

Economic Development & Transport Committee

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Quarterly Economic Report for Wales - February 2005

Executive Summary

The US economy continues to grow strongly and the Chinese economy is maintaining its breakneck development.

The Euro zone lags behind due to slowish growth and poor job creation in the two leading economies, France and Germany.

The UK is continuing to grow at a rate close to trend and the labour market picture is positive.

Insofar as there are risks to the global economy they come from the same factors that have been around for a while – oil price uncertainty and the US problems with budget and trade deficits.

Current Global Situation

The global economy is performing relatively well with the US and China driving growth. The Euro zone is more subdued and Japan continues its up and down path.

Strong growth continued in the US economy. GDP grew at an annualised rate of 4% in quarter 3 2004, up from 3.3% in quarter 2. GDP growth is being driven by a range of factors including strong consumer expenditure. The labour market continued to strengthen, albeit at a slower pace than GDP. Although the unemployment rate remained unchanged in December at 5.4%, the job creation figures for 2004 as a whole were at their highest level for 5 years. Commentators are expecting strong growth to continue into 2005 while the labour market is expected to improve steadily.

On the down side, inflation has been edging up driven primarily by oil prices. The consumer price index jumped by 3.3% in the year to December compared with 1.9% a year earlier. Oil prices are likely to be a major source of uncertainty in the coming months though there were some signs that they were

moderating in December. The underlying strength in the economy and the risks of higher inflation have led the Fed to increase interest rates 5 times since June. The latest rise in December took the primary interest rate (the rate at which commercial banks may borrow from the federal reserve bank) up to 3.25%.

As noted above, consumers' expenditure is helping to drive GDP. The latest consumer confidence index from the Conference Board suggests that consumer confidence remains high though future expectations have dipped a little.

Despite a weakening of the dollar, especially against the Euro, the US trade deficit is showing no sign of improving. The deficit on goods and services increased by \$4.3 billion in November to stand at \$60.3 billion. The other deficit that has been a major source of concern in the US is also worsening. The budget deficit is predicted by the White House to be \$427bn for the current fiscal year, up from the previous estimate of \$348bn, reflecting higher military spending.

In Asia, China is fast becoming the engine for growth. In 2004 GDP grew at a breakneck 9.5% which exceeded expectations and managed to beat the 9.1% in 2003. The growth occurred despite the efforts of the government to take some of the steam out of the economy by imposing restrictions on investment and credit. There are some concerns of overheating if producer price inflation of 7.1% has a knock-on effect on consumer prices. China has been one of the main beneficiaries of the weaker dollar. Its currency is pegged to the dollar, which helped China to increase exports by 35% in 2004.

In contrast, the Japanese economy continues to limp along. Revised GDP estimates for quarter 3 2004 suggest that the economy grew by just 0.2% on an annualised basis. Unemployment, however, was 4.5% in November, down from 5.2% on a year earlier. Inflation and interest rates remain low.

Although the Tsunami hit a number of Asian countries hard in terms of human and infrastructure costs, the economic impact is not expected to be severe in global terms. A number of the smaller economies struggle, particularly if tourism falls off but most of the bigger economies were largely unaffected.

Performance in the Euro zone remains sluggish despite some signs of optimism earlier in the year. The labour market is also relatively weak with unemployment stuck at around 9%. The problem for the ECB is that growth is being held back by weak domestic demand on the one hand and by a strong Euro which is dampening imports. This is compounded by the fact that inflation remains above the ECB's target rate at 2.3% - the normal remedy would be an increase in interest rates but this would have the effect of further dampening domestic demand and increasing the value of the Euro still further. The performance of the Euro zone is being driven by its two major economies.

The German economy experienced its fastest growth for four years in 2004, though this was still relatively low at 1.7%. Germany, however, typifies the Euro-zone's problems - growth is being driven by exports which are likely to be choked by a high Euro, domestic demand remains weak and unemployment reached its highest level since reunification in December to stand at 10.8%.

The other major Eurozone economy, France, has seen growth slowing recently. The third quarter of 2004 saw the weakest growth for more than a year driven by slower consumer spending. Unemployment remains stubbornly high at around 10%.

Global Outlook

The November Bank of England inflation report expected global growth to pick up after a mid-year dip, predicting growth rates "last seen nearly thirty years ago". Growth is expected to moderate a little in 2005 reflecting higher oil prices though the upward trend is predicted to continue. The OECD's Economic Outlook reports a similar picture with recent strong growth slowing a little but maintaining steady progress in the future. They expect growth to be driven by the Asian economies and North America though they are less certain about the Euro zone.

Domestic Assessment

The strong growth in the United Kingdom continued in quarter 4 2004. GDP increased by 0.7% in the final quarter compared to 0.5% in quarter 3. For the year as a whole GDP was 3.1% up on 2003. The final quarter figures were mainly driven by services which rose 1% quarter on quarter. Production industries, on the other hand, are estimated to have fallen by 0.5% which follows a decline of 1.3% in the previous quarter.

The most recent output data for Wales relate only to production and construction industries for the third quarter of 2004. The overall index for Wales for the latest 4 quarters rose by 4.9% compared to the previous four quarters. Over the same period the UK rose by just 1.4%. The improvement in Wales was as a result of big increases in the utilities and construction, though manufacturing output increased both on the previous quarter and previous year.

Analysis of manufacturer's input and output prices suggests that cost-push inflationary pressures may have eased towards the end of the year. Input prices (what manufacturers buy) fell by 2.3% between November and December – this was the largest monthly fall since July 2001. This fall was mainly due to price reductions in crude oil and machinery. Over the year to December input prices rose by 3.4% compared to an annual rise of 6.7% in November. Output prices rose by 2.9% over the year to December compared with 3.5% in the year to November. The monthly fall between November and December (0.4%) was the largest since November 2001 and was a reflection of price falls in other manufactured and petroleum products. The faster growth in input prices compared to output prices suggests that manufacturers profit margins continue to be squeezed.

The UK trade deficit improved in November to £3.1 billion from £3.6 billion in October. The improvement occurred mainly as a result of a sharp increase in the level of non-EU exports though EU exports also increased compared to October. Both imports and exports have been on a rising trend in recent months and despite the recent improvement, the overall trade balance has been on a worsening

trend.

Welsh exports data for the 4 quarters to quarter 3 2004 showed that the value of exports increased by 7.3% compared to the same period a year earlier. UK exports over the same period increased by a smaller percentage (1.0%). The increase in the Welsh figure was mainly due to a rise in non-EU exports which went up by 14.6% over the period. EU exports also rose but by a smaller amount (4.0%).

UK retailers reported a difficult December. Retail sales figures (volume) fell by 1.0% between November and December – the worst December fall since 1981. However, sales for the quarter were up both on the previous quarter and on the same period a year ago (4.7%) and the December figure was still 3.2% higher than the previous year. A number of major retailers reported a disappointing festive period and a British Retail Consortium survey found that Christmas 2004 was the worst for 10 years. However, it may be too soon to draw any firm conclusions due to timing issues around the Christmas and New Year period.

Recent data suggests that the UK housing market may be cooling a little. Figures from the ODPM suggest that prices fell slightly in November while the Halifax, the country's biggest mortgage lender reported that prices rose in December for the first time since September. The Nationwide also reported a dip in prices, December prices fell 0.2% compared to the previous month. The picture was also supported by figures from the Bank of England which suggested that the number of new mortgages in November fell compared to recent months. Despite the recent cooling annual house price inflation is still high with estimates of around 15% on average.

Headline inflation rose slightly in December to 1.6% from 1.5% the previous month. The rise came as a bit of a surprise and was driven by a number of seasonal factors including increases in some gifts, computer games and air fares. The level remains well below the target rate of 2.0% and the Monetary Policy Committee has kept interest rates on hold at 4.75% since August 2004.

The latest Labour Force Survey data shows that the labour market remains relatively robust at both the UK and Wales levels. The data for November shows that employment levels rose for both Wales and the UK and Welsh employment is at a record level of 1,335,000.

The Welsh (working age) employment rate stood at 72.5% in the three months Sept – Nov and was only two percentage points short of the UK rate (74.8%). The Welsh employment rate is not quite at a record level because of increases in the working age population.

Unemployment remains relatively low. In December the claimant count level was 3,100 below the level of a year earlier while the LFS level for November was 5,000 lower than the previous year. In both cases the unemployment rates have remained fairly constant recently (3.0% for the claimant count and 4.4% for the LFS). The corresponding UK rates are 2.7% and 4.7%.

Overall the labour market performance is still very good. Employment in Wales is at a historically high

level and unemployment remains low.

Domestic Outlook

The Bank of England's Monetary Policy Committee forecast that growth in the UK economy will ease back to slightly below trend in 2005 but recover steadily thereafter. The key drivers of the trend are expected to be an easing off of public spending and private investment initially followed by a positive contribution from net trade and an increase in household spending.

The National Institute for Economic and Social Research predicted in its January forecast that GDP growth in 2004 would be 3% - the ONS preliminary estimate is 3.1%. They expect growth in the current year to be at or slightly above trend.

The latest average of independent forecasts compiled by HM Treasury (January 2005) suggests that the economy will grow by 2.5% in 2005. However, the forecasts range from a low of 1.1% to a high of 3.5%.

Current Business Conditions

Recent evidence from business surveys presents a mixed picture. The Purchasing Managers Index published in January reported that business activity increased for the twenty first consecutive month. Manufacturing outperformed services for the sixth month in a row. New orders were also up with both manufacturing and services reporting increases. The employment index fell slightly though most firms reported no change.

The British Chambers of Commerce quarterly survey showed that business confidence was positive in Wales for both manufacturing and services. Welsh manufacturers were more confident than any other region. Home sales and orders slowed contrasting with export markets where the situation was much more positive. Employment prospects were not so good, particularly in manufacturing where the Welsh index was the lowest of the UK regions.

Overall Assessment

The global economy appears relatively strong with the main drivers of growth being the US and China. Growth is a little more sluggish in the Euro zone where the major economies are struggling, particularly when it comes to job creation. There are risks to the global economy from the uncertainty over oil prices, a slowdown in the US caused by the twin deficits (trade and budget) and a sluggish Europe but these risks should not be overstated. The UK economy is buoyant with growth at trend or above and the labour market in good shape. In Wales the labour market continues to perform well and the recent data for production output and exports are encouraging.

Economic Advice Division

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