A THE ECONOMY

UK GDP has grown strongly over the past year. As many of the key uncertainties that had substantially dampened international activity receded during 2003, business and consumer confidence rose around the world and supported a solid resumption of output growth and world trade. Indeed, global growth in 2004 is robust, despite higher oil prices, which have been driven to record nominal highs largely by exceptionally strong demand growth. Against these positive international developments, UK GDP accelerated from mid-2003, and annual growth has now remained above trend for four consecutive quarters. There is also now significant evidence of a rebalancing in the composition of UK demand growth: latest data reveal private consumption has grown at more moderate rates over recent years than previously thought, while business investment has picked up strongly. However, despite historically high rates of world economic growth over the past year, a number of risks continue to surround the international outlook, some of which have become more prominent since Budget 2004.

With the economy still judged to be below trend, sound domestic fundamentals allied with a still buoyant outlook for world trade should allow a further period of growth at above trend rates over the short-term forecast horizon, without generating inflationary pressures. However, underlying growth has been easing gradually since late 2003 – when quarterly growth was at its fastest for almost four years – and this pattern is expected to persist through next year as the economy moves back towards trend. In the 2004 Pre-Budget Report forecast:

- **UK GDP is expected to grow by 3 to 3½ per cent in both 2004 and 2005, unchanged since the 2003 Budget forecast, as remaining slack in the economy is absorbed. This masks a continued easing in underlying growth during the course of 2005 before the output gap closes by early 2006.**
- **Consumer Prices Index (CPI) inflation is expected to rise gradually back to target by mid-2006, helped by monetary policy anchoring inflation expectations, and as upward pressure from import prices, accentuated by the recent depreciation of sterling, feeds through.**

Global developments remain a key influence on the UK outlook, and challenging judgements will continue to be faced in setting monetary and fiscal policy.

INTRODUCTION[1,2]

A1 This annex discusses recent economic developments and provides updated forecasts for the UK and world economies in the period to 2007. It begins with an overview of developments and prospects in the world economy. It then outlines the Government's latest assessment of the UK economy, followed by a more detailed discussion of sectoral issues and risks.

[1] The UK forecast is consistent with national accounts and balance of payments statistics to the second quarter of 2004 released by the Office for National Statistics on 29 September 2004, and output, income and expenditure data for the third quarter released on 26 November 2004. A detailed set of charts and tables relating to the economic forecast is available on the Treasury's internet site (http://www.hm-treasury.gov.uk) and copies can be obtained on request from the Treasury's Public Enquiry Unit (020 7270 4558).

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

THE WORLD ECONOMY

Overview

A2 The global economy has shown considerable strength over the past year, with growth rates comparable to those last seen 20 years ago. World growth during 2004 is estimated to be around 5 per cent – almost double the growth rate of 2001 when a number of the world's major economies suffered a slowdown. The strength of world growth is the result of much improved developments in both advanced and emerging economies. The US, Japan, China and wider Asia have all experienced strong growth, as have some other advanced economies where domestic demand has been strong. Growth in the euro area has improved and is now at around trend rates, although this is still low in comparison with other G7 economies.

Table A1: The world economy

	Percentage changes on a year earlier unless otherwise stated				
		Forecast			
	2003	2004	2005	2006	2007
Major 7 countries[1]					
Real GDP	2¼	3½	3	2¾	2¾
Consumer price inflation[2]	1½	3	2¼	1¾	1¾
Euro area					
Real GDP	½	2	2	2¼	2¼
World trade in goods and services	5	9½	8½	7¾	7¼
UK export markets[3]	3¾	8¾	8	7¼	6¾

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

[2] *Per cent, Q4.*

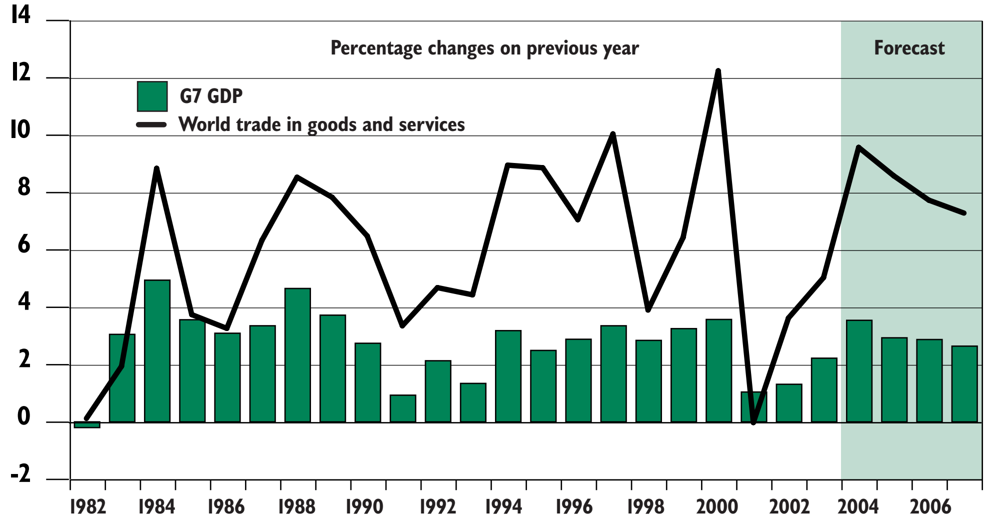
[3] *Other countries' imports of goods and services weighted according to their importance in UK exports.*

A3 The recovery in advanced and emerging economies has contributed to a marked pick-up in world trade, from very low growth in 2001, with stronger intra-regional trade in Asia and Europe also contributing to strong growth. Some key economies, particularly Germany, Japan and much of emerging Asia, have been dependent on net exports to support GDP growth. This has led to a continuation of global imbalances, and highlights one of the risks to sustainable and balanced global growth going forward.

A4 However, a number of risks and uncertainties continue to surround the global economic outlook. High oil prices, global imbalances, household and corporate balance sheet adjustment, the need for fiscal consolidation in a number of countries and the possibility that inflationary pressures could build, present downside risks. These factors can influence growth directly, for example by lowering profit margins and household disposable income, and can also have secondary effects through confidence channels with a potentially larger impact on growth. On the upside, oil prices could decline more rapidly than expected and orderly monetary and fiscal adjustment could boost confidence, which would tend to strengthen growth.

A5 High and rising oil prices reflect the combined effects of a number of supply uncertainties, low stocks and rapidly rising demand. Whilst higher oil prices appear to have had some dampening effect on economic activity since the middle of 2004, the strength of world demand that has contributed to pushing up prices has remained robust.

Chart A1: G7 GDP and world trade



A6 The strength of global growth, particularly in China, has also increased demand for raw materials, especially metals, pushing up primary commodity prices. This, together with high and rising oil prices, has fed through to a pick-up in headline inflation rates. However, due to relatively weak labour markets and continued spare capacity in many key economies, core inflation has been subdued to date.

A7 The improvement in global growth since 2003, and inflationary pressures stemming from higher commodity prices, have prompted a degree of monetary policy adjustment. This follows a prolonged period of historically low nominal and real interest rates. The shift in monetary policy will also have a positive impact in anchoring inflationary expectations before they begin to build. With monetary policy in most major economies focused on keeping inflation low and stable, the risks of any feed-through in the future remain low.

G7 activity

A8 Following a pick-up in G7 growth in 2003, economic activity has continued to strengthen in 2004, with a particularly marked acceleration in the early part of the year. This marks a significant improvement in global economic conditions compared with 2001 and 2002. G7 GDP growth is expected to be around $3^1/_2$ per cent in 2004 as a whole. In 2005, G7 growth is expected to settle back to around 3 per cent.

United States **A9** GDP growth in the US has been supported by strong private consumption as a result of monetary and fiscal stimulus during 2003 and early 2004, as well as solid house price growth and rising equity valuations which have boosted household wealth. Strong productivity growth has also contributed to robust GDP growth in the US, with GDP growing at 3 per cent in 2003. This has generated increased demand for imports, which has supported growth in a number of G7 and emerging economies.

A10 During mid-2004, private consumption growth moderated as high oil prices, rising interest rates, the expiry of temporary tax cuts and a weaker labour market all served to curb household spending. However, data released during the autumn show a recovery in private consumption and business investment growth. With levels of corporate profitability at historic highs, business investment growth should gain further strength in late 2004 and into 2005. US growth is recovering from the lull in mid-2004, and is expected to maintain a solid pace during 2005.

Euro area **A11** In the euro area, growth rebounded in the first half of 2004, and is expected to continue to grow at trend rates of about 2 per cent in 2004 and 2005. However, this is still low compared with other G7 and advanced economies. The recovery has been driven largely by a strong contribution from export growth, while domestic demand has made a much more limited contribution. However, this masks considerable variation across the member states. While Italy has experienced relatively modest growth, France and Spain have benefited from comparatively buoyant private consumption. In Germany, external demand has provided the main impetus to growth, while investment and consumption have been relatively weak. Looking forward, external demand should continue to support activity in the euro area, and a more widespread revival in investment and consumption should materialise over the next few years.

Japan **A12** After almost a decade of very weak growth, the Japanese economy appears to have picked up markedly in late 2003 and into 2004, although statistical uncertainties complicate the assessment. This turnaround has stemmed from demand for Japan's exports from Asia, particularly China, and the US, on top of a number of years of gradual reform and balance sheet adjustment. The sources of growth within the Japanese economy have started to broaden out, particularly towards private consumption, pointing to an improvement in the sustainability of growth over the medium term. In addition, after several years of deflation, the prospects for a return to inflation, albeit mild, are now more secure.

Emerging markets and developing economies

A13 Higher growth in the world's major economies has provided further support to activity in emerging market economies during 2004. In particular, Asian and Latin American economies have continued to benefit from buoyant US consumption, which has driven growth in demand for their exports. Trade between emerging markets has also become an increasingly important source of growth for these economies. In a number of countries, such as China and Brazil, these developments have helped to generate a pick-up in domestic demand and a general broadening of growth.

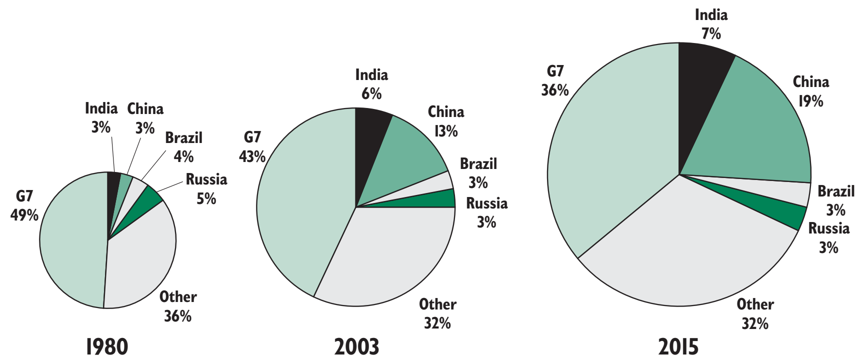
A14 Strong activity in emerging Asia has been largely underpinned by China, which has an increasingly significant role in shaping regional and global economic trends. Asia's prospects rely, in part, on the Chinese authorities' ability to moderate the current pace of growth to a more sustainable rate. Strong growth in India has been driven by expansion in the manufacturing and service sectors. Solid growth in Latin America has been aided by higher commodity prices, while the Middle East and Former Soviet Union countries have experienced strong growth on the back of higher than expected oil prices. Growth in Eastern Europe has also picked up, but has been somewhat constrained by lacklustre growth in Western Europe. Some African countries have experienced growth in 2004, but the picture is mixed. Concerted international action is required to ensure that all African countries can benefit from the global recovery and can participate fully in the world economy.

A15 The external financing environment for emerging markets remains generally supportive. During the second quarter of 2004 uncertainties relating to the onset and pace of monetary tightening in the US briefly caused emerging market bond spreads to widen but, as fears of a sharp rise in US interest rates receded, spreads returned to historically low levels. In addition, real interest rates have been relatively low. Financing conditions are likely to become more restrictive in the medium term as US interest rates continue to return to more neutral levels. However, emerging market debt now appears to be better structured and therefore more resilient to tightening global financial markets. Furthermore, a gradual and transparent withdrawal of monetary stimulus in the US should ensure a smooth transition towards higher interest rates and continued growth in emerging markets.

Box A1: Globalisation and emerging markets

***Long-term global economic challenges and opportunities for the UK*, published alongside the Pre-Budget Report, examines the changing nature of the global economy over the next decade. One of the key trends that it identifies is the rapid development of major emerging markets, particularly China and India.**

Evolving Shares of Global Output (PPP)



Source: IMF, Consensus Forecasts, HM Treasury.

Already, rapid growth in major emerging markets is driving a fundamental restructuring of the global economy. In 2004, world growth is forecast to be around 5 per cent, the strongest in around 20 years. Growth in emerging and developing countries is projected to be around 6½ per cent, compared to lower growth in advanced economies of around 3½ per cent. Emerging market growth is being driven by the re-emergence of China and India – together home to around a third of the world's population – as global economic powers. China and India are the second and fourth largest economies in the world respectively when measured on a purchasing power parity basis, and their shares of world GDP dwarf those of many of the smaller OECD countries when measured on the same basis. On such a basis, China alone contributed more to global GDP growth over 2001 to 2003 than the whole of the G7 combined.

Rapid development in China and India is due in part to market-based economic reforms. With liberalisation and the spread of markets, increasing numbers of Chinese and Indian workers are shifting into the more productive, traded economy – with the result that the world's production frontier has shifted outwards. Both countries now attract significant levels of foreign direct investment (FDI) – China has recently overtaken the US to become the world's largest FDI recipient. Moreover, rising skills and education levels are allowing these countries to compete increasingly in higher-skill sectors. Rapid growth has brought about significant poverty alleviation. On World Bank projections, the number of people living on less than one dollar per day in China and South Asia is expected to halve between 2000 and 2015.

Rapid growth in China and India is also having a profound impact on world commodity and manufactures markets. China is the world's largest user of steel, copper and iron ore and is contributing around a third of world oil demand growth. It is also the world's largest market for mobile phones. Together, China and India now account for 6½ per cent of world exports.

These developments have significant ramifications for the global economy. They create long-term challenges and opportunities for the UK economy. The Government's strategy for meeting them is summarised in Chapter 1, and described throughout this Pre-Budget Report.

World trade

A16 Growth in world trade picked up significantly in the second half of 2003 and during 2004, on the back of strong demand, particularly from the US, alongside robust growth in industrial production. In addition, stronger trade growth from emerging markets, particularly Asia, as well as improved export growth from the euro area and Japan, have boosted rates of trade growth. World trade has now grown from just above zero in 2001, the lowest in 20 years, to 5 per cent in 2003, and is expected to be around 9½ per cent in 2004. Increasing regional integration of production processes, reflecting the differing cost advantages of countries for different stages of the production process, together with rising consumption, have also contributed to greater intra-regional trade in Asia and wider Europe. Specifically, increasing comparative advantage in producing cheaper manufactures means that Asia is now a significant driver of world trade growth, underpinned by strong growth of final demand in North America and some European countries.

A17 Along with stronger world trade, UK export market growth has picked up in 2004 and is expected to be reasonably robust across the forecast horizon, albeit showing some moderation as world GDP and trade growth move towards trend rates. The improvement in UK export market growth reflects an improvement in growth since 2003 in the euro area, which is by far the UK's biggest export market, as well as demand growth in some other smaller economic regions that are important for UK exports, including Africa, Australasia, and the Middle East.

Oil and commodity prices

A18 Oil and non-fuel primary commodity markets have tightened over the past year, resulting in significant price growth. Rising demand for oil as the global economy has gathered pace, alongside disruptions and risks to supply, low stock levels, and low spare capacity have all contributed to tight supply and demand conditions and triggered upward pressure on prices, as discussed in Box A2. Price rises in non-fuel primary commodities, particularly materials and construction inputs, have principally been driven by strong demand from China and Asia resulting from their rapidly expanding industrial base.

A19 Brent oil prices started the year at around US$30 a barrel, but have since risen significantly, with peaks in October. Aside from supply uncertainties and disruptions, and low stocks which have continued since 2003, strong demand growth, disruption to production in the Gulf of Mexico and depleted spare capacity, have all added upward pressure to prices during 2004.

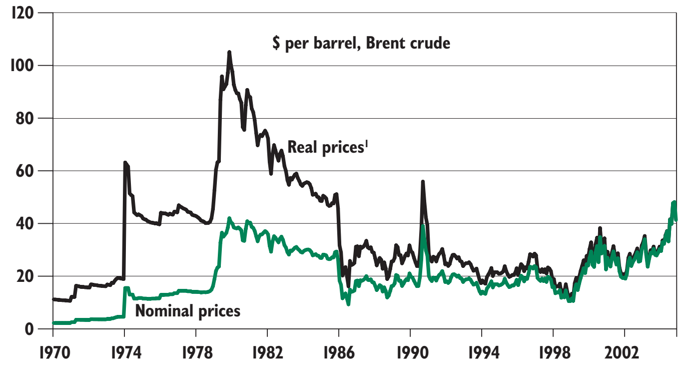
A20 With demand growth from Asia now representing a significant addition to more established demand from the major industrialised countries, and with the margin of spare supply capacity dwindling over the past couple of years, the oil market may be more volatile in the future than in recent years, as well as average prices being higher. While fundamentals suggest there is scope for some moderation in prices next year, the balance of risks to oil prices remains on the upside, with some associated risk to the outlook for global growth and inflation.

Box A2: Oil prices

Oil prices have risen significantly since the start of the year, reaching record nominal levels in October of over $50 per barrel for Brent, but have since fallen back somewhat. However, the situation is different to previous periods of high oil prices. Very strong global oil demand growth has been the principal driving force behind higher prices which, in real terms, are still well below the peak levels of the late 1970s and early 1980s.

With strong demand absorbing oil supplies, spare global oil production capacity and stocks are at low levels. The tight market has magnified market concerns over the continuity of supply from a number of key producers: Iraq (sabotage); Venezuela (political unrest); Saudi Arabia (terrorism); Russia (the financial position of Yukos); and Nigeria (strikes and social unrest). The economic effects of higher oil prices depend on the extent to which the increases derive from demand-side or supply-side factors:

Oil prices



[1] Nominal Brent crude 1 month futures prices deflated by US Consumer Price Index, at 2004 prices.

- if oil price rises result from increased global demand for goods and services which in turn use oil as an input, then higher oil prices will be associated with a net increase in global GDP. While production costs will also rise, this will tend to choke off only some of the extra non-oil output, and oil production itself is also likely to rise; and
- if oil prices rise in response to a decrease in oil supply, the impact on global GDP is unambiguously negative, as higher production costs for non-oil goods and services constrain their supply.

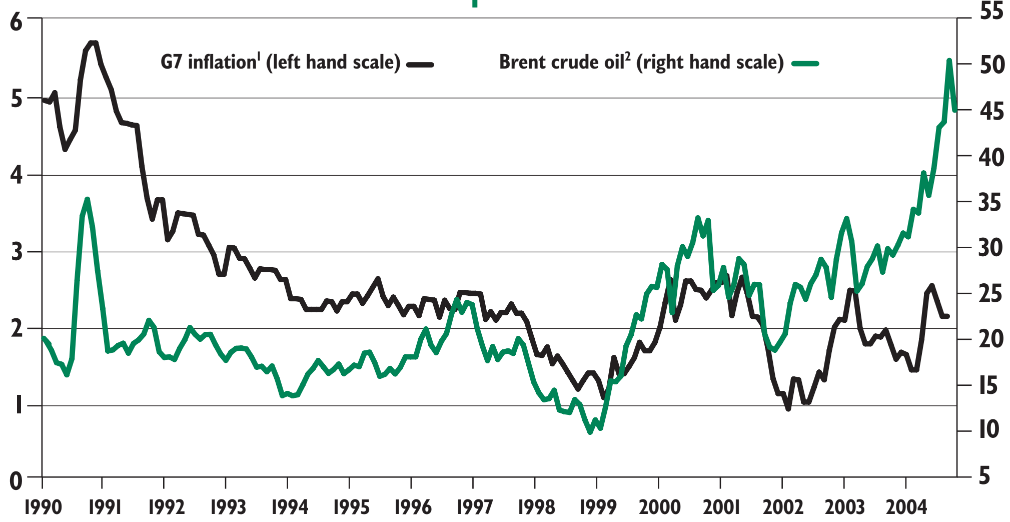
The impact of high oil prices on the global economy has so far been limited as strong world growth, particularly in Asia, has been a key driver of the rise in oil demand and therefore prices. Other factors have also helped: the oil intensity of world production has been decreasing since the 1970s; the real price of oil is still relatively low; and spare capacity coupled with weak labour markets in many advanced economies have so far offset the inflationary impact of the rise in oil prices. However, emerging economies have been more affected by oil price rises due to their higher energy intensity and lower energy efficiency.

Next year oil supply should continue to rise as producers respond to higher prices by expanding production capacity, while oil demand growth should moderate in the face of high prices. As a result, the market and most analysts expect oil prices to fall back, but only modestly and not to previous levels. However, the full impact of oil price rises is not yet clear, nor the extent to which business and consumer confidence may have been undermined. Sustained high oil prices therefore remain one of the primary risks to global growth and inflation in 2005.

G7 inflation

A21 During late 2003 and early 2004, the balance of concerns on inflation shifted from downside risks and the potential for deflation, to risks around mounting inflationary pressures. As the global economy has strengthened and commodity prices have increased, inflationary pressures have picked up, as reflected in the rise in headline inflation. However, core inflation has remained subdued and is still at historically low levels. This reflects weak labour markets in the US, Japan and the euro area containing wage pressures, and spare capacity in the G7 economies preventing price increases from being passed onto consumers. Deflation persists in Japan, though corporate price indices have started to pick up reflecting higher input prices. As a result of strong growth and signs that inflationary pressures have been building, some monetary authorities have already moved to contain inflationary expectations by raising interest rates. It therefore seems unlikely that inflation in the G7 economies will take hold.

Chart A2: G7 inflation and oil prices



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

Forecast issues and risks

A22 A number of risks continue to surround the international outlook, some of which have become more prominent since Budget 2004. Most of the risks have both upside and downside potential. Near-term uncertainties include oil prices, which could be higher or lower then assumed, the possibility of a slightly quicker pace of monetary adjustment if inflationary pressures start to build more quickly, and sharp exchange rate fluctuations in response to US fiscal and current account deficits. Over the medium term, correction of global imbalances through exchange rate adjustment and growth realignment poses a risk to global growth, as does the need for fiscal consolidation and corporate and household balance sheet adjustment. However, resolving these problems through pro-active policy reform will make growth prospects more secure and sustainable.

A23 There are also a number of more region-specific risks to growth. For example, in the US, market reactions to the US fiscal and current account deficits could lead to sharper exchange rate adjustments. However, business investment growth could be stronger than projected given high levels of profitability. In the euro area, a continuation of narrowly based growth and relatively low trend growth rates could limit its contribution to G7 growth, but structural reform could lead to better utilasation of resources and therefore stronger trend growth. Japan's export led recovery and associated business investment growth could come under strain if China's path to more sustainable growth rates is more sudden than currently expected. However, with private consumption growth strenghtening and therefore growth broadening out, prospects for the sustainability of Japan's growth could improve faster.

A24 Global financial conditions are generally favourable, which is an important factor in supporting emerging market growth and progress on economic reform, but this could be unsettled, and bond spreads could rise, if monetary adjustment in the G7 has to move at a quicker pace or if exchange rate adjustments become more pronounced in response to current account imbalances, undermining emerging market growth.

UK ECONOMY

Overview of recent developments

A25 UK GDP growth so far in 2004 has been consistent with the Treasury forecast range of 3 to 3½ per cent for the year as a whole. This range was first published as the two-year ahead forecast in the 2002 Pre-Budget Report, and has since remained unchanged. The independent consensus has progressively come into line with it over the past year or so, having previously been significantly lower.

A26 During the global economic downturn that began in 2000, the Government's macroeconomic framework allowed the UK economy to remain resilient against the challenges and uncertainties arising from prolonged international weakness. In contrast to previous world slowdowns, low inflation and sound public finances allowed UK macroeconomic policy to respond swiftly to support output in the face of the significant weakening in global growth. The UK was the only G7 economy to avoid any quarters of negative growth between 2001 and 2003. The UK continues to experience its longest unbroken expansion since the introduction of quarterly national accounts data 50 years ago, with GDP now having grown for 49 consecutive quarters.

A27 UK GDP growth began to pick up sharply during the second quarter of 2003, as some of the previous major international uncertainties diminished and recovery in the world economy became more firmly entrenched. Business and consumer confidence rose from their early 2003 lows and, with UK domestic macroeconomic fundamentals remaining sound, rising confidence quickly translated into a pick-up in domestic demand growth in the second half of last year. Final domestic demand grew at its strongest rate for five years in the first quarter of 2004, at 1.2 per cent on the quarter, but has since moderated a little.

A28 As the world economy and UK domestic demand have strengthened, the independent Monetary Policy Committee (MPC) of the Bank of England has raised repo rates on five occasions since November 2003, with a cumulative increase of 1¼ percentage points, consistent with its forward-looking and pre-emptive approach to lock in stability and low inflation at the target rate of 2 per cent for the CPI.

A29 Nonetheless, repo rates remain low by the standards of the past 50 years, currently standing at 4¾ per cent, and CPI inflation has been lower than expected and has remained below target, at around 1¼ per cent in recent months, despite rising oil prices. The credibility earned by the MPC has tended to anchor inflation expectations and reduce uncertainty about real interest rates and aggregate demand prospects in response to external shocks. This may at least partly account for an improvement in the short-term output-inflation trade-off through encouraging faster price adjustment in the face of tendencies for the economy to move away from trend, which may be an important factor in accounting for greater macroeconomic stability. Fiscal policy has supported monetary policy in helping to deliver economic stability, through the automatic stabilisers and an easing of the fiscal stance when the economy moved below trend and, subsequently as the economy returns to trend, by the overall impact of fiscal policy moving back towards a more neutral position.

A30 The labour market has remained robust in 2004, building further on the achievements of the Government's supply-side reforms in creating a more dynamic and flexible labour market. In the year to the third quarter, employment rose by just over 230,000. Although the employment rate has come down fractionally from its recent peak earlier in 2004, this reflects the population of working age rising a little faster than employment. Unemployment, measured on the International Labour Organisation (ILO) definition, declined by just under 110,000 in the year to the third quarter, with the rate falling to 4.6 per cent – the lowest among the G7 economies. Claimant unemployment has also continued to trend down, albeit a little more slowly than ILO unemployment, and stood at 2.7 per cent in October, 0.3 percentage points lower than a year earlier. Claimant unemployment has now been consistently below 1 million for over three and a half years. Over the past year, employment levels have risen in most regions and countries of the UK, with the West Midlands and the North East seeing the sharpest rise in their employment rates.

A31 In 2003 as a whole UK GDP rose 2.2 per cent, somewhat below its estimated trend rate. However, annual growth had already moved above trend by the final quarter of 2003, for the first time in three years, and it continued at above trend rates through the first half of 2004. GDP growth of 0.9 per cent in the third quarter of 2003 was followed by 1.0 per cent in the final quarter, 0.7 per cent in the first quarter of 2004 and 0.9 per cent in the second.

A32 Latest data suggest that growth in the economy eased in the third quarter of 2004 compared with the first half of the year, with GDP currently estimated to have risen by 0.4 per cent between the second and third quarters, though non-oil Gross Value Added (GVA) was up 0.5 per cent. The GDP reading appears to have been erratically low, with underlying growth considerably stronger. It was largely attributable to a decline in the manufacturing output index, which rose strongly in the second quarter before losing some ground in the third. However, oil and gas production was also unusually weak in the third quarter. Operators appear to have postponed routine maintenance work earlier in the year in order to capitalise on high oil prices, but were unable to delay this any further. Overall, weaker industrial production is estimated to have subtracted 0.3 percentage points from GDP growth in the third quarter.

A33 Manufacturing output has, however, risen modestly over the past year and, in the year to the third quarter, output remained 0.5 per cent up on a year earlier. The service sector has seen particularly strong expansion of late, with growth in the year to the second and third quarters of 2004 at its fastest for about four years. Growth within services has been broadly based, but particularly sharp in real estate, renting and business activities and financial intermediation. Royal Bank of Scotland Purchasing Managers' Indices (PMIs) have reported a continued expansion in output throughout all regions and devolved countries of the UK in recent months, despite some widespread easing compared with peaks around the turn of the year. Over the past year, London, the South East, South West and Northern Ireland have registered the strongest growth, according to PMIs.

A34 The rise in oil prices this year has gone hand-in-hand with strong global GDP growth, as discussed in Box A2. The recent oil price rise has still served as a negative supply shock for UK producers of non-oil goods and services. However, these same producers are also sharing in the stronger global demand for non-oil goods and services that has been driving up oil prices, boosting demand for UK exports. Moreover, the UK economy, by virtue of being an oil producer - indeed still a small net exporter of oil - also benefits from higher value added in the oil-producing sector. The net short-term impact on UK GDP of the negative supply and positive global demand effects associated with recent oil price movements is judged to be broadly neutral, though the impact on inflationary pressure is unambiguously positive. The UK is certainly less exposed to the risk of negative impacts on GDP and employment than most other major industrialised countries, and the global impact itself has so far been relatively limited for the reasons discussed in Box A2. The impact of oil prices on the UK public finances is discussed in Chapter 2.

A35 Despite strong growth of GDP, and nominal oil prices rising to record highs, wage pressures have remained subdued and CPI inflation has continued to undershoot its symmetrical 2 per cent target. CPI inflation stood at 1.2 per cent in October, and has averaged 1.3 per cent over the past 12 months.

Trend growth and the output gap

Table A2: Contributions to trend output growth[1]

	Estimated trend rates of growth, per cent per annum					
	Trend output per hour worked[2, 3]					
	Underlying	Actual	Trend average hours worked[3]	Trend employment rate[3]	Population of working age[4]	**Trend output**
	(1)	(2)	(3)	(4)	(5)	(6)
1986Q2 to 1997H1	2.22	2.04	–0.11	0.36	0.24	**2.55**
Over the recent past						
1997H1 to 2001Q3						
Budget 2002	2.14	1.96	–0.37	0.36	0.66	**2.63**
Budget 2003	2.35	2.14	–0.47	0.43	0.50	**2.61**
PBR 2003 and Budget 2004	2.65	2.44	–0.47	0.42	0.54	**2.94**
PBR 2004	2.70	2.50	–0.43	0.41	0.58	**3.06**
Projection[5]						
2001Q4 to 2006Q4						
Budget 2002	2.10	2.00	–0.1	0.2	0.6	**$2\frac{3}{4}$**
Budget 2003/PBR 2003/Budget 2004	2.35	2.25	–0.1	0.2	0.5	**$2\frac{3}{4}$**
PBR 2004[6]	2.35	2.25	–0.1	0.2	0.5	**$2\frac{3}{4}$**
2007Q1 onwards						
PBR 2004[6]	2.35	2.25	–0.1	0.2	0.3	**$2\frac{1}{2}$**

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

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

[3] The decomposition makes allowance for employment and hours worked lagging output. Employment is assumed to lag output by around three quarters, so that on-trend points for employment come three quarters after on-trend points for output, an assumption which can be supported by econometric evidence. Hours are easier to adjust than employment, and the decomposition assumes that hours lag output by just one quarter, though this lag is hard to support by econometric evidence, 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 trend assumptions around which the mid-points of the GDP forecast growth ranges from 2004Q4 are anchored.

A36 The Treasury's neutral estimate of the economy's trend rate of output growth for the 2004 Pre-Budget Report is $2^3/_4$ per cent a year to the end of 2006 and $2^1/_2$ per cent from early 2007 onwards, unchanged from Budget 2004 and first introduced in Budget 2002.[3] Between the end of 2006 and 2010, projections by the Government Actuary's Department (GAD) show that demographic effects are expected to depress growth in the working-age population, and hence trend output growth, by $^1/_4$ percentage point, reflecting post-War baby-boom women reaching retirement age. The Treasury reassesses its estimates of trend growth around the time each cycle is judged to have ended.

A37 Table A2 presents historical estimates of trend output growth and its decomposition between the estimated on-trend points in 1997 and 2001, and for the preceding cycle, as well as the forward-looking assumptions for trend growth built up from projections of components for the current cycle and beyond.

Box A3: Assessing the output gap

Output gap estimates are subject to a range of unavoidable uncertainties, particularly for the most recent past. Treasury estimates for the current cycle involve assessment of both the latest on-trend point and the subsequent trend rate of output growth, as well as depending on the accuracy of recent national accounts data. Other methods of output gap estimation are at least equally prone to uncertainty, as discussed in the Budget 2002 Trend Growth paper.[a] Reflecting the challenging nature of the assessments involved, there is a growing body of literature that looks at the range of errors around real-time output gap estimates.[b] It is difficult to be sure whether movements in economic variables are due to cyclical, short-term factors or more permanent, structural factors.

As one illustration, it is possible that more of the recent fall in average hours worked could be structural rather than cyclical, implying a less negative output gap than currently estimated. Uncertainties also apply in the opposite direction, despite the Treasury's estimate of the current output gap being more negative than estimates by most outside analysts. For example, the lack of inflationary pressure from average earnings growth suggests that the NAIRU may have fallen significantly more than assumed, and could be below the current unemployment rate of 4.6 per cent. This points to countenancing that the sustainable employment rate over the current cycle may exceed the projection, assisted by the Government's policies to improve employment opportunity and work incentives, in which case the actual employment rate would be further below trend than estimated, indicating a more negative output gap.

The present forecast, implying the current cycle comes to an end in early 2006, depends for its reliability on the inter-related assessments of the current output gap and output growth prospects. As some outside forecasters expect, in the event that the current output gap were to prove less negative than now estimated, and this was solely accounted for by over-estimation of the current trend rate of growth, then the existing short-term growth forecast would imply the current cycle ending earlier than 2006.

[a] *Trend Growth: Recent Developments and Prospects,* HM Treasury, April 2002.

[b] For example, *Should we be surprised by unreliability of real-time output gap estimates? Density estimates for the Eurozone,* National Institute of Economic and Social Research, 2003; *Estimates of the output gap in real time: how well have we been doing?* Reserve Bank of New Zealand, 2004; and *Output gaps in real time: are they reliable enough to use for monetary policy?* Reserve Bank of Australia, 2002.

[3] *Trend Growth: Recent Developments and Prospects,* HM Treasury, April 2002.

A38 In arriving at the judgement to retain the 2$^3/_4$ per cent trend growth assumption for the current cycle, the following developments since Budget 2004 have been assessed as not having a material impact on the trend rate of growth and so not warranting any changes:

- Updated population projections: GAD released their 2003-based population projections in September 2004. The updated projections do not imply any need to revise the previously assumed $^1/_2$ percentage point contribution of working-age population growth to trend output growth. The implicit net migration assumption makes slightly over $^1/_4$ percentage point contribution to trend output growth.

- GDP revisions: National accounts revisions introduced in Blue Book 2004 were relatively modest compared with last year's data changes.[4] Blue Book 2004 revised up GDP growth between 1999 and 2002 by 0.1 to 0.2 percentage points a year. There were small revisions to components of GDP, with government consumption being the most notable exception, partly reflecting improvements introduced in tandem with the Atkinson Review. These revisions slightly increased estimated productivity growth between the on-trend points in 1997 and 2001.

A39 The 2$^3/_4$ per cent trend growth assumption continues to reflect a cautious approach to the assessment of trend productivity growth rather than mechanistically projecting forward the full extent of estimated trend productivity growth from the 1997 to 2001 period, which would imply trend growth 0.3 percentage points higher than assumed.

A40 In light of recent output data, the trend growth assumption implies a negative output gap in the third quarter of 2004 at around 1 per cent of non-oil GVA, consistent with the Budget 2004 projection. Estimates of quarterly non-oil GVA growth in the second half of 2003 have been revised up since Budget time, tending to narrow the estimated output gap, but this effect has been offset by the current estimate of non-oil growth in the third quarter of 2004, at 0.5 per cent, being lower than the Budget forecast. Consistent with the decomposition of trend output growth, the output gap can be broken down into components by comparing productivity (output per hour), average hours worked and the employment rate against their assumed trend levels that make up the overall trend output projection:

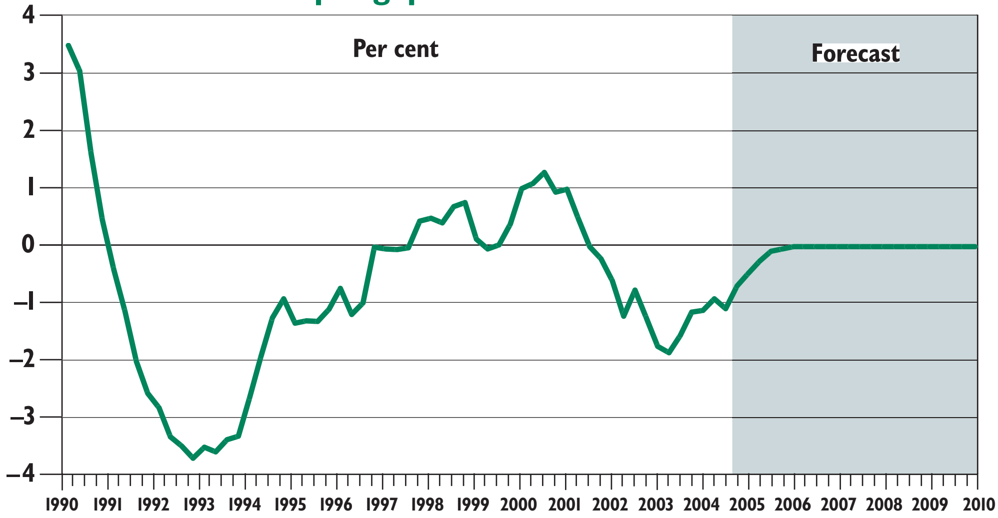
- between the third quarters of 2001 and 2003, the relevant measure of productivity grew below its assumed trend rate, averaging 2 per cent a year. However, with output accelerating and hours worked remaining relatively weak, output per hour has been growing well above its assumed trend rate since the end of 2003, and is now around its assumed trend level;

- average hours worked remain below their projected trend levels, implying a significant contribution to the negative output gap. The accelerated decline in average hours worked over the two years or so to early 2003 is judged largely to have been in response to global economic weakness, in the absence of convincing evidence to suggest it was structural. Average hours tend to move with the economic cycle as employers may prefer to adjust hours rather than employment when it is uncertain whether shocks to the economy are permanent or temporary. Over the past year or so average hours worked have continued to fall, but at a slower rate, and are judged to remain cyclically low;

[4] In September 2003, the Office for National Statistics introduced extensive new survey information and methodological improvements, including annual chain linking.

- the employment rate has grown at a little less than its assumed trend since the second half of 2003, and now makes an implied small negative contribution to the output gap. Growth in the employment rate can be divided between changes in the unemployment rate and changes in labour force participation. The unemployment rate has been below the assumed rate consistent with stable inflation (the NAIRU), implying a positive contribution to the output gap. However, participation has also been below assumed trend levels, entailing a negative contribution to the output gap, and the size of this effect has outweighed the unemployment rate effect.

Chart A3: The output gap[1]



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

A41 Thus the arithmetic of the assumed trend growth decomposition set out in table A2 attributes the estimated present negative output gap of around 1 per cent mainly to cyclical weakness in average hours worked, together with a small contribution from the employment rate.

A42 Other economic indicators also provide information on the output gap, including private sector business survey measures of capacity utilisation and recruitment difficulties:

- business survey indicators of capacity utilisation can be expected to be informative about the utilisation rates of both capital and labour that tend to drive fluctuations in output per worker around trend, and so mainly bear on the output per hour and average hours components of the output gap rather than the employment rate component. Surveys by the Confederation of British Industry (CBI) and British Chambers of Commerce (BCC) give mixed signals about the output gap, with capacity utilisation in manufacturing rising until the most recent quarter, and more volatile readings for the services sector;

- indicators of recruitment difficulties are more likely to provide information on the degree of slack in the labour market, and hence the employment rate component of the output gap. Survey indicators for both the manufacturing and service sectors have been fluctuating, but are now mainly just below levels seen on latest occasions when the output gap has been judged to be zero.

A43 Nevertheless, despite ambiguous signals from utilisation and to some extent recruitment indicators, wage and price data show little evidence of unsustainable inflationary pressures emerging. Although underlying average earnings growth, as measured by the rate excluding bonuses, appears higher than during the second half of 2003, it has been stable for the past six months. At around 4¼ per cent, it has remained significantly below the rate judged consistent with trend productivity growth and the inflation target in the medium term, despite the unemployment rate coming down to 4.6 per cent in the third quarter. In addition, CPI inflation recently has been well below the Bank of England's 2 per cent target, at around just 1¼ per cent over the past few months. The lack of apparent inflationary pressure in the economy lends strong support to the current assessment of a negative output gap.

A44 However, there are inevitable uncertainties that surround output gap estimates, as discussed in Box A3. The estimated output gap at the present time, together with the inter-linked judgements on trend and forecast rates of output growth, imply that the current cycle will come to an end in early 2006. However, were the present output gap less negative than estimated, then this would tend to point to the current cycle ending sooner.

A45 Another issue relevant to estimation of the current output gap relates to the method of trend projection for the current cycle. The cautious practice of not mechanistically projecting forward Blue Book upward revisions to trend productivity growth between 1997 and 2001 into the current trend output growth assumption provides an insurance against any factors that might tend to depress trend productivity in the current cycle relative to the 1997 to 2001 period. One such factor is the influence of compositional changes in the economy between higher and lower productivity sectors, and in particular between private and government sectors.[5] One possible implication is that at some point it may be desirable to refine the methodology for projecting trend growth and estimating the output gap.

A46 Notwithstanding these considerations, the balance of evidence on the components of the output gap and the evaluation of business surveys and indicators of inflationary pressure is judged to support the Pre-Budget Report retaining the 2¾ per cent neutral assumption for current trend output growth first adopted in Budget 2002. This is consistent with the assessment that the economy remains materially below trend. However, the public finance projections continue to be based on a deliberately cautious annual trend growth assumption that is ¼ percentage point lower than the neutral view.

Summary of prospects

A47 Sound macroeconomic fundamentals, recent underlying growth at above trend rates, and continued strong growth in the world economy point to a further period of robust growth in demand for UK output. Forward-looking private sector business survey indicators have already shown signs of stronger growth following a softer third quarter. For example, consumer confidence rose in both October and November and is currently above its long-run average and up on a year ealier, while the CIPS Reports on manufacturing and services point to a re-acceleration in demand in both sectors. Moreover, on the supply side, evidence of remaining slack in the economy supports the judgement that the economy has the potential for a period of further above trend growth in the short term, without risking inflationary pressures. UK GDP is expected to grow by 3¼ per cent in 2004, up from 2.2 per cent last year and 1.8 per cent in 2002, and unchanged since the Pre-Budget Report 2002 forecast.

[5] See Paragraph 3.11 of *Trend Growth: Recent Developments and Prospects*, HM Treasury, April 2002.

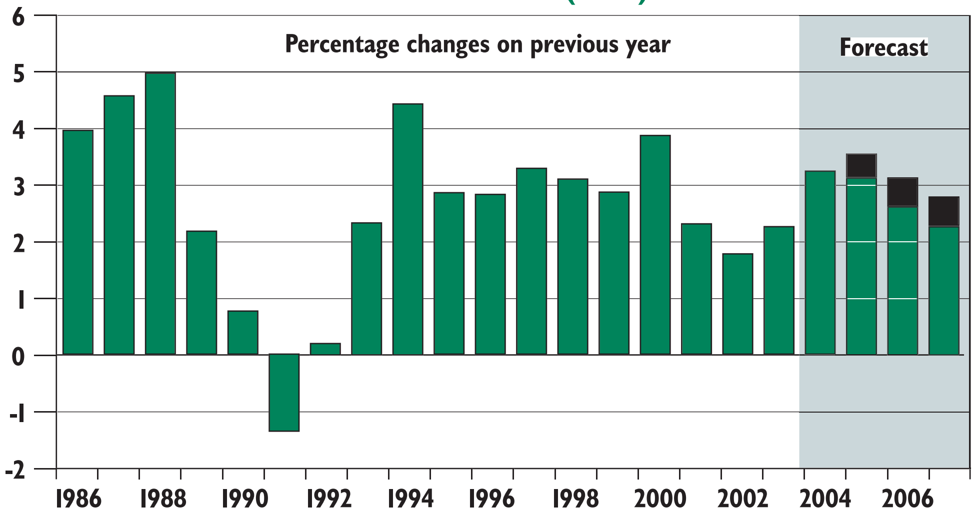
Table A3: Summary of forecast[1]

		Forecast			
	2003	2004	2005	2006	2007
GDP growth (per cent)	2¼	3¼	3 to 3½	2½ to 3	2¼ to 2¾
CPI inflation (per cent, Q4)	1½	1¼	1¾	2	2

[1] See footnote to table A9 for explanation of forecast ranges.

A48 Growth is forecast to remain within the 3 to 3½ per cent range for 2005 as a whole. However, the annual figures mask an underlying gradual slowing since the second half of 2003 as the output gap narrows. By early 2006, the output gap is forecast to have closed and GDP growth is expected to be back to trend rates. Moreover, with UK export markets expected to grow strongly in 2005, albeit less quickly than in 2004, the forecast also sees a shift in the composition of growth, with easing domestic demand growth offset by a much smaller drag from net trade. GDP growth forecasts for 2005 and 2006, and the implied ending of the current cycle in early 2006, therefore remain as in the Budget 2004 forecast, which was itself unchanged from both Pre-Budget Report and Budget 2003. In 2007, GDP growth is forecast to ease to 2¼ to 2¾ per cent in line with the trend projection.

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



[1] Shaded areas on bars represent forecast ranges.

A49 Consumer Prices Index (CPI) inflation is expected to rise gradually back to target by mid-2006, as upward pressure from import prices, accentuated by the recent depreciation of sterling, feeds through. The credibility of the Government's monetary policy framework is also expected to contribute in returning inflation to target through anchoring inflation expectations.

A50 Although the overall shape of the economic forecast is broadly unchanged from Budget time, the configuration of the surrounding risks and uncertainties has changed. In particular, high oil prices – if sustained – would tend to dampen growth, though to the extent that they partly reflect strong global demand rather than supply-side or risk premia shocks there are likely to be offsetting effects. Global developments will remain a key influence on the UK outlook, with risks on both the upside and downside, and challenging judgements will continue to be faced in setting monetary and fiscal policy.

UK DEVELOPMENTS AND PROSPECTS IN DETAIL

Demand

Consumption

A51 Real private consumption has grown broadly in line with the expansion of the economy as a whole over the recent past. It increased by almost 3 per cent in the year to the third quarter of 2004, supported by continued domestic macroeconomic stability with low inflation and further strong labour market outcomes. The four-quarter growth rate has averaged just under 3 per cent for the past year, in line with its post-2000 average and only marginally above the estimated trend rate of growth of the economy. In contrast, over the five years up to 2000, real private consumption had grown at an unsustainable average rate of over 4 per cent a year. Further evidence of the sustainability of recent rates of real private consumption growth is given by the declining share of *nominal* consumption in *money* GDP since 2001, with falling relative consumer prices providing significant support for real growth in spending. Although, the household saving ratio has recently moved slightly above its average since the late 1990s, over this period it has essentially been broadly flat, reflecting consumption on average growing in line with disposable income.

A52 With household debt still at historically high levels, households are expected to continue to be reluctant to increase spending at a faster rate than income. Recent interest rate increases and weaker growth in house prices may also act as further constraining factors on consumer spending growth. Private consumption is expected to rise by $3^1/_4$ per cent this year, broadly in line with GDP growth for the year. Thereafter, private consumption growth is forecast to be below GDP growth.

A53 Blue Book 2004 introduced revisions to government consumption going back to 1996. These revisions were partly attributable to new measures of real health output, implemented in tandem with the Atkinson Review. Although nominal government consumption was unchanged, there were significant upward revisions to estimates of real government consumption growth over recent years, and consequently lower increases in the implied deflator. Following strong growth over the past few years, real government consumption is expected to slow over the 2004 Spending Review period.

Investment

A54 Investment has strengthened significantly since early 2003, spurred by faster growth in government investment, continued strong growth in investment in private dwellings, and a marked upturn in business investment following what latest data show to have been a relatively shallow decline in the face of weakness in the world economy. With global conditions having strengthened, business confidence has risen compared with early 2003, and capital expenditure has followed suit. At the same time, private non-financial corporations have strengthened their balance sheets, becoming strong net lenders over the past two years, notwithstanding the stronger investment. Business investment has now grown for six consecutive quarters, and has clearly recovered from the effects of world economic weakness between 2001 and 2003.

A55 Business investment is expected to rise by $5^3/_4$ per cent in 2004, rather stronger than forecast in Budget 2004. With profitability and corporate balance sheets having strengthened considerably, and demand still judged to be growing strongly, business investment is expected to continue to grow solidly over the forecast horizon, albeit at a slightly slower rate than this year. It is forecast to rise by $4^1/_2$ to 5 per cent in 2005 and by $3^1/_2$ to $4^1/_4$ per cent in 2006. For the economy as a whole, growth in gross fixed capital formation is expected to be supported by continued strong growth in government investment into next year, reflecting the Government's spending plans.

Balance of growth **A56** The composition of UK GDP growth has therefore already undergone a significant degree of rebalancing. High levels of household debt, coupled with five increases in repo rates over the past year, have contributed in holding back private consumption growth. At the same time, the strong global environment has underpinned the pick-up in business investment seen over recent quarters. So far in 2004, whole economy gross fixed capital formation has grown by almost twice the rate of private consumption growth on a year earlier. Indeed, with further strong increases in the levels of government investment, quarterly growth in whole economy gross fixed capital formation growth has now been above that of private consumption in five of the past six quarters. The Pre-Budget Report forecasts a consolidation of these developments going forward, with investment growth outstripping that of consumption in every year of the projection period.

Exports **A57** There are also signs that improvements in external demand are beginning to feed through to UK exports. Until recently export growth had shown few signs of benefiting from the upturn in global demand since mid-2003, and goods and services export volumes ended 2003 marginally below levels prevailing at the start of the year. However, this masked a pick-up in growth to non-EU markets offset by further falls in export volumes destined for the EU, partly reflecting the composition of international demand growth in the initial stages of the global recovery. The recorded level of exports to the EU was also reduced by Customs and Excise efforts to tackle Missing Trader Intra-Community Fraud (MTIC), which led to the closure of a number of fraudulent VAT evading businesses and a reduction in illicit exports.

A58 Nonetheless, there have been signs of a broadening of export strength in the course of 2004. Goods export volumes in the third quarter were over 4 per cent up on a year earlier. Moreover, goods export volumes to the EU were at their highest level for a year and a half in the third quarter, though underlying growth to EU destinations continues to lag behind that to non-EU markets.

A59 Export growth is expected to gather more momentum in coming quarters as the recent pick-up in external demand continues to filter through to UK exports. The recent depreciation of sterling should provide some further impetus to export growth over the forecast horizon. UK goods and services export volumes are forecast to rise by 6½ to 7 per cent next year, building on growth of around 2¼ per cent this year, following two years when exports were more or less flat.

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

	Percentage points, unless otherwise stated				
		Forecast			
	2003	2004	2005	2006	2007
Private consumption	1½	2	1¾	1½	1½
Business investment	0	½	½	½	¼
Government	1	1	1¼	¾	¾
Change in inventories	0	0	0	0	0
Net trade	–¼	–¾	0	0	0
GDP growth, per cent	**2¼**	**3¼**	**3¼**	**2¾**	**2½**

[1] *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.*

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

Imports **A60** Import growth this year has picked up on the back of the acceleration in domestic demand. The pick-up in manufacturing output is also likely to have given an additional boost to imports through demand for component parts and semi-finished products. Imports of goods and services were up by over 6 per cent on a year earlier in both the second and third quarters of 2004, their fastest growth for over three years. Imports are forecast to grow slightly slower than exports in 2005 and beyond, implying a broadly neutral impact from net trade on GDP growth, following the drag exerted in 2004.

Output

A61 Manufacturing output growth has firmed significantly since the end of 2002. In 2003 as a whole, it rose marginally for the first time in three years, following a protracted period of declining output in almost all major economies. It then rose by 1.2 per cent between the first and second quarters of 2004, to stand 2.1 per cent higher than a year earlier. Moreover, most parts of the sector have seen output expand, with around three quarters of manufacturing industries recording positive growth in production over the past year. From a regional and country perspective, the BCC survey for the third quarter showed particularly strong growth in orders for manufacturers in the West Midlands, Wales and Yorkshire and Humberside.

A62 Over the third quarter, manufacturing output lost some of the ground made up since early 2003. Business survey evidence has also pointed to an easing in the pace of manufacturing output growth compared with the first half of 2004, although it has still signalled expansion.

A63 Most indicators still point to underlying growth in the manufacturing sector. For example, while output has faltered, manufactured exports have continued to grow in recent months, while strengthening UK business investment should also give a boost to the production of capital goods in the near term. Most business survey indicators too are pointing to further growth in manufacturing output going forward, although at a slower rate than in the first quarter of the year. Manufacturing output is expected to grow by $1^1/_4$ per cent this year, up from $^1/_2$ per cent in 2003, with growth rising again in 2005 and 2006 to $1^1/_4$ to $1^3/_4$ per cent and $1^3/_4$ to $2^1/_4$ per cent respectively.

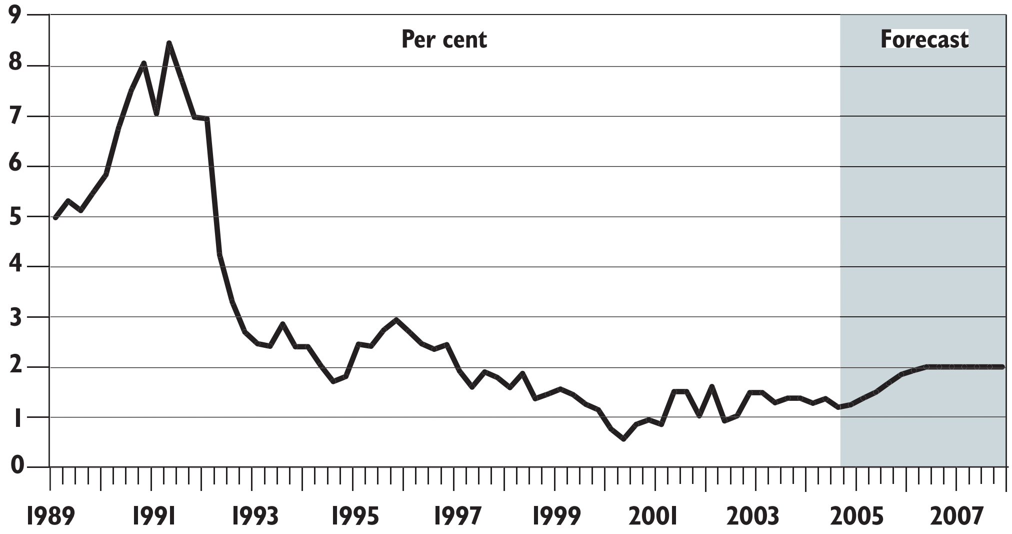
A64 Services output has continued to expand briskly in recent quarters, and is estimated to have risen 4 per cent in the year to the third quarter of 2004. Business survey evidence suggests the service sector should continue to expand at relatively robust rates going forward with the BCC survey for the third quarter showing particularly solid growth in domestic orders amongst service companies in the North East and East.

Inflation

CPI **A65** CPI inflation remains low. Over the past year, it has averaged 1.3 per cent, below the Government's symmetrical 2 per cent target. UK inflation remains among the lowest of all 25 EU countries. The gap between CPI and RPIX inflation has been broadly unchanged since Budget time, at just under 1 per cent.

A66 Recent inflation outturns reflect a variety of factors, with downward contributions more than offsetting a number of upward influences. This year saw relatively sharp seasonal reductions in airfares and, on a smaller scale, sea fares following the summer season. Price recoveries on clothing and footwear were also lower than normal after the summer sales. Average household energy bills have also risen of late, reflecting increases in gas and electricity tariffs. Unsurprisingly, as oil prices have risen, petrol and fuel prices have tended to exert an upward effect on inflation since the spring.

Chart A5: CPI inflation[1]



[1] Outturns until 2004Q3; forecasts for every second quarter from 2004Q4 to 2007Q4.

Producer prices

A67 Higher oil and commodity prices have fed through to increased manufacturers' input prices in recent months, with the cost of materials and fuels purchased rising by almost 8½ per cent in the year to October. While output prices have not accelerated to the same extent, suggesting some margin compression in the short term, they have picked up steadily over recent months, and rose at their fastest rate for over eight and a half years in the year to October.

Import prices

A68 Import prices fell almost continuously throughout the last world economic slowdown. As the world economy has strengthened and commodity prices have risen, goods import price inflation has picked up, rising at its fastest rate for four years in recent quarters.

House price inflation

A69 House price inflation picked up further over the spring and early summer, counter to most independent forecasters' expectations following earlier signs of easing. More recently, with five ¼ percentage point increases in repo rates since November 2003, coupled with high levels of existing debt, house price growth has again moderated. Halifax and Nationwide data show recent three-month on three-month house price inflation at its lowest for roughly four years. Regional indices suggest price growth in Greater London, the South East and the South West has been particularly weak in recent months.

Average earnings

A70 Average earnings growth has remained below rates judged consistent in the medium term with trend productivity growth and the Bank of England's 2 per cent symmetrical target for CPI inflation. Average earnings in the third quarter of 2004 were up 3.7 per cent on a year earlier, although excluding bonus payments they rose by 4.3 per cent over the same period, around the same rate that has been recorded since the spring. Private and public sector average earnings have increased at similar rates in recent months.

Prospects

A71 Going forward, the take-up of remaining slack in the economy is expected to remove a source of downward pressure on prices. With strong global demand growth already having contributed to higher world prices, the recently prolonged period of sterling import price deflation is expected to end, with the recent decline in the value of sterling also translating into a higher cost of overseas goods and services for UK consumers. As a result of these influences, inflation is forecast to rise through 2005 and to return to its 2 per cent symmetrical target by mid-2006. The credibility of the Government's monetary policy framework is also expected to contribute in returning inflation to target through anchoring inflation expectations.

The household sector

Private consumption

A72 UK household consumption has not been growing at unsustainable rates over the recent past. On average over the past decade, nominal private consumption has grown at similar rates to the economy as a whole. However, since mid-2001 the share of nominal consumption in money GDP has trended downwards, as relative consumer prices have tended to fall, and the share has recently been at its lowest since the end of 1998, as shown in Box A4, chart a. The household saving ratio has risen slightly since 2002, and in the second quarter of 2004 stood a little above its average since the late 1990s. Over the past six years or so, households have not increased their spending at a faster rate than their income.

Table A5: Household sector[1] expenditure and income

		Percentage changes on previous year unless otherwise stated			
		Forecast			
	2003	2004	2005	2006	2007
Household consumption[2]	2¼	3¼	2¼ to 2¾	2 to 2½	2 to 2½
Real household disposable income	2¼	4	2½ to 2¾	1¾ to 2¼	1¾ to 2¼
Saving ratio (level, per cent)	5½	6¼	6½	6½	6½

[1] *Including non-profit institutions serving households.*

[2] *Chained volume measures.*

A73 Underlying real private consumption rose by almost 3 per cent in the year to the third quarter of 2004, and has continued to be supported by further strong labour market outcomes, sound macroeconomic fundamentals and continued falls in relative consumer prices. Retail sales growth, which comprises around 35 per cent of private consumption, has been particularly solid over much of 2004: in the third quarter volumes were up over 1 per cent on the previous quarter and about 6½ per cent on a year earlier.

A74 Nonetheless, growth in real consumer spending post-2000 has been comfortably below rates seen in the preceding five years, broadly keeping track with the economy as a whole, as shown in Box A4, chart (b). Over the three years to 2003, real private consumption growth averaged 2.8 per cent, close to the economy's estimated trend rate of growth and significantly weaker than the unsustainable rate of over 4 per cent averaged during the previous five years.

Housing and household debt

A75 Housing market indicators now unambiguously suggest activity is slowing down, and aggregate house price indices have stopped rising in recent months. This has prompted speculation about whether and by how much house prices might need to decline, and whether any such adjustment might be gradual or sharp, and the potential impact on consumer spending.

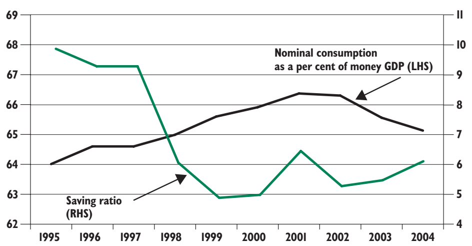
A76 The consensus view is that house prices exceed sustainable levels, though there is a wide range of opinion on the extent of disequilibrium. However, the common method of assessing this by comparing the current ratio of house prices to earnings (or some wider measure of income) with its long-run average can be highly misleading. There is no economic law to dictate that this ratio must revert to some constant level over the long term. Indeed, under conditions of price inelastic housing supply that characterise the UK housing market it would not be surprising if equilibrium house prices were to rise faster than incomes.

Time-series analysis of the ratio of house prices to income points to an upward trend, as suggested in Box A4, chart (c). If this were the case the implied extent of disequilibrium would be much narrower than if a constant ratio were assumed as the benchmark. Moreover, a relatively low degree of required adjustment, along with low inflation and general conditions of macroeconomic stability, tend to improve the chances of reversion taking place gradually rather than abruptly.

A77 Furthermore, in assessing the relationship between house prices and consumer spending, account should be taken not only of the effects via the impact on asset values for home-owners, but also effects tending to work in the opposite direction via the impact on the cost of housing services. This raises issues in interpreting the typically close co-movement between house prices and aggregate household consumption over the past (Box A4, chart (b)). Growth in real household consumption has been relatively moderate over the recent past when conditions of macroeconomic stability have prevailed. As house prices have risen so has mortgage equity withdrawal (MEW), with households maintaining a relatively stable proportion of equity in the value of the housing stock. MEW peaked at record levels earlier in 2004. However, instead of using it mainly to finance spending, households appear to have saved much of MEW, as borne out by the saving ratio edging up, and built-up their holdings of currency and deposits. Almost three quarters of the increase in households' mortgage debt since early 2000 has been matched by the rise in their deposit holdings.

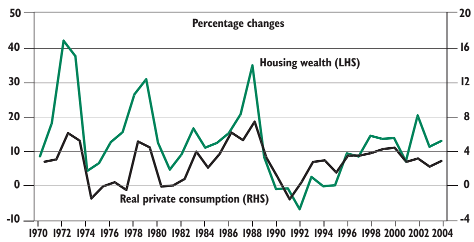
Box A4: Consumption and housing indicators

Chart a: Household saving ratio and nominal consumption[a]



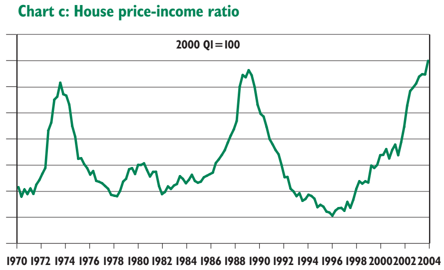
[a] 2004 = H1

Chart b: Housing wealth and real private consumption growth[a]



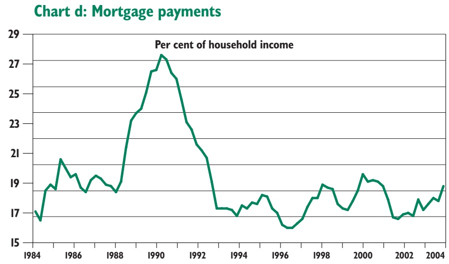
[a] 2004 = Part forecast.

Chart c: House price-income ratio



[1] OPDM Index

Chart d: Mortgage payments



[1] OPDM Index

A78 Some commentators have still questioned the sustainability of household spending in recent years on the grounds that household debt has become excessive. The ratio of household debt to income has risen to record levels, although growth in personal borrowing has eased back. Total lending to individuals rose at its slowest rate for around two years in the year to October, with both secured borrowing and unsecured credit growth having moderated. However, personal borrowing needs to be viewed alongside movements in overall household liabilities and assets: where households have significant levels of financial assets that can be easily liquidated, then the risk of debt burdens becoming unmanageable is reduced. A 2003 NMG Research survey for the Bank of England showed that the level of personal debt is positively correlated with income, and that debt had risen only amongst debtors in the highest income group over the previous three years, suggesting less exposure to the risk of adverse shocks than if borrowing has been concentrated amongst lower income groups. Moreover despite high levels of mortgage debt, the burden of mortgage repayments in relation to income for new mortgage holders remains low (Box A4, Chart d).

A79 Thus not only is the risk of a sizeable downward adjustment in house prices easily exaggerated, but conditions of macroeconomic stability may serve to limit the risk of any such adjustment significantly curtailing spending. Nevertheless symmetry across differing stages of the housing market cycle cannot be taken for granted, and the possibility of a housing market downturn adversely impacting on the wider economy needs to be recognised.

Prospects

A80 Real private consumption is forecast to rise by $3^1/_4$ per cent in 2004. While this is higher than seen over 2003 as a whole, it largely reflects a particularly strong rise in the first quarter of the year, with significantly weaker growth in subsequent quarters. The easing of consumption growth in recent years is expected to be consolidated going forward, as recent increases in interest rates, existing levels of debt, and more moderate house price inflation tend to inhibit borrowing and spending. Real private consumption is thus forecast to rise by between $2^1/_4$ and $2^3/_4$ per cent next year and by 2 to $2^1/_2$ per cent in 2006, below the forecast rates of GDP growth. The saving ratio is expected to rise a little further next year and to stabilise thereafter.

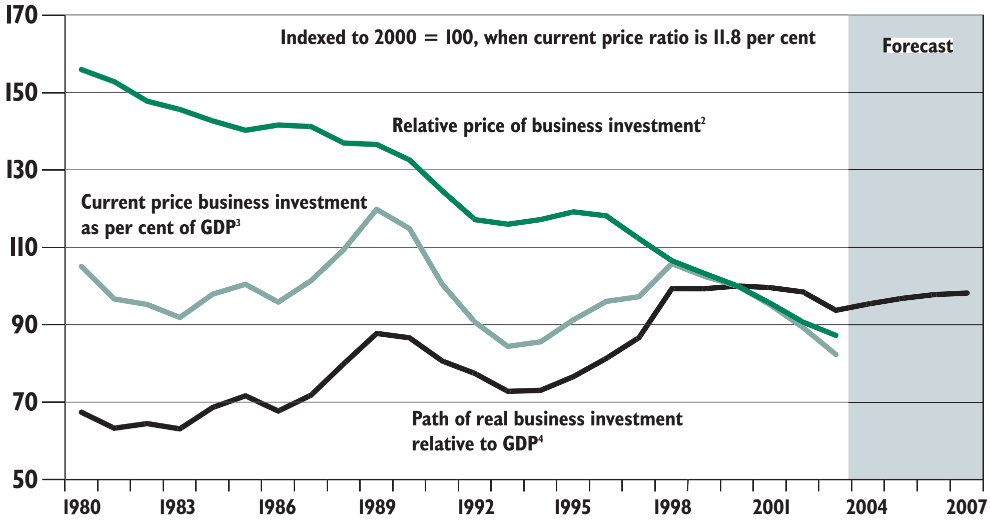
Companies and investment

A81 As with most industrialised countries, UK business investment was adversely affected by the weakness of the world economy between 2001 and 2003. However, although some temporary stalling during that period remains evident, latest data now show business investment held up far better than had been initially estimated. For example, preliminary data suggested a decline in business investment expenditure of 10 per cent in 2002. After subsequent revisions, reflecting both new information and methodological change, the data now show a small increase compared with 2001. Latest data also confirm that the downturn in business investment over the recent past was far shallower than in previous global slowdowns, with a peak to trough fall in the level of business investment of $6^3/_4$ per cent comparing with a decline of almost 20 per cent in the early 1990s.

A82 Indeed, since the end of 2001, latest data show there has only been one quarter in which business investment expenditure contracted. A sharp fall in the first quarter of 2003 coincided with the peak of international uncertainties and weakening in business sentiment throughout the global economy. The relatively smooth path of business investment in recent years suggests enhanced macroeconomic stability in the UK economy may have reduced the volatility of capital spending, compared with the very pronounced fluctuations of previous cycles.

A83 Since early 2003, as the global environment has strengthened, general business conditions have improved significantly, and UK business confidence rose solidly between early 2003 and 2004. Although recent months have seen a softening in sentiment, partly as a result of concern about rising oil and commodity prices, confidence generally remains firmer than in late 2002 and early 2003. Business sentiment has also seen some divergences between different regions and countries of the UK in recent months. While the CBI Regional Trends Survey for the third quarter reported a weakening in confidence nationally, this masked rising optimism in Yorkshire and Humberside, the North East and South West.

Chart A6: Business investment[1]



[1] *Business investment includes investment by public corporations 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.*

A84 At the same time, the pick-up in the international economy and the acceleration in domestic demand growth has bolstered profitability amongst UK businesses, despite the recent effects of rising commodity prices on input costs alongside less buoyant rates of output price inflation. Wage growth has remained subdued. Rates of return amongst private non-financial companies in the second quarter of 2004 were at their highest level since the end of 1999.

A85 Improved global prospects and strengthening in corporate conditions have underpinned a significant turnaround in real business investment over recent quarters. It has now increased for six consecutive quarters, and so far this year stands almost 6 per cent up on a year earlier. Real business investment has also been supported by declining prices for investment goods, with nominal capital spending having risen only modestly over the recent past. However, nominal expenditure on computer software and hardware – where asset prices typically trend downwards – has increased particularly sharply, rising over 13 per cent in the year to the third quarter of 2004, over twice the rate of increase in total business capital spending.

Table A6: Gross fixed capital formation

	Percentage changes on previous year				
		Forecast			
	2003	2004	2005	2006	2007
Whole economy[1]	$2\frac{1}{4}$	$6\frac{1}{2}$	$6\frac{3}{4}$ to $7\frac{1}{4}$	$3\frac{1}{4}$ to $3\frac{3}{4}$	$2\frac{3}{4}$ to $3\frac{1}{4}$
of which:					
Business[2,3]	–1	$5\frac{3}{4}$	$4\frac{1}{2}$ to 5	$3\frac{1}{2}$ to $4\frac{1}{4}$	$2\frac{1}{2}$ to $3\frac{1}{4}$
Private dwellings[3]	8	$9\frac{1}{2}$	$1\frac{1}{4}$ to $1\frac{1}{2}$	$1\frac{1}{2}$ to 2	$1\frac{3}{4}$ to $2\frac{1}{4}$
General government[3]	$23\frac{1}{2}$	$5\frac{3}{4}$	$30\frac{3}{4}$	$4\frac{3}{4}$	$5\frac{3}{4}$

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

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

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

A86 Business survey indicators point to further gains in investment spending going forward, with the BCC survey for the third quarter of 2004 showing both manufacturers and service sector firms intending to raise plant and machinery expenditure in coming months. In both manufacturing and services, investment intentions were strongest in the South West, while planned spending on plant and machinery was also relatively strong amongst manufacturers in Yorkshire and Humberside and service companies in the East.

A87 Pension fund deficits have decreased a little over the recent past, on account of rising equity values but also due to some companies raising cash contributions with the aim of tackling existing shortfalls. Overall there is little reason to change the Budget 2004 judgement regarding the likely impact of existing deficits on future business investment prospects.

Prospects

A88 In Budget 2004, business investment was considered to present upside risks to the economic forecast this year, and the current projection for 2004 is higher than the Budget forecast, with business investment now expected to grow by $5\frac{3}{4}$ per cent, compared with $3\frac{1}{2}$ to 4 per cent at Budget time. Beyond 2004, business investment is forecast to continue growing solidly, although the projection cautiously assumes weaker growth than seen in previous cycles. The relatively shallow downturn in investment spending as the world economy slowed implies companies should have a lighter backlog of delayed capital projects to bring on stream under stronger international conditions. The Government's success in delivering macroeconomic stability may now be starting to encourage a smoother evolution of business investment spending relative to historical experience.

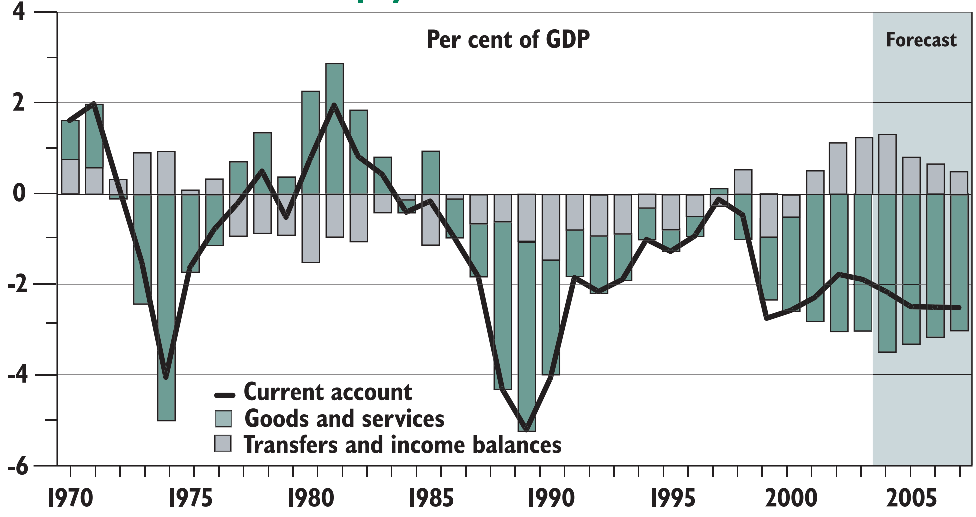
A89 Government investment is expected to continue growing strongly into next year, in line with the Government's spending plans.

Trade and the balance of payments

Trade in goods

A90 Trade volumes have been more erratic than usual of late, especially to non-EU markets where the introduction of a new system for recording export transactions by HM Customs and Excise has temporarily affected the recorded monthly export profile in recent months. Nonetheless, exports appear to have gained momentum through the course of 2004 on the back of stronger external demand. In the third quarter, goods export volumes were up over 4 per cent on a year earlier, with volumes to EU markets up over 5 per cent against a 3 per cent rise to non-EU destinations, though underlying growth in exports still appears to be somewhat stronger to the non-EU.

Chart A7: Balance of payments current account



A91 However, aggregate data on EU and non-EU exports masks variations within these markets. UK exports have risen strongly to many key EU economies in the course of the past year. Yet, despite strong growth of the US economy, nominal goods exports to that market have remained broadly flat, in contrast to many other non-EU destinations to which exports have grown sharply. Recent trade figures also continue to highlight the increasing importance of China to the UK's non-EU trade. In the third quarter of 2004, the nominal value of both exports to and imports from China was up about 30 per cent on a year earlier.

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]	
2003	0	1¼	1¼	½	¾	–32¾
Forecast						
2004	2¼	4¾	–¾	–¾	¼	–39¾
2005	6½ to 7	6 to 6¼	1¼	1	¼	–40
2006	6¼ to 6¾	5¼ to 5¾	2¾	2¾	0	–40¼
2007	6¼ to 6¾	5¼ to 5¾	2¼	2¼	0	–40½

[1] *Average value indices.*

[2] *Ratio of export to import prices.*

A92 Strong UK GDP growth has fed through to higher import volumes over the recent past. Goods import volumes rose about 7½ per cent in the year to the third quarter of 2004, the fastest rate of growth for three and a half years. As a result of import growth outstripping that of exports, the trade in goods deficit was £2¾ billion larger in the third quarter than a year earlier.

Trade in services

A93 A rising services surplus has, however, resulted in a more moderate widening of the total trade deficit. While the UK registered a deficit on oil trade in September, this reflected the impact of delayed maintenance work in reducing output and exports, and the UK remains a small net exporter of petroleum.

Current account **A94** As a result of the larger deficit on trade in goods and services, the current deficit has widened a little since the end of 2003 although, as a share of GDP, it has been broadly flat over the past five years. At the same time, the overseas investment income surplus has also eased back a little. Even after a recent slight moderation, the income surplus remains robust and close to historically high levels. Indeed, over the past eight quarters the income surplus has averaged $2^1/_4$ per cent of GDP, compared with a long-run average of 0.5 per cent. Some of this is likely to reflect temporary factors that are expected to unwind over the forecast horizon.

Prospects **A95** Export growth is forecast to gather more momentum in coming quarters as the recent pick-up in external demand continues to filter through to UK exports. Moreover, the sterling Exchange Rate Index has depreciated by around 4 per cent since the summer, largely due to a softening in the pound's value against the euro. This should provide some additional impetus to export growth over the forecast horizon. Goods and services export volumes are forecast to rise by $6^1/_2$ to 7 per cent next year, building on growth of around $2^1/_4$ per cent this year and following two years when exports were more or less flat.

A96 In 2004, UK export volumes are expected to grow significantly less than UK export markets and world trade, implying a corresponding loss of market share. While UK export market share has historically trended downwards, partly as a by-product of emerging economies experiencing strong growth of their internationally traded sectors, the recent implied fall is larger than would be expected on the basis of long-term trends. The forecast assumes further loss of market share, but more in line with its longer-term trend rate of decline.

A97 With the trade deficit widening a little next year, and the income surplus expected to moderate slightly compared with the record levels of recent years, the current deficit is expected to widen slightly in 2005, and thereafter to stabilise at around $2^1/_2$ per cent of GDP.

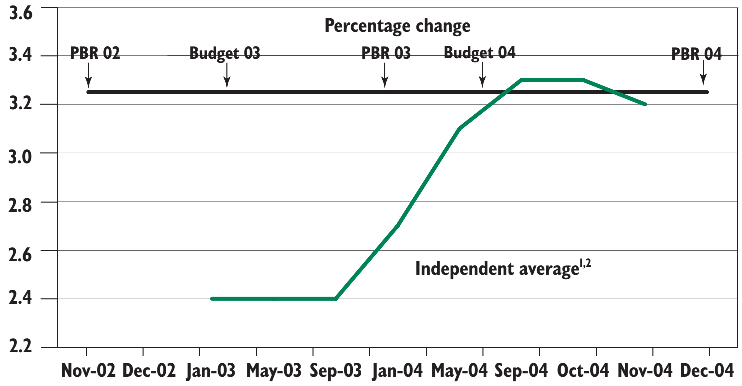
Independent forecasts

A98 The 2004 Pre-Budget Report forecast for GDP growth in 2004 of $3^1/_4$ per cent is at the centre of the forecast range of 3 to $3^1/_2$ per cent that has been maintained unchanged since it was first published as a two-year ahead forecast in the 2002 Pre-Budget Report. In contrast, the average of independent forecasts for GDP growth in 2004 (which was not fully canvassed until early 2003) was 2.4 per cent at the time of Budget 2003, rising progressively after the summer to 2.6 per cent by the time of Pre-Budget Report 2003 and 3.0 per cent by the time of Budget 2004. Subsequently the independent average for 2004 has increased further, and in November stood at 3.2 per cent, exactly in the middle of the 3 to $3^1/_2$ per cent range. The Treasury's recent economic forecasting performance is discussed in Box A5.

Box A5: Recent economic forecasting performance

As was the case at the time of Budget 2004, the Pre-Budget Report forecast for UK GDP growth in 2005 is higher than the latest external consensus, as presented in HM Treasury's comparison of independent forecasts.

HM Treasury and independent average GDP forecasts for 2004



[1] *Forecasts for the UK economy: A comparison of independent forecasts, HM Treasury.*
[2] *The average of independent forecasts for 2004 was not fully canvassed until January 2003.*

This is not the first time in recent years that Treasury forecasts have been above the prevailing consensus for a prolonged period. As discussed elsewhere in this annex, at the time of Budget 2003, the Treasury's GDP growth forecast for 2004 – at 3 to 3½ per cent – was significantly above the independent average but outside forecasters have subsequently converged on the Treasury's projection, as shown in the chart. Moreover, during the Asian and emerging markets crisis of the late 1990s, outside forecasters took a more pessimistic view of UK prospects at the time of Budget 1999: the independent average for GDP growth in that year was 0.6 per cent, compared with the Budget forecast range of 1 to 1½ per cent. In the event, the Treasury's projection proved closer to the actual outturn for the year, although both Treasury and outside forecasts proved too pessimistic, with subsequent data revisions for 1999 now showing GDP growth of 2.9 per cent.

More generally, the Treasury's recent forecasting record has been relatively good. Analysis of forecast errors for current and year-ahead forecasts made since 1995 indicates that Treasury forecasts have on average outperformed the independent consensus. However, both HM Treasury and the independent forecast have tended to under-predict GDP growth more often than they have over-predicted in recent years.

A99 Since the 1975 Industry Act first obliged governments to publish economic forecasts twice a year, it is without precedent for a government GDP growth forecast for any particular year to have been maintained unchanged for five successive forecasts up to and including the forecast made in the autumn of the year in question.

Table A8: Budget and independent[1] forecasts

	Percentage changes on a year earlier unless otherwise stated					
	2004			2005		
		Independent			Independent	
	PBR 2004	Average	Range	**PBR 2004**	Average	Range
Gross domestic product	$3\frac{1}{4}$	3.2	2.9 to 3.6	3 to $3\frac{1}{2}$	2.5	0.5 to 3.5
CPI (Q4)	$1\frac{1}{4}$	1.4	1.2 to 2.0	$1\frac{3}{4}$	1.8	1.3 to 2.8
Current account (£ billion)	$-24\frac{3}{4}$	–26.6	–31.8 to –18.0	$-30\frac{1}{4}$	–28.6	–41.2 to –15.0

[1] *'Forecasts for the UK Economy: A Comparison of Independent Forecasts', November 2004.*

A100 The independent average GDP forecast for 2005, at 2.5 per cent, is currently still below the Pre-Budget Report range of 3 to $3\frac{1}{2}$ per cent. Independent forecasters expect CPI inflation to rise to just fractionally below target by the end of next year.

Forecast risks

A101 The configuration of risks and uncertainties surrounding the economic forecast has changed since Budget time, and challenging judgements continue to be faced in setting monetary and fiscal policy, for example in estimating the economy's supply-side potential. Global developments remain a key influence on the UK outlook. Near-term uncertainties, which apply both ways, include movements in oil prices and their economic effects. Over the medium term, key factors posing risks to the global economy include correction of global imbalances through exchange rate adjustment and growth realignment, and the need for fiscal consolidation and corporate and household balance sheet adjustment in some countries.

A102 UK house prices continue to pose risks both ways, despite recent signs of gradual adjustment. While a smooth adjustment remains the most likely outcome, a sharper correction cannot be ruled out. However, evidence suggests that with the Government's macroeconomic framework delivering stability, private consumption growth has been relatively moderate compared to previous episodes of strong house price inflation, so the potential economic consequences of a weaker housing market would seem less clear than in the past.

A103 There are also upside risks to the UK forecast. For example, as has been the case in 2004, business investment could continue to surprise on the upside, given rising profitability and the improvements in corporate balance sheets over the recent past; and there may be headroom for stronger consumer spending without household finances getting stretched.

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]
	2003	**2004**	**2005**	**2006**	**2007**	
Output at constant market prices						
Gross domestic product (GDP)	2¼	3¼	3 to 3½	2½ to 3	2¼ to 2¾	¾
Manufacturing output	½	1¼	1¼ to 1¾	1¾ to 2¼	1¾ to 2¼	1¾
Expenditure components of GDP at constant market prices[6]						
Domestic demand	2½	4	3 to 3½	2½ to 3	2¼ to 2¾	¾
Household consumption[7]	2¼	3¼	2¼ to 2¾	2 to 2½	2 to 2½	¾
General government consumption	3½	4½	3	3	2½	1
Fixed investment	2¼	6½	6¾ to 7¼	3¼ to 3¾	2¾ to 3¼	2¼
Change in inventories[8]	0	0	0	0 to ¼	0	¼
Exports of goods and services	0	2¼	6½ to 7	6¼ to 6¾	6¼ to 6¾	2½
Imports of goods and services	1¼	4¾	6 to 6¼	5¼ to 5¾	5¼ to 5¾	2¼
Balance of payments current account						
£ billion	–20½	–24¾	–30¼	–31¾	–33¼	9
per cent of GDP	–1¾	–2¼	–2½	–2½	–2½	¾
Inflation						
CPI (Q4)	1½	1¼	1¾	2	2	–
Producer output prices (Q4)[9]	1½	3½	2½	2	2	1½
GDP deflator at market prices	3	2¼	2½	2¾	2¾	¾
Money GDP at market prices						
£ billion	1100	1161	1226 to 1231	1292 to 1303	1356 to 1376	8
percentage change	5¼	5½	5¾ to 6	5¼ to 5¾	5 to 5½	¾

[1] The forecast is consistent with the national accounts and balance of payments statistics to the second quarter of 2004, released by the Office for National Statistics on 29 September 2004, and output, income and expenditure data to the third quarter released on 26 November 2004.

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

[3] As in previous Budget and Pre-Budget Reports, the economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral assumption for the trend rate of output growth. 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 10 years. The average errors for the current account are calculated as a percent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2004 and 2005.

[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
2003		697.6	203.7	173.6	2.5	1077.4	272.9	1350.3	315.9	0.2	1034.6
2004		719.5	212.8	185.1	2.2	1119.6	279.2	1398.8	330.5	0.2	1068.4
2005		735.8 to 739.0	219.0	197.7 to 198.5	1.5 to 2.4	1154.0 to 1158.9	297.5 to 298.8	1451.5 to 1457.7	350.0 to 351.5	0.2	1101.6 to 1106.3
2006		750.8 to 757.7	225.8	204.0 to 205.9	1.8 to 3.9	1182.4 to 1193.3	316.3 to 319.2	1498.7 to 1512.5	368.5 to 371.9	0.2	1130.4 to 1140.8
2007		766.0 to 776.8	231.6	209.7 to 212.7	0.5 to 3.8	1207.8 to 1224.8	335.8 to 340.5	1543.6 to 1565.3	387.9 to 393.3	0.2	1155.9 to 1172.2
2003	1st half	346.2	100.3	85.7	0.7	533.0	136.5	669.6	157.0	0.1	512.7
	2nd half	351.5	103.3	87.9	1.8	544.4	136.4	680.8	159.0	0.1	521.9
2004	1st half	357.6	105.5	91.3	1.8	556.1	137.2	693.3	162.9	0.1	530.5
	2nd half	361.8	107.4	93.9	0.5	563.5	142.0	705.5	167.7	0.1	537.9
2005	1st half	365.9 to 367.0	108.7	98.2 to 98.5	0.1 to 0.4	572.8 to 574.6	146.5 to 146.9	719.3 to 721.5	172.6 to 173.2	0.1	546.8 to 548.4
	2nd half	369.9 to 371.9	110.4	99.5 to 100.0	1.4 to 2.0	581.2 to 584.4	151.0 to 151.8	732.2 to 736.2	177.4 to 178.4	0.1	554.9 to 557.9
2006	1st half	373.6 to 376.5	112.1	100.8 to 101.6	1.4 to 2.3	587.9 to 592.6	155.7 to 157.0	743.7 to 749.6	181.9 to 183.4	0.1	561.8 to 566.3
	2nd half	377.3 to 381.2	113.7	103.1 to 104.2	0.4 to 1.6	594.5 to 600.7	160.6 to 162.2	755.0 to 762.9	186.6 to 188.5	0.1	568.6 to 574.5
2007	1st half	381.1 to 386.0	115.1	104.0 to 105.4	0.6 to 2.1	600.8 to 608.5	165.4 to 167.5	766.2 to 776.0	191.4 to 193.9	0.1	574.9 to 582.2
	2nd half	384.9 to 390.8	116.4	105.7 to 107.3	0.0 to 1.7	607.0 to 616.3	170.4 to 173.0	777.4 to 789.3	196.4 to 199.4	0.1	581.0 to 590.0
		Percentage changes on previous year[4,5]									
2003		2¼	3½	2¼	0	2½	0	2	1¼	0	2¼
2004		3¼	4½	6½	0	4	2¼	3½	4¾	0	3¼
2005		2¼ to 2¾	3	6¾ to 7¼	0	3 to 3½	6½ to 7	3¾ to 4¼	6 to 6¼	0	3 to 3½
2006		2 to 2½	3	3¼ to 3¾	0 to ¼	2½ to 3	6¼ to 6¾	3¼ to 3¾	5¼ to 5¾	0	2½ to 3
2007		2 to 2½	2½	2¾ to 3¼	0	2¼ to 2¾	6¼ to 6¾	3 to 3½	5¼ to 5¾	0	2¼ to 2¾

[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.