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T Burns

Second Permanent Secretary

Chief Economic Adviser

25th July, 1980.

Dear Clive,

I attach some draft remarks for the Censure debate.

Yours

Terry

(TERRY BURNS)

Clive Whitmore, Esq.,

No. 10

Intro. - After recession
Disagree [illegible]
∴ Remedy.
Inf. & Unemployment down.
Long term causes. - Rigidity
Militancy
Failure to adapt.
Accel. infl.
World Recession. - Oil - Cost.
Short term. - Pay
MTFS. - Increase efficiency
& red. inflation.
chance for growth
No short cut. policy.
∴ no exchange rate/ interest.
∴ Monetary discipline.
Other influences in short run.
Sym
Need for Pay to Adjust
Opp. Pay
Reverse Targets
- Hyperinflation.
Increase Borrowing
Plan Industry.

## Introduction

1. Agree with seriousness of the inflation and unemployment problem. Difference is with the interpretation of why it has happened and the measures that are necessary to reverse the position. Important to see both inflation and unemployment as combination of three forces:

(i) the long term upward trend of unemployment and inflation that has been emerging for a generation but at an ever accelerating pace;

(ii) the short term and current problems stemming from the loss of control of the economy by previous administration in run-up to election which laid the basis for the inflation, high wage settlements and resulting unemployment;

(iii) the world problems of soaring oil prices and recession that is now beginning to grip the major industrial countries and from which we cannot escape.

## Long-Term Unemployment Increase

2. The long term problems lie at the heart of our difficulties and the problems to which government strategy is directed. Abstracting from cyclical considerations the unemployment figures have now been rising remorsely for at least a generation. There is also clear evidence that the trend is accelerating. In the second half of the 1950's there was an average of 300 thousand people unemployed. By the second half of the 1960's the average had risen to

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430 thousand; by the first half of the 1970's to 650 thousand and by the second half of the 1970's to 1 million 300 thousand. This is a stark reflection of the underlying weakness of the UK economy; it shows the growing rigidity of the economy; the failure to meet the customers demands; and the failure to adapt to the changing pressures for necessary skills. This is exemplified by the fact that over the same period the trend of the number of vacancies has not gone down; nor has the percentage of firms reporting capacity constraints on skilled labour to the CBI. The growing unemployment problem over the past 25 years in large part reflects the failure of the economy to adapt to the changing requirements of industry and the world economy. The Government is determined to bring about a major improvement of the business climate where profitable, enterprising jobs can survive and encouragement is given to the private sector to compete. That is one major part of the strategy.

(1)

Long-term Rise in Inflation

3. The second component of the strategy is the defeat of inflation; it is no coincidence that rising unemployment has been accompanied by rising inflation. In the first half of the sixties inflation was running at less than 3% per annum; by the first half of the seventies it was close to 10 per cent per annum; and by the second half of the seventies - the period covered almost entirely by the previous administration the average inflation rate was 16% per annum. There is an urgent need to correct this trend. No advanced free society can hope to prosper

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against the background of accelerating inflation; the last ten years shows the problems that emerge when rampant inflation takes control. Instead of producing more for people to consume valuable scarce resources have to be put into coping with high and varying inflation rates. And the uncertainty of high and varying interest rates discourages investment and the establishment of new business. During the last ten years there has been a major slowdown of investment. Is it surprising when interest rates and inflation rates are changing so rapidly and bringing with them the enormous risk that another inflationary surge will create yet another recession.

4. For all these reasons the government is determined to reverse this upward drift of inflation and lay the basis for improved efficient operation of the economy. It is only when inflation has been conquered and measures taken to improve incentives and free the market place that we will see a reversal of this dismal trend of rising unemployment.

World Recession

5. These are the long run problems that the government is determined to solve. Unfortunately we also have to cope with the world recession. The world is again reeling under the impact of a further round of oil price increases. This has pushed up inflation rates everywhere and growth rates are now under severe pressure. The recent tripling of oil prices is - in absolute terms - as big a blow to the industrial world as was the five-fold increase in 1974;

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and we remember the scale of the recession of 1974/75. Not surprisingly unemployment rates are rising around the world; in the United States unemployment has risen by over 2 million in the past year; in France, Italy, Germany we can now see a distinct weakening of economic activity. There is no way that we can escape from the damage to the world economy by unilateral action. Efforts to do this here in 1975 merely delayed the problem, and led to currency crisis of 1975 and 1976 and threw us into the arms of the IMF. The emerging world recession is hitting the car market particularly severely. From Detroit to the West Midlands the same story is evident; car sales have slumped; so have orders to component manufacturers and a massive de-stocking seems to be taking place. The Government can do little to stem this world wide problem; the only consolation is that phases of massive de-stocking are usually short lived, if painful. Once the world inflation is reduced and activity recovers this part of our unemployment problem will be reduced.

Excessive Pay Increases

Massive loss of competitiveness

6. But this is only part of our problem; the particular burden that we have to face is that against this difficult world background we have had much greater increasesin pay than elsewhere despite a rising exchange rate; the result has been a massive loss of competitiveness. This can only make unemployment significantly worse than elsewhere. In part the rapid rise in pay is the result of general inflationary pressure which is the delayed reaction to the acceleration of monetary growth and fiscal expansion during 1978 and 1979. Part is also due to the backlash effect

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from the previous administration's misguided statutory incomes policy. The combined result has been that pay increases in the UK have been running at 20%. Earnings growth in other major industrial countries has been rising some 10% less than in the UK. ? ½ the rate or $\frac{1}{10}$ less?

7. For all these reasons it is nonsense to assert that the recent increase in unemployment is due to the Government's policies; they reflect the lamentable past performance over the past several years; they reflect the severe recession that is taking place on a world wide basis and they reflect the grossly irresponsible wage behaviour over the past wage round.

Medium Term Financial Strategy

8. At the heart of the government's strategy is the commitment to improve the efficiency of the economy and to reduce inflation. It is intended to reduce the average inflation rate in the first half of the eighties well below that experienced in the second half of the seventies; and to achieve this without the use of statutory or administrative controls. This is the only way of reducing inflation permanently without storing up trouble for the future. We have many examples of pay/price policies in the UK. None of them have worked for long. When they have broken down they produce a backlash of inflation of the kind seen last year. They also do major damage to the efficiency of the economy. The Government's intention is to restore market mechanisms where possible in order to improve efficiency and productivity. Pay and price controls would be a move

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in the wrong direction. They are therefore ruled out.

9. We accept that the control of inflation requires firm discipline and a clear monetary framework. For much of our history we have had this framework in the form of fixed exchange rates. During that period the discipline ensured that our inflation did not deviate substantially from other countries. Since this system of fixed exchange rates, accompanied by low world inflation rates, tottered in the late sixties and collapsed in the early 70's major differences in inflation and monetary performance have emerged between countries. In these circumstances there is an overwhelming case for the necessity of monetary discipline.

10. Of course there are other influences upon the price level; the growth of money supply is not the only thing that matters for inflation, particularly in the short-run.

- oil prices and world prices clearly have a major effect
- the rise in VAT has had a sharp short run effect but will fall out of the index next month
- the timing and extent of nationalised industry prices, rates, rents and food prices all matter and
- the timing and extent of pay settlements is crucial and affects the time lags of the inflationary process.

But this does not avoid the necessity for maintenance of strict financial control.

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11. In practice we have to take account of the important time lags between monetary growth and inflation. The latest bout of inflation shows up clearly in the monetary figures from the end of 1977 and there are now indications that the whole sweep of inflationary pressure is about to be reversed. Money supply is under tighter control, and the major leading indications of inflation all point in the direction of lower inflation.

(1) 12. House prices which were booming when we came to office are scarcely rising at all; the (2) CBI indicator of firms planning to put up prices in the following four months is the lowest since 1973; wholesale (3) input prices which show the price increase that are paid by manufacturing industry have recently shown sharp signs of easing as many world prices have been falling and even oil prices have been rising less rapidly. In time this should all be translated into lower output prices and then lower inflation. Thus all the indications now point towards a significant slowdown in the inflation rate as we move through 1980 and into 1981. The benefit from the strategy will emerge in the defeat of inflation.

## Need for Pay to Adjust

13. Against a background of firm monetary targets it is important to note that output and employment will suffer if pay and prices do not move rapidly into line with monetary growth. The pattern of unemployment over the next few years will be determined by the depth of the world recession and the time lags in the response of wages and prices to

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the monetary deceleration. This is clear from the evidence of the last 10 years when the behaviour of unemployment has been crucially dependent upon whether earnings grew more or less rapidly than money supply. If earnings grow more rapidly than money supply unemployment will rise and vice versa. "This is not surprising; under these circumstances firms are either faced with putting up their prices and losing business or of reducing their profits in which case they will invest less and cut their stocks. Whichever route they take the outcome at the end of the day of earnings growth in excess of money supply will be higher unemployment. The implication is that increases in unemployment will be minimised if earnings grow in line with the monetary targets" although over the next year or so problems will still inevitably arise from the world recession.

14. In the case of public sector pay settlements the impact works through differently affecting the PSBR, extra taxation or reduced levels of service. The Government therefore intends to impose the firmest possible discipline on public sector pay. They fully accept that the Government must be seen to set an example.

Certainly there are those who ~~argue~~ take the view

Raise the Target

15. ~~It has been argued~~ that we should ~~abandon~~ forego the aim of reducing inflation and simply adjust to the current rate; or attempt to bring ~~to bring~~ inflation down only very slowly. It ~~has been~~ is argued argued that this ~~will~~ would avoid the transitional problems. If earnings growth is above the monetary target it is argued that we should relax the monetary target. The first essential problem is that this would soon lead to

/accelerating

Whilst

~~accelerating inflation~~. The Government ~~does not~~ believes ~~in attempting to reduce inflation too rapidly; but by the same token~~ it would be wrong to avoid any attempt to reduce inflation or to do it less rapidly than set out in the MTFS. The history of the past 20 years has been that attempts to adjust to inflation have merely led us to ever rising inflation rates. Each time commodity prices or oil prices move upwards we have been ratcheted to a new higher level of inflation. Each time it is argued this should be accommodated because the price of preventing it would be too great. The Government is determined to reverse this process. It is determined to establish credibility for sound financial management and resist attempts to argue for more adjustment accommodation. Accommodating inflation does not mean stable inflation at a higher level; it inevitably means accelerating inflation, leading to hyperinflation.

That would destroy confidence in our society and the credit and financial ... on the savings of the ~~[illegible]~~ people

## Increase Government Borrowing?

16. It has also been argued that we should relax fiscal policy and have a higher PSBR. This flies totally in the face of reason. In order to ensure that the impact of monetary policy falls evenly across the economy it is an important part of the strategy to curb Government borrowing as a percentage of output and to ensure that this reduction in PSBR is achieved by reducing the share of Government spending in output - taxes are far too high. If the PSBR is not controlled it will not be possible to reduce interest rates. We recognise that interest rates are determined by a number of factors; for example inflation rates and the pattern of the economic cycle. But the level of the PSBR

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is crucial. The higher is the PSBR the higher will be the level of interest rates relative to the inflation rate. During much of 1979 and early 1980 each of these factors was pointing towards higher interest rates; government borrowing was high; domestic demand was strong; inflation was rising and the monetary target was tight. Just as these forces are being reversed it is argued that we should have a higher PSBR. But this would involve higher interest rates unless we relaxed the monetary target; and as already emphasised, there is no intention of doing that. The outlook for interest rates depends upon our success in controlling the PSBR and public expenditure. Although monetary pressures might be expected to ease as recession emerges and inflation is reduced, the monetary target remains tight relative to the current inflation rate. This year's budget has been designed to help the process by reducing the PSBR; the public expenditure plans are designed for the same purpose. A reduced requirement to sell government debt is crucial if interest rates are to be safely reduced; this means lower government borrowing.

Any attempt at fiscal relaxation would damage the outlook for interest rates and the prospect of opening up the capital market to private companies. The company sector will be much better off with access to long term debt finance than with some general fiscal relaxation that would be indiscriminate in its effects.

/Manufacturing

Manufacturing Industry

17. It has also been argued that the Government's policies are leading to a destruction of manufacturing industry. We recognise that in the process of reducing inflation there will be some pressure upon manufacturing industry. The exchange rate tends to improve ahead of other wages and prices and if there is a significant time lag competitiveness will be lost. But that is only one minor part of the loss of competitiveness that we have recently seen:

(i) wages have continued to grow much faster than in competing countries. This wasunnecessary and extremely damaging.

(ii) [Much of the exchange rate increase was a reflection of how low it was in 1976.] ~~Then~~ a policy operated by the previous govt. of attempting to make companies profitable by forcing down the exchange rate achieved little but increase the inflation rate and disguised the extent to which British industry was inefficient. Those inefficiencies are now being exposed.

(iii) Say with these words.

(iii) The existence of North Sea oil has increased the exchange rate but this is an inevitable part of the adjustment of an oil rich economy. It is inevitable that there will be some switch between manufacturing and non-manufacturing industry.

(iv) The political disturbance in the Middle East has also made the UK a popular currency.

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18. It is often argued that we should take action to reduce the problems of high exchange rate and the loss of competitiveness. A variety of schemes are put forward.

(i) The first is intervention in the exchange market. It is extremely doubtful if this would be at all useful. Experience in 1976 and 1977 suggests that enormous flow across the exchanges can be generated by an attempt to hold the exchange rate in the face of sustained market pressure. During 1977 the authorities intervened heavily and reduced MLR sharply throughout the summer and autumn of that year. The attempt to 'cap' the exchange rate was unsuccessful and the large inflows plus the low level of interest rates at the end of 1977 was probably the main cause of expansion of sterling M3 in the following year.

(ii) The second course of action mentioned is inflow controls. Ideas flow in abundance; from two tier interest rates to barring non-resident purchasers of sterling to two tier exchange rates and restrictions on company borrowing abroad for domestic use. All schemes have the fundamental problem of making the controls effective. This could possibly be done for a few months but beyond this requires increasingly elaborate and comprehensive regulations. Such schemes also make it more difficult to finance the PSBR and this could mean higher interest rates and

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pressure upon companies from a different direction. Of course we have taken the major step of abolishing all exchange controls in an outward direction and we have not yet seen the full effect of that adjustment.

## CONCLUSIONS

19. To summarise

(i) Money supply growth is now coming under control.

(ii) There are now signs that inflation is about to turn.

(iii) To maintain this it is vital that we maintain control over the PSBR and government spending.

(iv) Unemployment is rising rapidly because of excessive pay settlements and world recession. This will continue until pay brought down to monetary growth rate.

(v) A reduction of inflation and the growth of pay within the monetary target will lay the basis for growth and reduction in unemployment.

None of the alternatives are attractive or offer much hope for a sustained improvement in the outlook.