

Economic Commentary

World Economy

The world economy continues to be relatively strong in 2006. However, the story of world economic growth is one characterised by sharply contrasting fortunes. Asia continues to be the fastest growing region in the world with China continuing to lead the way in growth terms. Here strong domestic demand is compensating for the declining contribution from net exports to deliver expected growth of 10.7% in 2006 and 9.8% in 2007 (The Economist, Sept 12th 2006). India, the region's other major emerging market economy, may also be witnessing the onset of its own sustained period of expansion with growth of 8% expected in 2006, following growth of around 7.3% in 2005. Rapid global growth has kept commodity prices high, benefiting key exporters in Latin America and Africa. Growth in Latin America is forecast at just over 4% in 2006, the third consecutive year of growth at or above this rate. Africa is also expected to see growth of 5.5% in 2006, its highest growth rate since 1974.

The picture in America, Europe and Japan is much more mixed. In its interim assessment of the economic outlook in September 2006, the Organisation for Economic Cooperation and Development (OECD) observed that in the first half of 2006, growth was much stronger than expected in Europe and significantly weaker in the United States and Japan. Things appear to be changing in the second half of the year however, with growth slowing somewhat in Europe whilst the US and Japanese expansions regain some momentum. A key area of uncertainty for all the major economies is whether the recent increases in oil and commodity prices are an "ephemeral blip" or a more permanent inflationary shock (OECD Economic Outlook, May 2006). This inevitably makes the task facing central bankers seeking to implement appropriate interest rate strategies considerably more difficult.

Rising household consumption in the US has resulted in a slight increase in GDP growth from 3.2% in 2005 to a forecast of 3.4% for 2006. However, the economy appears to be slowing sharply due largely to a slump in the housing market. Nationally, new home sales are down 17% in 2006 on 2005, and sales of existing homes have slumped by 12%. Declining residential investment looks set to depress economic growth by at least one percentage point in 2007. Much depends on how US consumers react to the slump in the housing market and here opinion is sharply divided. Some argue somewhat pessimistically that a housing bust will sharply cut consumer spending by reducing mortgage-equity withdrawal. Others argue that the mortgage-equity link may be relatively weak in practice and that consumer spending will be buoyed by other influences notably lower fuel prices and strong growth in wages and salaries (The Economist, Sept 14th 2006).

Japan's economic recovery continues to gather pace with a GDP growth rate of between 2 and 3% likely in 2006. This is largely a consequence of strong business fixed investment and growing household consumption, both of which are being reflected in rising price levels.

In general terms, the prospects for European economies are also looking reasonably healthy. *The Economist* (October 7th 2006) forecasts that GDP growth for the eurozone in 2006 will be 2.5% - a full one percentage point higher than in 2005. Activity in the eurozone accelerated markedly in the second quarter of 2006 with the Football World Cup and time-bound subsidies in the construction sector in Germany providing a positive, if transitory, fillip to growth (OECD Economic Outlook, Interim Assessment, Sept 2006). Area-wide unemployment in the euro area has in fact fallen to below 8% of the labour force for the first time since 2001.

Whilst the pace of growth in the eurozone has slackened a little in the latter half of the year, sustained buoyancy in retail sales and purchasing levels in manufacturing and services continue to boost overall performance. The eurozone economies also seem more resilient in the face of oil price rises and slower American growth, largely because of the growing volume of exports to oil producing nations and greater reliance on domestic demand as a source of growth. There may be more testing times ahead however and it is clear that positive performance in the eurozone as a whole may well mask significant cross-country variations both in terms of strength and sectoral orientation. Demand growth is expected to be dragged down a little in the early part of 2007 not least because of the planned 3% point rise in value-added tax in Germany. This is expected to curb the rate of GDP growth in the country from 2.2% in 2006 to 1.4% in 2007. This is destined to make for difficult times for the 'grand coalition' governing Germany which is already facing rapidly declining levels of popular support (The Economist, Sept 12th 2006). In France, an economic recovery fuelled by growing domestic demand coupled with declining unemployment offers some positive news for the country's embattled right-of-centre government. GDP growth in France is forecast to pick up from 1.2% in 2005 to 2.3% in 2006 before slowing to 1.8% in 2007 (The Economist, Oct 3rd 2006). Elsewhere, Spain and some of the smaller member

states are destined to enjoy more robust growth.

The UK Economy

According to the OECD, UK economic growth "continues to be resilient at around potential" (OECD Economic Outlook, Interim Assessment, Sept 2006) and indeed, all the evidence points to the UK continuing to be a relatively placid and stable economy. After growing by just 1.9% in 2005, GDP growth is expected to pick up in 2006 although forecasters differ in their estimations of both the size of the increase and its sustainability. The Economist predicts that GDP growth will increase to 2.5% in 2006, slowing to 2.3% in 2007 (The Economist Sept 18th 2006). The Treasury also predicts a growth rate of 2.5% in 2006, but is more optimistic about future prospects, predicting above-trend rates of growth of 2.75% and 3.25% in 2007 and 2008 respectively (HM Treasury Economic Forecast, July 2006). Other forecasters are less optimistic with the British Chamber of Commerce (BCC), for example, predicting growth of 2.6% for 2006 but just 2.4% for both 2007 and 2008 (BCC Briefing, Sept 28 2006).

It seems clear that whilst UK economic growth increased in the first half of 2006 buoyed by continuing service sector growth, it probably peaked in the second quarter of the year. Whilst the industrial and export sectors have benefited from the strength of overseas demand, such areas are likely to be unable to compensate fully for the slower growth in household spending predicted in the next few months, particular if the US economy starts to slow. Indeed, the main cause for concern with the UK economy is the relative weakness of the manufacturing sector and industry in general. This makes it difficult to reduce the current account deficit and may cause more job losses in certain sectors of the economy. Employment in the UK is currently at record levels with more than 28.7 million people in work, comprising 21.4 million in full-time work and 7.3 million in part-time work. House prices have continued to strengthen through 2006, and key business surveys remain positive. After raising interest rates to

4.75% in August 2006, the Bank of England's Monetary Policy Committee left the Base Rate unchanged until November when it was raised to 5% owing to increasing inflationary pressure. Given the state of the public finances, an increase in taxes also seems likely in 2007 making for perhaps a more austere fiscal and monetary environment (The Economist Sept 18th 2006).

The Welsh Economy

The Welsh economy has continued to perform well against certain indicators in 2006. Private sector output in Wales continues to grow and exports from Wales for the year to June 2006 were up £2.6 billion or 41% on 1999, the same percentage increase as the sum of the UK regions. The latest labour market

statistics for Wales, published by the Office for National Statistics in September 2006, indicate that the recent positive employment growth in the economy may, however, have slowed. The Labour Market Survey data reveals that the trend in the employment rate is broadly flat and the rate in the latest period is unchanged from a year ago. The data for the three months to July 2006 shows that the seasonally adjusted employment rate is 71.7%, unchanged on last year. The data also shows that the trend in the unemployment rate is rising with the seasonally adjusted unemployment rate up to 5.7% - up 1.2% points on last year. The seasonally adjusted claimant count was also up in the year to August 2006.

The news on the economic inactivity rate is more promising however and it seems that the Welsh economy continues to make steady progress in bringing this rate down. The level of economically inactive people in the May to July 2006 period in Wales was down by 0.9% points on the same period last year.

We expect the Welsh economy to grow by around 1.5% this year and by the same amount in 2007. The Welsh economy is expected to grow at a slower rate than the UK as a whole, where growth is expected to be around 2.5% per annum in both 2006 and 2007.

Table 1: Forecast Change in Real GVA (%)

	2006	2007	2008
Wales	1.5	1.5	2.0