THE ECONOMIC BACKGROUND

THE INTERNATIONAL ENVIRONMENT

The US economy remains strong and there is now widespread signs of recovery in most developed economies in 1997 from the slight pause in growth in 1996. For 1997 growth is expected to be between 2-2.5% for the North Americas, Europe and the OECD Asia region. Long term interest rates are expected to remain at historically low levels due to the expectations of low levels of inflation in all three areas.

The US

The US economy has had a sustained period of growth for over five years. Growth is in line with trend levels and is expected to continue at 2.3% in 1997 decreasing to 2.0% in 1998, returning to 2.3% in 1999. Growth in the final quarter of 1996 was 4.7% due mainly to exports and consumer spending. Also at the end of 1996 US incomes rose sharply, increasing 5.5% for the year. Monetary conditions have tightened as a result of the rising dollar. A small rise in the short term interest rate may be necessary to prevent the economy from overheating over the course of 1997. Although inflation was at its highest for 6 years in 1996 underlying inflation is at a 31 year low. Unemployment fell to its lowest level since 1989 while inflation has remained subdued throughout the period. Business and consumer confidence increased over 1996 while the Dow Jones index passed through 7,000 for the first time in February 1997. The outlook for the US economy is good with steady growth, low inflation, a declining budget deficit and low long term interest rates over at least the next two years.

Europe

European economies have now shaken off the constraints of the slowdown in 1995 with EU GDP growth rising from 1.6% in 1996 to 2.4% in 1997 and remaining at 2.5% for 1998 and 1999. The effective exchange rate has risen considerably in the UK and Italy which will probably dampen any stimulus to strong growth. The depreciation of the DM will stimulate demand in the German economy which continues to struggle slightly with unemployment reaching a new post war record at 12.2% in February 1997. Much of this is due to the government cost cutting programme aimed at reducing the government deficit. The deficit for 1996 reached DM78.3bn from DM59.9bn in 1995. This is 3.9% of GDP in 1996 and makes it even harder for Germany to qualify for EMU. There are now calls within Germany to delay EMU but the government want to press ahead according to the timetable. The government forecast for the deficit is now 2.9% for 1997 but most commentators believe that the actual figure will be slightly above 3%. The French economy is performing reasonably well with a record trade surplus for 1996 of FFr122.3bn, growth of 25% on last years surplus. The Franc has also depreciated recently but growth is expected to slow from 2.6% in 1997 to 2.4% in 1998 and 2.1% in 1999. Exports will continue to grow in France and inflation is expected to remain weak. However unemployment has reached 12.7% which is a postwar record. Although net job creation was high it is an increasing participation rate which is increasing unemployment.

Japan and Asia

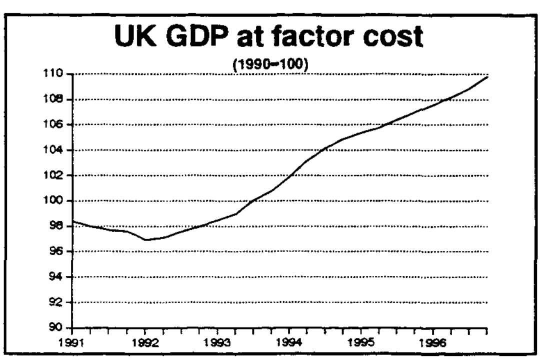
The Japanese economy is faltering slightly after growth of 3.4% in 1996 and things may get worse before they get better. The current account surplus declined by 31% in 1996, but the fall in the Yen had boosted output considerably in the first quarter of 1996. The government is to introduce measures like those in Europe aimed at reducing the government deficit from 7.4% (the projection for 1997) to 3% in 2006. Financial deregulation will be brought about in a 'Big Bang' rather than the phased moves due for completion in 2001. The banking and financial systems remain a problem for the Japanese government. Tax increases worth 1.5% of GDP have been announced for 1997. Export market growth has slowed slightly from 11.5% in 1995 to 6% in 1996 but is expected to rise to 10% in 1997. This growth is expected to continue in 1997 and 1998 and could add 1% to GDP in each of these years. Interest rates and inflation will continue to be among the lowest in the world and growth should rise to 2.7% in 1998, above trend, falling back to trend levels in 1999 and 2000 at 2.4%.

UK MACROECONOMIC TRENDS

In the third quarter of 1996, the estimate of **GDP at market prices** - 'money' GDP - rose by 1.3%. After allowing for inflation and adjusting for factor costs, GDP grew by 0.7% during the quarter, compared with the 0.6% increase recorded in the second quarter of 1996. Over the year to the third quarter, **'real' GDP** is estimated to have risen by 2.4%. When oil and gas extraction are excluded, 'real' GDP is estimated to have risen by 0.7% in the third quarter and by 2.3% over the same period a year ago.

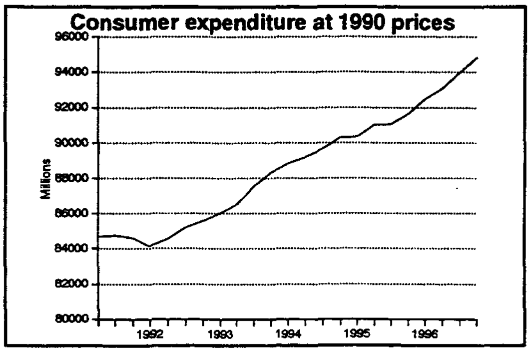
Provisional estimates are available for the fourth quarter 1996; these indicate that 'money' GDP rose by 1.4% in the fourth quarter while 'real' GDP increased by 0.8%. Over the year to fourth quarter, **'real' GDP** is estimated to have risen by 2.7%. When oil and gas extraction are excluded, 'real' GDP is estimated to have risen by 0.7% in the fourth quarter and by 2.5% over the same period a year ago. For 1996 as a whole 'real' GDP is estimated to have risen by 2.3%.

Output of the production industries in the fourth quarter rose by 0.9%, to a level 1.7% higher than the same period a year ago. Within production: **manufacturing** experienced an increase in output of 0.6% in the fourth quarter, the same rate of increase as in the third quarter after the fall of 0.1% in the second quarter and a contraction of 0.2% in the first quarter; output of the **other energy and water** supply industries rose by 2.7% in the fourth quarter, and **mining & quarrying, including oil & gas extraction** rose by 2%. Manufacturing output in the fourth quarter was 0.9% above the same period a year ago. The output of the **service sector** rose by 0.9% in the fourth quarter and by 3.4% over the fourth quarter 1995. The **construction industry** also experienced an increase: of 1.1% in the fourth quarter, and 1.6% over the corresponding quarter of 1995.



The **coincident cyclical indicator** for December 1996, which attempts to show current turning points around the long-term trend, fell slightly but has demonstrated a more or less flat profile during the second half of the year. The **shorter leading index,** which attempts to indicate turning points about six months in advance, fell in the three months to January and is now below long-term trend. The **longer leading index**, which purports to indicate turning points about one year in advance, fell in January after having fallen for the previous four months. (*Note: the Office of National Statistics have announced that the cyclical indicators will be discontinued forthwith due to the need to devote resources to other purposes and because in a survey of users the series was found to be the least valued of all the ONS products.*)

In the fourth quarter of 1996, **real consumers' expenditure** is provisionally estimated to have risen by 0.9%, compared with the 1% increase reported in the third quarter 1996. Spending during the fourth quarter rose by 3.7% on the same period a year earlier. For 1996 as a whole, consumers' expenditure is estimated to have risen by 3%. The official seasonally adjusted estimate of **retail sales** volume for December 1996 was 0.8% above the November figure. Over the year to December, the volume of seasonally adjusted sales rose by 2.9%. Taking the three months to December, the volume of retail sales rose by 0.9% over the preceding three months and by 3.6% over the same period a year earlier. The amount of outstanding **consumer credit** rose to £1,105m in November, the highest of the year. After jumping from 10.7% to 12.2% in the fourth quarter 1995, the **personal saving ratio** fell slightly to 11.8% in the first quarter of this year, and then fell further to 11.1% in the second quarter. The Treasury expect the saving ratio to continue to fall reaching 8.75% in the first half of 1998. The underlying increase in **average weekly earnings** in the year to December 1996 is provisionally estimated to have been 4.25%, the same rate of increase as in November but higher than the 4% recorded in each of the previous four months. Earnings growth remained at 3.75% from February to June and then rose to the 4% figure. Wage inflation still remains low by historical standards for the present stage of the cycle. The previous **Commentary** noted that the growth of **real personal disposable income (RPDI)**, slowed to 3.3% in the second quarter 1996 over the same quarter in 1995, below the rate of growth of earnings after registering an increase of 4% over the year to the first quarter. The Treasury forecast the RPDI to have grown by 3.75% in 1996 and by 2.25% in 1997.



General government final consumption rose by 0.2% in the fourth quarter of 1996. Government consumption in the fourth quarter was 1% higher than in the corresponding quarter of 1995.

Real gross fixed investment or Gross domestic fixed capital formation rose by 0.2% in the fourth quarter to a level 1.9% higher than in the fourth quarter of 1995. This represents a reversal of the decline of 2% in the second quarter of last year.

Turning to the **balance of payments**, the **current account** for the third quarter 1996 registered, after seasonal adjustment, a deficit of £0.1bn, following the *surplus* of, on revised figures, £0.3bn in the second quarter, and the deficit of £1.1bn in the first quarter. For **trade in goods and services**, the *deficit* improved to £1.1bn, in the third quarter, compared to £2.4bn in the second quarter, and £2.3bn in the first quarter. For **investment income and transfers**, there was a *surplus* of £1.1bn in the third quarter, compared with £1.8bn in the second quarter, and £1.2bn in the first quarter. In each of the quarters of 1996, net trade made a negative contribution to GDP growth.

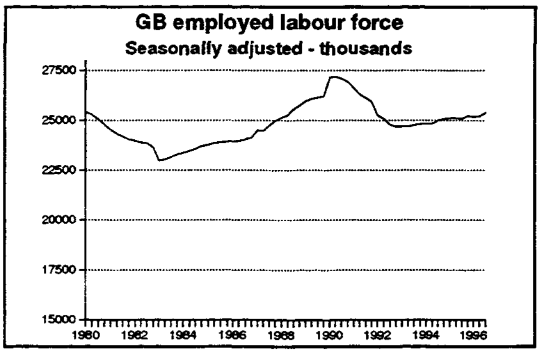
UK LABOUR MARKET

Employment and unemployment

Seasonally-adjusted UK claimant unemployment fell by 209,900 in the quarter to January, and by 391,500 over the full year. The fall in January alone was 67,800. UK unemployment now stands at 1,815,000, giving an overall unemployment rate of 6.5%, with a male and female rate of 8.8% and 3.5% respectively. These changes represent substantial reductions in unemployment, particularly apparent since August 1996. The UK employment information is a little less timely and indicates a rather more variable performance. Total employment in September 1996 stood at 26,076,000, an increase of 200,000 (0.7%) in the quarter from June, and an increase of 300,000 (1.2%) in the full year from September 1995. The rise in male employment over the last year, at 131,000 (0.9%) is lower both in absolute and proportionate terms than female employment at 168,000 (1.4%). UK employment in manufacturing increased by 14,000 (0.3%) in the quarter to September, though it only rose by 13,000 (0.3%) over the full year and more recent British manufacturing data show a fall in employment of 9,000 (0.2%) in the three months to December 1996. Whilst employment in manufacturing has been somewhat erratic over this calender year, service employment continues to show strong growth. It rose by 97,000 (0.6%) in the quarter to September 1996 and by 331,000 (2.0%) for the whole year from September 1995. However, these general improvements in the unemployment figures in the last quarter have not been accompanied by a rise in the number of vacancies registered at Jobcentres. In the quarter to January, the number rose by 200 (0.1%) though over the full year from January 1996 the figure increased by 75,500 (28.7%).

Earnings and productivity

Since the beginning of 1996, there has been a gradual, but persistent, increase in the level of annual wage inflation in the UK. Underlying wage inflation in the fourth quarter of 1995 was 3.25%. However, by the fourth quarter of 1996 this had increased to 4.25%. This increase is consistent with the steady tightening of the UK labour market that has been in evidence in the past year. A rise in average earnings has occurred in both manufacturing and services though there continues to be a differential between wage increases in these two sectors: in manufacturing the underlying year-on-year increase in average earnings to December was 4.75% and 4.0% in services. The rate of growth of labour productivity in the whole economy in the third quarter of 1996 was 1.5% and this figure has been relatively stable since the second quarter of 1995. The figures for manufacturing productivity, which had been very weak for most of 1996, improved towards the end of that year and the three months to December show a year on year increase in labour productivity of 1.3%. Given the gap between the increase in wages and the increase in labour productivity, there has been a rise in unit labour costs in both the whole economy and the manufacturing sector. In the third quarter of 1996, the rise in unit labour costs over the previous year was 1.7%, high relative to the performance in the previous two years. In manufacturing the annual increase in unit labour costs in the last quarter to December was 3.2%, the lowest value for that calender year, reflecting the relatively good manufacturing productivity performance.



UK OUTLOOK

Against a background of a steady improvement in the growth prospects for the world economy, UK output growth remains above trend and inflationary pressures remain weak. RPIX at 3.1% in January was unchanged on December, above the government's long-term target of 2.5% but still within the current target range of 1.5% - 4%. However, it is arguable that presently RPIX is masking the underlying inflationary pressure to some degree, due to significant short-run price competition in the retail sector and the present high value of sterling which is unlikely to be sustained. The rise in sterling last year does give some cause for concern as to its likely impact on net exports. Sterling's effective rate rose from an average of 82.9 in December 1995 to 95.9 in January of this year, an increase of nearly 16%. The exchange rate also rose against the dollar and the mark but fell back somewhat against the dollar in January. Therefore, sterling's rise will have had a favourable impact in the short-run on inflation but may hit the volume of net exports in 1997.

Turning to the performance of the manufacturing sector. Manufacturing output growth slowed during 1995-1996 reflecting the stock overhang and reduced demand from external markets, particularly Germany. Capacity utilisation, as measured by the CBI Industrial Trends Survey, also fell during this period. Manufacturing growth was, in consequence, some way below expectations. However, performance improved during the second half of 1996, with a slight downturn in growth during November followed by an upturn in December.

With export markets relatively subdued, the prospects for a faster growth outturn in 1997 (i.e. above the 2.3% GDP growth recorded in 1996) depend on the growth of consumers' expenditure. Both consumer confidence and retail sales rose quite strongly during 1996, although there was some retrenchment in December.

Overall, it would appear that the economy is set to grow more strongly in 1997 as domestic demand continues to pick up. The Treasury is forecasting GDP growth of 3.5% which is faster than predicted by many independent forecasters. We therefore expect the outturn in 1997 to be nearer 3.25%, falling to 2.75% in 1998 as interest rate rises during the remainder of this year begin to have their effect on demand in the second half of 1998. Net exports are predicted to continue to contribute negatively to growth during 1997, so the principal engine of growth will be, as noted above, consumer demand, with a forecast growth outturn of 4%. Faster growth of the real economy is to be set against a background of a fairly subdued inflationary expectations for the foreseeable future, although the Treasury's target of 2.5% inflation by the end of 1998 still appears to be over ambitious.