QUARTERLY ECONOMIC COMMENTARY

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Outlook and Appraisal

During 1984 the British economy maintained the growth rate of 2.5% achieved in the latter part of 1983. Growth in 1984 was depressed by the coal dispute which meant the direct loss of mining income and output and an associated reduction in the overall demand for the output of sectors such as Metal Goods and Mechanical Engineering. Resolution of the miners' dispute in the early part of the year and a full return to work will, with the associated "rebound" in activity, lead to a growth rate for 1985 of around 3%. The longer the dispute is prolonged, the closer UK growth to the end of 1985 will approach the underlying rate of about 2.5%.

The results of the January 1985 Scottish Business Survey indicate little improvement in optimism among Scottish industrialists. Firms in manufacturing report only marginally greater optimism about the general business situation while firms in construction are less optimistic than three months earlier. Greater optimism was expressed, however, among firms in the distribution sector, almost entirely as a consequence of continuing buoyancy in retailing. Expected employment patterns reflect these differences in optimism. Little change in employment is foreseen by manufacturers while construction firms expect further lay-offs. Only in retailing do companies expect to take on more labour. This intended increase in employment applies however, predominantly to part-time workers. As noted in previous **Commentaries,** such employment expansion has little impact on unemployment figures as many of the workers hired are females entering or re-entering the labour force, who were not previously registered as unemployed.

An important feature of UK growth during 1984 was the rise in investment expenditure, including manufacturing investment. In real terms industrial investment in the third quarter of 1984 was 7% higher than in the corresponding quarter of 1983. In part this was a consequence of higher company profits and liquidity during 1983-84. But investment expenditure is likely to fall to a lower level in 1985 because the 1984 increase was due also to a bringing forward of projects. This was induced by the announcement in the 1984 Budget of the phasing out of capital allowances and by uncertainty about the outcome of the regional policy review in November 1984. For Scottish firms the latter consideration proved well-founded. Under the revised regional policy replacement investment is no longer grant-aided: certain areas of Scotland no longer qualify for assistance; and overall payments of Regional Development Grants are likely to be reduced by well over half in the coming year (see Briefing Paper). Real interest rates at the beginning of 1985 are at historically high levels as a consequence of measures to defend sterling and high US interest rates. Continuation of interest rates at such levels will act to depress investment demand, and also consumption demand, over the coming months.

The rise in UK exports also contributed to growth during 1984. However, export expansion was modest by international standards, with UK exports growing more slowly than the volume of international trade and with a widening gap in UK trade in manufactures. The relatively poor performance of manufactured exports is particularly disappointing in view of the acceleration of growth in EEC markets which account for half of such exports and the weakness of sterling against the dollar. Exporters generally failed to take full advantage of the stimulus imparted to world trade by the massive US trade deficit. As the US economy slows down this stimulus will start to evaporate in 1985.

During 1984 public expenditure overshot planned targets. Part of the unanticipated growth in public spending was a consequence of the coal dispute, part reflected the higher than expected number of claimants for unemployment and supplementary benefit and the remainder resulted from increased debt interest payments. The government's Public Expenditure White Paper suggests broadly stable public spending in the coming year, providing little boost to demand.

The consumer boom, in which the **Scottish Business Survey** suggests Scotland has shared fully, looks set to continue. Consumption expenditure is likely to be higher than in 1984 partly because earnings continue to run 3-4% ahead of price inflation and partly because of recovery after the ending of the miners' strike. A further boost will be given to consumption expenditure if the Chancellor is able to deliver promised cuts in income tax in the March Budget.

Tax cuts will, the Chancellor contends, lead to employment creation. The scope for tax reductions is circumscribed by a number of influences. In November 1984 the Chancellor's arithmetic suggested tax cuts could amount to some £1.5bn. Subsequent greater optimism about levels of North Sea oil production during 1985 pointed to a higher amount. However, the recent downward pressures on oil prices have an opposite effect. The behaviour of the sterling/dollar exchange rate further complicates the arithmetic. Since the Chancellor's tax take is based on the dollar price of oil, sterling depreciation, largely in response to lower oil prices themselves, increases revenues. In contrast, scope for tax cuts is reduced by higher debt service charges resulting from the recent increases in interest rates to half sterling depreciation. An outcome broadly in line with the November figure would permit the Chancellor to raise tax thresholds by 10%.

The Chancellor advocates tax cuts on the grounds that they will improve the supply side of the economy by stimulating initiative and willingness to work and by reducing demands for pay rises. This represents a shift from the more conventional argument for tax cuts as a means of creating jobs, namely that they stimulate demand. The demand-based argument has frequently been eschewed on the grounds that increased disposable income is spent on imported rather than domestically-produced goods. However, the supply-side mechanisms identified by the Chancellor are unconvincing.

The incentive effects of tax cuts are unlikely to be very great. A 10% rise in tax thresholds would remove over a million households from tax. But over 40% of these would be pensioner households who no longer participate in the labour market. Less than 10% would be heads of households among whom higher tax thresholds may indeed reduce rather than increase the willingness to work since, by raising disposable incomes, lower taxes may mean the loss of means-tested benefits. Higher income earners who receive larger absolute increases in after-tax incomes may opt not for greater effort but for greater leisure.

Young people who comprise about 25% of those removed from tax might have greater incentives to seek work. But removal from tax for this group takes place at earnings over £40 per week, a level which employers might not be prepared to pay for new entrants to the labour market. Employers might find greater willingness to work and greater flexibility in work practices among the remaining 15% removed from tax, working wives. But tax cuts for this group, rather than tackling the increasingly politically-sensitive issue of unemployment, may simply reinforce the attraction into the labour market of women not previously registered as unemployed.

Tax cuts are also unlikely to lead to lower wage demands. The effects of cuts in direct income taxation will be offset where, as is expected, they are accompanied by an extension of value-added tax to cover presently zero-rated items such as books, newspapers and children's clothing. Moreover, typical individuals do not bargain with their employers over pay. That function is peformed by unions and no rational union will settle below the going rate.

Critics of the Chancellor, including the CBI, argue that increased government expenditure ought to be given greater priority than tax cuts. The Chancellor's opposition is two-fold. First, he blames the UK's poor performance on high government expenditure and taxation. Attributing cause and effect is however, problematic. Causation may well run in the opposite direction with poor growth requiring increased government expenditure on, for example, unemployment benefits and action to stimulate the economy. Secondly, the Chancellor argues that higher government expenditure will cause interest rates to rise. Yet in November he added the cost of the coal dispute to the PSBR without reference to dire consequences, suggesting that there is more room for higher government expenditure than he concedes.

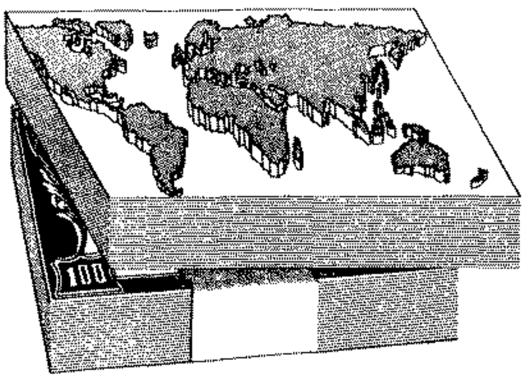
If, as argued above, the supply-side effects associated with tax cuts are limited, their main impact will operate through demand, and on the demand side government expenditure scores against tax cuts. The whole amount is injected into demand: unlike tax cuts where part will leak into savings. Moreover, Government expenditure can be directed to particular activities in specific areas; declining inner-city areas and deteriorating infrastructure such as roads, schools and sewers could be improved.

If, for ideological reasons, the Chancellor opposes higher government expenditure, an alternative approach to job creation is available which is entirely consistent with his supply-side emphasis. Much of the Chancellor's rhetoric has been directed at the need to reduce unit labour costs, with his preferred solution being one of wage cuts (see November **Commentary**). Unit labour costs, however, also include non-wage costs, an element which the Chancellor could take action to reduce.

In November 1984, as statutorily required, the Chancellor increased the **limits** for employers' national insurance contributions in line with the rate of inflation. He could take the opportunity of the forthcoming Budget to reduce the **rate** of contribution paid by employers for new workers. That would have a more immediate and direct impact on employment prospects than income tax reductions.

15 February 1985

The World Economy



During 1984 the growth rates of the major industrial economies converged. This did not result from a marked increase in the pace of recovery in European countries. Rather the modest recovery in Europe continued while the US economy decelerated from its very rapid rate of growth in the first half of the year. This narrowing of growth rates is expected to continue in 1985. As in 1984, the course of world recovery during 1985 will be largely influenced by inter-related developments in the US budget and current account deficits. The size of the budget deficit affects levels of interest rates while US imports affect the volume of world trade.

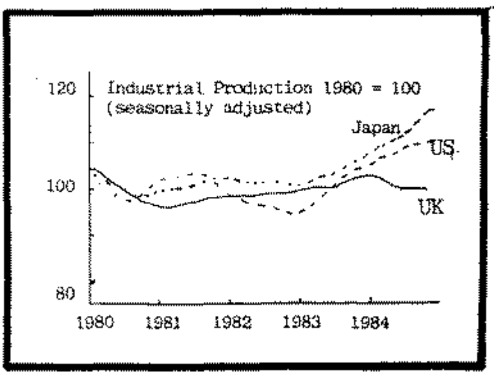
OUTPUT

In the first six months of 1984 US output grew by more than 8%, but increases in interest rates, associated with rapidly increasing demand for credit, contributed to slower growth in the second half of the year. During the third quarter slowing demand and increased import penetration caused corporate profits to stagnate. Pressure on domestic capacity utilisation also eased and production slowed as firms moderated their inventory accumulation. There are, however, signs that, with interest rates falling from the high levels of the summer, the US economy is recovering some momentum. In November the Commerce Department reported that the composite index of leading indicators rose, suggesting an upturn in domestic capacity in early 1985 above the levels of the latter part of 1984. US growth in 1985 is expected to be of the order of 3%.

Largely reflecting the third quarter slowdown in the US economy, total industrial production in the OECD areas rose by 5.6% in the year to October, as compared to an increase of 7.7% in the year to July. With annual rates of increase of 3.3% and 2.8% to the end of October industrial performance in OECD Europe and the EEC respectively fell some way short of that of North America where output grew by 6.9% over the same period. The most rapid industrial growth took place in Austria, Sweden, Australia, Japan and the Netherlands.

The strength of the dollar and the growth of domestic demand resulted in growing US demand for the output of other countries. The importance of this stimulus is seen most clearly in the case of Japan where, reflecting the pattern of developments in the US, exports and industrial output rose sharply in the first half of the year, before slowing in the third quarter. Japan also increased its exports to Europe and achieved a record current account surplus. Export expansion continued to raise corporate profits and, thereby, generate higher levels of fixed investment. The growth of exports contrasts with the slow growth of domestic demand resulting from the Japanese Government's restrictive fiscal policy stance.

Elsewhere, the stimulus of the US current account deficit has also been evident. In France, for example, increased exports contributed to a marked improvement in the trade deficit and growth in West Germany was dependent more on exports than on domestic demand. In the latter country, as in the UK, growth was depressed by industrial unrest. Unlike West Germany, however, UK exporters did not take advantage of the growth in world trade. Despite the depreciation of sterling, most noticeably against the dollar but also against other major currencies, UK manufactured exports experienced little growth. This, in conjunction with the coal dispute accounts for the UK's industrial performance to the end of October being below that of any of the other major industrial countries.

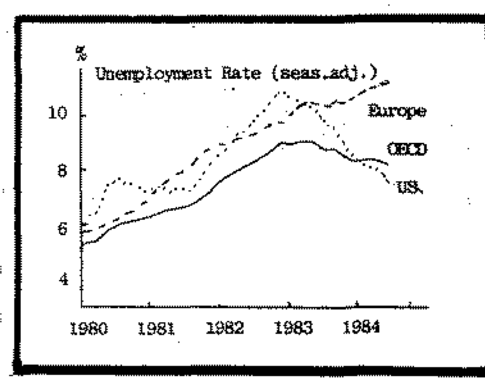


Growth in Europe has been constrained by domestic policies. Restrictive policies, aimed at controlling inflation, have tended to limit the growth of domestic demand including consumption demand, which has until recently been the major element in recovery. Consumption demand has been particularly depressed in France where the anti-inflation policy embraces controls on wages and prices. Apart from exports, much of the impetus to growth in EEC countries during 1984 came from increasing fixed investment, in response to higher corporate profits. This increased investment will help to sustain recovery in Europe.

LABOUR MARKETS

With the standardised unemployment rate at the end of the third quarter standing at 8.2%, unemployment in the OECD area as a whole has shown little change over the past year. This relative stability of the overall rate disguises, however, differences in experience among countries. The unemployment rate in the US has been reduced to around 7.3% from 9.7% in 1983, and this has helped keep the OECD rate steady in the face of increasing unemployment in Europe.

Unemployment has increased from 1983 rates of 10.3% and 10.2% to 11.0% and 10.6% for OECD Europe and the EEC respectively. These increases in unemployment do not simply reflect the slower pace of European recovery. They are also due to demographic factors and to a structural change in the nature of labour markets. Employment contraction has been averted but labour supply has been expanding more rapidly than employment opportunities. Part of the increase in the labour supply is induced by an increasing shift towards part-time employment, a tendency particularly noticeable in the UK. This leads to the entry or re-entry into the labour market of females many of whom were not on the unemployment register.

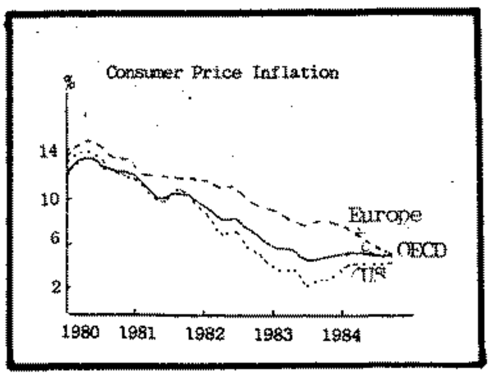


Unemployment in the US is forecast to continue falling in 1985, Although less srapidly than in 1984. In Europe, however, the prospect is of still higher levels of unemployment. Indeed, the OECD anticipates unemployment in Europe rising by the end of the decade to levels higher than at any time since the 1930's.

INFLATION

Within the OECD area there has been widespread progress in reducing rates of inflation. As with growth rates, differences in inflation rates among the major countries are being reduced. For the OECD area as a whole the annual rate of inflation has been reduced from around 13% in 1980 to 5.1% at the end of October 1984.

With annual rates of 7.3% and 5.7% at the end of the third quarter of 1984 for OECD Europe and the EEC respectively, inflation in Europe continues to exceed that in the US. Moreover, within Europe there is considerable diversity of experience with rates ranging from 2.1% for West Germany through 5.0% for UK and 9.4% for Italy, to 18.4% for Greece.



Generally, inflationary pressures have been weakened by depressed oil and commodity prices. In the US inflationary pressures have been moderated by the strength of the dollar. Despite the stronger recovery than in European countries, the inflation rate in the US stands at only 4.2%. The influence of the exchange rate operates in a number of ways. The strong dollar reduces the domestic prices of imports; increases the leakage of US demand to foreign economies; and subjects domestic producers to greater competition from foreign suppliers.

Increasing competition in product markets may also help account for the relatively low increases in wage settlements both in import-competing industries and overall. US nominal wage rates show no signs of acceleration and real wages continue to be under downward pressure. With output growth exceeding real wage increases, the outcome has been lower unit labour costs.

Exchange rate movements against the dollar have generated opposite effects in Europe, but there, as in the US, growth in wages has been lower than suggested by experience during previous periods of recovery. In West Germany wage increases just over 3% have been agreed in both the public and private sectors. Wage growth in France has been restrained through controls with the Government imposing a 2% ceiling increase on public sector wages. In the UK, however, the picture is less encouraging. Unit labour costs have increased, particularly in manufacturing. For the OECD area as a whole the forecast for 1985 is of relatively stable inflation, with a continuing narrowing of the differences between countries with the highest rates of inflation and those with the lowest.

PROGNOSIS

Predominant features of the world economy in 1984 were the continuing strength of the US dollar and high interest rates. The combination of an appreciating dollar and growing domestic demand have meant the US provides an expanding market for other countries' exports. By the end of 1984 the US had accumulated a current account deficit in excess of $120bn. A deficit of such magnitude would normally signal a dollar depreciation. The dollar has remained strong, however, because the US has been simultaneously running a substantial budget deficit. The associated high interest rates have attracted foreign capital inflows into the US and on balance the net inflows on capital account have outweighed to date the opposing influence of the current account deficit.

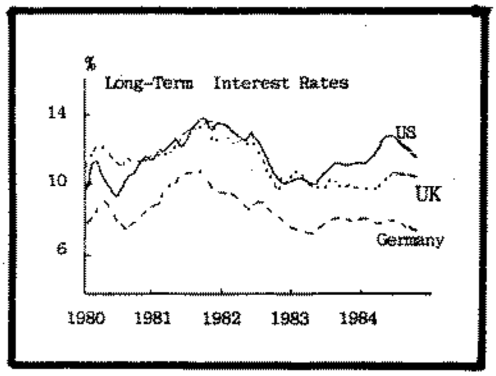
The combination of a strong dollar and high interest rates cannot be sustained indefinitely, however. Against a back-ground of a very large trade deficit and decelerating growth in the US economy, foreign investors will not be prepared to continue adding to their holdings of dollar securities. There is no risk of the US defaulting on debt since ultimately dollar-denominated debt can be redeemed through US monetary expansion. But there is an exchange risk. Servicing increasing indebtedness requires surpluses on visible trade and/or further borrowing. Prospects of a shift to trade surpluses are remote. And there are already indications that foreign capital inflows are not proceeding at the previous rapid pace. Foreign capital inflows to the US fell by around 25% between 1982 and 1984. The net capital inflows required to finance the growing deficit on current account have come increasingly from reductions in US investment abroad rather than from more rapid capital inflows.

The contraction in foreign lending by US banks reflects slower growth elsewhere. But as international growth rates converge US lending abroad will recover, leading to a reduction in net capital inflows. Reversal of the influence of the elements in the balance of payments will then exert downward pressures on the dollar.

Depreciation of the dollar would contract US import demand but would relieve inflationary pressures in other countries and, particularly in the UK, permit an opportunity for reductions in interest rates. Whether reductions in international levels of interest rates can be achieved depends crucially on what is happening to the US budget deficit.

Slower US growth in 1985, while reducing the growth of demand for credit from the private sector, will at the same time increase the budget deficit in the absence of measures to cut Government spending. An increased budget deficit will require higher interest rates.

An outcome involving dollar depreciation and higher interest rates will damage the prospects for world recovery. Third World countries holding dollar-denominated debts would be particularly adversely affected, with contraction in their major export market and with interest rates raising costs of debt service.

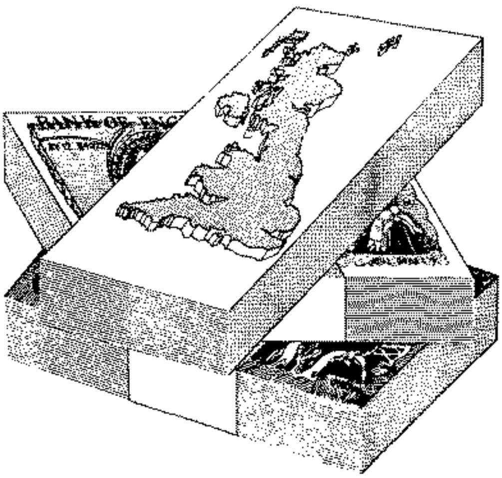


If, however, measures can be implemented to reduce the budget deficit a different outcome may be possible. Reduced government borrowing would relieve pressure on interest rates and with further slowing in net capital inflows would induce a fall in the dollar. A weaker dollar would then be accompanied by lower rather than higher interest rates.

The current debate on the US Budget is, therefore, of crucial importance. There has been increasing recognition in official circles of the need to reduce the budget deficit and the proposals before Congress are aimed at progressive reductions during the remaining years of the 1980s. The budget proposals emphasise, however, the structural rather than the cyclical nature of the deficit. It is proposed that the deficit be reduced by reducing Government non-defence spending. Having already made substantial cuts in social programmes, however, the scope for further cuts there is limited and the proposals may well be difficult, if not impossible, to steer through Congress.

If Congress seeks other means of reducing the deficit, defence expenditure and tax policies will need to be re-assessed with politically unpopular decisions having to be made. But failure to tackle the problem of the budget deficit will greatly diminish the prospects for continuing recovery in the world economy.

The British Economy



There was no acceleration in the rate of recovery in the UK economy in 1984. Growth was of the order of 2.5% which represented no improvement on the growth rate achieved in the latter part of 1983. Consumption expenditure and fixed investment were the main sources of growth. Although slackening in the letter part of the year, destocking continued. Output growth was sluggish, particularly in manufacturing and, despite sterling depreciation, the deficit on non-oil trade increased substantially.

The coal dispute depressed growth in 1984. On the assumption of an early resolution to the dispute, growth in 1985 is forecast to be around 3%. The longer the dispute is prolonged, the closer will growth approach the underlying rate of about 2.5%. There is a remarkable degree of consensus among forecasters about likely growth this year.

Inflation at the end of 1984 was very close to the official target of 4.5%. While running above 5% in each of the first six months of the year, inflation was at or below 5% from July to December. From 4.9% in November the rate fell to an end-year figure of 4.6% principally because of reductions in mortgage rates. In contrast to the reduction in price inflation, the underlying rate of earnings inflation has shown little change. The reduction in the recorded rate is due to the coal dispute and the delays in wage settlements of groups in the public sector including local authority non-manual workers.

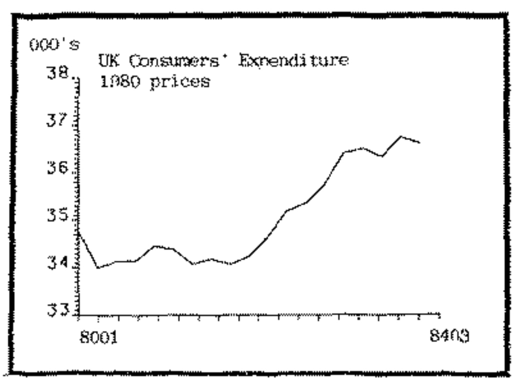
Employment expansion slowed in the second half of 1984 and the numbers of registered unemployed continued to rise. The Chancellor of the Exchequer has argued that reductions in income taxation in the forthcoming March Budget will contribute to the creation of employment opportunities. As argued elsewhere in this **Commentary**, however, income tax cuts are unlikely to have any appreciable impact on employment and are less effective in creating jobs than other uses to which the resources could be directed.

MACROECONOMIC TRENDS

For most of 1984 the CSO's cyclical indicators presented a disappointing prospect. The longer leading indicator, which predicts turning points about a year in advance, fell for five consecutive months from March. The shorter leading index, which predicts turning points some six months in advance, also fell over the summer. With some components depressed by the coal dispute, the coincident index remained relatively stable in the middle of the year. This evidence pointed to a downturn in economic activity around March 1985.

While interpretation is problematic because of the effects of the coal dispute and because the data employed are subject to revision, the indicators for the latter part of 1984 provide a better outlook for 1985. Reflecting increases in share prices, the longer leading index rose in each of the last three months of the year. The shorter leading index also rose in the last quarter, mainly due to movements in new consumer credit. Upward movement was also evident in the coincident index. These upturns in the indices point to a more prolonged recovery with the reduction in the underlying growth rate being delayed beyond March.

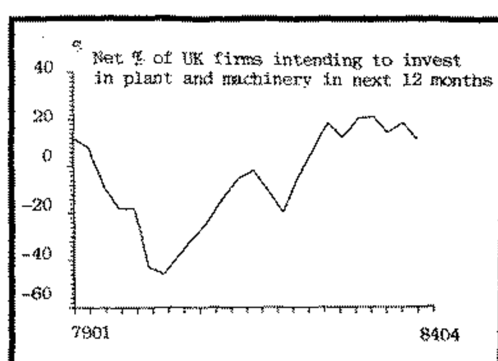
Preliminary estimates suggest that consumers' expenditure increased by 2% during the fourth quarter. After slackening to an annual rate of less than 1% in the third quarter, this component of demand increased in the last three months of 1984 to an annual rate of over 2%. While aggregate consumer expenditure continues to be adversely affected by the coal dispute, the seasonally adjusted estimates reflect increases in retail sales.



Retail sales remained more buoyant than consumers' expenditure, rising by 3% in the fourth quarter to a level 4.5% higher than a year earlier.

While the rate of growth of consumers' expenditure slackened over 1984 there was marked acceleration in the pace of fixed investment. The volume of gross domestic fixed capital formation in the first three quarters of 1984 was almost 6.5% higher than in the corresponding period of 1983. Investment recovery took place almost entirely in the private sector. The Department of Trade and Industry's Survey of Investment Intentions suggests an increase in the volume of manufacturing investment of 12% over 1983 levels. Although slowing during the middle part of the year from the rapid growth in the first quarter of 1984, investment in construction, distribution and selected service industries was also substantially higher, probably of the order of 10% above that of 1983.

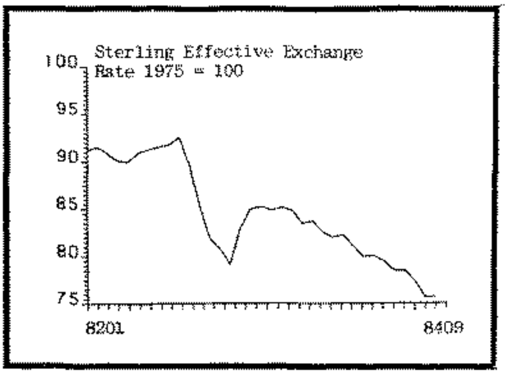
The slow downward trend in interest rates, higher corporate liquidity and the bringing forward of projects following the announcement of reductions in capital allowances and in anticipation of reduced regional incentives, have contributed to the recovery in investment. But the pace of investment recovery is expected to be slower this year. The DTI Survey suggests that investment in construction, distribution and selected service industries will increase by 9% and that manufacturing investment will increase by 7%. Slackening of investment growth is also indicated by the results of the CBI Industrial Trends Survey, although investment intentions remain strong in the capital goods sector. The balance of firms in the CBI Survey reporting present fixed capacity to be more than adequate is at its lowest level since 1979. Any continuation of the high levels of interest rates in the early weeks of 1985 will serve to depress investment intentions further.



During 1984 government expenditure exceeded planned totals. In the first three quarters of the year general government consumption was 3.8% above that of the corresponding period of 1983, with, within that total, central government expenditure growing at almost the same rate. For fiscal year 1984/85 spending is forecast to be £2bn above the £126.3bn target. The overshoot in total spending resulted from higher than anticipated increases in social security payments, local authority spending, costs of the coal dispute and debt interest payments. Part of the unanticipated expenditure was offset by windfall tax revenues from North Sea oil as a consequence of sterling depreciation and by revenues from the sale of British Telecom. Funding of the PSBR has already been completed on the assumption that the coal dispute would be settled by Christmas. Thus, public expenditure may be greater than budgeted for and the Government has shifted some spending into next fiscal year by announcing a moratorium on regional aid grants in January 1985.

The Public Expenditure White Paper published in January indicates that over the next three years government spending is planned to remain constant in real terms. The planning total for 1985/86 is that outlined in the previous White Paper. In order to recover some of the ground lost in 1984/85, the Government is planning to impose a cut in real spending during 1985/86. If it can be achieved, that reduction will be larger, the greater is the sum carried forward from the current fiscal year and the longer the coal dispute lasts.

With investment, consumption and government expenditure increasing but domestic output sluggish, the balance on current account deteriorated over 1984, the deterioration being more marked in successive quarters. After a surplus of £424m in the first quarter, then a deficit of £379 in the second, the current account deficit in the third quarter amounted to almost £550m. This pattern reflects the increasing deficit on non-oil trade. As argued in the last Commentary, the UK's non-oil trade performance is particularly disappointing in view of the depreciation of sterling during 1984.



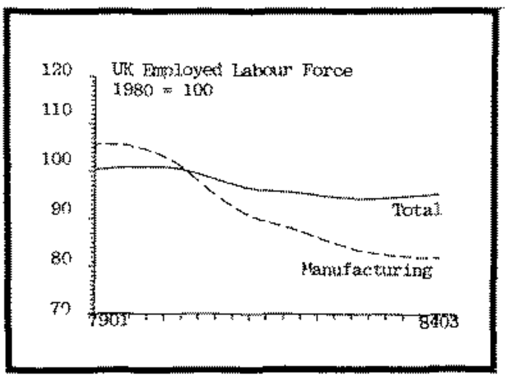
Sterling's weakness reflects a number of factors; an unfavourable unit cost performance; the unease and depressed growth resulting from the coal dispute; doubts about the conduct of UK monetary policy; downward pressures on oil prices and doubts about the cohesion of the OPEC cartel; and the strength of the dollar. Until December 1984 the authorities permitted UK interest rates to follow movements in US interest rates. As a result of increased fears about developments in oil markets, however, pressure on sterling intensified towards the end of the year. Interest rates were raised to prevent further depreciation and in January the authorities re-introduced for one day the Minimum Lending Rate, discontinued three and a half years earlier, to demonstrate authority over the markets. In January sterling's trade-weighted index stood 15% below its level of a year earlier. The factors causing sterling's weakness remain, however, and the short-run prospect is of interest rates staying around their present levels.

Total industrial output was 2% higher in the third quarter of 1984 but was broadly unchanged when compared with a year earlier. Manufacturing output which has been little affected by the coal dispute, showed signs of recovery with a rise of 1.5% over the previous three months. This increase was accounted for by higher output in chemicals and textiles and clothing. Despite continuing growth in consumer's expenditure, output of consumer goods increased only modestly. Similarly, despite the strength of the recovery in investment expenditure, output of capital goods was only marginally up over the quarter. There was, however, more rapid recovery in the output of intermediate goods.

THE LABOUR MARKET

EMPLOYMENT AND UNEMPLOYMENT

Employment continued to increase during the third and into the fourth quarter of 1984 and at a slightly faster rate than in the second quarter. The underlying pattern of employment gains remains much the same as in earlier quarters, however, with the bulk of increases being recorded in the service sector and with most of the job gains being for part-time workers. The decrease in manufacturing employment which had shown signs of slowing earlier in the year, appears to have been arrested towards the end of 1984.



Unemployment continued to rise during the fourth quarter of 1984 and into January 1985. While unemployment flows showed signs of moderating during the last quarter of 1984, this was sharply reversed in January. From November to January vacancies notified to Jobcentres fell.

The slower contraction in manufacturing employment in conjunction with the modest recovery of manufacturing output, has meant a continuing deceleration of productivity growth in this sector, whether measured per man or per manhour. Earnings in manufacaturing, however, continue to increase at a rate of 8.5%, broadly similar to the rate of a year earlier. Thus, unit costs continued to rise during the fourth quarter. More than offsetting sterling depreciation meant, however, that the UK's overall competitiveness in manufacturing improved.

INDUSTRIAL RELATIONS

The major issue continues to be the coal dispute. Maintenance of electricity supply through the first half of the winter, threatened secession by the Nottinghamshire miners from the NUM and the well-publicised gradual drift back to work of striking miners, brought the national dispute between the NUM and the NCB to a new stage and raised hopes of an imminent re-opening of talks. By the end of January, according to the NCB, more than 90% of Midlands and Nottinghamshire miners, 75% of Western, over 50% of North Derbyshire and 30% of Scottish miners but less than 10% of Yorkshire, Kent and South Wales miners were working. These figures underlay the fear of the national executive of the NUM that the first anniversary of the dispute would see more than 50% of their members at work and a break up of the union.

The union's attempts to reopen talks were resisted by Iain McGregor who terminated the unofficial discussions between the national secretary of the NUM and the industrial relations director of the NCB, accusing the latter of exceeding his brief. The NCB's strategy of rejecting the offer of unconditional talks and insisting on a written agreement to discuss the closure of uneconomic pits prior to negotiation reflects two main factors. First, the NCB is attempting to establish the contours of discussions with the NUM once the dispute is over.

Secondly, it reflects Government pressure. The role of David Hart as an adviser to Mrs Thatcher, organiser of the working miners' groups and of their legislative actions against the NUM, and a 'link' between Thatcher and MacGregor illustrates the depth of the Government involvement in the dispute. This second factor reinforces the implications of a Treasury Paper published in December on the possibility of extending privatisation to new fields including the mining industry, since such a policy would first require a fundamental weakening of the NUM.

However, the Government may have to modify its position in response to the rising costs of substituting oil for coal, given the weakness of the pound, and to avoid the growing criticism that it is unnecessarily prolonging the dispute.

The NCB strategy has led to increasing worries amongst the NACODS executive as to the value of their agreement on pit closures. In the October negotiations NACODS had sought an early warning system on pit closures to enable employees at a threatened pit to appeal for capital to make the pit productive again. This was rejected, allegedly by MacGregor, on the grounds that it would interfere with management's plans to manage to direct investment and, hence, to define "economic" and "uneconomic" pits.

Use of the pre-strike provisions of the 1984 Trade Union Act by British Leyland led to a £200,000 fine for the TGWU and the commencement of action for damages against a number of unions. Elsewhere little use has been made of this legislation, or of the closed shop provisions of the 1982 Employment Act which came into force in November. In an effort to avoid both confrontation and disruption, the practice amongst employers appears to be restricted to a formal statement that they will no longer operate the provisions of the closed shop agreement. Trade unions will have to make a more active response before March 1986 to the requirements of the 1984 Act in respect of political funds. All unions with such funds will have to follow the detailed and complex rules laid down by the Certification Officer, not the least of which is the requirement of a minimum of three scrutineers at each workplace ballot.

The Government's proposals to abolish Wages Councils, as part of its policy to generate increased flexibility and mobility in the labour market, were paradoxically criticised in the recommendations of the Home Office Committee of Inquiry into proposals to deregulate opening hours for shops. The Committee argued strongly for the retention of the Wages Council, and for an adequately staffed inspectorate to ensure the protection of the shop worker. The experience of the abolition of wages councils in other industries tends to support the Committee's recognition of the need to protect employees.

PROGNOSIS

In the wake of the recent increases in interest rates to defend sterling the Chancellor of the Exchequer has reaffirmed his commitment to the Medium Term Financial Strategy. The fundamental element of the MTFS is the need to maintain monetary demand in line with growth of the real economy and, thereby, to reduce or contain the rate of inflation. Allied to that is the pursuit of a restrictive fiscal policy aimed at reducing Government borrowing in order to reduce interest rates. Lowering inflation and interest rates will lead, it is held, to higher levels of output and employment.

UK economic policy cannot be conducted, however, independently of developments elsewhere. This is seen clearly with respect to interest rates. In the recent past the general level of interest rates has been determined by the rates necessary to fund the US budget deficit. But across countries interest rates vary around that general level reflecting differences in expectations about domestic inflation rates and exchange rate movements. The pressure on sterling, which reflects both external and internal factors and which contributes to inflationary pressures, has resulted in UK interest rates being raised above the general level. Higher interest rates are aimed at halting sterling's fall and the statement of continuing commitment to the MTFS is designed to dampen inflationary expectations.

The recent decline in sterling has been triggered by oil price uncertainties. Depreciation, which has accelerated since September against the dollar and, to a lesser extent, other currencies results also from a number of other influences. The strength of the dollar is undoubtedly one; the coal dispute another; and the behaviour of UK unit costs yet another. The conduct of monetary policy itself is, however, also an influence and the Chancellor's statement, which implies faith in present policy, is unlikely to restore confidence to markets.

In the March 1983 Budget the Chancellor substituted M0 for other previously targetted monetary variables, M1 and PSL2. Subsesquently M0 has been well-behaved remaining within the target range. It is widely recognised, however, that M0 indicates little about the conduct of monetary policy. And as pointed out in earlier **Commentaries** the growth of other monetary aggregates such as M1 and PSL2 has suggested expansionary monetary policy. As far as financial markets are concerned £M3 is the key monetary target. In the year to December 1984 £M3 grew less rapidly than M1 and PSL2. That recorded slower growth understates, however, underlying monetary expansion, the clues to which are seen in overfunding and the accumulation of commercial bills by the Bank of England.

During 1984 the Government indulged in debt sales in excess of the PSBR, ie. overfunding by more than £2bn. These debt sales reduced the growth of private sector deposits which largely determine £M3. In turn, restrained deposit growth has restricted banks' lending. Demand for credit has continued to be satisfied, however, by having the Bank of England buy commercial bills at rates below those on bank overdrafts. Thus credit has been expanded without corresponding growth in £M3.

Perception of such expansion suggests that the MTFS has been moved off course with consequent upward revision of inflationary expectations. Simultaneously, acceleration of UK monetary growth relative to that in other European countries, Japan and the US contributes to sterling depreciation.

The Chancellor's reaffirmation of faith in the MTFS thus rings hollow. A tighter monetary policy than at present, with targetted aggregates more accurately reflecting the monetary stance, is required if he is to succeed in constraining pressures on sterling and dampening inflationary expectations. The effects of a tighter monetary policy on growth can be offset if the Government at the same time relaxes fiscal policy. Increased government spending could be directed, as argued elsewhere in this **Commentary** to infrastructural improvement. And as US experience has shown, higher Government borrowing would attract capital from abroad and reverse exchange rate depreciation. Such a strategy may require UK interest rates above general international levels as at present, but it would eliminate the dangerous fiction of current offical rhetoric. The US example of tight monetary and expansionary fiscal policy has been criticised because of its impact on international interest rates but it is one the Chancellor would be well advised to follow.