# *The* ECONOMIC *Background*

## The International Environment

### Overview

The effects of the Asian financial crisis are now being felt across the globe but in Europe the slowdown in growth will present a soft rather than hard landing this year. The slowdown is forecast to continue into 1999. Eleven countries will join in the Euro on 1 January 1999 with interest rates of around 3.5%, growth of about 2.5% and low inflation. Those economies on the periphery of the Euro-zone will diverge sharply from those in the core (see Demertzis, Low, McAdam, *QEC*, Volume 22, No.1, December 1996). Most OECD countries are now pursuing prudent fiscal policies while employment policies have moved up the political agenda. The environmental costs of economic activity are also being given greater weight as evidenced by the Kyoto summit agreements. In most industrial countries inflation and interest rates remain low.

The financial and economic situation in Asia has eased over the last quarter and while still fragile, the region appears to be stable. This has diminished fears of contagion (especially in emerging markets) considerably. The Japanese economy continues to falter principally due to the underlying weakness of the banking system that has been aggravated by the Asian crisis. The government has announced a series of fiscal measures to help improve economic performance in the latter half of 1998. While there may be short term relief the government must (as stated in previous QECs) improve the balance sheet of the banking sector, tighten up supervision and regulation of the financial sector and implement fundamental structural reforms that should lead to a long run improvement in the Japanese economy. This will enhance competition, encourage new enterprises and leave the public finances in a much healthier position.

### The US

GDP growth for 1997 was 3.8% and 0.9% in the final quarter of 1997. These are the best figures since 1988. The main contributions to GDP growth were private consumption and stockbuilding (0.9% of GDP growth last year). The expectation for GDP growth this year is around 2.7%. Domestic demand has remained high with consumer confidence at its highest level for 30 years. Retails sales grew by 1.3% in the three months to February. External demand has weakened with export orders (especially to non-G7 countries) declining since the middle of 1997. The primary effect here is on manufacturing. Manufacturing output fell in both February and March. Industrial production rose by 5.8% in 1997 however, while growth was 1.8% for Q4 1997 it fell to 0.7% for Q1 1998. The reduction in external demand, the strength of the dollar and the decline in energy prices has helped reduce price pressures. The reduction in external demand has also meant that capacity utilisation will not be pushed to unsustainable levels. Total employment increased by 2.2% in 1997 while unemployment fell to 4.7%. Labour market pressures were further checked by labour market expansion of 1.8%. Total employment is forecast to rise by 1.5% in 1998 implying further price pressures. Inflation and interest rates are expected to remain low.

### Japan and Asia

Japanese GDP growth in 1997 was 0.9%, down considerably from the 4.1% seen in 1996. Growth in Q3 1997 was 0.8% but fell to –0.2% in Q4 1997. This fall is largely due to the reduction in private consumption as real disposable incomes and consumer confidence fell. Net exports made a positive contribution to GDP growth in the last quarter. Imports have slowed implying domestic demand remains weak and the rate of export growth slowed further in Q1 1998 suggesting the Asian crisis is biting hard in Japan. GDP growth is expected to be 0.8% this year. Industrial production in Q1 1998 was 0.4% lower than Q4 1997 and 4% lower than Q1 1997.

The government delivered fiscal measures releasing ¥2 trillion (0.4% of GDP) in income tax rebates in Q1 1998. In April a ¥16 trillion (3.1% of GDP) package was announced and is likely to provide ¥12 trillion in public works and ¥4 trillion in tax rebates in an attempt to stimulate the economy. The latest Tankan survey (March 1998) reveals a marked decline in business confidence and stock levels that producers view as excessive. Total employment grew over December to February by 0.4% while unemployment increased to 3.6% in February – the highest rate since comparable figures were recorded in 1953. Total employment is expected to fall by 0.2% and unemployment is forecast to rise to 3.7% in 1998. While inflation increased slightly in the latter half of 1997 it moderated towards the end of the year. Inflation fell to 1.9% in February from a peak of 2.5% in October.

In Japan over 40% of merchandise exports and 37% of service sector exports go to other Asian economies. Korea, Thailand, Malaysia, Indonesia and the Philippines account for 19.5% of export sales and 16.5% of imports. Growth of exports is forecast to fall from 10.5% in 1997 to 4% in 1998. Japan has outstanding loans of $97.2 billion (2.3% of GDP) to these five economies while total loans to Asian economies amount to $276 billion (6.4% of GDP). It is also estimated that Japanese banks currently have 'bad' loans of ¥77 trillion (15.2% of GDP). It is because of the serious position that the Japanese economy is in (and the other economies in that region) that recovery will be slow. The current economic situation also makes rigorous demands on the public finances and governments in the region must adopt prudent policies to secure a sustainable recovery. Structural reform, an effective supervisory and regulatory framework for the financial sector, improved trade agreements and sound public finances are prerequisites for this to happen.

## Europe

The recovery of GDP growth in Europe continued in 1997 with the fastest growth in Ireland (10.6%) and Finland (5.9%). There has been slower growth in Q4 1997 than in Q3 1997 generally. In Germany this is primarily because of weak domestic demand. In France, Spain and the Netherlands growth in Q4 1997 was similar to that of Q3 1997. In Germany underlying weak private consumption is the slow growth of real personal disposable incomes and high unemployment. Stockbuilding was the main contribution to domestic demand in Q4 1997 and accounted for two thirds of domestic demand in 1997. Government consumption fell again in Q4 1997 to meet the deficit criteria imposed by the Maastricht criteria. Industrial production, orders and consumer confidence are now strengthening while unemployment has fallen from 11.8% in December to 11.5% in March. Despite these factors retail sales remain weak.

In France private consumption contributed significantly to growth but investment fell slightly. Employment, wage growth and consumer confidence have all improved. Net exports accounted for just over half of GDP growth in 1997. French trade figures suggest that the Asian crisis has affected their trading position with Asia as they have moved from a surplus in Q3 1997 to a deficit in Q4 1997 due to falling exports. The January figures imply that the gap is widening. At the European level there is little evidence that the Asian crisis is having a major impact – the main effects are being felt in France.

Inflation in Germany continues to fall from a peak of 2.1% in August 1997 to 1.1% in March 1998. The slight appreciation of the DM and falling world commodity prices helped restrain import price inflation. In France inflation is lower than in Germany but the margin is narrowing. Across Europe inflation is expected to remain low although it may rise slightly in 1999. Countries with inflation forecast above the expected EU average include Denmark, Greece, Ireland, Italy, Netherlands, Spain and the UK. There seems little doubt that interest rates will remain low and this may cause inflation to rise in Ireland, Finland, Spain and Portugal who will have to maintain low interest rates for EMU.

**International Forecasts of Main Economic Indicators; 1997-1999**

| | GDP (% change) | | | Short Term Interest Rates (%) | | |
|---|---|---|---|---|---|---|
| | 97 | 98 | 99 | 97 | 98 | 99 |
| US | 3.8 | 2.7 | 2.2 | 5.6 | 5.6 | 5.5 |
| Japan | 0.9 | 0.8 | 1.4 | 0.6 | 0.6 | 0.6 |
| Germany | 2.3 | 2.6 | 2.9 | 3.3 | 3.6 | 3.8 |
| OECD[2] | 3.1 | 2.4 | 2.5 | - | - | - |
| EU | 2.6 | 2.7 | 2.9 | - | - | - |
| | Inflation (% change) | | | Unemployment Rate (%) | | |
| | 97 | 98 | 99 | 97 | 98 | 99 |
| US | 2.0 | 1.6 | 2.3 | 4.9 | 4.8 | 5.0 |
| Japan | 0.8 | 0.8 | 1.0 | 3.6 | 3.7 | 3.6 |
| Germany | 1.8 | 1.4 | 1.3 | 11.5 | 11.4 | 11.1 |
| OECD[2] | 1.7 | 1.4 | 1.7 | 7.2 | 7.1 | 7.0 |
| EU | 2.0 | 1.9 | 2.0 | 11.2 | 10.8 | 10.5 |

Data Sources:

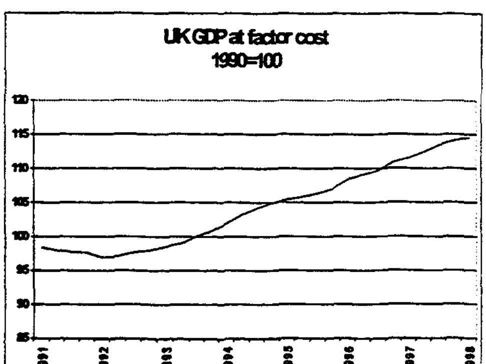
[1] Fraser of Allander Institute, Bank of England Quarterly Economic Bulletin, Barclays Economic Review, Financial Times, IMF World Economy, LBS Economic Outlook, National Institute Economic Review, OECD Economic Outlook, and various others.

[2] Economic Outlook, (1998), June, OECD, Paris

In Germany employment fell by half a million during 1997 with major job losses in the construction industry and from government training schemes. Survey results suggest that there will be there will be a slight improvement in employment in 1998. In France unemployment declined only modestly from 12.5% in 1997 despite the Jospin administration's priority on jobs. It is not expected to decrease significantly in neither 1998 nor 1999. Unemployment is forecast to be 12.4% and 12.3% respectively. The 1998 budget includes FF155 billion (4% of GDP) spending on employment measures. As these have not been finalised yet it is unclear by how much they reduce unemployment.

## UK MACROECONOMIC TRENDS

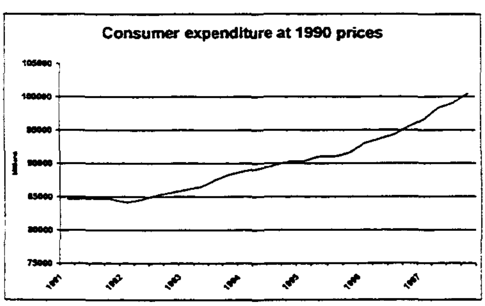
In the fourth quarter of 1997, the estimate of **GDP at market prices** - 'money' GDP - rose by 0.9%. After allowing for inflation and adjusting for factor costs, GDP grew by 0.6% during the quarter, compared with 0.9% in the third quarter, 0.9% in the second quarter and 0.5% in the first quarter. Over the year to the fourth quarter, **'real' GDP** is estimated to have risen by 2.9%. When oil and gas extraction are excluded, 'real' GDP is estimated to have risen by 0.7% in the fourth quarter and by 3% over the same period a year ago. Estimates of **'real' GDP** for the first quarter 1998 suggest an increase of 0.5% over the previous quarter to a level 2.9% higher than the first quarter of 1997. Removal of oil and gas extraction produces a quarterly growth rate for the first quarter 0.5%, with the annual rate remaining at 2.9%.




**Output of the production industries** in the fourth quarter *fell* by 0.9% to a level only 0.7% higher than the same period a year ago. Within production: **manufacturing** experienced a *decrease* in output of 0.5% in the fourth quarter, output of the **other energy and water** supply industries fell by 2.8% in the fourth quarter, and **mining & quarrying, including oil & gas extraction** fell by 2.3%. Manufacturing output in the fourth quarter was 0.9% above the same period a year ago. The output of the **service sector** rose by 1.2% in the fourth quarter and by 4.3% over the fourth quarter 1996. The **construction industry** experienced an increase in output in the fourth quarter of 1.4% with output in the industry rising by 1.8% over the year.

Estimates from the ONS for the first quarter of 1998 suggest that the **output of the production industries** *fell* by 0.3% over the fourth quarter. **Manufacturing, mining & quarrying, including oil & gas extraction, and other energy and water** all experienced a decrease, with manufacturing output declining by 0.1%, mining & quarrying contracting by 0.2%, and other energy & water output declining by 2%. In contrast, the output of the **service sector** is estimated to have risen by 0.7% in the first quarter and by 4.1% over the first quarter 1997. The construction industry is also estimated to have expanded again in the first quarter with growth of 1.1% over the fourth quarter to a level 3.3% higher than in the first quarter of 1997.

In the fourth quarter of 1997, **real consumers' expenditure** rose by 1.4% compared with the 0.7% recorded in the third quarter, the 1.8% increase in the third quarter and the 1% increase in the first quarter. Spending during the fourth quarter rose by 5.1% on the same period a year earlier. In the fourth quarter, consumers' expenditure again provided the main and an increased contribution to GDP growth along with an enhanced contribution from investment and a reduced contribution from government spending. The official seasonally adjusted estimate of **retail sales** volume for the fourth quarter 1997 was 1.5% higher than in the third quarter. In the first quarter 1998, there was a rise of 0.9% over the previous quarter. In April 1998 the seasonally adjusted volume of retail sales was 0.1% above the March figure. Over the year to April, the volume of seasonally adjusted sales rose by 4.2%. Taking the three months to April, the volume of retail sales rose by 0.2% over the preceding three months and by 4.3% over the same period a year earlier. The amount of outstanding **consumer credit** rose by £1.29bn in December and by £3.54bn in the fourth quarter of the year. This compares with an increase of £2.4bn in the third quarter. The Bank of England Inflation Report for May 1998 reports that the growth of consumer credit remains strong, with unsecured credit growing at an annual rate of 17.9% while the growth of secured credit, at 5.8%, was weaker than its average annual rate during 1997. The **personal saving ratio** rose to 10.8% in the fourth quarter of 1997 from, on revised figures, 10.1% in the third quarter compared to a rate of 12.8% in the second quarter and 10.6% in the first quarter. The underlying increase in **average weekly earnings** in the year to February 1998 is provisionally estimated to have been 4.9%, which represents an increase of 0.3% points above the January rate. Earnings growth in manufacturing increased to 5.3% from 4.7% in the year to January. In services the corresponding earnings growth rates were 5% and 4.8%, while the private sector registered an increase of 5.6% compared to 2.6% in the public sector. **Real personal disposable income (RPDI)** rose by 2.2% in the fourth quarter of 1997 and rose by 5% compared with the same quarter in 1996. The rise in the saving ratio in the fourth quarter reflects the slightly slower growth of consumers' expenditure compared to the growth of RPDI.


Consumer expenditure at 1990 prices

**General government final consumption** rose by 0.2% in the fourth quarter of 1997. Government consumption in the fourth quarter was 0.8% lower than in the corresponding quarter of 1996. As a result of this very small increase, the contribution to GDP growth was almost negligible.

**Real gross fixed investment** or gross domestic fixed capital formation rose by 1% in the fourth quarter to a level 5.9% higher than in the fourth quarter of 1996. Investment therefore made a much greater contribution to GDP growth in the fourth quarter (56%) compared to the contribution in the third quarter (12%), although the contribution to growth was about the same as in the first quarter (53%). In manufacturing, investment is estimated to have fallen by 4% in the forth quarter to a level 13% higher than in the fourth quarter of 1996. Other production investment fell by 5% during the quarter; construction investment fell 21% while investment in the service sector rose by 1%. Over the year to the fourth quarter, other production investment remained broadly unchanged; construction investment fell by 10% and investment in services by 1%.

Turning now to the **balance of payments**. The **current account** for the fourth quarter 1997 registered, after seasonal adjustment, a small surplus of £0.1bn, following the surpluses, on revised data, of £1.4bn in the third quarter, £1.7bn in the second quarter and £1.3bn in the first quarter. For 1997 as a whole there was a surplus of £4.5bn, compared to *deficits* of £1.8bn in 1996 and £3.7bn in 1995. For **trade in goods and services**, the *deficit* deteriorated sharply to £2bn in the fourth quarter, as the deficit in traded goods increased from £2.8bn to £4.2bn. The fourth quarter deficit compares with a deficit of £0.5bn in the third quarter, £0.6bn in the second quarter and £0.5bn in the first quarter. For **investment income and transfers**, there was a *surplus* of £2.2bn in the fourth quarter compared to surpluses of £1.8bn in the third quarter, £2.3bn in the second quarter and £1.8bn in the first quarter. Net trade made a large negative contribution to GDP growth in the fourth quarter (-208% of GDP growth) compared with a small positive contribution in the third quarter (16%), a sizeable negative contribution in the second quarter (-62%) and a small negative contribution in the first quarter (-4%).

## UK LABOUR MARKET

### Employment and Unemployment

Seasonally-adjusted UK claimant unemployment fell by 37,700 in the quarter to April and by 312,900 over the full year. UK claiment unemployment has been declining almost continuously since February 1994 and now stands at 1,356,100, giving an overall unemployment rate of 4.8%, with a male and female rate of 6.6% and 2.6% respectively. On the ILO definition, unemployment is slightly higher. For the quarter to March, it stood at 1,860,000 which is a rate of 6.4%. for over two years there has been a consistent increase in UK employment which matches the fall in unemployment. Total employment in December 1997 numbered 27,005,000, an increase of 121,000 (0.5%) in the quarter from September, and 389,000 (1.5%) in the full year from December 1996. However, employment experience in the various sectors of the UK economy varied markedly. The biggest proportionate increase in employment has occured in construction. This is particularly pronounced for male jobs. Total and male employment in this sector has increased by 16.7% and 19.4% respectively over the year to December 1997. On the other hand, employment in public administration, education and health fell in the year and quarter to December 1997 and employment in manufacturing was static over the same time period. Whilst the unemployment figures have been falling consistently, vacancies notified at Jobcentres have fluctuated: in the quarter to April they increased by 24,300 (12.2%), although there was a fall of 15,300 (6.4%) over the full year.

**Earnings and Productivity**

The headline rate of annual wage inflation in February 1998 was 4.9%. Wage inflation has been creeping up gradually over the last year - in March 1997 it stood at 4.3%. There is some variation across industrial sectors with wage rises in manufacturing a little higher than those in services. However, the main division comes between the public and private sectors. The annual increase in private sector pay to February 1998 is 5.6% whereas the increase in public sector pay over the same period is only 2.6%. Over the recent past wage increases in the public sector have consistently lagged behind those in the private sector and this gap has increased in the last year. The annual rate of growth of labour productivity in the whole economy in the fourth quarter of 1997 was 1.5%, which is down on the figure for the previous quarter. In the recent past manufacturing productivity growth has been very low and this remains the case. In the year to March, manufacturing productivity has risen by only 0.1%. 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 1997, the rise in whole-economy unit labour costs over the previous year was 3.6%: in manufacturing the increase in unit labour cost over the year to March 1998 is 6.1%. These figures are very high compared to the figures over the past 5 years which does not auger well for UK competitiveness.

## UK OUTLOOK

The majority of indicators appear to confirm the view expressed in the **March Commentary** that the growth of the economy is slowing down. However, as with all economic matters nothing is certain. Some recent indicators - retail sales and private sector earnings growth - suggest that domestic demand and inflationary pressure remain strong. Other data - manufacturing output and the balance of foreign trade in goods and services - can be interpreted as hinting at the prospect of a recession in the UK in 1998 and/or in 1999.

GDP growth slowed successively in the fourth quarter of 1997 and the first quarter of 1998. The trade balance for goods and services deteriorated significantly, resulting in a significant negative contribution to growth from net exports. The growth of total domestic expenditure actually rose between the fourth and first quarters. Consumer spending growth slowed somewhat. There was a marked decline in government consumption. Investment growth picked up, contributing positively to growth. And there was a marked increase in stock building in the first quarter, which made a significant positive contribution to growth. So, overall, the slow-down was driven by a contraction of external demand, with the growth of domestic demand being maintained by stock building and investment as consumption growth slowed slightly.

The slow-down in GDP growth given its external origin has come mainly from manufacturing output, which contracted by 0.5% and 0.1% in the fourth and first quarters, respectively. The growth of output in the service sector, on the other hand, has remained strong and above trend, although there was some slow-down between the fourth and first quarters. It appears likely that the deterioration in manufacturing and other exports will continue throughout the year and into 1999. Exporters have been fulfilling previously negotiated contracts and have reduced margins in the face of sterling's appreciation. But the sustained continuation of the high level of sterling has clearly led companies to re-establish margins for their exports, with the result that demand has fallen. However, as the Bank of England's Inflation Report for May notes, most of the deterioration in the trade balance has occurred due to a drop in sales to East Asia and US, with the EU trade balance more stable despite sterling's greater appreciation against EU countries. This might be interpreted as suggesting that the decline in exports is more a reflection of the 'Asian crisis' rather than sterling's appreciation. If so, this must serve to reinforce the prospect of a deteriorating trade balance as sterling's appreciation begins to affect EU trade. There is, therefore, a strong likelihood that for the foreseeable future GDP growth will be depressed by negative net exports. Moreover, we have yet to see the increase in imports from

East Asia that many expected as a result of the decline in the value of most of the major currencies in the region. The value of imports from East Asia in the 6 months to March, according to the Bank of England's Inflation Report for May, rose by around 4%, compared with an average 6 month increase of about 8% between 1990-96. Finally, the trade prospects are clouded further by the difficulties currently being experienced by the Japanese economy.

It should be expected that a decline in export performance would feed through into domestic demand as the demand for local business, financial and distribution services falls and as cutbacks in employment reduce labour incomes and personal sector spending. Yet domestic demand remains buoyant. Indications from first quarter data that consumer demand growth was slowing appear to have been confounded by the May retail sales data. Sales volumes increased by 1.7% over April, more than twice the expected growth, to a level 4.6% above the same period last year. However, the ONS noted that the underlying trend was little different from April. And the latest monetary indicators show signs of a deceleration. Conditions in the labour market, on the other hand, offer support for those who believe that the pressure of demand is too high. Private sector annual earnings growth is above 5% and wage settlements continue to rise. The labour market appears to be continuing to tighten with many economists believing that the present unemployment rate of 6.4% is below the NAIRU: the rate of unemployment consistent with non-accelerating inflation. Against this background it is to be expected that the Monetary Policy Committee (MPC) of the Bank of England will raise the repo rate again in July. However, if that is the outcome then the MPC must be prepared to bring rates down quickly if there is a further significant deterioration on the trade front.

The National Institute for Economic and Social Research (NIESR) expect a significant slowdown in GDP growth with output forecast to rise at below trend rates of 1.9% in 1998 and 1.6% in 1999. The NIESR are more pessimistic than other non-city and city forecasters both about the growth rate and the prospects for recession. The Treasury's June comparison of 45 independent forecasts reveals an average expectation for GDP growth in 1998 of 2.2%, with forecasts ranging from 1.1% to 3%. For 1999, the average is 1.9% ranging from 0.9% to 3.1%.