

The synchronised slowdown of growth in the US, Europe and Japan was a major influence on developments in the UK economy during 2001. But, in contrast to previous episodes of faltering global demand and rising economic uncertainty, the platform of low inflation and sound public finances delivered by the Government's new macroeconomic framework enabled policy to sustain stability and growth in the UK. In 2001:

- UK Gross Domestic Product (GDP) grew by $2\frac{1}{4}$ per cent, in line with the Pre-Budget Report projection and the lower end of the Budget 2001 forecast range;
- robust growth was supported by strong consumer demand, underpinned by the Monetary Policy Committee's decisive action to cut interest rates to their lowest level since 1964; and
- employment rose to new record highs during the year, and is now $1\frac{1}{2}$ million higher than in spring 1997, reflecting the ongoing success of Government policies designed to deliver increased employment opportunity and enhanced labour market flexibility.

Prospects for a recovery in G7 economic growth have improved significantly since the Pre-Budget Report, and latest indicators suggest that an upturn in UK economic activity is already under way. Looking ahead:

- UK GDP growth is forecast to be between 2 and $2\frac{1}{2}$ per cent in 2002, gathering pace during the year as the world economic recovery becomes more broad-based, and rising to between 3 and $3\frac{1}{2}$ per cent in 2003 before returning to trend the following year;
- growth is also forecast to become more balanced as stronger external demand and improved business confidence stimulate recoveries in UK exports and business investment, while household consumption moderates gradually to sustainable rates;
- the GDP forecast path is judged to be consistent with RPIX inflation remaining close to the Government's $2\frac{1}{2}$ per cent target; and
- the trend rate of output growth is now projected to be $2\frac{3}{4}$ per cent over the forecast period, supported by an updated assessment which incorporates the latest evidence. The mid-points of the economic forecast ranges are anchored around this neutral assumption.

INTRODUCTION^{1,2}

BI This chapter discusses economic developments since the November 2001 Pre-Budget Report and provides updated forecasts for the UK and other major economies in the period to 2004. It begins with an outline of world economic developments and prospects. The subsequent discussion sets out the key features of the UK forecast and the associated risks, followed by a more detailed assessment of sector-specific issues.

¹ The UK forecast is consistent with national accounts and balance of payments statistics to the fourth quarter of 2001, released by the Office for National Statistics on 27 March 2002. A detailed set of charts and tables relating to the economic forecast is available on the Treasury's internet site (<http://www.hm-treasury.gov.uk>), and copies can be obtained on request from the Treasury's Public Enquiry Unit (020 7270 4558).

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

THE WORLD ECONOMY

Table BI: The world economy

	Percentage changes on a year earlier unless otherwise stated			
	2001	2002	Forecast	
			2003	2004
<i>Major 7 countries¹</i>				
Real GDP	1	1½	2¾	2½
Consumer price inflation ²	1½	1½	1½	1½
World trade in goods and services	0	2¼	8½	7¼
UK export markets ³	-¼	1¾	7¾	6

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

² Per cent, Q4. For UK, RPIX.

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

Overview

B2 Last year, economic growth slowed significantly and simultaneously in the US, Europe and Japan. World trade growth, investment, industrial production and stock market valuations all declined sharply, and demand for information and communications technology (ICT) related goods collapsed. The terrorist attacks of 11 September heightened short-term uncertainty and weakened business confidence across the world economy, but the timely policy response appears to have prevented a prolonged downturn in activity. While firms held back production in the final months of 2001, lower interest rates and oil prices helped to support consumption, so that inventories were run down sharply across the world's major economies.

B3 Prospects for G7 growth in 2002 have improved significantly since the time of the Pre-Budget Report. A recovery is expected to be led by rebuilding of stocks in the short term, and to become more broad-based from the middle of this year with business investment picking up, world trade growth strengthening and monetary policy returning to a more neutral stance. The US is forecast to lead the G7 recovery, with a revival in Euro-area activity following closely behind. The immediate outlook for Japan remains weak, though improving external demand and the effects of the yen's depreciation should provide some stimulus to activity later this year. Developing economies were clearly affected by weaker world growth last year, but are expected to benefit from the upturn in global demand during 2002.

G7 activity

B4 G7 GDP grew by 1 per cent in 2001, in line with the Pre-Budget Report forecast, and prospects for growth in 2002 have improved significantly since then. G7 growth is now expected to rise to 1½ per cent this year, compared with the previous projection of ¾ per cent, with the difference largely reflecting improved prospects for US growth in the first half of the year. While stronger overall G7 activity this year will limit the scope for growth to pick up further in 2003, growth next year is nonetheless expected to reach 2¾ per cent.

B5 The US economy grew by just 1.2 per cent last year, its slowest annual rate since 1991. Investment fell sharply after a number of years of strong growth, and weak demand for ICT-related capital goods contributed to a 4¼ per cent year-on-year fall in manufacturing output. US GDP contracted in the third quarter of the year, and heightened uncertainty after 11 September further depressed business confidence and investment. However, decisive monetary policy action and lower oil prices boosted household consumption which, along with strong government spending, underpinned a return to growth in the fourth quarter of the year. Unexpectedly strong US consumer demand during the final months of 2001 contributed to a sharp rundown of inventories.

B6 Business confidence in the US has improved markedly in recent months as economic uncertainty associated with 11 September has diminished, and more gradual inventory liquidation is expected to boost production during the first half of 2002. Thereafter, growth is expected to become more balanced as sustained domestic consumption, strengthening external demand and expectations of ongoing productivity gains boost confidence and prompt renewed growth in business investment.

B7 Growth in the Euro-area also slowed significantly during 2001, with weakness in Germany particularly marked. Output contracted and confidence weakened further in the fourth quarter of the year, though forward-looking surveys have now recouped their losses since 11 September. Fading inventory liquidation, stronger US growth and the continuing effects of last year's interest rate cuts are expected to support a revival in Euro-area growth during 2002.

B8 Japan's economy is estimated to have contracted by 0.5 per cent last year and is expected to remain weak in the short term, with deflationary pressures persisting and unemployment remaining historically high. However, there are signs that production is stabilising, and the economy is expected to return to modest growth later this year as strengthening external demand and the effects of the yen's depreciation provide some stimulus to exports. Nonetheless, the economy is expected to register negative growth in 2002 as a whole.

Forecast issues and risks

B9 Decisive policy action helped to ensure that the short-term downside economic risks associated with the terrorist attacks of 11 September subsided relatively quickly, and that the world economy avoided a sharper or more protracted downturn. With clear signs of improving confidence in the US and Europe, it is possible that the strength of this year's recovery in G7 growth and world trade may exceed expectations. The scope for the recent acceleration in US productivity to continue, and to be emulated in other major economies, presents further upside potential to global growth prospects. In Japan, while progress towards structural reform may have mixed implications for growth and inflation in the short term, it would provide a welcome boost to medium-term economic prospects.

B10 However, there are also significant downside risks to the anticipated revival in global activity. The world economic outlook continues to depend on the prospects for sustained growth in the US, where any setback to business confidence would threaten the expected upturn in investment, and renewed weakness in equity or labour markets would present downside risks to consumption. Current high levels of household and corporate indebtedness could also constrain the pace of the US recovery, while a sudden sharp depreciation of the dollar remains a possibility given the level of the US current account deficit (see Box B1). Elsewhere, further sustained progress on economic reform is needed to enhance growth potential in the Euro-area, while the weakness of the banking sector in Japan presents clear economic risks. A sustained period of high oil prices would also adversely affect G7 growth.

Box BI: Financial imbalances in the US economy

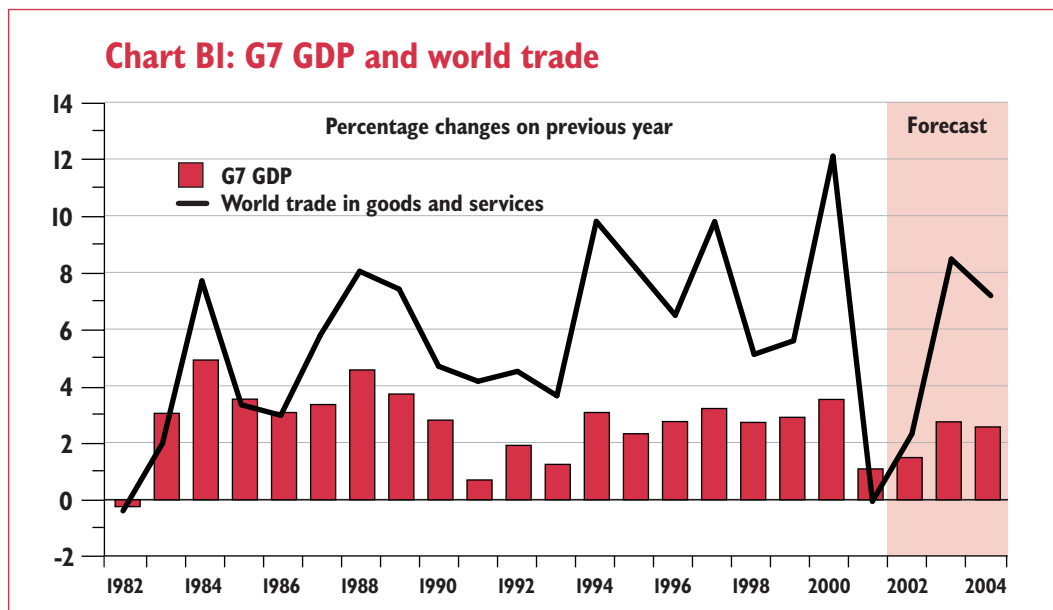
Sustained economic growth in the US during the second half of the 1990s was accompanied by rising household and corporate indebtedness, together with a widening current account deficit. Financial imbalances often arise during periods of strong economic growth and can be financed by an inflow of foreign capital attracted by profitable investment opportunities. However, if they reflect overly optimistic expectations of future economic performance, any downward revision to expectations could prompt a sudden, sharp adjustment to economic activity.

In the US, the marked acceleration in productivity over recent years suggests that expectations of stronger economic growth in the future are well founded. But the willingness of foreign investors to continue financing the US current account deficit will depend heavily on whether they expect recent relative productivity gains to be sustained. A benign scenario in relation to the unwinding of imbalances would see productivity in other major economies starting to catch up with that in the US, as they also benefit from 'new economy' gains. This would widen investment opportunities, allowing the dollar to adjust which, together with higher US domestic saving, would allow the imbalances in the US economy to unwind in a relatively slow and orderly manner.

An alternative scenario is that recent productivity gains in the US are not sustained, prompting households and firms to revise expectations and rebalance their financial positions more rapidly than anticipated. This could also reduce the supply of foreign capital, prompting a sudden adjustment in the value of the dollar. At the time of the Pre-Budget Report, it was feared that uncertainty surrounding the likely supply-side impact of the events of 11 September might bring about such a scenario. These fears have now largely abated, but there remains a risk that these imbalances will unwind rapidly at some point in the future, prompting financial market instability and presenting risks to global economic prospects.

World trade

BII World trade was badly affected by the synchronised slowdown in global growth and the collapse in demand for highly traded ICT goods during 2001, and is now estimated to have contracted marginally in 2001 as a whole. However, world trade growth is expected to increase to 2¹/₄ per cent in 2002, as the G7 recovery gathers pace and demand for ICT-related and other investment goods picks up, before rising to 8¹/₂ per cent in 2003. UK export markets are expected to recover broadly in line with world trade, growing by 1³/₄ per cent in 2002 and almost 8 per cent in 2003.



Emerging markets and developing countries

BI2 Emerging markets and the world's poorest economies were clearly affected as world trade, commodity prices and tourist revenues weakened last year. The slump in demand for ICT-related goods particularly affected emerging economies in Asia, which are highly open and depend heavily upon trade in these products. Eastern European economies were affected by weaker demand in the Euro-area.

BI3 Many of the world's poorest economies are dependent upon primary commodity exports, and therefore suffered disproportionately last year as a result of low commodity prices and weakening external demand. Resources released under the Highly Indebted Poor Countries (HIPC) initiative are, however, likely to have helped to sustain growth. There are now 26 countries benefiting from over £40 billion in HIPC debt relief, 22 of which are in Africa.

Box B2: Emerging market financial crises

In 2001, two significant emerging markets – Turkey and Argentina – experienced economic and financial crises. Both countries received significant financial assistance from the IMF and abandoned their fixed exchange rate systems. In Turkey, which is now following a comprehensive reform programme, recent indicators suggest that conditions are beginning to improve, with a fragile return of confidence. In contrast, the situation in Argentina has deteriorated rapidly since its debt default at the end of last year.

A notable feature of both crises is that neither triggered the contagion to other emerging market countries associated with many previous crises. As a result, foreign direct investment to emerging markets – their most important source of finance – held up well last year. One reason for the lack of contagion is that investors are increasingly able to differentiate between risk in different emerging markets. The fact that few other significant emerging markets exhibited the same vulnerabilities as those which led to difficulties in Turkey and Argentina will have further limited contagion. Moreover, given that financial market concerns over Argentina had been building for some time, investors were able gradually to reduce their exposure, instead of reacting abruptly to unanticipated events.

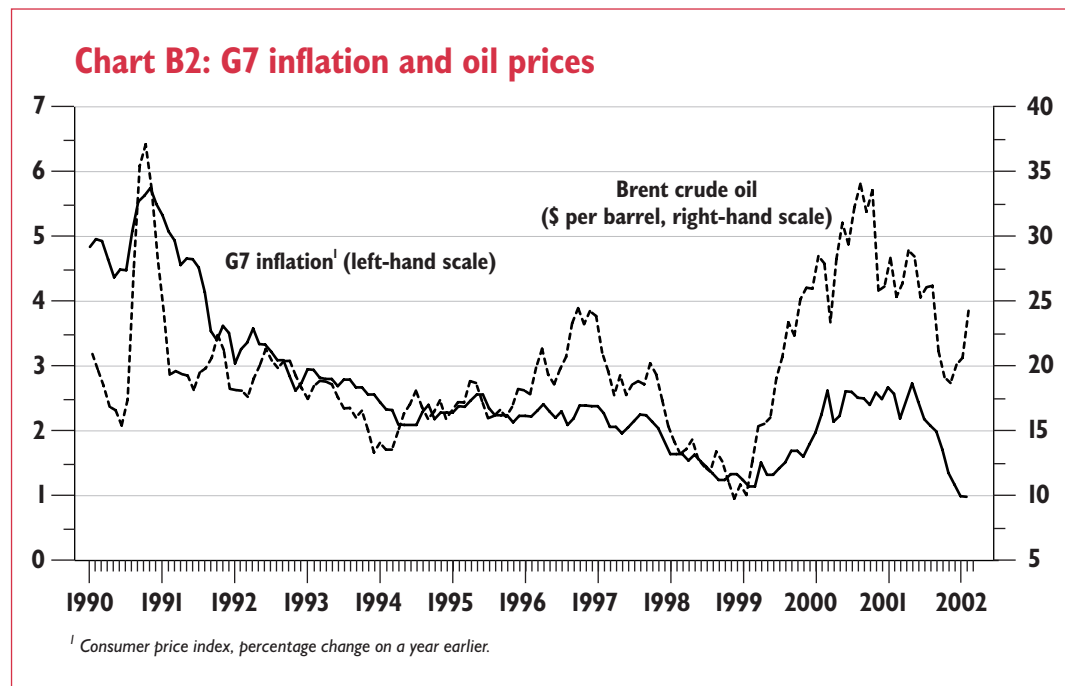
In the light of this relative lack of contagion, and given clearer signs of a recovery in G7 activity, conditions for emerging market financing and the outlook for emerging markets have improved significantly since the time of the Pre-Budget Report.

Oil and commodity prices

BI4 Weak global demand and good harvests put downward pressure on almost all primary commodity prices in 2001. Oil prices fell to two-year lows as a result of weak global demand and a re-evaluation of market conditions after 11 September, but rose sharply towards the end of the first quarter of 2002 as the prospects for global demand strengthened and political developments in the Middle East raised concerns over future supply. Circumstances in the Middle East may continue to put upward pressure on prices and encourage volatility. Given improved prospects for a global recovery, most other commodity prices are also now picking up, and this trend is expected to continue through 2002.

G7 inflation

BI5 G7 headline inflation fell from a peak of over 2½ per cent in spring 2001 to an average of 1½ per cent in the final quarter, consistent with a small negative output gap and lower oil prices. G7 inflation eased further in January, but is forecast to increase slightly to 1½ per cent by the final quarter of 2002, in line with the recovery in commodity prices and strengthening economic activity. Inflation is forecast to remain at this rate thereafter, with output growth around trend.



UK ECONOMY OVERVIEW

Summary

BI6 Last year, in contrast to previous episodes of faltering global demand and rising economic uncertainty, the platform of low inflation and sound public finances delivered by the Government's new macroeconomic framework enabled policy to sustain stability and growth in the UK. Decisive action by the Monetary Policy Committee supported consumer demand, and helped to counter the additional near-term economic risks posed by the terrorist attacks of 11 September, while fiscal policy supported monetary policy in sustaining demand over the course of the year.

BI7 There are now clear signs that activity in the UK is strengthening, and growth is forecast to gather pace during the course of this year as the world economic recovery becomes more broad-based. UK growth is also expected to become more balanced as stronger external demand provides renewed impetus to UK exports and business investment, while household consumption moderates gradually to sustainable rates.

BI8 The economic forecast is now anchored around a neutral assumption for trend output growth of $2\frac{3}{4}$ per cent a year, supported by an updated assessment of the prospects for trend growth and based on the judgement that the economy was operating at potential in the third quarter of last year. Consistent with past practice, projections for the public finances presented in Chapter C are based on the cautious assumption that trend growth is $\frac{1}{4}$ percentage point lower than the neutral view.

Table B2: Summary of forecast

	2001	Forecast		
		2002	2003	2004
GDP growth (per cent)	$2\frac{1}{4}$	2 to $2\frac{1}{2}$	3 to $3\frac{1}{2}$	$2\frac{1}{2}$ to 3
RPIX inflation (per cent, Q4)	2	$2\frac{1}{4}$	$2\frac{1}{2}$	$2\frac{1}{2}$

Recent developments

BI9 The pattern of UK growth over the past year has been influenced by the global downturn in trade, industrial production and investment, and by heightened uncertainty following the events of 11 September. Nonetheless, decisive interest rate cuts helped to ensure that consumer demand remained robust throughout the year, while fiscal policy also supported growth. As a result, GDP is estimated to have grown by 2.2 per cent last year – in line with the Pre-Budget Report projection and the lower end of the Budget 2001 forecast range.

B20 The important role played by household consumption in supporting GDP growth through 2001 was also underpinned by the resilience of the labour market, which helped to sustain consumer confidence and to ensure strong growth of real household disposable incomes. The impact on consumption of weaker equity values was compensated for by rising housing wealth. In contrast, the synchronised world slowdown and collapse in demand for ICT-related goods led to a marked contraction in UK manufacturing output and exports, and depressed business confidence and investment. The trade deficit widened in 2001 as external demand weakened and domestic consumption remained robust, though these effects were partly offset by falling demand for imports of intermediate and investment goods. Overall imports of goods and services grew by just $2\frac{3}{4}$ per cent, well below normal rates.

B21 At the time of the Pre-Budget Report, it was assumed that the terrorist attacks of 11 September would delay the global recovery until the second half of 2002, with knock-on effects to confidence and activity in the UK. In the immediate aftermath of the attacks, domestic business confidence deteriorated sharply, with the effects extending well beyond those firms directly affected by the downturn in external demand. Households also perceived that prospects for the UK economy had weakened, though they remained confident in the outlook for their own finances.

B22 Pre-emptive action by the Monetary Policy Committee helped to ensure that the downturn in UK consumer confidence after 11 September was short-lived. The aggregate GfK measure³ fell back in September and October, but remained above its long-run average and had returned close to a record high by January. While retailers reported a fall in sales in the days immediately after 11 September, the attacks do not appear to have had a significant lasting effect on consumer demand, and household consumption rose by 0.9 per cent in the final quarter of 2001. Although retail sales volumes levelled off around the turn of the year, they rebounded strongly in February. Other indicators of consumer activity and demand also suggest that household spending has retained more momentum in early 2002 than anticipated in the Pre-Budget Report.

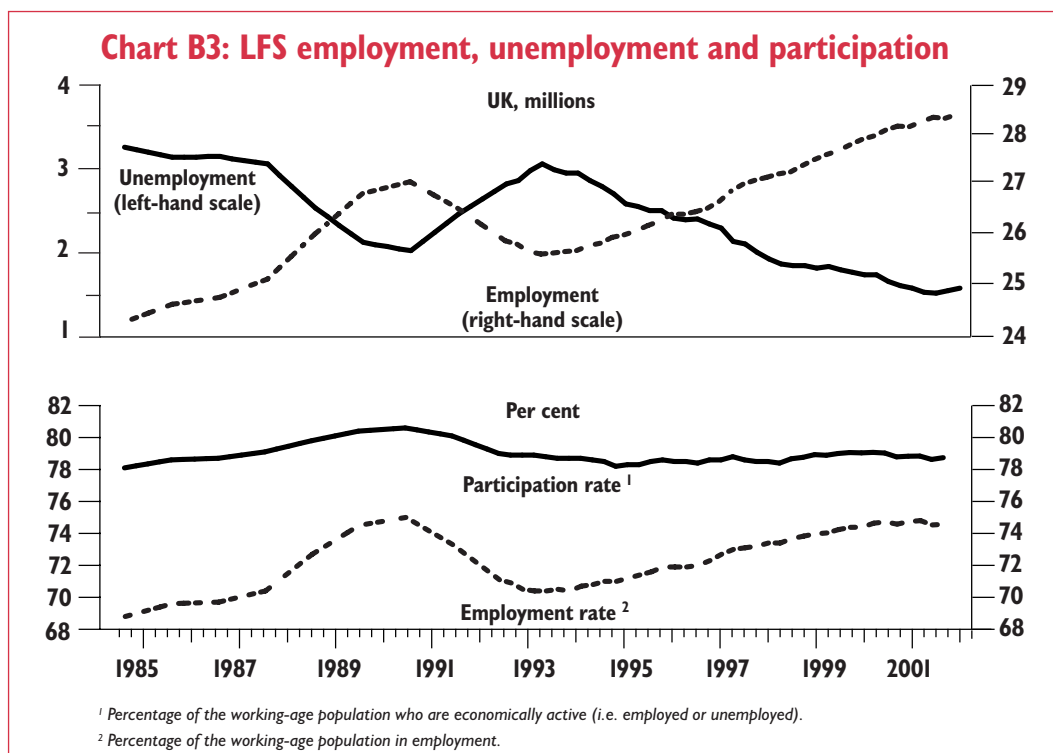
B23 Notwithstanding the strength of consumption, GDP registered zero growth in the fourth quarter of last year, as weak business confidence prompted firms to hold back production and defer investment. Continued strong consumer demand was partly met by a rundown in inventories, which reduced quarter-on-quarter GDP growth by $\frac{1}{2}$ percentage point. UK exports continued to fall as external demand remained weak, particularly from the Euro-area, and net trade exerted a significant drag on GDP growth as imports picked up modestly following significant contractions in the previous two quarters. Recent evidence from UK business surveys suggests that UK activity is likely to have strengthened in early 2002, with indicators of confidence, current activity and new orders improving in both manufacturing and service sectors. Indeed, official data showed a rise in manufacturing output in February.

B24 Despite the effects of the world slowdown on business confidence, employment rose to new record highs in late 2001 and early 2002, having risen by more than $1\frac{1}{2}$ million over the past five years. Although the population of working age has grown strongly, the Labour Force Survey (LFS) working-age employment rate is now just 0.3 percentage points below its spring 2001 peak, while unemployment rates remain close to their lowest levels since the 1970s on both International Labour Organisation (ILO) and claimant count measures. Underlying earnings growth (excluding bonuses) has fallen back to within sustainable limits, and weak commodity and import prices also contributed to keeping RPIX inflation below target for most of 2001 – its average of 2.1 per cent for the year as a whole was the same as 2000, the lowest annual figure since 1963. RPIX inflation rose marginally above target in January 2002, but subsequently fell back, and underlying inflationary pressures remain subdued.

The labour market

B25 The labour market proved remarkably resilient last year in the face of the global economic slowdown, though survey indicators of firms' demand for labour fell back in the second half of 2001. Consistent with expectations that the slowdown in activity would be short-lived, LFS measures show that firms responded mainly by reducing average hours per worker: total employment hardly fell, and then only over the summer. Indeed, towards the end of last year, employment increased to then record highs. It has since risen further and average hours worked have stabilised. Latest evidence from the Recruitment and Employment Confederation's Report on Jobs tends to confirm that a recovery in demand for labour is already under way. Continued stability in the labour market over the past year has underlined the importance of the new macroeconomic policy framework, and of policies to make work pay and promote greater labour market flexibility, in delivering sound economic fundamentals and increased employment opportunity.

³ Consumer confidence indicators published by Martin Hamblin GfK (Gesellschaft für Konsumforschung) on behalf of the European Commission.



B26 In the three months to February, LFS employment was 170,000 higher than a year earlier, with the increase almost entirely accounted for by rising full-time employment. Moreover, the apparent pause in employment growth over last summer may be at least partly explained by the ending of around 70,000 temporary jobs associated with the Census collection in the spring. Abstracting from this, temporary employment has remained on a downward trend since 1997, coinciding with continued strong growth of total employment. Increased willingness among employers to take on permanent staff may partly reflect greater confidence in future economic stability.

B27 With employment remaining more robust than in past economic slowdowns, unemployment rates have remained at, or very close to, levels last achieved in the 1970s. The ILO rate is now only marginally higher than its spring 2001 trough and, at just over 5 per cent, remains below most estimates of the NAIRU⁴, which is judged to have fallen broadly in line with actual unemployment over recent years. The claimant count remains below 1 million, and longer-term claimant unemployment (12 months plus) has continued to decline, with a fall of more than 43,000 over the past year. Although the claimant count rose slightly in the latter months of 2001, it has resumed falling in early 2002. Inflows to claimant unemployment, which often prove a timely indicator of the direction of future labour market developments, began falling last December having risen between July and November.

B28 The favourable trend in unemployment will, in part, reflect the ongoing success of the New Deal programmes. Over 350,000 young people and over 90,000 other long-term unemployed people have moved into work through the New Deal for Young People and the New Deal 25 plus respectively. Long-term youth and adult unemployment have both fallen by three quarters since spring 1997⁵. Recent extensions to the New Deals, and other measures described in Chapter 4, should also help to tackle the problem of working-age inactivity. There remain nearly 4 million people of working age who are economically inactive and on benefits, including people with disabilities or health problems, and lone parents. LFS data indicate that over 2¹/₄ million people of working age who are economically inactive report that they want a job.

⁴ Non-accelerating inflation rate of unemployment.

⁵ Claimant count. Long-term youth unemployment: aged 18–24, over 6 months duration. Long-term adult unemployment: aged 25+, over 18 months duration. Youth claimant unemployment over 12 months duration has been virtually eradicated.

B29 Earnings growth was more clearly affected than employment as the world economy slowed which, together with the adjustment of average hours worked, gives evidence of the labour market's flexibility. Having risen above 5 per cent in early 2001, the whole-economy headline measure fell back to just 1.9 per cent for the three months to February 2002. In the private sector, weaker bonuses account for a large part of this deceleration, though growth in underlying earnings (excluding bonuses) has also eased, from over 5 per cent last summer to around 4¹/₄ per cent in recent months. Public sector earnings growth continues to outpace that of the private sector, but has moderated from a peak of 5.7 per cent last autumn to 4.7 per cent in February.

B30 The robustness of employment as output growth moved below trend last year led to a cyclical downturn in productivity growth, which is expected to be reversed as output growth strengthens during 2002. The cyclical dip in whole economy productivity growth in the second half of last year was more marked in terms of output per job than output per hour, reflecting the downward adjustment in average hours worked. Manufacturing productivity has fallen back as a consequence of the significant reductions in output, with sharp falls in the electrical and optical engineering sector alone subtracting almost ¹/₂ percentage point from growth of whole-economy output per job in the year to the final quarter of 2001. In the first half of last year, the combination of strong earnings growth and more modest productivity gains implied a significant pick-up in annual growth of unit wage costs, though this began to ease in the second half as earnings growth moderated.

Trend output growth

B31 The latest available data from private-sector surveys and other sources support the judgement that the economy was on trend in the first half of 1997 and in mid-1999, and suggest that the economy moved back to trend in the third quarter of 2001. Table B3 presents a decomposition of trend output growth over the last two full economic cycles, and for the period between the first half of 1997 and the third quarter of 2001. Consideration of the latter period ensures that all available data can be taken into account when projecting components of trend output growth going forward. Moreover, relative to the short cycle judged to have ended in mid-1999, estimates of trend growth rates over this longer period are less sensitive to data revisions at the on-trend points, which may take place for several years after data are first published.

B32 Since the Pre-Budget Report, the decomposition has been developed further to take into account variations in hours worked. Thus the decomposition now includes productivity measured on the basis of output per hour worked and distinguishes the contribution to trend growth of average hours worked per person. For the purposes of decomposing trend growth, this represents an analytical refinement of the previous approach, where the productivity component was measured in terms of output per job with no further breakdown. Hours data are obtained from the LFS, and the employment rate is now expressed in terms of the more familiar LFS working-age employment rate, rather than the workforce jobs based measure previously used. This improves the consistency of the decomposition in the sense that the hours, employment and population components are all now based on LFS measures. Moreover, changes in the NAIRU and the trend inactivity rate, each of which contribute to trend employment rate growth, are naturally defined in terms of numbers of people.

B33 Looking at the recent past, the underlying trend rate of growth of output per hour worked is estimated to have been 2.1 per cent, a touch higher than over the last two full economic cycles. However, the new decomposition shows that trend growth of output per worker has been depressed in recent years by an unusually steep rate of decline in average hours per worker. Growth in the employment rate has continued to make a positive contribution to trend output growth, particularly during the short cycle ending in mid-1999, and the working-age population has increased more rapidly since 1997 than over the previous cycle.

B34 Table B3 shows projections for the various components in the period to 2006. These projections are described in more detail in Box B3 and in a technical paper⁶ published alongside the Budget. They are consistent with a neutral assumption of $2\frac{3}{4}$ per cent a year for the trend rate of output growth over this period. The mid-points of the economic forecast ranges are anchored around this neutral assumption, which does not rely on any improvement in the underlying trend rate of growth in output per hour worked relative to recent experience.

Table B3: Contributions to trend output growth¹

	Estimated trend rates of growth, per cent per annum					Trend output
	Trend output per hour worked ^{2,3}		Trend average hours worked ³	Trend employment rate ³	Population of working age ⁴	
	Underlying (1)	Actual (2)	(3)	(4)	(5)	
Over full economic cycles						
1986Q2 to 1997H1	2.06	1.84	-0.14	0.45	0.35	2.51
1997H1 to mid-1999	1.91	1.55	-0.28	0.72	0.63	2.64
Since 1997H1						
1997H1 to 2001Q3	2.14	1.96	-0.37	0.36	0.66	2.63
Projection⁵						
2001Q3 to 2006Q4	2.1	2.0	-0.1	0.2	0.6	2³/₄

¹ Treasury analysis based on the judgement that 1986Q2, 1997H1, mid-1999 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. Hours, employment and population data are consistent with revised LFS data released on 17 April 2002. Columns (2) + (3) + (4) + (5) = (6). Full data definitions and sources are set out in Annex A of 'Trend Growth: Recent Developments and Prospects', HM Treasury, April 2002.

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

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

⁴ UK household basis.

⁵ Neutral case assumptions underlying the mid-points of the GDP growth ranges from 2001Q4.

B35 Consistent with past practice, projections for the public finances are based upon the lower end of the economic forecast ranges, which are anchored around the deliberately cautious assumption of annual trend output growth $\frac{1}{4}$ percentage point lower than the neutral view. The symmetric upper bounds of the forecast ranges illustrate the potential for stronger supply-side performance, based on Government policies designed to increase the rate of productivity growth and to deliver enhanced employment opportunity.

⁶ Trend Growth: Recent Developments and Prospects, HM Treasury, April 2002.

Box B3: Projections for components of trend output growth

This box sets out the basis for the projections for the components of trend output growth presented in Table B3. More detail is presented in an accompanying paper¹.

The neutral assumption underpinning the economic forecast in this chapter entails trend underlying labour productivity on an **output per hour** basis continuing to grow in line with the evidence for the recent past. No allowance is made for the clear upside potential for enhanced productivity growth associated either with strong growth of ICT-related investment in recent years, or with the Government's comprehensive strategy to improve the UK's productivity performance.

The trend decline in **average hours worked** steepened in the second half of the 1990s. This is likely to have reflected a number of one-off factors, including: a fall in the number of self-employed, who tend to work above average hours; higher employment amongst 16-24 year-olds in full-time education, who tend to work relatively short hours; and the Working Time Directive, introduced in April 1999, which will have encouraged reductions in average hours at the upper end of the distribution.

Many of these factors are now likely to have run their course. Over the past couple of years, the shares of self-employment and of students in total employment have stabilised. On this basis, a case could be made for simply projecting a flat trend in average hours worked. However, the neutral projection for trend average hours worked assumes a decline of 0.1 per cent a year over the forecast period, in line with the trend decline over the 1986-97 economic cycle.

With the **employment rate** now close to its historic high, the scope for further increases is more limited than in the past. Accordingly, trend growth in the employment rate is projected at 0.2 per cent a year over the forecast period, a more moderate rate than in recent years or the previous two economic cycles. Activity rates within nearly all age and gender cohorts have increased over the recent past, and it is assumed that further increases in trend activity rates within cohorts will outweigh the negative effect of changing demographics. As in the Pre-Budget Report, the projection allows for only a very slight further decline in the **NAIRU**, despite a much higher estimated rate of decline over the recent past. The projection does not include any explicit allowance for the impact of Government policies which could further boost the employment rate in the coming years.

Assumed growth in the **population of working age** is based on the latest population projections published by the Government Actuary's Department (**GAD**). However, the 'principal' **GAD** projection for net migration appears excessively cautious in the light of recent experience. Net migration has been consistently under-predicted in recent years, and the Treasury projection for the population of working age presented in Table B3 therefore assumes a level of net migration half-way between the **GAD**'s 'principal' and 'high' migration projections. This is close to the average level of net migration for the latest three years of published data (1997-1999), although rather lower than the average for the latest two years.

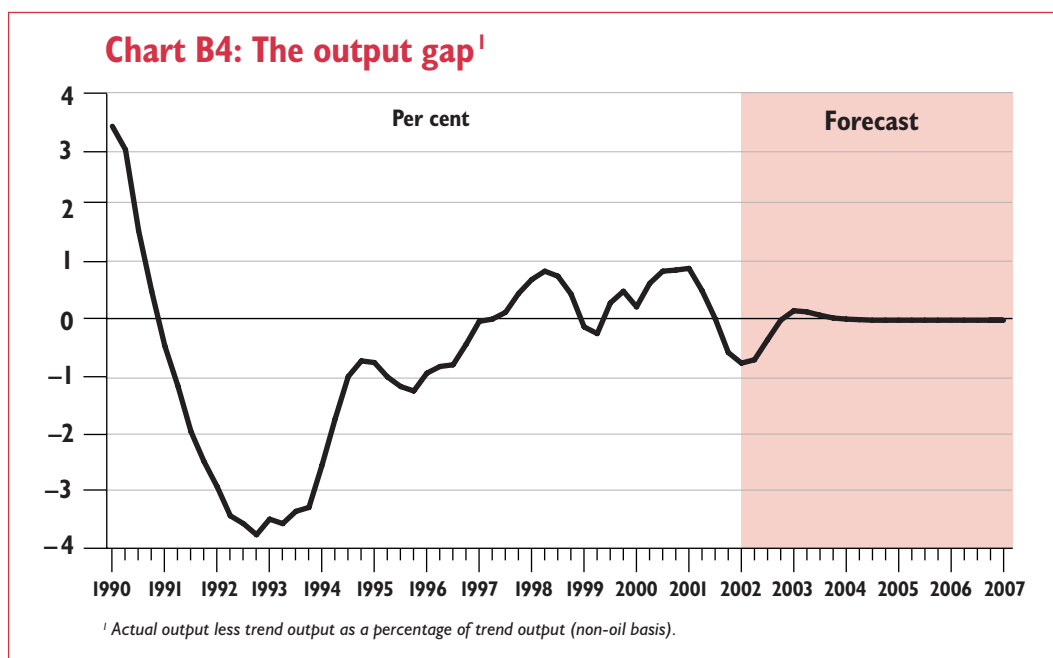
¹*Trend Growth: Recent Developments and Prospects*, HM Treasury, April 2002.

Output and demand

B36 The judgement that the economy was operating at potential in the third quarter of 2001 implies that a modest negative output gap opened up as GDP registered zero growth in the fourth quarter. Although survey evidence points towards an upturn in activity in the first quarter of 2002, growth is expected to have remained below trend, and the output gap is projected to have widened to over $\frac{3}{4}$ per cent of GDP.

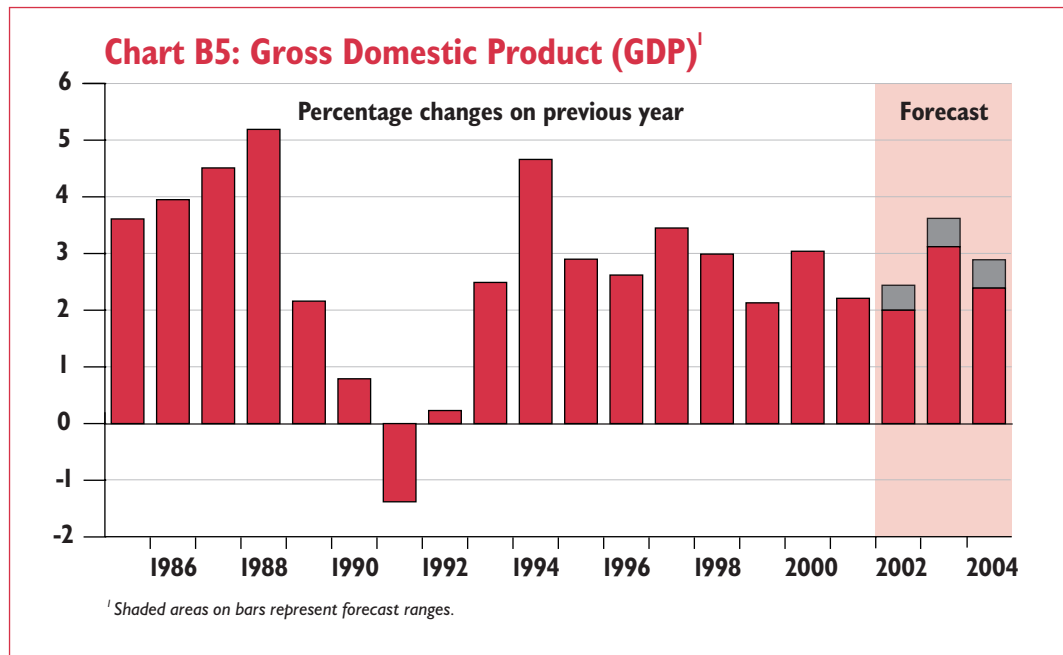
B37 As at the time of the Pre-Budget Report, GDP is forecast to increase by between 2 and 2½ per cent in 2002, with growth moving above trend and strengthening through the year as the world economic recovery becomes more broad-based. Growth is now forecast to rise to between 3 and 3½ per cent in 2003, before returning to trend in 2004. Over the forecast period, GDP growth averages around ¼ percentage point a year stronger than in the Pre-Budget Report forecast, reflecting the higher projection for the trend rate of output growth.

B38 The forecast shows a return to more balanced growth as stronger external demand supports a recovery in business investment and exports, and as household consumption growth moderates to sustainable rates. Improving business confidence and strengthening external demand are expected to prompt a recovery in business investment from mid-2002, with growth rising to between 5½ and 6¼ per cent in 2003 as deferred capital spending plans continue to come on stream. Public sector investment and current spending are projected to make an increased contribution to growth over the forecast horizon, as the overall spending envelope set in this Budget for the 2002 Spending Review allows for higher public expenditure from 2003-04 than assumed in the Pre-Budget Report.



B39 Reductions in interest rates were instrumental in supporting consumer confidence in the UK following the events of 11 September, and household consumption appears to have maintained more momentum into early 2002 than anticipated at the time of the Pre-Budget Report. Nonetheless, household consumption growth is expected to begin to moderate in the second half of this year and to grow more in line with developments in income and wealth thereafter, as households limit further accumulation of debt.

B40 Stronger external demand and the anticipated pick-up in world trade should also provide a significant boost to UK export growth, which is projected to increase markedly in the second half of this year, and to rise to between 7¾ and 8¼ per cent next year. Stronger exports and domestic business investment are forecast to raise demand for imports of intermediate and investment goods. Nevertheless, the acceleration in imports is expected to be limited by the combination of easing demand for imported consumer goods and the compositional shift towards spending on public services, which typically have relatively low import intensity. As a result, net trade is projected to exert a broadly neutral influence on GDP growth as exports rise faster than imports from the second half of 2002.



B41 Although domestic demand for consumer goods is therefore likely to grow more modestly than over recent years, the anticipated recovery in trade and investment in the UK and across the world economy is expected to provide a significant boost to UK manufacturing output, which was particularly affected by the global slowdown. Strengthening demand for ICT-related goods should stimulate a revival in the high-technology sectors, output of which weakened sharply last year. Other UK manufacturers should also benefit from the more general upturn in external demand. Manufacturing output growth is now expected to move above trend in the second half of 2002 and into 2003 (see Box B4), though output in 2002 as a whole is likely to be significantly weaker than in 2001.

B42 The downside risks associated with the events of 11 September have clearly diminished since the time of the Pre-Budget Report, with pre-emptive monetary policy action heading off any prolonged downturn in confidence and activity in the UK. However, prospects for a sustained upturn in growth continue to depend heavily on the strength of external demand. Any setback to the global recovery would delay the anticipated pick-up in UK export growth, prolong the current weakness in profitability and deter the projected strengthening of business investment. The knock-on effects to UK labour and equity markets could also prompt a sharper than expected deceleration of household consumption.

B43 Conversely, the possibility of a stronger than anticipated recovery in external demand presents upside risks to UK growth, and particularly to business investment and trade. A strong world recovery could also stimulate consumer demand significantly during 2002 and, with interest rates currently at historically low levels and debt servicing costs affordable, there remains a risk that consumption will moderate more gradually than forecast. While this would boost domestic demand in the short term, any further rises in household indebtedness would increase the likelihood of a sharper downward correction in consumption at some point in the future. Stronger than anticipated household consumption growth would also present upside risks to UK inflation.

Box B4: Manufacturing output: developments and prospects

Last year was a testing period for manufacturers across the world as global growth slowed, demand for ICT-related goods collapsed and uncertainty increased after the terrorist attacks of 11 September. Manufacturing output was affected in all the world's major economies in 2001: it fell by $2\frac{1}{4}$ per cent in the UK, compared with more than 4 per cent in the US and around $7\frac{3}{4}$ per cent in Japan. While manufacturing output increased marginally in France and Germany during 2001 as a whole, by the fourth quarter it was respectively, $2\frac{1}{2}$ and 4 per cent down on a year earlier.

In the UK, manufacturers were particularly affected by the collapse in global demand for ICT-related goods, with high-technology exports accounting for roughly 60 per cent of the fall in finished manufactured exports last year. Moreover, falling output in the ICT sector¹ accounted for almost half of the decline in total UK manufacturing output during 2001, compared with a quarter in the US and Germany and around 10 per cent in France, reflecting a particularly sharp downturn in UK telecommunications production. This might have been compounded by higher rates of mobile phone ownership in the UK reducing demand for new handsets relative to other countries.

Despite the impact of the global slowdown and weaker demand for ICT-related goods, output did increase in some UK manufacturing sectors last year. Output in the chemicals-related industries, which grew on average by $2\frac{1}{4}$ per cent a year over the five years to 2000, rose by a further 3.6 per cent during 2001; food, drink and tobacco industries registered an increase of 1.4 per cent; and car production increased by around $6\frac{3}{4}$ per cent between the first and second halves of the year.

Looking ahead, the foundations for a sustained recovery in manufacturing output now appear to be in place. Improving world economic prospects have already contributed to a pick-up in survey measures of confidence and activity amongst UK manufacturers, and should support a manufacturing recovery during 2002. Manufacturing output increased by 0.4 per cent in February on the official measure, consistent with the Chartered Institute of Purchasing & Supply (CIPS) Report on Manufacturing, which indicated rising output in February and March. Moreover, output expectations measures in both the CBI Industrial Trends survey and the Engineering Employers' Federation Engineering Outlook have recorded clear improvements this year.

Moreover, evidence from Asia that ICT-related intra-regional trade and exports to the US have picked up suggests that the ICT cycle may be bottoming out. Production of ICT goods in the US has stabilised after contracting by around 4 per cent in each of the last two quarters of 2001, while ICT output in the UK rose in February having been on a downward trend since the start of 2001.

The Budget forecast shows a further contraction of UK manufacturing output in 2002 as a whole, but this largely reflects the extent of the fall through last year, and disguises positive second quarter growth and an expected return to above-trend rates of growth in the second half of the year. Indeed, in the year to the first quarter of 2003, manufacturing output is forecast to grow by 3 per cent.

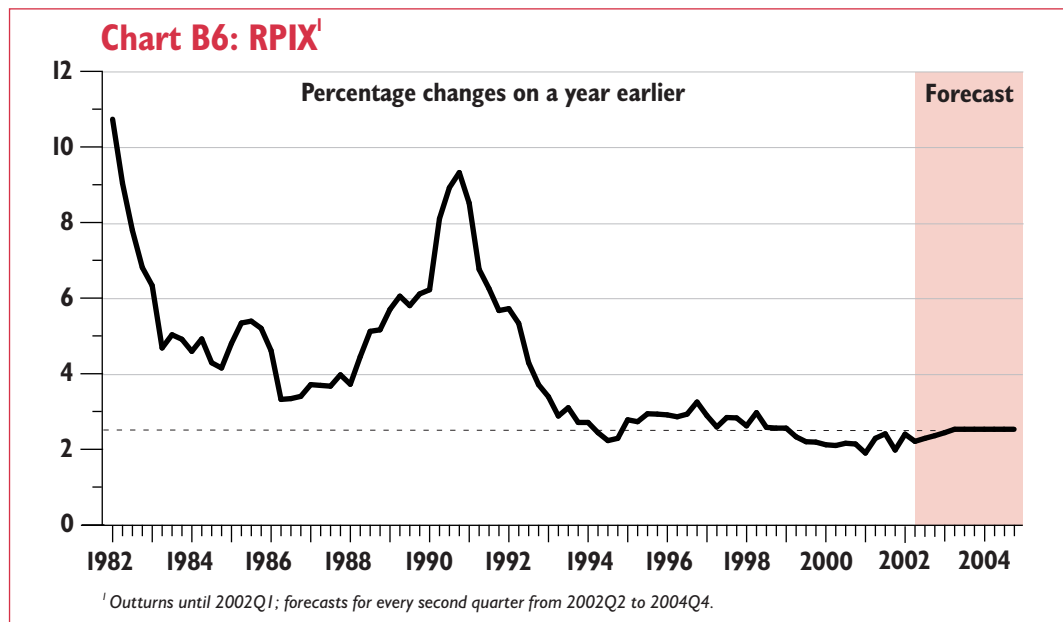
¹ ICT sector refers to the electrical and optical equipment sector for the UK, France and Germany, and the electrical machinery sector for the US.

Inflation

B44 The UK continues to experience the longest period of sustained low inflation since the 1960s. Annual RPIX inflation averaged 2.1 per cent in 2001, unchanged from 2000 and a little below the Government's $2\frac{1}{2}$ per cent target. Low and stable inflation allowed the Monetary Policy Committee to reduce interest rates during the course of last year in response to rising uncertainty over prospects for the world economy. All-items RPI inflation declined sharply during the year, reaching a low of just 0.7 per cent in December, reflecting falling mortgage interest payments.

B45 Annual RPIX inflation stood at 2 per cent in the final quarter of 2001. This was a little below the Pre-Budget Report forecast, owing to further petrol price cuts and a broader easing of core inflationary pressures. RPIX inflation spiked up to 2.6 per cent in January 2002 as past cuts in petrol prices dropped out of the annual comparison, and as discounting in the New Year sales was less aggressive than in 2001, but averaged 2.4 per cent for the first quarter as a whole. Rebuilding of retailers' margins is expected to make a positive contribution to inflation this year, though this effect is likely to diminish as moderating consumer demand reduces retailers' pricing power later in the year.

B46 Volatile price movements last year mean that the monthly profile for RPIX inflation is likely to remain erratic in the months ahead. Abstracting from these base effects, subdued price pressures further back in the supply chain should continue to exert a downward influence on RPIX inflation throughout 2002. Annual producer input price inflation has been negative since the middle of last year, reflecting low prices of oil and a range of commodity imports and, although oil prices have been higher recently, survey measures of cost and output price expectations remain low. Easing wage pressures and a cyclical upturn in productivity growth are expected to contribute to a moderation in annual unit wage cost growth this year.



B47 RPIX inflation is therefore projected to remain a little below target at the end of 2002, and to return to target by mid-2003 as a small positive output gap temporarily emerges and as commodity and other import prices pick up. GDP deflator inflation is projected to rise slightly above 2½ per cent for 2002 as a whole, mainly on account of a sizeable positive terms of trade contribution, but to fall back to 2½ per cent in 2003.

B48 Uncertainties surrounding future prospects for consumer demand present a clear risk to the inflation forecast. Unexpected strength in consumer spending could offer retailers scope to rebuild margins further than anticipated, pushing inflation higher; whereas high levels of household debt could prompt a sharper slowdown in consumer demand, which would have the opposite effect. World economic developments will also affect UK inflation through their potential impact on import prices, domestic confidence and demand, while any significant adjustment in the value of sterling would directly affect the cost of imported goods. However, if the recent weakness of the euro has encouraged European suppliers to increase margins rather than to reduce sterling-denominated prices, any future euro appreciation would not necessarily translate into a proportionate increase in UK import prices.

Independent forecasts

B49 Independent forecasts show a clear consensus for strengthening UK growth as external demand picks up in the period ahead. The average of all independent forecasts for GDP growth in 2002 is only marginally below the lower end of the Budget forecast range, and two thirds of the independent forecasts made within the last month lie within or above the Budget forecast range.

B50 For 2003, the average independent forecast for growth is around $\frac{1}{2}$ percentage point below the mid-point of the Budget forecast range. Independent forecasts have sometimes been overly pessimistic at times of heightened world economic uncertainty in the past. At the time of Budget 1999, in the aftermath of the Asian crisis, independent forecasts for UK growth in 1999 and 2000 were significantly below the Government's projections. In the event, growth in both years exceeded even the upper end of the Budget 1999 forecast ranges.

B51 Independent forecasts for RPIX inflation are very close to the Budget projection, and to the Government's $2\frac{1}{2}$ per cent target, reflecting the credibility of the new monetary policy framework. The average forecasts for the balance of payments current account show modestly smaller deficits in 2002 and 2003 than the Budget projections but, as usual, there is a wide range of forecasts around the independent average.

Table B4: Budget and independent¹ forecasts

	Percentage changes on a year earlier unless otherwise stated					
	2002			2003		
	April Budget	Independent		April Budget	Independent	
	Average	Range		Average	Range	
Gross domestic product	2 to $2\frac{1}{2}$	1.9	0.4 to 2.7	3 to $3\frac{1}{2}$	2.7	-0.1 to 3.6
RPIX (Q4)	$2\frac{1}{4}$	2.2	1.6 to 3.1	$2\frac{1}{2}$	2.4	1.8 to 3.3
Current account (£ billion)	$-25\frac{3}{4}$	-21.0	-29.7 to -10.0	$-23\frac{3}{4}$	-22.7	-49.1 to -8.0

¹ 'Forecasts for the UK Economy: A Comparison of Independent Forecasts', April 2002.

UK FORECAST IN DETAIL

The household sector

B52 Household consumption grew by around 1 per cent a quarter throughout 2001, but growth in real household disposable income was even stronger, supported by a resilient labour market and targeted government support to households. Consequently, the saving ratio averaged 1 percentage point higher last year than in 2000, consistent with the Budget 2001 forecast.

B53 Annual growth of household consumption has remained stable at around 4 per cent in each of the past six years, with households adjusting saving to cushion the effects of fluctuating income growth on spending. At the same time, growth of household consumption has, on average, exceeded that of real disposable incomes. The persistent relative strength of consumption growth may partly be accounted for by rising housing wealth, but it has also been accompanied by a significant increase in household indebtedness. This may, in part, have reflected lower and more stable inflation and interest rates relative to past experience, which have kept debt servicing costs stable relative to disposable incomes. However, growth in consumption cannot be sustained indefinitely at rates exceeding the trend growth rate of the economy. Households are therefore expected to limit further borrowing over the forecast horizon as they approach desired balance sheet positions.

Table B5: Household sector¹ expenditure and income

	Percentage changes on previous year unless otherwise stated			
	2001	Forecast		
		2002	2003	2004
Household consumption ²	3 ³ / ₄	3 to 3 ¹ / ₂	2 ¹ / ₄ to 2 ³ / ₄	1 ³ / ₄ to 2 ¹ / ₄
Real household disposable income	5	1 ¹ / ₄ to 1 ³ / ₄	2 to 2 ¹ / ₂	2 ¹ / ₂ to 3
Saving ratio (level, per cent)	5 ¹ / ₂	3 ³ / ₄	4 ¹ / ₄	4 ³ / ₄

¹ Including non-profit institutions serving households.

² At constant prices.

B54 With debt expanding less rapidly, household consumption is expected to grow more closely in line with developments in income and wealth. Household income growth is expected to slow significantly in 2002 as earnings growth continues to be depressed by negative bonus effects, particularly in the early part of the year. The lagged effects of falling equity prices over the past two years are also expected to restrain consumption growth this year, and house price inflation is projected to moderate towards its long-run relationship with earnings. Accordingly, although consumption growth appears to have maintained significant momentum in early 2002, it is forecast to begin to ease gradually during the second half of the year. But over the year as a whole, households are expected to cushion the impact of weaker disposable income growth through some temporary reduction in the saving ratio. By 2004, growth in consumer spending is expected to have slowed to below disposable income growth, with the saving ratio rising to 4³/₄ per cent.

B55 Nonetheless, considerable uncertainty still surrounds the outlook for consumption. Although debt servicing costs remain modest relative to disposable incomes, any sharp adjustment in households' expectations of future incomes or interest rates could prompt consumers to rein in spending and rebuild savings more rapidly than expected. The probability and scale of any such adjustment is difficult to assess but, with inflationary pressures remaining subdued and the economy judged to be operating currently below potential, financial markets do not expect interest rates to rise to levels witnessed in previous economic cycles. Present levels of indebtedness therefore appear less likely to cause financial distress than in the past, although the possibility that house prices have risen above sustainable levels may compound the risk of households being overly exposed to any rise in the burden of debt interest payments.

B56 Alternatively, recent interest rate cuts could provide a greater than anticipated stimulus to consumer demand in the remainder of this year, particularly if the strength of the world economic recovery exceeds expectations. Households' confidence in the outlook for their own finances has returned to record levels, house prices have been rising rapidly in the face of inelastic housing supply, and the pause in growth of retail sales volumes around the turn of the year was followed by a sharp pick-up in February. Nonetheless, continued unanticipated strength in consumer spending would, if funded by further increases in indebtedness, increase the likelihood of a sharper downward correction to consumption at some point in the future.

Companies and investment

B57 Slower world economic growth last year clearly affected UK companies. The manufacturing sector, which directly exports around 40 per cent of its gross output, was particularly affected by weaker external demand and by the slump in demand for ICT-related goods (see Box B4).

Table B6: Gross fixed capital formation

	Percentage changes on previous year			
	2001	Forecast		
		2002	2003	2004
Whole economy ¹	1/4	1 1/2 to 2	5 3/4 to 6 1/4	4 1/4 to 4 3/4
of which:				
Business ^{2,3}	-1 1/4	-1 to -1/2	5 1/2 to 6 1/4	3 3/4 to 4 1/4
Private dwellings ³	-1 3/4	-2 1/4 to -2	2 to 2 1/2	2 to 2 1/2
General government ^{3,4}	1 1/4	26 1/4	12 1/2	10 3/4

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

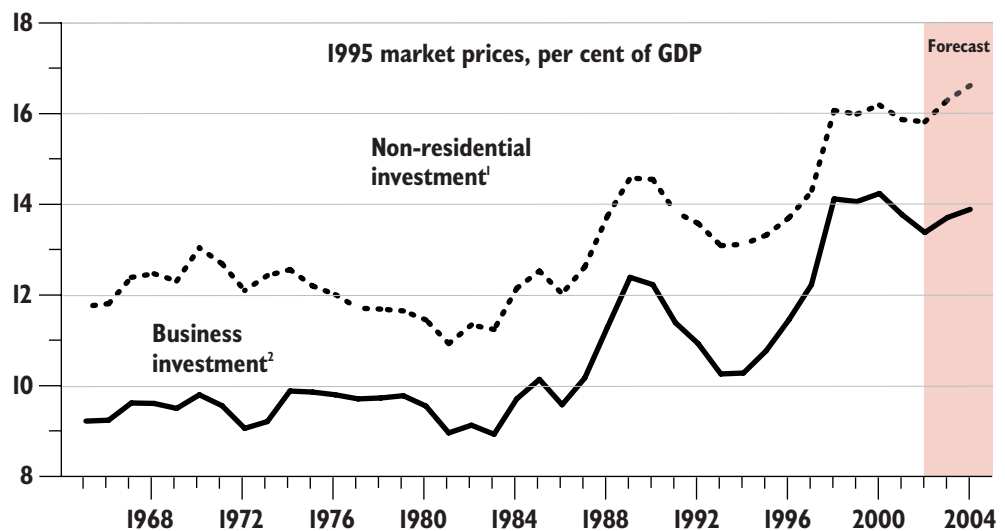
² Private sector and public corporations' (except National Health Service Trusts) non-residential investment. Includes investment under the Private Finance Initiative.

³ Excludes purchases less sales of land and existing buildings.

⁴ Includes National Health Service Trusts.

B58 Business investment growth was widely expected to moderate in 2001, having increased at an average annual rate of almost 9 per cent between 1995 and 2000. In the event, investment in the private service sector contracted through 2001, and manufacturing investment was particularly depressed in the second half of the year. Business investment fell by 1 1/4 per cent, as firms deferred capital spending in the face of weak and increasingly uncertain global demand. CBI surveys report that uncertainties surrounding future demand were the most commonly cited restraint on investment growth, particularly in the aftermath of 11 September. Weaker corporate profitability and lower equity market valuations are also likely to have had a negative influence, though interest rate cuts will have provided some support to company finances.

B59 The outlook for companies has improved in recent months, and trading conditions are expected to strengthen further as economic recovery takes shape in the UK's major export markets. Survey measures of UK business confidence have picked up since the end of last year, with indicators of current output and new orders bottoming out or improving in surveys of both manufacturing and service sectors. Manufacturing inventories rose in the first quarter of 2001 but fell back in subsequent quarters, so any upturn in demand is now more likely to translate into increased production.

Chart B7: Business and non-residential investment ratios

¹ Whole economy less dwellings.

² Business investment includes investment by public corporations (except National Health Service Trusts) and investment under the Private Finance Initiative.

B60 Most survey measures of the level of spare capacity in the economy had moved above their long-run averages by early 2002, suggesting that business investment is likely to remain muted in the first half of the year. Thereafter, strengthening demand, confidence and profitability are expected to encourage firms to realise investment plans that were deferred in the uncertain climate of the past year. Continued technological advances should also provide an incentive for firms to upgrade existing machinery and equipment and, while ICT-related investment growth is not expected to return to the very strong rates witnessed in the late 1990s, telecommunications companies are likely to invest in new network infrastructure associated with third-generation (3G) technologies. Renewed momentum in business investment, coupled with rising external demand for ICT-related and other manufactured goods, should help to underpin a strong recovery in UK manufacturing output later this year and into 2003.

B61 Business investment remains close to its record share of GDP, measured at constant (1995) prices, averaging almost 14 per cent in 2001, and this share is forecast to rise towards its all-time high as business investment growth strengthens. General government investment is projected to accelerate further in 2002, having increased by almost 12 per cent last year, and growth is projected to remain in double digits in both 2003 and 2004. Whole-economy investment growth is therefore expected to rise from between 1½ and 2 per cent in 2002 to between 5¾ and 6¼ per cent in 2003.

Trade and the balance of payments

B62 The synchronised slowdown in the world economy inevitably affected UK trade. Weaker growth in the UK's major export markets, together with the global slump in demand for highly-traded ICT goods, led to a marked contraction in UK exports from the second quarter of 2001. The scale of the downturn in exports and domestic business investment, which have a higher import content than other components of final demand, meant that imports weakened much more sharply than projected in Budget 2001 (see Box B5), helping to moderate the widening of the deficit on trade in goods and services. In the final quarter of 2001, import volumes were 2½ per cent down on a year earlier.

Table B7: Trade in goods and services

	Percentage changes on previous year					£ billion Goods and services balance
	Volumes		Prices ¹		Terms of trade ²	
	Exports	Imports	Exports	Imports		
2001	1	2¾	0	0	0	-21¼
<i>Forecast</i>						
2002	-1½ to -1	1 to 1½	1¼	-½	1¾	-24
2003	7¾ to 8¼	6½ to 7	3	3½	-¾	-24¾
2004	6½ to 7	6 to 6½	3½	3½	0	-25½

¹ Average value indices.

² Ratio of export to import prices.

Box B5: Explaining the recent weakness of imports

Despite the strength of domestic demand last year, imports turned out substantially weaker than forecast in Budget 2001. UK trade data reveal that, while imports of consumption goods increased in 2001, imports of capital and intermediate goods fell by almost 10 per cent and over 20 per cent respectively in the year to the fourth quarter. Closer examination of the relationship between imports and selected expenditure components of final demand confirms that imports tend to be more closely correlated with growth of investment and exports than with household consumption.

There are no readily available and timely measures of the overall import content of individual components of final expenditure¹. However, there are reasons to believe the import content of household consumption expenditure is lower than that of business investment and exports. Almost half of household consumption is accounted for by services, many of which are not highly traded. At the same time it seems reasonable to assume that many non-durable goods, which account for around a quarter of consumption, are unlikely to have high import content.

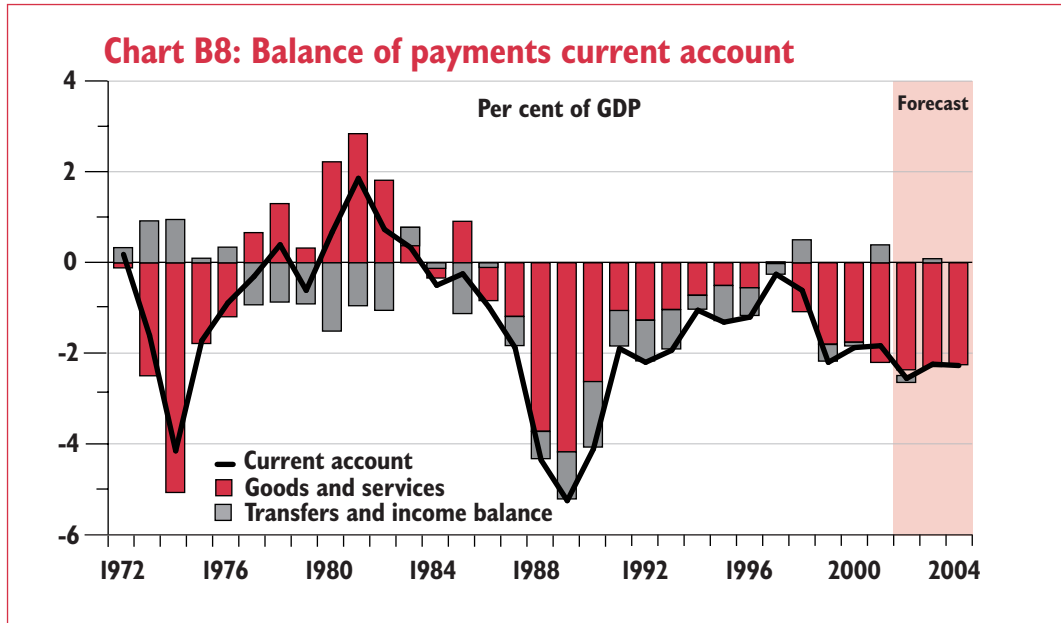
By contrast, capital goods are often either imported directly or contain imported components. While investment spending is only equivalent to roughly one-third of household consumption, the trade data indicate that investment and consumption goods account for a broadly similar proportion of total imports. The slowdown in business investment in the UK during 2001 is therefore likely to have had a greater impact on imports than its share of total final expenditure would suggest. Similarly, the slowdown in investment growth in other major industrialised economies may also have played an important role in explaining the collapse in world trade growth during 2001.

International production linkages may explain the close correlation between UK imports and exports. Multinational corporations are able to source different components from different countries, importing and re-exporting goods at various stages of the production process to take advantage of price and cost differentials. This is particularly common in industries where high value-to-weight ratios mean that transport costs are relatively low, such as ICT-related goods. In the UK, such goods account for around a quarter of manufactured imports, approximately double their share in manufactured output. The sharp slowdown in ICT-related exports will also therefore have contributed to the deceleration in total UK imports and world trade more generally.

Looking ahead, the projected recovery in investment and exports is likely to lead to a significant pick-up in import growth in the near term. However, this is expected to be limited by moderating household consumption growth and by the increasing share of government spending, which has a particularly low import content, in final expenditure.

¹The overall import content of final demand components comprises not only goods and services imported directly to final demand, but also indirect imports used as intermediate inputs in producing domestic goods and services to supply final demand. Estimates are not readily available for the UK in recent years, though in principle they could be derived from analysis of input-output information.

B63 Having increased over recent years, the goods deficit with non-EU countries narrowed in the second half of 2001, as the fall in import volumes from non-EU sources was particularly severe. This may partly have reflected the sharp slowdown in ICT-related imports, which account for a large share of goods imports from certain non-EU sources: 25 per cent for the US and 40 per cent for south-east Asia, compared with just over 15 per cent for goods imports from the EU. Meanwhile, the deficit on trade in goods with the EU widened significantly towards the end of 2001, reflecting the more modest decline in imports from the region and the impact of weakening Euro-area economic growth on demand for UK exports. Excluding a significant one-off fall in exports of services in September, which reflected insurance claims following the terrorist attacks in the US, the surplus on trade in services fell modestly in 2001.



B64 Looking forward, UK exports are forecast to pick up as export market growth strengthens later in 2002 and into 2003. Year-on-year growth is still projected to be negative for 2002 as a whole, but export volumes in the second half of the year are forecast to be almost 4 per cent higher than in the first half. Imports are also expected to accelerate significantly this year, as the projected pick-up in final demand is led by investment and exports. Nonetheless, the anticipated moderation in household consumption growth and the increasing share of final expenditure accounted for by government spending, which generally has a relatively low import content, are expected to limit import growth over the medium term. Import volumes are therefore projected to grow less rapidly than exports from the second half of 2002, so that the deficit on trade in goods and services levels off at $2\frac{1}{4}$ per cent of GDP.

B65 The relatively modest widening of the trade deficit, combined with a significant rise in the net surplus on income and transfers, meant that the current account deficit increased only marginally in 2001 as a whole. Although it rose significantly in the fourth quarter as the erratic investment income surplus fell back sharply, it is expected to narrow gradually from the second half of this year as UK earnings on overseas assets return to more normal levels and the trade deficit levels off. Thereafter, the current account deficit is expected to stabilise at $2\frac{1}{4}$ per cent of GDP, a level which is readily financeable and which remains well below past peaks.

Table B8: Summary of economic prospects¹

	Percentage changes on a year earlier unless otherwise stated					
	Forecast ²				Average errors from past forecasts ³	
	2001	2002	2003	2004	2002	2003
Output at constant market prices						
Gross domestic product (GDP)	2 ¹ / ₄	2 to 2 ¹ / ₂	3 to 3 ¹ / ₂	2 ¹ / ₂ to 3	³ / ₄	¹ / ₂
Manufacturing output	-2 ¹ / ₄	-3 to -2 ¹ / ₂	2 ¹ / ₄ to 2 ³ / ₄	1 ³ / ₄ to 2 ¹ / ₄	1	1 ³ / ₄
Expenditure components of GDP at constant market prices⁴						
Domestic demand	2 ³ / ₄	2 ³ / ₄ to 3 ¹ / ₄	3 to 3 ¹ / ₂	2 ¹ / ₂ to 3	¹ / ₂	1
Household consumption ⁵	3 ³ / ₄	3 to 3 ¹ / ₂	2 ¹ / ₄ to 2 ³ / ₄	1 ³ / ₄ to 2 ¹ / ₄	³ / ₄	1 ¹ / ₄
General government consumption	2 ³ / ₄	3 ¹ / ₄	3 ¹ / ₄	3 ¹ / ₄	³ / ₄	1
Fixed investment	¹ / ₄	1 ¹ / ₂ to 2	5 ³ / ₄ to 6 ¹ / ₄	4 ¹ / ₄ to 4 ³ / ₄	2	2 ¹ / ₄
Change in inventories ⁶	- ¹ / ₄	0	0	0	¹ / ₄	¹ / ₄
Exports of goods and services	1	-1 ¹ / ₂ to -1	7 ³ / ₄ to 8 ¹ / ₄	6 ¹ / ₂ to 7	2 ¹ / ₂	2 ¹ / ₂
Imports of goods and services	2 ³ / ₄	1 to 1 ¹ / ₂	6 ¹ / ₂ to 7	6 to 6 ¹ / ₂	2 ¹ / ₂	3
Balance of payments current account						
£ billion	-17 ¹ / ₂	-25 ³ / ₄	-23 ³ / ₄	-25 ¹ / ₂	6 ³ / ₄	7
per cent of GDP	-1 ³ / ₄	-2 ¹ / ₂	-2 ¹ / ₄	-2 ¹ / ₄	³ / ₄	³ / ₄
Inflation						
RPIX (Q4)	2	2 ¹ / ₄	2 ¹ / ₂	2 ¹ / ₂	¹ / ₂	¹ / ₂
Producer output prices (Q4) ⁷	- ¹ / ₄	1	2	2 ¹ / ₄	1	1 ¹ / ₂
GDP deflator at market prices	2 ¹ / ₂	2 ³ / ₄	2 ¹ / ₂	2 ¹ / ₂	¹ / ₂	³ / ₄
Money GDP at market prices						
£ billion	989	1036 to 1041	1094 to 1104	1149 to 1166	8	13
percentage change	4 ³ / ₄	4 ³ / ₄ to 5 ¹ / ₄	5 ¹ / ₂ to 6	5 to 5 ¹ / ₂	³ / ₄	1 ¹ / ₄

¹ The forecast is consistent with national accounts and balance of payments statistics to the fourth quarter of 2001, released by the Office for National Statistics on 27 March 2002.

² 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.

³ Average absolute errors for year-ahead projections made in spring forecasts over the past ten years. The average errors for the current account are calculated as a per cent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2002 and 2003.

⁴ Further detail on the expenditure components of GDP is given in Table B9.

⁵ Includes households and non-profit institutions serving households.

⁶ Contribution to GDP growth, percentage points.

⁷ Excluding excise duties.

Table B9: Gross domestic product and its components

£ billion at 1995 prices, seasonally adjusted										
	Household consumption ¹	General government consumption	Fixed investment	Change in inventories	Domestic demand ²	Exports of goods and services	Total final expenditure	Less imports of goods and services	Plus statistical discrepancy ³	GDP at market prices
2001	580.2	158.1	156.6	1.2	896.4	288.4	1184.8	338.8	-0.3	845.7
2002	598.3 to 600.8	163.3	158.9 to 159.6	0.9 to 1.6	921.4 to 925.4	284.0 to 285.2	1205.4 to 1210.6	342.5 to 344.0	-0.3	862.6 to 866.3
2003	611.0 to 616.6	168.8	168.1 to 169.7	0.1 to 1.7	948.1 to 956.8	306.2 to 309.0	1254.3 to 1265.8	364.5 to 367.8	-0.3	889.5 to 897.7
2004	621.8 to 630.6	174.3	175.3 to 177.7	-0.3 to 2.2	971.1 to 984.8	326.0 to 330.7	1297.1 to 1315.4	386.1 to 391.5	-0.3	910.8 to 923.6
2001 1st half	287.2	79.1	78.5	1.2	446.2	147.4	593.6	172.0	-0.2	421.4
2nd half	293.0	78.9	78.0	0.0	450.2	141.0	591.2	166.8	-0.1	424.3
2002 1st half	297.4 to 298.3	81.4	78.8 to 79.0	-0.7 to -0.5	456.9 to 458.3	139.4 to 139.8	596.3 to 598.1	168.8 to 169.3	-0.1	427.3 to 428.6
2nd half	300.9 to 302.5	81.9	80.1 to 80.6	1.7 to 2.1	464.5 to 467.1	144.6 to 145.4	609.2 to 612.5	173.7 to 174.7	-0.1	435.3 to 437.7
2003 1st half	304.0 to 306.4	83.7	82.9 to 83.6	0.8 to 1.5	471.4 to 475.2	150.4 to 151.6	621.8 to 626.8	179.5 to 180.9	-0.1	442.2 to 445.7
2nd half	307.0 to 310.2	85.1	85.2 to 86.1	-0.7 to 0.2	476.6 to 481.6	155.8 to 157.4	632.4 to 639.0	185.0 to 186.9	-0.1	447.3 to 451.9
2004 1st half	309.6 to 313.6	87.0	86.8 to 87.9	-0.9 to 0.2	482.5 to 488.7	160.6 to 162.6	643.1 to 651.4	190.3 to 192.8	-0.1	452.6 to 458.4
2nd half	312.2 to 317.0	87.3	88.5 to 89.8	0.6 to 2.0	488.6 to 496.0	165.5 to 168.0	654.0 to 664.1	195.7 to 198.7	-0.1	458.2 to 465.2
Percentage changes on previous year ^{4,5}										
2001	3 ³ / ₄	2 ³ / ₄	1 ¹ / ₄	-1 ¹ / ₄	2 ³ / ₄	1	2 ¹ / ₄	2 ³ / ₄	0	2 ¹ / ₄
2002	3 to 3 ¹ / ₂	3 ¹ / ₄	1 ¹ / ₂ to 2	0	2 ³ / ₄ to 3 ¹ / ₄	-1 ¹ / ₂ to -1	1 ³ / ₄ to 2 ¹ / ₄	1 to 1 ¹ / ₂	0	2 to 2 ¹ / ₂
2003	2 ¹ / ₄ to 2 ³ / ₄	3 ¹ / ₄	5 ³ / ₄ to 6 ¹ / ₄	0	3 to 3 ¹ / ₂	7 ³ / ₄ to 8 ¹ / ₄	4 to 4 ¹ / ₂	6 ¹ / ₂ to 7	0	3 to 3 ¹ / ₂
2004	1 ³ / ₄ to 2 ¹ / ₄	3 ¹ / ₄	4 ¹ / ₄ to 4 ³ / ₄	0	2 ¹ / ₂ to 3	6 ¹ / ₂ to 7	3 ¹ / ₂ to 4	6 to 6 ¹ / ₂	0	2 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 per cent of GDP.

⁵ Growth ranges for GDP components do not necessarily sum to the 1/2 percentage point ranges for GDP growth because of rounding and the assumed invariance of the levels of public spending within the forecast ranges.