The ECONOMIC *Background*

THE INTERNATIONAL ENVIRONMENT

Overview

In the US domestic demand growth continues to be significant with increased competition in the labour market. European growth remains sluggish but the evidence now firmly indicates a more positive outlook on growth over the year 2000. The situation in Japan remains fragile despite encouraging signs. It is widely suggested that employment will fall further yet and the financial sector still requires some structural reform. World trade has grown but most of this is due to emerging markets and the recovery in Asia. Import prices have risen slightly in the world's major economies primarily due to the oil price increase. Despite this inflationary pressures are not substantial.

World GDP growth was 2.5% in 1998 (down from 4.2% in 1997) compared to the IMF forecast of 3% for 1999 and 3.5% for the year 2000. In the latter half of 1999 world growth was driven by the US. Another significant factor in the world economy over the last two years has been the reduction in demand in emerging economies. This has led to falling commodity and trade prices. It has also allowed higher growth with very little inflationary pressures. Our forecasts of main economic indicators for the major economies are given in Table 1.

The US Economy

The Feds Fund Rate rose 0.25% to 5.25% in August 1999. GDP growth was 1.2% in Q3 in the US with consumption and fixed investment remaining important. The deficit on net trade is reducing steadily. The dollar rose by a small amount against the Euro but fell by about 10% against the Yen. A trend in the 1990s is the falling level of stocks relative to sales. Trade growth in the US fell sharply over 1997/98 (a drop of nearly 15%) but has risen significantly over late 1998-early 1999. Import prices have risen by 4.3% between January-September 1999. The economy is now more flexible with respect to labour, stocks and capacity. It is also more open and is highly deregulated.

Table 1: Forecasts of International Main Economic Indicators; 1999-2001.

	GDP (% change)			Short Term Interest Rates (%)		
	1999	2000	2001	1999	2000	2001
US	3.8	2.5	1.8	5.2	5.8	5.8
Japan	0.8	0.6	1.7	0.3	0.5	1.0
Germany	1.6	2.8	2.6	2.8	3.3	4.0
France	2.5	2.8	2.6	2.8	3.3	4.0
OECD	2.8	2.6	2.3	-	-	-
Euro Area	2.1	2.7	2.5	2.8	3.3	4.0
EU	2.1	2.6	2.4	-	-	-
	Inflation (% change)			Unemployment Rate (%)		
	1999	2000	2001	1999	2000	2001
US	1.4	2.3	2.2	4.2	4.4	4.7
Japan	-0.3	0.2	0.8	4.8	5.0	5.3
Germany	0.8	1.0	1.4	10.5	10.0	9.9
France	0.7	1.0	1.1	11.1	10.8	10.2
OECD	1.1	1.7	1.8	7.2	7.1	7.0
Euro Area	1.2	1.4	1.5	10.3	9.7	9.4
EU	1.3	1.6	2.8	9.5	9.1	8.8

Data Sources;

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.

There are still some concerns over the pace of output growth as monetary accommodation may have gone too far. The US has a large external imbalance and if there is a need for monetary tightening then interest rates may have to rise quickly and more aggressively. If the economy weakens at all in the next 18 months then it could be due to three factors;

Underlying factors supporting domestic demand (particularly consumption) diminish;

The tightening of credit last year was too little too late and may require a sharper correction to dampen inflation and

A sizeable correction in Wall Street occurs due to overvalued stocks.

Any of these events would have a significant effect on the world economy, world trade and exports from the UK to the US.

Europe

The ECB left interest rates unchanged in the period August- October 1999 despite the growth of M3 being consistently above the target of 4.5% since the beginning of monetary union. The Euro is relatively weak – it has fallen against the Yen but has had a slight appreciation against the US dollar. Euro Area GDP growth was 0.5% in 1999q2 compared to 0.4% in the first quarter. Output was 1.6% above that in the same period in 1998 following growth of 2.7% in 1998 as a whole. Domestic demand remains relatively weak. Both exports and imports grew significantly in the second quarter with the net balance being positive. This is the first time this has happened since 1998q2. The main reasons for this are the recovery of demand in Asia and the Euro depreciation earlier in the year. Export growth is forecast to grow in the latter half of 1999. Euro Area GDP growth is forecast to be 2.1% in 1999 and 2.7% in 2000 following growth of 2.7% in 1998 as a whole. German GDP growth is forecast to be 1.6% only in 1999 compared to 2.5% in France. Both are forecast to grow at 2.8% in the year 2000. Italy is another country that has constrained growth in the Euro Area.

Confidence is high in Europe with unemployment expected to decline over the period 1999-2001. Higher import prices have pushed up European inflation due to the weakness of the Euro and increased commodity prices. In Germany exports to Russia and Asia fell considerably due to the slowdown in 1998 and in 1999. Domestic demand is now the main constraint on activity. Both export orders and industrial production indicate a recovery in the latter half of 1999. The slowdown in imports last year was less pronounced than that for exports. Import growth has remained surprisingly strong given weak domestic demand and relatively weaker domestic prices.

France had stronger domestic demand in 1998 which was the main driver of GDP growth. Since then domestic demand has weakened but growth is still forecast to be 2.5% and 2.8% for 1999 and 2000 respectively. French trade with Germany and the UK is important to the economy. Net exports are now contributing positively to GDP growth (since 1999q2) and are expected to strengthen.

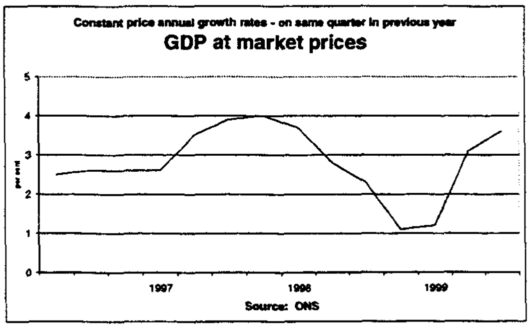
Japan and Asia

The Yen has appreciated against all the major currencies recently. It is uncertain as to how much this will depress Japanese GDP growth. Japan is a relatively closed economy with exports and imports comprising only 10% of GDP. While this is a similar proportion to the US and the Euro Area proportions it is considerably lower than the share of output traded by typical small economies. Since August 1998 the exchange rate has appreciated by 36% while export prices have fallen by 18%. The financial sector has undergone significant restructuring with ¥60 trillion (12% of GDP) being spent to support the sector. There has been a significant rise in equity prices and given that the Y2K effect did not materialise in Japan then the financial sector is expected to consolidate its performance. There is however still a major amount of restructuring to be done and the bad debt problem has yet to be fully resolved.

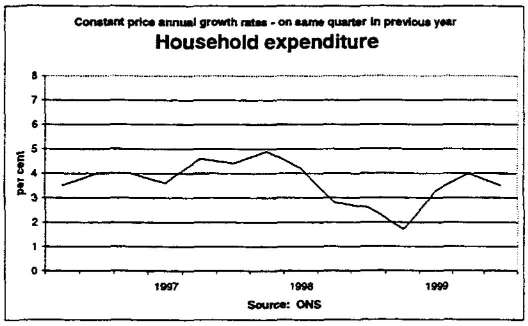
GDP growth was only 0.2% in 1999q2 after 2% growth in the first quarter. A great deal of the latter was due to the fiscal stimulus provided by government. Another fiscal package has been announced, designed to stimulate growth in the year 2000. Net trade made a small positive contribution to GDP growth in 1999q2 primarily due to the recovery of Asian export markets. The third quarter of 1999 is encouraging with industrial production growth of 3.8% (the largest since 1976q2), an improvement in confidence in all sectors in the September Tankan survey and slight employment growth in August. Unemployment also fell from 4.9% to 4.7% in the same period. It appears however that firms intend to continue reducing unemployment, decreasing inventory levels and cutting investment. Japanese growth is forecast to be 0.6% in 2000 and 1.7% by 2001. It should also be stated that it is much more difficult to interpret the events in Japan and to make reasonable forecasts of activity.

UK MACROECONOMIC TRENDS

In the third quarter of 1999, 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 0.8%, compared with 0.7% in the second quarter, 0.4% in the first quarter, 0% in the fourth quarter 1999, and 0.5% in the third quarter. Over the year to the third quarter, 'real' GDP at constant market prices is estimated to have risen by 1.9%.

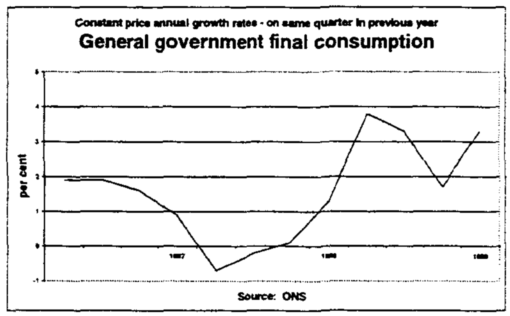


Output of the production industries in the third quarter rose by 1.2% to a level 0.7% higher than the same period a year ago. Within production: manufacturing experienced a further increase in output of 1.2% in the third quarter, output of the other energy and water supply industries rose by 1.6% in the third quarter, and mining & quarrying, including oil & gas extraction rose by 1.1%. Manufacturing output in the third quarter was 0.2% above the same period a year ago, thereby reversing some of the losses from contractions in output over the year. The output of the service sector rose by 0.6% in the third quarter. Over the year to the third quarter service sector output rose by 2.3%. The construction industry experienced an increase in output in the third quarter of 0.6% with output in the industry rising by 1.4% over the year.

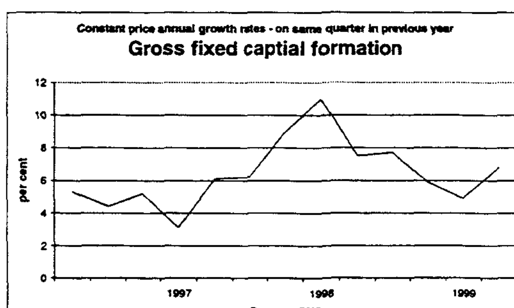


In the third quarter of 1999, real households' expenditure (which is consumers' expenditure *minus* expenditure by non-profit making institutions serving households) rose by 0.6%. This compares with a 0.8% rise in the second quarter, a 1.7% rise in the first quarter, a 0.4% rise in the fourth quarter 1998, and a 0.5% rise in the third quarter. Spending during the third quarter rose by 3.5% on the same period a year earlier. In the third quarter, households' expenditure provided the main positive contribution to GDP growth. The contribution to the GDP growth rate of 0.8% was 0.4% compared to a contribution of 0.27% from net exports, 0.13% from government spending and 0.02% from investment. The official seasonally adjusted estimate of retail sales volume for the three months to November indicates an increase of 1.1% over the preceding three months and a rise of 4.1% over the same period a year earlier. The seasonally adjusted household saving ratio fell to 4.5% in the third quarter (the lowest since 1989q2), from 7% in the second quarter of, 5.1% in the first quarter, 6.4% in the fourth quarter of 1998, and 5.6% in the third quarter of that year. Real household disposable income (RHDI) fell by 1.1% in the third quarter to a level 2.4% higher than in the same quarter in 1998. The fall in the saving ratio in the third quarter reflects the strong positive growth of households' expenditure compared to the fall in RHDI. The reported underlying increase in average weekly earnings in the year to October 1999 was provisionally estimated to have been 5.1%, compared to an increase of 4.6% in the year to September and 5% in the year to August. In October, private sector earnings grew by 5.3% over the year, while earnings in the public sector grew by 4%.

General government final consumption, rose by 0.7% in the third quarter, compared to an increase of 0.9% in the second quarter, 1.1% in the first quarter, 0.5% in the fourth quarter 1998, and 1.1% in the third quarter. Government consumption in the third quarter was 3.2% higher than in the corresponding quarter of 1998. Government consumption made a contribution of 0.13% points to overall GDP growth of 0.77% in the third quarter.

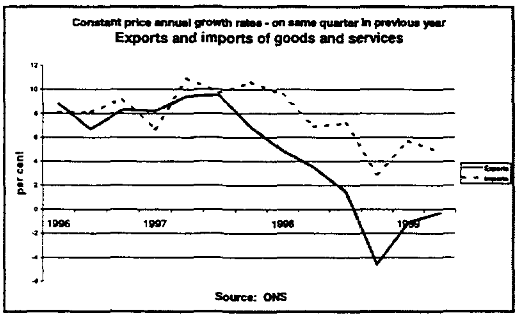


Real gross fixed investment or Gross fixed capital formation rose by 0.1% in the third quarter to a level 3% higher than in the third quarter of 1998. The growth of investment has slowed since the third quarter of last year, although there was some pick up in the second quarter of 1999.



Inventory investment contributed positively to growth in the third quarter of 1998 after the run down of stocks in the second quarter. In the third quarter, this aggregate made a negative contribution of 0.06% points to overall GDP growth of 0.77%.

Turning now to the balance of payments, the current account for the third quarter 1999 registered, after seasonal adjustment, a deficit of £2.8 billion. This follows deficits of £2.9 billion in the second quarter, £3.6 billion in the first quarter, £1.9 billion in the fourth quarter 1998 and a surplus of £1.4 billion in the third quarter. For trade in goods and services, the *deficit* improved slightly to £2.9 billion in the third quarter, from £3.3 billion in the second quarter. The deficit in traded goods fell to £5.9 billion in the third quarter, from £6.4 billion in the second quarter, £7.5 billion in the first quarter, £6 billion in the fourth quarter 1998 and £5.5 billion in the third quarter. For income and current transfers, there was a surplus of £0.1 billion in the third quarter compared to a surplus of £0.4 billion in the second quarter, following surpluses of £1.4 billion in the first quarter, £1.4 billion in the fourth quarter 1998 and £3.6 billion in the third quarter. The improvement in the trade balance meant that net exports made a positive contribution to growth in the third quarter raising GDP growth by 0.3% points.



UK LABOUR MARKET

Employment growth for July-September 1999 was 0.3% over the last three months bringing employment to 27,504,000 (all aged 16+ years), a rate of 74.1% (females aged 16-59 and 16-64 for males) up from 74.0% in the preceding three months. For August-October the employment change was up by 66,000 (0.1%) to 27,478,000 with no change in the rate from the previous period. The number in work rose by 30,000 for each sex for August-October with the number of men rising to 13,780,000 compared to 6,870,000 women. The rate for August-October a year earlier was 73.7%. Employment has now risen by 271,000 over the year. The number of workforce jobs for September 1999 was 27,829,000 – a fall of 48,000 but the number of employee jobs rose by 80,000 to stand at 24,140,000. Manufacturing employee jobs fell by 151,000 over the year to August-October 1999. Over the quarter to September 1999 production workforce jobs fell by 48,000 while the service sector grew by 17,000 with other industries decreased by 20,000. The economic activity rate stood at 78.8% (29,194,000) for August-October. Part-time employment was 6,820,000 which was up by 4,000 on the May-July level. This included 1,400,000 men and 5,420,000 women.

ILO unemployment for all persons was 1,716,000 (5.9%) for the same period, a fall of 12,000. This was unchanged compared to the May-July period but was down from the 6.2% a year earlier. The number of ILO unemployed for men and women was 1,033,000 (6.4%) and 683,000 (5.3%) respectively. These figures represented a change of down 28,000 and up 16,000 for men and women over the May-July period. ILO unemployment over the twelve months to August-October was 503,000, an increase of 7,000 over the previous period. Claimant count unemployment for November 1999 was 1,192,400 (4.1%) compared to 1,203,000 (4.2%) in October 1999 demonstrating a fall of 0.9% on a monthly basis and a 10.0% fall over the year. The number who were economically inactive over August-October was 7,612,000 (a rate of 21.2%) of which 2,275,000 did want a job. New vacancies notified to Jobcentres stood at 235,800 for November 1999, a fall of 5,600 on the previous month 13,100 higher than a year ago. The stock of unfilled vacancies for November was up 4,000 to 346,200, a rise of 32,100 over the year.

Whole economy productivity was 0.6% higher in the second quarter of 1999 compared to 1998 while whole economy wage costs increased by 4.4% in 1999q2 on an annual basis. Manufacturing productivity rose by 5.2% for August-October compared with the same period a year ago. Manufacturing wage costs were 0.9% lower compared on the same basis. Average earnings for August-October 1999 grew by 4.9% for the three months over the year and was up 0.2% on the September figure. The annual figures for manufacturing and the service sectors were 4.2% and 5.2%. Private and public sectors were 5.1% and 3.9% respectively on an annual basis.

UK OUTLOOK

Growth in the UK economy continues to pick up, with the quarterly growth rising during the first three quarters of the year. The manufacturing sector, which contracted for three successive quarters from Q2 1998, has now moved out of recession with positive growth evident in the second and third quarters. The service sector continues to exhibit positive growth.

Household expenditures continue to provide the principal impetus to growth, although the quarterly growth rate slackened in both the second and third quarters. Government final consumption continued to contribute positively to growth, although there was some slackening in its growth in the second and third quarters. Private sector investment, on the other hand, only contributed weakly to growth in the third quarter and there must be some concern that insufficient investment is being undertaken to sustain the present upturn for a prolonged period. However, the adverse movements in net trade ceased in the second quarter, following a fairly strong pick up in export volumes and a reduction in the deficit on traded goods in both the second and third quarters.

During most of 1999 RPIX inflation was below the government's target of 2.5%. However, there is considerable uncertainty over the prospects for inflation as both output and earnings growth rises. The exchange rate and price-cost margins also are not certain and contribute to the problem of projecting inflation. The growth of house prices is a particular concern, as is the future course of labour earnings as the labour market tightens. In addition, commodity prices now appear to be turning up - after a sustained contraction - and particularly the price of oil.

The latest Treasury comparison of 26 independent forecasts suggests an average for GDP growth in 1999 of 1.8%, ranging between 1.4% and 2%, rising to 2.9% in 2000, with a range of 1.5% to 3.8%. The National Institute for Economic and Social Research (NIESR) is forecasting GDP growth close to these averages: 1.8% in 1999 and 2.9% in 2000. Forecasts were generally revised up between the November and December comparisons. The forecasters are, on average, predicting an RPIX rate of 2.9% in the fourth quarter of this year, which is above the government's target rate. Against this background, the recent decision of the Monetary Policy Committee to raise interest rates by a quarter per cent point to 5.75% again seems prudent from the standpoint of the overall UK economy.