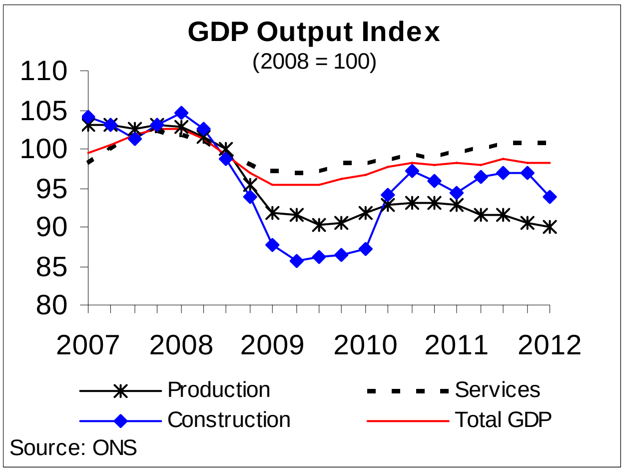
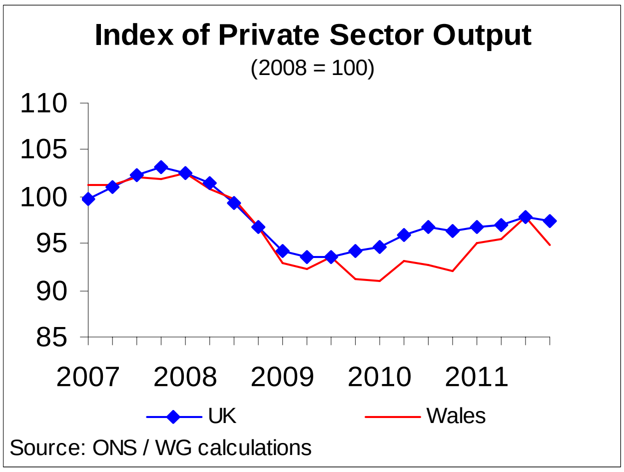
ECONOMIC UPDATE - MAY 2012
Chief Economist's Office, Welsh Government

Headlines

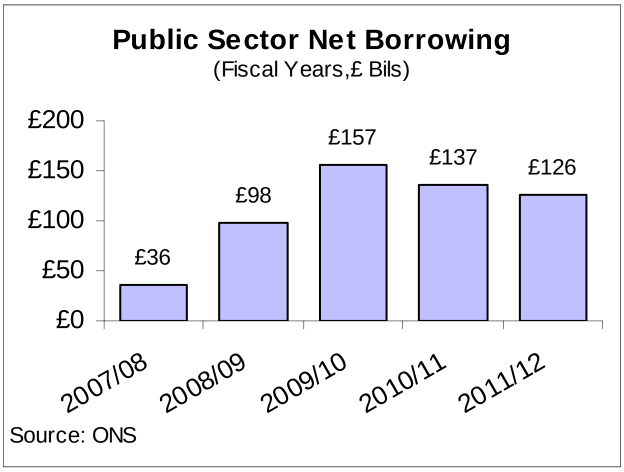
- GDP fell by 0.3% in the **first** quarter. As GDP also declined in the previous quarter, the UK economy is technically back in recession. Developments in the Welsh economy are likely broadly similar to the UK.
- Government borrowing totalled £126b in the **2011/2012** fiscal year, down 7.9% compared with **2010/2011**. A budget deficit of £92b is targeted for the current fiscal year.
- Annual inflation was 3.0% in **April** – down from 3.5% in **March**. Both the Bank of England and the Office for Budget Responsibility expect inflation to fall below 2% in **2013**.
- Political and financial events in **France**, **Italy**, **Spain**, the **Netherlands** and **Greece** have greatly added to risks in the eurozone with tensions rising between those advocating fiscal austerity and those favouring a greater emphasis on growth. The prospect of Greece leaving the eurozone in a disruptive fashion has increased since last month's report.
- Labour market developments in Wales and the UK are summarised on page 4.



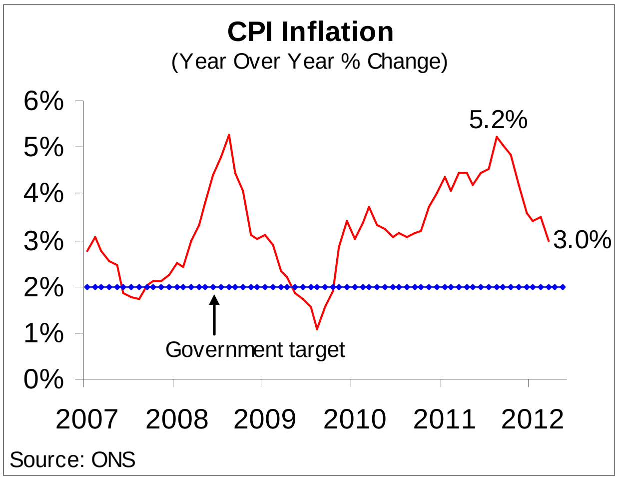
GDP The second estimate of GDP for the **first** quarter **2012** reported that the economy shrank by 0.3%. GDP has now declined for two consecutive quarters (it fell by 0.3% in the **fourth** quarter) meaning that the economy is, technically, in recession. Construction output (8% of GDP) fell by 4.8% and disproportionately influenced the headline GDP result. However, industrial production (15% of GDP) including manufacturing is trending down and the service sector (76% of GDP) is barely growing (see chart). Since the **2008/2009** recession ended GDP growth has averaged just 0.1% per quarter and its current level is 4.3% below its peak of early **2008**. GDP will likely fall in the current quarter owing to output being interrupted by the extra holiday for the Diamond Jubilee



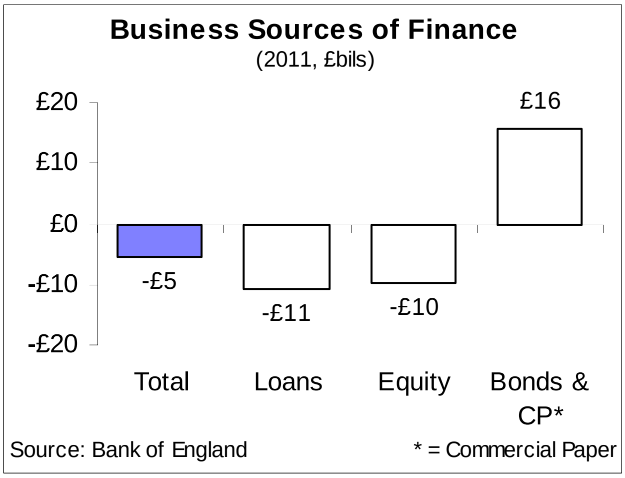
Output in Wales GDP data are not available for Wales. **Annual** Gross Value Added (**GVA**) data are available up to **2010** in nominal terms. Output performance in **2011** is captured by **quarterly** data on industrial production, construction and market services (available up to the **fourth** quarter). Together these sectors represent the bulk of the private sector and account for about 75% of GVA. While it is clear from the chart opposite that output in Wales follows a trajectory that is broadly similar to the UK, the index suggests the recession was somewhat deeper in Wales. And, that like the position in the UK, recovery has been slow with output still some way below its pre-recession level. A similar picture of the Welsh economy emerges from labour market data.



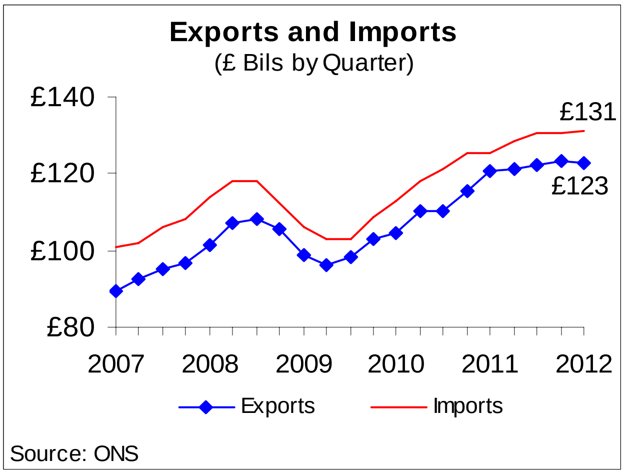
Public Finances Public sector net borrowing was £18.2b in **March**, up £223m or 1.2% on **March 2011**. Borrowing for the full **2011/2012** fiscal year was £126b, down £10.9b or 7.9% on the prior year (see chart). The improvement in the deficit was concentrated in the early part of last year. For the current fiscal year, the UK Government expects the deficit to fall by £34b or 27% to £92b. This large expected reduction is due in some part to tighter fiscal policy. Mainly though it reflects the impact of the transfer of the Royal Mail's pension fund into the public sector which will cut the deficit by £28b. As this 'one-off' effect fades, the deficit is expected to increase to £98b in **2013/14** and then resume its downward trajectory. By **2016/17**, the deficit is expected to be £21b.



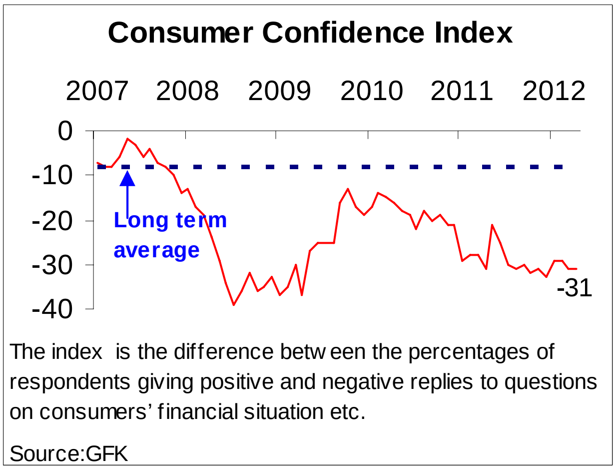
<u>Inflation</u> Annual consumer price inflation (CPI) was 3.0% in **April** (3.5% in **March**) and remains above the Government's 2% target. Even so, inflation has declined for five of the last six months. In a recent speech, the Bank of England's Chief Economist noted: "*There are good reasons for thinking that inflation will continue to fall. There is some degree of slack within our economy, primarily within the labour market. And although I expect growth to resume this year, the pace of the recovery is likely to remain weak in the near term. Those factors should continue to push down on domestic costs and prices and so cause inflation to fall further*". Both the Bank of England and the Office for Budget Responsibility expect inflation to fall below 2% in **2013**.



<u>Financial Conditions</u> At its **May** meeting, the Bank of England's Monetary Policy Committee (MPC) voted to leave Bank rate on hold at 0.5% and to maintain the stock of financial assets it has purchased over the last three years in its programme of quantitative easing at £325b. Despite this enormous injection of cash into the banking system, lending to businesses continues to fall, particularly to SMEs. The chart opposite shows how businesses raised external funds in **2011**. Companies raised capital from debt markets (bonds and commercial paper) while paying down bank loans and reducing equity. Overall, businesses repaid funds, a pattern that continued into early **2012**. These data are consistent with other data highlighting businesses' reluctance to invest or hire new workers.

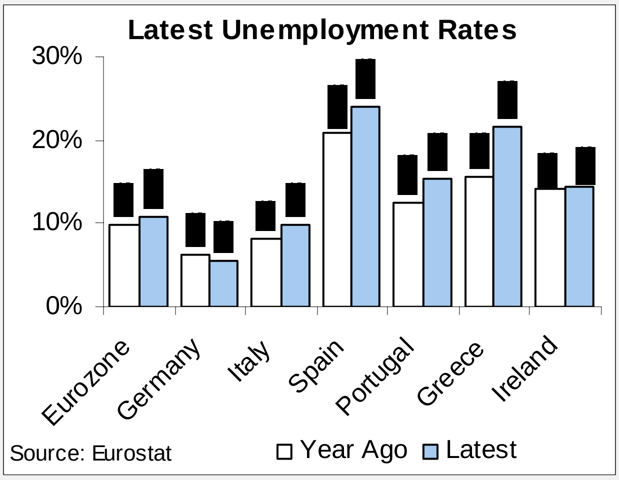


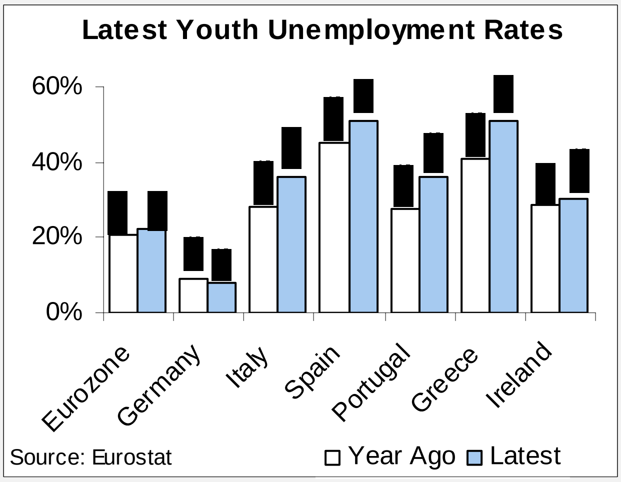
<u>Trade</u> Exports of goods and services declined by 0.3% to £123b in the **first** quarter. Imports increased by 0.3% to £131b compared with the prior quarter. As a result the trade deficit widened to £7.9b from £7.1b. Because the deficit widened this means that net trade subtracted from GDP in the first three months of the year after making a modest contribution in the previous quarter (full details will be available when the ONS releases its second estimate of **first** quarter GDP later this month). Trade data are volatile even on a quarterly basis. So, it is sensible to view performance over a longer period. Since the **2008/2009** recession ended, net trade has contributed to GDP albeit against a backdrop of exceptionally weak consumer spending which has curbed household appetite for imports.



<u>Consumer Confidence</u> The GFK index of consumer confidence (which is based on responses to questions on household finances, general economic situation and perceptions of climate for making large purchases) recorded a score of -31 points in **March**, down two points compared with **February**. Sentiment has hovered at recession type levels for much of the past year and indeed, the economy has flirted with recession since mid **2010**. Confidence is substantially lower than its long term average reading of -8 (see chart opposite). GFK noted: "*the index shows that consumers are becoming increasingly pessimistic about their personal economic circumstances over the next twelve months*" and suggests that last month's Budget may adversely affect spending.

International Economic Conditions





The relative calm that descended over the financial markets of the **eurozone's** peripheral economies earlier this year has now all but dissipated. That period of relative tranquillity was prompted in part by the European Central Bank granting €1.3 trillion in loans to Eurozone banks at an interest rate of just 1%. While these loans may have kept some banks afloat, risks have not disappeared, a point demonstrated by Moody's decision to downgrade ratings of several of **Italy's** banks and by **Spain's** Government committing €4.5b to prop up Bankia, the country's third largest bank. Spain's banks are sitting on a raft of bad debts following a housing market collapse which, pre-financial crisis, had boomed on the back of easy credit being made available to households. Those households are now heavily in debt as is the Government, which is struggling also to reduce a budget deficit (8.5% of GDP in **2011**) despite introducing a programme of fiscal austerity.

Fiscal austerity is a common theme across much of the eurozone. It is proving deeply unpopular as evidenced by election results in **France** and **Greece** and the fall of the **Dutch** Government. Moreover, the effectiveness of public spending cuts and tax hikes in economies that are already weak is questionable. That is to say such measures may be shrinking GDP faster than budget deficits. The parlous state of peripheral eurozone economies is vividly demonstrated in unemployment statistics. There are 17 million unemployment people in the eurozone and the unemployment rate is 10.9%. Unemployment is higher in some member states than in others (see chart). Youth unemployment is especially worrisome: at 51% in Spain and Greece; 36% in Italy and **Portugal** and 30% in **Ireland**. It is not surprising then that the idea of a 'growth' compact to accompany the fiscal compact, agreed some months back by EU leaders, is gaining adherents. Such a pact could well be too late for Greece which is now moving closer to leaving the eurozone. Should Greece exit in a disorderly fashion, it could unleash chaos in financial markets and recession in the eurozone and beyond.

Summary and Economic Prospects

UK GDP declined by 0.3% in the **first** quarter, having contracted by 0.3% in the **fourth** quarter also; outcomes that mean the economy is now technically in recession. True, there are question marks about the disproportionate adverse impact the construction sector has had in reducing total output. Construction aside though, it is clear there is little positive momentum behind the economy. Since mid **2010**, the economy has eked out an average growth rate of just 0.1%, far below its trend rate of 0.4 - 0.5%. Moreover, following the extraordinarily deep recession of **2008/2009**, there should be ample scope for the economy to grow faster than trend to make good some of the losses in output incurred during the downturn. That that has not happened yet is not entirely unexpected because, as mentioned in previous reports, recessions caused by financial crisis typically have sluggish, drawn out recovery paths.

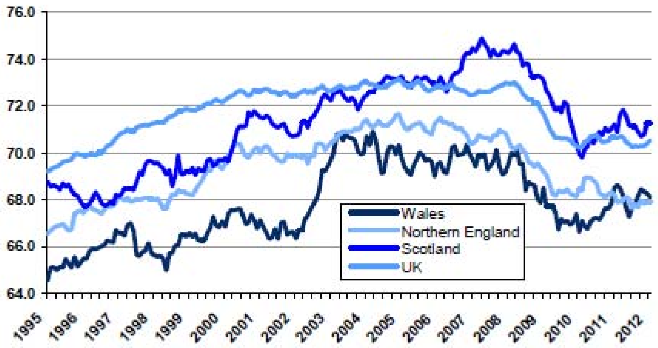
Even so a retreat back into recession was not in the central forecasts of either the Office for Budget Responsibility or the Bank of England. And even if revisions to GDP data cast recent performance in a better light, they will not be sufficient to disguise the fact the level of output today is considerably lower than expected a few years ago. A number of factors have contributed to the economy's weaker than expected performance. These include the economic crises in the eurozone which has undermined confidence and to some extent exports. Inflation has been considerably higher than expected and drained purchasing power from households. It was expected that fiscal retrenchment would act as a drag on the economy.

Near term prospects are highly uncertain, not least because of the crisis gripping the eurozone. In terms of UK Government macroeconomic policy options that could stimulate the economy, it is clear that that fiscal policy will not be relaxed. Therefore, much depends on how the economy responds to the loose stance of monetary policy and in particular the extent to which Bank of England actions succeed in improving the flow of credit to households and businesses.

1. SUMMARY OF THE LATEST LABOUR MARKET STATISTICS

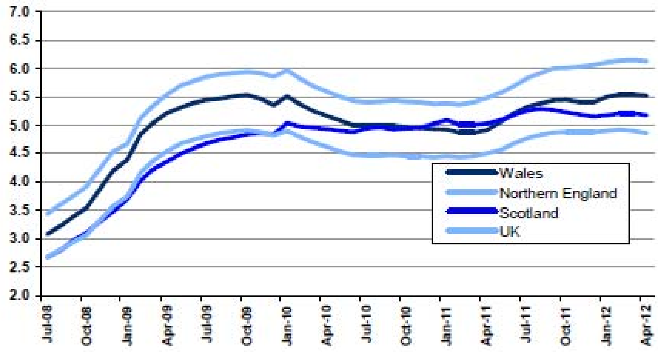
Employment rate

The historic gap in employment rates between Wales and the UK has narrowed since 2002.



Claimant Count Rate

Over the course of the recession the claimant count rate in Wales has followed the trend of the UK



Labour Market - Latest *Jan 2012 to Mar 2012* *Claimant count - Apr 2012*	Wales	UK
Employment Rate (levels)	**68.1** 1,341,000	**70.5** 29,233,000
Unemployment Rate (levels)	**9.0** 132,000	**8.2** 2,625,000
Inactivity Rate (levels)	**25.0** 473,000	**23.0** 9,250,000
Claimant Count Rate (levels)	**5.5** 79,500	**4.9** 1,590,300

Labour Market - Quarterly Change *Jan 2012 to Mar 2012* *Claimant count - Apr 2012*	Wales	UK
Employment Rate (change in levels)	**-0.3** -3,000	**0.2** 105,000
Unemployment Rate (change in levels)	**-0.1** -1,000	**-0.2** -45,000
Inactivity Rate (change in levels)	**0.4** 7,000	**-0.1** -35,000
Claimant Count Rate (change in levels)	**0.0** -300	**0.0** -13,700

NB: Change in claimant count is over the month

Labour Market - Annual Change *Jan 2012 to Mar 2012* *Claimant count - Apr 2012*	Wales	UK
Employment Rate (change in levels)	**-0.4** -6,000	**-0.2** -7,000
Unemployment Rate (change in levels)	**1.3** 20,000	**0.5** 170,000
Inactivity Rate (change in levels)	**-0.6** -11,000	**-0.2** -73,000
Claimant Count Rate (change in levels)	**8,100** 0.6	**106,600** 0.3

- Taking a medium term perspective, the overall employment position in the UK and Wales is broadly favourable compared with the mid 1990s but the unemployment position is similar to that period (see chart in top left).
- Latest employment estimates for the public and private sectors show (published 1 March 2012) that comparing December 2011 to September 2011 private sector employment in the UK increased 45,000 compared to a decrease of 37,000 in the public sector.
- Latest results show growth in average earnings continues to be outstripped by inflation. Growth in average earnings has now been outstripped by inflation since May 2010 and this may have contributed to the reduction in consumer spending.
- The growth in employment at the UK level continues to be driven by part-time jobs. The number of part-time workers ar 118,000 is the highest since comparable records began in 1992. Also the number of people working part-time because they could not find a full-time job at 1.42 million is the highest since comparable records began in 1992.
- Although the UK overall unemployment level fell, the number of people unemployed for over one year increased to 887,000, the highest since the three month to September 1996.
- Although the economic inactivity rate for Wales rose 0.4 percentage points on the quarter to 25.0 per cent it remains only 0.4 percentage points above its record low of 24.6 per cent.