

Date: 31 October 2002
Time: 9:00am - 12:30pm
Venue: Committee Room 1, National Assembly for Wales, Cardiff Bay
Title : Quarterly Economic Report for Wales - October 2002

Executive Summary

- The fragile global recovery appears to be continuing though the optimism that was emerging earlier in the year through surveys has not yet fed through into the "real" economy. Many forecasters are now predicting recovery later rather than sooner in 2003, about a year later than originally expected.
- Falling high street sales together with a widening trade deficit have increased fears for the US recovery. However, on the plus side, the latest labour market data is much better than expected.
- In the UK the labour market has remained healthy with falling unemployment and rising employment.
- Over the last twelve months Wales has out-performed the UK average with inactivity and unemployment falling faster than average and employment rising faster.
- Manufacturing output in the UK unexpectedly stalled in August while in Wales output of the production industries returned to growth on the back of recent business confidence. Short term growth forecasts are being revised downwards though acceleration is still predicted based on encouraging business conditions and consumer expenditure

Current Situation

US GDP growth fell back sharply in quarter 2 after a good first quarter. Both private investment and consumption grew at a slower rate than in Q1. Despite the slowdown in Q2 growth, the latest labour market data was welcome as it was better than expected.

Inflation remains low and downside risks remain leading the Federal Reserve to leave interest rates on hold at 1 $\frac{3}{4}$ %. They hinted that future cuts might be possible due to underlying risks to the recovery.

Activity in the manufacturing sector declined in September after seven consecutive months of expansion. Activity in the non-manufacturing sector, however, surged following subdued

growth in recent months.

The recent drop in **consumer confidence** has finally fed through to the high street. Retail sales fell by the largest amount in 10 months, and by twice as much as many analysts had predicted. At the same time, consumer sentiment fell to its lowest level in nine years. Since it represents such a large proportion of economic activity, a slowdown in consumer spending poses a significant potential threat to the US recovery.

But so far the US demand growth has helped support the world economy. The latest **US trade** figures show that imports have risen considerably leading to a record trade deficit of over \$35 billion. With many countries looking towards US sales to increase growth, the rise in imports represents a significant boost. Whether this can continue will depend, however, on the path of consumer expenditure.

The **Japanese** economy continues to perform weakly, though indications of a recovery can be seen in some areas. The impact of a large increase in exports and the recovery in industrial production are expected to spread to the overall economy. On the down-side, confidence, previously at an 18-month high, appears to be deserting many businesses in Japan as the number of business failures surges.

The recovery in **Europe** looks set to continue, though at a relatively slow pace. Second quarter GDP grew slightly faster than the first quarter, partly fuelled by subdued consumer prices. The contribution from exports fell away, however, but there was a substantial pick-up in imports. The difficulties in the manufacturing sector continue with Q2 growth largely concentrated in the service sector. Weaker industrial production is also forecast to restrict Q3 growth. Euro **inflation** remains low and stable and interest rates are unchanged at 3.25%.

However, respondents from recent business surveys suggest that, economic activity in the manufacturing and service sector fell across the Eurozone for the first time since early 2002. Prospects across the Eurozone also deteriorated significantly in both sectors, while service sector employment fell at the fastest rate in survey history.

The fragile nature of the recovery in **Germany** was illustrated in the modest Q2 GDP growth figures. The weakness of the economy was highlighted by the deterioration of a number of leading indicators. Quarter-on-quarter industrial output has held up fairly well but at the same time the volume of new orders fell considerably according to survey evidence, due primarily to a marked weakening of foreign demand. Business confidence fell on the back of the poor data and fears over the strength of the global upturn.

In **France** GDP grew by 0.5% in each of the first two quarters of 2002. However, concerns over the labour market, highlighted by rising unemployment, and poor industrial production figures have caused concerns over future performance.

Domestic Situation

UK GDP growth in Q3 2002 was similar to that in the previous quarter. The latest figures show year on year growth of 1.7%. This is roughly in line with current expectations, but below forecasts earlier this year.

Headline inflation in August rose to 1.7% and the underlying rate rose to 2.1%, though still below the target rate of 2.5%. Although this rise was unexpected, the MPC judged that the course of inflation was still likely to remain within the target range and decided to leave interest rates at 4%. The Governor of the Bank of England hinted that the next movement in interest rates might even be downwards. This may further fuel the rise in **house prices** which have continued to increase, with little sign of slowing.

The latest figures (Q2 2002) from the **Welsh Index of Production and Construction** show a rise in the second quarter compared both to the first quarter and the second quarter of last year. Comparing the latest 4 quarters with the previous 4 quarters the Index is still down. Much of the decline is due to falls in the first half of last year, since then the trend has been more positive. Of particular note is the upturn in manufacturing where the confidence reported in the sector over the previous quarters appears to have finally materialised.

Production figures released for the UK highlighted the stop-start nature of the recovery. Manufacturing output stalled in August following a sharp increase in July, though many economic commentators had forecast significant growth. The overall production index fell slightly on July and remains down on last year's figure.

The slower than expected recovery in the Eurozone has hit **UK exports**. Exports to EU countries fell by 9% with a slight fall to the rest of the world. Overall, the trade deficit rose as exports fell by a greater proportion than the fall in imports.

Given the current economic indicators many commentators have been surprised by the recent strength of the labour market, but it has been consistently robust with unemployment tending to fall and employment to rise. Over the last twelve months Wales has, if anything, outperformed the UK average. Although **unemployment rates**, whether ILO or claimant count, in the UK and Wales remain unchanged this month, over the year Wales had the second largest fall in the ILO unemployment rate of any region in the UK. On the LFS measures, **total employment** in Wales over the year has increased at a faster rate than the UK average and the **inactivity** rate has declined at a faster rate. The employer-based ABI series shows that employment falls in some sectors, notably manufacturing have been more than offset by increases in the rest of the economy, notably construction and public administration and health.

Retail sales rose in the month of September but the rate of growth was lower than in August.

The September figures show the lowest rate of annual growth since January 2001. Nevertheless, there are no signs of a large fall in the growth of consumer spending.

Global Outlook

While the global recovery is expected to continue, it will be weaker and slower than originally expected, according to the IMF. Global growth is forecast to be 2.8% in 2002 (as forecast earlier in the year) with recovery expected in 2003 with growth at 3.7%, a downward revision from six months ago. Among the industrial countries, the recovery in the US is now expected to be considerably weaker than earlier thought. Euro area projections have also been reduced while forecasts for Japan have been revised upwards.

However, contrary to the view that the global recovery will be slow and fragile, the OECD forecast strong growth in 2003 **and** 2002 believing that the growth will be driven by "remarkable" productivity gains.

Domestic Outlook and Assessment

Economic Forecasts

The latest average of **Independent Forecasts** compiled by HM Treasury (October 2002) forecast UK economy to grow by 1.6% in 2002, unchanged from September but down on the August forecast. The forecast for 2003 has also been revised downwards by 0.1 percentage points in each month since August to stand at 2.5%. These forecasts are below the Treasury's Budget forecasts of 2-2.5% this year and 3-3.5% next year. There are now indications that Treasury forecasts to be published in the Pre-Budget Report may be revised downwards in the light of recent data.

The latest forecasts published by **Cambridge Econometrics** (July 2002) forecast UK GVA (GDP at basic prices) to increase by 1.8% in 2002 with growth recovering in 2003 to 2.9%. Cambridge Econometrics forecast the Welsh economy to grow by 1.3% in 2002 and 2.4% in 2003. More recent forecasts by Business Strategies are due to be published later this month.

Current Business Conditions

The main surveys have reported mixed views regarding **Business confidence**. The CBI report that a higher proportion of Welsh manufacturers reported a fall in confidence than last quarter. The BCC, in contrast, reported that business confidence remains high despite a slight fall. Both surveys reported that confidence amongst Welsh manufacturers is above levels recorded in the UK as a whole. In the service sector, BCC report that turnover prospects in Wales improved on last quarter while confidence regarding future profits fell. In the UK, both measures of confidence fell.

There were also mixed signals from the business surveys regarding domestic **sales and orders**. New orders (UK-level) in manufacturing and service sector firms increased according to the CIPS Purchasing Manager's Index (PMI), while the BCC reported a different picture, particularly in Wales. Domestic sales and orders showed marked deterioration in the manufacturing sector with contraction reported following several quarters of growth. Domestic sales and orders in the service sector in Wales showed expansion, while the situation in the UK showed slight expansion, unchanged from last quarter. The strong performance of Welsh manufacturers in the export markets continues, with increased orders and sales, well above UK levels.

Survey results show that manufacturing firms continue to downsize. The majority of Welsh manufacturing companies reported a reduction in their **employment levels**, with future falls expected. The majority of service sector firms increased employment and are forecast to do so again during the forthcoming quarter in both Wales and the UK. However the CIPS survey showed companies reduced employment in both sectors, with further deterioration expected.

Economic Advice Division
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