

*cc Mr Hodgson  
Mr Lankster  
Mr Whitmore*

*cc Questions filing*

*Prime Minister's Office*

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The first note sets out the points Ken Bernik made last Thursday. The second argues the case against the Chancellor's medium term financial plan. Shall we discuss again when we have the Governor's comments?

*TL  
25/2*

Qa 04447

To: MR LANKSTER  
From: SIR KENNETH BERRILL

1. I attach two personal notes of mine which the Prime Minister might like to read.
2. The first is on "the UK problem" as I see it which the Prime Minister might find useful as background for the forthcoming Censure Debate. I have deliberately written it in note form to save time and space.
3. The second is on the Chancellor's proposed medium term monetary plan. I have some doubts, which I believe the Prime Minister may share, on the wisdom of the Government hooking itself on a programme for the reduction of M3 over the years ahead, and the note covers my first reactions to reading the Chancellor's paper on Friday.

*Not copied  
as above*

*KB*

25 February 1980

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NOTES ON "THE UK PROBLEM"

1. There is general agreement that the UK problem is basically one of fast inflation since the early 1970s and economic growth which, for the last third of a century at least, has been slow in comparison with our competitors.

2. With slow economic growth has come falling competitiveness in every important aspect - quality, design, reliability of delivery, concern for the customer, etc. Some of these failings are due to labour but many of them are at least equally the responsibility of management.

Why has this happened?

3. For the 25 years after 1945 we failed to join in the great period of expansion in world trade - and the expanding years of the EEC. We lived on Beveridge (demands that the State protect us from all adversity) and on myths (that British craftsmanship is the best in the world). At the same time, the balance of power in the labour market was shifting - partly due to the law but mainly due to changes in practice (e.g. picketing and blacking).

4. Governments of both parties concentrated on demand rather than supply. They aimed to keep demand sufficiently high to create near full employment (under half a million unemployed) but not so high as to cause unacceptable inflation. The belief was that strong demand would produce strong responses in terms of investment and improvements on the supply side. Small changes in the level of demand would be sufficient to alter the bargaining strength of the unions and hence the level of wage settlements and inflation.

5. There was a continuous refusal to recognise how fast and how far the UK was slipping and continuous optimism in the sense of planning increases in public expenditure which could only be justified on assumptions of economic growth and balance of payments performance which were seldom achieved.

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6. The balance of payments constraint forced continuous rounds of stop-go economies. But when the brakes were applied they were not allowed to affect the most uncompetitive parts of the economy. Every effort was made to cushion the effects by regional policy and unemployment protection measures.

7. The efficient operation of the market was further inhibited by Government action in many fields - particularly by recurrent bouts of incomes policy.

8. By the 1970s the world was about to shift from 20 years of unprecedented fast growth to what now looks like 20 years of much slower growth, and the UK was badly organised to adjust to this - membership of the EEC at this particular time did not help.

9. The most important event was that the unions discovered just how much power had really had in the three-day week and at the Saltley coke depot. The Labour spending spree of 1974 (which followed a Tory spending spree at the end of the previous Administration) made things worse. The balance of payments and the IMF eventually put the brakes on the spending but only after a great deal of damage had been done (a 20 per cent increase in public expenditure over a period when the GNP had risen hardly at all).

10. In the face of the evident imbalance in the labour market (union power) the Labour Party was constitutionally incapable of trying to move the power balance back. The alternative for them was either a "social contract" under which unions would agree to hold their power in abeyance (temporarily) or mitigating that power by whatever level of unemployment proved necessary.

11. Naturally they chose the "social contract" - incomes policy in exchange for social security spending plus further changes in the law in favour of the unions, including health and safety, redundancy, etc.

12. The combination of an incomes policy (£6 a week) which squeezed differentials and the inability under the social contract to raise indirect taxes adequately meant that with inflation the impact of direct tax spread right down through the income levels creating major and unforeseen problems of the 'in-and-out' of work trap and the poverty trap.

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13. By 1979 the stage was set for a major increase in inflation as soon as incomes policy was removed and, despite cut backs in public expenditure programmes following the IMF, there was still sufficient growth remaining in public expenditure programmes to present major headaches in a period of no economic growth and a long wait ahead for the fiscal benefits of North Sea oil and gas.

14. Given that the UK problem is how to reduce inflation and increase growth against a background of slow growth in the world economy, the main areas of adjustment have to be -

(i) how to get a better balance of power in the labour market - changes in law, changes in practice under the law, move to smaller units. All this accompanied by efforts to change worker attitudes towards the need for their companies to be productive (and profitable) in order that higher real wages may be possible. A major task for management is better communications with the work force (not necessarily along Bullock lines).

(ii) How to improve incentives - level and structure of direct taxation; the in-and-out of work problem; the poverty trap.

(iii) How to 'roll back' the size of the public sector and to achieve more accountability and efficiency within what remains - including local government.

(iv) How to move away from the emphasis on the large firm and the large plant by encouraging demergers, break up of nationalised industries, small firms, etc.

(v) While improving productivity, how to encourage an emphasis on quality as well as quantity - British standards, public sector purchasing, R and D policy.

15. In the short run, as far as inflation is concerned, the present imbalance in the labour market means that the choice is between unions not using their strength (incomes policy) or having their strength sapped by a weak market for labour (unemployment) and stronger employer resistance. This last can be brought about by fiscal measures to

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weaken demand and by monetary constraint which reduce the ability to pay higher wages. Unfortunately, given the present power and attitudes of trades unions in the UK, we do not know how severe the restraint would have to be to weaken that power and hence what damage would need to be done in terms of reduction of investment, bankruptcies, etc. - the incidence of which could be both capricious and unfortunate.

16. Against this background, what are the Government's main achievements so far?

17. They have begun the process of monetary restraint and the process of shifting the balance of power in the labour market through the operation of trades union law and practice. The immediate effects of the monetary squeeze are obviously unfortunate. How long it will need to last it is impossible to say. Only when the balance of power and attitudes in the labour market make free collective bargaining compatible with very modest inflation can the constraints be eased and significant economic growth be resumed.

18. On incentives the first moves have been made on both direct tax and the overlap of tax and social security payments. Public spending programmes have been cut but the inheritance of the Labour Government (including Clegg) was such that, broadly speaking, we will have to wait for the arrival of North Sea oil and gas receipts before going much farther.

19. A start has begun on rolling back the nationalised sector on breaking up into smaller units and on the improvements in efficiency and accountability (Rayner). It will all take time.

20. But what are the alternatives?

21. Back to incomes policy and the social contract under which union power is increased and public spending expanded?

22. Back to continued support for inefficient production in the nationalised sector - steel, shipbuilding, British Rail, postal services - and British Leyland.

23. How would this begin to tackle the twin British problems of inflation and inefficiency?

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MEDIUM TERM FINANCIAL STRATEGY

1. The Chancellor is proposing to publish a document which commits the Government to progressive reduction in the rate of increase in the money supply (sterling M3) over the coming four years. The document would necessarily include figures for the possible growth of GNP over the period as well as figures for the growth in public expenditure and public receipts (including in particular receipts from North Sea oil and gas).
2. The main arguments for publishing such a document are that the Government's commitment to monetary policy has led markets to expect such a document. To be effective, monetary policy needs a medium term approach. Publication of this programme would show how determined and how ambitious the Government was in its attack on inflation by both monetary and fiscal means. It would bring cheer to the markets and be a severe warning to employers on the struggles ahead.
3. It would bring cheer to the public generally and to the Government's supporters by showing that towards the end of the period North Sea oil and gas would bring opportunities for reduced taxation and some relaxation on public expenditure. The 'blue skies' should indeed be there before the next Election.
4. These are compelling arguments but there are strong ones on the other side, and the judgement between them is both difficult and primarily political.
5. First, the paper itself could give ammunition to the Opposition. It assumes a very small annual growth in GNP over the whole of the life of the present Government. It produces no figures for unemployment and these will, of course, depend on productivity changes - higher productivity the worse the unemployment. But even with low productivity rise the unemployment prospects look poor. Equally, it gives no data on the rate at which inflation is expected to be brought down to the rate of increase in the money supply; no figures on the exchange rate or the rate of interest: nothing, in fact, on the cost of this policy beyond a very bland sentence that it "may entail some transitional losses of output".

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6. The monetary targets are expressed in terms of M3. It is a small point, but the Treasury is about to produce a consultative document on monetary base control and the choice of variables for monetary policy. It seems odd to produce such a consultative document if the medium term financial strategy is to be based on M3.

7. Also the document does not discuss the extent to which constraints on M3 can be avoided by market operations and how these avoidance problems might increase. The Bank of England will, of course, have views on all this. As I understand it, they were not consulted on the final version of the medium term paper nor its recommendations.

8. But by far the biggest question mark has to be placed against the whole concept of Government deliberately hooking itself on a programme for M3 which it intends to stick to come what may. Giving such complete primacy to M3 means, almost certainly, giving up joining EMS for the time being. But it also means sticking to M3 targets irrespective of what unforeseen things happen either internationally (OPEC, minor wars, etc.) or domestically.

9. Domestically the plan fact is that we do not know how severe will be the effect of the deceleration in the real money supply implied in the Chancellor's paper. In the early years the squeeze is Draconian (given our present inflation rate) - it eases later on. This battle (which has only just begun) is between the irresistible force (trades union power) and the immovable object (the money supply). Given British conditions, it could be a very bloody battle indeed with interest rates, exchange rate, reduced investment, bankruptcies, at unknown levels. By declaring its determination to plough on with its monetary targets regardless the Government is giving itself very little elasticity.

10. Also the timing of the 'blue skies' could slip. Not so much from the receipts side - the output of North Sea oil and gas can be relied upon and the world price is unlikely to fall, but on the expenditure side. The history of PESC programmes is that 'present policies' always seem to cost more two or three years' hence when you actually get there.

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11. Both the above could be important in terms of the timing of an Election.

12. As has been said, there are difficult and important considerations for and against a medium term financial strategy. We live in a very uncertain world; forecasting is inevitably imprecise and room for manoeuvre to deal with the unexpected an important element of policy. This is one of many decisions which is, in the end, more a matter of political than economic judgement.





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