

Economic Development and Transport Committee

Date: Weds September 22nd 2004
Time: 9.00 am to 12.30 pm
Venue: Committee Room 1, National Assembly for Wales, Cardiff Bay
Title: Quarterly Economic Report

Quarterly Economic Report for Wales September 2004

Executive Summary

- Broader economic recovery led by sustained growth in the United States with progressive revival in Japan.
- The Euro-zone still lags behind due to Germany's poor performance, but there does seem to be some recovery despite the appreciation of the Euro.
- Above trend UK output growth in early 2004 is expected to continue but there are signs of a gradual return to trend.
- Overall reports of current UK business conditions from business surveys are strongly positive.

Current Global Situation

The global recovery seems to be well underway with strong growth in the US supporting an expansion in world trade.

The US economy remains the driving force behind global economic recovery. The economy grew by just over 0.7% during the second quarter (2.8% on an annual basis), with above trend growth set to continue. The latest release of the closely watched University of Michigan survey found that consumer confidence in the US has fallen in recent months due to rising inflation and higher interest rates. There are recent signs of gradual employment growth, with unemployment continuing to fall slowly, currently standing at 5.4%. Continued strong output growth is generally expected to continue. The "twin deficits" i.e. America's widening current account deficit and the increasing federal budget deficit have led to some concerns over the certainty of continued growth, with many commentators arguing that the budget deficit is excessive and needs to be brought under control.

The current account deficit is 5.7% of US GDP, which means that the US is borrowing that amount from

the rest of the world. Much of the borrowing is to finance the US budget deficit, which currently stands at 3.8% of US GDP. This borrowing is sustainable only so long as the rest of the world is prepared to lend. This will depend on the perceived sustainability of US fiscal policy.

The Federal reserve has increased the primary interest rate (the rate at which commercial banks may borrow from the federal reserve bank) from 2.0% to 2.5%. This decision was based on the Committee's judgement that the probability of a period of inflation (rising prices) was greater than the probability of a fall in prices.

The Japanese economy grew by 0.3% in Q2, which is a significantly weaker recovery than the market consensus expected. The July to September quarter got off to a weak start with stagnant industrial production, rising unemployment and persistent deflation. Despite this disappointing growth business investment and export levels have increased. Private consumption has also shown signs of recovery. With sales and employment stabilising in recent months, recorded profits were significantly higher than in 2003. This has led to the Economic and Social Research Institute for Japan to report that optimism, though still relatively low, is at its highest level for some years.

Part of the explanation of Japan's upturn may be investment to support increasing exports to other Asian countries, notably China. Recent data suggests that China's growth is slowing from the probably unsustainable 10% rate but remains rapid. Growth of 7.3% is forecast for 2004.

At present exports to China from the UK (and Wales) remain a small proportion of the UK (and Welsh) total; but induced buoyancy elsewhere, especially in Asia, will also tend to boost exports. There has been a noticeable effect through Chinese imports of particular commodities such as cement and steel. Strong Chinese demand is now significant on a world scale. China accounted for just over one quarter of world steel consumption in 2002. Strong Chinese growth may put upward pressure on the price of particular commodities.

The Euro-Zone seems to have passed the turning point on the road to recovery, though the strength of the Euro is hampering the revival. Despite higher retail trade volumes and increasing exports, unemployment remains high at 9%. Several business and consumer confidence indices have been seen to rise in recent months. The ECB has maintained the main interest rate at the low level of 2%.

The poor performance of the euro-zone is largely explained by Germany, where output is growing, but at a rather modest rate. In quarter 2 2004 growth was only 0.5%. An unemployment rate of around 10% remains a major concern. Growth, however, is projected to pick up further into 2004, driven by strengthening exports.

The French Economy continued to look healthy in early 2004 with (quarterly) growth of 0.8%. Unemployment has stabilised but remains high at nearly 10%, which has meant that consumers remain cautious. In recent months industrial production has contracted and general business confidence remains broadly flat. Growth is expected to move roughly in line with the euro-zone average.

The other significant development in the world economy has been a rise in certain commodity prices, notably the price of oil. Measuring in an index of currencies, oil prices have risen by almost 52 per cent over the past year. The rise probably reflects a number of factors including geopolitical risk, reductions in OPEC quotas, the recovery in the world economy and the above-mentioned rapid growth in China. However, after peaking in mid-August at around \$45 per barrel, Brent crude prices have fallen back to just under \$41 per barrel.

Global Outlook

The August Bank of England Inflation report states that the global economic recovery is broadening with growth firming in the Euro-Area and the Japanese economy continuing to expand quickly. There are signs that Chinese growth may be slowing, though the pace of expansion remains rapid. The Monetary Policy Committee expects the global recovery to continue.

The latest OECD global outlook (June 2004) forecasts growth of 3.4% in 2004 with sustained growth in 2005 for OECD countries as a whole. The July 2004 forecast from the National Institute of Economic and Social research puts forward an even brighter view of world prospects. Global growth for 2004 is forecast at 4.2% falling slightly to 4.1% in 2005. Optimistic projections were due to a robust and broadly based recovery in the US, with a rebound in the Japanese economy and a continued boom in China.

Domestic Assessment

Growth in the United Kingdom was well above trend in the second quarter of 2004 (0.9%). This represents a continuation of the above-trend growth at the end of 2003, after the small downturn in Q1. Business survey data remains very strong. The high growth recorded largely results from strong performance in production industries during the second quarter, including manufacturing.

The most recent output data for Wales relate only to production and construction industries for the fourth quarter 2003. The index for Wales over the latest four quarters fell by 2.2% compared with the same period a year ago. The UK index rose by 0.7% over the same period. The difficulties in Wales largely reflect well-known reductions last year in the output of basic metals and opto-electronics. Construction output continues to improve, with fourth quarter growth above that for the UK as a whole. Survey evidence is reporting that production industries are still performing less well than services at UK level, and a similar picture is likely to emerge for Wales.

Output price (what manufacturers sell) annual inflation for all manufactured products stood at 2.6% for August. Input price (what manufacturers buy) annual inflation rose to 4.8%. The rise in the output price measure for all manufactured products reflects price increases in petroleum related products, however this was partially offset by a fall in alcohol product prices. However, the relative rise in input prices will tend to squeeze profit margins in manufacturing.

The UK trade balance reached a deficit of £3.7 bn in July quarter of 2004. The export index remain stable, however the UK import index continues to increase causing the deficit on trade in goods with both EU and Non- EU countries to increase.

Welsh Exports data for the four quarters up to and including quarter 2 2004 showed that exports had increased by 5.2% on the previous four quarters. The value of exports for the UK over the same period also increased, but by a smaller percentage than in Wales (2.3%). The increase in the value of Welsh exports was a result of a large increase in the value of trade with non-EU countries.

Following a sustained period of robust growth since October 2003, a slowdown in the underlying growth rate of retail sales is evident in the latest results for the retail sales index. The volume of retail sales grew by 1.4% in the three months June to August when compared to the previous three months, a significantly smaller growth figure than the recent trend. Many retailers reported negative effects from the poor weather in August.

The housing market is finally showing signs of slowdown, with house price growth hitting a two and a half year low according to the August Nationwide survey. Although the ODPM house price series is showing continued growth the more timely Halifax survey recorded the first fall in house prices for two years. Data from the Bank of England shows that the number of mortgages approved has fallen steeply in recent months. House prices are clearly slowing down but there are no signs that a significant fall is on the way.

Headline inflation for August was below the central target of 2.0% (under the new CPI measure) at 1.3%. In September the Bank of England's Monetary Policy Committee (MPC) decided to maintain interest rates at 4.75%. Commentators still expect rates to continue to rise a little over the rest of the year.

The latest LFS figures (for the three months ending July) show employment down on the same period a year ago by 6,000. There was a fall in the employment rate in Wales over the year of 1.0 percentage point, while the rate for the UK as a whole showed no change. Nevertheless employment in Wales is still being maintained close to the historically high level reached last year.

The overall (working age) employment rate remains at a historically high (though not record) rate of 71.7%, about three percentage points short of the UK figure of 74.6%.

Unemployment performance remains good, but the claimant count in Wales fell by 300 in August, and the rate was unchanged at 3.0%, the lowest level since February 1975. In the UK overall there was a drop in the claimant count in August of 6,100. And the rate was unchanged at 2.7%.

The level of labour market performance is very good even if not quite at record levels. In Wales the employment rate, although it has fallen, is still pretty high by historical standards. Welsh performance still looks fairly strong, although labour market indicators are not quite as robust as in the UK as a whole. If the UK economy can slow to trend with continuing good growth in investment and an

improvement in net exports (which should be helped by reasonable strength in the world economy) this would represent a pretty solid performance. The LFS employment rate in Wales is just below the UK average

Domestic Outlook

The Monetary Policy Committee of the Bank of England forecast that assuming the official interest rate remained at 4.75%, GDP growth would be well above trend over the coming months, sustained by continued buoyancy in public consumption and private investment. The Committee argues that consumer spending will ease in the longer term as domestic demand slows in the face of lower house price inflation.

The July 2004 forecasts produced by the National Institute for Social and Economic Research advise that the UK economy will grow by 3.3% in 2004. Above trend growth will continue in 2005 with growth of 2.7% forecast.

The latest average of independent forecasts compiled by HM Treasury (August 2004) suggests that the UK economy will grow by 3.3% in 2004. But the forecasts range from a lowest estimate of 2.5% and a highest of 3.6%.

The latest regional economic forecasts (August 2004) published by Cambridge Econometrics predict UK economic growth (Gross Value Added) of 3.1% in 2004, with growth expected to remain stable in 2005; and Welsh growth of 3.4% in 2004 and 2.7% in 2005.

Current Business Conditions

Recent business survey evidence has reported high levels of optimism. The Purchasing Managers Index and British Chambers of Commerce surveys both recorded increased business confidence, perhaps due to further increases in new orders. The PMI continues to record that the Welsh business activity Index is rising at a faster rate than the UK Index. The BCC reports that confidence in both the manufacturing and service sectors in Wales is above the national average. The BCC and Cardiff Chambers of Commerce both recorded an increase in Welsh sales and orders with the CCC reporting domestic sales in the service sector to be at their highest level since June 2001. The BCC also reported strong evidence of an increase in manufacturing investment. The CCC also recorded the highest manufacturing employment index level since September 1997.

The Welsh Index of Production and Construction fell during quarter 4, 2003. However construction output continues to improve with strong quarterly growth. Export prospects in Wales seem strong and broadly in line with the UK as a whole. Overall investment remains largely unchanged.

Overall Assessment

World growth continues to look strong, being driven by continuous US growth. Domestically, there are some signs that the interest rate rises are taking effect and UK growth is slowing and returning to trend. The UK is, however, performing better than the euro -zone and this trend looks set to continue. Wales is likely to share in this broad picture. The labour market data shows Wales consolidating its recent very good performance; and the Welsh Export data are encouraging.

Economic Advice Division
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