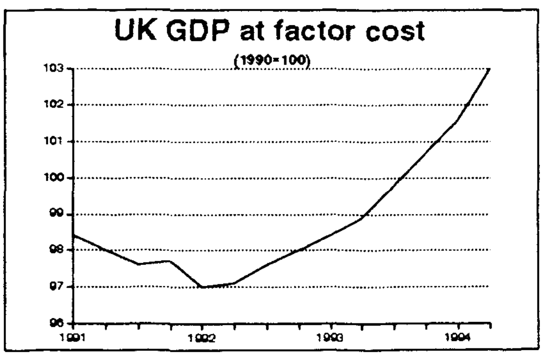
THE BRITISH ECONOMY

UK MACROECONOMIC TRENDS

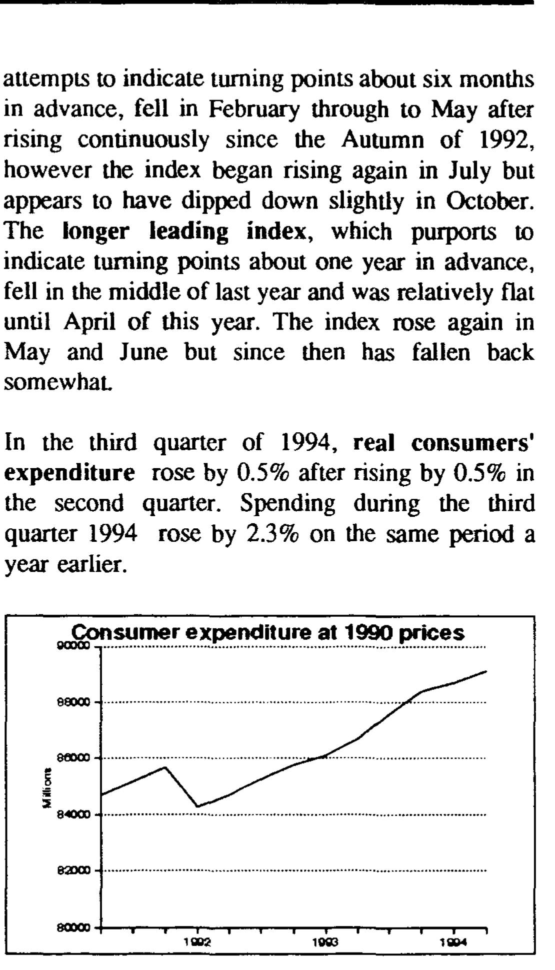
In the third quarter of 1994, the provisional estimate of **GDP at market prices** - 'money' GDP - rose by 1.8%. After allowing for inflation and adjusting for factor costs, GDP grew by 0.9% during the quarter, compared with the 1.3% increase recorded in the second quarter of 1994. Over the year to the third quarter, **'real' GDP** is estimated to have risen by 4.2%, to a level 3.2% higher than the last peak in the cycle in the second quarter 1990. When oil and gas extraction are excluded 'real' GDP is estimated to have risen by 0.9% in the third quarter and by 3.7% over the same period a year ago.

Output of the production industries in the three months to September 1994 is provisionally estimated to have risen by 1.2% over the previous three months, with output rising by 5.9% 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 rose by 1.6%, and production of oil and gas rose by 1.5%. Manufacturing output in the third quarter was 5% above the same period a year ago and 1.1% below the second quarter 1990 peak. The output of the **service sector** is provisionally estimated to have risen by 0.9% in the third quarter and by 3.3% over the third quarter 1993.



The CSO's **coincident cyclical indicator** for September 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 July but appears to have dipped down slightly in October. 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. The index rose again in May and June but since then has fallen back somewhat.

In the third quarter of 1994, **real consumers' expenditure** rose by 0.5% after rising by 0.5% in the second quarter. Spending during the third quarter 1994 rose by 2.3% on the same period a year earlier.



The provisional official **retail sales** volume figures seasonally adjusted for October 1994, were 0.1% above the September figure. Over the year to October, the volume of sales rose by 3.1%. Taking the three months to October, the volume of retail sales rose by 0.6% and by 3.3% over the same period a year earlier. So, after a slight fall in the volume of retail sales in August, sales picked up in September and October, although at a slower rate than earlier in the year.

The underlying determinants of consumers' spending appear to have strengthened slightly in the middle of the year. The consumer credit figures for August show that **net lending to consumers** by finance houses and other credit grantors (excluding bank loans) rose to £632m in August from £603m in June. Net lending to consumers in the three months to August rose to £1,584m compared with £1,155m in the previous three months. The **saving**

ratio fell in the second quarter 1994 from 11% in the fourth quarter 1993 to 9.3%. The underlying increase in **average weekly earnings** in the year to September 1994 is provisionally estimated to have been 3.75%, unchanged from June and July. **Real personal disposable income** is estimated to have fallen by 1.8% in the second quarter 1994 to a level 1.2% lower than in the same period in 1993.

General government final consumption rose by 0.3% in the third quarter 1994. Government consumption in the third quarter was 1.2% higher than in the corresponding quarter of 1993.

Real gross fixed investment fell in the third quarter after rising (on revised figures) in the second quarter and falling in the first quarter of 1994. Gross domestic fixed capital formation fell by 1% to a level 2.3% higher than in the third quarter 1993.

Turning to the **balance of payments**, the deficit on **current account** for the second quarter 1994 was, on revised figures after seasonal adjustment, £0.7bn, lower than the £1.3bn deficit recorded in the first quarter, the £2.2bn deficit recorded in the fourth quarter 1993, and the deficits of £1.9bn, £3.1bn, and £3.2bn recorded, respectively, in the third, second and first quarters of last year. The surplus on **invisible trade** stood at £1.7bn, the same as in the first quarter. On **visible trade**, the second quarter deficit stood at £2.4bn compared with £3bn in the first quarter and an average of £3.3bn per quarter during 1993. The decrease was principally due to a 4.5% rise in the value of exports between the first and second quarter, while the value of imports rose by just 2.5%. The surplus on the **oil account** rose from £894m in the first quarter to £1328m in the second quarter.

UK LABOUR MARKET

Employment and Unemployment

UK unemployment has been falling almost continuously since February 1993 and this fall was maintained in the three months up to October 1994. The overall UK rate of unemployment now stands at 8.9%, with a male and female rate of 12.1% and 4.9% respectively. The fall in unemployment has also been accompanied by a rise in unfilled vacancies, which have been increasing now for over a year. However, a rather different position concerning the labour market can be discerned from the employment figures. Total UK employment is now almost 2 million less than the peak in June 1990. Whilst there was a trough in employment in 1993 and even some gains in the first half of that year, total employment has been falling since September 1993 and the employment figures for June 1994 are below those for June 1993. The fall in the last three quarters registered in all the major sectors of the economy. More up to date figures are available for manufacturing and the energy and water supply industry. Whilst manufacturing shows a very small increase in employment for the quarter to September 1994, energy and water is still experiencing employment decline. It is perhaps to these very weak employment figures that the government should turn when attempting to explain the lack of a "feel-good" factor.

Earnings and Productivity

Wage inflation has stabilised in the quarter up to September 1994 at a annual rate of 3.75%, with the rise in wages continuing to be around 1% greater in manufacturing and production industries than in services. The rate of growth of labour productivity in the whole economy, but particularly in manufacturing, has been high and increasing over 1994. For the whole economy, in the second quarter productivity was 3.8% above the figure for the previous year and third quarter manufacturing productivity was 6% higher than the same figure for 1993. The result is that manufacturing experienced a fall in unit labour costs, compared to the previous year, of 0.2% in the second quarter and 1.4% in the third quarter of 1994. For the whole economy, the most up to date figures are for the second quarter where unit labour costs were also down, this time by 0.3%.

UK OUTLOOK

GDP growth continues above the trend rate of growth for the British economy, with output rising by 4.2% in the year to the third quarter and by 3.7% when North Sea oil and gas are excluded. Growth continues to be broadly based across principal sectors, although manufacturing and construction output is still below the previous peak in the second quarter 1990, while service sector output is well above its earlier peak, although the sector suffered by less in the recession. The source of the recovery began to shift during the past year away from consumption towards exports, and so far net trade accounts for about half the growth in 1994. Capacity utilisation is increasing and the CBI survey indicates that utilisation in manufacturing has returned to normal levels. While the "output gap" appears to be reducing it is not clear to what extent the present level of utilisation represents a constraint on expansion. Anecdotal evidence suggests that competitive pressure may be forcing companies to utilise their existing capacity more efficiently. Labour shortages do not yet appear to be much of a problem and there is a large pool of available labour in spite of the large fall in unemployment which has occurred since the end of 1992. As a result the underlying rate of inflation is historically low at around 2%. Investment is growing only slowly and is not expected to grow by more than 2% next year. Nevertheless, after the restructuring of companies' balance sheets in the recession, many firms have large financial surpluses which should facilitate the rapid expansion of investment next year.

The Government is forecasting GDP growth of 4% this year and 3.25% in 1995, a significant upward revision to its summer forecast of 2.75% in each year. In contrast, the Treasury's Panel of Independent Forecasters is more conservative, predicting on average an increase of 3.6% this year and 3% in 1995. Much the same can be said for the Government's forecasts of inflation and the current account. The economy is therefore seen, at least for the short-run, to be in an almost virtuous cycle enjoying rapid export-led growth, low inflation and a disappearing current account deficit. It is against this background that the Chancellor's November Budget predictions are constructed.

The Chancellor announced that the strategy underpinning his Budget was threefold, to sustain recovery; encourage job creation; and promote long-run growth. On taxation he announced that there was no justification for significant tax cuts, and conversely no need to further increase tax revenue overall. In other words, the Budget would be neutral overall as far as taxation is concerned. The Chancellor was clearly aware that tax cuts at this time would be seen by the financial markets as taking risks with inflation and, more significantly, perhaps indicate an unwillingness to keep the public finances under control particularly when Government borrowing currently continues at high levels. However, the Budget was not neutral in terms of public expenditure. Further cuts to expenditure in cash terms were introduced, with the control total falling by £24bn and General Government expenditure falling by £28bn over the next three years, compared with the expenditure plans revealed in the November Budget last year. However, these cuts are more apparent than real. They largely reflect:

- lower inflation than forecast in the last Budget: expenditure is planned in cash terms with an allowance made for inflation, if inflation is lower than expected then expenditure will be lower even though the real volume of purchases is unchanged. Correspondingly, a lower forecast rate of inflation over the next few years allows expenditure plans to be cut in line with the lower inflation expectation;

- a reduction in the *contingency reserve* which the Government sets aside in case of expenditure overruns. This is sensible if there is a possibility that inflation will be less than the Government forecasts and if the Government believes it has a firm control over its expenditures.

Indeed a close inspection of the data accompanying the Chancellor's statement indicates that in the present year 1994/5 while the cash value of general Government expenditure has fallen, in real terms it has *increased* by 2.3% compared with the plans last year for a real reduction of 0.1%. Real reductions are planned for the next two years but this year's experience perhaps suggests that the Government may find it difficult to 'hold the line' and deliver a real reduction.

The effect of this cutback in cash expenditures and a neutral taxation position - i.e. compared with the November 1993 Budget - is that the PSBR, is projected to fall by more than would have been the case. So, the PSBR is now forecast to be £21.5bn in the 1995/96 compared with the £30bn expected in last year's Budget. In 1996/97, the PSBR is expected to be £13bn compared with £21bn, and in 1997/98, £5bn compared with £12bn. A 'balanced budget' is expected to materialise in 1998 followed by a surplus in the last two years of the century.

In other words, the Government is now expecting that "order" will be restored to the public finances more quickly than could have been hoped for last year. The significance of this is that the Government now appears to be in a position to introduce tax cuts in 1995 or 1996 in advance of the next election, when that seemed a forlorn possibility last year. However, whether such an opportunity will in fact arise depends on the Government's assumptions or forecasts about the future performance of the economy being realised.

The likelihood of the Government PSBR forecasts being realised depends crucially on the realisation of their forecasts for growth, inflation and the balance of payments. Some commentators would argue that the Government is too optimistic about the outcomes for all three of these macroeconomic indicators. However, while this may be true, it is only fair to point out that many believed last year that the Government was being too optimistic about inflation and growth yet, in the event, the Government's view appears to have been vindicated.

As noted above, its growth forecasts appear to be more optimistic than independent forecasters predict. If growth does in fact turn out to be lower than the Government anticipates then tax revenues will be lower and social security payments will be higher with the result that the PSBR forecast will not be met. The same consideration applies to inflation. The Government is forecasting that inflation will be about 2% to 2.5% next year whereas the consensus of independent forecasters predict that it is more likely to be nearer 3%. If inflation is faster than the Government expects then expenditure which is planned in cash terms will be higher, there will be some gain in tax revenues but the net effect will be a greater PSBR than forecast by the Government. In addition, higher than anticipated inflation will place upward pressure on interest rates thereby increasing the costs of servicing the Government's debt and adding to the PSBR. Equally, a higher than anticipated rate of inflation will increase the risk of wage pressure from public sector workers which again could add to the expenditure and hence raise the PSBR. The Government expects the balance of payments to improve further during the coming year, by about £6bn, and by a further £0.5bn in 1995. The expected improvement is somewhat better than that anticipated by independent forecasters. If this improvement does not materialise by the predicted amount then this will put downward pressure on sterling and raise the possibility of an increase in base rates, which will worsen the PSBR for the reasons noted earlier.

Overall, the Budget demonstrates the Government's determination to keep control of the public finances but this objective has been made much easier by the strong growth of the economy this year and by lower than anticipated inflation. A marked deterioration on either of these indicators would be bound to frustrate the Government's plans and its evident desire to offer tax cuts in the next Budget. However, from a strict economic, rather than political, standpoint there are great dangers for the economy if the Chancellor pursues a give-away Budget next year. A consumer led boom would damage the prospect of sustained growth led by exports and investment. It would increase the prospect of the economy again running up against an inflation and balance of payments constraint. And a promising economic recovery would, not for the first time in Britain, end in tears.