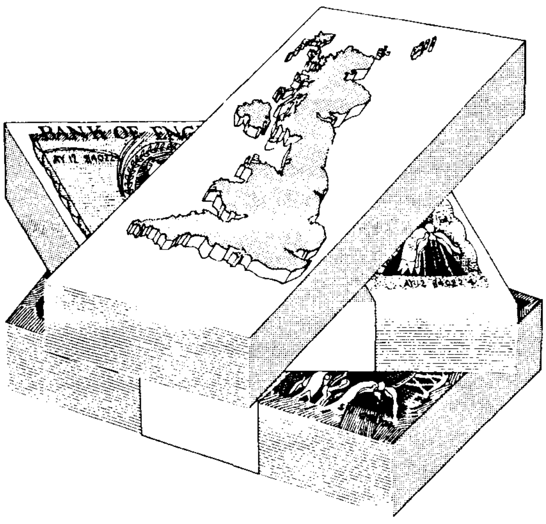
Ashcroft, Brian and Love, Jim and Boyle, Stephen and Draper, Paul and Dunlop, Stewart and Harrigan, Frank and Lockyer, Cliff and McGregor, Peter and McNicoll, Iain and Perman, Roger and Simpson, David (1988) The British economy [June 1988]. Quarterly Economic Commentary, 13 (4). pp. 5-11. ISSN 2046-5378 ,

The British Economy

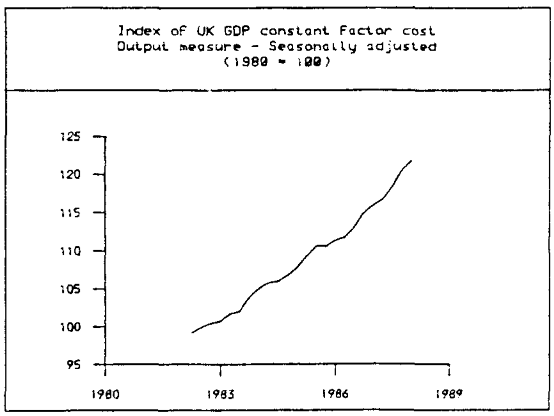


OVERVIEW

The rate of growth of output in the British economy appears to be slowing down in line with earlier expectations for 1988. The rate of growth of domestic demand remains strong. Manufacturing investment is forecast to rise to record levels during 1988 and there is little evidence that the growth in consumer demand is slackening. The slow-down in the rate of growth is therefore largely a reflection of decline in the external demand for exports and buoyant import growth. The progressive upward movement of sterling in recent months and the evidence of increasing inflationary pressure, has placed the Government in a significant policy dilemma. Recent events are a clear illustration that interest rate policy cannot be used both to target the exchange rate and to regulate the expansion of domestic money and credit.

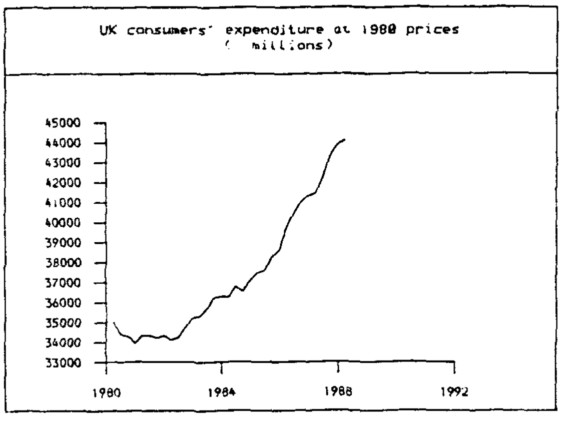
MACROECONOMIC TRENDS

The average measure of GDP at current market prices, nominal or "money" GDP, rose by 1.8% between the third and fourth quarters of 1987. The change can be compared with the 3.4% increase recorded between the second and third quarters of the year, the 2.6% increase recorded between the first and second quarters, the 1.7% increase during the first quarter and the 2.5% rise in the final quarter of 1986. Over the year, between the fourth quarters of 1986 and 1987, "money" GDP rose by 9.8%, compared with 10.6% in the year to the previous quarter. After allowance for inflation, the average measure of GDP at constant market prices, "real" GDP, rose by 0.6% between the third and fourth quarters, compared with increases of 2.1%, 1.0%, 0.9% and 1.5%, respectively, between the previous four quarters. Between the fourth quarters of 1986 and 1987, "real" GDP rose by 4.6%, compared with increases of 5.6% and 4.1% in the year to the preceding two quarters. The output based measure of GDP, which is usually regarded as the most reliable indicator of change in the short run, recorded an increase of 1% between the third and fourth quarters of 1987; this can be compared with the 2% rise between the second and third quarters. Overall, the level in the fourth quarter was 5.2% higher than in the same quarter of 1986. During the first quarter of 1988, preliminary estimates suggest that output rose by 0.2% to a level 4.6% higher than in the same quarter of 1987.



Following the significant increase in GDP between the second and third quarters, the rate of growth appears to be slowing down. Preliminary estimates are frequently revised in the light of further information, so the recent data may not fully reflect the underlying growth performance of the British economy. Nevertheless, most indicators appear to be pointing in the direction of a reduction in the rate of growth. The CSO's coincident cyclical indicator, which purports to show current turning points in the business cycle around the long-term trend, fell slightly in the first four months of 1988, reflecting the recent slower growth of the Index of Production (see below) and the output based measure of GDP.

Real consumers' expenditure rose by 1% between the third and fourth quarters of 1987, to a level 6.1% higher than in the final quarter of 1986, indicating a 5.1% increase for 1987 as a whole. In this latest quarter, expenditure on most categories of goods and services increased, with spending on durables and food falling following the very sharp rise in the third quarter. The preliminary estimate of "real" consumers' expenditure for the first quarter of 1988 showed an increase of 0.6% over the previous quarter, reflecting continued growth in retail sales which was partly offset by reduced expenditures on energy due to the mild winter. In the year to the first quarter, consumers' expenditure increased by 6.2%.



The Department of Trade and Industry's (DTI) retail sales volume index rose, in seasonally adjusted terms and on revised figures, by only 0.7% in April and greater than the increase of around 0.2% in March. In the three months to April, the index was nearly 1.5% higher than in the previous three months and 6.5% higher than in the same period a year earlier. In the year to April, sales were 7% higher compared with a 7.5% increase in the year to March. The CBI/FT distributive trades survey, on the the other hand, reported a slow-down in the rate of increase of sales, with growth in April falling short of retailers expectations. A balance of plus 31% reported an increase in sales during the month, compared with positive balances of 40% and 46% in March and February, respectively. The rate of growth of retail sales may be moderating but the evidence is mixed. Further monthly data are required before any firm conclusions can be drawn.

Wholesalers also reported a slow-down in sales growth during April, with sales falling below expectations.

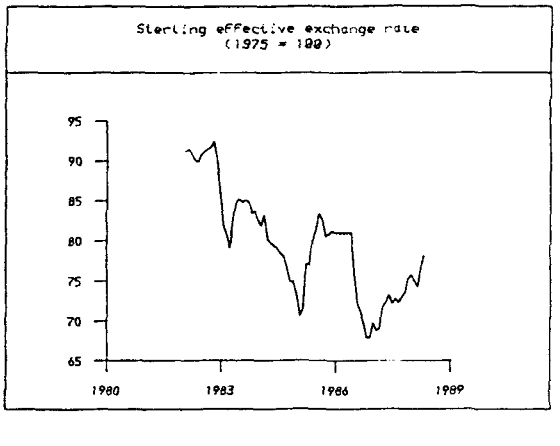
The underlying determinants of the growth of consumer demand remain buoyant. The rate of growth of average earnings continues on an upward trend. The underlying increase over the previous twelve months was provisionally estimated at 8.5% in March. Although the rate of increase has been at this level since December it represents a progressive increase from the 7.5% recorded at the beginning of 1987. Real personal disposable income (RPDI) also continues to rise. RPDI grew by 1% between the third and fourth quarter of 1987, reaching a level 3.5% higher than in the fourth quarter of 1986 and 3% higher during 1987 than in 1986. Broadly similar growth in consumers' expenditure during the fourth quarter resulted in the saving ratio remaining at around 4.5%. However, taking 1987 as a whole, the saving ratio was, at 5.5%, around 2% lower than in 1986. The March Commentary highlighted the historically low level of the British saving ratio but noted that its calculation was subject to a wide margin of error. Nevertheless, it is clear that the current consumer "boom" has in part been financed by a run-down of personal wealth which cannot be sustained for that much longer.

General government consumption rose by 1.4% in the fourth quarter of 1987. For 1987 as a whole, government expenditure was around 1% higher than in 1986.

Gross fixed investment rose by 4% between the two halves of 1987 and for the year as a whole was 3.5% higher than in 1986. Public investment fell again during the second half of 1987, falling by 1.7%. Private sector investment, on the other hand, rose by 5.1% over the same period, with manufacturing investment largely unchanged between the two six month periods. By type of asset, investment in plant and machinery rose by 0.5% between the first six month periods; vehicle investment rose by 7.4%, compared with 5.5%; investment in dwellings rose by 9.9% (4.5%), and other new building and works by 3.9% (5.4%). The stock market crash appears to have done little to damage investment intentions. The latest DTI survey of investment intentions suggests that total private sector investment will rise by about 12% during 1988 and manufacturing investment by a record 16%, compared with the Treasury's Budget forecast of 11.5%. Provisional figures suggest that manufacturing investment increased by nearly 5% in the first quarter of 1988 compared with the preceding three months. This outturn is more that 8.5% higher than in the same period in 1987.

The trade accounts, as forecast in the March Commentary continue to deteriorate. The visible trade balance recorded a deficit of £3.0 bn in the fourth quarter of 1987, down by £0.1 bn on the third quarter. But for 1987 as a whole the deficit reached £9.6 bn compared with deficits of £8.5 bn and £2.2 bn in 1986 and 1985 respectively. The non-oil trade deficit rose slightly to £4.1 bn in the fourth quarter of 1987 from the £4.0 bn recorded in the previous quarter. For the year as a whole the deficit on this account stood at £13.8 bn compared with £12.5 bn in 1986 and £10.3 bn in 1985. The growth in export volumes continues to lag behind that of import volumes, even though manufacturing exports grew faster than world trade in 1987. Exports increased by by 7.1% during 1987 compared with an 8.4% rise in the volume of imports. In the first quarter of 1988, the volume of visible exports fell significantly by 6.5% compared with the previous quarter - 2.6% lower than the first quarter of 1987 - while import volumes fell by only 2.6% - 10.7% higher than the first quarter of 1987. New methods of recording trade flows may in part account for the apparent relative deterioration of exports so the first quarter fall may be an aberration. Nevertheless, the continued high level of sterling makes it unlikely that there will be much improvement in the relative export position over the coming months.

The oil surplus increased by £0.1 bn to under £1.1 bn in the fourth quarter of 1987. For 1987 as a whole the surplus stood at £4.2 bn compared with £4.1 bn in 1986 and the much greater £8.1 bn in 1985.



The balance on current account produced a deficit of £1.3 bn in the fourth quarter of 1987, following a deficit of £0.9 bn in the third quarter of the year. The overall deficit for 1987 therefore reached £1.7 bn compared with revised estimates of approximate balance in 1986 and a £3.3 bn surplus in 1985. During the first quarter of 1988 the deficit on current account increased to £1.8 bn. While this high figure may, as noted above, be an aberration, the provisional estimate of the deficit for April of £525 m suggests that the deterioration in Britain's trade position is continuing.

In the first quarter of 1988, the output of the production industries is provisionally estimated to have declined by 1% from the level attained in the previous quarter. This can be compared with successive increases of 1.5% and 1% in the preceding two quarters. By March output was 2.5% higher than in the first quarter of 1987. Manufacturing output fell slightly (0.2%) during the first quarter but was 5.5% higher than in the same period a year earlier. Although it is perhaps too early to draw any firm conclusions, it does appear from these data that the rate of growth of output in the UK is coming down to more manageable levels.

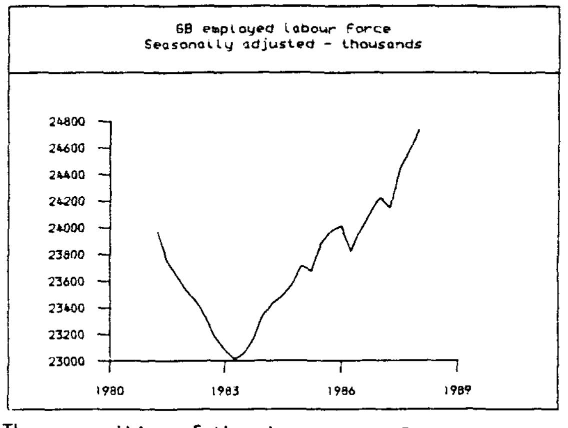
In the first quarter there was the usual variations in the output performance of individual sectors. The output of the energy sector continues to fluctuate falling by 2.5% over the previous quarter and 5% below the same period last year. The previous three quarters have seen energy output rising by 1%, falling by 1% and increasing by 1.5% during the second quarter of last year. Within manufacturing, the output of other minerals increased by 6%, metals by 4%, and food drink and tobacco, and "other manufacturing" by 2%. A decline in output of 2% was recorded for both the engineering and allied industries, and the textiles and clothing sectors. In the chemicals industry output fell by 1%. The output of the construction industry is estimated to have risen by 3.5% during the fourth quarter of 1987 compared with an increase of 5% in the third quarter and a decrease of 3.5% during the second quarter of last year. At the end of the fourth quarter construction output was 9% higher than in the same period a year earlier. Overall, output in the production and construction industries in the fourth quarter of 1987 was 1% higher than in the preceding three months and 4.5% above the same

The output of the consumer goods industries increased by 0.5% between the latest two quarters, compared with increases of 1% and 2% in the preceding two quarters. The output of the investment goods industries fell by 3% compared with the earlier quarter.

THE LABOUR MARKET

EMPLOYMENT AND UNEMPLOYMENT

The fourth quarter of 1987 saw another substantial increase in the employed labour force with an increase of 146,000 reported over the previous three months. For 1987 as a whole, the employed labour force is estimated to have increased by 506,000 and by 1,659,000 since March 1983.



The composition of the change in employment in the fourth quarter has again tended to follow the established pattern. The number of employees in the service sector rose by an estimated 133,000, compared with, on revised figures, 72,000 and 100,000 in the two preceding quarters. Manufacturing employment fell by 6,000 following the 22,000 fall in the previous quarter and the small increase of 3,000 in the second quarter of 1987. In other sectors, the decline in employment in energy and water continued with a 7,000 reduction and the other industries category lost 3,000 jobs following, on revised figures, falls of 5,000, 3,000, 11,000 and 1,000 in the preceding four quarters respectively.

Productivity - output per head - growth remains high. In the fourth quarter of 1987 output per head in the whole economy was 3.1% higher than a year earlier. Productivity growth averaged 3.15% in the second half of 1987, the same as in the second half of 1986 but greater than the 2.15% averaged in the second half of 1985. In manufacturing the marked improvement experienced in the second half of 1986 continues to be sustained but the rate of increase has been falling since the third quarter of 1987 when the percentage increase on a year earlier was 7.6%. In the final quarter of 1987 and the first quarter of 1988 the increases over the same quarter in the previous year were 5.8% and 5.4%, respectively.

The underlying increase in average weekly earnings in the year to March is provisionally estimated to have been 8.5%. This represents a 0.25% point increase over the figure reported in the last Commentary for the year to November.

The increase in unit labour costs remains moderate compared to earlier years. During the final two quarters of 1987, the increase in the whole economy averaged 4.1% compared to 4.9% and 5.2% during the same period in 1986 and 1985 respectively. In manufacturing, the annual increase in wages and salaries per unit of output rose to 2.5% in the fourth quarter of 1987 followed by a similar increase in the first quarter of 1988. The increase still remains considerably lower than in quarters prior to the first half of 1986 and reflects the considerable improvements in productivity growth in this sector. In the three months ending March 1988, unit labour costs in manufacturing were 2.5% higher than in the same period in 1987.

Seasonally adjusted unemployment continues on a downward trend although the rate of decline appears to have slowed since the Commentary last reported in March. In the six months ending April, the reduction - on provisional estimates - averaged 43,100 per month, compared with 44,700, 48,800, 51,400 and in the six months to March, February and January, respectively. By April, seasonally adjusted unemployment stood at 2.455 million, or 8.8% of the working population, down by 49,000 on the previous month.

INDUSTRIAL RELATIONS

In its 1987 Annual Report the Advisory, Conciliation and Arbitration Service highlighted a number of changing features of British industrial relations. Firstly, a growing emphasis on enhancing flexibility in work practices. Secondly, the increasingly critical review of the current scope and structure of collective bargaining. Thirdly, a greater optimism amongst management as to the state of industrial relations. Fourthly, a questioning of the value of trade union recognition. Significantly, the Report noted that "both management and trade unions were considering how best to organise themselves to cope with the challenging circumstances of the years ahead". For the trade union movement the most pressing organisational issue was the position of the EEPTU and the policy over single union deals.

By March it had been widely expected the EEPTU would be suspended by the TUC. In May EEPTU balloted members on the question of whether the union should withdraw from the TUC in light of the TUC's policies on no strike agreements, and the continuing recriminations over the actions of the EEPTU at Wapping. In the intervening period the union continued to sign further single union arrangements with employers. Increasingly the question focused on whether the EEPTU would seek to establish a rival to the TUC. There is some evidence of discussions with a number of unions. The role of the AEU may prove crucial in this respect. Firstly, the AEU has argued that the movement will need to adopt a more flexible approach towards recognition. This will be necessary by the 1990s to combat both the growth derecognition and weakening of recognition levels, as well as prepare for the changes to the market in 1992. Such a policy would be more relaxed towards single union arrangements and hence the point of the move towards expelling the EEPTU would disappear. Secondly and more importantly, are the signs of merger discussions between the AEU and EEPTU. The EEPTU might well return to the TUC as part of a merged union.

Merger and amalgamation has become a widespread feature of the movement. The Union of Communication Workers has discussed merger with the National Communications Union and SOGAT has had similar discussions with the NGA. Now the UCW and SOGAT have commenced talks with a view to establishing a broad communications grouping, ACTT to merge with Broadcasting and Entertainment Trades Alliance. Merger discussions have taken place between the NUT and NAS/UWT, and MSF has emerged out of a merger between ASTMS and TASS. Such a spate of merger discussions lends credibility to the view that by 2000 the movement may have four "super unions" - the TGWU, GMBATU, MSF and NALGO & NUPE.

Not all the movement shares the same concerns and fears as to the future size of the movement. Whilst, in overall terms, the movement lost over 2.5 million members between 1979 and 1986, there were small rises in membership in banking and financial services. Trade union density has been variously calculated as 38% of the working population to 51% if self employed and others are excluded from the working population. Whilst there is evidence to suggest that union finances are relatively sound, and a number of unions have recorded increases in union membership, there are few grounds for optimism. The growth areas include those where the spread of merit/performance related pay has been greatest, and there is much to suggest that such schemes will weaken the sense of collectivism. Furthermore, the removal of the traditional supports to collective bargaining may well herald further declines in membership. Above all the spread of privatisation and competitive tendering will reduce membership levels.

From a trade union perspective the rise of single union agreements and no strike accords are not without their problems. Reports that AEU membership in Nissan may be as low as 7% -although other studies suggest a figure of 20% - indicate an inability of the union to win support for membership in an industry which would typically be regarded as a union stronghold.

The issue of more flexible working practices underlay a number of disputes and developments. The Government, in describing demarcation and closed shop practices in television as the last bastion of restrictive practices, initiated an inquiry into such practices by the Monopolies and Mergers Commission. The earlier Peacock Report, into the future of the industry, had claimed television production was wasteful of resources through overmanning, self indulgent work practices, and that the requirements for in-house production were at the root of union restrictive practices. All the television companies, including the BBC are under pressure to reduce costs to compete with cable and satellite productions, and to meet Government demands that 25% plus of programmes are made by independents. Additionally, the new technologies and experiences in Australia and the United States indicate the potential for savings in manning levels. Granada, Scottish, Tyne Tees, and Yorkshire have already made major changes to manning as have other television companies.

Currently the BBC is seeking greater freedom to hire outside staff and an ability to hire overseas. The objective is to increase flexibility of working and hence to release more resources for news and current affairs. London Weekend Television is discussion changes in employment practices involving the loss of 239 jobs, reductions in the levels of overtime, increased flexibility in manning levels and rostering, the right to use non-staff crews and studios around the world. Central Television is encouraging: early retirement at 61; non replacement of staff; redeployment, and staff members to become either free-lance or independent. In May the company had reached a flexibility agreement which replaced 6 job classifications with a single grade. ITN are proposing to impose changes to working practices, including: single technician camera crews; remote control cameras in all recording studios; a reduction in the number of studio production assistants; an introduction of a single grade to replace existing grades of floor manager, sound technician and scenery supervision. As yet TVAM appears to be the only company following the Wapping model and seeking to de-unionise staff.

The dispute between the National Union of Seamen and P & O Ferries reflected similar management concerns to reduce costs and promote more effective labour utilisation. P & O's action stemmed from the need to:

1. compete with the cost structure of channel tunnel.

2. Reduce costs due to the EEC decision to extend VAT to ferries.

3. Reduce costs to absorb losses which will arise from the EEC decision to phase out duty- frees.

The policy was to seek to reduce the number of crews per ferry from 3.6 to 3. This in turn required new patterns of working and a reduction in the number of rest days. Sealink for similar reasons wished to cut crews to 2.5 per ship. Both P & O and Sealink embarked on a policy of negotiation, however, P & O's long running action culminated in widespread dismissal and a series of court actions. P & O's actions were the fifteenth contempt of court actions against trade unions and the NUS is the fifth union to face sequestration. By April P & O had restarted first cargo ferry and later restarted passenger ferries. The dispute prompts the question as to how will the Eurotunnel organise its employee relations? Either a single union, although it is questionable as to whether there would be widespread official support for the NUR, and no strike agreement with a moderate union, or, but less likely, the company may pursue a non union policy.

Questions of flexibility also arose in British Rail with a degree of resistance from ASLEF over the extension of single manning on trains operating at higher speeds. BR is now on sixth round of productivity proposals. The Inland Revenue Staff Association voted to accept a flexibility package. For Local Authorities the issues of change and flexibility are of major importance. At a conference in March, jointly organised by the Local Government Personnel and Management Services Society and the Institute of Management Services, it was predicted that upwards of 550,000 local authority jobs would be lost as a result of competitive tendering. The figures might be higher if increased work flexibility could not be introduced.

Elsewhere in the public sector the proposals to reform the Civil Service have been seen as implying a further weakening of national bargaining and a greater reliance on merit related pay. In the NHS three year contracts of employment and annual assessment of performance related pay are already operational for general managers, PRP will be introduced for other senior staff from September 1988. The current scheme can mean increases ranging from 0% to 20% depending on assessment.

Evidence of a declining commitment to national bargaining arrangements can be seen in the considerations by Philips to replace the current industry-wide bargaining arrangement with eight separate sets of negotiations reflecting the eight business divisions of the company. The NUJ's withdrawal from the national bargaining structure prompted the provincial newspapers to review the whole question of recognition.

The spread of merit related pay was further evidenced by BIFU's decision to look more favourably on such schemes, this was not surprising given the widespread use of such schemes in the banking and insurance sector.

However, moves towards regional pay variations were resisted by the Pay Review Bodies for both teachers and nurses. These bodies found little evidence in support of such variations, other than the well known allowances for the London area.

PROGNOSIS

The rate of growth of output in the British economy appears to be slowing down in line with expectations for 1988 compared with the high rate achieved in 1987. The rate of growth of domestic demand remains strong. Manufacturing investment is forecast to rise to record levels during 1988 and there is little evidence that the growth in consumer demand is slackening. It follows that any faltering in the rate of growth is a reflection of decline in the external demand for exports and buoyant import growth. The progressive upward movement of sterling in recent months and the evidence of increasing inflationary pressure, has placed the Government in a significant policy dilemma. Recent events are a clear illustration that interest rate policy cannot be used both to target the exchange rate and to regulate the expansion of domestic money and credit.

The movements of the CSO's two leading economic indicators are consistent with a slowing down in the rate of economic growth during 1988. The shorter leading indicator, which purports to predict turning points some six months in advance, fell back in November after fairly consistent increases earlier in the year. After November, the index has remained on a generally flat path, although in April there was a small fall compared with March. The longer leading indicator, which purports to predict turning points in economic activity one year in advance, has been declining gradually since July 1987. This fall has continued during the early months of 1988.

The latest Treasury analysis of independent forecasts, suggests that the economy will grow by 3.1% in 1988 and by 2.1% next year. This represents an upward revision of the earlier forecasts reported in the March Commentary and reflects a further discounting of the predicted effects of the stock market crash in October last year. In contrast, forecasters are more pessimistic about the outturn for the balance of payments, with a current account deficit of nearly £5 bn forecast for 1988 and a deficit of £6.3 bn in 1989. Inflation is expected to average 3.9% this year, slightly down on earlier forecasts of 4%.

Recent events have presented the Government with a dilemma as to the appropriate monetary policy stance. Prior to March it appeared that the Treasury was targeting the exchange rate to the range of 2.80 DM to 3 DM. The rationale behind this policy was presumably that the longer term benefits of reduced inflationary expectations through shadowing the Deutschemark would offset any short-term impact of varying interest rates on the domestic demand for money and credit. Since March, it is clear that in the face of increased demand for sterling the authorities have sought to maintain a given monetary policy stance by trading off variations in the exchange rate against interest rate changes. The five changes in interest rates since February are, therefore, less extreme than would have been the case if the Government had chosen to maintain its original exchange rate target. The fear that the increased demand for sterling in March would result in base rates falling to levels which would add a further twist to the spiral of increased money demand - and hence inflationary pressure - presumably accounted for the shift in policy.

The difficulty with this policy is that the absence of an apparent exchange rate target will do nothing for inflationary expectations. The increase in the exchange rate is, in the short run, likely to damage further Britain's external competitiveness producing an unsatisfactory balance of demand in the economy. And it is by no means certain that trading off interest and exchange rate changes will have a neutral effect on money demand. Moreover, it is the Government's insistence on effectively removing fiscal - tax - changes as an instrument of macroeconomic policy that partly accounts for the Government's current difficulties. Using base rates to target the exchange rate and tax adjustments to moderate the domestic pressure of demand would in principle secure both external and domestic objectives. But with taxes being cut in the recent Budget and further cuts promised irrespective of the state of demand, the Government's policy dilemma will almost certainly continue.