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Economic Commentary

World Economy

The latest *World Economic Outlook*, published by the International Monetary Fund (IMF) in September 2003, provides some optimism for a renewed recovery in global growth. Whilst the IMF's forecasts for the World economy have remained unchanged since the last *Outlook* (growth of 3.2% this year, and of 4.1% in 2004), they consider prospects to have improved. However, the IMF caution against complacency. Growth is likely to be unbalanced, with some economies faring far better than others. In addition concerns remain of an over-dependence on the US economy as the main growth driver.

The overall forecasts for World economic growth are unchanged, however there are revisions to country forecasts. Figure 1 shows latest IMF growth estimates for selected economies.

The IMF's forecast for US economic growth has been revised slightly upwards for 2003 and 2004 to 2.6% and 3.9% respectively. Government and consumer expenditures in the US increased in the early part of this year and recent business surveys have reported increased levels of confidence. Housing markets also remain strong, providing support to consumer spending, but there are fears that housing market growth in the US cannot be sustained at current levels. In addition, whilst output growth appears to be picking up, employment has fallen, hence earning the label of a 'jobless recovery' (*Economist*, September 13^{th}). In sectors where employment growth has occurred, this has tended to be in temporary or part-time jobs, hence increasing firms' flexibility and productivity.

Recently there has been some encouraging economic news from Japan. Estimates of output growth in the first half of this year have been higher than expected, and IMF forecasts for 2003 have been revised up to 2% (an increase of 1.2 percentage points compared to the previous forecast in April 2003). The forecast for 2004 has also been revised upwards to 1.4%. However, problems remain in the Japanese economy. For example, retail sales volumes have been falling, and levels of government debt are increasing. In addition, the economy is still in a period of deflation. In the year to August, consumer prices, producer prices and wages all fell, by 0.9%, 2% and 2.7% respectively.

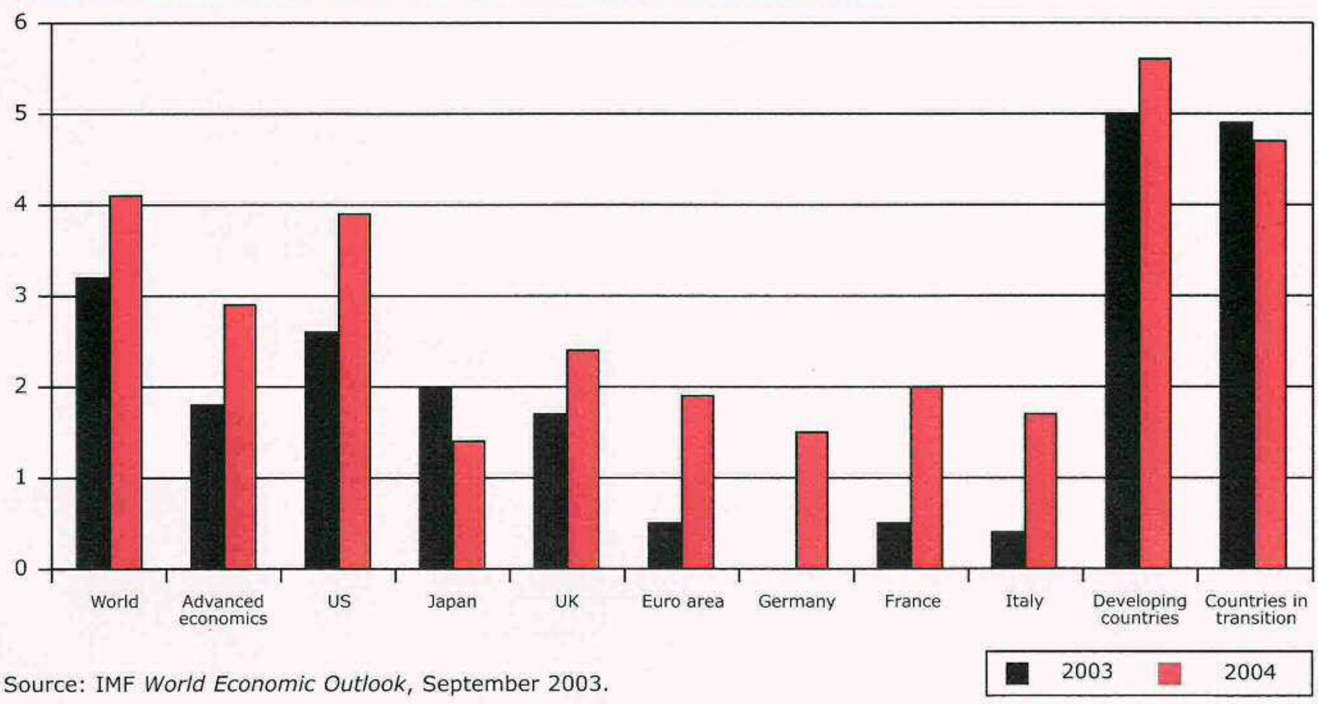
Economic growth in Japan is influenced by its trade with the faster growing developing Asian economies, such as China. The Chinese economy grew by 7.5% in 2001 and by 8% in 2002, with growth for 2003 and 2004 forecast at 7.5%. The Indian economy is also growing strongly, with growth of over 5.5% expected both this year and in 2004.

Output in the Euro area declined during the second quarter of this year. There were reductions in output in Germany, Italy and France. During the summer months unemployment in the Euro area reached a 42 month high of 8.9%. In June, the European Central Bank reduced interest rates by 0.5%. A business climate survey undertaken in Germany during August showed increasing levels of business confidence, for the fourth consecutive month. However, it is still unlikely that Germany will experience any economic growth this year, although forecasts do suggest that there will be some modest growth (see Figure 1, also *Economist Poll*, 11^{th} October). For the Euro area as a whole, growth of 0.5% is expected this year, increasing to 1.9% in 2004. Better growth in 2004 is expected, partly as a result of higher exports to the rest of the World, and particularly due to the close connections between the European and the US economy, with the latter now strengthening.

Foreign Direct Investment (FDI).

In September 2003, the United Nations Conference on Trade and Development (UNCTAD) published their latest *World Investment Report*. This report provided estimates for World foreign direct investment activity, and showed that for this year, inflows of FDI to developed

Figure 1: Forecast Output Growth (annual % change), Selected Economies.



Source: IMF *World Economic Outlook*, September 2003.

countries declined for the second year in a row. Both the US and UK experienced significant falls in FDI flows (see Figure 2), largely as a consequence of reduced cross border mergers and acquisitions, and a fall in intra-company loans.

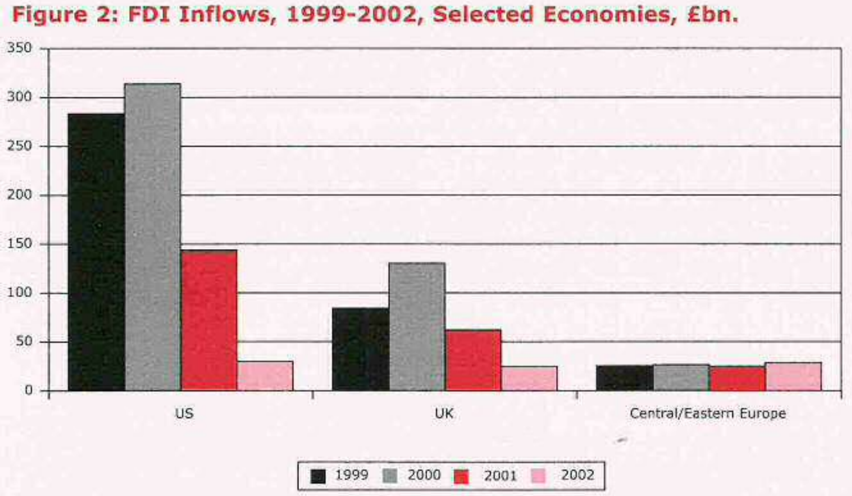
Figure 2 also shows FDI inflows into Central and Eastern Europe (CEE). Historically, these flows have been much smaller in absolute terms compared with, for example, the US and UK. However in 2002, the *flow* of FDI into CEE reached a high of almost £29bn, which is comparable to both UK and US FDI inflows for that year (although noting that the *stock* of FDI is significantly higher in the US and in the UK than in CEE).

Within CEE, the automotive industry has been a major recipient of FDI, with expectations that this trend will continue. For example, Peugeot-Citroën recently began construction of a new plant in Slovakia, and is planning another in the Czech Republic (jointly with Toyota), whilst both Audi and Suzuki are expanding existing operations in Hungary. However, in other sectors, such as electronics, CEE nations have been vulnerable to cost competition from elsewhere (e.g. from China), and from a downturn in global demand. The future enlargement of the EU, and cost (labour and non-labour) competition factors have encouraged FDI to CEE. However more recently some low-skill activities are being replaced by higher value-added functions which utilise labour forces with relatively high educational achievements in some CEE nations. Figure 3 shows FDI flows for 2001 and 2002 in selected CEE countries.

The UK Economy

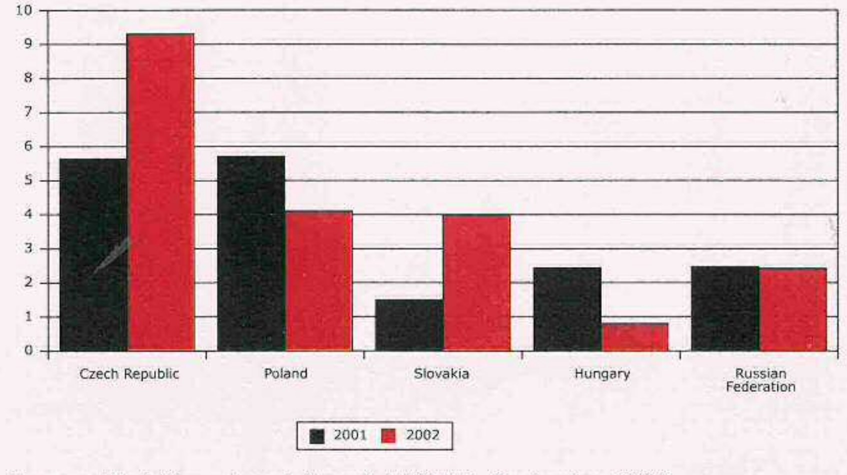
The UK economy is estimated to have grown by 1.7% in 2002 (Office for National Statistics), with expectations of a similar growth rate being achieved this year, and of higher growth for 2004 (see Figure 1). Consumption spending in the UK has remained strong, partly fuelled by a growth in housing equity withdrawal. Whilst UK house price inflation had been slowing until recent months, the rising property values are still providing an indirect prop to household expenditure. In August, retail sales volumes were 3.8% higher than the previous year, and this figure increased marginally in September. Spending during the summer months was also reportedly boosted by the good weather. In November, the Bank of England increased interest rates to 3.75%. This increase, the first in almost four years, was widely anticipated due to increased consumer debt and house price inflation concerns. The Bank commented that the modest increase was necessary to keep inflation in line with the 2.5% target.

Figure 2: FDI Inflows, 1999-2002, Selected Economies, £bn.



Source: *World Investment Report*, UNCTAD, September 2003.

Figure 3: FDI Inflows to Central and Eastern Europe 2001 and 2002, Selected Countries, £bn.



Source: *World Investment Report*, UNCTAD, September 2003.

Recent estimates from the *International Passenger Survey* show that the number of overseas visits to the UK increased by 7% in the year to August 2003. The almost 24.5 million visits to the UK were associated with around £12bn of expenditures by visitors. The largest increase in visits were by western Europeans, accounting for over 60% of total visits. Visits from North America (which represented less than 20% of visits) declined by around 3% in the year to August 2003. This fall was largely expected as a consequence of the war in Iraq, and other world events which have impacted more heavily on American visitors. American visitors account for a relatively small share of visitors to the UK, but they are typically associated with longer stays and hence higher expenditures.

Industrial production in the year to August fell by 0.8%, and the unemployment rate for August remained fairly constant (at 5%, ILO measure) compared with the previous year. Recent UK employment news includes the increasing prospect that 20,000 public sector jobs could be relocated away from London and the South East. In his April Budget, the Chancellor asked Sir Michael Lyons to undertake an independent study into the scope for relocations. In September, an interim report was published indicating that these relocations should be possible, and that the benefits would include cost saving to departments, better service delivery to customers and an improved quality of life for employees (due to lower house prices and commute times).

Further concerns for UK jobs in banking, finance and other sectors were raised in October following the announcement by HSBC that several thousand UK jobs would be lost due to a transfer of some (back-office/call centre) activities to Asia. According to unions tens of thousands of UK jobs are threatened by such moves. The labour cost competitiveness of countries such as India, Malaysia and China has already attracted companies such as BA, BT, Tesco, Prudential and Powergen. However, whilst investments overseas are increasing in these sectors, there are some indications that total call centre employment in Britain is still rising, with expectations of further growth next year (*Economist*, 26th July). In addition, whilst some activities can be readily outsourced overseas, other activities may require a local presence to fully meet customer needs.

The Welsh Economy

Recent Welsh labour market data has shown both increasing employment and falling unemployment. Employment gains have occurred mostly in the services sector, with the most significant gains being in the public sector, a consequence of increased Welsh Assembly Government expenditures in sectors such as education and health, and other increases in public administration employment. However, balanced against this, have been employment and output losses in production sectors (see Industrial Activity section of this *Review*).

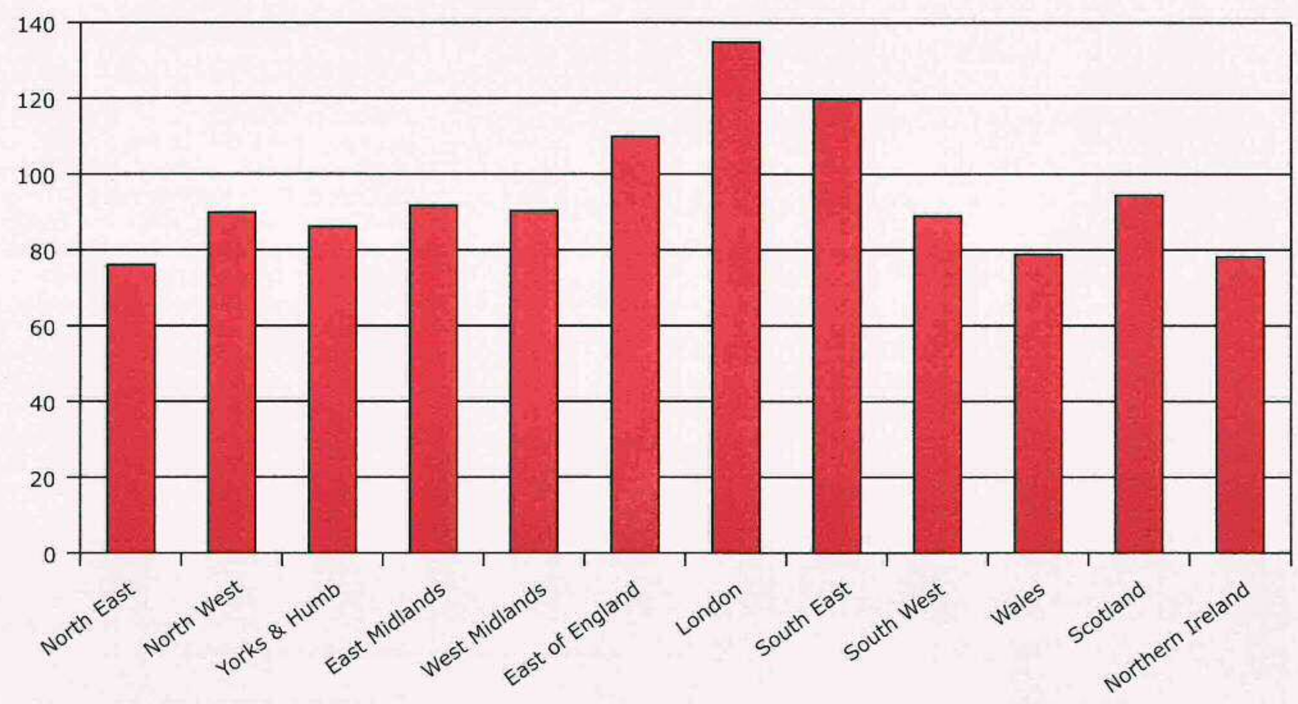
During the summer of this year the Office for National Statistics published provisional estimates of regional gross value added (GVA) up to the year 2001. In 2001 Welsh GVA was estimated at £33.1bn, which was 3.8% of the UK total, whilst GVA per head in Wales was estimated at £11, 400, or just 78.8% of the UK average. GVA per head in Wales has fallen from almost 85% of the UK average to less than 80% over the 1989 to 2001 period. Of all the UK regions, the North East had the lowest levels of GVA per head in 2001, at 76.1% of the UK average, followed by Northern Ireland (at 78.2% of UK average) and then Wales (figure 4).

The provisional GVA data enables some analysis of Wales' economic performance in the recent past. However care must be taken in this exercise. The published regional data provides current price, or nominal GVA estimates. In order to establish real growth rates for the economy, these nominal estimates should be adjusted for price changes over the period. The appropriate adjustment mechanism is to apply a deflator to the data time series. These deflators are available for the UK economy. However, there are no equivalent deflators published for the UK regions (although plans for the publication of regional price data were mentioned in the last Budget, see p6 in the previous volume of the *Review*). Whilst there is some expectation that a regional deflator would vary from a UK deflator, the latter can be applied to Welsh data to provide some indication of real economic growth. In 1997 Welsh GVA (in current prices) was estimated to be £28.5bn, increasing to £33.1bn by 2001. Use of the UK deflator reveals that Welsh GVA grew by an average of around 1.6% per annum over the period (compared to approximately 2.6% pa for the UK).

Whilst more recent data is currently unavailable (estimates for 2002 are due to be published in March 2004), there are unlikely to be significant improvements in real growth rates since 2001. The political economy section of this *Review* describes the nature of recent employment trends, and the increase in generally low value-added type employment. Combined with falling employment and output in manufacturing activities in Wales, these factors are unlikely to provide a growth tonic for the Welsh economy.

One potential boost to the Welsh economy in the period 2000 - 2006 will be provided by European Structural Funds. The most significant of the various programmes currently underway in Wales is the Objective 1 programme for West Wales and the Valleys. The mid-term evaluation of this programme was recently published and showed that progress, in terms of funds committed, was generally good. However the overarching targets in terms of GVA and employment growth may be overly ambitious. Whilst there is some possibility that these targets will be

Figure 4: GVA per head 2001*, UK = 100.



Source: Office for National Statistics *Provisional figures revisited, the structural funds programmes will now need to focus on the support and generation of value-adding activity that can be sustained beyond the programme period.

Forecasts

Table 1 presents forecasts for the Welsh economy for the period 2003-2005. The forecasts for 2004 and 2005 are unchanged from the Spring volume of the *Review*, whilst the forecast for this year has been revised slightly to 1.5%.

Table 1: Forecast Change in Real GVA (%)

	2003	2004	2005
Wales	1.5	1.5	2.0