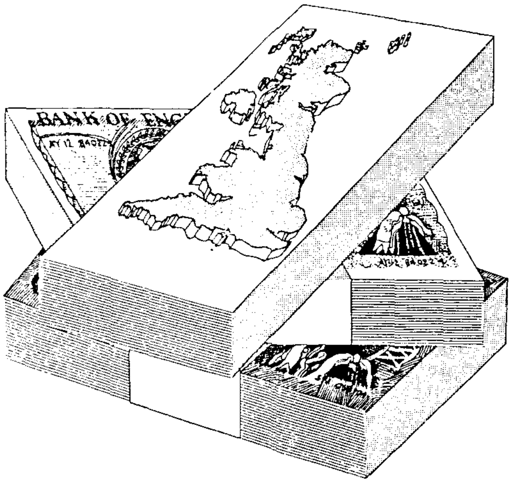
The British Economy



External events have had a considerable impact on the UK economy. In line with developments elsewhere, UK growth has slowed, interest rates have been reduced and the inflation rate has fallen. However, underlying inflationary pressures in the UK continue to operate with relatively rapid growth of average earnings and substantial growth of private sector liquidity.

MACROECONOMIC TRENDS

Throughout the period since the miners' dispute in 1984 the CSO's cyclical indicators have provided unclear signals about developments in the UK economy. While the effects of the miners' dispute have now worked their way through the system, difficulties of interpretation have arisen in recent quarters from the volatility of certain components, including consumer credit, and from the effects on the component series of the privatisation of British Telecom. The evidence of the indicators does suggest, however, that the UK has shifted to a weaker underlying rate of economic growth. This has been consistently forecast in the **Commentary** since late 1984.

After successive falls in November and December of last year the longer leading indicator, which typically predicts turning points about one year in advance, reached a level in January lower than any reached in the previous year. Apart from a slight fall in May the index has subsequently risen in successive months to a value in June higher than any recorded in the past year. Movements in this index reflect changes in interest rates and share prices, with these components series, and especially the latter, accounting entirely for this year's growth in the index. All other available series have exerted a generally negative influence.

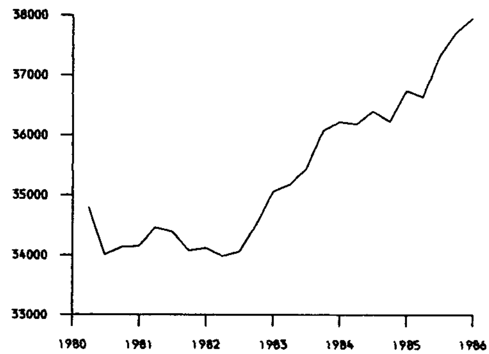
Interpretation of the shorter leading index which is intended to predict turning points some six months in advance, is rendered particularly difficult by the volatility of the component series. After changing little during 1985 this index rose in December wholly in response to increases in consumer credit which more than offset declines in all of the other components. The next four months then saw sharp reductions in the index which were only halted in May when the effect of high levels of car registrations outweighed the contraction in consumer credit. While the decline in the shorter leading index seems to be becoming more firmly based, it remains difficult to determine from the two leading indicators whether the shift to weaker economic growth is becoming established or is likely to be of short duration.

The lagging index has remained relatively flat over the year to June 1986 and the coincident indicator has continued to fall since last November. These patterns are consistent with the deceleration of growth evident from the estimates of gross domestic product for 1985 and the first part of this year. Since 1981, the last year of negative growth, the UK has experienced successive years of positive growth and by the end of 1985 output was almost 13% higher than in the 1981 trough. After allowing for the impact of the miners' dispute, output at the end of 1985 was, however, only around 1.5% higher than at the end of 1984. Estimates of output for the first quarter of 1986 confirm the slowing in the underlying growth rate which began in early 1985. The output-based measure of GDP, which is conventionally regarded as the most reliable indicator of change in the short-term, recorded only very modest growth between the last quarter of 1985 and the first quarter of 1986.

Over the past eighteen months, although quarterly changes in spending have been somewhat erratic, the principal element driving growth has been the growth of consumers' expenditure. The more recent quarters have produced evidence, however, of some slowing in this component of aggregate demand. After increasing by 0.8% in the final quarter of 1985, real consumers' expenditure rose by 0.6% and then 0.4% in the first two quarters of this year. The increases in 1986 reflect higher spending on most categories of goods.

Continuing growth in the determinants of spending and recent evidence on retail sales suggest, however, that the provisional estimate of consumers' expenditure for the second quarter of this year underestimates growth in this component of demand. During 1985 real disposable income rose by more than 2% and the underlying determinants of that increase continue to operate. Average earnings show no sign of slowing from the rate of around 7.5% experienced during the past two years while the rate of inflation has continued to fall. Real disposable income was also raised by the reduction in the basic rate of income taxation from 30% to 29% and the adjustment of personal allowances in the March Budget and by the fall in mortgage interest rates which took effect in early June. Moreover, consumer credit has continued to expand as rapidly during last year.

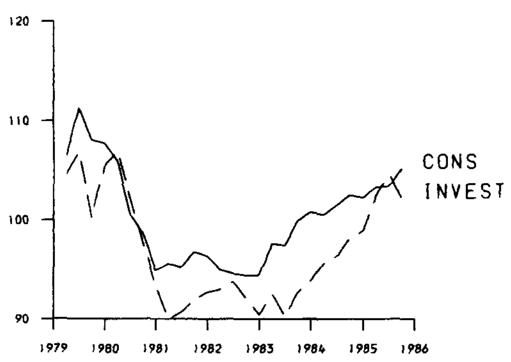
UK CONSUMER EXPENDITURE 1980 PRICES
(BILLIONS)



In the first quarter of 1986 the slowing of consumers' expenditure was mirrored in the reduced buoyancy of retail sales. An important factor contributing to the depression of sales during the first quarter of this year was the bad weather which adversely affected sales of spring fashions. The March CBI/FT Survey of Distributive Trades confirmed that sales volumes had grown more slowly than in earlier periods and that firms were carrying excessively high stocks. Subsequent CBI/FT Surveys, although suggesting that sales were lower than a year earlier, indicate some recovery from the poor performance in the first quarter. Signs of a stronger recovery were provided by the Department of Trade and Industry's (DTI) estimates for June's retail sales. According to the DTI, retail sales volumes had risen to a record level and were 5.3% higher than in June 1985. Sales were reported as buoyant in all major retailing sectors and particularly in clothing and footwear.

Retailers responding to the July CBI/FT Survey reported continuing high levels of stocks. Following a marked increase in retailers' stocks in the last quarter of 1985, stocks increased by a further £96m at 1980 prices in the first quarter of this year. Wholesalers' stocks which had fallen in the last six months of 1985 rose sharply in the first quarter by £316m. The weakness of the first quarter's retail sales suggests that much of the increase in stocks in distribution may have been involuntary. These increases in stocks far exceeded the fall in manufacturers stocks of £116mm. After remaining unchanged throughout 1985, the stock-output ratio fell in manufacturing in the first quarter of 1986, thus resuming the downward trend apparent for over a decade.

UK CONSUMER AND INVESTMENT GOODS
1980=100



Improvements in stock control are one element of cost reductions which in conjunction with growth of output have contributed to the growth in profitability of UK manufacturing companies during the recent cylical upswing. Higher output levels and increased profitability have in turn led to an expansion in manufacturing investment, an important source of growth in the UK economy in 1984 and 1985. As argued in previous **Commentaries**, the growth of investment expenditure is expected to be less strong during 1986 than in either of the preceding years as a consequence of continuing high real rates of interest and less robust growth of aggregate demand.

This year's quarterly pattern of investment expenditure will, however, be similar to that of 1985 with firms bringing forward investment plans to take advantage of capital allowances before reductions in first year allowances in April.

Including leasing of assets from the financial sector, manufacturers' investment rose in the first quarter of 1986 by 6% over the level of the last quarter of 1985. Excluding leasing, which became relatively less attractive following tax changes and increased company profitability, investment increased by only 2.7% compared with 9.1% during the corresponding quarter of 1985.

With continuing expenditure constraints public sector investment in 1985 fell by more than 15% below the level of 1984. Entirely due to increases in spending by the public corporations, public sector investment rose by just over 7% in the first quarter of 1986.

In contrast, private sector investment rose by less than 3%. This reversal of the well-established pattern of investment by sector also occurred in investment in dwellings by sector. Public investment in dwellings rose by almost 13% while private sector investment fell by almost 10%. Overall, however, investment in dwellings fell by over 1% partially reversing the recovery that took place in the second half of last year in response to higher levels of private sector activity.

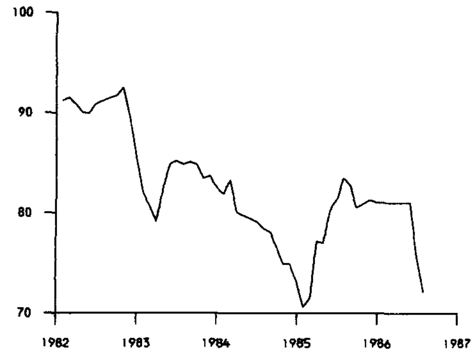
Despite the bunching of investment in the first quarter of 1986, the slackening of the impetus given to UK growth by investment expenditure is evident in comparison with developments in the first quarter of last year. Total investment was some 3% lower in the first three months of 1986 than in 1985. In contrast to the dramatic rise of 22.5% during the first quarter of 1985 over the levels of the corresponding quarter of 1984, investment in plant and machinery fell by over 3% in the first three months of 1986 from the level of the corresponding quarter of last year. Even more pronounced was the decline in investment in vehicles, ships and aircraft. After increasing by more than 42% in the first quarter of 1985, investment in these assets fell by over 32% in the first three months of this year. Only investment in dwellings and in other new buildings and works recorded increases. The former rose by 3.7% and the latter by 7.5% compared with decreases of 9.6% and 2.9% respectively in the first quarter of last year.

Particularly during the first half of the year, trade contributed positively to last year's growth in the UK economy. 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 following the ending of the miners' dispute. In the latter half of the year, however, these volume movements were reversed. Nevertheless, the visible trade deficit fell in the later quarters of the year. This improvement reflected the terms of trade effect generated by sterling's appreciation after February 1985.

Adverse volume movements have continued in the first quarter of 1986 when exports of goods excluding oil fell by more than 8%. Further reductions took place in the second quarter when non-oil export volumes are estimated provisionally to have fallen by 1%. Non-oil imports rose slightly in both quarters. The non-oil trade deficit increased from £2.1bn in the last quarter of 1985 to £3.6bn in the first quarter of 1986. The oil surplus increased slightly in the first quarter to almost £2bn as greater volumes of net crude oil exports more than compensated for lower oil prices. The current account surplus for the first quarter was £528m.

A further current account surplus of £546m has been estimated provisionally for the second quarter. The continuing deficit on non-oil visible trade is now accompanied, however, by a falling surplus on oil In the second quarter the oil trade surplus declined to £765m. With more recent falls in the oil price affecting the oil surplus over the coming months and little expectation of improvement in non-oil trade, the balance on visible trade is likely to deteriorate further in the second half of the year.

STERLING EFFECTIVE EXCHANGE RATE
1975=100



In the three months to the end of May output of the production industries is estimated provisionally to have increased by 1% from the level of the immediately preceding three-month period, and to be 0.5% higher than in the corresponding period of 1985. Comparisons with 1985 remain affected by the miners' dispute and, after allowing for that, output is estimated to be 0.5% lower than a year ago.

Manufacturing output in the three months to May was unchanged from the level of the previous three months but was 1% lower 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% in other manufacturing, remained unchanged for engineering and allied industries, other minerals, and food, drink and tobacco, and fell in textiles and clothing. Output of energy and water supply rose by 2.5% while construction output fell by 3.5%. Overall, output of the production and construction industries is estimated to have remained unchanged.

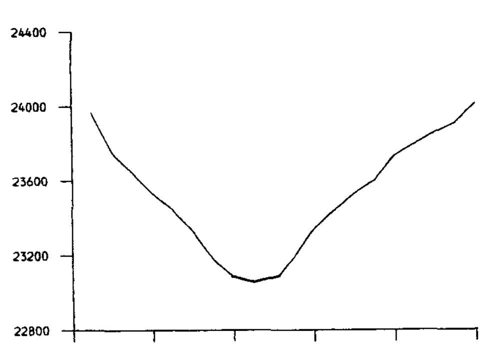
As in previous quarters, the relative importance of the determinants of demand growth were not fully reflected in changes in output by market sector. Despite the continuing, although reducing, importance of consumers' expenditure, output of consumers goods rose by only 0.5%. There was little evidence in the first two months of the year that the first quarter rise in investment expenditure was affecting the output of investment goods. Only a small increase was recorded in March before output fell back to previous levels.

THE LABOUR MARKET

EMPLOYMENT AND UNEMPLOYMENT

The slowing of output growth in the UK has been followed by increases in the rate of unemployment. Over the first six months of this year the seasonally adjusted series rose by 15,000 per month on average, indicating a clear upward trend. Compilation of unemployment statistics has now been revised and, on the new basis for measuring the number of claimants unemployed on the specified count date, the UK unemployment rate, seasonally adjusted and excluding school-leavers, was provisionally estimated for June at 11.7%.

GB EMPLOYED LABOUR FORCE
SEASONALLY ADJUSTED - THOUSANDS



The pace of employment creation slackened appreciably during 1985 when the average quarterly rise in employment was 65,000 as against 84,000 in 1984. As output has decelerated, this slackening has continued into 1986. In the first quarter of this year the employed labour force is estimated to have increased by only 25,000. This increase, which falls far short of the increase of 68,000 in the corresponding quarter of 1985, was comprised of an assumed increase of 30,000 in self-employment and a fall of 5,000 in the number of employees in employment.

Employment change in the first quarter again followed the pattern evident throughout 1984 and 1985. There was a seasonally adjusted increase of 51,000 employees in the service sector but decreases of 36,000 in manufacturing, of 14,000 in energy and water supply and of 6,000 in other industries including construction, agriculture, forestry and fishing. Data are not yet available for the service sector for April and May but those estimates which are available for manufacturing and for energy and water supply indicate continuing job losses. Employment fell over those two months by 28,000 in manufacturing and by 4,000 in energy and water supply.

As is typical of a slowing phase of economic activity, productivity growth has slowed. For the economy as a whole output per head declined slightly in the first quarter although for manufacturing there was a very small increase. Later data on manufacturing output per head for April and May suggest only a further small rise. There is, as yet, no sign of earnings adjusting to slowing productivity or to reductions in the rate of inflation. The underlying increase in average weekly earnings in the year to April was around 7.5%, the rate that has prevailed over the past two years. In manufacturing the underlying increase is of the order of 8%. In the three months ending April, wages and salaries per unit of output in manufacturing industries were 7.6% higher than a year earlier.

The growth of unit labour costs remains higher than in other major industrial economies. While there has been some depreciation of sterling against major currencies, particularly the dollar, UK competitiveness showed some improvement only in the final quarter of last year.

INDUSTRIAL RELATIONS

An indication of the changes that have taken place in mining following the industry's dispute during 1984/85 appeared in the publication of the NCB's preliminary results for 1985/86. The report highlighted: the return to profitability of the industry; the closure of 27 unprofitable pits; a 20% reduction in manpower (down 35,900); and a significant rise in productivity. It is clear, however, that the profitability is unlikely to be maintained given the rapid decline in oil prices since late 1985. Given that movements in oil prices, there is the possibility of a 3% per annum drop in market share for coal. If coal prices drop to £40 per tonne then employment may fall to 89,000 a drop of 45,000. The lowering of oil prices threatens a large contraction of the mining industry, leaving virtually only the super pits. Early indications of job losses can be seen in announcements of 4,000 redundancies in Yorkshire over the next year.

Apart from the continuation of pit closures and reductions in membership the NUM faces problems elsewhere. First, its membership is now probably below 100,000. Hence, it should lose the automatic right to a seat on the General Council of the TUC. Secondly, the NUM continues to face problems regarding the annual wage negotiations. The NCB, at the end of April, imposed a deadline on the union for acceptance of a 5% pay offer. Otherwise the offer would be withdrawn along with backpay of up to £200 per member.

Thirdly, the union faced further delays in its attempts to discharge the receiver, finally overcoming these difficulties at the end of June. The union's final costs of legal fees, receivership and sequestration amounted to over £1.5 million. Additionally, the TUC rejected the NUM's request for £500,000 to help the NUM meet these costs. Fourthly, proposed changes to the pit consultation scheme arguably favoured the UDM at the expense of the NUM. These proposals envisage the NUM, UDM, NACODS and BACM each having two national representatives, with APEX (representing clerical workers) having one seat. This consultative body would discuss issues such as health and safety, efficiency, objectives and performance. At the pit level the structure would be different, only the union representing the majority of the workers would have guaranteed seats, it would be up to the colliery manager to appoint observers from other unions who could take part in discussions only with the permission of the colliery manager. The NUM have doubts over whether the pit level scheme would operate uniformly across the industry or whether they would be excluded in the areas where the UDM has a majority. Fifthly, the NUM was unsuccessful in its legal action to maintain the structure of the negotiating and conciliation structure in the industry which effectively gave the union sole bargaining rights in the industry. The NCB proposal to change the structure to enable the UDM to negotiate directly with the NCB was upheld by the High Court. These problems have given additional impetus in the NUM to attempt to end the split between itself and the UDM and, possibly more significantly, to weaken Mr Scargill's influence on the union.

Two issues continue to dominate the health service. First, there is the issue of the terms and conditions of those employees affected by the government policy of competitive tendering for ancilliary work in the NHS. To a degree the concern is less now than a year ago. The long running disputes between employees and private contractors have been disowned by the trade unions, and a number of contractors have reached agreement with unions over recognition and the payment of NHS rates. Nevertheless, there is evidence from the TUC that the costs of privatisation fall on the employees. Secondly, the resignation of the chairman of the NHS Board, who had the responsibility for introducing the recommendations of the Griffiths Report, revealed the extent of concern as to the deleterious effects on morale of government pressure for a new management ethos on NHS staff and of fears as to the degree of competence of the new general managers.

The public sector also featured in a number of disputes in the last quarter. Industrial action by prison officers stemmed from the Home Office's attempts to increase flexibility in manning and work schedules in order to reduce manning and overtime levels. These proposals were withdrawn despite initial calls for 'tough' action by ministers. However, the recent proposals for changing the working week of prison officers to eliminate systematic overtime heralds the possibility of renewed industrial action. Flexible work schedules underlay the dispute between members of the Union of Communication Workers and the Post Office. Attempts to improve productivity by the employment of part-timers and flexible work patterns to meet peaks in demand have featured in negotiations and disputes over the past few years, although these issues are possibly less likely in the future given recent changes in the composition of the national executive of the union. The consequences of previous negotiations over flexibility and productivity featured in the temporary breakdown in negotiations between trade unions and the Electricity Council. The claim for a technician grade, a bridge between manual workers and supervisors, stemmed from earlier changes to work practices. Paradoxically, the teachers' dispute and subsequent negotiations have sought to reduce the extensive but informal flexibility that characterised teachers' work, and to replace it with a far more formalised, detailed and, in some respects, rigid contract of employment.

The impact of recent legislation was particularly apparent in the rail industry. Popular interest focussed on the successful action for damages against both ASLEF and the NUR brought by a traveller for loss and inconvenience suffered as a result of the one day train strike. Whilst this case illustrated the significance of the restrictions on immunities for industrial action where ballots, required under the 1984 Trade Union Act, are not held, it was less important than the impact of the requirement to ballot. The pre-strike ballot in respect of industrial action over British Rail's programme of workshop closures resulted in a clear defeat for the union. It illustrated, yet again, the difficulties the NUR, and other unions, face in winning support for issues which only affect a segment of the membership. The effect of balloting may well result in the abandonment of national action in support of members affected by the further introduction of one man operated trains.

Elsewhere in the public sector proposals for a more flexible use of labour in the docks were rejected by the TGWU. However, an agreement providing for full co-operation and flexibility in the introduction of new technology was reached with the CPSA. The CPSA became increasingly involved in an internal dispute over the election of a new general secretary and treasurer. The left wing and militant-led faction within the CPSA had been increasing their influence for some time before the the general secretary, Alistair Graham, announced his resignation. The growing influence of the left wing had prompted the largely centre right dominated national executive to bring forward to June the election for a new general secretary, a move thought to favour Mr Ellis the current deputy general secretary. By May it was clear that the national executive had underestimated the influence of the militant tendency and were becoming alarmed at the patterns of voting in the union. The militant influenced DHSS branch at Liverpool was said to have recorded a 775 - 0 vote against the agreement over the introduction of new technology, a result which led to accusations of 'political fraud' and 'coming members'. Such accusations emerged again, following the election of the hard left candidate as pro general secretary, and led to further claims of ballot manipulation and subsequently to the establishment of an inquiry into the election.

Within local government the arguments with central government, as to the degree of financial support to fund the index-linked pay of police officers, are likely to delay the implementation of increases. First estimates by the Staff Commission suggest some 6,500 redundancies have arisen from the abolition of the GLC and Metropolitan county councils

The printing industry continued to be the source of most industrial action and comment. New technologies for gathering, editing and setting out news, and for producing newspapers are at the heart of the radical transformation of the industry and its patterns of employment. Whilst News International and the Shah group have dominated the headlines, all of the national newspaper groups, and most of the provincial press, have sought new, and dramatically reduced, manning levels to generate savings. Thus, whilst it cost United Newspapers up to £60 million to shed 2,500 jobs without disruption the savings amount to £50 million per year. Similarly, News International's move to Wapping is probably saving upwards of £50 million per annum. Other newspapers are now introducing similar changes to work practices as those at United Newspapers and News International. For example, the Financial Times has announced agreement to: move to a new site; copy set directly by advertising and editorial staff rather than by traditional printing methods; 400 redundancies with a reduction of over 70% amongst composing staff; reorganised bargaining arrangements including a reduction in the number of bargaining arrangements from 25 to 3; full work flexibility and an end to demarcation lines. However, the search for no strike agreements, which featured in early discussions in a number of newspapers, now seems to have been dropped in favour of a slightly more flexible approach.

At the end of April News International was still pursuing with journalists the offer of a substantial pay rise in return for acceptance of a legally binding, no strike agreement. This was a response to the proposal within the NUJ to discipline members working at Wapping. This was extended in June by a 'loyalty' rise to journalists who had ignored the policies of the NUJ to refuse to work at Wapping or had voted to stop working in support of print workers. Those who accepted the NUJ policy have been either suspended or sacked. Print unions had been set a three week deadline on the offer aimed at settling the dispute over the move to Wapping. This was later replaced by the suggestion to introduce a single union agreement at Wapping. Employees would still be able to be members of other unions but management would only recognise and negotiate with one union. A further 'final offer' was made by the company in May. This included: redundancy pay based on four weeks pay for each year of service; dismissed workers not to be excluded from the chance of future employment with the company; union recognition would be reviewed within a year; legal action against print unions to be withdrawn; and the Grays Inn road site would be transferred to the unions. Whilst SOGAT recommended the acceptance of the offer members in the three print unions accepted the advice of the NGA and rejected the offer. Following this rejection there was some uncertainty as to what should be the policy of the print unions.

The TUC continued to be involved and maintained its policy of seeking the best endeavours of those at Wapping to bring about union recognition and re-deployment. SOGAT's change in strategy had been prompted by a number of factors. First, the cost of the dispute had risen to almost £4 million by June. Secondly, the union faced the need to regain control of the union's assets from the sequestrator. Accordingly, the union withdrew its instructions to members working in wholesalers to black News International's papers. However, the London branches opposed this move seeking an injunction to stop the union holding the ballot of members over the offer from News International. The NGA sought once again the expulsion of the EEPTU from the TUC, accusing the EEPTU of 'the worst treachery and collusion in the history of trade unionism over its action in the Wapping dispute'. The rank and file continued the weekly protest demonstrations at Wapping. In the absence of any new initiatives the level of violence increased culminating in considerable damage to a number of newspaper distribution depots which handle News International newspapers. For its part News International successfully sought fresh injunctions against the NGA, SOGAT and three London branches and six officials of SOGAT to restrict the picketing at Wapping and other locations to six pickets and orderly marches.

It is increasingly apparent to the print unions that their options are limited to: first, continuing to seek full union recognition in Wapping, an extremely doubtful proposition; secondly, hoping for increased compensation for those who lost jobs; and thirdly, over the longer term, seeking to replace the electricians at Wapping by print workers with some form of union recognition. Such essentially pragmatic responses still appear unacceptable to those who have been active.

It is difficult to assess whether the Green Paper on profit related pay is the Government snatching at the ideas of yet another American economic guru, an election gimmick, or a serious and considered attempt to reform the pattern and rigidities of pay determination in Britain. There is clearly a degree of confusion within the Government as to the reasons for, benefits of, evidence on, and support for such a set of proposals. At the NEDC the Chancellor stressed two advantages of PRP: firstly, it would increase employment involvement and hence improve motivation and productivity. Secondly, as pay would become more responsive to market conditions there would be a reduction in the pressure for redundancies and an incentive on firms to increase employment in periods of economic growth. The Green Paper was less explicit as to the employment benefits that would accrue, apart from a reiteration of the familiar homily that increased pay flexibility would obviously lead to employment stability and growth.

The basic principle of PRP is that a proportion of pay, possibly up to 20% is linked to profits. If, in a given period, profits rise then a proporton of the enlarged profits would go to employees in the form of an additional bonus; conversely, if profits fall some of the employees' pay, up to 20%, is at risk and can be lost. As an encouragement to accept an element of risk in a proportion of pay it is proposed that the proportion of pay linked to profits should be subject to a degree of tax relief. The Green Paper proposes that a minimum of 5% of an employee's pay must be linked to profits to qualify for tax relief. Additionally, to be acceptable a scheme would have to last more than a year and cover 80% of employees in an employment unit. A quarter of profit related pay received by each employee would be exempt from income tax up to a maximum of the lesser of £1,000 or 5% of total pay.

PRP thus appears to be concerned with changing the method of pay setting, relating pay more closely to profits and promoting greater employment, rather than as encouraging a wider share ownership, participation or democracy at work.

There is little to commend such a scheme to the majority of employers in either the proposals to date or in the writings of Professor Weitzman of MIT, the pre-eminent advocate of PRP. On the other hand there are a considerable number of major reservations. First, supporters of the scheme argue that public service employees, since they do not create profits, should not be eligible to any profit sharing or tax advantages. Moreover, they do not run the same risks of variation in pay since their employment is more secure than those in the private sector. In recent years problems of comparability between the public and private sectors has been a major feature of public sector disputes. Such a scheme, without some matching process for the public sector would seem likely to stimulate long-term dissatisfaction and unrest in the public sector.

Secondly, as even monetarists note, altering the price of labour can change the rate of investment and thus levels of employment. PRP, by linking pay to profits, may discourage capital intensive investment, and thus, in the long term, reduce economic competitiveness.

Thirdly, Weitzman is clear that the employer must retain absolute control over employment and dismissal. As Professor Meade comments it is questionable whether employees generally wish to become risktakers along with investors. If they are asked to take additional risks in the form of PRP they may well insist on participating in decision-making on company policies. Risk without representation may well not prove popular.

Fourthly, there is much to suggest that existing workers may wish to prevent the employment of others rather than see their bonus diluted. Employers, for different reasons are likely to reach similar conclusions. The scheme does little to offset the non-wage labour costs and firms seeking to cut costs will still declare employees redundant. The pursuit of increased flexibility of labour will continue to be a more attractive avenue for management to pursue than the employment of additional labour as suggested by supporters of PRP.

Fifthly, there are a number of practical problems. The impact of such schemes on pensions, shift work and other premia, and the possibility that the low paid may drift in and out of FIS, create potentially formidable payroll problems. There is uncertainty as to qualifying periods, acceptable ratios of distribution of risk and profits. A period of wage inflation may be a feature of the initial stages of such a scheme as trade unions seek to raise the guaranteed base pay as high as possible.

Sixthly, most enterprise or plant wide bonus schemes have faced intermittent disputes as to the division of profits between production employees, ie those who generate the bonus, and non production workers. A parallel situation may develop under PRP. Employees who bear the greatest risk of loss or temporary layoff may well seek a greater proportion of bonuses in comparison to managerial jobs which are perceived to be more secure.

Seventhly, the scheme appears to be based on somewhat naive assumptions as to the nature of accounts and profits. It would require an annual scrutiny of accounts, and raises questions as to the nature of the link between employee performance and profits and the issues of distributing profits rather than investing for growth. Such problems ignore the policies of multinational companies who, via transfer pricing, seek to declre profits where the best tax advantages are obtained.

Amongst the first signs of a general election looming into view is a plethora of articles on the state of industrial relations and proposals for legislative reform. In recent weeks organisations as diverse as the Communist Party, SDP, Institute of Directors, Institute of Economic Affairs, and trade unions have contributed to the developing debate. Amongst the more radical proposals have been: increased involvement of trade unions in sports events and pop concerts to help them become an integral part of the social and cultural life of Britain (Communist Party); abolishing closed shop ballots and limiting or abolishing the immunity for trade unions and their officials when industrial action is organised in essential services (Institute of Directors); compulsory pre-strike arbitration and limits on strikes in essential services (SDP); and, legally binding collective agreements, picketing to be unlawful unless organised by the police, employers to have the right to maintain and exchange worker blacklists (IEA paper). The next **Commentary** will review the TUC-Labour Party proposals and issues arising from the probable settlement of the teachers' dispute.

PROGNOSIS

The increasing significance of events abroad for UK indicators of performance was discussed in the May **Commentary.** Developments over the last quarter illustrate that significance. Falls in oil prices and the continuing softness of non-oil commodity markets contributed to widespread associated reductions in inflation rates. Encouraged by associated reductions in inflationary expectations, monetary authorities lowered interest rates. This in turn permitted reductions in UK rates with little risk that financial markets would interpret lowering of interest rates as indicating a loosening of UK monetary policy.

With interest rates falling only in line with international movements, the UK maintained the historically high real differentials which the Cnancellor considers necessary to keep sterling's value at a level consistent with the monetary conditions required to reduce the rate of inflation, the primary focus of the Medium Term Financial Strategy. In large part the need to maintain high interest rate differentials is a consequence of the continuing inability to restrain the growth of relative labour costs. While inflationary pressures have been much reduced throughout the OECD area, underlying inflation in the UK remains between 4% and 5% above the OECD average. This is the outcome of: the persistent growth of UK average earnings of 7.5%; current retail price inflation of around 2.5%; and productivity growth of the order of 1%.

Repeated Government exhortations for moderation of wage settlements have had little impact and the productivity growth of 1983 and 1984 has waned over the past eighteen months. Thus, against a background of fears that exchange rate depreciation would exert upward pressure on the rate of inflation, the Government continues to operate a policy combination of high interest rates and a strong pound. While there has been some reduction in sterling's trade-weighted index since last September's Plaza meeting, the index has moved within a fairly narrow range of 74.5 to 77.0 in recent months.

Interpretation of the factors indicating the degree of tightness of monetary policy is, however, problematic. Certain factors suggest that monetary policy remains tight. With continuing high real interest rates and only modest sterling depreciation, output growth has slowed and unemployment has risen. In addition, retail price inflation has continued to fall. Finally, the narrow measure of money M0 grew by only 0.25% in July producing an annual growth rate of 3% which falls in the lower half of its target range of 2-6%.

In contrast, accelerating bank lending suggests loosening of monetary conditions. In July the annual rate of growth of sterling M3 rose to 19.5%, well above the increased target range of 11-15% announced in the March Budget. In the month to the middle of July two influences operated to partially offset the affect of higher lending on the growth of sterling M3, namely, Government debt sales to the private sector in excess of borrowing requirement and a large rights issue by the National Westminster Bank. However, the continuing and rising growth of bank lending raises the spectre for the Chancellor of future inflationary pressure as a consequence of increasing private sector liquidity.

The prospect that an oil price-induced fall in the exchange rate might raise the rate of inflation have been lifted, at least temporarily, by the boost imparted to sterling as a result of the OPEC agreement on production reductions. The durability of that agreement remains uncertain, however and fears about the build-up of private sector liquidity are likely to preclude any reductions in interest rates in the near future.

There is at present no sign of any significant change in the UK's policy stance. The Chancellor remains opposed to providing a fiscal stimulus through increased government spending, waiting instead for the impact of lower inflation rates to stimulate world demand and joining the US in exhorting the Japanese and West Germans to expand demand. This, despite the fact that growth of UK nominal GDP, a central element of the MTFS, is now undershooting the rate of 6.75% projected for 1986/87. The only prospective fiscal measures are reductions in income taxation in next year's Budget.

The outlook remains, therefore, one of slowing growth in the real economy and little prospect of any reduction in the underlying growth of UK unemployment.