QUARTERLY ECONOMIC COMMENTARY

Opinions expressed in signed contributions are those of the authors and not necessarily those of the Fraser Institute.

Fraser of Allander Institute 1985

Outlook and Appraisal

The dominant recent issue in Scotland has been the controversy over the rating system. Protest over Scottish revaluation has led to a reconsideration of the rating system at UK level and a number of different options for reform, including a poll tax, different forms of property tax and a local income tax, are under consideration. There is, however, no obvious single option that will simultaneously satisfy industrial, commercial and domestic ratepayers and politicians. While it is well nigh impossible to disentangle economic and political considerations in this context, there is concern that rates increases will force business closures and redundancies, and in early May the Scottish Secretary made available £40m to reduce rates burdens on businesses.

Elsewhere, however, the Government has resisted mounting pressure for a shift in policy emphasis to tackle the problem of rising unemployment. In April unemployment in Scotland stood at 15.7% and the average annual rate has increased in successive years since 1979. Unemployment has continued to rise in the recent past although the numbers in employment have also increased. In December 1984 over 1.93m Scots were in employment as compared to 1.91m a year earlier.

The apparent paradox of simultaneous increases in both employment and unemployment is easily resolved. Many of those taking up employment in the recent past have been women entering or re-entering the labour force who were previously not registered as seeking employment while the numbers registered as unemployed have grown as school-leavers are added to the labour supply and as workers have been made redundant in contracting activities.

In official circles much is made of Scotland's improved position in the regional unemployment league and of the expansion in employment over the past two years. But these developments must be seen in perspective. Against a background of Scotland's unemployment rate of just over 7.0% in 1979 being exceeded only by those of Northern Ireland and the North of England and of subsequent trend increases, it is cold comfort that in 1985 Scotland's unemployment rate is now exceeded also by those for Wales and the North West. With respect to recent employment expansion, it must be noted that the numbers now employed in Scotland are still below mid-1979 levels and that much of the recent increase has been made up of low-paid and part-time service sector employment. Moreover, it is difficult to foresee any expansion of employment in Scotland that is likely to make significant inroads into the problem of unemployment.

Like two earlier **Surveys** the most recent **Scottish Business Survey** suggests, that further jobs may be created in the distribution sector, predominantly in retailing and most probably for part-time, female workers. In manufacturing there is slightly greater optimism about the business climate, reflecting expected higher sales and orders, much of which are expected to come from overseas markets. Respondents also indicate that job-shedding may have come to an end. There seems little prospect, however, of significant labour-hiring. Construction respondents have reported actual and expected lay-offs in all three **Surveys** to date. A clear picture is emerging in construction of a recovery in private sector orders, but one insufficient to offset the contractionary effects of a fall in orders from the public sector at both central and local government levels. Disturbingly, private sector activity seems threatened by continuing shortfalls in building societies' receipts.

The essential monetarist argument has been that unemployment would rise as the rate of inflation was being reduced by tight monetary and fiscal policies. Higher unemployment was expected, however, to be temporary rather than prolonged. Despite considerable success in slowing the rate of inflation, buttressed during the 1980s in its effects on competitiveness by marked depreciation of sterling's trade-weighted index, unemployment has continued to rise.

Increasingly the emphasis on monetary control and contraction of thePSBR has been accompanied by greater concentration on the functioning of labour markets, and almost exclusively on factors operating on the supply side of those markets. The limited likely impact on employment of individuals "pricing themselves into jobs" and of the incentive effects of tax cuts have already been discussed in previous **Commentaries.** Elsewhere in this **Commentary** scepticism is expressed over the real wage/employment relationship advanced in the Treasury Model (see **Briefing Paper**).

It would be wrong to contend, however, that concern with supply-side influences is entirely misdirected. Much of the labour currently being wasted in unemployment embodies skills required for industries in which Scotland has lost comparative advantage. Retraining schemes, and training schemes for new entrants to the labour force, are therefore appropriate. In addition, the Budget adjustment of employers' national insurance contributions for low-paid workers is to be welcomed, although the removal of the upper earnings limit on employers' contributions will limit the net employment effects.

Supply-side measures by themselves are, however, inadequate. Producers hire additional labour only if there is a demand for the output that labour produces. Demand for labour may also be generated if the cost of labour can be reduced relative to the cost of capital but such an effect will have a bearing not on present capital stock but on future investment plans and will manifest itself only in the longer-term.

Tackling the unemployment problem requires, therefore, measures that will affect the demand side of the labour market. This could be achieved by some relaxation of fiscal policy through increased government spending. A number of arguments are typically adduced against such a strategy. Specific arguments are that higher government spending would force interest rates up and that it would be inflationary. At a more general level it is contended that increased government spending would weaken confidence in financial markets.

Given the already high levels of UK interest rates and the range of factors influencing those rates (see **British Economy**), significant increases in interest rates, if any, are unlikely. It is possible that in industries operating at, or near, full capacity inflationary pressures could result. The confidence argument is largely one of the Government's own making with its repeated elevation of the importance of reducing the PSBR. But the arguments about inflation and confidence depend critically on the nature of the increased expenditure.

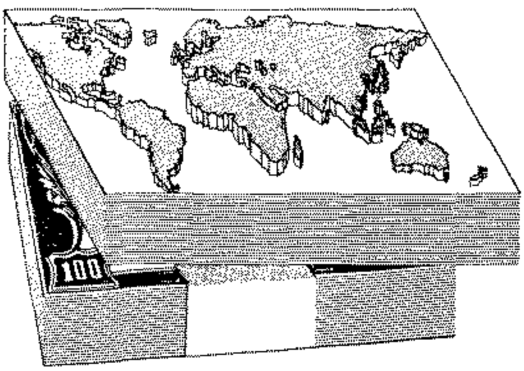
There is a large measure of agreement within Scotland, as in the rest of the UK, about the need for investment in infrastructure. Moreover, as the recent **Scottish Business Survey** has indicated, private firms in the Scottish construction industry, whose activities have a low import content and do not lead to a diversion of exportables, are currently operating at low levels of capacity utilisation. Fiscal relaxation could then be aimed at infrastructural improvement.

Judging financial market sentiment is always problematic and confidence might be upset by sudden large-scale increases in public sector spending. The argument here is not, however, for wholesale reflation and that selective expenditure which is being advocated is aimed at improving the efficiency of the transportation network and the quality of educational premises and of the housing stock. It is in any case unrealistic, given present Government attitudes, to expect substantial policy relaxation.

Scotland has been mooted as a possible testing ground for some form of rates reform. A much more appealling exercise would involve increased expenditure on schemes designed to create employment in Scotland's construction sector.

20 May 1985

The World Economy



During the latter part of 1984 and in early 1985 concern grew about the continuing budget and current account deficits in the US. Much of that concern was prompted by the comments of the Chairman of the Federal Reserve Board, Paul Volcker. Nevertheless, the dollar remained strong against other major currencies. The first quarter of 1985 saw, however, a marked deceleration in US output growth. In contrast to the extraordinary high annual rate of over 10% recorded in the first quarter of 1984, the US economy grew at a real annual rate of 1.3% in the corresponding quarter of 1985, a rate well below the earlier "flash" estimate of 2.1%. A number of thrift institutions in Ohio also ran into difficulties in the first few months of 1985. The dollar then experienced some depreciation against other currencies.

Further developments in the US will dominate the course of world trade, exchange rates and the level of international interest rates during the remainder of 1985.

OUTPUT

After the rapid growth achieved in the first quarter of 1984 the US economy experienced slower growth in subsequent quarters. In the fourth quarter US output grew at an annual rate of 4.3%. Although domestic demand continued to grow in response to the continuing budget deficit and reductions in interest rates from the high levels of the summer, the US manufacturing, agricultural and mining sectors increasingly encountered difficulties because of the strength of the dollar and associated import-penetration, and US corporate profits declined in the fourth quarter. In late 1984 Department of Commerce indicators pointed to an upturn in the economy in early 1985. That upturn has not materialised. The unexpectedly poor performance in the first quarter of 1985 and the decline in the leading indicators in March to the level of one year earlier suggest that US growth in 1985 is likely to be around 3.0%, a rate somewhat lower than earlier official forecasts.

Reflecting the performance of the US economy, aggregate growth in the OECD was less rapid in the latter part, and particularly the last quarter, of 1984. In the final quarter of 1984 industrial production in the OECD area rose at an annual rate of 4.6%, compared to an annual rate of 5.6% in the quarter to the end of October. While the deceleration in the US economy contributed to convergence of growth rates in the major industrial countries, industrial performance in OECD Europe and the EEC, with annual rates of increase of 1.8% and 0.9% respectively, still fell far short of the growth rate of 5.1% recorded in North America.

In contrast to the slower European recovery, growth in Japan proceeded at an annual rate in the fourth quarter of 1984 of 9.0%. The Japanese expansion largely reflected the continuing momentum given to international trade by the substantial US current account deficit. During 1984 the volume of world trade grew by 9%. Japan, the United States' single most important trading partner, increased further its already substantial trading surplus with the US and overtook West Germany as the world's largest exporter of manufactured goods. Countries of South-east Asia also took advantage of the US deficit to increase manufactured exports. In Europe the outcome was mixed. The surplus on current account increased in West Germany while the deficit recorded in 1983 in France was eliminated, as was the small 1983 UK surplus.

Non-oil exporting developing countries increased their total export earnings by more than 7% in 1984. Reflecting the pattern of US growth, non-oil exports grew more rapidly in the first half of the year. Despite subsequent slower export growth, the aggregate 1984 current account position improved for non-oil exporting developing countries, with countries in Latin America and South-east Asia faring better than African countries.

Generally domestic policies in the major industrial countries continue to be directed at controlling inflation rather than providing a direct direct stimulus to output growth. In the UK, Germany, France and Japan, a common feature of fiscal policy is the attempt to reduce the budget deficit both in nominal terms and as a proportion of total output. Reduction in the budget deficit is now also intended in the US where, although the deficit has contributed considerably to recent growth, there is increasing concern that the resulting high interest rates will slow the future pace of recovery and that the simultaneous existence of large budget and current account deficits cannot be sustained. Slowing growth gives additional urgency to the debate on the budget deficit which has been increasingly recognised as structural rather than cyclical in nature. Deceleration of growth will affect government tax receipts and contribute to an increasing deficit. As discussed in previous **Commentaries**, the likely course of future recovery both in the US and elsewhere continues to be greatly dependent on the outcome of the debate in Congress on the budget deficit.

The pre-eminence of the objective of reducing rates of inflation is also seen in the extensive use of targets for monetary growth. In Germany, France and the UK, growth of targetted monetary aggregates tended to be within pre-announced ranges during 1984 while in the US, although the narrower measures grew within targets, concern heightened in official circles about the more rapid expansion of broader aggregates. Generally, targets have been tightened further for 1985.

LABOUR MARKETS

Unemployment in the OECD area fell only slightly in the course of 1984. The standardised unemployment rate of 8.1% for the fourth quarter was the same as in the third quarter and only just below the rates of 8.3% and 8.2% for the first and second quarters respectively. Nevertheless, unemployment was lower in 1984 than in 1983, the rate falling to 8.2% from 8.7%.

Lower unemployment was, however, by no means widespread among OECD countries. The decrease in 1984 resulted primarily from reductions in unemployment in North America, from 9.7% to 8.7%, which more than offset increases recorded elsewhere. Unemployment fell in both the US and Canada and, despite the marked deceleration of US growth in the last six months of 1984, both countries experienced reductions in unemployment in each successive quarter. The effects of slower US growth are seen, however, in estimates for the first quarter of 1985 which suggest that unemployment has risen in the US to 7.3% as compared to 7.1% in the final quarter of last year.

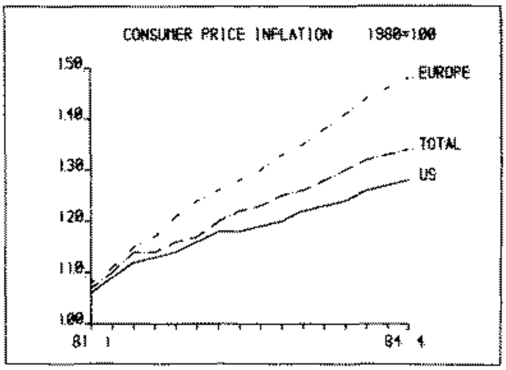
Unemployment increased from 1983 rates of 10.2% for both OECD Europe and the EEC to rates of 10.8% and 10.7% respectively. As discussed in the last **Commentary** these higher unemployment rates than in North America reflect not only slower growth but also structural changes in European labour markets. Despite extremely cold weather which adversely affected the construction sector, unemployment has fallen in West Germany during the first part of 1985. Elsewhere in Europe, however, unemployment remains at the same levels as at the end of 1984 or, as in the UK, Belgium and Sweden, has increased. The prospect for

OECD Europe and the EEC is that unemployment levels will creep up further during 1985.

US success in creating employment has been one of the outstanding features of the recent recovery. With the strength of the dollar and competition from imports, jobs have been shed in the US manufacturing sector. Those losses have been more than compensated for however, by increases in service sector employment. Much of that new employment has been created in low-paid occupations giving rise to a prima facie case for the contention that workers' willingness to accept low wages permits employment expansion. But that supply-side influence has not operated independently of demand factors. The increasing shift in the US to two-earner families has created greater demand for fast-food and restaurant services. In addition, changing population structure has led to increased demand for nursing and hospital services. Such services account for much of the increased employment.

A recent AFL-CIO report on the contribution of the service sector to employment expansion strikes a note of caution on two counts. As well as being low-paid, much of the employment is part-time and many of the 5.3m additional workers may prefer full-time employment. Thus, even without taking account of the estimated 1.5m "discouraged workers" who are thought to have stopped seeking employment, recorded unemployment may understate the numbers unable to obtain full-time jobs. Secondly, that employment based on the provision of services to industrial producers is jeopardised by continuing contraction of the industrial sector.

INFLATION



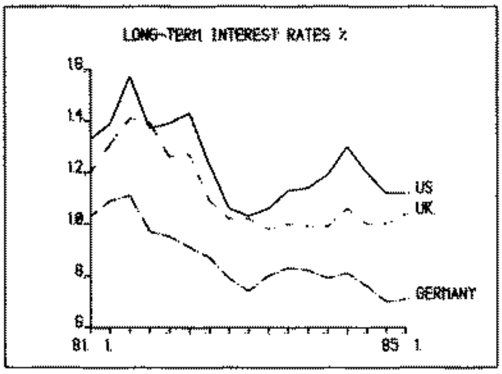
Within the OECD area there has been continuing widespread progress in reducing rates of inflation. For the OECD area as a whole the annual rate of inflation has been reduced from 5.1% at the end of October 1984 to 4.9% in January 1985. As with growth rates, there has been further convergence in inflation rates among the major industrial countries. However, inflation in Europe, with annual rates at the end of January 1985 of 7.1% and 5.5% for OECD Europe and the EEC respectively, continue to exceed the rate in the US of only 3.6%. Moreover, within Europe there remain considerable, although less marked than previously, differences among countries with rates ranging from 2.1% for West Germany through 5.0% for the UK and 9.1% for Italy to 19% for Greece.

Generally, inflationary pressures in the major OECD countries have been restrained by tight monetary policies, weak commodity prices and downward pressures on oil prices. In addition, wages growth has continued to be modest to such an extent that, with productivity increases, unit labour costs have shown little change over the past eighteen months.

The absence of strong inflationary pressure has been perhaps the most striking feature of the recent US recovery. In the February **Commentary** it was argued that the strength of the dollar has contributed to low inflation in a number of ways. Among these is the exposing of domestic producers to greater competition from foreign suppliers. That factor, in conjunction with increased competition among domestic producers and reduced union power as a consequence of high unemployment in the early 1980s, appears to have wrought a change in the nature of US wage bargaining. Wage negotiations increasingly focus on the circumstances of the individual plant rather than on industry-wide bargains, with the plant's unit labour costs and profitability being of major importance. Concession bargaining has resulted in employers reducing benefits in areas such as time-off with pay. Two-tier wage structures have also emerged which give lower wage rates and much reduced benefits to new employees.

PROGNOSIS

The US current account and budget deficits continue to dominate developments in the world economy. The high interest rates necessary to ensure funding of the budget deficit, pose a threat to the strength and durability of the recovery and have helped maintain a strong dollar, although there has been some easing of the dollar exchange rate in March and April in response to the slackening of US growth. The strength of the dollar, by intensifying competition within the US from foreign suppliers and restraining foreign demand for US goods, has led to an increase in protectionist sentiment in influential industrial and agricultural lobbies.



Against a background of a substantial share of world trade already conducted on a discriminatory basis, the renewed pressure for protectionism has endowed negotiations on trade arrangements with much significance. There are several weighty reasons for opposing greater protectionism. Although protection is often defended at the individual country level as necessary to maintain employment levels and to permit industrial restructuring, the outcome is typically ossification of resource allocation. Protection impedes the reallocation of resources from protected into other sectors and prolongs the need for adjustment. In addition, restriction of supplies and tariff barriers impose costs on domestic consumers in the form of higher prices. At an aggregate international level, the contraction of markets, often reinforced by retaliatory measures, creates difficulties for open and export-dependent economies, with in turn reduction in their capacity to import from partner countries.

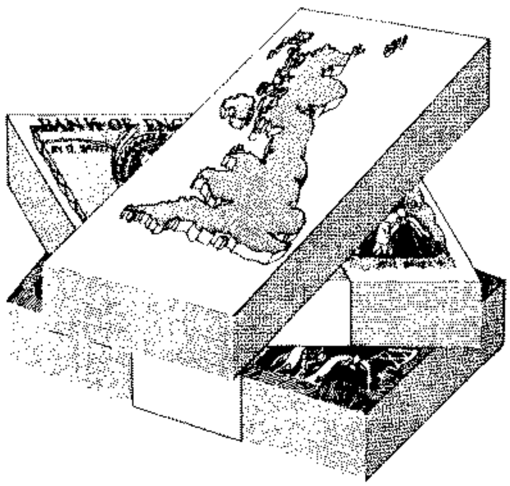
Market contraction is particularly acute for heavily indebted developing countries. Such countries require expanding exports to enable servicing of their debt. Despite the persistently high levels of international interest rates, the debt problems of developing countries have attracted much less attention in the recent past than in 1983 and early 1984. This is primarily because, given the stimulus imparted to world trade by the rapidly growing US demand for imports, major debtor countries such as Brazil and Mexico have achieved record trade surpluses. There are worrying signs, however, that debt problems are again intensifying.

Trade surpluses have been made possible by the switching of resources into the external sector. Given the absence of deflationary monetary and fiscal policies, the prospect is one of rapidly rising rates of domestic inflation. Debtor countries whose export prospects are already threatened by the slowing growth of their major export market, the United States, now increasingly find themselves on the horns of a dilemma. The trade surpluses necessary to service debt and the control of inflation are only likely to be achieved simultaneously by tightening of monetary and fiscal policies. Such a strategy, however, jeopardises short-run domestic recovery and raises the spectre of political instability.

The recent Bonn summit highlighted the distance between those of the seven major OECD countries seeking further trade liberalisation, particularly the US and the UK, and those with nationalistic interests in retaining protective measures, Japan and France. It is to be hoped that Mr Nakasone's apparent personal commitment to trade liberalisation is more than window-dressing and that President Mitterand's protectionist stance is only that. If not, a retreat into protectionism bodes ill for both developed and developing countries.

Further protectionism will exacerbate the problems of debtor developing countries and will accelerate the re-emergence of the debt crisis that, in turn, will threaten once more the stability of the international monetary system.

The British Economy



During the first part of 1985 economic policy and financial markets were dominated largely by the sharp depreciation of sterling and fears of inflationary pressures. The proximate cause of sterling's depreciation at the beginning of the year was the weakening of dollar oil prices. Market uncertainties were compounded by a sharp rise in banks' lending figures, by reports of higher industrial costs in January and by speculation, fuelled by higher than expected public expenditure, that the Government was slackening in its resolve to achieve lower rates of inflation. In response to market pressures base-rates rose to 14% in late January.

The March Budget was then fashioned to reaffirm the Chancellor's commitment to the MTFS. To reassure markets the Chancellor announced a PSBR target of £7.1b for 1985/6 as against an estimate of £10.5b, which includes the costs of the miners' dispute, for 1984/5 and target ranges for monetary growth of 3-7% for narrow money (M0) and 5-9% for broad money (£M3). These ranges are both 1% lower than in the previous year and are as announced in the 1984 MTFS. The Chancellor's re-introduction of MLR in January in defence of sterling indicated that, while he may have no exchange rate target, he is not indifferent to exchange rate movements. In the Budget he explicitly recognised the potential impact on internal policy of exchange rate variations. Formulation of policy is now to take closer account of the behaviour of the exchange rate.

Given his over-riding concern with the MTFS and intensive lobbying by groups likely to be affected by tax reform, the Chancellor did not pursue the reform of the tax structure begun in 1984. After much speculation about likely targets for reform, the Chancellor chose only to increase personal tax allowances by a modest amount in excess of the rate of inflation. Eschewing the conventional demand-stimulus argument for tax cuts, the Chancellor sought to improve incentives to work. As argued in the last **Commentary**, the incentive effects of reductions in income tax as announced in the Budget are likely to have little impact on employment expansion. In line with his supply-side leanings, the Chancellor also restructured national insurance contributions to make employment of low-paid workers more attractive to employers.

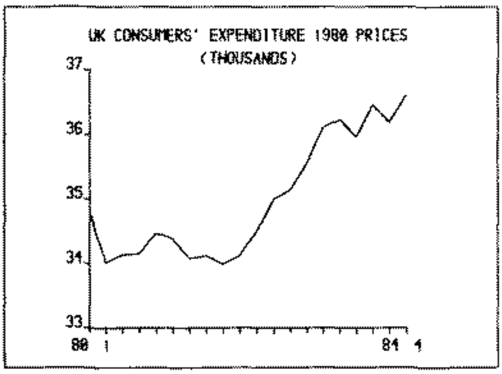
In response to the Budget, the slowing of US growth and signs of firmer agreement among OPEC countries, sterling recovered against the dollar in March and April. There has been only limited easing of UK interest rates, however, and prospects of further immediate reductions have been diminished by the money supply figures for April. As a result of continuing increases in bank lending to the private sector, the broad measure of money rose sharply above its target range. Reflecting earlier sterling depreciation and the associated higher interest rates and import prices, the inflation rate rose from 5.4% in March to 6.1% in April.

For much of 1984 the CSO's cyclical indicators offered a disappointing prospect. From its peak level of March 1984 the longer leading indicator,which predicts turning points about one year in advance, fell for five consecutive months. The shorter leading index, which predicts turning points some six months in advance, also fell over the summer. This evidence pointed to a downturn in economic activity at the end of the first quarter of 1985. However, subsequent revision to the data and rises in both indicators during the latter part of 1984 raised doubts about this prediction. The longer leading indicator then fell in the first three months of 1985 while the shorter leading indicator rose in both January and February. However, mainly because of distortions to the data series as a consequence of industrial disputes, particularly the coal strike, the picture remains confused.

Further confusion is added by the evidence from the coincidentindicator, which reflects current developments. Like the other indicators, the coincident indicator rose in the second half of 1984 and increased also in January 1985. It fell, however, in February and that is consistent with the CSO's earlier prediction of a first quarter slowdown in activity.

In its early stages the recent recovery in the UK was sustained principally by the growth of consumption expenditure in response to a decline in the savings ratio as the rate of inflation decreased and to falls in interest rates between 1981 and 1983. Some slackening in the pace of growth of consumers' expenditure became obvious in 1984. This largely reflected the depressing effects of the miners' dispute and consumers' expenditure grew by only 1.5% during 1984 in contrast to the growth of 3.9% in 1983.

Consumers' expenditure fell in the third quarter of 1984 but rose sharply in the last three months because of increased spending on retail goods particularly on consumer durables including cars. Provisional estimates suggest that in the



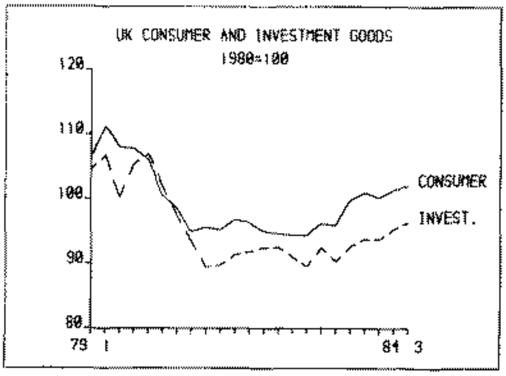
first quarter of 1985 consumers' expenditure was unchanged from the level of the last quarter of 1985. There appears to have been a fall in expenditure on food which was offset by increases elsewhere, mainly in expenditure on energy consumption.

Nevertheless, consumers' expenditure is set to grow more rapidly in 1985 that in 1984. Since mid-1983 consumers' expenditure has grown roughly in line with income and real disposable income is likely to grow by around 3.5% this year as a result of earnings growth in excess of the rate of inflation, some expansion of employment and tax reductions in the March Budget. Thus, although high real interest rates may induce a rise in the savings ratio, consumers' expenditure is forecast to rise by around 3% in 1985.

Retail sales remained more buoyant than consumers' expenditure in 1984 and rose by 3% in the fourth quarter. In the first two months of 1985 retail sales fell below last year's fourth quarter levels, before recovering sharply in March and April.

Since late 1983 private investment and exports have assumed an increasingly important role in determining growth. The recovery in investment has, however, followed a somewhat uneven path with decreases in total investment spending in the second and third quarters of 1984. Nevertheless, higher corporate liquidity, particularly in manufacturing, and the slow downward drift in interest rates during 1984 meant that total investment was almost 13% higher than in 1983 and greater than in the previous peak year of 1979.

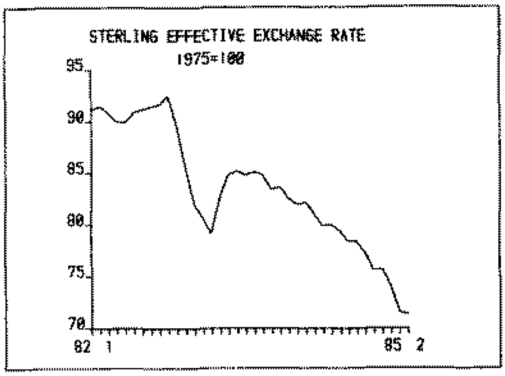
In 1984 manufacturing investment increased for the first time since 1979, although it still fell some 25% short of 1979 levels. Private sector house-building increased sharply in the first part of the year, before slowing in the face of higher July interest rates. Investment in the distribution and service industries continued to grow rapidly.



The April 1985 Industrial Trends Survey conducted by the CBI suggests that investment will continue to rise over the next year. The proportion of firms citing fixed capacity as more than adequate fell as did the proportion identifying inadequate returns and uncertainties about demand as constraints on investment activity. Although these latter factors remain the dominant constraints, the costs and availability of funds appear to have become more important.

After a fall of about 3.5% in the stock-output ratio during 1983, destocking continued in 1984. In the first three quarters of 1984 destocking amounted to £1b at 1980 prices before recovering by around £400m in the fourth quarter. The coal dispute accounted for more than half the destocking over the year, and the ending of the dispute will be a major influence on stock-building during the remainder of 1985. Elsewhere, however, the prospect is of further stock reductions in response to high real interest rates and the abolition of stock relief in the 1984 Budget.

UK exports grew in volume terms by almost 7.5% during 1984, a more rapid increase than in any of the previous four years. However, with total world trade expanding by 9% in real terms and continuing depreciation of sterling against major currencies, particularly the dollar, this was a disappointing performance.



Sterling weakened in 1984 for a number of reasons (see last **Commentary**). The lower exchange rate meant that, despite faster earnings growth in manufacturing than in our major competitors, UK manufacturers improved their price and cost competitiveness by around 10%. However, although there was some improvement in exports of manufactures in the fourth quarter, the deficit on non-oil exports increased to £11.39b in 1984 from £8.01b in 1983. This was offset by surpluses of £7.14b and £4.31b on oil and services respectively to give a balance on current account of £0.05b. The coal strike reduced net oil exports and increased net coal imports at a cost to the current account of almost £2.75b. But even after allowing for this direct effect of the coal dispute, the current account would not have improved much over the balance of £2.54b recorded in 1983.

Preliminary estimates suggest that the effects of improved competitiveness evident in late 1984 have been maintained in early 1985. In the three months to February manufactured export volumes are reported to be 6% higher than in the corresponding period a year earlier while import volumes are up only 4%. Non-oil export volumes were 11% higher than a year earlier and 3.5% higher than in the previous three month period.

Nevertheless, despite record export levels the balance on current account for the three months to February was only £0.61b. This should increase in coming months, however, as net oil exports rise and net coal imports fall following the ending of the miners' dispute.

In the March Budget the Chancellor revised certain elements of the Public Expenditure White Paper published in January. Largely as a consequence of the first quarter costs of the miners' dispute, the out-turn for public expenditure for 1984/85 was revised upwards by £1.6b to £129.7b. The Chancellor also adjusted the planning total for 1985/86 to £134.2b from the White Paper estimate of £132.1b. The adjustment of £2.1b comprised two elements. To accommodate the White Paper's potentially low forecasts for spending on social security and for debt interest, the Contingency Reserve was raised by £2b to £5b. This reflects considerable caution on the Chancellor's part since the Reserve is usually reduced in the Budget when the prospects for both expenditure and revenues in the coming year are more certain. In addition, the Chancellor allocated £0.1b to enlargement of the YTS and the Community Programme.

After allowing for the costs of the coal dispute, expenditure is projected to remain unchanged in real terms from 1984/85 levels. This zero real growth in public expenditure is central to the MTFS. With revenues growing more or less in line with nominal GDP the PSBR is forecast to fall both in absolute terms and as a proportion of GDP.

Overall the planned fiscal stance is tighter than in 1984/85. The Chancellor's target for the 1985/86 PSBR is £7.1b with a net fiscal stimulus of £0.7b. This target may be threatened, however, on a number of fronts. On the expenditure side, the Chancellor may be unable to contain departmental spending, while, on the revenue side, any weakening of oil prices and/or appreciation of sterling against the dollar will reduce sterling oil revenues.

In the three months to the end of February 1985 output of the production industries is estimated provisionally to have increased by 1.5% over the immediately preceding three month period, but to be little changed from the corresponding period to end-February a year earlier. Output continued to be affected by the dispute in the coal industry whose output normally represents around 4% of total industrial production. It is estimated that the coal dispute reduced the level of total output by around 3.5% in the six months to February. Manufacturing output, which remained resilient in the face of the coal dispute, increased by 1% over the level of the previous three months and was 2.5% higher than a year earlier.

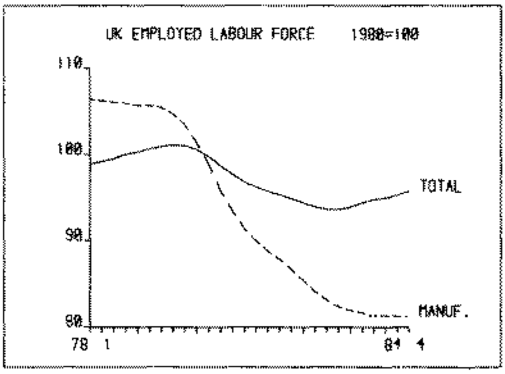
Among manufacturing sectors, the output of Energy and Water Supply rose by 4%, mainly as a consequence of higher demand for gas and electricity and increased output of North Sea oil and gas. Output of Chemicals and Other Manufacturing rose by 2% and that of both Food, Drink and Tobacco and Engineering and Allied Industries by 1%. Textiles and Clothing showed little change. The recovery in investment and the continuing consumer boom were reflected in output. Production of the intermediate and investment goods and consumer goods rose by 2% and 1% respectively. Output of the construction sector fell by around 2% during the last quarter of 1984.

THE LABOUR MARKET

EMPLOYMENT AND UNEMPLOYMENT

Employment increased in the final quarter of 1984 at a more rapid rate than in the two previous quarters. The underlying pattern of employment gains remained the same as over the past two years, with increases in the services sector more than offsetting decreases in manufacturing and other industries. Data are not yet available for services for the early part of 1985 but estimates for manufacturing suggest continuing job losses in January and February.

After remaining relatively constant at around 12.8% throughout the final quarter of 1984 at a seasonally adjusted rate of 12.8% unemployment began to rise in 1985 and reached 13.1% in April.



With the marked slowing in the rate of contraction of manufacturing employment and the slow rate of growth of manufacturing output, productivity growth in this sector, whether measured per man or per manhour, decelerated in the third quarter and then fell in the final quarter of 1984. This deceleration of manufacturing productivity has not been accompanied, however, by a similar reduction in earnings growth. Average earnings continued to grow at the underlying rate of 8.5% during the last quarter of 1984 and the first two months of 1985. Despite the consequent increases in unit labour costs, the competitiveness of British manufacturing exports continued to improve as a result of more than offsetting depreciation of sterling.

INDUSTRIAL RELATIONS

The ending of the miners' dispute and the re-emergence of the 'old faithfuls' of industrial relations, namely the exposure of a trade union ballot rigging scandal and industrial action affecting bank holiday travel arrangements, combined to create the impression that business was back to normal in British industrial relations.

However, on reflection, most observers would agree with ACAS in that with the passing of the 1984 Trade Union Act "and its predecessors the Employment Acts 1980 and 1982, Parliament has introduced a complex series of provisions which significantly change the framework of law within which managements and trade unions operate". The widely publicised use of these Acts has contributed to a significant increase in awareness by both employers and trade unions of the way in which the law might affect their actions. In addition, the use of the courts in recent disputes, has provided a series of rulings for future disputes. Together with the recent announcement of a new Public Order Act and its provisions for 'violent disorder' and 'riot', these changes represent a considerable step in the processes of making unlawful much of traditional industrial action.

'One of the most important single stoppages to have arisen in British industry in living memory' (ACAS) ended after a year. The mining dispute raised fundamental questions as to public order, the role of the law, civil liberties and the operation of the social welfare system. The pit closure programme, the immediate cause of the dispute is continuing. The estimated 50,000 miners seeking redundancy has made this programme of closures easier. Nevertheless, the NCB is seeking to lose some 40,000 jobs this year implying the closure of over 20 pits. The statement by the NCB at the end of March that it planned to close pits without consulting unions finally demonstrated the value of the agreement NACODS had reached last year and does much to explain the proposals by the union to commence an overtime ban.

The pre-strike ballot provisions of the 1984 Act appear to be exerting a major influence, especially in the public sector, on the conduct of relations between employers and trade unions. The Government's intimation that it was applying for a writ, via the Treasury solicitor, seeking an injunction restraining the CPSA from proceeding with a strike without a ballot in support of its wage claim, effectively destroyed the planned campaign by civil service unions to pursue wage and salary claims around the 15% level. The ballot conducted by the CPSA indicated that a majority of members were against industrial action and for accepting the 4% offered.

The 1984 Act was also influential in

resolving the unofficial industrial action at a number of Post Office sorting offices. Initially the dispute related to the payment for distributing material relating to the local elections. However, the action at the Mount Pleasant sorting office in London ostensibly related to the 300 jobs that would be lost if a new optical character recognition machine was accepted. The underlying cause of the disputes was not new. Talks had been held for more than a year over management plans to increase the number of part-time staff from 8,500 to 20,000 as part of the strategy to increase the flexibility of labour and to promote greater productivity. The Union of Communication Workers had been seeking a freeze on the recruitment of more part-time staff fearing the earnings and job security implications of such a change in recruitment policy. However, following a High Court injunction, the Union of Communication Workers encouraged members to return to work pending a secret ballot. At the same time management's offer of a temporary freeze on the introduction of part-time staff helped resolve the dispute.

However, the provisions of the 1984 Act were not an influence on the rail unions' decision to call a day of action in Scotland over the planned cutbacks to the Springburn railway engineering workshops. Following the national action, British Rail indicated its intention to seek damages under the Act. Intermittent action by the rail unions is likely to continue as part of their strategy to oppose reductions in staff at the engineering workshops. Additionally, the increasing discontent amongst ASLEF members over flexible rostering may spill over into industrial action.

Further implications of the 1984 Act were illustrated in the successful action by Solihull Borough Council against the National Union of Teachers. The union, as part of the national pay campaign, had instructed members not to cover for absent colleagues or carry out voluntary actions. The Council, citing the 1971 ASLEF case, successfully argued that cessation of voluntary and non-contractual duties constituted a breach of contract under the 1984 Act and, therefore, a ballot should precede such action. The Council's action did much to reinforce support for the pay claim especially amongst the other teaching unions. Developments towards a settlement of the dispute were frustrated, once again, by the actions of the Secretary of State for Education. All the local authorities (the lawful employers) had agreed that an increase, above the current offer, was essential to resolve both the dispute and the longer-term problems facing the teaching profession. However, the Secretary of State was adamant that no money was available for increases over the current offer. His action will help to ensure that the action will continue into the next school year and raises doubts as to whether the government wishes to settle the growing problems facing education. The 1983 ACAS Annual Report noted the need for agreement on new methods of pay determination in the public sector. More than a year later when the need is even more apparent, little progress has been made towards devising or introducing such procedures.

Intermittent action involving a number of unions and both national and provincial newspapers stems from a number of factors, although the continuing saga of the impact of new technologies is the most important. Whilst newspaper proprietors have always been amongst the most frequent users of the courts in their conduct of industrial relations, there is clear evidence of their increasing readiness to use the provisions of the 1984 labour legislation, especially the sections relating to pre-strike ballots. The labour problems in the newspaper industry, deskilling, blurring of traditional demarcation lines and reducing of manning levels, are the consequence of the progressive introduction of new information technologies. The introduction of new technology has been a factor in the intermittent industrial action in a number of apparently unconnected industries from car production to the television companies.

Discussions between the Nissan Motor Company and a number of trade unions resulted in the AUEW being granted sole negotiating rights in the company's new factory at Washington, near Sunderland. In return for a single status, single union deal, the union has agreed to: the formation of a 'Company Council' which will resolve all domestic issues, compulsory conciliation and restricted arbitration; and maximum flexibility for all production and maintenance staff with workers responsible for their own quality control, materials handling etc. Such arrangements are not new and there is much evidence to suggest that an agreement in itself will not guarantee industrial harmony. Many no strike and sole negotiating agreements erode after a few years and require considerable management action and the goodwill of the labour force to be maintained.

Undoubtedly the 'popular' labour item concerned the irregularities in the TGWU's election for a new general secretary. Trades unions face immense problems in conducting elections. Maintaining up-to-date membership lists for electoral purposes is a difficult task given high rates of membership turnover and reliance on lay officials at the branch level. Alternative methods of balloting, such as postal ballots, are not without their disadvantages as newspaper acceptability is in danger of replacing effectiveness as the criteria for popularity. The available evidence suggests a combination of enthusiasm, imcompetence and Irish political practice (vote early, vote often and let the dead vote) rather than organised ballot rigging.

Paradoxically, the two most important items went largely unreported. First, from 1 June the qualifying period before an employee is entitled to use the unfair dismissals law will be standardised at two years. This already applied to employees working for employers with less than twenty employees, but all other employees had only to be employed for one year before they could use the legislation. The effect of this change will be to significantly reduce the number o cases arising under the legislation. Secondly, the Government published a discussion paper covering proposals to amend the powers of wages councils. Two options for action were contained in the Consultative Paper. First, the abolition of the entire wages councils system to establish minimum hourly rates for adult workers. The latter option would necessitate removing the powers of councils to determine rates and conditions for young workers, overtime, holiday entitlements, pay guarantees and other conditions of employment. Either option offers little security for the 2.75 million workers covered by wages councils who are already amongst the lowest paid and least protected groups of employees.

PROGNOSIS

Central to the MTFS is the notion that reduction of the PSBR is necessary to permit achievement of monetary objectives at low real interest rates. Tight monetary policy is aimed at maintaining downward pressure on money GDP and controlling inflation but might be expected to push interest rates up. Contraction of public borrowing is seen as essential to offset that upward pressure and such contraction has been a consistently high policy objective.

UK interest rates rose sharply in the early part of 1985 and have remained several percentage points higher than elsewhere. Moreover, there are unlikely to be substantial early reductions in UK interest rates. The reasons for both the first quarter measures and the absence of much downward movement emphasise that the PSBR, while held to be an important earnest of the Government's commitment to the MTFS, is by no means the sole influence on interest rates.

The general level of international interest rates is set by the rates necessary to fund the US budget deficit, the target of much rhetoric from European policy-makers over the past two years. The excess of UK interest rates above that level is determined by developments in factors affecting UK economic conditions. Despite oil markets having settled down in the first quarter and the reassuring effect of the Budget on markets, interest rates have eased only slightly and remain relatively high in both nominal and real terms.

Reservations were expressed in the last **Commentary** that the use of £M3 as a target variable understates the extent of monetary expansion. Even then, and despite continuing high interest rates, £M3 grew well above target in April. A number of factors account for this rapid growth. Bank lending to the private sector increased as companies sought to take advantage of higher rates of capital allowances. As announced in the 1984 Budget, first year capital allowances were reduced from 75% to 50% in April. Given the healthy state of corporate liquidity, the extent of the demands on the banking sector for this purpose is disturbingly high. Consumer credit also grew rapidly, with attendant threats of inflationary pressure. In addition, monetary growth may have been affected by an inflow of foreign capital as the dollar weakened against sterling.

Much of the immediate prospects for lower interest rates depends on these influences being short-lived. Of the three, the first is the most likely to wane in the near future. Some incentive to bring forward investment projects remains as first year capital allowances are to be reduced further to 25% next year, when a new, and according to the CBI, less attractive, scheme comes into operation. This will help to maintain investment spending, although at lower rates, and pressure on the money supply on this count will be most obvious towards the end of the current fiscal year.

With earnings still running ahead of inflation, however, consumer credit will probably continue to grow. Moreover, any further weakening of the dollar will put pressure on the money supply through the capital account of the balance of payments. Maintenance of demand for consumer credit and capital inflows will then require increased government funding to permit achievement of monetary targets. This in turn will exert upward pressure on interest rates.

There is, moreover, little prospect of lower UK interest rates as a consequence of reductions in the general international level. The current slowdown in the US economy, although reducing the growth of private sector demand for credit, will intensify the problem of the US budget deficit by slowing the growth of tax revenues. As noted in the last **Commentary**, foreign capital inflows to the US have been slowing and capital export by the US banking system is likely to recover. The possibility of lower interest rates then becomes more remote as the US authorities seek to fund the budget deficit. Only if Congress can obtain cuts in the deficit through reductions in expenditure larger than proposed in the January Budget statement will the international level of interest rates start to decline.

In addition to these influences, however, a shift has taken place in the nature of UK monetary policy which itself reduces the likelihood of lower rates of interest. Until now the MTFS has been based on an assumption of a constant relationship between monetary growth and the growth of nominal income. This year's Red Book forecast is of the growth in nominal GDP rising from 6.75% in 1984/85 to 8.5% in 1985/86 while monetary targets have been lowered by 1%. That tightening in monetary policy marks a change in the basic money supply/monetary income growth relationship and is likely to reinforce the need for overfunding with further pressure on interest rates.

It is to be hoped that the shift from an assumption of the need for constancy between monetary growth and nominal GDP growth presages greater recognition of the various influences, including the role of the PSBR, on interest rates. That would permit a move to a US-type mix of tight monetary and looser fiscal policy, as advocated in the last **Commentary**. The present combination of a relatively unchanged fiscal stance and a tightening of monetary policy bodes ill for the continuation of output recovery. Real interest rates are unlkely to fall much before the end of 1985. That stickiness, with the present policy mix, raises serious doubts about the durability of recovery.