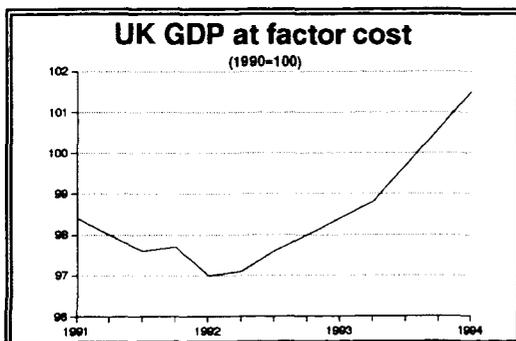


THE BRITISH ECONOMY

UK MACROECONOMIC TRENDS

In the second quarter of 1994, the provisional estimate of **GDP at market prices** - 'money' GDP - rose by 1.4%. After allowing for inflation and adjusting for factor costs, GDP grew by 1% during the quarter, compared with the 0.9% increase recorded in the first quarter of 1994. Over the year to the second quarter, 'real' GDP is estimated to have risen by 3.7%, and now stands 1.8% above the last peak in the second quarter 1990 which preceded the recession. When oil and gas extraction are excluded 'real' GDP is estimated to have risen by 0.8% in the second quarter and by 3% over the same period a year ago.

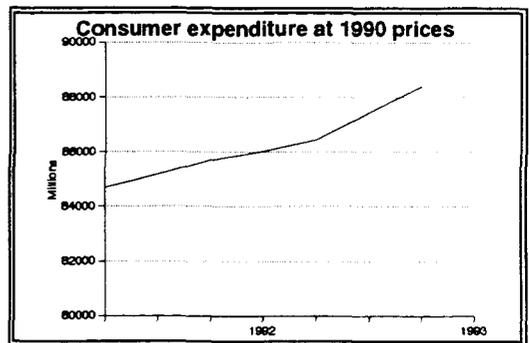
Output of the production industries in the three months to July 1994 is provisionally estimated to have risen by 1.6% over the previous three months, with output rising by 5.4% compared with the same period a year ago. Within production, **manufacturing** experienced an increase in output of 1.3% on the previous three months, output of the other energy and water supply industries rose by 2.3%, and production of oil and gas (including mining & quarrying) rose by 3.9%. Manufacturing output in the second quarter was 3.9% above the same period a year ago and 2.5% below the second quarter 1990 peak. The output of the **service sector** is provisionally estimated to have risen by 0.6% in the second quarter and by 2.9% over the second quarter 1993.



The CSO's **coincident cyclical indicator** for June 1994, which attempts to show current turning points around the long-term trend, continued to rise. The index has been steadily rising since May 1992,

suggesting an upturn in the spring of that year. The **shorter leading index**, which attempts to indicate turning points about six months in advance, fell in February through to May after rising continuously since the Autumn of 1992. However the index began rising again in June. The **longer leading index**, which purports to indicate turning points about one year in advance, fell in the middle of last year and was relatively flat until April of this year. Since then, the index has begun to rise again.

In the second quarter of 1994, **real consumers' expenditure** rose by 0.4% after rising by 0.4% in the first quarter. Spending during the second quarter 1994 rose by 3% on the same period a year earlier.



The provisional official **retail sales** volume figures seasonally adjusted for July 1994, were 0.4% above the June figure. Over the year to July, the volume of sales rose by 3.8%. Taking the three months to July, the volume of retail sales rose by 0.9% and by 3.7% over the same period a year earlier. So, after a slowing in the rate of growth of retail sales in June, growth appears to have picked up again.

The underlying determinants of consumers' spending appear to have weakened slightly in the first part of the year. The consumer credit figures for July show that **net lending to consumers** by finance houses and other credit grantors (excluding bank loans) fell to £296m in July from £683m in June. Net lending to consumers in the three months to July fell slightly to £1,187m compared with £1,281m in the previous three months. The **saving ratio** rose slightly in the first quarter 1994 from

10.3% in the fourth quarter 1993 to 10.4%. The underlying increase in **average weekly earnings** in the year to July 1994 is provisionally estimated to have been 3.75%, unchanged from June. **Real personal disposable income** is estimated to have risen by 0.7% in the first quarter 1994 to a level 1.4% higher than in the same period in 1993.

General government final consumption rose by 0.8% in the second quarter 1994. Government consumption in the second quarter was 1.8% higher than in the corresponding quarter of 1993.

Real gross fixed investment fell in the second quarter after rising in the first quarter 1994. Gross domestic fixed capital formation rose by 0.3% to a level 6.4% higher than in the second quarter 1993.

Turning to the **balance of payments**, the deficit on **current account** for the first quarter 1994 was, on revised figures after seasonal adjustment, £0.7bn, appreciably lower than the £2.05bn deficit recorded in the fourth quarter 1993, and the deficits of £1.99bn, £3.46bn, and £3.39bn recorded, respectively, in the third, second and first quarters of last year. For 1993 as a whole, on revised figures, the deficit stood at £10.88bn compared with £10.54bn in 1992 and £7.65bn in 1991. On **visible trade**, the first quarter deficit stood at £3.07bn compared with £3.58bn in the fourth quarter. The decrease was principally due to a 2.5% rise in the value of exports, while the value of imports rose by just 1%. The surplus on the **oil account** rose from £700m in the fourth quarter to £937m in the first quarter.

UK LABOUR MARKET

Employment and Unemployment

UK unemployment continues to fall, though the improvement in the labour market remains very modest. The reduction in unemployment in the three months to July is less than a half the reduction in the previous three months and female unemployment actually rose. The rather muted improvement in the unemployment position is reinforced by the total employment figures. Again, although recorded unemployment declined, total UK employment failed to rise and actually fell 73,000 in the first quarter of 1994. The reduction in employment was not restricted to any one sector or segment of the labour market. It hit both males and females and covered all the main categories except those on work related government training programmes. Manufacturing, energy and service

industries all experienced employment reductions. Moreover, the more up to date information for production industries shows employment continuing to fall to June.

Earnings and Productivity

After a virtually uninterrupted fall in wage inflation since July 1990, wage inflation rose over the winter of 1993 but has stabilised in the quarter to June at 3.75%. The rise in wages continues to be greater in manufacturing and production industries than in services, although the rate of wage inflation fell in all sectors in the last quarter. After a drop in the rate of growth of labour productivity in manufacturing in the last two quarters of 1993, manufacturing output per employee has risen rapidly in the last three months and the whole economy productivity growth figures similarly improved in the first quarter of 1994. The result is that in manufacturing, the annual growth in unit labour costs, which was beginning to rise in the first quarter, had fallen to almost zero by June. The most recent whole-economy unit labour cost figures are for the first quarter and these still show an annual growth of 1.8%.

UK OUTLOOK

The pace of growth quickened in the second quarter of the year. Real GDP growth over the year reached 3.7% which is significantly above the UK trend rate of growth of around 2% to 2.25%. However, removal of the contribution of oil and gas, which has little bearing on the supply position of the UK economy, reduces the growth rate over the year to 3%. Nevertheless, the fact that aggregate demand now appears to be growing faster than aggregate supply potential suggests that the "output gap" will be rapidly reducing and raises questions about the prospects for inflation, which we consider further below. Growth is becoming more broadly based, with the rate of growth of manufacturing nearly 4% in the year to the second quarter, while the production industries as a whole grew by 5.4% and the service sector by just under 3%. Consumer demand, growing at around 3% in the 12 months to March, continues to provide the main motor behind demand growth, although there are indications that the pattern of demand growth is also becoming more balanced. Export growth picked up in the first quarter, considerably reducing the trade and current account deficit. However, while investment rose in the first quarter, capital formation declined in the succeeding three months. Nevertheless, we would expect investment to continue to pick up.

With rising demand and companies' financial position now much better than for several years, investment should grow strongly in the second half of this year and throughout 1995. It seems probable that GDP growth will continue at similar rates for the remainder of the year, although it should be noted that the CSO's leading indicators are suggesting a slow-down of growth in the second half of the year, and the economy has still to experience the full effects of the tax rises introduced in the last two Budgets, which will disproportionately hit the consumer. On the other hand, the stimulating effects of earlier monetary slackening - interest rate cuts - will continue to benefit the economy favourably for some time.

In the **June Commentary** we suggested that the main policy uncertainty concerned the future course of interest rates. We predicted that the next move for interest rates would be up rather than down, and that base rates would be at 6% or more by the end of the year. On September 12, base rates were raised by half a percentage point and further increases are likely over the next two years. It is arguable whether the base rate rise is justified by current inflationary conditions. On the one hand, average earnings growth remains low and the housing market is weak, while on the other, input prices have been rising sharply while output prices have just started to rise. Perhaps of greater concern is the indications that the output gap is smaller than the Government expected. The CBI's indicator of capacity utilization in manufacturing, drawn from its Industrial Trends Survey, is now at levels similar to the mid-1970's peak, although below the levels attained during the boom conditions of the late 1980s. There are therefore indications that the base rate rise may be justified on current inflationary condition. However, much the most important justification for the rise lies in the Chancellor's desire to enhance the credibility of the Government's monetary policy.

Since the enforced departure of sterling from the ERM, the financial markets have been sceptical about the Government's willingness to make the control of inflation its paramount economic policy priority. The Chancellor's decision earlier this year to lower base rates by a quarter of a percentage point, and evident disagreements between the Treasury and the Bank of England on the future course of monetary policy, fuelled these doubts. One consequence of this was that 10-year yields on British Government bonds, which are an indicator of the financial market's view of future inflation, began to increase. Before the latest base rate

increase, the yield on British bonds had risen to 8.8%, compared with around 7.5% in the US and Germany, and Japan around 4.5%. Only Italy, with its well-known problems, had a higher bond yield than Britain. Yet Britain's recent inflation performance has been good by international standards and, amongst the G7 countries, only bettered by France and Japan. The higher bond yields demanded by the financial markets on British bonds therefore appear to reflect an inflation premium due, in part, to Britain's earlier exit from the ERM, and the recently perceived lack of a credible alternative monetary policy. The base rate increase reflects an attempt to restore that credibility.

The paradox is that if the recent base rate rise and the declared willingness by the Chancellor to raise rates further to control future inflation, enhances the credibility of British monetary policy then long-term bond yields should fall helping to stimulate investment - which is usually financed at the medium to long end - and reduce future inflationary pressure. Interest rates must therefore be expected to rise further with the extent of the rise dependent on the success the Government has in restoring and maintaining the credibility of its monetary policy.

These financial considerations apart, which largely concern the prospects for future inflation, some concern must be expressed at the evidence, all be it weak, that incipient inflationary pressures are already beginning to be seen after only two years of the recovery. The indications that capacity utilization in manufacturing is already high, that capacity limitations are viewed by manufacturers as increasingly a problem, suggests that the output gap is now relatively small and that the supply-side of the British economy is less robust than the Government had hoped. While manufacturers are not yet reporting problems of shortages of materials and skilled labour it is likely that it will not be long before such reports appear, providing further confirmation of the historic failure of the British economy to properly invest in productive capacity and the skills of its people.