B THE ECONOMY

The Government's pursuit of economic stability has delivered the most favourable combination of low interest rates, low inflation and low unemployment since the 1960s. The challenge ahead lies in securing further progress towards full employment and closing the productivity gap, leading to stronger sustained growth in living standards for all:

- **The Government's policy frameworks helped to secure continued strong economic performance in 2000. GDP growth rose to 3 per cent, RPIX inflation averaged just over 2 per cent and unemployment fell to its lowest levels since the 1970s.**
- **GDP growth is still expected to ease back to its assumed trend rate of 2¼ to 2¾ per cent in 2001 and later years. The impact of weaker than previously expected global demand is likely to be offset by stronger momentum in domestic spending in the shorter term.**
- **But with economic stability and strong employment gains already secured, the UK economy is now well placed to achieve a much stronger productivity performance. This would lay the foundation for GDP growth at or beyond the upper ends of the Budget forecast ranges.**
- **The UK economy is now enjoying its longest period of sustained low inflation since the 1960s, helping to keep interest rates at historically low levels. RPIX inflation is forecast to rise gradually back to 2½ per cent by spring 2002.**
- **The economic outlook has become more uncertain since the Pre-Budget Report, in particular reflecting risks to US growth. But with sound public finances and low inflation, policy is well placed to respond to adverse news.**

Introduction[1,2]

B1 This chapter sets out the economic background to Budget 2001, providing updated forecasts for the UK and world economies over the next three years. The overview section provides a summary of the UK outlook in the light of developments since the November 2000 Pre-Budget Report, and in particular the recent slowdown in the US economy. Global prospects are summarised at the end of this chapter, preceded by a more detailed discussion of UK forecast issues and risks.

[1] The forecast is consistent with output, income and expenditure data to the fourth quarter of 2000 released by the Office for National Statistics (ONS) on 23 February 2001. This release also contained revisions to earlier quarters of 2000 which the Treasury has carried through to certain other national accounts series that the ONS has not yet revised, in particular sectoral saving and net borrowing. A fully consistent national accounts dataset for 2000 will be published by ONS on 26 March. A detailed set of charts and tables relating to the economic forecast is available on the Treasury's internet site (http://www.hm-treasury.gov.uk), and copies can be obtained on request from the Treasury's Public Enquiry Unit (020 7270 4558).

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

UK ECONOMY OVERVIEW

Table B1: Summary of forecast

		Forecast		
	2000	2001	2002	2003
GDP growth (per cent)	3	$2^1/_4$ to $2^3/_4$	$2^1/_4$ to $2^3/_4$	$2^1/_4$ to $2^3/_4$
RPIX inflation (per cent, Q4)	2	2	$2^1/_2$	$2^1/_2$

Recent developments

B2 2000 was a successful year for the UK economy. GDP growth increased to 3 per cent, in line with the Government's forecasts, and significantly above its post-war average of around $2^1/_2$ per cent. Strong growth in domestic demand more than accounted for the expansion, driven by a 3.6 per cent rise in household consumption, still well above trend rates. As had been expected, business investment decelerated significantly in 2000 following rapid growth over previous years, though it gathered pace in the second half. Whole economy fixed capital formation was supported by an estimated 5 per cent increase in general government investment.

B3 Buoyant external demand lifted total export volume growth to nearly $7^1/_2$ per cent in 2000, and goods volumes rose at their fastest rate since 1973. Manufacturing output growth of 1.6 per cent therefore was the highest since 1994, albeit still lagging the stronger expansion in services, but variation in performance within the sector remains marked. This contributed to a better net trade performance compared to the previous two years, though still robust growth in import volumes meant that net exports reduced GDP growth by 0.9 percentrage points in 2000. The current account deficit overall showed signs of stabilising at around $1^1/_2$ per cent of GDP.

B4 Further gains in the employment rate have driven unemployment to its lowest level since the 1970s, ending 2000 at 5.3 per cent on the International Labour Organisation (ILO) measure and just 3.5 per cent on a claimant count basis. Nevertheless, productivity growth rose to an estimated $2^1/_4$ per cent for the year as a whole, a considerable improvement over previous years. Despite labour market tightening and evidence of skills shortages, growth in average earnings and unit wage costs remain within sustainable limits. RPIX inflation was just 2.1 per cent in 2000, the lowest annual average since 1963, notwithstanding the sharp rise in oil prices during the course of the year.

B5 The main news since the Pre-Budget Report has been the significant slacking in global economic growth during the second half of 2000. This was driven by a sharper than anticipated slowdown in the US, with growth falling from 1.4 per cent in the second quarter of 2000 to just 0.3 per cent in the fourth quarter. Consumer and business sentiment weakened sharply, financial conditions tightened and the manufacturing sector began to contract. In response, the Federal Reserve cut interest rates by 100 basis points in January. Growth in Europe has eased far more modestly, with consumer demand remaining firm. The mild recovery in Japan appears to be losing momentum, and countries in emerging Asia have slowed markedly.

B6 UK growth also slowed during the second half of 2000, though the latest GDP growth estimate probably understates the continued underlying strength of demand in the UK goods and labour markets. GDP rose by just 0.3 per cent in the fourth quarter of 2000, down from 1.0 per cent and 0.8 per cent in the second and third quarters respectively. However, an erratic fall in oil and gas output had a significant impact, reducing fourth quarter GDP growth by 0.2 percentage points. Poor autumn weather and disruption to the rail network may also have affected the growth profile.

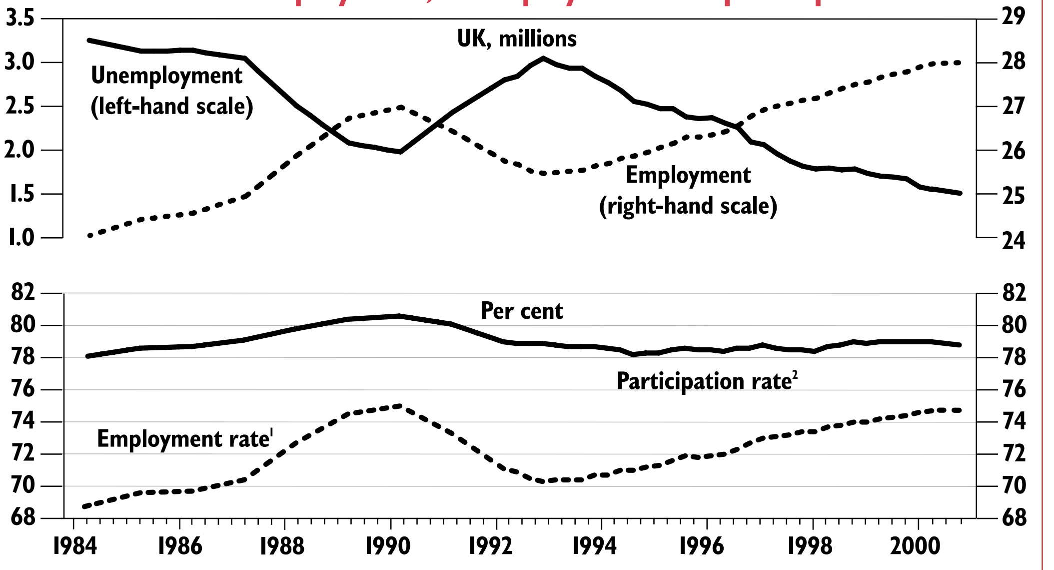
B7 Excluding oil and gas output, GDP growth was much closer to trend in the fourth quarter of 2000, in line with the Pre-Budget Report forecast. This was also reflected in still buoyant growth in final domestic demand, which rose by 0.7 per cent. Household consumption growth eased to 0.7 per cent though, following revisions to earlier quarters, it now shows little sign of an underlying slowing during the course of 2000. Strong growth in retail sales volumes and a recovery in car registrations during the fourth quarter tell a similar story. Consumer confidence remains at high levels and the saving ratio has declined further.

B8 Still buoyant growth in household spending was reinforced by growth in general government consumption during the second half of 2000. Total business investment growth also picked up significantly, driven by services, but with manufacturing investment remaining subdued, despite improved sentiment recorded in business surveys. Goods export volume growth has remained robust, despite slacker external demand, but services volumes fell markedly in the fourth quarter. Import volume growth has been rather weaker than expected, surprisingly so from EU countries, with net trade making a modest positive contribution to growth in the fourth quarter.

The labour market

B9 Latest official data indicate that the working-age employment rate has recently flattened out at a historically high level, having stayed close to 74.6 per cent since last spring. But with population rising strongly, Labour Force Survey (LFS) employment increased by a further 225 thousand during the course of 2000, contributing to a total rise of more than one million since spring 1997[3]. Modest falls in employment recorded in the autumn probably reflected temporary factors. Severe weather and transport disruption may have led to one-off dislocations in labour supply: fewer temporary employees more than accounted for the dip in total employment, and LFS employment in the fourth quarter was little changed on its third quarter record high.

Chart B1: LFS employment, unemployment and participation



[1]Employment as a per cent of working-age population.
[2]Percentage of the working-age population who are economically active (i.e. employed or unemployed).

[3] The LFS has not yet been re-grossed to new (higher) population estimates post-1998, and the published LFS data quoted in this chapter will in due course be subject to revision.

B10 Moreover, business surveys provide little evidence of any stalling in employment growth. The Chartered Institute of Purchasing and Supply (CIPS) whole economy employment index has remained close to levels last seen in mid-1998. This mainly reflects buoyant service sector readings, though the manufacturing index has edged up close to the level consistent with employment bottoming out. Forward-looking survey measures of employment intentions also signal buoyant labour demand, backed by still high levels of new notified vacancies and record readings for the Recruitment and Employment Confederation index of press recruitment advertising. Ratios of new and total unfilled vacancies to unemployment remain close to record highs, and survey evidence of recruitment difficulties is still widespread.

B11 ILO unemployment has flattened somewhat since summer 2000, and currently stands at just over $1^1/_2$ million, or 5.3 per cent. Labour market turning points are typically signalled by an increased rate of job loss. However, at around seven people in every thousand in autumn 2000, the redundancy rate remained at a low level and is little changed on a year earlier. This compares to a peak of well over ten per thousand in the early 1990s. Similarly, the flattening in claimant unemployment last autumn largely reflected a decline in people leaving the count, with inflows into unemployment showing a gradual downward trend in 2000. Subsequent substantial falls in claimant unemployment in December and January have driven the rate to just 3.5 per cent, its lowest since 1975.

B12 Wage pressures have increased moderately since the Pre-Budget Report. Headline earnings growth was 4.4 per cent in the three months to December, around $^1/_2$ percentage point above its trough in summer 2000, though still well down on its 6 per cent millennium peak. Monthly data show that overall earnings growth in December was boosted by renewed positive contributions from bonus payments. But underlying earnings (excluding bonuses) growth has also moved just above $4^1/_2$ per cent, and settlements have been edging up too. Nevertheless, with the step up in productivity growth to well over 2 per cent since late 1999, unit wage cost growth has come down. It is estimated to have remained below $2^1/_2$ per cent in the fourth quarter of 2000, despite the erratic dip in output growth. Manufacturing productivity growth picked up to 4.8 per cent in the fourth quarter, and unit wage cost growth turned negative again after a year of modest growth.

B13 The National Minimum Wage (NMW) of £3.60 per hour for employees aged 22 years and over was introduced in April 1999, and increased to £3.70 in October 2000. Before introducing a NMW the Government carefully considered its wider impact, and ensured that it was set at a prudent and sensible level. To date there is little or no evidence of any adverse effects on employment or inflationary pressures. The Government has announced that the adult rate will be increased to £4.10 from October 2001, and £4.20 from October 2002. Compared with the introductory adult NMW of £3.60, the increase to £4.10 might boost total wage costs by under $^1/_4$ per cent, and the further increase in October 2002 is in line with expected inflation.

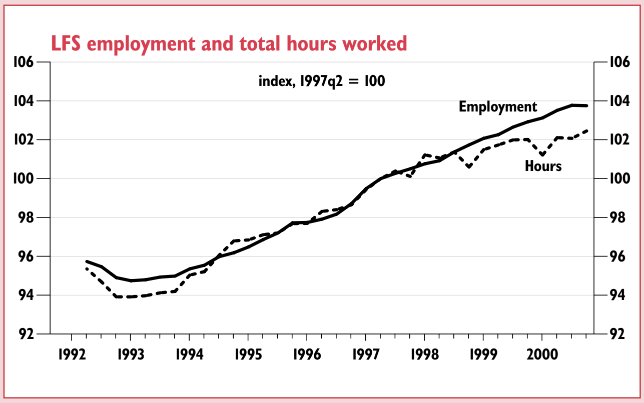
Trend output growth

B14 Sustainable output growth in the late 1990s has been driven by a substantial rise in the employment rate to just below the 75 per cent figure recorded in 1990. But then it reflected a strong cyclical peak in the output cycle, and labour cost pressures rose significantly. By contrast, wage and price inflation have remained relatively subdued in recent years, signalling improved underlying labour market performance. This has taken most commentators by surprise, and consensus forecasts for employment and unemployment have typically proved too pessimistic. Box B1 looks at the unexpected strength of employment growth in more detail.

Box B1: Why has employment growth been so strong?

Between spring 1997 and the fourth quarter of 2000 ILO unemployment has fallen by 520 thousand, with the rate down from 7.2 per cent to 5.3 per cent. Moreover, as set out in the Pre-Budget Report, this fall is judged to have been mainly structural rather than cyclical, given the surprisingly subdued trend in wage inflation. In other words, the sustainable or non-accelerating inflation rate of unemployment (NAIRU) has come down sharply, providing an important supply-side boost for the UK economy by raising available labour supply, despite the relatively weak upward trend in aggregate labour market participation.

Among various factors contributing to a lower NAIRU, significant reductions in long-term unemployment are thought to have played a key role. More effective job search has helped to contain pay pressures at lower aggregate levels of unemployment. Numbers unemployed for more than 12 months (ILO basis) have nearly halved since spring 1997, a fall of 380 thousand in total, compared to a 11 per cent reduction in shorter-term unemployment. This is likely to reflect the culmination of a succession of labour market programmes, including the impact of the New Deal. Enhanced product market competition and greater economic stability, by anchoring inflation expectations, are also likely to have helped to moderate wage pressures.



Labour market adjustment to supply-side changes is typically fairly sluggish, meaning that actual unemployment can deviate from its sustainable level for long periods. This reflects costs of adjustment for both firms and workers. However, LFS employment has risen by well over a million since spring 1997, and the working-age employment rate has risen from 72.9 per cent to 74.6 per cent, and across all age groups. This rapid absorption of increased labour supply into employment suggests that employer demand-side factors have also been more conducive to employment growth in recent years.

An examination of trends in heads and hours-based measures of labour provides part of the explanation. LFS total hours worked have risen at an annual average 0.7 per cent since the second quarter of 1997, compared to 1.1 per cent a year growth in numbers employed. Hence falling average hours appear to have boosted demand for workers, accounting for around one third of the increase in LFS employment. The modestly rising share of part-time employment within the total accounts for only a small part of the reduction in average hours overall. Rather, a fall in full-time average hours has been the main driver, and this is likely to have been a trend rather than cyclical effect.

Greater economic stability provides one possible explanation for relatively rapid growth in heads-based measures of labour demand. Uncertainty about prospects encourages firms to increase labour demand through rising hours and temporary employment. Conversely, economic stability lowers firms' perceived risk of incurring hiring and firing costs and so encourages them to take on permanent employees and reduce overtime. Indeed, the proportion of temporary employees within total employment has fallen markedly against a previously rising trend, from 6.7 per cent in spring 1997 to 6 per cent currently. By contrast, the share of temporary employees increased significantly in the earlier 1990s, accounting for around one third of employment gains between spring 1993 and spring 1997. At the same time, overtime hours and involuntary part-time working have also declined in recent years, and increased job security has probably been a key factor supporting high levels of consumer confidence.

Thus against the background of fundamental supply-side improvements pushing down the NAIRU, the impact of greater economic stability in boosting demand for workers may be another important factor in explaining the buoyancy of employment growth since 1997.

B15 A formal analysis of trend output growth was set out in the Pre-Budget Report[4]. The non-accelerating inflation rate of unemployment (NAIRU) appears to have fallen broadly in line with actual unemployment over recent years, to around $5^1/_2$ per cent on the ILO definition. This has underpinned estimated trend output growth of just over $2^1/_2$ per cent a year since the first half of 1997. Rising employment probably also largely explains temporarily subdued productivity growth over the same period, given the evidence that those entering work tend to have lower than average productivity levels. Underlying productivity performance is estimated to have been only just below the long-run average growth rate of around 2 per cent a year.

B16 Looking ahead, the mid-points of the Budget 2001 forecast ranges are again anchored on the neutral assumption of $2^1/_2$ per cent a year trend output growth, whereas projections for the public finances (Chapter C) continue to be based on the deliberately cautious $2^1/_4$ per cent assumption. However, a number of respected independent organisations explicitly adopt a more favourable central view. In particular, it is argued that the UK is now well placed to achieve a significantly stronger productivity performance than the neutral 2 per cent assumption underlying the economic forecast. This might partly reflect a period of 'catch-up', with businesses striving to secure further productivity improvements in order to restore profitability, and also to avoid excess wage pressures in a tight labour market. Such factors would encourage a gradual rebalancing from employment to productivity-led growth, as seen over the past year.

B17 Moreover, there are good grounds for anticipating a more fundamental improvement in productivity. There has been growing support for the view that 'capital deepening' through Information and communications technologies (ICT) investment and related diffusion of know-how has contributed to the acceleration in US trend productivity since the mid-1990s. The UK's ICT spending record appears broadly comparable to the US, with investment estimated to have risen by around 30 per cent a year in real terms in the late 1990s[5]. Moreover, a Department of Trade and Industry study[6] shows that the UK fares well internationally in terms of firms' computer usage, internet access, and provision of ICT training. But while the evidence suggests that UK firms are well placed at least partly to emulate US performance, the Budget 2001 forecast makes only a small allowance for upside productivity potential within the upper limits of the forecast ranges.

B18 The upper ends of the forecast ranges also make only a very modest allowance for the possibility of further employment rate increases, beyond the modest 0.1 per cent a year figure built in to the neutral trend growth assumption. Here the scope for doing better is highlighted by continued dispersion in regional and local labour market performance, despite the significant narrowing already achieved. As set out in chapters 2, 3 and 4 of the EFSR, Government policies to extend employment opportunity and close the productivity gap, backed by the continued delivery of economic stability, will play their part in raising the trend rate of growth.

[4] See Annex A of the *Pre-Budget Report*, HM Treasury, November 2000 and especially Table A2, page 147. This table decomposes trend output growth during the 1990s into estimated contributions from growth in trend labour productivity and the employment rate. It also set out the Government's $2^1/_2$ per cent a year neutral assessment of the outlook for trend output growth.

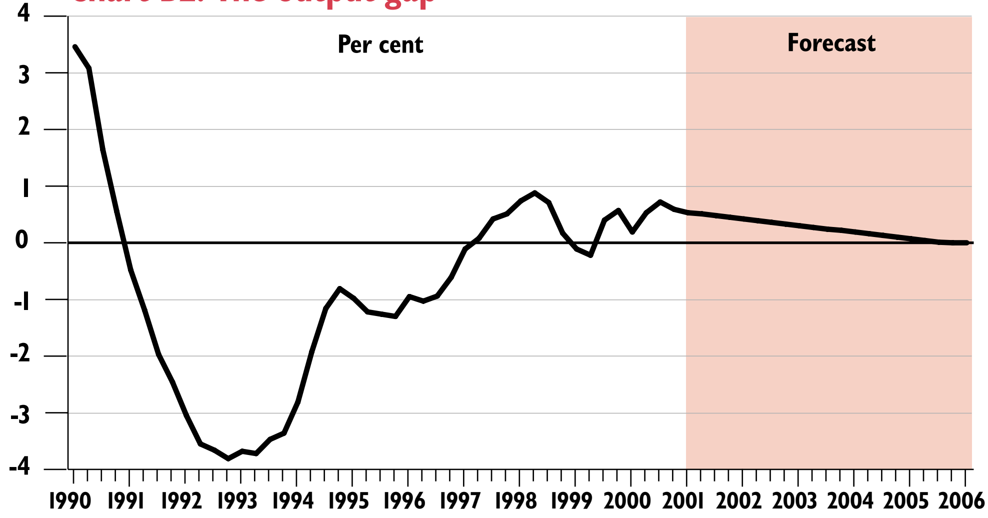
[5] Treasury estimate based on input-output tables for the period 1995–98.

[6] *Business in the Information Age: International Benchmarking Study 2000*, UK Online for Business, Department of Trade and Industry, October 2000.

Output and demand

B19 There are no compelling reasons to change the judgement that the economy is currently operating just above potential. Assuming trend growth of just over 2$^1/_2$ per cent through to end-2000, latest data imply an output gap of just over $^1/_2$ per cent in the fourth quarter of 2000, much as expected in the Pre-Budget Report. Although underlying earnings growth has edged up slightly, most measures of domestic inflation remain subdued and some survey indicators of capacity utilisation have recently eased. Thus there is a case for a slightly stronger estimate of trend growth since 1997, and hence a somewhat smaller estimate of the current output gap. However, a longer run of supporting evidence would be needed fully to justify such a judgement.

Chart B2: The output gap[1]



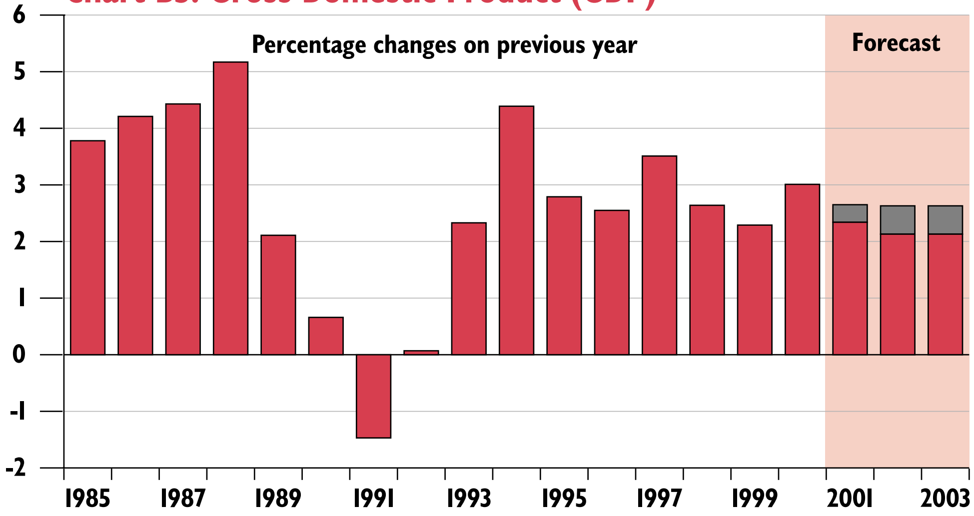
[1] *Actual output less trend output as a percentage of trend output (non-oil basis).*

B20 While overall growth prospects are little changed since the Pre-Budget Report, recent developments suggest that the short-run composition of demand is likely to be different. US import growth dried up late in 2000 and the short-term outlook for US growth has deteriorated significantly (see Box B3). With the US market accounting for less than one fifth of UK exports, direct impacts on UK growth are unlikely to be very large. However, taking account of implications for third countries, UK export market growth is now forecast to slow more sharply than previously expected during the course of 2001, falling to 6 per cent for the year as a whole, down from 11$^1/_4$ per cent in 2000.

B21 Though improved business survey indicators signalled robust export demand early in 2001, weaker world demand is now expected to drive a significant slowing in export volume growth during the course of the year. The full impact is likely to be only partly offset by sterling's depreciation: the exchange rate index has fallen by around 5 per cent since its peak in October 2000. Export volumes are now forecast to grow by 5$^1/_2$ to 5$^3/_4$ per cent in 2001 and 4$^3/_4$ to 5$^1/_4$ per cent in 2002, though this masks an expected pick-up in both export markets and sales during the course of 2002. Net exports are now expected to subtract 1 percentage point from GDP growth in 2001 and 2002, both $^1/_2$ percentage point weaker than the Pre-Budget Report forecast.

B22 The weaker global outlook may also impact on domestic spending. Company earnings on the UK's substantial equity and direct investments in the US are likely to fall, and prospects for future output growth have become more uncertain. Such factors could restrain business investment growth in the UK, though underlying profitability has improved and survey investment intentions are generally buoyant. Moreover, domestic confidence has shown little reaction to US developments. The Confederation of British Industry (CBI) business optimism indicator rose to long-run levels in January and consumer confidence, particularly in their own financial situation, remains historically high. Sentiment should be buoyed by the Monetary Policy Committee's (MPC) pre-emptive cut in interest rates in February.

Chart B3: Gross Domestic Product (GDP)[1]



[1]*Shaded areas on bars represent forecast ranges.*

B23 Indeed continued momentum in domestic demand is expected fully to offset weaker trade prospects. Consumer spending in particular has continued to exceed expectations, rising at an annualised rate of over $3\frac{1}{2}$ per cent in the second half of 2000. It is now forecast to grow by $3\frac{1}{4}$ to $3\frac{1}{2}$ per cent in 2001, easing only modestly from 2000, and about 1 percentage point stronger than expected in November. Buoyant consumer demand is expected to be reinforced by the planned increase in government spending and some pick-up in business investment. Rapid growth in final demand may be partly met by de-stocking given strong inventory accumulation in mid-2000. Domestic demand overall is therefore forecast to rise by $3\frac{1}{4}$ to $3\frac{1}{2}$ per cent this year, $\frac{1}{2}$ percentage point above the Pre-Budget Report forecast, underpinning an unchanged GDP growth forecast of $2\frac{1}{4}$ to $2\frac{3}{4}$ per cent in 2001.

B24 Increased indebtedness is expected to encourage households to rebuild saving beyond 2001, and so the unexplained element in recent consumer spending strength is assumed to dissipate. Household consumption growth is therefore forecast to fall back to $2\frac{1}{4}$ to $2\frac{3}{4}$ per cent by 2003, bringing it much closer into line with key determinants, including an easing in real income growth back to longer-run rates in 2002 and diminished wealth effects. Growth in government spending is also planned to ease beyond 2001–02, and so domestic demand growth overall is forecast to fall back gradually to $2\frac{3}{4}$ to $3\frac{1}{4}$ per cent in 2002 and $2\frac{1}{4}$ to $2\frac{3}{4}$ per cent in 2003. The contribution of net trade to GDP growth is forecast to strengthen gradually over the same period, as import volume growth eases to trend rates and export demand recovers. GDP growth overall therefore is expected to remain around its estimated trend rate of $2\frac{1}{4}$ to $2\frac{3}{4}$ per cent in 2002 and 2003.

B25 Downside risks to the outlook have clearly sharpened since November, mainly reflecting the possibility of a harder landing for the US economy. This would imply further weakening in demand for UK exports, though possibly partly offset by adjustments in world exchange rates. Adverse global news might also temporarily depress UK business and consumer confidence. Nevertheless, private sector financial imbalances remain moderate both compared to the past, and to current US experience. Overall balance sheet health also suggests that adjustment in private demand should be fairly gradual, and provides some cushion against adverse external events (see Box B2). But private sector financial health is clearly susceptible to further falls in share prices, despite the substantial adjustment in high technology stocks that has already occurred.

B26 The economic forecast makes no allowance for the economic effects of the current outbreak of Foot and Mouth Disease. Whereas this has potentially serious implications for the livestock farming and related sectors of the economy, on any reasonable assumptions about the duration and direct and knock-on effects of the outbreak, there is unlikely to be a discernible impact on aggregate GDP growth.

Inflation

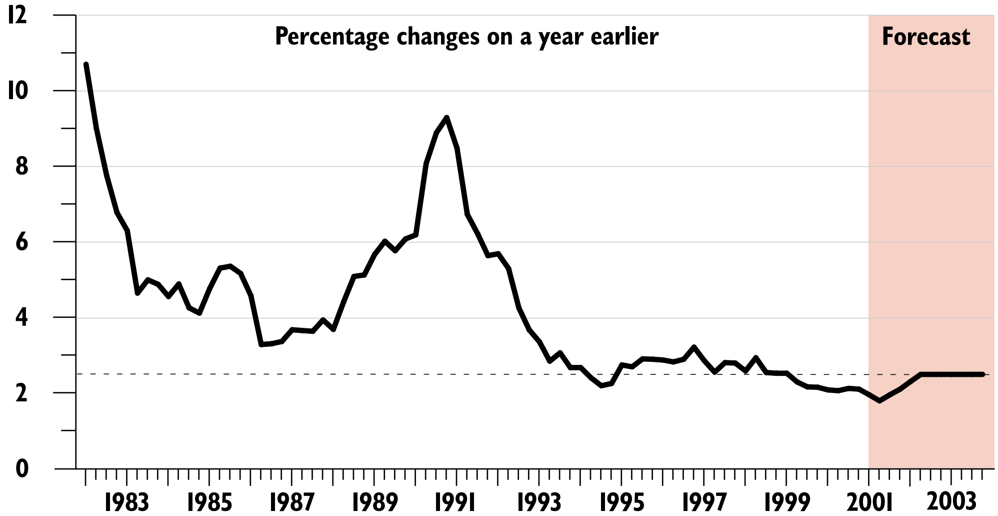
B27 The UK economy is witnessing the longest period of sustained low inflation since the 1960s and, on the HICP measure, UK inflation since the end of 1999 has been the lowest in the EU. RPIX inflation modestly undershot the Government's inflation target throughout 2000, averaging just over 2 per cent for the year as a whole. Direct upward pressures on petrol pump prices as a result of dearer oil were more than offset by further deflation in other goods sectors and, within services, significant cuts in utility prices in the spring. With oil prices falling from their autumn 2000 peak, RPIX inflation has edged down since the Pre-Budget Report, reaching just 1.8 per cent in January. This is lower than expected in November, though sharp changes in petrol prices have contributed to volatility in the monthly outturns.

B28 The rise in oil prices to more than $30 per barrel in September 2000 provided the main inflationary impulse last year. Direct impacts on petrol and domestic heating prices added around 0.6 per cent to RPIX inflation during the year, and headline producer input and output price inflation also trended higher until the autumn. However, core output price inflation was much more subdued, remaining at around 1 per cent for much of the year. With non-oil import prices also rising gradually during 2000, this indicates a further compression of producer margins helping to contain domestic inflationary pressures.

B29 The significant deceleration in unit wage costs provides the clearest evidence that domestic price pressures have moderated. Unit wage cost growth fell below 2 per cent from mid-2000, reflecting both the slowing in average earnings growth since spring and also the significant pick-up in productivity growth. While shorter-term movements in productivity can be misleading, the recent trend in domestic cost growth suggests that still buoyant expansion in domestic demand can be accommodated for a period. Against this, beyond a sharp fall in insurance price inflation, there has been only very tentative evidence of a more general moderation in core services inflation.

B30 This highlights the protracted, but uneven, impact of sterling's strength on margins across the various sectors of the UK economy. RPIX goods inflation outturns have benefited not only from a further compression of producer margins, but also a continued squeeze at the retail level. Inflation in some sectors, including household goods and clothing and footwear, has reached 40-year lows. By contrast, the service sector is relatively sheltered from competitive forces associated with the level of sterling, and profitability is likely to have risen as headline earnings growth fell back. Latest evidence suggests that the underlying pace of retail goods deflation may be easing, helped by the recent recovery of the euro. An increasing balance of retailers expect to raise prices in the period ahead, according to the CBI Distributive Trades Survey.

Chart B4: RPIX[1]



[1]*Outturns until 2000Q4; forecasts for every second quarter from 2001Q2 to 2003Q4.*

B31 As in November, oil prices are assumed to remain around the mid-point of the OPEC target range of \$22-\$28 a barrel, implying that their direct contribution to inflation will turn negative from spring 2001. Nevertheless, RPIX inflation is expected to rise gradually back to its $2^1/_2$ per cent target by spring 2002, reflecting upward pressure from non-oil import prices and a declining negative contribution from changes in margins. Wage inflation has edged up recently, and domestic costs may exert further upward pressure on inflation before the output gap closes. Compared to the Pre-Budget Report forecast, the more prolonged expected undershoot of the Government's inflation target mainly reflects both a lower starting point for the projection and a smaller contribution from indirect taxes. Budget 2001 excise duty measures, compared to revalorisation of rates, are expected to lower RPIX inflation by around 0.3 percentage points between July 2001 and March 2002, and by marginally less up to July.

B32 GDP deflator inflation averaged 1.8 per cent in 2000, down from 2.3 per cent in 1999. The fall reflected a smaller positive contribution from the terms of trade coupled with a sharp drop in consumers' expenditure deflator (CED) inflation to its lowest level since 1959. CED inflation is now more than 1 percentage point below RPIX inflation, mainly reflecting coverage differences. CED inflation is expected to move gradually back in line with RPIX inflation through 2001, pushing up overall GDP deflator inflation to $2^1/_4$ per cent in 2001 and $2^1/_2$ per cent thereafter.

Independent forecasts

B33 The independent consensus for GDP growth in both 2001 and 2002 is 2.6 per cent, little changed since autumn, and very close to the mid-points of the Budget 2001 forecast ranges. New independent forecasts for GDP growth released in February were slightly weaker on average, possibly reflecting the latest global developments, though moderate UK growth in the fourth quarter of 2000 will have been a factor. Independent forecasts show the balance of payments current account deficit stabilizing at around $1^3/_4$ per cent of GDP in 2001 and 2002. These deficits are smaller than in the Budget 2001 forecast though, as always, there exists a very wide range of views around the independent average.

Table B2: Budget and independent[1] forecasts

	Percentage changes on a year earlier unless otherwise stated					
	2001			2002		
		Independent			Independent	
	March Budget	**Average**	**Range**	**March Budget**	**Average**	**Range**
Gross domestic product	$2^1/_4$ to $2^3/_4$	2.6	1.5 to 3.2	$2^1/_4$ to $2^3/_4$	2.6	0.7 to 3.6
RPIX (Q4)	2	2.2	1.3 to 2.6	$2^1/_2$	2.4	1.4 to 3.2
Current account (£ billion)	$-21^3/_4$	–17.7	–26.0 to –4.9	$-25^1/_4$	–17.6	–37.9 to –8.0

[1] *'Forecasts for the UK Economy: A Comparison of Independent Forecasts', February 2001.*

B34 The average projection for RPIX inflation in the fourth quarter of 2001 has edged down to 2.2 per cent, broadly in line with the Budget 2001 forecast. It is expected to return gradually to its $2^1/_2$ per cent target by the fourth quarter of 2002. The consensus of medium-term forecasts regularly monitored by the Treasury shows average GDP growth of between $2^1/_2$ and $2^3/_4$ per cent in the period 2003 to 2005, with RPIX inflation remaining close to target. This suggests that independent analysts' assumptions for trend output growth may be above the Government's neutral $2^1/_2$ per cent assessment.

UK FORECAST IN DETAIL

The household sector

B35 With revised data now showing annualised growth in household consumption stuck at $3^1/_2$ to 4 per cent during much of 2000, clear signs of a slowing to more sustainable rates are now hard to discern. Available evidence suggests that the 0.7 per cent expansion in consumption in the fourth quarter of 2000 was driven by further robust services and retail goods spending. However, much more rapid growth in the durables category is also notable, particularly given the temporary weakness in spending on vehicles. Durables are typically the most cyclical element of household consumption, and so any deceleration in spending might have been expected to show most clearly in this area. Consistent with this, housing market indicators have shown some firming in prices and expected turnover since the Pre-Budget Report.

Box B2: Private sector financial position

Households and private non-financial companies (PNFCs) have both moved into overall financial deficit in recent years (chart a), driven mainly by lower household saving and increased PNFC capital spending. The desire to contain net borrowing has clearly helped to restrain company spending recently, and business investment has decelerated significantly despite buoyant output growth and signs of improved profitability. A key feature of the Budget 2001 forecast is that household spending behaviour follows suit, with a gradual recovery in the saving ratio helping to return consumption growth to sustainable rates by 2002.

There is, however, a risk of sharper or deeper adjustment in domestic spending. In the shorter term, events in the US could act as the catalyst given direct financial market and investment linkages, as well as the possibility of a more general loss of confidence. Past experience suggests that this risk may hinge on several factors. Not surprisingly, the overall scale of financial imbalances is crucial. However, the speed of any adjustment is also likely to depend on the private sector's overall balance sheet position. Monetary policy may also be important.

Despite the deterioration over recent years, the UK private sector and current account deficits remain modest by US standards, and still well below late 1980s levels. Relatively restrained investment in housing assets in particular has helped to contain household net borrowing, despite the sharp fall in the saving ratio. Company investment has been stronger, but saving has held up, keeping PNFC net borrowing well below its end-1980s' peak.

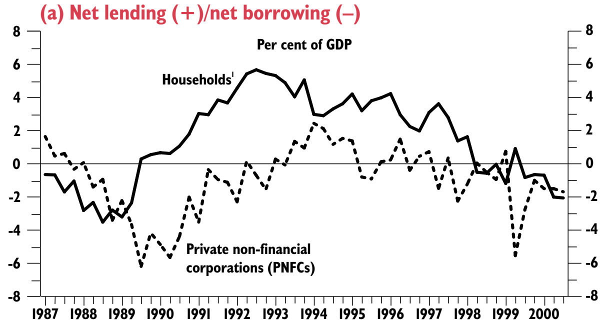
Most important, the burden of interest payments is now decisively lower (chart b). Because the economy is fairly close to trend, there seems little prospect of higher interest rates driving income gearing to the levels that caused severe financial distress in the early 1990s. It also implies greater scope for monetary policy manoeuvre in the event of any general weakening in prospects.

Although the household sector debt-income ratio has risen to record levels in recent years, this has been more than matched, and probably encouraged, by rapid gains in wealth (chart c). Strong growth in financial wealth in particular has pushed the ratio of total household wealth to income to record levels, though such gains are likely to have been skewed towards the top end of the income distribution. Similarly, company worth has risen sharply, meaning that PNFC capital gearing (the ratio of debt to share capital) at market valuations is relatively benign (chart d), despite large increases in debt. This may also mask significant distributional variation; debt burdens and capital gearing is likely to be much higher within sectors undergoing rapid technological change, notably telecommunications.

Private balance sheet strength seems likely to encourage a gradual, as opposed to sharp, reduction in future borrowing and also provides some cushion against adverse news. But any failure of demand to adjust would raise the risk of a more serious retrenchment in the medium term. Moreover, with private debt at high levels, overall financial health remains susceptible to asset valuations, notwithstanding the recent modest decline in share prices. In the event of a much sharper fall in equities, households and firms would probably want to reduce their debt burden. So particularly in the company sector, where debt as a proportion of the capital stock at purchasers' prices is now very high, any re-assessment of future income prospects could have a significant impact on spending and therefore the short-term economic outlook.

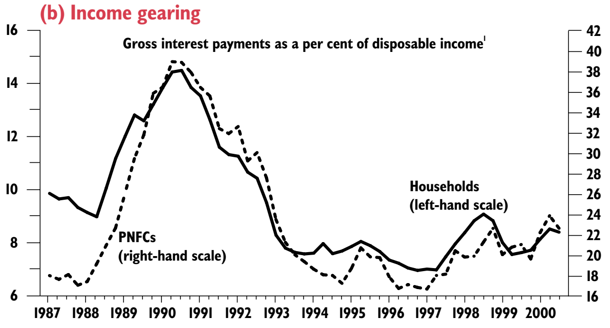
Box B2: Charts

(a) Net lending (+)/net borrowing (–)



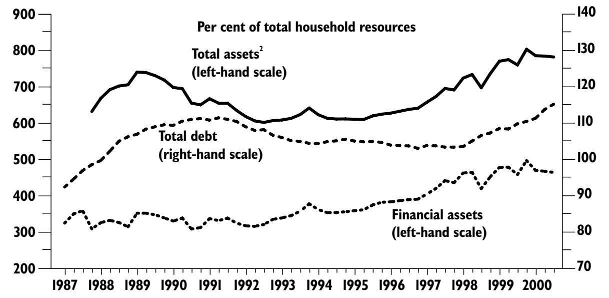
[1] Including non-profit institutions serving households, as with other charts in this box.

(b) Income gearing



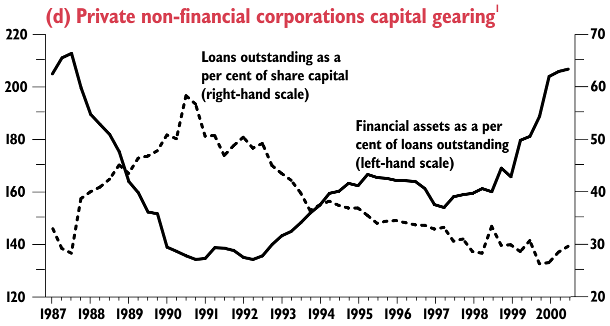
[1] Denominator for PNFCs is post-tax profits (gross operating surplus less taxes on income).

(c) Household debt and wealth ratios[1]



[1] Stocks of assets and liabilities expressed as a per cent of household resources over past year.
[2] Includes tangible (mainly housing) assets. Treasury estimates in 2000.

(d) Private non-financial corporations capital gearing[1]



[1] Assets and share liabilities valued at market prices.

B36 It is difficult to account for the pace of consumption growth over recent years in terms of long-run determinants such as real incomes, wealth and interest rates. A significant slowing in household consumption might have been expected during the course of 2000, as earlier monetary policy tightening took effect and support to spending from past gains in household wealth dissipated. Continued robust spending could reflect a range of factors. For example, Bank of England analysis shows that only a small part of the increase in official interest rates during the second half of 1999 was passed on to consumers. Increased job security resulting from reductions in involuntary part-time and temporary working may also have played a part in boosting consumer confidence (Box B1). However, the failure of economic models to account for the strength of the recent consumer cycle is not unusual in an historical context. In particular, the timing of turning points in consumer borrowing is very hard to predict.

B37 Unexpected strength in consumer spending has been mirrored in a significant decline in the household saving ratio. Greater job security and low inflation may have permanently reduced longer-term precautionary motives for saving, and net household borrowing is estimated to be around 1½ per cent of GDP in 2000. However, the Budget 2001 forecast assumes that households will wish to curtail borrowing beyond 2001, notwithstanding the recent reduction in official interest rates. Household consumption growth therefore is expected to fall back from 3¼ to 3½ per cent in 2001 to 2¼ to 2¾ per cent by 2003, more clearly in line with key determinants, including slower real income growth and more moderate gains in wealth. Any further significant deterioration in household financial balances would heighten the risk of a sharper adjustment in spending in later years (Box B2).

Table B3: Household sector[1] expenditure and income

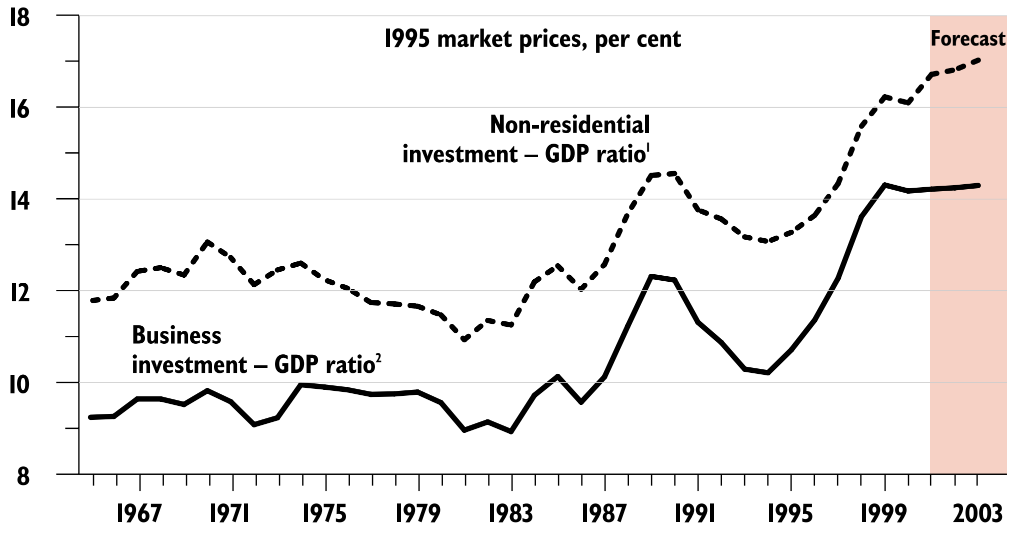
	Percentage changes on previous year			
		Forecast		
	2000	2001	2002	2003
Household consumption[2]	3¾	3¼ to 3½	2½ to 3	2¼ to 2¾
Real household disposable income	2¼	4¼ to 4½	2½ to 3	2½ to 3
Saving ratio (level, per cent)	3¾	4¾	5	5¼

[1] *Including non-profit institutions serving households.*
[2] *At constant prices.*

Companies and investment

B38 Business investment growth fell back to 2.1 per cent in 2000, closely in line with the Budget 2000 and Pre-Budget Report forecasts. The ratio of business investment to GDP at constant prices ended the year at 14.5 per cent, a new record high, buoyed by continued falls in the price of ICT capital goods. This has contributed to a marked increase in PNFC borrowing since the mid-1990s, reaching 2 per cent of GDP in 1999 though easing somewhat in 2000. Although historically low average interest rates have kept income gearing at low levels, a desire to contain the deterioration in company finances probably goes a long way towards explaining the recent slowing in investment growth. Moreover, the underlying trend may have been exaggerated by a bunching of expenditures in the run-up to the millennium. The profile of business investment during 2000 supports this, with quarterly growth rising above 3 per cent in the fourth quarter following a much weaker first half of the year.

Chart B5: Business and non-residential investment ratios



[1]*Whole economy less dwellings.*
[2]*Business investment includes investment by public corporations (except National Health Service Trusts) and investment under the Private Finance Initiative.*

B39 Increased corporate indebtedness is expected to prevent further rapid growth in business investment in the period ahead, notwithstanding evidence of improved company profitability. The PNFC gross operating surplus stepped up markedly in 2000, though buoyed by the sharp improvement in North-Sea profits. Underlying pressures also look to have eased as still robust output growth drove a significant upturn in productivity, and export prices began to rise, now assisted by the stronger euro. The British Chambers of Commerce (BCC) measures of profit expectations have risen above their long-run averages, and manufacturing investment intentions have recovered well above the levels that foreshadowed weak spending since 1999. Still buoyant service sector intentions are harder to interpret. The BCC measure failed to pick up the earlier deceleration in services investment, perhaps reflecting a significantly uneven distribution of spending within the sector.

Table B4: Gross fixed capital formation

	Percentage changes on previous year			
		Forecast		
	2000	2001	2002	2003
Whole economy[1]	2¼	5½ to 5¾	3 to 3½	3½ to 4
of which:				
Business[2,3]	2	2½ to 3	2¼ to 2¾	2½ to 3
Private dwellings[3]	2¾	¼ to ¾	2 to 2½	2 to 2½
General government[3,4]	5	43½	8½	11¾

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

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

[3] *Excludes purchases less sales of land and existing buildings.*

[4] *Includes National Health Service Trusts.*

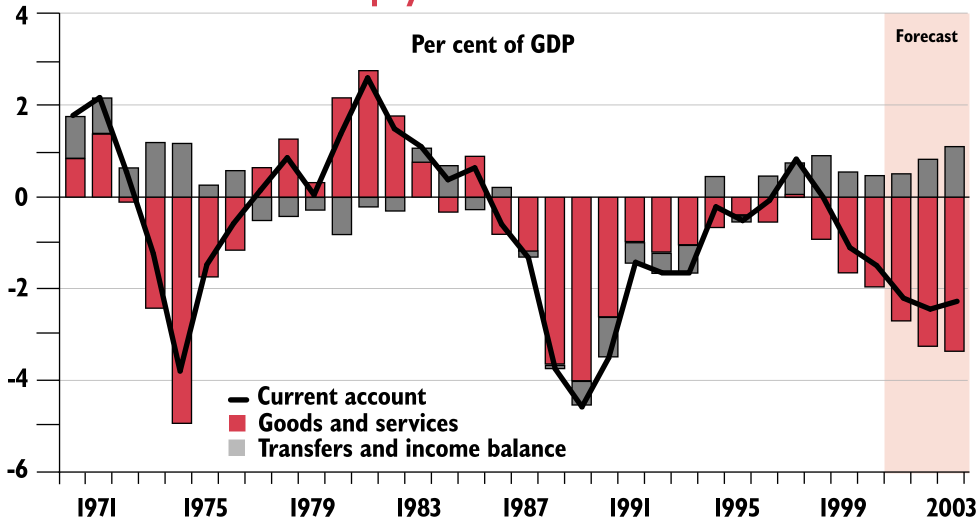
B40 Business investment growth is forecast to rise to 2½ to 3 per cent in 2001, remaining around this rate in later years. Business investment as a proportion of GDP is therefore expected to remain very close to its recent record high, leading to persistent, though narrowing, company financial deficits. Overall company balance sheet health suggests that these deficits should be readily financeable, preventing any sharp retrenchment in capital spending (Box B2). However, PNFC net worth and capital gearing remain susceptible to market valuations of company assets, notwithstanding recent falls in equity prices. So private investment spending is vulnerable to downward revisions to earnings expectations, particularly in the more highly geared technology sectors, which have spent heavily in recent years. Total fixed investment will be boosted by much sharper increases in general government investment, averaging around 20 per cent a year over the next three years.

Trade and the balance of payments

B41 The trade in goods and services deficit in 2000 rose much more modestly than in the previous two years, to 2 per cent of GDP. Greater stability in the trade deficit mainly reflected much stronger growth in export volumes. Rapid growth in UK export markets lifted growth in non-oil goods volumes to 11 per cent - the strongest since 1973 – but services export volumes fell by 2 per cent, probably partly reflecting weaker financial markets. Import volumes were slightly weaker than expected in the second half of 2000, but rose by nearly 9 per cent during the year as a whole. The resulting significant deterioration in the real trade balance was partly offset by an improvement in the terms of trade. The current account deficit is now estimated at 1.5 per cent of GDP in 2000, as expected in the Pre-Budget Report.

B42 Movements in the overall trade deficit have masked divergent trends against European Union (EU) and non-EU countries. Trade with the EU moved close to balance during the second half of 2000, contrasting with a continued widening of the deficit with non-EU countries. The UK's position as a net oil exporter to the EU has benefited from relatively high spot prices, boosting oil revenues from the EU by more than £3 billion in 2000. But rising oil prices have the opposite effect on non-EU trade, where the UK typically runs a deficit on oil. Moreover, while total export volumes to both areas have grown strongly, there have been stark differences in import trends: imports from non-EU countries rose more than three times faster than imports from the EU in 2000.

Chart B6: Balance of payments current account



B43 Weaker than expected global demand is expected to drive a renewed widening in the trade deficit over the next two years. Export volume growth is forecast to fall back more sharply than anticipated in November, troughing at $4^3/_4$ to $5^1/_4$ per cent in 2002, in line with lower expected export market growth. Exporters' share in UK export markets is assumed to remain broadly constant. This more than explains the larger trade in goods and services deficit, now forecast at $3^1/_4$ per cent of GDP in 2002. Import volume growth is now expected to ease more gradually to trend, given stronger than previously anticipated domestic demand. But the trade balance effect is offset by lower import price inflation in 2001, partly reflecting the impact of weaker global demand on commodity prices. The current account deficit is expected to rise to $2^1/_2$ per cent of GDP in 2002, $^3/_4$ percentage point larger than forecast in November, partly reflecting a slightly weaker investment income surplus. But the UK's net overseas asset position is strong, and so investment income should pick up with stronger global growth, particularly in the US, helping the current account deficit to narrow in 2003.

Table B5: Trade in goods and services

	Percentage changes on previous year					£ billion
	Volumes		Prices[1]			Goods and services balance
	Exports	Imports	Exports	Imports	Terms of trade[2]	
2000	7 1/2	8 3/4	1 1/2	1	1/2	–18 1/2
Forecast						
2001	5 1/2 to 5 3/4	7 1/2 to 7 3/4	1 1/4	1 3/4	–1/2	–26 3/4
2002	4 3/4 to 5 1/4	6 1/4 to 6 3/4	3 3/4	3 3/4	0	–33 3/4
2003	5 1/2 to 6	5 1/2 to 6	3	3	0	–36 3/4

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

B44 Risks to US and global growth mean that overall trade prospects are very uncertain. The US accounts directly for over 15 per cent of UK exports, with booming US import growth in 2000 contributing to the first bilateral goods surplus since 1988. While this implies a small direct weight in UK GDP, third country impacts, including global equity price and confidence effects, will tend to magnify the overall impact on UK demand. Moreover, the UK's significant direct and equity investment in the US generates substantial overseas earnings. Reciprocal flows from the US provide an important support to UK business, though any weakening might be partly offset by other foreign investors diverting funds to more attractive non-US markets. As discussed in Box B3, a 1 percentage point reduction in US growth is estimated to lower growth in UK export markets by 1 percentage point or more, equivalent to a drag on UK GDP growth of more than 1/4 percentage point.

Table B6: Summary of economic prospects[1]

	Percentage changes on a year earlier unless otherwise stated					
		Forecast[2]			Average errors from past forecasts[3]	
	2000	2001	2002	2003	2001	2002
Output at constant market prices						
Gross domestic product (GDP)	3	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾	½	¾
Manufacturing output	1½	1¾ to 2	1½ to 2	1½ to 2	¾	2¼
Expenditure components of GDP at constant market prices[4]						
Domestic demand	3¾	3¼ to 3½	2¾ to 3¼	2¼ to 2¾	½	1¼
Household consumption[5]	3¾	3¼ to 3½	2½ to 3	2¼ to 2¾	½	1¼
General government consumption	2½	4¼	3¼	3	1	1¼
Fixed investment	2¼	5½ to 5¾	3 to 3½	3½ to 4	1½	2¼
Change in inventories[6]	½	–½	¼	–¼	¼	½
Export of goods and services	7½	5½ to 5¾	4¾ to 5¼	5½ to 6	1¾	2½
Imports of goods and services	8¾	7½ to 7¾	6¼ to 6¾	5½ to 6	2	3
Balance of payments current account						
£ billion	–14	–21¾	–25¼	–25	7	9
per cent of GDP	–1½	–2¼	–2½	–2¼	¾	¾
Inflation						
RPIX (Q4)	2	2	2½	2½	½	½
Producer output prices (Q4)[7]	1¾	1¾	2	2	½	1¾
GDP deflator at market prices	1¾	2¼	2½	2½	¾	1
Money GDP at market prices						
£ billion	935	978 to 982	1025 to 1033	1073 to 1086	8	12
percentage change	5	4¾ to 5	4¾ to 5¼	4¾ to 5¼	¾	1¼

[1] *The forecast is consistent with output, income and expenditure data to the fourth quarter of 2000, released by the Office for National Statistics on 23rd February 2001. See also footnote 1 on the first page of this chapter.*

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

[3] *Average absolute errors for year-ahead projections made in spring forecasts over the past ten years. The average errors for the current account are calculated as a per cent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2001 and 2002.*

[4] *Further detail on the expenditure components of GDP is given in Table B7.*

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

[6] *Contribution to GDP growth, percentage points.*

[7] *Excluding excise duties.*

Table B7: Gross domestic product and its components

	£ billion at 1995 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
2000	551.3	152.6	155.7	2.3	862.3	270.8	1133.2	313.3	–0.2	819.7
2001	568.5 to 570.3	159.1	164.3 to 164.8	–2.3 to –1.8	889.7 to 892.4	285.8 to 286.7	1175.5 to 1179.1	336.4 to 337.4	–0.2	838.9 to 841.5
2002	582.3 to 586.9	164.3	169.1 to 170.4	–0.4 to 0.9	915.2 to 922.5	299.5 to 301.9	1214.7 to 1224.4	357.8 to 360.6	–0.2	856.8 to 863.6
2003	594.8 to 602.4	169.2	174.9 to 177.1	–2.4 to –0.2	936.4 to 948.5	316.1 to 320.2	1252.5 to 1268.7	377.3 to 382.2	–0.2	875.1 to 886.4
2000 1st half	273.2	75.5	77.0	1.4	427.3	133.5	560.7	153.8	–0.1	406.8
2nd half	278.1	77.1	78.7	0.9	435.1	137.4	572.5	159.5	–0.1	412.9
2001 1st half	282.4 to 282.9	78.9	82.0 to 82.2	–2.1 to –1.9	441.2 to 442.1	141.3 to 141.5	582.5 to 583.6	165.2 to 165.5	–0.1	417.2 to 418.0
2nd half	286.2 to 287.4	80.2	82.3 to 82.7	–0.3 to 0.1	448.4 to 450.3	144.6 to 145.2	593.0 to 595.5	171.2 to 172.0	–0.1	421.7 to 423.5
2002 1st half	289.6 to 291.5	81.4	83.7 to 84.3	0.0 to 0.6	454.7 to 457.8	147.9 to 148.9	602.6 to 606.6	176.4 to 177.5	–0.1	426.1 to 429.0
2nd half	292.7 to 295.4	82.8	85.4 to 86.1	–0.4 to 0.4	460.5 to 464.7	151.7 to 153.0	612.2 to 617.8	181.4 to 183.1	–0.1	430.7 to 434.6
2003 1st half	295.8 to 299.3	84.0	86.8 to 87.8	–1.0 to –0.1	465.6 to 471.1	155.9 to 157.7	621.5 to 628.8	186.2 to 188.4	–0.1	435.2 to 440.3
2nd half	298.9 to 303.2	85.2	88.0 to 89.3	–1.3 to –0.2	470.8 to 477.4	160.2 to 162.5	631.0 to 639.9	191.1 to 193.8	–0.1	439.8 to 446.1
	Percentage changes on previous year[4,5]									
2000	3¾	2½	2¼	½	3¾	7½	4½	8¾	0	3
2001	3¼ to 3½	4¼	5½ to 5¾	–½	3¼ to 3½	5½ to 5¾	3¾ to 4	7½ to 7¾	0	2¼ to 2¾
2002	2½ to 3	3¼	3 to 3½	¼	2¾ to 3¼	4¾ to 5¼	3¼ to 3¾	6¼ to 6¾	0	2¼ to 2¾
2003	2¼ to 2¾	3	3½ to 4	–¼	2¼ to 2¾	5½ to 6	3 to 3½	5½ to 6	0	2¼ to 2¾

[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.*

THE WORLD ECONOMY

Overview

B45 After a year of rapid expansion in 2000, global activity looks set to ease this year, led by a sharp slowdown in the US economy and renewed weakness in Japan. Inflation concerns should fade and world trade growth is likely to fall back quite sharply. G7 growth is slowing more rapidly than expected at the time of the Pre-Budget Report, which will depress activity in other regions. Emerging Asia is already experiencing a significant slowdown, exacerbated by the global weakness in electronics markets. Oil exporters face moderating prices, and countries with close trade links with the US will see weaker exports. Europe could prove relatively insulated, as trade links are comparatively modest and domestic demand remains robust.

Table B8: The world economy

	Percentage change on a year earlier			
		Forecast		
	2000[1]	2001	2002	2003
Major 7 countries[2]				
Real GDP	4	2	2½	2½
Consumer price inflation[3]	2½	2¼	2¼	2¼
World trade in goods and services	11¾	6¾	6½	6¾
UK export markets[4]	11¼	6	5¼	5¾

[1] *Estimates, except consumer price inflation.*

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

[3] *Final quarter of each period. For UK, RPIX.*

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

G7 activity

B46 G7 growth has been weaker than expected since the Pre-Budget Report, reflecting the marked US slowdown in the fourth quarter of 2000 and downward revisions to GDP estimates in Japan. This weakness looks set to persist into the first half of 2001. G7 GDP growth for the year as a whole is now forecast at 2 per cent, revised down from 3 per cent in November. However, the European economies should continue to grow at healthy rates and the US slowdown is expected to be short-lived. So, even though Japan's prospects for a self-sustaining recovery have faded, G7 growth is projected to pick up to 2½ per cent in 2002 and 2003.

B47 Falling stock prices, higher energy prices, tightening conditions in private credit markets, and declining confidence have all contributed to slower US growth. The Federal Reserve responded quickly, cutting the Federal Funds rate by 100 basis points in January. But the economy will remain weak in the first half of 2001 and unemployment is likely to rise. After that, there is great uncertainty about the outlook. Most analysts expect the economy to recover in the second half of 2001 as monetary policy loosening, improving confidence, moderating oil prices and prospective fiscal easing take effect. However, there are clear risks of a much sharper adjustment in private spending (see Box B3). The Budget forecast assumes that US GDP growth returns gradually to its potential rate by 2003.

Box B3: The US economy - outlook and risks

Since 1997 the US economy has expanded at over 4 per cent a year, and labour productivity growth has accelerated, helped by a surge in the capital equipment and software available for each worker. But demand has increased even more quickly than the economy's ability to supply goods and services. The rapid pace of expansion needed to slacken and, as expected, the economy began to slow last summer. However, falling exports and weak business investment contributed to a much sharper than anticipated slowdown in the final quarter of last year, with growth falling to just 1.1 per cent at an annualised rate. Recent data point to near zero growth in the first quarter of this year.

In response to the rapid slowdown, the US Federal Reserve cut official interest rates by a total of 100 basis points during January, and financial markets expect further cuts in the near future. Since then, investor and consumer confidence has weakened further, raising fears of a more prolonged downturn. The outlook is uncertain. Most analysts expect the economy to recover in the second half of this year, as looser monetary policy, moderating oil prices and continuing strong underlying productivity growth combine to boost activity. The economy is expected to return to healthy growth in 2002.

There are, however, significant downside risks that could increase both the depth and the duration of the downturn. The large imbalances in the economy, including a current account deficit of around $4\frac{1}{2}$ per cent of GDP, a negative personal savings ratio and a record level of household debt as a share of disposable income, could unwind rapidly, reinforcing the slowdown that is already in place.

The decline in corporate profits has already led to a sharp cutback in investment. However, consumption has continued to grow, and provided ongoing stimulus to the economy. The risk is that consumer confidence will continue to fall, prompting an abrupt decline in consumption. In addition, consumers may rein in their spending, as wealth gains no longer offset the negative savings ratio. With lower growth prospects, investors may be unwilling to finance the current account deficit, leading to a sharp correction in the dollar. On the supply side, if much of the recent productivity gains prove to be cyclical this could lead to heightened inflationary pressures, which would require a more prolonged period of lower growth to bring the economy back to its potential output level.

A deeper and more prolonged downturn in the US would affect the rest of the world through trade and financial market links, and spillovers to confidence. It is difficult to quantify the effects of a US slowdown on the rest of the world, because they depend on how policy and financial markets would respond. Nevertheless, estimates informed by world macroeconomic model simulations suggest that a temporary reduction in US growth of 1 percentage point, assuming a moderate fall in equity prices, might reduce UK export market growth by the order of 1 percentage point or more.

B48 In Japan, near-term economic prospects have deteriorated. Business confidence has peaked, and equity prices have fallen further from low levels, causing renewed strains in the banking sector. Private consumption remains weak and industrial production is depressed by the downturn in the global electronics market. With ongoing restructuring and a weaker external environment, it now seems that Japan's economy will slow in 2001, and the outlook remains uncertain.

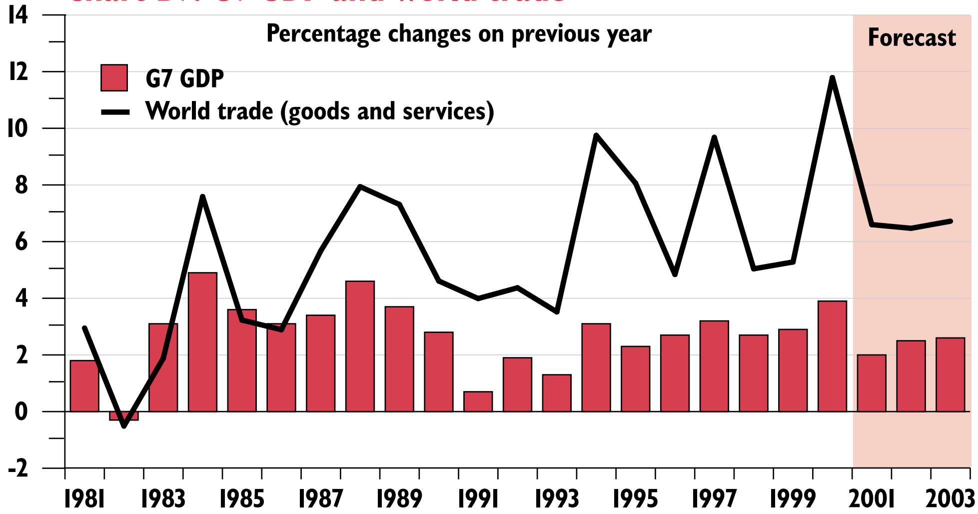
B49 As expected in the Pre-Budget Report, growth in the euro area remains healthy. Firm consumer and business confidence, some fiscal stimulus and weaker oil prices are all expected to support economic growth in 2001. Together with strong growth in Canada, this should provide support to the world economy during 2001. However, in both areas the weaker external environment is likely to dampen activity somewhat beyond 2001, and economic growth is expected to fall back towards trend in later years.

The developing countries

B50 After a robust performance during much of 2000, growth in developing countries has begun to moderate. The Asian economies are slowing markedly. Equity prices have fallen significantly over the past year, and market confidence remains weak. The slow pace of corporate and financial restructuring is undercutting recovery in several countries. However, with the exception of Indonesia and the Philippines, the region is now much less vulnerable to financing crises.

B51 Growth in Latin America should moderate this year, as countries dependent on either the US or oil begin to slow. Large current account deficits and refinancing needs make the region vulnerable to a pronounced global slowdown and any increase in investor risk aversion. However, global monetary easing should provide scope to lower interest rates and reduce debt-servicing costs for countries such as Argentina. Prospects in Eastern Europe remain good, as healthy growth continues in the euro area and Russia continues to benefit from buoyant oil prices.

Chart B7: G7 GDP and world trade



World trade

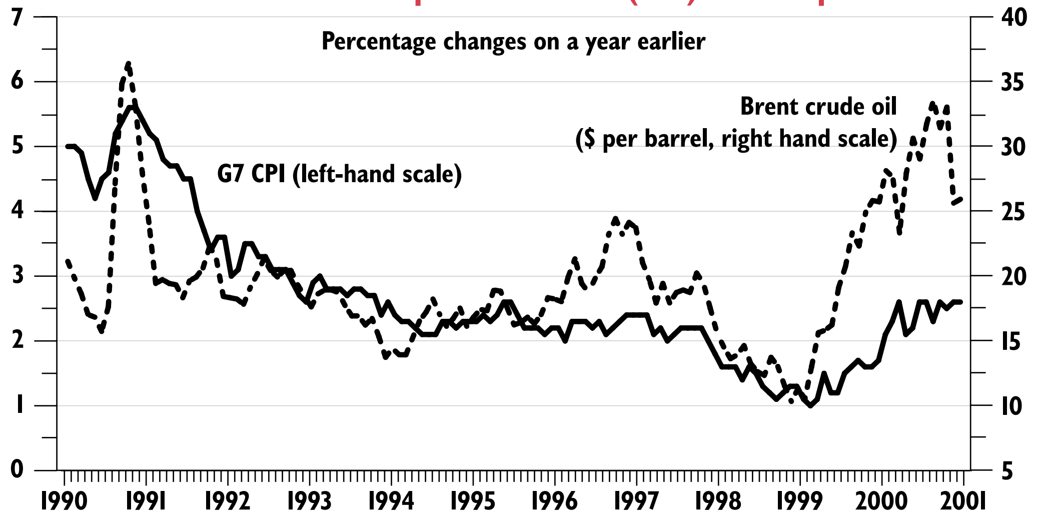
B52 World trade grew by $11^3/_4$ per cent in 2000. This partly reflected cyclical strength in world economic activity but also the surge in industrial production in the 1997–98 crisis-hit economies, as inventories were rebuilt. World trade growth is expected to fall back significantly, due to weaker global activity, and in particular a sharp slowing in US import volume growth from $13^3/_4$ per cent in 2000. World trade growth is expected to slow sharply to $6^3/_4$ per cent in 2001, and $6^1/_2$ per cent in 2002.

B53 UK export markets grew by $11^1/_4$ per cent in 2000, driven by buoyant US and European imports. These effects are expected to fade, as the US slows significantly and the European expansion eases. Weaker import growth in emerging Asia will also play a part, so that the UK's export market growth is expected to fall back to 6 per cent this year and $5^1/_4$ per cent in 2002.

G7 inflation

B54 High oil prices lifted headline inflation in 2000 in the major economies other than Japan, and there was some acceleration in the rate of growth of the prices of intermediate inputs. However, core inflation – which excludes energy and food prices – remained low. Concerns about inflationary pressures in 2001 have faded as growth prospects have weakened, world oil prices have eased, and wage growth has remained moderate. The US cut short-term interest rates by 100 basis points in January, and interest rate expectations in the US and the euro area have declined. G7 inflation is expected to fall from $2^1/_2$ per cent in 2000, to $2^1/_4$ per cent in 2001 and 2002.

Chart B8: G7 consumer price inflation (CPI) and oil prices



Oil and commodity prices

B55 Commodity prices pose little risk to global inflation in 2001. Oil prices have fallen back from their autumn peaks, and non-oil commodity prices remain subdued. Increasing supply and high stock levels are projected to keep agricultural prices in check, while metals and minerals prices are expected to grow moderately in line with global economic growth.