

The UK economy continued to perform strongly in 2007, growing 3 per cent on a year earlier, in line with Treasury forecasts published since the 2005 Pre-Budget Report, and the fastest growth rate among the G7 economies. Inflation returned to close to target from mid-2007. Employment growth picked up during the year, with employment reaching a record high of almost 29½ million; unemployment continued to fall, and the claimant count reached a 32-year low.

Over the past decade, the UK economy has shown clear evidence of much improved resilience in response to a number of shocks and has become the most stable of the G7 economies, having previously been one of the least stable. This provides a solid platform from which to cope with the economic shocks from the ongoing disruption in global financial markets and increased global commodity prices.

Since the 2007 Pre-Budget Report, concerted action by the world's major central banks has helped somewhat to ease pressures in money markets, but conditions in credit markets have deteriorated and a number of markets remain effectively closed. There has been further evidence of this feeding through to tighter credit conditions facing households and companies. In addition, forecasters have revised down their expectations for growth in the euro area and US, despite the significant monetary policy easing and announced fiscal stimulus in the US. Together, the euro area and US account for around two-thirds of the UK's export markets.

Given the nature of the global financial market shock, the judgements and assumptions on which the Budget economic forecast is based are subject to considerable uncertainty. The forecast assumes the negative impact on output growth will be somewhat larger and more prolonged than assumed in the 2007 Pre-Budget Report. The resilience of the UK economy demonstrates the pay-off to the Government's macroeconomic policy framework and promotion of open and flexible product, labour and capital markets. So beyond 2008, the forecast is that GDP growth will pick up as financial markets normalise and markets adjust.

Inflation is currently close to target, but significant increases in global agricultural commodity and energy prices are expected to lift inflation in the short term. In addition, the recent depreciation of sterling will exert continued upward pressure on prices, so although the economy is forecast to be operating below trend from mid-2008, inflation is not expected to move below target.

The Budget 2008 economic forecast is for:

- UK GDP growth of 1¾ to 2¼ per cent in 2008, picking up to 2¼ to 2¾ per cent in 2009 before returning close to trend rates of 2½ to 3 per cent from 2010; and
- CPI inflation to pick up in the near term, before falling back to 2½ per cent by the end of 2008, returning to target in 2009 and remaining on target thereafter.

As was the case at the time of the 2007 Pre-Budget Report, there are clear risks to the Budget 2008 economic forecast from the disruption in global financial markets. Its extent and duration, and the feed-through to credit conditions faced by households and companies, and hence their spending, remain highly uncertain. These uncertainties reinforce the case for using the bottom end of the growth forecast range when projecting the public finances, a cautious assumption that is regularly audited by the National Audit Office. With UK private business survey indicators pointing to the economy carrying momentum into 2008, and the possibility that GDP growth in the euro area may exceed current expectations, there are also upside risks to the Budget 2008 GDP growth forecast.

INTRODUCTION^{1,2}

B.1 This chapter discusses recent economic and financial market developments and provides updated forecasts for the UK and world economies in the period to 2010. It begins with an overview of developments in the world economy and global financial markets, which sets the global context for recent developments and prospects in the UK. It then outlines the UK economic forecast, before concluding with a more detailed discussion of sectoral issues, the components of growth, and risks and uncertainties surrounding the forecast.

B.2 The Budget 2008 economic forecast is made against a backdrop of considerable uncertainty related to the ongoing disruption in global financial markets, and there are clear risks to the forecast emanating from these developments. The extent and duration of the disruption and the feed-through to credit conditions faced by households and companies, and thus private sector spending, remain highly uncertain. Given the nature of the global financial market shock currently unfolding, the judgements and assumptions on which the Budget 2008 economic forecast is based are subject to exceptional uncertainties. This chapter discusses in detail those judgements and assumptions, and the risks and uncertainties to which they are subject.

THE WORLD ECONOMY

Overview

B.3 The world economy entered 2007 with considerable momentum. In 2006, the world grew at its fastest rate for over 15 years, and strong growth carried through into the first half of 2007. However, prospects for the world economy have deteriorated since the time of the 2007 Pre-Budget Report, primarily due to the tightening of credit conditions associated with the ongoing disruption in global financial markets.

B.4 World output growth is expected to slow from 4¾ per cent in 2007 to 4 per cent in 2008, which, though below the rate of the past four years, remains solid from a historical perspective. Estimates of recent world growth rates are lower than those reported in the 2007 Pre-Budget Report, reflecting updated World Bank estimates of the weight of individual economies in the world economy, as explained in Table B1.

B.5 Growth in 2008 is forecast to moderate relatively more among advanced than emerging economies. As a group, the G7 major industrial economies are expected to grow 1½ per cent on a year earlier, down from 2¼ per cent in 2007, and the weakest rate since 2002. Emerging markets should be supported by domestic demand growth and the improvement in macroeconomic fundamentals that has taken place over recent years. As advanced economies slow significantly, world trade growth is expected to moderate to 7 per cent in 2008, still robust by historical standards. Growth in UK export markets is forecast to slow to 5¾ per cent, reflecting relative weakness in the euro area and US, which together account for around two-thirds of UK export demand. On the assumption that credit conditions start to ease during the second half of 2008 and normalise by mid-2009, growth in the US and euro area is expected to pick up in 2009 and 2010 back towards trend rates.

¹The UK forecast is consistent with output, income and expenditure data to the fourth quarter of 2007 released by the Office for National Statistics (ONS) on 27 February 2008. This release also contained revisions to earlier quarters of 2007, which the Treasury has carried through to other National Accounts series that the ONS has not yet revised, in particular sectoral saving and borrowing. A fully consistent National Accounts dataset will be published by the ONS on 28 March. A detailed set of charts and tables relating to the economic forecast is available on the Treasury's internet site. Copies can be obtained on request from the Treasury's Public Enquiry Unit (020 7270 4558).

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

Table B1: The world economy

	Percentage change on a year earlier, unless otherwise stated				
	2006	2007	Forecast		
			2008	2009	2010
World GDP ¹	4¾	4¾	4	4¼	4½
Major 7 countries ² :					
Real GDP	2¾	2¼	1½	2	2½
Consumer price inflation ³	1½	3	2	2½	2¼
Euro area GDP	2¾	2½	1¾	2	2¼
World trade in goods and services	9½	7½	7	7¼	7¾
UK export markets ⁴	8½	6¾	5¾	6¼	6¾

¹ For the Budget 2008 forecast, historical world GDP growth estimates have been revised due to the application of new weights to calculate the Treasury's world growth aggregate. This reflects improvements to World Bank estimates of Purchasing Power Parity exchange rates (PPPs) that are used to weight growth in different regions. The revised PPPs give a lower weight to fast-growing emerging economies and a higher weight to slower-growing advanced economies. The effect of these revisions was to lower estimated world GDP growth in 2006 by about ½ a percentage point compared with the estimate reported in the 2007 Pre-Budget Report.

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

³ Per cent, Q4.

⁴ Other countries' imports of goods and services weighted according to the importance of imports from the UK in those countries' total imports.

B.6 Since the 2007 Pre-Budget Report, market interest rate expectations in most advanced economies have shifted further to pricing in monetary policy easing, reflecting the weaker outlook for growth. In a number of countries, central banks have reduced interest rates, while in the US, the Federal Reserve has cut interest rates significantly, by 1½ percentage points, bringing them to a two and a half year low of 3 per cent.

Global financial markets

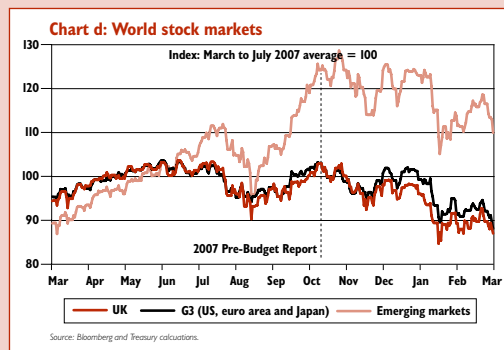
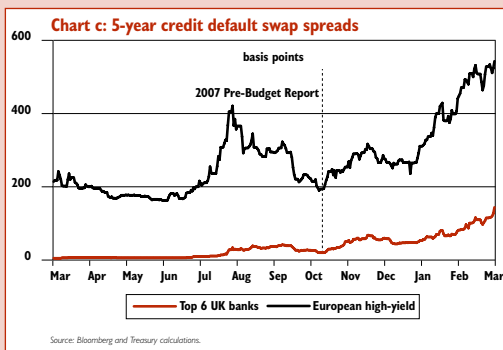
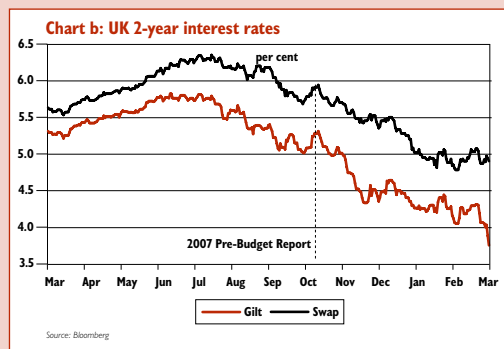
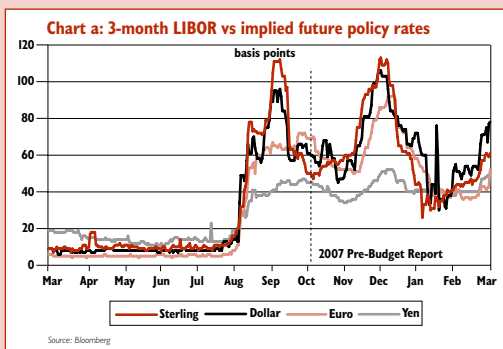
Financial market disruption

B.7 The Budget 2008 economic forecast is made against a backdrop of considerable uncertainty related to the ongoing disruption in global financial markets. Box B1 sets out the evolving nature of the disruption as it has spread across markets for different financial assets. The implications of these developments for credit conditions facing households and companies in the UK are discussed in more detail later in the chapter.

Box B1: The ongoing disruption in global financial markets

Since July 2007, global financial markets have experienced a period of sustained disruption and volatility that was triggered by concerns in the US sub-prime mortgage market and spread swiftly across countries and markets. Initially, spreads on asset-backed securities and related commercial paper increased sharply. Uncertainty over the precise size and location of potential losses made banks reluctant to lend to one another for more than the shortest periods. This liquidity squeeze has kept the spread between 3-month interbank lending rates and expected policy rates above the level prevailing before July 2007 (chart a). The combination of investors marking down growth and interest rate expectations, and some ‘flight to quality’ as investors reduced their exposures to private sector risk, pushed short-term government bond yields lower. To a lesser extent interest rate swap rates have also fallen (chart b). This is significant in the UK, where swap rates have played an important role in the mortgage market as the benchmark against which short-term fixed-rate mortgages have been priced.

Concerted liquidity provision by the world’s major central banks since December has helped somewhat to ease short-term pressures in interbank markets, but strains in credit markets have intensified. Long-term funding markets such as those for residential mortgage-backed securities are still effectively closed, and markets for securitised assets more generally have become increasingly strained. Increased uncertainty in credit markets is evident from credit default swap spreads, which have been rising since the beginning of January, suggesting investors have become more wary of credit risk (chart c). For the most part, the disruption in money and asset-backed securities markets had a muted impact on stock markets through the second half of 2007, and emerging market indices continued to perform strongly. Since January, that situation has changed, with stock markets in advanced and emerging economies declining (chart d).



Advanced economies

Euro area B.8 Solid growth in the euro area continued through 2007, with the economy expanding 2½ per cent, compared with an estimated trend rate of growth of around 2 per cent. Growth continued to reflect the strength of domestic demand, particularly business investment driven by strong profitability and high capacity utilisation rates. Improvements in the labour market have continued, with unemployment falling continuously since early 2005. Against this, business survey and consumer confidence indicators have fallen in recent months, pointing to a slower expansion in the quarters to come. Core and headline inflation increased throughout the second half of 2007, to 2.3 per cent and 3.2 per cent respectively, and the European Central Bank has kept interest rates on hold at 4 per cent.

B.9 Euro area GDP growth is expected to slow to below-trend rates in 2008, before returning to around trend in 2009. Strong labour market conditions are expected to support consumption overall, although weaker consumer confidence and retail sales in recent months suggest private consumption growth will be slower in 2008 than in 2007. Business investment growth is also expected to moderate, reflecting tighter credit conditions. Net exports are expected to weaken as the stronger value of the euro takes effect. Since the 2007 Pre-Budget Report, the consensus forecast for euro area GDP growth in 2008 has been revised down by 0.4 percentage points to 1.6 per cent.

United States B.10 While US GDP growth in 2007 was broadly in line with expectations, the outlook has deteriorated considerably since the 2007 Pre-Budget Report. The correction in the housing market has become more acute, with one measure of house prices falling for 17 consecutive months and housing activity falling at its fastest rate in over a decade. The labour market has shown signs of weakening more recently, with a fall in payroll numbers and the unemployment rate up to around 5 per cent. There has also been a broad-based tightening of lending standards, which is expected to constrain business investment.

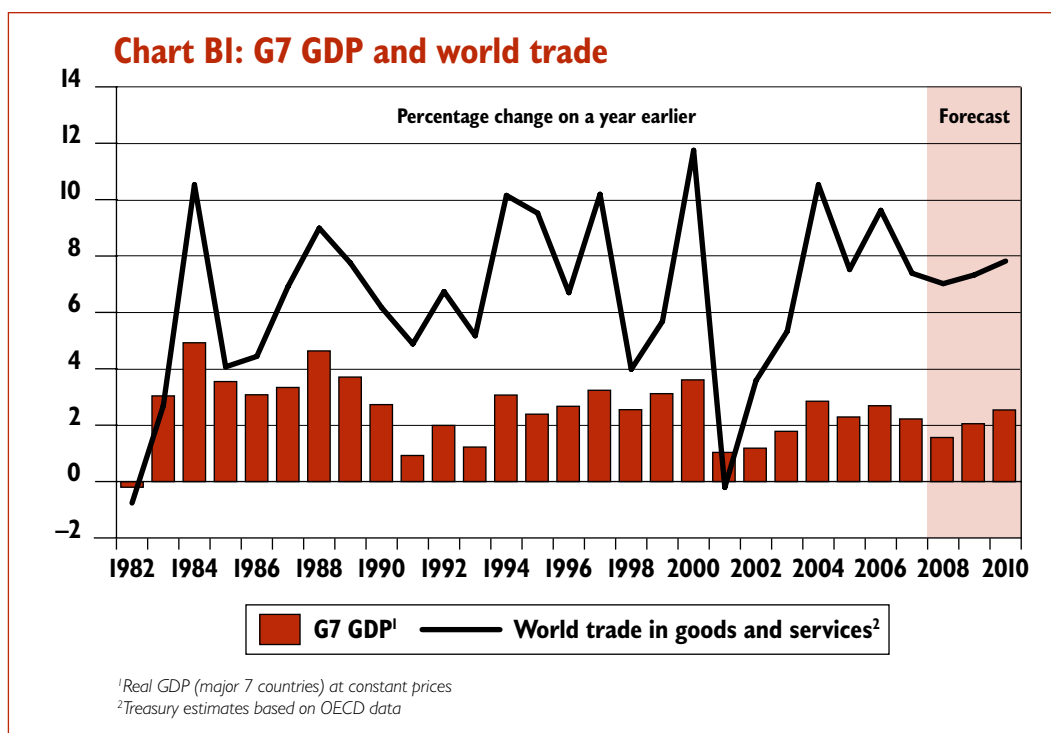
B.11 Headline inflation, which in the US is particularly sensitive to developments in oil prices, increased sharply towards the end of 2007, to over 4 per cent. Core inflation has remained more stable but has also picked up in recent months. Inflation is expected to moderate during 2008 reflecting weaker domestic demand growth.

B.12 Against this deteriorating backdrop, authorities in the US have responded to support the economy. The Federal Reserve has cut interest rates by 2¼ percentage points since August 2007. The US Congress has passed a fiscal stimulus package, including more than \$100 billion of personal tax rebates and further measures aimed at stimulating business investment. Overall, it is estimated that the package will total around 1 per cent of GDP.

B.13 Forecasters expect the US slowdown to be sharper than was envisaged at the time of the 2007 Pre-Budget Report, with the consensus forecast for US GDP growth in 2008 revised down by 0.8 percentage points to 1.6 per cent. Growth is expected to be very weak in the first half of 2008, before recovering thereafter on the back of more supportive conditions. The consensus forecast is for 2.6 per cent growth in 2009, close to estimates of trend growth in the US of around 2¾ per cent. Weak consumption growth should be boosted temporarily in the second half of 2008 as the fiscal stimulus takes effect. The positive outlook for net exports, supported by a weakening dollar, should mean continuation of the recent improvement in the US current account position.

Japan B.14 In 2007, recorded GDP growth in Japan remained volatile, although the economy expanded by 2 per cent in the year as a whole. Growth has been supported by net exports, which have so far been insulated from slowing demand in the US by strong demand from other markets. Business investment has moderated slightly and consumption has remained sluggish. Recent confidence surveys suggest the economy is likely to slow in coming quarters.

Since the 2007 Pre-Budget Report, the consensus forecast for GDP growth in Japan has been revised down by 0.5 percentage points to 1.4 per cent. Core inflation in Japan remains negative, but rising energy prices caused headline inflation to pick up at the end of 2007, raising concerns about cost pressures reducing the profitability of export industries.



Emerging economies

Emerging Asia B.15 Emerging Asia expanded at the fastest rate for over a decade in 2007. Growth in the region is expected to moderate from these very high rates in 2008, but to remain strong overall, supported by rising domestic demand. Although slower growth in advanced economies will impact on the region, many countries have become less reliant on US demand, with the euro area and intra-Asian trade accounting for an increasing share of exports.

China B.16 Growth of around 11½ per cent in China in 2007 reflected increasing private consumption and strong business investment growth, with net exports making a more modest positive contribution than in recent years, though China's large current account surplus continued to expand. Headline inflation has remained elevated as a result of high food prices, although core inflation has remained low and stable. In response to higher inflation, the People's Bank of China has tightened monetary policy, including by doubling reserve requirements ratios over the past 18 months. GDP growth is expected to moderate towards more sustainable levels of 9 to 10 per cent as growth in export markets slows and tighter monetary policy begins to bite.

India B.17 In 2007, the increasing contribution of domestic demand to growth in India continued, due to rising private consumption and government spending. GDP growth is expected to moderate through 2008, reflecting weaker contributions from domestic and external demand, to rates closer to estimated trend rates of 8 to 9 per cent. Higher interest rates, appreciation of the Indian rupee, and lower domestic food prices resulting from a bumper harvest, helped to reduce inflation in 2007, although food prices have started to rise again more recently.

Emerging Europe B.18 In 2007, growth in Central and Eastern Europe slowed somewhat, reflecting strong domestic demand growth but a negative contribution from net exports. Domestic demand has been supported by high wage and credit growth, leading in turn to rising inflation and

concerns about overheating in some countries. Growth is expected to continue to moderate in 2008.

Russia B.19 Growth in Russia remained strong in 2007, driven by private consumption and business investment. Inflation picked up through the second half of 2007, reflecting rising food prices and rapid money growth. Growth is expected to moderate, while lower energy prices and appreciation of the Russian rouble are expected to contribute to weaker net exports and a smaller trade surplus.

Latin America B.20 Growth in Latin America, and especially Brazil, was stronger than expected in 2007, maintaining the pace of expansion from 2006. Economic activity in the region is expected to moderate somewhat in 2008, reflecting a weaker contribution from net exports. The relatively closed nature of economies in the region, combined with more diversified export markets built from strong growth in trade with Asia and Europe, should limit regional exposure to slower US growth. A high dependency on commodity exports makes the region vulnerable to price fluctuations in those markets. In some countries, higher food prices and fiscal expansion have contributed to inflation remaining elevated.

World trade and UK export markets

World trade B.21 As forecast at the time of the 2007 Pre-Budget Report, world trade growth slowed in 2007, to 7½ per cent on a year earlier, reflecting a broad-based slowdown across all regions. World trade growth has exceeded its historical average in recent years, driven by the ongoing integration of emerging markets into the world's trading system. In 2007, Asian countries, excluding Japan, and emerging Europe are estimated to have accounted for around half of total world trade growth.

B.22 World trade growth is expected to moderate in 2008 as the world economy slows. A considerable share of emerging economies' trade, particularly within Asia, consists of goods in the intermediate stages of production that are ultimately exported outside the region. As a result, while greater diversification of export markets has made many economies less dependent on US demand than in the past, trade in both advanced and emerging economies is still likely to be affected by slower growth in advanced economies. In line with developments in world output growth, world trade growth is expected to recover somewhat from 2009.

UK export markets B.23 Growth in UK export markets moderated to around 6¾ per cent on a year earlier in 2007, and is expected to slow to 5¾ per cent in 2008, as G7 growth slows. The moderation is expected to exceed that in world trade overall, since around two-thirds of UK exports go to the US and the euro area, where demand growth is expected to slow more than in emerging markets.

Oil and other commodity prices

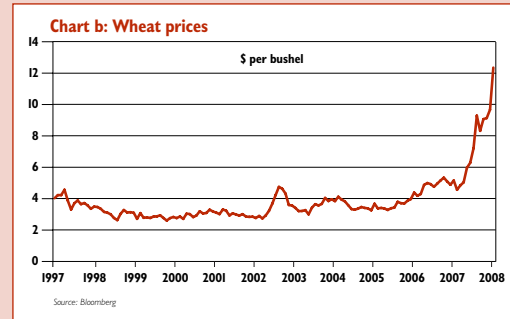
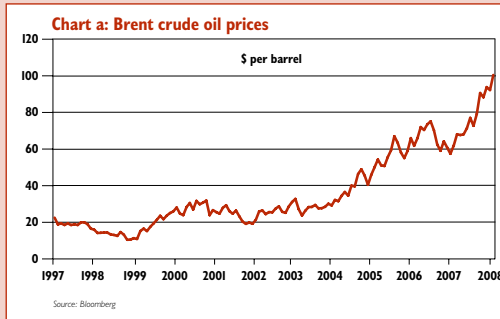
B.24 Following several years of strong gains, commodity prices remained very high during 2007. Energy prices have risen most dramatically, although industrial metals prices have also increased strongly. More recently, prices of agricultural commodities have risen sharply. These trends are discussed further in Box B2. Energy, food and metals prices are expected to moderate in 2008, reflecting the combination of additional supply capacity and slowing world demand. As always, the outlook for commodity prices is sensitive to geo-political, regulatory and weather-related risks in the major producer and consumer nations, representing a key risk to the economic forecast.

Box B2: Developments in commodity prices

Since 2002, oil and other energy prices have risen rapidly and, following some moderation in the second half of 2006, they continued to do so in 2007 and early 2008. The price of a barrel of Brent crude oil, the European standard, averaged around \$73 in 2007 and \$93 in February 2008, compared with \$25 in 2002 (chart a). Since the 2007 Pre-Budget Report, oil prices have risen above consensus forecasts due to low levels of inventories in advance of increased winter demand, contributing to increases in headline inflation rates in a number of countries towards the end of 2007. Consensus forecasts for oil prices in 2008 show analysts expect prices to fall, as supply growth is expected to exceed demand growth, thereby increasing spare capacity.

Since early 2006, agricultural commodity prices have risen sharply, further lifting headline inflation, particularly in emerging markets. Soybean and grain prices have shown some of the biggest increases, with wheat prices briefly reaching an all-time high of \$13 a bushel during the past month (chart b). While increased demand, particularly from large emerging markets, but also for bio-fuels, has contributed to higher food prices, supply disruptions have been the more dominant driver of the recent sharp rises. Grain prices in particular were affected by poor harvests in a number of countries, most notably a serious drought in Australia. In line with the assessment of the United Nations' Food and Agriculture Organisation, food prices are expected to moderate in 2008, reflecting an improvement on last year's poor harvests, and lower energy and transport costs.

Metals prices have also risen significantly in recent years, driven by strong demand from emerging markets, especially China. Industrial metals prices eased towards the end of 2007, and are expected to continue to moderate in 2008, in line with slower world growth and increasing supply. Steel prices are, however, expected to rise following an agreement between producers to pay up to 70 per cent more for iron ore.



Box B3: Government policy on EMU

The Government's policy on membership of the single currency was set out by the former Chancellor in his statement to Parliament in October 1997, as set out in Box B1 of Budget 2007.

The Chancellor's statement to the House of Commons on 9 June 2003 on UK membership of the single currency set out a reform agenda of concrete and practical steps to address the policy requirements identified by the assessment of the five economic tests. This Budget, and *The UK economy: analysis of long-term performance and strategic challenges* published alongside the Budget, set out progress on the Government's reform agenda, including on reforms to enhance the flexibility of labour, capital and product markets in the UK.

On the Stability and Growth Pact, the Government continues to emphasise the need for a prudent interpretation of the Pact as described in Budget 2004. The reforms to the Pact agreed in March 2005 rightly place a greater focus on the avoidance of pro-cyclical policies, and on achieving low debt levels and thereby enhancing the long-term sustainability of public finances, with the flexibility for low debt countries such as the UK to invest in the provision of much needed public services. The Government continues to work closely with Member States and EU institutions as the success of these reforms relies on how they are implemented and used. It is also essential to recognise the importance of national frameworks and national ownership of fiscal policy.

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

UK ECONOMIC FORECAST**The Treasury's approach to economic forecasting**

B.25 Economic forecasting inevitably involves judgement about the uncertain path of future events, which is informed by analysis of past economic performance. The following paragraphs set out the Treasury's general approach to economic forecasting. Given the nature of the global financial market shock currently unfolding, the judgements and assumptions on which the Budget 2008 economic forecast is based are subject to considerable uncertainties.

B.26 The Treasury's approach to forecasting macroeconomic developments, set out in detail in Budget 2007,³ accords with the growth cycle approach favoured by many policymakers. The essential building blocks of this approach are the estimate of the 'trend' level and rate of growth of output, and analysis of cyclical movements around that trend, the 'output gap'. The trend growth projection provides the medium-term anchor for the forecast. The current output gap estimate, and an assessment of the economy's momentum based on analysis of the individual output, income and expenditure components of activity, informs judgement on the path of the economy back towards trend.

B.27 The Treasury assesses trend output growth on the basis of non-oil gross value added (GVA) rather than overall GDP because, while the oil and gas sector affects output, it has little direct impact on capacity pressures in the rest of the economy, and hence the sustainable level of non-oil activity or employment.

³See paragraphs B.30 to B.35 of Budget 2007.

B.28 Once the effects of known shocks are forecast to have dissipated, and the economy is forecast to have returned to trend, growth is generally held at its trend rate and the output gap at zero. That is not to suggest that the growth rate will actually be constant in later periods of the forecast, but that future shocks to the economy are as likely to be positive as negative so that, on average, the best forecast of growth once present shocks have worked through will be the trend rate.

B.29 The UK's growth performance over the past decade provides evidence of how a flexible economy can prove resilient to shocks, absorbing their impact and rebounding, often sooner than forecasters predict. Such adjustment is a natural process in well-functioning market economies, where shocks deliver price signals that encourage firms and households to reallocate their resources to different activities. The resilience of the UK economy over the past decade is described in Box B4. It is the ability to adjust quickly and smoothly to changing economic circumstances that allows an economy to be resilient to shocks, and thus to achieve and maintain macroeconomic stability. These characteristics inform the Treasury's assessment and judgements on the path of the economy back towards trend over the forecast period.

Overview of recent developments

B.30 Over the past decade, the UK economy has proved strong and stable, with GDP growth averaging almost 3 per cent a year and inflation close to the Government's symmetric inflation target. The economy has continued to adapt flexibly to the changing economic circumstances presented by globalisation and technological change, focusing resources on areas of comparative advantage and creating almost 3 million jobs. As discussed in *The UK economy: analysis of long-term performance and strategic challenges*,⁴ published alongside Budget 2008, the flexibility and resilience of the UK economy provides a solid platform from which to meet immediate and longer-term challenges.

⁴*The UK economy: analysis of long-term performance and strategic challenges*, HM Treasury, March 2008.

Box B4: Resilience of the UK economy

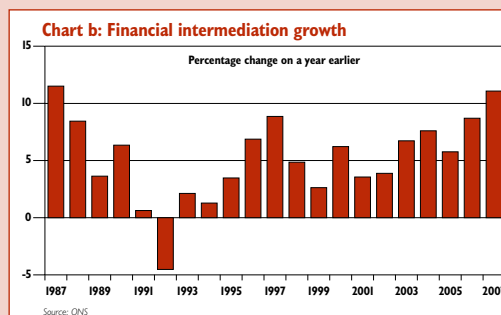
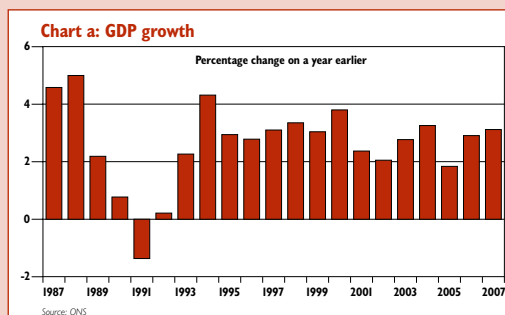
Economic shocks are a regular feature of developments in an open economy like the UK. Whether a shock is positive – for example, advances in information and communications technologies – or negative – for example, oil prices rising to \$100 a barrel – the economy must adjust to the changing economic landscape. The greater the resilience of an economy in the face of shocks, the shorter the time taken to adjust, and the lower the costs incurred while that adjustment takes place.

Over the past decade, the UK economy has demonstrated much improved resilience, delivering macroeconomic stability and positive growth despite a number of significant global economic shocks:

- The Asian crisis of 1997, and the Long-Term Capital Management hedge fund collapse and the Russian debt crisis of 1998, created considerable volatility in global financial markets. UK financial sector output slowed, falling briefly, but overall GDP growth remained strong. Financial sector growth recovered quickly in late 1999.
- Following the bursting of the dotcom bubble in 2000, and the terrorist attacks of September 2001, global equity prices fell by around 50 per cent. Again, UK financial sector output slowed, and briefly fell, before rebounding strongly. UK GDP growth remained positive throughout, with slower growth of 2¼ per cent in 2001 and 2 per cent in 2002 followed by stronger growth of 2¾ per cent in 2003 and 3 per cent in 2004.
- More recently, the combination of the sharp rise in oil prices, euro area weakness and a subdued housing market contributed to measured growth slowing in 2005 to 1¾ per cent, although the cyclical indicators monitored by the Treasury are not consistent with such a significant slowdown between 2004 and 2005. The economy rebounded quickly, with slightly above-trend rates of growth of 3 per cent in both 2006 and 2007.

A Treasury Economic Working Paper published alongside Budget 2008^a builds on OECD analysis exploring evidence of resilience in the UK and 13 other OECD countries over the past two decades. While still an area of ongoing research, the paper finds that most economies demonstrated improved resilience in the 1994 to 2005 period compared with 1982 to 1993. For the UK, the analysis suggests the improvement was particularly marked, with the UK estimated to have been the most resilient of the economies studied in the latter period. The paper finds some evidence that improvements in product and labour market flexibility have contributed to greater resilience in the UK and other advanced economies.

After a decade of sound macroeconomic policy and the promotion of flexible and open product, labour and capital markets, there is clear evidence that the UK economy is more resilient than in the past. The pay-off has been seen in much enhanced macroeconomic stability, and provides a strong foundation from which to deal with current economic shocks.



^a Resilience in the UK and other OECD economies: Treasury Economic Working Paper No.2, HM Treasury, March 2008.

GDP growth B.31 The UK economy continued to perform strongly in 2007, growing 3 per cent on a year earlier, in line with Treasury forecasts published since the 2005 Pre-Budget Report, and the fastest growth rate among the G7 economies. Non-oil GVA growth was slightly higher, at 3¼ per cent on a year earlier.

B.32 The largest contribution to GDP growth came from private consumption, which grew by 3¼ per cent and accounted for around 2 percentage points of whole economy GDP growth. Whole economy investment contributed 1 percentage point to growth, reflecting business investment growth of 6¾ per cent on a year earlier. Including the contribution of stock building, the domestic private sector fully accounted for growth in 2007. With the UK having expanded at a faster rate than its major trading partners, import growth exceeded export growth, with the result that recorded net trade subtracted around ½ a percentage point from overall GDP growth.

Labour market developments B.33 Employment growth picked up through 2007, from around 50,000 during the first half of the year to almost 250,000 during the second half. On the Labour Force Survey measure, the unemployment rate, which started the year at 5½ per cent, began to fall in the second quarter and reached 5¼ per cent by the end of the year. The claimant count fell in every month of the year, falling below 800,000 in January 2008 for the first time since mid-1975. The claimant count has fallen by more than 160,000 since September 2006. Average earnings growth excluding bonuses, as measured by the Average Earnings Index, was stable and subdued throughout 2007, ranging between 3½ and 3¾ per cent on a year earlier. The experimental Average Weekly Earnings measure suggested somewhat stronger earnings growth, rising from 3¾ per cent on a year earlier in the first quarter of 2007 to 4½ per cent by the final quarter.

Credit conditions B.34 At the time of the 2007 Pre-Budget Report, the disruption in financial markets was in its early stages and its likely impact on credit conditions facing households and companies was highly uncertain. The forecast assumed some feed-through to tighter conditions and hence to household and company spending in the short term, but that conditions would ease relatively soon. It was noted that the longer the disruption persisted, the greater the risk of it impacting negatively on credit conditions and detracting further from growth. Box B5 sets out the channels through which tighter credit conditions could affect the real economy.

B.35 Since the Pre-Budget Report, there has been clear evidence that the disruption in financial markets has evolved. The intervention of the world's central banks helped to ease pressures in money markets somewhat, but conditions in a number of credit markets have continued to deteriorate. Some markets, notably those related to mortgage-backed securities, remain effectively closed. As the disruption has spread and intensified in credit markets, so credit conditions facing households and companies have tightened. The Bank of England's *Credit Conditions Survey* published in early January showed lenders had tightened conditions significantly for all types of borrower, and that they expected to tighten conditions further in the first quarter of 2008.

B.36 Bank of England data on average quoted interest rates show that the feed-through from market rates to lending rates has been abnormally muted in recent months. For example, the 2-year swap rate has fallen by almost 1 percentage point since October, but the average quoted interest rate on a 2-year fixed rate mortgage, which typically moves in step with the swap rate, has fallen only slightly. There has also been some evidence of reduced availability of mortgage products, and increases in fees and other charges.

Box B5: Credit conditions and the real economy

The ongoing disruption in financial markets has affected credit conditions facing households and companies. Assessing the likely response of banks and other credit issuers to developments in financial markets, and of companies and households to developments in credit conditions, represents the primary uncertainty for the Budget 2008 economic forecast.

- For **banks**, the deterioration in wholesale capital markets has increased funding costs. Higher funding costs could be passed on to borrowers through higher retail interest rates or related fees, which might be combined with a degree of credit rationing until markets normalise. Strains on banks' balance sheets caused by writing down the value of sub-prime and other related assets, bringing some previously off-balance sheet assets onto their balance sheets, and falls in commercial property prices, could also lead banks to reduce the availability and raise the price of credit, particularly to riskier borrowers, in order to rebuild their capital.
- Tighter credit conditions facing **companies** and reduced availability of credit tend to reduce investment spending, since higher financing costs lower the net return from investment. Even for firms with sufficient free cashflow to fund investment from internal sources, the cost of capital would still be higher, and so inhibit investment spending.
- Tighter credit conditions facing **households** and reduced availability of credit tend to reduce consumer spending and encourage saving, through the higher cost of borrowing and return on saving. Reduced availability of credit would also tend to increase the number of credit-constrained households and so reduce the ability of households in aggregate to maintain spending in the face of slower income growth.

At the macroeconomic level, the size of the impact on consumer and investment spending is likely to depend on the household and corporate sectors' financial position. Over the past 5 years, the UK non-financial corporate sector has run a financial surplus, while the UK household sector has run a financial deficit. This suggests that if the tightening in credit conditions were similar across sectors, consumer spending could be affected more than investment spending, although typically investment is more responsive to changing economic conditions.

Developments in credit conditions cannot, however, be considered in isolation. The responses of one sector are likely to impact on factors affecting credit conditions for others. More importantly, the recent tightening of credit conditions has gone hand-in-hand with heightened economic uncertainty, although this is set against recent monetary policy easing by the Bank of England.

Current account B.37 Data for the current account are typically subject to significant revisions, and data at this time are more than usually uncertain, as discussed later in this chapter. In December 2007, the Office for National Statistics (ONS) published revisions to estimates of investment income flows and the UK's current account deficit. These revisions, described further in Box B8, mean that the UK current account deficit was estimated to have increased from 3¼ per cent of GDP in 2006 to an average of 5 per cent of GDP in the first three quarters of 2007. Sterling has depreciated by around 7 per cent since the 2007 Pre-Budget Report, which can be expected to support demand through its positive effect on demand for UK exports, but could put upward pressure on inflation through its effect on import prices.

Inflation B.38 Since the beginning of 2007, headline Consumer Prices Index (CPI) inflation has continued to be affected by changes in food and energy prices. Reflecting movements in

wholesale gas prices, domestic energy prices increased sharply in early 2007, contributing to above-target inflation, but fell in the second half of the year. Subsequently, lower wholesale gas prices and consequent cuts in utility bills subtracted from inflation rates, and CPI inflation fell back to close to target. In January it stood at 2.2 per cent.

B.39 With wholesale gas prices having risen again, a further round of utility price increases was announced in January and February. Following a change in methodology to reflect more accurately current billing practices of energy providers, the ONS will have incorporated the full effect of these increases by the February CPI release to be published on 18 March. Rising oil prices pushed petrol prices up 19½ per cent on a year earlier by January 2008, while further increases in global agricultural commodity prices had pushed food price inflation up to 6½ per cent. RPI inflation has remained elevated, partly reflecting the effect of past monetary policy tightening on mortgage interest payments, though it eased from 4.8 per cent in March 2007 to 4.1 per cent in January 2008.

Inflation expectations and earnings

B.40 Against a backdrop of higher inflation outturns and higher prices of some regularly purchased items such as energy and food, which figure prominently in household expenditure, survey measures of households' inflation expectations have risen. Supply-chain pressures have been building, with sharp increases in producer input prices being partly passed on into output prices. Evidence from business surveys indicates that companies' output price expectations have picked up, and inflation expectations derived from some financial market instruments have also moved higher. So there remains a risk that wage and price-setters expect inflation to remain above the inflation target beyond the immediate cost shock, and that this will translate into second-round effects from higher inflation outturns to increased wage pressures. Similar cost shocks in 2005 and 2006 were largely absorbed by producers in margins, or offset by bearing down on other costs, including wages. To date there has been no evidence of second-round wage effects: underlying earnings growth has remained stable and subdued.

Monetary and fiscal policy

B.41 With growth above trend for much of 2006 and 2007, the MPC raised Bank Rate by 1¼ percentage points between August 2006 and July 2007. Monetary policy was supported by a fiscal tightening during 2006-07. As the disruption in global financial markets took hold in the second half of 2007, and its effect on credit conditions became clearer, the MPC cut Bank Rate by a ¼ percentage point in both December 2007 and February 2008 to the current level of 5¼ per cent. Market-derived interest rate expectations point to some further easing over the coming year. In the press release accompanying its decision in February, the MPC highlighted the challenging environment in which monetary policy is being set: "The Committee needs to balance the risk that a sharp slowing in activity pulls inflation below the target in the medium term against the risk that elevated inflation expectations keep inflation above target".⁵

UK Statistics Authority

B.42 From April 2008, the Statistics and Registration Services Act 2007 will come into full force, and official statistics will be governed by the new independent UK Statistics Authority, which will answer directly to Parliament. The Authority will take up its role at a time when there will be a premium on understanding data limitations and minimising the extent to which difficulties in interpreting economic developments are compounded by uncertainties over data quality.

⁵News release: Bank of England reduces Bank Rate by 0.25 percentage points to 5.25 per cent, Bank of England, February 2008.

Assessment of the output gap

Latest National Accounts data **B.43** Since the 2007 Pre-Budget Report, ONS estimates of non-oil GVA growth in 2006 have been revised up slightly, from 3 per cent to 3¼ per cent on a year earlier. As a result of changes to the estimated quarterly path of output in 2006, with stronger growth in the first and fourth quarters but slightly weaker growth in the third quarter, the trend growth arithmetic,⁶ based on the latest National Accounts data and the Treasury's trend output growth assumptions, implies output passed up through trend in the second half of 2006. In 2007, non-oil GVA grew 3¼ per cent, implying that a small positive output gap, of around a ¼ per cent, had opened up by the end of the year.

Evidence from the cyclical indicators **B.44** Evidence from the broad range of cyclical indicators monitored by the Treasury continues to support the 2007 Pre-Budget Report assessment that the economy passed up through trend towards the end of 2006. On balance, the cyclical indicators suggest the economy was slightly above trend during 2007:

- Evidence from quarterly business surveys conducted by the Confederation of British Industry (CBI) and the British Chambers of Commerce (BCC) suggests that capacity utilisation rates are currently at levels consistent with the economy operating slightly above trend. The Bank of England's Regional Agents have reported some easing from above-average capacity utilisation rates since late 2007.
- Indicators of recruitment conditions from the quarterly business surveys convey mixed signals. For the services sector, which accounts for around 75 per cent of private sector employment, the BCC's indicator of recruitment difficulties is at its highest since 1998, whereas for manufacturing it appears to indicate a degree of slack. The Bank's Regional Agents have reported some easing in recruitment difficulties since the time of the 2007 Pre-Budget Report.
- The latest ONS labour market data generally suggest tighter conditions, with strong growth in employment, lower unemployment and further significant falls in the claimant count to a 32-year low. The number of vacancies has continued to rise, despite a small decline in the number of vacancies in the financial sector. Against this evidence of a tightening labour market, average earnings growth has remained subdued, and some measures of domestically generated inflation stable.

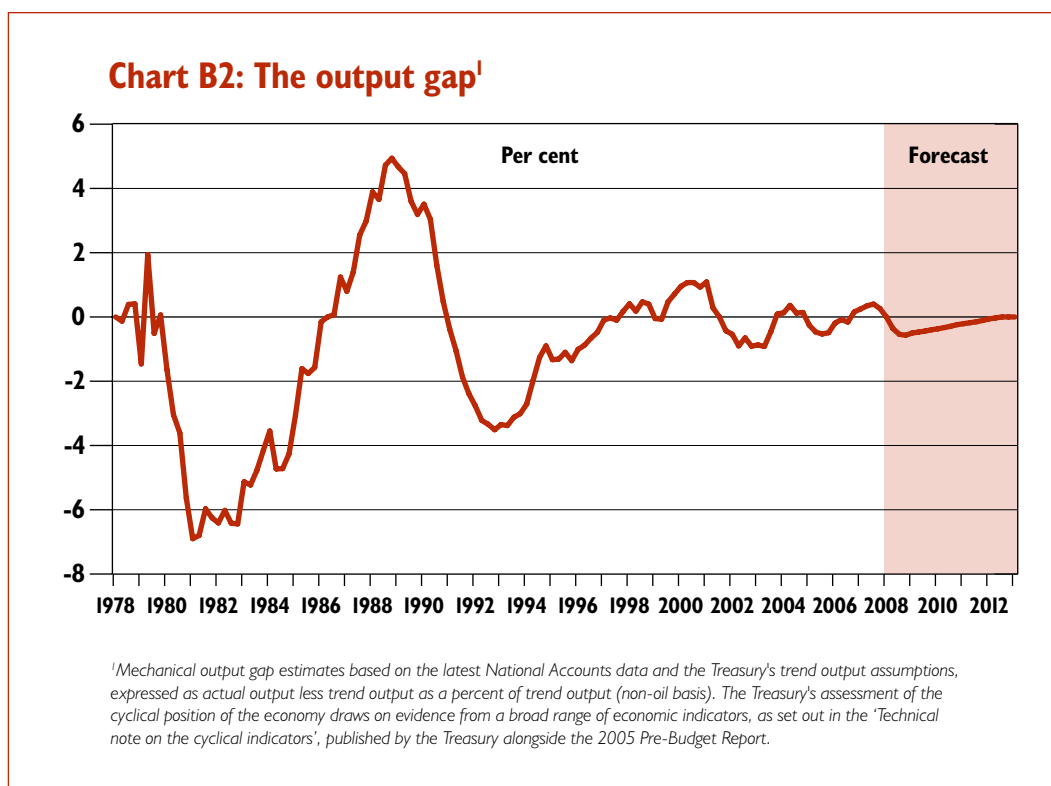
Economic cycle **B.45** Although evidence from the cyclical indicators, and the latest National Accounts data, continue to suggest that the economy passed up through trend towards the end of 2006, neither discriminates unambiguously between the third and fourth quarters of 2006 as the point at which the economy was on trend. So for the purposes of the Budget 2008 economic forecast it has been assumed that, on average, the economy was on trend during the second half of 2006. With output judged to be close to trend at the end of 2007, growth forecast to slow to below trend rates in 2008 and 2009, and prospective National Accounts revisions, it remains too soon to assess whether the apparent move through trend in the second half of 2006 marks the end of the economic cycle that is judged to have started in the first half of 1997.

B.46 The current uncertainty over dating of the cycle is expected partly to recede once the ONS National Accounts modernisation programme secures improvements to the quality of the data for recent years. As announced in February 2007,⁷ resource re-prioritisation in order to deliver on this programme has necessitated some temporary increase in uncertainty

⁶See paragraph B.32 to B.34 of Budget 2007 for a fuller explanation of the trend growth arithmetic.

⁷*Modernising the UK's National Accounts*, ONS, subsequently published in *Economic & Labour Market Review*, April 2007.

surrounding the quality of the National Accounts, with the possibility of substantive revisions to come. Over the period of transition to modernised National Accounts, the ONS has introduced additional quality monitoring of the quarterly estimates.



Assessment of trend growth

B.47 The Treasury's neutral estimate of the economy's trend rate of output growth for Budget 2008 remains at 2¾ per cent a year to the end of the projection period, unchanged since the reassessment published alongside the 2006 Pre-Budget Report.⁸

B.48 Table B2 presents estimates of trend output growth and its decomposition to the second half of 2006, and the Treasury's projections thereafter. From now on, the Treasury will present the decomposition of past and projected trend output growth on the basis of the adult population of all people over the age of 16, rather than the working-age population of people aged between 16 and the State Pension age. The reasons for this adjustment are set out in Box B6.

⁸ *Trend growth: new evidence and prospects*, HM Treasury, December 2006.

Table B2: Contributions to trend output growth^{1,2}

	Estimated trend rates of growth, per cent per annum					
	Trend output per hour worked ^{3, 4}		Trend	Trend	Population ⁵	Trend
	Underlying	Unadjusted	average hours	employment		output
	(1)	(2)	worked ³	rate ³	(5)	(6)
1986Q2 to 1997H1						
Latest data						
Working-age population ⁶	2.13	1.95	-0.11	0.36	0.25	2.46
Adult population ⁶	2.12	1.93	-0.11	0.37	0.26	2.46
Over the recent past						
1997H1 to 2001Q3						
Latest data						
Working-age population	2.89	2.70	-0.45	0.38	0.53	3.17
Adult population	2.86	2.61	-0.45	0.49	0.51	3.17
2001Q3 to 2006H2						
Latest data ⁷						
Working-age population	2.36	2.36	-0.31	0.00	0.70	2.76
Adult population	2.26	2.21	-0.31	0.09	0.75	2.76
Projection⁸						
2006H2 onwards						
Budget 2008 ⁹						
Working-age population	2.35	2.30	-0.25	0.1	0.6	2¾
Adult population	2.25	2.30	-0.25	-0.1	0.8	2¾

¹ Treasury analysis based on judgement that 1986Q2, 1997H1 and 2001Q3 were on-trend points of the output cycle. Figures independently rounded. Trend output growth is estimated as growth of non-oil gross value added between on-trend points for the past, and by projecting components going forward.

Columns (2) + (3) + (4) + (5) = (6).

Full data definitions and sources are set out in Annex A of 'Trend growth: new evidence and prospects', HM Treasury, December 2006.

² Interim projections between Budget 2002 and PBR 2007 are provided in an expanded table in 'Budget 2008: the economy and public finances – supplementary material'.

³ The underlying trend rate is the unadjusted trend rate adjusted for changes in the employment rate, i.e. assuming the employment rate had remained constant.

Column (1) = column (2) + (1-a).column (4), where a is the ratio of new to average worker productivity levels. The figuring is consistent with this ratio being of the order of 50 per cent, informed by econometric evidence and LFS data on relative entry wages.

⁴ The decomposition makes allowances for employment and hours worked lagging output. Employment is assumed to lag output by around three quarters, so that on-trend points for employment come three quarters after on-trend points for output, an assumption which can be supported by econometric evidence. Hours are easier to adjust than employment, and the decomposition assumes that average hours worked lag output by just one quarter, though this lag is harder to support by econometric evidence.

⁵ UK resident household basis.

⁶ Working-age population defined as population aged 16 to State Pension age. Adult population defined as population aged 16 and over.

⁷ Estimates based on the assumption that the economy passed up through trend in the second half of 2006.

⁸ Neutral case assumptions for trend from 2006H2.

⁹ Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2006H2 are anchored.

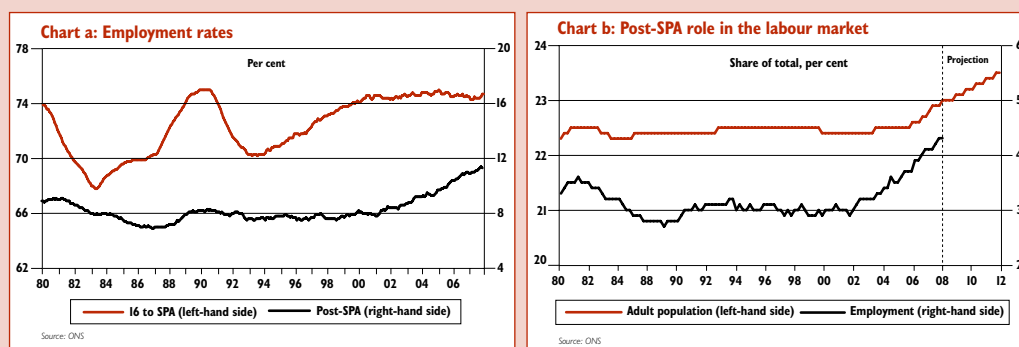
Population growth **B.49** At the time of the 2006 Pre-Budget Report, the Treasury revised up its estimate of the economy's trend rate of output growth from 2007 onwards. This revision was based on analysis of new evidence that pointed to the contribution of net migration being a ¼ percentage point higher than previously projected. Taken together with the contribution of natural population change, this implies growth of the adult population of ¾ per cent a year over the projection period. The ONS estimate of net inward migration in 2006, published in November 2007, was 191,000, consistent with the assumption underpinning the Treasury's population projection. The ONS 2006-based population projections published in October 2007 assume stronger net migration over the next 5 years, although the Treasury projection accords with the ONS longer-term migration assumption. The ONS, drawing on cross-Departmental support, continues to work to improve the quality of migration statistics, implementing the recommendations of the Inter-departmental Task Force on Migration Statistics.⁹

⁹ Report of the Inter-departmental Task Force on Migration Statistics, ONS, December 2006.

Box B6: Population definitions in the trend growth framework

The definition of population used in the Treasury’s trend growth estimates has, until Budget 2008, been the working-age population measure used by the ONS in the Labour Force Survey. The working-age population includes all those aged between 16 and the State Pension age (SPA), currently 16 to 59 for women and 16 to 64 for men. Under the 1995 Pensions Act, the SPA for women will rise by 1 year every other year from 2010, until the SPA for men and women is equalised at 65 in 2020. While this change will only need to be reflected in ONS population definitions when it begins to take effect in 2010, it has already moved into the Treasury’s economic projection horizon.

The pattern of employment growth over recent years provides further rationale for reconsidering the population definition used in the trend growth framework, with the employment rate of the post-SPA population rising significantly from 8 per cent to 11¼ per cent since 2001 (chart a). Participation and employment among the post-SPA population are projected to continue to rise. In addition, demographic trends mean the proportion of post-SPA people in the adult population will continue to rise (chart b). As such, the post-SPA share of employment is likely to continue rising. To ensure the Treasury’s trend growth framework is fully representative of the changing structure of employment, a wider ‘adult population’ definition, including all those aged 16 and over, has been adopted to underpin the Budget 2008 and subsequent trend growth projections.



Labour market B.50 As set out in Box B6, the proportion of older people in the adult population is set to continue rising. Given lower employment rates among older people, even with rising employment rates for given age cohorts, the changing age structure of the adult population means that, on the adult population basis, the trend employment rate is projected to decline slightly over the forecast horizon. This is consistent with a gently rising trend in the working-age employment rate.

B.51 Employment growth picked up during 2007, rising nearly 300,000 in the year to the final quarter, to a record high of almost 29½ million. As a result, the adult employment rate ended the year at 60¼ per cent, a little above its estimated trend level.

B.52 In line with the trend between the estimated on-trend points in the third quarter of 2001 and the second half of 2006, trend average hours of the adult population are projected to decline by a ¼ per cent a year. The small fall in average hours worked since the start of 2007 has been in line with the projected trend rate, consistent with the economy operating close to trend.

Productivity growth B.53 The Treasury’s projection of productivity growth is informed by the estimate of underlying productivity growth over the recent past, adjusted for the projected change in the employment rate to project actual productivity growth. On this basis, underlying productivity (output per hour worked by the adult population) is projected to grow at a trend rate of 2¼ per cent a year, consistent with the rate of growth between the estimated on-trend points in 2001

and 2006. Together with the employment rate assumption, this implies an actual trend productivity growth projection of 2.3 per cent from 2007 onwards, on the cautious side of the estimated trend from 1997 to 2006, though well above the 1.9 per cent average over the previous cycle.

B.54 Since the second half of 2006, productivity growth, measured in terms of output per hour worked, has averaged around 2¼ per cent, in line with the projected trend rate. As productivity growth tends to fluctuate positively with the cycle, this is consistent with the economy operating close to trend during 2007.

GDP and inflation forecasts

Credit conditions B.55 The Budget 2008 economic forecast is made against the backdrop of considerable uncertainty related to the ongoing disruption in global financial markets, and in particular the size and persistence of its effects on credit conditions facing households and companies. With only limited evidence available at the time of the 2007 Pre-Budget Report, the forecast assumed some feed-through to tighter credit conditions and hence to household and company spending in the short term. More recent evidence suggests that the intensity and duration of the negative impact on credit conditions are likely to be greater than assumed in the Pre-Budget Report.

B.56 The judgements in the Budget 2008 forecast are conditioned on an updated forecasting assumption that credit markets will remain strained through the first half of 2008, start easing during the second half and only normalise by mid-2009. There is considerable uncertainty surrounding this assumed path. It is consistent with a view that progressively greater information disclosure by the world's financial institutions will help the price discovery process in the credit markets that are currently strained, but that despite the flexibility of financial markets this process will take time. Tighter credit conditions are therefore assumed to constrain growth in household and business spending by somewhat more and for somewhat longer than was forecast in the 2007 Pre-Budget Report.

Table B3: Summary of forecast¹

	2007	Forecast		
		2008	2009	2010
GDP growth (per cent)	3	1¾ to 2¼	2¼ to 2¾	2½ to 3
CPI inflation (per cent, Q4)	2	2½	2	2

¹ See footnote to Table B9 for explanation of forecast ranges.

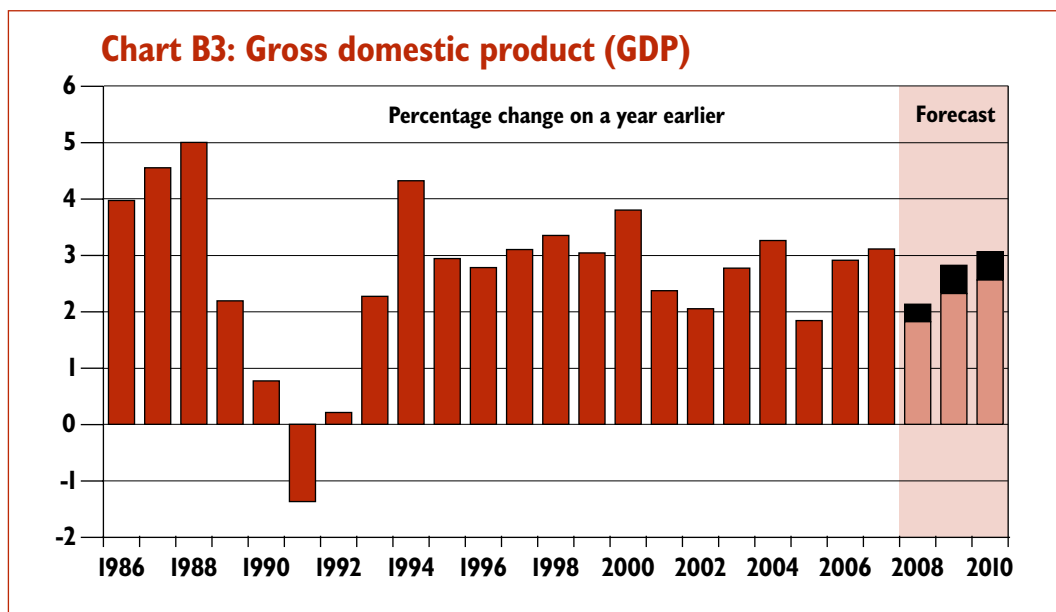
GDP and the output gap B.57 GDP growth in 2007 was in line with the 2007 Pre-Budget Report forecast of 3 per cent, with growth in the final quarter of 0.6 per cent consistent with the slowing that was expected following the monetary policy tightening in the year to July 2007. The risk of a further tightening of credit conditions identified in the Pre-Budget Report has since materialised, while prospects for growth in the US and euro area, the UK's main export markets, have deteriorated. Growth is therefore forecast to slow a little more in 2008 than forecast in the Pre-Budget Report, and to recover less quickly in 2009. The small positive output gap at the beginning of 2008 is forecast to turn negative during 2008, to stand at around ½ a per cent in the first half of 2009, and to close gradually thereafter.

B.58 During 2008 and early 2009, when the negative effects of tighter credit conditions on output are assumed to be largest, underlying monetary conditions are set to be supportive. Sterling has depreciated around 7 per cent since the 2007 Pre-Budget Report, which is forecast to boost export growth in 2008 and 2009. The Bank of England has reduced Bank Rate by ½ a percentage point since early December 2007, and markets expect some further easing over

the coming year. To the extent that these expectations are realised, and given the typical lags involved in the pass-through from interest rate changes to households' and companies' spending, interest rates should progressively support growth from the second half of this year. It is, however, possible that the pass-through of Bank Rate changes to market interest rates and credit conditions will be more muted while the period of disruption in financial markets persists.

B.59 On the assumption that financial markets and credit conditions start easing during the second half of 2008 and normalise by mid-2009, annual growth is expected to pick up from the first half of 2009. Once financial markets begin to function normally again, the forecast assumes that natural adjustment processes of a well-functioning market economy will take further hold, helping to sustain output growth at or slightly above trend rates. As described in Box B4, the UK economy has been able to absorb and adjust to a number of shocks over the decade, as wage and price flexibility have supported output and recovery. It is this resilience in the face of shocks, underpinned by the Government's macroeconomic policy framework and promotion of open and flexible markets, that has contributed to the significant improvement in macroeconomic stability over the past decade. Indeed, the recent strength of employment growth, and continuing absence of wage pressures, suggests the labour market will continue to support the economy through 2008 and beyond.

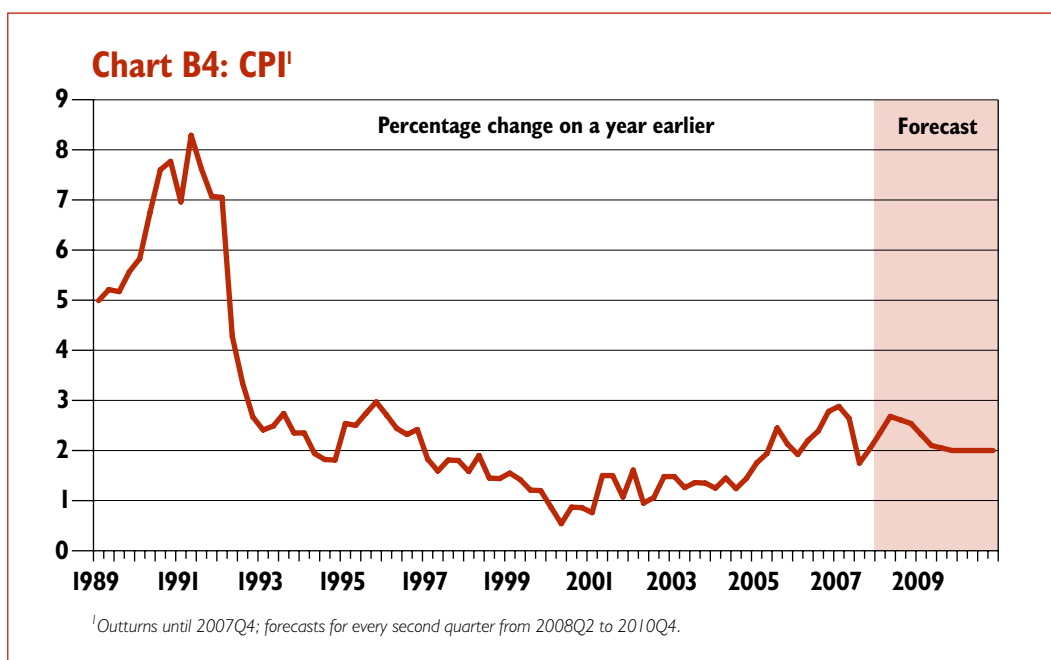
B.60 Reflecting this combination of factors, GDP growth is forecast to slow from 3 per cent in 2007 to 1¾ to 2¼ per cent in 2008, before picking up to 2¼ to 2¾ per cent in 2009 and 2½ to 3 per cent in 2010. Consistent with assumed developments in credit conditions, GDP growth is forecast to slow to 1½ to 2 per cent on a year earlier in the second half of 2008, picking up to 2 to 2½ per cent in the first half of 2009 and 2½ to 3 per cent by the second half of 2009. Once credit markets have normalised, the assumed gradual closing of the output gap reflects uncertainty over the degree to which the shock may prove to have temporary or more permanent effects, as discussed further in paragraph B.100. Given the declining trend in North Sea output, non-oil GVA grows a little faster than whole economy GDP, and at slightly above-trend rates.



Inflation B.61 Inflation is expected to rise in the near term, largely reflecting ongoing increases in food and energy prices, including the effect of already announced rises in household energy bills. These effects on consumer prices reflect developments in global markets for agricultural commodities, crude oil and wholesale gas. Some upward pressure on import prices is expected

due to the depreciation in sterling since the 2007 Pre-Budget Report. The impact of higher import prices on CPI inflation will depend on the extent to which producers and retailers choose to pass them on to consumers or to absorb higher costs through lower margins or offset them by bearing down on other input costs, including wages. During recent cost shocks, much of the effect appears to have been absorbed or offset before reaching the level of consumer prices.

B.62 Despite strong domestic demand growth through to the third quarter of 2007 and reduced spare capacity, core inflation measures have remained relatively subdued and CPI inflation fell back to target in the second half of the year, as forecast in Budget 2007. The emerging negative output gap, reflecting slower growth since the final quarter of last year and into 2008, would be expected to put downward pressure on domestically generated inflation, offsetting the upward inflationary pressures from commodity prices and a weaker exchange rate. Inflation is forecast to pick up in the near term, before falling back to 2½ per cent by the end of 2008, returning to target in 2009 and remaining on target thereafter.



UK DEMAND AND OUTPUT IN DETAIL

Rebalancing of demand

B.63 Between 2000 and 2004, GDP growth in the UK was driven primarily by private consumption growth, which contributed an average of 2¼ percentage points to the 2¾ per cent average annual growth rate. However, in nominal terms, the share of private consumption in total demand declined from its peak in 2001, reflecting relatively subdued consumer price inflation. Since 2005, some domestic demand rebalancing has taken place with investment accounting for a larger share of growth alongside continued strong consumption growth. However, the expected rebalancing of domestic and external demand does not yet appear to have materialised. Latest estimates suggest net trade subtracted ½ a percentage point from growth in 2007, in line with the average between 2000 and 2004. With sterling having depreciated by around 7 per cent since the 2007 Pre-Budget Report, the conditions are in place for external demand to contribute more positively to GDP growth over the forecast horizon.

Table B4: Contributions to GDP growth^{1,2}

	Percentage points, unless otherwise stated						
	Average 2000 to 2004	2005	2006	2007	Forecast		
					2008	2009	2010
GDP growth, per cent	2¾	1¾	3	3	1¾ to 2¼	2¼ to 2¾	2½ to 3
Main contributions							
Private consumption	2¼	1	1¼	2	1	1½	1¾
Business investment	¼	¼	¾	¾	¼	½	½
Government ³	¾	½	½	½	½	½	½
Change in inventories	0	0	-¼	½	0	0	0
Net trade	-½	0	0	-½	¼	¼	0

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

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

³ The sum of government consumption and government investment.

Households and consumption¹⁰

B.64 Household consumption is the largest expenditure component of demand in the UK, accounting for around 63 per cent of nominal GDP in 2007, having fallen steadily from above 65 per cent between 2000 and 2002.

Disposable income B.65 Real household disposable income growth in 2007 is estimated to have been 1¼ per cent on a year earlier. It is expected to pick up to 1½ to 2 per cent on a year earlier in 2008, reflecting the recent strength of employment growth and a positive contribution from net changes in benefits and taxes. Households' purchasing power is likely to be negatively affected during 2008 by commodity-price driven increases in food and energy prices, and the relatively slow pass-through to date of Bank Rate reductions to mortgage rates.

Household spending B.66 Private consumption growth in 2007 was slightly stronger than expected, at 3¼ per cent on a year earlier. Latest estimates suggest growth was particularly strong in the third quarter, at 0.9 per cent on the previous quarter, before easing to 0.2 per cent in the final quarter of the year. That was below the 0.4 per cent growth of retail sales volumes in the quarter, which, in the absence of subsequent revisions, would suggest that consumer spending on services slowed by more than spending on goods. Such developments would be consistent with reports from the Bank of England's Regional Agents. Reported retail sales volume growth was firm in January 2008, although given the very large seasonal patterns in consumer spending around Christmas, these figures must be interpreted with caution.

B.67 With credit conditions facing households expected to remain restrictive through 2008, and despite strong employment growth in the final quarter of 2007, prospects for household consumption have moderated since the 2007 Pre-Budget Report. Growth is expected to moderate to 1¼ to 1¾ per cent in 2008, and to pick up gradually in 2009 and 2010 in the wake of the assumed normalisation of credit conditions from mid-2009. Household consumption growth is expected to remain slightly below whole economy GDP growth, as domestic demand further rebalances.

¹⁰In the National Accounts, private consumption comprises final consumption expenditure by households and non-profit institutions serving households (NPISH). Throughout this section, the terms 'household consumption' and 'private consumption' always refer to total final consumption expenditure by both households and NPISH.

Table B5: Household sector¹ expenditure and income

	Percentage change on a year earlier, unless otherwise stated			
	2007	Forecast		
		2008	2009	2010
Household consumption ¹	3¼	1¼ to 1¾	2 to 2½	2¼ to 2¾
Real household disposable income ²	1¼	1½ to 2	2 to 2½	2¼ to 2¾
Saving ratio ³ (level, per cent)	3	3½	3½	3¾

¹Including non-profit institutions serving households.

²Chained volume measures.

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

Saving ratio B.68 The household saving ratio is estimated to have averaged 3¼ per cent in the first half of 2007. As foreshadowed in the 2007 Pre-Budget Report, in the latest National Accounts release the ONS revised up estimates of the saving ratio in the first half of the year, from an average of 2½ per cent. The saving ratio is expected to average 3 per cent in 2007 as a whole and to firm over the forecast horizon, given the likely effect of tighter credit conditions on households' willingness and ability to borrow in the short term, and an expected rebuilding of balance sheets in the medium term.

Housing market B.69 Annual house price inflation has slowed, from above 10 per cent in August 2007 to around 2½ per cent in February 2008. This slowdown has come somewhat more quickly than would have been expected on the basis of past relationships with leading indicators such as mortgage approvals and the ratio of sales to the stock of available property reported by the Royal Institute of Chartered Surveyors. These leading indicators have continued to ease since the 2007 Pre-Budget Report, pointing to a period of sluggish or flat house price growth in 2008.

B.70 A feature of the disruption in financial markets has been the effective closure of the residential mortgage-backed securities market in the UK and a number of other advanced economies. This closure has put added strain on banks' funding positions, which appears to have exacerbated the tightening in credit conditions for secured lending to households, particularly from specialist lenders more reliant on securitised funding. This could affect house price inflation in coming months, and seems likely to reduce the volume of activity in property markets.

Box B7: Housing and private consumption in the UK

The relationship between house prices and consumer spending has been the subject of extensive debate and research. In the past, there has been a strong, positive co-movement between the two: increases in house prices tended to be associated with increases in consumption. A major challenge in economics is to distinguish causality from correlation. Do rising house prices *cause* strong consumption growth, or are both caused by common ‘third factors’, such as falling real interest rates or rising income expectations linked to labour market developments? And if there is a causal relationship, what is the mechanism that links the two?

On the question of causality, at the macroeconomic level, Case, Quigley and Schiller^a find evidence of a housing wealth effect without considering common factors, but Aron and Muellbauer^b conclude that “a substantial part of the earlier correlation [between house prices and consumption] was due to variation in common causal factors”. Using similar microeconomic data, Attanasio *et al*^c find that house prices play no independent role in explaining consumption, but Campbell and Cocco^d reach the opposite conclusion, that they play a large role.

On the question of the mechanism, there are two main channels that have been suggested as linking house prices to consumption. The most obvious is a pure wealth effect; as with any other asset, rising house prices may make households feel wealthier and therefore consume more. However, houses are different to other assets, such as shares, as they also provide a service that is consumed: as house prices rise, the extra wealth gained from the increase in the price of the asset is offset, at the aggregate level, by the increase in the cost of that service, accommodation. Rising house prices distribute wealth away from those who have limited housing assets and still have a lot of housing to consume over their lifetime (the young) to those who own a large amount of housing assets but have less housing services to consume (the old).

An alternative channel is through the collateral effect. As housing equity can be used as collateral to borrow against, a rise in house prices may allow previously credit-constrained households to borrow more and increase consumption. This channel has recently been explored in two working papers by Bank of England staff,^{e,f} both of which find some role for collateral in explaining the co-movement of house prices and consumption. However, with the level of housing equity currently very high, other things equal, a slowdown in house price growth would be unlikely to have a large impact on consumption through significantly increasing credit constraints.

If the historic co-movement between house prices and consumption primarily reflects common factors and collateral effects, then a slowdown in growth of house prices need not necessarily imply a slowdown in consumer spending. Moreover, strong recent labour market performance means that conditions are in place for house prices to slow without a significant negative impact on consumption. Nevertheless, there remains the risk that, combined with the broader tightening of credit conditions caused by the disruption in global financial markets, consumer spending could slow more than forecast.

^a Case, K., Quigley, J. and Schiller, R., *Comparing wealth effects: The stock market versus the housing market*, in *Advances in macroeconomics*, Volume 5, 2005.

^b Aron, J. and Muellbauer, J., *Housing wealth, credit conditions and consumption*, presented to the IMF, 2006.

^c Attanasio, O., Blow, L., Hamilton, R. and Leicester, A., *Booms and Busts: Consumption, house prices and expectations*, IFS working paper 05/24, 2005.

^d Campbell, J.Y. and Cocco, J.F., *How do house prices affect consumption? Evidence from micro data*. NBER Working paper 11534 (August), 2005.

^e Benito, A. and Mumtaz, H., *Consumption excess sensitivity, liquidity constraints and the collateral role of housing*. Bank of England Working paper no. 306, 2006.

^f Benito, A., *Housing equity as a buffer: Evidence from UK households*, Bank of England Working paper no. 324, 2007.

Companies and investment

B.71 Investment in physical assets, by affecting the amount of capital available to each worker, plays an important role in an economy's productivity performance through its influence on how much a unit of labour can produce. On conventional measures, as currently adopted by the ONS, business investment accounts for around 10 per cent of nominal GDP in the UK, but such measures may understate the true role of investment in the economy. As set out in a recent Treasury Economic Working Paper,¹¹ investment in intangible assets has been growing more rapidly than investment in physical assets, as the UK economy has become increasingly knowledge intensive.

Company finances B.72 Companies can finance investment internally, using the cashflow generated by their operations, or externally, through bank lending or by issuing equity or debt to investors. Since the 2007 Pre-Budget Report, gross operating surpluses in the corporate sector have continued to grow strongly, up 9 per cent on a year earlier in the fourth quarter of 2007. Analysts' earnings estimates for listed non-financial companies point to continued growth in 2008. This suggests internal sources of finance should remain supportive for business investment growth. By contrast, external financing conditions have deteriorated since the Pre-Budget Report. Equity prices are more than 10 per cent lower, while credit conditions have tightened, particularly for companies with lower credit ratings. Higher rated corporate bond yields have declined as government bond yields have fallen, although spreads have risen recently.

Table B6: Gross fixed capital formation

	Percentage change on a year earlier			
	2007	Forecast		
		2008	2009	2010
Whole economy ¹	5	1¾ to 2¼	2¾ to 3¼	3½ to 4
of which:				
Business ^{2,3}	6¾	1¾ to 2¼	3¼ to 3¾	3¾ to 4¼
Private dwellings ³	2	-¼ to ¼	1¼ to 1¾	2¾ to 3¼
General government ³	4	7	3½	5

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

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

³ Excludes purchases less sales of land and existing buildings.

Business investment B.73 Business investment growth remained strong through 2007, growing 6¾ per cent on a year earlier following 7 per cent growth in 2006. The latest data suggest business investment contracted slightly in the fourth quarter of 2007, although this weakness is not consistent with private business survey indicators, and estimates of business investment have historically been subject to significant revision. The price of investment goods relative to all other goods and services has continued to fall, which has allowed the volume of investment to rise as a share of total activity while the share of business investment in nominal spending, as currently measured, has remained broadly stable.

B.74 Recent profit growth has remained strong and surveys of investment intentions, though having eased, remain consistent with sustained growth. It is, however, likely that uncertainty over demand prospects and the potential impact of tighter credit conditions on the finances of some companies will cause business investment growth to slow more than forecast in the 2007 Pre-Budget Report. Due to the weakness of the current estimate of business investment growth in the final quarter of 2007, the Budget forecast shows a significant slowdown in annual business investment growth to 1¾ to 2¼ per cent in 2008. As credit conditions ease

¹¹ *Intangible investment and Britain's productivity: Treasury Economic Working Paper No. 1*, HM Treasury, October 2007.

and normalise during 2009, and uncertainty over demand recedes, business investment is forecast to pick up in 2009 and 2010.

Investment in dwellings **B.75** Private investment in dwellings, which comprises investment in new dwellings and improvements to existing dwellings, grew 8¾ per cent in 2006 and 5½ per cent on a year earlier in the first half of 2007. With activity in the housing market moderating, credit conditions remaining tight and households likely to reduce their overall net borrowing position in 2008, investment in dwellings is forecast to be flat compared with 2007. Growth is forecast to pick up in 2009 and 2010, supported by the Government's target for house building set out in the Green Paper *Homes for the future: more affordable, more sustainable*.¹²

Trade and the balance of payments

B.76 As noted in previous Budget and Pre-Budget Reports, annual growth in recorded exports and imports of goods and services has been distorted by activity related to missing-trader intra-community fraud (MTIC), which significantly inflated the value of measured goods trade in the first half of 2006. Since the second half of 2006, Government measures to tackle MTIC fraud have led to a sharp fall in estimated MTIC-related activity, to a low level. In view of the inevitable measurement difficulties involved in adjusting for MTIC-related activity, the ONS advises that comparisons of trade volumes and prices "should be treated with a great deal of caution".¹³ The economic forecast abstracts from MTIC effects by making the neutral assumption that the adjustment for MTIC-related activity remains constant throughout the forecast at the latest quarterly estimate, and that trade grows in line with underlying determinants. Table B7 presents export and import growth forecasts excluding the MTIC adjustment.

B.77 It is difficult to reconcile the trade data for 2006 and 2007 with the evidence from private business survey indicators and domestic demand growth in the UK's main trading partners. At present, measured growth of goods export volumes excluding the MTIC adjustment appears stronger in the first half of 2006, and much weaker in the second half of 2006 and first half of 2007, than other indicators suggest. The path of goods trade growth is also very different from that of services trade growth, again suggesting possible measurement difficulties in estimating underlying goods trade volumes. Net trade volume estimates are likely to be significantly more informative than the gross export and import estimates.

Exports of goods and services **B.78** Over the past decade, in common with other G7 countries, the UK's share of world goods trade has fallen as fast-growing emerging markets have become increasingly integrated into the world trading system. However, the UK's comparative advantage in a range of financial and business services has meant that it is the only G7 country to have achieved a rising share of global trade in services.

B.79 Growth in the measured volume of goods and services exports, excluding the MTIC adjustment, is estimated to have eased from 7¾ per cent in 2006 to just ½ a per cent in 2007. Services exports continued to perform strongly in 2006 and 2007, with growth estimated to have picked up from 6¾ per cent in 2006 to 8 per cent in 2007, while goods exports, excluding the MTIC adjustment, are estimated to have grown 8½ per cent in 2006, but contracted 3¾ per cent in 2007. Export volume growth is estimated to have been stronger in the second half of 2007 than the first.

B.80 In view of the forecast slowdown in UK export markets growth in 2008, underlying growth of export volumes is likely to be below the 4¾ per cent average between 2003 and 2007, though sterling has depreciated by 7 per cent since the 2007 Pre-Budget Report, and measured

¹²*Homes for the future: more affordable, more sustainable*, Communities and Local Government, July 2007.

¹³*UK trade December 2007: First release*, ONS, February 2008.

export growth picked up in the second half of 2007. Reflecting this combination of factors, the volume of goods and services exports is forecast to grow $3\frac{1}{4}$ to $3\frac{3}{4}$ per cent in 2008 and to strengthen further in 2009 and 2010 as demand growth in the UK's largest trading partners, the euro area and US, recovers. However, the data uncertainties compound the difficulties of judging prospects for measured export volumes.

Imports of goods and services B.81 The volume of imports of goods and services, excluding the MTIC adjustment, is estimated to have grown $2\frac{1}{2}$ per cent in 2007, having slowed from 7 per cent in 2006. Slower growth of total goods and services imports in 2007 comprises a modest slowdown in growth of services imports and a larger slowdown in growth of goods imports excluding the MTIC adjustment.

B.82 With slower domestic demand growth in the UK, combined with the expected impact of weaker sterling on import prices, the volume of goods and services imports is forecast to grow by 2 to $2\frac{1}{2}$ per cent in 2008. Import growth is forecast to pick up in 2009 and 2010 in line with the forecast for domestic demand growth. As a result of import growth being forecast to slow a little, and export growth to pick up, net trade is expected to contribute a $\frac{1}{4}$ percentage point to GDP growth in 2008 and 2009, as shown in Table B4.

Table B7: Trade in goods and services

	Percentage change on a year earlier					£ billion Goods and services balance
	Volumes (MTIC-adjusted) ¹		Prices ²		Terms of trade ³	
	Exports	Imports	Exports	Imports		
2007	$\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{4}$	$\frac{3}{4}$	$1\frac{1}{4}$	$-48\frac{3}{4}$
<i>Forecast</i>						
2008	$3\frac{1}{4}$ to $3\frac{3}{4}$	2 to $2\frac{1}{2}$	$2\frac{1}{2}$	3	$-\frac{1}{2}$	$-48\frac{3}{4}$
2009	5 to $5\frac{1}{2}$	$3\frac{3}{4}$ to $4\frac{1}{4}$	$1\frac{1}{2}$	2	$-\frac{3}{4}$	$-49\frac{3}{4}$
2010	5 to $5\frac{1}{2}$	4 to $4\frac{1}{2}$	$2\frac{1}{4}$	$2\frac{1}{4}$	0	-50

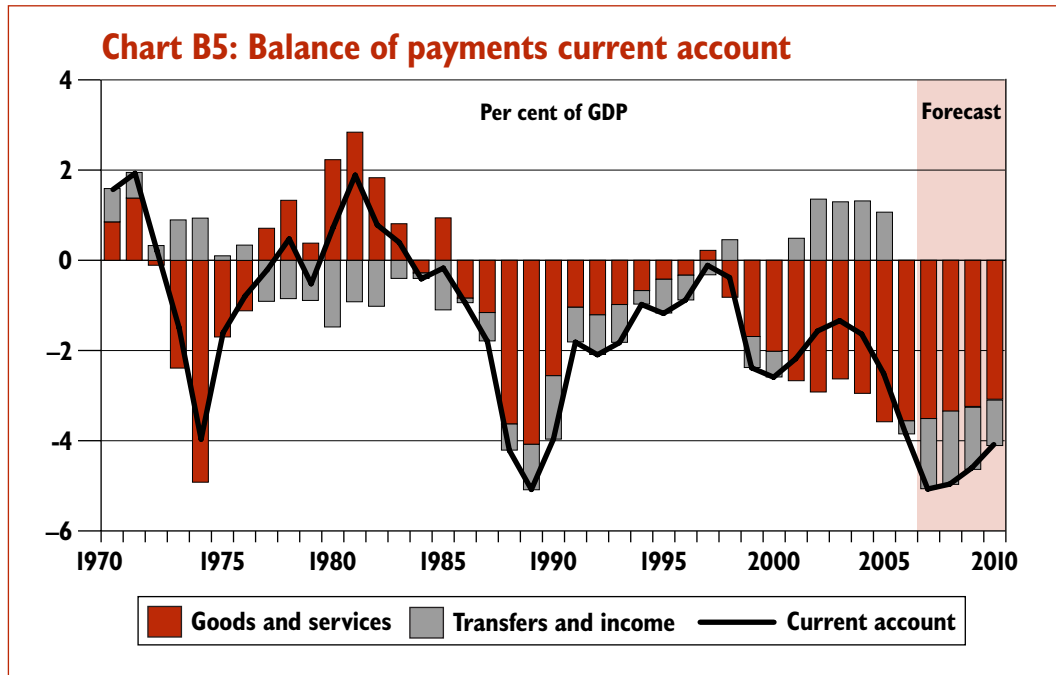
¹ Table B9 contains figures without the MTIC adjustment. The forecast is based on the neutral assumption that the level of the MTIC adjustment stays flat at the latest quarterly estimate throughout the forecast.

² Average value indices.

³ Ratio of export to import prices.

Current account balance B.83 Data for the current account are typically subject to significant revisions, and data at this time are more than usually uncertain. The deficit on trade in goods is estimated to have increased from 6 per cent of GDP in 2006 to $6\frac{1}{4}$ per cent in 2007, while the estimated surplus on trade in services increased from $2\frac{1}{2}$ per cent of GDP in 2006 to $2\frac{3}{4}$ per cent in 2007, reflecting continued strong growth in exports of financial services. The balance of trade in goods and services therefore had little impact on changes in the UK's current account deficit between 2006 and 2007. However, significant revisions to estimates of investment income flows, described in Box B8, mean that the UK current account deficit was estimated to have increased from $3\frac{3}{4}$ per cent of GDP in 2006 to an average of 5 per cent in the first three quarters of 2007.

B.84 The balance of domestic demand growth in the UK and overseas should begin to reduce the trade deficit as a percentage of GDP through 2008, while the recent depreciation of sterling should have a substantial positive impact on the sterling value of the UK's overseas assets and subsequently on the income earned from those assets. Conditioned on the data uncertainties already set out, the UK's current account deficit is expected to remain at 5 per cent of GDP in 2008 and to decline in 2009 and 2010. External forecasters on average expect the UK current account deficit to narrow in 2008 and again in 2009.



Foreign direct investment

B.85 The UK continued to attract large flows in inward foreign direct investment (FDI) in 2007, amounting to over £68 billion in the first three quarters of the year. That followed more than £80 billion in 2006 and almost £100 billion in 2005, and continues the trend of the UK being the top European recipient of inward FDI, and second in the world after the US. The stock of inward FDI in the UK, equivalent to around 46 per cent of GDP, is considerably higher than in other major advanced economies. The UN Conference on Trade and Development's 2007 World Investment Report¹⁴ shows the stock of inward FDI to be 35 per cent of GDP in France, 17½ per cent in Germany and 13½ per cent in the US. In absolute terms, the UK is host to the second largest stock of FDI in the world after the US.

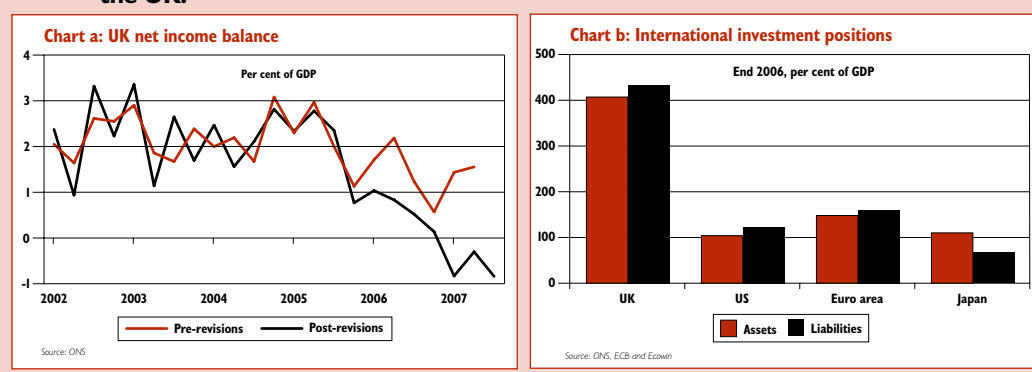
¹⁴ World Investment Report 2007 - Transnational Corporations, Extractive Industries and development, UNCTAD, October 2007.

Box B8: The current account and investment income balances

Data for the current account are typically subject to significant revision. Since the 2007 Pre-Budget Report, the ONS has incorporated new annual Foreign Direct Investment survey results into the balance of payments statistics. This led to larger than usual revisions to the UK's investment income balance, which is now estimated to have moved into deficit during 2007 (chart a). The revisions reduced income by £10¼ billion in 2006 and £12¼ billion in the first half of 2007, more than accounting for the revision to the 2006 current account deficit from 3½ to 4 per cent of GDP.

As the world's leading centre for cross-border financial intermediation, the UK's external assets and liabilities as a percent of GDP are much larger than in other advanced economies (chart b). Consequently, small changes in the structure or valuation of assets and liabilities, or rates of return, can cause relatively large changes in estimated net investment income flows. Both factors have featured over the past two years:

- sterling appreciation in 2006 and early 2007 increased the sterling value of UK liabilities more than UK assets because a greater proportion of assets are denominated in foreign currencies, thus also reducing the sterling value of income received from abroad; and
- changes in the implied rates of return on FDI assets and liabilities, and in the large stocks of other investment, chiefly bank deposits, reduced the net income flow to the UK.

**Service sector output**

B.86 The share of UK output accounted for by the service sector has risen steadily, reaching 75 per cent in 2006, up around 20 percentage points over the past three decades. Financial sector output, as currently measured, accounts for around 9½ per cent of total output and business services another 25 per cent. As explored in *The UK economy: analysis of long-term performance and strategic challenges*, published alongside Budget 2008, the service sector's share of output and exports is higher in the UK, and has risen more over the past decade, than in most other G7 economies. As already noted, the UK economy's flexible response to the challenges and opportunities of globalisation mean that it is the only G7 country that has achieved a rising share of global trade in services.

B.87 Service sector output grew 3¾ per cent in 2007. Within that, the finance and business services sector was particularly strong, growing 4¾ per cent, accounting for around half of measured whole economy output growth in 2007. Box B9 discusses the possible implications of the ongoing disruption in global financial markets for the UK's financial sector.

B.88 In line with growth prospects more generally, but given specific factors likely to impact more heavily on the financial sector, service sector growth is likely to moderate in 2008. The most recent private business survey indicators suggest that the extent of the moderation has

so far been limited, with the February 2008 indicators released by the Chartered Institute of Purchasing and Supply increasing to a 5-month high, and the report noting a pick-up in confidence in the financial sector. Looking further ahead, the UK financial sector's track record of rebounding vigorously from previous shocks suggests that service sector growth should recover relatively quickly as financial market conditions normalise.

Box B9: Financial sector performance

In recent years, financial intermediation has been one of the most rapidly growing sectors of the UK economy. International comparisons show the UK's financial sector to account for a significantly larger share of output than Germany's, France's or Italy's, and a similar share as the US. In 2006, financial services exports accounted for 22½ per cent of the UK's services exports, compared with 10½ per cent in the US and 6 per cent in the euro area.

The relative size of the UK's financial sector presents a risk to the growth outlook during a period of disruption in global financial markets. Quarterly growth of financial intermediation output averaged 3½ per cent in the first three quarters of 2007, before slowing to 1¼ per cent in the final quarter. As outlined in Box B4, the sector has proved quick to recover from a number of financial market shocks over the past decade.

Services that banks and other financial institutions charge for directly (such as the provision of insurance products) can be measured, but much of their economic activity involves using their own balance sheets to intermediate or manage risk for the non-financial sector. Measuring such activity with conventional National Accounts concepts can be difficult, particularly when financial instruments are constantly evolving. Moreover, under internationally-agreed National Accounts principles, much of this is measured indirectly via the spread earned between deposit and lending rates, known as Financial Intermediation Services Indirectly Measured (FISIM). At present, FISIM is treated as intermediate consumption in the UK's National Accounts, and is therefore stripped out of whole economy gross value added (GVA). Having delayed implementation to ensure data quality, ONS intend that from Blue Book 2008 FISIM consumed by firms will be counted as intermediate consumption of the relevant industrial sector, while that part attributed to final consumption of households, or to exports, will score in whole economy GVA. The ONS estimate that the revised treatment of FISIM will increase the value of measured whole economy output by an average of around 1½ per cent over 1993 to 2004, though the precise effect, particularly on estimates of recent output volume growth, will not be clear until the new methodology has been fully implemented.

Given current FISIM methodology, and the difficulties of measuring the output of such a rapidly evolving sector, it is possible that measured GVA growth might not fully capture changes in activity associated with financial markets.

Manufacturing and North Sea output

Manufacturing B.89 Manufacturing accounts for around 13 per cent of total UK output. The sector grew ½ a per cent on a year earlier in 2007, which was somewhat below the rate consistent with evidence from a range of private sector business surveys. Output of the capital and intermediate goods sectors increased most strongly. The recent depreciation of sterling should provide some support to manufacturing growth during 2008, although that will be set against weaker growth prospects in the UK's main trading partners. Manufacturing is forecast to grow ¾ to 1¼ per cent in 2008, picking up to in 2009 on the back of stronger export growth.

North Sea B.90 Output from the North Sea oil and gas sector fell by 25 per cent over the three years to 2006, reflecting a series of temporary disruptions exacerbating the underlying decline in North Sea output. Despite the Buzzard field beginning production in 2007, North Sea output fell 2¼

per cent on a year earlier. Over the forecast horizon North Sea output is expected to continue its long-run trend decline, falling by over 5 per cent a year on average.

Independent forecasts

B.91 Since the 2007 Pre-Budget Report, the average of independent forecasts for GDP growth in 2008 has been revised down from 2.0 to 1.7 per cent, consistent with the lower end of the Budget 2008 forecast range. The lower average independent forecast reflects downward revisions to components of domestic demand growth, with the contribution from net trade revised marginally higher. The average independent GDP growth forecast for 2009 stands at 1.9 per cent, below the Budget 2008 forecast range. With forecasters on average expecting oil prices to remain above \$80 a barrel in both 2008 and 2009, the average forecast for CPI inflation in the final quarter of 2008 is 2.4 per cent, in line with the Budget 2008 forecast. Independent forecasters expect inflation to return to target in 2009.

B.92 Treasury forecasts for GDP growth since 1997 have, on average, exhibited smaller forecast errors than the independent consensus. Judged using this metric, Treasury forecasts continue to compare well against a sample of forecasters that includes leading international organisations (IMF, OECD, EC), research institutes (Oxford Economics, NIESR) and private sector forecasters (Goldman Sachs, HSBC, JP Morgan).

Table B8: Budget and independent¹ forecasts

	Percentage change on a year earlier, unless otherwise stated					
	2008			2009		
	Budget 2008	Independent		Budget 2008	Independent	
		Average	Range		Average	Range
GDP growth	1¾ to 2¼	1.7	-0.1 to 2.1	2¼ to 2¾	1.9	-1.3 to 2.7
CPI (Q4)	2½	2.4	1.9 to 3.0	2	2.0	1.3 to 3.3
Current account (£ billion)	-72½	-59.1	-88.0 to -40.2	-71	-53.5	-90.7 to -35.0

¹ Forecasts for the UK economy: A comparison of independent forecasts', March 2008, compiled by HM Treasury.

FORECAST ISSUES AND RISKS

B.93 All economic forecasting judgements are subject to uncertainty, not least because of the wide range of factors that can influence developments in the income and spending of households and companies in the UK and overseas. The Budget 2008 economic forecast is made against a backdrop of exceptional uncertainty related to the duration, intensity and broader effects of the ongoing disruption in global financial markets. There are clear risks to the forecast from the feed-through from these developments to credit conditions facing households and companies.

Global financial markets B.94 The Budget forecast is conditioned on the assumption that the disruption in financial markets will start to ease during the second half of 2008 and that credit market functions will normalise by mid-2009. The Budget forecast is not dependent on a rapid return to normality, so conditions could improve more quickly than assumed.

Global economy B.95 While the impact of tighter credit conditions represents a risk to growth in all economies, that risk is clearly greater in the US, where falling house prices have exacerbated the difficulties in reaching market-clearing prices for financial market instruments backed by real estate assets. These downside risks to US growth are offset by the upside risk that the significant monetary and fiscal policy response could provide a greater stimulus to confidence and activity than expected. Significant policy easing, coinciding with further dollar depreciation, does, however, present possible upside risks to inflation. Growth in the euro

area could also exceed current expectations, with the latest private sector business surveys picking up a little in some countries, and labour markets providing support to consumption.

B.96 The extent to which domestic demand in emerging markets can make up for weaker external demand from advanced economies presents a clear risk to world output growth and particularly to world trade growth. Macroeconomic fundamentals in many emerging markets have improved significantly, which, coupled with the momentum from strong growth in 2007, could result in emerging market activity exceeding expectations, as it has repeatedly in recent years. With emerging markets accounting for a smaller proportion of UK export markets than of world trade or output, the impact on UK demand of slower than expected growth in emerging markets should be relatively limited.

Free trade and global imbalances

B.97 Risks to the multilateral trading system remain, especially from the proliferation of bilateral and regional trade agreements and, increasingly, from protectionist trade policies. A firm stance against protectionism can help to ensure that trade continues to improve living standards across advanced and emerging economies.

B.98 While the US current account deficit has started to decline, this has not yet been accompanied by a reduction of the large surpluses of some Asian countries. There remains a risk of disorderly unwinding of global imbalances, with the economic costs such a process would entail. To reduce this risk it is important that major world economies allow a continued rebalancing of demand and flexibility in their exchange rates.

UK growth prospects

B.99 For the UK economy, there are clear downside risks to growth if credit conditions were to deteriorate further, raising the price of and limiting access to finance for companies and households by more or for longer than has been assumed. There are upside risks from the weaker exchange rate providing support for export growth, and from the strength of the labour market, which could support income growth and consumer spending by more than has been assumed. Recent private business survey indicators suggest that the economy may have carried more momentum into 2008 than the forecast assumes, which presents a further upside risk to the near-term growth forecast.

B.100 In real time, it is extremely difficult to tell the extent to which the financial market shock will prove to have temporary or more persistent effects, so developments in the price of credit could conceivably have implications for the medium-term supply potential of the economy. If the price were to settle at a new equilibrium significantly higher than that prevailing over recent years, for example as a result of higher pricing of risk reflecting greater risk aversion, it could detract from the average rate of output growth over the medium term by raising the costs of supply. Uncertainty over the extent to which the shock to global credit conditions represents a shock to demand and/or supply will not be resolved for some time.

Supply-side performance

B.101 Over the past decade, the flexibility of UK product and labour markets, supported by sound macroeconomic policy, has delivered strong growth and low inflation. Output per hour productivity growth has averaged 2.4 per cent a year since 1997, compared with 1.9 per cent in the previous two economic cycles. This improved supply-side performance has been achieved despite sterling oil prices rising over four-fold since the late 1990s. Further improvement would be consistent with a GDP growth forecast towards the top of the Budget 2008 forecast range.

UK property markets

B.102 Since the 2007 Pre-Budget Report, commercial property prices in the UK have fallen, annual house price inflation has slowed and the volume of property transactions has declined. While this is expected to impact directly on residential investment and the approximately one-third of business investment that comprises buildings and structures, further unanticipated adjustment in the commercial or residential property markets could

present risks to the forecasts for business investment or private consumption through effects on confidence or the value of collateral.

UK inflation B.103 There are short-term upside risks to inflation from rising wholesale agricultural and energy prices, although in the event of global demand easing by more than expected, this risk could be reversed. The extent to which the monetary policy easing undertaken so far, and further easing expected by financial markets, feeds through to mortgage rates presents a key uncertainty for RPI inflation prospects.

B.104 Recent survey measures of inflation expectations have risen following the period of above-target inflation earlier in 2007. With CPI inflation expected to rise again in the near term, there is a risk that higher inflation expectations could feed through to second-round effects on wage settlements and earnings growth, though there has been no evidence of that as yet, with underlying earnings growth remaining stable and subdued.

Table B9: Summary of economic prospects¹

	Percentage change on a year earlier, unless otherwise stated					
	2007	Forecast ^{2,3,4}			Average errors from past forecasts ⁵	
		2008	2009	2010	2008	2009
Output at constant market prices						
Gross domestic product (GDP)	3	1¾ to 2¼	2¼ to 2¾	2½ to 3	¾	½
Manufacturing output	½	¾ to 1¼	1¾ to 2¼	1¾ to 2¼	1¼	1¾
Expenditure components of GDP at constant market prices⁶						
Domestic demand	3¾	1½ to 1¾	2 to 2½	2½ to 3	¾	¾
Household consumption ⁷	3¼	1¼ to 1¾	2 to 2½	2¼ to 2¾	½	1
General government consumption	2	2¼	2	2	¾	¾
Fixed investment	5	1¾ to 2¼	2¾ to 3¼	3½ to 4	3	2¼
Change in inventories ⁸	½	0	0	0	¼	¼
Exports of goods and services ⁹	-5½	3¼ to 3½	5 to 5½	5 to 5½	2½	4
Imports of goods and services ⁹	-3¼	2 to 2¼	3¾ to 4¼	4 to 4½	3	3
Exports of goods and services (excluding MTIC)	½	3¼ to 3¾	5 to 5½	5 to 5½	-	-
Imports of goods and services (excluding MTIC)	2½	2 to 2½	3¾ to 4¼	4 to 4½	-	-
Balance of payments current account						
£ billion	-70¼	-72½	-71	-66¼	13	14¾
Per cent of GDP	-5	-5	-4½	-4	1	1
Inflation						
CPI (Q4)	2	2½	2	2	¼	½
Producer output prices (Q4) ¹⁰	4¾	2¾	2	2	1¼	1½
GDP deflator at market prices	3	3¼	2¾	2¾	½	½
Money GDP at market prices						
£ billion	1385	1457 to 1461	1531 to 1543	1611 to 1632	11¼	8
Percentage change	6¼	5¼ to 5½	5 to 5½	5¼ to 5¾	¾	½

¹ The forecast is consistent with the income, output and expenditure data for the fourth quarter of 2007, released by the Office for National Statistics on 27 February 2008. See also footnote 1 on the second page of this chapter.

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

³ As in previous Budget and Pre-Budget Reports, the economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral assumption for the trend rate of output growth of 2¾ per cent. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of trend growth used as the basis for projecting the public finances, which is a ¼ percentage point below the neutral assumption.

⁴ The size of the growth ranges for GDP components may differ from those for total GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.

⁵ Average absolute errors for current year and year-ahead projections made in spring forecasts over the past 10 years. The average errors for the current account are calculated as a per cent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2008.

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

⁷ Includes households and non-profit institutions serving households.

⁸ Contribution to GDP growth, percentage points.

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

¹⁰ Excluding excise duties.

Table B10: Gross domestic product and its components

£ billion chained volume measures at market prices, seasonally adjusted										
	Household consumption ¹	General government consumption	Fixed investment	Change in inventories	Domestic demand ²	Exports of goods and services	Total final expenditure	Less imports of goods and services	Plus statistical discrepancy ³	GDP at market prices
2007	800.4	255.8	227.4	6.5	1290.6	339.8	1630.4	382.9	0.3	1247.9
2008	811.1 to 813.6	261.8	231.5 to 232.2	5.8 to 6.6	1310.3 to 1314.3	350.9 to 352.0	1661.1 to 1666.2	390.7 to 391.9	0.2	1270.6 to 1274.5
2009	828.1 to 834.7	267.0	237.6 to 239.5	4.3 to 6.5	1337.0 to 1347.6	368.2 to 371.1	1705.2 to 1718.7	405.4 to 408.6	0.2	1300.0 to 1310.4
2010	847.4 to 858.3	272.3	245.7 to 248.9	3.3 to 6.9	1368.8 to 1386.5	386.1 to 391.1	1755.0 to 1777.6	421.8 to 427.3	0.2	1333.3 to 1350.5
2007 1st half	397.4	127.4	113.2	0.6	639.0	168.8	807.9	188.6	0.2	619.5
2nd half	402.9	128.4	114.2	5.9	651.5	171.0	822.6	194.3	0.1	628.4
2008 1st half	404.3 to 405.1	130.1	115.2 to 115.4	4.1 to 4.4	653.8 to 655.0	173.4 to 173.7	827.3 to 828.8	194.5 to 194.9	0.1	632.8 to 634.0
2nd half	406.8 to 408.5	131.7	116.3 to 116.8	1.7 to 2.2	656.4 to 659.2	177.4 to 178.2	833.9 to 837.4	196.2 to 197.0	0.1	637.8 to 640.5
2009 1st half	411.3 to 414.1	132.9	117.9 to 118.7	2.1 to 3.0	664.2 to 668.7	181.8 to 183.0	846.0 to 851.7	200.2 to 201.6	0.1	645.9 to 650.2
2nd half	416.7 to 420.6	134.1	119.8 to 120.8	2.2 to 3.5	672.8 to 679.0	186.4 to 188.1	859.2 to 867.0	205.1 to 207.0	0.1	654.1 to 660.1
2010 1st half	421.6 to 426.5	135.4	121.8 to 123.2	1.7 to 3.3	680.6 to 688.5	190.9 to 193.1	871.4 to 881.5	209.1 to 211.5	0.1	662.5 to 670.2
2nd half	425.8 to 431.8	136.9	124.0 to 125.7	1.6 to 3.5	688.3 to 698.0	195.3 to 198.0	883.6 to 896.0	212.8 to 215.8	0.1	670.9 to 680.3
Percentage change on a year earlier ^{4,5}										
2007	3/4	2	5	1/2	3/4	-5/2	1/2	-3/4	0	3
2008	1/4 to 1/4	2/4	1/4 to 2/4	0	1/2 to 1/4	3/4 to 3/2	2 to 2/4	2 to 2/4	0	1/4 to 2/4
2009	2 to 2/2	2	2/4 to 3/4	0	2 to 2/2	5 to 5/2	2/4 to 3/4	3/4 to 4/4	0	2/4 to 2/4
2010	2/4 to 2/4	2	3/2 to 4	0	2/2 to 3	5 to 5/2	3 to 3/2	4 to 4/2	0	2/2 to 3

¹ Includes households and non-profit institutions serving households.

² Also includes acquisitions less disposals of valuables.

³ Expenditure adjustment.

⁴ For change in inventories and the statistical discrepancy, changes are expressed as a per cent of GDP.

⁵ Growth ranges for GDP components do not necessarily sum to the 1/2 percentage point ranges for GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.

