacturing companies who are able to pass on high costs only so long as they can maintain a market for their output. If a firm faces a declining market it is compelled to contract or to find cheaper methods of production.

5. To some degree an industry which has monopoly powers may be able to escape these consequences - the nationalised industries may be in this situation for example. Agriculture tends to be treated like a nationalised industry and to have built a traditional claim on public expenditure, as they have done. But we have taken the view that traditional claims for special protection must be subordinated to our basic strategy. In particular, it would not be consistent with that strategy to regard the maintenance of a defined level of real income for farmers as a legitimate policy objective, and to adopt the "cost-plus" approach to pricing that I describe in paragraph 4(i) above as the means of achieving this. Moreover the evidence of recent years is that a policy of maintaining real incomes by increasing end-prices is self-defeating. While the level of agricultural prices in real terms has been broadly maintained, this has not prevented some fall in real incomes. Instead costs have been allowed to rise until they erode the benefits. I realise that it is frequently argued that we should seek, within reason, to maximise agricultural output in the UK in the interest, for example, of increased self-sufficiency. But, so far as they are valid, objectives of this kind must not be allowed to imperil or override our more fundamental objectives.

6. All this reinforces the case for exposing agriculture to pressures encouraging cost reduction and improved efficiency. Other sectors are having to face price restraint through the operation of market pressures, and the consequences of exchange rate movements. We should start from an intention that agriculture should take a reasonable share of the burden. Currently, for example, agriculture is shielded from the recent appreciation of sterling; the green pound is now undervalued by over 8 per cent.

7. Another aspect of CAP price determination on which I suggest we should hammer away in the Community, especially in discussions with the Germans, is the effect on inflation. Prices which are set too high add to inflation through the price level, through national budgets and through costs and prices: and they are

too high to allow markets to be "cleared". Hence surpluses - and all that.

8. We cannot, of course, ignore the effect of CAP pricing policies on the incomes of farmers in this country. But when studying such figures we must be on our guard against drawing false conclusions. Officials are now examining the ways of estimating farm incomes and their discussions have revealed differences of view on the proper method of measurement. In any case, we cannot draw conclusions about policy on the basis of temporal comparisons confined to the agricultural sector alone. We must also have regard to the general state of the economy. In other areas of our policy, we have rejected the idea that incomes should be determined so as to preserve some past standard of real consumption. Past inflation should not be material to what incomes should be in the future. This should depend essentially on productivity and ability to find markets.

9. To sum up, considerations of general economic policy require us to dedicate our efforts to securing very modest price increases at the next CAP price review. If we were to lose sight of this objective, there would be a real risk that we should finish up with a very bad deal indeed for the United Kingdom - namely, a common price increase which was excessive when judged by the considerations set out in this paper and, <u>in addition</u>, an undervalued green pound which increased the protection of the UK farmer still further at the expense of our consumers and our price level. In fighting to avoid such a damaging outcome, we must not underestimate our chances of success. We shall be able to call in aid the political need, now acknowledged in other Member States, to reduce agricultural surpluses, and also the agreed objective of restructuring the Community Budget which will not be possible without a strict check on the growth of agricultural expenditure.

H.M. Treasury
29 October 1980

(G.H.)