SECRET

PART 9

Confidential Filing

Economic Strategy

Pay and Prices Monthly Economic Report

The Economic Prospect

ECONOMIC POLICY

Part 1: May 79

Part 9: June 81

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~16-6-81~~							
~~17-6-81~~							
~~19.6.81~~							
~~23-6-81~~							
~~2.7.81~~							
~~27.7.81~~							
~~31.7.81~~							
~~3-8-81~~							
~~7-8-81~~							
~~17-8-81~~							
~~28-8-81~~							
16.9.81							
~~17.9.81~~							
~~29.9.81~~							
~~5-10-81~~							
9.10.81							
-ends-							

PREM 19/424

PART 9 ends:-

9.10.81

PART 10 begins:-

12.10.81

TO BE RETAINED AS TOP ENCLOSURE

Cabinet / Cabinet Committee Documents

Reference	Date
E(81) 66	12/06/81
C(81) 29	12/06/81
C(81) 30	12/06/81
CC(81) 23rd Conclusions, Item 1	17/06/81
LCA, CC(81) 23rd Conclusions	17/06/81
E(81) 73	29/06/81
E(81) 23rd Conclusions, Item 1	02/07/81
MISC 14(81) 5	09/07/81
MISC 14(81) 6	17/07/81
MISC 14(81) 1st Meeting, Item 2	23/07/81
E(81) 83	03/08/81
E(81) 84	28/08/81
E(81) 95	02/10/81

The documents listed above, which were enclosed on this file, have been removed and destroyed. Such documents are the responsibility of the Cabinet Office. When released they are available in the appropriate **CAB** (CABINET OFFICE) CLASSES

Signed CWayland Date 23 November 2010

PREM Records Team

Published Papers

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

1. House of Commons Hansard, 27 July 1981, columns 828-837 (debate at 4.16 pm)

2. "Changing Gear: what the government should do next": Proposals from a group of Conservative MPs Published by Macmillan, October 1981

Signed OWayland Date 22 March 2011

PREM Records Team

Mike - we shall ~~person~~ of these points in question

PERSONAL

Econ Pol

~~C.P. Walker~~ J. Walker A. Duguid 2

Prime Minister

MCS 9/10

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

PRIME MINISTER

As you probably know, the "Blue Chip" Dining Club published yesterday their pamphlet "Changing Gear", launching it with a press conference and a number of broadcasts by individuals on radio and television. The chief interest of the pamphlet for a wider audience undoubtedly lies in its comments on economic policy and the importance of a change in style and tone of voice. The pamphlet's launch has been somewhat overshadowed and its impact diminished by Ted Heath's activities. However in the longer run I suspect that their relative importance could switch, Ted's outbursts being so much more immoderate in both tone and content, and much less well-written too.

..... 2. I attach a copy of the text, side-lined for quick skimming; a very brief summary of the most important arguments, which deals mainly with the economic content; and some brief comments.

3. Over and above policy, there remains the discussion of the closely related questions of style and flexibility, which are dealt with in Chapter 1. These remarks will undoubtedly strike many chords both in the party and outside, and I think we must heed them: a number of their policy prescriptions and much more of their argument appears to have been prompted by their failure to see that our case is nothing like as "simplistic" as they suggest.

4. That said, my own inclination in commenting on it in public at this stage would be to stress that it supports the

thrust of Government policy in most respects - and to point to its cautious overt attitude to reflation, emphasis on goals we support, such as helping industry, holding down pay, and so on. Where there are differences of view with the Government, in some cases the proposals offered are unrealistic (however desirable), e.g. a Heseltine-like trade-off of lower pay for higher investment; and in others imprudent, e.g. down-grading the objective of lower inflation.

5. We shall try to formulate a more considered line tomorrow in the light of the initial public reactions.

(G.H.)

9 October 1981

CHANGING GEAR: SOME SALIENT POINTS

Chapter		Page
I	Dangers of being dominated by economic theories.	1
General	Need to shift emphasis from inflation to unemployment. Dangers of inflexibility; and the old Liberal laissez faire model. Mastering inflation not of itself enough to ensure recovery; real demand must be expanded too in a non-inflationary way.	2 3
II Economic Policy	Critique of the Lawson theory of expansion (viz that demand grows when price growth falls below that of money): too vulnerable to shocks, and will not act sufficiently quickly, seen politically. Acceptance that crude reflation will be no good. Though all economic theories are immensely vulnerable, that would be no justification for doing nothing. Time for "decisive action". Govt should undertake capital spending and help industry similarly, in exchange for pay restraint and fall in living standards.	5 6
	Also it should cut NIS, interest rates, soften energy prices - again, the quid pro quo in restraint in pay; the sanction, income taxes. Gross cost £4-5bn for 2 years on capital, £2bn NIS; of which half might return to exchequer in lower benefits etc. If this overburdened public finances, income tax would have to to up.	7
	Admittedly "reflationary ... but some upswing in borrowing can probably be accommodated without affecting interest rates much ..."	
III		
Industry	Steer middle way between Benn-Godley and	8

Chapter		Page
	laissez-faire.	
	Selective assistance for sunrise industries.	
	Cut current public spending by more and have more capital spending.	9
	Some scepticism about regional policy benefits.	10
	More on R&D to match competitors. Help Science Parks.	11,12
	Supercharge existing small business programmes, simplify their taxes.	13
	Press on with NI privatisation, regionalisation, removal of monopolies. Introduce audit and regulation of their prices.	14
	More effective anti-dumping.	
IV		
Employment & Productivity	Six major reforms urged in next stage in reforming TU law: enforceable procedure; higher closed shop compensation; no union-only contracts; review-procedures for closed shops; lifting obligation on employers to maintain guaranteed pay when employees rendered idle by disputes; no-strike provisions in return for compulsory arbitration in vulnerable sectors.	17
	Encourage unions to join debate about economic policy. More moves to wider share ownership, code of practice on participation.	18
V	Reorganise training/apprenticeship on German model.	20
Labour Force	"Costs of upgrading ... MSC's present schemes on the German model are not as great as might appear."	21
	More flexibility in the retirement age, but not compulsory lowering.	22

Chapter		Page
	Make family the theme, to which poverty the greatest threat.	23
Social Policy	"The case seems strong for the promotion of family income at the lower end of the scale." Introduce mothers benefit, uprate child benefit to unemployed children's rates. All to be paid for from married man's tax allowance.	24
	Phase out pensioners' earnings rule and Inv income surcharge.	25
	Rebuild bridges between NHS and Private Sector.	
VII Constitutional	Reform H of Lords to strengthen checks and balances.	26,27
	Equivocal discussion of PR and, to a lesser extent, devolution.	29
	Reform rates with transfer of some functions to CG, and new local tax.	
VIII	Qualified enthusiasm for Trident.	30
Foreign, Defence, Europe	Argue for "reforms aimed at stabilising the world's economic system and developing trade".	31
IX Conclusion	One nation.	

BRIEF COMMENTS

1. Unlike most critics, the Blue Chips identify ways in which their tax and expenditure proposals might by funded. Thus they are prepared to see income tax raised to finance their proposed increases in capital spending and the cut in NIS if the markets necessitate it and if offsetting cuts in public sector pay cannot be achieved. And they would phase out the married man's tax allowance to fund the changes they propose in Social Security.

2. On the other hand this does not of itself make their preferred proposals feasible, nor the presentation realistic. Several aspects of their case provokes serious scepticism.

(a) They are arguing, for preference, for as much as a PSBR increase as can be got away with, for the explicitly stated reason that more borrowing would not much affect interest rates. This is even less easy to believe today than when the pamphlet was written.

(b) They criticise general reflation violently, while themselves commending a kind of selective reflation as if it were radically different merely by virtue of their having listed in detail how the money would be spent.

(c) They openly advocate taking risks with the inflationary prospect in the belief that it isn't of great importance politically or in determining employment prospects. History supports neither judgement.

(d) The trade-off between lower pay and on the other hand an NIS cut and higher investment is not negotiable, however desirable.

(e) Some of their costing is optimistic. Flexible early retirement would be rather costly, and would necessitate higher NI contributions. The cost of German-type training for the young would not self-evidently be "not as great as might appear", indeed the opposite is probable.

(f) The opening attack on the excessive importance of the money supply target and objective of mastering inflation is a caricature, which perhaps suggests they are victims of their own and others' rhetoric. Ministers have, of course, long argued for a very wide range of measures over and beyond monetary control, and implemented them in substantial measure, particularly to encourage the supply side, an aspect of policy the paper does not discuss as such.

(g) The Blue Chips clearly believe the Government can still do a lot to create effective real demand, and neglect the way that a flexible exchange rate and open financial markets now shortcircuit that "Keynesian" process before it can deliver growth, and punish one with higher import prices, worsened inflation and higher interest rates instead.

(h) They give the strong impression of believing that it is the PSBR which determines the level of real demand and that monetary control can be dispensed with. Experience on the other hand shows that monetary control is essential, and that the money supply determines demand - in which case the failure to discuss what are the proper monetary targets is a serious gap. It is also now clear that in broad terms interest rates fall and the share of private spending in economic activity rises if the PSBR is cut; and that PSBR increases are not expansionary.

cc Mr. Scholar
Mr. Hoskyns
Mr. Duguid
Mr. Howe
Mr. Gaffin

MR. PATTISON

Changing Gear

We spoke about the pamphlet "Changing Gear", which is to be launched at a Press Conference in the House of Commons on Thursday morning; I have had a quick look at it, and you and others may find it convenient to have this short note about the main features. It is not particularly long if others would wish to read it, although it makes pretty dry reading. It harks back unashamedly to the Macmillan era of "the middle way", a phrase which is used more than once in the text; and Macmillan is not only the publisher, but also the origin of the introductory quotation (". . . who I believe will not be led away from the old tradition of consensus"). The authors also make no secret of the fact that their principle motivation is the changing of Government policy in a direction which is likely to enable the Conservative Party to win the next election.

Chapter 1 is devoted largely to an attack on the pursuit of "a particular economic theory", which is not specified but is clearly intended to be monetarism. It is suggested that the Conservative Party now needs to move the emphasis of the policy, as inflation moderates, to a programme of industrial and social reconstruction to relieve unemployment. There are some good points: the Government is criticised for preaching an unpopular ideology which they have not carried out in practice; and there are some totally unsupported propositions, such as that monetarism leads to a series of short term policies, and that it is "political nonsense" to minimise the role of Government in commerce and industry. The general message is that the Conservative Party need not be on the defensive, and should move to a phase of "construction rather than destruction".

Chapter 2, on Economic Policy, is decidedly weak - as well as short. After rehearsing the arguments for the monetary strategy, the authors argue that "a political strategy based on economic theory is a house built on sand", without explaining why; and go

/ on to

on to make the case for increased Government capital investment in exchange for pay restraint, rather along the lines proposed by Mr. Heseltine in the recent discussions on public sector pay. But they had previously argued against the 1972/73 policy of expanding demand while using a statutory prices and incomes policy to supress inflation. The authors identify house building, roads, telecommunications, schools and major projects such as the Severn barrage and railway electrification as suitable objects for increased investment. They cost this package at £4-5 billion, with a further £2 billion in NIC cuts. This should be paid for by abandoning the commitment to lower income taxes "without affecting interest rates much". There is no analysis of the effect of this programme on interest rates, inflation or long term employment.

The more substantial chapter is the one on Industrial Policy, where it is argued that the Government should on the one hand selectively support the "sunrise" industries, with positive growth and profitability prospects, and on the other hand support other basic industries fundamental to the economy which are temporarily uncompetitive, such as cars and steel. There should be more Government support for the commercial exploitation of technology, and for small businesses. In the public sector the authors recommend largely what the Government is already doing: privatisation, breaking monopolies, breaking up into small units, improving management, and restricting price increases. (This last point is convincingly argued in Sarah Hogg's first article in the Sunday Times this week.)

There is nothing very original in Chapter 4 on Employment and Productivity, which is actually about industrial relations legislation. The authors welcome the cautious approach of the Government, and conclude that the need to win acceptance of the changes in the law precludes the more radical ideas which have been suggested (wholesale abolition of immunities or the closed shop, compulsory sequestration of union funds).

Chapter 5 on Improving the Labour Force is rather better: the authors ~~assumed~~ assume that 2.5 - 3 million will be unemployed for some considerable period, concentrated mainly in declining areas

/ of

manufacturing activity; and argue for at least one year's training, rising to two years by 1990, for school leavers, with an [illegible] allowance along the German lines payable.

Chapter 6 on Social Policy goes rather more against the current Government approach. The pamphlet concludes that family income at the lower end of the scale should be increased, through the introduction of a "mother's benefit" and a real uprating of child benefit. There is no discussion of the issue of real wages at the overlap with unemployment benefit. Wider availability of index linked bonds, and a closer connection between private and NHS medicine are also supported.

In the Chapter on Constitutional Reform, the authors conclude that the House of Lords should be elected by proportional representation, but are unable to reach a clear position on PR for the House of Commons. They do however argue for the reform of the rating system and a reduction of national Government funding of local authorities.

Finally, on foreign affairs, the authors say that they see less need for new policy directions than in any other area of Government activity: they support Europe, NATO and Trident, but would wish to see more aid for the thirty poorest countries.

There are two striking omissions: I found nothing directly relevant to the state of the inner cities, and the recent civil disturbances; and no reference to Northern Ireland.

5 October 1981

Pra.

MR. SCHOLAR

cc. Mr. Pattison
Mr. Hoskyns
Mr. Gaffin

Prime Minister's Press Conference in Melbourne: Economic Issues

As we agreed on Friday, I spoke to Bernard Ingham at the weekend about the possible Press Conference which Clive mentioned over the telephone to you. Bernard Ingham confirmed that the Prime Minister planned to hold an on-the-record discussion (not a Press Conference) with British correspondents in Melbourne at mid-day on Wednesday, local time. I mentioned to him the drawbacks as we saw it, but his firm view was that the Prime Minister would be seen to be running away from the problems if she declined to meet these correspondents.

The likely issues are those we identified on Friday, notably interest rates and the implications of recent developments for the economic strategy, which are covered in the note I sent you on Friday evening. But Bernard suggested that it would be useful for the Prime Minister to be provided with some additional factual background, along the following lines:

(i) Pay settlements and real disposable income over the last year. MP

(ii) Recent developments in productivity.. BEPB

(iii) Present and prospective unemployment. D/E

(iv) International comparisons on unemployment and interest rates.

I expect Mike Pattison has these figures ready to hand; I can certainly help on pay settlements if not.

5 October 1981

cc [illegible]

H M Treasury   Oct 5

Parliament Street London SW1P 3AG

Switchboard 01-233 3000
Direct Dialling 01-233 5618

A N Ridley
Special Adviser

Dear Scholar,

Tim Lankester may have told you that we kept in fairly close touch on a variety of issues, major & minor. I hope we can have a word soon to carry on that relationship! In the meantime you may like to glance at the attached note & since it could be of interest to the PM. It is necessarily somewhat provisional & subject to constant revision, but the basic points

Should stand the test of time –

Yours sincerely

Adam Ridley.

I.17

CHANCELLOR

cc Chief Secretary
Financial Secretary
Minister of State (C)
Minister of State (L)
Mr Middleton
Mr Hancock
Mrs Gilmore
Mr Towers
Mr Cropper
Mr Harris

PRESENTATION OF RECENT FINANCIAL EVENTS

At a meeting held by the CST earlier this week it was agreed that it would be valuable to put the UK's "crisis" in a wider context to dispel the view that it is a homegrown affair. With help from Mr Towers in IDT we can now put the recent developments in the financial markets in a useful historical perspective. A set of tables containing basic figures is attached. Mr Middleton and others may be able to suggest improvements in the material. But in the meantime I think it can be used as it stands. They suggest the following key points for use in public debate.

AR

ADAM RIDLEY
1 October 1981

THE STOCK MARKET

Looking at the FT 30 share index level of 481.2 on 29 September (after it had recovered from Monday's fall),

1. Compared with the position at Budget time, 10 March 1981;

- it was only ½% below its level at Budget time of 483.3;

- of the major stock exchanges in the world, only those of Japan and West Germany registered any upward movement over that period and, more striking, the general indices fell by over 10% on every other major exchange, viz US, France, Italy, Canada, Hong Kong, Singapore, Switzerland. Moreover the average for all world stock exchanges fell by 11%.

The striking conclusion is therefore how well the London Exchange has performed this year when compared with international experience.

2. Compared with the position in mid August (14.8.81) around when market confidence began to deteriorate seriously,

- the 15% fall in the UK's index by 29 September was very substantial. But it did not greatly exceed the fall in world stock market average of 11½%; moreover indices fell significantly without exception on every major stock exchange; and by 9% or more in every case except France (which had collapsed already) and West Germany.

3. Compared with levels prevailing in earlier months or years, the 29 September level was

- well above the January 1981 average of 460;

- well above the average levels in 1978 (480), 1979 (476) and 1980 (465);

- almost exactly three times the level of 160 prevailing in December 1974 when the market nearly collapsed.

INTEREST RATES

Taking three month rates as a basis of comparison (which are convenient for statistical reasons, and as good as any indicator of shortish term interest rate conditions),

- the 4¾% increase in the UK between Budget day and 29 September, though larger than the average for the "world basket" (excluding UK) of 2%, has been matched or exceeded by other countries such as France (+8%).

- More importantly, UK developments have to be seen in the context of the objectives of Government policy. The aim of the Budget was to make it easier to reduce interest rates and keep them down. From March till August UK three month rates were 1 to 1½% lower than the world basket average, and the differential vis-a-vis the all-important dollar rate widened steadily from under 1% in March to nearly 4% by mid August. This was a notable achievement. However it was only possible as long as prospects of an imminent fall in US and hence world rates remained reasonable. By September growing anxieties in the US eliminated that prospect, and made a sudden, large and substantial move of UK rates to US levels inevitable.

Conclusion: the Government deserves credit for creating conditions in which UK interest rates remained low for so long in the face of growing and increasingly powerful upward pressures, rather than criticism for allowing interest rates to rise to what in the end became firm levels dictated by the close connections between UK and other markets.

EXCHANGE RATES

Recently the £ has not fallen or shown the volatility of stock markets, though it might have been expected to do so in such circumstances. That in itself is perhaps a mark of underlying confidence in UK policies. In addition the general pattern of currency movements reveals a number of interesting points:

1. On all measures sterling is above its low point of the last few months.

2. On a longer timescale the main reason for the fall in sterling has been the growing strength of the $. Thus since Budget day 1981, the £ has fallen by around 12% from 98.6 to about 87 in effective terms, while the $ effective rose by circa 10%.

3. Another importance influence since June has been a decline relative to other currencies as well, reflecting a slacker oil market and the strengthening of the US economy.

4. The net effect of all this is to leave the effective exchange rate at around the same level (86.3) as when the Government came to power in May 1979 - in which circumstances it is worth observing that the loss of competitiveneww over the period can be attributed mainly to faster growth in UK costs than overseas.

TABLE 1

STOCK EXCHANGES - INTERNATIONAL COMPARISONS March, August Sept. 1981

	10 Mar v 29 Sept (% change)				14 Aug v 29 Sept (% chang			
UK	484.3	v	481.2	(-0.6 %)	572.5	v	481.2	(-15%)
US	972.66	v	847.89	(-13%)	936.93	v	847.89	(-9%)
JAP	507.17	v	546.37	(+18%)	602.5	v	546.37	(-9%)
WG	678.5	v	681.3	(+0.4%)	733.2	v	681.3	(-7%)
FCE	111.8	v	91.4	(-18%)	93.3	v	91.4	(-2%)
ITY	226.98	v	195.08	(-14%)	214.6	v	195.08	(-9%)
CAN	2190.1	v	1894.8	(-13%)	2311.4	v	1894.8	(-18%)
WORLD	153.4	v	(136.6 :	(-11%)	154.5	v	(136.6 :	-11½%)
HK	1371.42	v	1218.2	(-11%)	1694.75	v	1218.2	(-28%)
SING	825.47	v	642.38	(-22%)	757.53	v	642.38	(-15%)
AUSTRALIA	657.2	v	468.0	(-29%)	655.5	v	458.9	(-28%)
SWITZ	293.4	v	253.5	(-14%)	288.4	v	253.5	(-12%)

Source: John Cogswell (Statistics Dept. The Economist)
/I understand from Mr. Cogswell that the date is
taken every day from the relevant page of the FT.7

TABLE 2

UK STOCK EXCHANGE - LONGER RUN PERSPECTIVE

Fr 30 (1 JULY 1935 = 100)

1973		435.6	
1974		251.2	Lower Month: 160.1 (December)
1975		311.0	
1976		368.0	
1977		452.3	
1978		479.4	
1979		475.5	
1980		464.5	
1981	Jan	459.6	
	Feb	487.0	
	Mar	497.8	10 Mar: 484.3
	April	559.2	
	May	557.8	
	June	545.0	
	July	528.2	
	Aug		
	Sept		29 Sept: 481.2

Figures are monthly or yearly averages for the 30 share index

Source:- Economic Trends, table 66;
- The Economist (for daily figures)

TABLE 3

THREE MONTH INTEREST RATES - INTERNATIONAL COMPARISON

	Feb 81	Mar 81	* 16 Mar 81	Aug 81	Mid(17) Aug	28 Sept 81
UK	13.20	12.65	12.81	14.23	14.09	16.63
USA	16.17	14.50	13.62	17.78	17.95	16.20
JAP	8.35	7.90	7.78	7.22	7.21	7.20
WG	10.29	13.79	13.25	12.88	12.88	12.20
FCE	11.55	12.73	12.56	17.53	17.50	18.50
ITY	17.72	18.63	17.75	21.18	21.13	21.38
CAN	17.32	16.93	16.75	21.94	21.40	20.00
World Basket ++	13.45	13.50	12.93	15.71	15.75	14.98

Source:- Bank of England (via EF2 Division)

++ Weighted Basket of all above rates except UK's

* UK Budget on 10 March

TABLE 4

TABLE OF EXCHANGE RATE MOVEMENTS

	£-$	£-DM	£-ECU*	£ EFF	$-ECU	$ EFF	DM EFF
May 1979	2.06	3.93		86.3		95.0	125.1
May 1980	2.30	4.13		94.7		93.6	130.2
10 March 1981 (Budget Day)	2.21	4.66		98.6		99.6	120.8
May 1981	2.09	4.79	1.89	98.8	1.21	106.0	118.1
August 28	1.85	4.53		91.3		111.2	116.1
Noon September 29	1.79	4.14		86.1		10.90	120.2
Opening September 30	1.80	4.16	1.68	86.5	1.07	n/a	n/a
Sterling high	2.42 (October 1981)	4.92 (February 1981)		102.5 (February 1981)		-	-
Sterling low	1.76 (10 Aug)	4.08 (21 Sep)		85.7 (27 Sep)		-	-
Sterling % depreciation from high	-26%	-15.9%		-16%		-	-
Sterling % appreciation from low	+1.7%	+1.5%		+0.8%		-	-

Source:
EF1 Division

*Note: Sterling is part of the ECU currency basket. Moves in the ECU rate do not therefore fully reflect sterling's relative position against European currencies. The £-DM rate is generally the best indicator of how rates are moving against other European currencies.

Econ Pol

p.a.

cc ~~Mr. Scholar~~
Mr. Hoskyns
Mr. Duguid
Mr. Howe
Mr. Gaffin

MR. PATTISON

Changing Gear

We spoke about the pamphlet "Changing Gear", which is to be launched at a Press Conference in the House of Commons on Thursday morning; I have had a quick look at it, and you and others may find it convenient to have this short note about the main features. It is not particularly long if others would wish to read it, although it makes pretty dry reading. It harks back unashamedly to the Macmillan era of "the middle way", a phrase which is used more than once in the text; and Macmillan is not only the publisher, but also the origin of the introductory quotation (". . . who I believe will not be led away from the old tradition of consensus"). The authors also make no secret of the fact that their principle motivation is the changing of Government policy in a direction which is likely to enable the Conservative Party to win the next election.

Chapter 1 is devoted largely to an attack on the pursuit of "a particular economic theory", which is not specified but is clearly intended to be monetarism. It is suggested that the Conservative Party now needs to move the emphasis of the policy, as inflation moderates, to a programme of industrial and social reconstruction to relieve unemployment. There are some good points: the Government is criticised for preaching an unpopular ideology which they have not carried out in practice; and there are some totally unsupported propositions, such as that monetarism leads to a series of short term policies, and that it is "political nonsense" to minimise the role of Government in commerce and industry. The general message is that the Conservative Party need not be on the defensive, and should move to a phase of "construction rather than destruction".

Chapter 2, on Economic Policy, is decidedly weak - as well as short. After rehearsing the arguments for the monetary strategy, the authors argue that "a political strategy based on economic theory is a house built on sand", without explaining why; and go

/ on to

on to make the case for increased Government capital investment in exchange for pay restraint, rather along the lines proposed by Mr. Heseltine in the recent discussions on public sector pay. But they had previously argued against the 1972/73 policy of expanding demand while using a statutory prices and incomes policy to supress inflation. The authors identify house building, roads, telecommunications, schools and major projects such as the Severn barrage and railway electrification as suitable objects for increased investment. They cost this package at £4-5 billion, with a further £2 billion in NIC cuts. This should be paid for by abandoning the commitment to lower income taxes "without affecting interest rates much". There is no analysis of the effect of this programme on interest rates, inflation or long term employment.

The more substantial chapter is the one on Industrial Policy, where it is argued that the Government should on the one hand selectively support the "sunrise" industries, with positive growth and profitability prospects, and on the other hand support other basic industries fundamental to the economy which are temporarily uncompetitive, such as cars and steel. There should be more Government support for the commercial exploitation of technology, and for small businesses. In the public sector the authors recommend largely what the Government is already doing: privatisation, breaking monopolies, breaking up into small units, improving management, and restricting price increases. (This last point is convincingly argued in Sarah Hogg's first article in the Sunday Times this week.)

There is nothing very original in Chapter 4 on Employment and Productivity, which is actually about industrial relations legislation. The authors welcome the cautious approach of the Government, and conclude that the need to win acceptance of the changes in the law precludes the more radical ideas which have been suggested (wholesale abolition of immunities or the closed shop, compulsory sequestration of union funds).

Chapter 5 on Improving the Labour Force is rather better: the authors ~~assumed~~ assume that 2.5 - 3 million will be unemployed for some considerable period, concentrated mainly in declining areas

/ of

manufacturing activity; and argue for at least one year's training, rising to two years by 1990, for school leavers, with an allowance along the German lines payable.

Chapter 6 on Social Policy goes rather more against the current Government approach. The pamphlet concludes that family income at the lower end of the scale should be increased, through the introduction of a "mother's benefit" and a real uprating of child benefit. There is no discussion of the issue of real wages at the overlap with unemployment benefit. Wider availability of index linked bonds, and a closer connection between private and NHS medicine are also supported.

In the Chapter on Constitutional Reform, the authors conclude that the House of Lords should be elected by proportional representation, but are unable to reach a clear position on PR for the House of Commons. They do however argue for the reform of the rating system and a reduction of national Government funding of local authorities.

Finally, on foreign affairs, the authors say that they see less need for new policy directions than in any other area of Government activity: they support Europe, NATO and Trident, but would wish to see more aid for the thirty poorest countries.

There are two striking omissions: I found nothing directly relevant to the state of the inner cities, and the recent civil disturbances; and no reference to Northern Ireland.

J.

5 October 1981

CONFIDENTIAL

MR. SCHOLAR

c.c. Mr. Hoskyns
Mr. Walters
Press Office

Prime Minister's Press Conference in Melbourne: Economic Issues

We had a word this afternoon about the possibility of the Prime Minister holding a Press Conference in Melbourne next week; I have looked through some of the recent media comment on developments in the markets over the last two weeks, and at relevant bits of the Prime Minister's speeches and interviews. What follows, and the material attached to it, has very much in mind the fact that neither the Prime Minister nor Bernard Ingham will have been exposed in the normal way to day-to-day reporting of events, and may therefore wish to catch up on some of the flavour.

General Line to take

What usually comes across after a Press Conference is not so much detailed answers to particular questions as an overall attitude to recent developments. I think this overall attitude which it would be appropriate for the Prime Minister to display should be based on two points:

(i) Let's not panic because of a short term reversal, which has been largely due to high US interest rates, and which we hope will not last for long.

(ii) The papers contain much talk about when will the suffering end, or where is the light at the end of the tunnel - but let's not forget that those in work did not overall in the last pay round take a real cut in pay. For most of them, the significant fall in living standards which is an essential part of our return to competitiveness has not even begun.

The Prime Minister might like to glance through the transcripts of the Chancellor's defence of Government policies in the face of the rise in interest rates on TV and radio on 1 October (Flag A).

/ Obvious Questions

Obvious Questions

As I said when we discussed, the non-specialist nature of the journalists who are accompanying the Prime Minister makes it very likely that questions will be posed in the broadest and most fundamental way, along these lines:

When is the upturn coming?

Governments don't make economic upturns. I see the upturn coming when you (the British people) are competitive.

Where are the signs of success?

Inflation is now on a downward trend (very convincing argument for this in Terry Burns' Washington speech on 24 September, extract of which is at Flag B ; productivity; realism on wages; growth of small businesses).

Is high unemployment going to be a permanent feature of Tory policy?

Unemployment probably now near its peak; it won't come down fast; but the UK is in the same boat as other western economies.

Subtler Questions

Alert, or more economically minded journalists, might try either of these tacks:

The money supply figures (published here on 6 October) show that monetarism has failed. As Brian Griffiths points out in his article in today's Daily Telegraph (Flag C), present circumstances have arisen not because monetarism has failed, but because the Government still has a long way to go in implementing the policies, especially on the public expenditure side, that are central to the monetarist approach. But the Prime Minister should also be aware that today's Economist, while acknowledging the international issues, does argue that the Bank of England's resistance to indexed securities means that interest rates are higher than they need to be (Flag D).

/ Interest

<u>Interest rates, exchange rates, inflation, unemployment, and money supply are all now moving in the wrong direction; isn't it time to change</u>? (This question might also be formulated in terms of even the Government's friends, such as the Tory Press and the barons of industry, are saying that it's time for a change.)

Just because one course of action is painful is not a reason for supposing that another one will be better. In fact, reflation would mean higher interest rates, a lower exchange rate, more inflation, faster depreciation of the value of money, and eventually even less ability to compete, so fewer jobs.

<u>Awkward Questions</u>

There is no limit to the recent remarks of the Prime Minister or the Chancellor which might be quoted back at them in present circumstances. Fortunately, two of the most obvious sources - the Jimmy Young interview, and the interview with George Negus, do not on a quick reading seem to have covered the prospects for interest rates and their role in economic recovery. And the Prime Minister's speeches to the CBI, both in Wales on 11 December and at the Annual Dinner in London on 16 June, contain nothing that could be used against her. The principal difficulties may arise over what has been said in the House. I know that Mike Pattison is arranging for this to be looked at; he may draw your attention to three particular pieces:

(i) In his Budget Statement on 10 March, the Chancellor said "These tax changes should enable us to achieve our monetary objectives without having to face intolerably high interest rates."

(ii) At the end of the Unemployment Debate on 24 June, the Prime Minister said that "There are now clear signs that the worst of the recession is over", but recent indicators (longer leading cyclical trends and the CBI business opinion survey) do not seem to bear this out.

/(iii)

(iii) In her reply to the Opposition's Censure Motion on 27 July, the Prime Minister said "If the pound plunges with consequent increases in interest rates and inflationary expectations, bang will go all our hopes for more jobs. That will be the effect of the rt. hon. gentleman's policies".

I think it sufficiently likely that someone might refer to that particular debate for it to be worth while attaching the text of the whole of the Prime Minister's speech, which is full of useful points that could be quoted back at journalists (Flag F).

I think that tactically the right way to answer these kinds of questions is to look forward rather than back. That is, to explain that the Government has a clear vision of what needs to be done to get the economy competitive again. That includes continued monetary restraint to keep inflation on its downward path, and an intensified effort on the supply side of the economy to create the conditions for sustainable growth of output and employment.

JV.

2 October, 1981.

A

SIR GEOFFREY HOWE (CHANCELLOR OF THE EXCHEQUER) - Defence of Government Economic Policies.

Transcript from BBC Radio 4, The World at 1, 1 October 1981.

PRESENTER: .. ... Well, Sir Geoffrey Howe, the Chancellor of the Exchequer, is with me and was listening to that. Sir Geoffrey, your response to Mr Peter Shore.

CHANCELLOR: Well, I fear that he's drawn quite the wrong conclusions in every respect. He argued, at the time of the budget, that I was seeking to target for too low a borrowing requirement, that a sensible Chancellor would be borrowing much more. If I had taken his advice, interest rates would have been under far more substantial pressure than they are today. He fails altogether to take account of the fact that what's happening to interest rates is part of a worldwide phenom em, we've seen, in the last week or two, that what happens in New York has a dramatic effect around the rest of the world. It's one of the things we've been discussing at the International Monitary und, the extent to which the size of American borrowing is making it difficult for them to get interest rates down. And I've found out that when I come back from the world in which people are contending with these problems in every other country, and are discussing these things together, they are looking at it in a realistic sense and the absolute necessity is to make sure we do control our own borrowing and, above all, for the rest of us to restrain our own demands; keep our own pay levels down and do everything we can to improve the competitiveness of our industry I know very well that high interest rates don't serve that; that's why we wanted to do what we could to keep them down.

INTERVIEWER: But only yesterday - you mentioned the IMF - you were telling them that you were on track; that things, you could see some sort of light; that really can't sit very comfortably with this sort of announcement today with all that it means for industry.

CHANCELLOR: I wasn't actually using those words. What I was saying and I have no doubt about it whatsoever, is that there is no alternative to the course we are following and, of course, it's tough and difficult; British industry has been losing competitiveness for a very large number of years now. Over the last 5 years our unit labour costs have risen 10 times as much as they have in Germany and in Japan, in the same period, they haven't risen at all. Now we're having to claw back all that. It's crucial to control public spending and borrowing, to keep interest rates going down rather than up; crucial above all for management and workforce to be going for sensible pay settlements. There's no way in which one can find some different policy. If one threw one's hand in or did whatever Peter Shore said - invited him to come along - he'd be facing exactly the same difficulties and if he were to follow the kind of course that he was implying then the thing would become far worse.

INTERVIEWER: But a 4 per cent increase in interest rates over a period of 2 to 3 weeks is bound to be inflationary in itself, is it not? I mean, this goes exactly against your plan of. .....

CHANCELLOR: In itself, of course, it has an impact on the cost of living for people in terms of their mortgages and it makes it more difficult for industry to borrow. I fully understand that.
And it represents, in one way, the way in which we're all having to face cuts in our real living standards. But it makes it all the more important for us to all that we can do ourselvesto restrain those things that go on putting our costs up. Again, that comes back to the importance of good sense about pay bargaining.

INTERVIEWER: Bluntly, do you think our living standards are dropping and will have to continue to drop in the foreseeable future.

CHANCELLOR: Our living standards are dropping and for some time I think they going to have to do so. You see, what's happened over the last 3 years is that our own living standards, the standards of people who've remained at work, have risen very substantially, while our production has hardly grown at all and profitability in industry has fallen dramatically. Ten years ago we had industrial profits of 14 and 15 per cent, now they're down to about 2 per cent. Yet in other countries they've kept profits up by keeping pay costs down; they're a better place to invest than face the stormy world which we now are. I think that there's no point in our trying to conceal the truth from each other, the world is a very rough place.

INTERVIEWER: You're not going to be able to conceal the truth, either, from the Tory Party Conference which is coming up soon: what on earth are you going to be able to tell them about your strartergy: will you be able to tell them that you're on track, you've got a timetable, you're sticking with it?

CHANCELLOR: Yes, what I shall tell them is, thank Heaven, in the manifesto on which we fought and won the last election, we did tell people the truth. We said that it was going to be very tough and very difficult and it would be a long haul and we've been doing the things we then said were necessary. Imagain what would have happened had we not set about trying to control public spending; if we'd gone on spending wrecklessly as a Labour Government would have done. So I shall tell them we are doing the right things - the things which are massively endorsed by other Finance Ministers and endorsed, incidentally, very clearly by the Managing Director of the International Monitary Fund 2 days ago. If we were now to go, as a Labour Government had to do, to an international bank manager, he would be giving us the advice that I am acting on: stick with the policies you're following, you've got to see them through.

INTERVIEWER: Sir Geoffrey, thank you very much indeed for joining us.

Text of an interview with the Chancellor of the Exchequer for ITN in Washington

INTERVIEWER: Sir Geoffrey, in your speech you express support for the American economic policy, aren't we, in a sense, tying ourselves to America's coat-tails, destined to suffer whatever they suffer?

CHANCELLOR: We're not tying ourselves to America's coat-tails. I noticed one of the leading German bankers, the other day, saying that for all of us, the American economy was like sharing a boat with an elephant. It really is by far and away the world's largest economy and what it does is crucial to all of us. It's very important that they should beat inflation and that's what I support.

INTERVIEWER: Have you been trying to persuade them to lower their high interest rates?

CHANCELLOR: I don't go round discussing particular points of other countries' economic policy in that sense.

What is clear, frm what the President announced last week and what they're seeking to do, is that they want to get inflation down and they want to get interest rates down. They know that to do that they ve got to get their budget deficet down and they're taking steps to achieve that. They want it as much as we do.

INTERVIEWER: Our interest rates have gone up only in the last few days and are likely to go up again. The Pound is not exactly stable; the City tumbled the other day; isn't there an all-rould lack of confidence in your Government's economic policies?

CHANCELLOR: No, I wouldn't accept that judgement. There's an all-round lack of stability around the world economy much influenced by some of the anxieties there have been about American policy, I think a lot of thats now been responding to the decisions taken by the President in the House last week. But if you stand back and look at the scene the problems are exactly the same as they have been for a long time. We in Britain have got to get back into selling our goods and services in world markets; that means we've got to get on top of inflation. We've got, therefore, to sustain the attack on our own interest rates. That means keeping public spending, public borrowing down; it means being sensible about pay bargaining. People understand those things, I think, very clearly and we've just got to keep on following those policies.

INTERVIEWER: But things don't seem to be going right at the moment. Interest rates have gone up once, they might be about to go up again. As I said, the stock market tumbled dramatically on Monday. I mean, isn't it about time the Government perhaps thought well, may be we are on the wrong track?

CHANCELLOR: No, precisely not. You see, the style of television interviewing and the style of commentary, is so well illustrated by the opening phrase of your question,not being right at the moment. The correction of economic problems is not a matter of 'at the moment'. Our problems have been building up for a very long time, we've always made it clear it would take a long time to get them licked. We've got inflation, now, down much lower than it was; we've got productivity improving; we've got pay bargaining taking place at a much more sensible level and we are fighting, gradually, to restore our place in the world economy that's very tough: and the conditions, at the moment, are reasons for sustaining our adherence to the policies we are following

following, not for getting into dispair about them, absolutely not.

INTERVIEWER: If not dispair, then, how do you account for what happened on the stock market last Monday, a fall of 29 points?

CHANCELLOR: Well again, stand back and look at it. You will have noticed that in other markets around the world, on all sides of the world - this world that is now practically connecting itself with eachother; one world market - stock markets all behaved in a very eratic way, their part of the responses to uncertainty, at that stage, about where US economic policy is heading. But when people, as I say, stand back and look at it again, of course, they see things are tough but that, basically, we're doing the only thing that can be done to get ourselves out of the wood we're in.

INTERVIEWER: Are you expecting the Americans to lower their interest rates in the near future?

CHANCELLOR: Well, I don't make comments or predictions about the expectations of their interest rates or anybody else's. What I do know is that, as I said in my speech, the high level of interest rates is a factor in the battle against inflation. They want to see them come down, that's why they are seeking to control their deficets. It's very interesting, you see, the extent to which their approach to the solution of their problems and the approach of every other Finance Minister I've met here, underlines the good sense of our own case. We've got to get public borrowing down if we're ever to get interest rates coming downcoming down. That means keeping public spending under control. We've got to get inflation down if we're to get jobs coming back and that means keeping pay bargaining on a sensible basis.

INTERVIEWER: Your Government is halfway through its term, is your economic policy on course?

CHANCELLOR: On course again implies too high a degree of precision that today we're going to be there, tomorrow we're going to be there. That it is the right policy and that it is moving in the right direction, I have no doubt at all. As I say, inflation has responded very sharply, and we're making good headway on improving our competetiveness in British industry, and I think that, provided we keep on that course, that we should be looking forward to better results as the years go by.

INTERVIEWER: So institutions that have shown some sign of nervousness, like the stock market in London, are just plain wrong?

CHANCELLOR: I think that one of the questions put to me earlier today really gave one of the reasons for the nervousness. Their anxiety is whether our policies will deliver results quickly enough and firmly enough to secure our re-election. Well that, if you like, is an endorsement of the policies we're following. It means we've got to follow them with tenacity, as we shall, and I am confident that they are the right ones and I think that's what the Government and most people

INTERVIEWER: And if unemployment reaches the 3 million; it's still worth it?

CHANCELLOR: Yes, overwhelmingly. I dislike unemployment as passionately as anybody. All the policies we are following are designed to secure the conquest of unemployment. But, as Jim Callaghan said when he was Prime Minister two or three years ago, at one of the Summit meetings he attended, inflation is not a cure for unemployment, it is one of its most powerful causes. So we've got to get on top of inflation, got to get on top of public borrowing and public spending that's too high, got to be sensible about pay bargaining. That's what every other country in the world is trying to do. We're making headway at it, we ought to keep at it.

__INTERVIEWER__: And this will happen in time for the next election?

__CHANCELLOR__: We shall be seen to have made enough progress to secure our re-election, I have no doubt about that; and then we go on to the second stage of what we've always said was going to be a long policy to correct the deep-seated troubles in our own economy.

SIR GEOFFREY HOWE (CHANCELLOR OF THE EXCHEQUER) - Sharp Rise in Interest Rates.

Transcript from ITN, 1 o'clock News, 1 October 1981.

INTERVIEWER: Sir Geoffrey, why has it been necessary for the banks to make two large increases like this in such a short space of time?

CHANCELLOR: Well as they explained, they ve been responding, as they have to do, to what's happening in the marketplace, in markets and, of course, around the world. We've seen, in the last week or so, the extent to which what happens in New York affects what happens in the rest of the world very directly, and interest rates around the world, at the moment, have been going up and are very high.

INTERVIEWER: But the Government could, if it thought it wise and necessary, intervene against these market forces, no matter what its idiology, and if it thought it was right to do so isn't it abdicating its responsibility by not acting now?

CHANCELLOR: No. I think that's one of the lessons of all our history in recent years; that Government can't, in the end, intervene, idiology or not, against what's happening in the marketplace. What they can do is to make sure that they are not, themselves, trying to borrow too much. This is one of the things we've been discussing in Washington as to whether the American budget deficet is higher than it ought to be for comfort and it's one of the reasons why, in my budget this year, I was so determined to keep our borrowing requirement down to a reasonably low level.

INTERVIEWER: But, on that very subject, is it not the case, however, that your Government's borrowing is actually running at a much higher level than you'd expected so you haven't won on either plank?

CHANCELLOR: No. I think there's no reason to believe that our borrowing pattern this year is away from the course we'd expected over the whole year. Of course, it has been distorted by the effects of the Civil Service strike. That's one of the additional features, it underlines how crucially important it is for people in this country to be going for pay bargains that are low and sensible, to keep down the cost of public spending and public borrowing, to maintain the competitiveness of British indistry - to improve the competitiveness of it in these very tough world conditions.

INTERVIEWER: But isn't it industry whose going to be the most hard hit by these increases in the interest rate?

CHANCELLOR: I wouldn't begin to argue that higher interest rates are not uncomfortable for industry as for everybody else. But I think one has got to remember that industry is benefitting from the fact that pay settlements have come down very sharply since last year, the inflation rate has come down very sharply since last year and, moreover, those in industry who thought they ought to have had a lower exchange rate are in a better position to compete as a result of that.

It just means that we have to go on doing all we've been trying to do and doing it even harder. It's crucial that we should be improving our productivity, getting pay settlements down, keeping costs down. We're still far behind our competitors in Japan and Germany in that respect.

INTERVIEWER: But, nonetheless, industrialists are going to be heavily hit by this, some people I've already talked about, saying that it's going to cut out all expansion during the coming year. Now, can this possibly be to the country's advantage?

CHANCELLOR: I wouldn't accept that dramatic description ~~xx~~ of the consequences. Of course, it's not comfortable. It means that

we in the country, we in Government and industry - both sides of industry - have to try very much harder still to do the right things. It's all the more important for us to keep down the size of Government borrowing. That's one of the crucial lessons on which everyone is agreed from the conference that I've been at. That's the first thing. All the more important for us to avoid raising our unit labour costs as we have been doing faster than our competitors. So, tight control on public spending, as much reason and sense as we can possibly have on pay settlements, let's go on improving productitivy
The worlds a tough place, we've got to do just that much better in these conditions.

<u>INTERVIEWER</u>: Can I quote the CBI who said, this morning, that it's now even more urgent that the Government cut the National Insurance surcharge which is simply a tax on jobs. Now jobs are going to be badly affected and isn't this a valid point.

<u>CHANCELLOR</u>: Well a sentence taken in isolation, I think, may be slightly misleading. We would all like to reduce the tax levels, particularly taxes that affect the prospects of employment. But if one does that without having got down the expenditure level then one increases borrowing and runs the threat of still higher interest rates. The thing that is, above all, important - and the CBI and muself and most of us, I think, agree on this - the best way of keeping down the tax on jobs is to keep down the tax on jobs we impose by having pay settlements too high. Industry - both sides of industry - have got that crucially within their control. It's something they can do something about, are doing something about, we've got to do even better.

<u>INTERVIEWER</u>: The trouble with what's going to happen is that, not only are wage settlements not going to be too high in the coming year but, with an average 4 per cent pay rise in the public sector, the man whose going to have to face a 2 per cent increase in his mortgage rateis goin[

to face a severe cut in his real living standards.

CHANCELLOR: It may well be the case that living standards, real living standards, are being cut; that again is happening in most countries around the world. It's one of the consequences of the terific shocks the world economic system has been taking from huge increases in the price of oil and the crucial thing is to keep our chances of maintaining our living standards in being by being sensible about pay. In the last 5 years we have doubled our unit labour costs. In Germany theyve gone up by just one 5th - that's one 10th as little an increase in Germany - and in Japan they haven't gone up at all. That's why it's terribly important for us to be sensible about our pay, why it's a good thing that we've seen some improvements in productivity this year, and why it's very crucial for me, in Governmennt, with the support of my colleagues and of the country, to be controlling Government spending and keeping Government borrowing down.

INTERVIEWER: Aren't increases like this, though, bound to be inflationary in the long run because, although they'll deter some people from borrowing, the sum total of borrowing is going to be greatly increased, particularly with the increase in mortgage rate, it's going to affect the Retail Price Index.

CHANCELLOR: They affect the cost of living for ordinary people like you and I but they are themselves, of course, a consequence of and part of the problem of inflation. That's why it's important for us all to be doing what we can, either by controlling the growth of Government spending or by controlling the size of our pay claims.
Trying to get all those figures coming down, where they are under our control. Because the world outside is not a friendly place.
That's the message I bring back from Washington: and that is all the

more reason for us to be as helpful as we can to our own purposes by doing the right thing here.

INTERVIEWER: Well until recently you've been holding out some hope that the recession will bottom out in the near future. Haven't these rises put pay to that idea?

CHANCELLOR: No. It's, perhaps, tempting to state things like that in rather flat terms. Clearly, high interest rates represent a discouragement and one doesn't want to see them rising, that's why we've got to keep public spending down. But, as I say, there are other factors that still have been working the right way. Our productivity this year has been improving, our pay settlements have come down, and, as I say, the Pound is at a lower level for the purposes of exports abroad, as industry wanted. So there are those things that are going the right way; let us be determined to make the most of what is going for us and make the other things go better still, if we can.

INTERVIEWER: Are you still hopeful, then, that the recession will bottom out in the near future?

CHANCELLOR: I don't think there's any reason to conclude that we're going to keep on going down, the signs are that we've oome to the end of the downturn and I think that it depends very much on how we, ourselves, perform. If we want to get back into the growth league we've got to be as sensible, as productive and as reasonable in our pay claims as our competitors are trying to be.

INTERVIEWER: Sir Geoffrey, thank you very much indeed.

CHANCELLOR: Thank you.

------

the Tory course of treatment

MRS THATCHER has now been in office for two-and-a-half years. Over this time we have experienced the worst economic recession since the 'thirties, with real output six per cent. lower and unemployment doubling to a total of nearly three million. Most recently, interest rates and inflation, which had been coming down, have started rising again. In view of this record even the most enthusiastic Tory supporter is justified in questioning the wisdom of the Government continuing with present policies.

Broadly speaking, there are three different kinds of explanations for what has happened: that the policies are inherently unsound because monetarism is at heart a flawed doctrine; that the Government has failed to implement the monetarist policies which it talks about; and that, although the Government has tried to conduct monetarist policies, the economy has been blown off course by factors outside the Government's control.

I find it difficult to believe that the basic policies on which the last election was fought and won, and which the Government has sought to implement, are fundamentally unsound. The problems of the British economy were seen as chronic inflation, high taxation and low productivity resulting from an excessive growth in government, and an imbalance between union power and management on the shop floor. The prescriptions which followed were to tighten control of the creation of money and credit to reduce inflation, to cut public spending so as to reduce the tax burden, to ensure at the same time that the public sector borrowing requirement was being reduced so that interest rates would not rise to excessive levels, to privatise potentially productive public sector assets and to correct the imbalances in the labour market.

★

THE major criticisms of this approach have been that it is too simplistic, that it relies too much on controlling one thing, namely the money supply; there are also doubts as to whether it can work in the expected manner in an economy with powerful trade unions and a large public sector.

To start with, control of the money supply is just one aspect of policy. In attempting to restore stability and prosperity to this country Government policy is just as much concerned with public spending, taxation, denationalisation and breaking the monopoly hold of trade unions as with the money supply. Money supply control has received such emphasis only because it is crucial to controlling inflation, which is an important objective of policy.

The reason the Government has rejected a prices and incomes policy as a supplement to monetary policy in the fight against inflation is simply that it hasn't worked in the past. Since 1948 we have had six or seven major incomes policies and all have followed the same pattern: dramatic initial success in the first phase, then problems over differentials and inconsistencies between price and wage norms and monetary growth and finally a round of strikes and industrial unrest, a collapse of the policy and a burst of wage rises, such as happened in the winters of 1973-4 and 1978-9.

Powerful unions have a perverse effect in any economy and ours is no exception: they increase their wages at the expense of other people's jobs, they hold back productivity growth and they slow down the process of change. But unless they control money supply growth directly, or unless public sector wage awards are financed by printing money or increased borrowing, unions do not affect the basic policy of inflationary control.

As interest rates rise again, BRIAN GRIFFITHS defends basic Government strategy

A large public sector is more of a problem. Central Government, local authorities and the nationalised industries are less responsive to market forces than are private companies. Although less money means lower inflation even with a large public sector, the problem which arises is that, unless the Government is prepared to take whatever steps are necessary to force the public sector to contract, the private sector is left bearing the lion's share of any deflationary impact.

Then there is the explanation that what has happened has to do with factors outside the Government's control, primarily the legacy which it inherited from the previous Government and the behaviour of the exchange rate. While by no means of primary importance, these problems should not be ignored. When the present Government came to office there was a good deal of suppressed inflation within the public sector as a result of the previous price and wage controls. Various public sector unions were queueing up for back-dated pay awards and nationalised industry prices had got hopelessly out of line with economic realities. In addition, there was far more hidden unemployment in both public and private corporations than most had expected.

As the pendulum in British industry swung over the 1970s from management to unions and the cost of closing plants was the prospect of a major strike, so companies hoarded unproductive labour. The full extent of what was happening has only now become apparent in terms of current unemployment figures.

Again, of some but not crucial importance has been the behaviour of sterling. The extraordinary and rapid appreciation of the pound in 1980 and its equally sharp fall this year have very much followed movements in the world price of oil. The rise last year had a beneficial impact on reducing inflation but was a major setback to exporters. Similarly the fall this year will certainly add to inflationary pressures though exporters will now benefit.

Although the Callaghan legacy and the price of oil are important factors in explaining the rise in unemployment, to account for rising inflation, rising interest rates and the burden imposed on the private sector during the past 18 months we have to turn to the third factor, namely the failure of the Government to control money supply and cut public spending.

★

SINCE the Government has been in office it has consistently overshot its money supply targets and by a substantial amount: roughly speaking it has aimed for 8-9 per cent and the outcome has been 14-16 per cent.

There are only three possible explanations: that it is impossible to control the money supply, or that Treasury Ministers have, for political reasons, not minded overshooting the targets, or else the Bank of England's present techniques of monetary control are inadequate. The first of these I would categorically reject. We have controlled money supply in the past. Other countries do now. The second may be true but if so would be quite out of line with the speeches, statements and White Papers which have come from the Treasury. There are good grounds for thinking that the root cause of this problem lies with the Bank and its resolute determination to avoid, seemingly at all costs, having to control the growth of its own lending.

The other major failure has been to cut public spending. The time has surely now arrived when it is no use for the Treasury simply to call for another general percentage cut from each spending Ministry. The Government must begin to axe functions and overhaul the process of costing and accountability within the public sector.

The Government has paid a high price for its mistakes: tax increases in the last Budget, continuing high interest rates and now a rising rate of inflation. With a Cabinet reshuffle which has tilted the balance in favour of greater monetary and fiscal control, with high interest rates imposed from abroad (which set money growth moving in the right direction) and, I hope, with the right lessons having been learnt from the mistakes of the past two years, the Government is now in a better position than it has been for the past 18 months to implement those policies for which it was elected.

D

The Economist

OCTOBER 3, 1981

Things that go bump

This was the week when world stock markets were relieved at having temporarily made fools of themselves. On Monday morning investors in a dozen countries with totally differing internal economic prospects, led by three with a rather promising outlook for real income rises (Japan, Australia, Hongkong), started dumping good and bad domestic shares into some of their fastest-ever falls, at a rate that must have cut tens of billions from the nominal fortunes of their dozen peoples. They did so because they thought that there would be a bigger crash, in reaction to an unimpressive telecast by President Reagan which few of them had seen, when the waking hour of 10am moved west to Wall Street. When Wall Street opened, it tentatively refused to crash, and the other markets spent the next two days erasing red marks and red faces.

The rumbling memory remains that the crash of 1929 was preceded by three or four such false downstarts and that the volume of volatile because internationally telecommunicatable money is now far greater. After last Monday the world's financial markets stand more revealed than ever as an American-dominated wired village, and there must be fears that some time in 1981-82 they could suddenly and for some days stop functioning as places with a sufficient spread of views to ensure that each seller can find a buyer at somewhere near the prevailing price. If such a market-shattering panic really does catch hold, it will be a sign that a change in policy needs to be made in the world's leading capitalist country of the United States—and it will then have to be a change that abruptly reverses and therefore surprises markets.

Which rods in pickle?

At present the Reagan administration is surprising informed people mainly by its implausibility (see page 39). The president's latest spending minicuts did not persuade investors that interest rates will come down, except investors who trust to Murphy's law that everything which can conceivably go right will from this moment be deemed to do so. Every private analyst who is not called Murphy is now forecasting a bigger American budget deficit in 1982 through 1985 than the White House does, especially as the fastest increasing spending programme, which is defence, is the one most prone to overruns on costs. The difference of opinion is whether it is logical or rather nuts to suppose that a budget deficit of around 2% of gnp could send American inflation and interest rates soaring. If the self-fulfilling expectation catches light that it could—and opinion seems around 50-50—there are three ways in which the administration might then hope suddenly to reverse expectations, but two probably would not work.

First, it could seek to balance the budget by announcing $50-billion-a-year bigger cuts in government civil expenditure, such as in America's over-indexed middle-class pensions. This would be unlikely to work because few people would believe that congress would enact them. There is a general assumption that congress will not enact even the less unpopular (because more narrowly anti-poor) cuts that President Reagan has proposed already. There might be more hope of pushing through cuts in planned defence spending, especially by cancelling some specific projects such as the B-1 bomber, but these cannot comfortably star as instant correctives. As Mr Haig starts his disarmament talks with Mr Gromyko, it would be unseemly if each noontime Dow sent him strip-teasing into the conference chamber.

Second, if stock markets start crashing because of fears of rises in American interest rates, the administration might urge the Federal Reserve to turn to open-market policies designed to try to keep interest rates down. Like other central bank policies to "stabilise" exchange rates by offering one's reserves of foreign exchange at a domestic-currency price a bit cheaper than everybody knows it will fetch after next weekend, these policies at any such time would not work. If markets are falling because the administration's fiscal policies are deemed too soft, confidence would not be restored by softening the Fed's monetary ones.

Third, then, the United States could cut its budget deficit by tax increases. It would be nice if there were a potential tax yielding $50 billion a year with useful national and international effects instead of slump-creating ones. As it happens, there is.

As Mr Felix Rohatyn argued in these columns two weeks ago, there is every case for America to take advantage of the temporary weakness of Opec by imposing an import fee that would translate into $50 billion of American tax revenue this coming year and into a 50-cent rise towards $2-per-gallon gasoline at American pumps. That would still be 50% below the price at European pumps. It would impose a maximum price rise of 1½-2% on the gdp deflator if one assumes that there would be no consequent fall in world oil prices (which there would be). It would create its international effect by weakening the surplus of oil producers, which is what is most needed. If congress will not tolerate petrol tax hoists or social security reforms against the voting classes, this is tantamount to saying that an anti-inflationary America is ungovernable. The more popular tax increases are less desirable than this; either a rescinding of the income tax cuts (which would deflate all remaining Reaganaut elan), or a value-added tax (which would be more inflationary than a petrol tax, and muddle local authorities' finances).

Among the other possible ways of surprising markets back into confidence, some Americans suggest a return to the gold standard. This is a mechanism for promising to flagellate oneself under duress after having refused to exercise sensible self-discipline under greater personal freedom, and the promise would be believed for few weekends. The more that countries move back to automatic mechanisms, the more they are likely to rely on sudden jumps in interest rates of the two-point sort to which Britain resorted two weeks ago last Monday in the belief that everybody would then buy bonds since they would deduce that the next movement in British interest rates must be down. Actually, by the next Friday British markets were expecting another two-point rise instead. This resort to ever-dearer money across the world restricts real activity, especially investment when American long-term interest rates of 17% are way above what most American businesses could hope to earn by building a new plant; and it is a main factor in increasing the consumer price index, especially for housing and durables. It is time that President Reagan and Mrs Thatcher recognised that they were not elected to do either of these things, which prompts the question of what smaller countries like Britain should do with their monetarism if America refuses sufficiently to reform its deficit fiscalism.

How Britain can avoid dear money

Unlike Mr Reagan, Mrs Thatcher has no difficulty in passing budget cuts and cash limits through her parliament. Her problem is that her extra-parliamentary baronies (the civil service, the public-sector unions, the nationalised industries) then take no blind notice of them. As we argued here last week, if Britain's nationalised monopolies had responded to their problems of underdemand in the normal competitive way by cutting prices, instead of raising them by 20% in the year to August while British private industries raised theirs by less than 6%, then total British inflation in the past 12 months could have been 3-4% instead of 11½%. Mrs Thatcher's first fight against inflation and dearer money should be to demand cost-cutting sales-effectiveness from her nationalised baronies, and she should start with the Bank of England.

The Bank of England has been pushing British fixed-interest rates higher during September because of its usual difficulty: it can control money supply by sales of fixed-interest bonds only when people think a reduction of inflation will send fixed-interest bonds higher—ie, it can sell government debt only when it does not need to. The most cost-effective money-supply controller at present would be open auction sales of various sorts of index-linked stock (not just closed auctions of unsuitable stock for certain sorts of institutions or rationed former granny bonds for everybody at prices below the market). The Bank of England's arguments against open auctions of indexed securities have successively been: (a) such auctions would be too successful, attracting too much Arab money and driving the petropound too high (without understanding that higher sales of indexed securities would mean lower needed sales of gilts and thus lower gilt-edged interest rates): then (b), by last year, that such auctions would be completely unsuccessful, since every Briton could see that British fixed-interest rates and inflation were steadily coming down.

If last year one had asked the authorities "would you favour such issues when a glutted petropound was below $1.80, when interest rates looked like having to rise by two points twice in three weeks, when both external capital flows and internal money supply were rising?" the answer would have been "of course, but that combination is impossible". This is the combination now existing, and Mrs Thatcher should insist on open auctions of index-linked securities at once.

Otherwise, money in Britain is going to be dearer than it need be. The government's political as well as economic prospects are tightly tied to that. At this stage, let us descend from the pulpit into making guesses about how stock markets might go.

Low, but trending lower?

Fighting the stock market tapes has proved a thankless task at least since 1929 when John D. Rockefeller announced "believing that the fundamental conditions of the country are sound . . . my son and I have for some days been purchasing sound common stocks". So scepticism was assured when American treasury secretary Donald Regan ascribed the latest panic on the world bourses to "a lot of technicalities" and the London stock exchange's Nicholas Goodison scolded de-investing investors for paying insufficient attention to "the improving profitability of British industry".

For stock markets, the comparison with 1929 ought to end there. This time there is no speculative bubble to burst. New York's Dow Jones industrial average and London's Financial Times ordinary index were lower this week than they were 13 years ago when David Stockman was a history undergraduate at Michigan State University, when British Bank rate stood at 7½% and oil cost less then $2 a barrel. Make allowances for the ravages of inflation in the meantime, and most shareholders have since then lost their underclothes as well as their shirts.

Even so the 1981 decline of the London and New York and other markets from these already much depressed levels is not as inexplicable as it may seem to the tenderfoot investor whose 100 shares in, say, Britain's GEC were worth 758 pence each in mid-September and only 640 pence precisely a fortnight later. If deficit fiscalism and dear money are to continue, a correction was overdue. Price/earnings ratios, by traditional criteria, were low. But shares offering, before the retreat, a dividend yield of around 5½% both in London and New York were not attractive when measured against the returns available on British bills, bonds and gilts of 13-16½%; those on American money-market funds yielding a nearly riskless 17% (along with most of the conveniences of a bank account), and on D-mark deposits offering over 11% with a sporting chance of currency appreciation.

Some of Mr Regan's "technicalities" are true. Perversely reductions in the maximum effective rate of tax of long-term capital gains in the United States may be depressing the markets. Brokers say the cut in this tax from 49% to 28% under the Carter administration has unlocked a lot of previously tightly held stock, and that the further cut to 20% in the Reagan tax bill will unleash further selling. The correction that began in earnest in New York in midsummer, and then sent London reeling, was made more severe by the efforts in both countries to protect politically sensitive sectors from tight money. America's All-Savers certificates, offering a tax-free 12%-plus, will help mortgage financing by sucking more money out of stocks.

By the end of last week markets were sufficiently scared for the vaudevillian Mr Joseph Granville to predict that Wall Street would suffer the bluest of Mondays, but sufficiently sound for his call to bring forth institutional bargain-hunters instead of sales from sheep. It would be premature (see page 67) to hail this New York bounce back as a decisive turning point. Investors have been bruised by the crisis of confidence that by early this week had caused share prices in New York and London to close around 20% below their highs for 1981, and those on the racier Hongkong and Singapore markets to shed close to one third of their values. For the umpteenth time investors who have bought shares on the assumption of an early and sustained fall in sky-high interest rates have been disappointed. Confidence is fragile and it is hard to see how a solid market advance can be launched until bonds make a strong recovery on the back of a convincing fall in inflation and interest rates. Then, and only then, are the arguments for equity investment in London and New York likely to become compelling.

Equities in waiting

For nearly 50 years fixed-interest securities have proved to be a "prudent" way to subside into genteel poverty. Take the British investors who were persuaded, in 1932, to swap £100 of 5% War Loan bought patriotically during the Kaiser's war for £100 of 3½% War Loan. By this week their investment fetched £25, which would buy less than £1 8s 0d did in 1932.

Optimists can make a better case that ordinary shares in London and New York have been depressed so far and for so long that they now discount just about everything except the election of a Labour government led by Mr Tony Benn and the nomination of supply-siders Mr Art Laffer and Mr Jack Kemp to the Federal Reserve Board. In London, cost-cutting and labour-shedding by private British companies ought to ensure a strong improvement in productivity, even if the recovery proves slow and initially weak. A 30% increase in British corporate profit in 1982 looks possible, with a lower pound helping exporters and import substituters. But London and other European markets, and European currencies, are unlikely to soar while dollar interest rates in the high teens depress the New York Stock Exchange.

When Wall Street eventually smiles, other markets will beam too, but such joy is likely to be postponed until a born-again Reagan administration brings the budget back towards balance so that the Fed can ease up on the money supply. There is a more frightening reason why this is necessary. "From ghoulies and ghosties and long-leggety beasties, And things that go bump in the night", sang the minstrel, "Good Lord, deliver us". If our guesses are right, world stock markets need not bump into a 1929, but another ghoulie threatens.

The overborrowers

Although investors have not overborrowed to keep stock markets too high as they did in 1929, many other groups have overborrowed in 1981 to do many other things. The overborrowers include houseowners and property men everywhere, holders of many glutted and stockpiled raw materials, bankrupt private companies which cannot afford to meet obligatory redundancy payments, nationalised corporations with a dozen successive years of negative cash flow, governments with estimates for small budget deficits that are obvious fibs, countries like freedom-seeking Poland and growing Brazil and starving Bangladesh.

If this overborrowing were ever punctured, there could be crashes in property prices from California to Hongkong, in companies from Detroit to Seoul, in state corporations from Milan to the North Sea, in overstocked materials from Oregon timber to Nigerian oil, in government credit from Washington to Tokyo, in banks and near-banks from Switzerland to Singapore, in financial consortia and their clients everywhere. The downward multiplier from all that could make 1929's little local stock market difficulties look like a controlled parachute drop.

As money grows dearer round the world, some of these overborrowers are overborrowing more so as to meet their higher interest payments. They are increasing their indebtedness to pay for their debt. This must make punctures more possible. That is why it is so wrong to be meeting and aggravating slumpflation by ever higher interest rates, so awful that overborrowing governments are borrowing more instead of cutting the money wages of their employees, so bumbling that central banks are bidding fixed-interest rates higher instead of borrowing on the index-linked securities that would be cheaper at this time, so frightening that even very conservative governments are cutting taxes and pretending that these will be covered by expenditure cuts that will not actually come into effect.

1. MR TURNBULL AT 2/9

2. CHANCELLOR

cc Chief Secretary
Financial Secretary
Minister of State (C)
Sir Douglas Wass
Mr Ryrie
Mr Burns
Mr Middleton
Mr Britton
Mr Kemp
Mr Monck
Mrs Lomax
Mr Riley
Mr Pickford
Mr H J Davies
Miss Roach
Mr Crook
Mr Guy
Mr Scholar - No 10

PROVISIONAL MONETARY AGGREGATES FOR SEPTEMBER

I attach the Bank's note on the provisional monetary figures for September. £M3 is estimated to have risen by £1530 million (2.1 per cent), which is little changed from the 'first guess' of £1625 million (2.2 per cent). The Press Announcement will therefore refer to a rise of about 2 per cent. The increase in the first seven months of the target period was 10.7 per cent.

2. The counterparts were much as estimated in the 'first guess'. The large increase in bank lending in sterling to the private sector was confirmed at £1200 million, although £400 million of this is accounted for by the seasonal adjustment factor. The reduction in the bill leak is now estimated to have been around £110 million rather than £300 million as in the 'first guess', which means that the underlying increase in bank lending in September will have been even greater than was at first thought. Almost all of the increase in lending to persons of £270 million is thought to have been for house purchase.

3. Of the other aggregates, M1 rose by 1.7 per cent following last month's fall of 2.4 per cent. Over the last seven months it has risen by 7.2 per cent. Total M3 rose by 2.2 per cent, compared with an increase in banking August of 1.6 per cent.

PSL1 rose by 2.0 per cent and PSL2 by 1.6 per cent, compared with 1.3 per cent and 1.1 per cent respectively in August.

4. The markets have been very uncertain about what increases in £M3 to expect; estimates have ranged from ½ per cent to 3 per cent. Although the recorded increase of 2.1 per cent is in the upper half of the range, it may not have a strong adverse effect on the markets when published, as the markets should recognise that it was in anticipation of this that the Treasury and the Bank allowed interest rates to increase. The recorded figures are likely to be seen to validate the increase in interest rates.

5. When the figures are published next Tuesday, it will not be possible to explain away the large recorded increase as being mainly due to the aftermath of the Civil Service dispute, as the effect of the dispute in banking September was to add only about ¼ per cent to £M3. Nor will the markets expect there to have been much round-tripping, particularly at the end of the banking month, as this will have been discouraged by expectations of an increase in base rates (which occurred on September 16). Although the counterparts to the increase in £M3 will not be published on Tuesday, the markets will infer from the clearing banks' figures (also published on that day) that bank lending has again been an important factor in the increase in £M3. They will also be aware that funding has been low.

6. The line that we propose to take in press briefing is therefore that the rise in £M3 has confirmed the need for the higher interest rates now ruling. Thus the authorities have already responded. It is clear that the strong growth of bank lending referred to in the announcement of 14 September has continued.

7. Only a small part of the increase in September was attributable to the Civil Service strike but in accordance

with the Prime Minister's wish, we will propose to take the opportunity next Tuesday to prepare the markets further for the October figure, when the strike distortion to the CGBR is expected to be large.

8. Perhaps copy recipients could let HF3 have comments on the proposed line for press briefing by close on Monday.

C D Harrison

C D HARRISON
2 October 1981

FOR MR. TURNBULL

PROVISIONAL MONETARY AGGREGATES FOR SEPTEMBER

£ millions, seasonally adjusted

As usual at this stage all figures are subject to revision, particularly those affected by overseas holdings of gilts and others shown in brackets in the attached table.

1 Sterling M3 is provisionally estimated to have risen by 1,530 (2.1%) in banking September. This brings the rise in £M3 in the first seven months of the current target period to 10.7%, or 19.0% at an annual rate. The annual rate calculation is of course misleading as it involves grossing up the distortion in the figures resulting from the Civil Servants' dispute whereas in fact there is an overhang of net receipts due to the Exchequer of about £5½ billion, most of which is expected to come back in during the remainder of the target period.

2 The wide monetary base rose by 270 (2.3%) including a sharp rise in notes and coin in circulation with the public (+150); the annual rate of growth since mid-February is increased to 5.8%. M1 rose by 540 (1.7%) following last month's fall of 2.4%. Over the seven months since mid-February it has risen by 7.2% (12.6% at an annual rate). More than half (+310) of the rise this month was in interest-bearing sight deposits and the non-interest-bearing component rose by only 0.9%; it has risen by 5.9% since mid-February (10.4% at an annual rate). PSL1 rose by 2.0% and PSL2 by rather less, 1.6%, with the building societies' contribution rising by 1.1% (12.2% at an annual rate since mid-February). UK residents' deposits in foreign currencies rose by 290 (transactions +300, valuation -10) and total M3 rose by 2.2%.

3 The accompanying table shows the counterparts to the rise in £M3 together with their forecasts. The CGBR of 1,230 was much as forecast. Own account transactions accounted for 1,040 of this, about 600 resulting from further strike distortions, and on-lending to the rest of the public sector of 190 was also much as expected. The direct contribution of the rest of the public sector was again much less than forecast, repaying 240 rather than borrowing 230. Non-bank private sector purchases of central government debt were 210, the bulk of it (170) coming from National Savings.

4 Sterling lending to the private sector rose very sharply, by 1,200. It is difficult to identify the categories of borrower mainly responsible because there was a substantial shift between different forms of borrowing with advances rising by only 230 (unadjusted) but bill finance expanding sharply by 530 (unadjusted; the seasonal adjustment of +410 accounts for most of the remainder). Lending to persons continued to increase strongly, by 270, with almost all of this going for house purchase. Private sector acceptances issued increased by 420 and there was a fall of 110 in bills held outside the banking system*. Within the banking system the bulk of the extra bills were held in the discount market (+770 including bills issued by other sectors), with banks' holdings increasing by 170 and Issue Department selling 190.

5 External and foreign currency items in total were modestly contractionary (-210). After taking account of transactions with banks in foreign currencies by UK residents, and increases in banks' foreign currency capital, the implied balance of the private sector on current and capital account appears to have been a deficit of around 150. The financing breakdown of external flows shows a large rise of 460 in sterling lending to overseas offset by a fall in the reserves of 280, and banks' switching into sterling of 240. Lending in sterling to overseas this month included a large rise in bill finance, probably largely reflecting acceptance credit facilities to foreign oil companies (Agip and Pemex); only 160 was accounted for by lending to banks abroad.

---

*Substantially less than estimated from the weekly figures mainly because of a rise in acceptances by non-weekly banks.

Non-deposit liabilities rose by an erratically large 240.

✓

SECRET

£ millions
seasonally adjusted

PROVISIONAL DCE, STERLING M3 ETC IN BANKING SEPTEMBER 1981

	Preliminary*		Forecast**	
CGBR: own account	+1,041		+,1010	
on-lending to LAs	- 121		- 90	
on-lending to PCs	+ 307		+ 260	
		+1,227		+1,180
Net purchases of CG debt ly non-bank private sector: (inc -)				
Gilts				
Treasury bills	- 16		- 15	
National Savings	+ 14		+ 65	
TSB claim on FBS	- 174		- 225	
	-		-	
Certificates of tax deposit etc	- 30		+ 330	
		- 206		+ 155
Other public sector: Local Authorities	- 35		+ 240	
Public Corporations	- 201		- 10	
		- 236		+ 230
Sterling lending to the private sector:				
Bank lending to private sector	+1,395			
Issue Department commercial bills	- 193		+ 80	
		+1,202		+ 80
Sterling lending to the overseas sector:				
Bank lending to overseas sector	+ 461		+ 250	
		+ 461		+ 250
External and foreign currency finance:				
Increase in reserves (inc +)	- 281		- 49	
Official borrowing (inc -)	+ 40		+ 49	
Overseas purchases (-) of: gilts	(- 12)		)+ 100	
treasury bills	(- 12)		) -	
LA debt	(+ 4)		) -	
Overseas sterling deposits (inc -)	- 120		- 100	
Banks' net currency deposits (inc -)	- 239		+ 155	
Seasonal adjustment	- 53		- 53	
		- 673		+ 102
Non-deposit liabilities (inc -)		- 245		- 150
Sterling M3		+1,530		+1,847
		+ 2.1%		+ 2.5%
DCE		+2,448		+1,895

* Figures in brackets are more uncertain than other figures.
** As circulated in the Monetary Review of 17 September 1981.

3(a) B4

MCS.

MR. PATTISON

cc. Mr. Scholar
Mr. Hoskyns
Mr. Ingham

Good News?

In my unrelenting search for useful sources of genuine indications of dynamism in the economy and the growth of new enterprises, I may have stumbled across a useful indicator.

I visited the Stock Exchange yesterday, largely for a run-down on how the system actually works. In discussing the various different kinds of market, the people I talked to were particularly enthusiastic about the way in which they had dealt with the growing problem of smaller but potentially interesting companies, who were unable or unwilling to meet the formal listing requirements, but who wished to raise money. This had led to the establishment of the "unlisted market", which now comprises 65 companies. The interesting thing about this market is that it reflects not so much new companies - which as we know from VAT registrations are not much of an indication of anything - but established small companies who are growing, which ought to be a good indication of the growth of the small business sector. So it might be worth while, subject to the views of those who know much more about the markets than I do, keeping an eye on the number of companies in this market, its level, and the volume of securities traded.

J. M. M. VEREKER

1 October 1981

BOX

Prime Minister.

To see.

MR. WHITMORE

Hector Laing rang me this afternoon. He said that he had just been at a lunch in Southampton given by the Southern Region Branch of the Bank of England: he was there in his capacity as a member of the Court along with Bob Clark. There were Chairmen of several major companies there, including Metal Box and Twinings. Most of the companies were not doing at all well in terms of profit and loss, but all those present said that the Government should "stick to its guns" on ~~the~~ economic policy. They felt that it would be disastrous to let up at this juncture. If the Government did let up, we would simply return to the overmanning and crazy pay settlements of the past.

Hector said he thought the Prime Minister would be interested in this, and I said I would pass it on. I leave it to you to decide whether to show it to the Prime Minister.

25 September 1981

CONFIDENTIAL

cc Walters
Ingrid
Vereker

SECRETARY OF STATE FOR EMPLOYMENT

Caxton House Tothill Street London SW1H 9NF
Telephone Direct Line 01-213 6400 GTN 213
Switchboard 01-213 3000

R..

Tim Lankester Esq
Private Secretary
10 Downing Street
LONDON SW1

23 September 1981

24/9.

Dear Tim

I attach a copy of the latest monthly pay brief. Copies also go to the Private Secretaries to members of E, members of E(PSP), E(EA) and to Sir Robert Armstrong.

Yours

Marie Fahey

MISS M C FAHEY
Private Secretary

PAY BRIEF - POSITION AT MID-SEPTEMBER

SUMMARY OF THE 1980/81 PAY YEAR

1. In the pay year ending 31 July 1981, the Department was given information about 1,004 settlements covering 11,538,000 employees. The overall average level of these settlements was 8½%.

2. In the PUBLIC SECTOR, 109 settlements covering 6,448,000 employees, the average level was just under 8½%. The average in the trading sector was just under 9½% and in the services sector was 8%. A major factor contributing to the high level in the trading sector was the above average settlements in British Rail, gas, electricity, water services and telecommunications. The lower level in the services sector was largely attributable to the 6% pay factor limit set by the Government; apart from special cases (Police, Firemen, Armed Forces) virtually all of the major groups settled for 7½% or less.

3. The average level in the PRIVATE SECTOR, 895 settlements covering 5,090,000 employees, was just under 9% for both manufacturing and for non-manufacturing. The average in non-manufacturing, however, was depressed by the 6.7% settlement for Building and Civil Engineering and implementation of an offer worth 3%-6% in Motor Vehicle Retail and Repair. Exclusion of these settlements would increase the average for this sector to about 10%.

4. Though not strictly comparable the information provided to the CBI in their Databank survey of manufacturing industries broadly supports the information given to the Department. According to the survey there was little change in the general pattern of settlements from October 1980 onwards with pay settlements averaging around 8%.

5. Evidence is tentative at present but it is estimated that the outturn on average earnings for the year measured by the underlying average in the September official earnings index published in November will be just over 10% for the economy as a whole, about 11% for the private sector and about 9% for the public sector. This points to wage drift of about 1½% for the whole economy. There is no evidence of drift in the public services but drift was at least 2% in the public trading sector and about 2% in the private sector. The September index is a more accurate reflection of movements in the pay round than the July or August figures because it is not usually distorted by the timing of back pay or of staged awards. The July index

(11.5% underlying average, 12.1% actual) published earlier this month is still affected by back pay and staged awards from settlements in the 1979/80 round and this will not fully work through the index until September by which time any delayed payments from the 1980/81 round will also have found their way into the index. There are few settlements which are both reached and paid during August or September so that the September index most accurately reflects changes in earnings over the pay round. The underlying average is used rather than the actual increase in earnings to iron out any distortion such as back pay which artificially affect the earnings of individuals in a particular month or week. Wage drift - the gap between what sponsoring departments and the private sector estimate will be the extent to which earnings will be increased by settlements, and the outturn as measured by the official earnings statistics - is partly a result of inaccurate estimates and partly the result of many other factors affecting actual earnings. A reduction in hours worked, for example, took place over the year and this had the effect of depressing earnings (negative drift); but for this reduction in hours the whole economy drift would have been 2%.

6. The round started with retail prices at 16%-17% above the level of a year earlier and settlements averaging about 19%. By October, however, the position was reversed with prices at about 15½% and monthly settlement levels falling rapidly to about 11%. As the round progressed both prices and settlement levels fell steadily and by July the increase in the RPI had fallen to about 11% with settlements being negotiated at about 8%. Even allowing for drift, average earnings (just over 10%) for the round as a whole are likely to be about 1% below the level of the RPI.

CHARACTERISTICS

7. The trend in settlement levels was similar both in the private and in the public sectors. As expected, early settlements in the private sector tended to reflect the general level of the previous round and, together with the special case increase for Police (21.3%), the effect was to give an average at the start of the round of about 19%. By December with new settlements averaging about 9-10% the overall average had fallen to about 12%. For the remainder of the round the monthly averages stabilised at between 7% and 10%, with a tendency towards the lower end of the range when the round closed.

8. There was a wide range of settlements both within and between industries. Industries in the private sector with below average increases include engineering, road haulage and textiles. Those above average include petroleum and chemicals, food and drink, insurance, banking and finance and distribution. In the public trading sector settlements fell into two camps: the monopoly industries including British Rail but not the Post Office had settlements in the 9½%-12% range; the other industries settled

at levels much lower. A major factor influencing the level in the public services was the settlement for Local Authority manuals agreed early in the round.

9. About 1/5 of employees in private sector groups but few employees in the public sector secured holiday improvements.

10. Few settlements included reductions in hours; nevertheless, a substantial number of employees benefited during the round from forward looking agreements to reduce hours made in the previous round and further reductions will result from these agreements in the 1981/82 round.

11. A number of major groups in both the public and private sectors negotiated agreements to last for other than 12 months, but the majority of settlements were for 12 months.

12. A confidential CBI survey of members in manufacturing industries about factors influencing settlements showed that comparability was an important influence on less than ½ of settlements. It had been an important influence on more than ⅔ of settlements in the previous round. There was a marked strengthening of downward pressures-principally low profits, price competition and fear of redundancy. The principal upwards pressure was the cost of living but this was less important than it had been in the previous round.

CURRENT PAY YEAR

SETTLEMENTS

13. Since the July pay brief 29 settlements covering 197,000 employees with operative dates after 31 July 1981 have been recorded. In the private sector (28 settlements covering 59,000 employees) the weighted average level of settlements was just under 8½%. The only settlement in the public sector was for Police (138,000) at 13.2%.

14. Because of the small number of settlements notified the average for settlements effective after 31 July 1981 must be treated with caution. Perhaps a better indication of the level of recent settlements can be obtained from an analysis of the 329 settlements covering 4,189,000 recorded in the last 3 months (since mid-June). This shows the level in the public sector (50 settlements covering 2,803,000 employees) to be 7½% - about 7½% for services and just under 8½% for trading. In the private sector (279 settlements covering 1,386,000 employees)

the average was just under 8% - just over 8% in manufacturing and about 7½% in non-manufacturing.

NEGOTIATIONS

15. In the PUBLIC SECTOR, British Telecom executive grades (1 July - 7,000) have rejected an offer estimated to be worth 10% on earnings, which has been accepted by all other Telecom negotiating groups. The union (SCPS) is continuing to negotiate for pay parity with telephone engineers. UKAEA manuals (1 October - 4,760) have rejected an offer of 4½% on rates. The claim is for a substantial increase. Talks are due to begin soon for Coalmining, manuals (1 November - 198,000), Local Authority, manuals (4 November - 1,077,000), Fire Service (7 November - 39,000) and Water Service, manuals (7 December - 30,600).

16. In the PRIVATE SECTOR, a claim for a substantial increase in line with the cost of living and improvements in conditions has been submitted for employees covered by the National Engineering Agreement (1 November - 1,900,000). The Employers Federation are to reply at a meeting on 24 September. Oil Tanker Drivers (17 November - 8,600) have submitted a claim for substantial increases. Talks at BP begin on 24 September. In Electrical Contracting E & W (1 January - 45,000) discussions are taking place on an undisclosed offer. Next meeting 18 September. An offer of 4% and other benefits, with an additional 1% available in exchange for concessions, to Vauxhall Motors Ltd, manuals (20 September - 23,800) has been rejected by union negotiators but is to be put to members. The claim is for a substantial increase, phased reduction to a 35 hour week and other improvements. An offer of 8.5% to Flour Milling employees (18 August - 7,100) has been rejected after a ballot. The claim is for 9%. At Rolls Royce Motors Ltd, Crewe (1 August - 6,000) an offer of 4.5% and a revised bonus scheme has been rejected. Talks continue. A claim for £20 increase has been submitted for BL (Cars) manuals (1 November - 33,000). The Company is expected to reply by 25 September. Merchant Navy Seamen (2 January - 26,000) have submitted a claim for a substantial increase in pay and other benefits estimated to be worth well over 20%. Employers are to reply at a meeting on 3 November.

PRICES AND EARNINGS INDICES

PRICES

17. In August the year on year increase in retail prices was 11.5% compared with 10.9% in July.

EARNINGS

18. Average earnings increased by 12.1% in the year to July but this was inflated by about ½ percentage point on account of back-pay and a further ½ per cent owing to comparability increases stemming from 1978-9 round settlements. On the other hand it was depressed by up to ½ percentage point by the fall in hours worked during the year. Also the index does not yet fully reflect the impact of the 1980-1 round.

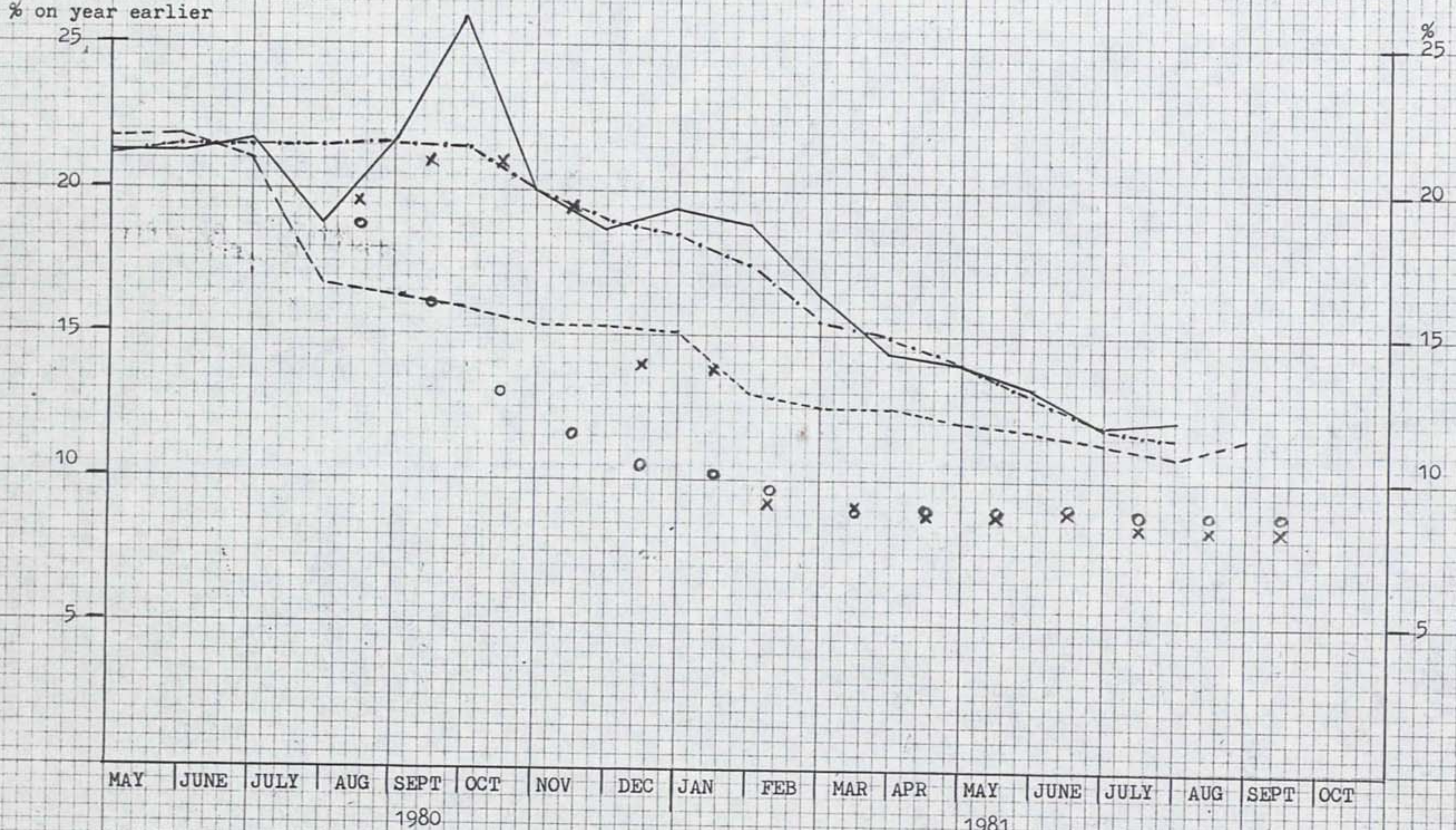
REAL DISPOSABLE INCOME

19. The real disposable income - taking account of the change in earnings, prices and taxes - of a married man on average adult male earnings with a non-working wife and two children under 11 (with no other tax liabilities or allowances and not contracted out of the State Pension Scheme) fell by about 1% in the year to June.

CONFIDENTIAL

APPENDIX 3

TRENDS IN EARNINGS AND PRICES



- - - Retail Price Index

——— Average Earnings Index (whole economy)

X Public Sector Settlements)
o Private Sector Settlements) Cumulative Average Increase in Earnings (effective between 1 August 1980 and 31 July 1981)

—·—·— Underlying rate of increase in earnings

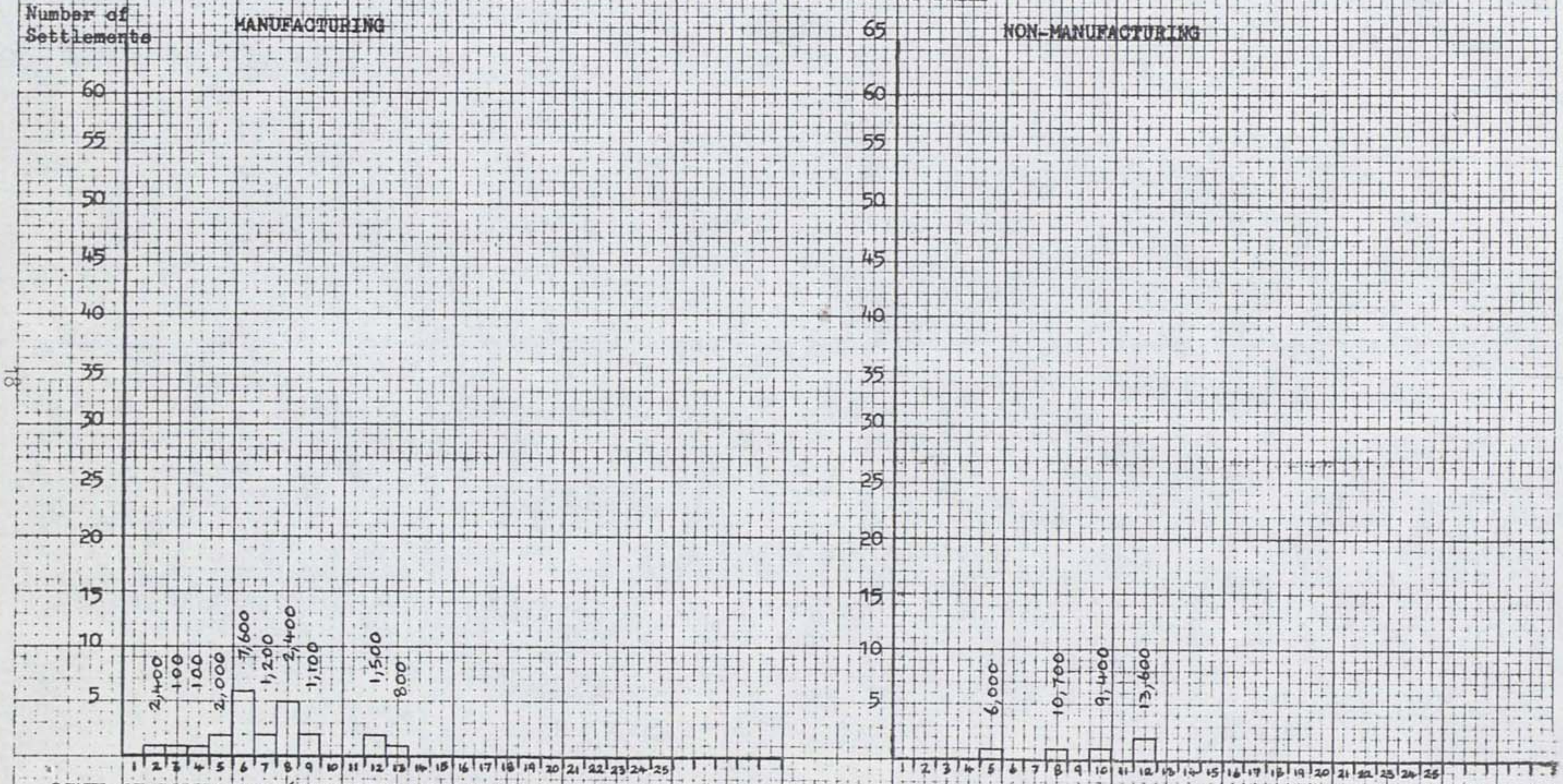
CONFIDENTIAL

CONFIDENTIAL

APPENDIX 4

DISTRIBUTION OF SETTLEMENTS IN THE PRIVATE SECTOR BY LEVEL OF SETTLEMENT FROM 1 AUGUST 1981

KEY ■ SETTLEMENTS UP TO THE LAST PAY BRIEF
□ SETTLEMENTS SINCE THE LAST PAY BRIEF



LEVEL OF SETTLEMENT (ROUNDED TO THE NEAREST WHOLE NUMBER)

NOTE THE NUMBER OF WORKERS (ROUNDED TO THE NEAREST HUNDRED) AFFECTED BY THE SETTLEMENT IS GIVEN ABOVE THE APPROPRIATE INDICATOR.

CONFIDENTIAL

Econ Pol
Strategy.

Acknowledged
by. C.S.
Deputy D/y Clerk

Box

House of Lords

19 Sept 1981

Dear Caroline,

Pages 20 et seq of the enclosed are what Mrs. Thatcher wanted to sustain her argument on full employment. I promised to send them. Could you see she gets them?

Yours ever

John Vaizey

Miss C. Stephens
10 Downing Street

John

With compliments & best wishes.

Tom.

UNIVERSITY OF GLASGOW

Discussion Paper In Economics No. 37

Policy in War and Peace: The Recommendations of J.M. Keynes

by TOM WILSON

April 1981

Department of Social & Economic Research

POLICY IN WAR AND PEACE:

THE RECOMMENDATIONS OF

J. M. KEYNES*

T. WILSON

* This paper was the basis of a lecture at the Keynes Seminar, University of Kent at Canterbury, November 1980.

I Introduction

Over the past decade, Keynesian policies have been subjected to severe attack and there can be no doubt that Keynesianism has lost much ground - if ground can be measured by political and academic support. Today, when Keynesians are thus fighting a defensive action, it must be hard for members of a younger generation to appreciate the immense excitement that followed the publication of the General Theory of Employment, Interest and Money in 1936. It was a time of hope - hope that was to pervade the wartime discussion of post-war policies and was to remain strong for many years thereafter. It is true that, by 1936, a recovery from the worst depths of the depression had taken place and this recovery owed little to expansionary fiscal policies of a Keynesian type; but it was also an incomplete recovery. Unemployment was still high and, even in 1937, the USA had barely regained its 1929 level of GNP when another downturn took place.

A different approach to policy seemed to be required. Admittedly the measures recommended by Keynes were not altogether new in the sense of never having been propounded before. But the General Theory gave, or was believed to give, what had hitherto been lacking: that is to say, a firm and incontestable foundation for proposals that had previously been dismissed as heretical, eccentric and irresponsible. It was with these basic ideas that the General Theory was primarily concerned but the policy recommendations that seemed to follow were not presented in any detail in that work. Subsequently Keynes expounded his views in three articles in The Times for 12, 13 and 14 January, 1937 (reprinted in Keynes v. the Keynesians by T.W. Hutchison, Institute of Economic Affairs, 1977). War came before he had been able to do much more than this. As was to be expected, Keynes then responded quickly to the new situation and was soon applying his analytical mind to the problems of inflation, first as an academic economist and then as a government adviser. But the problems of peace were not neglected even in wartime and, within Whitehall, discussion of employment policy had already begun in 1941. Keynes, of course, played a leading part. Thus, when we turn our attention to Keynes's activities, we find him actively engaged in devising measures to deal both with the current wartime problems of inflation and scarcity on the one hand and with the possible recurrence after the war of the deflationary pressures that were so much in his mind when he was writing the General Theory.

With the publication of volume XXVll of the Collected Writings of John Maynard Keynes, important official memoranda and correspondence have become available for the first time and new light is thrown on some important issues.

II Wartime Inflation

It need scarcely be said that inflation was far from being a new topic for economists. Indeed it has been one of Keynes's complaints that economists had devoted too much attention to periods of rising prices and had tended to neglect unemployment, sometimes on the dubious ground that if booms could be prevented slumps would also be avoided. What was new about Keynes's approach was his use of national income accounts to analyse the prospective inflationary gap, and not only to analyse it but to estimate its probable magnitude. In doing so he was applying the theoretical approach of the General Theory with appropriate modifications and was drawing upon the pioneering statistical work of Colin Clark and, later, of Richard Stone.

In two articles in The Times (14, 15 November, 1939) and in his pamphlet (How to Pay for the War, Macmillan, 1940), Keynes presented his estimates of potential output and of the probable claims upon it. An inflationary gap was to be anticipated. How best could it be dealt with?

The problem would be eased and the size of gap lessened by a rise in voluntary saving. But "saving" is a tricky concept. If more money was created and more was spent than the flow goods available at constant prices, then prices would rise, if allowed to do so, and the bulk of the population would be forced to consume less in real terms. Profits would be swollen but the few who received these inflated profits would have a high propensity to save and, in wartime conditions, would also have small inclination to spend on capital goods. Thus the shift in the distribution of income would bring about an initial voluntary reduction in private expenditure, but this would not be a stable position. For, after a lag, wages would be forced upwards and a foolish inflationary spiral would then ensue. (Ch. IX of How to Pay for the War.)

The more voluntary saving that could be encouraged the better without relying on this distributional twist, but it was not to be expected that the emergence of a serious inflationary gap could be prevented. Demand might then be held back by rationing, but rationing could not be comprehensive and demand would thus be diverted to what was not rationed. There should, indeed, be an iron ration of essentials combined with price controls. This was crucially important but would not, by itself, suffice.(1)

"The general character of our solution", he wrote "... must be, therefore, that it withdraws from expenditure a proportion of the increased earnings" (that would be engendered in the wartime economy). This must be done by taxation and there was no escape from the fact that additional taxation would fall on the population as a whole; it was statistically impossible to make the rich alone pay for the war. Taxation was required but there should be a new element in the tax structure: deferred tax credits. Part of the additional tax contribution should, in effect, take the form of a compulsory loan which would be repaid at an appropriate stage after the war when this repayment would help to prevent the slump that was then to be anticipated.[2]

In crude summary this was the essence of Keynes's proposal. He held that, in this way, the wartime burden would do less harm by reducing incentives and weakening morale. There should, he claimed, be no permanent reduction in the standard of living of the working class - a bold claim that depended upon the way in which the post-war repayments would be financed.[3] What is true is that the workers would be better off that way than with uncontrolled inflation leading to profiteering. Whether their position would be significantly better than without tax credits is not obvious.

Did this scheme really have a significant effect on the war economy? The answer must surely be in the negative. In part this was because the scheme as adopted by Kingsley Wood in the 1941 budget was on only about a quarter of the scale Keynes had recommended. If it had been more fully adopted, would it have been possible to raise total taxation, including that backed by post-war credits, to a still higher level? If so there would have been less market pressure on the controls. It is not clear, however, that deferred tax credits, even on a larger scale, would have had as big an effect on morale as Keynes, for his part, anticipated. It may be the case that, apart from a few economists and other intellectuals, not many people were inclined to put so much trust in Treasury promises of post-war repayment as to be influenced in their wartime conduct thereby! Such scepticism certainly proved to be justified in the event, for the credits were not repaid for a long time after the war and then only in heavily depreciated currency. Whether the device was worth using once may be debated; it would certainly be difficult to use it again.

The pamphlet, How to Pay for the War, greatly interested economists at the time and there may still be an inclination to suppose that the scheme there propounded constituted Keynes's main contribution to the effective running of the war economy. That, of course, was not so. On the international side he took a leading part in the Lend-Lease negotiations on which so much depended and, more generally, was actively concerned with external financial matters throughout the war. On the domestic side, there was no other "Keynes Plan", in addition to the post-war credit plan; but his influence was not restricted to his devising of such labelled schemes. The war was run with a much greater regard for fairness than had been the case in the First World War. The iron ration of basic foodstuffs, the more flexible points system for other foods and the system of clothes rationing with lines of partially standardised production - all these measures went a long way to ensure fair shares. Price control and subsidies held down the cost-of-living. Of course there were black markets but these were less important than would have been the case if fiscal policy had been slacker. It would be wrong, admittedly, to leave the impression that planning was based essentially on estimates of national output and the claims upon it. That was not so. The war effort was organised largely by means of quantitative plans for production with estimates - sometimes rather rough estimates - of the requirements for manpower, shipping, raw materials and so on. These plans were enforced substantially by means of direct controls. Keynes, for his part, was not involved in this kind of physical planning. Indeed he was not a member of either of the two crucially important committees, the Manpower Committee and the Shipping Committee. But is is also necessary to make the point that if inflationary pressure had been stronger, as it would have been had financial policy been more lax, it could have weakened the effectiveness of this kind of planning in physical terms. Although finance seemed to play a very subsidiary role, the physical and the financial aspects were in fact interlocked in a whole variety of ways.[4] It is hard to assess the extent to which Keynes contributed to all this, even with the Collected Writings at hand, but it may be a reasonable inference that those contributions by Keynes which did not bear a visible Keynes "trade-mark" were at least as substantial as those that did.

I have made no mention so far of an important aspect of war finance for which we do know that Keynes was partly responsible. This was a cheap-money war. Keynes was quite insistent that it should be so. As early as 28 September 1939, he had maintained in a letter to The Times that the Treasury should not borrow at more than 2½ per cent and he continued to advise along these lines. There was not, I think, much opposition to a cheap-money war, but Hicks rightly gave a warning in a letter to Keynes of 4 October, 1939: "Although I am quite in agreement with you about the pros of keeping interest rates down during the war, I cannot help feeling that that policy has the considerable disadvantage of piling up liquid funds in the hands of the public, which is likely to make the problem of controlling the post-war boom even more intractable." Keynes did not agree. He did not think effective demand after the war would be much affected by the terms on which it was borrowed during the war - thus missing Hicks' point that with very low wartime interest rates more capital would be held in short-term liquid assets and in cash. In the event, the suppressed inflation of wartime left for post-war a problem of pent-up demand backed by accumulated purchasing power, as Hicks had anticipated. Keynes was inclined to underestimate this danger for another reason. At that stage he was anticipating only a short war [5] to be followed by a short boom which might "only be an event of a few months". (CWK, vol. XXII, pp. 29-36). He was later to modify his views about the probable length of the boom, as we shall see when we turn to his work on post-war policies; but he remained a cheap money man to the end.

III Post-War Policies: Social Security

Even in the early days of the war, Keynes was already directing some attention to the probable requirements of the post-war period. What now seems a rather odd example is to be found in the first section of vol. XXVII of the *Collected Writings* which deals with the anticipated accumulation of stocks of primary products in some of the main producing countries and the possible use of these surpluses for post-war relief. A special section of the Ministry of Economic Warfare was charged with exploring the possibilities and Keynes took part in the interdepartmental discussions which, of course, involved the Treasury. It has to be borne in mind that many people, including Keynes, had initially anticipated a short war. Its prolongation and the various changes in the areas affected were soon to strip these investigations of whatever interest they may have had. Work on the more general problems of commodity markets was to continue, however, and to be reflected in the discussion of post-war policies, in so far as this related to buffer-stock and commodity-stabilisation schemes. Keynes's interest was therefore sustained and his flow of comments and suggestions continued. These matters cannot, however, be further explored in the present paper. Let us turn, then, to domestic policy.

In June 1941, Beveridge was invited to review the existing arrangements for social security and to suggest amendments where these seemed appropriate. As his work progressed, however, he began to formulate a new scheme for comprehensive social security and this was to become a topic of lively debate in Whitehall. Some difference of opinion was to be expected about the proper form and scope of a social security scheme but the central issue of debate was the extent to which Government should commit itself. Most of its members were preoccupied with the task of fighting the war. Look, if you will, at the minutes published as appendices to Churchill's memoirs and consider the extraordinary range of decisions relating to the war with which he had to deal. It is amazing that he had any time and energy to devote to post-war problems. In such circumstances it would not have been unreasonable to hold that, although the formulation of post-war policies might continue, financial commitments should not be accepted. The case for caution was strengthened at this time by the sharp difference of opinion between two of the leading economic advisers: H.D. Henderson on the one hand who was deeply pessimistic about post-war prospects and Keynes, on the other, who took a more sanguine view. Once again the national income accounts were put to what was, in those days, a comparatively novel use, for estimates were projected forward on various assumptions to a hypothetical post-war year, and this procedure allowed the differences between the contestants to be presented in quantitative form. In the event, Keynes was, on balance, the winner for the Cabinet was persuaded to accept the greater part of what Beveridge had recommended.(6)

Of the many issues raised in the course of this debate, two are of particular interest because of the relationship they bear to Keynes's views on post-war macro-economic policy. The first was his emphasis on the importance of making it clear that "it is not intended in future to put the benefits and the contributions on a cost of living sliding scale, but only to make adjustments when there have been major disturbances, as, for example, between pre-war values and probably post-war values" (CWK, vol.

XXV11, p. 204). This was also Beveridge's own view. (see William Beveridge by José Harris, O.U.P., 1978). Neither Beveridge nor Keynes had a remotely adequate anticipation of the inflationary pressures that have persisted for many years since the war, but both believed that indexation would weaken the resistance to inflation.[7]

The second point to be noted here is that Keynes believed strongly, as Beveridge did, in financing social security by hypothecated contributions. He concedes that the proposed social insurance fund is "admittedly, to some extent, a fiction. Certainly it is not a fund in any actuarial sense." (CWK, vol. XXC11, p. 224). As the former chairman of an insurance company he could scarcely say otherwise! There were, however, two reasons why he believed in earmarked contributions. First, this method of finance would make clear to people what they were paying for - a point that had been much stressed by Beveridge. Secondly, it was not desirable that current payments and current contributions should always balance, but the surpluses and deficits that would thus appear would not be allowed to disturb the balance of the Chancellor's ordinary budget. He held, therefore, that: "The social security budget should be one section of a capital or long-term budget. ....*For the ordinary budget should be balanced at all times*." (CWK, XXV11, p. 325 Italics added.) Thus he was fitting the security proposals into what he regarded as the appropriate framework for post-war stabilisation policy.

IV Post-War Policies: Maintaining Employment

Within Whitehall work on employment policy began at an early stage. In February 1941, James Meade had prepared a memorandum on the subject and this was the start of prolonged discussions between the Economic Section, under Lionel Robbins, to which Meade belonged, the Treasury with Keynes and Henderson again at odds, the Ministry of Reconstruction under Greenwood and the Prime Minister's Statistical Branch under Cherwell.

The outcome was the White Paper on Employment Policy (Cmd. 6520) which appeared on the very eve of the Second Front in May 1944. It was an exceedingly important state paper for, in it, a British Government accepted for the first time the obligation to try to maintain "a high and stable level of employment." The means proposed for the attainment of this objective were set out and were soon attacked as being too cautious. The proposals did not go far enough to satisfy the critics and it was rumoured that Keynes had been only partly successful in getting his recommendations accepted. It is a belief that has persisted. Thus, in 1969, Donald Winch could say that "... the chief weakness of the White Paper lay in its treatment of the budget as a means of controlling the level of employment. The paragraphs dealing with this subject are highly confused. The main remedies proposed, contra-cyclical public investment programmes and variations in national insurance contributions, were both outside the framework of normal budgeting." (Economics and Policy, Penguin, ed., 1967, p. 281-2) With the official papers not then available Winch could not have been aware that these very aspects of the White Paper reflected Keynes's own views! Thus on the basis of the evidence then available to Winch it was reasonable to infer that "... if Keynes's views had prevailed the document would have been much better." (Op.cit., p. 282). As we shall see the evidence now available leads to a somewhat different verdict.

Keynes had given broad indications of his position in The General Theory of Employment, Interest and Money, and had been more explicit in articles contributed to The Times in 1937, mentioned above. Then in 1942 he explained his general position in a broadcast: "Here is a real problem, fundamental yet essentially simple, which it is important for all of us to try to understand. The first task is to make sure that there is enough demand to provide employment for everyone. The second task is to prevent a demand in excess of the physical possibilities of supply, which is the proper meaning of inflation." (CWK, vol. XXV11, p. 267; reprinted from the Listener, 2 April, 1942). Simple indeed - over-simple in the light of experience, for there is no hint here of the problems of stagflation. Let us, however, leave that formidable complication aside for the moment and direct our attention to the ways in which Keynes believed these basic objectives could be achieved.

The first point to observe is his discarding in the General Theory of a technique of stabilisation on which he had laid great stress five years earlier in A Treatise on Money (1931). This was the manipulation of long-term interest rates in order to offset fluctuations in the expected return on investment. His abandonment of this recommendation followed from his liquidity preference theory which can be detected in the Treatise on Money but became a central feature of his analysis in the General Theory. If the complex of bond yields depends upon liquidity preference, given the amount of money, and if liquidity preference is based on past experience, then it may be hard to get bond yields down sufficiently to check a recession if previously raised to halt a boom. In his Times articles of 1937, Keynes held that dear money must be avoided "as we would hell-fire". It was true that some investment should be held back during a recovery to prevent excess demand. "But we must find other means of achieving this than a higher rate of interest. For if we allow the rate of interest to be affected, we cannot easily reverse the trend." (Italics added).

What he was postulating was, in effect, a bond-yield ratchet, in addition to the money-wage ratchet. Why a ratchet? If past experience of high yields makes it hard to lower yields, would past experience of low yields not make it hard to raise them? The apparent asymmetry could be explained in Keynesian terms by saying that to keep bond prices up in face of official sales, people would have to run down their liquid balances (M_2) which are limited;(8) in the opposite circumstances, however, they would allow these balances to grow indefinitely. We may note in passing that Keynes was here conceding nothing to the "Pigou effect" - although he himself had suggested an effect of this kind to Denis Robertson in the mid-twenties - see Banking Policy and the Price Level, p. 51n.

For Keynes, the crucial point was to be in a position to keep rates down, for the long-run prospect was a saturation of investment opportunities with the return on investment falling to a very low figure (General Theory, pp. 375-6). It is true that even an indefinitely sustained cheap-money policy could not ensure that there would be no liquidity trap; but the trap would be located on a lower contour of bond rates if bond prices were not allowed to fall even in order to restrain a boom. This was so because spells of dear money would inflate the generally held idea of what could be regarded as the "safe" bond yield below which increased liquidity would be prudent.

So far I have referred deliberately to the stabilisation of bond yields without claiming that Keynes wanted to provide a fully elastic supply of money. In fact there are some passages which suggest that he did not. Thus: "Changes in the complex of interest rates, with a view to controlling the trade cycle and to offset inflationary or deflationary trends, should not be precluded but should affect the shorter-term rather than the longer-term issues, and should, as a rule, be regarded as secondary to the technique of rationing the volume, rather than altering the terms of credit." (CWK, vol. XXVII, p. 397). That is to say, increases in short-term rates would sometimes be appropriate but higher long-term rates never. How the two markets, the short and the long, were to be so segregated is not made clear and his proposal for their separation is all the more odd because in the Treatise he had confidently maintained that important changes in the former would be quickly transmitted to the latter. Thus there is a puzzle here and perhaps a contradiction. But it cannot be doubted that interest-rate policy was accorded at most a minor role by Keynes when the Treatise had been left behind. He did not hold, however, as some neo-Keynesians are wont to do, that the supply of money should completely accommodate changes in demand; short-rates would sometimes rise and, in particular, the other conditions on which funds were provided should be tightened up - that is to say direct control rather than control by interest rates.

The White Paper on Employment Policy accords some role to monetary policy but makes the familiar point that changes in interest rates may be more effective in checking a boom than in curing a slump. (paras. 59 and 60) The need for fiscal measures was therefore held to be established. It did not necessarily follow from this reasoning that dear money should be avoided in a boom when monetary policy could be effected. - The theory of liquidity preference was needed to bring the smell of hell-fire that so troubled Keynes.

It is true that Keynes was not as much concerned with controlling booms as with preventing depressions, but he did not challenge the general assumption that the war would be followed by a potentially inflationary boom. Early in the war, he had expected this phase to be short (CWK, vol. XXV11, pp. 29136); but by May 1943 he was suggesting five years (CWK, vol. XXV11, p. 322; Meade thought Keynes's estimate too long, op. cit., p. 328). How should this prospective inflation be contained? Not in Keynes's view by higher interest rates. A cheap-money war was to be followed by a cheap-money peace. Continuity would be preserved right through the post-war inflation with, for example, 10 year bonds issued at 3 per cent. (Not quite Dalton's policy but a long way towards it). Excess private demand would be held back essentially as in war-time by taxation and by direct controls over private expenditure; public investment would be carefully phased. It must be admitted, however, that his account of the measures he favoured was brief and sadly inadequate. There appears to be little perception, in his comments, of the difficulty of maintaining direct controls in peace-time - difficulties which reflect both the increasing diversity of the output demanded and the increasing reluctance of the public to submit to controls. In particular the manpower budget which had been of central importance in wartime, could not be expected to work as well even in a short post-war boom. There is no evidence that Keynes devoted much attention to such considerations and this was unfortunate for, had he done so, he might have appreciated more fully the dangers of the high liquidity that accompanied his cheap money policy, and therefore the case for a financial policy that could be used in tandem with the remaining but increasingly less effective direct controls.

The truth is that Keynes's real interest lay not in the post-war inflationary period but (a) in a period of normal potential instability which he expected to follow and (b) in another period - perhaps 10-20 years ahead (CWK, vol. XXV11, p. 359) - when a secular insufficiency of expenditure would manifest itself unless prevented by appropriate policy. Let us now direct attention to period (a), a period of potential cyclical instability with no marked trend as yet towards chronic deflation.

The method for preventing instability on which he laid most stress was the stabilisation of investment. It was true that a country might import its instability but ".... the proportion of investment represented by the balance of trade, which is not easily brought under short-term control, may be smaller than before" (CWK, vol. XXV11, p. 322). He goes on: "The main task should be to prevent large fluctuations by a stable long-term programme." Changes in public investment, if appropriate in timing and amount, would offset variations in private investment. The traditional remedy of public works could thus be expanded and dignified as a policy for public investment. Secondly, means could be found of making industrial investment itself more stable. "If two-thirds or three-quarters of total investment is carried out or can be influenced by public or semi-public bodies, a programme of a stable character should be capable of reducing the potential range of fluctuations to much narrower limits than formerly ...." (CWK, vol. XXV11, p. 322). As we have observed, interest rate policy was not to be used to this end and Keynes was not at all explicit about the way in which other techniques could be employed when controls had largely been removed with the ending of the post-war boom. Meade threw out some suggestions in a letter to Keynes, June 3, 1943, but he had already warned Keynes that, in the view of the Economic Section, control might not be easy. (See CWK, vol. XXV11, pp. 317, 330-1, 365). In the White Paper, there is a hint of an arrangement by which firms might accumulate tax-credits in good years that could be used in bad years - a technique that was developed most fully in Sweden.

There is another and more basic criticism of Keynes's treatment of investment. Rather too often in his writings Keynes treated investment as though its primary function was to serve as a channel for the disbursement of purchasing power. Of course it would be absurd, quite absurd, to suggest that he neglected the other functions of investment; but this particular one was so much in his thoughts that the others sometimes sank out of sight. There is, however, a warning in the White Paper (paras. 61-2) that there are limits to the extent to which investment can be, or should be, controlled for the sake of stability. Postwar experience was to underline the fact that the loss in other respects cannot be lightly disregarded. Those responsible for investment in electricity supply, in public transport, in coal-mining and so on, are naturally resentful when their investment programmes are warped in order to serve macro-economic objectives. Even if their objections are over-ruled, there will be lags before significant changes can be made, as Christopher Dow was to demonstrate on the basis of our post-war experience. (The Management of the British Economy, 1954-60).

If we now turn to industrial investment we find that Keynes's treatment was much less adequate than might be expected in view of the weight he attached to it. Indeed the treatment of investment in the General Theory has long been regarded as one of its weakest parts. What is particularly puzzling and regrettable is the fact that his views on investment did not reflect more adequately the work of his close colleague, D.H. Robertson. Robertson believed that industrial investment was bound to fluctuate because technical change came in spurts. Such innovational investment could not be stabilised without sacrificing growth, but secondary waves of rising or receding expenditure might be avoided by appropriate policies. Whether or not the whole of Robertson's theory is held to be applicable today, it is clear that he appreciated the possible tension between the different functions performed by investment expenditure.

There can be no serious doubt that, notwithstanding all the difficulties just mentioned, useful measures can be taken to reduce the instability of total investment. That this is the case seems clear enough when we reflect upon the folly of cutting public investment at a time when private investment was severely depressed - as in the early thirties - and when there was no stagflation to complicate the situation. The question is whether such measures are likely to suffice. In particular, would the effectiveness of public action not be greatly fortified by anti-cyclical variations in the budget which might now be in deficit, now move into surplus?

As observed apove (p. 9), Keynes wanted to have two budgets, a current budget, and a capital budget, and "_the ordinary budget should be balanced at all times_" (_CWK_, vol. XXVll, p. 325, italics added). It has also been observed that the caution of the White Paper on _Employment Policy_ has generally been regarded as evidence of a failure by Keynes to get his way in Whitehall. One of the sentences that seemed to justify this inference may be quoted here: "None of the proposals contained in this Paper involves deliberate planning for a deficit in the National Budget in years of sub-normal trade activity." (para. 74). In reality this was Keynes's _own_ view.

The "ordinary" or "national" budget would cover all current expenditure on goods and services and all transfers other than social security transfers which were to be included in the capital budget. Receipts would consist of the proceeds of all taxation other than social security contributions.

If taxes were lowered, it would be hard to raise them again. If deficits were proposed, the proposal would provoke opposition and perhaps weaken confidence - a possibility that was recognised in the General Theory. There was, however, another reason for Keynes' opposition which provokes quite basic questions about his theoretical position. This was his scepticism about the possibility of affecting consumers' expenditure in the short run.

Before dealing with this point we must first note an omission. The current budget could be put out of balance in either direction by changes in the consumption expenditure of the public authorities without corresponding changes in taxation. There is some guarded speculation about the possibility of such variations in the White Paper of 1944; but Keynes does not seem to have been much interested. It was on private consumption that he expressed his views so clearly - and the surprising fact is that he was highly sceptical about what could be done to alter such expenditure by changes in taxation. "I doubt" he says "if much is to be hoped from proposals to offset unforeseen short-period fluctuations in investment by stimulating short-period changes in consumption." This view is not to be explained by saying that direct taxation, as he envisaged it in the forties, would be paid mainly by the rich whose propensity to save was high. For he referred also quite specifically to indirect taxes. He had other reasons for his scepticism. (CWK, XXVll, p. 323). The point he stressed was that consumption is likely to be unresponsive to changes in disposable income in the short run. In some sentences of the recently published papers, he is anticipating the theory of permanent income to be developed much later by Friedman. Thus: "People have established standards of life. Nothing will upset them more than to be subject to pressure constantly to vary them up and down." (CWK, vol. XXVll, p. 319). It has long been recognised in the literature of the Keynesian school that the marginal propensity to consume may be lower in the short run than in the long; but Keynes himself had carried the argument much further in these official papers by maintaining that the marginal propensity to consume is so low in the short period as to make counter-cyclical changes in personal taxation of little value. What then becomes of the theory of the multiplier which he continued to stress? Perhaps an attempt at reconciliation might be made by suggesting that consumers will respond more to a change in income obtained by getting employment than to a change brought about by lower taxation; for the former may be assumed to be more lasting than the latter. Whether or not this is thought to be a convincing line, it is not a line Keynes himself developed.

There is, however, another puzzle here. For, as we have seen, Keynes <u>did</u> come down strongly in support of counter-cyclical fluctuations in social security contributions. Even without such variations, the social security system is, of course, a built-in stabiliser (of expenditure). Meade's proposal to vary the contribution rates with variations in unemployment was designed to create a super built-in stabiliser. But the effect of changing the employee's contribution will come through only if income receivers adjust their consumption when disposable income changes. By endorsing Meade's proposal, Keynes accepted this implication (<u>CWK</u>, XXV11, p. 327), but did not explain how it could be reconciled with his view, expressed in the rejecting of the case for cuts in other taxes, that the short-run marginal propensity to consume was very small. Why should people respond in this way only to changes in the social security contribution?

At this point it may be tempting to speculate that Keynes was placing his faith in variations in the <u>employer's</u> contribution rather than the <u>employee's</u>. For the employer's contribution not only reduces cash flow but is seen as a discriminatory tax on employment. In fact, however, Keynes attached little or no importance to changes in the employer's payroll tax and even tried to persuade Meade to confine his recommendation to the employee's contribution.

X There is no escape from the conclusion that Keynes had got into a muddle over all this. Nor is there any escape from the conclusion that the limitations of the White Paper, so much stressed by its critics, are to be largely explained by the fact that Keynes's own views, far from having been over-ridden, had actually prevailed. It would perhaps be natural to suppose that the Economic Section, under Robbins, would be more cautious than Keynes. But the Economic Section's proposals, as presented by Meade, had been favourable to counter-cyclical changes in other taxes and dubious about the usefulness of having a current budget and a capital budget (CWK, XXVll, pp. 317-8). There was also support for a bolder tax policy from the Prime Minister's Statistical Branch. Of course there were other sceptics as well as Keynes but the fact remains that the caution of the White Paper was not inconsistent with Keynes's own position.

X Keynes was also cautious in his estimates of the minimum level to which unemployment could be reduced.(9) Writing to The Times at the beginning of 1937 he had said: "It is natural to interject that it is premature to abate our efforts to increase employment so long as the figures of unemployment remain so large. But I believe we are approaching, or have reached, the point where there is not much advantage in applying a further general stimulus at the centre." At that time unemployment was about 14 per cent on the old basis - roughly the same as in 1980 on the new basis. It should not be inferred, of course, that Keynes was satisfied with unemployment at that level. For it could, he believed, be brought down by measures to deal with structural problems. Thus: "We are more in need today of a rightly distributed demand than of a greater aggregate demand." But he went on to add that "*the Treasury would be entitled to economise elsewhere to compensate for the cost of special assistance to the distressed areas*." (Italics added).

The war itself was to bring about large structural changes and Keynes strongly recommended that structural policies should be maintained after the war. In June 1943, he came down in favour of 5 per cent as the *average* figure to be aimed at. Presumably this would imply a lower figure in good years but he did not offer a guess about dispersion around the average. (*CWK*, XXV11, p. 335). He was, however, sceptical about Beveridge's 3 per cent, given in *Full Employment in a Free Society* (1944). "No harm in aiming at 3 per cent unemployment, but I shall be surprised if we succeed." (*CWK*, XXV11, p. 381; this was on the new basis). As things turned out, unemployment was to be well below even Beveridge's average for a quarter of a century after the war, and any suggestion that it was too low provoked an indignant reply. Thus when the Commission on Incomes and Prices suggested in 1962 that unemployment might be allowed to rise above its current figure, about 2 per cent, it was fiercely denounced by many who regarded themselves as Keynesians! The Commission may well have been right but it is also surely the case that Keynes's 5 per cent was rather too high for that period - and would have been considered so by some economists who did not claim to be fully committed Keynesians.

Keynes's high figure for unemployment has an indirect bearing on another issue, the difficulties of fine-tuning. Fine-tuning was not a problem of immediate concern in the early thirties when there was a desperate need to raise expenditure and no immediate danger of over-doing it.

In the nineteen-forties, however, Keynes was stressing the desirability of devising policies that would prevent slumps, rather than simply cure them, and this required the stabilising of expenditure. (More correctly it should be the rate of growth of expenditure relatively to the growth of potential output, but Keynes did not normally express his views in terms appropriate to a growing economy). Such stabilisation would seem to call for the fine-tuning that is so hard to achieve. Keynes, for his part, had little conception of these difficulties but is not open to serious criticism on that account. For the use of the national accounts in the formulation and execution of policy was still a new technique with both its potentialities and its limitations unknown. There is, however, a question as to how stable expenditure had to be to achieve the aim of "stability". Some dispersion was clearly contemplated by Keynes, by Meade and also by Beveridge - indeed a good deal more than was acceptable in the fifties and sixties. The fineness of the tuning that was attempted was very fine indeed - far more so than anything Keynes had in mind. It would be roughly true to say that we came to attach as much importance to a variation of 0.1 per cent in unemployment as Keynes attached to a variation of 1 per cent. It should be recalled that the scheme for varying social security contributions which Keynes strongly supported contemplated fluctuations in unemployment that would have been thought intolerable after the war. The variable contribution rates referred to brackets of 2 per cent in unemployment. The lowest range for the highest contribution was under 5 per cent; the highest over 11 per cent.

As we have recorded, Keynes expected a growing long-term deflationary pressure as investment opportunities became exhausted - phase (b) above. This forecast of secular stagnation had been made in the General Theory bud did not really follow from the central core of the analysis.

Additional highly speculative assumptions were needed to sustain it and these have proved so far to be singularly inappropriate. Keynes thought it would be necessary to stimulate consumption and discourage saving; the emphasis has rather been on the need to foster relatively more investment and therefore more saving. We need not go on to discuss the various aspects of this theory of stagnation but it is important to record that Keynes's attachment to it may have served to distract his attention from the very different problems of avoiding or curing inflation.

In some notes written just before his death in April 1946, Keynes said: "We have been using "inflation" to mean pressure of demand to raise prices above current cost of production, e.g. in Budget Speech. Quite a useful practice. But inflation of this sort a temporary factor, I think, and one we have learned to keep under good control." (CWK, vol. XXV11, p. 417). Inflation had indeed been suppressed fairly effectively in wartime in the sense that the inflationary gap had been prevented by an elaborate system of rationing and controls from having the effect it would otherwise have had on the price level. It can fairly be said, however, that Keynes was over-optimistic about the ease with which inflation could be controlled in peacetime by fiscal methods, unsupported by other regulations or by restrictions on the rate of growth of the money supply.

Keynes was, it is true, somewhat apprehensive lest sustained full employment in peacetime would lead to wage-inflation. In the White Paper it was firmly laid down that: "The level of prices must be kept reasonably stable." (para. 39). The "joint efforts of the Government, employers and organized labour" should be directed to this end. There is, however, no recommendation in favour of an incomes policy, merely an exhortation that: "Workers must examine their trade practices and customs to ensure that they do not constitute a serious impediment to an expansionist economy and so defeat the object of a full employment policy". (para. 53). The employers, too, must seek "in larger output rather than higher prices the reward of enterprise and good management." The White Paper went on to recommend that Government should take action against restrictive practices by employers but there is no suggestion of official action against the unions (10) - a marked asymmetry that was to characterise public policy for many years and does so today in the sense that action against the union monopolists is still very mild (1980).

It is a reasonable inference that Keynes broadly accepted what the White Paper had to say on these matters. It is true that in 1926 he had strongly denounced the trade unions: "There are the Trade-Unionists, once the oppressed, now the tyrants, whose selfish and sectional pretensions need to be bravely opposed." (Essays in Persuasion, p. 341). There is, however, no similar statement to be found in his writings on policy for the period after World War II and we do not know how far he would have endorsed measures to prevent the abuse of power by the unions. Would he have favoured an incomes policy? We know that he disliked controls and it is hard to believe that he would have supported proposals for the detailed and permanent control of incomes. But the term "incomes policy" has many meanings. Perhaps he would have lent his support to one or another of the more liberal versions, but this can only be speculation. What can be said with confidence, however, is that wage inflation would have been much less if full employment had been interpreted to mean an average of about 5 per cent!

I have concentrated attention in this paper on domestic policies, as required to do by my remit from the organisers of this conference.

In doing so, I have also been reflecting the principal contents of volume XXVll of the CWK. (The main exception is the earlier part of the volume on commodity policy) A brief word must, however, be added about his views of international trade and finance. Much of the time and effort of his last years was devoted to the establishment of new international institutions and the devising of appropriate rules of behaviour for a liberal economic order. Although the Bretton Woods agreement did not give him as much as he had asked, he was optimistic. In particular, he was pleased by the scarce currency clause in the constitution of the IMF. (article Vll). These new international measures and the new measures for maintaining employment would complement and support each other. In these circumstances he abandoned his old protectionist attitude and was sharply critical of those who advocated protection by means of high tariffs, import controls and discrimination. The anti-liberal proposals which came both from Right Wing Tories and Left Wing Socialists must be rejected. Thus he wrote to Kalecki in December 1944 to express admiration for The Economics of Full Employment (Blackwell, 1944) - a collection of papers sponsored by the Oxford Institute of Statistics. But he went on to say: "The one exception I make to this, as perhaps you have guessed, is the section on International Aspects......What is happening to Balogh? He has done some excellent stuff in the past, but much of what I have seen of his lately strikes me as extremely confused." (CWK, XXVll, pp. 382-3).

In June 1944, he wrote to Professor Hayek about the latter's Road to Serfdom: "In my opinion a grand book... you will not expect me to accept quite all the economic dicta in it. But morally and philosophically I find myself in agreement with virtually the whole of it.... One point which you might have perhaps have pressed further is the tendency to disparage the profit motive while still depending on it and putting nothing in its place...." But he firmly repudiated the view that "...as soon as one moves in the planned direction you are necessarily launched on the slippery path which will lead you in due course over the precipice..." He differed radically from Hayek on this issue, just as he differed from the more doctrinaire Left. "Reading the New Statesman & Nation one sometimes feels that those who write there, while they cannot safely oppose moderate planning, are really hoping in their hearts that it will not succeed; and so prejudice more violent action." He himself had no doubt that: "Moderate planning will be safe if those carrying it out are rightly orientated in their own minds and hearts to the moral issue." (CWK, XXV11, pp. 385-7). A crucial condition, of course.

This was his own basic position throughout. A freer society must be preserved. He had no sympathy for Communism which was, in his view, not only oppressive but inefficient. (Although I can find no reference to that tragic example of such ruthless, incompetent planning, the Russian famine of 1933, in which 8 - 9 million people died, he can scarcely have been unaware of it). The Communist path was to be rejected. So was extreme laisser faire, especially at a time of mass unemployment. In the General Theory he had written: "It is certain that the world will not tolerate much longer the unemployment which, apart from brief intervals of excitement, is associated - and in my mind inevitably associated - with present day capitalistic individualism. But it may be possible by a right analysis of the problem to cure the disease whilst preserving efficiency and freedom." (p. 381) We had a very long period of "excitement" after the War; but it is over now, and with its passing Keynes's general message is once more directly relevant to the needs of our society, although it would certainly have to be given a somewhat different practical expression from that of the neo-Keynesian era.

NOTES

1. We may note in passing that his analysis at this point was very similar to earlier theories of forced savings, notably that developed by D.H. Robertson ("Industrial Fluctuation and the Natural Rate of Interest", EJ, 1934, reprinted in Essays in Monetary Theory, P.S. King & Son, London, 1940); "Robertson, Money and Monetarism" by T. Wilson, Journal of Economic Literature, Dec. 1980.

   Keynes himself had subjected the theory of forced savings to exaggerated and undiscriminating condemnation in the General Theory.

2. It may be of interest to record an incident not mentioned in the CWK, vol. XXVII.
   A proposal for post-war credits was also put forward by Professor H.O. Meredith of Queen's University, Belfast, who had been a Fellow of King's and a contemporary of Keynes. Meredith sent his article to Keynes as editor of the Economic Journal but Keynes returned it, a little curtly perhaps, on the ground that he was about to publish an article of his own on this subject - an article which was to appear in the issue for 1939. Meredith's paper appeared in the Political Quarterly in 1940 and, I suspect, attracted no attention. It is true that Keynes had worked out a more elaborate scheme which made use of the national income statistics. One might, however, have expected a reference by Keynes to Meredith's paper. Its omission was presumably a regrettable oversight not an uncharacteristic lack of generosity on Keynes's part. The omission, was, however, the more surprising in view of their friendly correspondence just after the publication of the General Theory when Meredith sent Keynes some shrewd and perceptive comments. (CWK, vol. XXIX, pp. 211-3).

3. Keynes was not sufficiently explicit on this last point. Whenever repaid, expenditure by recipients of the credits would be a claim on current output in that period. If, as a result of repayment, output was larger because any deflationary pressures were offset in this way, and would not have been offset in any other way, then it would follow that, to this extent, neither the workers nor indeed the rest of society would have made a permanent sacrifice. But these are rather special circumstances. Another possibility would be to make the rich contribute a higher proportion of the cost of the war in the long run than they could be made to do during the period of hostilities. Keynes had presumably something of the kind in mind when he proposed initially - though not in his later memoranda - that a capital levy should be imposed after the war. But such a levy, by definition, cannot be met from current income and thus a more protracted period would have to elapse before the workers were recompensed. There could, of course, be some intergenerational transfer of the ultimate cost within classes.

4. Official thinking on the economics of war went back a long way. In particular, reference should be made to a Treasury memorandum of 1929 on The Course of Prices in a Great War. (See British War Economy by W.K. Hancock and M.M. Cowing, HMSO, 1949, pp. 46 *et seq*.)

5. As late as August 14, 1939, Keynes observed in a letter to R.F. Kahn that "I shall be most surprised if it ends in war. It seems to me that Hitler's argument is unanswerable that he must get Danzig, because it matters so little to him or to anyone else." (CWK, vol. XX11, p. 3). When war came he thought it could be ended soon with a negotiated peace. (*Op. cit*., p. 37). His failure to anticipate both the length and the intensity of the struggle was reflected in his early suggestions about building up livestock on the farms and about devoting a greater effort to exports. He was, however, by no means alone in making these early under-assessments.

6. It may also be of interest to add that Lord Cherwell, usually regarded as a monster of black reaction, was on the same side and helped to reassure Churchill. He had come to the conclusion that the extra cost of the Beveridge scheme over what would be spent on existing schemes would not be an intolerably heavy burden.

7. In the event benefits were raised over the years roughly in line with average pre-tax earnings and were more than doubled in real terms. Thus we have gone far beyond what Beveridge or Keynes anticipated. Yet it is frequently maintained that Beveridge's proposals have not, even now, been accepted. This is a confused complaint that is valid only with regard to the continued use of means tests.

8. M_2 is used here in Keynes' sense which was not the same as the M_2 of the financial statistics for the USA and some other countries.

9. See Keynes v. the Keynes ed. by Hutchison which contains Keynes's articles from The Times of 1937 and also comments by Kahn and Hutchison. See also the interesting article by G.C. Peden: "Keynes, The Treasury and Unemployment", OEP, March 1980.

10. Any attempt to include such a suggestion would, of course, have met with fierce opposition from Labour members of the wartime coalition.

J. Vereker
A. Duguid
A. Walters

PRIVY COUNCIL OFFICE

WHITEHALL LONDON SW1A 2AT

2

17 September 1981

Prime Minister

This is a briefing note that Mr Pym has sent round to colleagues on the 4% pay factor.

MS

Dear Willie

As you know, we announced on Tuesday the pay and price factors that will be used for planning purposes in this year's Public Expenditure Survey. As we expected, public and media attention has focussed on the pay factor, which has been widely interpreted as a 4% limit on public service pay.

TL
18/9

The decision was announced as part of our move to the cash planning of public expenditure; and it is not intended to be in any way a "norm" or incomes policy. But we did have very much in mind the need to lower public expectations about pay in the pay round just beginning, and to explain the relationship between pay and employment. The lower the rate of wage increases, the more room for new investment and new jobs. Our success as a Government depends on getting unemployment down and output back up again.

It is up to all of us in the weeks ahead, if our policies are to succeed, to help put our message across, both in our speeches and in discussions with employers and others. I hope you will find the enclosed speaking note helpful.

I am copying this letter and enclosure to all Cabinet colleagues with the request that they should bring it to the attention of Ministers in their Departments.

Yours ever

Francis

FRANCIS PYM

The Rt Hon William Whitelaw CH MC MP

Econ Pol

MR. LANKESTER

TL

10 DOWNING STREET

16 September 1981

Dear Peter,

I attended the Copeman/Moore meeting on "team enterprise and the job securing pay deal." I am afraid that many of the claims were wildly exaggerated. And much of the presentation was on a level little more than kindergarten. But even so, I think they had some ideas worth considering.

In particular, I think there is a very good argument for vesting similar to the way in which it is used in the United States. We have already argued in other contexts that vesting of pension rights is important for mobility. This may be preaching to the converted, but I think it is useful.

A second proposal is the removal of the £1000 per annum limit on appropriations of tax relieved shares. Copeman and Moore suggest that we go towards the United States system. And I can see considerable benefits in that.

A third point is the removal of shareholder approval for employee share schemes. This is a Stock Exchange matter, but I guess they would be amenable to a little persuasion. I think Copeman and Moore are right. There has been no abuse of this even mentioned in the United States. I am much more nervous about their suggestions for changes in Corporation Tax. What they have in mind seems to me to be a mare's nest of problems.

Finally, a little nostalgia. They deal with cases where the real rate of return on capital varies between 20 and 30%. If only we had problems like that!

Yours ever

Alan

P.J. Cropper, Esq.,
HM Treasury.

MR. LANKESTER

PRIME MINISTER

MEETING WITH THE CHANCELLOR: WEDNESDAY 16 SEPTEMBER: 1715 HOURS

The Chancellor wishes to raise with you the following subjects:

(i) EMS

You told Cabinet yesterday that the Chancellor was reconsidering the possibility of our joining the EMS, and you agreed to John Nott's request that no final decisions should be taken without the approval of Cabinet or E. Treasury officials are working on a paper which they hope to have ready for the Chancellor to show you before he leaves for Washington. I understand that the paper is unlikely to come up with a firm recommendation; rather, it will set out the facts and considerations that have to be taken into account. The Chancellor will wish to take your mind on how you want to carry all this forward. I am sure you will want a discussion with him and the Foreign Secretary before anything is circulated to other colleagues. Whether you should have this discussion on Friday, or when you and the Chancellor are both back, really depends upon the time scale the Chancellor has in mind for decisions. No doubt the Foreign Secretary would like to have a meeting this week so that the issue can be brought to Cabinet, say, on 20 October before you leave for Mexico. However, the Chancellor is - I know - reluctant to be pushed into a quick decision by the Foreign Office. Indeed, he may say that he wants to have a first discussion with you without the Foreign Secretary. My own view is that this is unlikely to be profitable; it would be better to bring the Foreign Secretary in from the beginning.

(ii) Future of the CSD

At your request we have arranged a meeting on Friday afternoon with the Chancellor, Robert Armstrong and Douglas Wass. The Chancellor wants a preliminary word with you on what you hope to get out of that meeting. Robert has already spoken to Douglas about it, and I hope - by the time the Chancellor comes to the meeting - Douglas will have spoken to him also.

/ (iii)

(iii) Defence Cash Limit

As you know, officials in the Treasury and MOD have been reviewing the case for adjusting this year's defence cash limit. (It was agreed in Cabinet last November that the 1981/82 defence cash limit should be reviewed taking account of (a) the reduction required to offset the 1980/81 overspend (in the event £64 m); (b) the cost of any pay increase beyond the 6% provided; and (c) any change justified by the movement of defence prices in relation to the 11% provided for). Treasury Ministers and the Defence Secretary have now met, and have reached an impasse.

Mr. Nott is predicting an overspend of £350 m, largely on account of higher than expected inflation (in turn partly due to the worse than expected exchange rate). He has also argued that there should be an extra £64 m allowed against the deduction for last year's overspend. In short, he has argued for a supplementary estimate of £414 m.

The meeting apparently finished with Mr. Nott saying that he may be able to get by with an increase of £300 m; Treasury Ministers said that they might be prepared to go up to £200 m. Mr. Nott told them that if the supplementary was restricted to £200 m, the cash limit would simply be overspent and there would have to be a second supplementary in the spring.

As in previous years, I fear you will have to resolve this. With the current market uncertainties, any supplementary now is going to be difficult. I think it would be better to go for a lower figure now - i.e. £200 m - and risk a further supplementary in the spring.

(iv) Public Expenditure Decisions in October

The Chancellor wants to take your mind on the handling of these decisions. He has in mind, I understand, some sort of "grand jury" consisting of a few senior Ministers who would grill spending Ministers now before the Chancellor brings his proposals on public expenditure to Cabinet on 20 October.

T. P. LANKESTER

16 September 1981

CHANCELLOR OF THE EXCHEQUER

Personal.

Tim.

Can we have a word?

2. I suspect that the issues mentioned in this minute may come up at 5.15 today

3. Also the Defence Cash Limit, on which I sent you a copy, which sh'd have been marked Personal, of a record earlier today.

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary
Financial Secretary
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Sir Anthony Rawlinson
Mr Ryrie
Mr Barratt
Mr Middleton
Mr Battishill
Mr Bridgeman
Mr Cassell
Mr Evans
Mrs Gilmore
Mr Norgrove
Mr Ridley
Mr Cardona
Mr Cropper

TAX/PUBLIC EXPENDITURE/MACRO-ECONOMIC DISCUSSIONS

You held a meeting on 5 August last to discuss the way forward on the papers etc prepared for the tax/public expenditure discussions to be held in the autumn, most notably at the Cabinet on 20 October. The basis of the discussion was my minute of 31 July. One matter that was let over in the discussion was the question of whether and if so how there might be, before the papers for 20 October were widely circulated, some discussion of their content among some small group of senior Ministers - a process you characterised as a "grand jury". You said at the meeting that you would want to take this up with the Prime Minister in the autumn.

2. You may think the time for this has now come, and the purpose of this note is to provide an aide-memoire for any discussion. Alternatively, of course, we could provide a draft of a note for you to send to No 10.

3. You will have your own views as to the desirability of a grand jury procedure. On the whole, however, it would seem to be worth while to try your proposals out before they are widely circulated, on a small group of senior colleagues. The proposals you are going to have to make will be difficult and important, and will be as much "political" as economic. It would surely help you, and perhaps make for a better discussion in Cabinet, if some of your senior colleagues at least had advanced knowledge and understanding of your proposals, even if they continued to have reservations about them.

4. So far as timing goes, our present thinking is that we hope to be able to let you have an outline of your main paper (it has been agreed that the Chief

Secretary will be submitting a companion paper on the detailed public expenditure aspects) before you leave for the Bahamas around the 18 September. We hope to have a fuller draft for you to look at on your return from Washington around 2 October, though there might still be some gaps at this stage. Your paper would then be finalised during the week beginning 5 October with a view to circulation early in the week of 12 October against Cabinet on the 20th. We understand the Prime Minister returns from abroad around 8 October, and you would presumably wish to discuss your proposals with her before they were circulated. This would point to a grand jury process some time around the middle of the week beginning 5 October.

5. You would want to consider who would make up the grand jury. We had previously suggested that this might comprise two or three senior "non economic" Ministers, perhaps one or two senior spending Ministers, as well as yourself and the Chief Secretary. It might be worth also considering whether to involve some non Ministers - eg Mr Ibbs. But all this is something to which you would want to give careful thought.

6. A somewhat similar point is whether or not, after 20 October, there might be established what we have characterised as a "star chamber" procedure purely on the public expenditure front to help bring detailed discussions to a conclusion. There is perhaps no need to consider in detail now how such a procedure might work (in an ideal world there would be no need for it) and whether and how it might be put in hand could be left over until much nearer 20 October. But if you are mentioning the grand jury to the Prime Minister you may wish also to mention the possibility, if it seemed necessary, of a star chamber also.

E P KEMP

8 September 1981

Econ Pol Strategy File

PSE

MR. WRIGHT

CABINET OFFICE

The Prime Minister has seen the proposals for September meetings of E set out in your minute, reference A05423, of 7 August. She is content and will await further advice on invitees nearer the time.

M. A. PATTISON

17 August 1981

CONFIDENTIAL

F 0292

01- 233 8288

CABINET OFFICE
70 WHITEHALL
LONDON SW1A 2AS

12 August 1981

A J Wiggins Esq
Private Secretary to the Chancellor
of the Exchequer
HM Treasury

Dear John

E: SEPTEMBER

This letter is to let you know what items are likely to be on the agenda of the three E meetings arranged for September: Wednesday 16, Monday 21 and Wednesday 23, all at 1500. All of what follows is of course subject to confirmation later.

2. The largest block of work relates to local government finance: the possible withholding of RSG from English local authorities in 1981-82, the proposed consultative document on long term alternatives to domestic rating, the interim measures to curb rate increases discussed in E(81)71 and the proposals in E(81)82. We envisage that all of these items will be on the agenda on 16 September; Ministers may well want to look again at some of the issues they raise at one of the two subsequent meetings.

3. Pay of National Coal Board and Electricity Board Members is also likely to be on the agenda on September 16.

4. Trade union immunities are likely to be on the agenda on 21 September; and nationalised industries' external financing limits on 23 September, with the Armitage report on heavy lorries also considered at one of these meetings.

5. I am copying this letter to the Private Secretaries of all members of E, and of the Secretaries of State for Scotland, Wales, Social Services, Education and Science and Transport.

Yours sincerely

David Bostock

D J BOSTOCK

CONFIDENTIAL

Treasury Chambers, Parliament Street, SWIP 3AG
01-233 3000

PRIME MINISTER

Prime Minister

You said you would think about this again after your holiday.

TL 17/8

Keith Joseph has sent me a copy of his letter to you of 6 August, proposing an approach to Tim Bell on presentation of economic facts.

2. I am sure that we have not done enough yet to put over the basic reality of poor competitiveness as the key weakness in the British economy. The present is a good time to start planning a campaign because of the recent fall in the exchange rate. For British industry cannot easily use the argument that Government policy has pushed up the exchange rate to a level at which de-industrialisation is unavoidable - and thus avoid their own responsibility for the level of costs. Indeed, in the present situation I believe that the CBI could play a valuable part in getting all these points into the minds of TV and radio participants. I am encouraging them to think of ways of doing this.

3. On the particular difference of emphasis between Keith Joseph and John Hoskyns, I do not think we should flinch from arguing on the basis of unit labour costs. Certainly, in the first instance, higher productivity can mean fewer jobs. But one would be taking a very pessimistic view of the working of the market if one did not see beyond that the certainty that reduced unit costs would lead to enhanced competitive power and a consequent revival of activity. We must not subscribe to the favourite trade union thesis that there is only a limit amount of work to be done and that it therefore has to be shared round.

4. It would be most interesting to have Tim Bell's advice on presentation, ready perhaps for consideration at the beginning of September.

5. I am copying this minute to Keith Joseph, Norman Tebbit, Ian Gow and John Hoskyns.

Peter Jenkins

for (G.H.)

11 August 1981

(Approved by the Chancellor of the Exchequer and signed in his absence).

1

Prime Minister

I think we will just have to go ahead with these meetings despite the absences. Where necessary, we should ask junior Ministers. ~~[illegible]~~. Agree?

R 7/8

Ref: A05423

MR LANKESTER

Yes MT

Meetings of Ministerial Committee on Economic Strategy in September

You have offered times for three meetings of E in September: at 3.00 pm on each of Wednesday 16 September, Monday 21 September and Wednesday 23 September. A number of senior Ministers will be abroad in this period and, while those with direct departmental interests in the papers could be represented, I should be grateful for your confirmation that the arrangements we propose are acceptable.

2. Subject to checking at the end of August, the papers for the three meetings would be -

1. Local authority expenditure 1981-82: withholding of grant.

* 2. Interim measures to curb rate increases.

3. Consultative document on long term alternatives to domestic rates.

* 4. Transport subsidies.

5. Pay of NCB and Electricity Area Board members.

* 6. Trade Union immunities (not ready for discussion before 21 September).

7. Nationalised Industries' EFLs (would slip if the Industries were late in making their returns).

8. The Armitage report on heavy lorries.

* Policy decisions on these items are needed prior to legislation provisionally included in the 1981-82 programme.

3. Decisions on these papers are necessary for operational reasons and, for some of them, to clarify policy prior to legislation in the 1981-82 Session and prior to the Party Conference. We are, moreover, working against the constraint that it will not be possible for the Prime Minister to chair meetings of E between 25 September and 8 October when she will be in the Gulf and at Melbourne and that the Party Conference and the Cancun Summit will limit the time available for meetings in mid-October.

4. Although we see no alternative to going ahead with the meetings in September, a number of senior Ministers will be missing from them. The Secretaries of State for Industry, Defence and Trade and the Minister of Agriculture will be abroad at the time of all three meetings. The Chancellor of the Exchequer, the Foreign Secretary and the Lord President will be abroad for the meetings on 21 and 23 September. The Secretary of State for Industry will need to be represented at the discussion of all the papers and the Secretary of State for Trade at the discussion of the papers on Nationalised Industries and Trade Union immunities. The Home Secretary may not be able to attend the meetings on 16 and 21 September.

5. Subject to your confirmation, we will now issue meeting notices to ensure that the times are booked in diaries. We will put forward further advice in the first week in September when we should be in a position to make more precise proposals for agenda and for invitees.

D J Wright

D J WRIGHT

7th August 1981

R H

Eco Pol

cc: Mr Gow
Mr Hoskyns
Mr Tebbitt D.Ind
Mr Jenkins, HMT

10 DOWNING STREET

From the Private Secretary

7 August, 1981

As you know, the Prime Minister has left for Cornwall this morning. She has asked me therefore to thank you for your letter of 6 August about publicity.

The Prime Minister was interested in your proposal that Tim Bell should be asked to help in the presentation of the reasons for the rise in unemployment, but she would rather not reach a firm view on this until she returns.

I am sending a copy of this letter to the recipients of yours.

T. P. LANKESTER

The Rt Hon Sir Keith Joseph, Bt, MP

Mr Lankester [COPY]

CABINET OFFICE
70 WHITEHALL
LONDON SW1A 2AS

Econ Pol

01 233 7029

7 August 1981

CONFIDENTIAL

Reference E 0257

Peter Jenkins Esq,
Private Secretary,
Chancellor of the Exchequer,
H M TREASURY.
Great George Street,
LONDON SW1

Dear Peter

MISC 14

Following Cabinet's discussion on 17 June of the economic strategy, Tim Lankester wrote on 26 June to John Wiggins to say that the Prime Minister would like the Chancellor of the Exchequer's MISC 14 Group to consider ways of further reducing the hindrances to employment identified in the Cabinet's discussion and in the Chancellor's paper. He went on to say that the Prime Minister would like the Chancellor to report to her before the Summer Recess on progress in following up the Cabinet's remit.

2. At their meeting on 23 July MISC 14:

(i) Agreed that no further action was needed at present on Enterprise Zones and on local authority planning procedures.

(ii) Agreed that there should be no changes at this stage in the present employment protection legislation or in the present system of redundancy payments and that there should be no immediate references of restrictive labour practices to the Monopolies and Mergers Commission.

(iii) Invited the Secretary of State for Employment to prepare a paper on the matching of labour supply with market needs.

(iv) Invited the Secretary of State for Industry to consider the scope for further work on standards and on implementing EDC reports.

(v) Invited the CPRS to prepare a paper on regional policy.

(vi) Agreed that the CPRS and the Secretaries of State for the Environment and for Employment should consider further some outstanding but detailed issues on labour mobility.

(vii) Took note that the Chancellor of the Exchequer would consider further, in consultation with the CPRS, what were the key issues on which the Group might usefully concentrate for the future and that he would also arrange for further consideration of how work on public sector management techniques might best be carried forward.

(i) and (ii) above answer the specific points on hindrances to employment which were raised in the Cabinet's discussion on 17 June (sub-paragraph (1) of the minutes.)

3. The Prime Minister has seen the minutes of the MISC 14 meeting on 23 July and I have agreed with Tim Lankester that there is no need to advise the Chancellor to report to her at this stage. The next main step is for the Chancellor to agree with the CPRS what other further areas he would like the Group to examine. When he has done so the Group will need to meet again although, if this is not before the Chancellor goes to New Zealand on 21 September, there will be few opportunities until after Cancun at the end of October.

4. As a separate matter, and subject of course to his views on the substance, I suggest that the Chancellor should authorise you to send the attached draft letter which will clear up one small piece of business which has been outstanding for some time and for which there was no time for discussion on 23 July.

5. I am sending a copy of this letter but not the attachment to Tim Lankester in No 10, to the Private Secretaries to the Secretaries of State for Industry, Employment and Environment, to Robin Ibbs and John Hoskyns and to David Wright here.

Yours sincerely,
David Moore

D J L MOORE

cc Mr Walters
Mr Duguid

PRIVY COUNCIL OFFICE
WHITEHALL LONDON SW1A 2AT

2

Chancellor of the Duchy of Lancaster
and
Paymaster General

6 August 1981

Prime Minister

I am not sure whether you read the Chancellor's paper for NEDC - now circulated to Cabinet.

(The graphs at the end are good).

Dear Private Secretary

At NEDC on 5 August, the Chancellor spoke to a paper, now publicly available and attached, which explained that there will be more jobs in the British economy when this country can produce goods and services more competitively.

Both he and the CBI put it to the unions that since they are clearly concerned about the level of unemployment, they should accept the need for continued wage restraint. The NEDC Director-General had also circulated a paper saying that a slower growth in earnings is a major factor in bringing inflation down further, thus improving competitiveness, and improving prospects for employment.

Although there was agreement among the NEDC parties on the need to continue to fight inflation while bringing unemployment down, and that the common link between these two objectives is the need to improve productivity and competitiveness, there was sharp disagreement by the unions about the part which needs to be played by wage moderation. The TUC continues unwilling to discuss wages unless it is also allowed a role in the formulation of economic policy.

There will no doubt be considerable media interest in all this, and the Treasury hopes that Ministers generally will take every opportunity to explain the importance the Government attaches to the relationship between pay and employment and-without taking an adversarial line in relation to the unions-the regret it feels that this could not be explored in greater depth with the unions in NEDC.

Contd /...

Private Secretary

The Government's position is clear: unemployment would not be helped by higher wage increases all round.

I am writing in similar terms to the Private Secretaries to all Members of Cabinet and am copying this letter to John Vereker (Number Ten) and David Wright (Cabinet Office).

Yours sincerely

Nick Huxtable

N P M HUXTABLE
Private Secretary

National Economic Development Council

ECONOMIC POLICY: A STOCKTAKING NEDC(81)47

Note by the Chancellor of the Exchequer

This paper is intended to help the Council take stock of economic policy and to identify the key issues on which further progress needs to be made. It is vital for us all that we get these right.

2. Our national economic objectives are clear:

- we aim to create the foundations for sustainable growth of output and employment so that the country can afford higher living standards and better social services;

- to do this we need to make the UK economy more competitive, so that more people at home and abroad will pay us for the goods and services we produce;

- before we can become competitive or bring about sustainable growth we have to break out of the chronic circle of high unit labour costs, low productivity and progressive depreciation of the currency which has caused the rise in unemployment;

- we have to bring inflation down and keep it down.

3. There is no dispute about any of this. It is common ground in the Council that high inflation is damaging. Similarly it is accepted that to flourish as a trading nation, we have to respond to changing market requirements and meet them in competition with countries overseas. And we are agreed on the need for positive adjustment to provide a sound and lasting basis for rising output and new jobs. Our agreement on these points is reflected in the summary of the Council's activities contained in the latest Annual Report.

4. Securing the necessary fundamental changes - not least changes in attitude in the public sector as well as in industry and commerce towards the disciplines of competition and sound money - is not easy.

This is especially so given our many years of relatively poor performance, the tougher world setting and the competition we face from overseas economies much fitter than our own. Our problems are deep-seated and we cannot expect quick solutions. Some progress had already been made - helped by valuable work in the EDCs and SWPs - and we need to build on these beginnings. Action is required from the Government, from managements in all parts of the economy and from workforces: all these groups share responsibility for our predicament.

I Setting the scene

5. Throughout the industrial world, inflation accelerated and growth slowed down during the 1970s. Almost everywhere this was accompanied by sluggish productivity and rising unemployment. As noted in my earlier paper NEDC(81)39, the 1979 oil price increase compounded the difficulties faced by the industrialised countries.

6. The acceleration of inflation and slowdown in growth proved especially bad in Britain. Chart A shows how, through two decades, money incomes grew increasingly fast - much faster in fact, than in other industrial countries - while growth of real output slowed down. Between 1970 and 1980 output grew only 16 per cent. But money incomes increased by 335 per cent. In other industrial countries the increase in earnings over the period of the second oil shock was much more moderate than in the UK. At the same time our productivity did not increase anywhere near fast enough. Our unit labour costs increased by leaps and bounds. Our quality and marketing did not improve enough. There has thus been a serious decline in our competitive position.

7. As Chart B shows, this decline in competitiveness is mainly because unit labour costs have risen much more steeply than those of our competitors and North Sea oil has prevented them from being accommodated to the same extent as in former years by a declining exchange rate. Chart C compares UK performance on pay and productivity in manufacturing with that of other countries. If our productivity were up to French or German standards - on existing plant as well as on new capacity - and if we produced goods which people at home and overseas wanted to buy, we could achieve much higher levels of

output and improved living standards. Instead a declining share of real resources has gone to profit, capital and investment and a growing share to pay and consumption. The effect has been that many of those in work and others whose income is protected against inflation, have taken more than their share at the expense not only of those who become unemployed but also of the seeds of real growth and recovery. At the same time imports of manufactured goods have steadily taken a rising share of our home market.

II <u>Inflation</u>

8. Control of inflation remains essential:-

- Because, if not controlled, inflation tends to accelerate, so undermining investment confidence and leading to an economic "stop"

- Because the attitudes which go with high inflation also tend to produce poor productivity, demoralised management, loss of competitiveness, and hence reduced growth and employment

- Because inflation is unjust and divisive.

9. As Chart D shows, in the past year inflation has fallen much more quickly in Britain than in the rest of the OECD. And there is encouraging evidence that productivity has improved recently. But

- Our inflation is still above the OECD average and remains too high

- Cost performance must improve markedly to help put into reverse our loss of competitiveness.

10. Progress on inflation can be affected in the short run by factors such as:-

- The possibility of a faster rise in some world prices, as activity recovers

- Pressures when our economy picks up, as profit margins recover and employers bid for skilled labour

- The recent fall in the exchange rate

One example of what these factors can do has been the recent increase in sterling oil prices, which has inevitably put pressure on industry's input costs. In these circumstances it is all the more important to give priority to control of inflation in every context. For the Government this means pursuing appropriate fiscal and monetary policies and encouraging good cost performance in the public sector. For the private sector firm restraint of domestic costs is similarly essential.

11. Britain, like other countries, has reacted to rising inflation by taking measures to limit the growth of total money expenditure, and to reduce inflationary expectations by stressing the need to adapt behaviour to the lower growth of money. The effect of setting targets for the growth of the money supply is similar to establishing a "cash limit" for the whole economy. Within that framework total increases will be divided into the part taken by inflation - rising prices and rising <u>money</u> incomes - and the part that represents real growth of output. The aim must be to maximise the latter. For its part the Government will continue to contain its labour costs within cash limits. Beyond that, Government cannot directly control how much of the increase in money national income in the period ahead will take the form of rising output and how much will be eaten up by rising costs and prices. Rather the pace of adjustment in the direction of lower inflation and higher output will continue to depend on decisions taken in industry and commerce - including those on pay, but also including those on new techniques, better use of investment, energy conservation, quality control and marketing.

III <u>Output</u>

12. In part the recent fall in UK output - down about 4 per cent since the first half of 1979 - has reflected world-wide developments. Output in the major countries of the European Community, for example, has fallen during the past year and is expected to remain roughly flat for the rest of this year.

13. In this country the recession has been deeper than others partly because of the longstanding underlying weakness of our economy and partly because of the more recent combination of a petro-currency

exchange rate and sharply rising unit costs. But there are signs that the fall in output has now levelled off and in some industries and parts of industries activity is increasing. Recent surveys indicate an improvement in business confidence.

14. But to convert this into a sustained recovery we must perservere, and not allow recovery of output to be undermined by unrealistic pay settlements. The world environment is unfriendly and intensely competitive, and the prospects are for relatively slow growth in world output over the next year or so. In this difficult setting business and industry will have to fight hard to create or win new markets and to increase market share, at home as well as abroad. This is the only basis for sustainable growth of output.

15. The Government's ain is to help the process. For example, it has to keep its pay settlements under control. It has a responsbility to encourage better efficiency in the public sector (whose costs feed directly or indirectly into those of the private sector) as well as to provide the right framework of incentives. And, in recognition of the difficult adjustment industry is having to make to higher energy prices, the external financing requirements of the gas and electricity industries have been adjusted to permit some relaxation in their pricing proposals. The Government will, of course, continue to play its part in consideration of this topic.

16. More generally, much wider understanding is still needed, both in the public and private sector, of the importance of combined effort in pursuit of better productivity and better quality. Too many obstacles remain to economic change and flexibility.

IV <u>Employment</u>

17. Chart G shows the recent very sharp rise in unemployment, following a long upward trend. But since last autumn the average monthly rate of increase has been more than halved - something that would almost certainly not have been seen without the fall in pay settlements to single figures. An improved picture on output and employment must depend a great deal on further moderation of pay settlements.

18. Action by companies to improve productivity and competitiveness - cost cutting, removal of restrictive practices, increasing efficiency - will initially tend to raise unemployment. But in the longer term improving productivity and so competitiveness

leads to faster growth and more jobs. That is the lesson of, for example, the Japanese experience and is confirmed by the record of some successful parts of the British economy. The need is to bring our average performance nearer to what our most successful firms and industries have shown to be possible.

19. New investment can of course make a major contribution to improved productivity and employment opportunities. It is therefore important to get the right climate for that investment - which, as noted above, requires progress on inflation. There must too be more efficient and profitable use of existing capacity. Better profitability is the key to increased investment yet Chart E shows real industrial profitability has fallen from about 14 per cent to virtually nil in the past 20 years. Not surprisingly the rate of new investment (after allowing for replacement of old plant) has also fallen. Chart F shows the contrast over the past three years between falling company incomes - down 29 per cent - and rising personal incomes - up 17 per cent.

20. Everything possible needs to be done, without provoking renewed inflation, to speed the sustainable expansion of productive activity and real output. But it will take time for the trend on unemployment to be reversed. Meanwhile we must all continue to seek ways of containing unemployment as far as possible. Particularly hard-hit groups, such as the young, are getting special help through the government's special employment measures. But experience in other countries (Germany for instance) suggests there may be further steps, not necessarily requiring additional public spending, that could be taken to increase real opportunities for the young. The higher the cost and the greater the difficulty of taking on new labour, the smaller will be the number of new jobs.

V Tax and public expenditure

21. Within the limits of a necessarily firm fiscal policy - which has enabled interest rates to compare favourably with those prevailing in the USA and in our leading European competitors - significant improvements have been made to the tax system so as to encourage growth and enterprise. It is in small and new firms that many of the new jobs will arise. To this end in both

the 1980 and 1981 Budgets, the government introduced substantial packages of measures to encourage business start-ups, the growth of small companies and the better availability of finance for them.

22. The outlook for any more general reduction in the tax burden on industry and enterprise will depend largely on public expenditure, given the need to restrain public borrowing to prevent an excessive burden of interest rates on the private sector. Some progress on reducing expenditure has been made. Cash spending in the current year is expected to be £5 billion less than the previous administration planned, despite some additional spending due directly to the recession. For next year the White Paper plans imply expenditure nearly £10 billion less than that planned by the previous administration.

23. However planned spending in 1981-82, for example, still represents an increase of around 60 per cent over 1978-79, compared with an increase in retail prices of around 50 per cent. The spending plans for 1982-83 onwards, as set out in the White Paper Cmnd 8175, are now the subject of the usual annual review. The need to strike an acceptable balance between current and capital spending will be very much in mind. Within a given total of spending, capital expenditure can be increased only if current expenditure is reduced.

24. Given the constraints on total spending, it is vital to make every effort to contain public sector costs, including pay. As in the private sector, public sector managers must consider whether their costs are too high in relation to limited finance and desired levels of investment. Containment of current costs can enable a higher level of public services and/or more capital spending to be provided within a given cash ceiling. In the nationalised industries the available external finance can sustain higher levels of investment.

VI <u>The way ahead</u>

25. For the reasons explained, the speed of recovery depends to a large extent on the rate at which cost inflation can continue to be brought down. We cannot count on the benefit of an appreciating exchange rate. Furthermore, <u>sustained</u> expansion of

output and jobs will be possible only if we remedy all the sources of weaknesses in the economy - poor productivity and competitiveness, resistance to change rather than adaptation to it, poor and ineffective design, development and marketing and the chronic tendency to pay ourselves more than we earn.

26. A firm fiscal and monetary policy must remain part of this environment within which business decisions are taken. Similarly the government will continue action to remove obstacles to the efficient functioning of markets, as well as acting wherever possible to improve incentives and encourage enterprise through the fiscal system.

27. Of course alternative approaches have been suggested. One often mentioned as a way of promoting early recovery is massive increase in public expenditure which, it is suggested, would raise output and employment. But in practice a net increase in public spending (current or capital) will have little lasting effect on total output and employment and could have undesirable effects on their composition. If the extra spending were accommodated by an increase in the money supply then the result other than in the short run would be a higher price level, eroding the initial stimulus to demand.

28. In fact, given the need to control inflation, total money incomes have to be restrained and this means adhering to the Government's monetary targets. If extra public spending is not to lead to ever higher interest rates (which are the ultimate but undesirable mechanism for restraining total spending in the face of an initial increase in one area) it has to be offset by reductions in spending elsewhere in the economy. This could mean offsetting cuts elsewhere in public expenditure (e.g. reductions in current spending to match an increase in capital spending) or reductions in private sector spending secured through tax increases.

29. Within the disciplines of monetary targets, growth will occur in parallel with the reduction of inflation and costs. As

inflation falls the growth in total nominal income permitted by monetary and fiscal policies will increasingly consist of rising real output. Simply to add to nominal incomes would be self-defeating. Policies must leave room for the growth of sustainable real output, eschewing the purely temporary increase in output which would follow reflationary action.

30. There are other suggestions, which can appear attractive at first sight. But in reality they do not seem to offer the right way forward. Recent history indicates that there are no real short cuts. Some of the main policies suggested have been:

- Relax control of the money supply. Excessive monetary growth would lead to even more inflation, so any initial effects on unemployment would be small and short-lived. And it would worsen the long-term problem of securing a better balance between output and inflation. Council has accepted the need for responsible control of the money supply to combat inflation.

- Formal incomes policy. We certainly need to ensure that the rate of growth of money incomes continues to fall, and to obtain a wider understanding of the links between pay, output and jobs. Without this there can be no increase in real incomes paid for from increased output. But there is wide agreement that any success achieved by <u>formal</u> control is short-lived and counter-productive when its distorting effects unwind.

- Import controls. Council has agreed that selective and temporary controls can have a part to play in tackling disruptive import penetration. But in face of more widespread action retaliation would be inevitable, and any short-run benefits to output and employment would be purchased at the expense of efficiency and higher prices and so of consumers.

- Bring down the exchange rate. Sterling remains higher against the D-mark than it was two years ago but it has recently moved sharply down against the dollar. Although this will help some UK exports, in the short run at least it inevitably adds to inflationary pressures. This underlines

- the need to adjust our costs to the exchange rate and not vice versa.

None of these, any more than attempted reflation through deliberate increases in public expenditure, would provide a basis for lasting improvement.

VII Points for discussion

31. Our objectives are clear and agreed. But there is much to be done by all of us - employers, workforce and government. I set out below what I see as some of the main areas for action, which I suggest we discuss.

32. The main areas are these:-

(a) How can we secure much wider understanding of our problems, their underlying causes and the links between competitiveness, pay, productivity, profits and jobs?

(b) What more can we do to sustain the change already seen in the attitudes of pay bargainers, in public and private sectors alike, and to get better understanding of the need for considerably lower pay settlements in the coming year?

(c) What more should be done to remove obstacles to mobility and efficiency, for example in the housing market and in the labour market?

(d) What should be done to tackle monopolies and restrictive practices, whether in private or public industry or in the labour market?

(e) What else should be done to improve business opportunities particularly for new and growing firms?

(f) What role do we see for the EDCs and SWPs aimed at achieving our objectives?

33. I hope and expect that other members of the Council will have suggestions for discussion too.

(G.H.)

HM Treasury
20 July 1981

CHART A

United Kingdom average annual growth rates

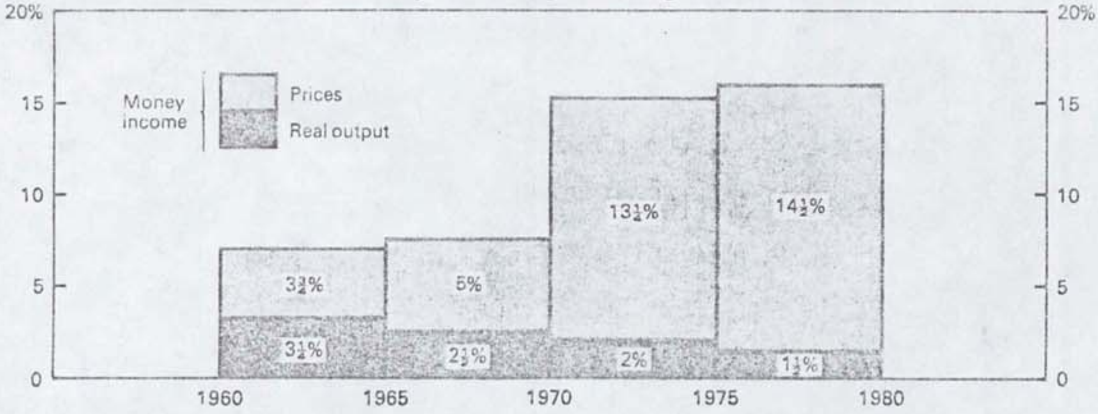


CHART B

Exchange rate, wage costs and competitiveness
1975 = 100

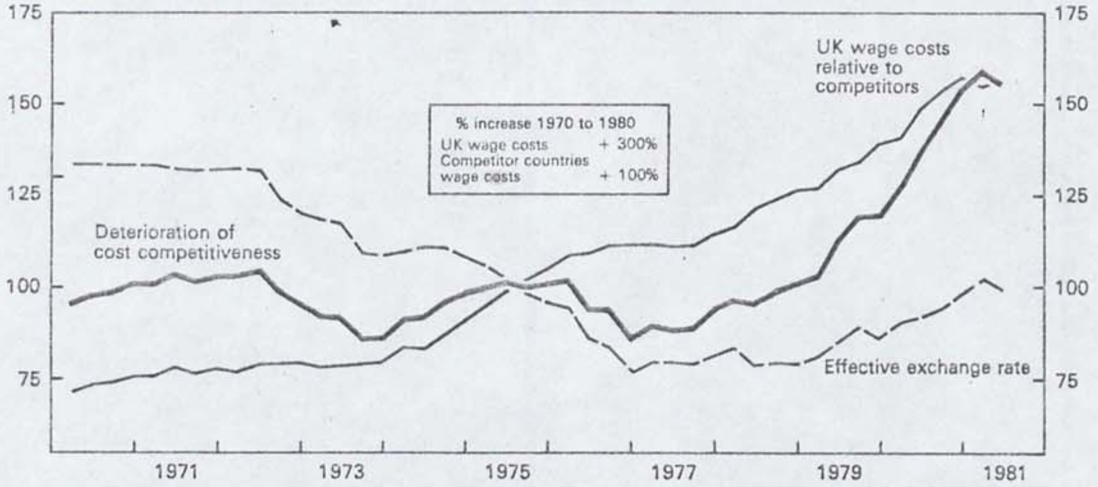


CHART C

Pay and productivity in manufacturing
Average annual rates of growth 1976 QIV — 1980 QIV

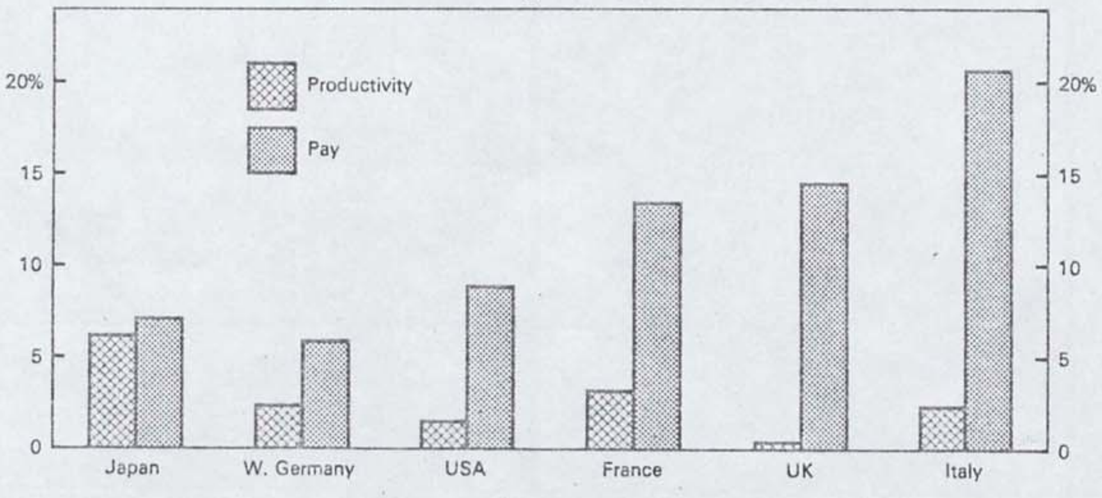


CHART D

Inflation
Average annual rates

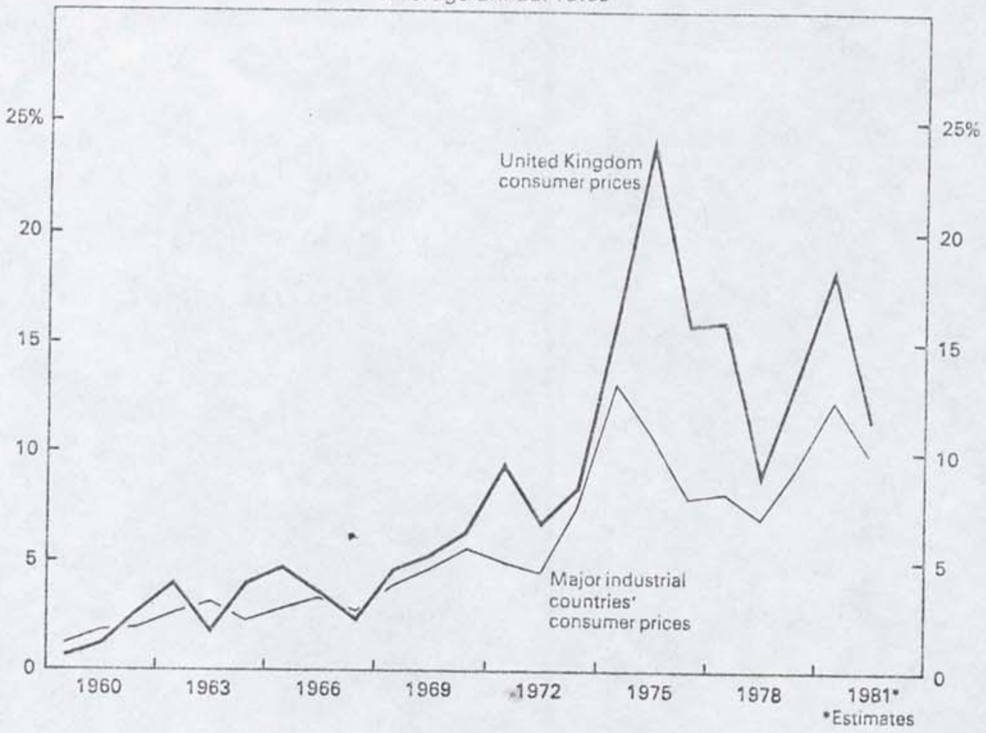


CHART E

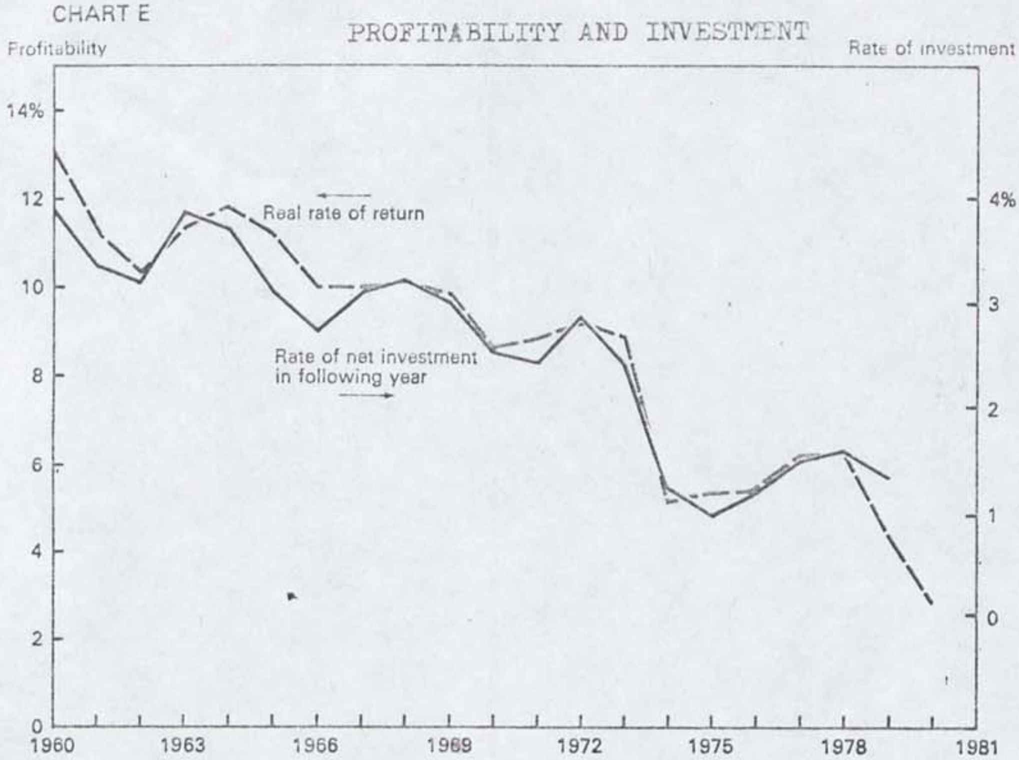


CHART F

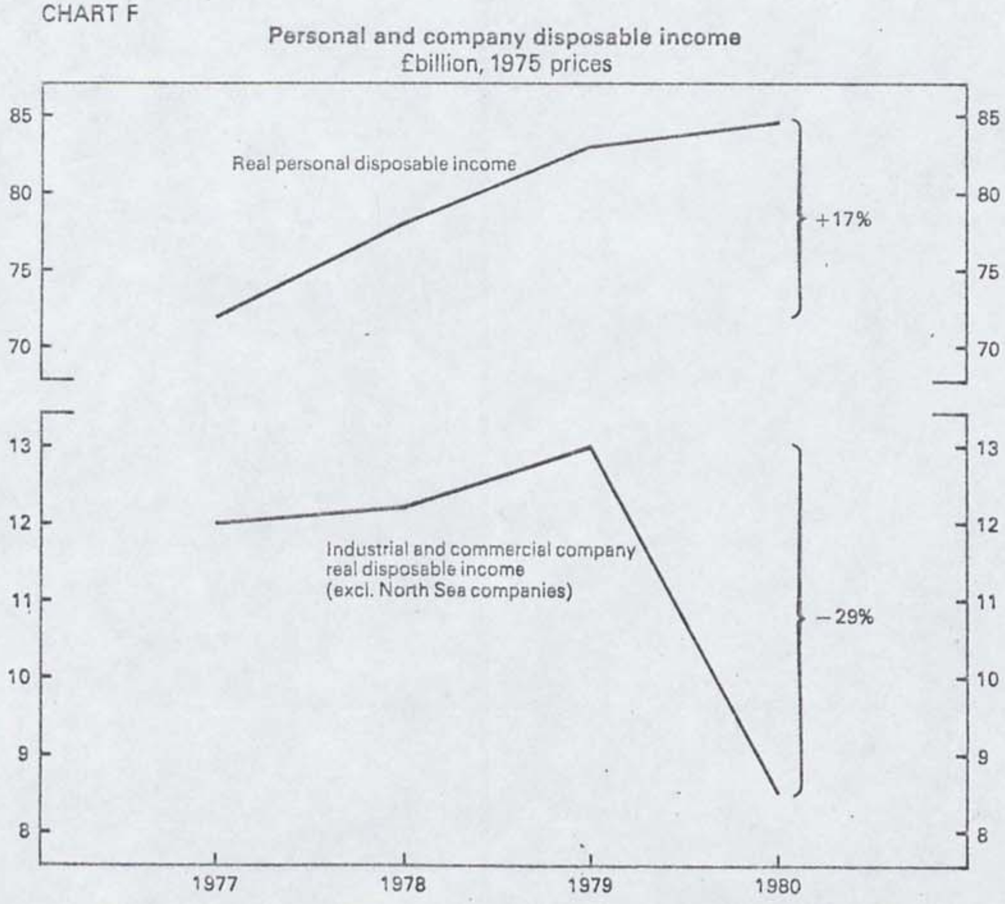
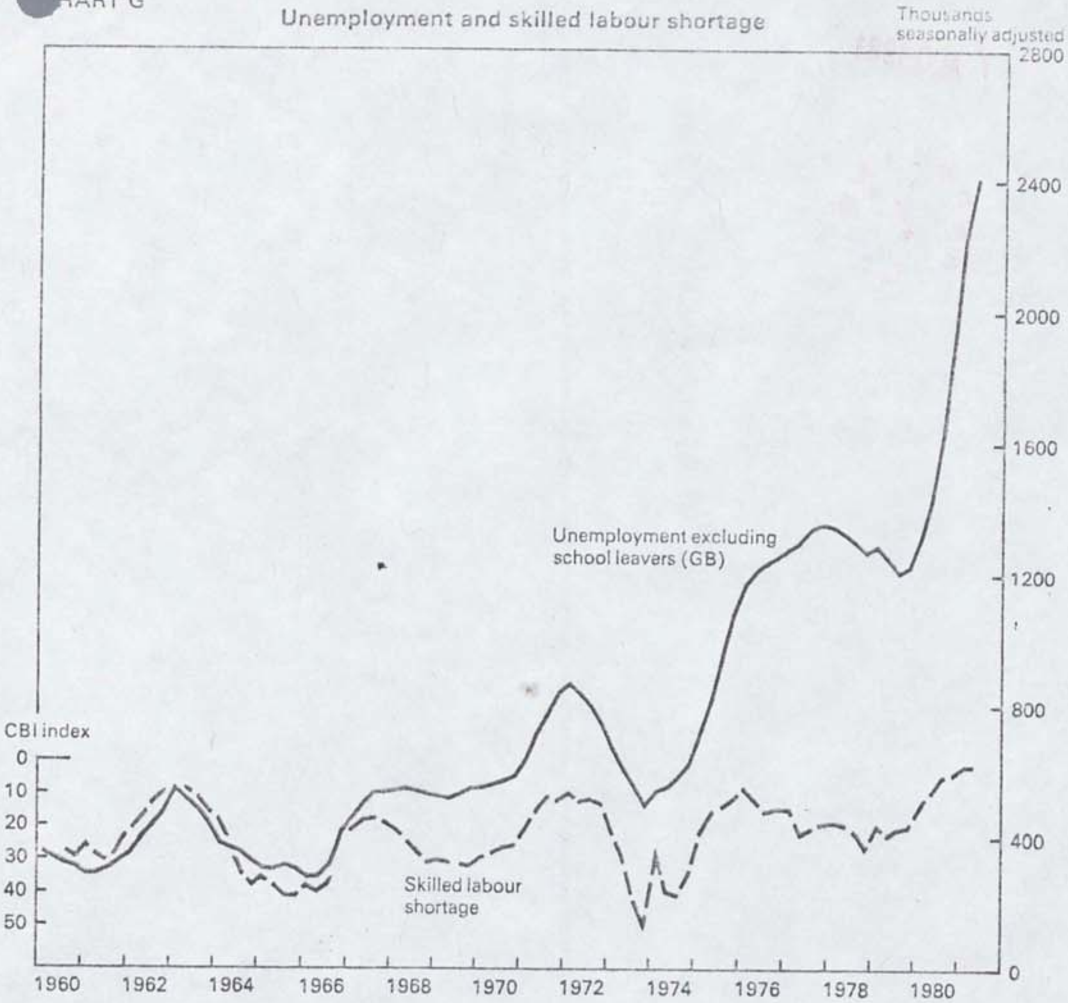


CHART G

Unemployment and skilled labour shortage



From: The Rt.Hon. Sir Keith Joseph, Bt., M.P.

The Rt.Hon. Mrs. Margaret Thatcher, M.P., 6th August 1981.
Prime Minister,
10 Downing Street,
London, S.W.1.

R 14/9

I only bother you with this letter just before you go on holiday in case you should think that the contents justify some working up in preparation for your return.

My perception is that we have not yet effectively enough persuaded the country that the rise in unemployment is largely due to the level of unit labour costs and that the prospects for employment in the future depend mainly upon recovering competitiveness, particularly in these same unit labour costs.

My suggestion is that you should authorise an approach to Tim Bell - the best presenter known to me of a case - about the best way we should intensify our efforts. My hope is that you will give him free rein to propose what should be presented, by whom, by what methods, on what occasion and with what follow-up.

The subject lends itself to visual aids: possibly to an intellectual confrontation: possibly to trade union participation: on no part of this have I opinions worth having. But Tim Bell would.

Tim would require an intellectual background.

He would need to have the distinction drawn between the impact of the £ on the one hand, and the impact of rising unit labour costs over recent years, and particularly in 1980, on the other. You used some of the key figures very effectively yourself in the recent censure debate.

He would need to be careful not to exonerate management, which ranges from brilliant to poor: bad design, weak marketing, sloppy production control have been, and are, important factors - but the confidence and the scope of management, and the profits they need for expansion, have all been hammered over recent years by much trade union short-sightedness.

We would need to identify for him the remorseless rise of the wages share and the consequent fall of the profit share of company income - and the effect this has had on labour costs, competitiveness and management scope, and therefore the effect on jobs.

(Please note that the raw statistics do not show profits being raided by labour costs in the way that we know has in fact happened: Department of Industry statisticians have however explained why it is still true that profits have been raided by earnings, in an answered prepared at my request to a question from Mickey Grylls).

He will need to be given our unit labour costs in comparison with those of our competitors.

It seems to me that we would want to stress that management defects need to be reduced as well as excessive unit labour costs, but we can surely explain that the defects of management cannot be cured overnight - marketing and design and development failings take time to correct - whereas unit labour cost excesses can be cured overnight, or can at least be prevented from getting overnight even worse.

We surely should not flinch from the fact that we stressed unemployment under Labour as one of our election themes. How could we be expected to have known that the £ would rise so sharply: that there would be another oil hike: and that, above all, there would be the job-annihilating pay increases of 1980. To add that massacre of jobs, on top of those already destroyed by the increase in unit labour costs of previous years, was the responsibility of the trade unions, who were warned by us - and who are now leading the complaints.

It is my hope that if Tim Bell were given the material he would be able to suggest how best to present it to secure interest, understanding and follow-up. Provided that we do not flinch from management's role, and our own part where relevant, we have an impeccable case.

In putting the argument for a new presentation to John Hoskyns there has, however, been revealed a difference of emphasis. He accepts the main thesis, but he argues that our stress should be on keeping future pay settlements moderate, while I would prefer to stress reduction in unit labour costs. He argues that reducing unit labour costs will involve higher productivity, which will increase unemployment over and above that which is already spontaneously emerging. I argue that only to the extent that, for instance, Merseyside or Glasgow proclaim themselves convincingly as areas of sustained low unit labour costs would employers be attracted to them. I note this disagreement for what it is worth: the two purposes of moderated settlements and lower unit labour costs are of course mutually consistent.

Lastly, I turn to an aspect which is right outside my detailed knowledge, but I get the impression that very few television interviewers and very few news presenters show any interest in, or understanding of, cause and effect in connection with unemployment. This has often been deplored by us, but surely we should try to do something about it. My necessarily - because I am so ignorant in this area - feeble suggestion is that we should seek the advice of those who do have interest and do have understanding, such as Robin Day - and there may be others - on how an increase in interest and understanding could be achieved among other interviewers and presenters. Efforts would have to be made one by one, and any gain in interest and understanding would be worth having. I know that Aims has given study to this subject, and might be able to give us some analysis.

I am sending this to you unpolished in order to reach you before you go off. I am copying to Geoffrey Howe, Norman Tebbit, Ian Gow and John Hoskyns, to each of whom I have to varying extents exposed the ideas for what they are worth.

~~Kay~~

Yours, We do not have the Peter Shore letter AD 5/8

Alan - We have nothing on this. Can you recheck pl? Kay 7/8

Mr. Lankester

This is the final version of the reply the Chancellor plans to send today to Mr. Shore. He will be signing it after the meeting on coal. PJ 4.8

2

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

. . August 1981

cc Press Office

The Rt. Hon. Peter Shore, M.P.,
House of Commons

MS

Prime Minister

The Chancellor's reply to Mr Shore.

TL 4/8

The Prime Minister has asked me to reply to your letter of 3 August about the present state of the economy.

Of course, the phrase "end of the recession" can be used in different senses. But the most useful meaning of the word "recession" is as a description of a situation in which industrial production and total national output is falling. In saying last Thursday that "we are now at the end of the recession" I was referring to the fact that output has now broadly stabilised.

The question of whether "the economy has started to pick up" (as you put it) or when it will do so is a related but separate one.

It is never possible to be precise about such things. But the Government sees no reason to depart from what was stated in the Financial Statement and Budget Report, produced at the time of the Budget. Paragraph 16 on page 27 of that document suggested that domestic demand would recover over the forecast period; but that the prospect for domestic output was "one of only gentle recovery" over the period to mid-1982. The majority of outside commentators' expectations are consistent with that view.

I agree entirely with your statement that "to restore the health of Britain's economy is the paramount need of today", and that, while much progress has been made, there is a long way to go. What is absolutely plain is that the prescription of massive reflation advocated by the Labour Party would be a sure recipe for runaway inflation and economic collapse.

GEOFFREY HOWE

cc Mr Gow
Mr Ingham
Mr Vereker
Mr Duguid

28/8

Peter SHORE MP

3 August 1981

I attach a copy of Peter Shore's letter to the Prime Minister which was released to the Press this morning.

The Prime Minister and the Chancellor had a word about this this afternoon. The Chancellor has agreed to reply. I should be grateful for a copy of the reply for our records in due course.

I am sending a copy of this letter and enclosure to David Heyhoe (Chancellor of the Duchy of Lancaster's Office).

MAP

Peter Jenkins, Esq.,
HM Treasury.

SFH

3 August 1981

I am writing on behalf of the Prime Minister to acknowledge receipt of a copy of your letter of 3 August to her. (The original has still not reached us.)

I will place this before the Prime ~~Miniseer~~ Minister immediately.

MAP

The Rt. Hon. Peter Shore, MP.

From: The Rt. Hon. Peter Shore, M.P.

HOUSE OF COMMONS
LONDON SWIA OAA

G.R

To replace the earlier photocopy in pending, M

MAP

3 August 1981

R4

The Rt Hon Margaret Thatcher MP
Prime Minister & First Lord of the Treasury
10 Downing Street
London SW1

Dear Prime Minister,

I am writing to you in your capacity as First Lord of the Treasury - and therefore the Senior Economic Minister of the Government - to seek a clear statement from you as to the Government's official and considered view of the present state of the economy. I regret the need to write to you in this way, since in normal circumstances, the word of the Chancellor of the Exchequer can be taken as expressing the collective view of the Government. But as you will be only too well aware, the Chancellor's view is seriously at odds with that of other Senior Ministers and we are all as a consequence unsure as to which view represents official Government policy.

A most serious example - though by no means the only one - of this confusion occurred on Thursday last, in the wake of the publication of CBI's latest Industrial Trends survey. The Chancellor told the House, without qualification that "we are now at the end of the recession" and claimed at the same time that the CBI's survey was "consistent" with this "fact".

Such optimism was in no way however consistent with the remarks at the week-end of the Leader of the House, Mr Francis Pym nor with those made by the Chairman of the Conservative Party, Lord Thorneycroft - and the attempt by Sir Geoffrey in a radio interview at textual reconciliation between his position and that of Mr Pym was wholly unconvincing.

In his speech at Alnwick Mr Pym said: "there are few signs yet of when a general upturn will come" and in his radio interview, Lord Thorneycroft said: "there is no great sign of it (the economy) picking up". These remarks are very much at odds with the Chancellors', since on the normal meaning of words, "the end of the recession" must imply that the economy has started to pick up.

Moreover the Chancellor's claim that he was supported by the evidence of the CBI survey has itself been challenged by the authors of the survey, the CBI, as The Financial Times reported on Friday. "There is no sign of any general upturn in the economy" was the comment of the Chairman of the CBI's economic situation committee.

To restore the health of Britain's economy is the paramount need of today. Nothing is more damaging to that restoration and to the development of confidence in our economic future, than uncertainties emanating from the Government itself.

That is why I called for a clear statement this morning and, failing that, why I am asking you for an unambiguous view of the Government's considered assessment of the state of the economy and of the prospects for its recovery.

Since this matter is now the subject of widespread public debate, I am releasing this letter to the press.

Yours sincerely

Peter Shore

From: The Rt. Hon. Peter Shore, M.P.

cc Press
I.Gow.
TL.
J.V.
A.D.

HOUSE OF COMMONS
LONDON SWIA OAA

3 August 1981

The Rt Hon Margaret Thatcher MP
Prime Minister & First Lord of the Treasury
10 Downing Street
London SW1

Dear Prime Minister,

I am writing to you in your capacity as First Lord of the Treasury - and therefore the Senior Economic Minister of the Government - to seek a clear statement from you as to the Government's official and considered view of the present state of the economy. I regret the need to write to you in this way, since in normal circumstances, the word of the Chancellor of the Exchequer can be taken as expressing the collective view of the Government. But as you will be only too well aware, the Chancellor's view is seriously at odds with that of other Senior Ministers and we are all as a consequence unsure as to which view represents official Government policy.

A most serious example - though by no means the only one - of this confusion occurred on Thursday last, in the wake of the publication of CBI's latest Industrial Trends survey. The Chancellor told the House, without qualification that "we are now at the end of the recession" and claimed at the same time that the CBI's survey was "consistent" with this "fact".

Such optimism was in no way however consistent with the remarks at the week-end of the Leader of the House, Mr Frances Pym nor with those made by the Chairman of the Conservative Party, Lord Thorneycroft - and the attempt by Sir Geoffrey in a radio interview at textual reconciliation between his position and that of Mr Pym was wholly unconvincing.

In his speech at Alnwick Mr Pym said: "there are few signs yet of when a general upturn will come" and in his radio interview, Lord Thorneycroft said: "there is no great sign of it (the economy) picking up". These remarks are very much at odds with the Chancellors', since on the normal meaning of words, "the end of the recession" must imply that the economy has started to pick up.

/2

Moreover the Chancellors' claim that he was supported by the evidence of the CBI survey has itself been challenged by the authors of the survey, the CBI, as The Financial Times reported on Friday. "There is no sign of any general upturn in the economy" was the comment of the Chairman of the CBI's economic situation committee.

To restore the health of Britain's economy is the paramount need of today. Nothing is more damaging to that restoration and to the development of confidence in our economic future, than uncertainties emanating from the Government itself.

That is why I called for a clear statement .
this morning and, failing that, why I am asking you for an unambiguous view of the Government's considered assessment of the state of the economy and of the prospects for its recovery.

Since this matter is now the subject of widespread public debate, I am releasing this letter to the press.

Yours sincerely

[illegible]

Econ Pol. 2

10 DOWNING STREET

From the Press Secretary

CHANCELLOR OF THE DUCHY

cc. Mr. Whitmore

3vii

Presentation

You will recall my minute of July 8, attached (Annex I). I had a follow up meeting this week of Heads of Information of Economic Departments.

Our conclusion was that we had emerged from a most difficult month, even at the best of times, in far better shape than we might have reasonably expected, considering:

- the riots (and subsequent trouble in Brixton and Toxteth);

- the Warrington by-election which presented more problems for Labour than the Government, even if the Conservative lost his deposit; and

- the economic situation.

On the last point inflation; unemployment; industrial disputes (with the ending of the Civil Service and Tube disputes, the quiescence in the ambulance dispute and equivocation in the B/Rail dispute); and the victory in the economic Census Debate, have all turned out better than expected.

Over and above all this the triumph of the Royal Wedding has been a national tonic.

/Contrary

Contrary to all our expectations, we have ended July - and entered Recess - on a higher rather than lower note. That is gratifying.

But all my colleagues, while being pleasantly surprised and warmed by this, subscribe to the view that there are no grounds for euphoria. We are lucky to have got through to the Recess in such good heart. But we face a formidable autumn and winter and the only sensible approach is a thoughtful caution.

I shall be preparing papers next week on presentation during the second half of the year which should provide a useful basis for discussion early in September.

B. INGHAM

31 July, 1981

10 DOWNING STREET

From the Press Secretary

CHANCELLOR OF THE DUCHY   cc. Mr. Whitmore

Presentation

I held a meeting yesterday with a number of Heads of Information of the Economic Departments to consider presentation over the next few months. The consensus can be summarised in two words: deeply worried.

July is always the most dangerous month politically. Historically, it is the month of crisis measures (and I am repeatedly asked by the press whether they should expect a mini-Budget or re-shuffle). But this time the dangers are compounded by:

- the riots in Southall, Toxteth, Wood Green, Moss Side (and where next?), all of which apply pressure to the Government's economic policies and detract from the Government's good law and order reputation;

- the Warrington by-election where the Conservative candidate could well lose his deposit (which is perhaps rather better from the Government's point of view than SDP winning; by the same token, an SDP win and a Tory lost deposit would be appalling);

- the possibility of a stagnant or, at worst, slight increase in the Index of Retail Prices;

- the certainty of much worse unemployment figures, and very much worse youth unemployment - even if this month's count is not statistically reliable;

/- the risk

- the risk, putting it at its lowest, of a rail/ tube/London bus strike coming on top of continuing ambulance/Civil Service strikes;

- the threat that what the Royal Wedding will bring to unrelieved gloom will be reduced by industrial action and the national atmosphere soured;

- the Government side will be propelled into the Recess in a state of profound agitation, depression and gloom instead of, as it should be, sent away to recuperate on the upbeat, as a consequence of which good news - e.g. evidence of real economic recovery - may be swamped.

The Government's presentation/morale problems are clearly serious and I think you should consider having, at an early stage, an initial meeting with us in No. 10, perhaps followed by a discussion with Heads of Information of Treasury, Employment, Industry, Energy and DHSS. Its objective would be to consider the immediate way ahead and how we might enter the Recess on the most positive note. If you agree, I will provide a paper.

B. INGHAM

8 July, 1981

CONFIDENTIAL

Econ Pol

cc J. Vereker

PRIME MINISTER

PAY BRIEF

I attach my Department's pay brief for July. I am sending copies to members of E, E(PSP), and E(EA) Committees, and to Sir Robert Armstrong.

J P

27 July 1981

PAY BRIEF - POSITION IN MID-JULY

SETTLEMENTS

1 Since the June pay brief 151 settlements covering 2,334,000 employees have been reported. In the private sector the weighted average level of settlements over the last month was just over 7½%, but this was dominated by the Building and Civil Engineering agreement of 6.7% (450,000 employees). The average in the public sector (10 settlements covering 1,386,000 employees) was just over 6½%.

2 The cumulative average level of settlements for the whole economy this round has fallen from 9% last month to about 8½% (855 settlements covering 9,880,000 employees).

3 In the private sector the cumulative average is just under 9% (785 settlements covering 4,711,000 employees). There is little difference between the average level in manufacturing and in non-manufacturing, both are just under 9%. The average in non-manufacturing, however, is depressed by the Building and Civil Engineering settlement and the implementation of a 3% to 6% offer to Motor Vehicle Retail and Repair (370,000 employees). Exclusion of these settlements would increase the average for this sector by just over 1%. There is a wide range of settlements (see Appendix 4). About ½ of the settlements are below 10%, with recent settlements tending to be in the 6% to 10% range.

4 According to the CBI Data Bank Survey there has been little change in the general pattern of manufacturing settlements since last October with pay settlements in that sector continuing to average between 8% and 9%.

5 In the public sector the cumulative average is about 8½% (70 settlements covering 5,170,000 employees). The average for the trading sector (45 settlements covering 1,372,000 employees) is just over 9% and for the services sector (25 settlements covering 3,798,000 employees) is just over 8%.

NEGOTIATIONS

6 In the PUBLIC SECTOR, Civil Service non-industrials (1 April - 562,000) are being consulted on an improved offer of 7% plus £30, worth about 7½% overall. Two unions - SCPS and CSU - are recommending rejection. Industrial Civil Servants (1 July - 148,000) are expected to be offered the alternative of 7½% for 12 months or 5⅝% for 9 months. If accepted the latter option would give a 1 April settlement date for 1982. National Health Service ambulancemen (1 January - 17,000) have called off their industrial action and a settlement within the 6% pay factor is likely to be reached on 3 August. An offer of 6% has been rejected by National Health Service admin and clerical grades (1 April - 121,000). The Staff Side have agreed to recommend acceptance of a 6% offer for NHS professions supplementary to medicine (1 April - 25,500). Negotiations for British Rail clerical and conciliation grades (20 April - 150,000) have resumed following the recommendation by the Railway Staffs National Tribunal for an increase of 8% from 20 April with a further 3% from

1 August. Worth about 10.5% overall. After a ballot British Telecom executive grades (1 July - 7,000) have rejected an offer estimated to add 9% to the paybill. The union (SCPS) has called for a 24 hour stoppage on Friday, 24 July. The recent settlement for London Transport drivers and conductors (28 March - 19,800) giving an 8% increase in basic rates has been reviewed following the 11½% settlement for LTE rail staff and an additional 3% has been offered, plus £50 compensation for erosion of free travel benefits.

7 In the PRIVATE SECTOR, Food Manufacture workers (2 June - 40,000) are claiming 8.5% in response to a 7.7% offer. The parties have failed to agree and the dispute is being referred to arbitration. Registered dock workers at the Port of Liverpool (1 May - 4,051) have rejected a 7.6% offer in reply to their claim for 13%. Intermittent industrial action is being taken. A 'final' offer of 8.5% plus improved terms for consolidation of bonus to ICI manuals (1 June - 47,000) has been rejected by the unions, but members are being consulted. The claim is for substantial increases and extra holidays. Scottish Printing Industry workers (1 July - 20,000) are being balloted on an offer worth about 9.5% to 10%. The result is expected shortly.

PRICES AND EARNINGS INDICES

PRICES

8 In June the year on year increase in retail prices was 11.3% compared with 11.7% in May.

EARNINGS

9 In May the year on year increase in average earnings for the whole economy was 13.2% compared with 13.9% in April. Since August the underlying rate of increase has averaged about ¾% per month.

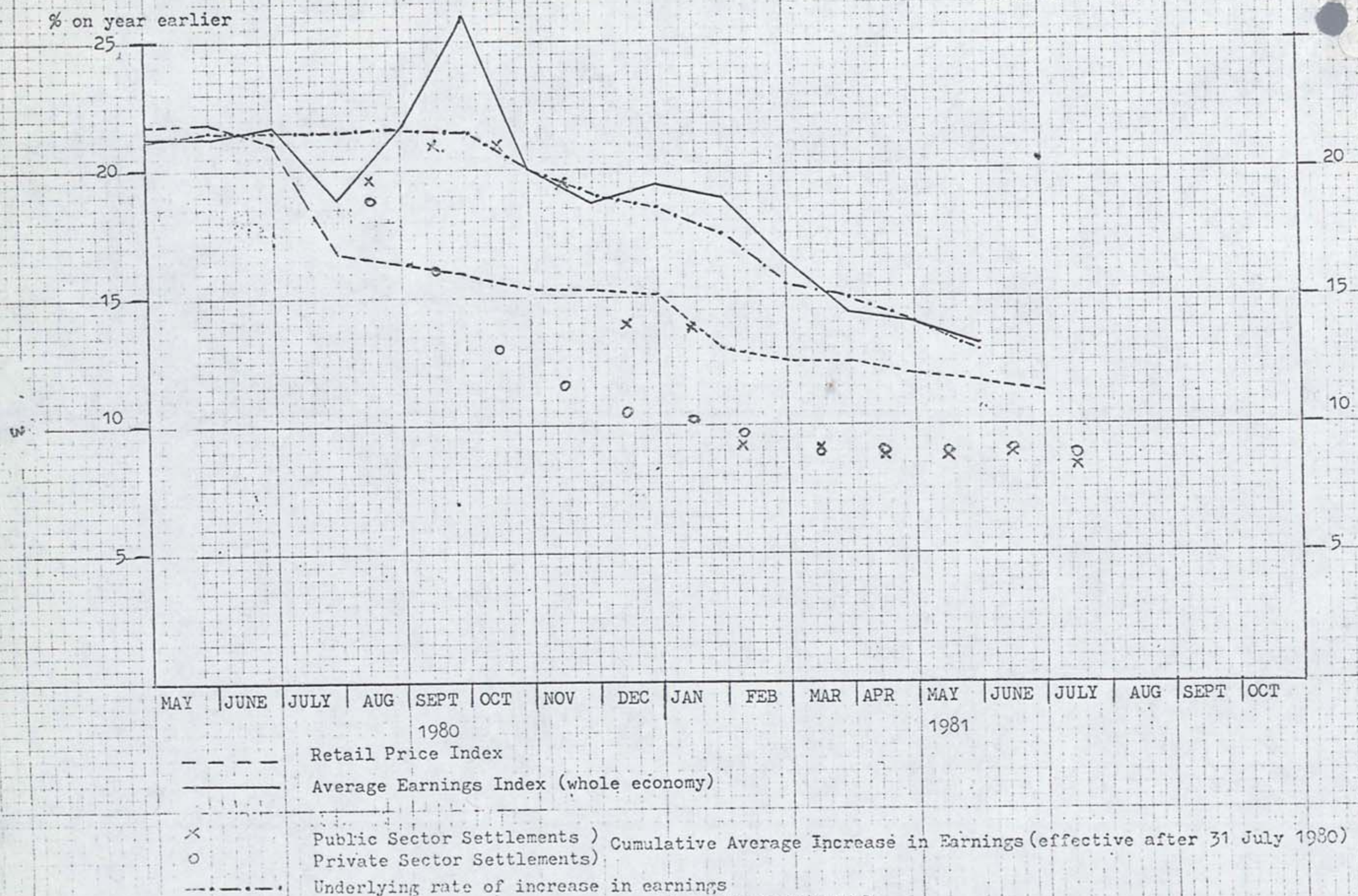
REAL DISPOSABLE INCOME

10 The real disposable income - taking account of the changes in earnings, prices and taxes - of a married man on average adult male earnings with a non-working wife and two children under 11 (with no other tax liabilities or allowances and not contracted out of the State Pension Scheme) fell by about 1% in the year to April.

CONFIDENTIAL

APPENDIX I

TRENDS IN EARNINGS AND PRICES



CONFIDENTIAL

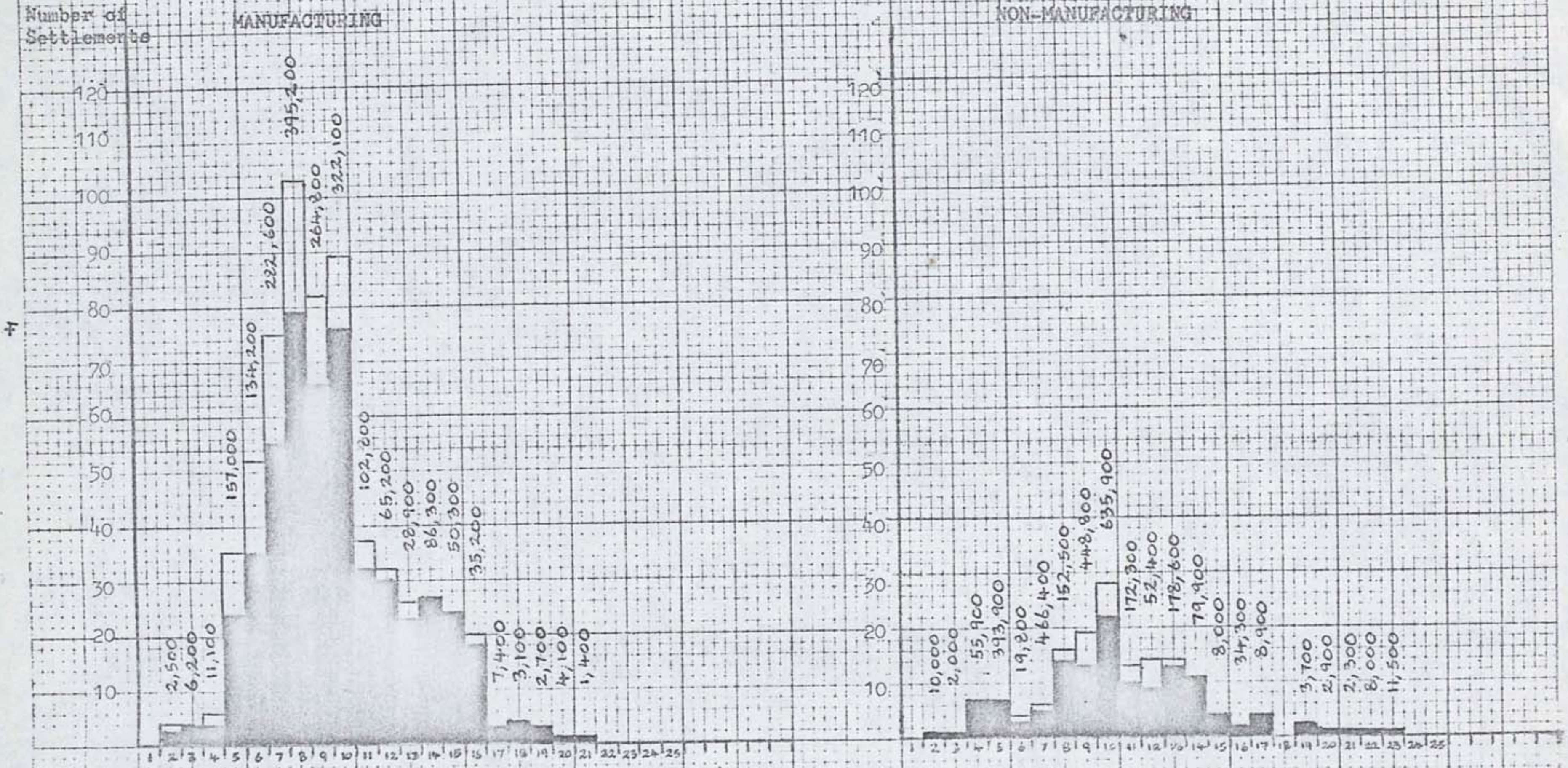
CONFIDENTIAL

APPENDIX 2

DISTRIBUTION OF SETTLEMENTS IN THE PRIVATE SECTOR BY LEVEL OF SETTLEMENT FROM 1 AUGUST 1980

KEY: SETTLEMENTS UP TO THE LAST PAY BRIEF

SETTLEMENTS SINCE THE LAST PAY BRIEF



LEVEL OF SETTLEMENT (ROUNDED TO THE NEAREST WHOLE NUMBER)

NOTE - THE NUMBER OF WORKERS (ROUNDED TO THE NEAREST HUNDRED) AFFECTED BY THE SETTLEMENT IS GIVEN ABOVE THE APPROPRIATE INDICATOR.

CONFIDENTIAL

24 July 1981
Policy Unit

tear Rd

PRIME MINISTER

STRATEGY MEETING, CHEQUERS

This minute contains some thoughts for tomorrow's discussion, and reflects the rather jittery state of some colleagues' nerves and Jim Prior's attempts to bounce us into an inflationary unemployment package.

1. OUR PRESENT SITUATION

1.1 In the past, we have often criticised the colleagues for under-estimating the size of the problem we're trying to tackle. This time, however, our view is rather different. In purely economic terms, we are doing better than many of them think. Despite the agonisingly slow bottoming out, the indications are that the recession is turning. The rise in unemployment is decelerating. Productivity is rising. Inflation is falling. Growth in the monetary base is only 5% or 6%. Upward pressure on our surprisingly low short interest rates is inevitable, but the "Unthinkable" Budget strategy has been fully vindicated. There is no suggestion at all of the need for a summer or autumn Budget. Sterling shows no sign of collapse and remains above its purchasing power parity. And we are weathering astronomically high US interest rates.

1.2 Of course two years is not long to change electoral attitudes. But two years is a long time in terms of the business cycle. The colleagues are behaving as if the Election was only six months off. If that was the case, then we would be in trouble. But it isn't the case.

1.3 Of course, psychology does matter (see Sam Brittan's article of 23 July). If businessmen think we might lose the Election, then they will behave accordingly. But reflation/inflation and a plummeting pound is not the way to renew business confidence! We have to review the strategy, make sure we've got it right, and then sell it both within the Cabinet and to the opinion-formers outside, as the way to save the economy and win the Election.

2. THE STRATEGY FROM NOW ON

2.1 We agreed at our Chequers strategy day in January that the medium-term strategy had always rested on:

(a) Reducing inflation and inflationary expectations.

(b) Reducing public expenditure as a percentage of GDP (which includes getting control of the nationalised industries).

(c) Freeing-up the labour market so as to minimise transitional unemployment.

On (a), we are on course and must resist all attempts to push us off. On (b), you know that we regard Civil Service reform as the real key and this won't be possible during the present Parliament (see the Cattell letter, in yesterday's Times, attached). On the nationalised industries, again it's not a simple problem to be solved this Parliament, but CPRS (we have seen their draft report) has sensible proposals. On (c) we have failed to move fast enough because Jim has obstructed everything from trade union reform to the abolition of the Wages Councils. But the orchestration of the response to the Green Paper is bearing fruit, and Alan Walters has since produced a non-cosmetic scheme for speeding up that process.

2.2 The strategy from this point on does of course have to fit into tighter constraints than it would if we still had four years to go. It has to meet four conditions: it must be compatible with the financial strategy; it must ensure that inflation is still falling and unemployment is starting to fall six to nine months before the Election; it must persuade the public that we're being tough because we do care, not because we don't; and it must unite rather than divide the colleagues.

2.3 Given the unsolved problems of the Civil Service, nationalised industries and indexed social security, it may now prove impossible to do what we want on public spending cuts.

2.4 We should therefore play down further tax cuts for the present. Even if we could find room for them, they won't affect unemployment within two years; while they could easily destroy the last chance of controlling PSBR and inflation. If everything goes miraculously well and we find room for them in 1983 - well and good. But we should not try to gear our strategy to something which at the moment looks arithmetically quite impossible.

2.5 It follows that the next wage round in its effects on public spending, nationalised industry prices and unemployment, is probably the decisive factor for the next Election. Given the untackled rigidity of the labour market and the futility (certainly at this stage in the game) of any sort of freeze, we don't yet have an answer to the "how" on this, except through example in the public sector. We must think very carefully about all the different trade-offs that may be worthwhile in order to get the pay outturn right.

3. AGENDA FOR CHEQUERS

3.1 Peter Thorneycroft's paper should help us to start thinking the next two years through as carefully as possible, while there is still time. Tomorrow's session can do no more than help us to walk the course in preparation.

3.2 If you want a reasonably structured agenda, here are some headings which may help us to keep on track:

(1) After Peter has introduced his paper, you could give a brief resume of where we now stand, on the lines of Section 1 and also 2.1 above. I think it's important to give as much weight to the things that are not going well as to those that are. If you don't emphasise them, others may hesitate to raise them.

(2) The key electoral groups. We need a clear picture of the different categories, eg the Tory faithful; disillusioned Tories; floaters who might be won over if we can outflank the SDP.

(3) The key issues. CRD's opinion research on the Government's rating on the top half dozen issues. We need to classify (not necessarily now), eg:

- issues on which actual results must show through before the Election
- issues on which visible Government action (but not necessarily early results) is necessary
- issues on which Manifesto pledges are needed and possible
- issues on which Manifesto pledges could be dangerously constricting for 1984-9.

(4) <u>Communications</u>:

- Events (including <u>bad</u> news) which we can use to influence attitudes.

- Winning the "no turning back" argument, so that today's predictable nervousness is turned right round and people realise that it is "turning back" that should make them nervous, not pressing on.

- We must take every opportunity of showing the electorate how <u>utterly different</u> (morally, socially, economically) our <u>objectives</u> are from the other parties, and thus how different our <u>means</u> often have to be.

- How can we best counter Labour's successful campaign to depict you personally as the arch "doctrinaire monetarist" deliberately inflicting unemployment and hardship etc? (We believe that this is one of the most important tasks).

- How can we achieve and then demonstrate greater Cabinet unity? To the public, a visibly divided Cabinet suggests a divided country.

(5) <u>Action plan</u>. Who should be doing what, to ensure that, despite all the day-to-day pressures of office, this two-year Election programme actually happens?

JOHN HOSKYNS

ANNEX A

ELECTORAL ISSUES

In no particular order:

1. Unemployment.

2. Inflation (nationalised industry prices, world commodity price pressures, MBC, public expenditure and public services pay).

3. Trade union reform.

4. Law and order.

5. Housing.

6. Defence, CND/anti-nuclear energy movement.

7. Europe.

8. Constitutional changes (freedom of information, the Lords, Bill of Rights, state support for political parties, contracting in, PR, referenda for single issues, local authority finance. Most of these issues will surface as the Election approaches.)

9. Government style. Qualitative aspects of Government; evidence of firmness and fairness, imagination and vigour, treating the public as adults not children, a united Government for a united Britain.

Times
Thursday, 23 July 1981

LETTERS TO THE EDITOR

New attitudes to manning levels

From Mr G. H. B. Cattell

Sir, Last week (July 14) you reported the CBI's proposals concerning manpower reductions in the public service. You also reported Sir Leo Pliatzky's views (July 15), which were to the effect that the CBI's aspirations were unrealistic and unachievable.

It is important to our future as a free and politically stable country that people should be persuaded that the CBI's proposals are practicable. We need desperately to find new money for investment in modern public services and for the refurbishment of our dilapidated and depressed urban areas. We cannot do that if we preserve the gross overmanning which exists in the public sector. Over the last 20 years technology has advanced at a rate which causes older people to catch their breath in astonishment. The effect of this advance has been to make it possible to reduce, significantly, the number of people required for manual and office work. Yet over the same 20 year period the number of people employed in local authorities has risen by 80 per cent and in central government and public corporations, excluding nationalized industries, by over 45 per cent.

Almost all companies which are still trading in the private sector have been forced to reduce their payrolls by amounts which would have been considered inconceivable two years ago. My own company has reduced its labour force by 25 per cent in 18 months. Yet we are still trading at the same level of turnover, and although still feeling the effects of the recession, we are much more efficient and poised to take advantage of the upturn when it comes. Never again will we return to the manning levels or unit labour costs which fear of organized labour and our own complacency dictated in times now passed.

I know from my own experience as Director of Manpower and Productivity Services at the Department of Employment that the CBI is not preaching nonsense. A 10 per cent manpower reduction in our public services is easily obtainable, given the necessary management ability and will.

A further, but temporary, increase in the numbers unemployed should not deter us. By releasing large numbers of underemployed people in the public service we can also release vast funds for the re-employment of people in new enterprises, both public and private.

The preservation of unnecessary jobs prolongs the unemployment of those who could and would work in new ventures.

Would *The Times* please thunder a little in support of the brave proposition now advanced by our industrialists, who are preaching what they themselves now practise?

Yours faithfully,
G. H. B. CATTELL,
19-23 Knightsbridge, SW1.

From Mr Gordon James

Sir, We have noted with considerable anxiety the intention to relax the statutory requirement that companies employing 20 or more staff should employ three per cent disabled persons.

Whilst it is a common fact that a percentage of companies do not comply with the statutory requirement, it is our experience that most reputable companies make some effort to offer a contribution to society by employing as many disabled people as they can in a variety of jobs.

We in Arthritis Care are particularly concerned at what can only be considered a retrograde step, particularly when our prime concern is to assist arthritic sufferers to remain useful members of the community.

None of the statements supporting the intention to abolish the statute gives any valid reason for eliminating it, and at the present time, when there are many other massive drains on the economy, I consider that every effort should be made to continue gainfully to employ people who are not only anxious to make their contribution, but would otherwise be yet another, unwilling, liability on the nation.

I trust therefore no retrograde action will be taken in this matter, without full discussion, not only with industry but with the welfare bodies, such as ourselves, who are working under ever-increasing financial stress voluntarily to help a very considerable number of disabled people to continue to earn an honest living.

Yours faithfully,
GORDON JAMES, Chairman,
Arthritis Care,
6 Grosvenor Crescent, SW1.

From Mr Michael Norman

Sir, It is gratifying to see one's name in print in Britain's newspaper of record for the first time (University of Kent results, July 18). It is surely going to be decades before one has another chance of such prominence — if ever — as one swims in a sea of three million unemployed.

Yours faithfully,
MICHAEL NORMAN,
The Coach House,
Hammerwood Park,
East Grinstead,
Sussex.

Placing the cuts in university grants

From Sir Andrew Huxley, PRS

Sir, The general letter from the chairman of the University Grants Committee to vice-chancellors and principals (report, July 2) referred to advice received from, among others, the Royal Society. I believe it appropriate now to say publicly that that advice was in favour of selectivity in the distribution of the funds now being made available by government.

I and my colleagues on the Council of the Royal Society, therefore, applaud the endeavour of the UGC to support excellence and to foster important growing points. The need for greater selectivity of support within the university system has been apparent for some time, and the present cuts provide an opportunity for such selectivity.

However, in the implementation of the cuts there are risks of serious damage to several vital parts of the system and the greatest possible care and vigilance will be needed to avoid, or at least minimize, this damage. For instance, the recruitment of able young staff may dry up almost completely and this would be disastrous for research and education; special efforts will be needed to ensure a steady intake of very able young people.

The Council of the Royal Society will be monitoring the changes now taking place in the university system with special reference to the wellbeing of science, including applied science and technology, their teaching and their impact in industry. These studies will be conducted in consultation with the UGC and vice-chancellors, and the society will be in close touch with the research councils and with other sponsors of research, including industry, which provide an essential third element in the support of university research.

We shall welcome specific information about individual groups engaged in high quality scientific or technological research which become seriously threatened by the cuts.

Yours faithfully,
ANDREW HUXLEY, President,
The Royal Society,
6 Carlton House Terrace, S.W.1.
July 20.

Practical moderation

From Mr George Mikes

Sir, Nearly all the newspapers and many politicians (some with avuncular benevolence, others with irony tinged with envy) have remarked that all's very well but the time has come now when the

Mr Hoskyns.

CABINET OFFICE
Central Policy Review Staff

With the compliments of

From: J. R. Ibbs

Sir Kenneth Berrill KCB

70 Whitehall, London SW1A 2AS

Telephone 01-233 7765

CABINET OFFICE
Central Policy Review Staff
70 Whitehall, London SW1A 2AS Telephone 01-233 7765

From: J. R. Ibbs

h

Qa 05639

CONFIDENTIAL

21 July 1981

Dear Chancellor,

MISC 14(81)5: Future Work Programme of MISC 14

I should like to offer the following comments on this paper which MISC 14 is to discuss on Thursday, 23 July.

First, for completeness, a check list of issues affecting the supply side in the broadest sense would range more widely than the annex to your paper, and would include, for example, such issues as the impact of taxation on profits and incentives, the role of the financial institutions and competition policy. It is not MISC 14's task, of course, to keep track of all these issues, but it will be important that the implications for the supply side are taken fully into account when topics in these areas arise for decision elsewhere.

I see the primary task of MISC 14 as being to look at issues which are not being addressed elsewhere. However, given the heavy pressures on the time of both Ministers and officials, it is clearly necessary to adopt a selective approach. In my view, the Committee should identify just two or three key issues on which the Government can realistically expect to be able to take action - despite other conflicting pressures - which could significantly affect the responsiveness of the economy.

In choosing the Agenda, I suggest that the question of timescale is particularly important. Many supply side problems are deeply rooted in our culture and institutions: they will not be solved within the short or medium term. That is, of course, no reason for not beginning to address the long term problems: a start must be made on them some time. But it

The Rt Hon Sir Geoffrey Howe QC MP
HM TREASURY
S W 1

is to the short and medium term prospects for economic recovery that Ministers' minds are bound principally to be addressed. I suggest, therefore, that at least one of the issues for study should be directed to action which could have a reasonably early effect.

From this stand point I entirely agree that one of the top items should be concerned with meeting labour market needs efficiently (Annex A reference 1(iv)). I would not, however, favour framing this narrowly in terms of the efficiency of the MSC. A better starting point would be: how to prevent shortages of skill (or manpower more generally) from inhibiting the recovery of the economy. Although the level of skill shortages is currently extremely low there are widespread fears that shortages would quickly recur as the business climate improves.

The following are some of the questions which a study of this subject might address:

- How much substance is there to the fears of shortages arising?
- Is it possible to predict the geographical areas and types of skill in which difficulties are most likely to arise?
- Will there be a reversal of the wastage of skilled manpower to other jobs which has presumably occurred during the recession?
- What scope is there for the MSC to develop an improved national employment service for key skills? For example, the aim might be to attract a much higher level of vacancy notification from employers by offering skill testing and a vacancy circulation service to workers employed outside their skills, coupled perhaps with some refresher training facilities.
- Given that unions' insistence on skilled jobs being done by 'time-served' men will not vanish overnight, should more be done to equip unemployed time-served men with more relevant skills?

In addition, some of the proposals in our report on (geographical) labour mobility would be relevant to such a study.

If you see merit in examining this topic, the first step might be to invite the Secretary of State for Employment to report to MISC 14 on the current position as seen by his Department and the MSC, on the steps which are already being taken to prevent shortages, and their views on the scope for doing more. This would enable the Committee to decide whether a further study would be worthwhile.

I was interested to see that regional policy features among the list of wider issues in Annex A. The heavy concentrations of unemployment in particular regions is one of the key issues which has to be addressed in any examination of how to bring our vast unemployed reserve of manpower back into use. As you know the CPRS believes that there is a need for a fundamental review of regional policy, for the reasons set out in our recent Merseyside report. If MISC 14 would like to consider these issues, we could prepare a paper, based on the regional policy ideas in that report, to serve as a starting point for discussion.

Outside the field of labour market issues, I agree that there is scope for useful action in the field of standards and their contribution to efficiency (item 3(ii)). Standards and certification machinery and the legal and institutional framework within which they operate have an important bearing on the competitiveness of our manufactured products in export markets, particularly where non-price factors are concerned. The CPRS has done some background research and would be willing to submit a paper covering the institutional (and if necessary, legislative) changes which would be necessary to improve our position among the major OECD countries.

I am sending copies of this letter to the other members of MISC 14, and to Sir Robert Armstrong.

Yours sincerely,

J R Ibbs

MR. WHITMORE

Mr. Foot announced at Question Time today that the Opposition intend to table a Censure Motion.

Discussions through the usual channels are now taking place, but it seems likely that Messrs. Foot and Healey will speak for the Opposition. We do not yet have the terms of the Motion, but Mr. Pym's strong inclination is to get this out of the way next week. He believes that it will be extremely difficult to hold matters as long as 3 August if the Motion is tabled tomorrow. His initial preference would be to take the Motion on Monday next, thereby disposing of it as rapidly as possible.

From the narrow point of view of the Prime Minister's diary, all of next week is pretty disastrous. However, a Censure Motion in the House has to take precedence over virtually all other business. Given the problems caused by bilaterals and other events linked to the wedding, you may think that it would in fact be easiest to take it next Monday, thus allowing the weekend to be used for speech writing. If we were to go for Tuesday or Thursday of next week, the speech writing process would in fact mean disrupting at least two of the days supposedly allocated to wedding business.

Whatever date is chosen, the House will have to sit at least through 3 August.

As soon as we have any more indications from this end, we will let you know. But the earliest possible indication of the Prime Minister's timing preferences would be most helpful. (I assume that she will insist on speaking immediately after the Motion is moved, and on not winding up, this time).

Mike Pattison

21 July 1981

E Flder

HOME OFFICE
QUEEN ANNE'S GATE
LONDON SWIH 9AT

21st July 1981

Dear Mr Pattison,

ECONOMIC STRATEGY

The Home Secretary very much regrets that he will be unable to attend the meeting of the Economic Strategy Committee on Monday 27th July. He has had a long-standing engagement to attend the Queen at Windsor Castle.

I should be grateful if you could convey the Home Secretary's apologies to the Prime Minister on this occasion.

A copy of this letter goes to David Wright.

Yours sincerely

John Fields

J. E. FIELDS
Assistant Private Secretary

M. Pattison, Esq.

Eco Pol
Strategy

Econ Pol

Schroders

J. Henry Schroder Wagg & Co. Limited,

72

Economic Perspective

Summer 1981

The UK Short Term Outlook

The trade weighted value of sterling has fallen by 10% from its peak at the end of January. The effect of the fall has been to put a stop to the downward movement of inflation and to emphasise the vulnerability of the economy to a renewal of inflationary pressures. The Government's policy towards the exchange rate has been one of benign neglect since coming to power. The Government was surprised by the extent of the rise of sterling in 1979 and 1980, especially as monetary growth was high, though they probably believed that the beneficial effects on inflation of sterling strength outweighed the adverse consequences for industrial competitiveness. In principle they should not be concerned now, if sterling falls. However another immediate 10% decline in the exchange rate would probably render their inflation objectives as completely unobtainable.

In this context, the effect of the civil servants' industrial action on government borrowing and the money supply is to add further complications to the conduct of policy. In the meantime we still await firm and unequivocal evidence pointing to an upturn of output in the economy.

☐ Sterling has fallen by 20% against the dollar since the end of January but by only 5% against EEC currencies. This is a particularly unfortunate combination; the fall against the dollar will add proportionately more to costs and prices, to the extent that world trade prices are denominated in dollars, but not help to restore some of the lost competitiveness where it really matters, which is in Europe. A realignment of currencies which reversed the fall against the dollar, and resulted in a lower sterling parity against the DM, the French franc and other European currencies would be much more helpful.

Our judgment is that such a realignment is likely within the next twelve months. We expect lower US growth and inflation, and as a consequence, lower US interest rates. We also expect an improved German current account. This will permit a recovery of the DM against the dollar, and lower interest rates generally, which should then support a recovery of world output and trade. If the DM were to recover against the dollar, then the trade weighted value of sterling would fall a little further.

☐ The principal consequence of this to the UK will be to limit the possibility for an upturn of inflation in 1982. There is now little immediate prospect of single figure inflation, but the annual rate would be kept down to low double figures.

☐ In such circumstances, short interest rates are likely to be relatively stable at current levels. The stabilization of inflation will set a lower bound to short interest rates, though the risk is that interest rates will be forced up if strong downward pressure develops on sterling.

☐ Destocking in the first quarter continued at a rapid rate, particularly in manufacturing. Business surveys are, though, becoming more optimistic about orders, which suggests that the rate of destocking will now fall away. There are, moreover, grounds for expecting a recovery of investment in 1982. Meanwhile housing starts continue to recover, albeit from a very low base. Consumer spending rose by almost $1\frac{1}{2}$% in the first quarter as savings were run down. There is some scope for a further rundown of savings, and this is likely to happen as real incomes are now being squeezed. These considerations certainly suggest that the recovery in demand this year will be modest and be related very much to the turnaround of destocking. However it is as well to note that the growth of the real money supply points to a more rapid rate of expansion of demand than is suggested by looking at the individual components of demand.

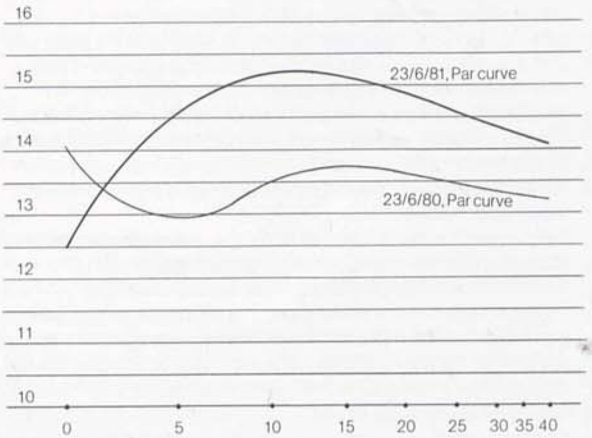
☐ Real profitability in the non-oil industrial sector fell to a new low at the end of 1980. The Bank of England estimate that the real rate of return declined to 2% from a level of over 6% in 1978. However the stage is now set for a recovery of profitability which is likely to continue into 1982, even if, as seems likely, the economy does not continue to recover strongly next year. First, wages growth is unlikely to respond quickly to any deterioration in inflation, as labour markets are so depressed; we expect average earnings growth to stabilize at around 10% over the next year. Second, the fall of the exchange rate will allow a substantial rebuilding of profit margins.

Gross Total return

%	1978	1979	1980	1981Q1	1981Q2
F.T. All Share Index	+ 8·4	+10·5	+35·2	+ 7·6	+ 4·9
F.T. Govt. Secs. over 15 years	− 3·4	+ 4·5	+21·4	+ 5·5	− 4·3
Schroder Property Unit Trust	+17·8	+25·2	+21·1	+ 3·7	+ 5·0
S & P Composite Index*	+ 6·6	−24·3	+23·0	+ 8·1	+13·7
New Tokyo SE Index*	+55·9	−45·9	+18·8	+11·0	+20·0

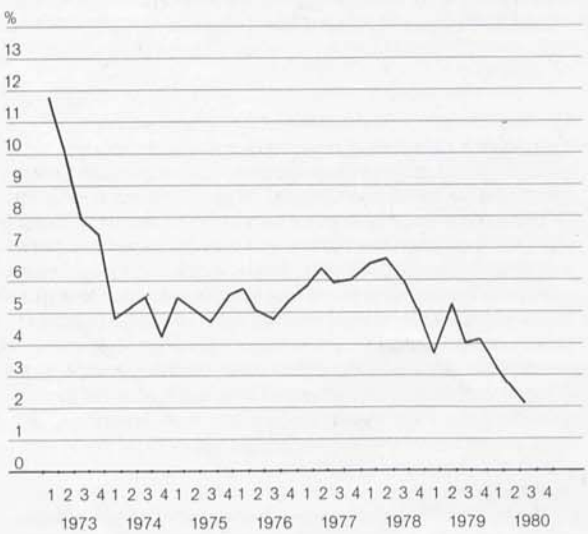
*through $ premium (discontinued on 23rd October, 1979).

Gross yield curves



A comparison of the yield curve now, with that of twelve months ago, indicates the extent to which earlier interest rate expectations have not been met. This in turn reflects the deteriorating expectations with respect to inflation. Although short interest rates are now lower, interest rates at around two years are close to levels of a year ago; beyond that the yield curve is at least 1 full percentage point higher.

The real rate of return for non-North Sea industrial & commercial companies



Source: Bank of England.

Aggregate profitability outside the oil sector fell to dangerously low levels in the third quarter of 1980. However, there should be a steady improvement in profitability in both 1981 and 1982.

Recent Market Movements

Increasing confidence that the recession was past the worst and that certain areas of the economy were already seeing some sign of upturn helped the UK equity market to continue to advance through April. This took the All Share Index up a further 7% to a new high of 332, while the Industrial 30 Share Index produced a rare spell of outperformance, rising by nearly twice this amount.
Inevitably this enthusiasm resulted in a series of rights issues during May and June culminating in the largest ever equity issue made – by BP on 18th June. The effect of these issues, together with the widening yield gap – as long gilt prices were moving in the opposite direction – caused a modest reaction in the equity market, leaving it 3.7% below its best level by the end of June. Within the equity market there was outperformance by export orientated stocks while interest rate sensitive stocks became relatively weak.
As indicated above, long dated Government stocks declined during the quarter taking yields up from just under 14% to 15%. The main reason for this was the sharp and largely unexpected rise in US prime rates which, together with a weakening oil price, had the effect of depressing sterling and thus producing a less encouraging outlook for inflation.
Property values continued to edge up at a slightly faster rate than retail prices.

Market Outlook

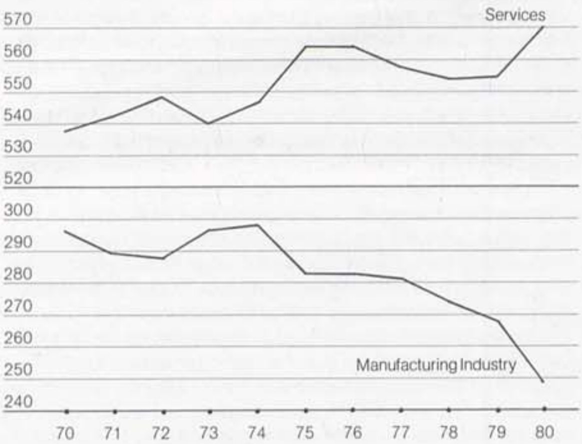
The gilt market has responded relatively quickly to a deterioration in the inflation outlook and does not appear expensive, though the prospect of a significant advance must be reduced now that the economic cycle is approaching an upturn, albeit a modest one.
For the UK equity market the crucial question is whether it can continue to respond to the outlook for higher profits in 1982 in spite of the pressures of a wider yield gap. In this context recent experience in the US would suggest that equities can withstand such pressures, though inevitably the market's strength becomes more muted.
The prospect of higher company profits and continued double figure inflation in 1982 may well result in a rather more favourable background to property investment.

Overseas

Rather more than half sterling's decline since its peak in January occurred during the second quarter, and this combined with a small fall in US equities and a rather larger rise in Japanese equities, left these markets giving relatively good returns of 13·7% and 20·0% in sterling terms.
The main features of European stockmarkets were the sharp fall in French share prices following President Mitterrand's election, and the continued strength of the Scandinavian markets; EMS currencies made modest gains against sterling, bringing to an end a long period of major weakness.
As the economic problems facing the UK Government are seen to be increasingly intractable and as the government approaches the second half of their term in office, the relative attractions of a number of overseas markets become more apparent. The recent fall in sterling should therefore be seen in the context of its earlier much larger rise and should not detract from continued investment overseas.

Structural change

Sector weights in GDP



Sources: CSO and Schroder estimates.

Structural Change in the United Kingdom Economy

Long Term Trends

Over the longer term, the evidence clearly points to the declining importance of manufacturing industry as a contributor to Gross Domestic Product. The share of GDP attributable to the manufacturing sector has fallen from 30% to 25% in the last ten years. Although a large part of this fall in share has taken place very recently, there has been a gradual decline throughout the last decade (See chart). Within manufacturing industry, the largest declines have been in metal manufacturing (including the steel industry) and textiles, while chemicals and engineering have done relatively well.

The mirror image of the declining manufacturing share of GDP has been the expansion of the services share, particularly the public sector. The services share has grown from 54% to 57% since 1970. "Public goods" services (ie health, education, administration and defence) have gained an increasing share of GDP, rising from under 12% in 1969 to over 14% by 1980. In the private sector, the insurance, banking and finance sector has increased its share from 6.8% in 1969 to 9.1% in 1979.

The present recession has seen an acceleration of past trends. Although output has been falling over almost the entire economy, the decline has been sharpest in the manufacturing sector. The index of output for manufacturing reached 94.8 in 1980 (1975 = 100) while the 1980 index level was 105 for industry as a whole and 107 for GDP. There are as yet few signs of a recovery in manufacturing; output in the first quarter of this year was down 12.8% on the same quarter last year. Again the largest falls have been in metal manufacturing and textiles.

Detailed information on the recent performance of the service sectors is not available yet, but what figures are available suggest that services have held up better than industry, gaining an increasing share of GDP.

One must be careful to distinguish cyclical changes, which may well be reversed, from long term fundamental changes in the structure of the economy. However, it does seem likely, from the basic similarity of short and long term changes in the structure of output, that short and long term factors are reinforcing in their effects.

North Sea Oil

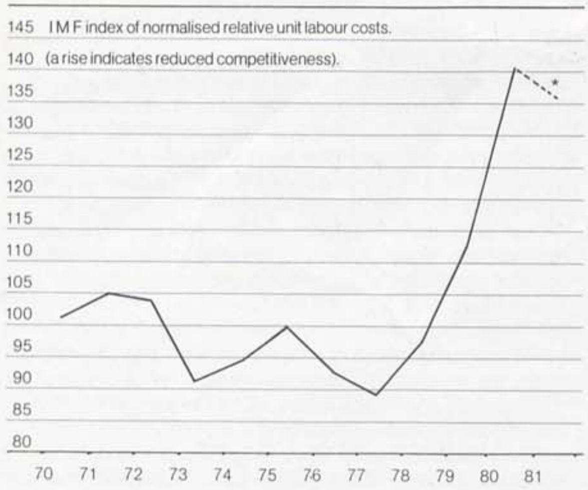
In this respect it is clear that North Sea oil is of particular significance. The table opposite indicates the difference in the distribution of national output between 1976, when oil output was scarcely significant, and 1980. In 1980, North Sea oil contributed 3.4% to GNP, while the share of manufacturing output had fallen by 3.4% since 1976. Thus manufacturing would seem to have borne the brunt of the adjustment on its own. If this is indeed so, then it is entirely predictable, as North Sea oil reduces the need to export manufacturing goods and requires that output be redistributed towards non-tradeables. Kay and Forsyth (in Fiscal Studies 1980) made estimates of the effect of such a redirection of resources and interestingly the 1980 output distribution is very close to their estimates.

The structure of production (1975 prices)

% distribution	1976	1980
North Sea oil	0.4	3.4
Other primary production	2.5	3.1
Distribution	10.0	10.3
Transport	8.5	9.0
Other services	38.0	37.8
Manufacturing	28.4	25.0
Other industry	12.2	11.4
	100.0	100.0

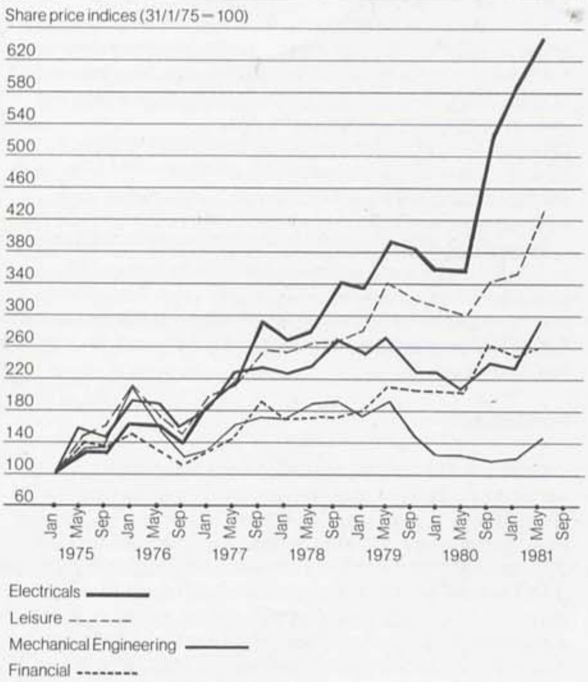
Source: Estimated from CSO.

UK Competitiveness



*Schroder estimate.

Stock market performance



Source: F.T.A. Share Indices

Competitiveness

The principal mechanism that has brought about such an adjustment is the rise of sterling. Profitability in manufacturing has been squeezed as a consequence, while at the same time, personal incomes have risen strongly. The effect of the rise of sterling has been to reduce the competitiveness of manufactured goods by some 40%, in terms of traditional measures of competitiveness, of which one is illustrated opposite.

One feature of the chart which is of considerable interest is that there has recently been a small recovery of some of the lost competitiveness. It raises the question as to whether all of the lost competitiveness of recent years will be reversed.

There are two reasons for believing that this will not happen.

The first reason is that macro measures of competitiveness can be misleading, if considerable structural change is taking place. Thus an extended period of currency strength, such as we have seen, forces sectors and industries to adapt in such a way that invalidates long term comparisons of aggregate competitiveness. This is well illustrated in the final chart which indicates how the prices of certain selected sections of the stockmarket have moved since 1974. There is a substantial divergence, especially from 1976 onwards, (ie when North Sea oil production began). This reflects the higher growth and better prospects of more advanced technology manufacturing, such as electronics and of non-tradeable consumer goods such as leisure goods, which are less dependent on a position of strong international price competitiveness.

The second reason is however that the existence of North Sea oil is a structural factor that will reduce competitiveness, in the longer term. One part of the explanation for the loss of trade competitiveness is North Sea oil, and in the absence of a collapse of world oil prices, UK manufactured costs will remain high relative to the early 1970's.

There are however, good reasons for believing that UK competitiveness will continue to improve a little more, though perhaps by no more than 10%. The first is that weak oil prices and the growing perception that they may stay weak increases the required contribution for tradeable goods manufacturing, which will push sterling down. The second is that the large current account surplus of 1980 and early 1981 is likely to be reduced. This important cyclical influence on the exchange rate, which is also evident from the depressed level of output, will also tend to weaken sterling.

6th July 1981

The Research Department,
J. Henry Schroder Wagg & Co. Limited,
120 Cheapside, London EC2V 6DS.
Telephone: 588 4000 Telex: 885029

FROM: THE RT HON MICHAEL JOPLING MP

To Mr Gow
Mr Lankester

Prime Minister

Government Chief Whip

12 Downing Street, London SW1

SIR GEOFFREY HOWE

Maurice Macmillan came to see me last night following the One Nation Group dinner which was attended by: Ancram, Fletcher-Cooke, David Hunt, Lyell, Needham, Pollock, Rathbone, Renton, Rhodes-James, Royle, Sainsbury and Temple-Morris.

He told me that in general they agreed with the management of the economy so far, but feared it might be conducted from now on in a way which would be damaging to our Party. He said that they felt that our policy was not political enough and that there was a need for us to be quicker acting so that things could be seen positively to be improving before the next election. In particular they expressed concern about the method of calculating the PSBR, the need to carry out the derv claw-back and the decision over the BBC's external services. I suggested that they might consider asking you to attend a future dinner and Maurice said that he would think over whether to suggest it to the other Members.

I am copying this note to the Prime Minister.

17 July 1981

RESTRICTED

vb

c HO
FCO MOD
HMT DOE
LPO CØ
D/M
MAFF
D/TRADE
D/N
CS, HMT

10 DOWNING STREET

From the Private Secretary

17 July 1981

Dear Ian,

The Prime Minister has now had an opportunity to consider your Secretary of State's minute of 13 July. She very much agrees with Sir Keith that it would be a good idea for Ministers to make a special effort to arrange meetings with individual business representatives, journalists and interviewers to explain how, through improved competitiveness and changed work practices, employment opportunities can be improved.

I am sending copies of this letter to the Private Secretaries to other members of E, the Chancellor of the Duchy, Mr. Ibbs and Sir Robert Armstrong.

Yours ever,

Tim Lankester.

Ian Ellison, Esq.,
Department of Industry.

RESTRICTED

MR. INGHAM

c.c. Mr. Lankester
Mr. Wolfson
Mr. Hoskyns

R

Possible Prime Ministerial Speech

After our meeting this morning, you asked me to let you have the draft of a note you could give the Prime Minister containing our agreed advice about the need for and timing of a speech on the economy.

I attach a draft: because I was called out of the meeting before it ended, I am not absolutely certain that it reflects the conclusions, so I am sending a copy of it to the other participants who may wish to comment before you send it in.

J. M. M. VEREKER

16 July, 1981.

PRIME MINISTER

Possible Speech on the Economy

When you met Brian Griffiths on 15 July, you discussed the possibility of a major economic speech, perhaps during August. At the same time, I had been considering - in consultation with my colleagues in other Departments - the need for us to find an opportunity for you to make a measured response to recent developments on the economic front, to cover also such new policy measures as we are able to announce before the Recess. Because these two sets of ideas needed to be married together, those of us concerned here in No.10 met this morning to agree what advice we should give you, which is now contained in this note.

We think your programme, dominated as it will be by the Royal Wedding and the related events, and the normal acceleration of Ministerial business at the end of July, rules out any speech or substantial media interview by you before the Recess.

As for a speech during the Recess, we feel that it would be a mistake both in terms of timing and of substance to try and deliver a major economic analysis in the middle of August. It now seems rather unlikely that any decision about an unemployment package will be made until mid September, so there would be no significant new policy measures to announce; and, even at the beginning of the Recess, your audience will have more of an eye on their forthcoming holidays than on what the Government is up to.

But there are a sufficient number of developments in the economy, and policy responses to them, for us to think seriously about a major economic speech by you - which, since Parliament will not be sitting, could include the announcement of the unemployment package - in the middle of September (after the TUC Conference). We envisage this not so much as an intellectual re-statement of the economic foundations of the strategy, as a new attempt to relate what the Government is trying to achieve to

/ the

the problems people now see in the economy, including of course unemployment and the prospects for inflation. We would particularly be trying to respond to the TUC Conference by putting more of the responsibility for reducing unemployment on union leaders, in the way suggested by Keith Joseph in his minute to you of 13 July. And we would of course want to back this up by encouraging other Ministers to make a similar effort, and with selected briefing of media opinion formers (Alan Walters already has something on ~~and~~ these lines on hand).

Content if I now look around for a suitable platform in the 2nd or 3rd weeks in September (after you come back from Balmoral)?

<u>16 July, 1981</u>.

PRIME MINISTER

Professor Griffiths - Media

In Tim's note for the record you say you would like to consider bringing together a group of sympathetic economists and ~~economic journalists~~ in early August to see if they could help mobilise public opinion.

A word of caution.

We have already had our problems over an invitation to a group of economists; their meeting with you leaked and you re-arranged.

We have also a celebrated case of a problem over inviting in a group of Lobby journalists, let alone economic journalists who, in my experience, have little respect for rules.

The fact that both groups are friendly is neither here nor there; they talk.

Boring and tedious though it may be, it is better to operate, certainly with journalists, on an individual basis.

B. INGHAM

16 July, 1981

Only economists

MT

bcc: Caroline Stephens

15 July 1981

MR INGHAM

cc Mr Whitmore
Mr Lankester
Mr Wolfson
Mr Gow
Mr Vereker
Mr Walters

POSSIBLE PRIME MINISTERIAL SPEECH BEFORE THE RECESS

I have read John Vereker's note of 14 July.

I very much agree with his general argument for a tour d'horizon economique, putting into their proper context the economic strategy, our policy response to unemployment, and the trade union role in alleviating unemployment.

Can I, however, suggest that we should instead think of a Ministerial broadcast by the Prime Minister in early September when the evenings are dark, people are back from their holidays, and they want to know what's going on now they are back.

My reasons for suggesting this are as follows:

(1) The work load on the Prime Minister and the queue of unfinished Cabinet/Committee business is now immense and it will not be possible, I would judge, for her to devote enough time to a major speech between now and, say, mid-August, without a heavy cost in other areas.

(2) I believe that speeches are not particularly cost-effective anyway. The press coverage is often surprisingly small (except for set piece "calendar" occasions like the Conference Speech) and the TV coverage is usually "stereotype-selective" - in other words, short and predictable clips with a "Lady's not for turning" flavour, which are of no real interest to the public.

(3) The policy response John Vereker outlines should itself provide the positive note on which to go into the Recess, especially the appointment of the Inner City Supremo. The present press coverage of law and order measures must also be beginning to compensate for the rather shaky Government image of the past week.

The suggestion of early briefing meetings between Ministers and journalists/interviewers, to get the latter to challenge trade union leaders on unemployment, seems a good one.

For similar reasons, I would have thought that the Griffiths/Walters economic speech during the Recess is not a good idea. And it could also end up looking rather defensive. As John Vereker says, the first thing to settle is the timing. I believe that when people come back from their holidays is a much better time than when they are all, at least in their minds, loading up the car; and the Ministers are scrambling to get through unfinished business.

JH

JOHN HOSKYNS

CONFIDENTIAL

NL: Clive

I will be discussing this with Bernard etc, hopefully later today. TL 15/7

cc: ~~Mr. Lankester~~
Mr. Walters
Mr. Duguid
Mr. Gaffin

MR. INGHAM

Possible Prime Ministerial Speech before the Recess

After your meeting this morning, I agreed to let you have some thoughts about the need for a possible speech before or at the beginning of the recess, in the light of our discussion about the need to relate the economic strategy in a more convincing way to unemployment and the recent civil disturbances.

Coincidentally, Tim Lankester reported to us at lunchtime today that the Prime Minister had been discussing this morning with Brian Griffiths and Alan Walters the need for a major economic speech during the recess, with the particular objective of reaffirming the intellectual case for the strategy in the face of the continuing lack of evidence of its success. The Prime Minister is apparently keen to have this speech in the holiday season, when interest in current affairs is otherwise minimal, but I feel that it should be more closely related to current events and should be made at a time when there is likely to be a more receptive audience - which would also pick up the point you have made to Francis Pym about the need to enter the recess on a positive note. So, if there is to be a speech, the first point to settle is the timing.

As for the content it seems to me inevitable that it cannot be a purely economic defence of the current strategy, and must stray over into the Government's policy in response to unemployment, with the 3 million mark probably just passed, and the riots, even though we may hope they will have died down by then. And I think that it would be wrong to see such a speech purely in isolation. We ought surely to be aiming for a three stage approach to our current problems:

i) An agreed analysis of what is wrong: this would cover the causes of unemployment, particularly among young people,

/ as well as

CONFIDENTIAL

as well as the causes of the riots, which is simply a question of finding the right words for a mixture of compassion, law and order, race relations and unemployment.

ii) A policy response, which we may hope will be brought forward in the next week or two, covering E's decision on the unemployment package, the appointment of the Inner City Supremo, the outcome of the 23 July economic strategy discussion, and our law and order measures.

iii) At that point we should be in a position to put together a coherent presentation of policies, which ought to contain a number of ingredients:

a) Certainly a keynote speech by the Prime Minister would be of enormous help;

b) And we ought to arrange for other Ministers to speak in similar vein, which would be hard if not impossible if this is done during the recess; and

c) I think there is a strong case for following up the ideas in Keith Joseph's minute to the Prime Minister dated 13 July, of which you have a copy, and particularly a series of small briefing meetings between Ministers and journalists and interviewers, with a view to encouraging the latter to take a much more aggressive line with trade union leaders on trade union policies which restrict employment opportunities.

I think we ought to have an early discussion within the office with a view to putting these ideas into a suitable shape for the Prime Minister.

J. M. M. VEREKER

14 July 1981

1

10 DOWNING STREET

Prime Minister

Sir Keith's proposal in para 7 fits in closely with your thinking as expressed to Alan Walters and Brian Griffiths.

Shall I say you agree?

Yes m[illegible]

[illegible]

12/7

JU367

.OCC

RESTRICTED

Prime Minister

I imagine Sir Keith may raise this at E: he wants a renewed effort to establish better an understanding of the connection between jobs and competitiveness.

TL

13/7

Mr Ingham
Mr Vereker
Mr Hoskyns

PRIME MINISTER

Parallel to our consideration of the proposals to reduce unemployment, may we also consider a renewed effort to explain to the country where new real jobs come from and how people can co-operate to accelerate the process?

2 We are all saying time and again the same thing - investment and expansion depend upon profit; profit depends upon competitiveness; and competitiveness depends upon good management, co-operative, adaptable workforces and keeping unit labour costs low. We all stress that competitive unit labour costs do not mean low earnings because they can be achieved by rising productivy.

3 Most people probably still do not see how to turn these perceptions into new jobs. The assumption is still that money from the taxpayer - regardless of the jobs destroyed in raising it - is the panacea.

4 We need to convey to people not only that jobs now endangered could by saved by changes in work practices but also that many projects actual or potential now aborted because of assumptions

RESTRICTED

about high unit labour costs and work attitudes might be implemented if work groups and trades unions undertook to offer sustained high productivity.

5 When there is a NISSAN in the offing, offers of co-operation are commonplace. There are some less dramatic projects now going ahead on the basis of such undertakings. But if we could increase the awareness of this approach we would remove barriers to expansion and investment in many fields.

6 While I believe that speeches explaining this thesis are essential and might be useful, I think that we should try to persuade business representatives and leader writers and interviewers of the analysis in the hope that union leaders and politicians who put the responsibility for reducing unemployment only on the Government might much more often than now be met by shrewder questioning.

7 What I am suggesting would involve a series of very small meetings between Ministers and individual business representatives, journalists and interviewers.

8 I am copying to the members of E Committee, the Chancellor of the Duchy, Mr Ibbs and Sir Robert Armstrong.

for K J

Department of Industry 13 July 1981

CONFIDENTIAL

Prime Minister 2

✓ Walters

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000

TL

9th July 1981

9/7

T P Lankester Esq.
10 Downing Street
LONDON
SW1

MO

Dear Tim,

MONTHLY NOTE TO THE PRIME MINISTER ON THE CENTRAL GOVERNMENT BORROWING REQUIREMENT

.... I am enclosing this month's note for the Prime Minister. The main points are summarised on the first page.

The borrowing requirement in June was high - £2,240 million - because of the effect of the civil service dispute. We have already implied in a written answer a strike effect in June of around £1 billion, so commentators will be expecting a high figure for the CGBR.

The note gives "underlying" forecasts of the CGBR to the end of September which exclude effects of the strike. The note I sent you on 3 July gave estimates of the path of strike effects.

Yours

John

A.J. WIGGINS
Private Secretary

MONTHLY NOTE ON THE CENTRAL GOVERNMENT BORROWING REQUIREMENT

Outturn for June 1981 and Forecast to end-September 1981

Summary

- the provisional estimate of the CGBR in June is £2,240 million, including the effects of the strike.

- about £1-1¼ billion reflects delays in tax and national insurance collected. Apart from this, the CGBR would have been about £1 billion, £¼ billion better than forecast a month ago, again mainly because of lower lending to the rest of the public sector.

- the cumulative CGBR to the end of June is estimated at £7,371 million.

- for the six months to end-September the underlying CGBR (excluding effects of the strike) is forecast to be around £7 billion, a little better than last year. The actual CGBR will be considerably higher even if the strike ends quickly.

CGBR IN JUNE

1. The provisional estimate of the CGBR in June is £2,240 million and the cumulative total since 1 April is £7,371 million. The figures will be published on Thursday 9 July.

2. It is estimated that £1-1¼ billion of tax and national insurance receipts were delayed by the civil service dispute in June. Apart from this, the outturn in June would have been around £1 billion, that is, £¼ billion better than forecast a month ago. As last month, lower net lending to local authorities and public corporations accounted for most of the difference.

3. Table 1, attached, presents a detailed comparison of the forecast and outturn for June. The presentation below explains the principal differences, distinguishing between effects of the strike and other factors.

Outturn: June

	Effect on CGBR (- means adverse) £ million
Strike effects on revenue	
Inland Revenue taxes (mainly PAYE) National Insurance Contributions (Included in 'Other funds and accounts' in table 1) National Insurance surcharge (Included in Consolidated Fund "other" receipts in table 1)	-900 (approx)
Customs and Excise taxes (net of blocked VAT refunds)	-200 to -300
	-1,100 to -1,200
Other strike effects (net)	
Payments not made (+), some civil service wages not paid (+), additional interest (-)	0 to +25

Other factors

timing effect of receipts from purchases of certificates of tax deposits (1)	+120
Other Customs and Excise receipts	-20 to -120
Lower net lending (to local authorities	+110
(to public corporations	+ 70
	+180 to +280
Net effect on CGBR	-920

(1) this will be offset in July.

Strike effects in June

4. Getting on for £1 billion of Inland Revenue receipts were delayed by the strike during June. Perhaps three-quarters of revenue due was banked, helped by some catching-up on the back-log.

5. Customs and Excise net receipts in June were not as good as for the previous strike-affected months. The shortfall due to the strike is thought to have been around £¼ billion. Computer-produced returns for the quarter beginning in June had not been sent out to traders. A manual operation - such as Customs have had for the largest VAT payers since the strike began - is now functioning to cover the next to largest, but it was too early to see its benefits in June.

6. Other effects were small compared with the revenue delayed. Selective action at the MAFF/IBAP computer centre is still thought to be delaying payments of about £17 million a week; and there was a small saving in wages not paid to striking civil servants. Partly reducing these two advantageous effects on the CGBR was the interest on additional borrowing. The net effect on social security payments was thought to be negligible in June. The reduced ability of DHSS and the Department of Employment to check records and establish entitlement must be leading to increased expenditure (an irrecoverable cost) through fraud and abuse but some benefits are temporarily being paid at only the minimum rate, thereby reducing expenditure. The effect of industrial action at the Paymaster General's Office (on the payment of public pensions) is not thought to have been significant by the end of June.

Strike effects to date

7. Our best estimate of the cumulative backlog of revenue since the strike began is £4 to £4½ billion, given in reply to a written Parliamentary Question on 3 July (Mr Sheldon (La.) - Ashton-under-Lyne). Still over three-quarters of the revenue believed due since the start of the strike has been paid in. The civil service unions' estimate of £6½ billion delayed revenue ignores the non-payment of VAT refunds. Apart from this their figure is not very different from ours.

8. Interest payable on the additional borrowing caused by the strike amounted to an estimated £70-80 million up to the end of June (also quoted in the answer to Mr Sheldon's Question). This is a permanent cost against which can be offset the small saving in wages not paid to striking civil servants (about £15 million to date with the tax loss netted off).

Other effects in June

9. We continue to be without much of the usual detail because of the strike.

10. Customs and Excise duties were lower than forecast, mainly because distributors are still running down the very high level of stocks of dutiable goods built up before the Budget.

11. Net lending to local authorities and public corporations in June was nearly £200 million below forecast. Local authorities may have been borrowing in the market while short-term rates were good. The lower lending to public corporations is mainly due to short-term fluctuations in net lending to the National Coal Board.

FORECAST FOR THE NEXT THREE MONTHS

12. Forecasts for July, August and September presented in Table 2 do not take account of the strike and will serve mainly as a base against which to measure the strike effects. Apart from this, the forecasts are consistent with the latest short-term economic forecast, which point to an underlying CGBR slightly less than forecast in the FSBR, mainly because of higher tax receipts.

13. Net lending to local authorities is forecast to remain at a fairly low level, though increasing in September. It could be as late as November before we get a clear idea of whether the total for the year is likely to be lower than forecast at present.

14. Table 3 shows the outturn/forecast month by month and cumulatively to the end of September compared with last year's outturn. The underlying 'strike-free' forecast to the end of September would bring the cumulative CGBR to between £6.7 and 7.1 billion, a little less than last year. The low figure in September is helped by the very large oil tax receipts due that month: these are the first half-yearly payment of Petroleum Revenue Tax and the first half of the new Supplementary Petroleum Duty for the year (the rest will then be paid monthly).

15. The likely future strike effects were discussed in the paper to the Prime Minister of 3 July on the financial effects of the civil service dispute, taking a basic assumption that the strike would end at the end of July. Since then, the Inland Revenue Staff Federation has announced its aim of halting receipts of other Inland Revenue taxes in addition to PAYE. We estimate that this action could delay a further £½ billion or so in July. This will be partly offset by non-payment of public sector pensions as a result of the strike at the Paymaster General's Office. Payments usually total over £100 million a month, but not all these will be halted.

16. The CGBR to the end of September will be considerably greater than the 'strike-free' forecast even if the strike ends very quickly.

CONFIDENTIAL

TABLE 1

CENTRAL GOVERNMENT BORROWING REQUIREMENT - JUNE

	Forecast (excluding strike effects)	Outturn (including strike effects)	Difference on CGBR
			£ million
RECEIPTS			
Consolidated Fund			
Inland Revenue	2,300	2,081 [1]	-219
Customs and Excise	1,840	1,519	-321
Other	820	314	-506
National Loans Fund			
Interest, etc receipts	270	292	+ 22
Total receipts	5,230	4,206	-1,024
EXPENDITURE			
Supply services and Contingencies Fund	5,600	5,549	+ 51
Other	270	274	- 4
National Loans Fund			
Service of the national debt	450	399	+ 51
Net Lending	230	65	+165
Total expenditure	6,550	6,287	+261
Other funds and accounts	-	-159	-159
CGBR	-1,320	-2,240	-920
of which: estimated strike effect	-	-1,100 to -1,200	-1, 00 to -1,200
: excluding strike effect (say)	-1,320	-1,040 to -1,140	+ 180 to + 280

[1] Includes £120 million from purchases of certificates of tax deposits, which will be offset in July.

CONFIDENTIAL

TABLE 2

CENTRAL GOVERNMENT BORROWING REQUIREMENT

	Latest Forecast (excluding effect of strike)		
	July	August	September
RECEIPTS			
Consolidated Fund			
Inland Revenue	3,470	2,350	4,400
Customs and Excise	2,600	1,880	1,850
Other	830	650	730
National Loans Fund			
Interest etc, receipts	140	300	770
Total receipts	7,040	5,180	7,750
EXPENDITURE			
Consolidated Fund			
Supply services	5,800	5,900	6,200
Other	320	440	320
National Loans Fund			
Service of the national debt	1,440	770	1,200
Net Lending	300	430	750
Total expenditure	7,860	7,540	8,470
Other funds and accounts	-	+450	+370
CGBR excluding strike effect	-820	-1,910	-350

CONFIDENTIAL

TABLE 3

CENTRAL GOVERNMENT BORROWING REQUIREMENT

	1980-81		1981-82			
			Outturn/Forecast excluding estimated strike effect		Outturn including strike effect	
	In Month	Cumulative	In Month	Cumulative	In Month	Cumulative
April	0.9	0.9	1.0-1.2	1.0-1.2	2.4	2.4
May	2.4	3.3	1.6-1.7	2.6-2.9	2.7	5.1
June	1.3	4.6	1.0-1.1	3.6-4.0	2.2	7.4
July	0.8	5.4	(0.8)	(4.4-4.8)		
August	1.6	7.0	(1.9)	(6.3-6.7)		
September	0.8	7.9	(0.4)	(6.7-7.1)		
October	0.2	8.0				
November	2.8	10.9				
December	2.2	13.1				
January	-1.7	11.4				
February	0.7	12.0				
March	0.9	12.9				

Notes: - Forecast for 1981-82 in Financial Statement and Budget Report is £11,497 million.

.. Some rows may not add across because of rounding.

Prime Minister 4

10 DOWNING STREET

9 July 1981

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
LONDON SW1

TL 10/7

Dear Geoffrey

I had hoped to come back to you sooner with some further thoughts about the pay round debate. Unfortunately I have been a bit tied up on other things.

I was about to drop you a line, however, on one particular possibility. This is that we should try - implicitly and subtly, not very obviously - to link in people's minds the moral similarity between high pay claims demanded with menaces and other forms of anti-social behaviour, including rioting and looting.

As so often happens, a cartoonist has made the connection* already and the attached makes the point for us. This means that we can perhaps be gradually more explicit in linking the two.

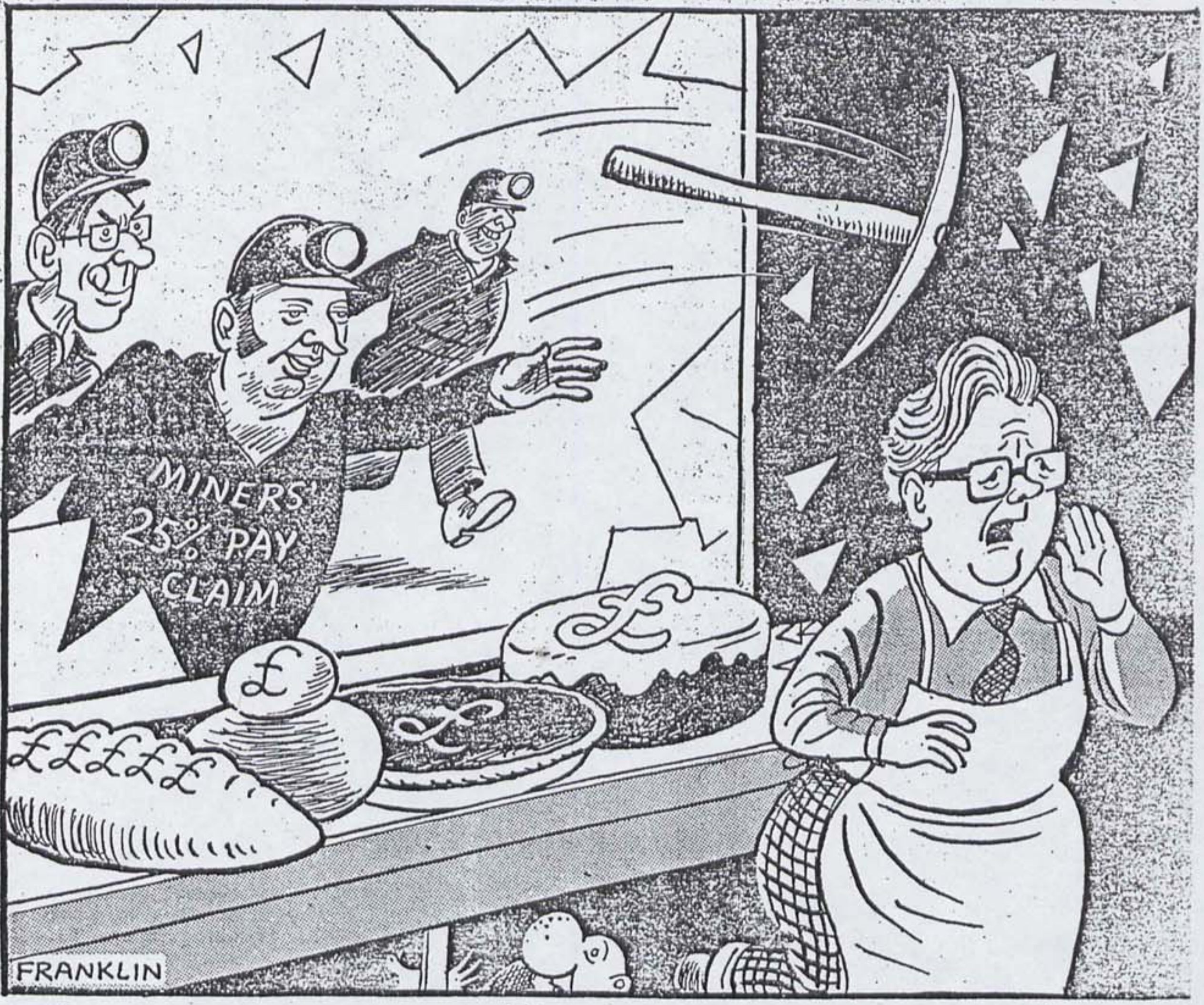
There is another associated point to make. If we are to spend anything more on training and extension of youth employment special measures, we can only do so to the extent that organised labour - especially in the monopoly nationalised industries and the public services - do not pre-empt those resources. So we should say, as and when we are ready to say anything about spending to help youth employment (and of course I am not talking about the very large sums that have recently been mooted) that the more the miners or the railwaymen etc get, for their members who are in jobs, the less the Government can spend - and it's got little enough to play with as it is - on helping the young who have not yet got jobs.

I am copying this letter to the Prime Minister.

Yours ever
John

JOHN HOSKYNS

* What Norman calls a "thematic bridge" to make people see something in an emotionally different way.



"MAGGIE! THEY'RE ON THE RAMPAGE AGAIN!"

IF I were a black community leader, I would

Why the

Britain, announced that, in London, Liverpool and Glasgow, home-content premiums would be

Mr. Whitmore

10 DOWNING STREET

From the Press Secretary

CHANCELLOR OF THE DUCHY

cc. Mr. Whitmore

Presentation

I held a meeting yesterday with a number of Heads of Information of the Economic Departments to consider presentation over the next few months. The consensus can be summarised in two words: deeply worried.

July is always the most dangerous month politically. Historically, it is the month of crisis measures (and I am repeatedly asked by the press whether they should expect a mini-Budget or re-shuffle). But this time the dangers are compounded by:

- the riots in Southall, Toxteth, Wood Green, Moss Side (and where next?), all of which apply pressure to the Government's economic policies and detract from the Government's good law and order reputation;

- the Warrington by-election where the Conservative candidate could well lose his deposit (which is perhaps rather better from the Government's point of view than SDP winning; by the same token, an SDP win and a Tory lost deposit would be appalling);

- the possibility of a stagnant or, at worst, slight increase in the Index of Retail Prices;

- the certainty of much worse unemployment figures, and very much worse youth unemployment - even if this month's count is not statistically reliable;

/- the risk

- the risk, putting it at its lowest, of a rail/tube/London bus strike coming on top of continuing ambulance/Civil Service strikes;

- the threat that what the Royal Wedding will bring to unrelieved gloom will be reduced by industrial action and the national atmosphere soured;

- the Government side will be propelled into the Recess in a state of profound agitation, depression and gloom instead of, as it should be, sent away to recuperate on the upbeat, as a consequence of which good news - e.g. evidence of real economic recovery - may be swamped.

The Government's presentation/morale problems are clearly serious and I think you should consider having, at an early stage, an initial meeting with us in No. 10, perhaps followed by a discussion with Heads of Information of Treasury, Employment, Industry, Energy and DHSS. Its objective would be to consider the immediate way ahead and how we might enter the Recess on the most positive note. If you agree, I will provide a paper.

B. INGHAM

8 July, 1981

Econ Pol

Ref: A05193

CONFIDENTIAL

PRIME MINISTER

Pay in the Coming Year
(E(81) 66)

BACKGROUND

This paper was part of the background for the general economic discussion at Cabinet on 17th June, but was not separately discussed then. At that meeting the Cabinet instructed the CPRS to examine what action should be taken to achieve the Government's objectives for pay settlements in the public and private sectors. Their report is likely to be available to Ministers when they return from the summer holidays. There is no necessary contradiction between the Chancellor's present paper and the study commissioned from the CPRS but, apart from coming to a view on the Chancellor's procedural conclusions, E Committee may like to use the present occasion for a general discussion on pay matters which the CPRS can take into account in their further work.

Objective

2. On the Chancellor's paper as such there is likely to be no argument about his broad conclusion that lower pay settlements in the next round are a highly desirable objective. The issues are those of tactics and procedure.

Tactics
Procedure

3. Some of your colleagues may argue that, however desirable, the Chancellor's objective of settlements in the next pay round "in low single figures" is unrealistic. Employees will be feeling the pinch from the cut in real wages this year, the recession will be bottoming out and (with the fall in the exchange rate) inflationary pressures may be higher than earlier expected. Moreover, the miners' settlement this year comes near the beginning of the pay round and, coupled with a high settlement for the police (if the present indexing arrangements are not changed), is likely to get the pay bargaining season off to a bad start. This year's relatively low settlements in the public services may store up trouble for next year, when large numbers of employees in the local authorities, the National Health Service and the Civil Service, will be trying to "catch up". None of this means that it is wrong to try to achieve the Chancellor's objective: it must mean that the task will get progressively harder.

CONFIDENTIAL

4. On tactics it is clearly right to try to talk down expectations. But the pressures may be more acute than this year, especially in the public sector. Tough cash limits may be in order for local authorities where the strain can be taken by the rates and further cuts in services (and where arbitration is available to the unions). But the Civil Service unions will be banking on the Government's promise to enter into negotiations with them in 1982 without predetermined cash limits; and the nurses may well be seeking to cash in on the more generalised promises they have been given about not falling behind.

5. As to procedure the Chancellor makes two suggestions - that there should be a plan for handling public service pay negotiations in the next round, including the timing and nature of statements about cash limits, to be handled by the Ministerial Sub-Committee on Public Service Pay (E(PSP)) which he chairs; and that there should be a review by officials of the prospects for pay settlements in the nationalised industries and the means available for implementing them. The Chancellor suggests that this last task might be carried out by the existing Official Committee on Nationalised Industry Policy (NIP) which meets under Treasury chairmanship. The first proposal is acceptable as a means of getting the work done, though you would no doubt wish the Chancellor's Committee to report to E before decisions are taken. The second suggestion is consistent with your earlier view that nationalised industry pay matters should not be dealt with in the Chancellor's Committee (E(PSP) (or in its supporting Official Committee - PSP(O)) in order to avoid the appearance of establishing a public sector pay policy. But it is untidy to have two Official Committees operating in the same general area - PSP(O) for the public services and NIP for the nationalised industries - and it is for consideration whether nationalised industry pay matters should after all be brought within the remit of the Chancellor's Committee - E(PSP). However this matter is handled, you will want this work also to be reported to E before decisions are taken.

HANDLING

6. You will want to remind colleagues at the outset that the CPRS study is now under way and is likely to be available in September. The discussion might therefore most fruitfully be regarded as a first 'tour d'horizon' with

definitive discussion reserved until after the Recess - when it could perhaps usefully be combined with consideration of any further work commissioned by the present meeting. You might then invite the Chancellor of the Exchequer to speak to his paper, followed by the Secretary of State for Employment, the Lord President of the Council and other colleagues at will. You may also want to ask Mr. Ibbs about how he sees the CPRS study group (he recently sent you a minute on this).

7. In addition you could use the occasion to hear progress reports on the Civil Service dispute from both the Lord President and the Chancellor, though it would be as well to separate this out from the general discussion.

CONCLUSIONS

8. Subject to discussion, the only necessary conclusion may be to ask the Committee to note that you will be considering further whether, and if so how, reports should be prepared on pay in the public services and the nationalised industries for consideration by colleagues after the summer break. The Committee may also want to give a general blessing to the Chancellor's proposal that a publicity campaign should be prepared and put in hand. If so, he might be invited to co-ordinate this work with the Chancellor of the Duchy of Lancaster.

RA

Robert Armstrong

C.P.S.A.
I.R.

- L. Pres -

Home Sec.

L-S P.

D.E. ✓ -
Ind ✓
Soc Serv.

Avg. - cash. -
Productivity.

1st July, 1981

Scottish Sec. ← Tactics →

Explanation

CONFIDENTIAL

PRIME MINISTER

E, 2 JULY: THE NEXT PAY ROUND

The Chancellor's paper, E(81)66, does not seek decisions; but it poses a question - can we halve the increase in earnings, to an average of less than 5%? - and suggests a programme of action, of which the principle elements are the conditioning of public opinion and working out how to handle public sector pay negotiations.

Many of the factors which will determine the outcome of the next pay round are outside the immediate control of Government. These include the movement of prices, the demand for labour, and company profitability. The factors over which the Government does have some control can conveniently be put into three categories:

(i) The relative bargaining power of employers vis-a-vis employees.
The CPRS have already outlined the aspects of this they propose to examine. The answer to the Chancellor's question is yes: since we have to get pay rises down in order to restore competitiveness and increase employment, we have asked the CPRS what is to stop us doing it. (Not all of the things the CPRS will look at, e.g. trade union reform, need to wait until the report before action can be taken).

(ii) The treatment of specific issues.
Attitudes are determined by what the Government does, not by what it says. The right decisions on, say, the Civil Service dispute are worth a dozen Ministerial speeches.

/ Other

CONFIDENTIAL

Other issues on which decisions were and will be crucial to the next pay round include: whether to allow local authority white collar workers access to arbitration; whether to continue index linking for the police and, later, the firemen; what pay assumption to build into the RSG; what pay factor to build into cash limits; and how to influence the balance between wages and investment in the nationalised industries.

(iii) Publicity.

Bernard Ingham has already pointed out, in his note of 16 June, that the Chancellor's paper attaches too much weight to the likely effectiveness of public presentation in determining attitudes. And it overlooks the extent to which recent speeches and statements by you, the Chancellor and Terence Beckett have already brought the concept of low single figures into circulation. This has already been interpreted, with some justification, as an incomes policy by exhortation; further publicity must concentrate on explanation, with the arguments put in terms of individual self-interest, rather than exhortation to sacrifice self interest for the sake of some vague greater good (the Chancellor's concept of the "national cash limit" is particularly unhelpful in this context, as was Terence Beckett's saying what pay rises ought to be, rather than what his members could afford.)

Explanation

/ No doubt

No doubt Ministers in E will want to have a general discussion of the prospects for the next pay round. But rather than simply endorse the Chancellor's paper, it would be useful to conclude that:

(i) the prospects should be examined again very early in the autumn in the light of the CPRS report;

(ii) more weight should be carried by policy decisions in the public sector, and less by publicity; and

(iii) the importance of getting pay settlements below 5% is so high that the whole economic strategy would be at risk if the obstacles identified by the CPRS, and forthcoming public sector policy decisions, are not dealt with in the right way.

J.

1 July 1981

Econ Pol

10 DOWNING STREET

From the Principal Private Secretary

MR WRIGHT

CABINET MEETINGS ON PUBLIC EXPENDITURE

Thank you for your minute A05187 of 1 July 1981 about Cabinet meetings over the next six months on public expenditure and related matters.

I am quite content for you to write as you propose.

CAW

1 July 1981

10 DOWNING STREET

Mr Whitmore

all checked &

O.K.

C.S.

1/7.

CW

I take it it is all right not to grade this.

Yes.

CONFIDENTIAL

Ref. A05187

MR. WHITMORE

Cabinet Meetings on Public Expenditure

Sir Robert Armstrong minuted you on 21st May about the public expenditure timetable to Christmas 1981. You subsequently wrote to the Private Secretaries to members of the Cabinet revising the dates in September which they needed to keep clear for Cabinet meetings but without specifying that two of the September dates would be devoted to public expenditure questions.

2. The Treasury have now suggested that since we are only three weeks away from the first public expenditure Cabinet, on 23rd July, it might be advisable to warn Cabinet Ministers of the intended public expenditure programme for Cabinet between now and the autumn. This would have two advantages. In the first place it would ensure that any Ministers who are considering taking on commitments which might cause them to be absent from public expenditure Cabinets could take the programme into account in making their plans. Secondly, it would help the Treasury in their discussions with Departments if both sides were clear as to the precise dates to which they are working. Provided you agree, therefore, I would propose to send the attached letter to Private Secretaries to Cabinet Ministers. Sir Robert Armstrong has seen and agreed it.

D.J. Wright

D.J. WRIGHT

1st July, 1981

CONFIDENTIAL

CONFIDENTIAL

DRAFT PRIVATE SECRETARY LETTER

PS(81)

Cabinet Meetings on Public Expenditure and Related Matters

In planning your Ministers' programmes over the summer and early autumn, you will wish to bear in mind that a number of the meetings of Cabinet during this period will be devoted to public expenditure questions. On present plans the Treasury expects the programme to be as follows:-

Thursday, 23rd July

Preliminary discussion of public expenditure for 1982-83 onwards.

Preliminary guidance to local authorities for 1982-83.

Tuesday, 15th September

Review and final decision on inflation factors.

Final decisions on totals for local authority services in 1982-83.

Thursday, 24th September

Final decisions on local authority expenditure in 1982-83 (if it has not been possible to complete the discussion of this on 15th September).

Tuesday, 20th October

Further review of economic strategy.

Specific public expenditure proposals from Treasury Ministers covering all programmes from 1982-83 onwards.

CONFIDENTIAL

CONFIDENTIAL

Late October to mid-November

Final decisions on detailed public expenditure plans for 1982-83.

Final decisions on RSG for 1982-83.

I should be grateful if you could ensure that the confidentiality of this programme of discussions is scrupulously observed and that the only officials to be informed of it are those responsible for discussing Departments' expenditure plans with the Treasury.

I am sending copies of this letter to the Private Secretaries to members of the Cabinet and the Chief Whip.

CONFIDENTIAL

Econ Pol Strategy

29 June 1981

MR LANKESTER

Could I see a copy of the paper Robin Ibbs proposed to put round for the Cabinet Economic Strategy discussion?

JOHN HOSKYNS

(The paper was not circulated in the event)

CF

file pls.

TL

CONFIDENTIAL

bc Mr Hoskyns ✓

Econ Pol Strategy

#10

10 DOWNING STREET

From the Private Secretary

26 June 1981

MISC 14

The Cabinet on 17 June took note that the Prime Minister would arrange for the Ministers concerned to consider ways of further reducing the hindrances to employment identified in their discussion and in the Chancellor of the Exchequer's memorandum C(81)29.

The Prime Minister would like the Chancellor of the Exchequer to take the lead in this further work, and she suggests that he might use his Steering Group on Government Strategy (MISC 14) for this purpose. The main task of MISC 14 will be to ensure that the necessary work is put in hand and pursued urgently; when Ministers have specific proposals, requiring operational decisions, they should be put directly to the appropriate Ministerial committee for decision. The Prime Minister would like the Chancellor of the Exchequer to report to her before the Summer Recess on progress in following up the Cabinet's remit.

The Prime Minister understands that the Secretary of State for Employment is frequently invited to meetings at MISC 14. In view of his strong departmental interest in the work of the group, she would like him to attend, with the Secretaries of State for Industry and for the Environment, on a regular basis. The Chancellor of the Exchequer will no doubt continue to invite other Ministers to meetings of the group as necessary.

I am sending copies of this letter to the Private Secretaries to the Secretaries of State for Industry, Employment and the Environment; for information, to the Private Secretaries of other Members of the Cabinet; and to Robin Ibbs and Sir Robert Armstrong.

TPL

A.J. Wiggins, Esq.,
HM Treasury.

CONFIDENTIAL

File

c. MR. WHITMORE
MR. WOLFSON

Econ Strategy

10 DOWNING STREET

BF 24/7

MR. GOW

I have changed the strategy meeting from Friday, 24 July to Saturday 25 July. The meeting will start at 1030 as both the Home Secretary and the Chancellor want to get away after lunch.

CAROLINE STEPHENS

26 June 1981

1

Tell Ian

PRIME MINISTER

As you know, David Wolfson asked me to set up a meeting to discuss strategy with the Chairman, Chancellor, Home Secretary, Chief Whip, John Hoskyns and Alan Howarth. This is to be at 1030 hours on Friday 24 July for 1 hour.

The Chairman, who has spoken to Ian Gow does not consider this sufficient time and wonders whether you would agree to the meeting taking place on the following day, Saturday 25 July, at Chequers. You are due to go to Glyndebourne on the Sunday and it is the weekend preceding the Royal Wedding.

Yes
MT

Can you let me know if in principle you agree to this idea? I do not yet know whether it would suit the Chancellor, the Home Secretary or the Chief Whip.

DS.

25 June 1981

SP

CONFIDENTIAL

Prime Minister
To glance

PRIME MINISTER

PAY BRIEF

I attach my Department's pay brief for June. I am sending copies to members of E, E(PSP), and E(EA) Committees, and to Sir Robert Armstrong.

26/6

J P

23 June 1981

PAY BRIEF - POSITION IN MID-JUNE

SETTLEMENTS

1. Since the May pay brief 85 settlements covering 885,000 employees have been reported. The weighted average level of settlements over the last month in the private sector was just over 9½%. In the public sector the average was just over 10% (10 settlements covering 379,000 employees).

2. The cumulative average level of settlements for the whole economy this round has remained at about 9% since March.

3. In the private sector the cumulative average is just over 9% (644 settlements covering 3,763,000 employees). In manufacturing, the average level is 9%. The average in non-manufacturing is just under 9½%, but this is heavily influenced by the implementation of a 3% to 6% offer for Motor Vehicle Retail and Repair (370,000) exclusion of which would increase the average for this sector by about 1%. There is a wide range of settlements (see Appendix 4). About ½ of the settlements are below 10%. Recent settlements have tended to be in the 7% to 10% range.

4. In the public sector the cumulative average is 9% (60 settlements covering 3,784,000 employees). The average for the trading sector (40 settlements covering 1,178,000 employees) is just under 10% and for the services sector (20 settlements covering 2,605,000 employees) is just over 8½%. The 6% increase for NHS Doctors and Dentists (87,300) has not yet been accepted by junior hospital doctors and dentists and has been excluded from the statistics.

NEGOTIATIONS

5. In the PUBLIC SECTOR, Civil Service non-industrials (1 April - 562,000) have voted to continue selective industrial action. At a meeting on 5 June Lord Soames refused to improve on the 7% offer. Industrial Civil Servants (1 July - 165,800) were told at a meeting on 15 June that a settlement must be within the 6% pay factor. The claim is for increases in line with inflation plus improvements in holidays and hours. Talks continue on behalf of National Health Service nurses and midwives (1 April - 492,000). At a meeting with the Secretary of State on 10 June the Staff Side were told that there could be no increase in the 6% cash limit pay factor and are consulting members on whether they should negotiate a settlement within the 6%. Unions on behalf of NHS Ambulancemen (1 January - 17,000) have decided on a series of 24 hour periods of industrial action starting on 17 June.

An offer, within the 6% pay factor, of 7.75% on basic rates to last for 15 months plus an extra day's holiday for some staff has been rejected. 6% offers have been rejected by NHS admin and clerical grades (1 April - 121,000) and NHS professions supplementary to medicine (1 April - 25,500). Negotiations for these groups are continuing. Unions are to recommend acceptance of a 7.5% offer for Local Authority non-manuals (1 July - 595,000). Unions representing British Rail clerical and conciliation grades (20 April - 150,000) have rejected an offer of 7% and referred the claim for a substantial increase to the Railway Staff National Tribunal. The findings are expected in early July. An offer of 8% plus a productivity package made in response to a claim for 12.5% increases by London Transport rail supervisory and conciliation grades (20 April - 15,550) is being referred by the unions to their executive committees for consideration. At British Steel (1 January - 140,000) the proposal to defer the settlement for 6 months with a 7% increase from 1 July has been accepted by the craft and general unions but rejected by ISTC. The issue has been referred to the ISTC conference for a decision on future action, but BSC intend to implement the 7% from 1 July in the absence of a fully agreed settlement. Unions are considering an offer to Electricity Supply clericals (1 May - 50,000) of increases in salary ranging from 10.8% (top) to 9% (bottom) plus a 1 hour reduction in the working week.

6. In the PRIVATE SECTOR, Building and Civil Engineering employees (28 June - 450,000) have been made an offer worth 6%. UCATT, the largest union, is recommending acceptance, but the other 3 unions have rejected the offer and are planning industrial action. The claim is for increases over 20%. National negotiations have broken down for Chemical Industries Association process workers (1 May - 50,000) who have rejected an offer of 7.3% in reply to their claim for about 21% on rates. The largest union (GMWU) is to pursue local deals. ICI manuals (1 June - 47,000) are considering an 8.5% 'final' offer. The claim is for a substantial increase and extra holidays. Most of the unions representing Newspaper Publishers Association workers (1 January - 33,000) are recommending acceptance of a 10% offer. The results of ballots are expected by the end of June. Cement Manufacture workers (1 May - 10,800) have been made an offer of 19.4% increase in rates, to be paid in 2 stages, and 1 hour reduction in the working week - to last for 20 months. Process workers are to ballot on the offer and craft unions are to hold a delegate conference on 19 June. Selective industrial action continues. Registered dock workers at the Port of Southampton (1 January - 1,685) are taking industrial action in support of a claim for about 30% on rates following rejection of a 7% offer. RDW's at Liverpool (1 May - 4,051) have rejected a 7.6% offer on a 13%

claim. Intermittent industrial action is being taken. Food Manufacture workers (2 June - 40,000) have submitted a claim for a £65 minimum rate plus an extra day's holiday, worth 11.5%. A meeting has been arranged for 19 June.

PRICES AND EARNINGS INDICES

PRICES

7. In May the year on year increase in retail prices was 11.7% compared with 12.0% in April.

EARNINGS

8. In April the year on year increase in average earnings for the whole economy was 14.0% compared with 14.5% in March.

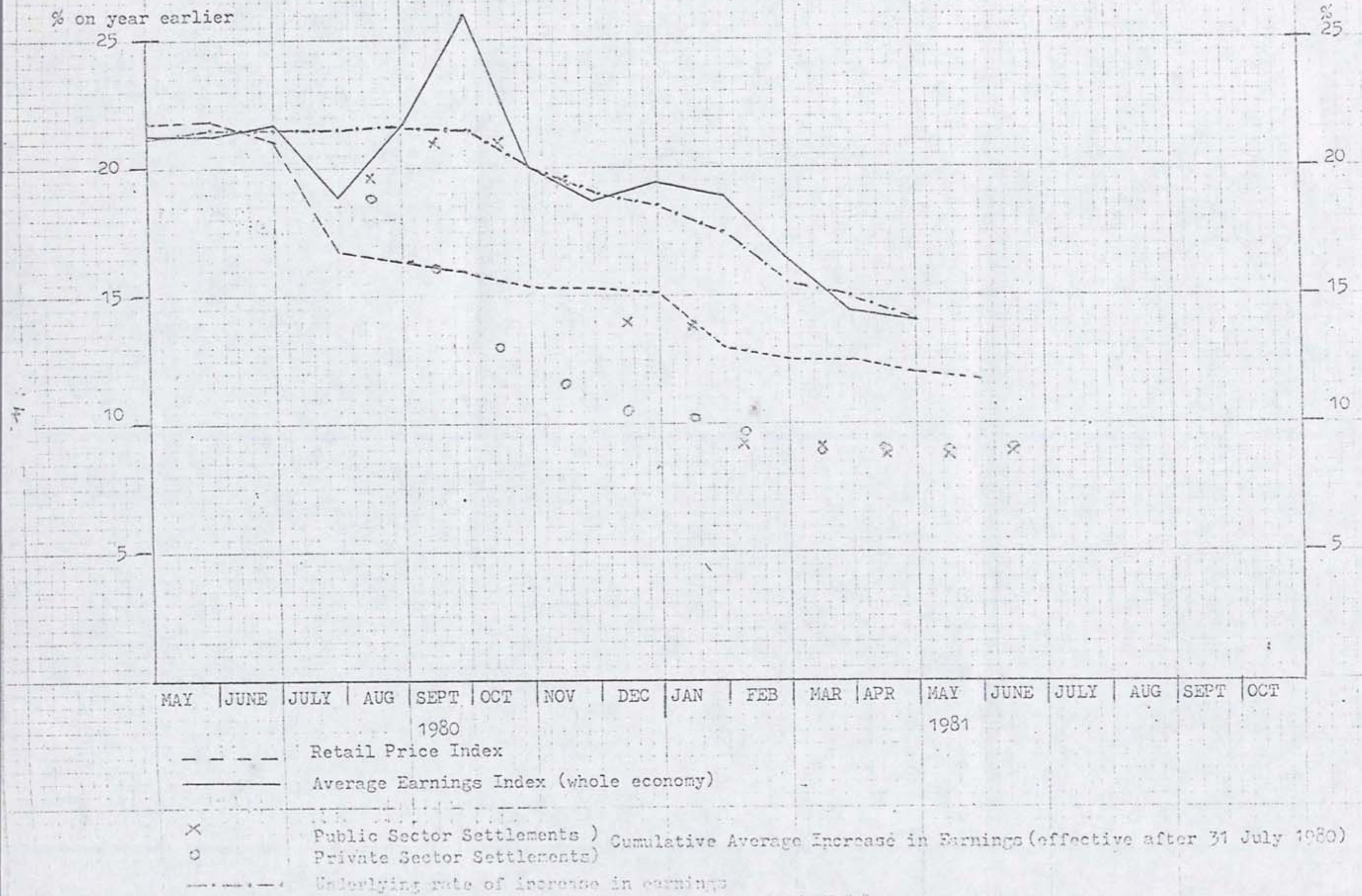
REAL DISPOSABLE INCOME

9. The real disposable income - taking account of the changes in earnings, prices and taxes - of a married man on average adult male earnings with a non-working wife and two children under 11 (with no other tax liabilities or allowances and not contracted out of the State Pension Scheme) rose by about 1½% in the year to March.

CONFIDENTIAL

APPENDIX 1

TRENDS IN EARNINGS AND PRICES



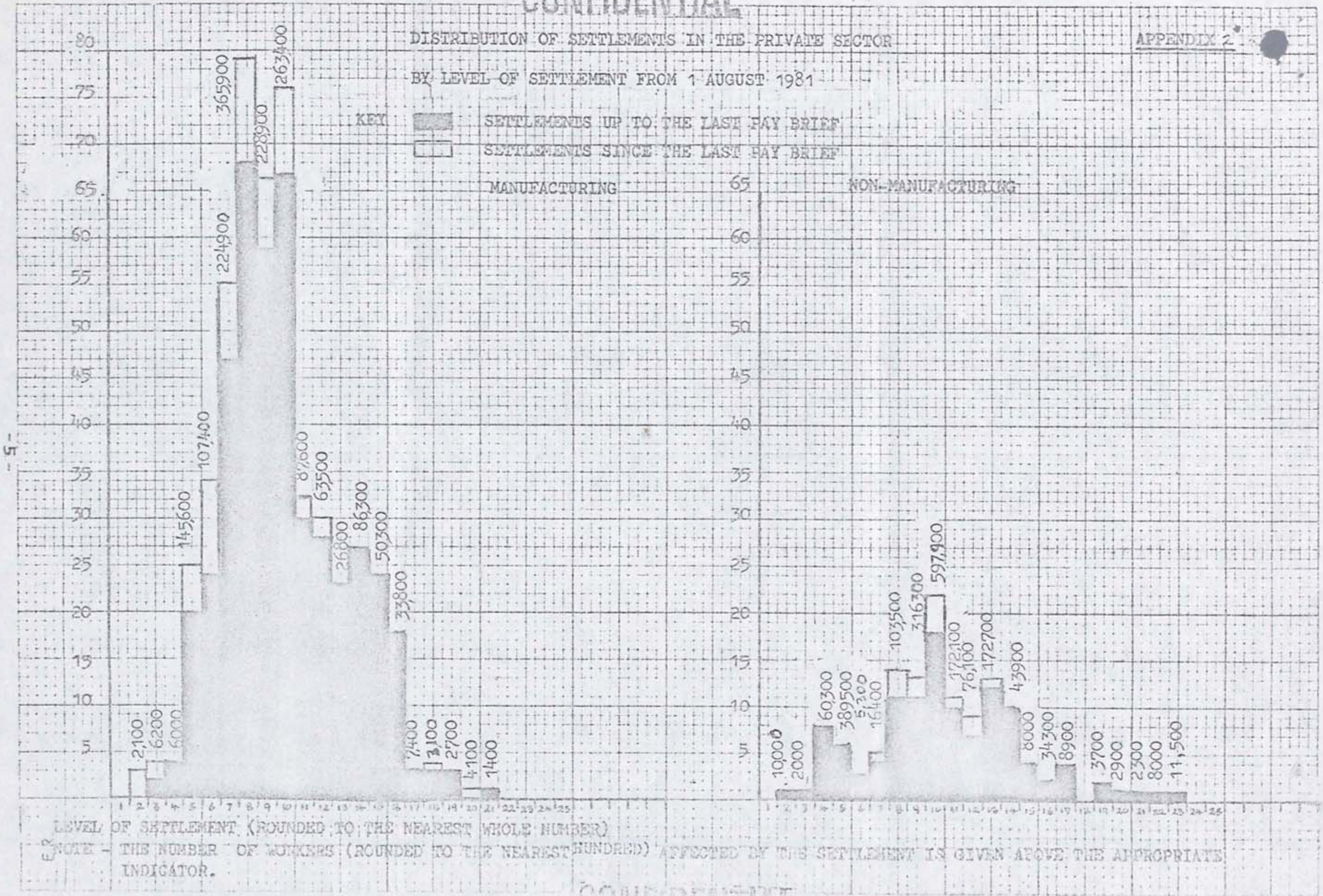
CONFIDENTIAL

CONFIDENTIAL

APPENDIX 2

DISTRIBUTION OF SETTLEMENTS IN THE PRIVATE SECTOR

BY LEVEL OF SETTLEMENT FROM 1 AUGUST 1981



LEVEL OF SETTLEMENT (ROUNDED TO THE NEAREST WHOLE NUMBER)

NOTE - THE NUMBER OF WORKERS (ROUNDED TO THE NEAREST HUNDRED) AFFECTED BY THE SETTLEMENT IS GIVEN ABOVE THE APPROPRIATE INDICATOR.

CONFIDENTIAL

Prime Minister
This seems a sensible way of dealing with this remit. Agree?
TL

1

Ref. A05137

MR LANKESTER

Agreed MT

The Cabinet on 17 June took note that the Prime Minister would arrange for the Ministers concerned to consider ways of further reducing the hindrances to employment identified in their discussion and in the Chancellor of the Echequer's memorandum C(81) 29. (CC(81) 23rd Conclusions, 2(i)).

2. This work might best be carried out by the Chancellor of the Exchequer's Steering Group on Government Strategy (MISC 14). The role of the group might be to chase progress, to stimulate further action to deal with problems on the supply side of the economy, and to ensure that where necessary operational proposals are being put forward to the appropriate committees. The Chancellor of the Exchequer might be asked to report progress on this to the Prime Minister before the Recess.

3. MISC 14 was set up in July 1979 with a very small membership - the Chancellor of the Exchequer, the Secretaries of State for Industry and for the Environment, Mr Hoskyns and the Head of the CPRS (E(79) 6th Meeting, Item 4). The group invites other Ministers to attend as necessary and, inevitably, the Secretary of State for Employment has attended a good number of the meetings. Given that the Secretary of State for Employment has a strong departmental interest in a number of the questions which will come up for future consideration, I suggest that he should be made a full member of the group.

--- 4. These proposals are set out in the attached draft letter. I understand that they will be welcome to the Chancellor of the Exchequer.

D J Wright

D J WRIGHT

23 June 1981

DRAFT LETTER FROM THE PRIME MINISTER'S PRIVATE SECRETARY TO THE PRIVATE SECRETARY TO THE CHANCELLOR OF THE EXCHEQUER

MISC 14

The Cabinet on 17 June took note that the Prime Minister would arrange for the Ministers concerned to consider ways of further reducing the hindrances to employment identified in their discussion and in the Chancellor of the Exchequer's memorandum C(81) 29.

The Prime Minister would like the Chancellor of the Exchequer to take the lead in this further work, and she suggests that he might use his Steering Group on Government Strategy (MISC 14) for this purpose. The main task of MISC 14 will be to ensure that the necessary work is put in hand and pursued urgently; when Ministers have specific proposals, requiring operational decisions, they should be put directly to the appropriate Ministerial committee for decision. The Prime Minister would like the Chancellor of the Exchequer to report to her before the Summer Recess on progress in following up the Cabinet's remit.

The Prime Minister understands that the Secretary of State for Employment is frequently invited to meetings at MISC 14. In view of his strong departmental interest in the work of the group, she would like him to attend, with the Secretaries of State for Industry and for the Environment, on a regular basis. The Chancellor of the Exchequer will no doubt continue to invite other Ministers to meetings of the group as necessary.

I am sending copies of this letter to the Private Secretaries to the Secretaries of State for Industry, Employment and the Environment; for information, to the Private Secretaries of other Members of the Cabinet; and to ~~Mr~~ Ibbs~~, Mr Hoskyn~~s and Robin Sir Robert Armstrong.

Blind cc Hoskyns

Econ Pol
strategy

Econ Pol.

MR. WHITMORE
MR. LANKESTER

I am afraid that in the wee hours this morning there was some confusion about the status of the "conclusion" that I 'phoned in. The Prime Minister had asked me to provide a conclusion for the paper on economic strategy which the Chancellor is giving at the Cabinet on 17 June. Apparently you knew nothing about this and interpreted my "conclusion" as a possible conclusion to the speech. I should have attached a note of explanation, but in those small hours it did not occur to me. I apologise.

16 June 1981

ALAN WALTERS

Mr Lankester

PRIME MINISTER

ECONOMIC STRATEGY BRIEFING

I attach a draft brief for press officers for use after Cabinet tomorrow. It is in two parts:

- a short on-the-record statement; I see no reason to be coy about the Cabinet since everyone knows it is taking place and what its subject is;

- a longer speaking note of useful points to get over, drawn from the papers; it is important we do not miss the opportunity afforded by the Cabinet to mould public opinion.

2. It may be possible, of course, to strengthen the on-the-record summary after the meeting - eg if it is possible to say that the strategy was reaffirmed.

3. The broadcasting media are trying to get Ministers to go on programmes tomorrow after Cabinet. I have told Departments not to respond - and certainly not without clearing with me on your behalf. I take it that you do not want the Cabinet discussion aired on radio or television or in the newspapers after the meeting.

4. Patrick Jenkin, by arrangement, is volunteering himself for the 'Today' programme to deal with the ambulance dispute. I have been in touch with his office and he will deal with wider economic/ pay issues only in general terms.

5. Content?

B. INGHAM

16 June, 1981

<u>DRAFT SPEAKING NOTE FOR PRESS OFFICERS</u>

<u>ECONOMIC CABINET - 17 JUNE, 1981</u>

<u>On-the-Record</u>

The Cabinet met this morning for two hours to review the Government's economic strategy. All members were present.

A similar meeting was held on 3 July last year.

The Cabinet held a wide-ranging discussion on the basis of stocktaking papers submitted by the Chancellor of the Exchequer.

The meeting was not required to take decisions.

The central objective of Government economic policy remains to conquer inflation and keep it under control. This is the only basis on which sustainable growth and genuine jobs can be secured.

Points to get over in background briefing

The Government is trying to treat a long-standing national disease, the symptoms of which are:

- chronic inflation
- low productivity
- lack of competitiveness
- poor management
- progressive devaluation of the currency

It is seeking to achieve sustainable growth by conquering inflation and improving efficiency.

This involves changing attitudes at a time of deep international recession primarily caused by a doubling in oil prices (from \$17-\$34) since General Election.

The British experience has been particularly difficult. This reflects its very serious decline in competitiveness during the 1970s.

Over 10 years, 1970-80, output rose only 16% while money incomes went up 335%. In addition, North Sea oil held up Exchange Rate which would otherwise have fallen with our declining competitiveness.

Our problem is therefore deep-seated.

Inflation has fallen substantially and productivity is up.

But inflation is still far too high. Moreover, fall in value of £ has made problem of containing inflation more difficult.

We must therefore not ease up on elements within our control - our own unit costs and expenditure.

Recession deeper in Britain because we are overmanned, uncompetitive, and we have paid ourselves excessive wage increases.

As a consequence real industrial profitability has plummetted - from an average of 14% to zero in 20 years. We must rebuild company profitability as the economy starts to grow.

Our competitors - notably Japan and Germany - show just how higher productivity, competitiveness and adoption of new technology produce jobs and growth.

It is clear that because of the long-standing nature of our problem unemployment is likely to rise for some time yet, though more slowly. Important to handle long-term employment and help youngsters.

It is also clear that if taxes are to be reduced public expenditure must be reduced over the years ahead.

Expenditure in current year £5 bn below Labour's plans; and that planned for next year £10 bn below Labour's plans.

But in cash terms it is higher than forecast a year ago. Must do better.

And we must ensure that such public investment that is undertaken makes the economy more productive and competitive.

Recovery likely to be slow, but we shall not recover unless we tackle chronic weakness.

Government is determined to fight inflation and stick with it. And to convince people it intends to do just that.

From this all else - more jobs, competitiveness, growth - follows.

But inflation will not be conquered unless pay settlements on average are held to low single figures. This is inescapable.

After years of paying ourselves too much we cannot afford anything unless fully offset by productivity.

Thus we need - and must have - a further reduction in the present average level of settlements of just under 10%.

CONFIDENTIAL

DRAFT PAPER BY THE S OF S FOR EMPLOYMENT

THE ECONOMIC STRATEGY

1 We ought in considering the economic strategy, to examine very carefully the prospects for 1983. I am particularly concerned about the likely outlook on unemployment and pay.

2 The unemployment assumptions for this year's Public Expenditure White Paper are:

	1981/82	1982/83	1983/84
		- Thousands -	
GB (excluding school leavers)	2,500	2,700	2,700
Northern Ireland (ditto)	108	116	116
School leavers	212	212	212
UK Totals	2,820	3,028	3,028

Two points stand out. These figures are annual averages, and therefore the surge of school leavers will take the total well over 3 million in the late summer and early autumn in 1982 and 1983. Furthermore, the average number of people unemployed is not expected to fall between 1982/83 and 1983/84.

3 The impact upon particular groups will be greater than these totals reveal. With 3 million unemployed, according to my Department's estimates:

- two thirds of those under 18 will be without a normal job;
- around 800,000 people will have been out of work for more than a year by 1983;
- many places will have overall unemployment rates of 20 per cent or more (while similar rates have been common in Northern Ireland, unemployment percentages of this size had been unknown in mainland Britain for more than forty years until seen recently in towns such as Corby, Consett and Irvine);
- within these totals, unemployment will tend to be concentrated upon the unskilled and the ethnic minorities;

4 There may be a modest fall in unemployment in the course of 1983 - by perhaps a quarter of a million, if we get reasonable output growth. Even that small decline could be wiped out by a faster growth in productivity or the labour force. Indeed, a continued rise in unemployment cannot be ruled out.

5 These are the prospects for 1983 if the economic strategy succeeds. The political consequences of such high levels of unemployment with at best only marginal signs of improvement are deeply disturbing.

6 It is also important that we should be aware of the dangers to the strategy on the pay front. In the next pay round we shall need to see many settlements below the rate of inflation for the second year in succession if we are to avoid a renewed surge in prices and unemployment. The strategy then requires a third year of restraint during which settlements are not much higher than the rate of inflation, and there is no compensation for the losses in real income that many people will have experienced over the previous two pay rounds. This could be very difficult.

7 We must be prepared to anticipate and deal with these prospects and dangers. Any discussion of economic policy must take them into account and in pursuing our chosen strategy we must also consider the tactics which will give it the best chance of overall success.

8 It is clear that we will have to accept that unemployment will be much higher in 1983 than it was when we came into office. But by then the argument that high unemployment existed before 1979 will have worn rather thin. We have to be seen to be doing all we can to tackle the problem. The extended programme of employment measures which I shall be bringing forward can be regarded as an attempt to relieve the consequences of unemployment as well as slightly reducing numbers. But this alone is not enough. Anything which can be done, within the framework of our overall strategy, to bring forward or strengthen the growth in output would be of far greater benefit. It would take some of the edge off the criticisms of our opponents and of industrialists in the Midlands and the North. It would increase the likelihood of a fall in unemployment in 1983.

9
We must guard against the pressures which will have developed in a third year of quite severe wage restraint. Faster output growth would also unlock the productivity potential embodied in the changes in attitudes and working practices which have taken place in industry recently. It would allow for higher wage increases in 1982/83 than would otherwise be the case without adding to inflation. It would thereby ease what might otherwise be a very difficult winter on the pay front. Finally, and perhaps most importantly, it should help reduce the considerable risk that we as a Government will have presided over the period of sacrifice without reaping the rewards of prosperity.

10 It is not possible to avoid some conflict between measures to promote faster growth and our counter-inflation policy. We cannot afford to let the inflation rate rise, but it may be wise to settle for a slower fall to permit some action to help forward the upturn.

11. In considering the future conduct of economic policy, I would therefore ask colleagues to address themselves to three questions:

(a) whether, in 1983, unemployment at over 3 million - and possibly rising - is politically acceptable?

(b) whether it is realistic on present prospects to expect non-inflationary pay settlements in 1982/83?

(c) whether, without provoking a rise in the inflation rate, we can now take steps to bring forward and strengthen the upturn?

16/6

CONFIDENTIAL

Chancellor of the Exchequer
cc Mr Lankester
Mr Wolfson
Mr Hoskyns
Mr Vereker

PRIME MINISTER

CABINET, 17 JUNE: ECONOMIC STRATEGY

Changing Patterns of Economic Behaviour, notably on Pay

The Chancellor's paper for tomorrow's Cabinet discussion on the economic strategy concludes that Cabinet ought to focus on how to change the patterns of economic behaviour (paragraph 43), particularly in the sense of explaining the importance of the fight against inflation, and achieving a continuation of moderate pay behaviour. The Chancellor's ideas are developed further in the second of the two papers circulated under cover of C(81)30, entitled "Pay in the Coming Year".

2. Since his approach to pay is seen largely in terms of public presentation of the economic strategy, you and the Chancellor may find it helpful to have our comments on the need for and the likely effectiveness of this approach.

3. The first question the Chancellor asks in paragraph 43 of his paper is how to secure wider understanding of the scale of our problems. We question whether the Government actually wants to achieve that. As the Chancellor's paper makes clear, many of our problems are actually looking worse than when the Government took office: thus the tax burden has been increased; public expenditure as a share of GDP has been increased; private sector output has declined sharply; inflation may temporarily at least be bottoming out; and the prospects for unemployment are for a continuing rise. It is difficult to explain the severity of the country's economic problems at the same time as defending the Government's economic record.

4. The Chancellor then suggests in (b) and (c) of paragraph 43 that we should consider what more we can do to convince people of the need to conquer inflation, and to secure a sustained change in the attitudes of pay bargainers, especially in the coming autumn and winter. We know the main determinants of public attitudes in these areas :

i The public perceives economic realities as a result of events, to a far greater extent than it perceives them as a result of explanations by Government spokesmen. Thus, over the past two years public perception of economic/pay reality has been principally determined by the Government's treatment of the steel strike, the threatened coal strike, the civil servants' industrial action, and above all by the announcements of the pay factors in the public sector cash limits.

ii Attitudes taken up by intermediaries, who are not seen as Government spokesmen, are also an important ingredient. It is therefore very important to ensure that the CBI say the right things at the right time. Attitudes developed in NEDC and similar fora can also help.

CONFIDENTIAL

iii Direct presentation by Ministers is of significance only when undertaken by the most senior ones, and possibly only by yourself and the Chancellor. While all Ministers should play their part in explaining the Government's policies, and while a useful direct audience will be reached in this way, we must not delude ourselves that the media are interested in routine reaffirmations of policy by junior Ministers. The main speeches by the Prime Minister and the Chancellor are the key instruments.

5. It follows that the weight which is attached to public presentation in paragraphs 17 to 20, and 24, of the Chancellor's paper on pay in the coming year is too great. The Chancellor proposes a plan "for getting this message disseminated on the broadcasting front", including "a sequence of Ministerial speeches, liaison with the CBI and other forms of publicity". This implies that presentation will be more important in the next pay round than the actual policy decisions, eg on cash limits and the treatment of any threatened miners' strike. This is not so, though the effective presentation of policy decisions is important. We must concentrate both on getting the policy right; and on really getting the message over. We have, of course, already started.

Conclusion

6. The current pay round has indeed not gone too badly, but that was probably due as much to the falling RPI and rising unemployment as to the efforts we made to explain the role of pay in economic recovery, however great those were. In the next pay round, the economic environment will be rather different, and Ministers would be buoying themselves up with false hopes if they assumed that a similar presentational effort would on its own achieve a similar success.

B. INGHAM

16 June, 1981.

16/c

Ref: A05085

CONFIDENTIAL

PRIME MINISTER

Economic Strategy
(C(81) 29 and 30)

BACKGROUND

In addition to the Chancellor of the Exchequer's main paper, C(81) 29, on the Economic Strategy the Cabinet have, as background for their discussion, two other papers by the Chancellor circulated under my covering note C(81) 30 - the paper on the Economic Impact of North Sea Oil and Gas Revenues which was briefly discussed by your Ministerial Group on Energy Prices (MISC 56), and a paper on pay in the coming year which has been circulated as E(81) 66 for discussion in due course by the Ministerial Committee on Economic Strategy.

2. In his main paper (C(81) 29) the Chancellor of the Exchequer takes stock of the last two years and of current economic problems. The Chancellor stresses the need to give continuing priority to the control of inflation, avoiding short term expedients; points to the need for public expenditure reductions, both to contribute to the reduction of inflation and to avoid entering the Election with a tax burden heavier than that inherited which the Chancellor sees as politically and economically intolerable (his paragraph 38); and calls for action to help on the supply side, notably by reducing the rate of pay increases and by improving productivity and competitiveness. The key paragraphs are 41, which warns against entering blind alleys (relaxing monetary controls, increasing public expenditure, introducing import controls and so on) and 43 in which he sets out some questions which might lead to action for changing the patterns of economic behaviour, particularly on the pay front, for improving the supply side of the economy, and for striking the right balance of fiscal policy.

3. The main gap in the Chancellor's paper is any indication of the forecasts of the main components of the economy on present policies: of money supply growth, the PSBR, output, employment and inflation, and the balance of payments. He may be prepared to give orally indications on these matters

which he would prefer not to put in writing. It is not easy for the Cabinet to reach fully considered conclusions without some such indications.

4. The Chancellor of the Exchequer's main objective will be to get the Cabinet's broad endorsement of the need to maintain the Government's present general approach to the economy (his paragraph 45(i)). He also wants to prepare the way for thepublic expenditure discussions in July, and later in the year, by getting recognition of the need for reductions in public expenditure to enable cuts in tax. Thus, the most important of his questions is 43(i) - 'How much importance do we attach to securing significant cuts in the present tax burden? And how important are other commitments if we are to make room for tax cuts?' He will be looking for answers which will strengthen his hand when it comes to the discussion on public expenditure; and his colleagues may be chary of giving them.

5. Three Ministers have given indication of points they are likely to raise:-

(i) The Secretary of State for Employment has given notice that he will wish to draw attention to the likely outlook on unemployment and pay and to ask Cabinet to consider three questions:-

(a) Whether, in 1983, unemployment at over 3 million - and possibly rising - is politically acceptable.

(b) Whether it is realistic on present prospects to expect non-inflationary pay settlements in 1983-84.

(c) Whether, without provoking a rise in the inflation rate, the Government can and should now take steps to bring forward and strengthen the upturn?

(ii) The Secretary of State for the Environment wrote to the Chancellor of the Exchequer on 6th May, with copies to all Members of Cabinet, to call for additional capital investment in the public sector financed by savings on current account, and in particular by nil or very low cash limits for public sector pay. He agreed not to press this at the time of the Cabinet's discussion of the Guidelines for the Public Expenditure Survey on the understanding that he would do so in the economic strategy discussion. The Chancellor of the Exchequer has prepared for this in Annex B of C(81) 29 which discusses the mix of capital and current expenditure.

(iii) The Minister of Agriculture has sent all Members of Cabinet, under cover of a letter of 11th June, a booklet published by the French Government on their aids to industry. His concern seems to be that the French, by vigorous marketing of an attractive package of incentives, are encouraging investment in France, both by French firms and by others (including, potentially, British firms) which will lead to increased competitiveness at the United Kingdom's expense, particularly in the food industry (turkeys are the main current example).

6. The discussion seems likely to cover the following questions:

(i) How does the Chancellor of the Exchequer see the economy developing in the run-up to the Election? - specifically, what are his latest views on the money supply, interest rates, the exchange rate, output, employment and inflation? What are the prospects for the size and timing of the upturn?

(ii) What if anything can and should be done to ease the way through the difficult period up to the date of the next Election? Is the balance of priorities in the present policy right?

(iii) Is there any more to be done to help to bring about the Chancellor's objective of a steadily reducing level of pay settlements over the years ahead, defined (in paragraph 12 of his note on pay annexed to C(81) 30) as keeping the level of pay increases "well below the rate of inflation for two years or so"

7. It will not be the aim of Wednesday's discussion to take specific operational decisions but rather to prepare the way for those decisions in separate discussions later in the year. As the following paragraphs show there is already a 'home' for further discussion of nearly all the questions which the Chancellor of the Exchequer has raised and also those which are likely to be raised by other Ministers.

8. Cabinet's first substantive discussion of the 1981 public expenditure exercise has been fixed for 23rd July, and there is a programme for further discussions from September through to November. This will be the occasion for specific decisions on the balance between the Government's taxation and expenditure objectives, and on the balance within the public expenditure programme between capital and current expenditure. Thus it will cover the questions posed by the Chancellor in (h) and (i) of his paragraph 43; and the scope for further help to private sector firms, particularly small ones (his paragraph 43(d)), and for dealing with proposals for further capital investment, turns largely on how much room can be made by public expenditure cuts.

9. The Economic Strategy Committee is due to consider:-

(i) In the near future, the Chancellor of the Exchequer's memorandum on pay in the coming year (E(81) 66): this covers (b) and (c) in his paragraph 43.

(ii) Early in July, a paper by the Secretary of State for Employment on improvements to training schemes and the problems of youth unemployment - this is partly in response to the CPRS' work earlier in the year on these questions and partly following your meeting with him and other Ministers on 13th May (recorded in Mr. Lankester's letter of that date) - the Chancellor's paragraph 43(f).

(iii) Later in July, a paper by the Secretary of State for Employment on the outcome of the consultations on his Green Paper on Trade Union Immunities which, as Cabinet has already noted, is likely to lead to legislation next Session - part of the Chancellor's paragraph 43(g).

10. The Chancellor of the Exchequer's Steering Group on Government Strategy, MISC 14, already has work in hand on removing obstacles to mobility and efficiency, and has commissioned a further paper from the Secretary of State for the Environment (the Chancellor's paragraph 43(e)). The Chancellor of the Exchequer may say that he wants to use this forum for carrying forward his ideas on improving the supply side of the economy. This may well be useful, but it is a very small group - the only Ministerial members are the Secretaries of State for Industry and for the Environment, although other Ministers are sometimes invited. If the Cabinet is disposed to use MISC 14 for following up these matters, you may want to think of adding one or two Ministers to it. Alternatively, it might be better for operational decisions to be passed directly to the appropriate Ministerial Committees - either E or to E(DL), for privatisation proposals, or to E(EA) for more general questions.

11. The Chancellor of the Exchequer, together with the Chancellor of the Duchy of Lancaster, may wish to give some further thought on how to carry forward his paragraph 43(a) - 'how can we secure much wider understanding of the scale of our problems and of their real causes?' It may well be that a good deal could be done by using the information and charts available in C(81) 29.

HANDLING

(1) 12. You may wish to open the discussion by saying that the aim is not to take specific operational decisions but to take stock and to prepare the way for discussions and decisions later in the year. If asked, you could confirm that you have it in mind that there should be another general discussion of the economy in October, and a further one in January, preparing the way for the 1982 Budget; but you may prefer not to commit yourself on this, if you can avoid doing so.

(2)

13. After the Chancellor of the Exchequer has introduced his paper, you have agreed that the Secretary of State for Employment should speak next. You might then give the Secretary of State for the Environment an early opportunity to put his points. If the Secretary of State for Industry were to come in at this point he could usefully give his reactions to their proposals and provide the Chancellor with some support. No doubt all your colleagues will want to speak. The main aim in the $1\frac{3}{4}$ hours available will be to ensure that the Cabinet are satisfied that they have had a wide-ranging discussion and that each has had the opportunity to say his piece.

CONCLUSIONS

14. You will want to record endorsement of the need to maintain the (1) Government's general approach to the economy (paragraph 45(i) of C(81) 29), (2) and to note the points made in discussion as background to later specific decisions. You may be able to record decisions to follow up specific points in the appropriate ways (see paragraphs 8 to 11 above).

15. You may also want to agree with the Cabinet the line to be taken with the Press - and to invite them to resist the temptation to embroider it.

RA

(Robert Armstrong)

16th June 1981

Inflation – has to come down.
– resources for market sector; where majority of people work
Smaller propn to govt. TAX.
Social Security Pensions Pay / Benefit.
Factors determining pay settlements

CONFIDENTIAL

MR. INGHAM

c. Mr. Lankester
Mr. Duguid

<u>Cabinet Discussion on the Economic Strategy</u>

We had a word about the Chancellor's paper C(81)29, and also about his paper for E on the next pay round, C(81)30, both of which I now attach. We agreed that I would let you have a draft minute to send to the Prime Minister about those parts of the paper relating to presentation of the strategy.

You should know that the Treasury have been keeping me in touch with the drafting of the paper on the next pay round; I attended a discussion of an early draft, chaired by Mr. Ryrie, and I was asked on a personal basis for some comments on the penultimate draft, which have <u>not</u> on the whole been taken into account. The burden of my comments has been the same as the main point in the attached draft, namely that there is very little substance in what the Chancellor is proposing on the next pay round other than a programme of attempts by Ministers to change pay behaviour by exhortation.

JOHN VEREKER

15 June 1981

CONFIDENTIAL

CONFIDENTIAL

DRAFT MINUTE FROM MR. INGHAM TO THE PRIME MINISTER

CABINET, 17 JUNE : ECONOMIC STRATEGY

Changing Patterns of Economic Behaviour, notably on Pay

The Chancellor's paper for tomorrow's Cabinet discussion on the economic strategy concludes that Cabinet ought to focus on how to change the patterns of economic behaviour (paragraph 43), particularly in the sense of explaining the importance of the fight against inflation, and achieving a continuation of moderate pay behaviour. The Chancellor's ideas are developed further in the second of the two papers circulated under cover of C(81)30, entitled "Pay in the Coming Year". Since his approach to pay is seen largely in terms of public presentation of the economic strategy, you and the Chancellor may find it helpful to have my comments on the need for and the likely effectiveness of this approach.

The first question the Chancellor asks in paragraph 43 of his paper is how to secure wider understanding of the scale of our problems. I question whether the Government actually wants to achieve that. As the Chancellor's paper makes clear, many of our problems are actually looking worse than when the Government took office: thus the tax burden has been increased; public expenditure as a share of GDP has been increased; private sector output has declined sharply; inflation may have bottomed out; and the prospects for unemployment are for a continuing rise. It is difficult to explain the severity of the country's economic problems at the same time as defending the Government's economic record.

/ The Chancellor

CONFIDENTIAL

The Chancellor then suggests in (b) and (c) of paragraph 43 that we should consider what more we can do to convince people of the need to conquer inflation, and to secure a sustained change in the attitudes of pay bargainers, especially in the coming autumn and winter. I am quite clear what are the main determinants of public attitudes in these areas:

(i) The public perceives economic realities as a result of events, to a far greater extent than it perceives them as a result of explanations by Government spokesmen. Thus, over the past two years public perception of economic reality has been principally determined by the Government's treatment of the steel strike, the threatened coal strike, the civil servants' industrial action, and above all by the announcements of the pay factors in the public sector cash limits.

(ii) Attitudes taken up by intermediaries, who are not seen as Government spokesmen, are also an important ingredient. So it is very important to ensure that the CBI say the right things at the right time, and attitudes developed in NEDC and similar fora can also help.

(iii) Direct presentation by Ministers is of significance only when undertaken by the most senior ones, and possibly only by the Prime Minister and the Chancellor. Although it is of course important that all Ministers should play their part in explaining the Government's policies, and

/although a

although a useful direct audience will be reached in this way, we must not delude ourselves that the media are interested in routine reaffirmations of policy by junior Ministers. So the effort here should concentrate on the main speeches by the Prime Minister and the Chancellor.

It follows that in my view the weight which is attached to public presentation in paragraphs 17 to 20, and 24, of the Chancellor's paper on pay in the coming year is too great. The Chancellor proposes a plan "for getting this message disseminated on the broadest front", including "a sequence of Ministerial speeches, liaison with the CBI and other forms of publicity". To place this recommendation first wrongly implies that presentation will be more important in the next pay round than the actual policy decisions, eg on cash limits and the treatment of any threatened miners' strike. It makes unnecessarily heavy weather of the process of providing Ministers with ~~the necessary~~ material for their speeches. It implies that these speeches can be coordinated in some planned fashion, whereas in practice it is just as useful to take advantage of opportunities as they arise naturally. And, perhaps most importantly of all, it overlooks the fact that almost all of these recommendations are unnecessary, since they are already part of our routine, day-to-day presentation. In particular, there have of course already been discussions between the Treasury and the CBI; successful steps have been been taken by those concerned with the media to ensure that references have been made to low single figures - 5% has been mentioned - in the next pay round; and a speaking note specifically on the next pay round has already been distributed to all ~~the~~ Ministers.

Conclusion

The current pay round has indeed not gone too badly, but that was probably due as much to the falling RPI and rising unemployment as to the efforts we made to explain the role of pay in economic recovery, however great those were. In the next pay round, the economic environment will rather different, and Ministers ~~will~~ would be buoying themselves up with false hopes if they assumed that a similar presentational effort ~~will~~ would on its own achieve a similar success.

12 June 1981
Policy Unit

2.1

PRIME MINISTER

CABINET MACRO-ECONOMIC DISCUSSION

1. Alan Walters provided some comments on the Treasury paper last weekend. As he said then, we see this discussion as an opportunity to teach some colleagues the hard realities of economic choice. For this purpose, the paper contains a useful examination of the various blind alleys. The first aim of the meeting should be to expose and nail them.

2. Of course this won't be achieved in one meeting. But some progress should be possible. Thereafter, we should be trying to change attitudes from scepticism to recommitment to the essential steps towards a healthier economy, with the defeat of inflation as the number one priority.

3. These objectives are pretty obvious. But the tactics for achieving them may be less so. We think that the best tactics will be:

(a) to invite Geoffrey to highlight the main points in his paper; and he must ensure that he makes the Government's economic objectives clear;

(b) to allow - even encourage - colleagues full rein in exploring the blind alleys;

(c) to let the experts (I really mean Alan and Terry Burns rather than the Treasury team, whom they will simply see as colleagues with whom they disagree) nail the fallacies, wherever possible with support from other non-Treasury colleagues;

(d) to limit your own role, as far as possible, to summing up; the summing up to remind them that this is the point at which so many Governments in the past have started to become less determined and purposeful, with some Ministers opting out because it all looks too tiring and too difficult. Everything depends on our ability to summon up the will and mental energy to keep thinking and working, especially on the public spending problem.

4. One of the more insidious fallacies is an unspoken belief that it "doesn't really matter" if we fail to get inflation right down to 3% or so, or even less. Many unthinking colleagues believe that such an objective is simply "unrealistic", because without any historical perspective, they have spent virtually the whole of their political career in a world where inflation is part of the scenery. Geoffrey and others should show that this is not so, explaining why we have to set our sights on virtually eliminating inflation if we are ever to get back to real economic growth. I think that Alan could well be invited to comment on this particular point, showing how negligible inflation and even falling prices in past periods of history have coincided with economic growth. The received wisdom in this area is completely mistaken.

5. I understand that Geoffrey is canvassing some of the colleagues in order to get them thinking the right way. But it is still important that you and he are in agreement on the purpose and tactics beforehand. Hence this minute.

JH

JOHN HOSKYNS

Prime Minister

You might discuss with the Chancellor on Sunday evening whether it would be helpful to circulate this note to Cabinet. My view is that it would.

IL 12/6

Covering CONFIDENTIAL

Qa 05390

12 June 1981

To: MR LANKESTER

From: J R IBBS

<u>Economic Strategy</u>

1. I attach a draft note by the CPRS which, if the Prime Minister were content, might be circulated as a contribution towards suggesting answers to some of the questions posed by the Chancellor at the end of his paper.

2. I am sending a copy of this Minute and the note to Sir Robert Armstrong.

Most colleagues did not like the "seminar" presentation last year which is why we are having ordinary Cabinet meeting this year. Colleagues will have to read the [illegible]

See also John Hoskyns' note below.

When I told John Hoskyns you had agreed that he and Alan Walters should attend this meeting of Cabinet, I made it clear it would be in a non-speaking capacity, sitting at the [illegible] with the rest of us. But his note quotes this and assumes Alan Walters and Terry Burns will be full participants.

[illegible]

cc T. Hodges

CONFIDENTIAL

ECONOMIC STRATEGY

Note by the Central Policy Review Staff

1. The CPRS agrees with the Chancellor that it would be wrong to risk throwing away the gains made by the Government's economic policies, by a hasty reflation now. Too often in the past, at the trough in the cycle when output has stopped falling but unemployment (given the lags) is continuing to rise, Governments have acted to hasten the upswing, leading straight to overheating and the next "Stop". Though the situation now is in some ways worse than in previous recessions, we firmly believe that a drastic change of fiscal and monetary stance would have bad effects on the pay outlook, the exchange rate and therefore on inflation which would outweigh and outlast any temporary gain in employment.

2. But the "national cash limit" means that it is absolutely imperative to hold back pay settlements. As the Chancellor explains, the higher the share of that overall limit taken by inflation, the less room there is for real growth of output. The uncomfortable conclusion is that if wage inflation is not somehow kept below the overall limit, there can be no sustained recovery in output and no prospect of reducing unemployment.

3. There has been some success in the present wages round; keeping to the present firm stance on fiscal and monetary policy, and on public service pay, will help to maintain this. But there is a limit to what can be done by exhortation. Even while people recognise their interest in lower inflation as consumers, and as a nation, they see that as wage-bargainers they risk falling behind if they accept a low settlement. As result, in areas of the private sector where profits are higher (e.g. the financial sector), or in monopoly industries in the public sector, union negotiators will exploit their bargaining power. This in turn tends to increase what those who recognise the relative weakness of their position nevertheless expect.

4. The CPRS therefore believes that Ministers should ask officials to carry out urgently a wide-ranging study into ways of reforming the wage-bargaining process. This should consider all feasible suggestions for

limiting pay settlements, by shifting the balance of industrial power or altering the incentives and penalties which face wage bargainers now. We recognise that a great deal of work has been done on these questions in the past. But in our judgement the issue is crucial to the success of the Government's policy, and likely to be highlighted even more starkly over the coming months and years. Hence it is worth the most thorough study, without preconceptions, to present options for Ministers to consider.

5. Even if wages can be held down, output will only rise to the extent that industry is able to produce saleable goods and services. Gains in productivity should give firms a better base for expanding output when they see market opportunities at home or abroad. But firms will only find market opportunities to exploit if they have the right products. And they will only design and develop new products and make the necessary investment if their cash-flow and profitability justify this. Confidence in future improvement is also essential if investment is to occur. Some sign of encouragement is therefore important.

6. The Chancellor's paper asks how important it is to secure significant cuts in the present tax burden. In the CPRS's view, despite the need to reduce the burden of personal taxation, a priority in this crucial phase of recovery should be to help industry obtain some improvement in profitability as a basis for expansion. Among fiscal measures with this aim, one would be to reduce the National Insurance surcharge on employers. But again this will merely boost inflation unless some means can be found of preventing the extra cash flowing through into higher wages; this reinforces our conviction of the need to find a way of curtailing these.

<u>Summary</u>

7. Among the answers to the questions at the end of the Chancellor's paper, the CPRS wishes to emphasise:

(a) the urgent need to carry out a wide-ranging study of options for reforming the wage bargaining process;

(b) the need to switch fiscal resources into industry, e.g. by cutting the National Insurance surcharge.

ECONOMIC STRATEGY

Note by the
Chancellor of the Exchequer

June 1981

ECONOMIC STRATEGY

Note by the Chancellor of the Exchequer

This paper is intended to help us to take stock of our first two years of office and to identify the key issues we need to face in the remainder of this Parliament and in preparation for the next.

2. Our objectives are clear

- We aim to break out of the circle of high inflation, low productivity, poor market disciplines and responses, poor management and progressive devaluation. These are all closely linked.

- Success in this is essential for a sustainable growth of output, employment and living standards.

  This means ...

- we must substantially improve the efficiency and the competitiveness of the economy. And ...

- we must bring inflation down and keep it down.

3. As we made clear in our Manifesto, bringing about the necessary fundamental changes - not least changes in attitude on the part of management and labour towards the disciplines of competition and honest money - is not easy. This is especially so given the years of neglect, the tougher world setting and the competition we face from economies overseas which are much fitter than our own. We have made significant progress already. We have to consider the next stage.

I Setting the scene

4. Throughout the industrial world inflation accelerated and growth slowed down during the 1970s. Almost everywhere this was accompanied by sluggish productivity and rising unemployment.

$ 14 5. The second oil price shock (oil price $17 a barrel on polling day and about $34 early this month) has seriously worsened the prospects for the world economy over the next few years. Growth prospects for the 1980s have been scaled down markedly. Earlier hopes that, once the first oil price shock had been absorbed, the world economy would regain the growth rates enjoyed in the 1960s have long since been abandoned. In most industrial countries there are doubts whether growth in the 1980s will reach even the level recorded in the 1970s. In short, the world setting is much harsher than expected when we came into office.

6. The acceleration of inflation and slowdown in growth has been especially bad in Britain. Chart A shows how, through two decades, money incomes grew increasingly fast - much faster in fact, than in other industrial countries - while growth of real output slowed down. Between 1970 and 1980 output grew only 16 per cent. But money incomes increased by 335 per cent. In other industrial countries the increase in earnings over the period of the second oil shock was much more moderate than in the UK.

A

7. We are thus badly handicapped by a serious decline in our ability to compete. As Chart B shows, this is because our wage costs have risen much more steeply than those of our competitors and, to a much lesser extent, because North Sea oil has prevented them from being accommodated to the same extent as in former years by a continuously declining exchange rate. Chart C compares our performance on pay and productivity in manufacturing with that of other countries. If our productivity was up to French or German standards, we could have getting on for twice the output from our existing labour force.

8. As the decline in our ability to compete has gone on for a number of years, its causes are plainly deep-seated. We cannot therefore expect a speedy recovery from our industrial problems.

9. Britain, like other countries, has reacted to rising inflation by taking measures to limit the growth of total money expenditure; and to reduce inflationary expectations by persuading people to accept and adapt to the lower growth of money, especially in wage demands. This has included setting targets for the growth of the money supply. The effect is similar to establishing a cash limit for the whole economy, within which cash limits for the public sector are a natural consequence. The object must be to reduce from year to year the rate at which these cash limits grow until inflation is under control. Within that framework the total increases will be divided into the part taken by inflation and the part that represents real growth of output. Our task must, of course, be to reduce the former and increase the latter.

Inflation

10. Control of inflation, which was the first task in our Manifesto, must then remain first:-

- Because, if not controlled, inflation tends to accelerate and lead to an economic "stop".

- Because the attitudes which go with high inflation also produce poor productivity, poor management and loss of competitiveness, so reducing growth and employment.

- Because inflation is unjust and unpopular.

- Because our success or failure in reducing it is one of the main things by which we shall be judged.

11. Inflation was accelerating when we came in. We have reversed that trend. Inflation is now about 12 per cent, compared with about 22 per cent a year ago.

12. As Chart D shows, in the past year inflation has fallen much more quickly in Britain than in the rest of the OECD. And productivity has improved in some industries. But

- Our inflation is still above the OECD average and far too high.
- We must bring down our costs substantially, to help reverse our loss of competitiveness.
- The progress so far made will be hard to maintain.

13. This last point is important. Although most projections show inflation continuing to fall, there is a real risk of some temporary reversal, even if, by firm control of the money supply, we can prevent this from going too far. This could come about because of such factors as:-

- A faster rise in some world prices, as activity recovers.
- Pressures when our economy picks up, as profit margins recover and employers bid for skilled labour.
- The recent fall in the exchange rate and the possibility of further falls.

14. Some of these factors are inevitably beyond our control. So it is all the more important not to ease up on what we can do. We must take the expenditure and tax decisions that are necessary if we are to achieve our monetary targets and be in a position to help industry, for example on interest rates. We need also to lighten the burden of rates and taxes and to improve incentives.

15. In addition we must:-

- take all possible steps to secure a reduction in unit labour costs and in the cost of the public sector;
- maintain and strengthen expectations that inflation will continue to fall, despite short term difficulties.

I Output

16. To repeat, over the past 10 years prices have risen by 275 per cent and money incomes by 335 per cent, but real output by only 16 per cent. Since the first half of 1979 output has actually fallen by 5 to 6 per cent.

17. In part this recent fall in output reflects world-wide developments, as most major economies experienced recession following the oil price rises. Output in all the major countries of the European Community, for example, has fallen during the past year and is expected to remain roughly flat for the rest of the year.

18. But the recession has been deeper in Britain, reflecting:-

- The underlying weakness of our economy, much of it over-manned and uncompetitive.
- Excessive pay increases over many years.
- An uncomfortable side-effect of North Sea oil, through the impact of the high exchange rate on some manufacturing industry.
- The need to bring down inflation by more than other countries have had to do.

19. Chart E shows that real industrial profitability has fallen from about 14 per cent to virtually nil in the past 20 years. The rate of new investment (after allowing for the replacement of old plant) has also fallen. Chart F shows the contrast in recent years between falling company incomes - down by 25 per cent - and rising personal incomes - up by 18 per cent.

20. There are signs that, with the rundown in stocks coming to an end, and retail sales high so far this year, we are nearing the end of the recession; a number of recent indicators suggest that the fall in output is levelling off and that in some industries activity is increasing. There are encouraging reports of improved productivity. Recent CBI and other reports offer evidence of some improvement in business confidence.

21. But as with our success on inflation the improvement here is fragile. If we are to have the basis for sustainable growth we must resist any temptation to relax. The world economic setting is unfriendly and intensely competitive.

22. In this difficult setting, any upturn in the economic cycle will take us only a small part of the way. Essentially it will be up to business and industry to create or win new markets and to increase market share, at home as well as abroad. Government must help and not hinder this process. We still need much wider understanding, above all in the public sector where several effective labour monopolies exist, of the importance of combined effort in purusit of better productivity. There are still too many obstacles to economic change and flexibility, probably above all in the labour market. But not only there.

IV Employment

23. Chart G shows the recent very sharp rise in unemployment, following a long upward trend.

24. Most of the actions required to improve productivity and competitiveness - cost cutting, removal of restrictive practices, increasing efficiency - necessarily increase unemployment at first. We face the consequences of years of over-manning. In the longer run improving productivity and so competitiveness leads to faster growth and more jobs. That is the clear lesson of, for example, the Japanese experience. It is in fact confirmed by the record of some successful parts of the British economy. The need is to bring our average performance nearer to what our most successful firms and industries have shown to be possible and at the same time to promote the expansion of real and sustainable new employment opportunities.

25. Nevertheless, we must recognise that, because of the big improvements needed in our competitiveness and of a growing labour force, unemployment is likely to continue to rise for some time yet, although at a slower pace. It will take a long time for business and industry to develop and exploit new markets on a sufficient scale.

26. There is another point. As Chart G shows, recorded unemployment has for some years been increasing out of line with other indicators of the pressure of demand for labour. Chart G also shows how over time each cyclical peak of unemployment is higher than the last. This implies that even when the economy recovers and the demand for labour improves, unemployment is quite likely to stabilise at a higher level than in earlier decades. We need to do all we can, without provoking renewed inflation, to speed the sustainable expansion of productive activity and real output. But we must also seek ways of containing unemployment meanwhile.

27. We need to consider the needs of particular groups, such as the young. But any such action cannot be allowed to jeopardise the need to control total public expenditure. Once again we see the need for more flexibility within the labour market. The higher the cost and the greater the difficulty of taking on new labour, the smaller will be the number of new jobs.

V

Tax and public expenditure

28. So far in our period of office the tax and public expenditure burdens have both risen, as Chart H shows. We have reduced the PSBR as a proportion of GDP - but only by covering higher public expenditure by even higher taxes.

29. Within the limits of the very tight fiscal situation we have been facing, we have made significant improvements in the tax system so as to encourage growth and enterprise: thus we have dramatically reduced the confiscatory top rates of income tax, and we have introduced an array of new incentives to promote the establishment and growth of small businesses. But nonetheless the tax burden has sharply increased since 1978-79:-

- Although some switch has been made from taxes on personal income to taxes on expenditure, both direct and indirect taxes are heavier than when we came to power. Excluding the effects of the North Sea, this year taxes (including National Insurance and rates) will take 39½ per cent of the nation's income compared with 35 per cent in Labour's last year.

- A married man on average earnings now pays 48½ per cent of his income in direct and indirect taxes and contributions compared with 45½ per cent when we came to office.

- We have made only moderate progress in easing capital taxes and in lightening company taxation.

Moreover, on the projections published at Budget time (based on our plans for declining public expenditure, as set out in the White Paper) the tax burden in 1983-84 would still be 38 per cent of GDP - 3 points above the level we inherited.

30. This falls well short of what is expected of us by our supporters and indeed by the country as a whole. For economic as well as political reasons we have to do better.

31. On public expenditure we set out to reduce the total substantially as a proportion of GDP. Business and industry still rightly regard

this as an essential objective. We have had some success. We held the ratio steady for our first year in office. Expenditure during the current year is expected to be £5 billion less than our predecessors were planning, despite the additional costs of unemployment benefit and employment support due to the recession, for which their plans included no provision. For next year, our March plans represent expenditure nearly £10 billion less than they were planning. In achieving these reductions from previously planned levels, we have not shrunk from some very difficult decisions. But:-

- In 1980-81 the total as a proportion of GDP shot up - both because GDP fell and because expenditure was higher than we intended (less than half of this excess can be explained by the fact that the recession was worse than expected).

- This year the ratio could approach the peak reached in the early years of the last Labour Government. In cash terms expenditure by central and local government in 1981-82 is estimated to be about £6 billion higher than forecast a year ago.

- This represents an increase of more than 60 per cent between 1979-80 and 1981-82, compared with an increase in retail prices of 49 per cent.

32. Public expenditure must be paid for by the private sector, either through taxes or through the high interest rates that accompany higher borrowing. To improve the outlook for the private sector we have to reverse the growth of the public sector. Charts I and J show the present breakdown of spending. They demonstrate the programmes we shall have to look to for this. And because we want to do this without adding to inflation, the apparently easy option of further increasing public sector, particularly nationalised industry, prices beyond the levels currently envisaged is not open to us.

33. We have already recognised, and said publicly in the last Public Expenditure White Paper, that the present expenditure programmes are higher than we wish in relation to financial and economic objectives.

Nothing has happened to invalidate that judgement. The need is clear to reduce the public expenditure totals for the years ahead below the equivalent of those in the last White Paper.

34. Yet there are already pressures for increases in certain programmes, notably for nationalised industries (relatively little for investment), for industry generally, for unemployment related programmes, and for defence.

35. There is a case for changing the composition of our spending programmes to create room for public sector investment which gives a good return and which would also improve the relative prospects for private sector output and employment. Within the total increase of 60 per cent in public expenditure between 1979-80 and 1981-82, fixed investment was static in cash terms. We should certainly do all we can to ensure that the public investments we undertake are those which will contribute most to making the economy more productive and competitive. The best way to finance profitable public investment is to cut out unprofitable public investment.

36. We could go further and increase public investment at the cost of current expenditure. But to the extent that we increase public expenditure on investment (or indeed increase any other programme) we have to forego the chances of lower taxes or lower interest rates which might otherwise result from cuts in other programmes. (This is discussed at more length in the note attached at Annex B.) There are already signs of a repetition of last year, with difficult reductions being required simply to hold the total against increases which we may find unavoidable, let alone to reduce it as we need.

37. As well as reducing the size of the public sector we must make every effort to contain costs. This year pay in the public services - but not in the nationalised industries - is in general rising less rapidly than pay in the private sector. We need to do better still - especially in the nationalised industries - and at least to ensure that we hold the improvements so far made.

38. To repeat, on present spending plans, even on optimistic assumptions about the growth of the economy, we shall enter the election with an overall tax burden much heavier than the one we inherited. Not only politically, but also economically, that is not tolerable.

VI The way ahead

39. Recovery is bound to be slow, unemployment will go on rising for some time yet - although more slowly - and the fight against inflation will grow harder, particularly since we may no longer have the benefit of an appreciating exchange rate. A sustained expansion of output and jobs will only be possible if we maintain progress against the deep-seated weaknesses of the economy - poor productivity and competitiveness, resistance to difficult changes, a large public sector and, perhaps above all, monopolistic and selfishly used power in pay bargaining.

40. What the Government can do directly is limited. It is a job for everyone, Government, management, unions and individuals. But we must go further towards creating the right climate for bringing about the needed changes. The need for perseverance over a relatively protracted period poses a formidable political problem.

41. What should we be doing? There are plenty of blind alleys. Thus:-

- Relax our money stance? An inappropriate cut in interest rates would lead to excessive monetary growth and even more inflation, and any effects on unemployment would be small and short-lived. And it would worsen the long-term problem of securing a proper balance between output and inflation.
- Formal incomes policy? We certainly need to ensure that the rate of growth of money incomes continues to fall. But experience shows that any success achieved by formal control is always short-lived and counter-productive when its distorting effects unwind.
- Import controls? For a major trading nation like Britain retaliation would be inevitable, and any short-run benefits to output and employment would be purchased at the expense of efficiency and so of consumers and of higher inflation.
- Bring down the exchange rate? It has recently moved sharply down against the dollar, but remains much higher against the D-mark than when we came into office.

Although it will help sales of UK exports in the US, the recent movement is bound to cause some anxiety about the effect of higher import prices on inflation.

- Putting North Sea revenues to "better" use? A North Sea Oil Fund perhaps? But North Sea revenues, which by 1983-84 are expected to amount to only about 6 per cent of general Government revenues (about half of annual defence spending and less than we are already spending on investment by publicly owned industries) are already helping to keep down the PSBR, and so interest rates. And in any individual year uncertainties over output levels, oil prices and the exchange rate affect actual receipts. Any new accounting device would at best be cosmetic and, given the uncertainties, could constrain our freedom of action.

- A straight increase in public expenditure? In order to prevent this leading to higher inflation, it would entail higher taxes or higher interest rates, neither of which would help the recovery of the private sector. This would be so even if the extra public spending took the form of capital investment. The effect would be to discourage private spending, including investment. Yet in the long run private sector investment decisions would almost certainly create more wealth than extra public spending.

42. Clearly we must avoid the mistakes of the past and be willing to sustain the right policies for long enough to secure a lasting improvement in underlying performance. This certainly means maintaining firm control on the amount of money available in the economy, the national cash limit. By making clear our determination to stick to this discipline we can sustain the change in expectations and attitudes within industry. There are encouraging signs. But we need to build on them and not risk dissipating them.

43. To repeat, the vital need, in economic terms, is to go on reducing the share of the rising national cash limit that is absorbed by inflation and to increase the share that represents

real growth of output. I set out below some of the difficult areas where we need to concentrate our thinking.

Changing the patterns of economic behaviour

(a) How can we secure much wider understanding of the scale of our problems and of their real causes?

(b) What more can we do to convince people of the need - and of our determination - to maintain the fight against inflation, if unemployment is to begin to yield? And to secure a sustained change in the attitudes of pay bargainers, in public and private sectors alike?

(c) In particular, what more can we do to create the climate for a moderate rate of pay increases, well down in single figures, especially in the public sector, in the coming autumn and winter?

Improving the supply side of the economy

(d) How should we continue increasing and improving opportunities for the private sector and, most of all, for new and expanding businesses?

(e) What more should be done to remove obstacles to mobility and efficiency, for example in the housing market and in the labour market?

(f) How do we handle the prospect of a continued growth in unemployment, particularly amongst the young?

(g) Should we be doing more to tackle monopolies and restrictive practices, whether in private or state industry or in the labour market? In particular, what more could we contemplate doing to tackle the problems of union power and union behaviour?

The balance of fiscal policy

(h) How do we make faster progress in reducing the size - and cost - of the public sector and so ensuring further progress towards lower interest rates and reducing the tax burden on the private sector?

(i) How much importance do we attach to securing significant cuts in the present tax burden? And how important are other commitments if we are to make room for tax cuts?

44. These are difficult questions for difficult times. Popular expectations remain high and people are (understandably) impatient for success. Yet we can restore the economy to health only if we are determined, for some time to come, to sustain the policies needed to achieve a fundamental change in attitudes and institutions.

VII CONCLUSIONS

45. I invite my colleagues to:-

(i) note the need to maintain the Government's present general approach to the economy;

(ii) offer their views on how best to promote the changes in patterns of economic behaviour and in the working of markets essential if we are to improve the performance of the economy; and how best to adapt our fiscal and other policies to contribute to these objectives.

(iii) Plans to train and occupy young people

G.H.

H.M. TREASURY
11 June 1981

ANNEX A

Technical note on figures and concepts used in the charts

CHART A Money Income is gross domestic product (GDP) at current market prices. Output growth is the change in GDP measured at 1975 prices.

CHART C Productivity is measured by change in output per man-hour in manufacturing. Pay is hourly earnings.

CHART E Relates to industrial and commercial companies, excluding North Sea activities. Profitability is the estimated gross trading profits plus rent less stock appreciation and capital consumption at current replacement cost expressed as a percentage of net fixed capital stock at current replacement cost plus the book value of stocks. Net Investment measures the growth of the companies' capital stock.

CHART F Real disposable income is gross income less direct taxes and contributions deflated to real terms by the GDP deflator. For companies this is equivalent to retained income plus dividend payments.

CHART G "Skilled labour shortage" in Chart G is the 'skilled labour constraint' index in the CBI business trends survey showing the percentage of respondents reporting skilled labour shortage as a factor holding back output. It is plotted in the chart with the scale inverted so that it can be more readily compared with movements in unemployment.

CHART H As paragraph 29 says the tax burden is calculated excluding the effects of the North Sea. More specifically, it embraces all taxes (including local rates) and contributions except taxes on North Sea operations, and is expressed as a percentage of GDP excluding the contribution of North Sea oil and gas. The "national income" denominator for the tax burden thus differs from that used for calculating the ratio of public expenditure to GDP. For this reason the absolute levels of the two lines in the chart are not directly comparable. The chart is designed to bring out the movements of the tax burden and public expenditure over time.

CHART I Total expenditure in this chart relates to general government (i.e. central and local government) and is divided into the main economic categories. Total expenditure on goods and services comprises the three right hand segments. "Lending to nationalised industries etc" is lending by general government only; it excludes public corporations' direct borrowing from the market and overseas.

CHART J Breaks down the main programmes into their major economic categories. Sales of council houses and land have been netted off "subsidies, grants and loans" (rather than off "fixed investment"); fees of general practitioners have been included in health pay. Programmes are on a UK basis; for example, "social security" includes the Northern Ireland expenditure (whereas "social security" in Chart I does not.

CHART A

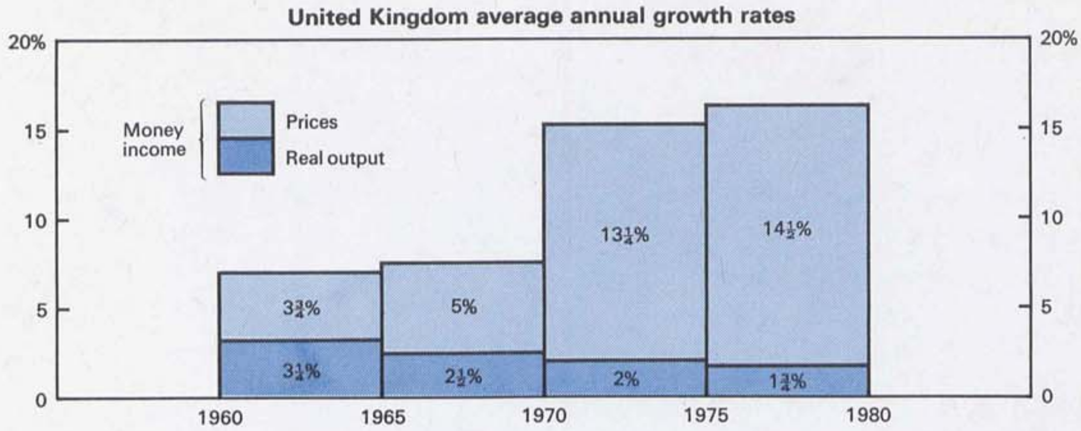


CHART B

CHART C

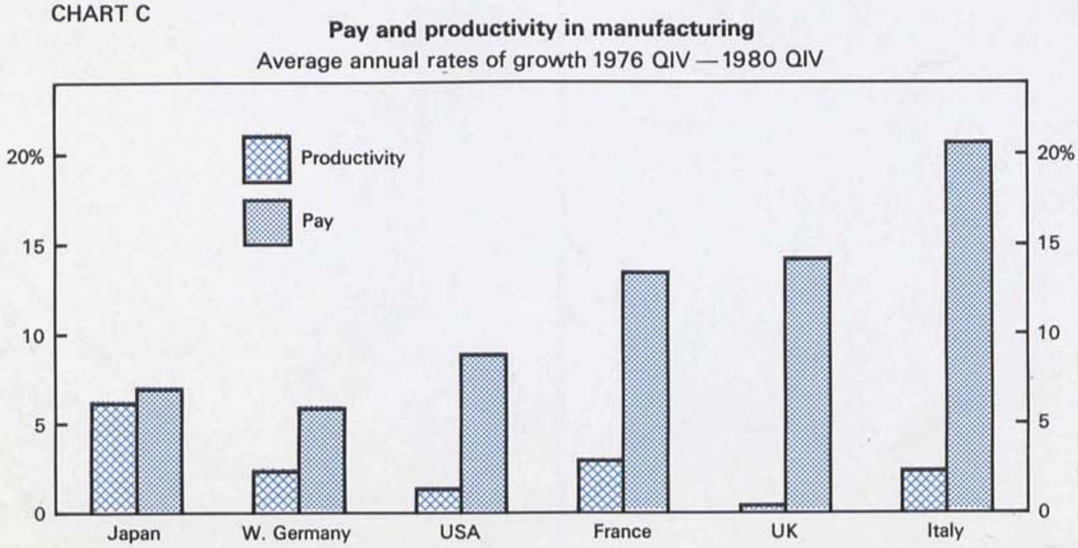
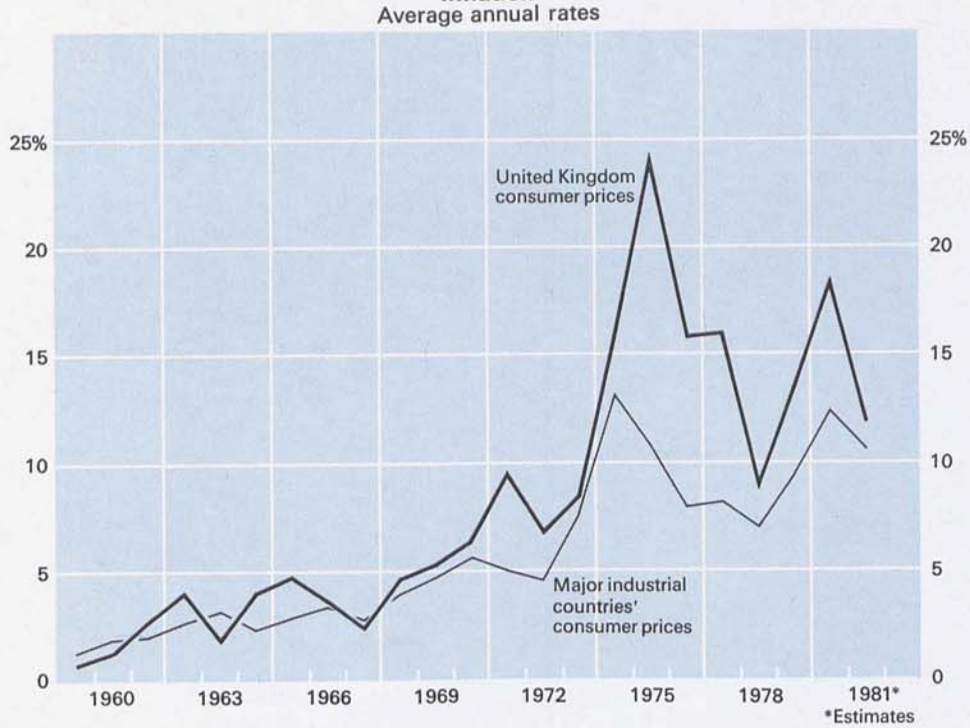


CHART D

Inflation
Average annual rates



Defn^s of RPI?

CPI.

CHART E

Profitability and Investment

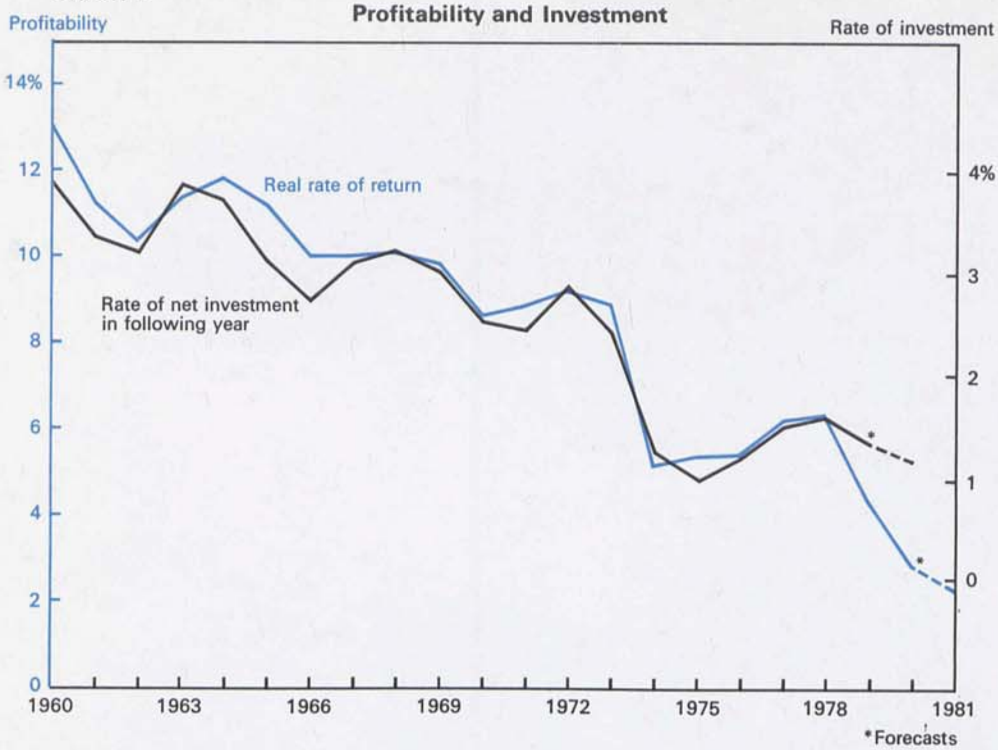


CHART F

Personal and company disposable income
£billion, 1975 prices

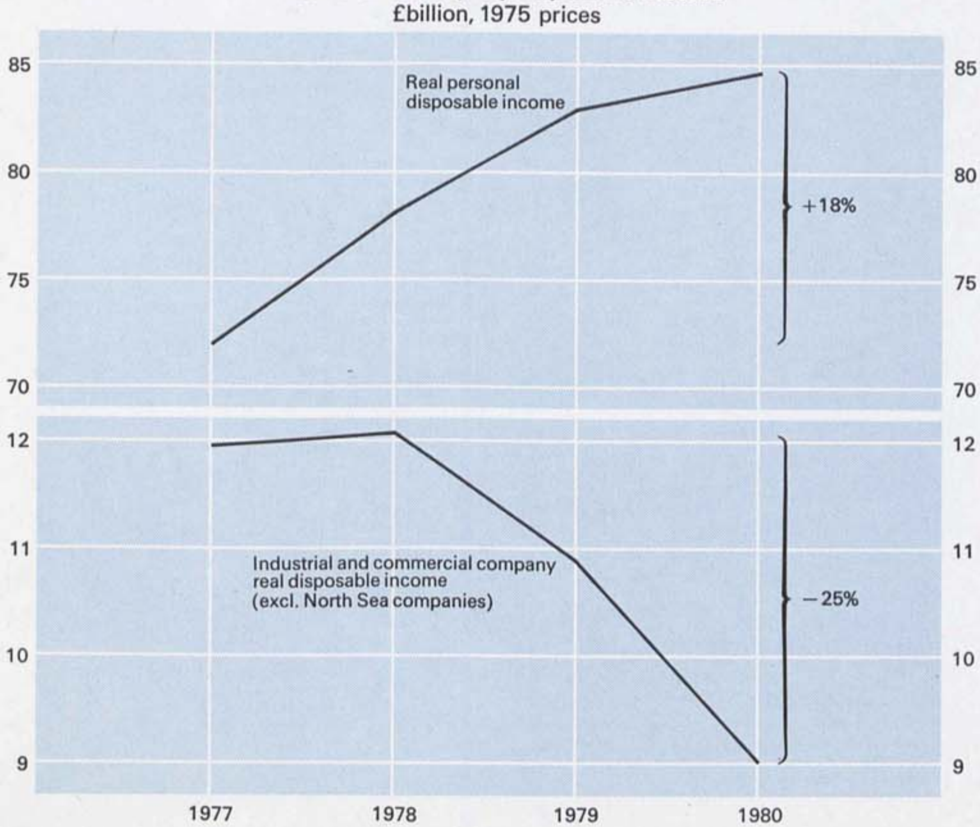


CHART G

Unemployment and skilled labour shortage

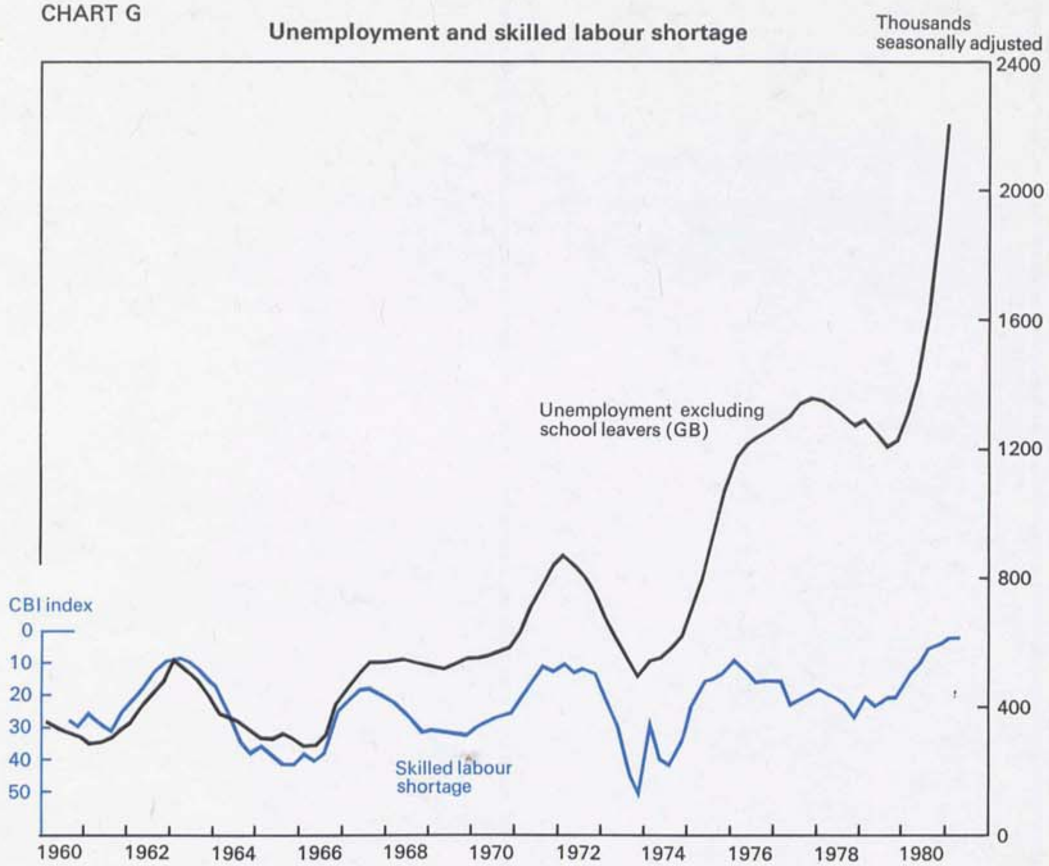


CHART H

Public expenditure and non-North Sea taxes as a proportion of national income

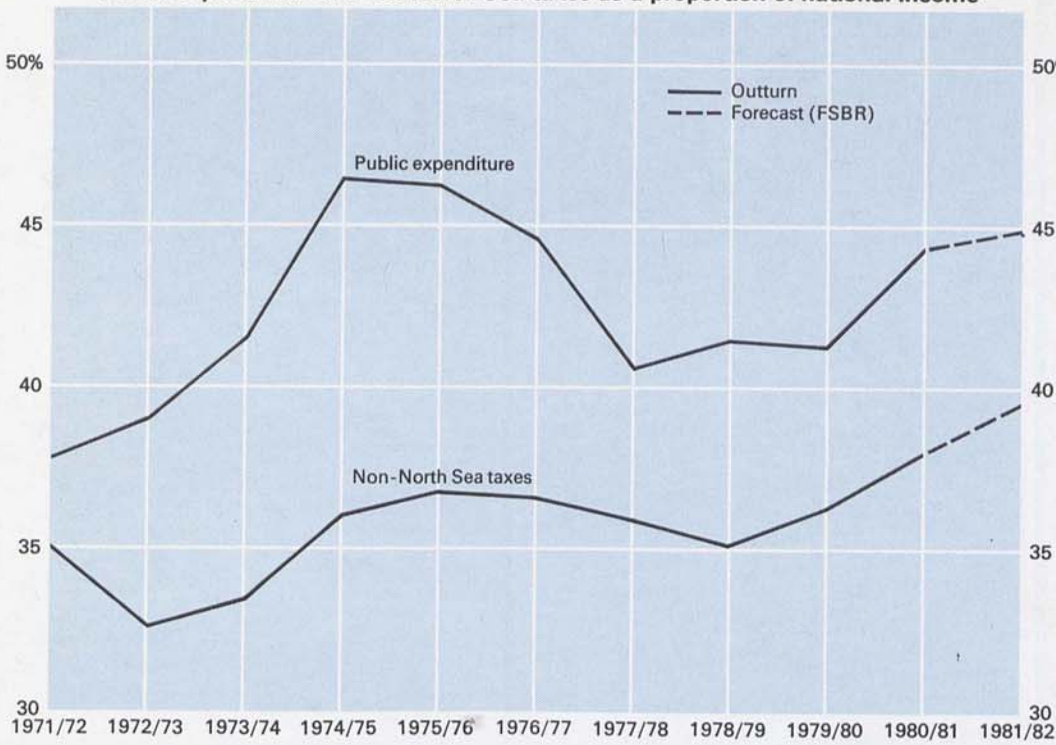
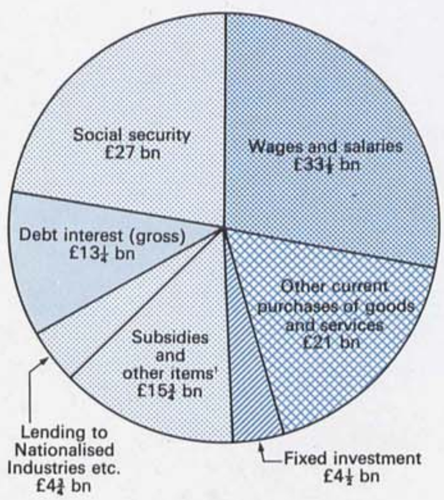


CHART I

Central and Local Government expenditure, 1981/82

Total cash expenditure : £120 billion

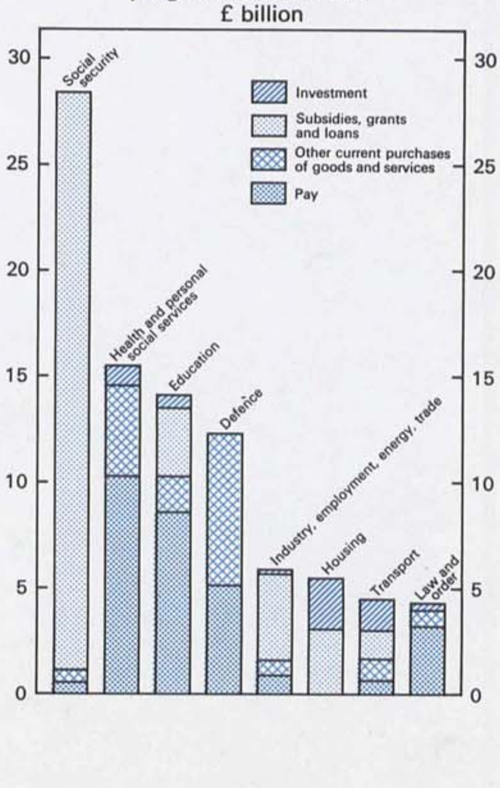


¹Other items include industrial and regional assistance, current grants abroad, student awards, grants to universities and lending for house purchase.

CHART J

Main public expenditure programmes, 1981/82

£ billion



ANNEX B

CAPITAL AND CURRENT EXPENDITURE

There is a wide-spread feeling at present that capital expenditure in the public sector should be increased. This note examines some of the issues briefly.

2. First, some facts. The plans we published last March show that the dramatic shift between capital and current spending occurred between 1975-76 and 1978-79, when public capital spending (including Government loans to nationalised industries) fell by over one-third - £6 billion in 1980 Survey prices - while current spending rose - by over £3 billion. Between 1978-79 and 1980-81 capital expenditure will have fallen by a further £1½ billion, while current spending increases by a further £3 billion.

3. It should be noted that some of this reduction has reflected a decline in needs. For example, there is now less need for a major road building programme than there was in the late 1960s and 70s, so capital spending on Motorways has fallen from its previous high level. (In fact, the need at present is to maintain the Motorways in good order, and this falls on current expenditure rather than capital.) Similarly, a decline in the numbers of school children has reduced the need for new school buildings.

4. So far as nationalised industries go, where pressure for additional capital spending is greatest, the position is that from 1977-78 to 1980-81 capital expenditure has been broadly maintained in real terms at about £4½ billion per year; and this is already expected to rise to about £5.2 billion for each of the years up to 1983-84. This is a level for investment last attained in 1976-77. This is all in marked contrast to the fall which has taken place, and may continue to take place, in private sector investment.

5. It is widely assumed that capital expenditure is good because it builds up the long term productive capacity for the economy, whereas current expenditure is wasteful and does not do so. This is not

always the case, because the categorisation of expenditure as capital or current is not of course made on that basis.

6. Not all capital expenditure produces a long term economic benefit, and some current expenditure does. Research and development and industrial training, for example, are generally classified as current expenditure but ought to be adding to the nation's productive capacity. Investment in prisons and unemployment benefit offices, on the other hand, however beneficial or necessary they may be on other grounds, can hardly be regarded as adding to the nation's productive capacity. Over simplified application of commercial accounting principles can mislead in the case of public spending.

Current

7. Moreover, even in the case of capital investment which undoubtedly adds to productive capacity, its desirability, compared with alternative uses of the resources involved, must obviously depend on the quality of the investment. Public investment is only worth undertaking if it yields a satisfactory return. At present the test which is applied to nationalised industry investment is whether it will enable the spending programme in question overall to yield 5 per cent in real terms. Worthwhile projects have to be identified. But history shows how difficult this is. There are numerous examples of unprofitable, misguided or wasteful public sector investment projects such as the Isle of Grain power station and British Steel's investment programme of the early 1970's. The return on nationalised industry investment since 1972 in the aggregate has been very poor - never significantly above zero - and well below that of the private sector.

8. The difficulties that arise are, in part at least, a reflection of the fact that the process by which the market appraises a private sector invitation to investors is trusted, but the process by which government appraises a nationalised industries application for funds for capital investment is less clear cut, dependent on administrative discretion, and therefore less acceptable.

9. Indeed, even the 5 per cent test applied in the public sector is not really comparable to the market test faced by investment in the private sector. Some nationalised industries can produce any given

rate of return by the exercise of monopoly powers, regardless of whether the project genuinely increases efficiency. In other cases the rate of return is met by reducing the cost of providing a service which already runs at a loss (this is the meaning of the 11 per cent claim for electrification of rail, for instance - it would show an 11 per cent return as compared with investment in diesels).

10. If investment proposals do pass appropriate tests, the next question is how they should be financed. If our central economic objective is to defeat inflation by controlling the growth of money, at any given time the total level of money expenditure in the economy must be limited. This means that investment proposals can only be financed at the expense of other expenditure.

11. This is true, whether one is speaking of public investment or private. In the case of private investment proposals, the general economic climate within which they are put forward is of course materially influenced by the Government's fiscal and monetary policies, but both the total level of investment and its distribution between projects are determined by the market.

12. In the case of the nationalised industries, if investment can only be financed at the expense of other expenditure, the way in which this can be done outside the governmental rationing system is for the necessary funds to be generated internally. In other words, nationalised industries should primarily finance investment out of their trading surpluses - which may often only be attainable by taking quite radical steps, such as substantial manpower reductions and significant cuts in real earnings levels, but not, of course, unjustifiable price rises brought about through the exercise of monopoly power.

13. But in the case of public sector investment the competition for funds is wholly distorted by the Government's own credit being behind the borrowing, quite apart from the existence in many cases of monopoly power. Investors naturally like the security of lending to public sector bodies, whether there is an explicit Government guarantee or not.

The power to borrow is in effect backed by the power to tax, and this makes it radically different from private borrowing. The more borrowing of this kind there is, within the monetary limits we have set, the more difficult or expensive it must be for the private sector to borrow. Even if private investment is possible interest rates can be forced up and in that sense crowding out can take place. That is why the extent of public borrowing has had to be rationed by the Government, just as it is in other Western countries with both a public and a private sector. The invention of new methods of finance for the public sector does not alter this basic point.

14. The possibility of allowing nationalised industries to raise part or all of this finance for capital projects direct from the market has of course been carefully considered and final conclusions on this question have not yet been reached and will be taken in the light of the findings of the NEDC taskforce set up following the June Council under Treasury Chairmanship. But it would only be worth doing if some genuine link could be made between the performance and efficiency of the industry and the returns on the bond - so that investors are able to put the same sort of pressures on to management as shareholders do in the private sector. The effect of a direct relationship with the markets, including the issue of prospectuses, could have a useful impact on performance in efficiency, if this genuine link could be made. Without the real prospect of savings through greater efficiency the higher cost of private rather than Government finance would not be justifiable. Again the difficulties of the monopoly powers and protected competitive position of many of the industries present themselves; but it may be that a limited move in this area would be possible. This would not affect the main issue, as it would not justify any increase in total expenditure.

15. The difficulties of determining the level, distribution and financing of public investment all underline the conclusion that we have long ago reached that, whenever it is at all attainable, by far the best course is privatisation. But however vigorously that is pursued, the problem of the distribution of capital and current expenditure within a reduce public sector will remain.

16. It may well be true that the present pattern of capital and current expenditure within the public sector is not the best one. When total expenditure has to be cut, it is often easier to cut the capital, both in Government and in nationalised industries. There may well be projects for capital expenditure in both these areas which should be given some degree of preference.

17. The best way to finance profitable public investment is to cut out unprofitable public investment, or make offsetting reductions in current expenditure in the public sector whether within Government or in the nationalised industries. But if additional investments adds to the totals, either or both of two consequences must follow:-

(i) There must be more public sector borrowing and thus higher interest rates and less private investment; or

(ii) taxes must be higher so as to reduce private consumption.

H.M. TREASURY
11 June 1981

PART 8 ends:-

TPL to PM 10/6/81

PART 9 begins:-

C(81)29 12/6/81