

Global economic conditions have remained challenging since the 2002 Pre-Budget Report. Last year, concern over accounting scandals and tensions in the Middle East brought uncertainty and volatility to equity and oil prices. In recent months, geo-political risks, particularly surrounding hostilities in Iraq, have compounded global uncertainties. Although oil prices have now fallen back, they have recently been at their highest level for around two and a half years, and global equity and exchange rate markets have witnessed further turbulence since the time of the Pre-Budget Report. Protracted uncertainty has prompted falls in business and consumer confidence and the further deferral of business investment plans, further delaying the global recovery. Consequently, G7 growth this year is forecast to be weaker than expected in the Pre-Budget Report, with prospects for the Euro-area particularly badly affected by a combination of cyclical and structural factors.

International developments continue to be a key influence on UK economic prospects, and subdued external demand has exerted both a direct and indirect drag on GDP growth. Nonetheless, low inflation and sound public finances have allowed macroeconomic policy to support the economy during this period of global weakness and the UK has been better placed than on previous occasions to maintain growth and stability. Last year, the economy grew by 1.8 per cent, above the Pre-Budget Report forecast and behind only North America among the G7 economies. The labour market also performed strongly, with further gains in employment, and unemployment remaining at its lowest level for a generation.

Looking ahead, stronger UK growth prospects are forecast as global uncertainties diminish and the global recovery gathers pace. In the Budget:

- UK GDP is expected to grow by between 2 and 2½ per cent this year, as ongoing global uncertainty continues to subdue demand in key UK export markets and hold back business investment in the first half of the year. Subsequently, reduced uncertainty and a stronger global recovery should allow GDP to grow by 3 to 3½ per cent in both 2004 and 2005 as the economy returns to trend; and
- RPIX inflation is expected to remain a little above target in the coming months, temporarily boosted partly by housing cost effects. Thereafter, RPIX inflation is forecast to ease back as temporary factors unwind, slack in the economy puts downward pressure on domestic prices, and import prices rise. Inflation is expected to settle at target from early 2004.

As in the 2002 Pre-Budget Report, a rebalancing of growth is expected over the forecast horizon. Strengthening world conditions are expected to boost growth in manufacturing output and business investment, while consumption growth gradually reverts to more sustainable rates in response to weaker real income growth and falls in equity prices.

INTRODUCTION^{1,2}

B1 This chapter discusses economic developments since the 2002 Pre-Budget Report and provides updated forecasts for the UK and world economies in the period to 2005. It begins with an overview of developments and prospects in the world economy. In the light of this, it then outlines the Government's latest assessment of the UK economy, followed by a more detailed discussion of sectoral issues and risks.

B2 The forecast assumes that geo-political uncertainties will diminish in the second half of this year, prompting a steady recovery in business and consumer confidence.

THE WORLD ECONOMY

Table B1: The world economy

	Percentage changes on a year earlier unless otherwise stated			
	2002	2003	Forecast 2004	2005
<i>Major 7 countries¹</i>				
Real GDP	1½	1¾	2¾	3
Consumer price inflation ²	1¾	1¼	1½	1½
<i>Euro-area</i>				
Real GDP	¾	1	2¼	2¾
World trade in goods and services	2½	4¾	8½	7¾
UK export markets ³	1¾	4¼	7½	7

¹ G7: US, Japan, Germany, France, UK, Italy and Canada.

² Per cent, Q4. For UK, RPIX.

³ Other countries' imports of goods and services weighted according to their importance in UK exports.

Overview

B3 During 2002 a number of factors compounded existing uncertainty surrounding the strength of the global recovery. A series of accounting scandals, the ongoing threat of terrorist activity and developments in the Middle East depressed business and consumer confidence across the major economies and prompted volatility in financial markets. As a result, the global recovery had less momentum during the second half of last year than had been anticipated at the time of the last Budget. Since the 2002 Pre-Budget Report, heightened concerns surrounding the conflict in Iraq have triggered a further round of volatility in financial markets. Equity prices have fallen further, oil prices reached two and a half year highs, before falling back once the conflict in Iraq began, and there have been significant movements in the major bilateral exchange rates.

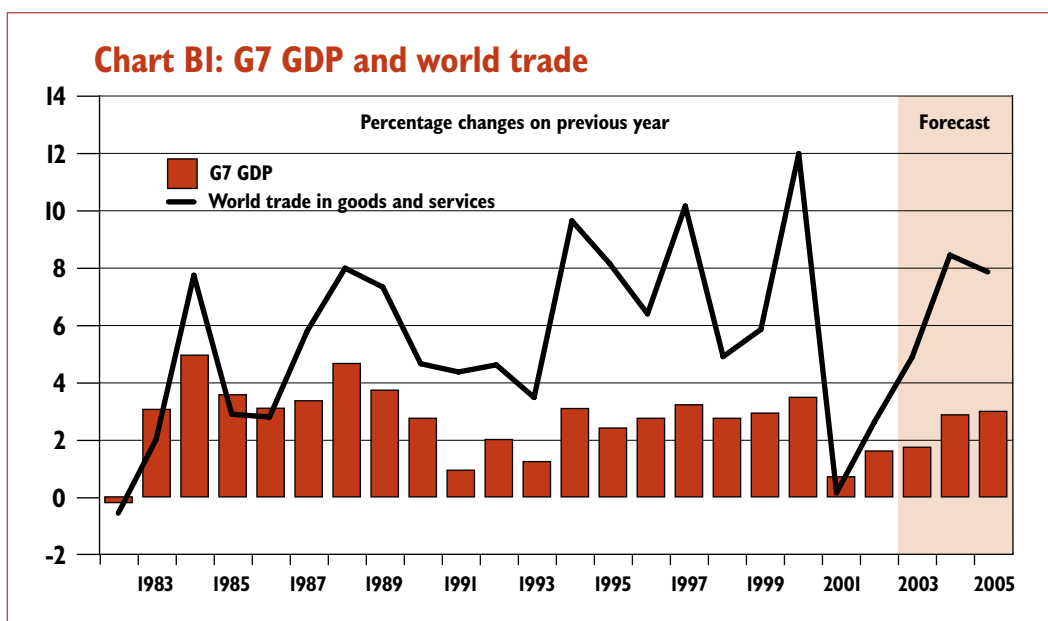
B4 As expected, growth slowed across the G7 economies in the final months of 2002. However, since the turn of the year uncertainty surrounding equity markets has prompted further sharp falls in consumer confidence and weaker than expected household consumption in most of the major economies. With business confidence also remaining at low levels, and further evidence that firms are continuing to defer investment decisions, global economic activity in the first few months of 2003 is now forecast to be weaker than was anticipated at the time of the Pre-Budget Report.

¹ The UK forecast is consistent with national accounts and balance of payments statistics to the fourth quarter of 2002, released by the Office for National Statistics on 27 March 2003. A detailed set of charts and tables relating to the economic forecast is available on the Treasury's internet site (<http://www.hm-treasury.gov.uk>), and copies can be obtained on request from the Treasury's Public Enquiry Unit (020 7270 4558).

² The forecast is based on the assumption that the exchange rate moves in line with an uncovered interest parity condition, consistent with the interest rates underlying the economic forecast.

B5 Policy-makers around the world have responded to heightened uncertainty and the weaker near-term outlook for the global economy. Monetary policy has been loosened further in both the US and the Euro-area in recent months, while fiscal policy is continuing to support monetary policy in the US. In Europe, the automatic stabilisers have generally been allowed to work, although in 2003 a tightening of the fiscal stance is planned in some countries.

B6 Despite the weaker short-term outlook, global economic activity is expected to strengthen from the middle of 2003 as uncertainty dissipates and the recovery in the US gathers pace. However, growth in the Euro-area is now expected to be weaker than was anticipated a few months ago. The latest Consensus Forecasts³ indicate that Euro-area GDP, which was expected to grow by 1.7 per cent in 2003 at the time of the Pre-Budget Report, is now expected to grow by around 1 per cent. The downward revision reflects the impact of a number of cyclical and structural factors, including the recent appreciation of the euro, planned fiscal consolidation in some Euro-area countries, and depressed business and consumer confidence. These ongoing downward revisions to the prospects for the Euro-area further emphasise the need for structural reform. A reduction in uncertainty remains crucial to the global economic outlook. While a stronger recovery could yet materialise should uncertainties dissipate more quickly than currently anticipated, a period of prolonged uncertainty poses the clearest downside risk to the outlook (Box B1).



G7 activity

B7 G7 GDP is now expected to grow by $1\frac{3}{4}$ per cent in 2003 and $2\frac{3}{4}$ per cent in 2004. In part this reflects the impact, in the first half of 2003, that heightened uncertainty surrounding events in Iraq is having on activity in the major economies. It also reflects the expectation that growth in most Euro-area economies will now be weaker throughout 2003 than was anticipated at the time of the 2002 Pre-Budget Report. Euro-area GDP is forecast to grow by 1 per cent in 2003 and by $2\frac{1}{4}$ per cent in 2004.

³ Consensus Forecasts, Consensus Economics Inc.

B8 US GDP growth slowed in the final quarter of last year, but the first quarterly rise in business investment since early 2001 provided further evidence that a recovery is underway. In recent months, heightened concerns about the situation in Iraq have prompted a renewed bout of volatility in financial markets, and these concerns have triggered falls in consumer and business confidence. The latest retail sales and industrial activity data suggest that growth in the early months of 2003 will be slightly weaker than was anticipated at the time of the 2002 Pre-Budget Report. Nonetheless, household consumption, while weaker than previously expected, should continue to support growth, underpinned by low interest rates, tax cuts and a strong housing market. Investment growth is expected to strengthen in the second half of the year as uncertainties dissipate.

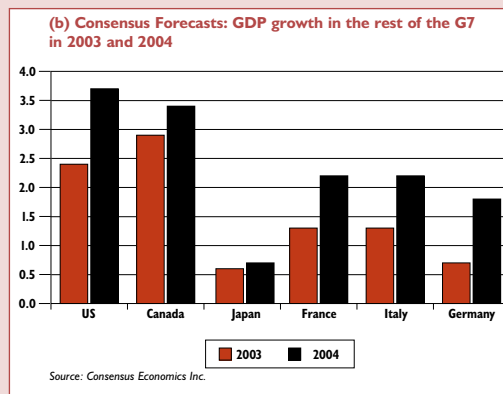
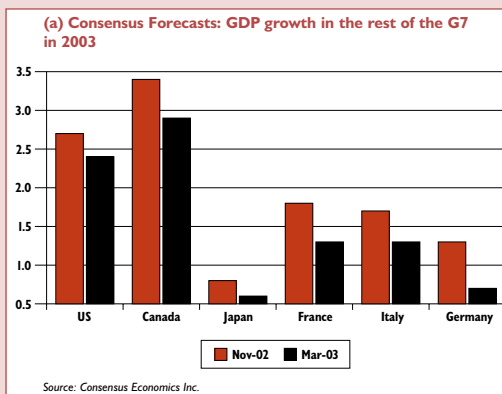
B9 Euro-area GDP growth was lower than in the US and Canada last year, and is expected to be lower again in 2003. In part this is due to lower rates of potential growth in the major Euro-area economies, especially Germany, but it is also the result of weak domestic demand. Deteriorating labour markets and increased geo-political uncertainty have already reduced consumer confidence and will continue to weigh on consumer demand in early 2003. Investment remains weak, but is expected to recover as uncertainties recede. Even some of the previously higher growth Euro-area economies, such as Portugal and the Netherlands, are expecting another year of slower growth.

B10 Stronger growth in the US remains key to an improvement in the short-term outlook for the Euro-area. However, net trade, which played an important role in supporting growth in the Euro-area last year, is likely to be adversely affected by the appreciation of the euro. While monetary policy has eased recently, national authorities plan to tighten fiscal policy in some parts of the Euro-area during 2003, particularly in Germany. More generally, Euro-area economies need further structural reform to raise potential growth rates and establish greater resilience to shocks.

B11 Last year saw a strong export-led recovery in Japan, on the back of demand from Asia and the US, but momentum slowed towards the end of the year reflecting the impact of heightened uncertainty on global economic activity. Domestic demand, which surprised on the upside in 2002, now looks set to slow, compounded by the effect of unemployment at near historical highs. Gradual implementation of the Takenaka financial and corporate sector restructuring plan, while providing a boost to medium-term prospects, will also hold back growth this year. With limited scope for further policy easing the economy remains reliant on external demand, and growth is only expected to pick up as the global recovery gathers pace during the second half of this year.

Box B1: Global uncertainty and G7 activity

A series of accounting and corporate governance scandals in the US, the threat of terrorist activity and broader geo-political risks led to sharp falls in equity prices and rises in the price of oil during 2002, depressing business and consumer confidence across the major economies. In recent months heightened concerns about the situation in Iraq have compounded the existing uncertainty. Business confidence has remained at low levels, while consumer confidence has experienced further sharp falls, with sentiment in the US and the Euro-area now at its lowest levels since the early 1990s.



While forecasters expected developments in Iraq to affect the global outlook in the first few months of this year, retail sales and industrial activity data suggest the impact on activity has been greater than anticipated. As a result, independent forecasters have revised down their projections for growth during 2003 in all G7 economies, and particularly in the Euro-area, in the relatively short space of time since the Pre-Budget Report (see chart a). However, the latest Consensus Forecasts indicate that growth is still expected to recover in the second half of this year and during 2004 as the uncertainties currently affecting the outlook ease (see chart b).

In the current, highly uncertain global environment there is a wider than usual range of possible outcomes for G7 GDP growth. The scale of the recent fall in confidence raises the possibility of a period of more prolonged uncertainty and continued volatility in global financial markets. This risk is particularly pronounced in the US, where prolonged uncertainty could encourage firms to continue deferring investment decisions. Moreover, any further falls in equity prices or deterioration in the labour market could lead to slower than anticipated household consumption growth. A weaker than expected US recovery during 2003 would impact strongly on growth in the Euro-area and Japan, where domestic demand remains weak. However, there are also upside risks to the outlook. In particular, current uncertainties could recede more quickly than generally expected, with a sharper recovery in confidence and growth.

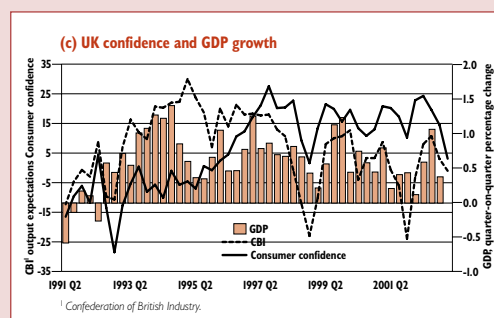
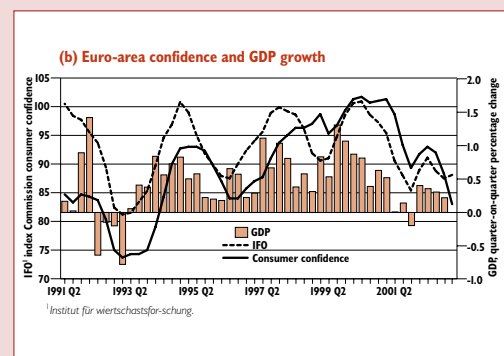
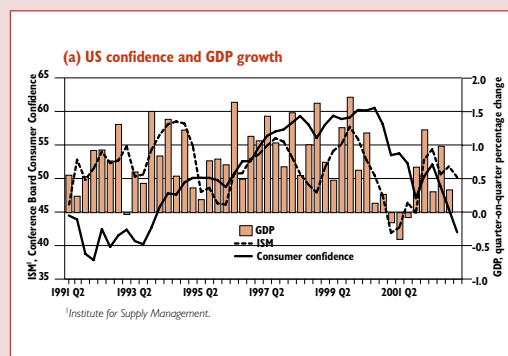
The response of policy-makers in a number of the major economies has played an important role in preventing a more severe slowdown in activity over recent years. The current uncertain environment highlights the need for policy-makers to remain vigilant to the risks facing the global economy, and stand ready to respond should the economic outlook deteriorate further over the coming months.

Emerging markets and developing countries

BI2 The disappointing growth performance of emerging economies in Latin America and the Middle East during 2002 contrasted with the robust performance of Central and Eastern Europe and the relatively strong performance of Asia, particularly China. In East Asia growth was underpinned by a combination of strong domestic demand and exports, both within the region and to the US. In Sub-Saharan Africa growth during 2002 was affected by conflict, political instability and poor weather, and the challenge remains to put in place the conditions necessary to meet the Millennium Development Goals.

Box B2: Global confidence measures and growth

Measures of business and consumer confidence are often regarded as forward-looking indicators of economic activity. In the UK, consumer confidence has proven more robust than business confidence during the course of the global slowdown, as a strong labour market and continued house price gains have helped to cushion household wealth from the impact of declines on equity markets. More recently, however, UK consumer confidence has shown signs of easing. This pattern is repeated elsewhere, with sentiment in the US and the Euro-area declining to its lowest since the early to mid-1990s.



These trends have been driven by a number of factors, including ongoing uncertainty surrounding events in Iraq, and further sharp falls on equity markets. In the UK, these factors have led to a reduction in households' confidence about general economic prospects, but have had a more modest impact on households' perceptions of their own financial position.

There are some signs that activity has weakened in the past couple of months. However, despite recent uncertainties, both consumer and business confidence measures remain above the levels seen in the early 1990s. Moreover, as the charts illustrate, while the correlation between confidence and growth over the medium to long term is reasonably close, in the short term confidence can often prove more sensitive than GDP to temporary factors. For example, although business confidence fell sharply in the UK, the US and the Euro-area at the peak of Asian financial crisis in late 1998, this had little impact on growth in each of these areas. Similarly, US GDP growth picked up sharply in the early 1990s despite consumer confidence taking much longer to recover.

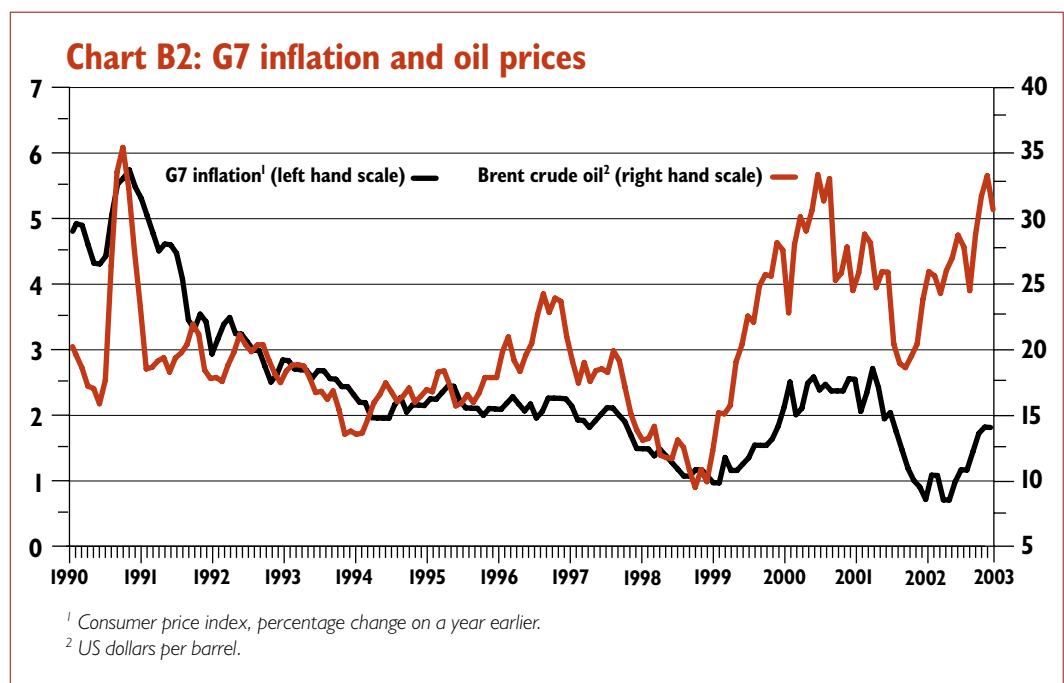
BI3 In general, those emerging economies with robust macroeconomic frameworks and sustainable exchange rate regimes appear to have coped better with increased volatility in global financial markets. The possibility of a further deterioration in global activity and an increase in risk aversion among investors pose a clear risk to the outlook. The conflict in Iraq poses a further threat to those economies with trade links in the region, as well as to those with high oil import requirements, heavy reliance on tourism receipts or significant external financing needs. Any significant increase in the incidence of Severe Acute Respiratory Syndrome (SARS) currently concentrated within Asia, could pose a further risk to the economic outlook in the region.

World trade

BI4 As anticipated at the time of the Pre-Budget Report, world trade growth slowed during the second half of 2002. In line with the forecast pick-up in global activity, world trade is now expected to grow by $4\frac{3}{4}$ per cent in 2003 and $8\frac{1}{2}$ per cent in 2004, somewhat slower than expected at the time of the Pre-Budget Report. UK export market growth is also now expected to be slightly weaker, reflecting the impact of weaker growth in the Euro-area.

Oil and commodity prices

BI5 The price of oil rose sharply during the final months of 2002, reflecting heightened concerns surrounding the situation in the Middle East and the impact of the strike in Venezuela. While the oil price has fallen back in recent weeks, developments in the Middle East could result in higher and more volatile oil prices over the forecast period. As at the time of the 2002 Pre-Budget Report, non-oil commodity prices are expected to strengthen in line with the global recovery.



G7 inflation

B16 Underlying inflationary pressures remain weak in most G7 economies, reflecting the existence of small negative output gaps in most cases. G7 inflation rose around the turn of the year as a result of movements in energy prices, but is expected to fall back during 2003 before settling at 1½ per cent in 2004 as the recovery gathers pace.

Forecast issues and risks

B17 In recent months, heightened concerns about the situation in Iraq have clearly added to the uncertainties already surrounding the global economic outlook. These uncertainties are expected to ease during 2003, but a period of prolonged uncertainty, accompanied by continued volatility in financial markets, weaker equity prices and higher oil prices, poses the clearest downside risk to G7 activity.

B18 The persistent US current account deficit, and the emergence of projected fiscal deficits over the coming years, pose the additional risk of a sudden, sharp fall in the value of the dollar. In Germany, persistent high levels of unemployment and fears about job security continue to pose a downside risk to household consumption growth and raise concerns about more significant structural weaknesses. In Japan, rigorous implementation of the Takenaka plan, while providing a much-needed boost to Japan's medium-term prospects, would further depress activity in the short term.

B19 On the upside, the various uncertainties currently affecting the outlook could dissipate more quickly, and confidence could recover more sharply, than anticipated. Moreover, the recently announced fiscal stimulus package in the US, combined with low interest rates and a strong housing market, could lead to stronger than expected household consumption growth, with knock-on effects to other major economies. Further evidence of strong productivity growth in the US also raises the possibility that other economies might emulate recent information and communication technology (ICT) related improvements. Decisive structural reform in Europe and financial restructuring in Japan could provide a further boost to world growth prospects in the medium term.

UK ECONOMY OVERVIEW

Summary

B20 International developments continue to be a key influence on UK economic prospects, and recently ongoing global uncertainty and subdued external demand have continued to depress UK business confidence and hold back investment and exports. Nonetheless, low inflation and sound public finances have allowed macroeconomic policy to support the economy during this period of global weakness, so that the UK has been better placed than on previous occasions to maintain growth and stability. Interest rates are now at their lowest level for almost fifty years while fiscal policy has supported monetary policy in sustaining domestic demand. A robust labour market and sound economic fundamentals have also helped to support private consumption and offset the drag on growth from global weakness.

B21 Whereas UK GDP growth over the past year has been stronger than in late 2001 and early 2002, in the immediate wake of the events of 11 September 2001, prospects for the UK economy will continue to depend heavily on global developments. UK GDP is expected to accelerate in the second half of 2003 as international uncertainty recedes and the pace of the world recovery strengthens. Growth is also expected to become more balanced over the forecast horizon as deferred business investment comes back on stream, exports pick up in response to stronger global demand, and private consumption growth moderates. Inflation is expected to remain low and close to the Government's target throughout the forecast period.

Table B2: Summary of forecast

	2002	Forecast		
		2003	2004	2005
GDP growth (per cent)	1¾	2 to 2½	3 to 3½	3 to 3½
RPIX inflation (per cent, Q4)	2½	2¾	2½	2½

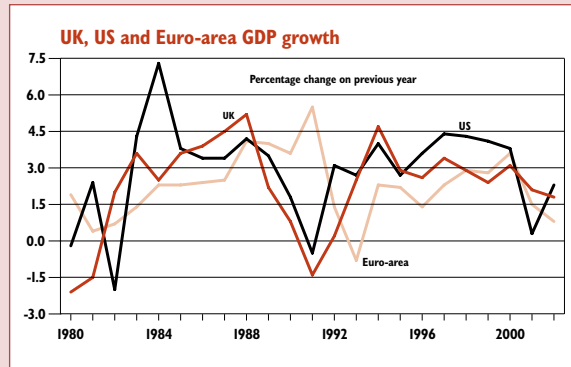
Recent developments

B22 The uncertain global environment that influenced UK economic prospects throughout last year has continued into 2003. Heightened geo-political risks – particularly surrounding events in Iraq – a renewal of turbulence on equity markets, and concerns about the need for further structural reform in the Euro-area, have affected perceptions of the world economic outlook over recent months. This uncertainty, combined with an already sluggish global recovery, has kept business confidence subdued and discouraged firms from bringing deferred investment projects back on stream.

B23 Nevertheless, the UK economy continues to sustain its longest unbroken economic expansion since quarterly GDP records began almost 50 years ago. For the second year running, the UK economy has continued to grow in circumstances of weak global demand and faltering investment, in contrast to the experience of many other industrialised countries and of past world slowdowns (Box B3). With inflation remaining close to target, the Monetary Policy Committee (MPC) of the Bank of England has cut short-term interest rates to their lowest level for almost 50 years. Government spending has also supported domestic demand, with government consumption rising by 3¾ per cent in 2002, its strongest growth since the mid-1970s; and government investment rising by over 9 per cent, its strongest since the early 1990s. These factors helped offset the impact on GDP of declining business investment – experienced in the UK as in most other major economies. This contrasts markedly with previous occasions when falls in corporate capital expenditure have translated into an absolute decline in GDP.

Box B3: Recent growth performance of the major economies

World economic growth slowed sharply in 2001 as the global boom in ICT investment underwent an abrupt correction and equity prices came off their historic peaks. Although a recovery began in 2002, economic and geo-political uncertainties reduced its momentum over the second half of the year.



While the highly open UK economy was bound to be affected during this period of global weakness, growth in the UK has proved to be among the most resilient of all major industrialised economies. The UK grew faster than any other G7 country during 2001 and faster than all but North America during 2002. Most forecasters expect the UK and North America to lead the G7 again in 2003.

This experience contrasts favourably with that of previous world slowdowns, during which the UK often fared worse than other industrialised economies. Between the late 1980s and the early 1990s G7 growth fell sharply, from 3.7 per cent in 1989 to just 0.9 per cent in 1991. In the US, GDP contracted by 0.5 per cent during 1991, significantly less than in the UK, where output fell by 1.4 per cent – the largest annual fall in output of any G7 economy bar Canada throughout the whole of the 1990s. This clear distinction between past and present performance provides further evidence that the Government's reforms have greatly enhanced the UK's ability to weather difficult global conditions.

B24 GDP grew by 0.4 per cent in the final quarter of 2002, broadly as expected at the time of the 2002 Pre-Budget Report, to stand 2.2 per cent higher than a year earlier. While this compares with quarterly growth of 1.1 per cent in the third quarter, and 0.6 per cent in the second, the Golden Jubilee celebrations last year affected the quarterly pattern of growth, reducing activity in June. Underlying GDP growth in the second quarter was therefore probably stronger than headline estimates suggest, at between $\frac{3}{4}$ and $1\frac{1}{4}$ per cent, with underlying growth in the third quarter correspondingly weaker. Nonetheless, even allowing for Jubilee effects, GDP growth since last spring has been stronger than in late 2001 and early 2002, when uncertainty in the wake of the events of 11 September 2001 is likely to have had its most direct impact on economic activity. In 2002 as a whole, UK GDP increased by 1.8 per cent, above the 2002 Pre-Budget Report forecast and behind only North America among the G7 economies.

B25 Private consumption growth more than accounted for the increase in GDP last year, and government consumption also made a positive contribution to growth, together outweighing the negative contributions from investment and trade. With employment continuing to grow and interest rates low, consumers retained a high degree of confidence in the outlook for their own finances, though this has eased back since the turn of the year. Strong house price inflation also helped sustain growth in consumer spending, offsetting the negative impact of declining equity values on total household wealth, while mortgage equity withdrawal added a further stimulus to consumption.

B26 Nonetheless, growth in private consumption has progressively eased back from its peak in 2000, to below 4 per cent last year, and there have been signs of a further moderation in recent months. Retail sales, for example, were broadly unchanged between October 2002 and February 2003. Slower consumption growth, as consumers adjust expenditure patterns to reductions in financial wealth and real income growth, is consistent with previous forecasts, and desirable to the extent that it reflects an orderly adjustment of the household sector's balance sheet. Consumption growth in excess of the economy's trend growth rate, as for the past seven years, cannot be sustained indefinitely.

B27 The UK labour market has continued to go from strength to strength, providing further evidence of the success of the Government's labour market policies. Continued strong growth in employment alongside a substantial rise in the population of working age – characteristic of a strong labour market – has been in stark contrast to the 1980s, when a rising population led to high unemployment before employment adjusted. Over the past year employment has increased by over $\frac{1}{4}$ million, to stand over $1\frac{1}{2}$ million up since early 1997. The employment rate has also risen, particularly since the middle of last year, and over this period earlier small rises in unemployment have reversed leaving the unemployment rate at its lowest for a generation.

B28 RPIX inflation averaged 2.2 per cent in 2002, though it has risen steadily since last summer and in recent months has been slightly above the Government's symmetric $2\frac{1}{2}$ per cent target. Strong growth in house prices – which affect the housing depreciation component of the index – has been the largest single contributor to this rise. By contrast, the Harmonised Index of Consumer Prices (HICP) – which excludes components of housing costs included in RPIX, most notably housing depreciation – has remained a good deal more stable over the past year. UK HICP inflation stood at just 1.6 per cent in February, a fraction above its level a year earlier and significantly below both the EU and Euro-area averages.

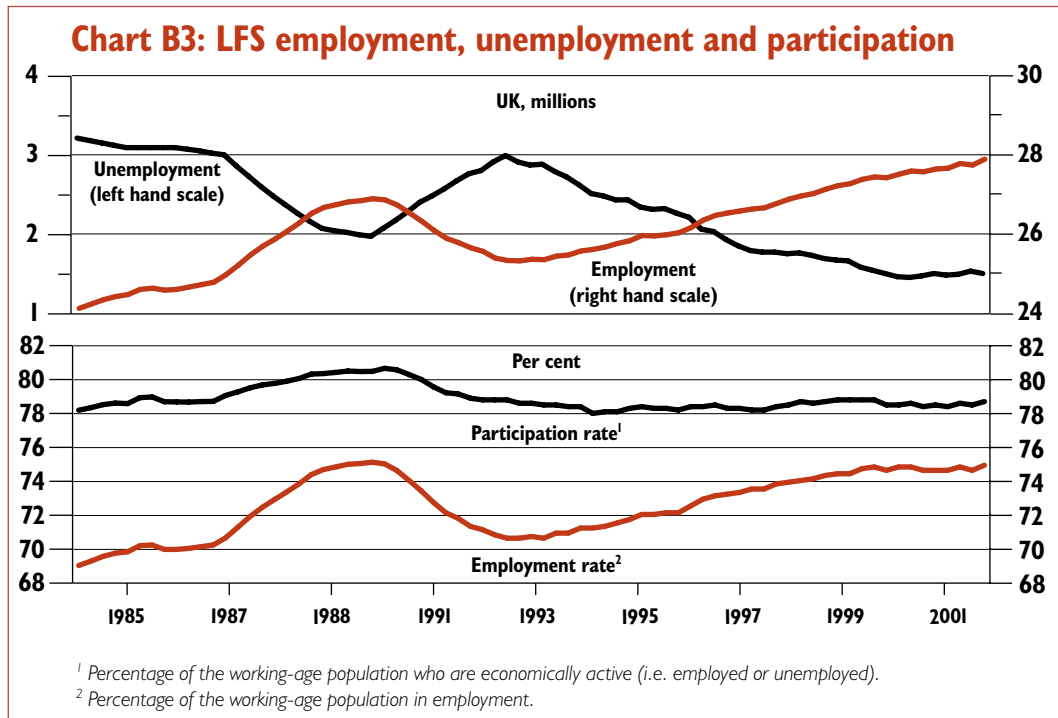
B29 While higher oil prices have led to increased petrol and fuel costs, goods inflation remains muted and prices in February were practically unchanged on those a year earlier. Excluding petrol and oil prices, the divergence between goods and services inflation remains historically high, with services inflation standing at 4.5 per cent in February.

B30 As elsewhere in the world, heightened global uncertainty and faltering external demand have continued to undermine private investment intentions, providing strong incentive to defer. With growth in the economy temporarily below trend, businesses have been able to meet demand from within existing capacity, further reducing the need to undertake new capital spending. Business investment declined by 8 per cent in 2002, a smaller fall than that projected in the 2002 Pre-Budget Report forecast. Nevertheless it has shown signs of bottoming out, with a broadly flat quarterly profile since early last year.

B31 While net trade made a significant positive contribution to GDP growth in the second quarter of last year – its largest for three years – latest trade data suggest that a loss of momentum in the global recovery from the middle of 2002 exerted a significant drag on UK exports. In 2002 as a whole, goods and services export volumes were 1 per cent lower than in 2001. With imports picking up slightly through the year, the overall trade deficit widened by over £3 billion between the first and second halves of 2002 as an increased deficit on merchandise trade more than offset a higher surplus on trade in services. Nonetheless, at £18.9 billion, the trade in goods and services deficit in 2002 was around £ $\frac{3}{4}$ billion lower than that in 2001.

The labour market

B32 Despite continued global economic weakness, the UK labour market appears to have strengthened since last summer, providing further evidence of significant supply-side improvements brought about by the Government's policies to deliver employment opportunity for all. Recent labour market performance also differentiates the UK from many other industrialised countries.



B33 Recent months have seen the level of unemployment fall back sharply. On the International Labour Organisation (ILO) definition, unemployment fell by 73,000 in the three months to January to stand 28,000 lower than a year earlier, more than reversing the temporary increase witnessed in the early part of 2002. At 5.0 per cent, ILO unemployment is now the lowest among the G7 economies. Claimant count unemployment has also fallen steadily since last summer, to levels last seen a generation ago, and since early 2001 it has remained below one million for the first time since 1975.

B34 Over the first nine months of last year, a sharp increase in the population of working age was mainly absorbed in higher part-time employment, with the numbers of those in full-time work declining slightly between the fourth quarter of 2001 and the third quarter of 2002. Since then, full-time employment has also expanded, rising by 121,000 in the three months to January compared with the previous three months and more than reversing the decline seen over much of last year. While part-time employment has continued to rise, the proportion of these workers who would prefer to occupy full-time positions remains at record lows, suggesting that the labour market has become more responsive to individuals' needs and circumstances.

B35 Total employment rose by 150,000 between the third and fourth quarters of last year – the largest quarterly rise for almost six years and the second largest since publication of quarterly employment estimates commenced in 1992. The employment rate has also begun to rise again: at 74.6 per cent in recent months it is around $\frac{1}{4}$ percentage points up on a year earlier.

B36 Growth in public sector employment has been a key influence on the labour market, with employment growth in public administration, education and health averaging almost 40,000 a quarter over the past year (on the workforce jobs measure, which has indicated weaker employment growth than the Labour Force Survey measure over this period). Sectors that have seen falls in employment over the past year or so correspond closely with those most affected by international uncertainty, including financial services and manufacturing. The reduction in hours worked over the course of the global slowdown has yet to reverse, with total hours worked broadly flat over the past year and significantly down on the peaks seen between the end of 2000 and mid-2001. This supports the view that the labour market has become significantly more flexible in recent years, and that companies, in choosing to reduce hours rather than staffing levels, have continued confidence in the medium-term prospects for the UK economy.

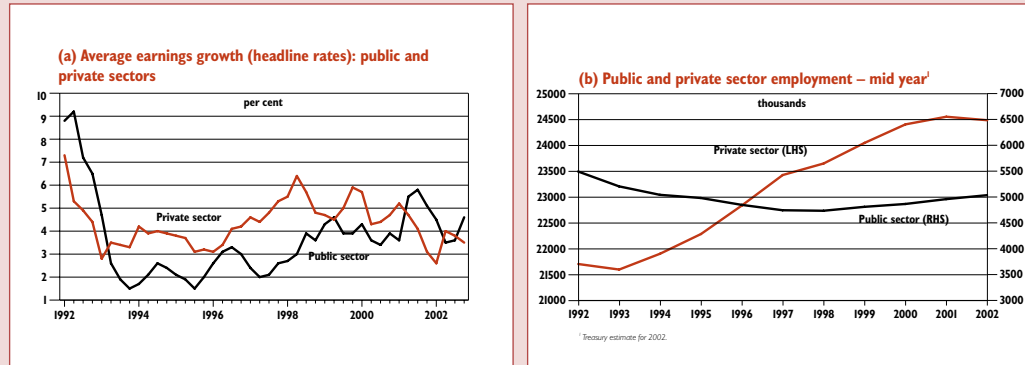
B37 With GDP expanding and the number of hours worked depressed by the effects of global economic fragility, output per hour worked has picked up since 2001, rising by 1.7 per cent in the year to the final quarter of last year.

B38 Average earnings growth remains below the 4½ per cent level deemed by the MPC to be consistent with the Government's inflation target in the medium term, with the rate excluding bonuses averaging just under 4 per cent since last summer. Private sector earnings growth has recently fallen to around 3 per cent under the influence of lower bonus payments than a year earlier, though excluding bonuses the rate has also been subdued, within the range of 3½ to 4 per cent since last summer. Public sector earnings growth has tended to be stronger, after adjusting for the effects of the delayed settlement for local authority workers which depressed the figures through the middle of last year, and has been running at around 5 per cent in latest months. However, it remains significantly lower than throughout most of 2001 and appears to pose very little near-term risk to overall earnings or inflation prospects. Public sector earnings are discussed further in Box B4.

B39 Despite growth in manufacturing output lagging that in the service sector, average earnings growth in private sector services has recently fallen to about 2½ per cent, well below that in manufacturing where the rate has been around 4 per cent. The fall back in private services is largely accounted for by bonuses, but the relatively strong growth in manufacturing earnings may at least partly reflect a strong pick-up in manufacturing productivity during 2002, with annual growth in output per worker recently at its strongest for over a year and a half. As a result, steady growth in manufacturing earnings has not put any significant upward pressure on unit wage costs, which remain virtually unchanged on a year earlier.

Box B4: Public sector employment and earnings

In order to deliver the Government's aim of improving the quality of public services, the public sector needs to be able to recruit and retain skilled and motivated staff. At the same time, the expansion of the public sector needs to be accommodated within the Government's broader economic objectives.



From the early 1990s until 2001, public sector earnings growth consistently lagged behind that in the private sector by a considerable margin. Private sector annual earnings growth between 1993 and 2000 averaged 4¼ per cent, compared with less than 3 per cent in the public sector. This tended to lower the level of public relative to private sector earnings, increasing the more recent challenge of attracting and retaining the skilled staff necessary to deliver the Government's priorities for improving public services.

Over the past two years, however, earnings growth in the public sector has run ahead of that in the private sector, coinciding with rising public sector employment as the Government's spending plans have come on stream. Indeed public sector employment has been rising since 1999, at about 1½ per cent a year on average, following years of decline. Nonetheless, the differential of public over private sector pay growth, while facilitating a substantial expansion in public services, remains modest, at approximately 1 percentage point in recent months. Moreover, overall growth in whole economy headline average earnings, at around 3½ per cent, has encouraged rather than posed a threat to employment.

Looking ahead, government departments have estimated that an increase in public sector employment of over 200,000 between 2003 and 2006 will be needed to deliver 2002 Spending Review commitments on public services. Departments are preparing pay and workforce strategies, which will help firm up these estimates. This implies an average increase of about 70,000, or just under 1½ per cent, a year. Against the background of recent favourable labour market developments, in particular for average earnings, and trend employment projections, such increases in public sector employment are realistic and achievable within cash spending plans.

Trend output growth

B40 Since the 2002 Pre-Budget Report, revisions have been made by the ONS to GDP from the start of 2001. Table B3 updates historical and forward-looking estimates of the composition of trend output growth in the light of these revised data. However, the revisions have not affected the estimate of trend output growth over the recent past (the first half of 1997 to the third quarter of 2001).

Table B3: Contributions to trend output growth¹

	Estimated trend rates of growth, per cent per annum					Trend output (6)
	Trend output per hour worked ^{2,3}		Trend average hours worked ³	Trend employment rate ³	Population of working age ⁴	
	Underlying (1)	Actual (2)				
1986 Q2 to 1997 H1	2.21	2.01	-0.14	0.41	0.22	2.51
Over the recent past						
1997 H1 to 2001 Q3						
Budget 2002	2.14	1.96	-0.37	0.36	0.66	2.63
PBR 2002	2.35	2.14	-0.47	0.43	0.50	2.61
Budget 2003	2.35	2.14	-0.47	0.43	0.50	2.61
Projection⁵						
2001 Q4 to 2006 Q4						
Budget 2002	2.1	2.0	-0.1	0.2	0.6	2³/₄
PBR 2002	2.35	2.25	-0.1	0.2	0.5	2³/₄
Budget 2003	2.35	2.25	-0.1	0.2	0.5	2³/₄

¹ Treasury analysis based on the judgement that 1986 Q2, 1997 H1, and 2001 Q3 were on-trend points of the output cycle. Figures independently rounded. Trend output growth is estimated as growth of non-oil gross value added between on-trend points for the past, and by projecting components going forward. Columns (2)+(3)+(4)+(5)=(6). Full data definitions and sources are set out in Annex A of 'Trend Growth: Recent Developments and Prospects', HM Treasury, April 2002.

² The underlying trend rate is the actual trend rate adjusted for changes in the employment rate, i.e. assuming the employment rate had remained constant. Column (1)=column (2) + (1-a) column (4), where a is the ratio of new to average worker productivity levels. The figuring is consistent with this ratio being of the order of 50 per cent, informed by econometric evidence and LFS data on relative entry wages.

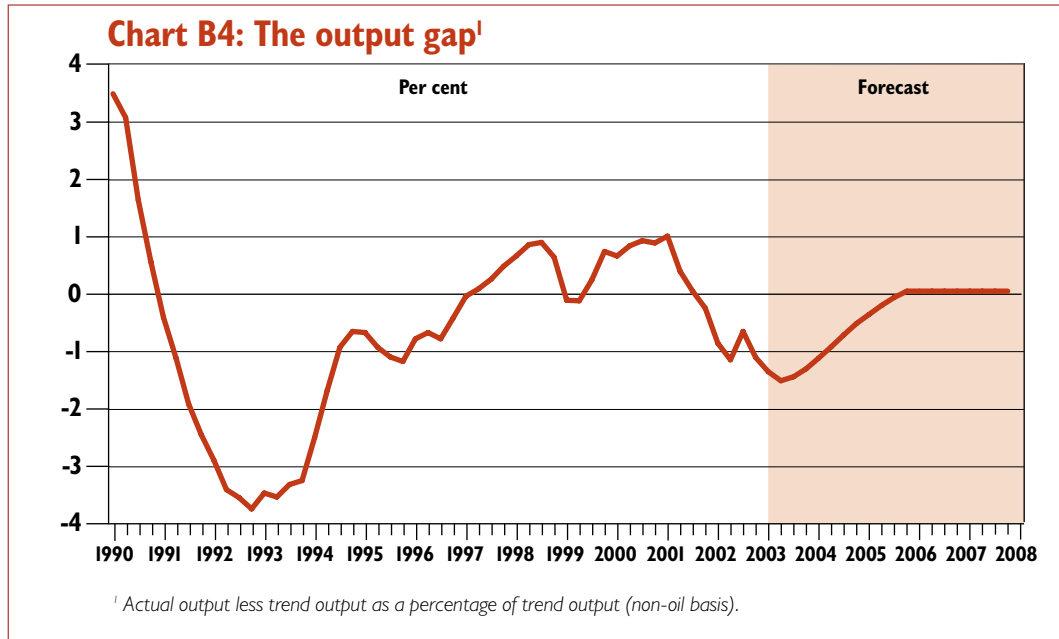
³ The decomposition makes allowance for the employment rate and average hours worked lagging output. Employment is assumed to lag output by around three quarters, so that on-trend points for employment come three quarters after on-trend points for output, an assumption which can be supported by econometric evidence. Hours are easier to adjust than employment, and the decomposition assumes that hours lag output by just one quarter, though this lag is hard to support by econometric evidence, not least because quarterly LFS data only extend as far back as 1992 Q2. Hours worked and the employment rate are measured on a working-age basis.

⁴ UK household basis.

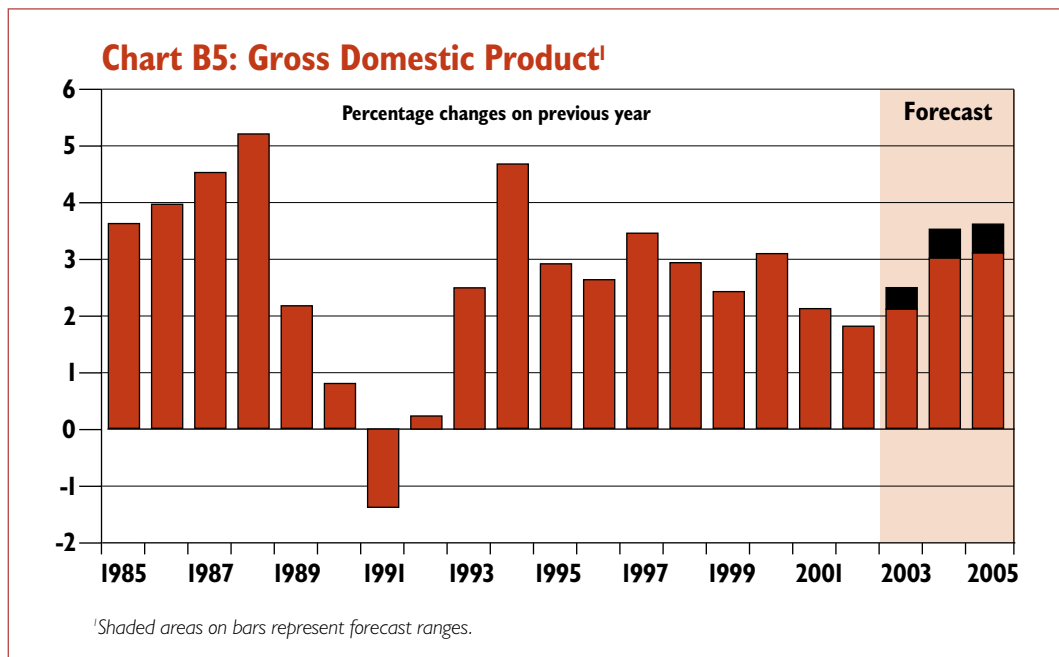
⁵ Neutral case assumptions for trend from 2001 Q3 and underlying the mid-points of the GDP forecast growth ranges from 2002 Q4.

Output and demand

B41 No change in the assessment of the economy's on-trend points since the 2002 Pre-Budget Report means that the start of the current cycle is still provisionally judged to have been in mid-1999. GDP growth was below its neutral trend rate of 2³/₄ per cent in 2002 implying a widening negative output gap since the economy was last estimated to have been on trend, in the third quarter of 2001. However, the gap at the end of last year is now a little smaller than estimated at the time of the Pre-Budget Report, reflecting the recent revisions to GDP data. The output gap is likely to widen a little further in the short term. From the second half of 2003 the output gap is expected to narrow, as the economy grows at above trend rates.



B42 The combination of sluggish external demand and global uncertainties that strongly shaped developments in 2002 has continued to dominate UK prospects into this year. With hostilities in Iraq ongoing, uncertainty over the geo-political situation, and its potential economic implications, has continued to affect the confidence of the UK corporate sector, and in recent months there has been some emerging evidence that the uncertain global outlook may also be adversely affecting consumer sentiment.



B43 UK GDP is now expected to rise by 2 to 2½ per cent this year, below its trend rate of growth of 2¾ per cent and the 2002 Pre-Budget Report forecast. This reflects the weaker near-term outlook for the world economy, and especially the UK's key export markets, combined with a continued short-term drag on investment arising from ongoing global uncertainty. However, GDP is expected to accelerate in the second half of 2003 and into 2004, as international uncertainty gradually abates and the expected gathering in the pace of the global economic recovery feeds through. GDP is therefore forecast to increase by 3 to 3½ per cent both next year and the year after, as the economy returns to trend by the end of 2005.

B44 The rebound in confidence as geo-political uncertainties are resolved might be stronger and faster than assumed, leading the output gap to diminish more quickly, with growth faster than projected. Alternatively, the effects of geo-political uncertainty and financial market volatility might, however, be less transitory than assumed. Firms and households could take a more cautious approach to spending decisions both in the UK and other economies, especially if hostilities in Iraq prove more protracted than generally assumed or in the event of terrorist reprisals. This would tend to prolong the economy's return to trend, though to the extent that this would put downward pressure on inflation, there would be some offset from lower interest rates to keep inflation on target.

B45 From this year onwards household consumption is forecast to grow at close to sustainable rates, ending seven years of unsustainable growth and completing the slowdown that began in 2001. Consumers are expected to adjust their expenditure with a lag to weaker real disposable income gains, and reductions in financial wealth following falls in equity prices over recent years. With the ratio of their debt to income at a historically high level, the current economic climate is likely to deter households from wanting to take on further debt.

B46 Ongoing global uncertainty has further affected the short-term outlook for business investment into 2003. With equity and other financial market prices undergoing a further bout of turbulence, and companies still uncertain about near-term global prospects and the duration and impact of hostilities in Iraq, the international environment has continued to make firms extremely hesitant about committing to new capital outlays.

B47 In 2003 as a whole, business investment is forecast to show a small fall on 2002, with some further weakening in the first half, despite its broadly flat path in previous quarters. However, with firms having largely tackled the significant levels of borrowing built up following the late 1990s' ICT boom, the marked improvement in the health of corporate balance sheets suggests that the foundations are largely in place for business investment to make a convincing recovery as global uncertainty lifts and a stronger world environment takes hold. Thus business investment is expected to pick-up from mid-2003 and accelerate into next year as diminished uncertainty in the global outlook encourages firms to continue bringing deferred expenditure back on stream. With government investment continuing to rise strongly, particularly this year, as a result of the Government's spending plans, whole economy fixed capital formation is expected to grow significantly faster than GDP in all forecast years.

B48 Manufacturing activity has remained weak. Despite rebounding in the third quarter, following a sharp fall in output in June as factories closed down for the Jubilee holidays, manufacturing output registered a further modest decline in the final quarter of 2002. Faced with fragile external demand and significant ongoing risks to the global outlook, manufacturers have continued to meet demand partly from existing inventories, rather than by stepping up production. In the final quarter of 2002, manufacturing output was 1.6 per cent lower than a year earlier; the larger fall of 4 per cent between 2001 and 2002 as a whole largely reflects the steep fall during 2001 rather than declines in the course of 2002.

B49 Abstracting from Jubilee effects, the recent trend in overall manufacturing output appears to have been broadly flat, with output in the three months to February this year only fractionally lower than a year earlier. The aggregate figures also continue to mask divergences within the sector. Output of chemicals-related industries remains higher than when the world slowdown began in 2001 while transport equipment has also made solid gains over the past year. Indeed, almost a half of the manufacturing sector registered higher output in the three months to February than a year earlier.

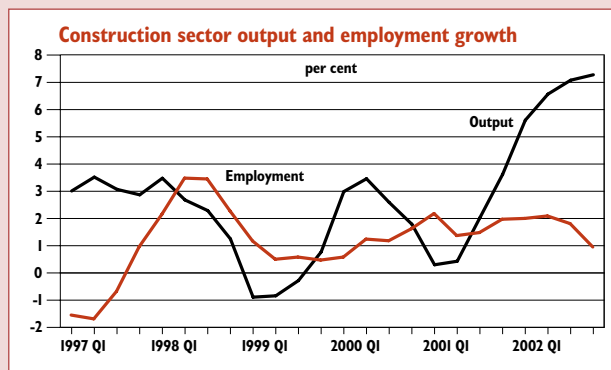
B50 Business survey results have pointed to further subdued manufacturing activity in recent months. Overall, however, business survey indicators have only given a very rough approximation of near-term manufacturing trends over the past year or so.

B51 Strengthening external demand from around the second half of 2003 is expected to underpin a recovery in the manufacturing sector through this year and into 2004, with the recent weakening of sterling against the euro likely to give a further fillip to the recovery in the sector. At the same time, the pick up in business investment, and an associated upswing in demand for ICT equipment, should provide additional impetus to manufacturing production going forward. Manufacturing output is expected to grow by $\frac{1}{4}$ to $\frac{3}{4}$ per cent this year, rising to $2\frac{1}{4}$ to $2\frac{3}{4}$ per cent in 2004 before easing back to growth of $1\frac{3}{4}$ to $2\frac{1}{4}$ per cent in 2005, below the trend rate of growth of the economy reflecting the long-established shift in industrial composition towards services.

Box B5: Developments in the construction sector

The UK construction industry accounts for around five per cent of UK GDP and employs 1.9 million people. UK designers, civil engineers, contractors and component and product manufacturers have first class reputations worldwide and are heavily engaged in both overseas, as well as domestic, construction projects.

In 2002, construction output saw its sharpest increase since 1988 with growth of 7½ per cent, significantly above that of the service sector and other areas of production. Construction output last year accounted for around a third of total output growth – its largest contribution to overall growth for fourteen years. This followed robust growth through 2001, when the level of construction output surpassed its previous peak in 1990 for the first time.



Progress towards realising the Government's commitments on public sector investment has been a key factor underpinning growth in construction output over the past two years. In 2002, total infrastructure output in current prices rose by over 13 per cent, with four fifths of the growth coming from public sector works, largely reflecting a 27 per cent

increase in road construction. At the same time, public sector construction output, outside of infrastructure and housing, also rose strongly, increasing by almost 30 per cent compared with 2001. Schools and colleges made the strongest contribution, as investment in higher education continued to come on stream, while construction contracts signed under the Private Finance Initiative have also boosted activity. The construction of health facilities meanwhile rose by almost a quarter last year.

Nonetheless, there have also been areas of strong private sector demand for construction. Railway infrastructure output rose by 26 per cent in 2002, and has more than doubled in the past two years reflecting the upgrading and maintenance of the national network. Construction of entertainment facilities and shops rose by 16 and 27 per cent respectively. Strong growth in construction sector output, together with continued robust growth in employment, which has risen by around 8¼ per cent since 1997, have begun to be reflected in emerging capacity pressures. For example, the Construction Trends Survey for the fourth quarter of 2002 reported that 59 per cent of building companies and 54 per cent of civil engineering contractors were working at, or close to, full capacity. Moreover, the Chartered Institute of Purchasing and Supply Managers (CIPS) Report on Construction for March indicated that supplier delivery times in the sector were continuing to lengthen. Capacity constraints also appear to be spilling over into prices: producer input prices for construction materials rose by 4½ per cent in the year to February, with the CIPS survey also showing input prices rising at a faster rate in recent months.

B52 A sustained turnaround in UK export volumes is dependent on a gathering in the strength of external demand growth. Goods and service export volumes are forecast to rise by $1\frac{1}{4}$ to $1\frac{1}{2}$ per cent this year, slightly below 2002 Pre-Budget Report projections as a result of a less pronounced pick-up in UK export market growth in the first half of the year. Exports are then expected to accelerate strongly through 2004 as the expansion in world trade gathers further momentum and the gain in competitiveness from the recent weakening of sterling against the euro begins to feed through. The UK's market share is expected to flatten out as the forecast period extends.

B53 Import growth beyond 2003 is forecast to be somewhat less than that of exports. The pick-up in UK business investment and manufacturing output are expected to stimulate a strengthening of import growth from around the middle of this year, on the back of higher demand for capital equipment and manufactured components. However, the rate of import growth is expected to stay below the sharp rates registered during most of the late 1990s, as the increasing share of government spending in GDP, which tends to have a lower import content than private sector expenditure, reduces import growth relative to that of GDP. Net trade is therefore forecast to make a relatively modest negative contribution to growth over the forecast horizon.

B53 The forecast contributions to GDP growth for the various components of demand are shown in Table B4.

Table B4: Contributions to GDP¹ growth^{2,3}

	Percentage points unless otherwise stated			
	2002	Forecast		
		2003	2004	2005
Private consumption	$2\frac{3}{4}$	2	$1\frac{3}{4}$	2
Business investment	-1	$-\frac{1}{4}$	$\frac{1}{2}$	$\frac{3}{4}$
Government	$\frac{3}{4}$	$1\frac{1}{2}$	1	$\frac{3}{4}$
Change in inventories	0	0	0	0
Net trade (goods and services)	-1	$-1\frac{1}{4}$	$-\frac{1}{4}$	$-\frac{1}{4}$
GDP growth, per cent	$1\frac{3}{4}$	$2\frac{1}{4}$	$3\frac{1}{4}$	$3\frac{1}{4}$

¹ At constant market prices.

² Components may not sum due to rounding and omission of private residential investment, the transfer costs of land and existing buildings and the statistical discrepancy.

³ Based on central case. For the purpose of public finance projections, forecasts are based on the bottom of the forecast GDP range.

Box B6: Chain-linking the UK national accounts

From September 2003, the Office for National Statistics (ONS) will introduce a new method, called annual chain-linking, for calculating the volume measure of real GDP and its components. This method will be used to revise past data as well as to provide latest estimates, and may possibly change measured GDP growth rates to an extent that could affect the interpretation of recent economic history.

Chain-linking uses annually updated 'current' price weights to value the contribution of individual products to total real GDP growth, in contrast to the existing practice of measuring real GDP using the relative prices of a single base year, currently 1995. In the past this base year has been periodically, but not annually, updated.

A key problem with the existing measure of real GDP is that it is prone to bias. The current base year of 1995 is now eight years ago. Relative prices have changed for a number of reasons, for example because some goods, such as electronic consumer goods, can now be produced much more cheaply, or because new products have entered the market. So the 1995 relative price weights no longer reflect the relative value of goods today.

Thus the move to chain-linking will represent a marked methodological improvement in measuring real GDP growth. It is recognised as international best practice, and is a requirement of the European System of Accounts 1995 national accounting standard. Some non-European countries, such as the USA, have also adopted chain-linked volume measures.

Guidance on the possible impact of the introduction of annual chain-linking on measured real GDP growth has been published by the ONS¹. Chain-linking will not, of course, affect nominal aggregates, including estimates of the public finances.

¹ For example, "The effects of annual chain linking on the output measure of GDP", A. Tuke and G. Reed, Economic Trends, No.575, October 2001.

Inflation

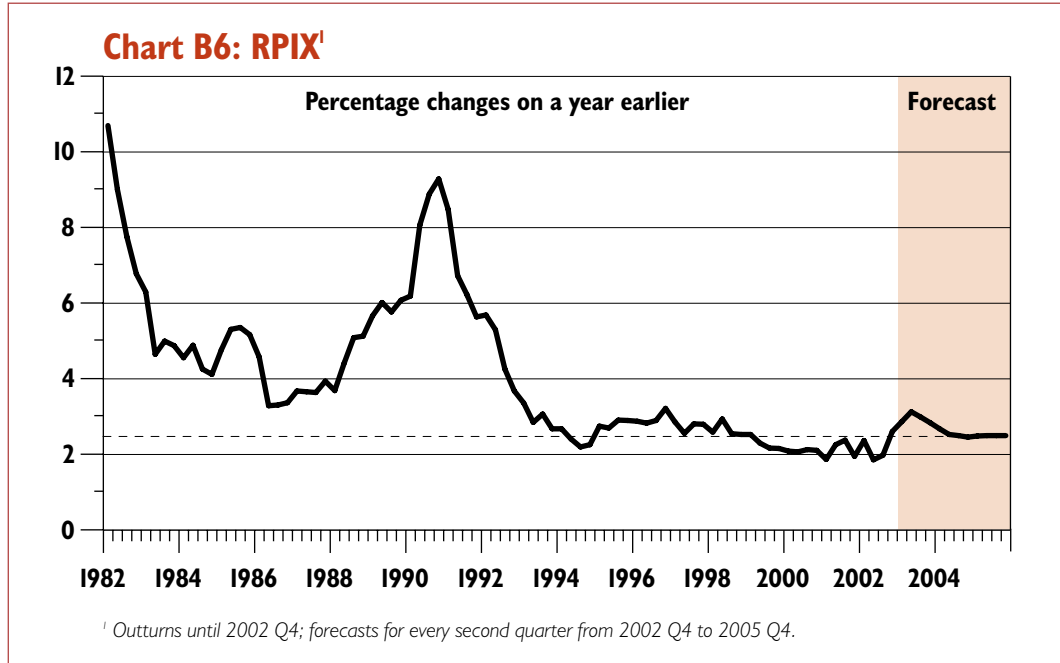
B54 Underlying inflation in the UK remains firmly in check. RPIX inflation, the Government's target measure, averaged 2.2 per cent last year. The average rate of UK HICP inflation over the past three years, at just 1.1 per cent, has been lower than in any other European Union country.

B55 RPIX inflation in February was slightly above target, at 3.0 per cent, whereas HICP inflation stood at 1.6 per cent. Strong house price gains in the second half of last year have temporarily lifted the contribution of housing costs to the 12-month RPIX inflation rate. Petrol prices have also contributed significantly to the recent uplift in inflation as the effects of sharply higher oil prices on a year earlier have fed through.

B56 Other temporary factors appear to have given an additional lift to inflation in February. In particular anecdotal evidence suggests that the New Year sales, especially for clothing and footwear, got underway earlier and ended sooner this season than last, when sales lingered into February, boosting the February inflation rate.

B57 Increases in oil prices have also been the main factor underpinning a pick-up in manufacturers' input costs in recent months, with material and fuel costs rising almost 6 per cent in the year to February, their fastest rate for over a year and a half. However, excluding erratic food, beverages, tobacco and petroleum prices, a still uncertain world outlook has kept underlying producer price inflation subdued, with input prices just 0.4 per cent higher in the year to February.

B58 House price inflation has moderated from its recent peaks in the second half of 2002, when annual price rises reached between 25 and 30 per cent. Monthly rates of growth have eased back, suggesting that the peak in the housing market has now passed. In the three months to March, the Nationwide House Price Index stood 4.4 per cent higher than in the previous three months, a significant moderation compared with its latest three month on three month peak of 7.7 per cent in August.



Box B7: Measuring inflation

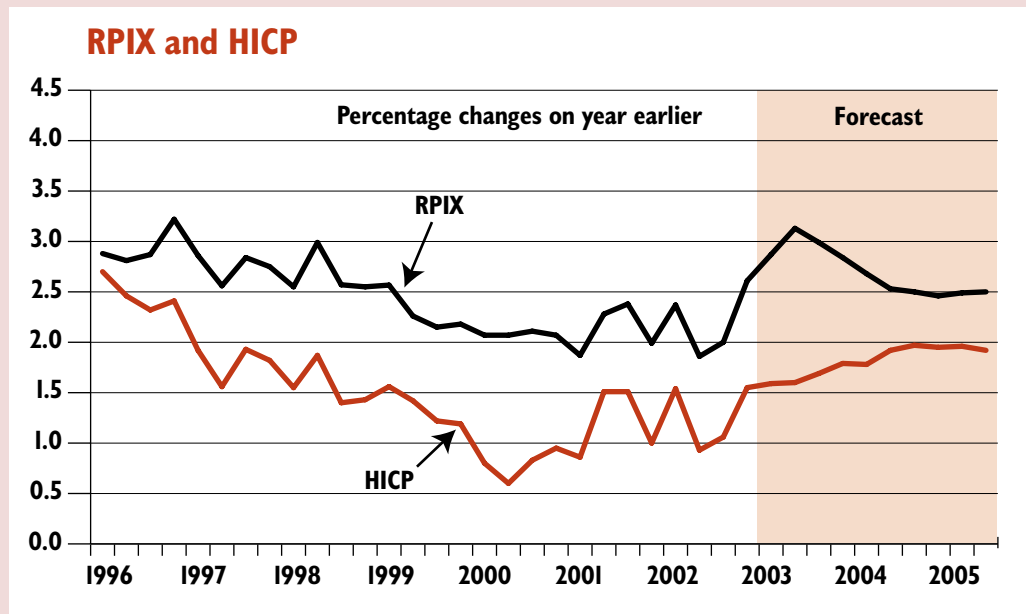
The inflation rate targeted by the Bank of England is the Retail Prices Index excluding mortgage interest payments (RPIX). RPIX inflation averaged 2.2 per cent last year. Although it has risen to 3.0 per cent in February of this year, reflecting strong house price gains and higher oil prices feeding through to increases in petrol prices, RPIX inflation is forecast to fall back to its 2.5 per cent target by the first half of next year.

An alternative measure of inflation, used for comparisons within the European Union, is the Harmonised Index of Consumer Prices (HICP)¹. In 2002, HICP inflation averaged 1.3 per cent. The current rate of UK HICP inflation is 1.6 per cent.

The differences between HICP inflation and RPIX inflation can be primarily explained by:

- a **formula effect**, from individual prices in the HICP being aggregated by a geometric mean rather than the arithmetic mean used in the RPIX; and
- a **coverage effect**, primarily arising from the inclusion in RPIX of some components of housing costs that are excluded from the HICP. There are also some less significant differences in coverage arising from expenditure patterns used to weight the indices. For example, RPIX excludes expenditure by the richest 4 per cent of households, most pensioners and overseas visitors.

While the current differential between HICP and RPIX is 1.4 percentage points, this gap is expected to narrow as house price inflation moderates. The Treasury forecasts the differential to narrow to around half a percentage point from the end of 2004.



¹ HICP is discussed further in "The Harmonised Index of Consumer Prices (HICP) – some factual information", HM Treasury, November 1998.

B59 Although house prices themselves are not a direct element of the RPI, they influence it because they are used in the calculation of housing depreciation. This is expected to remain a significant factor in keeping RPIX inflation slightly above target over coming months. But with house price increases expected progressively to moderate this year, and as last year's gains fall out of the 12-month comparison, the positive influence of housing depreciation on RPIX inflation should wane as the year goes on. Likewise, oil prices are expected soon to contribute to some easing of RPIX inflation, although there is the risk of further volatility.

B60 Other key influences on inflation over the next two years are expected to be: upward pressure from rising import prices, as a result of the recent fall in the exchange rate and the forecast pick-up in the global economy; and the continuing negative, albeit narrowing, output gap, exerting downward pressure on domestically generated inflation.

B61 The combined effect of these factors is that over the next 12 months RPIX inflation is forecast to fall back to its 2½ per cent target, as the temporary housing depreciation and oil price effects unwind, and the upward import price effect slightly outweighs the downward output gap effect. Thereafter inflation is expected to remain at target.

Independent forecasts

B62 Independent forecasts for UK GDP growth have been reduced since the 2002 Pre-Budget Report. The latest independent average for growth in 2003 is 2.0 per cent, down from 2.4 per cent at the time of the 2002 Pre-Budget Report but consistent with the lower end of the Budget forecast range. For 2004, the average of independent forecasts for GDP growth is 2.4 per cent, down from 2.9 per cent at the time of the 2002 Pre-Budget Report. Independent forecasters continue to expect inflation to remain close to target this year and next.

Table B5: Budget and independent¹ forecasts

	Percentage changes on a year earlier unless otherwise stated					
	2003			2004		
	April Budget	Independent		April Budget	Independent	
Average		Range	Average		Range	
Gross domestic product	2 to 2½	2.0	-0.4 to 2.7	3 to 3½	2.4	-0.3 to 3.3
RPIX (Q4)	2¾	2.5	1.8 to 3.7	2½	2.4	1.5 to 3.3
Current account (£ billion)	-23¼	-21.1	-30.4 to -9.8	-23¼	-21.3	-41.1 to -8.0

¹ Forecasts for the UK Economy: A Comparison of Independent Forecasts', HM Treasury, March 2003.

UK FORECAST IN DETAIL

The household sector

B63 Underlying growth in household consumption – supported by high employment and low interest rates – has remained robust and continued to support UK GDP growth in the face of subdued global demand. Strong house price gains have contributed by shielding household total net wealth from the impact of declining equity prices. Although real income growth has moderated, homeowners' borrowing capacity has been enhanced by significant appreciation in housing wealth, and mortgage equity withdrawal in the fourth quarter of 2002, at 7.2 per cent of post-tax income, was at its highest level since its 1988 peak (see Box B8 for a fuller discussion). In 2002 as a whole, private consumption rose by 3¾ per cent.

Table B6: Household sector¹ expenditure and income

	Percentage changes on previous year unless otherwise stated			
	2002	Forecast		
		2003	2004	2005
Household consumption ²	3¾	2¾ to 3	2½ to 2¾	2½ to 3
Real household disposable income	2¼	2 to 2½	2½ to 3	2½ to 3
Saving ratio (level, per cent)	5	4¾	5	5

¹ Including non-profit institutions serving households.

² At constant prices.

B64 Nonetheless, growth in private consumption has continued to moderate gradually from its most recent peak in 2000, when growth reached over 5 per cent. Retail sales growth fell back in the latter stages of 2002, with growth between the first and second halves at its slowest rate for over two years. While monthly sales growth picked up strongly in December, rising 1 per cent on November, this reflected the particularly late Christmas trading period in 2002. Thus, as widely anticipated, January saw a corresponding fallback in sales volumes; and another, albeit fractional, easing in February provided further confirmation that retail sales growth has slackened. In the year to February retail sales were 3.3 per cent up, around half the rate of growth seen in the year to February 2002. Moreover, excluding December, retail sales have remained virtually flat since October.

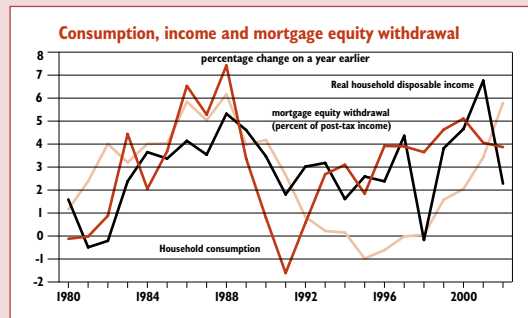
B65 Although retail sales account for only 35 per cent of household consumption, other evidence suggests that the slowdown in household expenditure is proving broad based. New car registrations have fallen back from record highs. Consumer confidence has also eased back in recent months; although consumers remain more positive over the outlook for their own finances, sentiment regarding prospects for the general economy has weakened considerably. The composite European Commission/GfK measure of consumer confidence has trended downwards since last summer and in March was at its lowest level since December 1995, albeit only just below its past long-run average. This possibly reflects a partially delayed reaction to last year's stock market turbulence, and renewed equity price weakness this year risks a further unravelling of confidence. However, shifts in confidence also suggest that volatility on financial markets in recent months have begun to have some adverse bearing on households' perceptions of economic prospects, while the recent moderation of underlying house price inflation may have further dampened consumer sentiment. Ongoing concerns over potential terrorist attacks in both the UK and US may also have played a role in reducing confidence.

B66 Lower income growth in 2002 is likely to prompt a continued moderation of private consumption growth through this year. Further recent declines on world equity markets, compounding already sharply reduced valuations in 2000 and 2001, are also expected to feed through to consumption as households adjust spending patterns to reductions in net financial wealth. Moreover, with house price inflation showing signs of having peaked, more moderate growth in valuations can be expected to reduce some of the recent momentum in household consumption too. With household debt having risen rapidly in recent years, increasing by over 40 per cent since 1998, consumers' appetite for further borrowing is likely to wane.

B67 Nonetheless, the strong fundamentals that have militated against any abrupt reversal in the strength of private consumption growth remain in place. Household consumption is therefore expected to continue slowing gradually through this year, growing by 2¾ to 3 per cent in 2003 as a whole. Thereafter growth is forecast to remain at sustainable rates, and significantly below the average of 4¼ per cent a year seen between 1996 and 2002.

Box B8: Mortgage equity withdrawal

Mortgage equity withdrawal (MEW) is that part of borrowing secured against housing that is not invested in property. It expanded rapidly in 2002, supporting further strong growth in consumption as owner occupiers took advantage of significant gains in the value of their houses accrued over the course of the past four to five years. Thus, despite a sharp fall in income growth from its recent peaks in 2001, together with sharply reduced household financial wealth as a result of equity price falls, consumption growth remained robust in 2002.



However, it is unlikely that all of the rise in MEW in 2002 seeped into additional consumption. MEW may simply act as a substitute for other types of borrowing, such as consumer credit, thus not necessarily adding to the sum of consumer demand. Moreover, it may be used to pay off other debt or to fund additions to financial assets rather than consumption. Households could be

holding funds generated by MEW to boost housing investment at some future date. Nevertheless, despite these alternative channels, a survey by the Council for Mortgage Lenders provides confirming evidence that MEW has partly boosted recent consumption growth, including spending on some housing related goods.

The recent rise in MEW has no doubt been driven by increases in house prices, which have more than doubled since their trough at the start of 1995, but it has been underpinned by a number of other related factors too. A fall in real interest rates has been one major influence, reducing the cost of borrowing to fund current spending. Furthermore, the fall in nominal interest rates has reduced the up-front cost of borrowing, although low inflation means real costs erode less quickly over time; and the macroeconomic framework is likely to have given households confidence that interest rates will be less volatile going forward. Falling interest rates have boosted housing transactions and remortgaging, facilitating access to housing wealth; and lenders appear to have reduced credit constraints, through the increased use of products such as flexible mortgages, thereby giving a one-off boost to borrowing and consumption.

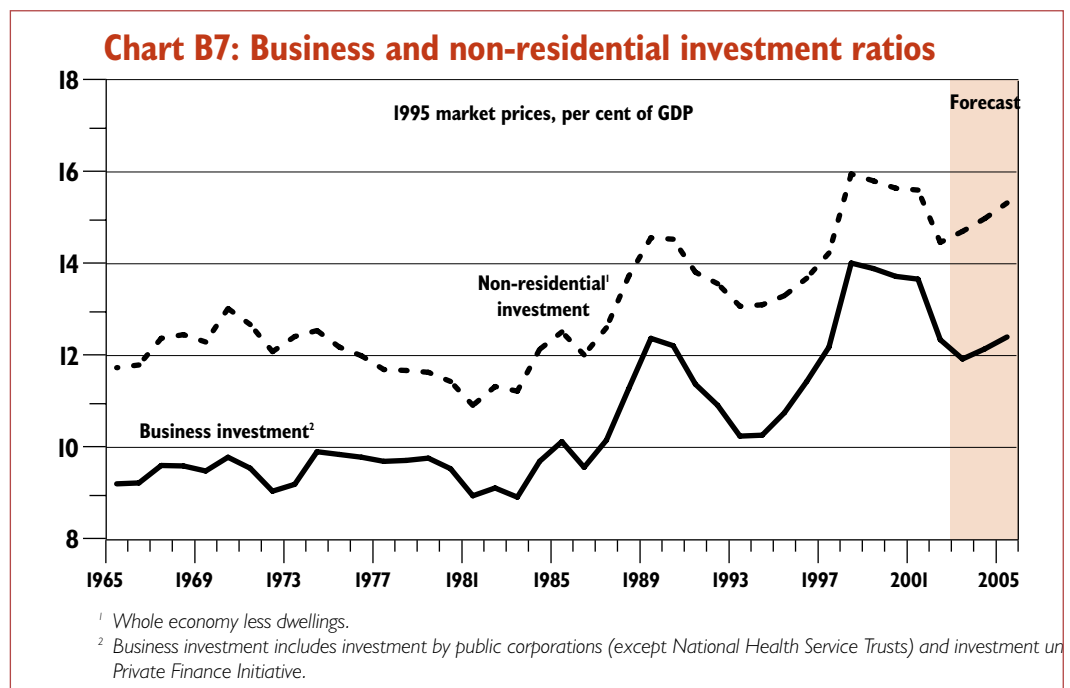
Looking ahead, further expansion in MEW is likely to be restrained by moderating house price inflation and the already high level of debt relative to income. However, MEW is likely to continue to have a supportive, albeit diminishing, effect on consumption as recent borrowing gradually works through to expenditure.

Investment

B68 Estimates of business investment from the beginning of 2001 have recently been revised up. As a result, business investment expenditure for last year as a whole is now estimated to have fallen by less, and to have been around 3½ per cent higher, than expected in the Pre-Budget Report.

B69 Nonetheless, these revisions have not significantly changed the recent pattern of business investment expenditure. Although there have been signs of business investment bottoming out, the subdued nature of the global recovery in 2002, together with ongoing international uncertainties, have continued to discourage firms from undertaking new investment. The CBI Industrial Trends Survey for the first quarter of 2003 showed that the importance of political and economic uncertainty as a constraint on investment intentions was at its highest since in the immediate aftermath of 11 September 2001, and similar to the levels witnessed at the height of the late 1990s' Asian crisis.

B70 The sharpest quarterly falls in business investment were concentrated over the second half of 2001 and into the first quarter of 2002, amidst significantly heightened uncertainty in the wake of 11 September. Business investment remained broadly flat between the first and second halves of last year, although it ended the year 5½ per cent lower than in late 2001. Ongoing international uncertainty and sharp falls on global equity markets through last year and into early 2003 have continued to blunt the incentive to invest.



B71 After the sharp downturn in ICT spending in 2001, high-technology investment declined further throughout 2002, accounting for over a quarter of the overall decline in current price business investment for the year as a whole. One factor that may have compounded the global investment downturn in keeping ICT spending subdued in recent years is an extension in the effective lives of many high-technology assets. While ICT equipment is subject to rapid obsolescence as new technologies come onto the market, machines bought around the end of the 1990s and in 2000 were massively more powerful than ones acquired a decade earlier, reflecting the marked increase in computer processor speed. As a result, firms may have been able to continue deriving service streams from ICT equipment for longer, diminishing the need for regular replacement and upgrading of computing systems and other high-technology assets.

B72 Nonetheless, there have been some early encouraging signs that the foundations necessary for a turnaround in business investment are beginning to emerge. Investment expenditure on software and hardware rose by almost 15 per cent in the third quarter and by a further 5³/₄ per cent in the final quarter of 2002. Moreover, both imports and production of capital equipment have shown some signs of having flattened out in recent months.

B73 Company profitability has shown encouraging signs of having stabilised. Rates of return in manufacturing have picked up from lows seen in 2001, while service sector rates remained broadly flat over last year as a whole. Moreover, private non-financial corporations have aggressively tackled debts accumulated during the investment boom of the late 1990s, and ran significant financial surpluses throughout last year.

Table B7: Gross fixed capital formation

	Percentage changes on previous year			
	2002	2003	Forecast 2004	2005
Whole economy ¹	-3 ¹ / ₄	4 ¹ / ₄ to 4 ³ / ₄	4 ³ / ₄ to 5 ¹ / ₄	5 to 5 ¹ / ₂
of which:				
Business ^{2,3}	-8	-1 ¹ / ₂ to -1	4 ³ / ₄ to 5 ¹ / ₂	5 ¹ / ₄ to 6
Private dwellings ³	13 ³ / ₄	4 ¹ / ₄ to 4 ¹ / ₂	2 to 2 ¹ / ₂	2 to 2 ¹ / ₂
General government ^{3,4}	9 ¹ / ₄	47	8	7 ³ / ₄

¹ Includes costs associated with the transfer of ownership of land and existing buildings.

² Private sector and public corporations' (except National Health Service Trusts) non-residential investment. Includes investment under the Private Finance Initiative.

³ Excludes purchases less sales of land and existing buildings.

⁴ Includes National Health Service Trusts

B74 Overall, these tentatively encouraging signs are consistent with private sector capital expenditure being at or close to its trough. Nonetheless, the main catalyst for a rebound in business investment in the second half of 2003 is still expected to be a strengthening of the global recovery.

B75 Mirroring the outlook for world growth, the Budget forecast shows business investment remaining subdued in early 2003, as the international environment continues to encourage a cautious approach to capital spending, but picking up from around the middle of the year and growing in the second half. In 2003 as a whole, business investment is forecast to decline by 1 to 1¹/₂ per cent, which masks growth of over 1¹/₄ per cent between the first and second halves of this year.

B76 As the global recovery gathers further momentum into 2004, and international uncertainties recede, postponed investment projects are expected to come back on stream as the outlook for demand improves. With firms having largely adjusted to the overhang from the investment boom of the late 1990s, a step-up in new ICT expenditure is expected to emerge over the course of the forecast horizon as a stronger world economy gives firms more confidence to upgrade and expand productive potential. Business investment is therefore forecast to grow by 4³/₄ to 5¹/₂ per cent next year and by 5¹/₄ to 6 per cent in 2005, accounting for a marked increase in its ratio to GDP.

Trade and the balance of payments

B77 A tentative recovery in world trade in the first half of 2002 temporarily boosted UK exports in the second quarter. However, faltering world trade growth in the second half was reflected in a sharp fall back in UK goods export volumes, which contracted by $5\frac{3}{4}$ per cent between the third and fourth quarters. So despite the spurt of growth earlier in the year, goods export volumes declined by nearly 2 per cent in 2002 as a whole, standing at their lowest level for three years in the final quarter. Services export volumes meanwhile increased marginally compared with 2001.

B78 The UK has recently seen a bigger decline in goods export volumes to non-EU markets than to the EU. Indeed, by value, a third of the decline in UK exports last year was attributable to the US alone. To some extent, this appears at odds with the pattern of global growth given GDP growth in the US outstripped that in the Euro-area last year. Moreover, although US imports were relatively weak in the third quarter of 2002, latest data show a sharp pick-up in the fourth quarter still coincided with a further weakening in UK exports to the US.

B79 Sterling has fallen by around 7 per cent against the euro since the 2002 Pre-Budget Report, and presently stands some 11 per cent lower than its most recent peak in February 2002. This should offer a spur to UK exports to the Euro-area. Although a corresponding increase of the sterling-dollar exchange rate over the past year is likely partially to offset any increase in UK market share at the global level, the composite Sterling Exchange Rate Index (ERI) has still eased back by around 7 per cent since early 2002, reflecting the far greater weight of the Euro-area in UK trade. Nonetheless, the lags typically judged to exist between exchange rate movements and trade flows mean that it is too early for these developments to have played a significant role in relative export trends in the course of 2002.

Table B8: Trade in goods and services

	Percentage changes on previous year					£ billion
	Volumes		Prices ¹		Terms of trade ²	Goods and services balance
	Exports	Imports	Exports	Imports		
2002	-1	1½	1½	-2	3¾	-18¾
<i>Forecast</i>						
2003	1¼ to 1½	4 to 4¼	2	1¾	¼	-26¾
2004	8¼ to 8¾	7¼ to 7¾	3	3¼	-¼	-27¾
2005	7 to 7½	6¼ to 6¾	2¾	2¾	0	-28¼

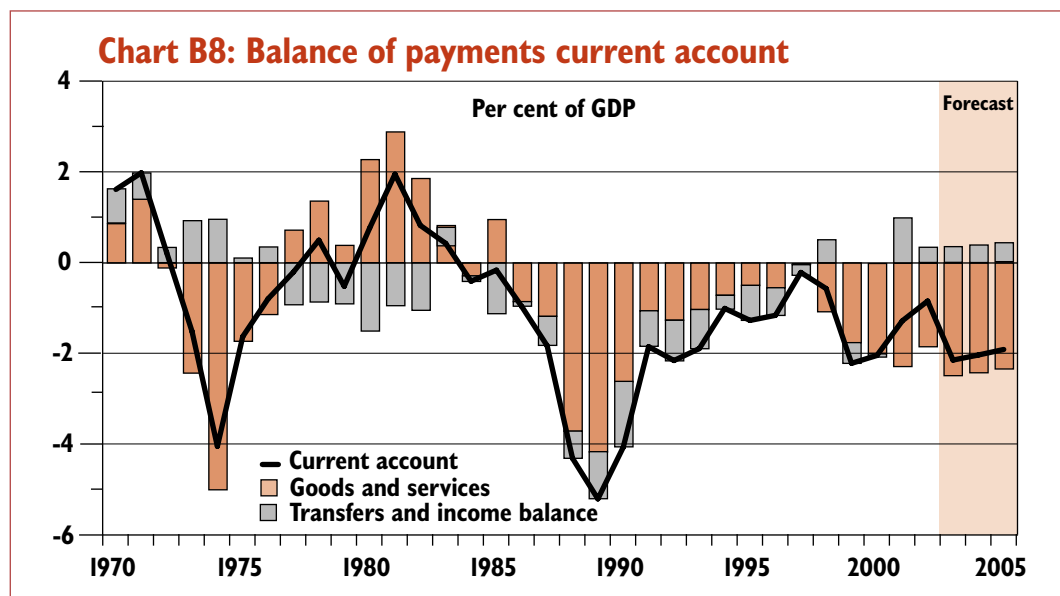
¹ Average value indices.

² Ratio of export to import prices.

B80 Imports appeared to resume growing in early 2002, having contracted over most of 2001 as weak manufacturing output and declining business investment reduced demand for both intermediate and capital goods. Nonetheless, any underlying turnaround in imports remains sluggish. Growth appears to have been inflated by a surge in imports of consumer goods through much of 2002, reflecting robust demand for new cars as well as the underlying strength of private consumption. However, with imports of non-car consumer goods having fallen back since the second quarter, goods import volumes in 2002 as a whole were less than 1 per cent up on 2001, and the underlying trend in import volumes in recent months now appears approximately flat.

B81 As a result of some recovery in imports and faltering exports, the deficit on trade in goods and services has widened since the first half of 2002. However, in 2002 as a whole it still narrowed as an increased surplus on services trade more than offset a widening in the goods deficit. This partly reflected a recovery in net exports of insurance services, following substantial insurance losses in 2001 arising from the 11 September tragedies. Moreover, in contrast to goods, underlying services export growth appears to have resumed in the second half of last year.

B82 As in the 2002 Pre-Budget Report, exports are expected to recover over the course of 2003 as world trade growth begins to gather increased momentum. Goods and services export volumes are forecast to rise by 1¹/₄ to 1¹/₂ per cent this year, slightly below the 2002 Pre-Budget Report projection as a result of a less pronounced pick-up in UK export market growth in the first half of the year, mainly reflecting a subdued near-term outlook for the Euro-area economies. Thereafter, exports are expected to strengthen considerably as the global recovery becomes more firmly entrenched and as the effects of increased UK price competitiveness from the recent weakening of sterling feed through. The volume of exports of goods and services is forecast to increase by 8¹/₄ to 8³/₄ per cent in 2004 and by 7 to 7¹/₂ per cent in 2005.



B83 At the same time, a sustained recovery in manufacturing output and renewed growth of UK business investment are expected to feed through to a strengthening of import growth over the forecast horizon. Overall, export and import volumes are expected to grow at broadly comparable rates for the foreseeable future, with the goods and services trade deficit levelling off, at around 2¹/₄ per cent of GDP, by 2005.

B84 Partly as a result of recent revisions to Balance of Payments data, the current account deficit for 2002, at under £9 billion, was less than half the level forecast in the 2002 Pre-Budget Report. The main reason for this is a stronger position on investment income, with 2002 registering another record surplus. This surplus is expected to moderate over the forecast period as stronger domestic GDP growth raises the relative profitability of overseas businesses operating in the UK and hence investment income debits, especially amongst financial service companies who appear to have been particularly affected by the recent period of weak global growth. Although a strengthening external environment should also

give a lift to UK earnings from overseas, the investment income surplus has been unusually high for the past two years or so, and the forecast assumes a return to a position more in line with historical experience. Together with a gradual widening of the deficit on trade in goods and services, this is expected to underpin a higher current account deficit in coming years. However, relative to GDP, the current deficit is expected to remain modest at around 2 per cent.

Table B9: Summary of economic prospects¹

	Percentage changes on a year earlier unless otherwise stated					
	2002	Forecast ²			Average errors from past forecasts ³	
		2003	2004	2005	2003	2004
Output at constant market prices						
Gross domestic product (GDP)	1¾	2 to 2½	3 to 3½	3 to 3½	¾	½
Manufacturing output	-4	¼ to ¾	2¼ to 2¾	1¾ to 2¼	1¼	2
Expenditure components of GDP at constant market prices⁴						
Domestic demand	2½	3 to 3½	3 to 3½	3 to 3½	¾	1
Household consumption ⁵	3¾	2¾ to 3	2½ to 2¾	2½ to 3	1	1¼
General government consumption	3¾	3¾	4	3	¾	1
Fixed investment	-3¼	4¼ to 4¾	4¾ to 5¼	5 to 5½	2½	2½
Change in inventories ⁶	0	0	0	0	¼	¼
Exports of goods and services	-1	1¼ to 1½	8¼ to 8¾	7 to 7½	2½	3
Imports of goods and services	1½	4 to 4¼	7¼ to 7¾	6¼ to 6¾	2¼	3½
Balance of payments						
current account						
£ billion	-8¾	-23¼	-23¼	-23¼	7¾	9½
per cent of GDP	-¾	-2	-2	-2	¾	¾
Inflation						
RPIX (Q4)	2½	2¾	2½	2½	¼	½
Producer output prices (Q4) ⁷	1	1¾	2¼	2	¾	1½
GDP deflator at market prices	3¼	2¾	2½	2½	½	¾
Money GDP at market prices						
£ billion	1043	1094 to 1098	1157 to 1166	1222 to 1238	5	9
percentage change	5	4¾ to 5¼	5¾ to 6¼	5¾ to 6¼	½	¾

¹ The forecast is consistent with the national accounts and balance of payments statistics to the fourth quarter of 2002, released by the Office for National Statistics on 27 March 2003.

² The size of the growth ranges for GDP components may differ from those for total GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.

³ Average absolute errors for year-ahead projections made in spring forecasts over the past 10 years. The average errors for the current account are calculated as a per cent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2003 and 2004.

⁴ Further detail on the expenditure components of GDP is given in Table B9.

⁵ Includes households and non-profit institutions serving households.

⁶ Contribution to GDP growth, percentage points.

⁷ Excluding excise duties.

