cc Mr Heseltine [?]

Prime Minister

The main paper for discussion is Flag A. You have seen other Ministers' comments (also in this folder), but not Mr Nott's at Flag B – he is against any kind of support package, preferring a drop in interest rates.

CONFIDENTIAL

Qa 05118

To: PRIME MINISTER

From: J R IBBS

Industrial Support

I understand that you are to have a meeting later this week with some of your colleagues to discuss industrial support. The following observations may be of some help on this -

The Difficulties which Industry is Facing

It is important to start any considerations of industrial support with an analysis of the nature of the present difficulties. The main problems are low levels of sales, of profits and of cash flow; these lead to liquidity problems and in the extreme to bankruptcy. The impact of the difficulties varies enormously from company to company and exceptions can therefore be found to many generalised statements which are nevertheless broadly valid. Some of the main reasons for the present difficulties are -

a. Weak world demand.

b. Low United Kingdom demand, especially for manufactured goods.

c. United Kingdom unit costs are too high because -

i. Wage increases have been too high and without regard for the need for productivity improvements to justify them.

ii. Methods of manufacture have not been sufficiently improved (the responsibility of management) and working practices have been hidebound (the responsibility of both management and workers).

iii. Some investment has been poorly selected and inefficiently used, and insufficient has been concentrated on better products and better processes.

iv. Some overheads have become too high and inefficiently utilised.

v. production runs are often too small - there has been failure to recognise the volume of production necessary to remain world competitive and some of British industry is still too fragmented.

d. Profit margins have for a long time been too narrow, which leaves companies very vulnerable to a downturn. In particular, lack of inflation adjusted accounting has prevented this from being properly appreciated. Management, the accountancy profession and Government have all been at fault here.

e. In some instances standards of design and service have been uncompetitive, which means that companies are hit particularly severely by loss of customers in a recession when alternative supplies become available.

f. The exchange rate has risen to levels which have seriously diminished competitiveness for exports and made the country unduly attractive for imports. There has been an offsetting advantage from reduced cost of imported materials and hence less inflation, and the strong exchange rate can also be represented as a useful spur to increased efficiency. Although the volume of exports has held up well, much of the business is now done at inadequate profit or at a loss, and the strength of the exchange rate has become a serious problem for some companies that would otherwise be fully viable by international standards.

g. Interest rates have been at high levels compared with those in competitor countries. This imposes a direct burden on costs but probably its more serious effect is as a cause of the high exchange rate.

h. Some competitor countries have provided their industries with important cost advantages - an obvious example is energy in the United States.

The Fundamental Problem Facing the Government

The fundamental problem is that some of these difficulties arise from steps which have been taken by the Government as part of a strategy designed to reduce inflation and increase efficiency. It is important that now that the policies are beginning to bite they should not be prematurely weakened, particularly as there is now evidence that wage expectations are moderating, and that managements are pressing harder to increase efficiency. On the other hand, although considerable pain for industry is inevitable, there is obviously some point at which damage to potentially sound businesses might become so extensive that the cure was worse than the disease. In my judgment that point has not yet been reached and the time is not ripe for major fiscal easements. But the hardest hit are bound by now to be making impassioned pleas to Ministers (even if they are reluctant to do so in public because of loyalty to the Government's basic objectives). I believe it is important to stand firm, but to show understanding and sympathy by taking selective action to help where this can be done without undermining the fundamental strategies.

Steps Which Should be Taken at this Stage

A difficulty facing industry, which is not in the least of its own making and which is greater than expected and a serious advantage to international competitors, is the strength of the exchange rate. I believe that action to ease this should have a high priority. I appreciate the difficulties. The quickest way to bring it down would be a substantial reduction in interest rates but this would not be consistent with the important basic financial strategy. I believe that some of the present strength derives from inflows of "hot" money. I appreciate that measures to control such flows would be difficult to apply and might only be temporary in their effect but I believe they deserve further immediate consideration. Other countries have had the same problem, for example, the Germans and the Swiss, and have devised various arrangements to discourage inflows; for example, two-tier interest rates or specified proportions of incoming money having to be banked at no interest. I know that it is said that because of the central position of the City in the world's financial network and the vast range and volume of dealings that are done here that comparable arrangements would not work and ways for getting round them would soon be invented. However, some easing of limited duration would be valuable. I believe that the seriousness of the exchange rate effect on industry has not yet been fully appreciated and that more could be done to try and find an arrangement, which however imperfectly, could provide some relief. It might have the secondary benefit that if it inhibited the inflow of "hot" money it would also mean that in due course when interest rates come down, the outflow and consequent fall in the exchange rate should be smaller. Clearly any study would be primarily a matter for the Treasury and the Bank of England but it might be useful if the Department of Industry (and possibly the CPRS) were associated with it to avoid it being no more than a restatement of past objections.

There are other weaknesses for which industry, though there are notable exceptions, itself carries the major responsibility - for example poor marketing, and the need for better management. In both of these areas the CBI should be encouraged to do a great deal more: indeed, this is a proper way to respond to some of its complaints. At present both management and marketing skills are distributed very unevenly, and, if the need and mutual advantage were more clearly appreciated, there is no doubt that the stronger companies (which are not necessarily the large ones) could do a great deal more to help some of the weaker companies. But there are also ways in which Government can help encourage wider use of good management practices and improved marketing. The Department of Industry needs to press on with initiatives already in hand and to consider what more could be done.

Flag A

This leads on to the question of Government assistance on lines discussed by the Secretary of State for Industry in his letter of 8 August. It is important to distinguish here measures which give generalised (and expensive) assistance to mitigate the liquidity squeeze, from those selective measures which are designed to protect activities of strategic importance which may otherwise be seriously damaged or fall altogether. For the reasons already given, I do not think that this is the time to consider wide ranging measures to ease liquidity problems across the board. I think however there is a good case for a modest and highly selective package of industrial support on the lines set out in paragraph 16 of Sir K Joseph's letter. There are however certain points to be made -

a. It is desirable that the emphasis should be placed on encouraging good development (where the UK has a very chequered record), rather than simply on more research (where we have a good record).

b. Even a modest support package (Sir K Joseph is proposing £50 million in 1981/1982 rising to £90 million in 1983/1984) requires considered criteria for selection. It is not clear that these have yet been adequately developed, and on past experience there are of course considerable difficulties in doing so. It is proper that Government should be reluctant to make such judgments, but if selective aid is the measure chosen it has to. DOI should be asked to put work in hand now on how the quality of selection could be improved, including possibly making more use of advisers from industry. What is required is a more systematic assessment of market based technological priorities than is yet available. Funds allocated over the next two or three years are likely to be used much more cost effectively if work on how to select is done at an early stage and not left for ad hoc or last minute decisions.

c. While it ought to be possible to accommodate the cost of a modest package, it should be borne in mind that (apart from other expenditure claims to be reconciled in PES discussions in October) a separate 'employment' package is being prepared by the Secretary of State for Employment. These packages - and their total cost - need to be looked at together, rather than separately, before final decisions are made. The timing of any announcement of such measures needs to be chosen so that they have been properly thought out, and so that if harsh measures on other aspects of public expenditure become necessary, these modest concessions can be presented at the same time as a realistic attempt to ease the most serious problems.

Summary

The main points arising from this paper are -

a. This is not the time for general measures to ease liquidity.

b. Measures to procure a temporary easement of the exchange rate should be urgently considered.

c. The CBI should be asked to give priority to improved management and marketing, and Government should do what it can to assist.

d. A modest selective package for industrial support should be considered, provided it concentrates on development (rather than research), and subject to further clarification by DOI of the technological and market criteria for application of additional funds.

10 September 1980

Ray Pennock

- N.I. surcharge cut.
  £750 per yr.
  - half to services.

- Wages.

- N. Ind. Relations Costs

Ind. Relns – [illegible] Industrial rights.

- Borrow [illegible]