# 2 MAINTAINING MACROECONOMIC STABILITY

**Earlier this year, global confidence and demand was dampened by geo-political tensions, volatility on international financial and exchange rate markets and general uncertainty regarding prospects for growth, in particular in the euro area. Since then, as some key uncertainties have receded, international growth prospects have generally recovered, although this improvement has remained uneven across counties. In particular, activity in the euro area has remained subdued. Meanwhile, UK economic growth picked up strongly in the second and third quarters, as forecast in Budget 2003. This pick-up in activity is expected to continue into 2004, as the world recovery continues to gather momentum.**

**UK GDP is forecast to grow by 2.1 per cent this year, and between 3 and 3½ per cent in 2004-05, consistent with the Budget 2003 forecast.**

**The Pre-Budget Report confirms that the target for monetary policy will switch to a target based on the harmonised index of consumer prices, which the National Statistician has named the Consumer Prices Index (CPI) for the UK. The level of the new CPI inflation target is being set at 2 per cent and the switch to the new target will apply from today. The advantages of CPI as a measure of inflation for monetary policy purposes are set out in a paper published by the ONS today. The CPI is a better measure of inflation for the purposes of setting monetary policy, as it has a more realistic characterisation of consumer behaviour, a wider population coverage, is the most comparable measure of inflation internationally and represents international best practice.**

**The interim projections for the public finances included in this Pre-Budget Report show that the Government is on track to meet its strict fiscal rules over the economic cycle:**

- **the average current budget since the start of the current economic cycle in 1999-2000 shows an average annual surplus up to 2005-06 of around 0.2 per cent of GDP, equivalent to a margin or surplus of £14 billion in this cycle, meaning the Government is on track to meet the golden rule on the basis of cautious assumptions. The current budget returns to balance by 2006-07, and the cyclically-adjusted current budget in the cautious case moves back to balance by the end of the projection period; and**
- **public sector net debt is projected to be low and stable over the next five years, stabilising at 35½ per cent of GDP and well below the 40 per cent ceiling set in the sustainable investment rule. The UK has the lowest ratio of debt to GDP in the G7.**

**This report and the UK's annual convergence programme also show that the projections in this Pre-Budget Report are consistent with a prudent interpretation of the Stability and Growth Pact, which takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment.**

**An improved and updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the 2003 *Long-term public finance report*. This shows that on the basis of an expanded range of assumptions, the public finances are sustainable in the longer term, and that the UK is well placed relative to other countries to meet the challenges of an ageing population.**

## THE MACROECONOMIC FRAMEWORK

**2.1** Earlier this year, global confidence and demand was dampened by geo-political tensions, volatility on international financial and exchange rate markets and general uncertainty regarding prospects for growth, in particular in the euro area. Since then, as some key uncertainties have receded, international growth prospects have generally recovered, although this improvement has remained uneven across countries. In particular, activity in the euro area has remained subdued. Meanwhile, UK economic growth picked up strongly in the second and third quarters, as forecast in Budget 2003. This pick-up in activity is expected to continue into 2004, as the world recovery continues to gather momentum.

**2.2** The Government's macroeconomic framework is designed to maintain long-term economic stability. Large fluctuations in output, employment and inflation add to uncertainty for firms, consumers and the public sector, and can reduce the economy's long-term growth potential. Stability allows businesses, individuals and the Government to plan more effectively for the long term, improving the quality and quantity of investment in physical and human capital and helping to raise productivity.

**2.3** The macroeconomic framework is based on the principles of transparency, responsibility and accountability.[1] The monetary policy framework seeks to ensure low and stable inflation, while fiscal policy is underpinned by clear objectives and two strict rules that ensure sound public finances over the medium term. The fiscal rules are the foundation of the Government's public spending framework, which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes. These policies work together in a coherent and integrated way.

### Monetary policy framework

**2.4** Since its introduction in 1997, the monetary policy framework has consistently delivered inflation close to the Government's target and allowed the Bank of England's Monetary Policy Committee (MPC) to mitigate the impact of global events on the UK economy. The framework is based on four key principles:

- clear and precise objectives. While the primary objective of monetary policy is to deliver price stability, the adoption of a single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the MPC in setting interest rates to meet the Government's inflation target;
- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt reporting of the minutes of monthly MPC meetings, and publication of the Bank of England's quarterly Inflation Report; and
- credibility and flexibility. The MPC has discretion to decide how and when to react to events, within the constraints of the inflation target and the open letter system.

[1] Further details can be found in *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002.

**2.5** These arrangements have removed the risk that short-term political factors could influence monetary policy and ensured that interest rates are set in a forward-looking manner to meet the Government's symmetrical inflation target.

**New inflation target**

**2.6** On 9 June 2003, the Chancellor announced that he intended to change the basis of the inflation target in the remit for the MPC. **This Pre-Budget Report confirms that from today the operational target for monetary policy will switch to a target based on the harmonised index of consumer prices, which the National Statistician has named the Consumer Prices Index (CPI) for the UK**. The Chancellor has written to the Governor of the Bank of England setting out the new remit. Attached to the letter is an annex explaining the new target, including the advantages of the CPI. In addition, the Office for National Statistics (ONS) has published a paper[2] setting out the technical and methodological basis of the CPI, the differences between the CPI and RPIX and the advantages of CPI for the purposes of setting monetary policy.

**2.7** As discussed in the ONS paper, the CPI is a better measure of inflation for the purposes of setting monetary policy, as it:

- better allows for the substitution of cheaper for more expensive goods and services within expenditure categories when relative prices change and so it is a more realistic characterisation of consumer behaviour;
- has a wider population coverage and is more consistent with national accounts principles of consumer expenditure, so it shares a coherence with other economic statistics and gives a better picture of spending patterns in the UK; and
- is a more comparable measure of inflation internationally and represents international best practice.

**2.8** **The level of the new CPI inflation target is being set at 2 per cent and the switch to the new target will apply from today.** The new target is 0.5 percentage points below the previous RPIX-based target, reflecting differences in the way that CPI and RPIX inflation are measured. The level of the new target is set to be consistent with the old target in two years' time, the typical forecast horizon for monetary policy purposes.

**2.9** All other aspects of the monetary policy framework remain unchanged. If the rate of CPI inflation diverges by more than one percentage point above or below the target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC proposes to take, the expected period of the deviation and how this approach meets the remit of the MPC.

**2.10** Benefits will continue to be uprated by the RPI, or derivative indices, as before. Recipients will continue to receive assistance with housing costs through the housing costs element of the RPI or through help for housing costs targeted at low-income households.[3] The Government will continue to issue gilts linked to the RPI measure of inflation.

[2] *The New Inflation Target: the Statistical Perspective*, ONS, December 2003.

[3] Housing Benefit, Council Tax Benefit and Income Support for Mortgage Interest are available to help low income households with housing costs.

**Box 2.1: The Consumer Prices Index**

**The Consumer Prices Index (CPI) is a measure of the change in the level of prices charged for consumer goods and services. It is constructed on a common, or harmonised, basis for all EU Member States. The common European standard is known as the Harmonised Index of Consumer Prices (HICP) and the CPI is the UK's measure.**

**As with RPIX, the CPI is calculated by weighting prices according to the pattern of households' expenditure. Both indices are 'chain-linked', which means that the weights are adjusted annually to reflect changes in the pattern of consumers' expenditure. While the CPI is calculated from the same raw price data as the RPI and RPIX, there are a number of methodological and coverage differences between RPIX and CPI that lead to differences between the inflation rates, as described in the Office for National Statistics (ONS) paper. These methodological differences can be broadly divided into two effects, the formula effect and the coverage effect.**

**The formula effect relates to the way the two indices aggregate individual prices within individual expenditure categories. The CPI uses the geometric mean and RPIX uses arithmetic means. The geometric mean is the approach used in most other countries, and as stated in the ONS paper, has some advantages over arithmetic means.**

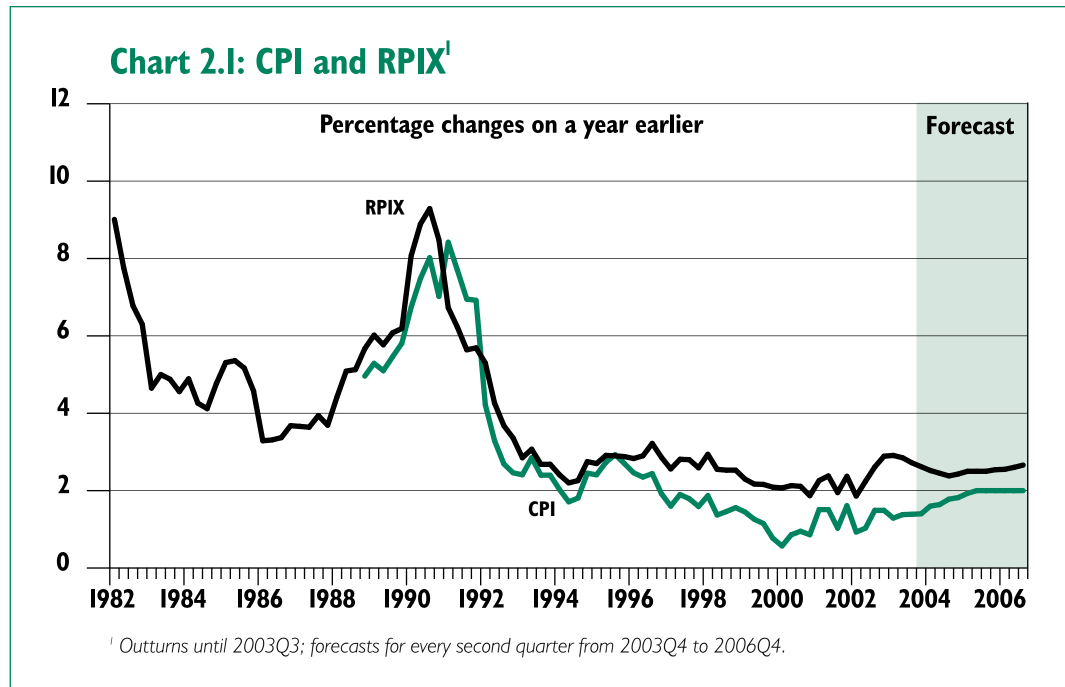
**The coverage effect is due to the different coverage of the two indices and relates primarily to differences in population and expenditure coverage, and commodity measurement. The population coverage differences reflect the fact that the CPI is based on the purchasing patterns of all private households, including expenditure by foreign visitors, the richest households and the poorest pensioner households, all of which are excluded from the RPI. On expenditure coverage, the major difference is the exclusion of several components of housing costs from the CPI that are included in RPIX, including housing depreciation and council tax. The commodity measurement effect reflects different treatment of items such as insurance premiums.**

**Since 1997, the formula effect and the difference in coverage relating to housing costs have been the main reasons for the differences between CPI and RPIX inflation. The other coverage effects have tended to be negligible on average.**

**2.11** The difference between CPI and RPIX inflation is expected to narrow markedly from 1.3 percentage points in October 2003 to ½ percentage point two years ahead, the typical forecast horizon for monetary policy purposes. Thereafter, the differential is expected to remain broadly stable, rising slightly above ½ percentage point in future years. With CPI inflation expected to remain at its target level of 2 per cent, RPIX inflation is expected to rise slightly above 2½ per cent depending on a range of economic factors and rounds up to 2¾ per cent in this Pre-Budget Report forecast.

**2.12** The exclusion of certain housing cost elements from the CPI does not mean that housing developments will not be an important factor in setting monetary policy or that house prices will be more volatile under a CPI-based target. Although the MPC will target CPI inflation, house prices are – and will continue to be – an important indicator in assessing macroeconomic developments for the purposes of setting monetary policy. Furthermore, as discussed in detail in the ONS paper, Eurostat is currently undertaking a pilot study (in which the UK is participating) to assess the preferred means of incorporating a measure of housing costs into the CPI. The ONS is expected to take into account any internationally agreed future changes in the measurement of inflation.

**Chart 2.1: CPI and RPIX[1]**




[1] *Outturns until 2003Q3; forecasts for every second quarter from 2003Q4 to 2006Q4.*

**Fiscal policy framework**

**2.13** The Government's fiscal policy framework is based on the five key principles set out in the *Code for fiscal stability*[4] – transparency, stability, responsibility, fairness and efficiency. The Code requires the Government to state both its objectives and the rules through which fiscal policy will be operated. The Government's fiscal policy objectives are:

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations; and
- over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.

**2.14** These objectives are implemented through two fiscal rules, against which the performance of fiscal policy can be judged. The fiscal rules are:

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

[4] *Code for fiscal stability*, HM Treasury, 1998.

**2.15** The fiscal rules ensure sound public finances in the medium term while allowing flexibility in two key respects:

- the rules are set over the economic cycle. This allows the fiscal balances to vary between years in line with the cyclical position of the economy, permitting the automatic stabilisers to operate freely to help smooth the path of the economy in the face of variations in demand; and
- the rules work together to promote capital investment while ensuring sustainable public finances in the long term. The golden rule requires the current budget to be in balance or surplus over the cycle, allowing the Government to borrow only to fund capital spending. The sustainable investment rule ensures that borrowing is maintained at a prudent level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle.

**2.16** The fiscal policy framework also takes account of uncertainty that is inherent in projections of the public finances. The fiscal projections are based on cautious assumptions for key economic variables, including the trend rate of growth, oil prices and the level of unemployment. This cautious approach builds a safety margin into the public finances and minimises the need for unexpected changes in taxation or spending. The assumptions are audited by the Comptroller and Auditor General as part of a three-year rolling review to ensure that they remain reasonable and cautious.

### Whole of Government Accounts

**2.17** Accurate data is essential if policy makers are to make the right decisions. Publishing this data improves the transparency of decision-making. Whole of Government Accounts can help do this by including all entities within the public sector and using best-practice accounting methods, thereby increasing the transparency of Government finances, providing an additional and valuable perspective on the public finances and improving the completeness and comparability of public sector financial data. However, the development work for Whole of Government Accounts raises significant methodological issues that will take some time to address. As a result, the Government will publish full Whole of Government Accounts for the first time based on figures for 2006-07 once these methodological issues have been addressed through dry-run processes.

### Economic statistics

**2.18** In February 2003, the Chancellor asked Christopher Allsopp to undertake a wide-ranging review of the informational and statistical requirements for monetary and wider economic policymaking, including to support the Government's objective of promoting economic growth in all regions. Allsopp's First Report is being published today and is described in Box A5. The Government welcomes the report and looks forward to discussing the proposals with Christopher Allsopp, the National Statistician and others.

### Public spending framework

**2.19** The fiscal rules underpin the Government's public spending framework. The golden rule increases the efficiency of public spending by ensuring that public investment is not sacrificed to meet short-term current spending pressures. Departments are now given separate allocations for resource and capital spending to help ensure adherence to the rule. The sustainable investment rule sets the context for the Government's public investment targets and ensures that borrowing for investment is conducted in a responsible way. Full details of the public spending framework are set out in Chapter 6.

## Financial stability framework

**2.20** A single statutory body for financial regulation, the Financial Services Authority (FSA), was set up in 1998 as part of a new tripartite structure for overseeing the UK financial system, with distinct roles for the Treasury, the Bank of England and the FSA. A Memorandum of Understanding[5] in 1997 established a framework for co-operation between these three bodies on financial stability. The Bank of England is responsible for the stability of the financial system as a whole, including the payments infrastructure. The FSA is responsible for the authorisation and supervision of financial institutions including banks, for supervising financial markets and securities clearing and settlement systems, and for regulatory policy. The Treasury has responsibility for the overall institutional structure of regulation and the legislation that governs it.

**2.21** A Standing Committee, comprising the Chancellor, the Governor of the Bank of England and the Chairman of the FSA, meets monthly (at Deputies level) to discuss financial stability, focusing on risks deemed to have systemic consequences. The Committee regularly reviews the key systemic risks to the UK's financial intermediaries and infrastructure and co-ordinates the three authorities' contingency plans. In the event of a crisis, it would meet at short notice and co-ordinate any necessary action by the authorities.

**2.22** A review of the soundness of the UK's financial sector completed in February 2003, under the Financial Sector Assessment Programme run jointly by the IMF and World Bank, commented that[6]: *"The UK's large and sophisticated financial sector features fundamentally sound and highly developed financial institutions, markets and infrastructure. It is supported by a financial stability policy framework that has been significantly strengthened in a number of ways in recent years, and that in many respects is at the forefront internationally."*

[5] Full text available at on the Treasury website www.hm-treasury.gov.uk.

[6] Full report available at www.imf.org.

**Box 2.2: Promoting stability and combating criminal abuse of the financial system**

**The Treasury has recently consulted on possible legislative responses to major operational disruption to the UK financial system. Following the publication of a Green Paper, *The financial system and major operational disruption,* in February 2003, the Treasury asked the Bank of England's Deputy Governor for Financial Stability, Sir Andrew Large, to chair a Task Force to examine whether further legislation was needed. The final report, *Do we need new statutory powers?,* was published on 3 December 2003. It concluded that no new statutory powers were needed, as the present range of legislative tools were appropriate to manage the risks posed by a major operational disruption. This conclusion is predicated on the considerable work already ongoing to address financial sector business continuity issues. The Task Force made eight recommendations aimed at reinforcing and developing that work. The Government has accepted its conclusions and recommendations, and a progress report will be published by October 2004.**

**The Government is committed to ensuring the effectiveness of financial systems and international standards that combat money laundering and terrorist financing. Reducing incentives to commit crime by depriving criminals of the proceeds of drug dealing, smuggling, fraud, theft and tax evasion is a key aim in the fight against money laundering. Since 2002, the UK has recovered over £48 million in criminal assets. The new Money Laundering Regulations will impose high-level objectives that are non-prescriptive and allow businesses the flexibility to make controls that are proportionate to the risk of money laundering.**

**The UK works closely with international partners in the global fight against terrorism by delivering technical assistance and promoting worldwide implementation of high level counter terrorist initiatives. The UK has fully implemented all UN anti-terrorist Resolutions. Over $10 million has been frozen in the UK since the terrorist attacks in September 2001. Following the liberation of Kabul, the bulk has been unfrozen and made available to the legitimate Government of Afghanistan. Around $500,000 remains frozen.**

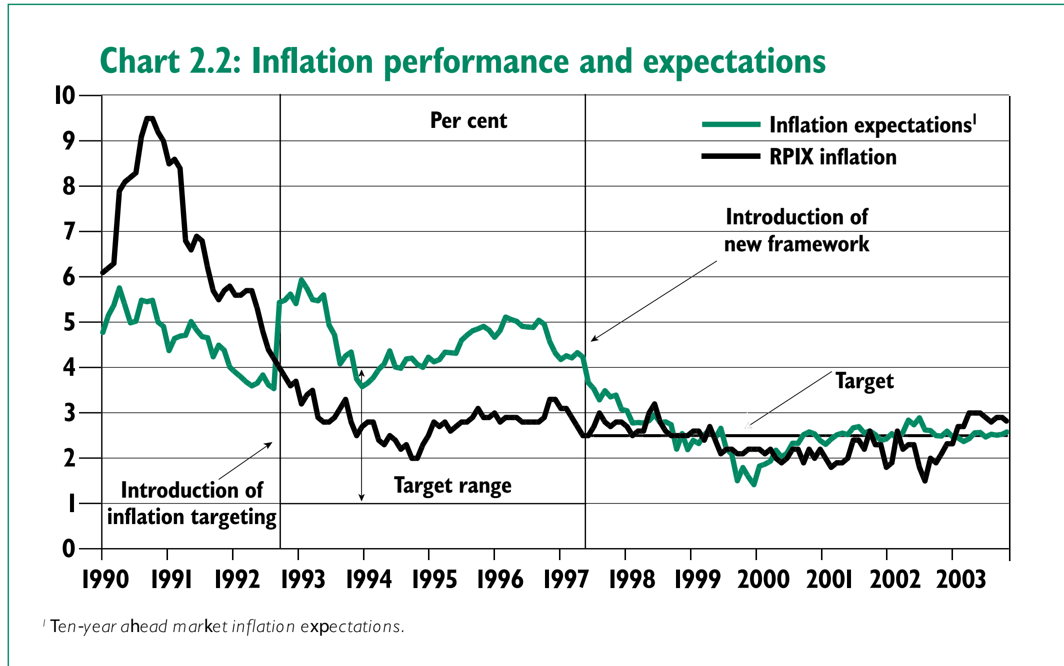
## THE PERFORMANCE OF THE FRAMEWORK

**2.23** The frameworks for monetary policy, fiscal policy and public spending provide a coherent strategy for maintaining high and stable levels of growth and employment, and for minimising the adverse impact of external events.

**Monetary policy**

**2.24** The monetary policy framework has improved the credibility of policy making and continues to deliver clear benefits. Since the framework was introduced:

- RPIX inflation has fluctuated in the narrow range of 1.5 to 3.2 per cent and has averaged 2.3 per cent, close to the Government's target; and
- long-term inflation expectations, as measured by financial markets data, show that expected inflation has remained close to the Government's target, having fallen from over 4 per cent in 1997, demonstrating the framework has a high degree of credibility.



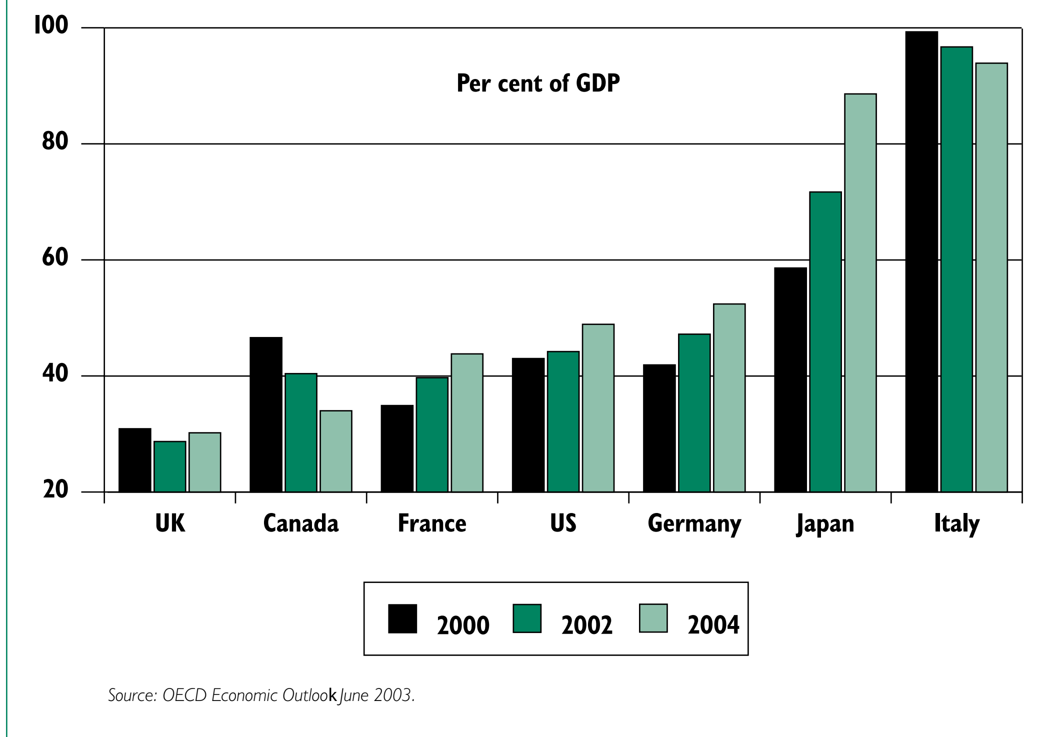

[1] Ten-year ahead market inflation expectations.

**2.25** The framework has also dealt successfully with unexpected economic events. The MPC responded quickly and decisively to the global slowdown during 2001 and to the events of 11 September 2001, cutting interest rates a total of nine times from 6 per cent to 3.5 per cent. This helped to keep output close to its trend level, while ensuring that inflation remained close to target. The MPC then increased interest rates in November 2003 in response to a strengthening global economy and a pick up in growth in the UK. Long-term 30 year interest rates are lower than in the US or the euro area, reducing the Government's debt interest payments and freeing up resources for investment in public services.

**Fiscal policy**

**2.26** The Government has taken tough decisions on taxation and spending to restore the public finances to a sustainable position. Between 1996-97 and 2000-01, the fiscal stance was tightened by more than 4 percentage points of GDP, supporting monetary policy during a period when the economy was generally above trend. Public sector net debt has also been reduced from 44 per cent of GDP in 1996-97 to around 31 per cent of GDP in 2002-03. As Chart 2.3 shows, the UK now has the lowest level of debt as a proportion of GDP in the G7.

## Chart 2.3: OECD estimate of general government net financial liabilities for G7 countries




Source: OECD *Economic Outlook* June 2003.

**2002 Spending Review**

**2.27** The 2002 Spending Review set spending plans for the years 2003-04 to 2005-06 for the public services other than the NHS, for which spending plans to 2007-08 were fixed in the 2002 Budget. Continuing the trend set in previous Spending Reviews, these spending plans allowed for significant increases in investment for the key public services, with resources focused on health, education, transport, criminal justice and housing. The overall spending 'envelope' set in Budget 2002 and confirmed in the 2002 Spending Review remains sustainable and fully consistent with the fiscal rules. This 'envelope' allows:

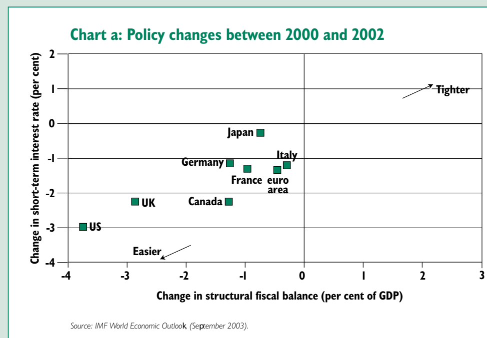
- public sector net investment to rise from its target of 1.6 per cent of GDP in 2003-04, to 2 per cent of GDP by 2005-06 and to 2¼ per cent by 2007-08, continuing to address the legacy of under-investment in public infrastructure, while meeting the sustainable investment rule;
- planned UK spending on the NHS to increase by an average of 7.1 per cent a year in real terms over the five years to 2007-08; and
- planned UK spending on education to increase by 6 per cent a year in real terms between 2002-03 and 2005-06.

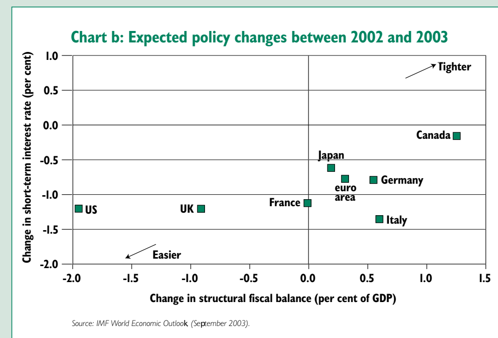
## Box 2.3: Comparative performance of macroeconomic frameworks

**In the first synchronised global slowdown in almost 30 years the US, Japan and parts of Europe all moved into recession in 2001. The leading role of business investment and confidence, combined with the increased globalisation of product markets, meant that volatility and uncertainty spread faster between economies than in the past. While the slowdown was synchronised, signs of recovery have so far been uneven. Since the last quarter of 2000, the UK's economy has grown at almost 5 per cent, while the euro area and Japan have witnessed growth around 2 per cent. A mixture of policy responses and structural factors can help explain this.**

**In the face of a series of large and destabilising shocks to the global economy, those countries with credible fiscal and monetary frameworks based on transparent, medium-term objectives have seen greater stability and stronger growth. The Bank of England cut short-term interest rates on nine occasions since 2001, from 6 per cent to 3.5 per cent, while maintaining long-term inflation expectations close to the inflation target. The combination of operational independence, a clear objective, and full accountability and transparency has allowed such flexibility while maintaining credibility.**

**In addition, low debt combined with structural improvements in the fiscal position in the UK have allowed fiscal policy to support monetary policy in recent years without undermining the sustainability of the public finances or the credibility of the fiscal framework. If the public finances had not been consolidated and debt levels not reduced, or if the fiscal rules had not been flexible enough to allow for the economic cycle, fiscal policy would not have been able to help support economic growth.**




**The charts above, based on IMF data, show that monetary and fiscal policy helped to support growth in both the UK and the US in the recent past. In comparison high debt levels and macroeconomic inflexibilities prevented fiscal policy from fully supporting monetary policy in many euro area countries in 2003.**

**Structural reform can also complement flexible macroeconomic frameworks and help economies to absorb shocks. The more responsive economies are to changing economic circumstances, the more likely a sustained recovery. The recent global economic slowdown has shown that more flexible labour markets keep unemployment down and employment up. More flexible product markets have also helped to cushion the shock while financial sectors, with better risk management and more diversified sources of finance, have remained robust.**

## RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

**Recent economic developments**

**2.28** At the beginning of 2003 significant global uncertainties weigh heavily on short-term prospects for the world economy. Global confidence and demand was dampened by geo-political tensions, volatility on international financial and exchange rate markets and general uncertainty regarding prospects for growth in the major economies, in particular the euro area where, during the first half of this year, output stagnated.

### Table 2.1: Summary of world forecast

| | Percentage changes on a year earlier unless otherwise stated | | | | |
|---|---|---|---|---|---|
| | Outturn | Forecasts | | | |
| | 2002 | 2003 | 2004 | 2005 | 2006 |
| *Major 7 countries*[1] | | | | | |
| Real GDP | 1½ | 2¼ | 3 | 2¾ | 2¾ |
| Consumer price inflation[2] | 1¾ | 1½ | 1½ | 1¾ | 1¾ |
| *Euro-area* | | | | | |
| Real GDP | ¾ | ½ | 1¾ | 2¾ | 2½ |
| World trade in goods and services | 3½ | 4 | 7¾ | 8 | 7¼ |
| UK export markets[3] | 2 | 3¼ | 6¼ | 7¼ | 6¾ |

[1] G7: US, Japan, Germany, France, UK, Italy and Canada.
[2] Per cent, Q4.
[3] Other countries' imports of goods and services weighted according to their importance in UK exports.

**2.29** In the first half of 2003, the UK economy was affected by these uncertainties. Faced with these challenging international conditions, UK companies further postponed decisions on new investment expenditure in the first quarter. Sluggish external demand continued to restrain underlying UK export growth in early 2003. Moreover, consumer confidence appears to have been dented by global geo-political tensions in the early months of the year.

**2.30** The domestic stability delivered by the Government's macroeconomic frameworks has enabled the UK economy to cope well in a challenging global economic environment and UK demand and activity has strengthened as geo-political uncertainties have receded. Against a steadily improving global background, financial markets have more than made up the losses incurred over the first quarter of 2003. Many forward-looking survey and confidence measures have also improved considerably in recent months and manufacturing output has risen. Following growth of 0.2 per cent in the first quarter – the weakest for almost eleven years – GDP grew by 0.6 per cent in the second and by 0.7 per cent in third quarter of the year, broadly in line with the Budget forecast.

**2.31** Growth in most G7 economies looks set to steadily improve during the course of 2004, though this acceleration is likely to remain uneven. While most forecasts for growth in the US and Japan have been revised up significantly since the spring, activity in the euro area, the UK's most important trading partner, has remained subdued. However, recent improvements in leading indicators, notably confidence measures and equity markets, point to a gradual recovery going forward.

**Revisions to UK national accounts**

**2.32** Extensive revisions to the UK national accounts were introduced by the Office for National Statistics (ONS) in the Blue Book 2003. These revisions reflect both methodological changes and new information on the economy. They mainly affect real volume measures with only small changes to nominal data. The overall effect of the revisions is that GDP growth since the mid-1990s is now stronger and relatively more balanced between expenditure components than previously estimated. In particular, household consumption is now estimated to have grown more slowly over the recent past, with business investment and net trade both stronger. More detail on the revisions can be found in Box A3.

### Box 2.4: Revisions to national accounts and trend growth

**Data revisions since Budget 2003 provide new information, and point to a higher than previously thought trend rate of output growth over the past few years, but for the Pre-Budget Report the existing 2¾ per cent trend growth rate projection is retained, and the public finance projections are based on a lower trend growth assumption of 2½ up to 2006-07 and 2¼ for subsequent years.**

**Substantial upward revisions to measured UK GDP data were introduced by the Office for National Statistics (ONS) in Blue Book 2003, and are discussed in more detail in Annex A. This has the effect of boosting the estimated trend rate of growth between the adjudged on-trend points in the first half of 1997 and the third quarter of 2001. Over this period, the Blue Book 2003 data yield an annual trend rate of output growth of 2.9 per cent, revised up from the previous estimate of 2.6 per cent at the time of Budget 2003.**

**There have been no significant revisions over the same period to outturns for the trend growth rates of average hours worked or employment, so the increase in the trend rate of output growth is reflected in the productivity growth component. Therefore, the estimated growth rate of underlying trend output per hour between 1997 and 2001 has increased to 2.7 per cent, 0.3 percentage points higher than at Budget time.**

**A mechanical application of the Treasury's trend growth methodology would project forward this trend productivity increase, which, with other trend growth components unchanged, would raise the trend output growth projection well above the existing 2¾ per cent neutral assumption. This would imply a negative output gap in mid-2003 in excess of the 1½ per cent gap estimated on the basis of the 2¾ per cent trend growth assumption. However, evidence and judgement suggest that a current negative output gap substantially wider than 1½ per cent of GDP would be implausible.**

**After considering the data and taking a cautious approach to projecting trend growth, the existing 2¾ per cent trend output growth projection is retained as the neutral judgement. However, the data revisions increase further confidence that the 2¾ per cent assumption is consistent with the economy's potential. More detail and explanation on the decomposition of trend growth can be found in Annex A. As shown in the table below, the public finances projections will continue to be based on a lower cautious view of trend growth of 2½ per cent, as audited by the NAO, up to 2006-07 and 2¼ per cent for subsequent years, with the slowdown reflecting expected demographic trends.**

#### Contributions to trend output growth[a]

| | Estimated trend rates of growth, per cent per year | | | | | |
|---|---|---|---|---|---|---|
| | Trend output per hour worked | | Trend average hours worked | Trend employment rate | Population of working age | Trend output |
| | Underlying | Actual | | | | |
| **Over the recent past (1997H1 to 2001Q3)** | | | | | | |
| Budget 2003 | 2.35 | 2.14 | –0.47 | 0.43 | 0.50 | **2.61** |
| PBR 2003 | 2.65 | 2.44 | –0.47 | 0.42 | 0.54 | **2.94** |
| **Projection** | | | | | | |
| Budget 2003 | 2.35 | 2.25 | –0.10 | 0.20 | 0.50 | **2¾** |
| PBR 2003 | 2.35 | 2.25 | –0.10 | 0.20 | 0.50 | **2¾** |

**Economic prospects**

**2.33** As a result of sound fundamentals, the UK economy is forecast to build on recent positive developments and accelerating through into 2004. GDP is expected to grow by 2.1 per cent in 2003 as a whole, within the lower half of the Budget 2003 forecast range. In both 2004 and 2005, GDP is forecast to grow by 3 to 3½ per cent. Growth is expected to fall back to its trend rate by early 2006 as slack in the economy is taken up and output returns to its trend level.

### Table 2.2: Summary of UK forecast

| | Outturn | Forecast | | | |
|---|---|---|---|---|---|
| | 2002 | 2003 | 2004 | 2005 | 2006 |
| GDP growth (per cent) | 1¾ | 2 | 3 to 3½ | 3 to 3½ | 2½ to 3 |
| CPI inflation (per cent, Q4) | 1½ | 1½ | 1¾ | 2 | 2 |

**2.34** Underlying consumption growth appears to have eased since the second half of 2002 and there have been tentative signs that a gradual business investment recovery is underway. The forecast also shows a continuing rebalancing of growth going forward. Household consumption is forecast to continue growing at around recent rates, increasing by 2½ per cent this year and by between 2¼ to 2¾ per cent in 2004 and 2005.

**2.35** At the same time, with corporate profitability having risen over the past year and company balance sheets far healthier than during the late 1990s ICT boom, businesses are well positioned to step up investment as the global recovery gathers pace into 2004. Business investment is forecast to rise by 3 to 3½ per cent next year and 5½ to 6¼ per cent in 2005. With government investment expected to continue growing strongly as a result of the Government's spending plans, whole economy fixed capital formation is expected to grow significantly faster than household consumption and GDP in all forecast years.

**2.36** CPI inflation is forecast to remain a little below target in 2004 as existing slack in the economy continues to dampen domestically generated pricing pressures. However, inflation is expected to return to target from 2005 as the combined effects of the recovery in the world economy and this year depreciation of sterling feed through to higher import prices.

**2.37** Until recently, independent forecasters had generally been revising down their projections for UK GDP growth in 2003, but they have lately upgraded their forecasts. The average of *new* growth forecasts in November was 2 per cent, consistent with the Pre-Budget Report estimate.

**Forecast risks**

**2.38** Downside risks to the forecast have receded since the time of Budget 2003. Nonetheless, if realised, the risks to the global forecast would clearly affect the UK's prospects. There are still significant imbalances in the global economy which pose the threat of sudden, sharp movements in exchange rates. These highlight the urgent need for policy makers to push ahead with the structural reforms that will ensure a broad based and sustainable recovery over the medium term. A further downside risk comes from the potential rebuilding of balance sheets. Though significant progress has been made in rebuilding household and corporate balance sheets across several major economies since the recession of 2001, this process may not be complete. Further balance sheet adjustment might entail significantly weaker spending from households or the business sector and could undermine the recovery. Sharp movements in exchange rates or further balance sheet adjustment in certain key economies would threaten UK external demand and confidence.

**2.39** Upside risks to the global outlook also raise the possibility of a sharper than expected upturn in UK economic growth going forward. The forecast for G7 GDP growth assumes a relatively modest acceleration in capital spending compared with previous recoveries, so it is possible that investment will rebound more sharply than forecast. Similarly, in the past, UK business investment has accelerated sharply and proved stronger than expected once GDP growth has picked up and again the forecast recovery in business investment could prove more robust than expected.

**2.40** In the UK, a sharp weakening of the housing market and a corresponding adjustment in prices would be likely to have an adverse effect on consumption expenditure. On the upside, momentum in consumer spending and house prices in the short term could continue to exceed expectations, though this would tend to increase the medium-term downside risks. Although household borrowing has increased, households net wealth has increased by over 50 per cent since the beginning of 1997, reflecting the boost to housing wealth from the strong rise in house prices. As a result, the ratio of household debt to total wealth has remained stable, as described in Box A6.

### The economic cycle

**2.41** While the national accounts data revisions introduced by the ONS in the Blue Book 2003 led to changes in the path of economic growth over the recent past, it contained no new evidence to alter the Government's provisional judgement on the dating of the current and past economic cycles. On this basis, the economy completed a full, though short, cycle between the first half of 1997 and mid-1999. The current economic cycle began in mid-1999 when actual output moved above the trend level. In the second half of 2001, the economy moved below trend with actual output remaining below the trend level since then. The economy is expected to return to trend by early 2006 as forecast in Budget 2003.

### Caution and the public finance projections

**2.42** A number of key assumptions that underpin the public finance projections are independently audited by the Comptroller and Auditor General under a three-year rolling review to ensure that they remain reasonable and cautious. A complete list of these assumptions is set out in Annex B. This prudent approach to fiscal policy builds an important 'safety margin' into the public finance projections to guard against unexpected events. It decreases the chance that, over the medium term, unforeseen economic or fiscal events will require changes in plans for taxation or spending.

**2.43** For this Pre-Budget Report, the Comptroller and Auditor General has audited the assumption relating to equity prices. While the assumption was an imprecise one over the last three years, the Comptroller and Auditor General concluded that it remains a sensible and transparent rule for forecasting purposes. In addition, following the change in the measure of inflation used in the inflation target, the Government has revised the assumption on the consistency of price indicators used to project the public finances, and this has also been audited. The assumption was deemed to be reasonable. The Comptroller and Auditor General also audited the assumption for projecting VAT receipts, and found that it had been less cautious than evidence at the time of making the assumption suggested it would be. The Comptroller and Auditor General will complete the audit of the assumption at the time of Budget 2004, after considering the additional analysis being undertaken by HM Customs and Excise, following the recent data revisions to UK national accounts. In the meantime, the existing assumption has been used for the projections in this Pre-Budget Report, an approach that the Comptroller and Auditor General considers a cautious response.[7]

[7] *Audit of Assumptions for the 2003 Pre-Budget Report*, National Audit Office, December 2003 (HC 35).

**2.44** The Government launched a comprehensive strategy for tackling VAT fraud, avoidance and non-compliance in the 2002 Pre-Budget Report. This strategy is being extended further, as described in Chapter 5, and consistent with previous practice the VAT ratio assumption takes account of the direct and preventive effects, but not the deterrent effects, and has been audited by the Comptroller and Auditor General who concluded that a reasonable and cautious approach had been adopted in the assumptions underlying the projected extra yield. In line with the cautious approach to the public finances, the Government has included an additional £185 million in 2004-05, rising to £315 million in 2006-07 in the public finance projections from the extension of the strategy.

**Box 2.5: Government policy on EMU**

**The Government's policy on membership of the single currency was set out by the Chancellor in his statement to Parliament in October 1997. In principle, the Government is in favour of UK membership; in practice, the economic conditions must be right. The determining factor is the national economic interest and whether, on the basis of an assessment of the five economic tests, the economic case for joining is clear and unambiguous.**

**An assessment of the five tests was made in June 2003.[a] This concluded that: *"since 1997, the UK has made real progress towards meeting the five economic tests. But, on balance, though the potential benefits of increased investment, trade, a boost to financial services, growth and jobs are clear, we cannot at this point in time conclude that there is sustainable and durable convergence or sufficient flexibility to cope with any potential difficulties within the euro area."* The assessment set out a reform agenda of concrete and practical steps, including:**

- **reforms at national, regional and local level to enhance the flexibility of labour, capital and product markets in the UK. The Government announced it would publish six monthly flexibility reports, the first of which is published as Annex C to this Pre-Budget Report;**
- **independent reviews, with interim reports published alongside this Pre-Budget Report, of mortgage finance and the supply of UK housing to examine their impact on economic stability;**
- **the publication of a draft referendum bill, published on 10 December 2003. The draft bill will allow for consultation over the details of a referendum if one were to be held; and**
- **the publication of the *Seventh report on euro preparations* on 18 November 2003, setting out the progress that has been made across the economy since June 2003. A further report will be published in spring 2004.**

**Work is also proceeding on a number of issues identified in the discussion paper *Fiscal stabilisation and EMU*.[b] This includes clarifying how a new fiscal stabilisation rule might work, the case for modernising the tax regulator powers, improving the understanding of the fiscal transmission mechanism, examining the case for strengthening automatic stabilisers and giving further consideration to the effectiveness of different fiscal instruments in stabilising the economy.**

**Budget 2004 will include a report on progress on the issues identified in the June 2003 assessment of the five tests, and will determine whether a further assessment of the five tests should be undertaken next year. If a further assessment were to conclude that the five tests had been met, the Government would put the issue before the British people in a referendum.**

[a] *UK membership of the single currency: An assessment of the five economic tests*, HM Treasury, June 2003 (Cm 5776).
[b] HM Treasury, June 2003.

## RECENT FISCAL TRENDS AND OUTLOOK

**2.45** The public finance projections in the Pre-Budget Report have a different status from those produced at the time of the Budget. They represent an interim forecast update and not necessarily the outcome that the Government is seeking. The projections for the public finances presented below include the effects of firm decisions announced since Budget 2003 and in this Pre-Budget Report, in accordance with the *Code for fiscal stability*.

**2.46** The forward-looking fiscal projections described in this section are complemented by the 2003 *End of year fiscal report,* published alongside this Pre-Budget Report, which provides detailed retrospective information on the public finances in 2001-02 and 2002-03.

**2.47** The economy is expected to grow by 2.1 per cent this year and by 3 to 3½ per cent in both 2004 and 2005, consistent with the Budget 2003 forecast. The composition of growth, however, is forecast to be different from that projected at the time of the Budget. In particular, growth in wages and salaries this year is forecast to be lower than projected.

**2.48** The Government has always remained vigilant to the uncertainties inherent in forecasting the public finances and it has created a margin against unexpected events through the use of cautious, audited assumptions and the cautious case. This caution combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt, means the Government can now draw on this margin to safeguard the increase in investment in priority public services, fully meet the UK's international commitments and allow the automatic stabilisers to work in full following a period of global economic uncertainty, while remaining on track to meet the fiscal rules.

### Table 2.3: Fiscal balances compared with Budget 2003

| | Outturn[1] | Estimate | | | Projections | | |
|---|---|---|---|---|---|---|---|
| | 2002-03 | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 |
| **Surplus on current budget (£ billion)** | | | | | | | |
| **Budget 2003** | **–11.7** | **–8.4** | **–1** | **2** | **6** | **9** | |
| Effect of changes to current receipts since Budget 2003 | –0.5 | –5.5 | –4 | –4 | –2 | 0 | |
| Effect of changes to current expenditure since Budget 2003 | 0.4 | –5.4 | –3 | –3 | –3 | –4 | |
| **PBR 2003** | **–11.8** | **–19.3** | **–8** | **–5** | **0** | **4** | **8** |
| **Net borrowing (£ billion)** | | | | | | | |
| **Budget 2003** | **24.0** | **27.3** | **24** | **23** | **22** | **22** | |
| Effects of changes in current surplus | 0.1 | 10.9 | 7 | 7 | 6 | 4 | |
| Effect of changes in net investment | –1.5 | –0.9 | 0 | 0 | 0 | 0 | |
| **PBR 2003** | **22.5** | **37.4** | **31** | **30** | **27** | **27** | **24** |
| **Cyclically-adjusted surplus on current budget (per cent of GDP)** | | | | | | | |
| Budget 2003[1] | –0.5 | 0.2 | 0.5 | 0.4 | 0.4 | 0.6 | |
| **PBR 2003** | **–0.6** | **–0.8** | **–0.1** | **–0.1** | **0.0** | **0.3** | **0.6** |
| **Cyclically-adjusted net borrowing (per cent of GDP)** | | | | | | | |
| Budget 2003[1] | 1.7 | 1.5 | 1.5 | 1.7 | 1.7 | 1.6 | |
| **PBR 2003** | **1.6** | **2.4** | **2.0** | **2.2** | **2.0** | **1.9** | **1.7** |
| **Net debt (per cent of GDP)** | | | | | | | |
| Budget 2003[1] | 30.9 | 32.2 | 32.7 | 33.2 | 33.5 | 33.8 | |
| **PBR 2003** | **30.9** | **32.8** | **33.8** | **34.6** | **35.1** | **35.4** | **35.5** |

*Note: Figures may not sum due to rounding.*
[1] *The 2002–03 figures were estimates in Budget 2003.*

**2.49** Table 2.3 shows the changes to the main fiscal aggregates since Budget 2003. The outturn for the current budget for 2002-03 is only marginally different from the Budget 2003 estimate, while net borrowing is now around £1.5 billion lower than estimated in Budget 2003. Projections for the current budget and net borrowing are now weaker, reflecting the changed pattern of growth compared with Budget 2003. The effect of the changed composition of growth has also affected estimates of the underlying structural position of the public finances, shown by the cyclically-adjusted current budget and net borrowing shown in Table 2.3.

**2.50** Table 2.4 explains the reasons for the change in public sector net borrowing and Table 2.5 shows how specific receipts and spending items have changed since Budget 2003. The proportion of the overall change in net borrowing explained by changes in GDP components is just under half in 2003-04, rising over the projection period.

## Table 2.4: Public sector net borrowing compared with Budget 2003

| £ billion | Estimate[1] | Projections | | | |
|---|---|---|---|---|---|
| | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
| **Budget 2003** | **27.3** | **24** | **23** | **22** | **22** |
| **Economic assumptions audited by the NAO**[2] | **–0.7** | **–1½** | **–1½** | **–2** | **–2** |
| of which: equity prices | –0.4 | –1 | –1½ | –1½ | –1½ |
| **GDP components** | **4.0** | **5½** | **5½** | **5** | **4** |
| of which: wages and salaries | 3.4 | 4 | 4 | 3½ | 3 |
| household consumption | 0.3 | ½ | 1 | 1 | ½ |
| **Other forecasting effects** | **4.2** | **2** | **2½** | **2** | **2** |
| of which: receipts | 2.1 | ½ | 1 | 0 | -1 |
| expenditure | 2.1 | 1 | 1½ | 2½ | 3 |
| **Total before discretionary measures** | **34.9** | **30** | **29** | **27** | **26** |
| Discretionary measures[2] | 2.5 | 1 | ½ | ½ | ½ |
| **PBR 2003** | **37.4** | **31** | **30** | **27** | **27** |

*Note: Figures may not sum due to rounding.*

[1] *The 2003-04 figures were projections in Budget 2003.*

[2] *The effects of the extension of the VAT strategy are included in discretionary measures.*

**Changes in receipts**

**2.51** The change in GDP components has had a significant impact on receipts. In particular, the lower growth in wages and salaries this year has reduced income tax and national insurance contributions receipts by around £4 billion. In addition, lower growth in consumers expenditure has reduced receipts from VAT.

**2.52** ONS revisions to GDP have increased the level of wages and salaries in 2002, which means that the effective tax rate of income tax and national insurance contributions was lower than expected, as described in the 2003 *End of year fiscal report.* In addition, the flexibility of the UK's labour market in the face of global and wider economic uncertainty has been reflected in lower than expected average earnings growth since the Budget. With broadly similar levels of wages and salaries compared to Budget 2003 over the medium term, receipts from income tax and national insurance contributions are lower.

**2.53** Changes in the economic determinants audited by the NAO have increased public sector receipts by around £2 billion per year from 2004-05 onwards. This is principally a result of higher equity prices, which have risen by around 20 per cent since the Budget. This higher level increases receipts from stamp duty, capital taxes and corporation tax from life assurance companies. In addition, despite lower than expected growth in household consumption, VAT revenues in the first half of 2003-04 have been substantially above the levels projected in Budget 2003. This is included under other forecasting effects and reflects, in part, the caution in the NAO audited assumption used to forecast VAT revenues. In addition, lower forecasts for companies' profits have reduced projected receipts from non-North Sea corporation tax by around £2 billion a year, as shown in Table 2.5.

### Table 2.5: Changes in projections of public sector net borrowing since Budget 2003

| £ billion | Estimate[1] | Projections | | | |
|---|---|---|---|---|---|
| | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 |
| **Budget 2003** | **27.3** | **24** | **23** | **22** | **22** |
| **Changes before discretionary measures** | **7.5** | **6** | **6** | **5** | **4** |
| of which: | | | | | |
| Income tax and NICs | 5.9 | 4½ | 5 | 4 | 3½ |
| Non-north sea corporation tax | 1.6 | 2 | 2 | 2 | 2 |
| Stamp duty and capital taxes | 0.5 | –½ | –½ | –1 | –1 |
| VAT | –2.5 | –2 | –2 | –2 | –2½ |
| AME[1] | 2.0 | 1½ | 1½ | 2 | 2½ |
| Other | 0.1 | ½ | ½ | –½ | –½ |
| **Discretionary measures[2]** | 2.5 | 1 | ½ | ½ | ½ |
| **PBR 2003** | **37.4** | **31** | **30** | **27** | **27** |

[1] *Resource AME.*

[2] *Including the impact of the extension of the VAT strategy.*

**Changes in spending**

**2.54** Projections for DEL up to 2005-06 are based on the 2002 Spending Review allocations, adjusted to take account of classification changes between DEL and AME that have no effect on overall public spending. Projections for AME programmes are higher than projected in Budget 2002. This is due to higher than projected take up of the Child and Working Tax Credits in the short term, greater than forecast spending on the Supporting People programme and higher debt interest payments.

**Discretionary policy changes**

**2.55** In considering the impact of additional discretionary policy changes on the fiscal position, the Government has taken into account the following factors:

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

**2.56** Consistent with the requirements of the *Code for fiscal stability,* the updated projections take into account the fiscal effects of all firm decisions announced in this Pre-Budget Report or since Budget 2003. This includes:

- increases in the child element of the Child Tax Credit, which will contribute to reducing the number of children in low income households;
- a package of measures designed to protect tax revenues for the benefit of all taxpayers, including an extension to the VAT strategy to tackle VAT fraud, avoidance and non-compliance; and
- the next steps in the Government's strategy to promote productivity growth through a more enterprising and highly skilled economy, including improvements to the VAT flat rate scheme and a new, clear and more accessible R&D tax credit definition.

**2.57** Since September 2001, the Government has spent nearly £2 billion on the war in Afghanistan and to combat terrorism both domestically and abroad. In Budget 2003, the Government made a special contingency provision of £3 billion to meet the costs of the military conflict in Iraq and its other international obligations. Of that special reserve, £1 billion was allocated to the Ministry of Defence DEL in 2002-03 with the rest remaining unallocated. A further £1.3 billion of current spending has been charged against the special reserve in 2003-04. **In this Pre-Budget Report, the Government carries forward the £2 billion unallocated special reserve into 2003-04 and adds a further £500 million taking provision in the special reserve for the year to £2.5 billion. A further £300 million will be added in 2004-05** as a prudent allowance against continuing commitments. This will ensure that the Government is able to meet all its internatonal commitments in Iraq and elsewhere in the war against terrorism.

**2.58** The fiscal impact of these and other measures is set out in Table B4. The projections do not take account of measures proposed in this Pre-Budget Report for consultation or other proposals where final decisions have yet to be taken.

## FISCAL POSITION AND MEDIUM-TERM PROSPECTS

**2.60** Table 2.5 presents a summary of the key fiscal aggregates under the five headings of fairness and prudence, sustainability, economic impact, financing and European commitments. It illustrates the Government's performance against its fiscal rules, and shows that the Government remains on track to meet its strict fiscal rules over the economic cycle.

### Table 2.6: Summary of public sector finances

| | Per cent of GDP | | | | | | |
|---|---|---|---|---|---|---|---|
| | Outturn | | Estimate | | | Projections | |
| | 2002-03 | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 |
| **Fairness and prudence** | | | | | | | |
| Surplus on current budget | –1.1 | –1.7 | –0.7 | –0.4 | 0.0 | 0.3 | 0.6 |
| Average surplus since 1999-2000 | 1.0 | 0.4 | 0.3 | 0.2 | 0.1 | 0.2 | 0.2 |
| Cyclically-adjusted surplus on current budget | –0.6 | –0.8 | –0.1 | –0.1 | 0.0 | 0.3 | 0.6 |
| **Long-term sustainability** | | | | | | | |
| Public sector net debt[1] | 30.9 | 32.8 | 33.8 | 34.6 | 35.1 | 35.4 | 35.5 |
| Core debt[1] | 31.2 | 32.2 | 32.6 | 33.2 | 33.7 | 34.1 | 34.3 |
| Net worth[2] | 24.3 | 21.5 | 19.4 | 16.2 | 16.0 | 14.8 | 14.4 |
| Primary balance | –0.5 | –1.7 | –0.9 | –0.7 | –0.4 | –0.3 | –0.1 |
| **Economic impact** | | | | | | | |
| Net investment | 1.0 | 1.6 | 1.9 | 2.0 | 2.1 | 2.2 | 2.2 |
| Public sector net borrowing (PSNB) | 2.1 | 3.4 | 2.6 | 2.4 | 2.1 | 1.9 | 1.7 |
| Cyclically-adjusted PSNB | 1.6 | 2.4 | 2.0 | 2.2 | 2.0 | 1.9 | 1.7 |
| **Financing** | | | | | | | |
| Central government net cash requirement | 2.1 | 3.6 | 2.8 | 2.6 | 2.5 | 2.1 | 1.8 |
| Public sector net cash requirement | 2.1 | 3.6 | 2.6 | 2.3 | 2.2 | 1.8 | 1.6 |
| **European commitments** | | | | | | | |
| *Treaty deficit*[3] | 2.1 | 3.3 | 2.6 | 2.4 | 2.1 | 2.0 | 1.8 |
| *Cyclically-adjusted Treaty deficit* | 1.5 | 2.4 | 2.0 | 2.2 | 2.1 | 2.0 | 1.8 |
| *Treaty debt ratio*[1,4] | 37.9 | 39.3 | 40.2 | 40.8 | 41.1 | 41.4 | 41.5 |
| *Memo: Output gap* | –1.1 | –1.4 | –0.7 | –0.2 | 0.0 | 0.0 | 0.0 |

[1] *At end March; GDP centred on end March.*

[2] *At end December; GDP centred on end December.*

[3] *General government net borrowing on a Maastricht basis.*

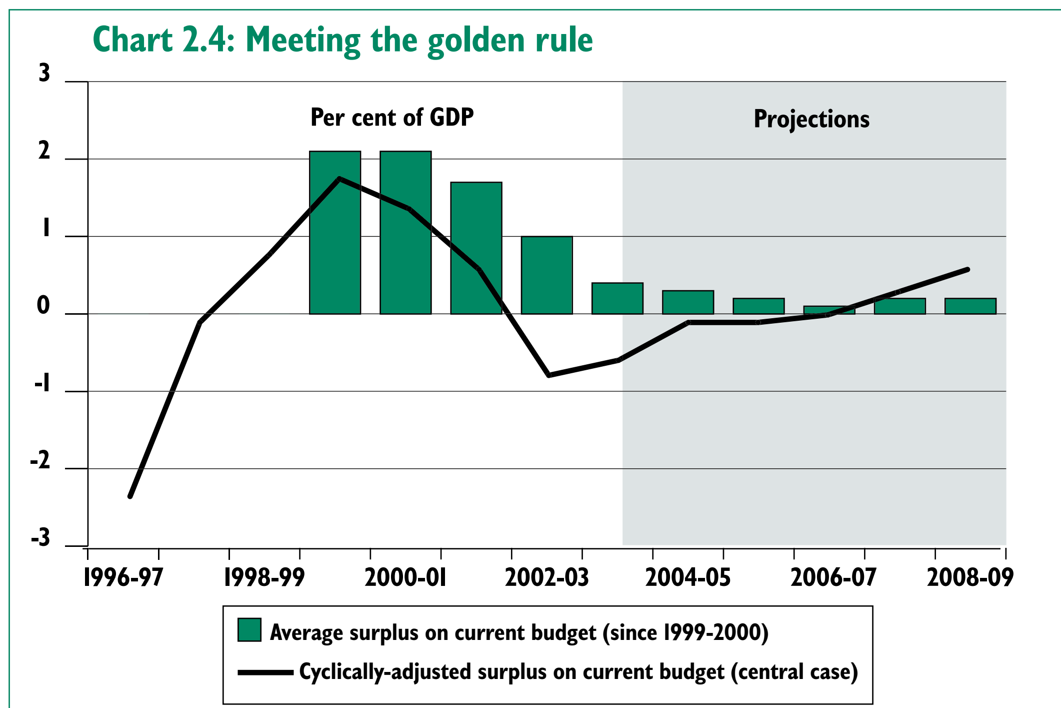
[4] *General government gross debt measures on a Maastricht basis.*

**Golden rule**

**2.61** The current budget balance represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the cost of paying for the public services they use and is therefore an important indicator of inter-generational fairness. Lower receipts and additional spending in the short term means that the deficit on the current budget is forecast to be 1.7 per cent of GDP this year, falling to 0.7 per cent next year and moving back to balance in 2006-07, and showing a surplus of 0.6 per cent of GDP by the end of the projection period.

**2.62** The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability through the impact of the automatic stabilisers. Progress against the rule is measured by the average annual surplus on the current budget as a percentage of GDP since the cycle began.[8] The average surplus on the current budget since 1999-2000, which on the Government's provisional judgement is the start of the current cycle, is positive in every year. The economy is projected to return to trend during 2005-06, meaning that over the whole cycle the average annual surplus on the current budget would be around an annual 0.2 per cent of GDP, equivalent to a margin or surplus in this cycle of £14 billion. On this basis, and based on cautious assumptions, the Government is on track to meet the golden rule. If the economic cycle were to have started in 1997-98, the average surplus on the current budget up to 2005-06 would be over 0.2 per cent of GDP.

**2.63** The economy is projected to return to trend by early 2006. With the economy assumed to be on trend from then on, the projections show, based on cautious assumptions, that the average surplus over the period 2005-06 to 2008-09 is 0.1 per cent of GDP. At this early stage, and based on cautious assumptions, the Government is therefore on track to continue to meet the golden rule after the end of this economic cycle.

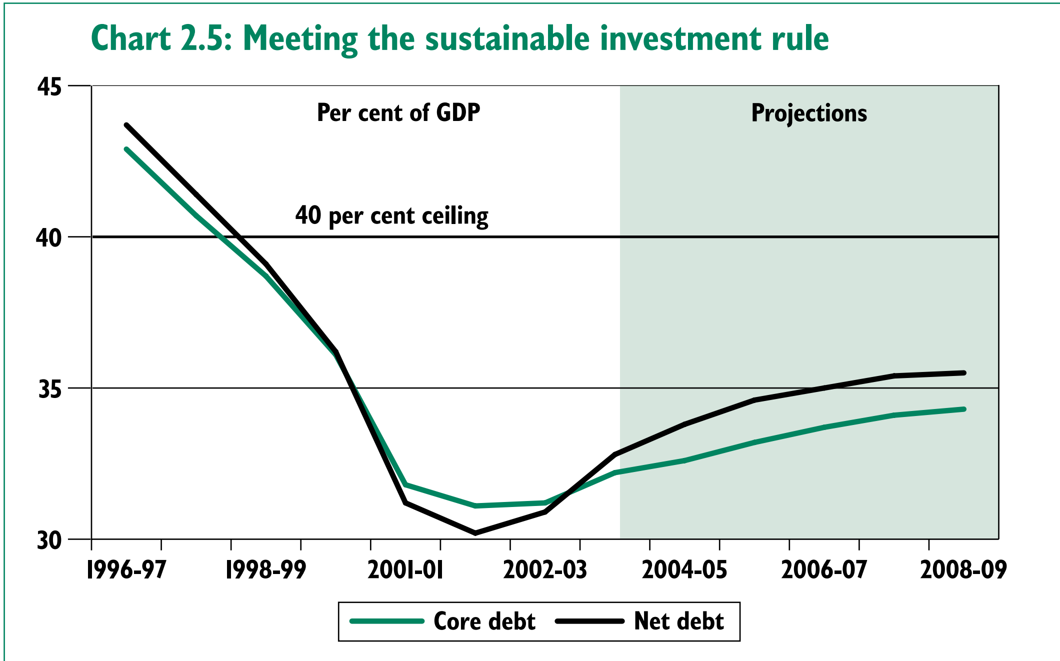



**2.64** The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public sector debt at a low and sustainable level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle.

[8] Measuring the fiscal rules is discussed in Chapter 9 of *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002 and performance over past cycles is described in Budget 2000.

**Sustainable investment rule**

**2.65** Chart 2.5 shows that, despite sustained weakness in the world economy, net debt is expected to remain low and stable, rising slightly from 31 per cent to stabilise at 35½ per cent at the end of the projection period – £64 billion below the 40 per cent level. Therefore, the Government comfortably meets its sustainable investment rule. Chart 2.5 also illustrates the Pre-Budget Report projections for core debt, which excludes the estimated impact of the economic cycle on public sector net debt. Core debt is projected to rise to just over 34 per cent of GDP as the Government borrows modestly to fund increased long-term capital investment in public services. This is consistent with the fiscal rules, and with the key objective of inter-generational fairness which underpins the fiscal framework.



**Box 2.6: Public finances in the G7**

**The table below compares the projections presented in this Pre-Budget Report with those for other G7 countries, as forecast by the European Commission or the OECD. While care needs to be taken when comparing numbers internationally, the UK performs well: gross debt is the lowest in the G7 and the deficit is below the average for the G7 as a whole.**

## Public finances in the G7

| Per cent of GDP | Estimate[a] | Projections | | | | |
|---|---|---|---|---|---|---|
| | 2003-04 | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 |
| **United Kingdom** | | | | | | |
| Treaty deficit | 3.3 | 2.6 | 2.4 | 2.1 | 2.0 | 1.8 |
| Cyclically-adjusted Treaty deficit | 2.4 | 2.0 | 2.2 | 2.1 | 2.0 | 1.8 |
| Treaty debt | 39.3 | 40.2 | 40.8 | 41.1 | 41.4 | 41.5 |
| Public sector net investment | 1.6 | 1.9 | 2.0 | 2.1 | 2.2 | 2.2 |
| | 2003 | 2004 | 2005 | | | |
| **France** | | | | | | |
| Treaty deficit | 4.2 | 3.8 | 3.6 | | | |
| Cyclically-adjusted Treaty deficit | 3.9 | 3.3 | 3.2 | | | |
| Treaty debt ratio | 62.6 | 64.3 | 65.6 | | | |
| **Germany** | | | | | | |
| Treaty deficit | 4.2 | 3.9 | 3.4 | | | |
| Cyclically-adjusted Treaty deficit | 3.5 | 3.3 | 3.0 | | | |
| Treaty debt ratio | 63.8 | 65.0 | 65.8 | | | |
| **Italy** | | | | | | |
| Treaty deficit | 2.6 | 2.8 | 3.5 | | | |
| Cyclically-adjusted Treaty deficit | 2.1 | 2.3 | 3.2 | | | |
| Treaty debt ratio | 106.4 | 106.1 | 106.1 | | | |
| **Canada** | | | | | | |
| Deficit | 1.0 | 0.7 | 0.8 | | | |
| Cyclically-adjusted deficit | 1.1 | 0.6 | 0.7 | | | |
| Gross debt ratio | 77.3 | 74.8 | | | | |
| **Japan** | | | | | | |
| Deficit | 7.4 | 6.8 | 6.9 | | | |
| Cyclically-adjusted deficit | 6.9 | 6.5 | 6.6 | | | |
| Gross debt ratio | 155.7 | 164.1 | | | | |
| **USA** | | | | | | |
| Deficit | 4.9 | 5.1 | 4.9 | | | |
| Cyclically-adjusted deficit | 4.5 | 5.1 | 5.0 | | | |
| Gross debt ratio | 63.8 | 65.7 | | | | |
| **G7 average[b]** | | | | | | |
| Deficit | 3.9 | 3.7 | 3.6 | | | |
| Cyclically-adjusted deficit | 3.5 | 3.3 | 3.4 | | | |
| Gross debt ratio | 81.2 | 82.8 | 69.4 | | | |

Source: data for EU countries excluding UK from European Commission autumn forecasts; non-EU countries from OECD: borrowing figures from OECD Economic Outlook 74 (preliminary version, November 2003), debt figures from OECD Economic Outlook 73 (June 2003). The fiscal aggregates forecast by the OECD are slightly different from those forecast by the European Commission, deficit refers to deficit on general government financial balance, gross debt to general government gross financial liabilities.

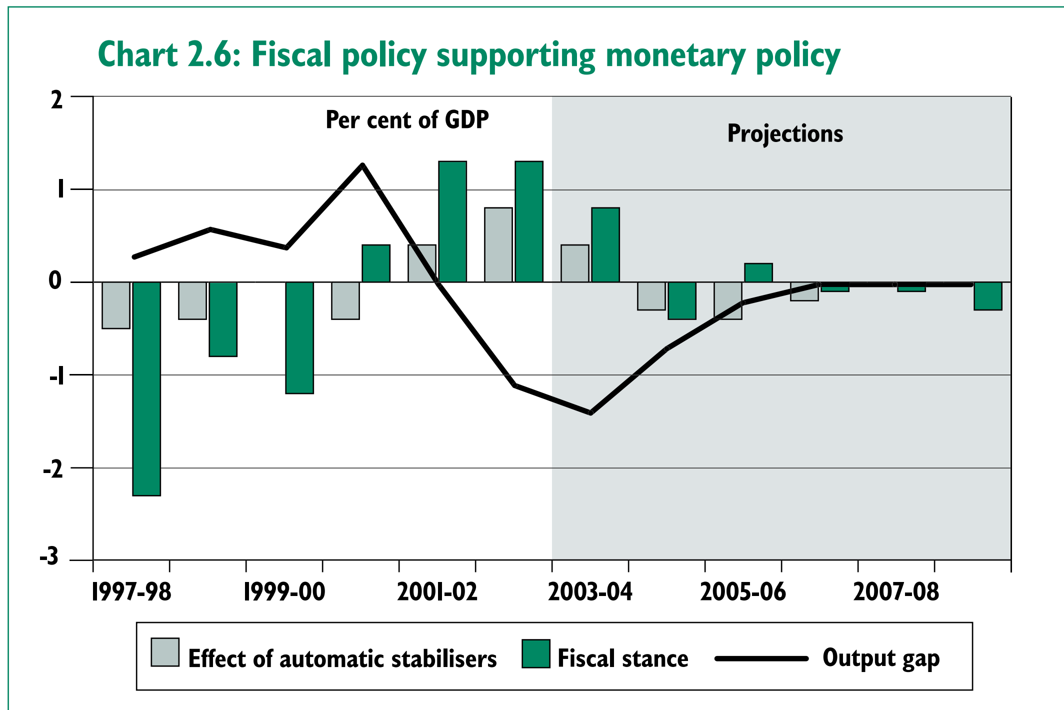
[a] The 2003-04 figures were projections in Budget 2003.

[b] Unweighted average (financial year figures used for UK).

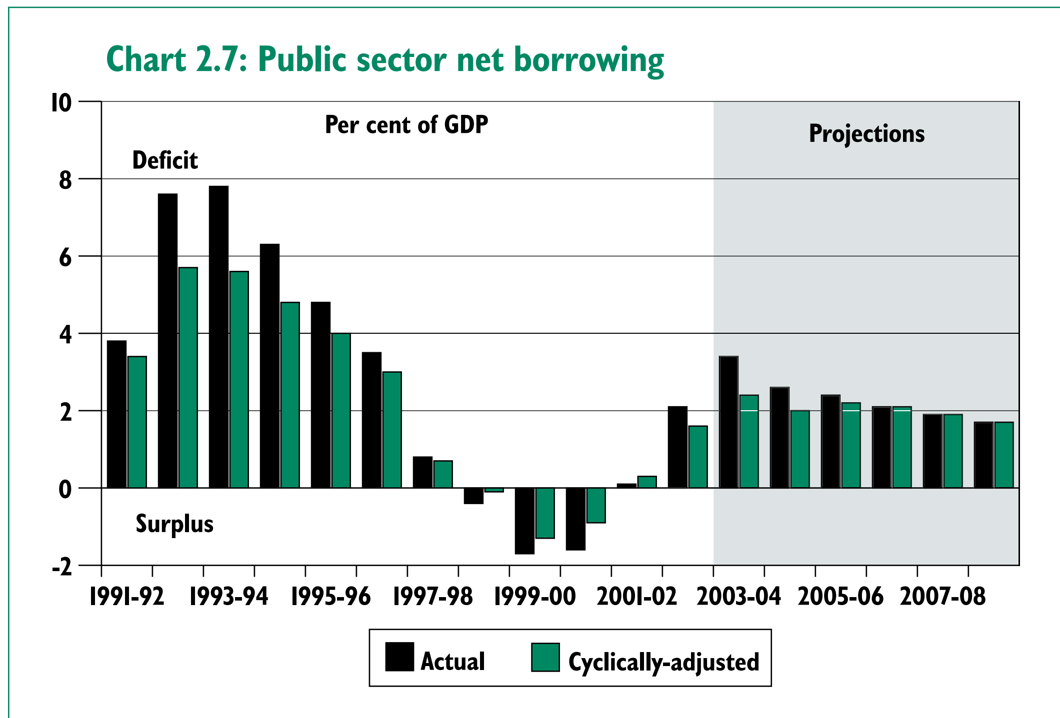
**Economic impact** **2.66** While the primary objective of fiscal policy is to ensure sound public finances, it also impacts on the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB). Chart 2.6 shows how the fiscal stance and automatic stabilisers have helped to support monetary policy.

**2.67** During the late 1990s, the fiscal stance tightened at a time when the economy was above trend, supported by the automatic stabilisers. As the economy has moved below trend so the fiscal stance has eased, helping to maintain economic stability. Over the next few years, as the economy returns to trend, fiscal policy moves towards a more neutral stance.

**Chart 2.6: Fiscal policy supporting monetary policy**




**2.68** Modest levels of borrowing over the forecast period reflect sustained capital investment in public services, and is fully consistent with meeting the Government's firm fiscal rules.




**Financing**

**2.69** As a result of the new projections for the fiscal balances, the forecast for the central government net cash requirement for 2003-04 has been revised from £35.3 billion to £40.5 billion. Accordingly, it has been decided to meet the increased financing requirement by increasing gross gilt sales by £2.3 billion to £49.7 billion. Full details and a revised financing table can be found in Annex B.

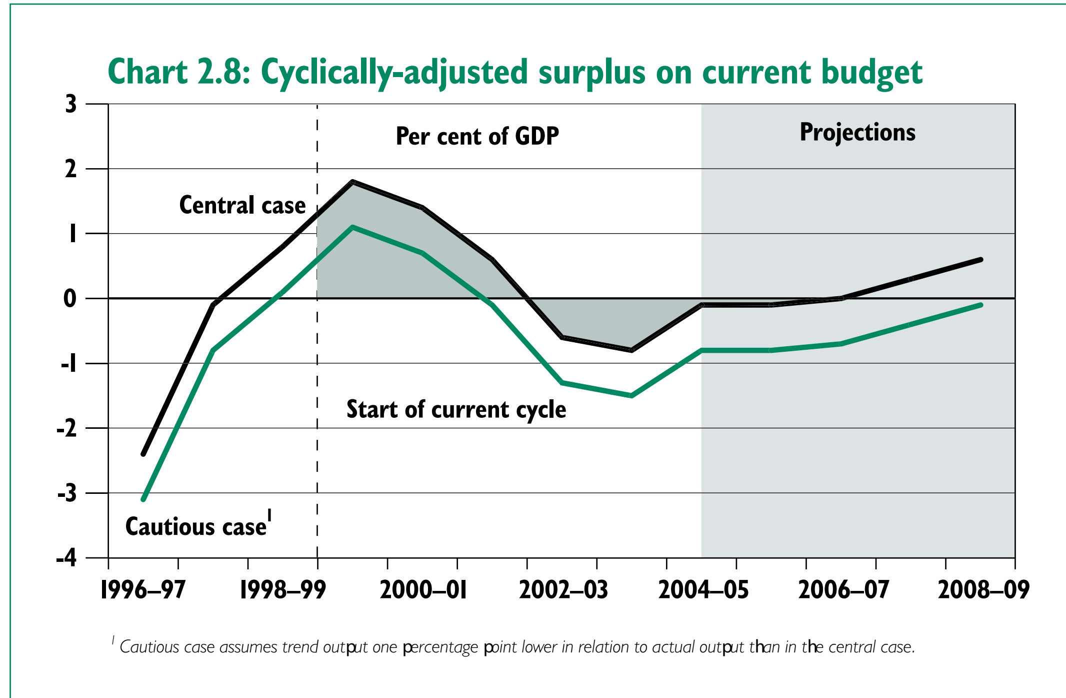
**European commitments**

**2.70** The Government supports a prudent interpretation of the Stability and Growth Pact as described in Box 2.7. This takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment. The public finance projections set out in this Pre-Budget Report, which show the Government on track to meet its fiscal rules over the cycle, low debt and sustainable public finances, combined with sustainable increases in public investment, are fully consistent with the prudent interpretation of the Pact. Box 2.6 also shows that the UK's public finances compare favourably to other G7 countries. As usual, the Treasury is sending a copy of an updated Convergence Programme to the European Commission. The updated annual Programme is subject to the usual UK parliamentary scrutiny and approval.

**Dealing with uncertainty**

**2.71** Forecasts for the public finances are subject to a considerable degree of uncertainty, in particular the fiscal balances, which represent the difference between two large aggregates. The use of cautious assumptions audited by the NAO builds a margin into the public finance projections to guard against unexpected events. To accommodate potential errors arising from misjudgements about the trend rate of growth of the economy in the medium term, the Government bases its public finance projections on a trend growth assumption that is ¼ percentage point lower than its neutral view.

**2.72** A second important source of potential error results from misjudging the position of the economy in relation to this trend. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be one percentage point lower than in the central case. Chart 2.8 illustrates the Pre-Budget Report projection for this cautious case.




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

**2.73** The Government has used the cautious case and cautious, audited assumptions to build a safety margin against unexpected events. Combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt, the Government can now draw on this margin to safeguard the increase in investment in priority public services, fully meet the UK's international commitments and allow the automatic stabilisers to work in full following a period of global economic uncertainty, while remaining on track to meet the fiscal rules.

**2.74** Drawing on this margin means the average surplus on the current budget in the cautious case is no longer positive, though the Government is on track to meet the golden rule. The projections show that this margin is being rebuilt at the end of the projection period as the current budget moves into surplus and the cyclically-adjusted surplus in the cautious case moves back to balance. In the meantime, the Government will remain vigilant to the risks and continue to base projections of the public finances on cautious assumptions.

**Box 2.7: The Stability and Growth Pact**

**The Stability and Growth Pact is intended to ensure that EU Member States maintain sound public finances. Fiscal sustainability is a prerequisite for macroeconomic stability, and the Government agrees with the principle of a strong Pact founded on sensible fiscal policy co-ordination.**

**The Government supports a prudent interpretation of the Pact that builds on the Code of Conduct, agreed by Member States in June 2001 and the report agreed by EU Finance Ministers on strengthening budgetary co-ordination in June 2003. A prudent interpretation would lock in long-term fiscal discipline and sustainability, enhancing credibility across the economic cycle, while allowing the automatic stabilisers to smooth fluctuations in output, and allow appropriate increases in investment in public services. Specifically, it would take into account all the following factors in applying a country by country approach to assessments of compliance with the medium-term fiscal objective of 'close to balance or in surplus':**

- **the economic cycle – by allowing the automatic stabilisers to operate fully and symmetrically over the cycle, fiscal policy can support monetary policy in smoothing the path of the economy. It is therefore welcome that the Council and Commission now focus more on cyclically-adjusted fiscal balances when assessing the public finances, and hence recognise the importance of avoiding pro-cyclical fiscal policy;**
- **sustainability – low debt levels enhance the sustainability of the public finances, allowing greater room for the automatic stabilisers to operate, and providing a sound basis for investment in public services. Assessment of the sustainability of the public finances should also take into account the long-term budgetary impact of ageing populations, such as that set out in the *Long-term public finance report*, published alongside the 2003 Pre-Budget Report; and**
- **public investment – against a background of sound public finances and economic stability and subject to the sustainable investment rule, public investment contributes to the provision of high-quality public services and can help to**

## Long-term fiscal sustainability

**2.75** While a key objective of fiscal policy is to ensure sound public finances over the short and medium term, the Government must also ensure that fiscal policy decisions are sustainable in the long term. Failure to do so would see financial burdens shifted to future generations, with detrimental effects on long-term growth. It would also be inconsistent with the principles of fiscal management as set out in the *Code for fiscal stability.* Many developed countries face significant challenges over the long term as a result of ageing populations. For example, the demand for health care is likely to rise as a result of the increased number of older people.

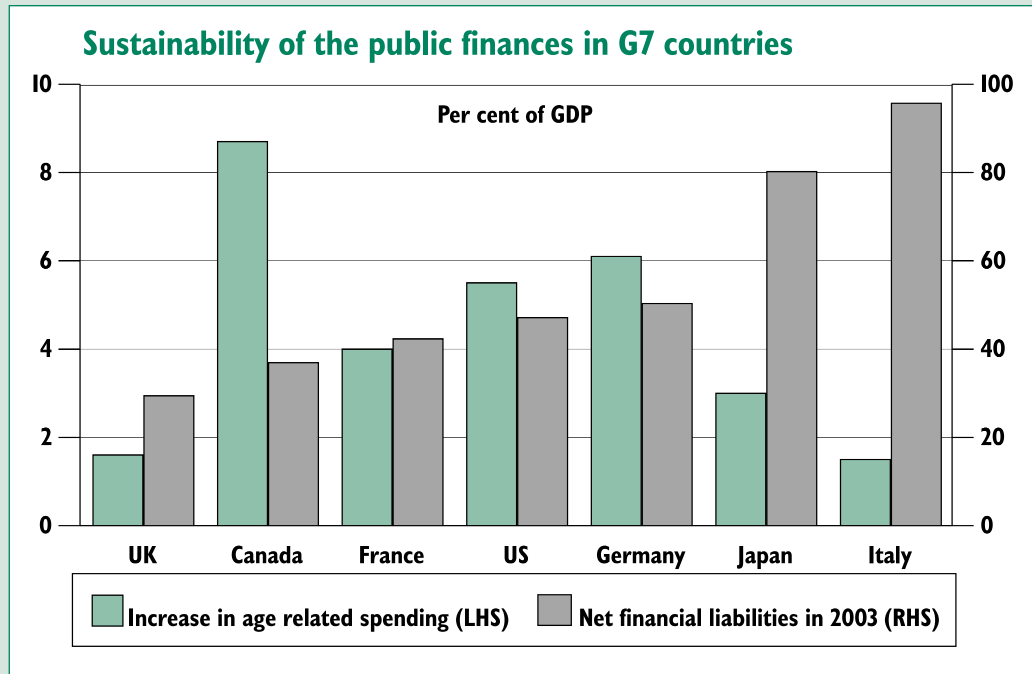
**2.76** An improved and updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the 2003 *Long-term public finance report.* The report provides a comprehensive analysis of long-term economic and demographic developments and their impact on the public finances, updating the illustrative long-term projections set out in Budget 2003. To provide a comprehensive and robust analysis, the report:

- shows performance against a wide range of indicators;
- includes analysis based on different population projections to test the robustness of the conclusions; and
- provides spending projections for education, health and pensions.

**2.77** The report shows that, based on reasonable assumptions, the public finances are sustainable in the longer term, and that the UK is well placed relative to other countries to meet the challenges of an ageing population. Current consumption can grow slightly faster than GDP growth in the long term while still meeting the golden rule. Public sector net investment can grow close to the economy's growth rate over the next 30-years without jeopardising the sustainable investment rule, and the net debt to GDP ratio is projected to remain below 40 per cent.

**Box 2.8: Comparisons of long-term fiscal sustainability within the G7**

**The challenges posed by an ageing population on the public finances vary considerably between countries. The chart below shows the ratio of net financial liabilities (net debt) to GDP of the G7 countries in 2003 and the projected increase in age-related spending.[a]**




*Source: Net financial liabilities from OECD Economic Outlook 73 (June 2003), Increase in age-related spending for UK from 2003 Long-term public finance report, other EU countries from European Union's Economic Policy Committee's working group on ageing 2003 and for non-EU countries from OECD Economic Outlook 69 (June 2001).*

**A number of countries face large projected increases in age-related spending over the next 50 years, mainly resulting from greater pension payments and higher spending on health and long-term care. Of those countries with relatively small projected increases in age-related spending, some have high starting levels of debt. In contrast, the UK has the lowest debt to GDP ratio in the G7 and faces only a relatively small increase in age-related spending, illustrating that the UK is well placed to meet the long-term challenges to the public finances.**

**A more detailed analysis of long-term trends and sustainability in different countries is presented in Chapter 6 of the 2003 *Long-term public finance report*.**

[a] *Defined primarily as the change in spending on pensions, health, long-term care and education between 2008-09 and 2052-53 for the UK and between 2000 and 2050 for others.*

## MACROECONOMIC STABILITY AND THE HOUSING MARKET

**2.78** The housing market in the UK has often been associated with instability in the economy as a whole. Pronounced cycles in the housing market have been a notable feature of the UK economy over the past three decades and have affected the wider economy through private consumption. Housing is a key asset for households and household spending is closely associated with changes in housing wealth. Reducing volatility in the housing market will therefore help promote macroeconomic stability.

**2.79** A number of structural features may contribute to the high levels of housing market volatility in the UK compared to other European countries, and could explain the strong link to consumption:

- the low responsiveness of housing supply to demand in the UK, which has contributed to the strong rise in real house prices in the UK and tends to increase house price volatility;
- the dominance of variable rate mortgages and high level of mortgage debt combine to explain both households' sensitivity to interest rate changes and the strong link between the housing market and consumption in the UK; and
- high levels of owner occupation, as compared to renting, and the ability of households to withdraw equity from housing adds to the impact of changes in housing wealth on consumption.

**2.80** A reduction in housing market volatility could help enhance macroeconomic stability if the UK were to remain outside EMU. Should the UK join EMU, it would become more important as the housing market forms an significant part of the monetary transmission mechanism – the means by which interest rates affect the wider economy.[9]

**2.81** The Government has recognised that reforms in the housing market are needed to reduce volatility and promote stability in the wider economy, and particularly importantly to increase the supply of affordable housing. Budget 2003 announced reforms in this area, and a step change in the planning system. The Chancellor asked Kate Barker to analyse the issues surrounding housing supply in the UK. Details of the interim report by Kate Barker are presented in Chapter 3.

**2.82** At the time of Budget 2003, the Chancellor also asked David Miles to review the mortgage market in the UK, to consider why, unlike in many other developed economies, very little mortgage debt in the UK is at longer-term fixed interest rates. Attention was to be paid to both supply and demand factors, and the examination of whether any market failure held back the development of this market, and the associated opportunities, risks and potential costs. An interim report was published on 9 December 2003. The Government will consider the interim report carefully and looks forward to the final report, which is due by Budget 2004.

[9] *Housing, consumption and EMU*, HM Treasury 2003.

### Box 2.9: The Miles Review interim report

**The dominance of variable rate mortgages has been associated with higher levels of housing market volatility in the UK. In Budget 2003, the Chancellor asked David Miles to review the mortgage market to consider why, unlike in many other developed countries, very little mortgage debt is at longer-term fixed interest rates. The Miles Review interim report analyses this and considers whether there are obstacles to the development of a larger market where interest rates are fixed for longer periods than is currently common.**

**The Report states that the following demand side factors are preventing the emergence of a larger market in longer-term fixed-rate mortgages:**

- **when choosing between mortgages, many borrowers attach too great a weight to the level of initial monthly repayments and too little to the likely overall cost of borrowing over the life of the loan;**
- **many borrowers' understanding of risk is poor. On average, longer-term fixed-rate mortgages are likely to have interest rates slightly above variable-rate mortgages but the added certainty over future payments is worth something – it can give homeowners insurance against unexpected changes in interest rates. If risk is not well understood by households this will not be appreciated; and**
- **the way in which many mortgage lenders compete for new business results in cross-subsidisation from existing borrowers paying Standard Variable Rates to new borrowers taking out discounted variable and short-term fixed-rate mortgages. This practice makes longer-term fixed-rate mortgages appear expensive when judged against the initial cost of discounted variable-rate mortgages.**

**The Report also considers a number of potential constraints to a larger market in longer-term fixed rate mortgages on the supply side. Some of these factors would probably prove temporary if greater demand emerged. For example, constraints due to insufficient liquidity or the inability of lenders to assess the pre-payment risk associated with fixed-rate products would ease as the market developed and lenders experience of pre-payments grew. Other constraints, such as capital requirements, accounting rules and legislative constraints on building societies might require a policy response to enable the market to develop properly.**

**The macroeconomic implications of the way in which households choose mortgages and the way in which mortgages are funded and priced are also analysed in the Report. Here the current functioning of the mortgage market is found to have adverse macroeconomic consequences for the wider economy. Borrowers tendency to focus excessively on the initial cost of a mortgage makes the housing market and wider economy more sensitive to short-term interest rate changes than it would otherwise be. This can make monetary policy more difficult to operate.**

**The Report does not see the UK mortgage market as fundamentally flawed and finds no evidence of classical anti-competitive behaviour. However, there are concerns that some features of the market are not working as well as they should and in the interests of all borrowers. In addition to his continuing consultation with market practitioners and others, David Miles now intends to have detailed discussion with the FSA and OFT. The report states that, in the light of these discussions, he will consider whether in his final report he should include, among his wider recommendations, a recommendation for action from the FSA or the OFT under their respective powers. The final report will be published at the time of Budget 2004.**