The ECONOMIC *Background*

The International Environment

Overview

The world economy has recently seen several shocks from the Asian financial crisis to the devaluation of the rouble. Columbia has also devalued and commodity prices have fallen sharply particularly the price of oil which has fallen from $18 to about $13. The financial crises have sent stock markets into downwards spirals where the Dow Jones Industrial Average lost all of its gains this year and Wall Street had $4 trillion wiped off share prices (equivalent to the GDP of Japan). As fundamentals in the global economy are not out of line, and as predicted stock markets have regained much of the ground. There is now severe pressure on Latin American and African economies that are suffering from the loss of commodity revenues. Growth in the developed economies continues although slowing from 1997 in some regions. It is unlikely that there will be a global recession as some forecasters are predicting.

Russia

The rouble has lost two thirds of its value in three weeks and Russia has placed a moratorium on foreign debt. Public sector workers have not received wages for some time now and consequently state companies do not receive revenue for services rendered. Only about 15% of all taxes are paid on time and 30% of taxes are never paid at all. Inflation in August alone was 15% and is expected to have a short lull before rising sharply. The severe drop in oil and other commodity prices has contributed to the situation but the underlying problem is a system of 2,500 corrupt banks and institutions and officials who have not implemented economic reform but have squandered the economic aid from the West.

Russia only contributes 2% to world output but it is its sheer geographical size, a population of 147M, it's rich endowment of natural resources and most importantly it's vast arsenal of nuclear weapons that demands the attention of the West. The solution to their problem is not clear (in practical .terms) – it is unlikely that a currency board pegging the rouble to the dollar could work – the country does not have enough discipline. The government urgently requires money to pay its bills and will probably achieve this by increasing the money supply. Hyperinflation will result. It may yet be possible for the IMF and the West to impose conditions on the aid given which, would have to include a restructuring of the financial and tax collection systems. As a result jobs will be lost in the drive for efficiency and prices in the shops will still rise but at least then they would have the basis for the economy to be run in a more effective and efficient way. Whatever way Russia chooses to go it will be painful and the West will support it while there are stockpiles of nuclear weapons at hand.

The US

Growth in the first quarter of 1998 grew sharply at 1.4%, inflation remained low and interest rates were unchanged. Domestic demand contributed 2% to Q1 1998 GDP growth and consumption and investment growth was quite robust. Stockbuilding also made a positive contribution to Q1 growth. The contribution of net trade was negative at –0.7%. The data for Q2 1998 also suggests strong growth as retail sales grew by 1.9%, household income and employment growth was quite strong and consumer confidence reached its highest since 1969.The widening trade deficit is a sign of the dollar's continued appreciation and strong domestic demand. Industrial production grew by 4.7% in Q1 1998 and by 4.2% in Q2. The increase in employment has largely been in the service sector; it grew by 0.7% in Q2 1998 but manufacturing employment fell by 0.1%. Estimated GDP growth for Q2 is 0.4% due to a negative contribution from stockbuilding and a further fall in net exports (mostly due to a decline in Asian markets). The labour market is tightening further with unemployment at 4.3% (the lowest since 1970) during May and June but rose to 4.5% in June. It is clear from Alan Greenspan's comments that should the financial crisis get any worse or if the American economy were to be threatened then interest rates would be lowered. After these comments the Dow Jones Industrial Average and other stock markets across the world recovered sharply. The current account balance is forecast to deteriorate by 2.4% and 3.0% in 1998 and 1999 respectively from -$155.2bn in 1997. The outlook for the US has not altered significantly since the last quarter.

Japan and Asia

The effects of the Asian crisis are being felt elsewhere in the world and domestic demand is particularly weak in the region. The growth in GDP for these economies is not encouraging. In Q2 1998 in Indonesia it fell by 15%, by 6-7% in South Korea and Thailand but in countries where domestic demand was relatively strong growth was positive; Singapore and Taiwan recording 1.6% and 5.2% respectively. China may become the engine for growth in the region with growth of 6.8% in Q2 1998. Trade and the external environment are significant problems in the region. Imports to the region are expected to decline by 5.5% this year and to South Korea alone by 25%. The most important exporter affected by this is Japan as trade has declined by 1.1% in the three months to May and the value of trade has fallen by 25%.

Japan has seen a mild recession at the beginning of the year as output fell by 1.3% in Q1 1998 and by 3.7% in Q2 1998. Consumption was higher than expected at 1.1% growth over last year but is forecast to be slightly negative during 1998. The economy is likely to be stabilised by the fiscal package previously announced but this will not have a long lasting effect. It is only a restructuring of the financial system that is likely to restore confidence in the economy. In 1997 GDP growth was led by exports and manufacturing growth. The June Tankan survey suggests that firms will reduce production as stocks are at record levels. Consumer confidence remains low and unemployment rose to 4.1% in May which was the highest recorded level. Exports fell by 3.8% primarily because of a fall in exports to Asia. Exports to the EU and the US increased but the Japanese share of exports in the US fell while China and Mexico increased their shares. The forecasts for growth for the Japanese economy have been revised downwards particularly for 1998 as shown below.

Europe

In 1998 growth is expected to slow in Germany and the UK but continue unabated in France, Netherlands and Spain. Italian GDP growth is expected to continue growing but at a lower level than the rest of it's European partners. GDP growth was 2.6% for 1997 compared to 1.8% in 1996 for the EU. Growth in the 'Euro area' (those countries that will take part in the first stage of the single currency) was largely dependent on the external sector as these currencies depreciated against the dollar and sterling. EU GDP rose by 0.5% in Q1 1998 taking it 3% higher than last year. The outlook for GDP growth in the EU is a steady trend of 2.6% to the year 2000. It may be that growth in the Euro area will be slightly ahead of this reflecting the slowdown in the UK. German GDP rose by 1% in Q1 1998 following growth of 0.7% and 0.3% in Q3 and Q4 respectively. Towards the end of 1997 stockbuilding made the largest contribution to GDP growth but in Q1 1998 all elements of domestic demand contributed significantly to GDP growth except stockbuilding. It is likely that Q2 growth may be slightly weaker as retail sales fell by 3.5% from Q1 and consumer confidence weakened. Investment grew strongly in Q1 and is likely to continue in the next two quarters. Net trade was –0.6% in Q1 1998 but looks likely to strengthen in the next quarter. The forecast of GDP growth for 1998 takes into account concerns over falling indicators but it is unlikely that they will not have any lasting effect on the economy. Unemployment peaked at 11.8% in Q4 1997 but the 0.8% reduction in the jobless mainly comes from government schemes and unemployment is predicted to fall up to the year 2000.

International Forecasts of Main Economic Indicators; 1997-2000[1]

	GDP (% change)			Short Term Interest Rates (%)		
	1997	1998	1999	1997	1998	1999
US	3.8	2.9	2.2	5.6	5.5	5.5
Japan	0.9	0.3	1.3	0.6	0.7	0.6
Germany	2.3	2.4	2.8	3.3	3.5	3.7
OECD[2]	3.1	2.4	2.5	-	-	-
EU	2.6	2.6	2.7	-	-	-
	Inflation (% change)			Unemployment Rate (%)		
	1997	1998	1999	1997	1998	1999
US	2.0	1.7	2.1	4.9	4.7	4.9
Japan	1.4	0.9	0.6	3.4	3.6	3.6
Germany	1.8	1.5	1.4	11.5	11.2	10.9
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	10.3

Data Sources;

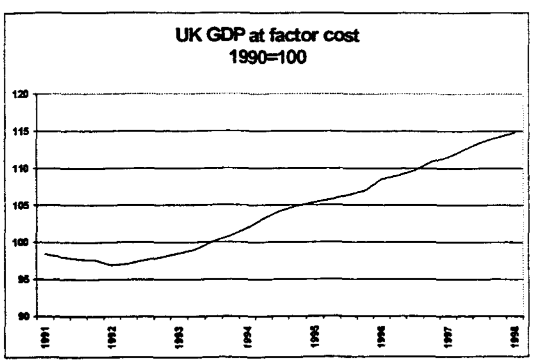
[1] Fraser of Allander Institute, Bank of England Quarterly Economic Bulletin, Barclays Economic Review, Financial Times, IMF World Economy, National Institute Economic Review, OECD Economic Outlook, and various others.

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

In France the recovery has been export led and GDP growth was 2.3% in 1997 and is forecast to peak at 3% in 1998 before slowing down slightly in the next two years. French GDP growth was 0.9% and 0.8% in quarters 3 and 4 of 1997 and 0.6% in Q1 1998. In Q1 1998 consumption, stockbuilding and investment all made positive contributions to GDP growth although net trade was –0.8%. Employment grew by 1.7% up to March 1998 giving a boost to incomes and consumer spending. Investment grew by 2.8% in Q1 1998 and is probably still strong in Q2 but industrial production slowed in Q2 1998. Services have had a large boost to growth due to the World Cup. In 1998 domestic demand is expected to be much stronger. Long-term interest rates have reached a historic low of 5.1% last seen in the 1960s. Inflation remains at 1.1% for 1997 and 1998 probably increasing slightly towards the end of the century. Unemployment is likely to fall steadily towards 10% by the year 2000. In May this year it was 11.9%, it's lowest rate for two years. Employment is projected to rise in both the manufacturing and service sectors.

UK MACROECONOMIC TRENDS

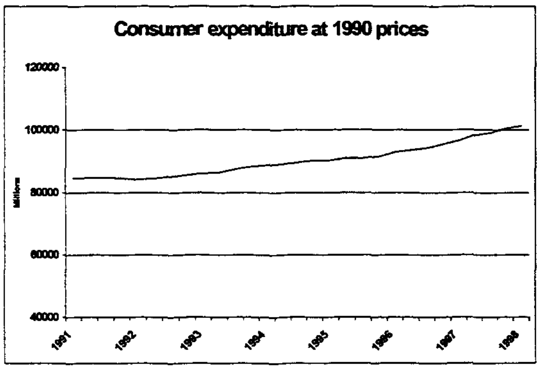
In the first quarter of 1998, the estimate of **GDP at market prices** - 'money' GDP - rose by 1%. After allowing for inflation and adjusting for factor costs, GDP grew by 0.5% during the quarter, compared with 0.6% in the fourth quarter of 1997, 0.9% in the third quarter, 0.9% in the second quarter and 0.5% in the first quarter. Over the year to the first quarter, **'real' GDP** is estimated to have risen by 3%. When oil and gas extraction are excluded, 'real' GDP is estimated to have risen by 0.6% in the first quarter and by 3% over the same period a year ago. Preliminary estimates of 'real' GDP growth for the second quarter suggest that the economy grew by 0.5% to a level 2.6% above the same period a year ago. Removal of oil and gas leads to an estimated 0.4% growth over the first quarter and growth of 2.5% over the year.



Output of the production industries in the first quarter *fell* by 0.3% to a level only 0.3% higher than the same period a year ago. Within production: **manufacturing** experienced a *decrease* in output of 0.1% in the first 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 2.1%. Manufacturing output in the first quarter was 0.2% above the same period a year ago. The output of the **service sector** rose by 0.7% in the first quarter compared to growth of 1.2% in the fourth quarter. Over the year to the first quarter service sector output rose by 4.1%. The **construction industry** experienced an increase in output in the first quarter of 2% with output in the industry rising by 4.2% over the year.

In the first quarter of 1998, **real consumers' expenditure** rose by 0.9% compared with the 1.4% in the fourth quarter 1997, the 0.7% rise in the third quarter, the 1.8% increase in the second quarter and the 1% increase in the first quarter. Spending during the first quarter rose by 4.9% on the same period a year earlier. In the first quarter, consumers' expenditure ceased to provide the main contribution to GDP growth (from 154% to 73% of GDP growth) as the contribution from investment rose appreciably (from 32% to 90% of GDP growth) while the contribution from government spending further declined. The official seasonally adjusted estimate of **retail sales** volume for the first quarter 1998 was 0.9% higher than in the fourth quarter 1997. In the second quarter 1998, there was a rise of 0.3% over the previous quarter. In July 1998 the seasonally adjusted volume of retail sales was 0.9% above the March figure. Over the year to July, the volume of seasonally adjusted sales rose by 3%. Taking the three months to July, the volume of retail sales rose by 1.1% over the preceding three months and by 3.2% over the same period a year earlier. The amount of outstanding **consumer credit** rose by £1.28bn in June and by £3.54bn in the second quarter of this year. This compares with an increase of £3.8bn in the first quarter and an increase of £3.51bn in the fourth quarter of 1997. The growth of consumer credit therefore remains strong. The **personal saving ratio** fell to 9.1% in the first quarter of 1998 from, on revised figures, 10.1% in the fourth quarter 1997 compared to a rate of 10.8% in the third quarter, 12.7% in the second quarter and 10.4% in the first quarter. The underlying increase in **average weekly earnings** in the year to May 1998 is provisionally estimated to have been 5%, which represents a decrease of 0.4% points from the April rate. Earnings growth in manufacturing decreased to 5.1% from 5.8% in the year to April. In services the corresponding earnings growth rates were 5.3% and 5.7%, while the private sector registered an increase of 5.7% compared to 3.2% in the public sector, with the former decreasing by 0.5% points on the April figure, while the latter rose by 0.4% points. **Real personal disposable income (RPDI)** fell by 0.2% in the first quarter of 1998 to a level 3.4% higher than in the same quarter in 1997. The fall in the saving ratio in the first quarter reflects the positive growth of consumers' expenditure compared to the fall in RPDI.

General government final consumption, fell by 0.4% in the first quarter of 1998. Government consumption in the first quarter was 0.2% higher than in the corresponding quarter of 1997.



Real gross fixed investment or Gross domestic fixed capital formation rose by 3.8% in the first quarter to a level 8.6% higher than in the first quarter of 1997. As a result, the contribution of investment to GDP growth rose appreciably (from 32% to 90% of GDP growth) overtaking consumption as the main driver of growth.

Turning now to the **balance of payments**. The **current account** for the first quarter 1998 registered, after seasonal adjustment, a large *deficit* of £3.2bn, following broad balance in the fourth quarter of 1997 and the surpluses, on revised data, of £1.4bn in the third quarter, £1.7bn in the second quarter and £1.4bn in the first quarter. For **trade in goods and services**, the *deficit* deteriorated further to £3.1bn in the first quarter, as the deficit in traded goods increased from £4.2bn to £4.7bn. The first quarter deficit compares with a deficits of £2bn in the fourth quarter, £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 *deficit* of £0.2bn in the first quarter, following *surpluses* of £2.1bn in the fourth quarter, £1.8bn in the third quarter, £2.3bn in the second quarter and £1.9bn in the first quarter. Net trade made a significant negative contribution to GDP growth in the first quarter (-76% of GDP growth), compared with a larger negative contribution in the fourth quarter 1997 (-113% of GDP growth), a small positive contribution in the third quarter (16%), a sizeable negative contribution in the second quarter (-50%) and a small negative contribution in the first quarter (-5%).

UK LABOUR MARKET

Employment and Unemployment

Seasonally-adjusted UK claimant unemployment fell by 27,500 in the quarter to July and by 214,900 over the full year. UK claimant unemployment has been declining almost continuously since February 1994 and now stands at 1,335,100, giving an overall unemployment rate of 4.7%, with a male and female rate of 6.5% and 2.4% respectively. On the ILO definition, unemployment is slightly higher. For the quarter to June, it stood at 1,802,000 which is a rate of 6.2%. For over two years there has been a consistent increase in UK employment which matches the fall in unemployment. Total employment in the quarter from April to June numbered 27,041,000 and this represents an employment rate of 73.3%. This was an increase of 21,000 (0.1%) on the previous quarter and 225,000 (0.8%) in the previous year. However, the employment experience in the various sectors of the UK economy varied markedly. The biggest proportionate increase in employment has occurred in construction. This is particularly pronounced for male jobs. Total and male employment in this sector has increased by 19.0% and 21.7% respectively over the year to March. On the other hand, total employment in agriculture and fishing fell in the year and the quarter to March by 6.8% and 3.4% respectively and in this industry it is female employment that has been proportionately most strongly affected. Moreover, the more up-to-date figures for manufacturing industry as a whole gives employment static in May and falling in June. Whilst total employment has been consistently rising, and unemployment falling, the level of vacancies notified at Jobcentres has fluctuated. However, both in the quarter and the year to July they fell by 3,500 (1.6%) and 7,800 (3.4%) respectively.

Earnings and Productivity

Wage inflation has been creeping up gradually over the last year. In June 1997 wage inflation stood at 4.3% whilst the May figure for the provisional headline rate of annual wage inflation had increased to 5.0% (though this figure had been higher over the previous two months and the April wage inflation level was 5.4%). Whilst there is some variation across industrial sectors, the main division comes between the public and private sectors. The annual increase in private sector pay to May 1998 is 5.7% whereas the increase in public sector pay over the same period is around half of this at 3.2%. 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 1.4%, which is identical to the figure for the previous quarter. In the recent past manufacturing productivity growth has been very low and this remains the case. In June 1998 manufacturing productivity was 0.4% lower than in June 1997. Given the relatively high increase in wages and the low (and even negative) changes in labour productivity, the change in unit labour costs has been high in both the whole economy and the manufacturing sector. In the first quarter of 1998, the rise in whole-economy unit labour costs over the previous year was 3.2%, broadly consistent with the results in 1997. However, manufacturing has experienced an increase in unit labour costs over the year to June of 4.8%. Whilst this figure is a little lower than the corresponding figures in the early part of this year, it is still very high compared to the average figures over the past 5 years.

UK OUTLOOK

The GDP data for the second quarter provide further evidence that the growth rate of the UK economy is slowing. The manufacturing sector is effectively in recession while growth in the service sector appears to be slowing although still remaining positive. The growth of consumers' expenditure continues to be strong but has slowed from the strong growth rates exhibited in the first half and the fourth quarter of 1997. Investment growth on the other hand has picked up appreciably with the result that the composition of growth has changed, with growth led by investment in the first quarter. The main downward pressure on growth continues to come from net trade, which in the first quarter almost exactly offset the positive impetus to growth from consumption.

Inflationary signals are mixed. The strength of demand in the economy remains stronger than many people are prepared to admit. A falling saving ratio and continuing strong growth in the demand for consumer credit are supporting the growth of consumers' expenditure. However, in view of the slowdown in the growth of real personal disposable income it might be expected that the growth of consumers' expenditure would continue to slow throughout the remainder of the year and into 1999. Earnings pressures are strong but diminishing. The growth of private sector earnings is still above 5% but is falling while public sector earnings growth is increasing, reflecting a process of catch-up with the private sector. The outturn for private sector earnings is key. Producer or factory gate prices and input prices are either flat or falling. The factory gate price index for home sales of manufactured products in July was only 0.8% above the figure in July 1997, while input prices (materials and fuel) *fell* by 1.1% between June and July and by 8.8% in the year to July. The large fall over the year reflects both the effect of the increase in sterling on the import of materials and fuels and the fall in the price of oil.

Of most immediate concern for the outlook and prospects for the UK economy is the turbulence on the world's financial markets, which has become much worse since we last reported in the **June Commentary**. The crisis in the Asian financial markets has spread to Russia and to Latin America and this in turn has de-stabilised stock markets in Western Europe and the US. While, at the time of writing, the worst moments of the crisis appear to have passed as both Wall Street and European stock markets have picked up, considerable uncertainty remains. The main threat to the 'real' economies of Western Europe stems from the effect on consumption and investment of significant falls in asset prices and from contractions in lending activity by UK and European banks whose investments in Russia and elsewhere have turned sour. The degree of exposure of British banks is limited but the reduction in liquidity and associated confidence effects could produce real effects. The classic policy response to a shortage of liquidity and diminishing confidence in financial markets is for central banks to be prepared to act as lenders of last resort at reduced cost i.e. lower interest rates. The recent indication by Alan Greenspan the Chairman of the Federal Reserve of the US that the likely direction for US interest rates is down rather than up appears to have been sufficient to dampen the crisis on Wall Street and in Europe. A similar signal from the Monetary Policy Committee (MPC) of the Bank of England is required. Against the background of tightening liquidity, falling financial asset prices and slowing UK GDP growth we expect that the MPC will start to ease UK interest rates downwards during the remainder of this year.