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RECORD OF A MEETING BETWEEN THE PRIME MINISTER AND SIR RAY PENNOCK AND SIR TERENCE BECKETT AT 10 DOWNING STREET AT 1145 HOURS ON WEDNESDAY 12 NOVEMBER 1980

Present:

Prime Minister	Sir Ray Pennock, President:CBI
Mr. David Wolfson	Sir Terence Beckett, Director-General: CBI
Mr. Clive Whitmore	
Mr. Tim Lankester	

Economic Policy and Industrial Situation

Sir Ray Pennock first reported briefly on the CBI Conference in Brighton. On the first day, there had been a discussion on the economic situation, overseas trade and industrial change; and this had been followed on the second day by a discussion on industrial relations and the Employment Act. The main impression of the Conference was the overwhelming support for the resolution on interest rates and the exchange rate. Both these factors were at the forefront of CBI members' minds. The Conference had supported the Government's basic aims - to bring down inflation and public expenditure; and members were pleased with the decision that had been taken on the 6% pay assumption for the Rate Support Grant. But they questioned whether the Government fully understood the gravity of the industrial situation: the latest CBI survey showed that more than 80% of companies' order books were below normal. Good companies were going out of business, and export volumes were beginning to fall and export profitability was vanishing.

Sir Terence Beckett said that he had taken on the job of Director-General because he was concerned about the future of British industry: he had given up a much more comfortable existence at Ford. He was determined to help industry get back to prosperity. He had completed seven visits to the regions just before the Conference, and had talked to the CBI Regional Councils and also - where they existed - small firms' councils. The impression he had obtained from these visits was that, while CBI members were not panicking,

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they were finding the speed of adjustment that was required of them too difficult; and they felt that the Government's general approach to industry was proving very destructive. In industry after industry domestic demand had collapsed between the first and second quarters of 1980. There was intense criticism of Government, particularly on the public expenditure front; and the feeling that the private sector was having to bear the brunt of the recession. There were also individual complaints about Government induced price increases - particularly in the energy field. Companies recognised that some of their troubles were self-inflicted because of the excessive pay increases of the last two years; but many of them also felt that the Government was to blame for their difficulties. All too often they seemed to be closing whole plants rather than improving efficiency and keeping them open. A more gradual approach on the Government's part would be more likely to lead to improved efficiency rather than closures. Industry also needed hope. New investment and expenditure on R&D was quite inadequate, and would continue to be so unless industry could see better prospects ahead. But when the real rate of return in industry had fallen to an all time low of 3%, it was easy to see why firms were not investing in the future.

Sir Terence went on to say that he was developing a medium term strategy for industry which would complement the Government's monetary strategy. All of the economicforecasting models were showing sharply rising unemployment over the next few years. This was partly because of North Sea Oil and the exchange rate, partly because of the deflation needed to get inflation down, and partly because they all assumed that our poor industrial performance would continue into the future. The crucial need was to invalidate this last assumption, and this would require major institutional changes. In the 19th century, Britain had had the institutions which had enabled rapid change to take place; now, our institutions had become fossilized and prevented change. His strategy would be calling for institutional changes in six major areas, of which one of the most important concerned the relationship between Government and nationalised industries. At present he had no specific proposals to make; rather he was proposing that the problems be studied by the best people available and solutions produced. He also felt it was time this country started picking winners again. There were plenty

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of examples of bad investment decisions: what was needed now were good decisions so that we used North Sea Oil to build up new industries to replace those in decline.

The Prime Minister said that industry's problems were to a large extent due to the world recession, and this was nothing to do with the Government;but the high exchange rate had also certainly been a factor. Sterling had risen faster than anyone could have expected, and it was causing real adjustment problems. But the influence the Government could have over the exchange rate was strictly limited. There was no fixed relationship between it and interest rates; moreover, industry would suffer if the rate were to plummet. Nonetheless, the Government were determined to get interest rates down as soon as possible - to give hope to industry if nothing else. But there could be no real alternative to industry adjusting to the new petro-currency situation. She was surprised that Sir Terence had implied that the Government were moving too quickly. Inflation had come down because of the tight monetary policy of last winter and because of the high exchange rate, but now monetary growth was running at an annual rate of about 19%. (Sir Terence interjected that his members in the regions did not understand what M3 meant; to which the Prime Minister retorted that they surely understood what "printing money" meant.)

The Prime Minister went on to say that she was very concerned about public expenditure. Expenditure was going up in three principal areas: defence, nationalised industries and social security. Nationalised industries were also putting up prices, and she thought CBI members could do more to criticize and bring out in the open nationalised industry inefficiency. She was also frankly amazed at Sir Michael Edwardes' comments at the Conference: he ought to at least recognise that BL were a huge drain on the Exchequer. Without the nationalised industry problem, interest rates would come down: they were a haemorrhage on the private sector. The Government had to try to bring greater financial discipline to bear on them; but they were riddled with restrictive practices and overmanning, and the only real answer was to get rid of their monopoly position. This was already being done in the case of telecommunications. As for social security, there was a

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legitimate argument that, when industry was in difficulty, retirement pensions and other benefits should not continue to be indexed.

Interest Rates

Sir Terence Beckett then said that, in the CBI's view, MLR could be reduced by four percentage points. This view was supported by many City experts, who doubted whether a much lower MLR would significantly increase the money supply - and some had argued that it would actually reduce it. Many companies would borrow less; four points off MLR would directly reduce companies' costs by £1 billion per annum. Borrowing would be further reduced because cash flow would be improved as a result of a lower pound. Public debt service would be lower, and this would reduce the PSBR by as much as £1 billion in a full year. In the view of many gilt brokers, adequate quantities of gilts could still be sold provided Government was still seen as committed to reducing inflation. Finally, the real rate of interest was now substantially positive: over the last four months the RPI had risen at an annual rate of 8%, while interest on bank overdrafts was 17-19%.

The Prime Minister said she was distressed that the CBI were asking for as large a reduction as 4%. In present circumstances, this would simply cause an explosion of the money supply because the authorities would be unable to sell sufficient quantities of gilts. While there were strong industrial arguments for lower interest rates and she was all in favour of getting them down as soon as possible, the decision on when and by how much had to be taken in a much broader context than the CBI were apparently prepared to consider.

Exchange Rate

Sir Terence said that there was no way in which industry could support the current value of the pound. He understood that there was no simple solution to getting it down, but he did think that something could be achieved not only by lower interest rates but by Ministers

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putting over the message that - at the current level of sterling - industry was quite uncompetitive. He had been disappointed by the reference to the exchange rate in the Chancellor's Mansion House speech: a stronger statement might have brought the rate down. Unless this happened, industries would be destroyed and investment would not recover. The Government had to understand that, even at its peak, oil would only represent some 7% of GNP, and that the economy would still depend very largely on manufacturing industry. The Prime Minister repeated that there was little the Government could do to influence the exchange rate; she also pointed out that some parts of industry had benefitted from the high rate.

National Insurance Surcharge

Sir Terence said that the CBI wanted the NIS abolished. This was essentially a tax on employment, and it would be much better to raise the equivalent revenue by taxing tobacco and alcohol. The Prime Minister responded that the Chancellor would almost certainly have to raise taxes on alcohol and tobacco anyway by a substantial amount in order to contain the PSBR, and there was a limit to the amount that could be raised through indirect taxes. Abolition of the NIS would be very expensive.

Public Sector Pay and Employment

Sir Ray Pennock asked about public servants' pay and the Clegg commitments. The Prime Minister said that under Labour's incomes policy, public servants had been left behind. The present Government had had no option but to honour the Clegg commitments. But now that public servants had caught up, or in some cases more than caught up, pay settlements would have to be much lower. Sir Ray also said that the CBI were concerned about the number of employees in the public services, which seemed to be much higher than in other countries. The Prime Minister said that the international comparisons were sometimes misleading because other countries' figures did not include the health service. But the Government were determined to reduce numbers; and in the Civil Service, there had been a 35,000 or approximately 5% reduction in 18 months. Sir Ray responded that the private sector were cutting back faster. His own company had cut back by 10% in 9 months without reducing the level of operation. Sir Terence said that at Ford he had reduced salaried staff by 15% in one year.

Sir Ray said that CBI members were also extremely resentful of public sector index-linked pensions. The Prime Minister said that the Scott Committee would be reporting shortly on this matter.

Information on the Public Sector

Finally, the Prime Minister said that she would like to send the CBI some facts and figures which they might draw on on public spending and on price increases in nationalised industries. Sir Terence said he would be glad to have this information.

The meeting ended at 1310.

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13 November 1980