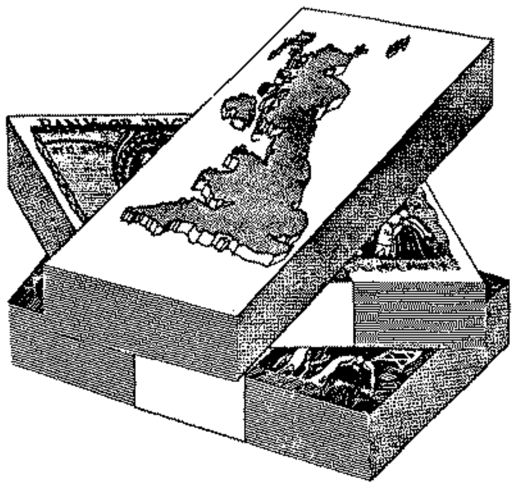
The British Economy



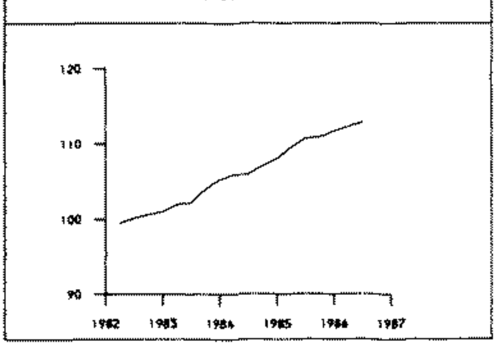
OVERVIEW

Recent developments in the UK economy suggest that the slowdown of growth in 1985 may only have been a temporary phenomenon. External events are continuing to play a significant role. Yet it is the trends within the domestic economy that are a major source of unease. Underlying inflationary pressures continue to operate via the relatively fast growth in average earnings, low productivity growth, the growth of private sector liquidity and the recent significant decrease in the value of sterling. An increase in the growth of non-oil imports adds to fears for the current account of the balance of payments. Perceptions of uncertainty in Government policy particularly towards the exchange rate are a continuing cause for concern.

MACROECONOMIC TRENDS

Nominal or 'money' GDP, the average measure of GDP at current market prices, increased by over 5.5% between the second quarters of 1985 and 1986. However, only a small increase (0.2%) was recorded between the first and second quarters of this year. 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 corresponding quarter in 1985. This should be compared with a real increase in total domestic expenditure - which by excluding/including spending on exports/imports is a good indicator of demand pressure within the economy - of 2.9% over the same period. There was little recorded change in real expenditure on either indicator between the first and second quarters of the year. In contrast, the output-based measure of GDP, which is conventionally regarded as the most reliable indicator of change in the short term, recorded an increase of 2% in the year to the second quarter and a small increase (0.5%) between the first and second quarters of the year.

INDEX OF UK GDP AT CONSTANT FACTOR COST
OUTPUT MEASURE - SEASONALLY ADJUSTED
(1980=100)

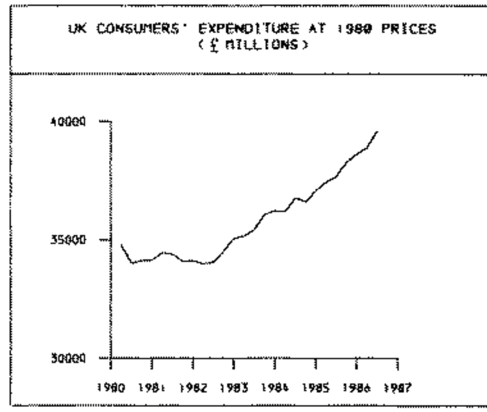


Since the trough of 1981 the UK experienced successive years of positive growth so that by the end of 1985 output had increased by nearly 13%. However, during 1985 growth appeared to be slowing down. By the end of 1985, after allowance for the effects of the miners' dispute, output was only 1.5% higher than in the final quarter of 1984. Estimates of output in the first quarter of 1986, where only very modest growth was recorded from the previous quarter, appeared to confirm this trend.

The most recent data on output therefore appear to suggest that the weakness in growth over the preceding year may have been only a temporary development. The CSO's coincident cyclical indicator, which purports to show **current** turning points in the business cycle around the long-term trend, fell almost continuously from the middle of 1985, then flattened out in April and May of this year and since June showed provisional signs that it may be starting to rise. The rise in the coincident index for the two months to August is accounted for by increases in the retail sales and industrial production components of the index and, for July only, in the CBI's survey of capacity utilisation.

Consumer expenditure was the main force behind Britain's economic growth during 1985. The evidence for the beginning of 1986 suggested that the growth of this key component of aggregate demand was slowing in line with the apparent weakening in the growth of GDP. The increase in real consumers' expenditure fell from 0.8% in the final quarter of 1985, to 0.6% and 0.4% in the first and second quarters of 1986, respectively. However, as reported in the August **Commentary**, the evidence on retail sales suggested that the provisional estimate of consumers' expenditure for the second quarter may have underestimated the growth in this component of demand. The revised figures for the second quarter confirm that view. The increase is now estimated to have been around 2%, taking real consumer expenditure to a level 5% higher than in the second quarter of 1985. Expenditure on durable goods and clothing, which rose by 11% and 6%, respectively, over the year, appeared to be the main source of the rise. Preliminary estimates for the third quarter of a 1.6% increase over the preceding quarter and a 5.2% increase over the same period in 1985, suggest that the upturn in consumer demand is continuing.

The Department of Trade and Industry's



(DTI) estimates for the volume of retail sales in June indicated that sales had reached a record level. This was followed by a decrease of 1.2% in July then a further large increase in August of 1.4% and, from the provisional figures, only a modest increase of 0.2% in September. The September CBI/FT Survey of Distributive Trades provided further evidence of recovery from the relatively poor performance in the first quarter. Seventy-five percent of retailers reported higher sales volumes compared with 9% reporting lower volumes. The balance of plus 66% is the highest since July 1984. Stocks in distribution remained too high in relation to expected sales in September but the survey showed that the net proportion of distributors reporting excessive stocks was the lowest for seven months.

Previous **Commentaries** have noted the importance of real income growth and the cost and availability of credit in determining the growth of consumer spending. The growth of average earnings has remained at around 7.5% for the past two years while the rate of inflation has progressively fallen. In the year to the second quarter, total wages and salaries increased by about 8% leading to an increase in real personal disposable income of almost 4%. Despite high real interest rates there was strong growth in consumer credit in the second half of last year. Growth continued strongly, apart from April, until August of this year when there was evidence of a slight easing in demand, but the underlying trend was still significantly positive. As noted in the May **Commentary,** higher real interest rates might be expected to raise consumption when the private sector's assets exceed liabilities. The fall in the savings ratio from 13.7% of personal disposable income in the fourth quarter of 1984 to 10.5% by the second quarter of this year, conforms with this expectation. A falling savings ratio might also be the result of a declining inflation rate raising the actual ratio of net worth to income relative to the desired rate. It remains to be seen what impact the one percentage point increase in base lending rates in October will have on the savings ratio and hence on consumer spending.

Growth in consumer spending has also clearly been influenced by increases in the availability of credit at given interest rates. Under the present Government, deregulation of the financial markets began in 1980 and further liberalising steps were taken in subsequent years. Net borrowing by the personal sector for house purchase rose by 94% betwen 1981 and 1985 from £9.5bn to £18.4bn, while net borrowing for other purposes rose by nearly 73% from £4bn to £6.9bn over the same period. This increase in the supply of credit has not only contributed to a marked increase in real new house prices since 1982, with possible implications for further wage inflation, but seems certain to have raised consumer spending. The 'leakage' of mortgage lending into consumer spending has been highlighted by the Governor of the Bank of England in recent speeches.

General government consumption remained largely static with a very slight fall recorded between the first and second quarters and no change from the second quarter of 1985.

Gross fixed investment, which was an important source of growth for the economy in 1984, has remained little changed in the first half of the year compared with the corresponding period in 1985. The quarterly pattern of investment expenditure has been influenced by the phased withdrawal of capital allowances introduced in the 1984 Budget and completed in March 1986. This has led to expenditures being brought forward to the first quarters of the last two years followed by some fall back in the second quarter, although the effect was less pronounced this year than last.

Excluding leasing of assets from the financial sector, manufacturers' investment rose by 1.7% in the first half of the year compared with the same period in 1985.

Public sector investment fell in 1985 to a level more than 15% below the level of 1984 reflecting the continuation of public expenditure restraint. In the first quarter of 1986 public investment rose by 8% over the previous quarter, largely due to increases in spending by the public corporations, falling back by nearly 4% in the second quarter of this year. In contrast, private sector investment **rose** by 7% in 1985, increased by 3.5% in the first quarter of 1986 against the preceding quarter, then fell back by 3% in the second quarter. Investment in dwellings recorded a fall of more than 4% between 1984 and 1985 with the bulk of the decline occurring in public (11%) rather than private (2%) investment. In the first quarter of the year public investment in dwellings reflected the general upsurge in public investment with an increase of 17%, compared with a 1% **decrease** in private investment in dwellings. The position was reversed in the second quarter when the public components fell by 8% while the private component rose by 7%.

The evidence that gross fixed investment has remained little changed in the first half of 1986 compared with the first six months of 1985 hides significant changes in the demand for particular assets. Between the two periods, investment in vehicles, ships and aircaraft fell by 19%, while investment in dwellings, plant and machinery, and other new buildings and works rose by 6%, 1.6% and 1.5%, respectively.

From mid-1983 to February 1985 sterling underwent a marked depreciation with the effective exchange rate falling from 84.9 to 71.3. The volume of exports rose in almost every quarter until the second quarter of 1985. Imports also rose, apart from a brief downturn at the beginning of 1984, until the end of 1984 but began to fall in the first half of 1985 largely as a result of lower oil imports following the end of the miners' strike. In the second half of the year these volume movements started to reverse yet the visible trade deficit continued to fall from the high level of the fourth quarter of 1984. This continuing improvement in the trade deficit reflected the terms of trade effect created by sterling's appreciation from the February 1985 low of 71.3 to a peak of 83.3 in July of that year. The favourable movements in the value of net exports therefore contributed positively to the growth of the economy last year.

In the first quarter of 1986 the adverse volume movements continued with a particularly sharp fall in non-oil exports. However, revised figures for the second quarter indicate that non-oil export volumes increased by nearly 7% with non oil import volumes exhibiting only a slight increase. Yet by the third quarter, provisional estimates suggest that non-oil exports are still lagging behind imports, being only 5.5% higher compared with an 11% rise in import volumes over the same period last year. The non-oil trade deficit increased sharply from £2.1bn in the last quarter of 1985 to £3.4bn in the first quarter of 1986 reflecting the decline in export volumes and deteriorating terms of trade as the exchange rate fell by 6%. In the second quarter the deficit fell again to £2.3bn largely because of the improvement in export volumes. The oil surplus increased slightly in the first quarter to almost £2bn reflecting an increase in the volume of net crude oil exports which was more than sufficient to compensate for lower oil prices. In the second quarter the oil surplus fell back markedly to £0.7bn due to a relative increase in the volume of oil imports and further falls in the price of oil.

The current account surplus remained largely unchanged between the last quarter of 1985 and the first quarter of 1986 having fallen from the second quarter of 1985. In the second quarter the surplus fell again from £597m to £345m and is provisionally estimated to have fallen to a deficit of £1.1bn in the third quarter of the year. This further significant deterioration in the current account is largely accounted for by a marked worsening in the non-oil balance. It is unlikely that the effect of the sharp depreciation of sterling from the second quarter of the year will produce much of a recovery in the non-oil balance by the final quarter. This coupled with the effect of lower oil prices on the oil account suggests that the current account surplus for the year is likely to be small and could even be in deficit for the first time in seven years.

In the three months to the end of August, output of the production industries is estimated provisionally to have fallen by 0.5% compared with the previous three months, and to be 1% higher than in the corresponding period in 1985.

Manufacturing output in the three months to August increased by 0.5% from the level of the preceding three month period but remained unchanged compared with the same period last year. Within manufacturing there was a fair degree of variation. Output increased by 3% in chemicals, 2% in metals and 1% in other manufacturing and other minerals, compared with the earlier three month period. Output fell in the recent three month period by 2.5% in energy and water supply and rose by 4% in the construction industry in the second quarter of the year. Little change was recorded over the three months in engineering and allied industries, food, drink and tobacco, textiles and clothing. Overall, output of the production and construction industries is estimated to have remained unchanged between the first and second quarters of the year.

The output of the consumer goods industries rose by only 0.5% in the three months to August following a similar increase in the earlier three month period. These data suggest that the continuing growth of consumer expenditure is only weakly reflected in the growth of domestic production. This evidence, when combined with the relatively faster growth of total domestic expenditure compared with GDP, noted at the beginning of this section, and unchanged stock levels, accounts for the underlying growth in non-oil import volumes. Similarly, while investment expenditure was largely unchanged during the first half of the year, the output of investment goods recorded only a small increase in the three months to March, then fell in the succeeding three months reducing by a further 0.5% in the three months to August.

THE LABOUR MARKET

EMPLOYMENT AND UNEMPLOYMENT

The slowing of output growth in the UK during 1985 led to a significant reduction in employment creation with the average quarterly increase falling to 65,000 compared with 84,000 in 1984. In the first quarter of this year there was a recorded increase of 36,000 in the employed labour force compared with an increase of 69,000 in the first quarter of 1985. In the second quarter the pace of employment creation slackened further with an estimated increase of only 19,000 against 64,000 in the same quarter last year. The second quarter increase reflected an assumed rise of 30,000 in the self-employed and an estimated decrease of 11,000 in the number of employees in employment.

The composition of the change in employment in the second quarter followed the established pattern. The number of employees in the service sector rose by 35,000 while employment declined in manufacturing (40,000) and in energy and water supply (8,000). However, a small increase of 2,000 is estimated to have occurred in other industries which includes construction, agriculture, forestry and fishing. Further data are available for July and August for manufacturing and for energy and water supply. These data indicate continuing job losses with employment falling over the two months by 26,000 in manufacturing and by 5,000 in energy and water supply. If the weakening of the growth of UK output during 1985 was only a temporary development then the recent slight upturn in growth has yet to be reflected in employment creation, although from the evidence of the CSO's coincident indicator, and allowing for the usual lags in the relation between output and employment, there may be some improvement in the latter part of the year.

The growth of productivity weakened from the middle of 1985 reflecting the slowdown in economic growth. For the economy as a whole, output per head registered a very small increase on revised figures for the first quarter of 1986. A similar increase was recorded for the second quarter. For manufacturing, revised figures show a small decline in the first quarter and an increase in the second quarter. Later data suggest that there was a further increase in July followed by a very small decline in Agust. Earnings growth has still not adjusted to declining inflation and the reduction in productivity growth. This failure of earnings to adjust may in part be due to the high profits earned by UK companies in recent years. The underlying increase in average weekly earnings in the year to August was still about 7.5%, a rate of increase which has persisted for the past two years. For manufacturing, the underlying increase is still just under 8%. In the three months ending August, wages and salaries per unit of output in manufacturing industries were 5.9% higher than in the same period last year. The growth of unit labour costs showed some evidence of moderating as against other major industrial countries in the first quarter of this year compared with the corresponding quarter of the previous year. Following the depreciation of sterling from the middle of 1985 UK trade competitiveness began to show some improvement in the final quarter of last year and the improvement continued into the first quarter of 1986.

The increase in seasonally adjusted unemployment, which was rising by 15,000 per month on average over the first six months of the year, has moderated somewhat. Following a small reduction in August of 4.2 thousand and a further large reduction in September of 22 thousand the level of unemployment fell back to the level previously recorded in March. The compilation of the unemployment statistics was changed in March. On the new basis for measuring the number of claimants unemployed on the specified count date, the seasonally adjusted UK unemployment rate, excluding school leavers, was 11.6%, which is very slightly lower than the average rate in the preceding three months.

INDUSTRIAL RELATIONS

The strengths and weaknesses of recent legislation on trade union balloting were well demonstrated by the CPSA's election of a new General Secretary and Treasurer. More than 40 complaints had been made concerning the conduct of the election. The Electoral Reform Society, whilst finding no evidence of ballot rigging, nevertheless, recommended a re-run of the election. The right-led national executive of the union, in adopting some of the views of the Electoral Reform Society, changed the rules for the second election to require every union member to be given a ballot before the meetings where they vote, thus favouring their candidate.

The Labour Party and TUC conferences outlined proposals to reform employment legislation. The Labour Party's official policy is to repeal the 1980 and 1982 Employment Acts and the 1984 Trade Union Act. The July 1986 statement by the TUC/Labour Party Liaison Committee, entitled **People at Work: New Rights, New Responsibilities**, indicates that some of Mrs Thatcher's legislation is likely to be retained, although the three statutes will be repealed. The policy would seem to combine an element of individualism and restriction of trade unions, but nevertheless, a number of the features of the traditional system would be restored. Thus, the proposals are to strengthen the rights of workers, both as individuals and as trade unionists, collective freedoms will be restored by an extension of individual worker's rights. Whilst the restrictive elements of industrial disputes legislation of 1980 - 1984 would be mismantled, a new legal framework - to guarantee the freedom of workers and their unions to organise effective industrial action, reduce the influence of the Courts in industrial disputes, and limit the use of the injunction - would be enacted. Finally, a future Labour Government appears committed to the introduction of industrial democracy through individual rights in three areas:- first, more information from employers including inspection of company accounts; secondly, prior consultation on decisions affecting workers' interests; and thirdly, representation at levels up to, and including, boards of management. Additionally, a future Labour Government is likely to re-introduce the traditional supports for union recognition and fair wages, and to return to consensus industrial relations by enhancing the powers of ACAS in helping to avoid disputes.

An indication of the permancy of the stress on individualism, and intervention and constraint on trade unions is shown by the proposals for retaining the statutory balloting provisions. The right of individual union members via a secret ballot to indicate their views on a range of trade union matters have proved popular with union members and the general public. **People at Work** proposes a statutory framework laying down principles for inclusion in union Rule Books on secret ballots for election of union executives and strike action. Balloting is to be either postal or workplace according to a code of practice to be drawn up by the TUC. An independent tribunal is proposed to investigate and rule on complaints by members about balloting procedures. Appeal to the Courts from the tribunal is to be only allowed on points of law.

The possibility of further reforms in this and other areas of trade union activity were heightened by the call for a meeting between Kenneth Clarke, Paymaster General, and representatives of unions outside the TUC. At the meeting, held in August, were representatives of the Professional Association of Teachers, Association of Nursery Nurses and Federation of Professional Railway Staff. Members of the Union of Democratic Miners sent observers. Whilst this meeting was to discuss the possibility of a general code of conduct, Mr Clarke indicated later the likelihood of further legislation to give trade union members more say in the internal affairs of their organisations.

Over the next year there will be considerable changes to many employees arising from the enactment of the Wages Act. Whilst the Wages Act 1986 is mainly associated with the operation of Wages Councils its impact is far greater. The new act changes the law relating to wages in three areas:-

1. The Truck Acts are repealed and all statutory constraints on how wages are paid are removed. The new regulations, including a right to complain to industrial tribunals for unauthorised deductions, set rules for the deduction from wages and salaries. Extra regulations exist for retail workers, these limit the deductions, on account of cash shortages or stock deficiencies - to not more than one-tenth of the gross amount of wages payable on that day. These rights, which come into force on 1 January, cover both manual and non-manual workers.

2. The powers of Wages Councils are reduced. Wages Council orders no longer apply to workers under the age of 21. Councils can only establish:- a single minimum hourly rate for all time worked in a week; a single overtime rate; and a maximum rate to be deducted to cover the costs of providing living accommodation by the employer. Arrangements for varying the work of Councils, for their amalgamation and abolition, are made easier. The existing 26 Wages Councils, covering 2.7 million workers are now under a statutory obligation to consider the impact of their awards on levels of employment.

3. There are adjustments to redundancy rebates and related payments to certain employers.

The appointment of Mr Haslam, as successor to Sir Ian MacGregor, was widely seen as ending the era of stormy union management relations within the coal industry. The well publicised attempts at reconciliation, regrets of past differences and closure of a UDM organised pit combined to add weight to such a view. Nevertheless, the NUM continues to face long term financial difficulties arising from the national stoppage and will have to continue to contend with the impact of major changes as British Coal seeks to reduce costs to the target of £1 per gigajoule.

The NUM's deficit is likely to exceed £2 million by the end of the year and only four of the union's areas are running in surplus. Moreover, as contributions are linked to basic wages rather than earnings, the increasing significance of bonus earnings (averaging 25% of earnings) further depresses contributions. Financial difficulties and declining membership underlay the proposal to reform the union by reducing the present 22 constituent associations and scaling down the size of the national offices.

The future for the union is bleak. To become efficient the industry will have to consider, and implement, major changes in work practices. An indication of the scope and direction of such reforms was given by Albert Wheeler, director of Nottingham-shire area, in a recent paper in the Mining Engineer. He suggested:- a move to a six day week, implying three extended shifts of nine hours per day ensuring 24 hour working to spread capital costs; and the concentration of production in fewer seams, with associated reductions in manpower. In addition, a major programme of training is suggested to introduce widespread job flexibility and deskilling. This would lead to a further 5% reduction in manning. Similar reductions would be possible by the increased use of sub contractors and a greater reliance on pit productivity schemes.

The reporting of disputes in the car industry prompted a degree of nostalgia amongst labour correspondentsover a possible return to the bad old days of labour relations in the motor industry. However, the stoppage by workers at Lucas reflects the problems of decline and change rather than a return to shopfloor power. Employees at the Lucas electrical factories have adopted major changes in work practices and productivity in return for low increases, whilst at the same time witnessing a widening of differentials between themselves and other employees in the aerospace divisions of the same company. Similar problems, plus an outdated grading structure, underlay the industrial action at Austin Rover.

Problems of poor quality production have prompted proposals to link bonuses to quality and to take a wider, but longer review of regrading. At Jaguar, the stoppage was a reaction to a succession of low wage increases at a time of increasing company growth and profitability. However, here management was able to forestall shopfloor militancy with significant pay rises and increases to bonuses.

Sea Containers, purchasers of Sealink, have experienced considerable difficulties in increasing profitability. Bad results, management reorganisations and rationalisations had all preceded the stoppage by crews over proposals to rationalise its Channel Island services and reduce employment by 492. Whilst accepting a series of cutbacks, the NUS has reacted strongly to what it regards as asset stripping and was largely successful in securing the withdrawal of the redundancy notices.

The newspaper industry continued its series of long-running disputes with writs piling upon one another, mounting accusations agaist the EETPU, and few signs of any settlement of the dispute between News International and the print unions. The NGA faced increased pressure to recommend acceptance of News International's offer, but once this was rejected, continues to face the difficulty of attempting to resolve the dispute. The NGA continues to seek TUC action against the EETPU in both the organisation and running of its Wapping operations. To date the TUC has drawn back from taking action that might threaten the unity of the movement.

SOGAT's involvement in the Wapping dispute has now cost the union in excess of £1 million. The union continues to face problems with its London branches with the rejection of the latest offer from News International.

Elsewhere the Mirror group faces problems arising from Mr Justice Mars-Jones refusal to allow the Mirror to abandon its contempt of court moves against two NGA members and to impose large fines on both individuals. However, the Telegraph has secured agreement with its employees providing for a 60% reduction in manning levels; compulsory arbitration and all provisions included in legally-binding individual contracts of employment.

In both Scotland and England Government initiatives ensured that popular comment focussed on the teachers' disputes. The laborious negotiations between the teaching unions and employers had produced a sketchy agreement, but intermittent industrial action continued. It had been clear for some time that the Government had considered adopting some of the provisions of the Main Report (on conditions of service and pay of Scottish teachers). In an attempt to force the pace of the established negotiating machinery, Kenneth Baker, the Secretary of State for Education, announced pay proposals based on the "well judged" recommendations of the Scottish inquiry, and to repeal the 1965 Remuneration of Teachers Act. The Government's proposals rely more on the findings of the Audit Commission's report on managing education, rather than the Main Report. Although both share a common belief in the need to develop managerialism and common standards.

At the time of writing trade unions and local authorities were attempting to negotiate an alternative. However, the Minister's reiteration of his views as to the contours of the settlement appears likely to reduce the chances of a settlement being reached by conventional means. Whilst the Minister's proposals strengthen the employers' arguments, both sides recognise that failure to agree will lead to a rapid centralisation of control of education and major changes to teachers' terms and conditions, and increased powers and responsibilities for head teachers. The first indications of the Secretary of State's intentions as to more detailed listing of teachers' duties prompts the suggestion that the Minister wishes to impose a statutory settlement of terms and conditions and is more concerned to prevent industrial action in the future, rather than to seriously seek to overcome the current problems facing secondary education and thus improve morale within the profession.

Government preoccupation with pay determination surfaced in suggestions by the Environment Secretary and Chancellor of the Exchequer, that local authorities should not feel constrained to accept national pay agreements and to pay staff "what they can afford". The practicality and implications of such a suggestion are, at best, alarming. Local authorities have been under Government pressure for some time to reduce the level of pay settlements. However, local government has been one of the few sectors to avoid disputes over comparisons in pay; to abandon this would be a "recipe for anarchy".

Government initiatives to vary established pay procedures have been announced for civil servants, health service managers, and prison officers. However, performance-related pay for civil servants is being reassessed in the face of considerable opposition. Elsewhere, the government proposals for profit-related pay met with lukewarm support. The Institute of Personnel Management, TUC and a number of public sector unions rejected the proposals. The CBI and Engineering Employers' Federation, whilst noting some advantages, remained highly critical.

Publication of exceptionally low strike statistics provided a timely reminder of the extent of changing attitudes towards strikes. As Norman Willis noted at the recent IPM conference, trade unions have inceasingly had to come to terms with the undoubted popularity of strike free deals amongst both their members and employers. Initiatives such as compulsory and/or pendulum arbitration have met with favourable comments from both the government and ACAS. Equally discernible are significant changes in attitudes towards flexibility. The TUC's economic committee has stressed the need to consider such practices and noted that "little is to be gained for workers in maintaining a status quo that is often ossified, conservative and unjust".

However, translating such views into agreements is not without difficulties as the recent negotiations between the EEF and CSEU demonstrate (the next issue of the **Commentary** will examine in depth moves towards work flexibility).

PROGNOSIS

In this section we consider the overall prospects for the economy in the short to medium term and the implications for policy.

The recent evidence on the growth of real GDP suggests that the slowing down of growth during 1985 may have been only a temporary development. However, the prospects for output growth and hence employment and unemployment over the next few months are unclear. The CSO's two leading indicators, which purport to provide an early indication of turning points in economic activity, provide little guide to future developments. the **shorter** leading indicator, which is intended to predict turning points some six months in advance, moved sharply upwards in the three months to August thus reversing the marked downward movement that occurred in the first four months of the year. The movements in the indicator are not however the result of consistent movements in its component series. So, the fall earlier in the year and the latest increase are accounted for almost entirely by movements in consumer credit. In contrast, the **longer** leading indicator, which is intended to predict turning points in activity about one year in advance, fell back during August and September after rising in successive months to a value in July higher than any recorded in the preceding year. This recent fall is accounted for my movements in interest rates and share prices.

The recent analysis published by the Treasury of the latest forecasts made by Britain's leading independent forecasting groups, shows an average expectation of only a modest increase in output growth over the coming year. The growth of GDP is, on average, forecast to be 2.3% for this year rising to 2.6% in 1987. The two key areas of concern which could confound the forecasts of even modest output growth are the rate of inflation and the current account of the balance of payments.

The annual growth of the Retail Price Index (RPI) fell to a low of 2.4% in August but all indicators suggest that it will rise again next year. The increase in mortgage rates following the 1% point rise in base rates in October, the continuing growth of UK average earnings at 7.5% per annum, low productivity growth at 1% per annum, and the recent rapid decline in the value of sterling are all pointers to higher inflation in the coming year. The fall in sterling has been quite marked with a 14% reduction in the effective rate and a reduction of 25% against the D-Mark over the past year. The average of independent forecasts suggests that inflation should remain at about 3% in the final three months of 1986 but it is then expected to rise to 4.5% in the same period in 1987. This compares with a more optimistic Treasury forecast of 3.75% for the same period published recently in the Chancellor's Autumn Statement. The underlying rate of inflation in the UK, based on producer prices, continues to be 5% above the OECD average which, along with fears about the underlying strength of the British economy and confusion about the Government's monetary policy stance, serves to put downward pressure on sterling and lead to further deterioration, at least in the short run, in the current account.

The average independent forecasts suggests that there will be a small surplus on the current account for 1986 of £0.8bn, although, as noted in the earlier section, if recent trends continue there could well be a small deficit. For 1987 all the forecasts suggest that the current account will deteriorate further with, on average, a deficit of £2.4bn expected over the year. Again the Autumn Statement is more optimistic forecasting only a £1.5bn deficit for 1987. These forecasts reflect a clear expectation that the effects of the decline in the oil price on Britain's trade performance will more than outweigh the effects of improved UK competitiveness which has resulted from the depreciation of sterling. The price of oil is expected to stabilise around a new but uncertain equilibrium level in the range of $14 to $17 following the recent temporary OPEC agreement on production quotas. This, along with the 1% point rise in UK base rates in October, should help reduce some of the immediate downward pressure on sterling helping inflation and the balance on the oil account. However, it is the deterioration in the non-oil balance that is giving the most immediate cause for concern. It is difficult to conclude that the recent upsurge in the volume of non-oil imports is a temporary phenomenon. If the buoyant growth of consumer spending continues along with low growth in the output of the consumer goods industries then non-oil import volumes will continue to rise. And , despite improvements in the UK's competitive position, it is difficult to envisage the expected growth in world economic activity next year, following the income effects of lower oil prices, leading to an improvement in the current account. It is unlikely that any growth in the demand for UK exports will be sufficient to balance the revenue lost to the UK through lower oil prices and the rising non-oil import trend.

The uncertainty about future economic developments is also mirrored in the British Government's current policy stance towards the macro-economy. However, the apparent uncertainty in Government policy over the past year also reflects an increasing awareness that traditional indicators of monetary conditions now appear to be less reliable than before.

Since 1980 the medium-term financial strategy (MTFS) has been the basis for economic policy. The Government, relying on the belief, and some evidence, that a stable relationship existed between the rate of growth of broad money and the rate of growth of prices, embarked upon a strategy of reducing the rate of growth of money GDP and hence inflation. The Government therefore tried to control the growth of sterling M3 (£M3) within specified and declining target ranges to effect the desired reduction in inflation and money GDP. In the 1960s and 1970s, the growth of £M3 was, on average, 1 to 2 per cent slower than money GDP. The accumulated evidence since 1980, with £M3 growth between 2 to 6 per cent faster than money GDP, suggests that the relationship may have changed and, may even have broken down.

So, the faster growth of £M3, implying on the conventional view lax monetary conditions, has led to overshooting of the target range. The August **Commentary** noted that in July the annual rate of growth of £M3 had risen to 19.5%, well above the target range of 11-15% announced in the Budget in March this year. The explanation for the change in the relationship between money GDP and £M3 lies in the removal of exchange controls, the ending of direct controls on credit growth and the international debt crisis, all of which have led to a growth in competition among and between banks and building societies. The result has been a growth in the attraction of liquid assets relative to other financial assets and hence a fall in what economists term the velocity of circulation: the average number of times a unit of money changes hands in a specified time period. The difficulty facing the authorities is that at present it is not clear whether these structural changes in the financial sector have produced a once-and-for-all adjustment in the relationship between £M3 and money GDP, or whether no such stable relationship now exists.

Government recognition of these developments has been evident in speeches by the Chancellor to the Lombard Association in April and in his Mansion House speech in October. Perhaps more significantly, the Governor of the Bank of England in his speech at Loughborough in late October hinted that the Government may be set to abandon formal targetting of £M3.

For all practical purposes the Government appears to be using the growth of M0, the narrow measure of money, and the exchange rate as the two prime indicators of monetary conditions. Indeed it was the movement of M0 up within its target range and the quickening pace in the depreciation of sterling which led the Chancellor to raise base rates by 1% point.

The difficulty facing the Government is that for many observers M0 is a lagging indicator providing little indication of future movements in inflation and economic activity. The exchange rate is therefore seen as the prime indicator of monetary conditions. Its recent downward movement, along with new evidence on the role of the mortgage boom and the growth in house prices, have led to the exchange rate also being seen as a major expected cause of future wage inflation. The Government's failure to signal a clear determination to stabilise the exchange rate, whether by adoption of a specified target, or by joining, or by an announced shadowing of, the EMS, increases the probability of downward pressure on sterling. Short-term interest rates have therefore to be higher than they might otherwise be, both to maintain a high interest rate differential between the UK and other industrial countries inducing holders of sterling not to switch to other currencies, and to curb the spending of the large holdings of domestic liquidity which could occur if inflationary expectations increase. This apparent lack of a policy for sterling may therefore be retarding the growth of the real economy.

One must, however, have some sympathy for the Government's position because there is no correct way of determining what the appropriate level of the exchange rate should be, either absolutely, or relatively following the recent reductions in oil prices. To tie sterling to some external standard such as the EMS would raise serious political difficulties in the event of an exogenous shock such as a further fall in oil prices. Moreover, there is no guarantee that such a linkage would moderate wage inflation and, if it failed to do so, the loss of this flexible instrument of adjustment could produce deflationary pressures which would further exacerbate the already high levels of uinemployment. An outcome that should be borne in mind in the light of the expected deterioration in the current account.

The Government must therefore be expected to continue with its current policy stance in the near future, in the hope that oil prices have stabilised, that the growth of world demand will raise substantially non-oil exports of trade goods and invisibles, that wage inflation will moderate, and that the forces leading to increased consumer spending do not produce a further trend increase in imports. The implication of the Autumn Statement that the Government, in allowing public spending to increase by 1.25% in real terms per year, has now abandoned its attempt to hold public spending in real terms, is not expected to change the PSBR target. Instead it is expected that maintenance of the target will still allow the Chancellor to reduce taxes in the Budget next year because of the buoyancy of non-oil tax revenues. Whether the Government can hold spending to the projected growth figure and hence whether the expected tax cuts will materialise is of course another matter. We should know by the middle of next year whether these hopes have been realised.