

The UK economy grew by $2\frac{3}{4}$ per cent in 2006, as forecast in the 2006 Pre-Budget Report, and has now expanded for 58 consecutive quarters, the longest unbroken expansion on record. The rebalancing of domestic demand gathered pace during 2006, with business investment ending the year growing at the fastest rate for eight years. In its latest report on the UK, the IMF described this recent macroeconomic performance as “impressive”.

The world economy grew at 5 per cent in 2006, a faster rate than at any time since 1990, and is expected to remain strong in 2007. With the G7, and particularly the euro area economies, recording stronger growth in the final quarter of 2006, the outlook for UK export market growth in 2007 appears slightly stronger than at the time of the Pre-Budget Report. This should support the rebalancing of domestic and external demand in the UK.

Following five consecutive quarters of slightly above-trend growth, the UK economy is estimated to have ended 2006 operating close to its trend level, although there remains evidence of some slack in the labour market. As expected, the temporary rise in unemployment during 2006 has abated, with the claimant count measure falling in seven of the past eight months and the broader Labour Force Survey measure falling in the final quarter of the year.

Inflation has risen further since the 2006 Pre-Budget Report, with the rise continuing to be largely attributable to energy and food prices. The contribution of energy prices to overall inflation is expected to fall quite sharply during 2007. Despite inflation having moved above target, monetary policy has kept inflation expectations firmly anchored and earnings growth has remained subdued.

The Budget 2007 economic forecast is little changed from that of the 2006 Pre-Budget Report:

- GDP is forecast to grow by $2\frac{3}{4}$ to $3\frac{1}{4}$ per cent in 2007. With the small negative output gap expected to have closed early in 2007, growth is expected to remain close to trend at $2\frac{1}{2}$ to 3 per cent in 2008 and 2009; and
- CPI inflation is expected to return to target in the second half of 2007.

INTRODUCTION^{1,2}

B.1 This chapter discusses recent economic developments and provides updated forecasts for the UK and world economies in the period to 2009. It begins with an overview of developments and prospects in the world economy, which sets the global context for recent developments and prospects in the UK. It then outlines the UK economic forecast, before concluding with a more detailed discussion of sectoral issues, the components of growth and risks surrounding the forecast.

¹ The UK forecast is consistent with output, income and expenditure data to the fourth quarter of 2006 released by the Office for National Statistics (ONS) on 23 February 2007. This release also contained revisions to earlier quarters of 2006, which the Treasury has carried through to other National Accounts series that the ONS has not yet revised, in particular sectoral saving and borrowing. A fully consistent National Accounts dataset to the fourth quarter will be published by the ONS on 28 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>). 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.

THE WORLD ECONOMY

Overview

B.2 The world economy grew at a faster rate in 2006 than at any time since 1990, with GDP growth of 5 per cent, reflecting a pick-up in G7 activity and continued strength in emerging markets. This was the third consecutive year of growth around 5 per cent. Global growth is expected to slow slightly in 2007, though to remain high by historical standards at $4\frac{3}{4}$ per cent.

B.3 Since 2003, world output growth has been driven by the US and Asia, particularly China. In 2006, GDP growth in the US remained above trend, despite a considerable contraction in residential investment. The euro area recovery strengthened and became more broad-based, while growth in Japan remained firm. In 2007, G7 activity is expected to moderate towards trend rates. Growth in the emerging markets is expected to ease somewhat from the very high rates of recent years.

Table BI: The world economy

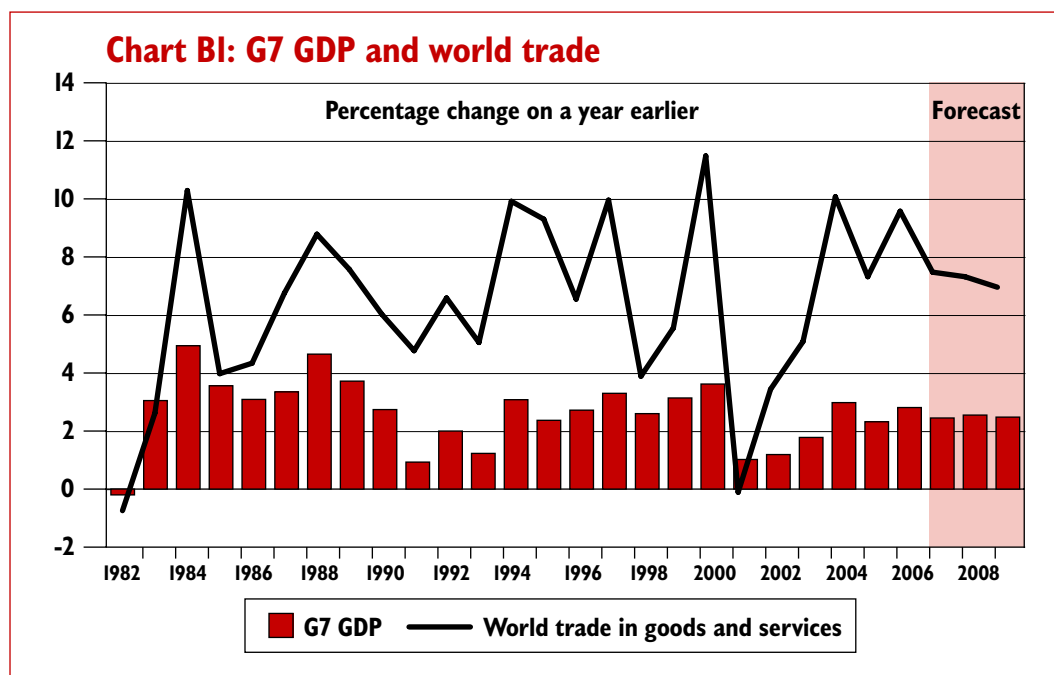
	Percentage change on a year earlier, unless otherwise stated			
	2006	Forecast		
		2007	2008	2009
World GDP	5	$4\frac{3}{4}$	$4\frac{3}{4}$	$4\frac{1}{2}$
<i>Major 7 countries¹:</i>				
Real GDP	$2\frac{3}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$
Consumer price inflation ²	$1\frac{1}{2}$	2	2	2
Euro area GDP	$2\frac{3}{4}$	$2\frac{1}{4}$	$2\frac{1}{4}$	$2\frac{1}{4}$
World trade in goods and services	$9\frac{3}{4}$	$7\frac{3}{4}$	$7\frac{1}{2}$	7
UK export markets ³	$8\frac{1}{2}$	7	$6\frac{1}{2}$	$6\frac{1}{4}$

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 the importance of imports from the UK in those countries' total imports.

B.4 World trade growth has recovered strongly over the past five years, rising from zero growth in 2001 to $9\frac{3}{4}$ per cent in 2006. The weaker path of US GDP growth since the second quarter of 2006 has not resulted in a softening of world trade growth. This is because the moderation in US demand has been largely contained to residential investment, while final demand in Asia and Europe has remained strong. Against this background, only a modest slowdown in world trade growth is forecast.



B.5 In recent years, persistent gaps between domestic demand and production growth across regions of the world have coincided with a widening of current account imbalances. In particular, the US current account deficit in 2006 reached 6½ per cent of GDP, while across Asia, parts of Europe and the oil-producing countries, surpluses have grown large. The risk of a disorderly unwinding of global current account imbalances remains, but there have been some recent signs of rebalancing. Exchange rate adjustment is ongoing, with the dollar having fallen around 20 per cent in real terms over the past five years and the euro having risen by a similar amount, while more recently the balance of world growth has shifted slightly towards Europe.

B.6 Recent falls in headline inflation rates in the G7 have reflected developments in energy prices. Core inflation has remained broadly stable, and low by historical standards. Monetary authorities across the developed world have continued to respond to inflationary pressures. Since the 2006 Pre-Budget Report, interest rates have been raised by the Bank of England, the Bank of Japan and the European Central Bank.

B.7 After the 2006 Pre-Budget Report, asset prices around the world continued to rise strongly, with a number of stock markets reaching all-time highs. However, in some less liquid, more specialised credit markets, the price of risk began to rise. Since late February, global financial markets have experienced a period of volatility. It is too early to draw conclusions as to what has driven recent financial market movements. It is possible that the period of volatility will be brief, similar to that in May and June 2006, but it is also possible that it could reflect a reaction to a general under-pricing of risk, a factor that has been highlighted by, among others, the Governor of the Bank of England.³ The risk from such a correction becoming sustained remains, and is discussed further in paragraph B.100.

G7 activity

B.8 GDP growth in the G7 picked up in 2006, to 2¾ per cent from 2¼ per cent in 2005. The expansion is expected to continue this year, albeit at a slightly more moderate pace of 2½ per cent.

³ See, for example, *Speech by Mervyn King, Governor of the Bank of England. At a dinner for Kent business contacts, 16 January 2006.* Available at: <http://www.bankofengland.co.uk/publications/speeches/2006/speech263.pdf>.

United States B.9 The US economy grew at an above-trend rate in 2006 despite a sharp fall in housing-related activity. New housing construction in the US is relatively sensitive to house prices, so the moderation in house price growth that began over a year ago was soon followed by a contraction in residential investment. Since the second half of 2005, the negative contribution to GDP growth from falling residential investment has been offset by solid growth in private consumption and business investment, which together account for over 80 per cent of demand in the US economy. Net trade made a small positive contribution to GDP growth in 2006, supported by the effect of a weaker dollar and strong world demand.

B.10 Growth in 2006 as a whole, at $3\frac{1}{4}$ per cent, was slightly stronger than in 2005, but growth eased through the year. More moderate rates of growth are set to continue in 2007, largely as was expected at the time of the 2006 Pre-Budget Report. Continued solid gains in the labour market, particularly via service sector employment, and rising real incomes should support consumption growth. Business investment growth is expected to moderate in 2007, from the six-year high reached in 2006. Finally, a mildly more positive outlook for net exports in the US should feed through to GDP growth.

Euro area B.11 Growth in the euro area continued to strengthen during 2006, supported by a solid pick-up in business investment and, to a lesser extent, private consumption. Strong job creation, most notably in the finance and business services sector, helped to drive down the unemployment rate by close to 1 percentage point in 2006. The euro area unemployment rate has fallen to its lowest level since the inception of the euro in 1999, though it remains high by international standards. The broadening of growth towards domestic demand has been accompanied by rising rates of import growth in by far the UK's largest export market.

B.12 Within the euro area, there has been a rebalancing of growth among Member States. Growth in Germany, Europe's largest economy, has picked up to its fastest rate since 2000. Revisions to euro area National Accounts data, alongside strong growth in the fourth quarter, suggest the economy is carrying more momentum into 2007 than was apparent at the time of the 2006 Pre-Budget Report. With euro area trend growth generally estimated to be around 2 per cent, growth of $2\frac{3}{4}$ per cent in 2006 represents a cyclical upswing. Over the forecast horizon, the recovery is expected to continue, albeit at rates of growth that are closer to trend. Fiscal consolidation measures, particularly in Germany, but also in Italy, are expected to slow domestic demand growth temporarily in these countries in the first half of 2007.

Japan B.13 Extensive revisions to Japan's National Accounts data in December 2006 led to significant changes in the measured level and composition of GDP growth. The economy is now estimated to have grown by $2\frac{1}{4}$ per cent in 2006, up only slightly from 2 per cent in 2005, with exports and business investment continuing to provide most of the momentum. Private consumption growth slowed in line with weaker real income growth, despite continued low rates of unemployment. In 2007, the Japanese economy is expected to grow slightly above its trend rate, which is generally estimated to be between $1\frac{1}{2}$ and 2 per cent.

Box B1: Government policy on EMU

The Government's policy on membership of the single currency was set out by the Chancellor in his statement to Parliament in October 1997. In principle, the Government is in favour of UK membership; in practice, the economic conditions must be right. The determining factor is the national economic interest and whether, on the basis of an assessment of the five economic tests, the economic case for joining is clear and unambiguous. An assessment of the five economic tests was published in June 2003. This concluded that: *"since 1997, the UK has made real progress towards meeting the five economic tests. But, on balance, though the potential benefits of increased investment, trade, a boost to financial services, growth and jobs are clear, we cannot at this point in time conclude that there is sustainable and durable convergence or sufficient flexibility to cope with any potential difficulties within the euro area."*

The Chancellor's statement to the House of Commons on 9 June 2003 on UK membership of the European single currency set out a reform agenda of concrete and practical steps to address the policy requirements identified by the assessment. The Budget reports on progress including:

- the introduction in December 2003 of a symmetric inflation target as measured by the Consumer Prices Index (CPI). CPI inflation has been within 1 percentage point of its target since its inception;
- reforms to increase housing supply and measures to improve consumer access to housing finance, described further in Chapter 3; and
- reforms at national, regional and local level to enhance the flexibility of labour, capital and product markets in the UK. Chapters 3 and 4 provide further detail.

As part of the policy of 'prepare and decide', the Government coordinates appropriate euro preparations across the UK economy. The Government also supports business in dealing with the euro as a foreign currency. Further information is available on the Treasury's euro website (www.euro.gov.uk).

On the Stability and Growth Pact, the Government continues to emphasise the need for a prudent interpretation of the Pact as described in Budget 2006. The reforms to the Pact agreed in March 2005 rightly place a greater focus on the avoidance of pro-cyclical policies, and on achieving low debt levels and thereby enhancing the long-term sustainability of public finances, with the flexibility for low debt countries such as the UK to invest in the provision of much needed public services. The Government continues to work closely with Member States and EU institutions, as the success of the reforms will depend on how they are implemented. It is also essential to recognise the importance of national frameworks and national ownership of fiscal policy.

In his statement to the House of Commons on 9 June 2003, the Chancellor committed the Government to an annual review of progress. The Government does not propose a euro assessment to be initiated at the time of this Budget. The Treasury will again review the situation at Budget time next year, as required by the Chancellor's June 2003 statement.

Emerging markets and developing economies

B.14 Emerging market economies continued to grow rapidly during 2006, supported by strong trade growth, buoyed by the resilience of the US economy and, in some cases, high commodity prices. Despite recent financial market volatility, interest rate spreads on emerging market sovereign debt, a measure of the relative risk that investors associate with these countries, remain low, in part reflecting improved macroeconomic fundamentals. As the global environment remains supportive, emerging markets' GDP growth is expected to continue at high rates, although it is likely to moderate slightly in 2007.

Emerging Asia B.15 Growth in emerging Asia was at a 10-year high in 2006, buoyed by rapid expansions in China and India. Recent momentum is expected to continue in 2007.

China B.16 In 2006, the Chinese economy grew by almost 11 per cent, slightly above market expectations, and contributing around a third of world growth.⁴ There are some signs that private consumption growth is picking up, although investment remains the largest contributor to GDP growth. Net exports provided a positive contribution to growth in 2006, as China's trade surplus continued to expand rapidly. Inflation picked up to 2.7 per cent in February 2007, from 0.9 per cent a year earlier, partly as a result of higher food prices. The Chinese Government has continued to implement measures aimed at reining back rapid fixed investment and credit growth, including a series of increases to commercial banks' reserve requirements at the central bank.

India B.17 In India, GDP has been revised up significantly for the period between 2004 and 2006, and is now estimated to have grown at an average annual rate of close to 9 per cent. The combination of brisk consumer demand, strong credit growth, and industrial capacity constraints has resulted in a marked increase in inflation, to more than 6 per cent in February 2007. Economic growth in India is widely forecast to moderate towards more sustainable rates from 2007 onwards.

Russia B.18 In 2006, growth in Russia continued to be strong, with GDP expanding by more than 6 per cent for the fourth consecutive year. Consumption growth remained rapid, while investment surprised on the upside after recovering from the slowdown in 2005. High commodity prices continued to contribute to a large current account surplus. Inflation in Russia has eased, but remains relatively high at 8¼ per cent in the year to January 2007.

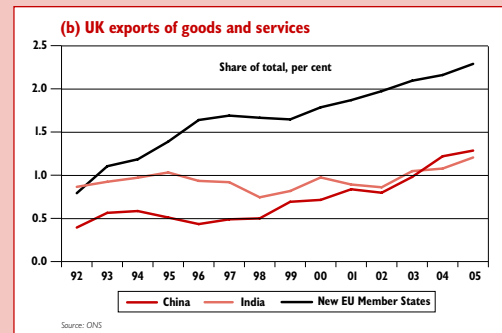
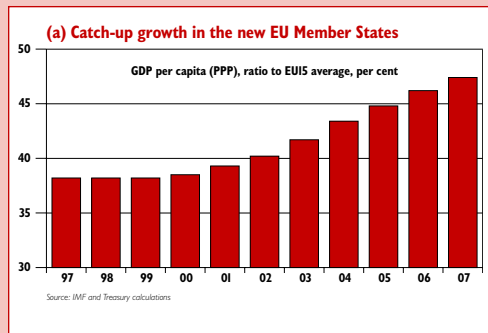
Emerging Europe B.19 As in the euro area, growth in emerging Europe in 2006 was slightly stronger than expected at the time of the 2006 Pre-Budget Report. Growth continues to be driven by strong domestic demand, boosted by the positive impact on trade from stronger euro area growth. The recent expansion has been accompanied by a moderate pick-up in inflation across the region.

⁴ China accounted for around a third of world GDP growth when the world's economies are weighted according to the 'purchasing power parity' (PPP) measure of their exchange rate, rather than market exchange rates. PPP exchange rates take account of the different prices of non-traded goods and services across countries – for example, a haircut or train journey will tend to be much cheaper in China than in the UK – and is therefore the appropriate measure when considering economic welfare. When weighted according to market exchange rates, a measure more appropriate for companies doing business across borders, China's share of world GDP growth is considerably lower.

Box B2: Growth in the new EU Member States

One of the marked features of European economic growth over the past decade is the rapid growth of the Central and Eastern European countries that recently joined the European Union (EU).^a Since 1996, growth in these new Member States, known as the accession 10 (A10), has averaged almost 4½ per cent a year, compared with 2¼ per cent in the ‘old’ EU Member States. The phenomenon of less mature economies, with lower per capita GDP, catching up with developed market economies, as in the EU (chart a), is a familiar one. In the case of the A10, the catch-up process followed economic reforms that started in the early 1990s, and are still ongoing. The reforms have supported growth by facilitating the reallocation of resources to more productive use. Importantly, they have raised the return to capital, which has encouraged strong investment, both domestic and foreign.

While clearly positive for the A10 countries themselves, this rapid growth also has positive implications for the UK. One obvious channel is through increased trade. A common tool used to analyse trade flows is the so-called gravity model, based on the intuition that trade between two countries will rise in line with geographical proximity, economic size and income levels. Such models do well in describing actual trade flows. Strong growth and rising income levels in the A10 should therefore be expected to be positive for UK exports. This is borne out by the evidence: the share of UK exports going to the A10 increased from less than 1 per cent in 1992 to 1½ per cent in 1999, and reached 2¼ per cent by 2005. In fact, UK exports to the A10 as a group have grown at a similar rate as those to China, and somewhat faster than those to India, and accounted for a larger share of UK exports in 2005 than either of those economies (chart b). Strong growth in the A10 also provides investment opportunities for UK companies: the stock of UK FDI in the A10 reached around £6 billion in 2005, while earnings on that investment approached £¾ billion.



^a The Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia joined in May 2004, along with Cyprus and Malta; Romania and Bulgaria joined in January 2007.

Latin America B.20 GDP growth in Latin America in 2006 was comfortably above its historical average. The downward trend for interest rates spreads on sovereign debt for the majority of Latin American countries continued in 2006. A number of countries took steps to reduce their external vulnerabilities by modifying their debt profiles. Inflation rates remain high in a number of countries, most notably Venezuela, where the rate increased to more than 20 per cent on a year earlier in February 2007.

Africa and the Middle East B.21 The latest estimates of growth in 2006 across Africa and the Middle East show GDP to have expanded at a rate above its historical average. As in recent years, strong global demand for oil and non-fuel commodities continued to drive economic activity. It is widely forecast that the region will continue to grow at similar rates in 2007.

World trade

B.22 Stronger than expected global economic activity over the past year has been reflected in world trade, which is now estimated to have grown by $9\frac{3}{4}$ per cent in 2006. World trade growth is expected to slow in 2007, to a rate of $7\frac{3}{4}$ per cent, with weaker contributions from all regions. From 2008 onwards, world trade is expected to grow at rates in line with the average of the past 20 years.

B.23 In parallel with developments in world trade, growth in UK export markets in 2006 was stronger than expected at the time of the 2006 Pre-Budget Report. The forecast for UK export market growth has also been revised up slightly from 2007 onwards, owing to stronger growth in the G7, and particularly the euro area economies which together account for 50 per cent of UK exports. While US demand has moderated, the impact on UK exports is expected to be limited since the moderation has been largely confined to residential investment.

B.24 World trade growth has been consistently stronger than UK export market growth in recent years due to the different composition of these two aggregates. Over the past four years, Asia contributed close to half of total world trade growth, but, given Asia's relatively small share in UK exports, only about a quarter of UK export market growth. The extent to which G7 economies have benefited from the recent growth boom in China and India has varied. Proximity and export composition explain the relatively high level of demand from China as a share of total demand for Japanese and German output, while on this score the UK ranks fourth in the G7. In the case of demand from India, the UK ranks first among the G7 countries, in part reflecting the relatively high share of services exports in the UK's trade with India. Other emerging economies are also important markets for the UK, in particular the new accession countries in Eastern Europe described in Box B2, which together currently represent a larger export market for the UK than either China or India.

Oil and commodity prices

B.25 Since the beginning of 2007, the price of a barrel of Brent crude oil, the European standard, has averaged around \$58, remaining below the average price in 2006 of \$66, but considerably above the 10-year average of around \$32.

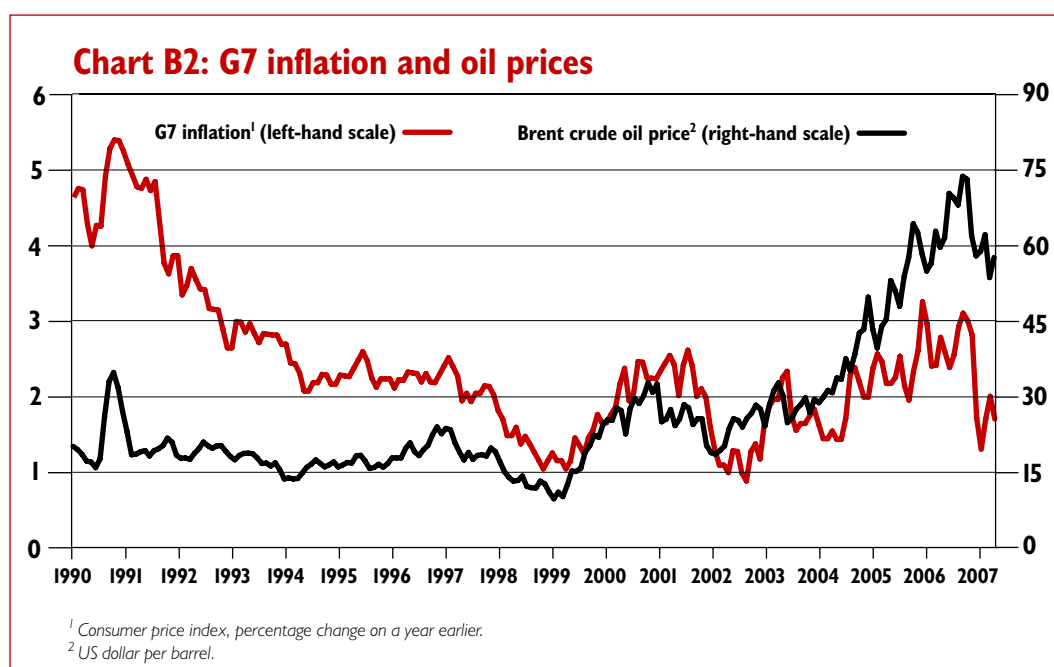
B.26 After the 2006 Pre-Budget Report, oil prices initially fell because of unusually warm winter temperatures in North America and Europe, before rebounding as normal weather conditions resumed and OPEC production cuts took effect. The average of independent forecasts for Brent oil prices in 2007 has fallen almost \$2 a barrel since December 2006, reflecting a slight easing of perceived market tightness as growth of supply is expected to outpace growth of demand. The outlook for oil prices remains sensitive to geo-political, regulatory and weather-related risks in the major producer and consumer nations.

B.27 Non-fuel commodity prices remain high. The major price indices for industrial metals, which, as noted in the 2006 Pre-Budget Report, tend to be positively correlated with the global business cycle, are currently at broadly similar levels to those prevailing at the time of the Pre-Budget Report. The price of some metals, notably lead, nickel and tin, have continued to rise strongly, while others, including copper and zinc, have eased from the peaks of 2006. Agricultural commodities also experienced significant price increases in the second half of 2006, particularly for grains and cattle. These increases coincided with rising food price inflation in a number of countries, including the UK.

G7 inflation

B.28 In recent months, movements in G7 headline inflation have reflected changes in energy prices, which have fallen from the high levels of a year ago. This downward effect has been most noticeable in the US, where the headline consumer price index is particularly sensitive to changes in oil prices. Favourable developments in energy prices have been somewhat offset by higher food prices across most G7 economies. In Japan, which suffered consumer price deflation between 1999 and 2005, negative headline inflation rates have been absent since May 2006.

B.29 Core inflation, excluding energy and food prices, remains elevated in the US, despite dipping briefly in the final quarter of 2006. In Europe, core inflation has picked up recently, though this partly reflects the 3 percentage point VAT increase in Germany in January 2007. Core inflation rates across the G7 are low by historical standards, while they remain negative in Japan.



THE UK ECONOMIC FORECAST

The Treasury's approach to economic forecasting

B.30 The Treasury's approach to forecasting macroeconomic developments accords with the 'growth cycle approach' favoured by many policymakers. At the heart of this approach is an estimate of the economy's 'trend' level and rate of growth, which provides the foundation for analysis of cyclical movements around that trend, the output gap, and developments in the components of demand. The Treasury's analysis of trend growth and the output gap is therefore central to the economic forecast that underpins the setting of fiscal policy. The trend growth assumption provides the medium-term anchor for the forecast. The current output gap estimate, and assessment of the economy's momentum through analysis of the individual income and expenditure components, inform judgement on the short-term path of the economy back to trend.

B.31 The Treasury assesses trend growth in the economy on the basis of non-oil gross value added (GVA) rather than overall GDP because, while the oil and gas sector affects output, it has little direct impact on capacity pressures in the rest of the economy, and hence the sustainable level of non-oil activity or employment.

B.32 The Office for National Statistics (ONS) compiles estimates of non-oil GVA in the National Accounts, but its trend level is not directly observable and must therefore be estimated. A wide variety of methods are available for decomposing the level of output into its trend and cyclical components.⁵ The Treasury's approach begins with the identification of 'on-trend' points, drawing on evidence from a broad range of economic indicators.⁶ The rate of trend output growth in completed past cycles is then estimated as the average growth rate between adjudged start and end-of-cycle on-trend points.

B.33 A different approach is required for estimating trend growth during the latest incomplete cycle and over the forecast horizon because the end-of-cycle on-trend point is in the future, and hence inherently uncertain. The Treasury's approach is to decompose the change in trend output over past cycles into changes in four components: output per hour; average hours worked per worker; the employment rate; and working-age population. The next section contains a discussion of developments in these components and how they inform the overall trend growth estimate since the 2001 on-trend point.

B.34 For any assumed trend rate of growth and trend level of output at a previous on-trend point, it is straightforward to calculate the size of the output gap implied by the latest National Accounts data on actual output. However, it is important to evaluate the plausibility of the output gap estimate implied by this 'trend growth arithmetic' by assessing the extent to which it is consistent with evidence from a broad range of cyclical indicators. Recent economic developments and an assessment of the cyclical indicators are discussed in the following sections.

B.35 The estimates of trend growth and the latest output gap provide the foundation for the detailed economic forecast. In the short term, the Treasury's judgement on the speed with which the economy will return to trend is informed by analysis of momentum in the key components of growth and their determinants, including assessment of the signals from private sector business survey-based indicators. Once the effects of any recent shocks are forecast to have dissipated and the economy is judged to have returned to trend, growth is generally held at its trend rate and the output gap at zero. That is not to suggest that the growth rate will actually be constant in later periods of the forecast, but rather that future shocks to the economy are as likely to be positive as negative so that, on average, the best forecast of growth once present shocks have worked through will be the trend rate.

Assessment of trend growth

B.36 The Treasury's neutral estimate of the economy's trend rate of growth of output for Budget 2007 remains at $2\frac{3}{4}$ per cent a year to the end of the projection period. This is unchanged from the 2006 Pre-Budget Report.⁷

⁵ See *Trend growth: recent developments and prospects*, HM Treasury, April 2002, and *Evidence on the UK economic cycle*, HM Treasury, July 2005, for further details of the Treasury's approach to estimating trend growth and a discussion of alternative approaches, including statistical filtering techniques and more explicit economic model-based methods.

⁶ Details of the indicators monitored by the Treasury can be found in the *Technical note on cyclical indicators*, HM Treasury, December 2005.

⁷ For a full discussion of the most recent review of the Treasury's trend growth projections see *Trend growth: new evidence and prospects*, HM Treasury, December 2006.

B.37 Table B2 presents historical estimates of trend output growth and its decomposition for the first half of the current economic cycle and for the previous cycle, together with the forward-looking assumption of trend growth based on projections of its components to the end of the current cycle and beyond.

Table B2: Contributions to trend output growth¹

	Estimated trend rates of growth, per cent per annum					Trend output
	Trend output per hour worked ^{2,3}		Trend	Trend	Population	
	Underlying	Unadjusted	average hours worked ³	employment rate ³	of working age ⁴	
	(1)	(2)	(3)	(4)	(5)	(6)
1986Q2 to 1997HI						
Budget 2006	2.22	2.04	-0.11	0.36	0.24	2.55
PBR 2006 and Budget 2007	2.10	1.92	-0.11	0.36	0.24	2.43
Over the recent past						
1997HI to 2001Q3						
Budget 2002	2.14	1.96	-0.37	0.36	0.66	2.63
PBR 2002 and 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
PBR 2004 and Budget 2005	2.70	2.50	-0.43	0.41	0.58	3.06
PBR 2005 and Budget 2006	2.79	2.59	-0.44	0.42	0.58	3.15
PBR 2006 and Budget 2007	2.81	2.60	-0.44	0.42	0.58	3.16
Projection⁵						
2001Q3 to 2006Q4						
Budget 2002	2.10	2.00	-0.1	0.2	0.6	2¾
PBR 2002 to Budget 2005	2.35	2.25	-0.1	0.2	0.5	2¾
PBR 2005 and Budget 2006	2.25	2.15	-0.2	0.2	0.6	2¾
PBR 2006 and Budget 2007 ^{6,7}	2.25	2.15	-0.2	0.2	0.7	2¾
2006Q4 onwards						
PBR 2004 and Budget 2005	2.35	2.25	-0.1	0.2	0.3	2½
PBR 2005 and Budget 2006	2.25	2.15	-0.2	0.2	0.4	2½
PBR 2006 and Budget 2007 ⁶	2.25	2.15	-0.2	0.2	0.6	2¾

¹ Treasury analysis based on judgement that 1986Q2, 1997HI and 2001Q3 were on-trend points of the output cycle. Figures independently rounded. Trend output growth is estimated as growth of non-oil GVA 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: new evidence and prospects', HM Treasury, December 2006.

² The underlying trend rate is the unadjusted 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 allowances 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. Hours worked and the employment rate are measured on a working-age basis.

⁴ UK resident household basis.

⁵ Neutral case assumptions for trend from 2001Q3.

⁶ Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2006Q4 are anchored.

⁷ The projection of working-age population is consistent with average growth since 2001Q3. This may change as a result of population data revisions.

Productivity growth **B.38** Since the latter half of 2005, productivity growth, measured in terms of output per hour worked, has grown at above-trend rates. This is likely to reflect the cyclical response to stronger output growth, since productivity growth tends to fluctuate positively with output growth, and thus the cycle.⁸ Annual growth in output per hour worked has averaged almost 2½ per cent since the on-trend point in 2001, compared with an unadjusted trend projection of 2.15 per cent. While recognising that uncertainties in the labour market data feed through into uncertainties around the strength of productivity growth, this evidence enhances confidence in the trend projection.

Labour market developments **B.39** In 2006, strong employment growth was accompanied by even stronger labour supply growth reflecting the combination of a fall in the inactivity rate during the first half of the year and ongoing strong growth in the population of working age. Over the past year, working-age employment grew by ½ per cent and total employment by ¾ per cent, the difference being due to the 7¼ per cent increase in employment of those above the State Pension age. In 2006, private sector employment grew by around 250,000 while public sector employment fell by 25,000. The working-age employment rate remained stable at around 74½ per cent through 2006, a little below its assumed trend, while by the end of the year the older workers' employment rate had risen to 11 per cent.

B.40 With employment continuing to rise through 2006 and labour supply growth moderating in the second half, by the end of the year the level and rate of unemployment had begun to fall, as expected at the time of the 2006 Pre-Budget Report. This pattern of solid employment growth and a gradual reduction in unemployment is expected to continue in 2007. Working-age population growth is expected to remain strong: the latest evidence suggests that migration to the UK from new Member States of the EU continued through 2006 at levels somewhat above those seen in 2005.

B.41 Employment growth over the past year has been much stronger among part-time than full-time employees, but average hours worked per week have remained steady at around the same level since late 2003.

B.42 As highlighted in the 2006 Pre-Budget Report, there are uncertainties surrounding official labour market data relating to the measurement of migration flows and growth of the working-age population, and the number of temporary foreign workers in the UK. As part of its work programme aimed at improving migration statistics, the ONS recently published a feasibility study into the production of short-term migration estimates.⁹ Based on the information gathered for this study, the ONS estimates that a significant proportion of the disparity between growth in jobs in 2005 as measured by the Labour Force Survey (LFS) and the workforce jobs series "might be explained by an increase in under-coverage of working short-term migrants"¹⁰ in the LFS.

Overview of recent developments

B.43 The UK's macroeconomic policy framework continues to deliver unprecedented growth and stability. GDP in the UK has now expanded for 58 consecutive quarters, the longest unbroken expansion since quarterly National Accounts began more than half a century ago. Over the past 10 years, the UK has enjoyed more stability in terms of GDP growth and inflation than in any decade since the war. Despite recent energy and food-related price rises, discussed below, inflation, on the RPI measure, has remained within a range of ¾ to 4¾

⁸ See *Productivity in the UK 6: Progress and new evidence*, HM Treasury, March 2006.

⁹ *Short-term migration feasibility report*, ONS, January 2007.

¹⁰ *Review of workforce job benchmarking*, ONS, March 2007.

per cent over the past 10 years, compared with a range of 1 to 11 per cent in the 1990s, 2½ to 22 per cent in the 1980s and 5 to 27 per cent in the 1970s.

GDP growth B.44 As forecast at the time of the 2006 Pre-Budget Report, the UK economy grew by 2¾ per cent in 2006. Having expanded at a rate of 0.7 per cent for four consecutive quarters, GDP growth picked up slightly to 0.8 per cent in the fourth quarter of 2006. Minor upward revisions to historical data show that GDP grew by 2 per cent in 2005.

Table B3: Quarterly GDP and non-oil GVA growth

	Percentage change on previous quarter							
	2005				2006			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP	0.3	0.5	0.5	0.7	0.7	0.7	0.7	0.8
Non-oil GVA	0.4	0.5	0.6	0.7	0.7	0.8	0.7	0.8

B.45 There was a notable degree of rebalancing in the sources of domestic demand in the economy in 2006. Nominal consumer spending has been trending down relative to nominal GDP for the past five years. Real household and government consumption, which had grown faster than the overall economy during the first half of this decade, grew in 2006 at rates below that of the whole economy, at 2¼ and 2 per cent respectively. Offsetting that, whole economy investment grew by 6 per cent, significantly above the 3 per cent average of the first half of the decade. Signs of a rebalancing of domestic and external sources of demand in 2006 were more tentative: despite the strongest export growth since 2000, net trade subtracted ½ a percentage point from GDP growth, in line with the average of the earlier years of this decade.

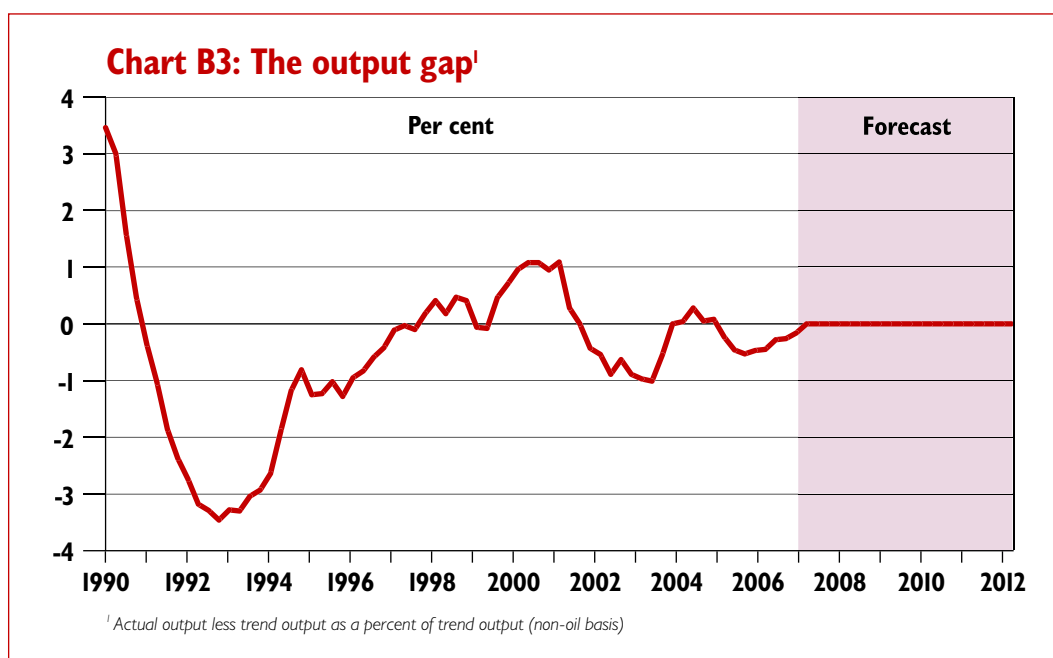
Inflation B.46 Consumer price inflation picked up during 2006, almost entirely attributable to the combined effect of higher energy and food prices, the former driven by higher oil and wholesale gas prices, and the latter by the unusually hot summer weather. CPI inflation has continued to rise since the 2006 Pre-Budget Report, from 2.4 per cent in October to a high of 3.0 per cent in December, before falling back to 2.8 per cent in February 2007. Inflation averaged 2¾ per cent during the fourth quarter of 2006, slightly higher than expected at the time of the Pre-Budget Report, mainly reflecting developments in the prices of seasonal foods. As expected, the contribution of energy prices to CPI inflation remained high at close to 1 percentage point. Despite inflation having picked up, there have been no signs of second-round effects on earnings growth, which has remained subdued. The Government has continued to emphasise the need for pay settlements to be consistent with the achievement of the inflation target of 2 per cent.

B.47 In terms of traded goods, import price inflation picked up steadily from a low of -3¼ per cent in February 2004 to a peak of 7¼ per cent in April 2006. In part this pick-up reflected rising oil and metals prices over the period, but even excluding these factors import price inflation increased from -2½ to 3¼ per cent. Since April 2006, it has fallen back sharply, and goods import prices fell in the year to January 2007. These developments have fed through to producers' input price inflation, which, having peaked at the end of 2005 at 18 per cent, turned negative in the year to January 2007. Manufacturers chose to absorb most of the increase in input prices in margins, and to a lesser extent offset it by reining back earnings growth. Consequently, output price inflation picked up only slightly, from 1¾ per cent at the end of 2005 to 3 per cent by mid-2006, before falling back to 2¼ per cent in the year to February 2007.

Monetary and fiscal policy **B.48** Since August 2006, as growth has strengthened and CPI inflation has moved above target, the MPC has acted by raising the Bank Rate on three occasions, the latest being in January 2007. At 5¹/₄ per cent, interest rates remain low by historical standards, having averaged 11³/₄ per cent in the 1980s and 9¹/₂ per cent in the first half of the 1990s. Market-derived interest rate expectations are for a further ¹/₄ percentage point increase in 2007. Fiscal policy has been moderately tightened since 2004-05.

Assessment of the output gap

B.49 Since the 2006 Pre-Budget Report, minor revisions to estimates of non-oil GVA growth since the beginning of 2005, alongside estimated growth of 0.8 per cent in the final quarter of 2006, show the economy to have been growing at slightly above-trend rates for five consecutive quarters through to the end of 2006. As a result, the trend growth arithmetic, based on the latest National Accounts data and the Treasury's trend output assumptions, implies only a small negative output gap in late 2006, of around -¹/₄ per cent. This is close to estimates from a number of external forecasters, and well within their range.



Evidence from cyclical indicators **B.50** The Treasury's assessment of the cyclical position of the UK economy draws on a broad range of economic indicators, including private sector business surveys, labour market indicators and price data. The indicators that have played a formal role in the dating of on-trend points were set out in the *Technical note on cyclical indicators*, published alongside the 2005 Pre-Budget Report. In line with recommendations made by the National Audit Office at that time,¹¹ Box B3 reports on the Bank of England's Regional Agents' scores, which provide additional information on the cyclical position of the economy and will therefore play a role in the Treasury's future judgements of where the economy stands in relation to trend.

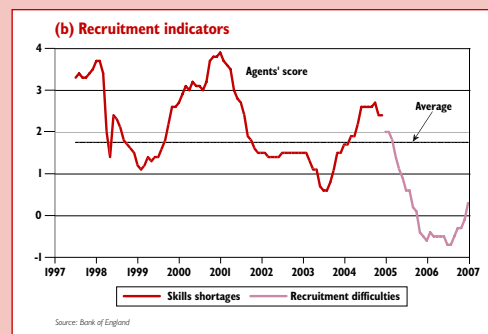
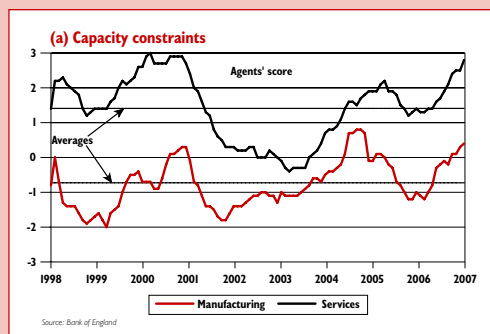
¹¹ See paragraph 74 of the *Audit of assumptions for the 2005 Pre-Budget Report*, National Audit Office, December 2005.

Box B3: The Bank of England's Agents' scores

Since 1997, the Monetary Policy Committee (MPC) of the Bank of England has been able to draw upon a set of quantitative assessments of current economic conditions reported to them by the Bank's twelve regional offices, or Agents. These 'Agents' scores' cover a broad range of economic factors,^a including capacity constraints and recruitment difficulties, which are relevant to the Treasury's assessment of the cyclical position of the economy. In January 2006, the Bank began to publish the scores on its website, thereby providing a source of information that has not previously been available to the Treasury in assessing the cyclical position of the economy.

The Agents' scores on capacity constraints in the manufacturing and service sectors were first compiled in January 1998. In terms of labour market slack, an Agents' score on skills shortages was reported between July 1997 and December 2004, and one on recruitment difficulties since then. In its description of the Agents' scores,^a the Bank advises that these two indicators are comparable. At just under a decade, the time-series for the Agents' scores are shorter than most of the other cyclical indicators the Treasury currently monitors. As such, a degree of caution should be exercised in drawing conclusions from the evidence they present.

The latest Agents' scores, published alongside the minutes of the February MPC meeting, suggest that both the manufacturing and service sectors have been operating at above average rates of capacity utilisation since the middle of 2006. In terms of the labour market, they point to a considerable degree of slack having opened up during the second half of 2005, and some tightening since the third quarter of 2006. Taken together, the Agents' scores appear consistent with the economy currently being close to trend, while pointing to a greater disparity between capacity constraints and labour market slack than is apparent in the other cyclical indicators the Treasury monitors.



^a For a general discussion of the Agents' scores, see Ellis, C. and Pike, T. *Introducing the Agents' scores*, Bank of England Quarterly Bulletin, Winter 2005.

B.5I Private sector business surveys of capacity utilisation in the manufacturing and service sectors have recently been at levels close to, and in some cases above, their long-run averages, consistent with the economy being close to trend. By contrast, indicators of recruitment difficulties point to some slack in the labour market, though, as at the time of the 2006 Pre-Budget Report, growth in the labour force appears to be having a differential impact on the availability of specific types of labour. Employers in the service sector are currently reporting difficulties in hiring skilled and clerical labour that are consistent with previous on-trend points, but simultaneously report an increased availability of semi- and unskilled workers. Similarly in the manufacturing sector, while overall recruitment difficulties have eased and remain below levels consistent with on-trend output, employers report varying levels of difficulty in recruiting individuals within different skill-sets.

B.52 Claimant count unemployment, which increased during 2005 and the first half of 2006, has fallen in seven of the past eight months, and is now lower than it was a year ago. Average earnings growth has remained subdued. During 2006 as a whole, private sector earnings growth was $4\frac{1}{4}$ per cent including bonuses, and 4 per cent excluding bonuses, and showed few signs of picking up despite private sector business surveys reporting strong demand for labour. The latest data, covering the three months to January 2007, show whole economy earnings including bonuses up $4\frac{1}{4}$ per cent on a year earlier. Excluding bonuses, whole economy earnings were up just $3\frac{1}{2}$ per cent over the same period. Wage developments have therefore remained consistent with there being some slack in the labour market. More generally, indicators of domestically-generated inflation appear consistent with the economy operating close to trend, with the recent rise in headline inflation dominated by non-cyclical factors.

B.53 On balance, capacity utilisation indicators tend to signal that output is currently close to trend, while labour market indicators point to some ongoing slack suggesting that overall the output gap may be slightly negative. There is, however, a degree of uncertainty about the interpretation of official and private sector business survey indicators of labour market developments at present. Looking further ahead, the ONS is currently engaged in a modernisation programme that aims to deliver better quality National Accounts using modernised systems and methods in the 2008 Blue Book, to be published in September 2008. In the meantime, the scope of revisions to National Accounts data will be limited, which will introduce some temporary additional uncertainty about the path of the economy.¹² One significant improvement that will be implemented in the 2007 Blue Book will be to the measurement of software investment, whereas improvements to the treatment of banking sector output, known as FISIM,¹³ will be made in 2008.

GDP and inflation forecasts

Table B4: Summary of forecast¹

	2006	Forecast		
		2007	2008	2009
GDP growth (per cent)	$2\frac{3}{4}$	$2\frac{3}{4}$ to $3\frac{1}{4}$	$2\frac{1}{2}$ to 3	$2\frac{1}{2}$ to 3
CPI inflation (per cent, Q4)	$2\frac{3}{4}$	2	2	2

¹ See footnote to Table B10 for explanation of forecast ranges.

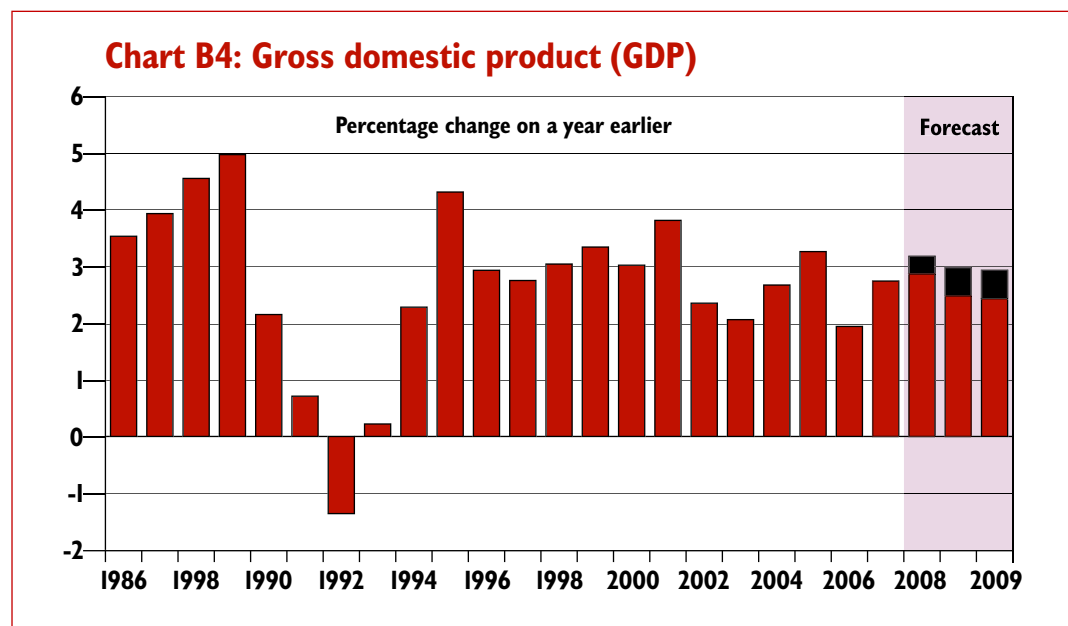
GDP and the output gap **B.54** The latest estimates of GDP and non-oil GVA growth to the fourth quarter of 2006 are consistent with the 2006 Pre-Budget Report forecast. The Budget 2007 GDP growth forecast is unchanged from the Pre-Budget Report: the small negative output gap is expected to have closed early in 2007, and growth is forecast to continue at close-to-trend rates throughout the forecast horizon. This implies GDP growth of $2\frac{3}{4}$ to $3\frac{1}{4}$ per cent in 2007, and $2\frac{1}{2}$ to 3 per cent a year thereafter.

Rebalancing of domestic demand **B.55** The rebalancing of domestic demand already evident during 2006 is expected to continue to a somewhat greater degree than was envisaged in the 2006 Pre-Budget Report forecast. Latest estimates of business investment in the second half of 2006 show particularly strong growth, which surprised on the upside, and some of that momentum is expected to carry through into 2007. Private consumption growth, also strong at the end of 2006 following alternately weaker and stronger quarterly growth through the year, is expected to moderate as recent increases in interest rates feed through to disposable income growth and

¹² See *Modernising the UK's National Accounts*, ONS, February 2007.

¹³ Financial intermediation services indirectly measured.

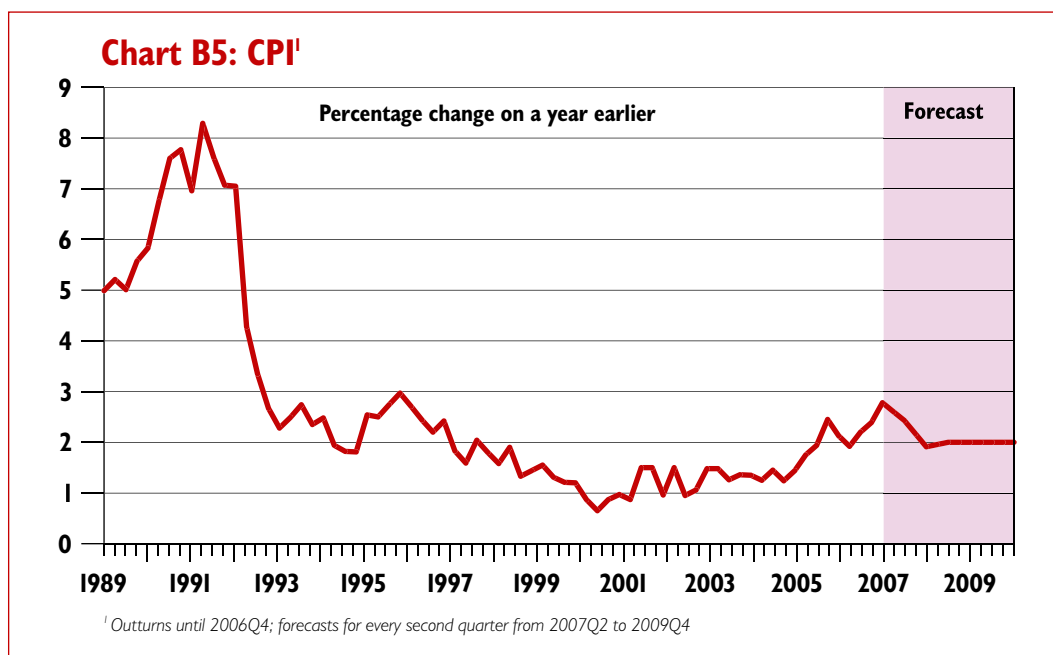
households' desire to save. The contribution of net trade to GDP growth is expected to remain slightly negative in 2007, but to be neutral thereafter.



Inflation B.56 The pick-up in headline inflation over the past year has mainly been attributable to energy and food prices, rather than domestic cyclical pressures, factors that are expected to unwind during 2007. By far the largest contributor to the rise in inflation during 2006 was energy prices, particularly domestic gas and electricity prices. At the time of the 2006 Pre-Budget Report, developments in wholesale gas prices pointed to energy prices stabilising, with their contribution to inflation falling during 2007. Since the Pre-Budget Report, a number of major energy providers have announced significant cuts in utility tariffs that imply the contribution of energy prices to inflation is likely to turn negative by the middle of 2007. Unless harvests prove incrementally worse during 2007 than in 2006, when the unusually hot summer pushed food prices higher, the contribution of food prices to overall inflation should also fall.

B.57 As a result of these expected energy and food-related price developments, CPI inflation is likely to fall quite sharply from its current level, returning to around target in the second half of 2007.

B.58 Inflation expectations remain anchored to the inflation target and earnings growth has remained subdued, suggesting there have been no second-round effects from the recent above-target rates of inflation, although this risk has not yet subsided.



UK DEMAND AND OUTPUT IN DETAIL

B.59 GDP grew by $2\frac{3}{4}$ per cent in 2006, just below the average of the past 10 years, but slightly above the average of the past five years. Within the components of demand, private consumption growth picked up from 2005, but remained slightly below that of the economy as a whole, while business investment picked up sharply, to its strongest rate since 1998. Together, these developments continued, and accelerated, the rebalancing of real domestic demand that began in 2005. The rebalancing of nominal domestic demand, which began earlier, also continued. On the output side of the economy, while the service sector continued to provide the main source of growth in 2006, the manufacturing sector expanded in every quarter of the year, for the first time since 2000.

Table B5: Contributions to GDP growth^{1,2}

	Percentage points, unless otherwise stated				
	Average 2000 to 2005	2006	Forecast		
			2007	2008	2009
GDP growth, per cent	$2\frac{3}{4}$	$2\frac{3}{4}$	$2\frac{3}{4}$ to $3\frac{1}{4}$	$2\frac{1}{2}$ to 3	$2\frac{1}{2}$ to 3
Main contributions					
Private consumption	2	$1\frac{1}{2}$	$1\frac{1}{2}$	$1\frac{1}{2}$	$1\frac{1}{2}$
Business investment	$\frac{1}{4}$	$\frac{3}{4}$	$\frac{3}{4}$	$\frac{1}{2}$	$\frac{1}{2}$
Government ³	$\frac{3}{4}$	$\frac{1}{2}$	$\frac{3}{4}$	$\frac{1}{2}$	$\frac{1}{2}$
Change in inventories	0	$\frac{1}{4}$	0	0	0
Net trade	$-\frac{1}{2}$	$-\frac{1}{2}$	$-\frac{1}{4}$	0	0

¹ Components may not sum to total due to rounding and omission of private residential investment, transfer costs of land and existing buildings and the statistical discrepancy.

² Based on central case. For the purpose of projecting public finances, forecasts are based on the bottom of the GDP forecast range.

³ The sum of government consumption and government investment.

Households and consumption¹⁴

B.60 Household consumption is the largest expenditure component of GDP, accounting for 64 per cent of the UK economy in nominal terms, having trended down from 66½ per cent in mid-2001. Between 1995 and 2004, as real private consumption grew faster than GDP, it increased steadily as a share of the real economy. Since then, in line with the rebalancing of the economy, consumption's share of real demand has fallen by around ¾ percentage points.

Table B6: Household sector¹ expenditure and income

	Percentage change on a year earlier, unless otherwise stated			
	2006	Forecast		
		2007	2008	2009
Household consumption ²	2¼	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾
Real household disposable income	1¾	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾
Saving ratio ³ (level, per cent)	5¼	5½	5¾	5¾

¹ Including non-profit institutions serving households.

² Chained volume measures.

³ Total household resources less consumption expenditure as a percent of total resources, where total resources comprise households' disposable income plus the increase in their net equity in pension funds.

Disposable income B.61 Real household disposable incomes in the first three quarters of 2006 grew by 1½ per cent on a year earlier. This was lower growth than in 2005, due to more moderate growth of nominal incomes. The slowdown was almost entirely accounted for by growth of net "property income", the balance between interest and dividends received and paid by households, falling from 17¼ per cent to 4¼ per cent. Real disposable incomes are expected to grow in a range of 2¼ to 2¾ per cent throughout the forecast horizon.

Household spending B.62 Private consumption grew 2¼ per cent in 2006, slightly above the 2006 Pre-Budget Report forecast. As with retail sales, described below, quarterly growth of consumption in 2006 alternated between weaker and stronger quarters, but averaged 0.7 per cent. Due to the strength of growth in the fourth quarter, private consumption began 2007 at a higher level than was expected at the time of the Pre-Budget Report, with knock-on effects for growth in 2007.

B.63 Private consumption growth is forecast to continue at rates slightly below that of the economy as a whole, reflecting the impact of recent interest rate rises and developments in households' real incomes. Given the slightly tighter interest rate environment currently than at the time of the 2006 Pre-Budget Report, quarterly consumption growth in 2007 is likely to be more moderate. However, the higher starting point for the year leaves the annual growth forecast in 2007 unchanged from the Pre-Budget Report forecast of 2¼ to 2¾ per cent.

¹⁴ In the National Accounts, private consumption is comprised of final consumption expenditure by households and non-profit institutions serving households (NPISH). Throughout this section, the terms 'household consumption' and 'private consumption' always refer to total final consumption expenditure by households and NPISH.

B.64 Retail sales growth has continued the pattern of fluctuating quarterly growth rates that began in the middle of 2005, with strong growth in the fourth quarter of 2006. Monthly growth rates tend to be particularly volatile over the Christmas period, despite attempts to adjust for seasonal spending patterns, this year rising 1.1 per cent in December but falling 1.8 per cent in January. Since 1986, unadjusted retail sales volumes have typically increased about 20 per cent from November to December, then fallen about 30 per cent in January, presenting obvious seasonal adjustment challenges. These may have been further complicated recently by a shift in the pattern of spending between December and January. December 2006 accounted for the highest proportion of full-year retail sales on record, while January 2007 accounted for the second lowest. The underlying trend in spending may therefore be better represented by a longer-run indicator such as the six-month on previous six months growth rate, which has been running at an annualised rate of 4 per cent or more since August 2006.

Saving ratio B.65 The household saving ratio is estimated to have declined slightly during 2006, to 5 per cent by the third quarter, but is expected to rise over the forecast period. The GfK consumer confidence survey reports that households' saving intentions remain at high levels, suggesting that a further increase in the saving ratio represents a downside risk to the consumption forecast.

House prices B.66 As expected at the time of the 2006 Pre-Budget Report, house price inflation picked up during the fourth quarter of 2006 to rates of around 10 per cent on a year earlier, though housing-related indicators have become more mixed since the Pre-Budget Report. As forecast at the time of the Pre-Budget Report, house price inflation is likely to slow during 2007.

B.67 Investment in dwellings has recently risen to around 4 per cent of nominal GDP, which, though rather less than half the ratio of business investment to GDP, is a significant component of demand. In line with other indicators of the housing market, growth of private sector investment in dwellings was strong in the first three quarters of 2006, up 8 per cent on a year earlier. While growth in residential investment is expected to slow, recent momentum and Barker Review commitments¹⁵ are expected to keep growth above that of the economy as a whole throughout the forecast period.

Companies and investment

B.68 Business investment accounts for around 10 per cent of nominal GDP, but its role in the economy extends beyond that. Investment also affects future growth by raising the amount of physical capital available to each worker with which to produce goods and services. Increasing capital intensity is an important driver of labour productivity growth. The contribution of investment to productivity and long-run economic growth is described in more detail in Chapter 3, and in *Productivity in the UK 6: Progress and new evidence* published alongside Budget 2006.

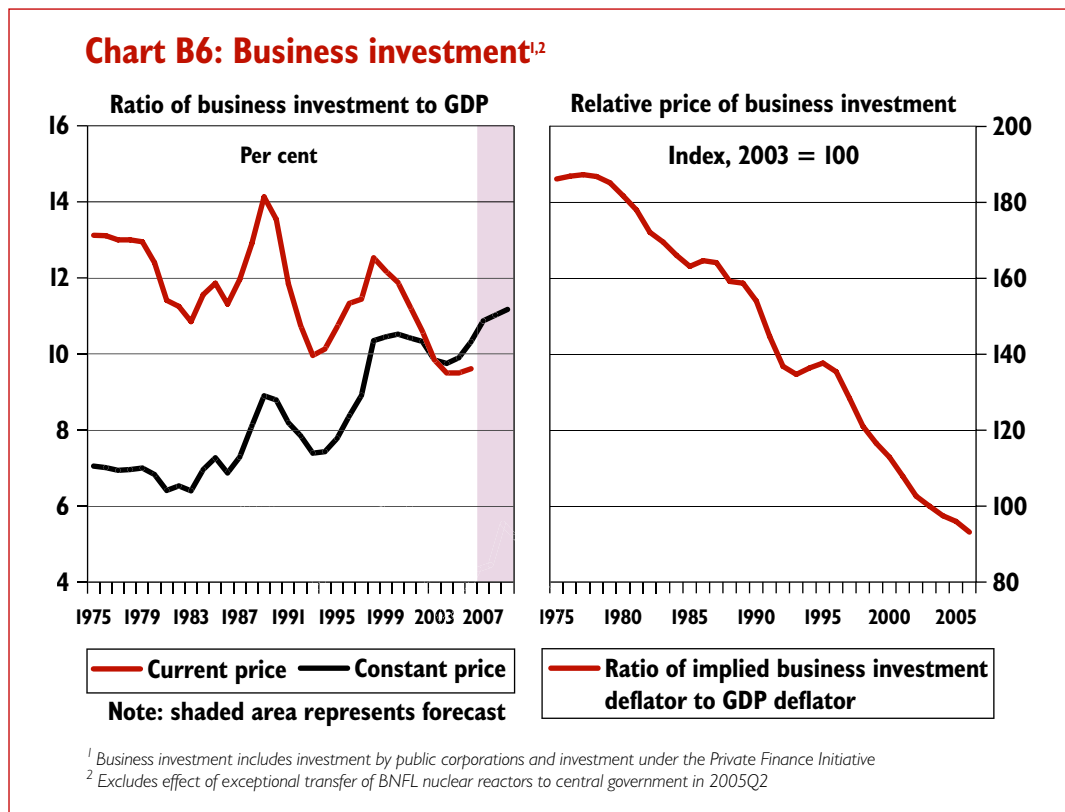
Company B.69 Companies have a variety of sources from which they can finance investment. These **finances** include internal sources, such as the cashflow generated on their operations or drawdown of accumulated financial assets, and external sources, including bank lending or the issuance of equity or debt to investors. Both sources remain supportive of business investment growth.

¹⁵ *The Government's response to Kate Barker's review of housing supply*, HM Treasury, December 2005.

B.70 Profitability, as measured by the net rate of return on capital in the non-financial corporate sector, reached another new record high, of 15¼ per cent, in the third quarter of 2006. While that partly reflected extremely high rates of return for companies operating on the UK continental shelf, rates of return remain near record highs in the service sector, and have begun to recover in the manufacturing sector.

B.71 Supportive external financing conditions over recent years have encouraged firms to expand their balance sheets, simultaneously taking on liabilities and building up financial assets. Bank lending to non-financial companies grew at rapid rates during 2006. As a result, capital gearing, a measure of net indebtedness in the corporate sector, has risen to a level that is high by historical standards. However, with interest rates remaining at historically low levels despite recent rises, income gearing, a measure of the ability to service debt, remains well below historic peaks. Since the 2006 Pre-Budget Report, the external financing environment has remained broadly supportive.

Business investment B.72 Official estimates of business investment growth in 2005 and 2006 are affected by the April 2005 transfer from British Nuclear Fuels Limited (BNFL) to the Nuclear Decommissioning Authority (NDA) of nuclear reactors that were reaching the end of their productive lives. Since BNFL is classified as a public corporation and the NDA is classified within central government, this transfer involved the movement of assets across the boundary between business investment and general government investment. The value of the transfer was negative, reflecting the costs of decommissioning the reactors. The impact on measured business investment growth was therefore positive in 2005 and negative in 2006. However, since this exceptional transfer has no effect on whole economy investment and does not reflect underlying developments in business investment, the following discussion, and the figures in Tables B5 and B7, and those behind Chart B6, exclude its impact.



B.73 Business investment has now expanded for eight consecutive quarters, the longest continuous expansion for nine years. The 2006 Pre-Budget Report noted upside risks to the investment forecast. Following a stronger than expected final quarter of 2006, with growth of 11 per cent on a year earlier, growth in the year as a whole reached 7 per cent, above the Pre-Budget Report forecast of $5\frac{3}{4}$ per cent. The service sector accounted for the majority of business investment growth in 2006, rising $6\frac{1}{4}$ per cent on a year earlier, while investment in the manufacturing sector fell 4 per cent, thereby only partly reversing very strong growth of $12\frac{1}{2}$ per cent in 2005.

B.74 Much of the momentum in 2006 was accounted for by the non-manufacturing production sector, which includes oil extraction and utilities companies. Given an expected slowdown in capital expenditure by North Sea corporations, the forecast quarterly path of business investment growth in 2007 has only been revised up marginally since the Pre-Budget Report. However, because of the strength of growth in the final quarter of 2006, that translates into a larger upward revision to full-year business investment growth, to $7\frac{1}{4}$ to $7\frac{3}{4}$ per cent in 2007.

Table B7: Gross fixed capital formation

	Percent change on a year earlier			
	2006	Forecast		
		2007	2008	2009
Whole economy ¹	6	$6\frac{1}{2}$ to 7	$3\frac{1}{4}$ to $3\frac{3}{4}$	$3\frac{1}{4}$ to $3\frac{3}{4}$
of which:				
Business ^{2,3,4}	7	$7\frac{1}{4}$ to $7\frac{3}{4}$	$3\frac{3}{4}$ to $4\frac{1}{4}$	$3\frac{3}{4}$ to $4\frac{1}{2}$
Private dwellings ²	8	$3\frac{3}{4}$ to $4\frac{1}{4}$	$2\frac{3}{4}$ to $3\frac{1}{4}$	$2\frac{3}{4}$ to $3\frac{1}{4}$
General government ^{3,4}	$2\frac{1}{2}$	$13\frac{1}{2}$	$3\frac{3}{4}$	2

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

² Private sector and public corporations' non-residential investment. Includes investment under the Private Finance Initiative.

³ Excludes purchases less sales of land and existing buildings.

⁴ Excludes effect of exceptional transfer of BNFL nuclear reactors to central government in 2005Q2.

Government

B.75 Government consumption grew by 2 per cent in 2006, slower than the economy as a whole. As a share of GDP, government consumption has stabilised at around 22 per cent in nominal terms. Measured government investment growth in 2005 and 2006 is subject to the same effects as business investment growth, related to the exceptional transfer of assets from BNFL to the NDA described in paragraph B.72. Excluding this effect, real government investment was up $1\frac{1}{4}$ per cent in 2005 and is expected to have grown by $2\frac{1}{2}$ per cent in 2006.

Trade and the balance of payments

B.76 As set out in the 2006 Pre-Budget Report, annual growth in recorded exports and imports of goods and services has been severely distorted by activity related to missing trader intra-community fraud (MTIC), which significantly inflated the value of measured goods trade in the first half of 2006.

B.77 While MTIC-related activity should not, in principle, affect official estimates of net trade because the impact on export and import volumes should be equal, inevitable measurement difficulties may in practice carry over to estimates of net trade. Based on detailed trade data supplied by HMRC, the ONS estimates that there were large fluctuations in MTIC-related activity during 2006, in light of which, the ONS continues to advise that, “comparisons of [trade] volumes and prices... should be treated with a great deal of caution.”¹⁶

B.78 The sharp fall in MTIC-related activity through 2006 has a significant effect on the forecast rates of growth of exports and imports in 2007. This is because the forecast abstracts from MTIC effects by assuming that beyond the latest quarter of data, export and import volumes grow in line with underlying trade, excluding MTIC-related activity. The forecast is therefore based on the neutral assumption that the level of MTIC-related activity stays flat at the latest quarterly estimate throughout the forecast. Table B8 presents export and import growth forecasts excluding the effects of MTIC-related activity.

Exports of goods and services **B.79** The volume of exports of goods and services excluding MTIC-related activity grew by 6¹/₄ per cent in 2006, up from 5 per cent in 2005, reflecting a pick-up in underlying goods exports growth to 7¹/₄ per cent from 5 per cent, and a slight slowdown in the growth of services exports to 4¹/₄ per cent from 5¹/₄ per cent.

B.80 The forecast for export growth has been revised up a little from the 2006 Pre-Budget Report, reflecting the slightly stronger outlook for UK export market growth as the balance of world growth has tilted towards Europe. Excluding MTIC-related activity, exports of goods and services are forecast to grow by 5¹/₄ to 5³/₄ per cent in 2007, and by slightly slower rates in 2008 and 2009. While the level of UK exports continues to grow, the forecast assumes that the UK's export market share decreases broadly in line with the average decline since the late 1990s, reflecting the ongoing integration of developing economies into the global economy.

Imports of goods and services **B.81** Imports of goods and services excluding MTIC-related activity showed strong growth in 2006, up 7 per cent on a year earlier, mainly reflecting a pick-up in goods imports growth to 8¹/₂ per cent from 4 per cent in 2005. Growth of services imports slowed from 5³/₄ per cent in 2005 to 3 per cent in 2006. With import growth in 2006 having been somewhat stronger than expected at the time of the 2006 Pre-Budget Report, and consistent with stronger expected business investment growth this year, the forecast for import growth in 2007 has been revised up slightly to 5 to 5¹/₂ per cent. As a result of small revisions to the forecasts for import and export growth, the contribution of net trade to GDP growth is expected to remain negative in 2007, but to be broadly neutral thereafter.

¹⁶ First release: UK trade, January 2007, ONS, March 2007.

Table B8: Trade in goods and services

	Percentage change on a year earlier					£ billion Goods and services balance
	Volumes (excluding MTIC) ¹		Prices ²		Terms of trade ³	
	Exports	Imports	Exports	Imports		
2006	6¼	7	1½	2½	-¾	-55¼
<i>Forecast</i>						
2007	5¼ to 5¾	5 to 5½	0	0	0	-56½
2008	5 to 5½	4¼ to 4¾	2	2	0	-58¼
2009	4½ to 5	4 to 4½	1½	1½	0	-60

¹ Table B10 contains figures including the effects of MTIC-related activity. In 2008 and 2009 export and import growth including and excluding MTIC are the same, reflecting forecast assumptions.

² Average value indices.

³ Ratio of export to import prices.

Sterling and the terms of trade

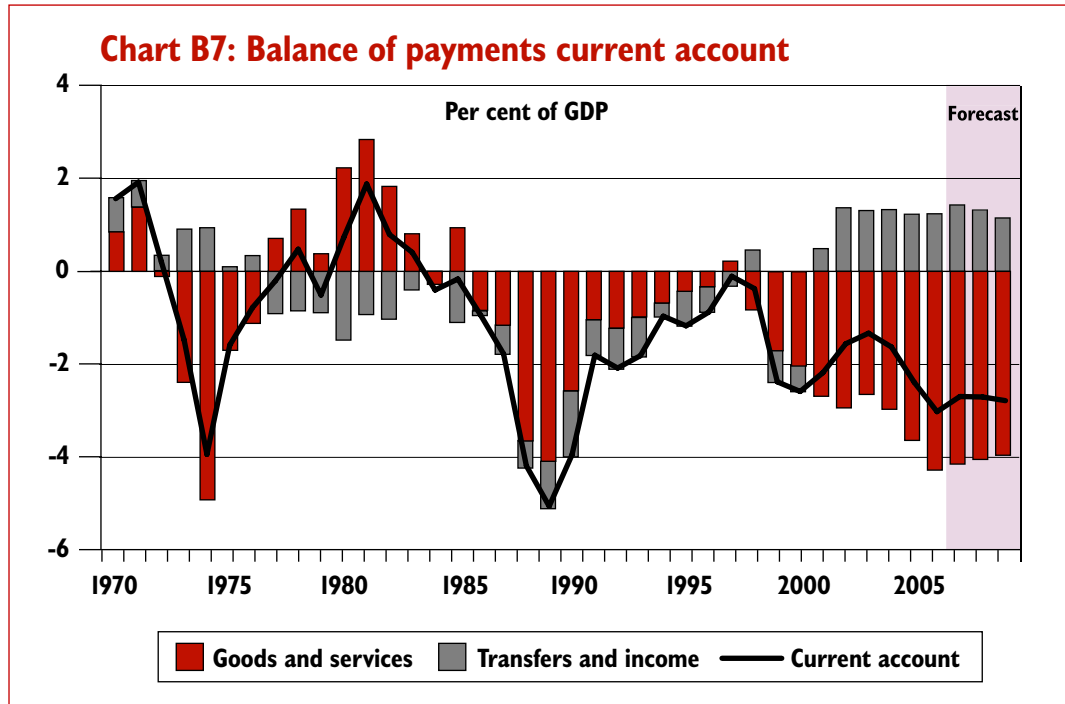
B.82 In the decade from 1995, the UK's terms of trade, a measure of the volume of imports the UK could purchase through the sale of a given volume of exports, improved steadily. The gains in purchasing power were particularly strong in the second half of the 1990s as sterling appreciated sharply, and in 2002 and 2003, coinciding with the rapid increase in the share of low-cost producers, particularly China, in world trade in goods. The UK's terms of trade subsequently deteriorated in 2005 and 2006, reflecting the sharp increase in the price of certain imported commodities, notably oil and metals. With export and import prices forecast to grow at similar rates, the UK's terms of trade are forecast to remain broadly stable.

Current account

B.83 The UK's deficit on trade in goods widened in 2006 relative to 2005, reaching 6½ per cent of GDP, although the deficit narrowed in the second half of the year compared with the first half. The surplus on trade in services rose from 2 per cent of GDP in 2005 to 2¼ per cent in 2006. Data on the breakdown of services trade to the third quarter of 2006 show that the increased surplus stemmed from strong growth in financial services exports, up 27 per cent on a year earlier in nominal terms, and the unwinding of the negative impact of Hurricane Katrina-related payments on insurance exports. The overall trade deficit in 2006 was 4¼ per cent of GDP, up from 3¾ per cent in 2005.

B.84 Significant income surpluses continued to offset the deficit on trade in goods and services in 2005 and 2006. The latest data show the income surplus running at 2¼ per cent of GDP in 2005 and over the first three quarters of 2006. The composition of the income surplus changed slightly between 2005 and 2006, with a larger surplus on income related to foreign direct investment (FDI), up from 3½ to 4 per cent of GDP, offset by a larger deficit on 'other investment' income, up from 1¼ to 1¾ per cent of GDP. 'Other investment' is largely comprised of flows through the financial sector, i.e. bank deposits and lending. Box B4 discusses the relationship between developments in the UK's international investment position and the income surplus.

B.85 The UK's current account deficit is expected to have risen from 2½ per cent of GDP in 2005 to 3 per cent of GDP in 2006, mainly reflecting developments in the goods trade deficit. From 2007, the current account deficit is expected to stabilise at 2¾ per cent of GDP.



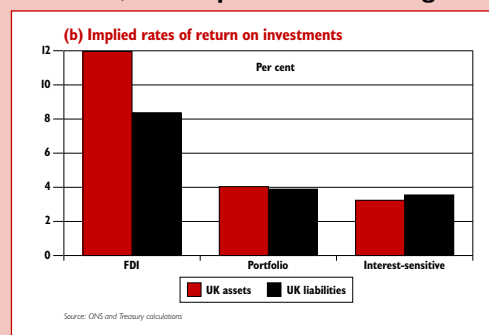
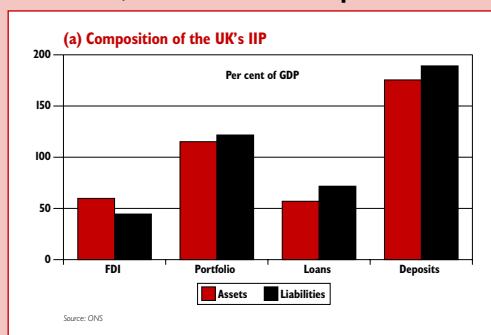
Foreign direct investment **B.86** The latest estimates show that the UK attracted a £108 billion inflow of FDI in 2005, around half of which was accounted for by the restructuring of Shell Transport and Trading and Royal Dutch Petroleum into Royal Dutch Shell. That represented a record high for the UK in both cash terms and relative to GDP and, according to the UN's 2006 *World Investment Report*, was the highest inflow ever recorded by a European country, and made the UK the world's largest recipient of inward FDI. Very strong inflows continued in the first three quarters of 2006, reaching almost £64 billion. That was a similar amount to the inflow to the US over the same period, and around twice that to China in 2006 as a whole. As a ratio to GDP, the stock of inward investment in the UK, at around 37 per cent in 2005, was almost three times higher than that in the US, twice that in Germany and a third higher than the ratio in France. The UK also has a larger stock of outward FDI as a ratio to GDP than any other major economy.

Box B4: International investment and the UK's income surplus

A key feature of the UK's current account in recent years has been the strong surplus on investment income, which amounted to 2¼ per cent of GDP in the first three quarters of 2006. This has been achieved despite the UK's international investment position (IIP) currently showing liabilities exceeding assets by around 19 per cent of GDP. There are two parts to the explanation of the UK's ability to earn net income on its net liability position:

- Firstly, the UK's IIP is not uniform across assets. On the contrary, low-yielding short-term loans and deposits more than account for the UK's net liabilities while the UK has a net asset position in high-yielding foreign direct investment (chart a). Based on the different rates of return that prevail for different types of investment, income flows to and from the UK should roughly balance despite the negative IIP.
- Secondly, while rates of return on portfolio investment and interest-sensitive loans and deposits are similar for the UK's assets and liabilities, UK companies earn a significantly higher return on their direct investment abroad than overseas companies earn on their direct investment in the UK (chart b). Figures for the year to the third quarter of 2006 imply that the rate of return UK companies earned on FDI abroad was around 12 per cent, compared with around 8¼ per cent earned by foreign companies on FDI in the UK. As UK companies' stock of investment abroad, £760 billion, is a third larger than that of foreign companies in the UK, £566 billion, the spread between the rates of return translated into net earnings on FDI equivalent to 3½ per cent of GDP over that period.

In terms of the positive yield differential on direct investment, two sectors of the economy play the major role: in 2005, financial services accounted for around 16 per cent of the UK's overseas assets, but 24 per cent of earnings; and mining and quarrying, mainly oil and gas extraction, accounted for 7½ per cent of overseas assets, but 21 per cent of earnings.



Service sector output

B.87 The service sector produces around 75 per cent of UK economic output, a share that has increased continually over the past decade and a half. The service sector as a whole has outperformed the wider economy in each year since 1990, growing by more than 66 per cent during that time. Services make up more than a third of the UK's total exports, a greater proportion than any other G7 economy, and more than double that of Canada, Germany or Japan. In recent years, strong growth in the service sector has been driven by the finance and business services sector, the largest in the UK economy, accounting for around a third of total activity.

B.88 The service sector grew by $3\frac{3}{4}$ per cent in 2006, up from 3 per cent in 2005 and above the average for the sector since 2000. Excluding 'government and other services', where the share of public sector activity is high, the service sector grew by $4\frac{1}{4}$ per cent in 2006. Growth picked up in the fourth quarter of the year, with activity in wholesale and retail trades expanding at its strongest quarterly rate in almost three years. Private sector business surveys point to continued expansion at similar rates in the first quarter of 2007. For example, monthly indicators of business activity and new business in the service sector compiled by the Chartered Institute of Purchasing and Supply remain well above their long-run averages.

Finance and business services B.89 The finance and business services sector was the main driver of growth in 2006, contributing more than half of the expansion of services output for the second year in succession. Within this sector, the output of other business services, a sector that includes professions ranging from management consultants to private investigators, grew by more than 8 per cent in 2006 as a whole, up from $7\frac{1}{2}$ per cent in 2005, with growth strengthening throughout the year.

Distribution B.90 Activity in the distribution sector picked up strongly in the final quarter of 2006, growing by $1\frac{1}{4}$ per cent on the previous quarter. On an annual basis, output rebounded from the weakness observed in 2005, to grow by $3\frac{1}{4}$ per cent, but remained below the average rate of growth over the past six years, consistent with the more balanced pattern of domestic expenditure seen across the wider economy.

Manufacturing and North Sea output

Manufacturing B.91 Manufacturing accounts for almost 80 per cent of total industrial production and around 14 per cent of whole economy GVA. Manufacturing output grew by $1\frac{1}{2}$ per cent in 2006, slightly above the 2006 Pre-Budget Report forecast, buoyed by stronger goods exports to the EU. In particular, production of capital goods grew strongly in 2006, having remained broadly flat in 2005. Monthly private sector business surveys, such as the CBI's *Industrial Trends Survey*, suggest that manufacturing output growth may pick up further in the first quarter of 2007.

North Sea B.92 While manufacturing grew by $1\frac{1}{2}$ per cent in 2006, total industrial production output, which includes energy extraction and utilities, was flat, due to an $8\frac{3}{4}$ per cent fall in output from the oil and gas sector. A number of temporary factors acted to exacerbate the underlying decline in output from the North Sea. A relatively large new field, 'Buzzard', started production in early 2007, which, along with a number of smaller start-ups in 2007 and 2008, should temporarily boost overall North Sea output.

Independent forecasts

B.93 Since the 2006 Pre-Budget Report, the average of independent forecasts for GDP growth in 2007 has increased from 2.4 per cent to 2.6 per cent. This remains below the Budget forecast range, although some prominent forecasters expect stronger growth than the average: the IMF's latest report on the UK economy, published on 5 March, forecasts growth of 2.9 per cent in 2007, while the Bank of England's February *Inflation Report* forecast, conditioned on market interest rate expectations, showed GDP growth of 3.1 per cent on a year earlier by the fourth quarter of 2007. The latest survey from Consensus Economics¹⁷ shows that the average forecast for GDP growth in 2007 is higher for the UK than for any other G7 economy.

¹⁷ Consensus forecasts, Consensus Economics Inc., March 2007.

B.94 As with the steady upward shift of the independent average forecast for growth in 2006, the forecast for 2007 has been driven higher by upward revisions to fixed investment growth, from 3.4 per cent at the time of the 2006 Pre-Budget Report to a latest forecast of 4.8 per cent. The average independent GDP growth forecast for 2008 is currently below the Budget forecast range, but one outlier forecast drags down the average, as evidenced by the median forecast of 2.5 per cent being above the mean forecast of 2.3 per cent. In the medium term, independent forecasters expect GDP growth to settle at around 2.6 per cent, in the lower half of the Budget forecast range. In line with the Budget forecast, independent forecasters expect inflation to return to target by the end of 2007 and to remain at target in 2008.

B.95 Treasury forecasts for GDP growth since 1997 have, on average, outperformed the independent consensus. They have also compared well against a sample of forecasters that includes leading international organisations (IMF, OECD, European Commission), research institutes (Oxford Economics, NIESR) and private sector forecasters (Goldman Sachs, HSBC, JP Morgan).¹⁸

Table B9: Budget and independent¹ forecasts

	Percentage change on a year earlier, unless otherwise stated					
	2007			2008		
	March Budget	Independent Average	Range	March Budget	Independent Average	Range
GDP growth	2¾ to 3¾	2.6	1.3 to 3.0	2½ to 3	2.3	-0.3 to 2.9
CPI (Q4)	2	1.9	1.4 to 3.0	2	2.0	1.5 to 2.3
Current account (£ billion)	-37	-36.1	-56.9 to -25.1	-39¼	-37.8	-63.7 to -23.8

¹ 'Forecasts for the UK economy: A comparison of independent forecasts', March 2007.

Forecast issues and risks

B.96 Risks to the Budget 2007 economic forecast appear balanced, given broadly offsetting developments since the 2006 Pre-Budget Report.

Global economy B.97 Growth in the final quarter of 2006 was strong in most of the world's major economies, including the UK, suggesting there is more momentum in these economies, particularly in the euro area, than was apparent at the time of the Pre-Budget Report. Additionally, the strength of growth in Asia, particularly China and India, surprised forecasters once more in 2006, and could do so again in 2007.

B.98 The risk from growing inflationary pressures, noted at the time of the Budget and Pre-Budget Reports in 2006, has yet to recede. G7 economic activity in 2007 is forecast to grow slightly faster than expected at the time of the Pre-Budget Report. Strong growth has been accompanied by increases in core rates of inflation, although they remain low by historical standards. A rise in energy prices, possibly caused by geo-political factors, remains a risk. These developments could prompt G7 central banks to tighten monetary policy further this year. Since the Pre-Budget Report there has been a more marked rise in inflation rates in some emerging markets, notably in India and China, and parts of Latin America and emerging Europe.

¹⁸ Treasury analysis based on various issues of *Forecasts for the UK economy: A comparison of independent forecasts*.

B.99 Among the major economies, the US has shown resilience to various shocks over the past four years, but growth could slow further if effects from the weaker housing market were to spill over to the wider economy. In Germany, there is the possibility of a greater than expected impact on domestic final demand following the 3 percentage point increase in VAT in January 2007. However, macroeconomic fundamentals in the euro area have improved, which, coupled with sustained growth momentum, could result in output growth in 2007 that exceeds current expectations.

B.100 Episodes of financial market volatility, such as that experienced in late February and early March this year, represent a further global risk to the outlook. Large and rapid fluctuations in the value of financial assets, possibly reflecting investors' changing attitudes to risk, can have an impact on global growth. These risks may be mitigated to some extent by the development of deeper, more diversified capital markets, and improvements in macroeconomic policy frameworks. In recent years, emerging markets, which tend to be particularly sensitive to developments in global financial markets, have generally improved macroeconomic fundamentals and significantly increased holdings of foreign currency reserves.

B.101 Global current account imbalances remain large. So far the adjustment in some currencies has been orderly, while more recently the balance of world growth has shifted slightly away from the US. However, a disorderly unwinding of these imbalances remains a risk to the global outlook.

B.102 Risks to the multilateral trading system remain, especially from the proliferation of bilateral and regional trade agreements, and increasingly protectionist trade policies. The most powerful signal that can be sent against protectionism is the successful conclusion of the current round of world trade talks. The UK Government continues to work hard with its EU partners, and in the World Trade Organisation, to build on the resumption of full-scale negotiations of the Doha Development Agenda. A firm commitment against protectionism can help to ensure that trade continues to improve living standards across developed and developing economies.

UK economy B.103 A key risk to the UK economic forecast remains the uncertainties over labour market data, and the possibility that if growth in the working-age population has been greater than officially recorded, there may be a greater degree of slack in the economy and thus more scope for growth. The disparities between survey indicators of capacity utilisation and recruitment difficulties, and at different skill levels within the recruitment surveys, add to the uncertainty over how close to trend the economy is currently operating.

B.104 In terms of the components of demand, despite strong growth in consumption at the end of 2006, forecast quarterly consumption growth rates in 2007 have been revised down from the 2006 Pre-Budget Report to reflect developments in interest rates and saving intentions. Risks to the forecast are therefore balanced between the upside risk from recent momentum and the downside risk that developments in households' finances will have a larger than expected impact on consumer spending. While some leading indicators suggest further strength in house price inflation in the short term, house prices remain high in comparison with incomes. The housing market therefore presents upside and downside risks to consumer spending. Business investment ended 2006 with even more momentum than was expected at the time of the Pre-Budget Report. To the extent that internal and external financing conditions remain supportive, and firms' margins recover as input cost pressures ease, there is again scope for investment growth to exceed expectations.

B.105 With inflation expected to remain above target during the first half of 2007, the risk remains that higher rates of actual inflation could feed through to inflation expectations and earnings growth. However, the evidence so far suggests that monetary policy has kept inflation expectations anchored to the inflation target and, while wage settlements growth has picked up a little, there has been no discernable impact on earnings growth.

Table B10: Summary of economic prospects¹

	Percentage change on a year earlier, unless otherwise stated				Average errors from past forecasts ⁵	
	2006	Forecast ^{2,3,4}			2007	2008
		2007	2008	2009		
Output at constant market prices						
Gross domestic product (GDP)	2¾	2¾ to 3¼	2½ to 3	2½ to 3	¾	½
Manufacturing output	1½	1¾ to 2	1¾ to 2¼	1¾ to 2¼	1¼	1¾
Expenditure components of GDP at constant market prices⁶						
Domestic demand	3	2¾ to 3¼	2½ to 3	2¼ to 2¾	¾	¾
Household consumption ⁷	2¼	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾	¾	1
General government consumption	2	2½	2½	2	½	1
Fixed investment	6	6½ to 7	3¼ to 3¾	3¼ to 3¾	2¾	2¼
Change in inventories ⁸	¼	-¼ to 0	0	0	¼	¼
Exports of goods and services ⁹	11¼	-2½ to -2	4¾ to 5¼	4½ to 5	2¼	3¼
Imports of goods and services ⁹	11½	-1¾ to -1½	4¼ to 4¾	4 to 4½	2½	2¾
Exports of goods and services (excluding MTIC)	6¼	5¼ to 5¾	5 to 5½	4½ to 5	-	-
Imports of goods and services (excluding MTIC)	7	5 to 5½	4¼ to 4¾	4 to 4½	-	-
Balance of payments current account						
£ billion	-39¼	-37	-39¼	-42¾	8¾	9¼
Per cent of GDP	-3	-2¾	-2¾	-2¾	¾	¾
Inflation						
CPI (Q4)	2¾	2	2	2	-	-
Producer output prices (Q4) ¹⁰	2	2¼	2	2	1	1½
GDP deflator at market prices	2¼	2¾	2¾	2¾	¼	½
Money GDP at market prices						
£ billion	1288¼	1361 to 1365	1432 to 1443	1506 to 1526	9	8
Percentage change	5¼	5½ to 6	5¼ to 5¾	5¼ to 5¾	¾	½

¹ The forecast is consistent with output, income and expenditure data for the fourth quarter of 2006, released by the Office for National Statistics on 23 February 2007. 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 assumption for the trend rate of output growth of 2¾ per cent. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of trend growth used as the basis for projecting the public finances, which is a ¼ percentage point below the neutral assumption.

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 current year and year-ahead projections made in spring forecasts over the past 10 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 2007 and 2008.

⁶ Further detail on the expenditure components of GDP is given in Table B11.

⁷ Includes households and non-profit institutions serving households.

⁸ Contribution to GDP growth, percentage points.

⁹ Figures up to and including 2007 are distorted by MTIC.

¹⁰ Excluding excise duties.

Table B11: 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
2006	775.3	252.2	207.6	5.6	1240.8	359.0	1599.9	400.6	1.5	1200.7
2007	793.3 to 795.7	258.2	221.2 to 221.9	3.7 to 4.5	1276.4 to 1280.3	350.4 to 351.5	1626.9 to 1631.8	393.6 to 394.8	1.8	1235.1 to 1238.9
2008	810.2 to 816.7	264.4	228.6 to 230.4	3.7 to 5.8	1306.9 to 1317.3	367.5 to 370.4	1674.4 to 1687.7	410.4 to 413.7	1.8	1265.7 to 1275.8
2009	828.8 to 839.4	269.8	235.8 to 238.9	3.5 to 7.0	1337.9 to 1355.1	383.6 to 388.5	1721.5 to 1743.6	426.8 to 432.3	1.8	1296.5 to 1313.1
2006	384.9	125.5	101.9	4.1	616.5	189.5	806.0	210.5	0.6	596.1
2nd half	390.4	126.8	105.7	1.5	624.3	169.5	793.9	190.1	0.9	604.6
2007	394.8 to 395.5	128.5	109.2 to 109.4	1.7 to 1.9	634.2 to 635.4	172.8 to 173.2	807.1 to 808.5	194.4 to 194.7	0.9	613.6 to 614.7
2nd half	398.5 to 400.2	129.7	112.0 to 112.5	2.0 to 2.6	642.2 to 645.0	177.6 to 178.3	819.8 to 823.3	199.2 to 200.0	0.9	621.5 to 624.1
2008	402.7 to 405.4	131.4	113.6 to 114.4	2.0 to 2.9	649.7 to 654.1	181.8 to 183.0	831.5 to 837.0	203.3 to 204.7	0.9	629.1 to 633.3
2nd half	407.5 to 411.3	133.0	115.0 to 116.0	1.7 to 2.9	657.2 to 663.3	185.7 to 187.4	842.9 to 850.6	207.1 to 209.0	0.9	636.7 to 642.5
2009	412.1 to 416.9	134.3	116.9 to 118.2	1.7 to 3.3	665.0 to 672.7	189.7 to 191.9	854.7 to 864.7	211.3 to 213.7	0.9	644.3 to 651.8
2nd half	416.6 to 422.5	135.5	119.0 to 120.6	1.8 to 3.7	672.9 to 682.4	193.8 to 196.6	866.7 to 879.0	215.5 to 218.6	0.9	652.1 to 661.3
Percentage changes on previous year ^{4,5}										
2006	2¼	2	6	¼	3	1¼	4¾	1½	¼	2¾
2007	2¼ to 2¾	2½	6½ to 7	0	2¾ to 3¼	-2½ to -2	1¾ to 2	-1¾ to -1½	0	2¾ to 3¼
2008	2¼ to 2¾	2½	3¼ to 3¾	0	2½ to 3	4¾ to 5¼	3 to 3½	4¼ to 4¾	0	2½ to 3
2009	2¼ to 2¾	2	3¼ to 3¾	0	2¼ to 2¾	4½ to 5	2¾ to 3¼	4 to 4½	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 per cent 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.