COVERING CONFIDENTIAL

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Prime Minister

TL 11/9

Treasury Chambers, Parliament Street, SWIP 3AG
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11th September 1980

(Any note of your last meeting with Pennock is also in this folder)

TL 11/9

T.P. Lankester, Esq.,
No.10, Downing Street

Dear Tim,

I attach a brief prepared by the Treasury for the Prime Minister's meeting with Sir Ray Pennock on 12 September. As you suggested in your letter of 8 September, it concentrates on pay; but some short notes are provided on other topics in which the CBI may be interested.

Yours

John

A.J. WIGGINS

SIR RAYMOND PENNOCK'S CALL ON THE PRIME MINISTER

There is no fixed agenda. We know that Sir Raymond is interested in discussing the pay scene. We know also, from the press and from contact with the CBI, that he will wish to go wider and discuss industrial problems generally and what the Government might do to alleviate them.

2. The meeting will take place after the discussion the Prime Minister is to have on 12 September with Ministers about industrial problems. That discussion will therefore provide part of the background.

3. The developments on the monetary front, and in particular the statement of 9 September, have already been the subject of substantial briefing. The notes following are therefore limited to the additional material which it may be useful for the Prime Minister to have in connection with Sir Raymond's call.

PAY

4. (a) Factual

August 1 traditionally marks the beginning of a new pay round, when negotiators look for a change in the typical level of settlement. Settlements in the round which has just ended averaged 17½%. With wage drift and catching-up payments from the last round, earnings will have increased by 22% over the round. These averages conceal some important features:-

(i) In the private sector, settlements averaged 18½%. Settlements in manufacturing industry averaged just under 17% (confirmed by CBI's Databank, which reports manufacturing settlements at 16.6%). Non-manufacturing settlements averaged 18½%. Exposure to the high exchange rate and recent job losses seem the factors operating to produce the lowest level of settlements. Because of low output, earnings in the private sector increased by 19½%, little more than the average settlement level.

(ii) The public trading sector settled on average at 18%, reflecting the same sort of factors as operated in the private sector.

(iii) The public services settled mostly for 14% increases, except for those with independent pay reviews. The average level was 15%, but comparability payments, the staged implementation of the April 1979 settlement for the non-industrial civil service, and wage drift raised average earnings for public service workers by another 12%.

(iv) About a quarter of manual workers negotiated reductions in the working week, mostly reductions of one hour effective in 1981. Many workers secured longer holidays. These improvements are likely to become more generalised in the coming round. Most of these changes do not show up in estimated settlement levels or earnings statistics.

(v) There was a continuing erosion of the principle that settlements should last for not less than 12 months.

(vi) There was no apparent acceleration in the rate of increases during the round; but also no signs of deceleration at the end of the round (despite press stories).

5. Some groups still await settlements from the last round, mostly in the public services and the Post Office. They will probably follow earlier settlements in those services. Talbot is the only major company still to settle in the private sector.

6. Very few settlements have been reached for the new round. Those that have been reported appear to be subject to the same influences and at the same levels as prevailed through the last round. It is too early to predict what private sector settlements will average; or whether a "going rate" will emerge. The main influences are likely to be:

- price movements. Now just under 17%; downward trend until the new year, though with hiccups, and then to fall;
- past earnings movements. Liable to move to 22% and not to fall markedly until the new year;
- unemployment. A major preoccupation of unions now;
- falling demand. Reflected in touch negotiating postures adopted by some employers (eg EEF, RHA);
- high cost of borrowing and high exchange rate.
- comparability. Groups who settled at relatively low levels in the last round (some manufacturing companies; many public services) may be looking to reclaim their old, or at least

retain their new, relative positions.

7. (b) Aims for the future

The financial and economic pressures on manufacturing industry, the Government's commitment to its monetary targets, and the need to avoid a further decline in international competitiveness, all point to settlements in single figures. Otherwise, the inevitable consequence will be a further and unnecessary increase in unemployment. Sir Raymond Pennock will be well aware of this and has been doing a valuable job in putting across the message himself. The Prime Minister might take the opportunity to thank him.

8. Some signs of a new atmosphere are already appearing in the private sector (the Talbot settlement at an annual rate of about 10%, the Lucas 10% imposed settlement, the Vauxhall 8% offer, which is going to secret ballot and has been narrowly accepted at Dunstable, the EEF stance on the National Engineering Agreement, although their 6.2% offer has been rejected. Nevertheless the latest Financial Times survey of business opinion shows half the respondents expecting wages to rise by 15%-19% over the next 12 months, whereas a year ago over half the respondents put the bracket at 10%-14%.

9. The Prime Minister can assure Sir Raymond Pennock that the Government will do all that it can to ensure that pay settlements in the public sector will not embarrass firms in achieving these low settlements. In the public services, this will be achieved through cash limits. It is too early to set these, but the Chancellor has indicated that the increases this year will need to be significantly lower than last year. The Prime Minister might speak in confidence in terms of single figures as a strong possibility.

10. Nationalised industries are more of a problem. Some will be heavily constrained by their financial position and EFLs and their workforces have relatively little bargaining power in current circumstances. Others (miners, electricity, water, perhaps railways) are either not so financially constrained and/or have workers with powerful muscle which they are prepared to use. Sir Raymond Pennock will be well aware of the problems here. The Prime Minister can assure him that the Government will do all that it can to hold settlements to realistic levels, but he will not under-estimate the

the difficulties. Since most nationalised industries are CBI members, it would be helpful if he could help to bring pressure to bear on nationalised industry managements through the CBI. It will be helpful to build up public opinion to voice its distate for excessive pay settlements (not just price increases) in monopoly nationalised industries.

11. This is not only a problem in the public sector. There are areas of the private sector - banks, oil companies, insurance - where firms have traditionally conceded high settlements and are not financially inhibited from doing so this year. The Government has no intention of intervening directly. But anything the CBI can do through their own contacts would be helpful. The Prime Minister mightask Sir Raymond Pennock whether he has any idea on how settlements might develop in this sort of area.

12. Finally, as Sir Raymond Pennock will be speaking also about interest rates and their effects on the exchange rate, profitability, output and employment, it is important that he should appreciate the links: interest rates are high partly because pay is being settled on a basis which is incompatible with the monetary targets - that lesson has not yet fully got across to the public and is important.

FISCAL SUGGESTIONS

13. The CBI have hitherto supported two proposals in particular, and may refer to them again:-

(a) Reduction in the NIS.

(b) The 'Lord' proposal that companies should be able to pay interest net of corporation tax.

Reduction/abolition of NIS

13a. The Chancellor's present thinking is that this is not the best way of using any money that could be found to give relief to manufacturing industry. A cut in the NIS would be very costly. Even a reduction of one percentage point (from 3½% to 2½%) would cost £750 million in a full year. It would also be rather indiscriminate - about two-thirds of the benefit would go to other than manufacturing industries, including the banks and oil companies. For a reduction to take effect in April 1981 a decision would need to be taken by mid-November. But there are precedents for a mid-year change which could be announced in Budget.

Interest Payments net of Corporation Tax

14. The "Lord" proposal was rejected by Ministers at the Committee Stage of the Finance Bill and the decision was reaffirmed by the Chancellor in correspondence with the CBI. The proposal would have assisted only those companies paying not mainstream tax. It would have complicated monetary policy and encouraged borrowing.

EXCHANGE RATE

15. The CBI supports the Government's main monetary objectives as the route to reducing inflation and accepts that a flexible exchange rate is a necessary counterpart to the firm monetary policy. Nevertheless they have shown great interest in any devices which could be employed to make the exchange rate lower than it now is, and there have been some contacts at technical level between the CBI and the Treasury about this. The problem with most such devices is likely incompatibility with monetary policy.

Level of Exchange Rate

16. We have no target level for the rate which, apart from some smoothing of excessive fluctuations, is determined by the balance of market forces. The rate is sensitive in the short-term to movements in relative interest rates, but the main factors underlying its present strength are probably our possession of North Sea oil at a time of continued uncertainty in the world oil market and overseas confidence in the Government's fiscal and monetary policies. On the other hand, as a result of the abolition of exchange controls the rate will probably be lower in the long-term than it would otherwise have been.

Intervention to reduce rate

17. Government intervention in the foreign exchange markets to seek to depress the exchange rate would risk monetary control, increasing inflation - and thereby damaging competitiveness except ~~in~~ possibly in the very short run. (CBI are unlikely to press this.)

Accelerate overseas official debt repayments

18. Repaying overseas official debt only affects the exchange rate if financed by intervention in the foreign exchange market to purchase the required foreign currency. The proposal would then be identical to that above. Repayments are in practice made directly from the reserves and thus have no effect either on the exchange rate or on the money supply.

Inflow controls

19. The experience of other countries is that inflow controls tend not to be effective for more than short periods. Taking into

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account the extremely sophisticated UK capital markets, it seems unlikely that the creation of barriers of this kind to the working of the market would have more than a temporary effect on the exchange rate.

NOTES ON RECENT INDUSTRIAL PERFORMANCE

Output

20. Provisional estimates to June show that industrial output fell during the first half of the year. Industrial output in the six months to June was some 3½% lower, and manufacturing output some 4½% lower, than in 1979 as a whole.

Index of Industrial Production (1975 = 100)

	All Industries	All industries other than North Sea	Manufacturing
1979	112.6	104.2	103.8
1980 Q1	110.3	101.7	100.7
Q2	107.4	99.1	97.9

Employment

21. Employment in index of production industries fell by 385,000 between June 1980 and June 1979. Over the same period employment in manufacturing industries fell by 355,000. There was a considerable reduction in the number of hours of overtime worked in manufacturing from 15.6 million in June 1979 to 12.4 million in June 1980. The number of workers in manufacturing on short time working also rose significantly from 36,000 in June 1979 to 205,000 in June this year.

Investment

22. The volume of capital expenditure by manufacturing industry fell 3% between the last quarter of 1979 and first quarter of 1980. The provisional estimate for the second quarter shows a further fall of 1%. A longer comparison, which gives a better indication of trends, shows the volume of investment in the first half of 1980 3% below the previous half year. Over the same period investment in plant and machinery, new building work and vehicles fell by 1%, 14% and 6% respectively.

23. The May Department of Industry Investment Intentions Survey indicated a fall in manufacturing investment of 8-12% between 1979 and 1980.

Manufacturing Industries Stocks

24. It is estimated that manufacturers' stocks fell by about £480M at 1975 prices in the first half of 1980. This is a turn round from a rise of £130m in the second half of 1979. During the first half of 1980 stocks of materials and fuel felly by £230m, work in progress by over £200m and stocks of finished goods by £50m. Despite this fall in stocks the stock/output ratio continued to rise due to the fall in manufacturing output more than offsetting the fall in stock levels. The August CBI monthly trends enquiry reported that the number of firms reporting that stocks of finished goods were more than adequate continued to rise to 42%. Further attempts at destocking are therefore likely.

Profits

25. Profit margins are being squeezed by weak demand, rising unit labour costs and reduced competitiveness. The CBI forecast that the real pre-tax rate of return of non-oil industrial and commercial companies to fall this year to below 2% the lowest level ever recorded. Measured by their net acquisition of financial assets industrial and commercial companies are estimated to have had a deficit of £2.4 billion in the six months to March 1980 compared with a deficit of £1.5 billion in the previous six month period.

COMPANY SECTOR LIQUIDITY

26. The Department of Industry's survey of company liquidity for the second quarter of 1980 was published in 'British Business' on 5 September. It showed a slight improvement in the overall position compared with the first quarter of 1980, but the liquidity ratio (total current assets as a percentage of total current liabilities) was still at the mid-74 level. The ratio for manufacturing companies deteriorated to its lowest level since mid-1975, while the position of non-manufacturing companies improved, with the ratio nearly back to the first half of 1979.

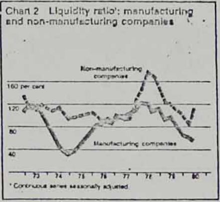

Chart 2 Liquidity ratio*: manufacturing and non-manufacturing companies

* Continuous series seasonally adjusted

/Prospects: not for disclosure: the outlook for the company sector, especially for industrial and commercial companies excluding the North Sea, is bleak. Profits and real rates of return are expected to fall and there is likely to be continued pressure on company liquidity./