2 MAINTAINING MACROECONOMIC STABILITY

Current world economic conditions pose significant challenges for policymakers. The Government's reforms to the macroeconomic framework leave the UK better placed than on previous occasions to cope with instability in the global economy and to continue to steer a course of stability:

- **the** monetary policy framework **is delivering low and stable inflation and is enabling the Bank of England's Monetary Policy Committee (MPC) to respond quickly to risks to the symmetrical inflation target;**
- **the** fiscal rules are set over the cycle **and the automatic stabilisers are allowed to operate fully, which lets fiscal policy smooth the path of the economy in the face of slower growth.**

Low inflation prospects have enabled the MPC to react pre-emptively to the global economic slowdown, cutting interest rates to their lowest level since 1964. Tough decisions on taxation and spending taken by the Government over the past four years to repay debt mean that fiscal policy is able to support monetary policy in maintaining economic stability as the economy temporarily moves below trend.

UK GDP is forecast to grow by 2¼ per cent this year, the bottom end of the Budget 2001 forecast range, and by between 2 and 2½ per cent next year. The Pre-Budget Report interim projections of the public finances show that the Government remains on track to meet both its fiscal rules over the cycle, including in the cautious case:

- **the current budget remains in surplus throughout the projection period, even using cautious assumptions, ensuring the Government remains on track to meet the golden rule;**
- **public sector net debt is expected to remain low and stable through the next five years; comfortably meeting the sustainable investment rule and, at 31 per cent of GDP, the lowest in the G7.**

The public finance projections show that, despite the world economic slowdown, the fiscal position remains sound, existing public spending plans are fully affordable, and the UK is better able than in the past to deal with the ups and downs of the global economy. In the short term, temporarily lower receipts compared to the Budget profile mean that fiscal policy is supporting monetary policy in maintaining economic stability. The forecast for the economy shows that the monetary policy response, supported by fiscal policy this year and next, will contribute to stronger and more balanced growth resuming next year.

THE MACROECONOMIC FRAMEWORK

2.1 In an increasingly integrated global economy, no country can be insulated from the impact of current world developments. The world economy is slowing more now than at any time over the past two decades, while the events of September 11 have intensified uncertainty, delaying the world recovery and adding to the risks to global growth. For the first time since 1974, the US, Europe and Japan are simultaneously facing a significant slowdown in growth. As one of the most open of the major economies, and a leading international financial centre, this external environment poses challenges for the UK economy.

2.2 The Government's role is to ensure that macroeconomic policy is able to react to adverse developments so that the UK can maintain high and stable levels of growth and employment. Large and unpredictable fluctuations in output, employment and inflation create uncertainty and difficulties across the economy – for people, companies and the public sector. By contrast, economic stability helps businesses, people and the Government to plan effectively for the long term.

2.3 Over the past four years, the Government has implemented important reforms to the macroeconomic framework. Based on principles of transparency, responsibility and credibility, the framework establishes a platform of economic stability for the long term.[1] The increasing interdependence of the world economy means that the Government must address the causes of domestic and international instability, minimising the risk and impact of disruption from external events. Because of the Government's reforms, the UK is now better placed than on previous occasions to respond to developments in the world economy and to continue to steer a course of economic stability.

2.4 The monetary policy framework aims to deliver low and stable inflation, while avoiding damaging fluctuations in output and growth. The fiscal policy framework is designed to achieve sound public finances over the medium term, and to support monetary policy over the cycle. Sound public finances are a prerequisite for sustained investment in public services. The public spending framework provides for better long-term planning and places a greater focus on the quality of public service provision and the outcomes achieved. All three components of policy work together in a coherent and integrated way.

The monetary policy framework

2.5 The introduction of a stable and credible monetary policy framework in 1997 has delivered positive results. In particular, the Bank of England's Monetary Policy Committee (MPC) has been able to respond pre-emptively to the current global slowdown, cushioning the impact of world events on the UK economy. The framework supports the Government's objective of maintaining economic stability and is based on:

- clear and precise objectives. The goal of monetary policy, price stability, is defined in terms of a symmetric inflation target. This means that outcomes below target are treated as seriously as those above target, eliminating incentives for the MPC to drive inflation below target at the cost of lost output and employment;
- full operational independence for the MPC in setting interest rates to meet its target of 2½ per cent for the 12 month increase in the Retail Prices Index excluding mortgage interest payments (RPIX), which applies at all times;
- openness, transparency and accountability which are enhanced through the publication of MPC members' voting records, prompt reporting of the minutes of monthly MPC meetings and publication of the Bank of England's quarterly Inflation Report; and
- flexibility and credibility. Because monetary policy is based on a credible framework the MPC can use discretion in deciding how quickly to react to external events or temporary difficulties beyond its control. This discretion is constrained by the inflation target and an 'Open Letter' system, under which, if inflation deviates by more than one percentage point above or below target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC proposes to take, the length of time before inflation will return to target and how this meets the MPC's remit.

The fiscal policy framework

2.6 The Government's fiscal policy framework is designed to ensure that the highest standards of transparency, responsibility and accountability apply to fiscal policy decisions. The *Code for Fiscal Stability* sets out five key principles of fiscal management that are at the heart of the framework: transparency, stability, responsibility, fairness and efficiency. The Code sets out how these principles relate to the formulation and implementation of fiscal policy in practice and requires the Government to state its objectives for fiscal policy based on these principles. The Government's objectives are:

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly both within and between generations; and

[1] Further detail is set out in the forthcoming HM Treasury book: *Reforming Britain's Economic and Financial Policy*, published by Palgrave, December 2001.

- over the short term, to support monetary policy; and, in particular, to allow the automatic stabilisers to play their role in smoothing the path of the economy.

2.7 These objectives are implemented through the Government's two fiscal rules, against which the performance of fiscal policy can be judged:

- the **golden rule:** over the economic cycle, the Government will borrow only to invest and not to fund current spending; and
- the **sustainable investment rule:** public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

2.8 These fiscal rules promote economic stability by ensuring sound public finances, while allowing flexibility in two key respects:

- the rules are set over the cycle, allowing fiscal balances to vary between years in line with the cyclical position of the economy. Box 2.1 sets out how this enables the automatic stabilisers to operate freely over the cycle; and
- the rules promote and protect capital investment while ensuring sustainable public finances in the longer term. The golden rule requires the current budget to be in balance or surplus on average over the cycle, allowing the Government to borrow only for capital spending. The sustainable investment rule limits government borrowing to a stable and prudent level.

2.9 The fiscal framework also recognises that projections of the current budget and net debt inevitably involve a considerable element of uncertainty. Projections of the public finances are therefore based deliberately on prudent assumptions for key economic variables,

Box 2.1 The automatic stabilisers

Several features of the tax and spending regime help to stabilise the economy over the economic cycle. As the economy strengthens, incomes tend to rise, resulting in higher income and corporation tax receipts. At the same time, lower unemployment rates reduce social security spending. As the economy weakens, the opposite effects occur. This means that government borrowing tends to fall when growth is relatively high, and rises when growth is relatively low. These 'automatic' effects help to reduce volatility in output over the cycle, by boosting aggregate demand when the economy is below trend, and reducing aggregate demand when the economy is above trend.

The Government's objectives for fiscal policy are to ensure sound public finances, while allowing the automatic stabilisers to operate over the cycle. This permits fiscal policy to support monetary policy in smoothing the path of the economy in the face of variations in demand, and explains why the fiscal rules are set over the economic cycle. For the golden rule, it means the surpluses in the current budget in periods of stronger growth can offset deficits in periods of weaker growth, helping to stabilise the economy. This is illustrated in Chart 2.5. Public debt will tend to rise as a proportion of GDP during periods of weaker growth, and fall as a proportion of GDP during periods of stronger growth.

The strength of the automatic stabilisers depends on the characteristics of the tax and spending regime, such as the progressivity of taxes, as well as the composition of changes in demand in the economy. Their impact can be seen by examining the difference between actual public sector net borrowing (PSNB) and the cyclically-adjusted PSNB position. Attempting to balance the current budget at all times would significantly increase swings in output over the economic cycle, damaging economic stability.

including the trend rate of growth of the economy. These assumptions, which include the levels of oil prices and equity prices, are audited by the National Audit Office (NAO) under a three-year rolling review to ensure they remain both reasonable and cautious. This minimises the need for unexpected changes in taxation or spending.

The public spending framework

2.10 Sound public finances that are sustainable over the cycle are not only essential to ensure economic stability. They are also necessary for sustainable investment in public services. A detailed description of the Government's public spending framework, how it is helping to deliver resources for key public services, and the Government's priorities for the 2002 Spending Review are provided in Chapter 6. The main elements of the framework are:

- three-year Departmental Expenditure Limits (DEL) to help departments plan and manage resources more effectively over the medium term;
- Annually Managed Expenditure (AME) which covers those elements of spending which cannot reasonably be subject to firm multi-year limits. DEL and AME sum to Total Managed Expenditure (TME);
- separate resource and capital budgets for each department, consistent with the distinction in the fiscal rules. Departments are required to manage their resource and capital budgets separately, removing the bias against investment which was present in the previous planning regime; and

Box 2.2: The fight against terrorism

The attacks of 11 September were an assault against all those who strive for global peace and stability. They have also further destabilised the world economy, damaging confidence and delaying the recovery in major economies. The Government, with its international partners, has acted decisively to tackle the sources of instability and risk, including through a series of cuts in interest rates.

Because of the UK's tragic experience of domestic terrorism, the Government is well equipped to deal with those who seek to fund terror. UK legislation meets tough new standards agreed by the International Financial Action Task Force. The Government is working with other countries to share knowledge and provide the technical assistance needed to raise standards across the world.

Action is also being taken to strengthen further the UK regime. The new Proceeds of Crime Bill provides extensive powers for the investigation and confiscation of criminal assets. The Anti-Terrorism, Crime and Security Bill, which was introduced on 12 November, has statutory provisions to permit the Inland Revenue and HM Customs and Excise to disclose information for use in criminal investigations and proceedings. Police powers to monitor accounts and seize assets will also be enhanced.

Efforts to tackle the financing of terrorism have already delivered results. Because of tough domestic action, intelligence sharing and cooperation with the US and other international allies, some £70 million of assets have already been frozen in response to United Nations (UN) resolutions that target the Taliban regime and Osama bin Laden. The Chancellor has pledged that the UK will continue to do whatever is necessary to deprive terrorists of the funds they rely on.

Work to stem the sources of terrorist financing is part of a broader programme of action to promote stability in the aftermath of 11 September. The Government is also contributing to international efforts to promote financial market stability and to implement a comprehensive humanitarian response to the crisis. In the crisis region itself, the Government has already provided £40 million in humanitarian assistance to Afghans, and £26 million to Pakistan to support ongoing reforms and communities affected by the refugee crisis. It continues to work closely with the UN, IMF and World Bank to implement an immediate and long-term response to the crisis.

- Public Service Agreements (PSAs) through which each department is committed to deliver challenging outcome-focused targets.

THE PERFORMANCE OF THE FRAMEWORK

2.11 The Government's frameworks for monetary and fiscal policy and for public spending have established an integrated strategy for maintaining high and stable levels of growth and employment, and minimising the impact of external shocks.

2.12 Since the reforms were introduced, the economy has experienced a period of stability and steady growth. Growth since the second quarter of 1997 has averaged 2.6 per cent on an annualised basis. Employment has risen by over 1.2 million since spring 1997, while unemployment has been at its lowest since the 1970s.

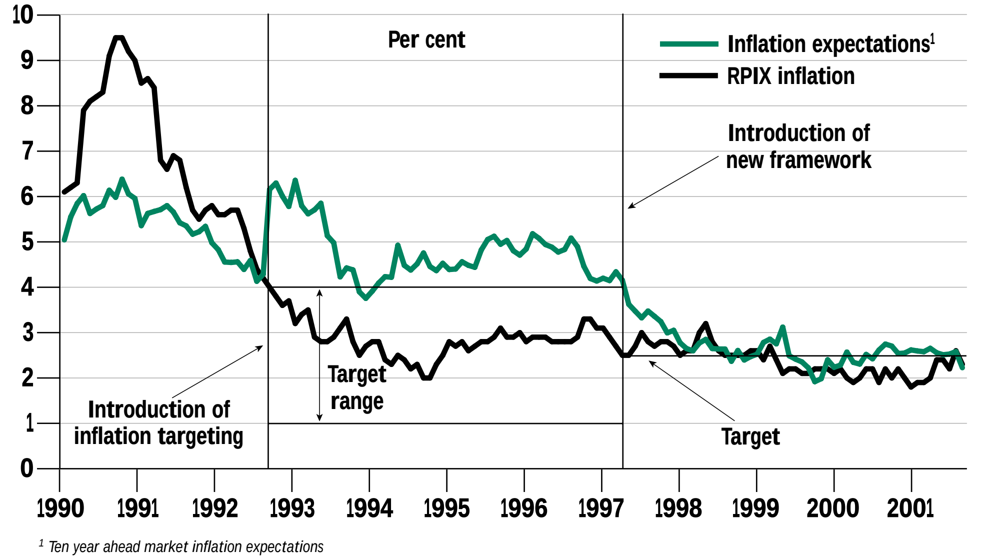
Monetary strategy

2.13 By enhancing the transparency and credibility of policy-making, the monetary policy framework has already delivered positive results. RPIX inflation has averaged 2.4 per cent since May 1997 - very close to the Government's $2^1/_2$ per cent target - and market inflation expectations suggest that low inflation is expected to continue: this has been achieved with less output and employment volatility than in the past.

2.14 The MPC has changed interest rates quickly in either direction in response to threats to economic stability. Beginning in February this year, the MPC saw the need to reduce interest rates. It also responded in a timely and considered manner to the uncertainty generated by the attacks on the US, demonstrating the flexibility of the framework. In accordance with the Bank of England Act 1998, the Governor of the Bank convened an unscheduled meeting of the MPC on 18 September 2001 to gauge the impact of, and determine a response to, the exceptional circumstances created by the terrorist attacks. In order to support UK consumer and business confidence, the MPC acted swiftly to reduce interest rates. Since then, rates have been cut on two further occasions and they are now at their lowest level since 1964.

2.15 These actions have reinforced the credibility of the monetary policy framework. This is demonstrated in the behaviour of inflation expectations, shown in Chart 2.1. Although inflation fell to levels close to 3 per cent annually in the years prior to 1997, when a target

Chart 2.1: Inflation performance and expectations



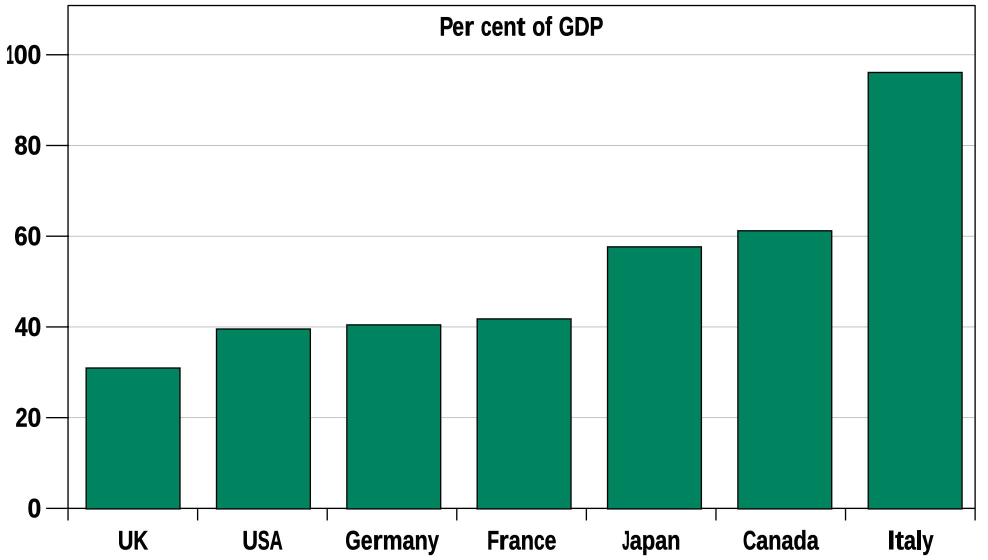
[1] *Ten year ahead market inflation expectations*

range of 1 to 4 per cent was in force, inflation expectations remained consistently outside this target range. Inflation expectations only fell to the target after the introduction of the new framework in 1997 and they have remained close to target since then. This credibility allows the MPC to react flexibly and to take account of the potential impact of global events on the UK economy without markets doubting its determination to meet the inflation target.

Fiscal strategy

2.16 On fiscal policy, the Government has taken a number of important steps over the past four years to restore the public finances to a sustainable position. These have included working within the previous Government's spending plans for the first two years, further fiscal consolidation through a series of tax changes, and using the proceeds from the auction of spectrum licences to reduce net debt. As a result of these decisions, and with the benefits of greater economic stability, over £50 billion of debt has been repaid since 1996-97 when public sector net debt stood at 44 per cent of GDP and there was an overall budget deficit of £28 billion. The current level of debt is close to 31 per cent of GDP, the lowest of all the G7 countries. This is illustrated by chart 2.2 which shows OECD projections for 2001.

Chart 2.2: OECD projections of general government net financial liabilities for G7 countries, 2001



Source: OECD Economic Outlook June 2001

2.17 A fiscal tightening of $4^1/_2$ percentage points of GDP between 1996-97 and 2000-01 supported monetary policy at a time when the economy was generally above trend. It has now left the public finances well placed to play their part in cushioning the effects of the global economic slowdown. Debt levels are stable and low, and strong surpluses on the current budget over the past two years provide room for manoeuvre within the fiscal rules over the remainder of the economic cycle.

2.18 The Government has also been able to release new resources for investment in public services. Budget 2000 set the spending envelope for the three years covered by the 2000 Spending Review, while ensuring the Government remained on track to meet its fiscal rules. As described in Chapter 6, within this envelope the Government has been able to release additional resources to priority services as a result of sound management of the economy and improved public finances. Savings have been made in a number of areas including:

- lower growth in spending on social security, through cutting the cost of worklessness; and
- reduced debt interest payments resulting from lower levels of debt and lower interest rates.

2.19 Evan after taking into account the impact of Pre-Budget Report measures, changes in social security benefits and debt interest payments are now expected to account for only 18 per cent of the change in TME over the period 2000-01 to 2003-04. This compares with 42 per cent over the period 1978-79 to 1996-97. Table 2.1 gives an illustration of this improvement.

Table 2.1: Changes in Total Managed Expenditure accounted for by social security benefits and debt interest payments

Per cent	1978-79 to 1996-97	1996-97 to 2003-04	2000-01 to 2003-04
Social security benefits[1]	33	25	22
Central government debt interest payments	9	–3	–4
Total change	**42**	**21**	**18**

[1] For the purpose of comparison, social security includes Working Families' Tax Credit and Disabled Persons Tax Credit.

Budget 2001

2.20 Budget 2001 released new resources to priority public services, including health, education and for fighting crime and drugs, on top of the 2000 Spending Review settlement, while maintaining a long-term sustainable fiscal position. The fiscal projections set out in Budget 2001 showed the Government was on track to meet its firm fiscal rules throughout the forecast period.

2002 Spending Review

2.21 The baseline year for the 2002 Spending Review will be 2003-04 and new departmental plans will be set for 2004-05 and 2005-06. As in previous Spending Reviews, the Government's aim is to release funds to spend in priority services. Chapter 6 explains in further detail.

Box 2.3: Government policy on EMU

The Government's policy on membership of the single currency remains as set out by the Chancellor in his statement to Parliament in October 1997. In principle, the Government is in favour of UK membership; in practice, the economic conditions must be right. The determining factor underpinning any Government decision on membership of the single currency is the national economic interest and whether the economic case for joining is clear and unambiguous.

The Government has set out five economic tests which must be met before any decision to join can be made. An assessment of the five tests will be made within two years of the start of this Parliament. This assessment will be comprehensive and rigorous. On the basis of the assessment, the Government will take a decision on whether the five tests have been met. If a decision to recommend joining is taken by the Government, it will be put to a vote in Parliament and then to a referendum of the British people.

In June 2001, the Chancellor explained that, before the assessment of the five tests is started, the Treasury would continue to undertake necessary preliminary and technical work to inform it. The scope of this work was set out in the original October 1997 assessment. This preliminary and technical work includes:

- **the cyclical behaviour of the UK economy relative to the Euro-area and their relative responses to economic shocks;**
- **the mechanisms by which product, labour and capital markets adjust and how well and how quickly they work;**
- **the impact of the single currency on the cost and availability of capital, macroeconomic stability, the stability of the real effective exchange rate and the location, quality and quantity of investment;**
- **the effect of the single currency on financial services, including the changes that have occurred in this sector in the UK and the Euro-area since 1997; and**
- **the impact of the single currency on trade, competition, productivity and employment.**

More detail was published in the Treasury paper, *Preliminary and technical work to prepare for the assessment of the five tests for UK membership of the single currency*.

The Government is actively helping UK businesses prepare for working with the euro. At the same time, preparations for possible UK entry continue under the outline National Changeover Plan. Further information is available in the Treasury's Fifth Report on Euro Preparations (see www.euro.gov.uk)

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments

2.22 For the first time since 1974, there has been a significant and simultaneous slowdown of growth in the US, Europe and Japan. The severity of the global slowdown has exceeded expectations at the time of Budget 2001, and the recent terrorist attacks have increased uncertainty, further weakened demand and delayed the global recovery. G7 GDP growth is expected to have fallen from $3^1/_2$ per cent in 2000 to just 1 per cent in 2001. However, the scale and speed of the policy response in the US and Europe is expected to support a global recovery which gathers pace from mid-2002.

Table 2.2: The world economy

	Percentage changes on a year earlier				
		Forecast			
	2000	2001	2002	2003	2004
Major 7 countries[1]					
Real GDP	3½	1	¾	3	2½
Consumer price inflation[2]	2½	2	1½	1½	1½
World trade in goods and services	11¾	1¼	1¾	7¾	7
UK export markets[3]	11¼	1	1¾	6¾	6

[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.

2.23 The UK economy is continuing to experience its longest period of sustained low inflation since the 1960s, with RPIX inflation averaging slightly below the Government's 2½ per cent target during 2001. Low inflation has enabled the MPC to cut interest rates to sustain domestic demand growth as the scale of the world slowdown has become apparent. Sound public finances mean that fiscal policy has been able to support monetary policy.

2.24 Nonetheless, the UK has been affected by the global slowdown. UK export markets are now expected to have grown by just 1 per cent in 2001, as a result of weaker growth abroad and the sharp slowdown in world trade growth. After a number of years of rising business investment, driven partly by the falling cost of information and communications technology (ICT) capital goods, the uncertain global outlook has also led to weaker than expected business investment. However, the strong performance of the labour market has underpinned robust growth in household consumption, which has played an important role in supporting UK growth throughout the year.

Table 2.3: Summary of UK forecast

		Forecast			
	2000	2001	2002	2003	2004
GDP growth (per cent)	3	2¼	2 to 2½	2¾ to 3¼	2¼ to 2¾
RPIX inflation (per cent, Q4)	2	2¼	2¼	2½	2½

Economic prospects

2.25 UK GDP growth is expected to move a little further below trend in the final quarter of 2001 and remain below trend during the first quarter of 2002. Consumer confidence in the general economic outlook has fallen during 2001, although recent interest rate cuts have supported households' confidence in their own financial position. Over the coming months, consumption growth is expected to moderate towards more sustainable levels. Business confidence, which had already weakened prior to 11 September, has deteriorated further since the attacks. Heightened economic uncertainty is likely to encourage firms to postpone investment decisions. Net trade is also expected to continue exerting a significant drag on growth in the short term.

2.26 Improving world economic conditions from the middle of 2002, supported by UK monetary and fiscal policy, should provide renewed impetus to the UK economy. Investment, trade and manufacturing output are all expected to pick up sharply during the second half of 2002, with UK growth moving temporarily above trend as the world economic recovery gathers pace. With household consumption growth expected to moderate, the UK economy is projected to return to stronger and more balanced growth.

2.27 Domestically generated cost pressures are expected to ease as the UK economy moves below potential. RPIX inflation is expected to remain slightly below the Government's $2^1/_2$ per cent target during 2002 as weaker price pressures in the supply chain feed through into retail prices. Growth is expected to move above trend during late 2002 and, with inflation forecast to be slightly below target, there is room for the economy to operate slightly above potential during 2003. RPIX inflation is therefore forecast to return to target by the end of that year.

2.28 The pick up in UK growth is supported by a sustained revival in world economic prospects. However, the outlook for the world economy remains highly uncertain. A deeper or more protracted global downturn, prompted by a further weakening of business and consumer confidence, is the clearest downside risk to UK growth. On the other hand, the decisive policy response over recent months in most of the major economies could lead to a sharper world recovery than currently anticipated, raising the prospects for stronger UK growth. Consumption growth may also be stronger in the UK as a result of weaker household saving. Although household debt is at record levels, low interest rates have ensured debt servicing costs have remained affordable. With sound public finances and low inflation in the UK, macroeconomic policy is currrently well placed to respond to either eventuality.

The economic cycle

2.29 In Budget 2001, the economy was assessed to have been at or close to trend in the first half of 1997 and again around mid-1999. Since then, most survey measures of capacity and labour utilisation have moved slightly above their long-run averages suggesting that the economy was operating slightly above trend in 2000 and the first half of 2001. This suggests that the probable shape of the UK economic cycle since 1997 has been a period above trend in 1997 and 1998, followed by a small deviation below trend in early 1999 before the economy moved back above trend in 2000 and early 2001. The impact of the global slowdown has since brought the economy back close to trend. For the purposes of assessing performance against the fiscal rules, the provisional judgement remains that a small cycle may have been completed by mid-1999 when the current cycle is assumed to have begun.

Trend growth

2.30 The judgement that the economy is currently operating close to its potential level is consistent with annual trend output growth of just over $2^1/_2$ per cent since the first half of 1997. The strong contribution of employment growth over this period since 1997 has been associated with relatively subdued productivity growth, in part because those entering work are typically less productive than the average worker. Deviations from trend are expected to be small by past standards. Adjusting for this temporary effect, the underlying rate of trend productivity growth is estimated to be broadly in line with its long-run average.

2.31 Looking ahead, the stability-oriented framework for macroeconomic policy should provide the right environment for businesses to plan ahead and invest with confidence. The UK has witnessed particularly strong growth of investment in ICT equipment over recent years and, notwithstanding the recent slowdown, there is some evidence from US experience that this may contribute to improved productivity performance. Over the longer term, the Government's reforms to boost productivity also provide upside potential to trend growth. Nevertheless, the economic forecast continues to be based on the neutral assumption of $2^1/_2$ per cent annual trend growth.

Caution and the public finance projections

2.32 The public finance projections continue to be based on the deliberately prudent and cautious trend growth assumption of $2^1/_4$ per cent. This is because the Government is determined not to repeat the mistakes of the past by assuming an improvement in trend growth before this has demonstrably been achieved and audited.

2.33 A prudent view of trend growth is one of several assumptions audited by the NAO under the three-year rolling review established in Budget 2000, which ensures they remain reasonable and cautious. An asymmetric approach to fiscal policy, which is in contrast to the symmetric approach taken to monetary policy, is particularly important to build in a safety margin against unexpected events. It gives greater certainty that, over the medium term, the Government is planning to spend only what it can afford on existing tax plans. The unemployment and oil price assumptions are scheduled for review in 2002.

RECENT FISCAL TRENDS AND OUTLOOK

2.34 The public finance projections in the Pre-Budget Report have a different status from those included in the EFSR and FSBR at Budget time. They represent an interim forecast update and not necessarily the outcome the Government is seeking. The fiscal effects of firm decisions announced in the Pre-Budget Report and since Budget 2001 have been incorporated into the fiscal projections in accordance with the requirements of the *Code for Fiscal Stability*.

2.35 Full details of changes in tax and spending since the Budget are set out in Annex B. The sound fiscal position means that, even on cautious assumptions, the Government can let fiscal policy support monetary policy, while remaining on track to meet the fiscal rules over the cycle.

Receipts

2.36 Based on the cautious audited assumptions, receipts are expected to grow at a slower rate than forecast in Budget 2001 in the short term. The forecast for receipts has been revised down by £7 billion in 2001-02 and by £10 billion in 2002-03. In the medium term, receipts are expected to recover to the Budget profile. Table 2.4 below decomposes the change in the forecast in receipts into its component factors.

Table 2.4: Factors behind changes to receipts since Budget 2001[1]

	Projections				
	2001–02	**2002–03**	**2003–04**	**2004–05**	**2005–06**
£ billion					
GDP	–1	–2	0	½	1
Audited assumptions	–1½	–4½	–3½	–2½	–2½
of which:					
Interest rate	*–1*	*–2*	*–1*	*0*	*0*
Equity price	*–1*	*–2*	*–2*	*–2*	*–2*
Other	*0*	*–½*	*–½*	*–½*	*–½*
Financial company profits	–3	–2½	0	1	2
Other factors	–2	–1	½	½	½
Total change	**–7**	**-10**	**–3**	**–½**	**1**

[1] Figures may not sum due to rounding.

2.37 Slower growth will reduce tax receipts by about £1 billion in 2001-02 and £2 billion in 2002-03 compared with Budget 2001. The audited assumptions – especially weaker equity prices – account for a further £1½ billion of the revisions to the Budget projection in 2001-02 and £4½ billion of the revision in 2002-03. Financial companies have been hit by the downturn in international capital markets, reducing taxable profits. These lower profits are not directly reflected in forecasts for GDP but are expected to account for an additional £3 billion of the revisions to the Budget forecast. Weaker profits are also expected to affect income tax receipts through lower bonus payments. The remaining £2 billion change to the forecast is explained by other factors, including weaker outturn data affecting the baseline for the forecast period. These factors are set out in more detail in Annex B.

2.38 Looking forward and consistent with the audited assumptions, the overall level of receipts is expected to return to the Budget path as the economy returns to its potential level of growth over the medium term and as financial companies' profits return to a cautious view of their long-term trend.

Departmental Expenditure Limits

2.39 Projections for DEL up to the end of 2003-04 are based on the 2000 Spending Review allocations, including the targeted additions announced in Budget 2001and the additional £1 billion for the UK National Health Service in 2002-03 announced in this Pre-Budget Report.

Annually Managed Expenditure

2.40 In AME, social security spending is estimated to be slightly higher in 2001-02 than in the Budget on account of the increase to the Winter Fuel Payment announced since March. Compared with the Budget forecast, debt interest payments are expected to be £0.8 billion lower in 2001-02 and £2.7 billion lower in 2002-03 on account of lower inflation and lower short term interest rates. Table B13 gives further details, including the offset in the AME margin.

Discretionary policy changes

2.41 In considering the impact of additional discretionary policy changes on the fiscal position, the Government has taken into account:

- the importance of ensuring that the fiscal rules are met over the economic cycle;
- its broader, medium-term fiscal policy objectives, including the need to ensure sound public finances and that spending and taxation impact fairly both within and across generations; and
- the need to ensure that fiscal policy supports monetary policy.

2.42 Within these strict constraints, it has been possible to release additional resources for a comprehensive package of further support for pensioners, worth £2$^{3}/_{4}$ billion a year by 2004-05, increased assistance for disabled children and to introduce new measures to support business enterprise and promote productivity. This is in addition to other measures to promote enterprise and productivity announced since Budget 2001, the fiscal impact of which is set out in Table B4 and which are included in the Pre-Budget Report projections.

2.43 Consistent with the requirements of the *Code for Fiscal Stability*, the forecast does not take account of:

- measures proposed in the Pre-Budget Report for further consultation in the run up to Budget 2002, including the R&D tax credit for large companies; and
- other proposals where final decisions have yet to be taken on rates, including the Working Tax Credit and the Child Tax Credit.

2.44 Decisions on these and other issues will be taken in Budget 2002 and, along with revised forecasts for the economy and the public finances will impact on the final Budget forecast. In line with the convention adopted in previous Pre-Budget Reports, forecasting changes for AME programmes have been offset in the AME margin.

Fiscal position and medium-term prospects

2.45 Table 2.5 compares the medium-term projections for the surplus on current budget and public sector net borrowing (PSNB) with those produced in Budget 2001. The changes are separated into those explained by policy measures and those explained by forecasting revisions and other changes. In a change to Budget 2001,the presentation includes the impact of the windfall tax and associated spending. Table B4 sets out detail.

Table 2.5: Fiscal balances: comparison with Budget 2001[1]

	Outturn[2]			Projections		
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06
Fiscal balances (£ billion)[3]						
Surplus on current budget						
Budget 2001	**22.3**	**16**	**14**	**8**	**9**	**9**
Effect on forecasting changes	2.8	-5.2	-10	-3	0	2
Effect of policy measures	–	-0.3	0	-2	-3	-3
PBR 2001	**25.1**	**10.3**	**3**	**4**	**7**	**8**
Net borrowing						
Budget 2001	**-15.0**	**-5**	**2**	**10**	**11**	**12**
Effect of forecasting changes	-3.8	6.8	10	3	0	-2
Effect of policy measures	–	0.3	0	2	3	3
PBR 2001	**-18.8**	**2.5**	**12**	**15**	**13**	**13**
Cyclically-adjusted budget balances (per cent of GDP)						
Surplus on current budget – Budget 2001	2.0	1.2	1.0	0.6	0.7	0.7
Surplus on current budget – PBR 2001	**2.3**	**1.0**	**0.3**	**0.3**	**0.5**	**0.7**
Net borrowing – Budget 2001	-1.3	-0.1	0.4	1.1	1.1	1.1
Net borrowing – PBR 2001	**-1.6**	**0.3**	**1.1**	**1.4**	**1.2**	**1.1**

[1] Including windfall tax receipts and associated spending.
[2] The 2000-01 figures were estimates in Budget 2000-01.
[3] Figures may not sum due to rounding.

2.46 The table distinguishes between the headline figures and estimates of the underlying structural position, adjusted for the impact of the economic cycle on the public finances. The outturn for 2000-01 shows a £2.8 billion larger surplus on the current budget and a £3.8 billion larger net repayment compared with the Budget. The headline figures for the current budget and net borrowing are weaker than forecast at Budget 2001 in the short term, reflecting the impact of the automatic fiscal stabilisers and other temporary factors. A current budget surplus of £10.3 billion is now expected for 2001-02, and public sector net borrowing is expected to be £2.5 billion. Over the medium term they are expected to return to close to their Budget profiles.

2.47 On a cyclically-adjusted basis, a current budget surplus of 1 per cent of GDP is expected in 2001-02, and net borrowing is expected to be equivalent to 0.3 per cent of GDP. The cyclically-adjusted balances are weaker in the following two years than previously forecast, but revert to close to the Budget profile by 2004-05. The underlying position therefore remains strong. Indeed, these estimates of cyclical changes understate the temporary nature of the revisions to the projections for receipts.[2]

2.48 Table 2.6 shows that, notwithstanding non-discretionary changes to receipts and spending and the release of new resources, the Government remains on course to meet its tough fiscal rules.

[2] The Treasury's methodology for cyclically-adjusting budget balances is set out in: *Fiscal Policy: public finances and the cycle,* March 1999.

Table 2.6: Summary of public sector finances[1]

	Per cent of GDP						
	Outturn		Projections				
	2000–01	2001–02	2002–03	2003–04	2004–05	2005–06	2006–07
Fairness and prudence							
Surplus on current budget	2.6	1.0	0.3	0.4	0.6	0.7	0.7
Average surplus since 1999–2000	2.5	2.0	1.6	1.3	1.2	1.1	1.1
Cyclically-adjusted surplus on current budget	2.3	1.0	0.3	0.3	0.5	0.7	0.7
Long-term sustainability							
Public sector net debt	31.2	30.7	30.6	31.0	31.1	31.1	31.1
Net worth	19.5	21.6	21.2	20.8	20.3	19.8	19.5
Primary balance	4.1	1.6	0.6	0.5	0.7	0.7	0.6
Economic impact							
Net investment	0.7	1.3	1.4	1.7	1.8	1.8	1.8
Public sector net borrowing (PSNB)	-2.0	0.3	1.1	1.3	1.2	1.1	1.1
Cyclically-adjusted PSNB	-1.6	0.3	1.1	1.4	1.2	1.1	1.1
Financing							
Central government net cash requirement	-3.7	0.6	1.3	1.7	1.3	1.2	1.3
European commitments							
Treaty deficit[2]	-2.0	0.2	1.1	1.3	1.1	1.0	1.0
Cyclically-adjusted Treaty deficit[2]	-1.7	0.3	1.0	1.3	1.1	1.0	1.0
Treaty debt ratio[3]	39.9	38.1	37.2	37.0	36.8	36.6	36.3
Memo: Output gap	**0.6**	**-0.1**	**-0.1**	**0.2**	**0.0**	**0.0**	**0.0**

[1]Including windfall tax receipts and associated spending.

[2]General government net borrowing.

[3]General government gross debt.

Golden rule

2.49 The surplus on the current budget represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the costs of paying for the public services they use and is therefore an important indicator of the generational fairness of the finances. The table shows that the surplus on the current budget is projected to be equivalent to 1 per cent of GDP in 2001-02. After falling to 0.3 per cent of GDP in 2002-03, it is projected to increase steadily through the remainder of the forecast period.

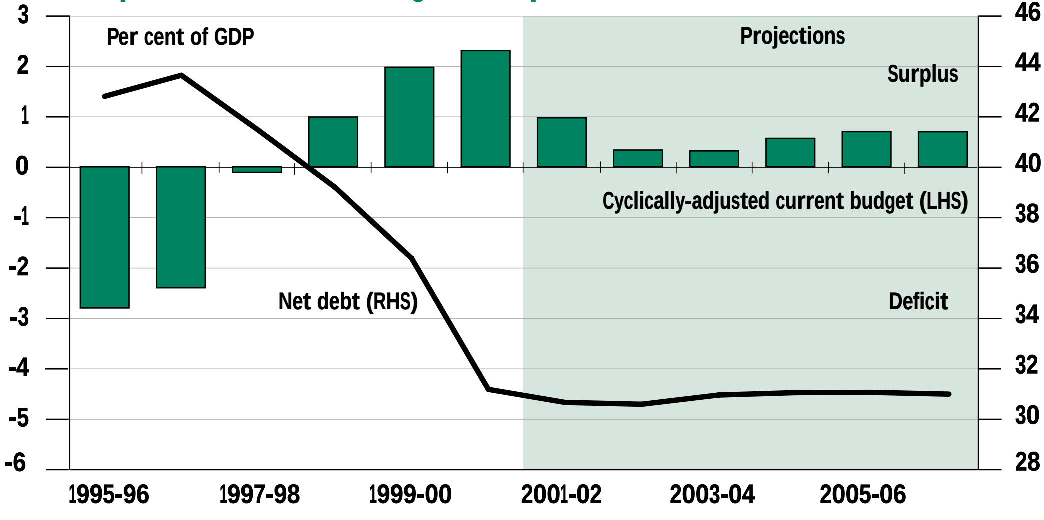
2.50 On a cyclically-adjusted basis, the surplus on current budget is positive in every year throughout the forecast period. The average surplus since 1999-00, which on the Government's provisional judgement is the start of the current cycle, is also positive over the next five years. The Government is therefore on track to meet the golden rule.

Sustainable investment rule

2.51 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public debt at a low and sustainable level. The Pre-Budget Report projections show that, as a result of the tough decisions taken over the past four years, net debt is expected to remain close to 31 per cent of GDP throughout the forecast period and well below 40 per cent. Sound public finances and greater economic stability mean that debt interest payments as a proportion of GDP are projected to be lower in each of the three years from 2001-02 to 2003-04 than at any time since the First World War. The Government is therefore firmly on track to meet the sustainable investment rule while also freeing up resources for investment in priority public services and maintaining a cushion against further unexpected events.

2.52 Chart 2.3 illustrates the low net debt ratio and the projected cyclically-adjusted current budget surpluses. It demonstrates that the Government met its fiscal rules over the economic cycle that was probably completed between mid-1997 and mid-1999, and that it is on track to meet them throughout the forecast period.

Chart 2.3: Meeting the fiscal rules – cyclically-adjusted surplus on current budget and public sector net debt



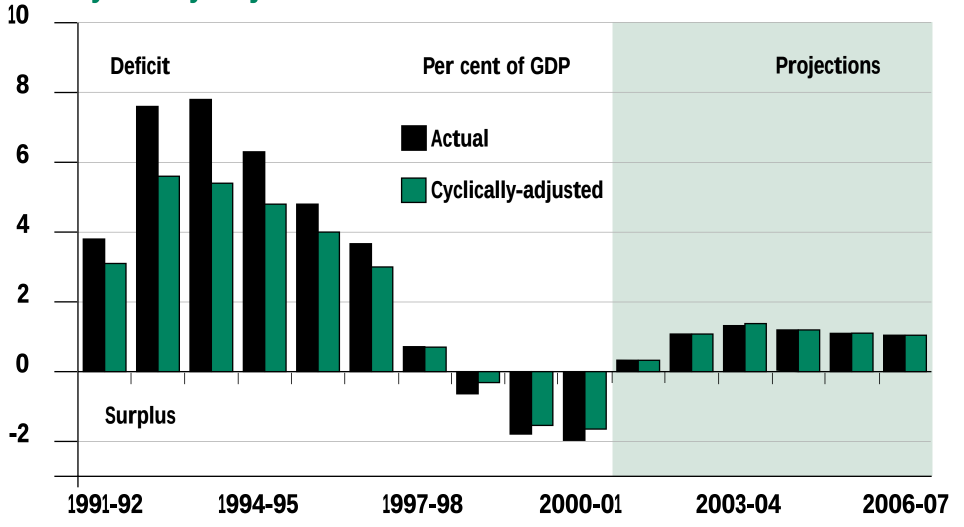
2.53 Another measure of the sustainability of the Government's fiscal position is net worth, the difference between the total assets and liabilities of the Government. Net worth is projected to remain broadly stable at about 20 per cent of GDP throughout the forecast period. This is a reflection of keeping debt at a prudent level while investing to maintain the public capital stock.

Economic impact

2.54 While the key objective of fiscal policy is to ensure sound public finances, the Government recognises that fiscal policy also impacts on the economy this year and next and therefore plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing. PSNB is expected to show a small deficit of 0.3 per cent GDP in 2001-02. Fiscal policy is supporting monetary policy as lower levels of receipts compared to the Budget will support demand as the economy moves temporarily below trend.

2.55 The interim forecast for net borrowing is summarised in Chart 2.4 which shows the actual and cyclically-adjusted figures as a percentage of GDP. The chart shows the move from surplus into deficit, which is projected to peak in 2003-04. The Government is planning to borrow modestly to fund increased investment in the country's capital stock. In the coming year, rising public spending including investment spending will support monetary policy. These increases are sustainable and fully consistent with the Government's long-term approach and the fiscal rules, since net debt is being held at a stable and prudent level.

Chart 2.4: Public sector net borrowing – actual and cyclically-adjusted



Financing

2.56 As a result of the new projections for the fiscal balances, the forecast for the central government net cash requirement (CGNCR) for 2001-02 has been revised from £0.3 billion to £6.3 billion. Accordingly, the DMO target for debt buy-backs from the secondary market has been scaled back to £0.5 billion. Combined with the expectation that National Savings' net contribution to government financing will be £3 billion higher, the revised net financing requirement for 2001-02 is £25.6 billion, an increase of £2.5 billion from the forecast published in April.

2.57 In line with the contingency measures outlined in the Debt and Reserves Management Report 2001-02, the Government has decided to:

- increase gross gilts issuance by £0.5 billion;
- increase the planned stock of outstanding Treasury bills by £1.4 billion; and
- increase the planned run down of the DMO's net cash position by £0.6 billion.

2.58 Full details of these measures and a revised table for the government financing requirement can be found in Annex B.

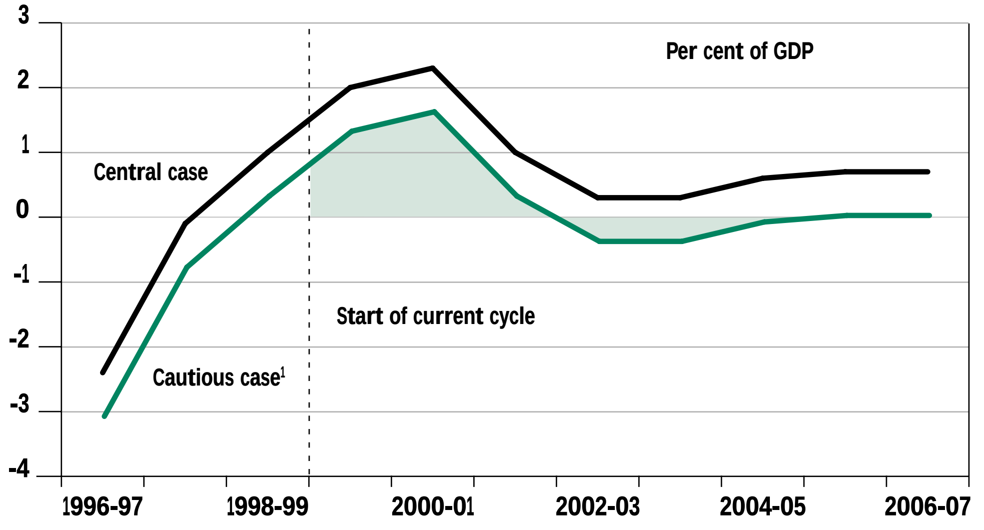
European commitments

2.59 The Pre-Budget Report projections easily meet the EU Treaty reference values for general government gross debt (60 per cent of GDP) and general government net borrowing (3 per cent of GDP) throughout the projection period. The projections are consistent with a prudent interpretation of the Stability and Growth Pact which takes into account the economic cycle, sustainability and the important role of public investment (as specified in Article 104 of the EU Treaty). Based on cautious assumptions and consistent with the Government's fiscal rules, the cyclically-adjusted Treaty deficit is projected to increase to 1.3 per cent of GDP in 2003-04 before returning to a deficit of 1 per cent at the end of the forecast period. General government gross debt, the Treaty measure, remains consistently well below the 60 per cent reference value, ensuring the public finances are sustainable.

Dealing with uncertainty

2.60 Fiscal balances represent the difference between two large aggregates and forecasts of them are inevitably subject to wide margins of error. The cautious assumptions audited by the NAO, including the trend growth assumption, take account of possible misjudgement about the trend growth of the economy in the medium term. A second important source of potential error results from misjudgement about the position of the economy in relation to this trend. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be 1 percentage point lower than on the central case. Chart 2.5 illustrates the interim forecast for this cautious case.

Chart 2.5: Cyclically-adjusted surplus on current budget



[1] *Cautious case assumes trend output 1 percentage point lower in relation to actual output than in the central case*

2.61 The chart shows that the cyclically-adjusted current budget in the cautious case was in a strong surplus in 1999-00, the start of the current cycle and again in 2000-01. It is then projected to move into deficit in 2001-02, before heading back into surplus by 2006-07. The cyclically-adjusted current budget remains in surplus on average in the cautious case, meeting the 'stress test' of the golden rule. The Government therefore remains on track to meet the golden rule over the cycle, including in the cautious case. The fact that the margin for error has narrowed since Budget 2001 but that the projections meet the fiscal rules demonstrates the importance of taking a prudent approach to fiscal policy.

CONCLUSION

2.62 Sound economic fundamentals are enabling the fiscal and monetary frameworks to respond to the global slowdown. Low inflation prospects have enabled the MPC to react pre-emptively in order to meet its symmetrical inflation target. Tough decisions on taxation and spending have restored the public finances to a healthy and sustainable position. This is letting fiscal policy support monetary policy as the economy moves temporarily below trend, while also ensuring the fiscal rules are not breached. Together the two arms of policy are working together to maintain economic stability and a return to stronger and more balanced growth from the middle of 2002. The challenge remains, however, to move to a significantly higher level of sustainable growth in the medium term. Improving productivity is central to this aim. The next chapter outlines measures the Government is taking to close the productivity gap.