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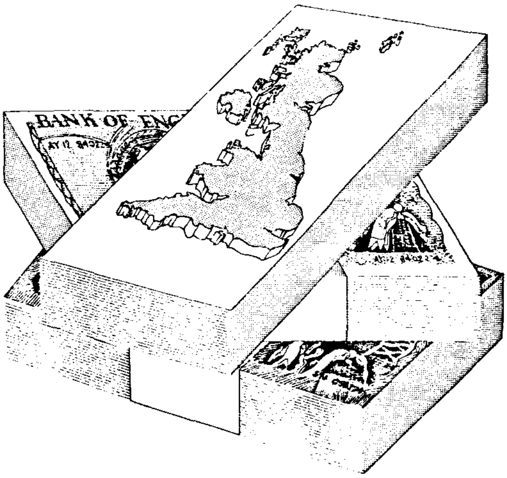
Love, James and Boyle, Stephen and Draper, Paul and Harrigan, Frank and Heeley, John and Jenkins, Iain and Lockyer, Cliff and Love, Jim H and McGregor, Peter and McNicoll, Iain and Simpson, David and Walker, Jim (1986) The British economy [May 1986]. Quarterly Economic Commentary, 11 (4). pp. 7-14. ISSN 2046-5378 ,

The British Economy



Since the last quarter of 1985 developments in the UK economy have been dominated by the sharp falls in oil prices. With UK interest rates high by international standards and the weakness of the US dollar there has, however, been no repetition of a sterling crisis on the scale of that in January 1985. The most immediate impact of the lower oil prices was felt in terms of the Chancellor's limited scope for income tax reductions in the March Budget. On balance, the UK will benefit in the medium term as a consequence of the stimulus given by lower oil prices to international trade and the depreciation of sterling against the major European currencies.

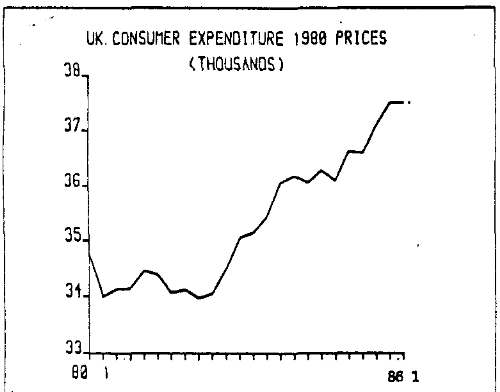
MACROECONOMIC TRENDS

As throughout the period since the miners' dispute in 1984, the CSO's cyclical indicators continue to provide unclear signals about developments in the economy. While the effects of the miners' dispute have now worked their way through the system, the volatility of certain components of the two leading indices, particularly share prices and consumer credit, have led to difficulties of interpretation.

After falling in July the longer-leading index, which typically predicts turning points about one year in advance, rose in each month to October before falling in November and December. From a level in January lower than any reached in the previous year the index rose in successive months to more than offset the gradual decline during 1984 and in March stood at a level previously attained in 1984. The principal cause of this recovery is the sharp rise in share prices. Interpretation of the shorter leading index, which is intended to predict turning points some six months in advance, is made particularly difficult by the volatility of the component series. This index changed little during 1985 before rising sharply from December to February in response entirely to increases in consumer credit which more than offset declines in all of the other components.

The coincident indicator, however fell in each month since May 1985 until January 1986 and remained unchanged in February 1986. This pattern is consistent with the estimates of gross domestic product which indicate some deceleration of growth during 1985. Output increased in the three months to September by only 0.25% as compared to an increase of 1.2% in the three months to the end of June, but there was some slight recovery in the last three months of the year with fourth quarter output being 0.5% higher than in the third quarter. After allowing for the impact of the miners' dispute in 1984, output in the fourth quarter of 1985 was around 1.5% higher than in the corresponding quarter a year earlier. During the last six months of 1985 the level of economic activity was almost 13% higher than the trough reached in 1981, the last year of negative economic growth. Since that trough the UK has experienced over four successive years of positive growth.

In expenditure terms, the principal element driving growth in 1985 was consumers' expenditure. The increases recorded in the first three quarters of 1985 continued into the fourth quarter when real consumers' expenditure increased by around 0.5%. In real terms this component of aggregate demand rose by 2.8% between 1984 and 1985 and the fourth quarter 1985 level was almost 3.5% above that of the corresponding quarter a year earlier. Preliminary estimates indicate that in the first quarter of 1986 consumers' expenditure remained unchanged from the level attained in the last quarter of 1985. Since the first quarter of 1985 growth has been due to increases in consumers' expenditure on durable goods, clothing, energy and services.



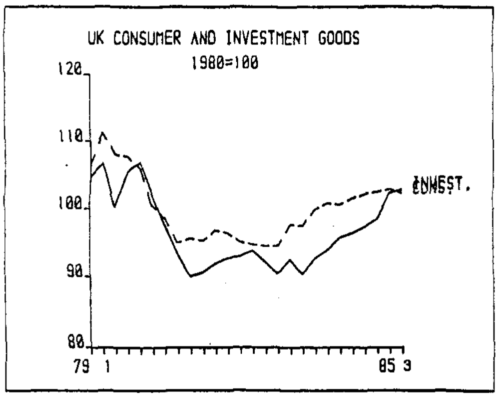
The slowing over the past six months in the growth of consumers' expenditure has been accompanied by changes in the pattern of retail sales. During 1984 and the first half of 1985 retail sales, which include some part of those goods and services comprising consumer expenditure, were more buoyant than consumers' expenditure. Much of that buoyancy has now been dissipated. The volume of retail sales fell in September and October, rose in December and then fell at the beginning of this year. One factor contributing to the depression of sales during the first quarter of 1986 was the poor weather which adversely affected sales of spring fashions. The March CBI/FT Survey of Distributive Trade suggested that sales volumes in March grew more slowly than in previous months, and that firms were carrying excessively high stocks.

As discussed in previous **Commentaries**, the growth in consumer spending in 1986 will be determined mainly by two factors. The first is the continuing growth of real incomes as a consequence of average earnings showing, as yet, no signs of slowing from the rate of around 7.5% experienced over the past two years in combination with further reductions in the rate of inflation. Real disposable income has also been raised by the reduction in the basic rate of income tax from 30% to 29% in the March Budget.

The effects of high real interest rates on consumer spending is difficult to assess. Despite high real rates of interest, consumer credit grew strongly in the latter half of last year. With the private sector's net assets exceeding liabilities, higher interest rates might be expected to generate higher consumption levels. The fall in the savings ratio in successive quarters of 1985 is consistent with this expectation. However, net borrowers' may be more sensistive to changes in disposable income and, if so, might be expected to postpone consumption expenditure in response to higher debt servicing.

Retailers responding to the March **FT/CBI Survey** reported increases in stocks. Such increases were already evident in the last quarter of 1985 when retail stocks rose by around £205m at 1980 prices. There were also increases in stocks in the energy and water supply industries of £260m. Taken together, these increases exceeded the reductions in manufacturers' and wholesalers' stocks of around £135m and £35m respectively, so that on balance fourth quarter stocks rose by almost £295m and contributed substantially to that quarter's growth. Although stocks fell in the first quarter of last year, the increases in the other three quarters meant that stockbuilding contributed positively to growth during 1985 after the negative contribution made in 1984.

As in 1984, investment also contributed to growth in 1985. The phasing out of capital allowances induced a sharp increase in investment expediture during the first quarter. As expected, investment then fell back in the second quarter before recovering in the third and fourth quarters. While first quarter 1985 investment was 9.1% higher than in the corresponding quarter of 1984, investment in the subsequent three quarters was lower than in the corresponding quarters a year earlier. Overall, however, the 1985 rise in investment was slightly greater than that in 1984.

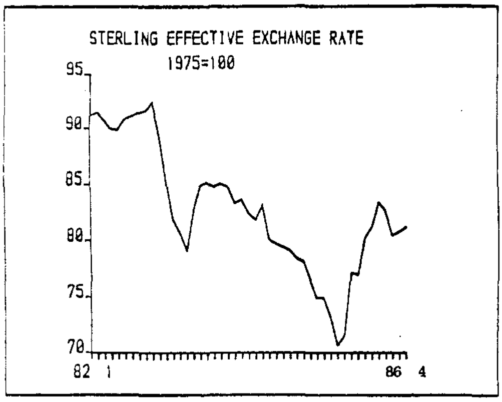


With continuing expenditure constraints public sector investment decreased in each quarter of 1985. For the year as a whole public sector investment fell by just over 15% below the level of 1984. Private sector investment rose, however, by 6.7%. The sectoral pattern and the timing of changes are reflected in the pattern of investment by type of asset. Investment in plant and machinery rose dramatically in the first quarter to a level 22.5% above that of a year earlier and then recorded only very modest rises in subsequent quarters. Investment in vehicles increased by almost 40% against the corresponding quarter of 1984 before a more modest second quarter rise was followed by decreases in the third and fourth quarters. In contrast, investment in dwellings fell in the first six months before recovering slightly in the second half of the year. The second half recovery was due entirely to private sector activity. Public sector investment in dwellings fell in all four quarters to register a decline for the year of around 8%.

With the final reductions in capital allowances in April, this year's quarterly pattern of investment expenditure is expected to replicate that of 1985. However, growth of investment in 1986 is likely to fall short of the rate achieved in 1985. The CBI's **Quarterly Industrial Trends Survey** detected a more pessimistic outlook for manufacturing investment in three successive **Surveys** in July and October 1985 and in January 1986. The latest April Survey suggests a more optimistic outlook with a balance of respondents forecasting increases in investment in plant and machinery and a slightly greater balance forecasting lower investment in buildings. Generally, however, manufacturers report more than adequate capacity with current output running below full capacity. Inadequate net returns and uncertainty about demand are cited as the principal constraints on investment activity.

In contrast to the experience of 1984, trade contributed to growth during 1985 and particularly in the first half of the year. Exports rose following the marked depreciation of sterling from mid-1983 to January 1985 while imports fell largely as a consequence of lower oil imports after the ending of the miners' dispute. Sterling's appreciation from February 1985 worked through into adverse volume movements in the latter half of the year with slowing growth of export volumes and faster growth of imports.

Despite the increasingly adverse volume changes, the visible trade deficit was much lower in the last three quarters than in the first. Overall, the visible trade deficit improved from just over £4391m to just over £2068m in 1985. This improvement reflected the terms of trade effect generated by sterling's appreciation since last February, and helped raise the surplus on current account from £879m in 1984 to £2952m in 1985.



Following the visible trade deficit of £225m in the last quarter of 1985, there was a surplus of £140m in January and a deficit of £338m in February. The February deficit comprised a £1bn deficit on non-oil trade which was partially offset by a surplus of £685m on oil. While non-oil exports volumes continued on a slight downward trend, import volumes show little underlying change. The current account surplus was £1,140m in January and £262m in February.

In the three months to the end of February output of the production industries is estimated provisionally to have fallen by 0.5% from the level of the immediately preceding three month period, but to be 3.5% higher than in the corresponding period of 1984. Comparisons with 1984 are, of course, seriously affected by the effects in that year of the miners' dispute. Taking a longer perspective, output of the production industries was 11.5% higher in the three months to the end of February 1985 than at the low point recorded in the first quarter of 1981.

Manufacturing output in the three months to February was unchanged from the level of the previous three months but 1% higher than in the same period a year earlier. The broadly unchanged level of total manufacturing output reflected different developments across sectors. Output increased by 1% both in food, drink and tobacco and in other minerals, but remained unchanged in engineering and allied industries and in other manufacturing, and fell by 1% in textiles and clothing and by 2% in chemicals and in metals.

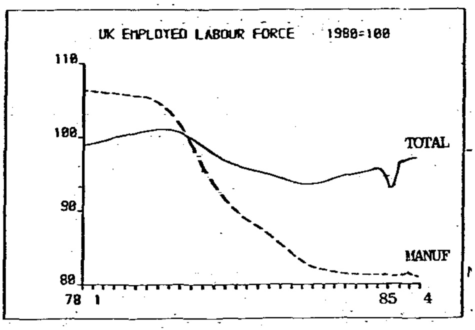
Output of energy and water supply fell by 1.5% while construction output rose by 2%. Overall, output of production and construction is estimated to have been 0.5% higher and 13.5% higher that in the first quarter trough in 1981.

The underlying shifts in determinants of demand growth were not fully reflected in changes in output by market sector. Disappointingly in view of the continuing importance of consumers' expenditure, output of consumer goods fell by 0.5% over the level of the previous three months. In addition, there is little evidence of the expected first quarter rise in investment. Output of investment goods was broadly unchanged while output of intermediate goods fell by 0.5% in the three months to the end of February.

THE LABOUR MARKET

EMPLOYMENT AND UNEMPLOYMENT

After an average quarterly rise of 84,000 in 1984 the pace of employment creation slackened appreciably during 1985. Following an increase of 143,000 over the first three quarters, employment rose by 117,000 in the three months to the end of December 1985. This fourth quarter increase was the net result of an assumed increase of 30,000 in self-employment, an increase of 90,000 in the number of employees in employment and a decrease of 3,000 in HM Forces.



Employment change in the fourth quarter again followed the pattern set throughout 1984 and into 1985. There was a seasonally adjusted increase of 124,000 employees in the service sector but decreases of 13,000 in manufacturing industries, 8,000 in energy and water supply industries and 13,000 in other industries including construction, agriculture, forestry and fishing. Data are not yet available for the service sector for January and February but a further 25,000 and 10,000 jobs were lost in manufacturing and energy and water supplies respectively over those months. After remaining unchanged at a rate of 12.9% from April to November last year, unemployment on a seasonally adjusted basis and excluding school-leavers rose from 13.0% in December to 13.2% in March. Unemployment increased by 37,000 between February and March. At least part of this increase may be attributable to severe weather conditions but taken in conjunction with changes over the preceding three months suggests a resumption of an upward trend in unemployment.

Government policy with respect to the labour market remains directed at employment creation through achieving increases in competitiveness as a consequence of lower unit labour costs. Over the past two years, however, there has been little change in the underlying earnings growth of around 7.5%. Thus, the UK's labour costs relative to other major industrial countries have continued to rise. This and sterling's appreciation raised the UK's relative export prices in the middle of last year. Subsequent depreciation of sterling against the major European currencies should, however, improve the UK's competitiveness in the course of this year.

INDUSTRIAL RELATIONS

The disputes involving the print and teaching unions continue to dominate British industrial relations. Superficially, there appears to be little in common between the apparent 'success' of the teachers' unions in securing additional payments in England, and an independent committee of inquiry in Scotland; and the inability of the print unions to influence News International. Nevertheless, underlying both is the common concern by the employers to make more efficient use of labour. Both disputes have focussed on issues of increased flexibility, but reduced demand for labour.

The continued action between print unions and News International tended to obscure parallel developments in other newspaper groups and more generally in printing. News International has sought from its current employees no strike agreements, largely modelled on similar agreements in operation in Britain at Japanese-owned firms. With ex-employees News International continued to make use of the changes to labour law introduced by the 1980 and 1982 Acts. Following the sequestration of SOGAT 82's funds all the print unions attempted to make a common approach to the company. This led to increased picketing in an attempt to delay the distribution of the Sunday titles; however, the violence of such mass action, rather than the actions of News International, became the focus of attention. The company's offer of the abandoned printing plant at Grays Inn Road, with an estimated value of £55 million, to ex-employees was not regarded as realistic or fair compensation for those who has lost their jobs. The continued weakness of the unions has gradually led to a change in emphasis, with the NGA, in order to survive, having to reach some accord with News International. It is likely that agreement over some form of compensation will eventually surface. However, the industrial action at Wapping apart from the conduct of the dispute has raised two issues.

First, there is the problem of inter union strife and the powers of the TUC. The ability of News International to commence production at Wapping relied heavily on the support of members of the EETPU. Such support raised questions of union poaching, breaching TUC policy over greenfield sites and single union agreements. This led to the General Council of the TUC considering a number of charges against the EETPU. Whilst the union was severely admonished by the TUC, the effect on future negotiations at Wapping appears limited. The TUC and print unions are in an essentially weak position vis a vis News International. Whilst they can prevent the EETPU signing a single union agreement with the company, they can do little to overcome its basic refusal to adopt traditional industrial relations practices.

Secondly, the dispute illustrates well how recent legislation has influenced the conduct of the dispute. Industrial action breaches a contract of employment and employers have the right to dismiss. The 1980 Act narrows the scope for lawful industrial action, by excluding secondary picketing and limiting peaceful picketing. Moreover, the ability of employers to commence actions leading to sequestration of union funds , has proved to be highly effective in limiting trade union opposition.

Elsewhere in printing both the NGA and SOGAT 82 recommended acceptance of work flexibility provisions. Reductions in demarcation, flexibility in arranging work patterns, and significant reductions in traditional NGA craft barriers, were contained in an agreement between the unions and the British Printing Industries Federation. The Financial Times secured an agreement introducing radical changes - three years full operational flexibility and the resolution of disputes through binding arbitration. United Newspapers, owners of Express Newspapers, has sought to cut the labour force by a third and has reached agreement with the NUJ over the loss of 160 jobs. The Telegraph has announced similar plans to reduce its labour force. Likewise the Guardian has sought a binding dispute and arbitration procedure and substantial staff reductions.

The disputes within the education sector are more fully detailed elsewhere in this issue. Nevertheless, the announcement by the Audit Commission that significant numbers of schools should close and teachers be offered redundancy terms casts doubts on the permanancy of the 'apparent' solution recently reached between the NUT, other teaching unions and the English local authorities. The employment issues arising from a decline in the birth rate will be a feature of industrial relations in education for the remainder of the decade.

Whilst it now more than a year since the ending of the national miners' dispute a number of issues still remain. Some of the legal aspects will not be dealt with until January 1987 when the High Court hears the case for damages against a number of leading officers of the union involved in the transfer of funds abroad. In the past year more than 24 pits have closed, 35,000 miners have left the industry, and output per man/shift has risen by 15%. The NCB, soon to be called British Coal, has been able to develop a strong decentralising business philosophy. The UDM has felt more vulnerable following the announcement of the retirement of Ian MacGregor, the main management supporter for the union. Several UDM officials expect the NCB to seek to rebuld relations with the NUM. Possible indications of this can be seen in the NCB proposals for master agreements - identical framework agreements - for both the NUM and UDM. The disclosure of Mr MacGregor's intention to publish an account of the miners' dispute prompted, once again, reassessment of the role of the Government in provoking the stoppage and its dealings with NACODS over pit closure procedures in 1984.

Flexibility and redundancy issues surfaced elsewhere in the public sector. The dispute between the Prison Officers' Association and the Home Office stems from attempts to reduce overtime and manning via more efficient work rotas. Similarly, within the Health Service the campaign by the RCN, its moves to scrap the no strike rule, and possible affiliation to the TUC, arise from the management pursuit of efficiency with the introducion of general managers into the service. Likewise proposals to change the basis of pay for doctors and dentists, to reward 'good' doctors and dentist more, may well lead to industrial action in this sector of the Health Service. The review of the grading structure of more than a million local authorities, commissioned as part of the 1985 agreement, may be influenced by Government fears as to the size of any pay increase. However, failure to agree to a new review, which takes into account the impact of Equal Value legislation may well render local authority employers vulnerable to a spate of Equal Value cases.

The Government's policy of holding back wage and salary increases in the public sector is now showing signs of strain. Civil Service, Post office, and Power Workers' unions have all called for improvements in current pay offers. Elsewhere redundancy continues to be the key issue: new proposals for redundancies amongst dockers met little support: the announcement of 3,500 redundancies in British Shipbuilders has led to threats of national action, as have similar announcements at BREL. Government policy has been the underlying reason behind several civil service unions, including the Inland Revenue Staff Association, establishing political funds. In the private sector the first results of privatisation policies have suggested that workers pay the hidden costs of privatisation in the form of poorer conditions of employment. In the longer term this may well engender a call for greater protection for individuals at work.

As ACAS notes in its annual report for 1985, the search for greater flexibility in the use of labour often has important implications for industrial relations, this can be clearly seen in the developments in both the public and private sector. However, it is difficult to assess the contribution, or even the desirability of Mr Lawson's proposals, (for flexibility in earnings and associated reductions in the rate of income tax), in improving labour utilisation and levels of employment. Much of the growth of unemployment in recent years would not have been reduced by moderation in wage settlements. The proposals would appear to reflect political rather than employment issues, and may well exacerbate industrial relations difficulties.

PROGNOSIS

Debate on macroeconomic policy in the UK over the past few years has been concerned with monetary policy and the appropriate targets for monetary variables. Somewhat belatedly in an economy with a high degree of openness, the exchange rate was elevated to the status of an indicator of monetary conditions in the 1985 Budget. This year's Budget saw a further statement of confidence in the Medium Term Financial Strategy (MTFS), although, as argued in the last **Commentary**, the present variant is much changed from that originally devised by Mr Lawson for the then Chancellor Sir Geoffrey Howe. Mr Lawson again repeated his support for the MTFS in his address to the Lombard Association in April.

Recent developments have highlighted, however, the importance of events abroad to the performance of key indicators in the UK including the rate of inflation, the primary focus of the MTFS. Softness in non-oil commodity markets and the recent sharp falls in oil prices have contributed to widespread reductions in inflation rates which have, in turn, exerted a downward influence on interest rates. However, financial markets' perceptions of the UK's performance relative to that of other industrial countries are such that substantial nominal and real interest rate differentials are required to keep sterling's value at a level consistent with the Chancellor's view of the monetary conditions necessary to reduce inflation.

Those perceptions are influenced by domestic factors including: the apparent inability to reduce the underlying growth of unit labour costs; and the conduct of monetary policy. As discussed in previous **Commentaries,** the attempts to tackle these problems account for the present dominant role of the exchange rate in UK policy. In the March Budget the Chancellor retained the target range for the narrow money aggregate, M0, but raised that for the more broadly defined aggregate, sterling M3 (£M3). Financial markets tend to place less store on M0 which is regarded as a lagging indicator rather than as a determinant of macroeconomic variables such as prices and output. M0 has the attractions to the Chancellor of being well-behaved and of giving some empirical basis to a claim of financial prudence.

In contrast £M3 has consistently overshot its target range including thus far in the post-Budget period the higher range of 11-15% for 1986/87. In large part, financial markets' concern over monetary policy is fuelled by the prospect that the continuing growth of £M3 will work its way through into higher UK inflation and, hence, will generate a loss of competitiveness for UK producers. Forestalling such an outcome would require the Chancellor to react to the growth of £M3 by raising further UK interest rates or by maintaining rates at current levels when, at least temporarily, interest rates are being reduced elsewhere.

Another option is that of joining the exchange rate mechanism of the European Monetary System. While consistent with the move to greater co-ordination of national economic policies (see **World Economy**), this option has a number of limitations. First, it reduces the Chancellor's degrees of freedom over the increasingly central element of policy. Secondly, although it may provide UK producers with greater exchange rate stability, membership of the exchange rate mechanism does likewise for foreign competitors in both European and UK markets. Moreover, whatever the Chancellor's own predilections, this option seems to be currently denied to him in Cabinet.

UK monetary policy has become more pragmatic and the framework within which the Goverment operates accordingly less robust. With increasing pressure for greater public spending, including from some quarters of the Conservative Party mindful of the approach of the next General Election, the guidelines of monetary policy contained in the MTFS may well be irretrievably breached.

The Chancellor now finds himself in a dilemma. High real interest rates, the sterling exchange rate and M0 are behaving consistently and, indeed, the tendency for M0 to grow at the lower end of its target range suggests policy is too tight. Adherence to that policy configuration, however, will damage the prospects of domestic output recovery. On the other hand, there must be concern for the Chancellor that the growth of £M3 is perceived by financial markets as signalling a re-emergence of inflationary pressure. Policy might then be read as being too slack. While the inflation rate will continue to be reduced by international developments at least in the course of this year, the Chancellor should probably take some risk on monetary looseness to reduce interest rates, depreciate sterling and increase the possibility of stimulating faster real growth.