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Treasury Chambers, Parliament Street, SW1P 3AG
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The Rt Hon Paul Channon MP
Secretary of State for Trade
and Industry

18 December 1986

Dear Paul

1986-87 PAY

As the new pay round gets under way, I am writing about the handling of pay issues.

I need not dwell long on the present pay scene. Across the economy as a whole, average earnings continue to increase at 7½ per cent per year, despite retail price inflation at 3 per cent. Lower growth in pay is essential for economic success. Every 1 per cent reduction in the rate of growth of real wages is estimated to increase employment by between 110,000 and 220,000. Last year our unit labour costs increased by 6 per cent compared with 2 per cent in USA, 1 per cent in Japan and zero in West Germany.

In the public services, lower wage settlements would allow better quality services to be delivered within public expenditure ceilings. In the public trading sector, they would help ensure that in meeting their financial targets nationalised industries do not make damaging price increases or forego investment.

Conditions for achieving lower settlements have rarely been better. While inflation will edge above 3 per cent, it will stay low. Indeed, when account is taken of tax cuts, increases in earnings of just over 2 per cent would compensate for price rises over the past year.

Private Sector

So far as the private sector is concerned, there are some signs that our message is beginning to get through. The CBI, for example, report that average private sector settlements are now running at about 5½ per cent compared with 6¼ per cent in the first half of this year. We must do all we can to make sure this trend continues. We have already made it clear that we will not relax our monetary and fiscal policies to accommodate lax pay bargaining. Pay bargainers should respond by concluding moderate settlements and I urge colleagues to continue to press this point home, and to reinforce the message the CBI is putting over.

However, we must, as ever, avoid the trap of seeming to suggest a norm (which simply becomes a floor). And of course we must avoid giving the misleading impression that we want a low pay economy. Quite the reverse: what we seek is a competitive, well paid, high productivity and high employment economy. Excessive pay rises threaten that.

The key point we need to keep pressing home is that current settlement levels and earnings increases are well above those occurring in our major international competitors, and thus a threat to jobs. I enclose some speaking notes which colleagues might draw upon.

Public Trading Sector

In the public trading sector we must use all the influence we have to get lower settlements.

One possibility which I hope sponsor Ministers will explore with Chairmen of nationalised industries and other public corporations is to introduce a greater degree of geographical pay variation, so as to get a better match between local pay and local labour market conditions. This is already a feature of some industries' pay arrangements; there is a strong case for extending it more widely.

I should be grateful if colleagues in charge of Departments which sponsor public corporations would make these points to the Chairmen; they should also remind them to keep Ministers in touch with their pay negotiations and give at least 7 days notice of offers and changes to previous offers. I am grateful for the efforts colleagues make to ensure proper consultation over pay, but there are cases where we are not consulted by the industries in time to make our views known or to influence negotiations. This is most unsatisfactory. The Chief Secretary must be consulted at least a week in advance of all pay offers being made and colleagues must make sure that the Chairmen co-operate to make this possible.

Public services

Finally there are the public services. So far as central Government groups are concerned, we should clearly be aiming for lower settlements than last time.

For the local authorities, however, pay is pretty much outside our direct control. But we must do everything we can to see that the teachers' settlement is ring-fenced.

Finally, there is the difficult position on MPs' and Ministers' pay. The problem is not, of course, the increases of about 4½ per cent due on 1 January 1987, but the substantial rises in MPs' pay (and, as a consequential, the

reduced MP's salary for Ministers) which are due to take effect in January 1988, when the link with salaries of Grade 6s in the Civil Service come into force. I will provide further briefing closer to the time on how to deal with the criticism this is bound to arouse: this will include the point that this linkage was introduced against the advice of the Government.

I am copying this letter to the Prime Minister, all Cabinet Ministers and to Sir Robert Armstrong.

NIGEL LAWSON

SPEAKING NOTES ON PAY

Facts

- Underlying average earnings growing at 7½ per cent - well ahead of prices and productivity.

- Latest comparable figures - first half 1986 on first half 1985: UK unit labour costs rose 7½ per cent, Japan 2½ per cent, US 1 per cent; France fell ½ per cent.

- Since 1979, real take-home pay of someone on average earnings up nearly 18 per cent.

- Combination of low inflation and tax reductions in 1986 Budget means that pay rises of just over 2 per cent would compensate the average taxpayer for past year's price rises.

- Every 1 per cent reduction in growth of real wages is estimated to mean an extra 110,000-220,000 jobs.

Arguments

- Companies and employees have to negotiate settlements in light of individual circumstances.

- But also have to negotiate against background (a) of what overseas competitors are doing and (b) of Government's firm fiscal and monetary policies. Will not accommodate excessive earnings growth by allowing it to feed through into higher inflation: so can only cost jobs.

- Should also negotiate in light of local circumstances, including variations by region in supply and demand for labour.

- If pay rises were lower, companies would have lower costs , so their products would stay more competitive. People would more often buy British - here and abroad. Profits would be more secure. And companies could hire more workers.

- Basic reason simple. The smaller the rise in the cost of employing people, the more of them will be employed.

- At present, profits benefiting from fall in commodity prices; but that can't last forever. And competitors have at least as much benefit as us from lower commodity prices - without incurring the same costs in excessive growth of pay.

- Industry now benefiting from improvement in competitiveness from exchange rate fall in response to halving of the oil price. Essential not to fritter this advantage away by excessive pay increases.

- Productivity gains should be used in part to cut prices and improve non-price competitiveness, so that industry can expand and produce more. Should not all be passed to existing workers through higher wages.

- In public sector, lower settlements would mean more room within public spending totals for service improvements and public sector investment.

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EUROPE

MONEY & MARKETS

Lawson Says He Doesn't Want To See Sterling Decline Further

By PETER NORMAN
Staff Reporter of THE WALL STREET JOURNAL

LONDON

BRITAIN'S CHANCELLOR of the Exchequer Nigel Lawson said he doesn't want to see the pound fall further on foreign exchange markets and said the government is "always" prepared to raise interest rates when necessary to maintain its anti-inflationary policy.

In a wide-ranging interview with The Wall Street Journal/Europe, Mr. Lawson also said he believes Britain will become a full member of the European Monetary System by joining the exchange-rate mechanism that limits fluctuations between most European Community currencies. "The question is when," he said. "It's a difficult issue. The government's view is that the time is not yet right. But the balance of argument has been swinging in the direction" of joining.

PRIME MINISTER MARGARET THATCHER, who is reportedly the main obstacle to Britain becoming a full member of the Deutsche mark-dominated currency block, was quoted recently as saying she considers the British economy too weak to join the EMS. In the interview, Mr. Lawson said he thinks the prime minister was misunderstood. "I don't think she meant that at all," he said. "She was saying we haven't got as strong an economy as the Germans have, and that is undoubtedly true."

Nigel Lawson

The 54-year-old chancellor said he was untroubled by signs of growing problems for the British economy. Despite double-digit interest rates, a revival of inflation and forecasts that Britain's current account balance of payments will move into deficit next year, he said the government would continue its present policy "because it's the policy that within reasonable margins is bringing the desirable results."

OVER THE PAST FIVE YEARS, he said, growth in the British economy and living standards has outstripped that of the country's major European competitors. Citing Britain's record of lowering inflation from a 21% annual rate in the second half of 1979 and increased output, productivity, industrial profitability, investment and exports in the past five years, he said: "you have to go a very, very long way back to find a period in which the British economy has been doing as well as it has been." Even unemployment – at 3.2 million in October – is coming down now, he said.

He admitted that Britain "is a country slow to change." The labor market remains too rigid, he said, and "there is room for a great deal of improvement in the standard and quality of British management." But Britain isn't incapable of changing, he insisted, saying many substantial improvements have occurred since the Conservative Party came to power in 1979. "It's almost a transformation, and I think that this is one of the difficulties we face in the election" that must be fought during the next 18 months. "The changes have been so great that people tend to forget what it was like in the 1970s" before Margaret Thatcher took power, he said.

In Mr. Lawson's view, Britain's refusal so far to become a full member of the EMS hasn't sapped the country's influence in international monetary affairs. "I think we have clout in international discussions that transcends economic strength because of our enormous international presence," he said. "It's not simply a matter of history and experience, but the fact that today our net overseas assets are second only to Japan. They are bigger than those of Germany, the U.S. and France."

He said Britain will play a leading part in tackling the problem of agricultural surpluses in the years ahead. "This is going to be one of the biggest if not *the* biggest problem of the next five

Please Turn to Page 22, Column 1

Fed Will Keep Credit Policy Steady In Short Term, Economists Predict

By TOM HERMAN
and EDWARD P. FOLDESSY
Staff Reporters of THE WALL STREET JOURNAL

NEW YORK – The U.S. Federal Reserve System will leave its credit policy unchanged for the next few weeks but probably will engineer further declines in interest rates early next year.

This view emerges from interviews with economists and bankers amid widespread

U.S. Credit Markets

speculation that the U.S. economy will sag in the first few months of 1987. The Fed's policy-making arm, the Federal Open Market Committee, meets today and tomorrow to review its credit strategy.

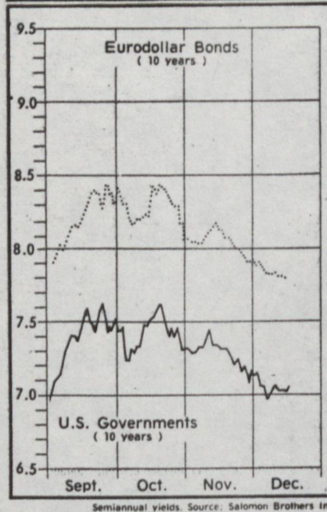
Fed officials "aren't likely to make any rules go into effect Jan. 1. In addition, many consumers have been buying big-ticket items while they can still deduct sales taxes on their federal income tax returns.

Fed officials will wait to see the effect of the tax package on the economy early next year before changing credit policy, says Samuel Kahan, chief financial economist at Kleinwort Benson Government Securities Inc. He contends the Fed would like to see the economy grow at close to a 3% pace. But he predicts business activity will expand at only a 1½% to 2% rate in 1987's first quarter, prompting the Fed to drive interest rates lower.

Easier Credit Conditions

The Fed's 12-member policy group won't make any changes in strategy at this week's meeting, agrees Philip Braverman, chief

BOND YIELDS



Semiannual yields. Source: Salomon Brothers Inc.

Group Moves To Share Data On Markets

By JOHN MARCOM JR.
Staff Reporter of THE WALL STREET JOURNAL

LONDON – British officials said an informal meeting of securities regulators from 10 countries will lead to enhanced exchanges of information among members of the group.

Britain invited the officials, who gathered last week outside London, in the hope of improving communication among authorities overseeing the world's major financial markets. British officials declined to discuss specific measures considered by the participants, who also used the gathering to hold a series of informal bilateral talks.

"The focus was on methods of enhancing arrangements for the exchange of information," said Brian Hilton, a British Trade and Industry Department official and the meeting's chairman. In particular, he indicated Britain seeks full information about entrants into its own markets from other countries. "We believe in prevention being better than the cure," he said.

Britain, which has overhauled its regulatory system to cope with the liberalization of London's securities markets, has sought to improve the flow of information with other major financial centers and recently signed a memorandum of understanding providing for information exchange with the U.S. Securities and Exchange Commission. Britain is negotiating a similar agreement with Japan and has said it will seek agreements with the others in the group.

Interest in the issue has been heightened by insider-trading cases in New York and London and the British investigation into trading of shares of Guinness PLC. Mr. Hilton declined to comment on the role of cooperation with the U.S. in the specific cases.

Mr. Hilton said it was the group's general impression that trading from offshore secrecy havens, despite its prominence in some recent cases, "is not so important a method of evading insider-dealing laws as has been suggested." But he declined to elaborate on what the group did consider the main methods.

In addition to Britain and the U.S., the authorities represented were from Australia, Canada, West Germany, France, Hong Kong, Japan, the Netherlands and Switzerland.

White House Sets Up Panel To Study Insider Trading

By a WALL STREET JOURNAL *Staff Reporter*

WASHINGTON – The White House has set up

Wall Street SEC Moves

By GEORGE ANDERS
Staff Reporter of THE WALL STREET JOU

NEW YORK – Was it necessary arbitrager Ivan F. Boesky unwin than $1.3 billion of securities posi recent months to avoid a stock panic?

The U.S. Securities and Exchang mission may have thought so, but so Street professionals aren't buying t ment. "The market has withstood f serious shocks than the Boesky case serious problems," said William P vice president at BEA Associates New York money manager. "Price have dropped in the first 48 hours, b end it would have been all right."

The question surfaced last wee SEC defended its decision to let Mr. sell stocks before an insider-tradi against him was announced Nov. 1 wasn't handled with discretion, have had a drastic effect on the m SEC Chairman John Shad told a sional hearing. "Uncontrolled sellin have ensued, he suggested.

Meanwhile, other arbitragers co complain that Mr. Boesky got a advantage by being allowed to sel details of the SEC's case were pu "If I'd known everything he did, have rushed to sell," said a major N arbitrager. "Why should his inves the benefit of his knowledge mine?"

As events unfolded, some Boesky's sales just before Nov. 14 tu to be highly propitious. In pa traders say his funds unloaded larg of Gillette Co. and Lockheed Cor those stocks were briefly buoyed over rumors. By late November, bo had fallen. By then, Mr. Boesky's p are believed to have shrunk more t from their summer peak, to less billion.

SEC Sticks to Position

On balance, however, SEC maintain that Mr. Boesky's early didn't aid his funds. Instead, it mi cost the funds profits when the stock rebounded early this month, M argued.

The SEC "was in a difficult situ terms of letting Mr. Boesky sell, Stephen Canter, head of Chase M Corp.'s money management subsid was damned if you do, damned don't."

NEW ISSUE

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Lawson Says He Doesn't Want To See Sterling Decline Further

Continued From Page 9

years," he said. "It is a problem of enormous dimensions and intractability. The huge surpluses are increasingly expensive to finance and have a very damaging effect on poorer countries which depend on exports of primary products."

But what about those niggling worries nearer home?

The annual rate of inflation in Britain has risen in recent months from its low point of 2.4% in the summer to 3.5% in November and many analysts in the City, London's financial district, predict it will continue up, perhaps beyond 5%. The Treasury forecasts that the current account balance of payments, which tallies the nation's trade in goods, services and certain unilateral transfers, will lurch into the red next year for the first time since 1979 with a deficit of £1.5 billion ($2.14 billion). And interest rates–with bank base rates set at 11%–are higher than in any other major industrialized country.

The chancellor insisted that the long-term trend of inflation is downward. "Inflation never comes down in a straight line," he said. "There tends to be a cyclical pattern in inflation that is broadly connected with the trade cycle." In this cycle, he noted, the low point of inflation has been lower than in the previous cycle and "the high point will be lower."

Fall in Oil Price

Britain's probable shift into a balance-of-payments deficit also doesn't appear to worry the chancellor. He said the deterioration in the current account largely reflects the fall in the oil price at the beginning of this year. "We lost overnight half the value of our oil exports and we are a substantial oil exporter."

Meanwhile the £1.5 billion current account deficit forecast by the Treasury for 1987 is "relatively small", he said. "Its about 0.5% of our gross domestic product or slightly less. And that's after five or six years of accumulated surplus of £21 billion and before the full beneficial effects on trade of the depreciation of sterling against the other major currencies." Over the past year, the pound has lost about 16% of its value against a trade-weighted basket of currencies, falling sharply against the Japanese yen, the Deutsche mark and other European currencies.

Mr. Lawson also had a ready explanation for Britain's interest rates, which currently exceed the traditionally sky-high rates of Italy. The looming election is playing a role, including "particularly ill-founded concern in some quarters" that the government might change its policy to win votes. The high interest rates partly reflect Britain's unit labor costs, which have risen at faster rates than those of the nation's major international competitors. Another factor, he said, has been the extensive liberalization of Britain's financial markets which has left the government with short-term interest rates as the main instrument to influence monetary policy.

But the chancellor brushed off suggestions in a recent parliamentary report that uncertainty about British economic policy–including the government's recent decision to boost its planned spending by about £5 billion in each of the next two fiscal years beginning April 1–could be unsettling financial markets and helping to keep interest rates high.

"I would suggest that the fact that our interest rates are high–instead of indicating some change of policy–demonstrates that we are pursuing an anti-inflationary tight monetary policy in order to keep control of inflation and eventually to get it down further," he said. "There's no lack of clarity in the policy. The philosophy is clear. The policy is clear. The track record is clear."

In the area of tax overhaul, Mr. Lawson said the government has achieved "more in the way of sensible tax reform" in the present legislative period since 1983 than "I can recall in any previous Parliament." Some of the British steps anticipated the recent U.S. tax restructuring. Corporate taxes were cut to 35%, providing an incentive for foreign companies to invest in Britain, and several tax breaks were abolished to lower the general level of taxes. Additionally some taxes, such as a levy on development land, a surcharge on investment income and the so-called national insurance surcharge that acted as a tax on jobs, were abolished completely.

Public Expenditure

"But the way of the tax reformer is hard," Mr. Lawson said, noting that the U.S. has a great advantage over Britain in that it has traditionally enjoyed lower tax rates, which are reflected in the new U.S. tax bill. "That derives directly from public expenditure as a small share of national output," he said, adding that Britain plans to continue reducing the share of public spending as a proportion of gross domestic product to make room for tax cuts in the years ahead.

"But there has been a big difference between us and the Americans," Mr. Lawson said. "We were prepared initially not only to get a grip on public expenditure but to put taxation up in order to reduce the grossly excessive budget deficit that we inherited. The Americans have not done that and that has caused problems for them."

Mr. Lawson's remarks preceded his weekend meeting with U.S. Treasury Secretary James Baker. The chancellor denied that Mr. Baker's efforts to increase international monetary cooperation between the Group of Five countries–the U.S., Japan, West Germany, Britain and France–had stalled following the success of the Plaza agreement of September 1985 to reduce the value of the dollar.

Persuading Japan

The Plaza agreement was "a very major development of a kind you wouldn't expect to happen very often," Mr. Lawson said. Its major achievement, he said, was persuading Japan to accept that the yen was undervalued and should rise in value to reduce the dominant role played by exports in the Japanese economy.

Fed Will Keep Credit Policy Steady In Short Term, Economists Predict

Continued From Page 9

prime, or base, rate on corporate loans to 6½% by mid-1987. The prime rate has stood at 7½% since late August.

Until a few weeks ago, many analysts thought the Fed might lower its discount rate this month. But those hopes faded after some recent government reports indicated unexpected strength in the economy. For example, the Labor Department on Dec. 5 said the number of workers on non-farm payrolls increased a strong 249,000 in November after rising 260,000 in October.

Federal Reserve figures to be released today are likely to show a healthy 0.5% increase in industrial production in November, many economists predict. Production was unchanged in October and was up a scant 0.1% in September.

Fed officials "have to ask themselves if the long-awaited improvement" in the economy finally is here, says Mr. Gramley of the Mortgage Bankers Association. "My guess is they will conclude it probably isn't. But they will will want to wait to be sure" before making any policy changes, he adds.

Some forecasters say the Fed won't move unless West Germany and Japan take similar action. They argue that the odds of another round of coordinated interest-rate reductions have greatly increased because of weak economic growth during the third quarter in both West Germany and Japan.

Nevertheless, recent increases in oil prices have sent jitters through the credit markets. Some investment managers worry that continued rises in oil prices could be a harbinger of renewed inflationary pressures.

Higher oil prices helped depress bond prices last Thursday and Friday. Some actively traded U.S. Treasury issues slumped about a point, or around $10 for each $1,000 face amount, on those two days.

The Treasury's 7½% bonds due 2016 fell on Friday to 101 10/32 from 101 22/32 on Thursday. The yield rose to 7.39% from 7.36%. The government's 7¼% notes due 1996 fell to 100 29/32 from 101 5/32, increasing the yield to 7.12% from 7.08%.

The rate on the latest 13-week Treasury bills fell to 5.47% bid Friday from 5.48% Thursday. The bid on the latest 26-week bills rose to 5.5% from 5.48%.

Havana's Creditor Banks Agree to Lend $85 Million

AP-Dow Jones News Service

LONDON–Cuba's commercial bank creditors have offered to lend the strapped country about 170 million Deutsche marks ($85 million) to meet interest payments on its foreign debt and to reschedule principal payments due in 1986 over 10 years, a source involved in the talks said.

The loan would cover interest payments due from July 1, 1986, to June 30, 1987, and would be repayable in June 1988, the source said. Those payments are estimated to total DM170 million, assuming an interest rate of 8%, he said. Cuba hasn't paid any interest on its debt since July.

In addition, the banks have offered to reschedule debts falling due in calendar 1986 over 10 years with a six-year grace period, he said. The debts involved include DM150 million of medium-term loans and DM1.2 billion of interbank credits.

The offer, agreed upon after talks among the banks Thursday and Friday in Paris, is little different than the banks' last offer over the summer. Talks then failed when Cuba held out for up to $300 million in new loans.

The bank source said the creditors remain adamant in opposing requests for fresh money but they saw little choice but to lend Cuba funds to meet its interest payments. "They have no money," he said.

A drought has curbed Cuba's agricultural export earnings while weak oil prices have reduced its earnings from the re-export of oil it receives from the Soviet union. President Fidel Castro recently said export earnings would fall by about 50% this year to about $600 million.

The banks hope to get a response from Cuba before Christmas and have a formal agreement ready for signing in January or February, the source said.

Manila, Its C To Resume

A Wall Street Journal *News Roundu*

NEW YORK – The Philippines' creditor banks, which on Friday gran nation a three-month moratorium on debt repayments, have sufficiently rowed their differences on a nego stance to justify the resumption of deb with the Manila government, b said.

"The committee has a consensus forward," one New York banker said confident that the negotiating proces again." Talks between the banks a Philippines broke down in Novemb

The three-month moratorium on that mature starting Jan. 1 giv country and its banks additional t resolve differences over the reschedu $3.6 billion in foreign debt due over t six years. The 12-bank advisory com that represents the Philippines' 48 mercial creditors met Thursday and in New York to discuss the co demands for better repayment terms debt. Philippine Finance Minister Ongpin said the committee advised pine officials Friday that it was offe three-month moratorium "to avoid tion where we would have had unilaterally."

New Repayment Terms

Earlier, Mr. Ongpin and other Ph officials had set a Jan. 1 deadl negotiating new repayment terms $3.6 billion in debt.

In addition to the moratoriu finance minister said, the banks a extend for six months a $3 billio facility that was due to expire at th the year.

Significantly, Mr. Ongpin said, th torium contains a clause stipulati whatever terms the Philippines ev negotiates with its creditors will be

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