A The economy

UK GDP growth has strengthened since early 2003. At the beginning of the year, significant global uncertainties weighed heavily on short-term prospects for the world economy. Global confidence and demand was dampened by geo-political tensions, volatility on international financial and exchange rate markets and general uncertainty regarding prospects for growth in major economies, in particular the euro area. It is inevitable that, as a highly open economy, the UK is substantively affected by global developments. Fragile business sentiment continued to affect investment expenditure, underlying external demand remained weak and household consumption also appeared to be constrained by global uncertainty. As a result, GDP growth in the first quarter of the year was significantly below trend.

Since early spring 2003, as geo-political uncertainties have receded, international growth prospects have improved considerably and are expected to strengthen further. Global financial markets have made up significant ground following sharp falls in 2002 and early 2003. US GDP growth has rebounded strongly with US business investment showing signs of recovery. In the UK, growth picked up strongly in the second and third quarters, as forecast in Budget 2003 and consistent with private business survey indicators in recent months.

This pick-up in activity is expected to be consolidated into 2004, broadly as envisaged in the Budget 2003 forecast, as some of the major uncertainties holding back the world economy recede and the global recovery gathers pace. Confidence in prospects for the UK economy has also been boosted by recent significant revisions to national accounts volume measures. These imply stronger trend output growth over the 1997 to 2001 period and more balanced growth than previously estimated, with consumption a little weaker and investment and net trade stronger.

The Pre-Budget Report economic assessment is that:

- **UK GDP is expected to grow by 2.1 per cent in 2003 and by 3 to 3½ per cent in both 2004 and 2005, in line with the Budget 2003 forecast. Growth is expected to fall back to its trend rate by early 2006 as slack in the economy is absorbed and output returns to its trend path. The forecast shows a continuing rebalancing of growth; and**
- **Consumer Prices Index (CPI) inflation is expected to rise slowly from early next year to reach its 2 per cent target in 2005 as the effects of recovery in the global economy and this year's depreciation of sterling feed through to higher import prices.**

Despite the positive outlook, risks remain for the UK economy. The uneven nature of the pick-up in global activity, the continued reliance on developments in the US, and the relatively disappointing performance of the euro area present a threat to the sustainability of recovery over the medium term. These factors also mean that global activity is vulnerable to the possibility of faltering US domestic demand in the short term. On the upside, given the relatively swift turnaround in activity since the spring, the present world recovery may have more momentum than currently expected.

INTRODUCTION[1,2]

A1 This annex discusses economic developments since Budget 2003 and provides updated forecasts for the UK and world economies in the period to 2006. 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

Table A1: The world economy

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

Source: EcoWin and HM Treasury.

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

Overview

A2 At the time of Budget 2003, economic activity in most major economies had slowed as geo-political uncertainties compounded existing vulnerabilities and led to significant falls in business and consumer confidence, increased volatility in financial markets and higher oil prices. As a result, the loss of momentum in global growth, which became apparent during autumn 2002, continued into early 2003. The Budget 2003 forecast assumed this would be a temporary slowing and, as expected, growth in several major economies has since strengthened as some key uncertainties have receded. Meanwhile, leading indicators – notably confidence measures and equity prices – have generally turned up across the G7.

A3 Growth in most G7 economies looks set to steadily improve during the course of 2004, though this acceleration is likely to be more pronounced in some economies than in others. Growth in the US appears to be increasing sharply and data from Japan suggest stronger growth than most forecasters expected. However, activity in parts of the euro area has been more subdued. During the first half of this year, euro area output stagnated. As a result, most forecasts for growth in the euro area have been revised down significantly since the spring.

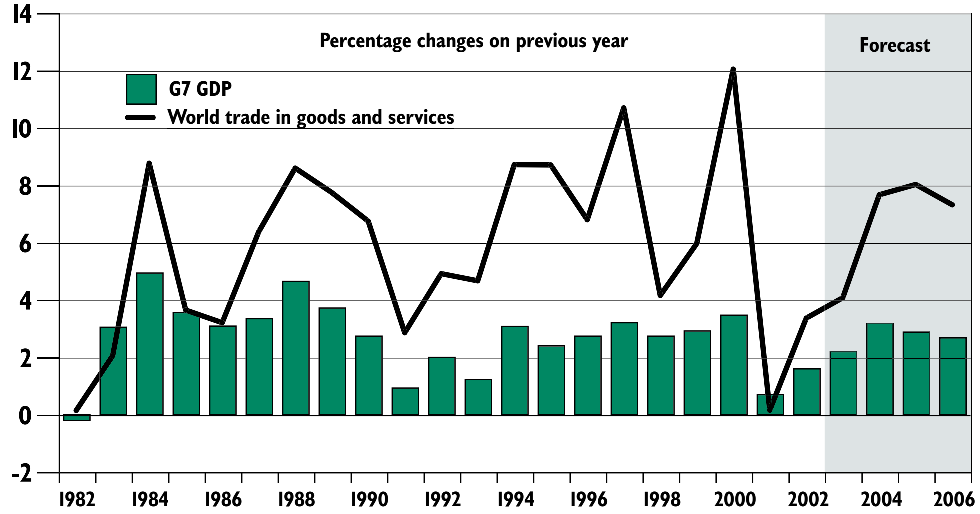
A4 Policy makers around the world have continued to support growth. US monetary policy has been loosened again since the spring and has been supported by a further easing in fiscal policy. Interest rates have also been lowered in the euro area.

[1] The UK forecast is consistent with national accounts and balance of payments statistics to the second quarter of 2003 released by the Office for National Statistics on 30 September 2003 and output, income and expenditure data for the third quarter released on 26 November 2003. A detailed set of charts and tables relating to the economic forecast is available on the Treasury's internet site (http://www.hm-treasury.gov.uk) and copies can be obtained on request from the Treasury's Public Enquiry Unit (020 7270 4558).
[2] The forecast is based on the assumption that the exchange rate moves in line with an uncovered interest parity condition, consistent with the interest rates underlying the economic forecast.

A5 Although some key uncertainties surrounding the global economy have diminished, significant risks still remain. In particular, imbalances between the world's major economies pose the risk of sudden, sharp movements in exchange rates. For example, further sharp falls in the value of the US dollar would pose a significant threat to regions where recovery is dependent on trade with the US. A further downside risk comes from labour markets, which have remained weak in a number of G7 economies. In some economies, activity might also be held back if balance sheet adjustment has further to run. Finally, ongoing security concerns and the continued threat from terrorism pose a risk of renewed volatility and nervousness in international financial markets and falls in consumer and business confidence.

A6 There are also a number of upside risks. Stockbuilding has generally remained modest by historical standards, and a turnaround in the inventory cycle could provide a powerful short-term stimulus to growth. In addition, there are clear signs that business investment is picking up in some major economies; and, in the past, recoveries in capital spending have often tended to accelerate faster than generally expected.

Chart A1: G7 GDP and world trade



G7 activity

A7 G7 GDP is forecast to grow by 2¼ per cent in 2003 and 3 per cent in 2004. This upward revision compared with the Budget 2003 forecast primarily reflects faster than expected recovery in the US, together with significant upward revisions to GDP in Japan during the first half of 2003. However, growth in the euro area is now forecast to be weaker than expected in Budget 2003, at ½ per cent in 2003 and 1¾ per cent in 2004.

A8 US growth slowed in the final quarter of 2002 and in early 2003 as heightened geo-political uncertainty hit confidence, depressing consumer spending and prompting businesses further to delay capital spending. Since then US GDP has accelerated sharply, with the third quarter recording the strongest quarterly growth since 1984. Much of the recent pick-up in activity reflects stronger household spending, partly in response to the latest fiscal package. However, business investment is also showing its first real signs of expansion since the recession in 2001. Many of the conditions for further increases in capital spending now seem to be in place. Stock markets have risen over 30 per cent since March, long-term interest rates are close to historical lows, corporate spreads have narrowed and profitability has increased by more than 30 per cent over the past year.

A9 Economic activity in the euro area remains weak, with growth this year expected to be just ½ per cent. Despite the pick-up in growth in the US and Japan, the further appreciation of the euro – which has now risen by around 20 per cent on a trade-weighted basis since the start of 2002 – hit net trade and acted as a drag on overall activity during the first half of the year. Meanwhile, private consumption has remained subdued, reflecting household concerns about the weak labour market, and investment has declined throughout the first three quarters of the year. In part, this reflects the unwinding of short-term factors that had supported capital spending in late 2002, such as reconstruction work following floods in Austria and Germany and investment incentives in Italy. Poor investment also reflects efforts to improve corporate balance sheets. In the third quarter, GDP growth picked up. Most of this improvement was the result of stronger exports, but business and consumer confidence have also increased in recent months and stock markets have risen markedly from their lows of early March, suggesting an improvement in domestic demand going forward. Therefore, the recovery is expected to continue during 2004, albeit with less momentum than had been projected at the time of Budget 2003.

A10 Since Budget 2003, GDP growth in Japan has significantly exceeded expectations. While this partly reflects recent data revisions, new data have also been stronger than expected. However, some of the recent acceleration in real GDP has been attributed to a more pronounced decline in the GDP deflator: nominal GDP in Japan has continued to fall over the past year. The latest Consensus forecast for GDP growth in Japan is 2.4 per cent in 2003, compared with 0.8 per cent at Budget time. Much of the recent acceleration in GDP in Japan is due to domestic demand, in particular business investment. This partly reflects successful restructuring by a number of large Japanese firms and is consistent with the improvements seen in confidence measures and corporate profitability, but it is also possible that the latest national accounts data are overstating this improvement. In particular, it is not easy to reconcile the recent strength of business investment with other indicators of capital spending. Going forward, domestic demand growth in Japan is expected to ease, although this should be partly offset by stronger demand from the external sector. With unemployment relatively high by historical standards and household income growth remaining weak, consumer spending is expected to remain subdued. Meanwhile business investment, which has played a key role in supporting growth so far during 2003, is expected to moderate as the impulse from recent restructuring and the associated increase in profits begins to wane.

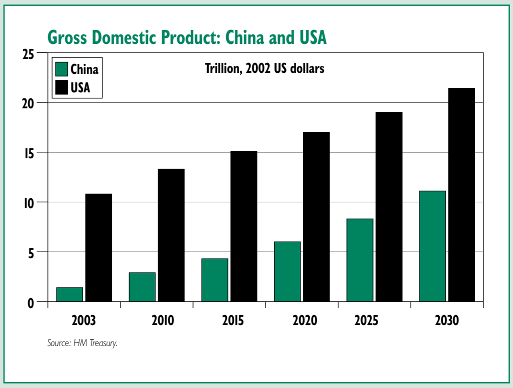
Emerging markets and developing economies

A11 Despite slower growth in the major world economies during late 2002 and early 2003, activity in emerging market economies has generally been resilient. While growth in parts of Asia slowed earlier in the year, this appears to have been a temporary response to shocks to confidence from heightened geo-political uncertainty and the outbreak of Severe Acute Respiratory Syndrome (SARS). More generally, activity in much of the region has remained robust, with China in particular providing a major driver for growth. In a number of Latin American economies the outlook suggests strengthening growth in 2004. Growth in sub-Saharan Africa remains subdued, though economic performance has been stronger in those countries where political stability has been achieved. Eastern European economies continue to be affected by the slow pace of growth in the euro area, although a number of smaller states have achieved sustained growth thanks to the positive impact of structural reforms and impending EU enlargement.

Box A1: The changing global economy

Rapid growth in a number of the world's emerging markets means that the geographical centre of gravity of the global economy is likely to change significantly over the coming decades. In particular, China is re-emerging as a global economic power. Valued at current market exchange rates China is already the sixth largest economy in the world, just behind the UK, and valued at purchasing power parities it is the second largest. Plausible projections of future growth over the coming decades suggest that China is set to rival the US in terms of the size of its economy, if not in per-capita income. Other countries are also forging ahead, notably India, Russia and in Eastern Europe. In short, the world's economic axis is gradually shifting eastwards.

Increasing prosperity among emerging economies will be a source of great wealth and opportunity for all. The advance of technology and continued progress in trade liberalisation will facilitate the reallocation of economic resources across the world, to benefit from comparative advantage and the international division of labour. Economies with high skill bases, such as the UK, will benefit from greater demand for higher value added goods and services as the spending power of emerging economies increases.



These structural adjustments in the global economy will also pose challenges. They underline the need for flexibility, particularly in labour markets, and for continual efforts to advance the skills of the workforce.

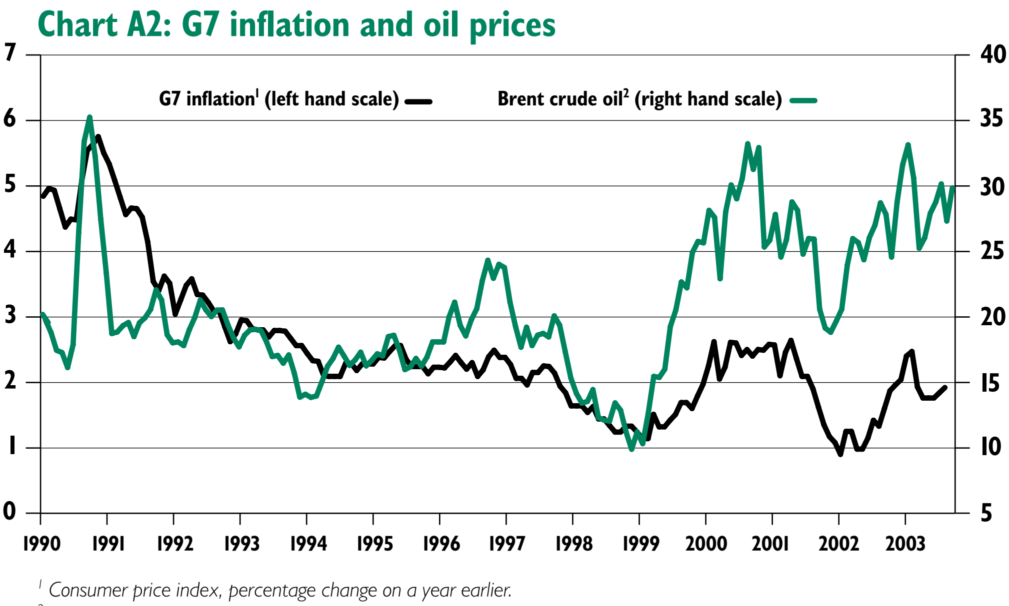
The changing shape of the global economy will have economic, social and political ramifications. There will be adjustments in the global supply, demand and hence prices of goods and services. The composition of demand for many products will evolve, reflecting the different tastes and preferences of consumers in emerging economies and the increasing influence of their culture on global society. Trading blocs will continue to evolve, and alternative currencies may be adopted as vehicles for trade and reserves. Global poverty reduction should be greatly expedited.

In the past the path of economic development has rarely been smooth. With rapid growth will come the risk of growing pains: inequality; ageing populations; booms and busts; and the political tensions that accompany great social shifts. As the importance of today's emerging economies continues to grow, so their challenges will become challenges for the whole world, reinforcing the need for co-operation in further developing the international financial architecture, and on issues such as the environment and the avoidance of protectionism, to ensure that progress is sustained.

A12 In general, those emerging economies with robust macroeconomic frameworks and sustainable exchange rate regimes appear to have coped better with the volatility in global financial markets during the early part of 2003.

World trade

A13 World trade growth slowed sharply during the second half of 2002, reflecting heightened geo-political uncertainty and slower growth in the world's major economies. Budget 2003 forecast this weakness to continue during early 2003 with a gradual acceleration taking hold in the second half of the year. Recent data suggests trade growth in early 2003 was even weaker than forecast, so while trade is still expected to accelerate during the remainder of the year, the forecast for 2003 as a whole is now lower than at Budget time. With the global recovery gaining momentum, world trade should continue to accelerate into 2004. However, although overall G7 growth is now expected to be stronger than previously forecast, the uneven nature of the recovery (discussed in Box A2) is likely to mean that world trade growth will be lower than projected in Budget 2003. In particular, the euro area accounts for a relatively large share of global trade, significantly greater than the US, and subdued activity in the euro area will tend to reduce overall world growth of exports and imports. This should be partly offset by trade in Asia, which is likely to continue to strengthen, supported by ongoing rapid economic growth in China. World trade is now expected to grow by 7¾ per cent in 2004, rising to 8 per cent in 2005 as the global recovery becomes more balanced.



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

Oil and commodity prices

A14 Heightened geo-political uncertainty, together with strikes in Venezuela, led to significant volatility in oil markets in early 2003. After peaking at over $33 per barrel in March, prices fell to around $24-26 per barrel as some key uncertainties receded. Prices edged up again during the summer to reflect the low level of global stocks, increased seasonal demand and stronger economic growth. Early autumn saw a gradual decline in prices, reflecting the seasonal fall in gasoline demand from the US, until an announcement of a cut in production targets by OPEC when Brent prices rose to above $30 per barrel. Current prices remain around $29 per barrel. Markets expect oil prices to moderate over the medium term in response to growing non-OPEC supply and increased production in Iraq, but given the current tightness in inventories further increases cannot be ruled out. Non-oil commodity prices were dampened in early 2003 by relatively weak demand due to low growth in global industrial production and trade. Since then prices have begun to rise again underpinned by a pick-up in demand, especially from Asia. This is expected to continue as the global recovery gathers momentum.

G7 inflation

A15 With output levels below potential in most major economies, inflationary pressures have remained subdued. G7 inflation rose around the turn of the year as a result of movements in oil prices but, as expected at Budget time, edged back down during the first half of 2003. As the global recovery gathers pace, spare capacity should be reduced and commodity prices are likely to rise, easing downward pressure on inflation.

Forecast issues and risks

A16 Some key downside risks have receded since the time of Budget 2003, and this has been accompanied by a sharper than expected recovery, especially in the US. However, other downside risks remain. There are still significant imbalances in the global economy which pose the threat of sudden, sharp movements in exchange rates. These highlight the urgent need for policy makers to push ahead with the structural reforms that will ensure a broad-based and sustainable recovery over the medium term (see Box A2). In the short term, imbalances may also lead to greater calls for protectionist measures in some economies which, if accommodated, would pose a major threat to global development. It is therefore essential that the WTO Doha Development Agenda negotiations are re-launched as soon as possible (see Box 5.5).

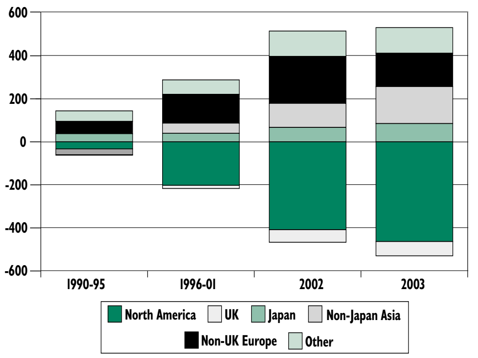
A17 A further downside risk comes from the potential rebuilding of balance sheets. Significant progress has been made in rebuilding household and corporate balance sheets across several major economies since the recession of 2001. However, this process may not be complete. Further balance sheet adjustment might entail significantly weaker spending by households or the business sector and could undermine the recovery. This is particularly a risk for the household sector when combined with weak labour markets. Finally, the ongoing threat of terrorism and continued concern over security pose the risk of renewed nervousness in financial markets and falls in consumer and business confidence.

A18 There are also significant upside risks to G7 growth. In particular, business inventories remain close to historically low levels, and a period of significant stock building could provide a powerful short-term stimulus to growth and trade. The G7 forecast also assumes only a relatively modest acceleration in capital spending when compared with previous recoveries. However, with internal and external financing conditions remaining stimulative in most major economies, investment may bounce back more sharply than forecast.

Box A2: Global imbalances

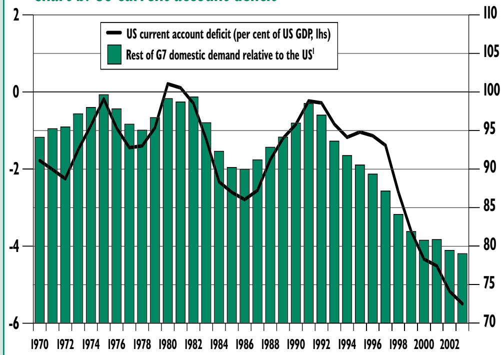
While some major short-term risks have diminished since the time of the Budget, policy makers around the world need to refocus attention on enhancing the medium-term sustainability of the global recovery. Perhaps the clearest threat to that recovery is that it remains uneven across the world's major economies. While differences in growth rates among the G7 economies are not new, the cumulative impact of these over time has in part led to unprecedented global net trade imbalances (Chart a).

Chart a: Global current account position (billion US dollars, 2000 prices)



Source: OECD.

Chart b: US current account deficit



[1] Ratio of Rest of G7 domestic demand to US domestic demand. 1980Q3 =100.
Source: OECD.

Such imbalances are unlikely to be sustainable over the medium term, raising the question of how they might unwind. The risk is that they will be resolved by large and sudden movements in major exchange rates. A sharp fall in the value of the US dollar would have significant implications for growth in those economies that are dependent on US trade, and might also hit US domestic demand by pushing up long-term interest rates and reducing household purchasing power.

A more benign unwinding of these imbalances could only occur against the backdrop of more balanced global growth. As Chart b illustrates, stronger domestic demand outside of the US is the key ingredient to this. This highlights the need for policy makers in all major economies to push ahead with the reforms needed to increase growth rates. For example, in Europe further sustained progress on wide-ranging economic reforms is necessary to enhance long-run growth potential and increase resilience to shocks. In particular, delivering high and stable levels of growth and employment demands even greater flexibility in European labour, product and capital markets. In Japan the Government must push ahead with its agenda for financial sector reform, while in Emerging Asia the momentum of structural reform must be maintained to sustain domestic demand growth.

UK ECONOMY

Trend growth

A19 Data revisions since Budget 2003 provide new information and point to a higher than previously thought trend rate of output growth over the past few years, but for the Pre-Budget Report the existing 2¾ per cent trend rate projection is retained.

A20 Substantial upward revisions to measured UK GDP data were introduced by the Office for National Statistics (ONS) in Blue Book 2003, and are discussed in detail in the next section. These revisions have been driven by new information from surveys and by methodological improvements, including the annual chain-linking of the national accounts. In particular, non-oil gross value added (GVA) growth was revised up in all years from 1996 to 2001. This has the effect of boosting the estimated trend rate of growth between the adjudged on-trend points in the first half of 1997 and the third quarter of 2001.

A21 Over this period, the Blue Book 2003 data yield an annual trend rate of output growth of 2.9 per cent, revised up from the previous estimate of 2.6 per cent at the time of Budget 2003. There have been no significant revisions over the same period to outturns for the trend growth rates of average hours worked or employment, so the increase in the trend rate of output growth is captured almost entirely in the productivity growth component. Therefore, the estimated growth rate of underlying trend output per hour between 1997 and 2001 has increased to 2.7 per cent, 0.3 percentage points higher than at Budget 2003.

A22 A mechanical application of the Treasury's trend growth methodology would project forward this trend productivity increase which, with other trend growth components unchanged, would raise the trend output growth projection well above the existing 2¾ per cent neutral assumption. This would imply a negative output gap in mid-2003 well in excess of the 1½ per cent gap estimated on the basis of the 2¾ per cent trend growth assumption. However, evidence and judgement suggest that a current negative output gap much wider than 1½ per cent of GDP would be implausible:

- it would be surprising for such a wide gap to have opened up since late 2001 without any rise in the unemployment rate – which has been flat at just over 5 per cent – even allowing for lags between output and employment and businesses hoarding labour in the expectation that the slowdown in activity would be short-lived;
- nevertheless it may be that the sustainable rate of unemployment has continued to fall significantly since 2001, to well below the actual rate. This would be broadly consistent with the fall in private sector average earnings growth over the same period and various other economic indicators, such as the CBI and BCC surveys, which also point to slack in the economy at present. However, it is difficult to believe that these indicators point to a larger negative output gap than implied by the 2¾ per cent trend growth assumption;
- there is little evidence of the degree of downward pressure on inflation that might be expected if there were a large negative output gap;

- GDP data for latest quarters are more prone to upward revision than those for the more distant past,[3] imparting a possible bias towards overstating the absolute size of current output gaps if estimates are derived from the difference between mechanical projection of past trends and the latest quarter's data. This is part of the uncertainty surrounding output gap estimates, which is why projections of the public finances are stress-tested against the risk that the current output gap may be less negative (or more positive) than the central estimate; and

- uncertainty about underlying trends is compounded as the economy moves further away from its latest on-trend point. It has been two years or so since the last on-trend point in the third quarter of 2001. Therefore, trend growth projections must be cautious and guard against the risk that what happened in the economy more than two years ago is becoming a less reliable guide to current developments.

A23 Table A2 shows the contributions from the various components of trend output growth over the 1997 to 2001 period, and the decomposition of the 2¾ per cent trend growth projection assumed at Budget time. Data revisions prior to the third quarter of 2001, when the economy is judged last to have been on trend, and outturns for more recent quarters, raise a number of issues bearing on the components of the trend growth projection:

- the implication that trend output growth between 1997 and 2001 was more productivity rich than previously estimated raises the possibility of stronger trend productivity growth over the current cycle than projected at Budget time. However, compositional changes in employment perhaps tend to point in the opposite direction. For example, the increasing share of public sector employment in the economy over the past few years may have slightly depressed measured whole economy productivity growth,[4] though any such effect is unlikely to be large enough to be discernible. Moreover, actual growth in output per hour since 2001 has averaged below 2 per cent, but this weakness could wholly reflect cyclical factors;

- average hours worked have come down by ¾ per cent a year on average since the third quarter of 2001, though they have been flat since late 2002. At the current stage in the cycle it is difficult to judge whether this pattern primarily reflects cyclical or structural factors. However, it is possible that the trend fall in average hours worked over the current cycle could be more than the 0.1 per cent a year assumed in the Budget 2002 and Budget 2003 projections: past evidence suggests that the pro-cyclical response of average hours worked has typically been significantly weaker than the actual fall observed since 2001;

- the working-age employment rate has grown at an annualised rate of 0.2 per cent since the third quarter of 2001, in line with the trend projection first introduced in Budget 2002. However, the possibility that the sustainable rate of unemployment has carried on falling significantly over the past couple of years suggests the trend employment rate over the cycle may turn out to exceed the projection; and

[3] The ONS (*Revisions to quarterly GDP growth*, L.Akritidis, Economic Trends, No.594, May 2003) quoted an average upward revision to four-quarter GDP growth compared to initial estimates of approximately 3/4 percentage points between the first quarter of 1993 and the final quarter of 1999, with the total revision taking several years to come through.

[4] As explained in the Budget 2002 Trend Growth paper (*Trend Growth: Recent Developments and Prospects*, HM Treasury, April 2002).

- the working-age population has grown at an annualised rate of 0.5 per cent since the third quarter of 2001, in line with the 2002 Pre-Budget Report and Budget 2003 projections. Following recently released revisions to ONS mid-year population estimates, the Government Actuary's Department (GAD) will publish new 2002-based population projections on 18 December. The assumptions GAD will apply for these projections have already been published, and preliminary indications are that they point to growth in the population of working age averaging ½ per cent a year until 2006, slowing for demographic reasons to ¼ per cent for 2007 and 2008. However, the net inward migration assumption of 130,000 a year is almost 30,000 below latest estimates of the average for the past five years, 1998 to 2002, when outturns have varied between about 140,000 and 170,000. This suggests upside potential to the projection.

A24 After weighing up all the considerations relating to the estimated current output gap and the components of the trend growth projection, and continuing to take a cautious approach to productivity prospects, the existing 2¾ per cent trend output growth projection is retained as the neutral judgement. However, the data revisions further increase confidence that the 2¾ per cent assumption is consistent with the economy's potential. A deliberately cautious trend growth assumption ¼ percentage point below the neutral view continues to be used for the purposes of projecting the public finances.

Table A2: Contributions to trend output growth[1]

	Estimated trend rates of growth, per cent per annum					
	Trend output per hour worked[2, 3]		Trend average hours worked[3]	Trend employment rate[3]	Population of working age[4]	**Trend output**
	Underlying (1)	Actual (2)	(3)	(4)	(5)	(6)
1986Q2 to 1997H1	2.22	2.05	–0.10	0.33	0.24	**2.54**
Over the recent past						
1997H1 to 2001Q3						
Budget 2002	2.14	1.96	–0.37	0.36	0.66	**2.63**
Budget 2003	2.35	2.14	–0.47	0.43	0.50	**2.61**
PBR 2003	2.65	2.44	–0.47	0.42	0.54	**2.94**
Projection[5]						
2001Q3 to 2006Q4						
Budget 2002	2.1	2.0	–0.1	0.2	0.6	**2¾**
Budget 2003	2.35	2.25	–0.1	0.2	0.5	**2¾**
PBR 2003[6]	2.35	2.25	–0.1	0.2	0.5	**2¾**

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

[2] *The underlying trend rate is the actual trend rate adjusted for changes in the employment rate, i.e. assuming the employment rate had remained constant. Column (1)=column (2) + (1-a) column (4), where a is the ratio of new to average worker productivity levels. The figuring is consistent with this ratio being of the order of 50 per cent, informed by econometric evidence and LFS data on relative entry wages.*

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

[4] *UK household basis.*

[5] *Neutral case assumptions for trend from 2001Q3.*

[6] *Underlying the mid-points of the GDP forecast growth ranges from 2003Q4.*

Overview of recent developments and prospects

Table A3: Summary of forecast[1]

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

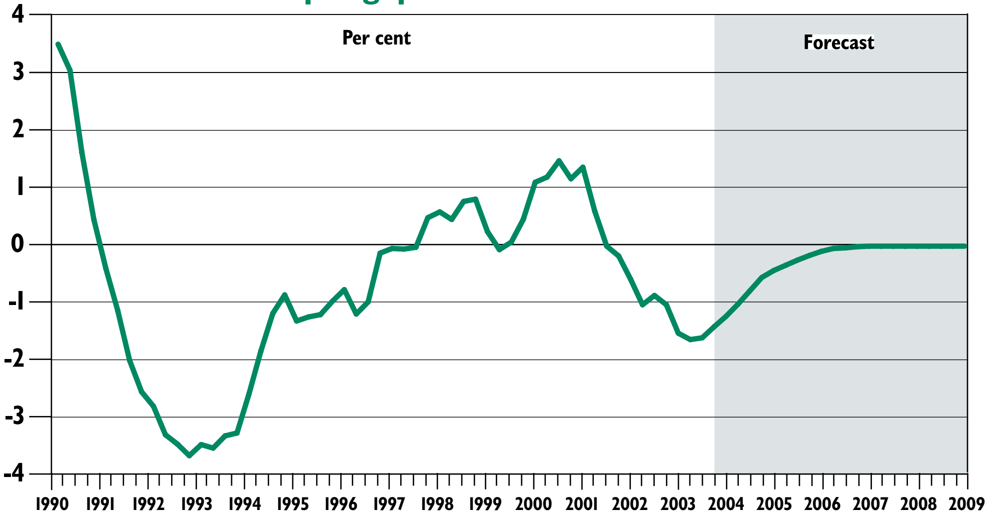
[1] *See footnote 3 to Table A9 for explanation of forecast ranges*

A25 The extensive revisions to UK GDP data introduced by the ONS in Blue Book 2003 have mainly affected real volume measures, with only small changes to nominal data. While some of the effects have worked in opposing directions, the overall effect is that measured GDP growth since the mid-1990s is now stronger and relatively more balanced between expenditure components than previously estimated. In particular, household consumption growth is now estimated to have grown more slowly over the recent past, with business investment and net trade both stronger. These revisions are discussed more fully in Box A3.

A26 In recent years, the domestic stability delivered by the Government's macroeconomic framework has enabled the UK economy to cope well in a challenging global economic environment. Strong economic fundamentals and proactive monetary policy action have supported private consumption, and fiscal policy has also supported demand, with sound public finances allowing counter-cyclical action through the operation of the automatic stabilisers. With inflation on the RPIX measure having remained close to its symmetric 2½ per cent target and few inflationary pressures on the horizon, the independent Monetary Policy Committee of the Bank of England reduced interest rates by a further 25 basis points on 10 July, the second cut of the year and the ninth since the beginning of 2001. This took base rates to 3½ per cent, their lowest level for 50 years. Fiscal policy has continued to complement monetary policy in helping to offset the effects on the UK of a weak international economy.

A27 In the circumstances, UK GDP has held up well, though it has grown at below trend rates. UK GDP rose by 2.1 per cent in 2001 and by 1.7 per cent in 2002. In the first half of 2003, the UK economy was affected by uncertainty surrounding the conflict in Iraq, high oil prices and volatility on financial and exchange rate markets, which compounded an already fragile global environment and undermined confidence in all major economies. Faced with these challenging international conditions, UK companies further postponed decisions on new investment expenditure in the first quarter. Sluggish external demand continued to restrain underlying UK export growth in early 2003, with export demand from EU markets – which account for over half of UK trade – particularly weak. Moreover, consumer confidence appears to have been dented by global geo-political tensions in the early months of the year. As a result, UK GDP growth in the first quarter of 2003 remained below trend, at 0.2 per cent, down from 0.5 per cent in the final quarter of last year and the weakest quarter-on-quarter increase for just under 11 years.

Chart A3: The output gap[1]



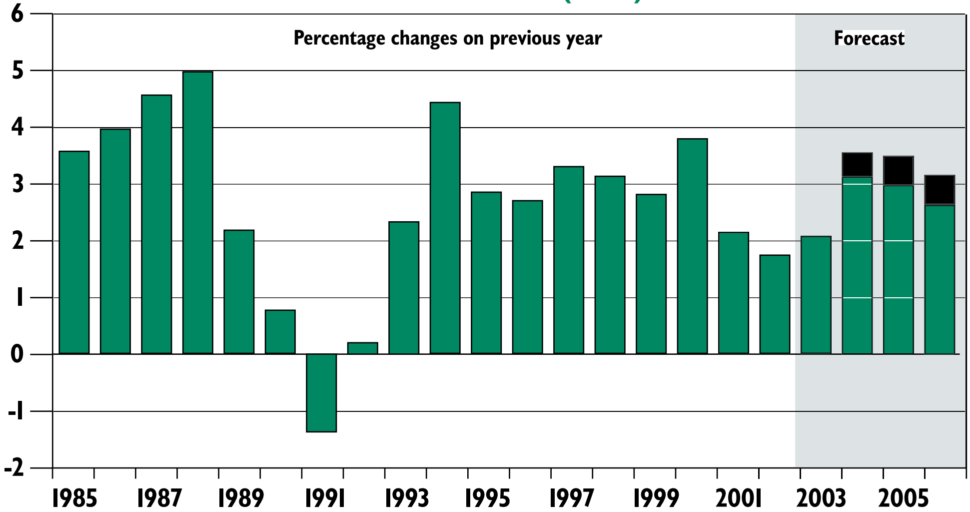
[1] *Actual output less trend output as a percent of trend output (non-oil basis).*

A28 UK demand and activity have strengthened as geo-political uncertainties have receded. Against a steadily improving global background, financial markets have more than made up for losses incurred during the first quarter of 2003, though they remain significantly below the peaks of 1999 and 2000. The FTSE 100 Index has risen by over 30 per cent since its trough in March, while overseas financial markets have seen similar gains. Many forward-looking survey and confidence measures have also improved considerably in recent months. While the MPC pre-emptively increased interest rates by 25 basis points on 6 November, this still leaves base rates close to 40 year lows, and no higher than at the time of Budget 2003. GDP grew by 0.6 per cent in the second quarter and by 0.7 per cent in the third quarter of the year, more or less in line with the Budget forecast, to stand 2.0 per cent higher than a year earlier.

A29 Royal Bank of Scotland Purchasing Managers Indices for the regions and devolved countries suggest the pick-up in demand and output has been relatively widespread across the UK, with all 12 regions recording increased business activity in the three months to November.

A30 The UK economy has continued to perform well compared with most of its major competitors. UK GDP growth in the first three quarters of 2003 outpaced that in Germany, France and the euro area as a whole, continuing the trend of recent years. UK GDP growth has now been above that in the euro area for nine of the past 11 quarters.

Chart A4: Gross Domestic Product (GDP)[1]



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

A31 The size of the estimated negative output gap in the third quarter of 2003 – around 1½ per cent of GDP on the assumption of 2¾ per cent trend output growth – is the same as the forecast made at Budget time, despite data revisions for 2002. So the forecast path for GDP is also broadly unchanged, with the economy building on recent positive developments and accelerating through into 2004. GDP is now expected to grow by 2.1 per cent in 2003 as a whole, within the lower half of the Budget 2003 forecast range. In both 2004 and 2005, GDP is forecast to grow by 3 to 3½ per cent. Growth is expected to fall back to its trend rate by early 2006 as slack in the economy is taken up and output returns to its trend level. Relative to recent years, the forecast implies more balanced growth.

A32 CPI inflation, which the Pre-Budget Report confirms as the operational target for monetary policy to apply from now on, is forecast to remain a little below target in 2004 as existing slack in the economy continues to dampen domestically generated pricing pressures. However, inflation is expected to return to target from 2005 as the combined effects of the recent depreciation of sterling and the strengthening recovery in the world economy feed through to higher import prices.

Box A3: Revisions to the UK national accounts

The extensive revisions to UK national accounts real volume measures introduced by the Office for National Statistics in Blue Book 2003 not only raised estimated GDP growth since the mid-1990s but also affected all of the main expenditure components.

Annual growth of private household consumption between 2000 and 2002 now averages $3\frac{3}{4}$ per cent – around 0.5 percentage points lower than previously estimated. This mainly reflects the introduction of annual chain-linking and the implied re-weighting of indices to reflect more contemporary prices and expenditure patterns.

Business investment was stronger in recent years than previously estimated. In the second quarter of 2003, business investment stood $4\frac{1}{4}$ per cent below its peak in the final quarter of 2000, compared with a decline of $11\frac{1}{4}$ per cent on the basis of pre-Blue Book 2003 data. The recent decline in business investment expenditure is now also judged to have been shallower than in the downturns of the early 1980s and 1990s. Upward revisions to investment figures reflect the inclusion of new information and also updated price weights. Given sharp falls in prices of ICT equipment in recent years, the weight of these items in investment spending has been reduced, mitigating their drag on total investment during the recent global economic slowdown. Revisions to trade data mainly reflect upward revisions to import price indices and adjustments for the effects of VAT missing trader intra-Community (MTIC) fraud – see Box A7. The revised data indicate net trade exerted a less negative drag on growth between 1998 and 2000, with changes to exports and imports offsetting each other in 2001. In 2002, there is a larger drag from net trade as a result of the scale of MTIC fraud.

These revisions show that growth has been relatively more balanced than previously estimated.

Demand

A33 Global uncertainties in the first quarter of 2003 appear to have temporarily dented household expenditure. As a result, household consumption in the first quarter of the year recorded a marginal fall, only its second quarterly decline in the past eight years. Since then, as geo-political uncertainties have receded, consumer confidence has recovered to above its long-run average, supported by continued strong labour market outcomes, further house price gains and the recovery in equity prices. Private consumption growth has consequently resumed, increasing by 0.7 per cent in the second quarter and by 0.8 per cent in the third. Retail sales have also picked up, after having been close to flat over the first few months of the year, growing 1.5 per cent in the three months to October.

A34 Against a backdrop of low inflation, a strong labour market and a pick-up in GDP growth, household real disposable income growth should strengthen, and so consumption should continue to grow relatively robustly over the forecast horizon. Nevertheless, underlying consumption growth is expected to remain below rates seen since the mid-1990s as a result of moderating house price inflation and slower rises in households' wealth, together with a diminishing appetite for borrowing as consumers adjust to relatively high levels of debt. However, this outlook is particularly prone to both upside risks in the short term and downside risks more generally.

Table A4: Contributions to GDP[1] growth[2,3]

	Percentage points, unless otherwise stated				
		Forecast			
	2002	2003	2004	2005	2006
Private consumption	2¼	1¾	1¾	1¾	1¾
Business investment	–½	0	¼	¾	½
Government	½	1	1	¾	¾
Change in inventories	–¼	0	¼	0	0
Net trade	–1½	–½	–¼	0	0
GDP growth, per cent	**1¾**	**2**	**3¼**	**3¼**	**2¾**

[1] *Fixed base volumes*

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

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

A35 Real government spending on current goods and services, as measured in the national accounts, has accelerated a lot less than nominal spending over the recent past, but measurement difficulties mean that the real measure is almost certainly highly misleading (see Box A4). Following growth of 3¼ per cent in 2003, the forecast assumes that growth in real government consumption slows to about 2½ per cent a year. This implies less of a slowdown in real than in nominal spending, given that growth in nominal government consumption is projected to slow from around 10½ per cent this year to around 6 per cent.

A36 Business investment has shown tentative signs of strengthening since the spring, as the effects of uncertainties have receded. In the year to the third quarter of 2003, business investment rose marginally – the first positive annual growth since the end of 2001. At the same time, strong growth in government investment has continued to support overall capital expenditure, with general government capital spending in the year to the third quarter up around 10 per cent on a year earlier.

A37 With corporate profitability having risen over the past year and company balance sheets far healthier than during the late 1990s' ICT boom, businesses are well positioned to step up investment as the global recovery gathers pace into 2004. Business investment is forecast to rise by ¾ per cent in 2003 as a whole, accelerating to between 3 to 3½ per cent in 2004 and to 5½ to 6¼ per cent the year after.

A38 Substantial upward revisions to imports from the EU from 1999 onwards have recently been introduced into the UK trade statistics. These revisions reflect initial adjustments for the impact of VAT missing trader intra-Community (MTIC) fraud, which for at least the past four years had led to a significant under-recording of UK imports from the EU, an issue discussed in more detail in Box A7.

A39 Interpreting trade data has been further complicated by technical problems in the recording of goods exports. Goods exports volumes have been erratic, but appear to have fallen a little further since the start of the year. Most of the recent weakness of exports has been due to trade with the EU, partly as a result of HM Customs and Excise closing down businesses involved in MTIC fraud, but also reflecting disappointing growth in the euro area over the first half of 2003. In recent months, goods export volumes to the EU have been at their lowest level for around four years. However, recent trade figures are still likely to be prone to revisions.

A40 Looking ahead, exports are expected to pick up into 2004 as momentum in the global economy gathers pace and as the lagged effects of the weakening in sterling against the euro over the past year feed through. At the same time, stronger business investment and a continued recovery in manufacturing output are expected to underpin stronger import growth.

Output

A41 Manufacturing output has increased over the past year and the latest data show it has now registered three consecutive quarters of positive growth. While global uncertainties meant growth was marginal between the final quarter of 2002 and the first quarter of 2003, manufacturing output rose 0.5 per cent in the second quarter of the year, growing at a faster rate than the service sector for only the second time in the past two and a half years. Manufacturing output rose gradually in the third quarter, although production was possibly affected by the exceptionally hot weather in August. October saw a particularly sharp pick up of 1 per cent on the month: abstracting from the period around the Golden Jubilee in 2002, this is the fastest increase since August 2001. Aggregate manufacturing output does, however, continue to mask divergences within the sector, with seven of the 14 main industries seeing growth between the second and third quarters of this year and five seeing further declines.

A42 Some parts of the high-technology electrical and optical equipment sector appear to have seen output bottom out, with ICT production having increased from lows in the second half of last year. However, the impact of the global recovery in ICT on UK high-technology businesses is unclear: computers and semiconductors production have both increased since the end of last year, but output of mobile phones has continued to contract, with production having declined by two thirds since the onset of the global economic slowdown in 2001. In Scotland, where the global downturn had a particularly severe impact due to the concentration of ICT businesses based in 'Silicon Glen', high-technology production has yet to pick-up following sharp falls in 2001 and 2002.

A43 Many survey indicators suggest that manufacturing activity has picked-up further, in line with recent official output data. For example, the CIPS manufacturing survey for November showed new orders rising at their fastest pace for almost four years with firms reporting a relatively marked acceleration in export demand. The November CBI monthly trends survey also reported order books improving.

A44 The British Chambers of Commerce survey for the third quarter showed manufacturers' confidence regarding future profitability and turnover improving in seven of the 12 UK countries and regions. Manufacturers in the South East and North East were the most optimistic, while confidence amongst firms in Scotland, Wales, Northern Ireland and the North West remained considerably below the national average.

A45 The pick-up in business investment, allied with improving prospects for world trade, are expected to underpin a strengthening of manufacturing output into next year and 2005, building on recent signs of a turnaround in the sector. Following growth of ¼ per cent this year, manufacturing output is forecast to rise by 1¾ to 2¼ per cent in both 2004 and 2005, consistent with its long-run performance.

A46 Construction output grew by 2.5 per cent between the second and third quarters of 2003. This followed particularly sharp growth of over 4 per cent in the second quarter, the fastest quarterly increase for almost 16 years. Construction activity has benefited from strong growth in public investment in recent years as the Government's spending plans have come on stream. Other evidence suggests the commercial sector has played an increasingly important role in boosting total construction demand in recent months.

Box A4: Measuring real government output

Budget 2002 announced significant increases in government spending over the next few years. The composition of this growth between increases in real output and prices has important implications for evaluating the Government's drive to improve public services.

The non-market nature of most government services means that measuring government output (or real consumption) and productivity is not straightforward. Traditionally real government consumption has been measured by real inputs, ruling out productivity improvements. However, in recent years the ONS has been developing a direct volume approach to measuring government output. In principle this allows for productivity change, conforming with recommended international best practice, but the existing volume measures, at their current stage of development, have considerable drawbacks in practice. In particular, satisfactory methods have yet to be found to take account of changes in the quality of services provided; and the relevance and coverage of the indicators offer ample scope for further advance.

The approach used to measure educational output illustrates some of the issues. The basic output indicator used is the total number of pupil years of teaching, on the grounds that pupils consume lessons. This means that for a given number of pupils, extra education spending will not feed through at all to recorded output. Instead it will show up one-for-one in a higher rise in the implied deflator. It will not capture service improvements such as reduced class sizes or the delivery of better quality teaching. Whereas extra spending need not necessarily be expected, at least in the short term, to raise teacher productivity, in so far as it leads to better educational standards it should add value and so raise real output. But under the existing method of measurement it cannot.

Over 60 per cent of government output is now measured using direct volume indicators, including health and education services which together constitute around half of government output. Over the past few years, nominal current spending on health and education has accelerated relatively strongly. Yet there has been relatively weak growth in measured real output in these services, with a strong pick-up in the implied deflator. For example, in the second and third quarters of 2003, nominal government consumption was up about 11¾ per cent on a year earlier, split into measured real growth of just around 4 per cent and an increase in the implied deflator of almost 7½ per cent – well in excess of the rate of input cost inflation.

Measurement practices may well explain this, and mean that the measures in question are underscoring real growth and conveying misleading policy signals. In any case, it is appropriate at present to raise the priority accorded to further improving measurement, because stronger growth in government spending aimed at delivering tangible public service improvements sharpens the focus on performance indicators and policy evaluation. The National Statistician announced on 4 December 2003 that Sir Tony Atkinson had been asked to undertake a review of the future development of measures of government output, productivity and associated price indices so as to advance methodologies. A preliminary report will be produced by July 2004 and a final report by January 2005.

A47 Service sector output growth weakened considerably in the first half of 2003. Following growth of 0.9 per cent in the final quarter of 2002, the private services sector registered growth of 0.4 per cent in the first quarter of this year and output remained flat in the second quarter. This temporary weakness appeared partly to reflect the effects of global uncertainty, and the conflict in Iraq in particular, on certain service industries. A reluctance to make overseas trips during the period of the conflict triggered a sharp fall in air travel between the end of 2002 and mid-2003, with hotels and restaurants output remaining virtually flat in the first quarter.

A48 More recently, the service sector has rebounded as global uncertainties have diminished. Private sector services output rose by 0.8 per cent between the second and third quarters. Moreover, business survey evidence points to this pattern being consolidated going forward. In particular, the CIPS Reports on services have suggested a marked pick-up in the sector since the summer, with business activity growing at its fastest rate for almost six and a half years in November and business expectations regarding the near-term outlook signaling further robust growth in coming months.

A49 The BCC third quarter survey also showed confidence regarding future turnover and profitability among service sector firms rising above their long-run averages. However, the regional picture remains mixed. Confidence in Scotland and the North West remains significantly below the national average, with Wales and the East Midlands among the more optimistic regions. Service sector confidence generally remains above that in manufacturing, with the exception of the South East.

A50 The regional distribution of private sector rates of capacity utilisation over the past year, as measured by the BCC survey, suggests that it tends to be high when unemployment rates are low, as might be expected if regional variations in sustainable unemployment rates were relatively limited. Unemployment rates were lowest in the South West and South East, and highest in Greater London and the North East, but capacity utilisation rates in these regions tended to accord with the negative relationship with unemployment. The main outliers to the relationship are Yorkshire and Humberside and particularly Scotland, where utilisation rates were higher than unemployment rates might have suggested, and the Eastern region, where both unemployment and capacity utilisation rates were relatively low. This perhaps tends to suggest that, compared to other regions, there may be supply-side factors making it relatively easier to sustain low unemployment in the Eastern region and relatively more difficult in Yorkshire and Humberside and Scotland.

A51 In February 2003, the Chancellor asked Christopher Allsopp to undertake a wide-ranging review of the informational and statistical requirements for monetary and wider economic policymaking, including to support the Government's objective of promoting economic growth in all regions. The Review team's First Report, described in Box A5, concentrates on regional statistics and is being published today. The Government welcomes the report and looks forward to discussing the proposals with the Review team, the National Statistician and others.

Box A5: The Allsopp Review: Regional information

As part of his review, Christopher Allsopp was asked to produce an assessment of the regional information and statistical framework needed to support the Government's objective of promoting economic growth in all regions and reducing the persistent gap in growth rates between the regions.

Christopher Allsopp's First Report proposes bringing regional accounts more into the national accounts framework and improved, more timely GVA estimates based on production data.

Many of the First Report's recommendations concern the processes required to provide adequate regional and sub-regional data, including expansion of a number of key surveys. The recommendations include:

- **a better quality and more timely measure of real regional Gross Value Added;**
- **expanding the range of microeconomic and sub-regional data already available;**
- **an Office for National Statistics (ONS) or Government Statistical Service (GSS) presence in the English regions, to complement that which already exists in Scotland, Wales and Northern Ireland; and**
- **greater access for the ONS to administrative data held within government, which could improve both regional and national data, while offering important savings in the compliance burden on business.**

The labour market

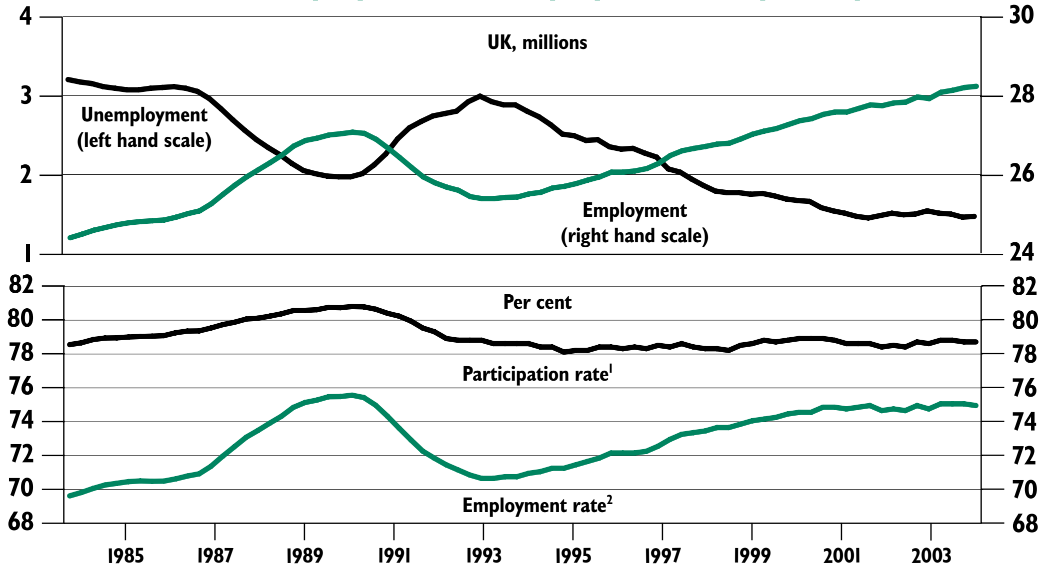
A52 The UK labour market has remained resilient to shocks from global economic developments. The employment rate is close to record highs and unemployment rates have remained stable. The performance of the UK labour market provides evidence that the Government's supply-side reforms are creating a more dynamic and flexible labour market in the UK. The resilience of the UK labour market contrasts with many other industrialised countries where unemployment has risen.

A53 The unemployment rate, on the International Labour Organisation (ILO) definition, trended gently downwards over the year to the third quarter of 2003, while remaining broadly flat over the past two years or so. At 5.0 per cent, it remains the lowest among the G7 economies. Claimant count unemployment has also nudged down in recent months, following short-lived increases in the earlier months of the year. It has been below one million for over two and a half years, and is now at its lowest level since 1975. In October, the claimant rate stood at just 3.0 per cent.

A54 Growth in the working-age population – which rose by an estimated 180,000, or 0.5 per cent, in the year to the third quarter – has been more than absorbed by growth in employment. However, with unemployment down by 70,000 in the year to the third quarter, working-age inactivity has been little changed over the past year, though the rate edged down. In the third quarter, employment was about 310,000 up on a year earlier. This brought the employment level to a new record high of over 28 million, and the employment rate to 74.6 per cent, up a little on a year earlier and exceeding most analysts' expectations at the time of Budget 2003.

A55 Most regions and countries of the UK have seen a continuation of rising employment and falling unemployment over the past year. However, there have been regional variations. All regions bar the North East, East Midlands and West Midlands have seen increases in employment in the year to the third quarter of 2003; and three regions – London, the North East and the East – have seen rises in unemployment. These rises have been very modest and associated with increasing numbers of economically active people. London saw unemployment rise 8,000 over this period, possibly due to the downturn in financial services, though overall employment in the capital rose markedly. The dispersion of unemployment rates between regions and countries of the UK also remains narrow compared with the experience in the 1980s and 1990s.

Chart A5: LFS employment, unemployment and participation



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

A56 Of the 310,000 – or 1.1 per cent – rise in total employment in the year to the third quarter of 2003, over two-thirds was accounted for by full-time self-employment, with its share rising significantly. This implies a larger increase in private than public sector employment. However, the number of full-time employees fell slightly on the year, with the corresponding decline in share virtually mirroring the rise in the share of full-time self-employment. This left the share of overall full-time employment in total employment little changed on the year, whereas over the previous year it had fallen sharply. Most of the rise in full-time self-employment appears to have been concentrated in the banking, finance and insurance sector mainly in London and the South East, perhaps reflecting the establishment of new businesses by individuals made redundant by City financial institutions, and in construction, reflecting ongoing buoyancy in this sector nationwide.

A57 Rising public sector employment has been a key feature of recent labour market developments, as the Government's spending commitments aimed at improving key public services come on stream. Public sector jobs increased by 86,000 in the year to mid-2002, with the majority of gains in the health sector. Since then jobs in public administration, education and health (which mainly comprise public sector employment) have increased on average by around 45,000 a quarter, compared to around 25,000 a quarter over the previous year. With self-employment accounting for most of the growth in total employment over the past year or so, and total employees in the third quarter of 2003 little changed on a year earlier, rising public sector employment seems to have been accompanied by falls in private sector employees over this period, notably in manufacturing.

A58 Over the year to summer 2002, average weekly hours worked declined sharply as firms responded flexibly to global uncertainty by adjusting hours rather than employment. This contrasts with many other countries where employment took more of the strain of global uncertainties. Since then average weekly hours worked have been relatively flat, but some cyclical upturn is expected as businesses respond to strengthening demand.

A59 Productivity growth slowed in 2001 and 2002 as companies chose to retain workers during the recent period of international weakness when output growth eased back in the face of weak external demand. However, it has shown some signs of cyclical recovery more recently. Unit wage costs have continued their downward trend in recent months, rising just 1.2 per cent in the year to the second quarter of 2003, the lowest rate of growth for over seven years.

A60 Whole economy average earnings growth has remained well within sustainable limits over the past two years, notably falling from around 3¾ per cent in the summer and autumn of last year to around 3 per cent in spring this year before edging up in more recent months. There remains a divergence between growth in public and private sector pay. Average earnings growth (including bonuses) this year has been running at about 3 per cent in the private sector and in excess of 5 per cent in the public sector, where recent rates have been temporarily boosted by pay rises in health, social work and public administration having been awarded at a different time to last year. Over the first three quarters of 2003 whole economy average earnings were 3.4 per cent up on a year earlier, compared to the independent average forecast prevailing at the time of Budget 2003 of 4.0 per cent growth for the year as a whole. The recent behaviour of earnings growth, as well as average hours worked, appears to reflect a flexible response to the cooling in output and demand growth as the world economy weakened, thereby supporting employment.

THE UK FORECAST IN DETAIL

Inflation

A61 The Pre-Budget Report confirms that the operational target for monetary policy to apply from now on will be defined in terms of Consumer Prices Index (CPI) inflation, instead of RPIX inflation. Underlying inflation remains firmly in check. Since the inception of the present monetary policy framework in May 1997, inflation has been kept close to target and within a narrow band, with RPIX inflation averaging 2.4 per cent over this period. In October 2003, RPIX stood at 2.7 per cent. CPI inflation stood at 1.4 per cent, among the lowest in the EU.

A62 There have been a number of influences on inflation outturns in recent months. Shallower discounting of clothing and footwear prices in the summer sales, coupled with subsequently stronger price recoveries, made an upward contribution to annual inflation in August, and the unusually hot and dry summer in the UK and mainland Europe adversely affected supplies of many fresh vegetables. However, the cost of foreign package holidays has fallen significantly this year, especially to European destinations, possibly reflecting the effects of geo-political uncertainties. Petrol prices have been more stable in recent months following previous increases in oil prices through 2002 and into 2003.

A63 Divergences between the rates of goods and services price inflation have narrowed in recent months. Goods prices in the retail prices basket stood 0.6 per cent higher in October than a year earlier. At the same time, service sector price inflation has moderated, with price rises for leisure and recreational services especially having eased back over the past year or so.

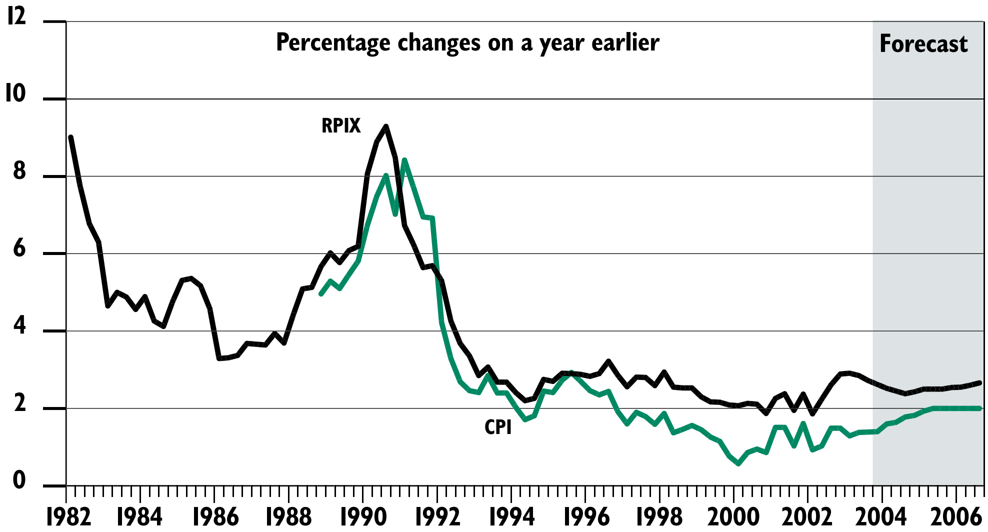
A64 Since spring 2003, moderation in the underlying growth of house prices has generally made a downward contribution to RPIX inflation, as measured through the housing depreciation component. The wedge between RPIX and CPI inflation arising from housing components has consequently narrowed, and was at its smallest for almost a year in October.

A65 On the basis of the Halifax house price index, annual rates of house price growth have almost halved since their peak in October 2002, and the Nationwide and ODPM measures corroborate this picture. However, monthly house price growth has picked up since earlier in the year, and the housing market has maintained more momentum than many were expecting. National house price indices continue to mask relatively significant dispersion in house price inflation among the regions and countries of the UK. House price valuations in the northern regions and the Midlands have tended to see increases above those in the UK as a whole over the past year, while those in London and the South East have risen relatively modestly. As a result, Halifax estimates that the gap in the level of house prices between the north and south narrowed by around £8,000 in the year to the third quarter of 2003.

A66 Inflation prospects are likely to reflect the balance of opposing influences. Existing slack in the economy, built up during the recent world slowdown, is expected to exert further downward pressure on domestically generated inflation through 2004 and into 2005. However, working in the reverse direction, the lagged effects of the recent depreciation of sterling are expected to result in higher import price inflation over the forecast horizon. In addition, the further pick-up in the pace of global recovery is also expected to lift import prices in 2004 and 2005. CPI inflation is therefore forecast to rise slowly from early next year to settle at its 2 per cent target by the second half of 2005.

A67 The difference between CPI and RPIX inflation is expected to narrow markedly from 1.3 percentage points in October 2003 to ½ percentage point two years ahead, the typical forecast horizon for monetary policy purposes. Thereafter, the differential is expected to remain broadly stable, rising slightly above ½ percentage point in future years. With CPI inflation expected to remain at its target level of 2 per cent, RPIX inflation is expected to rise slightly above 2½ per cent depending on a range of economic factors, and rounds up to 2¾ per cent in this Pre-Budget Report forecast. The ONS is expected to take into account any internationally agreed future changes in the measurement of inflation.

Chart A6: CPI and RPIX[1]



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

The household sector

A68 As a result of the recent revisions to the UK national accounts, GDP growth since the mid-1990s has been less consumption rich than previously estimated, reflecting a combination of downward revisions to private consumption growth and upward revisions to GDP growth. Between 1995 and 2002, data available at the time of Budget 2003 showed real private consumption and real GDP up by almost 33 and 20 per cent respectively, whereas the revised data show corresponding estimates of just over 30 and 21 per cent. However, in nominal terms the latest data confirm a much narrower gap between private consumption and GDP growth which was also evident in the previous data, with private consumption up 50¾ per cent and GDP up 45¼ per cent over this period, and the share of private consumption in GDP at current prices up from about 64 to 66 per cent. Therefore, the nominal data indicate that growth in private consumption has been more sustainable than the real data suggest, reflecting a decline in the relative price of consumption goods and services. Revisions have also lowered estimated growth in real private consumption in 2003, which is now put at 2.5 per cent over the year to the second quarter, almost 1 percentage point lower than previously estimated.

Table A5: Household sector[1] expenditure and income

	Percentage changes on previous year, unless otherwise stated				
		Forecast			
	2002	2003	2004	2005	2006
Household consumption[2]	3½	2½	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾
Real household disposable income	1½	2	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾
Saving ratio (level, per cent)	5¼	4¾	4¾	4¾	4¾

[1] *Including non-profit institutions serving households.*
[2] *Chained volume measures.*

A69 Geo-political uncertainties and volatility on financial markets appear to have temporarily dented private consumption growth in the initial months of 2003. Consumer confidence dipped below its long-run average in February and March. The lagged effects of falls in net household wealth in 2002, arising from declining equity prices, may also have influenced consumer spending this year. In the first quarter, household consumption fell 0.2 per cent, its first decline since 1995, and retail sales, which comprise around 40 per cent of household consumption, also declined.

A70 Since early spring, consumer confidence has returned to above its long-run average as geo-political uncertainties have receded, equity prices have recovered and signs of a strengthening world economy have emerged. Underlying growth of retail sales has also strengthened, with volumes increasing 1.5 per cent in the three months to October compared with the previous three months, though it remains below rates seen for much of 2001 and 2002.

A71 While underlying consumption growth appears to have eased since the second half of 2002, it has continued to outpace increases in disposable income, thereby contributing to continued strong growth in demand for personal borrowing since Budget 2003. Low interest rates and further gains in house price valuations have helped maintain a benign borrowing environment for households. The recovery in equity prices since the spring and the corresponding boost to households' financial wealth, may also have enhanced confidence for taking on additional debt (see Box A6).

Box A6: Household balance sheets

Household borrowing rose by 14 per cent in the year to the third quarter of 2003. This was driven mainly by a strong rise in mortgage lending, which accounts for over 80 per cent of the stock of household debt. As illustrated in Chart a, the ratio of household debt to income reached a new peak of over 130 per cent in the second quarter of 2003.

However, any assessment of household finances needs to consider households' asset positions alongside levels of debt. The recent rise in household borrowing has been heavily influenced by developments in the housing market. While the strong rise in house prices over recent years has led to increased borrowing by home buyers, it has also significantly boosted the value of housing wealth, as can be seen in Chart a. The value of households' total net wealth has increased by over 50 per cent since the beginning of 1997, with sharp growth in housing wealth more than offsetting the effects of the weakening in global equity prices between 2000 and early 2003. As a result, the ratio of household debt to total wealth has remained stable. Moreover, while mortgage equity withdrawal has increased, households have simultaneously been building up their holdings of money and deposits. Mortgage equity withdrawal has not caught up with recent rises in house prices in the sense that untapped equity in the housing stock has continued to rise, presently standing at over 75 per cent of total housing wealth.

Chart a: Household debt and housing wealth as a percent of disposable income

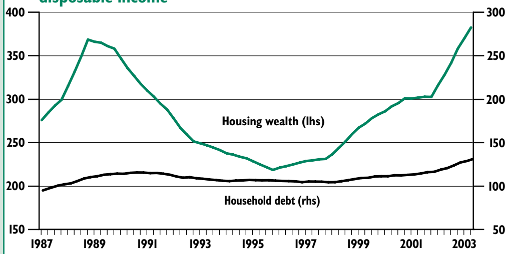
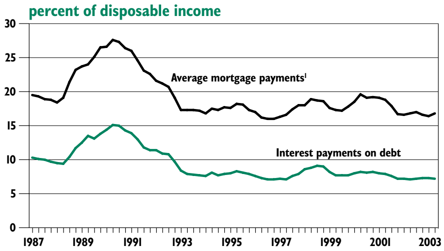


Chart b: Household interest and mortgage payments as a percent of disposable income



[1] *Average mortgage repayments for those taking out a mortgage for house purchase in the specified quarter.*

A key difference between the current position of households' balance sheets and conditions in the late 1980s is that interest rates are currently close to their lowest level for fifty years. Chart b shows that low interest rates have kept the proportion of household income taken in interest payments low by historical standards. Similarly, the average mortgage payment as a percent of income is also low.

Household borrowing inevitably poses risks to the forecast. However, economic stability based on low inflation, low interest rates and high levels of employment should ensure that existing levels of debt are sustainable. Widespread household defaults have in the past occurred only in the face of a significant rises in both interest rates and unemployment. Evidence from the last recession in the early 1990s suggests that growth in borrowing slowed from 1989 when households started to retrench as interest rates rose to around 15 per cent and interest payments reached 15 per cent of disposable income.[a] Interest payments currently account for 7.2 per cent of disposable income, significantly below early 1990s' levels, and so the prospect of an uncomfortably sharp retrenchment in household borrowing remains low.

[a] This figure does not take into account the impact of Mortgage Interest Relief at Source, which subsidised borrowing costs.

A72 Household consumption is forecast to continue growing at around recent rates. With personal debt at historically high levels, consumers' appetite for further increases in borrowing is likely to recede, and more moderate increases in house prices are expected to rein back mortgage equity withdrawal. Thus despite stronger growth of disposable incomes than of late, as the output gap closes, consumption growth over the forecast horizon is expected to be weaker than experienced since the mid-1990s. Private consumption is now forecast to increase by 2½ per cent this year and by between 2¼ to 2¾ per cent in 2004 and 2005, with the saving ratio stabilising.

Companies and investment

A73 The latest national accounts revisions show that business investment has been stronger in recent years than previously estimated. This partly reflects relative declines in the prices of many investment goods – and ICT goods in particular (see Box A3). The ratio of current price business investment expenditure to GDP has shown little trend over the past twenty years or so. Thus, while the relative price of business investment has trended downwards, real business investment has, on average, tended to grow faster than GDP over this period.

Table A6: Gross fixed capital formation

	Percentage changes on previous year				
		Forecast			
	2002	2003	2004	2005	2006
Whole economy[1]	1¾	2¼	6 to 6½	5½ to 6	4 to 4¾
of which:					
Business[2,3]	–3½	¾	3 to 3½	5½ to 6¼	4½ to 5¼
Private dwellings[3]	19¼	4½	3¾ to 4	3¾ to 4¼	1½ to 2
General government[3,4]	7¾	15½	30	9¼	6¾

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

[2] *Private sector and public corporations' (except National Health Service Trusts) non-residential investment. Includes investment under the Private Finance Initiative.*

[3] *Excludes purchases less sales of land and existing buildings.*

[4] *Includes National Health Service Trusts.*

A74 However, despite the effects of recent revisions, business investment remained subdued in the early stages of the year, as forecast in Budget 2003. Uncertainty surrounding the situation in Iraq, financial market volatility and other ongoing risks compounded the effects of an already fragile global economy and discouraged companies from bringing investment projects back on stream. Business investment remained broadly flat between the final quarter of 2002 and the first quarter of 2003, coinciding with the peak of global uncertainty surrounding the situation in Iraq. Relatively sharp declines on global equity markets in the early months of 2003, combined with remaining doubts about the momentum of the world recovery, are also likely to have constrained investment demand.

A75 More recently, there have been tentative signs that a gradual business investment recovery is underway. In the year to the third quarter of 2003, it recorded its first – albeit marginal – positive annual growth rate since the end of 2001. Imports of capital goods appear to have flattened out during the summer months, while production of capital equipment has seen a modest rise over the past year or so.

A76 However, in the past business investment has tended to lag GDP growth and a more substantial turnaround in companies' capital expenditure has yet to make itself evident. With the exception of corporate expenditure on vehicles, investment in machinery and equipment has remained subdued, while being partially offset by buoyant spending on buildings and structures. Nominal expenditure on computer hardware and software has also fallen a little further this year although, given declining prices for ICT goods, this may well mask growth in real terms. Investment by manufacturing firms remains low, reflecting the degree of spare capacity accumulated during the protracted period of global weakness.

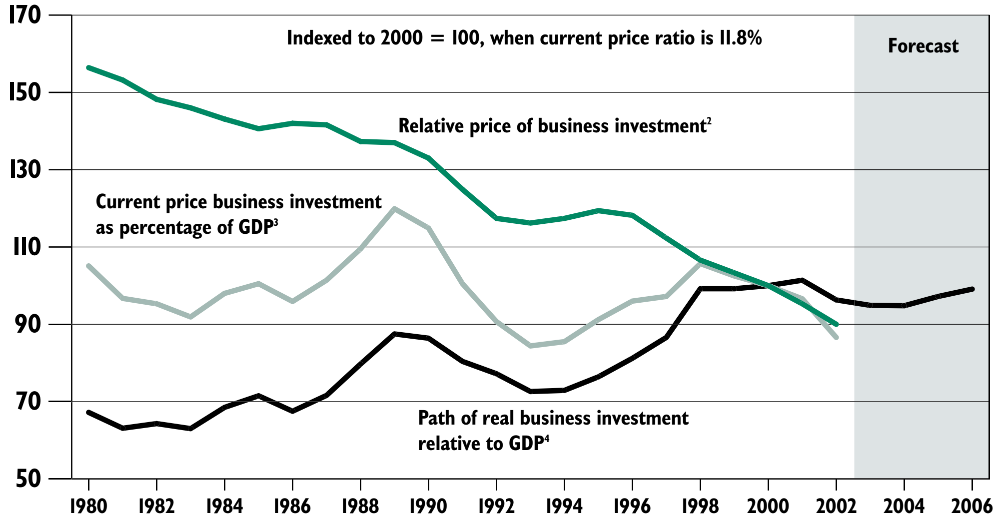
A77 Nonetheless, recent business survey indicators suggest that spare capacity in some of the regions and countries of the UK which were most exposed to the global slowdown is lower than in many other parts of the country. This tentatively indicates that investment in these areas may also have suffered disproportionately from weak external demand in recent years. Broadly consistent with the underlying picture from official data, the latest BCC survey suggests a gradual strengthening in investment intentions across most UK regions and countries into the third quarter, with particularly pronounced improvements in the West Midlands, the North West and South West.

A78 The July 2003 CBI Industrial Trends Survey showed the proportion of manufacturing companies citing demand uncertainty as a factor holding back investment at its highest since the aftermath of the 11 September 2001 tragedies. The proportion of companies emphasising uncertainty as the key factor in limiting investment expenditure fell back in the October 2003 CBI survey, though it remained slightly above its long-run average. Evidence from the survey suggests that uncertainty about demand continues to be the main constraint on investment in nearly all regions and countries of the UK, despite a number of key global uncertainties having receded. Only firms in the South West judge inadequate net return to be a more significant factor undermining the appetite of businesses to invest.

A79 Nonetheless, despite some lingering uncertainties, the UK corporate sector has shown positive signs of strengthening since the spring. Company profitability has improved in recent months. Manufacturers' rates of return have risen for four consecutive quarters, possibly reflecting the effects of the decline in the value of sterling on profit margins. Rates of return in the service sector also picked up over the second quarter. Company balance sheets have continued to improve, offering a solid foundation for raising capital expenditure going forward. Moreover, private non-financial corporations have now been net lenders for a year: net lending by private non-financial corporations was £3½ billion in the second quarter of 2003.

A80 The BCC third quarter survey showed indicators of confidence regarding future profitability among both manufacturing and service sector firms rising above their long-run averages. However, the regional picture remains mixed. Confidence in Scotland, Wales and the North West remains significantly below the national average, with Yorkshire and Humberside and the East Midlands among the more optimistic regions. Service sector confidence generally remains above that in manufacturing, with the exception of the South East.

Chart A7: Business investment[1]



[1] *Business investment includes investment by public corporations (except National Health Trusts) and investment under the Private Finance Initiative.*
[2] *Ratio of implied business investment deflator to GDP deflator.*
[3] *Ratio of business investment to GDP in current prices.*
[4] *Ratio of business investment to GDP in chained volume measures.*

A81 Investment expenditure is expected to gather further momentum into 2004 and 2005. Following growth of ¾ per cent this year, business investment is forecast to rise by 3 to 3½ per cent in 2004 and 5½ to 6¼ per cent in 2005. A gathering pace of recovery in the world economy is expected to be the main impetus for increased investment. Recoveries in equity valuations should also support the pick-up in business investment, while the fall-back in sterling against the euro, which may allow for the rebuilding of export margins, could act as an additional spur over the forecast horizon.

A82 With government investment expected to continue growing strongly as a result of the Government's spending plans, whole economy fixed capital formation is expected to grow significantly faster than private consumption and GDP in all forecast years.

Trade and the balance of payments

Table A7: Trade in goods and services

	Percentage changes on previous year					£ billion
	Volumes		Prices[1]			Goods and services balance
	Exports	Imports	Exports	Imports	Terms of trade[2]	
2002	–1	3¾	1¼	–2	2½	–31¼
Forecast						
2003	–1½	½	1	–¼	1¼	–33
2004	5¼ to 5¾	5¼ to 5¾	2	1¼	¾	–33
2005	7 to 7½	5¾ to 6¼	3¼	3	¼	–31½
2006	6¼ to 6¾	5¾ to 6¼	3	2¾	0	–32½

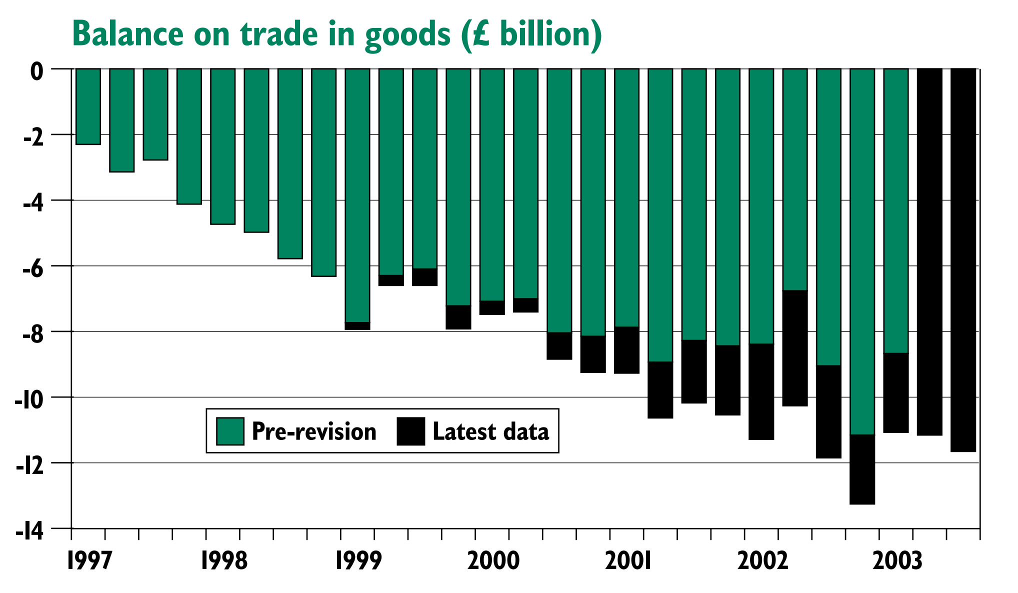
[1] *Average value indices.*
[2] *Ratio of export to import prices.*

A83 There have been large revisions to official trade data since Budget 2003 (see Box A3). Box A7 discusses the substantial upward revisions to imports from the EU and the trade deficit from 1999 onwards to correct for under-recording owing to VAT missing trader intra-Community (MTIC) fraud. Other revisions, in particular to import price indices, have generally reduced estimates of goods import volumes growth in recent years. MTIC fraud has also affected UK goods export volumes.

Box A7: Missing trader intra-Community fraud

In July 2003, the ONS introduced substantial upward revisions from 1999 onwards to imports from the EU, and hence the estimated UK trade deficit, to adjust for initial estimates of the impact of VAT missing trader intra-Community fraud (MTIC). This fraud had, for at least the past four years, led to UK imports from the EU being significantly under-recorded, though the revisions had only a very modest impact on measured GDP growth. Essentially, fraudsters have not been declaring their imports from the EU, and then have been selling them on at VAT inclusive prices and going missing without paying the VAT over to HM Customs and Excise. The fraud is not exclusive to the UK: it can be perpetrated between any two or more Member States because these VAT arrangements apply throughout the EU.

The fraud had been growing for several years to a peak in 2002, when imports from the EU were under-recorded by over £11 billion, equivalent to 1 per cent of GDP. This adds directly to the trade deficit, which is now estimated to have been 3 per cent of GDP in 2002 compared to 2 per cent previously.



Over the past year or so, HM Customs and Excise made significant progress in tackling this fraud and several firms have ceased operations. This has resulted in a sharp drop in illicit exports and imports of mobile phones and computer components (the commodities of choice for the fraudsters) which has depressed overall UK trade growth over the past year. For example, in the first three quarters of 2003 exports volumes fell by 2¾ per cent on a year earlier, whereas excluding fraud-related exports volumes grew by 1¼ per cent.

The ONS estimates that as a result of the fraud alone, real GDP growth in 2000 and 2001 would have been revised down by 0 to 0.2 percentage points each year. Estimates of real GDP growth from the beginning of 2002 have not been affected by the import revisions as they are measured primarily by output data. These fraud-related GDP revisions were introduced as part of the 2003 Blue Book dataset published in September 2003, but they were more than offset by other revisions which raised real GDP growth over 1997 to 2000.

A84 Interpreting trade data over more recent months is also complicated by problems arising from the introduction of a new system of recording exports by HM Customs and Excise. While these problems appear now to have been resolved, it is still possible that recent data may be less reliable than usual.

A85 Despite signs that the world economy has turned the corner and even after allowing for the effects of MTIC fraud, underlying export volumes have remained weak. Fraud-adjusted goods export volumes rose by less than ¼ per cent between the second and third quarters of this year, although they stood 1¾ per cent higher than a year earlier. Over the past year, volumes to the EU have been far weaker than those to non-EU markets, which appears consistent with the pattern of global GDP growth. In the third quarter, goods export volumes to the EU were at their lowest for four years. While export volumes to non-EU countries have been more erratic than usual, they have shown some signs of recovery: in the third quarter of 2003, they were 6½ per cent higher than a year earlier and up 15½ per cent compared with their recent trough in the final quarter of last year.

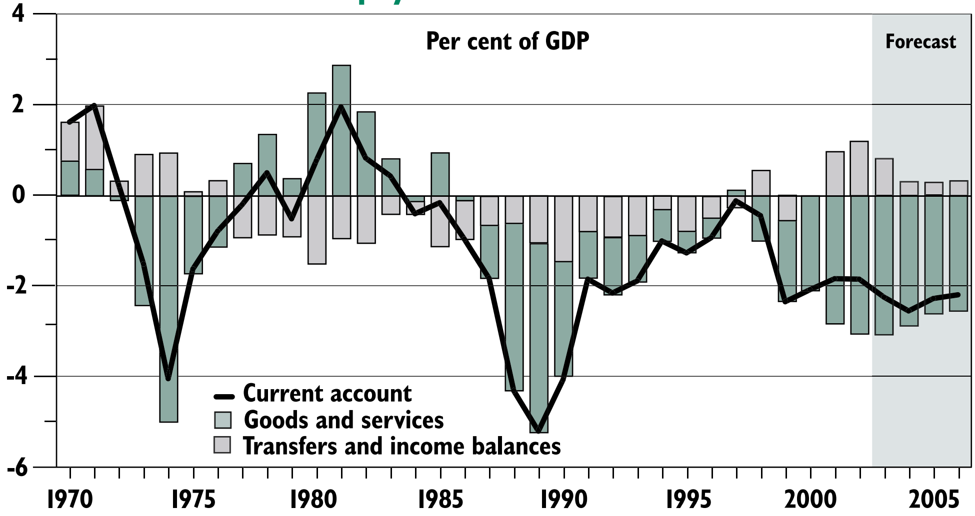
A86 Survey evidence has generally corroborated this picture of weak export demand over recent months, with the CBI July Regional Trends Survey showing the export orders balances in half the regions of the UK below their long-run averages. Scottish Executive data suggest Scottish manufactured exports continued to decline in the first quarter of the year, though at a slower rate than in previous quarters. High-technology electrical and instrumental engineering goods account for around 40 per cent of total Scottish manufactured exports. Scottish exports of these goods have declined by almost 60 per cent since the onset of the global slowdown in 2001.

A87 In recent years, services exports have generally proved more resilient than goods exports to the challenges of a weak global economy. Indeed, trade in services was in record surplus in 2002. However, uncertainties in early 2003 dented external demand for UK services. In particular, security concerns during the conflict in Iraq significantly discouraged overseas travellers to the UK, and visitor numbers from North America fell 14 per cent in the year to the second quarter of 2003. General economic uncertainty and volatility on financial markets also appear to have adversely affected demand for business and financial services earlier in the year. Despite some evidence of a pick-up in the value of service exports since the first quarter, they remain significantly down compared with the pattern of recent years. With the exception of the third quarter of 2001, when the events of September 11 had their most direct effect on overseas travel and payouts from UK-based insurance institutions, the surplus on services trade stood at its lowest for over seven years in the second quarter.

A88 The current account deficit over the first half of 2003 was broadly unchanged on a year earlier, although there was a sharp widening between the first and second quarters. A large surplus on investment income has continued partly to offset the trade deficit within the current account. In 2002, the UK had a record surplus on investment income of over £21 billion, while in the first six months of this year the income surplus was also up on a year earlier. A number of factors have maintained sizeable income surpluses over the recent past. Overseas investments by UK oil operators benefited from a period of relatively high world oil prices. The global downturn in financial services since 2000 has affected the UK's financial services industry, reducing profits earned by overseas banks and institutions with bases in the UK. While long-term structural factors should underpin income surpluses going forward, the forecast entails a moderation relative to recent years.

A89 Compared with last year, the UK trade deficit is expected to remain broadly flat in 2003 as a whole. The trade deficit is then expected to widen slightly over the forecast horizon, as UK import growth picks up around the same time as export growth, in response to strengthening business investment and brightening conditions in the manufacturing sector. Relative to GDP, the current account deficit is expected to remain modest compared to historical peaks, stabilising at around 2¼ per cent of GDP by the end of the forecast horizon.

Chart A8: Balance of payments current account



Independent forecasts

A90 Until recently, independent forecasters had generally been revising down their projections for UK GDP growth in 2003, but have lately upgraded their forecasts. The average of *new* growth forecasts in November was 2 per cent, consistent with the Pre-Budget Report estimate. The average of independent forecasts for 2004, at 2.6 per cent, remains below the Pre-Budget Report range, but is slightly higher than at the time of Budget 2003. Moreover, a number of prominent forecasters, including the European Commission and OECD, have recently revised up their projections for growth in 2004, with their forecasts now only a little below the Pre-Budget Report range. Indeed, almost two thirds of those included in the Treasury's Comparison of Independent Forecasts who have issued new projections since September have revised up their estimates of growth for 2004.

Table A8: Pre-Budget Report and independent[1] forecasts

Percentage changes on a year earlier unless otherwise stated

	2003			2004		
		Independent			Independent	
	Pre-Budget Report	Average	Range	Pre-Budget Report	Average	Range
Gross domestic product	2	1.9	1.6 to 2.2	3 to 3½	2.6	0.3 to 3.5
RPIX (Q4)	2¾	2.7	2.2 to 2.9	2½	2.4	1.7 to 3.3
Current account (£ billion)	–24¼	–22.2	–39.3 to –8.0	–29½	–23.5	–43.9 to –5.0

[1] *'Forecasts for the UK Economy: A Comparison of Independent Forecasts', November 2003.*

Forecast risks

A91 Downside risks to the forecast have diminished since Budget 2003. Nonetheless, if realised, the risks to the global forecast would clearly affect the UK's prospects. In particular, sharp movements in exchange rates or further balance sheet adjustment in certain key economies would threaten UK external demand and confidence. However, upside risks to the global outlook raise the possibility of a sharper upturn in UK economic growth going forward.

A92 In the UK, a sharp weakening of the housing market and a corresponding adjustment in prices would be likely to have an adverse effect on consumption expenditure. Similarly, an unexpectedly sharp retrenchment in household borrowing would also undermine growth in consumer spending. On the upside, momentum in consumer spending and house prices in the short term could continue to exceed expectations, though this would tend to increase the medium-term downside risks.

A93 At the present time, the improvement in UK business investment remains tentative, and investment could be subject to further unexpected weakness if business confidence is subjected to further shocks. Nonetheless, the business investment forecast carries upside risks. In past upturns, business investment has accelerated sharply and proved stronger than expected once GDP growth has picked up, and again the recovery in business investment could surprise in this direction over the forecast horizon.

Table A9: Summary of economic prospects[1, 2, 3]

	Percentage changes on a year earlier unless otherwise stated					
		Forecast[4]				Average errors from past forecasts[5]
	2002	2003	2004	2005	2006	
Output at chained volume measures						
Gross domestic product (GDP)	1¾	2	3 to 3½	3 to 3½	2½ to 3	¾
Manufacturing output	–3½	¼	1¾ to 2¼	1¾ to 2¼	1¾ to 2¼	1¾
Expenditure components of GDP at chained volume measures[6]						
Domestic demand	3	2½	3¼ to 3¾	2¾ to 3¼	2¾ to 3¼	¾
Household consumption[7]	3½	2½	2¼ to 2¾	2¼ to 2¾	2¼ to 2¾	1
General government consumption	2½	3¼	2½	2½	2½	1¼
Fixed investment	1¾	2¼	6 to 6½	5½ to 6	4 to 4¾	1½
Change in inventories[8]	–¼	0	¼	0	0 to ¼	¼
Exports of goods and services	–1	–1½	5¼ to 5¾	7 to 7½	6¼ to 6¾	2¼
Imports of goods and services	3¾	½	5¼ to 5¾	5¾ to 6¼	5¾ to 6¼	2
Balance of payments current account						
£ billion	–19	–24¼	–29½	–28	–28¼	7¼
per cent of GDP	–1¾	–2¼	–2½	–2¼	–2¼	¾
Inflation						
CPI (Q4)	1½	1½	1¾	2	2	–
RPIX (Q4)	2½	2¾	2½	2½	2¾	¼
Producer output prices (Q4)[9]	1	1½	2¼	2	2	1¼
GDP deflator at market prices	3¼	3	2½	2½	2¾	1
Money GDP at market prices						
£ billion	1044	1096	1158 to 1164	1222 to 1234	1287 to 1306	10
percentage change	5	5	5½ to 6	5½ to 6	5¼ to 5¾	¾

[1] *The forecast is consistent with the national accounts and balance of payments statistics to the second quarter of 2003, released by the Office for National Statistics on 30 September 2003, and output, income and expenditure data for the third quarter released on 26 November 2003.*

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

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

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

[5] *Average absolute errors for year-ahead projections made in autumn forecasts over the past ten years. The average errors for the current account are calculated as a per cent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2004.*

[6] *Further detail on the expenditure components of GDP is given in Table A10.*

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

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

[9] *Excluding excise duties.*

Table A10: Gross domestic product and its components

		£ billion chained volume measures at market prices, seasonally adjusted									
		Household consumption[1]	General government consumption	Fixed investment	Change in inventories	Domestic demand[2]	Exports of goods and services	Total final expenditure	*Less* imports of goods and services	*Plus* statistical discrepancy[3]	GDP at market prices
2002		669.0	185.2	170.0	1.5	1025.9	271.2	1297.1	310.2	1.5	988.3
2003		685.3	191.2	174.0	0.7	1051.4	267.3	1318.6	311.4	1.5	1008.7
2004		701.2 to 704.7	195.8	184.4 to 185.3	3.3 to 4.3	1084.7 to 1090.0	281.4 to 282.7	1366.0 to 1372.7	327.5 to 329.1	1.5	1040.1 to 1045.2
2005		717.9 to 724.9	200.5	194.3 to 196.3	2.0 to 4.0	1114.7 to 1125.6	300.9 to 303.8	1415.6 to 1429.5	346.1 to 349.5	1.5	1071.0 to 1081.5
2006		734.0 to 744.8	205.3	202.4 to 205.3	2.3 to 5.4	1144.0 to 1160.8	319.4 to 324.1	1463.3 to 1484.9	365.8 to 371.2	1.5	1099.1 to 1115.3
2002	1st half	331.4	92.7	83.8	0.7	508.7	136.4	645.1	154.4	0.7	491.3
	2nd half	337.6	92.5	86.2	0.8	517.2	134.8	652.0	155.8	0.8	497.1
2003	1st half	340.3 to 340.3	95.3	86.5 to 86.5	–0.5 to –0.5	521.8 to 521.8	133.7 to 133.7	655.5 to 655.5	155.6 to 155.6	0.8	500.7 to 500.7
	2nd half	344.8 to 345.2	95.9	87.5 to 87.6	1.2 to 1.3	529.4 to 529.9	133.5 to 133.6	662.9 to 663.6	155.8 to 155.9	0.8	507.9 to 508.4
2004	1st half	348.5 to 349.7	97.0	90.9 to 91.2	1.7 to 2.1	538.1 to 540.1	138.3 to 138.8	676.3 to 678.8	161.3 to 161.8	0.8	515.8 to 517.7
	2nd half	352.8 to 354.9	98.8	93.5 to 94.1	1.6 to 2.2	546.6 to 549.9	143.1 to 144.0	689.7 to 693.9	166.3 to 167.3	0.8	524.2 to 527.4
2005	1st half	357.0 to 360.0	99.2	96.0 to 96.8	1.4 to 2.3	553.6 to 558.4	148.2 to 149.5	701.8 to 707.8	170.7 to 172.1	0.8	531.9 to 536.4
	2nd half	360.9 to 364.9	101.3	98.3 to 99.4	0.6 to 1.8	561.1 to 567.3	152.7 to 154.4	713.8 to 721.7	175.5 to 177.4	0.8	539.1 to 545.0
2006	1st half	364.9 to 369.9	101.8	100.3 to 101.7	1.4 to 2.8	568.5 to 576.2	157.3 to 159.4	725.8 to 735.6	180.4 to 182.8	0.8	546.2 to 553.6
	2nd half	369.0 to 374.9	103.5	102.0 to 103.7	0.9 to 2.6	575.5 to 584.7	162.0 to 164.6	737.5 to 749.3	185.4 to 188.4	0.8	552.9 to 561.7
		Percentage changes on previous year[4,5]									
2002		3½	2½	1¾	–¼	3	–1	2	3¾	¼	1¾
2003		2½	3¼	2¼	0	2½	–1½	1¾	½	0	2
2004		2¼ to 2¾	2½	6 to 6½	¼	3¼ to 3¾	5¼ to 5¾	3½ to 4	5¼ to 5¾	0	3 to 3½
2005		2¼ to 2¾	2½	5½ to 6	0	2¾ to 3¼	7 to 7½	3¾ to 4¼	5¾ to 6¼	0	3 to 3½
2006		2¼ to 2¾	2½	4 to 4¾	0 to ¼	2¾ to 3¼	6¼ to 6¾	3¼ to 4	5¾ to 6¼	0	2½ to 3

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

[2] *Also includes acquisitions less disposals of valuables.*

[3] *Expenditure adjustment.*

[4] *For change in inventories and the statistical discrepancy, changes are expressed as a percent of GDP.*

[5] *Growth ranges for GDP components do not necessarily sum to the ½ percentage point ranges for GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.*