B

THE ECONOMY

Economic developments and prospects remain much as envisaged in the 2003 Pre-Budget Report. UK GDP has grown strongly in recent months, broadly in line with the 2003 Pre-Budget Report forecast. With the major uncertainties that dominated the international economic outlook in early 2003 receding, global demand continuing to pick up and UK macroeconomic fundamentals remaining sound, business and consumer confidence have strengthened. As a result, domestic demand growth rose significantly through last year as private consumption growth recovered from temporary lows and business investment started to rise. Moreover, tentative signs of improved international prospects feeding through to higher external demand have also emerged. UK GDP rose 0.9 per cent in the fourth quarter of 2003, the fastest rate for over three and a half years and following on from growth of 0.8 per cent in the third quarter. For 2003 as a whole GDP rose by 2.3 per cent, consistent with the Budget 2003 forecast of 2 to 2½ per cent and a little above the 2003 Pre-Budget Report estimate of 2.1 per cent.

As at Pre-Budget Report time, the pick-up in activity seen since spring 2003 is expected to be consolidated through 2004 and into 2005. Business survey evidence points to a considerable strengthening of investment intentions in recent months, suggesting further growth in private sector capital expenditure is in the pipeline. Rising world trade is also expected to underpin a renewed acceleration in exports through this year and into next. Although sterling has risen since last summer, this mainly reflects movement against the dollar. Sterling remains around 10 per cent weaker against the euro compared with rates prevailing two or so years ago, providing a boost to demand from the UK's largest export market. At the same time, private consumption growth is forecast to remain comfortably below the rates seen for much of the period since the mid-1990s. Therefore, as investment and exports pick up, the composition of demand is projected to become more balanced than in recent years.

The Budget 2004 economic assessment is that:

- **UK GDP is expected to grow by 3 to 3½ per cent in both 2004 and 2005, unchanged from both the Budget 2003 and Pre-Budget Report 2003 forecasts. By 2006, with slack in the economy absorbed and the output gap closed, growth is expected to return to its trend rate of 2½ to 3 per cent;**
- **Consumer Prices Index (CPI) inflation is expected to rise through the course of this year to reach its 2 per cent target by mid-2005 as the lagged effects of sterling's depreciation against the euro since 2002, combined with the effects of the strengthening synchronised recovery in the world economy, feed through to higher import prices. The credibility of the Government's monetary policy framework is also expected to contribute in returning inflation to target through anchoring inflation expectations.**

However, while uncertainties have receded since early 2003, a number of downside and upside risks continue to surround the Budget forecast. Sudden, sharp movements in major exchange rates could potentially disrupt the ongoing recovery in the global economy. In the UK, there remains the risk that house price inflation will slow by more than expected, raising the possibility of a greater than forecast moderation in consumer spending. On the upside, the strengthening in both global and UK growth could reveal more short-term momentum than assumed in the forecast. In particular, business investment has, in the past, tended to accelerate markedly once a pick-up in growth gets underway. UK consumer spending growth could also continue to surprise on the upside, especially in the near term.

INTRODUCTION[1,2]

B1 This chapter discusses recent economic developments and provides updated forecasts for the UK and world economies in the period to 2006. It begins with an overview of developments and prospects in the world economy. It then outlines the Government's latest assessment of the UK economy, followed by a more detailed discussion of sectoral issues and risks.

THE WORLD ECONOMY

Overview

B2 In early 2003, geo-political and other uncertainties weighed heavily on international growth prospects, and global activity remained weak. However, growth in several major economies had already picked up by the middle of last year and, as expected at the time of the 2003 Pre-Budget Report, activity has continued to strengthen across the world's major economies. While this improvement has been led by a sharp pick-up in growth in the United States (US) and rapid growth in Asia, there are now clearer signs that activity is strengthening elsewhere, suggesting that the global recovery is becoming more broadly based. Overall, leading indicators have continued to improve and financial conditions remain highly supportive, pointing to the prospect of a sustained recovery over the medium term.

B3 G7 GDP growth is expected to increase further in 2004, with the US economy expanding briskly and a gradual recovery taking shape in the euro area. Growth in Japan is also expected to remain robust, but to moderate slightly from its strong rate in 2003. Stronger global demand has fed a recovery in world industrial production and trade. As expected at the time of the Pre-Budget Report, world trade accelerated sharply during the second half of 2003, and is forecast to record further strong growth during 2004.

B4 Policy makers around the world have continued to support growth. In the US, monetary policy has remained highly accommodative and fiscal policy played a key role in prompting a pick-up in household spending during the second half of 2003. In the euro area and Japan interest rates remain low. Financial markets are now expecting the Federal Reserve and European Central Bank to keep short-term interest rates unchanged through much of this year, a slightly more accommodative stance than had been expected last December.

B5 Although some key uncertainties have diminished as the global recovery has gathered pace, significant risks still remain. The main downside risks come from global imbalances and exchange rate movements, generally weak labour markets, further balance sheet adjustment, high oil prices, ongoing geo-political concerns and the continued threat of international terrorism. On the other hand, pent-up demand and low inventory levels may prompt a faster recovery in GDP and world trade growth than currently expected.

[1] The UK forecast is consistent with output, income and expenditure data to the fourth quarter of 2003 released by the Office for National Statistics on 25 February 2004. This release also contained revisions to earlier quarters of 2003 which the Treasury has carried through to certain other national accounts series that the ONS have not yet revised, in particular sectoral saving and borrowing. A fully consistent national accounts dataset for 2003 will be published by ONS on 26 March. 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.

Table B1: The world economy

	Percentage changes on a year earlier unless otherwise stated			
		Forecast		
	2003	2004	2005	2006
Major 7 countries[1]				
Real GDP	2¼	3¼	3	2¾
Consumer price inflation[2]	1½	1½	1¾	1¾
Euro-area				
Real GDP	½	1¾	2¾	2½
World trade in goods and services	4¼	7¾	8	7¼
UK export markets[3]	3¾	6¼	7¼	6¾

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

[2] *Per cent, Q4.*

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

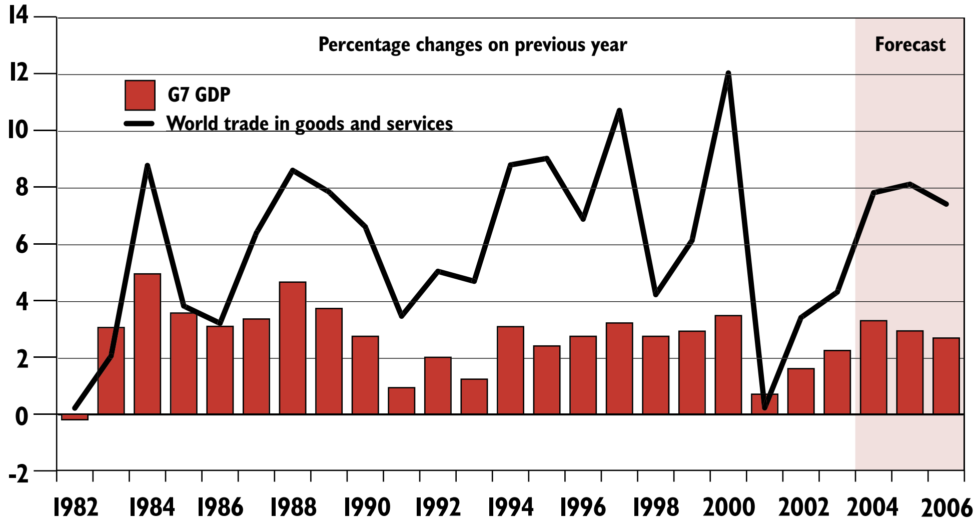
G7 activity

B6 After expanding by 2¼ per cent in 2003, G7 GDP is forecast to grow by 3¼ per cent in 2004, a little above the projection made in last December's Pre-Budget Report. This upward revision primarily reflects stronger than expected growth in the US and Japan. In the euro area, signs that a recovery is taking root have become more evident, and a gradual acceleration in GDP is expected through 2004.

B7 US GDP accelerated sharply during the second half of 2003. Reduced geo-political uncertainty, significant policy stimulus, and strengthening financial markets contributed to an improvement in business and consumer confidence, a pick-up in household spending and a recovery in business investment. For 2003 as a whole, the US recorded growth of 3.1 per cent, a little below most estimates of trend, but significantly higher than in 2001 and 2002. A key development in recent months has been the first significant evidence of a recovery in capital spending since the recession in 2001. Business investment turned up sharply during the second half of 2003, and leading indicators and financial conditions suggest this improvement should be sustained through 2004. Stock markets have rebounded significantly since their spring 2003 lows, long-term interest rates remain at low levels, corporate spreads have narrowed, and profitability has risen rapidly.

B8 The 2003 Pre-Budget Report noted several early signs of recovery in the euro area, and this has been confirmed with a return to positive growth in the second half of 2003. Nevertheless, GDP growth, of under ½ per cent for 2003 as a whole, was weak, and several economies, including Germany, Italy and the Netherlands, experienced short recessions. Spain and Greece were able to generate more robust growth, based on continued strength in domestic demand. The pace and strength of the upturn in euro area activity remains uncertain. Strong external demand should support trade, partly offsetting the effects of the recent appreciation of the euro. Investment appears to be strengthening in response to low financing costs, rising stock markets and growing confidence. Further out, household spending is expected to strengthen gradually as labour market conditions slowly improve although, in the short term, confidence in some of the larger economies may remain subdued. The main downside risks are further appreciation of the euro, and a failure of household confidence to improve on the back of a strengthening global economy.

Chart B1: G7 GDP and world trade



B9 Since the 2003 Pre-Budget Report, data have generally confirmed a pick-up in activity in Japan. Strong export demand from Asia, low inventory levels and restructuring among Japan's large manufacturers have boosted profitability and production. During 2003 this encouraged a recovery in business investment which looks set to continue, at least through the first half of 2004. The momentum in the export and manufacturing sectors has also fed an improvement in the labour market and rising consumer confidence. In conjunction with a falling saving ratio, private consumption is expected to strengthen during 2004, potentially leading to a more self-sustaining recovery. If the pace of structural reform can be lifted in the non-manufacturing and banking sectors, then the likelihood of more autonomous economic growth will increase. For the moment, however, the recovery remains vulnerable to developments overseas.

Emerging markets and developing economies

B10 Emerging market economies have rebounded strongly as the global recovery has gathered momentum. In particular, growth in emerging Asia bounced back significantly during the second half of 2003 as the temporary impact from Severe Acute Respiratory Syndrome (SARS) and geo-political uncertainties started to fade. Both exports and domestic demand have provided the impetus for this growth. China continues to play a pivotal role in the region, with official estimates of growth at just over 9 per cent. In a number of Latin American economies growth has also strengthened and prospects for 2004 have continued to improve. Although relatively resilient throughout the downturn, a rebound in Eastern Europe has been restrained by the sluggishness of domestic activity in the euro area. Prospects for the new EU Member States are discussed in Box B1. India's growth, at around 7 per cent in 2003, has been boosted significantly by a recovery in the agricultural sector. In the Middle East and Russia, growth has been supported by relatively high oil prices, and this is likely to continue in 2004. However, structural reform is still needed to ensure sustainable long-term growth. GDP growth in sub-Saharan Africa increased modestly in 2003 and is expected to strengthen further during 2004, reflecting a combination of improving macroeconomic fundamentals, higher commodity and energy prices, and improved political stability.

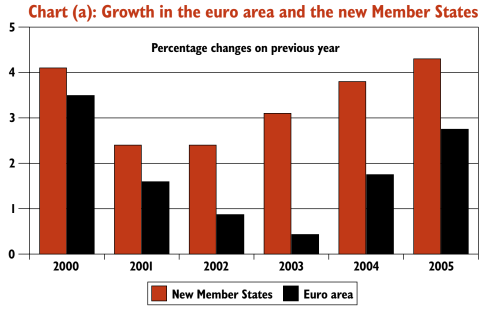
Box B1: EU enlargement

From 1 May 2004, membership of the EU will be expanded to include ten new Member States: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia. This will increase the size of the single market, in population terms, beyond that of the North American Free Trade Area.

The new Member States have undergone radical transformations since 1989, and have implemented substantial economic reforms in preparation for EU membership. These reforms have helped deliver significant improvements in economic performance. Average growth in the new Member States has been above 3 per cent in the past five years, with several of the smaller Member States experiencing growth rates above 4 per cent. This was despite an easing in growth during 2001 and 2002, in line with the global slowdown.

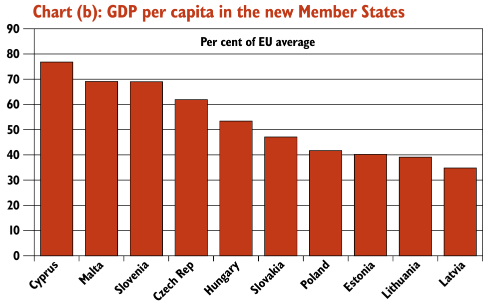
The expected recovery in the euro area should have a positive impact on the new Member States, as a large proportion of their trade is carried out with existing euro area economies. The European Commission estimates growth in the new Member States will be close to 4 per cent in both 2004 and 2005, as shown in Chart (a). Strong growth and continued reform is particularly important to raising living standards in the new Member States, which remain significantly below those in the EU15, as shown in Chart (b). Enlargement should offer new opportunities for the EU as a whole, by increasing supply-side competitive pressures and generating new demand for goods and services. Realising these benefits will require flexibility and continued reform to ensure countries can adapt quickly and efficiently to changes in competition and comparative advantage.

Chart (a): Growth in the euro area and the new Member States



Source: European Commission, (Autumn Forecast 2003) and HM Treasury.

Chart (b): GDP per capita in the new Member States



Source: Eurostat, Structural Indicators.

B11 Activity in many emerging markets has been supported by benign financing conditions, with bond spreads for many countries falling to new lows. However, looking ahead, higher global interest rates could pose a significant risk to emerging market financing conditions.

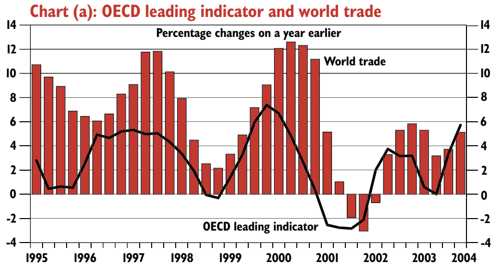
World trade

B12 World trade growth stalled during the second half of 2002, and dipped further in the early months of 2003 in response to weaker global activity. However, leading indicators of exports and industrial production improved rapidly during the final months of 2003, and as global demand has continued to strengthen, world trade appears to have gathered momentum. With the global recovery expected to continue and become more broadly based, trade should accelerate further. As in the 2003 Pre-Budget Report, world trade is forecast to grow by 7¾ per cent in 2004 and 8 per cent in 2005. Growth in UK export markets is likely to be somewhat weaker, reflecting domestic demand in the euro area remaining relatively subdued and these economies accounting for around 50 per cent of UK trade.

Box B2: The recovery in world trade

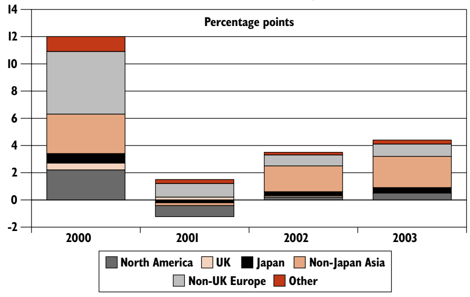
Recent data releases and a raft of leading indicators point to a sharp acceleration in world trade through 2004. For example, the OECD leading activity indicator, which has mapped movements in world trade fairly closely over the past, turned up sharply during 2003, as shown in Chart (a). Shipping freight indices, export orders and semi-conductor billings are also rising rapidly.

Chart (a): OECD leading indicator and world trade



Source: OECD, EcoWin and HM Treasury estimates.

Chart (b): Contributions to world trade growth



Source: HM Treasury estimates based on OECD data.

Chart (b) shows that while world trade growth slowed sharply in 2001, a recovery did take root in 2002 and 2003. However, even these relatively low world trade growth readings were heavily reliant on rapidly growing intra-regional trade in Asia. Trade activity across the G7 economies remained much more muted. Looking forward, the Budget 2004 forecast projects that global trade growth will become more broad-based, as economic activity becomes more balanced across the world's major economies.

To minimise the medium-term risks to the global economy and seize the opportunities from the recovery in economic activity and trade, it is vital that each country plays its part in addressing the causes of the current imbalances. This means every government should press ahead with reforms to labour, product and capital markets, making their economies more flexible and better able to adjust to the ongoing changes to the pattern of global growth. In the short term, imbalances may lead to greater calls for protectionist measures in some economies which, if accomodated, would pose a major threat to global development. Trade is a principal engine of global economic growth, and all countries can gain from the improving global prospects by further opening up their markets. It is therefore crucial that significant progress is made in the World Trade Organisation Doha Development Agenda negotiations as soon as possible. Balanced global growth will require the inclusion of all countries in the global economy, which is why the developed world needs to live up to its commitments to the developing world, including through innovative financing mechanisms and the removal of trade barriers.

Oil and commodity prices

B13 Oil prices have remained in a range of $28 to $34 a barrel since the 2003 Pre-Budget Report, with low crude inventories, cold weather in the US and stronger global demand supporting prices. The depreciation in the US dollar has also pushed up prices, with recent rises much less pronounced in sterling terms. In the expectation of demand easing in the spring, OPEC recently decided to cut its production quotas from 1 April 2004. This decision has increased the risk that the market will remain tight through the spring. For the remainder of the year, prices are likely to stay significantly above their long-run average and, given low stock levels, remain vulnerable to shocks. Meanwhile, non-oil commodity prices have also continued to rise strongly in recent months. As with oil prices, these increases reflect strengthening global demand, rapid industrialisation in China, and the depreciation of the US dollar, as discussed further in Box B3.

Box B3: Recent developments in commodity prices

In recent months commodity price inflation has picked up sharply. In part this reflects the pricing of most major commodities in US dollars. With the US dollar exchange rate depreciating significantly since early 2002, international commodity producers have had an incentive to raise the US dollar price of their output in order to maintain their domestic profit margins. This is illustrated in Chart (a). Although non-oil industrial materials prices have risen by around 25 per cent over the past year, in sterling terms this increase is much less pronounced, at around 10 per cent.

Chart (a): Non-oil industrial commodity prices

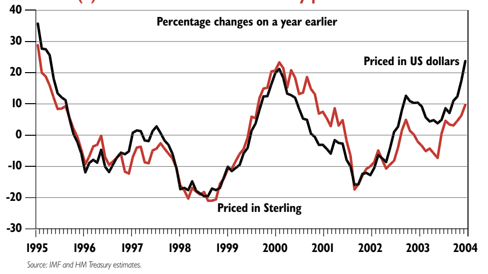
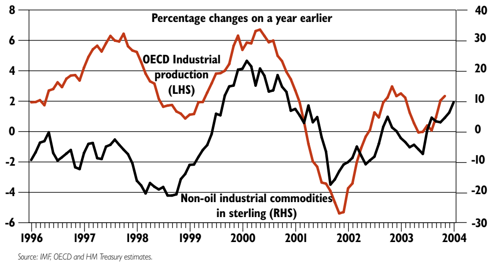


Chart (b): Commodity prices and industrial production

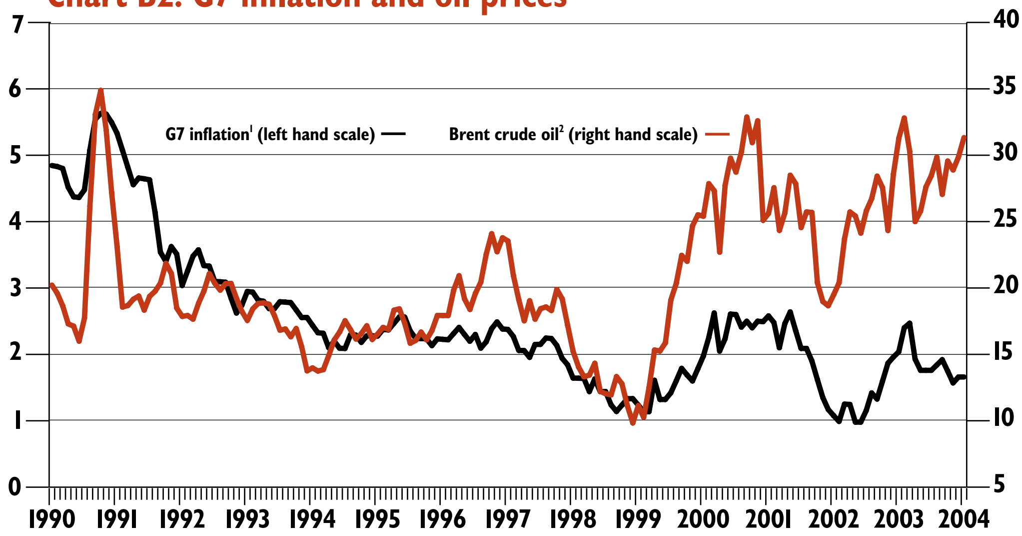


Movements in major exchange rates are not the only factor contributing to the pick-up in commodity prices. The cyclical improvement in global demand is also playing an important role. Chart (b) shows that the recent acceleration in prices is broadly consistent with the upturn in OECD industrial production. Economies outside the OECD are also having an important and growing impact. In particular, rapidly expanding industrial production in China is increasingly consuming large quantities of raw materials and metals. For example, industrial production in China is growing at an annual rate of over 20 per cent. There are also clear signs that demand from Asia is bidding up shipping freight costs. For example, the Baltic Freight Index is now around 300 per cent above its long-run average.

G7 inflation

B14 With output levels below potential in most major economies, inflationary pressures have remained very subdued. However, continued global recovery should reduce spare capacity, and rising commodity and goods prices are expected to push inflation higher. Consumer prices in the G7 are expected to rise by 1½ per cent in 2004 and 1¾ per cent in 2005.

Chart B2: G7 inflation and oil prices



[1] Consumer price index, percentage change on a year earlier.
[2] US dollars per barrel.

Forecast issues and risks

B15 As the global recovery has gathered pace, some key uncertainties have diminished. However, other risks remain. In recent months, the US dollar has continued to decline against some other major currencies. So far, this has been an orderly depreciation, accompanied by improving financial conditions and strengthening growth, but given continued large global imbalances, sharper movements in major exchange rates cannot be ruled out. This highlights the urgent need for policy makers to push ahead with structural reforms that will ensure a more broadly based and sustainable global recovery over the medium term, minimising the risk of a disorderly unwinding of global trade positions.

B16 A further downside risk comes from the potential rebuilding of balance sheets. Significant progress has been made in rebuilding household and corporate balance sheets across several major economies since the recession of 2001. However, this process may not be complete, and could resume once the stimulus from policy begins to fade. Further balance sheet adjustment might entail significantly weaker spending by households or the business sector, and could undermine the recovery. This is particularly a risk for the household sector when combined with weak labour markets: despite the acceleration in G7 GDP, employment growth has remained very subdued. Policy makers will also have to continue to be vigilant to a number of other downside risks, including remaining geo-political uncertainties, high oil prices, and viral epidemics, most recently avian flu.

B17 There are also a number of important upside risks. After several years of subdued activity, pent-up demand may prompt a sharper bounce in growth than currently assumed. The clearest example is capital spending, which has tended to pick up quickly in previous global upturns. Similarly, world trade may also accelerate more quickly than expected, given the continued strength in Asia and that the Budget 2004 projections entail growth rates well below those seen before the 2001 slowdown. Finally, with inventories at low levels across most major economies, a return to stock-building could provide a powerful short-term stimulus to growth.

UK ECONOMY

Trend growth

B18 The Treasury's neutral estimate of the economy's trend output growth rate for the 2004 Budget is and remains 2¾ per cent to the end of 2006. Business surveys and data reported since the 2003 Pre-Budget Report do not suggest any change in the Government's estimate of the growth potential of the economy.

B19 Table B2 presents the historical and forward-looking estimates of the composition of trend output growth. They are unchanged from the estimates in the 2003 Pre-Budget Report. The neutral trend projection from the economy's last adjudged on-trend point in the third quarter of 2001 provides the trend path around which the mid-points of the economic forecast ranges from the fourth quarter of 2003 are anchored.

B20 Blue Book 2003 introduced substantial revisions to the data underlying the Treasury's trend growth assumptions, and showed that both trend output and productivity growth over the recent past – between the estimated on-trend points in 1997H1 and 2001Q3 – had been stronger than previously thought. Trend output growth over this period is now estimated at 2.9 per cent. This further increased confidence that the 2¾ per cent trend growth assumption is consistent with the economy's potential. However, the Treasury continues to base the public finance projections on a deliberately cautious annual trend growth assumption that is ¼ percentage point below the neutral view.

Table B2: Contributions to trend output growth[1]

	Estimated trend rates of growth, per cent per annum					
	Trend output per hour worked[2, 3]		Trend average hours worked[3]	Trend employment rate[3]	Population of working age[4]	**Trend output**
	Underlying (1)	Actual (2)	(3)	(4)	(5)	(6)
1986Q2 to 1997H1	2.22	2.05	–0.10	0.33	0.24	**2.54**
Over the recent past						
1997H1 to 2001Q3						
Budget 2002	2.14	1.96	–0.37	0.36	0.66	**2.63**
Budget 2003	2.35	2.14	–0.47	0.43	0.50	**2.61**
PBR 2003 and Budget 2004	2.65	2.44	–0.47	0.42	0.54	**2.94**
Projection[5]						
2001Q4 to 2006Q4						
Budget 2002	2.10	2.0	–0.1	0.2	0.6	**2¾**
Budget and PBR 2003	2.35	2.25	–0.1	0.2	0.5	**2¾**
Budget 2004[6]	2.35	2.25	–0.1	0.2	0.5	**2¾**

[1] *Treasury analysis based on judgement that 1986Q2, 1997H1, and 2001Q3 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 employment and 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 1992Q2. Hours worked and the employment rate are measured on a working-age basis.*

[4] *UK household basis.*

[5] *Neutral case assumptions for trend from 2001Q4.*

[6] *Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2003Q4 are anchored.*

Overview of recent developments and prospects

Recent developments

B21 The domestic stability delivered by the Government's macroeconomic framework has enabled the UK economy to cope well with the significant challenges that have faced the world economy over recent years. Sound fundamentals allowed the independent Monetary Policy Committee of the Bank of England to cut interest rates nine times between February 2001 and July 2003, supporting private consumption during a protracted period of external weakness. Fiscal policy also helped maintain domestic demand, with sound public finances allowing counter-cyclical action through the operation of the automatic stabilisers. While many of the world's major economies have experienced recession, the UK grew continuously throughout the global downturn that began in 2001. Indeed, the UK is the only G7 economy not to have experienced at least one quarterly contraction in output over the past three years, with GDP now having grown for 46 consecutive quarters which, on the basis of quarterly national accounts data, is the longest sustained expansion on record.

Table B3: Summary of forecast[1]

		Forecast		
	2003	**2004**	**2005**	**2006**
GDP growth (per cent)	2¼	3 to 3½	3 to 3½	2½ to 3
CPI inflation (per cent, Q4)	1½	1¾	2	2

[1] *See footnote 3 to table B9 for explanation of forecast ranges.*

B22 Nonetheless, while macroeconomic stability, and the proactive policy action that it permitted, helped to support GDP, a highly open economy such as the UK cannot insulate itself completely from global developments. With geo-political and other international uncertainties weighing heavily on global economic prospects and underlying external demand remaining weak, UK GDP growth fell below trend rates in the course of 2001. With the exception of the post Jubilee 'bounce' in output in the third quarter of 2002, growth remained below trend through 2002 and into 2003.

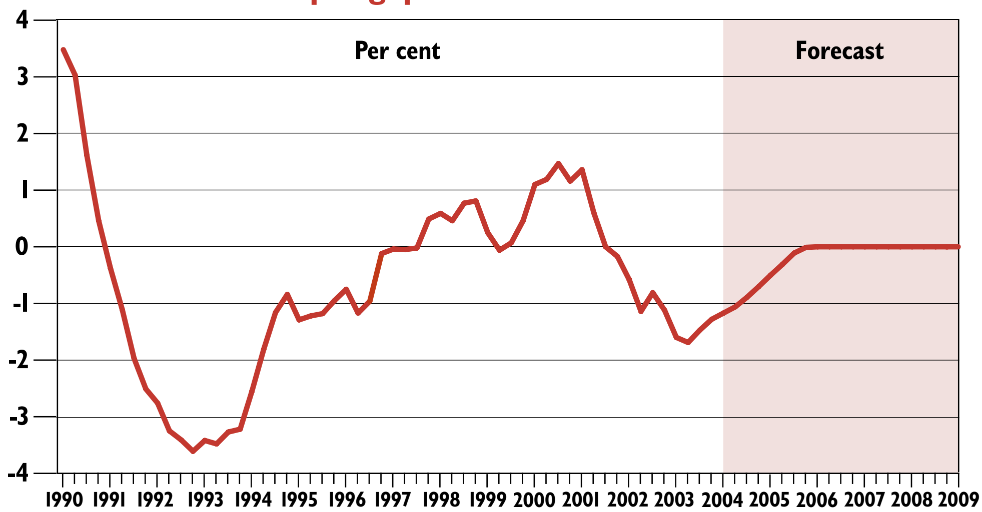
B23 Global economic prospects have strengthened significantly since early 2003. As geo-political and other uncertainties have receded, global demand has strengthened and most major international financial markets have seen valuations rise back to around the levels of spring or summer 2002. With the international outlook continuing to improve, UK business and consumer confidence have risen further since the time of the 2003 Pre-Budget Report. Moreover, improved sentiment has underpinned a significant pick-up in domestic demand growth since early last year. Following growth of 0.8 per cent in the third quarter, UK GDP rose 0.9 per cent in the final quarter of 2003, above trend rates and the fastest rate of quarter-on-quarter growth for over three and a half years. For 2003 as a whole, UK GDP rose by 2.3 per cent, fully in line with the 2003 Budget forecast of 2 to 2½ per cent and slightly above the 2003 Pre-Budget Report estimate of 2.1 per cent. As activity has strengthened, the Monetary Policy Committee has continued to adopt a proactive approach, with two pre-emptive ¼ percentage point increases in interest rates since November 2003, taking base rates to just a little above the 50 year lows that prevailed for most of 2003.

B24 Royal Bank of Scotland Purchasing Managers' Indices for the regions and devolved countries of the UK continue to offer evidence that the pick-up in activity has been geographically widespread. While London, the North West, the West Midlands and Northern Ireland reported the largest output gains in the three months to February 2004, all parts of the UK registered relatively sharp rates of growth compared with historical survey readings.

Output gap

B25 As GDP growth has picked up to above trend rates, the size of the negative output gap is judged to have narrowed a little. The gap is currently estimated to have stood at around 1¼ per cent in the final quarter of 2003, as expected in the 2003 Pre-Budget Report. Although GDP growth during 2003 has been revised up since the Pre-Budget Report, non-oil Gross Value Added (GVA), which is the basis for calculating the level of trend output and the output gap, has been subject to smaller revisions. Moreover, in six of the past seven quarters, GDP growth, measured at market prices, has been stronger than growth in non-oil GVA, which is measured at basic prices, with the wedge between the two reflecting movements in both the basic price adjustment and North Sea output.

Chart B3: The output gap[1]



[1] Actual output less trend output as a percent of trend output (non-oil basis).

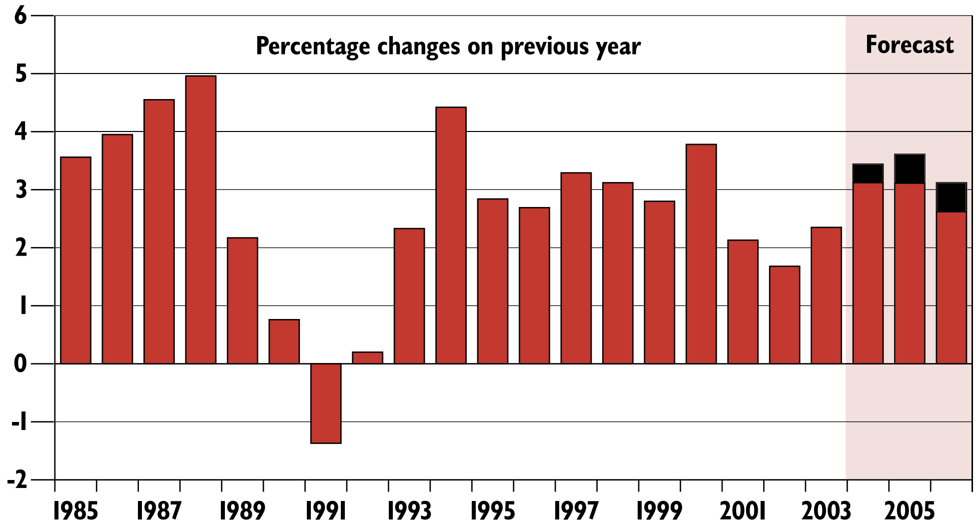
B26 The output gap can be broken down into components by comparing output per hour, average hours worked and the employment rate against their assumed trend levels that make up the overall trend output projection. Such analysis tends to suggest that the deviation of output per hour from trend accounts for only a relatively small part of the estimated 1¼ per cent output gap in the fourth quarter of 2003, with cyclical weakness in average hours worked and the employment rate judged to be somewhat more significant factors:

- earlier in 2003, output per hour was significantly further below its assumed trend but, with output accelerating and hours remaining relatively weak, output per hour has been growing at above trend rates since last spring, narrowing its contribution to the negative output gap. Indeed, non-oil output per hour worked is estimated to have risen by 2¾ per cent over the year to the fourth quarter of 2003;
- at least part of the sharp fall in average hours worked during the period of global economic downturn to the second half of 2002 is judged to have been cyclical, and not yet to have unwound: average hours worked have remained broadly flat since late 2002; and
- despite some business survey indicators of labour availability currently suggesting little slack in the labour market, subdued wage pressures provide evidence that the employment rate is below trend, consistent with unemployment being somewhat above its sustainable rate.

Prospects

B27 As demand continues to accelerate into 2004, GDP is forecast to grow by 3 to 3½ per cent both this year and in 2005. The output gap is forecast to close by early 2006 and GDP growth is forecast to moderate thereafter, with the economy projected to remain at trend. The 2004 Budget forecast for GDP growth is therefore the same as in the 2003 Budget and Pre-Budget Reports in every year of the current projection period.

Chart B4: Gross Domestic Product (GDP)[1]



[1] Shaded areas on bars represent forecast ranges.

B28 The forecast for CPI inflation is also broadly unchanged compared with the 2003 Pre-Budget Report. Inflation is expected to remain a little below its symmetrical 2 per cent target in 2004 as existing slack in the economy continues to subdue domestically generated pricing pressures. However, inflation is expected to return to target by mid-2005 as the lagged effects of sterling's depreciation against the euro since 2002, combined with the effects – already evident in commodity prices – of the strengthening synchronised recovery in the world economy (Box B3), feed through to higher import prices. The credibility of the Government's monetary policy framework is also expected to contribute in returning inflation to target through anchoring inflation expectations.

Demand

Private consumption **B29** Consumer confidence was temporarily dented in early 2003 by heightened geo-political uncertainties and global economic weakness. As a result, real private household consumption registered only its second, albeit marginal, fall for eight years during the first quarter of last year.

B30 Against a backdrop of easing international uncertainties, private consumption rebounded in the second quarter and picked up further momentum over the second half of 2003, increasing by 1.1 per cent in each of the last two quarters of the year. Having remained broadly flat in the first few months of 2003, retail sales have also shown resumed growth since last summer. In the three months to January, retail sales volumes were 1.7 per cent up on the previous three months, over double the rate in the corresponding period a year earlier when international uncertainties were close to their peak. Nonetheless, despite the pick-up in consumers' expenditure growth through last year, real private consumption growth for 2003 as a whole, of 2.9 per cent, was at its weakest for eight years.

B31 The Budget 2004 forecast assumes that the renewed momentum seen in private consumption since early last year moderates. While sound economic fundamentals coupled with sustained strong labour market outcomes should provide support to private consumption, monetary policy has already been tightened in recent months, and relatively high levels of personal debt and weaker growth of disposable incomes can eventually be expected to dampen spending. Private consumption is forecast to grow by 3 to 3¼ per cent this year, and by 2¼ to 2¾ per cent in both 2005 and 2006. Thus, growth in private consumption is expected to be below the rate of growth of the economy as a whole throughout the forecast period.

Investment **B32** Business investment shows signs of having increased in recent months, following a prolonged period of weakness during which global uncertainty reduced companies' appetite to undertake capital expenditure. In the final quarter of 2003, business investment rose by 1.3 per cent on the previous quarter and stood 0.6 per cent higher than a year earlier.

B33 Previous experience suggests that business investment often lags GDP growth in the initial phases of an upswing, and survey evidence indicates investment intentions have risen sharply in recent months. For example, the British Chambers of Commerce (BCC) survey for the final quarter of last year showed service sector companies' plans to raise investment in plant and machinery at their highest since the onset of the world economic slowdown in early 2001. Moreover, manufacturers' investment intentions stood at their highest level for six years. Data on capital goods industries' output also offer grounds to suggest that a further acceleration in investment demand is in the pipeline, with production of capital equipment rising by 3¾ per cent in the year to the final quarter of 2003.

B34 Business investment is forecast to pick up through this year as the global recovery gathers pace. The sharp improvements in business confidence already seen should increasingly translate into higher levels of capital expenditure through 2004 and 2005, as companies respond to growing demand and bring postponed investment projects back on stream.

Exports **B35** Export growth also resumed in late 2003, although interpreting recent trends is complicated by the incidence of VAT missing trader intra-Community (MTIC) fraud and the closure of several fraudulent businesses in 2003. Moreover, the recent move by HM Customs and Excise to an electronic system of recording non-EU exports, from a previously paper-based system, may have made appropriate seasonal adjustment more difficult in the short term.

B36 Excluding MTIC trade, volumes of goods exports rose 2¼ per cent between the third and fourth quarters of 2003, to stand over 9 per cent up on a year earlier. For 2003 as a whole, goods export volumes excluding MTIC trade were 3½ per cent higher than in 2002. This masks far stronger growth in volumes to non-EU destinations, including the US, but relatively flat export volumes to the EU, despite a fall of around 10 per cent in sterling's value against the euro over the past two years or so.

Table B4: Contributions to GDP[1] growth[2,3]

	Percentage points unless otherwise stated			
		Forecast		
	2003	2004	2005	2006
Private consumption	2	2¼	1¾	1¾
Business investment	–¼	½	¾	½
Government	¾	¾	1	¾
Change in inventories	0	0	0	0
Net trade	–¼	–¼	0	0
GDP growth, per cent	**2¼**	**3¼**	**3¼**	**2¾**

[1] *Fixed base volumes.*

[2] *Components may not sum to total 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.*

B37 Export growth is expected to pick up more significantly through 2004 and 2005 as external demand continues to accelerate. The weakening of sterling against the euro should provide a boost to export volumes as euro area GDP growth picks up and the lags between exchange rates and trade flows work through. However, sterling's rise against the US dollar could inhibit demand from the US and other economies whose currencies are linked to that of the US.

B38 Strengthening demand at the national level appears, according to recent private sector business survey evidence, to be mirrored by the patterns in most countries and regions of the UK. For example, the BCC Survey for the final quarter of 2003 reported rising manufacturing orders in nine of the twelve regions and countries, and increasing services orders in eight. Scotland was the only part of the UK to report declines in both manufacturing and services order books.

Output

Manufacturing

B39 Manufacturing output has shown tentative signs of strengthening in recent months, although it still remains relatively subdued. Manufacturing production rose in every quarter of 2003, increasing a little for the year as a whole in line with the 2003 Pre-Budget Report forecast, and stood just over 1 per cent up on a year earlier in the three months to January 2004.

B40 However, despite official manufacturing output figures thus far pointing to only a moderate pick-up, forward-looking business surveys offer evidence that manufacturing output is set to accelerate into 2004. This contrast between official output data and business surveys is discussed further in Box B4. Recent Chartered Institute of Purchasing and Supply (CIPS) Reports suggest manufacturing activity, as measured by the composite Purchasing Managers' Index (PMI), has been at around a four-year high. January's survey also showed new orders growing at their fastest rate since December 1999; and although February saw an easing back, growth remained comfortably within positive territory. The BCC survey for the final quarter of 2003 showed export orders rising at their fastest rate for almost seven years, with domestic orders also picking up to a little above the long-run average for the series. These results were closely mirrored by robust results from the Confederation of British

Industry (CBI) Quarterly Industrial Trends Survey for the final quarter. Moreover, survey evidence suggests this turnaround in manufacturing is proving regionally widespread. Indeed, the latest CBI/Experian Regional Trends Survey showed business optimism in almost half the regions and countries of the UK at its highest level for at least five years.

B41 The Budget forecast shows recovery in manufacturing output becoming increasingly evident in 2004 and into 2005. A continued global economic recovery is expected to underpin strengthening external demand for UK manufactures over the forecast horizon. At the same time, the pick-up in UK business investment is also expected to act as a spur to rising manufacturing output. Manufacturing output is forecast to rise by 1½ to 2 per cent this year, and by 1¾ to 2¼ per cent in both 2005 and 2006.

Services

B42 Service sector output growth weakened in the first half of 2003 as heightened international uncertainties fed through to lower demand in many key areas of services activity. For example, some service businesses dependent on overseas travel and tourism were affected by reduced visitor numbers around the peak of geo-political tensions in early 2003: after correcting for seasonal patterns, overseas visitors to the UK fell by over 8½ per cent between the final quarter of 2002 and the second quarter of 2003. Meanwhile, financial intermediation output was broadly flat between the end of 2002 and mid-2003, likely reflecting economic uncertainty and financial market volatility around that time. Having averaged 0.9 per cent a quarter in the previous six years, growth in service sector output was just 0.3 per cent in the first and second quarters of 2003.

B43 Service sector output growth has gathered pace since then, with growth of 1 per cent in both the third and fourth quarters of 2003. In particular, two sectors – financial intermediation and real estate, renting and business activities – saw output rebounding strongly over the latter stages of the year.

B44 Survey evidence points to a continuation of this pattern into 2004. The CIPS Report on Services for January 2004, for example, showed activity and new orders in the service sector growing at or close to their fastest rates for around four years, with business expectations remaining at historically high levels.

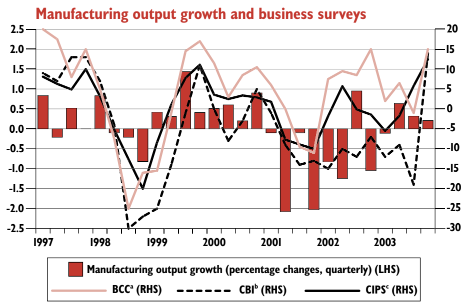
B45 Construction output has been significantly boosted in recent years by strong government investment in priority areas of public service delivery. While quarterly growth of construction output cooled in the second half of 2003, rates of annual growth remain brisk, with output increasing by over 6 per cent in 2003 as a whole.

B46 Recent evidence from the Royal Bank of Scotland's Purchasing Managers' Indices suggest the pick-up in business sector output growth has been relatively broad-based across the countries and regions of the UK, with February results suggesting activity has accelerated most strongly in London, the South East and Northern Ireland.

Box B4: Reconciling recent business surveys with the Index of Production

In recent months, nearly all major private sector business surveys have suggested that a strong recovery in manufacturing output is underway. For example, the headline PMI figure in the December 2003 and the January 2004 CIPS Report on Manufacturing was at its highest level since 1999. The CBI Industrial Trends Survey for the final quarter was similarly upbeat – the output and total orders balances reached their highest levels since the mid-1990s. Meanwhile, the BCC survey showed export orders at their highest for seven years in the final quarter of 2003.

In contrast, official Index of Production figures have, thus far, painted a weaker picture. For example, manufacturing output in the three months to January 2004 grew only marginally on the previous three months, and the level of output still remains 5¾ per cent lower than its peak in December 2000.



[a] Manufacturing home and export sales.
[b] Volume of output.
[c] Purchasing Managers Index (PMI).

This would not be the first time that private survey results have failed to be mirrored in official output figures. During the Asian crisis in 1999, survey indicators proved too pessimistic, significantly overstating actual output losses. It is plausible that they have been correspondingly too optimistic during the recent upswing. However, there are a number of other reasons that could help reconcile the differing conclusions drawn from business surveys and official data in recent months:

- surveys may be telling more about manufacturing activity going forward than about current output. For example, responses to survey questions regarding the number of new orders or levels of business sentiment are likely to be more related to future output than current production;
- both Index of Production and private survey data are often revised, and it may be that current discrepancies are reconciled as further information becomes available; and
- surveys only record the balance of firms reporting increased activity; they do not measure the magnitude of such increases. It is therefore possible that while many firms and sectors have seen a gradual rise in output, others are yet to reap the benefits of stronger demand and their production has remained flat. Consequently, survey readings could be overstating actual output growth. This may particularly be the case during the initial stages of a recovery as increased demand takes time to filter down through the supply chain.

Despite official figures thus far pointing to only a modest recovery in manufacturing as a whole, some sectors have still performed strongly over recent months, with rates of growth well above that for the economy as a whole. For example, in the three months to January, output of machine tools and other special purpose machinery was up by around 10 per cent, pharmaceuticals up 13 per cent and televisions, VCRs and stereos up almost 22 per cent on the same three months a year earlier. As the global economy continues to gather strength and investment recovers, UK manufacturing should experience a more broad-based recovery throughout 2004 and into 2005.

Box B5: The Allsopp Review

Christopher Allsopp is undertaking a review of statistics for economic policymaking, examining the statistics and information needed to support the Government's key regional policy objectives, and whether official economic statistics have properly reflected the changing economic structure of the UK. His First Report to the Chancellor of the Exchequer, the Governor of the Bank of England and the National Statistician was published on 10 December.

The Report explained how the devolution and regional economic policy agendas have led to a growing demand for regional data that is not met adequately under present arrangements. Its recommendations responded to the current and future needs of policymakers and the wider user community, including business and academics, at both national and local levels. These included:

- bringing Regional Accounts more into the National Accounts framework, including development of an improved and timely measure of regional real Gross Value Added;
- expanding the range of microeconomic and sub-regional data already available, with the infrastructure used by the Office for National Statistics' (ONS) Neighbourhood Statistics Service becoming the primary platform for area-based National Statistics;
- an ONS or Government Statistical Service (GSS) presence in the English regions to complement that which already exists in Scotland, Wales and Northern Ireland; and
- greater access for the ONS to administrative data held within government, which could improve both regional and national data while offering important savings in the compliance burden on business.

Christopher Allsopp and the Review Team have been involved in a range of events to present and discuss the conclusions and recommendations of the First Report. A large number of useful comments have been received and were generally supportive of the First Report's recommendations. There were 30 responses from government, regional and private sector bodies and individuals to the formal consultation that followed the First Report, and the team is very grateful to all who have contributed.

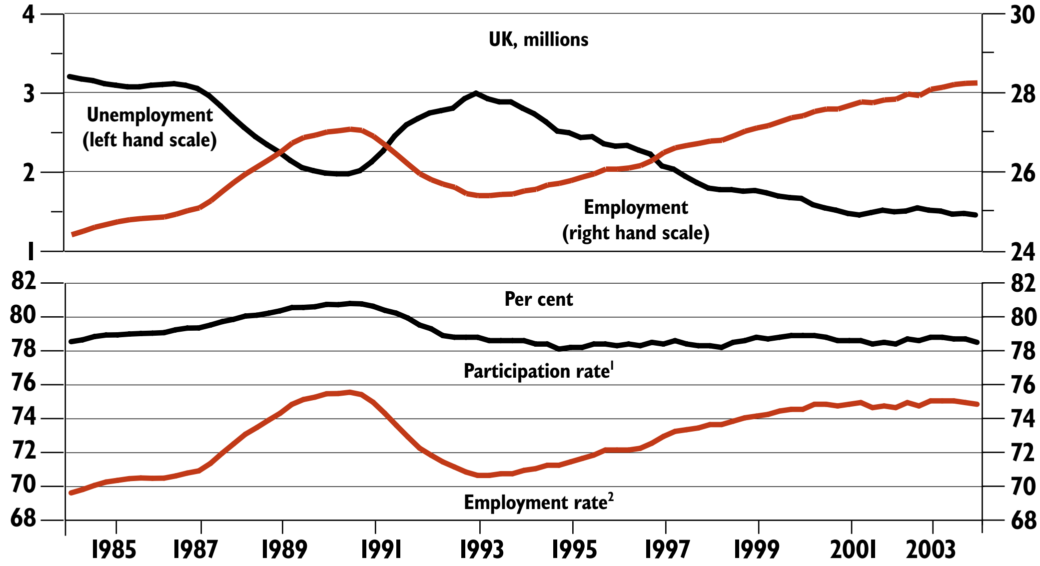
The two areas that attracted most comment were the suggestion of an ONS or GSS presence in the English regions, and the possible use of administrative and tax data for statistical purposes, where the potential benefits appear considerable, but there remain a number of difficult issues to be resolved. The Final Report, to be published after the Budget, will note that there is considerable variation in the English Regions' institutional frameworks, and propose that the decision on the location of regional statisticians should be taken on a region-by-region basis in consultation with key users and regional bodies, consistent within an outward-looking role and protection of sensitive information.

The Final Report will also consider in more detail whether official statistics properly reflect the changing economic structure of the UK, and make further recommendations to improve the coverage and quality of the economic statistics. The full set of recommendations will include changes to those in the First Report to reflect comments received, but the broad thrust of the recommendations on regional data remains unchanged.

The labour market

B47 The UK labour market has continued to build on the excellent performance of recent years, providing further evidence that the Government's supply-side reforms are creating a more dynamic and flexible labour market in the UK.

Chart B5: LFS employment, unemployment and participation



[1] *Percentage of the working-age population who are economically active (i.e. employed or unemployed).*
[2] *Percentage of the working-age population in employment.*

Unemployment

B48 Unemployment, on the International Labour Organisation (ILO) measure, declined by almost 55,000 between the fourth quarters of 2002 and 2003, to stand a little below 1.5 million. The rate of ILO unemployment, at 4.9 per cent, is at its lowest for almost 30 years, and has been the lowest of all G7 economies since October 2001. The majority of the UK countries and regions saw declining rates of unemployment in the year to the fourth quarter of 2003. The claimant count measure of unemployment declined by 40,300 in the year to January 2004 to stand just above 892,000. The claimant count rate in January was 2.9 per cent, the first time it has dipped below 3 per cent since April 1975. With the exception of the South East, the level of claimant count unemployment has fallen in every region and country of the UK in the past year.

Employment

B49 Numbers of economically active individuals have risen further since the end of 2002, increasing by just over 100,000 in the year to the fourth quarter of last year. However, with unemployment declining, employment has expanded even more sharply than activity. The level of employment increased by 156,000 in the year to the final quarter of 2003, with the working-age employment rate remaining broadly stable.

B50 Self-employment has continued to outpace overall employment over recent months. There were 294,000 more self-employed workers in the final quarter of 2003 than a year earlier, 80 per cent of whom were in full-time self-employment. By contrast, growth in the number of part-time employees has been more than offset by declining numbers of full-time employees.

B51 Some of the sectors particularly affected by weak international conditions in recent years also appear to have begun expanding their workforces again. For example, employment in distribution, hotels and restaurants rose by 11,000 between the second and third quarters of 2003, making up some of the job losses incurred around the time of peak geo-political uncertainties early in 2003. Employment in finance and business services, which fell through most of 2002, rose by almost 100,000 in the year to September 2003. Government spending has continued to contribute to employment growth in public administration, education and health: growth of jobs in these sectors averaged just under 40,000 a quarter over the year to September 2003, very similar to the rate of increase over the previous 12 months. Buoyant construction sector activity, partly related to government spending on priority public services, has given a significant boost to construction employment, which expanded by 105,000 in the year to the third quarter of 2003.

Average hours worked

B52 Weekly average hours worked eased back following the onset of the global slowdown in 2001, demonstrating a highly flexible cyclical response by businesses and workers to the effects of a weak global environment. Despite the pick-up in GDP growth over the second half of 2003, weekly average hours worked have not yet picked up, suggesting that cyclical weakness has still to unwind.

Average earnings

B53 Whole economy average earnings growth remains modest, and the three-month average rate has now been consistently below 4 per cent for over two years. In the final quarter of 2003, average earnings were just under 3½ per cent up on a year earlier. There has been some narrowing of the differential between rates of average earnings growth in the private and public sectors. In particular, timing changes in the awarding of local government pay settlements in 2002 temporarily raised the annual rate of public sector average earnings growth in late summer and early autumn 2003, but have subsequently fallen out of the annual comparisons. On a three-month average basis, the differential between public and private sector average earnings growth was at its narrowest for over a year in December 2003, with public sector earnings 4.4 per cent higher than a year earlier and private sector earnings up 3.2 per cent.

Productivity

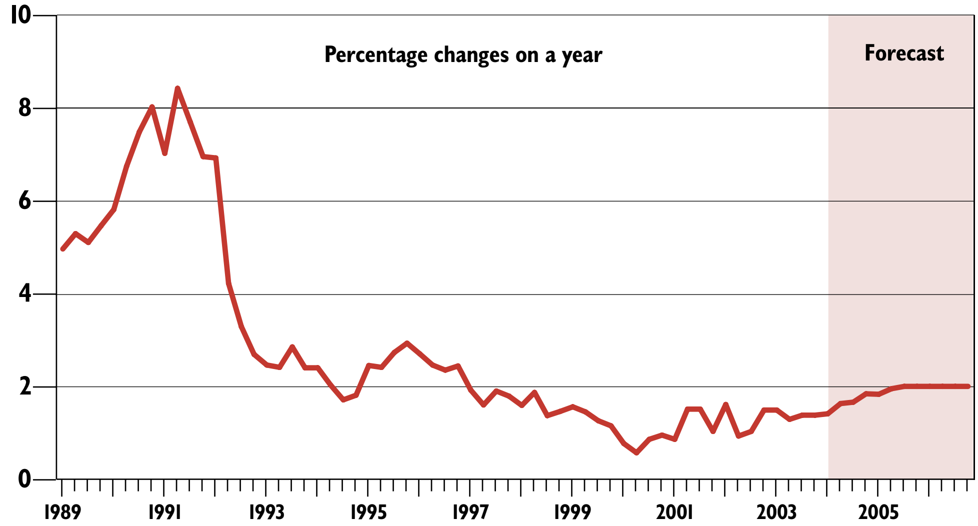
B54 With output rising strongly and average hours worked remaining subdued, growth of productivity, as measured on an output per hour basis, has picked up significantly compared with the cyclical lows experienced at the peak of global uncertainties early last year. Non-oil output per hour worked is estimated to have risen by over 1¼ per cent in the final quarter of last year, following growth averaging ¾ per cent in the previous two quarters. The quarterly rate of growth in the fourth quarter was the fastest rate since the first quarter of 2000, and the annual rate of growth rose to 2¾ per cent, well above its estimated trend rate.

THE UK FORECAST IN DETAIL

Inflation

B55 Underlying inflation remains firmly in check. Since the inception of the present monetary policy framework in 1997, CPI inflation has averaged 1.3 per cent. Over the same period, RPIX inflation, which was the target of monetary policy until the switch to the CPI target at the time of the 2003 Pre-Budget Report, averaged 2.4 per cent, very close to its 2½ per cent target. Almost two thirds of the average differential between the two measures over this period is accounted for by housing components excluded from the CPI but included in the RPIX measure.

Chart B6: CPI[1]



[1] Outturns until 2003Q4; forecasts for every second quarter from 2004Q1 to 2006Q4.

B56 CPI inflation has remained broadly unchanged since the 2003 Pre-Budget Report, standing at 1.3 per cent in February 2004. Seasonal increases in airfares over the recent Christmas period were lower than a year earlier, but subsequent discounting on tickets was shallower. Reductions on clothing and footwear prices were also more subdued than in late 2002 and early 2003, with new season stocks coming in at higher prices. Downward contributions have come from satellite and digital television subscriptions, where unchanged pricing this year contrasted with increases in early 2003, and from declining charges for television and video rentals.

House price inflation

B57 House price inflation has eased back significantly over the past year or so, despite appearing to edge up in early 2004. Office of the Deputy Prime Minister (ODPM) statistics show the annual rate of UK house price inflation declining by around two thirds between the beginning and the end of 2003, to 8¼ per cent in December, before rising to 9¾ per cent in January 2004. However, this masks variations between regions and countries. For example, while house prices in Wales and the North East have risen at roughly twice the national average over the past year, increases in London and the South East have continued to undershoot those in most of the country, although prices in these regions do appear to have firmed a little of late. As a result of moderating house price inflation, while housing components remain the largest single factor in the differential between RPIX and CPI inflation, the size of the wedge attributable to them has diminished by over 0.4 percentage points since its peak in April 2003. Indeed, of late the overall gap between RPIX inflation (2.3 per cent) and CPI inflation (1.3 per cent) has been around its lowest for 16 months.

Prospects

B58 CPI inflation is forecast to rise gradually through this year, reflecting partly offsetting factors. The effects of the continued synchronised strengthening of the world economy, already evident in commodity prices (as discussed in Box B3), allied with the lagged effects of the weakening in sterling against the euro since 2002, are forecast to lift import prices. This is expected more than to offset downward pressures on domestically generated inflation from continued slack in the economy built up over the course of the recent world economic slowdown. The credibility of the Government's monetary policy framework is also expected to contribute in returning inflation to target through anchoring inflation expectations. CPI inflation is expected to settle at its 2 per cent target by mid-2005. The differential between CPI and RPIX inflation is expected to diminish further over the same period to ½ percentage point, the size of the underlying formulae effect. Thereafter the differential is expected to remain broadly stable, rising slightly to round to ¾ percentage points in the Budget forecast, depending on a range of economic factors.

The household sector

Private consumption

B59 Growth of real household consumption eased back in 2003, increasing by 2.8 per cent, its slowest annual rate since 1995. In early 2003, consumer confidence was adversely affected by heightened global uncertainties and sluggish near-term prospects for the world economy. As a result, real private consumption growth in the first quarter of 2003 was at its weakest for over two years, with household expenditure registering a marginal contraction on the quarter. Moreover, much of the growth in household consumption volumes over the past year appears to have been spurred by strong competition exerting downward pressures on prices in parts of the retail and service sectors: in nominal terms private consumption in 2003 grew by 4.4 per cent, its slowest rate since 1949, and its share in GDP fell by more than in any year since 1977. This further supports the evidence set out in the 2003 Pre-Budget Report that since the mid-1990s the data in nominal terms indicate growth in private consumption has been more sustainable than the real measures suggest. However, it also suggests that, independent of the temporary effects of the global uncertainties prevailing earlier in 2003, households' expenditure patterns have gradually begun to adjust to relatively high levels of indebtedness and the past two years of slower growth in real incomes compared with the previous three years.

Table B5: Household sector[1] expenditure and income

	Percentage changes on previous year unless otherwise stated			
		Forecast		
	2003	2004	2005	2006
Household consumption[2]	3	3 to 3¼	2¼ to 2¾	2¼ to 2¾
Real household disposable income	2¾	3 to 3¼	2½ to 3	2 to 2½
Saving ratio (level, per cent)	5¼	5	5½	5½

[1] *Including non-profit institutions serving households.*
[2] *Chained volume measures.*

B60 Nonetheless, as international uncertainties have receded, growth in real consumer spending has picked up from its low in early 2003 and revealed more momentum than previously expected, with growth of 1 per cent or more in each of the past three quarters. Retail sales growth has also risen: retail sales volumes were 1.7 per cent up in the three months to January 2004 compared with the previous three months, double the rate of growth recorded for the same period in 2003. This has corresponded with a broad strengthening of consumer confidence indicators. In February 2004, the composite measure of consumers' confidence was well above its long-run average, with households' sentiment in the outlook for the general economy having risen sharply since late last year.

Household debt

B61 The unexpected momentum of private consumption since early 2003 has been accompanied by continued growth in household borrowing at historically high rates. In the three months to January 2004, the stock of household debt was up by just over 13 per cent on a year earlier. However, this masks a pick-up in the growth of secured debt and significant cooling in the rate of consumer credit growth. Indeed, while secured lending grew at its fastest annual rate since mid-1989 in the final quarter of 2003, credit registered its weakest rise for nine years.

B62 Although the ratio of household debt to income has climbed to historically high levels, this needs to be viewed alongside developments in household assets. The ratio of household debt to total net wealth is currently estimated to be no higher than it was in 1995. Moreover, more than three quarters of the increase in household mortgage debt since early 2000 has been matched by the build-up of household holdings of money and deposits. This is consistent both with the view that much of mortgage equity withdrawal (MEW) over this period has been saved rather than used to finance spending, and with the relatively stable saving ratio in recent years. It also suggests that the risk of moderation in house price inflation and sharply lower MEW leading to faltering consumer spending growth should not be overstated. In any case, despite strong increases in MEW, households' equity in housing has continued to build up: equity is estimated to have risen recently to three quarters of house values, which is high by historical standards. This reduces the likelihood of MEW coming rapidly to an end.

B63 The relative stability of the household saving ratio over the past six years, around an average rate of about 5¾ per cent, is perhaps surprising in view of the rise in the ratio of household gross wealth to income over the same period, which might have been expected to reduce the motive to save out of current income.

Prospects

B64 Despite its recent strengthening in momentum, real household consumption growth in 2004 is forecast to remain comfortably below the rates seen over much of the period between 1996 and 2002. Monetary policy has already been tightened, and with household debt remaining at relatively high levels, and disposable income growth having moderated, consumers' appetite for additional net borrowing can be expected to moderate. Private consumption is forecast to rise by 3 to 3¼ per cent this year and 2¼ to 2¾ per cent in both 2005 and 2006. The saving ratio is expected to remain broadly stable over the forecast horizon.

Companies and investment

Business investment

B65 Latest business investment data tentatively suggest that corporate sector capital expenditure has picked up following a protracted period during which global uncertainty held back investment plans. Business investment rose by 1.3 per cent between the third and fourth quarters of 2003 and stood 0.6 per cent higher than in the final quarter of the previous year – the first time annual growth has turned positive for nine quarters. Moreover, nominal spending on computer hardware and software also rose over the final quarter, increasing by around 7½ per cent.

B66 In the past, business investment has tended to lag the turnaround in GDP, so it is perhaps unsurprising that companies have only recently increased capital expenditure. However, past experience also suggests that once business investment enters into a recovery phase it can often increase more rapidly than expected and temporarily at rates well above the rate of output growth.

Table B6: Gross fixed capital formation

	Percentage changes on previous year			
		Forecast		
	2003	2004	2005	2006
Whole economy[1]	2½	5½ to 5¾	6½ to 7	4¼ to 4¾
of which:				
Business[2,3]	–1	3½ to 4	5½ to 6¼	4¾ to 5¼
Private dwellings[3]	11¼	5½ to 5¾	3¼ to 3¾	1½ to 2
General government[3,4]	19	17	18	6¾

[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.*

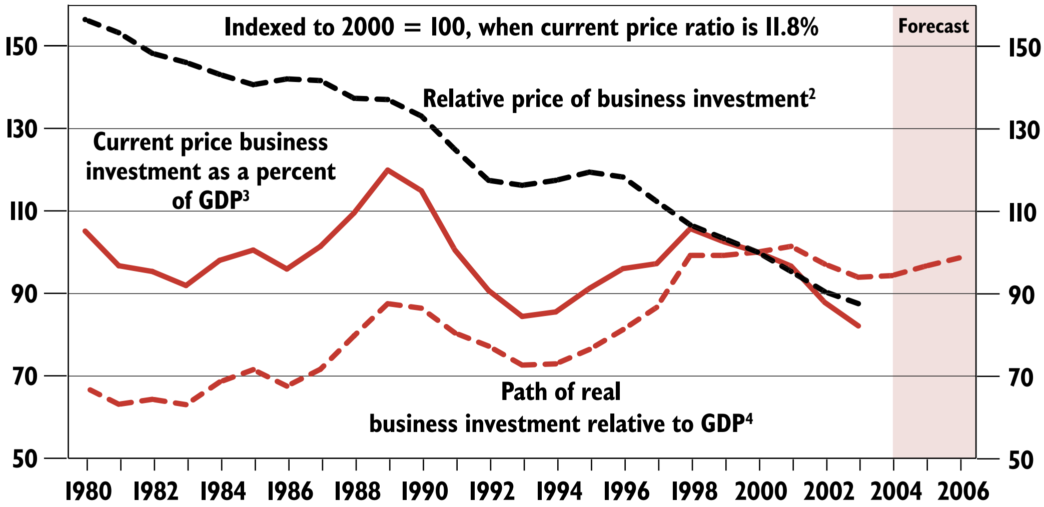
[4] *Includes National Health Service Trusts.*

B67 Business surveys provide firmer evidence that a more significant pick-up in business investment may now be beginning to emerge. The BCC survey for the final quarter of 2003 suggests investment intentions are rising in nearly every region and country of the UK, with only Scottish manufacturers reporting a decline in expected spending on plant and machinery. Within manufacturing, the North East and Yorkshire and Humberside reported particularly robust plans to step up capital expenditure, while the East and West Midlands recorded the strongest investment intentions within the service sector. The BCC survey also showed service sector companies' plans to invest in new plant and machinery at their highest since the beginning of 2001. Moreover, manufacturers' investment intentions rose to their highest level for six years. The January CBI Industrial Trends Survey pointed to a strengthening of investment plans in the manufacturing sector too.

B68 There has been debate recently on whether corporate pension fund deficits may serve as a brake on investment. As equity prices declined over the three years or so to early 2003, large deficits were incurred on many defined benefit schemes. For large companies that have ready access to external finance, these deficits should not threaten clearly profitable investment projects, though more marginal projects might be deterred if internal funds get diverted into pension funds because internal finance is cheaper than external finance. Cash flow constraints are likely to be more binding on investment by small and medium-sized enterprises where recourse to external finance is a less viable option. However, serious pension fund deficits tend to be concentrated amongst larger companies.

B69 In any case, for many funds the issue can be addressed through gradual adjustment, rather than immediate correction; and the 30 per cent rise in equity prices since their trough in March 2003 has boosted the value of fund assets. Rising bond yields over the same period will have partly offset this effect by depressing the value of bonds within pension funds' asset portfolios. However, rising bond yields will also have lowered the discounted present value of fund liabilities. Overall there seems little doubt that the net effect of movements in bond and equity prices over the past 12 months has been to reduce deficits. Chapter 5 describes the action the Government is taking to improve the availability and quality of statistics on pension fund deficits.

Chart B7: Business investment[1]



[1] Business investment includes investment by public corporations (except National Health Service Trusts) and investment under the Private Finace Initiative.
[2] Ratio of implied business investment deflator to GDP deflator.
[3] Ratio of business investment to GDP in current prices.
[4] Ratio of business investment to GDP in chained volume measures.

Prospects

B70 Business investment is forecast to accelerate over this year and into 2005. With demand already having strengthened and business expectations rising, firms can be expected to become significantly more confident about committing to increased investment expenditure. Improvements in company balance sheets since the late 1990s' ICT boom, allied with continued sound fundamentals, also offer solid foundations for the corporate sector to step-up investment plans, with private non-financial corporations now having been net lenders for six consecutive quarters. Profitability has already picked up: rates of return outside of the UK Continental Shelf stood at 11.7 per cent in the third quarter of 2003, compared with a recent trough of 10.4 per cent at the end of 2002. Moreover, the share of corporate profits in national income has risen in recent quarters and, at a little over 25 per cent, was at its highest since the start of 2000 in the final quarter of last year. Business investment is forecast to rise by 3½ to 4 per cent in 2004 and by 5½ to 6¼ per cent in 2005.

B71 General government investment is estimated to have risen 19 per cent in 2003, the fastest annual rate of growth for 13 years. With government investment expected to continue growing strongly, in line with the Government's spending plans, whole economy fixed capital formation is expected to grow significantly faster than private consumption and GDP in all forecast years.

Trade and the balance of payments

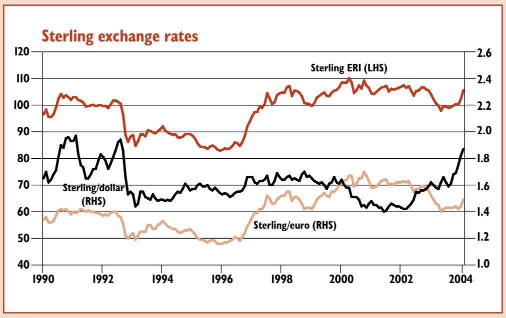
Goods exports

B72 There are tentative signs emerging that the strengthening of the world economic environment is already feeding through to increased external demand for UK goods and services. Movements in goods export volume data have been distorted since 2002 by HM Customs and Excise having made significant progress in tackling VAT MTIC fraud, with several firms having ceased operations, resulting in a sharp drop in illicit exports. Excluding MTIC trade, UK export volumes of goods rose over 9 per cent in the year to the final quarter of 2003, the fastest growth since late 2000. In addition, the recent move by HM Customs and Excise to an electronic system of recording non-EU exports, from a previously paper-based system, may have made appropriate seasonal adjustment more difficult in the short term.

Box B6: Implications of recent movements in the sterling exchange rate

Although the overall sterling exchange rate index (ERI) is currently close to levels prevailing two years ago, this masks divergent movements within the basket of currencies that make up the ERI. Compared with early 2002, sterling has risen by around a quarter against the US dollar, and has recently been trading at close to an eleven-year high. By contrast, sterling has weakened by around 10 per cent against the euro, and is not far from its lowest level since the single currency's inception in January 1999. Moreover, with UK inflation having been consistently below the euro area average in recent years, sterling has weakened by even more against the euro when measured in real terms.

Movements in exchange rates have implications for UK trade flows. The euro area is by far the UK's largest single trading partner, accounting for approximately 50 per cent of all UK trade in goods and services, compared with just 15 per cent of trade with the US. The depreciation of sterling relative to the euro over the past two years is therefore expected to provide a significant boost to the UK's exports to the euro area, although domestic demand in euro member states will also be an important factor in determining near-term prospects. At the same time, the rise in sterling against the US dollar is likely to dampen export demand from the US although, thus far at least, robust US GDP growth has tended to obscure any effects. With many emerging market currencies linked to the US dollar, these impacts are likely to extend to trade with some third countries.



However, compositional differences between the UK's trade patterns with the EU and US suggest that recent exchange rate movements could have different impacts on the UK's goods and services sectors. Around 55 per cent of all UK goods exports are destined for euro area markets, almost four times the share of goods exports to and imports from the US. Yet the euro area only accounts for around a third of UK services export trade, while the US accounts for a quarter, significantly above the US share in goods. Only around a fifth of total UK exports to the euro area is in services, against 45 per cent of exports destined for the US. Goods exporters, including manufacturers, are likely to receive a proportionately greater boost from sterling's depreciation against the euro, while services firms may incur a relatively bigger impact from the pound's strengthening against the US dollar. Nonetheless, the UK is the second largest exporter of services in the world, and underlying competitive advantages should allow service firms to prove resilient to increased pressure in dollar-denominated markets.

Exchange rate movements also have potential implications for relative prices and inflationary pressures. A weaker exchange rate tends to raise the sterling price of imports and exports, with domestic firms, at least in the short term, capturing some of the improved competitiveness through higher margins. A stronger exchange rate typically has the opposite effects, and there is already evidence that recent movements in bilateral exchange rates are having an impact on trade pricing. For example, while both goods export and import prices to non-EU countries fell in 2003, export prices to the EU rose at their fastest rate for a decade, with import prices rising at their sharpest rate for eight years.

Table B7: Trade in goods and services

	Percentage changes on previous year					£ billion
	Volumes		Prices[1]			
	Exports	Imports	Exports	Imports	Terms of trade[2]	Goods and services balance
2003	–1/2	3/4	1 1/4	1/2	3/4	–33 1/4
Forecast						
2004	5 1/4 to 5 1/2	5 1/2 to 6	1 1/2	1 1/4	1/4	–35 3/4
2005	6 3/4 to 7 1/4	6 to 6 1/2	3	2 3/4	1/4	–35 3/4
2006	6 1/4 to 6 3/4	5 3/4 to 6 1/4	2 3/4	2 3/4	0	–36 1/4

[1] *Average value indices.*
[2] *Ratio of export to import prices.*

B73 The pattern of UK goods exports over the past year or so appears broadly consistent with the recent composition of growth amongst industrialised nations. Export volume growth to the rest of the EU appears to have been further held back by relatively weak EU GDP growth over much of 2003. Excluding MTIC trade, goods exports to the EU in the final quarter of 2003 are estimated to have stood around 4 per cent lower than a year earlier. By contrast, exports to non-EU economies have picked up, with goods exports already having surpassed levels reached at the onset of the global downturn in 2001. For example, in value terms, goods exports to the US rose by almost 15 per cent in the year to the final quarter of 2003.

B74 The pick-up in external demand seen so far appears to be feeding through to nearly every region and country of the UK. The BCC survey for the final quarter of 2003 showed that every region except Yorkshire and Humberside recorded growth in export sales, with Scotland recording the strongest balance. Moreover, the survey pointed to further export growth going forward, with export orders rising in every region except Wales, and particularly strong readings from the South East and Scotland. Despite the latest CBI/Experian survey reporting a slightly different regional balance, it also suggested that the sharpest turnaround in export demand was experienced in Scotland.

Services exports

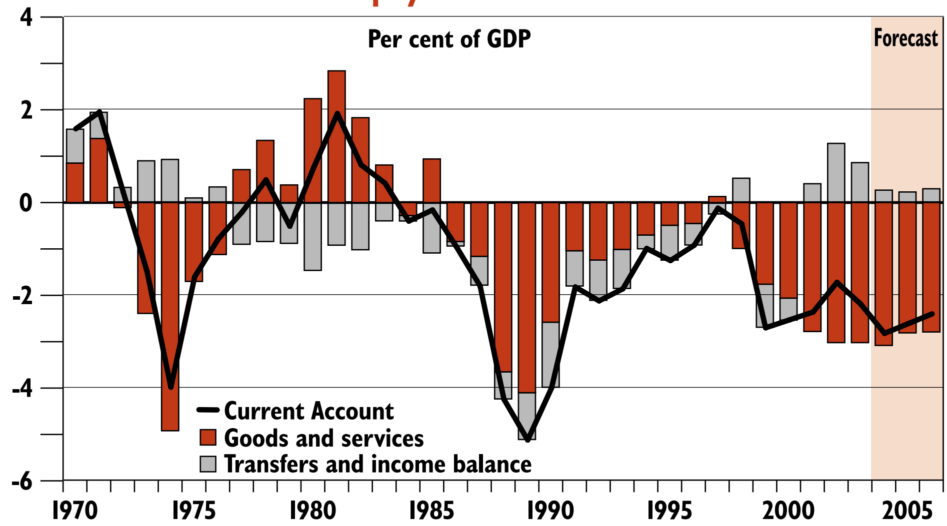
B75 Exports of services too appear to have been boosted by strengthening global conditions in recent months. In the first half of 2003, services export volumes were adversely affected by heightened global uncertainty, and declined for three consecutive quarters between the end of 2002 and mid-2003. Indeed, with the exception of the third quarter of 2001, when the effects of the events of 11 September 2001 had their most direct impact on travel, the UK registered its lowest surplus on trade in services for over seven years in the second quarter of 2003. More recent months suggest the easing of international uncertainties and rising external demand have given a renewed boost to services exports. Overseas visitors have become less reluctant to travel, increasing demand in tourism-related industries, while financial and business services exports have also increased following the drop in demand that corresponded with global uncertainties in early 2003.

Sterling ERI

B76 The sterling ERI has strengthened a little since the 2003 Pre-Budget Report. This mainly reflects further rises in sterling's exchange rate with the US dollar, which has recently been trading at around an eleven year high. Sterling has been relatively more stable against the euro, but remains significantly weaker in relation to it than for most of the first four years of the euro's existence. Recent exchange rate developments are discussed in more detail in Box B6.

Overseas income **B77** The UK's surplus on overseas income declined in 2003, albeit from unusually high levels. Despite global economic weakness, the UK income surplus was at a record level in the first quarter of 2003 as high oil prices boosted earnings of UK petroleum companies' overseas operations, and financial market volatility hampered profitability of overseas institutions based in the City of London. It has subsequently moderated as these temporary influences have waned, although it remains substantially in surplus.

Chart B8: Balance of payments current account



Prospects **B78** Looking forward, export volumes are expected to accelerate over coming months. The strengthening of the world economy, and the corresponding pick-up in world trade growth, should make itself increasingly felt in external demand through this year and next, giving a significant boost to UK export growth. At the same time, the lagged effects of sterling's weakening against the euro since 2002 are likely to give an additional fillip to UK exports over the period ahead. However, against this, the recent weakness of the US dollar may dampen demand growth from the US and other smaller economies whose currencies are linked to that of the US.

B79 Projected surpluses on overseas income, albeit at more modest levels than seen over recent years, are expected partly to counter continued deficits on trade. Relative to GDP, the current account deficit is expected to remain modest compared to historical peaks, stabilising at around 2½ per cent of GDP from next year.

Independent forecasts

B80 At the time of last year's Budget, independent forecasts for 2004 UK GDP growth averaged 2.4 per cent, and the average remained at that level through to August 2003, with new forecasts that month averaging slightly less, at 2.3 per cent. This was well below the Budget 2003 forecast range of 3 to 3½ per cent, with only 8 per cent of forecasters at the time falling within that band.

B81 Since last summer, over 90 per cent of forecasters included in the comparison have revised up growth projections for 2004. The independent average has consequently risen to reach 3.0 per cent, consistent with the unchanged Budget forecast range of 3 to 3½ per cent for the first time, while the average of new forecasts made in the past month is a little higher than the overall consensus, at 3.1 per cent. Almost two thirds of forecasts included in the comparison are now within or above the Budget range.

B82 The independent average forecast for CPI inflation in 2004 is 1.6 per cent, but rises to only fractionally below the Government's symmetrical 2 per cent target in 2005.

Table B8: Budget and independent[1] forecasts

	Percentage changes on a year earlier unless otherwise stated					
	2004			2005		
		Independent			Independent	
	March Budget	Average	Range	March Budget	Average	Range
Gross domestic product	3 to 3½	3.0	2.4 to 3.8	3 to 3½	2.6	0.4 to 3.5
CPI (Q4)	1¾	1.7	1.2 to 2.3	2	1.9	1.2 to 2.7
Current account (£ billion)	–32¾	–27.3	–37.4 to –18.0	–32	–28.3	–53.2 to –10.0

[1] '*Forecasts for the UK Economy: A Comparison of Independent Forecasts*', March 2004.

Forecast risks

B83 Risks on the upside and downside have changed little since the time of the 2003 Pre-Budget Report. In particular, a number of ongoing risks and uncertainties to the world economy would, if realised, influence the UK. Although the US dollar's decline against some other major currencies in recent months has continued to be orderly, large global imbalances mean that much sharper movements in major exchange rates cannot be ruled out. UK external demand also faces downside risk from world labour markets, which have generally remained weak despite strengthening G7 GDP growth. However, after several years of relatively subdued activity, pent-up demand may prompt a sharper bounce in UK export markets' growth than currently assumed.

B84 In the UK, downside risks continue to be associated with the outlook for consumer spending. While the forecast allows for a moderation in the growth of private consumption, expenditure could undergo a sharper than expected correction if, for example, house prices were to decline significantly or the world economy were to suffer a negative shock.

B85 On the upside, the pick-up in growth seen since early 2003 could prove stronger than expected in the short term. In particular, business investment has, in the past, tended to surprise on the upside once into an upswing, and private sector capital expenditure could once more turn out stronger than forecast over the projection period. Similarly, private consumption could again prove to have more near-term momentum than envisaged in the Budget forecast, although this would raise the risk of a sharp correction in the opposite direction further out.

Table B9: Summary of economic prospects[1, 2, 3]

	Percentage changes on a year earlier unless otherwise stated					
		Forecast[4]			Average errors from past forecasts[5]	
	2003	2004	2005	2006	2004	2005
Output at constant market prices						
Gross domestic product (GDP)	2¼	3 to 3½	3 to 3½	2½ to 3	¾	½
Manufacturing output	¼	1½ to 2	1¾ to 2¼	1¾ to 2¼	1¼	2
Expenditure components of GDP at constant market prices[6]						
Domestic demand	2¾	3¼ to 3½	3 to 3½	2½ to 3	½	¾
Household consumption[7]	3	3 to 3¼	2¼ to 2¾	2¼ to 2¾	½	1
General government consumption	2	2¼	2½	2½	¾	1
Fixed investment	2½	5½ to 5¾	6½ to 7	4¼ to 4¾	1¾	1¾
Change in inventories[8]	0	0	0	0	¼	¼
Exports of goods and services	–½	5¼ to 5½	6¾ to 7¼	6¼ to 6¾	2¼	3½
Imports of goods and services	¾	5½ to 6	6 to 6½	5¾ to 6¼	2¼	2¾
Balance of payments current account						
£ billion	–24	–32¾	–32	–31¼	7½	9½
per cent of GDP	–2¼	–2¾	–2½	–2½	¾	¾
Inflation						
CPI (Q4)	1½	1¾	2	2	–	–
Producer output prices (Q4)[9]	1½	2¼	2	2	1	1½
GDP deflator at market prices	3	2¼	2½	2¾	¼	¾
Money GDP at market prices						
£ billion	1100	1160 to 1164	1226 to 1236	1291 to 1308	9	9
percentage change	5½	5½ to 5¾	5¾ to 6¼	5¼ to 5¾	¾	¾

1 *The forecast is consistent with output, income and expenditure data for the fourth quarter of 2003 released by the Office for National Statistics on 25 February 2004. See also footnote 1 on the first page of this chapter.*

2 *All growth rates in tables throughout this chapter are rounded to the nearest ¼ percentage point.*

3 *As in previous Budget and Pre-Budget Reports, the economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral 2¾ per cent assumption for the trend rate of output growth. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of 2½ per cent a year trend growth used as the basis for projecting the public finances.*

4 *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.*

5 *Average absolute errors for year-ahead projections made in spring forecasts over the past ten years. The average errors for the current account are calculated as a percent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2004 and 2005.*

6 *Further detail on the expenditure components of GDP is given in Table B10.*

7 *Includes households and non-profit institutions serving households.*

8 *Contribution to GDP growth, percentage points.*

9 *Excluding excise duties.*

Table B10: Gross domestic product and its components

		£ billion chained volume measures at market prices, seasonally adjusted								
		Household consumption[1]	General government consumption	Fixed investment	Change in inventories	Domestic demand[2]	Exports of goods and services	Total final expenditure	*Less* imports of goods and services	*Plus* statistical discrepancy[3]	GDP at market prices
2003		687.1	189.6	174.4	1.5	1052.6	271.3	1323.9	313.7	0.9	1011.1
2004		708.0 to 710.2	193.7	183.8 to 184.4	1.7 to 2.3	1087.2 to 1090.5	285.7 to 286.6	1372.9 to 1377.1	331.1 to 332.1	0.8	1042.6 to 1045.8
2005		723.5 to 729.2	198.6	195.8 to 197.3	1.9 to 3.5	1119.7 to 1128.6	305.2 to 307.6	1424.9 to 1436.2	350.6 to 353.4	0.8	1075.1 to 1083.6
2006		739.4 to 748.9	203.8	203.9 to 206.5	1.2 to 3.8	1148.2 to 1163.0	324.6 to 328.8	1472.8 to 1491.7	370.3 to 375.1	0.8	1103.2 to 1117.4
2003	1st half	339.8	94.3	86.1	0.9	521.2	135.9	657.1	156.1	0.5	501.4
	2nd half	347.2	95.4	88.3	0.6	531.4	135.4	666.8	157.5	0.4	509.7
2004	1st half	352.2 to 352.8	96.4	90.4 to 90.6	0.8 to 0.9	539.8 to 540.7	140.3 to 140.6	680.1 to 681.3	163.0 to 163.3	0.4	517.4 to 518.4
	2nd half	355.9 to 357.4	97.3	93.4 to 93.8	0.9 to 1.3	547.5 to 549.8	145.4 to 146.0	692.8 to 695.8	168.0 to 168.7	0.4	525.2 to 527.4
2005	1st half	359.7 to 362.1	98.7	96.5 to 97.2	0.8 to 1.5	555.7 to 559.5	150.2 to 151.2	705.9 to 710.7	172.9 to 174.0	0.4	533.5 to 537.1
	2nd half	363.7 to 367.1	99.9	99.2 to 100.1	1.0 to 2.0	563.9 to 569.1	155.0 to 156.4	718.9 to 725.5	177.7 to 179.3	0.4	541.6 to 546.6
2006	1st half	367.7 to 371.9	101.3	101.2 to 102.3	0.7 to 1.9	570.8 to 577.4	159.8 to 161.7	730.6 to 739.1	182.6 to 184.8	0.4	548.4 to 554.7
	2nd half	371.7 to 376.9	102.5	102.7 to 104.2	0.5 to 2.0	577.4 to 585.6	164.7 to 167.1	742.2 to 752.6	187.7 to 190.3	0.4	554.9 to 562.7
						Percentage changes on previous year[4,5]					
2003		3	2	2½	0	2¾	–½	2	¾	0	2¼
2004		3 to 3¼	2¼	5½ to 5¾	0	3¼ to 3½	5¼ to 5½	3¾ to 4	5½ to 6	0	3 to 3½
2005		2¼ to 2¾	2½	6½ to 7	0	3 to 3½	6¾ to 7¼	3¾ to 4¼	6 to 6½	0	3 to 3½
2006		2¼ to 2¾	2½	4¼ to 4¾	0	2½ to 3	6¼ to 6¾	3¼ to 3¾	5¾ to 6¼	0	2½ to 3

[1] *Includes households and non-profit institutions serving households.*

[2] *Also includes acquisitions less disposals of valuables.*

[3] *Expenditure adjustment.*

[4] *For change in inventories and the statistical discrepancy, changes are expressed as a percent of GDP.*

[5] *Growth ranges for GDP components do not necessarily sum to the ½ percentage point ranges for GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.*