

29 NOV 2001



Welsh Economic Review

Volume 13.2 Autumn 2001

Produced in association with



© Welsh Economy Research Unit 2001
ISSN 0965-2450

The *Welsh Economic Review* is produced twice yearly, by the Welsh Economy Research Unit (WERU) at Cardiff Business School. The aim of the *Review* is to provide an authoritative and objective analysis of the Welsh economy in a manner that promotes understanding and informs decision-making. The 'core' section of the *Review* is written by members of WERU, with feature articles contributed by academics or practitioners within or outside Wales. The *Review* is circulated widely within Wales, to both private and public sector organisations, including the education sector and the National Assembly.

Notes for Contributors

Authors should send papers for potential publication in the *Welsh Economic Review* to the Editor at the address given below, preferably via e-mail in a Word for Windows format. Papers are welcome on any topic that would be of general interest to the readership, and should be written in a style suitable for non-specialist readers. Papers should be approximately 3,000-4,000 words and any graphs or figures should be accompanied by the underlying data to allow reproduction.

Articles will be refereed within WERU. The Copyright for articles published in the *Welsh Economic Review* will be retained by WERU.

Dr Annette Roberts,
Editor, *Welsh Economic Review*,
Welsh Economy Research Unit,
Cardiff Business School,
Aberconway Building,
Colum Drive,
Cardiff, CF10 3EU.

Tel 029 2087 4173
Fax 020 2087 4419

e-mail robertsa1@cardiff.ac.uk

Economic Commentary

The World Economy

Economic prospects for the world economy had worsened even prior to the tragic events of September 11th. The International Monetary Fund (IMF), for example, had forecasted slowdowns in virtually every major world economy, revising their earlier forecasts (made in May) of world growth down from 3.2% to 2.6% for 2001, and from 3.9% to 3.5% for 2002, prior to the terrorist attack on the World Trade towers. In their press conference later in September the IMF noted that the attacks would have 'increased what were already significant downside risks to the short-term global economic outlook'. The IMF was, however, keen to emphasise reasons for 'cautious optimism' with respect to longer-term prospects. In particular it noted the aggressive responses of central banks, which should help reduce risks of a slowdown in consumer and business confidence. Moreover, global 'economic fundamentals' were viewed as considerably stronger now than in recent years (i.e. lower inflation, stronger fiscal policies, lower external vulnerability in emerging markets). According to the IMF 'there is still a reasonable prospect that recovery will begin in the first half of next year'.

Unfortunately, these sentiments may not stop the drift of the US economy. It had been hoped that consumer confidence would provide some much-needed buoyancy for the US economy through the winter months. However, there is every indication now that consumer confidence is falling. For example, a US consumer confidence index was at its lowest level in September (post attacks) since 1996, and showed the highest single monthly decline since the Gulf War in 1990 (Economist Sept 29th). Following The Federal Reserve's (Fed's) initial cut in interest rates, there was a further reduction in rates in early October to 2.5%, with more cuts in prospect. Congress has already agreed billions of dollars of attack-related 'aid'. This includes grants to airlines, selected tax cuts, increased spending and aid to industry, all of which is likely to be announced as part of the "Economic Recovery Package". The tightly synchronised world economies are particularly vulnerable to a prolonged slowdown in the USA. Stock markets in the US and Europe remain jittery.

The Japanese economy is also expected to have contracted this year. Industrial production has fallen (by 8.5% in the year to July), with the volume of retail sales also in decline (by 2.1% in the year to June). Latest data for Japanese consumer confidence reveals the worst level since 1977. Prospects for the Japanese economy in 2002 are expected to improve, with various groups predicting moderate economic growth. (The Economists poll, and the IMF, both pre Sept 11th, forecast growth of 0.5% and 0.2% respectively for the Japanese economy next year).

Bearing the brunt of uncertainty since the terrorist attacks has been the world airline business. The industry was already in difficulty prior to events in the USA – however, what was a downturn for the industry has now become a crisis. Major airline groups have announced thousands of job losses, reduced their schedules, and seen the value of their shares collapse. For example, American Airlines (the largest

US carrier) announced on 19th September that one third of its workforce (20,000 jobs) would go in order for them to remain in business, whilst British Airways will cut staff by over 5,000 and reduce schedules. Swissair, which has filed for bankruptcy, had aeroplanes grounded during October due to lack of funds, and Sabena (Belgium) was close to collapse. KLM, the Dutch airline and Lufthansa of Germany have also warned of operating losses for this year. Jobs in supply industries are also being lost. For example, Boeing is set to reduce its workforce by up to 30,000 in its commercial aircraft division by the end of next year.

Economic growth in the Euro-zone slowed to 0.1% in the second quarter of 2001. Germany, the largest European economy, has in recent months experienced a slowdown in production activity (by 1.5% in the year to July), with unemployment also increasing. Overall Euro-zone industrial production in July was 1.1% lower than the previous year, while the October Reuters/NTC surveys (which cover Germany, Italy, France, Spain and Ireland) show a fall in activity in September in both manufacturing and market services. Activity declines in services were particularly evident in transport, hotels and tourism (*Financial Times*, 3rd October 2001). The European Central Bank cut interest rates by a half-point to 3.75% in the immediate aftermath of the terrorist attacks. Further rate cuts are predicted before the end of the year.

The UK Economy

The UK economy, according to the IMF, is expected to have grown by 3.1% in 2000. Projections were, however, that growth would slow in 2001 to around 2%.

UK economic growth was reported to have been 2.1% in the year to 2001Q2. However the Office for National Statistics subsequently revised this upward, to 2.3%, reflecting faster growth in services and construction industry output. The (ILO)

unemployment rate for the UK averaged 5% in the period May-July 2001.

The UK economy is also relying on consumer confidence to support depressed production sectors. The September CBI survey of business confidence provided welcome news, suggesting that damage to UK consumer confidence from the terrorist attacks in the USA may be limited (although the survey period partially pre-dated the attacks). According to the CBI, 62% of retailers reported an increase in sales in September, with only 8% reporting a fall. However, some mortgage lenders expect a slowdown in the housing market, and consumers' willingness to spend is likely to fall.

Inflation edged higher, increasing by 0.4 percentage points to 2.6% in August (above the Bank of England's target of 2.5%). Despite this, and following monetary easing by other world central banks in response to events in the USA, the Bank of England cut rates by a quarter-point to 4.75% in mid-September. At their scheduled meeting in early October, interest rates were further cut to 4.5%, the sixth time rates have been cut this year. Interest rates in the UK are now at their lowest level since 1964. Despite mixed signals about the strength of the economy, the reasoning behind the decision to cut rates again was that "the weaker world outlook and increased uncertainty have set back business confidence, and may, for a time, restrain business and household spending."

The Welsh Economy

Both the ILO and claimant count measures of Welsh unemployment fell during the summer months, when compared with the same period last year. For example, the (ILO) unemployment rate in Wales averaged 5.9% between May and July 2001, a fall of half a percentage point since 2000 (although still above the UK average rate). This is surprising given the continuing damage to Welsh manufacturing (as a result of poor world economy conditions and the continued strength of Sterling), and the impacts

on the economy of foot-and-mouth disease. However the employment picture for Wales in the service sectors appears to be better. Both sectors saw overall employment gains in the first half of 2001. A concern for the Welsh economy is that whilst employment is continuing to be created in the non-production sectors of the economy, partially off-setting manufacturing employment losses, these jobs will often be in sectors where the potential for Gross Domestic Product (GDP) generation is limited.

The recent interest rate reduction will be welcome news for Welsh industry. However some sectors, particularly airline and aerospace industries, are facing additional uncertainties as a result of recent events. At the end of September, Vinci, the French construction group, pulled out of its take-over of TBI, which owns and operates Cardiff airport. This is a pattern mirrored around the globe, as mergers and take-overs are cancelled or postponed due to increasing uncertainty in the market. Cardiff airport is, however, in a stronger position than many other airports to survive the current crisis, as its flights are predominantly Mediterranean bound.

GE Aircraft Engine Services operations in Nantgarw, one of the few plants world-wide where airline engines are overhauled, announced early in the summer that around 200 jobs would be lost. In early October a further round of job losses were announced at the Nantgarw site. There are further concerns that the Airbus site in Flintshire could also be affected by a short-term decline in orders. The aerospace sector had been considered one of the more stable (and higher value added) parts of the Welsh economy.

Welsh tourism, already struggling from the fall-out of foot-and-mouth disease, is also likely to see a further reduction in visitor numbers as a result of events in the USA. Whilst it is too soon to estimate the cost to industry, there have been reports of a predicted 20% reduction in visitor numbers to Britain (America is Britain's and Wales' largest overseas tourism market).

Forecasts

In the last issue of the Welsh Economic Review, real GDP growth forecasts for Wales were revised downwards as a result of global and local economic conditions. Most economic forecasts for

the World and UK economies for 2001 have been revised downwards, as the probability of recession in the USA, which will then knock-on to other economies, has increased. There is still, however, some expectation that limited recovery could begin during 2002. Whilst overall employment in the Welsh economy has remained firm during this year, it is difficult to find sectors which will end 2001 in a stronger position than they started the year. Manufacturing production continues to fall steadily (see Industrial Production section of this Review).

The WERU forecasts for the period 2001-2003 are set out in Table 1 below. The forecast for 2001 has been revised down to 1.1%, as a result of slower than expected growth in the UK economy. As the impacts of job losses in aerospace, electronics, automotive and textiles feed through into the economy next year, it is likely that GDP growth will continue to be well below the expected UK average. With GDP growth in Wales unlikely to match that of the UK in the medium term, there is every prospect that the Welsh GDP gap with the UK will widen still further.

Table 1 Forecast Change in Real GDP (%)

	2001	2002	2003
Wales	1.1	1.0	1.8