

# Enterprise, Innovation and Networks Committee

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**Title: Quarterly Economic Report**

### Quarterly Economic Report for Wales March 2007

#### Executive Summary

The final quarter of 2006 showed signs of some weakening in the US economy with GDP growth revised downwards. Although consumer expenditure has remained broadly strong, weakness in the housing market has been dragging down real

GDP growth by over one percentage point and concerns over mortgage repayments led to falls in the US stock markets. Prospects across the Eurozone appear to be stronger with an acceleration in GDP as a consequence of a strong increase in investment and a rise in exports. Consumer confidence remains high following further improvements across European labour markets. The Japanese economy continues to show signs of expansion with the highest annual increase in GDP for five years. Following concerns that the Chinese economy was showing signs of overheating the Central Bank raised interest rates and introduced new measures to reduce consumer credit. These measures help to slow GDP growth in the second half of 2006 but the annual rate of growth was 10.7 per cent, the fourth successive year GDP growth has reached double figures.

In the UK, GDP continues to rise at trend or better, production output remains broadly flat while service sector output continues to rise. Retail sales fell in January following strong December trading but the overall trend remains robust. With headline inflation falling in January, the MPC maintained interest rates at 5.25 per cent. In Wales, GDP growth in 2005 kept pace with the UK average. After several months of stability, the labour market appears to be improving with a rise in employment to record high levels. The value of Welsh exports for the whole of 2006 rose by 7.5 per cent compared to 2005, the sixth highest amongst the UK countries and English regions. Manufacturing output fell further in the third quarter of 2006 while output in the service sector increased.

#### Current Global Situation

##### US

GDP for the fourth quarter of 2006 was revised downwards to 2.2 per cent from the provisional estimate of 3.5 per cent. Although the contribution from consumer expenditure rose during the fourth quarter there was a significant fall in private investment in particular residential investment reflecting

softening in the housing market. The number of new home sales fell by nearly 17 per cent between December and January, the biggest drop since 1994.

According to survey evidence the business outlook has improved with a rise in new business orders and production in February in both manufacturing and non-manufacturing sectors. In the non-manufacturing sectors this was the 47<sup>th</sup> consecutive monthly increase while the rise in the manufacturing index followed the contraction reported in January.

The labour market picture remains robust with a continued increase in employment and unemployment remaining broadly flat at 4.5 per cent. Reflecting the improvements across the labour market, the Conference Boards consumer confidence index rose to a 5-year high. Despite this rise in confidence, retail sales for February rose by only 0.1 per cent.

The latest minutes from the Federal Reserve pointed to some uncertainty over inflation. Core inflation, which excludes food and energy rose by 0.3 per cent in January and by 2.1 per cent compared to the previous year. The Federal Reserve, however maintained interest rates at 5.25 per cent due to the downside risks to economic activity following the slow down in the housing market.

## **Japan**

During the fourth quarter of 2006 the rate of GDP growth in Japan rose by 1.3 per cent, up from 1.2 per cent in the previous quarter. Annual GDP growth for 2006 was 5.5 per cent, the highest annual increase for five years. In light of the strong GDP figures the Bank of Japan raised interest rates to 0.5 per cent.

There are, however, signs of weakening in the household sector with a fall in consumer spending in December and a rise in unemployment from 4 per cent in November to 4.1 per cent in December. In the corporate sector industrial output fell by 1.5 per cent in January, however business investment increased with further increases in corporate profits. The business outlook for the early part of 2007 has shown a modest improvement.

## **China**

Following concerns that the Chinese economy was overheating, the central bank raised interest rates twice in the second half of 2006 and imposed stricter requirements for central banks in an attempt to reduce credit. Stricter policies on land supply were also implemented. These measures helped to ease the rate of investment but this was partially offset by a continued rise in exports. While the quarter-on-quarter GDP growth rate did ease during the third and fourth quarters of 2006, the annual rate of growth reached double figures for the fourth successive year with an annual growth rate of 10.7 per cent.

As exports continued to outpace imports by a large margin, the trade surplus reached new record highs and the contribution of net trade to GDP growth increased from almost 2 percentage points in the first half of 2006 to 3.3 percentage points in the second half. The World Bank estimate that China's current account surplus has overtaken Japan's in 2006 to be the world's largest.

## **Eurozone**

GDP in the fourth quarter of 2006 rose by 0.9 per cent compared to the previous quarter and 3.4 per cent compared to the same period in 2005. The quarterly increase was above that seen in the third quarter of 2006 (0.6 per cent). The acceleration in GDP was as a consequence of a strong increase in investment and a rise in exports. In addition the contribution from consumers increased, a trend seen throughout 2006 assisted by favourable labour market conditions. Unemployment fell further in January and is 0.8 percentage points below the rate seen last January. In Germany the unemployment rate fell to 7.7 per cent from 7.9 per cent in December while the rate in France fell to 8.4 per cent from 8.5 per cent.

Inflation fell below the 2 per cent inflation target to stand at 1.8 per cent in February according to the Eurostats flash estimate. Despite this fall, the European Central Bank raised interest rates by 0.25 percentage points with the headline rate at 3.75 per cent. This decision was taken in view of the upside risks to price stability over the medium term following the strong growth in GDP.

## **Domestic Assessment**

### **UK**

GDP rose by 0.8 per cent in the fourth quarter of 2006, compared to 0.7 per cent in the third quarter. Growth in the fourth quarter came from the service and construction sector while output in the production sector fell. For the year 2006 as a whole GDP rose by 2.7 per cent over 2005.

The UK deficit in trade in goods and services was £3.8 billion in January, compared with a deficit of £4.5 billion in December 2006. The surplus on trade in services was £2.4 billion in January, the same as in December. The deficit in trade in goods in January was £6.2 billion, compared with a deficit of £6.9 billion in December.

The index of services indicated that service sector output rose by 1.0 per cent in the three months to December compared to the three months to September. All five sub-sectors of the overall index reported an increase in output; the most significant increase was in business services and finance. Distribution output rose by 1.5 per cent in the three months to December. This was the strongest three month growth since May 2004. Hotels and restaurants output rose by 0.7 per cent in the three months to December while output from transport, storage and communications rose by 1.1 per cent compared with the three months to September.

According to the Index of production, overall production output was unchanged in the three months to January compared to the three months to October. Despite the 0.1 per cent increase in manufacturing output, and a 0.9 per cent increase in the energy supply sector, overall production output remained unchanged because of a 1.4 per cent decrease in output recorded in the mining and quarrying sector.

Retail sales slowed in January reflecting the seasonal fall in sales volumes following strong

December trading. The biggest contributions to the monthly fall came from clothing stores where sales fell by 4.4 per cent, household goods stores where sales fell by 4.2 per cent and 'other' non-food stores where sales fell by 3.7 per cent. The total volume of sales in January was 3.3 per cent higher than in January 2006. The volume of retail sales in the three months November to January was 0.9 per cent higher than in the previous three months, much inline with longer term trends.

CPI annual inflation fell to 2.7 per cent in January compared to 3.0 per cent in December. The December annual inflation rate was equal to the upper limit of the Bank of England's symmetrical inflation target. The largest downward effect on the CPI annual rate came from transport costs reflecting falls in the prices of fuels and lubricants and air travel. In the March meeting of the Monetary Policy Committee, The Bank of England maintained interest rates at 5.25 per cent.

According to the HPI, average house prices across the UK rose by 10.9 per cent in January 2007 compared to 9.9 per cent in December 2006. The price of the average house in January stood at ? 205,286 for the UK as a whole while the comparable figure for the UK excluding London and the South East of England was £178,346.

For the UK as a whole, total employment in the three months to January 2007 increased by 221,000 (or 0.8 per cent) on the previous year and an increase of 18,000 on the previous quarter. Despite this increase, the employment rate fell by 0.1 percentage points on the previous year and quarter to stand at 74.4 per cent.

ILO unemployment for the three months to January 2007 was up 151,000 on the previous year but down 3,000 on the previous quarter. The rate was 5.5 per cent, up 0.4 percentage points on the previous year. Claimant count unemployment decreased by 3,800 between January and February. The rate, however, was unchanged on the month and previous year at 2.9 per cent.

The UK inactivity figures for those of working age showed a reduction of 71,000 over the year, with the rate down 0.3 percentage points to 21.1 per cent.

## **Wales**

GVA in Wales in 2005 was estimated at ?40.9 billion, an increase of 3.9 per cent on 2004 and in line with the increase seen across the UK as a whole. GVA per head in 2005 increased by 3.7 per cent compared to 3.3 per cent for the UK as a whole. GVA per head in Wales in 2005 was 78.1 per cent of the UK average, the lowest amongst the devolved countries and English regions. This ranking for Wales has not changed since 1998. Estimates for 2004 show headline GVA per head in East Wales and West Wales and the Valleys at 100 per cent and 65 per cent of the UK average respectively.

The value of Welsh exports for the whole of 2006 rose by £646 million (7.5 per cent) compared to 2005. The increase for Wales was made up of an increase of £485 million in exports to non-EU countries (up 14.9 per cent) and an increase of £162 million in exports to EU countries (up 3.0 per cent). The Wales percentage increase between 2005 and 2006 was the sixth highest amongst the devolved countries and English regions.

The Index of Production for Wales for the four quarters to Quarter 3, 2006 (2003=100) fell by 0.9 per cent compared to the previous four quarters. Although there was an increase in output in the mining & quarrying sector, this was offset by a decrease in the manufacturing sector. The Index of Construction fell by 1.5 per cent in Wales over the same period compared to a marginal increase (0.3 per cent) across the UK.

The experimental Index of Distribution for Wales for the four quarters to Quarter 3 2006 rose by 5.8 per cent compared with the previous four quarters. The most significant rise was in retail output which increased by 10.3 per cent. Wholesale output for the latest four quarters also rose. This rises were partially offset by a fall in motor trade output.

The experimental Index of Hotels & Restaurants for Wales for the four quarters to Quarter 3 2006 rose by 3.8 per cent compared with the previous four quarters. All three components of the index rose with the largest increase in restaurants and catering.

The experimental Index of Transport, Storage and Communication for Wales for the four quarters to Quarter 3 2006 rose by 2.3 per cent compared with the previous four quarters. Falls in output in the land transport sector were more than offset by increases in the post and communications and transport support sectors.

Over the year to January 2007, the HPI in Wales increased by 10.2 per cent, up on the annual increase to December 2006 (9.1 per cent). This compares to an annual increase of 10.9 per cent across the UK. The average house price in Wales in January 2007 was £162,610 compared to £205,286 across the UK and 3178,346 across the UK excluding London and the South East of England.

After several months of broad stability, the labour market in Wales has shown signs of further improvement. Total employment in Wales in the three months to January 2007 stood at 1,352,000. This is a new record high, up 29,000 on the same period a year earlier and up 13,000 on the previous quarter. The employment rate amongst the working age was 72.2 per cent, up 0.5 percentage points on the previous year and on the previous quarter.

The ILO unemployment rate in Wales was 5.2 per cent, up 0.1 percentage points on the previous year but down 0.1 percentage points on the previous quarter. The claimant count level in February 2007 was up by 100 compared to January. Despite this increase the claimant count level was down 4.3 per cent compared to February 2006.

Economic inactivity in Wales for the three months to January fell by 10,000 compared to the same period in the previous year and by 7,000 compared to the previous quarter. The rate was 23.8 per cent, down 0.7 percentage points on the previous year.

The latest sub Wales employment data from the Annual Population Survey (previously the Welsh Local Labour Force Survey) shows that the employment rate in West Wales and the Valleys was 69.5 per cent in the year to 30 June 2006, whilst that for East Wales was 73.9 per cent (Wales: 71.1 per cent, UK: 74.1 per cent). In West Wales and the Valleys, the employment rate was unchanged on the year to 31 March 2006, and up 2.4 percentage points on 2001. In East Wales, it was up 0.2

percentage points on the year to 31 March 2006, and up 1.3 percentage points on 2001.

## **Summary of Business Surveys**

The latest business surveys for the fourth quarter of 2006 are reporting a rather mixed picture, although in the main the leading indicators still show positive views of business performance and perceptions.

In the manufacturing sector, according to the CBI the volume of output fell amongst the majority of survey respondents. This fall follows strong growth reported in the previous quarter's survey. The CBI also reported a fall in the proportion of businesses reporting a rise in the volume of orders. The British Chambers of Commerce survey, however, reported a slight increase in the number of businesses reporting a rise in the volume of domestic orders and a slight fall in export orders. Both the CBI and the BCC surveys reported an expected rise in output/turnover over the next three months. As in the previous quarter the employment position in the manufacturing sector worsened with a further reduction in head count expected by the majority of respondents.

The picture in the service sector was also a little mixed. The majority of respondents recorded a rise in home sales but a fall in home orders. Respondents also reported a fall in export sales and orders compared to the previous quarter. While service sector businesses expect both turnover and profitability to increase over the next quarter, businesses were less optimistic than in the previous quarter. Employment prospects in the service sector remained broadly flat.

The Purchasing Managers Index for Wales (which covers both the manufacturing and service sector) reported a rise in private sector output for the forty-sixth consecutive month. The proportion of respondents reporting a rise in the new orders slowed but remained positive. The PMI reported a rise in employment for the tenth consecutive month.

## **Economic Forecasts**

The latest economic forecasts from Cambridge Econometrics estimated that GVA growth in Wales was below the UK average in 2006 (2.4 per cent in Wales compared to 2.7 per cent for the UK). In 2007, Wales is forecast to match the UK annual growth of 2.5 per cent, but growth in 2008 is forecast to be below the UK figure with an annual growth rate of 2.2 per cent compared to 2.5 per cent. While manufacturing output is set for further modest recovery, output growth is expected to be slower in the main services industries compared to recent years. In services, the main slowdown in growth is expected in Financial & Business Services as the strong growth in call centres that characterised the 1990s in Wales has slowed down with future prospects for investment expected to be limited. Over the longer-term GVA growth in Wales is forecast to lag that of the UK by approximately one quarter of a percentage point with average annual growth rates of 2.4 per cent between 2005 and 2010 compared to 2.7 per cent across the UK.

Total employment in Wales is forecast to increase during 2005-10, albeit at a slower rate than seen during 2000-05. The average annual growth rate in employment between 2005 and 2010 is expected to be 0.9 per cent compared to 0.7 per cent across the UK. Manufacturing employment is expected to

decline further but at a slower rate than seen during 2000-05. This fall is expected to be offset by further increases in service sector employment although at a lower annual percentage increase than seen during 2000-05.