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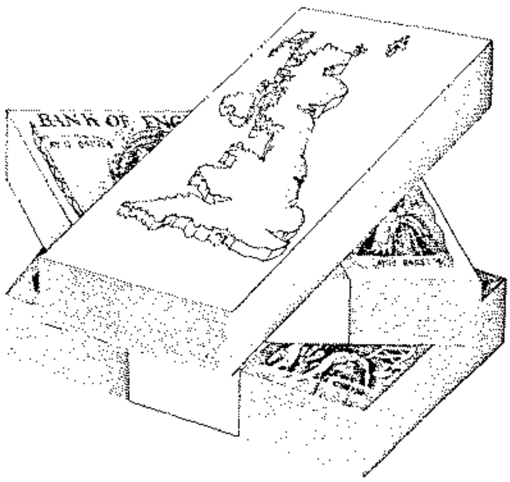
The British Economy



In his November Statement the Chancellor of the Exchequer has forecast continuing expansion of the economy during 1986. The recent growth of exports and investment is not expected to be maintained but consumer spending, boosted by higher real earnings and tax cuts in the Spring Budget, will rise.

The Chancellor's recent caution over the prospect of interest rate reductions is consistent with his forecast that sterling's trade-weighted index is likely to remain close to its average for the past six months. This combination of high interest rates and a strong pound is unlikely to improve prospects for UK manufacturers. There is, however, some slight increase in provision for increased public expenditure on capital projects in the areas of housing, health and transport.

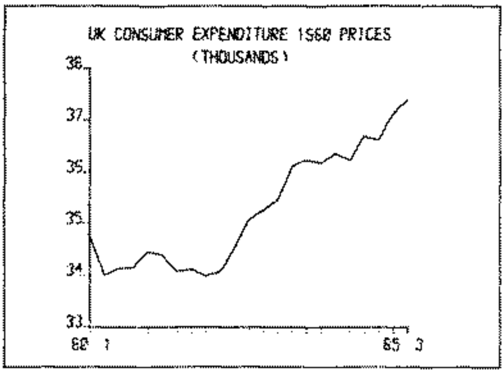
While the Chancellor reasserted his commitment to continuing restraint on public expenditure, his statement provided no detail on important issues affecting the public sector borrowing requirement such as the probable extent of oil revenues, likely expenditure over-runs and developments in public sector pay settlements. The outcome of these elements will determine the scope for tax reductions.

MACROECONOMIC TRENDS

As in earlier quarters of 1985, the CSO's cyclical indicators continue to give unclear signals about developments in the economy and, consequently, provide no secure basis for forecasting the next turning point in activity. Difficulties of interpretation created by the effects of industrial disputes, most notably the coal strike, remain and are, as during the previous quarter, compounded by the extent of volatility in certain of the component series.

After falling slightly in June the longer-leading index, which typically predicts turning points about one year in advance, rose in each of the three suceeding months. By September this index had risen almostto the level attained in January. This reversal of the gradual decline over the first half of the year was attributable to higher share prices. The shorter leading index, which is intended to predict turning points some six months in advance, also rose in July and August after falling in each month from March. These recent increases result from the continuing growth of consumer credit and the marked increases in new car registrations in August. The picture is further complicated by movements in the coincident indicator which reflects current developments. This index rose for fourteen consecutive months to the end of July before decreasing marginally in August. The upward trend in this index is attributable to recovery from the miners' dispute.

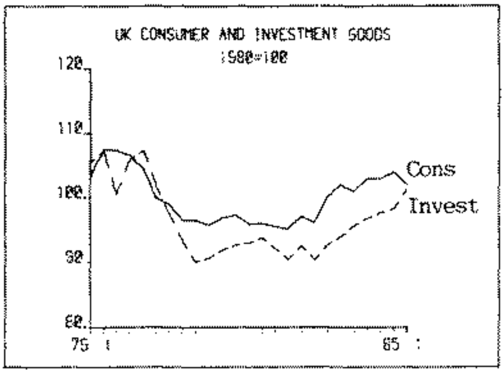
After adjustment for the direct effects of the miners' dispute, gross domestic product is estimated provisionally to have risen in real terms by around 4% between the second quarter of 1984 and the corresponding quarter this year. With continuing growth in the first half of 1985 the UK economy has now enjoyed four successive years of growth.



An important feature of this year's second quarter growth is the recovery in real consumers' expenditure. Primarily because of the miners' dispute consumers' expenditure grew less rapidly in 1984 than during 1981-83. Consumers' expenditure grew by only 1.5% during 1984 and in the first quarter of 1985 fell slightly below the level recorded in the last quarter of 1984. Subsequent increases in the second and third quarters of this year raised consumer spending at the end of the third quarter to a level 3% higher than a year earlier. Much of the recent increase in consumers' expenditure has been on durable goods including cars, energy products and clothing and footwear.

Retail sales have consistently been more buoyant than consumers' expediture. Over the three months June to August, retail sales were around 2% higher than in the previous three months and almost 5% higher than in the corresponding period last year. Sales fell, however, by 1.4% in September. This decrease from the record sales level in August appears to be related to unseasonal weather conditions, with the bad August weather inducing consumers to bring forward expenditure on consumer durables usually undertaken in the autumn.

The expectation remains that consumers' expenditure will assume a more important role in determining the growth of aggregate demand in 1986. Two factors are forecast to provide a boost to consumer spending: further increases in real incomes with average earnings likely to continue rising at present rates while the inflation rate is further reduced; and increases in disposable incomes as a consequence of reductions in income tax in the Budget.



In part also a relatively greater role for consumers' expenditure in driving growth next year will derive from some deceleration in two components of demand which have contributed substantially to developments since 1983, namely investment expenditure and exports. Gross investment rose in the first quarter of 1985 as firms sought to take advantage of the allowances on capital investment before these allowances were reduced to 50% in April. Nor surprisingly, gross investment then fell in the second quarter of 1985. The influence of the April change in allowances on private sector investment is easily discernible. In the first quarter private sector investment rose by 20.8% in real terms, a much more substantial increase than in any quarter since output recovery began in 1981, and then rose by only 4.3% in the second quarter, the lowest increase since the last quarter of 1983. With continuing expenditure constraints, public sector investment fell in both the first and second quarters.

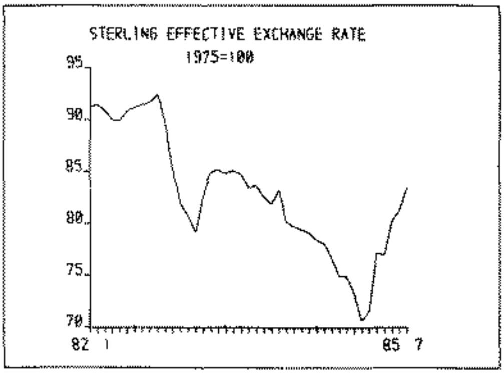
The sectoral pattern of changes in investment is reflected in the pattern of investment by type of asset. Investment in plant and machinery and vehicles rose sharply in the first quarter before falling in the second quarter to their lowest rates for a year. Investment in dwellings in the private and, particularly, the public sector fell in both quarters as did investment in other new buildings and works.

The more pessimistic outlook for manufacturing investment detected in the Department of Trade and Industry's June inquiry into investment intentions and the CBI's Quarterly **Industrial Trends Survey** in July has been confirmed by the outcome of the CBI's October Survey. This latest Survey forecasts only modestly higher investment in plant and machinery and more substantial reductions in investment in buildings over the next twelve months. With manufacturing companies continuing to report more than adequate capacity, uncertainties about future demand and inadequate returns on investment are indentified as the main constraints on investment activity.

As in 1985, it seems likely that investment in 1986 will be brought forward to the first quarter. Capital allowances are to be reduced further in April 1986, thus providing the basis for another first quarter rise in investment, although most probably on a smaller scale than in 1985.

The pattern of substantial destocking apparent during 1984 and the first quarter of 1985 was reversed in the second quarter. Modest second quarter stockbuilding provided some stimulus to output growth. Stocks held by the production industries, wholesalers and retailers increased by around £90m in 1980 prices. This increase was accounted for by higher stockholding in manufacturing being only partially offset by lower levels of stocks in wholesaling and energy and water supply industries. Following first quarter destocking, stocks of finished goods held by manufacturers rose as did work in progress, while stocks of materials and fuels continued to fall. With the increase in stocks being matched by a similar rise in output during the second quarter, the stocks/output ratio for manufacturing remained unchanged.

In the first three months of the year an improvement in the trade deficit contributed to UK growth, following the marked depreciation of sterling from mid-1983 to February 1985. The visible trade



deficit then fell by more than £1bn in current prices during the second quarter. This improvement continued during July and August and in the three months to the end of August the visible trade deficit amounted to £0.5bn which represents half the deficit recorded for the immediately preceding three months.

The improvement in the visible trade deficit this year has been attributable in almost equal part to an increase in the oil surplus and to a reduction in the non-oil deficit. While the effects of sterling's appreciation since February have not yet been felt fully in terms of export volumes, the more immediate terms of trade effect accounts for the bulk of the improvement in the non-oil trade deficit. Levels of non-oil import volumes have shown little change in recent months while the underlying level of export volumes has shown a slight decrease. This latter change is likely to become more pronounced in coming months.

Constraints on the Government's ability to achieve the public sector borrowing requirement target set in the March Budget have been discussed in the last two **Commentaries.** Containing government expenditure remains a primary policy objective. The Government also remains committed to reductions in income tax. It is clear that squaring the circle of expenditure and revenues will rely greatly on revenues from asset sales. The Government is, therefore, determined to proceed with its privatisation programme for Corporations such as British Gas. Attempts will also be made to attract private capital into operations at regional ariports such as Prestwick and Glasgow.

In the three months to the end of July 1985 output of the production industries is estimated provisionally to have increased by 0.5% over the level of the immediately preceding three month period and to be 5% higher than in the corresponding period of 1984. The miners' dispute continues to affect output although obviously less seriously than in earlier quarters. It is estimated that the dispute reduced the level of industrial output by less than 0.5% in the three months to the end of July compared with 2% in the previous three months and 3.5% in the three months to July 1984. The effect on manufacturing output has been small.

Manufacturing output fell by 0.5% from the level of the previous three months but was 2% higher than the level of a year earlier. Within manufacturing there was again some diversity of experience. Output of metals rose by 5% while output of other minerals increasesd by 1%. Little change took place for either other manufacturing or textiles and clothing.

With recovery in coal output and increases in electricity supply, energy and water supply rose by 3% in the three months to July. Output of the construction industry increased by 1%. Overall, output of the production and construction industries in the second quarter was 1.5% above its first quarter level.

Output by market sector reflected the second quarter waning of investment demand in that output of intermediate goods rose by only 2% while investment goods output remained unchanged, as compared with growth rates of 4% and 2% respectively in the first quarter. Disappointingly, in view of the resurgence of consumers' expenditure, second quarter output of consumer goods fell by 0.5%.

THE LABOUR MARKET

EMPLOYMENT AND UNEMPLOYMENT

After an average quarterly rise of 84,000 in 1984 the pace of employment creation appears to have slackened during 1985. Following the increase of 34,000 in the first quarter, employment rose by 78,000 in the three months to June. Excluding the self-employed, however, the number of employees in employment decreased by 4,000, a smaller reduction than the 9,000 recorded in the corresponding quarter last year.

The underlying pattern of employment change remained the same as over the recent past. There was a second quarter increase of 34,000 employees in the service sector but decreases of 7,000 in manufacturing, 10,000 in energy and water supply industries and 21,000 in other industries including construction, agriculture, forestry and fishing.

Data are not yet available for the service sector for July and August but a further 7,000 manufacturing jobs were lost over those months. Over the three months to

August, however, average monthly job losses have slowed to 3,000 from an average decrease of 5,000 in the immediately preceding three months.

After remaining unchanged at a rate of 13.1% from April to July unemployment (on a seasonally adjusted basis and excluding school leavers) rose to 13.2% in August before falling back again to 13.1% in September and October.

During the first quarter of 1985, whether measured per man or per man hour, productivity growth rose above the rate of the fourth quarter of 1984. This reflected both greater job losses and output recovery. This pattern continued into the second quarter of 1985 and the pace of productivity growth was maintained. Average earnings rose, however, from an underlying rate of just over 8.5% in the first quarter to almost 9% in the second quarter and to 9.25% in July. Unit wage costs in July stood at the highest level recorded this year.

INDUSTRIAL RELATIONS

The Government's policy of privatisation continues to exert a significant impact on the conduct of industrial relations in Britain. For a number of public sector unions it has meant that membership has spread into the private sector and has complicated bargaining and representational arrangements. The uncertainty of privatisation continues to be a stimulus to industrial action by several groups, including health service and transport workers. The logic of the NCB's policy within the mining industry likewise seems to be prompted by moves towards privatisation.

The TUC's endorsement of legislative proposals on four issues arising from the miners' strike - review of the cases of those imprisoned, reinstatement, reimbursement of funds, and ending of pit closures - represented the last success for the NUM. Since then the union has had to face: the establishment of the Union of Democratic Miners; a new plan for coal implying considerable cuts in capacity; the NCB's policy of weakening and fragmenting the NUM; and the need to purge the contempt at the High Court.

Despite the rhetoric of Bournemouth and Blackpool a key feature in the mining industry has been the establishment of the Union of Democratic Miners with some 30,000 plus members in Nottinghamshire, South Derbyshire and Durham. The significance of this 'breakaway' union is that it is largely the product of a radical change in the policy of the NCB. The NCB has encouraged the Union of Democratic miners by: granting sole representation for all miners in South Derbyshire; the offer of a wage increase of 5.9% (a combination of an increase in both the basic and incentive rates); implying there would be no increase to NUM members; an attendance bonus backdated to the beginning of the strike, and the proposal for pit by pit talks on productivity. The final element contains three schemes and includes separate arrangements for both face and other underground workers as well as a package designed for all workers. An implication is that pits would have to join the UDM in order to qualify for such incentive schemes. In these conditions the UDM is likely to spread to pits where bonus payments are a significant component of earnings, eg. to pits with large, easily mined reserves or pit complexes which have considerable capital investment.

The introduction of such a policy, which will inevitably lead to a succession of inter-union squabbles as well as heightening opposition from the NUM, seems curious. Nevertheless, a strategy of replacing industry-wide with pit bargaining and fragmenting the union would be a logical first step towards privatisation of the industry. The new plan for coal, with its emphasis on a market philosophy and letting the market dictate the size of the coal industry, represents another step towards privatisation. Significantly, the plan indicates that a further 56 pits (or 70,000 workers), in addition to the 34 closed or marked for closure since 1984, may have to close by mid-1987.

Complaints by both pit deputies and colliery managers over the introduction of new working practices indicate a further element in the NCB's strategy. There is much to suggest that the NCB is planning radical changes to work practice including: longer shifts; flexible working practices, and continental shift working as further ways of improving productivity.

Major labour problems are looming in several areas of the public sector. The abandonment of pay research within the Civil Service in 1980 led to years of ad hoc bargaining. Whilst there is now discussion as to the introduction of some form of survey of wage and salary movements, embodying much of the Megaw Report, the progressive introduction of bonus and extra payments to specific groups will, in the long term, lead to chaos. Thus extra payments to sections of GCHQ staff, payments of some £1,500 to customs office computer specialists, and to other groups working in areas where skills are in short supply is likely to lead to all groups claiming special case status and hence additional payments.

The offer of 11.7% to ambulancemen and 8% to local authority workers may well contribute to militancy in both the Health Service and more generally in the public sector, especially given the offer of 4.7% to health service ancilliary workers. The erosion of ancilliary workers' pay following privatisation (for some this has meant cuts of 50% in earnings and the loss of sick pay and holiday entitlements) has led to a number of exceptionally long-running strikes at hospitals. Already two stoppages have lasted more than twelve months and others seem likely to exceed this. In the longer term there may be a number of changes to the working arrangements of white collar employees in the NHS stemming from the appointment of a personnel director, committed to flexible work practices and coming from a non-union background, to the NHS Management Board from the private sector.

However, amongst all the labour issues in the public sector attention has focussed primarily on the rail and continuing teachers' dispute. Underlying the rail dispute has been the attempts by the Rail Board to: improve labour flexibility; cope with the problems of chronic underfunding and a progressive reduction in the Passenger Service Obligation subsidy, and deal with the privatisation of sections of its activities. In the long term there is still the possibility of privatisation of profitable rail links such as the Victoria-Gatwick link. The introduction of experiments in driver only operated commuter trains was the immediate cause of the stoppage. However, whilst this was in the long-term a major threat to the role of guards in British Rail, in the short-term it affected only a minority of the 11,000 guards. This, coupled with the 'hardline' management approach, led to the majority voting against national industrial action.

Following the ending of the dispute British Rail announced the introduction of additional driver only freight services. In five years, management plans to have 60% of freight trains operated by a driver alone, and some 13 passenger services similarly operated. However, the scope for improvements in labour efficiency are limited by lack of investment.

The long-running teachers' dispute progressed through a series of 'final' offers. At the heart of the dispute are the issues of low and declining pay and the Education Secretary's attempts to introduce a form of contract which will specify in far greater detail teachers' duties and prevent similar industrial action in the future. The recent re-jigging of the trade union side of the Burnham Committee to eliminate the absolute majority of the NUT may possibly lead to a settlement. However, it will do little to resolve the underlying problems in the teaching profession and will almost certainly contribute to a further decline in the quality of teaching.

Virtually all the available evidence cautions against the introduction of merit awards as an element in teachers' pay, unless the strategy is to reduce the overall cost of teachers' pay. If only 70% of teachers were awarded such payments there would be considerable savings in the costs of annual increments.

Industrial relations issues did not figure prominently in the 'conference' season. The Conservative Party indicated that further industrial relations legislation was not a priority, although there were suggestions for a 'right-to-work' act - measures to ensure that even where there had been a strike ballot in favour of action, there should be no obligation for all the membership to strike. The Government's policy of deregulation of employment implied hostility to EEC measures to increase workers' rights which were seen as irrelevant and dangerous to job creation schemes for part-time workers.

The Trades Union Congress at Blackpool provided the greatest volume of popular comment. Three issues appeared to dominate the Congress: the resolutions proposed by the National Union of Mineworkers; the question of disciplinary action against those unions who had accepted Government funds for ballot purposes in contravention of established TUC policy, and the possibility of a major split in the movement arising from the possible expulsion of the AUEW. By the end of the week two of these issues had been resolved and Normal Willis could look forward to a degree of increased stability within the movement over the next year. The broad political composition of the General Council remained unchanged and thus enabled the right and centre to maintain their majority on most issues. Whilst the question of recognising the Union of Democratic Miners remains a problem on the horizon for the TUC the issue of Government funds for ballots is likely to fade. Increasing numbers of unions are likely to be forced, for financial reasons, to accept such money. Through time the policy of the TUC is thus likely to change, and the suspension or expulsion of a major union over such an issue will be far less likely in the future.

Another issue at the Congress, although not on the formal agenda, was union mergers. The Society of Civil and Public Servants commenced merger talks with the Civil Service Union, this followed the breakdown of similar talks between the SCPS and CPSA. The talks between CSU and BIFU broke down over the fear that merger would fragment the sections that form the CSU.

Mergers and collaborative action figure prominently in the newspaper industry. Employers' attempts to reduce labour costs, introduce new production methods, and move away from traditional printing locations continue to be a source of industrial unrest. The implications of new technologies are clearly demonstrated by the agreement between Eddie Shah and the EEPTU - an agreement which renders obsolete and irrelevant a number of hitherto crucial printing trades organised by the NGA and SOGAT 82. This explains the attempts by the NGA to seek agreements with the NUJ. Given that most of the national newspapers have invested in new plant, based away from Fleet Street, and are convinced that union opposition is less now than several years ago when the Times suffered a long stoppage, intermittent action by unions over job losses and changed working practices are likely to be a feature of the industry for some considerable time.

PROGNOSIS

The Chancellor's Mansion House speech in October underlined the shift in emphasis in the conduct of monetary policy that was begun in the March Budget. Over recent years a central element of the Medium Term Financial Strategy has been the notion that monetary targets, established in advance, are essential to maintain downward pressure on nominal GDP. With policy concern directed at the behaviour of monetary aggregates, the exchange rate was determined by market forces. This strategy has been replaced since March by one in which the exchange rate appears as the primary element although, unlike the targets for monetary aggregates, there is no formally specified or publicised range. Higher interest rates have been used since February to maintain a differential against interest rates elsewhere and, thereby, to engineer an appreciation of sterling against other currencies, particularly the US dollar.

Certain of the operational implications of this policy shift are already apparent. Since the March Budget the Chancellor has been uneasy with the use as a target of sterling M3, which has greatly overshot its pre-determined range, and acceptance of the exchange rate as an indicator of monetary conditions has led to relegation of that aggregate. This has been clear in the financial markets with the previous practice of overfunding and the associated accumulation of commercial bills being reversed. (The relationships among sterling M3, overfunding and the "bill mountain" were discussed in the February **Commentary**.)

A further implication concerns the framework within which policy is conducted. Under the earlier regime preannounced monetary targets were intended to forestall domestic inflationary pressures. The new system is more reactive with interest rates being determined in such a way as to produce an exchange rate which will deliver the desired rate of inflation.

Whatever the state of the debate over whether this shift removes policy from the "monetarist" fold, the shift is consistent with the Government's over-riding objective of controlling inflation and, in that context, with continuing Government concern over inflationary pay settlements. As argued in the last **Commentary**, sterling's strength helps control inflationary pressures, in part, by exerting pressures on UK companies in both domestic and foreign markets and thereby discouraging companies from conceding to wage claims in excess of productivity increases. With there being little evidence that UK unit wage costs are decelerating, this perhaps best explains the shift in policy.

There are, however, pressures such as the prospect of some slowing of the rate of growth and, indeed, a falling rate of inflation which point to the need for reductions in the rate of interest. Despite the current high levels of UK rates in relation to international levels, the Chancellor shows little inclination for any significant early reductions. Given the greater international dimension in policy with the elevation in status of the exchange rate, such caution is necessary to the Chancellor's strategy.

Any benefits to the UK in terms of reducing inflation of the recent G5 agreement to induce dollar depreciation would be unwound were the Chancellor to reduce UK interest rates. Such reductions would generate monetary base expansion and sterling depreciation.

The major difficulty facing the Chancellor in the terms of his strategy is that sterling's strength has a telling impact on oil revenues at a time when he has reasserted his commitment to tax reductions and expenditure restraint. As argued earlier, however, the arithmetic of that problem has its solution for the Chancellor in the proposed programme of assets sales.

There is, therefore, an internal consistency to the Chancellor's strategy. Moreover, the premises on which it is based, namely, the needs to moderate unit labour costs and to improve incentives, remain intact. Scepticism over the efficacy of those premises has been expressed in previous **Commentaries**. That scepticism is now reinforced by the prospect of no imminent, substantial falls in interest rates or of sterling depreciation. UK manufacturers may find, therefore, that the shift in policy does little to improve trading prospects.