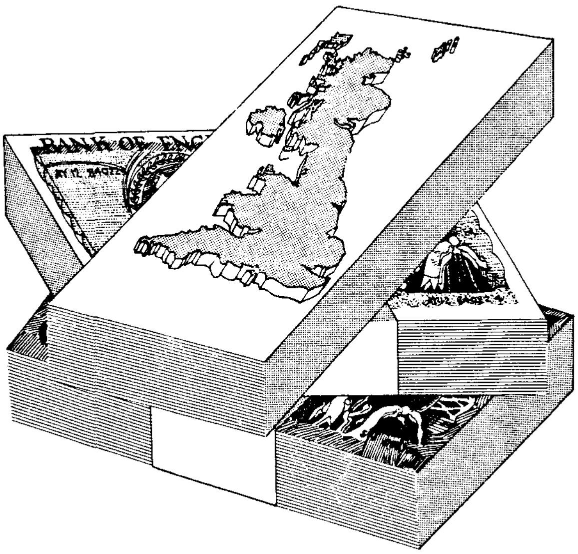
# The British Economy



## OVERVIEW

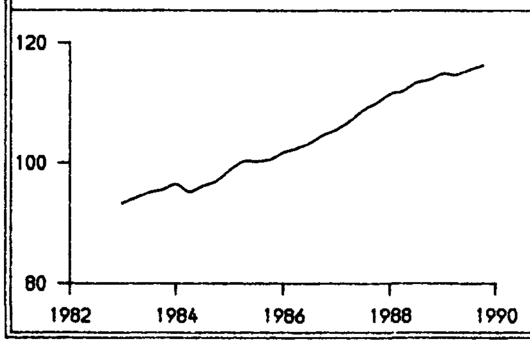
The growth of demand is almost certainly still too high in relation to supply for there to be much improvement in both the rate of inflation and the balance on current account over the next few months. Interest rates are in consequence likely to remain high and at present levels for the remainder of this year, unless a decision to enter the exchange rate mechanism of the EMS is taken within the next few months.

## MACROECONOMIC TRENDS

In the fourth quarter of 1989, the average measure of GDP at current market prices - nominal or 'money' GDP - rose by 2.4% during the quarter to a level 7.7% higher than the same period a year earlier. After allowing for price changes, the average measure of GDP at constant market prices - 'real' GDP - rose by 0.8% during the quarter after an increase of 0.4% in the previous quarter. Over the year to the fourth quarter 'real' GDP is estimated to have risen by 2.0%, which represents a slight reduction on the 2.3% growth rate during the year to the third quarter and on the 2.6% recorded for the year to the second quarter. When measured at constant factor cost - ie. after subtracting taxes on expenditure minus subsidies - GDP rose by 0.7% in the fourth quarter, a slight rise on the preceding three months. Using this measure, the increase between the fourth quarters of 1988 and 1989 was 2%, again very slightly up on the change over the year to the third quarter.

Between the full years 1988 and 1989, 'money GDP' rose by 9% and GNP at constant market prices - the UK's real income - rose by 2%. These figures can be compared with annual 'money' GDP growth rates of 11% between 1987 and 1988, 10% between 1986 and 1987, and 7% between 1985 and 1986. For the real income of the UK, the earlier annual growth rates for the same years were, respectively, 5%, 4%, and 3.5%.

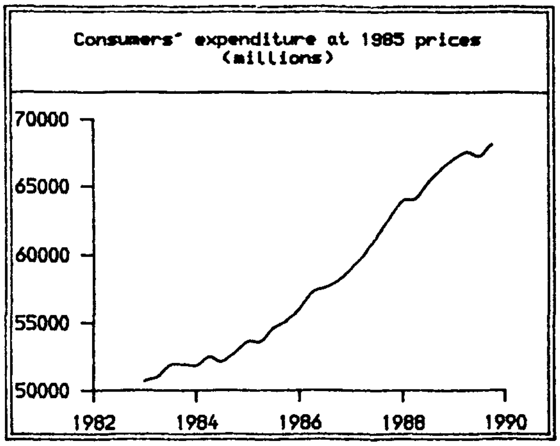
Index of UK GDP at constant factor cost
Output measure - seasonally adjusted
(1985=100)




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 1990 suggest that activity was 0.4% higher than in the fourth quarter of 1989 and 1.5% above that of a year earlier. The main stimulus to growth during the latest quarter again appears to have come from both the service and manufacturing sectors where output rose by 1%. After the previous significant recovery in the energy sector, where output rose by 1.5% between the third and fourth quarters of 1989, output in this sector fell by 3%.

The most recent GDP data again suggest that growth in the UK economy is slowing down compared with 1988 and early 1989, but the data confirm the judgement in the March Commentary that the rate of slowdown is slower than most forecasters had earlier expected. The CSO's coincident cyclical indicator for April, which attempts to show current turning points around the long-term trend, continues to decline with all five component series contributing to the fall. 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 fourth quarter of 1989 real consumers' expenditure - seasonally adjusted - rose by 1.3% after remaining unchanged between the second and third quarters. Spending therefore stood at 2.5% above the same period a year earlier, down on the 4% increase over the year to the third quarter. Expenditure on durable and non durable goods were both broadly unchanged over the year, while expenditure on services rose by about 5%. Between 1988 and 1989 as a whole, real consumer spending rose by 4%, compared with 7% between 1987 and 1988, and 6% between 1986 and 1987.



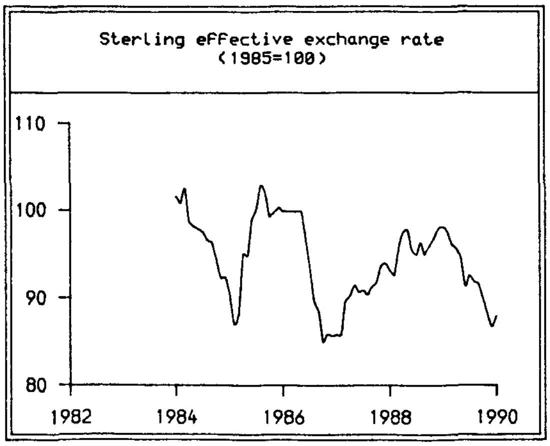

The official retail sales figures - seasonally adjusted - for April recorded an increase of 1% over the previous month, and in the three-month period to April rose by 1% compared with the previous three-month period and by 1.6% over the same period a year earlier. Consumer demand therefore continues to be buoyant despite the sustained high levels of interest rates. However, these recent figures were affected by the timing of Easter so it is likely that they contain a seasonal element and the consensus is that they do not presage a sustained increase in sales. The CBI/FT Distributive Trades survey for April also indicated that the growth of sales in retailing and wholesaling had picked up during the month. The balance of retailers reporting sales volumes higher than a year earlier rose to +41% compared with +18% in March. In addition, orders placed by retailers with suppliers grew in April, with +27% reporting that orders were higher than a year ago, the largest positive balance since May 1989. Also stocks continued to be run down, with a balance of only 13% of firms reporting excessive stocks, down on the March figure.

Turning now to the underlying determinants of consumers' spending it seems clear that it is the buoyancy of earnings and personal income growth that are accounting for the slow downward adjustment in the rate of growth of consumer spending. The latest consumer credit figures indicates a slowing in the growth of debt. An increase of £3.7bn in March was slightly below expectations and much the same as the February figure. The quarterly data provide a wider measure of consumer credit than the monthly figures and they indicate that the increase in credit during the six months to March was the lowest for three years. There appears to have been little growth in outstanding debt in the most recent quarter. The underlying increase in average weekly earnings in the year to March was 9.5%, a rate which has persisted since January and which has been slowly rising since June of last year. There is therefore little indication from these data that earnings increases are responding to the downturn in economic activity. During 1989 real personal disposable income rose by 5% and despite the increase in the saving ratio from 4% in 1988 to 5% in 1989 it is clear that real personal income growth has contributed significantly to the comparative buoyancy of consumers' spending.

General government final consumption rose by 0.2% during the fourth quarter of 1989 after a 1% rise in the third quarter. The new level was 1.7% higher than a year earlier and for 1989 as a whole spending was 0.5% higher than 1988.

Real gross fixed investment fell by 0.5% in the fourth quarter after remaining unchanged in the third quarter of 1989 and falling by 0.3% in the second quarter. The level of investment in the fourth quarter was therefore 1.7% above that of a year earlier. 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 evidence of the retrenchment in investment noted in recent Commentaries. Manufacturing industry investment rose by 5% between 1988 and 1989, while investment by the energy industries was up by 6.5%.

Turning to the balance of payments, the deficit on current account for the fourth quarter of 1989 fell to £5.1bn from the £6.3bn recorded in the third quarter. For 1989, the deficit therefore amounted to £20.9bn compared with £15bn in 1988. On visible trade, the fourth quarter deficit fell to £4.4bn from £6.4bn in the third quarter and £6.3bn and £6bn in the second and first quarters, respectively. In the first quarter of this year, the current account deficit rose again to £5.5bn, this included a deficit of £2.1bn in March, the third highest on record. In April, the deficit fell to £1.8bn but the slow improvement in the trade and current accounts which, with the exception of November, had been apparent since last August, appears to have reversed. The current and trade accounts are now running at an annual rate of deficit of £21.8bn which is significantly above the Government's Budget forecast for the 1990 current account of £15bn. Nevertheless, despite the pessimism that trade performance has deteriorated in the most recent quarter, when the longer period of six months to March 1990 is compared with the previous six months, then export volumes, excluding oil and erratics, rose by 6.7% while import volumes fell by 0.8%. However, it represents an act of faith in Government policy and British trade performance to assume that the six-monthly trend will continue.




In the first quarter of 1990, the output of the production industries is provisionally estimated to have changed little compared with the previous quarter. The level of production was therefore 0.5% higher than in the first quarter of 1989. In manufacturing industry, output rose by 1% in the recent quarter and was 1% higher than in the same period a year earlier. As usual there were clear variations within the sector. The principal increases recorded were again in textiles and clothing where production rose by 2%, the same rate of increase experienced by the chemicals sector and other manufacturing. Output in engineering and allied industries and in food, drink and tobacco increased 1%. At the other extreme, the output of other minerals again fell by 3%, while that of the metals industry fell by 2%. In the energy sector output was 3% lower in the first quarter but was unchanged compared with the same period a year earlier.

By market sector, the output of the consumer goods industries rose by 1% between the latest two quarters, compared with a 0.5% rise between the third and fourth quarters compared and a 0.5% fall between the second and third quarters. The output of the investment goods industries also rose by 1% while that of intermediate goods industries fell by 1%.

## LABOUR MARKET

### Employment and Unemployment

The UK workforce in employment increased to 27,075,000 at December 1989. The increase over the year was 728,000 (2.8%) and this continues the upward trend of the past six years. Again the increase in female employment (4.5% over the year to December) is significantly higher than the increase in male employment (1.4% over the same period). Disaggregating the figures indicates major differences between the employment performance of the various industrial sectors. For the year to December, there continued to be strong employment growth in services (3.5%) and employment decline in energy and water supply (-3.9%). However, after two years of continuous growth, employment in manufacturing has started to decline with UK manufacturing employment down by 0.5% in the year to December 1989. Figures are available on British employment in manufacturing up to March 1990. These show a continuing decline for the first quarter of the year and indicate that over the year to March, manufacturing employment has only increased in two individual months.


The seasonally adjusted UK unemployment level stood at 1,606,000 in April 1990. This represents a rate of 5.6%, with the separate rates for males and females being 7.2% and 3.5% respectively. As was noted in the previous issue, in the recent past UK unemployment has been falling but at a decreasing rate. This trend has continued with seasonally adjusted unemployment in April only 6,500 lower than the January figure, and there was a slight increase in unemployment in April of 1,200. The seasonally adjusted number of vacancies stood at 200,200 at April 1990. This figure was down by 23,000 on the corresponding figure for 1989. However, there was a slight increase in the number of vacancies in the first quarter of 1990.

Earnings and Productivity

The actual annual increase in the British whole economy average earnings for March 1990 was 9.2%. The underlying percentage increase was 9.5%. The actual figure is lower because of timing adjustments for bonus payments and settlements. This underlying increase of 9.5% has held for each of the last three months and there has been a clear upward shift in wage inflation from the 8.75% rate that held from June to August 1989. Whilst there are small variations in wage inflation between sectors, the spread is small with service industries at 9.25% and production industries at 9.75%.

Labour productivity in the whole economy in the fourth quarter of 1989 showed no change over the previous quarter, and was 0.3% lower than the figure for the fourth quarter of 1988. In manufacturing there was an increase of 2.8% in labour productivity in the fourth quarter of 1989 over the corresponding quarter in the previous year. However, here again there was no change in labour productivity over the previous quarter, and the monthly figures show manufacturing productivity declining continuously from October 1989 to February 1990. 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 1 percentage point in the first two quarters, and 0.5 and 0.25 of a percentage point in the third and fourth quarters of 1989 respectively.

In manufacturing, unit wage and salary costs increased over the year to February 1990 by 7.2%. The figure for the increase for the whole economy for the year up to the fourth quarter of 1989 was 9%. It is clear that high wage inflation plus low or negative growth in labour productivity are generating large increases in unit wage and salary costs.

INDUSTRIAL RELATIONS

A year ago a series of strikes in the public sector led a number of commentators to make comparisons with events in the mid 1970s. Today the comparisons are with levels of wage awards and inflationary pressures.

Whilst a "going rate" of between 9 - 11% has emerged, there are considerable variations reflecting differing labour market conditions, legal requirements and changing levels of consumer demand. Thus within retailing there is evidence of an increasing number of firms in electrical, DIY and furniture areas laying off staff, whilst in food and provisions wage increase of up to 26% over three years (Marks and Spencer) and 20% (Tesco and Sainsburys) have been awarded. These high increases reflect moves by firms to ensure that there is equal pay for equal work (e.g. female check out staff compared with male warehouse staff).

The Government continues to encounter difficulties in its move to end Wages Councils, whilst the powers of councils have been eroded and the numbers of inspectors reduced both a significant number of employers as well as trade unions have argued for their retention.

The announcement of redundancies amongst professional and managerial staffs in British Telecom, and technical and white collar staff in the BBC prompts a number of concerns. There is much evidence to suggest that many organisations will seek to reduce the numbers of white collar staffs as their first steps to improve labour efficiency. If the 1960s and 1970s were decades of reductions amongst manual workers we may well witness similar reductions amongst white collar staffs over the next few years.

A number of the development identified over the past years continue to spread to new industries. The ending of traditional industry wide bargaining arrangements has continued with the announcement of local bargaining in electrical supply, British Steel, and the introduction of similar arrangements by British ship owners. Running counter to this trend has been the moves by Milton Keynes Council to opt back to the industry wide bargaining arrangements.

However, there appears to be a reduction in the interest in performance related payment schemes. Whilst National Power announced its intention to introduce such a scheme, Coventry City Council scrapped its performance pay plan. Within Local Authorities there is evidence to suggest that such schemes do not resolve issues of labour retention. More generally the costs of such schemes has acted as a deterrent.

Within West Germany the 35 hour week has now been introduced for 3 million metal and electrical workers, yet sporadic action at a number of British firms continues.

Developments within education illustrate both the success and failure of Government policy. Clearly the ending of bargaining arrangements and changes to the law have eliminated the likelihood of concerted and widespread industrial action over the short term and limited the upward movement of salaries. Nevertheless, this has proved a pyrrhic victory as labour turnover and shortages of staff have replaced industrial action as the "problems" for management.

Union merger talks continue to prompt concern as to the future shape of the British trade union movement. Discussions continue between a number of sets of unions including: NALGO, NUPE and COHSE; SOGAT and NGA; TGWU and MSF; NUR and NUS; and AEU and EEPTU.

**PROGNOSIS**

Despite the indications that growth slowed during 1989 compared with the two previous years, the growth of demand is almost certainly still too high in relation to supply for there to be much improvement in both the rate of inflation and the balance on current account over the next few months. Interest rates are in consequence likely to remain high and at present levels for the remainder of this year, unless a decision to enter the exchange rate mechanism of the EMS is taken within the next few months. Entry to the ERM is unlikely given the present rate of price inflation which, however it is measured, remains considerably higher than the EMS country average when the British inflation rate is excluded.

The growth in export relative to import volumes is still too weak for much improvement in the current account to be realised by the end of the year. It is therefore unlikely that the Government's forecast for the current account deficit of £15bn for 1990 will be achieved and some improvement in current trade performance will be required for the outturn to be below £20bn. The estimated 1% growth in manufacturing output in the most recent quarter probably disguises some switching to foreign markets and therefore is to some degree compatible with a reduced rate of growth of domestic demand, but with the service sector also growing at the same rate this is clear indication of the comparative buoyancy of domestic demand.

This continued buoyancy of demand can now clearly be seen to reflect strong earnings and personal income growth, so while the growth of personal debt does appear to be moderating in response to high interest rates, the policy is so far having little impact on these other determinants of consumer spending. Investment demand remains fairly buoyant as shown by the recent survey of manufacturer's investment intentions, so there is little likelihood that the required reduction in demand growth will come from this aggregate. Indeed it would be most unfortunate if it did because of the longer term consequences on the availability and quality of supply.

Further monitoring of the underlying rate of inflation and the trade balance is required before we can have a clearer idea of the short-run direction of economic activity in the British economy.