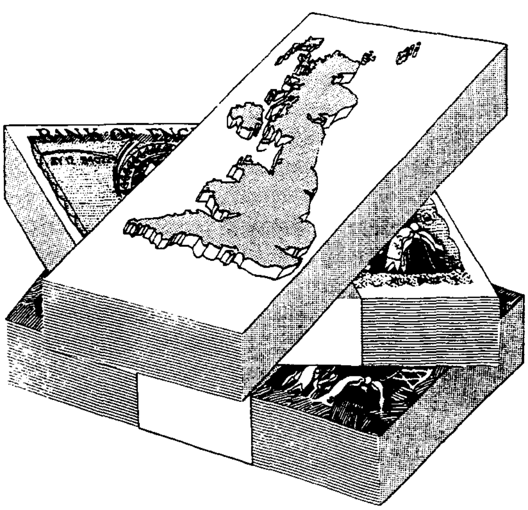
THE BRITISH ECONOMY



OVERVIEW

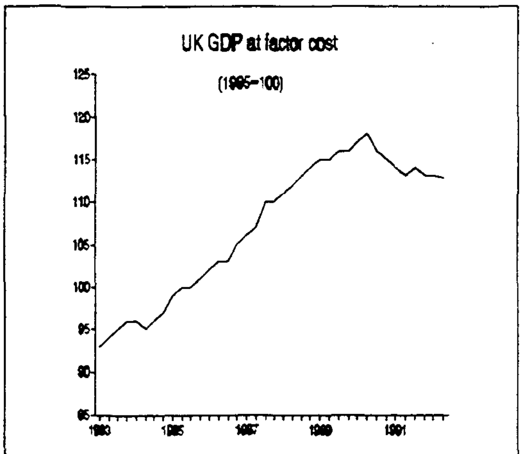
There are now some clear indications that domestic demand is beginning to pick up. However, the performance of domestic output is more uncertain and so it cannot yet be concluded that the economy is set firmly on an upward course.

MACROECONOMIC TRENDS

In the third quarter of 1992, the average measure of **GDP at market prices - 'money' GDP** - rose by 0.5%. After allowing for inflation and adjusting for factor costs, **GDP** grew by 0.1% during the quarter, compared with falls of 0.1% in the second quarter, 0.5% in the first quarter 1991, 0.3% in the fourth quarter 1991, and an increase of 0.2% in the third quarter 1991. Over the year to the third quarter, 'real' GDP is estimated to have fallen by 0.7%, and remains 4.1% below the level attained when the recession began after the second quarter 1990.

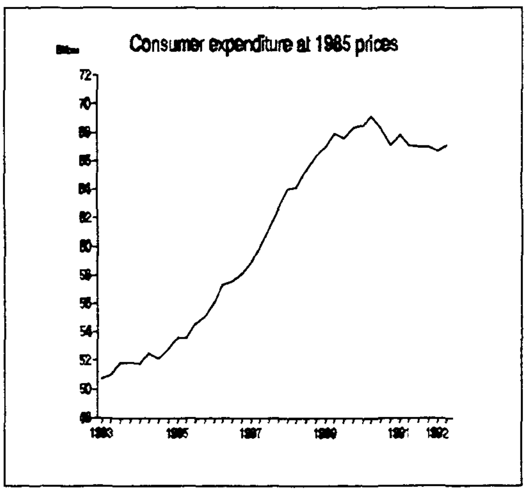
Preliminary estimates of the **output based measure of GDP** - which is usually taken to be the most reliable indicator of short-term change - in the fourth quarter of 1992, suggest that GDP increased by 0.2% compared with the previous quarter. When oil and gas extraction are excluded, GDP is estimated to have fallen by 0.1% in the most recent quarter. For 1992 as a whole, GDP is provisionally estimated to have fallen by 0.5% compared with 1991 and by 0.7% if oil and gas extraction excluded.

The **output of the production industries** in the fourth quarter of 1992 is provisionally estimated to have risen by 0.9% over the preceding quarter with output rising by 0.6% compared with the same period a year ago. Within production, manufacturing experienced a decrease in output of 0.2% in the fourth quarter, output of the other energy and water supply industries rose by 1.3%, while production of oil and gas increased by 6.3%. Manufacturing output in fourth quarter was 7.6% below the second quarter 1990 peak. The latest data indicate a sharp 0.8% increase in manufacturing output in January, to the highest level since August 1991. The output of the **service sector** is provisionally estimated to have fallen by 0.1% in the fourth quarter.



The CSO's **co-incident cyclical indicator** for January 1993, which attempts to show current turning points around the long-term trend, remained unchanged, 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 last year, rose slowly in May, and June, increased more quickly in July, slowed down again in August and September, and then appears to have stagnated since October. The implication appears to be that the upturn ran out of steam after the second quarter. The **shorter leading index**, which attempts to indicate turning points about six months in advance, rose fairly strongly in January 1993. This index rose from February 1992 until July but then stagnated until November. 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 that year and this fall continued until January 1992. After January, the series fluctuated, although strong upward movements were evident after October 1992.

In the third quarter of 1992, **real consumers' expenditure** rose by 0.4% after rising by 0.5% in the second quarter, falling by 0.7% in the first quarter, and by 0.1% in both the fourth and third quarters of 1991. Spending during the third quarter 1992 rose by 0.3% on the same period a year earlier. In the third quarter, spending on durables rose by 4.5%, while clothing and footwear expenditure rose by 1.3% and 3.5%, respectively.



The provisional official **retail sales** volume figures - seasonally adjusted - for January, 1993, rose strongly, by 1.6%, over December. Over the year to January, the volume of sales rose by 2.3%. Taking the three months to January, the volume of retail sales rose by 0.2% to a level 1.4% up on the same period a year ago. The **CBI Distributive Trades survey** for January and February shows retailers experiencing strong sales growth during both months. Sales volumes appear to have increased markedly over the year to January and February, although this in part reflects the weak state of demand in January and February 1992 and heavy discounting by retailers at the beginning of this year.

The underlying determinants of consumers' spending remain relatively weak. The **consumer credit** figures for September show that net lending by finance houses and other specialist credit grantors (excluding bank loans) rose by £151m, following increases of £105m, £17m and £72m, in December, November and October, respectively. However, the total amount of outstanding consumer credit has been falling since August 1991 except for a small net increase of £11m in February 1992. In the fourth quarter of 1992, the balance of outstanding credit fell by £47m, after falls of £147m, £244m and £98m in the third, second and first quarters respectively. These data suggest that consumers are continuing to pay off debt, although perhaps at a slackening rate, thus depressing expenditure.

The **saving ratio** continues to rise. In the third quarter 1992 the ratio was 12.3%, an increase of 0.9 percentage points on the 11.4% recorded in the first and second quarters of 1992. The savings ratio averaged 9.7% in 1991 compared to 8.3% in 1990, 6.6% in 1989 and 5.6% in 1988. The underlying increase in **average weekly earnings** in the year to December 1992 is provisionally estimated to have been 4.75%. This compares with a 5% increase in the year to November. **Real personal disposable income** rose by 1.4% in the third quarter to a level 2.5% higher than in the same period in 1991.

Other factors affecting the growth in consumers' spending include: continuing 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 fell by 1.2% in the third quarter of 1992 after rising by 1.1% in the second quarter, falling by 1.1% in the first quarter, rising slightly by 0.1% in the fourth quarter of 1991, and increasing by 0.4% in the third quarter. Government consumption in the third quarter 1992 was 0.7% lower than in the corresponding quarter of 1991.

Real gross fixed investment again fell slightly in the third quarter 1992. Gross domestic fixed capital formation fell by 0.1% after falling by 2.4% in the second quarter 1992 and rising by 1.4%, for the first time since early 1990, in the first quarter. In the third quarter investment stood at 0.1% below the level of a year earlier. Investment in vehicles, ships and aircraft fell by 3.1%, while investment in plant and machinery rose by 2%, investment in dwellings rose by 10.7% and in other new buildings and works it fell by 5.6%. Over the year to the third quarter, vehicles etc investment rose by 10.6%, plant and machinery rose by 2.9%, dwellings fell by 0.8%, and other new buildings etc fell by 5.1%. Provisional estimates of **capital expenditure by manufacturing industries** in the fourth quarter 1992 indicate that investment rose by 0.6% over the previous quarter but was 2% lower than in the fourth quarter 1991. For 1992 as a whole, manufacturing investment was 3.5% below the figure for 1991.

Stockbuilding by manufacturers, wholesalers, retailers and other industries in the fourth quarter 1992 is provisionally estimated to have decreased by £44m (1985 prices, seasonally adjusted), compared with a fall of £89m in the third quarter. The ratio of manufacturers stocks to output (Q4 1984 = 100) fell from 76.4 at the end of September to 75.7 at the end of December. The ratio stood 79.2 at the end of September 1991, fell to 76.5 by the end of March 1992, and stabilised thereafter until the most recent quarter.

Turning to the **balance of payments,** the deficit on **current account** for the third quarter 1992 was, after seasonal adjustment, £2.22bn, compared with £3.03bn in the second quarter, £2.81bn in the first quarter £2.03bn in the fourth quarter 1991, and £1.30bn in the third quarter. Provisional estimates for the fourth quarter 1992 indicate that the deficit rose to £3.75bn. For 1992 the current account deficit was £11.8bn compared with £6.32bn in 1991, £17.03bn in 1990 and £21.73bn in 1989. On **visible trade,** the third quarter deficit rose to £3.29bn from £3.13bn in the second quarter, £3bn in the first quarter, £2.87bn in the fourth quarter 1991, and £2.38bn in the third quarter. Provisional estimates for the fourth quarter 1992 indicate that the trade deficit rose further to £4.35bn. Within this account, the surplus on **oil** rose to £378m from £365m in the second quarter, £431m in the first quarter, £453m in the fourth quarter 1991, and £319m in the third quarter. The surplus on **invisibles** in the third quarter 1992 rose to £1.07bn from £100m in the second quarter, £186m in the first quarter, £847m in the fourth quarter 1991 and £1.08bn in the third quarter.

THE LABOUR MARKET

Employment and Unemployment

The fall in the UK workforce in employment of 409,000 (1.6%) in the third quarter to 1992 represents the largest decline in any one quarter in this recession. The fall in the figures for the year to September was 877,000 (3.4%) and the total of 24,933,000 means that employment is at its lowest level since March 1987. The absolute decrease in employment in services for this quarter was 233, 000, almost double the decline in manufacturing (129,000) though the proportionate reduction was greater in manufacturing, 2.8%, as against 1.5% in services. More up to date employment figures are available for British manufacturing and these show a further decline in the quarter to December 1992 of 67,000 (1.5%). Though this is only half the fall of the previous quarter, it still represents a sizable reduction in employment.

The provisional estimate for UK seasonally adjusted claimant unemployment in January 1993 stood at 2,995,100, an overall unemployment rate of 10.6%, with the separate male and female rates of 14.2% and 5.8% respectively. Perhaps more importantly, the unadjusted total increased to 3,062,065, breaking the psychologically important 3 million barrier. UK unemployment has now been rising monotonically for just under three years and stands at its highest level since April 1987: the increase in the last quarter was 127,300 and in the last year 388,000. There is considerable variation in the month on month changes in unemployment, so that whilst the increase in January was relatively small (22,100), the previous month of December was almost three times as large (60,300) and there is no consistent downward trend over the recent past. Continuously increasing unemployment has been associated with a fluctuating number of job vacancies, and whilst the number increased by 6,500 (6.6%) in the quarter to January 1993, there was a fall in vacancies in January, which was offset by increases in November and December.

Earnings and Productivity

In the quarter up to December 1992, the annual rate of increase in British average earnings continued its downward trend, which has been virtually uninterrupted since July 1990. The seasonally adjusted actual increase for the whole economy in December 1992 stood at 5.1%, slightly higher than the comparable figure for September. The underlying increase of 4.75% was lower, down from 5.5% in September. The actual increase is above the underlying increase because of timing adjustments for bonuses paid in December 1992 but in different months in 1991. The decline in wage inflation continues to be more marked in services than manufacturing: for services, the December actual and underlying annual wage inflation levels were 5.0% and 4.5%, against the corresponding figures for manufacturing of 5.4% and 5.5%.

Seasonally adjusted whole economy productivity levels increased by 1.4% in the third quarter of 1992, and were 2.4% higher than in the third quarter of 1991. Manufacturing productivity has shown an even more consistent rise, with an improvement in output per employee of 1.3% in the final quarter of 1992, and an increase over the year of 5.8%. When the productivity results are combined with the wage inflation figures they show whole economy unit labour costs falling in the second and third quarters of 1992, and an increase over the third quarter of 1991 of only 3%. This annual percentage increase is down from the peak of 10.7% in the third quarter of 1990. In manufacturing the improvement is even more marked, with the annual increase falling to 0% in the last quarter of 1992, compared to a corresponding figure of 10.4% in the last quarter of 1990.

PROGNOSIS

There are now some clear indications that in early 1993 domestic demand is beginning to pick up. The recent buoyancy of high street sales, with car sales especially strong, is the most obvious example of this. And the relatively strong growth of the narrow measure of the money stock, M0, - largely cash - provides confirmation of the trend. However, the evidence that the broad measure of the money stock, M4, which includes bank lending/deposits, is growing below its target range, indicates that caution should be exercised in predicting the future short-term course of consumer demand. Anecdotal reports suggest that retailers and high street traders undertook considerable discounting in January and February after the disappointing Christmas sales figures. Discounting tends to affect smaller items and is less likely to be applied to the larger items for which consumers would require to take out loans and increase their debt; hence, the failure of M4 to rise to the same extent as M0. Continuing increases in unemployment and slackness in the housing market are further reasons why consumers are likely to be reluctant to expand demand considerably through debt finance. However, the progressive cuts in short-term nominal interest rates since September must have eased the cash-flow problems of households considerably, if the 'bread-winners' remained in work.

The picture on the output front is, if anything, less sanguine than that for demand. GDP, excluding oil, and manufacturing output fell slightly in the fourth quarter. It remains to be seen whether the sharp increase in manufacturing output in January is simply a temporary 'blip' or heralds something more sustained and substantial. Taken with the comparative buoyancy of demand, the output data raise fears that imports may be taking the strain and adding considerably to the already considerable balance of trade pressures. To set against this fear is the evidence that because of recessionary effects and perhaps partly as a result of 'black'/'white' Wednesday, import growth appears to be moderating.

We cannot therefore be certain that we are now at the beginning of a sustained upturn. The situation in the summer of 1991 when, under very similar conditions, such an outcome seemed in prospect only to be confounded by subsequent events, offers a cautionary reminder of the dangers of precipitate optimism.

The Budget is too recent to draw definitive conclusions about its likely impact on the economy. However, the broad fiscal stance is clear. For tax year 1993-94 the stance is neutral compared with the pre-Budget position. In 1994-95, the effect of the tax changes is to take a further £6.5bn out of the economy, rising to £10.5bn in 1995-96. What are the implications of this change in the fiscal stance? Of the many issues of interest raised by the Budget, the two key issues of significance to the prospects of the economy are the consequences for economic recovery and the implications for the government's finances.

With little change in the overall fiscal stance in the 1993-94 tax year the Budget is expected by the Government to have, at worst, a neutral effect on economic activity. However, to suggest this is to ignore the effect of the Budget on expectations. By postponing the bulk of the tax increases until future tax years, the Chancellor obviously had an eye to not hindering the recovery and perhaps hoped that the prospect of higher taxes in the future might lead consumers to bring forward spending plans, so assisting recovery. Unfortunately, there is no guarantee of such an outcome. Much spending is recurrent and can not be brought forward.

Consumers are therefore faced with an expected permanent reduction in their real disposable personal income, which may induce greater savings effort to offset the loss. Consumption as a result might be lower in the coming tax year than it would otherwise have been. One possible benefit which might have a more immediate impact, is the abolition of stamp duty on houses valued up to £60,000. This could stimulate the housing market in the short term, particularly in the regions where average house prices are lower. To the extent that it produces a positive effect on house prices then this could feed through into higher consumption. However, the effect is unlikely to be immediate and may be cancelled out by the expected future tax rises.

Finally, it is clear that the tax increases flagged in the Budget will make only a relatively small contribution to lowering the PSBR. The scale of the deficit remains large and an increasingly larger portion of it appears structural rather than simply the outcome of recession. Futher increases in taxation and higher interest rates would appear inevitable irrespective of progress made in coming out of the recession. The growing recognition of this will do little to help the economic recovery.