

World growth in 2004 was at its strongest for nearly three decades and remains robust, although G7 growth has moderated slightly since the 2004 Pre-Budget Report, principally because of weaker than expected growth in the euro area and Japan. However, US growth remains strong and emerging markets, especially China, continue to grow at a rapid pace.

UK GDP expanded by over 3 per cent in 2004, above its assumed trend rate and the fastest for four years, despite growth dipping to slightly below its trend rate during the third quarter of the year. Growth has already become more balanced. With businesses more confident about global economic conditions, investment accelerated further in 2004, having already picked up in 2003. There are also increasing signs of stronger external demand translating into more robust UK export growth. At the same time, private consumption continues to grow at sustainable rates.

With world growth maintaining much of its recent momentum and UK business and consumer confidence having strengthened in recent months, both external and domestic demand are forecast to continue growing robustly in the short term. The UK economy is judged still to be carrying a modest degree of slack, allowing further growth at above trend rates in 2005 without generating domestic inflationary pressures. However, growth is expected gradually to ease back to trend rates around the end of 2005 as the output gap closes and the economic cycle ends. The Budget forecast is broadly the same as that in the 2004 Pre-Budget Report:

- GDP is expected to grow by 3 to 3½ per cent in 2005, with renewed growth at just above trend rates for much of the year, and 2½ to 3 per cent in 2006; and
- Consumer Prices Index (CPI) inflation is expected to rise gradually back to its 2 per cent target by mid-2006 under upward pressure from import prices, and helped by monetary policy anchoring inflation expectations.

Global risks will continue to have a key bearing on UK economic prospects, and challenging judgements will continue to be faced in setting monetary and fiscal policy.

INTRODUCTION^{1,2}

BI This chapter discusses recent economic developments and provides updated forecasts for the UK and world economies in the period to 2007. It begins with an overview of developments and prospects in the world economy. It then outlines the Government's latest assessment of the UK economy, followed by a more detailed discussion of sectoral issues and risks.

¹The UK forecast is consistent with output, income and expenditure data to the fourth quarter of 2004 released by the Office for National Statistics (ONS) on 25 February 2005. This release also contained revisions to earlier quarters of 2004 which the Treasury has carried through to certain other national accounts series that the ONS have not yet revised, in particular sectoral saving and borrowing. A fully consistent national accounts dataset for 2004 will be published by the ONS on 23 March. A detailed set of charts and tables relating to the economic forecast is available on the Treasury's internet site (<http://www.hm-treasury.gov.uk>) and copies can be obtained on request from the Treasury's Public Enquiry Unit (020 7270 4558).

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

THE WORLD ECONOMY

Overview

B2 World output growth in 2004 is estimated at around 5 per cent, the strongest rate for three decades and around twice the rate at its latest trough in 2001. The pick-up in world economic growth during 2003 and 2004 was the result of improved economic developments in most advanced economies as well as a number of major emerging economies.

B3 G7 GDP is estimated to have increased by $3\frac{1}{4}$ per cent in 2004, principally driven by the US. Euro area growth weakened in the second half of 2004, after an encouraging start to the year, but growth is expected to pick up again in 2005, moving back towards trend rates by 2006. Japan's growth was revised down significantly in late 2004, as a result of improved national accounting methodology, and the latest data indicate that the economy slipped back into a mild recession in the middle of 2004. Weaker growth in the euro area and Japan towards the end of last year feeds through into the 2005 G7 projection, resulting in a moderation of growth to $2\frac{1}{2}$ per cent, but growth is expected to improve a little in these economies in 2006, and will be reinforced by ongoing solid growth in the US, the UK and Canada.

Table B1: The world economy

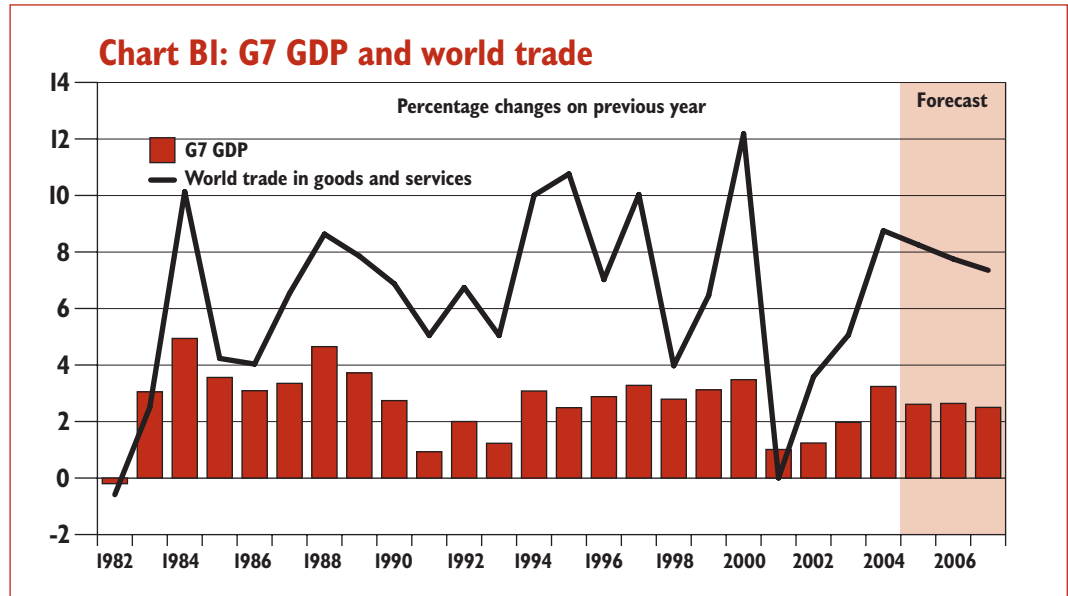
	Percentage changes on a year earlier unless otherwise stated			
	2004	Forecast		
		2005	2006	2007
<i>Major 7 countries¹</i>				
Real GDP	$3\frac{1}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$
Consumer price inflation ²	$2\frac{1}{2}$	$2\frac{1}{4}$	$1\frac{3}{4}$	$1\frac{3}{4}$
<i>Euro area</i>				
Real GDP	$1\frac{3}{4}$	$1\frac{1}{2}$	$2\frac{1}{4}$	$2\frac{1}{4}$
World trade in goods and services	$8\frac{3}{4}$	$8\frac{1}{4}$	$7\frac{3}{4}$	$7\frac{1}{4}$
UK export markets ³	$7\frac{1}{2}$	$7\frac{1}{2}$	7	$6\frac{3}{4}$

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

² Per cent, Q4.

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

B4 There has been a marked contrast in the growth profiles of advanced economies. Some countries, such as the US, the UK and to a lesser extent Canada, have experienced strong domestic demand associated with rising household wealth, while others, such as Japan and Germany, have had more dependence on exports, with a correspondingly higher exposure to external factors and exchange rate fluctuations. Growth in the former group has tended to be the stronger of the two.



B5 The strength of world output growth, together with increasing regional integration, particularly in Asia, buoyed the rate of world trade growth to around 8¼ per cent in 2004, significantly stronger than in recent years, but below the 30-year high reached in 2000. UK export markets expanded at slightly slower rates than world trade in 2004 because of weaker growth in the euro area, the UK's biggest export market. Growth for the euro area as a whole has been export orientated, with domestic demand remaining relatively subdued.

B6 Global economic growth has remained resilient despite high and volatile oil prices. This is because oil price rises have largely reflected strong demand for oil, particularly from China and other rapidly expanding emerging economies, rather than the predominantly supply-side influences that have driven previous episodes of high prices. In addition, energy intensity in the advanced economies has been in long-term decline. Nevertheless, the tight market for oil has resulted in prices being more sensitive to perceived supply risks, low stocks and capacity constraints. Prices rose rapidly from early 2004 and peaked in October at new record nominal highs. Prices have fluctuated since then, but recently reached another historical high in nominal terms.

B7 Non-fuel commodity prices also rose sharply during 2004 due to stronger than expected demand, but became more stable in the latter stages of 2004. Price increases were particularly strong for metals and other industrial inputs, due to the rapid expansion in China, India and other Asian emerging markets, on top of strong growth in some advanced economies.

B8 Despite declining spare capacity and the rise in commodity prices feeding through to headline rates of inflation in advanced economies, core inflation has remained relatively stable, allowing monetary tightening to be gradual, principally in the US, but also in the UK, Canada and some other advanced economies. Consequently, financing conditions continue to be supportive of growth.

B9 On balance there has been a reduction in the risks surrounding the forecast since the Pre-Budget Report. The risks to the global outlook of higher oil prices have diminished since the time of the Pre-Budget Report given the robustness of growth in face of high prices in 2004, with increasing recognition that high oil prices have been driven primarily by strong demand. The risks relating to exchange rates and a disorderly adjustment to the world's current account imbalances remain unchanged since the Pre-Budget Report. In the medium term, structural reform would help to rebalance growth and facilitate the unwinding of imbalances.

G7 activity

B10 Following the sharp downturn of the preceding two years or so, momentum in the G7 economies built during 2003 and 2004, with GDP growth rising to 3³/₄ per cent last year, but is expected gradually to moderate towards 2¹/₂ per cent going forward. The recovery was led by robust growth in the US, Canada and the UK. There was also a relatively solid contribution to growth from Japan in 2004 as a whole and some improvement in the euro area, although growth in these countries remains low relative to that of many other advanced economies, and Japan, Germany and Italy all saw output fall at stages during the second half of 2004. Domestic demand has been important in driving growth of the US, UK and to a lesser extent Canada, while export growth has been more dominant in Japan and Germany. French growth has been more consumption orientated than the other major euro area economies.

United States B11 The US recovery gained considerable pace during 2003 and 2004 after weak growth in 2001, when the US was hit by accounting scandals, equity price declines and the terrorist attacks of 11 September. The recovery has been predominantly consumption led, with increases in household wealth, low interest rates and tax cuts boosting consumption. Over the past two years, corporate profits have risen to historic highs, and this is now feeding through to strong business investment, which is also supporting GDP growth. The depreciation of the US dollar should begin to be reflected in some recovery in export growth going forward. However, the strength of consumption has led to rising imports and expanding trade and current account deficits. Consequently, net imports have been an increasing drag on GDP growth, and are expected to remain so in the short to medium term.

B12 Productivity growth has been particularly strong over the past three years, rising from around 2¹/₂ per cent in the late 1990s to around 4¹/₄ per cent over the past two years. While this has boosted growth and profit margins, it has been accompanied by relatively subdued employment and aggregate wage growth. Productivity growth is expected to remain solid, but at a slower rate of around 2¹/₂ per cent, with firmer growth in employment and wages. In addition, the household saving ratio is not expected to rise significantly, with household wealth remaining relatively stable. These factors should ensure private consumption remains buoyant.

Euro area B13 The euro area grew at a modest pace in 2004, below the rates achieved by the G7 and other advanced economies although stronger than in recent years. After strong growth in the first half of 2004, momentum faded as the year progressed. This deceleration reflected continued weakness in private consumption and less buoyant net exports, in contrast to the first half of the year which was driven by a strong contribution from external demand. There were considerable variations across Member States. In France and Spain, robust growth was supported by strength in private consumption, while in Germany weak domestic demand growth contrasted with significant net export growth. Looking forward, external demand growth, although moderating, should continue to support activity in the euro area before a more widespread revival in investment and consumption materialises.

Japan B14 In late 2004, Japan moved from a fixed-base to a chain-linked national accounting system, which led to revisions to GDP growth, mainly downward, back to 1995. The revisions were particularly marked in 2003 and 2004, and for some quarters led to negative growth estimates. Despite a particularly strong performance in the first quarter of last year, when annualised growth rose to 6 per cent, its fastest in over a decade, latest estimates show Japan was in mild recession through the middle of 2004, with output contracting by a cumulative ¹/₂ per cent, which impacts on the 2005 growth forecast.

BI5 However, while these revisions have lowered estimated GDP growth, they have not had a significant effect on the underlying composition, with net exports and business investment still shown to have underpinned the recent recovery in growth, while private consumption has remained weak. Moreover, despite the downward revisions, Japan's growth has still shown improvement over the past two years, compared with the 1990s and earlier this decade. Short-term indicators in early 2005 also point to some improvement compared with much of last year, including strong export growth to China continuing to support growth, corporate profitability continuing to rise and labour markets showing further modest improvement.

Emerging markets and developing economies

BI6 Emerging market economies continued to register high rates of growth in 2004. In particular, Asian and Latin American economies benefited from buoyant US consumption, which drove demand for their exports. In some countries this generated a knock-on stimulus to domestic demand. Strong activity in Asia has been underpinned by continued rapid growth in China, which grew by an estimated 9½ per cent in 2004. Asian prospects continue to depend, in part, on the Chinese authorities' ability to moderate overheating in certain sectors of the economy, although fears of a hard-landing have receded in recent months. India's growth, at around 6½ per cent in 2004, has been driven by expansion in the manufacturing and services sectors. Growth in the Middle East and Former Soviet Union has remained robust on the back of high oil prices. Similarly, growth in Latin America has been supported by increases in commodity prices.

BI7 The external financing environment for emerging markets remains generally very favourable, with bond spreads at near record lows. This is thought to reflect considerable liquidity in this asset class plus a general improvement in the structure of emerging market debt. Furthermore, high levels of foreign exchange reserves among many Asian countries reduces their external vulnerability. In mid-2004, uncertainties relating to the expected pace of monetary tightening in the US briefly caused bond spreads to widen, but as concerns about a more rapid adjustment receded spreads returned to historically low levels. Nevertheless, it is possible that financing conditions could deteriorate going forward if equity markets and bond spreads are unsettled by a potentially more rapid or disorderly adjustment of exchange rates.

World trade

BI8 Growth in world trade picked up significantly in the second half of 2003 and during 2004, supported by robust US demand and strong gains in worldwide industrial production. World trade grew by around 8¾ per cent in 2004, its fastest for four years and a significant pick-up from the trough in 2001, when growth for the year was close to zero. Increasing regional integration of production processes, reflecting the differing cost advantages of countries at different stages of the production chain, together with rising consumption, have also contributed to greater intra-regional trade in Asia and wider Europe. Specifically, increasing comparative advantage in producing cheaper manufactures means that Asia is now a significant driver of world trade growth, underpinned by strong growth of final demand in North America and some European countries.

UK export markets B19 UK export markets have grown a little slower than world trade, but have still seen a significant strengthening over the past four years. The continued improvement in UK export market growth into 2004 was largely due to the improvement in growth in wider Europe, the UK's major export market. Although GDP growth in the euro area lost momentum in the second half of 2004, for the year as a whole it remained stronger than in recent years. Moreover, some of the faster growing, but smaller, economies are key UK export markets. Stronger growth in some other key UK export markets, such as North America, Australasia, Africa and the Middle East, provided further support to the pick-up in UK export market growth, which is expected to remain strong in 2005.

Oil and commodity prices

B20 Oil prices rose sharply during 2004, reaching record highs in nominal terms. The price of Brent crude oil, a global bench-mark, rose from a low of \$10 per barrel in 1999 to over \$53 a barrel in recent weeks, though the average price so far in 2005 has been significantly lower. In sterling terms oil prices have also risen, but due to the depreciation of the US dollar price rises have been less pronounced. Nevertheless, prices are trading near nominal highs at around £27 a barrel. Futures prices have tended to fluctuate in line with spot prices, but to show a downward time path. Nominal oil prices are expected to remain high by historical standards and to continue to be sensitive to demand increases and supply disruptions. Over the medium term, prices are expected to moderate somewhat, as supply responds to higher prices and adjusts to meet demand.

B21 The impact of strong demand from China and other rapidly growing emerging economies has been a key driver of the marked pick-up in oil prices from mid-2004. Although China's demand has been rising for a number of years, in 2004 it coincided with stronger demand from advanced economies, low stocks and spare capacity, some uncertainty over supplies, and imbalances between the demand and supply of different grade crude oils. This combination of factors meant that small changes had a disproportionate effect on prices.

B22 Recent oil price rises have, so far, not had the detrimental economic impact that has been associated with rapid oil price rises in the past. Three factors explain this. First, high oil prices have stemmed largely from strong world demand. Second, in real terms oil prices have remained comfortably below historic peaks. Third, the energy intensity of production in advanced economies has continued to decline. Moreover, the impact on developing economies has been less than might have been expected, despite their higher energy intensity of production and greater exposure to foreign currency liabilities, because of relatively supportive international financial conditions, improvements in external debt positions and larger holdings of foreign exchange reserves.

B23 Non-fuel commodity prices also rose sharply during 2004, principally due to stronger than expected demand, but became more stable towards the end of the year. Price increases were particularly strong for metals and other industrial inputs, reflecting the rapid economic expansion in China, India and other Asian emerging markets, on top of strong growth in some advanced economies. Markets for other commodities such as most food items have been much less tight, holding down prices.

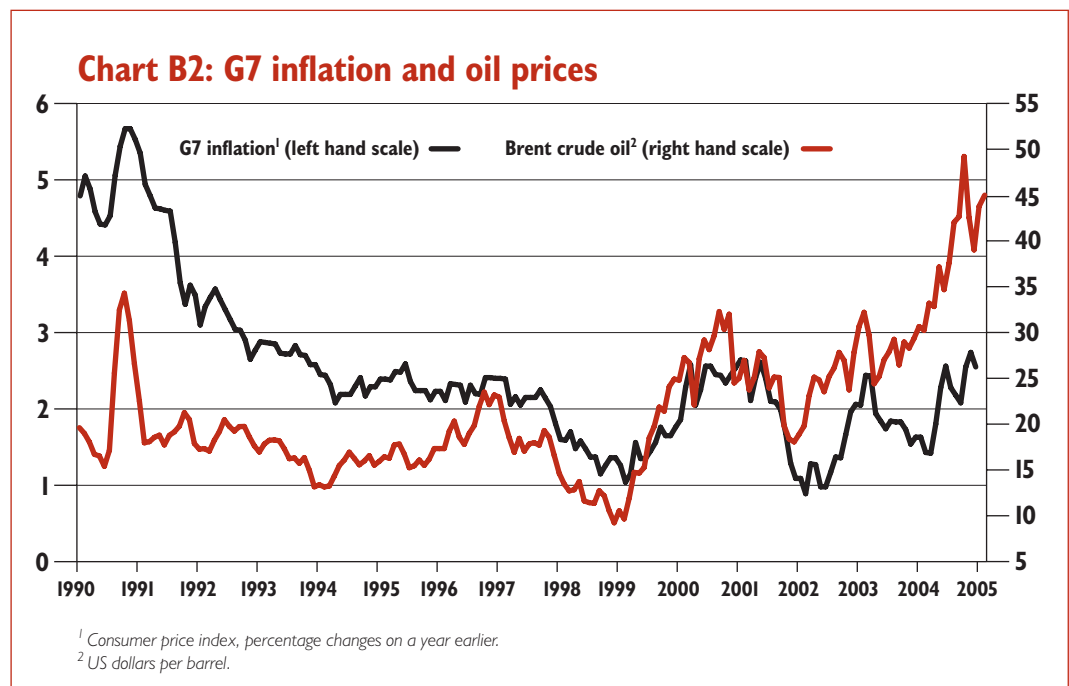
G7 inflation

B24 Overall inflationary pressures in the G7 have been rising gradually, with headline inflation picking up from 1½ per cent in 2003 to 2½ per cent in 2004. However, there remain some exceptions, notably Japan, where deflation continues and shows little sign of abating in the near term. As global growth has strengthened over the past two years, capacity utilisation

has risen, particularly in the US, and allowed some inflationary pressures to build. While core inflation remains stable and relatively low, headline inflation has picked up as oil and other input prices have risen. Rising employment in some G7 labour markets should give rise to higher wages and a consequent narrowing of profit margins, suggesting that more cost increases will tend to feed through to consumer prices and therefore core inflation.

B25 Although input prices have been rising during 2004, leading to rising headline inflation, central banks have generally been successful in anchoring inflation expectations, and core inflation is expected to rise only gradually. Beyond the near term, commodity, and therefore input, prices are expected to begin to moderate, and with subdued price pressures in the euro area and Japan, G7 headline inflation is forecast to ease gradually over the forecast horizon.

Forecast issues and risks



B26 Prospects for G7 economic growth and world trade have changed little since the 2004 Pre-Budget Report, though Japan’s national accounting revisions have slightly reduced G7 growth estimates across the years. However, with world trade buoyed by emerging markets, particularly Asia, it has been less affected by the slight adjustment to G7 growth.

B27 On balance there has been a reduction in the risks surrounding the forecast since the Pre-Budget Report, with financial conditions remaining supportive of growth and some of the uncertainties of 2003 and 2004 lifting. The risks to the global outlook of higher oil prices have diminished since the time of the Pre-Budget Report given the robustness of growth in face of high prices in 2004, with increasing recognition that high oil prices have been driven primarily by strong demand. The risks relating to exchange rates and a disorderly adjustment to the world’s current account imbalances remain unchanged since the Pre-Budget Report. In the medium term, structural reform would help to rebalance growth and facilitate the unwinding of imbalances

UK ECONOMY

Overview of recent developments

B28 The Government's macroeconomic framework allowed the UK economy to remain resilient in the face of the challenges and uncertainties that affected the world economy between 2001 and early 2003. Most of the world's major economies experienced recession during this period – conventionally defined as two consecutive quarters in which GDP contracted. The UK was the only G7 economy to avoid at least one quarter of negative GDP growth throughout.

B29 As global developments improved from around the middle of 2003 and growth of world trade and GDP strengthened, sustained domestic stability enabled the UK to benefit significantly from stronger international conditions. UK GDP has now grown for 50 consecutive quarters, the longest unbroken expansion on quarterly national accounts records.

B30 As both the world economy and UK domestic demand strengthened, the independent Monetary Policy Committee (MPC) of the Bank of England raised repo rates on five occasions between November 2003 and August 2004, consistent with its forward-looking and pre-emptive approach to lock in stability and low inflation at the target rate of 2 per cent. Since August 2004, the MPC has held rates unchanged at 4³/₄ per cent.

B31 During the second half of 2004, GDP growth dipped to slightly below its assumed trend rate, with growth in the third quarter estimated at 0.5 per cent and official data indicating a fall in manufacturing output. Since the Pre-Budget Report, UK economic developments have evolved broadly as expected. GDP growth strengthened to 0.7 per cent in the final quarter of 2004, with growth of 2.9 per cent on a year earlier, slightly above the economy's assumed trend rate of growth. In 2004 as a whole, UK GDP is currently estimated to have risen by 3.1 per cent – consistent with the 3 to 3¹/₂ per cent forecast range that the Government maintained unchanged from the 2002 Pre-Budget Report. This is the second year running that GDP growth has turned out in line with the Government's previous forecasts.

B32 Stronger expansion since last autumn's dip in growth has been accompanied by recent rises in manufacturing output, and supported by both the continued momentum of domestic demand, in particular business investment, and increasing signs of strong external demand translating into more vigorous export growth. Private sector business survey indicators in recent months have generally supported the view that robust growth of UK output and activity is expected to continue into 2005. For example, the British Chambers of Commerce (BCC) survey for the final quarter of 2004 suggested both external and domestic demand were growing at rates above their respective long-run averages, while the Chartered Institute of Purchasing and Supply (CIPS) Reports on both manufacturing and services suggest continued growth going into 2005. Regional and National Purchasing Managers' Indices (PMIs) from the Royal Bank of Scotland suggest growth has been particularly strong in London, the South East and the North West in the past year. Moreover, recently business survey confidence indicators have regained strength, while consumer confidence has reached its highest level for over two years, bolstered by strong growth of output, robust labour market outcomes, and low inflation and interest rates.

The labour market B33 The UK labour market continues to perform strongly, as the Government's supply-side reforms, described in full in Chapter 4, help create a more dynamic and flexible labour market. The employment rate eased and the inactivity rate rose slightly between the early months of 2004 and the summer, but these developments have subsequently been reversed. Employment picked up from the middle of 2004, and rose strongly by 300,000 – or 1 per cent – in the year to the fourth quarter. This is entirely accounted for by rising full-time employment, tending to boost average hours worked. Employment growth over the past year has been fairly evenly split between the private and public sectors. The employment rate in the fourth quarter stood just below 75 per cent, 0.3 percentage points up on a year earlier, and only exceeded over the past 30 years or so around cyclical peaks.

B34 Unemployment has continued to trend down over the past year, declining by almost 60,000 in the year to the fourth quarter of 2004, with the unemployment rate falling by 0.2 percentage points to 4.7 per cent – the second lowest in the G7. The claimant count has also continued to fall, reaching a new 30 year low of 2.6 per cent in January 2005, down relatively sharply by 0.4 percentage points on a year earlier. Almost all countries and regions of the UK have seen employment rise and unemployment fall, with employment growing particularly strongly in Northern Ireland, the West Midlands and Scotland. Nevertheless, labour market inactivity has remained high, though, as explained in Chapter 4 of the Economic and Fiscal Strategy Report (EFSR), the annual inflow to incapacity benefits has fallen by one-third since the mid-1990s.

B35 Despite strong employment growth, productivity has risen strongly over the recent past, buoyed by robust gains in output, although it has eased back compared with latest peaks. In the second and third quarters of 2004, output per hour averaged over 3 per cent up on a year earlier, comfortably above its estimated trend rate of 2 $\frac{1}{4}$ per cent.

Trend growth and the output gap

B36 The Treasury's neutral estimate of the economy's trend output growth rate for Budget 2005 remains at 2 $\frac{3}{4}$ per cent to the end of 2006. Between the end of 2006 and 2010, projections by the Government Actuary's Department (GAD) show that demographic effects are expected to depress growth in the working-age population, and hence trend output growth, by $\frac{1}{4}$ percentage point a year, reflecting post-War baby-boom women reaching retirement age. The Treasury reassesses its estimates of trend growth around the time each cycle is judged to have ended. One of the important considerations that will bear on the next assessment is discussed in Box B1.

B37 Table B2 presents historical estimates of trend output growth and its decomposition between the estimated on-trend points in 1997 and 2001, and for the preceding cycle, as well as the forward-looking assumptions for trend growth based on projections of its components for the current cycle and beyond.

Table B2: Contributions to trend output growth¹

	Estimated trend rates of growth, per cent per annum					
	Trend output per hour worked ^{2,3}		Trend	Trend	Population	Trend
	Underlying	Actual	average hours worked ³	employment rate ³	of working age ⁴	output
	(1)	(2)	(3)	(4)	(5)	(6)
1986Q2 to 1997H1	2.22	2.04	-0.11	0.36	0.24	2.55
Over the recent past						
1997H1 to 2001Q3						
Budget 2002	2.14	1.96	-0.37	0.36	0.66	2.63
Budget 2003	2.35	2.14	-0.47	0.43	0.50	2.61
PBR 2003 and Budget 2004	2.65	2.44	-0.47	0.42	0.54	2.94
PBR 2004	2.70	2.50	-0.43	0.41	0.58	3.06
Budget 2005	2.70	2.50	-0.43	0.41	0.58	3.06
Projection⁵						
2001Q4 to 2006Q4						
Budget 2002	2.10	2.00	-0.1	0.2	0.6	2³/₄
Budget 2003/PBR 2003/ Budget 2004/PBR 2004	2.35	2.25	-0.1	0.2	0.5	2³/₄
Budget 2005 ⁶	2.35	2.25	-0.1	0.2	0.5	2³/₄
2006Q4 onwards						
PBR 2004	2.35	2.25	-0.1	0.2	0.3	2¹/₂
Budget 2005 ⁶	2.35	2.25	-0.1	0.2	0.3	2¹/₂

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: Recent Developments and Prospects', HM Treasury, April 2002.

² The underlying trend rate is the actual trend rate adjusted for changes in the employment rate, i.e. assuming the employment rate had remained constant.

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

³ The decomposition makes allowance for employment and hours worked lagging output. Employment is assumed to lag output by around three quarters, so that on-trend points for employment come three quarters after on-trend points for output, an assumption which can be supported by econometric evidence. Hours are easier to adjust than employment, and the decomposition assumes that hours lag output by just one quarter, though this lag is hard to support by econometric evidence. Hours worked and the employment rate are measured on a working-age basis.

⁴ UK household basis.

⁵ Neutral case assumptions for trend from 2001Q3.

⁶ Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2004Q4 are anchored.

BOX B1: GOVERNMENT OUTPUT, THE OUTPUT GAP AND IMPLICATIONS OF THE ATKINSON REVIEW

The final report of the Atkinson Review, described in Chapter 6 of the EFSR, was published on 31 January 2005, and implementation of the recommendations is likely in due course to lead to further improvements in measuring government output, and hence GDP. Ideally changes to the way government output is measured ought not to change estimates of the output gap.^a

The output gap, because it measures fluctuations in output arising from the business cycle, should be determined by factors affecting the cyclical behaviour of the private or market sector of the economy rather than the rate of utilisation within the government or non-market sector:

- changes in government output (and employment) can be expected to influence the gap by affecting the resources available to the private sector and the demand for output produced by the private sector;
- variation in government output is more structural than cyclical, and hence not part of the output gap, despite affecting it; and
- revisions to government output data reflecting improvements in the way it is measured should not affect capacity pressures in the private sector or the whole economy.

However, in practice output gap estimates based on current estimation methods used by the Treasury and others may inadvertently be affected by government output changes or revisions to the data. This could happen if, for example:

- a changing government share of total employment were to affect whole economy productivity growth. This possibility was noted in the 2002 'Trend Growth' paper,^b but to date Treasury trend growth projections have not explicitly taken account of such factors; or
- revisions to government output data were to lead to unequal effects on whole economy actual and trend output estimates.

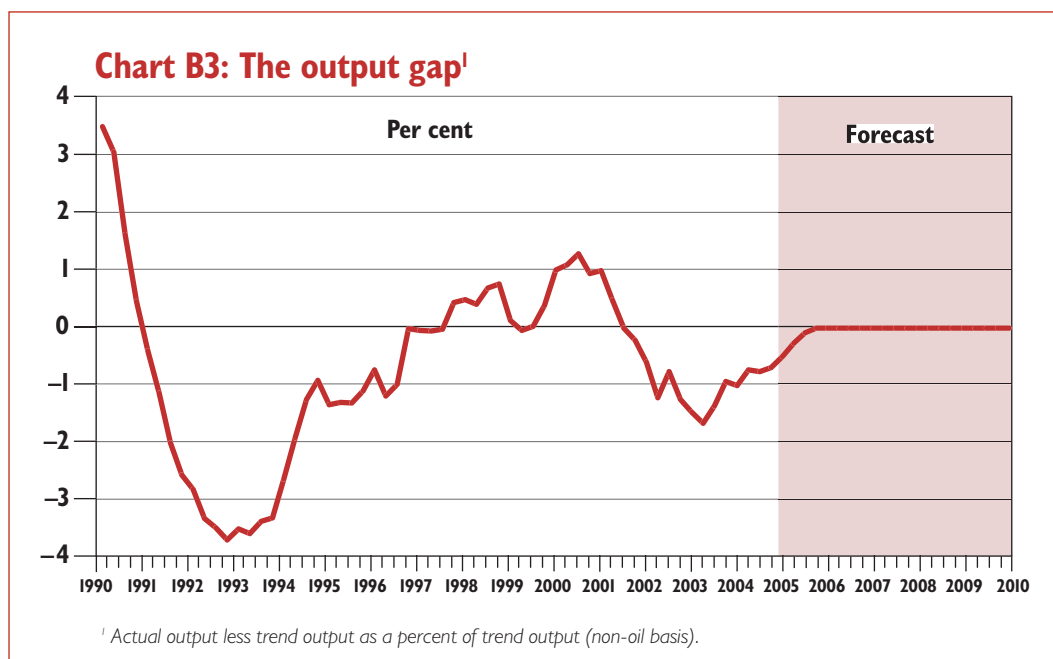
Treasury (and other) methods of estimating the output gap will require refinement to ensure that the estimates are properly insulated from prospective revisions to the way government output is measured. It will be necessary for the implications of changes in government output or employment, including those solely due to measurement changes, to be properly reflected in the projection for whole economy trend output.

Consideration will be given to introducing such refinement in time for future output gap assessments once prospective Atkinson Review related improvements start to feed through into revisions to GDP.

^aHM Treasury trend output and output gap estimates are measured in terms of non-oil Gross Value Added (GVA) at basic prices.

^b*Trend Growth: Recent Developments and Prospects*, HM Treasury, April 2002 (paragraph 3.11).

B38 The judgement on the size of the output gap has not changed compared to the 2004 Pre-Budget Report, though the composition implied by latest data is different. Since the 2004 Pre-Budget Report, cumulative growth in non-oil output from the start of 2003 has been revised up by around $\frac{1}{4}$ percentage points, as a result of methodological improvements in accounting for increased VAT compliance over the past couple of years. On its own this would have tended to narrow the estimate of the output gap implied by the $2\frac{3}{4}$ per cent trend growth assumption, compared to Pre-Budget Report time. However, growth over the second half of 2004 is now estimated to have been slightly below the Pre-Budget Report projection. These two developments offset, meaning that the implied output gap at the end of 2004 is the same as was forecast in the 2004 Pre-Budget Report, at around $\frac{3}{4}$ per cent of non-oil output.



B39 Consistent with the decomposition of trend output growth, the output gap can be broken down into components by comparing productivity (output per hour), average hours worked and the employment rate against their assumed trend levels that make up the overall trend output projection. Recent data, mainly on average hours worked, give rise to a different composition of the implied output gap at the end of 2004 compared to that projected at the time of the Pre-Budget Report:

- the accelerated decline in average hours from spring 2002 slowed in the year leading up to the 2004 Pre-Budget Report, and data released subsequently show a marked increase in average hours worked. It is still too early to be sure that the rise is not simply due to erratic data, but it is consistent with the cyclical recovery foreshadowed in previous assessments, as discussed further in Box B2. Therefore, although average hours still make an implied negative contribution to the output gap, it is much less pronounced than at the time of the 2004 Pre-Budget Report;
- the recent pick-up in average hours is balanced by slower growth in productivity measured on an output per hour basis. Productivity is now estimated to make a negative contribution to the output gap, in contrast with the Pre-Budget Report assessment which implied productivity close to its assumed trend; and
- the employment rate was estimated to have made a small negative contribution to the output gap at the time of the Pre-Budget Report. However, it grew at above its assumed trend rate in the second half of 2004 and, as a result, it is now estimated to be close to trend.

B40 Direct evidence on the output gap is provided by a variety of economic indicators, including business survey measures of capacity utilisation and recruitment difficulties. While indicators of capacity utilisation mainly reflect the output per hour and average hours components of the output gap, recruitment indicators are more likely to reflect the employment component.

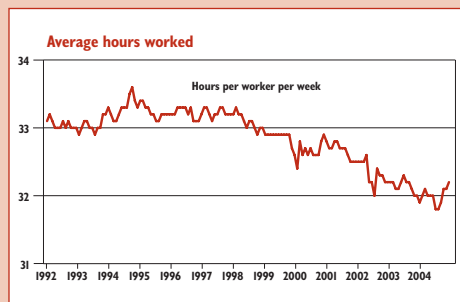
B41 Survey indicators of capacity utilisation in the service sector rose between the third and fourth quarters of last year, while indicators of capacity utilisation in manufacturing fell slightly. Given the relative size of the service sector in the economy, this is consistent with an overall narrowing of the output gap. Survey indicators of general recruitment difficulties showed less slack in the labour market towards the end of 2004, though when asked about difficulties in recruiting specific kinds of labour, firms' responses were more ambiguous about whether the labour market had tightened further in the final quarter of the year.

B42 Wage and price data still show little evidence of unsustainable inflationary pressures emerging. Underlying average earnings growth has remained below the rate judged consistent with trend productivity growth and the inflation target in the medium term. Moreover unit wage cost growth, estimated at around 2 per cent in the year to the fourth quarter of 2004, has been even further below sustainable rates. At the same time, CPI inflation has remained below the Bank of England's 2 per cent target.

B43 As discussed in the 2004 Pre-Budget Report, output gap estimates are subject to a range of unavoidable uncertainties, though the Treasury's approach yields estimates that have been less susceptible to revision than some alternative approaches. Nevertheless, since the estimated on-trend point in mid-1999, when the current cycle is judged to have started, output has so far grown at an annualised average rate of 2.8 per cent, consistent with the 2³/₄ per cent neutral view of trend growth. This confirms that the assumption of 2¹/₂ per cent trend growth used in the public finance projections has to date proved reasonable and cautious. The public finance projections contained in Budget 2005 continue to be based on this cautious view of prospects.

BOX B2: AVERAGE HOURS WORKED

Growth in average hours worked is one of the key determinants of the trend rate of economic growth. Therefore, deviations in average hours away from their assumed trend are one factor that can account for the emergence of positive or negative output gaps in the economy. Average hours worked have trended downwards in recent decades, and the Treasury's current estimates of potential growth embody a trend decrease in average hours of 0.1 per cent a year from the third quarter of 2001 onwards.



Between the start of the current economic cycle in mid-1999 and the latest estimated on-trend point in the third quarter of 2001, there does not appear to have been a significant trend in average hours worked. Subsequently average hours generally fell, as global economic weakness affected UK output growth and gave rise to a negative output gap. More recently, the rate of decrease in average hours worked

slowed and the final quarter of 2004 saw a significant bounce back, taking levels of average hours worked back to where they last were in mid-2003. This is consistent with the economy being below trend from 2001Q3, but with the size of the negative output gap diminishing recently as the economy has expanded at above trend rates. It also matches partly with full-time jobs entirely accounting for the increase in employment over the past year, and some recent reduction back towards trend in part-timers who would prefer full-time work. Overall, the recent rise in average hours worked appears consistent with a cyclical unwinding. However, average hours data can be volatile, and it would be premature to conclude with certainty that the recent increase can be attributed to a shift back towards trend until further data offer support for this interpretation.

In assessing the cyclical component of recent movements in average hours, the potential effect of structural influences needs to be carefully assessed. Factors such as trend changes in the part-time share of employment, the implementation of the EU Working Time Directive and changes to the composition of employment across sectors could all have affected underlying levels of average hours worked in recent years. However, it is hard to offer convincing evidence in support of the view that movements in average hours since 2002 have been predominantly structural. The Treasury's judgement remains that average hours are still making a contribution, albeit modest and declining, to a negative output gap.

B44 With output at the end of 2004 still assessed to be modestly below potential, growth is forecast to be above its trend rate until the current cycle completes, which is judged to occur around the end of 2005.

Summary of prospects

Table B3: Summary of forecast¹

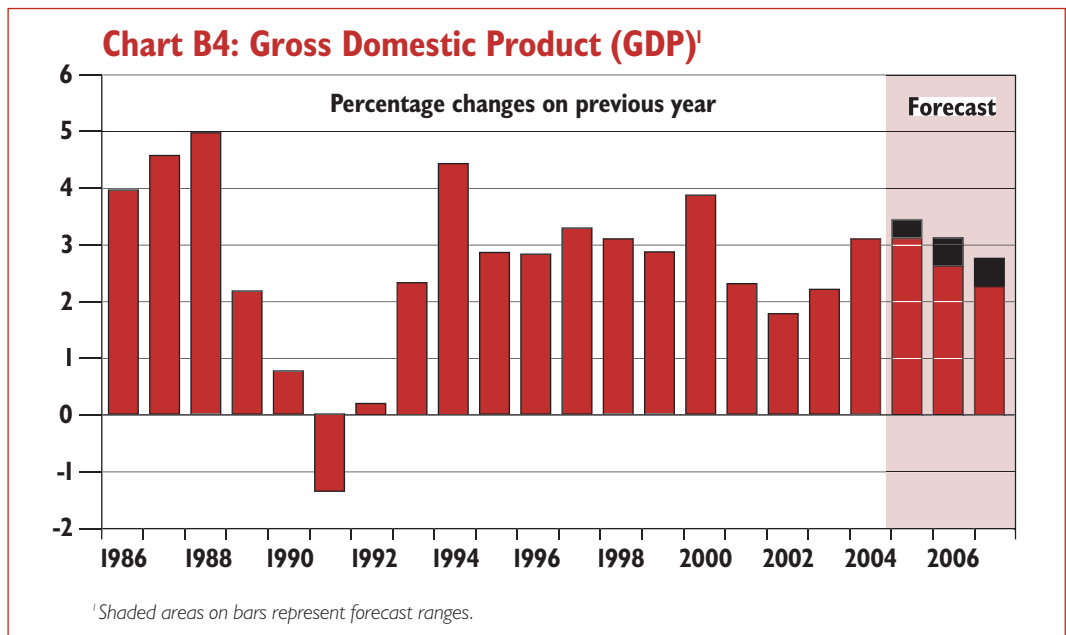
	2004	Forecast		
		2005	2006	2007
GDP growth (per cent)	3	3 to 3½	2½ to 3	2¼ to 2¾
CPI inflation (per cent, Q4)	1¼	1¾	2	2

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

GDP B45 The Budget 2005 forecast is very similar to that of the 2004 Pre-Budget Report. Offsetting effects of new data and revisions have left the estimated output gap at the end of 2004 unchanged, and more generally economic developments have continued to evolve as expected. With the world economy still expanding briskly, and business and consumer confidence having lately regained strength, the recent momentum of UK GDP growth is expected to carry through into 2005. Renewed growth at just above trend rates is therefore expected for much of 2005, as robust domestic demand growth is bolstered by a further pick-up in external demand for UK output. However, with the output gap narrowing further and monetary policy having undergone a tightening of 125 basis points since November 2003, growth is expected gradually to ease back to its trend rate later in the year. Fiscal policy should continue to support monetary policy with the overall impact of fiscal policy moving back towards a more neutral position.

B46 So the Budget forecast implies that the current economic cycle will come to a close around the end of 2005, in line with the Pre-Budget Report forecast. GDP is expected to grow by 3 to 3½ per cent in 2005 and 2½ to 3 per cent in 2006. This is the same forecast that has been maintained since Budget 2003, consistent with GDP growth in 2003 and 2004 turning out in line with the Budget (and subsequent) forecasts.

Inflation B47 CPI inflation is expected to rise gradually during the course of 2005 as further upward pressure from import prices, reflecting strong global growth, feeds through to inflation. The credibility of the Government’s monetary policy framework, through its effect in anchoring inflation expectations, is also expected to contribute in returning inflation to target by mid-2006.



UK DEVELOPMENTS AND PROSPECTS IN DETAIL

Demand

B48 In recent years GDP growth has become more balanced, with the composition having shifted away from private consumption and, more recently, investment and export growth picking up.

Private consumption B49 In 2004, nominal private consumption continued to drift down a little as a share of GDP, reaching its lowest level since 1998. This reflects the impact of continuing competitive pressure on consumer prices, with the private consumption deflator recently registering its weakest rate of growth since mid-2000. Real private consumption growth in 2004, at just over 3 per cent, was stronger than in 2003. This largely reflects a particularly strong rise of over 1 per cent in the first quarter – in contrast to an unusually weak beginning to the previous year. In the remainder of 2004, private consumption growth progressed at a little below its long-run average. Broadly in line with this, retail sales growth has eased back in recent months, following a string of particularly buoyant readings earlier in 2004.

B50 Levels of household debt and recent interest rate increases are expected to keep consumer spending growth at rates close to that of incomes over the forecast horizon. Thus private consumption is expected to continue growing relatively slowly, rising by $2\frac{1}{4}$ to $2\frac{3}{4}$ per cent this year and by 2 to $2\frac{1}{2}$ per cent in 2006, below forecast rates of GDP growth.

Government consumption B51 Real government consumption grew at relatively robust rates in 2004, rising by just over $4\frac{3}{4}$ per cent compared with 2003. Real government consumption growth is programmed to slow progressively over the 2004 Spending Review period.

Investment B52 Investment growth has strengthened significantly during the past two years, as corporate sentiment has risen on the back of improved global demand. Buoyant profitability and stronger company balance sheets have also acted to underpin renewed growth in capital spending. Business investment has now grown by an average rate of $1\frac{1}{4}$ per cent a quarter over the past five quarters. In the final quarter of 2004 it stood around $9\frac{1}{2}$ per cent higher than at its latest trough in early 2003. In 2004 as a whole, business investment grew by just under $5\frac{1}{2}$ per cent, its strongest performance for six years. Stronger private sector capital expenditure has also coincided with still strong growth of government investment, with whole economy gross fixed capital formation rising by just under 6 per cent in 2004 as a whole.

B53 Going forward, business investment is expected to continue growing at robust rates, albeit at a slightly slower pace than in 2004, as companies, with relatively supportive balance sheets, continue to respond to strong demand growth in the UK and abroad. High levels of profitability are expected to offer further support to expanding capital outlays. At the same time, growth in gross fixed capital formation for the economy as a whole is expected to be supported by continued strong growth in government investment into this year, reflecting the Government's spending plans. Whole economy gross fixed capital formation, building on growth of 6 per cent in 2004, is thus expected to rise by 6 to $6\frac{1}{4}$ per cent this year and by 4 to $4\frac{1}{2}$ per cent next year.

Exports B54 Export growth strengthened in 2004. While growth in goods and services export volumes for the year as a whole averaged just over $2\frac{1}{2}$ per cent, this masked much stronger growth after the early months. Over the final three quarters of 2004 export volume growth averaged $1\frac{3}{4}$ per cent a quarter, following a fall in the first quarter which coincided with a sharp drop in UK export market growth. Strong UK domestic demand has also underpinned

robust import growth over the recent past, with volumes rising by over 5 per cent last year, up from 1¾ per cent growth in 2003.

B55 The recent momentum of export growth is expected to carry through into 2005, supported by further robust demand in the world economy. Export volumes of goods and services are forecast to rise by 6 to 6½ per cent this year and by 6¼ to 6¾ per cent in 2006, similar to the 2004 Pre-Budget Report projections. The exports forecast for 2005 implies quarterly growth averaging marginally less than over the final three quarters of 2004. Import growth is also expected to follow a similar path to that set out in the Pre-Budget Report, growing a little more slowly than exports.

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

	Percentage points, unless otherwise stated			
	2004	Forecast		
		2005	2006	2007
Private consumption	2	1¾	1½	1½
Business investment	½	½	½	¼
Government	1	1	¾	¾
Change in inventories	-¼	¼	0	0
Net trade	-1	-¼	0	0
GDP growth, per cent	3	3¼	2¾	2½

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. Rounding contributes over half of the difference in 2004.

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

Balance of growth B56 The forecast thus implies a further rebalancing of growth away from private consumption, reinforcing the pattern established over the past few years.

Output

Manufacturing B57 Recent data revisions now reveal that manufacturing output grew more strongly over the recent past than previously estimated. Manufacturing production now appears to have grown by 0.7 per cent in the three months to January on the previous three months, having increased for three consecutive months. In 2004 as a whole, it rose by 1.4 per cent, slightly higher than forecast in the 2004 Pre-Budget Report and representing the sharpest increase for four years, following a relatively sharp decline in industrial activity throughout almost all advanced economies over much of the intervening period.

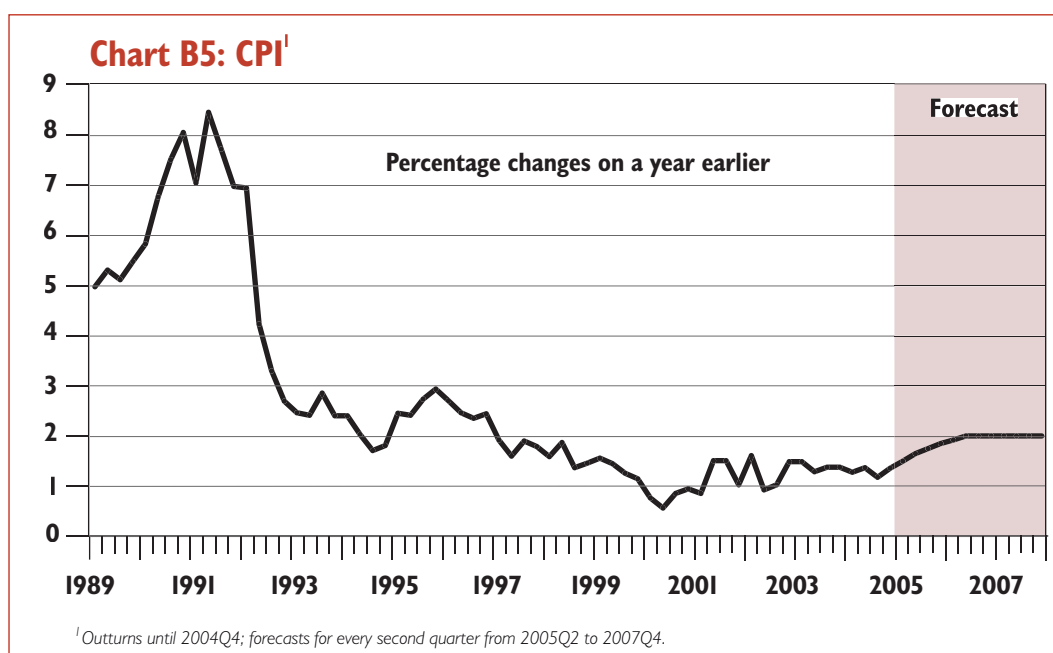
B58 As a result, official data are now more closely aligned with private sector business surveys over the recent past: prior to these revisions, surveys such as the CIPS Report on manufacturing and the BCC quarterly had portrayed a much stronger picture of manufacturing output than official estimates. Nonetheless, upward revisions have not fully reconciled official manufacturing data with the rather stronger signals coming from private surveys.

B59 Going forward, the pick-up in manufacturing output growth is expected to gather further momentum into 2005. Further strong export growth arising from robust global growth, coupled with still strong domestic investment expenditure, should together serve to spur further manufacturing output growth over the forecast horizon. Manufacturing output is thus forecast to rise by 1½ to 2 per cent this year and by 1¾ to 2¼ per cent next.

Services B60 Service sector output grew strongly throughout 2004, growing by 4 per cent in the year as a whole, its fastest rate for four years, with latest data showing a rise of almost 1 per cent between the third and fourth quarters of the year. Within services, business services and finance and transport storage and communications have seen particularly robust growth of late.

Inflation

CPI B61 Inflation has picked up a little since the time of the Pre-Budget Report, although underlying inflationary pressures remain firmly under control. CPI inflation averaged 1.3 per cent in 2004, marginally lower than in 2003, and a little below its 2 per cent target.



B62 In both December 2004 and January 2005, CPI inflation stood at 1.6 per cent, up from its recent low of 1.1 per cent in September and the highest rate for six months. Electricity and gas prices have been one important factor lately exerting upward effects as pre-announced increases in tariffs continue to be phased in. Petrol prices, however, have tended to have a downward impact in recent months. Overall, some of the recent uplift in the CPI measure of inflation is likely to have been due to erratic price movements within the basket, and any pick-up in underlying inflation is likely to be at a much more gradual pace than recent CPI outturns have suggested.

B63 Until recently, the wedge between CPI and RPIX inflation had remained relatively flat, at just under 1 percentage point. However, in January it fell sharply to just 0.5 percentage points, its lowest level for around eight and a half years. The marked narrowing between the two indices partly reflected shifting weights as part of the regular annual updating. Housing costs, as measured by the depreciation component of the RPI, continue to be the biggest source of the remaining difference between the indices, although the magnitude of the wedge attributable to housing is considerably smaller than in 2002 and 2003.

House price inflation B64 House price inflation eased significantly through the second half of 2004, and prices have been broadly flat in recent months. Both Halifax and the Nationwide reported annual house price inflation of around 10 per cent in the year to February 2005, down from around 20 per cent last summer, while monthly house price inflation has averaged very close to zero since the autumn. Other housing market indicators have also pointed to more subdued housing market activity over this period, but repossessions remain close to a record low, and latest indicators point to an emerging gradual pick-up in activity. House price inflation has eased in almost all parts of the UK in the past year, although there remain differences in the rates at which house values have been growing in different parts of the UK.

Producer prices B65 Producer input and output price inflation both picked up through 2004. This partly reflected the effects of higher oil prices, with both input and output prices for petroleum products rising by over 10 per cent in the final quarter. However, there are also some signs of a gradual pick-up in other categories, with core manufacturers' output prices – which exclude petroleum and certain other erratic product groups – rising at their fastest rate for just under nine years in the final quarter of last year. Import prices also appear to have been given a lift as a result of strong world growth and past increases in commodity prices, with goods import prices in the year to the final quarter of 2004 rising at their fastest rate for around two and a half years.

B66 Business surveys have also shown some pick-up in underlying price growth of late. The CBI Industrial Trends Survey has shown that more manufacturers expect to raise prices in coming months than cut them, for the first time in six years. Moreover, the CIPS Report on services has recently shown both input costs and prices charged rising at above their long-run averages. Nevertheless, the ONS's experimental corporate services price index has indicated falling inflationary pressures, with the rate of inflation easing back by around $\frac{3}{4}$ percentage points over the past year to just above 2 per cent in the fourth quarter of 2004.

Average earnings B67 The 12-month growth rates of both whole economy and private sector average earnings, either including or excluding bonuses, have fluctuated mainly within the range of 4 to $4\frac{1}{2}$ per cent since last spring, with no clear trend. Thus earnings growth has remained below thresholds at which it would be judged to begin posing a risk to inflation. Moreover, with productivity growth solid, unit wage costs have been growing well below sustainable rates over the recent past.

Prospects B68 The outlook for CPI inflation remains much as it was in the 2004 Pre-Budget Report forecast, despite slightly higher than expected outturns since that time. As 2005 unfolds, the absorption of the remaining slack in the economy is expected to remove one recent source of downward pressure on prices. At the same time, the effects of strong global growth and its ongoing boost to UK external demand are expected to continue to feed through to higher import prices. The credibility of the Government's monetary policy framework is also expected to contribute in returning inflation to target through anchoring inflation expectations.

The household sector

B69 Developments in household spending and finances since the 2004 Pre-Budget Report do not materially change the assessment made at that time. With house prices remaining broadly flat since last autumn and some emerging signs of a gradual pick-up in housing market activity, associated downside risks would appear to have receded a little.

Private consumption B70 2004 saw the third consecutive year of decline in nominal private consumption as a share of money GDP, for the first time in around 25 years, with the share falling to its lowest level since 1998. Nominal private consumption has recently been growing at its slowest rate for well over 50 years. This has been associated with fiercely competitive pricing in retail and other outlets supporting continued growth in real consumption volumes. Relative consumer prices have fallen in six of the past seven years, and more steeply since 2001.

B71 In real terms, average private consumption growth has been marginally below the growth in real GDP in recent quarters. Private consumption rose by 0.4 per cent in the fourth quarter, compared with a 0.6 per cent rise in the previous quarter, and stood 2.8 per cent higher than a year earlier. For 2004 as a whole, real private consumption grew by 3.1 per cent, the same rate of growth as that of GDP. This remains comfortably below the rates in the late 1990s and 2000, lending further weight to the Pre-Budget Report judgement that recent consumer spending growth has been sustainable. Underlying retail sales growth has also eased back, rising by around 4¼ per cent in the 3 months to January on a year earlier although, as is always the case, results covering the month around the busy Christmas trading period may have been affected by seasonal adjustment difficulties.

Household debt B72 Growth in household debt has continued to ease back, suggesting that households are adjusting to the effects of previously strong rises in their borrowing commitments. The total stock of household debt rose at its slowest rate for almost three years between the third and fourth quarters of 2004, with growth of both secured lending and consumer credit having slowed.

Consumer confidence B73 Nonetheless, consumer confidence has risen in recent months, reaching its highest level for two years, reflecting both improved sentiment in households' own finances and a more confident view of the outlook for the economy as a whole.

Prospects B74 Strong confidence, underpinned by the UK's continued domestic macroeconomic stability and sound fundamentals, should continue to ensure that private consumption grows at moderate rates going forward, although the Budget judgement remains for it to rise somewhat more slowly than real GDP over the forecast horizon. Private consumption is forecast to rise by 2¼ to 2¾ per cent this year and by 2 to 2½ per cent next. The saving ratio is expected to edge up in 2005 and to be broadly stable over the forecast horizon at just above its average over recent years.

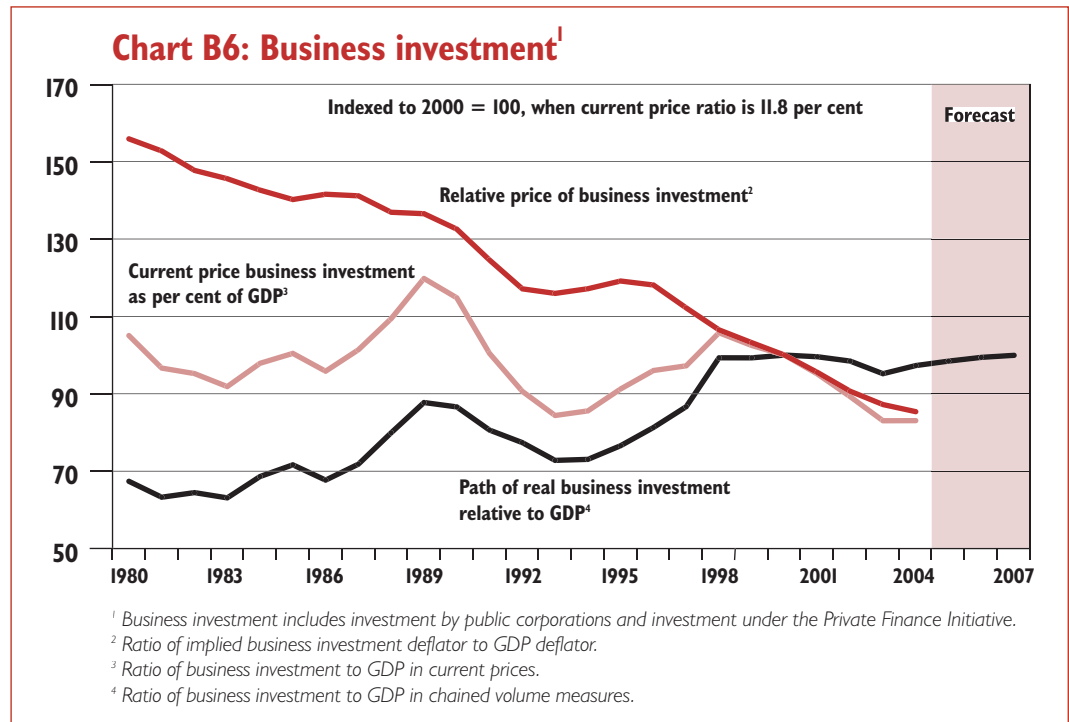
Table B5: Household sector¹ expenditure and income

	Percentage changes on previous year unless otherwise stated			
	2004	Forecast		
		2005	2006	2007
Household consumption ²	3¼	2¼ to 2¾	2 to 2½	2 to 2½
Real household disposable income	3	2¼ to 2½	1¾ to 2¼	1¾ to 2¼
Saving ratio (level, per cent)	5½	5¾	5¾	5¾

¹ Including non-profit institutions serving households.

² Chained volume measure.

Companies and investment



B75 As a result of improved corporate profitability and higher business confidence, business investment growth has picked up convincingly and at slightly stronger rates than had been assumed at the time of the 2003 Pre-Budget Report and 2004 Budget. Corporate profitability has risen sharply since early 2003, and in the past it has proved a good leading indicator of business investment growth. Business investment has now risen for seven consecutive quarters, and by an average rate of around 1¼ per cent a quarter for the past five quarters, rising by almost 5½ per cent in 2004 as a whole, the fastest rate for six years. Moreover, the pick-up in business investment is relatively broad-based, with both manufacturing and service sector companies stepping up capital spending. Indeed, manufacturing investment is now over 10 per cent higher than its latest trough. Government investment also rose strongly in 2004, with whole economy gross fixed capital formation growing by almost 6 per cent compared with 2003.

B76 Partly reflecting stronger profitability, private non-financial corporations (PNFCs) have now been net lenders for 10 consecutive quarters. PNFCs appear to have taken steps to build up liquidity and secure their balance sheets. With respect to company pension fund deficits, recent developments give little reason to change the Budget 2004 assessment implying that the process of adjustment is likely to be gradual, with a relatively muted impact on business investment prospects.

Prospects B77 Going forward, business investment is expected to make further solid gains over the forecast horizon. On balance, evidence from forward-looking business surveys clearly points to further increases in the pipeline, though indications of buoyant investment intentions from some surveys are tempered by weaker signals from others. At the regional level, the BCC survey for the fourth quarter of 2004 showed investment intentions were particularly strong in Wales, Yorkshire and the Humber and the South West. Only Scottish, North Eastern and Eastern service companies reported plans to lower levels of investment spending in coming months. Key fundamentals remain sound, and further strong demand growth allied with the marked increase in corporate profitability and sound corporate finances are expected to

continue motivating companies to build on existing levels of capital expenditure. Nevertheless, the shallower downturn in business investment in the earlier phases of the current cycle suggests that the present upturn may be less strong than seen in past cycles. Business investment is therefore forecast to rise by $4\frac{1}{4}$ to $4\frac{3}{4}$ per cent in 2005 and by $3\frac{1}{2}$ to $4\frac{1}{4}$ in 2006.

Table B6: Gross fixed capital formation

	Percentage changes on previous year			
	2004	Forecast		
		2005	2006	2007
Whole economy ¹	6	6 to $6\frac{1}{4}$	4 to $4\frac{1}{2}$	$2\frac{3}{4}$ to $3\frac{1}{4}$
of which:				
Business ^{2,3}	$5\frac{1}{4}$	$4\frac{1}{4}$ to $4\frac{3}{4}$	$3\frac{1}{2}$ to $4\frac{1}{4}$	$2\frac{1}{2}$ to $3\frac{1}{4}$
Private dwellings ³	$8\frac{3}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$	$1\frac{1}{4}$ to $1\frac{3}{4}$	$1\frac{1}{2}$ to 2
General government ³	$3\frac{3}{4}$	$22\frac{3}{4}$	$11\frac{1}{2}$	$5\frac{1}{4}$

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.

Trade and the balance of payments

Trade in goods and services³ B78 UK export growth picked up in 2004, following a prolonged period where weak global demand kept UK exports subdued. In the fourth quarter, goods exports were up by 4 per cent on a year earlier, despite falling in the first quarter. Growth to non-EU markets remains significantly above that to EU destinations, broadly reflecting relative GDP growth rates over the recent past.

B79 Underlying growth of services exports has remained somewhat stronger than that of goods, despite falling back in the third quarter, rising by around $4\frac{3}{4}$ per cent in 2004 as a whole. As a result, the UK's surplus on services trade has continued to increase, and reached another record high in 2004, at a little over £18 billion.

B80 As a result of strong growth in UK domestic demand, imports have also grown relatively briskly over recent quarters. With import growth outstripping that of exports, the trade deficit has continued to widen gradually, although for 2004 as a whole the overall deficit turned out in line with the 2004 Pre-Budget Report projection.

³Based on the output, income and expenditure data released by the ONS on 25 February 2005. The ONS released revisions to trade in goods data on 9 March 2005 that will carry through to revisions in the national accounts release scheduled for 23 March 2005.

Table B7: Trade in goods and services

	Percentage changes on previous year					£ billion Goods and services balance
	Volumes		Prices ¹		Terms of trade ²	
	Exports	Imports	Exports	Imports		
2004	2½	5	-½	-¾	¼	-39½
<i>Forecast</i>						
2005	6 to 6½	6 to 6½	1	1	0	-42
2006	6¼ to 6¾	5½ to 6	2¼	2	¼	-41¾
2007	6¼ to 6¾	5¼ to 5¾	1½	1½	0	-41¾

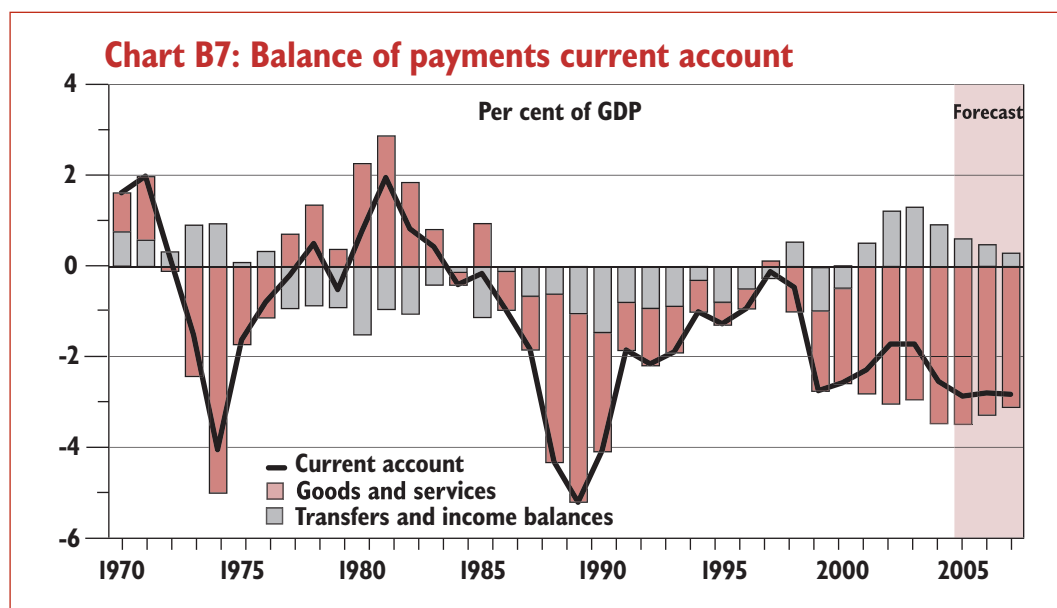
¹ Average value indices.

² Ratio of export to import prices.

Current account B81 The current account deficit widened over the first three quarters of 2004, mainly reflecting the widening in the trade in goods deficit. The income surplus has narrowed a little from 2003's record high, although still remains at very high levels relative to historical experience. The sterling Exchange Rate Index (ERI) has recently been close to levels prevailing a year or so ago. However, this masks a little softening in the exchange rate against the euro, broadly offset by some rise in sterling's value against the US dollar since spring 2004.

Prospects B82 In the Budget forecast, the recent momentum of export growth is expected to continue in 2005 as the effects of a further period of strong global demand feed through, implying a significant strengthening of export growth for the year as a whole compared to 2004. With export growth somewhat firmer than that of imports over the forecast horizon, the trade balance is expected to remain broadly flat.

B83 The income surplus is expected to moderate further from recent high levels as temporary factors that have been boosting it unwind. So the current account deficit is forecast to widen a little this year to around 2¼ per cent of GDP and to be stable at about that level thereafter.



Independent forecasts

B84 The average of independent forecasts for GDP growth in 2005 rose marginally in March, to 2.6 per cent. The shortfall of around ½ percentage point or more against the Budget forecast range of 3 to 3½ per cent largely reflects the relative weakness of the consensus forecast for investment growth in 2005.

B85 This is not the first time in recent years that Treasury forecasts have diverged from those of outside commentators. For example, the Treasury's forecast for 2004 growth of 3 to 3½ per cent first made in the 2002 Pre-Budget Report was maintained unchanged thereafter. By contrast, independent forecasters were originally projecting 2004 growth to be just 2.6 per cent, and only moved within the 3 to 3½ per cent range last August. Latest ONS data show GDP grew by 3.1 per cent in 2004.

Table B8: Budget and independent¹ forecasts

	Percentage changes on a year earlier unless otherwise stated					
	2005			2006		
	March Budget	Independent Average	Range	March Budget	Independent Average	Range
Gross domestic product	3 to 3½	2.6	1.5 to 3.2	2½ to 3	2.3	0.3 to 2.9
CPI (Q4)	1¾	1.8	1.4 to 3.0	2	1.9	1.5 to 3.2
Current account (£ billion)	-34½	-29.1	-38.4 to -20.0	-35¾	-28.9	-43.7 to -12.5

¹ 'Forecasts for the UK Economy: A Comparison of Independent Forecasts', March 2005.

B86 For 2006, the latest independent average for GDP growth of 2.3 per cent is only marginally below the lower end of the Budget forecast range of 2½ to 3 per cent.

Forecast risks

B87 On balance, the risks surrounding the economic forecast have diminished a little since the time of the 2004 Pre-Budget Report. The global outlook remains a key influence on UK prospects, and challenging judgements will continue to be faced in setting monetary and fiscal policy. Risks to the world outlook have become more focussed on exchange rates and the potential for a disorderly adjustment to the world's current account imbalances. In the medium term, structural reform is needed to rebalance growth and to facilitate the unwinding of imbalances. With high nominal oil prices now perceived to pose less of a threat, global prospects have become a little more secure.

B88 UK house prices continue to pose risks in both directions, although increasing evidence since Pre-Budget Report time of an orderly moderation of price inflation, and recent signs of some emerging revival in sentiment, suggest that the downside risk has become slightly less prominent.

B89 The forecast also continues to face upside risks. For example, growth of business investment in 2004 was faster than had been expected at the time of either the 2004 Budget or 2003 Pre-Budget Report, and could hold further potential for upside surprise going forward given current robust rates of demand growth with supportive corporate financial conditions. There may be also be headroom for stronger consumer spending without household finances getting stretched.

Table B9: Summary of economic prospects¹

	Percentage changes on a year earlier unless otherwise stated					
	2004	2005	Forecast ^{2,3,4}		Average errors from past forecasts ⁵	
			2006	2007	2005	2006
Output at constant market prices						
Gross domestic product (GDP)	3	3 to 3½	2½ to 3	2¼ to 2¾	½	½
Manufacturing output	1½	1½ to 2	1¾ to 2¼	1¾ to 2¼	1	1¾
Expenditure components of GDP at constant market prices⁶						
Domestic demand	3¾	3¼ to 3½	2½ to 3	2¼ to 2¾	½	¾
Household consumption ⁷	3¼	2¼ to 2¾	2 to 2½	2 to 2½	½	1
General government consumption	4¾	3¼	3	2¾	1	¾
Fixed investment	6	6 to 6¼	4 to 4½	2¾ to 3¼	2	1¾
Change in inventories ⁸	-¼	¼	0	0	¼	¼
Exports of goods and services	2½	6 to 6½	6¼ to 6¾	6¼ to 6¾	2¼	3¾
Imports of goods and services	5	6 to 6½	5½ to 6	5¼ to 5¾	2¼	2¾
Balance of payments current account						
£ billion	-29	-34½	-35¾	-37¾	7	8¼
per cent of GDP	-2½	-2¾	-2¾	-2¾	½	¾
Inflation						
CPI (Q4)	1¼	1¾	2	2	-	-
Producer output prices (Q4) ⁹	3½	2½	2	2	1	1½
GDP deflator at market prices	2	2½	2¾	2¾	½	½
Money GDP at market prices						
£ billion	1 158	1 223 to 1 227	1 288 to 1 299	1 353 to 1 370	7	7
percentage change	5¼	5½ to 6	5¼ to 5¾	5 to 5½	½	½

¹ The forecast is consistent with output, income and expenditure data to the fourth quarter of 2004, released by the Office for National Statistics on 25 February 2005. See also footnote 1 on the first page of this chapter.

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

³ As in previous Budget and Pre-Budget Reports, the economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral assumption for the trend rate of output growth of 2¾ per cent to the end of 2006 and 2½ per cent thereafter. 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 ¼ percentage point below the neutral assumption.

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

⁵ Average absolute errors for current year and year-ahead projections made in spring forecasts over the past 10 years. The average errors for the current account are calculated as a percent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2005 and 2006.

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 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
2004		719.1	213.1	184.0	0.5	1116.6	282.2	1398.9	333.9	1.2	1066.1
2005		735.8 to 738.0	220.1	195.0 to 195.6	1.9 to 2.6	1152.8 to 1156.3	299.4 to 300.3	1452.2 to 1456.6	354.3 to 355.4	1.4	1099.3 to 1102.6
2006		751.2 to 757.2	226.5	202.9 to 204.5	1.3 to 3.1	1181.9 to 1191.3	318.1 to 320.6	1500.0 to 1512.0	373.4 to 376.4	1.4	1128.0 to 1137.0
2007		766.0 to 775.9	232.6	208.3 to 211.0	0.5 to 3.5	1207.4 to 1223.0	337.7 to 342.0	1545.1 to 1565.0	393.0 to 398.1	1.4	1153.5 to 1168.3
2004	1st half	357.5	105.5	90.9	0.1	554.0	138.9	692.9	164.0	0.5	529.4
	2nd half	361.6	107.6	93.1	0.4	562.6	143.4	706.0	169.9	0.7	536.7
2005	1st half	365.8 to 366.5	109.3	95.3 to 95.5	1.8 to 2.0	572.2 to 573.2	147.4 to 147.7	719.6 to 720.9	174.8 to 175.2	0.7	545.5 to 546.5
	2nd half	370.0 to 371.6	110.8	99.7 to 100.1	0.1 to 0.6	580.6 to 583.1	152.0 to 152.6	732.6 to 735.7	179.5 to 180.2	0.7	553.8 to 556.2
2006	1st half	373.7 to 376.2	112.5	99.9 to 100.6	1.5 to 2.2	587.6 to 591.6	156.6 to 157.7	744.3 to 749.3	184.3 to 185.5	0.7	560.7 to 564.4
	2nd half	377.5 to 380.9	114.0	103.0 to 103.9	-0.2 to 0.9	594.3 to 599.8	161.4 to 162.9	755.8 to 762.7	189.1 to 190.8	0.7	567.4 to 572.6
2007	1st half	381.2 to 385.6	115.6	102.9 to 104.1	0.9 to 2.3	600.6 to 607.6	166.3 to 168.3	767.0 to 775.9	194.0 to 196.3	0.7	573.7 to 580.3
	2nd half	384.9 to 390.3	117.0	105.4 to 106.9	-0.5 to 1.2	606.8 to 615.4	171.4 to 173.8	778.2 to 789.2	199.0 to 201.8	0.7	579.8 to 588.0
Percentage changes on previous year ^{4,5}											
2004		3 1/4	4 3/4	6	-1/4	3 3/4	2 1/2	3 1/2	5	1/4	3
2005		2 1/4 to 2 3/4	3 1/4	6 to 6 1/4	1/4	3 1/4 to 3 1/2	6 to 6 1/2	3 3/4 to 4 1/4	6 to 6 1/2	0	3 to 3 1/2
2006		2 to 2 1/2	3	4 to 4 1/2	0	2 1/2 to 3	6 1/4 to 6 3/4	3 1/4 to 3 3/4	5 1/2 to 6	0	2 1/2 to 3
2007		2 to 2 1/2	2 3/4	2 3/4 to 3 1/4	0	2 1/4 to 2 3/4	6 1/4 to 6 3/4	3 to 3 1/2	5 1/4 to 5 3/4	0	2 1/4 to 2 3/4

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 percent of GDP.

⁵ Growth ranges for GDP components do not necessarily sum to the 1/4 percentage point ranges for GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.