MT

PART 10

Confidential Filing

Economic Strategy

Pay + Prices Monthly Economic Report

The Economic Prospect

ECONOMIC POLICY

Part 1: May 1979

Part 10: Oct 1981

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
~~16.10.81~~							
~~28.10.81~~							
16.11.81							
~~23.11.81~~							
~~25.11.81~~							
~~27.11.81~~							
~~30.11.81~~							
3.12.81							
Pt 10 Ends							

PREM 19/425

PART 10 ends:-

B.1 to Treas 3/12

PART 11 begins:-

LPC Guidance for March 3/12

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. University of Liverpool; Liverpool Research Group in Macroeconomics: Quarterly Economic Bulletin, 16 October 1981

2. House of Commons Hansard, 28 October 1981, Columns 883-889 (exchanges at 4.12 pm)

3. National Institute of Economic and Social Research: Economic Review, Number 98, November 1981

Signed CWayland Date 22 March 2011

PREM Records Team

cc Mr Scholar

Econ Pol

10 DOWNING STREET

From the Press Secretary

3 December 1981

Dear Rosalind,

This is, I think, the appropriate time to weep on each other's shoulder.

I cannot help but think that this morning's presentation of the outcome of the public expenditure review would have been better had the Government answered the questions I put on behalf of Heads of Inf. to the Lord President on November 27 - viz:

> "How is the overall outcome of the public expenditure review to be presented - in simple terms, as good or bad news; as taking credit for the outcome or regretting it? ....
>
> "We need, therefore to try and present the outcome as an achievement in keeping the likely PSBR on its downward path, despite the recession."

The Government clearly did not know the answers to these questions and felt unable to respond to the advice. In these circumstances we were all in worse trouble.

I say "worse trouble" because I believe we shall always be in trouble with the announcements of the outcome of the public expenditure review since we are in a position to give only one side of the equation. I think a small group of us should see what, if any, presentational lessons we can learn from this episode and I shall be calling a meeting to this end.

Against this background, and the impossible position in which you found yourself yesterday, I think I must let you know some of the complaints which have been communicated to me from the Lobby:

- the Chancellor was 20 minutes late; (my press officer at the Lobby managed to calm them down to prevent a walk-out but she tells me they were in a resentful mood by the time he appeared). I know you would have dearly wished to avoid this delay. If it helps, consider yourself free to use this letter to get over in Treasury how counter productive (and stupid) it is to keep the Lobby waiting on one of the days in the year when time is at an enormous premuim.

- There were no (or very few) copies of the statement available as it was being delivered, if only for evening newspapers, agencies and radio/TV; you and I know why but we are not going to win the Government any friends if we tell them the reasons. This is of course a fall out from the failure to decide the presentational strategy.

- The effect of the measures announced or implied in the Statement on the individual were not summarised; this was a victim of (i) the rush, and (ii) the decision to leave it to Departments to present their own thing. The information was available but inconveniently presented; we shall win no friends unless we conveniently package things for journalists working at the very brink of their deadlines. I must watch this in future. (This point raises the wider issue that we can have no complaint if, having the information, we fail to present it to the media and then find they make their own calculations).

Finally, I understand that the Chancellor has been forced by a last minute out of town engagement to re-arrange his Lobby with Sunday newspapers. This is compounding yesterday evening's felony. Again, if you care to use this letter to get over to those responsible how counter productive it is to treat the media as an optional extra to be fitted in as convenient, you may of course do so.

Yours sincerely

Bernard Ingham

B INGHAM

Mrs R Gilmore
HM Treasury

cc Mr. Ingham
Mr. Wolfson
Mr. Duguid
Mr. Scholar

Eco Pol

MR. HOSKYNS

The Mini Budget and the Strategy

You asked me to let you have a note on the extent to which the absence of a clearly perceivable economic strategy adversely affected the way in which yesterday's package was received.

Perhaps I could start with two propositions, which I would be prepared to support even though the Treasury might incline to dispute:

i) Although we do have a clear economic strategy, it was not perceivable in yesterday's announcements.

ii) The package was badly received.

But it does not necessarily follow that -

iii) The package was badly received because it was presented badly.

No clear economic strategy was perceivable in the announcements

It was always going to be difficult to decide how to present the package, because it was a compromise in which the proponents of two substantially different strategies could claim an element of success. Thus it was not possible to go clearly down either of two equally respectable, but conflicting, routes: first, to announce that the Government had concluded that, because of the depth of the recession, unemployment was the major problem facing the nation, that a very large amount of extra public money was therefore going to be made available for it, and that of course the country would expect that adjustment to public expenditure and charges elsewhere would be necessary; or second, to say that, having completed the public expenditure review, the Government was proud to announce that conclusions had been reached which were entirely consistent with the MTFS, because public spending next year would be lower in real terms than this, and because on unchanged

/assumptions

assumptions the PSBR would continue to decline in accordance with the strategy. Such clarity would have been unacceptable to one side or the other. So the best hope was the development of the "prudent flexibility" theme of the Prime Minister's speech on the Censure Debate on 28 October. A brief reference in this sense was indeed part of the fifth paragraph of the penultimate draft of the Chancellor's statement. It was not much, but it was at least something.

But, in the end, even that modest sentence was excised. We were left with a paragraph which is worth quoting in full: I do not exaggerate in saying that this is the only place in the Chancellor's statement where any explanation is given of the motivation behind the measures:

> "At the time of the Budget we expected cash expenditure in 1982-83 to grow more slowly than we now envisage. We now think it appropriate to increase the planned provision for certain programmes to reflect changed circumstances."

There was therefore in the statement not only no oratory or inspiration, which is not the Chancellor's style, but no indication that the announcements represented a step down a strategically determined path. A picture is given of a Government simply responding pragmatically to events, rather than determining them; the overwhelming impression was of a technical package consisting chiefly of bad news; and the picture was not helped by the Chancellor's subsequent repeated references, in discussion of his statement, to "balance" as the objective of the measures. Balance, whatever it means, is not exactly a thrilling strategic concept.

It is important to stress at this point that I am not criticising the drafting of the statement. The Chancellor has his own style; and, in the eyes of the Daily Telegraph at least, it is appropriate to his message. It is the absence of a strategic framework which is striking.

/ The package was badly received

CONFIDENTIAL

The package was badly received

I think there is no need to argue this point. But some analysis of the criticism may be useful. I think media comment falls into three categories:-

(i) That the package meant that everyone gets worse off, i.e., concentrating on the substance of the announcements;

(ii) That the package created an atmosphere of dismal gloom, i.e., concentrating on the presentation.

(iii) That the package gave an impression of a drifting Government that had lost its objective, i.e., concentrating on the failure of the strategy.

Some selected extracts of the media coverage are annexed. It is of course possible to select quotations to prove almost any point. But it is undeniable that only the Daily Telegraph is remotely supportive; and that the only good message to come out of the others is the possibility of tax cuts in the Budget - an expectation which I doubt the Treasury want to foster just at the moment.

Cause and effect

Bad news is always going to be seen as bad news, however well it is presented. But yesterday's announcements are being criticised not only because of their substance, but also because of their presentation. To some extent, therefore, criticism could have been deflected by different presentation. I have consulted Bernard Ingham about this, because he (and I) have been concerned for several weeks about the possible impact of the announcements. You may like to glance, because I think you did not see it at the time, at the attached note Bernard sent to Francis Pym on 24 November. You will see that we were then very concerned about the need to put the announcements in a strategic context, not least in order to limit the damage on pay bargaining. Bernard's view this morning was that:-

/ (a)

(a) The statement ought to have had some strategic underpinning in paragraph 5;

(b) It ought to have been more inspirational, and to have contained a few catch phrases, so as to have captured the headlines and the opening sentences in the Press.

(c) But it is inherent in the announcement of the autumn measures that we are going to have a bad reception, because the Chancellor is able to announce only one side of the equation.

Conclusions

1. Yesterday's package would have been received with less criticism if it had been presented in a more lively way, but the criticism of the substance would always have been there.

2. You can't get away with bad news unless you give people some hope that it is in a good cause. An announcement like this desperately needed to contain the basis for understanding why it was necessary.

3. That failure to put it in a strategic context, which stemmed from the fact that Ministers did not really have a consensus among themselves as to the strategy they were following, may well have an adverse effect on pay bargaining.

J. M. M. VEREKER

3 December, 1981.

Selected extracts of the Media coverage of the 2 December announcements

1. Coverage of the substance

"Howe makes us all suffer - Chancellor Geoffrey Howe put Christmas in reverse yesterday with a mini Budget sackful of gloom."
(Daily Express)

"Once again the Government is putting up taxes and prices - after winning an Election on the promise to bring both of them down."
(Daily Mirror)

"We can't cut Government spending as we would like to - so here's the bill"
"Because the Government has failed to cut its own spending, it is now having to cut the living standards of the British people."
(Daily Mail)

"Families got a £5 kick in the teeth from the Government yesterday."
(Sun)

"He admitted that the battle to contain public spending had been lost."
(Daily Telegraph)

"The Chancellor is allowing public spending to rise next year, but charges will have to go up to pay for it."
(ITV News at 10)

2. Coverage of the presentation

"The Chancellor's announcements were greeted with derision on the Labour side, and doubt and anxiety from the Tories."
(ITV News at 10)

/ "A.

"A drear and feeble old Treasury tune."
(Guardian)

"What message ..... what inspiration ..... what hope could they glean ..... Sir Geoffrey made it as electrifying as an algebra lesson."
(Daily Mail)

"There is nothing in it to uplift, invigorate or encourage ..... hope is a necessary part of the cure."
(Daily Express)

3. <u>Coverage of the strategy</u>

"It remains an open question how far neat budgeting is a substitute for an economic strategy ..... we remain in a pragmatic no-man's land."
(Financial Times)

"The truth is that the Chancellor has been compelled to recognise the failure of the Government economic strategy. It is in ruins."
(Daily Mirror)

"One senses a new pragmatism in the air; may it come to full flower in the Spring.".
(Times)

"The abandonment, in effect, of the Government's monetarist strategy."
(Guardian)

"The worst thing that could happen is for the Government to lose its nerve ..... dogged integrity should be the order of the day."
(Daily Telegraph)

Prime Minister

Good news

MHS 2/12

(2)

c. Mr. Hoskyns
Mr. Ingham
Mr. Duguid

MR. SCHOLAR

PAY

In the flurry of today's other economic events, one or two rather good pieces of pay news may have been over-looked, and you may feel they are worth drawing to the attention of the Prime Minister.

The latest gallup political index contains a survey on wage and price expectations, of which I attach a copy. Like all surveys, this can be interpreted in a variety of different ways. But however you look at it there must be significance in the fact that a quarter of the sample expect no pay increase this pay round, 93% of those who expressed a view expect less than a 10% increase, and the average increase expected is 4.6%. By comparison, the average price increase expected is 9.8%, and nearly half the sample expected prices to exceed 10%. If the sample is representative, it is clear that wage bargainers have already got the message that they are to expect a fall in living standards.

The latest figures from the CBI's pay data bank, released today, based on the rather small number of settlements - 172 - during the current pay round, indicate that most pay deals are now concentrated in the 5 - 7% range. That is significantly lower than the latest figure suggested by the Department of Employment's monthly pay brief, which was about 9½%. Even on this small sample, I think we can be reasonably confident that the pay round is starting lower than it did last year. That is true of the National Engineering agreement (8.2% last year, 5.1% this year), BL (6.8% last year, 3.8% this year) and of early indications in the mining and water industries.

Finally, the Prime Minister may have seen that the threat of a tanker drivers strike has now substantially disappeared, with today's news of the announcements by Texaco and Esso of

/the

the acceptance of the 8.1% offer, in addition to BP and Mobil who have already settled. ~~The main outstanding company is Esso, but on their own they are unlikely to cause major disruption~~.

J.

2 December 1981

Questions and answers	Today	Comparison
3 Over the next 12 months what, if any, percentage increase do you expect to get in your wages or salary?		
Nil	25	
1 or 2	3	
3 or 4	16	
5 or 6	19	
7 or 8	6	
9 or 10	10	
11 or 12	2	NA
13 or 14	1	
15-20	2	
Over 20	1	
Don't know	17	
Average	4.6	
4 Bearing in mind the present economic situation, inflation and unemployment, what level of wage or salary increases do you think workers should aim for?		
Nil	5	
1 or 2	1	
3 or 4	5	
5 or 6	21	
7 or 8	11	
9 or 10	24	NA
11 or 12	7	
13 or 14	1	
15-20	4	
Over 20	1	
Don't know	21	
Average	7.9	
5 Over the next twelve months, what percentage increase in prices do you expect?		
Nil	2	
1 or 2	3	
3 or 4	5	
5 or 6	7	
7 or 8	9	
9 or 10	20	NA
11 or 12	12	
13 or 14	5	
15-20	10	
Over 20	3	
Don't know	23	
Average	9.8	
(21-26.11.81)		

file no TEB/CA/01

PPS/CHANCELLOR

copied to:

Mr Salveson (for transmission to No.10)
PS/CST
PS/FST
PS/EST
PS/MST(C)
PS/MST(L)
PS/Home Secretary
PS/Lord Chancellor
PS/Foreign Secretary
PS/Secretary of State for Education and Science
PS/Lord President of the Council
PS/Secretary of State for Northern Ireland
PS/Secretary of State for Defence
PS/Minister of Agriculture, Fisheries and Food
PS/Secretary of State for the Environment
PS/Secretary of State for Scotland
PS/Secretary of State for Wales
PS/Lord Privy Seal
PS/Secretary of State for Industry
PS/Secretary of State for Social Services
PS/Secretary of State for Trade
PS/Secretary of State for Energy
PS/Secretary of State for Transport
PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY WEEKLY ECONOMIC BRIEF

I attach the latest version of this Brief. Changes from the previous Brief, of 23 November, are sidelined.

M M Deyes

M M DEYES

RA

R I G ALLEN

30 November 1981

EB Division
HM Treasury
01-233-3364

Note : Separate briefing being prepared for announcements being made this week and for forthcoming report of Treasury and Civil Service Committee -expected this week or next.

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires strict adherence to firm monetary and fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Relative importance given to inflation and unemployment?

Government is equally concerned about both. These are complementary not competitive objectives; unemployment will not be reduced by relaxing struggle against inflation.

3. What has Government achieved during term of office so far?

Removed constraints on market forces: reduced Government regulation and bureaucracy; fostered a new mood of realism; improved incentives to enterprise and efficiency. Specific measures to help small businesses to start up and/or expand. Manufacturing output up 1½ per cent in third quarter. Inflation below 12 per cent - nearly halved since Spring 1980 peak. Unemployment in latest three months rising less than half as quickly as in last quarter of 1980.

4. When will upturn in economy come?

Latest figures (published 12 November) suggest that both GDP and industrial production are are now rising. New CBI survey also suggests beginnings of a recovery. Manufacturing productivity (output per man) up 5 per cent since end-1980. Unit wage costs in manufacturing have shown little rise in first half 1981 [NB but rising more strongly again now]. Rate of de-stocking may now be slowing. Competitiveness improved. Prospects depend above all on further success in reducing inflation and improving industrial competitiveness and productivity. (See also B1 and 2.)

5. Statement on public expenditure?

A statement on public expenditure will be made on Wednesday 2 December.

6. When will Industry Act forecast be published?

We expect the Industry Act Forecast to be published on Wednesday 2 December.

7. British business in crisis? Manufacturing bearing the brunt?

Government has done a good deal to create right conditions for business to thrive but recession has obscured them. Best help Government can give is further progress in bringing down inflation. Glad to note leaders of industry (letter in The Times 26 November signed by among others, Chairman of Beechams, Cadbury, Schweppes, McAlpine's, Metal Box, Taylor-Woodrow, Whitbread and Wimpey), back us in our broad strategy against inflation and urge us not to be deflected. Many signs companies now tackling problems ignored for far too long. Unreasonable to expect problems of years to be solved overnight. Growing evidence of improvements in productivity and competitiveness.

8. Recent manufacturing productivity gains predictable consequence of recession?

[P Kellner in N. Statesman 13 and 20 November.]

During the downswing to this spring, manufacturing productivity fell less than would be expected, given fall in output. And rise in productivity this year has greatly outstripped increase in output. Output per man hour both in manufacturing and whole economy are higher than in first half 1979.

9. Productivity gains mean job losses?

No. Productivity a way of improving competitiveness and securing more growth in the economy.

10. Current unemployment levels intolerable? Going to get worse?

No immediate prospects for fall in unemployment but the rate of increase has slowed markedly since turn of year. Less short time working, overtime picking up. (See also C1) The prospects depend crucially on securing further reductions in pay settlements and increasing productivity so obtaining improved competitiveness. This is the way to get real sustainable jobs.

11. 10 per cent November inflation target now impossible? Inflation bound to get worse? Sacrifices have been for nothing?

Developments since the Budget (particularly fall in exchange rates) have certainly worsened short-term inflation outlook. But Government expect downward trend will continue, though precise timing is difficult to predict.

12. Government has failed to check public spending?

Public spending this year is expected to be somewhat higher than we had originally planned. An important reason for this is that we took the effect of the recession into account when we prepared our most recent plans. We remain committed to containing public spending.

13. Government has failed to allow accommodation to the recession?

Accusations that we are inflexible in our tactics are unfounded. Have been flexible within the limits of prudence over the levels of public spending and borrowing.

14. Government being flexible to point of laxity?

We must be flexible about particular policies while holding in place our policy framework. We cannot and will not allow the foundations to be destroyed.

15. Government has not taken fully into account effect of rising cost of unemployment on PSBR, and hence deflationary consequences?

[P Kellner in N Statesman 13 and 20 November; questioning at TCSC 16 November.]

Appropriate PSBR must be judged by taking account of all relevant factors including monetary conditions. It's the actual cash PSBR that has to be financed, not a notional 'constant employment' one. Limit on PSBR is extent to which it can be financed at tolerable levels of interest rates.

16. Why are high interest rates needed?

Current level of interest rates has reflected developments overseas and strength of bank lending. Although sterling has recently firmed, high level of bank lending continues. However it should be noted that bank base rates have come down by 1 per cent from the peak in September.

17. Rapid growth in £M3 shows slackening in monetary squeeze?

Not followed £M3 target slavishly to exclusion of all else. Allowed overshoot last year because judged could do so without endangering objectives for reducing inflation.

18. Is the MTFS still Government policy?

The MTFS sets out our broad strategy on fiscal and monetary policy. Objective is to provide assurance Government will continue to provide financial discipline. Judged by results, rather than precise numbers, we have done just this. (See also section H).

19. MTFS shot to pieces?

Completely untrue to say we have failed to achieve MTFS. Main objective is reduction in inflation, and progress here has been good. £M3 growth has been higher than we would have liked, though narrow measures of money have grown more slowly. But growth in nominal GDP (as discussed in November Economic Progress Report) seems to have been growing by about 10 per cent in first half 1981. The PSBR for this year is likely to be much as expected at the time of the 1981 Budget.

20. Government should change course?

(a) Moderate reflation the answer?

[Alternative reflationary packages continue to proliferate: eg NIESR suggested £5 billion in their November Review]

Government has shown willingness to adapt to recession and is allowing higher PSBR than envisaged last year. Fallacy that we could "spend our way out of recession" (i.e borrow much more) without seeing a resurgence of inflation, and as a consequence interest rates rising further and faster. Even large reflationary packages like those suggested by NIESR yield relatively small benefits in terms of higher output and lower unemployment.

(b) Reintroduce exchange controls and join EMS?

EMS is not a panacea. But Government does fully support EMS as an important step in monetary co-operation and closer integration in the European Community. Have stated that UK will participate in the EMS exchange rate mechanism when conditions appropriate both for the system and ourselves. Question is kept under constant review.

(c) More capital spending in public sector?

Projects must be economically sound. Not all capital spending virtuous nor all current spending bad. Cost of public sector investment in terms higher borrowing pushing up interest rates could outweigh immediate boost to jobs.

B ECONOMIC ACTIVITY AND PROSPECTS

1. Is recession over?

Ministers have been saying for many months that fall in output was ending. This now appears to be the case. Preliminary GDP output figures for Q3 up ¼ per cent on Q2. Manufacturing output increased by 1½ per cent in same period. Preliminary Q3 figures for manufacturing, distribution and wholesalers stock show rate of destocking reduced by about two-thirds compared with H1 1981. Some improvement in financial position of company sector (see N3).

IF PRESSED: Evidence not conclusive

Recognise all usual uncertainties. Equally I see no virtue in ignoring what has occurred. There has been a substantial improvement since the end of last year. GDP output has stabilised, manufacturing output has picked up, labour market indicators have improved (see C1). This year has seen higher engineering and construction orders and increased private sector housing starts, compared with the second half of last year. CSO's cyclical indicator system suggests turning point in Q2. (See B3 for independent forecasts).

[IF ASKED about decline in CSO's longer leading indicator: Too early to judge significance; recall that temporary weakening occurred in last cycle.]

2. Government assessment of prospects

Budget forecast assessment suggested beginnings of recovery in H2 1981. This now appears to be emerging. New Industry Act forecast will be released by Treasury on Wednesday 2 December.

3. Outside forecasts

[GDP profile in major forecasts released since June:

	H2 1981 on H1 1981	H1 1982 on H1 1981	per cent
LBS (Nov)	1/3	1	
NIESR	1	1¼	
CBI (Nov)	0	2/3	
Phillips & Drew (Nov)	0	½	
OECD (July)	-1/3	0	

November NIESR Review contains only annual data, but commentary suggests low point reached in H1 1981, with prospect of some recovery.

New P&D forecast to be published later this week.]

Recent major independent forecasts assess that low point in activity was reached in first half of year, with prospect of some recovery in the coming year.

4. New National Institute Review argues reflation needed?

[NIESR Review sees broadly flat medium-term profile, dismisses supply constraints and plays down danger of re-emergence of inflation. Consequently advocates £5 billion relation with 150-300,000 effect on unemployment.]

Note that NIESR adopt clearly what is usually implicit in their commentary ie substantial reflation. Also note that on their own calculations, such action would not be particularly successful in alleviating unemployment. Dismissal of supply side problems ignores our sorry experience of declining market shares.

5. CBI Economic Situation report gloomy?

Both the monthly enquiry and new forecast continue to show low point in output in H1 1981, with some modest recovery starting to show. Report assesses that "export volume will provide major contribution to growth in demand next year." Report stresses importance of further moderation in pay settlements, and need to improve productivity further.

6. Where will recovery come from?

Mainly from the reversal of the same factors that contributed to the downswing. There are signs that the rate of destocking is slowing, the savings ratio can be expected to decline further as inflation abates, and some recovery is expected in world trade. Additionally productivity and competitiveness are now improving [see second half of B7].

7. Recovery slow?

Never claimed it would be rapid [FSBR shows 1 per cent growth in GDP in year to H1 1982]. Economy has weakened cumulatively during the post war period. Have created the opportunities and foundations for improved economic performance.

8. Higher interest rates will abort recovery? Business confidence weakened?

Understand concern over higher interest rates, but it is absolutely essential to contain inflation. Inflation is inimical to sustainable recovery. Interest rates only one of factors affecting industry. Manufacturing productivity in second quarter some 5 per cent up on final quarter of last year. Together with last pay round's lower level of settlements, this has meant only a small rise in manufacturers' wage costs this year. This can be expected to contribute towards improved profitability and competitiveness.

9. Recession worse than in the 1930s?

Any such comparisons must of course be subject to a statistical health warning. It is true that the fall in output is comparable to the 1930s, but structure of the economy and society is much changed.

C LABOUR

1. Unemployment continues to rise?

[November total count was 2,954,000 (12.2 per cent) - second consecutive month showing slight decrease. Seasonally adjusted excluding school leavers figure was 2,764,000 (11.4 per cent)]

Unemployment rising much less rapidly. Increase in recent months less than half those at end of last year [44,000 per month in 3 months to November 1981 compared with 115,000 per month in Q4 1980]. Also should note within manufacturing short time working sharply cut -(down ¾ from January level), overtime showing signs of picking up and fall in employment much less. Result is that total hours worked have stabilised and now show signs of some pick up. Vacancies improving too.

2. Unemployment accelerating?

[Monthly increases in adult unemployment, seasonally adjusted, in 4 months July-October showed some acceleration, with successively 30,000; 44,000; 46,000; 56,000. November's 36,000 halts this.]

Recent months figures difficult to interpret [due to emergency procedures because of civil service dispute]. Reliability somewhat uncertain. November breaks any apparent trend. Remains the case that labour market indicators are much more favourable than at turn of year (see C1 above). IF PRESSED FURTHER: Unemployment forecasts and assessments always uncertain. What is essential is that all participants in the economy contribute to improved economic opportunities. Crucial to this is further moderation in pay settlements.

3. Employment continues to fall?

[Total employment fell further ¼ million in Q2 1981, much the same as in Q1. Total decline since mid-1979 1.7 million or 7½ per cent.]

Decline in manufacturing employment showing signs of further marked slackening in August and September (25,000 compared with about 50,000 per month earlier in year), and 80,000 per month in H2 1980.

4. Government forecasts for unemployment

[Public Expenditure White Paper published Budget Day used working assumption of an average level of 2.5 million unemployed in Great Britain (excluding school leavers) in 1981-82 and 2.7 million in 1982-83. Government Actuary's Report published 3 July revised 1981-82 assumption to 2.6 million. NB new GAD report will shortly be published]

Like previous administrations Government does not publish forecasts of unemployment, though Government Actuary Reports etc contain working assumptions. Government is concerned about unemployment. Scale of special employment measures (SEMs) adequate evidence of this. Prospects depend on further progress on productivity and competitiveness. [See 5 below for independent forecasts.]

5. Independent forecasts?

[Consensus is for medium term rise in "narrow definition" unemployment, reaching about 3 million in Q4 1982.]

History shows unemployment forecasts to be very uncertain (this is a major reason why Government does not publish one). This is reflected in range especially for beyond next year.

6. True level of unemployment is far higher than official figures?

[TUC now state it is above 4 million.]

Unemployment statistics are published on the same basis as under previous administration. MSC has wisely commented (in paper to NEDC) "the current definition provides a good and well understood series for discerning trends and once that firm ground is left, there is endless scope for statistical and semantic debate." We are concerned about unemployment however defined. But our policies are laying foundation for creation of secure employment.

7. Unemployment higher than in other countries?

[OECD standardised data show UK Q1 1981 at 10¾ per cent compared with OECD average of 6¾ per cent.]

Unemployment has been rising sharply in major industrialised countries, given weakness of world economy. In our case we are suffering the cumulative effects of lost competitiveness and low productivity and implications of inflationary pay settlements in 1978-79 and 1979-80 pay rounds. This is why the rise in UK unemployment has been higher than in most other countries, and points to the need to improve productivity and competitiveness.

8. Would work-sharing help reduce unemployment?

I doubt whether this is the answer. We prefer to leave the determination of hours and working schedules to the decision of employers and workers who know the local conditions. But unless people prepared to accept reduction in income commensurate with reduction in hours, effect on productivity and competitiveness likely to make worksharing counter productive.

9. What is the cost to the Exchequer of the unemployed?

[MSC estimate £438 million per 100,000 additional registered, private sector unemployment (similar figure estimated by Institute of Fiscal Studies); when "grossed up" gives £12½ billion for total unemployment. This figure has received much attention eg FT front page 9 November.]

All such calculations depend critically on and are sensitive to exact assumptions adopted eg composition (especially whether public or private sector workers), previous earnings, and benefit entitlement of the additional unemployed.

As explained in detail in Treasury's Economic Progress Report for February 1981, cannot gross up estimates by naive arithmetic to give cost of total unemployed - or of resources available for costlessly reducing unemployment. [IF PRESSED: No economy has zero unemployment: Moreover, any major change in policy would have implications for inflation, thereby affecting estimates by changing earnings, prices, taxes and benefits.]

10. Spend money on new jobs rather than unemployment benefit?

Cannot switch employment on and off like a tap. But Government doing a great deal to help. Special employment and training measures currently cover almost 700,000 people at a cost of over £1,100 million this year. Not easy to assess just how many being kept off unemployment register by SEMs, but Department of Employment estimate at around 345,000.

11. Should spend more, especially for young people?

In July announced further provision for special measures of around (gross) £700 million in 1982-83. A large part of this was for young people, including the new Young Workers Scheme. For the future, I expect my rhF the Employment Secretary will soon announce substantial further measures in the form of a comprehensive training scheme for young unemployed.

12. Need to improve training at all levels?

Agree. Aim must be both to help individual and strengthen economy by having a better trained workforce. Government has fully endorsed objectives of MSC's New Training Initiative. We shall be making a statement before the turn of the year about role which Government and others can play.

13. Unemployment as bad as in the 1930s?

Comparisons extremely difficult to make. Maximum recorded unemployment in 1930s was just under 3 million; but the labour force has grown by about $^1/_3$ since, so unemployment rates in the 1930s almost certainly higher than now. One also needs to bear in mind changed social conditions and protection given by the welfare state.

D TAXATION

1. Burden of taxation

[Total taxation in 1978-79 was 35 per cent of GDP (at market prices), 36½ per cent in 1979-80, 38 per cent 1980-81. It is forecast to be 40 per cent in 1981-82.]

This has inevitably increased during a time when national production has not been growing. But, for the vast majority, real personal disposable income is still higher than for most of the period when the Labour Party was in Government. Recent OECD report showed that the Government's total 'take' (by way of taxation and national insurance contribution) as percentage of GDP is less than in many other industrial countries - UK eleventh in OECD rankings, behind most other EC countries, including France and W Germany. [NB: HMG's position is that national insurance contributions are not a tax - compare F5].

2. No increase in income tax allowances and thresholds in next Budget?

No decisions have yet been taken, and it is ridiculous to read any such implications into my rhF the Chief Secretary's recent speech [18 November at Westminster and City Programmes Conference on Tax Reform]. Of course, this is one area in which my rhF the Chancellor's room for manoeuvre will be determined by the extent of our success in limiting the growth of public expenditure.

3. Government policy regressive?

Largest percentage reductions in take-home pay, as a result of March Budget, were for those with very high incomes.

4. Government policy has harmed incentives?

Marginal rates of income tax for most taxpayers lower than when the Government came to power. Basic rate still 3p below rate inherited from Labour.

5. Indirect tax increases inflationary?

True that the indirect tax increases have added to the RPI. But by reducing public borrowing, they will help to bring inflation down in the longer run and ensure that it stays down.

6. Heavy fuel oil duty

Costs involved mean that it would not be in the national interest to go beyond the Budget decision not to increase the duty in heavy fuel oil. Terms of North Sea gas contracts a commercial matter for the British Gas Corporation.

7. Reduce petrol/derv duties?

Pump price also dependent on pricing policies of oil companies and world market conditions. Real value of derv duty now about 60 per cent of 1970 level, and of petrol duty no higher than in 1970.

8. Reduce National Insurance Surcharge?

[Chancellor reminded CBI on 1 November of key importance of wages in costs, and told them no prospect of NIS being abolished. Institute of Directors have called for precedence to be given to cuts in income tax over cuts in NIS.]

Fully aware of all representations and of strength of feeling in some quarters in favour of reductions. But important to remember that wages are major element in industrial labour costs. Remains one of possible candidates for reduction if resources available. Scope for any tax measures dependent on what decisions reached on public spending. NIS (like income tax) a major revenue raiser, producing £3.8 billion in current year, and very costly to reduce.

[NB. This briefing may require amendment during the week - HMT will provide amended version if necessary.]

9. Progress with examining corporation tax structure?

[Promise to re-examine corporation tax structure in 1980 Budget Speech]

It is hoped to produce the Green Paper on corporation tax this winter.

10. What about 'inflation tax' suggested by Roy Jenkins at SDP Conference and Professor Layard in recent Guardian article?

Such a tax would essentially be a form of income policy with all the well known defects of such. (See J11). In addition collecting such a tax would mean considerable extra work for the Inland Revenue. It would go against our policy of simplifying the tax system.

11. Progress so far on tax reform/simplification?

[As in CST's speech 18 November]

Substantial progress has already been made in improving incentives and simplifying the tax system, eg switch from direct to indirect taxes in 1979, correction of worst features of Capital Transfer Tax, improvement in Capital Gains Tax and Development Land Tax regimes, introduction of Business Start Up scheme etc. But reform of the tax system must be pursued within a financially responsible framework.

12. North Sea fiscal regime?

See R3.

E PUBLIC EXPENDITURE AND FINANCE

1. Announcement of spending plans?

Decisions for 1982-83 will be announced this week. More detail will be published in the White Paper at the time of the Budget.

2. 1981-82: Overspending?

[Outturn for the current year is expected to be in the region of £107 billion against £104½ billion in the last White Paper.]

Spending is expected to be higher in 1981-82 than was planned in the last White Paper. The major reason for this is the present level of spending by local authorities.

3. Failure to cut spending?

[Planning total for next year expected to be in the region of £115 billion against £110 billion in the last White Paper. Figures have been quoted in the press. The Chancellor will announce decisions for 1982-83 on Wednesday.]

Necessary to take account of changing circumstances and the needs of programmes. The discussions of public expenditure this autumn have been about the extent to which it would be appropriate to increase spending and about the extent to which the increases we have agreed upon should be offset by reductions elsewhere so as to limit the overall increase in spending.

4. Implications for tax and monetary policy

A matter for the Budget. But a high level of spending does mean taxation higher than it would otherwise be. The alternative would be more borrowing and higher inflation and interest rates.

5. When will this year's Winter Supplementary Estimates be published?

Winter Supplementaries will be presented to the House shortly.

[Note: Proposed date is 4 December but this has not been announced.]

6. Will, as in previous years, interim monitoring figures for 1981-82 Central Government cash limits and votes be published at the same time?

Yes

7. What about the cash limits 1980-81 provisional outturn White Paper?

The provisional outturn White Paper will be presented to the House shortly.

[Note: Proposed date is 4 December but this has not been announced.]

8. Cut current not capital/Cut current to allow more capital spending?

The Government's objective is, wherever practicable, to give priority to worthwhile capital projects providing this involves no overall increase in public expenditure. Must not oversimplify distinction between current and capital spending. Capital expenditure frequently necessitates additional current expenditure which it is difficult to accommodate at a time when our main objective is to contain the overall level of public expenditure.

9. Public spending overwhelmingly on administration?

[90 per cent figure quoted by some critics]

Not all current expenditure is on administration. One-third is current payments such as money paid out to old age pensioners, and the unemployed, child benefit and so on. One-fifth is for purchase of goods and services, for example for defence. One-tenth is grants such as overseas aid and subsidies. Only a third of current expenditure is on wages and salaries, and much of that is for nurses, teachers, policemen, soldiers and so on. We made it clear in the White Paper, Efficiency in the Civil Service, (published last July) that the Government is seeking ways of improving efficiency and cost consciousness in the Civil Service.

10. Cut staff numbers in public services?

Numbers in public service have already fallen since we took office. Civil Service has been reduced by over 7 per cent to 679,800. This is the smallest for over 14 years and we are well on target to achieve our aim of having by end of this Parliament the smallest Civil Service since the war. Local authority manpower has been reduced by nearly 70,000 (over 3 per cent).

11. Moves to cash planning announced in Budget mean that Plowden system is being abandoned?

Government does recognise case for medium term planning. But it must be planning in relation to the availability of finance as well as in relation to prospective resources. Illusion to suppose there can be unconditional commitment to forward plans for services.

12. Ratio of public spending to GDP is getting back to the peak levels of the mid 1970's?

The ratios in 1980-81 (44½ per cent) and 1981-82 (45 per cent forecast) remain below the level of 1974-75 and 1975-76 (46½ per cent in both years). The large rise from 41½ per cent in 1979-80 is partly because of the "relative price effect" and partly because the volume of expenditure rose at a time when real GDP has fallen.

LOCAL GOVERNMENT

13. England: Measures to combat overspending

Although most local authorities in England are planning expenditure in line with the Government's targets, a few have increased their budgets. As a result, the overall total for current expenditure remains about 5½ per cent (Nov '80 prices) above the Government's plans. In view of this my rhF the Environment Secretary will be obliged to seek Parliamentary approval to reduce the total of rate support grant. Individual authorities which meet their target or spend less than their Grant Related Expenditure assessment will not lose grant.

14. Scotland: Measures to combat overspending

Scottish local authorities' original targets were 8.8 per cent (Nov '80 prices) above the Government's plans. In the light of this my rhF the Secretary of State for Scotland has withheld £31 million from three authorities which he considered were planning excessive and unreasonable expenditure. These authorities have now reduced their budgets. In view of the general high level of spending my rhF also intends to withhold a further £35 million from all authorities.

15. Rates: Powers to control

The Government is considering possible additional measures, including legislation, to bring home to individual high-spending authorities the consequences of their policies.

[Note: It is assumed the PM's Office will be in touch with Department of the Environment for latest developments.]

16. Rates: Alternatives

A Green Paper on alternatives to domestic rates will be published shortly.

F SOCIAL SECURITY

1. Government's forecast of 10 per cent inflation by November 1981 unlikely to be achieved; will it make good shortfall in November social security up-rating?

[Most social security benefits are due to be increased by 9 per cent this week (Child Benefit and Mobility Allowance by slightly more). 9 per cent increase based on Budget-time forecast of movement in prices November 1980 to November 1981 of 10 per cent, less 1 per cent to allow for over-payment in November 1980 increases.]

If we under-shoot this year, we can expect pensioners to catch up at the next uprating.

2. Government planning to cut real value of social security benefits?

Social Security Benefits, including Child Benefit, will be uprated in November by the amounts announced at Budget time and approved by Parliament. The level of upratings in November 1982 will be announced in due course. All public expenditure programmes are currently under examination; the social security programme cannot be excused from this process.

3. Announcement about National Insurance Fund contributions?

The level of contributions for 1982-83 will be announced later this week.

4. Will the Government ensure that the burden on employees/employers will not rise?

Whether or not we increase contribution rates, there is likely to be a cash increase in the amounts paid both by employers and employees because of increases in earnings, and, potentially, from changes to the earnings limits between which contributions are levied. Earnings limits or thresholds normally rise annually in line with prices.

[IF PRESSED: On employers: I am well aware of the need to limit the burden placed on employers. Members will recall that the increase in rates last year was confined to employees. But I cannot anticipate the decision we will be taking.

On employees: In deciding the level of contributions we shall ensure that we place no unjustifiable burden on employees.]

5. National Insurance Contributions are a tax?

National Insurance contributions are not a tax; they are paid into the National Insurance Fund specifically to meet the cost of national insurance benefits.

6. Statutory sick pay plans place new burden on employers?

[Social Security Bill, published on 6 November provides for reform of housing benefits and a statutory sick pay scheme (SSP). Most employers will gain from SSP, but some will lose]

Overall we expect employers to gain from the method of compensation we have adopted.

The CBI have recognised this and welcome the proposals.

[IF PRESSED: Employers will be compensated for the statutory sickness payments themselves, but not for the national insurance contributions and surcharge levied on them. Those employers who have no existing occupational schemes will, therefore, lose. This is unfortunate, but it applies to a relatively small proportion of sickness payments; and we believe that the advantages of the scheme outweigh this disadvantage.]

G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82

[Budget forecast PSBR in 1981-82 was £10.6 billion; PSBR in April - September, published 5 November, was £10 billion]

The Civil Service dispute has greatly affected the PSBR so far this year, but the underlying PSBR looks to be in line with the Budget forecast of £10½ billion.

2. Effect of civil service dispute on CGBR

[CGBR April-October was £9.2 billion]

The shortfall of net revenue outstanding at the end of October from the start of the dispute was around £5½-6 billion. £¾-1 billion of this shortfall affected March; the remainder this financial year. Interest costs on the additional borrowing caused by the dispute are over £¼ billion.

3. Will the Government be able to collect all delayed revenue this financial year?

It is not yet clear how soon all the delayed revenue will be collected. Since the dispute ended at the end of July, response has been quite good.

4. Public expenditure likely to overrun this year?

It is too early to say what the outturn for the current year will be.

[IF PRESSED: The local authorities are, admittedly, spending above the Government's plans. We are taking measures to deal with that but these measures cannot be effective this year. Expenditure which is under the Government's direct control is running broadly according to plan in total.]

5. Recession means that PSBR should be higher, not lower?

In my rhF's Budget statement earlier this year he explained that this year's PSBR would be larger on account of the recession. But experience shows that attempts to buy jobs with reflation simply fuel inflation and quickly have to be reversed. Our policies are designed to cut inflation and secure a sustainable improvement in output and employment.

6. What are implications for next year's PSBR of reported £5 billion overrun on public expenditure?

No decisions have yet been made on 1982-83 PSBR. Must await Budget. But is expected to decline as proportion of GDP - as outlined in MTFS in last FSBR (even before taking account of revenue delayed by civil service dispute).

H MONETARY AND FINANCIAL POLICY

1. Why has general level of interest rates risen?

[Clearing bank base rates rose by 4 percentage points to 16 per cent in September but have since fallen back 1 per cent.]

Immediate reason was pressure on sterling and rapid pace of bank lending. But important to note that rates overseas had been rising since the spring and while measures we took in the Budget enabled us for some months to keep our rates from being pulled up, we could not fly in face of developments abroad.

2. Sterling under less pressure: declining US rates; why is Bank of England appearing to brake the fall in UK rates?

Of course we want to see lower rates. But must proceed cautiously if we are not to let up in the fight against inflation. Clearing banks have already reduced base rates by 1 per cent. But wrong to think that rates could safely drop much further in near future without potentially dangerous consequences for inflation.

3. Why so much emphasis on cutting PSBR if efforts undermined so easily by high overseas rates and rapid pace of bank lending?

Interest rate decisions must take account of all potential risks of inflation, not justof PSBR. If we had not reined back the PSBR, interest rates would be still higher.

4. The death knell for the recovery?

Agree that higher interest rates will increase difficulties of industry. But no purpose served by allowing higher inflation, whether due to falling exchange rate or credit-financed consumer spending.

5. But increase in bank lending not inflationary: house prices stagnant, retail sales flat or falling?

Very hard to distinguish upward pressure on prices due to bank lending from downward pressure due to other factors, especially falling real personal disposable incomes. Effect of higher bank lending will not be felt on prices immediately, but only with a lag.

6. Two tier system of interest rates?

Not practicable in highly sophisticated financial market like UK's. Very difficult to prevent money borrowed at lower rate being on-lent at higher. A lower rate for specified borrowers would require extra Government subsidy which would push up borrowing or require cross-subsidisation by the banks. In either case the level of interest rates to other borrowers would be increased.

7. Ceilings on non-priority bank lending?

In UK's complex financial system, ways would be found of by-passing credit controls. Any improvements to money figures would prove to be cosmetic. Would create distortions and inhibit competition between banks.

8. Chancellor told TCSC there were signs that £M3 has risen outside target?

[£M3 increased by 1.7 per cent in banking October, bringing recorded increase in first eight months of target period to 12½ per cent. But position remains seriously distorted by effect of civil service dispute and aftermath.]

Recorded growth is running above target range because of Civil Service dispute. But too early to say whether target will be overshot over target period as a whole.

9. Where is underlying money supply in relation to target?

Cumulative distortion to £M3 is very large. Extremely difficult to say where we are in relation to target. Remain determined not to fuel inflation by excessive growth of money supply.

10. When will the strike distortions be eliminated?

Distortion will continue for some months yet. It increased again in banking October as Customs & Excise made VAT repayments more rapidly than they recovered outstanding VAT. Customs & Excise have been giving priority to refunding businesses affected by the strike. But from now on recoveries by Government are expected to exceed repayments.

11. Status of MTFS now?

[Press comment about a prospective Government announcement on revised MTFS is pure speculation. Have also been Press suggestions that £M3 target base will be rolled over this November; Prime Minister knows that we have made no commitment to such a rollover]

MTFS remains basic framework of Government's economic policy. But as Chancellor said in Budget speech, also take account of other monetary indicators, prospects for inflation, exchange rate, etc.

12. What will Government do about the Michael Grylls study group report?

This was produced independently for the Conservative Backbench Industry Committee but the Government are looking at its analysis and proposals with interest.

J PRICES AND EARNINGS

1. Inflation has increased under this Government?

Considerable progress has been made in bringing down inflation from a peak of 21.9 per cent in May 1980 to 11.7 per cent in October.

2. Inflation back on a rising trend?

[Year-on year rate of inflation rose to 11.7 per cent in October compared with 11.4 per cent in September and lowest recent level of 10.9 per cent in July. Effect of mortgage interest increases estimated at around ½ per cent on RPI in November, some 2/3 per cent in December.]

Progress on inflation has been affected by the fall in the exchange rate, and the rise in the mortgage interest rate will affect the RPI. We expect further progress in reducing inflation, but the timing is of necessity uncertain.

3. Budget time forecast achievable? (10 per cent by Q4 1981; 8 per cent Q2 1982)

[NOTE: Industry Act forecast due this autumn will include revised assessments for RPI and new forecast to Q4 1982.]

Now clear that increase in retail prices between November 1980 and November 1981 will be more than 10 per cent envisaged at Budget time, though precise figures impossible to predict at this stage. Over-run mainly due to fall in exchange rate, partly to higher mortgage interest rates. Government confident that downward trend in inflation will be resumed.

4. 9 per cent increase in prices in 1982-83?

The 9 per cent price factor for preparing public expenditure plans for next year represents what is considered a realistic provision for the prices to be paid by departments. It is not a precise forecast.

5. Nationalised industry prices

Nationalised industry price rises have been due in substantial part to the ending of the previous Government's policy of artificial and distortionary price restraint. The rate of nationalised industry price rises is now coming more closely into line with the RPI.

6. TPI

The fact that the TPI has been increasing faster than the RPI (3½ per cent faster over the year to October) reflects the measures which have been taken to restrain Government borrowing, which is essential if inflation is to be controlled.

7. A 4 per cent pay policy?

The 4 per cent factor announced on 15 September [for calculations in Public Expenditure Survey] is not a pay norm. It is a broad measure of what the Government thinks reasonable and can be afforded as a general allowance for increases in pay, at this stage of fixing the programme from which the public service wage bill has to be met.

8. Does the 4 per cent apply to the Civil Service?

The 4 per cent factor does not imply that all public service pay increases will or should be 4 per cent. Some may be more; some less. [IF PRESSED: In response to enquiries from the civil service unions, they have been told that the assurances they were given earlier in the year about next year's pay negotiations are unaffected by the announcement of the 4 per cent factor.]

9. Public sector ignoring 4 per cent policy?

[Firemen have now settled at 10.1 per cent; NUM have rejected revised offer worth 7.3 per cent on earnings; and water manuals have rejected 7.8 per cent on earnings]

Pay negotiations in local government and the nationalised industries are a matter for the parties concerned, as are the financial consequences of any settlements reached. There is no pay norm. What we need are settlements which are consistent with maintaining economic recovery and improving employment prospects. [NB Not enough settlements so far in private sector to comment on trend there.]

10. Government aiming to cut living standards?

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

11. Average earnings index

[Drop in year on year growth from 12.8 per cent in August to 9.4 per cent in September may attract attention, though (unpublished) underlying increase unchanged at 11 per cent]

I very much welcome the sharp reduction in pay settlements which has been achieved over the past year. Further moderation in settlements can only be helpful in maintaining jobs and getting inflation down.

12. Comparison of TPI and earnings index shows that real take-home pay has fallen over the past year

Yes. But follows growth of 17½ per cent in personal living standards in three years 1977-80.

13. Tax-based incomes policy?

[As in Mr Jenkin's proposals at SDP conference]

Like any other attempt to rely on incomes policy, a tax-based incomes policy would entail all the familiar problems of setting norms and interfering with market forces. Experience gives no encouragement to the idea that incomes policies can be made to work on a permanent basis. They always succumb to the distortions they create.

14. Index-linked pensions and the Scott Report

[Sunday Express 15 November gave examples of large impending increases for some recipients when pensions uprated next week; Sir William Clark asking for debate soon on Report (Hansard 12 November col 669).]

We hope to reach initial conclusions on the issues in next few months. General objective is to ensure that public service pensions should be fair, fairly paid for, and seen to be so. This principle will determine future decisions.

K BALANCE OF PAYMENTS

1. Trade figures for October

The October figures show that the current account continues in surplus. Exports have performed much better than many people expected and are well up on last year. Imports have recovered from the depressed level at the start of 1981. This is consistent with the apparent slowdown in destocking.

2. Exports

Export volumes in September/October were about the same as in 1979 and 1980. Despite the downturn in the world economy and the loss of competitiveness export volumes have not dropped as many people expected. Indeed export orders for British engineering industries show a 40 per cent increase since the summer.

3. Imports

The increase in import volumes confirms recent evidence of slowdown in destocking. Import volumes are 16 per cent higher than in the first four months of 1981 but are only 1 per cent higher than in 1980.

4. Invisibles

Invisible earnings continue in substantial surplus and are likely to rise to about £200 million a month in the fourth quarter of 1981 due to budget refunds from the EC.

5. Capital flows

The net capital outflows in 1981 Q2 was about £1.9 billion compared to over £3 billion in 1981 Q1. These capital flows represent overseas investments which will provide a valuable source of overseas income in future years. There is no evidence that outflows deprive UK firms of capital to invest.

L FOREIGN EXCHANGE, RESERVES AND IMF

1. Sterling still too high?

[Since July sterling has remained broadly stable against the dollar but has depreciated against the Deutschemark due to a slacker oil market and improved German current account. Recent "lows" have been $1.77 on 14 September, DM4.07 on 20 October. Rates at noon on 27 November were $1.9480; DM4.33 and an effective rate of 91.8. Reserves at end October stood at $23.2 billion, compared with $23.7 billion at end September]

Our policy is to allow the rate to be determined primarily by the balance of market forces. The effective exchange rate is only slightly higher than when the Government took office. Manipulating the rate is no answer to problems in the real economy.

2. Has the Bank intervened to support the rate?

The Bank intervene to smooth excessive fluctuations and preserve orderly markets. They do not seek to maintain any particular rate.

3. Does the Government have an exchange rate target:

No. As my rhF the Chancellor told the TCSC in July 1980, it is very difficult to make judgments about the 'right' level for the exchange rate or to resist strong market trends That continues to be the Governments' view. However, the Government is not indifferent to exchange market developments: account is taken of the level and movement in the exchange rate when taking decisions on interest rates.

4. Sterling should join the EMS?

[See M13]

5. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of perhaps 10 per cent so far this year. This is partly due to a decline in the exchange rate; more importantly because there are signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

6. Debt repayments

We have made substantial progress with our plans to reduce the burden of external debt substantially during this Parliament. We have now pre-paid the $2.5 billion Eurodollar loan and are continuing with other scheduled repayments. By end of 1981, total official external debt will be reduced to around $14 billion, compared with over $22 billion when the Government took office.

M EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. Outcome of European Council meeting 26-27 November?

Broad agreement on development of policies other than agriculture. Further work to be done on four issues - problems arising from Community milk surplus; support measures for Mediterranean agriculture; limiting spending on agriculture; and the Budget problem. Foreign Ministers to meet and report back to Heads of Government. Reaching agreement will not be easy, because fundamental issues at stake. But European Council made considerable progress.

2. Cost to UK of community membership too high?

Costs and benefits of UK membership of the Community must be viewed as a whole. We realise the need for reform of the Community financing as well as my hon Friend/the hon Member. We have already achieved a major reduction in our net contribution through the agreement reached on 30 May 1980. We shall continue to press for reform of the common agricultural policy (CAP) and restructuring of the Community Budget.

3. Net contribution too high?

A lot lower than it would have been without the agreement of 30 May last year. Important to build on that as soon as possible.

4. Lower Commission estimates of net contributions in respect of 1980 and 1981?

We shall need to examine the new Commission estimates with care. If it is true that our adjusted net contribution in respect of 1980 and 1981 will turn out to be lower than expected, that is very satisfactory, because the 30 May Agreement left us paying a large net contribution even though we are one of the poorer Member States. The problem of 1982 and later years remains to be solved.

5. Budget refunds reduced if net contribution less than originally estimated?

Have seen press reports that other member states take the view that our refunds should be reduced in those circumstances. The UK, however, is clear that the minimum net refunds payable under the 30 May agreement are 1175 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

6. Does recent vote of European Parliament's Budgets Committee to freeze part of 1982 budget provision for UK refunds mean UK will not receive its full entitlement to budget refunds?

No. The draft amendments supported by the Budgets Committee was not supported by the Parliament when it voted in plenary session on 5 November.

7. Do supplementary measures grants lead to additionality?

There is additionality in important sense that refunds are making possible a higher level of public expenditure in the regions and elsewhere than would otherwise have been possible. Both the participating authorities and other spending authorities are gaining the advantage of a higher level of expenditure than country could otherwise have afforded. Scheme does not, however, open way to increases in expenditure by participating authorities beyond levels already planned. In that sense there is no additionality.

8. Policy for CAP reform

Greater attention must be paid to the needs of the market, and action taken to curb surplus production and contain the growth of guarantee expenditure. Will continue to press for price restraint and other measures appropriate to surplus sectors.

9. Costs of CAP to UK consumers

My rhF, the Minister of Agriculture, has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

10. What if we hit the 1 per cent VAT ceiling before 1982?

Our position is that there will not be an increase in the 1 per cent VAT ceiling, and discussions on the restructuring of the budget and other matters are within that firm context.

EUROPEAN MONETARY SYSTEM

11. What is the current attitude of the UK Government?

We fully support the EMS, and acknowledge the contribution which it has made to stability in the exchange markets. However, we do not yet feel able to join the exchange rate mechanism. We must wait until conditions are right for the system and for ourselves.

N INDUSTRY

[NB. NEDC meeting on Wednesday 2 December]

1. Recent increases in interest rates - damaging for industry and investment?

(Each 1 per cent in interest rates raises interest payments on industry's borrowing by around £250 million.)

Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Recent rise in interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief H).

2. Prospects for industry - recovery?

Encouraging evidence that fall in output has now come to an end. Too early to talk about recovery: but index of manufacturing output rose 1½ per cent in the third quarter with chemicals and engineering performing particularly well.

3. Company sector finances improved?

[Gross Trading Profits of industrial and commercial companies (ICCs) other than North Sea activities net of stock appreciation were around £3¾ billion in Q2 1981 for third successive quarter. Borrowing requirement of ICCs has improved over last year, and financial deficit turned into surplus. Company liquidity has also improved markedly this year; company sector's liquidity position better in second quarter this year than at any time since third quarter of 1979].

Figures mildly encouraging (but not wildly so). Company financial position is in any case confused by effects of civil service dispute. After adjustment for stock appreciation and excluding North Sea, ICC profits have stabilised since mid-1980. Improvement in financial position partly reflects destocking and action to reduce overmanning.

SMALL FIRMS

4. Government help for small firms

Over 70 measures taken which help important small firms sector: in particular the Business Start-Up Scheme, the pilot Loan Guarantee Scheme, the Venture Capital Scheme, and reduction in the burden of small firms' corporation tax.

5. Response to Loan Guarantee Scheme?

Scheme has got off to very good start. We have already issued close on 1200 guarantees - well over half to new businesses. Total lending under scheme is already over £41 million. Substantial demand for loans has led the Government to double this year's lending limit under the scheme. Ten new banks were admitted to the Scheme in November: a total of twenty-seven financial institutions are now participating.

ENTERPRISE ZONES

6. Progress with setting up Enterprise Zones?

Excellent progress being made. Ten of the eleven zones are already in operation. We expect the final zone - Isle of Dogs - to come into operation early next year.

7. Response from private sector?

Initial response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

P NATIONALISED INDUSTRIES

1. Government policy on nationalised industries

To reduce State ownership and improve efficiency of publicly owned enterprises. Market forces are to be brought to bear, and private capital is being introduced - where appropriate. Competition Act has been used to refer selected nationalised industry operations to the Monopolies and Mergers Commission.

INVESTMENT

2. Government just not allowing for enough nationalised industry investment?

No. Last Public Expenditure White Paper showed nationalised industry planned investment 15 per cent higher in real terms this year than a year ago. Quantity of investment frustrated by tight EFL's is less than implied. TSSC report published last August estimated in range of £250-500 million this year.

3. Increased NI investment would boost private industry and add to productive potential?

Depends on whether or not extra investment is accommodated within existing public sector totals. If it were allowed to add to borrowing requirement, it would tend to raise interest rates and discourage other expenditure, including some private sector investment. Except in short term, net effect on private sector might not be beneficial and effect on future growth of productive potential is uncertain. Report from all-party TCSC accepted that there could be such financial "crowding-out".

4. Take nationalised industry investment out of the PSBR?

Since nationalised industries are part of the public sector, their borrowing - for whatever purpose - must by definition form part of the public sector borrowing requirement. The real problem of pressure on resources cannot be solved by changing statistical definitions.

5. Private finance for NI investment?

[The NEDC Working Party's study of nationalised industry investment was discussed at the Council's 5 October meeting; agreed that there should be a review of progress to be completed by June 1982]

We have indicated our willingness to consider new financing proposals, most recently in the context of the review carried out by the NEDC Working Party. But direct market finance can only be justified if there is a genuine element of performance-related risk for the investor, in order to improve incentives to management efficiency, and if new forms of saving are tapped, so as to avoid adverse monetary consequences. Market financing does not of itself reduce the PSBR, nor does it lessen the burden on financial markets.

6. Status of proposed British Telecom bond. If agreed, will this bond be outside PSBR and relevant EFL?

No. This is borrowing by a public sector body, thus public sector borrowing. The Government, with its overall responsibility for BT's finance, must continue to place limits on its external finance. But EFL might be somewhat larger on account of bond than it otherwise would be.

7. What problems have delayed the expected announcement? Does proposal meet criteria set out in the NEDC Working Party Report?

[Two criteria:- extra cost must be justified by pressure for greater efficiency; terms of investment won't involve unfair competition with private sector].

An intensive effort has been made to conclude this question, in the context of the public expenditure exercise and the decision on BT's EFL for 1982-83. Certain problems remain to be resolved before a decision can be taken.

[IF PRESSED: They are:-

(a) Cost to BT of the borrowing - will be greater than gilts, but the Government and BT must be sure that this will be justified by the contribution the bond makes to pressures for improved efficiency and profit.

(b) BT's pricing policy - some arrangement is needed to assure investors that BT's profits would not be constrained by the Government's holding prices down. But Government must protect consumers as well as investors. This is an industry where prices ought to fall in real terms, because of technological advance, ie to rise by less than the RPI. We have not so far been able to agree on a formula to deal with this]

8. Finance more nationalised industry investment by cutting current spending?

Yes. In particular, moderate pay settlements are essential. The ability to finance new investment in the nationalised industries is bound to diminish if excessive pay settlements are agreed.

9. But you cannot finance much investment by cutting current costs alone?

Not true. Each 1 per cent off wage costs would save about £125 million per annum; and each 1 per cent off total costs saves £300 million.

NATIONALISED INDUSTRY PAY AND PRICES

10. Pay assumption for next year's external financing limits?

The Government has made clear the need for significantly lower pay settlements across the economy. It is in the industries' own interests to secure their future by leaving enough room for investment. The Government has not set any norms for the industries, but it is bound to take a close interest in settlements in reaching its decisions on investment and finance.

11. Nationalised industries' prices have risen more rapidly than RPI?

True over last year or so, while adjustments from artificial and distortionary price restraints introduced by the Labour Government were working through the system. Unwelcome but inevitable: the only alternative is an increased burden on the taxpayer and a distortion of market forces.

12. What is happening now?

Nationalised industry price increases are falling relative to the RPI (14 per cent above in year to January, 3 per cent above in year to October). Fully expect them to come closer to RPI in next few months.

13. And the future?

Better price performance depends on improvements in efficiency and control of current costs, particularly pay. We are determined to see those improvements brought about. Privatisation and increasing competition have an especially important role here.

PRIVATISATION

[Announcements in week ending 24 October referred to Cable and Wireless, National Freight Corporation Ltd, BNOC's oil-producing business and BGC's monopoly of purchase of oil and its sale to industry; BR Hovercraft.]

14. The Government simply selling valuable national assets to achieve PSBR target?

Of course, the cash is welcome, but the benefits run wider than that. Not only will the main financial benefit be that future borrowing of these undertakings will be outside the PSBR and no longer burden the taxpayer, but the organisations concerned will be made responsive to market forces and thus have greater incentives to improve efficiency.

15. Why is disposal of BGC's gas showrooms to be delayed?

HMG has made it clear that safety standards must be fully maintained - this will require complex legislation, for which there is unlikely to be time during this Session.

16. Does the Government have more privatisation plans to announce?

Legislation already passed to enable public to hold equity stake in British Airways, British Transport Dock Board, subsidiaries of British Rail; and to dispose of some of British Telecom's peripheral activities. We shall be announcing further measures in due course.

17. Will these include British Leyland?

The 1982-83 Corporate Plan for BL being submitted shortly will doubtless refer to the prospects for disposals.

R NORTH SEA AND UK ECONOMY

1. Benefits of North Sea should be used to strengthen the economy?

[Direct contribution of North Sea oil and gas to GNP is estimated to rise from 3 per cent in 1980 to about 5 per cent in 1984; expected contribution to Government revenues estimated at £3¾ billion in 1980-81 and £6 billion in 1981-82 (at current prices). Less susceptible of measurement is boost given by North Sea to local employment and to industry in offshore equipment].

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Only one-twentieth of total general government receipts in 1981-82.

2. North Sea oil price rises following OPEC price reunification?

Price of North Sea oil is a matter of commercial negotiation between BNOC and the oil companies.

3. Will HMG change North Sea fiscal regime in line with oil industry's proposals?

[Memoranda lodged with Treasury and D/Energy 22 October].

I commend UKOOA (UK Offshore Operations Association) and BRINDEX for the hard work which they have put in. Obviously full study of their proposals is required. We shall look at their suggestions with an open mind, in close liaison with UKOOA and BRINDEX.

4. North Sea oil depletion policy?

Secretary of State for Energy announced in June that the Government would review in the Autumn the possibility of oil production cuts in 1982. We shall give the industry proper notice of our intentions.

5. Gas gathering pipeline - why did HMG not proceed?

The project has always been envisaged as a private sector utility. The vast bulk of economically recoverable gas will be brought ashore and this can and should be left to private enterprise as in the past. Note that oil companies are already planning a series of North Sea gas pipelines.

6. Government revenues from the North Sea should be used to finance cheap energy for industry?

It would be inequitable and inefficient to use the benefits of North Sea oil to subsidise some users. The age of cheap energy is past. Energy prices should recognise the cost of marginal supply and reflect the competitive position of industrial fuels. Only then can consumers receive reliable signals on which to base their energy consumption and investment decisions.

7. North Sea revenues should be channelled into a special fund to finance new investment, particularly in energy?

North Sea revenues are already committed. Setting up a special fund would make no difference. More money would not magically become available. So the money for this special fund would have to come from somewhere else - lower public expenditure, higher taxes or higher public borrowing.

8. North Sea oil bond?

Our present plan is to issue a North Sea oil bond, an entirely new kind of National Savings certificate, in the Spring of next year.

S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Governments' policies pushing world economy into recession?

[Output in OECD area grew modestly in first half 1981. Little information on Q3; but small rise in US and French GNP. Industrial production picture in Q3 mixed. Average unemployment rate rising.] [OECD believe output of member countries will have stayed flat in second half of this year, and will recover gradually in 1982. CONFIDENTIAL: NOT FOR USE This OECD forecast not yet published.]

No. Healthy growth only possible if anti-inflation policies persevered with. Some recovery of output expected next year. And unemployment should level off during the year.

2. OECD gloomier about world economic prospects?

[Draft report referred to in Sunday Times 15 November]

Latest OECD forecast is still being prepared. Most major forecasts, including the IMF's, expect modest growth next year. OECD forecasts unlikely to be markedly different.

3. Comment on latest NIESR Review forecast for industrial countries?

[Report published 26 November forecasts 'slow' economic growth and 'gradual' decline in inflation in industrial countries in 1982 and 1983.]

Interested to note that NIESR forecasts lower inflation and rising output in the industrial countries in next few years.

4. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries around 10 per cent in September. Underlying rates increasing in US and France. OECD and IMF expect some decline next year.]

Takes time to squeeze inflation out of system. Year-on-year consumer price inflation in major economies down from peak of 13 per cent in April 1980 to around 10 per cent in September 1981. Further decline expected next year.

5. Governments' policies have failed or worsened situation?

No. Adjustment to second oil shock better than to first. Investment has performed better, impact on wages better contained and dependence on oil reduced. But these gains must be reinforced by continued firm policies.

6. Countries disagree over direction of policy?

No. Both Ottawa Summit and IMF Interim Committee agreed that a clear priority had to be given to firm policies to reduce inflation. They stressed importance of steady and careful restraint on growth of monetary aggregates and emphasised need, in many countries, for reductions in size of budget deficits.

7. Other countries giving priority to unemployment rather than inflation?

No. All major countries agree that lasting reduction in unemployment can only be achieved when inflation brought down. France, an exception till October, is now acting to curb inflation. This best way to secure lower interest rates, encourage productive investment and achieve better rates of economic growth and employment.

8. Other governments not following such stern policies as UK?

[US, Canada and Germany have announced lower monetary targets for this year compared with last. Most major countries (US, Japan, Germany, Italy, Netherlands, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the deferral of FF15 billion (£1½ billion) of capital investment. Recent Canadian Budget will reduce deficit.]

Most governments persevering with firm policies to lay foundations of renewed non-inflationary growth. In particular, continuing with their efforts to control monetary growth, offset effects of recession on budget balances, and keep public spending in check.

9. US are pursuing mad policies and care nothing for their impact on rest of world?

US authorities have widespread international support in their battle against inflation. Sound $ is in everyone's best interests. Concern is over monetary/fiscal mix - a problem all countries familiar with.

10. Deeper than expected US recession will kill recovery in other countries?

Some fall of output in the US may be inevitable before inflationary expectations are reduced. In everyone's interests that US inflation should come down. A sustainable recovery will then be possible.

11. Recent comments by US Budget Director have undermined confidence?

[Press reports of Dr Stockman's description of Budget spending cuts as "hastily prepared and enacted" and tax cuts "Trojan horse" favouring the rich, while casting doubt on "Supply side" policies].

I note that Dr Stockman has apologised for his "careless ramblings to a reporter".

12. Recent international interest rate developments?

True that international interest rates have been high over last year, but glad to see some easing of US prime rates - down to 16 per cent from peak of 21½ per cent; also German rates declining.

13. <u>Prospects for international interest rates?</u>

Always difficult to forecast interest rates with certainty, but firm policies should over a period bring lasting reduction in both inflation and interest rates.

AIDE MEMOIRE ON THE UK ECONOMY 30 November 1981

PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS, ST JAMES) assess recession's trough was reached in H1 1981, with some recovery in year to H2 1982 (in range ½-2¼ per cent). Item are more pessimistic , seeing output fall a further 2 per cent in 1982, recovery thereafter. Unemployment (UK adult sa) forecast to increase to around 3 million by end 1982. Most major forecasters see year-on-year inflation in range 11-12½ per cent for Q4 1981, falling to 9½-11½ per cent in Q4 1982. Item and St James are more pessimistic; forecasting range of 13-15 per cent. Item see a sharp drop, well into single figures in 1983.

GDP output estimate rose ½ per cent in Q3 1981 the first rise for 7 quarters. In Q3 1981 industrial output rose ½ per cent and manufacturing output rose 1½ per cent.

Consumers' expenditure fell by ½ per cent in Q3 1981 returning to the level of Q3 1980. Retail sales rose 1 per cent in October 1981. In September and October the Volume of visible exports was 4 per cent above the average in January and February. Volume of visible imports rose 21 per cent on the same comparison. Manufacturing investment (excluding assets leased from the service sector) fell 4½ per cent in Q3 1981. Distributive and service industry investment (including shipping and leasing)was virtually unchanged in Q3 1981. DI investment intentions survey (conducted in April/May) suggests a fall in manufacturing investment after allowing for leasing of 11 to 14 per cent in 1981 with some recovery in 1982; distributive and service industries investment (including shipping) expected to rise by less than 5 per cent in both 1981 and 1982. Manufacturers', wholesalers' and retail stocks dropped by £0.2 bn (at 1975 prices) in Q3 1981 compared with destocking of £1.0 bn in H1 1981 and £1.9 bn in 1980 as a whole.

Unemployment (UK, seasonally adjusted excl. school-leavers) was 2,764,000 (11.4 per cent) at November count, up 36,000 on October. Vacancies rose slightly to 104,000 in November.

Wholesale input prices (fuel and materials) were unchanged in October but stand 18 per cent higher than a year earlier; wholesale output prices rose 1 per cent and are 11 per cent above a year ago. Year-on-year RPI increase was 11.7 per cent in October. Year-on-year increase in average earnings was 9.4 per cent in September. RPDI fell by 2½ per cent in Q2 1981 after a 1½ per cent fall in the previous quarter and a 17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio fell 2 per cent to 12½ per cent in Q2 1981.

PSBR £9.5 bn in the first half of 1981/82 and CGBR in April to October - £9.2 bn; but both distorted upwards by the civil service dispute. Underlying PSBR believed in line with Budget forecast (£10½ bn).

Sterling M3 increased by 1½-1¾ per cent in banking October but distorted by the consequences of the civil service dispute.

Visible trade showed an estimated surplus of £13 million in September and £116 million in October compared with an average monthly surplus of £368 million over the period July 1980 to February 1981. Invisibles surplus in first ten months of 1981 estimated at £2.3 billion. Reserves at end-October \$23.3 bn. At the close on 30 November the sterling exchange rate was \$1.96 and the effective rate was 91.76.

Econ Pol

MR. INGHAM

cc: Mr. Scholar
Mr. Gaffin
Mrs. Gilmore (HMT)

SPEAKING NOTES FOR MINISTERS

I have seen the minutes of the last meeting of Chief Information Officers and I see from the Agenda for today's meeting that there will be a further discussion of the value of speaking notes for Ministers. It may be helpful if I offer the following comments.

First, it is not the case that speaking notes are no longer produced. Speaking notes on non-economic subjects - none of my affair - do seem to have become much less frequent; on economic subjects, I have for some time been producing them only in relation to particular events, rather than as general background. Thus we have had economic notes on ambulancemen's pay (4 June), the economic censure motion in July (27 July), the NEDC discussion on pay (5 August) and the 4% pay factor (15 September). As you know, we have one in draft for issue this week on the pay implications of the Chancellor's package. There are strong arguments for continuing to do economic speaking notes, but only when there is a particular occasion. That is what the Lord President wants. It also means they are more heeded by Ministers, and they become less repetitive.

Second, Ministers are still doing their stuff on the economy. In the last two weeks I have received the texts of 19 speeches on economic issues by senior Ministers, of sufficient substance for me to think it worthwhile retaining them. That excludes two by the Prime Minister, and all those made in the House of Commons.

So I think the real gap is on non-economic issues. Trespassing on to the territory of others, I offer the reflection that it is surprising that Ministers have not received briefing on disarmament, Scarman, industrial relations legislation and recent developments in Northern Ireland.

JOHN VEREKER

30 November 1981

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pl. Mr VEREKER

10 DOWNING STREET

From the Private Secretary

30 November, 1981.

The Pay Scene

The Prime Minister was grateful for the Chancellor's minute of 26 November on the current position on the pay scene whose contents she has carefully noted.

I am sending copies of this letter to the Private Secretaries to the other members of the Cabinet, and to David Wright (Cabinet Office).

M. C. SCHOLAR

John Kerr, Esq.,
HM Treasury.

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Cabinet / Cabinet Committee Document

The following document, which was enclosed on this file, has 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.

Reference: E (81) 123

Date: 27 November 1981

Signed OWayland Date 22 March 2011

PREM Records Team

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c. Mr. Hoskyns
Mr. Ingham

PRIME MINISTER

THE PAY SCENE

The Chancellor's minute of 26 November requires no more than a Private Secretary acknowledgment, since - as he points out - the time has not yet come when there is much the Government can do to influence individual settlements. I saw the minute at an earlier stage, when it was drafted as a paper for E, and suggested then that the current pay issues did not merit collective ministerial discussion.

In two respects the Chancellor's minute is already overtaken by events: Ford have now increased their offer to 7.4%, which has also been rejected; and of course the meeting between the NCB and the NUM on 25 November made no progress, save for an agreement to meet again on 8 December, after the presidential ballot.

The Chancellor's main recommendation is to make sure the case for pay moderation is put across, particularly in the context of next week's announcements on public expenditure and related matters. Unfortunately, although the Chancellor has also suggested that we take careful account of the pay round implications in those decisions, the announcements will be almost entirely unhelpful. I believe Bernard Ingham has already mentioned to you that the Lord President has agreed to circulate guidance for ministerial colleagues on the day the announcement is made; and Bernard has asked me to let you see the present draft of this, which I attach.

27 November 1981

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D R A F T

GUIDANCE FOR MINISTERS

The Effect of the /2 December/ Announcements on Pay Bargaining

Background

The Chancellor's statement on public expenditure and the associated announcements of the Industry Act Forecast, the Government Actuary's Report, and the Government's decisions on the RSG make it even more apparent than it has been hitherto that if those in work settle for pay increases in low single figures they will suffer a significant fall in living standards. It is possible that the announcements may lead to a rise in the temperature of the pay bargaining climate; and it is therefore particularly important that colleagues take every opportunity to explain why the measures the Government is now taking are right; and why continued pay restraint is necessary, even if it means falling living standards in the short term.

The Announcements

The bad news for pay bargainers is:

(i) Take home pay will be lower because of the rise in National Insurance Contributions. And the Chancellor has made it clear that the level of public spending he has announced may mean higher taxes in the Budget if interest rates are not to rise further.

(ii) The cost of living (November 81 - November 82 RPI) is now officially forecast to rise by 10 per cent this pay round. This covers the cost increases implied by other announcements (such as higher rents and rates) but of course the sudden rise in those items will have a greater effect on pay expectations than the steady rise in prices throughout the year.

/(iii)

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(iii) Average Earnings are now officially forecast to rise by 7½ per cent in the course of the pay round. Employees in the public services will regard the difference between that and their 4 per cent cash limit as an indication of the extent to which they are being asked to settle for less than the going rate because of their greater job security.

The good news for pay bargainers is:

(i) The worst off are protected from the sharpest rises in costs - many of those paying rents, rates and health service charges receive special assistance in the form of rebates or exemptions.

(ii) Tight control of public spending means that taxes and/or interest rates are lower than they otherwise would be.

Points to make

1. The long term nature of any successful effort to get the economy competitive again. The Government has always said it would take years, not months. That is why it published a medium term strategy, covering the life time of this Parliament. We mustn't give up now just because things are looking difficult. The difficulties reflect the extent to which we allowed ourselves to fall behind our competitors in the 1960s and 1970s.

2. The Titanic struggle that any administration faces to keep public spending under control. All recent British Governments have faced regular public expenditure "crises". The fact is that public spending rises of its own accord unless it is strictly controlled. Controlling it in a recession is particularly difficult and some rise is inevitable. The Government has done well to keep it to a level which is consistent with the continuing fall in public borrowing set out in its medium term strategy.

3. We always said those in work would have to have a cut in their living standards. That is a necessary condition of becoming competitive again. It is widely recognised that there was a substantial moderation in pay settlements in the last pay round: but the rise in average earnings still almost kept pace with the rise in the cost of living. Getting competitive again does mean that sooner or later real pay has to be cut: the time for that is now.

4. So the 23 million who are employed will have to make some sacrifice to help the 3 million who are not. The unemployed have to be supported; and they also have to be given the hope of new jobs, which can only come if the employed help create a thriving economy. If wage earners won't accept the sacrifice in their pay packets, sooner or later the sacrifice will be made for them - in more job losses, or in higher taxation, or in higher interest rates.

5. It's working: don't let's throw it all away now. Over the five years to 1980, our labour costs (per unit of manufacturing output) nearly doubled. They rose by only one half in Canada, one third in the US, one sixth in Germany and not at all in Japan. But now for the first time for many years our unit labour costs are rising more slowly than those of our competitors. There's a long way still to go, but we're going to get there.

(2)

JV
AD
AW

Prime Minister

To note

MCS 27/11

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

PRIME MINISTER

THE PAY SCENE

Now that we are a few months into the 1981/82 pay round it is timely to take stock. The outcome remains of cardinal importance to our economic strategy, since it will determine whether there is room for growth within the monetary framework.

Background

2. The underlying increase in earnings in 1980-81 was about 10½ per cent - some 11-12 per cent in the market sector (with little difference between public and private) and 8 per cent in the public services. Wage settlements averaged about 8½ per cent, with drift of about 2 per cent concentrated in the market sector. Individual settlements varied widely, but the overall picture was of settlements at around half the level of 1979-80. After a few high settlements, the big drop came fairly early in the round.

3. The present round is off to a slow start (like the last one). The police had 13.2 per cent in September, and 10 per cent has been agreed between the local authorities and the firemen. Both these settlements are indexed to past movements in earnings. The overall level in the private sector so far is just under 8½ per cent, including agricultural workers at about 10 per cent and BL at about 4½ per cent. Vauxhall are moving towards a 5 per cent settlement; at Fords a 4½ per cent offer has been rejected and is likely to be increased.

4. Further developments in the public sector mostly await the coal industry outcome. The miners have rejected 7.3 per cent on earnings (presented as something like 9 per cent on rates). There is a further meeting today but no movement is likely before next week's NUM election. The water industry manuals have rejected 7.8 per cent on earnings, and will probably seek to match the miners' outcome. The other key early settlement in the public sector is the local authority manuals; but no offer is likely until the employers get some indication of the probable shape of the RSG settlement. The unions also are in no hurry, partly because they want to see how the round goes generally and partly because they still have in mind the possibility of co-ordinated action with other public service groups in the New Year.

5. In the private sector, the main engineering unions (1,750,000 workers) could well settle at 5.1 per cent on minimum basic rates, but we may not be sure for another fortnight. The BL episode has helped, both in the motor industry and more widely, to underscore the link between low pay settlements and job prospects, though the tanker drivers might still strike for 11 per cent.

6. Retail price increases seem steady around 11-12 per cent; last year they were falling, which helped.

7. Several issues in other contexts bear on pay:

(a) The Rate Support Grant settlement will both govern what local government employers can afford, and affect rates and thus the RPI.

(b) Public expenditure decisions, and especially:
(i) the question of extra provision for NHS pay; and
(ii) EFLs for nationalised industries.

(c) The Industry Act price forecast, due out in a week or so.

(d) Our decision on NIC, which must be announced by about the end of next week.

8. The Industry Act forecast and the NIC decisions both bear on expectations for real take-home pay, and presentation will be important. Telling nationalised industry boards their EFLs will provide another occasion for stressing our concern with the major public sector settlements; I hope sponsor Ministers will emphasise this strongly and watch developments very closely.

9. We must continue to seize every opportunity to put over the key message on the link between low pay settlements and job prospects, stressing also competitiveness and the need to leave room for investment. Generally, the CBI seek to put over the same general message as ourselves; we must encourage them to go on, and I shall do so when I see Sir Raymond Pennock later this week.

10. In sum BL was a good though in some respects atypical start; but the character of the round remains in the balance. We can as yet do little directly to influence settlements. There may be no major developments in the public sector until the miners have settled, and overt attempts at influence there would be counter-productive. But we can and must do three things:

(a) We must use all the influence we can in other public-sector cases.

(b) We must take careful account of pay-round implications in our own decisions, eg on expenditure.

(c) We must all stress publicly and repeatedly the direct and crucial link between pay and jobs.

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11. I am sending copies of the minute to our Cabinet colleagues, and to Sir Robert Armstrong.

(G.H.)

26 November 1981

(4)

MCS

QUEEN ANNE'S GATE
LONDON SWIH 9AT

26 November 1981

Dear Geoffrey

ECONOMIC BRIEFING

Thank you for your letter of 23 November. I wholly welcome the circulation of the weekly Treasury Economic Brief which I have no doubt will provide invaluable background in dealing with questions about our broad economic policies.

Copies of this letter go to the Prime Minister, to other members of the Cabinet, and to Sir Robert Armstrong.

Yours ever

Willie

The Rt. Hon. Sir Geoffrey Howe, QC, MP.

Prime Minister

This is not a very helpful note but I have put it in in case you wanted some commentary on the NIER

We are getting more useable material for Tuesday. The FT leader (copy attached) is quite good.

MCS 27/11

You have a copy

1. MR ~~SHIELDS~~ 26/11/81
2. CHANCELLOR OF THE EXCHEQUER

c Chief Secretary
Financial Secretary
Economic Secretary
Minister of State (L)
Sir Douglas Wass
Mr T Burns
Sir K Couzens
Mr Ryrie
Mr Quinlan
Mr Byatt
Mr Middleton
Mr Britton
Mr Cassell
Mr P Dixon
Mr Evans
Mr Kemp
Mr Monck
Mr R I G Allen
Mrs Gilmore
Mrs Lomax
Mr Riley
Mr Sedgwick
Mr J Page
Mr Mowl
Mr Hibberd
Mr Redley
Mr Ridley
Mr Harris
Mr Cropper

NATIONAL INSTITUTE REVIEW

The November issue is to be published tomorrow. Its situation report on the UK economy concludes, as it has before, that a reflationary fiscal stance is now required. The claim that supply constraints now exist is examined and dismissed, as is the danger of a strong resurgence of wage inflation. A list of alternative reflationary policies costing £5 billion is offered, together with an assessment of their cumulative effect over a five year period.

Forecasting the UK Economy

2. The period of the Institute forecast has been extended from two to five years to add emphasis to their presentation of the case for reflation. It is claimed that though the trough of the recession may have passed the future path of the economy will remain flat in the absence of intervention. The GDP forecast is markedly less optimistic in the short term than the Treasury's, although the employment consequences of the two forecasts are broadly the same. By the end of 1986, NIESR suggest that unemployment will have risen to 3.4 million.

3. The table below compares the main features of the NIESR projections until 1982 with the latest internal Treasury update designed for the forthcoming Industry Act Forecast.

		NIESR	Treasury IAF Latest Update
Retail Prices:			
% change year on year	1981	12.0	11.9
	1982	10.7	11.4
GDP			
% change year on year	1981	- 3.1	- 2.1
(1975 prices)	1982	0.6	0.9
Unemployment			
4th quarter, UK wholly	1981	2.8	2.8
unemployed, excluding school leavers	1982	3.0	3.1
PSBR			
£ billion (calendar years)	1981	11	12
	1982	11	6
Balance of payments			
(Current Account £ billion)	1981	4.2	6.5
	1982	4.5	1.9

3. On inflation, the expected rate of price increase is forecast to slow to 10.7% in 1982 and to 8.3% in the following year. However the downward inflexibility of real wages which is assumed in the NIESR model suggests that no further downward movement in inflation can be expected. The PSBR does not fall appreciably in the Institute's review until after 1983 when the rise in oil revenues is sufficient to offset the costs of further rises in unemployment. Some reduction in interest rates is foreseen next year.

4. The other major difference with the Treasury forecast lies in the balance of payments. Despite a lower projection of the current account surplus in 1981, NIESR forecast substantial surpluses continuing into 1982 and 1983. This reflects a more buoyant assessment of export prospects and slower growth in import volumes, although NIESR emphasise the uncertainty of their projections. The exchange rate is expected to stay roughly at current levels.

Policy Appraisal

5. The Institute's gloomy projections reflect their scepticism about automatic stabilisation processes which would bring the economy back without intervention towards what they would consider a full employment level within an acceptably short period. They reject what they term the monetarist case against a policy of active demand management on the grounds that it presupposes a stable economic system which is close to equilibrium. By contrast, they see a situation in which demand has for some years fallen so far short of a high-employment level of output that the overriding priority of public policy should be towards closing the gap. The Review also includes an assessment of causes of the short-fall in output between 1979 and 1981. Drawing on papers presented by the NIESR and the London Business School to the Bank of England's Panel of Academic Consultants, the Review points to the restrictive stance of fiscal and monetary policy and the rise in the real exchange rate (itself partly reflecting these policies) as the main explanations for the severity (although not the origin) of the recession.

6. The reflationary packages suggested by the Institute are not shown to be particularly effective in bringing down the projected unemployment levels. A cut in income tax costing £5 billion gross per year is assessed to reduce unemployment by 150,000 to 200,000 after five years, with a fairly small (perhaps even a negative) effect on the price level. Increases in government spending on goods and services of a similar gross amount would produce an effect on unemployment of over 300,000 although having a worse effect on inflation (raising the price level by perhaps 7 per cent in five years). Wage subsidies or cuts in indirect taxes produce a similar benefit in terms of unemployment to that of an income tax cut, but with beneficial effects on the rate of inflation.

M G REDLEY
26 November 1981

EA1

FINANCIAL TIMES
BRACKEN HOUSE, CANNON STREET, LONDON EC4P 4BY
Telegrams: Finantimo, London PS4. Telex: 8954871
Telephone: 01-248 8000

Friday November 27 1981

A 1930s cure for the 1980s

THE VIEW that the recession and the grim rise in unemployment are largely or entirely the result of mistaken Government policy is naturally very popular among politicians. The appearance of a carefully reasoned case for this view, based on a medium-term projection of UK prospects is therefore likely to be more influential than a routine short-term forecast from the National Institute for Economic and Social Research, and deserves close attention.

Obsession

The review argues that the Anglo-American obsession with so-called supply-side measures has come at exactly the wrong time. In normal times, output follows a trend which is determined by supply influences—invention, natural resources, productivity and the size of the working population. These are the factors on which medium-term projections have been based; short-term "fine tuning" of the level of demand has been concerned only with correcting cyclical swings about this trend.

Now, however, the Review sees the situation as radically different. Our largely ineffective struggles with inflation during the eight years since the first Opec oil shock have depressed activity far below the potential readily available from our resources of capital and labour. On this view, deficient demand is now a medium-term problem.

The Review therefore urges a cut in cost-raising taxes. The same suggestion has occurred to many other analysts, ranging from the CBI leftwards. The novelty in the Review is the attempt to quantify the rewards over several years and to examine the arguments usually advanced against this course.

The projection is not altogether persuasive, for it shows the estimated rewards vary wildly on the basis of abstract and rather questionable assumptions about wage behaviour. On the other hand the objections are also cut down to size.

Endorsed

The Review is particularly hard on the assertion that workers have "priced themselves out of jobs" through excessive real wages. The figures show that the growth of real wages has been rather slow in recent years—and probably largely due to tighter monetary policies which raised the real exchange rate. The damage, if it is damage, was done in the 1960s, when take home pay rose by a fifth.

The argument that welfare benefits have reached a level which encourages idleness also emerges battered. The ratio of welfare to earned incomes has been falling quite steadily—and on some measures, rapidly—it peaked in the late 1960s. The Review does concede, however, that the combined cost of enhanced real wages and of welfare benefits and charges appears to have squeezed profits to an unacceptably low level. This argument also points to a cut in employers' national insurance contributions. The CBI could only applaud.

The only trouble with this analysis is that it seems to leave out most of the problems which have rendered economic management so baffling in the 1970s. Most notably, there is little attempt to ask why, if the Government's whole approach is so radically and tragically mistaken, it has been endorsed in general by so many other governments and international institutions.

Indeed, the Review, by assuming that we are not in danger of straining capacity seems to wish away the whole of the stabilisation problem which so preoccupies the world. It simply assumes, for no clear reason, that we have come through a violent storm into the doldrums, so that the problem now is to set more sail. Have conditions really become stable, almost overnight? It seems highly implausible.

Embroiled

The world's problem is partly that of a still unfinished adaptation to relative energy prices—which is why the Bank for International Settlements argues for real income restraints to make room for balance of payments correction and for higher investment. A point which the Review merely acknowledges in passing is that the energy crisis has rendered much capital plant obsolete. Some existing "capacity" is so much scrap metal, as Detroit could testify.

Above all, we are still embroiled in a world of violent financial instability, in which unprecedented swings in real exchanges and real interest rates disrupt business planning, and threaten weak economies with bankruptcy. This financial picture has no resemblance at all to the sullen stagnation for which the Review prescribes.

Much of the present painful readjustment round the world is an effort to avoid adding to the mountain of unstable debt which threatens to topple on us all. Its management and consolidation might be assisted by the advice of a new Keynes; it is hardly to be solved by the proposals of the old one to break a *deflationary* recession 50 years ago.

RH

Econ Pol

10 DOWNING STREET

From the Private Secretary

25 November 1981

Dear John,

The Prime Minister has seen a copy of the Chancellor's letter to the Chairman of the Party of 17 November. She has asked me to say she believes the Chancellor has identified one area where promotional liaison could be improved.

It so happens that Bernard Ingham, her Chief Press Secretary, has been looking at this general area and is aware of the Party dimension: he will be giving David Wolfson here some ideas on the subject in a few days.

I am sending copies of this letter to Michael Collon (Lord Chancellor's Office) and David Heyhoe (Lord President's Office).

Yours sincerely,
Caroline Stephens

John Kerr, Esq.,
HM Treasury.

DS

CONFIDENTIAL

c. Mr. Scholar
Mr. Hoskyns
Mrs. Gilmore) HMT
Mr. Dixon)

MR. INGHAM

EFFECT OF THE FORTHCOMING ANNOUNCEMENTS ON PAY BARGAINING

You asked me after your meeting yesterday to have a look at the likely effect of next week's announcements on the behaviour of typical pay bargainers, on various assumptions about the decisions Ministers have to take over the next few days. And I undertook to think how best to present the whole package from the point of view of minimising the adverse effect on pay determination.

I did attempt some quantification, but rapidly concluded that I had neither the information nor the resources to do it properly. It is, however, clear what the main effects will be, and that they will be unhelpful. I am not sure that we gain anything very much by going further than breaking the effects down as between reductions in take-home pay and increases in the cost of living.

So I have attempted in the attached draft some guidance for Ministers indicating where the dangers lie, and suggesting how the announcements might be put across in a way which may lead pay bargainers to believe that what is proposed is reasonable, and necessary for longer term recovery. If you think it worthwhile, we could take the opportunity of our meeting with the Lord President at midday today to ask him whether he would consider circulating something along these lines to his colleagues on the day of the announcement (assuming always that they all come out at once). Against that possibility, therefore, I am sending a copy of this note and enclosure to Rosalind Gilmore and Peter Dixon in the Treasury for their comments. Ideally, this guidance ought

/also to

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also to contain a paragraph about the relationship between the Government's monetary targets and the recovery, the issue extensively exposed in the various exchanges of minutes between me and Alan Walters. But it is only fair to await Alan Walters' own recovery before going firm on that.

J. M. M. VEREKER

25 November 1981

DRAFT

GUIDANCE FOR MINISTERS

The Effect of the /‾2 December 7 Announcements on Pay Bargaining

Background

The Chancellor's statement on public expenditure and the associated announcements of the Industry Act Forecast, the Government Actuary's Report, /‾RSG decisions and Nationalised Industry EFLs_7 make it even more apparent than it has been hitherto that if those in work settle for pay increases in low single figures they will suffer a significant fall in living standards. It is possible that the announcements may lead to a significant rise in the temperature of the pay bargaining climate; and it is therefore particularly important that colleagues take every opportunity to explain why the measures the Government is now taking are right; and why continued pay restraint is necessary, even if it means falling living standards.

The Announcements

The bad news for pay bargainers is:

(i) Take home pay will be lower because of the rise in National Insurance Contributions - £ a week for the average wage earner. Family income will be reduced where a member is unemployed, because of the cut in unemployment benefit - £ a week below the level implied by full linking to the rate of inflation. And the Chancellor has made it clear that the level of public spending he has announced /‾may/will_7 mean higher taxes in the Budget if interest rates are not to rise further.

(ii) The cost of living (November 81-November 82 RPI) is now officially forecast to rise by 10 per cent this pay round. This covers the cost increases implied by other announcements, i.e. higher rents and rates, prescription and dental charges, and students fees, but of course the sudden rise in those items will have a greater effect on pay expectations than the steady rise in other items throughout the year.

/iii)

(iii) Average Earnings are now officially forecast to rise by 7½ per cent in the course of the pay round. Employees in the public services will regard the difference between that and their 4 per cent cash limit as an indication of the extent to which they are being asked to settle for less than the going rate because of their greater job security.

The good news for pay bargainers is:

(i) The worst off are protected from the sharpest rises in costs - [40 per cent] of those paying rents, rates and health service charges receive special assistance in the form of rebates or exemptions.

(ii) Tight control of public spending means that taxes and/or interest rates are lower than they otherwise would be.

Points to make

1. The long term nature of any successful effort to get the economy competitive again. The Government has always said it would take years, not months. That is why it published a medium term strategy, covering the life time of this Parliament. We mustn't give up now just because things are looking difficult. The difficulties reflect the extent to which we allowed ourselves to fall behind our competitors in the 1960s and 1970s.

2. The Titanic struggle that any administration faces to keep public spending under control. All recent British Governments have faced regular public expenditure "crises". The fact is that public spending rises of its own accord unless it is strictly controlled. Controlling it in a recession is particularly difficult and some rise is inevitable. The Government has done well to keep it to a level which is consistent with the continuing fall in public borrowing set out in its medium term strategy. NO

/3. We

3. We always said those in work would have to have a cut in their living standards. It is widely recognised that there was a substantial moderation in pay settlements in the last pay round: but the rise in average earnings still almost kept pace with the rise in the cost of living. Getting competitive again means a temporary set-back in living standards: the time for that is now.

4. So the 23 million who are employed will have to make some sacrifice to help the 3 million who are not. The unemployed have to be supported; and they also have to be given the hope of new jobs, which can only come if the employed help create a thriving economy. If wage earners won't accept the sacrifice in their pay packets, sooner or later the sacrifice will be made for them - in more job losses, or in higher taxation, or in higher interest rates.

5. It's working: don't let's throw it all away now. Over the five years to 1980, our labour costs (per unit of manufacturing output) nearly doubled. They rose by only one half in Canada, one third in the US, one sixth in Germany and not at all in Japan. But now for the first time for many years our unit labour costs are rising more slowly than those of our competitors. There's a long way still to go, but we're going to get there.

c. Mr. Hoskyns
Mr. Walters
Mr. Duguid
Mr. Scholar

MR. INGHAM

MONETARY TARGETS AND THE RECOVERY

We had a word about your note to me of 23 November, which you wrote after seeing Alan Walters' note about the relationship between monetary targets and the recovery.

I think it is widely recognised within this office that we have a major presentational difficulty here. It is much harder, for some reason which I find difficult to analyse, to justify adherence to strict monetary targets at a time when the recovery is beginning, than it was to justify it when we were on the downward slope of the recession. This may be because we justified the conscious deepening of the recession on the grounds that it was necessary in order to establish the basis for a sustainable recovery, and it is now seen as something akin to immoral to deny people the fruits of that earlier sacrifice. I would like to try to arrange a short discussion of this among those of us concerned: unfortunately, Alan Walters has fallen victim to excessive indulgence of oysters and will not be available until tomorrow. There is to my mind (and to Andrew Duguid's) a rather clear contradiction between what Alan Walters is saying - that since all we are doing is adhering to a fixed path of monetary deceleration through both phases of the economic cycle, there is no specific policy to choke off the recovery in output - and what Terry Burns is saying, which seems to be that until inflation has got below the growth rate of monetary incomes implied by the monetary policy, our policy <u>is</u> intended to restrict output. And, as the media are now pointing out with ever increasing justification, it does look as if we are nipping the recovery in the bud.

In the meantime, therefore, I think we must rest on the lines suggested in the last paragraph of my earlier minute - 23 November to Alan Walters. The recovery we are looking for is a special kind of recovery, characterised by our ability to sustain it, and requiring therefore a continuation of our improvement in competitiveness, which means a lower rate of

/inflation

inflation than we have at present achieved. Given that most forecasters are now doubtful about single figure inflation next year, and almost all forecasters see inflation exceeding the target growth rate of money supply this side of the Election, that is a pretty unpalatable message. But it is, if I understand it aright, the Government's policy.

24 November 1981

(4)

Prime Minister

MLS 24/11

Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000 23 November 1981

The Rt Hon William Whitelaw CH MC MP
Secretary of State for the Home Department
Home Office
50 Queen Anne's Gate
LONDON SW1H 9AT

Dear Willie

ECONOMIC BRIEFING

You may have seen an Economic Brief which was sent to the offices of all members of Cabinet on 16 November. This letter explains why I had it sent round in this way.

Each week the Treasury prepare a Brief for the Prime Minister in the House. It has in the past also gone to officials in selected Departments. But I thought it would be valuable to draw it to Cabinet colleagues' attention, since it seems important to ensure that all of us are kept in touch with the progress of our economic policies, know something of our successes (and our weaknesses), and are aware that there are answers, and usually good answers, to most of the irresponsible criticism and suggestions that are thrown to us. The Brief may also be of some use in the preparation of speeches.

If you have not seen it before, it may seem a pretty indigestible bundle - not least because it is written in a very compact (though carefully worded) style. Even so, you may find it useful if you have a chance to tuck the flavour of it into the back of your mind - particularly if you are about to be exposed to any kind of economic cross-examination.

I propose to circulate each weekly edition in the same way in future. In each successive edition any changes or additions are clearly identified, which also helps a little.

Copies of this letter go to the Prime Minister, to other members of the Cabinet, and to Sir Robert Armstrong.

Yours ever
Geoffrey

GEOFFREY HOWE

Econ Pol Strategy

81

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MR. VEREKER

Econ Pol

10 DOWNING STREET

From the Private Secretary 23 November 1981

NEDC

We had a word about a possible date for the Prime Minister to chair a meeting of NEDC.

I have now had an opportunity to consult the Prime Minister. She would like to plan on chairing the meeting on 3 February. I should be grateful if you would let me know as soon as possible what the options are as to what might be included on the agenda for that meeting.

I am copying this letter to Jeremy Colman (Sir Douglas Wass's Office).

M. C. SCHOLAR

Peter Jenkins, Esq.,
HM Treasury.

1. Mr Ingham. cc. Mr Hoskyns.

You should be aware. The PM at NEDC in early February could be quite an explosive mixture.

2. Mr Scholar

I should be very grateful if you could keep me au fait with the agenda. Pay is likely to have to feature, & will need very careful treatment; & the presentation of the whole event will be tricky.

J.V. 24/11

(1)

PRIME MINISTER

CHAIRING A MEETING OF NEDC

You last chaired NEDC in February, and we wonder when you would think it right next to chair such a meeting.

There is a case for not allowing more than a year or so to elapse between these two occasions. There is an argument for avoiding a date too near that of the Budget. This points perhaps to your choosing the a February date.

If you are in principle willing to contemplate this timing, I will let you have the options as to what might be included on the agenda.

Should we start planning for a February meeting?

MCS

Yes mt

20 November 1981

CONFIDENTIAL

(2)

Prime Minister

MLS 20/11

SECRETARY OF STATE FOR EMPLOYMENT

PRIME MINISTER

PAY BRIEF

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

NT

N T

20 November 1981

PAY BRIEF: POSITION IN MID-NOVEMBER

1 Since the October pay brief 75 settlements covering 445,000 employees have been reported. Only 3 settlements covering 40,000 employees are in the public sector and the weighted average level of these (about 9½%) is dominated by the increase for Firemen (just under 10%). The average in the private sector of just under 8½% is heavily influenced by the 10% proposed settlement for Agriculture (E & W) (256,000) - to be confirmed in December.

2 The cumulative weighted average level of settlements for the whole economy this round is about 9½%, but only about 5% of employees have reached settlements.

3 In the private sector the cumulative average is just under 8½% (123 settlements covering 496,000 employees). In manufacturing the average level is just under 6%. The average in non-manufacturing is just under 10%. Settlements range up to 13%; but about ¾ covering about ¾ of the employees are in a 5% - 10% band (see appendix 2). No going rate is as yet apparent.

4 In the public sector (4 settlements covering 178,000 employees) the cumulative average of about 12½% is still dominated by the increase for Police (13.2%).

NEGOTIATIONS

5 In the PUBLIC SECTOR, Coalmining manuals (1 November - 198,000) have submitted a claim for £100 basic minimum for surface workers - which is worth about 23.7% on rates - reduced hours, improved holiday pay and other benefits. The NUM Executive have rejected an improved offer of £100m (previously £71m) giving increases of 7.8% on basic rates, holiday bonus of between £30 and £70 and improved incentive bonus (overall estimate is 7.3% on average earnings). A further meeting has been arranged for 25 November. Water Service Manuals (7 December - 30,600) have rejected a new offer of 7.8% (8.1% on rates) in response to their claim for an increase in basic rates not less than the current rate of inflation, a reduction in the working week and improved holidays. UKAEA manuals (1 October - 4,760) have rejected an offer of 4.5% on rates. The claim is for a substantial pay increase. Next meeting has been arranged for 25 November. Negotiations have not yet begun for Local Authority manuals (4 November - 1,077,000) who have submitted a claim for increases in line with inflation, a shorter working week and longer holidays, which is worth about 15% to 16% in total. Meeting arranged for 10 December. British Telecom executive grades (1 July - 7,000) are taking limited industrial action over their claim for pay parity with telephone engineers. An offer estimated to be worth 10% on earnings and which has been accepted by all other Telecom negotiating groups has been rejected.

6 In the PRIVATE SECTOR, the CSEU negotiators are to consult member unions on an offer of about 5.1% for Engineering employees (1 November - 1,750,000). Backdating to 1 November is subject to acceptance by 8 December. The union representing Oil Tanker Drivers (17 November - 7,900) has rejected 8% on rates but is putting it to members. BP have accepted. Shell have rejected but have agreed to talks with ACAS. Strike action threatened from 16 November has been postponed. The claim is for 11% on rates similar to the settlement for Mobil in May 1981. Shell UK Refinery manuals (1 October - 3,400) have rejected an 8% offer. In the Road Haulage Industry (November/March - 97,000) 15 of the 21 areas have presented claims for £100 per week, longer holidays and other improvements estimated to be worth about 50% overall. The employers have made offers of between 3.1% and 3.75% in 3 of the areas. A revised offer to Seamen (2 January - 26,000) of about 8% is being put to members with a recommendation by the union to accept. Talks in the Electrical Contracting Industry (1 January - 45,000) appear to be deadlocked. An offer understood to be worth 6% to 7% has been rejected. The union is thought to be seeking an increase of about 20%. Unions representing Ford Motor Co manuals (24 November - 56,500) have rejected an offer of about 4½% and have threatened strike action from 24 November. A meeting has been arranged for 23 November. The claim is for consolidation of attendance bonus, increase of £20 per week, move towards a 35 hour week and other benefits. Vauxhall Motors Ltd manuals (15 September - 15,600) have been made an offer of 4% with an additional 1% available and the prospect of a 39 hour week in exchange for concessions. The offer has been accepted by the majority of workers. Negotiations are continuing on behalf of Newspaper Publishers Association production workers (1 January - 33,000). The claim is worth about 15%. Employers have suggested a 6 month pay freeze.

PRICES AND EARNINGS INDICES

PRICES

7 In October the year on year increase in retail prices was 11.7% compared with 11.4% in September.

EARNINGS

8 In September the year on year increase in average earnings for the whole economy was 9.4% compared with 12.8% in August. However the underlying change, allowing for temporary influences such as backpay in September 1980, was about 11%; similar to the figure for August but about ½% higher than the figure for the 1980/81 pay round because of the increase in hours worked.

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) fell by about 2% in the year to August.

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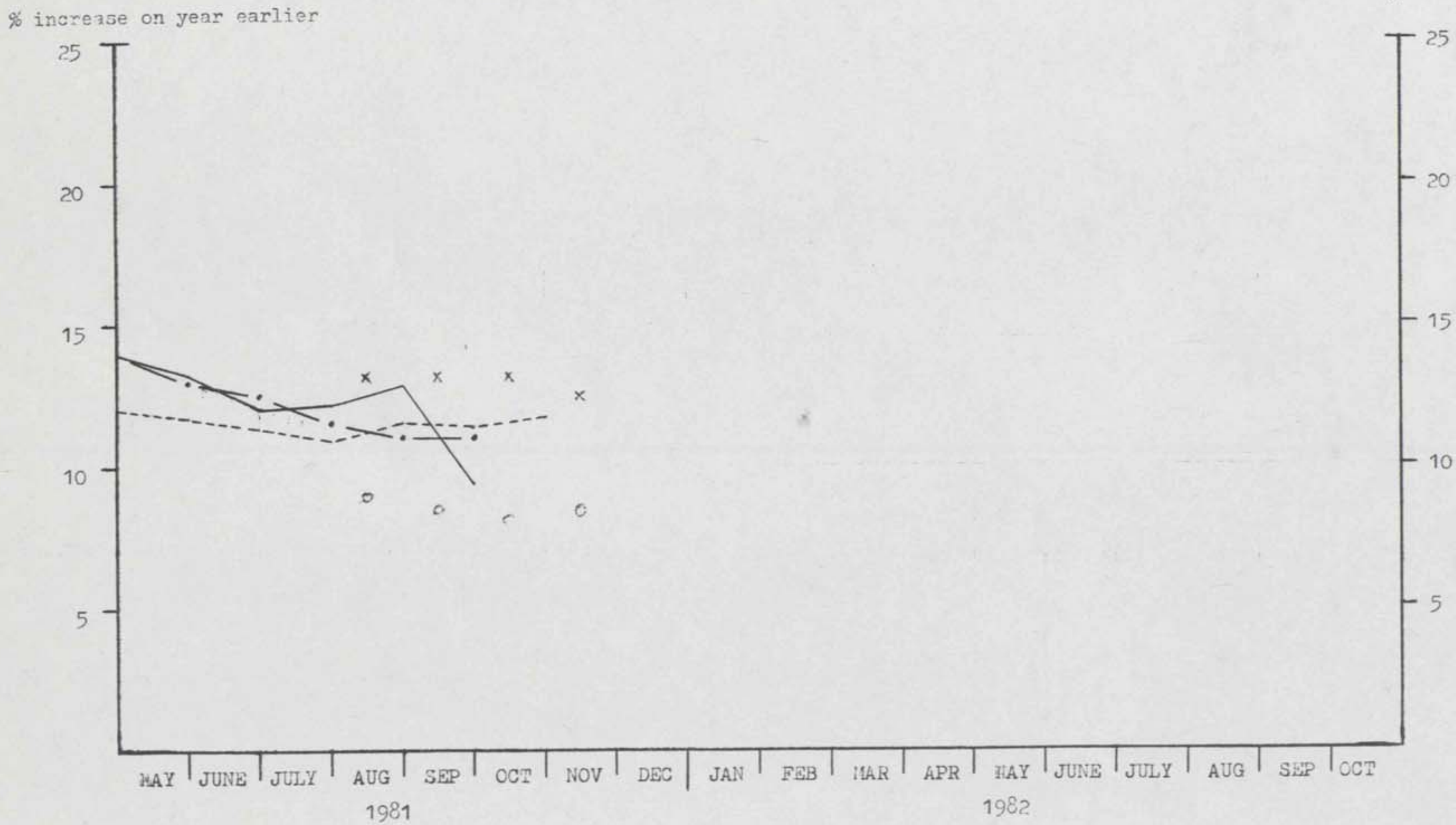
APPENDIX 1

TRENDS IN EARNINGS AND PRICES



- - - - - Retail Price Index

——— Average Earnings Index (whole economy)

. ——— . Underlying rate of increase in earnings

× Public Sector Settlements)
o Private Sector Settlements) Cumulative Average Increase in Earnings

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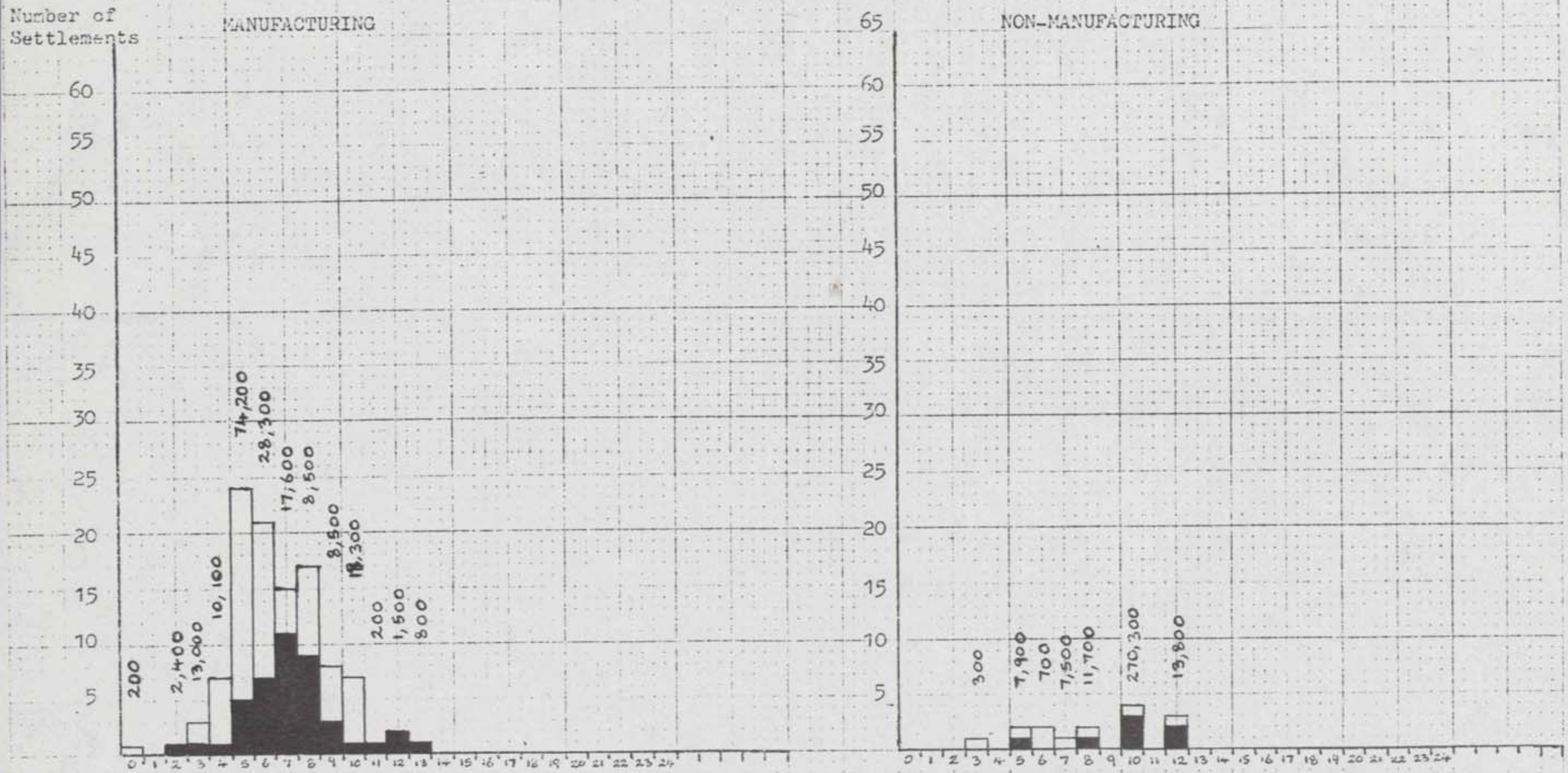
APPENDIX 2

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

KEY [shaded] SETTLEMENTS UP TO THE LAST PAY BRIEF

[open] 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.

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PRIME MINISTER

The Chancellor has written attached to the Chairman of the Party, copied to the Lord Chancellor and Lord President as well as yourself:

- praising a recent economic speech in a Party forum by Lord Hailsham;
- regretting the lack of publicity for it; and
- asking what might be done by Departments/CCO to maximise publicity for major speeches.

As it happens, I recently had lunch with Alan Howarth of CCO at which the main subject was the undeniable need to improve information/presentational liaison as between Party and Government. I am about to produce a paper for him. The point raised by the Chancellor is germane.

Could I suggest Michael Scholar writes to the Chancellor's Private Secretary, copying as appropriate, as attached.

Yes - thank you

MT

B. INGHAM

19 November, 1981

GR/ pl type fms MCS 20/11 Confidential C.F. · PPs please MCS. 20/11

DRAFT LETTER FOR MICHAEL SCHOLAR TO SEND TO THE CHANCELLOR'S PRIVATE SECRETARY

cc. Lord Chancellor's } PS
Lord President's

The Prime Minister has seen a copy of the Chancellor's letter to the Chairman of the Party of November 17. ~~and~~ She has asked me to say she believes ~~he~~ the Chancellor has identified one area where promotional liaison could be improved.

It so happens that Bernard Ingham, her Chief Press Secretary, has been looking at this general area and ~~has on board~~ is aware of the Party dimension: ~~He intends to give~~ he will be giving David Wolfson here some ideas on the subject in a few days.

I am sending copies ——— .

Blind copy to J Vereker
B Ingham

RECORD OF A DISCUSSION BETWEEN THE CHANCELLOR OF THE EXCHEQUER AND THE FEDERAL MINISTER OF ECONOMICS IN THE FEDERAL MINISTRY OF ECONOMICS, BONN AT 9.15 A.M. ON WEDNESDAY 18TH NOVEMBER 1981

Present:

Chancellor of the Exchequer	Dr. Otto Graf Lambsdorff
Sir Kenneth Couzens	Dr. Muller-Thuns (Deputy Secretry)
Mr. P.W. Unwin	Herr Grimm (Under Secretary)
Mr. J.O. Kerr	Dr. Goldschmidt (Assistant Secretary)

FIFTH MEDIUM TERM ECONOMIC PROGRAMME

Count Lambsdorff said that he was concerned that the Ortoli Foreword to the Fifth Medium Term Economic Programme could prove divisive of the Community. It was a highly unsatisfactory document, and discussion of it might serve to highlight the fact that unanimity within the Community on economic diagnosis and prescription no longer existed. The Danes and Benelux countries would try to jump on Ortoli's bandwagon. It would be helpful if the United Kingdom and the FRG could speak with a common voice. The Chancellor said that there was still a wide measure of agreement on the need for monetary and fiscal restraint. Even Delors saw this. Sir Kenneth Couzens suggested that the principal issue was whether - as we and the Germans thought - the common aim should still be to reduce levels of public borrowing. Count Lambsdorff agreed. The disquieting feature of Ortoli's personal foreword was that it offered encouragement to those who might wish to pursue other aims. It was therefore likely to be damaging to the co-ordination of economic policy within the Community. He was very much afraid that we might soon see a rather restrictive new French trade policy. There was no idealogical barrier to protectionism in France. Since high interest rates in the United States would be with us for some time, the Europeans ought to be attempting to de-couple themselves by reducing their own deficits. This must remain the paramount aim. To wait for healthy developments in the United States to bring down interest rates generally would be to wait too long.

Contacts with the United States

2. Count Lambsdorff added that we must of course continue to do all we could to encourage healthy developments in the United States, particularly on fiscal policy. The Chancellor agreed. What was required was not a formal European demarche to the Americans, but tactful and discreet pressure behind the scenes. Insufficient progress had been made at Ottawa, and the further efforts made at the time of the IMF Washington meeting had produced few results, perhaps because Stockman's star was waning.

3. Count Lambsdorff said that the German Cabinet had agreed on 17 November on the need to strengthen ties with US public opinion. Chancellor Schmidt had authorised an intensive programme of Ministerial visits to all parts of the United States. Count Lambsdorff would himself be going in February. The Chancellor said that he too was contemplating the possibility of a visit around the turn of the year. Sir Kenneth Couzens said that the US Administration were more likely to listen to the Germans and the British than to the French in present circumstances. Count Lambsdorff agreed, adding that the Germans fully accepted that it was important to avoid any suggestion of confrontation with the US Administration. Sir Kenneth Couzens said that the US economy was moving rather rapidly into recession, which made the fiscal action necessary to deal with the deficit problem still more difficult for the Administration. If the dollar were to weaken, as it undoubtedly would, particularly against the deutschemark, the Americans would presumably start to become more interested in the external dimension of economic policy. They might, for example, change their current narrow view of the circumstances in which intervention in the currency markets would be appropriate.

Contacts with Japan

4. The Chancellor said that he was struck by the extent to which the history of Community relations with the Japanese on trade issues was one of talk, not action. He had recently received a Keidanren delegation in London, and had received advance briefing from UK

officials strikingly similar to the briefing he had received on similar occasions in 1973. The Community had totally failed to use its leverage on the Japanese, who had not been required to change their internal market. And the Europeans had failed to defend their own industries successfully against Japanese imports. Count Lambsdorff demurred. There *had* been a change in the Japanese Government's position. They were now attempting to deal with the deep-rooted resistance in Japanese society to buying foreign goods. The 20-point programme which the Heidanren delegation had been given in London was very good. And efficient European industries were now successfully fighting back against Japanese import penetration. The German car industry was one example. The need for non-tariff barriers, and quotas on Japanese imports, was not yet proven. He would prefer to try to defend European industries in a broader, and more long-term way.

Insurance directive

5. The Chancellor said that some progress on the draft directive had been made in the Finance Council on 17 November. The question of notification remained contentious, but Dr. Schulmann's flexibility had been beneficial. Count Lambsdorff said that the FRG would not go beyond the concessions which Dr. Schulmann had offered on 17 November. Resistance in Germany to the proposed directive came not just from the insurance industry, but from German industry as a whole. This was a new development, as industries requiring insurance cover had previously favoured a greater element of competition. Resistance would stiffen the longer the debate in the Community dragged on. The Chancellor said that the UK insurance industry would of course see little virtue in a directive which lacked all substance. But he was not despairing of progress in the Finance Council.

The Mandate

6. The Chancellor said that there was a clear convergence in the UK and German approaches to the problem of the Community budget. He had made clear - e.g. in his speech at The Hague -

the importance we attached to establishing a system for rational budget decision-taking. The Germans had made plain their concern at the growing size of the net budget. We should join forces to hammer out a logical new approach. Count Lambsdorff said that the Germans were ready for a compromise. They were prepared to remain a net contributor, and would not argue for a 'juste retour'. But they could not accept that the United Kingdom and the FRG should be the only net contributors. Other countries were much richer in terms of per capita GNP. And, while the Germans would certainly defend the 1 per cent limit, they would wish to ensure that within it more resources were made available for spending on energy, social programmes, and the regions, rather than the appetites of agriculture. The Chancellor said that there must be limits to national contributions; and a system to determine what policies the budget should be designed to promote. At present the budget was no more than an aggregate of the demands of individual programmes, arrived at without any rational system for according priorities in resource allocation. Dr. Muller-Thuns said that a long-term system was certainly desirable. The curious position which had developed on the 1980 and 1981 refunds to the UK showed the dangers and disadvantages of random ad hoc solutions to budgetary problems. Sir Kenneth Couzens said that the UK had not of course devised, or even welcomed, the 30 May 1980 arrangement. We would very much prefer a durable system, respecting the principle of relative per capita GNP; and we had in fact put together a scheme involving limits to net contributions. We did not think that the Commission's proposals were quite right: they amounted to only another ad hoc scheme. Dr. Muller-Thuns said that the Germans too disliked the Commission's scheme.

7. The discussion ended at 10.30 a.m.

J.O. KERR
24 November 1981

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CS10

1) MCS
2) CS.

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

18 November 1981

Michael Scholar Esq
Private Secretary
Prime Minister's Office
No.10 Downing Street
LONDON SW1

Caroline

Could we do the 3rd Feb?

Yes - Lorne entered in diary

M

Will it require a lot of preparation?

CS.

Dear Michael

PRIME MINISTER'S VISIT TO THE NEDC

You mentioned last week that the Prime Minister might like to visit the NEDC again early in the New Year, and you wondered when would be the most suitable time.

Our feeling is that the best time for her to come would be February (the Council meeting will be at 10 am on the 3rd of the month). The January meeting probably has to be ruled out, partly because a visit by the Prime Minister requires some careful arranging, and there may not be enough time to do this properly by the beginning of January, and partly because, with a meeting so soon after Christmas, there could be difficulties in getting a full turn-out of Council members. A visit in March is a possibility, but would be likely to be close to the Budget.

The agenda for the February meeting has not yet been finalised. If the Prime Minister did want to attend the February Council, we would endeavour to put together an agenda which she would find interesting and attractive.

CS.

I wouldn't have thought more than the avg E mtg.

M

Yours ever

Peter

P S JENKINS
Private Secretary

PERSONAL

C Mr Ingham

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

17 November 1981

The Rt. Hon. Cecil Parkinson, MP
Paymaster General and Chairman of the
Conservative Party
Privy Council Office
Whitehall
LONDON
SW1

Dear Cecil

I have been reading, with admiration, the Central Office press release of the speech which Quintin Hailsham made to the Oxford University Conservative Association on 6 November. Not for the first time, it seems to me that Quintin strikes exactly the right note - instructive, but not didactic - in his description of the causes of our current economic difficulties, and the various panaceas on offer. And, also not for the first time, it seems to me a very great pity that, unless I missed some reports, press coverage of the speech has been quite inadequate.

I wonder whether there is anything that we can do to remedy this for the future. If, for example, Francis Pym's or Number 10's or the Treasury's press people were given advance notification of a major speech of this kind we could ensure that the appropriate correspondents were tipped off. My people might be able to give particular help with financial and economic correspondents if the speech had an economic theme. It seems a shame to see so much fragrance wasted on the desert air, if a Cambridge man may so describe OUCA.

I am sending a copy of this letter to Quintin and Francis, as also to the Prime Minister. No doubt you or he will let me know if you see any merit in my suggestion of some advance preparation of the ground in Fleet Street next time.

Yours

Geoffrey

GEOFFREY HOWE

PS/CHANCELLOR

file no TEB/CA/01

copied to:

Mr Salveson (for transmission to No.10)
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PS/Lord President of the Council
PS/Secretary of State for Northern Ireland
PS/Secretary of State for Defence
PS/Minister of Agriculture, Fisheries and Food
PS/Secretary of State for the Environment
PS/Secretary of State for Scotland
PS/Secretary of State for Wales
PS/Lord Privy Seal
PS/Secretary of State for Industry
PS/Secretary of State for Social Services
PS/Secretary of State for Trade
PS/Secretary of State for Energy
PS/Secretary of State for Transport
PS/Chancellor of the Duchy of Lancaster
PS/Secretary of State for Employment
PS/Paymaster General
and officials in HMT, Revenue Departments and other Departments in Whitehall

TREASURY WEEKLY ECONOMIC BRIEF

I attach the latest version of this Brief which we have been preparing for the Prime Minister's information before her weekly Question Time (and which is still drafted to meet that purpose) but which we now propose to circulate more widely among Treasury and non-Treasury Ministers.

This week's brief does not take account of the transfer of some of the former CSD's functions to the Treasury. Whether and how to do this is under consideration.

Changes from the previous Brief, of 9 November, are sidelined.

M M Deyes

M M DEYES

R.A

R I G ALLEN

16 November 1981

EB Division
HM Treasury
01-233-3364

ECONOMIC BRIEF: CONTENTS

A GENERAL ECONOMIC STRATEGY

1. Government's main economic objectives

Main objectives are to achieve, over a period, a sustained improvement in the economy through reduction of inflation and promotion of enterprise and initiative. Reduction of inflation requires strict adherence to firm monetary and fiscal policies. Improvement of supply side depends on restoration of flexible and competitive market economy and better incentives.

2. Relative importance given to inflation and unemployment?

Government is equally concerned about both. These are complementary not competitive objectives; unemployment will not be reduced by relaxing struggle against inflation.

3. What has Government achieved during term of office so far?

Removed constraints on market forces: reduced Government regulation and bureaucracy; fostered a new mood of realism; improved incentives to enterprise and efficiency. Specific measures to help small businesses to start up and/or expand. Manufacturing output up 1½ per cent in third quarter. Inflation below 12 per cent - nearly halved since Spring 1980 peak. Unemployment in latest three months rising less than half as quickly as in last quarter of 1980.

4. When will upturn in economy come?

Latest figures (published 12 October) suggest some rise in industrial production since spring 1981. Manufacturing productivity (output per man) up 5 per cent since end-1980. Unit wage costs in manufacturing have shown little rise in first half 1981. [NB but rising more strongly again now]. Competitiveness improved. Prospects depend above all on further success in reducing inflation and improving industrial competitiveness and productivity.

5. Major economic statement to be made in November?

In the normal course of events, some announcements will have to be made in the autumn.

6. When will Industry Act forecast be published?

A forecast will be published this autumn in the usual way.

7. British business in crisis? Manufacturing bearing the brunt?

Government has done a good deal to create right conditions for business to thrive but recession has obscured them. Best help Government can give is further progress in bringing down inflation. Many signs companies now tackling problems ignored for far too long. Unreasonable to expect problems of years to be solved overnight. Growing evidence of improvements in productivity and competitiveness.

8. Productivity gains normal in recession?

[P Kellner in N. Statesman 13 November.]

Productivity has held up well in relation to fall in manufacturing in last 2½ years. Both output per hour for whole economy and output per man hour in manufacturing are higher than in first half 1979.

9. Productivity gains mean job losses?

No. Productivity a way of improving competitiveness and securing more growth in the economy.

10. Current unemployment levels intolerable? Going to get worse?

No immediate prospects for unemployment turnaround but the rate of increase has slowed markedly since turn of year. Less short time working, overtime picking up. The prospects depend crucially on securing further reductions in pay settlements and increasing productivity so obtaining improved competitiveness. This is the way to get real sustainable jobs.

11. Cost of unemployment?

[MSC estimate reported in Financial Times 9 November used to under pin pressure for reflation]

(See C9.)

12. 10 per cent November inflation target now impossible? Inflation bound to get worse? Sacrifices have been for nothing?

Developments since the Budget (particularly fall in exchange rates) have certainly worsened short-term inflation outlook. But Government expect downward trend will continue, though precise timing is difficult to predict.

13. Government's pay policy means falling living standards?

If recent improvement in competitiveness is to continue, we must achieve further reductions in pay settlements in the coming round. It is now clear that the increase in retail prices in the year to November 1981 will be higher than the 10 per cent forecast in the FSBR. (See also Section J.) Acknowledge this could mean lower real incomes in short term. But best way to safeguard jobs and build longer term prosperity. And must be set against 17½ per cent rise in RPDI in 3 years to 1980.

14. Government has failed to check public spending?

Public spending this year is expected to be somewhat higher than we had originally planned. An important reason for this is that we took the effect of the recession into account when we prepared our most recent plans. We remain committed to containing public spending. The annual review is currently in progress (see further Section E). [IF PRESSED on when results will be made public; Main decisions for 1982-83 will be announced within the next few weeks. Full details will be published in the next Public Expenditure White Paper on Budget day next year.]

15. Government has failed to allow accommodation to the recession?

Accusations we are inflexible in our tactics are unfounded. Have been flexible within the limits of prudence over the levels of public spending and public deficit.

16. Government being flexible to point of laxity?

We must be flexible about particular policies while holding in place our policy framework. We cannot and will not allow the foundations to be destroyed.

17. Why are high interest rates needed?

Current level of interest rates has reflected developments overseas and strength of bank lending. Although sterling has recently firmed, high level of bank lending continues. However it should be noted that bank base rates have come down by 1 per cent from the peak in September.

18. Rapid growth in £M3 shows slackening in monetary squeeze?

Not followed £M3 target slavishly to exclusion of all else. Allowed overshoot last year because judged could do so without endangering objectives for reducing inflation.

19. Is the MTFS still Government policy?

The MTFS sets out our broad strategy on fiscal and monetary policy. Objective is to provide assurance Government will continue to provide financial discipline. Judged by results, rather than precise numbers, we have done just this. (See also section H).

20. MTFS shot to pieces?

Completely untrue to say we have failed to achieve MTFS. Main objective is reduction in inflation, and progress here has been good. £M3 growth has been higher than we would have liked, though narrow measures of money have grown more slowly. But growth in nominal GDP (as discussed in November Economic Progress Report) seems to have been growing by about 10 per cent in first half 1981. The PSBR for this year is likely to be much as expected at the time of the 1981 Budget.

21. Government should change course?

[Most recent commentary from Sir Ian Gilmour, Max Wilkinson and S Brittan in FT.]

(a) Moderate reflation the answer?

Government has shown willingness to adapt to recession and is allowing higher PSBR than envisaged last year. Fallacy that we could "spend our way out of recession" (i.e borrow much more) without seeing a resurgence of inflation, and as a consequence interest rates rising further and faster. Economically and politically this is nonsense: no Western government believes it, and our own painful experience (1971-73, 1974-76) refutes it. George Cardona has pointed out in FT 16 November the prize to be won in lower inflation by maintaining thrust of Government strategy.

(b) Reintroduce exchange controls and join EMS?

Exchange controls are a very modest and limited weapon, and the EMS is not a panacea. No substitute for responsible monetary and fiscal policies. Creating a European island of currency stability, as rt hon Gentleman (Mr Heath) suggests, will not of itself eliminate instability vis a vis the dollar, yen or OPEC world.

(c) More capital spending in public sector?

Projects must be economically sound. Not all capital spending virtuous nor all current spending bad. Cost of public sector investment in terms higher borrowing pushing up interest rates could outweigh immediate boost to jobs.

(d) Cut NIS?

See D11.

B ECONOMIC ACTIVITY AND PROSPECTS

1. Is recession over?

Ministers have been saying for many months that fall in output was ending. This now appears to be the case. Firmest evidence to date that fall in output is now over comes from latest figures for industrial and manufacturing output. In third quarter manufacturing output increased by 1½ per cent. Some improvement in financial position of company sector (see N3).

IF PRESSED: Evidence not conclusive

Recognise all usual uncertainties. Equally I see no virtue in ignoring what has occurred. There has been a substantial improvement since the end of last year. Manufacturing output has picked up, labour market indicators have improved (see C1). This year has seen higher engineering and construction orders and increased private sector housing starts, compared with the second half of last year. (See B4 for independent forecasts).

[IF ASKED about decline in CSO's longer leading indicator: Too early to judge significance; recall that temporary weakening occurred in last cycle.]

[NOTE: 3rd quarter GDP figures to be published 18 November; new cyclical indicators 19 November]

2. Government assessment of prospects

Budget forecast assessment suggested beginnings of recovery in H2 1981. New Industry Act forecast will be released by Treasury around the end of the month.

3. Outside forecasts

[GDP profile in major forecasts released since June:

	H2 1981 on H1 1981	H1 1982 on H1 1981	per cent
LBS (Nov)	$^1/_3$	1	
NIESR (Sept)	1	1¼	
CBI (Aug)	0	½	
Phillips & Drew (Nov)	0	½	
OECD (July)	$-^1/_3$	0	

Recent major independent forecasts assess that low point in activity was reached in first half of year, with prospect of some recovery in the coming year.

4. <u>Where will recovery come from?</u>

Mainly from the reversal of the same factors that contributed to the downswing. There are signs that the rate of destocking is slowing, the savings ratio can be expected to decline further as inflation abates, and some recovery is expected in world trade. Additionally productivity and competitiveness are now improving [see second half of B6].

5. <u>Recovery slow?</u>

Never claimed it would be rapid [FSBR shows 1 per cent growth in GDP in year to H1 1982]. Economy has weakened cumulatively during the post war period. Have created the opportunities and foundations for improved economic performance.

6. <u>Higher interest rates will abort recovery? Business confidence weakened?</u>

Understand concern over higher interest rates, but it is absolutely essential to contain inflation. Inflation is inimical to sustainable recovery. Interest rates only one of factors affecting industry. Manufacturing productivity in second quarter some 5 per cent up on final quarter of last year. Together with last pay round's lower level of settlements, this has meant only a small rise in manufacturers' wage costs this year. This can be expected to contribute towards improved profitability and competitiveness.

7. <u>Recession worse than in the 1930s?</u>

Any such comparisons must of course be subject to a statistical health warning. It is true that the fall in output is comparable to the 1930s, but structure of the economy and society is much changed.

C LABOUR

1. Unemployment continues to rise?

[October total count was 2,989,000 (12.4 per cent). Seasonally adjusted excluding school leavers figure was 2,729,000 (11.3 per cent)]

Unemployment rising much less rapidly. Increase in recent months less than half those at end of last year [50,000 per month in 3 months to October 1981 compared with 115,000 per month in Q4 1980]. Also should note dramatic reduction in short time working in manufacturing - down ¾ from that at turn of year. Overtime showing signs of picking up. Result is that total hours worked have stabilised over recent months within manufacturing sector.

2. Unemployment accelerating?

[Monthly increases, seasonally adjusted, excluding school leavers, in 4 months July-October have been successively 30,000; 44,000; 46,000; 56,000]

True there has been some apparent upward drift in rate of increase over recent months (As figures involve some degree of estimation [due to emergency procedures because of civil service dispute] their reliability is somewhat uncertain.) Nevertheless it remains the case that labour market indicators are much more favourable than at turn of year (see C1 above). IF PRESSED FURTHER: Unemployment forecasts and assessments always uncertain. What is essential is that all participants in the economy contribute to improved economic opportunities. Crucial to this is further moderation in pay settlements.

3. Employment continues to fall?

[Employment fell a further ½ million in Q2 1981 much the same as in Q1. Total decline since mid-1979 1.7 million or 7½ per cent.]

Decline in manufacturing employment showing signs of slackening in August (17,000 compared with about 50,000 per month earlier in year). [See also C1 above].

4. Government forecasts for unemployment

[Public Expenditure White Paper published Budget Day used working assumption of an average level of 2.5 million unemployed in Great Britain (excluding school leavers) in 1981-82 and 2.7 million in 1982-83. Government Actuary's Report published 3 July revised 1981-82 assumption to 2.6 million. NB new GAD report will shortly be published]

Like previous administrations Government does not publish forecasts of unemployment, though Government Actuary Reports etc contain working assumptions. Government is concerned about unemployment. Scale of special employment measures (SEMs) adequate evidence of this. Prospects depend on further progress on productivity and competitiveness. [See 5 below for independent forecasts.]

5. Independent forecasts?

[Consensus is for medium term rise in "narrow definition" unemployment, reaching about 3 million in Q4 1982. In wake of SEMs, some forecasters (NIESR, CBI and P&D) revised down earlier forecasts by about 0.2 million.]

History shows unemployment forecasts to be very uncertain (this is a major reason why Government does not publish one). This is reflected in range especially for beyond next year. Some forecasters reduced their assessments following announcement of SEMs.

6. True level of unemployment is far higher than official figures?

[TUC now state it is above 4 million.]

Unemployment statistics are published on the same basis as under previous administration. MSC has wisely commented (in paper to NEDC) "the current definition provides a good and well understood series for discerning trends and once that firm ground is left, there is endless scope for statistical and semantic debate." We are concerned about unemployment however defined. But our policies are laying foundation for creation of secure employment.

7. Unemployment higher than in other countries?

[OECD standardised data show UK Q1 1981 at 10¼ per cent compared with OECD average of 6½ per cent.]

Unemployment has been rising sharply in major industrialised countries, given weakness of world economy. In our case we are suffering the cumulative effects of lost competitiveness and low productivity and implications of inflationary pay settlements in 1978-79 and 1979-80 pay rounds. This is why the rise in UK unemployment has been higher than in most other countries, and points to the need to improve productivity and competitiveness.

8. Would work-sharing help reduce unemployment?

I doubt whether this is the answer. We prefer to leave the determination of hours and working schedules to the decision of employers and workers who know the local conditions. But unless people prepared to accept reduction in income commensurate with reduction in hours, effect on productivity and competitiveness likely to make worksharing counter productive.

9. What is the cost to the Exchequer of the unemployed?

[MSC estimate £438 million per 100,000 additional registered, private sector, unemployment (similar figure estimated by Institute of Fiscal Studies); when "grossed up" gives £12½ billion for total unemployment. This figure has received much attention eg FT front page 9 November.

Latest HMT estimate (Written PQ) is £415 million for extra 100,000 registered private sector unemployment in 1981-82. This compares with £340 million for 1980-81 published in Economic Progress Report February 1981. Latter figure now revised to £360 million.]

All such calculations depend critically on and are sensitive to exact assumptions adopted eg composition (especially whether public or private sector workers), previous earnings, and benefit entitlement of the additional unemployed.

As explained in detail in Treasury's Economic Progress Report for February 1981, cannot gross up estimates by naive arithmetic to give cost of total unemployed - or of resources available for costlessly reducing unemployment. [IF PRESSED: No economy has zero unemployment: Moreover, any major change in policy would have implications for inflation, thereby affecting estimates by changing earnings, prices, taxes and benefits.]

10. Spend money on new jobs rather than unemployment benefit?

Cannot switch employment on and off like a tap. But Government doing a great deal to help. Special employment and training measures currently cover almost 700,000 people at a cost of over £1,100 million this year. Not easy to assess just how many being kept off unemployment register by SEMs, but Department of Employment estimate at around 345,000.

11. Should spend more, especially for young people?

In July announced further provision for special measures of around (gross) £700 million in 1982-83. A large part of this was for young people, including the new Young Workers Scheme. For the future, I expect my rhF the Employment Secretary will soon announce substantial further measures in the form of a comprehensive training scheme for the young unemployed.

12. Need to improve training at all levels?

Agree. Aim must be both to help individual and strengthen economy by having a better trained workforce. Government has fully endorsed objectives of MSC's New Training Initiative. We shall be making a statement later in this session about the role which the Government and others can play.

13. Unemployment as bad as in the 1930s?

Comparisons extremely difficult to make. Maximum recorded unemployment in 1930s was just under 3 million; but the labour force has grown by about $^1/_3$ since, so unemployment rates in the 1930s almost certainly higher than now. One also needs to bear in mind changed social conditions and protection given by the welfare state.

D TAXATION

1. Burden of taxation

[Total taxation in 1978-79 was 35 per cent of GDP (at market prices), 36½ per cent in 1979-80, 38 per cent 1980-81. It is forecast to be 40 per cent in 1981-82.]

This has inevitably increased during a time when national production has not been growing. But, for the vast majority, real personal disposable income is still higher than for most of the period when the Labour Party was in Government.

2. British taxes rose more sharply than in any other leading industrial nation in 1980?

[OECD report quoted in The Times 18 October]

Burden of taxation has inevitably increased during a time when national production has not been growing. This re-emphasises the need to control public expenditure and reduce inflation. The OECD report shows that the whole Government 'take' (by way of taxation and national insurance contribution) as percentage of GDP in Britain is less than in many other industrial countries - UK eleventh in OECD rankings, behind most other EC countries, including France and W Germany. [NB: HMG position is that national insurance contributions are not a tax - compare F3].

3. Government policy regressive?

Largest percentage reductions in take-home pay, as a result of March Budget, were for those with very high incomes.

4. Government policy has harmed incentives?

Marginal rates of income tax for most taxpayers lower than when the Government came to power. Basic rate still 3p below rate inherited from Labour.

5. Wrong not to index personal allowances in March Budget?

To index personal allowances would have cost £1900 million in 1981-82 (or £2,500 million in a full year). Circumstances did not permit such a large injection of resources into the personal sector this year. We thought it right to concentrate what help we could afford on the company sector.

6. Taxation of unemployment benefit?

Unemployment benefits paid from 5 July 1982 onwards will be liable to tax. The delay in bringing the scheme into operation is due to the complex administrative arrangements. (IF PRESSED: civil service dispute was one of factors which led to starting date being delayed from April 1982. Cost of deferment will be of the order of £100 million.)

7. Indirect tax increases inflationary?

True that the indirect tax increases have added to the RPI. But by reducing public borrowing, they will help to bring inflation down in the longer run and ensure that it stays down.

8. Heavy fuel oil duty

Costs involved mean that it would not be in the national interest to go beyond the Budget decision not to increase the duty in heavy fuel oil. Terms of North Sea gas contracts a commercial matter for the British Gas Corporation.

9. Reduce petrol/derv duties?

Pump price also dependent on pricing policies of oil companies and world market conditions. Real value of derv duty now about 60 per cent of 1970 level, and of petrol duty no higher than in 1970.

10. Not enough tax relief for industry in the Budget?

Direct help given to industry in the Budget, despite the tight constraint, has been considerale and under-estimated. The Budget gave a major concession on stock relief (costing some £450 million in a full year) and help worth £120 million to help keep down industrial gas and electricity prices.

11. Reduce National Insurance Surcharge?

[Chancellor remineded CBI on 1 November of key importance of wages in costs, and told them no prospect of NIS being abolished. Institute of Directors have called for precedence to be given to cuts in income tax over cuts in NIS.]

Fully aware of all representations and of strength of feeling in some quarters in favour of reductions. But important to remember that wages are major element in industrial labour costs. Remains one of possible candidates for reduction if resources available. Scope for any tax measures dependent on what decisions reached on public spending. NIS (like income tax) a major revenue raiser, producing £3.8 billion in current year, and very costly to reduce.

12. Progress with examining corporation tax structure?

[Promise to re-examine corporation tax structure in 1980 Budget Speech]

It is hoped to produce the Green Paper on corporation tax this winter.

13. What about 'inflation tax' suggested by Roy Jenkins at SDP Conference and Professor Layard in recent Guardian article?

Such a tax would essentially be a form of income policy with all the well known defects of such. (See J11). In addition collecting such a tax would mean considerable extra work for the Inland Revenue in monitoring pay settlements and identifying firms which would be liable. It would go against our policy of simplifying the tax system.

14. North Sea fiscal regime?

See R3.

E PUBLIC EXPENDITURE AND FINANCE

1. Government has failed to cut public expenditure?

The recession has created pressure to increase spending. We took this into account in our plans. Remains our policy to contain public spending.

2. Will Government make further cuts in public spending?

We are now looking at our plans and at proposals for spending over the next three years. Our decisions on public expenditure will be announced in due course.

3. Cuts of £5 billion proposed?

[Treasury Ministers proposed at Cabinet on 20 October totals for 1982-83 which were in fact somewhat higher than had been planned in the last White Paper].

Talk of cuts in the total of public expenditure is misconceived. We have already agreed some increases in earlier plans - notably the £$\frac{3}{4}$ billion employment package announced last July - and we are discussing other proposals for increases. Government is having to decide how far to accept these and how far to offset by cuts in other expenditure.

4. How much higher than planned?/Large increases in plans likely?

[The media quote a figure of £5 billion as a possible increase over planned spending and Chief Secretary said on BBC radio 21 October; "What is proposed is a figure for public spending which is higher than that which is, at present, allowed for; and the question is, how much higher one should go"].

Cannot say at this stage. That is what we are discussing. Every survey of public expenditure involves looking at proposals for new or additional spending as well as at proposals for reductions and ways of offsetting increases. This is what we are doing now and involves taking into account changing circumstances and examining the implications of planned spending for fiscal and monetary policy.

5. Increase capital spending?

If not offset by cuts in current spending, this would mean more inflation and would be paid for by the private sector by more taxation, higher interest rates or both. The need is to contain overall spending.

6. Cut current not capital/Cut current to allow more capital spending?

The Government's objective is, wherever practicable, to give priority to worthwhile capital projects providing this involves no overall increase in public expenditure. Must not oversimplify distinction between current and capital spending. Capital expenditure frequently necessitates additional current expenditure which it is difficult to accommodate at a time when our main objective is to reduce the overall level of public expenditure.

7. 4 per cent a pay norm?

[The overall cash provision for the pay element of public expenditure was arrived at using a factor of 4 per cent for the movement from 1981-82 levels to 1982-83 levels]

Not a pay norm. Represents the overall increase in the pay bill for which provision is being made. A limit on the overall size of the pay bill, not on settlements - some may be less and some may be more.

8. 9 per cent a forecast of inflation?

[A factor of 9 per cent for the movement in public sector prices between 1981-82 and 1982-83 has been used in arriving at the cash provision for non-pay items for 1982-83 and later years]

Not a forecast of inflation. This is the allowance we have made for the overall increase in public sector prices over the coming year.

9. Public spending overwhelmingly on administration?

[90 per cent figure quoted by some critics]

Not all current expenditure is on administration. One-third is current payments such as money paid out to old age pensioners, and the unemployed, child benefit and so on. One-fifth is for purchase of goods and services, for example for defence. One-tenth is grants such as overseas aid and subsidies. Only a third of current expenditure is on wages and salaries, and much of that is for nurses, teachers, policemen, soldiers and so on. We made it clear in the White Paper, Efficiency in the Civil Service, (published last July) that the Government is seeking ways of improving efficiency and cost consciousness in the Civil Service.

10. Cut staff numbers in public services?

Numbers in public service have already fallen since we took office. Civil Service has been reduced by over 7 per cent to 679,800. This is the smallest for over 14 years and we are well on target to achieve our aim of having by end of this Parliament the smallest Civil Service since the war. Local authority manpower has been reduced by nearly 70,000 (over 3 per cent).

11. Moves to cash planning announced in Budget mean that Plowden system is being abandoned?

Government does recognise case for medium term planning. But it must be planning in relation to the availability of finance as well as in relation to prospective resources. Illusion to suppose there can be unconditional commitment to forward plans for services.

12. Ratio of public spending to GDP is getting back to the peak levels of the mid 1970's?

The ratios in 1980-81 (44½ per cent) and 1981-82 (45 per cent forecast) remain below the level of 1974-75 and 1975-76 (46½ per cent in both years). The large rise from 41½ per cent in 1979-80 is partly because of the "relative price effect" and partly because the volume of expenditure rose at a time when real GDP has fallen.

LOCAL GOVERNMENT

13. England: Measures to combat overspending

Although most local authorities in England are planning expenditure in line with the Government's targets, a few have increased their budgets. As a result, the overall total for current expenditure remains about 5½ per cent (Nov '80 prices) above the Government's plans. In view of this my rhF the Environment Secretary will be obliged to seek Parliamentary approval to reduce the total of rate support grant. Individual authorities which meet their target or spend less than their Grant Related Expenditure assessment will not lose grant.

14. Scotland: Measures to combat overspending

Scottish local authorities' original targets were 8.8 per cent (Nov '80 prices) above the Government's plans. In the light of this my rhF the Secretary of State for Scotland has withheld £31 million from three authorities which he considered were planning excessive and unreasonable expenditure. These authorities have now reduced their budgets. In view of the general high level of spending my rhF also intends to withhold a further £35 million from all authorities.

15. Rates: Powers to control

Local Government Finance Bill had First Reading 6 November. It includes provisions to make authorities planning excessive expenditure more accountable by obliging them to seek approval from their electors in a referendum.
[Note: It is assumed the PM's Office will be in touch with Department of the Environment for latest developments.]

16. Rates: Alternatives

A Green Paper on alternatives to domestic rates will be published very shortly.

F SOCIAL SECURITY

1. Press Reports that the deficit on the National Insurance Fund will force an increase in contributions?

[An announcement on contribution rates would normally be made in late November, but might this year be delayed to early December.]

Certainly there is a predicted deficit on the National Insurance Fund this year and it is likely, unless we take action, that it will be repeated next year. But no decision has yet been taken on the level of contributions for 1982-83. My rhF the Social Services Secretary is likely to make an announcement on this in a few weeks time.

2. Will the Government ensure that the burden on employees/employers will not rise?

Whether or not we increase contribution rates, there is likely to be a cash increase in the amounts paid both by employers and employees because of increases in earnings, and, potentially, from changes to the earnings limits between which contributions are levied. Earnings limits or thresholds normally rise annually in line with prices.

[IF PRESSED: On employers: I am well aware of the need to limit the burden placed on employers. Members will recall that the increase in rates last year was confined to employees. But I cannot anticipate the decision we will be taking.

On employees: In deciding the level of contributions we shall ensure that we place no unjustifiable burden on employees.]

3. National Insurance Contributions are a tax?

National Insurance contributions are not a tax; they are paid into the National Insurance Fund specifically to meet the cost of national insurance benefits.

4. Statutory sick pay plans place new burden on employers?

[Social Security Bill, published on 6 November provides for reform of housing benefits and a statutory sick pay scheme (SSP). Most employers will gain from SSP, but some will lose]

Overall we expect employers to gain from the method of compensation we have adopted. The CBI have recognised this and welcome the proposals.

[IF PRESSED: Employers will be compensated for the statutory sickness payments themselves, but not for the national insurance contributions and surcharge levied on them. Those employers who have no existing occupational schemes will, therefore, lose. This is unfortunate, but it applies to a relatively small proportion of sickness payments; and we believe that the advantages of the scheme outweigh this disadvantage.]

5. Government's forecast of 10 per cent inflation by November 1981 unlikely to be achieved; will it make good shortfall in November social security up-rating?

[Most social security benefits are due to be increased by 9 per cent from 23 November (Child Benefit and Mobility Allowance by slightly more). 9 per cent increase based on Budget-time forecast of movement in prices November 1980 to November 1981 of 10 per cent, less 1 per cent to allow for over-payment in November 1980 increases.]

If we under-shoot this year, we can expect pensioners to catch up at the next uprating.

6. Government planning to cut real value of social security benefits?

[Press report in The Times 15.10.81 of intended cuts in unemployment benefit and deferment of child benefit uprating]

Social Security Benefits, including Child Benefit, will be uprated in November by the amounts announced at Budget time and approved by Parliament. The level of upratings in November 1982 will be announced in due course. All public expenditure programmes are currently under examination; the social security programme cannot be excused from this process.

7. Does Government intend to ensure that social security beneficiaries will have received all benefit to which legally entitled during civil service dispute?

[Frank Field and others have suggested some claimants being denied benefit to which were entitled (primarily Earnings Related Supplement) but which may not have received during dispute].

This is essentially a matter for my rhF Social Services Secretary. But if individuals think they have received less than their entitlement they should get in touch with the local office dealing with their claim.

G PUBLIC SECTOR BORROWING

1. PSBR in 1981-82

[Budget forecast PSBR in 1981-82 was £10.6 billion; PSBR in April - September, published 5 November, was £10 billion]

The Civil Service dispute has greatly affected the PSBR so far this year, but the underlying PSBR looks to be in line with the Budget forecast of £10½ billion.

2. Effect of civil service dispute on CGBR

[CGBR April-October was £9.2 billion]

The shortfall of net revenue outstanding at the end of October from the start of the dispute was around £5½-6 billion. £¾-1 billion of this shortfall affected March; the remainder this financial year. Interest costs on the additional borrowing caused by the dispute are over £½ billion.

3. Will the Government be able to collect all delayed revenue this financial year?

It is not yet clear how soon all the delayed revenue will be collected. Since the dispute ended at the end of July, response has been quite good.

4. Public expenditure likely to overrun this year?

It is too early to say what the outturn for the current year will be.

[IF PRESSED: The local authorities are, admittedly, spending above the Government's plans. We are taking measures to deal with that but these measures cannot be effective this year. Expenditure which is under the Government's direct control is running broadly according to plan in total.]

5. Recession means that PSBR should be higher, not lower?

In my rhF's Budget statement earlier this year he explained that this year's PSBR would be larger on account of the recession. But experience shows that attempts to buy jobs with reflation simply fuel inflation and quickly have to be reversed. Our policies are designed to cut inflation and secure a sustainable improvement in output and employment.

6. PSBR next year will be £3½ billion higher than planned because of expenditure increases?

No. The size and shape of total plans for public spending next year are still being considered, alongside the likely revenue. When these two factors are set alongside each other a decision will be made about the size of the PSBR. No decisions have yet been made.

H MONETARY AND FINANCIAL POLICY

[NOTE: Chancellor appearing before TCSC Monday 16 November to answer questions on monetary policy.]

1. Why has general level of interest rates risen?

[Clearing bank base rates rose by 4 percentage points to 16 per cent in September but have since fallen back 1 per cent.]

Immediate reason was pressure on sterling and rapid pace of bank lending. But important to note that rates overseas had been rising since the spring and while measures we took in the Budget enabled us for some months to keep our rates from being pulled up, we could not fly in face of developments abroad.

2. Why so much emphasis on cutting PSBR if efforts undermined so easily by high overseas rates?

High UK interest rates were partly due to international pressures including exchange rate developments; partly a response to the acceleration in bank lending. If we had not reined back the PSBR, interest rates would be still higher.

3. The death knell for the recovery?

Agree that higher interest rates will increase difficulties of industry. But no purpose served by allowing higher inflation, whether due to falling exchange rate or credit-financed consumer spending.

4. When can we expect interest rates to fall? Effect of declining US rates?

Clearing banks have already slightly reduced base rates. But cannot take for granted that lower interest rates abroad can be fully reflected in lower rates in UK. Nor can we promise a large or sustained reduction in interest rates while rapid growth of bank lending remains a threat to inflation.

5. What will Government do about the Michael Grylls study group report?

This was produced independently for the Conservative Backbench Industry Committee but the Government are looking at its analysis and proposals with interest.

6. Two tier system of interest rates?

Not practicable in highly sophisticated financial market like UK's. Very difficult to prevent money borrowed at lower rate being on-lent at higher. A lower rate for specified borrowers would require extra Government subsidy which would push up borrowing or require cross-subsidisation by the banks. In either case the level of interest rates to other borrowers would be increased.

7. Ceilings on non-priority bank lending?

In UK's complex financial system, ways would be found of by-passing credit controls. Any improvements to money figures would prove to be cosmetic. Would create distortions and inhibit competition between banks.

8. Where is underlying money supply growth in relation to target?

[£M3 increased by 1½-1¾ per cent in banking October, bringing recorded increase in first eight months of target period to 12½ per cent. But position remains seriously distorted by effect of civil service dispute and aftermath.]

Cumulative distortion to £M3 is very large. Extremely difficult to say where we are in relation to target. Remain determined not to fuel inflation by excessive growth of money supply.

9. Will there be an overshoot?

Too early to say.

10. When will the strike distortions be eliminated?

Distortion will continue for some months yet. It will increase again in banking October as Customs & Excise made VAT repayments more rapidly than they recovered outstanding VAT. Customs & Excise have been giving priority to refunding businesses affected by the strike. But from now on recoveries by Government are expected to exceed repayments.

11. Status of MTFS now?

[Press comment about a prospective Government announcement on revised MTFS is pure speculation. Have also been Press suggestions that £M3 target base will be rolled over this November; Prime Minister knows that we have made no commitment to such a rollover]

MTFS remains basic framework of Government's economic policy. But as Chancellor said in Budget speech, also take account of other monetary indicators, prospects for inflation, exchange rate, etc.

J PRICES AND EARNINGS

1. Inflation has increased under this Government?

Considerable progress has been made in bringing down inflation from a peak of 21.9 per cent in May 1980 to 11.7 per cent in October.

2. Inflation back on a rising trend?

[Year-on year rate of inflation rose to 11.7 per cent in October compared with 11.4 per cent in September and lowest recent level of 10.9 per cent in July. Effect of mortgage interest increases estimated at around ½ per cent on RPI in November, some 2/3 per cent in December.]

Progress on inflation has been affected by the fall in the exchange rate, and the rise in the mortgage interest rate will affect the RPI. We expect further progress in reducing inflation, but the timing is of necessity uncertain.

3. Budget time forecast achievable? (10 per cent by Q4 1981; 8 per cent Q2 1982)

[NOTE: Industry Act forecast due this autumn will include revised assessments for RPI and new forecast to Q4 1982.]

Now clear that increase ub retail prices between November 1980 and November 1981 will be more than 10 per cent envisaged at Budget time, though precise figures impossible to predict at this stage. Over-run mainly due to fall in exchange rate, partly to higher mortgage interest rates. Government confident that downward trend in inflation will be resumed.

4. 9 per cent increase in prices in 1982-83?

The 9 per cent price factor for preparing public expenditure plans for next year represents what is considered a realistic provision for the prices to be paid by departments. It is not a precise forecast.

5. Nationalised industry prices

Nationalised industry price rises have been due in substantial part to the ending of the previous Government's policy of artificial and distortionary price restraint. The rate of nationalised industry price rises is now coming more closely into line with the RPI.

6. TPI

The fact that the TPI has been increasing faster than the RPI (3½ per cent faster over the year to October) reflects the measures which have been taken to restrain Government borrowing, which is essential if inflation is to be controlled.

7. A 4 per cent pay policy?

[Government accused of discriminating against civil service - BBC radio interview with FDA Secretary 12 November]

The 4 per cent factor announced on 15 September [for calculations in Public Expenditure Survey] is not a pay norm. It is a broad measure of what the Government thinks reasonable and can be afforded as a general allowance for increases in pay, at the stage of fixing the programme from which the public service wage bill has to be met.

8. Public sector ignoring 4 per cent policy?

[NUM have rejected revised offer worth 7.3 per cent on earnings; firemen now settled at 10.1 per cent; water manuals offered 6.7 per cent]

Pay negotiations in local government and the nationalised industries are a matter for the parties concerned, as are the financial consequences of any settlements reached. There is no pay norm. What we need are settlements which are consistent with maintaining economic recovery and improving employment prospects. [NB Not enough settlements so far in private sector to comment on trend there.]

9. Government aiming to cut living standards?

Government seeking to create conditions for sustained improvements in living standards. This requires creation of more competitive and profitable industrial sector. Means that less of increase in nominal incomes should be absorbed by higher pay. The lower the level of settlements, the greater the headroom for output and employment to expand.

10. Comparison of TPI and earnings index shows that real take-home pay has fallen over the past year

Yes. But follows growth of 17½ per cent in personal living standards in three years 1977-80.

11. Tax-based incomes policy

[As in Mr Jenkin's proposals at SDP conference]

Like any other attempt to rely on incomes policy, a tax-based incomes policy would entail all the familiar problems of setting norms and interfering with market forces. Experience gives no encouragement to the idea that incomes policies can be made to work on a permanent basis. They always succumb to the distortions they create.

12. Index-linked pensions and the Scott Report

[Sunday Express 15 November gave examples of large impending increases for some recipients when pensions uprated next week; Sir William Clark asking for debate soon on Report (Hansard 12 November col 669).]

We hope to reach initial conclusions on the issues in next few months. General objective is to ensure that public service pensions should be fair, fairly paid for, and seen to be so. This principle will determine future decisions.

K BALANCE OF PAYMENTS

1. September trade figures disappointing?

[September trade figures were published 20 October. Because of Civil Service dispute, last published trade figures were for February].

The figures are encouraging if extremely hard to interpret - coming after long gap. But exports (volume) have increased significantly, when most commentators expected them to have declined. And imports (volume) rising to around the level of 18 months ago is not inconsistent with our assessment that there are signs of recovery in industrial output.

2. Main features of figures for balance of payments in Q2 1981?

The net identified outflow on capital account was about £1.9 billion in Q2 compared with over £3 billion in Q1. The surplus on invisibles was £0.9 billion in Q2.

3. Overseas flows a drain on the economy?

Outflows on the capital account are the necessary counterparts to our recent healthy current account surpluses. Overseas investment will provide a valuable source of income from abroad in future. There is no evidence that outflows deprive UK firms of investment.

4. Will Government reintroduce exchange controls?

[Analysis of effect of abolition is contained in October issue of Economic Progress Report]

No. Exchange controls were an unnecessary administrative burden on the economy. We have no intention of reintroducing them.

L FOREIGN EXCHANGE, RESERVES AND IMF

1. Sterling still too high?

[Since July sterling has remained broadly stable against the dollar but has depreciated against the Deutschemark due to a slacker oil market and improved German current account. Recent "lows" have been $1.77 on 14 September, DM4.07 on 20 October. Rates at noon on 13 November were $1.9040; DM4.21 and an effective rate of 90.09. Reserves at end October stood at $23.2 billion, compared with $23.7 billion at end September]

Our policy is to allow the rate to be determined primarily by the balance of market forces. The effective exchange rate is now around the same level as when the Government took office. Manipulating the rate is no answer to problems in the real economy.

2. Has the Bank intervened to support the rate?

The Bank intervene to smooth excessive fluctuations and preserve orderly markets. They do not seek to maintain any particular rate.

3. Sterling should join the EMS?

[See M13]

4. Exchange rate and competitiveness?

I welcome the improvement in UK cost competitiveness of perhaps 10 per cent so far this year. This is partly due to a decline in the exchange rate; more importantly because there are signs that our domestic unit labour costs are now growing more slowly than those of our major competitors.

5. Debt repayments

We have made substantial progress with our plans to reduce the burden of external debt substantially during this Parliament. We have now pre-paid the $2.5 billion Eurodollar loan and are continuing with other scheduled repayments. By end of 1981, total official external debt will be reduced to around $14 billion, compared with over $22 billion when the Government took office.

M EUROPEAN MATTERS

MEMBERSHIP OF EUROPEAN COMMUNITY

1. Cost to UK of membership too high?

Costs and benefits of UK membership of the Community must be viewed as a whole. We realise the need for reform of the Community financing as well as my hon Friend/the hon Member. We have already achieved a major reduction in our net contribution through the agreement reached on 30 May 1980. We shall continue to press for reform of the common agricultural policy (CAP) and restructuring of the Community Budget.

2. Net contribution too high?

A lot lower than it would have been without the agreement of 30 May last year. Important to build on that as soon as possible.

3. Lower Commission estimates of net contributions in respect of 1980 and 1981?

We shall need to examine the new Commission estimates with care. If it is true that our adjusted net contribution in respect of 1980 and 1981 will turn out to be lower than expected, that is very satisfactory, because the 30 May Agreement left us paying a large net contribution even though we are one of the poorer Member States. The problem of 1982 and later years remains to be solved.

4. Budget refunds reduced if net contribution less than originally estimated?

Have seen press reports that other member states take the view that our refunds should be reduced in those circumstances. The UK, however, is clear that the minimum net refunds payable under the 30 May agreement are 1175 million ecus (European Currency Units) for 1980 and 1410 million ecus for 1981.

5. Does recent vote of European Parliament's Budgets Committee to freeze part of 1982 budget provision for UK refunds mean UK will not receive its full entitlement to budget refunds?

No. The draft amendment supported by the Budgets Committee was not supported by the Parliament when it voted in plenary session on 5 November.

6. What are the payment arrangements for supplementary measures?

Community payments are made to Government Departments with policy responsibility for the investment programmes concerned.

7. Do supplementary measures grants lead to additionality?

There is additionality in important sense that refunds are making possible a higher level of public expenditure in the regions and elsewhere than would otherwise have been possible. Both the participating authorities and other spending authorities are gaining the advantage of a higher level of expenditure than country could otherwise have afforded. Scheme does not, however, open way to increases in expenditure by participating authorities beyond levels already planned. In that sense there is no additionality.

8. Do participating regions and programmes benefit?

Yes - in important sense explained in answer to previous question.

9. How can refunds both enable a higher level of public expenditure and reduce PSBR? (Compare answer on 3.6.80 Hansard col 1241)

There is no inconsistency here. The refunds are reducing PSBR. Without them, further cuts in domestic expenditure programmes would have been needed to reduce PSBR.

10. Policy for CAP reform

Greater attention must be paid to the needs of the market, and action taken to curb surplus production and contain the growth of guarantee expenditure. Will continue to press for price restraint and other measures appropriate to surplus sectors.

11. Costs of CAP to UK consumers

My rhF, the Minister of Agriculture, has dealt with a number of questions on this. Costs to consumers of the CAP as such depend on nature of alternative support system that is envisaged. Arrangements leading to a reduction in the cost of food to the consumer could well involve increased costs to taxpayers.

12. What if we hit the 1 per cent VAT ceiling before 1982?

Our position is that there will not be an increase in the 1 per cent VAT ceiling, and discussions on the restructuring of the budget and other matters are within that firm context.

EUROPEAN MONETARY SYSTEM

[Press reports "teach-in" at No 10 deferred]

13. What is the current attitude of the UK Government?

We fully support the EMS, and acknowledge the contribution which it has made to stability in the exchange markets. However, we do not yet feel able to join the exchange rate mechanism. We must wait until conditions are right for the system and for ourselves.

N . INDUSTRY

1. Recent increases in interest rates - damaging for industry and investment?

(Each 1 per cent in interest rates raises interest payments on industry's borrowing by around £250 million.)

Government believes best way it can help industry and promote investment is to create a climate in which business can flourish. Essential to get rate of inflation down so as to create a stable environment for business decision-taking. Recent rise in interest rates must be seen in context of priority attached to reducing inflation and need to control growth in money supply underlying the MTFS. (See brief H).

2. Prospects for industry - recovery?

Encouraging evidence that fall in output has now come to an end. Too early to talk about recovery: but index of manufacturing output rose by nearly 2 per cent in the 3 months July-August over the previous three months with chemicals, metal manufacturing and engineering performing particularly well. [NB Industrial production figures for September due out Tuesday 10 November].

3. Company sector finances improved?

[Gross Trading Profits of industrial and commercial companies (ICCs) other than North Sea activities net of stock appreciation were around £3¾ billion in Q2 1981 for third successive quarter. Borrowing requirement of ICCs has improved over last year, and financial deficit turned into surplus. Company liquidity has also improved markedly this year; company sector's liquidity position better in second quarter this year than at any time since third quarter of 1979].

Figures mildly encouraging (but not wildly so). Company financial position is in any case confused by effects of civil service dispute. After adjustment for stock appreciation and excluding North Sea, ICC profits have stabilised since mid-1980. Improvement in financial position partly reflects destocking and action to reduce overmanning.

4. NEDC meeting 11 November - TUC attack on government's plan to privatize BNOC

My rt hon Friend the Secretary of State for Energy gave the NEDC a full justification of the Government's proposals for BNOC along the lines outlined in his speech to the House on Tuesday 10 November.

5. NEDC task force shows that industrial energy prices in the UK are still out of line with the continent

The report of the NEDO task force shows that the gap between energy prices in the UK and on the continent has been narrowed, and, in the case of gas and foundry coke, been eliminated altogether. This partly reflects the measures announced by the Government and implemented by the fuel industry the last report of the NEDO task force.

SMALL FIRMS

6. Government help for small firms

Government has taken major steps to encourage enterprise in the important small firms sector: in particular the Business Start-Up Scheme, the pilot Loan Guarantee Scheme, the Venture Capital Scheme, and reduction in the burden of small firms' corporation tax.

7. Response to Loan Guarantee Scheme?

Scheme has got off to very good start. We have already issued close on 1200 guarantees - well over half to new businesses. Total lending under scheme is already over £41 million. Substantial demand for loans has led the Government to double this year's lending limit under the scheme (to £100 million). (Overall commitment over three years stays unchanged for the present.)

ENTERPRISE ZONES

7. Progress with setting up Enterprise Zones?

Excellent progress being made. Ten of the eleven zones are already in operation. We expect the final zone - Isle of Dogs - to come into operation early next year.

8. Response from private sector?

Initial response has been very encouraging. Many new firms are setting up in the zones, existing firms are expanding their activities and vacant land has been brought into use. Too early to assess success of zones.

P NATIONALISED INDUSTRIES

1. Government policy on nationalised industries

To reduce State ownership and improve efficiency of publicly owned enterprises. Market forces are to be brought to bear, and private capital is being introduced - where appropriate. Competition Act has been used to refer selected nationalised industry operations to the Monopolies and Mergers Commission.

INVESTMENT

2. Government just not allowing for enough nationalised industry investment?

No. The latest Public Expenditure White Paper shows nationalised industry planned investment rising from £4.5 billion in 1980-81 to £5.2 billion in each of the next three years (at 1980 Survey Prices) or a 15 per cent increase in real terms. The quantity of investment frustrated by tight EFL's is less than implied. TSSC report published last August estimated in range of £250-500 million this year.

3. Increased NI investment would boost private industry and add to productive potential?

Depends on whether or not extra investment is accommodated within existing public sector totals. If it were allowed to add to borrowing requirement, it would tend to raise interest rates and discourage other expenditure, including some private sector investment. Except in short term, net effect on private sector might not be beneficial and effect on future growth of productive potential is uncertain. Report from all-party TCSC accepted that there could be such financial "crowding-out".

4. Take nationalised industry investment out of the PSBR?

Since nationalised industries are part of the public sector, their borrowing - for whatever purpose - must by definition form part of the public sector borrowing requirement. The real problem of pressure on resources cannot be solved by changing statistical definitions.

5. New forms of finance for NI investment?

(The NEDC Working Party's study of nationalised industry investment was discussed at the Council's 5 October meeting, which noted the report; survey of the main options and of the circumstances in which direct market finance might be justified. It was agreed that there should be a review of progress to be completed by June 1982]

We have indicated our willingness to consider new financing proposals, most recently in the context of the review carried out by the NEDC Working Party. But direct market finance can only be justified if there is a genuine element of performance-related risk for the investor, in order to improve incentives to management efficiency, and if new forms of saving are tapped, so as to avoid adverse monetary consequences. Market financing does not of itself reduce the PSBR, nor does it lessen the burden on financial markets.

6. Status of proposed British Telecom bond? If agreed, will this bond be outside PSBR and relevant EFL?

No. This is borrowing by a public sector body, thus public sector borrowing. And the Government, with its overall responsibility for BT's finance must continue to place limits on its external finance. But the EFL might be somewhat larger on account of the bond than it otherwise would be.

7. What problems have delayed the expected announcement? Does proposal meet criteria set out in the NEDC Working Party Report?

[Two criteria:- extra cost must be justified by pressure for greater efficiency; terms of investment won't involve unfair competition with private sector].

An intensive effort has been made to conclude this question, in the context of the public expenditure exercise and the decision on BT's EFL for 1982-83. Certain problems remain to be resolved before a decision can be taken.

[IF PRESSED: They are:-

(a) Cost to BT of the borrowing - will be greater than gilts, but the Government and BT must be sure that this will be justified by the contribution the bond makes to pressures for improved efficiency and profit.

(b) BT's pricing policy - some arrangement is needed to assure investors that BT's profits would not be constrained by the Government's holding prices down. But Government must protect consumers as well as investors. This is an industry where prices ought to fall in real terms, because of technological advance, ie to rise by less than the RPI. We have not so far been able to agree on a formula to deal with this]

8. Finance more nationalised industry investment by cutting current spending?

Yes. In particular, moderate pay settlements are essential. The ability to finance new investment in the nationalised industries is bound to diminish if excessive pay settlements are agreed.

9. But you cannot finance much investment by cutting current costs alone?

Not true. Each 1 per cent off wage costs would save about £125 million per annum; and each 1 per cent off total costs saves £300 million.

NATIONALISED INDUSTRY PAY

10. Pay assumption for next year's external financing limits?

The Government has made clear the need for significantly lower pay settlements across the economy. It is in the industries' own interests to secure their future by leaving enough room for investment. The Government has not set any norms for the industries, but it is bound to take a close interest in settlements in reaching its decisions on investment and finance.

NATIONALISED INDUSTRY PRICES

11. Nationalised industries' prices have risen more rapidly than RPI?

True over last year or so, while artificial and distortionary prise restraints introduced by the Labour Government were working through the system. Unwelcome but inevitable: the only alternative is an increased burden on the taxpayer and a distortion of market forces.

12. What is happening now?

Nationalised industry price increases are falling [14 per cent above RPI in year to January, 3 per cent above in year to October]. Fully expect them to come closer to RPI in next few months.

13. And the future?

Better price performance depends on improvements in efficiency and control of current costs, particularly pay. We are determined to see those improvements brought about. Privatisation and increasing competition have an especially important role here.

PRIVATISATION

[Announcements in week ending 24 October referred to Cable and Wireless, National Freight Corporation Ltd, BNOC's oil-producing business and BGC's monopoly of purchase of oil and its sale to industry; BR Hovercraft.]

14. The Government simply selling valuable national assets to achieve PSBR target?

Of course, the cash is welcome, but the benefits run wider than that. Not only will the main financial benefit be that future borrowing of these undertakings will be outside the PSBR and no longer burden the taxpayer, but the organisations concerned will be made responsive to market forces and thus have greater incentives to improve efficiency.

15. TUC attack on proposals for BNOC

(see N4)

16. Why is disposal of BGC's gas showrooms to be delayed?

HMG has made it clear that safety standards must be fully maintained - this will require complex legislation, for which there is unlikely to be time during this Session.

17. Does the Government have more privatisation plans to announce?

Legislation already passed to enable public to hold equity stake in British Airways, British Transport Dock Board, subsidiaries of British Rail; and to dispose of some of British Telecom's peripheral activities. We shall be announcing further measures in due course.

18. Will these include British Leyland?

The 1982-83 Corporate Plan for BL being submitted shortly will doubtless refer to the prospects for disposals.

R NORTH SEA AND UK ECONOMY

1. Benefits of North Sea should be used to strengthen the economy?

[Direct contribution of North Sea oil and gas to GNP is estimated to rise from 3 per cent in 1980 to about 5 per cent in 1984; expected contribution to Government revenues estimated at £3¾ billion in 1980-81 and £6 billion in 1981-82 (at current prices). Less susceptible of measurement is boost given by North Sea to local employment and to industry in offshore equipment].

Yes. Government's strategy derives greatest possible long-term benefit from North Sea. Revenues ease task of controlling public borrowing. This will help to achieve a lower level of interest rates to the benefit of industry and the economy as a whole. Without North Sea revenue other taxes would be higher or public expenditure lower. But keep revenues in perspective. Only one-twentieth of total general government receipts in 1981-82.

2. North Sea oil price rises following OPEC price reunification?

Price of North Sea oil is a matter of commercial negotiation between BNOC and the oil companies.

3. Will HMG change North Sea fiscal regime in line with oil industry's proposals?

[Memoranda lodged with Treasury and D/Energy 22 October].

I commend UKOOA (UK Offshore Operations Association) and BRINDEX for the hard work which they have put in. Obviously full study of their proposals is required. We shall look at their suggestions with an open mind, in close liaison with UKOOA and BRINDEX.

4. North Sea oil depletion policy?

Secretary of State for Energy announced in June that the Government would review in the Autumn the possibility of oil production cuts in 1982. We shall give the industry proper notice of our intentions.

5. Gas gathering pipeline - why did HMG not proceed?

The project has always been envisaged as a private sector utility. The vast bulk of economically recoverable gas will be brought ashore and this can and should be left to private enterprise as in the past. Note that oil companies are already planning a series of North Sea gas pipelines.

6. Government revenues from the North Sea should be used to finance cheap energy for industry?

It would be inequitable and inefficient to use the benefits of North Sea oil to subsidise some users. The age of cheap energy is past. Energy prices should recognise the cost of marginal supply and reflect the competitive position of industrial fuels. Only then can consumers receive reliable signals on which to base their energy consumption and investment decisions.

7. North Sea revenues should be channelled into a special fund to finance new investment, particularly in energy?

North Sea revenues are already committed. Setting up a special fund would make no difference. More money would not magically become available. So the money for this special fund would have to come from somewhere else - lower public expenditure, higher taxes or higher public borrowing.

8. North Sea oil bond?

We expect to issue the North Sea oil bond, an entirely new kind of National Savings certificate, in January.

S WORLD ECONOMIC DEVELOPMENTS AND INTERNATIONAL FINANCE

1. Governments' policies pushing world economy into recession?

[Combined GNP in major economies flat in Q2. Little information on Q3. But small fall in US GNP for second consecutive quarter. And signs that industrial production stagnating in major seven countries. Average unemployment rate steady but likely to worsen. IMF and OECD forecasts suggest some recovery towards end of this year. Unemployment may level off in H2 1982].

No. Healthy growth only possible if anti-inflation policies persevered with. Some recovery of output expected next year. And unemployment should level off during the year.

2. OECD gloomier about world economic prospects?

[Draft report referred to in Sunday Times 15 November]

Latest OECD forecast is still being prepared. Most major forecasts, including the IMF's, expect modest growth next year. OECD forecasts unlikely to be markedly different.

3. Anti-inflation policies not working?

[Year on year consumer price inflation in major countries around 10 per cent in September. Underlying rates increasing in US and France. OECD and IMF expect some decline next year.]

Takes time to squeeze inflation out of system. Year-on-year consumer price inflation in major economies down from peak of 13 per cent in April 1980 to around 10 per cent in September 1981. Further decline expected next year.

4. Governments' policies have failed or worsened situation?

No. Adjustment to second oil shock better than to first. Investment has performed better, impact on wages better contained and dependence on oil reduced. But these gains must be reinforced by continued firm policies.

5. Countries disagree over direction of policy?

No. Both Ottawa Summit and IMF Interim Committee agreed that a clear priority had to be given to firm policies to reduce inflation. They stressed importance of steady and careful restraint on growth of monetary aggregates and emphasised need, in many countries, for reductions in size of budget deficits.

6. Other countries giving priority to unemployment rather than inflation?

No. All major countries agree that lasting reduction in unemployment can only be achieved when inflation brought down. France, an exception till October, is now acting to curb inflation. This best way to secure lower interest rates, encourage productive investment and achieve better rates of economic growth and employment.

7. Other governments not following such stern policies as UK?

[US, Canada and Germany have announced lower monetary targets for this year compared with last. Most major countries (US, Japan, Germany, Italy, Netherlands, Australia, Sweden) have recently announced measures to cut planned public spending. France has announced the deferral of FF15 billion (£1½ billion) of capital investment.]

Most governments persevering with firm policies to lay foundations of renewed non-inflationary growth. In particular, continuing with their efforts to control monetary growth, offset effects of recession on budget balances, and keep public spending in check.

8. US are pursuing mad policies and care nothing for their impact on rest of world?

US authorities have widespread international support in their battle against inflation. Sound $ is in everyone's best interests. Concern is over monetary/fiscal mix - a problem all countries familiar with.

9. Deeper than expected US recession will kill recovery in other countries?

Some fall of output in the US may be inevitable before inflationary expectations are reduced. In everyone's interests that US inflation should come down. A sustainable recovery will then be possible.

10. Recent comments by US Budget Director have undermined confidence?

[Press reports of Dr Stockman's description of Budget spending cuts as "hastily prepared and enacted" and tax cuts "Trojan horse" favouring the rich, while casting doubt on "Supply side" policies].

I note that Dr Stockman has apologised for his "careless ramblings to a reporter".

11. Recent international interest rate developments?

True that international interest rates have been high over last year, but glad to see some easing of US prime rates - down to 17 per cent from peak of 21½ per cent; also German rates declining.

12. Prospects for international interest rates?

Always difficult to forecast interest rates with certainty, but firm policies should over a period bring lasting reduction in both inflation and interest rates.

AIDE MEMOIRE ON THE UK ECONOMY 16 November 1981

PRESENT SITUATION

Most recent major outside forecasts (NIESR, P&D, CBI, LBS, ST JAMES) assess recession's trough was reached in H1 1981, with some recovery in year to H2 1982 (in range ½-2¼ per cent). Item are more pessimistic , seeing output fall a further 2 per cent in 1982, recovery thereafter. Unemployment forecast to increase but only Item (3¼ million 2H 1982) see it reaching 3 million (narrow definition) by end 1982. Most forecasters see year-on-year inflation in range 10½-11 per cent for Q4 1981, falling to 9-10½ per cent in Q4 1982. Item and St James are more pessimistic; forecasting range of 13-15 per cent. Item see a sharp drop, well into single figures in 1983.

GDP output estimate fell ½ per cent in Q2 1981 following a similar fall in Q1 and an average quarterly fall of 1½ per cent throughout 1980. In the 3 months to July manufacturing output increased by 2 per cent over the preceding 3 months.

Consumers' expenditure fell by ½ per cent in Q3 1981 returning to the level of Q3 1980. Retail sales fell nearly 1 per cent between Q2 and Q3 1981. Volume of visible exports in September were 6 per cent above the average in January and February. Volume of visible imports were 24 per cent higher on the same comparison. Manufacturing investment (excluding assets leased from the service sector) fell 2½ per cent in Q2 1981. Distributive and service industry investment (including shipping and leasing) rose 4½ per cent in Q2 1981. DI investment intentions survey (conducted in April/May) suggests a fall in manufacturing investment after allowing for leasing of 11 to 14 per cent in 1981 with some recovery in 1982; distributive and service industries investment (including shipping) expected to rise by less than 5 per cent in both 1981 and 1982. Manufacturers', wholesalers' and retail stocks dropped by £0.5 bn (at 1975 prices) in Q2 1981 compared with destocking of £0.4 bn in Q1 and £1.9 bn in 1980 as a whole.

Unemployment (UK, seasonally adjusted excl. school-leavers) was 2,728,900 (11.3 per cent) at October count, up 56,000 on September. Vacancies rose slightly to 98,600 in October.

Wholesale input prices (fuel and materials) were unchanged in October but stand 18 per cent higher than a year earlier; wholesale output prices rose 1 per cent and are 11 per cent above a year ago. Year-on-year RPI increase was 11.7 per cent in October. Year-on-year increase in average earnings was 12.8 per cent in August. RPDI fell by 2½ per cent in Q2 1981 after a 1½ per cent fall in the previous quarter and a 17.5 per cent rise over the 3 years 1977 to 1980. The savings ratio fell 2 per cent to 12½ per cent in Q2 1981.

PSBR £9.5 bn in the first half of 1981/82 and CGBR in April to October - £9.2 bn; but both distorted upwards by the civil service dispute. Underlying PSBR believed in line with Budget forecast (£10½ bn).

Sterling M3 increased by 1½ -1¾ per cent in banking October but distorted by the consequences of the civil service dispute.

Visible trade showed a surplus of £13 million in September compared with an average monthly surplus of £368 million over the period July 1980 to February 1981. Invisibles surplus in first three quarters of 1981 estimated at £2.1 billion. Reserves at end-October $23.3 bn. At the close of 13 November the Sterling Exchange rate was $1.9125 and the effective rate was 90.7.

cc Mr Wolfson
Mr Howe

Grant Pd

Mr Cardona's article reported in the FT 16/11/81

WILL THE GOVERNMENT REFLATE?

This note is an attempt to analyse the pressures on the Government for and against reflating before the next election. Reflation is here used to mean taking measures that would allow monetary growth in excess of ranges in the Medium Term Financial Strategy (MTFS). It is defined in this way because one could argue that the Government's stance is already reflationary: there is a sizeable public sector deficit, and monetary growth is at present higher than both the recent and prospective rate of inflation. However, these are problems about defining monetary growth (something familiar to observers of the British economy) and there has never been a period during the life of the MTFS when the readings given by the monetary figures could have been said to be really clear.

The most fundamental reason for supposing that there will not be any reflation is both moral and economic. The Government, in the sense of the majority of the Cabinet, quite simply believe in the Government's economic strategy and they want to do what they think is right. They believe that past experience of managing the British economy shows that reflation would have a small short-term impact on employment but would, in the slightly longer run, lead to higher inflation, a lower level of sterling (if not a collapse) and a worsening of the structural problems that have afflicted the British economy for so many years.

Of course there is always room for argument about exactly how many members of the Cabinet—apart from the economic ministers—are fully committed to the strategy. It is only natural that there should always be people with anxieties, and there are also people so busy managing their own departments that they never really have time to immerse themselves in economic issues. But one must take people at face value. Every member of the Cabinet must be considered a supporter of the strategy unless he resigns. No Cabinet minister has shown any sign of resignation, and there is no reason to suppose that any will. Whenever there have been Cabinet discussions of macro-economic policy, the Government's strategy has been endorsed.

This does not mean that there are no internal arguments. There are an infinite number of ways to juggle the equation of public expenditure proposals, tax proposals and interest rates to try to arrive at the monetary growth provided for in the MTFS. But the fact that there are always internal arguments for the press to seize on does not mean that the Cabinet is not determined to press on with the overall strategy.

The most important argument urged by those in the Party who want reflation, and by those outside who think the Government will reflate, is the apparently obvious one that the Government should reflate in order to win the election. This argument is accepted quite uncritically by a large number of people, yet it is demonstrably weak, and the members of the Cabinet perceive it to be weak.

First of all there are the lessons of recent history. The Heath Government reflated as the election approached, though probably not so much for electoral reasons as out of very genuine concern about the level of unemployment. Yet that Government lost the next election. (Admittedly the February 1974 election was held in rather special circumstances. But there are always going to be unpredictable special factors in any election; certainly the lesson seems to be that reflation does not help). The Callaghan Government reflated before the 1979 election, and lost by a massive margin.

A more subtle electoral calculation that could be made by the present Government is this. Reflation now could well be followed by either a sterling or funding crisis of some severity. The interest rates that would have to be used to defend sterling or to fund in such a crisis would make interest rates of 16-17 per cent (at the time of writing) look positively pleasant. Such extra high interest rates would result in more bankruptcies and a further check to growth and employment; and the crises here presupposed would make the Government look incompetent and less likely to be re-elected.

Even if, making a more optimistic assumption, reflation were not followed by a funding or sterling crisis, the impact on unemployment by the time of the election would be minimal. One well known simulation was that published by David Blake in the Times during the summer. He argued that an extra £4 billion in public borrowing might reduce unemployment by about 100,000. (There have been other simulations published, but David Blake's is probably the clearest and best known).

A reduction in unemployment of some 100,000 could have no significant impact on the election. It would probably mean unemployment of, say, 2.8 million instead of 2.9 million; or 2.7 million instead of 2.8 million. To suppose that a grateful public would re-elect a Conservative Government in such circumstances is naive nonsense. The public will, quite rightly, regard any level of unemployment above 2½ million as very high indeed. They will not stop to wonder, before casting their vote, whether unemployment might have been slightly higher had there been a smaller PSBR two years before the election.

There is, therefore, no question but that the Conservative Government will have to face the next election with a high level of unemployment and playing around with the figures and assumptions would not alter this conclusion. Even a reduction in unemployment of 250,000 would not bring the total below 2½ million (always assuming there was not a crisis after any attempt to bring unemployment down by such a margin).

There is no choice for the Government but to fight the next election with high unemployment. But there is a choice about inflation. If the Government sticks ot its strategy it can realistically hope for a very healthy—and falling—inflation rate of, say, 5-6 per cent, by the election. If things went very well indeed—such as some unpredictable political event in the USA pushing really large capital flows into sterling—then the Government could actually achieve an outturn of 3-4 per cent inflation. If things went less well, the outturn could be 7-8 per cent. That is still quite creditable. But if the Government were to reflate, then it would be more likely to fight the election with inflation at, say, 12-16 per cent and rising. That would impress nobody. It would also be very unstable; it could easily accelerate upwards. It would be very likely to do so if the reflation were part of a deal with the trade unions under the terms of which they restrained pay demands—for by 1984, after a few years of restraint, their members would be determined to press for higher pay awards.

The choice before the Government is therefore to fight an election with higher unemployment and low inflation, or with higher unemployment and high inflation. The former is obviously better. So the Government has every electoral interest in sticking to its strategy.

Nevertheless, the question may still be asked: what if enough members of the Conservative Party do not see the political arguments this way, and they try to force a change of course on the Government?

Again one must look at the recent past. At the time of writing, the "Wets" have not organised themselves into a coherent group either for lobbying or voting. They are certainly not a Party within the Party; they are not even a tendency. (It is no criticism of them to say they are not an organised group: it has not been their intention to organise). They have not voted against the Government as a group, partly because there has not been an issue on which they felt strongly enough to vote against their own Government and partly because there are not many of them. Any political journalist would be hard put to name twenty "Wets".

There is certainly a small group of highly intelligent and articulate "Wet" members of Parliament who have a good deal of influence on the Press.

But they are greatly outnumbered by the many back-benchers who are convinced the Government's broad strategy is correct. It is highly significant that the only important Parliamentary revolt which the Treasury has faced during this Government was over the price of petrol and not over the Government's strategy. The rebels in that case were mainly the solid supporters in the rural shires, voting in a constituency interest.

Although the number of committed "Wets" is small, one cannot overlook the possibility that just enough members might be found to vote against a Budget that contained dramatic increases in taxation. But this is not how the Conservative Party—or indeed any other political party—works. The Budget is indeed secret until the moment it is announced, and it is true that even the Cabinet do not see the Budget until it is almost ready to be announced; but the Budget is not prepared in a political vacuum. Members of Parliament who are worried will have delicately given notice of their positions through the Whip's office, which is probably one of the most effective intelligence networks anywhere in the world. When the Budget is finally put together it naturally takes account, as far as possible, of the known predilections of members on the Government's side (and of course of political pressures generally). This system is not infallible. It broke down when the decision was taken to raise the retail price of petrol by 20 pence in the 1981 Budget, largely because public protest was expected to concentrate on the failure to improve personal allowances. But by and large the system works to safeguard Government from introducing legislation which cannot be passed. Forewarned is forearmed: the Government should know enough soon enough about the disposition of Parliamentary forces to find ways of meeting the MTFS targets.

There are other political pressures on the Government which have not been discussed so far. One is the emergence of the Social Democratic Party. It is sometimes said that the Conservative Party will have to trim to the left if it is not to lose votes, or MPs, to the SDP. But the reality is by no means so obvious or clear-cut. What is interesting about the evidence available on the motives of voters who threaten to switch from the Government to SDP is that they criticise the Government from the Right as often as from the Left. Thus they criticise the Government's generosity towards nationalised industries and they urge a tougher policy on trade unions; but on the doorsteps they do not usually call for a bigger PSBR or loose monetary policy—though admittedly some do call for lower interest rates.

Another political factor that has been dragged into the debate about whether the Government should reflate is last summer's rioting. The assumption is that high unemployment causes social stress, such as the inner city riots. It is a doubtful assumption: unemployment is probably only one factor out of many (and moreover high inflation also produces social strains). But even if it were true that inner city riots were caused only by unemployment, to reflate the entire economy would be a senseless way to deal with the problem of four or five parts of the country. The sensible policy is that which the Government has already followed: to direct attention and funds at the areas affected.

CONCLUSION

The main burden of the argument of this note is that the Government will stick to its overall economic strategy, not out of stubbonness or a temperamental inability to change, but because to persevere with the strategy is in the interests both of the country and of the Conservative Party. To reflate now would lose the Government the next election.

There could, of course be unintended reflation if borrowing by local authorities and nationalised industries overshoots such provision as may have been made for it. And there may be some cosmetic changes designed to lessen the burden of criticism—for example, some further help to industry on energy prices is possible, but it would be cosmetic for PSBR purposes because it would be paid for out of the contingency reserve. There will, however, be no *policy* of reflation.

FINANCIAL TIMES
16 NOVEMBER 1981

Government 'resigned to high total of jobless'

By David Marsh

THE GOVERMNENT is resigned to fighting the next election with unemployment high, probably well above 2.5m. It will not reflate the economy before then because of the fear of further worsening its re-election chances by adding to inflation, according to Mr George Cardona, who has just left his job as one of the Treasury's political advisers.

In an article to be published in the Economic and Monetary Review of London stockbrokers Laing and Cruickshank next month, Mr Cardona—a keen devotee of present government policies of "sticking firm"—says reflation would have only a minimal impact on unemployment by the next election.

It would however push up both inflation and interest rates. If the Government stuck to its present strategy, it could realistically hope for a "healthy" inflation rate of around 6 to 7 per cent by the next election.

Mr Cardona, who was attached to the office of Mr Nigel Lawson, former Financial Secretary, departed from the Treasury in September when Mr Lawson became Energy Secretary.

He says in the article that unintended inflation could take place if borrowing by local authorities and nationalised industries overshoots.

Reflation through extra public borrowing might mean, by the next election, unemployment of 2.8m instead of 2.9m or 2.7m instead of 2.8m. "To suppose a grateful public would re-elect a Conservative Government in such circumstances is naive nonsense."

Moves to expand the economy could trigger a sterling or funding crisis. Higher interest rates would arise that would make recent levels of 16 to 17 per cent look "positively pleasant."

File BK

1/12

cc: Alan Walters
Andrew Duguid
T. Burns, HMT

Prof. MINFORD

13 November 1981

Following our telephone conversation this morning I am writing to confirm that the Prime Minister looks forward to a general discussion at 11 am on Wednesday, 2 December. I would expect the meeting to last around half an hour.

With best wishes,

MICHAEL SCHOLAR

Professor A.P.L. Minford

File

bc: Alan Walters.

9 November 1981

The Prime Minister was most grateful for your letter of 21 October, together with the latest University of Liverpool Quarterly Economic Bulletin. She has read this with much interest.

Perhaps when you are next in London you would givw me a ring (01-930-4433) and we will try to find half an hour in the Prime Minister's diary for a discussion. I am sure that in the event it is going to be very difficult.to fit this in: but I know that the Prime Minister would welcome a talk.

M. C. SCHOLAR

Professor A. P. L. Minford.

CONFIDENTIAL

Ind Policy
cc AD 1
AW
JU.

(4)

Prime Minister

Treasury Chambers, Parliament Street, SW1P 3AG MCS 3/11
01-233 3000

3 November 1981

J R Ibbs Esq.
Central Policy Review Staff
Cabinet Office
LONDON
SW1

MT

Dear Robin

THE HEALTH OF INDUSTRY

Thank you for your letter of 16 October.

I have some sympathy with the case you and others are making for a reduction in the National Insurance surcharge next year, as you will have seen from my recent reply to Patrick Jenkin, and as you know from our discussion last Friday.

But as you recognise, and as I have to stress, my room for manoeuvre is very strictly limited by the fiscal prospect generally for next year, and the public expenditure prospect in particular. It may well be, as you suggest, that I shall not be in a position to pledge myself to cut the rate next April when decisions have to be taken next month.

For that reason I was interested to see your idea for keeping the options open. Since the responsibility for collecting NIS along with National Insurance contributions rests with the DHSS it must be for Norman Fowler to consider your suggestion for preparing alternative sets of tables for employers, and I am, therefore, copying our correspondence to him. But I am bound to say that, on my and my officials understanding of the logistics of a change, the need to issue the new tables to employers as early as January so that they can prepare for the new contribution year, coupled with the prior need for legislation, seems to rule it out as a practical possibility.

Nevertheless, you should not conclude that if I have to leave the rate as it is next April, there is no possibility of a lower NIS until April 1983. Arrangements have been explored in the past for making a mid-year change in the rate following

/an announcement

an announcement in the Budget, and though these are not without practical problems and inconvenience for DHSS, I hope Norman Fowler will be able to confirm that we could proceed that way if the need arose.

As well as Norman Fowler, I am sending copies of this letter to the Prime Minister, Patrick Jenkin and Sir Robert Armstrong.

GEOFFREY HOWE

file FB

10 DOWNING STREET

From the Private Secretary

2 November 1981

The Prime Minister was most grateful for your letter of 30 October with the attached work on unit labour costs. This is very useful material to back up arguments which have been used by the Prime Minister and other Ministers in recent weeks about competitiveness.

M. C. SCHOLAR

P. J. Cropper, Esq.

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-233 3000
Direct Dialling 01-233 3672

P J Cropper
Special Adviser

30 October 1981

The Rt Hon
Margaret Thatcher MP
10 Downing Street
LONDON SW1

Dear Mrs Thatcher,

I am sorry there has been a misunderstanding about work on Unit Labour Costs. I am, indeed, working on presentational aspects of this matter with Sir Keith Joseph, but had not so far produced a proper study.

However the matter can be brought together without too much difficulty and I have drawn up for you the attached interim study of the basic facts. The technical excerpt from "Economic Trends" is enclosed, not because you need to read it, but in order to indicate the status of the underlying statistical work.

Yours sincerely

Peter Cropper
P J Cropper

ENCS

UNIT LABOUR COSTS

There are various ways of measuring a country's international trade competitiveness. The share of world trade might be said to be an indicator of competitiveness; when it increases, the nation must have become more competitive by one means or another. However this is a slightly circular argument.

A different approach is to look at costs rather than prices, and within this to concentrate on the largest element, labour costs. This is done in a series of statistics for relative unit labour costs produced by the IMF. Research by the Bank of England and the Treasury has found these series to be a good explanatory variable for changes in exports and manufactures.

The attached tables provide, from 1975, series on unit labour costs for the UK alone and, converted to a standard dollar basis, for five leading industrial countries.

Exchange rates account for a significant part of the variations in UK relative unit labour costs over the past six years. A fall in the index (i.e. a movement towards greater competitiveness) took place in 1976. A peak was reached in the first quarter of 1981.

However the long term trend of UK unit labour costs over this period has been highly disadvantageous. At 1981 (i), the UK index - with a 1975 base of 100 - had reached 216. At that time the USA figure was 142, the Japanese 147 and the West German 139.

The IMF figures are not available for periods later than the first quarter of 1981. Estimates can be made, however, and these indicate a sharp recovery in UK competitiveness accompanying the recent fall in the sterling exchange rate. The estimated figures for 1981 (ii) and (iii) on the attached table <u>must</u> be checked up to the moment before being publicly used.

P J CROPPER
29 October 1981

Unit Labour costs index+

		UK	USA	Japan	France	W.Germany
1975		100	100	100	100	100
6		91	101	100	94	96
7		96	107	115	100	110
8		120	114	144	117	130
9		152	122	135	132	146
1980		204	136	131	151	158
1977	i	90	106	106	94	104
	ii	93	107	112	98	108
	iii	97	108	117	102	111
	iv	105	110	126	106	117
1978	i	115	114	129	109	123
	ii	113	114	137	113	127
	iii	122	114	155	122	130
	iv	132	116	156	125	140
1979	i	137	119	147	131	145
	ii	144	122	135	127	139
	iii	162	123	134	131	146
	iv	164	125	122	140	153
1980	i	181	129	118	145	154
	ii	197	136	126	148	156
	iii	216	140	138	158	165
	iv	222	139	144	154	157
1981	i	216	142	147		139
	ii		144			

Source: Economic Trends

+ All the indices are in terms of the US dollar

IMF index of relative unit labour costs*

		UK
1975		100.0
6		93.6
7		89.9
8		97.9
9		113.0
1980		138.9
1977	i	89.1
	ii	88.3
	iii	88.7
	iv	93.3
1978	i	97.3
	ii	95.7
	iii	98.4
	iv	100.3
1979	i	102.4
	ii	112.0
	iii	118.7
	iv	119.0
1980	i	126.4
	ii	136.0
	iii	143.4
	iv	149.7
1981	i	156.2
	ii	152 (estimate)
	iii	135 (estimate)

Source: IMF

* A downwards movement indicates greater competitiveness

Aspects of United Kingdom trade competitiveness

E. A. DOGGETT and J. C. CRESSWELL, Central Statistical Office

In the last year or two there has been an increasing interest in ways of measuring the competitiveness of nations in international trade. Many institutions, including the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD) now publish indicators of trade competitiveness.[1,2,3,4] The reasons for this interest are clear. Variations in the rate of inflation and fluctuations in exchange rates make it difficult to assess a country's competitive position at a time when the slow rate of growth in world trade is making competitiveness crucial. For the United Kingdom, which exports about a third of the net output of its manufacturing industry, trade competitiveness is clearly important. This article introduces a new table of indicators which is to be published regularly among the standing tables in *Economic Trends* from next month.

Competitiveness is essentially a relative concept. No absolute standard of competitiveness exists. The indicators are constructed by compiling an index to show how some relevant characteristic of the UK economy has changed over time, and then comparing the index with the corresponding indices for other countries. A practical consequence of this is that the indicators of competitiveness are restricted by the availability of comparable data for other countries.

There can be no single comprehensive index of competitiveness because of the variety of possible contributory factors. The share of world trade at constant prices might be said to be an indicator of competitiveness; when it increases the nation must have become more competitive by one means or another. However, it does not help to determine by what means competitiveness has increased. The first step in such an analysis is to distinguish between price and non-price aspects.

Non-price competitiveness consists of factors such as quality, product design, reliability, salesmanship, delivery times and after sales service. These factors are important, but are intangible and difficult to measure. For example, though delivery times are in principle measurable, it would be difficult and expensive to do so in practice, and even harder to establish comparable statistics for other countries. The indicators that are published here and elsewhere are therefore of price, and of cost, competitiveness. Nevertheless, the price and non-price factors are interdependent; high profitability can stimulate improvement of the non-price factors, and improvement in quality, etc., can usually be obtained at a cost.

When comparing prices or costs, coverage should ideally be confined to tradable items. Many of the indices available for international comparison of price changes are too wide in scope. The implied deflators for gross domestic product and consumer prices are widely used as indicators of inflation, but they include large elements which are not directly relevant to international trade, for example housing and other construction work and the provision of many services. It is not possible to avoid these difficulties completely, but many of the problems of comparability can be eliminated by confining consideration to manufactured goods*. These comprise about two thirds of UK exports and about half of UK imports of goods and services. Limiting the coverage in this way also facilitates comparability of cost and price indices for the United Kingdom and statistics for other countries generally, although the comparability is not perfect.

A major factor in competitiveness is the exchange rate. The rates at which settlements take place are often determined by long term contracts, or by forward currency market transactions. Nevertheless, movements in the spot rate which is used in compiling the indices are a guide to the effect on competitiveness. The basic indicators of costs and prices have been converted to US dollars and therefore reflect changes in the exchange rate of the domestic currency with the dollar, but comparing the corresponding series for different countries will give an indication of changes in their relative trade competitiveness. The summary measures, being ratios, are independent of the currency employed in the calculation.

For some time now *Economic Trends* has published an index of relative export prices, and this is to be continued in the new table. This index would appear to be the natural measure of competitiveness and it is readily defined and compiled. Nevertheless it has certain limitations; it takes no account of goods which are not exported because their prices are too high; and it is based on unit values as a proxy for price. It also reflects changes in profitability and costs, and does not cover the competition with domestic production in the countries to which the United Kingdom exports nor the competition with imports in the UK domestic market. To cover these points a range of indicators is to be published.

To broaden the scope of the price competitiveness measures, an index of relative wholesale prices has been constructed. For the commodities covered, it reflects the prices of all goods rather than merely those that were actually sold abroad. Its weaknesses are that the coverage is not restricted to export sales, and therefore does not allow for the possibility of manufacturers taking a different margin of profit on exports or producing to different specifications for the export market. In fact, the UK index relates strictly to home sales, and an index of profitability of exports relative to home sales based on movements in the export unit value index and the wholesale price index is also shown in the table. The coverage and methods of calculation of wholesale price

* Defined as in sections 5 to 8 of the Standard International Trade Classification, Revision 2 (SITC Rev 2). Food, drink, tobacco and fuels are the principal exclusions.

indices vary from country to country. For the United Kingdom, the index covers the output of all manufacturing industry, which, apart from including the food, drink and tobacco and fuels industries, is broadly comparable with the coverage of the SITC definition of manufactured goods.

A different approach is to look at costs rather than prices. Data limitations restrict the comparison to labour costs, and this will usually overstate the amplitude of movements in total costs. Nevertheless, the IMF index of relative normal unit labour costs which is included in the new table has been found in research by the Bank of England† and the Treasury to be a good explanatory variable for changes in exports of manufactures.

Further discussion of the relative merits of the different indices can be found in the *Bank of England Quarterly Bulletin* for June 1978[3], and the Treasury's *Economic Progress Report* for February 1978[4].

The table shows five summary measures of UK trade competitiveness together with sets of indices of three of the relevant factors for the United Kingdom and four other countries.

The following are brief descriptions of the methodology used in the construction of the summary indices, together with notes on sources of the data.

Summary measures of the relative position of the United Kingdom

The index of *relative export prices* is the unit value index of UK exports of manufactured goods divided by a weighted average of competitors' export price indices for manufactures, all expressed in US dollars. The index is prepared by the Department of Trade using, in addition to the unit value index for the United Kingdom, indices published by the United Nations for the other main manufacturing countries‡. The index is chain weighted. The weight given to each country reflects the relative importance of that country in the United Kingdom's overseas markets weighted by the importance of that market to the United Kingdom.§ A table showing for each country the unit value index and the overall weight given is published quarterly in *Trade and Industry*[5].

The index of *relative wholesale prices* is the UK wholesale price index for home sales of manufactures (including products of the food, drink and tobacco industries) divided by a weighted average of the indices of competitors' wholesale prices all expressed in US dollars. The index is prepared by the Department of Trade using national indices made available by the IMF. With three exceptions they refer to the manufacturing or industry component of the wholesale or producer price index. For Italy the 'finished goods' component and for Switzerland the 'home goods' component of the wholesale price index is used. The French index is not a true wholesale price index but is the manufactured goods component of their consumer price index. The competitor countries included in calculating the index, and the weighting given to each, are the same as for the relative export prices index.

The index of *relative normal unit labour costs* is an index of normal labour costs per unit of output in the United Kingdom divided by a weighted geometric average of competitors' normal unit labour costs adjusted for exchange rate changes. The normalisation of the basic indices is an attempt to allow for short term variations in productivity from its long term potential.‖ The index, which relates to manufacturing industry, is calculated by the research department of the International Monetary Fund. The weighting used by the IMF in constructing the indices for relative normal unit labour costs is somewhat different from that used in the relative export price and relative wholesale price indices described above, in that it attempts to take account of competition with domestic production in particular markets as well as competition with third countries.

The index of *relative profitability of exports* is the ratio of the UK export unit value index for manufactured goods (sections 5 to 8 of the Standard International Trade Classification, Revision 2) to the UK wholesale price index for home market sales of the products of manufacturing industries, other than the food, drink and tobacco manufacturing industries. Although the range of products covered by the two indices is much the same, the weighting pattern of the wholesale price index reflects the net sales in the base year of the constituent industries, whereas the weighting of the export unit value index reflects the export pattern in the base year. There is also a difference in timing, in that wholesale prices relate largely to quotations for orders in the period, while unit values reflect the price of goods leaving the country in the period. These differences may on occasion lead to movements in the index which do not reflect changes in profitability.

The index of *import price competitiveness* is the UK wholesale price index for home market sales of manufactures other than products of the food, drink and tobacco industries, divided by the unit value index of imports of finished manufactures (sections 7 to 8 of Standard International Trade Classification, Revision 2). There are problems of weighting and timing, similar to those for the index of relative profitability of exports. Semi-manufactured goods have been excluded from the import unit value index because they form a large part of imports of manufactures but only a small part of the net sales of manufacturing industry, on which the wholesale price index is based. In the case of exports the disparity is much smaller. The effect of tariff changes has not been taken into the calculation.

Sets of indices for competing nations

Export price index for manufactures

The export unit value index for the United Kingdom is calculated by taking a wide selection of closely defined

† The relative normal unit labour costs index was compared with the index of relative export prices, relative profitability, unnormalised relative unit labour costs, and other measures of trade competitiveness over the period 1967 to 1977 (2nd quarter). The process of normalising the relative unit labour costs index to remove cyclical effects significantly improved its contribution to explaining changes in exports of manufactures.[3]

‡ Canada, the United States, Japan, Sweden, Switzerland, Belgium/Luxembourg, France, the Federal Republic of Germany, Italy and the Netherlands.

§ Based on an export matrix. The total UK export market is divided into 11 areas. Area *A*, for example, receives 6·8 per cent of the UK total exports of manufactures. The ten competitor countries listed above also export to area *A*, and of their total exports of manufactures to area *A* 3·7 per cent came from the United States. The weight given to the United States as a result of this transaction is

$$\frac{6\cdot8}{100} \times \frac{3\cdot7}{100} = \cdot002516$$

The total weight given to the United States in the index is obtained by adding to this the weights similarly derived for the United States in the other 10 market areas.

‖ Based on the fitting of Cobb-Douglas production functions.[6]

relatively homogeneous trade headings, and within each of these trade headings calculating the average value (i.e. the ratio of value to quantity). The average values for selected headings are weighted together (with fixed weights) to calculate aggregate unit value indices. The unit value index differs from a true price index to the extent that the average values for the selected headings differ from prices. Each country calculates its own indicator of export price changes and the methods vary in the degree of detail employed in the calculation and in the choice of weights. The UK weights reflect the pattern of exports in the base year (1975). Those for France and West Germany are current year weighted, while the United States and Japan employ chain linked Fisher indices. The unit value indices for all countries covered by the index of relative export prices are published quarterly by the Department of Trade.[5]

Wholesale price index

These indices, which are derived from national sources, are supplied by the IMF in national currency terms and converted by the Department of Trade to a US dollar basis. As indicated earlier, the precise coverage of the indices varies from country to country.

Unit labour costs index

These are basic (i.e. unnormalised) unit labour costs indices as published by the OECD in *Main Economic Indicators* for each country except France. They represent changes in the actual labour costs per unit of output converted to a US dollar basis. Labour costs cover principally wages and salaries and employers' social security contributions. The index for France has been provided by the Institut National de la Statistique et des Etudes Economiques, and converted to US dollar terms by the CSO.

Recent movements

The charts show movements in the indicators of trade competitiveness which are to be published in *Economic Trends*, together with the UK share in exports of manufactured goods by the main manufacturing countries of the world, and the effective exchange rate index for sterling. A decline in an indicator of competitiveness signifies an improvement in that aspect of the UK competitive position. A decline in the profitability index signifies a deterioration in relative profitability of exports.

The various measures of competitiveness show some prominent similarities. The sharp improvements in the third quarter of 1973 and throughout 1976 reflect declines in the effective exchange rate for sterling. Between these periods there was loss of competitiveness in early 1974 associated with an increase in the exchange rate, followed by a year and a half of stable or slowly deteriorating competitiveness, when increases in export prices were to a large extent offset by a steadily declining exchange rate. During 1975, costs (adjusted for exchange rate changes) increased by no more than those of our competitors, and by the end of the year the relative profitability of exports was slightly higher than at the beginning.

The decline in the exchange rate in 1976 brought with it an improvement in competitiveness and at the same time a significant improvement in the profitability of exports relative to home sales. The relative profitability of exporting reached its peak in the fourth quarter of 1976, but has remained high ever since. The 10 per cent appreciation of sterling between the fourth quarter of 1976 and the first quarter of 1978 brought with it general losses of competitiveness, but the extent of the losses shown by different indices varied. In terms of domestic prices, relative normal unit labour costs rose only slightly faster than those in the rest of the world, whereas export prices and wholesale prices rose much faster in the United Kingdom, so that when the effects of exchange rate changes are added in, the loss of competitiveness was quite sharp. In the second quarter of 1978 there were large recoveries in price competitiveness, and a smaller recovery in cost competitiveness. For the latter half of 1978 information is incomplete, but sterling has strengthened somewhat, tending to worsen UK competitiveness, particularly in relation to the United States, where the dollar has been weak.¶

¶ This conclusion is necessarily tentative. Little is known yet about the performance of other countries over the period.

References

1 *International Financial Statistics* (IMF) monthly

2 'The international competitiveness of selected OECD countries', *OECD Economic Outlook: Occasional Studies*, July 1978 (OECD)

3 'Measures of competitiveness in international trade', *Bank of England Quarterly Bulletin*, June 1978

4 *Economic Progress Report*, February 1978 and September 1978, HM Treasury

5 'Economic indicators of the industrial countries: quarterly analysis', *Trade and Industry* (most recently in the issue of 2 December 1978)

6 J. R. ARTUS, 'Measures of potential output in manufacturing for eight industrial countries, 1955-78' *IMF Staff Papers*, March 1977

(2)

PRIME MINISTER

MS

I attach the latest macro-economic report from the Liverpool Group, together with a letter to you from Professor Patrick Minford.

The report forecasts that the recovery in output which began in the summer will be slowed down by recent events in financial markets but will gather pace in the middle of 1982, as short-term interest rates decline. It forecasts GDP growth at 2.5 per cent in 1982 and 4.5 per cent in 1983; and inflation falling to 7.5 per cent in 1982 and 4 per cent in 1983. It makes a number of proposals for reducing unemployment - proposals for union ~~and~~ law reform, to reduce social security benefits to the unemployed, elimination of central Government subsidies of council house rents, ~~from~~ a general public expenditure cuts of 5 per cent from the 1981 White Paper; and a raising of tax thresholds, together with a lowering of the standard rate of tax to 25 p.

If you agree, I will write to Professor Minford thanking him for writing, but declining a discussion on diary grounds.*

MLS

26 October 1981

Should love to have a talk with him - & Alan [illegible] - when P.M next comes to [illegible] - 'I'll [illegible] in convenient'. [illegible]

* since dictating this note Alan Walters has suggested that a short discussion with Patrick Minford would be good value. Shall we try and find 1/2 hour for this? (Keeping the discussion to a v. small group: say Minford, A Walters and T Burns / P. Middleton?)
MLS

PPS R24
Att.

EDWARD GONNER PROFESSOR OF APPLIED ECONOMICS

A.P.L. MINFORD, B.A., M.Sc., Ph.D.
ELEANOR RATHBONE BUILDING P.O. BOX 147 LIVERPOOL L69 3BX

TEL: 051 – 709 - 6022 EXT.

The University of Liverpool

APLM/PB

21st October 1981

The Rt.Hon.Margaret Thatcher M.P.,
Prime Minister,
10 Downing Street,
London SW 1.

Dear Prime Minister,

I am taking the liberty of sending you our latest economic analysis because it formulates specific suggestions for reducing unemployment without damaging - indeed while, in my view, strengthening - the anti-inflation strategy. I would be delighted to come and discuss it with you (if you were able to spare the time) and with your advisers.

Yours sincerely,

Patrick Minford

(Patrick Minford)

PS. It was kind of you to write to me earlier this year about my Times article. It was a pleasure to write it!

EMBARGO: 12 NOON MONDAY 26TH OCTOBER

PRESS RELEASE

Quarterly Economic Bulletin - The Liverpool Group

The Liverpool Research Group in Macroeconomics today released an updated forecast for the UK economy, and proposals for union law reform, taxes, and public spending and social security designed to cut unemployment by 1.25 million within the next three years.

The forecast is that the output recovery materialising in the summer will be slowed down by recent events in financial markets but will gather pace in the middle of 1982, as short term interest rates decline. GDP growth is forecast at 2.5% in 1982 and 4.5% in 1983.

Because of the monetary and market pressures, wage settlements will continue to decline to about 4% in the 1981/2 wage round. Inflation is expected to fall to 7.5% in 1982 and 4% in 1983.

The exchange rate is likely to stabilise around its current level. But longer term interest rates will remain fairly high because the commitment of opposition parties to varying degrees of reflation worsens the inflation possibilities after the next election.

The Group's unemployment proposals, which have been worked out so as to have no net cost to the Public Sector Borrowing Requirement, are designed to increase the incentives to create and take jobs. They can be grouped into 5 parts;

1. The 1906 (Immunities) Act, except for the clause allowing peaceful picketing, should be repealed, the Closed Shop declared illegal, and a Labour Monopolies Commission set up.

2. Social Security Benefits to the unemployed should be indexed to the lower of wages and prices, to reflect the nation's productive capacity more accurately; and a ceiling for total unemployment benefits per household of 75% of previous net earnings should be phased in.

3. In order to improve labour mobility, subsidies by central government of council house rents should be eliminated; and remaining rent/lease controls should be abolished.

4. There should be general public expenditure cuts of 5% on total programmes on top of those planned in the 1981 White Paper. These should, with previous proposals, save the PSBR £11 billion.

5. With the proceeds, child benefit allowance should be raised £2 per child; tax thresholds raised by 15%; a lower tax band of 15p (on the first £1000) and a standard rate of 25p instituted; and employers' National Insurance Contributions cut by 2%.

The whole package is estimated to raise the productive capacity of the economy by 6%, and to lower unemployment to below 1 million by 1984; it is also expected to strengthen the counter inflation strategy by improving the supply side of the economy.

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J.Vereker
A Duguid
A Walters

CONFIDENTIAL

(2)

Prime Minister

MCA 16/10

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

Econ Pol

16 October 1981

The Rt Hon Patrick Jenkin MP
Secretary of State for Industry
Department of Industry
Ashdown House
123 Victoria Street
LONDON SW1E 6RB

MS

Dear Patrick

- with P.M. (Blackpool)

Thank you for your letter of 12 October. As I said when we met on Monday, there is a good deal in it with which I am in sympathy.

There are, of course, other views, even in industry, about the best form of fiscal relief - if any were to become possible. Even so, the case for an early cut in the national insurance surcharge, to ease the strain on costs and prices, and to help stimulate greater output and more jobs, is explicitly acknowledged in the paper Leon Brittan and I have circulated to colleagues for next week's public expenditure Cabinet.

So too is the case for realism in setting public expenditure levels if we are ever to be in a position to move in the direction you would wish. We are suggesting that the maximum public expenditure we can afford falls well short of the bids that colleagues have made. Even so, because the levels are well above our White Paper plans, they are likely on present indications to use up the room I hoped would be available for tax cuts next year - and indeed the risk is that taxes may have to rise even higher. As you know, we shall be reviewing the rates and levels of NICs next month.

Leon has written to you about your proposal to reduce the deferment of RDGs. I have to look at this in the context of your public expenditure programme and of expenditure programmes as a whole. Much as I would like to reduce - indeed abolish - the deferment of RDGs there is no room for the additional expenditure in 1982-83. As Leon has said, not only are he and I bound to reject your bid, but we must ask for further cuts in your programme beyond what you have offered.

/The public expenditure

The public expenditure situation is thus crucial. Of course, your programme alone could not conceivably produce the sort of savings that would be necessary to finance a significant cut in the NIS. That is why I hope for your full support in pressing in Cabinet for the lowest possible public expenditure totals consistent with our political requirements. If we can successfully press our colleagues to make savings of the same severity as those being sought from the Industry programme, leading to lower overall figures than Leon and I have put forward, the prospects for taxation, and industry generally, will be that much improved.

As far as electricity price reductions are concerned, I understand that some proposals have been put to Nigel Lawson. No doubt he will be discussing them with you soon, if indeed he has not already done so.

I am sending copies of this letter to the Prime Minister, Sir Robert Armstrong and Robin Ibbs.

GEOFFREY HOWE

Mr. Scholar.

CABINET OFFICE
Central Policy Review Staff

From: J. R. Ibbs

70 Whitehall, London SW1A 2AS

Telephone 01-233 7765

SECRET

(2)

Prime Minister

MUS 16/10

2

CABINET OFFICE

Central Policy Review Staff

70 Whitehall, London SW1A 2AS Telephone 01-233 7765

From: J. R. Ibbs

Qa 05703 16 October 1981

Dear Chancellor,

The Health of Industry

The Secretary of State for Industry sent me a copy of his letter to you dated 12 October.

As you know I too have major worries about the possible long term damage which the current recession may inflict on British manufacturers. The forcing out of inefficiencies is an important benefit and I have ample evidence from my own contacts that managements are effectively tackling fundamental long standing problems and that unions are accepting some much needed changes. However, a persistent climate of low profitability undoubtedly inhibits development and investment in many established businesses and can wipe out the efficiency gains. This brings a heavy penalty in terms of international competitiveness if companies overseas are meanwhile making technological advances. The whole area is one where generalisation is extremely difficult because the balance of the relevant factors varies widely between sectors and between companies. However, a central problem is the morale of management and owners; prolonged retrenchment stifles enterprise and willingness to take risks. The problem is one of preserving faith in the future rather than of creating an immediately easier environment. Against the background of continuing difficulties, of which the most recent is the increases in interest rates, an acknowledgement of the need for some encouragement would be extremely valuable.

It is in this context that I am attracted to the Secretary of State's suggestion of reducing the National Insurance Surcharge (NIS). I am pleased

The Rt Hon Sir Geoffrey Howe QC MP
H M Treasury
S W 1

SECRET

to see in your paper on Economic Policy and Public Spending that you too attach considerable importance to it. Once implemented, such a cut would have a direct and immediate impact on employers' cash flow. By reducing labour costs it would help to improve cost competitiveness and/or enable companies to re-build profits and invest and/or reduce borrowings. It would be a valuable boost to business morale.

I am well aware of the problems associated with reducing NIS. First, within a predetermined national cash limit, easement of NIS must mean greater economies or additional taxation elsewhere. Personally I would not wish to urge a cut if this merely led to other greater difficulties, but this is a matter of priorities and I doubt whether NIS and the morale of industry should come bottom of the list. Second, there is a fear that a reduction of NIS might weaken the resolve of some employers on pay, although I believe it may be possible to reduce this risk by suitable timing as I indicate below.

All these problems are made worse by the inflexibility of NIS and the need to make preparations for a change six months before it is put into effect. I am told there are also severe administrative difficulties if the change occurs at other than the beginning of a tax year. This inflexibility, which calls for a decision now if it is to take effect in April 1982, may understandably mean that, because of uncertainties in the budget arithmetic and doubts about the pay round, you feel you have to rule it out.

One solution you may like to consider would be to put in hand now arrangements that would make possible a cut in NIS by a given percentage in April 1982, but to postpone the actual decision to next Spring. There would still be some administrative problems because DHSS would have to prepare two sets of tables but these difficulties would be less serious than a mid year change. The merit of the proposal is that you would retain freedom to take the final decision when the overall macro-situation in 1982 is clearer and when there is a fair indication of the outturn of the pay round.

There is of course the risk that knowledge of your creating such an option would leak. This might not be a bad thing because it would be interpreted as concern for industry and it could be pointed out that the final decision depended, among other things, upon a satisfactory outcome on pay settlements.

I am sending a copy of this letter to the Prime Minister, the Secretary of State for Industry and to Sir Robert Armstrong.

Yours sincerely,

J R Ibbs

JU572

A. Duguid
cc A Walters

TOTAL COPIES 20

COPY No. 2

SECRET

DEPARTMENT OF INDUSTRY
ASHDOWN HOUSE
123 VICTORIA STREET
LONDON SW1E 6RB
TELEPHONE DIRECT LINE 01-212 3301
SWITCHBOARD 01-212 7676

1

Secretary of State for Industry

12 October 1981

The Rt Hon Sir Geoffrey Howe QC MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SW1P 3HE

Prime Minister

MVS 13/10

Dear Geoffrey,

THE HEALTH OF INDUSTRY

One of the central tenets of our policies is that we must create conditions in which industry can prosper. Of course the control of inflation is central to these policies, and will bring huge benefits to industry as to the rest of the country. The fact remains, however, that while we are in the process of containing inflation we are also maintaining conditions which are damaging to the long term health of industry to an important extent as a result of unintended and unexpected consequences of our broader policies.

Costs in industry are too high. This has reduced profits and also competitiveness in domestic and overseas markets. Industrial profitability has been falling progressively over the last two decades. In 1980 it was down to an average real return in manufacturing of 2 per cent. The consequences of this on the willingness and ability of industry to invest both in fixed assets and in advanced technology and, perhaps even more important, to undertake new ventures, develop new products and open up new businesses, are extremely worrying. Moreover, the lack of profit has made it impossible in many cases for firms to take advantage of the capital allowances for investment, to which they are entitled under the present tax regime. Company liquidity, while less strained than last year because of the sharp physical cutbacks by industry, is still weak, and is likely to be put under further strain once stockbuilding becomes positive again.

So far as the events under our own administration are concerned, in 1980 the exchange rate rose far more strongly than we had foreseen. While the rise brought great benefits to us in the battle against inflation it imposed great strains on our export industries. The recent fall in the rate will relieve those pressures to some degree, but in its place the sharp rise in interest rates - the need for which I appreciate - has created a new and damaging strain. The pressures on nationalised industries to reduce their deficits, again a policy I strongly support, have resulted in input prices to industry rising faster than warranted by world conditions.

I believe that we should act promptly to reduce the strain on industry. The first priority of the CBI is a cut in the National Insurance Surcharge (NIS). I am in full agreement with them. It happens that the political and economic circumstances are particularly favourable for such action. On the political level NIS is a tax introduced by Labour as a short-term emergency measure. We strongly criticised its introduction and by retaining it we are acting in economic terms against our own policies. As it is a tax which adds directly to industry's costs any cut in it should feed through into extra profits or into a reduction in price rises and inflation and also into overseas competitiveness. Previous discussion of the case for a reduction drew attention to the danger of such action feeding through into an increase in wages. I believe that it is one of the real benefits of our overall policies that that risk is now much less and that the recognition amongst wage bargainers, in manufacturing especially, of the relation between wage increases, the competitive position of their firm and job prospects is now markedly greater.

There are two other measures which could usefully be considered alongside so as to constitute a worthwhile package for industry. The first, which I believe is both necessary and urgent, is to press ahead with a scheme to reduce electricity prices to the largest consumers, as was agreed in principle in the summer. This proposal has been with us now for many months. I hope it can now be quickly brought to finality.

The second relates to expenditure by my own Department. The position on this was set out in my letter to you of 5 October. In that I referred to the possibility of a reduction in the period of deferment for RDGs. The points I have set out above emphasise the desirability of that step.

I recognise of course the scale of cost of the actions I am suggesting, especially in relation to the NIS. In the last resort it must be for you to advise the Cabinet how large a cut can be afforded and how it should be financed. I am, however, clear that early and substantial action is needed and that an announcement of a cut should be made forthwith, for implementation at the earliest practicable date.* A cut of 1½ per cent is what I would like; anything less than 1 per cent would be derisory.

* presumably 1.4.82

What I am suggesting would of course have very direct implications for many colleagues, but at this stage I am copying this letter only to the Prime Minister, Sir Robert Armstrong and Robin Ibbs.

Yours ever

Patrick

1. Chancellor
2. Prime Minister
3. Sir Robert Armstrong
4. Robin Ibbs
5. PS/KB
6. PS/NL
7. PS/JW
8. PS/JM
9. PS/Sec
10. Mr Gill
11. Mr Mauzee
12. Miss Mueller
13. Mr Croft
14. Mr Liesner
15. Mr Berman
16. Mr Treadgold
17. Mr Farrow
18. Mr Oulen
19. Mr Michell (on file)
20. Masters

PART 9 ends:-

9. 10. 87

PART 10 begins:-

12. 10. 87