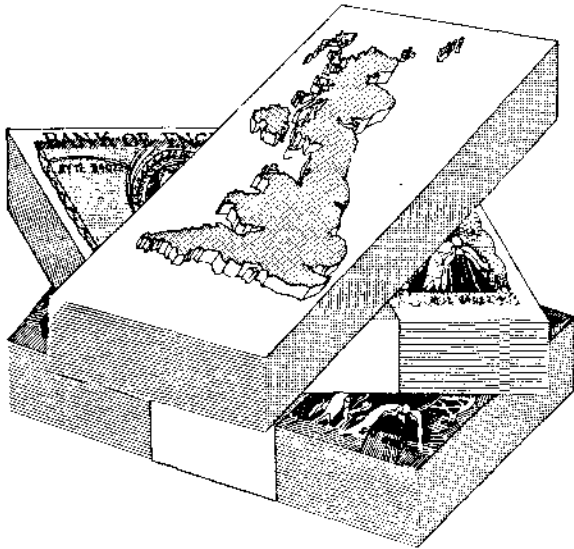


The British Economy



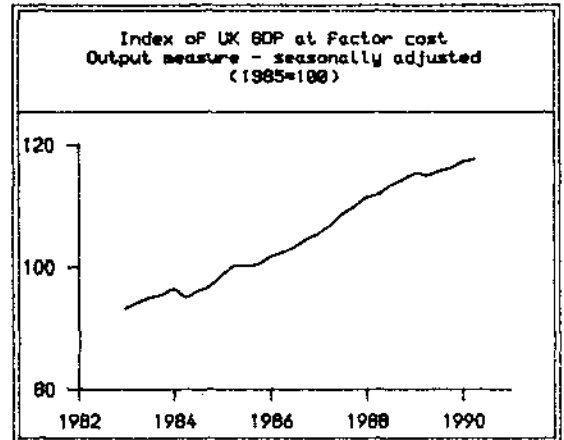
OVERVIEW

The British economy suffered a sharp deterioration in performance from the middle of the year. The economy is now evidently in recession. The entry of sterling into the ERM at an overvalued central rate against the DM and the almost inevitable prospect of a Gulf war suggest the prospect of zero or negative growth in 1991.

MACROECONOMIC TRENDS

In the second quarter of 1990, the average measure of GDP at current market prices - nominal or 'money' GDP - rose by 1.6% during the quarter to a level 7.5% higher than the same period a year earlier. The rate of growth of money GDP therefore fell compared with the previous quarter where the rate of increase was 2.1%. After allowing for price changes, the average measure of GDP at constant market prices - 'real' GDP - rose by 0.9% during the quarter after an increase of 0.4% in the previous quarter. Over the year to the first quarter 'real' GDP is estimated to have risen by 2.5%, a small increase on the 1.9% growth realised over the year to the first quarter 1990. When measured at constant factor cost - ie. after subtracting taxes on expenditure minus subsidies - GDP rose by 0.3% in the first quarter, slightly less than the rate recorded during the preceding three months. Using this measure, the increase

between the second quarters of 1989 and 1990 was 2.3% compared with 1.6% over the year to the first quarter.



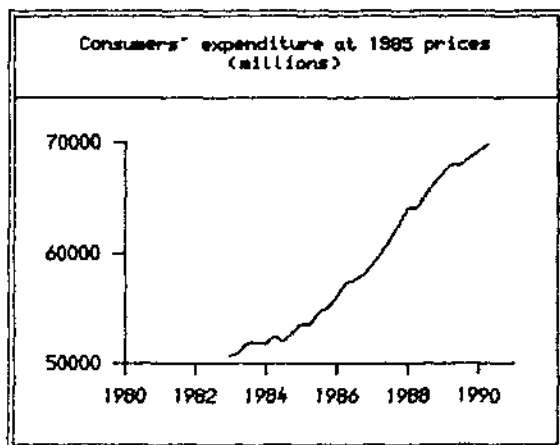
Preliminary estimates of the output-based measure of GDP - which is usually taken to be the most reliable indicator of short-term change in the third quarter of 1990 suggest that activity fell by 1% compared with the previous quarter and rose by 0.5% over the year. The main contribution to the decline in the latest quarter appears to have come from the performance of the oil and gas industries where output fell by 16.7% over the previous quarter, owing to safety work being undertaken in the North Sea. When oil and gas is excluded GDP is shown to have fallen by only 0.25%. Nevertheless, output of the production industries, which includes manufacturing, fell by 3% in the third quarter (see below), while service sector activity, accounting for almost three fifths of total output, rose by 0.1%.

The most recent GDP data now suggest that the UK economy has entered a recession which is particularly affecting manufacturing. The downturn in production appears to have accelerated since we last reported and it seems likely that negative GDP growth will again be recorded in the final quarter of the year and possibly for one or two quarters after that. The relative depression of manufacturing production and relative buoyancy of service sector activity gives some cause for

concern since the main hope for a speedy and non-inflationary route out of the present growth pause is via export led growth of tradeables.

The CSO's coincident cyclical indicator for July, which attempts to show current turning points around the long-term trend, continues to decline slowly, reflecting falls in retail sales and industrial production. This indicator has fallen continuously since the peak of August 1988 suggesting that the economy is firmly in the down phase of the growth cycle.

In the second quarter of 1990 real consumers' expenditure - seasonally adjusted - rose by 1%, down on the 1.4% rate of growth recorded in the first quarter. Spending therefore stood at 2.7% above the same period a year earlier, slightly down on the 3% increase over the year to the first quarter, and broadly similar to the increase recorded over the year to the fourth quarter 1989. Expenditure on durable goods fell by 1% in the most recent quarter to a level 6% lower than a year earlier. Non durable goods expenditure, in contrast, rose by 1% in the second quarter to a level 1% higher than in the second quarter of 1989. Expenditure on services rose by 1% between the latest two quarters and by 6% over the year.



The official retail sales figures - seasonally adjusted - for October recorded a sharp fall of 1.1% over the previous month. Sales fell by 1.25% in the three-month period to October compared with the previous three-month period, and were little higher than the same period a year ago. These data now provide clear evidence that high interest rates are curbing high street spending

and there is no indication that the one percentage point cut in interest rates at the beginning of October has slowed the contraction in consumer demand. The results from the CBI/Financial Times distributive trades survey for October provide confirmation of the official figures. A net balance of -14% reported lower sales in October, the worst performance since the survey was launched seven years ago. However, this figure masks a relatively more buoyant, if subdued, retail sales performance owing to poor trading performance in wholesaling and the motor trades.

The underlying determinants of consumers' spending have again moderated since we last reported in the September Commentary.

The latest consumer credit figures show that consumers took out £3.69bn of new credit in August compared to £3.91bn in July. The August figure represents the lowest monthly growth of new consumer borrowings since September 1989. The cumulative amount of outstanding credit recorded a net increase of £148m in August over July, following net increases of £133m, £242m and £324m in July, June and May, respectively.

The saving ratio rose to 7.7% in the second quarter of the year from 7.4% in the first quarter and a quarterly average of 6.7% in 1989 and 5.4% in 1988.

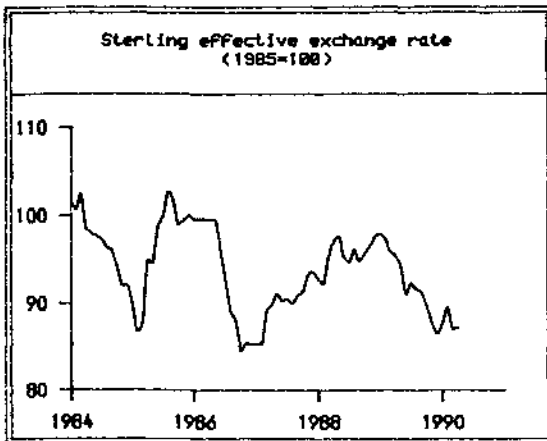
The underlying increase in average weekly earnings in the year to August remained at the July figure of 10.25%, after an increase of 10% in June, increases of 9.75% in April and May and an average increase of 9.5% in each of the first three months of the year. As we reported in the September Commentary there is little indication to date that earnings increases are responding to the downturn in economic activity. Indeed, earnings growth has been progressively rising since a "low-point" in the annual increase of 8.75% was reached during the months of June, July and August last year.

General government final consumption rose by 2.5% during the second quarter of 1990 after increases of 0.1, 0.2% and 1% during the preceding three quarters. The new level was 3.7% higher than a year earlier, compared with an increase of 1.3% in the year to the previous quarter.

Real gross fixed investment fell by 3.1% in the second quarter of 1990 after rising by 2.3% in the first quarter, falling by 0.5% in the fourth

quarter of 1989, remaining unchanged in the third quarter of 1989 and falling by 0.3% in the second quarter. The level of investment in the second quarter of this year therefore fell 1% below that of a year earlier. Over the same period, investment in manufacturing fell by 3%, while investment in the non-production industries fell slightly and investment in energy and water supply rose by 18.8%. Between 1988 and 1989, spending on this component of aggregate demand rose by 5%, compared with 13.7% between 1987 and 1988 and 8.6% between 1986 and 1987. These figures provide further confirmation of the retrenchment in investment noted in recent Commentaries.

Turning to the balance of payments, the deficit on current account for the second quarter of 1990 rose to £4.9bn from £4.6bn in the first quarter, £3.8bn in the fourth quarter of 1989 and £6.2bn in the third quarter of last year. After revisions the deficit for 1989, now stands at £19.1bn compared with £15.2bn in 1988 and £4.2bn in 1987. On visible trade, the second quarter deficit fell to £5bn compared with £5.8bn, £4.4bn, £6.6bn, and £6.6bn, respectively, in the previous four quarters. The surplus on the oil account averaged £128m per month in the first eight months of the year but rose to £205m in September, reflecting the increase in the price of oil following the Iraqi invasion of Kuwait.



In the third quarter of 1990, the output of the production industries is provisionally estimated to have fallen by 3%, compared with a 2.4% increase during the previous quarter. In manufacturing industry, output fell by 1.8% in the recent quarter - the sharpest quarterly fall since

the 1981 recession - and was 0.5% lower than in the same period a year earlier. As usual there were clear variations within the sector. The principal increase recorded between the latest two quarters was in the food, drink and tobacco industries, where production rose by 1.1%. In contrast, the output of clothing and footwear fell by 4.1% mechanical engineering fell by 3.9%, electrical engineering fell by 3.4%, while chemicals and man-made fibres' output fell by between 2 and 3 per cent. Finally, energy and water recorded a fall of 6.3% due to the safety work in the North Sea noted earlier.

LABOUR MARKET

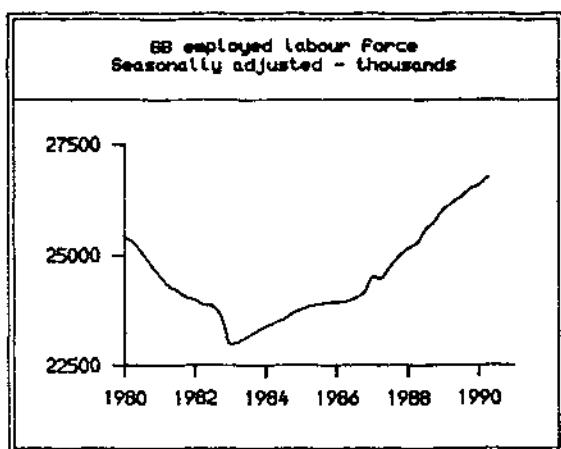
Employment and Unemployment

In June 1990, the UK workforce in employment totaled 27,346,000. This represents an increase of 579,000 (2.2%) for the year and 163,000 (0.6%) for the quarter. Thus the upward trend in total UK employment which has been evident for the past seven years continues. The Government argue that there are indications of a slowdown in employment growth. Insofar as this is true it arises in two areas, the self-employed and those on work-related government training programmes. However, for the self employed the employment change figures are only guessed for the most recent time periods and will be adjusted after the results of the Labour Force Survey become available. Therefore, the only clear indication of any employment slowdown comes in the government's own training programmes.

Disaggregating the figures indicates persistent differences between the employment performance of the various industrial sectors. Manufacturing employment continues to fall, with declines of 3,000 over the quarter and 35,000 (0.7%) over the year to June. This trend is continued in the British manufacturing data which are available up to September and have employment 23,000 lower than for June. However, both UK and British figures show much larger falls in the earlier rather than later months of the year. There continues to be strong employment growth in services where the quarterly and annual increases to June were 159,000 (1.0%) and 533,000 (3.4%) respectively.

UK seasonally adjusted unemployment stood at 1,703,000 in October 1990. This represents an

overall unemployment rate of 6.0%, with a male and female figures of 7.8% and 3.5%. This is the seventh month in succession that UK unemployment has increased, with the increases particularly marked for males. Moreover, the slackening in the labour market seems to be concentrated in the South: over the three months to September, the seasonally adjusted unemployment total rose by 10.8% in the South East and 9.8% in East Anglia but actually fell in Scotland and Northern Ireland. The rise in national unemployment has been accompanied by a fall in the number of notified vacancies. In October, the UK figure was 142,600 with a fall of 28,200 (16.5%) and 72,000 (33.6%) over the previous quarter and year respectively.



Earnings and Productivity

The actual annual increase in the British whole economy average earnings for September 1990 was 9.6% with an underlying increase of 10.25%. The underlying figure is higher than the actual figure because of timing adjustments for employees who have been paid two settlements in the last twelve months. This rise in underlying wage inflation continues the consistent upward trend that has been evident since June 1989 when the rate was 8.75%. Whilst there are small variations in wage inflation between sectors, the spread is small with service industries at 10% and manufacturing industries at 9.5%.

Labour productivity in the whole economy for the second quarter of 1990 was 0.1% lower than the previous quarter and unchanged from the figure

for the second quarter of 1989. Data for manufacturing productivity up to August indicate an annual decrease of 0.1% but a quarterly decline of 1.9%. Part of the explanation of these poor productivity figures are the effects of the Piper Alpha disaster which are estimated to have reduced the increase in whole economy output per head by 0.5 and 0.25 of a percentage point in the third and fourth quarters of 1989 respectively.

The continuing high wage inflation combined with low or negative labour productivity growth generates large increases in unit labour cost. In manufacturing, the unit labour cost in September 1990 was 9.8% higher than the corresponding figure for the previous year, for the whole economy, information is slightly more dated, but the annual increase in unit wage and salary costs up to the second quarter of 1990 is 9.6%.

PROGNOSIS

It is now clear that the British economy suffered a sharp deterioration in performance from the middle of the year. With GDP falling on provisional estimates for the third quarter and the likelihood of further falls in output in the fourth and possibly subsequent quarters, the economy is evidently in recession. (Technically, economists define a recession as having occurred when output has fallen for two successive quarters.) Both consumer spending and investment demand remain weak and export demand has also clearly been affected by the high levels of sterling prior to, and for a short while after, Britain's entry into the ERM. Perhaps as a result, the principal impact of falling demand appears to have been more on manufacturing activity than on the provision of services.

The central issue concerning Britain's future short-run economic performance is therefore the likely extent and duration of the present recession. The one percentage point cut in interest rates, coinciding with Britain's entry into the ERM, should have only a marginal effect on demand and is therefore unlikely to affect overmuch the depth and duration of the recession. The factor most likely to cause the recession to "bottom-out" next year is the projected gradual upturn in world trade leading to a faster growth in UK export volumes and net exports as UK

domestic demand grows more slowly than elsewhere. The CSO's longer leading index, which indicates turning points in activity about one year in advance, points to the economy reaching the trough of the recession around May or June next year. However, since that indicator is currently on a flat path there is little indication yet as to when the upturn will occur.

Two factors serve to complicate the position. First, there is Britain's entry to the ERM at a central rate of 2.95DM to the pound which in our view is too high and in the long-run unsustainable. However, in the short-run the effect of this rate will be to slow the rate of UK output growth than otherwise would have been the case as British exports are less competitive and less able to take advantage of the gradual upturn in world trade. On the other hand, expected exchange rate stability should provide some boost to exports but in our view the effect in the short run is unlikely to be great and may be undermined by the expectation that the chosen central rate

cannot be sustained. Second, future prospects are clouded by the increasing prospect of a Gulf war which on most scenarios would be likely through the reduction of oil supply to have a depressing effect on world output while causing upward pressures on inflation. In these circumstances, 1991 could be a year of marked recession which although not as severe as 1981 would nevertheless be more significant than most forecasters were predicting three to six months ago.

The Treasury forecasts accompanying the Chancellor's Autumn Statement suggest that the economy will in real terms grow at a rate of 0.5% in 1991 following a 0.75% growth rate this year and 3% in 1989. On this occasion the Treasury is more pessimistic about growth in 1991 than many independent forecasters and in our view the official forecast is much the more likely outcome. Yet for the reasons given above we would not be surprised if the economy experienced falling or zero growth next year with the recession extending past the necessary technical definition of negative growth in two consecutive quarters.