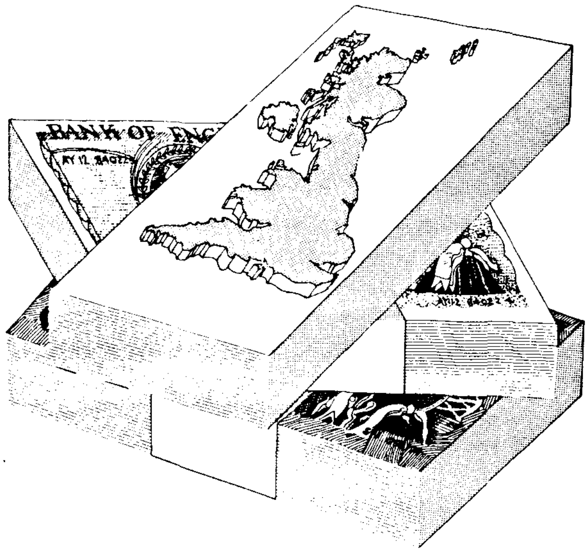
The British Economy



OVERVIEW

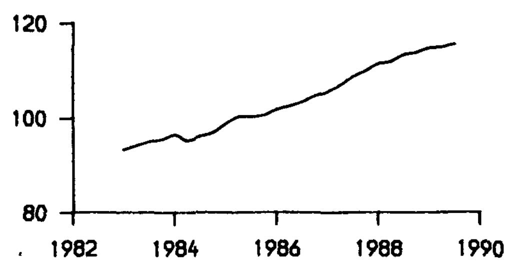
The rate of growth of output continues to decline but the rate of slowdown of domestic demand appears to have eased. Prospects for inflation have worsened. A tightening of fiscal policy offers the best guarantee of minimising further inflationary pressure, allowing base rates to come down sooner than presently appears to be likely.

MACROECONOMIC TRENDS

In the third quarter of 1989, the average measure of GDP at current market prices - nominal or 'money' GDP - rose by 1.5% during the quarter to a level 8.6% 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 0.4% during the quarter after remaining almost unchanged in the previous quarter. Over the year to the third quarter 'real' GDP is estimated to have risen by 2.3%, which represents a slight reduction on the 2.6% growth rate during the year to the second quarter. When measured at constant factor cost - ie. after subtracting taxes on expenditure minus subsidies - GDP rose by 0.5% in the third quarter. Using this measure, the increase between the third quarters of 1988 and 1989 was 1.9%.

As noted in the last two Commentaries the estimates of the average measure of GDP have recently been affected by the erratic quarterly paths of the expenditure and income measures of GDP. In the latest quarterly estimates the CSO has applied statistical adjustments to the estimated expenditure and income change to allow for probable under and overestimation of these series. The adjustments are experimental and cannot be guaranteed to be accurate but as a result the quarterly paths of the different measures - and particularly the average measure - now move more closely together and are now very closely in line with movements of the output measure, which is usually taken to be the most reliable indicator of short-term change.

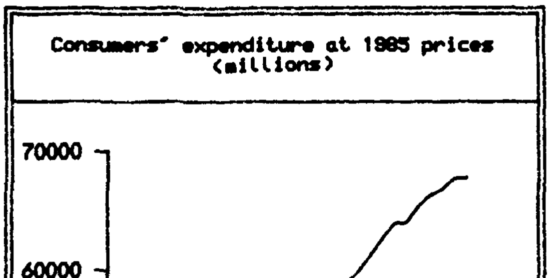
Index of UK GDP at constant factor cost
Output measure - seasonally adjusted
(1985=100)



Preliminary estimates of the output-based measure of GDP in the fourth quarter suggest that activity was 0.6% higher than in the third quarter and 2.1% above that of a year earlier. The main stimulus to growth during the latest quarter again appears to have come from the recovery in the energy sector where output rose by 1.5% over the previous quarter. Manufacturing output was little changed while service sector output was 0.5% higher than in the third quarter.

The most recent GDP data continue to suggest that growth in the UK economy is slowing down compared with 1988 and early 1989, although the rate of slowdown appears to have eased. The CSO's coincident cyclical indicator, which attempts to show current turning points around the long-term trend, continues to decline but has fallen less steeply in recent months. The CSO, in February, suggests that this easing in the rate of decline will be a temporary feature because the series was affected by the high levels of retail sales in December of last year. The series has been declining since August 1988 which now appears to be the peak of the last growth phase.

In the third quarter real consumers' expenditure - seasonally adjusted - remained much the same as in the second quarter but stood at a level 4% higher than a year earlier. Consumer spending therefore slackened again in this quarter after picking up somewhat during the second quarter. Expenditure on durable goods again remained broadly unchanged in the third quarter as in second quarter with the result that expenditure on this category of goods is still at the same level as in the third quarter of 1988. This provides a clear indication of the effect of higher interest rates on this key component of consumer demand. Expenditure on non durable goods fell by 1.5% in the third quarter to a level 0.5% higher than the same period in 1988. But expenditure on services ran largely against the trend, rising by 1.5% in the third quarter to a level 6.5% above that in the third quarter of 1988.



Preliminary estimates of real consumers' expenditure - seasonally adjusted - for the fourth quarter of last year indicate that there was a not insignificant increase of 1.2% over the period. Nevertheless, for the year to the fourth quarter spending is estimated to have risen by 3.5%. For 1989 as a whole, real consumers' expenditure is estimated to have risen by almost 4.5% above the 1988 figure. The preliminary estimates are partly forecasts and so are almost certainly subject to revision. Nevertheless, if correct these data do indicate that the growth of this component of aggregate demand is registering the effects of the earlier progressive base rate rises, although the rate of adjustment of spending is probably slower than expected.

The official retail sales figures - seasonally adjusted - for January showed an decrease of 1.3% over the previous month, and in the three-month period to January rose by only 1.5% over the same period a year earlier. In December retail sales rose considerably by 1.9%, promoting fears of a resurgence of consumers' demand despite the high interest rates. The 1.3% January fall was not sufficient to reassure that the December figures were an aberration. These fears were further reinforced by the CBI/FT Distributive Trades survey for January which, in contrast to the official figures, indicated that the growth of retail spending continued to be buoyant. The balance of retailers reporting sales volumes higher than a year earlier rose to +50% compared with +30% in December and the +11% of traders who in December expected sales to rise in the following month.

In addition, orders placed by retailers grew in January and stocks continued to be run down from the high levels recorded in November. Wholesalers, on the other hand, reported a reduction in sales compared to the previous January and orders from suppliers were lower than a year earlier for the first time since March 1989.

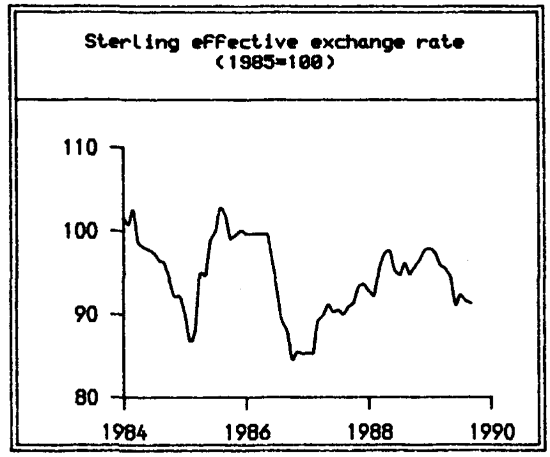
With consumer debt recently rising to a record 27bn and annual earnings growth continuing at nine and one quarter percent, the underlying determinants of consumers' spending remain fairly buoyant.

General government final consumption rose by 1% during the third quarter of 1989 after remaining virtually unchanged between the first and second quarters. This figure was some 2% higher than a year earlier. As reported in the December Commentary further increases should be evident this year following the expenditure plans revealed by the government in the 1989 Autumn Statement.

Real gross fixed investment remained unchanged in the third quarter of 1989 after falling by 0.3% in the second quarter and rising by 1% during the first three months of the year. The level of investment in the third quarter was therefore 3.5% above that of a year earlier. These figures provide further evidence of the retrenchment in investment noted in recent Commentaries. Manufacturing industry investment fell by 0.5% between July and September to a level 7.5% higher than the level attained in the third quarter of 1988. But in contrast, investment by the energy industries rose by 13.5% on a year earlier reflecting the increased prospects for North Sea oil production. Fixed investment fell by 1.5% in the non-production industries during the third quarter, 7% down on a year earlier. By type of asset over the year to the third quarter, investment in vehicles, ships and aircraft grew by 5% compared with 11.5% in the year to the previous quarter, in plant and machinery by 8% compared with 8.5%, while investment in dwellings declined by 5% compared with a 9% fall in the year to the second quarter, and in other new buildings and works investment rose by 0.5% compared with a fall of 1.5%. Recent figures from the CSO for the fourth quarter of last year reveal further declines in real investment spending to a level 2% higher than the same period in 1988.

With the exception of the latest January figures, the monthly deficit on the current account of the balance of payments has continued to show signs of improvement as the rate of growth of domestic demand slows and producers of tradeables seek to compensate by switching to export markets. The deficit for the third quarter rose to a revised 6.5bn, reflecting the large deficit in July. On visible trade, the third quarter deficit rose to 6.7bn compared with 5.9bn in the second quarter, but fell to 4.5bn in the fourth quarter following successive reductions in the monthly trade balance from August. Export volumes grew by 13% during 1989 and manufacturing exports grew by 24%, both considerably faster than the growth of world trade at 7 to 8%. This suggests that despite the recent deterioration in the balance on current account in January the deficit should continue to decline as the rate of growth of domestic demand contracts and as the lower effective exchange rate - 12% down during 1989 - improves the price competitiveness of British exports.

In the fourth quarter of 1989, the output of the production industries is provisionally estimated to have increased by 0.5% compared with a 1.7% increase in the previous quarter. The level of production was therefore 1.5% higher than in the fourth quarter of 1988. In manufacturing industry, output changed little during the recent quarter but was 3% higher than in the same period a year earlier. As usual there were clear variations within the sector. The principal increases recorded were in textiles and clothing where production rose by 2%, and in engineering and allied industries where the increase was 1%. At the other extreme, the output of other minerals again fell by 3%, while that of chemicals and food, drink and tobacco fell by 1%. The metals industry and "other manufacturing" experienced little change in production during the latest quarter. In the energy sector output was 1.5% higher in the fourth quarter but, due to the continuing effects of the Piper Alpha disaster, was 2.5% down on the last three months of 1988.

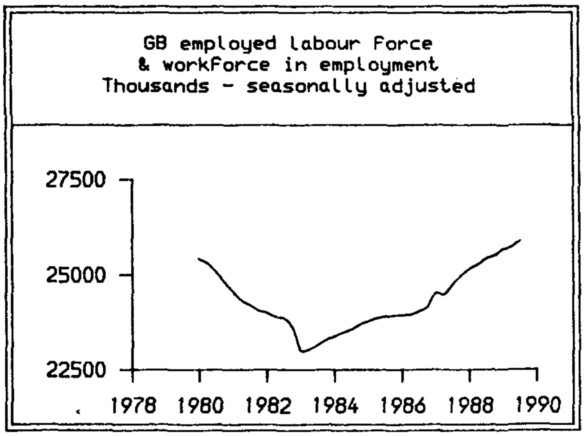


By market sector, the output of the consumer goods industries rose by 0.5% between the third and fourth quarters compared with a 0.5% fall between the second and third quarters. The output of the investment goods industries rose by 1.5% while that of intermediate goods was little changed. Comparing 1989 with 1988, the output of the production industries rose by 1% following growth of 3.5% between 1987 and 1988. Manufacturing grew by 5% compared with 7% between 1987 and 1988. The output of the energy sector fell by 9.5% between 1988 and 1989 compared with a 4.5% fall between the previous two years.

LABOUR MARKET

Employment and Unemployment

The workforce in employment in the UK reached a level of 26,487,000 at September 1989. This represents an increase of 1.8% over the previous year, and of 0.6% over the previous quarter. The growth of female employment (2.7% for the year to September 1989) is more than double the male figure of 1.0% for the same period. When employment change is disaggregated by sector, one finds a small increase in manufacturing employment for the quarter to September 1989, but a 1.2% fall for the year ending at the same date. For manufacturing, figures are available for Great Britain up to December 1989. These show that with the exception of August, employment has fallen each month since January 1989: employment fell 0.4% through the quarter and 1% through the year to December 1989. Employment continues to decline in energy and water, but there are large increases in services, with a 0.8% rise in the quarter and 1.4% rise in the year to September 1989.



The UK seasonally adjusted level of unemployment stood at 1,611,400 in January 1990. This represents an overall unemployment rate of 5.7%, with a male rate of 7.2% and a female rate of 3.6%. Unemployment continues to fall but by decreasing amounts. The average monthly reduction in unemployment for the 3 and 6 months up to January 1990 were 21,000 and 29,300 respectively, as compared to the corresponding figures for January 1989 of 46,600 and 56,700. The UK seasonally adjusted number of unfilled vacancies has declined by 15,300 (7%) over the three months to January 1990. This is a continuation of a general trend over 1989: the fall in unfilled vacancies over the year to January 1990 was 31,600.

The actual increase in average British weekly earnings in the year to December 1989 was 7.2%. However, the underlying increase was 9.25% as arrears in pay were much larger in December 1988, the main groups involved being nurses and midwives.

The figure of 9.25% held for the whole of the last quarter of the year suggesting that there is no easing of inflationary pressure in the labour market, despite the slight fall in wage increases that occurred during the summer. The spread of wage increases across sectors is small, with the service sector the highest at 9.25% and manufacturing the lowest at 8.75%.

The growth in labour productivity in the UK has shown a dramatic fall over the last three years. In manufacturing, for the year up to December 1989 the figure was 3.3%, very low by the standards of the recent past. But more importantly, for the third quarter of 1989 labour productivity for the whole economy was only 0.6% higher than one year earlier. Whilst the Piper Alpha disaster and other oil industry interruptions have reduced the increase in whole economy output per head by an estimated 0.5% over this same period, the whole economy productivity increase is still small.

Unit wages and salary costs are calculated as the difference between the rates of change of earnings and labour productivity. With the rate of wage increases not slackening and the rate of productivity increase (particularly whole economy productivity) falling, there has been an adverse impact on unit labour costs. For manufacturing industry, the rise in unit labour costs up to December 1989 were 4.6% over the previous twelve months. For the whole economy, the annual rise in unit labour costs up to the third quarter of 1989 was 9.6%. The whole economy unit labour costs have been rising monotonically since the second quarter of 1987.

INDUSTRIAL RELATIONS

The long running dispute by ambulance workers epitomises much of the contemporary British industrial relations. To a degree the result of the dispute was inevitable. The Government's refusal to change, unwillingness to go to arbitration, and reluctance to enter into further negotiations, mirrored its strategy in earlier disputes by public sector employees.

Four issues are raised by the dispute. First is the thorny problem of how to establish terms and conditions for essential staffs and the rights to industrial action such groups should enjoy. At present the rates of pay for fireman and police are set by a formula reflecting the moves of wages and salaries in the private sector, although there is some concern among members of both groups as to how long such arrangements for determining pay will continue. The present Government has received several sets of suggestions to reduce the rights of employees in essential services to undertake industrial action. So far the problems of balancing loss of rights to withdraw labour have implied a counterbalancing right to either compulsory arbitration, or to the introduction of an agreed formula to determine pay. Whilst the Government is encouraged to seek a reduction in the rights to withdraw labour it has not wished to implement the second element.

Secondly the dispute raises questions as to the effectiveness of the established methods to establish pay and conditions in the National Health Service. More than half Health Service employees have their pay determined outside the official bargaining machinery, often by the use of a pay review body. All the recent review bodies have commented on the problems of retaining staff and have recognised the need for higher awards than those suggested by the treasury. All have been critical of Government proposals for pay flexibility. Several, e.g. the review group for teachers, have stressed the degree to which the Government undervalues its employees.

Thirdly, the widespread support for ambulance workers, more than £4 million was collected from the public, reflects public concern for developments within the Health Service (see Scottish section).

Fourthly, the ending of the dispute raises questions as to whether the Government will introduce measures to decentralise the bargaining structure. The introduction of local bargaining has featured quite widely in the public sector. The ending of the five month dispute by lecturers in FE colleges has led to the introduction of local bargaining for some senior staff. Kent County Council has indicated that it will be withdrawing from national wage bargaining for nearly all white collar staff, similar moves are being considered by Buckingham, Berkshire and Essex County Councils. British Steel has introduced the principle of ending national bargaining. The Government has raised, once again, the issue of ending the residual powers of the remaining 26 Wages Councils, although it has postponed moves following opposition from employers.

In the private sector ship owners plan to end the national bargaining structure which was first established in 1919. In the private sector decentralisation of bargaining has often been accompanied by other changes including: streamlining bargaining arrangements, reform of organisational and business structures. Thus Associated British Ports has decentralised bargaining to each of its 19 ports; British Airport Authority has decentralised bargaining to each of its airports. On the other hand others have decentralised to product or divisional levels.

The second major dispute has been the rolling campaign by the Confederation of Shipbuilding and Engineering Unions in pursuit of the 37 hour week. A further 11 plants have been targeted for industrial action. Already a number of companies have settled and it seems likely, if the unions can maintain the action, that the 37 hour week will be a more common feature amongst larger firms in the engineering industry.

Undoubtedly the size of the settlement by the Ford Motor Company has posed the greatest concern as to the annual level of wage settlements. Ford's agreement includes a substantial increase for craftsmen, indicating the shortage of such employees and as such their increasing ability to command high settlements. There is some evidence of a rising wage militancy, based on rising labour demand. British Rail unions have rejected an 8% and reduction in working hours offer; Electricity Supply unions have similarly rejected 8.5%; Gas workers were only narrowly in favour of a 9-9.8% increase. Whilst indications of similar wage pressures in Japan might provide some comfort, the overall trends in wages and productivity remain gloomy. Britain's productivity remains low in Europe for a number of reasons. However, of increasing concern is the extent to which the continue failure to invest in adequate training and employee involvement schemes. In a climate of shortages of skills firms might be encouraged to hoard labour or to pursue half baked productivity schemes. In the longer run the market does not provide an effective answer to Britain's problems.

A second feature of the Fords agreement was the higher than average award for functional flexibility (i.e. to those employees in integrated work teams).

Interest in flexibility and in introducing individual contracts continues unabated. Associated British Ports have introduced individual contracts for some 450 staff, others have been introduced by British Telecom, Electricity Supply (1000 managers), British Airways (technical and production engineers and foremen), and in British Rail, often with an ending of established bargaining arrangements. The Alliance and Leicester Building Society claim that performance related pay has reduced turnover amongst key staff to under 3% but has meant that more than 50% of the worst performers have left. However such personal contracts have met with employee opposition. Flexible work practises have been introduced by:- print employers (24 hour shift working); British Gas (outside normal hours coverage); Engineering Construction (reduction of demarcation).

The fifth anniversary of the miner's strike was marked by allegations as to the misuse of union monies and the usage national officials made of some 14 accounts. Curiously, one of the effects of the labour legislation of the last 10 years has been a centralisation of power within the union and the development of tighter internal organisations.

PROGNOSIS

The economic indicators suggest that the rate of growth of output continues to decline but the rate of slowdown of domestic demand appears to have eased. The main growth stimulus continues to come from the energy sector as the industry recovers from the disasters in the North Sea. But with output in manufacturing little changed in the most recent quarter while the service sector experiences positive growth, there is little sign as yet of a significant shift from the production of non-tradeables to tradeables, which we have argued is essential if the economy is to significantly improve the current account deficit while avoiding recession. Yet despite recent monthly trade figures the growth in export volumes relative to imports over the last few months does suggest that the current account deficit will continue to improve, if slowly, during the year.

Sterling has again fallen considerably over the last few weeks and this should facilitate a further switch from the domestic production of non-tradeables to tradeables during the year if exporters expect the lower level to be sustained. However, the fall in sterling is likely to be unhelpful to the government's desire to control the rate of inflation, both directly through higher sterling import prices and indirectly via an increase in the external demand for British products, at a time when domestic demand has remained more buoyant than expected. The inflationary impetus has been given further force by the continuing high level of wage settlements, earnings, and falling productivity, growth, as well as the recent switch from domestic rates to the poll tax in England and Wales. Company profits are therefore likely to continue to be squeezed with the inevitable implications for employment while the prospects for increased inflation worsen.

The Chancellor has so far avoided raising interest rates again in response to the falls in sterling, perhaps in part because of the demand reducing effects of the recent rise in mortgage rates. But if sterling continues to fall it is difficult to see how he can avoid tightening monetary policy further. The political implications of a further increase in base rates are something that the government may not wish to contemplate. It is therefore likely that by the time this piece is read we will have heard that the Chancellor has tightened his fiscal stance in the Budget by, for example, failing to fully index tax allowances. A tight Budget would appear to be essential to keep the brakes on domestic demand and wage inflation. It might not prevent a further rise in base rates but it should help rates to fall more quickly than they otherwise would have done once inflation has stabilised.