PRIME MINISTER

Visit to the Engineering Industries Council

Background

You will be visiting the Engineering Industries Council on Monday at 1730 for one hour. The nature of the Council and the list of members who will be attending is at Annex A. Annex B sets out the issues which Sir Peter Matthews thinks are likely to come up. I have agreed with him that you will not be asked to open with a statement on the UK economy (this engagement was agreed on the understanding that it was a listening rather than speaking one). Instead, he will ask selected members to speak on specific issues to which you can then respond.

Objectives

With a gathering of leaders from manufacturing industry, and its weakest sector, engineering, there is a danger that the meeting could degenerate into "what will the Government do for us?". Your aim should be to keep the ball in their court; to make it clear that the Government is maintaining the right financial framework and is working to ensure the operation of competitive market forces. For the rest, it is largely over to them:

(i) By controlling their wage costs (earnings in manufacturing are rising faster than in the economy as a whole - $9\frac{1}{4}$ versus $7\frac{3}{4}$ per cent).

(ii) By continuing the drive for new technology and new working practices. You can praise their achievements so far in raising productivity.

(iii) By developing new products and new markets. In absolute terms our wage levels are much lower than in the US or Europe. If productivity can be increased, the UK could be extremely competitive.

/(iv) By giving

(iv) By giving the customer the service he requires.

You should resist arguments that what is needed is a growth of demand. Domestic demand has grown strongly in the past two years, e.g. car registrations this year will be a new record. The weak link is the response of supply.

If they raise the NIS, you should put the question back to them, saying that it can make no sense for wages in the most troubled sector of the economy, and the one most exposed to competition, to be rising faster than the rest of the economy.

Of those attending the meeting only Dr. McFarlane will have been at the NEDC meeting which discussed the Chancellor's paper on the prospects for jobs. Others, however, may well be aware of the paper and could charge the Government with sitting on its hands while the long term decline of manufacturing continues. You should reply that the decline in the importance of manufacturing as an employer has been going on for sometime and is not unique to this country. This does not mean that the industry need decline in terms of profitability. The manufacturing sector needs to adapt to changing conditions, as it has done in the more successful economies.

Attached are briefs on specific issues:

Energy Prices - Brief C
Growth and Order Books - Brief D
Competitiveness and the Exchange Rates - Brief E
Capital versus Current Expenditure - Brief F
Interest Rates - Brief G
Non-wage Costs - Brief H
The Manufacturing Sector and North Sea Oil - Brief I.

AT

ANDREW TURNBULL

9 December, 1983

A

BRIEF FOR THE PRIME MINISTER'S MEETING WITH THE ENGINEERING INDUSTRIES COUNCIL ON MONDAY, 12 DECEMBER, 1983

The Council comprises a number of Chairmen and Chief Executives of large and medium-sized employers in the private engineering sector. A full list of members of the Council is at Flag A. It is an informal body with membership by invitation and acts as a pressure group without executive functions, though there is a secretary from the CBI. Although Ministers have had regular contact with the Council and Mr Jenkin, Mr Prior, Sir Keith Joseph and Mr Biffen have all attended meetings, because of the very nature of their activity the Council have had little contact with Department of Trade and Industry officials.

By comparison with continental engineering industries (the German industry in particular) or indeed by comparison with our own chemical and related industries, the British mechanical engineering industry is woefully weak in its trade association structure. This weakness has been most noticeable in the European context both on the negative side of resisting unwelcome Commission initiatives and on the more positive side of steering matters in the direction we would want.

The Engineering Industries Council has been active in encouraging improvement in the representation of the mechanical engineering sector. It has been taking a leading role in the development of COMMET (the Council of Mechanical and Metal Trade Associations), which seeks to bring together trade associations in the sector, to present a united voice in dealings with the Government and with the Community.

MEE3d
Department of Trade and Industry

23 November 1983

ENGINEERING INDUSTRIES COUNCIL

NOVEMBER 1983

Sir Peter Matthews	Chairman	Vickers
Sir Arnold Hall	Vice Chairman	Hawker Siddeley
H P N Benson		Davy Corpn.
Sir Basil Blackwell		Westland
Sir Richard Cave		Thorn E M I
Sir Kenneth Corfield		Standard Telephones
H C Harrison		Simon Engineering
Sir Ernest Harrison		Racal
Sir Trevor Holdsworth		G K N
Sir Robert Hunt		Dowty Group
Sir Brian Kellett		T I
Sir Duncan McDonald		N E I
R G Messervy		Lucas
Lord Nelson of Stafford		G E C
Eric Swainson		I M I
Sam Toy		Ford
W Gregson	Br. Electrical & Allied Manufacturers' Association.	Ferranti
John Bolton	Engineering Inds. Assn.	
J G Campbell	Machine Tool Trades Assn.	
P E G Bates	Socy. of British Aerospace Constructors.	Plessey
J C A Crawford	Process Plant Association.	Motherwell Bridge
G H Turnbull	Socy. of British Motor Mfrs. and Traders.	Talbot
✓ Dr J S Mc Farlane	Engineering Employers' Fed.	
E M Felgate	Secretary	

B

ENGINEERING INDUSTRIES COUNCIL

12th December 1983

POINTS FOR DISCUSSION

1. We shall of course be very pleased indeed to hear the Prime Minister's present views regarding outlook for the UK economy - and perhaps in addition that of world trade - insofar as these are likely to have an impact on the Engineering Industry. Particularly, of course, we should be interested to know anything specifically arising from the Commonwealth Conference.

2. The Prime Minister will of course be aware that many of the Council members are employers of large numbers of people spread over a large number of factories where for some years capacity has exceeded demand, which has resulted in reduced profits, partly on account of lack of volume and partly from competitive pressures. This has occurred at a time when we know computerisation and automation provide the means for continuing substantial de-manning, given the capital available to invest. A number of members' firms have reduced staff by up to 40% and see the possibility of going much further than this without loss of capacity.

3. None of us seeks hand-outs, nor to escape our share of the general tax burden. If, however, we are to compete internationally, we need to do so on as nearly as possible equal terms with foreign competitors. We welcome and endorse the Government's priority of continuing to reduce inflation. In this regard, and that of productivity, we are now very much better placed than we were but are still not as well placed as some others, particularly for instance Germany, and we know we must pay some price for closing this gap. Amongst the things we do press Government for is alleviation of any general burdens which we feel bear heavily on industry, particularly the NIS and the high burden of local rates.

4. A number of us too feel that further attention should be given to adjusting or explaining Government's policy in regard to energy. The recent rise in gas and electricity prices is seen by some as a tax, and although it is possible to state that oil and gas are expensive, it is nevertheless a fact that in a number of competitor countries - France and Germany - who have to buy their energy, this is made available to industry at lower prices than obtained in the UK. This can lead to the simple belief that whilst our reserves of oil and gas last, energy is being sold at a high price at home and abroad, so achieving a positive balance of payments and a situation where the growing contribution of oil and gas to the GDP is being offset by a reduction in manufacturing (in some cases loss of capability), which leads to anxiety about what will happen when the oil runs out.

5. Overall, I have no doubt that the views of members of Council will support:-

i) continued struggle against inflation;

ii) reduction of costs imposed on industry;

iii) all moves aimed at lowering interest rates, which although now reduced are still strongly positive in relation to the rate of inflation;

iv) any further pressure or moves the Government can make to substitute capital expenditure for current expenditure within the economy, perhaps particularly at Local Government level.

PAM
30.11.83

C

ENERGY PRICES

Points to make:

(i) Energy prices for next year are still under discussion with and within the gas and electricity industries. But whatever is decided will be less than the rate of inflation.

(ii) If, as expected, domestic gas prices rise in January, this will be 15 months after the last price rise; industrial gas prices are unlikely to rise before April, 1984, 18 months after the last rise; and electricity prices are frozen, at least until April, 24 months after the last price rise.

(iii) Energy prices not being used as a tax. Policy remains to set prices in line with costs including the need to earn an adequate return on the investment.

(iv) Not true that the energy industries are making excessive profits. Last year's profit of £868 million before interest in the electricity industry may sound a lot but this is on assets of £32 billion. A financial target of 1.4 per cent in real terms is hardly exorbitant. The profits of £660 million (5.7 per cent last year in gas) may also look high but this is strongly influenced by BTC's access to cheap gas contracts signed many years ago. Wrong to base prices on those contracts when they are gradually running out and being replaced by much more expensive gas.

(v) Do not accept that energy prices generally are unfavourable in relation to those abroad. There are countries, e.g. France and Sweden, where prices are lower but this is justified by their lower generating costs. Difficulties are largely confined to the very high load users [most of whom are not in the engineering sector].

PRIME MINISTER'S MEETING WITH ENGINEERING INDUSTRIES' COUNCIL, 12 DECEMBER

ENERGY PRICES TO INDUSTRY

i. GAS AND ELECTRICITY

Policy: Gas and electricity prices must reflect the cost of providing a supply on a continuing basis and the need for the industries to earn a reasonable return on the huge public investment in them (now some £45 billion).

Prices: Gas and electricity prices are a matter for the industries concerned to determine in the light of their costs and financial obligations. Government has no power to impose increases. Average electricity prices and industrial gas contract prices have not increased since April 1982. The industries have not yet made any formal announcements about prices next year /contrary to the impression in the Engineering Industries' Council note/. Any electricity and domestic gas price increases next year are expected to be within the rate of inflation; BGC indicated on 8 December that they expect to extend the industrial contract price freeze until April 1984.

ii. COAL

Terms for the price and supply of coal to industry are a matter for commercial negotiations. NCB coal is competitive with imports over most of the country; NCB coal prices reflect the financial support provided by Government. The Coal Firing Scheme has helped industry to reduce energy costs by switching to coal; DTI are considering extension of the Scheme beyond December.

iii. OIL

Oil product prices are determined in the competitive market. Purchasers are well advised to take advantage of competition, eg by obtaining alternative offers of supply and by seeking to maximise any rebates offered on scheduled prices.

iv. MEASURES OF ASSISTANCE

HMG, together with the gas and electricity industries, has taken a number of measures to assist industry with energy cost in recent years:

electricity	: load management schemes have been introduced offering substantial price reductions especially for larger users; average prices have been frozen for 1983/84.
gas	: contract renewal gas prices have risen only 3½-4% since the end of 1980.
heavy fuel oil	: duty has been frozen for the last 3 years.

v. INTERNATIONAL COMPARISONS

Very difficult to make meaningful comparisons of UK energy prices to industry with those in other countries: exchange rate movements in particular can change the picture rapidly. However evidence from the CBI survey in February and subsequent information is that in general UK prices compare well with those elsewhere in Europe. HMG has pressed the European Commission to investigate pricing policies and practices in Member States of the Community and this is now in train.

Defensive Points if raised (see para 4 of Sir Peter Matthew's note of points for discussion; briefing on the effects of North Sea Oil on manufacturing industry is being provided by Treasury).

- French electricity prices are generally lower than those in the UK or elsewhere, reflecting significant nuclear and hydro-electric resources. However French electricity prices rose by 8% in April and a further 3.5% in September, while UK prices have been frozen for 1983/84. [The recent fall in the French franc however counterbalances French price increases when a comparison is made in sterling terms.]

- West Germany No general disparity is apparent between UK industrial energy prices and those in Germany. German electricity prices have risen this year.

- **High Load Factor Users** Accept that Continental electricity tariffs decline more rapidly than our own as load factor increases, and that this may result in disparities at extremely high load factors. However in part this reflects subsidies, e.g. Italy, and studies show that prices here do fairly reflect the load and structure of UK electricity supply costs. The engineering industries are mostly not in the category of extremely high load factor users where disparaties may emerge.

- **New CBI Survey** Understand CBI is working on a further survey of comparative industrial energy prices: look forward to seeing results.

vi. GENERAL POINTS TO MAKE

- Energy prices are not the principal determinant of industrial success: though there are exceptions in general energy accounts for a low proportion of industry's total costs (under 5%). Japan for example faces particularly high energy costs.
- Subsidies are not a solution: they merely mean abrupt price increases later.
- Efficiency is the key to containing costs: the Government is continually encouraging the nationalised energy supply industries to improve performance by setting financial and performance indicators and by following up efficiency studies (MMC reports on electricity industry and NCB, Deloitte's report on BGC). Efficiency gains help both to hold down prices and to achieve a reasonable return for the taxpayer.

BACKGROUND

1. Current concern is likely to focus on gas and electricity prices; detailed background is contained in the factsheet already provided.

2. HFO duty has attracted criticism because, at £8/tonne, it is higher than in most other EC Member States. This is a matter for

the Chancellor, and Sir Geoffrey Howe when Chancellor explained publicly that any reduction in duty would bring an increase in the cost of imported gas to BGC. Sir Geoffrey Howe took the view that the wider national interest was best served by keeping the duty at its present level.

D

ECONOMIC GROWTH AND ORDER BOOKS

Background

A gathering of industrialists, particularly from the engineering sector, is likely to complain about business prospects. If the discussion develops in this way you might ask whether prospects really are as gloomy as they make out.

Business surveys such as the CBI's reveal a number of positive features:

- positive output expectations for 10 successive months
- order books in November at strongest since September 1979
- position on stocks has been improving consistently.

There are other positive indications:

- profits of industrial and commercial companies up 25% in 1983 H1 compared with a year earlier
- growth of GDP has been steady and sustained
- production of chemicals up 7½% on a year ago, steel 21% on a year ago, and car production 17% up in the first 10 months of this year compared with the same period in 1982.

You might ask the meeting whether it agrees with the CBI that growth is beginning to spread out from consumption to investment and exports.

The meeting might challenge the Treasury forecast as being too optimistic. In response you can argue:

/ (i)

(i) Virtually all forecasting teams have revised their estimates upwards in recent months.

(ii) The consensus view of economists has been distinctly fallible. Most failed to predict the recovery when it began in 1981.

Line to take

(i) Your aim should be to establish whether their gloomy views have taken adequate account of the large number of favourable indicators which have appeared recently.

E

COMPETITIVENESS AND THE EXCHANGE RATE

Background

According to the IMF's favoured measure - relative unit labour costs - the competitiveness of UK manufacturing industry has worsened substantially since the 1970s (30% since 1978, 10% since 1979). But on the same measure, competitiveness has improved substantially - over 25% - since the worst point in the first half of 1981. The figures are set out in the attached table.

It is not denied that competitiveness has worsened; the argument is about how it occurred and how it can be improved. When the Government took office, the effective exchange rate stood at about 87, compared with 83 now. Thus over the life of the Government, the exchange rate has contributed little to the change. The most significant factor has been the failure to control wage costs, particularly in 1979 and 1980. Over the last two years, unit wage costs in manufacturing have been growing much more slowly, only 2.8% in the year to 1983 Q3, and 5.1% in the year before that.

Line to take

(i) Sterling, as a widely traded international currency and petro-currency, is bound to fluctuate as a result of market forces, and Government cannot influence the rate significantly apart from short-term smoothing operations. To seek to improve competitiveness by promoting devaluation would merely fuel inflation and increase living costs.

(ii) There are two ways to improve competitiveness; first, to limit the rise in unit wage costs by keeping down earnings and raising productivity. Earnings have been rising by about 9% - this figure needs to be reduced. Wage costs per unit of output,

/ however

however, have risen only $2\frac{3}{4}$% over the past year because productivity has risen sharply. Output per head in manufacturing is now at record levels, 11% above the previous peak in 1979.

(iii) The other approach is to produce the goods which customers want to buy. This involves not just prices but all the non-price factors. There are increasing reports that this is beginning to happen in this country. We should follow the German and Japanese pattern. Between 1970 and 1980 Germany's cost competitiveness deteriorated 20% but she maintained her 20% share of industrial countries' exports; between 1970 and 1981 Japan managed to increase her share from 12% to 18% despite a slightly worsening cost competitiveness.

Measures of UK competitiveness in trade in manufactures

1980 = 100

	Summary measures[1]						Export unit value index[2]				
	Relative export prices[3]	Relative producer prices[3]	IMF index of relative unit labour costs[2]: Actual	IMF index of relative unit labour costs[2]: Normalised	Import price competitiveness[4]	Relative profitability of exports[4]	United Kingdom	United States	Japan	France	Federal Republic of Germany
1978	84.5	78.6	68.3	70.0	88.2	105.3	68.4	79	89	78	83
1979	90.4	87.3	80.1	80.9	94.9	106.1	82.6	91	94	90	94
1980	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100	100	100	100
1981	98.1	101.7	102.7	107.8	100.6	100.5	93.1	112	106	87	85
1982	92.5	99.4	96.6	104.6	98.4	101.6	86.3	119	100	83	85
1981 1	105.4	107.6	111.8	115.4	102.6	100.2	102.8	108	109	92	90
2	100.9	105.0	105.1	109.6	102.1	99.8	94.2	111	105	85	83
3	93.3	97.3	98.2	103.7	100.2	100.4	85.6	114	102	84	79
4	92.8	96.9	95.9	102.4	97.4	101.6	89.8	117	107	87	88
1982 1	93.4	99.2	97.6	104.9	99.8	101.3	89.4	120	105	87	85
2	91.7	99.1	96.9	104 6	98.7	100.9	86.8	119	102	86	87
3	93.6	100.7	97.3	106.1	98.2	101.7	85.8	118	98	79	83
4	91.3	98.8	94.6	102.7	96.7	102.5	83.1	119	95	80	83
1983 1	86.3	90.1	84.2	92.9	93.0	105.2	80.5	122	99	83	83
2	93.0	95.0	88.9	98.6	91.8	106.1	83.7	120	91	78	83
	Percentage change, quarter on corresponding quarter of previous year.										
1980 2	*+ 9.8*	*+14.2*	*+25.2*	*+20.8*	*+ 4.3*	*− 1.3*	*+22.9*	*+ 7*	*+ 7*	*+15*	*+11*
3	*+ 8.4*	*+ 9.4*	*+20.2*	*+21.6*	*+ 2.8*	*+ 0.3*	*+18.9*	*+10*	*+ 5*	*+13*	*+ 8*
4	*+13.6*	*+16.3*	*+27.9*	*+28.7*	*+ 4.7*	—	*+20.2*	*+11*	*+16*	*+ 4*	*− 2*
1981 1	*+10.3*	*+12.6*	*+20.6*	*+27.4*	*+ 3.3*	*+ 1.0*	*+ 9.8*	*+13*	*+16*	*− 6*	*−11*
2	*+ 1.9*	*+ 6.5*	*+ 8.6*	*+13.2*	*+ 2.7*	*− 0.6*	*− 4.1*	*+13*	*+ 6*	*−14*	*−16*
3	*− 8.4*	*− 3.8*	*− 3.5*	*+ 0.8*	*+ 0.1*	*− 0.3*	*−17.7*	*+12*	*+ 1*	*−19*	*−22*
4	*−10.4*	*− 7.5*	*−11.8*	*− 6.7*	*− 3.7*	*+ 1.9*	*−13.8*	*+11*	*+ 1*	*−12*	*−10*
1982 1	*−11.5*	*− 7.8*	*−12.7*	*− 9.1*	*− 2.7*	*− 1.1*	*−13.0*	*+11*	*− 4*	*− 6*	*− 5*
2	*− 9.1*	*− 5.6*	*− 7.8*	*− 4.6*	*− 3.3*	*+ 1.1*	*− 7.9*	*+ 8*	*− 3*	*+ 1*	*+ 4*
3	*− 0.3*	*+ 3.5*	*− 0.9*	*+ 2.3*	*− 2.0*	*+ 1.3*	*− 0.2*	*+ 4*	*− 4*	*− 6*	*+ 5*
4	*− 1.6*	*+ 2.0*	*− 1.4*	*+ 0.3*	*− 0.7*	*+ 0.9*	*− 7.4*	*+ 2*	*−11*	*− 7*	*− 5*
1983 1	*− 7.5*	*− 9.2*	*−13.7*	*−11.4*	*− 6.8*	*+ 3.8*	*− 9.9*	*+ 2*	*− 5*	*− 4*	*− 2*
2	*+ 1.4*	*− 4.1*	*− 8.3*	*− 5.7*	*− 7.0*	*+ 5.2*	*− 3.6*	*+ 1*	*−11*	*− 9*	*− 4*

	Producer price index[2]					Unit labour costs index[2]				
	United Kingdom	United States	Japan	France	Federal Republic of Germany	United Kingdom[5]	United States	Japan	France	Federal Republic of Germany
1978	63.2	78.1	89.1	72.5	80.4	59	84	110	76	83
1979	78.5	87.5	90.2	85.5	92.3	74	90	103	88	92
1980	100.0	100.0	100.0	100.0	100.0	100	100	100	100	100
1981	96.1	109.3	103.6	87.9	86.9	95	107	107	88	85
1982	90.3	112.0	92.7	81.2	85.5	87	116	102	80	82
1981 1	105.3	106.7	109.8	93.5	90.9	108	103	113	95	89
2	98.1	109.4	103.3	86.2	85.4	96	105	108	87	84
3	88.4	110.3	98.9	83.8	81.6	86	107	102	83	80
4	92.7	110.9	102.3	88.2	89.7	90	111	104	89	87
1982 1	92.9	111.6	98.6	85.6	87.3	89	115	105	86	82†
2	91.1	111.5	94.1	84.1	87.0	87	116	103	83	82
3	89.7	112.4	89.2	77.3	84.1	86	116	98	76	81
4	87.5	112.5	89.0	77.6	83.7	84	117	100	75	82
1983 1	82.7	112.3	96.6	81.2	86.7	76	118	111	78	82
2	85.3	112.5	95.3	76.9	84.3	78	116	109	73	78
	Percentage change, quarter on corresponding quarter of previous year.									
1981 1	*+13.7*	*+10.6*	*+22.5*	*− 3.6*	*− 9.1*	*+22*	*+ 9*	*+25*	—	*− 9*
2	*+ 0.4*	*+10.6*	*+ 5.6*	*−12.9*	*−14.8*	—	*+ 5*	*+12*	*−12*	*−15*
3	*−15.1*	*+ 8.9*	*− 5.2*	*−19.6*	*−20.6*	*−19*	*+ 4*	*− 3*	*−21*	*−24*
4	*−12.2*	*+ 7.3*	*− 5.5*	*−11.7*	*− 7.4*	*−19*	*+ 9*	*− 5*	*−12*	*−12*
1982 1	*−11.8*	*+ 4.6*	*−10.2*	*− 8.4*	*− 4.0*	*−17*	*+11*	*− 7*	*−10*	*− 7*
2	*− 7.1*	*+ 1.9*	*− 8.9*	*− 2.4*	*+ 1.9*	*− 9*	*+10*	*− 5*	*− 4*	*− 3*
3	*+ 1.5*	*+ 1.9*	*− 9.8*	*− 7.8*	*+ 3.1*	—	*+ 9*	*− 4*	*− 8*	*+ 2*
4	*− 5.6*	*+ 1.4*	*−13.0*	*−12.0*	*− 6.7*	*− 6*	*+ 5*	*− 3*	*−16*	*− 6*
1983 1	*−11.0*	*+ 0.6*	*− 2.0*	*− 5.1*	*− 0.7*	*−15*	*+ 3*	*+ 5*	*−10*	*− 1*
2	*− 6.4*	*+ 0.9*	*+ 1.3*	*− 8.6*	*− 3.1*	*−10*	*− 1*	*+ 6*	*−12*	*− 4*

[1] The summary measures of competitiveness were described in *Economic Trends* No. 304, February 1979. Revised measures of import price competitiveness and relative profitability of exports were described in an article in *Economic Trends*, No. 319, May 1980 – see footnote [3].

[2] All the indices are in terms of US dollars.

[3] Figures are now base weighted using 1980 export data. Downwards movements indicate greater competitiveness.

[4] Excludes erratics (ships, North Sea installations, aircraft and precious stones).

[5] See footnote [3] to page 40.

F

CAPITAL VERSUS CURRENT EXPENDITURE

Background

Business groups have been vocal in calling for more capital expenditure. Sir Terence Beckett recently referred to the infrastructure of the UK as shabby and increasingly costly to operate.

Line to take

(i) The Government's first priority is to ensure control of total public expenditure. This offers business the best prospect of prosperity as it is the only way to secure lower interest rates. Government not going to allow calls for more capital expenditure to be used as a stalking horse for more reflationary policies.

(ii) Capital expenditure is not a good thing per se; capital is an expensive resource and one that has to be used productively. Regrettably this has not always been the case e.g. investment in steel, coal, electricity, Concorde, Kielder Dam.

(iii) There are areas where the Government would like to be able to spend more but could do so only if the pressures for current expenditure were not so great. Government is making great efforts to reduce the running costs of the public sector

- number of civil servants lowest since the War

- new initiative to improve management in the NHS

- has proved it difficult to get local authorities to switch their plans towards capital expenditure.

(iv) Debate is not being helped by the way the Government presents figures on capital expenditure in the White

/ Paper

Paper. Because assets' sales, e.g. sales of council houses, are netted-off, because nationalised industry capital expenditure is not included and because "capital" expenditure on defence is by convention treated as current expenditure, the amount of capital expenditure by the public sector is substantially understated. The next White Paper will present the figures on a more sensible basis.

G

INTEREST RATES

Background

The CBI and other industrialists' groups have argued for lower interest rates though the calls have been muted by comparison with some earlier times. With base rate at 9%, rates are 7% below their peak in October 1981. Each 1% saves manufacturing industry about £350 million.

The argument may be expressed in terms of real rates, with a comparison being made with other countries. The latest position is set out as attached.

Line to take

(i) Base rates now back at their lowest level for 5½ years and seven points below their peak in October 1981. Fall in rates in October 1983 welcome, but only reliable way to get further falls in interest rates is to stand by strategy set out in MTFS for sound financial conditions, low inflation and low PSBR.

(ii) Real interest rates are high whilst the economy adjusts to a new low level of inflation - just as real interest rates were negative when inflation was accelerating in the 1970s. Real interest rates in the UK are not unusually high by international standards. Now witnessing some fall in real interest rates in developed countries as inflation is brought firmly under control. Best way to secure further reductions is firm control of public borrowing here and abroad.

ESTIMATES OF REAL SHORT-TERM INTEREST RATES
IN MAJOR OECD COUNTRIES IN 1983

	United Kingdom	Germany	United States	Japan
January	4.8	3.0	4.3	4.3
February	4.9	2.7	4.6	5.1
March	4.6	2.1	4.5	6.0
April	4.1	2.0	4.0	5.8
May	4.1	2.2	3.5	5.3
June	3.7	2.5	4.0	5.0
July	3.4	2.5	4.2	4.7
August	3.3	2.6	4.4	4.7
September	3.1	2.6	4.0	4.9

Source Unpublished Bank of England estimates

The nominal interest rates used for particular countries are monthly averages of three month rates. For the UK and Germany interbank rates used, CDs for the US, and the Gensaki rate for Japan. The expected rate of inflation is the recorded change in consumer prices between six months past and six months ahead where available, and an estimate for recent periods for which data are not yet available.

H1

GOVERNMENT ACTION ON BUSINESS COSTS

The Government is concerned that business costs should not be unnecessarily high. It has therefore taken such action as it can within its overall priorities.

NIS

In the debate on the Queen's Speech earlier this year, the Prime Minister said the Government hoped to abolish NIS in the life of this Parliament.

The Chancellor did not feel able to announce any further reductions in the rate of NIS in the Autumn Statement because of the need to control public borrowing and keep interest rates down.

The private sector is, however, already benefiting from reductions in previous years to the tune of £2 billion a year. NIS has been cut from 3½ per cent when the Government first came to office to 1 per cent from 1 August 1983.

Non-domestic rates

The Government recognises the problems rates can set for businesses and has proposed several reforms in the White Paper on Rates which will benefit them directly or indirectly:

(i) rate-capping of high spenders will protect businesses just as it will all rate-payers;

(ii) a new statutory duty on local authorities to consult business representatives before rates are set will be a more effective way of securing accountability than was the business vote;

(iii) rates on empty industrial property will be suspended from 1 April 1984;

(iv) the threshold under which rate payments by instalment may be made will be raised (to £10,000 in London and £5,000 outside);

(v) there will be a non-domestic revaluation but the timing has not yet been decided.

Interest rates

These are an important component of business costs. Base rates are now back at their lowest level for 5½ years and 7 percentage points below their peak in October 1981. The CBI estimate each percentage point cut in interest rates provides a net benefit to industry of £270 million.

Wage costs

Wage settlements have come down over the last three years. If the economic recovery is not to be impeded it is vital that they continue to come down. It is up to employers/employees themselves to agree pay settlements. Employers however should not pay more than they can afford or more than is necessary to recruit, retain or motivate employees. Otherwise competitiveness and hence output and jobs will suffer.

I

"FOOLISH TO ALLOW MANUFACTURING INDUSTRY TO DECLINE IF IT WILL NEED TO BE BUILT UP AGAIN WHEN OIL RUNS OUT"

Points to make

(1) Distinction between manufacturing and services in many ways artificial.. For example, with advent of developments in information technology work previously done by manufacturing companies in-house often now bought in from companies in services sector. Better distinction is between 'tradables' (ie industries exposed to overseas competition) and 'non-tradables'. Service industries make important contribution to balance of payments which is reflected in strength of our invisible account.

(2) In no sense correct to say Government has "allowed" manufacturing to decline. Manufacturing has been in decline over long period as figures below show:

Proportions of whole economy totals:

		1960	1980
Output	Services	45	55
	Manufacturing	36	27
Employment	Services	47	59
	Manufacturing	37	30
Investment	Services	37	43*
	Manufacturing	25	19*

*(allowing for leasing from services by manufacturing)

Many other OECD countries have experienced similar trends.

(3) Decline in manufacturing, which is more exposed to overseas competition than most other parts of UK industry, due to deep-seated problems: wage increases beyond those which companies could afford, poor quality, design and marketing, restrictive practices etc. As a result net real rates of return have been falling over long period and reached all-time low in 1981 of just over 2 per cent.

(4) Industries in the manufacturing sector will benefit from the success of the Government's policies to reduce inflation and positive adjustment measures designed to remove rigidities in product and labour market (eg removal of pay, prices and dividend

controls, employment legislation, etc). Where consistent with overall strategy, Government has sought to give relief to parts of company sector hit hardest by recession (priority given to reduction in NIS in part reflects this). But some decline probably inevitable. Published study by Treasury economists (Byatt and others) suggested North Sea oil led to a rise of as much as 10-15 per cent in real exchange rate and that this and the rise in world oil prices may have helped to 'crowd out' UK manufacturing production. This has been offset by rise in overseas investment from which UK will reap benefits in years to come.

(5) Prospects. Not possible for Governments to determine future industrial structure. In hard-pressed parts of manufacturing sector, key to success lies in making strenuous efforts to overcome competitive weaknesses by cutting costs, further reducing over-manning and improving design, efficiency and productivity. Government provides measure of assistance through DTI's provision for industrial R&D and innovation which in 1983/84 is expected to cost £332 million - more than double the amount provided in 1979. But main responsibility for improving industrial performance rests with employers and employees. During last 3 years or so signs that British manufacturing industry has achieved notable improvement in productivity performance. Since trough of recession (1981 Q1) manufacturing output has increased by 3 per cent and manufacturing productivity by no less than 20 per cent. Most outside forecasting bodies are expecting manufacturing output to grow at least as fast as the rest of the economy in 1984 and are also forecasting substantial increases in manufacturing investment.

D/N
DTI

10 DOWNING STREET

From the Private Secretary

2 December, 1983.

Engineering Industries Council

The Prime Minister is attending a meeting of the Engineering Industries Council on Monday, 12 December. The format of the meeting, which will last about an hour, will be that selected members of the Council will speak on current concerns of manufacturing industry. The Prime Minister will then be asked to respond. The attached letter from Sir Peter Matthews indicates the most likely topics.

These are likely to be:-

(i) Government policy on energy pricing and international comparisons of energy prices;

(ii) Business costs, in particular NIS and rates;

(iii) Interest rates;

(iv) Competitiveness of engineering sector;

(v) Capital versus current expenditure;

(vi) Prospects for economic growth and the state of industries' order books;

(vii) The argument that it is foolish to allow manufacturing industry to decline if it will have to be built up again when oil runs out.

We have sufficient material here to deal with (iii), (iv), (v) and (vi). I would be grateful if you could arrange for a note to be provided on (ii) and (vii), and if Michael Reidy, to whom I am copying this letter, could provide a note on (i). Could these notes reach me by close of play on Thursday, 8 December.

I am also copying this letter to Callum McCarthy (Department of Trade and Industry).

MR. A. TURNBULL

Miss Margaret O'Mara,
HM Treasury.

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JF2393
Secretary of State for Industry

10 January 1983

Ms Caroline Stephens
Private Secretary to the
Prime Minister
10 Downing Street
LONDON
SW1

Dear Caroline

Thank you for your letter of 15 December about the invitation to the Prime Minister to attend a meeting with The Engineering Industries Council.

2 The Council comprises a number of Chairmen and Chief Executives of large and medium-sized employers in the private engineering sector. It is an informal body with membership by invitation and acts as a pressure group without executive functions though there is a secretary from the CBI. Departments have had regular contact with the Council and Mr Jenkin, Mr Prior, Sir Keith Joseph and Mr Biffen have all attended meetings over the last three years.

3 By comparison with Continental engineering industries (the German industry in particular) or indeed by comparison with our own chemical and related industries, the British mechanical engineering industry is woefully weak in its trade association structure. In the European context this weakness has been most noticeable, both on the negative side of resisting unwelcome Commission initiatives and on the more positive side of steering matters in the direction we want.

4 The Engineering Industries Council has been active in encouraging improvement in the representation of the mechanical engineering sector. It has been taking a leading role in the development of COMMET (The Council of Mechanical and Metal Trade Associations), which seeks to bring together trade associations in this sector, to present a united voice in dealing with the Government and with the Community.

5 This is not a speaking engagement, but rather a listening engagement. It would be an opportunity for an off-the-record exchange of views. As such, it is very much for the Prime Minister herself to decide whether or not to accept. The EIC is an important and influential body, and such a meeting could prove very useful, but we would not go so far as to recommend acceptance of the invitation.

Yours sincerely
David Saunders

DAVID SAUNDERS
Private Secretary