

Enterprise, Innovation and Networks Committee

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Quarterly Economic Report for Wales September 2006

Executive Summary

Global growth appears to be strong in the short term but there are fears of a sharp slow down. This is due to global imbalances and signs of the US economy weakening. Although its GDP has continued to grow, the US housing market has been slowing and consumer confidence falling. Other regions show signs of their economies strengthening: the Eurozone saw GDP growth of 2.6% year-on-year; in Japan the economy has been expanding on the back of increased investment and household consumption, while in China GDP growth has again been high. In the UK, as in the Eurozone and the US, inflation has been above the target level. However GDP has increased and the trade deficit has narrowed. The employment rate has shown little change while unemployment has increased slightly, and the economic inactivity rate has declined. In Wales, employment has shown little change while economic inactivity has fallen. The index of distribution and that of transport, storage and communication rose, and there was some growth in exports.

Current Global Situation

In the second quarter of 2006, the world GDP indicator as calculated by *The Economist* rose by 5.3% on a year earlier, its highest rate for two years. The International Monetary Fund forecasts that the world is set to enjoy a fifth record year of high growth next year, but it warns that the risks of a sharp slowdown have significantly increased. Its central forecast predicts global growth of 4.9 per cent next year, with G7 economies slowing from 2.9 per cent in 2006 to 2.5 per cent in 2007.

According to the NTC global Purchasing managers' Index (PMI), growth in output and new orders in the manufacturing sector weakened in August. Despite this, job creation occurred at the sharpest rate for four months. In the service sector, growth continued to weaken with the smallest rate of expansion since September 2005.

US

The US economy has recently shown signs of weakening: the annual rate of GDP growth in the second quarter of 2006 fell to 2.9% from 5.6% in the previous quarter. Likewise, consumer spending

declined from 4.8% in the first quarter, to 2.6% in the second and consumer confidence has been sliding: the Conference Board's index fell to a nine-month low of 99.6 in August, from 107.0 in July, while the University of Michigan's August index of consumer confidence, fell to 78.7 from 84.7 in July.

An important development in the US economy has been a slowing of the housing market. In July, the price of previously owned homes rose at its lowest rate in more than 11 years. This has impacted on the construction industry: building permits for privately owned houses were down 20.8% year-on-year in July. Inventories of homes reached 3.9m, a record, which will take over seven months to clear at July's pace of sales.

In July, personal savings declined further to \$-83.5 billion or -0.9% of income, implying that personal debt increased. Credit is a factor influencing consumer spending, and is partly obtained on the back of equity in homes. The slowing of the housing market could therefore impact on consumer spending, and thus, on the economy as a whole.

In July, the trade deficit rose to \$68bn, up from \$64.8bn in June. About one-third of the July increase was due to higher prices for oil imports. The value of exports also fell, particularly for aircraft, computers and medical supplies. The overall deficit this year is now running at \$77.6bn.

In August, the Federal Reserve left interest rates unchanged at 5.25%. During the first seven months of 2006, the CPI rose at a 4.8 percent seasonally adjusted annual rate (SAAR). This compares with an increase of 3.4 percent for all of 2005. The index for energy, which rose 17.1 percent in 2005, was somewhat higher in the first seven months of 2006 at 25.3 percent SAAR.

Japan

Japan has adjusted the basket of goods which it uses for calculating inflation in order to reflect changing trends in household consumption. The base year has also been changed from 2000 to 2005. The revised inflation figures are lower than those previously released; the headline rate (excluding fresh food) is now 0.3%, compared to 0.8% under the previous measure. In response to the previous figures, interest rates were raised in July by 25 basis points, marking the end of a six-year period of zero interest rates.

The rate of GDP growth has recently been revised upwards to an annualised 1.0 percent for the April-June quarter. This represented the sixth successive quarter of economic expansion.

The labour market continues to improve, unemployment fell to 4.1% in July, and there are now 1.09 jobs for every applicant at the government run employment agencies, the highest ratio since 1992. In conjunction with rising compensation for workers, this has assisted in increasing household consumption. Meanwhile, the corporate sector has been enjoying strong profits and orders, further contributing to a positive outlook for the economy.

China

China's economy appears strong: GDP grew by 11.3% in the year to the second quarter as a result of strong investment and a plentiful harvest. This was the fastest expansion since 1994, although this has prompted fears of overheating. Meanwhile, the Asian Development Bank (ADB) has upgraded its gross domestic product (GDP) growth outlook for China this year to 10.4% after fixed-asset investment and strong export trade saw first half data exceed expectations. Investment has been aided by China having enjoyed the highest level of foreign direct investment (\$79.1 billion) among emerging economies in 2005.

China's trade surplus reached \$95.7bn through the first eight months of the year, soaring to a monthly record of \$18.8bn in August, exceeding the \$14.6bn achieved in July. Compared to the same period in 2005, the aggregate trade surplus has widened nearly 60 percent. This rise has been driven by increasing exports: in August alone, exports rose 32.8 percent while imports increased 24.6 percent. The IMF has warned that China needs to tighten its monetary policy in order to prevent a boom-bust economic cycle from emerging.

Eurozone

At its August meeting, the Governing Council of the European Central Bank raised the interest rate on the marginal lending facility in the EuroZone by 25 basis points to 4.0%. This decision was taken on the basis of inflation expectations: according to Eurostat's flash estimate of HICP inflation, the rate was 2.5% in July. It is likely to remain above 2% in the near future as a result of direct and indirect effects of oil price rises and changes in indirect taxes (Germany is to apply a 3 point rise in VAT in January 2007).

Surveys and monthly indicators suggest that economic growth has continued at a sustained pace. In the second quarter of 2006, GDP grew 0.9% quarter-on-quarter, and 2.6% year-on year while household consumption expenditure increased 0.3%, and investment by 2.1%. The business confidence indicators have been buoyed by the football World Cup and time-bound subsidies in the German construction sector. Strengthening of employment should further assist in driving consumption growth. Indeed, unemployment has fallen below 8% of the labour force for the first time since 2001. In France, the unemployment rate fell to 8.9% in July, from 9.1% in May, while in Germany it fell to 8.1% .

Domestic Assessment

UK

GDP rose by 0.8 per cent in the second quarter of 2006, compared with 0.7 per cent in the first quarter. Growth came mainly from services, which increased more strongly than in the previous quarter.

The UK deficit in trade in goods and services narrowed in the three months to July to £12.8 billion, from a deficit of £13.5 billion in the preceding three months.

According to the Index of Services (2003=100), services), services output rose by 1.0 per cent in the

three months to June compared with the three months to March. The most significant increase was in business services and finance. Distribution output rose by 1.0 per cent in the three months to June. Increases in retail output were partially offset by a fall in the motor trades and wholesale output. Hotels and restaurants output rose by 0.3 per cent in the three months to June, while that of transport, storage and communications increased by 0.9 per cent.

The Index of production (2003=100) indicated that manufacturing output increased by 0.9 per cent in the three months to July 2006 compared with the three months to April 2006. Nine out of the thirteen subsectors showed increases in output, three subsectors showed decreases and one remained unchanged. Of the subsectors which increased in output, the manufacturing sector grew for the third month in succession.

Retail sales growth slowed in July, although it remained robust when compared with the rates of growth seen generally over the last two years. Increased sales growth by retailers of food and drink contrasted with slower growth by non-food stores, in particular household goods stores. The volume of retail sales in the three months to July was 1.8 per cent higher than in the previous three months. This follows 2.0 per cent growth in the three months to June

CPI annual inflation rose to 2.5% in August up from 2.4% in July. The largest upward effect came from recreation and culture, where prices for games, toys and hobbies increased by a greater amount this August than last year, with the main upward contribution coming from computer games.

Across the UK as a whole, the HPI increased by 5.2 per cent over the year to June 2006, down on the annual increase to May 2006 (5.6 per cent). The UK average mix-adjusted house price stood at £190,883, whilst the UK figure excluding London and the South East was £166,161.

The input price index for materials and fuels purchased by the manufacturing industry fell 1.2 percent between July and August (seasonally adjusted). This was mostly due to a fall in the price of crude oil. In line with this, the output price index for domestic sales of manufactured goods indicated that growth in prices slowed between July and August 2006. The index showed a rise of 2.6 percent in August, compared to 2.9 percent in July.

For the UK as a whole, the employment rate for the three months to July 2006 was 74.6 per cent, down 0.2 percentage points on the previous year and down 0.1 percentage points on the previous quarter. However, there was an increase in employment of 220,000 (0.8 percent) on the previous year and an increase of 38,000 (or 0.1 per cent) on the previous quarter.

The UK ILO unemployment rate was 5.5 per cent, and the claimant count fell by 3,900 (or 0.4 per cent) between July and August. The rate was up 0.3 percent on the quarter and up 0.8 percentage points on the previous year. The number of unemployed was up 280,000 on the previous year and 93,000 on the previous quarter.

The UK inactivity figures for those of working age showed a reduction of 50,000 over the quarter, with the rate down 0.2 percentage points over the quarter, and down 0.5 percent over the year to 20.9 per cent.

Wales

Welsh export statistics for Quarter 2, 2006 indicate that the value of exports over the latest four quarters increased by £246 million (2.8%) compared to the previous four quarters. This increase consisted of an increase of £408 million (13.1%) in exports outside the EU, which was partly offset by a fall in exports to other members of the EU of £163 million (-2.9%).

The index of production for Wales for the four quarters to Quarter 1, 2006 (2003 = 100) fell by 5.1% compared to the previous four quarters. This was a greater decline than that observed for the UK as a whole. Although the mining and quarrying sector in Wales saw an increase in output during this period, this was offset by the manufacturing sector which saw a decline. The index of construction fell 4.4% over the same period.

The experimental Welsh index of distribution for the four quarters to Quarter 1, 2006 (2003 = 100) rose by 5.4% compared with the previous four quarters. Of the components of the index, retail output saw the largest rise (7.7%) for the same period, followed by wholesale output (6.2%). These rises were partially offset by a decline of 2.9% in motor trade output.

The experimental Welsh index of hotels and restaurants for the four quarters to Quarter 1, 2006 (2003 = 100) fell by 2.2% compared to the previous four quarters. The output of the pubs and clubs sector was 7% lower than that of the previous four quarters while the accommodation sector saw a decline of 6.1% and restaurants, and catering a fall of 5.7% over the same period.

The experimental Welsh index of transport, storage and communication for the four quarters to Quarter 1, 2006 (2003 = 100) rose by 8.5% compared with the previous four quarters. Post and telecommunications output was 18.2% above that of the previous four quarters while transport saw a rise of 5.8% over the same period. However, land transport output was 0.4% lower than the previous four quarters.

Over the year to June 2006, the HPI in Wales increased by 8.2 per cent, up on the annual increase to May 2006 (4.8 per cent). The average house price* in Wales in June 2006 was £155,041, the seventh highest figure amongst the regions of the UK (higher than in Scotland, Northern Ireland, North East, North West and Yorkshire & Humber).

The employment rate amongst the working age in May to July was 71.7 per cent, unchanged on the previous year but down 0.1 percentage points on the previous quarter. On the LFS-based employment measure, seasonally adjusted total employment in Wales in the three months to July 2006 stood at 1,339,000, up 18,000 (or 1.3 per cent) on the same period a year earlier and up 6,000 (or 0.4 per cent) on the previous quarter. This level is a record high.

The unemployment rate in Wales was 5.7 per cent, up 1.2 percentage points on the previous year and above the UK average of 5.5 per cent. At 44,400, seasonally adjusted claimant count unemployment in Wales was up 100 (or 0.2 per cent) in August compared to July. The rate was unchanged on the month at 3.2 per cent and up 0.2 percentage points on the year.

Seasonally adjusted ILO unemployment for Wales for July 2006 was similar to the figure for last month, but represented a sharp rise on the previous quarter. The level was up 18,000 on the previous year and 12,000 on the previous quarter. The rate was 5.7 per cent, up 1.2 percentage points on the previous year.

Economic inactivity amongst working age people in Wales for the three months to June fell by 14,000 compared to the same period in the previous year and by 10,000 compared to the previous quarter. The rate was 23.9 per cent, down 0.9 percentage points on the previous year.

Summary of Business Surveys

During Quarter 2, 2006, manufacturing saw its output and orders increase both on the domestic and export market. Services lagged manufacturing with domestic and export sales weakening. There is conflicting evidence with regard to domestic orders: the British Chamber of Commerce (BCC) and South Wales Chamber of Commerce (SWCC) suggested that there was little change in domestic orders during this quarter, as compared to the previous quarter. In contrast, the Purchasing Managers' Index (PMI) indicated that the service sector saw a sharper increase in new orders than the manufacturing sector. Input prices have continued to rise: manufacturers have been more affected by higher raw material prices (PMI SWCC), particularly metals, while service providers have felt higher energy and wage costs (PMI) and financial costs (BCC, SWCC). Output prices have risen at a lower rate, with some indications of falling output prices due to market competition (PMI). This has resulted in the squeezing of margins. Despite this, confidence in the business situation and export prospects in the manufacturing sector improved (CBI). Firms plan to reduce investment in training and buildings over the coming year although investment in plant and machinery is expected to remain stable (CBI). Where capital expenditure was planned, this was mostly for the purposes of replacement and increased efficiency, as opposed to expansion (CBI). The surveys revealed contrasting changes to employment: according to the CBI, in the manufacturing sector, it continued to deteriorate over the past three months and is expected to decline further over the coming quarter (CBI). On the other hand, PMI, BCC and SWCC indicated that employment increased (PMI, BCC, SWCC).