A THE ECONOMY

Since Budget 2005, the UK economy has faced major challenges from sustained rises in oil prices, continued weak growth of its major export markets and a subdued housing market. In previous decades these factors would have risked being accompanied by recession. By contrast, the UK economy now continues to enjoy its longest unbroken expansion on record, and has shown greater stability and stronger GDP growth than most of its major competitors.

Although world growth has remained strong this year, there has been some moderation compared with 2004, at least partly due to high oil prices. The slowdown in growth has been more pronounced in some major advanced economies, with many emerging and developing economies maintaining rapid growth close to the rates seen in 2004.

Blue Book 2005 revisions to the UK national accounts and latest data for the first three quarters of 2005 have significantly altered the path of UK output relative to Budget 2005. Latest estimates show stronger GDP growth through the year to early 2004, a sharp slowing in mid-2004 and growth at well below trend rates since then. The revisions to 2004 data arithmetically deduct from forecast growth for 2005 as a whole. While there is considerable uncertainty about the degree to which the UK economy has slowed since early 2004, and the extent of the current negative output gap, GDP growth has clearly been at somewhat below trend rates in recent quarters.

Unexpected rises in oil prices, which reached $67 a barrel in the summer and have remained well above previous historic peaks since, have dampened real income growth for both consumers and companies outside the oil sector. Evidence of higher than expected inflation and GDP growing at below-trend rates is consistent with higher oil prices imparting a negative supply-side shock to the economy. Moreover, recent increases in oil prices have also adversely affected demand in the UK's main export market, the EU, where demand growth has already proved weak relative to some other major economies that make smaller contributions to overall demand for UK output. In addition to these external shocks, there has been some weakness in domestically generated demand growth: household income has also been affected by lower than expected average earnings growth, though employment has grown strongly. These are the main clearly identifiable economic factors which account for lower GDP growth in 2005 than expected at Budget time.

UK GDP growth is expected to remain below trend in the short term as the effects of higher oil prices on both domestic and external demand continue to work through. However, with the Government's macroeconomic framework continuing to deliver domestic macroeconomic stability, and the economy performing substantially stronger than in previous periods of high oil prices, weak external demand or a subdued housing market, the UK economy remains well placed for a resumption of stronger growth:

- **GDP is now expected to grow by 1¾ per cent in 2005, with growth strengthening to 2 to 2½ per cent in 2006 and then to 2¾ to 3¼ per cent in both 2007 and 2008 as the output gap closes.**
- **CPI inflation is expected to dip slightly below target in 2006 as the direct effects of higher oil prices abate, before returning back to its 2 per cent target in 2007 as the output gap narrows and import prices continue to rise.**

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

INTRODUCTION[1,2]

A.1 This annex discusses recent economic developments and provides updated forecasts for the UK and world economies in the period to 2008. It begins with an overview of developments and prospects in the world economy. It then outlines the Government's latest assessment of the UK economy, followed by a more detailed discussion of sectoral issues and risks.

THE WORLD ECONOMY

Overview

A.2 The world economy grew at its strongest rate for three decades in 2004, with annual growth of over 5 per cent. World GDP growth has principally been driven by the US and China over the recent past. G7 GDP also grew relatively robustly during 2004, building on the recovery that became established during 2003, although as usual it did not grow as strongly as world GDP.

A.3 World growth in 2005, while still robust, has moderated compared with 2004, due to a combination of high oil product prices, cyclical moderation, and structural factors limiting resilience and adjustment to shocks in some countries. This easing in growth rates looks to have been more pronounced amongst advanced economies, especially the UK's main export markets, with emerging economies showing very little slowing during 2005. These patterns are expected to persist into 2006.

A.4 G7 growth has been led by the US, which has now been growing at or above potential rates for 10 consecutive quarters. Japan has made a marked recovery in the first half of 2005, and prospects for a further improvement in the sustainability of growth have firmed as domestic demand has begun to strengthen. However, euro area growth has been much more subdued, and has continued to under-perform forecasts, with the weakness in activity concentrated amongst the larger EU member states.

A.5 High and volatile oil prices stemming from strong demand growth, constrained spare capacity, and supply uncertainties initially had relatively limited impact on world growth. However, as oil price rises have started to feed through more significantly to higher pump prices, particularly during the summer amidst disruption to US refining capacity arising from hurricanes in the Gulf of Mexico, there has been a more discernible effect on consumption and confidence, especially in some advanced economies. Consequently, growth – while still healthy – has been pared by the negative effects on disposable incomes, profitability, and confidence. Developments also suggest that higher oil prices may be hitting productive potential outside the oil sector.

[1] The UK forecast is consistent with output, income and expenditure data to the third quarter of 2005 released by the Office for National Statistics (ONS) on 25 November 2005. A fully consistent national accounts dataset for the third quarter will be published by the ONS on 22 December. 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.

A.6 Whilst high energy prices have been reflected in rising headline consumer and producer price inflation, core inflation has been contained: competitive pressure in product markets has helped hold down wage demands; remaining slack in some key labour markets has contained labour costs and wage growth; and the credibility of monetary frameworks and institutions has served to anchor inflation expectations. Nevertheless, there has been some pre-emptive monetary tightening, notably in the US and China, to counter rising underlying inflationary pressures. In spite of higher short-term interest rates, long-term rates have hardly changed, so the global financial environment remains benign and supportive of growth.

Table A1: The world economy

	Percentage changes on a year earlier unless otherwise stated				
		Forecast			
	2004	2005	2006	2007	2008
Major 7 countries[1]					
Real GDP	3¼	2½	2½	2½	2½
Consumer price inflation[2]	2½	2¾	2¼	1¾	1¾
Euro area					
Real GDP	1¾	1½	1¾	2	2¼
World GDP	5	4¼	4¼	4¼	4
World trade in goods and services	10	6¾	7¾	7¼	7
UK export markets[3]	9¼	6	7	6¾	6¼

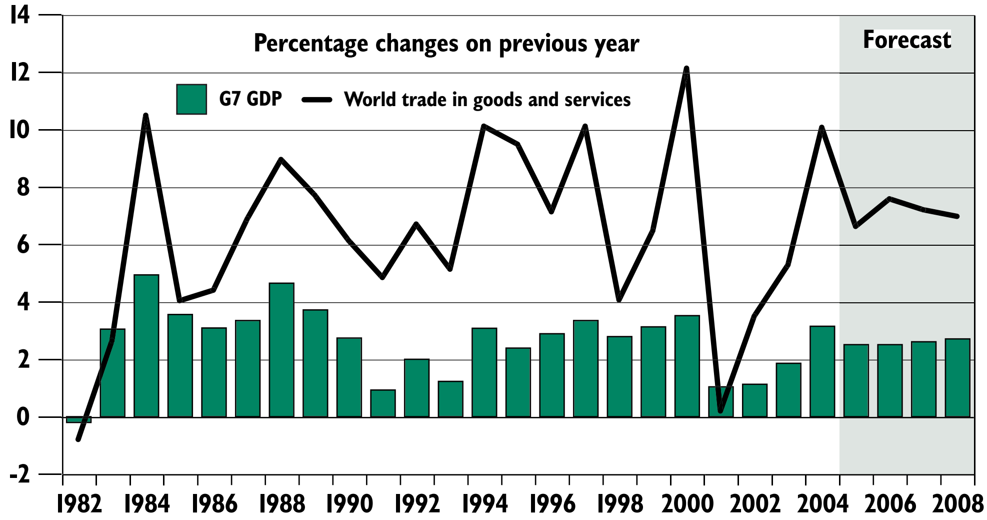
[1] *G7: US, Japan, Germany, UK, France, Italy and Canada.*

[2] *Per cent, Q4.*

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

A.7 As a result of the distribution of GDP growth across regions, and the sources of growth within the major economies, world imbalances in the demand and supply of goods and services, as well as savings and investment, have been reflected in rising current and capital account imbalances. The US current account deficit has now risen to over 6 per cent of GDP, and is not forecast to narrow significantly. This is counterbalanced by current account surpluses in Asia and particularly the Middle East, where the surplus has risen from 4½ per cent of GDP in 2002 to over 20 per cent in 2005, driven by higher oil prices.

Chart A1: G7 GDP and world trade



G7 activity

A.8 G7 GDP growth remained relatively robust in the early part of 2005. However, compared with 2004, when G7 GDP grew by $3^1/_4$ per cent, its strongest for four years, growth has moderated during the course of 2005 due to higher oil and fuel prices and other cyclical and structural factors. G7 GDP growth is expected to stabilise around $2^1/_2$ per cent over the forecast horizon. Although forecast G7 growth in 2005, at $2^1/_2$ per cent, has changed little since Budget 2005, the distribution of growth has shifted, with the three largest euro area economies weaker than expected, against stronger Japanese GDP growth. The US has continued to grow faster than other G7 economies, following a period of below-trend growth in 2001 and 2002 which created a significant negative output gap. This slack has permitted recent above potential growth without a significant increase in inflationary pressures. However, monetary policy has been gradually tightened since June 2004, so as to ensure that inflation expectations remain anchored and inflationary pressures are contained.

A.9 US growth has been driven by domestic demand, with net exports generally continuing to detract from GDP. As a result, growth has been accompanied by an increase in the US current account deficit, which reflects both internal imbalances as well as less robust external demand in US export markets. Private consumption has provided the main impetus to US growth, with rising household wealth alongside declining saving rates supporting household expenditure and partly cushioning spending from rising energy costs and interest rates. The gradual rise in wage growth will provide support to consumption going forward, particularly in the event that the saving rate begins to recover, the housing market moderates or high energy costs persist.

A.10 Economic growth in the euro area continues to lag behind the G7 average and that of other advanced countries, and in some of the major euro area economies it has been falling short of expectations at Budget 2005. The loss of momentum during 2004 persisted into the first half of 2005, with growth now expected to be below trend rates in both 2005 and 2006. Weak consumption growth, coupled with weak growth in investment spending, are the main factors accounting for euro area weakness. Export growth is still relatively strong. Lower than expected domestic demand growth in the euro area has fed through to demand for imports, adversely affecting UK export markets growth.

A.11 Economic growth rates vary widely across euro-area Member States, with weak growth in Germany and Italy contrasting with stronger growth in Spain and some of the smaller Member States. The sources of growth have also diverged, with Germany's growth relying on external demand against more consumption-orientated growth in France and Spain.

A.12 The Japanese economy is undergoing a renewed recovery. In contrast to previous upturns, recent Japanese growth has been substantially supported by strengthening domestic demand. After three quarters of near-zero growth in 2004, the pick-up in the first half of 2005 has been broad-based, with strong contributions from both business investment and private consumption. This has been the result of an improving labour market, with unemployment coming back down to its long-term rate, and on-going corporate restructuring as profitability continues to improve. The contribution of net exports has been more erratic, but with strong growth in China and the US providing underlying support to external demand, net trade should continue to be positive for Japanese growth. The recovery is forecast to be sustained through 2005 and into next year, but difficult policy decisions will have to be made as to the pace and timing of the appropriate monetary response as deflation comes to an end, and on fiscal consolidation.

Box A1: Government policy on EMU

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

As part of the policy of 'prepare and decide', the Government coordinates appropriate euro preparations across the UK economy. The Government also supports business in dealing with the euro as a foreign currency. Further information is available on the Treasury's euro website www.euro.gov.uk.

On the Stability and Growth Pact, the Government continues to emphasise the need for a prudent interpretation of the Pact as described in Budget 2005. The reforms to the Pact agreed in March 2005 rightly place a greater focus on the avoidance of pro-cyclical policies and on reducing and maintaining low debt, with the flexibility for low debt countries such as the UK to invest in the provision of much needed public services. During the UK's Presidency of the European Union and beyond, the Government has and will continue to work closely with Member States and EU institutions to ensure effective implementation of the new Pact going forward. It is also essential to recognise the importance of national frameworks and national ownership of fiscal policy.

The Chancellor's statement to the House of Commons on 9 June 2003 on UK membership of the European single currency set out a reform agenda of concrete and practical steps to address the policy requirements identified by the June 2003 assessment, the latest progress report on which was made in Budget 2005. While the Government did not propose a euro assessment to be initiated at the time of Budget 2005, the Treasury will again review the situation at Budget time next year as required by the Chancellor's June 2003 statement.

Emerging markets and developing economies

A.13 Emerging markets have shown considerable resilience in the face of high energy prices. Emerging Asian economies[3] are expected to grow around 7 per cent this year, only a little below the 7½ per cent growth of 2004, with Latin America expanding around 4 per cent, compared with 5½ per cent in 2004. China and India, in particular, have performed well. Chinese GDP grew by about 9½ per cent in the year to the third quarter of 2005, buoyed by strong external demand reflected in a rising trade surplus which is expected to exceed $100bn this year, equivalent to around 4 per cent of GDP, and by continued strong growth in investment. Fears of overheating have receded on signs that investment has successfully been channelled to bottleneck sectors such as energy supply. India has also maintained strong growth, with GDP forecast to grow by around 7 per cent this year.

[3] Non-Japan Asia.

A.14 Rapid growth in Asia has boosted demand for commodities. Some developing economies have clearly been disadvantaged by the resulting rise in energy and food prices. But Latin America has been a major beneficiary, and is expected to register a second consecutive year of current account surplus in 2005, reversing a long-term trend.

A.15 The current account surpluses of the Organisation of the Petroleum Exporting Countries (OPEC) have also risen significantly, and are expected to average 20 per cent of GDP in 2005 and 2006, compared to 5 per cent in 2002. The recycling of oil revenues from oil producers back into the global financial system will be a key issue. Global markets are more integrated than in the past and financial institutions in the Middle East, in particular, have developed and become more international. Analysis[4] suggests that the rate of revenue recycling has almost doubled since the 1980s, suggesting that the world economy will be more resilient to oil price rises than in the past.

World trade

A.16 World trade has continued to grow at a solid pace during 2005, mirroring strong world GDP growth. For 2005 as a whole, world trade is expected to grow by around 6¾ per cent, down from the recent high of 10 per cent in 2004. The strength of world trade growth over the recent past has been primarily driven by the emerging economies, and this trend is expected to continue. This reflects a combination of regional integration in production systems, as well as rising consumption as income levels rise. Nevertheless, the moderation in G7 GDP growth will filter through to world trade growth, with a discernible effect on UK prospects.

A.17 UK export markets growth also slowed in 2005. However, compared with overall world trade – which has been boosted by the continued strong expansion of emerging economies – UK export markets growth has been disproportionately affected by the further weakness of demand in the euro area, with growth now expected to be 6 per cent this year, 1½ percentage points lower than forecast in Budget 2005. Around half of the reduction in UK export markets growth in 2005, compared with the Budget forecast, is attributable to weaker euro area import growth, and nearly all of the reduction can be accounted for by weaker than forecast import growth in Europe as a whole. The improvement in growth in the Middle East and Africa and the recycling of higher export earnings from high commodity prices has had a positive impact, notwithstanding these countries' low weights in total UK export markets.

Oil and commodity prices

A.18 Oil prices have increased sharply since the beginning of 2004 and have significantly exceeded market expectations since Budget 2005. At its peak in September 2005, the price of Brent reached $67 a barrel. This marked a doubling of oil prices since early 2004 and a tripling since early 2002. Since the peak in September, oil prices have dropped back to around $55 a barrel. In the short term, nominal oil prices are expected to remain high by historical standards and to continue to be sensitive to demand increases and supply disruptions. Over the medium term, prices are expected to moderate somewhat, but to remain at a higher level than the average of the past 20 years.

A.19 Rapid growth in the demand for oil, particularly from China, has been the primary driver underpinning rising oil prices since 2004. In 2005, continuing strong demand growth, constrained spare capacity, supply uncertainties and disruptions, and imbalance between the demand and supply of different grades of crude in a constrained refining environment, have led to prices significantly exceeding market expectations at Budget time.

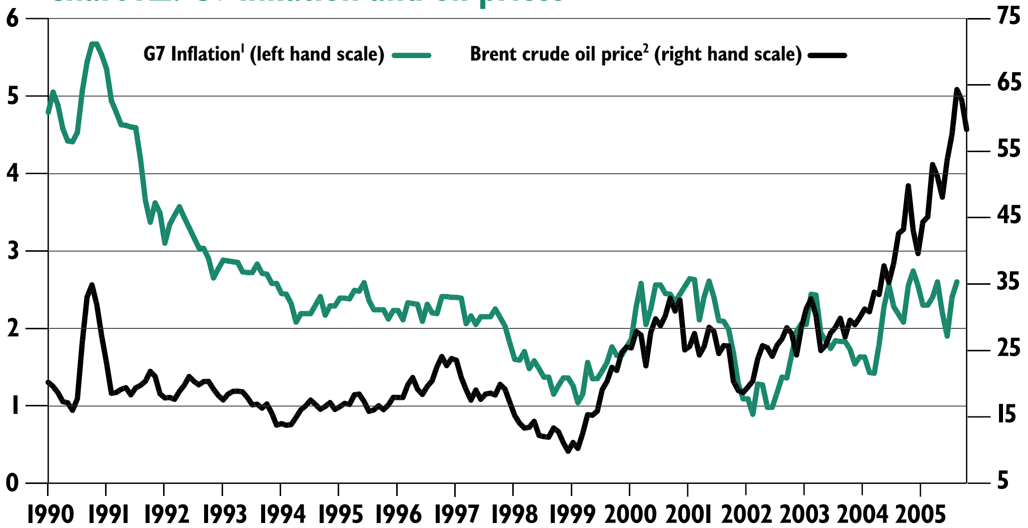
[4] Bundesbank (May 2005) *Has the recycling of oil revenues to the consumer countries accelerated?*

A.20 The UK contributed to the International Energy Agency members' release of emergency stocks in response to the supply shock triggered by Hurricane Katrina. At this time, EU and G7 Finance Ministers, meeting under the UK's Presidencies, supported the Chancellor's calls for concerted global actions to address high and volatile oil prices and their impacts (see Box 2.4).

A.21 The current situation of demand-driven prices differs from the supply-side shocks that drove the oil price hikes of the 1970s and 1980s. On this occasion, higher demand-driven oil prices have been associated with stronger world output, instead of the weakening of output typically observed in the face of supply-side shocks. World growth and economic activity have also been less susceptible to the rapid increase in oil prices because of the decline in the energy intensity of output, and the limited impact on inflationary pressures reducing the need for interest rate rises.

A.22 Nevertheless, there are increasing concerns that the persistence of high oil prices, and their volatility, may begin to have a more discernible adverse impact on world output. High oil prices risk hitting consumer and business confidence, eroding disposable income and profitability, and depressing consumption and investment - particularly to the extent that consumers and businesses perceive the current high price levels as being more permanent, rather than temporary. If world growth were to moderate, however, this would itself ease demand for oil and the current pressure on prices.

Chart A2: G7 inflation and oil prices



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

G7 inflation

A.23 Headline inflation has risen significantly in recent months, principally due to the dramatic rise in energy prices, though higher non-fuel commodity prices have also exerted some upward pressure. However, core inflation has remained stable and low. A combination of factors has limited the pass-through from headline inflationary pressures to core inflation including the competitive pressure of cheaper emerging market exports, on-going slack in labour markets containing wage bargaining, as well as the credibility of monetary frameworks serving to anchor inflation expectations.

A.24 Despite the recent oil-induced increases in headline inflation rates, headline and core inflation have declined significantly compared with previous decades. The persistence of this low inflation environment will ultimately depend on the continued credibility of monetary frameworks maintaining inflation expectations at low rates; but the degree of competitive pressures being brought to bear by emerging economies, as they move up the value added chain, will be an important influence in the medium term.

Forecast issues and risks

A.25 Some risks to the world economic outlook have intensified since the time of Budget 2005. The further significant rise in oil prices has fed through to both producer and consumer price inflation, and world imbalances have widened, adding to the downside risks. In addition, increasing protectionist sentiment in some advanced economies, stemming from rising competitive pressures from emerging economies, could have an adverse influence on policy. There is also a continued need to secure long-term fiscal sustainability, in view of ageing populations, in both advanced and some key emerging economies.

A.26 Rising US interest rates could reduce global demand growth, and increase financing costs for emerging markets. However, by maintaining prudent fiscal and monetary policies, the main emerging markets are relatively well placed to support economic growth and stability if external conditions deteriorate.

A.27 There are also upside risks, particularly relating to the strength of growth and underlying momentum in emerging markets, which have outperformed projections made in Budget 2005. In addition, US growth continues to remain resilient and it is possible that it will continue at a robust pace for longer than expected. Nevertheless, the imbalances within the US economy clearly present downside risks to the international outlook.

A.28 A key uncertainty relates to energy markets. But to the extent that oil prices do reduce future growth, and therefore lower the rate of expansion in demand for oil, then that itself would act to ease market pressures on prices.

UK ECONOMY

Overview of recent developments

A.29 The Government's macroeconomic framework has continued to deliver an unprecedented period of sustained and stable economic growth with low inflation. UK GDP has now expanded for 53 consecutive quarters. On the basis of quarterly national accounts data, this is the longest unbroken expansion since records began 50 years ago. Moreover, the current economic expansion has persisted for well over twice the duration of the previous period of unbroken growth, with output having grown by 25 per cent since 1997. The potential role of macroeconomic stability in raising the economy's trend rate of growth is discussed in Box A2.

A.30 There have been three significant developments affecting the outlook for GDP growth since Budget 2005: significant statistical revision to the quarterly profile of growth, external shocks such as higher oil prices and weaker demand growth in the euro area, and some weakness in domestically generated demand growth.

A.31 Extensive revisions to the UK national accounts were published by the Office for National Statistics (ONS) in the 2005 Blue Book dataset on 30 June. The inevitability of revisions is discussed in Box A3. While GDP growth rates in 2001, 2002, 2003 and 2004 have all been revised up, the quarterly profile of growth through the course of last year now looks very different. Quarterly GDP growth is now estimated to have slowed from over 1 per cent in the first quarter of 2004 to just 0.3 per cent by the third quarter. The previous vintage of data had shown less strong growth through the year to early 2004, and a far less pronounced slowdown in the course of 2004. These 2004 data revisions since Budget 2005 arithmetically deduct almost $^1/_2$ percentage point from forecast growth for 2005 as a whole for any given quarterly growth path through 2005. Box A3 includes an explanation of how these revisions to past quarterly data affected the forecast future annual growth rate.

A.32 Other evidence, such as private business survey indicators as well as labour market data, point to a less sharp slowing of growth around the middle of 2004, with a more even distribution of growth throughout the year. The distribution of growth in 2004 now looks particularly skewed, with strong above-trend growth in the first half followed by significantly below-trend growth in the second half.

Box A2: Stability, economic growth and living standards

The UK economy is experiencing an unprecedented period of sustained and stable economic growth. Macroeconomic stability can lead to higher living standards:

- **reduced fluctuations in output around trend will raise living standards because individuals tend to prefer a steady stream of goods and services over time rather than a highly uneven consumption path;[a]**
- **lower amplitude inflationary cycles will lead to clearer relative price signals with prices closer to their market clearing levels, which should lead to better resource allocation and therefore a sustained higher level of output; and**
- **greater macroeconomic stability may improve the quality and quantity of investment and so lead to higher economic growth. If sustained over a number of years, even a small increase in the average rate of growth can lead to a large improvement in living standards.**

The quality of investment may improve as a result of increased stability.[b] It is likely that firms overestimate the prospective profitability of investments at the peak of the economic cycle, and underestimate it at the trough. Thus a smoother output path and smoother investment should raise the average return on investment, which in turn would raise economic growth. This would apply even if the average level of investment were to stay the same over the cycle. Moreover, there are reasons to believe that the quantity of investment may also rise as a result of increased stability. The substantial economic literature on adjustment costs (which includes, for example, costs associated with installing machinery and training employees) offers another explanation for this relationship.

Evidence from cross-country comparisons[c] suggests that countries with higher GDP volatility have lower average economic growth rates, even after taking account of other drivers of growth such as education, the initial level of GDP per capita, the average population growth rate and, importantly, the average level of investment. This provides support for the view that the link between volatility and growth is not only via the quantity of investment, but also through the quality of investment.

[a] Estimates of these types of benefits are generally small. Influential analysis by Lucas, (Lucas, R. E. Jr, (1987), *Models of Business Cycles*, Yrjö Jahnsson Foundation, Yrjö Jahnsson Lectures, Basil Blackwell) concluded that the costs of fluctuations in aggregate consumption were "negligible" compared to the benefits associated with even a small increase in the economic growth rate.

[b] See Barlevy, G., *The cost of business cycles under endogenous growth*, American Economic Review 94(4): 964-990.

[c] Ramey, G. and Ramey, V. A., *Cross-country evidence on the link between volatility and growth*, American Economic Review 85(5), 1138-51.

[d] Kose, M. A., et al *Growth and volatility in an era of globalisation,* IMF Staff Paper, Vol. 52.

[e] Aghion, P., et al *Volatility and growth: credit constraints and productivity-enhancing investment*, NBER Working Paper Series, No 11349.

A.33 The latest GDP data suggest that the economy entered 2005 with considerably less momentum than implicit in the Budget 2005 forecast. Moreover, growth is currently estimated to have remained significantly below its estimated trend rate (of around 0.7 per cent a quarter) in the first three quarters of 2005. GDP rose by 0.3 per cent in the first quarter, 0.5 per cent in the second quarter, and 0.4 per cent in the third quarter.

A.34 Non-oil GVA, which is the basis for Treasury estimates of trend growth, rose slightly more than total GDP in the third quarter, growing by 0.6 per cent on the quarter. This wedge between GVA and non-oil GVA growth reflects a particularly sharp drop in oil and gas production in the late summer, resulting from delayed maintenance work and the effects of a fire at BP's Schiehallion field which shut in some 100,000 barrels per day of production for three weeks in August.

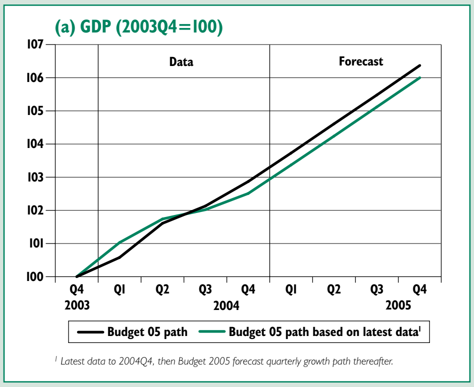
Box A3: Revisions to the UK national accounts

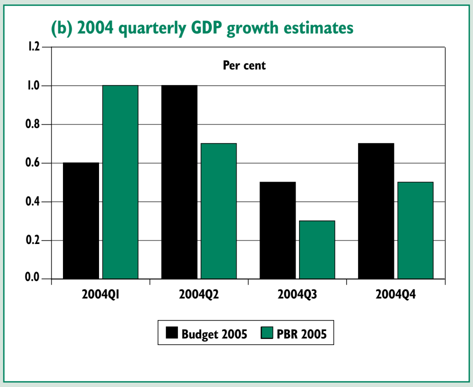
As noted by the Statistics Commission,[a] "For most economic statistics, revisions are the norm." When producing data, the ONS faces a trade-off between timeliness and accuracy in its reporting on the economy. As a result, and as is the case for all advanced economies, statistics are frequently revised, sometimes for many years after the period to which the data relate, because:

- new and more comprehensive data become available over time;
- improvements to statistical methodologies are introduced; and/or
- there are other unavoidable reasons, such as the correction of errors.

In practice, errors are rarely the source of data revisions, with increased data availability and methodological advances by far the more important reasons why statistics change. Less than 50 per cent of the preliminary, or 'month one', ONS estimate of GDP is based on statistical data sources, with the remainder comprising projections. Even by the 'month three' estimate, the compilation still includes around a fifth of projected values, which are only replaced with actual data once the annual statistical sources become available. In addition, the balancing of output, income and expenditure data in the national accounts through the supply-use process with benchmark data from the Annual Business Inquiry typically leads to further revisions.

In order to enhance the transparency of the revisions process, the ONS publishes revisions triangles to provide users with a clear means of tracking the evolution of estimates and revisions over time. On average, ONS revisions to UK GDP have tended to be upwards in recent years. Since 1993, the evidence points to quarter-on-quarter GDP growth on average being revised up between the first and latest estimate by almost 0.2 percentage points. As an illustration, GDP growth in 1999 was estimated at 2 per cent at the time of Budget 2000, whereas now it is estimated at 3 per cent.





Revisions to past quarterly data can change the immediate future forecast annual growth rate for any given future quarterly growth path, as happened to forecasts of GDP growth for 2005 as a whole when the ONS recently revised the profile of past quarterly GDP data during 2004. The revisions left the average level of GDP in 2004 unchanged, but lowered the level in the fourth quarter by almost ½ percentage point, thereby knocking the same amount off forecast growth for 2005 as a whole for any given quarterly growth profile through the year. Chart (a) illustrates.

[a] *Revisions to Economic Statistics*, Statistics Commission Report No. 17, April 2004.

A.35 Unexpected rises in oil prices, with Brent crude prices reaching new record highs in September of $67 a barrel, have boosted inflation and had a negative impact on growth of demand and output. The stronger than expected rise in inflation over the past year, alongside weaker than expected and below-trend rates of GDP growth, is consistent with the view that the UK economy has experienced a negative supply-side shock as a result of the sustained increase in oil prices, as discussed in Box 2.5. At the same time, demand in the euro area – which accounts for around 50 per cent of UK exports – has continued to grow at relatively subdued rates, significantly depressing UK export markets growth compared to expectations at the time of Budget 2005.

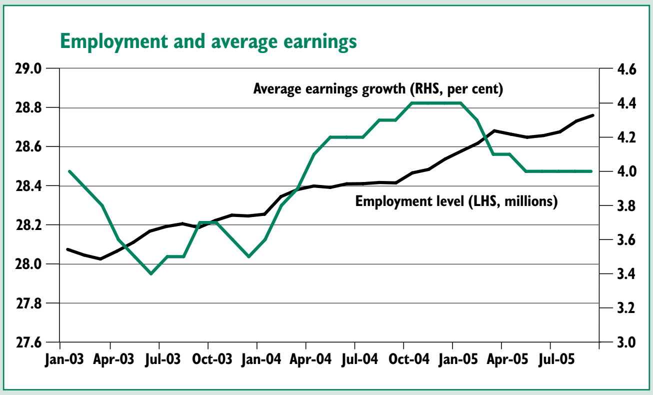
A36 In addition to these external shocks there has also been some weakness in domestically-generated demand growth. In particular, average earnings growth has been slower than expected, which has further reduced spending power. At a time of a slowdown in house price growth, this slower earnings growth has further contributed to the slowdown in consumption growth.

A.37 Against the backdrop of a strong world economy and above-trend UK GDP growth in late 2003 and into 2004, the independent Monetary Policy Committee (MPC) of the Bank of England pre-emptively raised interest rates by 25 basis points on five occasions between November 2003 and August 2004. With UK GDP growth dipping below trend, the MPC reduced the repo rate by 25 basis points on 4 August. The 125 basis point increase in the repo rate, together with the slowdown in house price inflation, despite no surprises on either score relative to what was known or expected at Budget 2005, may also have contributed to the unforeseen slowdown in GDP growth by having a somewhat more pronounced impact on the economy than envisaged. A slightly expansionary fiscal stance supported the economy as output moved back towards trend in early 2004. In 2005-06 and 2006-07 there is expected to be a modest tightening in the impact of fiscal policy, with the effect of the tighter fiscal stance just outweighing the effect of the automatic stabilisers.

A.38 UK employment has continued to rise strongly, as the Government's supply-side reforms, described in full in Chapter 4, help create a more dynamic and flexible labour market. Further strong growth in the population of working age has been readily translated into employment, with only a very small rise in unemployment. The level of employment increased by $1^1/_4$ per cent in the year to the third quarter of 2005, the strongest rise in 18 months, with the employment rate steady over the past year or so. Despite robust employment growth, average earnings growth has been lower than expected. Labour market developments are discussed in more detail in Box A4.

Box A4: Labour market developments

The labour market is performing strongly, with employment growing robustly and more people in work than ever before. The unemployment rate remains close to historic lows and inactivity levels have begun to decline. At present, there are no signs of incipient inflationary wage pressures.



Employment increased by over 300,000 (1¼ per cent) during the year to the third quarter of 2005, and by over 120,000 in the third quarter alone. There has been an even greater increase in the number employed on a full-time basis, and employees have accounted for most of the increase. This substantial increase in full-time employees may reflect businesses confidence in long-term economic prospects.

A striking feature of recent developments is that strong increases in the population of working age have been absorbed into employment, with the unemployment rate relatively stable, unlike during the mid-1980s when similarly strong population growth showed up mainly in a protracted rise in the unemployment rate. Over the past year, the working-age population has increased by 270,000, driven primarily by net inward migration (though the data exclude foreign workers temporarily in the UK for less than a year). These developments provide evidence of how higher levels of migration can be associated with higher levels of employment and enhance the long-term supply of potential of the economy.

The strong increase in job creation, low rates of unemployment and increases in living costs due to higher energy prices have not led to higher wage demands. Average earnings growth has come down to just under 4 per cent recently, after moderating from nearly 4½ per cent at the end of last year. Firms have been able to resist higher wage growth and even share some of the burden of higher costs with employees. This is in marked contrast to episodes in the past when energy shocks and low unemployment have led to inflationary pay pressures. As well as being the result of credibility in the Government's macroeconomic framework, there is growing evidence that increasing integration with the rest of the world is influencing labour market behaviour. International trade ensures competitive pressures from overseas suppliers and migration creates more flexible labour supply. It is too early to identify the relative importance of these factors.

Trend growth and the output gap

A.39 The Treasury's neutral estimate of the economy's trend output growth rate for the 2005 Pre-Budget Report is 2¾ percent a year to the end of 2006, slowing to 2½ per cent thereafter due to demographic effects, unchanged from Budget 2005.

A.40 Table A2 presents historical estimates of trend output growth and its decomposition for the first half of the current cycle and also for the previous cycle. It also presents the forward-looking assumptions for trend growth based on projections of its components for the current phase of the cycle and beyond.

Table A2: Contributions to trend output growth[1]

	Estimated trend rates of growth, per cent per annum					
	Trend output per hour worked[2, 3]		Trend average hours worked[3]	Trend employment rate[3]	Population of working age[4]	**Trend output**
	Underlying	Actual				
	(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 and Budget 2005	2.70	2.50	–0.43	0.41	0.58	**3.06**
PBR 2005	2.79	2.59	–0.44	0.42	0.58	**3.15**
Projection[5]						
2001Q4 to 2006Q4						
Budget 2002	2.10	2.00	–0.1	0.2	0.6	**2¾**
Budget /PBR 2003 Budget/PBR 2004 and Budget 2005	2.35	2.25	–0.1	0.2	0.5	**2¾**
PBR 2005	2.25	2.15	–0.2	0.2	0.6	**2¾**
2006Q4 onwards						
PBR 2004 and Budget 2005	2.35	2.25	–0.1	0.2	0.3	**2½**
PBR 2005[6]	2.25	2.15	–0.2	0.2	0.4	**2½**

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

[4] UK resident 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 2005Q3 are anchored.

A.41 Official estimates of the UK population in 2004 and 2005 have been revised up recently. The estimate of working-age population in mid-2005 is now 121,000 higher than previously reported. This increase is at least in part due to higher net inward migration flows than previously projected by the Government Actuary's Department (GAD). In light of this, GAD has revised up its new projections, particularly up until 2008. This is driven partly by assumed inflows from the eight Central and Eastern European accession countries (A8) which joined the European Union in May 2004. GAD's principal projection for net inward migration to the UK incorporates the assumption of an extra 150,000 migrants from the A8 countries in the first three years following accession.

A.42 The upward revisions to the ONS population estimates and to the GAD projections point to a somewhat higher rate of growth of the working-age population component of trend output growth than assumed in the Budget 2005 projection. This is reflected in a 0.1 percentage point upward revision shown in Table A2 which, other things equal, would suggest a faster trend rate of output growth. However, the evidence is not firm enough at this stage of the cycle to change the overall projection. Thus, for the sake of arithmetical consistency and in the interests of caution, small offsetting adjustments have been made to the output per worker component of the overall projection, leaving trend output growth unchanged at $2^3/_4$ per cent. The Treasury will continue to keep its estimates of trend output under review.

A.43 The recent significant revisions to non-oil GVA data released by the Office for National Statistics in June, supported by new data on market sector GVA, led the Treasury to revise its provisional judgement that the current cycle started in mid-1999. The Treasury's revised judgement is that the current economic cycle began in the first half of 1997, rather than in 1999. This assessment was set out in *Evidence on the UK economic cycle* published by the Treasury in July 2005, and is discussed in Box A5. Chapter 2 reports the NAO's audit of the Treasury's revised judgement that the current cycle started in 1997. This revised assessment does not have implications for the output gap profile during the current down-phase of the cycle, because the assessment of the third quarter of 2001 as the latest on-trend point and the projection for trend output growth thereafter remain unchanged.

A.44 In contrast, revisions to non-oil GVA growth data between the last adjudged on-trend point in 2001 and the end of 2004 and weaker than expected growth in the first three quarters of 2005 have affected the profile of the implied output gap in the current phase of the cycle, compared with the assessment made at the time of Budget 2005. A narrower output gap in both 2003 and 2004 is now implied, with the economy coming close to trend in the first half of 2004. Downward revisions to growth in the second half of 2004 coupled with weaker than forecast growth in the first three quarters of 2005 imply a widening of the output gap to around minus $1^1/_4$ percent by the third quarter, in contrast to the Budget 2005 forecast which projected a further narrowing of the gap.

Box A5: Evidence on the UK economic cycle

Estimation of the economy's trend growth and cyclical position is central to the Treasury's assessment of economic prospects and the setting of fiscal policy. In June 2004, the ONS published significant revisions to GDP and Gross Value Added (GVA) dating back to 1996. Around the same time the ONS also published an experimental series for market sector GVA, which provides an alternative basis for measuring the economic cycle. In response to this new information, in July 2005, HM Treasury published a paper, *Evidence on the UK economic cycle,* presenting analysis of evidence relevant to the dating of the economic cycle.

At the time of Budget 2000, the Treasury made the provisional judgement that the economy may have completed a full cycle between 1997H1 and mid-1999. This judgement was provisional because the cycle was clearly indistinct by historical standards. Subsequent data revision up until Budget 2005 continued to show only an indistinct dip below trend in 1999, so this judgement remained provisional.

The revisions to GVA published by the ONS in June included a significant upward revision to 1999 GVA growth of 0.5 percentage points, with non-oil GVA growth in 1999 revised up to 3.1 per cent, from 1.8 per cent estimated at the time of Budget 2000. This significantly changed the profile of the economic cycle around 1999. There is now no evidence of a clear dip below trend in early 1999. So the below-trend phase of the previously identified 1997H1 to mid-1999 'cycle' now looks non-existent.

Chart (a): Whole economy GVA output gap estimates and data revisions

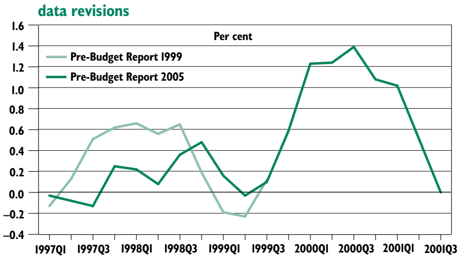
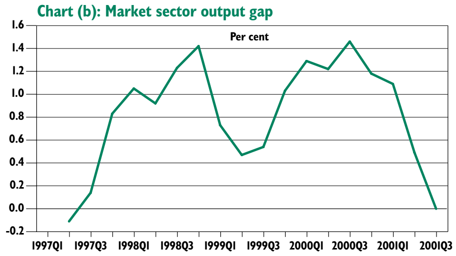


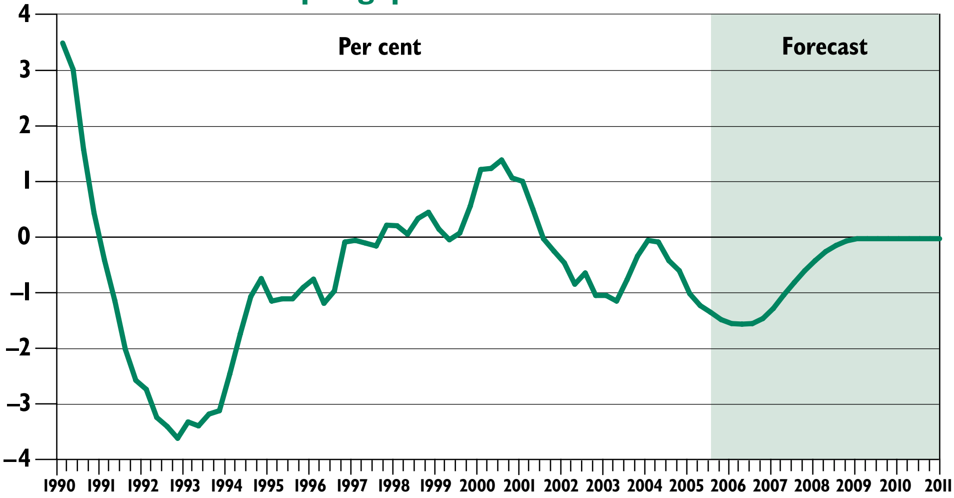
Chart (b): Market sector output gap



New market sector GVA data also released by the ONS in June 2005 reinforce the view that mid-1999 was not an end or start point of the economic cycle. As discussed in Budget 2005, market sector output may provide a better basis than whole economy output for measuring the output gap, because cycles are essentially a feature of the market sector. On the basis of these new market sector GVA data, output did not touch trend in 1999, remaining notably above trend throughout the period from the end of 1997 through to early 2001. New analysis by the Treasury of data on the labour share of value added offers further evidence on the dating of the latest cycle.

In conclusion, the recent revisions to GVA provide significant new information on the timing of the economic cycle since 1997. This evidence shows that while the economy was close to trend in 1999, this was not a period when the economy could be judged to have been at the end of a cycle or the beginning of a new one. Therefore, the Treasury's revised judgement, based on this new evidence, is that the current economic cycle began in the first half of 1997, rather than in 1999. This conclusion is corroborated by new data from the ONS for market sector GVA and new analysis of the labour share of value added.

Chart A3: The output gap[1]



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

A.45 There are a number of uncertainties surrounding the current output gap estimate implied by latest data and the trend growth assumptions. The profile of output growth over the past two years or so shown by the latest national accounts data is not easy to rationalise. In particular it remains to be explained why output should have grown so strongly during the second half of 2003 and early 2004 (by about 1 per cent a quarter), or why it should have slowed to the extent shown by the data in mid-2004. Moreover, private sector business surveys tend to suggest that output growth over the past year or so may have been slightly stronger than recorded by the national accounts data. Indeed, the history of national accounts data revisions points to the expectation that in due course there will tend to be some upward revisions to latest estimates of GDP growth over recent quarters. Evidence since the early 1990s suggests that on average initial estimates of four-quarter GDP growth can be expected eventually to get revised up by about $^3/_4$ percentage points.

A.46 Average earnings growth offers support for the assessment of a sizeable negative output gap at present. While CPI inflation is currently above target, buoyed by oil prices, average earnings growth during 2005 has been lower than expected, consistent with a wider than expected negative output gap. Several factors might have influenced this, including slower than expected demand growth or positive effects on potential output, perhaps, for example, from growth in UK labour supply being under-recorded. At least part of the explanation could also be that earnings growth has adjusted down for any given output gap in the face of higher oil prices, with the UK's flexible labour market allowing pressure on profit margins to be channelled back into downward pressure on wages, instead of forward into upward pressure on prices and loss of output to international competition. The possibility that such features of labour market flexibility may partly account for recent favourable employment and earnings outcomes is discussed further in Box A4.

A.47 On the basis of more conventional wisdom, the rise in oil prices since early 2004 may have been expected to boost wage pressures and raise production costs, and so tended to impact adversely on the productive potential of the non-oil economy, as discussed in Box 2.5 However, the evidence of unexpectedly positive labour market outcomes at least points to flexibility reducing the extent to which high oil prices may threaten output growth and the anchoring of inflation expectations.

A.48 Estimating the output gap in terms of market sector non-oil GVA tends to suggest a somewhat narrower gap than when estimated on a whole economy basis. Compared with the half cycle between 1997 and 2001, the stronger growth of public relative to private sector employment may have slowed the growth in labour supply to the private sector enough to have kept the economy somewhat closer to trend than implied by the output data and the trend growth assumptions. Since 2001, although public sector employment has risen by less than private sector employment, it has grown at a rate of about three times faster than the assumed trend rate of growth of whole economy employment (of 0.7 per cent), whereas between 1997 and 2001 it fell marginally short of the whole economy trend. Measuring the output gap in terms of market sector GVA is discussed further in Box A6.

A.49 A range of inferences about the recent evolution of slack in the economy can be drawn from labour market information. Increased estimates of population growth and related labour supply measurement issues point to an uncertain but sizeable negative output gap, consistent with the data on average earnings. However, the employment rate remains slightly above its rate in mid-2004; and the unemployment rate has been virtually flat over the past year or so. In contrast, given the measured rates of output growth over this period, firms might have been expected to have adjusted their labour demand accordingly, implying a significant fall in the employment rate and a significant rise in the unemployment rate. Nevertheless, if firms have been hoarding labour in expectation of only a short-lived slowdown in the economy, then the labour market and output data would be more readily reconcilable.

A.50 Private sector business survey indicators of capacity utilisation and recruitment difficulties support the assessment of a widening negative output gap in recent quarters. However, when the cyclical indicators used for the dating of on-trend points have previously been around current levels, the output gap has typically been somewhat narrower than currently estimated. The indicators used by the Treasury to date on-trend points are set out in the *Technical note on cyclical indicators*.[5]

Box A6: Estimating the output gap and trend output

Budget 2005 and *Evidence on the UK economic cycle* (HM Treasury, 2005) discussed the treatment of government output in estimating the output gap and trend output growth. Since the output gap should measure fluctuations arising from the business cycle, it may be better measured by private or market sector output, rather than whole economy output.

In July 2005, the ONS released an experimental series for market sector non-oil GVA, extending back to 1995, and a measure of the output gap using these data was reported in *Evidence on the UK economic cycle*. However, data limitations imply that it is not yet appropriate to move to estimating the output gap and trend output growth on a market sector only basis.

As explained in *Trend growth: recent developments and prospects* (HM Treasury, 2002), the Treasury's methodology for projecting the productivity (output per hour) component of trend output growth is based on estimates of underlying productivity growth over the recent past. Thus a market sector based approach would require data on market sector productivity for the recent past. The ONS is currently considering producing a measure of market sector productivity - both on an output per worker and an output per hour basis. However, it is not expected to do so until next year, the main constraint being an appropriate measure of private or market sector hours worked. The Treasury will keep under review the issue of whether to switch to a market sector based approach to estimating the output gap and trend output growth.

[5] http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr05/assoc_docs/prebud_pbr05_adnao.cfm

A.51 Together these factors provide evidence to suggest that recent economic data are not easy to interpret overall, with different indicators tending to point in differing directions and proving less easy to reconcile than usual. So considerable uncertainty surrounds estimates of the current output gap. The public finance projections continue to be based on a deliberately cautious annual trend growth assumption that is 1/4 percentage point lower than the neutral view.

Summary of prospects

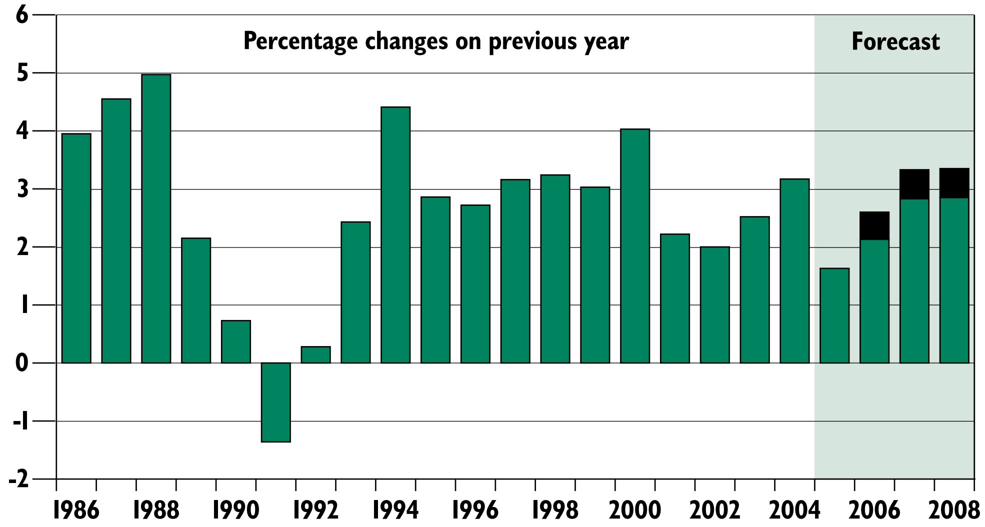
Table A3: Summary of forecast[1]

		Forecast			
	2004	2005	2006	2007	2008
GDP growth (per cent)	3 1/4	1 3/4	2 to 2 1/2	2 3/4 to 3 1/4	2 3/4 to 3 1/4
CPI inflation (per cent, Q4)	1 1/4	2 1/4	1 3/4	2	2

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

A.52 Sound macroeconomic fundamentals continue to support growth and stability in the UK, helping the economy to remain far more resilient to challenges and shocks than it has in the past. However, with the economy facing the largest oil price shock since the 1970s, alongside continued weak growth in the UK's main export markets, growth is likely to remain below trend in coming quarters. This is consistent with forward-looking indicators which suggest that growth has remained relatively muted since the third quarter, albeit having firmed a little since the summer.

Chart A4: Gross Domestic Product



A.53 UK GDP is now expected to rise by 1 3/4 per cent in 2005 as a whole. Growth in 2006 as a whole is forecast to remain at below-trend rates of between 2 to 2 1/2 per cent. This reflects the continued drag on real household incomes arising from high oil prices, together with the ongoing effects of subdued earnings growth, acting to keep growth of private consumption at relatively moderate rates. The effects of oil prices on business confidence, together with subdued demand growth, are also expected to encourage the corporate sector to remain cautious about stepping up business investment growth in the short term. Export growth is expected to increase only slightly on 2005.

A.54 Further ahead, as the effects of oil price rises on real household income growth wane, private consumption growth should firm a little, although remaining at rates below recent peaks and growth in the economy as a whole. As uncertainty regarding oil prices recedes, and with corporate fundamentals sound, companies should be well placed to undertake firmer growth in investment spending as demand accelerates in 2007. Growth in UK export markets should also be stronger from 2006. As a result, GDP growth is forecast to be above trend rates at between 2¾ and 3¼ per cent in both 2007 and 2008, with spare capacity being absorbed and the output gap closing in 2008-09.

A.55 CPI inflation is expected to remain a little above target in the short term as a result of the continued effects of rises in oil prices and increases in import prices. However, as the direct effects of oil price rises abate, the drag on domestic inflation from continued slack in the economy should become more dominant, bringing inflation back to a little below target later in 2006. As the output gap narrows and import prices continue to rise, inflation is forecast to rise back to its 2 per cent target in 2007.

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

	Percentage points unless otherwise stated				
		Forecast			
	2004	2005	2006	2007	2008
Private consumption	2½	1¼	1½	1¾	1¾
Business investment	¼	¼	¼	½	½
Government	¾	½	¾	¾	¾
Change in inventories	0	0	0	0	0
Net trade	–¾	–¼	0	0	0
GDP growth, per cent	**3¼**	**1¾**	**2¼**	**3**	**3**

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

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

UK DEVELOPMENTS AND PROSPECTS IN DETAIL

Demand

A.56 Nominal private consumption has continued to drift down as a proportion of money GDP. In the third quarter of 2005, it accounted for around 65¼ per cent of nominal GDP, its lowest for seven years and significantly down on the peak of 67 per cent reached four years earlier.

A.57 Real private consumption growth is estimated to have slowed sharply from the middle of 2004, with four-quarter growth falling from a rate of almost 4 per cent towards the end of last year to just 1.6 per cent by the second quarter of 2005. A number of expected and unexpected developments have contributed to this slowdown.

A.58 The slowdown in the UK housing market since mid-2004 has been much as expected, and households have continued to adjust to high levels of personal debt by paying off borrowing and maintaining saving rates.

A.59 However, relative to the Budget forecast, the sustained and unexpected rise in oil prices has had the effect of raising consumer prices and thus reducing real household income growth, with a direct estimated impact on real income growth in the year to mid-2005 of up to 0.5 percentage points. In addition, uncertainty regarding future oil prices may have also served to dampen consumer confidence in recent months, further adversely affecting household expenditure growth. At the same time, average earnings growth has turned out lower than expected, also reducing households' spending power. In the year to the third quarter of 2005, average earnings rose by only just over 4 per cent on a year earlier, compared with the average of independent forecasts at the time of the 2005 Budget of $4^1/_2$ per cent for the year as whole.

A.60 Private consumption is expected to pick up slightly as the lagged effects of previous rises in oil prices diminish, and growth in real household disposable income picks up, although in 2006 oil prices are still expected to exert a drag and earnings growth is expected to remain subdued. So following growth of $1^3/_4$ per cent in 2005, private consumption is forecast to grow by $1^3/_4$ to $2^1/_4$ per cent next year, by $2^1/_4$ to $2^3/_4$ per cent in 2007 and by $2^1/_2$ to 3 per cent in 2008, below GDP growth in each year of the forecast.

A.61 Nominal government consumption rose by over 6 per cent in the year to the third quarter of 2005. However, growth in real government consumption is presently estimated to have been much weaker, rising $1^1/_2$ per cent over the same period, implying only a small contribution to GDP growth, although the reliability of the data on the price-volume split will not be assured until the recommendations of the Atkinson Review are fully implemented. Real government consumption is forecast to rise by 2 per cent in 2006, up from $1^1/_2$ per cent in 2005, accelerating to $2^1/_2$ per cent in both 2007 and 2008.

A.62 Business investment growth is estimated to have been relatively subdued in recent quarters, although early estimates are prone to large revisions. Over the first three quarters of 2005 business investment was 3 per cent up on a year earlier. In the UK, ongoing weak demand growth in the euro area has dampened demand for UK exports which, alongside muted private consumption expenditure growth, is likely to have encouraged the corporate sector to postpone capital spending decisions. Moreover, corporate gearing remains at historically high levels so, despite strong profitability, continued balance sheet concerns may also have motivated companies to continue adopting a cautious approach to investing, as is happening in a number of advanced economies.

A.63 Business investment data are notoriously volatile and subject to extensive revisions for a number of years after the data period, and there have been some signs from private business survey evidence in recent quarters that underlying growth of business investment has been somewhat stronger than official estimates presently suggest. Strong profitability amongst private non-financial corporations (PNFCs) – both within and outside the oil sector – also contrasts with recent rates of business investment growth, with non-oil PNFCs' rates of return in the second quarter of 2005 rising to their highest rates in five and a half years. Business investment, though, does tend to lag trends in profitability.

A.64 Below-trend GDP growth and high oil prices are expected to keep business investment subdued in the short term with growth of 3 per cent in 2005 as a whole. However, healthy rates of profitability and a benign financial environment should underpin strengthening rates of growth in private sector capital expenditure in 2006 and 2007 as companies respond to the expected acceleration of demand. So business investment is forecast to rise by 3 to $3^1/_2$ per cent in 2006 and $4^1/_2$ to $5^1/_4$ per cent in 2007.

A.65 Interpretation of recent trade data has been complicated again by Missing Trade fraud, which is now affecting non-EU countries. Partly as a result, the evolution of trade flows has been particularly erratic over the recent past. Export volumes in the third quarter of 2005 were about $5\frac{1}{2}$ per cent up on a year earlier. Imports have not grown quite as much as exports over the past year, and net trade has made a broadly neutral contribution to GDP growth over the first three quarters of 2005.

A.66 Export growth remains stronger to non-EU than EU markets. In the year to the third quarter of 2005, the volume of UK goods exports to non-EU countries grew about three times faster than goods exports to the EU, although these figures are distorted by Missing Trader fraud.

A.67 Exports of goods and services are now expected to grow by $4\frac{3}{4}$ per cent in 2005, with the shortfall compared to the Budget forecast reflecting the unexpected weakness of demand in the UK's key European export markets. In 2006 and 2007, stronger UK export markets growth is forecast to drive a pick-up in export growth to around $5\frac{1}{2}$ per cent, supported by sterling's recent depreciation. This is slightly stronger than the forecast rates of import growth.

Output

A.68 Following relatively strong growth in late 2003 and early 2004, manufacturing output lost ground in the second half of last year. Continued weak external demand from the euro-area, together with slowing growth of private consumption and business investment, are all likely to have contributed to a weakening of manufacturing activity. High global oil prices have also raised manufacturers' input costs around the world and are likely to have further constrained UK manufacturing output growth over the recent past. Global competition has intensified in recent years, reflecting the rising significance of rapidly growing emerging markets like China and India in international markets.

A.69 Manufacturing output declined in the first half of 2005, following almost 2 per cent growth in 2004. Since the spring, it has shown some signs of a gradual pick-up. Output rose for four consecutive months between April and July, the longest run of unbroken monthly growth for six years. In the third quarter as a whole, output was up by 0.4 per cent on the previous quarter.

A.70 Business survey evidence of manufacturing conditions has been mixed in recent months. The Chartered Institute of Purchasing and Supply (CIPS) Report on manufacturing for November showed the Purchasing Managers Index remained at robust levels, with output growth at its highest for a year. However, both the CBI quarterly Industrial Trends Survey and the British Chambers of Commerce (BCC) survey for the third quarter pointed to weaker growth of manufacturing activity although, in common with the CIPS survey, they have signalled some pick-up in export demand. At the regional level, evidence from the CBI Regional Trends survey suggests manufacturing has been weakest in Northern Ireland, the South East and London, with output growth at its firmest in Scotland and the East Midlands.

A.71 Manufacturing output is forecast to grow by 1 to $1\frac{1}{4}$ per cent in 2006, as the effects of recent oil price rises, weak growth in key export markets and relatively modest increases in domestic demand continue to constrain output. However, as these effects unwind and consumer and investment spending gather more impetus in late 2006 and 2007, manufacturing output growth should also gain, and is forecast to rise by $1\frac{3}{4}$ to $2\frac{1}{4}$ per cent in 2007.

A.72 Service sector output growth has moderated since mid-2004. In the year to the third quarter of 2005, service sector output rose by 2.3 per cent. However, within the service sector there are some quite marked divergences between different industries, with growth in financial intermediation and real estate, renting and business activities growing at rates well above that of the sector as a whole in recent quarters. At the regional level, evidence from the BCC survey for the third quarter of 2005 suggests that service sector activity balances were in positive territory in most regions.

Inflation

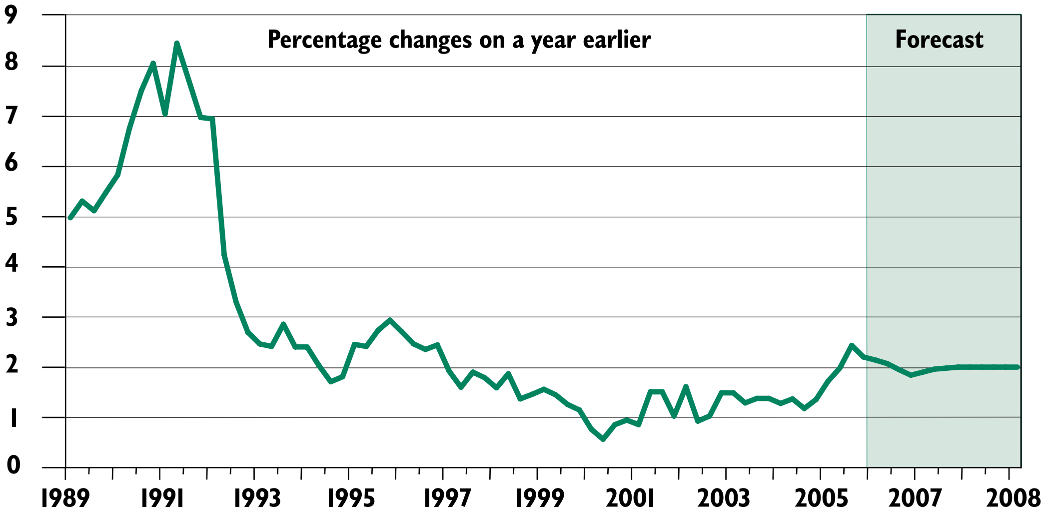
A.73 CPI inflation rose gradually from autumn 2004 through to September 2005, primarily reflecting the effects of higher oil prices on domestic fuel and energy prices, which directly accounted for over half of the increase in inflation. Core inflation, which excludes energy prices and the volatile food component of the CPI, has remained at lower rates, although has still shown some pick-up through the course of this year, possibly in part reflecting the indirect effects of oil prices working their way through the supply chain. CPI inflation peaked at 2.5 per cent in September, up from 1.9 per cent at the time of the 2005 Budget. It eased back in October to 2.3 per cent. The pick-up in UK CPI inflation over the past year is similar to that seen in other major economies and UK inflation remains close to the European average.

A.74 Overall inflation rates conceal divergences between domestic and external sources of pricing pressures. Import prices have picked up briskly since early 2004, boosted by higher oil prices. Even excluding oil prices, import price inflation has firmed on the back of strong global demand growth over the recent past, with non-oil goods import prices rising at their fastest rates for four years through much of 2005, and imported material prices rising at rates of over 5 per cent in recent months. At the same time, domestically generated inflation has remained muted, reflecting the downward pressure from a continued negative output gap and the success of the Government's macroeconomic framework in anchoring inflation expectations.

A.75 The differential between RPIX inflation, the previous basis for the inflation target, and CPI inflation fell to zero in September for the first time since 1996, the start date for the official monthly CPI. This reflects the continuing downward effect on the housing component of RPIX from the easing in house price inflation, together with a further narrowing in the gap due to the use of different weights in the two indices.

A.76 High oil prices have a proportionately larger impact on producer than consumer prices. Both manufacturing output and input price inflation eased in October, but only after input price inflation had peaked at over 10 per cent in the year to September. Petroleum input prices were up over 40 per cent over this period, accounting for around a half of overall input price inflation. Producer output price inflation has remained considerably lower, fluctuating within a $2^1/_2$ to $3^1/_2$ per cent band over the past year or so and falling from 3.3 per cent in September to 2.6 per cent in October. These developments will have squeezed manufacturers' margins, as indicated by private sector business survey evidence. Corporate services price inflation has also risen, reaching 3.8 per cent in the year to the third quarter, up from 2.2 per cent a year earlier and the highest rate of price growth since 1996, when the index starts.

Chart A5: CPI[1]



[1] Outturns until 2005Q3; forecasts for every second quarter from 2005Q4 to 2008Q4.

A.77 Despite high oil prices feeding through to consumer prices, inflation expectations remain firmly anchored close to rates consistent with the symmetric 2 per cent CPI inflation target. This reflects the credibility of the Government's monetary policy framework.

A.78 Average earnings growth so far in 2005 has been lower than expected, and remained well below the range judged to trigger upward inflationary risks, as discussed in Box A4. Average earnings, either including or excluding bonuses, grew by less than 4 per cent in the 12 months to September, and the rate excluding bonuses has been broadly flat throughout the year to date, staying close to 4 per cent.

A.79 In the past, periods of strong house price growth have been followed by periods of sharp falls in prices, for example in the mid-1970s and early 1990s, accompanied by economic recession. By contrast, after the strong house price growth over recent years, prices have moderated sustainably as expected, stabilising between the middle of 2004 and spring 2005, before edging up more recently. The economy has continued to grow throughout this period. There are important differences between the current environment and past historical experience, which mean the risks of a protracted decline in house prices in the current cycle are far lower. There is significant evidence that the increase in house prices in recent years has been driven, at least in part, by a number of fundamental factors. For example: households have benefited from rising employment and robust income growth; the macroeconomic environment is much more stable, with low inflation and interest rates, supporting higher borrowing levels and giving people the confidence to enter the housing market; the housing market is characterised by constrained supply conditions; demographic change has led to smaller households and increased demand for homes; and affordability measures for first-time buyers show that the average loan-to-value ratio is the lowest for 25 years, further attracting people into the market.

A.80 There have been some signs of a modest strengthening in underlying house prices of late, with both the Halifax and the Nationwide reporting some pick-up in the three-month on three-month rate of house price inflation in recent months, consistent with the recent recovery in mortgage approvals and housing market transactions. At the regional level, the slowdown in house price inflation has been most apparent in the South East, South West and outer metropolitan London over the past year, although on the basis of the Nationwide index only the South East has seen absolute falls in prices.

A.81 CPI inflation is expected to ease back gradually, while remaining a little above target in coming months as the effects of higher world oil prices continue to work through to consumer prices. It is then forecast to dip slightly below target later in 2006, as the effects of previous energy price rises abate and ongoing slack in the economy continues to put downward pressure on domestically generated inflation, before returning to its 2 per cent target in 2007 as the output gap narrows and import prices continue to rise. The credibility of the Government's monetary policy framework is expected to continue to contribute in keeping inflation close to target through anchoring inflation expectations.

The household sector

A.82 The 2005 Blue Book dataset revised up growth of real private consumption expenditure in each of the past three years, although GDP growth for 2004 as a whole remained unchanged. Thus the balance of recent growth has been slightly more consumption rich than previously thought.

Table A5: Household sector[1] expenditure and income

	Percentage changes on previous year unless otherwise stated				
		Forecast			
	2004	2005	2006	2007	2008
Household consumption[2]	$3\frac{3}{4}$	$1\frac{3}{4}$	$1\frac{3}{4}$ to $2\frac{1}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$	$2\frac{1}{2}$ to 3
Real household disposable income	$2\frac{1}{4}$	$1\frac{1}{2}$	$1\frac{1}{2}$ to 2	$2\frac{1}{4}$ to $2\frac{3}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$
Saving ratio[3] (level, per cent)	$4\frac{1}{4}$	$4\frac{3}{4}$	$4\frac{3}{4}$	$4\frac{3}{4}$	$4\frac{3}{4}$

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

[2] *Chained volume measures.*

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

A.83 The first three quarters of 2005 have seen the share of money GDP accounted for by nominal private consumption continue the gradual trend decline established in recent years. Since its most recent peak of close to 67 per cent in the third quarter of 2001, nominal private consumption has fallen back to around $65\frac{1}{4}$ per cent of nominal GDP, the lowest share since the final quarter of 1998, and breaking with the upward trend over the two decades or so from the late 1970s. As Budget 2005 noted, this has been associated with intensely competitive pricing in the retail sector, although more recently goods price deflation has come to an end. Rising consumer price inflation over the past year or so and the continued downward trend in nominal consumer spending as a share of money GDP go together with the weakening of growth in real consumer spending.

A.84 In recent quarters real private consumption growth has been weaker than in the first half of 2004. Private consumption rose by an average of 0.3 per cent in the first three quarters of 2005, to stand 1.6 per cent up on a year earlier in the third quarter. Although consumer confidence has fallen since the start of 2005, and now lies around its long-run average, consumers' confidence in their own financial positions has held up better than the composite measure.

A.85 A number of factors have acted to slow private consumption growth. As expected, households have continued to adjust to continued high levels of personal debt and the lagged effects of increases in interest rates between late 2003 and summer 2004. Also as expected, house price inflation has moderated to low rates, with house prices broadly flat for much of the past year and a half, which will have curtailed the opportunity afforded by rising house prices for householders to liquidate funds through mortgage equity withdrawal without reducing their proportionate equity in the housing market. Non-householders, though, may have reacted by showing less urge to increase saving for future house purchase.

A.86 In addition, unforeseen increases in oil prices have contributed to unexpectedly weak growth in real household disposable income, with the direct effects of increases in fuel bills and petrol prices estimated to have cut real income growth by up to $^1/_2$ percentage point in the year to mid-2005. Earnings growth has also remained unexpectedly subdued over the past year, as discussed in Box A4.

A.87 Recently, however, in line with more buoyant activity in the housing market, retail sales – which account for around a third of private consumption – have started to pick up, with growth in the second and third quarters of 2005 of 0.6 and 0.4 per cent a quarter respectively, following broadly flat sales in the previous two quarters.

A.88 Real private consumption growth is expected to be $1^3/_4$ per cent in 2005 as a whole. Underpinned by a strong labour market and continued domestic macroeconomic stability, private consumption growth is expected to pick up slightly in 2006, as the lagged effects of previous rises in oil prices dissipate, and growth in real household disposable income picks up. Rates of growth in private consumption are forecast to rise to $1^3/_4$ to $2^1/_4$ per cent next year and to $2^1/_4$ to $2^3/_4$ per cent in 2007.

A.89 Despite household consumption slightly outpacing disposable income, the saving ratio is expected to be broadly stable over the forecast horizon at just above its average over the recent past, reflecting the assumption that households net equity in pension funds continues to increase at recent rates.

Companies and investment

A.90 Business investment is currently estimated to have grown at relatively moderate rates in recent quarters. Following growth of $3^1/_4$ per cent in 2004 – the strongest for four years – business investment has risen modestly during 2005 to stand around 2 per cent up on a year earlier in the third quarter.

Table A6: Gross fixed capital formation

	Percentage changes on previous year				
		Forecast			
	2004	**2005**	**2006**	**2007**	**2008**
Whole economy[1]	5	$2^3/_4$	$3^3/_4$ to $4^1/_4$	$4^3/_4$ to $5^1/_4$	$4^1/_4$ to $4^3/_4$
of which:					
Business[2,3]	$3^1/_4$	3	3 to $3^1/_2$	$4^1/_2$ to $5^1/_4$	$4^1/_2$ to $5^1/_4$
Private dwellings[3]	$9^1/_2$	$^1/_4$	1 to $1^1/_4$	$2^3/_4$ to $3^1/_4$	3 to $3^1/_2$
General government[3]	6	11	$12^1/_2$	$9^3/_4$	$6^1/_4$

[1] *Includes costs associated with the transfer of ownership of land and existing buildings.*
[2] *Private sector and public corporations' non-residential investment. Includes investment under the Private Finance Initiative.*
[3] *Excludes purchases less sales of land and existing buildings.*

A.91 Weak growth in private consumption and continued weakness in the UK's key European export markets has probably encouraged companies to adopt a cautious approach to capital expenditure. The CBI Industrial Trends Survey suggests companies are continuing to focus investments on replacing capital and increasing efficiency, rather than expanding capacity. The impact of high oil prices on potential profitability is also likely to have been a factor discouraging stronger growth of private investment, especially within industries where the production process is particularly oil-intensive.

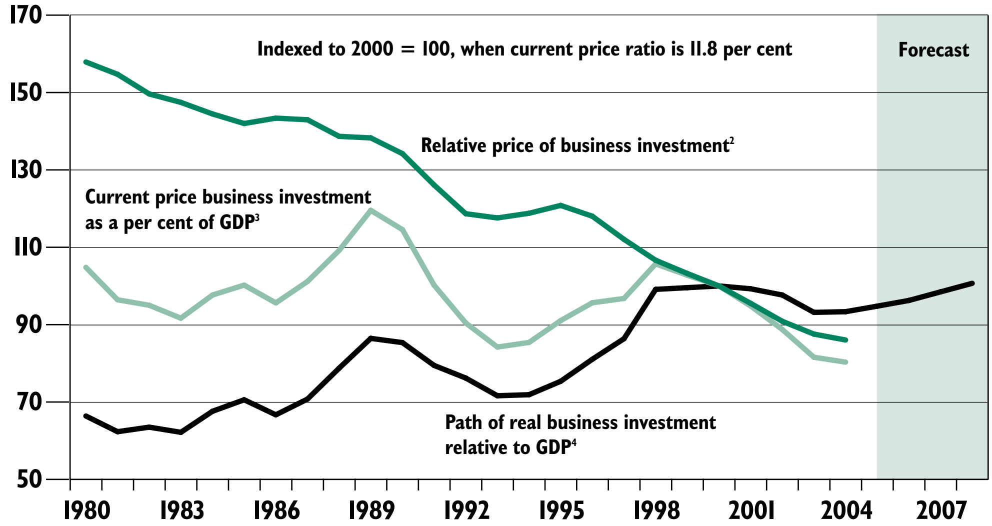
A.92 Despite evidence that companies have continued to divert resources into funding existing pension fund deficits, there are no clear grounds for supposing that this has exerted much material constraint on investment, given that the deficits tend to be concentrated amongst large companies that have ready access to external finance. Moreover, companies have consistently remained net lenders in recent quarters, although corporate gearing remains at historically high levels.

A.93 Early estimates of business investment are prone to large revisions. Muted private investment growth contrasts with strong corporate profitability. Private sector business survey evidence has pointed to somewhat stronger growth of private investment than official data. The recent pattern of business investment also contrasts with the profile of output growth, with estimated business investment growth in the first half of 2005 stronger than a year earlier when the economy was growing at rates considerably above trend.

A.94 For 2005 as a whole, business investment is expected to grow by 3 per cent, somewhat below the Budget 2005 forecast of $4\frac{1}{4}$ to $4\frac{3}{4}$ per cent. In the near term, even as uncertainties unwind, business investment is likely to be affected by slower rates of GDP growth and high oil prices. Nonetheless, with the corporate sector maintaining healthy rates of profitability, and the financial environment benign, the conditions remain in place for a somewhat stronger pick-up in business investment later in 2006 and 2007, as companies respond to an underlying acceleration of demand. Business investment growth is forecast to pick up to 3 to $3\frac{1}{2}$ per cent in 2006 and then to $4\frac{1}{2}$ to $5\frac{1}{4}$ per cent in 2007.

A.95 Government investment growth is expected to remain strong in 2006 and 2007, consistent with the Government's spending plans, at close to the 11 per cent increase expected over 2005 as a whole. As a result, whole economy investment growth is forecast to firm a little more than business investment in 2006, with growth expected to rise to $3\frac{3}{4}$ to $4\frac{1}{4}$ per cent next year from $2\frac{3}{4}$ per cent in 2005.

Chart A6: Business investment[1]



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

Trade and the balance of payments

A.96 UK trade data have been particularly erratic over the recent past and have again been distorted by Missing Trader fraud. The higher than usual degree of noise has made it very difficult to interpret the recent trade data.

A.97 Total UK export volumes of goods and services are estimated to have risen by around 5½ per cent in the year to the third quarter of 2005, following similar growth in the year to the second quarter. However, recent quarterly growth has varied a lot, with a fall of ¾ per cent in the first quarter of 2005 followed by rises of 4¼ per cent in the second and ¾ per cent in the third. This masks an erratically large increase in goods exports in June, followed by an almost identical dip in July, which boosted second quarter growth and depressed that in the third. The underlying rise in exports over the recent past is thought to have been weaker than these data suggest, partly because of the effects of Missing Trader fraud.

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]	
2004	4	6	–¾	–½	–¼	–39
Forecast						
2005	4¾	4¾	1¾	2¾	–1	–45
2006	5 to 5½	4½ to 5	1¼	1¼	0	–46¼
2007	5¼ to 5¾	4¾ to 5¼	¼	¾	–¼	–47½
2008	5 to 5½	4¾ to 5¼	¼	½	–¼	–49½

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

A.98 External demand for UK output from non-EU countries appears to have remained significantly stronger than from the EU. In the third quarter of 2005, the volume of goods exports to non-EU countries was up by around 13 per cent on a year earlier, compared with growth of only around 4 per cent for goods exports to the EU, although Missing Trader activity is likely to have distorted these patterns somewhat.

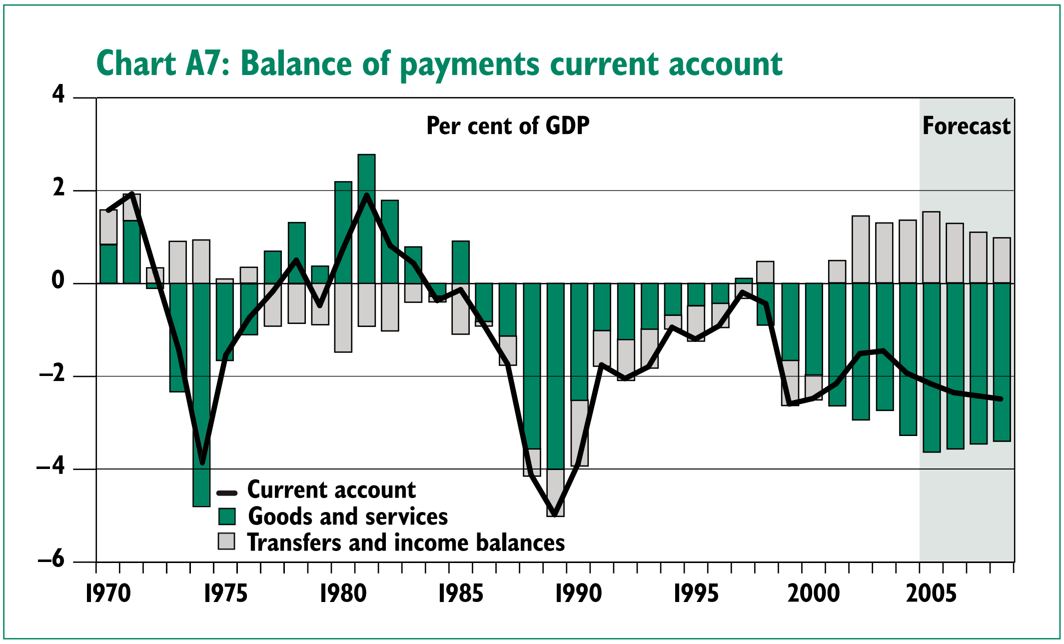
A.99 Exports of services have remained broadly flat in recent quarters, although the UK has continued to maintain a robust surplus in services trade at close to record levels. Services trade in the third quarter was distorted by the recording of insurance payments relating to Hurricane Katrina.

A.100 Since Budget 2005, there has been some depreciation of the sterling effective exchange rate. From a long-term perspective the exchange rate has continued a period of relative stability. Since the introduction of the euro in January 1999, the volatility of the sterling effective exchange rate has been under half that of the euro and under a third that of the US dollar.

A.101 The UK trade deficit in the third quarter of 2005 stood at £$12^3/_4$ bn, compared with around £$10^1/_2$ bn in the same period a year earlier. However, excluding the temporary effects of insurance payments related to Hurricane Katrina, the widening of the trade deficit was significantly smaller, by around £$1^1/_4$ bn. Despite the widening in the UK trade deficit, the overall current account deficit in the first half of 2005 was more or less unchanged on a year earlier. The UK's surplus on overseas income has continued to rise in 2005, reaching new record highs both in absolute terms and as a proportion of GDP. Growth in the income surplus partly reflects high oil prices: the UK is a net overseas investor in oil extraction and refining so higher oil prices tend to boost UK earnings by more than they enhance returns to overseas investors in the UK's own oil sector.

A.102 For 2005 as a whole, UK goods and services exports are expected to grow by $4^3/_4$ per cent. This is weaker than forecast at Budget 2005, in line with weaker than expected UK export markets growth. In 2006 and 2007, stronger UK export markets growth is forecast to drive a pick-up in export growth, supported by sterling's recent depreciation. Goods and services exports are therefore forecast to grow by 5 to $5^1/_2$ per cent in 2006 and $5^1/_4$ to $5^3/_4$ per cent in 2007. This is slightly stronger than the forecast rates of import growth.

A.103 The income surplus is expected to moderate from recent high levels as temporary beneficial factors unwind. So the current account deficit is forecast to widen a little before stabilising at around $2^1/_2$ per cent of GDP, well below historical peaks.



Independent forecasts

A.104 The November average of independent forecasts for UK GDP growth in 2005 is 1.7 per cent, in line with the Pre-Budget Report 2005 forecast. For 2006, the latest independent average is for GDP growth of 2.1 per cent, just slightly below the middle of the Pre-Budget Report forecast range. Many prominent forecasting organisations are closely clustered around 2¼ per cent. The average of independent forecasts for CPI inflation shows it continuing to run above target in the fourth quarter of 2005, at 2.4 per cent, before dipping marginally below target by the end of 2006.

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

	Percentage changes on a year earlier unless otherwise stated					
	2005			2006		
		Independent			Independent	
	December PBR	Average	Range	December PBR	Average	Range
Gross domestic product	1¾	1.7	1.5 to 1.9	2 to 2½	2.1	0.2 to 2.9
CPI (Q4)	2¼	2.4	1.9 to 2.7	1¾	1.9	1.3 to 2.8
Current account (£ billion)	–26½	–22.8	–28.0 to –17.8	–30	–26.0	–38.0 to –15

[1] *Forecasts for the UK Economy: A Comparison of Independent Forecasts,* November 2005.

A.105 Despite growth for 2005 as a whole now expected to come in below the Budget 2005 forecast range, Treasury forecasts have still, on average, outperformed the independent consensus since 1997. Indeed, in a sample that includes Goldman Sachs, the IMF, the OECD, NIESR, the OEF, EC, HSBC, Deutsche Bank and JP Morgan, the Treasury has had the best GDP growth forecasting record of all since 1997.

Forecast risks

A.106 A similar set of risks surround the forecast as at Budget time. However, the magnitudes attached to some of these risks have evolved.

A.107 Risks to the world economy, if realised would inevitably impinge on the UK. Already high oil prices could hit the UK economy harder than expected in 2006, though in the event of a fall there could be less of a drag.

A.108 Moreover, euro area domestic demand has continued to disappoint forecasts in 2005. Were it to remain weaker than expected, this would clearly continue to have an adverse impact on UK external demand and net trade.

A.109 On the domestic side, an important risk relates to the considerable degree of uncertainty surrounding current output gap estimates based on the latest vintage of ONS data. If the economy has recently been growing at stronger (weaker) rates than presently shown by official estimates, this would suggest a narrower (wider) negative output gap than current mechanical estimates imply, and thus less (more) scope for above trend growth, without inflationary pressures, going forward.

A.110 Risks in both directions continue to surround private consumption growth. On the downside, private consumption growth may continue to undershoot expectations if average earnings growth continues to remain unexpectedly subdued, although this could be linked with stronger than expected employment growth which would tend to counter any negative effects on aggregate household incomes. Household expenditure could also surprise on the upside if, for example, housing market developments were associated with rising consumer confidence. There is now increasing evidence that the housing market is undergoing an orderly adjustment, with little prospect of a sustained fall in house prices. Indeed, prices have firmed a little of late.

A.111 Business investment growth could also surprise on the upside. Given strong rates of profitability allied with a low cost of capital and benign financial conditions, companies are likely to be in a good position to step up investment spending relatively quickly in the event of other upside surprises from demand.

Table A9: Summary of economic prospects[1]

	Percentage changes on a year earlier unless otherwise stated					
				Forecast[2, 3, 4]		Average errors from past forecasts[5]
	2004	2005	2006	2007	2008	
Output at constant market prices						
Gross domestic product (GDP)	3¼	1¾	2 to 2½	2¾ to 3¼	2¾ to 3¼	½
Manufacturing output	2	–½	1 to 1¼	1¾ to 2¼	1¾ to 2¼	1½
Expenditure components of GDP at constant market prices[6]						
Domestic demand	3¾	1¾	2 to 2½	2¾ to 3¼	2¾ to 3¼	¾
Household consumption[7]	3¾	1¾	1¾ to 2¼	2¼ to 2¾	2½ to 3	1
General government consumption	2½	1½	2	2½	2½	1¼
Fixed investment	5	2¾	3¾ to 4¼	4¾ to 5¼	4¼ to 4¾	2¼
Change in inventories[8]	0	0	0	0	0	¼
Exports of goods and services	4	4¾	5 to 5½	5¼ to 5¾	5 to 5½	2
Imports of goods and services	6	4¾	4½ to 5	4¾ to 5¼	4¾ to 5¼	2¼
Balance of payments current account						
£ billion	–23¼	–26½	–30	–32¾	–35¾	10
per cent of GDP	–2	–2¼	–2¼	–2½	–2½	¾
Inflation						
CPI (Q4)	1¼	2¼	1¾	2	2	–
Producer output prices (Q4)[9]	3½	2¾	1¼	2	2	1
GDP deflator at market prices	2	2½	2½	2½	2¾	¾
Money GDP at market prices						
£ billion	1164	1212	1267 to 1273	1338 to 1350	1413 to 1433	9
percentage change	5¼	4¼	4½ to 5	5½ to 6	5¾ to 6¼	¾

[1] The forecast is consistent with output, income and expenditure data for the third quarter of 2005, released by the Office for National Statistics on 25 November 2005. See also footnote 1 on the second page of this annex.

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

[3] As in previous Budget and Pre-Budget Reports, the economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral assumption for the trend rate of output growth of the 2¾ per cent to the end of 2006 and 2½ per cent thereafter. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of trend growth used as the basis for projecting the public finances, which is ¼ percentage point below the neutral assupmption.

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

[5] Average absolute errors for current year and year-ahead projections made in 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 2005 and 2006.

[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
2004		737.0	226.2	181.0	5.1	1149.4	289.0	1438.4	330.4	1.0	1108.9
2005		750.5	229.4	186.0	3.8	1169.5	303.0	1472.5	346.2	1.0	1127.3
2006		764.4 to 767.7	233.8	193.1 to 194.0	2.4 to 3.4	1193.7 to 1198.8	318.0 to 319.3	1511.7 to 1518.2	361.7 to 363.3	1.0	1150.9 to 1155.9
2007		782.4 to 789.6	239.7	202.2 to 204.1	2.7 to 4.3	1226.5 to 1237.8	334.9 to 338.0	1561.4 to 1575.8	378.5 to 382.0	1.0	1183.9 to 1194.7
2008		802.2 to 813.5	210.8	210.8 to 213.8	2.2 to 5.7	1260.9 to 1278.7	351.9 to 356.9	1612.8 to 1635.6	396.1 to 401.7	1.0	1217.7 to 1234.9
2004	1st half	365.8	112.9	89.7	2.3	570.8	143.0	713.8	162.1	0.4	552.0
	2nd half	371.2	113.2	91.4	2.8	578.6	146.0	724.6	168.3	0.5	556.8
2005	1st half	373.6	114.3	92.1	1.7	581.6	149.0	730.6	170.1	0.5	561.0
	2nd half	377.0	115.1	93.9	2.1	587.9	154.0	741.9	176.1	0.5	566.3
2006	1st half	380.3 to 381.4	116.2	95.5 to 95.8	1.5 to 1.9	593.5 to 595.3	157.1 to 157.5	750.6 to 752.9	179.0 to 179.6	0.5	572.0 to 573.8
	2nd half	384.1 to 386.2	117.6	97.6 to 98.1	0.8 to 1.5	600.2 to 603.5	160.9 to 161.8	761.1 to 765.3	182.7 to 183.7	0.5	578.9 to 582.1
2007	1st half	388.7 to 391.8	119.1	100.0 to 100.8	0.9 to 1.8	608.7 to 613.6	165.3 to 166.6	774.0 to 780.1	187.0 to 188.4	0.5	587.5 to 592.2
	2nd half	393.7 to 397.8	120.6	102.3 to 103.3	1.2 to 2.5	617.8 to 624.2	169.7 to 171.4	787.4 to 795.6	191.6 to 193.6	0.5	596.4 to 602.6
2008	1st half	398.7 to 403.9	122.1	104.5 to 105.8	1.2 to 2.8	626.5 to 634.6	173.9 to 176.1	800.4 to 810.8	196.0 to 198.5	0.5	604.9 to 612.7
	2nd half	403.5 to 409.7	123.6	106.3 to 108.0	1.0 to 2.9	634.4 to 644.1	178.0 to 180.7	812.4 to 824.8	200.1 to 203.2	0.5	612.8 to 622.2
		Percentage changes on previous year[4,5]									
2004		3¾	2½	5	0	3¾	4	3¾	6	0	3¼
2005		1¾	1½	2¾	0	1¾	4¾	2¼	4¾	0	1¾
2006		1¾ to 2¼	2	3¾ to 4¼	0	2 to 2½	5 to 5½	2¾ to 3	4½ to 5	0	2 to 2½
2007		2¼ to 2¾	2½	4¾ to 5¼	0	2¾ to 3¼	5¼ to 5¾	3¼ to 3¾	4¾ to 5¼	0	2¾ to 3¼
2008		2½ to 3	2½	4¼ to 4¾	0	2¾ to 3¼	5 to 5½	3¼ to 3¾	4¾ to 5¼	0	2¾ to 3¼

[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.