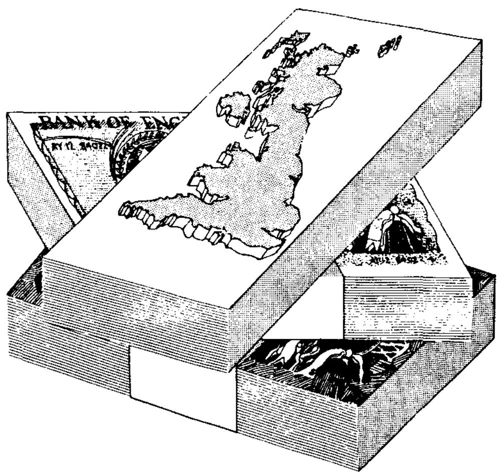
Ashcroft, Brian and Love, Jim and Boyle, Stephen and Draper, Paul and Dunlop, Stewart and Jenkins, Iain and Lockyer, Cliff and McGregor, Peter and McNicoll, Iain and Pearlman, Mike and Simpson, David and Stevens, Jim (1988) The British economy [March 1988]. Quarterly Economic Commentary, 13 (3). pp. 8-15. ISSN 2046-5378 ,

The British Economy

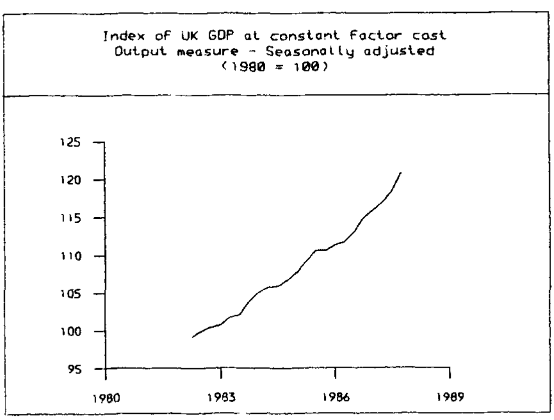


OVERVIEW

Growth in the British economy continues at a high rate. To date there is little evidence that the collapse of share prices in October has had much effect on consumer demand or on business confidence. The expected decline in the UK growth rate during 1988 is likely to prevent any occurence of the symptoms of overheating which were evident before the events of last October. Further significant deterioration in the balance of payments is to be expected this year. The size of the deterioration and the extent of downward pressure on the exchange rate will in part depend on the degree to which the economy can contain incipient cost inflationary pressures.

MACROECONOMIC TRENDS

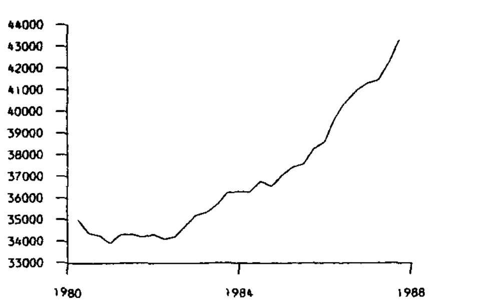
The average measure of **GDP at current marker prices,** nominal or 'money' GDP, rose by 3.5% between the second and third quarters of 1987. The change can be compared with the 1.7% increase recorded between the first and second quarters of the year and the 2.3% rise in the final quarter of 1986. Over the year between the third quarters of 1986 and 1987 'money' GDP rose by 10.5% compared with 8% in the year to the previous quarter. After allowance for inflation, the average measure of **GDP at constant market prices,** 'real' GDP, rose by 2.2% between the middle two quarters of the year, compared with increases of 1% and 0.9% respectively, between the first two quarters of 1987 and the final two quarters of 1986. Between the third quarters of 1986 and 1987, 'real' GDP rose by 5.3% compared with the 3.8% increase recorded in the year to the previous quarter. The **output based measure of GDP,** which is conventionally regarded as the most reliable indicator of change in the short run, recorded an increase of some 2% between the second and third quarters of 1987, representing a doubling of the rate of growth recorded in the previous two quarters. Overall, this measure posted an increase of 5% between the third quarters of 1986 and 1987.



The rate of growth of GDP clearly displayed a significant increase between the second and third quarters of last year. Provisional growth figures are frequently revised in the light of further information, so the recent data may overstate the underlying growth performance of the British economy. If the performance of the economy in the first three quarters of 1987 is compared with that of 1986 then 'real' GDP, at constant factor cost, grew at a rate of 4%, which is more likely to be the outturn for 1987 as a whole. Evidence that the economy continues to be buoyant is also provided by the CSO's **coincident cyclical indicator,** which purports to show current turning points in the business cycle around the long-term trend. The index displayed a marked rise after April which continued until September and then flattened out in the later months of the year, reflecting the absence of GDP data, one of the key components series of the index.

Real **consumers' expenditure** rose by 2.5% between the second and third quarters of 1987, to a level over 5.5% above the third quarter of 1986. In this latest quarter expenditure on most categories of goods and services increased, so there is little evidence from these data of any slackening in the growth of this key aggregate. However, it should be noted that these data describe the situation before the stock market crash of 19th October. The preliminary estimate of 'real' consumers' expenditure for the fourth quarter of 1987 showed only a small increase on the previous quarter of 0.1%, reflecting the slow-down in retail sales reported below.

UK consumers' expenditure at 1980 prices
(£ millions)



The Department of Trade and Industry's (DTI) retail sales volume index rose, in seasonally adjusted terms, by 1% in November to a new record level. The increase followed a 0.9% increase in October. In the three months to November the index was 1.5% higher than in the preceding three months and nearly 6% higher than in the same period a year earlier. However, the CBI/FT distributive trades survey reported that high street sales in November were below retailers' expectations and that the recent rapid growth in retail sales could be faltering. By December the DTI index had fallen by 1.1% over the preceding month, while the CBI/FT survey reported a modest increase in sales which had fallen below retailers' expectations. In addition retailers forecasts for January were the least optimistic for any month since 1983, with a balance of plus 40% expecting an increase compared with January 1987. These data perhaps suggest that the wealth effect on consumer spending of the fall in stock market prices may now be affecting high street sales resulting in a slowing down of the previously fast rate of growth. Nevertheless, the underlying trend in the level of sales continues to be upwards.

Apart from the negative wealth effects of the stock market crash, the underlying determinants of the growth of consumer demand remain buoyant. The growth of **average earnings** has continued to accelerate. In April 1987 the seasonally adjusted annual average rate rose from 7.5% to 7.75% and continued at that level until September. In October, the rate rose to 8% and the provisional figures for November suggest a further increase to 8.25%. **Real personal disposable income** (RPDI) has continued to rise. RPDI rose by 1% between the second and third quarters of 1987 to reach a level 3.5% higher than in the third quarter of 1986. The faster rate of growth of consumers' expenditure during this period indicates that the **saving ratio** had fallen to around 5% in the third quarter from 6.4% in the preceding quarter. This represents the lowest rate of savings since the fourth quarter of 1959. The fall in the ratio is partly explained by company pension holidays and may also be subject to a wide margin of error since it is calculated as the difference between the RPDI and consumers' expenditure. The CSO suggests that a better guide to the saving ratio is the figure for the first three quarters of 1987. During this period the ratio was around 6.5% compared with 7.5% in 1986 as a whole. It seems unlikely that the ratio will continue at such low levels. The need to rebuild wealth following the stock market crash, coupled with the effects of the recent increase in base rates, should produce a rise in the ratio over the coming months.

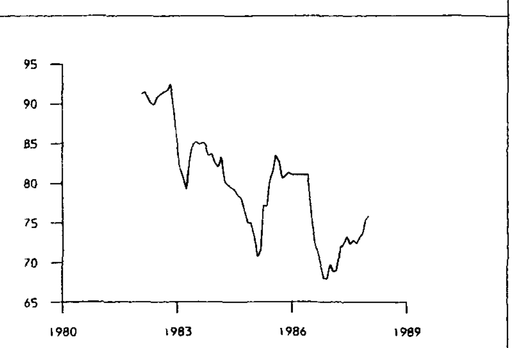
General government consumption rose by 1.5% in the third quarter of 1987. This increase served to offset the reductions, on revised figures, in the previous three quarters. Between the third quarters of 1986 and 1987 the overall increase was small at just over 0.5%.

Gross fixed investment has fluctuated markedly over the last two years, following the phased withdrawal of investment allowances introduced in the 1984 budget and completed in April 1986. This phased reduction in first year capital allowances led to first quarter investment in 1985 and 1986 being higher than otherwise would have been the case. The 2% fall in investment between the first quarters of 1986 and 1987 in part reflects the distortionary effects of the withdrawal. However, a comparison of investment during the first three quarters of 1986 and 1987 shows an increase of 3.5%. Investment remained unchanged between the second and third quarters of 1987 and was 2% higher in the third quarter compared with the same quarter in 1986. During the first half of 1987, public investment continued to decline, particularly in the public corporations, while that in the private sector rose markedly by 8.2% over the same period in 1986. This increase was distributed between: investment in plant and machinery (3.6%), vehicles, ships and aircraft (5.5%), other new building and works (5.4%), and dwellings (4.5%). The DTI's survey of investment intentions, which was published in December, reports that manufacturers expect to invest 11% more in real terms in 1988 than in 1987. If this increase is realised the level of investment would exceed the peak which was attained in 1979. Total investment is also forecast to increase markedly in 1988 by about 8%. It is worth noting though that the DTI's survey was conducted before the collapse in share prices in mid-October. Opinion remains divided on the likely effects of the crash on business confidence in the UK and elsewhere, although the balance of opinion is moving towards the view that the harmful effects are not likely to be significant.

The deterioration in the trade accounts continued throughout 1987. Following a deficit of £8.5 bn in **the visible trade balance** in 1986, compared with £2.2 bn in 1985, further deficits were recorded in the first three quarters of 1987. By the end of that quarter the deficit for the year sttod at £6.6 bn. The **non-oil trade deficit** improved during the first quarter of the year rising from £3.5 bn in the final quarter of 1986 to £2.3 bn. However, in the second and third quarters the deficit again worsened, rising to £3.4 bn and £4 bn respectively. The November **Commentary** reported that the improvement in the first quarter was largely due to an unseasonal reduction in import volumes. In the second and third quarters the volume of non-oil imports rose first to the level attained in the final quarter of 1986 and then in the third quarter rose by a further 7.1%. Export volumes on the other hand fell slightly during the first quarter of 1987, fell again by 1.9 in the second quarter and then rose by 5.3% in the subsequent period. The terms of trade improved in the first quarter following the appreciation of sterling but was not sufficient to offset the harmful effect on the non-oil trade deficit of the deterioration in trade volumes. Further deterioration in this account is in prospect as the price effects of a higher sterling rate affect the relative demands for exports and imports while the growth in consumer expenditure and a resurgence in investment expenditure raises import volumes.

The **oil surplus** stood at £4.1bn in 1986 having fallen from £8.1 bn in 1985. During the first quarter of 1987 the surplus rose from £0.62 bn and £0.78 bn in the third and fourth quarters of 1986 to £1.16 bn. This increase reflected rising oil prices during the period coupled with some improvement in net export volumes. In the second and third quarters of 1987 the surplus fell again to £1.03 bn and £0.94 bn, respectively.

Sterling effective exchange rate
(1975 = 100)



The balance on **current account** for 1986, showing a deficit of £0.94bn, was the first annual deficit for seven years. During the first part of 1987 this account moved sharply into surplus, £572m on a seasonally adjusted basis, in the first quarter, but this was followed by significant deficits in subsequent quarters. In the second quarter the deficit stood at £659m, rising to £1.15 bn in the third quarter. The current account is expected to continue to deteriorate through 1988.

In the fourth quarter of 1987, the **output of the production industries** is provisionally estimated to have increased by 1.5% from the level of the previous three months. This can be compared with an increase of 1% in the preceding three month period. The fourth quarter increase took the prduction industries' output to a level 4.5% higher than in the same period a year earlier. Manufacturing output was 1.5% higher in the latest quarter and 5.6% higher than in the same period a year earlier. This should be compared with an increase of only 0.5% between 1985 and 1986. Moreover, the underlying trend in the growth of manufacturing output is believed to be 6% to 6.5%, because of an unusually high level of output in the fourth quarter of 1986. However, the data suggest that manufacturing output fell by 0.35% in December and the increase in the fourth quarter was less than the 2.6% achieved in the third quarter. Nevertheless, many observers believe that the volatility of the figures provides no evidence that the rate of growth in manufacturing is slowing down due to the effect of the stock market crash and the appreciation of sterling. The strong growth experienced in manufacturing during 1987 appears to be continuing.

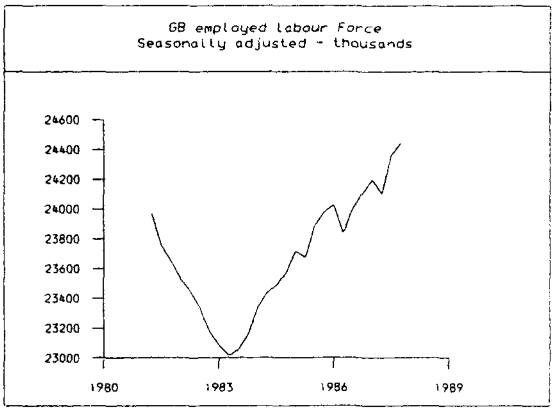
In the fourth quarter there was the usual variation in the output performance of individual sectors. The output of the energy sector continues to fluctuate rising by 1% in the latest quarter compared with a 1% fall in the preceding three month period and an increase of 1.5% in the period before that. The level of output in this sector now stands at a level 1% higher than in the same period last year. Within manufacturing, the output of the engineering and allied and 'other manufacturing' industries rose by 2% over the preceding three months, and the output of all the other broad industry groups rose by 1%. Construction industry output rose by 5% in the third quarter, compared with a fall of 3.5% in the previous quarter. By the third quarter, output in the industry was 9% higher than in the same period a year earlier. Overall, output in the production and construction industries in the third quarter was 2% higher than in the preceding three months and 4% above the same period in 1986.

The output of the consumer goods industries increased by 1% between the latest two quarters, compared with an increase of 2% in the preceding three month period. The output of the invstment and intermediate goods industries rose by 2.5% and 0.5%, respectively, in the latest period, with the rise in investment output being significantly greater than the 0.5% achieved in the preceding quarter.

THE LABOUR MARKET

EMPLOYMENT AND UNEMPLOYMENT

The employed labour force in Britain continues to rise. In the third quarter an increase of 84,000 is estimated, the eighteenth consecutive quarterly increase. This represents a somewhat smaller increase in the first quarter than the 108,000, and 136,000 - on revised figures - recorded in the first and second quarters, respectively. Nevertheless, the increase is significantly above the average for the preceding twelve months.



The composition of the change in employment in the third quarter has again tended to follow the established pattern. The number of employees in the service sector rose by an estimated 85,000, compared with 99,000 and 114,000 in the two preceding quarters. Manufacturing employment fell by 22,000, thus reversing the gratifying increase of 10,000 that occurred in the second quarter. In other sectors, energy and water continues to decline, although now at a much slower rate. In the third quarter employment in this sector fell by 2,000 compared with 5,000 and 14,000 in the preceding two quarters. The other industries category, lost 3,000 jobs, following increases of 7,000, 14,000 and 3,000, respectively in the preceding three quarters.

The growth of **productivity** - output per head - continues to be high. In the whole economy the percentage increase on a year earlier rose from 1.5% in the first quarter of 1986 to 3.6% in the first quarter of 1987. A slackening in the rate of productivity growth in the seecond quarter to a level 2.8% higher than in the second quarter of 1986 was followed in the third quarter by an increase of 3.5% over the same period in 1986. In manufacturing, the marked improvement in the growth of productivity in the second half of 1986 has been sustained during 1987. In the first three quarters of 1987 the percentage increase over the year stood at 8%, 6.8% and 7.5%, respectively. By October, ouput per head in manufacturing had risen by 2.2% over the preceding three months and was 7.2% above the same period a year ago.

The underlying increase in average weekly **earnings** in the year to November is provisionally estimated to have been 8.25%. As noted in the discussion on the determinants of consumer spending above, the underlying increase has edged up gradually from the 7.5% recorded at the beginning of 1987. However, some if not all of this increase may be accounted for by increased overtime payments. But the recent increases in the size of pay settlements suggests that the underlying increase will not fall and may conceivably rise over the coming months.

The increase in **unit labour costs** moderated in the second half of 1986 following improvements in productivity, particularly in manufacturing. In the first quarter of 1987 unit labour costs in manufacturing, on revised figures, actually fell by 0.1%, compared with a recorded annual increase of 8.2% to the first quarter of 1986. For the whole economy, the data show increases of 3.5% and 6.2% respectively. Subsequently, wages and salaries per unit of output began to rise again in manufacturing, although still at the fairly low rates of 0.8% and 0.9% over a year earlier in the second and third quarters, respectively. In the whole economy, the comparative figures are 4.1% and 3.3%. In the three months ending October, unit labour costs in manufacturing were 1.1% higher than in the same period in 1986.

Seasonally adjusted **unemployment** continues on a downward trend. In the six months ending December, the reduction has averaged 51,900 per month, which represents a further acceleration of the decline noted in previous **Commentaries.** By January seasonally adjusted unemployment stood at 2.563 million, or 9.2% of the working population, down by 51,000 on the previous month.

INDUSTRIAL RELATIONS

A flurry of industrial action in a number of industries prompted comparisons with the 'winter of discontent' of 1978 - 79. Whilst it is clear that industrial action will be more widespread in 1988 than for a number of years, there is little evidence to suggest it will return to the levels of the previous decade. Legislative changes, declining trade union membership, and clear evidence of an increasing trend against trade unions, all combine to reduce the likelihood of coordinated widespread industrial action. Deciphering the underlying messages of the current crop of industrial disputes is important in any understanding of the changing contours of industrial relations in Britain.

Over the past year most television companies have sought to introduce new work practices for technician staff. STV has proposed changes to technical staff including reducing job demarcation, crew levels and overmanning; Yorkshire Television has embarked on negotiations over changes to work practices, Thames and Television South has agreed and implemented changes. These and similar negotiations in the other television companies are focusing on a number of areas:- crewing; night-working levels and payment rates; demarcation between studio and technicians; rostering staff cuts, and remote operations (unmanned stations). To date TV AM's management and the policies adopted at News International - the decision not to negotiate and to seek alternatives to trade unions.

It is unclear as to how ACTT will respond, the initial search for support from journalists and other groups did not meet with success. ACTT may not wish to seek to extend the industrial action to other television companies for fear that they too will seek in house associations in preference to established trade unions.

The progress, and breakdown, of the negotiations between trade unions and the Ford Motor Company led to concern as to the impact of the dispute on Ford's

European operations and on extent to which the settlement would constitute the 'norm' for wage claims within the industry. This latter concern was heightened by industrial action at Rover and General Motors. However, it is Nissan, rather than Ford, which is the pace setter for the industry. With a single union, single status and considerable flexibility Nissan has a number of production advantages over other car manufacturers in Britain, Ford's objectives in the proposed three year agreement were as follows: First, a synchronisation of negotiations within its European plants. It sought to have negotiations within Britain to take place one year later than those in Europe. The result, not too damaging, will lead to negotiations being conducted concurrently throughout its European operations. Secondly, to introduce changes to work practice allowing for a greater flexibility both between and within manual and white collar workers and the creation of flexible work teams. Thirdly, the company aims to reduce the percentage of skilled workers. This is to be achieved by a number of methods including on-line maintenance.

It is clear that Ford misunderstood the mood of its employees. The offer of a three year agreement was rapidly changed after industrial action which highlighted the vulnerability of a large number of plants given a policy of integrated production and reduced stock levels.

The contest for the presidentship of the NUM arguably excited more interest outwith the industry than within. In the 30 months following the strike the pattern and inevitability of changes in the industry were clear. Irrespective of who was elected the decline of the industry and progressive introduction of new work patterns would continue. The only issues in question were those as to the nature of the association with the UDM and the degree of hostility between British Coal and the union. In the longer term the moves to decentralise pay, link survival of pits to the introduction of six day and other more flexibile working practices, and local productivity schemes, will further reduce the degree of control of the national executive over the NUM.

The escalation of the dispute over manning levels on the Isle of Man ferries led to injunctions being sought by both P and O and Sealink. Such action was inevitable given the unions call for secondary action and without any pre-strike balloting. However, the NUS successfully evaded heavy fines by successfully arguing that independent action existed between its members and P and O. Within the industry there is management pressure to reduce manning levels. P and O are seeking to reduce absenteeism, currently running at 15%, and also a reduction in the number of crews per ferry from 3.6 to 2.5 per ferry. Suggestions that Scandanavian ferry companies have achieved manning levels of 1,5 crews per ship indicate that further management initiatives are possible. The general decline in membership has prompted the NUS to enter into merger talks with the NUR.

Elsewhere within the transport sector British Rail continue with its plans to simplify the established collective bargaining and arbitration machinery. The plans do not envisage an abandonment of the principle of bargaining at the national level, but rather a refocussing of the system to relate bargaining to the business of the five business sectors and to give managers authority to conduct negotiations at local levels.

Widespread industrial action within the National Health Service constituted the major focus of industrial relations in the past quarter and will continue to be the dominant issue for sometime. Pay, allowances, staffing, frustration and under funding have combined to lead to action by several groups. At the core of the dispute are the twin issues of funding levels and attempts to engender market criteria into the management and perception of health. The deepening sense of despair within the service has lead to high levels of staff turnover and to the RCN considering the abandonment of its 'no strike' policy. Both trade unions and professional bodies have been alarmed by reports of a policy initiative, appearing in the Guardian (28.1.88), to encourage the Government to disband a number of 'old fashioned trade unions' including NUPE, COHSE, and ASTMS. Although at this stage such proposals have only been 'trailed' in right wing groups.

It is evident that plans to reform work arrangements within the Civil Service have been under development for some time. One ten stage proposal envisages rewriting the basic civil service contract to allow for considerable variations in working conditions and arrangements. Such changes would permit the introduction, on a wide scale, of extensive numbers of:- part time employees; temporary workers and sub contracting. Equally, these changes would facilitate flexible working hours, self-employed civil servants and staff working from home, with the possibilities of pay being related to annual hours worked rather than to established collectively bargained salary structures. Additionally, a cadre of retained retired staff is envisaged to meet short term peaks in demand for labour.

Similar issues of reform continue to preoccupy COSLA and local authority bargaining structures. Whist COSLA foresees problems emerging because of the falling-off of relative pay for local authority staff, the longer-term problems hinge over how to regionalise pay and engender flexibility into the national system. The initial proposals are for the rentention of a national framework, but with discretion and variation at local and regional levels.

Seasonal industrial action within the Post Office was prompted by the long running issue of reductions to the length of the working week and management concern to reduce the rate of overtime working, currently accounting for 14% of the annual wages bill. Attempts to vary working hours and employment patterns to peaks in demand coupled with other productivity proposals have figured in negotiations for some time and look likely to continue through 1988.

The Wapping dispute continues to provoke problems both for the TUC and EETPU. The former rejected the EETPU's report, thus raising questions as to whether this year's TUC will see moves to suspend or expel the union. The EETPU continues to reassess its role in the dispute.

PROGNOSIS

Growth in the British economy continues at a high rate. To date there is little evidence that the October collapse in stock market prices has had much effect on consumer demand or on business confidence. According to the recent CBI Industrial Trends Survey, export prospects during the coming months are expected to be the most likely casualty of the upheavals in the world's financial markets. The expected decline in the UK growth rate during 1988, compared with the rate achieved in 1987, is likely to prevent any occurrence of the symptoms of overheating which were evident before the events of last October. However, a further significant deterioration in the balance of payments is to be expected this year. The size of the deterioration and the extent of downward pressure on the exchange rate will in part depend on how successfully the economy contains incipient cost inflationary pressures.

The CSO's two leading economic indicators both indicated that the economy would continue to enjoy an upswing in 1987. However, since July 1987 the two indicators began to diverge. The **shorter leading indicator,** which purports to predict turning points some six months in advance, continued to rise until October but fell back slightly in November. The **longer leading indicator,** which purports to predict turning points in economic activity one year in advance, reached a peak in July and has fallen gradually since. The fall in October was the most marked. The decline in this index largely reflects the fall in share prices, one of its principal components. While the latest indices are difficult to interpret because of a lack of information on a number of component series, their recent movements appear to be in line with the expectation that growth will be lower in 1988 than in 1987.

The latest Treasury analysis of independent forecasts suggests that the economy will grow by 2.4% in 1988 compared with 4% in 1987. Growth is expected to slow down more markedly as the year progresses. However, despite the expected slow-down in growth, the balance of payments is forecast to deteriorate significantly. On average, the forecasts suggest that the current account deficit will widen from £2bn in 1987 to £3.6bn this year. Unemployment is expected to continue to decline but at a slower rate, averaging 2.6m in the fourth quarter of 1988 compared with 2.7m in the same quarter of 1987. Inflation is expected to remain at around 4% by the final quarter of the year.

In the coming Budget the Chancellor has the difficulty of reconciling an appropriate fiscal policy stance with his political objectives of lower tax rates and tax reform. Current estimates of the public sector borrowing requirement (PSBR) indicate a cumulative surplus of £6.9bn for the first ten months of the current fiscal year. Despite the expectation that the growth of demand will slow down in 1988 and the current account deteriorate, the present economic situation does not appear to warrant a significant relaxation of the current fiscal policy stance. From the CBI Industrial Trends Survey, the current level of capacity utilisation is probably as high now than at any time since the boom of 1973/4. Secondly, while the deterioration in the current account will serve to reduce the growth of final expenditure, any fiscal stimulus would be bound to have a further deteriorating effect on that account. Maintenance of the current fiscal policy stance should ensure that demand grows in line with capacity. The growing evidence of cost-plus inflationary pressures would appear to require that the government 'holds the line' on monetary policy by maintaining the exchange rate at round about current levels. The disinflationary benefits of maintaining the exchange rate probably outweigh the foregone benefits of an improvement in the current account through a depreciation of the sterling, and particularly the D-Mark/sterling, rate. Even on current projections the expected deficit is, at under 1%, small in relation to GDP. Moreover, UK foreign exchange reserves are high.

Maintenance of the current fiscal stance implies that the Chancellor could remit about £4bn to £5bn in tax cuts during the forthcoming fiscal year. A fiscal adjustment of this size would be necessary to offset the progressive increase in tax revenues following further growth in the economy and a rate of growth of public expenditure which is slower than that of GDP. We have argued in earlier **Commentaries** that the economic rationale for further tax cuts - particularly in the basic rate - is dubious. It is possible that they may have an effect in mitigating inflationary pay claims but the more likely effect will be to harm the balance of payments through their effect on consumer demand. The incentive or supply-side effect of tax cuts is not proven to say the least and the evidence that does exist suggests that they are just as likely to have a disincentive as an incentive effect. The balance of the economic argument probably favours action which stimulates investment via either tax cuts and increased allowances or direct expenditures. Moreover, the government appears to underestimate the harmful supply-side effects that can result from a deteriorating social infrastructure due to a relative deficiency in the level of public expenditure.