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Ewan PS.



Treasury Chambers, Parliament Street, SW1P 3AG
01-233 3000
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T. Lankester, Esq.,
Private Secretary,
10, Downing Street

Dr Tref

B.

MC

INFLUENCING NATIONAL PAY BEHAVIOUR

.... I enclose a copy of a Treasury ^{paper} for discussion at tomorrow's meeting at 5.00 p.m. at No.11.

I am copying this letter to Bernard Ingham and John Hoskyns, and to Douglas Smith in the Department of Employment.

G. aw,
MA

M.A. HALL

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INFLUENCING NATIONAL PAY BEHAVIOUR

1. People's expectations about pay settlements are influenced by a number of considerations, including past and future expected rates of inflation and what other groups have settled for. Although there has been some variety in the level of settlements over the last year, following the removal of all restraints, there has still been a tendency for some kind of going rate to emerge, or at least a range within which people expect to settle. The range of expectations for settlements at the moment is around 18%, with total earnings some 3% above this. There has been a tendency for the range to edge upwards in the last few months, while the RPI has been rising.
2. The danger is that we will move into the Autumn with expectations still hovering at around this level. So the climate may be one in which settlements of say 13% or 14% are regarded as low and 16% or 17% will be considered satisfactory. What is needed is to create a climate in which the figures to which people's minds naturally move are lower than this.
3. **It is of course** important to avoid anything which looks like the Government setting a norm. But one can distinguish between a government-announced norm and a range of expectations which can grow up. In countries which have been more successful in dealing with inflation, such as Germany, there is no norm; but there is a range of influences on employer and employee behaviour which help keep expectations within a range which is compatible with moderate or falling inflation. It is not easy to exercise a downward influence^{on} expectations. But by drawing on economically defensible figures which point to substantially lower increases in earnings it may be possible to bring home to people the step change in expectations which is necessary. This note considers the various arguments which might be used to induce a climate of expectations in which pay settlements over the coming year will be of an altogether smaller order of magnitude than last year's.
4. The two factors which provide the clearest guide to the general level of pay settlements which can be accommodated without causing additional inflation and higher unemployment are the target growth range for the money supply and the effect of relative labour costs on

international competitiveness. Other factors may also be used to influence thinking but they are less basic. And there are pitfalls to be avoided in the use of every argument.

Monetary Targets

5. A strong case can be made that if wage increases in general exceed the growth of the money supply significantly this will lead to increased unemployment. It can be shown that during the 1970s unemployment rose when the growth of earnings exceeded the growth of M3, with only a short lag, and fell when they grew more slowly than M3. The two graphs attached show (i) the relationship between unemployment and the ratio of average earnings to the money supply and (ii) the percentage change in unemployment compared with a year earlier and the percentage change in the ratio of average earnings to money supply compared with a year earlier.

6. It is not possible to determine at all precisely the rate of increase in average earnings over the coming year above which unemployment would rise more than it otherwise will. The rapid growth of earnings in the past means that there is already a considerable rise in unemployment in the pipeline. But on recent evidence and given the monetary target the threshold must be in the region of 9% or 10%.

7. What use it would be best to make of this is of course another question. There is a strong case for arguing that everyone, other Ministers in the Government, industrial and trade union leaders and the public at large should be made fully aware of this underlying fact. But the fact is that the money targets are themselves a subject of controversy and arouse strong emotions in some quarters. There is a risk that the logic of this approach will be turned on its head by those who are opposed to the Government's policies who will argue that it is the Government which is creating unemployment through tight monetary policies. The Government can of course reply that the targets are essential if inflation is to be reduced. But it will be necessary to consider carefully how this argument in paragraph 5 above should be used and by whom.

Competitiveness

8. An approach based on our competitive situation points to very similar figures. If we lose competitiveness further by allowing our labour costs to continue to grow faster than in other countries, more jobs will be lost. Over the last year we have suffered a serious loss of competitiveness, with our earnings rising at about double the rate in other OECD countries on average (20% as against 10%) and the exchange rate appreciating by about 8% at the same time. This loss of competitiveness must already entail a substantial rise in unemployment. Assuming that the exchange rate does not move significantly, any further rise in our relative unit labour costs must mean more unemployment in the sector of the economy which is involved in international trade.

9. Once again one cannot be very precise. The OECD forecasts that earnings in the OECD area this year will rise by about 10%, and one might reasonably assume that the rate of increase will be similar in the first half of 1981. Making allowance for improvements in productivity, unit labour costs in our main competitor countries, on average, are likely to be rising over the coming year by something substantially less than 10%, perhaps as little as 7%. In other words, if we are to do no more than avoid a further loss of competitiveness through labour costs over the coming year (a modest aim), wage settlements ought probably to be in single figures. There is a strong case for saying that if settlements in industries involved in international trade in general exceed about 10% there will probably be a further loss of jobs.

10. This argument is open to the objection that competitiveness can be influenced by the exchange rate; and if during the year the exchange rate fell significantly the argument might be weakened. It may also be argued that the high exchange rate is in part a consequence of the Government's monetary policy, so that it is the Government, in fact, which is creating unemployment. But there are strong and widely accepted arguments against depreciation of the exchange rate as a means of improving competitiveness and it should therefore be possible to carry some conviction by arguing that an increase in labour costs in the industries involved in international trade beyond a figure of

roughly 10% implies a further loss of jobs. But once again it will be necessary to consider how such an argument should be presented and by whom.

Retail Price Index

11. The RPI obviously has a powerful influence on wage expectations - indeed perhaps the most powerful single influence. Arguments related to the RPI, if they are to be successful in reducing pay expectations must rely on convincing people

a. that they should accept wage settlements below the RPI ie accept a cut in real earnings- and

b. that the RPI will be falling over the coming year (for reasons other than pay restraint). The forecast is that the movement of the RPI through the 1980/81 pay round may be about 13.5%.

12. These two arguments taken together could be used to mount a case for figures not greatly different from those suggested by the arguments based on the money supply and competitiveness. The public understands well that high wages result in high inflation. One would argue that if inflation is to fall further without a substantial further rise in unemployment, wage settlements must keep below the forecast rise in the RPI. One could reinforce this by pointing to the behaviour of other countries. In the OECD as a whole average earnings have increased by less than retail prices over the last year, although this picture is dominated by experience in the United States, where consumer prices have been increasing by about 6% more than earnings. But in a number of other countries also - Netherlands, Sweden and Australia for example - earnings are rising more slowly than prices. In Germany, France and Japan earnings are just keeping pace with inflation; nevertheless because of high productivity growth this implies an increase in unit labour costs in these countries well below the rate of inflation.

13. The difficulty about relying too much on this argument is simply that it invites people to think in terms of the RPI and this probably tends to make them think in terms of matching it. There is also the

difficulty of persuading people that the RPI will fall as much as the Government expects - there may be some scepticism about this, especially since we have just come through a year in which the RPI was rising and a number of groups who settled early in the round believe they have lost out in consequence. The TPI is not likely to offer much additional ammunition since it is forecast to run at annual rates above the RPI over the next pay round.

Cash Limits

14. The Government's own decisions about pay in the public services will have an important impact on the general atmosphere. Obviously it will be essential to consider any proposals for putting about figures which one might hope would influence the private sector against this background. The question of the precise level at which cash limits for pay should be set is a difficult one which will require careful consideration. It is too early now to come to conclusions about this and indeed the question when the limits should be set and published is still undecided. However, the Government can expect to exert some influence on the general climate merely by going for lower figures for the public services than last year, illustrating its determination to get inflation down. But how much lower? The Chancellor has already indicated that the cash limit of 13% in the Rate Support Grant must be the starting point for deciding the provision for 1981/82, by which time inflation should be falling. Will it be realistic to envisage going as low as the range of figures suggested by arguments based on the money supply and competitiveness? Conversely if those arguments, suggesting figures in the region of 10%, were used by the Government would this make it difficult for the Government to set cash limits for pay in the public sector any higher, eg at 12%?

Conclusion

15. All this suggests that the following questions should be considered urgently

- a. Should the Government embark on an effort to influence thinking and pay behaviour using not only general arguments but arguments which suggest a range of figures significantly lower than present expectations?

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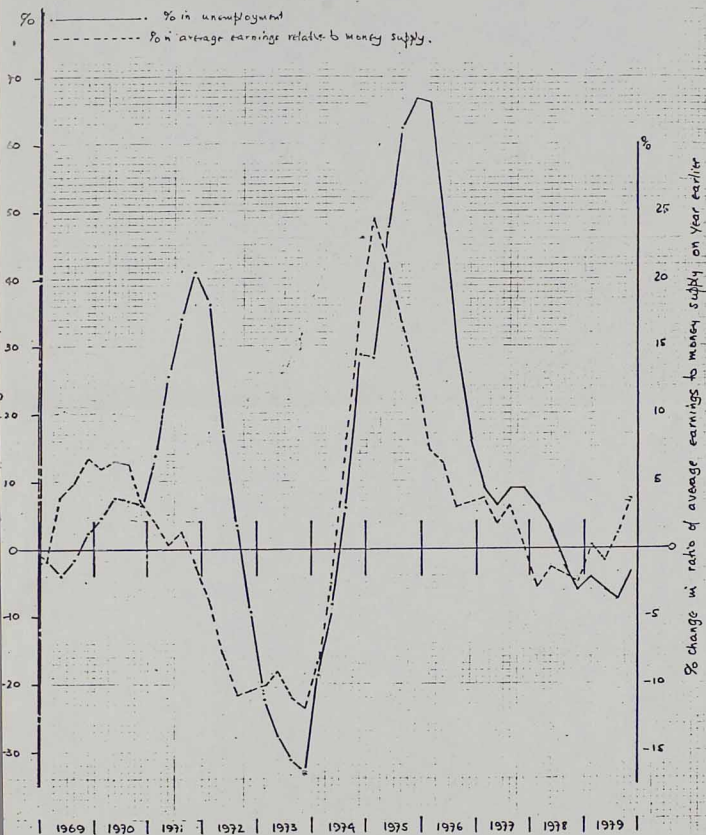
- b. If so, should the arguments based on the money supply and competitiveness be used so as to suggest that settlements exceeding something like 10% will add to unemployment?
 - c. What use should be made of arguments relating to the RPI and reductions in real earnings?
 - d. What implications does this carry for the fixing of cash limits and what line should Government spokesmen be taking on this question now?
16. There are also questions about who should put forward any arguments on this subject and when. It could be argued that some of the ideas discussed above - for example the argument based on the money supply - should be presented by others such as the Governor of the Bank of England or the CBI rather than Ministers.

by reference to monetary growth. The high level of settlements in the last pay round has exacerbated the problem for this year, both because of the precedents they have set and because the starting point for the next round will be above the level assumed when the monetary targets were set. The savings and settlement figures can only therefore have a value as a reference point, being a figure which is substantially more than can be afforded this year.

CONCLUSION

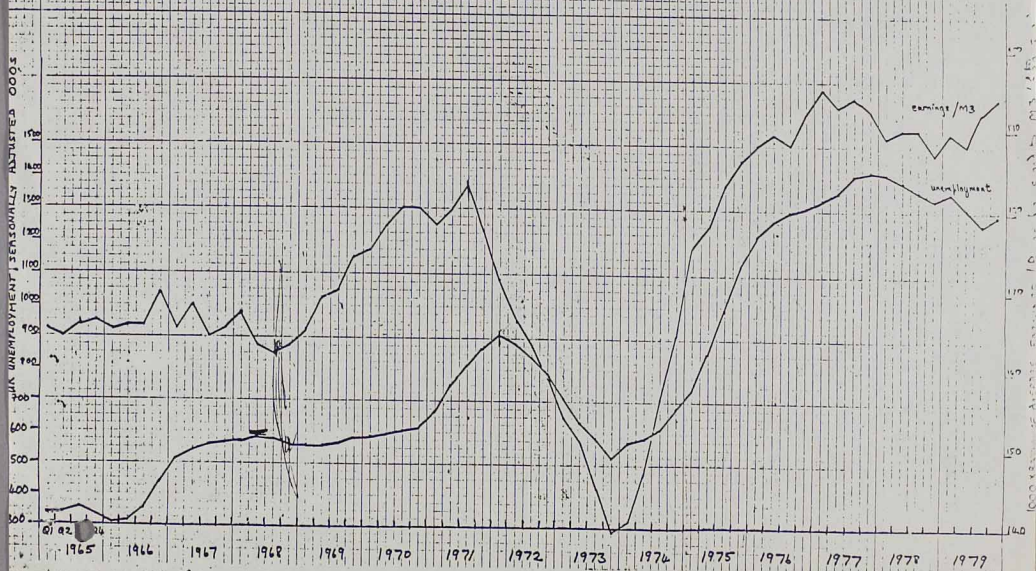
15. The increases in earnings which would be consistent with the planned growth in the money supply and at least maintaining our competitiveness would be in single figures. The prospects of actually achieving this in the next pay round are slim, but nonetheless the importance of these criteria for determining the appropriate level of pay settlement means that they should be given prominence in the hope of exercising a moderating influence on settlement levels. It must be made clear that the consequence of failing to meet our monetary targets and maintaining competitiveness will be either a substantial reduction in real income with a minimal increase in employment or the maintenance (or a small fall in) real incomes with a considerable increase in unemployment. We need radically to change the climate of wage bargaining and this cannot be done without indicating that the problem is a serious one which will necessitate some hardship.

16. If the Chancellor agrees that this message is one which should be put across, a number of questions arise on presentation, but these can probably best be considered in the context of further work on the education/publicity campaign. Our present concern is to establish whether he considers that the message of the importance of the figures for growth of the money supply and competitiveness in the pay bargaining context should be developed.



GRAPH 1

$y \leftarrow \frac{M}{P}$
 $GDP \leftarrow \frac{M}{P}$





16 JUN 1960