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DEPARTMENT OF INDUSTRY  
ASHDOWN HOUSE

PRIME MINISTER

This letter is very important: 123 VICTORIA STREET  
LONDON SW1E 6RB

it suggests a number of TELEPHONE DIRECT LINE 01-212 3301  
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Secretary of State for Industry

*different measures, some expensive*

August 1980

Press Office  
Mr Wolfson  
Mr Hasllyn

*Perhaps by the Chancellor's cabinet on stage. It will come to Ministers collectively a later*

*early discussion like very early (not)*

The Rt Hon Sir Geoffrey Howe QC, MP  
Chancellor of the Exchequer  
HM Treasury  
Parliament Street,  
LONDON  
SW1P 3HE

*Further discussion, and no doubt much changed; but you ought to see it now*

- |               |                    |
|---------------|--------------------|
| Ministers     | Mr Leeming         |
| Secretary     | Mr Wright          |
| Miss Mueller  | Mr Chapman         |
| Mr Bullock    | Mr Worman          |
| Mr Ridley     | Mr D W F Johnson   |
| Mr Manzie     | Mr Hilton          |
| Mr Liesner    | Mr Owen            |
| Dr Davies     | Mr Cochlin         |
| Mr I Lightman | Mr Stanley         |
| Mr L Lightman | Mr Charik          |
| Mr Treadgold  | Mr Mitchell (file) |

*not Sir Geoffrey*

INDUSTRIAL SUPPORT

1. At Cabinet on 10 July you were asked in consultation with those of us concerned to circulate a paper in due course on the options for further measures of industrial support. I should like to give you my initial views on this question before the summer break, although I hope there will be an opportunity to review the position again and to discuss your paper before you circulate it more widely to colleagues.

The Prospects for Companies

2. It is now clear that in the last few months industry has moved sharply into recession. The one point reduction in MFR, though helpful, has not had a significant effect on companies' finances. The corporate sector's financial deficit may well be very high this year. The cumulative effect of deficits in 1979 and over this year and next will be that many companies become highly geared. Dependence on bank borrowing will increase, while liquidity declines. Company liquidations are now at a higher level than previous peaks, and rising.

3. Within the corporate sector, manufacturing companies are expected to be hit particularly hard. They face intense competition and weak demand in both home and overseas markets. The destocking that appears to be taking place is helpful to liquidity, but damages output and suppliers (though it may also reduce imports). The profitability of manufacturing companies may be even worse than in 1974/75, itself the culmination of years of declining profitability, and it is certain that large areas of manufacturing industry will be operating at a loss in real terms this year.

4. Our policy of squeezing inflation out of the economy of course requires a period of pressure on the corporate sector,



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in order to lay the basis for the sound sustainable growth described in our Medium Term Financial Strategy. I do not in any sense advocate a change in that policy. Indeed one possible way forward would be to identify further public expenditure cuts to reduce the PSBR and bring interest rates down more rapidly. Unfortunately it may be very difficult to achieve quick results through this route. But while in the medium term companies' prospects will be much improved by a reduction in inflation and (I assume) in interest rates, I believe in the shorter term we need to keep a careful watch on the speed at which pressure develops and the possible consequences for certain sectors and activities. Companies inevitably require time to adjust. To the extent that a reduction in inflation reflects an inability by firms to raise prices, even this may initially intensify the liquidity squeeze and reduce profitability in the short term.

5. The evidence so far available suggests the possibility of a severe liquidity shortage developing, leading to loss of productive potential in several hitherto viable sectors. Where productive potential is maintained, discretionary expenditure of all kinds (including capital investment, R & D, product improvement and marketing) is likely to be cut back, jeopardising companies' ability to respond to the improving environment ahead.

6. We also have to bear in mind the likelihood that, even after interest rates have come down, North Sea oil will keep the exchange rate higher than it would otherwise be. This will increase the pressure on those sectors (typically in manufacturing industry) exposed to international competition.

7. I attach a paper setting out in summary form our latest assessment of the position and prospects of the main sectors of manufacturing industry. Assessments of this kind must be treated cautiously and I do not place too much weight on this one. Nevertheless, even taking account of prospective reductions in inflation and interest rates, it indicates serious cause for concern about the future of large parts of industries such as vehicles and components, construction equipment, domestic electrical appliances, batteries, consumer electronics, clothing, knitwear, footwear, leather, paper and board and furniture. This list excludes public sector steel and shipbuilding, which have their own difficulties, and a number of other industries which undoubtedly face a tough period ahead.

## Work Already in Hand

8. The reduction of inflation will in the medium term be our greatest single contribution to laying the foundation for the prosperity of the corporate sector. But we have also given companies a great deal of help through your Budgets and by other measures, and we have a programme of continuing work in hand.

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9. I attach particular importance to the work of the FASE Group. The issues under consideration there are central to the restoration of vitality to the corporate sector and I am sure you will agree that we should press on with this part of our work with all possible speed.

Need for Further Measures

10. Nevertheless I am convinced that the situation has reached a point where we must now consider yet further measures which, without departing from our basic strategy, will seek to ensure that the corporate sector retains the ability to take advantage of the improved business climate that will surely come. I believe we must contemplate a change in the balance of allocation of our scarce resources in favour of the corporate sector. I realise of course that the public sector of industry has claimed - and may continue to claim - a greater share of resources than we envisaged. This is a matter of profound regret to me, although it must be remembered that much of the extra assistance going to the public sector is finding its way through to suppliers and support industries in the private sector and to that extent may be more beneficial than may immediately appear. However, I believe we should now exercise some of the options for giving further support to the private sector.

11. With some exceptions, most of the possible measures we could take would take several months to become effective. This means that to some extent any decisions we take must be based on a judgment about future developments. It also means, I believe, that we must review all the possibilities at this stage, even though the real squeeze has only just begun, so that we can be in a position to take decisions quickly if it becomes necessary. Even where measures take time to become fully effective, an early announcement can give a considerable psychological boost to the confidence which is often a vital factor in business decisions.

12. For these reasons I very much hope you will agree to include in your paper for colleagues the fiscal options open to us as well as the expenditure options. Many (though perhaps not necessarily all) of the fiscal options could no doubt only be implemented in a Budget context, but to be effective from the date of the next Budget many of them would have to be considered, and in some cases announced, some months beforehand. I do not think it would be helpful to restrict the next Cabinet discussion to expenditure measures alone. In general, fiscal measures will tend to benefit corporate liquidity, and expenditure measures will help preserve some parts of productive potential and maintain "seed corn". I believe we need to consider both these approaches. Within them I see distinctions more in terms of the relative objectives, size and speed of possible measures, and whether they are likely to be indiscriminate or selective in the benefits they confer.

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13. I set out below the list of possibilities I should like to see considered. I should stress that I regard these as options. I shall not necessarily be proposing that they should all be implemented at this stage: clearly there are significant PSBR implications. Nevertheless within the list (which you will notice already omits a number of possibilities I have decided not even to offer for consideration) there are some items which I would regard as having a certain priority, and as worth doing in their own right independent of the present economic conjuncture. These are:

- (a) <sup>3</sup> the increase in support for science and technology (which I have already discussed in detail with John Biffen);
- (b) more effective use of public purchasing;
- (c) <sup>?</sup> assistance related to large overseas projects; and
- (d) further assistance for small firms.

I deal with each of these in more detail below.

14. Concentrating first on measures aimed at easing liquidity pressures, I believe we should consider the following options:-

i) The National Insurance Surcharge

This was imposed by the previous Government in response to a crisis largely of their own making, and we should get rid of it as soon as circumstances permit. At Cabinet on 3 July there was general agreement not to modify the NIS at this stage and I am not now in favour of this form of help because it can so easily leak into pay. I believe, however, that we should give serious study to the NIS for the future in case the liquidity crisis became really severe and a reduction became necessary. I understand that in order to implement a reduction by the time of the 1981 Budget, you would need to announce the change in about November of this year. I believe we should consider that option seriously, though of course I know there would be difficult PSBR implications.

ii) The "Lord" Proposal

This is much smaller-scale but could be useful in directing assistance of perhaps £0.3bn a year to tax-exhausted but viable companies (although I recognise that the scheme could encourage bank borrowing). I know you are already studying this proposal, and I hope you will consider including it in your paper for colleagues.

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iii) Reduction of Employers' Contribution to Redundancy Payments

I believe we should consider giving further relief to companies through a larger increase in the rebates payable from the Redundancy Fund. We have already agreed (but not yet announced) that rebates should be increased this November from 41% to 50% of the statutory minimum payments. I believe we should consider a further increase to 60%. This would be of direct assistance to companies which are forced through financial difficulties into declaring redundancies.

iv) Heavy Fuel Oil Duty

UK excise duty on heavy fuel oil is the highest in the European Community. It currently yields £170m in a full year. Abolition would initially help the oil companies, but the corporate sector as a whole should be able to secure a share in the benefit in the form of reduced costs. To the extent that heavy fuel oil is used in electricity generation, there should also be a marginal benefit on electricity prices. You may wish to consider replacing the duty by VAT, thus bringing the UK into line with our principal Community partners.

v) Extension of Deferral of Stock Relief Clawback

The present Finance Bill contains a useful deferral of the stock relief clawback for businesses that reduce their stock levels for one year only. Since the current period of destocking seems likely to continue for several months, I believe there is a case for extending the relief to dips that last for two years. In addition, to help those businesses forced to make large reductions in stocks, we may need to consider writing off stock relief after 3 years instead of the present 6 years.

15. In addition to these possibilities, I know your officials and the Revenue are already looking at the implications of offering improvements in the tax relief on R & D expenditure. I shall be interested to see the result of this work, and I hope we can consider this possibility alongside the others I have listed.

16. I turn now to measures designed to encourage companies to maintain discretionary expenditure or to help our firms win important contracts overseas. Such measures would be distinct from any general or discriminatory relief from pressures on liquidity. They need not be expensive, and in relation to the economy as a whole their effect may seem small. But their aim would be to counteract the undesirable effects of the liquidity squeeze in certain cases, by maintaining "seed corn"

expenditure/....





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expenditure on which future prosperity relies. I do not envisage that any new instruments would be required: the Science and Technology Act 1965 and the Industry Act 1972 provide sufficient powers. Within these existing instruments, it is difficult at this stage to be precise about where further resources could most effectively be spent. This will depend on what possibilities emerge and on the overall situation as it develops. Nor is it easy to quantify precisely how much extra money would be needed, but I envisage additional expenditure of the order of £50m in 1981/2, £70m in 1982/3 and £90m in 1983/4, inclusive of the additional science and technology funds for which I have already bid. I would envisage allocating such extra resources under the following broad headings:

i) R & D and Product and Process Development

In addition to the additional funds for which I have already bid, I believe the allocation of further resources to the Product and Process Development Scheme could be helpful. Improvement of the scheme might usefully take the form of an increase in the percentage (currently 25%) of Government assistance, or of some simplification of the administrative procedures.

ii) Public Purchasing

Better use of public purchasing policy could bring considerable help to industry. There are several ways in which this could be done, including development contracts for new products or processes and purchases of prototypes for demonstration or testing in the public sector.

iii) Overseas Projects

A relatively small amount of Government assistance - for example with the development of a product or process - can sometimes enable British companies to win large overseas contracts which can provide a firm basis for future expansion and development. I believe an increase in expenditure in this area could bring considerable help to certain sectors.

iv) Investment Incentives

I believe there may be scope for giving effective assistance to companies, in terms of maintaining investment levels for a relatively low Government outlay, via stimulation of the demand for assistance under Section 8 of the Industry Act. Again, we may need to look at the possibility of some modification of the present criteria.

v) Private Sector Exchange Risk Guarantee Scheme

The exchange risk guarantee scheme for EIB and ECSC loans has proved a useful way of stimulating private investment.

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There is no immediate cost to the PSBR and I believe we should consider a further increase in the limit on this scheme. We may also need to consider an extension of its period of operation beyond the present limit of the end of 1981.

#### Energy Costs

17. I have already listed (paragraph 14(iv)) one relatively minor way in which industry's energy costs might be reduced. But I believe we need to look urgently at the whole area of energy costs. There is increasing evidence that we are now out of line with our main competitors and that this is putting our industry at a disadvantage. I am writing separately to the Secretary of State for Energy on this issue and I may well need to come back to it with you in due course.

#### Small Firms

18. Many of the measures I have listed would help small firms as well as large. But I believe that in addition we should keep up the momentum of improvements in the assistance offered specifically to small firms. I believe that fiscal measures are the most effective means of stimulating the small firms sector and I attach particular importance to the results of the FASE exercise. But there are also various possible measures involving expenditure. I am considering in particular an initiative which would increase the resources available for helping small firms in the urban areas, ie those parts of England not covered by COSIRA.

#### Regional Development Grants

19. Many of the possibilities I have listed could only take effect in 1981/2. If the liquidity pressures sharpen quickly in the coming weeks, I believe we may need to consider more immediate and quicker-acting measures. Principal among these would be the removal of the 4-month deferment of Regional Development Grants introduced in your 1979 Budget. I realise this option is unpalatable on public expenditure grounds, and indeed goes against our current thinking that the period of deferment might even be lengthened, which I am exploring with colleagues concerned as I undertook to do. Nevertheless, I believe that we should bear in mind the possibility of cancelling the deferment in response to what might become a rapidly changing set of circumstances facing the corporate sector. This option is one of the few capable of bringing immediate relief to a considerable section of industry.

20. I hope that during the Recess our officials can go through all these options in detail, and I look forward to discussing

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the terms of your paper to colleagues when we return.

21. I am copying this letter to the Prime Minister, the Secretaries of State for Employment, the Environment, Scotland, Wales and Northern Ireland and Trade, Energy, the Chief Secretary, and Sir Robert Armstrong.

*Yours*

*Kerr*





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## THE POSITION AND PROSPECTS OF MANUFACTURING INDUSTRY

The attached papers (Annex A) give an up to date assessment of the position and prospects of UK manufacturing industry (excluding the British Steel Corporation and British Shipbuilders). They are based on the assessments of Department of Industry divisions and regional offices. Where trade associations and individual companies have been consulted, judgment has been applied to the information. The assessment is therefore essentially subjective, and individual figures should be treated with caution.

Section One of Annex A gives a narrative description of the position of each sector. Section Two attempts a more precise assessment of four particular issues:-

- i) The percentage of each industry currently losing money
- ii) The percentage of the loss-makers owned by multinationals
- iii) The percentage of the Industry likely to survive the next 12 months.
- iv) The unemployment consequences.

Where loss-making has been assessed on a historic cost basis, it may not be a reliable guide to the likelihood of survival (see, in particular, the assessments for domestic electrical appliances and batteries). The potential for survival has been assumed on the basis of present conditions and pressures broadly continuing. As explained in the Secretary of State's letter, a reduction in inflation and interest rates is unlikely to bring substantial relief to industry in the short term.

Department of Industry  
7 August 1980

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