PA
(cf file)

MS
8/1

MRS GILMORE

cc PS/Chancellor
PS/Chief Secretary
PS/Financial Secretary
PS/Minister of State (C)
PS/Minister of State (L)
Sir Douglas Wass
Mr Burns
Sir Kenneth Couzens
Sir Anthony Rawlinson
Mr Ryrie
Mr Middleton
Mr Bridgeman
Mr Britton
Miss Brown
Mr Burgner
Mr Cassell
Mr Dixon
Mr Evans
Mr Lavelle
Mr Monck
Mr Bottrill
Mr Aaronson
Mr Folger
Mr Ridley
Mr Cropper
Mr Cardona
Mr Ingham
Mr Lankester } No 10
Mr Vereker

1

PRIME MINISTER

You might like to glance through Annex A and Annexes C and D before Questions, since you may get some of the Select Cttee's charges thrown at you.

The Report itself is attached; Tim has sidelined some of the more awkward bits.

MS 17/12

TREASURY SELECT COMMITTEE'S REPORT ON THE GOVERNMENT'S ECONOMIC POLICY: PRESS BRIEFING

I attach background briefing on the above which will be released publicly at a press conference at noon tomorrow (CFRs having been issued at 3.00 pm today). The brief reflects inter alia discussion with the Chancellor, the views expressed by the Financial Secretary, and various conversations with Mr Ridley. It is based on the draft text given to us in advance for factual vetting, subject to amendments we understand have subsequently been made, but will still need checking against the final report as it emerges.

2. The briefing contains:

Annex A: some general points about the Committee's overall approach and some of the more important individual points of substance. These are the main positive points to try to get over.

Annex B: material on the deficiencies of the Committee's remarks on forecasts.

Annex C: material on the Committee's treatment of monetary developments.

Annex D: A note on the Committee's treatment of competitiveness. (This includes useful material on the sterling appreciation that took place under Mr Healey rather than the present Government).

Annex E: some remarks (provided by Sir Ken Couzens) in the light of the recent staff report by the IMF team. This should be used with care and is primarily intended for use in a Ministerial speech or statement. It does not refer to the IMF report as such (we do not wish to set a precedent here) but it alludes to some of its content in order to contrast the omissions of the Treasury Committee's report with the broader approach of the IMF team who saw UK policies in their proper international context and gave appropriate credit for the Government's achievements on the inflation front. (NB: Mr Healey referred publicly in 1978 to the contents of the report of an IMF mission - Hansard col 1723-1726, 25 May 1978).

3. Most of the material is pitched fairly aggressively, which reflects, I think, the Chancellor's desired general approach. But equally the Chancellor saw the aggression as being more in sorrow than in anger that the Committee should see fit to adopt such a hostile, carping and unconstructive approach.

4. You may also like to be reminded of Mr du Cann's 26 November letter about the treatment of public service pay for cash limit purposes. It and the Chancellor's letter of 24 November were released to the press (copies of the correspondence are attached to this note). But there is little of real substance now left between the Committee and the Government in this area and there are no points for us to score off the Committee.

5. The material above should not, of course, be used until the CFRs are out this afternoon. Nor (to preserve the letter of the usual conventions) should we allow the impression to be derived that the briefing is in any sense the Government's formal response to the Committee's report. As the Chancellor agreed, we must consider later, in the light of press comments etc, whether it will be to the Government's advantage formally to respond. The report as such does not require such a response since there are no recommendations in it.

J B UNWIN
17 December 1980

A

Annex A

MAIN POINTS TO MAKE ON THE COMMITTEE'S REPORT AND THEIR GENERAL APPROACH

A COMMITTEE'S GENERAL APPROACH

1. The Report is largely unconstructive nit-picking about individual aspects of government policy and the current economic situation. There are no recommendations, let alone any alternative strategy to the government's broad approach: (the analogy of the surveyors report might be used here - plenty of detailed comments on bits of the structure, but nothing on the house as a whole).

2. The Report is not even coherent or internally consistent. For example, the Committee suggest that monetary conditions have been simultaneously too tight and too lax. Again there are complaints about increased public spending this year - a good part of which is due to the impact of the recession on the financial position of nationalised industries, yet elsewhere there is concern expressed about cutbacks in nationalised industry investment.

3. A major fallacy is the attribution of too much importance to government policy as a determinant of economic performance. The main reason for present failings is the cumulative impact of many years' poor industrial performance (under governments of both Parties), compounded now by the world recession (which the Committee effectively ignore) and the increase in oil prices. The Committee largely ignores these points.

4. The Committee remain obsessed by forecasting which (as the Chancellor and his predecessor have stressed many times) is a very inexact science. Too much is made of the - entirely unsurprising- fact that 8 months after the Budget the government now has a rather different forecast for the economic outlook. At the same time the Committee seek to put the gloomiest possible interpretation on recent events and continue to ignore the fact that the Treasury's forecast for 1981-82 is in many respects not far out of line with the views of reputable outside forecasters (see para 6 below).

5. This Report (and other aspects of the Committee's performance so far) must come as a disappointment to those [like the Chancellor himself] who saw in the new Select Committee system the potential for promoting a more informed and responsible debate about the real problems facing government. The Committee have not really progressed beyond the catalogue of observations in their Second Report 1979-80 (on the Budget and MTFS) and have not offered any new perspective or analysis.

B SOME INDIVIDUAL POINTS OF SUBSTANCE

(a) Path of output

6. In their commentary on the path of demand over 1981 the Committee apparently seek to leave the impression that output is likely to be much more depressed next year than the Industry Act forecast suggests. Naturally they offer no firm view of their own but they might at least have paid some attention to recent forecasts from respected outside bodies. Recent forecasts from eg Phillips & Drew, LBS and NIESR all agree in predicting no further fall in GDP during 1981 and indeed signs of the beginning of an upturn by the year end.

(b) Fiscal policy and 1981-82 PSBR

7. Throughout the report it is most unclear whether the Committee accept that the PSBR can properly be allowed to rise above trend in a recession. This is one of the key considerations for the 1981 Budget and it would have been helpful to the debate to have had the Committee's views. The government has made it clear that (as the MTFS provided) it believes the effects of the recession on the PSBR should be taken into account.

(c) Impact of recession on manufacturing

8. It is common ground that, partly because of unexpected strength of sterling [beyond government control], manufacturing has been particularly hard hit. The Committee say nothing on this that Treasury Ministers have not already told the House. Indeed as long ago as his October speech to the Party Conference and again in the 24 November statement the Chancellor stressed the need to ease the burden now falling on industry and indeed has already taken important steps in this direction (eg stock relief, weighting of NIC

contributions next year on to employees, measures to provide direct help to industry and employment).

(d) "Reentry" problems

9. The Committee claim that

(a) the shake-out of labour will mean fewer new jobs than usual when output recovers;

(b) pay pressures may grow again as profits recover

but (a) because they have not hoarded labour during the recession firms may well take on more new workers when the upturns comes;

(b) there is encouraging evidence of a new realism in the pay field and no reason to believe the lessons underlying it ("not pricing yourself out of a job") will not persist. The Committee's fears about a reversal in the current reduction in inflation have no foundation and can themselves only help to damage the prospects.

(e) Public expenditure in 1981-82

10. The Report says the Treasury cannot provide any additional information for 1981-82 beyond the policy changes announced on 24 November. This ignores the information given in the Chancellor's statement when he said "I now expect the volume of expenditure this year [1980-81] be some 1½% higher than expected at the time of the last White Paper" (col 313) and that "our aim is to keep the planning total for the volume of public expenditure in 1981-82 about 1% below the outturn now expected for the current year" (col 314). These two pieces of information give an order of magnitude for the planning total for 1981-82.

11. If necessary we can point out that, by simple arithmetic, the information given in the Chancellor's statement implies that the outturn for 1980-81 is expected to be between £79 billion and £79½ billion in 1980 survey prices (ie late 1979 prices) and that the aim for the planning total in 1981-82 is somewhere around £78-78½ billion.

12. The turnround in NIF Financing

The Committee states that its previously expressed fears about Government assumptions on improvements in nationalised industries' finances were well founded. The Committee fears were that in fact whether the very large improvement in NIs' financing would be achieved by 1983-84. It is much too early to deliver a verdict. What is clear - as Mr Burns' evidence emphasised - is that, because of the severity and the nature of the recession, the NIs will need to borrow more in 1980-81 and 1981-82 than was expected when the White Paper (Cmnd 7841) was prepared. However, the White Paper went out of its way to stress the uncertainty attaching to the aggregate figures for the nationalised industries, especially for the later years. This emphasis remains relevant. Nonetheless, despite the increased EFLs published for 1981-82 the Government still anticipate a substantial improvement in the NIs' finances over the period covered by the White Paper, ie. to 1983-84.

1981-82 CASH LIMITS

24 Nov 1980

The Chancellor of the Exchequer, the Rt Hon Sir Geoffrey Howe, QC MP, has written today to the Rt Hon Edward Du Cann, MP, Chairman of the Treasury and Civil Service Committee. The text of the letter is as follows:

'My stateme·ı today covers certain general aspects of the 1981-82 cash limits relating to pay in the public services. To avoid any misunderstanding I am writing now to inform you and the Treasury and Civil Service Committee of two further specific points; and I am releasing this letter to the press.

First, the prospective increase in the paybill between financial years. In particule cash limits or Votes the actual percentage increase between 1980-81 and 1981-82 in the provision for pay will differ from the announced provision for the increase in earnings from due settlement dates. The number employed may change. In some cases the settlement date is not 1 April, so each financial year will include a period at the rate before and a period at the rate after the due settlement date. In addition, the increase in the provision for pay between 1980-81 and 1981-82 will be affected in some cases by settlements having been staged in 1980-81 with increases paid later than the usual settlement dates, but such staging not being repeated in 1981-82. This last will contribu some 1% to the increase in the total public service paybill between the two years.

Second, staging. The staging of awards has in the past resulted in a higher rate of pay being carried forward into subsequent years than otherwise would have been consistent with the cash limit. This erodes the effectiveness of the cash limit system and confuses the comparisons of the growth of earnings.

The Government therefore thinks it desirable for the future to avoid the delay or staging of awards, and will avoid it where it is itself the employer. If, this general policy notwithstanding, a public services employer were to delay or stage an award, the Governmen', when setting the relevant cash limits for the subsequen: year, would not allow for the element of the award which had only been made compatible with the cash limit by such delay or staging.'

PRESS OFFICE
HM TREASURY
PARLIAMENT STREET

From: the Rt. Hon. Edward du Cann, M.P.

CH/EXCHEQUER	
REC.	27 NOV 1980
ACTION	M. Bridgeman
COPIES TO	CST
	FST
	Sir D. Wass
	M Burns

M. Ryrie
Sir A. Rawlinson

HOUSE OF COMMONS
LONDON SW1A OAA

M. Hansford — M. Unwin
M. Bridgeman — M. Bottrill
M. Fuagwara — Mrs Gilmore
M. Kemp — Mrs Woods
M. Ridley
M. Cardona

26 November
1980

Mr Folger
Mr Bush
F(SCT1)

27/xi

Thank you for your letter of 24 November about the way in which Civil Service pay is to be controlled in future.

Let me say at once that the Committee warmly welcomed the way in which you have gone a long way to implement the recommendations made in their Fifth Report. We had noted the Treasury's observations on the Fifth Report with some concern and we had intended to publish a further report which would have been critical of these observations. This will not now be necessary, and the Committee is glad that it is not. However, the Committee wished to make certain observations which we hope will be helpful to you. The Committee read your letter as meaning that a full explanation will be given at the relevant time explaining any difference there may be between the actual percentage increase between 1980/81 and 1981/82 in the provision for pay and the announced provision for increases in earnings from due settlement dates. As you point out there could be a number of reasons for any such differences and the Committee are convinced that it would be most helpful for a proper understanding of Government policy if the reasons for these differences were spelt out in full.

The Committee particularly welcomed your assurance that the Government will, in future, avoid the staging of awards which has given rise to confusion in the past and made control of total spending the more difficult. They are also glad to see that where a staged award is made by a public services employer, the Government, when setting the relevant cash limit for the subsequent year, would not allow for that part of the award which had been fitted into the previous year's cash limit by delaying or staging.

The third main point in the Fifth report stressed the difficulties which arose from splitting the provision for pay between the main Departmental Estimates and a global Estimate for increases arising from the annual pay settlement. With the suspension of pay research presumably no question of a split Estimate arises this year and the Committee trust that it will be avoided if and when pay research is resumed.

The text of this letter is being released to the Press.

The Rt Hon Sir Geoffrey Howe, Q.C.,M.P.,
Treasury Chambers
Parliament Street
S W1P 3AG

Annex B

ECONOMIC FORECASTS

GDP and demand

1. The Committee's report rightly stresses the uncertainties still remaining over economic developments in 1980 and points out that although the patterns of expenditure and output were somewhat different from those in the Budget forecast, the fall predicted for GDP this year was quite close to the 3% fall now expected.

2. We should stress the fallibility of the forecasts and the importance of not interpreting them too literally. Hence the reluctance on the part of the Chancellor and officials to be too precise. Of course any forecasts offer only a precarious foundation for firm expectations about future developments in the economy. The report singles out stockbuilding for comment and says there seems room for further substantial destocking during 1981. Table 2 of the Industry Act Forecast shows precisely this phenomenon: destocking of £1.6 billion in 1981, a larger fall in stocks than ever before recorded. Hence any suggestion that the Treasury output forecast is contingent on no further substantial destocking is just plain wrong. The slight recovery in GDP in the Treasury forecast already allows for further substantial destocking during 1981.

Manufacturing output

3. The Committee naturally draws attention to the large downward revision in the forecast of manufacturing output for 1980, some of which was due to the unexpected amount of destocking. There is a suggestion in paragraph 12 that the fall in output, in the economy and in manufacturing, is entirely a consequence of the rise in the exchange rate. Such a conclusion is fairly clearly false.

4. In their comments on 1981 manufacturing output the Committee take what can charitably be described as an over-literal interpretation of rounded forecasts: the broad picture is one of fairly flat output from the second half of 1980 and it is absurd to read too much into quarterly fluctuations.

Unemployment

5. It is worth stressing the uncertainties in this area, though the Committee's findings seem here as elsewhere to be on the gloomy side. For instance, paragraph 20 refers to the possibility that some of the recent rise in unemployment has been due to a shake-out of labour in manufacturing and draws the conclusion that this worsens the future prospect for employment. An alternative approach would be to stress that a shake-out resulting in improved competitiveness is favourable for long-term employment prospects.

Corporate sector and inflation

6. The Committee rightly stresses the uncertainty over recent figures, let alone over forecasts. Clearly the company sector is being squeezed. In consequence we are seeing a lower rate of increase, first of prices and now in wages. It is perfectly reasonable to point out, as the Committee does, that the reduction in the inflation rate has been achieved at the cost of a severe squeeze on profit margins, but the Committee could also have laid emphasis on the ensuing reduction in wage settlements.

PSBR

7. In the concluding paragraphs of their report, the Committee assert that the Treasury's estimate of the PSBR in 1981-82 is about 4½-5% of GDP at market prices. In fact such a figure, or range, is not contained either in the Industry Act Forecast or in the subsequent evidence to the Treasury Committee. On the 1981-82 PSBR the Industry Act forecast said simply:

> "... on the basis of the fiscal and monetary policy assumptions [emphasis supplied] used in constructing this forecast, the prospect is for some fall in the PSBR as a percentage of GDP." [ie to something below the estimate of 5% of GDP quoted for the 1980-81 PSBR]

We must not be drawn beyond that statement. But it is important to note that the Committee misrepresents the government's position on the 1981-82 PSBR. It has been made abundantly clear that a judgement on the 1981-82 figure will be taken in the Budget and consistently with the need to restrain monetary growth. So the Committee is tilting at a windmill with its questioning about consistency of the fiscal stance with a particular monetary growth target.

Annex C

MONETARY DEVELOPMENTS

Inflation and Money

(i) The report comments that '... it is not easy to relate this success [in reducing inflation] to a close control of the money supply.

The point of this oblique remark is unclear. There are, as we have often pointed out, a number of factors which may influence the rate of inflation in the short term. The level of the exchange rate, and the trimming of margins on the part of companies in order to reduce stocks are two current examples. But there is considerable evidence, which we have drawn to the Committee's attention, attesting to the decisive impact, in the medium and long term, of the rate of growth in the money supply. If the Committee wishes to contest the existence of such a relationship it should say so.

Money Supply

(ii) The report also claims that the Treasury's explanations of the excessgrowth of £M3 are circular and argues that the Government has completely failed to control its one target variable.

Of course it is true that the counterparts discussed by Treasury officials at the hearing have the characteristics of an accounting identity. But the current account of the balance of payments and the PSBR are the counterparts of the private sector's demand for financial assets generally and changes in them do therefore tell us something about the demand for money. Movements in bank lending to the company sector reveal evidence of the financial imbalances between sectors. It is frivolous to describe the explanations offered for recent changes as 'saying that the money supply has risen because the money supply has risen'.

(iii) Paragraph 43 claims that 'there has been a suspension of the money supply numbers'.

We accept that the £M3 figure for 1980-81 will probably not come within the target range, although the Chancellor has explained the reasons why we expect growth to be lower in the latter part of the financial year. But the target is not suspended. At this stage in the financial year the Government's ability to influence the rate of growth is clearly limited, but the National Savings initiative, for instance, will be helpful to monetary control. We certainly hope to see the rate of growth move back towards the top end of the target range. The essential commitment remains to the MTFS and a new target consistent with that approach will be announced at the time of the Budget, together with any fiscal action needed to validate it.

(iv) Paragraph 44 appears to question the reasons for the 2% reduction in MLR announced on 24 November.

The reasons for the reduction were explained fully at the time. We observed a sizeable financial imbalance between the company and personal sectors, increasing signs of monetary stringency in the behaviour of the other aggregates, and rising real interest rates as inflation fell. It was right to take account too of the prospective slowing of monetary growth over the rest of the year, eg as bank lending slowed down (as it is now seen to have done in November). To have maintained MLR at 16% would have implied an increasingly restrictive policy.

Annex D D.

COMPETITIVENESS

Facts

1975=100

	IMF index of UK relative normalised unit labour costs	Relative export prices
1977	89.2	102.1
1978	96.5	108.4
1979	111.8	115.8
1980 Q1	126.1	123.3
Q2	134.0	127.2
Q3	140 *	131 *
Q4	147 *	135 *

* Treasury projections; precise figures not for public use

On the IMF measure, competitiveness has declined by 65% since 1977 (a low point): some 50% since 1978 and around 30% since May 1979.

Points to Make

(i) The Government has not sought this decline in competitiveness. Since 1978 two fifths of the decline is accounted for by the rise in the nominal exchange rate and three fifths by the faster rise in UK costs relative to costs abroad. So the decline owes as much or more to continuing to pay ourselves more than we can afford than to the rise in the exchange rate.

(ii) Although no one understands all the reasons for sterling's strength, there is little doubt that the main factor is our possession of North Sea oil in the face of continued uncertainty in the world oil market. High sterling interest rates may also be a factor, but their effect is smaller and much less certain, as demonstrated by recent events. Over the last six months the \$/£ interest differential has shifted from 6% in sterling's favour to 6% in the \$'s favour; while the £/\$ exchange rate is now at much the same level as it was six months ago.

(iii) Of the rise in the exchange rate since 1976 more than half took place under Mr Healey's stewardship.

	rise in £/\$ exchange rate
End October 1976 - 4 May 1979	31%
End October 1976 - 15 December 1980	47%

(iv) Despite the loss of competitiveness exports are keeping up remarkably well, and there are no signs of a surge in imports. The current account surplus is running at record levels, totalling £2.3 billion over the six months up to November.

(v) For the future there are factors that may help to ease the strength of sterling to set against those that have been supporting it. The balance of payments figures show that capital outflows made possible by abolishing exchange controls are still accelerating; as UK interest rates fall these outflows may be swollen by increased overseas borrowing in the sterling market; and as countries such as Germany and Japan get their balance ofpayments back into better shape some of the relative attractions of sterling may diminish.

INTERNATIONAL CONTEXT AND IMF VIEWS

The Committee say in their Report that they have concentrated on developments in the economy in the 8 months since the Budget. They do rather seem however to fall into the error, not unknown among some economists, of writing as if the whole world consisted of the British Government and the British macro-economy, and that everything that happened to the latter was the result of the actions of the former.

2. For example, there is no recognition of the impact on our effective exchange rate of the Iran-Iraq war, of the uncertainties over Poland, of the development of the OPEC surplus and of the deficits of countries like Germany. There is no recognition of the development of the US recession since our March Budget. It is perhaps natural that, by contrast, the recent IMF mission at the time of its annual visit to the UK specifically took the point that we were seeking to achieve the control of inflation in an unfavourable world environment. But they stressed that they supported the objectives and broad thrust of our medium term strategy and agreed with our judgement that the control of inflation is necessary in Britain to establish the basis for sustained growth.

3. Similarly, the Treasury Committee's Report has little or nothing to say about the recent evolution of pay and its contribution to economic developments: indeed its references to pay are largely confined to some rather technical remarks about civil service pay in cash limited programmes. The Report discusses the squeeze on industry's profit margins as if this was the result of Government policy or miscalculation. The IMF mission on the other hand while welcoming the moderation in wage claims in the present round, said that a further deceleration of wage increases appeared to be indispensable before a significant recovery in profit margins and therefore in output could be expected, and expressed the hope that such a deceleration could be achieved without too much delay in both private and public sectors. They also endorsed the steps the Chancellor announced on 24 November as appropriate to a situation in which, in spite of the £M3 figures, monetary policy has proved to be tight, and in which action to correct the course of the PSBR was necessary.