The ECONOMIC *Background*

THE INTERNATIONAL ENVIRONMENT

Over the last quarter the emerging Asian economies have suffered crucial blows to their economies. The Tiger economies have experienced a turbulent time in the currency markets while Japan has seen the collapse of Yamaichi and Hokkaido Takushoku (the fourth largest stockbroker and tenth largest commercial bank). Despite the uncertainty in Asian markets the US and Europe continue to grow with no signs of inflation becoming a severe problem. Rate rises have been limited to check overheating in the world economy. Unemployment in general continues to fall while trade continues growing and currencies are relatively stable except in the Far East. World commodity prices have weakened which is good news for the developed nations.

The US

The US is now six years into an expansion and it appears that the economy is showing robust signs of improvement over the last fifteen years. GDP growth in Q2 1997 was 0.8% up to a level which is 3.4% above that a year ago and is above trend at the moment. Growth is forecast to be 3.5% in 1997 but expected to slow in 1998 to 2% as the world economy cools. Inflation will remain low typically in the 2-2.5% p.a. range over the next two years. Unemployment is forecast to be 5.0% and 5.1% in 1997 and 1998 respectively. Alan Greenspan (the Federal Reserve chairman) expressed confidence in the US economy dismissing speculation that the current problems in South East Asia would damage the economy. He believes that any inflationary pressures have been dampened over the past few weeks. Productivity in the US has also improved which will lead to higher than expected profits in the private sector. This will stimulate higher business investment but after the 1998 slowdown this will decrease considerably. Consumer spending in the US fell for three consecutive months but there were modest increases in June, July and August. This suggests that in Q3 1997 consumer spending could generate an annualised rise in sales of 5%. This is probably due to steady employment growth, the remote prospect of higher inflation, real wage gains this year resulting in an increase in real personal disposable income and many consumers holding unrealized stock gains. These factors will tend to drive consumption (the savings ratio will decline but net financial assets will increase) leading to a further fall in unemployment in Q1 1998 to 4.5%. During 1998, because of the slowdown, exports will also slow driving up unemployment. Industrial production will decline and the strength of the dollar will not help. In 1998 this will result in growth of average earnings slowing as wage pressures moderate. The outlook for the US is promising.

Europe

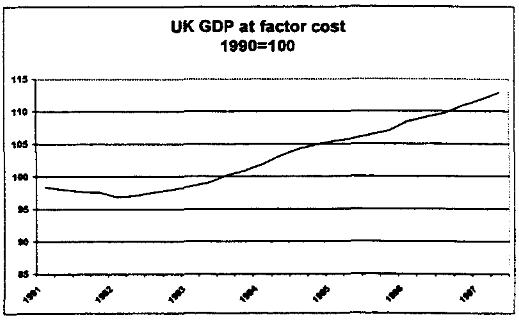
GDP growth in the main European economies continues to be driven by net exports. Both France and Germany have GDP growth of 1% in Q2 1997. Italian growth is much weaker than growth in the rest of Europe. Private consumption is weak in Germany but is significantly weaker in France. France has above trend growth in imports but this is not driven by domestic demand. Industrial production continues to rise in both economies suggesting strong Q3 1997 growth. GDP growth of 2.8% is forecast for 1998 for both economies but in 1999 this will drop back slightly, more so for France. In Italy underlying GDP growth was probably only 0.5% in Q2 1997 but is expected to increase to 2.7% in 1998. Inflation for the period 1997-1999 in France and Germany is forecast to be 1.5% p.a. but in Italy it will be nearer to 2.5% p.a. Most of the rest of Europe continues to benefit from low inflation. German unemployment continues its relentless rise standing at 11.2% in October 1997. The seasonally adjusted figure has risen above 4.5 million unemployed for the first time. Both France and Italy are forecast to have unemployment circa 12% in 1997 and 1998 whereas in Germany it is forecast to fall from its present level to 10.5% in 1998. The outlook for Europe is healthy as export growth continues particularly towards the US and Asia. EMU remains on schedule and looks certain to be a broad membership rather than a narrow base. The main question is will Spain and Portugal participate? If Italy is excluded, as it has some way to go to meet the criteria, then perhaps Spain and Portugal will be persuaded to accept delayed entry. The UK government made a positive statement regarding EMU while ruling out joining the first wave. This has paved the way for the Germans and the French to back a UK seat on the board of the European Central Bank when the UK joins the single currency.

Japan and Asia

The Japanese recovery is nervous as in Q2 1997 GDP growth was -2.9%. This coupled with the inherent weakness of the financial sector has caused uncertainty in markets. GDP growth in 1996 was however 3.6% which was the strongest of any of the G7 countries and suggest that this may be no more than a wobble in the Japanese recovery. It may be due to spending switching prior to the introduction of indirect taxes following growth of 1.4% in the first quarter and the problems in South East Asia. GDP growth is forecast to be 1.3% in 1997, 2.4% in 1998 and 2.7% in 1999. Private sector consumption fell by 5.7% in Q2 1997 but we expect growth of around 1.9% in 1998 and 1999. During this period investment will also increase, particularly business investment. Japanese inflation remains insignificant and is forecast to be in the 1.5-2.0% range in the years 1997 and 1998. The Bank of Japan's quarterly Tankan survey revealed in October low confidence, particularly in retail and construction. It also indicated investment was due to increase. Unemployment is rising in Japan to 3.3% in 1997 and 3.1% in 1998 which, for Japan with historically negligible unemployment rates, is relatively high. The outlook for Japanese growth is dependent critically on whether the Asian crisis is a real or nominal shock. If this is a real shock and trend growth for Asia will be lower then this will have serious implications for Japan who has extensive markets in Asia. If the shock is nominal then the problem will be easier to deal with. The massive deflations seen, if sustained, will reduce export prices and increase export competitiveness for the economies of South East Asia thus making it harder for Japan and threatening a deflation not only to Japan but the global economy. The realistic assessment is that most large exporters (Singapore, Malaysia, Philippines, Hong Kong) also are large importers. Unless they are importing from an economy with a larger devaluation than their own then the scope for export price cuts is limited. Similarly countries with high exposure to foreign debt (which includes Philippines, Malaysia, Thailand and South Korea) will be constrained in cutting export prices. Other factors which are crucial to this outcome are substitution of domestic demand for exports, the capacity for increased demand and the composition of trade. It is highly unlikely that the South East economies can set world prices and it is more likely that this will promote non inflationary growth in the Western economies. It is difficult to assess the outlook for the Asian economies.

UK MACROECONOMIC TRENDS

In the second quarter of 1997, the estimate of **GDP at market prices** - 'money' GDP - rose by 1.6%. After allowing for inflation and adjusting for factor costs, GDP grew by 1% during the quarter, compared with the 0.9% increase recorded in the first quarter. Over the year to the second quarter, **'real' GDP** is estimated to have risen by 3.5%. When oil and gas extraction are excluded, 'real' GDP is estimated to have risen by 1% in the second quarter and by 3.6% over the same period a year ago. Preliminary estimates of **'real' GDP** for the third quarter 1997 suggest an increase of 1% over the previous quarter to a level 3.9% higher than the third quarter of 1996. Removal of oil and gas extraction produces a quarterly growth rate for the third quarter 0.9%, while the annual rate rises to 4%.



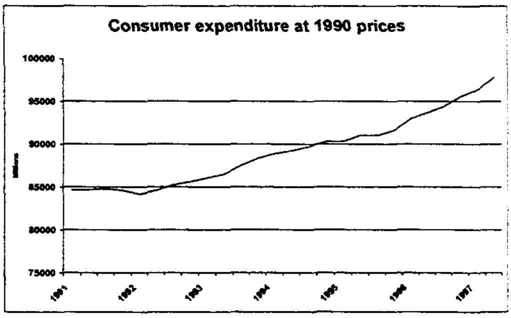
Output of the production industries in the second quarter rose slightly by 0.6%, to a level 1.6% higher than the same period a year ago. Within production: **manufacturing** experienced an increase in output of 0.3% in the second quarter, output of the **other energy and water**

supply industries rose by 5.2% in the second quarter, and **mining & quarrying, including oil & gas extraction** *fell* by 0.8%. Manufacturing output in the second quarter was 2.1% above the same period a year ago. The output of the **service sector** rose by 1.2% in the second quarter and by 4.3% over the second quarter 1996. The **construction industry** also experienced an increase: of 0.9% in the second quarter, and 3.5% over the corresponding quarter of 1996.

Preliminary estimates from the ONS for the third quarter of 1997 suggest that the **output of the production industries** was "relatively robust". **Manufacturing, mining & quarrying, including oil & gas extraction**, and **other energy and water** all experienced an increase. The output of the **service sector** rose by 1% in the third quarter and by 3.9% over the third quarter 1996.

In the second quarter of 1997, **real consumers' expenditure** rose by 1.5%, compared with the 0.9% increase reported in the fourth quarter 1996. Spending during the second quarter rose by 4.4% on the same period a year earlier. In the second quarter, consumers' expenditure again provided the main contribution to GDP growth, of 0.95% points, along with an enhanced contribution from investment and a small offering from stockbuilding. The official seasonally adjusted estimate of **retail sales** volume for October 1997 was 2.8% above the September figure. Over the year to October, the volume of seasonally adjusted sales rose by 6.4%. Taking the three months to October, the volume of retail sales rose by 0.4% over the preceding three months and by 5.1% over the same period a year earlier. The amount of outstanding **consumer credit** rose by £901m in October and by £2.2bn in the third quarter of the year. The **personal saving ratio** rose to 11.7% in the second quarter of 1997 from 10.4% in the first quarter and 11.4% in the fourth quarter of 1996. The underlying increase in **average weekly earnings** in the year to September 1997 is provisionally estimated to have been 4.25%, one-quarter points lower than August. **Real personal disposable income (RPDI)** rose by 3% in the second quarter of 1997 and by 4.2% compared with the same quarter in 1996. The rise in the saving ratio in the second quarter reflects the slower growth of consumers' expenditure compared to personal income.

General government final consumption, rose by 0.2% in the second quarter of 1997. Government consumption in the second quarter was 0.7% higher than in the corresponding quarter of 1996. The contribution to GDP growth was almost zero in this as in the previous quarter.



Real gross fixed investment or Gross domestic fixed capital formation rose by 2% in the second quarter to a level 2.5% higher than in the second quarter of 1996. Investment made a reasonably positive contribution to GDP growth of 0.34% points in the second quarter after making almost no contribution in the first quarter. In manufacturing, investment is estimated to have risen by 10% to a level 27% higher than in the second quarter of 1996. In other sectors, capital expenditure rose by 15% in other production, by 61% in construction and by 4% in services compared with the first quarter. Over the year to the second quarter 1997, capital expenditure rose by 13% in other production, by 3% in services and by 19% in construction.

Turning now to the **balance of payments**. The **current account** for the second quarter 1997 registered, after seasonal adjustment, a surplus of £0.9bn, following the surplus, on revised figures, of £1.4bn in the first quarter. These figures compare with a surplus of £0.5bn in the fourth quarter of 1996, a deficit of £0.4bn in the third quarter, a surplus of £0.7bn in the second quarter, and a deficit of £1.2bn in the first quarter. For **trade in goods and services**, the *deficit* deteriorated to £0.52bn in the second quarter from £0.20bn in the first quarter, £0.52bn in the fourth quarter 1996, £1.25bn in the third quarter, £1.28bn in the second quarter and £2.42bn in the second quarter of 1996. For **investment income and transfers**, there was a *surplus* of £1.41bn in the second quarter 1997. This can be compared with a surplus, on revised figures, of £1.6bn in the first quarter, £1.02bn in the fourth quarter 1996, £0.8bn in the third quarter, £2bn in the second quarter and £1.2bn in the second quarter 1996. Net trade made a negative contribution to GDP growth in the second quarter of this year, lowering the quarterly growth rate from 1.4% to 1%, following a positive contribution in the first quarter and a slight negative contribution in the fourth quarter of 1996.

UK LABOUR MARKET

Employment and Unemployment

Seasonally-adjusted UK claimant unemployment fell by 80,900 in the quarter to October and by 560,900 over the full year (though figures in the period October to May have been affected by the introduction of the Jobseeker's Allowance). UK unemployment now stands at 1,464,300, giving an overall unemployment rate of 5.2%, with a male and female rate of 7.2% and 2.7% respectively. Whilst the level of unemployment has shown a persistent downward trend, UK employment has, in the past, exhibited a rather more variable performance. However, over the last eighteen months there has been a consistent increase in employment. Total employment in June numbered 26,507,000, an increase of 65,000 (0.2%) in the quarter from March, and 473,000 (1.8%) in the full year from June 1996. Within the various sectors of the UK economy, employment in manufacturing increased in the quarter to June by 12,000 and in the full year by 43,000, although the more recent figures for British manufacturing show a decrease in the last quarter of 30,000. There have been much more substantive employment gains in the service sector. In this sector employment increased by 324,000 in the year to June, 35,000 jobs coming in the last quarter. The general improvements in the unemployment figures have been accompanied by a rise in the number of vacancies registered at Jobcentres. In the quarter to October, the number registered vacancies rose by 27,100 (9.5%) and in the full year from October 1996 the figure increased by 49,600 (18.9%).

Earnings and Productivity

The underlying level of annual wage inflation in September was 4.25%, slightly lower than the figures at the beginning of the year. Throughout 1996 there was a gradual increase in wage inflation, but this peaked in December 1996 and January 1997 at a rate of 4.75%. Since that time there has a gradual decline in UK wage inflation. From the second quarter of 1991, wage increases in manufacturing had been persistently higher than those in service sectors. In 1996, this sectoral differential narrowed and since February 1997 the underlying wage growth in services has been higher than that in manufacturing, with the September figure being 4.0% in manufacturing as against 4.5% in services. The rate of growth of labour productivity in the whole economy in the second quarter of 1997 was 1.6%. Whilst the figures for whole-economy labour productivity have jumped about a little over the last couple of years, the current value is relatively high. In all four quarters of 1996, manufacturing productivity was lower than in the previous year. However, in the first three periods of 1997, manufacturing productivity has been increasing and in the third quarter was 2.0% above the value in the corresponding period in 1996. Given the gap between the increase in wages and the increase in labour productivity, unit labour costs have been rising in both the whole economy and the manufacturing sector. In the second quarter of 1997, the rise in whole-economy unit labour costs over the previous year was 2.7%. Whilst this is a little down on the figure for the previous quarter it is still very high compared to the figures over the past 5 years. In manufacturing the position is a rather more sanguine. The increase in unit labour cost in the third quarter of 1997 is 2.1%, which is the lowest increase since the fourth quarter of 1994.

UK OUTLOOK

In the September **Commentary** we noted that mixed signals were coming from the UK economy about the likely future growth path. The economy was still displaying above trend growth (2.25% to 2.5% per annum) although the quarterly rate of growth appeared to be decelerating. Yet manufacturing investment appeared to be picking up and export growth remained strong despite the rise in sterling. There also appeared to be little sign of a moderation in the rate of growth of consumers' expenditure, which grew at annual rate above 6% in the second quarter. We noted that the consensus view was for a slow down in the rate of growth of aggregate demand in late 1997 and 1998. This was expected by many because of the anticipated contractionary effects of the high level of sterling, the July Budget, higher base rates and the diminishing impact of the windfall gains arising from the demutualisation of building societies.

To be set against the consensus was the view that the consumer 'boom' had still some way to run, since consumer confidence was high and rising and further spending effects had still to come through from the windfall gains. Added to this was the expectation that the higher level of sterling would have little impact in the immediate run. The economy, on the minority view, was therefore set for further rapid expansion, raising the prospect of a 'hard landing' in 1998 or 1999, as further monetary and fiscal tightening became necessary to deflate the over expansion.

The situation in mid-December is A little easier to read than in mid-September. The consensus view remains that economic growth will slow in 1998. All of the 46 forecasters surveyed by the Treasury predict that growth will be slower next year, with the average expectation being that the growth rate will fall from 3.4% in 1997 to 2.5% in 1998. This prediction is reinforced following the further tightening of the base rate in early November to 7.25%. However, consumers' expenditure is still growing strongly despite the downward 'blip' in retail sales volumes in September – attributed to the loss of part of trading on Saturday September 6th, due to the funeral of Diana Princess of Wales. In addition, both private investment and exports are growing strongly, while the weak growth of public expenditure and the strong growth of imports have served to dampen the demand for domestic goods and services.

The consensus view that the economy is slowing down reflects a belief that the strong growth in consumers' expenditure and in exports is a temporary phenomenon. Thus it is believed that the windfall gains from demutualisation that consumers are willing to spend are soon likely to be exhausted, while export growth is finally expected to slow down in the face of the sustained high level of sterling.

The latest issue of the National Institute Economic Review persuasively argues that the recent buoyancy of export and sluggishness of import growth cannot be explained by: a fall in import costs offsetting the exchange rate rise; firms having adjusted their profit margins downwards; or, by a sharp quality improvement in UK traded goods and services. A fall in import costs would only serve to offset the increase in sterling if the import content of exports was high and domestic value added was low. NIESR point out that the average import content of UK exports is only 22%. On the argument that firms have taken the rise in sterling in reduced profit margins, NIESR demonstrate that export prices have only fallen by 6.5% in sterling terms during the period when sterling appreciated by 20%. This implies a 13% rise in the foreign currency price of UK traded goods and services. Finally, NIESR argues that there is no evidence of a sudden quality improvement in UK products sufficient to offset the effect of the price rise.

The National Institute therefore concludes that the best explanation of buoyant exports and relatively sluggish import growth is that the effect on trade of the exchange rate rise has been delayed. The delay must reflect the view that the rise in sterling was temporary. Accordingly, we are persuaded by this view and expect, in line with the consensus, that growth will slow in the final quarter of 1997 and in 1998 as export demand for UK goods and services falls and the growth of consumption moderates. However, it is likely that growth in 1998 will still be slightly above trend at around 2.5%.