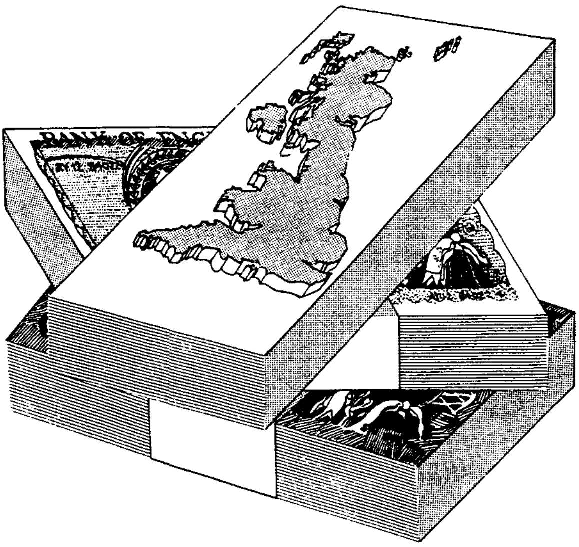
THE BRITISH ECONOMY



OVERVIEW

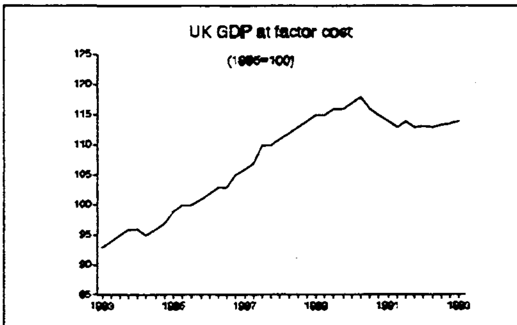
The recession is over. All the available evidence suggests that the economy 'bottomed out' in the second quarter of 1992. However, the recovery was weak until the turn of the year. In the first quarter of this year, the momentum of recovery appears to have moved up a gear.

MACROECONOMIC TRENDS

In the fourth quarter of 1992, the average measure of **GDP at market prices - 'money' GDP** - fell by 0.4%. After allowing for inflation and adjusting for factor costs, **GDP** grew by 0.2% during the quarter, compared with a rise of 0.1% in the third quarter, 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 fourth quarter, 'real' GDP is estimated to have risen by 0.1%, and remains 3.5% 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 first quarter of 1993, suggest that GDP increased by 0.2% compared with the previous quarter. When oil and gas extraction are excluded, GDP is estimated to have risen by 0.6% in the most recent quarter. Both total GDP and GDP excluding oil and gas extraction are estimated to have increased by 0.6% over the same period a year ago.

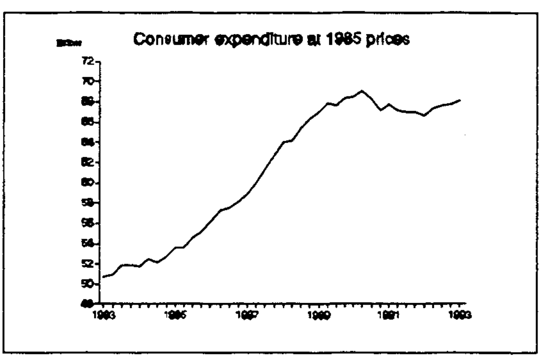
The **output of the production industries** in February 1993 is provisionally estimated to have risen by 0.3% over the previous three months with output rising by 1.2% compared with the same period a year ago. Within production, manufacturing experienced an increase in output of 1.2% on the previous three months, output of the other energy and water supply industries fell by 1.9%, and production of oil and gas fell by 2.4%. Manufacturing output in February was 5.3% below the second quarter 1990 peak. The output of the **service sector** is provisionally estimated to have risen by 0.5% in the first quarter.



The CSO's **co-incident cyclical indicator** for March 1993, which attempts to show current turning points around the long-term trend, rose slightly. All components of the index have been rising in the first few months of 1993 and an upturn in the economy is clearly signalled around May and June of last year. The **shorter leading index**, which attempts to indicate turning points about six months in advance, is now rising again after falling slightly last autumn. 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, and strong upward movements were evident after October 1992, although the series has flattened in recent months.

In the fourth quarter of 1992, **real consumers' expenditure** rose by 0.3% after rising by 0.4% in the third quarter, 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 fourth quarter 1992 rose by 1.3% on the same period a year earlier. In the fourth quarter, spending on durables rose by 0.5%, expenditure on non-durable goods was broadly unchanged, while expenditure on services rose by 0.5%.

The provisional official **retail sales** volume figures - seasonally adjusted - for March, 1993, rose by 0.5% over February. Over the year to March, the volume of sales rose by 4.1%. Taking the three months to March, the volume of retail sales rose by 1.6% to a level 3.3% up on the same period a year ago. The **CBI Distributive Trades survey** for March shows retailers continuing to experience sales growth. Sales volumes increased over the year for the third consecutive month, although increases in spending had not spread to all sectors of the high street being mainly concentrated on the large chain stores and mail order companies.



The underlying determinants of consumers' spending still remain relatively weak. The **consumer credit** figures for February show that net lending by finance houses and other specialist credit grantors (excluding bank loans) rose by £49m, following increases of £151m, £105m, £17m and £72m, in January, December, November and October, respectively. However, the total amount of outstanding consumer credit has until recently 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. In January of this year the balance rose by £75m only to fall back by £19m in February. These data suggest that consumers are still cautious about their debt position.

The **saving ratio** fell in the fourth quarter 1992. In the fourth quarter the ratio was 11.4%, a decrease of 0.9 percentage points on the 12.3% recorded in the third quarter of 1992. The savings ratio averaged 11.6% in 1992 compared to 9.7% in 1991, 8.3% in 1990, 6.6% in 1989 and 5.6% in 1988. The underlying increase in **average weekly earnings** in the year to February 1993 is provisionally estimated to have been 4.5%. This compares with a 4.75% increase in the year to January. **Real personal disposable income** fell by 0.8% in the fourth quarter 1992 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 indicated by recent surveys; and a relatively weak **housing market**, although latest data suggest that house prices are now rising. The Halifax Building Society reported that house prices in the UK rose by 1.6% in April, the largest monthly increase for more than four years.

General government final consumption rose by 0.2% in the fourth quarter of 1992, after falling by 1.2% in the third quarter of 1992, 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 fourth quarter 1992 was 0.2% lower than in the corresponding quarter of 1991.

Real gross fixed investment fell again in the fourth quarter 1992. Gross domestic fixed capital formation fell by 0.8% after falling by 0.1% in the third quarter, by 2.4% in the second quarter 1992 and rising by 1.4% in the first quarter 1992 for the first time since early 1990. In the fourth quarter investment stood at 0.7% above the level of a year earlier. Investment in vehicles, ships and aircraft rose by 1.3%, investment in plant and machinery rose by 0.9%, while investment in dwellings fell by 2.4% and in other new buildings and works it fell by 2.6%. Over the year to the fourth quarter, vehicles etc. investment fell by 14.7%, plant and machinery rose by 6.1%, dwellings fell by 1.7%, and other new buildings etc fell by 0.5%.

Turning to the **balance of payments,** the deficit on **current account** for the fourth quarter 1992 was, after seasonal adjustment, £3.56bn, compared with £2.24bn in the third quarter, £3.21bn in the second quarter, £2.91bn in the first quarter and £1.95bn in the fourth quarter 1991. For 1992 the current account deficit was £11.9bn compared with £6.38bn in 1991, £17.03bn in 1990 and £21.73bn in 1989. On **visible trade**, the fourth quarter deficit rose to £4.35bn from £3.29bn in the third quarter, £3.13bn in the second quarter, £3bn in the first quarter, and £2.87bn in the fourth quarter 1991. Following the completion of the Single European Market at the end of 1992, customs declarations - the former source of trade statistics - are no longer required. No data on trade with other EC countries for the first quarter of 1993 are available. A new system is being put in place to collect intra-EC trade data but it is not expected that these data will be available until June.

THE LABOUR MARKET

Employment and unemployment

The level of UK seasonally adjusted claimant unemployment fell in both February and March, bringing to an end 34 months of continuously increasing unemployment. The reductions in unemployment are small, so that the March total is only 31,600 less than the figure for December, and total unemployment therefore remains very high: the seasonally adjusted figure for March 1993 stood at 2,940,800, an overall unemployment rate of 10.5%, with the separate male and female rates of 14.1% and 5.6% respectively. The fall in unemployment for two consecutive months was unexpected. Although it is generally accepted that the economy is now moving out of recession, in past recoveries the labour market reacted has been more sluggishly. Moreover, in the preceding months, there was no clear indication that unemployment was about to peak. The level of unfilled vacancies is a rather erratic series, with a lot of monthly variation, so that over the period in which unemployment was monotonically increasing, vacancies did not continuously fall. However, since December 1992, there has been persistent positive values for the average three monthly change. In February 1993, seasonally adjusted vacancies stood at 122,300, an increase of 21,500 (21.3%) over the November 1992, and 2,300 (1.9%) over February 1992.

Figures for employment lag behind those for unemployment, and at 24,960,000, UK workforce in employment fell 92,000 (0.4%) in the fourth quarter of 1992. However, this has to be set against the 398,000 (1.6%) fall in the previous quarter, and the December 1992 figure was 721,000 (2.8%) lower than for the same month in the previous year. The only indication of labour market recovery here is in services, where there was a small rise in employment of 36,000 (0.2%) in the final quarter, after a very large decrease in the previous quarter. Figures for manufacturing show a continuing employment decline. For the UK figures, the employment fall in the quarter to December 1992 is large at 90,000 (2.0%), and the more up to date GB figures register a decline in the three months to February 1993 of 49,000 (1.2%).

Earnings and productivity

In February 1993, the annual rate of increase in British average weekly earnings continued the downward trend which has been virtually uninterrupted since July 1990. The seasonally adjusted actual increase for the whole economy stood at 4.2%, with an underlying increase of 4.25%: the underlying increase at November 1992 was 5% and at February 1992, 7.5%. The decline in wage inflation continues to be more marked in services than manufacturing: for services, the February underlying annual wage inflation level was 4.25%, against the corresponding figure for manufacturing of 5.0%.

Seasonally adjusted whole economy productivity levels increased by 1.0% in the fourth quarter of 1992, and were 3.1% higher than in the fourth quarter of 1991. Manufacturing productivity has shown an even more persistent rise, with an increase in output per employee of 3.7% in the quarter to February 1993, and an increase over the year of 7.2%. 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 a very small increase (0.1%) in quarter four. Unit labour costs in the fourth quarter of 1992 were only 1.9% higher than the corresponding value in the last quarter of 1991. In manufacturing the improvement is even more marked: unit labour costs falling since October 1992, and the February 1993 figure is 1.7% lower than November 1992 and 2.0% lower than February 1992.

PROGNOSIS

The recession is over. All the available evidence suggests that the economy 'bottomed out' in the second quarter of 1992. However, the recovery was weak until the turn of the year. In the first quarter of this year, the momentum of recovery appears to have moved up a gear. Manufacturing output rose by 1.2% in the three months to February. Non-oil GDP appears to have risen by 0.6% in the first quarter. Surveys are reporting that business confidence is high. Retail sales are showing signs of strong growth, rising by 1.6% in the three months to March, and consumer spending generally continues to rise. Unemployment has fallen for two consecutive months and activity in the housing market has picked up with turnover rising and increases in house prices reported for the first time in many months. Yet it is not all good news. Consumer confidence is reported to be weak. Investment performance is disappointing. Growth in consumer spending has yet to spread to all areas of the high street. And the trade balance continues to deteriorate, although the picture is clouded by the absence of intra-EC trade figures during the first half of this year.

The general consensus amongst forecasters is that recovery will remain relatively weak this year, with GDP expected to grow by no more than 1.5%. The prospects for external demand are uncertain. Recovery in the US is hesitant and recession in Germany suggests that the UK cannot look to Europe for the desired growth in demand. The slow growth of broad money (M4) is causing concern to some economists suggesting that the current revival of demand cannot be maintained. Economists of a more Keynesian persuasion are less concerned about this apparent monetary constraint on growth. They take the view that the demand for goods and services will benefit as people seek to run down the sizeable money balances built up in the 1980s due to lower real interest rates having raised the opportunity cost of holding money. We are sympathetic to this latter view and do not believe that a deficiency of domestic household demand will abort the recovery. Nor do we believe that inflation will act as a constraint over the next twelve to eighteen months. The once-and-for-all effect of devaluation appears to have fully worked through the economy. There are few signs that pay claims are accelerating and some economists are arguing, perhaps prematurely, that a 'new pay culture' has been created. Added to this is the obvious point that much spare capacity exists in the economy. Estimates of the extent to which the economy is below potential output range from 6% to 13%. On either figure, there is sufficient spare capacity to allow considerable annual growth without much acceleration of inflation for a few years at least.

Yet this relatively sanguine view must be tempered by recognition of the potential limits on future economic growth of what has become known as the 'twin-deficits' problem. The public sector borrowing requirement (PSBR) is now at around 6% of GDP and forecast to rise to over 8% next year. The Chancellor's Budget measures are unlikely to make much inroad into this significant deficit. Increased economic growth will reduce the deficit but according to recent OECD estimates the cyclical (ie. recession) element of the revenue shortfall does not account for the major part of the deterioration in the public finances. On present policies, the scale of the deficit is likely to threaten recovery in the long term by increasing the risk of higher inflation, higher real interest rates and greater debt interest. The government will clearly be tempted to cut back public expenditure significantly in the November Budget. This would be a mistake. Public expenditure must be kept under strict control but there is little value in swingeing cuts in expenditure programmes. Capital programmes are the easiest politically to cut. But the government appears now to be more aware of the dangers to the supply side of the British economy of cutting these back for stabilisation purposes. Further privatisation, which in this context is effectively an accounting device for cutting back the PSBR, is likely to be increasingly opposed on the government backbenches by MPs fearful of the political implications. Cuts in current expenditure will superficially appear to be the most attractive and a further tightening of public sector pay restraint the most likely target. However, the implementation of such measures could be severely de-stabilising. The public sector is already labouring under quite marked pay restraint, coupled with restructuring and manpower reductions. A further tightening of the screw on pay could provoke widespread industrial action which would have damaging implications for the economy. It could result in much of the hard won responsibility on pay displayed by the public sector unions in recent years being thrown away in a scramble to right felt injustices. Moreover, it would be likely to precipitate knock-on effects in the private sector, stimulating industrial action there and increasing the pressure on employers to give up some of the benefits of devaluation.

In the March Budget the Chancellor was probably right not to raise taxes immediately. At the time, the strength of the recovery was unclear and consumer confidence could have been damaged at the expense of the nascent recovery. However, we expect that by November the recovery will be sufficiently well established for further tax increases to be a feasible policy option. These can be 'sold' to the markets and the general public as a necessary means for keeping interest rates down and a more relaxed monetary policy than would otherwise be necessary. In this way higher taxes need not be damaging to the recovery.

A sustained recovery is also vulnerable to a deterioration in the current account deficit. The external deficit stood at 2% of GDP even at the trough of the recession. The great fear is that as the economy expands imports will be drawn in disproportionately and the deficit will deteriorate, causing a run on the pound which would force the government to raise interest rates markedly thus aborting the recovery. The problem is not so much one of financing a large current account deficit, although that problem would become real if the deficit was sustained for a long time, but rather the medium-term inflationary implications of a falling exchange rate and the uncertainty caused for tradeable activities in the face of large swings in the exchange rate. Moreover, the potential constraint on the recovery imposed by the current account deficit is likely to occur at an earlier phase in the upturn the more the recovery is led by domestic consumption and the less by export growth.

The implications of a large current account deficit at the trough of a recession is that the real exchange rate is overvalued. The 15% devaluation in the nominal exchange rate subsequent to withdrawal from the ERM has gone some way to correct the overvaluation. However, we cannot be certain that the current sterling parity is sufficient to restore both internal and external equilibrium. British manufacturing capacity was significantly eroded in the 1979/81 recession and much of our problems today are a reflection of that loss of export capacity. Moreover, the economy must adjust to the declining significance of North Sea oil. Given UK import propensities this requires an expansion of the domestic production of tradeable goods and services. Much of this production may have to come from the creation of new firms as well as the expansion of the activities of existing firms in this sector. The government must, therefore, continue with a low exchange rate policy for the foreseeable future. It would be folly to return to the ERM until we are more certain of the exchange rate that is likely to produce external as well as internal balance in the long run. Such a policy requires, of course, to be supported by actions and exhortations to moderate the growth of domestic costs relative to our international competitors. However, this will not be secured simply by a further tightening of public sector pay restraint. Indeed, we argued above that this could be counterproductive. What is required from government is a stable and certain macroeconomic framework, coupled with a more active industrial policy to improve the supply-side of the British economy. But in the end it is the private sector that must deliver the goods.