

THE ECONOMIC BACKGROUND

THE INTERNATIONAL ENVIRONMENT

The IMF published its latest growth forecasts for the G-7 group of industrialised countries. All growth figures were revised down, with the exception of Italy, which will fulfill its earlier forecast for the year. Japan suffered a severe setback from almost 2% growth for the year to less than 0.5%. North America led the growth table in May with forecast growth of more than 3% and almost 5% for the United States and Canada, respectively. These figures have now been revised to 2.8% for the USA and 2.7% for Canada. The other G-7 countries are forecast to grow at roughly 3% in the case of Germany, France and Italy, and 2.8% for Britain.

The United States of America

In its latest report on regional economic trends, the Federal Reserve reported a moderate expansion with little upward pressure on prices. Economic growth in North America thus slowed, growing only by 0.7%. As total demand slowed less than total growth, consumer prices increased by 0.1% in August, making this the third consecutive month of moderate price increases. All in all, the USA has now seen 16 consecutive quarters of economic growth, and the recent slowdown in growth followed increases in interest rates last year and at the beginning of this year. It is now hoped that the fall in long-term interest rates after July will provide an economic stimulus.

On September 13th, the dollar broke decisively through the important psychological barrier of ¥100, reaching an eight-month high against the yen. Before that, it had fallen to a historic low of ¥79.75 in April, after hovering around ¥100 for a couple of years before. The dollar gained as much as 4.9% against the yen, and 2.4% against the D-Mark, in the week following the cut in Japan's official discount rate and German official interest rates. The announced Japanese economy-boosting fiscal package, intended to stimulate the economy, may bring yet another boost to the fortunes of the dollar.

There is still no hard evidence that the fashion for budget-cutting in the USA has taken firm hold. The plan to make cuts in the so-called "entitlement" programmes like Medicare and welfare that have made the federal deficit so hard to control is still in limbo between the White House and Congress. The OECD reckons that the USA spent 14.3% of the country's GDP on health care in 1994, more than the year before and way above everyone else's spending among the 25 OECD countries.

Japan

Of the many problems plaguing the Japanese economy, the troubled financial service and life insurance industries sectors seem to be hardest hit. With the publication of official figures in June, the scope of the banking crisis in Japan is finally becoming apparent. The Ministry of Finance reckons that ¥40,000 billion (£296 billion) of all loans are non-performing ones. This is a sum equivalent to almost 10% of Japanese GDP and puts paid to the attempt of Japan's top bureaucrats to deny the seriousness of the country's financial plight. Given the well-known reluctance of officials to admit the true figure in order to reassure investors and savers, it is generally acknowledged that the figures understate the actual extent of the problems. The figure for problem loans at the 21 largest banks comes to roughly half the figure of ¥40,000 billion. In July, the Ministry of Finance explained that the figure excluded various little problems, bringing the total to nearly ¥50,000 billion. Since then, every month has seen another piece of bad news for the embattled banking and financial insurance sectors. The liquidation of Cosmo, Japan's fifth-largest credit-union, at the end of July, merely seemed to be a dress rehearsal. In August, the authorities suspended new business for Kizu, Japan's second-largest credit union. Just like a month before in the case of Cosmo, this was preceded by a run on the bank. The collapse of Cosmo, which saw the first run on a Japanese financial institution since the 1930s, has brought home to the public the seriousness of the situation. In the case of Cosmo, an astonishing 73% of its loan book was not performing. Kizu's unrecoverable loans amounted to 57% of its loan book. The

authorities also suspended the operations of Hyogo, the first commercial bank to be shut down in Japan since 1945. Hyogo's bad loans equalled 55% of its loan book. This leads to the question how much deeper the rot runs in Japan's financial system. Besides having many dud loans of their own, many of the bigger Japanese financial institutions either have ties to the smaller regional banks or are direct shareholders in them. The task ahead for the financial authorities now is to reassure the Japanese taxpayers that public money will be needed to bail out more banks and that they do indeed possess a good plan for getting to grips with the problem. Ultimately, the bad debt problem may hamper new loans to corporate and retail customers.

There is little other good economic news for Japan, which lingers still perilously close to recession. Unemployment is running at the record level of 3.2%, domestic demand remains stagnant and the rising yen has driven down import prices, thereby worsening the price deflation that has gripped the economy, has held back domestic output growth and has brought financial firms closer to default. The sharp appreciation of the yen, the depressing effect of falling prices and the recurring trade squabbles with the USA are all severe blows to Japanese confidence. Evidence of the consequences of the high yen was July's merchandise-trade surplus with the rest of the world, which dropped by 23% to \$9.4 billion compared to a year earlier. Japan's surplus with the USA fell by 31% to \$3.9 billion.

Western Europe

The economic fortunes of the main western European countries have generally been positive. Growth has remained strong in continental Europe, above all Italy and Spain, while inflationary pressures have diverged. Consequently, some countries have raised interest rates while others have lowered them. Italy and Spain thus lifted interest rates in the second quarter as a result of increasing consumer and producer inflation, while Germany's cut of official interest rates triggered a wave of interest rate cuts among ERM countries.

France's ambitious reform programme has suffered a setback with the sacking of the Finance Minister amid the last stages of preparing next year's budget. This has raised fears that the programme of economic reform might run out of steam. Over the past three months, the Chirac administration has started to tackle France's fundamental structural

problems: employers' social-security charges have been cut; the minimum wage has been raised by 4%; state pensions have been increased; grants for parents with children have been tripled; and an extra 20,000 emergency homes were provided for the homeless. Future items on the agenda are interest-free loans to home-buyers, halving the tax on the transfer of family businesses, and offering more help to pensioners, students, small businesses and the poor. But the sacking raises fear about the speed and magnitude of changes. Instead of the tinkering with welfare and "reform without haste", which is what the Chirac administration has done so far, the sacked finance minister wanted radical reform now, including deep cuts in welfare spending and public-sector pensions.

Since the ascension of Jacques Chirac to the presidency, the government has made the fight against unemployment the main economic priority. As such, it has declared war on what is probably the most nagging and persistent French macroeconomic problem. A high level of unemployment is seen as a blow to confidence and therefore consumption. At 11.4%, France has the highest unemployment rate among G-7 countries and one of the highest rates in Western Europe. Unemployment has, however, fallen from 12.5%, its equivalent level one year ago, to below 3m in numbers for the first time since early 1993. All in all, this was the tenth consecutive monthly decline in the unemployment rate. Having said this, this fall went hand in hand with a new method of its calculation. The new statistics exclude from the list of jobseekers those working more than 78 hours in a month. At a stroke, this removed more than 250,000 from the unemployment roster.

Almost six years after unification, and after a long statistical blackout this year, Germany has finally published its first figures for the whole of Germany. In the second quarter of this year, all-German GDP grew at an annual rate of 4.3%, which is 2.2% higher than a year ago. The reweighted and rebased statistics for the monthly cost of living increase, for example, fell below the important psychological barrier of 2% for the first time since May.

The Bundesbank warned against the high, and rising, level of subsidies still going to the former East Germany. Eastern Germany, so the Bundesbank says, is in danger of developing a "subsidy mentality". Subsidies were meant to serve two purposes: to help easterners cope with the pain of restructuring and to jump-start private investment in the region. As such, they were meant to be short-

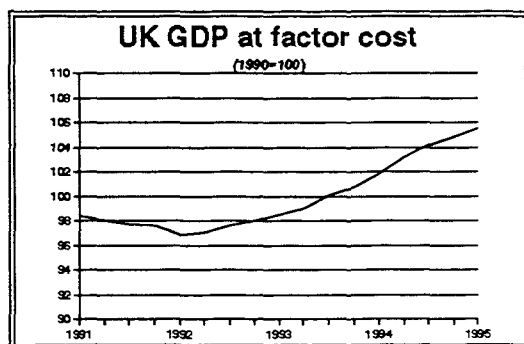
term and limited. In fact, they have become bigger and lasted for longer than anyone expected. Over the past five years, an amount of roughly DM630 billion (£280 billion) has made its way from the old West Germany to the new Länder. In yearly terms, net public transfers increased from DM100 billion (£44 billion) in 1991 to an estimated DM170 billion (£75 billion) in 1995. Worryingly, the bulk of transfers goes on consumption, which weakens eastern Germany's ability to compete. The consequence is a "trade deficit" with western Germany, making the region ever more dependent on transfers. But by fuelling consumption, the transfers are stopping much needed economic adjustments that make the East catch up with the rest of the country.

Italy's caretaker government of Lamberto Dini, on loan from the Central Bank, has been more successful than anticipated. The latest achievement is the long-overdue overhaul of the state pension system, linking at last pensions with actual contributions. Other good economic news also includes a strengthening of the lira from its historic low of 1,275 against the D-Mark in March to 1,102 on August 30th, reaching a six-month high. Almost three years after the lire left the ERM, Italian ministers have now dropped heavy hints that they would like to see the currency back again before the end of the year. This would be possible at a rate of 1,050 lira to the D-Mark. The move is undoubtedly intended to strengthen Italy's case for EMU, which will take place, at the earliest, on January 1st 1999. As Italy will struggle to meet other EMU criteria, most notably the criterion that a country's debt-to-GDP ratio should not exceed 60% (Italy's was 125% at the end of last year) or at least be falling fast towards that figure, ERM membership is widely seen as a way of bringing Italy back into favour.

UK MACROECONOMIC TRENDS

In the second quarter of 1995, the provisional estimate of **GDP at market prices** - 'money' GDP - rose by 1%. After allowing for inflation and adjusting for factor costs, GDP grew by 0.5% during the quarter, compared with the 0.7% increase recorded in the first quarter of 1995. Over the year to the second quarter, 'real' GDP is estimated to have risen by 2.8%. When oil and gas extraction are excluded 'real' GDP is estimated to have risen by 0.6% in the second quarter and by 2.8% over the same period a year ago.

Output of the production industries in the second quarter is provisionally estimated to have risen by 0.1%, with output rising by 2.1% compared with the same period a year ago. Within production, **manufacturing** experienced an increase in output of 0.5%, output of the **other energy and water supply industries** rose by 1%, and **mining & quarrying, including production of oil and gas** fell by 3%. Manufacturing output in the second quarter was 2.3% above the same period a year ago. The output of the **service sector** is provisionally estimated to have risen by 0.7% in the second quarter and by 3.4% over the second quarter 1995.

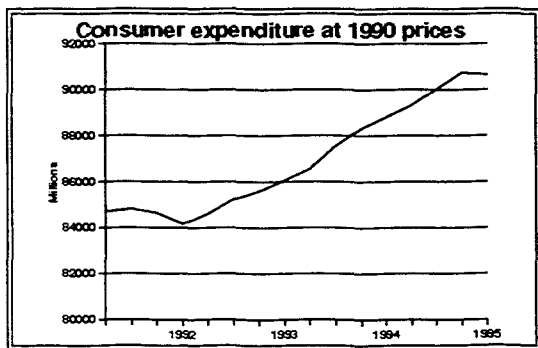


The CSO's **coincident cyclical indicator** for July 1995, which attempts to show current turning points around the long-term trend, remained unchanged. After rising steadily from July 1992, suggesting an **upturn in the spring/summer** of that year, the index appears to have peaked in April of this year and has shown little movement thereafter. The **shorter leading index**, which attempts to indicate turning points about six months in advance, peaked in early 1994 and has fluctuated thereafter on a slight downward trend. The **longer leading index**, which purports to indicate turning points about one year in advance, continued the decline which began in June of last year.

In the second quarter of 1995, **real consumers' expenditure** rose by 0.8% after falling slightly in the first quarter. Spending during the second quarter rose by 2.3% on the same period a year earlier.

The provisional official **retail sales** volume figures seasonally adjusted for July 1995, were 0.4% above the June figure. Over the year to July, the volume of sales rose by 1.4%. Taking the three months to July, the volume of retail sales rose by 0.7% and by 1.4% over the same period a year earlier.

The influences on consumers' spending appear to be operating in both positive and negative directions, although negative influences are probably dominating. In the second quarter the amount of outstanding consumer credit rose by £1,759m, which was much the same increase as in the first quarter. The net increase in the amount of credit outstanding in July was £701m, which was above the monthly average increase of £585m in the second quarter. The personal saving ratio fell, on revised figures, in the fourth quarter 1994 to 8.8% from 9.4% in the third quarter, only to rise to 10.6% in the first quarter 1995. The underlying increase in average weekly earnings in the year to July 1995 is provisionally estimated to have been 3.25%, a quarter point down from the rate in June and May. Real personal disposable income is estimated to have risen by 1.8% in the first quarter 1995 to a level 2.5% higher than in the same period in 1994. However, it is suggested that this increase can be largely attributed to buoyant dividend payments mainly to pension funds and life assurance companies which form part of the personal sector. Real income from employment, which is likely to be more significant for consumer spending, increased by less than 1% over the year to the first quarter.



General government final consumption rose by 0.6% in the second quarter 1995. Government consumption in the second quarter was 0.4% higher than in the corresponding quarter of 1994.

Real gross fixed investment or Gross domestic fixed capital formation rose by 1.3% in the second quarter to a level 2.4% higher than in the second quarter 1994. Capital expenditure by manufacturing industries rose (in real terms) by 7% in the second quarter and by 12% over the second quarter 1994.

Turning to the balance of payments, the current

account for the first quarter 1995 was, after seasonal adjustment, in deficit to the tune of £0.4bn, compared to revised estimates of a deficit of £0.5bn in the fourth quarter 1994, a surplus of £0.4bn in the third quarter, and deficits of £0.6bn and £1.0bn in the second and first quarters of 1994, respectively. The surplus on invisible trade stood at £1.6bn, a decrease on the £2.5bn recorded in the fourth quarter 1994, the £2.7bn surplus in the third quarter, the £1.7bn surplus in the second quarter, and the £2.1bn surplus in the first quarter. On visible trade, the first quarter deficit stood at £2.0bn compared with £3.0bn in the fourth quarter 1994, £2.2bn in the third quarter, £2.3bn in the second quarter and £3.1bn in the first quarter. The surplus on the oil account rose from £1,046m in the fourth quarter to £1,298m in the first quarter 1995.

UK LABOUR MARKET

Employment and Unemployment

Seasonally-adjusted UK claimant unemployment fell by 22,000 in the quarter to September 1995. This represents a marked slow-down in the reduction in unemployment, and the seasonally unadjusted figures show a rise in unemployment in the last quarter. Total seasonally-adjusted unemployment now stands at 2,295,400, giving an overall unemployment rate of 8.2%, with a male and female rate of 11.1% and 4.5% respectively. This means that although UK unemployment has now been falling continuously for 25 months, this decline seems to be tailing off. The reduction in unemployment continues to be accompanied by rather erratic movements in the number of unfilled vacancies. There was a slight increase in seasonally-adjusted unfilled vacancies in the quarter to August, but a reduction in the unadjusted figure.

Total UK employment in June 1995 was 25,730,000, an increase of 15,000 (0.1%) in the quarter from March, and an increase of 252,000 (1.0%) in the year from June 1994. Though UK employment in manufacturing and the mining, energy and water supply industries fell in the quarter to June, this was offset by an employment increase in services. Data for the British non-service industries are available to July and continue to indicate a decline in employment in these sectors. These employment and unemployment figures for the second quarter of 1995 therefore suggest that whilst there was a strong recovery in the second half of 1994, the labour market in the first half of 1995 has been rather sluggish.

Earnings and Productivity

In July, overall underlying annual wage inflation stood at 3.25%. For the last two years the annual wage inflation figure has remained very stable, lying within the 3-4% band. However, there continues to be a large differential between manufacturing and service sector wage increases: for British production, manufacturing and service industries, the underlying year-on-year increase in average earnings to July was 4.75%, 4.5% and 2.5% respectively. The rate of growth of labour productivity in the whole economy continues to be high. In the first quarter of 1995 productivity was 3% above productivity in the same quarter of 1994. However, this is slowing, having reached a peak of 4.1% in the second quarter of 1994. This process is even more marked for manufacturing. Here labour productivity in the three months ending in July was only 1% higher than the figure for the corresponding period in 1994, down from an annual increase of 5.8% in the third quarter of 1994. This means that the whole-economy unit labour costs showed an annual increase of 0.5% in the first quarter of 1995 and manufacturing unit labour costs rose by 3.4% in the year to July.

UK OUTLOOK

In the June Commentary we argued that there was not a strong case for further increases in interest rates in the immediate future. The growth of manufacturing output and the contribution of net trade to output growth, appeared to be weakening, although there was some evidence of inflationary pressure from the cost side. More recent data confirm the slowdown in the rate of growth of the British economy, while continuing uncertainty about the underlying extent of inflationary pressure maintains the dilemma over the appropriate policy stance towards interest rates.

The rate of growth of GDP in the first two quarters of 1995 has averaged about 2.6% per annum, considerably lower than the average of over 4% in the first three quarters of 1994. A slow down in the rate of growth of consumer spending appears to be the principle reason accounting for the deceleration, although both investment and net trade have also weakened. Consumer spending growth remains weak because income from employment has risen more slowly than real personal disposable income as a whole and most of the growth in employment income has had to be used to pay higher taxes. In

addition, the continuing weakness of the housing market has resulted in little stimulus to consumption from the asset side. The growth of investment continued to be relatively weak in the second quarter, although capital spending by manufacturing firms was considerably stronger, and investment growth should be expected to further strengthen throughout the remainder of 1995. Net trade is expected to continue to contribute positively to growth into 1996, although the prospect of sterling appreciation and increases in capital goods imports as investment expands may well begin to reduce the stimulus to growth from this source.

Overall, it seems clear that the economy has passed the growth peak of the present recovery with anticipated growth lower in both 1995 and 1996 than in preceding years. Most estimates suggest that growth will be under 3% this year, falling to around two and three quarter percent in 1996 and 1997.

The slowdown in the rate of growth cannot, however, be taken as evidence that inflationary pressures have subsided. The retail prices index, excluding mortgage interest payments, stabilised in July at a 2.8% change over the previous twelve months, having risen successively by 0.1 percentage points in April and May. In August producer price inflation stood at 4.4% over the preceding twelve month period, reflecting slight upward pressure after June. Input price inflation is, however, much stronger than the increase in output prices. Over the year to August the price index for materials and fuels purchased by manufacturing industry rose by 8.9%, compared with an increase of 9.6% in the year to July. The increase in input prices over the previous twelve months has been falling since March of this year as commodity price pressures have eased.

Generally, input prices are much less important to the final product price than wage and salary costs. With the fall in sterling during the year it might be expected that this would begin to feed into wage claims. To date there is little evidence of this. It appeared that the growth in average earnings was beginning to creep up gradually in April as annual earnings growth increased to 3.75% but by July the underlying annual rate of growth was down to 3.25%. Nevertheless, in manufacturing, whose occupations tend to act as lead sectors, annual earnings growth was running at 4.5% in July, and wages and salaries per unit of output had increased by 3.4% over the year, a figure which has been steadily rising since March. At the present point in time it is, therefore, by no means certain that the

British economy will enjoy a similar outcome to what followed after sterling's exit from the ERM in September 1992 when wage inflation failed to pick up, thus ushering in the export-led growth which has been a key ingredient of the present recovery. The conclusion must therefore be that despite the slowdown in output growth interest rates may still have to rise in the near future if rising wages are expected to threaten an acceleration in inflation.