

PRIME MINISTER

BILATERAL WITH THE CHANCELLOR: 3 OCTOBER

Your regular bilateral meeting with the Chancellor tomorrow follows a talk you are having with him and a wider group of colleagues on public expenditure (see separate folder).

There is a fuller than usual agenda for the bilateral, and we have therefore set aside 45 minutes. The main items are as follows:

(1) Markets/interest rates The Chancellor will want to report on the latest position and discuss the handling of the next two weeks. Alan Walters tells me there were divided views at the Chancellor's internal meeting this evening; the hawks still favour an interest rate increase if the markets react badly to any Bundesbank move on Thursday, while others are more cautious. I have included in folder 1 below the note I put to you at the weekend, together with today's evening report. The foreign exchange markets today have been surprisingly calm.

(2) Civil Service Pay for Grades 5-7 There is a note from the Chancellor in folder 2.

This concerns the first of the settlements for Grades 5-7 (i.e. Assistant Secretaries to Principals) under the new long term pay agreement. This follows the first of the levels surveys. It is believed that agreement could be reached on the basis of the following four point package:

- (i) an across the board increase of 6.5% from 1 August. Taken together with 4% pay from 1 April, this would provide increases at an equivalent annual rate of 8% to cover the full period from 1 April 1989 to 1 August 1990;
- (ii) an extra spine point for staff in London, worth between £800 and £1500. But this would be staged and not paid until 1 December or 1 January 1990;

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- (iii) shortening the Grade 7 scale (Principals) by taking two points off the bottom;
- (iv) some restructuring of the pay spines to give most Grade 5s (Assistant Secretaries) and a few Grade 6s up to 1.5% more.

This total package would cost 7.9% in the first twelve months and 8.7% in a full year.

This I understand was the package recommended to the Chancellor. It is also supported by Robin Butler - see his minute also in folder 2. And my impression is that other colleagues, who expressed particular concern in the last MISC 66 discussion about pay at these levels, would want a package that could be agreed with unions.

But the Chancellor is concerned about these proposals. He fears that they may be unfavourably compared with other pay negotiations. And he sees advantage in being seen to impose a settlement on the unions. He therefore proposes to reject (iv) above. In cash terms this would save some £1.3 million and would reduce the first year costs to 7.7% and the full year costs to 8.4%. He recognises however that there will be "a lot of recrimination and accusations of bad faith" and "the effect on morale and motivation could be quite substantial". Robin Butler would be unhappy with this approach, as would other colleagues.

** He argues that imposition to achieve so little is not worth the candle.*

One other point to note is that MPs' pay is linked to that of Grade 6. From 1 January 1990 they would receive under this package 10.75% - both the 4% pay from 1 April and the 6.5% proposed from 1 August. The position for MPs is unaffected by the Chancellor's proposal to override (iv) in the Civil Service package. The Chancellor suggests that to try and unscramble the formula for MPs could well produce something worse.

The timetable position for the Civil Service settlement is now tight and the Treasury is therefore keen for an early reaction. You will presumably want to talk this through with the Chancellor tomorrow afternoon. But if you have strong feelings as between

the original four point package or the Chancellor's imposed alternative it would be helpful if I could give the Treasury an initial reaction first thing tomorrow morning.

Which option do you prefer?

*10.75% for
M.P.'s would be catastrophic
Can we not reduce it? mb*

(3) Balancing Items Following discussion with Hector Laing you asked me to commission a note from the Treasury about treatment of balancing items both in this country and overseas. This is now available and is in folder 3, together with a copy of the original Bank of England report that Hector Laing showed you.

(4) Ownership of Pension Fund Assets At the end of last month you wrote to Keith Joseph in terms drafted by the Treasury concerning various proposals from Lord Vinson and Mr. Philip Chappell about concentration of share ownership in pension funds. You agreed not to raise in that letter a suggestion from the Policy Unit that the Occupational Pensions Board would have a thorough look at the question of who owns pension funds' assets. But you indicated you may want to mention this to the Chancellor at a bilateral. I have included the key papers in folder 4.

(5) Bank of England Deputy Governor At some point, the Chancellor will want to raise the question of a successor to George Blunden. But he may not be in a position to do so tomorrow. So please do not raise this until the Chancellor does.

Recc.

(PAUL GRAY)

2 October 1989