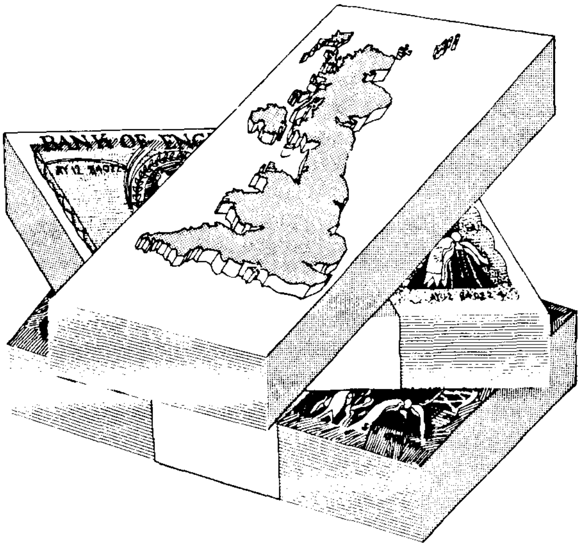
The British Economy

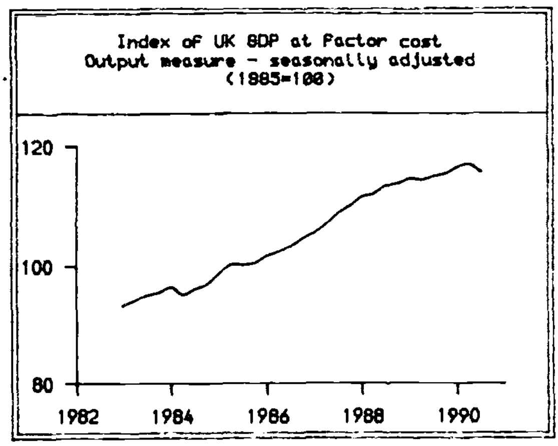


OVERVIEW

The British economy is clearly now well into the down phase of the growth cycle. It is likely that GDP will begin to increase again during the second half of the year, however, employment and unemployment are unlikely to improve until 1992. Recovery is constrained by the current parity for sterling within the ERM and the upward pressure on German interest rates due to unification.

MACROECONOMIC TRENDS

In the third quarter of 1990, the average measure of GDP at current market prices - nominal or 'money' GDP - rose by 0.6% during the quarter to a level 7.7% higher than the same period a year earlier. The rate of growth of money GDP therefore fell compared with the previous two quarters where the rate of increase was 1.6% and 2.1%, respectively. It should be noted, however, that comparisons of GDP at current market prices are distorted by the replacement of domestic rates by the community charge. Since the latter is not treated as part of consumers' expenditure whereas the former was, consumers' expenditure at current market prices is effectively lower under the new local tax regime particularly after the second quarter 1990 when the change occurred in England and Wales. After allowing for price changes, the average measure of GDP at constant market prices - 'real' GDP - fell by 1.3% in the third quarter, compared with a rise of 0.9% during the second quarter and an increase of 0.4% in the first quarter of the year. Over the year to the third quarter 'real' GDP is estimated to have risen by 0.6% compared with increases of 2.5% and 1.9% in the year to the second and first quarters of 1990 respectively. When measured at constant factor cost - ie. after subtracting taxes on expenditure minus subsidies - GDP fell by 1.2% in the third quarter, compared with the small 0.3% increase recorded in the previous quarter. Using this measure, the increase between the third quarters of 1989 and 1990 was also 0.6% compared with 2.3% and 1.6% over the year to the second and first quarters, respectively.



Preliminary estimates of the output-based measure of GDP - which is usually taken to be the most reliable indicator of short-term change - in the fourth quarter of 1990, suggest that activity fell by 0.9% compared with the previous quarter to a level 1.1% lower than the fourth quarter of 1989. Manufacturing output fell by 3% in the latest quarter, while the output of the production industries as a whole fell by 2.5%. Service sector output fell by 0.5%, while the output of the energy sector rose by 2.5% in the fourth quarter.

With GDP now seen to have fallen in two successive quarters the economy can be formally described as being in recession, confirming the view taken in the December Commentary that the UK economy had entered a recession which was particularly affecting manufacturing. Just as we predicted that negative GDP growth would again be recorded in the final quarter of 1990 so we maintain that negative or zero growth is likely to persist for the first two quarters of 1991 at least.

The CSO's coincident cyclical indicator for January 1991, which attempts to show current turning points around the long-term trend, continues to decline slowly, reflecting further falls in all its component series. This indicator has fallen continuously since the peak of August 1988 suggesting that the economy is well into the down phase of the growth cycle.

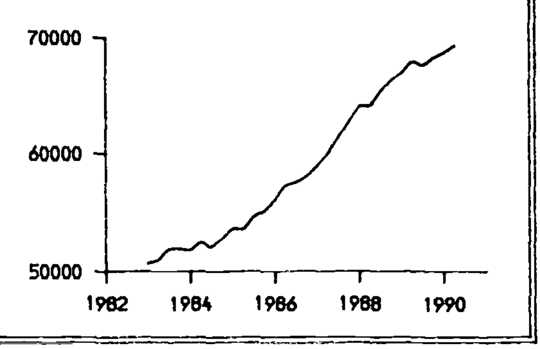
In the third quarter of 1990 real consumers' expenditure - seasonally adjusted - fell by 0.6% compared with a 1% increase in the previous quarter, and the 1.4% rate of growth recorded in the first quarter. Spending therefore stood at 2.1% above the same period a year earlier, down on the 2.7% and 3% increases recorded over the year to the second and first quarters, respectively. Expenditure on durable goods continued to fall with a 2% reduction between the second and third quarters after the 1% fall in the first quarter of 1990. Durable expenditures now stand at a level 7% lower than a year earlier. Non durable goods expenditure also fell by 1% in the third quarter, after the 1% rise in the second quarter, to a level 1% higher than in the third quarter of 1989. Expenditure on services was broadly unchanged between the second and third quarters of 1990, after rising by 1% between the first two quarters of the year, to a level 4% higher than a year earlier.

The official retail sales figures - seasonally adjusted - for January recorded a sharp fall of 1.4% over the previous month. This was the second largest monthly fall for ten years. Sales fell by 2.4% in the three-month period to October compared with the previous three-month period, and were 1.1% lower than the same period a year ago, the fourth consecutive month that sales volumes have been recorded as lower than in the same month a year earlier.

The underlying determinants of consumers' spending have again moderated since we last reported in the December Commentary.

The latest consumer credit figures show that consumers took out £3.9bn of new credit in December, representing little change from November but £300m down on October. The cumulative amount of outstanding credit recorded a net increase of £141m in December over November, following net increases of £229m, £342m, £331m and £196m in November, October, September and August, respectively. The rate of growth of borrowing for consumption was 8.9% in the third quarter of 1990 compared with its peak growth of 23% in the third quarter of 1988.

Consumers' expenditure at 1985 prices (millions)



The saving ratio rose to 8.8% in the third quarter of 1990, compared with 7.4% in the second quarter, 7.8% in the first quarter and an average of 6.7% in 1989 and 5.3% in 1988. Data from the Bank of England show that the personal sector moved into surplus in the first three quarters of 1990 after the record deficit of 1988. Improvements in the savings ratio are attributed by the Bank to people being discouraged from consumption spending, despite rising real incomes, owing to stagnation in the housing market. Real personal disposable income rose by 1% in the third quarter to a level 4.2% higher than in the third quarter 1989.

The underlying increase in average weekly earnings in the year to December remained at the November and October figure of 9.75%. However, since we last reported the underlying increase has moderated somewhat after its peak increase of 10.25% in the year to July. In the year to August and September the increase moderated slightly to 10% and then moderated again to 9.75% in October. Nevertheless, this rate of increase still remains above consumer price inflation and is of some concern both in terms of the potential contribution to demand in the economy - although of less importance in view of the recession - and, given the decline in productivity in the whole economy during the third quarter, to the competitiveness of the economy.

General government final consumption fell by 0.4% in the third quarter of 1990 after rising by 2.5% during the second quarter and increases of 0.1, 0.2% and 1% during the preceding three quarters. The new level was 2.9% higher than a year earlier, compared with an increase of 3.7% in the year to the previous quarter.

Real gross fixed investment again fell markedly in the third quarter by 3.8%, after the 3.1% fall in the second quarter of last year and an increase of 2.3% in the first quarter. The level of investment in third quarter was therefore 2.7% below that of a year earlier. Over the same annual period, investment in manufacturing fell by 8%, while investment in the non-production industries was little changed and investment in energy and water supply rose by 7%. Between 1988 and 1989, spending on this component of aggregate demand rose by 5%, compared with 13.7% between 1987 and 1988 and 8.6% between 1986 and 1987. Provisional estimates of real capital expenditure in manufacturing for the fourth quarter of 1990 suggest a fall of 7% over the previous quarter to a level 15% below the fourth quarter of 1989. In addition, the CSO's survey of manufacturing investment intentions indicates an expected fall of 7% in the volume of investment in 1991 and no change in volume in 1992. These figures offer continuing confirmation of the retrenchment in investment noted in recent Commentaries.

Turning to the balance of payments, the deficit on current account for the third quarter declined to £3.5bn, after the £4.9bn deficit in the second quarter of 1990, a £4.5bn deficit in in the first quarter, and a £3.9bn deficit in the fourth quarter of 1989. After revisions, the deficit for 1989 now stands at £19.6bn compared with £15.3bn in 1988 and £4.3bn in 1987. On visible trade, the third quarter deficit fell to £3.8bn compared with £5.2bn, £5.8bn, £4.4bn, and £6.6bn, respectively, in the previous four quarters. The surplus on the oil account was £0.4bn in the third quarter, representing little change on the previous two quarters.

In the fourth quarter of 1990, the output of the production industries is provisionally estimated to have fallen by 1.5% compared with the previous quarter. The fall in output has therefore slowed compared with the 3% fall in the third quarter. In manufacturing industry, output fell sharply by 3% in the recent quarter - the sharpest quarterly fall since the 1981 recession - and was 3% lower than in the same period a year earlier. As usual there were clear variations within the sector, although in this quarter all the main sectors experienced falling output. Food, drink and tobacco continued its relatively better performance, although on this occasion output fell by 1%. Other minerals, and textiles and clothing output fell by 2%. A fall of 3% was recorded in the output of engineering and allied industries and in "other manufacturing". The chemicals industry experienced a 4% fall, and output in metals fell by 5%.

In contrast, the output of the energy sector was 2.5% higher in the fourth quarter than in the previous quarter but 4% lower than in the same period a year earlier.

Output in all the principal market sectors fell between the latest two quarters. The output of the intermediate goods, consumer goods, and investment goods industries fell by 0.5%, 1% and 4.5%, respectively.

LABOUR MARKET

Employment and Unemployment

The UK workforce in employment in September 1990 numbered 27,393,000. This reflects an increase of 475,000 (1.8%) for the year and 56,000 (0.2%) for the quarter. However, these figures represent the lowest quarterly increase since June 1986 and the lowest annual increase since the year to March 1987. The Government expect the upward trend in total UK employment, which has been evident for the past seven years, to cease in the very near future.

Disaggregating the figures indicates persistent differences between the employment performance of the various industrial sectors. Manufacturing employment has declined in each of the last four quarters to September 1990. In the last quarter the fall was 21,000 (0.4%) and in the year 57,000 (1.1%). The fall is continued in the British manufacturing data which are available up to December: the figure of 5,031,000 is the lowest ever. The fall in GB employment in the quarter and year to December 1990 are 65,000 (1.3%) and 113,000 (2.2%) respectively. However, there is continual employment growth in UK services where the quarterly and annual increases to September 1990 were 47,000 (0.3%) and 460,000 (2.9%) respectively.

The provisional figure for UK seasonally adjusted unemployment stood at 1,888,500 in January 1990. This translates to an overall unemployment rate of 6.6%, with male and female rates of 8.7% and 3.8% respectively. This is the tenth successive month that UK unemployment has risen, with the increases particularly marked for males. Moreover, the recent rises in unemployment still seem more concentrated in the Midlands and South-East, though this is rather less marked than in the last quarter. Whilst to accompany the rise in unemployment there has been a general fall in the number of notified vacancies of 56,900 (28%) for the year to January 1991, in the last month there has been an increase in vacancies of 15,100, generating a small increase of 1,200 (0.8%) for the quarter.

Earnings and Productivity

The actual annual increase in the British whole economy average earnings for December 1990 was 10.1% with an underlying increase of 9.75%. The underlying figure is lower than the actual figure because arrears of pay, which were higher than in December 1989, more than balanced timing adjustments for workers who have not been paid an increase in the past 12 months. The recent rise in underlying wage inflation seems to have peaked at 10.25% in July 1990 and has taken the value of 9.75% for each of the months in the last quarter of the year. This underlying increase in earnings is consistent across sectors of the economy.

The labour productivity performance of the economy continues to be very poor. For the whole economy, productivity in the third quarter of 1990 was 1.6% lower than the previous quarter and 1.2% lower than the same quarter in 1989. Data for manufacturing productivity up to December 1990 indicate an annual fall of 2.2% and a decline for the last quarter of the year of 1.3%. The combination of high wage inflation and negative productivity growth has led to very large increases in unit labour costs. These showed a 12.5% increase for manufacturing for the year up to December 1990 and a 12.1% increase for the whole economy for the year to the third quarter of 1990. Increases in unit labour costs have shown a strong and consistent rise from the last quarter of 1988 where they stood at 2.7%.

PROGNOSIS

The British economy is clearly now well into the down phase of the growth cycle. After reaching peak growth in August 1988, growth has subsequently moderated in the face of tight monetary policy. It is now evident that the economy entered a recession during the third quarter of 1990. The sustained high interest rates, despite the recent cuts, and the less favourable export environment will almost certainly result in the economy contracting further during the first half of this year. It is likely that an upturn in output will occur during the second half of the year as world trade picks up and as falling inflation - expected to moderate to 5% by the end of the year - provides further scope for interest rate reductions. However, employment and unemployment are unlikely to improve until 1992.

The recovery is, however, likely to be constrained by two factors. First, Britain's participation in the ERM means that the maintenance of the price of sterling within the 6% bands around a central rate of 2.95DM to the pound is the paramount objective of British monetary, and therefore interest rate, policy. In our view, at the present range of variation allowed to sterling within the ERM around the central rate, the currency is overvalued relative to the DM in particular and other participants. If so, current exchange rate and interest rate policy are therefore incompatible with the maintenance of a balance between supply and demand in the domestic economy. The implication is that domestic demand is, and will continue to be, lower than it otherwise would be in relation to the supply potential of the economy. Second, the course of German monetary and fiscal policy - see World Economy section - is likely to generate upward pressure on German interest rates in order to finance the costs of unification. Given the nature of the ERM and the central role played by Germany and the DM, other members are therefore likely to have to follow the German policy, or delay making much needed interest rate cuts, in order to maintain the desired exchange rate parities.

We therefore expect UK GDP to decline by between 0.3%-0.5% this year and to average between 2.5%-2.7% per annum growth during the 1992-95 period. Inflation should continue to decline, averaging 3.8%-4% over the period and the current account should continue to improve, all be it slowly, to 1995, as slower export growth is offset by an even slower growth in imports. Perhaps the key point to stress is that without a re-alignment of sterling within the ERM the UK is likely to produce average growth rates which are below the 2.93% annual growth rate which many economists believe is the rate which is compatible with stable inflation and unemployment.