

Date: 30 January 2003
Time : 9:00 to 12:30
Venue: Committee Room 3, National Assembly for Wales, Cardiff Bay
Title: Quarterly Economic Report - January 2003

Quarterly Economic Report for Wales - January 2003

Executive Summary

- Many forecasters are now expecting significant recovery to be delayed until 2004 but with moderate growth in 2003.
- The Eurozone recovery has lost some momentum. Germany has experienced low growth and rising unemployment.
- The UK labour market remains remarkably robust. Economic growth continues, but many forecasts for 2003 (including the Chancellor's) have been revised downwards.
- In both the UK and Wales the performance of the service sector has been better than the production sector. The latest business surveys give conflicting evidence about prospects.
- Over the longer term a healthy recovery requires some rebalancing of the economy away from consumption and towards investment and exports.

Current Global Situation

Following rather subdued growth in the second quarter of last year, **US GDP** rebounded strongly in Q3. The major contributor to Q3 growth was private consumption, private investment dropped off considerably.

More recent evidence is a little mixed. Manufacturing activity rose following three months of decline according to survey evidence and the new orders index recorded its biggest monthly increase since 1980. Activity in the non-manufacturing sector continues to increase, although at a slower rate than in previous months. However industrial production fell slightly month on month, contributing to a considerable quarterly fall and consumer sentiment continues to deteriorate. Both the present and expectations index fell fuelled by concerns regarding the labour market. Despite the falls in confidence, retail sales have held up fairly well.

The US trade deficit continues to widen. The dollar has weakened significantly against the euro. The increase in imports thus far has helped prop up growth elsewhere in the world. But this stimulus to world growth could be attenuated if the US economy slows down, or if a dollar depreciation cuts import growth.

Despite better than expected economic growth in **Japan**, recent indicators show mixed prospects. Industrial output has fallen for the third consecutive month. Business conditions improved slightly towards the end of 2002. However, the business outlook is expected to deteriorate across all sectors in 2003 according to survey evidence. Unemployment rose to levels not seen since the 1940s, until a slight fall in unemployment late in 2002. Nevertheless the Bank of Japan has revised down its growth forecasts for next year.

Growth across **Europe** failed to gather momentum during the second half of 2002, with fears of stagnation emerging. These fears prompted the ECB to cut interest rates by 0.5 percentage points to 2.75%. But the latest indicators show that industrial production contracted in Q4. The manufacturing Index in December fell at its fastest rate for eleven months while the new orders index fell below the no change level. In the service sector, business activity remains flat, as downturns reported in Germany offset growth in other main economies. But unemployment remains stable at 8.4%, while **inflation** has fallen slightly to 2.2%.

The situation in **Germany** continues to deteriorate. Growth in Europe's leading economy grew at an annual rate of 0.2% in 2002, its lowest annual rate since the 1993 recession. Industrial production has contracted for the second consecutive month, while unemployment has reached a four-year high. Contraction in manufacturing has gathered pace according to survey evidence with falling output and order books. The service sector also reported contraction, for the fifth consecutive month. The EC also confirmed that Germany must reduce its budget deficit or face financial penalties following forecasts that the public sector deficit for 2002 would exceed the imposed ceiling of 3% of GDP.

The **French** economy is showing some signs of slowing following encouraging growth earlier in 2002. Concerns over the labour market continue despite unemployment (currently at 9%) stabilising. Consumer confidence remains low. Industrial production, however, rose in November, following a previous fall. Business confidence remains low, but is showing some signs of improvement.

Global Outlook

The OECD forecast that economic growth will remain weak in 2003, but with growth accelerating in 2004. Current political tensions have contributed to a rise in oil prices to a two-year high. The decision by OPEC to increase output resulted in only a temporary fall. Commentators such as US Federal Reserve chairman Alan Greenspan have stated that associated uncertainties are likely to restrict growth.

Domestic Assessment

UK performance has held up well by international standards. Preliminary estimates for Q4 GDP growth showed an annual growth rate of 1.7%, a fraction lower than some forecasts, but still a reasonable rate given the world situation. Service sector growth had slowed. Claimant count unemployment has continued to fall and is at levels not seen since the 1970s and employment is up over the year. It remains the case that some parts of the economy are performing better than others, with the production sector performing less well than services. However manufacturing output in the UK rose in November for the first time for four months though mining, electricity and gas performed less well.

Headline inflation fell in December from November's four year high. Although the underlying rate stood at 2.7%, which is slightly above the target rate of 2.5%, there are no signs of a sustained pick up in inflation which would lead the Bank of England's Monetary Policy Committee to raise interest rates sharply. Interest rates were left unchanged at 4%. The one area where prices are rising fast is housing. House prices rose at an annual rate of over 25% in 2002. This increase in household wealth may be helping to support the strength of consumer spending.

The latest indications we have on consumption are for retail sales (which accounts for a substantial part of consumer spending). Despite the concerns expressed by a number of high street retailers, the **Retail sales** figures in December were 1.1% higher than in November and 6.4% higher than the December 2001 level, indicating that consumption remains strong.

The picture on exports and investment is less robust. Exports have fallen, no doubt because of weakness in foreign markets (see also surveys below)) rather than changes in UK competitiveness. And investment remains weak.

The recent data for Wales suggest cautious optimism. The latest figures (Q3 2002) from the **Welsh Index of Production and Construction** continue to show signs of improvement. The overall Index shows the third quarterly rise in succession and the year-on-year figure has risen by 1.5 percentage points. Comparing the latest 4 quarters with the previous 4 quarters the Index is still down but this is entirely due to falls in the first half of last year and is less than that experienced in the UK during the same period. Following the rise in Q2, manufacturing output experienced a moderate fall in Q3. The other components of the Index have risen.

The **labour market** in Wales remains remarkably robust given the overall economic situation. Over the last twelve months it would appear that Wales is performing slightly better than the UK as a whole. Employment increased by 36,000 over the year in Wales. Indeed, Wales has seen the biggest increase in the **employment** rate of any region of the UK and the biggest fall in the **inactivity** rate. Although ILO **unemployment** has risen very slightly in Wales and the

UK over the year, on the Claimant Count measure, the unemployment rate in Wales fell by 0.2 percentage points compared to 0.1 percentage point in the UK. As in the UK overall manufacturing employment has fallen, but that has been offset by increases in services, both private and public.

Business failures across Britain increased by 7.2% to nearly 43,500, the highest number since the recession in 1994. Business failures increased in all but two regions. In Wales, the number of business failures increased by 1.6%. Quarter-on-quarter the number of business failures fell by nearly 9%, compared to 5% in the UK. The number of business failures in Wales has fallen in each quarter since Q1 2002.

Domestic Outlook

The Chancellor, as was widely anticipated revised down his growth forecasts for 2003 to 2.5-3% and for 2004 to 3-3.5%. The average of independent forecasters is similar: growth is forecast to be 2.6% in 2003.

The latest forecasts produced by Business Strategies / Experian (Autumn 2002) forecast UK GVA growth of 1.2% in 2002 rising to 2.5% in 2003. In 2002, Wales was forecast to have out-performed the UK, with growth of 1.8%. However BSL/Experian are clearly at the pessimistic end of forecasts.

More up-to-date economic forecasts are due to be published in Spring 2003.

Current Business Conditions

Recent business survey evidence has been conflicting. The CBI (manufacturing only) reported deterioration in **overall confidence** amongst manufacturers in both Wales and the UK. The BCC (both manufacturing and services), however, suggested a more optimistic outlook with expectations for profitability in Wales well above UK levels. Confidence in the service sector continues to improve as prospects for turnover and profitability rise in Wales, again above UK levels. Cardiff Chambers of Commerce also reported that confidence was high in both sectors in South East Wales.

Reports regarding the **domestic market** for manufacturers was also mixed. The CBI reported that a higher proportion of Welsh manufacturers reported a fall in domestic orders and deliveries with further falls expected. The BCC reported that domestic sales have rebounded following recent falls. Service sector performance in the domestic market once again improved.

Confidence in the **export market** has deteriorated following three consecutive quarters of improvement, according to the CBI. The main factor cited is weak growth in export markets rather than rising costs or other factors. The CBI and BCC reported a rise in the proportion of

firms reporting a fall in export sales and orders.

Cardiff Chambers of Commerce reported that domestic and export sales rose according to their quarterly survey. Prospects for future sales are down a little as domestic and export orders fell slightly.

A new Purchasing Managers Index (PMI) Survey for the UK regions suggested that Wales was out performing the UK on a number of important measures including business activity, new orders and employment. The PMI survey is regarded as a key world-wide economic indicator.

Potential risks to domestic outlook

The UK economy has been performing well, but the imbalances between different parts of the economy are a cause of concern. In the long run it is not sustainable for the trade position to continue to deteriorate and consumers' indebtedness cannot increase without limit. A satisfactory outcome would be for consumption growth to slow while investment and net exports picked up. Most commentators remain of the view that this will happen slowly over the course of the next year or so. The risks are either of an outright recession in world markets, as opposed to the current situation of weak but positive growth, or of a sharp retrenchment by consumers before other elements of expenditure have picked up. This could be fuelled by a fall in house prices. However the situation now is very different from that in the early 1990s: overall inflation is low, interest rates are low and there are no immediate reasons to expect a sharp rise. Therefore there is no reason to suppose that house owners will be faced by the sharp rise in housing cost of earlier slowdowns. So, although most of the risks seem to be on the downside, the overall situation remains one of modest optimism.

Economic Advice Division
January 2003