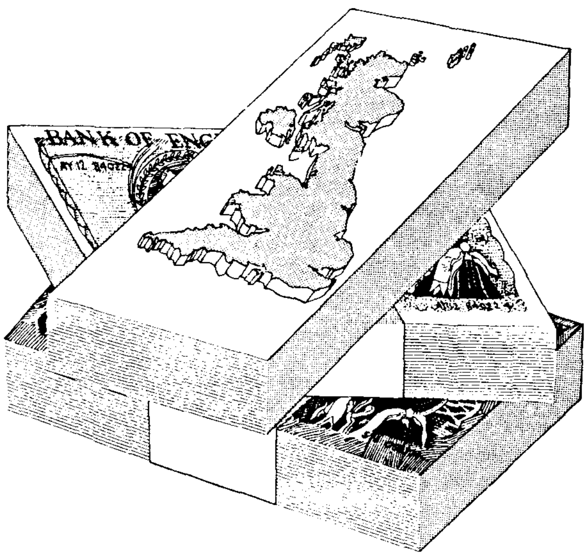
The British Economy

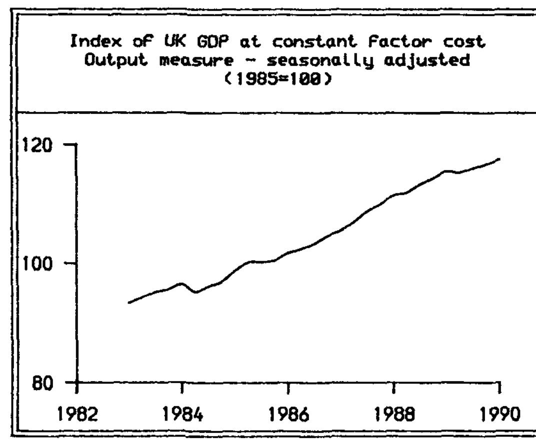


OVERVIEW

Output growth continues to slow and, following the significant increase in the exchange rate, there are fears of a small recession or at best stagnant growth in the latter half of this year. In addition, the rate of growth of prices appears to be increasing, fuelled by buoyant earnings growth and the recent increases in the price of oil.

MACROECONOMIC TRENDS

In the first quarter of 1990, the average measure of GDP at current market prices - nominal or 'money' GDP - rose by 2.1% during the quarter to a level 8% higher than the same period a year earlier. The rate of growth of money GDP therefore rose slightly compared with the previous quarter. After allowing for price changes, the average measure of GDP at constant market prices - 'real' GDP - rose by 0.4% during the quarter after an increase of 0.8% in the previous quarter. Over the year to the first quarter 'real' GDP is estimated to have risen by 1.9%, a further slight reduction on the 2% growth realised over the year to the fourth quarter 1989, the 2.3% growth rate during the year to the third quarter and the 2.6% growth recorded for the year to the second quarter 1989. When measured at constant factor cost - ie. after subtracting taxes on expenditure minus subsidies - GDP rose by 0.7% in the first quarter, the same rate as that recorded during the preceding three months. Using this measure, the increase between the first quarters of 1989 and 1990 was 1.6%, slightly down on the 2% change over the year to the fourth quarter.



Between the full years 1988 and 1989, 'money GDP' rose by 9% and GNP at constant market prices - the UK's real income - rose by 2%. These figures can be compared with annual 'money' GDP growth rates of 11% between 1987 and 1988, 10% between 1986 and 1987, and 7% between 1985 and 1986. For the real income of the UK, the earlier annual growth rates for the same years were, respectively, 5%, 4%, and 3.5%.

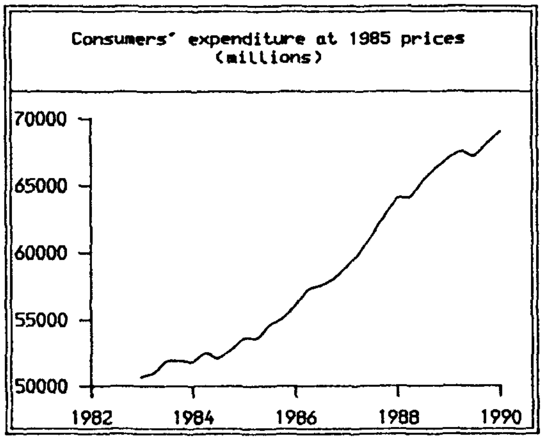
Preliminary estimates of the output-based measure of GDP - which is usually taken to be the most reliable indicator of short-term change - in the second quarter of 1990 suggest that activity was 0.9% higher than in the previous quarter and 2.7% above that of a year earlier. The main stimulus to growth during the latest quarter appears to have come from the performance of the production industries where output rose by 2.4% over the previous quarter, with the output of the energy sector rising by 5.2% and manufacturing output increasing by 1.5%. Service sector output, in contrast, rose by only 0.3%.

The most recent GDP data again suggest that growth in the UK economy is slowing down compared with

1988 and 1989, but while the rate of growth of real output contracts, money GDP growth appears to be rising, indicating the strength of inflationary pressure in the economy. Nevertheless, the most recent moderation of service sector growth relative to manufacturing would appear to be in line with need for the British economy to shift production at the margin to tradeables and away from non-tradeables.

The CSO's coincident cyclical indicator for July, which attempts to show current turning points around the long-term trend, continues to decline slowly. This indicator has fallen continuously since the peak of August 1988 suggesting that the economy is firmly in the down phase of the growth cycle.

In the first quarter of 1990 real consumers' expenditure - seasonally adjusted - rose by 1.4%, broadly the same as the rate of growth between the third and fourth quarters of last year. Spending therefore stood at 3% above the same period a year earlier, up on the 2.5% increase over the year to the fourth quarter, but down on the 4% rise over the year to the third quarter. Expenditure on both durable and non durable goods changed little between the fourth quarter of 1989 and the first quarter of 1990, but expenditure on the former was 2.5% down on a year earlier, while non-durable spending rose by 1% since the first quarter of 1989. Expenditure on services rose by about 3% between the latest two quarters and by 5.5% over the year.



The official retail sales figures - seasonally adjusted - for July recorded an increase of 1.4% over the previous month, after the 2.6% fall in June. These changes taken together mean that sales rose by only 0.25% in the three-month period to July compared with the previous three-month period and by 0.25% over the same period a year earlier. These data would appear to provide clear evidence that high interest rates are finally curbing high street spending.

The underlying determinants of consumers' spending are nevertheless generally still buoyant, though less so than when we last reported in the June Commentary.

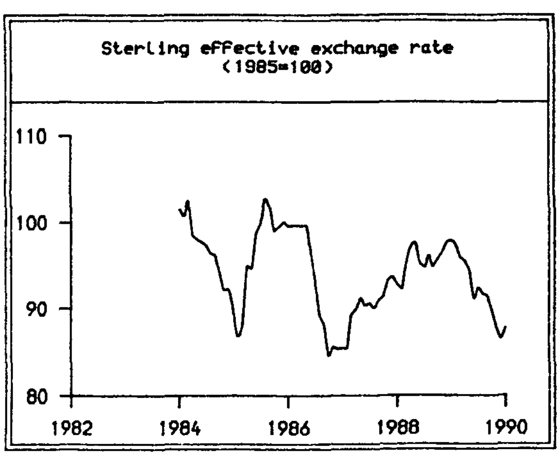
The latest consumer credit figures show an increase of £3.9bn in July, which was £200m above the rise in June, when new credit fell by £300m over May. The July figures may, however, be untypical since it is likely that a significant proportion of the growth reflects increased credit for new cars to meet the seasonal peak in motor demand associated with the introduction of the new registration letter in August. Other evidence suggests that the demand for credit slackened again during August.

The underlying increase in average weekly earnings in the year to June rose to 10%, after increases of 9.75% in April and May and an average increase of 9.5% in each of the first three months of the year. There is therefore little indication from these data that earnings increases are responding to the downturn in economic activity. Indeed, earnings growth has been progressively rising since a "low-point" in the annual increase of 8.75% was reached during the months of June, July and August last year.

General government final consumption fell by 0.1% during the first quarter of 1990 after increases of 0.2% and 1% during the fourth and third quarters of 1989. The new level was 1.3% higher than a year earlier, compared with an increase of 1.7% in the year to the previous quarter.

Real gross fixed investment rose by 2.3% in the first quarter of 1990 after falling by 0.5% in the fourth quarter of 1989, remaining unchanged in the third quarter of 1989 and falling by 0.3% in the second quarter. The level of investment in the first quarter was therefore only 0.7% above that of a year earlier. 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. These figures provide further evidence of the retrenchment in investment noted in recent Commentaries, although closer examination of the data shows that it is investment in dwellings, falling by 16.4% in the year to the first quarter, which largely accounts for the moderation in overall investment growth.

Turning to the balance of payments, the deficit on current account for the first quarter of 1990 rose to £4.7bn from £4.2bn in the fourth quarter of 1989 and £6.0bn in the third quarter. After revisions the deficit for 1989, now stands at £19bn compared with £15bn in 1988 and £4.4bn in 1987. On visible trade, the first quarter deficit rose to £5.5bn compared with £4.4bn, £6.4bn, and £6.3bn, respectively in the previous three quarters. Provisional estimates suggest that the current account deficit fell slightly to £4.5bn in the second quarter of this year. Indicators suggest that the recovery of exports is continuing but imports also remain buoyant, and the recent strength of the pound, while in the short run likely to have a favourable effect on the current balance, could damage the export recovery.



In the second quarter of 1990, the output of the production industries is provisionally estimated to have increased by 2.4%, compared with little change during the previous quarter. The level of production was therefore 3.3% higher than in the second quarter of 1989. In manufacturing industry, output rose by 1.5% in the recent quarter and was 2% higher than in the same period a year earlier. As usual there were clear variations within the sector. The principal increases recorded between the latest two quarters were in the output of metals, and engineering and allied industries, where production rose by 4% and 3% respectively. Output in food, drink and tobacco, minerals, and "other manufacturing" rose by 1%, while at the other extreme, the output of textiles fell by 3% and chemicals industry production fell by 2%. In the energy sector, output was 5% higher than in the previous quarter, compared with a 3% fall in the first quarter, and was 7% higher than a year earlier.

By market sector, the output of the consumer goods industries remained unchanged, compared with a 1% rise between the previous two quarters. The output of the investment goods industries, on the other hand, rose by 3.5% while that of intermediate goods industries rose by 3%.

LABOUR MARKET

Employment and Unemployment

The UK workforce in employment stood at 27,198,000 in March 1990, showing an increase of 582,000 (2.2%) for the year and 116,000 (0.4%) for the quarter. This continues the upward trend in employment of the past seven years. However, there are clear indications of a slowdown in employment growth: this is the lowest annual increase since the year to June 1987 and male employment actually declined in the quarter to March, the first quarterly decline in male employment since December 1986. Disaggregating the figures indicates major differences between the employment performance of the various industrial sectors. Manufacturing employment showed consistent increases from March 1987 to March 1989. However, in the last year to March 1990 employment in this sector declined by 49,000 (just under 1%) and the decline in the quarter to March was 20,000. This trend is continued in the British manufacturing figures which are more up to date and indicate a further employment fall of 13,000 for the quarter to June. However, there continues to be strong employment growth in services, which more than offsets the decline in manufacturing and other sectors.

UK seasonally adjusted unemployment stood at 1,629,100 in July 1990. This is an unemployment rate of 5.7%, with a male figure of 7.4% and a female figure of 3.5%. Unemployment began to fall in July 1986 and subsequently fell every month to April 1990. In that month there was a small increase and in the quarter to July this trend has continued: unemployment has risen in every month and these increases are themselves becoming larger, with the average monthly increase in unemployment over the last 6 months being 2,800. The slackening in the labour market is also reflected in the vacancy figures where over the three months to July the number of seasonally adjusted vacancies fell by 9,800 per month to stand at a figure of 170,800

Earnings and Productivity

The actual annual increase in the British whole economy average earnings for June 1990 was 10.2%. The underlying increase was 10%, the first time it has been in double figures since May 1982. The underlying figure is lower than the actual figure because arrears of pay were greater in 1990 than a year earlier. This rise in underlying wage inflation from 9.5% in March is the continuation of a consistent upward trend that has been evident since June 1989 when the rate was 8.75%. Whilst there are small variations in wage inflation between sectors, the spread is small with service industries at 10% and manufacturing industries at 9.5%.

Labour productivity in the whole economy in the first quarter of 1990 was 0.1% higher than the previous quarter but 0.7% lower than the figure for the first quarter of 1989. Data for manufacturing productivity are available up to June and show an annual increase of 2.8 but a quarterly increase of only 0.2% with an actual fall in the figure from May. Part of the explanation of these poor productivity figures are the effects of the Piper Alpha disaster which are estimated to have reduced the increase in whole economy output per head by 1 percentage point in the first two quarters, and 0.5 and 0.25 of a percentage point in the third and fourth quarters of 1989 respectively.

In manufacturing, for the three months ending in June 1990 unit labour costs showed a 6.5% increase over the previous year. This is a sharp reduction from the previous quarter where the figure was 7.9%. For the whole economy, the annual increase in unit wage and salary costs up to the first quarter of 1990 was 10.1%. This is lower than the corresponding figure for the previous two quarters, but in this case only slightly lower. The combination of high wage inflation and low or negative labour productivity growth generates these poor unit labour cost figures.

INDUSTRIAL RELATIONS

Popular concern as to events arising from the national mining dispute of 1984-85 have acted to conceal significant developments elsewhere. Inevitably the 133 page report of the Lightman Inquiry into allegations of misuse of NUM funds drew attention away from other problems facing the NUM, trade union reaction to the Labour Party's proposals for labour law reform, and longer term concerns facing the trade union movement.

Since 1985 the NUM has had to contend with declining membership, competition from the UDM, loss of bargaining rights, financial difficulties, and continued questions as to whether it could effectively resist the work changes being introduced by British Coal. Increasingly the NUM is being forced to face the need for a merger with another trade union, possibly the TGWU. The Lightman findings as to the control of secret funds and the role of the International Miners Organisation prompted the national executive of the NUM to endeavour to recover funds donated by Soviet miners. The realisation amongst the national executive that they had not been informed as to the existence of a number of secret funds some three years after the dispute will further reduce Arthur Scargill's power and influence both within the union and in the wider trade union movement.

Irrespective of the apparent settlement of issues between the executive of the NUM and IMO both Scargill and Heathfield will face up to 30 charges in Sheffield Magistrates Court that they failed to keep proper accounts.

A key issue at the TUC was the degree of support for the Labour Party's proposals on employment law. The proposals including: the retention of ballots; a right to strike but limits on picketing; ending support for the closed shop; limits on secondary action, plus concern for issues including health and safety. Notwithstanding criticisms from some delegates that these proposals eroded the traditional rights and freedoms of the voluntary system, the proposals were accepted.

Possibly of greater long term significance has been the discussion on reforming the pay bargaining structure. The GMBATU and UCW paper entitled "A New Agenda" discusses the problems of the current pay bargaining structure and, drawing on experience in other countries, suggests the adoption of a more centralised and co-ordinated bargaining structure which would overcome the problems of fragmented and competitive bargaining. There are many factors which underpin the co-ordinated bargaining structures in West Germany, Japan and Sweden, including Government policy and traditions of both the labour movements and employers organisations. It would be difficult to introduce such a system in Britain without introducing the other features of these societies. Nevertheless, such a reform of collective bargaining would have many advantages.

Declining trade union membership continues to be a major problem facing the trade union movement, between December 1988 and December 1989 trade union membership in unions affiliated to the TUC fell by 247,491 to 8,404,827. Declines in membership have led many trade unions into merger and amalgamation. The most recent merger has involved the NUR and NUS to form the Union of Rail, Maritime and Transport Workers. Discussion continues as to mergers involving a number of unions in printing and television, manufacturing and central government.

There is increasing evidence that declining union membership will be a long term problem. In 1989 Labour Force Survey included, for the first time, a question on trade union membership. The results from this question confirmed many of the ideas we would expect, union membership being highest amongst male employees, manual employees and full time employees. The level of membership for part time employees, one of the faster growth areas of employment, was only 22%. The Labour Force Survey suggests that overall density is 39%. This is somewhat lower than the figures from the Certification Officer and the TUC; however both these figures can include a proportion of retired employees. According to the British Social Attitudes Surveys up to 12% of retired people say they are current members of trade unions.

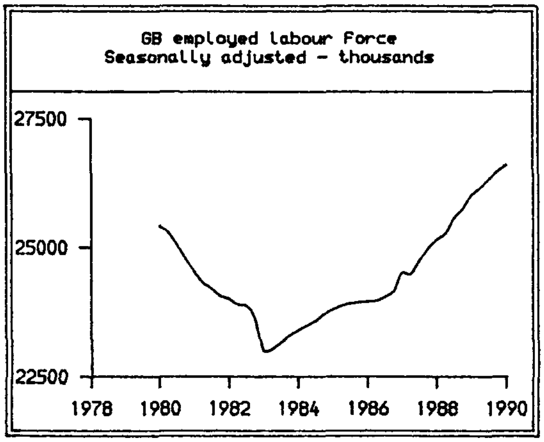
Of particular interest in the Labour Force Survey results is the pattern of union density by age group. Whilst there are a number of reasons why we should expect union membership to be highest amongst older workers - unions have more opportunities to recruit longer service employees - there are major trade union concerns given the low levels of trade union organisation amongst young workers, especially if these levels indicate shifts in attitudes towards trade unionism.

The survey found that trade union density was only 16% for male workers between 16-19 and 15% for female workers in the same age group. For workers aged between 20-24 density amongst male workers was 31% and for females 28%. For male workers the density rose to 39% for workers between 25-29 and to 54% for workers aged between 50-54. The comparable figures for female workers were lower, reflecting the different work patterns. Membership reached a plateau of 36% between 25-29 and thereafter falling until a future peak of 40% for women aged between 50-54.

Elsewhere, and especially in the public sector, moves away from national pay bargaining structures continue. Within Local Government up to 1/3 of district councils are considering moving further away from national pay bargaining. Currently, it is estimated that 16% of councils, mainly in the South East, have locally determined pay and conditions primarily for senior white collar staff. An increasing degree of local bargaining seems inevitable in education given Government proposals to allow local authorities to opt out of national pay bargaining. Within the Health Service the first formal moves away from national pay structures have been proposed.

Work flexibility continues to figure prominently in pay bargaining. In the retail sector B & Q has offered a range of new terms and conditions designed to attract/retain women workers, these included working days and hours only during school term time. Ford have announced plans to revise their pay structures to reduce the number of job titles among manual workers from 58 to 2. This is part of a wider revision of pay structure to lead to a pay system in which employees will be rewarded through training and assessment. It reflects longer term concerns to reform work practices and promote job flexibility, which is lacking under the present wage payment scheme.

Whilst the pay round appears to have settled around 8-9% there have been a number of exceptions. Forestry workers rejected a 14% pay and conditions package on the grounds that it would have increased considerably their travelling time. Some NHS staff have been offered up to 30% supplement in a bid to solve recruitment and retention problems. The offer applies only to medical laboratory staff in a number of regions and reflects a wider issue of skill shortages.



For several years the Government has considered introducing restrictions on the right to strike for employees in emergency services. Despite much rhetoric no proposals as yet have emerged from the British Government. However, the Manx Government is proposing legislation restricting the right to strike. Compulsory and binding arbitration will be introduced for the essential services. Such workers taking industrial action will lay themselves open to civil court action by employers if they take industrial action.

The announcement of the six month sentence plus 12 months suspended for a train driver involved in a rail accident poses many questions as to employees rights and employers responsibilities. Within the rail industry the union argues that the timetables requires drivers to pass through amber lights at speed. If the rules were operated properly then train drivers would drive with caution when encountering amber lights, thus slowing the network to a halt. In the first six months of 1990 there have been 412 cases of trains driving through danger signals.

The wider question is what is the legal protection for an employee to stop work? The EEC framework directive on health and safety has proposed that workers should have the right to stop work in the event of serious, imminent and unavoidable danger. The adoption of such measures would be problematic and would require a significant reform of labour law.

PROGNOSIS

In the first half of the year the rate of growth of nominal demand was more buoyant than expected, while the rate of growth of real output was slowing but less fast than earlier forecasts had suggested. Subsequent evidence since June that the slowdown in production has become more rapid has produced fears of a small recession or at best stagnant growth in the latter half of this year. In addition, the rate of growth of prices appears to be increasing, fuelled by buoyant earnings growth and the recent increases in the price of oil.

Two factors principally govern the short-term outlook for the economy: the significant rise in the exchange rate, where the effective rate has risen by around 10% since May; and the events in the Gulf with their attendant effects on the price of oil.

The increase in the exchange rate is probably the outcome of the market revising its expectations about the future course of monetary policy over the next year, following an apparent firming in the government's commitment to enter the ERM before the end of the year, and signals that the tight interest rate policy is likely to be maintained for some considerable time to combat increasing inflationary pressure.

Views differ on the likely effect of exchange rate appreciation on the rate of growth of output. One view is that there should be little or no effect on the demand for UK produced goods and services, as firms use currently high profit margins to cushion the deterioration that would otherwise occur in the competitiveness of British products. At the other extreme, if firms seek to maintain profit margins demand for UK goods and services could fall. Expectations of the latter outcome would appear to be reflected in the recent CBI industrial trends survey and it does seem likely that the effect both of continuing high interest rates and a high exchange rate will serve to depress manufacturing production in the coming months. And for these two reasons the rate of growth of output next year should be lower than previously predicted.

Higher oil prices have resulted following the loss to the world markets of Iraqi and Kuwaiti oil production, although this is being to a partial degree offset by greater production by both other

OPEC and non-OPEC members. If a major military confrontation in the Gulf is avoided during the remainder of the year then the price of oil is unlikely to average more than $25 per barrel. At this price, the UK rate of inflation will be greater than previously expected, but by no more than a half to one percentage point. In addition, there will be a small favourable effect on the balance of payments and government revenues. However, if the Gulf crisis soon escalates to a major military conflagration with the loss of Saudi oil production then the upward pressure on the oil price will be significant. In the short run, even that outcome should have minimal impact on UK output growth this year, although the prospects for next year would clearly be much less sanguine.