THE ECONOMIC BACKGROUND

THE INTERNATIONAL ENVIRONMENT

The international environment is one of increased growth mainly due to a rise in world trade. The recovery is quite strong and growth is seen across the globe. Japan has the strongest growth primarily due to the depreciation of the Yen and the government's expansionary policy. The importance of Asian markets to world trade and hence growth cannot be underestimated. It is not only Japan but the 'Tiger' economies, China and some of the smaller South-East Asian economies which have made a strong contribution to world growth. The rise in intra-Asian trade has been followed by an increase in world trade. Globalisation has brought about the structural changes in the 'Western' economies which are due to low cost high quality competitors like the 'Tiger' economies. European growth is relatively weaker than that seen elsewhere in the world economy. EMU is almost certain to go ahead in 1999 with a small group of countries.

The US

The dollar has appreciated against most other currencies but output and employment have continued to grow rapidly in the US. In Q4 1996 GDP grew by 1% giving GDP growth of 2.5% for 1996 rising to 2.75% in 1997. The oil price has had a significant drop which has held off rising inflationary pressures. This also accounts for the economy operating at above capacity levels. The US stock market is rising rapidly. The question is; is this a speculative bubble or is it the true state of the economy? Some commentators have proposed that the dollar is over valued while the Yen and DM are undervalued. At the moment the evidence suggests that the US economy is actually represented by the asset prices prevailing. While there have been small changes in short term interest rates to curb inflationary pressures it is not expected that long term interest rates will change significantly. The main threats to the above trend growth in the US will probably come from the labour market. Unemployment has fallen steadily since 1994 but is forecast to rise to 5.4% in 1998. The minimum wage is to be increased in the Autumn which will lead to short term labour market inflationary pressure. The Bank of England demonstrates an increasing divergence between consumer prices and average weekly earnings in the US.

Germany and Europe

Of the major economic blocs the EU demonstrates the weakest GDP growth in recent times. OECD Europe has the lowest growth in world trade over the 1995-97 period. The growth of world trade in 1997 is forecast to be double that in 1996. Within Europe the pattern of behaviour will be different. Part of the explanation for this is the realignment of exchange rates which has slowed trade and output growth. In 1996 growth was slower in Germany, France, Switzerland, Italy, Sweden and Austria but was stronger in the UK, the Netherlands, Denmark, Ireland, Spain, Portugal and Norway. Consumption is still relatively weak however. EU GDP was just over 2% in 1996 and is forecast to be 2.5% in 1997 and 1998. Due to the appreciation of the DM those countries in the DM bloc will experience strong net export growth. The main drivers of EU GDP growth are business confidence and investment unlike the US where consumption is the main stimulus to GDP growth. There is little inflationary pressures in Europe with inflation forecast to fall to 2.5% in 1997. Long term interest rates in Europe have fallen slightly although it is expected that short term interest rates will rise slightly. European unemployment remains relatively high when compared to other major economies. As stated in previous Commentaries EMU is near certain to proceed in 1999 despite the election of the socialist Lionel Jospin in France. It is more likely now that the EMU will be more widely based and weaker. Politicians across Europe are now being forced by the electorate to direct economic policy to reduce high levels of unemployment. This implies that the criteria for EMU will be loosely adhered to, particularly the deficit and national debt targets.

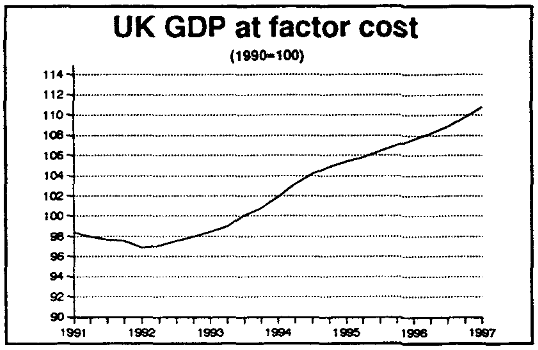
Japan and Asia

The Japanese economy has made a moderate to strong recovery in the early part of 1996. The stimulus to this was fiscal expansion and extremely low interest rates. When the third Tankan survey is seen as confirming a sustained recovery the expectation is that short term interest rates will rise slightly given the depreciation of the Yen and its subsequent inflationary consequences. Long term interest rates are not expected to show much change. The manufacturing sector is leading the Japanese GDP growth while some service sectors are still very weak. Industrial production is forecast to rise by circa 4.5% in 1997. The US is unhappy about Japan returning to export led growth, concerned that a fiscal contraction now may stifle domestic demand. Public sector investment which led the recovery is now declining steadily. Despite a slight slowdown in growth employment is rising. Unemployment is set to increase modestly as employment growth cannot match current labour force participation growth. The effects of globalisation and structural change are being felt around the world but originate in South East Asia. GDP growth is very strong generally and is considerably greater than world GDP. Most economies (except South Korea and Thailand) have a surplus position boosting foreign exchange reserves. China has been unaffected economically by Deng's death and Hong Kong is preparing to reap the benefits that its service sector will undoubtedly gather as it develops the industrial and export potential of the Chinese economy.

UK MACROECONOMIC TRENDS

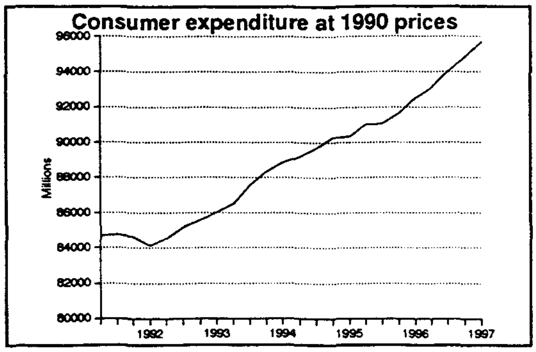
In the fourth quarter of 1996, the estimate of **GDP at market prices** - 'money' GDP - rose by 1.4%. After allowing for inflation and adjusting for factor costs, GDP grew by 0.8% during the quarter, compared with the 0.7% increase recorded in the third quarter of 1996. Over the year to the fourth quarter, **'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** rose by 2.3% both including and excluding oil and gas extraction. Preliminary estimates of **'real' GDP** for the first quarter 1997 suggest an increase of 1% over the previous quarter to a level 3% higher than the first quarter of 1996. Removal of oil and gas extraction leaves the quarterly and annual growth rates for the first quarter unchanged.

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 a 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. For 1996 as a whole, **manufacturing** output rose by 0.5%, **mining & quarrying, including oil & gas extraction** rose by 3.1%, **other energy and water** supply industries rose by 5.1%, **construction** output increased by 0.6%, and **service sector** output rose by 3.3%.



In the three months to February the **output of the production industries** increased by 0.8% compared to the previous three months and by 1.9% compared with the same period a year ago. The **manufacturing** sector expanded by 0.6% over the same three month period to a level 1.6% above the corresponding period a year ago. **Mining & quarrying, including oil & gas extraction**, grew by 1.8% in the three months to February and by 4.1% over the year, while the **other energy and water** supply industries rose by 0.9% over the three months and by 1.5% over the year.

In the fourth quarter of 1996, **real consumers' expenditure** rose 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 March 1997 was 0.3% above the February figure. Over the year to March, the volume of seasonally adjusted sales rose by 4%. Taking the three months to March, the volume of retail sales rose by 1% over the preceding three months and by 4.4% over the same period a year earlier. The provisional **retail sales** data for April indicate a further rise, with sales volume increasing by 0.1% over the March figure, and by 4.7% over the level in April 1996. In the three months to April, sales volume was 1.2% above the previous three months and 4.5% higher than the same period in 1996. The CBI distributive trades survey for April suggests that retail sales increased considerably during the month with a positive balance of 42% of retailers reporting annual growth, the highest rate of increase since November last year. The amount of outstanding **consumer credit** rose by £780m in March, and by £2.5bn in the first quarter of the year, the third highest quarterly increase in three years. After jumping from 10.6% to 12.4% in the fourth quarter 1995, the **personal saving ratio** fell slightly to 11.6% in the first quarter of last year, remaining broadly at this level for the remainder of the year. The underlying increase in **average weekly earnings** in the year to March 1997 is provisionally estimated to have been 4.5%, the same as the revised figure for February and one quarter point lower than January and December but a quarter point higher than the November rise. Earnings growth stood at 4% during the months from July to October. Despite the lower rate of increase in February and March, wage inflation does appear to be progressively rising, although at a slower rate at this time than in previous cycles. **Real personal disposable income (RPDI)**, rose by just under 3% in the fourth quarter of 1996 compared with the same quarter in 1995, this represent a reduction on the 4.5% growth experienced between the third quarters of 1996 and 1995. For 1996 as a whole, RPDI grew by 3.8%.



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. For 1996 as a whole, the aggregate was 0.8% higher than in 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. The provisional estimate of capital expenditure by manufacturing industry in the first quarter 1997 (at constant prices) indicates that spending was 9% higher than in the previous quarter and 5% higher than in the first quarter of 1996. In other sectors, capital expenditure *fell* compared with the previous quarter: by 11% in other production, by 3% in services and by 1% in construction. Over the year to the first quarter, capital expenditure fell by 19% in other production and rose by 11% in services and 37% in construction.

Turning to the **balance of payments**, the **current account** for the fourth quarter 1996 registered, after seasonal adjustment, a surplus of £0.9bn, following the deficit of, on revised figures, £0.3bn in the third quarter, and the surplus of £0.8bn in the second quarter, and the deficit of 1.4bn in the first quarter of 1996. The current account was just about in balance in 1996 overall (-£14m) compared with a deficit of £3.7bn in 1995. For **trade in goods and services**, the *deficit* improved to £0.6bn, in the fourth quarter, compared to £1.2bn in the third quarter, £1.3bn in the second quarter and £2.4bn in the first quarter. For **investment income and transfers**, there was a *surplus* of £1.5bn in the fourth quarter, compared with £0.9bn in the third quarter, £2bn in the second quarter and £1.1bn in the first quarter of 1996. Net trade made a positive contribution to GDP growth in the fourth and second quarters of last year and a negative contribution in the first and third quarters.

UK LABOUR MARKET

Employment and Unemployment

Seasonally-adjusted UK claimant unemployment fell by 163,100 in the quarter to April, and by 531,000 over the full year. The fall in April alone was 59,400. UK unemployment now stands at 1,651,400, giving an overall unemployment rate of 6.0%, with a male and female rate of 8.1% and 3.1% respectively. It is important to note that these figures are still affected by distortions linked to the introduction of the Jobseeker's Allowance, though the month-on-month reductions in unemployment in the early part of this year have been greater than the corresponding reductions in mid 1996. Whilst the level of unemployment has shown a persistent downward trend, UK employment has had a rather more variable performance and generally increased employment has not matched the fall in unemployment. Total employment in December 1996 stood at 26,147,000, an increase of 47,000 (0.2%) in the quarter from September, and 222,000 (0.8%) in the full year from December 1995. The rise in male employment over the last year, at 97,000 (0.7%) is lower both in absolute and proportionate terms than female employment at 126,000 (1.1%). Within the various sectors of the UK economy, employment in manufacturing has fallen by 32,000 (0.8%) in the year to December 1996, and the more recent figures for British manufacturing show only a very slight increase in employment of 3,000 (0.1%) in the quarter to March 1997. Employment gains have been almost exclusively restricted to the service sector. The general improvements in the unemployment figures in the last quarter have been accompanied by a rise in the number of vacancies registered at Jobcentres. In the quarter to April, the number of registered vacancies rose by 12,500 (4.8%) and in the full year from April 1996 the figure increased by 78,600 (39.9%).

Earnings and Productivity

There has been a growth in UK wage inflation throughout 1996, with the underlying level rising from 3.25% per annum in the last quarter of 1995 to 4.75% in December 1996. However, official figures see these wage increases as peaking in December 1996 and January 1997, with the underlying rate of wage inflation falling to an annual rate of 4.5% in February and March. Since the second quarter of 1991, wage increases in manufacturing have been persistently higher than those in service sectors. In 1996, this sectoral differential narrowed and the figure for February 1997 has underlying wage growth in services as higher than that in manufacturing (4.75% as against 4.5%). The rate of growth of labour productivity in the whole economy in the fourth quarter of 1996 was 1.6% 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 in the first three months of 1997 and stood at 1.7% higher than the figure for the same period in the previous year. Given the gap between the increase in wages and the increase in labour productivity, unit labour costs have been rising in both the whole economy and the manufacturing sector. In the fourth quarter of 1996, the rise in whole-economy unit labour costs over the previous year was 1.8%, relatively high given the performance in the previous two years. However, in manufacturing the annual increase in unit labour costs in the first quarter to March was 2.6%, the lowest value since the first quarter of 1995.

UK OUTLOOK

During 1996 growth slowed somewhat compared with 1995. The expenditure-based measure of 'real' GDP, adjusted for factor cost, grew by 2.3% in 1996 compared with growth of 2.6% in 1995. However, the comparatively weaker performance in 1996 reflected the continuation of the strong growth experienced in 1994 into the first and second quarters of 1995. Growth 'bottomed' out in the fourth quarter of 1995 at 2.01% over the same quarter in 1994 and then slowly but progressively rose throughout 1996, through 2.1% in the first quarter, 2.25% in the second quarter, 2.36% in the third quarter and 2.66% in the final three months of the year.

The upturn during 1996 was also associated with a change in the composition of growth. The growth of consumers' expenditure contributed more to overall growth while net trade, apart from the second quarter, contributed less. In addition, stockbuilding contributed negatively to growth as stocks, following the earlier involuntary rise, were run down. Investment also made a stronger contribution, at least in the first half of the year after which the initial investment impetus slackened.

Despite the progressive rise in the growth rate of GDP during 1996 following the growth pause of 1995, inflationary pressures remained largely subdued. The annual rate of increase of output prices peaked in July 1995 at 4.5%, and remained broadly unchanged for the remainder of the year. During 1996, the rate of growth of output prices gradually slackened. By July the rate of increase had reduced to 2.2% and by December the figure was 1.6%. Further slackening was evident in the first two months of 1997 with the rate of increase reaching 1.3% in February. It is clear that the main determinant of the slackening of the rate of growth in output prices was the continued sharp decline in input prices. Average earnings growth, on the other hand, rose slowly throughout 1996 from an annual rate of 3.25% in January to 4.25% in December. Assuming a 2% growth in productivity, the contribution of earnings growth to inflationary pressure during this period appears likely to have been weak and more than offset by the weakening of input price growth. In December 1995, input prices grew at 6% during the year since December 1994, by December 1996 input prices had *fallen* by 6.1% over the year. Further reductions occurred during the first three months of 1997 with the strongest decline of 6.6% registered in February.

The marked contraction in the growth of input prices is clearly not unrelated to the rapid rise in the effective rate of exchange of sterling. In December 1995 the sterling rate stood at 82.9. By April 1997, the rate had risen to 99.5, an increase of 20%. There can be no clearer indication of the extent to which the rise in sterling has served to dampen inflationary pressure within the British economy than the steep decline in the rate of growth of input prices during 1996.

These developments pose something of a dilemma for the authorities' policy stance. The National Institute for Economic and Social Research (NIESR) in their April 1997 Review take the view that the increase in sterling obviates the need for any increase in interest rates, both the one following the election and any others that might be mooted in the coming months by the now independent Bank of England. Simulations using the NIESR domestic macroeconometric forecasting model suggest that a 5% increase in the nominal exchange rate would have the following effects: the price level would be lower by about 5%, output would fall by 1%, unemployment would rise by 100,000 after two years and £4bn would be added to the government's budget deficit. However, these simulations are based on the assumption that the rise in sterling is permanent.

A strong argument can be made that the increase is temporary. It is likely that the rise in sterling reflects two key factors. First, the reaction of the foreign exchange markets to the present position of the UK and US economies in the economic cycle relative to their principal European and Asian competitor economies. Second, a reaction to the increase in uncertainty generated by the prospect of EMU and the timing of entry by the 'first wave' of which Britain is unlikely to be part. Another, more recent factor, likely to contribute to a one-off increase in the exchange value of sterling is the decision to make the Bank of England independent. This seems likely to have been viewed by the markets as contributing to the macroeconomic stability of the UK economy in the longer run thereby inducing some reallocation of portfolios in favour of sterling. It follows, if the above arguments are correct, that sterling will begin to fall once it is clear that the principal European economies of Germany and France are growing relatively more quickly and when the progression towards EMU is clarified. Progress on the latter will be made at the Amsterdam summit in June.

Nevertheless, against this background it is necessary for the Bank of England to be cautious about the next interest rate rise. Exporters are clearly being hurt by the current strength of sterling but their reaction appears to discount the expected pick up in the growth of the UK's principal export markets and the recent strength of profits. Market share has so far been protected by some reduction in the sterling price of manufactured and non-manufactured exports and hence a reduction in profit margins. But business profits currently stand at fairly high levels. There was strong profits growth in 1996, which allowed company saving to rise and corporate debt to fall even though dividend distributions rose. So, it is likely that firms will continue to absorb the rise in sterling by further reductions in the sterling price of exports and if the sterling exchange rate does moderate in the next few months there will be little loss of export markets and the main cost will have been some stagnation in profits.

The situation for exporters and for the general balance of the economy would, moreover, benefit from an appropriate co-ordination of fiscal and monetary policy. The new government cannot expect stabilisation to be the sole responsibility of the Bank of England in its new independent guise. If the exchange rate is to be viewed as more than temporarily fixed by the expectations of the foreign exchange markets then the importance of fiscal policy to stabilisation increases markedly. In these circumstances, a tighter fiscal policy stance would help to dampen down inflationary pressure while at the same time improving the balance of the economy between the tradable and non-tradable sectors. Furthermore, there is a strong case for fiscal tightening in the Chancellor's expected June budget to deal with the continuing weakness of the public finances. Public sector borrowing is higher than would be expected at this stage of the economic cycle. The deficit continues to be large and has led to a deterioration in the public sector balance sheet in recent years. The NIESR point out that public sector net worth has fallen from 50% of GDP at the beginning of the 1990s to an estimated 11% currently. It is arguable that a continuation of this deterioration is not sustainable, raising the prospect that the government will not be able to increase taxation sufficiently to service its debts. The fiscal stance therefore needs to be tightened quickly by £3bn to £4bn and in our view this should be realised by increases in the appropriate taxes rather than further public expenditure cuts. We believe that the realisation of the government's electoral promises on education and health preclude any further real cuts in public expenditure.

The growth of GDP is expected to be faster in 1997 than in 1996. The critical question is: how much faster? We still take the view that growth in 1997 will be slightly above 3% compared with 2.4% (on the average measure) in 1996, as consumers' expenditure continues to rise. Strong consumption growth is to be expected throughout 1997 due to the increased growth of labour income, the further impact of the 'windfalls' from building society demutualisation, higher consumer confidence, increased mortgage equity withdrawal and increased consumer borrowing resulting in further falls in the saving ratio. However, our view on growth depends crucially on the impact of the rise in sterling. The NIESR takes the view that there will be significant real effects on output growth as a result of the sterling's increase, with GDP growth expected to be 2.6% in 1997. We are more sanguine and believe that exporters will consider the rise of sterling to be largely temporary so that market share will be protected by a sufficient cut in profit margins. However, growth at 3% is not sustainable and it is certain that growth will be lower in 1998 both because of capacity constraints and/or because of the eventual impact of sterling's appreciation particularly if the rise is perceived to be more than temporary.