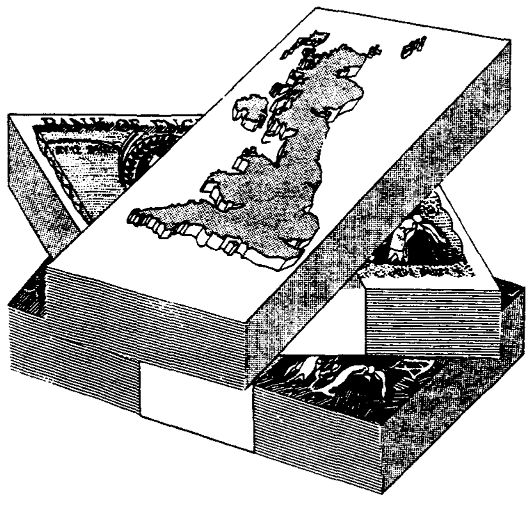
# THE BRITISH ECONOMY



## OVERVIEW

Despite the measures announced in the Autumn Statement the recession is likely to continue into 1993. Moreover, the government's current policy stance appears to be running the risk of returning the economy back to a stop-go cycle with damaging consequences for medium to long-term growth.

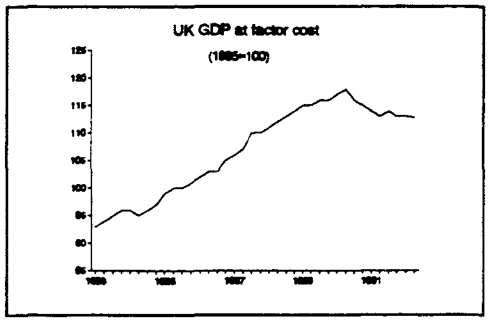
## MACROECONOMIC TRENDS

In the second quarter of 1992, the average measure of **GDP at market prices - 'money' GDP** - rose by 1.6%. After allowing for inflation and adjusting for factor costs, **GDP** fell by 0.1% during the quarter, compared with a fall of 0.5% in the first quarter 1991, a fall of 0.3% in the fourth quarter 1991, an increase of 0.2% in the third quarter, and reductions of 0.9%, 0.8%, 0.9%, and 1.1% respectively in the preceding four quarters. When oil and gas are excluded 'real' GDP rose by 0.1% in the second quarter. Over the year to the second quarter, 'real' GDP is estimated to have fallen by 0.6%, and by 4.1% - 3.8% excluding oil and gas - since the recession began after the second quarter 1990.

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 third quarter of 1992, suggest that GDP remained unchanged compared with the previous quarter. When oil and gas extraction are excluded, GDP is estimated to have fallen by 0.3% in the most recent quarter.

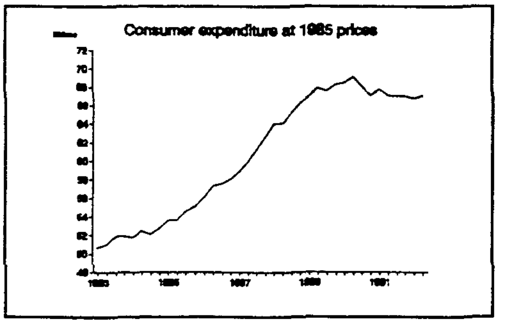
The **output of the production industries** in the third quarter of 1992 is provisionally estimated to have risen by 0.6% over the preceding quarter with output falling by 0.6% compared with the same period a year ago. Within production, manufacturing experienced a decrease in output of 0.1% in the third quarter, output of the other energy and water supply industries fell by 1%, while production of oil and gas increased by 6.7%. Manufacturing output in the third quarter was 7.4% below the second quarter 1990 peak.

It still remains the case that GDP remains flat but with the promised indication of a gradual pick up in manufacturing that was evident in the second quarter now appearing to have dissipated.




The CSO's **co-incident cyclical indicator** for September 1992, which attempts to show current turning points around the long-term trend, rose slightly, although the index for the month was based on partial information and so should be viewed with caution. The index appears to have bottomed out in April of this year, rose slowly in May, June, followed by a larger increase in July and smaller increases in August and September. The implication appears to be that the upturn in the second quarter ran out of steam in the third quarter. The **shorter leading index**, which attempts to indicate turning points about six months in advance, rose from February until July but then turned down in August and September. The **longer leading index**, which purports to indicate turning points about one year in advance, had been rising strongly since January 1991, but began to fall back again in November and December of last year and this fall continued until January, after which the series has fluctuated, although there was a marked upward movement in October based on partial information.

In the second quarter of 1992, **real consumers' expenditure** rose by 0.5% after falling by 0.7% in the first quarter, by 0.1% in both the fourth and third quarters of 1991, by 1.6% in the second quarter, and by 0.2% in the first quarter. Spending during the second quarter 1992 therefore remained largely unchanged on the same period a year earlier. In the second quarter, spending on durables rose by 1.3%, while clothing and footwear expenditure rose by 3.3% and 4.9%, respectively.




The provisional official **retail sales** volume figures - seasonally adjusted - for October, remained largely unchanged compared with September. Over the year to October, sales rose by 1.8%. Taking the three months to October, the volume of retail sales rose by 0.9% to a level 1.6% up on the same period a year ago. The **CBI Distributive Trades survey** for October paints an even darker picture of the current state of consumer demand with high street sales falling in October compared with September, when sales rose slightly. Sales volumes also fell for wholesalers and motor traders.

The underlying determinants of consumers' spending continue to be weak. The **consumer credit** figures for September show that net lending by finance houses and other specialist credit grantors (excluding bank loans) fell by £60m, following the £30m fall in August. The total amount of outstanding consumer credit has been falling since August 1991 except for a small net increase of £13m in February 1992. In the third quarter of 1992, the balance of outstanding credit fell by £154m, after falls of £210m and £120m in the second and first quarters respectively. These data suggest that consumers are continuing to pay off debt thus depressing expenditure.

The **saving ratio** rose in the first quarter of 1992 to 11.5% from 10% in the fourth quarter 1991 after falling 11.1% to 10.4% between the second and third quarters. The savings ratio averaged 10.3% in 1991 compared to 8.9% in 1990, 7% in 1989 and 5.4% in 1988. **Real personal disposable income** rose by 1% in the first quarter of 1992 to a level 0.4% higher than in the same period in 1991.

The underlying increase in **average weekly earnings** in the year to September is provisionally estimated to have been 5.5%, the smallest increase for 25 years. This compares with a 6.25% increase in the year to June.

Other factors restricting the growth in consumers' spending include: low levels of **consumer confidence** as unemployment continues to rise, and debt levels remain high; and a weak **housing market** with falling prices diminishing the wealth effect on consumption.

**General government final consumption** rose by 1.1% in the second quarter of 1992 after falling by 1.1% in the first quarter, rising slightly by 0.1% in the fourth quarter of 1991, increasing by 0.4% in the third quarter, remaining largely unchanged in the second quarter and rising by 1% in the first quarter. Government consumption in the second quarter 1992 was 0.5% lower than in the corresponding quarter of 1991.

**Real gross fixed investment** has begun to decline again after increasing slightly in the first quarter. In the second quarter 1992 gross domestic fixed capital formation fell by 2.4% after rising by 1.4%, for the first time since early 1990, in the first quarter. In the second quarter investment stood at 3.5% below the level of a year earlier. Investment in vehicles, ships and aircraft rose by 3.9%, while investment in plant and machinery fell by 1.3%, investment in dwellings fell by 11.5% and in other new buildings and works it fell by 1.2%. Over the year to the second quarter vehicles etc investment fell by 2.3%, plant and machinery remained largely unchanged, dwellings fell by 9.5%, and other new buildings etc fell by 5.1%. Provisional estimates of **capital expenditure by manufacturing industries** in the third quarter 1992 indicate that investment changed little from the previous quarter but was 2% lower than in the third quarter 1991.

**Stockbuilding** by manufacturers, wholesalers, retailers and other industries in the third quarter 1992 is estimated to have decreased by £19m (1985 prices, seasonally adjusted), compared with a fall of £364m in the second quarter. The ratio of manufacturers stocks to output (Q4 1984 = 100) rose from 76.4 at the end of June to 76.7 at the end of September, after falling from 77.0 at the end of March. The ratio stood 79.2 at the end of September 1991 and had fallen to 78.2 by the end of December 1991. The increase in the stock ratio to September suggests that demand rose by less than manufacturers anticipations in the preceding quarter thus reducing the decrease in stock building compared with the previous quarter.

Turning to the **balance of payments**, the deficit on **current account** for the second quarter 1992 was, after seasonal adjustment, £2.85bn compared with £2.88bn in the first quarter, £1.71bn in the fourth quarter 1991, and £1.29bn in the third quarter. Provisional estimates for the third quarter 1992 indicate that the deficit rose to £2.95bn. For 1991 the current account deficit was £6.32bn compared with £17.03bn in 1990 and £20.4bn in 1989. On **visible trade**, the second quarter deficit rose to £3.19bn from £3.05bn in the first quarter, £2.63bn in the fourth quarter 1991, and £2.39bn in the third quarter. Provisional estimates for the third quarter 1992 indicate that the trade deficit rose to £3.25bn. Within this account, the surplus on **oil** fell to £365m from £432m in the first quarter, £453m in the fourth quarter 1991, and £319m in the third quarter. Provisional estimates for the third quarter 1992 indicate that the oil surplus rose slightly to £378m. The surplus on **invisibles** in the second quarter 1992 rose to £336m from £168m in the first quarter, £920m in the fourth quarter 1991 and £1.09bn in the third quarter. Provisional estimates for the third quarter 1992 indicate that the invisibles surplus fell slightly to £300m.

## THE LABOUR MARKET

### Employment and unemployment

The UK workforce in employment fell for the eighth successive quarter to 25,361,000 at June 1992. Employment is 659,000 (2.5%) lower than the corresponding figure for June 1991, and 195,000 (0.8%) lower than the quarter to March 1992. The employment decline over the most recently reported quarter is less than the very large reductions in the first two quarters of last year, but much higher than the change over the first quarter of this year, which now seems an anomaly. Employment in the quarter fell roughly equally for males and females and also by the same proportionate amount in manufacturing and services. Again this contrasts with the figures for employment change over the previous quarter where both female and service employment actually rose. More up to date employment figures are available for British manufacturing. These show a further decline to September 1992 of 128,000 (2.8%), the largest quarterly reduction in manufacturing employment during this recession.

The provisional estimate for UK seasonally adjusted claimant unemployment in October 1992 was 2,867,600, an overall unemployment rate of 10.1%, with the separate male and female rates standing at 13.6% and 5.5% respectively. UK unemployment has now been rising monotonically for 31 months now and stands at its highest level for almost five and a half years: the increase in the last quarter was 107,500 and in the last year 390,500. The month on month changes in unemployment are very variable, and show no consistent downward trend over the recent past. Continuously increasing unemployment has been associated with a fluctuating number of job vacancies, but in each of the months in the quarter up to October, the number of vacancies fell, with the reduction on the quarter being 15,000 (13.3%).

### Earnings and productivity

The rate of increase in British average earnings continued its downward trend, which has been virtually uninterrupted since July 1990, in the quarter up to September. Seasonally adjusted, the actual increase in average earnings for the whole economy in September 1992 stood at 4.9%, with an underlying increase of 5.5%. This is to be compared with actual and underlying increases of 6.1% and 6.25% in June. The fall in wage inflation has, since April 1991 been more marked in services than manufacturing: for services, the September actual and underlying annual wage inflation levels were 4.9% and 5.25%, against the corresponding figures for manufacturing of 5.8% and 6.0%.

Whilst the seasonally adjusted level of whole economy productivity, as measured by output per employee, increased by only 0.3% in the second quarter of 1992, it was 2.1% higher than for the corresponding quarter in 1991. Manufacturing productivity has shown a more marked improvement, with annual increases of 4.3% to the second quarter of 1992. Although the annual increases to individual months are rather variable, the increased manufacturing productivity by quarter has shown a continuing increase over the last year. These results, combined with the wage inflation figures mean that the unit labour costs in the whole economy continued to rise at the substantial annual rate of 4.2% to the second quarter of 1992. However, this figure has been falling, almost continuously, from the high value of 10.7% in the third quarter of 1990. In manufacturing the position is rather better, with the annual increase in unit labour costs in the second quarter of 1.6%, a fall as compared to the first quarter result of 4.1%.

## PROGNOSIS

In the September **Commentary** we reported that the performance of the British economy appeared to have deteriorated between the second and third quarters. The relative improvement in the second quarter of the year now appears to have been a "false dawn". The persistent weakness of demand through the summer, with new (manufacturing) orders in September at their lowest level since last winter, and the effects on business confidence of turmoil in the international currency markets, including Britain's forced withdrawal from the ERM, served to depress both output expectations and investment intentions. The recession therefore looks likely, at best, to continue into 1993 and, at worst, could deteriorate into a more prolonged slump if both consumer and business confidence are not quickly restored.

However, since Britain's withdrawal from the ERM, sterling has been effectively devalued against the DM by around 13% to 14% and the base rate has been cut to 7%, the lowest level since 1978. Monetary policy is now considerably looser than it was on the eve of Britain's exit from the ERM. The Chancellor's Autumn Statement included a package of temporary fiscal measures designed to boost confidence and largely maintained, in the aggregate, earlier spending plans, with the result that a real increase of just under 4% in total general government expenditure is planned between 1992/3 and 1993/4. With lower than planned tax receipts, due to the continuation of low levels of economic activity, the PSBR is projected to outturn at £37bn in 1992/3 or 7.5% of GDP, and is expected to rise to over 8% of GDP in the 1993/4 financial year.

So while macro-economic policy now appears overall to be providing a significant stimulus to the domestic economy, there still remains the question whether the policy stance is appropriate to the government's objective of stimulating recovery in the short-run and producing sustainable growth in the medium to longer term.

Our view is that the overall package may be insufficient to generate recovery, while the balance of monetary to fiscal policy runs the risk of an inflationary spiral in the mid-1990s which will be damaging to growth. The Treasury is now projecting that GDP will fall by 1% this year followed by an increase of 1% in 1993. However, even this cautious forecast is predicated, in part, upon strong export growth which reflects an assumption that the devaluation and loose monetary policy generally will not feed significantly into inflation in the coming year. While there may be some justification in the assumption that the cost and price competitiveness resulting from the devaluation will be retained for some time, given the low level of current economic activity, the assumption becomes increasingly difficult to sustain for later years if the history of previous British devaluations and depreciations is any guide. Finally, given the very depressed state of business and consumer confidence, a case could have been made for the government to have relaxed fiscal policy considerably in the Autumn Statement. A greater fiscal stimulus currently could be clawed back later by subsequent tax increases or spending cuts and might lead to little deterioration of the public finances if, as a result, the economy did take off. Unfortunately, the government appears to have missed the opportunity while at the same time increasing the risk of the economy moving back to the stop-go cycle of old.