A THE ECONOMY

In 2007, the UK economy has continued to perform strongly, and has now expanded in 60 consecutive quarters. GDP growth in the first half of the year reached 3¼ per cent on a year earlier, towards the upper end of the Budget 2007 forecast range. External forecasters expect the UK to grow more strongly in 2007 than any other G7 economy. The world economy is expected to remain robust in 2007, growing by 5 per cent, with emerging markets continuing to expand rapidly.

As forecast at Budget 2007, UK inflation has returned close to target in the second half of this year, falling to 1.8 per cent in August. Employment has reached a new record high, above 29 million, and unemployment has fallen, with the claimant count lower in 11 consecutive months and down by more than 100,000 since September 2006.

Evidence from the cyclical indicators monitored by the Treasury, and latest National Accounts data, imply the economy may have moved up through trend towards the end of 2006. However, it is too soon to assess whether or not the economic cycle has ended.

The disruption in global financial markets has meant economic prospects have become more uncertain, and events need to unfold further before the impact on the economy can be rigorously quantified. For the purposes of the economic forecast, it has been assumed that there will be some feed-through to tighter credit conditions and to household and company spending in the short term.

Reflecting the combination of momentum in the economy, but higher interest rates than markets expected at the time of Budget 2007, the 2007 Pre-Budget Report economic forecast is for:

- **GDP growth of 3 per cent in 2007, slowing to 2 to 2½ per cent in 2008, before returning to its trend rate of 2½ to 3 per cent in 2009 and 2010; and**
- **CPI inflation to remain close to target throughout the forecast horizon.**

Financial market disruption presents clear risks to the economic forecast, though these are judged to be broadly balanced. Considerable uncertainty surrounds the timing and extent to which the disruption might affect the wider economy, and the longer it persists, the greater the risk of it detracting from growth. However, the UK economy has proved resilient to a number of shocks over the past decade, demonstrating the pay-off to the Government's macroeconomic framework and promotion of open and flexible labour, product and capital markets. As such, growth could also slow by less than expected.

INTRODUCTION[1,2]

A.1 This chapter discusses recent economic developments and provides updated forecasts for the UK and world economies in the period to 2010. It begins with an overview of developments and prospects in the world economy, which set the global context for recent developments and prospects in the UK. It then outlines the UK economic forecast, before concluding with a more detailed discussion of sectoral issues, the components of growth, and the risks and uncertainties surrounding the forecast.

[1] The UK forecast is consistent with National Accounts and balance of payments statistics to the second quarter of 2007 released by the Office for National Statistics on 26 September 2007. 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). Copies can be obtained on request from the Treasury's Public Enquiry Unit (020 7270 4558).

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

THE WORLD ECONOMY

Overview

A.2 The world economy grew by $5\frac{1}{4}$ per cent in 2006, the fastest rate since 1990. This reflected strong growth in advanced economies and particularly in the emerging markets, which accounted for more than half of total world growth. This was the third consecutive year of global growth above $4\frac{1}{2}$ per cent. It is expected to ease slightly in 2007, though to remain high by historical standards at 5 per cent.

A.3 Although global growth is expected to remain healthly, prospects have moderated in recent months reflecting the effects of financial market disruption. In 2007, G7 growth is expected to slow to 2 per cent, due in particular to the ongoing slowdown in the US, and to remain moderate in 2008. Growth in some emerging markets is expected to ease somewhat from the very high rates of recent years, but to remain strong. Emerging markets are expected to continue to account for the majority of world growth. Against this background, world trade is forecast to grow at $7\frac{3}{4}$ per cent in 2007, feeding through to UK export markets growth of 7 per cent.

Table A1: The world economy

	Percentage change on a year earlier, unless otherwise stated				
		Forecast			
	2006	2007	2008	2009	2010
World GDP	$5\frac{1}{4}$	5	5	$4\frac{3}{4}$	$4\frac{3}{4}$
Major 7 countries[1]					
Real GDP	$2\frac{3}{4}$	2	2	$2\frac{1}{2}$	$2\frac{1}{2}$
Consumer price inflation[2]	$1\frac{3}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$	$2\frac{1}{2}$
Euro area GDP	3	$2\frac{1}{2}$	2	2	2
World trade in goods and services	10	$7\frac{3}{4}$	$7\frac{3}{4}$	$7\frac{3}{4}$	$7\frac{3}{4}$
UK export markets[3]	9	7	$6\frac{1}{2}$	$6\frac{3}{4}$	$6\frac{3}{4}$

[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 the importance of imports from the UK in those countries' total imports.*

A.4 Recent falls in headline inflation rates in the G7 have mainly reflected developments in energy prices, with core inflation remaining low and stable by historical standards. Since Budget 2007, central banks in most advanced economies have tightened monetary policy, although the Federal Reserve in the US cut interest rates by $\frac{1}{2}$ a percentage point in September, in response to recent financial market disruption. This was the first cut since 2003.

Global financial markets

A.5 Since July 2007, there has been considerable financial market disruption around the world. Underlying these developments has been an ongoing re-pricing of risk, and further deterioration of the US sub-prime mortgage market, where a combination of higher interest rates, slower house price growth, and looser lending standards has caused the number of borrowers defaulting on their loans to rise. In recent years, many types of loan, including these higher-risk mortgages, have been combined and repackaged into securities that accrue an income stream from future interest payments. In some cases, these asset-backed securities were further repackaged into different tranches offering varying degrees of risk and rates of return, and sold to global investors and held in investment vehicles. A number of hedge funds and major banks have suffered significant losses due to their exposure to some asset-backed securities and related derivatives, triggering a widening in spreads in money and credit markets, described in Box A1.

A.6 The timing and extent to which these developments might affect the wider economy is not yet clear. Events need to unfold further before the economic impact can be properly quantified. As such, the global and UK economic prospects discussed in this chapter have become more uncertain. The risks associated with financial market disruption are discussed in more detail from paragraph A.78.

G7 activity and inflation

United States

A.7 Revisions to US National Accounts data released in July 2007 showed that US GDP growth slowed marginally in 2006, and was slightly lower than previously estimated. Below-trend growth has continued in the first half of 2007, as the correction in the housing market has persisted. Against a background of weaker home sales and falling property prices, the inventory of unsold houses has increased sharply compared with early 2007. So far, other components of demand have partly compensated for negative growth in residential investment.

A.8 US GDP growth is set to continue at below-trend rates in 2007 and early 2008, and to recover more gradually through 2008. This reflects a more protracted contraction in residential investment than expected at the time of Budget 2007, and the effects of recent financial market disruption. The latest estimates of consumption growth suggest that it has started to moderate, as a result of tighter financing conditions, weakness in the housing market and softer employment growth. Against this, the outlook for net exports remains positive, which should support the recent improvement in the US current account position.

Euro area

A.9 Stronger euro area growth in 2006 has been carried through into the first half of 2007, with growth this year driven by strong domestic demand, particularly business investment. The labour market has continued to improve: employment growth across the region has been strong, particularly in Germany, and the unemployment rate has this year fallen below 7 per cent for the first time since 1993. Survey readings of euro area and country-specific business and consumer confidence have fallen during the recent period of financial market disruption, potentially signalling a slower expansion in the quarters to come, although they remain above historical averages.

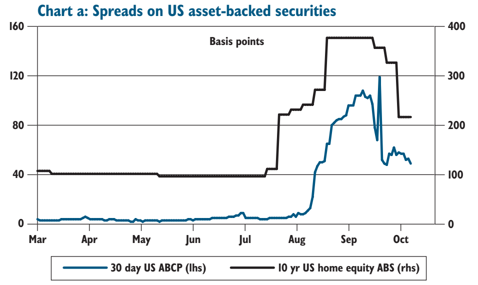
A.10 Solid growth is forecast to continue during the rest of 2007, largely due to the momentum implied by stronger than expected outturn data in the first half of the year. Growth is expected to moderate to around its trend rate in 2008.

Box A1: Developments in global financial markets

Recent financial market developments have been associated with changes in the pricing of risk. The period of disruption since July was triggered by renewed concerns about the US sub-prime mortgage market, following earlier periods of stress in February and March. The impact soon spread to a range of markets for asset-backed securities and related commercial paper (chart a). Uncertainty over which institutions were exposed to potential losses, the size of any exposures, and the extent to which banks might have to bring many of these assets back onto their balance sheets, caused money market liquidity to contract and inter-bank lending rates to rise sharply in all major financial centres (chart b). As investors' appetite for risk diminished, the value of a range of higher-risk assets fell, including lower-rated corporate bonds, emerging market bonds and equities (chart c), and even high-yielding currencies like the Australian and New Zealand dollars. By contrast, the price of US Treasury bills, often seen as a safe haven in times of volatility, increased sharply causing the yield, which moves inversely with the price, to fall well below the US policy rate (chart d).

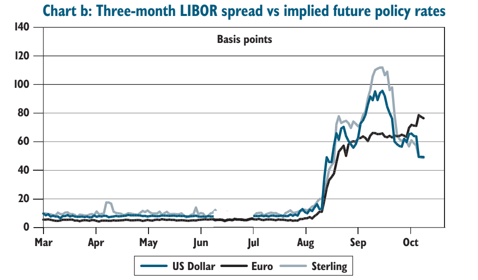
Central banks have offered more liquidity at slightly longer maturities, including in the three-month money market, and, in some cases, against a broader range of collateral than usual. The spread of three-month inter-bank lending rates over expected policy rates has since fallen, while stock, bond and currency markets have stabilised somewhat. However, while the disruption has eased, inter-bank spreads remain high, while more specialised credit markets remain illiquid.

Chart a: Spreads on US asset-backed securities



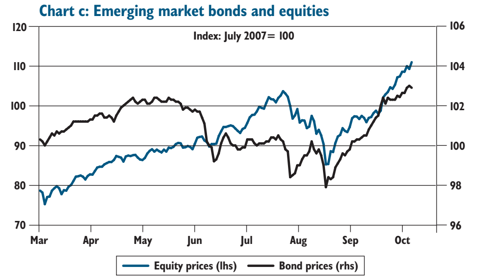
Source: Bloomberg.

Chart b: Three-month LIBOR spread vs implied future policy rates



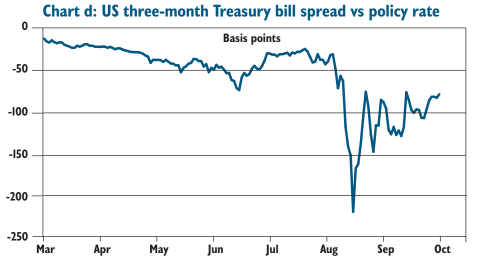
Source: Bloomberg.

Chart c: Emerging market bonds and equities



Source: Bloomberg.

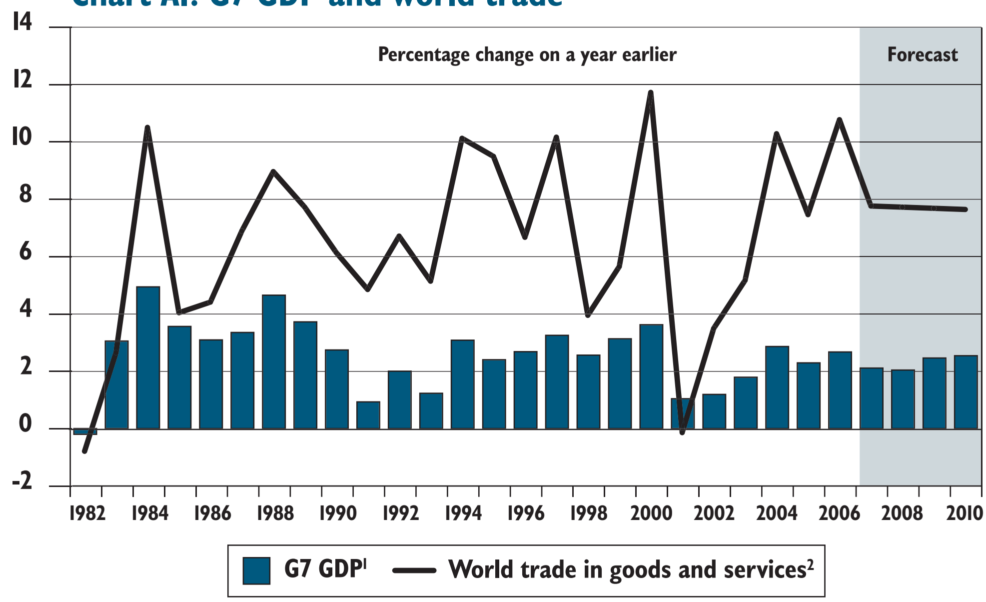
Chart d: US three-month Treasury bill spread vs policy rate



Source: Bloomberg

Japan **A.11** In Japan, recorded GDP growth in the first half of 2007 has been volatile: a very strong first quarter was followed by contraction in the second quarter. Some modest underlying strength is expected to continue, reflecting a positive contribution to growth from business investment and net exports, with private consumption growth remaining sluggish. The Japanese economy is expected to grow at slightly above-trend rates in 2007, before slowing in 2008.

Chart A1: G7 GDP and world trade

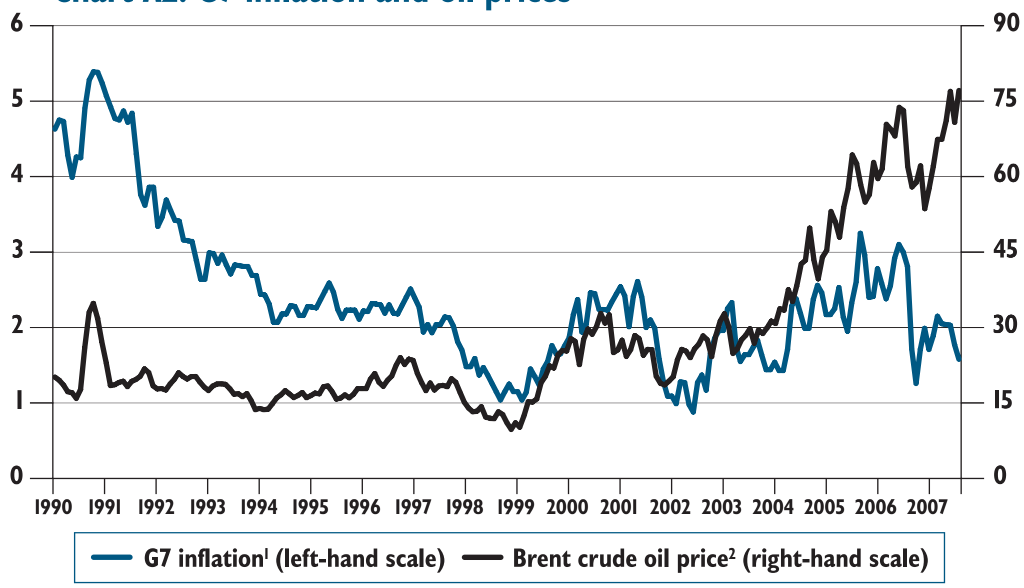


[1] Real GDP (Major 7 countries) at constant prices.
[2] HM Treasury estimates based on OECD data.

G7 inflation prospects

A.12 Recent falls in headline inflation rates among the G7 economies have mainly reflected developments in energy prices. Core inflation has remained broadly stable, and low by historical standards. G7 inflation is expected to remain at moderate rates throughout the forecast horizon.

Chart A2: G7 inflation and oil prices



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

Emerging markets and developing economies

Emerging Asia

A.13 Emerging Asia is expected to continue growing strongly this year and next, continuing the pattern of recent years. The Chinese economy grew by more than 11 per cent in 2006, and the growth rate picked up further in the first half of 2007. Rapid export growth has been an important driver, as reflected in the expanding trade surplus. Inflation has picked up sharply as a result of higher food prices, while asset prices have risen rapidly. Policy tightening is expected to cause a small moderation of growth from 2008. The recent performance of the Indian economy has also been impressive, with growth of more than 9 per cent in 2006. This year, GDP growth is expected to moderate slightly, as a result of higher interest rates and appreciation of the Indian rupee. These factors have also helped to reduce inflation.

Emerging Europe

A.14 In Russia, output in 2007 is expected to grow by more than 6 per cent for the fifth consecutive year. In the wider region, momentum in domestic demand since 2006 is expected to carry through to this year, with growth expected to moderate to more sustainable rates from 2008. Some countries have experienced a pick-up in inflation on the back of rapid demand growth and tighter labour markets.

Latin America

A.15 Following strong GDP growth in 2006, the expansion in Latin America is expected to ease through 2007 and 2008, reflecting the impact of slower US growth on the region's net exports. Higher food prices have resulted in a pick-up in inflation in several countries in the region, which in turn has led to concern about overheating and, in some cases, prompted tighter monetary policy.

World trade and UK export markets

A.16 As forecast at the time of Budget 2007, world trade growth slowed in the first half of 2007, to $7^3/_4$ per cent on a year earlier, reflecting a broad-based slowdown across all regions. From 2008 onwards, world trade is expected to grow at rates slightly above the historical average. Recent momentum in world trade has largely reflected strength across emerging markets: in 2007, Asia excluding Japan and emerging Europe are expected to account for around half of total world trade growth.

A.17 Slower-growing mature economies make up a larger proportion of UK export markets than of overall world trade. As a result, consistent with the expected moderate growth in the G7 economies, and particularly the US, growth in UK export markets is forecast to be slightly below that of world trade.

Oil and commodity prices

A.18 Since 2002, the price of a barrel of Brent crude oil, the European standard, has more than trebled. It has averaged around \$68 so far in 2007, close to the \$66 average in 2006, but considerably above the \$20 a barrel average over the decade to 2002.

A.19 Since Budget 2007, oil prices have risen above consensus forecasts, reaching new nominal highs over the past month. Various factors, including resilient demand, weak supply growth, unexpected difficulties in the US refining sector, and real and perceived risks to supply, have put upward pressure on prices. The average of independent forecasts is for the price of Brent crude to ease slightly in 2008. The outlook for oil prices remains sensitive to geo-political, regulatory and weather-related risks in the major producer and consumer nations.

A.20 Non-fuel commodity prices remain high. The price of metals has continued to rise strongly in 2007, although most prices have moderated more recently in response to financial market developments. Some agricultural commodities have experienced significant and more widespread price increases in 2007, notably the price of wheat, which reached an 11-year peak in nominal terms over the past month due to the poor crop in a number of major producing countries, and rising demand for bio-fuels.

THE UK ECONOMIC FORECAST

The Treasury's approach to economic forecasting

A.21 The Treasury's approach to forecasting macroeconomic developments, set out in detail in Budget 2007,[3] accords with the growth cycle approach favoured by many policymakers. The essential building blocks of this approach are the estimate of the 'trend' level and rate of growth of output, and analysis of cyclical movements around that trend, the 'output gap'. The trend growth projection provides the medium-term anchor for the forecast. The current output gap estimate, and an assessment of the economy's momentum based on analysis of the individual output, income and expenditure components of activity, informs judgement on the short-term path of the economy back to trend.

A.22 Once the effects of known shocks are forecast to have dissipated and the economy is judged to have returned to trend, growth is generally held at its trend rate and the output gap at zero. That is not to suggest that the growth rate will actually be constant in later periods of the forecast, but rather that future shocks to the economy are as likely to be positive as negative so that, on average, the best forecast of growth once present shocks have worked through will be the trend rate.

A.23 The Treasury assesses trend output growth on the basis of non-oil gross value added (GVA) rather than overall GDP because, while the oil and gas sector affects output, it has little direct impact on capacity pressures in the rest of the economy, and hence the sustainable level of non-oil activity or employment.

Overview of recent developments

A.24 The UK's macroeconomic performance continues to be strong and stable. GDP in the UK has now expanded for 60 consecutive quarters, the longest expansion since quarterly National Accounts began in the mid-1950s. According to the latest Office for National Statistics (ONS) estimates, since late 2005 quarterly growth rates have been slightly above trend and have varied by no more than 0.1 percentage points.

GDP growth

A.25 Between Budget and Pre-Budget Reports, National Accounts data are typically subject to significant revisions during the annual Blue Book process, at which time the ONS takes on information from new and more comprehensive data sources, as well as making improvements to statistical methodologies. As a result of resource reprioritisation necessary to deliver modernised National Accounts in 2008, the 2007 Blue Book process was limited in scope.[4] The revisions to GDP growth contained in Blue Book 2007 were therefore smaller than those in recent Blue Books: no more than 0.1 percentage points in any year. In consequence, there could be larger than normal revisions in Blue Book 2008.

A.26 As reported in Budget 2007, the UK economy grew by 2 3/4 per cent in 2006. Data released since Budget time show that GDP grew by 0.8 per cent in each of the first and second quarters of 2007, bringing output growth in the first half of the year to 3 1/4 per cent on a year earlier, towards the upper end of the Budget 2007 forecast range for the year as a whole. Non-oil GVA growth in the year to the second quarter of 2007 was above trend at 3 1/4 per cent, slightly stronger than expected at the time of Budget 2007.

[3] See paragraphs B.30 to B.35, Budget 2007.

[4] Blue Book 2007 included improvements to the measurement of own-account software investment, but delayed until 2008 improvements to the treatment of banking sector output, known as FISIM (financial intermediation services indirectly measured), and the normally annual process of benchmarking and balancing the accounts. For more detail see *Modernising the UK's National Accounts*, Economic & Labour Market Review, ONS, April 2007.

A.27 The process of rebalancing between the domestic components of demand that began in 2005 has continued. In 2006 as a whole, private consumption grew by 2 per cent, below the 2 3/4 per cent rate of the whole economy, while business investment grew by 7 1/2 per cent. In the first half of 2007, consumption was up 3 per cent on a year earlier, compared with 3 1/4 per cent for whole economy GDP, and business investment was 8 3/4 per cent higher. In terms of the rebalancing between domestic and external demand, net exports continued to subtract from growth in 2006, but appear to have been more neutral in the first half of 2007, though trade data are subject to possible measurement difficulties discussed in paragraph A.62. On the output side, while the service sector remained the main source of growth, manufacturing has also contributed positively to growth over the past year and a half, while oil production picked up during the first half of 2007 after an extended period of negative growth.

Inflation

A.28 Having risen during 2006, consumer price inflation continued to rise during the first quarter of 2007, peaking at 3.1 per cent in March. The rise in headline inflation was initially driven by energy price developments, caused by high oil and wholesale gas prices. On top of that, food price inflation was pushed higher by the effects of the unusually hot UK summer in 2006 and, thereafter, global supply and demand pressures. RPI inflation increased by more than CPI inflation, peaking at 4.8 per cent in March, mainly reflecting the impact of tighter monetary policy on mortgage interest payments.

A.29 CPI inflation has fallen back sharply from its peak in March to stand at 1.8 per cent in August, mainly due to the ongoing effect of utility price cuts, and some supermarket-led reductions in food prices. RPI inflation has also eased, to 4.1 per cent by August. Volatile movements in the price of furniture and furnishings, with monthly changes more than twice as large during 2007 than on average over the preceding decade, have made short-term forecasting of inflation more difficult. Nevertheless headline inflation has eased as expected.

A.30 Despite record employment levels and high oil prices, inflation expectations have remained anchored to target, and there has been little sign of any significant upward pressure on wages. The Government has demonstrated its commitment to ensuring that wage pressures remain consistent with the 2 per cent CPI inflation target by delivering overall headline awards for Pay Review Body groups in 2007-08 that average 1.9 per cent.

Monetary and fiscal policy

A.31 The Bank of England has continued to tighten monetary policy since Budget 2007, raising Bank Rate by a 1/4 percentage point in May and again in July, taking the cumulative tightening to 1 1/4 percentage points since August 2006. Market-derived interest rate expectations at the end of July implied a further tightening of monetary policy, but since then market expectations have shifted significantly and now point to some easing over coming months. At 5 3/4 per cent, Bank Rate remains significantly below the 9 1/2 per cent average of the first half of the 1990s, and further still below the 11 3/4 per cent average of the 1980s. During the period of above-trend growth in 2006-07, monetary policy was supported by a fiscal tightening.

Financial markets

A.32 The global financial market disruption described in Box A1 has had an impact on UK financial markets, in common with other major financial centres. Most notable has been the rise in short-term interest rates on lending between financial institutions, where the spread between Bank Rate and the three-month sterling LIBOR[5] interest rate, normally around 20

[5] The 'London inter-bank offered rate', LIBOR, is the rate at which banks are willing to lend to one another on an unsecured basis.

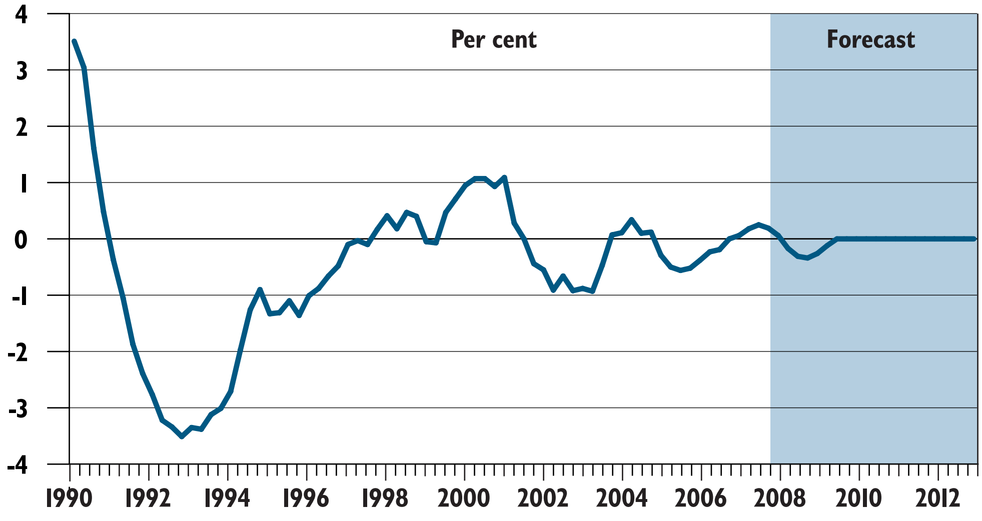
basis points, rose to more than 100 basis points in the first half of September before easing in recent weeks. At the current rate of around 6¹/₄ per cent, three-month interest rates remain low compared with the 9¹/₂ per cent average of the early 1990s and the 12 per cent average of the 1980s.

Money growth and credit conditions **A.33** Beyond any direct impact of financial market disruption on incomes and profits in the financial sector, recent developments could affect the wider economy through their impact on credit conditions for households and companies. Growth rates of the broad money supply and lending to the private sector remained strong during the year to August 2007, though they have eased slightly from the historically high rates seen during the second half of 2006. The Bank of England's new *Credit Conditions Survey*, published for the first time on 26 September, suggested that recent financial market disruption had yet to impact on credit conditions facing households, although there was evidence that it was to some extent affecting the price and availability of credit to the corporate sector. Bank of England data on effective interest rates on deposits and lending for August 2007 presented a similar picture, with more muted increases in borrowing rates for households than for companies.

Assessment of the output gap

Evidence from the cyclical indicators **A.34** Since Budget 2007, upward revisions to estimates of non-oil GVA growth in 2006, combined with estimates of 0.8 per cent growth in each of the first two quarters of 2007, show the UK economy to have been growing at slightly above-trend rates for seven consecutive quarters through to mid-2007. Evidence from the broad range of cyclical indicators monitored by the Treasury,[6] set out in the following paragraphs, suggests the economy may currently be operating slightly above trend and that output may have moved up through trend towards the end of 2006.

Chart A3: The output gap[1]



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

[6] Details of these indicators can be found in the *Technical note on cyclical indicators*, HM Treasury, December 2005.

A.35 Private sector business surveys suggest that capacity utilisation in the manufacturing and service sectors had moved to levels consistent with the economy being marginally above trend by the second quarter of 2007. These indicators have generally risen since Budget 2007.

A.36 Indicators of recruitment difficulties, which at the time of Budget 2007 signalled spare capacity remaining in the labour market, have also picked up, providing evidence of diminishing slack. The Bank of England Regional Agents' score for recruitment difficulties has risen progressively since January 2007, and by August had moved fractionally above its long-run average. Other indicators provide further evidence of diminishing slack and strong demand for labour. For example, claimant count unemployment has fallen for 11 consecutive months, and by more than 100,000 since September 2006. The Labour Force Survey unemployment rate has edged down, although it remains above its lows in 2005. The number of vacancies has risen to a six-year high. Labour market developments typically lag changes in output, so signs of the labour market tightening through 2007 would be consistent with the economy moving upwards through trend towards the end of 2006.

A.37 Average earnings growth has so far remained subdued, with whole economy measures including and excluding bonuses standing at just $3\,^1/_2$ per cent on a year earlier in the second quarter of 2007. More generally though, indicators of domestically-generated inflation appear consistent with the economy operating close to trend, with recent fluctuations in headline CPI inflation not driven by domestic cyclical factors.

A.38 The trend growth arithmetic,[7] based on the latest National Accounts data and the Treasury's trend output assumptions, implies output passed through trend in the final quarter of 2006 and that a small positive output gap, of around a $^1/_4$ per cent, has opened up. However, with output assessed still to be close to trend, National Accounts data more than usually subject to revision, and growth forecast to slow in 2008, it is too soon to assess whether or not the economic cycle has ended.

Assessment of trend growth

A.39 The Treasury's neutral estimate of the economy's trend rate of output growth for the 2007 Pre-Budget Report remains at $2\,^3/_4$ per cent a year to the end of the projection period, the same assumption that underpinned the previous two economic forecasts.[8]

A.40 Table A2 presents estimates of trend output growth and its decomposition to the end of 2006, and the Treasury's projection thereafter.

Summary of outturns from 2001 to 2006

A.41 The latest National Accounts data show that the average rate of growth of non-oil GVA between the 2001 on-trend point and the final quarter of 2006 was 2.77 per cent, in line with the Treasury's trend output projection for that period, which has been consistently maintained since it was introduced at Budget 2002.[9] In terms of the composition of trend growth, the latest data suggest that average annual productivity growth over the period was slightly higher than the projections set out in Budget 2007, while the average annual growth rates of the working-age employment rate and average hours were slightly lower.

[7] See paragraph B.34 of Budget 2007 for a fuller explanation of the trend growth arithmetic.

[8] For a full discussion of the most recent review of the Treasury's trend growth projections, see *Trend growth: new evidence and prospects*, HM Treasury, December 2006.

[9] See *Trend growth: recent developments and prospects*, HM Treasury, April 2002.

A.42 Despite the data underlying these calculations remaining subject to revision, the evidence suggests that, for the time being, small technical adjustments should be made to the projected growth rates of the components of trend growth for the period from 2007 onwards, to align these component projections with latest data. As such, the projection for trend productivity growth on an unadjusted basis has been increased from 2.15 to 2.30 per cent, and projections for the annual trend rate of growth of the employment rate and average hours worked have been changed from 0.2 to 0.1 per cent and -0.2 to -0.25 per cent respectively. These adjustments offset each other within the unchanged overall projection for trend output growth, which remains at 2 3/4 per cent a year.

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	Unadjusted				
	(1)	(2)	(3)	(4)	(5)	(6)
1986Q2 to 1997H1						
Latest data	2.13	1.95	–0.11	0.36	0.25	**2.46**
Over the recent past						
1997H1 to 2001Q3						
Latest data	2.89	2.70	–0.46	0.38	0.53	**3.17**
2001Q3 to 2006Q4						
Budget 2002[5]	2.10	2.00	–0.1	0.2	0.6	**2¾**
PBR 2006 and Budget 2007	2.25	2.15	–0.2	0.2	0.7	**2¾**
Latest data[6,7]	2.35	2.32	–0.27	0.06	0.65	**2.77**
Projection[8]						
2006Q4 onwards						
PBR 2006 and Budget 2007	2.25	2.15	–0.2	0.2	0.6	**2¾**
PBR 2007[9]	2.35	2.30	–0.25	0.1	0.6	**2¾**

[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: new evidence and prospects', HM Treasury, December 2006.
[2] The underlying trend rate is the unadjusted 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 average hours worked lag output by just one quarter, though this lag is harder to support by econometric evidence. Hours worked and the employment rate are measured on a working-age basis.
[4] UK resident household basis.
[5] Interim projections between Budget 2002 and PBR 2006 are provided in an expanded table in '2007 Pre-Budget Report: the economy and public finances – supplementary charts and tables', HM Treasury, October 2007.
[6] Estimates based on the assumption that the economy passed up through trend in the final quarter of 2006.
[7] Estimates have been adjusted in line with the mid-year population estimates published in August 2007. Labour market statistics consistent with the latest population estimates will be published by the ONS in due course.
[8] Neutral case assumptions for trend from 2006Q4.
[9] Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2006Q4 are anchored.

Labour market developments

A.43 Employment grew by around 275,000 in the year to the fourth quarter of 2006, with roughly 30 per cent of that increase accounted for by workers of above the State Pension age. As a result, while the working-age employment rate was broadly stable through the year at around 74½ per cent, the employment rate for older workers increased from 10½ to 11 per cent. Despite that increase, the employment rate among all adults has remained broadly stable at around 60 per cent. Employment rose by 84,000 in the three months to July and stands at a record high above 29 million. Private sector employment growth has been solid, up around 175,000 on year earlier in the second quarter, while public sector employment has fallen by more than 40,000 over the same period. Employment rates among the working-age and older workers have remained stable in 2007.

A.44 At the time of the 2006 Pre-Budget Report, the Treasury revised up its estimate of the economy's trend rate of output growth from 2007 onwards based on analysis of evidence that pointed to the contribution of net migration being a ¼ percentage point a year higher than previously assumed. The ONS's latest population estimates published in August 2007, and the long-term net migration assumption for UK population projections published in September, were consistent with the assumption underpinning the 2¾ per cent trend growth estimate. Evidence relating to short-term migrants from the new EU Member States suggests the flow in the year to the second quarter of 2007 continued at a similar rate to that in 2006.

GDP and inflation forecasts

Table A3: Summary of forecast[1]

		Forecast			
	2006	2007	2008	2009	2010
GDP growth (per cent)	2¾	3	2 to 2½	2½ to 3	2½ to 3
CPI inflation (per cent, Q4)	2¾	2	2	2	2

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

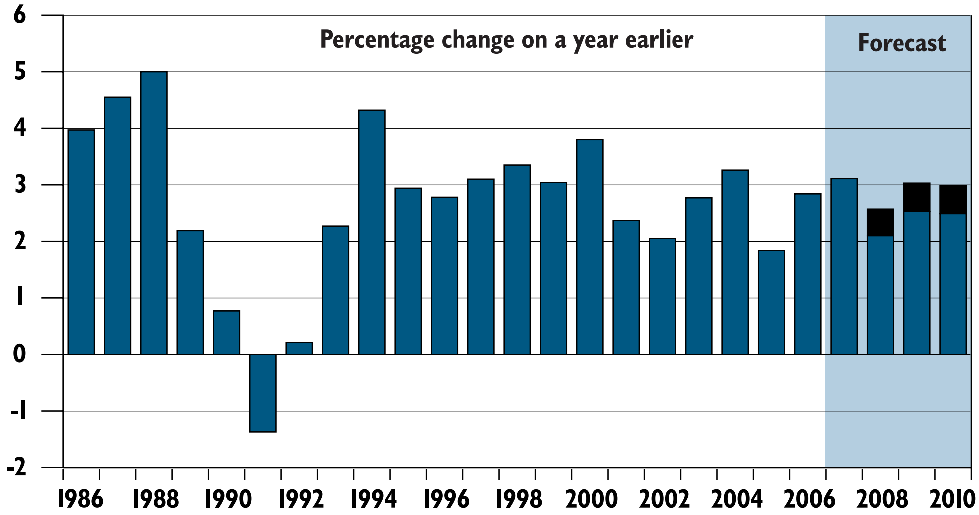
GDP and the output gap

A.45 GDP growth in the first half of 2007 was towards the upper end of the Budget 2007 forecast range for the year as a whole, itself unchanged since the 2005 Pre-Budget Report, at 3¼ per cent on a year earlier. With recent growth in non-oil GVA having been slightly stronger than expected at the time of Budget 2007, the output gap in mid-2007 is estimated to be slightly positive, compared with zero in the Budget forecast. On unchanged trend output growth assumptions, this implies a little less scope for growth over the year ahead if the inflation target is to be met.

A.46 Private sector business surveys, most notably those published by the Chartered Institute of Purchasing and Supply, and the Bank of England's Regional Agents' scores, suggest the economy carried significant momentum into the second half of 2007. In light of such evidence, the 2007 Pre-Budget Report forecast is for GDP growth of 3 per cent in the year as a whole, in line with the Budget 2007 forecast. Growth of non-oil GVA is forecast to be slightly stronger than it was in Budget 2007.

A.47 The MPC has raised Bank Rate by more than financial markets expected at Budget time, which can be expected to impact on growth in 2008. In addition, disruption in financial markets has meant economic prospects have become more uncertain, and events need to unfold further before the impact on the economy can be rigorously quantified. For the purposes of the economic forecast, it has been assumed that there will be some feed-through to tighter credit conditions and to household and company spending in the short term. Market expectations of future Bank Rate have moved lower since July 2007, and now point to some easing over coming months. The UK economy has proved resilient to a number of shocks over the past decade, demonstrating the pay-off to the Government's macroeconomic framework and promotion of open and flexible labour, product and capital markets, but it would be unreasonable to assume the effects of an unexpected shock could be absorbed immediately.

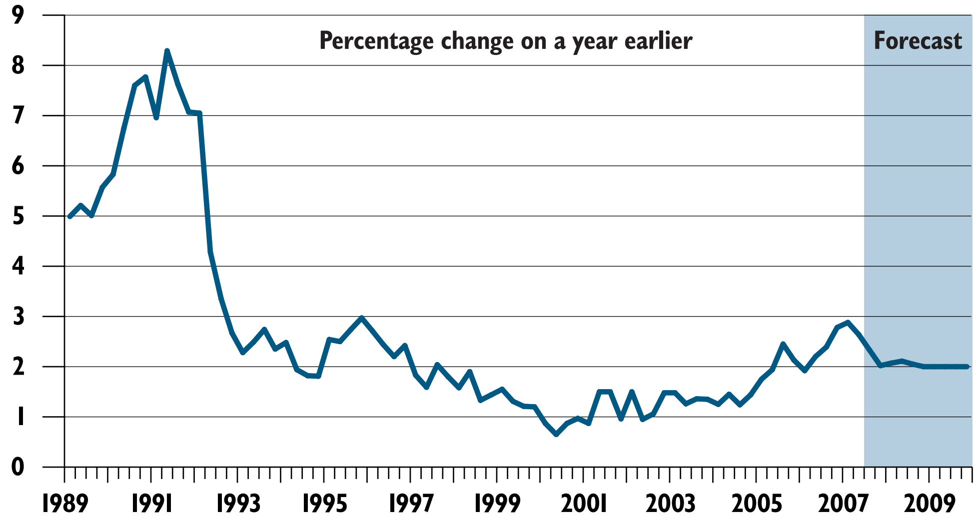
Chart A4: Gross Domestic Product (GDP)[1]



[1] Shaded areas on bars represent forecast ranges.

A.48 Against this backdrop, GDP growth in 2008 is forecast to slow to 2 to 2 1/2 per cent, below its trend rate, consistent with keeping inflationary pressures in check. The economy is forecast to return to trend in 2009, with growth forecast to be in the range of 2 1/2 to 3 per cent from then onwards.

Chart A5: CPI[1]



[1] Outturns until 2007Q2; forecasts for every second quarter from 2007Q4 to 2010Q4.

Inflation **A.49** CPI inflation is forecast to remain close to the 2 per cent inflation target throughout the forecast horizon reflecting the offsetting effects of a number of factors. These include upward cost pressures from food and oil prices, and downward pressures from the ongoing effect of monetary policy tightening over the past year and below-trend growth in 2008.

UK DEMAND AND OUTPUT IN DETAIL

A.50 During the early years of this decade, the strength of private consumption growth relative to the other components of demand caused its share of the economy to rise to historic highs. The process of rebalancing between the sources of growth, described in paragraph A.27 above, is forecast to continue. Private consumption is forecast to grow at rates slightly below that of the whole economy, while business investment growth is forecast to be slightly stronger and the contribution of net trade to return to broad neutrality.

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

	Percentage points, unless otherwise stated						
	Average			Forecast			
	2000 to 2004	2005	2006	2007	2008	2009	2010
GDP growth, per cent	$2\frac{3}{4}$	$1\frac{3}{4}$	$2\frac{3}{4}$	3	2 to $2\frac{1}{2}$	$2\frac{1}{2}$ to 3	$2\frac{1}{2}$ to 3
Main contributions							
Private consumption	$2\frac{1}{4}$	1	$1\frac{1}{4}$	2	$1\frac{1}{4}$	$1\frac{1}{2}$	$1\frac{1}{2}$
Business investment[3]	$\frac{1}{4}$	$\frac{1}{4}$	$\frac{3}{4}$	$\frac{3}{4}$	$\frac{1}{2}$	$\frac{1}{2}$	$\frac{1}{2}$
Government[3,4]	$\frac{3}{4}$	$\frac{1}{2}$	$\frac{1}{2}$	$\frac{3}{4}$	$\frac{3}{4}$	$\frac{1}{2}$	$\frac{1}{2}$
Change in inventories	0	0	$-\frac{1}{4}$	0	0	0	0
Net trade	$-\frac{1}{2}$	0	$-\frac{1}{4}$	$-\frac{1}{4}$	0	0	0

[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 projecting the public finances, forecasts are based on the bottom of the GDP forecast range.*

[3] *Excludes exceptional transfer of BNFL nuclear reactors to central government in 2005Q2.*

[4] *The sum of government consumption and government investment.*

Households and consumption[10]

A.51 Private consumption is the largest expenditure component of demand, accounting for around 63 per cent of nominal GDP. In line with the recent rebalancing of the economy, that ratio has come down from a peak of 66 per cent in mid-2001.

Table A5: Household sector[1] expenditure and income

	Percentage change on a year earlier, unless otherwise stated				
		Forecast			
	2006	2007	2008	2009	2010
Household consumption[2]	2	3	$1\frac{3}{4}$ to $2\frac{1}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$
Real household disposable income	$1\frac{1}{4}$	$1\frac{1}{2}$	$1\frac{3}{4}$ to $2\frac{1}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$	$2\frac{1}{4}$ to $2\frac{3}{4}$
Saving ratio[3] (level, per cent)	5	$3\frac{1}{2}$	$3\frac{3}{4}$	4	$4\frac{1}{4}$

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

[2] *Chained volume measures.*

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

[10] In the National Accounts, private consumption is comprised of final consumption expenditure by households and non-profit institutions serving households (NPISH). Throughout this section, the terms 'household consumption' and 'private consumption' always refer to total final consumption expenditure by households and NPISH.

Disposable income

A.52 Real household disposable incomes grew by 1¼ per cent in 2006, with growth having moderated from 2005. Growth of wages and salaries remained solid, with the slowdown primarily explained by growth in net property income, the difference between interest and dividends received and paid by households, which fell from 20 per cent in 2005 to 1 per cent in 2006. Growth of real incomes is expected to firm from 2007.

Box A2: Developments in private sector balance sheets

Developments in private sector balance sheets are a key element of the macroeconomic backdrop against which to analyse the potential impact of higher market and policy interest rates on demand. Over the past decade, the success of the Government's macroeconomic policy framework in delivering stability with low interest rates has given households and companies the confidence to borrow and invest. The size of household and corporate sector financial balance sheets relative to GDP has expanded on both the asset and liability sides.

In aggregate, household sector net worth, the value of all financial and non-financial assets less financial liabilities, is almost £7 trillion. Households now have almost £4 trillion of financial assets, up from £2.2 trillion at the beginning of 1997, outweighing around £1.3 trillion of outstanding debt. Within their financial assets, households have more than £1 trillion worth of cash and bank deposits, and while the ratio of these liquid assets to GDP has continued to rise over the past three years, households' unsecured borrowing has stabilised. The household sector's net financial assets are more or less matched by the corporate sector's net financial liabilities, since it is through companies' investment of those funds that returns are generated for investors and savers.

In both the household and corporate sectors, interest-bearing financial assets and liabilities, deposits and loans, have been growing more strongly than other components of the financial balance sheet. As such, changes in effective interest rates on the stock of assets or liabilities will lead to larger changes in total interest receipts and payments than in the past. The net effect of these larger flows will tend to be broadly offsetting at the macroeconomic level, although it will depend on the extent to which interest rates on saving and borrowing move in step.

Chart a: Household sector interest-bearing assets and liabilities

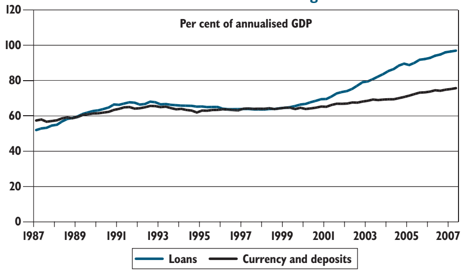
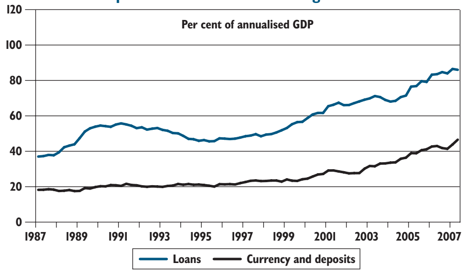


Chart b: Corporate sector interest-bearing assets and liabilities



While these macroeconomic balance sheet measures are key to understanding the potential effect of changes in interest rates on activity, developments will not have been uniform within sectors. So, while the household sector in aggregate has accumulated financial assets and liabilities, there will be disparities across households. The Government recognises that for a small minority of households, excessive personal debt can become a problem, leading potentially to financial difficulties. Actions to address these issues are set out in Chapter 5.

Household spending **A.53** Private consumption grew by 2 per cent in 2006, and by 3 per cent on a year earlier in the first half of 2007, somewhat stronger than expected at Budget time. It is expected to grow by 3 per cent in 2007, slightly above the Budget 2007 forecast range. Retail sales volumes in July and August were up by $1\frac{1}{2}$ per cent on the second quarter. This suggests that consumption may continue to grow at rates close to that of the whole economy in 2007, although retail sales account for only around a third of total consumer spending.

A.54 With Bank Rate currently somewhat higher than financial markets expected at the time of Budget 2007, consumption growth is forecast to slow, with growth of $1\frac{3}{4}$ to $2\frac{1}{4}$ per cent in 2008, lower than forecast at Budget time, before returning to rates of growth just below that of the whole economy from 2009. So far there appears to have been little evidence of financial market disruption feeding through to credit conditions for households, and the September GfK consumer confidence survey suggested households remained relatively upbeat about the prospects for their own finances over the coming 12 months.

Saving ratio **A.55** The household saving ratio is estimated to have fallen from 5 per cent in 2006 to $2\frac{1}{2}$ per cent in the first half of 2007, though early estimates can be subject to substantial revision. For example, initial estimates of 3 per cent for the saving ratio in mid-2000 have been subsequently revised up to almost 5 per cent. The saving ratio is forecast to rise over the forecast horizon, with disposable income growing slightly faster than consumer spending.

House prices **A.56** The latest releases from the main mortgage lenders report house price inflation of around 9 per cent on a year earlier. There is, though, evidence that house price inflation is easing, with monthly increases averaging 0.4 per cent since May 2007, compared with 1.0 per cent during the first four months of the year. House price inflation is expected to continue to ease over the coming year.

A.57 Investment in dwellings increased by $8\frac{1}{2}$ per cent in 2006, contributing around $1\frac{1}{2}$ percentage points to the $8\frac{1}{4}$ per cent growth of whole economy investment, and is forecast to grow by $4\frac{1}{4}$ per cent in 2007. Growth in later years of the forecast is expected to be slightly above that of whole economy GDP, supported by the Government's target for house building set out in the Green Paper *Homes for the future: more affordable, more sustainable*.[11]

Companies and investment

A.58 As currently measured, business investment accounts for slightly more than 10 per cent of nominal GDP, but its importance to the economy extends beyond that through its role in increasing the capital intensity of the UK economy, a key driver of labour productivity growth. Indeed, as discussed in Box A3 and the Treasury Economic Working Paper published alongside the Pre-Budget Report, its role in the economy may be greater than suggested by conventional measures of investment, given the growing importance of investment in intangible assets in the UK's increasingly knowledge-intensive economy. A rising share of investment in intangible assets would help to resolve some of the apparent puzzle concerning past business investment growth.

[11] *Homes for the future: more affordable, more sustainable*, Communities and Local Government, July 2007.

Company finances

A.59 Profit growth and profitability remained strong in the first half of 2007. The gross operating surplus of the private non-financial corporate sector, a measure of nominal profits, rose by 11½ per cent on a year earlier, and the sector's financial surplus reached 3 per cent of GDP. The net rate of return on capital, a measure of profitability, reached new record highs in the second quarter, at 15¾ per cent across all private non-financial companies and 21½ per cent in the service sector.

A.60 External financing conditions have become somewhat less supportive over recent months, particularly in the credit markets. Spreads on corporate bonds have widened, most notably for companies with lower credit ratings. Growth in bank lending to the corporate sector remained strong in the year to August 2007, although the Bank of England's *Credit Conditions Survey*, released on 26 September, suggested that financial market disruption was to some extent affecting the price and availability of credit to non-financial companies. However, non-financial company equity prices have firmed over the past month, and are up around 6 per cent since Budget 2007.

Table A6: Gross fixed capital formation

	Percentage change on a year earlier				
		Forecast			
	2006	**2007**	**2008**	**2009**	**2010**
Whole economy[1]	8¼	5¾	3¼ to 3¾	3¼ to 3¾	3¼ to 3¾
of which:					
Business[2,3,4]	7½	6	3¼ to 3¾	3¾ to 4¼	3¾ to 4¼
Private dwellings[3]	8½	4¼	2¼ to 2¾	2¾ to 3¼	2¾ to 3¼
General government[3,4]	6	10½	7½	3	5

[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.*

[4] *Excludes exceptional transfer of BNFL nuclear reactors to central government in 2005Q2.*

Business investment

A.61 Business investment growth picked up from 3 per cent in 2005 to 7½ per cent in 2006, the fastest rate since 1998. Although quarterly growth rates slowed in the first half of 2007, the level of investment remained high, up 8¾ per cent on a year earlier, and business investment is forecast to grow by 6 per cent in the year as a whole. Strong profitability, combined with survey evidence of positive investment intentions and capacity constraints beginning to bind, point to ongoing business investment growth. However, with evidence that the cost of capital has risen since Budget time, business investment growth is forecast to slow in 2008, to 3¼ to 3¾ per cent.

Box A3: Intangible investment and Britain's productivity

Rapid technological change and the emergence of newly industrialised economies are intensifying competition in the global economy, with knowledge and other intangible assets of growing importance in maintaining competitiveness. A Treasury Economic Working Paper published alongside the Pre-Budget Report investigates the consequences for a range of macroeconomic variables, including productivity, of treating spending on knowledge as investment.[a]

The knowledge assets considered are scientific R&D, software, design, non-scientific R&D and spending by firms on reputation, human and organisational capital. By assembling investment data on these knowledge assets and adjusting National Accounts macroeconomic variables in the appropriate way, the research finds that treating spending on knowledge as investment would have the following impact:

- **business investment in 2004 would have been about double the conventional measure. Investment in intangibles was £123 billion, compared with tangible investment of £96 billion;**
- **the value of measured market sector output would have been higher by about 6 per cent in 1970 and 13 per cent in 2004;**
- **instead of the ratio of nominal business investment to market sector output falling since 1970, it would have been rising;**
- **growth in labour productivity and capital deepening would have been higher than previously estimated;**
- **total factor productivity growth would not have slowed down since 1990, as it appears on current measures, but would have been picking up; and**
- **comparing the results with the US suggests that the share of intangible investment in market sector output is similar in both countries.**

These results suggest that conventional measures of investment may not be capturing the dynamic changes that are taking place as knowledge-intensive industries increase in importance. The Government has identified investment and innovation as two of the key drivers for raising productivity growth, and has implemented major reform programmes under each (discussed further in Chapter 4). The results in the working paper highlight the importance of these two drivers, and of focusing on more than just conventional measures of tangible capital.

[a] Giorgio Marrano, M. , Haskel, J. and Wallis, G. (2007), *Intangible investment and Britain's productivity,* Treasury Economic Working Paper No.1 (new series), available on the Treasury website: www.hm-treasury.gov.uk

Trade and the balance of payments

A.62 As set out in Budget 2007, annual growth in recorded exports and imports of goods and services has been distorted by activity related to missing trader intra-community fraud (MTIC), which significantly inflated the value of measured goods trade in the first half of 2006. Since the second half of 2006, Government measures to tackle MTIC fraud have led to a sharp fall in estimated MTIC-related activity, to a low level. In view of inevitable measurement difficulties involved in estimating MTIC-related activity, the ONS advises that comparisons of trade volumes and prices "should be treated with a great deal of caution".[12] The forecast abstracts from MTIC effects by assuming that beyond the latest quarter of data, export and import volumes grow in line with underlying trade, excluding MTIC-related activity. The forecast is therefore based on the neutral assumption that the level of MTIC-related activity remains constant throughout the forecast at the latest quarterly estimate. Table A7 presents export and import growth forecasts excluding the effect of MTIC-related activity.

[12] *First release: UK trade, July 2007*, ONS, September 2007.

Exports of goods and services

A.63 Growth in the volume of exports of goods and services excluding MTIC-related activity is estimated to have moderated progressively over the past year and a half, from $11\frac{1}{2}$ per cent on a year earlier in the first half of 2006 to 3 per cent in the second half and minus 1 per cent in the first half of 2007. Growth in services export volumes picked up from $4\frac{1}{2}$ per cent in 2006 to $8\frac{3}{4}$ per cent in the first half of 2007, so all of the slowdown was explained by lower, then negative, growth in goods export volumes. The slowdown in measured goods trade volumes this year has been at odds with evidence from a broad range of private sector business surveys, which are consistent with growth having picked up. The latest monthly estimates of export growth point to a stronger third quarter of 2007.

A.64 Given the pattern of measured export growth so far in 2007, the volume of exports excluding MTIC-related activity is forecast to grow by $3\frac{1}{4}$ per cent in 2007, below the Budget 2007 forecast range. Growth is expected to pick up to rates of around $4\frac{1}{2}$ to $5\frac{1}{4}$ per cent from 2008. One channel through which global financial market disruption could affect the UK economy is its impact on the financial sectors of key trading partners. For example, exports of financial services to the US made up around $7\frac{1}{2}$ per cent of total UK exports in 2006.

Imports of goods and services

A.65 Estimates of imports of goods and services excluding MTIC-related activity have followed a very similar pattern to exports, with annual growth slowing from $9\frac{1}{4}$ to $4\frac{1}{2}$ to $1\frac{1}{4}$ per cent over successive half-year periods. Again, the volume of services imports picked up in the first half of 2007, from $3\frac{1}{2}$ per cent on a year earlier in 2006 to $7\frac{1}{4}$ per cent, so the slowdown has been entirely accounted for by the volume of goods imports. Together these developments suggest that some of the recent moderation in the growth of goods trade volumes could be related to the measurement difficulties outlined above. Since the estimated slowdown has been of a similar magnitude for imports and exports, estimates of net trade should be broadly unaffected.

A.66 As with exports, import growth excluding MTIC-related activity in 2007 is expected to slow from 2006, to $3\frac{3}{4}$ per cent on a year earlier. With UK consumption and investment growth forecast to ease in 2008, import growth is forecast to pick up slightly less than export growth, to around $3\frac{3}{4}$ to $4\frac{1}{2}$ per cent. As a result, having subtracted a $\frac{1}{4}$ percentage point from growth in 2006 and 2007, the contribution of net trade to growth is forecast to return to neutrality from 2008.

Table A7: Trade in goods and services

	Percentage change on a year earlier					£ billion
	Volumes (excluding MTIC)[1]		Prices[2]			Goods and services balance
	Exports	Imports	Exports	Imports	Terms of trade[3]	
2006	7	$6\frac{3}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$	0	$-48\frac{1}{4}$
Forecast						
2007	$3\frac{1}{4}$	$3\frac{3}{4}$	$1\frac{1}{2}$	0	$1\frac{1}{2}$	$-45\frac{3}{4}$
2008	$4\frac{1}{2}$ to 5	$3\frac{3}{4}$ to $4\frac{1}{4}$	$\frac{1}{2}$	$\frac{1}{2}$	0	$-45\frac{1}{4}$
2009	$4\frac{3}{4}$ to $5\frac{1}{4}$	4 to $4\frac{1}{2}$	$1\frac{1}{4}$	$1\frac{1}{2}$	0	$-45\frac{3}{4}$
2010	$4\frac{3}{4}$ to $5\frac{1}{4}$	4 to $4\frac{1}{2}$	2	$2\frac{1}{4}$	0	$-46\frac{3}{4}$

[1] *Table A9 contains figures including the effects of MTIC-related activity.*

[2] *Average value indices.*

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

Current account balance

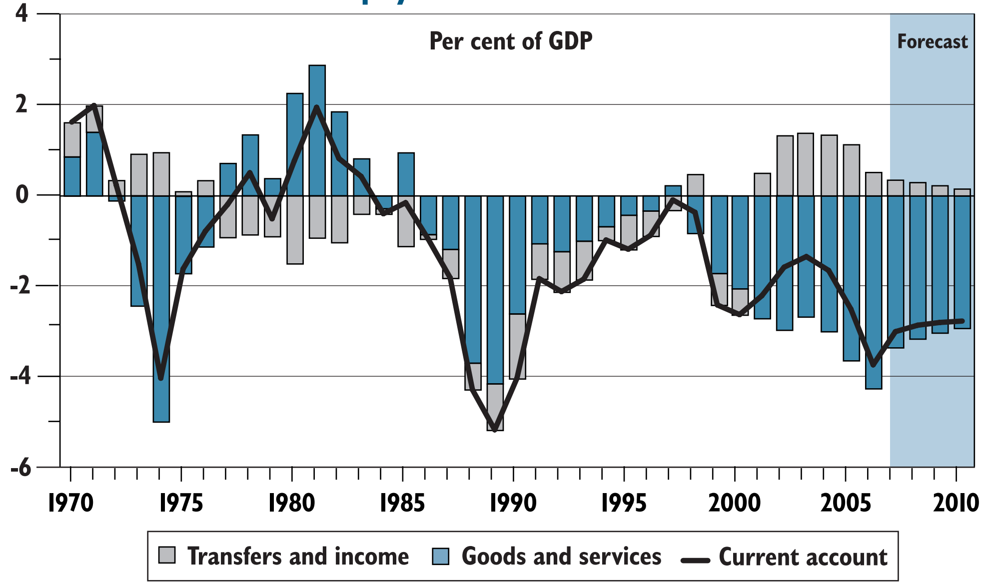
A.67 The UK's deficit on trade in goods and services narrowed to 3½ per cent of GDP in the first half of 2007 from 3¾ per cent in 2006, reflecting a slightly larger surplus on trade in services and a broadly stable deficit on trade in goods. On the goods side, the UK's balance of trade in crude oil returned to surplus in the first half of 2007 from a small deficit in 2006. The UK's surplus on investment income was 1½ per cent of GDP in the first half of 2007, unchanged from 2006. Within that, the surplus on FDI-related earnings picked up from 3¼ to 3¾ per cent of GDP, as UK companies continued to earn significantly higher returns on their investments overseas than are earned by foreign companies on their assets in the UK.

A.68 The UK's current account deficit narrowed from 3¼ per cent of GDP in 2006 to 3 per cent of GDP in the first half of 2007. It is expected to continue to narrow in 2008 and to stabilise at around 2¾ per cent of GDP.

Foreign direct investment

A.69 The UK continues to attract large amounts of inward FDI. Foreign companies invested a further £46½ billion in the UK in the first half of 2007, having invested £77 billion in 2006 and a record £108 billion in 2005. UK companies also continue to invest overseas, with the flow of outward FDI reaching £32¼ billion in the first half of 2007, on top of almost £70 billion in 2006.

Chart A6: Balance of payments current account



Service sector output

A.70 The share of UK output accounted for by the service sector has risen steadily in recent years to reach 75 per cent. That is higher than in most developed economies, and its share has risen more quickly in the UK than in other G7 economies. The service sector also plays a larger role in UK exports than it does for other G7 economies, its share having risen from less than a quarter to more than a third in just 10 years.

A.71 Service sector output growth rose from 3 per cent in 2005 to 3¾ per cent in 2006 and the first half of 2007. Within that, the finance and business services sector has been notably strong, accounting for around half of measured whole economy output growth. The financial sector alone has seen annual growth rates pick up from 5¾ per cent in 2005 to 8½ per cent in 2006 and 10½ per cent in the first half of 2007. That momentum seems likely to diminish in the short term in light of recent financial market developments, though it is notable that the UK's innovative financial sector was relatively quick to recover following periods of financial market disruption in 1998 and 2001.

Manufacturing and North Sea output

Manufacturing **A.72** Manufacturing accounts for around 14 per cent of the UK economy. In 2006, boosted by the pick-up in export growth in the first half of the year, and the strength of business investment growth throughout the year, manufacturing output grew by $1^1/_4$ per cent on a year earlier. Consistent with investment as the key driver, growth was strongest in the capital goods sector, at $3^3/_4$ per cent. Manufacturing output was up 1 per cent on a year earlier in the first eight months of 2007, somewhat below the rate consistent with evidence from a range of private sector business surveys. The sector is forecast to grow 1 per cent in 2007 as a whole, picking up to $1^1/_2$ to 2 per cent in 2008.

North Sea **A.73** In the period to the end of 2006, a succession of temporary factors exacerbated the underlying decline in output from the North Sea to the extent that total output from the oil and gas sector had fallen by 30 per cent over three years. In the first half of 2007, helped by the Buzzard oil fields commencing output, oil production rose by around $5^1/_2$ per cent on the second half of 2006, though gas production fell by a similar amount. In addition to Buzzard, a number of smaller start-ups in 2007 and 2008 should temporarily boost oil production.

Independent forecasts

A.74 Since the 2006 Pre-Budget Report, the average of independent forecasts for GDP growth in 2007 has increased from 2.4 to 2.9 per cent, rising to within the Treasury's forecast range maintained since the 2005 Pre-Budget Report. The increase mainly reflects upward revisions to the average forecast for fixed investment growth, from 3.4 to 5.3 per cent, and for private consumption growth, from 2.3 to 2.8 per cent.

A.75 In its September 2007 interim assessment, the OECD revised up its forecast of UK growth in 2007 from 2.7 to 3.1 per cent.[13] According to the September survey by Consensus Economics,[14] growth in the UK in 2007 is currently projected to exceed that of all other G7 economies and to outperform the euro area.

A.76 The average independent GDP growth forecast for 2008 stands at the lower end of the 2007 Pre-Budget Report forecast range, at 2.0 per cent. Since Budget 2007, the average independent forecast for 2008 has been revised down by around a $^1/_4$ percentage point. The average of independent forecasts for inflation is for it to remain at target this year and next.

A.77 Treasury forecasts for GDP growth since 1997 have, on average, outperformed the independent consensus. They continue to compare well against a sample of forecasters that includes leading international organisations (IMF, OECD, EC), research institutes (Oxford Economics, NIESR) and private sector forecasters (Goldman Sachs, HSBC, JP Morgan).

[13] *What is the outlook for OECD countries? An interim assessment*, Organisation for Economic Cooperation and Development, September 2007.

[14] *Consensus forecasts*, Consensus Economics Inc., September 2007.

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

	Percentage change on a year earlier, unless otherwise stated					
	2007			2008		
	October	Independent		October	Independent	
	PBR	Average	Range	PBR	Average	Range
GDP growth	3	2.9	2.5 to 3.1	2 to $2\frac{1}{2}$	2.0	–0.3 to 2.8
CPI (Q4)	2	2.0	1.7 to 2.4	2	2.0	1.5 to 2.5
Current account (£ billion)	–41	–43.5	–53.2 to –35.0	–41	–45.9	–59.3 to –32.0

[1] *'Forecasts for the UK economy: A comparison of independent forecasts', October 2007.*

FORECAST ISSUES AND RISKS

Global financial markets

A.78 The economic outlook has recently become more uncertain. Since Budget 2007, developments in global credit markets have led to higher market interest rates across almost all developed and emerging economies. Considerable uncertainty exists over the timing and extent to which these developments might affect the wider economic outlook. Among the developed economies, the longer the recent financial disruption persists, the greater the risk of it feeding through to tighter credit conditions for households and companies, and detracting from growth. Were this to happen, the effects could spill over to the rest of the global economy through financial, trade and confidence channels.

Global economy

A.79 Among the major economies, growth in the US could slow further if the effects of the weaker housing market were to spread to the wider economy. Potentially, weaker US demand for imports could pose a risk to a number of developed and emerging economies where recent growth has been driven by net exports. However, macroeconomic fundamentals in many emerging markets have improved, which, coupled with sustained momentum, could result in output growth that exceeds current expectations. The euro area economy could prove more resilient to the US slowdown than forecast, while the monetary policy response in the US could reduce the extent of that slowdown.

A.80 Growing inflationary pressures, noted at the time of Budget 2007, remain a risk. Inflation rates have moderated in most developed countries, but have yet to recede in many emerging markets, most notably China. Energy and food prices pose an ongoing risk to inflation in developed and emerging economies alike.

A.81 The US current account deficit has narrowed from almost 7 per cent of GDP in late 2005 to $5\frac{1}{2}$ per cent by mid-2007, the lowest since 2004. While this represents a positive development, the risk of a disorderly unwinding of global imbalances remains.

UK economy

A.82 Financial market disruption could affect the UK economy through a number of channels. In relative terms, the UK has a larger financial sector than in most advanced economies. If the recent disruption were to persist, the direct impact of slower growth in the financial sector could be larger than assumed. However, if the UK's innovative financial sector, and flexible economy in general, were to absorb the shock more quickly than has been assumed, growth could be stronger than forecast.

A.83 It is too soon to quantify rigorously the effect of higher market interest rates feeding through to tighter credit conditions and to household and company spending. Indeed, the spread between market interest rates and Bank Rate has fallen significantly since mid-September, and if the spread continues to fall and rapidly reverts to historically normal levels, the economy could slow by less than expected. However, if the effective interest rates received and paid by households and companies were to rise, the impact on disposable incomes could be larger than would have been the case in the past due to the growth of private sector balance sheets described in Box A2.

Table A9: Summary of economic prospects[1]

	Percentage change on a year earlier, unless otherwise stated					
		Forecast[2,3,4]				Average errors from past forecasts[5]
	2006	2007	2008	2009	2010	2008
Output at constant market prices						
Gross domestic product (GDP)	2¾	3	2 to 2½	2½ to 3	2½ to 3	¾
Manufacturing output	1¼	1	1½ to 2	1¾ to 2¼	1¾ to 2¼	1½
Expenditure components of GDP at constant market prices[6]						
Domestic demand	3	3¼	2 to 2½	2½ to 3	2¼ to 2¾	¼
Household consumption[7]	2	3	1¾ to 2¼	2¼ to 2¾	2¼ to 2¾	1
General government consumption	2	2½	2½	2	2	1
Fixed investment	8¼	5¾	3¼ to 3¾	3¼ to 3¾	3¼ to 3¾	2¾
Change in inventories[8]	–¼	0	–¼ to 0	0 to ¼	0	¼
Exports of goods and services[9]	10¼	–3¼	4½ to 5	4¾ to 5¼	4¾ to 5¼	2¼
Imports of goods and services[9]	9¾	–2	3¾ to 4¼	4 to 4½	4 to 4½	3
Exports of goods and services (excluding MTIC)	7	3¼	4½ to 5	4¾ to 5¼	4¾ to 5¼	–
Imports of goods and services (excluding MTIC)	6¾	3¾	3¾ to 4¼	4 to 4½	4 to 4½	–
Balance of payments current account						
£ billion	–42	–41	–41	–42½	–44¼	10¾
Per cent of GDP	–3¼	–3	–2¾	–2¾	–2¾	¾
Inflation						
CPI (Q4)	2¾	2	2	2	2	–
Producer output prices (Q4)[10]	2	3	2	2	2	1
GDP deflator at market prices	2½	3¼	2¾	2¾	2¾	½
Money GDP at market prices						
£ billion	1302	1386	1453 to 1461	1530 to 1546	1609 to 1634	11
Percentage change	5½	6½	5 to 5½	5¼ to 5¾	5¼ to 5¾	¾

[1] *The forecast is consistent with National Accounts data for the second quarter of 2007, released by the Office for National Statistics on 26 September 2007. See footnote 1 on the first 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 2¾ per cent. 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 a ¼ percentage point below the neutral assumption.*

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

[5] *Average absolute errors for year-ahead projections made in autumn forecasts over the past 10 years. The average errors for the current account are calculated as a percent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2008.*

[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] *Figures up to and including 2007 are distorted by estimates of MTIC-related activity.*

[10] *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[3]	*Plus* statistical discrepancy[3]	GDP at market prices
2006		776.2	251.7	217.1	1.2	1246.3	357.1	1603.5	394.9	0.8	1209.4
2007		798.9	257.7	229.4	0.5	1287.1	345.8	1632.9	386.7	0.8	1246.9
2008		812.2 to 816.7	264.5	237.0 to 238.3	–1.7 to –0.2	1312.0 to 1319.2	361.1 to 363.1	1673.1 to 1682.3	401.3 to 403.5	0.8	1272.6 to 1279.6
2009		829.6 to 838.2	270.1	244.6 to 247.1	–0.9 to 1.9	1343.4 to 1357.4	378.0 to 382.0	1721.4 to 1739.4	417.5 to 421.9	0.8	1304.7 to 1318.3
2010		848.3 to 861.3	275.8	252.8 to 256.7	–1.8 to 2.4	1375.1 to 1396.2	396.0 to 402.0	1771.0 to 1798.2	434.6 to 441.3	0.8	1337.3 to 1357.8
2006	1st half	385.4	125.5	105.8	0.2	617.0	189.7	806.6	206.8	0.4	600.2
	2nd half	390.8	126.3	111.3	1.0	629.4	167.4	796.8	188.0	0.4	609.2
2007	1st half	397.0	127.5	113.8	1.1	639.8	168.1	808.0	189.3	0.4	619.0
	2nd half	401.9	130.3	115.6	–0.6	647.2	177.7	824.9	197.4	0.4	627.9
2008	1st half	404.5 to 406.2	131.8	117.3 to 117.8	–0.9 to –0.3	652.7 to 655.5	180.2 to 181.0	832.9 to 836.4	200.0 to 200.8	0.4	633.3 to 636.0
	2nd half	407.7 to 410.5	132.7	119.7 to 120.5	–0.8 to 0.1	659.3 to 663.8	180.9 to 182.1	840.2 to 845.9	201.4 to 202.7	0.4	639.3 to 643.6
2009	1st half	412.4 to 416.2	134.3	121.5 to 122.7	–0.6 to 0.6	667.6 to 673.8	186.1 to 187.8	853.8 to 861.6	206.3 to 208.2	0.4	647.8 to 653.8
	2nd half	417.2 to 422.1	135.8	123.1 to 124.5	–0.3 to 1.3	675.8 to 683.6	191.9 to 194.2	867.7 to 877.8	211.2 to 213.7	0.4	656.9 to 664.5
2010	1st half	421.8 to 427.8	137.1	125.2 to 127.0	–0.7 to 1.3	683.5 to 693.2	196.1 to 198.8	879.6 to 892.0	215.3 to 218.3	0.4	664.7 to 674.1
	2nd half	426.4 to 433.5	138.6	127.6 to 129.7	–1.2 to 1.1	691.5 to 703.0	199.9 to 203.2	891.4 to 906.2	219.3 to 222.9	0.4	672.6 to 683.7
		Percentage change on a year earlier[4,5]									
2006		2	2	$8\frac{1}{4}$	$-\frac{1}{4}$	3	$10\frac{1}{4}$	$4\frac{1}{2}$	$9\frac{3}{4}$	0	$2\frac{3}{4}$
2007		3	$2\frac{1}{2}$	$5\frac{3}{4}$	0	$3\frac{1}{4}$	$-3\frac{1}{4}$	$1\frac{3}{4}$	–2	0	3
2008		$1\frac{3}{4}$ to $2\frac{1}{4}$	$2\frac{1}{2}$	$3\frac{1}{4}$ to $3\frac{3}{4}$	0	2 to $2\frac{1}{2}$	$4\frac{1}{2}$ to 5	$2\frac{1}{2}$ to 3	$3\frac{3}{4}$ to $4\frac{1}{4}$	0	2 to $2\frac{1}{2}$
2009		$2\frac{1}{4}$ to $2\frac{3}{4}$	2	$3\frac{1}{4}$ to $3\frac{3}{4}$	0	$2\frac{1}{2}$ to 3	$4\frac{3}{4}$ to $5\frac{1}{4}$	3 to $3\frac{1}{2}$	4 to $4\frac{1}{2}$	0	$2\frac{1}{2}$ to 3
2010		$2\frac{1}{4}$ to $2\frac{3}{4}$	2	$3\frac{1}{4}$ to $3\frac{3}{4}$	0	$2\frac{1}{4}$ to $2\frac{3}{4}$	$4\frac{3}{4}$ to $5\frac{1}{4}$	3 to $3\frac{1}{2}$	4 to $4\frac{1}{2}$	0	$2\frac{1}{2}$ to 3

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

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

[3] *Expenditure adjustment.*

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

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