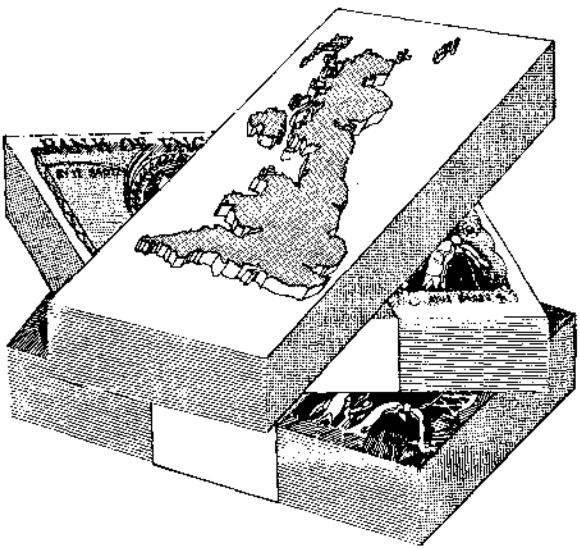
The British Economy



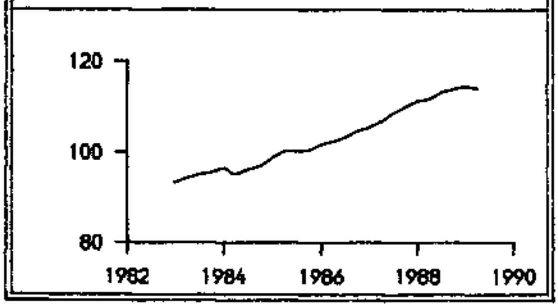
OVERVIEW

After another quarter it seems clear that the slowdown is continuing but probably at a slower rate than many commentators first expected. However, the form of the slowdown does give cause for concern both for the prospects of a 'soft landing' and for the balance of payments. Inflation pressures appear, for the moment, to be contained.

MACROECONOMIC TRENDS

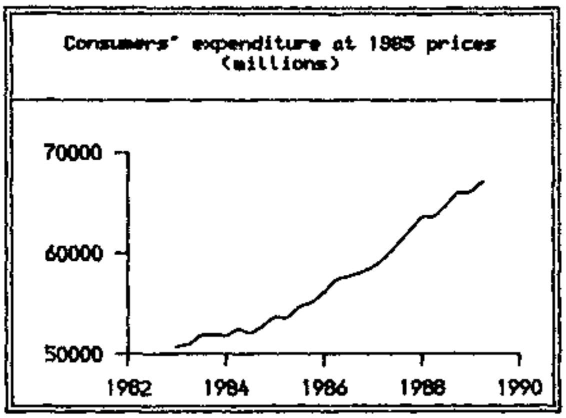
In the first quarter of 1989, the average measure of GDP at current market prices - nominal or 'money' GDP - was 2.2% up on the fourth quarter of 1988 and nearly 10% higher than the same period a year earlier. After allowing for price changes, the average measure of GDP at constant market prices - 'real' GDP - rose by 0.2% during the first quarter of the year to a level which was 1.7% above the first three months of 1988. When measured at constant factor cost, the average measure of GDP rose by 0.5% in the first quarter and 1.5% in the year to the first quarter. However, the CSO point out that the estimates of the average measure are affected by the "erratic quarterly paths of the expenditure and income measures of GDP." The CSO suggest that a more informative comparison is to compare the latest half-year figures - ie. for the period of the fourth quarter 1988 and the first quarter 1989 - with those for the same period a year ago: over this period the average measure of GDP rose by 2.5%. The output-based measure of GDP, conventionally the most reliable indicator of short-term change, did not change in the first quarter of 1989. Latest estimates of the average GDP indicator for the second quarter 1989 suggest that output was largely unchanged compared with the first three months of the year and 2% higher than a year earlier.

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



The most recent GDP data provide strong confirmation that not only is growth slowing down but that the economy could experience one or more quarters of negative growth before returning to a positive quarterly growth rate. The CSO's coincident cyclical indicator for July, which attempts to show current turning points around the long-term trend, continued the decline which began in mid-1988. The current path of this index is therefore consistent with a slowing down of economic growth which remains below trend.

Real consumers' expenditure is estimated to have increased by 0.5% in the first quarter of this year to a level 4.5% higher than a year earlier. This represents a marked slowdown on the 2% rate for the fourth quarter of 1988 reported in the June Commentary. However, spending on durable goods rose again in the first quarter, by 1.5%, thus returning to the increases which appeared to have ceased when no change was reported during the final three months of last year. Nevertheless, the growth of real spending on durables is considerably down if annual change figures are considered: in the year to the first quarter 1989 spending on durables rose by 5.5%, compared with 10% over the year to the fourth quarter 1988 and 14% to the third quarter of last year. Preliminary estimates of real consumers' expenditure for the second quarter of this year suggest that there was an increase of 0.7% in that quarter bringing the level of spending to 5% above that attained in the second quarter of 1988. Consumers' expenditure is now clearly growing at a much slower rate than two years ago; but in some ways it can be seen as holding up quite stubbornly, and more so than domestic output, in view of the significant base rate rises over the past year.



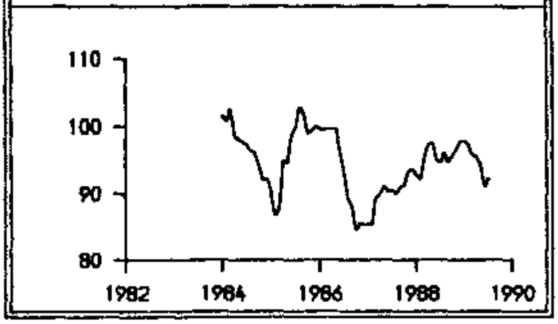
The provisional, official (ex DTI now CSO) retail sales figures for July indicated a fall of 0.6% over June and an increase of only 0.25% in the three months to July. Over the year to May-July sales rose by only 2.25%, which is the lowest annual growth rate since October 1982. The CBI/FT distributive trades survey for July indicated a marked slowdown in retail spending. Sales were well below expectations with only +2% of respondents reporting sales higher than a year ago, the lowest on record; this should be compared with a balance of +27% in June. Unusual seasonal factors such as the hot weather this summer and transport strikes may have resulted in a reduction in sales demand below what otherwise might have been expected. Nevertheless, there appears now to be very clear evidence that the government's high interest rate policy is taking the steam out of high street sales.

The underlying determinants of the growth of consumer spending continue to point in different directions. The growth in average earnings was provisionally estimated to be 9.25% in the twelve months to July. Although this constituted a rise from the 9% recorded in the twelve months to June, the annual rate of change of earnings has averaged around 9.25% for most of this year. Real personal disposable income (RPDI) rose by 0.5% between the fourth quarter of 1988 and the first quarter of 1989 to a level 4.5% higher than the first quarter of 1988. The first quarter increase is significantly lower than the 4% growth recorded during the final quarter of last year. Both RPDI and real consumers' expenditure rose at the same rate between the fourth quarter of last and first quarter of this year. The saving ratio therefore remained unchanged at 5.1%, which is nevertheless higher than the 4.5% rate achieved for 1988 as a whole. There is therefore some suggestion here that the saving ratio is responding to the higher interest rate regime and we should expect some further rises during the year. Monthly consumer credit data - excluding bank credit other than bank credit cards ie. around 60% of credit agreements - rose by a record 505m in May, but the increase may have been due to unusual seasonal influences and households raising their borrowing levels in the face of higher mortgage rates. In any event, in June, outstanding consumer credit rose by only 182m, yet that still meant that the May/June monthly average was above the average for the first six months of the year. However, the rate of increase of consumer credit still appears to be declining if the quarterly changes - which include bank credit - over the past twelve months are compared. According to the TSB Scotland Treasury review, net advances of consumer credit in the first six months of the year were 8.6% down on the same period of 1988 and 6.8% down on the previous six months.

General government final expenditure rose by 0.5% during the first three months of the year taking it to a level 1.5% above that of a year previously. This compares with a 0.6% increase in the final quarter of last year. Latest information suggests that government consumption expenditures remained at much the same level in the second quarter and unchanged on a year earlier.

Real gross fixed investment rose by 1% in the first quarter compared with the 1.2% increase in the final quarter of last year. Investment demand has therefore continued to grow strongly over the year. By the end of the first quarter it stood 9.5% higher than a year earlier. Latest information suggests however that there has been some retrenchment recently, perhaps due to the effects of higher interest rates. In the second quarter investment demand fell by 0.5% to a level which is 2% above a year previously.

The deficit on the current account of the balance of payments continues at a high level. During 1988 the deficit reached 14.6bn after a deficit of 3.7bn, on revised figures, in 1987. In the second quarter of 1989, the deficit rose to 4.9bn from the 4.8bn of the first quarter. The latest quarterly figure is still lower than the 5.4bn deficit recorded in the final quarter of last year but at the current quarterly rate we must expect a current account deficit this year of some 19.4bn. The visible trade balance which deteriorated persistently throughout 1988 has continued at high deficit levels during 1989. The second quarter deficit of 5.8bn represented a slight reduction on the 6bn outturn in the first quarter, which in turn represented some improvement on the 6.5bn deficit incurred between September and December of last year. Some improvements in the terms of trade during 1989 compared with 1988 and a relative improvement in export volumes appear to account for the slight turnaround. In the first quarter of the year export volumes of non-oil goods rose by more than 7% while imports rose by 3.6%. However, in the second quarter export volumes rose by under 1% but imports remained largely unchanged. Export volumes will of course have to outgrow import volumes for some time before the deficit on current account is substantially reduced. Finally, the oil account recorded an increase of 0.1bn in the second quarter, the first recorded increase since the second quarter of last year. The average quarterly surplus of 286 million so far this year is significantly down on the 1988 quarterly average of 697m and the 1bn attained during 1987.



Sterling effective exchange rate (1985=100)

In the second quarter of 1989, the output of the production industries is provisionally estimated to have fallen by 1% compared with the previous quarter to a level 1% below the same period a year earlier. This compares with a 1.4% fall during the previous quarter. Latest information shows that in the three months to July production had fallen by 0.5% over the previous three months to a level 1.5% lower than the same period a year ago. The downturn in production activity clearly reflects the general state of demand in the economy but also has been influenced by the special circumstances of the energy sector where interruptions to oil extraction following the Piper Alpha disaster and other accidents have reduced output considerably. During the second quarter of this year, energy sector output fell by 3.5% to a level 16% below that during the same period of 1988. Manufacturing output, on the other hand, was little changed from the first quarter and stood at 5.5% above the second quarter of 1989. The growth of manufacturing can also be seen to be slowing down - compare the 0.7% rise in the first quarter and the 6.6% annual rate - as the growth of demand in the economy moderates. Within manufacturing, the principal increases recorded between the latest two quarters were in food, drink, and tobacco, 2%, and in other manufacturing, 1%. Output in the metals industry fell by 4%, in other minerals it fell by 2% and in chemicals, textiles and clothing a drop of 1% was recorded.

By market sector, the output of the consumer goods industries rose by 0.5% in the second quarter, compared with a 0.9% increase in first three months of the year. The output of the investment goods sector remained unchanged after decreasing in the preceding two quarters. Production in the intermediate goods sector fell by 2% after falling by 2.8% between January and March. Compared with the same period a year ago output of consumer goods has risen by 3%, down on the 5.1% recorded in the year to the previous quarter; investment goods output is up 8.8% over the same period, down on 9.4%; and intermediate goods output has fallen by 5.9% compared with a 3.3% fall in the twelve months to the first quarter.

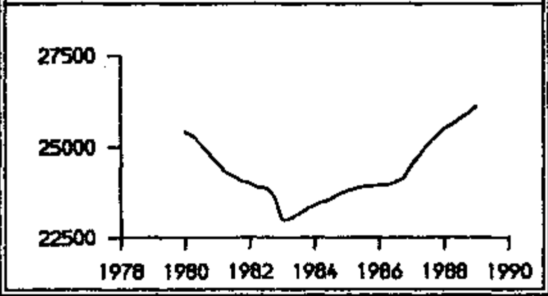
LABOUR MARKET

EMPLOYMENT AND UNEMPLOYMENT

Employees in employment in the UK is estimated to have risen by 0.7%, that is 181,000, in the first quarter of 1989. The increase in the year up to March 1989 is 598,000 (2.3%) and this keeps the number of employees in employment on the increasing trend which has been evident for the last six years. When the total figure is broken down, the following results emerge. First, there is a continuation in the long-term secular increase in female, relative to male, employment. Over the past year to March, female employment has risen by 2.8%, as against 0.7% for male employment. Within broad industrial sectors of the economy, employment in services continues to expand, with an increase of just over 400,000 (2.6%) for the year up to March. However, the recent increase in manufacturing employment has halted. In the year to March 1988 there were four consecutive quarterly increases in manufacturing employment. However, in the four quarters to March 1989 manufacturing employment change has been small and in the last quarter was negative. The overall figure for manufacturing employment in March 1989 is, as a result, very slightly down on the corresponding figure for 1988.

UK Seasonally Adjusted Unemployment fell by 69,000 in the three months up to July 1989 to a total of 1,789,000 (though the unadjusted total actually rose). The July unemployment rate stands at 6.3%, which is down from 6.5% in April and 7.9% in July 1988. Although unemployment continues to fall, this has been at a diminishing rate since late 1988: the average monthly reductions in total seasonally adjusted unemployment for the four quarters to July 1989 are 36,500, 56,700, 43,300 and 23,000 respectively. Moreover the provisional estimate of the unemployment rate for July fails to show any reduction over the June figure. Although there was a relatively large increase in the seasonally adjusted number of unfilled vacancies at jobcentres in June, this was more than offset by reductions in May and July so that overall in the quarter to July there was a reduction of 2,200 (1%). This maintains a trend of reductions in vacancies which has been apparent since mid 1988.

GB employed labour force & workforce in employment
Thousands - seasonally adjusted



The increase in average earnings of employees in Great Britain is estimated at 9.3% to the year to June. However, the underlying increase was lower at 9% as arrears in 1988 were lower than in May 1989 and some groups of workers have had more than one pay increase in the past 12 months. This represents a slight reduction in the rate of wage increases from the figure of 9.25% which held between February and May. There is some difference between the underlying increase in average earnings in different sectors of the economy, with the rate in energy and water supply and manufacturing being slightly above that for service industries in the last quarter, but the differences are small, of the order of 0.25% to 0.5.

Productivity in manufacturing fluctuates from month to month. However, taking averages over three month periods and comparing with the corresponding period in the previous year shows that the growth rate of productivity has been falling continuously from the beginning of the year. For the 3 months ending in February, output per employee was 6.5% higher than in the corresponding period in the previous year and this falls to 5.5% for the 3 months ending in June. Whilst productivity in manufacturing is still rising at a historically high rate, the position for the whole economy is much less sanguine. The increase in output per head for the whole economy was 0.3% lower in the first quarter of 1989 than it had been in the last quarter of 1988, and only 0.4% higher than the same quarter a year earlier. It is estimated that the Piper Alpha disaster and other oil industry interruptions reduced the increase in output per employee in the economy as a whole by 0.5% in each of the last 2 quarters of 1988 and by 1% in the first quarter of 1989.

The percentage change in unit wage and salary cost is calculated as the difference between the rates of change of average earnings and labour productivity. From the data above it can be seen that in the first quarter of 1989, unit wage and salary costs were 3.2% higher in manufacturing and 8.3% higher in the economy as a whole than the figure for the corresponding quarter in 1988. The difference reflects the much higher increase in labour productivity in manufacturing as compared to the economy as a whole.

INDUSTRIAL RELATIONS

The annual Trades Union Congress heralds both a retrospective and forward view of British industrial relations.

The spring and summer of 'aspiration', the series of short lived strikes indicated clearly the changed nature of British industrial relations. Firstly, the pattern of selective industrial action in British Rail, the BBC and British Airways indicates a greater strategic awareness amongst trade unions. Secondly, the NUR's success highlights the weaknesses of 'hardline' management approaches of threatening mass dismissals at a time of shortage of skills, declining unemployment and more attractive employment elsewhere. Problems of recruitment were already apparent to British Rail. Travellers Fare, for example, had found it necessary to increase pay rates by between 5 and 25% in April and by August was offering a 'bounty' of £60 to attract recruits.

No industrial relations legislation can prevent employees voting with their feet by leaving for higher paid employment, a problem increasingly acute in several areas of the public sector. Thirdly, the British Rail dispute illustrated the ability of unions to take effective industrial action within the new legal framework. Fourthly, the Government's threefold response, a threat to investment, privatisation or the exploration of the possibility of banning industrial action in essential services, did not demonstrate an understanding of the underlying issues and causes of the dispute. It is highly doubtful whether privatisation will solve issues of low morale, staff turnover and low pay.

Fifthly, the dispute exposed fundamental weaknesses in the corporate industrial relations strategy. The public associated stock and service issues with management weaknesses and sympathised with the employees. There was some hope amongst passengers that the NUR would follow the example of the French transport unions whose industrial action took the form of refusing to collect fares on certain days, but maintained an otherwise perfect service. A reliance on the law was shown to be inadequate and unjustified.

As the Financial Times noted - 'The brutal truth is that a key part of the corporations' strategy has been forced off the rails'. Sixthly, the settlement of 8.8% inevitably became a target for other groups.

However, indications that the public believe that managers are more to blame for Britain's economic ills and other public opinion surveys which indicate a growing popularity for trade unions, nor the 'success' of the NUR cannot hide a series of weaknesses facing the trade union movement as it gathers at Blackpool. The announcement, in June, of the ending of industrial action by ex P and O seamen and the dispute by dock workers over the ending of the National Dock Labour Scheme illustrates a different facet of British industrial relations. The different labour market condition, inland container ports, changing patterns of freight movement, non registered ports all combined with the provisions of the legislation to ensure the defeat of any industrial action.

In terms of legislation British workers have fewer rights than almost all their counterparts in the EEC. Moreover, the 20% decline in the numbers of safety inspectors and the increasing number of accidents at work indicates an increasing vulnerability in other aspects of employment. The Government focus is primarily upon the collective rather than individual labour law. It has announced its intention to explore further legislation, including bans on strikes in essential public services.

It would be difficult to define essential services and whether the actions of all employees in 'essential services' should be covered by such action. It would be necessary to consider what protections would be necessary for the loss of such rights. Traditionally, this has been taken to mean automatic indexing of earnings to inflation and/or to matched groups of employees in the private sector. However, it is unlikely that the Government would welcome such an intrusion in the free market economy. In Europe essential services have been defined as those necessary to health, safety, law and order, and defence. All the European examples allow either some additional protection for the individual worker, some minimum notice or provision of some minimum service in limited areas - especially police and armed services. Few, if any, have found an effective, democratic and practical approach to essential services other than police and armed services. Current industrial action by airline pilots in Australia, a country with a strong tradition of arbitration, is a further example of government impotence in the face of scarce skills and an absence of alternative forms of transport.

Trade unions still face a declining membership, membership of TUC affiliated unions dropped by 145,000 members to 8,652,318 at the end of 1988 (this excludes 330,000 EETPU members). The TUC has pledged to fight against non unionism by strengthening recruiting initiatives, recognising the differing needs of particular sections of the labour force, and endeavouring to ensure a more collaborative approach between unions over recognition issues. The latter seems problematic given the intermittent raiding activities by the EETPU on the membership of several unions and the pressure for major unions to concede single union deals with foreign-owned firms especially. The problems were forcibly brought home to delegates as they had to forego the traditional stay at the Imperial Hotel. Since the owners, Trust House Forte, refused recognition rights to the GMB, delegates had to find alternative accommodation at Blackpool.

Instances of derecognition have been noted in earlier issues of the Journal, it is estimated that some 60 cases have occurred since the mid 1980s. A number of these have been well publicised. Whilst News International actually now has considerable numbers of printing union members in employment, it is seen as a classic example, along with P & O, Sky Television, parts of BT and sections of the hotel and catering industry, as the beginning of a trend towards derecognition. Such policy changes by employers coupled with the rise of part-time employment, rise of small firms, changes to the public sector through CCT could herald a long-term decline in union membership.

For the union the agenda is clear. Unions will have to develop survival strategies. Suggestions have included unions entering into training working hours compacts with employers, to accept greater flexibility, to offer more relevant services to the increasing proportion of part-time, self-employed and traditionally non-trade union groups. For employers the need is for training and the elimination of areas of scarce skills. For the government the issue is to contend with the reality that the settlement rate has been set by both the NUR settlement, and higher rises in the private sector. Aspirations are harder to control when high pay settlements appear to be awarded to other groups and to senior staffs for no apparent or consistent reason.

PROGNOSIS

We argued in the June Commentary that the balance of the evidence suggested that the economy was slowing down. After another quarter it seems clear that the slowdown is continuing but probably at a slower rate than many commentators first expected. However, the form of the slowdown does give cause for concern both for the prospects of a 'soft landing' and for the balance of payments. The rate of inflation appears to be moderating and should be around 7% by the end of the year but will continue above 5% for the foreseeable future. For inflation to remain at these levels, cost-push pressures in the economy must be contained, world commodity price changes must be reasonable and no significant depreciation of sterling should occur.

The form of the economic slowdown gives some cause for concern because from the scant evidence available it appears that production in the non-tradeable sector of the economy is currently holding up better than tradeables. In the June Commentary we noted that for a 'soft landing' to be secured there would at some point have to be a relative contraction of demand and output in the non-traded sector - principally, construction and a large proportion of services - and a relative expansion of the traded sector - largely manufacturing and the traded services such as insurance, other financial services and tourism. In the most recent quarter for which data are available - April to June - manufacturing output remained unchanged, and energy sector output fell considerably, so with an unchanged GDP at constant prices and output of the production industries falling, it appears likely that service sector output rose.

Worrying secondary indicators are that during this period consumers' expenditure continued to rise, although at a slower rate than previously, while investment expenditure fell. This is perhaps another indication that the effect of higher interest rates has been different from what the government expected, in that investment demand has not escaped being hit by the higher cost of capital. The more investment in the British economy falters the less likely the economy can build up the capacity to ensure an effective switch in demand in favour of the domestic, and away from the foreign, production of tradeables. Without that, the balance of payments will only improve through a significant deflation of domestic demand. In the meantime Britain can only continue to run its extremely large deficit on current account if foreign holders and purchasers of sterling retain confidence in the economy. A collapse of confidence would see a run on sterling, a significant depreciation, higher interest rates and the inevitable emergence of higher price rises and much reduced output and employment: stagflation.