A THE ECONOMY

While UK GDP growth has strengthened since the beginning of 2002, recovery in the world economy currently has less momentum than was expected at Budget time. Since then, sharp falls on global equity markets – with the S&P 500 and FTSE 100 indices both currently down between 20 and 25 per cent since March – and continued uncertainty about the strength of recovery, have prompted falls in confidence in nearly all G7 economies. International conditions have continued to be a major influence on UK economic developments and prospects as an uncertain outlook for global demand has deterred companies from investing and stepping up production. In the face of the present uncertainties, the Government remains vigilant to potential risks surrrounding economic prospects.

The economic stability delivered by the Government's macroeconomic reforms has nonetheless left the UK economy in a relatively strong position. The lowest rates of unemployment since the 1970s, subdued inflation and historically low interest rates have all helped cushion domestic consumer demand from external weakness, ensuring that the UK continues to experience the longest unbroken economic expansion on record. Sound fundamentals also mean the economy is well placed to respond positively when the world economic recovery gathers pace.

The Pre-Budget Report economic assessment shows slightly below trend growth until the middle of next year, in lagged response to this year's global uncertainty and equity price falls, and stronger growth thereafter as global financial conditions and demand improve:

- **UK GDP growth is expected to be 1.6 per cent this year, below the Budget 2002 forecast. From mid-2003, a strengthening in the pace of global recovery should allow the UK to achieve a temporary period of non-inflationary above trend growth, rising to between 3 and 3½ per cent in 2004;**
- **a rebalancing of growth becomes gradually more evident over the forecast horizon. In particular, household consumption growth is expected to moderate, as the delayed effects of stock market falls and weaker income growth take hold, and the appetite for further increases in debt recedes;**
- **investment growth is forecast to pick up from next year. Strengthening global demand, reduced uncertainty and improvements in corporate finances are expected to encourage firms to replace existing assets, bring deferred capital spending back on stream and begin expanding capacity again. Higher demand for investment goods and rising external demand should help the manufacturing sector to build on the stabilisation in output seen through this year; and**
- **RPIX inflation is expected to fall marginally below target next year, with downward pressure from slack in the economy, but to edge up to its 2½ per cent target during 2004 as the effects of a pick-up in import prices and the economy accelerating back to trend work through.**

INTRODUCTION[1,2,3]

A1. This annex discusses economic developments since Budget 2002 and provides updated forecasts for the UK and world economies in the period to 2005. It begins with an overview of developments and prospects in the world economy. In the light of this, it then outlines the Government's latest assessment of the UK economy followed by a more detailed discussion of sectoral issues and risks.

THE WORLD ECONOMY

Table A1: The world economy

	Percentage changes on a year earlier unless otherwise stated				
		Forecast			
	2001	2002	2003	2004	2005
Major 7 countries[1]					
Real GDP	1/2	1 1/2	2 1/4	3	2 3/4
Consumer price inflation[2]	1 1/2	1 3/4	1 1/4	1 1/2	1 1/2
World trade in goods and services	1/2	2	5 1/2	8 3/4	7 1/2
UK export markets[3]	1	1 1/2	5	8	6 1/2

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

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

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

Overview

A2. Last year, even before the events of 11 September, economic growth slowed significantly and simultaneously in the US, Europe and Japan, the first synchronised slowdown in three decades and the sharpest slowdown in world growth since 1974. For the US and the Euro-area, last year's slowdown brought to an end a period of continuous growth stretching back to the beginning of 1993. Twenty of the world's biggest economies have been, or still are, in recession. Only decisive action by policy-makers, particularly in the aftermath of the terrorist attacks on the US, ensured that the slowdown was relatively short-lived.

A3. During the first half of 2002, a recovery in world trade and industrial production provided clear evidence that a global economic recovery was underway. However, the immediate outlook for the world economy has weakened in more recent months as corporate accounting scandals, further declines on global equity markets, developments in the Middle East and rising oil prices have compounded existing uncertainty over the strength of the global recovery. Consequently, the global economic recovery currently appears to have less momentum than was anticipated earlier in the year.

A4. As at the time of the Budget, the US is expected to lead the global recovery, with growth in the Euro-area following. However, compared with the Budget forecast, G7 GDP growth is now expected to be weaker until the middle of 2003, before gaining strength thereafter.

[1] The UK forecast is consistent with national accounts and balance of payments statistics to the second quarter of 2002 released by the Office for National Statistics on 27 September, and output, income and expenditure data for the third quarter released on 27 November. 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).

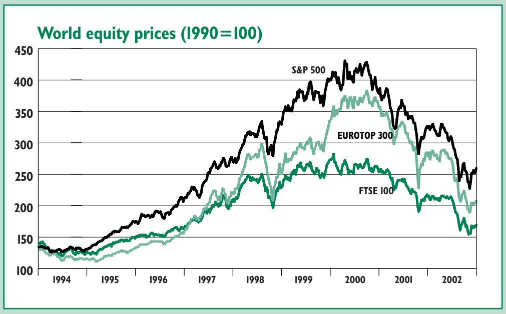
[2] The forecast is based on the assumption that the exchange rate moves in line with an uncovered interest parity condition, consistent with the interest rates underlying the economic forecast.

[3] The forecast does not build in any specific assumptions about the probabilities of alternative outcomes from prevailing geo-political tensions, beyond those already implicit in market expectations and other current economic indicators, and the contingency allocation set out in Chapter 6.

Box A1: Global equity market developments

2002 has been another turbulent year for equity markets. Following strong gains during the 1990s, most major stock markets peaked in 2000 and fell back during 2001. Having been relatively stable in the initial stages of this year, markets began a renewed bout of weakness in the spring. Both the S&P 500 and FTSE 100 indices fell by some 30 per cent between the middle of March and the beginning of October and the Eurotop 300 declined by 35 per cent. Post-September, equity prices have firmed around the world but are still no higher than levels seen in 1997 or 1998.

The most recent period of declining equity prices reflects a number of factors. Most obviously, a chain of high profile corporate accounting scandals and other financial malpractices in the United States sparked considerable nervousness over the financial health of US corporations. While these accounting scandals have so far remained confined to US shores, the aftershocks have stretched far beyond. Heightened concerns over the outcome of tensions with the Middle East have also compounded uncertainties surrounding the short-term outlook for the world economy, dampening profit expectations, and hence equity values, since the spring.



The experience of recent years has starkly illustrated how increased cross-border integration of financial and product markets amplifies the knock-on effects between exchanges in different parts of the world. International trading in shares has increased hugely over the past decade. In developed countries, households are increasingly investing in foreign as well as domestic equities, while many big firms are listed on more than one stock market and a growing slice of company profits come from abroad. Partly as a result, business confidence has become more globally correlated, which further increases the likelihood of share prices moving together. Global production patterns by multinational corporations may also mean a period of turbulence for one economy carries implications for overseas operations. Thus, even where economic and financial fundamentals may differ between countries, shocks originating in one financial centre now resonate to a greater extent and spread more quickly to other markets.

Nevertheless, since the spring the Eurotop 300 has seen sharper falls than Wall Street, and the positive gap between price-earnings ratios on US and European exchanges has widened. With scant evidence of corporate accounting malpractice in Europe, this may be at least partly attributable to a reassessment of fundamentals reflected in weaker European growth prospects.

G7 Activity

A5. Although G7 GDP is still expected to grow by around $1^1/_2$ per cent in 2002, in line with the Budget 2002 forecast, this masks weaker growth in the US and Europe offset by stronger than expected growth in Japan and Canada. With the global economy currently having less momentum than was anticipated at Budget time, G7 growth is now expected to be $2^1/_4$ per cent next year, compared with the Budget forecast of $2^3/_4$ per cent. Weaker growth in 2003 will, however, provide scope for stronger activity the year after, and growth in the G7 economies is now expected to reach 3 per cent in 2004.

A6. Latest GDP data now show that the US economy contracted during the first three quarters of 2001, and grew by just 0.3 per cent over the year as a whole. Last year's slowdown was therefore deeper and more protracted than previously reported. Decisive monetary policy action and strong government spending supported a return to growth in the final quarter of 2001. Continued strong household consumption and a more gradual rate of inventory liquidation accounted for stronger than expected growth in the first quarter of 2002.

A7. Over more recent months, however, a series of high-profile corporate accounting scandals and concern over political developments in the Middle East have prompted sharp falls in equity markets and rises in oil prices. Greater uncertainty has dented business confidence and led firms to defer investment decisions, with the consequence that the US recovery currently appears to have less momentum than was anticipated earlier in the year. Household consumption is nonetheless expected to continue to support growth, underpinned by low interest rates and housing market gains, and US GDP growth is expected to gather pace and to become more balanced during 2003 as a recovery in business confidence supports renewed investment growth.

A8. While GDP in the Euro-area has recovered after contracting in the final quarter of 2001, domestic demand remains weak, particularly in Germany. Household consumption has been affected by persistently high levels of unemployment and fears over job security. Business confidence has also fallen in recent months, as a result of the weaker than expected US recovery and recent equity price falls. However, a pick-up in overall Euro-area growth is expected during 2003, as stronger US growth and a more certain global outlook prompt renewed investment growth.

A9. Stronger external demand contributed to Japan's growth in the first half of 2002 but this has faded as uncertainty surrounding global prospects has increased. While the economy is expected to see a decline in GDP for 2002 as a whole, private consumption has proved surprisingly robust and has prevented a more severe contraction. A recovery in external demand is expected to support a return to modest growth in 2003. However, final domestic demand remains fragile with unemployment at historically high levels and continuing deflation.

Forecast issues and risks

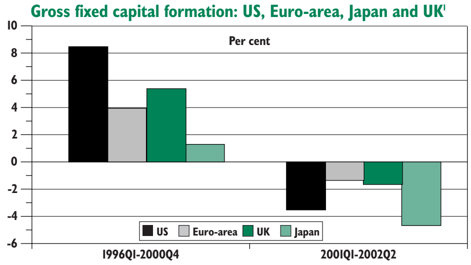
A10. Continued volatility in global equity markets and the possibility of renewed rises in oil prices pose a clear risk to the global economic outlook. Heightened investor uncertainty, as a result of any more high profile corporate failures or deterioration in the political situation in the Middle East, could delay the global investment recovery. Household consumption would be further negatively affected by the impact of any additional equity price falls on household wealth, by any continued weakening in the US or Euro-area labour markets, or by higher oil prices. A decisive resolution of the problem of non-performing loans in Japan, while positive for Japan's medium-term economic outlook, could depress activity there in the short-term. Moreover, any disorderly unwinding of the US current account deficit could lead to a sudden, sharp depreciation of the dollar, complicating macroeconomic policy around the world.

A11. Accommodating fiscal and monetary policy could yet, however, lead to a stronger than anticipated global recovery. In the US for example, low interest rates and further significant house price gains could stimulate faster than expected household consumption growth. Recent actions in the US to strengthen corporate governance, accounting and auditing have the potential to boost confidence, prompting a sharp rebound in equity markets and a more rapid pick-up in investment growth. A swift diminution of tensions in the Middle East could also bolster confidence. Over the medium-term, other major economies may emulate US

Box A2: Investment: global developments and prospects

A notable feature of last year's world slowdown was the reversal in investment across the world's major economies. G7 investment fell by 2 per cent during 2001 – the largest fall since 1982 – and the slowdown in the rate of investment growth was the sharpest since 1974. At Budget time, G7 investment was expected to recover during the first half of 2002, but the global investment outlook has been hampered by continued uncertainties. Compared with a year earlier, G7 investment was down 4½ per cent in the first quarter of this year and by 3½ per cent in the second quarter.

Gross fixed capital formation: US, Euro-area, Japan and UK[1]



[1] Average four quarter rate of change.

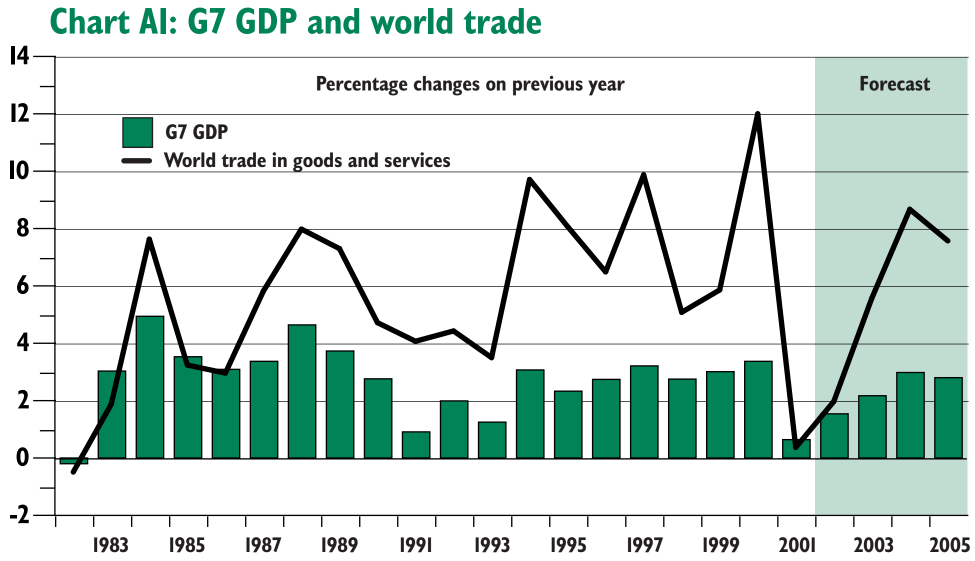
During the second half of the 1990s the US experienced particularly strong growth in investment, fuelled by a rising stock market and by expenditure on ICT and related technological advances. Over this period whole economy investment in the US grew by 8.5 per cent a year on average, while investment also accelerated in the UK and the Euro-area, growing respectively by 5.4 per cent and 3.9 per cent a year on average.

This strong growth was reversed during 2001 and 2002 in all the major economies. Unsurprisingly, this reversal was larger in the US than in the UK or Euro-area. There are a number of reasons why investment fell so sharply last year. In some cases firms simply over-stretched their ability to absorb new capital equipment. Moreover, the late 1990s investment boom saw some companies accumulating large amounts of debt to finance capital projects. Consequently, significant falls in world stock markets since the middle of 2000 and worsening corporate profitability are likely to have motivated a scaling back of plans last year. A number of factors explain Japan's weakness since 2001, including a fallback from particularly strong business investment in 2000 and significant falls in public sector investment.

Concerns over corporate accounting standards and events in the Middle East have led to further sharp falls in equity markets and rising oil prices during 2002, prompting further declines in confidence and renewed uncertainty about the strength of the global recovery. This increase in uncertainty appears to have encouraged firms across the major advanced economies to defer investment decisions. As a result, investment growth in the US and Europe is now expected to be weaker this year than was anticipated at Budget time.

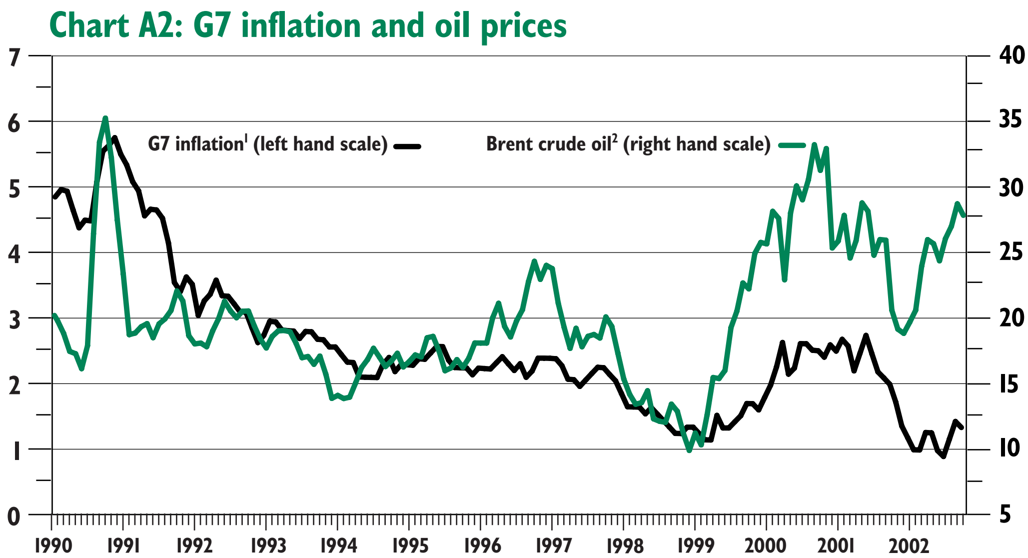
However, there have been encouraging signs from the US that suggest strong investment may yield substantial productivity gains. Looking ahead, investment should recover during 2003 as uncertainty recedes, deferred investment comes back on stream, renewal of shorter-life high-technology capital becomes more of a priority and economic slack gets taken up as the global recovery gathers pace.

productivity performance: evidence for recent quarters continues to suggest that the US may be benefiting from sustainable productivity growth improvements associated with widespread information and communications technology (ICT) investment. Further sustained progress on economic reform in the Euro-area, financial sector reform and corporate restructuring in Japan, would enhance the productive capacity of these economies and boost medium-term economic prospects.



World trade

A12. The recovery in world trade during the first half of 2002 was slightly stronger than anticipated at Budget time, underpinned by the pick-up in industrial production in a number of economies. Despite this, the weaker than expected global recovery in the second half of the year means that world trade is now expected to grow by just 2 per cent in 2002, compared to 12 per cent in 2000. As the global recovery gathers pace, world trade growth is now expected to rise to $5^1/_2$ per cent in 2003 and to $8^3/_4$ per cent in 2004. UK export market growth is expected to be a little lower than growth in world trade as a result of weaker than expected growth in the UK's major trading partners – the Euro-area and the US.



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

Emerging markets and developing countries

A13. While favourable financing conditions during the first half of 2002 have been eroded in recent months, the limited financial contagion from events in Turkey, Argentina and Brazil suggests that investors are continuing to discriminate between emerging markets. Any increase in risk aversion among investors, and vulnerabilities surrounding the global recovery, pose the main threats to the outlook for emerging markets.

A14. Growth in the world's poorest economies has undoubtedly been affected by the recent global slowdown. However, surprisingly strong GDP growth in Africa during 2001 and the first half of 2002 suggests that debt relief provided under the Heavily Indebted Poor Countries (HIPC) initiative, and improved macroeconomic policies, are helping to sustain economic growth in those parts of the region where they have been implemented.

Oil and commodity prices

A15. Evidence that the global recovery was underway prompted a recovery in commodity prices during the first half of 2002. Oil prices also picked up sharply from the spring onwards as further OPEC production cuts began to bite, and as political uncertainty in the Middle East raised concerns about future supply. Prices have recently fallen back, largely due to ongoing developments in the Middle East. Non-oil commodity prices are expected to strengthen in line with the global recovery.

G7 inflation

A16. G7 inflation fell during the course of 2001, from around $2^1/_2$ per cent at the beginning of the year to just over 1 per cent by the start of 2002. While underlying inflationary pressures remain weak across the G7, the impact of weak oil prices in the final quarter of 2001 is expected to boost G7 inflation to around $1^3/_4$ per cent by the turn of the year. Inflation is forecast to fall back slightly during 2003, consistent with a small negative output gap, before settling at $1^1/_2$ per cent in 2004.

UK ECONOMY OVERVIEW

The economy in 2002

A17. Following the marked slowdown in the world economy during 2001, UK GDP has accelerated since the beginning of 2002. However, although world activity is judged to have troughed at the end of last year, 2002 has presented new global challenges and risks. Stock markets around the world have seen sharp falls since the spring. Corporate accounting malpractices in the United States were clearly one trigger for these developments, but equity market turbulence has rippled far beyond Wall Street and other US exchanges. Despite scant evidence of accounting irregularities in the UK or Europe, the FTSE 100 index fell by around 30 per cent between March and early October while the Eurotop 300 was down by 35 per cent over the same period. This, together with tensions in the Middle East and other ongoing risks, has compounded uncertainty over the current degree of momentum underpinning the world economic recovery and clearly hampered already fragile business confidence, including in the UK. As a result, mirroring developments in most major economies, the corporate sector has remained highly reluctant to step up investment spending, and the anticipated strengthening in UK activity has been weaker than forecast at the time of the Budget. UK GDP is estimated to have risen by 0.6 per cent in the second quarter and by 0.8 in the third quarter, to stand 1.8 per cent up on a year earlier.

Table A2: Summary of forecast[1]

		Forecast			
	2001	2002	2003	2004	2005
GDP growth (per cent)	2	$1\frac{1}{2}$	$2\frac{1}{2}$ to 3	3 to $3\frac{1}{2}$	$2\frac{3}{4}$ to $3\frac{1}{4}$
RPIX inflation (per cent, Q4)	2	$2\frac{1}{2}$	$2\frac{1}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$

[1] *See footnote 2 to Table A8 for explanation of forecast ranges.*

A18. The pattern of growth this year has also been distorted by a special public holiday in June to mark the Golden Jubilee. Output growth is widely perceived to have been depressed during the second quarter, as the additional public holiday and, in some cases, factory closures over the whole of that week, caused output to be lost. Growth, however, is judged to have received a corresponding boost in the third quarter as working patterns returned to normal. In contrast, the football World Cup, which was held over May and June, appears to have had virtually no overall impact on activity: anecdotal evidence suggests that working hours lost to allow employees to watch matches were fully made up at other times.

A19. The Government's reforms to the macroeconomic framework have created a platform of low inflation and fiscal discipline which has enabled the UK economy to face the recent challenges posed by the world environment from a position of underlying strength. As the world economy turned down in 2001, the independent Monetary Policy Committee (MPC) of the Bank of England was able to reduce interest rates on four occasions in the first eight months of the year. Further rate reductions after the terrorist atrocities of 11 September made a total of seven cuts and a cumulative reduction of 2 percentage points during 2001. This helped to restore business and consumer confidence to around the levels prevailing before the terrorist attacks, and to mitigate against any further drags on activity amidst already very difficult global conditions. With inflation remaining a little below target this year, interest rates have been kept at their lowest for almost 40 years, while fiscal policy has also been supportive of a pick-up in GDP growth.

A20. Last year the UK weathered the storm better than all other major economies, achieving the highest rate of GDP growth in the G7, at 2 per cent. This year, amid new uncertainties and risks, the UK economy has continued to grow more strongly than many other industrialised countries, despite having been equally exposed to global equity market turbulence. UK GDP growth has now been unbroken for 41 consecutive quarters, the longest sustained expansion since quarterly records began in 1955.

A21. RPIX inflation has remained below the Government's target since Budget time, although monthly movements have been unusually erratic of late: in October RPIX was back up to 2.3 per cent, as seen in March and April, following its June trough of 1.5 per cent. The divergence between goods and services price inflation has widened further this year, as services price inflation has picked up and weak and highly competitive global markets have continued to exert downward pricing pressures on more exposed tradeable sectors. Producer output prices have remained subdued in the face of ongoing global uncertainties inhibiting the degree of momentum underpinning demand: while manufacturing output has shown signs of having bottomed out following sharp falls in 2001, recovery is yet to get fully underway.

A22. The UK labour market remained resilient to the sharp slowdown in world growth in 2001. Continued global uncertainties this year have largely failed to undermine domestic employment, providing further evidence that the Government's macroeconomic and structural reforms have continued to yield substantive supply-side gains. Building on the impressive expansion of recent years, employment has continued to trend upwards during 2002, with the coming on stream of Government spending plans permitting public sector employment growth to take up the baton from preceding strong private sector employment growth. Employment has risen by 1.3 million since 1997 and has recently been at record levels. Unemployment has remained close to its lowest rate since the 1970s on both the International Labour Organisation (ILO) and claimant count measures. The resilience of the UK labour market has set the UK economy apart from most other industrialised countries, many of which have seen the rate of unemployment rise significantly over the past year or so.

A23. The strain of ongoing global uncertainty this year has continued to be felt in weak business investment (Box A2). Indeed, compared with the Budget forecast, the relative weakness of UK GDP growth in the first nine months of 2002 is entirely accounted for by lower than expected investment. Fragile confidence in the prospects for external demand, and heightened uncertainties and increases in the cost of capital following declines in global equity markets, are likely to have reduced corporate incentives to increase capital expenditure. Business investment has fallen in each of the past seven quarters.

A24. In recent years, strong labour market outcomes have continued to support growth in private consumption. As fragile confidence in global prospects has depressed private investment demand and inhibited underlying export growth, GDP growth has continued to be more than accounted for by household consumption. With close to record employment rates coinciding with buoyant gains in house prices, consumer confidence and spending have thus far held surprisingly firm against falling equity values and fragility in the world economy. While growth in consumer spending has moderated from its peaks in 2000, underlying growth has remained relatively strong. House prices have risen sharply, and may have been boosted by demand emanating from diversification out of equity markets.

A25. At the same time, government expenditure has also been helping to support growth in UK GDP. With the Government's spending plans continuing to come on stream, real government consumption in the first three quarters of 2002 is currently estimated to have been $4^3/_4$ per cent up on a year earlier.

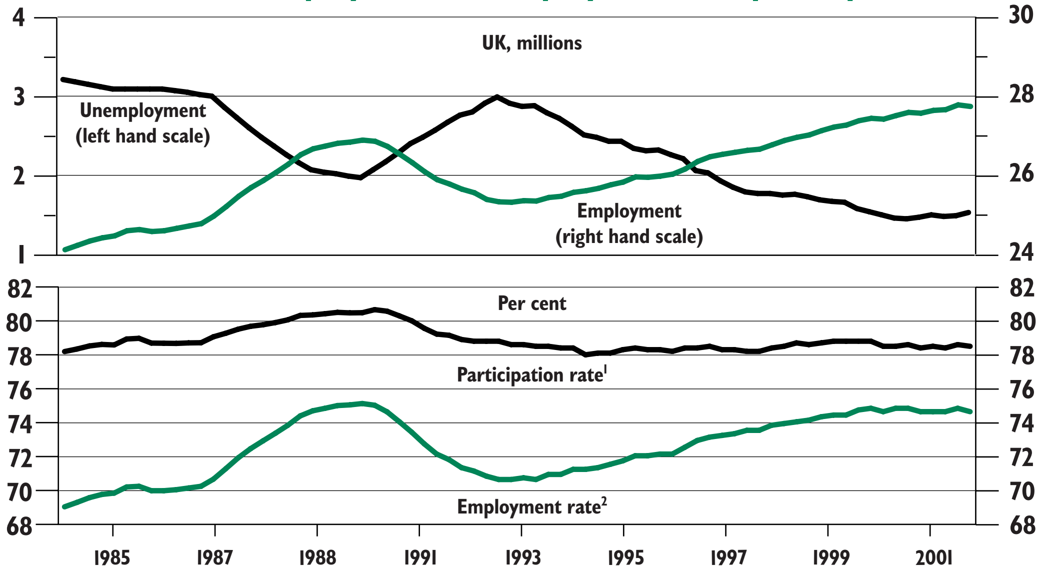
A26. The composition of aggregate demand growth, with relatively import-intensive investment and industrial activity weak, but consumer spending robust, has continued to restrain import growth. Thus, net trade made only a small negative contribution to growth in the first half of this year, as a resumption of export growth in the second quarter more than offset a modest increase in imports. However, faltering industrial production and demand in a number of the UK's key export markets appears to have been reflected in a significant contraction in exports in the third quarter, though imports fell too so net trade exerted less of a drag on GDP than exports.

The labour market

A27. The results from the 2001 Census showed the UK population of working age was about one million lower than previously estimated, mainly on account of fewer individuals in the 25 to 39 age cohort. Labour Force Survey (LFS) statistics have needed to be re-scaled to the new population estimates, but this does not change the conclusion that UK labour market performance has been robust in recent years. Employment rates are still shown to have risen close to record highs previously achieved only at the top of the cycle, while the results have hardly had any effect on estimated unemployment rates.

A28. The UK labour market has remained buoyant in 2002, outstripping most analysts' expectations by a significant margin. In the third quarter, the Labour Force Survey (LFS) measure of employment was 175,000 higher than a year earlier and, despite continued strong expansion in the population of working age, the working age employment rate has been stable over the past year or so, as has the inactivity rate. It would appear that, as Government spending plans continue to come on stream, the public sector has been contributing strongly

Chart A3: LFS employment, unemployment and participation



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

to overall employment growth. Increases in the number of workforce jobs in public administration, education and health sectors have averaged around 30,000 a quarter over the past year. This apparent expansion in public sector employment may help partly to explain the divergence between the resilience of the labour market indicated by official statistics, and the more moderate impression gained from private sector surveys.

A29. Part-time workers have more than accounted for the overall growth in employment over the past year. However, part-time working has increasingly become a matter of preference rather than inability to find a full-time position. At less than $8^{1}/_{4}$ per cent during the third quarter, the proportion of part-time workers who could not find a full-time job has recently been the lowest in the ten-year history of the series.

A30. ILO unemployment has been nudging up since spring last year, but by a lot less than the rise in the population of working age. Indeed, in the year to the third quarter of 2002, increased employment successfully absorbed over three quarters of the 185,000 increase in the population of working age. While the rate of ILO unemployment has increased a little, to 5.3 per cent in the third quarter, and is now judged to be above its sustainable rate, claimant count unemployment, at 3.1 per cent, remains at its lowest rate since August 1975. Claimant outflows have continued to increase modestly against broadly flat inflows. The Government's Welfare to Work policies have also ensured that long-term unemployment has continued to fall, with both youth and adult long-term unemployment now having fallen by more than three quarters since spring 1997[4].

[4] Claimant count. Long-term youth unemployment: aged 18-24, over 6 months duration. Long-term adult unemployment: aged 25 and over, over 18 months duration. Youth claimant unemployment over 12 months duration has been virtually eradicated; and over the past year New Deal 25+ has continued to make a substantial contribution to the fall in long-term adult unemployment.

A31. Although UK employment has held up extremely well to a challenging global environment, the slowdown in GDP growth in 2001 and early 2002 appears to have made itself felt in the labour market partly through a decline in average hours worked, which were down over $1^3/_4$ per cent in the year to the second quarter of 2002. This decline was not just the effect of rising part-time employment, as average hours worked by full-time workers also fell, consistent with companies expecting only a modest and short-lived period of below-trend growth. In the third quarter average hours worked picked up, though to some extent the second quarter figures are likely to have been depressed by the Jubilee holiday.

A32. Average earnings also appear to have responded to the cyclical path of output, giving further evidence of a flexible labour market. Whole economy average earnings growth has picked up since earlier in the year, following a period from the second half of 2001 when it fell sharply, but at about $3^3/_4$ per cent in the third quarter of 2002 it was still well down on a year earlier. This reflects a return to more normal bonus patterns after falling bonuses in late 2001 and early 2002 restrained earnings growth as the economy slowed. Excluding bonus effects, average earnings growth has fallen steadily since summer 2001. And whether bonuses are included or excluded, average earnings growth remains well within the range deemed by the MPC to be consistent with the Government's inflation target of $2^1/_2$ per cent in the medium-term. As growth in whole economy earnings excluding bonuses has moderated, growth in unit wage costs has declined, to its slowest rate for almost two years in the year to the second quarter of 2002.

A33. Despite strong growth in public sector employment, public sector average earnings growth has fallen back markedly since summer 2001, when growth reflected the exceptional pay rises linked to reforms in education and health. It was less than 4 per cent in the year to September 2002, not much above the rate of private sector earnings growth. Nevertheless, recently public sector earnings growth has been depressed by delayed settlement for 1.3 million local authority workers, which will feed through into earnings data from October. It is essential that public sector pay awards are designed, in conjunction with reforms, to be consistent with delivering the Government's plans for improved public services, and are affordable within the 2002 Spending Review expenditure limits. Excessive pay, not linked to improvements in productivity, puts upward pressure on inflation and threatens hard-won macroeconomic stability.

A34. The corollary of Census 2001 related downward revisions to employment and hours in recent years has been somewhat stronger productivity growth than previous estimates suggested. However, the broad pattern of productivity growth has remained largely unaffected. Whole economy productivity growth (output per worker) slowed in 2001 as employment growth proved resilient to the slowdown in global demand. Manufacturing productivity slowed particularly sharply last year, as the worldwide slump in ICT output took a heavy toll on production in the UK's high-technology industries. Despite also slowing last year, productivity growth measured on the basis of output per hour is estimated to have remained firmer than on a per worker basis as the number of hours worked eased back.

A35. Although productivity growth has remained below trend in the first half of this year, it does now appear to have strengthened following the cyclical easing seen in 2001. Manufacturing productivity growth has improved in line with the stabilisation in output and, partly as a result, in the second quarter of this year whole economy productivity on an output per job basis saw its fastest quarter-on-quarter rise since the end of 1999. Output per hour worked is also estimated to have risen significantly. In the longer term, Government policies designed to strengthen the drivers of productivity growth offer the potential to increase the economy's underlying productivity growth rate.

Trend output growth

A36. At the time of Budget 2002 the Treasury published a paper[5] setting out its latest assessment of the trend rate of output growth over the recent past and the neutral rate around which to anchor economic forecasts. Despite new and revised data released since the Budget, there are no reasons to change this assessment, although estimates of the *composition* of trend growth for both the recent past and going forward have been affected.

A37. There have been revisions since the Budget to GDP data for recent years, though these have had only a marginal effect on the average rate of growth between the first half of 1997 and the third quarter of 2001. Nothing has changed since Budget time to affect the judgement that the economy was on trend at these dates, and that mid-1999 was also an on-trend point. However, as explained in the Budget paper, the longer period since the first half of 1997 is preferred to the shorter period from mid-1999 as the basis for estimating the recent trend rate of growth. There is still some doubt about whether the economy was on trend in mid-1999 or just close to trend, so the judgement that the present cycle started in mid-1999 remains provisional. The data and methodology for estimating on-trend points and dating cycles are kept under review. But whether the current cycle started in 1997 or 1999 does not affect the judgement that the Government remains firmly on track to meet the fiscal rules over the cycle: the average current surplus since both 1997-98 and 1999-2000 is positive in every year of the projection period.

A38. The main data changes bearing on the assessment of trend growth derive from the 2001 Census of Population results, to which the Office for National Statistics and the Government Actuary's Department (GAD) have responded by revising related statistics on a timely interim basis. The Census results indicated that the population of working age in 2001 was one million lower than had previously been estimated, attributed mainly to under-recording of emigration in annual data. This prompted interim downward revisions to past estimates of population levels and growth, and subsequent downward revisions to the main LFS statistics for employment, hours worked, unemployment and inactivity. LFS data needed to be revised because the LFS is a household sample survey which is grossed to population. Employment, unemployment and inactivity rates by gender and age cohort were assumed to be unaffected, though this implied some revisions to aggregate rate series owing to compositional effects. Moreover, downward revisions to estimates of the levels and growth of employment and hours worked implied upward revision to the productivity growth component of trend output growth, more or less exactly offsetting the downward revision to the population growth component.

[5] *Trend growth: recent developments and prospects*, HM Treasury, April 2002.

A39. In view of the Census results, and taking into account latest data on net migration, GAD has released new population projections. These reduce the assumption for growth in the population of working age going forward, but by less than the downward revision to its growth in recent years implied by the Census. The offset derives mainly from taking account of recent information from the International Passenger Survey, which shows a larger increase in net inward migration than was previously assumed.

A40. In addition to the limited compositional effect of Census related revisions on the employment rate over the recent past, the estimated trend in the employment rate has also been affected by LFS data to the second quarter of 2002 that were not available at Budget time. The methodology set out in the Budget 2002 paper on trend growth assumes that employment lags output by three quarters. This meant that at Budget time estimation of the employment rate component of trend output growth for the period to the third quarter of 2001 had to be based on a projection of the employment rate to the second quarter of 2002 instead of actual data.

Table A3: Contributions to trend output growth[1]

	Estimated trend rates of growth, per cent per annum					
	Trend output per hour worked[2, 3]		Trend average hours worked[3]	Trends employment rate[3]	Population of working age[4]	**Trend output**
	Underlying (1)	Actual (2)	+ (3)	+ (4)	+ (5)	= (6)
1986Q2 to 1997H1	*2.21*	2.01	–0.14	0.41	0.22	**2.51**
Over the recent past						
1997H1 to 2001Q3						
Budget 2002	*2.14*	1.96	–0.37	0.36	0.66	**2.63**
PBR 2002	*2.35*	2.14	–0.47	0.43	0.50	**2.61**
Projection[5]						
2001Q4 to 2006Q4						
Budget 2002	*2.1*	2.0	–0.1	0.2	0.6	**$2\frac{3}{4}$**
PBR 2002	*2.35*	2.25	–0.1	0.2	0.5	**$2\frac{3}{4}$**

[1] *Treasury analysis based on the judgement that 1986Q2, 1997H1, and 2001Q3 were on-trend points of the output cycle. Figures independently rounded. Trend output growth is estimated as growth of non-oil gross value added between on-trend points for the past, and by projecting components going forward. Hours, employment and population data are consistent with Census related revisions to LFS data released on 30 October and 8 November 2002. Columns (2)+(3)+(4)+(5)=(6). Full data definitions and sources are set out in Annex A of 'Trend Growth: Recent Developments and Prospects', HM Treasury, April 2002.*

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

[4] *UK household basis.*

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

A41. Table A3 summarises the overall effect of these changes on the decomposition of trend growth over the recent past and the projection going forward. The key points compared with the estimates reported at Budget time are that:

- over both the recent past and the projection period, trend output growth is now estimated to be more productivity rich, with a smaller contribution from population growth;

- over the recent past, the estimate of trend output growth is virtually unchanged. An upward revision to trend growth in output per hour of 0.2 percentage points nearly exactly offsets the downward revision to growth in the population of working age, and revisions to trend growth in average hours worked and trend employment rate growth also offset; and

- going forward, the upward revision to output per hour growth knocks through directly, but the downward revision to the population growth component (based on GAD projections) is less than over the past, reflecting the offsetting influence of latest migration data. So the net effect on projected trend output growth components tends if anything to be marginally upward.

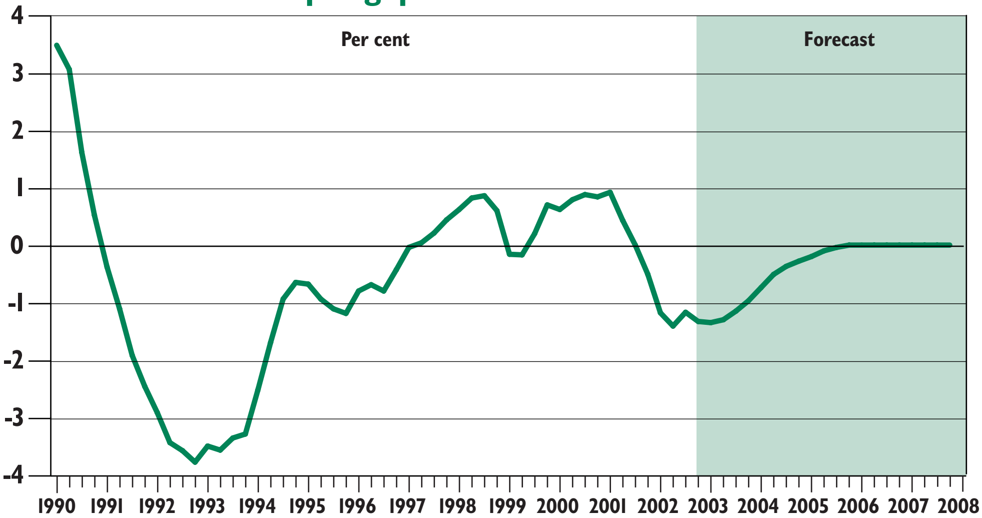
A42. Overall, the latest evidence implies that the $2^3/_4$ per cent forward-looking projection of trend output growth set out in the Budget 2002 paper remains a sound estimate.

Output and demand

A43. As a result of a modest downgrade to growth in late 2001 and weaker than projected growth so far this year, the latest national accounts data suggest the economy has built up a larger negative output gap than expected at Budget time, although its precise magnitude remains sensitive to potential data revisions in future.

A44. On the basis that the economy was last on-trend in the third quarter of 2001, as judged at Budget time, and with trend growth since then of $2^3/_4$ per cent, the implied size of the negative output gap in the third quarter of 2002 is just under $1^1/_4$ per cent. Measured output gaps of a similar magnitude also occurred at the end of 1995 and in mid-1991. However, the labour market appears tighter than on these previous occasions, probably reflecting confidence that the cyclical slowdown will not persist. The behaviour of average hours worked, which have fallen while employment has held up, tends to support this. The estimated output gap in the third quarter would diminish if recent GDP data were revised up, or if the fourth rather than third quarter of 2001 were judged to be the last on-trend point. But although some indicators do not clearly distinguish between these two quarters as on-trend points, there seems no convincing direct evidence to change the overall assessment that the economy was on trend in the third quarter of last year.

Chart A4: The output gap[1]



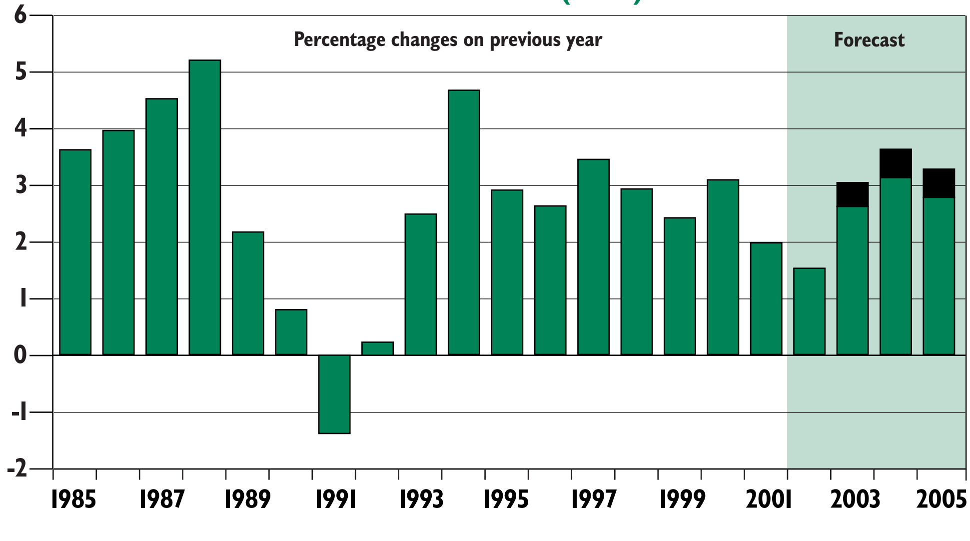
[1] *Actual output less trend output as a percentage of trend output (non-oil basis).*

A45. GDP is now expected to grow by 1.6 per cent in 2002, 0.4 percentage points below the lower end of the Budget forecast range. This shortfall is more than accounted for by much weaker than expected business investment, reflecting the set back to prospects for recovery in the world economy. The effects of global uncertainty and equity price falls this year are expected to restrain UK GDP growth at slightly below trend rates through to the middle of next year.

A46. Thereafter GDP is forecast to see a period of above trend growth, as recovery in the world economy becomes more firmly established and gathers pace, allowing slack in the UK economy to be taken up. The swift and decisive policy action taken by the MPC in 2001 is also likely to offer further impetus to activity, given the widely recognised lags between monetary policy and demand, although both monetary and fiscal policies must remain vigilant to respond to global risks. GDP is now forecast to grow by $2^1/_2$ to 3 per cent next year, around its estimated trend rate, accelerating from the second half of 2003 to reach 3 to $3^1/_2$ per cent in 2004. As the output gap closes, growth is expected to return to trend rates by the end of the forecast horizon.

A47. While growth has remained unbalanced this year, to some extent reflecting global developments, there have been preliminary signs that divergences may gradually be starting to unwind. In particular, growth in consumer spending has shown some signs of easing and manufacturing output has broadly stabilised. This pattern is expected to evolve further over the forecast horizon.

Chart A5: Gross Domestic Product (GDP)[1]



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

A48. Private consumption growth has averaged 0.9 per cent a quarter this year, with particularly strong growth in the second quarter falling back to 0.8 per cent in the third quarter. The declines in income growth and net financial wealth seen in 2002, together with the need to service higher levels of debt, are expected further to slow consumer spending through to next summer. Nonetheless, for 2002 as a whole, growth in private consumption is likely to be around the upper end of the Budget 2002 forecast range. In 2003, consumption growth is expected temporarily to slip slightly below its long-run average, though there is a risk that strong house price gains will discourage saving and further sustain momentum in consumer spending. Further ahead, household consumption is forecast to stabilise at around sustainable rates, as income growth settles around a more moderate pace than over recent years and the saving ratio tends to stabilise too.

A49. As evidence of improved world economic conditions mounts, so businesses should feel more confident about replacing existing assets, reviving postponed investment plans and expanding capacity. There are already some signs that corporate profitability may be turning the corner following a global profit squeeze in 2001, while marked improvements in company balance sheets and the relatively swift closure of the output gap over the forecast horizon should also support a climate for renewed private investment growth. Further increases in government investment are expected to work in tandem with private sector capital expenditure in contributing to a rebalancing of growth and activity in coming years.

A50. Flagging momentum in UK export markets appears to have undermined export growth in the third quarter of 2002, following a relatively strong first half of the year. Although the Jubilee holidays have complicated monthly patterns, goods export volumes have fallen back sharply in more recent months, with declines across nearly all product categories and to most key overseas markets. Faster external demand growth from the middle of next year should provide exports with renewed impetus, with export growth expected to be above its long-run average in both 2004 and 2005. At the same time stronger domestic demand is expected to spur renewed growth in import volumes, although additional government spending, which typically has a lower import intensity than private investment or consumption, is likely to keep import growth below rates seen in the late 1990s. Net trade is forecast to make a relatively modest negative contribution to GDP compared with the drag exerted over recent years.

A51. There is some evidence that UK manufacturing output has now bottomed out following the worldwide slump in industrial production last year. Although output fell sharply in the second quarter of 2002, this largely reflected the effect of Jubilee celebrations, during which a number of week-long factory closures compounded the impact of two June public holidays. The bulk of this output was made up in July and, although a sharp increase in car production has partially flattered outturns, the recent pattern of manufacturing output now appears close to flat.

A52. ICT output has been volatile this year, following sharp worldwide falls last year. In September, output was almost exactly at levels last seen at the turn of the year, suggesting that the pronounced downturn experienced in 2001 may have drawn to a close while, in the US, ICT industries saw a relatively strong bounce back in the first half of the year. However, around two thirds of UK ICT trade is with the EU, where the recovery in high-technology output has been much less convincing, and concerns over the degree of recovery in investment demand and continued over-supply in certain high-technology markets have also prevented UK ICT industries from making up lost ground. More generally, the continued weakness of investment spending worldwide is likely to have dampened the rate of recovery in manufacturing. With fragile global conditions generating continued uncertainty over the prospects for demand, manufacturers' sales have partly been serviced from further run-downs in inventories, following already significant de-stocking last year. Relatively high oil prices this year may also have hampered recovery in the manufacturing sector.

A53. Business survey indicators of manufacturing prospects have been mixed in recent months. The Chartered Institute of Purchasing and Supply Managers (CIPS) Report has generally pointed to an expansion in manufacturing activity since early this year, although the survey was temporarily affected by the Jubilee, and weak global sentiment has also coloured the results. The British Chambers of Commerce (BCC) Survey for the third quarter suggested that while domestic demand for manufactures was increasing, growth in external demand remained muted, with export balances below their long-run averages. The Confederation of British Industry (CBI) quarterly survey has been more downbeat, indicating continuing declines in manufacturing demand, albeit more modest than reported in 2001. While firms responding to both the BCC and CBI surveys expect to see an increase in demand in the coming months, survey expectations have not proved a reliable indicator to subsequent activity so far this year.

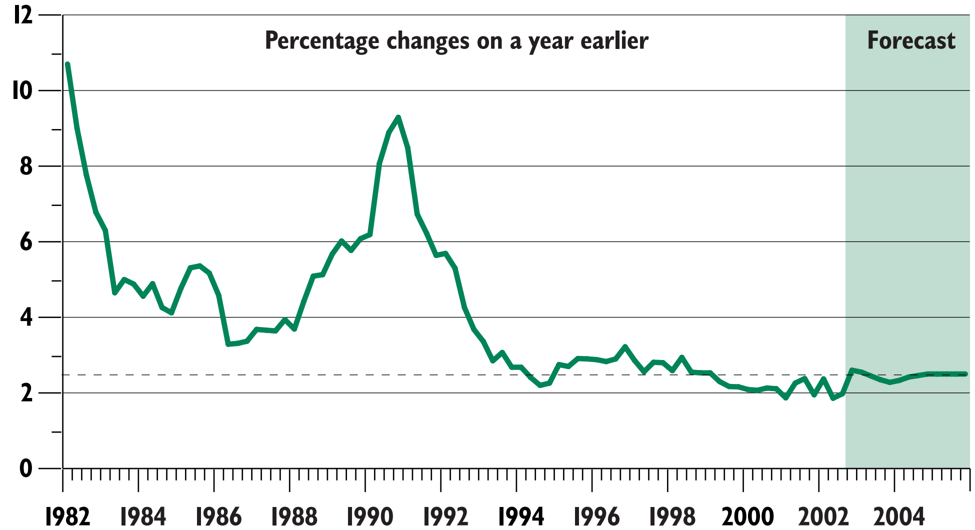
A54. Manufacturing output in 2002 is now expected to be down 4 per cent on 2001, although this at least partly reflects base effects as a result of the sharp declines in output during the course of 2001. Once adjustment is made for Jubilee distortions between the second and third quarters, manufacturing output appears to have been broadly flat since the beginning of this year. However, some parts of manufacturing have continued to expand with, for example, output in chemicals and related industries trending upwards this year, rising by almost 2 per cent between the first and third quarters. While a recovery in manufacturing output has been held back by weaker than expected global prospects, strengthening world conditions are expected to underpin an acceleration in output in 2003 and 2004 and to prompt a partial reversal in manufacturers' run-down of inventories. A resumption of business investment growth on the back of a stronger global outlook should also feed through to manufacturing activity. Manufacturing output is expected to increase by $1^3/_4$ to $2^1/_4$ per cent next year, accelerating further in 2004 to significantly above its long-run trend. Thereafter, output growth is forecast to slow slightly, although further increases in investment expenditure and export demand should help support underlying growth at around trend rates.

Inflation

A55. The UK economy continues to enjoy the longest period of sustained low inflation for four decades, with the targeted RPIX measure averaging 2.3 per since the inception of the MPC in May 1997. On the Harmonised Index of Consumer Prices (HICP) measure, targeted by the European Central Bank and designed to make cross-country comparisons, UK inflation is currently one of the lowest in the EU, having been the lowest for most of the past two and a half years.

A56. While monthly movements have been unusually volatile since Budget time, RPIX inflation has remained below the Government's $2^1/_2$ per cent target throughout. Falls in the

Chart A6: RPIX[1]



[1] *Outturns until 2002Q3; forecasts for every second quarter from 2002Q4 to 2005Q4.*

prices of seasonal food, petrol and a variety of other retail goods pushed RPIX inflation down to 1.5 per cent in June, its lowest rate since August 1967. It has since edged up, reaching 2.3 per cent in October, largely reflecting marked increases in housing costs. Higher contributions from erratic food and petrol prices compared with the same period in 2001 have also contributed to the pick-up in inflation.

A57. Aggregate inflation measures have continued to mask an increasing divergence between goods and services price inflation. In the year to October 2002, goods prices fell by 0.7 per cent – the sixth consecutive month of negative goods inflation, which is unprecedented since records began in 1988. Producer price pressures also remain highly subdued, with domestic manufactured output prices, excluding duties, rising by just 0.6 per cent in the year to October. Despite some pick-up in export and import prices since the end of 2001, and a fall back in sterling against the euro, competitive pressures from global markets have remained fierce with an uncertain outlook posing little risk of any supply shortages in the near term.

A58. In contrast, services price inflation was 4.8 per cent in September and October, the highest rate since May 1993. The continued strength of service sector inflation may appear at odds with a backdrop of moderate growth in unit wage costs, global uncertainty and subdued profitability. However, pricing behaviour within the service sector has diverged broadly in line with the contrasting patterns of household spending and corporate sector activity. Housing costs have increased firmly on the back of the strength in the housing market, while household services and foreign holidays have also made positive contributions to inflation in recent months. In contrast, utility and catering inflation has moderated. At the same time, the relative weakness of the corporate sector has been reflected in prices of business-to-business services, which have recently been rising at their lowest rate for six years according to the ONS's experimental index.

A59. Having remained somewhat below target for most of 2002, RPIX inflation is forecast to rise back to target in the final quarter as last autumn's falls in oil and housing costs drop out of the annual comparison. Inflation is expected to dip slightly below target again in 2003, as a negative output gap exerts modest downward pressure, but is projected to return to $2^1/_2$ per cent by the end of 2004. A pick-up in import price growth, arising from a gathering in the pace of the world economic recovery, is expected to feed through to higher UK inflation from around the second half of 2003. Moreover, although the currently estimated degree of slack in the economy offers ample scope to accommodate a period of above trend growth without jeopardising the inflation target, some modest upward inflationary pressure may emerge in 2004 as the economy accelerates back towards trend.

Independent forecasts

A60. Independent forecasts for UK GDP growth this year and next have come down since the time of the Budget. The latest independent average forecast for growth in 2002 is in line with the Pre-Budget Report projection. While the independent average for GDP growth next year is slightly below the Pre-Budget Report forecast range, this largely reflects the inclusion of one particularly marked outlier. Indeed, three quarters of the forecasters that comprise the independent average expect GDP growth next year to be either within or above the Pre-Budget Report forecast range.

A61. Consistent with the Pre-Budget Report forecast, independent forecasters on average expect RPIX inflation to be below target in 2003. The independent average forecast for the current account deficit next year is slightly smaller than projected in the Pre-Budget Report.

Table A4: Pre-Budget Report and independent forecasts

	Percentage changes on a year earlier unless otherwise stated					
	2002			2003		
		Independent			Independent	
	Pre-Budget Report	Average	Range	**Pre-Budget Report**	Average	Range
Gross domestic product	1½	1.6	0.6 to 2.0	2½ to 3	2.4	–0.3 to 3.1
RPIX (Q4)	2½	2.2	1.5 to 2.6	2¼	2.3	1.7 to 3.3
Current account (£ billion)	–18¾	–18.7	–24.6 to –13.3	–24	–21.5	–36.4 to –13.8

Source: *Forecasts for the UK Economy: A Comparison of Independent Forecasts*, HM Treasury, November 2002.

UK FORECAST IN DETAIL

The household sector

A62. Against the background of underlying global weakness, robust growth in consumer spending in the UK has continued to provide substantial support to GDP growth, more than accounting for the increase in GDP in the first three quarters of 2002. Private consumption rose by 1.3 per cent in the second quarter and by 0.8 per cent in the third quarter. Over the six years to 2001 private consumption growth averaged more than 4 per cent a year, and reached a peak of 5¼ per cent in 2000.

A63. National accounts revisions now show that income growth in recent years has been somewhat stronger than previously estimated. As a result, movements in income now explain more of the strength in consumption over recent years. Between 1996 and 2001 real household disposable income grew on average by 3¾ per cent a year, but growth has moderated this year on the back of weaker earnings growth and falling dividend payments.

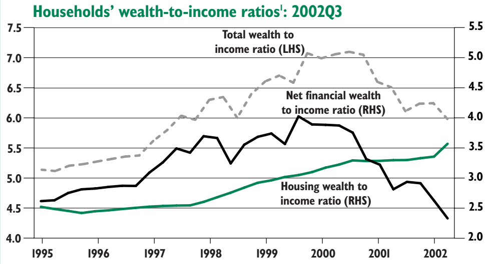
A64. Changes in household wealth are also likely to have had an important influence on consumer spending (Box A3). Sharp falls on global stock markets since 2000 and rising debt have dented households' net financial wealth. However, buoyant gains in house prices have partially cushioned households' wealth against falls in equity prices, though the ratio of total net wealth to income has recently returned to around its 1997 levels and growth in private consumption slowed from 5¼ per cent in 2000 to 4 per cent last year. Sharp house price rises may to some extent be a consequence of investors switching from equities into housing assets, a development perhaps most evident in the buy-to-let market. But house prices have also been supported by strong fundamentals, including a marked rise in the sustainable employment rate and low interest rates, which have underpinned high levels of consumer confidence. Consumer confidence in the general economic situation has remained well above its long-run average, while households' confidence in their own finances appears particularly robust, at around record highs. Households have become safer in the belief that the Government's monetary policy framework will continue to ensure low inflation and interest rates, so that debt servicing costs relative to income will not rise sharply. Structural housing supply constraints also support house prices, especially in the South East (Box A4).

A65. On the back of strong house price gains, the stock of personal borrowing rose by over 13 per cent in the year to September, and a steep rise in housing equity withdrawal is likely to have contributed to financing consumption. As a consequence, the saving ratio is expected to fall back in 2002 as a whole following a pick-up last year.

Box A3: Household wealth and consumption

Since the end of 1999 the FTSE all share index has lost around 40 per cent of its value. Households tend to offset falls in the value of their equity holdings by gradually saving more, implying a lagged negative effect on consumer spending. It has often been supposed that this link is weaker in the UK than in the US, because UK households hold a higher share of their equity wealth indirectly in life assurance and pension funds rather than through direct ownership. However, improved regulations on disclosure, for example through pension and endowment projections, and gravitation from defined benefit to defined contribution occupational pension schemes, will recently have made individuals more aware of the value of their indirect institutional asset holdings. These developments, and associated publicity, can therefore be expected to have strengthened the link between changes in indirect wealth holdings and consumer spending.

Households' wealth-to-income ratios[1]: 2002Q3



[1] HM Treasury estimates for 2002Q3.

In contrast to equities, house prices have continued to rise strongly, and are currently well above their long-run average relative to earnings. House price appreciation has given a significant lift to the ratio of housing equity to market valuation, which rose from around 68 per cent at the end of 1995 to almost 75 per cent in the fourth quarter of 2000. Although house prices have since risen sharply, households have chosen to withdraw these additional gains rather than let equity accrue further, supporting robust consumption growth. In the second quarter of 2002, the ratio of mortgage equity withdrawal to post-tax income was almost 6 per cent – the highest since its peak of just over 8 per cent in autumn 1988. But despite this, the housing equity ratio remains only just below its long-run average.

House price rises have been supported by strong fundamentals, but may also to some extent reflect falling equity prices, with funds flowing out of equities and into property in search of higher returns. Divergences between equity and property prices have been apparent in various other countries too. This *substitution* effect, at least to date, looks to have outweighed the *income* effect whereby falling equity prices reduce household wealth and curtail demand for housing as well as for all other goods and services. In any case, continued strong growth in consumption and high consumer confidence suggest that high capital gains on housing have dominated sharp falls in equity prices in terms of their impact on consumer spending.

The clearest evidence of diversification out of equities into property comes from the buy-to-let market, where the value of mortgages on buy-to-let purchases has increased over two and a half fold since end-1999. This is likely to have been further encouraged by structural easing of credit constraints, with landlords now able to use rents against mortgage applications. Rising investment demand for such properties led to very sharp capital gains, and although rental returns have fallen as the supply of rental properties has increased, total returns have remained much better than on equities.

Rising house prices have also encouraged households to borrow more generally in recent years, with their debt-to-income ratio reaching a record level in mid-2002. Thus, although house price gains have directly tended to shield households' total net wealth from falling equity prices, net wealth has nevertheless fallen since its peak in 2000. At the same time consumption growth has eased back, but remained strong.

A66. Nevertheless, there have been some signs that private consumption growth has gradually been losing a little of its momentum. In the third quarter of 2002, private consumption was up 0.8 per cent on the previous quarter and 3.8 per cent on a year earlier. While still robust, average quarterly growth appears to have eased back, falling from 1.2 per cent in 2000 to 1 per cent in 2001 and 0.9 per cent in the year to date. Retail sales growth up to September had also shown traces of slowing, after exceptionally strong growth in 2001, and consumer confidence has recently lost a little of its buoyancy. However, growth in retail sales in October was stronger than in preceding months and broadly based; and surveys by the British Retail Consortium and the CBI have also indicated a recent pick up in retail spending growth. So latest monthly indicators cast an element of doubt over the extent to which consumer spending may currently be slowing.

A67. For 2002 as a whole, private consumption is expected to grow by 3½ per cent. This would be a more moderate rate than in 2001, and indeed the slowest rate since 1995, although still unsustainably strong and at the upper end of the Budget 2002 forecast range.

Table A5: Household sector[1] expenditure and income

	Percentage changes on previous year unless otherwise stated				
		Forecast			
	2001	2002	2003	2004	2005
Household consumption[2]	4	3½	2¼ to 2½	2¾ to 3¼	2¼ to 2¾
Real household disposable income	6½	2	3 to 3½	2½ to 3	2 to 2½
Saving ratio (level, per cent)	6¼	4½	5¼	5	4¾

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

A68. Growth in private consumption is expected to slow further in the early part of next year, as lagged effects from lower income growth and falls in equity prices feed through to spending patterns, and households' willingness to take on further debt recedes. Thereafter, consumption growth is expected to pick up temporarily, reaching 2¾ to 3¼ per cent in 2004, as GDP accelerates and income growth recovers from this year's lows. However, with income growth likely to remain subdued relative to rates seen between 1999 and 2001, and with historically high debt-to-income ratios continuing to limit households' appetite for further increases in borrowing, private consumption growth is expected to ease back over the remainder of the forecast horizon while the saving ratio tends to stabilise. With inflation and borrowing costs remaining low and employment around record highs, a gradual slackening in consumer spending growth is in prospect rather than an abrupt turnaround.

A69. Clear risks surround this outlook, but the Government's monetary policy framework, which has delivered inflation close to its symmetric target, means that the MPC can respond equally effectively to either negative or positive demand shocks. Any further falls in equity prices would pose a downside risk to this outlook, and the seemingly enhanced reliance of consumption on housing wealth raises a number of risks, leaving consumer spending exposed to any future adverse shift in valuations. While the Government's framework for macroeconomic stability and robust fundamentals mean debt servicing costs can be expected to remain low in relation to income, subdued inflation also means that the real value of debt is not eroded as quickly as in the past. Moreover, some regional and local markets may be more exposed than others. Parts of London and the South East have seen house price increases well in excess of the country as a whole (Box A4), and sustainability will depend on the extent to which this reflects fundamental demand and supply factors or inflated expectations.

A70. Nonetheless, recent developments do not foreshadow a repeat of the late 1980s and early 1990s and there may well be structural reasons why house prices have increased permanently. Economic fundamentals are far stronger today than they were in the late 1980s, when RPIX inflation reached $9^{1}/_{2}$ per cent and interest rates peaked at 15 per cent. Moreover, with financial markets expecting low inflation and only a modest rise in interest rates in the future, the risk of indebtedness leading to financial distress is much lower than in the late 1980s and early 1990s.

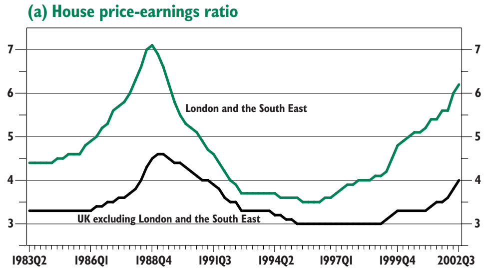
A71. However, there is as yet not much conclusive evidence of house price inflation and growth in consumer spending slowing to sustainable rates in the near term, and the momentum could prove stronger than forecast, especially if supported by global recovery coming through sooner than expected. Although a slowing must come at some point, the longer it is delayed the greater the risk of a sharp correction.

Box A4: Regional house price differentials

It is important to consider regional differences in house prices. Chart (a) shows movements in the house price-earnings ratio – a measure of housing affordability – over time for the South East (SE), including London (L), and the Rest of the UK. It illustrates that over time the house price-earnings ratio in the South East tends consistently to be higher, to lead the rest of the country and have a greater amplitude across its cycle. The relative levels and cyclical sensitivity of house prices in the South East to changes in demand appear to be consistent with relatively more binding constraints on housing supply.

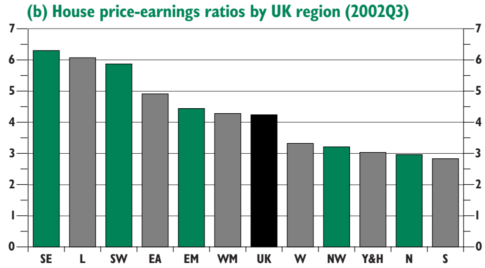
However, once South East prices have been bid up, households have greater incentives to demand housing in adjoining areas. These pressures tend to lead in due course to a partial equalisation of house price differentials. Nevertheless the ratio in the South East has always tended to be higher than elsewhere. Currently both the ratio and its gap with the rest of the country remain below their late 1980s peaks.

(a) House price-earnings ratio



Source: HBOS plc

(b) House price-earnings ratios by UK region (2002Q3)



Source: HBOS plc

Chart (b) shows in more detail the recent distribution of house prices in relation to income across the regions of Britain. This clearly illustrates that house prices are higher relative to earnings the nearer the region to the South East. However, the relatively high price of housing in the south is likely to moderate southern house price inflation and boost demand elsewhere. Furthermore, this also appears to be the case sub-regionally. Halifax report that recent house price gains in London have been focused on relatively inexpensive London boroughs. House prices are likely to stabilise in relatively high priced regions and areas, but the spill over of demand into less expensive areas could maintain strong national house price inflation in the near term.

Companies and investment

A72. At the time of the Budget, a global economic recovery had been expected to encourage firms to bring delayed investment projects back on stream from thereon. In the event, this outcome was undermined by heightened perceptions of downside risks to global prospects and a softening of profit expectations, reflected in lower equity prices and increases in the cost of capital. These factors have continued to deter investment through 2002. Mergers and acquisitions activity has also fallen casualty to lower equity prices.

A73. Indeed, as discussed in Box A2, weak private investment has been the main factor holding back growth worldwide this year. Historically, investment and global prospects have been closely intertwined and business investment has tended to amplify the global economic cycle, rising faster than GDP in upswings but slowing more markedly during downturns. The slowdown in the global economy during 2001 was no exception to this pattern, being characterised by sharp falls in investment in nearly all major industrialised economies, and ongoing uncertainties this year have continued to keep capital spending subdued. Thus, while G7 GDP grew by 1.2 per cent in the year to the second quarter of 2002, whole economy gross fixed capital formation fell by $3^1/_2$ per cent: it was down by $3^3/_4$ per cent in the US, $5^1/_2$ per cent in the UK, 6 per cent in Japan and $6^1/_2$ per cent in Germany.

A74. The slowdown in the global economy last year clearly had a marked impact on UK business investment: companies carrying significant levels of debt from the late 1990s investment boom were quick to curtail capital spending when faced with the prospect of temporarily weaker profit margins as the global environment deteriorated. By the fourth quarter of 2001 business investment was over 8 per cent down on its peak a year earlier, despite pre-emptive monetary policy action tending to limit the scale of decline. Although around 70 per cent of UK business investment is in the service sector, which has lower direct external exposure than manufacturing, a number of service-based industries may have suffered disproportionately from weak global confidence. Post and telecommunications and financial services, industries in which global difficulties have been particularly acute, together account for around 15 per cent of private sector investment in the UK, and investment by airline companies may have been adversely affected in the aftermath of 11 September. Moreover, the share of ICT services in business sector output is higher in the UK than in any other G7 economy, and the proportion of ICT services turnover accounted for by multinational corporations is also significantly higher than in most OECD countries. This suggests investment by ICT service businesses based in the UK may have been particularly exposed to global headwinds.

A75. Amidst heightened global uncertainties business investment has weakened further in 2002 and has now declined for seven consecutive quarters, with the CBI Industrial Trends Survey indicating that uncertainty about demand has remained the key factor holding back investment. Current price estimates of ICT investment also point to continued weakness in spending on high-technology assets following the sharp slowdown in 2001. Hardware spending was almost 25 per cent lower in the first three quarters of 2002 compared with a year earlier, while software expenditure was down by almost 10 per cent.

A76. While significant global downside risks remain, businesses are now better placed than they were last year to revive postponed investment plans once uncertainty recedes and the pace of recovery in the global economy strengthens. After a difficult 2001, company profitability, which is closely correlated with business investment, has strengthened this year. Moreover, debt accumulated as a result of fast investment growth in the late 1990s has been reined in – private non-financial corporations became net lenders in the first half of 2002, having run financial deficits in each of the past five years, and their capital gearing position has eased. This means that companies should have greater financial flexibility in funding increases in investment.

Table A6: Gross fixed capital formation

	Percentage changes on previous year				
		Forecast			
	2001	2002	2003	2004	2005
Whole economy[1]	$^1/_4$	$-4^1/_4$	$6^1/_2$ to 7	4 to $4^1/_2$	$4^1/_4$ to $4^3/_4$
of which:					
Business[2,3]	1	$-10^1/_2$	$2^3/_4$ to $3^1/_4$	$3^3/_4$ to $4^1/_2$	4 to $4^3/_4$
Private dwellings[3]	$-6^1/_2$	$10^1/_2$	$2^1/_2$ to $2^3/_4$	2 to $2^1/_2$	2 to $2^1/_2$
General government[3,4]	$5^1/_4$	$24^3/_4$	$36^1/_2$	$8^1/_2$	$7^1/_2$

[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.*

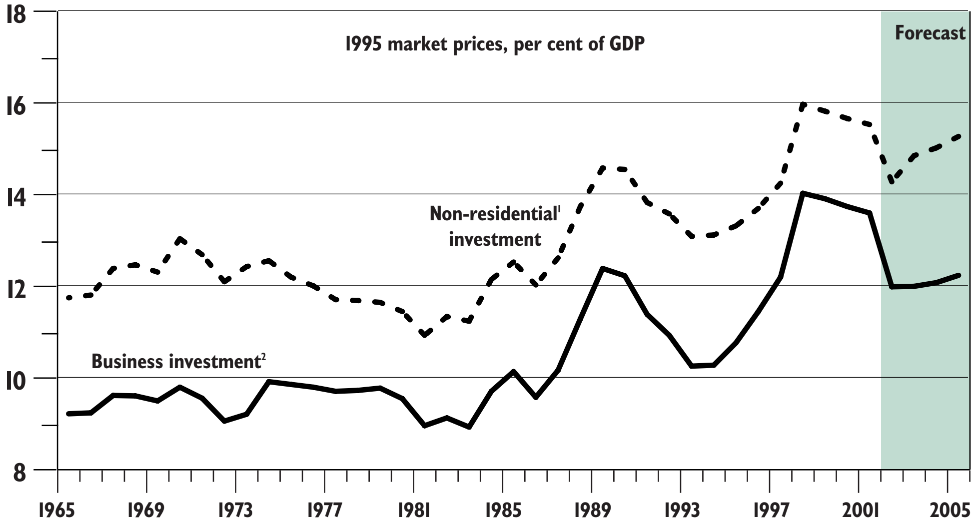
[4] *Includes National Health Service Trusts.*

A77. According to the BCC survey, service sector investment intentions have already strengthened since the end of last year, to around the survey's long-run average. Nevertheless business investment is forecast to be down by around 10 per cent in 2002 as a whole, although this partly reflects base effects from the steepness of the falls through 2001.

A78. Business investment is expected to return to growth during 2003. A strengthening in the pace of demand growth, coupled with a further rebalancing of activity, is expected to enhance corporate prospects and encourage renewed expansion in production capacity. The anticipated pick-up in both domestic and external demand in 2003 and 2004 should also encourage firms to pursue more aggressive investment strategies as spare capacity gets absorbed, and to bring postponed projects back on stream. Moreover, the replacement cycle in ICT should begin to have an effect in the near term as assets acquired in the late 1990s investment boom become obsolete. These factors are expected to allow business investment to grow temporarily above its long-run average rate and boost the capital-labour ratio. Government policies aimed at improving the UK's underlying investment record should further help support capital spending in the medium term.

A79. Thus business investment growth is forecast to pick up to between $2^3/_4$ to $3^1/_4$ per cent in 2003 as the world recovery finally gathers pace, and to reach 4 to $4^3/_4$ per cent in 2005. Whereas there are downside risks to this prospect, which would be revealed in resumed faltering on global equity markets, distinct upside risks are also readily conceivable, particularly from the latter half of next year. Business investment typically rebounds strongly following cyclical downturns. The current downturn in business investment has been globally, as opposed to domestically, induced unlike in the early 1990s, and has possibly led to an abnormal degree of deferred capital spending waiting to come back on stream as the cycle turns up. Moreover, strong investment spending in the late 1990s on ICT equipment with short asset lives may mean more pent up replacement demand than normal for the current stage of the cycle. A faster turnaround in global conditions, for example on the back of reduced tension and uncertainty over developments in the Middle East and a lower oil price premium, would also tend to call forth a sharper pick-up in private investment than envisaged.

Chart A7: Business and non-residential investment ratios



[1] *Whole economy less dwellings.*

[2] *Business investment by public corporations (except National Health Service Trusts) and investment under the Private Finance Initiative.*

A80. Government investment is forecast to show further strong expansion in 2003, as the Government's spending plans continue to deliver sustained spending increases on priority public services. Together with the anticipated pick up in business investment from next year, further growth in government investment should contribute to promoting a rebalancing of GDP growth over the forecast horizon: whole economy investment growth is projected to outstrip household consumption growth throughout.

Trade and the balance of payments

A81. Despite the global economic recovery currently having less momentum than expected at Budget time, net trade made its largest positive contribution to GDP growth for over 7 years in the second quarter of this year. Moreover, although net trade contributed negatively to growth in the third quarter, the deficit on trade in goods and services was still £1$^3/_4$ billion smaller than in the third quarter of 2001.

A82. Trade flows have been volatile in recent months. Goods export volumes rose at their sharpest rate for two years in the second quarter, more than offsetting a further decline in services exports. Taking the first half of the year as a whole, export volumes were up by 1$^1/_4$ per cent on the second half of 2001. Imports also picked up in the first half of 2002, but growth remained muted and almost entirely accounted for by consumer goods as global fragility, weak investment demand and a still delicate manufacturing recovery held back imports of capital and intermediate goods.

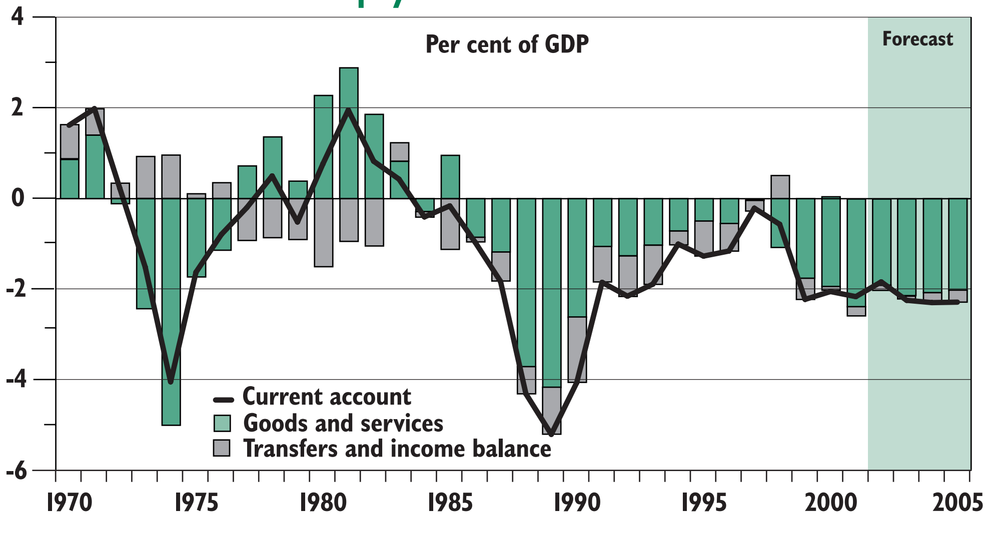
A83. However, following this broadly encouraging start to 2002, the third quarter saw growth in exports and imports of goods fall back, indicating that overall growth earlier in the year failed to gather any significant momentum amidst fragile worldwide business confidence.

A84. After having moved in tandem for much of 2001, goods exports to EU and non-EU markets have diverged since earlier this year. Goods exports to the EU faltered in the third quarter of 2002, declining to their lowest level since the start of 2000, in line with sluggish demand in Europe and the continued weakness of the euro. In contrast, goods exports to the non-EU were over 9 per cent above their first quarter trough, helped by the turnaround in world trade earlier this year. Exports to the EU have been held back by relatively weak consumption growth on the continent, with consumer goods exports, excluding cars, at their lowest level for seven years in the third quarter of 2002. But elsewhere, more robust household expenditure has seen consumer goods exports to non-EU markets increase in each of the past four quarters. To some extent, however, non-EU exports may have been boosted a number of temporary factors. In the US, a more gradual rate of inventory liquidation in the first quarter may have fed through to UK export demand. The relatively short-lived pick-up in world industrial production during the second quarter also appears to have fed through to UK exports of intermediate goods, once allowance is made for Jubilee effects; and exports of motor vehicles to the US are likely to have been boosted by the reintroduction of zero financing deals.

A85. While the Sterling Exchange Rate Index (ERI) has fallen modestly since the time of the Budget, this masks a modest fall in sterling against the euro which has been partly offset by a strengthening against the dollar.

A86. The deficit on trade in goods and services in 2002 is expected to be around £19 billion, or just over $1^3/_4$ per cent of GDP, significantly lower than forecast at Budget time. The deficit is forecast to widen slightly next year. Export volume growth is expected to pick up further in 2003 as the recovery in the world economy gains momentum. But import growth is also expected to increase from next year, as the recovery in manufacturing output moves onto a surer footing, boosting intermediate imports, and businesses again start to increase investment spending.

Chart A8: Balance of payments current account



A87. However, despite above trend growth in GDP between 2003 and 2005, import growth is not expected to return to the strong rates seen over the five years to 2000. This partly reflects the increasing importance of government spending in overall demand in the coming years, given its lower import content relative to private spending. As in the Budget forecast, export and import volume growth are expected broadly to keep in step over most of the forecast horizon, and the deficit on trade in goods and services is forecast to remain more or less stable as a percentage of GDP beyond next year.

Table A7: 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]	
2001	$1^1/_4$	$2^3/_4$	$-^1/_4$	$-^1/_4$	0	–23
Forecast						
2002	$-1^3/_4$	$^1/_4$	$1^1/_4$	–2	$3^1/_4$	$-19^1/_4$
2003	$3^3/_4$ to $4^1/_4$	$4^3/_4$ to 5	$^1/_2$	$^1/_2$	0	$-22^3/_4$
2004	$7^3/_4$ to $8^1/_4$	7 to $7^1/_2$	$2^3/_4$	$2^3/_4$	0	$-23^1/_2$
2005	$6^3/_4$ to $7^1/_4$	$6^1/_4$ to $6^3/_4$	$2^1/_2$	$2^1/_2$	0	$-24^1/_4$

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

A88. The current account deficit declined in the first half of 2002 and is expected to narrow markedly over 2002 as a whole, mainly due to a lower trade deficit. Over the next two years, the current account deficit is forecast to widen a little. The position on overseas income and transfers, taken together, is expected to weaken somewhat over coming years. Although a strengthening in the pace of world recovery should promote UK earnings overseas, faster UK growth is likely to boost foreign investors profits on UK operations. Moreover, the level of the UK's overseas income surplus in recent years has been unusually high, and the forecast assumes some convergence between the rates of return on overseas and UK assets. Nonetheless, relative to GDP, the current account deficit is expected to remain modest, levelling out at around $2^1/_4$ per cent from 2004.

Table A8: Summary of economic prospects[1, 2]

	Percentage changes on a year earlier unless otherwise stated					
		Forecast[2]				Average errors from past forecasts[4]
	2001	**2002**	**2003**	**2004**	**2005**	
Output at constant market prices						
Gross domestic product (GDP)	2	1½	2½ to 3	3 to 3½	2¾ to 3¼	1
Manufacturing output	–2½	–4	1¾ to 2¼	2¼ to 2¾	1¾ to 2¼	1¾
Expenditure components of GDP at constant market prices[5]						
Domestic demand	2¾	2¼	3 to 3½	3¼ to 3¾	2¾ to 3¼	1
Household consumption[6]	4	3½	2¼ to 2½	2¾ to 3¼	2¼ to 2¾	1¼
General government consumption	3	4¼	3¾	3	3½	1
Fixed investment	¼	–4¼	6½ to 7	4 to 4½	4¼ to 4¾	2
Change in inventories[7]	–¾	–¼	–¼ to 0	¼	0	¼
Exports of goods and services	1¼	–1¾	3¾ to 4¼	7¾ to 8¼	6¾ to 7¼	2½
Imports of goods and services	2¾	½	4¾ to 5	7 to 7½	6¼ to 6¾	2½
Balance of payments current account						
£ billion	–21	–18¾	–24	–26	–27¼	6¾
per cent of GDP	–2¼	–1¾	–2¼	–2¼	–2¼	¾
Inflation						
RPIX (Q4)	2	2½	2¼	2½	2½	½
Producer output prices (Q4)[8]	-¼	¾	1¾	2¼	2	1
GDP deflator at market prices	2	3	2	2½	2½	¾
Money GDP at market prices						
£ billion	988	1033	1082 to 1087	1143 to 1153	1204 to 1220	13
percentage change	4	4½	4¾ to 5¼	5½ to 6	5¼ to 5¾	1¼

[1] *The forecast is consistent with the national accounts and balance of payments statistics to the second quarter of 2002, released by the Office for National Statistics on 27 September 2002, and output, income and expenditure data for the third quarter released on 27 November.*

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

[3] *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.*

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

[5] *Further detail on the expenditure components of GDP is given in Table A9.*

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

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

[8] *Excluding excise duties.*

Table A9: Gross domestic product and its components

		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
		£ billion at 1995 prices, seasonally adjusted									
2001		588.4	157.2	152.4	0.4	898.8	288.6	1187.4	340.8	–0.8	845.8
2002		609.4	164.2	146.1	-1.4	918.2	283.3	1201.5	341.5	-1.0	859.1
2003		622.7 to 625.3	170.4	155.6 to 156.2	-2.7 to -2.0	945.9 to 950.0	293.8 to 295.1	1239.7 to 1245.0	357.3 to 358.8	-1.0	881.5 to 885.2
2004		639.3 to 645.1	175.6	161.9 to 163.4	-0.9 to 0.7	975.9 to 984.8	316.7 to 319.6	1292.6 to 1304.4	382.6 to 386.1	-1.0	909.0 to 917.3
2005		654.4 to 663.6	181.8	168.8 to 171.1	-1.3 to 1.2	1003.6 to 1017.8	338.1 to 342.9	1341.7 to 1360.6	406.4 to 412.2	-1.0	934.4 to 947.5
2001	1st half	291.3	77.5	77.3	0.7	446.9	148.0	594.8	172.9	–0.3	421.6
	2nd half	297.1	79.8	75.2	–0.4	451.9	140.6	592.6	167.9	–0.5	424.2
2002	1st half	302.2 to 302.2	81.7	72.8 to 72.8	–0.4 to –0.4	456.3 to 456.3	141.7 to 141.7	598.0 to 598.0	170.9 to 170.9	–0.5	426.6 to 426.6
	2nd half	307.1 to 307.3	82.5	73.3 to 73.3	-1.0 to -1.0	461.9 to 462.1	141.5 to 141.6	603.4 to 603.7	170.5 to 170.6	-0.5	432.4 to 432.6
2003	1st half	309.5 to 310.5	84.5	77.5 to 77.8	-2.0 to -1.7	469.6 to 471.0	144.3 to 144.7	613.9 to 615.8	175.9 to 176.4	-0.5	437.5 to 438.9
	2nd half	313.1 to 314.8	85.8	78.0 to 78.5	-0.7 to -0.2	476.3 to 478.9	149.5 to 150.3	625.8 to 629.2	181.4 to 182.4	-0.5	443.9 to 446.4
2004	1st half	317.5 to 320.0	87.1	80.0 to 80.7	-0.4 to 0.3	484.2 to 488.0	155.5 to 156.7	639.7 to 644.8	188.1 to 189.6	-0.5	451.1 to 454.7
	2nd half	321.8 to 325.1	88.5	81.9 to 82.7	-0.5 to 0.4	491.7 to 496.8	161.2 to 162.9	652.9 to 659.7	194.5 to 196.6	-0.5	457.9 to 462.6
2005	1st half	325.4 to 329.6	89.6	83.7 to 84.7	-0.2 to 0.9	498.5 to 504.9	166.5 to 168.6	665.0 to 673.5	200.4 to 203.0	-0.5	464.1 to 470.1
	2nd half	329.0 to 334.0	92.2	85.1 to 86.4	-1.1 to 0.3	505.1 to 512.9	171.6 to 174.2	676.8 to 687.1	206.0 to 209.2	-0.5	470.2 to 477.5
		Percentage changes on previous year[4,5]									
2001		4	3	¼	–¾	2¾	1¼	2¼	2¾	0	2
2002		3½	4½	–4¼	–¼	2¼	–1¾	1¼	¼	0	1½
2003		2¼ to 2½	3¾	6½ to 7	–¼ to 0	3 to 3½	3¾ to 4¼	3 to 3½	4¾ to 5	0	2½ to 3
2004		2¾ to 3¼	3	4 to 4½	¼	3¼ to 3¾	7¾ to 8¼	4¼ to 4¾	7 to 7½	0	3 to 3½
2005		2¼ to 2¾	3½	4¼ to 4¾	0	2¾ to 3¼	6¾ to 7¼	3¾ to 4¼	6¼ to 6¾	0	2¾ to 3¼

[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.*