The ECONOMIC *Background*

THE INTERNATIONAL ENVIRONMENT

Overview

There is moderate to strong growth in the global economy (excluding the Asian crisis) with strong Q3 1997 growth in the US although the Japanese economy is slowing. Both France and Germany are showing signs of a strengthening recovery. There are low stable interest rates and low inflation in the industrialised economies. The Far East has been hit by a currency crisis that is rooted in a weak financial system, overvalued currencies, large levels of foreign borrowing and capital inflows as well as political interference. The crisis has deepened and widened since December 1997 and forecasts of world growth have been revised downwards. The US and Europe are not as severely affected as Japan and others with close trading links with these countries.

The US

There was strong growth in Q3 1997 and a significant contribution to GDP growth from consumer's expenditure in the same period. There has also been falling net exports (Q1 to Q3 1997) which has been offset by the strength of domestic demand relative to the main trading partners of the US and a rise in the dollar effective exchange rate. Q4 1997 saw strong industrial production and unemployment is at its lowest since 1970 Q1 at 4.7%. The labour market is however tightening and wage pressures are beginning to appear as the Employment Cost Index is rising quite steadily. Price pressures are not feeding into the US economy because of the strength of the dollar and weakening world commodity prices.

Japan

The economy is slowing with GDP in Q3 1997 just slightly higher than it was in Q3 1996. The recovery is based mainly on consumer's expenditure but the outlook for this is bleak - there have been low retail and car sales for Q4 1997. Net exports were strong in Q2 1997 but are now falling with the Q4 data showing the effects of the Asian crisis. Exports to Indonesia, Philippines, Thailand and Malaysia (ASEAN4), which account for 10% of Japan's exports, fell by 6.9% in Q4 1997 compared to Q3 1997. Exports to the EU (18% share) and to the US (28% share) rose by 16.9% and 7.6% in Q4 1997. There has been weaker industrial production and business confidence has fallen. Consequently the Government has loosened fiscal policy (1% of GDP) and put in place measures to stabilise the financial system (6% of GDP). Japan has low and stable inflation.

Europe

The German recovery depends on net exports with growth 0.8% in Q3 1997 but 2.3% higher on an annual basis. There is a significant recovery of investment but there are concerns over exports to Asia. Consumers' expenditure was weak in Q3 1997 reflecting high unemployment (11.9% in December 1997) but we expect consumption to grow at trend level in 1998 (circa 2.3%). The manufacturing sector is driven by exports but there is a slight slowing in Q4 1997. Inflation was 1.8% in December 1997.

In France the recovery is led by domestic demand with GDP growth of 0.9% in Q3 1997 but this is 2.6% over the year. Investment has also strengthened. Q3 GDP growth is slightly weaker than Q2 but in previous quarters it relied on net exports. Net exports have fallen for the first time since Q2 1996. Employment is up 0.7% and unemployment was 12.4% in November 1997. Inflation was 1.1% in December 1997.

Italy is expected to exceed the government target for GDP growth of 1.2% but this is still below trend. Output was up 0.4% in Q3 1997 or 2.1% on an annual basis. Inflation was 1.5% in December 1997. Strong GDP growth also occurred in the Netherlands, Finland, Denmark and Ireland. OECD estimates for growth in 1997 will be 2.5% compared to 1.75% in 1996. With the exception of Greece and France (by 0.1% for the latter) all European countries will have fiscal deficits of less than or equal to 3% of GDP, the target for EMU. Only four countries (France, Luxembourg, Finland and the UK) however will have a debt: GDP ratio that will be less than 60%.

Asian Crisis

The economies engulfed by the crisis have had investment led growth with moderate inflation, widening current account deficits, large capital inflows with a build up of foreign reserves leading to an increase in the money supply. They also have weak and inexperienced financial systems coupled with political interference and in some cases corruption. These factors laid the foundations for the crisis. In 1995/6 large credit and property bubbles appeared. By June 1997 the share of short loans outstanding was highest in Korea (68%), Thailand (66%), Indonesia (59%) and Malaysia (56%). Weak export performance followed as their main trading partners economies slowed. The excess supply in the electronics industry led to sharp falls in revenue resulting in a loss of competitiveness for the ASEAN4.

The trigger for the crisis was several commercial banks admitting they were having difficulty in meeting their short-term commitments. Eventually the Thai authorities floated the Bhat and in the first three months it fell by 20%. The currency turbulence spread to the Philippines, Malaysia, Singapore, Indonesia and northwards through Hong Kong towards Japan. Due to their prudent management of their financial system with a more mature system Hong Kong, Singapore and Taiwan have weathered the storm better than others have even when the currency came under pressure. The IMF has put in place a rescue package that has been advanced to Korea to prevent defaulting on payments (which almost occurred in December 1997).

There have been some spillover effects but this has been contained to Eastern Europe, South America (particularly Argentina and Brazil), and Mexico. The effects were successfully dealt with by higher interest rates. Both the IMF and OECD have revised downwards their world growth figures from 4.3% to 3.5% for 1998. This compares to world growth of ≈6% in 1996 and 1997. The greatest revisions apply to Asia where growth for Korea, Taiwan, Hong Kong and Singapore has been reduced from 6% to 3.5%. Japanese growth has been decreased to 1% from 2% but the revisions for the US and Europe are quite minor reflecting the smaller share of trade with Asia. The crisis has deepened and widened since December 1997 into 1998, the situation worsening in Korea and Japan. OECD growth (excludes ASEAN4) is forecast to be 2.9% in 1998 but reflects stronger growth in the US. As these forecasts were made in November then we expect OECD growth to be lower than the forecast.

There are three main ways the effects of the crisis can be felt:

a) A fall in domestic demand leads to a fall in output leading to concentration of increasing net exports to offset the fall in capital inflows. There will also be a corresponding decrease in imports that will reduce the level of UK exports. The decrease for UK exports will be less than that seen in the US.

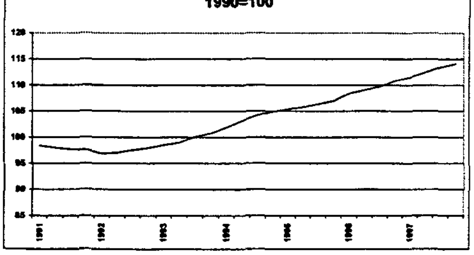
b) There will be shifts in the real exchange rates. The currency falls are major shocks in the short run but there will be a small impact on the sterling effective exchange rate (2 points) as the share of trade with the area is small.

c) Contagion is the fear of central bankers but this has been limited to emerging economies that are not quite mature enough to deal with these shocks yet or where speculators plague the currency whenever shocks occur. Banks have reassessed their exposure to the Far East making it more difficult for Asia to secure foreign lending which has led to an increase in the price of credit.

The National Institute for Economic and Social Research have used their model to simulate some of the effects of the Asian crisis (see *National Institute Economic Review*, 1998, Volume 1, February). World trade decreases due to the decline of capital flow but recovers slowly and steadily. It is clear that there will be a small effect on the UK but it is not as large as was first feared. Certainly it is not as large as that for the OECD or for Japan. Relative export prices rise but again the effect is not huge. More important the demand for exports falls significantly through 1998 and only recovers very slowly. Overall the crisis will reduce UK GDP, probably more so than that of the EU or the OECD. The assumptions here include automatic stabilisers whereas if the same simulation were to be undertaken with fixed exchange rates and interest rates then the effects, particularly on Japan would be much greater. It should also be noted that the Japanese financial system did not cope well with this crisis and in fact it may well have been slowing down the world economy without the Asian crisis. It is most likely that UK GDP will be reduced by about 0.5% given the range of forecasts available (0.2% to 1.3%). In conclusion the main effects will be a slowing of world trade growth, a decrease in the competitiveness of the UK and a fall in export demand.

UK MACROECONOMIC TRENDS

In the third quarter of 1997, the estimate of **GDP at market prices** - 'money' GDP - rose by 1.6%. After allowing for inflation and adjusting for factor costs, GDP grew by 0.8% during the quarter, compared with the 1% increase registered in the second quarter and the 0.7% increase in the first quarter. Over the year to the third quarter, **'real' GDP** is estimated to have risen by 3.7%. When oil and gas extraction are excluded, 'real' GDP is estimated to have risen by 0.8% in the second quarter and by 3.8% over the same period a year ago. Preliminary estimates of **'real' GDP** for the fourth quarter 1997 suggest an increase of 0.5% over the previous quarter to a level 3.1% higher than the fourth quarter of 1996. Removal of oil and gas extraction produces a quarterly growth rate for the fourth quarter of 0.5%, while the annual rate rises slightly to 3.2%.



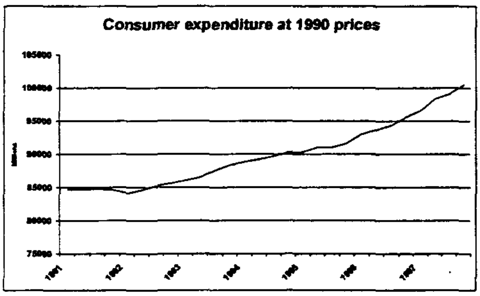
UK GDP at factor cost
1990=100

Output of the production industries in the third quarter rose slightly by 1.2% to a level 2.3% higher than the same period a year ago. Within production: **manufacturing** experienced an increase in output of 0.6% in the third quarter, output of the **other energy and water supply** industries rose by 3.7% in the third quarter, and **mining & quarrying, including oil & gas extraction** rose by 3.2%. Manufacturing output in the third quarter was 1.9% above the same period a year ago. The output of the **service sector** rose by 0.9% in the third quarter and by 4.9% over the third quarter 1996. The **construction industry** experienced a decline in output in the third quarter of 0.1% but output in the industry rose by 2.3% over the year.

Estimates from the ONS for the fourth quarter of 1997 suggest that the **output of the production industries** fell by 1% over the third quarter. **Manufacturing, mining & quarrying, including oil & gas extraction,** and **other energy and water** all experienced a decrease, with manufacturing output declining by 0.6%, mining & quarrying contracting by 2.3%, oil & gas extraction falling by 2% and other energy & water output declining by 2.8%. In contrast, the output of the **service sector** is estimated to have risen by 1% in the fourth quarter and by 4.4% over the fourth quarter 1996.

In the third quarter of 1997, **real consumers' expenditure** rose by 0.7% compared with the 1.6% recorded in the second quarter and the 0.9% increase in the first quarter. Spending during the third quarter rose by 4.3% on the same period a year earlier. In the third quarter, consumers' expenditure again provided the main, albeit a reduced, contribution to GDP growth along with an enhanced contribution from both government spending and stockbuilding. The official seasonally adjusted estimate of **retail sales** volume for the third quarter 1997 was 0.8% higher than in the second quarter. In the fourth quarter, there was a rise of 1.5% over the third quarter. In January 1998 the seasonally adjusted volume of retail sales was 1.8% above the December figure. Over the year to January, the volume of seasonally adjusted sales rose by 6.9%. Taking the three months to January, the volume of retail sales rose by 1.6% over the preceding three months and by 5.7% over the same period a year earlier. The amount of outstanding **consumer credit** rose by £1.29 billion in December and by £3.54 billion in the fourth quarter of the year. This compares with an increase of £2.4 billion in the third quarter. The **personal saving ratio** fell to 10.8% in the third quarter of 1997 from, on revised figures, 12.6% in the second quarter and 10.4% in the first quarter. The underlying increase in **average weekly earnings** in the year to December 1997 is provisionally estimated to have been 4.75%, the same as in November but 0.25% points higher than in October and 0.5% points higher than in September. **Real personal disposable income (RPDI)** *fell* by 1.3% in the third quarter of 1997 and rose by 3.4% compared with the same quarter in 1996. The fall in the saving ratio in the third quarter reflects the maintenance of the growth of consumers' expenditure as RPDI fell.

General government final consumption, rose by 1.4% in the third quarter of 1997. Government consumption in the third quarter was 3.3% higher than in the corresponding quarter of 1996. As a result of this increase, the contribution to GDP growth rose appreciably. Only consumers' expenditure made a greater contribution (47% of GDP growth) than government spending (30%).



Real gross fixed investment or Gross domestic fixed capital formation *fell* by 0.5% in the third quarter to a level 3.1% higher than in the third quarter of 1996. Investment made a negative contribution to GDP growth in the third quarter (-9%) after making a positive contribution in the second quarter (55%) and a small negative contribution in the first quarter (-3%). In manufacturing, investment is estimated to have fallen by 4% in the third quarter to a level 20% higher than in the third quarter of 1996. Private sector investment fell by 2.5% in the third quarter while general government investment rose by 33%. However, private sector investment was 6% higher than the third quarter 1996 while government investment was 19% lower.

Turning now to the **balance of payments**. The **current account** for the third quarter 1997 registered, after seasonal adjustment, a surplus of £0.5bn, following the surpluses, on revised data, of £1.4bn in the second quarter and £1.6bn in the first quarter. These figures compare with a surplus of £0.3bn in the fourth quarter of 1996, a deficit of £0.6bn in the third quarter, broad balance in the second quarter, and a deficit of £1.5bn in the first quarter. For **trade in goods and services**, the *deficit* improved to £0.25bn in the third quarter from £0.45bn in the second quarter and £0.17bn in the first quarter. For **investment income and transfers**, there was a *surplus* of £0.73bn in the third quarter, compared to surpluses of £1.89bn in the second quarter and £1.81bn in the first quarter. Net trade made a very small contribution to GDP growth in the third quarter (6% of GDP growth) compared with a large negative contribution in the second quarter (-57%) and a positive contribution in the first quarter (24%).

UK LABOUR MARKET

Employment and Unemployment

Seasonally-adjusted UK claimant unemployment fell by 64,700 in the quarter to January and by 416,000 over the full year (though figures in the period January to May 1997 have been affected by the introduction of the Jobseeker's Allowance). UK unemployment has been falling almost continuously since February 1994 and now stands at 1,398,500, giving an overall unemployment rate of 5.0%, with a male and female rate of 6.8% and 2.7% respectively. For almost two years there has been a consistent increase in UK employment. Total employment in September 1997 numbered 26,595,000, an increase of 73,000 (0.2%) in the quarter from June, and 338,000 (1.3%) in the full year from September 1996. However, employment experience in the various sectors of the UK economy varied markedly. Employment in manufacturing fell in the quarter to September by 20,000 and in the full year by 2,000 and the more recent figures for British manufacturing show a further decrease in manufacturing employment in the last quarter to December of 9,000. Offsetting this has been substantive employment gains in the service sector. In this sector employment increased by 287,000 in the year to September, 69,000 jobs coming in the last quarter. Whilst there has been a general improvement in the unemployment figures, this has not been accompanied by a rise in the number of vacancies registered at Jobcentres which fell in the quarter to January by 43,100 (13.8%), though there was a small increase of 5,300 (2%) over the full year.

Earnings and Productivity

The underlying level of annual wage inflation in September 1997 was 4.75%. This is the same level as the figure at the beginning of the year. Wage inflation has fluctuated a little over the last couple of years but now appears to be rising again. From the second quarter of 1991, wage increases in manufacturing had been persistently higher than those in service sectors. In 1996, this sectoral differential narrowed and for eight months up to October 1997 the underlying wage growth in services was higher than that in manufacturing. For the last three months in 1997 wage increases in both sectors have been the same and presently stand at 4.75%. The rate of growth of labour productivity in the whole economy in the third quarter of 1997 was 2.2%. This figure is the highest since the first quarter of 1995. In the recent past manufacturing productivity growth has been very low. In all four quarters of 1996, manufacturing productivity was equal or lower than in the previous year. However, in the first three periods of 1997, manufacturing productivity has been increasing though at a rate lower than the whole economy. 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 third quarter of 1997, the rise in whole-economy unit labour costs over the previous year was 2.6%. Whilst this is a little down on the figure for the previous quarter it is still very high compared to the figures over the past 5 years. In manufacturing the increase in unit labour cost over the previous year in the fourth quarter of 1997 is 3.6%. This is the highest figure for any quarter in 1997, though the figure is lower than any quarter in 1996.

UK OUTLOOK

It now seems fairly clear that the growth of the UK economy is slowing down. Since we last reported, the so-called Asian crisis has occurred. This is likely to damage further the prospects for manufacturing exports to the region and adds to the effect of the 25% appreciation of sterling (against the DM) since August 1996. Export growth is expected by the Treasury to be lower in 1998 than forecast in November with the increase in export volumes dropping from 5% to 3%. The volume of imports, on the other hand, is projected to grow by 8%. Thus the current account of the balance of payments will deteriorate in 1998 with a £7bn deficit expected and net trade contributing negatively to UK growth. The consensus of independent forecasters is that GDP growth will be around 2.3% this year, while the Treasury is anticipating growth in the range of 2% to 2.5% (see UK Budget section).

The National Institute for Economic and Social Research (NIESR) believes that as a result of the strong pound and to a lesser extent the Asian crisis, the economy will slow markedly in the first half of 1998. The principal source of the slow down will be the contraction in manufacturing activity. Service sector growth will offset this to some extent but will not be sufficient to halt the deceleration. Against this background it also seems likely that we shall start to see some slowing down in the growth of consumers' demand and perhaps some slight reduction in the gradually building wage bargaining pressures. The responsibility on the Bank of England to judge its interest rate policy correctly is therefore immense especially since the Chancellor has eschewed a role for fiscal policy in demand management in his latest Budget (see UK Budget section). The risks of a recession are therefore very real. And this is independent of the course of action on interest rates to be taken by the Bank in the next few months. The NIESR estimate that there is a one in four chance of recession in 1998. One hope is that sterling will start to fall as the British economy slows and as decisions are made on the rates the first wave EMU countries agree to peg their domestic currencies to the EURO. However, by then it may be too late to prevent a UK recession, although such changes could well affect the duration of any recession.