
The **ECONOMIC** *Background*

THE INTERNATIONAL ENVIRONMENT

Overview

The global economy has been dominated by a series of adverse financial shocks recently. This includes the continuing problems in the Far East, a debt moratorium in Russia as well as fears of contagion in Latin America. There is the possibility of further shocks with adverse effects on financial markets that could lead to a global recession. It is more probable however that 1999 will see a considerable slowdown in economic activity. The IMF has forecast that it will grow by 3.7% in 1998, a considerable contraction compared to 1997 before rising to 4.6% in 1999.

With the exception of Japan, economic activity in the industrialised countries has been robust in the second quarter of this year. Inflationary pressures are weak due mainly to falling commodity prices. A reduction in interest rates is required to avert a sudden and deep reduction in economic activity and Q3 1998 has seen an easing of monetary policy in the US and Japan as well as some European countries. This is unlikely to compromise inflation goals. The most likely outlook for growth in the OECD is 2.4% in 1998, falling to slightly below 2% in 1999 but recovering in the next two years to just above 2% p.a. It is the sustained expansion in the US and Europe that supports growth in the world economy.

The US

US GDP grew by 0.5% in Q2 1998 compared to 1.4% in the previous quarter and is expected to be 0.8% in Q3 1998. Final domestic demand fell from 1.6% in Q2 1998 to 0.8% in Q3. The reduction in net exports contributed to this fall in growth in Q2 1998 when domestic demand held up. Both the weakness of Asian markets and the strength of the dollar constrain export growth. GDP rose by 2% in the first half

compared to the latter half of last year (a similar pattern to that observed throughout 1997). GDP growth is expected to be just over 3% in 1998 but to slow considerably to 1.5% in 1999. It is likely that it will remain around this figure in the next year. Consumption growth remains strong (1.5% in Q2 1998) and contributed a full percentage point to GDP growth. Growth in consumer's expenditure will fall from 4.5% in 1998 to around 2% p.a. in 1999 and the year 2000. Domestic demand is expected to fall from 5.5% this year to 2.2% next year. Net export growth will probably be negative in both 1998 and 1999. Investment has been significant although it has slowed in both Q2 and Q3 1998 and may reduce further. In 1999 growth in investment in housing is likely to be half of what it was in 1998 while government investment is expected to rise from 0.1% in 1998 to 2% in 1999.

Of US exports in 1997, 21% were to Asia and 15% were to Latin America. The direct effects (mostly trade, activity and price effects) of the recent global situation will be more pronounced on the US as the problems of these two regions will affect it more than those elsewhere. The effect from Russia will be negligible on the US economy. Both capital flows and exports to these regions will decrease significantly over the next two years. Both business and consumer confidence have fallen recently as have profits. Capacity utilisation is on a falling trend and industrial production was static in Q3 1998. There is still real income growth and the labour market is buoyant although there are signs of tightening. Both these factors will lead to an increase in inflationary pressures. Unemployment was 4.6% in September up from a cyclical low of 4.3% in May of this year. Recent moves by the Federal Reserve to lower interest rates are the strongest signal yet of a potential slowdown in economic activity. Rates have been 5.5% since March and have been lowered twice in September with signs of further reductions to come. The Federal Reserve is also concerned about the cost of capital to businesses. Monetary conditions have also eased because of the effective exchange rate. The depreciation of the dollar is expected to continue next year raising import prices so the risk of price inflation still remains.

Japan and Asia

One of the main reasons for the weakness in the world economy is the poor performance of the Japanese economy, the second largest economy in the world. GDP fell by 0.8%

during Q2 1998, it's third successive fall. A small increase in net trade failed to offset the deterioration in domestic demand. There is little evidence that the fiscal stimulus is as yet helping the situation. This is primarily because local government spending is being held back until budgets are confirmed. This may not materialise until Q4 1998.

Consumer confidence has remained weak while private consumption has fallen by 0.8% in Q2 1998. This has completely negated the 0.3% rise in Q1 1998. Weak domestic demand and export markets have boosted stocks to near record levels. Industrial production fell by 0.3% in Q3 1998. The natural reaction of business has been to reduce both output and employment, as well as reducing investment. Investment fell by 5.5% in Q2 1998 following a 5.2% fall in Q1.

28% of Japanese exports go to the Asian region and therefore the Far East crisis is biting hard. The weakness of the Yen has partially restrained deflationary pressures by lifting import prices and limiting the effect of falling commodity prices. Despite this, deflation has occurred in Japan with both consumer and producer prices lower than those of last September. GDP growth is expected to fall by 2.5% in 1998, will probably be close to zero in 1999 and is forecast to be 1.5% in 2000. We expect that the low level of final demand will persist for some time yet. The very recent appreciation of the Yen will not help export performance. The growth of exports of goods by volume rose was 11.9% in 1997, is forecast to be slightly negative in 1998 and only 2% in 1999 before recovering to 5.5% in the year 2000. Net exports are a source of growth only because imports are declining faster than exports. It is expected that net exports will add 0.7% to GDP in 1998.

Inflation has moderated recently and was -0.3% in August 1998. Claimant unemployment is forecast to rise to around 4% in 1998, then to 5% p.a. in 1999 and 2000. Total employment has declined by 0.5% in the three months to August 1998 with job losses concentrated in manufacturing. The present drop in employment is the first since the downturn in 1991. This will have significant effects on income growth and real personal disposable income. Personal sector expenditure has declined by 2.7% in the second half of 1997 but this drop may have moderated. There is still considerable concern over the state of the financial system as nearly 12% of GDP has been committed to support it.

The extent of lending in the region has also contributed to the economy's weak performance. Recent evidence at the end of March 1998 estimates that there are non-performing loans outstanding of ¥35.2 trillion. Further assessments suggest that some ¥87.5 trillion (17.5% of GDP) of loans require active risk management. This figure is after allowing for a write-off of ¥44 trillion over the last five years. It is likely however that it will be some time yet before this problem is resolved.

Europe

Growth in the prospective Euro area (EU11) slowed in Q2 1998 mainly due to events in Germany and Italy. Growth in the smaller European economies remains strong. GDP in the EU11 rose by 0.5% in Q2 1998, slightly down from 0.8% in Q1 1998. Domestic demand was very robust during 1998. It is unlikely that stockbuilding has risen at the same pace as it did in Germany and Italy over the second quarter. Any reduction in stockbuilding will contribute negatively to GDP growth from Q4 1998 onwards. Industrial production slowed over Q2 1998 and more recently weaker external demand has depressed industrial production.

EU GDP grew by 2.7% in 1997 and is forecast to remain at 2.7% in 1998 but to fall to 2.3% p.a. in the years 1999 and 2000. Growth was driven last year by strong external demand with more modest increases in domestic demand. We expect domestic demand to continue to increase and net exports to decrease. Consumption has grown significantly this year. Retail trade indicators remain high despite lower consumer confidence. The sharpest declines were seen in the UK, Denmark and Ireland. Investment activity is strong this year, helped by low interest rates. Although confidence in the construction industry has increased, industrial confidence has begun to decline. Government expenditure increased significantly across Europe as countries had reduced expenditure to meet the Maastricht criteria. According to Eurostat data the fiscal deficit for the EU was 2.3% of GDP in 1997. Annual inflation in Germany, France and Italy is lower than that found in the EU11. Again falling world commodity prices have helped but the target for 1999 and 2000 is 1.8% and only five of the eleven are expected to be above 1.8%.

Employment growth has been high across Europe particularly in France and the outlook for consumption depends on continued

employment growth. The French economy is in cyclical upswing at the moment whereas the German job creation is largely due to publicly funded programmes. It should be noted however that German labour costs remain relatively high compared to other Euro area countries. Unemployment is forecast to fall below 10% p.a. in Germany over 1999-2000 and in France is forecast to drop from 12.4% in 1997 to 11.1% in 2000. Italian unemployment will probably remain static over the same period at around 12%. This should be compared to forecast rising unemployment in the UK and relatively static unemployment rates in the EU11 of ~10%.

International Forecasts of Main Economic Indicators: 1998-2000¹

	GDP (% Change)			Short Term Interest Rates (%)		
	1998	1999	2000	1998	1999	2000
US	3.4	1.6	1.5	5.4	4.8	4.8
Japan	2.4	0.2	1.5	0.8	0.4	0.4
Germany	2.6	2.4	2.3	3.5	3.5	3.7
OECD	2.4	1.9	2.1	-	-	-
EU	2.7	2.3	2.3	-	-	-
	Inflation (% Change)			Unemployment Rate (%)		
	1998	1999	2000	1998	1999	2000
US	1.1	1.9	2.2	4.5	4.7	5.1
Japan	0.6	-0.2	0.6	4.2	4.8	5.0
Germany	1.2	1.4	1.6	11.0	10.4	9.8
OECD	1.1	1.5	1.9	7.1	6.9	7.0
EU	1.6	1.6	1.8	10.8	10.4	10.3

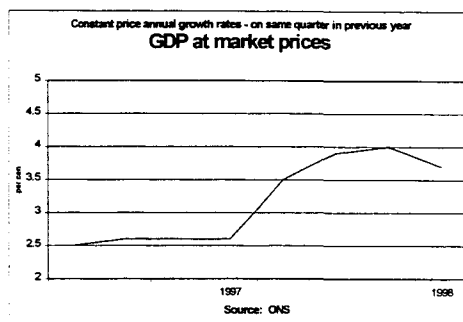
1. Fraser of Allander Institute, Bank of England Quarterly Economic Bulletin, Barclays Economic Review, Financial Times, IMF World Economy, National Institute Economic Review, OECD Economic Outlook, and various others.

UK MACROECONOMIC TRENDS

From the second quarter 1998, the UK national accounts have been produced under the European System of Accounts using 1995 weights and prices. This has resulted in a considerable number of changes to definitions and content. Consequently, the quarterly data are now only comparable back to the second quarter of 1996.

In the second quarter of 1998, the estimate of **GDP at market prices** - 'money' GDP - rose by 1.1%. After allowing for inflation, **GDP at constant 1995 market prices** grew by 0.5% during the quarter, compared with 0.8% in the first quarter, 0.7% in the fourth quarter of 1997, and 1% in the third quarter. Over the year to the second quarter, 'real' GDP at constant market prices is estimated to have risen by 3%. Preliminary estimates of 'real'

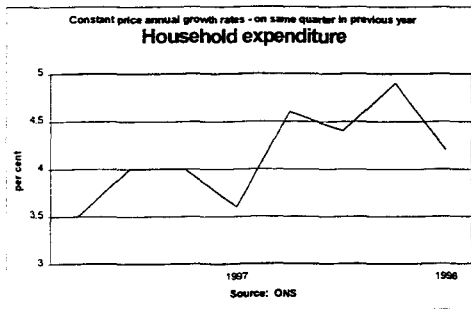
GDP growth for the third quarter suggest that the economy grew by 0.5% to a level 2.5% above the same period a year ago.



Output of the production industries in the second quarter rose by 1.2% to a level 1% 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% in the second quarter, and **mining & quarrying, including oil & gas extraction**, rose by 4.9%. Manufacturing output in the second quarter was 0.7% above the same period a year ago. The output of the **service sector** rose by 0.5% in the second quarter compared to growth of 0.9% in the first quarter. Over the year to the second quarter service sector output rose by 3.8%. The **construction industry** experienced a decrease in output in the second quarter of 2.9% with output in the industry rising by only 0.5% over the year.

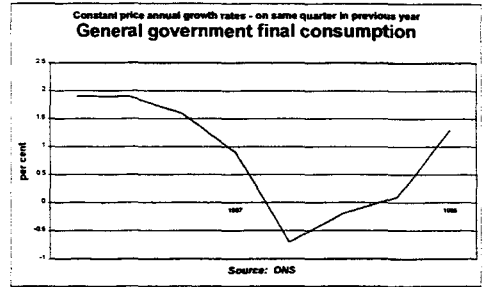
In the second quarter of 1998, **real households' expenditure** (which is consumers' expenditure minus expenditure by non-profit making institutions serving households) rose by 0.4% compared with the 0.5% rise in the first quarter, the 1.5% rise in the fourth quarter of 1997, the 0.4% rise in the third quarter, the 1.8% increase in the second quarter and the 1.1% increase in the first quarter. Spending during the second quarter rose by 2.8% on the same period a year earlier. In the second quarter, consumers' expenditure again failed to provide the main contribution to GDP growth with its contribution of 50% behind the 59% contribution from stock building. The official seasonally adjusted estimate of **retail sales** volume for the second quarter 1998 was 0.2% higher than in the first quarter. In the third quarter 1998, there was a rise of 0.6% over the previous quarter. The rise over the year to the second quarter was 3.1% and 3% over the year to the third quarter. The amount of outstanding **consumer credit** rose by £3.47 billion in the second quarter of this

year and by £3.86 billion in the third quarter. This compares with an increase of £3.78 billion in the first quarter and an increase of £3.45 billion in the fourth quarter of 1997. The growth of consumer credit therefore remains strong. The household saving ratio rose to 7.8% in the second quarter of 1998 from, 6.8% in the first quarter, 9.2% in the fourth quarter 1997, 9% in the third quarter, 10.3% in the second quarter and 9.5% in the first quarter 1997. The publication of the average earnings index was suspended in November pending investigation of suspected inaccuracies in previous data. The reported underlying increase in average weekly earnings in the year to July 1998 was provisionally estimated to have been 4.6%, which represents a decrease of 0.6% points from the June rate. Earnings growth in manufacturing decreased to 5% from 5.2% in the year to June. In services the corresponding earnings growth rates were 4.5% and 5.2%, while the private sector registered an increase of 4.7% compared to 4.6% in the public sector, with the former decreasing by 0.7% points on the June figure, while the latter rose by 0.1% points. Real household disposable income (RHDI) rose by 2% in the second quarter of 1998 to a level 1.3% higher than in the same quarter in 1997. The rise in the saving ratio in the first quarter reflects the slower growth of households' expenditure compared to the rise in RHDI.

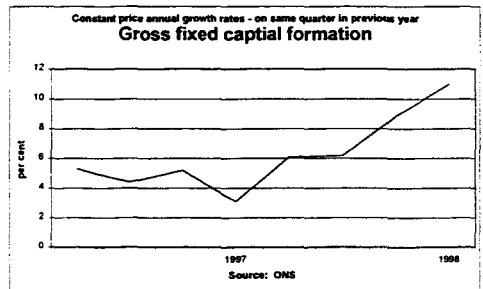


General government final consumption, rose by 0.9% in the second quarter of 1998, compared to increases of 0.9%, 0.4% and 0.2% in, respectively, the first quarter, the fourth quarter 1997 and the third quarter of last year. Government consumption in the second quarter was 2.5% higher than in the corresponding quarter of 1997 compared to annual increases of 1.3% to the first quarter and 0.1% to the fourth quarter 1997. The faster growth of government expenditure has meant that the contribution to GDP growth has risen in recent quarters, from 3% in the third quarter 1997, to 11% in the fourth quarter, 23% in the

first quarter 1998 and 36% in the second quarter.

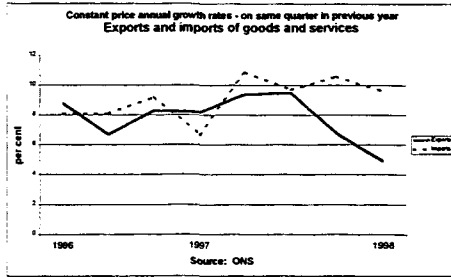


Real gross fixed investment or Gross fixed capital formation fell by 1.4% in the second quarter to a level 5.7% higher than in the second quarter of 1997. Therefore, the contribution of investment to GDP growth fell appreciably (from 82% to minus 68% of GDP growth).



Turning now to the balance of payments, where the presentation of data from the second quarter has changed to follow the IMF Balance of Payments manual 5th edition (BPM5). The definition of the current account has changed and is conceptually different from previously. Specifically, the main change is the exclusion of capital transfers, which are assigned to a new account, the capital account. On the new definition, the current account for the second quarter 1998 registered, after seasonal adjustment, a surplus of £0.6 billion. This follows a deficit of £0.5 billion in the first quarter, a surplus of £1.98 billion in the fourth quarter of 1997 and surpluses of £2.1 billion in the third quarter, £2.1 billion in the second quarter and £1.9 billion in the first quarter. For trade in goods and services, the deficit improved to £1.03 billion in the second quarter, as the deficit in traded goods decreased from £4.5 billion to £4.3 billion. The second quarter deficit compares with deficits of £1.37 billion in the first quarter, £1.06 billion in the fourth quarter 1997, a surplus of £0.21 billion in the third quarter, a deficit of £0.25 billion in the second quarter and a surplus £0.46 billion in the first quarter 1997. For income and current transfers, there was

a surplus of £1.6 billion in the second quarter, following surpluses of £0.9 billion in the first quarter, £3 billion in the fourth quarter 1997, £1.8 billion in the third quarter, £2.3 billion in the second quarter and £1.5 billion in the first quarter. Net exports contributed positively to growth in the second quarter of this year (22%), due to the slight reduction in the trade deficit.



UK LABOUR MARKET

Employment and Unemployment

Seasonally-adjusted UK claimant unemployment fell by 13,800 in the quarter to October and by 150,600 over the full year. UK claimant unemployment has been declining almost continuously since February 1994 and now stands at 1,319,400 giving an overall unemployment rate of 4.6%, with a male and female rate of 6.4% and 2.4% respectively. On the ILO definition, unemployment is slightly higher. For the quarter to September, it stood at 1,804,000 which is a rate of 6.2%. On the ILO definition there has also been a small increase in unemployment since the previous quarter though this is well within the 95% confidence limit set by potential sampling error. The UK unemployment rate is below the OECD total and also the EU average rate. For over two years there has been a consistent increase in UK employment which matches the fall in unemployment. Total employment in the quarter from April to June numbered 27,165,000 and this represents an employment rate of 73.6%. This was an increase of 124,000 (0.5%) on the previous quarter and 253,000 (0.8%) in the previous year. However, the employment experience in the various sectors of the UK economy varied markedly. The biggest proportionate increase in employment has occurred in construction. This is particularly pronounced for male jobs. Total and male employment in this sector has increased by 14.3% and 15.0% respectively over the year to June. On the other hand, total employment in agriculture and fishing, energy and water and manufacturing fell in the year

by 0.9%, 2.5% and 0.7% respectively. Moreover, the more up-to-date figures for manufacturing industry gives employment 1% lower in September 1998 as against the figure for 12 months earlier. Whilst the total employment and unemployment figures change in a rather consistent manner, the level of vacancies notified at Jobcentres has fluctuated. The notified vacancy figure fell in July and August, but increased in September and October to a level 16.3% higher than the corresponding figure for October 1997.

Earnings and Productivity

Wage inflation figures have not been published in November. The next figures will not be produced until later in this month. This is because the Treasury has had concerns about the accuracy of the wage figures and has asked Martin Weale from the National Institute for Economic and Social Research to undertake a review. The annual rate of growth of labour productivity in the whole economy in the second quarter of 1998 was 1.8%, 0.1% lower than in the previous quarter but 0.2% higher than the same quarter of 1997. In the recent past manufacturing productivity growth has been very low and this remains the case. In September 1998 manufacturing productivity was only 0.6% higher than the 1995 figure, although it was 0.9% higher than the level of productivity for September 1997.

UK OUTLOOK

The GDP data for the second quarter provide further evidence that the growth rate of the UK economy is slowing. The annual percentage change of GDP at constant market prices peaked at 4% in the fourth quarter of last year. The annual percentage change then fell gradually to 3.7% in the first quarter of 1998 and 3% in the second quarter. Growth in the manufacturing sector was just positive at 0.3% in the second quarter rising by 0.7% year on year and by 0.7% on the second quarter 1997. The manufacturing sector, therefore, while technically not in recession, is nevertheless stagnating. Growth in the service sector to the second quarter remained modest with output rising by 0.5% over the first quarter and by 3.8% over the second quarter 1997.

The growth of consumers' expenditure was strong during 1997 but has slowed since the fourth quarter, from 1.5% in that quarter to 0.5% in the first quarter of 1998 to 0.4% in the second quarter. The contribution of consumers' expenditure to growth therefore

declined and in the first two quarters of this year, the aggregate ceased to be the principal source of GDP growth. Investment growth picked up appreciably during 1997 with the result that GDP growth was led by investment in the first quarter 1998, although investment contributed negatively to growth in the second quarter. The main downward pressure on growth during the period has come from net trade, reflecting the effects of the high pound and the Asian 'crisis', which in the first quarter 1998 almost exactly offset the positive impetus to growth from consumption. Net trade made a small positive contribution to growth in the second quarter reflecting a slight, 5%, improvement in the trade deficit during the three months. Another development of significance is the increasing importance of stock building to growth, which by the second quarter was providing the main growth impetus. This is likely to foreshadow a further slow down in the GDP growth rate to the extent that the inventory build up was unanticipated.

Confirmation of this expectation is, in part, provided by recent economic statistics. The preliminary estimate of GDP for the third quarter indicates growth of 0.5%, with output rising by 2.4% over the year to the third quarter. The latest business surveys indicate a further marked deterioration in business confidence, particularly in the SME sector. Moreover, the latest figures on high street spending from the British Retail Consortium suggest that the sector is stagnating, with sales falling by 0.6% in October, which was only the second fall in sales since March 1995. Finally, with the publication of the October unemployment data, there is now evidence that the unemployment rate has reached a turning point and may be starting to rise.

Inflationary signals are mixed. The strength of demand in the economy is falling. Earnings pressures are uncertain, given the recent confusion over the statistics, but appear to be diminishing. The factory gate price index remains flat, while input prices (materials and fuel) continue to fall. Nevertheless, the Bank of England expects UK inflation to rise slightly in 1999 above the 2.5% target rate before returning to that level in two years. The Bank expects GDP growth to come in at around 1% in 1999, which is at the bottom end of the growth range of 1% to 1.5% forecast by the Chancellor in his pre-Budget report. The crisis in the world's financial markets is likely to have its strongest impact on UK GDP growth in 1999, assuming that the crisis has

now stabilised and there is no further spread of the contagion. Following the 0.5% cut in interest rates in early November it appears unlikely on current information that rates will be cut further in December, although the likelihood could change as further economic data become available. Considerably uncertainty remains but our judgement is that a recession should be avoided in 1999 and growth should pick up thereafter. But given the tendency in the past for forecasters to fail to appreciate the extent of the peaks and troughs in the business cycle there must be at least a 1 in 3 chance of recession in 1999 and a period of stagnant growth thereafter.