

Date: 28 November 2001
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Title: Quarterly Economic Report for Wales - October / November 2001

Executive Summary

- A global economic slowdown was underway before the terrorist attacks in the US. Whilst it is too early to give a full assessment of the economic impact of the attacks, it now seems probable that the result will be a deeper and more prolonged period of slower growth.
- Recent forecasts for most of the major industrialised economies show further downward revisions, particularly for 2002. Immediate prospects for the UK economy remain robust however, with GDP growth for 2001 currently forecast to be at or just below the long-run trend, but lower in 2002. However, there remain a number of downside risks.
- The UK's sectoral imbalance has persisted with continued adverse trends in manufacturing, and despite some recent moderation, robust performance in large parts of the service sector. The labour market has also been resilient, although recent data suggests that employment growth and the decline in unemployment may have abated.
- Inflationary pressures in the UK remain very light, providing the Bank of England with scope for further monetary easing, if economic conditions were to trend downwards.

World Outlook and Assessment

1. Following a period of strong and sustained economic growth in most of the main industrialised economies, a number of which were operating at around full capacity, some gradual moderation in growth rates was to be expected. By mid-2000 there were already signs that business confidence was beginning to weaken. Economic data shows that growth of output and trade has been slowing significantly in most of the major economic regions, largely the consequence of simultaneous economic slowdowns in the US, Japan and Germany.
2. According to the NIESR's October forecast, the US, Japan and Germany are all likely to be in recession over the next few months with the world economy forecast to grow by 2 per cent this year and 2.2 per cent in 2002 (compared to 4.7 per cent in 2000). The latest economic forecasts from The Economist's panel of forecasters (published 10th November) shows US GDP expected to grow by 1.0 per cent in 2001, before slowing to

0.8% in 2002 (down from 1.0 per cent forecast last month). Euro-area GDP is expected to grow by 1.5% in 2001, declining to 1.2 per cent in 2002. The UK is forecast to fare better with real GDP growth of 2.2 per cent and 1.8 per cent forecast in 2001 and 2002, respectively.

● USA

1. Even before the terrorist attacks, the US economy was showing signs of significant slowing, although many economists were predicting that the US would avoid a technical recession. Some economic data also provided tentative signs that the sharp decline in the US manufacturing sector may have been bottoming out. However, prospects for a swift economic recovery appear to have since deteriorated.
2. In response to the attacks and the more general economic slowdown that preceded September 11th, the US Federal Reserve has provided a significant loosening of monetary policy to stimulate the US economy (the federal funds target rate currently stands at 2.0 per cent). However, it is not clear at this stage whether that this will be sufficient to prevent recession in the US.
3. Recent figures on industrial output and employment have reflected a further erosion in economic activity. US GDP contracted at a provisional annualised rate of 0.4 per cent this quarter, following weak growth 0.3 per cent in the previous quarter. The National Association of Purchasing Management's manufacturing index fell to 39.8 in October, reportedly its lowest level since February 1991. Survey information also suggests weakening conditions in the non-manufacturing sector – indicating that deteriorating conditions in US manufacturing have now spread to the wider economy.
4. The US labour market has weakened with economic data showing that the unemployment rate increased by half a percentage point to 5.4% in October. The weakening labour market may feed through to further falls in consumer spending – which until recently had been a strong point of the US the economy. However, the latest picture for consumer confidence is, surprisingly, rather mixed. The US Conference Board index of consumer confidence declined from 97.0 in September to 85.5 in October, its lowest in seven years. In contrast, the University of Michigan's consumer-sentiment index rose to 83.4 in October from 81.8 in September.

● Japan

1. The Japanese economy has continued to falter with GDP contracting by 0.7% in the second quarter of 2001 and industrial production falling sharply in the year to September. Business confidence has continued to fall. Price deflation and consumer pessimism, arising from concerns about rising unemployment, also remain persistent problems. Japan's unemployment rate rose to 5.3 per cent in September, continuing the sharp increase from 3.2 per cent in 1995. Some economists are forecasting that unemployment will reach 6 per cent or higher early next year.
2. Prospects for the Japanese economy have also weakened to the brink of recession. The

Japanese government recently forecast that GDP would contract by 0.9 per cent in the year ending March 2002.

- **Europe**

1. The economic outlook for the euro-area has worsened in recent months, with survey evidence indicating a weakening in both consumer and business confidence and the labour markets. The IMF, amongst others, have revised down their forecasts, particularly for growth in 2002. However, euro-zone inflationary pressures appear to be moderating and this should give the ECB scope to pursue a more active policy of monetary loosening, as conditions dictate.
2. The German economy in particular has suffered from both weakening domestic demand and has proved vulnerable to its dependence on the production of relatively volatile investment goods. Investment spending has contracted sharply. Unemployment appears to be rising with seasonally adjusted unemployment increasing to 3.92m (9.5 per cent of the workforce). The concern is that rising unemployment could have a further effect on the already deteriorating consumer confidence. Many economists now expect growth of below 1 per cent this year.
3. Economic data suggest that unemployment in France increased slightly to 9.1% of the work force in September, although this was better than generally expected. Despite the negative impact of the rise in unemployment in recent months, consumption is reported to have been remarkably resilient in Q3. A recent survey by Insee, the official French statistics agency, also showed consumer sentiment stabilising. France is expected to be one of the better euro-zone performers with growth at around 2.0 per cent forecast by many economists for this year before moderating in 2002.

Domestic Outlook and Assessment

1. Overall, the UK economy looks to have been quite resilient, with growth contracting at a slower rate than many had anticipated. On balance, the prospects for the UK have fallen back, with some further deterioration in business and consumer confidence following the recent terrorist attacks. Renewed pressures on world economic growth have added to concerns about the UK's external position, which was already under pressure from the Sterling/Euro exchange rate.
2. The latest ONS estimates of GDP at constant market prices show an upward revision suggesting that economic activity in the first half of 2001 was not as weak as had been provisionally estimated. The preliminary estimate of GDP at constant market prices also shows a rise of 0.6 per cent in the third quarter of 2001 compared with the previous quarter, or an annual rate for this quarter over the third quarter of 2000 of 2.2 per cent.
3. Most of the recent business surveys show significant falls in business optimism. Whilst this is of concern, similar surveys showed such movements at the end of 1998 and beginning of 1999 but these did not translate into a significant contraction in economic activity. However, a number of economists have noted that further weakening in the

corporate sector could impact on the household sector via the labour market. Any significant deterioration in labour market conditions would be likely to impact on consumer confidence – the mainstay of the economy to this point.

4. Some of the recent manufacturing activity surveys also point tentatively to a moderation in the pace of sectoral decline. For example, the latest CBI Industrial Trends survey (UK) for October 2001 indicates a further fall in the balance of output volume over the past 4 months, but that this was less sharp than reported in the July 2001 survey. The Chartered Institute of Purchasing and Supply's purchasing managers' index reports a rise in the index to 46.7 in October from 46.5 in September (although a balance below 50 indicates a further contraction in manufacturing activity). However, the concern is that conditions in the wider economy may now be deteriorating. The CBI distributive trades survey for October indicates a significant contraction of overall sales from a balance of +23 reporting sales above/below normal in September to -2 in October.
5. A survey by the European Commission (published October 2001) suggests that UK consumer confidence may have fallen, with the index of overall confidence declining by four points to -5. Confidence in the UK's economic prospects also fell back by 13 points to -33, the lowest figure for 11 years.

● **Sectoral Performance**

1. Manufacturing has been through a difficult period this year, particularly those elements dependent on the internationally traded sector where external demand has fallen as a result of slower growth in the US and Europe. Data from the ONS indicates that UK manufacturing output fell by 1.6 per cent in September following August's unexpected rise, with output down 0.8 per cent on the quarter, and 2.9 per cent on the year. Manufacturing output prices and profitability remain under pressure.
2. This picture is not uniform across the entire manufacturing sector with a notable divergence between businesses producing investment goods and those producing output for the consumer sector. The September 2001 UK Index of Production shows output of investment goods fell 3.4 per cent on the quarter, but output of durable goods was up by 4.1 per cent, with non-durable goods seeing an increase of 0.9 per cent.
3. Data from the Welsh Index of Production and Construction for Q2 2001 points to a second quarter of sharp decline in production and construction output. Overall, the index for the latest four quarters has fallen by 4.6 per cent compared with the same period a year ago. Manufacturing output in Wales in the latest four quarters was 3.2 per cent lower than over the same period a year earlier, largely as a result of falls in electrical & optical equipment and also basic metals & fabricated metal products. This compares to data for the UK as a whole where the latest four quarters on a year earlier show output up by 0.2 per cent, and manufacturing output up by 0.6 per cent.
4. The performance of the UK manufacturing sector contrasts somewhat with the service sector which has been performing well. However, there are now indications that some of the manufacturing gloom may have spread to the service sector with a number of business surveys pointing to a potential reduction in activity. The Service companies' net

rate of return declined modestly to 12.4 per cent in Q2 2001 (the latest available figures) from 13.8% in the previous quarter. This is still considerably better than in manufacturing.

5. Inflationary pressures in the UK remain moderate with the all items Retail Prices Index (RPI) falling back to 1.6% in October from 1.7% the previous month. Despite the strong annual house price inflation figures reported by the Nationwide and Halifax, recent surveys suggest that house prices may have faltered recently, reflecting concerns and uncertainty over the economic slowdown. Growth in average earnings also appears to be moderating. The headline rate of growth of average earnings in September 2001 was 4.4 per cent, down 0.1 percentage points from the previous month.
6. This moderate inflationary pressure has enabled the Bank of England's Monetary Policy Committee (MPC) to continue its loosening of monetary policy with further cuts in the repo rate to a current level of 4.0 per cent. There remains scope for further base rate cuts if appropriate.

● **Economic Impact of the Terrorist Attacks**

1. Prior to the attacks on the US, many economists were forecasting that the UK to grow by just over 2 per cent this year and by around 2.5 per cent in 2002. The economy was characterised by strong consumer expenditure continuing to drive service sector growth, but with manufacturing in recession. The labour market and household sector were also performing well.
2. There were already signs of deteriorating trade with the UK's balance on trade in goods and services in August provisionally estimated as a record deficit of £2.4 billion. Data also suggested a deterioration of almost 3 per cent in exports of goods and services in the three months to August 2001 compared with the previous three months, with imports also falling.
3. The terrorist attacks in the US could affect the UK economy via two main routes: declining sales to a less confident US and a decline in consumer confidence within the UK (if confidence similarly declined across Europe that would also have a significant effect). UK growth has been heavily dependent on consumer demand recently so the effects on consumer demand are crucial.
4. However, despite the increased uncertainty there is no fundamental reason why the attacks should push the UK economy into recession, although there is now a significant risk of a more prolonged slowdown than had initially been anticipated. There are also additional downside risks to be taken into account. A significant oil price rise could exacerbate the position – though inflation world-wide is much lower than on the occasions of previous oil price hikes in the 1970s, early 1980s and the beginning of the 1990s. In addition, any prolonged downturn in the financial markets, which threatened financial stability, would be worrying (but there is no indication that this is likely to happen).
5. Whilst the economy as a whole is expected to slow, certain business sectors such as air-travel and UK tourism have been adversely affected in the short-term by the events of

September 11th - although the large contractions in air travel seem to be, at least in part, a reflection of a long-expected restructuring in the industry. However, although this will affect specific sectors we also need to consider the potential for substitution: expenditure that would have taken place on such activities may be spent on other goods or services, leading to a lower impact than some have estimated.

6. Like the rest of the UK, Wales has experienced weak manufacturing performance offset to some degree by strong service sector growth. But in Wales manufacturing performance has been weaker and services growth less strong than in the UK. Whether Wales will be more affected by the terrorist attacks than the UK is difficult to judge. Wales is more dependent on manufacturing, but less dependent on US export markets and overseas tourism, than most other UK regions. Again, everything depends on confidence.

● Economic Forecasts

1. The October 2001 Comparison of Independent Forecasts compiled by HM Treasury suggests that UK GDP is expected to grow at 2.1 per cent in 2001 (unchanged from the September independent forecasters average) and by 2.2 per cent in 2002 (down from 2.5 from the September average). Many economic forecasters are also forecasting a further contraction in manufacturing output. The National Institute for Economic and Social Research (NIESR) in their October 2001 publication forecast that manufacturing output will contract by 1.5 per cent in 2001 and by 0.6 per cent in 2002 before returning to growth of 2.5 per cent in 2003. Most forecasters are also now predicting a rise in claimant count unemployment with the Treasury-compiled Independent Forecasters average suggesting a figure of 1.07 million by Q4 2002.
2. Business Strategies (BSL), a commercial economic consultancy, (full report has not yet been published) forecast that UK GDP will grow by around 2.3 per cent in 2001. Of greater concern is that UK GDP is expected to grow at 1.7 per cent in 2002 suggesting a more prolonged slowdown than had been previously anticipated.
3. This same forecast suggests that Wales will have experienced growth of 0.1 per cent in 2001, lower than any other UK region. Only the North West (0.5 per cent growth forecast) and the North East (0.9%) also have below 1 per cent growth forecast for this year. GVA growth is expected to accelerate to 1.7 per cent in Wales next year, above the forecast of 1.6 per cent for the "northern regions" as a whole and the same as the UK average. The longer-term forecast for 2003-06 shows annual average growth of 2.7 per cent forecast for Wales, again equal to the UK over this period. Employment in Wales (measured as FTEs) is forecast to grow by 0.8 per cent in 2001, compared to 0.7 per cent in the UK, and by 0.1 per cent in 2002.
4. Cambridge Econometrics report revisions to their July 2001 forecasts. These suggest a stronger performance in Wales in 2001 than forecast by BSL, but indicate further slowing in 2002, whilst BSL are predicting that GVA growth in Wales will accelerate.
5. Whilst these forecasts provide a useful impression of where the economy may tend, they are subject to considerable judgement. We expect that these forecasts will continue

to be subject to further revisions given the current climate of economic uncertainty.

● **The Labour Market**

1. Unemployment is low and employment high by historical standards in the UK and in Wales, with strong employment growth in the services sector roughly offsetting the continued job reductions in manufacturing. However, there are some signs that conditions in the labour market may be moderating. The latest figures show employment in the UK falling by 24,000 to 28.15 million, in the period July to September 2001 compared with the previous three months – although this is still 159,000 higher than in same period a year ago. UK ILO unemployment also increased over this period by 28,000, to 5.1% of the workforce. UK claimant count unemployment rose by 4,300 in October 2001 to stand at 951,100 (3.2% of the total workforce).
2. The labour market in Wales continues to perform well. Information from the Labour Force Survey over the year to September 2001 indicates stable employment and unemployment falling slightly in Wales. In the three months to September 2001, the employment rate was 68.7 per cent, down 0.9 percentage points on a year earlier with the ILO unemployment rate at 5.4 per cent, down 1.0 percentage points on a year earlier. Claimant count unemployment in Wales was recorded as 49,200 in October 2001, a rate of 3.8% of the workforce. Over the 12 months to October 2001 it has fallen by 7,300.

● **Domestic and International Business Conditions**

1. Recent survey data tends to suggest continued declining fortunes in manufacturing, with the service sector performing robustly in Wales.
2. The October CBI survey (survey of 75 Welsh manufacturing companies and conducted in the aftermath of the terrorist attacks on America) indicates a sharp fall in business optimism to a balance of -72, down from -21 in the previous survey. It is not clear as yet whether this is a temporary movement following the terrorist attacks. This survey also indicates a sharp decline in export optimism and contraction in export trade activity. The balance of domestic orders and expectations for domestic orders in the next four months also fell sharply.
3. The latest British Chambers of Commerce survey (survey of 63 Welsh manufacturing companies and 151 service sector companies, and largely conducted before the terrorist attacks) indicates a significant drop in both domestic and export manufacturing sales and orders. Both confidence about turnover (down 50 points to +27) and confidence about profitability (down 65 points to +4) have fallen sharply, to a level more in line with the UK. In contrast, the service sector continued to show robust performance with the domestic sales balance improving and home orders, export sales and export orders only falling slightly. Confidence for turnover and profitability also appears strong, with both balances above the reported level for the UK.
4. Perhaps unexpectedly, the Dun and Bradstreet figures for business failures

(bankruptcies and liquidations) show a small fall in the UK (of 0.83 per cent) in the first three quarters of this year compared to the same period a year ago. Overall, Wales experienced the biggest fall in failures of any GB region – of 10.3 per cent, with liquidations reported to have fallen by 6.5 per cent and bankruptcies declining by 12 per cent.

**Economic Advice Division
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