

Economic Development and Transport Committee

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Quarterly Economic Report for Wales January 2006

Executive Summary

The high trade deficit and the likely cessation of interest-rate rises in the US has led analysts to suggest that the dollar will weaken in 2006. The Japanese economy is showing signs of improvement while GDP grew in China in 2005 at 9.9%, to reach a level which may place it as the world's 4th largest economy. Within the Eurozone, interest rates were raised for the first time in two and a half years. Germany is showing signs of economic recovery. The UK economy showed mixed signals with the current account deficit widening in November 2005 and annual productivity growth falling in the third quarter of 2005 but manufacturing output increased between October and November 2005, as did the volume of retail sales between September and November. In Wales, GVA rose in 2004, earnings increased between 2004 and 2005 and exports in the four quarters ending September 2005 rose over the previous four quarters. However, the employment rate declined slightly in the three months to November 2005 while the unemployment rate rose slightly on the same period in the previous year.

Current Global Situation

USA

A new Chairman of the Federal Reserve has been nominated to replace Alan Greenspan (who will depart next month). Early indications are that he will aim for continuity of the Greenspan approach, so this is not expected to bring about radical change. However, the period of interest-rate increases which has been in place since June 2004 is reaching an end. This was thought to be responsible for the dollar hitting a two-month low against the Euro at \$1.21 on January 4th. This likely cessation of interest-rate rises coupled with the trade deficit reaching a record high of \$68.9bn in October 2005 has led some analysts to suggest that the dollar will fall in 2006.

Although productivity growth in the non-farm business sector rose by 4.7% in the 3rd quarter of 2005 and GDP rose at an annual rate of 4.1% in quarter 3 of 2005, other statistics point towards a less buoyant

economy: the index of manufacturing activity published by the Institute of Supply Management showed a greater fall than expected in December, reaching a four-month low; the unemployment rate in December rose by only 0.1% to 4.9%; and the consumer price index (CPI) fell by 0.4% in December 2005 on the previous month, signalling a 3.4% increase on December 2004.

Japan

The Japanese economy has been giving out mixed signals. After five years of falling prices, (with the exception of a temporary 'blip' in October 2003) the core rate of consumer price inflation (excluding fresh foods) turned positive (0.1%) in the year to November 2005. However, the overall headline inflation continued to fall at an annual rate of 0.8%. It is hoped that this change in consumer price inflation signals and end to the period of deflation, from which Japan has been suffering. Indeed, the group of forecasters polled by The Economist predicts that prices will rise by 0.3% in 2006.

The unemployment rate rose to 4.6%. A more optimistic picture is painted by the ratio of job vacancies to applicants which rose to its highest since 1992, and suggests an improvement in the labour market.

China

China revised its annual growth figures upwards in December such that the economy in 2004 was found to be 17% greater than previously reported. Meanwhile figures for 2005 show GDP growth of 9.9% which may place it 4th in the world, overtaking France and the UK. The OECD predicts GDP growth of 9.4% in 2006.

China recorded a trade surplus in December of \$11bn, nearly the same amount as the same month in 2004, maintaining a trend evident since August of strengthening imports on the back of a revival in domestic demand.

Eurozone

After two and a half years of maintaining interest rates at 2%, the ECB raised interest rates on 1st December 2005, by 25 base points to 2.25%. The decision should assist in keeping medium to long-term inflation expectations at levels consistent with price stability. The average inflation rate slowed to 2.2% in the 12 months to December, down from a recent high of 2.6% in September but remains in excess of a target rate of 2%. Recent data and survey evidence suggest that in the second half of 2005, economic activity strengthened: Eurostat's first estimate of GDP growth for quarter three was 0.6% on the previous quarter. Eurosystem staff projections forecast GDP to grow between 1.4% and 2.4% in 2006 and 2007. Despite such indications of a strengthening economy, the Eurozone's cumulated current account was in deficit by €20.312bn in the 12 months to November, compared to a surplus of €42.6bn a year earlier.

Unemployment in the Eurozone was 8.3% in October, down from 8.8% a year earlier. France and

Germany saw unemployment fall to 9% and 11.2%, respectively in December. In the case of France, while this signals an improvement in the labour market, due to government interventions such as subsidised wages for trainees, it is difficult to ascertain the extent to which this signals an upturn in the economy. For Germany there are further signs of economic recovery such as industrial orders rising 1.7% in November. In January 2006, the IFO Institute's business climate index reached its highest level since May 2000, suggesting business optimism. However, recent GDP growth figures of 0.9% in 2005, compared to 1.6% in 2004, indicate that although there are signs of recovery, the rate has so far been slow. Optimism has been dampened by retail sales figures for December, which were released at the end of January. Contrary to an expected rise, these showed a fall in retail sales of 1.4% compared to November 2005. This has given rise to fears that overall growth weakened at the end of 2005 which have been augmented by the release of January's unemployment figures which show a rise to 11.3%. Although the election of Angela Merkel as head of the grand coalition seems to have been heralded by the German populace as a chance to drive the economy forward, the government faces the challenge of attempting to reduce the federal deficit without slowing down the economy. Problems of labour market inflexibility resulting from labour legislation could prove more difficult to resolve under the grand coalition that emerged after the election than if a clear mandate had been won. Failure to push forward labour market reform would limit the country's ability to achieve sustainable economic growth. As the largest country in the Eurozone, this has important implications for the Euro area itself.

Domestic Assessment

UK

Recent UK statistics provide a mixed picture of the UK economy. On one hand, the current account deficit increased by £8.8 billion between the second and third quarters of 2005 to £10.2 billion. This is equivalent to -3.4 per cent of GDP, and represents the largest deficit as a percentage of GDP since the fourth quarter of 2000. The deficit on trade in goods and services widened in November to £4.5 billion from a revised deficit of £3.4 billion in October. This can be attributed to a fall in exports of 0.4 per cent over the third quarter, within which exports of goods rose by 0.4 per cent and exports of services fell by 2.0 per cent. Imports rose by 1.9 per cent as imports of goods rose by 2.6 per cent and imports of services fell by 0.8 per cent.

Annual productivity growth fell in the third quarter of 2005, to 0.4% (measured by output per worker), down from growth of 0.6 per cent in the previous quarter. This was due to the increase in whole economy employment more than offsetting an increase in output. Growth in the third quarter of 2005 was driven by a rise of 0.7 per cent in the service sector, with strength shown within the business services and finance, government and other, and transport and communication sectors.

GDP rose by 0.6 per cent in the fourth quarter of 2005, up from 0.4 per cent in the previous quarter. For the year 2005 as a whole GDP increased by 1.8 per cent over 2004.

On the other hand, between October and November, manufacturing output increased by 0.4 per cent.

The overall Index of Production increased by 0.6 per cent between October and November. Within the energy supply sector, the gas supply output increased by 10.4 per cent. November was colder than the long-term average temperature and this increased demand for gas within the UK for heating purposes.

The Index of Distribution rose by 0.7 per cent in the three months to November compared with the three months to August. The most significant increase was in retail; wholesale output also increased. There was, though, a decrease in the motor trades.

The Consumer Price Index measure of annual inflation fell to 2.0 per cent in December 2005, down from 2.1 per cent in November. Meanwhile, the headline rate of retail price inflation - which includes mortgage interest payments - fell to 2.2% from 2.4% a month earlier.

The volume of retail sales in the three months October to December 2005 was 1.6 per cent higher than in the previous three months, the highest since July 2004. This follows growth of 1.0 per cent in the three months to November and compares with a decrease of 0.3 per cent at the same time in 2004.

For the UK as a whole, in November 2005, the employment rate was 74.5 per cent, down 0.3 percentage points on both the previous year and the previous quarter. The ILO unemployment for the three months to November 2005 was up 121,000 on the previous year and 111,000 on the previous quarter. The rate was 5.0 per cent, up 0.3 percentage points on the previous year. The claimant count increased by 7,200 (or 0.8 per cent) between November and December. The rate was unchanged on the month at 2.9 per cent, but up 0.3 percentage points on the previous year.

Wales

According to the Labour Force Survey, the employment rate in Wales amongst the working age population in September to November was 71.8 per cent, down 0.6 percentage points on the previous year and down 0.1 percentage points on the previous quarter. The unemployment rate in Wales was 4.7 per cent, up 0.3 percentage points on the previous year. The claimant count level in December was up 300 (or 0.7 per cent) on November. The rate was unchanged on the month at 3.3 per cent but up 0.4 percentage points on the year. In December 2004, according to the Annual Business Inquiry, there were 1.161 million employee jobs in Wales, 3.9 per cent higher than the figure of 1.117 million in 2003 and 8.6 per cent higher than the figure of 1.070 million in 1999.

Between 2004 and 2005, earnings in Wales rose by 3.6% compared to a 3.7% rise for the UK as a whole, so that average earnings in Wales in April 2005 stood at £454.4.

Total headline GVA in Wales in 2004 was £39.2 billion, up 5.0 per cent on 2003. Headline GVA per head in Wales in 2004 was £13,292 or 79.1 per cent of the UK average, its highest level relative to the UK average since 1998.

Over the year to November 2005, the House Price Index in Wales increased by 6.5 per cent, down on the

annual increase to October 2005 (8.8 per cent).

The Index of Distribution for Wales for the four quarters to the second quarter of 2005 rose by 2.6% compared with the previous four quarters. There were increases in the Retail and Wholesale sectors which were offset by a decrease in the Motor Trade.

The Index of Production for Wales for the latest four quarters fell by 5.8 per cent compared with the previous four quarters. There was an increase in the Mining & quarrying sector, which was offset by decreases in the Electricity, gas & water and Manufacturing sectors. The UK index fell by 1 per cent over the same period. Manufacturing output in Wales fell by 0.1 per cent in the latest quarter compared with the previous quarter. The UK index fell by 0.2 per cent. Construction output in Wales for the latest quarter decreased by 2.7 per cent compared with the previous quarter. In the same period, UK output increased slightly by 0.4 per cent.

Exports of goods for the four quarters ending in September 2005 from Wales rose by £727 million (9.3 per cent) over the previous four quarters. USA was the largest export market for Welsh products, followed by Germany, Ireland, France and Belgium.