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# Welsh Economic Review

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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 Welsh Assembly Government.

#### **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.

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# Economic Commentary

## World Economy

Both the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD) recently published their latest economic outlooks (IMF in April and OECD in May). Both organisations report a stronger and more sustained recovery in the world economy. According to the IMF, world output growth was 3.9% in 2003, which is higher than had been expected. The IMF's growth forecasts for the global economy have been revised upwards to around 4.5% for both 2004 and 2005. These improvements are a result of increasing levels of industrial production, stronger world trade and strengthening business confidence. However there are some concerns for the global recovery, most notably the continued risks from terrorist attacks, and oil price rises. Crude oil prices surged during late May/early June. The price of West Texas Intermediate (a benchmark price) rose to over \$42 a barrel. Prices had not been this high (in nominal terms) since 1990 at the time of the first Gulf war. Prices, however, quickly fell back on the expectation that the Organisation of Petroleum Exporting Countries (OPEC) would increase production.

In the United States, recovery has been aided by expansionist fiscal and monetary policies. The business sector is reporting productivity and profits growth, signalling an increase in future investment and output. There are some signs of US labour market improvements, although the market still remains relatively weak, and this may provide a future constraint on household income and consumption. A further concern is the US budgetary position, resulting from tax cuts and higher spending. Any adjustments to the deficit would most likely be connected to a slowdown in economic growth, which could have implications for other world economies. Financial markets in the US and elsewhere have been sensitive to oil price changes. The US, which consumes around 25% of the world's petroleum, remains the world's largest user by far. Besides oil, prices are rising in the US at rates faster than expected by many

economists. Whilst inflation remains low, the US Federal Reserve (Fed) has recently indicated that interest rates are likely to rise in the near future. US interest rates are currently at a 46 year low of 1%.

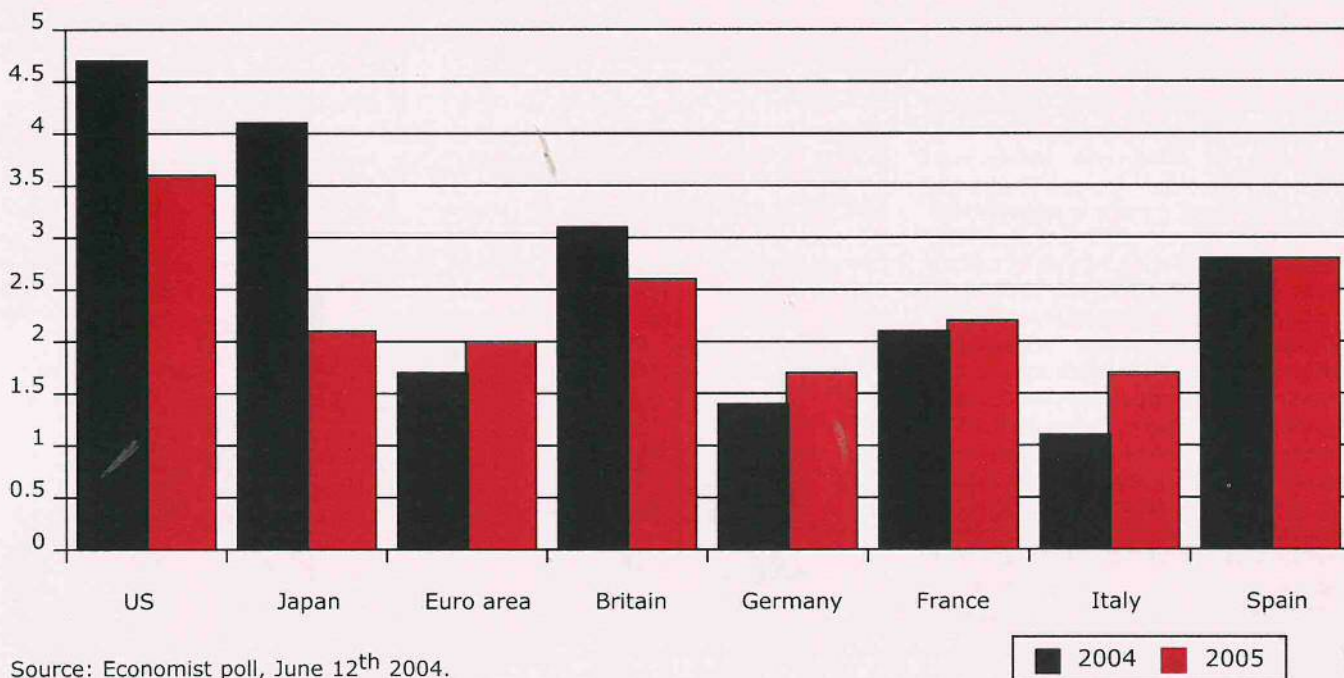
Figure 1 shows the Economist poll of output forecasts for selected economies. Output growth is expected to be 4.7% in the US in 2004, and 3.6% in 2005.

Whilst the global recovery appears to be well under way, the size and scope of recovery varies by region. The upturn has been rapid in emerging Asian markets, particularly in China. Output growth in emerging Asia accelerated to around 7% in 2003, accounting for about 50% of world growth (IMF). Growth is expected to remain at these levels in 2004. This strong performance has been related to favourable macroeconomic policies, competitive

exchange rates, and a recovery in the IT sector. China has been key to the growth of this area. Increases in investment and exports have provided an important boost to activity in countries within and outside Asia, although there are some reports that the Chinese economy is close to overheating.

Japan is experiencing a stronger and broader economic recovery than had been expected. In the year to April, industrial production in Japan grew by 8.5%, whilst the unemployment rate was 4.7%, compared to 5.4% a year earlier. However, the country is still experiencing a period of deflation, although it is hoped that an easing of monetary policy and steady recovery will deliver positive and sustainable inflation in the near future. Output growth in Japan is forecast to be 4.1% in 2004 and 2.1% in 2005 (Figure 1).

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





The global recovery is largely bypassing Continental Europe, where domestic demand and household expenditure remain relatively weak. In the euro area economic growth is expected to increase from less than 1% in 2003 to around 1.7% in 2004 and 2% in 2005. However, further appreciation of the Euro, and low levels of consumer confidence could limit recovery. In April unemployment in the euro area averaged 9%, a marginal increase on the previous year's figures. The unemployment rates in Germany and France were 10.5% and 9.8% respectively.

On May 1<sup>st</sup> the European Union expanded to take in ten new member countries, mostly from Central Europe. This occasion was marked with a mix of concern and optimism in existing member states. Many of the concerns related to the potential flows of migrants from new member states, who may either be work-seeking, or work-shy and seeking benefits. As a result many governments have imposed restrictions preventing the inflow of migrants for at least two years. However, EU expansion has the potential to greatly improve the economic prospects for new members whose economies have previously suffered under hostile political regimes. In addition, whilst new member countries may have small economies, many are growing at much faster rates than those of existing members. This provides opportunities for European companies in a larger and more dynamic market. At the same time the generally lower cost base in new member states may stimulate competition with existing members, encouraging them to cut costs and reform their own economies (*Economist*, 1<sup>st</sup> May p.11).

## The UK Economy

In the UK economy output growth was just over 2% and inflation stayed within its target band during 2003. The stock market made some recovery from the turbulence of 2001 and 2002, but remained well below its previous high levels. UK output growth is expected to be around 3.1% in 2004 and 2.6% in 2005.

A central concern of monetary policy is to stabilise inflation. The increase in inflation during 2003 contributed to the Monetary Policy Committee's (MPC) decision to raise interest rates to 3.75% in November. This was the first increase in base rates for over 2 years. Since then, interest rates increased in February, May and June, and currently stand at 4.5%. Whilst inflation is within its target, the MPC was concerned about maintaining the target in the future. Consumer spending has been growing strongly (retail sales increased by over 6% in the year to April) and investment and the housing market have also

grown. However, tight labour markets and decreasing levels of spare capacity are contributing to cost pressures. Unemployment in the UK has fallen, and wages increased by an average of 5.2% in March (compared with 3.3% a year earlier).

Further potential problems for the UK economy relate to levels of consumer debt. Household debt has been increasing rapidly and is now well above the peak of the late 1980s. Households are thus considered to be vulnerable to any kind economic shock, which may result in changes to employment and growth rates. These debt levels are closely related to the housing market and hence mortgage borrowing. Recent house price figures indicate that the housing boom remains strong. Halifax reported that the average UK house price has doubled in less than a decade.

As noted earlier, a further area of concern is oil prices. Although the UK is less oil-dependent than it was in the 1970s, higher prices can still impact directly on UK business profitability and household incomes, whilst the impacts on the global economy have further implications for UK companies.

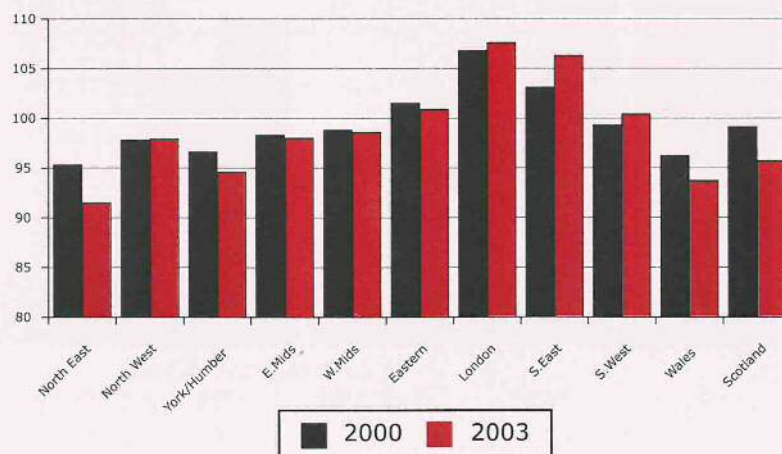
The previous volume of the *Review* commented on world foreign direct investment (FDI) flows, and noted the falling levels of FDI into the UK during 2001 and 2002. The Economist Intelligence Unit (EIU) recently reported that inward investment into Britain was just \$14.5bn in 2003, falling from a peak of \$120bn in 2000. The EIU noted that Britain's share of EU FDI has fallen every year since 1998, and that in 2003 its share was just 5.4% (compared with over 25% in 1998). Part of the explanation may be related to mergers and acquisitions (M&A) which have

formed an important component of FDI flows into the UK. These forms of FDI are more volatile, and hence expose Britain to cyclical trends. It is then possible that the UK could disproportionately benefit if there is an upturn in M&A activity. However, according to the EIU, a further potential factor explaining Britain's poor FDI performance is the fact that the UK is not part of the euro zone. The EIU conclude that staying outside the zone will cost Britain one third or more of its potential FDI flows, whilst other economists have suggested this figure could be higher (*Economist*, May 29<sup>th</sup> p.30).

In November 2003, the Office for National Statistics published estimates of differences in regional price levels. This information is part of a longer-term project to develop regional price data, as mentioned in the Chancellor's Budget last year.

Figure 2 shows the average price in each region relative to the national average price, and compares results for 2003 with those of 2000. This comparison is only indicative of the changes over that period as there are some small compilation differences between the two surveys. Unsurprisingly London is shown as the most expensive place to live in the UK, closely followed by the South East. Prices are lowest in the North East, followed by Wales, Yorkshire and Humberside, Scotland and Northern Ireland (Northern Ireland is not shown in Figure 2 due to lack of price data for the year 2000). Information is also available on price differences for 14 groups of expenditure. The largest regional price differences were in housing costs, whilst the lowest differences were in food items.

**Figure 2: Average Price in each Region, 2000 and 2003, UK=100.**



Source: Office for National Statistics



## The Welsh Economy

In December 2003 estimates of economic activity for sub-regions of the UK were published. The Nomenclature of Units for Territorial Statistics (NUTS) provides a uniform geographical breakdown of areas for the production of regional statistics. The sub-regional (or level 3 of the NUTS geography) results relate to the year 2001, and these data are required by the European Union to inform structural funding decisions.

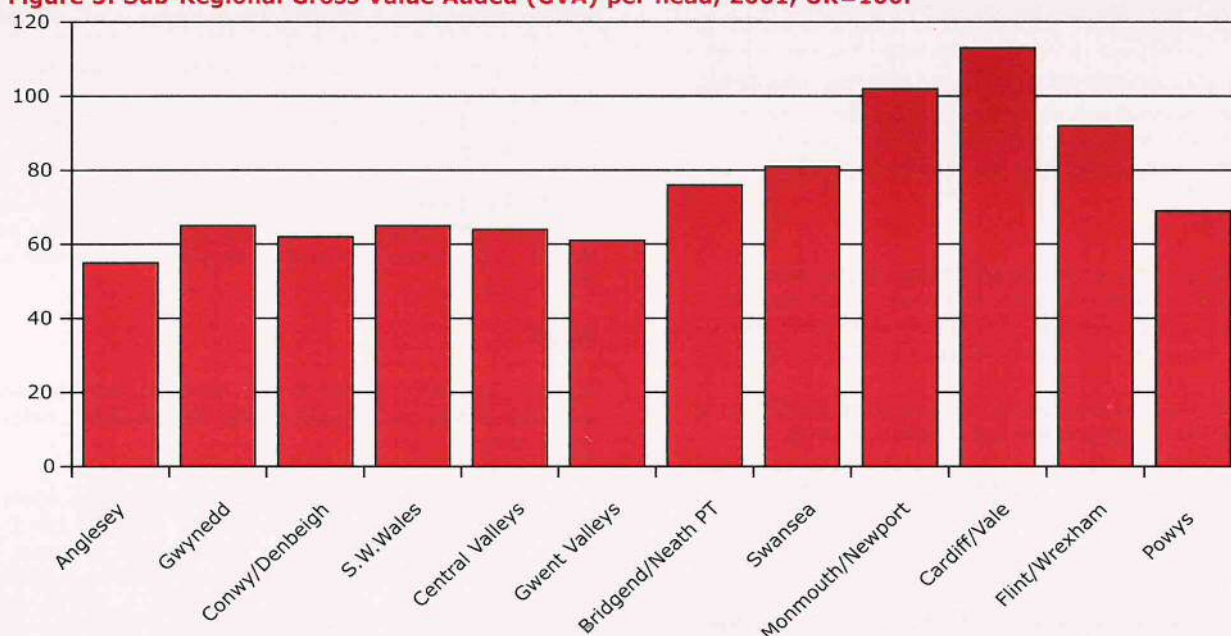
The first 8 areas in Figure 3 comprise West Wales and the Valleys area (WWV), which is currently receiving Objective One structural funding from

(GVA) for 2002. The previous volume of the *Review* commented on the GVA estimates up to the year 2001, which had shown the poor performance of GVA per head in Wales compared to the UK average. Unfortunately the 2002 data for Wales is not encouraging, with no signs that the gap between Wales and the UK is closing. The Welsh Assembly Government's aspiration that GVA per head in Wales would reach 90% of the UK average by 2010 thus appears highly optimistic. Welsh GVA was estimated at £35.084bn in 2002, which was 3.8% of the UK total, whilst GVA per head was £12,020, or just 78.8% of the UK average.

announcements have been countered by rationalisations of existing chain stores across the UK, and whilst there continue to be new announcements of call centre developments, this sector also remains volatile to company restructurings (such as by Norwich Union).

The public sector is an important provider of jobs and incomes in Wales, and education and health sectors are likely to continue their expansion, supported by further increases in government spending (see Public Sector Spending section of this *Review*). Whilst other areas of the public sector (for example, defence) have seen reductions in employment, there are some

**Figure 3: Sub-Regional Gross Value Added (GVA) per head, 2001, UK=100.**



the European Union. On average, this WWV area had a GVA per head of 67% of the UK average in 2001. Within this area, Swansea had the highest levels of GVA per head, whilst in Anglesey GVA per head was estimated at just 55% of the UK average. In East Wales overall (the final 4 areas in Figure 3), average GVA per head was equal to the UK average, with the highest levels found in Cardiff and the Vale of Glamorgan, and lowest levels in Powys.

More recent information is available for Wales as a whole. In April the Office for National Statistics published provisional estimates of regional gross value added

There has been some more encouraging economic news recently. As noted earlier, the global economy is now growing strongly, which has implications for the Welsh economy. Manufacturing output, which had been falling steadily each quarter showed a marginal improvement at the end of 2003 (see Industrial Activity section of this *Review*). Although output remains well below 2000 levels, business surveys have suggested there is an increase in confidence, orders and output amongst respondents.

There has been mixed news in the services sectors. In retail, new store

expectations that Wales may benefit from the proposed relocation of public sector jobs away from the South East of England to the UK's regions and nations (see previous volume of the *Review*, p.6).

### Forecasts

Table 1 presents forecasts for the Welsh economy for the period 2004 – 2006. As a result of the higher levels of economic optimism both globally and locally the forecast for 2004 has been revised to 2.2%. In 2005 and 2006 growth is forecast at 2% in each year.

**Table 1: Forecast Change in Real GVA (%)**

	2004	2005	2006
Wales	2.2	2.0	2.0