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From the Private Secretary

24 January 1990

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SUBJECT
CeMASTER

PRIME MINISTER'S MEETING WITH
SIR TREVOR HOLDSWORTH

Sir Trevor Holdsworth came to see the Prime Minister yesterday to discuss the general economic position, and in particular pay developments. The meeting was at his initiative and followed an earlier brief discussion at a social event.

The meeting was conducted in a very friendly atmosphere. Sir Trevor's general message on pay, delivered a little diffidently, was to ask that the Government should 'trust business'. From time to time he acknowledged that the recent trend unit labour costs did point to a potential problem, but for the most part he implied that the aggregate figures were misleading and that what was happening on the ground in pay negotiations in business was more encouraging. '90 per cent of our managers recognise the problem and realise what they have got to do - but give them a chance'. At the end of the meeting Sir Trevor handed over the enclosed draft of the paper he would be putting to today's meeting of the CBI Council. At a couple of points in the discussion he referred obliquely to the CBI's allegation of 'inflationary own goals' by the Government but he did not come out at all directly with it in the way that the Council paper and other recent CBI comments do.

The Prime Minister did not respond directly to the plea to give business a chance. She noted that Sir Trevor seemed not to be as worried as she was and said that, if the pay issue was raised with her in Parliament and elsewhere, she would continue to point to the trade off between high wage costs and jobs.

Other points that came up in the discussion were:

- the CBI quarterly survey to be published next Monday would be generally encouraging. Confidence was less, with growth expected to be only just positive, but investment was holding up. Exports were continuing to do very well. And there was no upward shift in the outlook for output prices.
- a recent competitiveness study by INSEAD had put the UK at second position in Europe behind Spain. Sir Trevor was looking into the details. (I think the Prime Minister would

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- 2 -

find it helpful to have a note on this study.) Sir Trevor said that British industry was not looking to the Government to ease its position by a depreciating exchange rate. Indeed, business was strongly supportive of the Government's counter inflationary approach, and had no major complaints on interest rates.

- the Prime Minister pointed to the importance of improving our record on training; a more positive approach was needed. Sir Trevor said he thought UK training performance was improving, and particularly welcomed the development of TECs. He also made bullish comments about the UK record on research and development, but said it was important to recognise there was no great spin off benefit from large expenditure on defence R & D.
- The Prime Minister expressed concern about high levels of UK imports of straight forward products - eg cotton wool and chipboard - that UK industry really ought to be able to produce competitively. Sir Trevor was optimistic about the future trends in UK trade in cars; he could foresee the UK industry building up to produce 2 - 2.5 million units. The great strength of Japan continued to be their production, engineering and application skills. This was an area of major skill shortage in the UK.
- both the Prime Minister and Sir Trevor expressed concern about 'short-termism' by the financial institutions. Sir Trevor said that management and ownership had grown too far apart in this country. Amongst the financial institutions Sir Trevor said that life companies took the longest term view, but pension fund managers were dominated by requirements of quarterly performance. Sir Trevor thought that increasingly wide share ownership would help but that the process would be slow. The Prime Minister asked whether it was possible for business leaders to influence the behaviour of the managers of their own company pension funds; Sir Trevor said it was but had become more difficult with the growth in the number of member trustees.

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C 2 90 (Summary)

TO THE COUNCIL FOR THE MEETING ON 24 JANUARY 1990

Pay and Competitiveness

- 1 The 1989 CBI Pay and Performance Presentation demonstrated the substantial achievements made by industry in the 1980s to improve efficiency, competitiveness and profitability and highlighted the challenges in the years ahead.
- 2 More recently, the rise in pay settlement levels and unit labour costs coupled with the downturn in consumer demand are squeezing the manufacturing sector. Manufacturing productivity growth is tending to slow and economic growth has fallen back from the high levels of the 1980s.
- 3 The present inflation is not pay led; factory gate price increases are low compared to increases in mortgages and other Government imposed charges.
- 4 Public service settlements continue to follow those in the trading sector, without compensating improvements in performance or reductions in manning levels.
- 5 Members' views are sought on the following: should the CBI
 - a) acknowledge that a problem of performance not fully off-setting pay rises in the trading sector is emerging, which threatens competitiveness, while insisting that it should not be misread either as indicating that management have not tackled pay issues or as the underlying cause of present inflation;
 - b) identify all the factors contributing to current inflation and publicise the findings to counter the pay-led argument;
 - c) build on the message of the 1989 Pay and Performance presentation, by providing information about good practice on performance measurement and its use in pay negotiations;
 - d) oppose anything approaching a 'pay norm' as inappropriate and as setting a figure that will be seen an entitlement, likely to boost rather than ease inflation;

- e) press for the easement of Government-imposed charges that are contributing to inflationary pressures on pay via the RPI;
- f) carry forward work on public service pay, stressing the need for performance there to be seen to justify increases too.

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TO THE COUNCIL FOR THE MEETING ON WEDNESDAY, 24 JANUARY 1990

POLITICAL ISSUE OF THE DAY:

PAY AND COMPETITIVENESS

- 1 The CBI supports the objective of a high performance, high pay economy. A continuing improvement in our unit labour cost competitiveness is necessary for the attainment of this goal. This was the central message of CBI's 1989 Pay and Performance Presentation. With pay settlements now running at their highest level for eight years - 8.3% (Q3) in manufacturing and 8.6% in services - and concern that productivity growth will slow over the next 12 months, the danger is that labour costs will rise disproportionately in 1990, putting pressure on margins and prices.
- 2 The purpose of this paper is to report on members' reaction to the Pay and Performance presentation, to assess the developing pay scene and to suggest how CBI might respond.

The Present Pay Scene

- 3 In a wide ranging assessment, the 1989 Pay Presentation demonstrated the substantial achievements of the past decade and highlighted the challenges for 1990 and the years ahead. It emphasised that in every year since 1980, CBI Pay Databank responses had shown over 25% of manufacturing pay settlements incorporating revisions of working arrangements as part of the deal. Changes made included the removal of restrictive practices and their replacement by more flexible arrangements, appropriate manning of new technology and reductions in the numbers employed. Not all of the changes had been directly linked to pay settlements; in a number of cases the improvements have been the straightforward result of tighter management: but in all cases they should have operated to assist unit labour cost competitiveness.
- 4 More recently, there had been a substantial increase in investment levels. Manufacturing investment estimates for the second quarter of 1989 totalled over £3.1bn, 13.2% up on the previous quarter and 7.8% up on the same period in 1988. A survey conducted in the middle of the year indicated and Pay Databank figures confirmed that employers were expecting

this investment to achieve further significant productivity improvements in the period ahead.

- 5 The combination of changes in working practices and substantial investment were shown to be creating the potential for improved competitiveness through a narrowing of the gap between productivity in the British economy and that achieved by major competitors.
- 6 Responses to the Pay and Performance Presentation supported the need to maintain progress on productivity and unit labour costs. However, members also stressed that:
 - inflationary pressures were more complex now than simple retail prices, which inadequately reflected some cost-of-living elements for many employees - notably the impact of interest rates rises on many newer mortgage holders;
 - uncertainty about inflationary pressures was hampering the desirable growth of 2 and 3 year settlements;
 - future investment plans were being scaled down, which may affect maintenance of productivity improvement beyond the next 12 months;
 - labour shortages were occasionally prompting distortions to pay structures which may not be sustainable;
 - despite the CSEU's campaign in engineering, there was no major pressure on hours of work.
- 7 A further cause for concern to CBI over recent years has been developments in the public services. Data is limited and productivity more difficult to assess than in manufacturing, but settlements reported have been running at comparable levels to those in the productive sector, and little evidence of comparable performance improvements has been shown.
- 8 Earnings growth across the public sector as a whole appears to have closely shadowed that in the private sector throughout the decade. The New Earnings Survey figures for median earnings for men in the public sector show an increase of 152% between April 1979 and April 1989, compared with 151% in the private sector - notwithstanding that major productivity improvements to finance pay rises have been a feature of the private sector rather than the public.
- 9 Concern about what has been going on in the public services must be more acute because of the double burden created for manufacturing: there is not only the possible labour market

pressure but the fact that manufacturing ultimately has to carry much of the cost of the consequent pay bill.

- 10 So far as private services are concerned, whilst reservations can again legitimately be expressed about output measures, the figures here also suggest a rise in pay costs which is substantially greater than growth in output. Settlement figures, showing the anticipated effect on average earnings, are not far out of line with output growth: but there has been a significant increase in the numbers employed - with obvious implications for total pay costs. The adverse implication for unit labour costs is clear: and whilst labour costs are less important across the private services as a whole they still represent over 25% of sales revenue in more than two thirds of service companies, so concern is surely justified.

Recent Developments

- 11 The economic situation has changed in recent months. There is now clear evidence from CBI surveys and Government figures that consumers' demand growth has slowed considerably. In the three months to November, retail sales were up just 1% on a year earlier, compared to growth rates of 8% recorded early in 1988, and manufacturing is feeling the squeeze. The CBI Monthly Trends Enquiry shows that manufacturers' order books have been considered 'below normal' since May. The latest results for November show that most manufacturers expect virtually no increase in output in the four months ahead. Manufacturing stocks are increasing, whilst CBI's Distributive Trades Survey for November 1989 showed the highest stock levels since the survey began (in 1983).
- 12 The steady economic growth of the 1980s, remarkable by Britain's historic standards, has come to a halt for the time being and output is now generally forecast to grow by very little in 1990, picking up only gradually in 1991.
- 13 Pay levels are not yet reflecting this gloomier domestic outlook. CBI's Databank shows that settlements continue to be fairly narrowly bunched around the RPI rate and, whilst the average may have stopped rising, it has, at best, plateaued at just over 8%. Most respondents in manufacturing believe that productivity improvements of around 6 or 7% have been achieved over the last year, making their settlements largely self-financing: and that they can continue the same rate of progress into the year ahead.
- 14 Evidence is now emerging that this productivity expectation may be over-optimistic. The trend in productivity achievement recorded in CBI's Databank is now downwards,

whilst pay rises remain unchanged, confirming the adverse movement in unit labour costs. Meanwhile, investment, to which most employers had been looking as the main source of further productivity improvements, is no longer growing. It is expected to be no higher in 1990 than in 1989, with only modest growth forecast thereafter.

- 15 The uncompetitive trend in Britain's unit labour costs is not yet adversely affecting exports, where volume growth of non-oil exports has averaged 7% per annum since 1987 - double the average growth of the previous 16 years. But, as UK unit labour cost levels were close to those of competing nations before the most recent deterioration, this achievement may now be in jeopardy.

MANUFACTURING UNIT LABOUR COSTS - INTERNATIONAL COMPARISONS

Percentage annual rate of increase on previous 12 months

	1986	1987	1988	1989*	Average 1985-9*
West Germany	+4.0	+2.9	0	+0.5	+1.8
USA	+1.0	-1.0	+1.0	+0.5	+0.4
Japan	+4.0	-2.9	-3.0	-1.75	+0.9
France	+2.0	0	-3.0	+2.0	+0.25
Italy	+2.0	+3.0	+1.0	n.a.	+2.0
UK	+4.4	+1.4	+2.8	+4.0	+3.2

* estimate

Source: CBI, DE, OECD

The Implications

- 16 What the figures do not show (and as the government now appears to acknowledge) is that present inflation is pay led. Pay Databank responses show the causal effect working much more strongly in the other direction. The cost of living dramatically increased in importance as an upward pressure on pay, being cited by 59% of manufacturing employers in 1988/9 compared with 23% a year earlier, as mortgage rate increases affected their employees' disposable incomes.

- 17 In fact, although employers face this unit labour cost pressure, the rate of increase in factory gate prices has fallen back to below 5% per annum (4.9% in November 1989), while both the July and October 1989 Industrial Trends Surveys showed a slower rate of price increases than a year earlier. Prices of manufactured goods in the shops are rising at 4% (November). Expectations for the coming 4 months show no upward movement as a result of the labour cost pressures now emerging: the indications are that employers will have to accept reduced margins, as competitive pressures limit the scope for price increases.
- 18 What this experience indicates is that pay rises can best be linked to performance when inflation is low and stable. Pay Databank evidence is that in recent years of lower inflation employers were having considerable success in building this link. The main influences on settlements in 1986 and 1987 were performance factors - profits and productivity - and labour market considerations.
- 19 As mortgage rates began their sharp upward movement, however, the picture changed. The mortgage cost element in the RPI was running at close to or above 50% throughout the first 3 quarters of 1989, and other charges outside employers' control - rent, rates and water - were also rising at less spectacular but well above average levels. This has made it more difficult for employers to concentrate bargainers' minds on performance factors: the cost of living has again become the main focus of attention, whilst labour market pressures have not yet eased, and this is reflected in settlement levels.
- 20 Meanwhile, public service settlements continue to shadow trading sector settlements, in a way which does little to encourage greater realism amongst workforces generally.

Proposed CBI Response

- 21 If pay rises run out of line with productivity improvements, the scene is set for growing pressure on margins and the possibility of a reversal to the recent trend in factory gate prices. In these circumstances, international competitiveness will be adversely affected, and Ministers will tend to discount the 'own-goal' impact on inflation of interest rate rises and other Government-imposed charges, insisting that pay rises are a more suitable explanation for the RPI rate.
- 22 The task for CBI is to help members reinforce the link between pay and productivity: by drawing attention to the real problem; by encouraging greater awareness of possible approaches to it; and by both identifying inflationary

pressures on pay and making the case for their easement wherever possible.

23 The following course of action is proposed : CBI should

- a) acknowledge that a problem of performance not fully offsetting pay rises in the trading sector is emerging, which threatens competitiveness, while insisting that it should not be misread either as indicating that management have not tackled pay issues or as the underlying cause of present inflation;
- b) identify all the factors contributing to current inflation, including interest rates and other Government-imposed charges, and publicise the findings to counter the pay-led argument;
- c) build on the 1989 Pay and Performance presentation, by highlighting the realities of the current economic situation and prospects to members and the need to relate those to pay, and by providing information about good practice on performance measurement and its use in pay negotiations;
- d) oppose anything approaching a 'pay norm' as inappropriate and as setting a figure that will be seen an entitlement, likely to boost rather than ease inflation;
- e) press for the easement of Government-imposed charges that are contributing to inflationary pressures on pay via the RPI;
- f) carry forward work on public service pay, stressing the need for performance there to be seen to justify increases too.