THE ECONOMIC BACKGROUND

INTERNATIONAL ENVIRONMENT

Growth in 1995 has slowed down in the world economy with the exception of the dynamic Asian economies. G7 average growth has fallen from 2.8%p.a. in 1994 to 2.3%p.a. in 1995, and is forecast to remain at this level in 1996 before rising to 1994 levels in 1998. The slowdown has meant that interest rates have fallen. These lower rates are expected to be sustained, due to a fall in inflation in most major economies, particularly Germany and Japan. Consumer prices have tended to rise at an average of 2%p.a. in the world economy. However world demand is sluggish as European economies and the US continue their efforts to reduce the public sector deficit. This has produced either declining industrial production or a slow rise as stocks are reduced. The strong DM has also dampened growth whereas economies with weaker currencies, i.e. the UK, have experienced stronger growth at the expense of slightly higher inflation. In Japan, depreciation of the Yen will be a major factor bearing on recovery in 1996. The IMF predicts world growth in 1996 to be 4.3%, the highest level since 1988. It also forecasts that North America, Europe and Asia will benefit from a strong synchronised expansion, something not seen since the 1980s.

The US

The Federal Reserve has successfully managed to check inflation while preserving growth in 1995. Industrial production and retail sales fell slightly as interest rates rose in 1994. At the end of 1995, a slow reduction in interest rates has prevented the slowdown becoming a recession. Consumer price inflation has fallen from 3.2% to 2.5% in 1995. Imports increased by 10% in 1995 but the dollar has appreciated and world commodity prices have fallen, allowing the pressure from rising imports to be offset. The trade deficit became larger in the first half of 1995 but this was slightly offset by improved net investment income and lower official transfers. Growth in Q3 1995 was boosted by unusually high construction growth and GDP growth is up 1.8% on last year. The prospects for the US are for growth to be 2.1%in 1996, 2.5% in 1997 rising to under 3% in 1998. Inflation is expected to be 2.5% this year and next but will rise to 2.8% in 1998. The employment levels are thought to remain stable or rise slightly with unemployment falling steadily over the next three years. Import growth will fall to 7% in 1996 and 1997 while exports growth will also fall to 7.5% this year but will rise to above 8% in 1997.

Germany and Europe

The strong DM has depressed export growth, employment and growth in Germany, which has become uncharacteristically less competitive than some of it's European neighbours. This has been exacerbated by the slowdown in both the US and Japanese economies which has led to lower extra-EU exports. The last two quarters of 1995 have seen GDP growth fall. This has led to a marked deterioration in business confidence, although consumer spending is proving incredibly resilient, probably due to a relatively large growth in disposable incomes at the beginning of 1995. This has been slightly offset by an increase in the savings ratio which had reached historically low levels. A further problem is the rise in unemployment displayed in 1995. Much of this is due to the increased social security costs while the government has committed itself to reducing welfare spending. The recent rise in unemployment should help curb wage demands. Consumer price inflation was 1.8% in 1995 and is expected to remain low with little upward pressure from producer prices. The German budget deficit has failed to meet the Maastricht criteria in 1995, and government plan further spending reductions and privatisation of state industries to alleviate this problem. The economy is expected to recover slightly this year with investment and improved export growth being main drivers of that recovery. Growth is expected to be 2.5% in 1997 and possibly 3% by the year 2000. Countries with close trading links to Germany or who aligned their currency with the DM have suffered a corresponding slowdown in growth. Countries such as the UK and Italy with weaker currencies have sustained growth from net exports and have a competitive edge. In 1996 world trade is expected to recover and growth is estimated for the EC4 to be 2.4%p.a. High unemployment will remain but industrial production should recover. Inflation is expected to continue to be just under 3%p.a. over the next three years. In Germany and France this will probably be below 2%. French 10 year bonds will offer lower yields than their German counterparts for only the third occasion in recent times . This is thought to be due to France's commitment to EMU, the poor performance of the German economy and low short term interest rates.

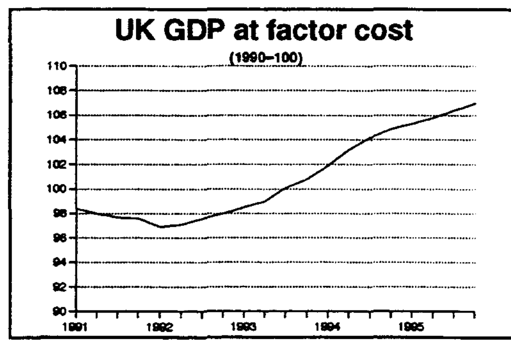
Japan and Asia

The economy has experienced a slowdown in 1995, the fourth year of poor GDP growth. The Kobe earthquake and the terrorist attack in Tokyo has severely dented confidence, and the financial sector continues to suffer from accumulating bad debts and falling land prices. Monetary policy has been relaxed to accommodate this problem. Unemployment has continued to rise and lifetime employment policies mean some workers are engaged but do not do any productive work thus masking 'real' unemployment level. Imports have increased substantially as the Yen appreciated during the first half of 1995. The current level of imports is expected to be maintained and could reduce the current account surplus to 1.5% of GDP by the year 2000. A period of deflation currently exists, mainly due to the flow of imports and the exchange rate. However a rise in long term interest rates does not make this a sustainable position. The Yen depreciated towards the end of 1995 and is expected to depreciate further in 1996 resulting in a slight rise in inflation, reaching 1% p.a. by the year 1997 and 1998. The dynamic Asian economies however are performing well with no slowdown in growth and the exploitation of their 'catch-up' potential is likely to last until the end of the decade. South Korea has been exporting large volumes of goods to Japan and Japanese investment is flowing in large quantities to these economies to take advantage of the particularly low labour costs.

UK MACROECONOMIC TRENDS

In the fourth quarter of 1995, the provisional estimate of **GDP at market prices** - 'money' GDP - rose by 0.7%. After allowing for inflation and adjusting for factor costs, GDP grew by 0.5% during the quarter, compared with the 0.5% increase recorded in the third quarter of 1995. Over the year to the fourth quarter, **'real' GDP** is estimated to have risen by 1.9%. When oil and gas extraction are excluded, 'real' GDP is estimated to have risen by 0.5% in the fourth quarter and by 1.8% over the same period a year ago. For 1995 as a whole, 'real' GDP is estimated to have risen by 2.4% over 1994, compared with the increase of 4% in 1994.

Output of the production industries in the fourth quarter is estimated to have remained unchanged, with output rising by 1.5% compared with the same period a year ago. Within production, **manufacturing** experienced a *decrease* in output of 0.2% in the fourth quarter, output of the **other energy and water** supply industries rose by 0.5%, and **mining & quarrying, including oil & gas extraction** rose by 0.7%. Manufacturing output in the fourth quarter was 0.4% above the same period a year ago. The output of the **service sector** rose by 0.8% in the fourth quarter and by 2.7% over the third quarter 1994. The **construction industry**, on the other hand, experienced an increase in output of 1.1% in the fourth quarter, but output *fell* by 2.5% compared with the corresponding quarter of 1994. For 1995 as a whole, production output is estimated to have risen by 2.4%, with manufacturing increasing by 2%. The growth of output in the service sector in 1995 amounted to 3%.



Preliminary estimates of **GDP** for the first quarter of 1996, indicate a 0.4% increase compared with the fourth quarter 1995 and a 2% rise over a year earlier. **GDP excluding oil and gas extraction** is estimated to have risen by 0.4% in the first quarter and by 2% over the first quarter of 1995. **Output of the production industries** is estimated to have risen by 0.2% in first quarter of 1996, with output *falling* by 0.2% in **manufacturing,** rising by 3% in **other energy and water,** and increasing by 1% in **mining & quarrying, including oil & gas extraction.**

The CSO's **coincident cyclical indicator** for March 1996, which attempts to show current turning points around the long-term trend, was unchanged on March after falling gradually since October last year. The index reached its above-trend peak in April 1995, fell back slightly in May, June and July, picked up again in subsequent months and then fell back again after October. The **shorter leading index**, which attempts to indicate turning points about six months in advance, showed a slight increase in April. The index peaked in January 1994 and has fluctuated on a gradual downward trend until November last year; since then there is a suggestion of a gradual upward trend. The **longer leading index**, which purports to indicate turning points about one year in advance, rose slightly in April and has continued to rise since December after falling steadily from mid-1994.

In the fourth quarter of 1995, **real consumers' expenditure** rose by 0.7%, the same rate of increase as in the third quarter. Spending during the fourth quarter rose by 2.5% on the same period a year earlier. For 1995 as a whole, consumer spending grew by 2.4% compared with 2.8% in 1994.

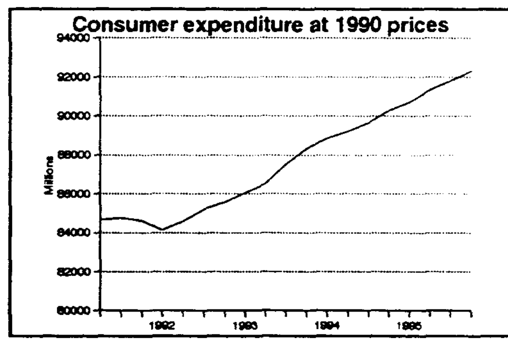
The official **retail sales** volume figures seasonally adjusted for March 1996, were 0.2% above the February figure. Over the year to March, the volume of seasonally adjusted sales rose by 2.2%. Taking the three months to March, the volume of retail sales rose by 0.4% over the preceding three months and by 2.1% over the same period a year earlier.

Despite the dip in retail sales in January, the recent data suggest that consumer demand is continuing to pick up and this should continue during 1996. The amount of outstanding **consumer credit** continued to rise in the first quarter of 1996 maintaining the high levels of the final two quarters of 1995. The **personal saving ratio** fell from 10.3% in the first quarter 1995 to 9.3% in the second quarter and then to 8.6% in the third quarter. The ratio is likely to stay at around 9% during the rest of 1996, prevented from falling further by the increasing level of private pension commitments and the continuing caution of households about taking on further debt after their experience of falling house prices, sustained job insecurity and relatively high real interest rates. The underlying increase in **average weekly earnings** in the year to March 1996 is provisionally estimated to have been 3.75%, continuing the gradual increase which began in January after the rate had remained at a low of 3.25% from July to December.

General government final consumption rose by 0.2% in the fourth quarter 1995. Government consumption in the fourth quarter was 0.8% higher than in the corresponding quarter of 1994. For 1995 as a whole, government spending grew by 0.6% compared with 1.9% in 1994.

Real gross fixed investment or Gross domestic fixed capital formation rose by 1.1% in the fourth quarter to a level 0.8% higher than in the fourth quarter 1994. For 1995 as a whole, fixed investment grew by 1.2% compared with 3.1% in 1994.

Turning to the **balance of payments**, the **current account** for the fourth quarter 1995 was, after seasonal adjustment, in *deficit* by £1.8bn, compared to revised estimates of deficits of £2.1bn in the third quarter, £1.9bn in the second quarter, and £0.8bn in the first quarter. The surplus on **invisible trade** amounted to £0.9bn, a reduction on the £1.4bn recorded in the third quarter. On **visible trade**, the visible deficit improved slightly to £2.8bn, compared with £3.6bn in the third quarter, £3.3bn in the second quarter and £1.9bn in the first quarter. The surplus on the **oil account** rose to £1.176bn from £0.82bn in the third quarter, £1.027bn in the second quarter and £1.260bn in the first quarter. The overall deficit on current account for 1995 was £6.670bn compared with £2.080bn in 1994 and £11.042bn in 1993.



UK LABOUR MARKET

Employment and Unemployment

Seasonally-adjusted UK claimant unemployment fell by 23,300 in the quarter to April, and by 148,300 over the full year. UK unemployment now stands at 2,183,500, giving an overall unemployment rate of 7.8%, with a male and female rate of 10.6% and 4.2% respectively. Although the number of unemployed continues to decline, the rate of decline is now small, and a slight rise in total unemployment was recorded in March and a slight rise in female unemployment in April. Total UK employment in December 1995 was 25,772,000, an increase of 68,000 (0.3%) in the quarter from September, though only an increase of 72,000 (0.3%) in the full year from December 1994. The increase in the workforce in employment over the last year has come totally from expansion in the number of employees in employment. The numbers of people self employed, in the armed forces or on work-related government-supported training has fallen. UK employment in manufacturing industry rose by 27,000 (0.6%) in the quarter to December 1995 and increased by 35,000 (0.9%) over the full year. However, more recent British manufacturing data show a fall in employment by 29,000 (0.7%) in the three months to March 1996. Employment has been increasing in services almost continuously since December 1992. The rise in the last quarter of 1995 was 53,000 (0.3%) and for the whole year it was 181,000 (1.1%). Whilst the UK employment, unemployment and vacancy figures are still generally moving in a favourable direction, improvements at present are small and rather uncertain.

Earnings and Productivity

In the first quarter of 1996, the underlying level of annual wage inflation began to increase. After almost 2 years of gradual but continuously falling British wage inflation, the percentage change in earnings over the year to March 1996 was 3.75%, as against 3.25% in December 1995. A rise has occurred in wage inflation in both manufacturing and services, though there continues to be a discernable differential between wage increases in the two sectors. The underlying year-on-year increase in average earnings to March was 4.25% in manufacturing and production industries and 3.25% in services. The rate of growth of labour productivity in the whole economy in the last quarter of 1995 is a little higher, at 1.7%, than it had been in the previous two quarters. However, the present figures on the growth of whole-economy productivity are around a half those registered in mid-1994. The figures for manufacturing productivity are even less sanguine. For the first quarter of 1996, the annual growth of labour productivity in manufacturing is only 0.2%. An implication of the labour-productivity and wage-inflation figures is that unit labour costs for the whole economy in the fourth quarter of 1995 are 1.4% higher than for the same quarter in the previous year. Moreover, for manufacturing, the increase in unit labour costs is much greater. In the first quarter of 1996, the increase in manufacturing unit labour costs was 4.1%, although this figure is lower than the value for the last quarter of 1995, which was 4.5%.

UK OUTLOOK

The growth of the UK economy in 1995 was, at 2.4% over 1994, lower than earlier expectations, even the Chancellor's 2.75% forecast in the November Budget. Growth slowed in the second half of last year. Manufacturing, in particular, could technically be described as being in recession since the sector experienced successive falls in output in two successive quarters: the fourth quarter 1995 and the first quarter of this year. During 1995, services became the leading growth sector, with output expanding by 0.8% in the fourth quarter last year over the third quarter, and by 3% in 1995 as a whole. These data are compatible with the expected shift in the balance of growth from being led by exports to being driven more by consumer demand.

The slow down in manufacturing growth is a clear reflection of weakness in key markets, particularly Germany and France where demand has been weak in recent months. GDP fell in both economies in the fourth quarter of 1995 and unemployment has continued to rise. In addition, the earlier build up of stocks, noted in the previous **Commentary**, will have served to push output growth below the growth in demand. Total stockbuilding in 1995 amounted to £3½ billion, the highest figure since 1988. Disaggregated data show that the stock build up was largely concentrated among manufacturers and retailers, with both the ratio of manufacturers' stocks to manufacturing output and retailers' stocks to retail sales rising sharply. The recent weakness of investment has also affected output growth. While manufacturing investment grew by 12¼ per cent in the year to the third quarter 1995, there was a fall of 5 per cent in the fourth quarter leaving it just 0.3 per cent higher than a year earlier. The weakness of total investment may be partly due to delays in the start of Private Finance Initiative (PFI) projects, many of which will replace projects which would otherwise have been carried out by the public sector.

Some analysts believe, however, that the weakening of growth has been overstated. According to the Centre for Economic and Business Research, the growth of productivity is being under recorded due to the technical difficulties of accounting for growth in new types of business and products. It is also suggested that the national accounts may be under-recording investment, since the data make no allowance for quality improvements as happens in the United States national accounts. Accordingly, it is argued that investment prices are being over-recorded and volumes under-recorded, an example being computers where quality improvements have been significant over the past few years. When allowance is made for these changes, the Centre for Economic and Business Research estimates that UK real GDP growth rose by 2.9% between the fourth quarters of 1994 and 1995 compared with the official estimate of 1.9%.

Nevertheless, it remains likely that growth will be seen to have continued to be sluggish during the first six months of 1996 but will pick up thereafter. The slight upturn in the Shorter Leading Indicator (offering an average six-month lead) at the turn of the year points in this direction. As noted above, the recent data suggest that consumer demand is continuing to pick up and this is expected to be sustained during the remainder of 1996. Activity is expected to pick up in Germany and France in the second half of this year as monetary policy is eased further. This should provide a boost to British exports, although the BSE 'crisis' will push growth slightly below earlier expectations.

The Treasury Panel of Economic Consultants predict, on average, that GDP will increase by 2.2% this year rising to 3.3% in 1997. Unemployment is expected to fall further from 2.13 millions in the fourth quarter of 1996 to 1.87 millions in the same quarter of 1997. Retail price inflation is expected to be broadly stable, despite the recent small increase in average earnings, standing at 2.5% in the fourth quarter of 1996 and 2.6% in the final three months of 1997. The deficit on the current account of the balance of payments is expected to improve from the outturn of £6.7bn in 1995, to £3.5bn in 1996, with a slight further deterioration in 1997 to £4.8bn. These figures may be somewhat optimistic if the growth of consumer demand accounts for an increasing percentage of growth.