

Enterprise, Innovation and Networks Committee

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Executive Summary

The dollar has weakened over the last quarter, mainly due to speculation that the period of interest rate rises is coming to an end. The Japanese economy has continued to see signs of improvement, in particular, employment has increased. In China, GDP growth exceeded expectations, prompting an increase in the interest rate. The Eurozone economy has also strengthened, reflected in an increase in the growth rate and rising business confidence. In the UK, the inflation rate rose, GDP increased as did retail sales, but unemployment increased. In Wales, the labour market also deteriorated slightly in the first quarter of 2006 though remains strong by historical standards. Data for 2005 showed an increase in the value of Welsh exports and in the index of distribution.

Current Global Situation

USA

The change of federal bank chairman from Alan Greenspan to Ben Bernanke three months ago coincided with expectations that the period of predictable interest rate rises is coming to an end. This has led to uncertainty in markets as attempts are made to interpret Bernanke's statements. The dollar has been sliding against its major trading partners since mid-April largely due to speculation that the US Federal Reserve will at least pause in its steps towards further monetary tightening. In the meantime, however, there was a further interest rate rise to 5% at the May meeting. A recent suggestion made by Bernanke that the Fed may sit on its hands while waiting for data to clarify the outlook has eroded confidence in policy. The size of the US current account deficit and budget deficit continue to be of global concern due to a belief in their unsustainability in the long-term. Furthermore, further weakening of the dollar would boost US exports which could impact on the economic recovery occurring in the Eurozone.

Energy prices have been impacting on inflation: the index for energy reached 30.1% in the first four months of 2006 (seasonally adjusted annual rate (SAAR)). The rate for all items less food and energy reached 3% for the four months to April (SAAR), with that for all items at 5.1% (SAAR). The year-on-year index for energy in March was the second highest among OECD members.

The economy appears to have rebounded in the first quarter of 2006 following the slowdown in the wake of Hurricane Katrina. Advance estimates of real GDP show an increase at an annual rate of 4.8

% in the first quarter of 2006, (according to advance estimates released by the Bureau of Economic Analysis). This represents a considerable increase on the fourth quarter of 2005 when the increase was just 1.7 %. This rise was driven by domestic demand which increased in response to: growth in disposable personal income (a month-on-month increase of 0.8% in March 2006); and greater business investment in equipment and software; and federal spending on defence.

Personal savings (as a percentage of personal income) deteriorated from -0.6% in February 2006 to -0.8% in March 2006, indicating that borrowing increased. This occurred despite growth in disposable income which itself may have arisen from observed increases in labour productivity in the first quarter of 2006 compared to the final quarter of 2005. An increase in 3.2% was seen in the non-farm business sector and 4.2% in the manufacturing sector.

Continued growth in production and spending is expected, although at a more moderate pace than that observed in the first quarter of 2006. The fall in unemployment during the first quarter to 4.7 percent in April 2006 may have a positive influence on incomes, and thus, contribute to further growth. Survey evidence suggests that 2006 will see businesses continuing to invest in plant and equipment. Manufacturers saw increases in new orders in March, suggesting a positive outlook for the sector, which should encourage such investment.

However, a larger-than-forecast fall in housing starts of 7.4% and news that confidence among homebuilders was at an 11-year low has revived fears that consumers may begin reining in their spending. Michigan University's measure of consumer confidence fell to its lowest since September, suggesting that demand may fall in the coming quarter.

Japan

The Japanese economy has continued to show signs of improvement. In March 2006, inflation was up 0.3% on March 2005, indicating that the period of deflation is ending. This mostly arose from energy price inflation (7.1%). Industrial production expanded 0.2% in March, a rise of 3.1% on the previous year. This was driven by transport equipment, electronics and paper products. Gross Domestic Product grew at an annualised rate of 1.9% in the March quarter, exceeding expectations. Further positive indications were shown in the Bank of Japan's March 2006 Tankan survey which suggested that the proportion of surveyed firms regarding current business conditions as favourable has risen. Furthermore, new orders in the manufacturing sector have increased, suggesting an optimistic outlook. The economy is expected to continue expanding at a robust pace on the back of strong growth in domestic demand and the ongoing rebound in export activity.

In March 2006, employment was up 0.8% on the previous year, and the unemployment rate was unchanged on the previous month at 4.1%. The labour force rose in the year to April for the first time in eight years. This suggests that people who had left the labour market have rejoined as job prospects have improved. This is indicated by more jobs being on offer than applicants.

China

Contrary to predictions of gentle easing, China's growth has continued to increase. In the first quarter

of 2006, the economy grew 10.2% year-on-year, exceeding last year's annual rate of 9.9%. This growth was driven by investment and easy credit: investment in fixed assets such as roads, factories and machinery rose 27.7%. In March alone for urban areas, this was as high as 32.7% year-on-year. In response to fears that the economy is overheating, the central bank raised interest rates at the end of April by 27 base points to 5.85% and gave guidelines to control lending to several industries. Concern exists that a proportion of this investment is irrational and resource-wasting and could exacerbate the existing bad-debt burden of state-owned banks which could eventually lead to a fall in the supply of credit, resulting in a sudden slowdown. The potential problems of issuing loans for investment is highlighted by losses in the first quarter increasing by 32.3%, and profits by 21.3%. Some industries are suffering from oversupply and rises in the prices of raw materials, resulting in thin margins. The trade surplus has also surged, to a level 41% above the surplus of January to March last year.

EuroZone

The Eurozone economy has continued to show signs of strengthening during the first quarter of 2006. GDP rose by 0.6% in the first quarter, according to data from Eurostat. This represents a considerable improvement on the previous quarter when growth was 0.3%. The European Commission business climate indicator for the Euro area improved strongly in April 2006 to reach its highest level since January 2001. The increase was largely attributable to orders and the assessment of industry managers of the production trend observed in recent months. According to the April 2006 JP Morgan Global Report on Manufacturing, Euro area manufacturing in March 2006 output rose at the most robust pace since August 2000 and succeeding in outpacing the US for the first time in three years. Germany recorded the fastest growth followed by Austria, Italy and France. Germany enjoyed its highest new order volumes for six years.

Favourable financing conditions, balance sheet restructuring and accumulated and ongoing gains in earnings and business efficiency are expected to sustain investment activity over the coming quarters, contributing to growth. Over time, consumption growth should strengthen as real disposable income and employment levels increase. Although the outlook remains positive, downside risk, arising from oil prices and global imbalances, exists.

According to Eurostat's estimate, annual inflation rose to 2.4% in April 2006 from 2.25% in March. In the short-term, inflation is expected to remain above 2% with monthly fluctuations arising from developments in oil prices and the extent to which these are transmitted along the production chain. Domestic inflationary pressures have been dampened in recent month by wage moderation. The European Central Bank left the interest rate unchanged at its April and May meetings following its 25 base point increase in March.

Domestic Assessment

UK

In April, there were signs that upward inflationary pressures arising from the oil price were starting to impact when CPI annual inflation rose to 2%, up from 1.8% in March. The increase was mostly

driven by transport, particularly air fares. Upward pressure was also exerted by gas and electricity bills, food and non-alcoholic beverages and, miscellaneous goods and services, in particular prices of appliances and products for personal care. The main downward pressure came from restaurants and hotels. Across the UK as a whole, the House Price Index increased by 4.3% over the year to January 2006, up on the annual increase to December 2005 (2.9%).

GDP rose by 0.6% in the first quarter of 2006 (broadly in line with the long run trend), showing no change on the final quarter of 2005. However, there were differences in the distribution of growth across sectors. Growth increased in production but weakened in services this quarter, resulting in more even growth across all sectors. Growth was assisted by an increase in the value of exports, with that of goods rising 2.5% in March. This contributed to a fall in the UK's deficit on trade in goods and services from £5.4 billion in February to £3.8 billion in March.

Despite steady growth, retail sales weakened in the three months to March 2006, falling 0.7% on the previous quarter. However, they rose again in the three months to April by 0.1%. This increase may reflect changes in earnings: the annual rate of growth in average earnings including bonuses rose 4.2% in the year to March, (up from 4.1% in February) and retail sales increasing. According to data released in May 2006, total household disposable income grew 3.2% in 2004.

The employment rate for people of working age was 74.7% for the three months ending in March 2006. This was up 0.2% over the quarter but down 0.2% over the year. The unemployment rate was 5.2%, up 0.1% over the quarter and up 0.5% over the year. The quarterly increase in unemployment was due to more unemployed women. In the three months to March 2006, the economic inactivity figures for those of working age showed a fall of 86,000 over the quarter, with the rate down 0.3 percentage points over the quarter to 21.2%.

Wales

During the first quarter of 2006, there has been a slight weakening of the labour market with the employment rate amongst the working age in the period December to February down 0.9 percentage points on the previous year and 0.4 percentage points on the previous quarter at 71.3%. The unemployment rate over the same period rose 0.6 percentage points to 5.0%. The claimant count level in Wales in March was up 700 (or 1.6%) on February. Economic inactivity amongst working age people in Wales for the three months to February increased by 11,000, compared to the same period in the previous year, and by 5,000 compared to the previous quarter. The rate was 24.8%, up 0.5 percentage points on the previous year. However, the labour market remains strong by historical standards.

The Index of Distribution for Wales for the four quarters to Quarter 3, 2005 rose by 2.9% compared with the previous four quarters. The largest rises were seen in wholesale sector (6.1%) and the retail sector (4.5%), while the motor trade saw a fall of 3.7%. Over the same period, the Index of Hotels & Restaurants fell by 2.3% compared with the previous four quarters. Although the restaurant and catering sector saw a rise of 5.2%, the pubs and clubs sector saw a fall of 4.0% and the accommodation sector, a fall of 9.0%.

Over the year to January 2006, the HPI in Wales increased by 6.4%, up on the annual increase to December 2005 (5.1%).

Data on the value of exports for Wales for the whole of 2005, show an increase of 2.9% on 2004, a change of £237 million. This was composed of an increase in exports to non-EU countries of £436 but a decline in exports to EU countries of £198 million.

Headline gross disposable household income (GDHI) per head in Wales in 2004 was £11,278 or 88.0 per cent of the UK average, its highest relative level since 1996. Having declined between 1995 and 2000, this proportion has increased in each of the last 4 years

Business Conditions

The Purchasing Managers Index Wales Report on March 2006 indicates that output growth was maintained in March but the rate was slightly down on that of January and February. However, firms reported that orders improved. This is consistent with the CBI survey for April which suggests that output is expected to increase over the coming quarter. According to the PMI report, productivity increased in March as employment declined. The CBI survey suggests employment will decline further in the next three months, while the BCC survey suggests that it will increase. Unit costs continue to increase (CBI, PMI). This has been matched by an increase in domestic prices. The outlook for the next three months indicates that margins are expected to improve through a fall in unit costs, and continued domestic price increases (CBI).