# Economic Development and Transport Committee

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| **Date:** | 28 September 2005 |
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| **Venue:** | National Assembly for Wales, Cardiff Bay |
| **Title:** | Quarterly Economic Report |

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## Quarterly Economic Report for Wales

## September 2005

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### Executive Summary

- The US is expected to continue with robust growth despite the devastation caused by Hurricane Katrina.
- The Eurozone continues with sluggish growth though there were encouraging falls in the German and French unemployment rates.
- Growth at slightly below trend is expected in the UK in 2005. The labour market is expected to stabilise having softened in the first half of 2005.
- Business conditions in the UK are generally optimistic with investment, output and employment expected to improve over the second half of 2005. Input inflation, caused by higher oil prices, is a persistent concern.

### Current Global Situation

The impact of Hurricane Katrina on the US economy is not yet known and is not reflected in the most recent data. Whilst the cost is expected to be great in the short-term most analysts expect the economy to continue with robust growth in 2005 and beyond.

Over the three months to June the US economy grew at a rate of 3.3% in comparison with the same period a year earlier. This was less than initial estimates but nonetheless a solid performance. Prior to Hurricane Katrina the US had been expected to grow by 3.5% this year. However, the damage could cost the US economy as much as $100bn (£55bn), which has led the US Treasury Secretary to estimate that as much 0.5% may be knocked off the US's annual gross domestic product.

Labour market data for August showed a cooling of job creation with 169,000 new positions being created, which was lower than expected and down from July's revised 242,000 total. However, US unemployment dropped to 4.9%, the lowest level for four years.

The US Federal Reserve has voted to raise interest rates by one quarter of a percentage point from 3.25% to 3.5%, the 10th increase in succession. The Fed is continuing to raise interest rates in a determined effort to stamp out inflationary pressures and to bring the housing market under control. The most recent inflation figures were much more encouraging than had been expected with an increase in consumer prices of 0.5% over the year to August. Analysts had been concerned that record oil prices would stoke inflation and force the Fed to speed up interest rate rises. Stripping out the effects of volatile fuel and food costs reduces price growth to only 0.1%.

Of more concern is the growth of retail sales, which fell by 2.1% last month compared with the same period a year earlier. This is the largest drop in retail sales since the months following the 11 September terrorist attacks in 2001. The Federal Reserve's stance is that rates are still low enough not to hinder economic growth and that monetary stimulus would be removed at a "measured" pace. Further interest rate increases are expected in coming months.

There was a surprise fall of 2.6% recorded in the US trade deficit from $59.54bn in June to $57.9bn in July despite record oil imports. The $18.5bn shortfall in oil trade was offset by high exports, particularly of cotton and steelmaking products and imports of capital goods such as computers, civilian aircraft and oilfield equipment were sharply down. Analysts said the improvement in the trade deficit was likely to be brief because of the increase in the price of oil.

Prior to the Hurricane the expected budget deficit had been revised down by $94bn (£53bn) less in 2005 than the $427bn that had originally been projected due to increased tax revenues in recent months. Earlier this year the Fed had warned that unless the huge budget deficit was addressed it could have "severe" consequences.

The Chinese economy is still the driving force in Asia with GDP growth of 9% expected in 2005. China has chosen to end its peg to the US dollar after considerable pressure from the US, IMF and the G8. The

Chinese decided in July to strengthen the yuan by 2.1%, and to allow it to float within a narrow 0.15% band either side of a level set by a basket of currencies. However, the Chinese authorities will be careful not to move too quickly on revaluation as this could destabilise both exports and the huge inward investments made by Western firms.

In the long-run China is expected to focus less on export-led growth and more on supplying the needs of its own consumers, the government will benefit as the lower prices for imports will help keep inflation in check. The difficulties in accommodating China as a global trade-partner have been illustrated recently by complicated trade negotiations by both the US and the EU with regard to the exceeding of quota limits in textile (clothing) markets.

Estimates for annual growth rate in Japan have been revised upwards to 3.3%, far stronger than the earlier 1.1% estimate. Hopes of an economic recovery in Japan are based largely upon the recent re-election of the Prime Minister, Junichiro Koizumi. The election was effectively a referendum upon whether economic reforms, of which the centrepiece is a plan to privatise the national post office, are undertaken. The central bank of Japan has kept interest rates virtually at zero for about four years in an attempt to encourage a return to growth. Investors and business leaders are now watching for signs that the Bank of Japan may bank begin to tighten monetary policy.

The Eurozone remains fraught with problems despite falls in both the German and French unemployment rates. The 12-nation Eurozone saw growth falling to 0.3% in the three months to June from 0.5% in the previous quarter leading to an expected annual rate of growth of just 1.2%. Member states that are struggling are Germany, where zero growth was reported, and Greece and Finland whose economies contracted in the second quarter by 0.5% and 1.2%, respectively. In contrast, Italy - whose 0.5% contraction in the first three months of the year stirred talk of their abandonment of the single currency - recovered to growth of 0.7% in the second quarter.

The European Central Bank has kept interest rates at 2% level for more than two years and is optimistic of an upturn in the second half of 2005. Inflation is above the ECB target of 2% though it is expected to fall from 2.2% in July to 2.1% in August.

## Global Outlook

The August Bank of England Inflation report (prior to Hurricane Katrina) expected firm growth in the United States to continue in coming years and a mild recovery in the Eurozone. The OECD and IMF have both played down the impact of the Hurricane upon the world economy. The OECD forecast growth of 3.6% in 2005 provided that the financial and energy market stress can be minimised over the coming months. Analysts argue that the eventual rebuilding of the U.S. Gulf region will start to add to U. S. economic activity data by early 2006.

## Domestic Assessment

Estimated GDP growth for the second quarter of 2005 was 0.5%, which is slightly faster than had been expected due to the performance of the manufacturing sector. However, the annual growth rate, for the year ending July, only amounted to 1.7%, which is below trend. The slowdown in growth during 2005 had been anticipated as part of a more general global slowdown.

There was no growth in retail sales during August though the decline of 0.3% in July has been revised to a larger fall of 0.6%. Contributory factors to the slowdown are concerns over the housing market and higher fuel prices. The annual figures for retail sales growth are still positive at 0.8% yet the consumer slowdown is expected by some analysts to prompt more interest rate cuts.

The latest data from the British Retail Consortium indicates falling demand for furniture, carpets and electrical goods with like-for-like sales falling by 1% in August. Although the decline was an improvement on July's fall of 1.9% (according to the BRC), it marked the fifth month in a row that like-for-like retail sales had fallen.

Consumer price inflation rose to 2.4% in August from 2.3% in July, the highest level since current records began eight years ago. It is the second month running that inflation has been higher than the 2% target set by the government although it is still within the 1 per cent margin of error. The increase in CPI was almost entirely due to increases in petrol costs prior to Hurricane Katrina. The expectation is that the impact of the Hurricane, which sent oil prices soaring, will only be short term. The price of oil has already fallen back from the record level of $70.85 to $64 with further falls expected.

The Bank of England’s Monetary Policy Committee voted in August to reduce the Bank’s repo rate by 0.25 percentage points to 4.5% due to subdued output growth, slower household spending and low business investment growth. The latest decision by the MPC has been to keep interest rates at the same level since any further cuts in interest rates might increase inflationary pressures.

The most recent housing market data indicated that mortgage approvals increased by a more-than-expected 97,000 in July. Across the UK as a whole, the House Price Index increased by 4.0 per cent over the year to July 2005, down on the annual increase to June 2005 (5.0 per cent). **Independent building societies also indicate positive house price growth with activity remaining stable and with signs of increased buyer interest. Expectations of house prices are consistent with a continued controlled slowdown.**

After an improvement in the UK’s trade deficit during June, hopes of an export-driven recovery faded after the deficit widened to £3.4 billion in July. The surplus on trade in services was £1.6 billion in July whilst the deficit in goods was £5.1 billion, which was the same level as that for May.

The most recent labour market figures indicate that the softening in the first half of 2005 may have come to a halt. Although unemployment levels have risen for seven consecutive months the long-term trend is flat and the rate, at 4.7%, is the lowest for 30 years. Employment rates are also higher, at 74.8%, than at any time since comparable records began in 1971. The level of claimant count unemployed in July was unchanged on the previous month and the rate stands at 2.8%. There is some concern that the consumer spending slowdown has put pressure on retailers and other service sector firms with average job vacancies falling by 7,400 in the three months to August.

In Wales the labour market is also stabilising after a softening in the first half of 2005. The unemployment rate has fallen slightly over the year to July and now stands at 4.5%, back below the UK average. Employment has fallen over the year by 0.1% to 71.7%, which is below the record 73% seen in the middle of 2003 but is also well above the 66-68% that was the common experience before 2001. Inactivity remains above the UK average at 24.9%. The claimant count rate stands at 3.1%, which is unchanged upon the previous month but 0.2% higher than a year earlier.

The latest output figures relate to the Index of Production and Construction up until the first quarter of 2005. Over the latest four quarters compared with the same period a year earlier, the overall index rose by 1.2%, which was marginally higher than growth for the UK as a whole (0.8%). Growth in both production and construction output outpaced that of the UK average although there was a contraction in manufacturing output, where as the UK as a whole expanded.

Data relating to exports indicate that Wales had the second highest percentage increase of all UK regions. The value of exports rose by 14.0% over the four quarters to Q2 2005 compared with the same period a year earlier. Over the same period the total of all UK regions was an increase of 4.6%. The majority of the increase in Welsh exports was composed of increases to non-EU countries (26.4%) combined with a less substantial increase to EU destinations (7.9%).

## Domestic Outlook

The August bank of England Inflation report indicates that GDP growth has softened in the past twelve months and is projected to remain a little below trend in the near term reflecting the sluggishness of domestic demand. The profile for GDP growth is weaker in the near term but stronger further out. Inflation is projected to rise above the 2% target, as has already occurred, and then dips as the impact of increased oil prices lessens and pressures on capacity ease.

The most recent average of independent forecasts compiled by HM treasury (August 2005) predicts growth in 2005 of 2.1%. The range of forecasts was from a low of 1.3% to a high of 2.8%.

The CBI’s August Economic Forecast saw a significant downgrade to growth prospects, the estimate for GDP growth being revised from 2.5% to 1.9%. The CBI concurs with the projection of the Bank of England in that a modest acceleration in growth is expected in the second half of this year leading to growth of 2.2% in 2006.

## Current Business Conditions

The latest PMI Wales report indicates a positive outlook for the Welsh economy in August. There were larger than expected rises in growth of output and of new orders for Welsh private sector businesses. The PMI also indicates gains in employment with the rate of growth increasing at its fastest rate since a year earlier, mainly stemming form the service sector. The inflationary effects of higher oil prices led to input price inflation accelerating for the second month running. In order to alleviate the effect of greater cost burdens output prices increased across both sectors.

The most recent CBI industrial trends survey in July, which relates to the manufacturing sector in Wales, was less optimistic. According to the CBI Business sentiment deteriorated over the latest quarter reflecting falls in orders, output and a tightening of profit margins. Costs increased and are expected to continue increasing over the next quarter. The CBI report positive investment intentions for all categories of capital expenditure for the second consecutive quarter. The main reason for increasing capital expenditure being efficiency, with capacity expansion also emerging as a significant factor.

## Overall assessment

With a few exceptions, the current global economic picture is relatively stable at the moment. There is likely to be some short-term shock from Hurricane Katrina but the expectation is that steady growth should be resumed in most regions. The Eurozone remains sluggish and growth in the UK, while below trend, remains positive with a pick-up expected later in the year.