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The improvements in output, employment and unemployment, appear to be continuing. The growth in consumer spending may be beginning to slacken, although in view of the underlying buoyancy in its key determinants and the eventful effects of the Budget changes, this judgement may be a little premature. Investment is expected to rise substantially above 1986 levels by the end of the year. Exports appear also to be on a rising trend. The main cause for concern over the coming months is whether Britain's domestic supply capacity can accommodate a sustained increase in aggregate demand and whether lower interest rates will add to domestic demand pressures in a situation when monetary demand conditions are already relatively lax.

MACROECONOMIC TRENDS

The average measure of GDP at current market prices, commonly known as nominal or 'money' GDP, increased by 2.0% between the third and fourth quarters of 1986. So for the year as a whole, nominal GDP rose by 0.2%, 2.0%, and 2.0% between the first and second, second and third, and third and fourth quarters, respectively. The increase of 5.8% for the year to the fourth quarter was very slightly above the annual increase to the previous quarter. After allowance for inflation, the average measure of GDP at constant market prices rose by 0.3% between the third and fourth quarters, resulting in a 3.1% change between the corresponding quarters in 1985 and 1986. The output-based measure of GDP, which is conventionally regarded as the most reliable indicator of change in the short-term, recorded an increase of 0.3% between the third and fourth quarters, following the marked rise of 1.2% between the previous two quarters and an increase of 0.5% in the first two quarters of the year. Overall, this measure recorded an increase of 3.2% in the year to the fourth quarter of 1986.
declined in the four months to February. Changes in the growth of retail sales appear to be the primary influence on the indicator's performance, coupled with changes in material stocks and reported capacity utilisation.

Consumer expenditure continued to provide the main source of growth in 1986 as it did in 1985. During 1986 real consumer expenditure rose by 0.6%, 2%, 1.5%, respectively in the first three quarters of the year but remained unchanged in the final quarter. However, in this final quarter, expenditure on most categories of retail goods continued to grow strongly, while that on vehicles, food and energy declined. For 1986 as a whole, real consumer expenditure rose by about 4.5%, a reduction on the estimate referred to in the February Commentary, owing to the lower than anticipated growth in the final quarter. The preliminary estimate for the first quarter of 1987 appears to confirm the slackening in the growth of this aggregate. The estimate suggests that the level of real consumer expenditure was unchanged from that recorded in the fourth quarter of 1986 and about 3.5% greater than in the corresponding quarter of 1986.

The February Commentary suggested that consumer spending was unlikely to play the same dominant role in UK economic growth in 1987 as it did in 1986. The evidence on the growth of consumer spending in the final quarter of 1986, the preliminary estimate for the first quarter of 1987 and the recent data on the growth of retail sales, offers some support for this contention. However, the underlying determinants of the growth of consumer demand are, if anything, tending in the opposite direction.

By February the growth of average earnings still remained at an underlying annual rate of 7.5%, after rising to 7.75% in November and December. The average level of pay settlements in the quarter to January was 5.2% according to Industrial Relations Services, 0.2 per cent points higher than in the three months to December. Real personal disposable income, which, on revised figures, rose by 0.5%, 1.5% and 0.5%, respectively in the first three quarters of last year, again rose by a further 1% in the final quarter of 1986, to a level which was 3.5% higher than in the same quarter of 1985. Finally, the demand for consumer credit continues at record levels with the total of outstanding credit reaching £24.5bn at the end of February, more than £4bn higher than the amount outstanding in November.

General government consumption again remained largely unchanged, increasing by only 0.3% between the third and fourth quarters of 1986. An increase of 2% is now reported over the year since the fourth quarter of 1985, compared with an annual increase of 2.5% to the third quarter.
Gross fixed investment rose by only 0.4% between the fourth quarter of 1985 and 1986, after fluctuating throughout the year. The low level of investment in 1986 in part reflects the distortionary effects of the phased withdrawal of investment allowances introduced in the 1984 Budget and completed in March 1986. As reported in the February Commentary, investment is expected to increase during 1987, in response to increases in consumer spending and the growth in world trade, to a level about 4% higher than in 1986.

Public sector investment increased by 8% in the first quarter of 1986 after the large fall in 1985, followed - on revised figures - by a decrease of 6% in the second quarter, a 1.6% fall in the third quarter, and no change in the final quarter. Private sector investment, on the other hand, rose by 7.5% in 1985, increased, on revised figures, by 1% during the first quarter of 1986, followed by a fall of 1.6% in the second quarter, an increase of 4% in the third quarter and, finally, a fall of 3.2% in the fourth quarter of the year. So taking 1986 as a whole, private sector investment was only 0.2% higher than in 1985 whereas public sector investment was actually 1.9% higher over the year.

Although gross fixed investment changed little over the year there was, as usual, significant variations in the demand for specific assets. Investment in dwellings was 10.5% higher in 1986 than in 1985, with private sector investment in dwellings 13.2% higher and dwellings produced by the public sector increasing by only 1.5%. Investment in other new buildings and works rose by only 0.5%, while investment in vehicles, ships and aircraft, and plant and machinery fell by 11% in the former and by 1% in the latter.

Following the fall in the price of oil and the related decline in sterling in the second half of 1985, there occurred a fairly rapid deterioration in the visible trade balance on both oil and non-oil accounts, reflecting the operation of the well-known J-curve effect. The non-oil trade deficit rose from £2.2bn in the final quarter of 1985 to, on revised seasonally adjusted figures, £3.1bn in the first quarter of 1986. A fairly marked increase in non-oil export volumes relative to imports in the second quarter, reflecting the delayed effects of the earlier depreciation of sterling, reduced the non-trade deficit to £2.3bn. In the third quarter, with non-oil export volumes unchanged, import volumes increasing by 6.2% and further sterling depreciation reducing the terms of trade, the deficit increased to £3.5bn. The preliminary figures for the fourth quarter show that non-oil export volumes picked up, increasing by 7.3% on the previous quarter, compared with a 4.2% increase in the volume of non-oil imports.

![Sterling effective exchange rate](image)

However, the fall in the sterling effective rate from 74 in July to 68.5 by December, contributed to an increase in the unit value of non-oil imports of 4.2% between the two quarters, while the unit value of non-oil exports rose by only 1.9%. In consequence, the non-oil trade deficit remained little changed in the fourth quarter of £3.4bn, leaving a deficit of £12.4bn for 1986 as a whole. On revised figures, the oil surplus fell slightly from £2bn to £1.9bn in the first quarter of 1986. Further falls in the price of oil and a relative increase in the volume of oil imports again reduced the surplus to £0.77bn and £0.65bn in the second and third quarters, respectively. In the fourth quarter, as the oil price firmed slightly and export volumes rose relative to imports, the oil surplus rose to £0.84bn, producing a surplus for the year of nearly £4.2bn compared with £8.1bn in 1985.

In the first quarter of 1986, the current account surplus stood at £682m, then deficits were subsequently recorded of £94m, £931m and £757m in the second, third and fourth quarters, respectively. The deficit for the year of £1.7bn, the first annual deficit for seven years, was greater than anticipated and compares with
a surplus of £2.9bn in 1985.

In the three months to February 1987, the output of the production industries is estimated provisionally to have increased by 0.5% from the level of the previous three months, resulting in a level of output 2.5% higher than in the same period a year earlier and 17% higher than at its trough in the first quarter of 1981. Manufacturing output also rose by 0.5% in the three months to February to a level 4% higher than in the same period a year earlier and 15.5% higher than the 1981 trough. Despite the buoyant performance of the production industries generally, performance continues to vary between individual sectors. The output of the energy sector was little changed during the preceding three months and over the same period a year earlier. Within manufacturing, production of textiles and clothing fell by 1% and other minerals by 3%, production of metals and food, drink and tobacco was little changed; and the output of chemicals, engineering and allied industries, and other manufacturing, all increased by 1% in the three months to February. The construction industry continued to expand with output 1% higher in the fourth quarter of 1986 compared with the previous quarter. Overall, the output of the production and construction industries was little changed between the third and fourth quarters of 1986, but was 16% above the level recorded at the trough in the first quarter of 1981.

The output of the consumer goods industries fell by 0.5% in the three months to February, following successive increases in the two earlier three month periods. This current fall suggests that British producers are not benefiting as much as was hoped from the upsurge in consumer spending in 1986, and may also reflect the downturn in spending at the turn of the year. However, output in the investment goods industries has continued to increase, rising by 1% in the three months to February following the 1.5% increase in the preceding three month period.

**THE LABOUR MARKET**

**EMPLOYMENT AND UNEMPLOYMENT**

The first half of 1986 saw a slackening in the recorded increase in the employed labour force from the 65,000 average quarterly increase in 1985 to, on revised figures, an increase of only 11,000 and 24,000 in the first and second quarters of 1986, respectively. However, improvements in UK output growth began to have an impact on the employment figures in the second half of the year, as the employed labour force increased by 54,000 and 87,000 in the third and fourth quarters of 1986, respectively. The increase of 87,000 in the quarter to December compares with an increase of 34,000 in the same quarter of 1985 and means that the total increase during the year to December is estimated to be 176,000.

The composition of the change in employment in the fourth quarter of 1986 again follows the established pattern. The number of employees in the service sector rose by an estimated 69,000, compared with a revised figure of 78,000 in the third quarter. The decline in manufacturing employment reduced significantly in the fourth quarter to 4,000, compared with reductions, on revised figures, of 35,000, 51,000, and 34,000 in the first, second and third quarters, respectively. This latest figure suggests that the effects of increased UK output growth are finally beginning to have an appreciable impact on manufacturing employment. In other sectors, energy and water supply posted a decline of 9,000 compared with a fall of 10,000 in the third quarter. The other industries category, which includes construction, agriculture, forestry and fishing, recorded an increase of 8,000 compared with revised figures of a fall of 5,000 in the first quarter of 1986, an increase of 3,000 in the second quarter.
and a fall of 7,000 in the third quarter.

Improvements in productivity - output per head - growth continued throughout 1986. For the economy as a whole, productivity increased by 0.4%, 1%, 1.2%, and 0.3%, during the first, second, third and fourth quarters, respectively. By the fourth quarter of 1986, output per head in the economy was nearly 3% higher than in the same quarter in 1985. In manufacturing, productivity improved markedly in the second half of 1986, following increases of 2.0% and 2.7% in the third and fourth quarters of the year. In the three months to February 1987, manufacturing productivity was 0.7% higher than in the preceding three months and 6.1% above the same period a year ago.

Although earnings growth does not appear to be moderating overmuch, the growth of wages and salaries per unit of output slackened in the second half of 1986 as productivity improved, particularly in manufacturing. In the three months ending December, January and February, the percentage increase in manufacturing over the year was 1.9%, 2% and 1.8% respectively. This can be compared with an annual change of 4.1%, 3.8% and 2.1%, in the three months ending September, October and November, respectively.

Seasonally adjusted unemployment has exhibited a downward trend since August of last year. In the six months ending April the reduction has averaged 23,300 per month and it is clear that the rate of decline has accelerated in recent months, with some deceleration in April. The February Commentary noted that the decline in seasonally adjusted unemployment reflected both the growth in government training schemes and the more favourable outturn for output and employment from the second quarter of 1986. The difficulty was in deciding how significant the one had been against the other, and that still remains the position today. By April seasonally adjusted unemployment, excluding school leavers, provisionally stood at 3.02 million, or 10.9% of the working population, down by 19,600 on the previous month.

INDUSTRIAL RELATIONS

The government's call for reform of the system of pay bargaining to reduce the reliance on industry-wide bargaining, and its proposals for further legislative reform received less than total support from both employers and trade unions. For some time, the Government and its supporters have trailed suggestions for reforming the system of national or industry-wide pay bargaining. Messrs Lawson and Ridley have argued that local authorities should pay what they could afford rather than be tied to national rates of pay. In recent years a number of traditional industry wide bargaining arrangements have, or are in the process of being dismantled, and it is noticeable that the Health Department, in its recent submissions to the Review Bodies indicated its support for regional pay increases for nurses and doctors. The Institute for Economic Affairs, often the radical herald of government policy, has recently advocated the abandonment of national pay scales for teachers and other groups. The current initiative for reform in this area rests with the publication by Mr Clarke, the Employment Minister, of a five point plan to improve labour flexibility. Arguing that 'our system of pay bargaining is one of the biggest weaknesses in the British economy' (paradoxically in West Germany such a system is advanced as one of the reasons for the success of the German economy), the Minister called for an end to: the annual pay round; the 'going rate'; comparability and national pay bargaining, and for wage competition and the ability to pay, coupled with award for merit and performance.

Not unsurprisingly these proposals were accepted without qualification by the Institute of Directors; the CBI, on the other hand, were far more critical - its own evidence demonstrated that industry-wide bargaining was far more flexible than that and able to adapt to local conditions. The Institute of Personnel Management was likewise critical, it noted the value of industry or national pay bargaining in acting as a reference point for smaller firms, and questioned the value of abandoning highly complex arrangements. National pay bargaining provides a degree of wage stability for employers, it prevents leapfrogging of wage rates, helps small firms, resolves disputes. Its absence may lead to anomalies, unfairness and worsened employer relations.

Two current sets of negotiations, one in the private sector involving the Engineering Employers' Federation and the
Confederation of Shipbuilding and Engineering Unions; and the other covering more than one million local authority workers in the public sector, illustrate clearly the advantages of industry-wide bargaining. In both, the aim is the introduction of new flexible working practices and the ending of conventional notions of the fixed working week. The local authority negotiations whilst facing current setbacks aim towards calculating working time on a monthly or even yearly basis, and if successful, would constitute a major step towards matching labour to seasonal or weekly demands, thus reducing the amount of overtime worked. It is questionable whether negotiations on an individual authority or regional basis would be able to establish such new, and more flexible, work patterns and avoid disputes over comparability – an issue which has been largely absent within the established bargaining arrangements for local authority employees.

The abandonment of industry-wide bargaining could lead to the American trade union practice of Key or Pattern Bargaining and the associated higher levels of industrial unrest. To a degree, the problems associated with national bargaining in the public sector reflect the government’s adherence to a strategy of ‘muddling through’ rather than a coherent policy; as such the fragmenting and regionalising of wages and salaries may, in the long-run, increase the likelihood of industrial action.

How public service pay has fared against the private sector (1981/82 - 1986/87)

<table>
<thead>
<tr>
<th>Service</th>
<th>% Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Police</td>
<td>+12</td>
</tr>
<tr>
<td>Teachers</td>
<td>- 6</td>
</tr>
<tr>
<td>Armed Services</td>
<td>- 8</td>
</tr>
<tr>
<td>Nurses</td>
<td>-11</td>
</tr>
<tr>
<td>Central Government Manual</td>
<td>-11</td>
</tr>
<tr>
<td>Local Authority Manual</td>
<td>-15</td>
</tr>
<tr>
<td>Civil Servants</td>
<td>-19</td>
</tr>
<tr>
<td>NHS Ancillaries</td>
<td>-26</td>
</tr>
<tr>
<td>Total Public Services</td>
<td>-10</td>
</tr>
</tbody>
</table>

Source: National Institute for Economic and Social Research

Within the civil service the claim for substantial wage increases stems from similar factors. In February, unions representing over 300,000 civil servants sought increases of some 15% and indicated their opposition to regional pay increases. Initially the CPSA, IRSA, SCPS and NIPSA (N. Ireland Public Service Alliance) envisaged combined action on a rolling strike programme. The CSU, IPCS and FDCS pursued separate negotiations. The unity of action proved fragile, and the Treasury was able to make separate and different offers to each union, arguably playing each union off against the others. An outline agreement was achieved with IFCS including a long-term agreement with merit or 'range' pay, the CSU recommended its members to accept the offer, and the CPSA and IRSA made no recommendations to
lowering of morale. The proposal for a will fundamentally change and intensify with enhanced powers to heads and parents, with fundamental change and intensify teachers' work and lead to a rise in the number of questions of comparability and fairness. There is the possibility of increasing incompatibility between the patterns of work that are likely to emerge, in a climate where heads and parental choice are far more important, and the new bargaining structures. Already difficulties are appearing over proposals to introduce staff development/performance appraisal and there is a greater dissatisfaction with the apparent inequalities in work loads both within and between schools.

The government's second initiative was contained in the green paper, Trade Unions and Their Members. This proposes five further areas of reform and has been drawn up in the light of a number of recent disputes. First, extensions to the rights of trade union members by: giving union members a right to restrain their union from calling for industrial action which has not been subject to a ballot; such ballot decisions providing a majority in favour of action to retain immunity; giving the individual the right to decide whether to continue work despite a call by a majority for industrial action; and protecting the union member against disciplinary action for exercising his right to cross a picket line and go to work. Secondly, the green paper proposes three measures to safeguard and control union funds by: depriving union officials of the capacity to breach the terms of court orders; reducing the ability of a union to pay the fines or damages incurred by officials or members, and improving the union member's access to union accounts.

Thirdly, further restrictions of the closed shop to promote a greater flexibility in the labour market and increased freedom of choice for employers when recruiting. Hence proposals to restrict more severely the ability of a union to seek a closed shop and effectively ending closed shop agreements by repealing the relevant sections of the 1984 Act. Fourthly, a further extension of democracy within trade unions by: the requirement for postal ballots for elections and a political fund ballot; including non-voting presidents in the category of officials whose appointment requires a ballot, and, the suggestion of a widening of the independent checks on the conduct of ballots and counting of votes. Finally, the green paper discusses the appointment of a Commissioner to enforce trade union laws. Such an office could act both in support of the individual trade union member and initiate actions against unions in his own
right, thus providing an improved method of enforcing the statutory duties of trade unions.

The relevancy and desirability of such reforms were questioned by both the TUC and the CBI. Interestingly, the CBI indicated its opposition to union members being given the right to work regardless of a lawful strike and to the creation of a Commissioner for Trade Union Affairs. The TUC appeared unconvinced by the Employment Minister's claim, in outlining the proposals, that the government legislative programme had saved the trade union movement from an even steeper decline over the past eight years.

The problems of coping with the consequences of the 1984-1985 strike and responding to new conditions and proposals to change working practices, continue to bedevil the National Union of Mineworkers. The costs of the stoppage, declining membership and competition from the UDM, have led to increases in union subscriptions and discussions about the possible merger of areas. However, restructuring of the union is complicated by fears, in some areas, that restructuring is designed to further centralise power within the union. Such fears have acted as an undercurrent to the issue of new working practices at the proposed development at Margam in South Wales. The South Wales NUM voted, albeit with strong pressure from British Coal, to accept the proposal of 6 day shifts and other changes to work practice. However, the NUM executive argued that such changes, on a national basis, could result in the loss of more than 25,000 jobs, and as such require national negotiation. But, within South Wales, such an argument has been seen as an attempt by Mr Scargill to reassert greater control over the union.

The introduction of technical change and new, more flexible and efficient work practices has, and continues to be a feature of negotiations and disputes in a number of sectors. Whilst the dispute between News International and the print unions finally ended, amongst disagreement between the union executives and the London branches, issues arising from technical change continue within the industry. It was the threat, and almost certainty, of sequestration of funds that finally drove both SCGAT and the NGA to call off industrial action against News International. Both unions had to look to the needs of other members and to their longer-term interests in a merger. Elsewhere within the industry difficulties arose over the Guardian's proposal for non pay lay-offs for NUJ staff if production is stopped by action outwith procedure.

In recent years more than a third of employees have experienced technical change. Significantly, surveys indicate that it has been easier to introduce flexibility to work practices when it is accompanied by technical change. Approximately half of firms introducing advanced technical change in the last 3 years have taken further steps to promote flexibility, such as breaking down demarcation or creating multi-skilled groups. Moreover, there is much to suggest that union recognition is not a significant factor affecting either the rate or scope of change, if this is the case the dispute at News International should be regarded as the exception
rather than the rule.

The impact of technical change is a major factor affecting employment relations in banking. The developments in cash dispenser software have enabled customers’ cash cards to be used at different banks, and a parallel development has taken place amongst a number of building societies. These developments will result in a reduction in staff levels and union membership. Such fears have acted as a spur to the proposal for merger talks between BIFU and the Clearing Banks Union. However, the CBU intimated a distinct lack of interest in the proposal. Such technical changes in banking further weaken the union’s influence, hence the bank’s proposals to impose a 5% wage award in the face of trade union claims for a 15% increase.

Progressive reductions in the demand for labour has prompted gloomily views as to the future size of the trade union movement. Trade union membership has fallen by over 19% since 1979 to 10.7 million, of whom only 9.2 million are affiliated to the TUC. The GMBU fears a further 2 million decline and a drop in the number of TUC affiliated trade unions from 90 to 40 over the next decade. The decline and absence of any indication of a reversal of the downward trends have prompted cost cutting exercises, recruitment drives, mergers and more vigorous defending of traditional recruitment areas. The TUC announced further measures to reduce costs including freezing salary levels, changes to the timing of paying affiliation fees and longer-term proposals to share and rationalise information systems. A number of individual unions face financial difficulties. The AEU has sought to reduce its staff and to cut affiliation fees. A number of merger talks have commenced including: SOGAT and the NGA; ASTMS and TASS (planned for the end of the year); APEX commenced preliminary discussions with TASS/ASTMS, TGWU, AEU and GMBU, the latter being the favoured area. For differing reasons mergers between the major teaching unions have been suggested. Both AEU and EEPTU have announced more aggressive recruitment campaigns - to enter the ‘cut throat battle for union members’ (Gavin Laird) - to recruit and retrain new technology workers. Both unions experience losses as new technology workers are upgraded from craft, and hence manual status, to technician and white collar status. Other unions, including GMBU, TGWU and NALGO have embarked on campaigns to recruit in new areas, including part-timers, young workers and the self employed. The EEPTU continues to seek new members via single union agreements and hence continues to face opposition from sectors of the movement.

The 1984 Act continues to exert an impact on trade unions. The first elections via secret ballot in USDAW resulted in four of the ruling executive council losing their seats. The long running allegations of ballot rigging in the NUS stem, in part, from the assertion that the whole electoral system is open to manipulation. The TUC inquiry team arguably judged the issue by citing the lack of sufficient evidence as the reason for its ability to conduct a full inquiry.

PROGNOSIS

The improvements, noted in the February Commentary, in output, employment and unemployment, appear to be continuing. The growth in consumer spending appears to be slackening somewhat, although in view of the underlying buoyancy in its key determinants and the soon-to-be-felt impact of the Budget changes, this judgement may be a little premature. Investment was sluggish in the fourth quarter of 1986 but is expected to rise substantially above 1986 levels by the end of the year. Exports appear also to be on a rising trend, although the extent to which the recent rise in sterling - from an effective rate of 68.4 in December to an average of 71.9 in March and above 73 in early May - will slow or reverse the trend, is an open question. The prospects for output and growth over the coming months therefore appear to be highly favourable.

The CBI’s latest quarterly Industrial Trends Survey shows that confidence in manufacturing is high, with output growth expected to accelerate over the next four months. The balance of plus 25 per cent of respondents exhibiting this expectation proved to be the highest for two years. The CSO’s two leading indicators have both been on an upward path over the last few
months, suggesting that growth may increase over the year. The shorter leading indicator, which is intended to predict turning points some six months in advance, moved successively upwards in December, January and February, reflecting movements in three of its five component series: consumer credit, and the CBI survey questions on new orders and expected changes in raw material stocks. The longer leading indicator, which is intended to predict turning points in activity about one year in advance, has risen rapidly since December, reflecting movements in only two of its five component series; increasing share prices and falls in interest rates. However, the effect of housing starts and the CBI question on the balance of business optimism were negative and neutral, respectively.

Recent forecasts are again more optimistic than those reported in the February Commentary. In the April Treasury review of the main independent forecasts, the average forecast of the growth of GDP has been revised upwards and that for inflation revised downwards since the Budget. Specifically, for 1987, GDP growth is forecast to be 2.9%, retail price inflation to be 4.4%, the current account to be in deficit by £2.8bn, and unemployment in the fourth quarter to have fallen to 2.97m. Despite the lowering of the inflation forecasts from an average of 4.8% in February, due to the absence of increases in excise duties in the Budget and the lowering of the mortgage rate by 1 per cent point in March, there is still some concern amongst economists that the consumer boom could continue, causing the economy to overheat and the inflation rate to rise. The prospects for the balance of payments and the exchange rate would also deteriorate if such an outcome materialised. The extent of the current upturn in demand, and the strength of the underlying forces promoting an increase, is probably greater than many people realise. It is therefore likely that the realised growth of GDP in 1987 could easily exceed 3%, rather than the lower average estimate noted above. What remains open to question is the extent to which Britain’s domestic supply capacity can accommodate a sustained increase in aggregate demand. Against the apparently large labour reserves, increasing labour productivity and lower unit costs, must be set the continuing structural, and particularly geographical, imbalances in the labour and housing markets and the low, although rising, levels of manufacturing investment.

The performance of the British economy can not of course be viewed in isolation. The prospects for world economic growth are now probably less sanguine than they were three months ago (see World Economy section). Further currency crises or deteriorating trade disputes could seriously damage Britain's currently favourable short-term economic prospects.

The major policy event during the past three months was of course the March Budget. By reducing the PSBR target for 1987–88 from £7bn to £4bn and offering tax cuts of £2.6bn, the Chancellor clearly sought to satisfy both the financial markets and the electorate at the forthcoming election. The cut in the PSBR target and the subsequent strengthening of sterling led to the expected cuts in interest rates, with base rates reaching 9% by the second week of May. The main cause for concern over the coming months is the extent to which lower interest rates will add to domestic demand pressures in a situation when monetary conditions are already relatively lax. The government's preferred monetary aggregate, M0, had by March, on a seasonally adjusted basis, grown at about 4% over the year. This is lower than the 5.2% growth reported in the February Commentary, and lies in the middle of the government's 2% to 5% target range. Sterling M3, for so long the centre-piece of the government's Medium Term Financial Strategy, was, as expected, officially abandoned as a monetary target for 1987/88 in the Chancellor's Budget speech. In the year to March, the growth of £M3, on an unadjusted basis, was over 19%, well outside the 11% to 15% target range. Recent purchases of foreign currency by the Bank of England, in an attempt to stem the rise of sterling, will have served to expand £M3, although it is clear that the Bank has been seeking to "sterilise" the effect on the domestic money supply through increased sales of government debt. In a textbook world, the policy authorities would seek to counter the over-expansionary effects of lower interest rates, which are necessary to keep sterling at a competitive rate, and any related monetary stimulus, by fiscal contraction. But in current circumstances the use of higher taxes to restrain aggregate demand is not on the political agenda.