The ECONOMIC *Background*

THE INTERNATIONAL ENVIRONMENT

Overview

The prospects for world economic growth in 2000 and 2001 have improved significantly since the last quarter (see *QEC* v25(1)). Most forecasts of GDP growth have been revised upwards. The US still continues to grow strongly and is driven by private domestic demand. The Federal Funds rate has had two 0.25% point increases, in November 1999 to 5.5% and in February 2000 to 5.75%. The expectation is that there will be a further tightening of monetary policy in light of economic activity continuing to strengthen. Within the Euro Area activity has increased particularly in 1999q3 but is expected to remain firm in 1999q4. The ECB has increased it rates from 2.5% to 3% in November and by a further 0.25% up to 3.25% in February 2000. The Japanese economy has improved slightly with net exports the main contributor to the increased growth as the economic situation in SE Asia improves. There are still concerns over weak private consumption and investment.

Emerging market growth is especially strong and Asian growth is expected to outperform Latin American growth. This growth is the prime driver of increased forecast world trade growth and could lead to a significant rise in net exports for industrialised countries. Oil prices have risen again due to OPEC cutting production but the growth in non-oil commodity prices is weaker. Inflationary pressures therefore have been alleviated somewhat. In February 2000 the Brent crude oil price breached $25 per barrel but the non-oil commodities price index has remained just above 70 (1990=100), (see *Bank of England Quarterly Bulletin*, vol. 40 (1) Feb 2000). With these current expectations of growth and inflation in mind the forecasts of unemployment in the main economies of the world have been revised downwards as shown in our forecasts of main economic indicators in Table 1.

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

	GDP (% change)			Short Term Interest Rates (%)		
	1999	2000	2001	1999	2000	2001
US	4.0	3.7	2.5	5.3	6.3	6.3
Japan	0.7	0.9	2.0	0.2	0.3	0.9
Germany	1.4	2.8	2.6	3.7	4.5	5.1
France	2.7	3.3	2.9	3.7	4.5	5.1
OECD	2.8	2.9	2.6	-	-	-
Euro Area	2.2	3.0	2.8	3.7	4.5	5.1
EU	2.1	3.0	2.7	-	-	-
	Inflation (% change)			Unemployment Rate (%)		
	1999	2000	2001	1999	2000	2001
US	1.6	2.6	2.2	4.2	4.4	4.4
Japan	-0.4	-0.1	0.2	4.7	4.6	4.6
Germany	0.8	1.4	1.6	9.1	8.8	8.6
France	0.8	1.4	1.6	11.1	10.2	9.5
OECD	1.1	1.5	1.8	6.7	6.4	6.3
Euro Area	1.4	1.7	1.9	10.0	9.4	9.0
EU	1.6	1.9	2.0	9.2	8.7	8.2

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.

The US Economy

1999q4 saw US GDP grow by 1.4% with the main driver being domestic demand. For 1999 as a whole growth was 4%. GDP growth was driven by private consumption and investment in 1999, which was quite similar to 1998. US labour productivity growth was also quite strong and could contribute to the explanation of subdued inflationary pressures in the USA. The labour market continued to tighten in 1999q4 with unemployment of 4.1% in October 1999, the lowest level in 30 years. This is due to employment growth being greater than the expansion of the labour force, 0.5% compared to 0.4% respectively.

Inflation has yet to show any signs of being fuelled by wage increases. Average hourly earnings increased by 0.4% in December whereas the Employment Cost Index (ECI), which includes benefits, rose by 1.1% in 1999q4. It would also appear that the NAIRU has fallen in the USA and temporary factors may underline why inflation remains low despite falling unemployment. The Federal Funds rate rose by 0.25% in November 1999 to 5.5% and again in February 2000 to 5.75%.

Europe

GDP in the Euro Area increased by 1% in 1999q3. Domestic demand contributed 0.5 percentage points to growth compared to 0.4 for net trade. Now we have stronger growth in the latter half of

1999 we expect GDP to be significantly stronger in 2000 and 2001. While imports in 1999q3 grew by 1.9% exports grew by 3%. Confidence in the Euro Area has also grown. Industrial confidence has grown considerably closing the gap between it and consumer confidence seen at the beginning of 1999.

Consumption growth was linked to movements in the labour market. Unemployment fell to 9.6% in December 1999 from 10.1% in the beginning of the year. France and Italy still have an unemployment rate greater than that of the Euro Area. Inflation has risen from 0.8% in January to 1.7% in December. Much of this is due to energy price increases. Retail energy prices rose by 10.2% on a year earlier in December. Core inflation however (excluding energy, food, alcohol and tobacco) has fallen since January 1999 to 1.1% in December. The three-month moving average annual growth of M3 grew by 6.1% in December 1999, which is significantly above the target of 4.5%. Growth in private sector credit was also strong at 10.5% in the year to December. German GDP grew by 1.4% in 1999 after growth of 2.2% in 1998.

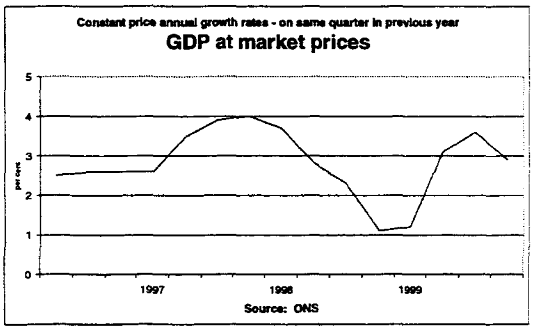
Japan and Asia

GDP growth was -0.1% in 1999q3 but there have been significant revisions to the data i.e. up 0.9% in 1999q2 (to 1%), so even taking into account the fall in quarter three, GDP grew by 1% in 1999q3 relative to a year earlier. The revisions reflect stronger private consumption in investment. GDP growth in 1999 was also driven by strong public demand. Headline inflation fell by 1.1% in December relative to a year earlier but prices were unchanged in 1999q4. Core consumer prices fell by 0.1% in the year to December. In November the government announced a supplementary budget of ¥18 trillion (3.6% of GDP). It is expected that fiscal policy will remain supportive.

The December Tankan survey suggested that there was a bleak outlook for investment primarily due to existing capacity in the economy. Production capacity and employment levels are still above the long run average. The labour market has steadied with unemployment of 4.7% for 1999. Two key factors here are; inactivity offset the decline in overall employment and secondly employment in manufacturing and services have had to restructure but construction has not and a considerable proportion of the fiscal stimulus is going into public works.

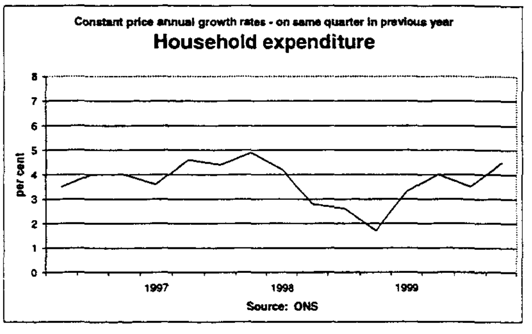
UK MACROECONOMIC TRENDS

In the fourth 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 1% in the third quarter, 0.7% in the second quarter, 0.4% in the first quarter, and 0% in the fourth quarter 1999. Over the year to the fourth quarter, 'real' GDP at constant market prices is estimated to have risen by 2.9%.

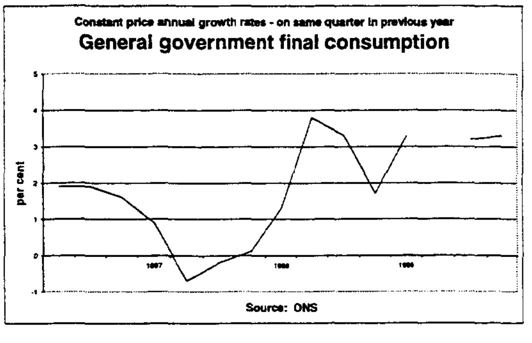


Output of the production industries in the fourth quarter rose by 0.3% to a level 1.8% higher than the same period a year ago. Within production: manufacturing experienced a further increase in output of 0.7% in the fourth quarter, output of the other energy and water supply industries fell slightly by -0.1%%, and mining & quarrying, including oil & gas extraction fell by 1.9%. Manufacturing output in the fourth quarter was 1.9% above the same period a year ago. The output of the service sector rose by 0.9% in the fourth quarter. Over the year to the fourth quarter service sector output rose by 2.9%. The construction industry experienced an increase in output in the fourth quarter of 0.7% with output in the industry rising by 2.2% over the year.

In the fourth quarter of 1999, real households' expenditure (which is consumers' expenditure *minus* expenditure by non-profit making institutions serving households) rose by 0.8%. This compares with a 0.6% rise in the third quarter, a 1.1% rise in the second quarter, a 2% rise in the first quarter, and a 0.4% rise in the fourth quarter 1998. Spending during the fourth quarter rose by 4.5% on the same period a year earlier. In the fourth quarter, households' expenditure provided the second main positive contribution to GDP growth behind inventory accumulation. The contribution to the GDP growth rate of 0.8% was 0.5% compared to a contribution of 0.98% from inventory accumulation, 0.21% from investment and 0.13% from government spending. Net exports made a negative contribution to growth of -1.18%. The official seasonally adjusted estimate of retail sales volume for the three months to February indicates an increase of 1.8% over the preceding three months and a rise of 5.5% over the same period a year earlier. The seasonally adjusted household saving ratio rose to 6.5% from 4.7% in the third quarter, 7% in the second quarter of, 5.1% in the first quarter, and 6.4% in the fourth quarter of 1998. Real household disposable income (RHDI) rose by 1.8% in the fourth quarter. The reported underlying increase in average weekly earnings in the year to January 2000 was provisionally estimated to have been 6.4%, compared to an increase of 6.2% in the year to December 1999 and 5.1% in the year to November. In January, private sector earnings grew by 6.9% over the year, while earnings in the public sector grew by 4.4%. The annual growth of private sector earnings picked up considerably in November and December, while public sector earnings growth was reasonably stable during this period but picked up in January.

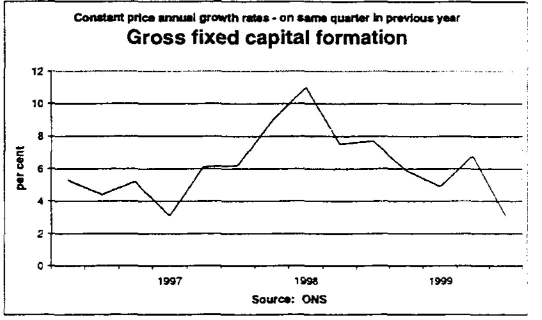


General government final consumption, rose by 0.7% in the fourth quarter, compared to an increase of 0.7% in the third quarter, an increase of 0.9% in the second quarter, 1.1% in the first quarter, and 0.5% in the fourth quarter 1998. Government consumption in the fourth quarter was 3.3% higher than in the corresponding quarter of 1998. Government consumption made a contribution of 0.13% points to overall GDP growth of 0.77% in the fourth quarter.



Real gross fixed investment or Gross fixed capital formation rose by 1.1% in the fourth quarter to a level 3.1% higher than in the fourth quarter of 1998. Investment made a contribution of 0.21% points to overall GDP growth in the fourth quarter.

Inventory investment contributed markedly to growth in the fourth quarter after the small positive contribution in the third quarter and the significant run down of stocks in the second quarter. In the fourth quarter, this aggregate made a positive contribution of 0.98% points to overall GDP growth.



Turning now to the balance of payments. At the time of writing information is not available on the current account for the fourth quarter. The current account for the third quarter 1999 registered, after seasonal adjustment, a deficit of £2.8bn. This follows deficits of £2.9bn in the second quarter, £3.6bn in the first quarter, 1.9bn in the fourth quarter 1998 and a surplus of £1.4bn in the third quarter. However, information is available of the fourth quarter for trade in goods and services. Here the *deficit* deteriorated in the fourth quarter to £4.8bn, from £2.6bn in the third quarter, £3.2bn in the second quarter, 4.9bn in the first quarter and £3.3bn in the fourth quarter of 1998. The deficit in traded goods rose to £7.5bn in the fourth quarter, from £5.4bn in the third quarter, £6.1bn in the second quarter, £7.3bn in the first quarter, and £6bn in the fourth quarter 1998.

UK OUTLOOK

UK growth continues to be strong averaging nearly 4% per annum in the third quarter 1999 and just above 3% per annum in the fourth quarter. This is above the estimated trend rate of growth for the British economy of 2.4% per annum. Growth was stronger in the second half of 1999 than during the first six months, with the result that the economy grew by a little over 2% between 1998 and 1999. The manufacturing sector continues to recover, although the weakness of the sector from the fourth quarter of 1998 to the second quarter of 1999 meant that the sector stagnated between 1998 and 1999, with output falling very slightly by 0.1%. The service sector, on the other hand, continued to grow in a sustained fashion, with output rising by 2.6% between 1998 and 1999.

The growth of household consumption remains strong but tended to be weaker in the second half of 1999 than in the first. For most of 1999, household consumption was the aggregate that made the greatest positive contribution to growth. However, the contribution of household expenditure to growth was surpassed by inventory accumulation in the final quarter of 1999, as companies began to rebuild their stock holdings after the sharp rundown in the first, and particularly the second, quarters of last year. Investment picked up slightly in the fourth quarter but remains weak compared to the second half of 1998. Total domestic expenditure grew at an annual rate of nearly 8% in the fourth quarter, by nearly 4% in the year to the fourth quarter and by 3.4% between 1998 and 1999. However, net exports deteriorated further in the fourth quarter as imports rose by 1.8% while exports *fell* by 1.6%. As a result, the deficit in traded goods rose to £7.5bn in the fourth quarter, from £5.4bn in the third quarter, to produce a deficit for the year of £26bn, compared to a surplus of £10.9bn on trade in services. What is clear from these data is that the strong growth of the British economy coupled with the sustained high value of sterling is producing a sizeable external imbalance.

The strong growth in UK domestic expenditure is beginning to have an effect on the growth of average earnings, with the percentage change for the whole economy over the year moving above 6% in December and to nearly 7% in the private sector. However, RPIX inflation remained at 2.2% in the final quarter of 1999, which is below the 2.5% target rate specified by the government. However, the moderation of inflation is in part a reflection of the strengthening of sterling, which has tended to offset domestic price and earnings pressures. For example, the Bank of England's February *Inflation Report* notes that domestically generated inflation pressures eased in the first three quarters of 1999 but remain in the 2.5% to 4% range.

In the recent Budget the Chancellor revised up his growth forecasts for the UK economy this year from 2.5% to 3% in the November's pre-Budget report to 2.75% to 3.25%. The upward revisions reflect a stronger than expected growth of consumer demand and bring the Treasury forecasts closer to the average of independent forecasters. The forecasts for 2001 and 2002 were not changed from November and at 2.25% to 2.75% are centred on the economy's estimated trend rate of growth. The Treasury is expecting that the growth of household spending will slow markedly during the second half of 2000 and with an expected recovery in net trade it is anticipated that there will be a more favourable balance in the economy between the domestic and export sectors. However, the Treasury forecast cautioned that household consumption might continue to grow above trend if the strong growth in earnings continues and if households continue to borrow against rising house and/or share prices to fund consumption.

The projected fiscal stance implied by the Budget is for a tightening this year, 1999-2000, followed by a small loosening in future years to the planning horizon of 2004-2005. However, the tightening this year is largely explained by unanticipated tax receipts and lower social security payments, while the higher spending and modest tax cuts lead to the subsequent loosening. The persistent undershoot in government forecasts of tax receipts is complicating the assessment of the likely future fiscal stance and the implications for aggregate demand. The Treasury expects that the special factors boosting revenues will not continue but it is difficult to be certain whether that will in fact be the case or whether the Treasury is continuing to be conservative in its forecasts of tax receipts. This uncertainty over the likely fiscal stance also complicates matters for the MPC of the Bank of England who must take a judgement on the likely impact of the Budget on the aggregate economy in setting interest rates.