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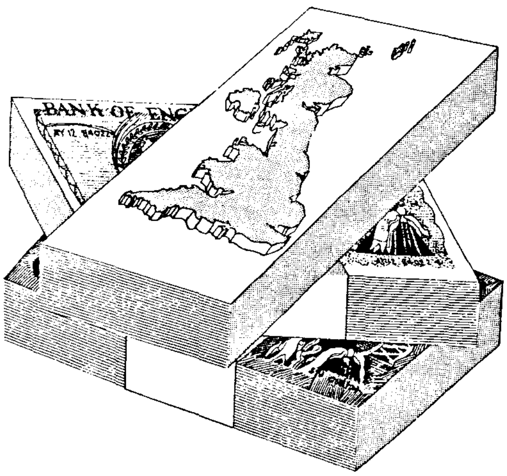
The British Economy



OVERVIEW

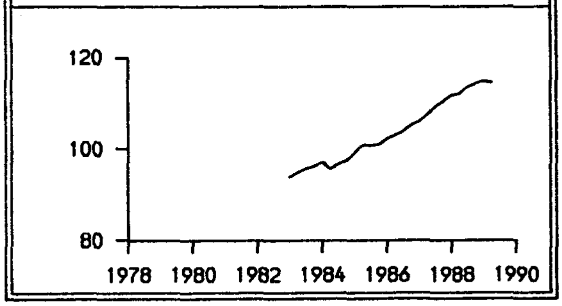
The rate of growth of output continues to slow down. The form of the economic contraction still gives cause for concern as the output of tradeables shows few signs of holding up better than non-tradeable production - the necessary requirement if recession is to be avoided. On the credit side investment, and particularly manufacturing investment, appears to be holding up well in the face of monetary contraction. In addition, the rate of growth of export volumes appears to be rising slowly relative to imports. The recent downward movement of sterling perhaps signals a change in economic policy.

MACROECONOMIC TRENDS

In the second quarter of 1989, the average measure of GDP at current market prices - nominal or 'money' GDP - rose by 1.5% during the quarter to a level 10.6% higher than the same period a year earlier. After allowing for price changes, the average measure of GDP at constant market prices - 'real' GDP - was almost unchanged over this period rising by only 0.16%. Over the year to the second quarter 'real' GDP is estimated to have risen by 2.6%. When measured at constant factor cost - ie. after subtracting taxes on expenditure minus subsidies - GDP was largely unchanged in the second quarter with a slight fall of 0.2% recorded. Using this measure, the increase between the second quarters of 1988 and 1989 was 2.2%.

In the September Commentary we noted the CSO's warning that the estimates of the average measure of GDP were affected by the erratic quarterly paths of the expenditure and income measures of GDP. In the latest quarterly estimates the CSO has applied statistical adjustments to the estimated expenditure and income change to allow for probable under and overestimation of these series. The adjustments are experimental and cannot be guaranteed to be accurate but as a result the quarterly paths of the different measures - and particularly the average measure - now move more closely together and are now very closely in line with movements of the output measure, which is usually taken to be the most reliable indicator of short-term change.

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



Preliminary estimates of the output-based measure of GDP in the third quarter suggest that activity was 1% higher than in the second quarter and 1.9% above that of a year earlier. This is the slowest annual rate of growth since the first quarter of

1985. The main stimulus to growth during the latest quarter appears to have come from the energy sector where, due to a recovery in North Sea oil production, output rose by 5.5%, compared with increases of only 0.5% in both manufacturing and service sectors.

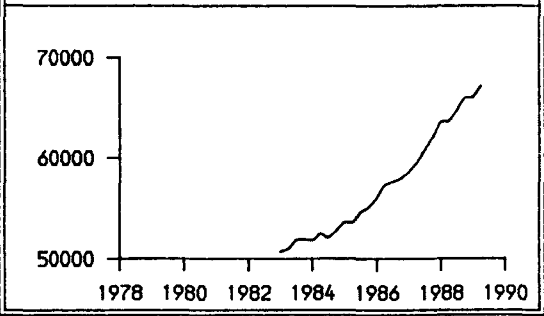
The most recent GDP data make clear that growth in the UK economy has slowed considerably this year. The growth rate for 1989 seems likely to be no more than 2% with the prospect of an even slower rate during 1990. The CSO's coincident cyclical indicator, which attempts to show current turning points around the long-term trend, continued to decline in October. The series has been declining since August 1988 which now appears to be the peak of the last growth phase.

Real consumers' expenditure rose by 1.6% during the second quarter to a level 5.4% higher than a year earlier. Consumer spending therefore picked up somewhat during this period after the 0.5% outturn recorded for the first quarter. Expenditure on durable goods remained unchanged in the second quarter compared with the 1.5% increase recorded in the first quarter. Nevertheless, by the second quarter spending on durables was 7.5% higher than a year earlier. Although this figure is higher than the 5.5% annual growth to the first quarter it is much below the yearly outturns recorded during 1988.

Preliminary estimates of real consumers' expenditure for the third quarter of this year indicate that there was a small increase of 0.1% over the period. For the year to the third quarter spending is estimated to have risen by 3.8%. The preliminary estimates are partly forecasts and so are almost certainly subject to revision. Nevertheless, if correct these data might indicate that the growth of this component of aggregate demand is now more clearly registering the effects of the earlier progressive base rate rises. In the September Commentary we noted that consumers' spending had been holding up quite stubbornly, and more so than domestic output, to the base rate rises.

The official retail sales figures - seasonally adjusted - for September showed an increase of 0.4% over the previous month, a 1.25% increase between July and September and an annual rate of growth of 2.2%. This latter figure can be compared with growth of 6.5% in 1988. In October retail sales actually fell by 0.4%, with sales volumes falling by 0.25% in the three months to October resulting in sales being only 1.5% higher than in the same period in 1989. Similarly, the CBI/FT Distributive Trades survey for October and early November indicated that the growth of retail spending continued to slow. The balance of companies reporting sales volumes higher than a year earlier fell to plus 18% compared with 23% in September. Stocks were expected to rise in the coming month and a further slowing of sales was expected. The latest provisional retail sales figures for November indicate that the squeeze on consumer demand is continuing. Sales volumes fell by 0.8% over the month, were 0.25% higher in the three months to November and 1% above the same period in 1988.

Consumers' expenditure at 1985 prices (millions)



The changes in the underlying determinants of consumers' spending potentially serve to push spending in opposite directions. The growth in average earnings was provisionally estimated to be 9% in the twelve months to September, a quarter of a percentage point up on the 12-month rate to August.

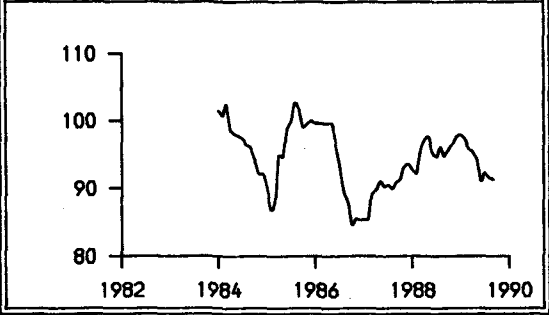
Real personal disposable income (RPDI) fell by 0.5% in the second quarter of the year to a level 4% above that in the second quarter of 1988. The growth in RPDI appears to be moderating, reflecting the slowdown in the economy which is clearly seen in the absolute decline in dividend income. However, with consumers' spending growing more rapidly than income in the second quarter the saving ratio fell to 3% from the 5.1% recorded in the first quarter. This confounds the prediction in the September Commentary that the saving ratio would be expected to move upwards in future quarters as savers responded to the higher interest rate regime. In October outstanding consumer credit rose by £174m in October, below the monthly average for new credit this year which stands at £256m. This provides further evidence of the effect of higher base rates on borrowing.

General government final consumption remained virtually unchanged between the first and second quarters, rising by 0.2% to almost exactly the level attained in the second quarter of 1988. Some increase should be evident next year following the expenditure plans revealed by the government in the recent Autumn Statement.

Real gross fixed investment fell by 0.3% in the second quarter after rising by 1% during the first three months of the year. The level of investment in the second quarter was therefore 2.2% above that of a year earlier. These figures confirm the retrenchment in investment noted in the September Commentary after the strong growth in 1987 and early 1988. Nevertheless, manufacturing industry investment rose by 14.2% between April and June to a level 9% higher than the level attained in the second quarter of 1988. Similarly, investment by the energy industries rose by 13% over the same period of 1988. Fixed investment fell by 3.5% in the non-production industries during the second quarter. By type of asset over the year to the second quarter, investment in vehicles, ships and aircraft grew by 11.5%, and in plant and machinery by 8.5%, but investment in dwellings declined by 9%, and in other new buildings and works the rate of decline was 1.5%. These last two figures provide a clear indication of the extent of the recession in the property and housing markets.

The monthly deficit on the current account of the balance of payments is now beginning to show signs of slight improvement as the rate of growth of domestic demand slows and producers of tradeables seek to compensate by switching to export markets. The October deficit fell to £1.54bn from £1.62bn in September and £1.9bn in August. However, the deficit for the third quarter rose to £5.8bn, reflecting the large deficit in July. The outcome for the deficit over the current year is therefore expected to be £21bn, or around £20bn if current improvements continue. On visible trade, the third quarter deficit rose to £6.7bn compared with £5.9bn in the second quarter, although the monthly trade balance has been declining since August. The growth in export volumes, excluding erratic items, was 3% higher in the three months to October than the preceding three month period. The volume of imports was, in contrast, only 1.5% higher over the same period. Over the year to the August - October quarter export volumes grew by 10% compared with import growth of 8%. In recent previous three month periods - ie. until September - the rate of growth of import volumes has outstripped that of exports.

Sterling effective exchange rate (1985=100)



In the third quarter of 1989, the output of the production industries is provisionally estimated to have increased by 1.7% compared with the previous quarter. The increase recorded in the most recent quarter therefore went some way to offset the declines recorded in the previous two quarters. As a result, the level of output attained is almost unchanged (+0.1%) on the third quarter of 1988. The relatively flat performance of industrial production over the year reflects both the relatively depressed state of domestic demand and the interruptions to energy supply beginning with the Piper Alpha disaster. In manufacturing industry output rose by 3.2% in the year to the latest three month period. The energy sector in contrast exhibited a fall in output of 8.2% over the year, although in the third quarter signs of recovery were clearly evident as production rose by 5.5%. Manufacturing output only rose by 0.5% during the third quarter but as usual there were clear variations within the sector. The principal increases recorded were in the engineering and allied industries where production rose by 2%, and in chemicals where the increase was 1%. At the other extreme, the output of other minerals fell by 3% and the output of "other manufacturing" by 1%. The metals industry, food, drink and tobacco, and textiles all experienced little change in production during the latest quarter.

By market sector, the output of the consumer goods industries fell by 0.5% in the third quarter compared to a 0.5% increase in the second quarter and a 0.9% rise between January and March. These data provide a strong indication of the effect on consumer demand of tighter monetary conditions. The investment goods and intermediate goods industries, on the other hand, held up well during this period with output rising by 3% and 2.5%, respectively, reflecting the buoyancy of investment demand in the manufacturing and energy sectors.

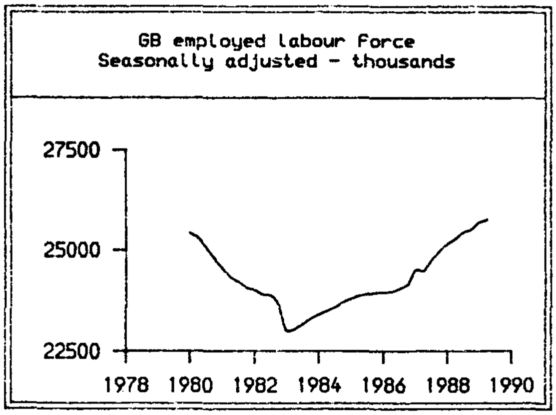
LABOUR MARKET

Employment and Unemployment

The workforce in employment in the UK rose by 71,000 in the second quarter of 1989 and by 479,000 for the year up to June to reach a total of 26,343,000. These are percentage rises of 0.3 and 1.9 respectively. Whilst this maintains the rising trend which has been evident in this series since 1983, it is the smallest quarterly increase for 2 years with male employment being almost static. The largest element of the workforce in employment is employees in employment. The increases in this figure have been much smaller: less that 0.1% in the second quarter of the year and 1% in the year up to June. However, self-employment and particularly employment in work-related government training schemes continue to grow rapidly. Employment on work-related training schemes increased by almost 40% in the year up to June and the increase in the numbers on these schemes made up 28% of the increase in the workforce in employment over the same period. The figures for employees in employment are available at a greater level of industrial disaggregation. Manufacturing employment has been falling for the first two quarters of this year after seven quarters of continuous employment growth. As a result, the June manufacturing employment figure is 0.5% lower than the corresponding figure for the previous year. However, the negative employment change in manufacturing and energy and water supply are more than offset by employment growth in service and other industries.

UK seasonally adjusted unemployment fell in the 3 months up to October by a total of 113,000 to a level of 1,674,000. this is an unemployment rate of 5.9%, with separate male and female rates of 7.4% and 3.9% respectively. The fall in unemployment is not evenly spread across the regions and for October we observe unemployment rising in East Anglia and the West Midlands. The change in seasonally adjusted unfilled vacancies at jobcentres fluctuates from month to month. However, over the 3-month period to October, there was a 2.7% fall in the number of unfilled vacancies. Again, there appears to be variation in the change in unfilled vacancies across regions. For example, in each of the 3 months to October, unfilled vacancies are rising in Scotland and the North West.

The increase in British average earnings for the year to September is estimated as 9.7% with an underlying increase of 9%. The difference between these two figures is due to arrears of pay being greater in 1989 than in 1988 and to some groups of workers having more than one pay increase in the past 12 months. There is no indication that the rate of increase of earnings is falling, as both the actual and underlying rate for the year to September is higher than the corresponding figures for each of the previous 3 months. There are small differences between the underlying rate of increase of average earnings in difference sectors of the economy, with services being lowest at 8.5% and production industries highest at 9.25%.



UK labour productivity, as measured by the value of output per head, fell in the second quarter of this year by 0.6%, and the annual increase to June was only 0.7%. However, the poor annual figure is partly attributable to the effects of the Piper

Alpha disaster and other oil industry interruptions which are estimated to have reduced the increase in whole economy output per head by 0.5% in each of the last two quarters of 1988 and by 1% in each of the two quarters of 1989. Perhaps more surprising is the fact that labour productivity in manufacturing actually fell by 0.4% in the 3 months to September and in the third quarter of the year the annual rate of increase fell to 3.5%, as against the figures of 6.1% and 6.0% for the previous two quarters.

The rate of change of unit wage and salary cost is calculated as the difference between the rate of increase in average earnings and the rate of increase of labour productivity. Over the recent past, the fall in the rate of increase of labour productivity and constant or rising wage inflation has led to sustained increases in unit labour costs for the whole economy. Over the period from the first quarter of 1987 to the second quarter of 1989, the annual increase in unit wage and salary costs has risen from 3.6% to 8.2%. For the manufacturing sector the position is slightly different, but even here the annual increase in unit wage and salary costs is 5.4% for the third quarter of 1989, double the figure for the previous two quarters.

INDUSTRIAL RELATIONS

Inevitably popular interest and concern has focused on the long running dispute involving ambulance workers. The relative worth and hence pay levels of ambulance workers as compared with staff in other emergency services raises all too clearly the need for a systematic mechanism, other than political expediency, to deal with comparability issues. In a wider sense, the dispute reflects much of the changes which the Government has sought to implement both in the public sector and more generally to British industrial relations.

The dispute commenced when ambulance staff rejected a pay offer recommended to them by the trade union side in the negotiating machinery. Initially the question of comparability with other emergency services was an underlying concern. However, during the progress of the dispute it became a central issue. The automatic award of 8.6%, under the established formula, to fire brigade staff heightened the focus on comparability. However, there is no agreement as to whether the ambulance service is an emergency or an essential service.

Five years ago there was a measure of parity between fire brigade and ambulance workers (those staff with five years service). Whilst the Minister has claimed that ambulance rates of pay have advanced faster than comparable groups the gap between ambulance and other essential services has widened.

The dispute raises a number of issues within the National Health Service:

> Whilst considerable use has been made of regrading and other special payments management has argued that any settlement which provides for an enhanced payment could engender problems with other groups. It is clear that some 90% have settled around 6.5%.
>
> A number of additional payments have been proposed including a payment of £500 for those with paramedic skills, and a reduced payment for those will less skills. However, the current proposals are still restricted and take little account of the range of training ambulance staff can undertake. Moreover, targeting payments to paramedic staff might encourage the emergence of a rigid distinction between the 10-20% normal emergency work and the delivery/routine work. Whilst this division may come, with a partial contracting out of delivery work, it does pose questions of coping with above normal levels of emergencies.
>
> It is unlikely that the current offer of 6.5% will resolve the issues of the extra long hours of work and shortages of staff in some areas.
>
> To a degree management is committed to the current course of action. It has to reflect the Government's wish for greater pay flexibility. This has led to suggestions from the chief executive of the NHS that each ambulance service should negotiate separately. Certainly, flexibility and local supplements could assist in overcoming problems of retention of labour.

By December the Minister had established a new negotiating body which gave representation to the association of professional ambulance personnel (with some 3,000 members). At the time of writing this had apparently negotiated an increase of 9% over 18 months. This "settlement" may well be imposed, possibly with a temporary limitation on bargaining, in an attempt to end the dispute.

The Government's objections to the Social Charter may well ignore a number of labour market problems. The single European market is likely to lead to a large mobile low paid workforce (largely from Spain and Portugal). This may well contribute to the further development of the two tier labour force (a smaller well protected and paid group with a larger pool of part-time and temporary workers). Such a development could heighten differences between regions within the United Kingdom and hence exacerbate problems of the mobility and utilisation of labour. Such fears might prompt the Government to consider those provisions within the Charter which oblige host states to give workers from other EC states, even working on temporary sub-contracts, the same social security, tax and pay benefits as their own workers.

The Government announcement of a sixth Employment Bill reflects a desire to seek to end the last vestiges of lawful closed shops, removes the remaining rights to secondary action, and attempts to deal with the problem of the unofficial dispute.

The Bill proposals:

- to allow employers, for the first time, to dismiss workers selectively for breach of contract for going on strike and barring unions from striking in support of employees so dismissed.

- to require a trade union to write to all members taking action.

- to require a trade union to repudiate the unofficial action and the views of those who call the action, or to take steps to make the action official. Failure to take these steps will render the union liable to civil action for damages.

However, the Bill defers, once again, plans for limiting stoppages in the public sector.

There has been a mixed reaction amongst Management organisations. The EEF has given a cautious welcome to the proposals. On the other hand the IPM fears the proposals could lead to more rather than less disputes and could prolong procedures for resolving disputes. It regards as impracticable the requirement on the union to write to all members concerned individually, believing that the BIll misunderstands the nature of unofficial action.

The spread of performance related pay continues. British Airways have announced plans to extend the scheme from senior management to some 700 hangar and workshop maintenance staff. "We need to move to a system of individually tailored performance." Associated newspapers plan to end collective bargaining for all 400 journalists and introduce a system of individual contracts and PRP. The NUJ would no longer be recognised for bargaining purposes. However, in a number of organisations the problems of performance appraisal and associated payment schemes have led to delays.

The introduction of performance appraisal for teachers has been delayed until 1990 at the earliest, although the Government remain committed to the principle. Similarly Barclays bank has announced a deferment of the introduction of PRP until 1991.

A similar spread of flexible work patterns is apparent in several recent negotiations, agreements and company proposals. British Gas is seeking more flexibility from 50,000 white collar employees in terms of work and hours. American Express has sought more flexible working arrangements in London and Brighton due to difficulties in recruiting and retaining staff. Its proposals include job share, flexitime and teamworking. Central Television's flexible rostering agreement will enable staff to work up to 60 hours per week without receiving any premium overtime rates and permits flexible timing of breaks.

The third trend is the continued move away from national bargaining. British Airways has created for the first time separate basic pay rates for staff in London and the South East. British Rail plans to change bargaining procedures continue to be strongly resisted by the union; at the heart of the plan is the establishment of a series of functional councils with powers to vary length of working week and pay and conditions. This would clearly dilute the current national bargaining arrangements. The NUS has indicated a willingness to negotiate the abandonment of joint national pay bargaining in the industry; this follows the move by a number of companies to introduce company wide bargaining. Finally the ending of centralised national pay bargaining in the Steel industry seems certain.

A fourth discernible trend is the de-recognition of trade unions. The movement experienced at first hand de-recognition when the TUC had to cancel its booking for 150 rooms at the trust House Forte Imperial Hotel due to the company's decision to end recognition of the GMB. De-recognition of trade unions has been proposed for groups at British Telecom, Thomson Regional Papers and ICL. Currently Thames TV is balloting 250 clerical staff as to whether they wish to retain a collective negotiating deal. ASDA has planned to de-recognise the TGWU and GMB at the 61 Gateway stores it recently acquired. Queensway stores proposes to de-recognise USDAW at 130 of its stores. This follows a decline in the membership when the company replaced about one quarter of its full time staff by part-timers.

Within the union movement merger proposals and discussions continue. The NUT and NUS are likely to merge in 1990. The proposal still requires a ballot in favour by members but this is thought likely by officials of both unions. The EEPTU, experiencing a decline in membership, has suggested a merger with TGWU.

PROGNOSIS

The rate of growth of output continues to slow down. The form of the economic contraction still gives us cause for concern as the output of tradeables shows few signs of holding up better than non-tradeable production. We noted in previous Commentaries that if the economy was to improve the rate of inflation and the deficit on current account while at the same time avoiding recession, there would soon have to be a change in the relative growth of the two sectors. Specifically, a relative contraction of demand and output in the non-traded sector - principally, construction and a large proportion of services - and a relative expansion of the traded sector - largely manufacturing and the traded services such as insurance, other financial services and tourism - would be required. Preliminary data for the most recent third quarter indicated that both manufacturing and services were growing similarly at a 2% annual rate. On the credit side investment, and particularly manufacturing investment, appears to be holding up well in the face of monetary contraction. In addition, the rate of growth of export volumes appears to be rising slowly relative to imports. But whether these are sufficient for the economy to avoid more than two successive quarters of negative growth - the technical definition of recession - is open to question.

The most recent forecasts by both government and the major forecasting organisations suggest that GDP growth in 1990 will range from 1.25% to around 1.8%, with the Treasury's forecast being at the low end of this range. Oil output is expected to be fairly buoyant next year, with the result that non-oil output growth is expected to be no more than 0.75%. Hence, even the official expectation is that we shall only avoid recession by the "skin of our teeth". Clearly, such an outcome becomes more remote if any of the following occur: if there is a collapse of confidence in sterling necessitating even higher base rates; if business investment fails to hold up in the face of the high interest rate regime - the Treasury forecasts 4.5% growth in 1990, cf. 9.25% in 1989 and 17.5% in 1988; if the rate of growth of exports fails to move significantly above previous levels - the Treasury forecasts export growth of 6.25% in 1990 cf. 4.74% in 1989 and 0.75% in 1988; and if the growth of import demand does not sufficiently moderate - Treasury forecasts 1.25% in 1990 cf. 9.25% in 1989 and 12.25% in 1988. None of these possibilities will necessarily be avoided.

As the new Chancellor settles in at the Treasury one thing is becoming clear. The exchange rate has been allowed to fall - particularly in relation to the D-Mark - by an amount that would have been unlikely under his predecessor. This in part reflects philosophical differences about the value of exchange rate targeting, but it may also reflect the new Chancellor's judgement that further increases in base rates are likely to push the economy into a recession with all the implications that would have for the government's electoral prospects. It therefore appears that current political imperatives are leading the government to take a greater risk with inflation than they did in 1980/81. Moreover, the signs are that we might be witnessing the beginning of a more eclectic approach to economic policy than has been seen in recent years. The sole reliance on interest rates as the instrument of economic management may soon be consigned to the dustbin of history.