THE UK ECONOMY

Preliminary estimates suggest that United Kingdom real GDP barely rose above its 1976 level last year, and may indeed have fallen. This aggregate indicator reflects the poor performance of its components, a stagnant index of industrial production, a large shortfall in government capital expenditure and a depressed level of personal consumption. Nonetheless, the prospects for 1978 look somewhat more encouraging, and real GDP may grow by the order of $2\frac{1}{2}\%$ to 3% on a calendar year basis. There are possibilities, however, that this more rapid pace of expansion may not be sustained much into 1979, as the current account of the balance of payments, and the rate of price inflation re-emerge as constraining factors.

Given the government's published expenditure plans and official indications of desired trends in broad monetary aggregates, the development of GDP over the remainder of this year is likely to be boosted somewhat by the Chancellor's measures. The £$2\frac{1}{2}$ billion reduction in personal taxation will provide a substantial stimulus to the volume of personal consumption from the latter half of this year. The overall effect will probably be to add $\frac{1}{2}\%$ or $\frac{3}{4}\%$ to the year on year rate of GDP growth. Indirect effects on the exchange rate and on wage bargains are somewhat more problematical however.

The scenario which the Chancellor surveyed contains two major imponderables - consumer's expenditure and pay policy. After three years of decline, real personal disposable income is again rising as a result of reduced fiscal drag and a rate of wage inflation which exceeds that of prices. This has begun to manifest itself in a more buoyant level of consumer demand in the early months of this year. As price inflation has declined, so has the personal savings ratio, providing a further boost to consumption. The budgetary measures in turn add a further stimulus. In time this increased demand should lead to a revival in manufacturing output and a consequential growth in employment. The strength of this effect is inversely related to consumers'marginal propensity to import. Some commentators have suggested that this propensity is sufficiently large to bring the current account of the balance of payments back into deficit by the end of 1979 in the event of even a moderate budgetary stimulus. Indeed, the Treasury forecast, published on Budget Day, and embodying very moderate wage growth, predicts a rapid decline in the current account surplus during 1979. Their forecast of earnings increases coupled with a rising rate of price inflation, implies falling real earnings in 1979.

Average earnings in the present round of bargaining seem likely to rise by 12-15%, implying substantial growth in real earnings so long as price inflation remains in single figures. Just how long this differential will persist is difficult to say. However, given a money supply target of 8-12%, and the diminishing possibility of an organised Stage Four, the period might well be quite short. Above average productivity growth as employers dishoard labour will tend to lengthen it, but the inevitable strengthening of the dollar and consequential weakening of sterling must have the opposite effect. In sum, the possibility of a return to higher levels of inflation by the end of 1979 must be accorded a high probability, with consequent unfavourable effects on prospects for output and employment.

This somewhat gloomy medium term scenario must cast doubt on the liklihood of a substantial revival of business fixed investment. The expected recovery of output during 1978 will undoubtedly have a stimulatary effect on the level of investment, but this effect is likely to fade rapidly as the balance of payments and the rate of price inflation resume their customary constraining roles in 1979. The White Paper on Public Expenditure would suggest little growth in public capital expenditure this year, and something of the order of 3-4% in 1979.

As a consequence of the short-lived recovery in the economy, employment can be expected to rise slowly over the months to the end of 1979, when the expected slowdown in activity will become apparent. Owing to the growth in the labour force, unemployment is unlikely to decline significantly and may well begin to rise by the second half of next year. The medium-term outlook would be more favourable if the government were to embark on a programme to successively reduce the annual rate of growth of the monetary aggregates over a period of years, to develop a restrictive but internally flexible pay policy, and to bring the direct tax system more into line with those of our European partners. However, given that this may well be an election year, government economic policy assumes a myopic quality, and unfortunately for Britain short-term prospects look reasonably favourable, enabling the government to postpone required remedial action.