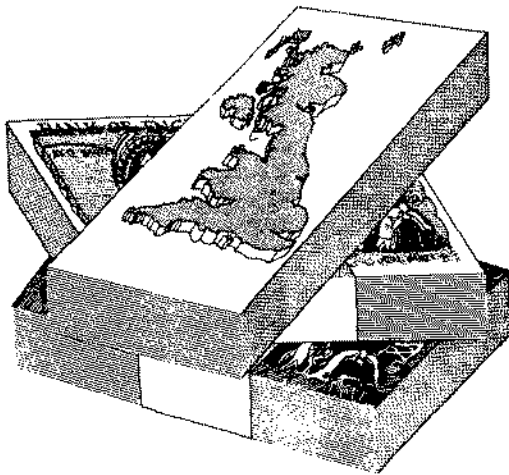

The British Economy

MACROECONOMIC TRENDS



The pace of economic growth rose above the underlying growth rate in the first half of 1985 as a consequence of recovery from the miners' dispute and first quarter bunching of investment expenditure. In response to higher interest rates and the Chancellor's continuing commitment to the Medium Term Financial Strategy, sterling has strengthened and has remained resilient in the face of continuing uncertainties concerning oil prices. Output is set to grow by more than 3% this year before falling back as the impetus of the rebound from the miners' dispute diminishes and investment expenditure slackens. This slowdown in activity is likely to be reinforced by the current levels of the exchange rate and of interest rates.

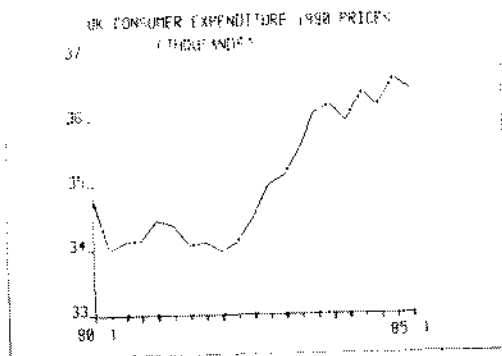
The CSO's cyclical indicators continue to provide unclear signals about developments in the economy and forecasting the next turning point in activity is not possible. Difficulties of interpretation caused by the miners' dispute remain and are now compounded by the extent of volatility in certain of the component series. The longer leading index, which typically predicts turning points about one year in advance, rose in May after falling during the earlier months of the year and then fell slightly in June. These movements follow the sharp decline in the index in the index during the first half of 1984 and recovery to the end of the year.

The shorter leading index, which is intended to predict turning points some six months in advance, fell in June for the fourth consecutive month to stand at the lowest level recorded during the year to the end of June. The picture is clouded further by the behaviour of the coincident indicator which reflects current developments. Following the declines associated with the miners' dispute in the early part of 1984 the coincident indicator has risen for thirteen consecutive months to the end of June.

Over the period 1981-83 the recovery in the UK was driven primarily by the growth in real consumers' expenditure. Reflecting the impact of the miners' dispute, consumers' expenditure grew less rapidly in 1984. Following growth of 3.9% in 1983, consumers' expenditure grew by only 1.5% during 1984.

After rising in the fourth quarter of 1984 because of increased spending on retail

goods, particularly consumer goods, consumers' expenditure fell back in the first quarter of 1985. This decrease was concentrated on spending for food and durable goods which was only partially offset by higher energy consumption. Provisional estimates suggest that in the second quarter of 1985 consumers' expenditure rose by around 2% above the level of the first quarter. There appear to have been increases in expenditure on most categories of goods and services.



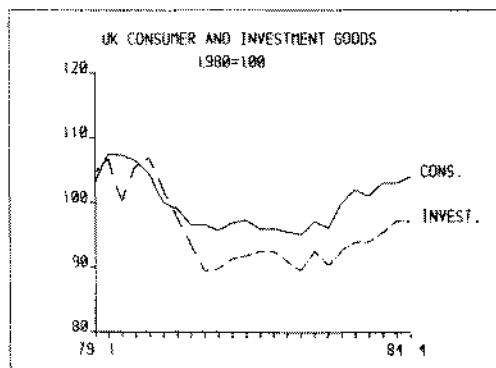
The second quarter recovery in consumers' expenditure is consistent with the forecast in the last **Commentary** that this component of demand would grow more rapidly in 1985 than in 1984. Beyond 1985 consumer spending is likely to assume once more a relatively important role in determining the growth of aggregate demand.

Retail sales remained more buoyant than consumers' expenditure during 1984. In the first quarter of 1985, however, retail sales fell below last year's fourth quarter levels before recovering sharply in April and May.

During 1984 much of the impetus to UK growth came from investment expenditure. Expansion in total investment continued in the first quarter of 1985 when growth of 5.4% over the previous quarter was higher than that for each of the last three quarters of 1984. The first quarter growth rate embraces very different experiences in the private and public sectors. With the Government's tightening of financial strictures on nationalised industries and local authorities, public sector investment fell by 8% in the first quarter. In contrast,

reflecting the continuing strength of corporate liquidity and the bringing forward of investment projects in response to the phased withdrawal of capital allowances announced in the April 1984 Budget, private sector investment rose by 13%.

The increase in manufacturing investment in the first quarter was primarily accounted for by increases in gross fixed investment in new buildings and works. This component of investment increased by 14.6% over the level of the fourth quarter of 1984 and by 28% over the level of a year earlier. Investment in plant and machinery fell slightly from its level in the last quarter of 1984 but still stood 6% higher than in the first three months of last year.

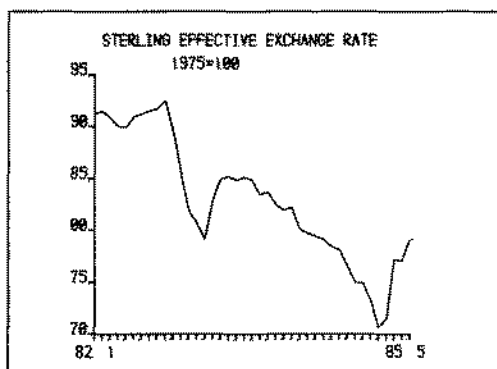


There are signs, however, that manufacturing investment is unlikely to maintain the first quarter growth rates during the remainder of the year. The Department of Trade and Industry's June inquiry into investment intentions suggested only slow growth in the near future. This more pessimistic outlook was reinforced by the results of the CBI's July Quarterly Industrial Trends Survey. In contrast to the April Survey's forecast of a continuing rise in investment over the next year, the July Survey suggests that investment in plant and machinery will remain flat over the coming twelve months, despite capacity becoming tighter in relation to expected demand. The proportions of firms identifying uncertainties about demand and inadequate returns on investment as constraints on investment rose from April. Although these factors remain the dominant constraints, the proportion of firms citing the cost of finance as a constraint

is at its highest level since 1980 when interest rates were, as at present, high.

Unlike other forms of investment, residential investment, which is carried out mainly in the private sector, showed little increase in the first quarter of 1985 and, the last quarter of 1984 apart, was lower than in any period since mid-1982. Construction activity has been greatly damaged by the interest rate increases in July 1984 and January 1985. Some, though not substantial, recovery is likely this year as interest rates decrease slowly.

During 1984 destocking took place on a substantial scale. Although there was some recovery in the fourth quarter destocking over the year approached £0.5 billion. This was a result of the effects of the miners' dispute on coal stocks and on general business confidence, the removal of tax relief on stocks and high real interest rates. Destocking, and a decline in the stock-output ratio, continued through the first quarter of 1985. With a value of £139 million destocking in the first three months of this year was considerably less than in the previous quarter. With continuing output recovery and reductions, albeit modest, in interest rates likely in the coming months, destocking will probably moderate and be reversed towards the end of the year.



An improvement in net trade contributed to UK growth in the first part of the year. This improvement follows the marked depreciation of sterling from mid-1983 to February 1985. In the three month period to the end of April non-oil export volumes rose by 3% to a level 12% higher than a

year earlier. Non-oil import volumes increased by 2% over the same period and by 6.5% over the corresponding period in 1984.

During the four months to April, a £2.5 billion oil surplus and a surplus on invisibles of £1.9 billion more than offset a £4.2 billion non-oil deficit to produce an estimated current account surplus of £0.2 billion.

In the March Budget the Chancellor established a target of £7 billion for the public sector borrowing requirement (PSBR). Doubts over whether this target could be met were discussed in the last **Commentary**. Over the first two months of the current financial year the PSBR amounted to £2.8 billion, around 40% of the year's target. The extent of likely overruns in departmental spending are not yet clear. Already, however, there have been a number of important departures from the assumptions contained in this year's Budget. First, the May inflation rate on which the November adjustment of Social Security benefits is based was 2% higher than forecast. This will raise spending by £300 million more than planned. Secondly, the Budget projections were based on an exchange rate of £1: US\$1.13. Each 1% increase in the £/\$ exchange rate is estimated to cost the Treasury £150 million and with the exchange rate rising well above that assumed in the Budget the Government may lose something of the order of £2 billion in oil revenues over the fiscal year. Thirdly, public sector pay looks certain to exceed the target of 3%. Much of this year's contingency reserve will meet the shortfall in oil revenues. Nevertheless, the target of £7 billion seems likely to be exceeded. Asset sales will be used to fund part of the spending overshoot.

In the three months to the end of May 1985 output of the production industries is estimated provisionally to have increased by 3% over the immediately preceding three month period and to be 4.5% higher than in the corresponding period a year earlier. The coal dispute continues to affect output although obviously less seriously than in earlier quarters. It is estimated that the coal dispute reduced the level of industrial output by around 1.5% in the three months to May compared with 3.5% in the immediately preceding quarter and 3% in the three months to May 1984.

Manufacturing output rose by 0.5% over the level of the previous three months and by 1.5% compared with a year earlier. This represents some slowing of growth from that achieved in the three months to February when the corresponding growth rates were 1% and 2.5% respectively. Within manufacturing there was some diversity of experience. Output of metals rose by 5% while increases of 1% were recorded for engineering and allied industries and other minerals. Little change took place for either chemicals or textiles and clothing while output fell by 1% for food, drink and tobacco and for other manufacturing.

With recovery in local output and increases in electricity and gas supply, energy and water supply rose by 9% in the three months to May. Output of the construction industry recovered from its fall in the last quarter of 1984 to rise by 2.5%. Overall, output of the production and construction industries in the first quarter was 1.5% above its fourth quarter 1984 level.

Output by market sector reflected the relative strength of the investment boom. Intermediate goods rose by 4% and investment goods by 2% while consumer goods changed little between the two latest three month periods.

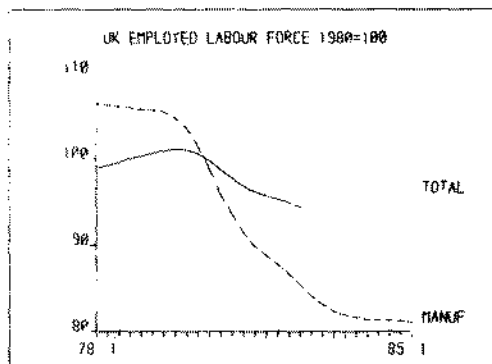
THE LABOUR MARKET

EMPLOYMENT AND UNEMPLOYMENT

After the fairly rapid increase experienced in the final quarter of 1984, employment in the UK rose more modestly in the first three months of 1985 than in any of the immediately preceding six quarterly periods. The increase of 28,000 falls well below the increase of 80,000 in the same quarter a year earlier.

The underlying pattern of employment change remained the same as over the recent past. There was an increase of 39,000 employees in the service industries but decreases of 27,000 in manufacturing, 6,000 in energy and water supply industries and 8,000 in other industries including construction, agriculture, forestry and fishing. Data are not yet

available for services for April and May but, despite an increase in employment in May, a further 7,000 jobs were lost in manufacturing over those two months.



After rising above the levels recorded in the first three months of the year, unemployment remained relatively constant at a seasonally adjusted rate of 13.1% from April to July. The figure for July does not include, however, 134,000 new school leavers who were not entitled to benefit.

During the second half of 1984 productivity growth in manufacturing, whether measured per man or per man hour, decelerated and then fell as the pace of job losses slackened and output growth slackened. With increases in job losses and output recovery, productivity growth picked up over the first five months of 1985. Average earnings rose, however, from the underlying rate of 8.5% recorded in the last quarter of 1984 and in the first two months of 1985 to 9% in May. On balance, unit wage costs rose, particularly in April.

With the weakness of sterling at the beginning of the year, however, the competitiveness of UK exports continued to improve in the first quarter. Although appreciation of sterling since February has exerted downward pressure on imported material and fuel costs, it has also placed UK manufacturers under greater competition. This is evident from the CBI's July Survey in which export orders are reported as showing a much slower increase than in April and a higher proportion of respondents now identify competitiveness as the main constraint on output.

INDUSTRIAL RELATIONS

The mining industry continues to be at the centre of British industrial relations. The progressive resolution of issues raised during the dispute has prompted both a reassessment of the conduct of the parties during the dispute and of the likely implications for both the industry and industrial relations.

Publication of a series of annual reports by the nationalised industries provided confirmation that the costs of the mining dispute were almost £2 billion above the figures suggested last November by the Chancellor of the Exchequer. Similarly, further announcements of pit closures, cutbacks and plans to open the UK coal market to imported coal for both private and CEEB consumption provide yet further indicators of the extent to which the mining industry will change its shape and size. In addition, the pattern of pay bargaining will change. There will be an extension of the moves towards area bargaining with increased emphasis on local productivity as the basis for pay increases.

The establishment of a 'breakaway' miners' union led by the Nottinghamshire area has attracted considerable publicity. The existence of a 'moderate' alternative and rival to the NUM, whilst an advantage to the NCB in its moves to area pay productivity bargaining, poses problems for the TUC and Labour Party. Whilst, on the one hand, it is possible to see the breakaway as a response to the current leadership style of the NUM, it might, on the other hand, be the precursor of a move to federalisation of the NUM. The latter option may be forced on the union given NCB policies of area bargaining, closure and privatisation.

Continued concern for miners sacked during the dispute finally led the NCB to make a number of concessions in its treatment of these miners. This will involve: a more favourable view towards those whose claims for unfair dismissal are upheld by industrial tribunals, leniency towards those who failed to make a claim to tribunals: and a case by case review for

each of the Scottish miners sacked as a result of the dispute. Concern has also been voiced over the courts' refusal to convict those pickets charged with riot. This has led to a further reassessment of the role of the police during the dispute and of the quality of the police evidence presented to the courts. Equally, it has prompted suggestions, possibly to surface at the forthcoming Conservative Party conference, for legislation to restrict picket line violence.

The ending of the summer heralds the beginning of the annual conference season. The actions of the NUM and its leadership will again be a significant factor in determining the success or failure of the Trades Union Congress and Labour Party conference and will constitute the basis of much debate and possible legislative proposals at the Conservative Party conference.

The TUC will have to resolve a number of potential clashes between the 'right' and 'left' sections of the movement over several issues. First, the AUEW and EEUPTU have broken existing TUC policy by accepting Government funds to conduct elections and are liable to be expelled. Secondly, the CPSA has suggested that the trade union movement should review the 1980-1984 legislation and retain parts of that legislation, although the current TUC policy is one of 'blanket' opposition. Thirdly, the EEUPTU has antagonised and threatened the printing union sections of the TUC by its discussions with Shah regarding 'sole' union recognition and bargaining practices for those employed on the proposed new national newspaper. Fourthly, the TUC will wish to maintain and continue the successful campaign to retain unions' political funds. Fifthly, the TUC will have to deal with calls for action in support of those miners sacked during the dispute. Failure to resolve any of these issues may polarise the 'left' v 'right' split in the movement and reduce the credibility of the joint action plan between the TUC and the Labour Party.

At its conference the Labour Party needs to demonstrate clearly a sense of competence and ability in order to maintain its main sources of revenue, namely trade union political funds. The 1984 Trade Union Act required any union

with a political fund to ballot its members before March 1986 as to whether the fund should continue. To date all 9 elections have voted in favour of the retention of political funds. It is likely that all 37 unions will vote in the same manner and even 8 unions without political funds are thinking of establishing one. The TUC attributes the success of such ballots to Government action which has politicised union members. However, a poorly organised Labour Party conference could change such attitudes.

The TUC organised campaign on political fund ballots has drawn attention not only to the clear definition of political funds under the 1984 Act, supporting a particular political party, but also to the contentious aspects such as the expenditure on any literature or publicity which seeks to change Government policy. It is the TUC emphasis upon these contentious elements which has led to the strongest criticism from the Secretary of State for Employment.

Unions' success in maintaining political funds will feature in the Conservative Party conference. The Secretary of State for Employment, apart from continuing to call the trade union campaign 'corrupt' and 'misleading propaganda', may call on unions to notify members of the rights to contract out of paying the political levy. More likely, since the underlying political purpose of the ballot provisions in the 1984 Act was to weaken the Labour Party, the Minister may announce a change in the Act and require trade union members to contract in to pay the levy as an alternative to the present 'contract out' arrangements. Such changes may form part of a wider policy designed to give union members more individual freedoms including the right to work without penalty during a strike, the right to elect district and area officials, and further restrictions on picketing.

Additionally, there may be an attempt to deal with an outstanding election manifesto issue - limitations on strikes in essential services. The Conservative Party's 'think tank', the Centre for Policy Studies, has discussed two possible courses of action: selective measures, which would extend and reinforce existing

principles of statute and case law; and the more favoured alternative, a general prohibition of industrial action in essential services. The Centre envisages that both unions and individuals would be liable to fines and, ultimately, imprisonment if they were responsible for disrupting the NHS, the gas, electricity, water, fire, sewerage and burial or cremation services.

The latter alternative would require, as the Centre for Policy Studies notes, compulsory arbitration and some agreed basis for the determination of public sector pay. The handling of 'top peoples' pay', the teachers' dispute and civil service pay suggest that whilst the Government may favour restriction of disputes it would not wish to accept the responsibility for establishing an agreed procedure for the determination of pay and pay differentials. This has been regarded as essential for many years by ACAS and is being increasingly stressed by other political parties. Such a procedure implies a partial return to the consensus politics of the 1960's and 1970's. Possibly the Labour Party conference will provide more detail on its recently announced version of such a process, the successor to the "social contract" of the mid-1970's.

PROGNOSIS

During 1984 the Chancellor, like other European Finance Ministers, regularly identified the growing US budget deficit as the cause of the high international level of interest rates. High interest rates were seen as threatening the prospects of continuing recovery. The Chancellor's view on interest rates have now shifted markedly.

Argument for lower interest rates to promote growth has been replaced by concern to maintain a sufficient interest rate differential in order to keep sterling strong. In January, UK interest rates were increased sharply in both nominal and real terms to defend sterling. The March Budget reaffirmed the Chancellor's commitment to the Medium Term Financial Strategy and the need to maintain monetary conditions consistent

with declining growth of money GDP and inflation. Simultaneously the exchange rate was identified as an important indicator of monetary conditions and has since emerged as the primary indicator.

Maintenance of a strong pound is seen as controlling inflationary pressures in a number of ways: by increasing competitive pressures on UK firms in both domestic and export markets; by discouraging companies from conceding to wage claims in excess of productivity changes; and by dampening inflationary expectations generated by sterling's depreciation in 1984. The UK's interest differential has kept sterling strong despite uncertainties about oil prices, the proximate cause of sterling's rapid decline at the end of 1984 and the beginning of 1985, and the Chancellor has resisted calls for substantial cuts in base rates. Sterling's current resilience has permitted some easing of rates but further reductions will be dependent on the behaviour of domestic monetary conditions and on movements in the Retail Price Index.

In recent months the Chancellor has sought to reduce the significance of the broad measure sterling M3, which comprises cash and bank deposits, as an indicator of monetary conditions in favour of the narrow measure M0, which comprises notes and coins in circulation. As argued in the February **Commentary**, financial markets tend to attach little significance to the behaviour of M0 which has remained within its target range. Sterling M3, on the other hand, has been expanding considerably in excess of targets. Shifting away from an ill-behaved aggregate follows earlier practice and interpretation of the behaviour of sterling M3 has been made difficult by structural changes in the pattern of asset-holding. Nevertheless, the growth of that aggregate, particularly in the light of still buoyant bank lending to the private sector, must suggest to the Chancellor the need for continuing caution in monetary policy.

Inflation has risen over the period May to July to levels higher than forecast in the March Budget. This has been due mainly to the effects of higher interest rates in the early part of the year. Easing of

the mortgage rate will contribute to some reduction in the inflation rate in the remainder of the year. Recent wage settlements indicate stronger underlying inflationary pressures. A number of factors are likely, however, to prevent rapid growth in wages including the continuing increases in the level of unemployment and the effects of the appreciation of sterling on corporate liquidity. In conjunction with the renewal of productivity growth evident in the early part of the year, these factors are likely to limit the increase in unit labour costs.

But until the Chancellor is confident that the combination of high interest rates and a strong pound is moderating both monetary growth and inflationary pressures, his present caution will persist. Such a strategy carries risks, however. Higher interest rates will deter investment and a strong pound will reduce exports and increase import penetration. As discussed earlier, signs of adverse effects on investment and exports have already emerged in last month's CBI Industrial Trends Survey. Against a background of decelerating world trade, the likely outcome is a deterioration in industrial confidence and slower growth in 1986.

The slowing of world trade reflects lower US growth and dollar depreciation. As argued elsewhere in the **Commentary** (see World Economy), the deceleration of the US economy will intensify the problems of the US budget deficit and in the absence of substantial cuts in Government spending will induce higher US interest rates. The consequent narrowing of UK/US interest rate differentials will tend to weaken sterling and, thereby, offset any pressures which emerge for lower UK interest rates. Even should the US Congress agree on spending cuts, implementation lags mean that effects on interest rates will not appear immediately.

With less buoyant world trade, a strong pound and high UK interest rates the prospects of avoiding a shift in 1986 to a lower underlying growth rate are very small.