OVERVIEW

Output and employment have improved in recent months, due to the delayed effects of more favourable conditions in the world economy and the growth of domestic consumer spending. Despite the most recent monthly figures, the rate of unemployment appears to be on a downward trend which is consistent with developments in output and employment, although government labour market initiatives are likely to have played a significant role. The future course of the rate of inflation and the balance of payments gives some cause for concern, suggesting that a fiscal stimulus, particularly in the form of income tax cuts, would be a less than appropriate strategy in the coming Budget.

MACROECONOMIC TRENDS

The average measure of GDP at current market prices, nominal or 'money' GDP, rose by 2.0% between the second and third quarters of 1986, compared with a small increase of 0.2% between the first two quarters of the year. For the year to the third quarter 'money' GDP rose by 5.7%. After allowance for inflation, specifically the GDP deflator at market prices, the provisional figures suggest that real expenditure on the domestic product was 1.5% higher than in the third quarter of 1985 and was little changed between the second and third quarters of 1986. The output-based measure of GDP, on the other hand, which is usually regarded as the most reliable indicator of change in the short term, recorded an increase of 1.2% between the second and third quarters, compared with the much smaller increase of 0.5% in the preceding two quarters. Overall, this measure recorded an increase of nearly 3.5% in the year to the third quarter, an improvement of 1.5 percent points over the annual increase to the second quarter.
exclusively due to strong growth in the retail sales component of the index with the other components exerting, on average, a depressive effect.

**Consumer expenditure** provided the main source of growth in 1986 as it did during 1985. After the decline in the increase in real consumer expenditure from 0.8% in the first quarter of 1986 to 0.6% in the final quarter of 1985, the growth in this key component of aggregate demand rose to 2% between the first and second quarters, and increased by a further 1.5% between the second and third quarters. Expenditure on durable goods and clothing continued to be the main source of the rise. Preliminary estimates for the final quarter of 1986 show an increase of about 1% over the preceding quarter, although the evidence on retail sales noted below suggests that this estimate could be on the low side. For 1986 as a whole, real consumer expenditure is therefore estimated to be 5% higher than in 1985.

The Department of Trade and Industry's (DTI) estimates for the volume of retail sales in November revealed a significant increase, in volume terms, of 2.5% over the preceding month. After the large increase in August of 1.4%, and comparative stabilisation in September and October, the November acceleration, reflecting the beginning of the Christmas shopping season, took the index to an all-time high. However, in December, the volume of retail sales fell slightly by 0.4% which, with the surge in November, repeated the pattern of 1985, perhaps indicating a tendency for Christmas shopping to be completed relatively early. For the three months October to December, the level of sales was 2.5% higher than in the preceding three month period, suggesting that the upward trend in sales is continuing. The December CBI/FT Survey of Distributive Trades supports this interpretation and also provides further evidence of retail sales in December being strong but less than anticipated. A balance of plus 54% of respondents reported that retail sales volumes were higher than the same month in 1985 and a balance of plus 45% expected sales in January to be higher than in the same month in 1986. The balance of retailers reporting that stocks were excessive increased marginally, but, in all sectors, the balance of distributors expecting stocks to be too high in relation to anticipated sales was the lowest since January 1985 when this question was first included in the survey.

The slight lessening in the quarterly rate of growth of consumer spending, and the expected buoyancy of other components of aggregate demand, suggests that this component will not play such a dominant role in UK economic growth in 1987, although it is likely to continue to make a significant contribution. The prognosis for the determinants underlying the growth of consumer demand is, however, less than clear. The growth of average earnings remains at an underlying annual rate of 7.5%. However, the CBI reported in December that average settlements in manufacturing over the preceding three months were running at 4.6%, compared with 5.6% in the third quarter and 6.1% in the first six months of the year. Other evidence does not, however, support this picture of a downturn in the value of pay settlements and earnings, given the level of productivity, overtime and other bonus payments. From an analysis of 38 pay settlements in January, Income Data Services concluded that no single trend was emerging across industry as a whole and that there had been only a slight adjustment to lower inflation. Real personal disposable income, which rose by 0.5% and 1% respectively in the first and second quarters of 1986, rose by a further 1.5% in the third quarter, to a level which was 5% higher than in the same quarter in 1985. The demand for consumer credit remains strong, despite a small reduction in demand in November and continuing high real interest rates. The total of outstanding credit reached the record level of £23.5bn in November. Yet, the savings ratio remains at around 10.5% although a further downward adjustment is possible if, as some forecasters expect,
there is a lagged response to falling inflation in the first half of 1986. Other economists discount inflation as having a real effect on savings, arguing that personal savings are largely composed of contractual savings by life funds and changes in transactions' balances which appear in the statistics as savings.

General government consumption remained largely unchanged between the second and third quarters of 1986, following the 1% increase, on revised figures, between the first and second quarters. An increase of nearly 2.5% is now reported over the year since the third quarter 1985.

Gross fixed investment has fluctuated unevenly over the past two years, as expenditure was brought forward in anticipation of the phased withdrawal of investment allowances announced in the 1984 Budget and completed in March 1986. Over the first three quarters of 1986, the level of investment expenditures was little changed compared with the corresponding period in 1985 and probably rose by no more than 1% for 1986 as a whole. The prospect of continuing increases in consumer spending and growth in world trade suggests that investment should improve in 1987. The DTI's investment intentions survey reports a rise of 6% for 1987 compared with a fall of about 1% in 1986 for the industries covered by the survey.

Following the large fall in public sector investment in 1985, there was an increase of 8% during the first quarter of 1986, followed by a decrease of 4% during the second quarter and almost no change in the succeeding quarter. Private sector investment, on the other hand, rose by 7.5% in 1985, increased, on revised figures, by 2.3% during the first quarter of 1986, followed by a fall of nearly 4% in the second quarter and an increase of 4% in the third quarter. Clearly, these quarterly patterns reflect the withdrawal of the capital allowance scheme but they still show that public investment remains relatively depressed compared with investment in the private sector. Much the same can be said for investment in dwellings. Between 1984 and 1985, public investment in dwellings fell by 11% while private investment fell by only 2%. In the first quarter of 1986 public investment in dwellings reflected the general upsurge in public investment in that quarter, rising by 17% compared with a 5% fall, on revised figures, in private investment. However, since the first quarter there has been a steady decline in investment in dwellings in the public sector and a significant increase in the private sector. The decline in the former amounted to 8% and 5% during the second and third quarters respectively, while the increases in the latter were 9% and 13.5% over the two periods.

The evidence that gross fixed investment was at much the same level during the first three quarters of 1986 as that over the corresponding period in 1985 masks a significant variation in the demand for specific assets. Between the two periods, investment in vehicles, ships and aircraft fell by 16%, investment in plant and machinery was largely unchanged, and investment in other new buildings and works, and in dwellings rose by 1% and 6% respectively.

After the marked depreciation of the sterling effective exchange rate from mid-1983 to February 1985 to a low of 71.3, sterling again appreciated to a peak of 83.3 in July of that year. The appreciation reversed the favourable volume movements of exports and imports following the earlier depreciation but the visible trade deficit initially continued to fall due to the terms of trade effect of the higher exchange rate. The first quarter of 1986 saw a continuation of these adverse volume movements with a sharp fall in non-oil export volumes. The fall in the price of oil and the related decline in sterling from the second half of 1985 led, via the well-known J-curve effect, to a fairly rapid deterioration in the visible balance on both oil and non-oil accounts. The non-oil trade deficit rose by £2.8bn in the last quarter of 1985 to £3.4bn in the first quarter of 1986. Improved export volumes relative to imports in the second quarter, served to cut back the non-oil trade deficit to £2.3bn. However, the subsequent combination of a relatively poor export performance, as non-oil export volumes rose by about 7% over the same period, and further reductions in the exchange rate, raised the non-oil trade deficit to
The oil surplus rose slightly to £3.7bn in the first quarter of 1986, reflecting an increase in the volume of net crude oil exports which was more than sufficient to compensate for lower oil prices. Further falls in the price of oil and a relative increase in the volume of oil imports reduced the surplus to £0.75bn in the second quarter and there was a further slight fall to £0.69bn in the third quarter. Provisional estimates suggest that, for 1986 as a whole, the oil surplus was £4.1bn compared with £8.2bn in 1985.

The current account surplus has fallen progressively since the second quarter of 1985 when it stood at £1.5bn. By the first quarter of 1986 the surplus stood at £549m, falling to £375m and a deficit of £781m in the second and third quarters, respectively. Preliminary figures for the fourth quarter suggest a further deficit of £229m which, as forecast in the November Commentary, results in the current account for the year being in deficit (£186m) for the first time in seven years. The reduction in the estimated size of the deficit between the third and fourth quarters reflects some levelling off in the rapid growth of imports and improving export performance in response to the earlier depreciation of sterling which, in terms of its effective rate, averaged 68.4 in December.

In the three months to November 1986, output of the production industries is estimated provisionally to have increased by 0.5% from the level of the previous three months, resulting in a level of output 1% higher than in the corresponding period in 1985. The most recent quarterly change should be compared with a 0.5% fall during the preceding three month period. Manufacturing output rose by 1.5%, compared with a rise of 0.5% in the three months to August. As usual there was a fair degree of variation within the production industries. Energy and water supply, which reduced output by 2.5% in the previous three month period, continued to contract with a further reduction of 1%. Output increased by 3% in metals, by 2% in engineering and allied industries, and by 1% in chemicals, compared with 2%, little change, and 3%, respectively in the three months to August. The output of other minerals, and other manufacturing increased by 1% in the most recent period, while there was little change in the output of the clothing, food, drink and tobacco, and textile industries. The construction industry continued to expand, raising its output by 3% over the previous quarter. Overall, the output of both production and construction industries was about 2% higher than in the previous quarter, after remaining unchanged between the first and second quarters.

The output of the consumer goods industries rose by 1% in the three months to November compared with 0.5% increase in the preceding three month period. The faster growth in consumer goods output, combined with the evidence of a small amount of destocking in the third quarter, suggests that British producers are beginning to take some advantage of, and benefit from, the upsurge in consumer spending in 1986. The decline in the exchange rate will also have helped domestic producers of importables to benefit from the buoyant consumer demand, although the demand for imports still remains strong, even though the growth of imports appears to be levelling off. Output in the investment goods industries also appears to be picking up. In the latest three month period output increased by 1.5%, compared with successive reductions in the two preceding three month periods.

The labour market

Employment and unemployment

After the reduction in employment creation during 1985 to an average quarterly
increase of 65,000, the recorded increase in the employed labour force slackened further to 34,000 in the first quarter of 1986. The second quarter increase of only 19,000, reported in the November Commentary, has now been revised to 40,000 which, with an estimated third quarter increase of 71,000, suggests that the growth of employment may have resumed its upward path. The November Commentary suggested that if the weakening of the growth of UK output during 1985 was only a temporary phenomenon then, after allowing for the usual lags in the relation between output and employment, some improvement in employment creation might be expected in the latter part of the year. The recent evidence confirms this judgement.

From the first quarter of 1986 the growth of productivity began to pick up after the slow-down during the middle of 1985. For the economy as a whole, the latest estimates show an increase of 1% between the second and third quarters of 1986, representing an increase of 2.5% over the corresponding period in 1985. In manufacturing, after the small decline in the first quarter of 1986, productivity rose successively by 1.5% and 2% in the second and third quarters, respectively. By October productivity in manufacturing was 3.6% higher than in October 1985.

It was noted above that earnings growth may now be beginning to adjust to lower inflation, although the evidence is mixed. Wages and salaries per unit of output do appear to be moderating in manufacturing. In the three months ending August, September and October, the percentage increase over the year was 5.5%, 4.1% and 3.8%, respectively. Compared with Japan, France and West Germany, the growth of unit labour costs appears to have moderated somewhat during the first half of 1986.

Seasonally adjusted unemployment rose by 15,000 per month on average over the first six months of 1986. Since August unemployment has exhibited a downward trend, falling on average by 26,000 per month over the last four months of the year. While some, indeed much, of this decline may be accounted for by the growth in government training schemes, the fall is also consistent with the more favourable outturn for output and employment in the second and third quarters of the year. Nevertheless, one worrying statistic is that the proportion of the labour force in work has remained little changed for a year or more, suggesting that many workers have left the unemployment register without finding jobs. By December, on the basis of the new method of compilation introduced in March, seasonally adjusted unemployment, excluding school leavers, stood at 3,116,400 or 11.3% of the working population.

The composition of the change in employment in the third quarter again follows the established pattern. The number of employees in the service sector rose by an estimated 81,000 in the third quarter, compared with a revised figure of 73,000 in the second quarter. On the other hand, employment declined in manufacturing by 34,000, against a decline, on revised figures, of 53,000 during the previous three month period. Energy and water supply also posted a decline of 11,000, which was 1,000 greater than the reduction in the quarter to June. The other industries category, which includes construction, agriculture, forestry and fishing, recorded, on revised figures, an increase of 4,000 in the three months to September. Later data are available for employment in manufacturing, which is estimated to have decreased by a further 8,000 in November, although it is clear that the rate of employment decline in manufacturing has reduced in recent months.

The TUC and the trade union movement faces increasing difficulties. Membership fell
to its lowest level for more than 20 years in 1985. At the end of 1985 there were 10.71 million members, an 18.9% decline since 1979. Today more than one million fewer workers are covered by closed shop agreements than in the late 1970's. Such a decline indicates and underlies a series of problems facing the movement.

First, the combination of declining membership and increasing costs has led to serious financial difficulties for the TUC. The cumulative deficit for 1986 and 1987 is likely to be in excess of £630,000. Secondly, falling membership rolls strain relationships between unions. Inter-union disputes have become entrenched and led to court actions, as in the case involving ASTMS. A number of trade unions have pursued single union arrangements with employers to preserve membership. For other unions the problem is survival. ACTT is currently considering a report which questions its ability to survive as an effective force in collective bargaining. The CBU faced bankruptcy until it made a series of economies. Thirdly, declining membership prompts interest in mergers. The CSU is preparing for a merger with the Society of Civil and Public Servants as are ASTMS and TASS. Both the AEU and the GMBU have approached APEX with merger proposals. Fourthly, a number of unions, most notably the TUCU, have announced plans for widening their recruitment patterns to include temporary workers.

Whilst ministers have claimed that strike activity is at a fifty-year low, this has not deterred the government from considering further industrial relations legislation, especially in the areas of trade union democracy and organisation. Nor has the reduced strike activity been apparent throughout the public sector. Although the decision, by the European Commission of Human Rights, to dismiss the claim by GCHQ staff for the right to trade union membership effectively marked an end to the campaign for trade union rights at the centre.

Government efforts to minimise trade union effectiveness were apparent in the Education Bill. This empowered the Secretary of State for Education to dismantle the existing negotiating machinery, the Burnham Committee, and, following consultations with such organisations as he deems necessary and relevant, make a statutory order regarding the pay and conditions of school teachers. The order, which cannot be varied by local authorities (the lawful employers of teachers), can:-

1. Make different provisions for different cases, including different areas.


3. Indicate those matters which may be settled by agreement between teachers and their employers.

These draconian powers were introduced to enable the government to settle the current teachers' dispute and, according to critics, to effectively emasculate trade union organisation within the profession thus minimising both employee and local authority opposition to other, far reaching, changes within education. Whilst the publication of the Bill acted as a strong incentive on the Burnham machinery it did not lead to a settlement acceptable to all the unions or to the Minister. However, a further set of suggestions, proposed by the Professional Association of Teachers, is currently under consideration by the Minister.

Elsewhere in the public sector the government faces long term problems over morale in the Health Service. A growing number of areas are facing problems arising from increasing labour turnover due to low rates of pay. Some 15% of places in nursing courses remain unfilled, vacancy levels for midwives are now running at over 15%. A survey by the RCN indicated that over 66% of nurses were dissatisfied with pay levels. A third had seriously considered leaving the NHS and 20% had changed jobs within the first seven months of 1986. 90% of those surveyed felt that realistic pay levels and 80% better pay, were the major factors necessary to reduce labour turnover. The policy of attracting men to fill nursing shortfalls will, in the long run, heighten
issues of low pay and do little to overcome the basic causes of low morale and high rates of labour turnover.

Whilst industrial relations within British Coal continued to be affected by issues arising from the miners' strike the moves to reorganise the industry for privatisation are the dominant features. British Coal has announced a series of proposals to change work practices to improve labour efficiency (these were outlined in an earlier issue of the Commentary). The intention is to move towards 24 hour operation for six days a week. This requires the introduction of new shift patterns and multi-skilled training. The first 58 apprentices have now started a four year programme which focuses on developing multi-skills. Whilst it is clear that privatisation is the long term aim of the government, possibly by 1990-1992, a partial privatisation is possible by widening the private licensing of pits. Such a policy would allow multi-national firms to enter mining. However, this policy would run counter to ministerial comments as to the possibility of jointly privatising the mining industry and power stations. The NUM's financial position continues to be weak. This is due to the costs of the miners' dispute and more recently to the reductions in income following redundancies and loss of members to the UDM. The union has had to curtail spending plans on a new headquarters and faces the possibility of having to defer redundancy payments and increasing subscriptions to curtail costs. However, the NUM gained some success at the Appeal Court over its claim that British Coal was making higher awards to UDM members than to those miners belonging to the NUM. The court heard that such a policy was an unlawful discrimination under section 23 of the Employment Protection (Consolidation) Act.

Evidence from the CBI databank and Industrial Relations Review and Report suggests a reduction in the level of pay settlements in the manufacturing industry. However, there is disagreement as to the rate of decline and as to whether the decline is a permanent one. Whilst the Department of Employment's New Earnings Survey findings could be interpreted as questioning the assumption that trade unions and industry wide bargaining structures artificially raise wages and generate inflationary pressures, the government has chosen to interpret the findings as supporting its drive for greater regional pay variation and ending of national bargaining arrangements in the public sector.

Industrial action by members of the EETPU at the BBC stems from two years of negotiation over a pay rise and comparability issues, however, underlying the dispute is an attempt, by the BBC, to change working practices. Industrial action may spread when further proposals to reduce labour costs - including flexibility, simplified job structures, sub-contracting amongst scenery carpenters and shifters - are presented to employees.

Balloting issues still affect sections of the trade union movement. A study of 265 union representatives by the Labour Research Department questioned the extent to which balloting provisions were used before industrial action. Some unions, such as the Fire Brigades Union have still to amend their rules with respect to pre-strike ballots. The results of the LRD study suggested that in very few cases were ballots held prior to industrial action. Allegations of ballot rigging within the NUS have led to calls to re-run all the recent elections.

The First Division of Civil Servants became the first union to vote against the maintenance or establishment of a political fund. The Association suffered considerable embarrassment in having to cancel a special conference to amend election rules to the requirements of the 1984 Act because its proposals were contrary to that Act. This was especially embarrassing as members of the Association were responsible for the drafting of the 1984 Act.

In recent months both the Secretary of State for Employment and his counterpart in the Department of the Environment have exhorted employers to move towards
devolved bargaining structures. In the private sector a number of firms, notably Lucas, have ended national bargaining arrangements. Others, such as Ford, argue that the potential labour costs of such a move outweigh any advantages. In the public sector ministers have called on local authorities to ignore nationally negotiated rates and consider the conditions in their local labour market. Both local authority employers and trade unions have sought to defend national wage bargaining, stressing that a failure to curb the growth in wages in the private sector will be the spark to major disputes in the public sector. However, these practical and more academic arguments have been ignored as the government has pressed ahead with a proposal for regional pay premiums for a number of public sector groups, including the soon to be privatised water boards.

The government has also considered the introduction of performance related pay to the Civil Service. It is already committed to such payments for groups within the Health Service and to the two most senior civil service grades below Permanent Secretary level. Currently discussions are proceeding on introducing such schemes to principal and above grades. There is evidence of a spread of such schemes in the private sector. Abbey National has concluded an agreement with its staff association for the introduction of performance related rather than across the board increases. The Abbey National scheme provides for clerical grades up to the level of regional manager to be graded on performance against previously agreed objectives. There are five grades: unacceptable (who will receive no increase); less than effective (who will receive half of the increase for effective performers); effective performers will receive 100% of an agreed benchmark rise (to be negotiated between the company and the staff association); more than effective (who will receive 150% of the agreed benchmark rise); and outstanding (these will receive 200% of the agreed benchmark increase).

The main growth of performance related pay would seem to be at the managerial rather than clerical level. The 1984 Finance Act's provisions make such schemes far more attractive to senior managers. For example, The Burton Group's earlier incentive schemes covered all 24,000 employees. However, the new scheme, which takes advantage of the 1984 Act, applies only to 80 senior employees who are offered share options worth up to eight times their annual remuneration. Other managers can exercise options worth four times their remuneration if the company's real earnings per share exceeds 30% within a four year period.

Faced with the threat of renewed legal action SOGAT 82 had to call off pickets from News International's Wapping plant and sought withdrawal of the Labour Party's boycott of the company's papers. Whilst some of the London branches of SOGAT will seek to continue the protest it is unlikely that the NGA will continue the dispute alone. The impact of the ending of the dispute is likely to be felt in terms of a renewal of pressure on the TUC to act against the EETPU and in moves towards, and terms of, the much rumoured merger between the NGA and SOGAT.

The dispute between British Telecom and the National Communications Union appears to question the assertion that privatisation automatically leads to better management. A major factor in the dispute has been the clumsiness of management, it was arguably tactless to announce an 11% increase in profits shortly before stating that the company could only afford a 5% increase in wages.

The significance of the dispute is two fold. First, it is a dispute in which the majority of those on strike hold shares in the company, and one in which the union has followed all the provisions of the recent legislation. Secondly, it is an indication of the industrial relations implications of privatisation. Since privatisation management has initiated a series of changes to the established industrial relations machinery. These have included a decentralisation of control with the establishment of a series of profit centres. The development of local management accountability has led to a 'hardline' management style in several regions. This undoubtedly contributed to the surprising degree of militancy amongst employees and to the regional difference in the conduct of the dispute. Thus,
whilst some regions faced an all-out stoppage, in others, eg. the north of Scotland, engineers have not been asked to sign assurances that they would work normally.

To date the result of privatisation has been a degree of demoralisation and sense of insecurity rather than efficiency. Possibly this has been exacerbated by a belief amongst employees that up to 30% of engineers might be lost. In preparation for the dispute British Telecom had settled with its managers and made it clear that they would be expected to undertake emergency repairs to keep the system intact. Additionally, BT had explored the possibility of using staff from Plessey and Marconi to repair exchanges. The proposals which led to industrial action included a series of measures to improve labour efficiency - increased flexibility in working practices; a lengthening of the working day by 45 minutes; multi skilling; and, a simplified pay structure. The offer of 5% plus for such changes was comprehensively rejected by more than 80% of the labour force.

PROGNOSIS

Output and employment are showing clear signs of improvement in the short term as the benefits of lower oil prices, a lower exchange rate, increased world growth, and domestic increases in consumer spending, work their way through to the real economy. Unemployment appears to be on a downward trend but whether this is due simply to government labour market initiatives, such as the Restart programme, rather than an increase in the real demand for labour is the subject of much debate. Yet prospects for the coming year are still far from clear. The CSO’s two leading indicators, continue to provide little indication of future developments. The shorter leading indicator, which is intended to predict turning points six months in advance, moved sharply upwards in the three months to August 1986, then stabilised during September and October before falling markedly in November to its lowest point since before 1982. However, the downturn was largely due to movements in two of the indicator’s component series: consumer credit and new car registrations. In contrast, the longer leading indicator, which is intended to predict turning points one year in advance, fell back between July and November due to the depressive effects of share price falls, interest rates and housing starts. Movements in share prices and interest rates caused the indicator to rise slightly in December. These indicators therefore provide few signals as to the likely future course of events. The absence of consistent upward movements does not give one confidence that the recent improvement in economic performance will strengthen and continue past the middle of the year. Equally, evidence of downturns in only a few of the component series cannot be taken as an indication that growth will begin to falter.

Recent forecasts are, if anything, slightly more optimistic than those summarised in the November Commentary, although the general concern about prospects for the balance of payments and inflation in 1987 and 1988 continues. Concern about government economic policy, particularly its fiscal policy stance in the run-up to the general election, is also widespread.

During 1987 we expect, from the available evidence, that GDP growth will be somewhat higher than the 2.5% achieved in 1986, probably just under 3%. Consumer spending should remain the main source of growth, easing slightly from the 5% rate attained in 1986. Growth should also be better balanced following improvements in both investment and export performance. Imports are also expected to grow rapidly, although the difference between real import growth and real export growth may, as some forecasters predict, not be as large as in 1986. Nevertheless, a substantial deficit on current account must be expected for 1987. Forecasts of the size of the deficit range from £1.5bn to £5.6bn, although we think it likely that the eventual outcome should be nearer £3bn. Inflation is expected by the end of the year to range from 3.5% to nearly 6%, with, on our judgement, the likely outcome being in the range of 4.5% to 5%. Unemployment should fall below 3m by the
end of the third quarter of year, due to the impact of government training programmes and the lagged effects of improved economic growth in late 1986 and early 1987.

The performance of the British economy in the short term is heavily dependent on conditions in the world economy and the government's macro-monetary and fiscal-policy stance. In the medium to longer term it is the supply capacity of the economy which is crucial and here government policies, both macro and micro, have a significant role to play. Continuing structural imbalances in the housing and labour markets - at both the occupational and regional levels - coupled with the seeming impossibility of British industry competing on a sustained basis in world markets, are likely to set the agenda for economic policy well into the next decade. Problems of inflation, the weakness of sterling and the growing deficit in the balance of payments are simply short-term symptoms of that deeper malaise.

In the short term, however, the major uncertainties in the world economy concern: the future course of oil prices, the size and duration of the upturn in the world economy, and the deterioration in trading relations between Europe and the US (see World Economy section).

On policy, the November Commentary reported that the government now appears to be using the growth of MO, the narrow measure of money, and the exchange rate, as the two prime indicators of monetary conditions. Changes in the financial structure of the UK economy appeared to have changed the relationship between £M3, the broader measure of money, for which targets were set under the government's Medium Term Financial Strategy (MTFS), and money GDP. The government, in consequence, appears to have discounted the rapid growth of £M3 in recent years as suggesting relatively lax monetary conditions. Yet, many indicators do appear to suggest that credit conditions, in some sectors of the economy at least, are not tight. A high rate of borrowing has been a significant contributory factor in the rapid rise in house prices, particularly in the south east, and the growth in consumer spending. Increased consumption has in turn drawn in substantial imports, as domestic industry seemed singularly incapable, in the short term at least, of satisfying the growing demand. Increased pressure on the balance of payments and sterling has been the result. Finally, recent evidence on the growth of MO, the government's preferred monetary aggregate, suggests an annual rate of growth of 5.2% per year, which is very close to top of the target range of 2% to 6%. In the last Commentary we argued that in circumstances such as these the case for an exchange rate target, which could be achieved by entry into the EMS, is very persuasive. If anything, current conditions make the case for entry even more persuasive, but it is certain that no final decision will be made on this until after the election.

In view of the uncertainties surrounding the rate of inflation, and the balance of payments over the coming months it would probably be unwise for the Chancellor to seek to give the economy a major fiscal stimulus in the forthcoming Budget. Tax revenues are currently very buoyant due to the recent growth in incomes and spending, and the recent partial reversal of the oil price fall. Current tax and revenue projections imply that the PSBR will be well below the government's £7bn target for the year, even allowing for the planned increase in public spending of 1.5% in real terms announced in the Autumn Statement. Some cuts in the basic rate of tax, of at least 2 per cent points, appear certain as the inevitable prelude to the election. In view of the projections, fiscal changes of that magnitude can quite easily be accommodated within the PSBR target. The problem is first, that the projections may not in fact hold. In 1986, the spending departments significantly overspent their planned allocations and pressures to do so again are likely to be even greater in an election year. Secondly, even if spending projections do hold, current economic uncertainties suggest that the Chancellor should err on the side of caution, allowing the buoyant tax revenues to temporarily lower the PSBR rather than contributing to a pre-election boom. Otherwise the Chancellor may find himself cast as Santa Claus to the next government's Scrooge.