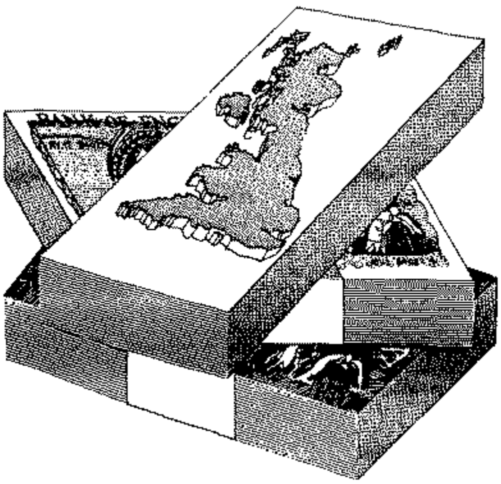
The British Economy



Growth in the UK economy looks set to continue in 1986 although at a lower rate than in preceding years. Consumer expenditure will play a dominant role in determining growth while exports and investment will expand less rapidly than in 1985. In the November Statement the Chancellor forecast further reductions in the inflation rate and reductions in income tax in the Spring Budget. Unlike previous years, however, the Chancellor provided no clear indication of the likely scale of tax cuts. Avoidance of any specific commitment has now been proven wise as the Exchequer's revenues have been reduced by falling oil prices.

One year after the last "sterling crisis" falling oil prices are again exerting considerable pressure on sterling. With his macroeconomic strategy firmly based on maintenance of a strong pound, the Chancellor's consistent caution over the prospect of interest rate reductions has shifted to concern over the extent to which interest rates may have to be raised to support sterling. In his November Statement the Chancellor forecast that during 1986 sterling's trade weighted index was likely to remain close to its average for the six months to November. Achieving such an outcome will require higher interest rates which, in conjunction with a continuing strong pound, will damage the strength of output recovery.

MACROECONOMIC TRENDS

As throughout 1985, the CSO's cyclical indicators continue to provide unclear signals about developments in the economy. Over the past two years the impact of the miners' dispute and volatility in certain of the components series of the two leading indicators have led to difficulties of interpretation. Although the effects of the miners' dispute have no current impact it still remains difficult to forecast activity from these two indicators. The picture starting to emerge from the coincident indicator, however, is one of slowing growth.

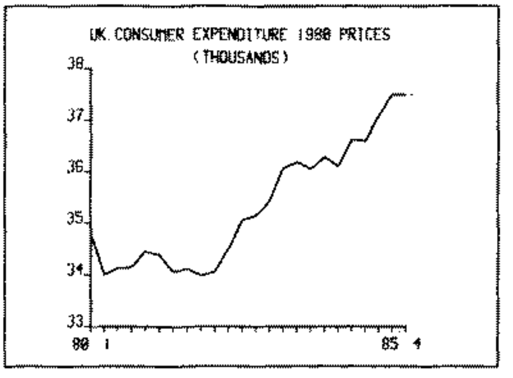
After falling in July the longer-leading index, which typically predicts turning points about one year in advance, rose in each of the four months to November to achieve a level previously recorded in the first part of 1985. The reversal of the gradual decline over the first seven months of 1985 was attributable to higher share prices. Movements in the longer leading index over 1985 are very similar to those in 1984. Interpretation of the shorter leading index, which is intended to predict turning points some six months in advance, continues to be difficult, particularly as a consequence of the volatility of certain component series. Since falling in May the coincident indicator has risen in each month to October as a result of the continuing strong growth in consumer credit and the marked increases in new car registrations in August.

Reflecting the "rebound" effects from the miners' dispute, the coincident indicator, which reflects current developments, rose in the first five months of 1985. Subsequently, it fell in each month and by November had reached its lowest level for over a year.

Estimates of gross domestic product are consistent with the suggestion of some deceleration in growth derived from the coincident indicator. The Central Statistical Office has introduced a new form of adjustment to output estimates for the manufacturing sector to take account of alleged persistent under-recording. In consequence, estimates of manufacturing output have been revised upwards for each of the six months to November. Even after taking account of these adjustments, however, the quarter on quarter increase in total real output was lower for the third than for the second quarter of 1985. Output increased in the three months to September by only 0.25% as compared to 1.2% in the three months to the end of June. Third quarter output in 1985 was 3.6% higher than in the corresponding quarter of 1984 and 11.5% higher than in the third quarter of 1984, the last year of negative growth. Apart from the early part of 1984, output has grown in each quarter since the beginning of 1982 and the UK has, therefore, experienced four successive years of growth.

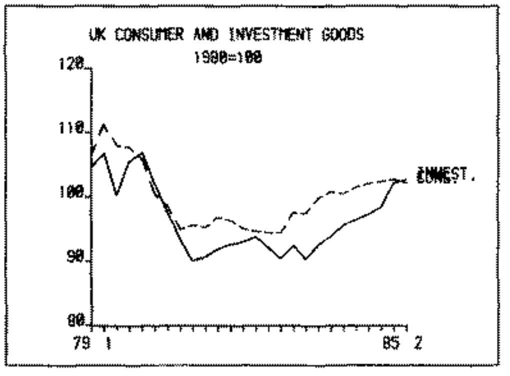
In expenditure terms, the main element driving growth is now consumers' expenditure. During 1985 consumer spending rose to a level 2.4% higher than in 1984. After increasing in each of the first three quarters of 1985, this component of demand remained unchanged between the third and fourth quarter at a level 2.3% higher than in the fourth quarter of 1984. Most categories of consumer expenditure are estimated to have grown by around 2% during 1985, the notable exception being spending on consumer durables which is estimated to have risen by around 5%.

Over the past two years retail sales have consistently been more buoyant than consumers' expenditure. After rising from April to August retail sales fell in September and October before recovering in the final months of 1985. Decreases in the autumn's retail sales appear to have resulted from unseasonal weather conditions in the summer which induced the bringing forward of expenditures usually undertaken later in the year. Retail sales in the fourth quarter remained unchanged from the level of the third quarter.



The role of consumers' expenditure in determining the growth of aggregate demand will become more dominant in 1986. In the November **Commentary** two factors were forecast to provide the basis for higher consumer spending: further increases in real incomes with average earnings continuing to rise at present rates while the inflation rate is further reduced and increases in disposable incomes as a consequence of reductions in income tax in the Budget. The prospect of the latter influence is now much diminished as a result of the effects of lower oil prices on Government revenues. However, the former and more important factor remains operative.

In 1985 real personal disposable income increased over the corresponding quarters of 1984 by 3.75% and 2.5% for the second and third quarters respectively. Disposable income was depressed in 1984 by the miners' dispute and delayed public sector pay settlements. The miners' return to work and the marked increases in their earnings combined with the payment of delayed settlements to push incomes in 1985 above the underlying trend growth. Over the course of 1986 average earnings are widely expected to continue rising at the present rate of around 7% while inflation is forecast to fall below 4%. During 1984 and the early part of 1985 demand growth was determined mainly by investment and exports. Private industrial investment grew by around 15% in 1984 and by an estimated 13% in 1985 while exports rose by 11% and 6% in these two years. Such growth will not be maintained in 1986 and the expected expansion of consumer demand will be insufficient to prevent a reduction in the overall growth rate.



Investment has been encouraged over the past two years by high corporate liquidity and the stimulus provided by the announcement in the 1984 Budget of the phasing out of capital allowances. While the profitability of manufacturing companies was squeezed as sterling appreciated, overall company profitability rose in 1985. Excluding North Sea companies, gross profits in the first six months of 1985 increased by almost 25% over the corresponding part of the previous year.

The impending reduction of capital allowances at the end of the fiscal year 1984/85 brought about a dramatic increase in investment expenditure during the first quarter of 1985. Gross fixed investment in that quarter was almost 10% higher than in the corresponding quarter of 1984. As expected, investment then fell back in the second quarter and remained more or less unchanged in the third quarter. The influence of the April changes in allowances on private sector investment is easily discernible. In the first quarter private sector investment rose by 12.9% before falling by 8.78% and then rising by 1.9% in subsequent quarters. With continuing expenditure constraints, public sector investment fell in each of the first three quarters of 1985.

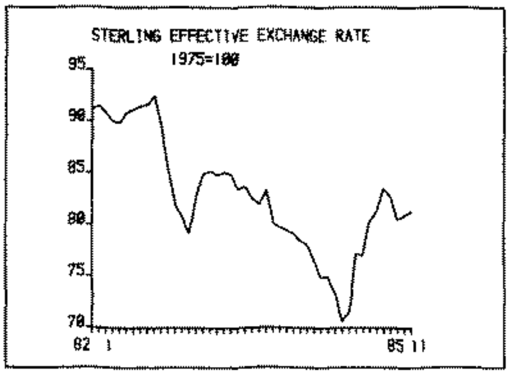
The sectoral pattern of changes in investment is reflected in the pattern of investment by type of asset. Investment in vehicles and in plant and machinery rose sharply in the first quarter before falling in the second quarter to their lowest levels for a year and then recovering slightly in the third quarter. Investment in dwellings fell in the first six months of the year before recovering slightly in the third quarter while investment in other new buildings and works fell in all three quarters.

With a further reduction in capital allowances at the end of the current fiscal year, this year's quarterly pattern of expenditure will replicate that of 1985. However, investment in 1986 is expected to fall short of the likely 1985 growth of around 7.5%. The more pessimistic outlook for manufacturing investment detected in the CBI's **Quarterly Industry Trend Survey** in July and then October has been confirmed by the January 1986 Survey. This latest Survey reinforces the forecast of only modestly higher investment in plant and machinery over the next twelve months. Although there are notable exceptions such as textiles, manufacturers generally report more than adequate capacity and falling capacity utilisation. Uncertainty about future demand is reported as the main constraint on investment activity, with firms expecting the first decline in orders since January 1985.

The pattern of destocking apparent during 1984 and the first quarter of 1985 was reversed in the second quarter of 1985. Stocks then fell, however, in the third quarter as a consequence of decreases in the stocks held by wholesalers more than offsetting increases in those held by manufacturers and retailers. In part the reductions in stocks and in the ratio of total stocks to GDP may reflect the introduction of improvements in stock control methods in response to the final abolition of stock relief announced in the 1984 Budget. More probably, however, it probably also reflects an adjustment to companies' perceptions of changing underlying trends. The CBI's January

Survey suggests that stocks are likely to continue falling over 1986.

Following the marked depreciation of sterling from mid-1983 to January 1985, the UK's visible trade deficit improved in 1985. In the early part of 1985 this resulted from some modest increase in manufactured exports and, more importantly, from the ending of the miners' dispute and the associated upswing in oil exports. Export volumes rose by 6% while import volumes grew by 4%. Much of the improvement in the current account from a deficit of over £4,100m in 1984 to just over £1,300m in 1985 is attributable, however, to the terms of trade effect generated by sterling's appreciation since last February.



With sterling's appreciation beginning to work through into adverse volume movements in the latter half of last year, the prospect is that export volumes are likely to grow less rapidly this year than over 1985. Loss of export competitiveness may be at least partially reversed if the recent weakness in oil markets induces some sterling depreciation. Reflecting the overhang from sterling's 1985 appreciation and slowing world trade, the UK is expected, particularly in the first six months of the year, to secure a smaller share of declining world markets.

The Treasury's annual Public Spending White Paper published in January holds that containing public sector spending remains a primary policy objective. It is intended to hold real public spending roughly constant until fiscal year 1988/89 through substantial reductions in defence expenditure, broadly unchanged expenditures on social security and a programme of asset sales. Real spending by central and local government is expected to fall in the current fiscal year, the first time this has been achieved since the Conservative Party came to power in 1979. Spending in the current year is expected to be within the target of £134.2bn despite an overshoot in expected social security payments of almost £1bn.

In the three months to the end of November 1985 output of the production industries is estimated provisionally to have increased by 2.0% over the level of the immediately preceding three month period and to be almost 6.5% higher than in the corresponding period of 1984. Comparisons with 1984 are, of course, seriously affected by the effects in that year of the miners' dispute. In the three months to November 1984 that dispute is estimated to have reduced output by almost 3.5% while there was a negligible effect an industrial production after the first quarter of 1985. Taking a longer perspective, however, output of the production industries was 15.5% higher in the three months to November 1985 than at the low point recorded in the first quarter of 1981.

Manufacturing output in the three months to November was 1% higher than in the previous three months and 3% higher than in the same period a year earlier. The increase in total manufacturing output reflected increases in most sectors. Output increased by 2% in other manufacturing and by 1% in each of other minerals, engineering and allied industries, food drink and tobacco, and textilesand clothing. Output fell, however, by 1% in chemicals and by 2% in metals.

As a consequence of increased extraction of oil and natural gas after the extensive maintenance work in the North Sea over the summer, output of energy and water supply rose by 4.5% in the three months to November. Output of the construction sector remained broadly unchanged. Overall, output of the construction and production industries remained roughly the same as in the previous three months.

Output by market sector did not fully reflect the underlying shifts in the determinants of demand growth. Disappointingly in view of the resurgence of consumers' expenditure, output of consumer goods in the three months to November rose by only 0.8% over the level of the previous three months. There was, however, some evidence that the modest end-year recovery in investment expenditure had an impact on the intermediate and investment goods sector. Output of the former increased by 2.4% and of the latter by 1.9% in the three months to November.

THE LABOUR MARKET

EMPLOYMENT AND UNEMPLOYMENT

After an average quarterly rise of 84,000 in 1984 the pace of employment creation slowed appreciably during 1985. Following increases of 34,000 and 78,000 in the first two quarters of the year, employment rose by only 31,000 in the three months to September. This increase was comprised completely of individuals in self-employment. A rise of just over 31,000 is assumed to have taken place in self-employment while a decrease of just under 1,000 took place in the number of employees in employment.

Employment change in the third quarter followed the now well-established pattern. There was a seasonally adjusted increase of 37,000 employees in the service sector but decreases of 11,000 in manufacturing industries, 16,000 in energy and water supply industries and 11,000 in other industries, including construction, agriculture, forestry and fishing. Data are not yet available for the service sector for October and November but a further 16,000 and 6,000 jobs were lost in manufacturing and energy and water supplies respectively over those months.

In the year to September 1985 the number of employees in employment rose by 96,000. This increase was heavily concentrated on part-time female employment. While male employment fell by almost 100,000, around 196,000 jobs were created for women and of these 180,000 were part-time. With the underlying shift towards services implied in the increasing importance of consumer spending in overall growth (see November **Commentary**), this pattern will be reinforced during 1986.

After remaining unchanged at a rate of 13.1% from September to November unemployment on a seasonally adjusted basis and excluding school-leavers rose to 13.2% in December and January. On an unadjusted basis and including school-leavers there was an increase from 13.5% in December to 14.1% in January, a sharper rise than expected and for which the Department of Employment was unable to offer specific explanation.

INDUSTRIAL RELATIONS

The question of flexibility in labour issues is likely to be a significant feature of industrial relations in 1986, creating problems for both employers and trade unions. There have been significant moves to break down traditional barriers to job mobility since 1980, especially craft demarcations. Since 1980 the emphasis has been on flexibility to take account of changed demands and requirements arising from new technologies. Flexibility issues have shown themselves on bargaining agendas, for example, the Ford Motor Company's productivity proposals, offering increases of up to 15% over two years for radical changes in working practices, were rejected by the unions representing Ford employees. However, Anglia Television negotiated the industry's first new technology and flexible working practices agreement. This ended demarcation lines between film and electronic sections, reduced manning levels and enabled the introduction of lightweight electronic cameras. Elsewhere, Esso reached agreement with its drivers over changes to work practice, and the Post Office commenced negotiations over proposed changes to work practices for some 24,000 counter staff.

There are other aspects of moves towards greater flexibility: shiftwork now affects 15% of the labour force; part-time working has increased (more than two thirds of new jobs created since 1983 have been for women working part-time); there has been increasing use of sub-contractors, including labour only contracting (an issue which contributed to the dispute affecting independent television broadcasts in December); and there have been reductions in working hours.

Generally the effects of new technology have been to reduce jobs. In banking the introduction of more than 6,500 automated telling machines has reduced the need for cashiers by between 0.7 to 2 cashiers per machine. However, the introduction of EFTPOS (electronic funds transfer at point of sale) will most probably have a greater impact on staffing levels. APTIS and PORTIS (all purpose ticket issuing system and portable ticket issuing system) in British rail will lead to a reduction of 300 clerical jobs in British Rail. LOMP (local offices micro computer project) in DHSS offices might lead to reductions of 600 clerical jobs.

It is a combination of new technologies, flexibility and manning levels which underlies the current problems in the newspaper industry. However, before the current dispute involving News International and the main printing unions, it was evident that radical changes, implying considerable job losses, would take place in the national newspaper industry. The employers were aware of the potential of the new methods of production, elements of which had been in existence for 25 years in other countries. The experience of the provincial newspaper proprietors indicated the potential of the information technology elements in printing. The ability to input, edit, draft a page and prepare the plate electronically offered the capability to improve the quality of production, reduce costs, improve revenue and overcome the drift towards losses which had been a feature of most of the national newspapers in recent years. SOGAT 82's own study of new technology in the American printing industry forewarned the union to expect job losses of the magnitude of 55% with whole sectors of the industry disappearing. More importantly, their study indicated a general deskilling, women replacing men and the futility of resistance by one union to help another 'bleeding some to help another union bleed less just did not work'. The NGA were likewise aware of the impact of changes and their long-term effects on membership and job opportunities.

The impact of the News International's strategy stems from its ability to combine a range of developments: first, the move to a new location; secondly, the installation of modern printing presses; thirdly, the adoption of the latest developments in information technology which embody electronic mail, financial, accounting, editing, storage and graphics features, over and above basic word processing functions; fourthly, negotiation with a non-printing union which was more amenable to no-strike and flexible working practices provisions; fifthly, the development of new distribution and satellite printing systems; and sixthly, recognition of the extent to which developments in labour legislation would open the traditional print and distribution unions to extensive court action should they seek to oppose the move to Wapping. The majority of the other national newspapers will move along the same technological route, with similar job losses, although not necessarily with the same degree of sophistication in destroying union opposition.

Once the NUJ agreed to move to Wapping any effective action by printing unions was over. The transfer of news production to Wapping may well render all picketing to be secondary (lawful picketing is only at an employee's place of employment). Sympathy action is unlawful. Hence, efforts by the TGWU to engender industrial action amongst its drivers is liable to injunctions and ultimately damages and sequestration of funds. Any employees of News International taking industrial action lose any claims to redundancy payments. Moreover, SOGAT 82 has been subject to sequestration of its funds, and NGA will recall the costs of earlier industrial action. The 1983 dispute cost the NGA almost £1m (possibly to be doubled if newspaper proprietors press their claims for damages).

The dispute raises further problems for the TUC, especially over the question of suspending the EEPTU under rules 11 and 13, a decision which the TUC deferred for a week thus enabling the EEPTU to meet a number of conditions aimed at restoring traditional union representation and bargaining practices with the company. The TUC thus drew back from taking action to gain acceptance of a joint union approach to deal with developments in printing. Possibly the TUC felt that it could exert more influence on the EETPU if the union remained within the TUC rather than if it were suspended. It is evident that the issue over recognition and recruitment in the newspaper industry relates to more general complaints against the EEPTU over single union and no strike agreements. In the longer term it questions the very thrust of TUC proposals for labour law reform.

The TUC and EEPTU are further divided over the approach to single union agreements and no-strike accords. The EEPTU'S agreements with Shah, Hitachi and Yuasa, amongst others, have been contested by other unions who claim they have lost recognition rights as a result. Subsequently, EEPTU's similar arrangements with national newspaper groups have further exacerbated this issue. However, such agreements and similar arrangements are not without their problems. Unions have found it difficult to deliver their members' agreement to the details of such agreements, as the EEPTU found, for example, with Xidex. Similar problems exist in agreements with no-strike or legally binding agreements. However, longer, more detailed, agreements - negotiated with employees rather than national officials - embodying elements of the new labour legislation are becoming more apparent and offer a greater likelihood of being successful.

The change in TUC policy over the acceptance of Government money to fund internal union ballots, heralded in the last issue, occurred, thus resolving the potential split between the EETPU and AUEW on the one hand and the TUC on the other. Over the next few years a number of unions - UCATT, ASTMS, USDAW - are likely to seek money. Possibly more significant has been the increasing acceptance of the 1984 Act by trade unions. A number of major unions including the TGWU have adapted their rules to conform to Section 1 of the 1984 Act, which contains the provisions relating to the election of executive officers.

The TUC has had less success in sustaining the policy of non-co-operation with closed shop ballots required under the 1982 Act. To date some 100 ballots covering over 30,000 workers have been conducted.

The TUC's move away from total opposition to recent legislation sigals the emergence of a more pragmatic approach by the movement to labour law. The TUC's consultative document on labour law reform includes: rewidening the definition of a trade union dispute, restrictions on the use of high court injunctions, redrawing the rights to picket, avoiding industrial action in essential services, and relaxing restrictions to the closed shop. More generally, the TUC and Labour Party will have to discuss not only proposals on labour law but also questions of incomes policy, low pay and renationalisation. In the light of the experience of the print workers' attempts to negotiate with News International, the TUC and the Labour Party may have to consider the possibility of establishing a set of positive rights for employees, including a requirement on both trade unions and employers to bargain in good faith.

Whilst both political parties, the TUC and the CBI are considering reforms of labour law, developments are taking place elsewhere. These suggest that any successful reforms need to reflect the accepted traditions of British industrial relations rather than adopt practices from other countries. Sweden, long regarded as possessing a model system of orderly and peaceful industrial relations, has faced in recent years the fragmentation of the central wage bargaining machinery and a free-for-all bargaining situation which contributed to wage costs rising by over 12% in 1984 and higher wage demands this year. The Swedish Government may well have to impose a rigid incomes policy. Equally, Germany, the other 'model' industrial relations system by comparison to British industrial relations, is showing considerable signs of strain. Unions are seeking more say over investment decisions in new technology, and managements are seeking to reduce the powers of works councils, one of the two main elements in the West German system of co-determination (industrial democracy). Increasingly German employees believe the system of participation is constraining them to accept job losses and are seeking a more independent stance. On the other hand the government is seeking to restrict trade union powers. Proposals to further restrict strikes has led to IG Metall, the largest trade union, to talk of a national stoppage. The West German system of industrial relations is set to become characterised by greater conflict.

Ballots over political funds continue to prompt comment and debate. To date all 27 such ballots have found in favour of the continuation of the fund. In addition, a number of unions - the Inland Revenue Staffs Association, Civil Service Union, Civil and Public Service Association, National Communications Union (clerical association), and National Union of Hosiery Workers - are planning to establish such funds. Government concern that civil service unions may establish such funds has prompted warnings that unions are misrepresenting the aims of the 1984 Act. In addition, the Government is considering: first, a propoganda drive to dissuade civil servants from supporting union proposals; secondly, clarifying the 1913 and 1984 Acts; and, thirdly, amending the Wages Bill to restrict check off arrangements of the political levy. The Institute of Directors has suggested legislative changes requiring specific questions on political funds on union application and check off forms - although the Association's basic aim is to shift political levy arrangements to contracting in rather than out.

Evidence from a survey by the Inland Revenue Staffs Association confirms the view that there is little to suggest that the existence of political funds or the political standpoint of candidates for union offices are regarded as very important by the majority of members.

Government proposals to reform Civil Service pay have met with mixed fortunes. Unions initially rejected pay proposals at the beginning of this year. A second proposal for bonus or merit payments of up to £500 per annum for about 20,000 civil servants in the grades from Under Secretary and above was met with considerable scepticism. Attempts to resolve problems of recruiting and retraining computer staff led to the Treasury offering computer specialists up to £2,000 per annum supplementary payments.

In many respects the operation of the supplementary payment scheme resembles more a merit scheme since a large proportion of payments are at the discretion of senior management. Nevertheless, the scheme fits into a series of selective awards which are fragmenting the traditional pay structure of the civil service. Almost 80,000 civil servants are covered by such schemes. The spread of such measures is making it increasingly harder for Civil Service unions to agree on a concentrated policy in the face of Government proposals to reform civil service pay.

Government hopes of a settlement to the teachers' dispute were raised by signs of divisions among teaching unions. These, coupled with changes to the union side of the Burnham negotiating committee, led to the NUT being outvoted. Subsequently the teaching unions, apart from the NUT, agreed to met ACAS with a view to conciliation. A provisional settlement offering teachers 6.9% backdated to 1 April and increased to 8.5% on 31 March would raise the base for the next round of negotiations (for which unions have put forward a 35% claim). Issues of pay, structure and conditions are to be included in the 1986 negotiations. There is some question as to whether the NUT and the grass roots of the NAS UWT will accept an agreement which gives them worse terms than those offered last September. Moreover, the Education Secretary's statement that the Government would do nothing to help local authorities meet the cost of the 1986/86 settlement further dampened hopes of a lasting settlement.

The National Union of Mineworkers continues to face problems arising from the year-long dispute, despite having apologised to the High Court. First, the NCB continues to aggressively support the UDM in terms of negotiations. Secondly, there are increasing rumours of the break up and privatisation of the industry, with the open cast operations , the most profitable element, being the first to be sold off. Thirdly, declining oil prices make oil a more competitive source of energy. Fourthly, the CEGB has announced plans to burn less coal in the future. All of these factors are combining to reduce still further the influence of Mr Scargill, now under attack from most sectors of the trade union movement, including the Left. Fifthly, the NUM is likely to face proposals for more flexible and profitable work practices incuding increasing the length of the shift to ten hours, increasing duties of supervisors, and increasing up-time of machines.

The rivalry between the UDM and NUM has become increasingly bitter with accusations that NCB personnel and UDM officials were offering inducements - including cars, pensions and improved salaries - to NUM officials to join the UDM. However, there is much to suggest that the first wave of enthusiasm for the UDM is past. The declining influence of Mr Scargill coupled with better NUM tactics have limited the NCB support for the UDM in Leicestershire and reduced the rate of growth of the UDM. Possibly the UDM is now more vulnerable than ever before. It depends on the continued support of the NCB which whilst present at the national level, might not be so strong at the pit level.

PROGNOSIS

There is a remarkable degree of consensus among forecasters that higher consumer spending will help sustain the UK's economic recovery during 1986, but that overall growth is likely to be lower than in 1985 as a consequence of offsetting slower growth in investment and exports. An important influence on export performance and general business confidence is the appreciation of sterling that took place in 1985. As argued in previous **Commentaries**, sterling's appreciation has been engineered through maintaining an interest rate differential, primarily to help tackle the Government's objective of reducing the rate of inflation. In last year's Budget the Chancellor shifted away from the use of monetary aggregates, and moved towards reliance on the exchange rate as an indicator of underlying monetary conditions. Exchange rate appreciation helps depress the inflationary component of growth in nominal GDP in two principal ways: UK companies are forced to compete more actively in both domestic and foreign markets and they are less, therefore, likely to concede pay settlements in excess of productivity growth; and costs of imports of raw materials and finished products are reduced.

Continuation of the Government's declared stance of monetary and fiscal restraint with attendant high interest rates and a strong pound would be consistent with achieving the Treasury's forecast of a reduction in the rate of inflation to 4.75% by the end of 1986. In addition, the planned programme of asset sales provides scope for the reductions in income tax, by which the Government lays much political store.

Over recent months, however, there has been intensification of concern over the conduct of UK macroeconomic policy. The Chancellor's November Statement suggested the maintenance of a firm monetary stance but some relaxation of fiscal policy. Signs of fiscal relaxation, over and above the long-standing problem of containing departmental spending overshoots, emerged in two key areas. First, the Chancellor seemed to be taking refuge in the curious convention of classifying the proceeds from asset sales as negative expenditure in drawing up his expenditure plans. After succesive years of failing to meet target reductions in real terms, the November Statement projected unchanged real expenditures up to 1988/89. Excluding the effects of asset sales, however, public expenditure is planned to grow slightly in real terms over that period. Secondly, the Chancellor formally relegated as a targetted aggregate sterling M3, which financial markets have increasingly focussed on as a touchstone of his determination to contain the PSBR. Subsequently, confidence in financial markets has been further diminished by the implications for the conduct of monetary policy of falling oil prices. As a consequence of developments in oil markets (see **World Economy**), dollar oil prices moved steadily downwards during 1985. In the UK, however, this was not fully reflected in sterling prices and Government revenues as a result of exchange rate policy. The recent sharp falls in oil prices pose two immediate problems for the Chancellor. First, with sterling under pressure, and the financial markets' tendency to overshoot, maintenance of current exchange rate strategy requires higher interest rates. Secondly, falling oil prices have effectively eliminated most of the scope for income tax reductions in the Spring Budget, although sterling depreciation would provide some offset to the reductions in sterling oil revenues.

Thus far sterling's depreciation has been relatively modest for a number of reasons: namely, the continuing high UK interest differential, which was reinforced by a rise in base rates in January; the commitment of £500m to exchange rate intervention by the Bank of England in December; and favourable money supply figures for January. Sterling's trade-weighted index embraces, however, substantial differences in the extent of depreciation against other currencies. The single largest influence on the index is sterling's performance against the dollar which has itself fallen in value against other currencies. Sterling has not depreciated against the dollar to any great extent but has fallen to a greater degree against currencies such as the Deutsche Mark, the sterling-Deutsche Mark rate now being as low as a year ago before the marked rise in UK interest rates. With many of the imported inputs for industry falling in prices denominated in dollars and with much of the UK's trade with Western Europe such differences in sterling's performance across currencies simultaneously provides some leverage on both the inflation target, through restraining costs, and improvements in the UK's competitive standing relative to other European countries.

The Government's antipathy towards depreciation has been based primarily on the view that the growth of unit labour costs lies at the heart of the problems faced by UK exporters and that such depreciation will raise inflationary expectations. As discussed earlier, recent revision to output data series has led to higher estimated output growth in manufacturing. Corresponding upward adjustment to productivty figures will then narrow, although not necessarily close, the gap between UK unit labour costs and those in other countries. The inadequacy of concentrating on the importance of unit labour costs to the exclusion of other influences affecting competitiveness, including the exchange rate, has been discussed in previous **Commentaries**. Even within the constraints of the Government's view, however, there may be greater room for manoeuvre than previously envisaged, given the upward revision to output data.

With the dollar unlikely to strengthen, continuing depression in commodity markets and the prospect of continuing softness in oil markets, depreciation of the sterling index would permit further competitive gains without significant prejudice to the inflation target. Politically, the erosion of oil revenues has probably cost the Chancellor any advantage to be gained from tax cuts, but that loss can be attributed to external market forces, an element regularly adduced in political defence. Moreover, the grounds on which the Chancellor basis has faith in tax cuts are, as argued in last February's **Commentary**, far from convincing.

The alternative strategy of maintaining a high interest rate differential and, thereby, resisting exchange rate depreciation may well help choke off inflationary pressures. Higher interest charges and an unchanged exchange rate, however, are, like wage costs, important determinants of competitiveness and this alternative strategy will do little to counterbalance the widely forecast slower growth of exports and investment and, therefore, of total output.