2 MAINTAINING MACROECONOMIC STABILITY

The UK's ability to adapt and respond to continued global economic challenges is built on its success in entrenching macroeconomic stability. Maintaining this will be an essential part of responding to the economic challenges of the next decade. The Government's macroeconomic framework has continued to deliver an unprecedented period of sustained and stable economic growth. UK GDP has now expanded for 53 consecutive quarters, which is the longest unbroken expansion since quarterly records began 50 years ago. This chapter sets out the action the Government is taking to maintain macroeconomic stability and build on the progress made since 1997.

Since Budget 2005, there have been extensive revisions to the UK national accounts that have altered the path of output relative to previous estimates. In particular there have been significant revisions to the profile of quarterly growth in 2004, which by reducing the level of output at the end of 2004, reduced 2005 growth by half a per cent. At the same time, UK economic activity has been affected in recent quarters by two key external developments: further rises in oil prices, with Brent crude prices reaching new record highs in September of over $65 a barrel, and continuing weak demand in the euro area, which remains by far the UK's largest export market. In previous decades, these factors, alongside a slowdown in house price growth, would have risked being accompanied by recession, but the UK continues to enjoy macroeconomic stability and has been the most stable economy in the G7 and OECD. With high oil prices continuing to act as a drag on the UK economy, growth is expected to remain below trend in 2006 before increasing in subsequent years as the output gap closes.

The interim update of the public finances projections published in this Pre-Budget Report shows that the Government is meeting its strict fiscal rules:

- **the current budget shows an average surplus as a percentage of GDP over this economic cycle, even using cautious assumptions, ensuring the Government is meeting the golden rule. Beyond the end of this cycle, the current budget moves clearly into surplus; and**
- **public sector net debt is projected to remain low and stable, stabilising at a level below the 40 per cent of GDP ceiling of the sustainable investment rule.**

An updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the 2005 *Long-term public finance report*. The report confirms that on the basis of current policies, the public finances are sustainable in the long term, and that in addition, the UK is in a strong position relative to many other countries to meet the challenges of an ageing population.

THE MACROECONOMIC FRAMEWORK

2.1 The Government's macroeconomic framework is designed to maintain long-term economic stability. Large fluctuations in output, employment and inflation add to uncertainty for firms, consumers and the public sector, and can reduce the economy's long-term growth potential. Stability allows businesses, individuals and the Government to plan more effectively for the long term, improving the quality and quantity of investment in physical and human capital and helping to raise productivity.

2.2 A more integrated global economy increases the speed and magnitude with which global shocks and imbalances can affect the UK and reinforces the need for a strong macroeconomic framework. The UK's framework has helped underpin the increased stability compared with earlier decades and compared with other OECD and G7 countries, as explained in Box 2.1.

2.3 The macroeconomic framework is based on the principles of transparency, responsibility and accountability.[1] The monetary policy framework seeks to ensure low and stable inflation, while fiscal policy is underpinned by clear objectives and two strict rules that ensure sound public finances over the medium term while allowing fiscal policy to support monetary policy over the cycle. These fiscal rules are the foundation of the Government's public spending framework, which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes. These policies work together in a coherent and integrated way.

Box 2.1: Macroeconomic stability in the UK

Economic stability builds resilience against economic shocks, reduces the risk of unemployment, reduces the cost of borrowing, and allows firms and individuals to make better economic decisions for the long term. In its 2005 Survey of the United Kingdom, the OECD[a] referred to the "impressive" stability and resilience of the UK economy since 1998. According to the OECD, the UK is now the most stable economy in the G7 and the OECD. It has the lowest variance of CPI inflation and the smallest absolute output gap over the period from 1998 to 2004, as shown in the table. As the OECD states "macroeconomic performance over the last decade has been a paragon of stability".

UK's ranking on key measures of stability, average 1998 to 2004

	Ranking among	
	G7	**OECD (30 countries)**
Smallest absolute output gap	1st	1st
Lowest variance of CPI inflation	1st	1st

Source: OECD (2005)

The UK's shift to a world-leading stable economic environment is particularly striking given that the UK was previously one of the most volatile G7 and OECD countries. As the OECD states, "This performance is a testament to the strength of the institutional arrangements for setting monetary and fiscal policy as well as to the flexibility of labour and product markets".

The increased stability highlighted by the OECD has real impacts in terms of better standards of living and higher rates of growth, discussed further in Box A2 of Annex A.

[a] *Survey of the United Kingdom*, OECD, 2005.

Monetary policy framework

2.4 Since its introduction in 1997, the monetary policy framework has consistently delivered inflation close to the Government's target. The framework is based on four key principles:

- clear and precise objectives. The objective of monetary policy is to deliver price stability. The adoption of a single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the Monetary Policy Committee (MPC) in setting interest rates to meet the Government's target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI), which applies at all times;

[1] Further details can be found in *Reforming Britain's economic and financial policy*, Balls and O'Donnell (eds.), 2002.

- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt publication of the minutes of monthly MPC meetings, and publication of the Bank of England's quarterly Inflation Report; and
- credibility and flexibility. The MPC has discretion to decide how and when to react to events within the constraints of the inflation target and the open letter system. If inflation deviates by more than one percentage point above or below target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC proposes to take, the expected duration of the deviation and how the proposed action meets the remit of the MPC.

2.5 These arrangements have removed the risk that short-term political factors can influence monetary policy and ensured that interest rates are set in a forward-looking manner to meet the Government's symmetrical inflation target.

Fiscal policy framework

2.6 The Government's fiscal policy framework is based on the five key principles set out in the *Code for fiscal stability*[2] – transparency, stability, responsibility, fairness and efficiency. The Code requires the Government to state both its objectives and the rules through which fiscal policy will be operated. The Government's fiscal policy objectives are:

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations; and
- over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.

2.7 These objectives are implemented through two fiscal rules, against which the performance of fiscal policy can be judged. The fiscal rules are:

- the golden rule: over the economic cycle, the Government will borrow only to invest and not to fund current spending; and
- the sustainable investment rule: public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle.

2.8 The fiscal rules ensure sound public finances in the medium term while allowing flexibility in two key respects:

- the rules are set over the economic cycle. This allows the fiscal balances to vary between years in line with the cyclical position of the economy, permitting the automatic stabilisers to operate freely to help smooth the path of the economy in the face of variations in demand; and
- the rules work together to promote capital investment while ensuring sustainable public finances in the long term. The golden rule requires the current budget to be in balance or surplus over the cycle, allowing the Government to borrow only to fund capital spending. The sustainable investment rule ensures that borrowing is maintained at a prudent level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle.

[2] *Code for fiscal stability*, HM Treasury, 1998.

Public spending framework

2.9 The fiscal rules underpin the Government's public spending framework. The golden rule increases the efficiency of public spending by ensuring that public investment is not sacrificed to meet short-term current spending pressures. Departments are now given separate allocations for resource and capital spending to help ensure adherence to the rule. The sustainable investment rule sets the context for the Government's public investment targets and ensures that borrowing for investment is conducted in a responsible way. Full details of the public spending framework are set out in Chapter 6.

Financial stability framework

2.10 A single statutory body for financial regulation, the Financial Services Authority (FSA), was set up in 1998 as part of a new tripartite structure for overseeing the UK financial system, with distinct roles for the Treasury, the Bank of England and the FSA. A Memorandum of Understanding[3] in 1997 established a framework for co-operation between these three bodies on financial stability.

2.11 The Bank of England is responsible for the stability of the financial system as a whole, including the payments infrastructure. The FSA is responsible for the authorisation and supervision of financial institutions including banks, for supervising financial markets and securities clearing and settlement systems, and for regulatory policy. The Treasury has responsibility for the overall institutional structure of regulation and the legislation that governs it.

2.12 A Standing Committee, comprising the Chancellor, the Governor of the Bank of England and the Chairman of the FSA, meets monthly (at Deputies level) to discuss financial stability, focusing on risks deemed to have systemic consequences. The Committee regularly reviews the key systemic risks to the UK's financial intermediaries and infrastructure. It also coordinates and tests the authorities' contingency plans. In the event of a crisis, it would convene at short notice and coordinate any necessary action by the authorities, as it did in reaction to the terrorist attacks on London in July 2005.

PERFORMANCE OF THE FRAMEWORK

2.13 The frameworks for monetary policy, fiscal policy and public spending provide a coherent strategy for maintaining high and stable levels of growth and employment, and for minimising the adverse impact of external events.

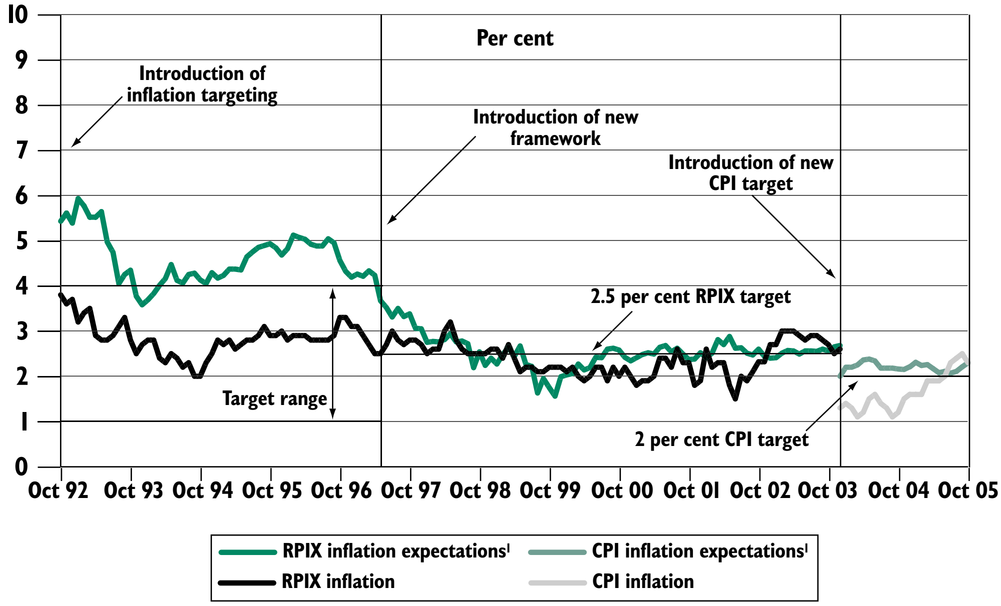
Monetary policy

2.14 The monetary policy framework has improved the credibility of policy making and continues to deliver clear benefits. Since the new framework was introduced:

- the annual increase in inflation up to December 2003, when RPIX was used as the inflation target measure, averaged 2.4 per cent, just below the 2.5 per cent RPIX target;
- inflation expectations have remained close to target following the switch to a 2 per cent CPI target. CPI inflation has averaged 1.6 per cent since its inception in December 2003, remaining within 1 percentage point of its target at all times; and
- under both targets, the UK has enjoyed the longest period of sustained low inflation since the late 1960s.

[3] Full text available on www.hm-treasury.gov.uk.

Chart 2.1: Inflation performance and expectations



[1]Implied expectations of average RPI inflation ten years ahead are derived from the difference between yields on nominal and index-linked government bonds. Implied CPI inflation expectations are derived from these RPI expectations and stylised assumptions about expected differences between RPI and CPI inflation in the medium term, including that the geometric averaging lowers CPI inflation by 0.5 percentage points relative to RPI inflation.

2.15 The monetary policy framework has given the MPC the flexibility to respond decisively to unexpected events over recent years. Consistent with its forward-looking approach, the MPC raised interest rates on five occasions from November 2003 to August 2004 to a level of $4\frac{3}{4}$ per cent. A year later the MPC cut rates by $\frac{1}{4}$ point responding to the slackening in the pressure of demand on supply capacity.

2.16 Low inflation expectations and a period of entrenched macroeconomic stability have helped UK long-term spot interest rates remain at historically low levels, averaging 4.4 per cent over the year. Ten-year forward rates have also averaged 4.4 per cent this year, marginally above those of the euro area and around $\frac{1}{2}$ percentage point below those in the US.[4] This compares with UK forward rates of 8 per cent in April 1997 before the introduction of the new macroeconomic framework. Low long-term interest rates reduce the Government's debt interest payments, free up resources for public services and help promote investment.

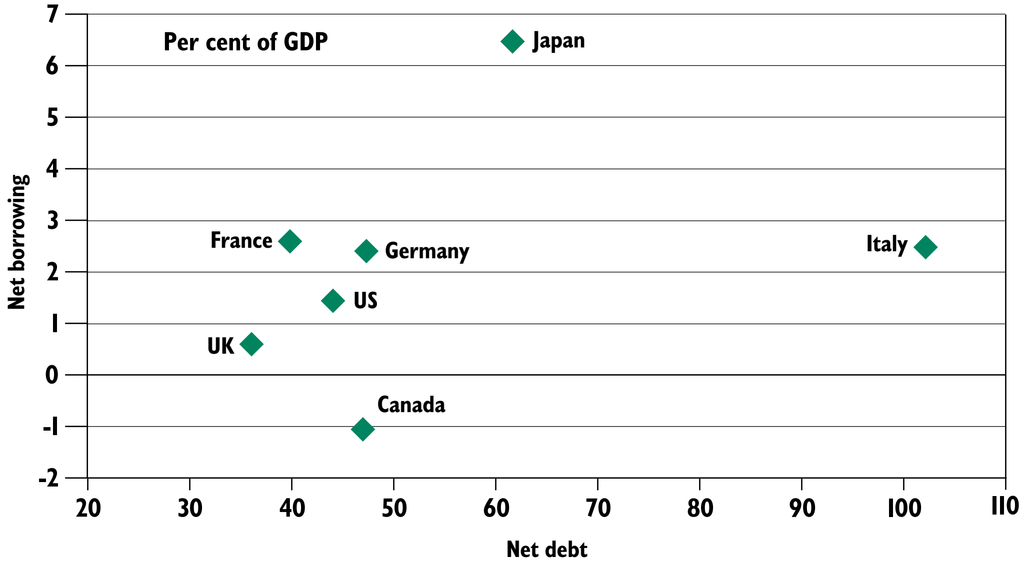
2.17 Since Budget 2005, there has been a slight depreciation of the sterling effective exchange rate, of around $1\frac{1}{2}$ per cent. From a longer-term perspective the exchange rate has continued a period of relative stability. Since the introduction of the euro in January 1999, the volatility of the sterling effective exchange rate has been under half that of the euro and under a third that of the US dollar.

[4] Ten year forward rates are market expectations, formed today, of short rates in ten years' time. They are less affected by short-term factors, such as the current cyclical position of the economy, than spot rates and are therefore a better basis for making international comparisons when cyclical conditions differ.

Fiscal policy

2.18 The Government has taken tough decisions on taxation and spending to restore the public finances to a sustainable position. Between 1996-97 and 2000-01, the fiscal stance was tightened by around 4 percentage points of GDP, supporting monetary policy during a period when the economy was generally above trend and reducing the level of net debt. In more recent years, fiscal policy supported monetary policy as the economy moved below trend in 2001, with support moderating as output returned towards trend. As Chart 2.2 shows, since 1997 the UK's public finances have compared favourably with other countries.

Chart 2.2: Public finances in the G7, average 1997 to 2004



Source: OECD Economic Outlook 77, June 2005

2004 Spending Review

2.19 The 2004 Spending Review set spending plans for the years 2005-06 to 2007-08, locking in the increased investment of previous spending reviews while providing for further investment in the most crucial areas of the public services. These plans provide for:

- current spending to increase by an annual average of 2.5 per cent in real terms over 2006-07 and 2007-08;
- public sector net investment to rise from 2 per cent of GDP to 2¼ per cent by 2007-08, to continue to address historic under-investment in the UK's infrastructure while meeting the sustainable investment rule; and
- agreed efficiency targets for all departments, delivering over £20 billion of efficiency gains a year by 2007-08 to be recycled to front-line public services.

Comprehensive Spending Review

2.20 The overall spending limits set in Budget 2004 and confirmed in the 2004 Spending Review remain sustainable and fully consistent with the fiscal rules. Building on these firm foundations, the second Comprehensive Spending Review (CSR), reporting in 2007, will provide the opportunity for a fundamental and long-term review of the Government's priorities and expenditure. As outlined in more detail in Chapter 6, the CSR will take a zero based approach to assessing the effectiveness of departments' baseline expenditure in delivering the outputs to which they are committed, and consider the further investments and reforms needed to ensure that Britain's public services are equipped to meet the global challenges of the decades ahead. The CSR will determine spending for 2008-09, 2009-10 and 2010-11, with allocations for 2007-08 held to the agreed figures already announced at the 2004 Spending Review.

Box 2.2: Independence for the Office for National Statistics

The Chancellor announced on 28 November 2005 that having reviewed the Framework for National Statistics, which was introduced in 2000, the Government proposes to legislate to make the Office for National Statistics (ONS) independent of government, making the governance and publication of official statistics the responsibility of a wholly separate body at arm's length from government and fully independent of it.

Drawing on the lessons of Bank of England independence, the Treasury will publish plans by early in the New Year to legislate for:

- **the creation of an independent Governing Board for the ONS, with delegated responsibility for meeting an overall objective for the statistical system's integrity;**
- **the appointment of external members to the Board, drawn from leading experts in statistics, and including men and women from academia and business; and**
- **a new accountability to Parliament through regular reporting by the Board to explain and to be questioned by the Treasury Select Committee on their performance.**

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

The world economy

2.21 World growth in 2005, while still robust by historical standards, is judged to have moderated compared with 2004, due to a combination of high oil and petroleum product prices plus structural difficulties adjusting to higher energy price and other shocks, and cyclical slowdowns following above potential growth in some economies. This easing in growth rates looks to have been more pronounced among advanced economies, especially the UK's main export markets in Europe, with emerging economies showing very little moderation during 2005.

Table 2.1: Summary of world forecast

	Percentage change on year earlier unless otherwise stated				
	Outturn	Forecasts			
	2004	2005	2006	2007	2008
Major 7 countries[1]					
Real GDP	3 1/4	2 1/2	2 1/2	2 1/2	2 1/2
Consumer price inflation[2]	2 1/2	2 3/4	2 1/4	1 3/4	1 3/4
Euro area					
Real GDP	1 3/4	1 1/2	1 3/4	2	2 1/4
World GDP	5	4 1/4	4 1/4	4 1/4	4
World trade in goods and services	10	6 3/4	7 1/4	7 1/4	7
UK export markets[3]	9 1/4	6	7	6 3/4	6 1/4

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

[2] *Per cent, Q4.*

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

The UK economy

2.22 There have been three main developments affecting the outlook for growth since Budget 2005: significant statistical revisions 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.

2.23 Following extensive data revisions, quarterly GDP growth is now estimated to have slowed from an above trend rate of over 1 per cent in the first quarter of 2004 to just 0.3 per cent by the third quarter. Compared to these revisions, the previous vintage of data had shown lower growth in the first quarter of 2004 and higher growth in the final three quarters. These data revisions automatically deduct almost $^1/_2$ percentage point from forecast growth for 2005 as a whole for any given quarterly growth path through 2005 as explained in Annex A.

2.24 The economy has also been affected by external shocks, such as higher oil prices and weaker demand growth in the euro area. The sustained and unexpected rises in oil prices, with Brent crude prices reaching new record highs in September of over $65 a barrel, have led to higher inflation and had a negative impact on the growth of demand and output. Oil price rises have also reduced real household income growth and contributed to the slowdown in consumption growth, as discussed in Box 2.5. High oil prices are expected to continue to be a drag on growth in 2006. Furthermore, 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 market growth compared with expectations at the time of Budget 2005.

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

2.26 Business investment is projected to grow by 3 per cent in 2005. Slower growth in private consumption and continued weaknesses in the UK's key euro area export markets has probably encouraged companies to adopt a cautious approach to capital expenditure. However, healthy rates of profitability and a benign financial environment are expected to underpin strengthening rates of growth in private sector capital expenditure in 2006 and 2007.

2.27 Overall GDP growth is currently estimated to have remained below its trend rate of $2^3/_4$ per cent in the first three quarters of 2005. GDP rose by 0.3 per cent in the first quarter, followed by a slightly stronger rise of 0.5 per cent in the second quarter, and 0.4 per cent in the third quarter. UK GDP is now expected to rise by $1^3/_4$ per cent in 2005 as a whole. Growth in 2006 is forecast at between 2 to $2^1/_2$ per cent. GDP growth is forecast to strengthen above its trend rate in 2007 and 2008, closing the output gap in 2008-09.

Table 2.2: Summary of UK forecast[1]

	Outturn	Forecasts			
	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.*

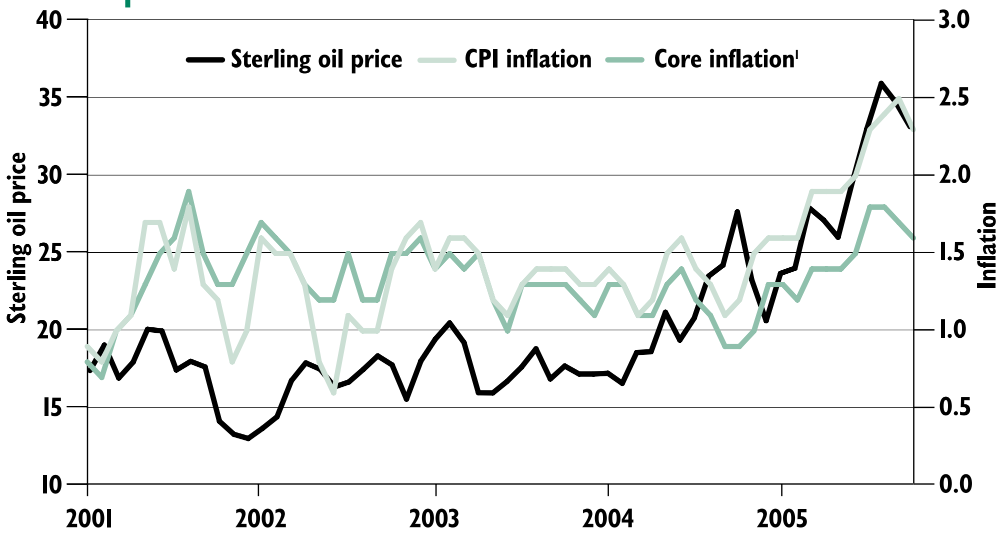
2.28 CPI inflation is expected to remain a little above target in the short term as a result of the continued effects of rises in oil prices and increases in import prices. However, as the direct effects of oil price rises abate, the drag on domestic inflation from continued slack in the economy should 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.

Box 2.3: Inflation, oil prices and pay

Since the Government established the new monetary policy framework in 1997, the UK has experienced the longest period of sustained and low inflation since the late 1960s. Against this background of historically low inflation, CPI inflation rose through 2005 before declining in October. This increase in the CPI inflation rate was in large part due to the temporary impact of higher oil prices. Once temporary, volatile factors have been stripped out, underlying or 'core' inflation has been below 2 per cent and in line with the average rates seen in recent years. This is confirmed by the decline in CPI inflation seen in October, as the temporary effects of the oil price rise began to unwind. As the Chancellor stated in his recent letter to the Pay Review Bodies: *"It will be important to ensure that public sector pay settlements do not contribute to inflationary pressure in the economy. To do so would risk converting a temporary increase in inflation into a permanent increase. The Pay Review Bodies should therefore base its pay settlements on the achievement of the inflation target of 2 per cent, rather than on the recent temporary rise in the rate of inflation".*

The chart shows that while headline inflation has risen in line with oil prices over the past year, core inflation remains much more subdued and is close to its average over the past five years. Measures of core inflation exclude certain items from the CPI basket whose price effects might be considered to be temporary and/or volatile: examples include energy prices and seasonal food prices. As such these measures are intended to give a measure of underlying inflation in the economy, which are more likely to reflect the balance of the pressures of demand and supply and thus be more relevant for the horizon over which pay settlements are determined.

Impact of oil on headline and core inflation



[1] *CPI excluding energy and seasonal food.*

Risks **2.29** A similar set of risks surround the forecast as at Budget time. 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. Were euro area growth to remain weaker than expected, this would continue to have an adverse impact on UK external demand and net trade. There are risks in both directions for private consumption growth, which may continue to undershoot expectations if average earnings growth continues to remain unexpectedly subdued, or could surprise on the upside if, for example, housing market developments prompted a rise in consumer confidence. 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.

Caution and the public finances **2.30** A number of key assumptions that underpin the public finance projections are independently audited by the Comptroller and Auditor General to ensure that they remain reasonable and cautious. A complete list of the assumptions used in the 2005 Pre-Budget Report is set out in Annex B. This prudent approach to fiscal policy builds an important safety margin into the public finance projections to guard against unexpected events. It decreases the chance that, over the medium term, unforeseen economic or fiscal events will require changes in plans for taxation or spending.

2.31 For this Pre-Budget Report, the Comptroller and Auditor General has audited the Treasury's judgement that the end date of the previous economic cycle was in the first half of 1997. The review concluded that, though there were uncertainties, there are reasonable grounds to date the end of the previous cycle to 1997 and that this would not reduce the extent of caution in making the fiscal projections. The NAO will also be asked to audit the end date of the current and future cycles once the Treasury has made a firm judgement.

2.32 The public finances continue to be based on a deliberately cautious assumption for trend output growth that is a $^1/_4$ percentage point lower than the Government's neutral view. The trend growth audit was due to have been completed at Budget 2005, but it was postponed because the economy was expected to return to trend around the end of 2005. Postponing the audit slightly until after the cycle was complete would have provided the Comptroller and Auditor General with information from an additional on-trend point. As the economy is now expected to return to trend in 2008-09, it is HM Treasury's intention to invite the NAO to complete its next rolling review of the trend growth assumption at Budget 2006.

2.33 The Comptroller and Auditor General also audited the oil price assumption and found that it has proved cautious over the three-year rolling review period and remains reasonable.

2.34 In addition the Comptroller and Auditor General audited the extension to the VAT forecasting rule in respect of the 2002 VAT strategy. He concluded that it was not possible at this stage to evaluate the degree to which the assumption has proved cautious and reasonable. A final assessment would require firmer direct evidence of the revenue effects of the strategy and would only be possible once final outturn data is available for 2005-06. Many uncertainties remain but HM Revenue and Customs has introduced some caution in the forward estimates by including only part of the forecast impacts in the fiscal projections. In light of the NAO's findings HM Treasury has indicated that it intends to ask the Comptroller and Auditor General to carry out a further review of the forecasting assumptions that underlie VAT receipts, including those related to the VAT strategy, as part of his audit of Budget assumptions for Budget 2007 or before.

Box 2.4: UK Presidencies of the G7/8 and EU

Far-reaching and fundamental changes in technology, production and trading patterns are shifting the balance of global economic activity and supporting the rise of the large emerging economies. These create challenges and opportunities for all economies. In its leadership of the G7/8 and EU this year, the UK has responded by addressing the challenges of international poverty reduction, structural economic reform and fairer trade through:

- **delivering key outcomes on international poverty reduction including 100 per cent multilateral debt relief for Heavily Indebted Poor Countries (HIPC); a commitment to provide by 2010 an extra $50 billion of aid compared to 2004 levels, with an extra $25 billion for Africa; debt relief worth $18 billion to produce a fair and sustainable debt deal for Nigeria; and the launch of the International Finance Facility for Immunisation. The details are set out in Chapter 5. The UK Presidency has also worked through both the G7/8 and EU to build support for economic regeneration as a contribution to the Middle East peace process;**
- **tackling high and volatile oil prices and their impact by: improving transparency in the oil market; establishing a new IMF facility for the poorest countries to mitigate the impact of oil price and other exogenous shocks; boosting supply by investment throughout the oil supply chain; strengthening dialogue with major oil producing regions, for example the Chancellor's November visit to Saudi Arabia; and supporting the establishment of a World Bank facility to promote investment in energy efficiency and low carbon technologies, primarily in developing countries;**
- **promoting a more Global Europe to deliver growth and full employment in the face of new and intense competitive pressures including by: improving the regulatory framework in Europe; promoting modern social and labour market policies – EU Member States have recently published their first ever Lisbon National Reform Programmes; strengthening the EU's relations with its major trade and investment partners, including a new EU-US economic partnership; and promoting an approach to financial services integration that is founded upon the principles of better regulation and proactive engagement with the global economy; and**
- **encouraging the EU to show leadership on fairer trade; pressing for an ambitious outcome to the Doha WTO Trade Round that delivers real benefits to developing countries through significant cuts in agricultural tariffs and domestic support and through eliminating export subsidies; and a comprehensive package for low income countries to ease adjustment costs and increase their capacity to trade.**

RECENT FISCAL TRENDS AND OUTLOOK

2.35 The public finance projections in the Pre-Budget Report have a different status from those produced at the time of the Budget. They represent an interim forecast update and not necessarily the outcome that the Government is seeking. The projections for the public finances presented below include the effects of firm decisions announced since Budget 2005 and in this Pre-Budget Report, in accordance with the *Code for fiscal stability*.

2.36 The forward-looking fiscal projections described in this section are complemented by the 2005 *End of year fiscal report*, published alongside this Pre-Budget Report, which provides detailed retrospective information on the public finances in 2003-04 and 2004-05.

Table 2.3: Fiscal balances compared with Budget 2005

	Outturn[1]	Estimate[2]	Projections				
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Surplus on current budget (£ billion)							
Budget 2005	**–16.1**	**–5.7**	**1**	**4**	**9**	**12**	
Effect of forecasting changes	–3.8	–4.2	–6½	–6½	–5	–3½	
Effect of policy decisions since Budget 2005	0.0	–0.8	2	2½	2½	2	
PBR 2005	**–19.9**	**–10.6**	**–4**	**0**	**7**	**11**	**13**
Net borrowing (£ billion)							
Budget 2005	**34.4**	**31.9**	**29**	**27**	**24**	**22**	
Changes to current budget	3.8	4.9	5	4	2½	1½	
Changes to net investment	0.6	0.1	0	0	0	0	
PBR 2005	**38.8**	**37.0**	**34**	**31**	**26**	**23**	**22**
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2005	–0.8	–0.3	0.1	0.3	0.6	0.8	
PBR 2005	**–1.3**	**–0.1**	**0.7**	**0.7**	**0.7**	**0.7**	**0.8**
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2005	2.4	2.4	2.2	2.0	1.6	1.5	
PBR 2005	**2.9**	**2.2**	**1.6**	**1.6**	**1.6**	**1.5**	**1.4**
Net debt (per cent of GDP)							
Budget 2005	34.4	35.5	36.2	36.8	37.1	37.1	
PBR 2005	**34.7**	**36.5**	**37.4**	**37.9**	**38.2**	**38.2**	**38.2**

Note: Figures may not sum due to rounding.

[1] The 2004-05 figures were estimates in Budget 2005.

[2] The 2005-06 figures were projections in Budget 2005.

Outturn for 2004-05

2.37 The outturn for the current budget for 2004-05 is around £3.8 billion lower than the Budget 2005 estimate, while net borrowing is now around £4.4 billion higher. Further details are given in Annex B.

2.38 The projections for the current budget and net borrowing reflect the weaker than expected economic growth and other forecasting changes in the short term. Thereafter the combined impact of policy decisions and forecasting changes mean the projections return close to those in Budget 2005.

Estimate for 2005-06

2.39 In 2005-06 the current budget deficit is around £9¼ billion lower than the deficit in 2004-05. However with net investment rising, the reduction in net borrowing is less, down by £1¾ billion compared with 2004-05. The slowdown in economic growth has reduced the receipts forecast, although by significantly less than might normally have been expected.

2.40 Although corporation tax revenues are lower than estimated in Budget 2005, receipts to date, especially from the financial sector and North Sea oil companies, are showing very strong growth. The buoyant financial sector has also contibuted to stronger growth in income tax and national insurance contributions receipts than would have been expected following the decrease in average earnings growth since Budget 2005. Receipts are now expected to grow by 7 per cent for the year as a whole, in line with outturns for first seven months of 2005-06.

2.41 Central government spending for the first seven months has been lower than expected at the time of the Budget, but expenditure over the year is expected to be broadly the same. Discretionary measures in 2005-06, including the addition to the special reserve, contribute to higher than expected borrowing.

Fiscal projections

2.42 Table 2.4 shows the projections for public sector net borrowing (PSNB) compared with those in Budget 2005. It disaggregates the changes into those attributable to the automatic stabilisers, other non-discretionary factors and discretionary measures, which include the policy measures set out below. The Treasury's methodology for estimating the impact of the economic cycle on the public finances is based on the average impact of changes in the output gap on the public finances over previous cycles. On the basis of previous cycles, the recent unexpected slowdown would have resulted in a substantial short-term increase in net borrowing. However, the resilience of receipts this year, boosted by the effects of factors such as higher oil and equity prices, partially offsets this and is shown as the effect of other non-discretionary factors.

2.43 As the economy returns to trend in 2008-09, the effects of the automatic stabilisers unwind. While some improvements, for example from the direct effect of higher oil prices, are sustained, other non-discretionary factors add to borrowing.

Table 2.4: Public sector net borrowing compared with Budget 2005

	Estimate[1]	Projections			
	2005-06	2006-07	2007-08	2008-09	2009-10
Budget 2005	**31.9**	**29**	**27**	**24**	**22**
Changes since Budget 2005					
Automatic stabilisers[2]	7.4	13½	8½	2½	0
Effect of other non-discretionary factors[3]	–3.1	–6	–2	2	3
Total before discretionary measures	**36.2**	**35**	**33**	**28**	**26**
Discretionary measures	**0.8**	**–2**	**–2**	**–2½**	**-2**
2005 Pre-Budget Report	**37.0**	**34**	**31**	**26**	**23**

Note: Figures may not sum due to rounding.

[1] The 2005-06 figures were projections in Budget 2005.

[2] Change in the cyclical component of PSNB, which is the difference between PSNB and cyclically-adjusted PSNB.

[3] Change in the cyclically-adjusted PSNB excluding discretionary measures.

Changes in receipts

2.44 Subdued growth in average earnings and in consumer expenditure, alongside a slower rise in the profitability of industrial and commercial companies, accounts for a substantial reduction in forecast receipts.

2.45 While higher oil prices have a direct positive impact on receipts over the projection period, other indirect effects offset this over time. Some of the indirect effects of higher oil prices contribute to the downward revisions in other tax receipts over the projection period. For example, the oil price increase feeds through to lower real household incomes, as well as to firms through higher input costs, reducing VAT and corporation tax receipts. The impact of higher oil prices on the public finances are described in more detail in Box 2.5. In addition, the non-cyclical shortfalls in some receipts have an impact throughout the projection, for example VAT, reflecting the NAO-audited assumption.

Box 2.5: The effect of oil prices on the UK's economy and public finances

Since Budget 2005, oil prices have significantly exceeded market expectations, as a result of robust demand growth, constrained spare capacity and supply disruptions. As a result of these developments, market forecasters have increased their expectation of the medium-term outlook for oil prices. Prices are expected to moderate from current high levels, but to be sustained at a higher level than the average over the last 20 years.

Despite the trade benefit from the UK still being a small net exporter of oil, increased petroleum costs still raise input costs and factory gate prices, reducing real incomes outside of the oil sector. Energy price rises have reduced real household disposable income growth, slowing private consumption growth by more than was expected in the Budget 2005 forecast. Evidence of higher than expected inflation and GDP growing at sub-trend rates is consistent with a negative supply shock to the economy from higher oil prices. Overall, the positive income effects derived by the UK's oil sector are outweighed by the negative effects of high oil prices on the rest of the economy.

Despite the large increases in consumer energy costs, overall UK inflation has been contained and inflation expectations have remained firmly anchored at close to the Government's symmetrical 2 per cent target, as can be seen in Chart 2.1, in contrast with the UK's past experience of high oil prices. Inflation and oil prices are discussed further in Box 2.3.

Oil prices also have an effect on the UK's public finances. Other things being equal, higher oil prices boost the tax take from petroleum revenue tax and North Sea corporation tax. There are a number of offsetting effects that limit the impact on the public finances as a whole. The scale of these offsetting effects, and in particular the effects that operate through the economic forecast, are extremely uncertain as they will depend on the response of individuals and businesses to rising prices. There will also be important timing effects, with any effects on inflation or the wider economy taking time to affect the public finances. The offsetting effects include those from:

- **higher pump prices, which reduces demand for road fuels and therefore reduces revenues from fuel duties;**
- **any temporary increase in inflation, which increases the indexation of allowances and limits for income tax and national insurance contributions and of indexation of tax credits and social security benefits; and**
- **possible impacts on the wider economy, as discussed above. In particular, other things being equal, higher input prices may reduce companies' profit margins, reducing their profitability and therefore reducing receipts of non-North Sea corporation tax.**

Overall, even after the North Sea oil measure announced in this Pre-Budget Report, the effects of oil prices on the public finances are broadly neutral.

Changes in spending

2.46 The forecast for expenditure before discretionary measures is broadly unchanged from Budget 2005, with a small rise in spending this year but with future years at Budget 2005 levels. Projections for Departmental Expenditure Limits (DEL) up to 2007-08 are based on 2004 Spending Review allocations, and apart from this year, projections for Annually Managed Expenditure (AME) are unchanged from Budget 2005.

Discretionary policy changes

2.47 In considering the impact of additional discretionary policy changes on the fiscal position, the Government has taken into account the following factors:

- the importance of ensuring the strict fiscal rules are met over the cycle;
- its broader, medium-term objectives for fiscal policy, including the need to ensure sound public finances and that spending and taxation impact fairly both within and between generations; and
- the need to ensure that fiscal policy supports monetary policy.

2.48 Consistent with the requirements of the *Code for fiscal stability*, the updated projections take into account the fiscal effects of all decisions announced in this Pre-Budget Report or since Budget 2005. This includes:

- an increase in North Sea oil taxation, striking the right balance between producers and consumers, to promote investment and ensure fairness for taxpayers;
- an extension of Winter Fuel Payments paid at £200 for households with someone aged 60 or over, rising to £300 for households with someone aged 80 or over, for the rest of this Parliament;
- an additional £300 million over three years to enable pensioners on Pension Credit to have central heating systems installed free of charge and to provide a £300 discount on central heating systems to all other pensioners who do not already have one in their homes;
- a continuation of the freeze in the main fuel duty rates and the duty rates for road fuel gases, due to continued oil market volatility; and
- action to protect tax revenues and modernise the tax system, including a number of measures to tackle tax fraud, avoidance and tax motivated incorporation.

2.49 In the 2002 Pre-Budget Report, the Government created a special reserve to meet the UK's international obligations. In this Pre-Budget Report, as a prudent allowance against continuing commitments, the Government is adding a further £580 million to the special reserve for 2005-06, and an additional £85 million to advance the ongoing fight against terrorism. Full details of the Government's spending and allocations for the military conflict in Iraq and on the war on terrorism at home and abroad are described in Chapter 6.

2.50 The fiscal impact of these and other measures is set out in Annex B. As usual, the projections do not take account of measures proposed in this Pre-Budget Report for consultation or other proposals where final decisions have yet to be taken.

FISCAL POSITION AND MEDIUM-TERM PROSPECTS

2.51 Table 2.5 presents a summary of the key fiscal aggregates under the five headings of fairness and prudence, sustainability, economic impact, financing and European commitments. It illustrates the Government's performance against its fiscal rules, and shows that the Government is meeting its strict fiscal rules over the economic cycle.

Table 2.5: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate			Projections		
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Fairness and prudence							
Surplus on current budget	–1.7	–0.9	–0.3	0.0	0.5	0.7	0.8
Average surplus since 1997-98	0.2	0.1	0.1	0.0	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	–1.3	–0.1	0.7	0.7	0.7	0.7	0.8
Long-term sustainability							
Public sector net debt[1]	34.7	36.5	37.4	37.9	38.2	38.2	38.2
Core debt[1]	34.1	35.1	35.1	35.1	35.3	35.5	35.6
Net worth[2]	29.1	26.6	25.7	25.3	25.5	24.6	24.0
Primary balance	–1.7	–1.3	–0.9	–0.5	–0.1	0.2	0.3
Economic impact							
Net investment	1.6	2.1	2.3	2.3	2.3	2.3	2.3
Public sector net borrowing (PSNB)	3.3	3.0	2.6	2.3	1.8	1.6	1.4
Cyclically-adjusted PSNB	2.9	2.2	1.6	1.6	1.6	1.5	1.4
Financing							
Central government net cash requirement	3.3	3.5	3.1	2.7	2.2	2.2	1.8
Public sector net cash requirement	3.3	3.3	2.8	2.4	1.9	1.8	1.5
European commitments							
Treaty deficit[3]	3.3	3.0	2.7	2.4	1.9	1.6	1.5
Cyclically-adjusted Treaty deficit[3]	2.9	2.2	1.7	1.7	1.7	1.6	1.5
Treaty debt ratio[4]	40.9	43.3	44.4	44.8	44.7	44.6	44.4
Memo: Output gap	–0.5	–1.4	–1.5	–0.7	–0.1	0.0	0.0

[1] *At end March; GDP centred on end March.*

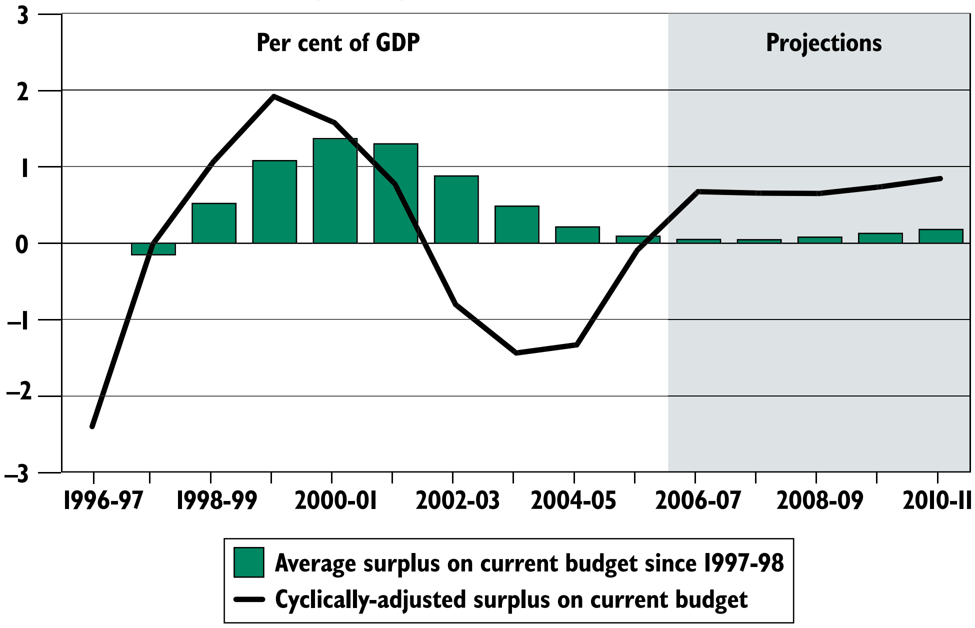
[2] *At end December; GDP centred on end December.*

[3] *General government net borrowing on a Maastricht basis.*

[4] *General government gross debt on a Maastricht basis.*

Golden rule **2.52** The current budget balance represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the cost of paying for the public services they use and it is therefore an important indicator of inter-generational fairness. The current surplus strengthens through the projection period reaching balance in 2007-08 and a surplus of 0.8 per cent of GDP in 2010-11.

Chart 2.3: Meeting the golden rule

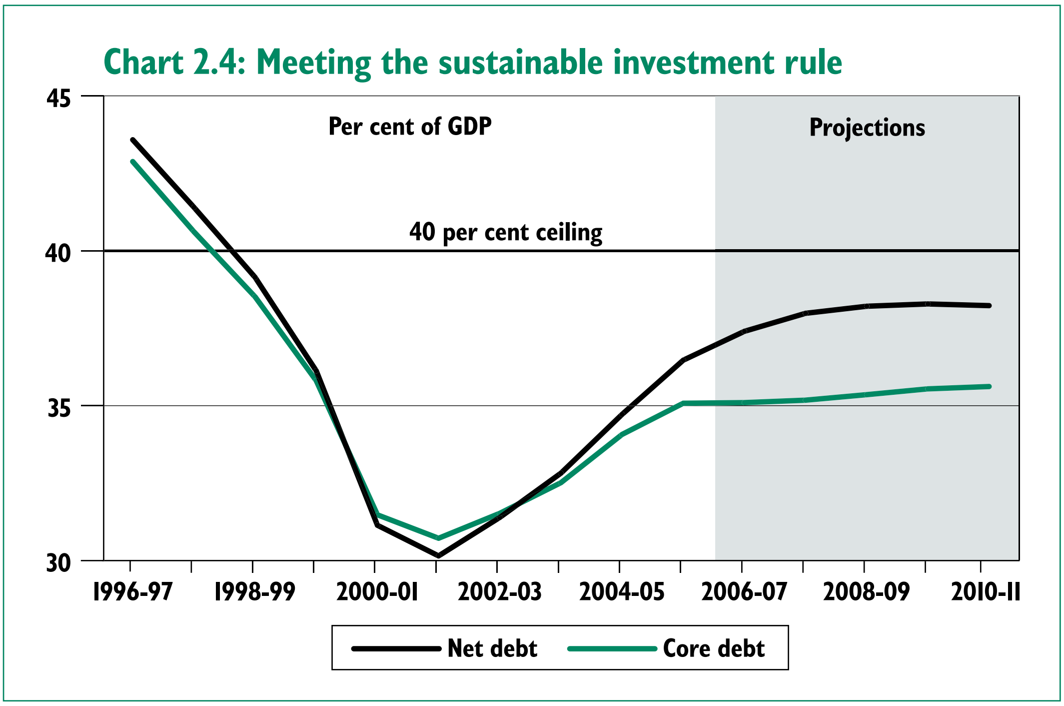


2.53 The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability. Progress against the rule is measured by the average annual surplus on the current budget as a percentage of GDP since the cycle began in 1997-98.[5]

2.54 The average surplus on the current budget since 1997-98 is in balance or surplus in every year of the projection period. The economy is projected to return to trend in 2008-09, meaning that over the whole cycle the average surplus on the current budget would be 0.1 per cent of GDP. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £16 billion in this cycle, including the AME margin.

2.55 With the economy assumed to return to trend in 2008-09, the projections show, based on cautious assumptions, that the average surplus over the period 2008-09 to 2010-11 is $^3/_4$ per cent of GDP. At this early stage, and based on cautious assumptions, the Government is therefore on course to meet the golden rule after the end of this economic cycle.

[5] Measuring the fiscal rules is discussed in Chapter 9 of *Reforming Britain's economic and financial policy,* Balls and O'Donnell (eds.), 2002.



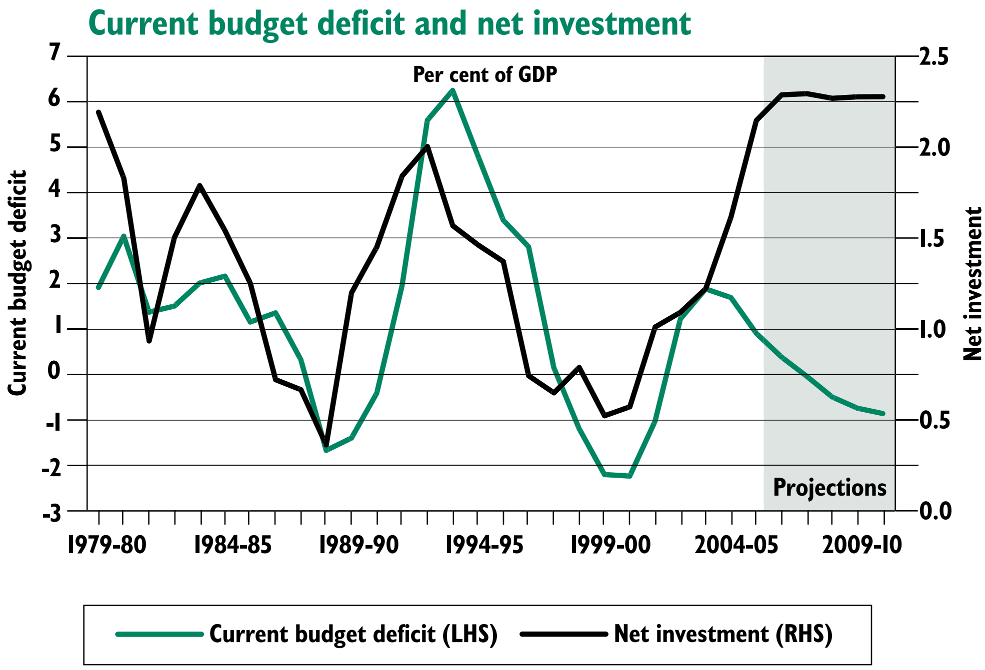
Sustainable investment rule

2.56 The Government's primary objective for fiscal policy is to ensure sound public finances in the medium term. This means maintaining public sector net debt at a low and sustainable level. To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle.

2.57 Chart 2.4 shows that public sector net debt is expected to stabilise at around 38 per cent of GDP from 2007-08. Therefore the Government continues to meet its sustainable investment rule while continuing to borrow to fund increased long-term capital investment in public services. Chart 2.4 also illustrates the Pre-Budget Report projections for core debt which excludes the estimated impact of the economic cycle on net debt. Core debt rises only modestly from 35 per cent to around 35½ per cent of GDP at the end of the medium term horizon.

Box 2.6: Borrowing for investment

The fiscal framework makes a distinction between capital and current spending and therefore is designed to remove the bias against capital spending. Historically, it has been extremely rare for investment to grow during periods of fiscal consolidation, and prior to the introduction of the macroeconomic framework, it had not happened for 40 years. The effectiveness of the golden rule in eliminating this historic bias against capital spending is illustrated by the break in the relationship between borrowing for current spending and borrowing for investment illustrated in the chart. As the chart shows, this pattern of reducing borrowing while maintaining net investment will continue in the coming years.



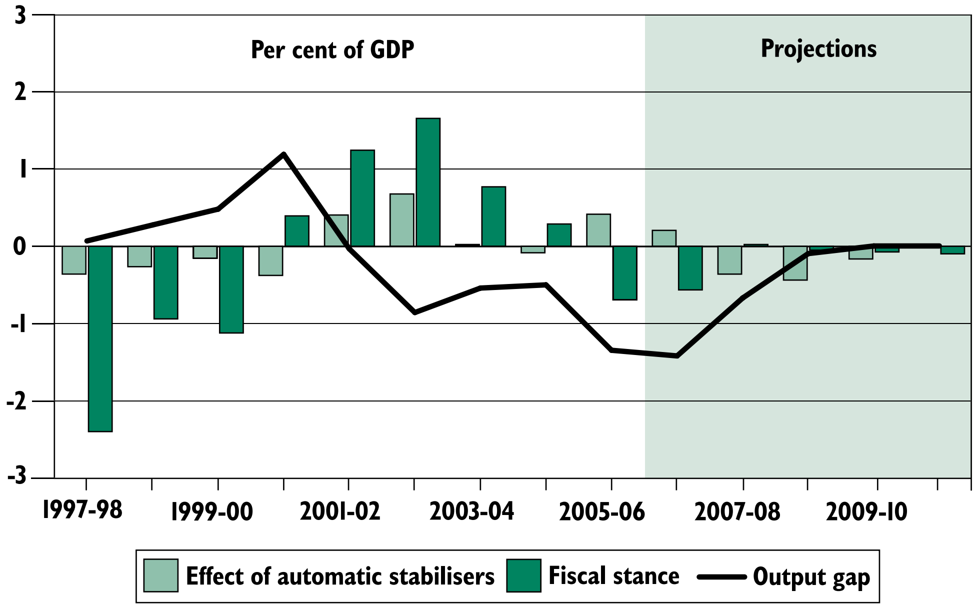
Public sector net investment is now over three times higher as a share of the economy than it was in 1997-98, having risen from less than ¾ per cent to 2¼ per cent of GDP this year. Net investment is now at its highest level for 26 years, and has never before risen as a share of the economy in six successive years. As a result of this sustained increase, public investment in priority areas has grown significantly: annual average real growth in capital budgets from 1999-2000 to 2007-08 will be 25 per cent in the NHS, 19 per cent in education and 15 per cent in transport. The Government's strategy for public investment is discussed in more detail in Chapter 6.

Economic impact

2.58 While the primary objective of fiscal policy is to ensure sound public finances, it also affects the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing. These can be broken down into changes due to the effects of the automatic stabilisers and those due to the change in the fiscal stance as illustrated in Chart 2.5.

2.59 During the late 1990s, the fiscal stance tightened at a time when the economy was above trend, supported by the automatic stabilisers. As the economy moved below trend in 2001, the automatic stabilisers and the fiscal stance supported the economy, with the degree of support moderating 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. The tighter fiscal stance over 2005-06 and 2006-07 reflects the strength of underlying tax receipts from the oil and financial sectors.

Chart 2.5: Fiscal policy supporting monetary policy



Note: The fiscal stance equals the annual change in the cyclically-adjusted PSNB. The effect of the automatic stabilisers equals the change in the cyclical component of PSNB, ie the difference between PSNB and the cyclically-adjusted PSNB.

Financing

2.60 The forecast for the central government net cash requirement for 2005-06 has been revised from £40.2 billion in Budget 2005 to £43.3 billion, an increase of £3.1 billion. It has been decided to meet this increased financing requirement by increasing gilt sales by £1.2 billion to £52.3 billion and by increasing the planned end financial-year Treasury bill stock by £1.2 billion to £19.2 billion. Further details and a revised financing table can be found in Annex B.

European commitments

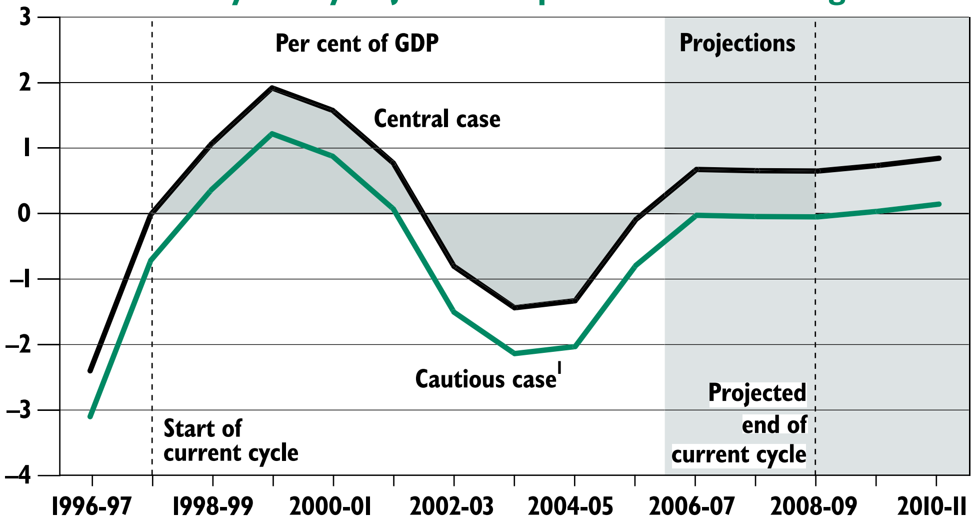
2.61 The Government supports a prudent interpretation of the Stability and Growth Pact as described in Box A1 in Annex A. This takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment. The public finance projections set out in this Pre-Budget Report, which show the Government on track to meet its fiscal rules over the cycle, with low debt and sustainable public finances, combined with sustainable increases in public investment, are fully consistent with the prudent interpretation of the Pact.

Dealing with uncertainty

2.62 Forecasts for the public finances are subject to a considerable degree of uncertainty, in particular the fiscal balances, which represent the difference between two large aggregates. The use of cautious assumptions audited by the NAO builds a margin into the public finance projections to guard against unexpected events. To accommodate potential errors arising from misjudgements about the trend rate of growth of the economy in the medium term, the Government bases its public finance projections on a trend growth assumption that is $^{1}/_{4}$ percentage point lower than its neutral view.

2.63 A second important source of potential error results from misjudging the position of the economy in relation to trend output. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be one percentage point lower than in the central case, as illustrated in Chart 2.6. This shows that the Government will have a cyclically adjusted current surplus in the cautious case at the end of the projection period.

Chart 2.6: Cyclically-adjusted surplus on current budget



[1] *Cautious case assumes trend output 1 percentage point lower in relation to actual output than in the central case.*

LONG-TERM FISCAL SUSTAINABILITY

2.64 While a key objective of fiscal policy is to ensure sound public finances over the short and medium term, the Government must also ensure that fiscal policy decisions are sustainable in the long term. Failure to do so would see financial burdens shifted to future generations, with detrimental effects on long-term growth. It would also be inconsistent with the principles of fiscal management as set out in the *Code for fiscal stability*.

2.65 An updated analysis of long-term fiscal sustainability is published alongside this Pre-Budget Report in the 2005 *Long-term public finance report.* Based on the latest population projections the report provides a comprehensive analysis of long-term economic and demographic developments and their impact on the public finances, updating the illustrative long-term projections set out in Budget 2005.

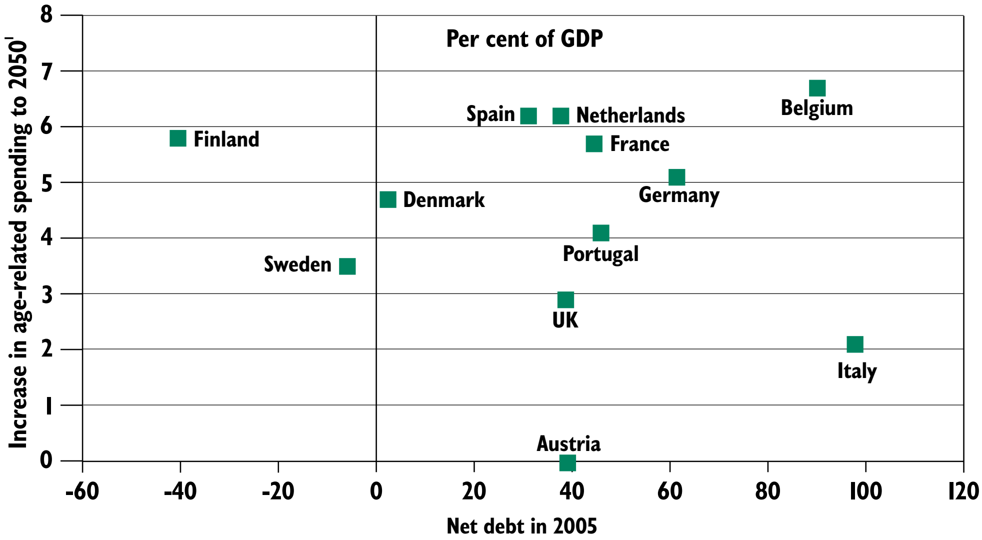
2.66 Using a range of sustainability indicators, including the intertemporal budget gap and fiscal gap, and based on current policies and reasonable assumptions, the report shows that the public finances are sustainable in the longer term. Moreover, as Box 2.7 shows, the UK is in a strong position relative to many of the other EU Member States to meet the challenges of an ageing population.

2.67 The Whole of Government Accounts programme is providing an additional and valuable perspective on the public finances and is covered in more detail in *Delivering the benefits of accruals accounting for the whole public sector,* published alongside this Pre-Budget Report.

Box 2.7: Long-term fiscal sustainability in the EU

The challenges posed by an ageing population vary considerably between countries. The chart below shows the relationship between the ratio of general government net financial liabilities to GDP and the projected increase in age-related spending over the period to 2050 for twelve of the EU15 Member States.[a]

Age-related spending increases in selected EU Member States



[1] The start date for the Commission's age-related spending projections varies from country to country. The earliest date is 2008 and the latest is 2011. Comparisons of projections need to be treated with caution as some include the cost of long-term care with the health projections.

Source: General government net financial liabilities from OECD Economic Outlook 77, June 2005. Increase in age-related spending data – HM Treasury 2005 and European Commission services' working documents on Member States' Stability and Convergence Programmes 2005.

The chart shows that a number of countries face a large projected increase in age-related spending in terms of GDP over the next 50 years, of more than 6 per cent of GDP in some cases, primarily due to large increases in pension and health spending. The UK has a relatively low ratio of debt to GDP and faces one of the smallest projected increases in age-related spending in the EU, suggesting that the UK is well-placed to meet the long-term challenges of an ageing population.

A full assessment of long-term sustainability requires a more comprehensive consideration of the demographic and non-demographic factors that could affect the public finances. Nevertheless, a country with a larger projected increase in age-related spending will, all else being equal, face a greater fiscal challenge over the long term. A more detailed analysis of the long-term trends and sustainability in different countries is presented in Chapter 5 of the 2005 *Long-term public finance report.*

[a] Neither OECD nor Eurostat net financial liabilities data is available for three of the EU15 Member States, so they are not included in the chart.