

Date: 8 May 2002
Time: 14.00 - 17.30
Venue: Committee Room 1, National Assembly for Wales, Cardiff Bay
Title: Quarterly Economic Report for Wales, May 2002

Executive Summary

- Both evidence and sentiment continue to point towards a global recovery after the slowdown during 2001.
- There are increasing signs of optimism in the largest economies (excluding Japan) though the pace of recovery in the US may not be as quick as hoped.
- The outlook for the UK appears good though the last two quarters growth data has been sluggish. The labour market continues to perform well and inflation remains within the target range.
- Prospects for the beleaguered manufacturing sector look promising. Recent business surveys reported a rise in optimism for the first time in over two years. The service sector continues to perform well.

Current Situation

US GDP grew at an annual rate of 5.8% in the first quarter of 2002. This followed the surprising return to growth in the final quarter of last year. It supports the belief that the US economy has turned the corner though there are no immediate expectations of a boom. The growth appears to be fuelled by defence spending and restocking.

The Non-manufacturing sector continues to perform strongly. In March, ISM's non-manufacturing business activity increased almost as strongly as it did in February. The March Index stood at 57.3% the second strongest (after February) business activity index since November 2000.

The March ISM manufacturing report validated the turnaround for manufacturing. While the growth in production slowed, new orders rose to a level last seen in October 1986. The report also showed that the rate of decline in employment is slowing and that a number of businesses indicated that they are starting to rehire.

The latest labour market data shows that, unemployment in March stood at 5.7%, up 0.2

percentage points from February.

The **Japanese** economy continues to struggle. For only the second time in two decades the Japanese economy shrank. GDP fell through the last nine months of 2001. The employment situation remains severe though with some small signs of improvement. Unemployment hit a 50 year high in December but has since fallen back a little. There is also encouragement in the latest industrial production figures which have show some improvement in February and March after steep declines. Personal consumption and capital investment continue to fall.

Real GDP is estimated to have fallen by 0.2% quarter-on-quarter in the 12 nations of the **eurozone** for the first time in a decade. The growth rate became progressively weaker during the course of last year, largely due to weak final demand and heavy de-stocking. However, inflation fell in April to 2.2% and unemployment for March remained stable.

After falling for two successive quarters Euro area industrial production rose month-on-month in December and available national data seems to suggest that it could also have increased in January. However, Euro area retail sales volumes decreased by 0.6% month-on-month in December 2001, following an increase in November.

The cyclical weakness of the **German** economy continued in the fourth quarter of 2001. Real GDP was 0.3% down on the previous quarter. On an annual average of 2001, growth amounted to 0.6% compared to 3% in 2000.

French GDP fell by 0.1% in the fourth quarter of 2001, which was slightly lower than the fall expected by many commentators. Overall, the average annual growth rate of GDP in 2001 was 2.0%, down from 3.6% in 2000. The industrial output index picked up in January after falling in December. Furthermore, according to the Central Bank's Survey, industrial activity picked up further in February after increasing significantly in January. Unemployment in March reached a 17 month high of 9.1%.

Domestic Situation

Provisional UK GDP figures for Q1 2002 show that growth was just 0.1% higher than the previous quarter and 1% higher than a year earlier. Revised quarter 4 figures showed zero growth in the final quarter of 2001. The zero growth rate was the weakest reading since the recession of the early 1990s. Overall GDP growth for 2001 was 2.2%, below the government's forecast range.

Consumer expenditure appears to be buoyant despite an unexpected decline in retail sales in December and January. Official data from the ONS shows that retail sales in February grew at their fastest pace in more than two years. The March data showed a slowdown though retail sales still grew by 0.1%. The British Retail Consortium report that retail sales recorded their

strongest growth in six years during March. Like-for-like sales rose by 7.5% compared to the previous year, the biggest rise since 1996.

The **rate of return** by private non-financial corporations in the UK fell only slightly in Q4 of 2001. The net rate of return in 2001 was 12.2% compared to 12.7% in 2000. The profitability in the manufacturing sector did however increase for the second quarter in a row, further indication a recovery in the sector.

There are further signs of a recovery from the recent manufacturing recession. The latest figures from ONS indicate that between January and February, **manufacturing output** rose in the UK by 0.4%, the first rise in six months. However, output in the latest three months was 1.4% below the previous three months and 6.2% below the same period a year ago. Within manufacturing, electrical and optical equipment industries were the hardest hit.

The latest figures from the **Welsh Index of Production and Construction** highlight difficulties experienced by certain sectors of production industries during 2001. The overall Index for the latest four quarters fell by 7.1% compared with the same period a year ago. Comparing the latest four quarters with the same period a year ago most of the components of the index fell. The worst hit was manufacturing which saw an 8.3% fall over the period. The only exception was the Index of Electricity, Gas and Water which increased by 3.1%. However there are some signs that the worst may be over. Although the quarter-on-quarter figures should be treated with some caution, the decline appears to be levelling off - most of the decline in the overall index occurred in the first half of last year. Since then the figures have been relatively stable. This is also reflected in the manufacturing figures where Wales fell by less than the UK (0.9% vs 1.7%).

The Chartered Institute of Purchasing and Supply's UK **Purchasing Managers' Index** in April showed further growth in the UK manufacturing sector following encouraging March results. The PMI rose for the fourth month running to record its highest level since December 1999, with the headline indicator above the critical no change mark for the third successive month.

Headline inflation in March rose by 1.3%, following rises in February of 1% and 1.3% in January. The underlying rate of inflation i.e. the all items excluding mortgage repayments (RPIX) rose to 2.3% just below the 2.5% target rate set for the MPC. The figures add to recent evidence that inflationary pressures are building up. However, the consensus amongst economists is that an imminent rise in interest rates remains unlikely. The Bank of England's Monetary Policy Committee (MPC) voted to maintain the bank's rate at 4% at its most recent meeting in April.

House prices in the UK continue to rise. The Nationwide building society reported that house prices has recorded their largest ever monthly increase in April, 3.4% up on the previous month. The Halifax reported that house prices in March rose by 0.4%, while the annual rate of

house price inflation eased to 16%. A report by the Royal Institute of Chartered Surveyors (RICS) indicated that the increase in house prices is expected to continue as the UK suffers from a property shortage.

The overall **labour market** picture remains remarkably strong with unemployment rates at their lowest levels since the mid 1970s.. The latest LFS employment level in the UK (December 2001 to February 2002) rose by 30,000 over the three months to February and 169,000 compared with a year earlier. The working age employment rate remained unchanged (74.6%) over the quarter. The unemployment rate in the UK based on the ILO measure remained unchanged at 5.1%. The claimant count unemployment rate also remained unchanged at 3.1%.

The **labour market in Wales** continues to perform relatively well. The latest LFS employment level in Wales was 1.26 million (corresponding to an employment rate of 68.9%), 1,000 higher than in the same period a year earlier but, down 7,000 in the three months to February compared to the previous three months. ILO unemployment in Wales continues to fall. In the three months to February ILO unemployment fell by 1,000 compared to the previous three months, while the rate fell marginally to 5.3%. Claimant count unemployment fell by 700 in the month to March 2002, while the rate fell by 0.1 percentage points to 3.6%. The fall in unemployment in Wales on either measure was the largest proportionate fall of any UK region.

Outlook

The **world** is set for a strong economic recovery next year according to the **OECD's** latest forecast. They report that confidence has returned more rapidly than expected and growth momentum will return with overall economic growth among rich countries rising from 1.8% this year to 3% in 2003. The recovery is expected to be strongest in the United States but weaker in Europe and the prospects for Japan still look bleak. The OECD however, warns that rising oil prices, or a sharp rise in interest rates while consumers still have large debts, could still derail the recovery. The World Bank echoed the views of the OECD that recovery is expected. However, they warn that some of the poorest countries may be left behind.

Although growth in the majority of the leading economies suffered during the latter half of 2001, improved growth prospects coupled with increased consumer and business optimism points to the prospects of a global recovery throughout 2002 and continuing in 2003.

A range of economic indices all indicate substantial upturns in confidence in the **USA**. Indices for the present situation, expectations and consumer confidence were all positive, though consumer confidence fell back slightly from March. However, the Fed has warned that recovery may not be as swift as originally hoped though the signs are still positive.

There are tentative signs of "timid shoots of growth" in **Japan**. With sluggish public investment and deteriorating business confidence the short-term prospects for economic recovery look

bleak. However, recent trade, employment and output data and optimism regarding the global economic outlook may slow the recent slump.

The **European Central Bank** (ECB) has indicated that an upturn could be around the corner, noting recent strong improvements in confidence indicators for the manufacturing sector.

The latest survey indicators confirm that confidence increased strongly in the Euro area manufacturing sector in the first quarter of this year. In particular, the Purchasing Managers' Index (PMI) for the Euro area manufacturing sector rose sharply in March 2002. This was the index's fifth consecutive increase, which brought it back to the "zero-growth" level of 50 for the first time since April 2001.

German Business confidence declined in April for the first time in 2002 according to the Ifo Business Climate Index. This was due to less favourable business conditions in the wholesale and retail sectors. Many other components of the Index remained unchanged. Any recovery in Germany could be hit by the threatened strike over pay by IG Metall, the country's biggest trade union.

Domestic Outlook and Assessment

Economic Forecasts

The latest comparison of **Independent Forecasts** compiled by HM Treasury (April 2002) suggest that UK GDP is expected to grow by 1.9%, unchanged from the March forecasts. In 2003, UK GDP is expected to grow by 2.7%, 0.1 percentage points higher than predicted in March and slightly above historical trend for the UK economy.

However, the Treasury forecast growth this year of 2 - 2½%, with the rate accelerating in the second half of the year, and growth in 2003 of 3 - 3½%. The latest **forecast from the Treasury** which underpinned the budget is based on a trend rate of growth of 2¾ percent. This is an upward revision (from 2½ percent) based primarily on the assumption of inward migration increasing the population of working age. This is regarded as an optimistic revision by a number of leading commentators.

The latest forecasts published by **Cambridge Econometrics** (February 2002) predict UK GVA (GDP at basic prices) will grow by 1.3% in 2002 and 2.9% in 2003. Cambridge forecast GVA in Wales to grow by 1% in 2002 with growth expected to recover to around historical UK trend of 2.4% in 2003.

Spring forecasts produced by **Oxford Economic Forecasting** were broadly inline with Cambridge Econometrics. Growth in 2002 is expected to be 1.1% in Wales compared to 1.8% in the UK. For 2003, growth in Wales is expected to be just below UK level (2.7% and 2.9%

respectively).

Whilst these forecasts provide a useful impression of short term trends, they get progressively more uncertain beyond a one year time horizon.

Current Business Conditions

Recent **survey evidence** suggests that optimism is returning to companies in the UK and Wales following poor results from previous quarters.

Overall **business confidence has improved considerably** since the previous quarter. The CBI reported that business confidence in the manufacturing sector rose for the first time in more than two years. A balance of 22% of Welsh manufacturing companies and 21% of UK manufacturing companies questioned said they were optimistic regarding the overall business situation. This optimism follows several quarters of pessimism. Manufacturers from the BCC survey reported that they were confident that profitability and turnover would increase. The service sector continues to show optimism in both Wales and the UK. Results from the BCC survey indicated that, in a number of respects, the Welsh economy is outperforming many of the other regions, particularly in the service sector where firms have performed well in home sales and orders.

There are renewed signs of optimism in the export markets with mixed results in the domestic market. The CBI report that export optimism for the year ahead in the UK has turned positive since the last survey. In Wales, export confidence has increased for the first time since July 2000. BCC report that, home sales and export orders increased from the previous quarter. The Cardiff Chambers of Commerce also reported an increase in sales and orders in the manufacturing sector. Home orders however did fall by 15 points to +28% and export sales fell by 22 points. It should be noted however, that last quarter Wales had the highest proportion of manufacturers reporting an increase in home sales and export sales.

The CBI and BCC reported that manufacturing firms continue to downsize, although the rate has eased over the past quarter with BCC reporting that firms' expectations of future job growth is the most positive for a year. Employment in the service sector continues to be strong with expectations of employment growth.

Economic Advice Division
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