THE ECONOMIC BACKGROUND

THE INTERNATIONAL ENVIRONMENT

There has been little change in the world economy since the last quarter. Interest rates were cut slightly in Europe in September 1996 but remain unchanged in the US and Japan. Monetary policy was loosened over 1995, and 1996 has seen contractionary fiscal policies. The result is that the global economy is now on an expansionary path again. The price of oil and food has increased substantially with the commodities price index rising by 20%. It is expected that in the next six months headline inflation will rise slightly but this will ease off in the second half of 1997. A major world issue at the moment is EMU, to be discussed in further detail later.

The US

There has been strong growth in the first two quarters of 1996 but this has slowed slightly in Q3 96. The main cause of this was the trade deficit moving up to $11.3bn in September 1996, a 10.1% increase since August. In addition industrial production growth slowed from 6.7% in Q2 96 to 4.4% in Q3 96. Inflation remains low, 2.5% in 1996 and forecast to be 2.6% and 2.8% in 1997 and 1998 respectively. Unemployment is at its lowest since June 1990 at 5.3% and is forecast to remain at a low level until 1998. The Federal Funds rate will probably rise by 75 basis points to curb inflationary pressure in 1997 but in the second half of the year this may be cut slightly. These factors combined will lead to steady growth for the US of 2.4% in 1996 and 1997 slowing to 2.2% in 1998 and 1999. The economy is close to trend according to the OECD and capacity utilisation in manufacturing is 82%, close to its post war average. The remaining question is over the current account balance which is 1.6% of GDP, the lowest since 1974. While the domestic deficit has been reduced there has been little progress on foreign trade. The current account deficit is forecast to become significantly larger from 1997 onwards.

Japan

Until recently Japan was out of step with the world economy but GDP growth is expected to be 3.7% in 1996 then slowing to 2.2% in 1997 but rising to 2.9% in 1998. Q1 96 growth was 2.9% making Japan the fastest growing economy in the G7. The strong growth has resulted from a fiscal and monetary stimulus which in turn has damaged the public finances considerably with debt rising to just under 60% of GDP. The current account has fallen by 35% between April to September and the trade surplus is at its lowest level since 6 years ago. Q2 growth has decreased by 0.7% but this was expected given the performance in the previous quarter. The main question is 'can the private sector sustain the recovery?' Most analysts agree that the recovery will be sustainable but will be more modest. Private consumption, industrial production, business confidence and export performance were relatively weak in Q2 96. Housing investment, capital spending and services continued to improve and will probably lead the recovery. It is unlikely that the Bank of Japan will increase interest rates until the end of 1997 when it becomes apparent that the recovery is being sustained. It is expected that monetary policy will support the recovery. Inflation will start to rise in 97 from its present insignificant levels but will remain well below 2%. This will be largely due to increased consumption tax and import prices.

Germany and Europe

Technically, Germany has been in recession with negative growth in Q4 95 and Q1 96. Q2 96 growth is 1.2% and is thought to be strong in Q3 96. The rise in growth during Q2 96 is the largest since unification. Industrial production and business confidence increased in the third quarter. Wage restraint, low interest rates, low inflation, favourable exchange rates and positive external developments have led to competitive gains which has meant increased exports. Exports are forecast to grow by 3.7% in 1997 and the recovery will be export led. GDP growth is expected to be 1.2% for 1996 but rising to 2.4% p.a. for the years 1997-99. The recent poor economic performance is due to structural factors not cyclical factors. Unemployment is still 10.3% and is unlikely to be halved by the year 2000. The economy requires deregulation of the labour markets, simplification of the tax system, a review of the welfare system and a decrease in general government spending. Fiscal policy will be tightened in 1997 and the current account deficit will get smaller from 1997 onwards, but only slowly. The general government deficit is expected to be 4% of GDP in 1996 and 3.4% in 1997. The government debt ratio will probably exceed 60% in 1997 but despite this Germany is expected to participate in EMU.

EMU is of great importance at the moment with all European governments implementing policies to meet the Maastricht criteria. EMU will probably take place in January 1999 with Austria, Belgium, Finland, France, Germany, Ireland, Luxembourg and the Netherlands expected to form the 'core' of EMU. Government bond yields in Germany, France and the Netherlands have converged demonstrating that the markets expect EMU to take place between these countries. It is highly unlikely that the UK and Denmark will participate.

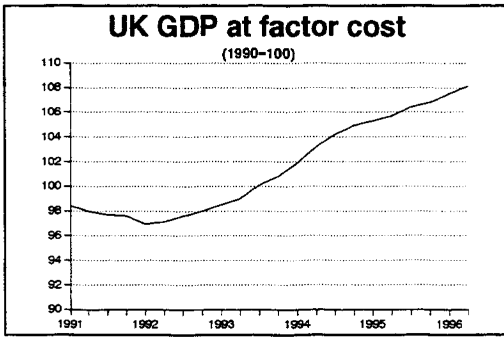
THE UK ECONOMY

Macroeconomic trends

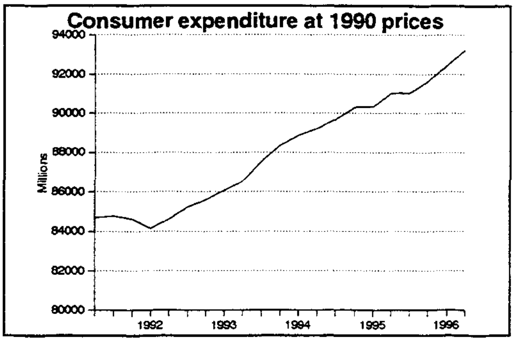
In the second quarter of 1996, the provisional estimate of **GDP at market prices** - 'money' GDP - rose by 1.3%. After allowing for inflation and adjusting for factor costs, GDP grew by 0.5% during the quarter, compared with the 0.4% increase recorded in the first quarter of 1996. Over the year to the second quarter, **'real' GDP** is estimated to have risen by 2.2%. When oil and gas extraction are excluded, 'real' GDP is estimated to have risen by 0.5% in the second quarter and by 2.1% over the same period a year ago.

Output of the production industries in the second quarter is estimated to have risen very slightly, by 0.1%, to a level 1% higher than the same period a year ago. Within production: **manufacturing** experienced a *decrease* in output of 0.2% in the second quarter, the same rate of decrease as in the first quarter; output of the **other energy and water** supply industries rose by 1%, and **mining & quarrying, including oil & gas extraction** rose by 1.5%. Manufacturing output in the second quarter was 0.1% *below* the same period a year ago. The output of the **service sector** rose by 0.9% in the second quarter and by 3.2% over the second quarter 1995. The **construction industry**, on the other hand, experienced a very small increase in output of 0.1% in the second quarter, with output rising slightly by 0.2% compared with the corresponding quarter of 1995.

The CSO's **coincident cyclical indicator** for August 1996, which attempts to show current turning points around the long-term trend, was slightly above the July figure and has risen in the three months to August having displayed a flat profile during the first half 1996. The **shorter leading index**, which attempts to indicate turning points about six months in advance, rose in August after a slight fall in July, no change in June and after displaying a gradual increase during the first five months of the year. The **longer leading index**, which purports to indicate turning points about one year in advance, rose very slightly in August, reflecting increased housing starts. The increase maintains the upward trend which has been present since last December.



In the second quarter of 1996, **real consumers' expenditure** rose by 0.8%, compared with the 0.9% increase reported in the first quarter 1996. Spending during the second quarter rose by 2.4% on the same period a year earlier. The official seasonally adjusted estimate of **retail sales** volume for August 1996 was 1% above the July figure. Over the year to August, the volume of seasonally adjusted sales rose by 4.4%. Taking the three months to August, the volume of retail sales rose by 1.6% over the preceding three months and by 3.5% over the same period a year earlier. The amount of outstanding **consumer credit** continued to rise in June and July, with the July figure of £1,027 million particularly high. After jumping from 10.7% to 12.2% in the fourth quarter 1995, the **personal saving ratio** fell slightly to 11.8% in the first quarter of this year, and then fell further to 11.1% in the second quarter. The underlying increase in **average weekly earnings** in the year to August 1996 is provisionally estimated to have been 4%, the same rate of increase as in July. Earnings growth remained at 3.75% from February to June and still remains low by historical standards for the present stage of the cycle. However, the growth of **real personal disposable income (RPDI)**, 3.3% in the second quarter 1996 over the same quarter in 1995, has now slowed below the rate of growth earnings after registering an increase of 4% over the year to the first quarter.



General government final consumption rose by 0.2% in the second quarter of 1996. Government consumption in the second quarter was 0.7% higher than in the corresponding quarter of 1995.

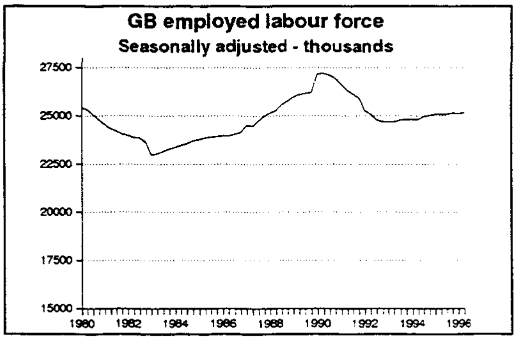
Real gross fixed investment or Gross domestic fixed capital formation rose by 2.9% in the second quarter to a level 3.2% higher than in the second quarter of 1995.

Turning to the **balance of payments**, the **current account** for the second quarter 1996 was, after seasonal adjustment, in *surplus* by £0.5bn, compared to revised estimates of *deficits* of £0.8bn in the first quarter, £1.2bn in fourth quarter 1995, £1.1bn in the third quarter, and £1bn in the second quarter. (We noted in the September **Commentary** that the Office of National Statistics (ONS) is no longer publishing series called "visible" and "invisible" trade. Visible trade is now referred to as "trade in goods" and the "invisibles" category is now broken down into "services", "investment income" and "transfers". In consequence, we noted that in future we proposed to refer to the categories "trade in goods and services" and "investment income and transfers".) For **trade in goods and services**, the deficit improved to £1.7bn, compared with £2.5bn in the first quarter, £1.8bn in the fourth quarter 1995, £1.9bn in the third quarter, £1.8bn in the second quarter and a *surplus* of £0.1bn in the first quarter. For **investment income and transfers**, there was a *surplus* of £2.2bn in the second quarter, compared with £1.7bn in the first quarter, £0.6bn in the fourth quarter 1995, £0.9bn in the third quarter, £0.8bn in the second quarter and £0.3bn in the first quarter.

UK LABOUR MARKET

Employment and unemployment

Seasonally-adjusted UK claimant unemployment fell by 96,000 in the quarter to October, and by 234.600 over the full year. UK unemployment now stands at 2,030,000, giving an overall unemployment rate of 7.2%, with a male and female rate of 9.8% and 4.0% respectively. These changes represent substantial reductions in unemployment, especially over the last three months. The UK employment data are a little less up to date but the figure for UK workforce in employment for June stands at 25,908,000, an increase of 87,000 (0.3%) in the quarter from March, and an increase of 124,000 (0.5%) in the full year from June 1995. The rise over the last year has come solely from expansion in the number of employees in employment. The numbers of people self employed, in the armed forces or on work-related government-supported training have all fallen. UK employment in manufacturing industry fell by 14,000 (0.3%) in the quarter to June, though it rose by 14,000 (0.3%) over the full year and more recent British manufacturing data show a rise in employment of 13,000 (0.3%) in the three months to September. Whilst employment in manufacturing has been somewhat erratic over this calender year, service employment continues to show strong growth. It rose by 142,000 (0.8%) in the quarter to June and by 257,000 (1.5%) for the whole year from June 1995. These general improvements in the labour market have been accompanied by a large increase in the number of vacancies registered at Jobcentres. In the quarter to October, the number rose by 32,800 (14.3%) and over the full year from October 1995 by 72,200 (37.9%).



Earnings and productivity

Since the beginning of 1996, there has been a gradual, but persistent, increase in the underlying level of annual wage inflation in the UK. Underlying inflation in the third and fourth quarters of 1995 was 3.25%. However, by the third quarter of 1996 this had increased to 4%. This increase in wage inflation is consistent with the steady tightening of the UK labour market that has been in evidence in the past year. A rise in average earnings has occurred in both manufacturing and services, though there continues to be a differential between wage increases in these two sectors: the underlying year-on-year increase in average earnings to September was 4.5% in manufacturing and 3.75% in services. The rate of growth of labour productivity in the whole economy in the second quarter of 1996 is 2.0%, higher than it has been since the first quarter of 1995. However, the figures for manufacturing are extremely weak. The level of labour productivity in the third quarter of 1996 is 0.7% lower than in the same quarter for 1995. This has important effects on unit labour costs. For the whole economy these are 1.0% higher in the second quarter of 1996 than they were a year earlier. However, in the third quarter manufacturing unit labour costs are 5.2% greater than the previous year.

UK OUTLOOK

The most significant economic event affecting the outlook for the UK economy since the publication of the last **Commentary** is the Chancellor's November Budget. The following provides an overview and outlook:

1996 BUDGET REVIEW

Economic background

When the Chancellor stood up the House of Commons on November 26th he knew that his Budget had to resolve a dilemma. This is the last Budget before the election and traditionally governments have tended to relax their tax and spend (or fiscal) policy in the pre-election budget. Taxes tend to be cut and public expenditure tends to be expanded. The obvious objective (if implicit) is to reassure the voters that all is well in the economy and that the government's policies are helping to improve their personal well-being.

The Chancellor's dilemma was that the public finances were not in a sufficiently healthy position to justify a 'give away' Budget. And a 'give away' Budget would certainly have antagonised the financial markets, would have taken risks with the economy and held out the prospect for much higher inflation and then subsequent higher unemployment in the future.

His November 1995 Budget, which offered modest tax cuts, was predicated on assumptions about economic growth and inflation which, as we noted in the last post-Budget Commentary, were likely to be too optimistic. The Chancellor was forecasting growth of 3% in 1996 and an inflation rate of 3%. He got his inflation forecast right but his growth forecast was badly wrong.

In the event, the economy is now expected to grow at 2.5% this year, largely because of the dampening effect on manufacturing industry performance of the stock over-hang that was built up last year, and also because the UK's principal European export customers, particularly Germany, were growing more slowly than expected. Hence, the export-led growth which had done so much to make the recovery from recession virtuous in economic terms began to dissipate. Fortunately, the one silver lining in the economic clouds of early 1996 was the growth of consumer spending which was beginning to pick up. The housing market was beginning to revive, consumers were more prepared to take on more debt and run down their savings a little. So, growth began to pick up by in the second half of the year, and is now forecast to be 2.5%, less than forecast in the last Budget but the same as last year. In the first half of this year it didn't look if we would even reach last year's growth rate.

The other 'good news' about the economy was that, as the Chancellor predicted, inflation remained fairly low for this stage of the economic cycle i.e. 4 years into an economic recovery. This was principally due to the growth of earnings and pressures for wage rises remaining fairly weak. However, there have been signs that inflation is beginning to rise as workers begin to press for higher wages and as the growth of consumer demand encourages suppliers, particularly retailers, to raise their margins.

The upshot of this slower than forecast growth of output was that government borrowing (the PSBR) was higher than the chancellor forecast last year. In fact some £4bn higher at -£26.5bn compared with the forecast of -£22.4bn.

Against this background, many economists have argued that the need to reduce government borrowing plus the fear of rising inflation associated with an expected faster growth of consumer demand, required a Budget which tightened the fiscal stance i.e. which raised taxes or cut public spending or both. But for the Chancellor, such an approach wouldn't perhaps play too well with the electorate.

The Budget measures

On *taxation*, the Budget measures taken together serve to *cut* taxes by £0.7bn next year (1997-98), and by £0.6bn in 1998-99, but will *raise* taxes by £0.8bn in 1999-2000, compared with plans in the last Budget. As usual, the Chancellor has effected his tax changes by giving to some and taking from others. But there must be some concern about the viability of his proposed net tax cuts. Taking next year (97-98) as an example. The main tax cuts are: the increase in personal allowances costing £840 million next year; the reduction in the basic rate by 1 pence to 23p will cost £1.25 billion, and the relief on business rates will cost £115 million. Therefore to realise net tax cuts of £735 million next year, his main sources of extra revenue are two fold. First, what are described as *"other measures"* such as the higher tax on insurance premiums and the extra air passenger duty will together raise £605 million, but by far the biggest savings are to come from what the Chancellor calls *"measures to secure the tax base"*. These are basically measures to reduce tax loopholes and are expected to bring in an extra £950 million next year. However, many analysts feel that the Chancellor is being over optimistic here and that such a return is unlikely to be realised, which, if proved correct, will mean that the net tax cuts are much greater than the economy can really afford.

Expenditure, on the other hand, is to be reduced overall by £1.9bn next year and £2.5bn and £2.7bn in the two subsequent years. Taking next year as an example the source of these cuts, *compared with last year's Budget plans*, is as follows. First, the government has had to raise planned expenditure by some £730 million to finance measures to prevent the spread of BSE (e.g. financing the cattle cull). In addition, the government has revised its spending plans upwards in Health (up by £770m including £470m to NHS), in Transport (up by £420m) and for Social Security payments (up by £600m). To reduce spending plans overall, the task was therefore made harder by these planned rises. The main areas to bear the brunt of the cuts are: a cut in the contingency reserve by £2.5bn; cuts in payments to local authorities on the education budget of £1.02 billion - a massive cut; a cut in defence spending of £800m, largely financed by the sale of married quarters which will raise £700m in the year, but obviously no more thereafter; cuts in overseas aid (£150m) and a cut in the Scottish Office budget of £300m.

When these planned cuts in taxes and the greater planned cuts in spending are put together, the net effect is to reduce projected government borrowing (PSBR) by £1.8bn next year, and by £3.2bn and £5.2bn in the subsequent two years. But given the slower growth than anticipated in the last Budget, the PSBR will not now be in balance until one year later than forecast in the 1995 Budget.

The problem with all this Budget arithmetic is that you can tell almost any story if you choose the right comparator to compare your proposed changes against. The changes I have just outlined are compared, as the Chancellor did yesterday, against *last year's Budget plans*. The difficulty, of course, is that last year's plans were not realised, as happens every year! The outturn on spending is invariably higher than the original plans so increases can be made to seem greater when compared with the previous spending plan rather than the outturn. This year the outturn on spending was only a little greater than expected: only £400m more. But the fact that spending tends to outrun plans and that the tax-take tends to be less than anticipated, particularly when growth is slower, suggests that the apparent small tightening of the fiscal stance in yesterday's Budget could turn out to be slightly expansionary in its effect on the economy. And even if its effect is neutral many analysts believe that this is not what the economy requires at the moment. So, with strong growth expected next year, the Chancellor should have tightened things up more than he did. But of course that would have been unacceptable on political grounds. Although what this does mean is that the prospect for further interest rate rises is now considerable, even before the election.

Macroeconomic assumptions

As noted above, the Chancellor's Budget arithmetic depends crucially on him getting his forecasts right. GDP is forecast to grow by 2.5% this year (the same as in 1995) rising to 3.5% in 1997. The faster growth next year is mainly due to the expected faster growth in consumption which is forecast to rise from 3% in 1996 to 4% plus in 1997. The GDP forecast for next year is slightly more optimistic than several forecasters, but most economists are agreed that growth will be strong next year and so few would quibble with his forecast here.

Business investment is predicted to rise sharply from 6% in 1996 to 10% in 1997.

This prediction is excessive for some. Investment has remained sluggish and has continually disappointed expectations. Investment will rise but perhaps not by as much as this forecast.

The Chancellor expects that his inflation target of 2.5% per annum will be met by the end of next year, with no further pick up in average earnings growth. This forecast also gives some cause for concern. With consumer spending beginning to pick up strongly and expected growth of over 4% in spending next year and overall growth around 3.5%, it would take a brave man or a foolhardy person to forecast that inflation would be back on target by the end of next year. If the outturn in inflation is higher than anticipated then it makes it much more difficult for the Government to meet its spending targets (especially when price inflation for goods and services purchased by government tends to be greater than general inflation), which means that the fiscal stance will be looser (and therefore more likely to stimulate the economy further). And, the need for further increases in interest rates will therefore be likely.

Conclusion

The main conclusion must be that the Chancellor when faced with the dilemma of a significant conflict between his political and economic objectives took a cautious way out, coupled with a some sleight of hand with the Budget arithmetic. He did not, as many of his predecessors have done before an election, offer significant tax cuts and spending increases. He knew that would be foolish. However, our judgement is that the fiscal stance resulting from the Budget is not tight enough, in view of the projected growth of the economy next year and particularly the expected increase in consumer spending. The likelihood is that monetary policy will therefore have to be invoked (through increases in interest rates) to restrain the growth in demand and the prospect of an acceleration in inflation. This is likely to have the further effect of appreciating the exchange rate with damaging effects on British exports. We therefore face the prospect of a consumer-led boom with long-run implications which will not be favourable for the British economy.