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cc B. Ingham

cc Cabinet Office

Prime Minister.
for 'E'.

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4/6/80.

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PRIME MINISTER

INFLATION AND PAY

In recent weeks commentators and critics have been probing the Government, trying to find inconsistencies between our emphasis on monetary control as fundamentally necessary if inflation is to be mastered, and what we have been saying about the impact of pay increases on the price level. Terry Burns here has now prepared the attached very helpful paper which puts the impact of pay on inflation in the wider context. You and the other members of E Committee may like to see it as background to our discussion of public sector pay on Thursday, 5th June.

2. I think it important to stress the temporary and transitional nature of much of the present inflation. This reflects once-for-all action by the Government to get nationalised industry prices and rents on to a sounder basis, and to shift some of the burden of taxation from income tax to VAT. Most of these special factors are now behind us, and the monetary side of the economy is under control. If monetary growth now affects inflation with the normal lags, there will be some unemployment as a consequence; action by wage bargainers which lengthens those lags will inevitably make unemployment worse. Conversely, action to shorten them will reduce the unemployment problem.

3. Another important message in the paper is that the high exchange rate does not call for specific action by the Government; rather it has clear implications for action by those operating in the market place - lower costs

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(particularly wage costs) and higher productivity are essential if competitiveness is to be sustained.

4. Within this framework the market forces for pay deceleration should be felt in the traded goods sector - labour intensive manufacturing will be most affected. Thereafter the rest of the private sector should follow the deceleration in manufacturing pay as the labour market weakens. What does this imply for pay in the public sector? One approach would have public sector pay decelerating in line with average private sector pay; this would not cause distortion within the public sector, but would still involve moving away from the current backward-looking comparability system and would still leave manufacturing facing the brunt of the pay battle. The alternative would be to try to bring public sector pay more into the front line, along with pay in manufacturing. This would involve not just ensuring that comparability operates on a current rather than a backward-looking basis, but also setting cash limits figures to take account of the varying levels of pay in different sectors and enforce the chosen level of pay increases. The course we should steer is the subject of our discussion later this week.

5. I am copying this minute to other members of E Committee.

Martin Hall

p.p. (G.H.)
4 June, 1980

[Approved by the Chancellor of the Exchequer and signed in his absence]

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INFLATION AND PAY

It is essential as we approach the difficult problems of pay to have a coherent explanation of the current rate of inflation, and its implications for the coming pay round. A public explanation that exaggerates the 'blame' for the recent high rate of inflation on excessive pay increases could be shown to be misleading - because much of the rise in the retail prices index over the past year stems from increases in energy prices, rents, the mortgage rate and VAT - and this would blunt the crucial message that moderation in pay restraint is essential to preserve jobs. Moreover, it would treat inflation in a totally different framework from the broad thrust of Government policy.

2. The rate of inflation at any time can be thought of as having two components:

> First, some part of the increase in prices will be due to the underlying growth in money supply, allowing for lags;
>
> Second, a further part will reflect the influence of a mass of special factors many of which will be temporary. These will include changes in world oil and commodity prices, in indirect taxes and in administered prices of, for example, the nationalised industries and local authority housing.

Over a number of years the influence of the second component should be zero, but in particular years it can have a significant positive or negative effect.

3. Inflationary pressures take time to build up. The underlying causes usually lie in the past. The recent rise in inflation is no exception. It reflects primarily the acceleration of monetary growth and fiscal expansion during 1978 and 1979. Whereas sterling M3 rose at an annual rate of 7 per cent between mid-1975 and mid-1977, it increased at more than twice that rate between mid-1977 and mid-1979 (if allowance is made for the effects of the bill leak).

This acceleration was associated with a major change in budgetary stance, involving increased public spending and tax cuts initiated in the autumn of 1977. This monetary and fiscal pressure continued until the autumn of last year, as the June 1979 Budget had the effect of concentrating tax reductions in the first half of the financial year. The problems of monetary control have put considerable upward pressure on interest rates. This in turn has raised the mortgage rate, which has a direct impact on the RPI.

4. However, a large part of the recent acceleration in inflation is attributable to special or temporary factors. The most important of these are:

(i) World price pressures from the rise in commodity prices. This is largely the effect of the further doubling of oil prices which has had a direct effect on retail prices equivalent to its effect in 1974. To some extent, the UK has been sheltered by the appreciation of sterling. Nonetheless, in sterling terms, wholesale input prices (including oil) increased by 26 per cent over the last year; in contrast, between 1977 and 1978, they fell by just under 4 per cent.

(ii) The necessary and overdue reduction in subsidies and nationalised industry external financing limits brought about some large increases in "administered" prices including council house rents. In some cases, particularly, energy, there was severe under-pricing by the nationalised industries and this, if it continued for long, would lead to a serious waste of scarce resources. Hence our policy decision to correct underpricing on a phased basis. There is an obvious contrast here with 1978, when downward pressures on local authority rates, rents and nationalised industry prices reduced the published inflation rate - but stored up enormous problems for the future. When mortgage rates come down, the housing element in the RPI will benefit.

(iii) The one-off switch from direct to indirect taxation announced in the June 1979 Budget added about 3½% to

the recorded inflation rate (the year-on-year change in the RPI) but this will drop out of the figures later this summer.

(iv) The backlash effect from the previous administration's attempts to hold down pay (including public sector pay).

5. A framework that places important emphasis on monetary behaviour as the long-run determinant of inflation can still allow for important short-run effects following sharp changes in particular prices or expenditure taxes. The result of these increases should be a "once and for all" increase in prices, but there can be longer run effects if pay bargainers gain compensation for the price increase. The temporary factors described above have all been adverse in their effect on prices. Most of them, by their very nature, reduce real personal incomes. There is, for example, an inevitable reduction in real take-home pay involved in making good the public sector pricing anomalies. However, a notable feature of the present pay round has been the unwillingness of pay negotiators to accept any increase below the increases in the RPI, despite cuts in income tax.

6. While the implication of this analysis is that it is easy to overstate the extent to which private sector pay settlements have added to the current inflation rate, this is certainly not to deny that if earnings growth had been lower in 1979 inflation would now be lower. The lags in the process mean that prices are not being affected by the current and previous wage rounds. The current pay round will continue to have implications for prices and unemployment later this year and beyond. The outlook for prices is now worse than forecast earlier in the year. The implications for unemployment are also stark; the enormous and potentially suicidal error that is being made by pay bargainers is to think that they can justify pay increases in line with the RPI. This ignores the fact that a considerable part of the current rate of price increases is due to factors that do not justify compensation in the form of higher pay. It is vital to get this message across.

7. The policy decisions on VAT, nationalised industry prices and public sector charges were all taken for their beneficial effects on the "supply side" of the economy. It is important that they be

seen as a special or once-for-all adjustment if continuous upward pressure on the inflation rate is to be avoided. The likelihood is that unless behaviour changes these decisions will make the task of reducing inflation that much greater - both in tersm of the time lags and lost output and employment. These implications of the current level of pay settlements make an overwhelming case for urging pay restraint pervasively, and not by references to small and nicely calculated amounts or percentages.

8. It is also important to recognise that even though wage claims may be 'explained' by previous monetary behaviour and the impact upon the price level of the temporary factors mentioned above this does not justify such increases. The transition problems of bringing down inflation are much smaller if wages are determined by reference to current and future monetary growth rather than being influenced by the events of previous periods. Everyone always thinks pay moderation is for the other man and average pay increases turn out too high - and with it unemployment also turns out unnecessarily high. Turning attention from what is past to the implications of current (and future) monetary growth is a vital part of the campaign on pay.

9. There are several clear signs that pay settlements have been sufficiently rapid to create major unemployment problems.

(i) Over the three years since Spring 1977 earnings have risen by a total of 12 per cent more than prices. Over the same period national output, including the output of North Sea oil, has risen only by 5 per cent. The inevitable result is severe pressure on company profits.

(ii) In some major competitor countries wage earners are accepting pay increases well below the going rate of inflation; normally in the industralised countries pay increases are 3 per cent more than price increases, reflecting the gain in productivity. This year earnings increases are on average 3 per cent less than the current rate of inflation as consumers

recognise that they cannot have compensation for oil increases. In the UK we cannot use this argument, as we are virtually self-sufficient in oil, but we have our own special circumstances.

(iii) Over the past year the exchange rate has risen by about 10 per cent. And yet earnings growth in the UK has been about 10 per cent faster than the average for other countries. The result is a serious loss of competitiveness. A major loss of jobs is inevitable.

10. As unemployment rises rapidly in the months ahead it is necessary to link this effectively to the costs of high wage settlements. The exchange rate should be shown to be a central feature of the need for pay restraint. There is no point in employers and employees complaining to the government about the exchange rate. What is important is that they react to the exchange rate and that implies negotiating lower pay settlements.