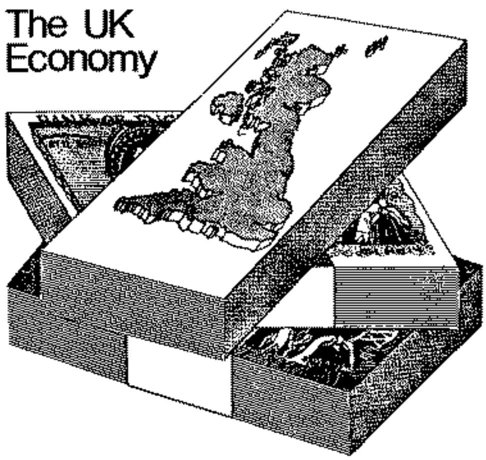
The British Economy

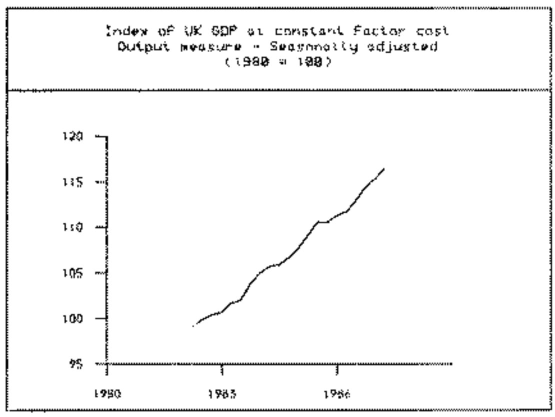


OVERVIEW

The prospects for output growth continue to be favourable. However, since the publication of the May **Commentary** concern has increased about the inflationary consequences of overheating and the prospects for the balance of payments during the remainder of the year. The government's response in raising base rates can probably be justified given the recent slight downward movement of sterling, but future policy action to moderate the rate of expansion should focus on the public sector borrowing requirement.

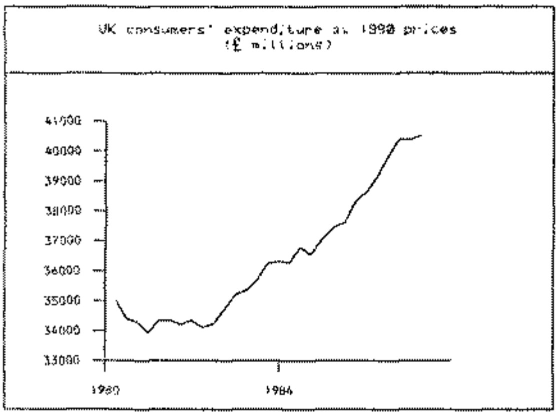
MACROECONOMIC TRENDS

The average measure of **GDP at current market prices,** commonly known as nominal or 'money' GDP, rose by 1.5% between the fourth quarter of 1986 and the first quarter of 1987. The increase was therefore somewhat lower than the 2% change recorded between the third and fourth quarters of 1986. Between the first quarters of 1986 and 1987 'money' GDP rose by 7%. After allowance for inflation, the average measure of **GDP at constant market prices** rose by 1.2% between the last quarter of 1986 and the first quarter of 1987, compared with a 0.9% increase in the previous two quarters. The increase in the GDP deflator therefore slackened somewhat between the two periods. Between the corresponding quarters of 1986 and 1987, 'real' GDP increased by 3.6%, compared with the 3.3% change recorded in the year to the preceding quarter. The **output-based measure of GDP**, which is conventionally regarded as the most reliable indicator of change in the short-term, recorded an increase of 1% between the fourth quarter of 1986 and the first quarter of 1987. An increase which was slightly higher than the previous quarterly rise. Overall, this measure recorded an increase of 4% between the first quarters of 1986 and 1987, compared with a 3.2% increase in the year to the fourth quarter of 1986.



These data again confirm the observation, noted in previous **Commentaries**, that the improvement in the growth of output after the apparent weakening at the end of 1985 is continuing. However, the CSO's **coincident cyclical indicator**, which purports to show current turning points in the business cycle around the long-term trend, after declining in the four months to February remained little changed by May.

The rate of increase in real **consumer expenditure** appears to be slackening. During 1986 real consumer expenditure rose by 0.6%, 2%, 1.5%, respectively, in the first three quarters of the year but remained unchanged in the final quarter. For 1986 as a whole, real consumer expenditure rose by about 4.5%. In the first quarter of 1987 the level of real consumer expenditure rose by under 0.5% from the final quarter of 1986 to a level 3.5% greater than in the corresponding quarter of 1986. In this most recent quarter, expenditure on most categories of goods fell but that on vehicles and energy increased.



The Department of Trade and Industry's (DTI) estimates for the volume of retail sales in the first three months of the year suggested that sales were on a downward trend. The May **Commentary** suggested that a number of factors could be expected to raise spending again in future months, the most important being the effects of the 2p cut in the basic tax rate announced in the Budget and lower interest and mortgage rates. Provisional estimates from the DTI for June appear to support this expectation, with the index rising by 3.1% after falling by 3.5% in May. The June CBI/FT Survey of Distributive Trades, in contrast, reported that a balance of only plus 43% experienced higher sales in June, compared with the balance of plus 49% reported in May. However, retailers still remained optimistic about future orders, with a balance of plus 35% of respondents forecasting an improvement in July. It should be noted though that retailers expectations have consistently been frustrated since the beginning of the year.

The underlying determinants of the growth of consumer demand remain buoyant with, for example, the growth of average earnings increasing to an underlying annual average rate of 7.75% in April, compared with the 7.5% rate recorded in March and preceding months. Provisional figures for May suggest that the higher rate is continuing. Real personal disposable income, which, on revised figures, rose by 2.5%, 0% and 0.5%, respectively, in the final three quarters of last year, rose by a further 2% in the first quarter of 1987, to a level which was 5% higher than in the same quarter of 1986. However, the savings ratio rose to 12% in the first quarter of 1987, as consumers' expenditure grew more slowly than real personal disposable income, which may be accounted for by expectations of higher inflation. Further increases in real personal disposable income are to be expected in the second quarter following the cut in income tax in this year's Budget.

General government consumption again remained largely unchanged between the fourth quarter of 1986 and the first quarter of 1987. An increase of 1% is now reported over the year since the first quarter of 1986, compared with an annual increase of 2% to the third quarter.

Gross fixed investment fell by 0.4% between the fourth quarter of 1986 and the first quarter of 1987 to a level nearly 2% below that of the first quarter of 1986. The low level of investment in 1986 in part reflects the distortionary effects of the phased withdrawal of investment allowances introduced in the 1984 Budget and completed in April 1986. This phased reduction in first year capital allowances resulted in first quarter investment in 1985 and 1986 being higher than otherwise would have been the case, thus accounting for the fall over the year to the first quarter 1987. As reported in the February and May editions of the **Commentary**, investment is expected to increase during 1987. Earlier falls in mortgage rates should maintain the growth in private housebuilding. Continued growth in consumer spending and world trade is likely to increase the significance of capacity constraints and with company profits remaining high investment should rise in 1987 to a level about 3% to 4% higher than in 1986. The main uncertainty is whether the one percentage point increase in base rates at the beginning of August will significantly reduce the propensity to invest.

Following the fall in the price of oil and the related decline in sterling in the second half of 1985, there occurred a fairly rapid deterioration in the **visible trade balance** on both oil and non-oil accounts, reflecting the operation of the well-known J-curve effect. The **non-oil trade deficit** rose from £2.2bn in the final quarter of 1985 to, on revised seasonally adjusted figures, £3.1bn in the first quarter of 1986. A fairly marked increase in non-oil export volumes relative to imports in the second quarter, reflecting the delayed effects of the earlier depreciation of sterling, reduced the non-oil trade deficit to £2.3bn. In the third quarter, with non-oil export volumes unchanged, import volumes increasing by 6.2% and further sterling depreciation reducing the terms of trade, the deficit increased to £3.5bn. In the fourth quarter non-oil export volumes picked up, rising by 7.3% on the previous quarter, compared with a 4.2% increase in the volume of non-oil imports. However, the fall in the sterling effective rate from 74 in July to 68.5 by December led to a further deterioration in the terms of trade and the non-oil trade deficit remained little changed at £3.4bn, leaving a deficit of £12.4bn for 1986 as a whole. Preliminary figures for the first quarter of 1987 show an improvement in the non-oil trade deficit to £2.3bn, due to a 6.6% fall in import volumes with export volumes and the terms of trade largely unchanged. Further deterioration can be expected in this account as the year proceeds, due to more rapid growth of imports following the expected increase in consumers' expenditure, and a slackening in the growth of exports, reflecting, in part, the appreciation of sterling earlier in the year.

The **oil surplus** fell slightly from £2bn to £1.9bn in the first quarter of 1986. Further falls in the price of oil and a relative increase in the volume of oil imports again reduced the surplus to £0.77bn and £0.65bn in the second and third quarters, respectively. In the fourth quarter, as the oil price firmed slightly and export volumes rose relative to imports, the oil surplus rose to £0.84bn, producing a surplus for the year of nearly £4.2bn compared with £8.1bn in 1985. Preliminary figures for the first quarterly of 1987 indicate a further improvement, with the surplus rising to £1.2bn.

On revised figures, the seasonally adjusted **current account surplus** stood at £1064m in the first quarter of 1986, falling to £163m in the second quarter. Deficits of £762m and £585m were subsequently recorded in the third and fourth quarters, respectively. Following these revisions of the figures reported in the May **Commentary,** the deficit for 1986 has now been revised downwards from £1.1bn to £120m, still the first annual deficit for seven years. In the first quarter of 1987, the current account returned into surplus at a preliminary figure of £667m, due largely to the fall in import volumes and the improvement in the oil surplus. In May a large deficit of £527m was recorded, with the volume of exports falling by 4%. While it is likely that these figures for one month are something of an aberration, clearly seen by the provisional figures for June where a deficit of £168m was recorded, further deficits must be expected during the remainder of the year. The crucial uncertainty concerns the size of these expected deficits.

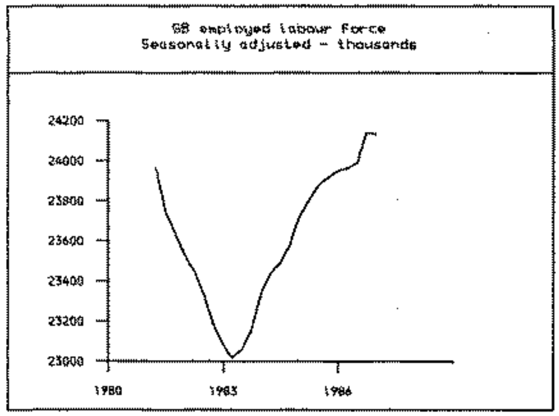
In the three months to May 1987, the **output of the production industries** is estimated provisionally to have increased by 1% from the level of the previous three months, compared with a 0.5% increase in the preceding three month period. The increase took output to a level 2.5% higher than in the same period a year earlier. Manufacturing output also rose by 1% in the three months to May to a level 4.5% higher than in the same period a year earlier. Despite the buoyant performance of the production industries generally, performance continues to vary between individual sectors, but less so than in some earlier periods. The output of the energy sector rose by 1.5% over the preceding three months but was 2% lower than the same period a year earlier. Within manufacturing, metals and other minerals both increased output by 3%, while engineering and allied, and 'other' manufacturing, experienced a 1% rise. Output in the other broad industry groups remained largely unchanged. The construction industry continued to expand rapidly with output 5% higher in the first quarter of 1987 than in the previous quarter. This can be compared with an increase of 1% in the fourth quarter of 1986 compared with the previous quarter. Overall, the output of the production and construction industries increased by 1.5% between the final quarter of 1986 and the first quarter of 1987, compared with little change between the previous two quarters.

The output of the consumer goods industries increased by 0.5% in the three months to May, compared with a fall of 0.5% in the preceding three month period, after earlier increases. Output in both the intermediate and investment goods industries continued to increase, rising by 1.5% in the three months to May.

THE LABOUR MARKET

EMPLOYMENT AND UNEMPLOYMENT

After an average quarterly increase in 1985 of 65,000, the first half of 1986 saw a slackening in the recorded increase in the **employed labour force** to, on revised figures, increases of only 13,000 and 23,000 in the first and second quarters of 1986, respectively. Improvements in UK output growth began to reverse the situation in the second half of the year, with the employed labour force increasing by 54,000 and 75,000 in the third and fourth quarters of 1986, respectively. With an estimated rose of 105,000 in the first quarter of 1987, including an assumed increase of 25,600 in the numbers self employed, the increase in the rate of employment growth is clearly continuing.



The composition of the change in employment in the first quarter of 1987 again follows the established pattern. The number of employees in the service sector rose by an estimated 106,000, compared with a revised figure of 66,000 in the fourth quarter. Manufacturing employment fell by 31,000, compared with reductions, on revised figures, of 39,000, 54,000, 38,000 and 7,000 in the first, second, third and fourth quarters of 1986, respectively. In other sectors, energy and water supply posted a decline of 14,000 compared with a fall of 10,000 in the previous quarter. The other industries category, which includes construction, agriculture, forestry and fishing, recorded an increase of 18,000 compared with reductions, on revised figures, of 9,000, 3,000, and 7,000, respectively, in the first three quarters of 1986, and an increase of 3,000 in the final quarter of that year.

Improvements in **productivity** - output per head - growth continued throughout 1986 and into the first quarter of 1987. For the economy as a whole, productivity increased, on revised figures, by 0.3%, 1.1%, 1.1%, 0.5% during the first, second, third and fourth quarters, respectively. A 0.5% increase was also recorded in the first quarter of 1987, with the result that output per head in the economy was 3.3% higher than in the same quarter in 1986. In manufacturing, productivity improved markedly in the second half of 1986, following increases, on revised figures, of 1.9% and 2.1% in the third and fourth quarters of the year. A further

0.9% increase was recorded in the first quarter of 1987. In the three months to May 1987, manufacturing productivity was 1.3% higher than in the preceding three months and 6.7% above the same period a year ago. It is, however, unlikely that productivity growth in manufacturing will continue at this rate. The recent improvement will in part be due to a once-and-for-all rise, following the increase in capacity utilisation as output in the economy has risen.

There are few signs that **earnings** growth is moderating. As reported above, the underlying increase in average weekly earnings in the year to April and the year to May rose slightly from 7.5% to 7.75%. On the other hand, the growth of wages and salaries per unit of output slackened in the second half of 1986 as productivity improved, particularly in manufacturing. In the three months ending March, April and May, the percentage increase in unit wage and salary costs in manufacturing over the year was 0.7%, 0.5% and 0.8%, respectively. This can be compared with annual increases of 2%, 1.8% and 1.2% respectively inDecember, January and February. These increases in turn tended to be lower than the recorded annual change of 4.1%, 3.8%, 2.1% and 1.9%, in the three months ending September, October, November, and December, respectively. However, in the economy as a whole during the first quarter of 1987, the increase in unit labour costs was still high at 4.1%, compared with 0.7% in manufacturing.

Seasonally adjusted **unemployment** continues the downward trend begun in August last year. In the six months ending July, the reduction has averaged 39,500 per month which represents a further acceleration of the decline noted in the May **Commentary**. With continuing reductions in seasonally adjusted unemployment it is becoming clear that the fall is increasingly reflecting the more favourable outturn for output and employment which began in the second quarter of 1986, rather than simply the effect of the growth in government training schemes. Schemes such as the Restart Programme are undoubtedly the prime factor in the fall in unemployment during the latter half of 1986. By July, seasonally adjusted unemployment, excluding school leavers, provisionally stood at 2.878 million million, or 10.4% of the working population, down by 47,600 on the previous month.

INDUSTRIAL RELATIONS

The election of the Conservative Party to a third term of office has prompted a wider recognition of the fundamental and largely unalterable changes which are taking place in our system of industrial relations. Hence within the trade union movement reform and restructure, to reverse the decline in membership, influence and resources, have become the priority issues. Since 1979 the trade union movement has lost more than 25% of its membership; the percentage of the labour force organised by TUC affiliated unions has dropped to 45%. Legislative changes, especially those affecting the status of the closed shop, coupled with the apparent growing trend towards de-recognition in the private sector and privatisation in the public sector indicate the likelihood of further declines in membership and resources. Such pressures led the TUC to devise a set of proposals to rebuild the movement and to increase its relevance to actual and potential members. The forthcoming TUC Congress will discuss a series of radical proposals aimed at regenerating the movement. However, the rising numbers of trade union members and the increased levels of inter-union strife - over poaching of members, single union and no strike deals - have arisen from the same set of pressures.

The TUC Congress could unite and focus on the common problems facing the movement. However, it could be dominated by attacks on those unions, for example the EEPTU, which have been the most aggressive in their recruiting campaigns, and the most willing to conclude single union and no strike agreements. If Congress becomes preoccupied with squabbling between unions there is the possibility of one or more unions leaving the TUC.

The TUC faces other problems. First, Government ministers in both Scotland and Wales appear to be far more prepared to consult with and listen to the views of trade unions than their colleagues in England. Secondly, over the past few years trade union membership has become increasingly concentrated in the public sector. Whereas 81% of the public sector is organised only 38% of private sector employees are members of a trade union. The public sector now accounts for 44% of trade union memgers. As such, the movement is highly vulnerable to the impact of privatisation on employment policies and radical shifts in industrial relations policies in the public sector. The Local Government Bill, requiring local authorities to put a range of services out to tender, and only allowing local authorities to perform the work themselves if they submit a more competitive tender, must lead to changes in the patterns and issues in established bargaining structures. Inevitably it will lead to losses in employment and trade union members. Such a greater emphasis on labour efficiency can be seen in the government's policies in the civil service and more generally in the public sector.

Three developments, common to both the public and recently privatised sectors, have been the introduction of flexible patterns of working, reduced influence for the trade unions, and an erosion of the importance of industry wide bargaining arrangements. Thus an outcome of the dispute involving British Telecom employees has been the introduction of part-time and short term contract employees, a reduction of flexible work patterns including new maintenance teams with line management taking over engineering work.

Management proposals for flexible working practices in the coal industry - the six day working, changes to shift hours and patterns, revised incentive schemes, multi skilled work groups, new technology in cutting equipment, reduction in number of coal faces, reduced manpower, and contracting out to private tender of peripheral activities - were initially linked to the development of the Margam complex. However, the NUM sought to link agreement to these to the disputed disciplinary procedure and at the annual conference voted to support Arthur Scargill's call to oppose six day working. Nevertheless, the NUM is vulnerable to such changes being imposed by management and to the UDM. Within the NUM many called for a more pragmatic approach given the decline in demand for deep mined coal and the consequences of partial or total privatisation.

Threats to modernise traditional working arrangements, namely the Dock Labour Scheme, underlay the treats of industrial action arising out of proposals to declare a number of dockers at Greenock and Liverpool redundant. The pressures for reductions in manning are likely to lead to modifications of the national scheme within the next few years.

Negotiations affecting over one million local authority employees led to a pay increase of 10.6% linked to increased flexibility and local variations in nationally agreed rates. Additionally, management and trade unions completed their major evaluation of jobs. However, LACSAB, the Local Authorities Condition of Service Board, recognise that authorities will be unable to ignore the movements towards greater labour efficiency and from the local Government Bill, the potential impact of these provisions could be clearly seen in the recent industrial action involving London bus staffs (competitive bus routes has meant wage cuts, longer hours and different work practices - the dispute arose from a wage cut from £4.17 to £3.20 per hour and four hour increase in the working week). Whilst NALGO has declared its opposition to the introduction of performance related pay for senior staff in Kent County Council, such schemes, along with a decline in the importance of industry-wide bargaining, seem inevitable. It is in this climate that LACSAB has embarked on a major review of the principles and philosophies guiding local authority employers, including the role of national agreements.

The Government, in its drive for greater labour efficiency in the Civil Service, has called for further policy initiatives. The extent and impact of such previous pressures can be discerned in the intensity of the recent national dispute. The conduct and issues involved indicate the extent of the shift away from traditional methods of pay determination, via comparability, to quit rates, and an emphasis on regional, flexible, and performance related pay. The current offer constitutes a reversal of the policies up to 1980 and illustrates the extent of government moves to 'deprivilege the civil service' and to reduce vulnerability to industrial action.

The Treasury's apparent strategy of dividing the unions had been largely successful, the improved offer to senior civil servants represented by the FDA effectively minimised the likelihood of the First Division allying itself with the other civil service unions. Secondly, the SCPS, one of the main unions involved in the rolling plan of industrial action, broke with CPSA over the strike policy and by the end of June supported acceptance of the Treasury offer. Even within the CPSA only a narrow majority supported the continuation of industrial action. It was clear that the action was now having only limited support. Moreover, the unions' policy of industrial action of key groups, such as Customs and Excise staff, has not been without difficulties. Both the SCPS and CPSA face the threat of a breakaway union for the 20,000 Customs and Excise staff who feel that they have been used to increase the effectiveness of the industrial action, yet the unions have ignored their special interests. Additionally, the CPSA continued to suffer from the controversy surrounding the elections for its national executive committee, a controversy which raised yet again the divisions between the right and left within the union. The SCPS fears considerable membership losses once the computerisation of DHSS is complete. The use of outside programmers and operators to complete the computerisation of records is an indication of the government's intention to minimise any industrial action.

Flexibility was apparent in proposals for 130,000 NHS administrative and clerical staffs. These would allow for considerable adjustment of pay rates in the light of local labour market conditions. The proposals are similar to those for science and technology specialists in the civil service, and would allow for regional variations in pay of up to £1,200 for the top of secretary grade B scale. No such regional variations were made for nurses and doctors, both of whome benefited from the the imminent general election as the government accepted in full the recommendations of the review boards.

The decision by the major teaching unions to suspend industrial action during the period leading up to the general election and the onset of the summer holidays combined to reduce the immediacy of events within education. Nevertheless, the announcement of the membership of the Teachers' Advisory Pay Panel indicates a continuation of the moves towards greater powers for head teachers and towards the introduction of some forms of assessment of teachers based on performance. As with the developments in Scotland the objective of reducing the powers and influence of the teachers' unions and local authorities will radically restructure patterns and conditions of employment.

Productivity issues dominated events in the private sector. In the banking industry BIFU had moderated its policy on opening hours and pursued agreements with individual banks following the collapse of joint pay bargaining. BIFU's negotiating position is relatively weak given its inability to organise effective industrial action, most of the members are prepared only to support a work to rule and lunch time stoppages only. BIFU also faces threats from other unions seeking to recruit in the expanding banking, insurance and finance sector, hence the merger with the Bank of England Staffs Organisation and attempts to merge with CBU.

Flexible work practices became the key issue in negotiations between management and staff at the General Motors plant at Bedford. The agreement with Isuzu for joint operation of the plant had included the introduction of 'japanese' style work practices.

In the service sector a number of firms have taken advantage of the 1986 Employment Act to introduce flexible work practices and to embark on deunionising actions. The inherent weaknesses of the trade union movement in this sector are such that even if the TUC supports the general secretary's proposals, for new forms of organisation and spheres of influence, unions will not be able to resist such moves. The implications for the terms and conditions of the 3 million employees formerly covered by Wages Council Regulations, given the pressures for increased labour efficiency, are likely to be considerable.

PROGNOSIS

The prospects for output growth continue to be favourable. However, since the publication of the May **Commentary** concern has increased about the inflationary consequences of overheating and the prospects for the balance of payments during the remainder of the year.

The CSO's two leading indicators have both exhibited a sustained increase since the beginning of the year, suggesting that growth will continue to increase over the coming months. However, with the publication of the most recent data the two indicators appear to have diverged. The **shorter leading indicator**, which purports to predict turning points some six months in advance, exhibited little change in May. Movements in consumer credit continued to dominate the behaviour of the index, however. The **longer leading indicator**, which purports to predict turning points in economic activity one year in advance, exhibited a very large increase in June. To some extent this favourable change should be discounted since it largely reflects the rapid movements in one of its component series, namely the share price index. Nevertheless, several of the other component series are contributing to the indicator's growth.

Of the two issues currently causing concern: the prospects for inflation and the balance of payments, it is the former that is most worthy of consideration. A significant deterioration in the balance of payments during the remainder of the year is a cause for concern only because it is likely to be the outcome of incipient inflationary forces. Any temporary deterioration at a non-inflationary exchange rate, reflecting adjustments to a faster rate of economic growth, can easily be financed from Britain's currently large holdings of gold and foreign currency reserves. The continuing deterioration in the prospects for world economic growth may also produce a dampening effect on export demand. But in our judgement the outturn for the current account over the coming months is more dependent on Britain's export competitiveness and the trend in the demand for imports. And the outcome for both depends on the extent to which the economy is subject to overheating and inflationary pressures.

The evidence on overheating is mixed. The recent CBI quarterly Industrial Trends Survey continues to show that confidence in manufacturing is high, with a balance of plus 25% of respondents expecting output and orders to increase over the next four months. This positive balance remains the same as that reported in April. In addition, the survey found no significant evidence of overheating: capacity utilisation was high but almost all sectors had spare capacity; investment intentions were favourable; and unit labour costs were falling. Nevertheless, 18% of respondents mentioned that shortages of skilled labour were a constraint on output, which is the highest level for over seven years. And the proportion reporting that lack of orders were a constraint on output was the lowest since 1979. Other indicators such as earnings, producer prices, house prices and the north-south house price differential, bank lending and money supply growth, have all exhibited fairly sharp upward movements recently, thus adding to the inflationary fears.

The one percentage point increase in base rates in the first week of August indicated the government's concern about the future course of inflation and the implications for future economic growth. The increase may also have been necessary to prevent the worsening trade position from unsettling the foreign exchange markets which could destabilise the pound. However, while the dollar has strengthened recently against the pound, the sterling effective rate and the rate against the D-Mark has remained reasonably steady. The latter has exhibited only gradual movement away from the government's implicit ceiling of DM3, which many economists consider is necessary to maintain the export competitiveness of British industry. The interest rate increase can be judged as a prudent move to tighten monetary conditions at a time when the government's preferred monetary aggregate, M0, is growing at an annual rate of more than 5%, at the upper end of the 2% to 6% target range. In addition, the reduction of base rates to 9% in May was largely prompted by the desire to prevent sterling from rising to an unacceptable level following the large speculative inflows of foreign capital in anticipation of a Conservative election victory. However, in view of the evidence of potential capacity constraints there must be concern about the effect of the interest rate rise on investment. The May **Commentary** suggested that when the authorities are concerned to moderate the effects of a too rapid rate of economic expansion and wish to keep the exchange rate competitive, then this can best be accomplished by fiscal contraction. The recent increase in base rates can probably be justified given the slight downward movement of sterling but future attempts to counter the likely continuing problems of overheating should be met by a further contraction of the public sector borrowing requirement. And this can be best achieved by the government foregoing, or at least postponing, its plans to reduce the basic rate of tax to 25%.