

# Economic Commentary

## World Economy

The International Monetary Fund (IMF) in its September 2004 *World Economic Outlook* was able to report that a global economy recovery was well established and that the world economy had grown by around 5% in the year to mid-2004. Improvements were founded on stronger growth in the main developed states, and with continued strong growth in the Chinese economy. However, the IMF also reported that, whilst growth in the first quarter of last year was stronger than forecast, the rate of recovery had slackened since this time, with growth of the US and Japanese economies lower than expected. Uncertainty remained over prospects in the Euro zone.

The above conclusions were echoed in the Organisation for Economic Co-operation and Development (OECD) November 2004 *Economic Outlook*. Table 1 shows a summary of OECD short term projections. The OECD reported that there were sound reasons to expect world economic growth to increase in momentum. In particular the OECD predicted improvements in business investment in North America and the EU, with better prospects resulting from a strengthening in consumer spending in anticipation of a reduction in oil prices. The OECD forecast growth across its member states (of which there are thirty) to average 2.9% this year, increasing to 3.1% in 2006. Unemployment was expected to fall in the OECD area from 6.5% this year to 6.3% in 2006. The OECD have linked economic growth to an increase in world trade of 9% this year and 9.5% in 2006. However, the pattern of short term growth is likely to be geographically uneven. Whilst prospects in Asia will be buoyed up by the continued growth of the Chinese economy, and growth prospects remain strong in North

America, there are residual concerns over the role of the Euro zone economies in any upswing. The OECD is rather bullish on this and expected a significant increase in demand in the Euro zone in 2005-06. Clearly, any appreciation of the Euro, and/or continuing upward volatility in oil prices would hit Continental Europe particularly hard, although the OECD does note that European dependence on oil has fallen significantly in the last two decades.

### The UK Economy

In the UK, the Chancellor of the Exchequer in the Budget was able to make some political capital from the stability of the domestic economy, and its reaction to improving global trading conditions, particularly when compared to poorer performances in the mainland European economies. During 2004 it is estimated that the UK economy grew by around 2.9%. Unemployment rates in the UK are at record lows and inflation rates are relatively stable (retail sales volumes increased by 3.6% in the year to February). Treasury 'headlines' make

much of the fact that UK employment has increased by an estimated 2.1m since 1997, and that the unemployment claimant count has fallen below 1m people for first time since the mid-1970s.

The Bank of England *Agents' Summary of Business Conditions* is a synopsis of monthly reports by the Bank's agents across the UK regions. This is one source used by the Monetary Policy Committee to inform decisions on interest rate changes. The latest summary, published in March 2005, highlighted that growth of consumer spending had slowed during the early months of this year, but that confidence in the housing market had improved a little. While, manufacturing output was reported to be growing slowly, business investment intentions were observed to be upbeat. However, these intentions might be curtailed if consumption spending continued to ease off during the year. Services sector output growth was reported as strong. A key feature of the March report were conclusions relating to the tightness of the UK labour

**Table 1 OECD Summary of Short Term Projections (% growth rates)**

	2004	2005	2006
<b>Real GDP growth</b>			
United States	4.4	3.3	3.6
Japan	4.0	2.1	2.3
Euro area	1.8	1.9	2.5
Total OECD	3.6	2.9	3.1
<b>Inflation</b>			
United States	2.0	1.8	1.7
Japan	-2.3	-1.3	-0.3
Euro area	1.9	1.7	1.8
Total OECD	1.8	1.7	1.7
<b>Unemployment</b>			
United States	5.5	5.3	5.1
Japan	4.8	4.5	4.2
Euro area	8.8	8.6	8.3
Total OECD	6.6	6.5	6.3
World trade growth	9.5	9.0	9.5

Source: OECD Economic Outlook; November 2004

market, although the agents felt that labour market pressures had eased somewhat in recent months. Importantly, businesses were reporting that wage costs were remaining under control. Input prices (particularly oil-based products) were, however, steadily increasing, but there were indications that the annual rate of input price inflation may have peaked.

The key question is where this leaves the UK economy for 2005 and 2006. Table 2 shows the results of a recent *Economist* poll of GDP growth forecasts. The UK economy is currently expected to grow by 2.5% this year and by 2.4% in 2006. This is lower than Treasury estimates, and lower than growth during 2004. The expected determining factors are a slowdown in consumer spending and in the housing market, and a moderation of investment growth. Clearly these forecasts are dependent on the absence of any political shocks during 2005, and assume steady oil prices.

**The Welsh Economy**

According to the main establishment surveys business confidence was fairly robust in Wales during the first half of last year. The Welsh index of manufacturing output (see later in this *Review*) showed a strong upward trend during the second and third quarters of 2004. A survey by the South Wales Group of Chambers of Commerce reported in October that regional manufacturers were taking their highest level of domestic orders for more than six years. However, this survey also reported that prospects were weaker for services industries, with falling domestic sales and fewer firms recruiting new staff during the year. During January of this year the Royal Bank of Scotland *Purchasing Managers Index* showed that Welsh business activity had grown for the 21st successive month in December

2004, and that the regional manufacturing sector had expanded output at a faster rate than the services sector.

Later parts of this *Review* reveal that unemployment in Wales is at historically low levels, and that overall employment has continued to grow steadily, although with concerns about the loss of manufacturing employment. Housing markets in Wales have slowed. The period of rapid catch up of house prices in the periphery of Wales is coming to an end. For example, the Halifax showed that in the year to 2004Q3 the highest UK county level house price inflation had been in Gwynedd (40%), and West Glamorgan (38%). However, the boom appears to be over with the November *Royal Institution of Chartered Surveyors’* survey of the UK housing market showing the first signs of a national decline in prices since March 1996. This report also found that new sales had fallen slightly in Wales in the period to November 2004. New housing starts in Wales fell by 28.2% in the year to 2004Q2.

Prospects across Welsh industries are expected to vary greatly during this year. Welsh agriculture continues to recover from recent problems. Farm incomes are growing only slowly. Mining and quarrying prospects continue to be hit by extraction taxes, environmental pressures, restructuring amongst the larger firms, and pressures in the construction sector to use more recycled materials. Regional manufacturing employment still appears to be vulnerable, particularly in large sectors such as electronic and electrical engineering (with further job losses expected amongst key inward investors) and the automotive components sector. Overall, much of the growth of employment and output in Wales is expected to result from improvements

in the service sectors and through growth in the non-market sectors, particularly education and health.

During December of last year new gross value added (GVA) figures were released by the Office for National Statistics. The data showed that Welsh GVA per capita was just 79% of the UK average in 2003, placing Wales only just ahead of the North East and Northern Ireland. This is of some concern with little evidence of the income per capita gaps closing between Wales and the UK average despite strong reported employment growth, and during a period when large parts of Wales have qualified for the highest levels of European structural funding under the Objective 1 programme. Unfortunately, this data actually suggests that the income per capita divide between Wales and the UK is still growing. This poses questions about the type of employment which is being created in the regional economy, and in particular how new opportunities are divided between part and full time, and between male and female employees. The evidence points to an increase in female opportunities, and increasing numbers of part-time jobs in sectors where pay is much lower than comparative UK averages. Coupled to this has been an expansion in the size of the Welsh non-market services sector.

This leads to the conclusion that growth in the Welsh economy will continue to lag behind that forecast for the wider UK economy. Growth of real GVA of around 2.0% is expected this year in line with improvements in employment, and continued growth amongst selected Welsh services sectors. In 2006, and in line with lower expected growth in the UK economy, Welsh economic growth is forecast at around 1.8%.

**Table 2: Economist poll of GDP growth forecasts April 2005**

	2005	2006
UK	2.5%	2.4%
US	3.7%	3.2%
Euro Area	1.6%	1.9%

Source: Economist, April 2nd

**Table 3: Forecast Change in Real GVA (%).**

	2004	2005	2006
Wales	1.9	2.0	1.8

Source: Economist, April 2nd