Mr Lankester.

10 DOWNING STREET

1 July 1980

Terry Burns Esq
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Dear Terry,

Thank you for sending us a copy of the draft of your presentation to Cabinet. I am sure this exercise will help a great deal in getting a fuller understanding of the Government's central economic objectives and the measures needed to achieve them. In particular, it should help to set the stage for the difficult Transitional Phase that we are entering and the need to anticipate both the political and economic problems of the adjustment process.

As you know, we are particularly concerned that if further adjustments to public spending are necessary, current spending - especially public sector pay - should bear its fair share without excessive reliance on capital spending cuts. This point was well made in a recent letter from the Federation of Civil Engineering Contractors to the Economist (copy attached).

I hope you will find some of the enclosed comments helpful: they include a few suggestions for extra points and some of the questions one might anticipate - most of which I am sure will already have occurred to you.

If there is anything I can do to help, please do not hesitate to ring.

I am copying this letter to Robin Ibbs and Tim Lankester.

Yours ever,

John

JOHN HOSKYNS

1 July 1980

COMMENTS ON DRAFT PRESENTATION TO CABINET

Objectives

1. The objectives of the presentation could be summarised as:

(a) To explain to a wider Cabinet audience the diagnosis of inflation and the financial strategy for conquering it.

(b) To reassure the audience that the plan stands a good chance of delivering the objective within the timescale required. In particular to reassure anyone who thinks that the plan has not been thought through or is based on an unproven theory.

(c) To convince colleagues that the risks associated with any alternative policy would be even higher.

(d) To prepare colleagues for a difficult adjustment process.

Comments

2. Paragraph 1. The brief reference to supply side measures could include the need to free-up the labour market. This is especially important not only to economic recovery when inflation is controlled, but also because the excessive rigidities of trade union bargaining power can make the transitional process longer and more painful.

3. Paragraph 3. The logical connections between each sentence of this paragraph are not immediately clear. We think the second sentence requires a little explanation.

4. Paragraph 9. The recent increase in inflation is attributed here to the further doubling of oil prices and the increase in world demand. This will prompt the audience to ask whether the inflation could have been avoided with correct monetary policies.

5. Paragraph 11. It might be best not to refer to a debate about whether the gap between UK and world growth is increasing. This seems to add one more area of serious uncertainty which does not help the achievement of the second objective. It might also be useful to say explicitly that you were not intending to discuss today the explanation of the 2% growth gap.

6. Paragraph 15. (iii) holds out the prospect of assessing the way the strategy unfolds in the period ahead. However, the rest of the presentation does not include any illustrative forecasts. Would it not be useful to quote the Medium-Term Financial Strategy and the forecast circulated recently to Chief Economic Advisers?

7. Paragraph 17. The last two points refer to the timing of NI price increases and pay settlements. The emphasis on timing could be wrongly taken to devalue the importance of requiring NIs to become more efficient - rather than simply pass on their poor performance and excessive pay settlements through price increases. Similarly, the level of pay settlements is surely important as well as the timing.

Should "expectations" appear in this list?

8. Paragraph 19. Does the last sentence contain any implications for changes in other lags in the system?

9. Paragraph 20. Would it be possible to express more certainty about the reversal of inflationary pressure?

How far do industrial disputes mentioned at (ii) represent a potential Achilles Heel in the future?

10. Paragraph 22. In addition to the movement of house prices, the CBI indicator and wholesale prices, could you also quote the evidence of export prices? Tim Congdon's analysis in the Times a few weeks ago seemed to show firm evidence of export prices only having risen by 5% during the last year, under competitive pressure which we are expecting to spread to other sectors. This might be a useful piece of evidence that inflation has already started coming down in this sector.

11. Paragraph 24(iii). Even when Government borrowing has been reduced, will it still be necessary to keep interest rates high in order to dissuade potential borrowers from banks?

12. Paragraph 28. When referring to firms exposed to international competition, it might be worth spelling out that this can be either at home or abroad.

13. Paragraph 30(i). Does the process of squeezing balances depend on continued high interest rates to ration the limited amount of money available?

14. Paragraph 34. The third sentence suggests that the rest of the private sector will follow the deceleration in manufacturing pay as the labour market weakens. It might be worth qualifying this by the importance of overcoming the institutional resistance to this spread of the deceleration process. No matter how many manufacturing jobs are lost, bank clerks are likely to feel that it is irrelevant in determining their wages when the banking sector is profitable. We think there could be a little more emphasis on the importance of public sector pay moving

in line - stressing the absolute size of the sector, and the fact that excessive pay awards can only be financed through increasing taxes or charges or the PSBR.

15. Paragraph 36. Would option (i) keep inflation at 20% or tend to accelerate it? We think you will need to spell out the objections to option (ii) a little more.

We are not sure that the limited life of a statutory incomes policy will seem a sufficient argument against it. Two years would presumably take us to the point where inflation was very low and the pressures on re-entry to a free market would be much less. The second objection quoted needs spelling out a little. If an explosion could be avoided at the end of the period, a statutorily-induced reduction in wages would presumably help to keep unemployment lower during the transitionary process.

16. Paragraph 37(vi). Is it possible to quantify (on the basis of the relationship described at paras. 31 and 32) the extent of unnecessary unemployment that would be associated with excessive pay settlements? A few examples might help to quantify the risks if the pay round goes badly wrong.

17. Paragraph 37(vii). It would be useful to indicate the likely timing of resumed growth and reduced unemployment.