

# Economic Commentary

## World Economy

In October of this year the International Monetary Fund (IMF) published their latest *World Economic Outlook*. This publication contains commentary and analysis of recent economic developments at the global and country level, as well as providing forecasts of key economic variables. The forecasts presented by the IMF are for 2007 and 2008. The previous volume of the *Welsh Economic Review* provided commentary on the Organisation for Economic Cooperation and Development (OECD) forecasts for 2007 and 2008 which were published in November of last year. Hence whilst the forecasts relate to the same years, the IMF incorporate much more recent developments in the world economy within their analysis.

According to the IMF the World economy grew by 5.4% in 2006, and their growth forecasts for 2007 and 2008 are 5.2% and 4.8% respectively. Figure 1 shows the IMF's output growth forecasts for 2007 and 2008. As intimated in Figure 1, the 'advanced economies' are expected to grow at a much slower rate (by 2.5% and 2.2% respectively for 2007 and 2008) than other emerging market and developing countries (which are, on average, expected to grow by 8.1% in 2007 and by 7.4% in 2008). Whilst this is generally to be expected, given that these economies are starting from a lower base, with more development opportunities than those economies which are already 'advanced', some of these differences are extremely high. In terms of regional groups, 'developing Asia', which includes China and India is expected to achieve the highest growth rates in 2007 and 2008.

The growth projections shown in Figure 1 are slightly lower than those made by the IMF in the summer of this year. The largest downward revisions to growth forecasts for 2008 are in the United States, and in countries which have the

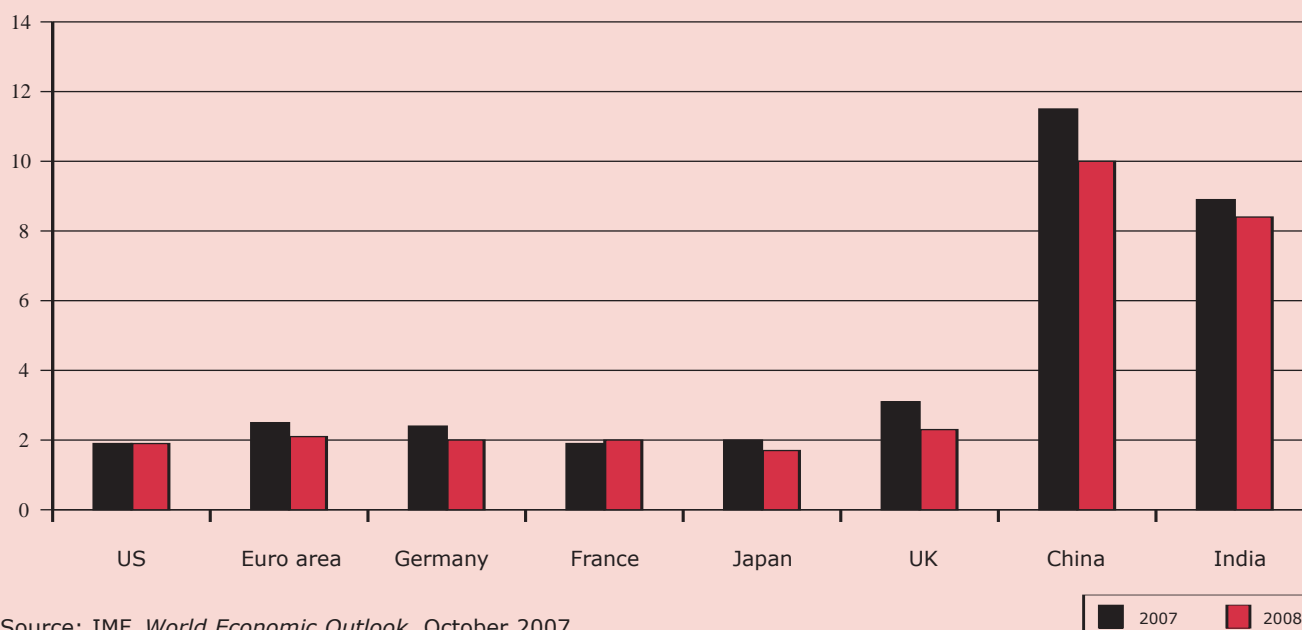
tightest connections to the US, and hence may be impacted by any slowdown in the US economy. Following a mixed start to 2007 the more recent data on the US economy suggests a slowing of the economy, this partly reflects the recent financial market difficulties linked to the collapse of the US sub-prime mortgage lending market, and surveys of consumer sentiment and business confidence have recently shown decline. The US housing market remains weak. In October the National Association of Home Builders index of expected sales fell to the lowest level since 1985 when the series began. In addition housing starts fell by 3.2% in August and by 10.2% in September (The Economist, 20 October 2007). The IMF now expects the US economy to grow by 1.9% in both 2007 and 2008 (the 2008 forecast was revised downward by 0.9 of a percentage point).

As already noted, output in emerging Asia is expected to grow at a rapid pace over the next year or so. Results for the first half of 2007 show that China and India leads the growth charts. In China both exports and domestic investment have increased. Industrial production in

China increased by a staggering 17.5% in the year to August 2007. In India, an expansion in domestic investment has contributed to its strong economic performance, and industrial production was 10.7% higher in August this year compared with last year. As Figure 1 shows, output is expected to grow by 11.5% in China in 2007, falling to 10% in 2008, with comparative figures for India of 8.9% and 8.4% respectively.

The IMF has also revised downwards its output growth forecasts for Japan to 2% in 2007 and to 1.7% in 2008. The Japanese economy showed a decline in real GDP in the second quarter of 2007 as a result of slowing investment and consumption growth, however there are more positive signs for the future. The Central Bank's quarterly survey of business confidence has remained solid, and the healthy labour market is expected to contribute to strong income and consumption growth. In August the unemployment rate was 3.8%. The IMF note that the downside risks to economic growth in Japan over the next year or so are the potential slowdown in the global economy, higher oil prices or a further appreciation of the yen.

**Figure 1: Output Growth Forecasts, Selected Economies, Annual % Change, 2007 and 2008.**



Source: IMF, *World Economic Outlook*, October 2007.

Deflation has been a feature of the Japanese economy in recent years, and despite healthy output growth in the period since 2004 (Japanese output grew by 2.7% in 2004, 1.9% in 2005 and 2.2% in 2006) the index of consumer prices was negative in August of this year, with no change in overall prices expected for 2007 (The Economist, 20 October 2007).

Output in the euro area is expected to grow by 2.5% in 2007 and by 2.1% in 2008 (figure 1). In August euro area unemployment averaged 6.9%, and industrial production was 4.3% higher than one year ago. Since the end of 2006 euro area output growth has outpaced that of the US, and expectations are that output growth in the euro area will be above that of the US and Japan in 2007 (The Economist, July 14 p.13). Germany, the largest European economy, experienced a prolonged period of slow growth, (during 1995-2005) but is now enjoying strong output growth despite a large increase in value-added tax. In 2006 German GDP grew by 2.9% (compared with only 1.1% in 2004 and 0.8% in 2005) and is expected to grow by 2.4% in 2007 and 2% in 2008. German industrial production was 5.2% higher in August than in the previous year, although unemployment remains relatively high at 8.8% in August. The fortunes of the euro area countries are however far from equal, and the recent financial market uncertainties and slowing growth in the US economy may constrain euro area growth in the near term.

**Foreign Direct Investment (FDI)**

A recent report by the Economist Intelligence Unit (EIU) in co-operation with the Columbia Program on International Investment (CPII), suggests that global FDI flows will dip

slightly in 2008, but that the longer-term outlook is favourable. In 2007 World FDI inflows are expected to be almost \$1,475bn, falling to \$1,406bn in 2008, before returning to steady growth in the period 2009-2011. The survey conducted for this report shows significantly heightened political risk perceptions amongst investors. The report also predicts that recent global financial difficulties will only have a limited impact on FDI flows, mainly through a slowing of cross-border mergers and acquisitions. Table 1 shows FDI inflows for 2006, as well as five-year forecasts for the 10 leading FDI recipient countries (the full report contains this information for 82 leading recipient countries). The US, Britain and China are set to remain the top recipients of FDI over the next 5 years.

**The UK Economy**

The IMF expect output in the UK to grow by 3.1% in 2007 falling to 2.3% in 2008 (figure 1), whilst the UK Treasury's forecast for GDP growth in 2008 was recently revised downwards from 2.5-3% to 2-2.5%. However, during his Pre-Budget Report the Chancellor said he expected economic growth would rebound in the period 2009-10 to between 2.5 and 3%, in line with earlier forecasts. In August industrial production increased by 0.1% which was 0.7% higher than the previous year. Consumer prices rose by 1.8% in the year to September, and unemployment stood at 5.4% in July. In their November meeting the Monetary Policy Committee decided to leave interest rates unchanged at 5.75%. The minutes of that meeting were not available at the time of writing, however the minutes of the October meeting show that the Committee considered that the downside risks to economic activity had increased in recent months as a result of problems in the financial markets,

however they noted that these changed conditions have not so far had a substantial impact on consumer or business confidence, with the exception of parts of the financial sector. In October only one member of the MPC voted against maintaining rates at current level, preferring instead a reduction of 0.25%.

The most significant recent economic 'event' in the UK has been the troubles at Northern Rock, and the more general global financial turmoil of which Northern Rock was both a victim and partly a cause. In September Northern Rock, the country's fifth biggest mortgage lender, faced a credit shortfall when international funding dried up. The queues which formed outside Northern Rock represented the first bank run in Britain since 1866. This only halted after the Chancellor announced, on September 17<sup>th</sup>, a guarantee that all existing deposits would be safe (see Property Markets section of this Review for further commentary).

In October the Office for National Statistics (ONS) released figures on overseas travel and tourism for the 12 month period to August 2007. During this period, the numbers of visits to the UK by overseas residents increased by an estimated 3% to 32.7 million. Visits from European residents increased by 3%, and accounted for 23.5 million visits, while visits from US residents, and residents from the rest of the world increased by 1% and 4.6% respectively. Expenditure in the UK by overseas visitors increased to £16.2 billion the 12 months to August 2007. During the same period visits abroad by UK residents increased by 1% to almost 70 million visits, and these visits accounted for £35.3 billion of expenditure, hence resulting in a deficit to the UK of £19.1 billion (ONS, 17 October 2007).

**Table 1: Foreign Direct Investment Inflows**

	2006, (US\$ bn)	2007-11 average, (US\$ bn)	Rank	% of world total
US	183.6	250.9	1	16.75
UK	137.7	112.9	2	7.54
China	78.1	86.8	3	5.79
France	86.9	78.2	4	5.22
Belgium	72.5	71.6	5	4.78
Germany	43.4	66.0	6	4.41
Canada	69.0	63.2	7	4.22
Hong Kong	42.9	48.0	8	3.20
Spain	20.2	44.9	9	2.99
Italy	39.0	41.6	10	2.77

Source: *World Investment Prospects to 2011*, (EIU and CPII)

**The Welsh Economy**

The unemployment rate in Wales in the three month period to July was 5.5%, only marginally above the UK average. The Labour Market section of this Review provides some details of the mixed fortunes among Welsh industries and local authority areas. For example, the trend of job losses in manufacturing, and job gains in services has continued during 2007, with the construction industry also showing a high percentage of job gains (although from a relatively low base). Construction industry output looks set to continue growing next year as a number of new projects get underway (see Property Markets section), although the impact of a slowing property market may partially offset some of this growth in the medium term.

The Industrial Activity section of this Review shows that industrial activity has picked-up during the first half of 2007 and comments that some regional forecasters are expecting the rate of loss of manufacturing employment to slow during 2007. In addition, exports of goods from Wales have maintained their value during the last 3 quarters, although compared with the same period last year, there is a drop in the value of exports in the year to 2007 quarter 2. Finally, job cuts and closures in the manufacturing sector continue to make headline news during 2007 as Welsh manufacturing operations battle against increasing competition from imports as well as lower cost locations overseas (see Diary and Industrial Activity sections). In the second quarter of 2007, the CBI survey of business

confidence reported falling levels of optimism amongst Welsh manufacturers.

Forecasts for the Welsh economy are shown in Table 2. In line with expectations for the UK economy, and the slightly better performance of the manufacturing sector, the growth forecast for Wales for 2007 has been revised to 2%. The forecasts for 2008 and 2009 remain unchanged. Generally, the UK and World economies are expecting slower growth in 2008, while the Treasury is expecting UK economic prospects to improve from 2009. It should however be noted that any forecasts made at this time may be subject to sharp revision depending on how the 'credit crunch' impacts global and local economies.

**Table 2: Forecast Change in Real GVA (%).**

	<b>2007</b>	<b>2008</b>	<b>2009</b>
Wales	2.0	1.5	2.0