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Economic Commentary

World Economy

In September the International Monetary Fund (IMF) published its latest *World Economic Outlook*. According to the IMF global prospects improved during the early part of the year with expanding service sector output more than offsetting slowing manufacturing and trade performance. Whilst business confidence and other indicators dipped slightly in the second quarter, global outputs from the manufacturing sector, and trade performance has since improved. However, increasing oil prices remain a constraint on growth, a situation recently worsened as a consequence of Hurricane Katrina. The IMF forecast is for global economic growth of 4.3% in 2005 and 2006; these forecasts are little changed from the previous *World Economic Outlook* which was published in April.

Figure 1 shows IMF output growth forecasts for 2005 and 2006 for selected economies. The US economy is expected to grow by 3.5% in 2005 and by 3.3% in 2006. These forecasts signal solid growth expectations. However, the US growth forecasts have been reduced. Whilst the IMF reported strong US economic performance in the first half of 2005, prospects in latter part of this year have been affected by the human and financial losses caused by Hurricane Katrina. US economic data for September showed that industrial production fell by 1.3%, the largest monthly decline since January 1982, although over the year industrial production increased (by 2% compared with September last year). The monthly fall in industrial production comprised a 0.5% fall in manufacturing output and a 9.1% fall in mining output, which includes offshore oil and gas (*Economist*, 22nd October). The US unemployment rate increased during September (to 5.1%), as there were some 35,000 job losses. In the absence of the Hurricane, the *Bureau of Labour Statistics* suggested there would have been employment gains during September, as there had been for the past 2 years. US retail sales grew during September, but by just 2%, whilst consumer prices increased by 1.2%, the largest monthly rise in 25 years. This

increase was mainly due to a 12% increase in energy costs.

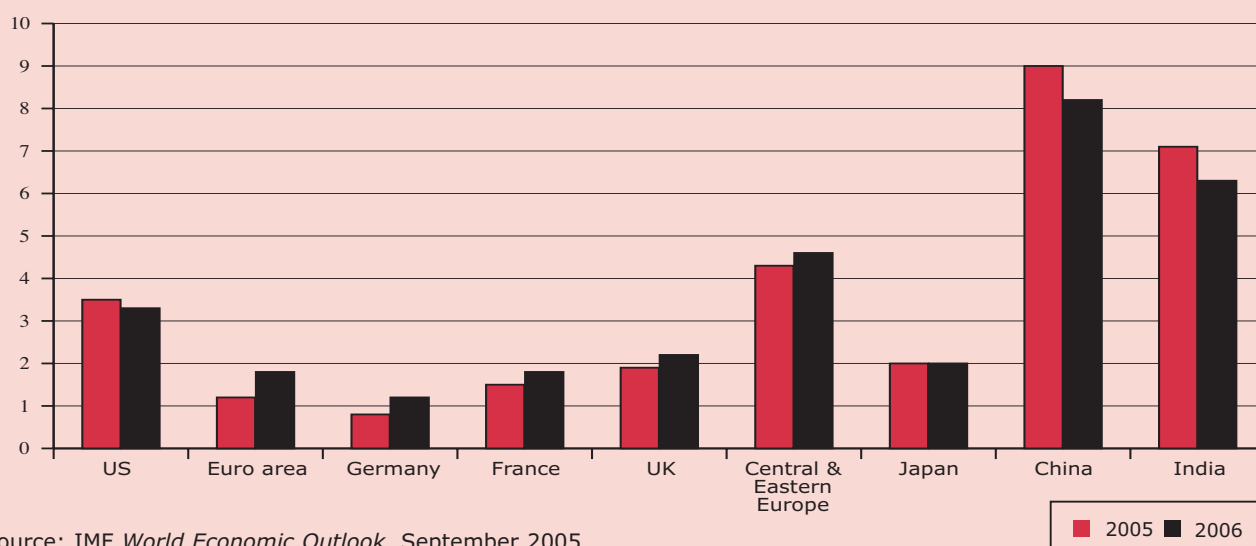
Figure 1 shows that the Japanese economy is expected to grow by 2% in 2005 and 2006. Japan's labour market performance has improved. The unemployment rate for August was 4.3%, compared with 4.8% one year earlier, and the IMF reported that full-time employment is now expanding for the first time in seven years, with positive impacts on private consumption. Retail sales in August were 1.9% higher than the previous year. Deflation however continues in Japan. Consumer prices in August were -0.3% below those of the previous year. Producer prices, however, increased by 1.7% in the year to September, although this was partly a consequence of higher fuel prices.

The Chinese economy grew by 9.5% in both 2003 and 2004, well above the growth rates of any of the advanced economies. China accounts for around 13% of world output (and almost 21% of the World's population), compared with 21% for the US (which has 4.7% of World population) and just over 15% for the Euro area (4.9% of population) (IMF). The Chinese economy is expected to grow by 9% in 2005 and by 8.2% in 2006. Figure 1 also shows the high

expected growth rates for the Indian economy, at 7.1% for 2005 and 6.3% for 2006. In 2003 the Indian economy grew by 7.4% and by 7.3% in 2004 (IMF). Hence along with China, India is now one of the fastest growing world economies. The IMF however commented that the impact of Indian economic growth on the global economy is limited, as India remains a relatively closed economy. Whilst India has become a popular location for outsourcing (for example call centre) activities, overall global trade linkages are relatively weak, although improving with economic reform.

Economic growth in the Euro area was just 0.7% in 2003, although there was an improvement to 2% in 2004. However this upturn is likely to be temporary with the IMF forecasting 1.2% output growth in 2005 and 1.8% in 2006, and economic performance across the Euro area remains uneven. The 2004 increases in Euro area domestic demand have since slowed, and confidence indicators remain subdued, although there have been some signs that manufacturing prospects may be improving. Industrial production in the Euro area increased by 0.8% in August (compared with a 0.1% gain in July) and retail sales in August were 2% higher than the previous year.

Figure 1: World Output (annual % change), Selected Economies, 2005 and 2006.



Source: IMF *World Economic Outlook*, September 2005.

Unemployment, however, remains high. In August the Euro area unemployment was 8.6%, a marginal improvement on the 8.9% in August 2004.

The UK Economy

The UK economy is estimated to have grown by 2.5% in 2003, and by 3.2% in 2004. The IMF have revised their forecasts downwards for this year and next compared with their April projections, to 1.9% for 2005 and 2.2% for 2006. The downward shift in the forecasts results from a slowdown in private consumption growth, and in the housing market, and weakening business confidence. As a result of a relatively poor performing Euro area in the coming year, demand for UK exports (a significant percentage of which is from Euro area markets) is projected to slow. In the year to September consumer price inflation increased to 2.5%. Inflation is now above the Bank of England's target rate of 2%.

The CBI *Industrial Trends Survey* for July reported a fall in new manufacturing orders for the third successive quarter, and business confidence fell for the fourth successive quarter. As a consequence the CBI expect investment in plant, machinery and buildings to slow over the coming year. In August the *Office for National Statistics* reported that UK industrial production was 1.9% lower than in the previous year. Retail sales volumes in September had however shown a marginal improvement of 0.7% over the year, and the unemployment rate has remained steady (at 4.7%, ILO rate) in the year to August. However during

September the number of people unemployed and claiming benefits increased by 8,200.

The *Bank of England Agent's Summary of Business Conditions* for October showed some positive economic signs. Whilst they reported weak industry investment intentions, and a slowdown in construction output growth, the Bank of England Agents noted a recovery in the housing market, and an improvement in some parts of the service sector. Professional services was reported to be the most buoyant part of the sector. This report also revealed that general short term employment intentions were to either maintain or reduce staffing levels.

The Welsh Economy

Statistics relating to the Welsh labour force show little change over the past year. The latest data, for the year to August, show an (ILO) unemployment rate of 4.6%, only marginally below that of the UK rate (of 4.7%). The Welsh economic activity rate was just over 75% for the same period, with only Northern Ireland, London and the North East having lower rates (see Labour Markets section of this *Review*). The Industrial Activity section of this *Review* paints a particularly gloomy picture of recent manufacturing sector performance. This section reports a significant drop in Manufacturing output over the year to mid 2005, whilst regional surveys, and recent job loss announcements in the sector (see *Diary*) are not encouraging for the sector's performance in the short-medium term.

In August, the *Office for National Statistics* published research and development (R&D) statistics (*Economic Trends* 621). The regional data available in this publication provided a breakdown of spend within business, within government establishments and within higher education institutions. Within these three sectors, R&D spend in Wales was an estimated £482m in 2003. This compares with £1,367m for Scotland, £233m for Northern Ireland, and £18,070m for England.

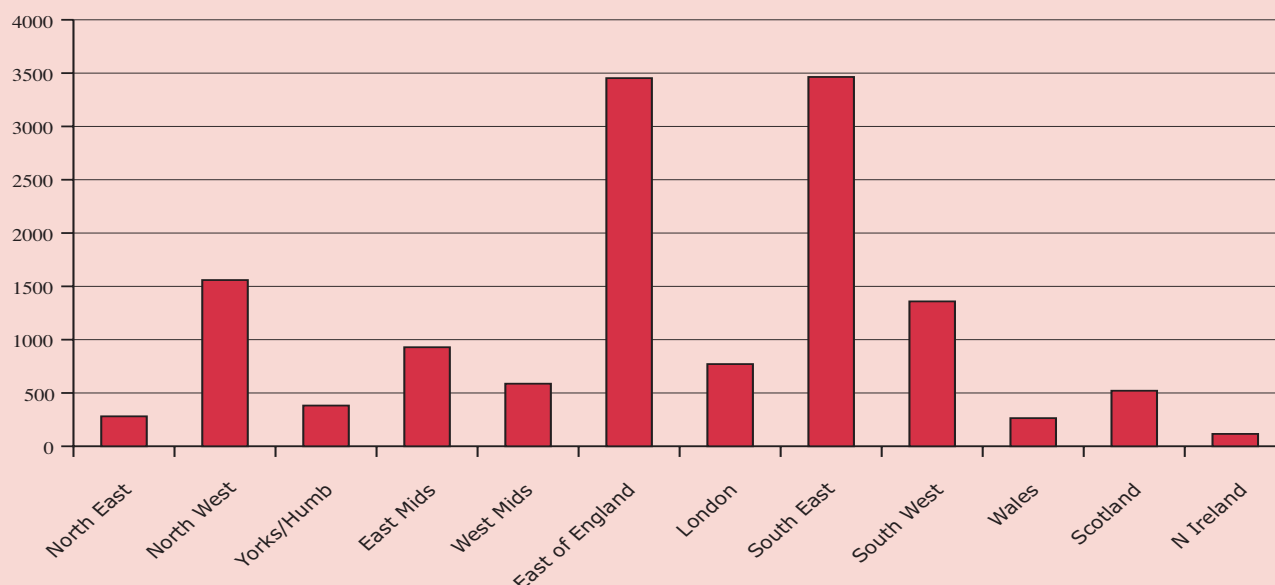
Figure 2 shows R&D spend within business by region. The highest business R&D spends were in the East of England, and the South East region. Business R&D spend in Wales was an estimated £264m 2003, and the *Office for National Statistics* suggest that this activity engaged around 3,600 (full time equivalent) personnel, or some 0.27% of the regional labour force. For the UK as a whole, some 0.57% of the labour force were engaged in within business R&D, compared with 0.30% in Scotland and 0.41% in Northern Ireland.

Forecasts

As noted earlier, the IMF economic growth forecasts for the UK economy for this year and next were revised downwards to 1.9% and 2.2% respectively. The Organisation for Economic Cooperation and Development (OECD) also down-rated their UK forecasts for the same period.

Table 1 shows forecasts for the Welsh economy for the period 2005-2007. Partly as a consequence of recent UK

Figure 2: R&D Performed within Business, 2003, £m.



Source: Office for National Statistics.

economic developments, and of a slow growing Euro area economy, these Welsh forecasts have been revised downwards compared to those made in the previous *Review*. Also of significance is the sharp fall in Welsh manufacturing output over the past year. Whilst the manufacturing sector is only a part of

the economy, Wales is more vulnerable to manufacturing slow down than the relatively more service-sector dominated UK economy. The Welsh economy has experienced job gains in service sectors (see Labour Markets section of this *Review*), however the generally lower value-added nature of

such employment means it will not directly replace outputs lost by manufacturing. The Welsh economy is then forecast to grow by less than 1% this year, increasing slightly to 1.2% in 2006 and 2007.

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

	2005	2006	2007
Wales	0.9	1.2	1.2