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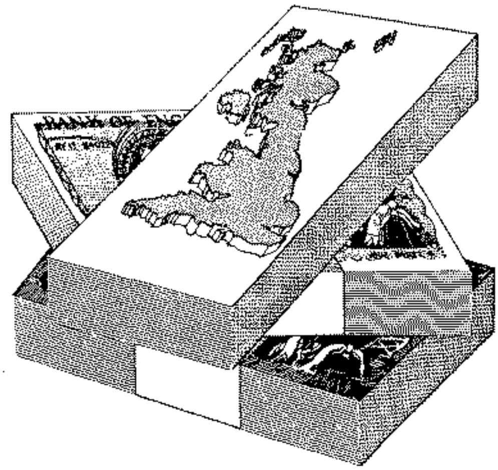
The British Economy

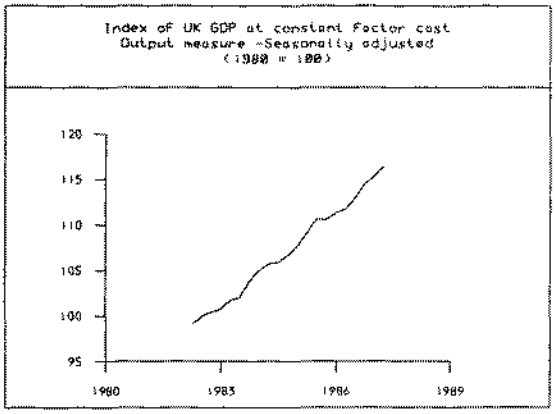


OVERVIEW

The British economy continues to grow strongly at a rate in excess of other major industrial countries. However, future prospects have been considerably clouded following the dramatic collapse of share prices in the world's major financial centres. The outlook for 1988 and beyond is likely to be heavily influenced by developments elsewhere in the world economy.

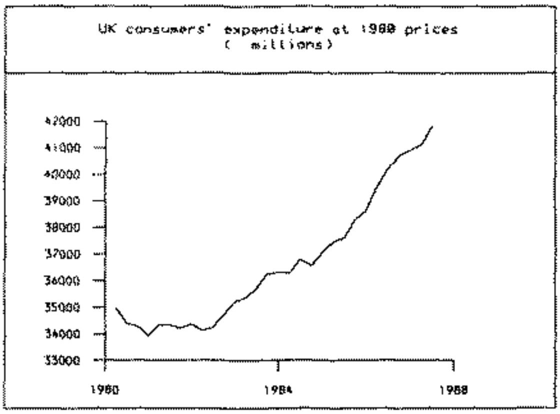
MACROECONOMIC TRENDS

The average measure of **GDP at current market prices**, nominal or 'money' GDP, rose by 1.7% between the first and second quarters of 1987. The increase was therefore similar to that recorded between the previous two quarters, which represented a fall from the 2.3% increase recorded between the third and fourth quarters of 1986. Over the year between the second quarters of 1986 and 1987 'money' GDP rose by 8%. After allowance for inflation, the average measure of GDP **at constant market prices**, 'real' GDP, rose by 0.4% between the first two quarters of the year, compared with a 1.2% increase between the last quarter of 1986 and the first quarter of 1987. The increase in the GDP price deflator therefore accelerated between the two periods. Over the year between the second quarters of 1986 and 1987, 'real' GDP rose by 3.7%, compared with the 4% increase recorded, on revised figures, in the year to the preceding quarter. 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 first two quarters of the year, which was similar to the increases in the previous two quarters. Overall, this measure recorded an increase of 4% between the second quarters of 1986 and 1987, maintaining the rate of growth achieved in the year to the first quarter.



It is clear from these data that the UK continues to maintain a high rate of real economic growth. This is supported 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 rose markedly in June, July and August and so has returned to an upward path after the slight decline and stagnation earlier in the year.

Real **consumers' expenditure** rose by over 1.5% between the first two quarters of the year. The apparent slackening in the growth of this key aggregate, which began to occur during the latter part of 1986 and the first quarter of 1987, does not appear to have continued into the second quarter of the year as expenditure on most categories of goods and services increased. Between the second quarters of 1986 and 1987 real expenditure was 4% higher, compared with an increase of 3.5% between the first quarters of the two years.



The Department of Trade and Industry's (DTI) estimates for the volume of retail sales has fluctuated over the year but even though the most recent figures for September show a provisional 0.8% fall over the previous month, the index still appears to be on an upward trend. In the three months to September, the index was 2.5% higher than the preceding three months and 6.5% greater than in the same period last year. The September CBI/FT Survey of Distributive Trades reported an improvement in retail sales compared with August's disappointing performance. The balance reporting higher sales was 42% in September compared with 38% in August. And for the year as a whole, a balance of plus 42% reported that sales were higher than in September 1986. Retailers expectations of future sales growth continue to be strong, with a balance of plus 55% expecting sales to be higher in October than in the same month last year. This compares with a balance of plus 60% and plus 52% predicting an increase for August and September, respectively. However, retailers' expectations have consistently been frustrated since the beginning of the year with a lower outturn than predicted in seven of the first nine months of the year.

Many of the underlying determinants of the growth of consumer demand continue to be buoyant, although the wealth effect of the recent significant decline in share prices is likely to have a depressing effect on consumers' expenditure in 1988 and the final months of this year. After increasing to an annual average rate of 7.75% in April, the growth of **average earnings** has continued at that rate in subsequent months. An analysis of pay prospects by Incomes Data Services at the end of September concluded that the rise in average earnings would remain close to 8% for the rest of the year. **Real personal disposable income** (RPDI), which, on revised figures, rose by 1%, 1% and 1.5%, respectively, during the final two quarters of 1986 and the first quarter of 1987, increased by a further 0.5% in the second quarter of this year. The annual increase to the second quarter was 3.5%, one and a half percentage points below the increase over the year to the first quarter. Nevertheless, between the first and second quarters consumers' expenditure grew more quickly than RPDI as the **saving ratio** fell to 8.6%. The saving ratio should be expected to rise in coming months, producing a depressing effect on consumers' expenditure as many individuals seek to rebuild their wealth following the significant downturn in the stock market. The Treasury's most recent forecast, contained in the Autumn Economic Statement, suggests that consumers' expenditure will grow by 5% this year, compared with nearly 6% in 1986.

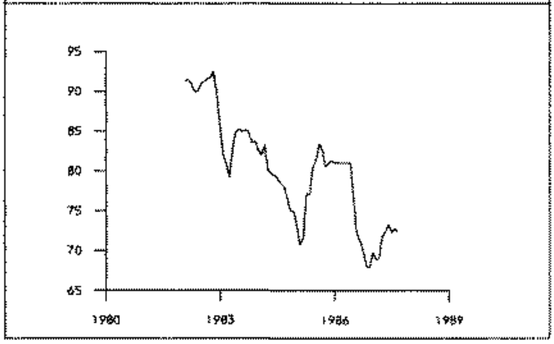
General government consumption rose by 0.7% between the first and second quarters of the year but remains largely unchanged over the year. The expected outturn for 1987 is for a small increase of 0.5%.

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 the 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 reflects, in part, the distortionary effects of the withdrawal. However, a comparison of investment between the first half of 1986 and 1987 shows an increase of 4.5%, while manufacturing investment rose by 7% between the second half of 1986, and the first half of 1987. As reported in earlier **Commentaries**, investment was expected to increase during 1987, following reductions in mortgage rates and the increasing significance of capacity constraints due to the continued growth of consumer spending and external trade. The continuing high levels of company profitability were expected to facilitate the expansion. The Autumn Statement suggests that investment should increase by 5.5% over the year as a whole.

During 1986, **the visible trade balance** on both oil and non-oil accounts deteriorated markedly producing a deficit of £8.5bn, compared wih a deficit of £2.2bn in 1985. The fall in the price of oil and the J-curve effects of sterling depreciation largely accounted for the worsening of the balance. In particular, the **non-oil trade deficit** increased from £10.3bn to £12.5bn. During 1987, the non-oil trade deficit improved during the first quarter to £2.3bn from the £3.5bn deficit recorded in the final quarter of 1986. However, this improvement was primarily due to a 6.5% fall in import volumes. The volume of exports actually fell by 1% and the terms of trade remained largely unchanged. The August **Commentary** suggested that the non-oil trade deficit could be expected to deteriorate further during the remainder of 1987. The continuing growth of consumers' expenditure was expected to increase the volume of imports, and exports were likely to be adversely affected by the appreciation of sterling earlier in the year. Subsequent events have confirmed this prognosis. In the second quarter export volumes fell by nearly 2% while import volumes rose by nearly 7%. The non-oil trade deficit increased to £3.4bn even though the terms of trade improved by 3.5% following further appreciation of sterling and lower commodity prices. Some improvement in non-oil export volumes has occurred since June but the volume of non-oil imports has increased rapidly. For 1987 as a whole, it is expected that non-oil export volumes will have risen by 7%, compared with an expected increase of 8% in the volume of non-oil imports.

The **oil surplus** fell from £8.1bn in 1985 to £4.1bn in 1986. The firming of oil prices towards the end of 1986 and the beginning of 1987, coupled with some improvement in net export volumes, led to an increase in the oil surplus from £0.62bn in the third quarter of 1986 to £0.78bn in the final quarter of the year. The improvement continued into the first quarter of 1987 with the surplus rising to nearly £1.2bn. Preliminary figures for the second quarter show a slight fall to a surplus just above £1bn. The surplus is expected to reach £4bn for the year as a whole, which is little different from that recorded in 1986.

Sterling effective exchange rate
(1975 = 100)



The figures for the balance on **current account** for 1986 have been revised again to show a deficit of £0.98bn, the first annual deficit for seven years. In the first quarter of 1987, the current account returned into surplus at a revised figure of £672m, due largely to the fall in non-oil import volumes and the improvement in the oil surplus. However, the subsequent deterioration in non-oil trade, which was more than sufficient to offset a slight improvement in the surplus on invisibles, produced a deficit in the second quarter of £174m. Deficits of £310m in July and £929m in August resulted from a further surge in import volumes. Both export and import volumes rose by over 6% in July, but in August export volumes actually fell by nearly 4%, while the volume of imports rose by nearly 5%. The current account is expected to continue to deteriorate. Preliminary figures suggest that by the end of the third quarter the cumulative deficit for the year stood at £1.25bn and the Treasury is forecasting a £2.5bn deficit for 1987 as a whole.

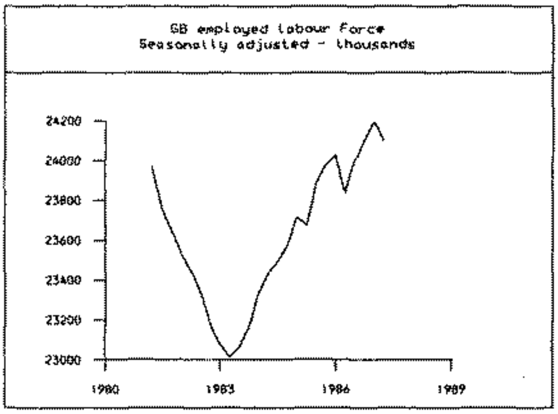
In the three months to August 1987, the **output of the production industries** is estimated to have increased by 1% from the level of the previous three months, compared with a 1% increase in the preceding three month period. The increase took output to a level 3% higher than in the same period a year earlier. Manufacturing output rose at a faster rate, increasing by 2% in the three months to August to a level 6% higher than in the same period last year. Domestic production has therefore continued to maintain a high rate of growth, with the usual variation in performance between individual sectors. The output of the energy sector continues to fluctuate having fallen by 1% over the preceding three months, compared with a 1.5% rise in the earlier period. The level of output in this sector now stands at a level 3% lower than in the same period last year. Within manufacturing, the output of the metals industry continued to expand rapidly rising by 6% over the preceding three months, while that of textiles and clothing, and 'other manufacturing' increased by 3%. Minerals output rose by 2%, while that of engineering and allied, and food, drink and tobacco, rose by 1%. Output in other broad industry groups remained largely unchanged. Construction industry output fell back in the second quarter, being 3.5% lower than in the first quarter of the year. Nevertheless, output in the industry is still 4% higher than in the same period last year. Overall, the decline in construction output resulted in the output of the production and construction industries being 0.5% lower in the second quarter than in the first quarter of the year, but 2.5% higher than in the second quarter of 1986.

The output of the consumer goods industries increased by 2% in the latest three month period, compared with an increase of 0.5% in the three months to May and a fall of 0.5% in the preceding three month period. Output in both the intermediate and investment goods industries continued to increase although at a slower rate, rising by 0.5% in the three months to August compared with a 1.5% increase in the three months to May.

THE LABOUR MARKET

EMPLOYMENT AND UNEMPLOYMENT

The employed labour force in Britain has increased in every quarter since March 1983. During 1986, the rate of increase first slackened to 13,000 and 23,000 in the first and second quarters respectively, then rose to 54,000 and 76,000 in the final two quarters of the year. Continuing improvements in the growth of UK output led to a further increase in employment growth in 1987, with, on revised figures, recorded increases of 108,000 in the first quarter and 134,000 in the second. The employed labour force has therefore risen by 372,000 in the year ending June 1987 and by 1,362,000 since March 1983.



The composition of the change in employment in the second quarter of 1987 has again tended to follow the established pattern, although the decline in manufacturing employment has ceased. The number of employees in the service sector rose by an estimated 99,000, compared with a revised figures of 114,000 in the first quarter. Manufacturing employment rose by 10,000, compared ith a reduction of 31,000 in the first quarter. In other sectors, energy and water continued to decline with employment falling by 5,000 compared with a reduction of 14,000 in the previous quarter. The other industries category, which includes construction, agriculture, forestry and fishing, recorded an increase of 5,000, compared with an increase, on revised figures, of 14,000 in the first quarter of the year. However, the level of employment in these industries is little changed since the final quarter of 1985.

The growth of **productivity** - output per head - in the whole economy continued to improve throughout 1986 and into the first quarter of 1987, rising from a 1.6% increase over the year in the first quarter of 1986 to 3.5% in the first quarter of 1987. In the second quarter, the rate of growth of productivity slackened somewhat as the percentage increase on a year earlier fell to 2.7%. In manufacturing, productivity growth improved markedly in the second half of 1986 and the improvement has continued into 1987, with the percentage increase over the year standing at 7.2% and 6.5% in the first and second quarters, respectively. In the three months to August 1987, output per head in manufacturing was 1.7% higher than in the preceding three months and 6.8% above the same period a year ago.

The underlying increase in average weekly **earnings** in the year to August was 7.75%. The rate of increase has continued at this high level since the increase from an annual average of 7.5% in May. However, the Chancellor's Autumn statement makes clear that this increase is more than accounted for by increased overtime payments. Once the data are adjusted for the number of overtime hours the growth in average earnings appears to have fallen somewhat over the past year, due to a reduction in the size of pay settlements since the second quarter of 1986. However, recent evidence provided by Incomes Data Services suggests that the size of pay settlements has risen again to match last summer's range of between 4.5% and 7.5%. Average earnings are expected to grow at close to an 8% annual rate throughout next year.

Improvements in the growth of productivity resulted in **unit labour costs** falling during the second half of 1986, particularly in manufacturing. By the first quarter of 1987, the percentage increase on a year earlier had fallen to 0.6% in manufacturing, compared with a recorded annual increase of 7.5% to the first quarter of 1986. Unit labour costs in manufacturing were therefore growing more slowly than in other major industrial countries for the first time since 1983. For the economy as a whole the comparable figures were 4% and 6%, respectively. However, there is some evidence that wages and salaries per unit of output have been rising again since the first quarter. In the second quarter, the percentage increase on a year earlier was 1.2% in manufacturing and 4.6% in the whole economy. And in the three months ending August, unit labour costs in manufacturing were 1.5% higher than in the same period last year.

Seasonally adjusted **unemployment** has been on a downward trend since August of last year. In the six months ending September, the reduction has averaged 44,100 per month, which represents a further acceleration of the decline noted in the May and August **Commentaries.** By October, seasonally adjusted unemployment, excluding school leavers, provisionally stood at 2.715 million, or 9.8% of the working population, down by 58,000 on the previous month.

INDUSTRIAL RELATIONS

Recent government figures indicate a continuing decline in the incidence of industrial action, the number of days lost in 1986 being the lowest since 1963. However, despite the image of industrial harmony the pace of change in industrial relations has dramatically increased in recent months.

Within the Public Sector the 'Fresh Start' proposals to reform pay and conditions amongst prison office staff have become bogged down on the issue of manning levels. The POA, in the light of disturbances within prisons, introduced limited industrial action. Nationally neither side wished to escalate the action and discussions continue over the question of additional officers; however, at local level the issue is an important one.

Industrial action by HM Coastguards over a pay increase did not materialise. However, the low rates of pay for coastguards as compared with rates for similar groups suggest that industrial action in the future is probable.

The preparedness of air traffic control staff to take industrial action, unlike their colleagues in the coastguard service, has prompted a different strategy by the government. The CAA has sought to break the link between the civil service and CAA staff pay. The union has delayed settlement, seeking clarification on the procedures for arbitration, the machinery for appeals against future redundancies, and a guarantee that future pay settlements will improve on those agreed within the civil service.

The CAA is not the first public sector area to seek to sever pay links with the civil service, both British Nuclear Fuels and BAA airports have taken such action, on the gounds that such a break is crucial in plans to improve productivity and efficiency. Such developments have heightened concern amongst Civil Service union leaders over more general moves towards local pay supplements and the introduction of formal regional variations in pay within the public sector. Similarly, more flexible patterns of employment are likely to develop. The SCPS, for example, has voted to accept an agreement which, according to the Treasury, contains new management policies including: the Government's new financial management initiative; new technology and new working practices; the use of outside consultants, short term contracts and the direct entry of staff at senior levels.

Further examples of this policy of distancing sectors from the rest of the Civil Service are illustrated by the three stage pay increase at GCHQ and introduction of random searches of staff.

Recognition by employers of the potential of greater flexibilities in labour utilisation, and the growth in the size of the flexible workforce (the Department of Employment estimated that approximately a third of the labour force could be seen as flexible workers), have prompted a number of developments in the private sector. The Building Employers' Confederation has sought to include self employed in the long-standing joint agreement regulating the sector. The register of workers would therefore include self employed as well as those directly employed. The EEPTU is co-operating with the Electrical Contractors Association on the agency, established by ECA for self employed electrical contracting workers. Both the union and the ECA hope this will enable them to retain effective control over those switching from the core of directly employed to self employed. Similarly the NUS is planning to establish a crew agency to compete with firms who supply crews to shipping companies outside the labour recruitment system established by thge General Council of British Shipping. The union hopes this will reduce the practice of staffing vessels under non-union arrangements.

Flexible work practices, with or without moves to reduce trade union influence, have featured in negotiations and management policies in a number of sectors. The CBI, in noting a series of workplace changes, drew attention to the general drift towards individualising workplace bargaining and the development of flexible work practices.

Arguments for flexibility underlay moves to de-unionise in a number of food processing and distributive firms. In the public sector British Rail aims to abolish existing collective bargaining arrangements and de-recognise unions representing its most senior 800 managers.

British Rail is planning radical changes to pay bargaining and employee relations. The objective is to simplify the bargaining structure and to lower the level of bargaining to reflect regional and function or business needs of particular sectors. This could be a precursor to regionalising pay. More generally, British Rail is introducing merit appraisal for its supervisors. This follows the application of appraisal and then performance pay schemes in Travellers Fare, BR's catering subsidy. From mid 1987 all regions are testing performance appraisal of supervisors with a view to permanent systems starting next year. In Travellers Fare the system is now being tested for clerical and manual workers. The plan is to extend flexible rostering, including hourly pay, to all 3,000 blue collar staff following the practices in Casey Jones, its fast food chain network.

The BA offer of a two year package to staff likewise reflects a wish for work changes which lead to a greater flexibility in the contractual bases under which staff are employed, more flexible rostering of workers, and the implementation of starter pay rates, below the grade minima for recruits.

Curiously the CBI has challenged such moves to decentralise pay and the government's case for the abolition of national pay bargaining, arguing that cohesion in pay rates and bargaining structures is essential to maximise benefits from the introduction of performance related pay. Additionally, the IPM has argued that the Government's legislation is now provoking industrial action. The voting requirements can limit negotiators freedom of action and hence disrupt shopfloor harmony.

Nevertheless, there is evidence to suggest that employers use of injunctions and legal weapons is increasing. Between May 1984 and April 1987, 62 injunctions were secured. Issues of pre strike ballots accounted for two-thirds of all injunctions; unlawful picketing 9 injunctions and secondary action 13 injunctions of which 10 related to blacking. The figures were dominated by three industries - printing, public services (teachers), transport and shipping. The main use of the legislation being to stop strikes.

Details of the government's new employment bill were announced at an Institute of Economic Affairs conference. The IEA has recently published a revised paper advocating a shift in emphasis away from promoting industrial democracy to protecting the public from the effects of strikes in essential services. A two stage programme for removing any remaining trade union legal immunities was proposed. The first step would cover those unions taking industrial action in monopoly essential services - water, gas, electricity, telephones and health etc. There have been some indications that the government may consider some of these suggestions at a later stage.

The government's White Paper, although more moderate in tone, has far reaching implications. Its intention is to prevent unions from disciplining their members if they defy a ballot in favour of a strike. As the minister argued, 'unions do not have the right to punish where they cannot persuade, to coerce when they cannot convince', union members have obligations to employer and family as well as to the union. A new provision, clause 16, requires a trade union intending to organise industrial action to conduct separate ballots at each place where members work. Section 16(2) requires that in a ballot for industrial action there must be a majority at each workplace, rather than a simple overall majority at the national level. This is likely to have a major impact on national negotiations, especially those in the public sector. It will be very difficult for unions to achieve such a requirement.

The Secretary of State for Education's proposals to reform primary and secondary education have met with considerable comment and criticism from educational unions and associations. The NAHT broadly accepts the principle of delegating financial responsibility to schools but is opposed to the detailed proposals in the three other areas: introduction of a national curriculum and pupil testing; provision for schools to opt out of the local authority system; and open enrolment, requiring schools to admit as many pupils as they can accommodate.

The opposition to the proposals stems from a combination of educational and employment concerns. Educationally, the fear is that the proposals constitute an attempt to create a new tier of quasi independent schools or private schools. Amongst employment concerns are the fears that the proposals will result in an intensification of teachers' work; secondly, fears have been expressed as to the security of employment if governors can hire and fire; thirdly concern has been expressed as to future development and career opportunities; and fourthly the NUT and NAS/UWT fear the rise of managerialism in schools.

Despite such common concerns divisions between teaching unions still exist, over policy and future pay claims.

Local government is likewise considering longer term reforms. The review of pay and industrial relations policies is due in 1988 and should constitute the basis for a discussion about the future role and extent of national and local bargaining. In the era of competitive tendering the status of the national agreement will have to change. Already a number of English local authorities, especially in the south of the country, are considering pulling out of the national negotiating structure on the grounds that the new national agreement does not give them sufficient flexibility. The Associations of County and District councils are seeking a greater local discretion in pay bargaining and a general decentralisation.

A number of local authorities have faced more immediate issues. West Glamorgan's rationalisation plans for local fire services prompted sporadic industrial action. This dispute was seen by many as a test of the union's ability to influence the series of reviews which will be conducted throughout the country and the extent to which councils, eager to make savings, are able to reduce fire cover to minimum levels.

Nalgo's policy of recruiting civilian staff in police services has been based on the issue of the relativly low pay of civilian staff compared with uniformed colleagues undertaking the same work. There are major implications facing authorities from such a development.

Industrial action over a number of issues continued in the mining industry. British Coal's moves to increase labour flexibility and introduce a new disciplinary code led to an overtime ban by the NUM. The union is convinced that management is using section 10, the definition of gross industrial misconduct, to dismiss union officials for organising industrial action. The dismissal of one official allegedly for such an offence, was the spur to the introduction of the overtime ban.

It is questionable whether the result is a vote of confidence in Arthur Scargill president of the NUM. His ability to use the issue as a means of reasserting his authority and papering over the conflicts in the union was undoubtedly aided by managements' incompetence in presenting and introducing the new code. It evoked all the images of a hardline management, and as such generated widespread and genuine mistrust and resentment towards the code.

Following discussions with ACAS some concessions were made by British Coal. However, these were rejected by the NUM who restated their demands that:

1. the disciplinary procedure be completed within 14 days including final appeal;
2. miners should not be disciplined for incidents away from their work;
3. the pit umpire scheme should be reintroduced;
4. miners should not be disciplined for participating in union activities;
5. a joint working party should be established to deal with code anomolies;
6. those miners already disciplined should either be reinstated or their cases should go to an independent umpire.

The NUM approached the ban with mixed feelings, the continuation of the programme of pit closures and fears of vulnerability combined to thwart attempts to increase the level of industrial action. By November, with the deferring of a pay increase by British Coal to NUM members, there were signs that the overtime ban was collapsing.

Intermittant action over use of casual labour and the threat of major industrial action over the Christmas period has featured in the Post Office. The actions stem from a long-running campaign by management to improve labour utilisation and productivity through the introduction of more flexible manning arrangements. An equally long running issue has been the union's attempts to gain a three hour reduction in the length of the working week.

Apart from the protracted national negotiations the main interest in the engineering industry are the developments at Ford. Management has sought to develop the role of the foreman by introducing, in Britain, what it sees as the best elements of supervisory and work practice from its plants in both Germany and Spain. The adoption of such practices would give supervisors a broader range of duties and imply the return of section leaders, or assistant foremen.

However, these proposals were initially rejected by supervisors. Notwithstanding northern disagreements, all twelve unions represented at Ford have embarked on joint industrial action in their support of their pay claim. Elsewhere Vauxhall plans a radical deal on pay, conditions and shift patterns, which would eliminate the need to stop production for lunch breaks etc.

Developments within insurance, banking and finance have illustrated BIFU's weaknesses. Action at both Barclays and TSB collapsed through lack of support. Barclays made its pay offer directly to staff rather than via the union, the Midland Bank closed the offices lent to BIFU and withdrew the facility for the union to send mail via the bank's internail mailing facilities. Elsewhere the Alliance and Leicester Building Society has introduced merit-only pay increases. This implies the scrapping of annual cost of living increases, basing pay increases on individual performance has been accepted by the staff association. A similar scheme has been adopted by Abbey National.

The vote by production staff at News International's plant at Wapping on representation by any union other than EEPTU has a number of implications. It will strengthen NGA and SOGAT's attempts to secure recognition at the plant. In many respects the vote is a sign of the lack of confidence in the EEPTU's ability to improve wages for a variety of reasons, including the policies of TUC. However, this was not a victory for the print unions, of the 846 ballotted 321 voted to seek another union, 239 voted for self representation via the staff council, 140 voted for EEPTU, and 146 didn't return papers.

The Trades Union Congress took place amongst growing concern at the decline in trade union membership and fears for the future. Such concerns spurred Congress to seek to minimise the long running differences between unions in favour of agreement over a review of trade union organisation and inter union relations. Despite the air of harmony considerable differences were apparent as to the future state and structure of the movement. TASS and ASTMS, soon to merge, have written to 100 unions (6 in TUC) suggesting they should join with them in the new planned union - Manufacturing, Science and Finance.

Others have questioned whether merger waves and the adoption of a 'business union philosophy' will be long term features of the movement. Some have argued that the low water mark of trade union density has been reached, suggesting that there will be minor fluctuations around a slightly declining trend for the next 5-10 years. Union density is now at 41.6% - or 60% in manufacturing, 80% in the public sector but only about 15% in the private service sector. However, such an optimistic view possibly ignores the potential decline in public sector membership. In the light of further declines in membership, policies to engender a new realism, a better image and an end of inter union strife, the agency of TUC review, are vital for the movement.

PROGNOSIS

The Briish economy continues to grow strongly at a rate in excess of other major industrial countries. However, future prospects have clouded appreciably since the publication of the August **Commentary** due to the dramatic collapse in share prices in London and other major financial centres. The outlook for 1988 and beyond is likely to be heavily influenced by developments elsewhere in the world economy. The major uncertainties concern: the progress likely to be made in reducing the current account and budgetary imbalances, particularly the US Budget deficit; the future response of the stock and foreign exchange markets to that uncertainty; and the effect on business confidence.

The CSO's two leading indicators both exhibited sustained increases from November 1986 to July 1987, suggesting an upswing in the rate of economic activity. However, after July the two indicators began to diverge. The **shorter leading indicator**, which purports to predict turning points some six months in advance, continued to rise through June, July and August after exhibiting only a slight increase in May. Movements in consumer credit continued to dominate the behaviour of this index. The **longer leading indicator**, which purports to predict turning points in economic activity one year in advance, declined in August and September, reflecting the rise in interest rates. The sharp fall in share prices at the beginning of August also served to depress this index. The thirty percent fall in the FT/Stock Exchange index in October will clearly have an even greater depressing effect on the longer leading indicator when the figures are published for that month.

Prior to the collapse of share prices the prospects for further output growth continued to be highly favourable. The recent CBI Quarterly Industrial Trends Survey, which was conducted in the last week of September and the first two weeks of October, reported that business confidence had improved for the fourth survey in succession. Order books were more above normal than at any time since 1977, when the question was first asked. Manufacturing output continued to grow strongly, with a balance of plus 25% of respondents expecting output to increase further over the next four months. And there were few signs of overheating, although the proportion of firms working below capacity had fallen to 41%, the lowest since October 1960, which in the view of the CBI highlights the need for investment in industrial capacity. Nevertheless, 85% of respondents reported fixed capacity to be adequate to meet expected future demand.

The fall in stock market prices will have a negative effect on the real economy as spending falls following the reduction in the wealth of shareholders. In the UK it is estimated that for a given reduction in share prices the negative wealth effects are likely to be smaller in the UK than in the US. This is because share ownership is more widespread in the US than in the UK. Pension funds and other institutions which hold the great majority of UK equities are unlikely to reduce their payment of benefits or raise the costs of contributions. The current consensus appears to be that both the growth of consumer spending and GDP growth will be about half a percentage point lower in 1988 than otherwise would have been the case. For example, the most recent Treasury forecast contained in the Autumn Economic Statement, predicts that GDP growth will be 2.5% next year compared with the 3% forecast in September and a likely outturn of 4% this year. However, these forecasts must be subject to more than the usual degree of uncertainty. Expectations of further declines in stock markets prices may lead to additional increases in the saving ratio and hence lower than predicted consumption. Firms' expansion plans may also be adversely affected, both by the existing and anticipated increases in the cost of equity finance and by the intangible effects of the crisis in the world's financial markets on business optimism. However, on the credit side the demand effects of the collapse of the share price index should reduce any overheating pressures which arguably were the result of a too rapid rate of economic growth.

The two half percentage point cuts in interest rates will go some way to ease the liquidity pressures on institutions and the increased cost of equity finance which have resulted from the fall in share prices. The Chancellor's decision not to use bond sales to sterlise the effects on the money supply of the Bank of England's support of the dollar will also serve to reduce the pressure on liquidity. Nevertheless, while the performance of the British economy continues to be sound, the government must be prepared to intervene more actively in the economy if the world financial crisis deteriorates further and precipitates a major recession in the US. In this situation, preservation of even a moderate rate of sustained growth would not only require further interest rate cuts but also an expansion of the public sector borrowing requirement (PSBR). By taking advantage of buoyant tax revenues to cut the PSBR to £1bn in 1987-88 and 1988-89, even with the likely tax cuts of £3bn in the next budget, the Chancellor has considerable scope for the adoption of a contra-cyclical fiscal policy if required. But if that recession appears likely to materialise then the interests of the economy will be best served by an expansion of public expenditure rather than extra tax cuts. Attempts to maintain the growth of the British economy in the face of external recession will almost certainly lead to a deterioration in the balance of payments. The deterioration would be minimised by the adoption of a rational programme of public expenditure increases rather than further cuts in the basic rate which would leak into imports to a considerable extent.