THE ECONOMIC BACKGROUND

THE INTERNATIONAL ENVIRONMENT

Concerns over the 1995 slowdown in the world economy are subsiding as recovery continues through 1996. The US and Japan are leading the recovery with European growth expected to strengthen later this year. Recent loose monetary policy, recovery from shocks and a relaxation of fiscal policy have all contributed to renewed growth. G7 growth is forecast to be 2.3% in 1996 and 2.5% in 1997 whilst OECD growth is forecast at 2.3 % and 2.6% in 1996 and 1997 respectively. Inflationary pressures are relatively weak. Exchange rates are now more consistent with fundamentals. The Deutchmark has depreciated against the Dollar as has the Yen thus helping the Japanese recovery. Global interest rates are relatively low and there is little evidence that they will rise significantly in the near future.

The US

The US economy grew by 0.6% in Q1 1996 due to increased investment and strong consumption. Destocking and decreased government consumption hampered growth slightly. Second quarter growth is expected to be about 1%-1.2%. As the economy is working near capacity it is surprising that inflationary pressures are still relatively weak. Structural changes in the labour market may have reduced the natural rate of unemployment. Unemployment is currently 5.3%, the lowest since June 1990. Taking into account the fact that M2 and M3 are growing more rapidly than the Federal Reserve's projections, inflation is not expected to rise significantly and the Federal Reserve are prepared to adjust interest rates if necessary. Long term rates will probably remain at their current levels. The Dollar has appreciated against the Yen and the DM and is expected to advance further despite its weakness in July. The current account deficit, at 2.1% of GDP, is expected to rise due to an increase in domestic demand for imports and the strong Dollar. The fiscal deficit is forecast to fall from $163bn in 1995 to $140bn in 1996 and to $130bn in 1997.

Germany and Europe

The slowdown in Europe was most evident in Germany. EU GDP growth was 2.6% in 1995 and is forecast to be 1.5%, 2.9% and 2.8% in 1996, 1997 and 1998 respectively. Inflation has fallen dramatically in some 'high inflation' countries, particularly those in Southern Europe and the Baltic. EU unemployment is set to continue at 11% for three years. German growth has been negative in 1996 Q1 and 1995 Q4. GDP growth was 2.1% in 1995 is forecast to be 0.8% in 1996 and 2.7% in 1997. The economy is weak because construction activity has been severely impaired and exports have fallen while imports are unchanged; the DM remains relatively strong thus Germany has become uncompetitive in world markets. However industrial production has increased by 1%. The Bundesbank is concerned with a prolonged downturn rather than rising inflation. The Discount and Lombard rates have been cut by 0.5% despite strong money supply growth. Average earnings are set to decline steadily until 1997 while unemployment will peak in 1996/97, consequently inflation is forecast to be 1.5% in 1996 and 1997. The German fiscal deficit was 3.5% of GDP in 1995 and is expected to rise to over 4% in 1996. A 2.5% cut in government expenditure is to be imposed in 1997 to meet the Maastricht criteria. The current account balance is forecast to be -$6.4bn or -0.3% of GDP by 1997. The recent slight weakening of the DM has helped export performance. The budget deficit condition of the Maastricht Treaty is causing problems for most European economies. If France and Germany fail to meet this target by 1997 they will still be sufficiently close to participate in EMU. Long term bond yields in France and Germany converged a few months ago thus the markets fully expect these countries to enter EMU. The Benelux countries, Denmark, Finland, Ireland, and the UK could all meet the conditions for EMU by 1997.

Japan and Asia

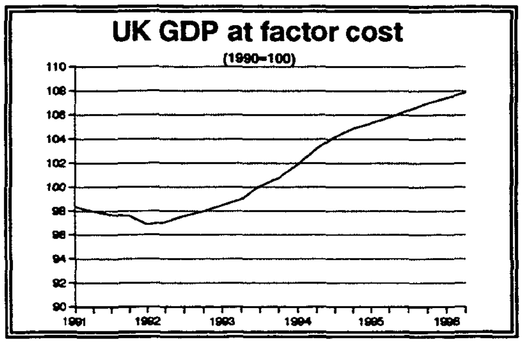
Japan's downturn in growth in 1991-95 was the longest in post-war history. GDP growth in Q1 was 3% rising to a level 5.8% higher than a year ago. Growth will slow considerably in the following quarters with GDP growth forecast to be 3.4% in 1996 slowing to 2.3% in 1997 and 1998. This will make Japan the fastest growing G7 economy. 40% of GDP growth in Q1 is attributable to the volume of fixed public investment and other fiscal measures introduced last year. Japan continues to have stable low inflation. Short term interest rates will be close to present levels, probably 1.3% in 1996 edging up to 2.2% in 1997. Long term rates are expected to remain in the range 3.3-3.8%. The expansionary fiscal policy Japan has followed recently is to end with a tightening of fiscal conditions. The fiscal deficit is now 5% of GDP and the government debt/GDP ratio is 90%. It is expected that government consumption and investment will decrease, sales tax will increase from 3% to 5% and tax rebates introduced in 1994 will be withdrawn by 1997. Unemployment continues to rise in Japan peaking at 3.5% in May. Japan is becoming more like the main European economies pursuing low inflation, deficit reduction and fiscal consolidation.

THE UK ECONOMY

Macroeconomic Trends

In the first quarter of 1996, 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 0.4% during the quarter, compared with the 0.5% increase recorded in the fourth quarter of 1995. Over the year to the first 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 0.4% in the fourth quarter and by 1.9% over the same period a year ago. For 1995 as a whole, 'real' GDP is now estimated, on revised figures, to have risen by 2.5% over 1994, compared with the increase of 4% in 1994.

Output of the production industries in the first quarter is estimated to have risen slightly, by 0.2%, to a level 1.2% higher than the same period a year ago. Within production, **manufacturing** experienced a *decrease* in output of 0.2% in the first quarter, output of the **other energy and water** supply industries rose by 3.2%, and **mining & quarrying, including oil & gas extraction** rose by 1%. Manufacturing output in the first quarter was 0.8% above the same period a year ago. The output of the **service sector** rose by 0.5% in the first quarter and by 2.5% over the first quarter 1995. The **construction industry**, on the other hand, experienced a *decrease* in output of 0.4% in the first quarter, with output *falling* by 1.1% compared with the corresponding quarter of 1995. For 1995 as a whole, production output is now estimated, on revised figures, to have risen by 2.6%, with manufacturing increasing by 2.2%. The growth of output in the service sector in 1995 is now estimated to have amounted to 2.9%.



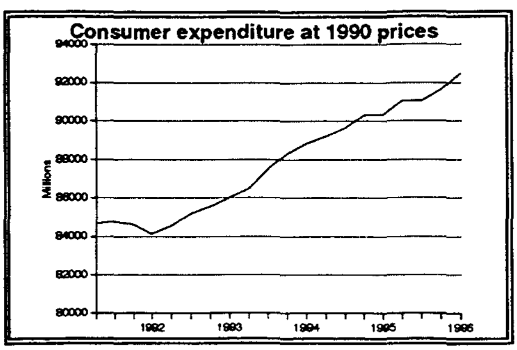
Preliminary estimates of **GDP** for the second quarter of 1996, indicate a further 0.4% increase compared with the first quarter 1996 and a 1.8% rise over a year earlier. **GDP excluding oil and gas extraction** is estimated to have risen by 0.3% in the second quarter and by 1.7% over the second quarter of 1995. **Output of the production industries** is estimated to have risen by 0.2% in the second quarter of 1996 (1.1% up over a year earlier), with output remaining unchanged in **manufacturing** (unchanged over the year), rising by 0.8% (up 5.5% over the year) in **other energy and water,** and increasing by 1.4% (up 5.6% over the year) in **mining & quarrying, including oil & gas extraction. Service sector** output is estimated to have risen by 0.7% in the second quarter (up 2.7% over the year), with **financial and business services** growing by 1.1% in the quarter and 3.9% over the year. The **construction sector**, on the other hand, *contracted* by 0.3% in the second quarter (down 0.6% over the year).

The CSO's **coincident cyclical indicator** for June 1996, which attempts to show current turning points around the long-term trend, was unchanged in May having displayed a flat profile during 1996. The **shorter leading index**, which attempts to indicate turning points about six months in advance, fell slightly in July after increasing gradually during the first five months of the year. The **longer leading index**, which purports to indicate turning points about one year in advance, rose in July, reflecting increased business optimism in the CBI quarterly industrial trends survey. The increase continues an upward trend which has been present since last December.

In the first quarter of 1996, **real consumers' expenditure** rose by 0.9%, compared with the 0.7% increase reported in the fourth quarter 1995. Spending during the first quarter rose by 2.4% on the same period a year earlier. For 1995 as a whole, consumer spending is now estimated to have grown by 2% compared with 2.8% in 1994. Preliminary estimates of real consumers' expenditure for the second quarter 1996 indicate that spending rose by a further 0.7%, to a level 2.3% higher than the second quarter of 1995.

The official seasonally adjusted estimate of **retail sales** volume for July 1996 was 0.6% below the June figure. Over the year to July, the volume of seasonally adjusted sales rose by 2.2%. Taking the three months to July, 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 fall in retail sales in July, the recent data continue to suggest that consumer demand is picking up slowly and this is expected to gather strength during the rest of 1996. The amount of outstanding **consumer credit** continued to rise in April and May, maintaining the high levels of recent quarters. After jumping from 10.7% to 12.2% in the fourth quarter 1995, the **personal saving ratio** fell again slightly to 12% in the first quarter of this year. The underlying increase in **average weekly earnings** in the year to June 1996 is provisionally estimated to have been 3.75%. Earnings growth has remained at this level since February and remains low by historical standards for the present stage of the cycle. However, the growth of **real personal disposable income (RPDI)** has been faster than earnings, registering an increase of 4% over the year to the first quarter. The greater buoyancy of RPDI reflects the more rapid growth in dividend and interest payments.



General government final consumption rose by 0.1% in the first quarter 1996. Government consumption in the first quarter was 0.8% higher than in the corresponding quarter of 1995. Provisional figures for the second quarter indicate that government spending rose by a further 0.7% to a level 1% higher than in the second quarter of last year.

Real gross fixed investment or Gross domestic fixed capital formation rose by 1.5% in the first quarter to a level 1.5% *lower* than in the first quarter of 1995. For 1995 as a whole, fixed investment is now estimated, on revised data, to have *fallen* slightly by 0.1% compared with a 3% increase in 1994. Preliminary data for the second quarter suggest that investment is picking up strongly with a 2.1% increase recorded, raising investment to a level 2.2% higher than in the second quarter of 1995. However, a disaggregation of the provisional data reveals that the overall growth in investment in the second quarter was driven by the capital expenditure of service and construction sectors which rose by 7% and 21% respectively; capital expenditure by manufacturers *fell* by 4% and capital expenditure in other production *fell* by 10%. Over the year to the second quarter, capital expenditure in manufacturing *fell* by 5%, while in other production, services, and construction capital spending *rose* by 26%, 3% and 16%, respectively.

Turning to the **balance of payments**, the **current account** for the first quarter 1996 was, after seasonal adjustment, in *deficit* by £1.1bn, compared to revised estimates of deficits of £1.2bn in the fourth quarter 1995, £1.1bn in the third quarter, and £1bn in the second quarter. (The Office of National Statistics (ONS) is no longer publishing series called "visible" and "invisible" trade. Visible trade is now referred to as "trade in goods" and the "invisibles" category is now broken down into "services", "investment income" and "transfers". We shall in future refer to the categories "trade in goods and services" and "investment income and transfers".) For **trade in goods and services**, the deficit deteriorated to £2.6bn, compared with £1.8bn in the fourth quarter 1995, £1.9bn in the third quarter, £1.8bn in the second quarter and a *surplus* of £0.1bn in the first quarter. For **investment income and transfers**, there was a *surplus* of £1.5bn in the first quarter, compared with surpluses of £0.6bn in the fourth quarter 1995, £0.9bn in the third quarter, £0.8bn in the second quarter and £0.3bn in the first quarter.

UK LABOUR MARKET

Employment and Unemployment

Seasonally-adjusted UK claimant unemployment fell by 56,200 in the three months to July, and by

184,800 over the full year. UK unemployment now stands at 2,126,200 which gives an overall unemployment rate of 7.6%, with a male rate of 10.3%. Female unemployment remained unchanged at 4.2%. The number of unemployed continued to decrease and the rate of decline increased in July relative to the preceding three months.

Total UK employment in March was 25,734,000 which represented a fall of 71,000 (0.3%) in the first quarter of 1996 although a rise of 15,000 (0.1%) over the year to March. The decrease in the workforce resulted from falls in all categories ie employees in employment, self employed, HM Forces and people on work-related government-supported training. UK employment in manufacturing industry fell by 28,000 in the quarter to March and decreased by 14,000 over the full year. Employment continued to increase in Services but the rate of increase eased to 15,000 during the first quarter.

Earnings and Productivity

In the second quarter of 1996 the underlying increase in average earnings for the whole economy remained unchanged at 3.75% from the May rate (revised up by 0.25%). The underlying year-on-year increase in average earnings in the three months to June was 4.25% in manufacturing, 4.0% in production and 3.5% in services. The rate of growth of labour productivity in the whole economy in the first quarter was 1.7% higher than in the same quarter one year earlier. Though output remained slightly higher than was the case in the previous three quarters it remains well below the levels recorded in 1994. For the second quarter of 1996, the annual growth of labour productivity in manufacturing rose to 0.9%. During the second quarter of 1996, whole economy wages and salaries per unit of output continued to rise and were 1.8% higher than in the same quarter of the previous year. Once again, the increase in unit labour costs recorded in manufacturing was much greater than for the whole economy (3.3% compared to the same quarter one year ago).

UK OUTLOOK

In the first two quarters of 1996, the UK economy grew at 0.4% in each quarter or 0.8% for the first half of the year. The slowdown to below trend growth was largely the outcome of a sharp reduction in stockbuilding in the second quarter and a weakening of external demand (net trade) which, given relatively weak domestic demand in 1995, contributed significantly to growth last year. With the growth of demand weak relative to the growth of capacity, inflationary pressures remain subdued. Pressures from the labour market are minimal with the real increase in earnings little more than 1% per annum. The growth of RPDI has been much stronger, however, due to higher interest and dividend payments which are in part a reflection of weak labour market pressures. Despite the weakness of demand, the growth of employment has continued buttressed by the slow growth in earnings; in July jobs were 150,000 higher than at the start of 1995 and unemployment was correspondingly lower at 2.17 million.

Growth in the first half of 1996, amounted to 0.75%. Almost 1% was contributed by growth in consumers' expenditure, supported by a 0.4% contribution from investment and a 0.1% contribution from government consumption. However, the decrease in stockbuilding and net trade contributed negatively to growth by just under 0.4% on both counts. These last two effects have had particular implications for both manufacturing output and investment where no growth was evident during the first half of the year. The service sector, on the other hand, has performed much more strongly with both output and investment rising. Output growth has also been relatively strong in the electricity, gas and water supply industries. Manufacturing performance appears to have been hit by a "double whammy" because not only has it suffered from the fall in net trade (which is primarily of goods), but the sector appears also to have been affected by a switch in domestic demand away from goods towards services. The National Institute for Economic Research (NIESR) suggests that the switch reflects in part a relative price affect as the growth in the price of non-tradeable goods has recently been much slower than the growth of the price of tradeables. This suggests that even if the pick-up in the growth of consumer demand continues the growth of manufacturing will remain relatively weak for the remainder of the year and must await the stronger net trade performance which is not expected until 1997 when the growth of exports is forecast to rise and the growth rate of imports to fall.

The outcome for overall growth in 1996 therefore depends considerably on the growth of consumers' expenditure during the remainder of the year. The NIESR is forecasting consumption growth of 2.8% in 1996 (cf. 2% in 1995) and this almost completely accounts for their forecast growth of output of 2.1%. While the growth of personal income (RPDI) has recently been strong and stronger than earnings growth, it is expected to move back into line during the remainder of the year as the labour market becomes tighter and dividend and interest payments fall to more normal levels. Yet, consumption is forecast by both the Treasury and NIESR to grow more quickly than RPDI in both 1996 and 1997 because of an expected progressive reduction in the saving ratio. The saving ratio is expected to fall because of continuing low nominal interest rates (enhanced by the quarter point cut to 5.75% in June), declining unemployment and the wealth effects of high share prices, increasing house prices and the transfers of wealth to the personal sector following the recent mergers of banks and building societies.

Clearly, when the course of the economy over the next politically significant nine months is so dependent on the course of one (all be it the major) aggregate then the temptation for the Chancellor to cut interest rates by a further quarter percentage point will be considerable if there appears to be some faltering in the retail sales and other consumption related data in the next few months. The present very favourable outlook on the inflation front may make that temptation difficult to resist.