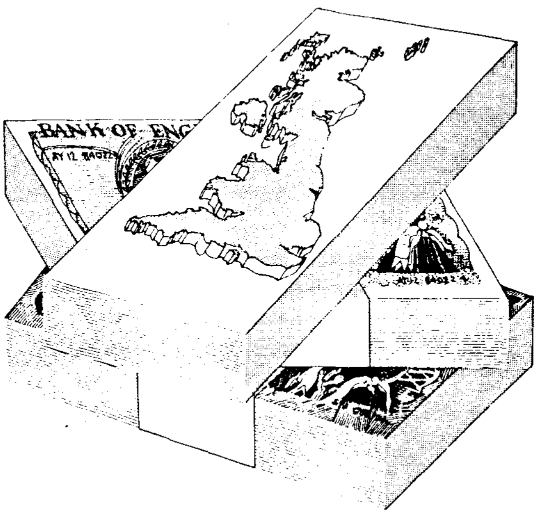
The British Economy



THE BRITISH ECONOMY

OVERVIEW

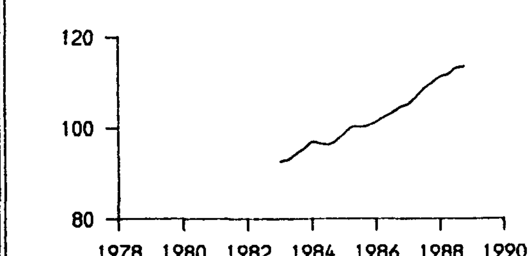
Despite the concern shown by the financial markets following the publication of the DTI's provisional retail sales figures for May, the balance of the evidence is that the economy is slowing down. What cannot be guaranteed is that the tightening of domestic demand will produce an outturn which has been described as a "soft landing". High earnings growth and the recent marked fall in sterling are likely to push the RPI above earlier expectations and, as base rates edge higher, the prospect of the economy avoiding a recessionary outcome almost certainly diminishes.

MACROECONOMIC TRENDS

The CSO has now reverted back to the usual procedure of averaging the three independent GDP measures: income, expenditure and output, in producing its average estimates of GDP. In the March Commentary we reported that indications of serious under-reporting had led the CSO to exclude the expenditure measure form the average estimates.

The average measure of GDP at current market prices nominal or "money" GDP, was 10.5% higher in the fourth quarter of 1988 than the fourth quarter of 1987. The same measure was also 10.5% higher in 1988 as a whole over 1987. After allowing for price changes, the average measure of GDP at constant market prices - "real" GDP - rose by 3.7% during 1988 above the 1987 level. When measured at constant factor cost, GDP was 4% higher in 1988 than in 1987 and 0.5% higher than in the third quarter of 1988. The output-based measure of GDP, conventionally the most reliable indicator of short-term change, also rose by 0.5% between the third and fourth quarters of 1988. Provisional estimates of output-based GDP for the first quarter of 1989 suggest that output changed little from that of the final quarter of 1988, falling by 0.2%.

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

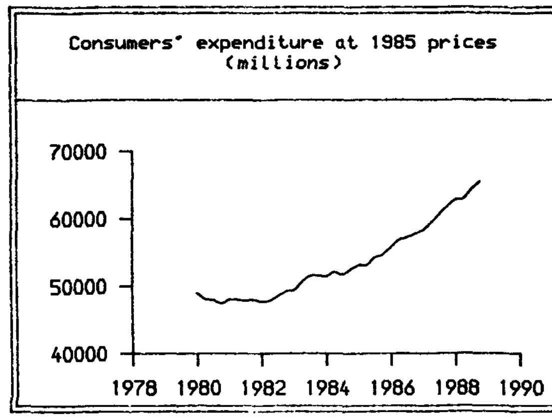


Despite the difficulty of interpreting the GDP figures, due to the erratic behaviour of the expenditure component in particular, the rate of growth of output in the British economy does appear to be slowing. Growth during 1988 is now estimated to have been 0.5% points lower than the earlier Treasury estimate and the quarterly rate appears to have fallen in two successive quarters. The CSO's coincident cyclical indicator, which attempts to show current turning points in the business cycle around the long-term trend, has continued to decline since early 1988, suggesting a slowdown in economic growth.

In view of the continuing concern about the accuracy of the GDP expenditure estimates, particularly estimates of quarterly change, the measures of the components of aggregate demand must be viewed with suspicion.

Real consumers' expenditure is estimated to have risen by 2% between the third and fourth quarters of 1988 to a level 6% above the same period in 1987. This represents no change from the estimated growth rate in the previous quarter where consumers' expenditure in fact grew more quickly than in the second and third quarters of last year. In the fourth quarter, however, whilst spending on other goods rose by 1.5% and on services by 3%, expenditure on durables was unchanged. This contrasts with earlier quarters where durable spending had continually risen. The evidence of a decline in durable goods spending is underlined by the annual spending between the same quarters: in the year to the third quarter 1988 the rate of growth was 14% but this had fallen to 10% by the fourth quarter. Preliminary estimates of real consumers' expenditure - seasonally adjusted - during the first quarter of 1989 suggest that there was an increase of 0.5% over the level of the fourth quarter of 1988. This compares with a 1.5% increase during the fourth quarter. The first quarter level of spending is therefore estimated to be 4.5% above the first quarter of 1988, compared with a 5.5% increase in the year to the fourth quarter.

The estimated slowdown in consumer spending in the first quarter 1989 reflects a reduction in the growth of retail sales and a fall in the consumption of energy products owing to the mild weather during the first three months of this year. The provisional DTI retail sales figures for April indicate a 1.4% fall in sales volume on the March level after adjustments for seasonal variations. However, in the three months to April, sales were 1% above the previous three month period but only 4% above the same period in 1988. The annual change has considerably reduced from the 7% rates attained during the middle of last year. Further evidence of a slowdown in the growth of retail sales is provided by the CBI/FT distributive trades survey for April. The balance of firms reporting higher sales fell from +35% in March to +31% in April. This latter figure is higher than the balances of +24% and +12% which were reported in January and February respectively, but is significantly below the balances of above +50% which were being reported throughout most of last year. The balance of retailers expecting an increase in next month's sales compared with a year earlier also fell during April from +36% to +28%.



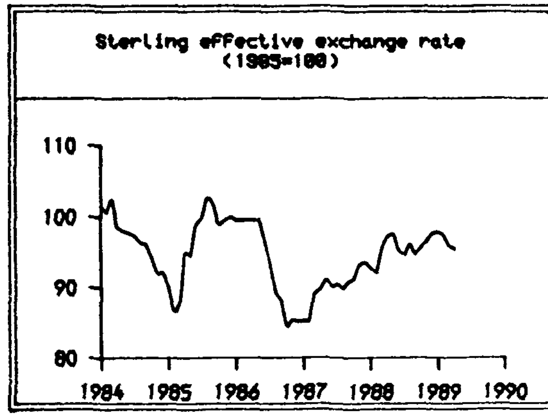
The underlying determinants of the growth of consumer spending are again tending to point in different directions. The growth in average earnings was provisionally estimated to be 9.25% in the twelve months to April. This represents no change on the twelve month figure to both March and February but since we last reported the rate has risen from the 8.75% recorded in December and November. This now looks to have been only a temporary fall in what appears to be an inexorable upward movement. These figures therefore offer the prospect of further upward pressures on the rate of growth of consumer spending. However, whether that in fact proves to be the case depends on the course of inflation and other determinants of disposable income as well as spending propensities. Real personal disposable income (RPDI) rose again by 2.9% during the fourth quarter of last year to stand at a level 5.3% above the same quarter of 1987. For 1988 as a whole, RPDI was around 5% above the level attained in 1987. Since consumers' expenditure grew at a slower rate than personal disposable income between the third and fourth quarters of 1988, the saving ratio rose from 3% to 4%. But for last year as a whole, the saving ratio was 1.5% points lower than in 1987 at 4%. With the recent rise in interest rates to 14% we should expect further increases in the saving ratio as spending responds to the tighter credit conditions. In the first quarter of 1989, the growth in seasonally adjusted consumer credit continued to moderate with an increase of £810m, the third successive quarterly reduction in the net increase.

General government final expenditure, in real terms, rose by 0.6% in the fourth quarter of 1988, slightly above the 0.5% increase in the previous quarter, to a level only 0.2% above that in the same quarter of 1987. During 1988 as a whole, this component of final demand rose by 0.5% over 1987.

Real Gross fixed investment, rose by 1.2% in the final quarter of last year, to a level 8.5% above that in the same quarter of 1987. During 1988, fixed investment increased by 11.8% over the level achieved in 1987. During 1988, investment by type of asset changed as follows: dwellings rose by 9.2%, other new buildings and works rose by 6.8%, vehicles, ships and aircraft rose by 3.5%, and plant and machinery rose by 8.1%.

We noted in the March Commentary that 1988 saw a marked deterioration in the current account as the severe demand pressure on UK productive capacity spilled significantly into imports. The estimated deficit of £14.7bn compares with a deficit of £2.9bn in 1987 and a small surplus of 0.15bn in 1986. In the first quarter of 1989, the current deficit stood at £4.4bn, down on the £5.5bn deficit recorded in the fourth quarter of 1988 but £2.4bn worse than the first quarter deficit in 1988. The visible trade balance, which deteriorated persistently throughout 1988, registered a £5.9bn deficit in the first quarter of this year: a slight improvement on the £6.3bn deficit recorded in the fourth quarter of 1988, but a £1.9bn deterioration over the first quarter of last year. Export volumes rose by 3.9% between the last two quarters while import volumes rose by 4.2%. The slight improvement in the visible balance over the period therefore reflected the offsetting effects of an improvement in the terms of trade as the index rose by 2.4%. In the year to the first quarter 1989, export volumes rose by 4.3% while import volumes increased by 17.4%. Finally, the oil account continued to deteriorate during the first three months of this year, with the surplus dropping to £64m from £340m in the fourth quarter and £730m in the first quarter of last year.

In the first quarter of 1989, the output of the production industries - accounting for 34.5% of



GDP - is provisionally estimated to have fallen by 1.4% compared with the previous quarter. By the end of that quarter output was 1.2% higher than a year ago. The slackening in the rate of growth of industrial output continues to reflect the special circumstances in the energy sector, following the Piper Alpha disaster and other accidents affecting supply, as well as a general downturn in the growth of demand. The output of the energy sector fell by 7.2% in the latest quarter to a level 12.1% below that during the same three months a year ago. On the other hand, output in manufacturing rose slightly by 0.7% in the first quarter to a level 6.6% above that in the first quarter of 1988. Within manufacturing, the principal increases recorded in the latest quarter were in chemicals and "other manufacturing" industries, where output rose by 3%, and in metals and other minerals by 2%. Output in the engineering and allied industries, and in food, drink and tobacco fell by 1% and remained unchanged in textiles and clothing.

By market sector, the output of the consumer goods industries rose by 0.9% during the latest quarter, the same rate of growth exhibited in the previous quarter. The output of the investment goods industries fell again in the first quarter, by 0.5%, compared with a 1.5% reduction in the preceding three months, and the intermediate goods sector registered a 2.8% fall. Compared with the same period a year ago output of consumer goods has risen by 5.1%, investment goods by 9.4% and intermediate goods has fallen by 3.3%.

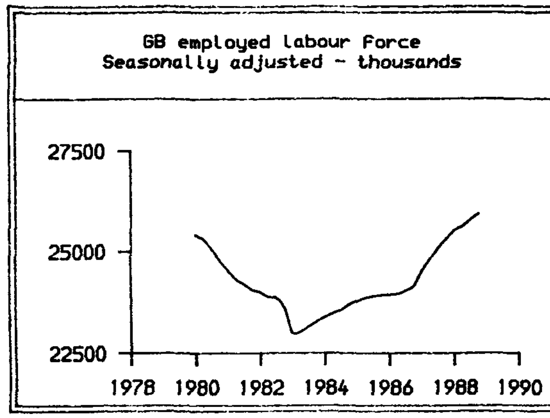
THE LABOUR MARKET

EMPLOYMENT AND UNEMPLOYMENT

Employment figures have generally been revised upwards following the 1988 Labour Force Survey. The UK workforce in employment - which includes the employed labour force plus participants in work related government training programmes (see September Commentary) - is estimated to have risen by 143,000 in the fourth quarter of 1988, to a level 640,000 above that in the fourth quarter of 1987. The fourth quarter rise can be compared with estimated increases of 168,000, 110,000 and 220,000 in the third, second, and first quarters of 1988, respectively.

Employees in employment in the UK rose by 71,000 in the fourth quarter of 1988, compared with increases of 213,000, 80,000 and 112,000, in the first, second and third quarters of the year, respectively. Service sector employment rose by 69,000 in the most recent quarter, compared with increases of 180,000, 93,000 and 124,000 in the first three quarters of the year. On the new data, manufacturing employment now shows positive growth from the second quarter of 1987. After falling by 31,000 in the first quarter of 1987, net job creation in the sector rose to 27,000 in the second quarter, 11,000, in the third and 26,000 between September and December. During 1988, manufacturing employment exhibited an almost unprecedented increase of 35,000 in the first quarter, but after that net job creation was much more modest, with no change in the second quarter and increases of only 1,000 and 2,000 in the third and fourth quarters, respectively. Jobs continued to be shed in the energy and water sector, falling by 12,000, 10,000, 2,000 and 4,000 in successive quarters during 1988. The other industries sector also exhibits employment decline: after an increase of 10,000 in the first quarter of 1988 there followed successive quarterly decreases of 3,000, 11,000 and 5,000.

Productivity - output per head - growth continues to slacken in the economy as a whole and growth rates have been revised downwards since we last reported. This is no doubt a reflection of the upward revisions in the employment estimates following the 1988 Labour Force Survey. After the percentage increase on a year earlier averaged 2.6% per quarter during 1987, the rate of increase in the whole economy fell to an average 1.1% per quarter during 1988. Indeed, in the final quarter



of 1988 the percentage increase on a year earlier was only 0.5%. Manufacturing productivity growth has also been revised downwards but still remains high. During 1986 the percentage increase on a year earlier averaged 3.1% per quarter, and only 0.3% in the first two quarters. In 1987 the average rose to 6.5% and during 1988 stayed at the high level of 5.4%. The good productivity performance in manufacturing appears to be continuing, with the percentage increase on a year earlier being recorded at 6%.

As noted in the consumer spending section above, the underlying increase in average earnings over the previous twelve months rose from 8.75% in December to 9% in January, 9.25% in February and continued at that rate in March. This supports the judgement in the March Commentary that the reduction in earnings reported in November and maintained in December, could not be construed as indicating that the rate of growth of earnings had moved onto a downward trend. We said then that wage claims tend to reflect expectations of future inflation which are to a large extent based on the experience of past price inflation. A reduction in economic activity may lower earnings growth as overtime payments fall but in the short-run may have little impact on wage claims.

The rate of growth of unit labour costs has been further revised upwards following the downward revisions in productivity growth. In the March Commentary the percentage increase on a year earlier averaged 5.3% per quarter during the first nine months of last year. The latest revisions suggest that the increase had risen an average 7% over the same period. In the final quarter of 1988 the percentage increase on a year earlier rose to 8.4%. Similarly, in manufacturing, the average quarterly rate of growth of average labour costs rose to 2.9% during 1988. In the first quarter of 1989 this had risen again to 3.1% above the level of a year ago.

Seasonally adjusted unemployment continues to decline at a fairly rapid rate. During the six months ending April the monthly decline averaged 50,300. By April, seasonally adjusted unemployment - based on the claimant count - stood at 1.856 million. or 6.5% of the workforce, down 60,200 on the previous month.

INDUSTRIAL RELATIONS

The widespread series of strikes in public transport, docks, manufacturing, communications, education and local government has led a number of commentators to comparisons with events in the mid 1970s and analogies to summers of discontent.

Such comparisons are misleading for several reasons. First those making comparisons with the 1970s ignore the changes in the legal framework. These are most clearly demonstrated in the series of legal actions associated with industrial action over Government proposals to end the National Dock Labour Scheme. Secondly, with some exceptions, the majority of groups taking industrial action have traditionally been amongst the most moderate of trade union members. Thirdly, in the majority of cases the actions are rear-guard attempts to retain traditional working practices and/or established bargaining machinery. Staff in the bus, rail and London underground have taken action over management proposals to scrap the current industry-wide bargaining. The proposals for London Underground include new work practices with single manning of trains, new work schedules, promotion to be based on merit and not seniority. For dockers the issue is the ending of the National Dock Labour Scheme and the end of the current pattern of industry wide bargaining. Firemen have similarly threatened action over government proposals to change the national bargaining structure and to review the current formula governing pay levels.

The current action within registered ports illustrates well the complexities underlying the current industrial relations issues. The 1947 Dock Labour Scheme had been a target for reform and abolition by a number of groups for several years. More recently employers had argued that the scheme imposed costs of some £20 million per annum. These could be saved by the introduction of more flexible work practices and more realistic manning levels. The popular image of the scheme providing "jobs for life" and the historical images of casual employment conceal the participative aspects of the scheme. Under the 1947 Act trade unions are involved not only in national bargaining but share decision making with employers in training, pensions, medical provisions, discipline and above all employment guarantees.

It was clear to all that the ending of the scheme would herald the introduction of local bargaining and an ending of the trade union involvement in these employment issues. Under current legislation a strike against the government would not constitute a proper industrial dispute. Hence the union sought to delay calling a ballot and industrial action until the union could be seen to have distanced itself from the political dimension by negotiation with the employers. The need to stay within the new legal framework ran counter to the traditional response of the dockers - a call for industrial action to endeavour to persuade the government to change its decision to end the Dock Labour Scheme.

The employers were resistant to ideas to retain industry-wide bargaining and after five weeks the TGWU called a ballot. The employers sought an injunction restraining the strike; this was not successful. However, on appeal the employers were successful in securing a ban on the trade union calling industrial action. Both the arguments and views of the court, and the union response are highly significant for the conduct of industrial relations at the national level and especially in the public sector.

The court argued in terms of a duty under the Dock Labour Scheme not to strike, but stressed the need to protect the public interest. Such arguments could apply to a number of industries - communications, transport, utilities and sections of health and local government - in both the public and private sector. The decision could be the basis for future cases and lead to a legal restriction on national action, even where a proper ballot has been called.

The as yet untested 1988 Act raises questions as to what are appropriate bargaining units i.e. national or local. It is interesting to speculate what arguments may be advanced. Moreover, the courts can be asked to give detailed interpretation of a ballot question, its meaning and the union intention. Current action has shown that in complex bargaining negotiations it can be difficult to reduce the arguments to a simple yes and no question on a ballot.

The response in the dock industry was unofficial action, despite calls against such action by the TGWU. It seems that such action is waning, possibly due to threats of dismissal by employers. However, the rising number of unofficial disputes have prompted the Government to announce plans of a white paper outlining further legislative reforms to deal with unofficial action. This may require unions to expel members who took part in unofficial action without a ballot. Employers would have the right to withdraw recognition from those unions who are ineffectual in controlling their members with respect to unofficial action. A number of right wing groups have suggested the alternative of the withdrawal of all immunities in monopoly public services.

The Government response is problematic. To attempt to seize the assets of workers or to imprison those taking unofficial industrial action raises questions as to the fundamental rights of the individual and the freedom of employees to withdraw their labour. The Government faces a dilemma, it can continue with its policy of further reducing the powers of trade unions or it can seek to make them more responsible for their members. But this requires a Government acceptance of their role and the possession of sufficient powers to control the individual member and to influence employers. Moreover, many disputes stem from a management rejection, especially in the public sector, of the use of arbitration or conciliation to peacefully resolve disputes, such rejection and/or bad management is a frequent cause of employees choosing to use wildcat or unofficial and unconstitutional action.

Attempts to restrict strikes, limit the pre-entry closed shop, and provide increased rights for individuals in dealing with trade unions featured in the Government proposals, published in March.

The Government in the White Paper "Removing Barriers to Employment" argued that approximately 100,000 jobs would be created if the pre-entry closed shop were removed. Additionally a further paper is likely to indicate the end of wages councils, but amongst employers opinion remains equally divided as to whether to abolish or retain wages councils.

Currently Britain is the only member of the European Community opposed in principle to the EEC Social Charter on workers' rights. There is much to suggest that employees in Britain have the fewest rights in comparison with European workers. Increasing recognition of this may do little to contribute to good employee relations and increased worker efficiency.

Within the communication sector unrest at the BBC has continued over pay and comparability with similar work. Despite four sets of action no progress appears to have been made. Meanwhile ITN has offered a pay package linked to performance pay - including buying out overtime and flexible hours. Individualising employment contracts continues at British Telecom where middle managers have accepted, against union advice, individual contracts of employment.

The ending of the dispute by the AUT marked the end of industry-wide bargaining for university staff and the introduction of a degree of performance, or merit, related pay. Undoubtedly greater variation in pay both between universities and within colleges will be a feature of the future. As yet it is uncertain whether university staff will witness the same developments that have been a feature of FE colleges, namely the introduction of individual contracts of employment and changes to working conditions.

Within the primary and secondary education sectors union opposition to government proposals to recruit unqualified teachers grew as did opposition to business sponsored city technology colleges. unions are still seeking assurances of some return to bargaining and the maintenance of a form of industry wide bargaining.

The spread of CTCs, some 19 have achieved some private sponsorship pose problems for the teaching unions. The early CTC trusts have indicated a preference not to recognise any of the teaching unions. A series of polls suggest major problems of morale and motivation amongst teachers in primary and secondary education. In one survey more than one third indicated they wished to leave teaching, and 96% agreed with the head of the HMI that teachers feel misjudged and seriously undervalued. The pace of change and new pressures have contributed to the problems of low pay. These pressures may suggest a long-term need for re-directions in Government policy. Indications that pressures have been especially apparent amongst teachers questions the value of current measures to devolving staff and financial responsibilities to head teachers. It is not unsurprising to note that head teachers have been largely unwilling to accept the first experiment of new appointments on five year contracts.

The Government may have to provide more funds to cover the wage costs of nurses regrading successes. In April 19,000 RCN appeals were outstanding, but this may be an under-estimate. All hospital groups have opposed the plans for opting out and for increased financial responsibilities for GPs. However, a number of hospital groups have expressed interest for fear that if they do not they will receive lower funding.

In Local Government there are further pressures for a reduction in the influence of national negotiations. For example, Huntington District Council has introduced a consultant devised scheme to endeavour to overcome problems of recruitment and retention. Such pressures tend to suggest that NALGO's call for action to support industry-wide bargaining will not be successful.

Disputes amongst London Underground and British rail staff reflect proposed changes to bargaining structures and manning arrangements. Within British Rail the imposition of a 7% pay award coupled with plans to end industry-wide bargaining has led to a vote for industrial action. However, the one-day strike planned by NUR has been contested by British Rail on grounds that some employees did not receive ballot papers.

June witnessed the end of unofficial action by ex-P & O employees against P & O ferries after some 16 months. Some 250 of the 900 sacked voted to end the action.

The trade union landscape continues to change with a series of mergers and merger talks. Within the Health Service the RCN is considering whether to recruit ancillaries. In the Civil Service talks are taking place between the CPSA and the National Union of Civil and Public Servants, the CPSA is also talking to the GMB as to a possible merger; whilst in Local Government NALGO and NUPE are discussing merger. These talks may involve COHSE. The pattern of trade union organisation in the communications sector is likely to change considerably if three sets of merger talks prove successful. First, BETA, ACTT and other TV and film unions have established a joint committee. Secondly, the Union of Communications Workers and National Communications Workers have commenced merger talks. Thirdly, within printing SOGAT and NGA are involved in discussions which may involve the NUJ. These three unions may associate with the larger communications union.

Elsewhere the TGWU has been involved in two sets of merger discussions, the first involves the National Union of Mineworkers and both supervisory and management mining unions. The second involves discussions with MSF. Success in either of these negotiations is likely to dramatically change the shape of British trade unionism and could herald the rise of a series of "super" unions. The GMB is similarly involved in merger talks with the National Union of Tailor and Garment Workers and has already merged with APEX and the Greater London Staff Association. The NUS has voted to merge with NUR, but both of these may seek association with larger unions.

There have been calls for the TUC to reconsider reinstatement of EEPTU. However, this may be made harder given the EEPTU's merger discussions with the non-TUC unions including the Institute of Journalists and Union of Democratic Miners. Such actions contributed to the AEU calling off merger discussions with the EEPTU.

PROGNOSIS

Despite the concern shown by the financial markets following the publication of the DTI's provisional retail sales figures for May, the balance of the evidence is that the economy is slowing down. What cannot be guaranteed, however, is that the tightening of domestic demand will produce an outturn which has been described as a "soft landing"; that is, a significant improvement in the trade balance and price inflation without a large fall in domestic output and employment. For this to be achieved we should expect to see demand and then output in the non-traded sector of the economy - principally, construction and a large proportion of services - falling, while demand and output in the traded sector - largely manufacturing and the traded services such as insurance, other financial services, and tourism - should hold up. Output and employment in the traded sector might fall initially as domestic demand is reduced but the essence of the "soft landing" thesis is that a "fitter and leaner" British industry can rapidly switch and expand production to satisfy foreign demands thus avoiding a painful recession. The more competitive British industry is in foreign markets i.e. the lower the real sterling exchange rate, the more likely such a switch and expansion of the traded sector will be achieved.

The evidence to date in support of the "soft landing" contention is mixed. The provisional DTI retail sales figures for May, show a 2.5% increase in sales volumes to a new record level. Whether this represents a return to the earlier upward trend or simply a perverse movement cannot be determined until more data are available. However, the retail sales data for a period longer than one month continue to support the view that domestic demand is falling. For example, in the three months to May sales grew by 4% compared with the 7% growth seen n the same period last year. The rate of GDP growth is clearly slowing as expected and while manufacturing growth is slowing too, the first quarter's figures suggest that output in this sector might be holding up better than in the economy as a whole. All this is not inconsistent with the expectation of a "soft landing".

However, one contra-indication is the lack of any significant evidence of an improvement in the trade balance. Export volumes were relatively buoyant in the first quarter but the rate of import growth continued to be more rapid. Nevertheless, the percentage point gap between the two did narrow to 0.3% points, compared with 3.5% points, 6.6% points and 1.7% points, in the fourth, third and second quarters of 1988, respectively. It is, though, too early to say from these figures whether they presage an improvement in the trade balance against the deteriorating trend that was established last year.

Perhaps of greater concern for the "soft landing" expectation is the evidence from the May CBI industrial trends survey where export orders continued to be weaker than domestic orders. However, the gap between domestic and export orders appeared to be narrowing which would be consistent with a switch in production from domestic to export markets.

Finally, the other side of the "soft landing" thesis is that inflation should peak at an annual rate of around 8% and progressively fall to around 6% or even lower. The annual rate looks set to move above the 8% mark and whether it moves to a much higher rate than that depends on what happens to inflationary expectations, which fuel wage claims, and the course of sterling over the next few months. Recent data on factory gate and input prices offer some hope of a moderation in the inflation rate by the end of the year, and this will be supported by the technical reason that last year's mortgage rate increases will by then have dropped out of the index. But earnings growth continues strongly and with the recent severe falls in sterling both should eventually feed through into the RPI, even though the higher base rates following the sterling fall are designed to maintain tight monetary conditions. Moreover, as base rates edge higher, the prospect of the economy avoiding a recessionary outcome almost certainly diminishes.