

Overall economic developments since the 2005 Pre-Budget Report have been as forecast. In 2005, the UK economy was affected by sustained rises in oil prices, weak euro area demand and a subdued housing market. In previous decades these factors would have risked being accompanied by recession. By contrast, the Government's macroeconomic framework has continued to deliver unprecedented macroeconomic stability with low inflation, and GDP now having grown for 54 consecutive quarters. Economic growth has gradually increased momentum through the latter stages of 2005 and into 2006, and the outlook is for growth to pick up to above-trend rates.

G7 economic developments have also been in line with Pre-Budget Report expectations. World growth has remained strong, due partly to the underlying momentum of some emerging economies, particularly in Asia. Oil prices have remained high. The composition of global growth, with strong growth in Asia and other emerging markets contrasting with relative weakness in Europe, accounts for some of the recent undershoot of UK export market growth relative to that of world trade. Financial conditions remain benign, with long-term interest rates remaining historically low despite some gradual increases in rates at shorter-term maturities.

UK GDP growth has firmed compared with early 2005, but remains slightly below trend. Despite the ongoing dampening effects of higher oil prices, still subdued average earnings growth, and households continuing to consolidate their finances, private consumption growth has picked up through the course of 2005. Business investment growth has remained modest according to latest estimates, as firms have continued to adopt a cautious approach to stepping up capital spending despite healthy profitability. As the economy adjusts to higher oil prices, both consumption and investment are expected to strengthen.

With the Government's macroeconomic framework continuing to deliver domestic stability, the UK economy remains well placed for a further pick-up in growth to above-trend rates by early 2007. Overall, the Budget forecast is as set out in the 2005 Pre-Budget Report:

- GDP is forecast to grow by 2 to 2½ per cent in 2006, rising to above-trend rates of 2¾ to 3¼ per cent in both 2007 and 2008. The Treasury's trend growth judgement is unchanged, so the output gap is still expected to close in 2008-09;
- CPI inflation is expected to remain close to target as inflation expectations remain firmly anchored. The ongoing effects of higher energy prices exert slightly more upward pressure this year than previously expected, but have only a temporary effect on inflation.

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<sup>1,2</sup>

**B.1** This chapter discusses recent economic developments and provides updated forecasts for the UK and world economies in the period to 2008. 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.

## THE WORLD ECONOMY

### Overview

**B.2** Developments in the global economy have been broadly as forecast in the 2005 Pre-Budget Report. World output growth in 2005 was driven by emerging Asia, particularly China, as well as by continued robust growth in the US.

**B.3** World growth has contributed to the sustained increase in the level of oil prices. Oil prices have remained high since the autumn, whilst at the same time world growth is now estimated to have been slightly stronger than expected, largely reflecting the strength of underlying momentum in Asia.

**B.4** World trade growth has remained robust, despite having moderated compared with the four-year high reached in 2004. The importance of world trade growth to the growing prosperity of the global economy underlines the need to avoid protectionist responses to the competitive pressures brought to bear by the expansion and increasing integration of emerging markets into the global economy.

**Table B1: The world economy**

	Percentage changes on a year earlier unless otherwise stated			
	2005	Forecast		
		2006	2007	2008
<i>Major 7 countries<sup>1</sup>:</i>				
Real GDP	2½	2½	2½	2½
Consumer price inflation <sup>2</sup>	2½	2½	2¼	2½
<i>Euro area: Real GDP</i>	1½	1¾	2	2
World GDP	4½	4½	4½	4½
World trade in goods and services	7	7¾	7	6¾
UK export markets <sup>3</sup>	6¼	7¼	6¼	6

<sup>1</sup> G7: US, Japan, Germany, UK, France, Italy and Canada.

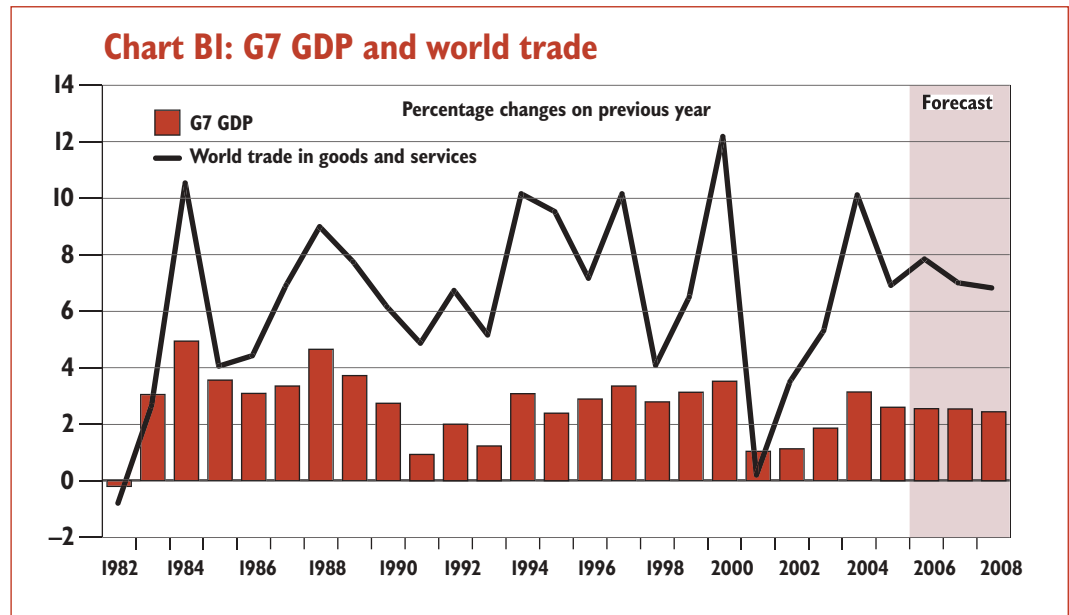
<sup>2</sup> Per cent, Q4.

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

<sup>1</sup> The UK forecast is consistent with output, income and expenditure data to the fourth quarter of 2005 released by the Office for National Statistics (ONS) on 24 February 2006. This release also contained revisions to earlier quarters of 2005 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 for 2005 will be published by the ONS on 29 March 2006. 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).

<sup>2</sup> 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.

**B.5** Oil prices have doubled over the past two years, alongside rises in other energy and some non-fuel commodity prices, and been accompanied by continued strong growth in world GDP. This supports the view that the escalation in oil prices over the recent past, in contrast to that of the 1970s or 1980s, has reflected strong demand which has created a tight market in which supply-side factors have had a disproportionate impact on prices. Nevertheless, such high oil and energy prices are likely to have undermined GDP growth by denting disposable incomes, profits and confidence to some extent, although the impact has varied depending on country-specific factors, including underlying momentum and energy intensity.



**B.6** In spite of these sharp and sustained rises in oil prices, as well as marked growth in other industrial input prices, world inflation has remained relatively low. Moreover, the pick-up in headline inflation has not fed through to comparable increases in core inflation, which has remained relatively low and stable to date. Three key factors are thought to be holding down inflationary pressures and expectations: the credibility of central banks and monetary authorities anchoring inflationary expectations; the downward pressure on traded goods prices stemming from the increasing integration of China, India and other emerging economies into the global economy; and the increase in the mobility of labour, particularly in Europe and wider Asia, holding down wage pressures.

**B.7** Long-term interest rates have been stable or even declined, contrary to what may have been expected on the basis of expectations of future short-term interest rates and term risk premia, rising short-term rates, particularly in the US, and high energy and non-oil commodity prices contributing to inflationary pressures. However, in the event current account imbalances and high levels of liquidity in the global economy, with the tendency of some Central Banks, particularly in Asia, to accumulate foreign assets, have fed into strong demand for US bonds and tended to hold down yields. This may mean that investors are driving down risk premia and perhaps under-pricing risk. Low long-term interest rates may have contributed to the run-up in asset prices in some sectors and economies, tending to add to current account imbalances.

**B.8** G7 GDP is expected to grow in line with the Pre-Budget Report forecast, with growth at 2½ per cent in 2006. The weaker growth in the US at the end of 2005 is expected to be largely

offset by a rebound in early 2006, but underlying growth is still expected to moderate somewhat during 2006 and 2007. Slower US growth is expected to coincide with a more established and robust recovery in Japan, together with signs that confidence and sentiment are improving in the euro area, which should feed through to strengthening activity.

**B.9** The risks to the outlook remain as identified in the Pre-Budget Report. Further sustained rises in oil prices could undermine confidence and lead to weaker than expected GDP growth. Furthermore, the persistence of global imbalances in an increasingly integrated world economy raises the risk of an abrupt reaction in financial markets, for example in exchange rates or bond yields. It is possible that low long-term bond yields may reflect the under-pricing of risk. There is also the continued threat of global competitive pressures giving rise to protectionist policy responses, and the ongoing possibility that inappropriate timing of monetary or fiscal policy adjustment could undermine fragile recoveries in some economies. On the upside, growth disparities are already narrowing, and with conditions supportive of growth there is potential for faster growth in activity in the US, Asia and the euro area. Moreover, the underlying momentum of the world economy has proved stronger than expected over the recent past.

## **G7 activity**

**B.10** The US economy has grown at a robust pace over the past three years since its recovery began in early 2003, averaging 4 per cent annualised growth between mid-2003 and late 2005, above estimated potential rates and thus reducing the negative output gap built up during the 2001 downturn.

**B.11** US domestic demand growth maintained considerable strength in the third quarter of 2005, despite the disruption caused by the hurricanes to regional production, the labour market, confidence and energy prices. Growth weakened in late 2005 due to a range of temporary factors, and it is expected to show a marked rebound in the first quarter of 2006. Whilst private consumption growth is expected to moderate from the strength of the past couple of years, business investment should sustain domestic demand growth over the forecast horizon. Similarly, as import growth begins to moderate, partly in line with consumption, and the export sector recovers, reflecting lagged response to past dollar depreciation and possible benefit from firmer overseas demand, the current account deficit should begin to narrow, albeit slowly.

**B.12** Stronger growth in the euro area emerged in the second half of 2005, due to robust export performance, stronger industrial production and a rise in business sentiment that stimulated some recovery in investment expenditure. However, because of the more muted performance in the first half of the year, growth in 2005 as a whole slowed and significantly lagged that of the G7 and other advanced economies. In addition, lower than expected official GDP growth statistics for the fourth quarter of 2005 highlight the underlying fragility of the recovery. Domestic demand growth slowed in 2005 due to weak private consumption growth affected by persistently high unemployment, restrained wage growth and marked energy price rises. A moderate recovery is expected throughout 2006 as investment expenditure gathers pace and export demand continues to grow, reflecting robust world trade growth and further gains in competitiveness.

**B.13** Performance in the euro area as a whole masks significant cross country variations both in terms of strength and sectoral orientation. Weaker economic growth from the major euro area economies, particularly Germany and Italy, has been offset by more robust growth in Spain and some of the smaller Member States. Growth in Germany has been driven by strong export performance, while France has been more reliant on domestic demand.

**Box B1: Global imbalances**

Imbalances in trade and financial flows have increased over the past five years. The US current account deficit hit a new high in 2005, exceeding 6 per cent of GDP, or \$760 billion. By contrast, the Japanese current account surplus exceeded \$150 billion, China and other high growth East Asian economies generated a surplus of \$210 billion, and Russia and all Middle Eastern countries traded a surplus of \$320 billion. Together the surpluses of these three groupings were equivalent to more than 80 per cent of the US deficit over the past two years.

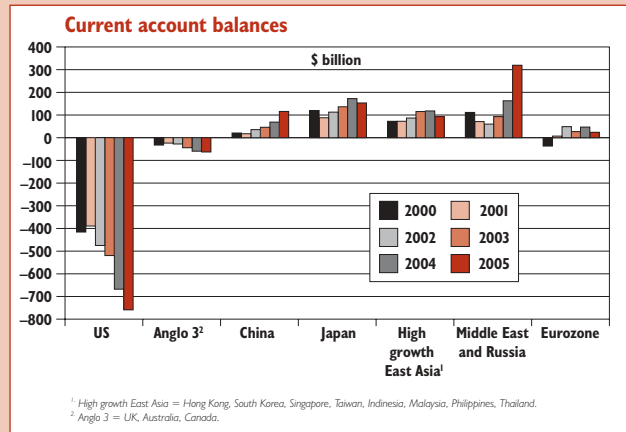
Much attention has focused on the financing of the US trade position through official purchases of US assets, especially US bonds, by Asian Central Banks. China and Japan have together amassed \$930 billion of US Treasury securities and continue to increase their reserve holdings at a rate of \$2 billion a month. Nevertheless, in 2004 purchases of official assets

represented only about a quarter of all overseas purchases of US assets, whilst purchases of non-official (private sector) assets accounted for the remainder.

In addition, there is evidence that the profits generated by higher oil revenues are also supporting the accommodative financing environment as oil exporters seek overseas investment opportunities.

Typically, the financing requirements of a large and persistent current account deficit tend to put upward pressure on nominal and real interest rates. However, yields on US long-term bonds have remained low, despite the Federal Reserve increasing the Federal Funds rate by 200 basis points during 2005. This largely reflects strong global demand for bonds at least partly associated with global imbalances, and the relatively favourable investment opportunities and low inflation expectations in the US, encouraging private domestic and foreign investors to hold US assets. As long as private (domestic and foreign) and official sectors are willing to buy US assets, the external deficits can be maintained with a stable currency.

However, a US deficit of more than 6 per cent of GDP, with the counterpart of high saving and current account surpluses in other key economies, limits the capacity of the global economy to adjust to macroeconomic shocks, and makes the dollar more vulnerable. A quick reversal in the financing environment may leave the US exposed to a disorderly adjustment of its balance of payments position, via interest rates, the exchange rate and equity markets, with global economic ramifications. An orderly rebalancing of the global economy will require key players to adopt domestic economic policies that are supportive of more sustainable growth, trade and financial flows. G7 policy makers have committed to adopting domestic policies that will contribute to more balanced domestic and therefore global growth.



**Box B2: Government policy on EMU**

The Government's policy on membership of the single currency was set out by the Chancellor in his statement to Parliament in October 1997. In principle, the Government is in favour of UK membership; in practice, the economic conditions must be right. The determining factor is the national economic interest and whether, on the basis of an assessment of the five economic tests, the economic case for joining is clear and unambiguous. An assessment of the five economic tests was published in June 2003. This concluded that: *"since 1997, the UK has made real progress towards meeting the five economic tests. But, on balance, though the potential benefits of increased investment, trade, a boost to financial services, growth and jobs are clear, we cannot at this point in time conclude that there is sustainable and durable convergence or sufficient flexibility to cope with any potential difficulties within the euro area."*

The Chancellor's statement to the House of Commons on 9 June 2003 on UK membership of the European single currency set out a reform agenda of concrete and practical steps to address the policy requirements identified by the assessment. The Budget reports on progress including:

- the introduction in December 2003 of a symmetric inflation target as measured by the Consumer Price Index (CPI). CPI inflation has been within 1 percentage point of its target since its inception;
- reforms to address both supply and demand in the housing market through implementing a programme of change to increase supply and responsiveness of the housing market as recommended in the Barker review and action taken in response to the Miles review on the mortgage market, described further in Chapter 3; and
- reforms at national, regional and local level to enhance the flexibility of labour, capital and product markets in the UK. Chapters 3 and 4 provide further detail.

As part of the policy of 'prepare and decide', the Government coordinates appropriate euro preparations across the UK economy. The Government also supports business in dealing with the euro as a foreign currency. Further information is available on the Treasury's euro website [www.euro.gov.uk](http://www.euro.gov.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 2005. 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 the reforms will depend on how they are implemented. 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 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.

**B.14** Japan's economic recovery has continued, with above-trend growth since 2003. In contrast to previous upturns, growth has been supported by strong contributions from domestic demand, improving prospects for the sustainability of the present recovery. The considerable monetary stimulus of recent years, and the restructuring of the corporate and financial sectors, have translated into greater profitability, renewed consumer optimism and improving labour market prospects. The recovery is forecast to continue in 2006, as the

elimination of lingering deflationary pressures results in real interest rates coming down, providing further support to growth. Some moderation is expected in 2007, as accommodative monetary policy unwinds further and export market growth begins to moderate.

## Emerging markets and developing economies

**B.15** Emerging market economies are growing strongly, helped by continued strength in global demand, and a virtuous circle of improved fundamentals and a positive financing environment. Favourable financing conditions are reflected in the premium on emerging market bonds falling below 200 basis points<sup>3</sup> for the first time in February 2006, driven by improved economic fundamentals, less exposed debt positions and the continuing 'search for yield' in financial markets.

**B.16** Asia continues to be the fastest growing region, with developing Asia<sup>4</sup> recording growth of just under 8 per cent in 2005, and with growth expected to be around 8 per cent in 2006. China continues to lead the region's growth, with strong domestic demand compensating for a declining contribution from net exports to deliver expected growth of 9 1/2 per cent this year, following almost 10 per cent in 2005. India, the region's other major emerging market economy, may be seeing the beginning of its own sustained period of rapid growth, with around 8 per cent expected in 2006, following broad-based growth of around 7 1/4 per cent in 2005.

**B.17** Rapid global growth has kept commodity prices high, benefiting key commodity exporters in Latin America and Africa. Growth in Latin America is forecast at just over 4 per cent this year, the third consecutive year of growth at or above this rate, and the first time this has happened since the early 1970s. Africa is expected to see growth of 5 1/2 per cent in 2006, its highest growth rate since 1974, delivering the fourth consecutive year of growth above 4 per cent, the strongest run of growth since the early 1960s.

**B.18** Rising oil prices have benefited oil exporters, improving their trade performance significantly and raising GDP growth. In 2005 the average current account surplus in the Middle East exceeded 15 per cent of GDP, whilst members of OPEC and Russia had an average current account surplus of 23 per cent of GDP. Domestic and regional equity markets, particularly those in the Middle East, have shown strong and broadly based growth, and many oil exporters have taken the opportunity to reduce public sector debt, strengthening their long-term fiscal position. In addition, oil producers have been exporting large quantities of capital. Rising demand from oil producers as they recycle revenues will also increase demand for imports and contribute to world trade growth.

## World trade

**B.19** World trade has continued to grow solidly, in line with the overall strength of the world economy, but also reflecting the increasing integration of emerging economies into the global economy and of production systems across regions. Expectations of strengthening domestic demand in the major emerging economies, particularly China, should contribute to sustained trade growth over the next few years. However, the competitive challenge presented by the expansion and integration of major emerging economy exporters has encouraged protectionist sentiment, particularly in the EU and the US. With trade being a significant source of global prosperity, these challenges need to be met through flexibility and efficient allocation of resources, rather than through erecting damaging trade barriers.

<sup>3</sup> As measured by the Goldman Sachs Emerging Market Bond Index (EMBI).

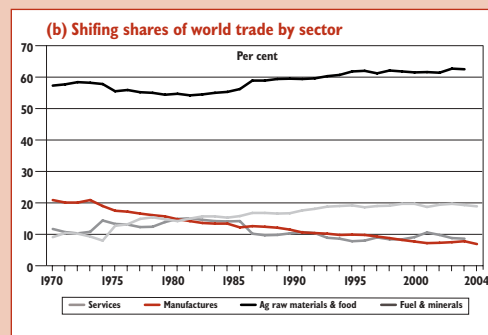
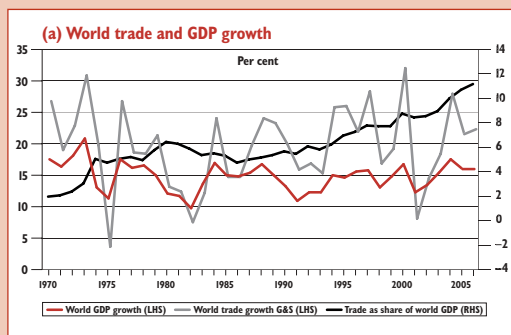
<sup>4</sup> Developing Asia consists of all East and South Asia except Japan, the Koreans, Taiwan, Hong Kong, and Singapore.

**B.20** World trade growth has been largely driven by Asia, with the Asia-Pacific region contributing around 40 per cent to world trade growth over the past three years, in contrast to around 15 per cent from each of the US, the euro area and the rest of Europe. Asia accounts for just 15 per cent of UK export markets, whereas the euro area, which is growing more slowly, accounts for around half of the UK's export markets. In 2006 UK export market growth is expected to strengthen as world trade growth remains robust and the composition shifts in the UK's favour, with some pick-up in demand from the euro area, and higher US import growth as strong imports in late 2005 feed through to 2006.

**Box B3: The importance of trade to world growth**

World trade growth is a key source of rising global prosperity. Free trade:

- enables consumers and businesses to engage in transactions with wider markets, increasing choice and opportunities;
- increases transparency and competition, and therefore efficiency and productivity; and
- promotes more rapid assimilation of technological innovations into world-wide production processes.



World trade has made an increasingly important contribution to world output growth in recent decades, with trade accounting for almost 30 per cent of world GDP in 2005, almost three times its share in 1970<sup>a</sup>. Manufactures account for the majority of cross-border trade, at around 60 per cent of the total, a share that has remained fairly stable over the past three and a half decades. However, services have increased significantly as a proportion of world trade, doubling from around 10 per cent in 1970 to around 20 per cent in 2004. Moreover, the impediments to trade in services are declining quickly, due to advances in communications and information technology, and gradual withdrawal of protectionism in some service industries.

The importance of free trade in raising growth and living standards means that adopting protectionist policies in the face of competitive pressures constrains growth and long-term opportunities. A more beneficial and resource-efficient strategy is to move further towards an open and fair multi-lateral trading system, and to adopt domestic policies that enhance flexibility and facilitate the movement of resources between sectors<sup>b</sup>.

Results from studies of the gains from full trade liberalisation vary depending on the assumptions used, but the World Bank estimates that full liberalisation of agriculture and industrial trade over the next five years could yield gains of \$290 billion a year by 2015. That would reduce the number of people living on no more than \$1 a day by 32 million, or 5 per cent, by 2015. Progress towards a successful outcome in the multi-lateral World Trade Organisation negotiations is critical to the pursuit of an open and fair world trading system, the continuation of robust and sustainable world growth, and the raising of living standards. A multi-lateral trading system is more efficient and more transparent than an increasing array of bilateral and regional trade agreements.

<sup>a</sup> Based on IMF September 2005 WEO data; GDP and world trade at current prices.

<sup>b</sup> See *Long-term global economic challenges and opportunities for the UK*, HM Treasury, December 2004.

## Oil and commodity prices

**B.21** Oil prices have increased sharply since the beginning of 2004, though in real terms they have remained below historic peaks. The price of Brent crude oil, the European standard, rose from a low of \$10 a barrel in 1999 to a peak of over \$67 a barrel in September 2005. Prices declined from this peak towards the end of 2005, but have risen again in early 2006 to average \$62 a barrel for the year to date, compared to an average of \$55 a barrel during 2005.

**B.22** Rapid growth in the demand for oil, particularly from emerging market economies, and limited investment, have been primary causes of low levels of spare capacity and rising oil prices since 2004. In this environment, supply disruptions and uncertainties have had a magnified impact on price. An imbalance between the demand and supply of different grades of crude in a constrained refining environment has also contributed to pressure on prices. The further increase in prices in early 2006 has been driven by strong demand, further supply disruptions (in Iraq, Nigeria and Russia) and an increase in perceptions of geo-political supply risk.

**B.23** Higher nominal oil prices are expected to be sustained into the medium term. G8 Finance Ministers continue to take global action to address high and volatile oil prices and their impacts.

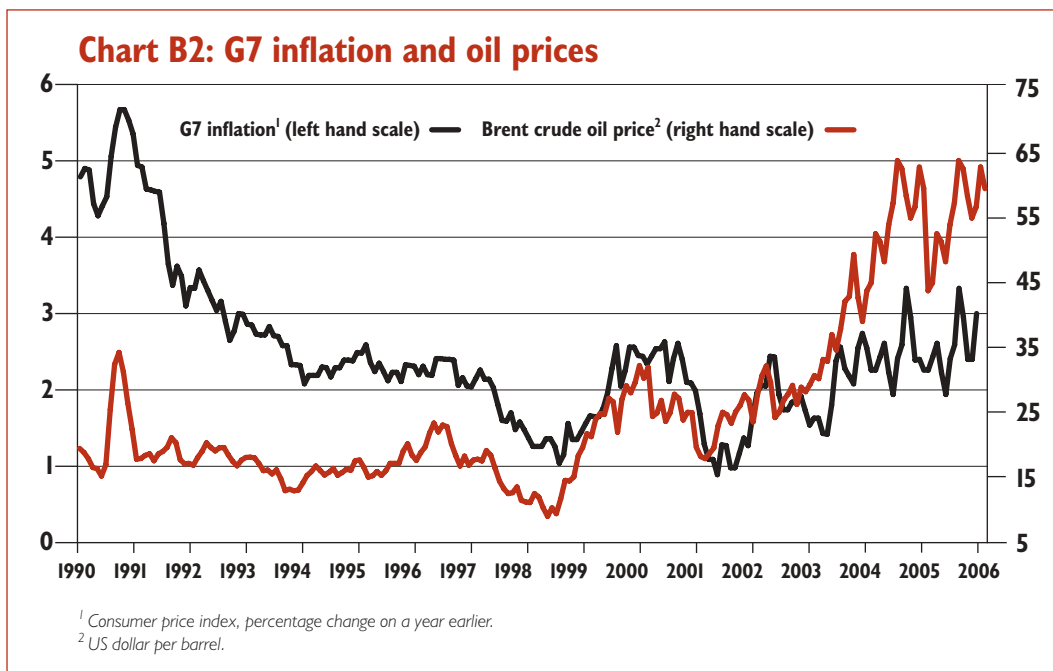
**B.24** In the past, such rapid rises in oil prices have had a significant impact on global economic growth. Four key factors have served to mitigate some of the potentially adverse impact of the recent oil price increases: first, high oil prices have stemmed largely from strong world demand; second, more stable macroeconomic frameworks, in particular greater credibility of monetary policy and authorities, have limited the pass-through to core inflation and anchored inflationary expectations, reducing the need for a more marked monetary tightening; third, the pass-through has also been limited by greater competition in the world economy maintaining pressure on margins and wage rates; and fourth, the energy intensity of production is lower than in the past.

**B.25** Non-fuel commodity prices have also been rising due to increased global demand, reflecting the strength of world output, as well as supply constraints for some commodities in key producing regions. Whilst non-fuel commodity prices have risen by 17 per cent over the past year, industrial input prices have risen by 24 per cent and metal prices have risen by over 30 per cent. Metals that are extensively used in manufacturing and industrial output, such as copper, iron and steel, have seen even stronger price increases.

## G7 inflation

**B.26** G7 headline inflation picked up during 2005, reflecting the escalation of energy costs, and particularly oil prices, in the autumn. The rise in G7 inflation from mid-2005 primarily reflected developments in US inflation. Headline inflation in other G7 economies also rose, but it did so to a lesser degree than in the US. In Japan, deflation gradually subsided during 2005 with a return to positive rates of inflation towards the end of the year, although underlying price pressures remain weak.

**B.27** In the G7 economies, headline inflation has risen broadly in accordance with energy prices, whereas core inflation has remained very stable. This reflects the limited pass-through of energy price increases to other goods and services, and hence from headline inflation to core inflation. The credibility of monetary frameworks has been a key factor contributing to the limited pass-through by anchoring inflation expectations at low rates.



### Forecast issues and risks

**B.28** Whilst there are some upside risks relating to a stronger recovery in the US in early 2006, more persistent strength in Japan than projected or a quicker recovery in the euro area, there are also some downside risks to the current projections and the strength of the world and G7 economies. These risks remain broadly similar to those at the time of the 2005 Pre-Budget Report – the persistence of global imbalances, high and volatile oil and energy prices, inflationary pressures necessitating more marked monetary tightening, and the possibility of increasingly protectionist trade policies.

**B.29** The improved growth prospects in Japan and the euro area are positive developments in terms of narrowing current account imbalances over the medium term, and the stability of core inflation has allowed monetary policy to be adjusted at a gradual pace with short rates at relatively modest levels. As the euro area and Japan join the US in removing monetary stimulus, it is possible that the world economy will begin to face a somewhat tighter financial environment, though high levels of liquidity, particularly in Asia, are likely partly to offset the tightening in monetary conditions at the short end by holding down longer-term interest rates. Nevertheless, there is a risk that if the market begins to lose confidence in US economic prospects and its capacity to finance its outstanding liabilities associated with the current account and fiscal deficits, agents will demand higher rates of return over the medium term, and longer-term interest rates will rise. However, unless high levels of global liquidity are adjusted simultaneously, the saving surplus will seek alternative investment opportunities, holding down yields elsewhere.

**B.30** Policy makers continue to strive for a successful outcome to the Doha multilateral trade negotiations to ensure further progress towards an open, fair and transparent world trading system, and hence growing global prosperity, though this is no guarantee that unilateral barriers to trade will not be created.

## UK ECONOMY

### Overview of recent developments

**B.31** The UK economy was resilient in the face of a number of challenges in 2005. After strong growth at above-trend rates in late 2003 and through the first half of 2004, GDP decelerated from mid-2004 and has since grown at below-trend rates in the face of sustained higher oil prices, weak demand growth in the euro area, and a slowing housing market.

**B.32** In previous decades, such factors would have risked being accompanied by recession. By contrast, the Government's macroeconomic framework has continued to deliver an unprecedented period of sustained and stable economic growth with low inflation. UK GDP has now expanded for 54 consecutive quarters. On the basis of quarterly national accounts data, this is the longest unbroken expansion since records began 50 years ago. Moreover, the current economic expansion has persisted for well over twice the duration of the previous period of unbroken growth.

**B.33** Overall developments since the 2005 Pre-Budget Report have been as forecast. GDP rose by 0.6 per cent in the final quarter of 2005, remaining a little below trend although slightly stronger than in the second and third quarters and significantly above growth at the start of last year. Growth in the final quarter was underpinned by rising private and government consumption, alongside a small positive contribution from net trade, while investment fell back.

**B.34** Growth in non-oil GVA, which is the basis for the Government's output gap estimates, has followed a similar profile to that of total GDP although it has been a little smoother: total GDP has been affected by variations in oil production over the past 18 months. Non-oil GVA grew fractionally faster than total GDP in the third quarter of last year and at the same, below-trend rate as GDP in the final quarter.

**B.35** In 2005 as a whole, UK GDP is currently estimated to have risen by  $1\frac{3}{4}$  per cent, consistent with the 2005 Pre-Budget Report forecast. UK GDP growth last year was above growth in the euro area as a whole for the tenth consecutive year, with UK growth, on average, only behind that of North America amongst G7 economies since 1997.

**B.36** The economy has undergone a degree of rebalancing in recent years. The ratio of nominal private consumption to GDP has trended downwards significantly since its peak in 2001 despite a run of relatively strong real consumption growth, part of which helped to shield the UK economy between 2001 and 2003 from some of the negative effects of the sharpest slowdown in the world economy for around 30 years. More recently real private consumption growth has moderated from around  $3\frac{1}{2}$  per cent in 2004 as a whole to around  $1\frac{1}{2}$  per cent in the year to the second half of 2005. Consumer spending grew at the same rate as GDP in 2005 as a whole, whereas growth in total investment and to a lesser extent government consumption exceeded GDP growth, and net exports made a neutral contribution. Whole economy investment rose by  $3\frac{1}{4}$  per cent last year, weaker than growth in 2004, but stronger than for the three previous years.

**B.37** Against a backdrop of above-trend UK GDP growth, the Monetary Policy Committee (MPC) of the Bank of England pre-emptively increased interest rates on five occasions between November 2003 and August 2004. This followed a pre-emptive series of rate cuts during the global downturn between 2001 and 2003. The MPC subsequently reduced repo rates by 25 basis points on 4 August 2005, with rates remaining unchanged since then. The expansionary impact of fiscal policy has moderated since 2002-03.

**B.38** CPI inflation rose above target in the second half of 2005, peaking in September, primarily on account of the direct and indirect effects of oil price rises. However, CPI inflation declined in the final quarter to just below target by the end of the year, and stood at target in February 2006, despite high oil prices and wider energy costs still putting some residual upward pressure on inflation in recent months.

**B.39** Revisions to the national accounts made subsequent to the 2005 Pre-Budget Report have relieved some of the tension between the recorded path of GDP growth since early 2004 and other indicators of activity and demand. The slowdown in output growth from mid-2004 is now less pronounced than previously estimated. However, it is still relatively marked given other economic developments at that time, and over more recent quarters the official estimates of output have continued to suggest somewhat weaker growth than private sector business survey indicators of manufacturing and service sectors.

**B.40** Latest labour market data also now look to be more consistent with below-trend growth, in contrast to much of 2005 when employment and unemployment indicators had remained significantly more buoyant than might have been expected on the basis of measured output growth. Having remained broadly stable for the first three quarters of 2005, the employment rate has subsequently fallen back by 0.4 percentage points to 74.5 per cent in late 2005 and early 2006, while the unemployment rate rose by  $\frac{1}{4}$  percentage point to around 5 per cent over the same period. Moreover, average earnings growth has continued to track down. However, it is unclear thus far to what degree the labour market has undergone an underlying softening and to what extent some of the recent weakening may be temporary and erratic.

**B.41** Recent data therefore appear broadly consistent with the view that sustained high oil prices and consumers' caution over their finances, with house price inflation subdued and muted growth in average earnings, have continued to dampen UK GDP growth. Nevertheless uncertainties continue to surround the precise extent to which the economy has been operating below trend over the recent past.

## Trend growth and the output gap

**B.42** The Treasury's neutral estimate of the economy's trend rate of growth of output for Budget 2006 remains at  $2\frac{3}{4}$  per cent a year to the end of 2006, slowing to  $2\frac{1}{2}$  per cent thereafter due to the demographic effects of post-War baby-boom women reaching retirement age and depressing the growth rate of the working-age population. This is unchanged from the 2005 Pre-Budget Report.

**B.43** Table B2 presents historical estimates of trend output growth and its decomposition for the first half of the current cycle and for the previous cycle, together with the forward-looking assumptions for trend growth based on projections of its components for the current phase of the cycle and beyond. These also remain unchanged from the Pre-Budget Report. Over the first half of the current economic cycle, between the on-trend points in 1997 and 2001, trend productivity growth, measured on an output per hour worked basis, was 2.6 per cent a year, compared with around 2 per cent over the previous two economic cycles as discussed further in Chapter 3.

**B.44** Consistent with past practice, projections of the public finances are based upon the lower end of the economic forecast ranges, which are anchored around the deliberately cautious assumption of annual trend output growth  $\frac{1}{4}$  percentage point lower than the neutral view – see Box C2. For Budget 2006 this cautious assumption for the trend growth rate has been audited by the NAO under the rolling review process,<sup>5</sup> as was proposed in the 2005 Pre-Budget Report.

**B.45** Chart B3 shows the estimated output gap profile over the past and the forecast going forward. With only marginal upward revisions to output growth, the output gap profile over the recent past remains very similar to that at the time of the Pre-Budget Report. The negative output gap at the end of last year is now estimated at  $-1\frac{1}{4}$  per cent, slightly narrower than forecast at the time of the Pre-Budget Report, reflecting the small revisions to the data for previous quarters.

**Table B2: Contributions to trend output growth<sup>1</sup>**

	Estimated trend rates of growth, per cent per annum					
	Trend output per hour worked <sup>2, 3</sup>		Trend	Trend	Population	Trend
	Underlying	Actual	average hours worked <sup>3</sup>	employment rate <sup>3</sup>	of working age <sup>4</sup>	output
	(1)	(2)	(3)	(4)	(5)	(6)
<b>1986Q2 to 1997H1</b>	2.22	2.04	-0.11	0.36	0.24	<b>2.55</b>
<b>Over the recent past</b>						
<b>1997H1 to 2001Q3</b>						
Budget 2002	2.14	1.96	-0.37	0.36	0.66	<b>2.63</b>
Budget 2003	2.35	2.14	-0.47	0.43	0.50	<b>2.61</b>
PBR 2003 and Budget 2004	2.65	2.44	-0.47	0.42	0.54	<b>2.94</b>
PBR 2004 and Budget 2005	2.70	2.50	-0.43	0.41	0.58	<b>3.06</b>
PBR 2005	2.79	2.59	-0.44	0.42	0.58	<b>3.15</b>
Budget 2006	2.79	2.59	-0.44	0.42	0.58	<b>3.15</b>
<b>Projection<sup>5</sup></b>						
<b>2001Q4 to 2006Q4</b>						
Budget 2002	2.10	2.00	-0.1	0.2	0.6	<b>2<math>\frac{3}{4}</math></b>
Budget/PBR 2003, Budget/ PBR 2004 and Budget 2005	2.35	2.25	-0.1	0.2	0.5	<b>2<math>\frac{3}{4}</math></b>
PBR 2005	2.25	2.15	-0.2	0.2	0.6	<b>2<math>\frac{3}{4}</math></b>
Budget 2006 <sup>6</sup>	2.25	2.15	-0.2	0.2	0.6	<b>2<math>\frac{3}{4}</math></b>
<b>2006Q4 onwards</b>						
PBR 2004 and Budget 2005	2.35	2.25	-0.1	0.2	0.3	<b>2<math>\frac{1}{2}</math></b>
PBR 2005	2.25	2.15	-0.2	0.2	0.4	<b>2<math>\frac{1}{2}</math></b>
Budget 2006 <sup>6</sup>	2.25	2.15	-0.2	0.2	0.4	<b>2<math>\frac{1}{2}</math></b>

<sup>1</sup> 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.

<sup>2</sup> 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.

<sup>3</sup> 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.

<sup>4</sup> UK resident household basis.

<sup>5</sup> Neutral case assumptions for trend from 2001Q3.

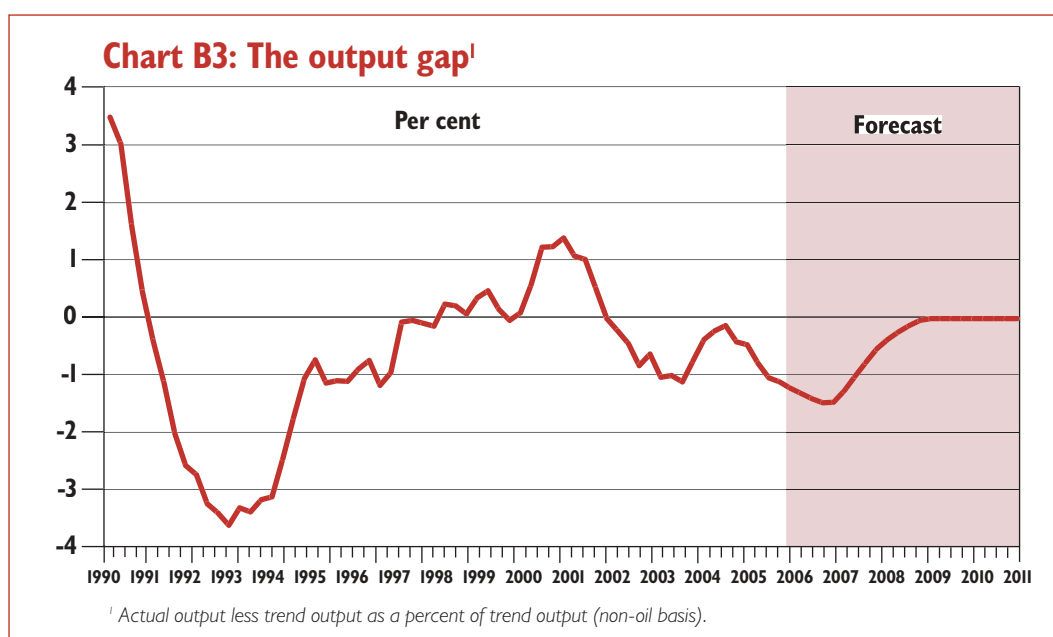
<sup>6</sup> Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2006Q1 are anchored.

<sup>5</sup> See Box 2.1 and NAO Audit of Assumptions for Budget 2006.

**B.46** The Pre-Budget Report noted a number of uncertainties surrounding the output gap estimates over the recent past. To a large extent, these uncertainties remain. Below trend output growth coupled with robust employment growth since mid-2004, implies that the widening of the output gap has been accompanied by weaker productivity growth, according to the latest national accounts and labour market data. However, with the labour market showing signs of some easing in the last quarter of 2005, it is possible that the observed weak productivity growth may – at least in part – be attributable to labour hoarding during the period of weak demand.

**B.47** The fall in the employment rate since the third quarter of 2005, following the slight rise over the previous year, together with the latest national accounts data, implies a marked pick-up in productivity growth in the final quarter, resulting in some rebalancing in the drivers of the output gap from productivity to employment. But as previously discussed, the apparent labour market softening in the final quarter could be temporary and erratic, which means that the assessment of previous labour hoarding unravelling towards the end of the year remains tentative.

**B.48** Although the suggested softening of the labour market has gone some way towards reconciling output and labour market indicators, the extent of the measured cyclical slowdown in productivity continues to puzzle many commentators. There is still some difficulty reconciling strong output growth in the first half of 2004 and the subsequent slowing of growth with evidence from private sector business surveys.



**B.49** Indicators of capacity utilisation in manufacturing continue to support the assessment of a widening output gap since mid-2004, though not to the extent implied by the latest national accounts data. The BCC measure of utilisation in the service sector picked up at the end of 2005 following weakness in the first three quarters of 2005. Business survey indicators of recruitment difficulties show that firms in the services sector were finding it slightly more difficult to find suitable labour at the end of 2005, while the picture for manufacturing is more mixed.

**B50** However, average earnings growth was fairly weak in 2005 as a whole, and fell further in the final quarter, with the whole economy rate excluding bonuses down to around  $3\frac{3}{4}$  per cent in recent months, compared to about  $4\frac{1}{2}$  per cent in late 2004. This lends support to the view that a significant negative output gap remains. CPI inflation has slowed back to target, though developments in oil prices mean that CPI inflation is a less clear indicator of overall capacity pressures than normal.

**B.51** Overall, national accounts and labour market data point to a sizable negative output gap in 2005, widening slightly through the year. While there appears to be a consensus amongst external forecasters that the UK is currently operating with a negative output gap, there is some uncertainty regarding the exact magnitude of that gap, and its quarterly path. Different methodological approaches to determining the economy's cyclical position tend to result in somewhat different conclusions<sup>6</sup>.

#### **Box B4: Older workers**

The labour market activity rate of older workers, aged 50 and above, has risen by around  $3\frac{1}{2}$  percentage points over the past decade. By contrast, over the same period, the activity rate of those aged between 16 and 49 has fallen by around  $1\frac{1}{2}$  percentage points. As a result, the contribution of people over 50 to the working-age activity rate has risen from around  $14\frac{1}{2}$  per cent in 1992 to 18 per cent last year.

For the individual, remaining active in the labour market for longer can raise financial standards of living during retirement. It can also increase social inclusion and improve health.

Higher activity rates have important implications for the UK economy as a whole. The rising trend in participation among older people, all else equal, raises the economy's trend rate of growth, because rising activity rates broadly translate into increases in the employment rate component of trend output growth. Changes in the participation rate of older workers could also affect the productivity and average hours components of trend output growth.

Despite some cyclical influences, activity rate rises amongst older workers over the past decade have mostly been driven by structural factors, including an ageing population, less gender discrimination and other social and economic changes.

Going forward, there are a number of factors which are likely to raise the activity rate of older workers further. The State Pension Age will be equalised by 2020 at 65. Although some female workers may already have started adapting to this change, the experience of New Zealand – which underwent a similar policy change between 1992 and 2000 – points to further upward effects on participation. Moreover, age discrimination legislation will come into effect from October 2006; and the proportion of people aged 50 or over in the population is forecast to hit almost 50 per cent by 2024. This means that the participation behaviour of older workers will become an increasingly important factor in whole economy performance.

<sup>6</sup> See *Evidence on the UK Economic Cycle*, HM Treasury, July 2005

## Summary of prospects

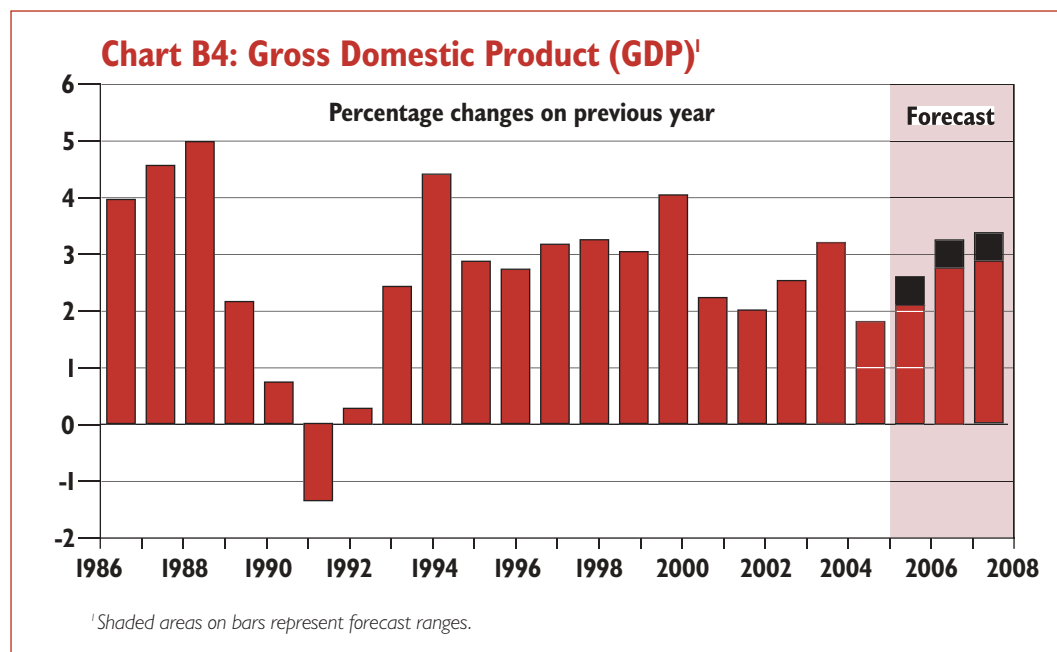
**B.52** Sound macroeconomic fundamentals continue to support growth and stability in the UK, helping the economy to remain far more resilient to challenges and shocks than it has in the past. As a result of the domestic macroeconomic stability that the Government's policies have delivered, the UK is well placed for a resumption of above-trend growth as the effects of current dampening influences on activity abate. However, uncertainties about the effects of high oil prices and current levels of household and corporate debt pose particular risks to the outlook, both downside and upside.

**Table B3: Summary of forecast<sup>1</sup>**

	2005	Forecast		
		2006	2007	2008
GDP growth (per cent)	1¾	2 to 2½	2¾ to 3¼	2¾ to 3¼
CPI inflation (per cent, Q4)	2¼	2	2	2

<sup>1</sup> See footnote to table B9 for explanation of forecast ranges.

**B.53** Overall, the economic forecast is unchanged from the 2005 Pre-Budget Report. Following growth of 1¾ per cent in 2005, UK GDP is expected to grow by between 2 and 2½ per cent this year, still slightly below trend rates. This reflects a number of factors. Private consumption growth is expected to be further restrained by continued household appetite for saving, weak growth in labour incomes, and the residual effects of higher energy prices. Companies are likely to remain cautious about stepping up business investment in the face of high oil prices, further below-trend growth in the near term, and high levels of capital gearing.



**B.54** However, the economy has already shown signs of gradually increasing momentum through the latter stages of 2005 and into 2006. The Government's macroeconomic framework has continued to deliver unprecedented stability, with inflation at target, despite the effects of higher oil prices, and GDP growth remaining above rates seen when the economy has faced shocks in past decades. So the economy remains well placed to see a renewed period of above-trend growth from 2007 and beyond as factors temporarily subduing growth over the recent past abate.

**B.55** With the effects on spending of previous oil price rises and the recent adjustment in the household saving ratio receding, private consumption growth should firm a little further in 2007 and 2008, although rising at rates well below recent peaks and growth in the economy as a whole. With adjustment to higher oil prices working through and corporate fundamentals generally supportive, companies should be well placed to undertake firmer growth in investment spending as demand accelerates in 2007. As a result, GDP growth is forecast to be above trend rates at between  $2\frac{3}{4}$  and  $3\frac{1}{4}$  per cent in both 2007 and 2008, with spare capacity being absorbed and the output gap closing in 2008-09, unchanged from the 2005 Pre-Budget Report judgement.

**B.56** The 2006 Budget forecast implies further rebalancing of GDP growth going forward, with business investment accelerating and outpacing private consumption from the end of 2006. Private consumption growth is expected to be in line with GDP growth this year, but to fall short of it thereafter. Net exports are forecast to make a neutral contribution to GDP growth, in contrast to the negative contribution in the years preceding 2005.

**B.57** CPI inflation is expected to remain close to target, as inflation expectations remain firmly anchored, and energy prices exert slightly more upward pressure on inflation in 2006 than expected at the time of the Pre-Budget Report.

## UK DEVELOPMENTS AND PROSPECTS IN DETAIL

### Demand

**B.58** The share of nominal consumption expenditure in UK GDP stabilised in 2005, having drifted down in each of the previous four years largely on the back of strong price competition in retail and other consumer markets.

**B.59** Real private consumption rose by around  $1\frac{3}{4}$  per cent in 2005. The slowing in private consumption growth compared with much of the recent past accords with the pattern of Budget and Pre-Budget Report forecasts since 2004, although the magnitude of that slowdown, on the basis of latest estimates, is somewhat greater than had been forecast.

**B.60** Consumer spending growth picked up in the second half of 2005. However, this was from a weak base and growth remains below its long-run average. There are a number of factors that have continued to impinge on underlying household expenditure growth. Latest data, including data revisions introduced since the Pre-Budget Report, now show households increased saving in 2005, with the saving ratio estimated at around  $5\frac{1}{4}$  per cent for the year as a whole, compared with  $4\frac{1}{2}$  per cent in 2004. This is consistent with households undertaking some adjustment to their financial positions following strong borrowing and build up of debt over recent years. Additionally, with the labour market softening a little, there may have been some increase in the precautionary motive for saving. Moreover, average earnings growth has remained subdued and below most forecasters' prior expectations for 2005, although growth in non-labour components of household income boosted growth in nominal disposable income compared to 2004. Nevertheless, growth in real disposable income and consumption has been squeezed by higher than expected inflation through much of last year, largely reflecting the ongoing effects of oil-related rises in energy prices.

**B.61** Most recent evidence is consistent with consumer spending growth gathering gradual momentum through the past year, although still below rates prevailing prior to the recent slowdown. Retail sales growth has clearly picked up from its trough, with sales in recent months averaging over  $2\frac{1}{2}$  per cent up on a year earlier. Consumer confidence also appears to have firmed of late.

**B.62** The Budget forecast for private consumption growth in 2006 is slightly higher than in the Pre-Budget Report, on account of the level effects arising from stronger than expected growth in the fourth quarter of 2005. Spending in 2006 is expected to continue being affected by higher energy prices and households' efforts to readjust their financial positions in response to high levels of borrowing over previous years. As these factors abate, private consumption growth should pick up from 2007, although remaining well below the peaks reached earlier this decade.

**B.63** Latest official business investment estimates suggest private sector capital expenditure grew at only modest rates from the end of 2004 and through 2005. Ostensibly, this is consistent with the recent behaviour in a number of factors that are commonly perceived to have a strong influence on business investment. Subdued domestic demand and slower export market growth for much of the past year are likely to have discouraged firms from expanding capital budgets. High oil prices are likely to have been a further factor underpinning companies' reluctance to invest. Capital gearing remains high, despite having declined a little since its 2003 peak, and may have also acted as a constraint on business investment growth. In addition, it has been suggested that some companies may have been undertaking further adjustment in the face of still high pension fund deficits, though it is not clear that this has been materially holding back investment: profits, after taking into account pension fund payments, remain relatively high.

**B.64** Nonetheless, there are grounds for thinking that business investment may have been somewhat stronger over the recent past than presently suggested by the official data. In particular, corporate profitability has been strong throughout the past two or so years; and business investment data are prone to relatively large revisions. So it is possible that later estimates may present a firmer picture of private capital spending than currently prevails. One important source of revisions arises from methodological and measurement advances. For example, as discussed in Box B6, the Office for National Statistics has recently published details of improvements to the way in which computer software investment is measured, suggesting that firms' own account in-house software investment has been significantly under-estimated in the UK.

**B.65** Business investment growth is expected to remain at only modest rates over the near term, in response to still subdued growth of private consumption and companies' desire to reduce still high levels of capital gearing. However, with the corporate sector carrying substantial reserves of liquidity, and a historically low cost of capital contributing to a supportive financial environment, the foundations remain in place for a stronger pick-up in business investment to emerge later in 2006 and into 2007 and 2008. Business investment is projected to rise by between 1 to 1½ per cent this year – close to growth in 2005 – rising to 4½ to 5¼ per cent in 2007 and to 4½ to 5¼ per cent in 2008.

**B.66** Government investment is estimated to have risen by 18½ per cent in 2005, continuing the strong growth of recent years. It is forecast to rise robustly again this year and next, in line with the Government's spending plans.

**B.67** Interpretation of trade data was complicated in 2005 by the discovery of new Missing Trader fraud, which affects the figures for both imports and exports but not net trade. At face value, UK goods and services export volumes rose at their fastest rate for five years in 2005, up by 5¼ per cent on 2004. However, excluding Missing Trader activity, underlying export growth last year was more subdued, at just under 3 per cent. Chapter 5 sets out steps to strengthen the Government's strategy for combating the fraud.

**B.68** Goods and services import growth also moderated last year, easing from a four-year high of 6¾ per cent in 2004 to around 4¾ per cent in 2005. Excluding Missing Trader activity, import volumes grew by just 2½ per cent in 2005. This is broadly consistent with the

slowdown in UK domestic demand growth since around mid-2004. As a result, the contribution from net trade to UK GDP growth last year was broadly neutral, in contrast to the run of negative contributions since 1997, with the exception of 2000.

**B.69** Total export volume growth in 2006 is forecast to be about the same as last year, though this masks an underlying firming as UK export market growth picks up on the back of stronger demand from the euro area. (Missing Trader activity is assumed to make a zero contribution to growth in trade volumes). With export growth expected to be a little above that of imports over the forecast horizon, net trade is forecast to make a broadly neutral contribution to GDP growth throughout.

**Table B4: Contributions to GDP growth<sup>1,2</sup>**

	Percentage points, unless otherwise stated			
	2005	Forecast		
		2006	2007	2008
<b>GDP growth, per cent</b>	$1\frac{3}{4}$	$2\frac{1}{4}$	<b>3</b>	<b>3</b>
<b>Main components:</b>				
Private consumption	$1\frac{1}{4}$	$1\frac{1}{2}$	$1\frac{3}{4}$	2
Business investment	$\frac{1}{4}$	0	$\frac{1}{2}$	$\frac{1}{2}$
Government	$\frac{3}{4}$	$\frac{3}{4}$	$\frac{3}{4}$	$\frac{3}{4}$
Change in inventories	$-\frac{1}{4}$	0	0	0
Net trade	0	0	0	0

<sup>1</sup> 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.

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

**B.70** The Budget forecast shows further rebalancing of GDP growth going forward, with business investment accelerating and outpacing real private consumption from the end of 2006. Private consumption is expected to grow in line with GDP this year, but then to undershoot it as the economy moves to above-trend rates of growth in 2007 and 2008. Net exports are forecast to make a neutral contribution to GDP growth, in contrast to the negative contribution in the years preceding 2005.

## Output

**B.71** Manufacturing output was subdued through much of 2005 and declined by around 1 per cent for the year as a whole, following on from the strongest growth in the sector for four years in 2004. Manufacturing output growth has been held back by a number of factors over the recent past: continued weak growth in the euro area over much of 2005 restrained external demand for UK manufactured output, while high oil prices caused a sharp rise in producer input prices, squeezing margins and impinging on corporate confidence. At the same time, subdued growth in private consumption and business investment have acted to depress demand for manufacturing output.

**B.72** Private sector business survey evidence on manufacturing activity has been mixed in recent months, but points to some gradual strengthening in output growth, already evident in the most recent data. Manufacturing output is forecast to rise by  $\frac{1}{2}$  to 1 per cent this year, slightly less than in the Pre-Budget Report forecast, reflecting data revisions, and to rise by  $1\frac{3}{4}$  to  $2\frac{1}{4}$  per cent in 2007 and 2008 with stronger whole economy GDP growth.

**B.73** Service sector output rose by just over  $2\frac{1}{2}$  per cent in 2005, down from  $3\frac{1}{2}$  per cent in 2004, reflecting lower growth in demand for both household and business services and a sharp fall in service sector export growth: last year was a particularly subdued year for services

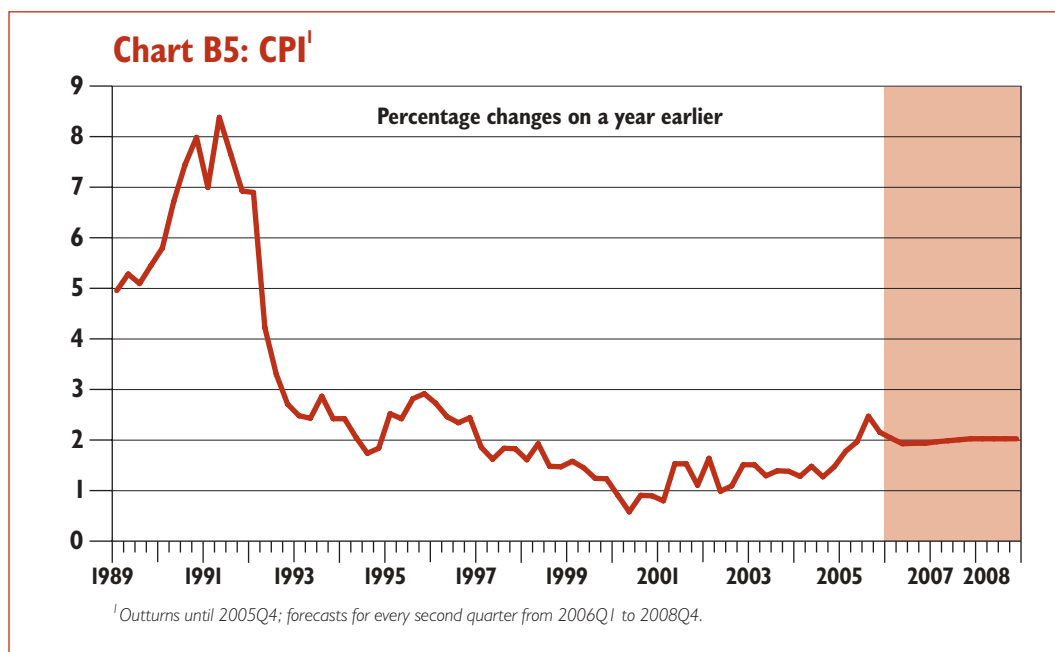
exports, which rose by just 1 per cent compared with 2004. This partly reflects the impact of the 7 July London terrorist attacks on tourism in the third quarter, but also more generalised weakness in external demand for service sector output. Private sector business survey evidence has, however, suggested a marked pick-up in demand for service sector output in early 2006, with the CIPS report on services showing the Activity Index at its highest for nearly two years in February.

## Inflation

**B.74** CPI inflation has fallen back since the time of the 2005 Pre-Budget Report, and by more than most commentators expected. CPI inflation rose through the summer to peak at 2½ per cent in September, principally reflecting higher oil prices feeding through to the energy prices faced by households. Since then CPI inflation has fallen, edging down to fractionally below target in both December and January, before returning to target in February. This is despite high oil prices and wider energy costs still exerting residual upward pressure on inflation, and provides evidence of inflation expectations remaining firmly anchored, reflecting the credibility of the Government’s monetary policy framework.

**B.75** The increases in both oil and gas prices mean that energy prices are currently contributing 0.6 percentage points to CPI inflation. In particular, wholesale gas prices have risen significantly in the past six months, spiking sharply upwards on a number of occasions due to supply concerns. The recently announced increases in domestic gas prices from most major UK suppliers indicate that these increases in costs are beginning to be passed through to consumers. Reflecting this, energy prices are expected to continue to make a significant contribution to CPI inflation in the coming months, before easing off later in the year as the effects of last year’s increase in oil prices falls out of the annual rate.

**B.76** Both RPI and RPIX inflation have remained broadly where they were last autumn. RPI inflation stood at 2.4 per cent in February while RPIX inflation – the previous basis for the Government’s inflation target – was a little lower at 2.3 per cent. The wedge between RPIX inflation and CPI inflation fell to zero in September, partly as a result of the slowdown in house price inflation, for the first time since the inception of the CPI. Subsequently, it has widened a little, although it has remained narrow relative to the wedge that prevailed between the two inflation rates for much of 2003 and 2004.

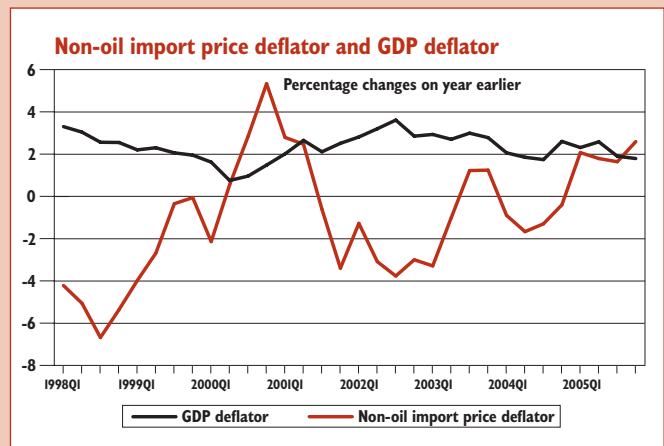


**B.77** House price inflation appears to have firmed a little compared with much of the period through late 2004 and the first half of 2005. Both the Halifax and Nationwide have reported moderate three-month on three-month rates of house price inflation in recent months which are a little stronger than rates prevailing a year earlier. Moreover, annual rates of house price inflation look to have recently been running at around a range of 4 to 5 per cent, significantly below the rates of well in excess of 20 per cent that prevailed from autumn 2002 through to summer 2003.

**Box B5: Globalisation and inflation**

The integration of low cost emerging markets into the global economy in recent years has important implications for both global commodity prices and UK consumer prices. China alone now accounts for 6 per cent of world trade, and emerging Asia as a whole accounts for around 20 per cent, and its share is growing. This growth in global trade flows has had a significant effect on global demand. In the past 10 years alone, Chinese demand for oil has doubled, and primary non-oil commodity prices have risen significantly over the past few years. However, there is little indication so far that the commodity price increases have had any overall sustained influence on core consumer price pressures in the UK. In part this is because the effect on prices will not be all one way. The increased participation of developing economies in international trade has resulted in a sharp increase in the supply of cheap goods and services, and is also likely to have provided a boost to competitive pressures in all developed countries.

This has served to lower UK inflationary pressures, through the direct effect of cheaper non-oil import prices and downward pressure on domestic production costs. The first of these effects is illustrated in the chart, which shows that over the recent past the prices of (non-oil) imported goods and services have consistently grown at a slower rate than overall prices



in the economy. Moreover, the effects of increased competition from emerging markets can also have an effect on the dynamics of wage settlements – the correlation between wages increases and price inflation has decreased throughout developed economies over the past decade. Looking forward, the potential for an extended period of expansion in developing economies such as China implies that the duration of the disinflationary impact owing to globalisation is likely to be lengthy. Moreover, it also suggests that current and future wage settlements in the UK may be increasingly influenced by global competitive pressures.

**B.78** Recent evidence is therefore consistent with the view that to date the UK housing market has undergone a smooth realignment, without a prolonged period of declining prices as experienced in the economic cycle of the 1980s and 1990s.

**B.79** CPI inflation is expected to move marginally below target in coming months. However, CPI inflation is forecast to be back around its 2 per cent target by the end of 2006, as previous rises in oil and wholesale gas prices continue to feed through to household utility bills. Energy price increases are now expected to exert slightly more upward pressure on

inflation this year than expected at the time of the Pre-Budget Report. Beyond 2006, CPI inflation is projected to remain close to target as inflation expectations remain firmly anchored.

## The household sector

**Table B5: Household sector<sup>1</sup> expenditure and income**

	Percentage changes on previous year unless otherwise stated			
	2005	2006	Forecast	
			2007	2008
Household consumption <sup>2</sup>	1 <sup>3</sup> / <sub>4</sub>	2 to 2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>4</sub> to 2 <sup>3</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub> to 3
Real household disposable income	2 <sup>1</sup> / <sub>4</sub>	2 <sup>1</sup> / <sub>2</sub> to 2 <sup>3</sup> / <sub>4</sub>	2 to 2 <sup>1</sup> / <sub>2</sub>	2 <sup>1</sup> / <sub>4</sub> to 2 <sup>3</sup> / <sub>4</sub>
Saving ratio <sup>3</sup> (level, per cent)	5 <sup>1</sup> / <sub>4</sub>	5 <sup>3</sup> / <sub>4</sub>	5 <sup>1</sup> / <sub>2</sub>	5 <sup>1</sup> / <sub>2</sub>

<sup>1</sup> Including non-profit institutions serving households.

<sup>2</sup> Chained volume measure.

<sup>3</sup> Total 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.

**B.80** The share of nominal consumption expenditure in UK GDP remained flat in 2005, having drifted down in each of the previous four years largely on the back of strong price competition in retail and other consumer markets.

**B.81** Revisions to real private consumption since the 2005 Pre-Budget Report indicate a slightly more even profile for growth through 2004 and weaker outturns in the first half of 2005 than previously estimated. For 2005 as a whole, private consumption growth was just 1<sup>3</sup>/<sub>4</sub> per cent. However, this entailed particularly subdued growth in the first half of the year with quarterly private consumption growth picking up through the course of the year: in the fourth quarter it had reached 0.7 per cent, from a first quarter outturn of virtually zero.

**B.82** In contrast to generally downward revisions to real private consumption, real household disposable income growth last year is now estimated to have been stronger than expected at the time of the 2005 Pre-Budget Report, partly reflecting data revisions.

**B.83** Despite the gradual acceleration of private consumption throughout 2005, stronger nominal household income growth did not fully feed through into higher consumption growth. Indeed, the household saving ratio is estimated to have risen from 4<sup>1</sup>/<sub>2</sub> per cent in 2004 to around 5<sup>1</sup>/<sub>4</sub> per cent in 2005. It would appear that there have been several factors which have limited the expansion of private consumption. Sustained increases in oil prices have led to rising energy bills and dampened real income and consumption growth. Alongside a rise in unemployment in recent months, households have continued to adjust to high levels of personal debt by exercising more caution over their finances. This has been evidenced by, for example, substantially more moderate growth of unsecured credit, which has been rising at its slowest rate in around 12 years in recent months. All these factors have therefore kept real private consumption growth well below its average of the past eight years and accounted for most of the slowdown in UK GDP growth between 2004 and 2005.

**B.84** The pattern of monthly retail sales volumes has been uneven in recent months. Nonetheless, three-month on three-month growth in retail sales has clearly picked up from its trough in early 2005. In the three months to February, retail sales volumes stood around 0.5 per cent up on the previous three months and 2<sup>3</sup>/<sub>4</sub> per cent higher than a year earlier.

**B.85** Consumer confidence has picked up a little from the lows seen towards the end of 2005. Although seasonal factors associated with the effects of promotional activity on major purchases may have artificially buoyed overall confidence at the start of this year, there also appears to have been a modest underlying improvement in sentiment. In particular, consumers' expectations of the performance of the economy over the next year have increased since late 2005 and now lie close to their long-run average, while households' perceptions of both their current and future financial situation have also firmed a little since late 2005.

**B.86** The outlook for private consumption is little changed compared with the Pre-Budget Report. Despite more robust consumer activity in the final quarter of 2005, real private consumption growth is expected to remain relatively moderate as households continue to adjust to still rising energy bills and high levels of debt, and as labour income growth remains sluggish. Underpinned by continued domestic macroeconomic stability, private consumption growth is forecast to pick up slightly as these dampening influences abate, while continuing to grow somewhat slower than real GDP over the forecast horizon. Private consumption is forecast to rise by 2 to 2½ per cent this year and to fall short of GDP growth thereafter, growing by 2¼ to 2¾ per cent in 2007 and 2½ to 3 per cent in 2008. The saving ratio is expected to rise again in 2006, and then to remain at levels just above its average over recent years.

## Companies and investment

**B.87** Over the recent past, the corporate sector has faced a low cost of capital, non-manufacturing profitability has been strong, and corporate cash flow has been healthy. Private non-financial corporations have now been net lenders in every quarter since the start of 2002, with their surplus building to an estimated 2 per cent of GDP in 2005. Yet business investment, on the basis of latest estimates, grew modestly in 2005, rising by 1½ per cent on the previous year, and compared with growth of 3¾ per cent in 2004 – its strongest for four years.

**B.88** Business investment data are prone to large revisions, and accounting conventions mean that the data do not include spending that many businesses would view as investment. In particular, as discussed in Box B6, current UK national accounts practices mean that much of companies' own account, or in-house, software spending is excluded from measurement. Intangible investment, like product innovation and increasing employees' human capital is also excluded, partly reflecting the obvious obstacles to accurately measuring these factors. Moreover, as the UK and other developed economies continue to shift to producing higher value-added manufactured goods and services, the nature of investment will also change.

**B.89** The changing structure and strong performance of the UK economy reflects firms' ability to respond to global challenges, new business processes and changing consumer tastes. Service sector output now accounts for 73 per cent of total output and 80 per cent of jobs, up from only 55 per cent and 68 per cent respectively two decades ago. Within this broad category, financial services, education, creative industries and health now contribute 25 per cent of total output and 32 per cent of jobs. These changes to the structure of the economy will likely affect the way in which business investment is viewed and recorded.

**B.90** Not only is the nature of business investment changing, the relative price of investment goods has also been falling in recent years. Capital goods prices declined in eight of the past nine years, making it possible for companies to increase real investment by holding capital budgets unchanged from year to year. Such factors could partly help to explain why the recorded nominal business investment to GDP ratio is currently low by historical standards.

**B.91** However, there are a number of reasons why real business investment growth may have been subdued over the recent past, with companies reluctant to pursue expansive investment strategies. Cyclical factors are likely to have contributed: subdued private consumption growth alongside weak growth in key UK exports over much of 2005 will have tended to discourage companies from raising physical capacity. High oil prices have also probably contributed to the recent reluctance to step up capital expenditure.

**B.92** Capital gearing, which remains high by historical standards, albeit down on its 2003 peak, is likely to have been another influence on corporate investment; and steps taken by companies to reduce pension fund deficits have also been cited by some as a factor constraining capital expenditure. Some evidence points to companies having long-run balance sheet (capital gearing) targets, so when gearing is driven above desired long-run levels, adjustments to profits (costs and prices), dividends, net equity issuance and/or investment may be made to rein in gearing.

**B.93** Defined benefit pension liabilities are very similar to long-term debt. Nevertheless, there is no clear evidence for the UK that increased pension contributions have significantly affected business investment in aggregate. This does not preclude the possibility of increased stock of net pension liabilities being a factor impacting on investment spending. However, companies are still in possession of significant cash holdings. The UK corporate sector has increased its holdings of currency and deposits by about two thirds, or around £200 billion, over the past three years, mainly with overseas monetary and financial institutions. So the evidence does not suggest, at least at an aggregate level, that cash constraints are preventing companies from investing or paying down pension fund deficits at the present time.

**Table B6: Gross fixed capital formation**

	Percentage changes on previous year			
	2005	Forecast		
		2006	2007	2008
Whole economy <sup>1</sup>	3¼	1¾ to 2	4 to 4½	4 to 4½
of which:				
Business <sup>2,3</sup>	1½	1 to 1½	4½ to 5¼	4½ to 5¼
Private dwellings <sup>3</sup>	-½	0 to ¼	2¾ to 3¼	3 to 3½
General government <sup>3</sup>	18½	8½	7	5

<sup>1</sup> Includes costs associated with the transfer of ownership of land and existing buildings.

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

<sup>3</sup> Excludes purchases less sales of land and existing buildings.

**B.94** Nonetheless, other indicators point to rather more robust business investment spending growth than current official statistics suggest. In particular, corporate profitability has been sustained at healthy rates while the cost of capital has been kept historically low due to a combination of low inflation, domestic macroeconomic stability and strong global liquidity. There have been marked divergences between sectors in recent quarters, with relatively robust growth in large parts of the service sector being offset by weakness in other, smaller sectors like construction and manufacturing. However, recent official outturns are not particularly out of line with private business survey evidence on company intentions with respect to capital spending.

**B.95** Business investment growth is expected to remain muted in the near term. However, with corporate fundamentals relatively sound, liquidity high and the cost of capital historically low, within the context of sustained domestic macroeconomic stability, the corporate sector should be relatively well placed to undertake somewhat stronger business investment growth as domestic demand growth picks up and stronger underlying export

growth becomes established. The projections for business investment growth remain cautious relative to rates reached in the late 1990s and in previous economic cycles, in accordance with the greater stability of investment growth through the post-2000 global downturn, and the element of downside surprise over the past few years.

#### **Box B6: Business investment – revisions and measurement issues**

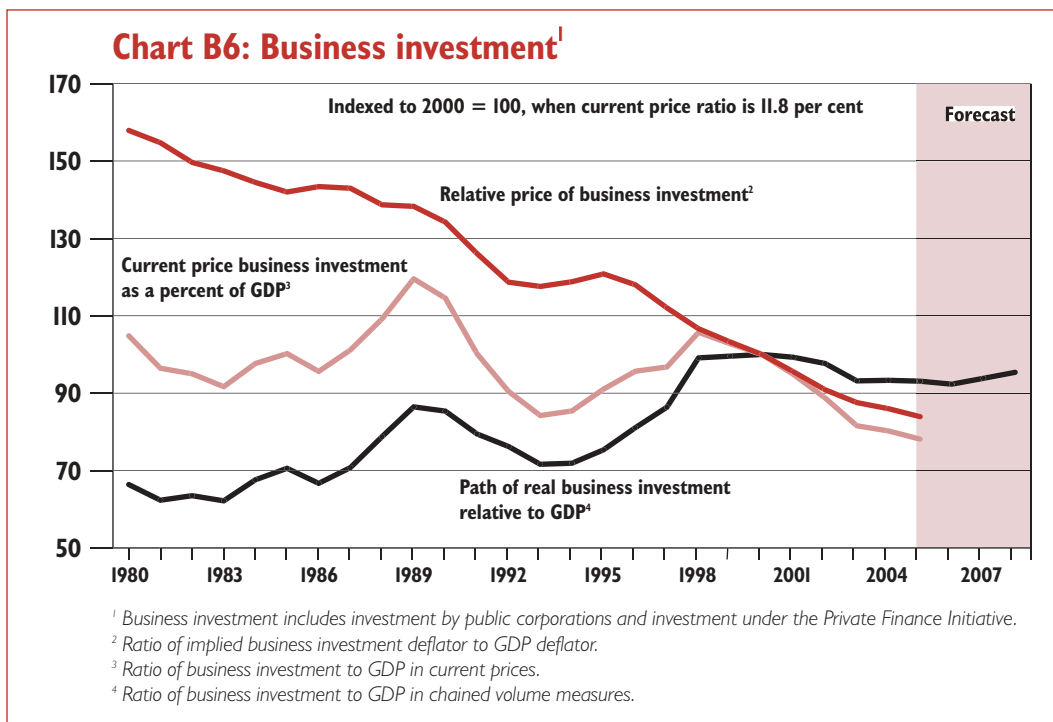
Investment figures tend to get revised substantially over time as, for example, new and more comprehensive data become available and improvements to statistical methodologies are introduced. On average, estimates of both whole economy and business investment growth have been revised up over recent years. For example, the provisional estimate of business investment growth in the year to the first quarter of 2002 was -1.1 per cent, but latest estimates suggest growth was positive, at 2 per cent.

As the UK and other developed economies continue to shift to producing higher value-added manufactured goods and services, the nature of investment will change. The boundaries between manufacturing and services are also likely to become increasingly blurred. Likewise, it may become less clear whether what is classed as investment in the national accounts is consistent with firms' definitions of investment. For example, expenditure on R&D, organisational change, training and some elements of branding and software investment are all currently recorded as current expenditure in the national accounts, whereas firms might reasonably consider them investments aimed at raising future capacity and efficiency.

These developments present significant measurement challenges for national statistical offices. However, progress is being made. For example, the Office for National Statistics has recently published details of improvements to the way in which computer software investment is measured. These revisions have important implications for understanding the economy, suggesting that firms' own-account, in-house software investment has been significantly under-estimated in the UK. Existing estimates suggest that total software investment was £8 billion in 2003, whereas revised estimates suggest a figure of around £21 billion. Software investment is now thought to have accounted for around 12 per cent of UK investment in 2003, and 1.9 per cent of GDP, suggesting that UK software investment is similar to that in the US as a percent of GDP.

These estimates are experimental and will not be incorporated into the national accounts until summer 2007. In addition, as highlighted above, other revisions are also likely to be made to the investment data between now and then. However, all else equal:

- the increase in own account software investment of £10.5 billion will add around 1 per cent to the level of GDP;
- the effect on GDP growth may be up to 0.1 percentage points a year; and
- the investment to GDP ratio will be higher, rising from 16 per cent in 2003 on current estimates to around 17 per cent.



**B.96** Government investment is expected to continue to grow strongly, consistent with the Government’s aim to deliver world-class public services through sustained investment matched by far-reaching reform. Whole economy investment is expected slightly to outpace business investment in 2006, before this is reversed as business investment growth strengthens.

### Trade and the balance of payments

**B.97** Volumes of goods and services exports rose by around 5¼ per cent in 2005, up on the 4½ per cent growth recorded in 2004. However, trade figures over the recent past have been distorted by Missing Trader activity, which boosts both measured exports and imports – measured net exports are largely unaffected. As a result, the underlying growth of exports over the past year has been much more subdued than headline figures suggest. Excluding Missing Trader activity, exports of goods and services are estimated to have risen by just under 3 per cent last year, compared with growth of around 5¼ per cent in 2004.

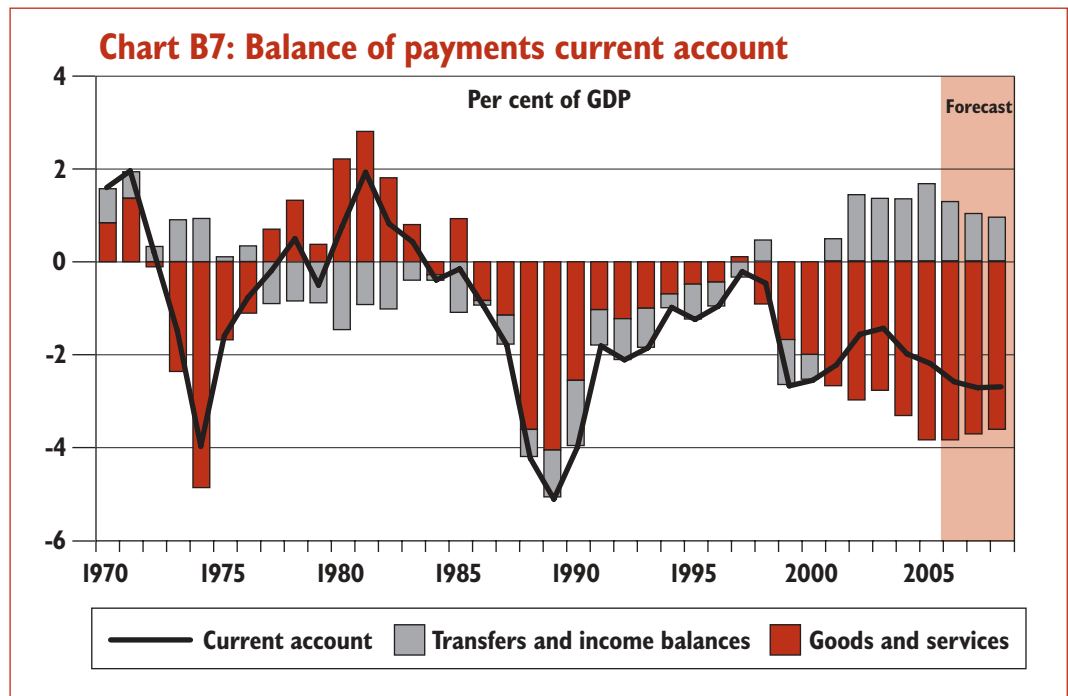
**B.98** A number of factors have held back export growth in recent quarters. For much of 2005, still subdued GDP growth, and in particular import demand, in the euro area – which accounts for around half of UK export markets – hampered underlying growth of UK exports. At the same time, oil exports fell last year, in spite of sustained high oil prices, reflecting both short-term disruptions to production and long-term structural factors related to the underlying depletion of North Sea oil reserves.

**B.99** Last year exports of UK services are estimated to have risen by just 1 per cent compared with 2004, the weakest growth for 13 years. Some of this likely reflects the short-term effects on tourism following the 7 July terrorist atrocities in central London. However, demand for UK service sector exports may have also experienced more generalised weakness as a result of muted growth in some key export markets through much of 2005.

**B.100** Import growth fell back in 2005 on the back of the weaker expansion in domestic demand although, broadly consistent with the pattern of GDP growth, it picked up a little between the beginning and the end of the year. Goods and services import volumes rose by around  $4\frac{3}{4}$  per cent in 2005, down from  $6\frac{3}{4}$  per cent in 2004. So net trade made a more or less neutral contribution to GDP growth last year, following a run of significant negative contributions since 1997, with the exception of 2000.

**B.101** The sterling exchange rate index remains close to the level prevailing at the time of the 2005 Pre-Budget Report.

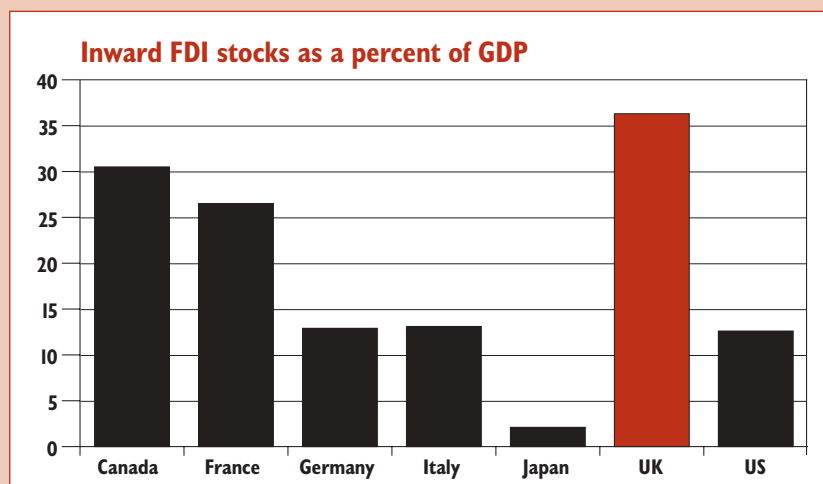
**B.102** The overall UK current deficit widened sharply in the third quarter of 2005, reflecting a larger trade deficit, largely due to the accounting treatment of insurance claims associated with Hurricane Katrina, and a sharp decline in the UK's surplus on overseas income. However, quarterly current account data can be erratic, and over 2005 as a whole the current deficit is estimated to have averaged around  $2\frac{1}{4}$  per cent of GDP, as expected in the Pre-Budget Report.



**B.103** The UK is estimated to have continued to run another record surplus on overseas income earnings in 2005, at around  $2\frac{3}{4}$  per cent of GDP. UK income earnings have been maintained at record levels in recent quarters by a number of factors. Sustained rises in oil prices have tended to boost UK oil companies earnings from overseas by more than they have increased foreign oil companies returns on their UK subsidiaries, as a result the UK's continued position as a net overseas oil investor. More generally, rates of return earned on UK investments overseas have historically tended to be above those foreign investors have been able to earn on their investments in the UK, and this continues to remain the case.

**Box B7: Foreign Direct Investment**

The UK has traditionally been a large source and recipient of Foreign Direct Investment (FDI), holding the highest stock of inward FDI as a percent of GDP in the G7 (see chart).



Following the global downturn in cross-border investment earlier this decade, FDI inflows to the UK picked up significantly in 2004 and 2005. International comparisons suggest that in 2005 the UK topped the global FDI inflow table for the first time since 1977, attracting around half of all inflows to Europe<sup>a</sup>. Almost half of the inflows to the UK in 2005 can be accounted for by the restructuring of Shell Transport and Trading Company plc and Royal Dutch Petroleum Company into Royal Dutch Shell, highlighting the volatile nature of international investment flows. However, even leaving aside this transaction, the UK still received more inward investment in 2005 than the second biggest recipient, the US.

FDI can be an important source of new ideas, management techniques and production methods. As such, FDI can lead to improvements in productivity directly – for example, through its impact on the productivity of firms which have been involved in cross-border mergers and acquisitions – and indirectly, through spillovers – for example, the diffusion of knowledge and techniques throughout the economy. Studies have found that foreign-owned multinationals are more productive than both British owned multinationals and domestic firms. There are also a significant number of jobs linked to FDI projects in the UK. Figures show a rise in inward investment projects of 31 per cent in 2004-05 compared with the previous financial year, with more than 39,000 jobs linked to these new projects<sup>b</sup>.

Unprecedented macroeconomic stability and sustained growth since 1997, as well as the introduction of microeconomic reforms aimed at increasing the flexibility of the UK's product and labour markets, are likely to have contributed to the attractiveness of the UK as a destination for international investment. This is reflected in business surveys, which have shown the UK rising up rankings of investor confidence in recent years<sup>c</sup> and maintaining its attractiveness to investors in the face of increasing competition from emerging markets like India and China<sup>d</sup>.

<sup>a</sup> UNCTAD press release PR/2006/002, 23 January 2006.

<sup>b</sup> *UK inward investment 2004/05*, Report by UK Trade and Investment.

<sup>c</sup> A.T. Kearney's 2004 FDI Confidence Index showed the UK rising from seventh to fourth place.

<sup>d</sup> See Ernst and Young's European Attractiveness Surveys 2004 and 2005.

**B.104** Total export growth in 2006 is forecast to be about the same as last year. However, this masks a firming in underlying export growth excluding fraudulent Missing Trader activity as UK export market growth picks up this year, partly on the back of stronger demand from the euro area. The forecast assumes that export and import volumes grow in line with underlying trade, ie excluding Missing Trader activity. This amounts to making the neutral assumption that Missing Trader activity stays flat at its 2005 level in each year of the forecast. Steps to strengthen the Government's strategy for combating the fraud are set out in Chapter 5, and in so far as Missing Trader activity changes from its 2005 level, then both export and import forecasts would be affected, but not the forecast for net trade. With export growth expected to be a little above that of imports over the forecast horizon, despite some assumed further loss of export market share, net trade is forecast to make a broadly neutral contribution to GDP growth throughout.

**B.105** With the trade deficit expected to remain broadly flat, and the income surplus expected to ease back somewhat from last years record level, the current deficit is projected to widen in 2006 and then remain stable over the forecast horizon at around  $2\frac{3}{4}$  per cent of GDP.

**Table B7: Trade in goods and services**

	Percentage changes on previous year					£ billion Goods and services balance
	Volumes		Prices <sup>1</sup>		Terms of trade <sup>2</sup>	
	Exports	Imports	Exports	Imports		
2005	$5\frac{1}{4}$	$4\frac{3}{4}$	$1\frac{3}{4}$	$3\frac{3}{4}$	$-1\frac{3}{4}$	-47
<i>Forecast</i>						
2006	5 to $5\frac{1}{2}$	$4\frac{1}{4}$ to $4\frac{3}{4}$	$1\frac{1}{4}$	$1\frac{3}{4}$	$-\frac{1}{2}$	$-49\frac{1}{4}$
2007	$4\frac{3}{4}$ to $5\frac{1}{4}$	$4\frac{1}{2}$ to 5	$\frac{3}{4}$	$\frac{3}{4}$	$\frac{1}{4}$	$-50\frac{1}{4}$
2008	$4\frac{3}{4}$ to $5\frac{1}{4}$	$4\frac{1}{2}$ to 5	$\frac{1}{2}$	$\frac{1}{2}$	0	$-51\frac{3}{4}$

<sup>1</sup> Average value indices.

<sup>2</sup> Ratio of export to import prices.

## Independent forecasts

**B.106** Some outside forecasts have edged up a little in recent months. The latest average of independent forecasts for GDP growth in 2006 is 2.2 per cent, at the centre of the Budget forecast range of 2 to  $2\frac{1}{2}$  per cent.

**B.107** For 2007, the latest independent average for GDP growth stands at 2.4 per cent, below the Budget range of  $2\frac{3}{4}$  to  $3\frac{1}{4}$  per cent, although a number of prominent outside forecasts come within the range, and the average is depressed by one extreme outlier. Outside forecasts for 2008 currently average 2.7 per cent, at the lower end of the Budget range of  $2\frac{3}{4}$  to  $3\frac{1}{4}$  per cent.

**B.108** Despite the latest estimates for growth in 2005 being lower than forecast in last year's Budget, the Treasury has continued to maintain a good forecast performance in recent years. Since 1997, Treasury forecasts for GDP growth have on average been more accurate than those of almost all prominent external forecasters, as well as showing improvement on the Treasury's own previous track record.

**Table B8: Budget and independent<sup>1</sup> forecasts**

	Percentage changes on a year earlier unless otherwise stated					
	2006			2007		
	March	Independent		March	Independent	
	Budget	Average	Range	Budget	Average	Range
Gross domestic product	2 to 2½	2.2	1.4 to 2.8	2¾ to 3¼	2.4	0.1 to 2.9
CPI (Q4)	2	1.9	1.4 to 2.4	2	2.0	1.6 to 2.8
Current account (£ billion)	-32¾	-28.4	-45.7 to -18.7	-36½	29.3	-45.2 to -15

<sup>1</sup> 'Forecasts for the UK Economy: A Comparison of Independent Forecasts', March 2006.

## Forecast risks

**B.I09** The set of risks surrounding the Budget 2006 economic outlook is similar to those surrounding the 2005 Pre-Budget Report forecast. However, the balance of risks has shifted a little, with domestic risks having receded while global uncertainties have increased somewhat. Globalisation means that the UK economy shares ever increasingly in the risks affecting the world economy, and that domestic risks are harder to differentiate.

**B.II0** Uncertainty continues to surround the current output gap estimate given ongoing uncertainty as to whether the latest vintage of ONS data is correctly approximating the degree to which the economy has been growing below trend over the recent past. To the extent that the economy has been growing more (less) quickly than implied by existing data, then that would mean less (more) scope for above-trend growth over the forecast horizon.

**B.III** The forecast for private consumption continues to be surrounded by both upside and downside risks. Further unexpected weakness of average earnings growth would tend to undermine household expenditure, although the boost to employment from weakening labour costs would tend at least partly to offset this effect. Related downside risks to consumption growth also come from the current uncertainties about the extent to which the recent increase in unemployment may prove temporary and erratic. In so far as it might tend to encourage higher precautionary saving, it would inhibit spending. Independent forecasters expect a marginal strengthening of employment growth next year.

**B.II2** Private consumption growth also poses the potential for upside surprises relative to the Budget forecast. With increasing evidence that the housing market has undergone a smooth realignment with some modest recent firming in house prices, and with consumer confidence having firmed, household spending could accelerate more sharply than envisaged.

**B.II3** Business investment growth could also surprise on the upside, as has previously been recognised in recent Pre-Budget and Budget Reports, despite the weakness in capital spending indicated by latest official estimates for 2005 and the uncertainties surrounding the effects capital gearing and pension fund deficits are presently having on investment.

Table B9: Summary of economic prospects<sup>1</sup>

	Percentage changes on a year earlier unless otherwise stated					
	2005	2006	Forecast <sup>2,3,4</sup>		Average errors from past forecasts <sup>5</sup>	
			2007	2008	2006	2007
<b>Output at constant market prices</b>						
Gross domestic product (GDP)	1 $\frac{3}{4}$	2 to 2 $\frac{1}{2}$	2 $\frac{3}{4}$ to 3 $\frac{1}{4}$	2 $\frac{3}{4}$ to 3 $\frac{1}{4}$	$\frac{3}{4}$	$\frac{1}{2}$
Manufacturing output	-1	$\frac{1}{2}$ to 1	1 $\frac{3}{4}$ to 2 $\frac{1}{4}$	1 $\frac{3}{4}$ to 2 $\frac{1}{4}$	1 $\frac{1}{4}$	2
<b>Expenditure components of GDP at constant market prices<sup>6</sup></b>						
Domestic demand	1 $\frac{3}{4}$	2 to 2 $\frac{1}{4}$	2 $\frac{3}{4}$ to 3 $\frac{1}{4}$	2 $\frac{3}{4}$ to 3 $\frac{1}{4}$	$\frac{3}{4}$	$\frac{3}{4}$
Household consumption <sup>7</sup>	1 $\frac{3}{4}$	2 to 2 $\frac{1}{2}$	2 $\frac{1}{4}$ to 2 $\frac{3}{4}$	2 $\frac{1}{2}$ to 3	$\frac{3}{4}$	1
General government consumption	2	2 $\frac{1}{2}$	2 $\frac{1}{2}$	2 $\frac{1}{2}$	1	1 $\frac{1}{4}$
Fixed investment	3 $\frac{1}{4}$	1 $\frac{3}{4}$ to 2	4 to 4 $\frac{1}{2}$	4 to 4 $\frac{1}{2}$	2 $\frac{1}{2}$	2 $\frac{1}{4}$
Change in inventories <sup>8</sup>	- $\frac{1}{4}$	- $\frac{1}{4}$ to 0	0 to $\frac{1}{4}$	0	$\frac{1}{4}$	$\frac{1}{4}$
Exports of goods and services	5 $\frac{1}{4}$	5 to 5 $\frac{1}{2}$	4 $\frac{3}{4}$ to 5 $\frac{1}{4}$	4 $\frac{3}{4}$ to 5 $\frac{1}{4}$	1 $\frac{3}{4}$	3 $\frac{1}{4}$
Imports of goods and services	4 $\frac{3}{4}$	4 $\frac{1}{4}$ to 4 $\frac{3}{4}$	4 $\frac{1}{2}$ to 5	4 $\frac{1}{2}$ to 5	2 $\frac{1}{4}$	2 $\frac{1}{2}$
<b>Balance of payments current account</b>						
£ billion	-26 $\frac{3}{4}$	-32 $\frac{3}{4}$	-36 $\frac{1}{2}$	-38 $\frac{1}{4}$	7 $\frac{1}{4}$	8
per cent of GDP	-2 $\frac{1}{4}$	-2 $\frac{1}{2}$	-2 $\frac{3}{4}$	-2 $\frac{3}{4}$	$\frac{1}{2}$	$\frac{3}{4}$
<b>Inflation</b>						
CPI (Q4)	2 $\frac{1}{4}$	2	2	2	-	-
Producer output prices (Q4) <sup>9</sup>	2 $\frac{1}{2}$	1 $\frac{3}{4}$	2	2	1	1 $\frac{1}{2}$
GDP deflator at market prices	2 $\frac{1}{4}$	2 $\frac{1}{4}$	2 $\frac{1}{2}$	2 $\frac{3}{4}$	$\frac{1}{2}$	$\frac{1}{2}$
<b>Money GDP at market prices</b>						
£ billion	1211 $\frac{1}{4}$	1266 to 1269	1334 to 1345	1409 to 1428	9	9
percentage change	4	4 $\frac{1}{2}$ to 4 $\frac{3}{4}$	5 $\frac{1}{2}$ to 6	5 $\frac{1}{2}$ to 6 $\frac{1}{4}$	$\frac{3}{4}$	$\frac{3}{4}$

<sup>1</sup> The forecast is consistent with output, income and expenditure data for the fourth quarter of 2005, released by the Office for National Statistics on 24 February 2006. See also footnote 1 on the first page of this chapter.

<sup>2</sup> All growth rates in tables throughout this chapter are rounded to the nearest  $\frac{1}{4}$  percentage point.

<sup>3</sup> 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 2 $\frac{3}{4}$  per cent to the end of 2006 and 2 $\frac{1}{2}$  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  $\frac{1}{4}$  percentage point below the neutral assumption.

<sup>4</sup> 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.

<sup>5</sup> 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 2006 and 2007.

<sup>6</sup> Further detail on the expenditure components of GDP is given in Table B10.

<sup>7</sup> Includes households and non-profit institutions serving households.

<sup>8</sup> Contribution to GDP growth, percentage points.

<sup>9</sup> Excluding excise duties.

**Table B10: Gross domestic product and its components**

£ billion chained volume measures at market prices, seasonally adjusted										
	Household consumption <sup>1</sup>	General government consumption	Fixed investment	Change in inventories	Domestic demand <sup>2</sup>	Exports of goods and services	Total final expenditure	Less imports of goods and services	Plus statistical discrepancy <sup>3</sup>	GDP at market prices
<b>2005</b>	749.9	232.1	187.5	2.7	1171.9	306.0	1477.9	348.9	0.3	1129.2
<b>2006</b>	765.6 to 767.9	237.7	190.8 to 191.4	1.1 to 1.9	1195.3 to 1198.9	321.6 to 322.5	1516.8 to 1521.4	364.1 to 365.2	0.3	1153.0 to 1156.5
<b>2007</b>	783.6 to 789.8	243.9	198.6 to 200.2	1.8 to 3.8	1227.9 to 1237.7	337.0 to 339.7	1564.9 to 1577.4	380.4 to 383.5	0.3	1184.7 to 1194.2
<b>2008</b>	803.9 to 814.3	250.1	206.7 to 209.3	1.9 to 5.1	1262.5 to 1278.8	353.1 to 357.6	1615.6 to 1636.4	397.4 to 402.5	0.3	1218.5 to 1234.2
<b>2005</b>	372.8	115.1	92.6	1.7	582.2	150.8	733.0	171.4	0.1	561.7
2nd half	377.1	117.0	94.9	1.0	589.7	155.2	744.9	177.5	0.1	567.5
<b>2006</b>	380.8 to 381.5	118.2	94.8 to 95.0	0.8 to 1.0	594.7 to 595.7	158.9 to 159.2	753.6 to 755.0	180.3 to 180.6	0.1	573.4 to 574.5
2nd half	384.7 to 386.4	119.5	96.0 to 96.4	0.3 to 0.8	600.6 to 603.2	162.6 to 163.3	763.2 to 766.5	183.8 to 184.6	0.1	579.6 to 582.0
<b>2007</b>	389.3 to 391.9	121.2	98.2 to 98.9	0.5 to 1.3	609.1 to 613.2	166.5 to 167.7	775.7 to 780.9	188.0 to 189.2	0.1	587.8 to 591.8
2nd half	394.3 to 397.9	122.7	100.4 to 101.3	1.3 to 2.5	618.8 to 624.5	170.5 to 172.0	789.3 to 796.5	192.5 to 194.2	0.1	596.9 to 602.4
<b>2008</b>	399.5 to 404.2	124.3	102.4 to 103.6	1.0 to 2.5	627.3 to 634.6	174.5 to 176.6	801.9 to 811.2	196.7 to 198.9	0.1	605.3 to 612.4
2nd half	404.4 to 410.1	125.7	104.2 to 105.7	0.8 to 2.6	635.2 to 644.2	178.5 to 181.1	813.7 to 825.2	200.7 to 203.6	0.1	613.1 to 621.8
Percentage changes on previous year <sup>4,5</sup>										
<b>2005</b>	1 3/4	2	3 3/4	-1/4	1 3/4	5 1/4	2 1/2	4 3/4	0	1 3/4
<b>2006</b>	2 to 2 1/2	2 1/2	1 3/4 to 2	-1/4 to 0	2 to 2 1/4	5 to 5 1/2	2 3/4 to 3	4 1/4 to 4 3/4	0	2 to 2 1/2
<b>2007</b>	2 1/4 to 2 3/4	2 1/2	4 to 4 1/2	0 to 1/4	2 3/4 to 3 1/4	4 3/4 to 5 1/4	3 1/4 to 3 3/4	4 1/2 to 5	0	2 3/4 to 3 1/4
<b>2008</b>	2 1/2 to 3	2 1/2	4 to 4 1/2	0	2 3/4 to 3 1/4	4 3/4 to 5 1/4	3 1/4 to 3 3/4	4 1/2 to 5	0	2 3/4 to 3 1/4

<sup>1</sup> Includes households and non-profit institutions serving households.

<sup>2</sup> Also includes acquisitions less disposals of valuables.

<sup>3</sup> Expenditure adjustment.

<sup>4</sup> For change in inventories and the statistical discrepancy, changes are expressed as a percent of GDP.

<sup>5</sup> 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.