B The economy

The global economy is in the early stages of recovery following the most severe and synchronised downturn since the Great Depression in the 1930s. In line with the Budget 2009 and the 2009 Pre-Budget Report forecasts, growth in the world economy resumed in the second half of 2009 and trade volumes have begun to recover, but the nascent recovery remains fragile. There is a marked difference in the pace of recovery across countries, with many emerging economies already returning to pre-crisis growth rates while growth in many advanced economies, including the UK's largest trading partner, the euro area, remains below long-run trend rates.

The Budget world economy growth forecast remains broadly unchanged from the 2009 Pre-Budget Report. However, the forecast for UK export markets growth has been revised down in 2011, reflecting a weaker outlook for the euro area.

The UK economy stabilised in the second half of 2009, aided by the substantial macroeconomic policy stimulus and government interventions in the financial system to help ease the flow of credit to the economy. In line with the Budget 2009 forecast and the 2009 Pre-Budget Report forecast, output returned to modest growth in the final quarter of 2009, but reflecting sharp falls at the start of the year, output fell by 5 per cent over 2009 – the largest annual decline on record. Growth is expected to continue through 2010, with a moderate recovery in the first half of 2010, before strengthening in the second half of the year.

The significant past depreciation of sterling and the recovery in world demand provide the conditions to support a sustained recovery in the UK economy and a rebalancing of global and domestic demand. The Budget 2010 economic forecast is for:

- UK GDP growth of 1¼ per cent in 2010, with fiscal policy, the lagged effects of monetary policy stimulus and easing credit conditions supporting the recovery. GDP growth is then forecast to strengthen, to between 3 and 3½ per cent in 2011. Growth is then expected to rise to 3¼ and 3¾ per cent in 2012, with a recovery in net exports and business investment, but a falling share of consumption in GDP;
- CPI inflation to fall back through 2010, reaching 2 per cent by the end of the year as the effect of higher import prices wanes, and to fall further through the first half of 2011, as the VAT change drops out of the annual comparison and the large degree of spare capacity continues to bear down on inflation. As the economy recovers, CPI inflation is expected to rise back to target by the end of 2012;
- Claimant count unemployment to peak around the middle of 2010 at just under 1¾ million, then falling back to around 1¼ million at the end of 2012, as demand recovers and the UK's flexible markets support the adjustment of the labour market.

The extreme downside risks have receded over the last year, but given the size and nature of the financial shocks and the ensuing scale and depth of the global economic downturn, the Budget 2010 economic forecast remains subject to significant uncertainty and risks, including: the pace and balance of global recovery; the impact of the financial crisis on trend output; the degree of private sector rebalancing; and the availability of credit to support the recovery. These risks are reflected in the wide range of outside forecasts. The Treasury's forecast for growth is just above the Bank of England's mean forecast of around 3 per cent in 2011 and 2012 and above the consensus.

INTRODUCTION[1,2]

B.1 The global economy is recovering following the most severe and synchronised contraction since the Great Depression. The financial crisis, which was triggered in the summer 2007 by disruption in the US subprime mortgage market quickly spread concerns about the solvency of banks around the world. Although the rapid action taken by the UK and other governments prevented the collapse of the global financial system, the crisis created a severe global economic shock and it will take time for the world economy to fully recover.

B.2 The world economy was hit by a succession of shocks during 2007 and 2008. Initially, credit conditions tightened across advanced economies. Then the rise in global commodity prices squeezed real incomes. Together, these factors pushed many advanced economies into recession. Finally, the intensification of the credit shock into a global financial crisis delivered a severe blow to confidence in an already weakened world economy, precipitating a steep global downturn. World GDP fell in 2009, suffering its first full year decline in the post-war era. Global trade and industrial production plummeted, dropping by over 18 per cent and over 11 per cent respectively in the first quarter of 2009 on a year earlier. Global equity prices fell and by early 2009 they had lost 50 per cent from their peak.

B.3 The extent of global financial and economic shocks led to unprecedented support by governments and central banks around the world. In the UK, household and corporate incomes are being supported by substantial fiscal support, worth almost 5 per cent of GDP in 2009-10, and targeted measures to help the labour market, home-owners and businesses. The economy continues to be reinforced by the monetary policy stimulus which remains in place: Bank Rate has been maintained at ½ per cent since March 2009 and the stock of assets purchased by the Bank of England now stands at £200 billion. The Government's financial sector interventions to recapitalise banks and ensure access to finance for credit-worthy borrowers have helped to promote the flow of credit to the economy.

B.4 In line with the Budget 2009 forecast, the world economy returned to growth in 2009, driven by a strong rebound in the Asian economies and substantial monetary and fiscal policy interventions across the world that helped ease conditions in financial markets and stabilise demand. The UK economy stabilised before returning to growth in the final quarter of 2009, in line with the forecast at Budget 2009 and 2009 Pre-Budget Report.

B.5 Despite the sharper fall in UK output through this recession than in the 1990s, the decline in employment has been smaller than at that time and less than expected at the time of Budget 2009. This, combined with the smaller than expected decline in house prices, has been reflected in relatively lower arrears and repossessions than in the 1990s recession, preventing the potential adverse feedback loop of lower asset values, thinner bank capital ratios and lower lending that could have weakened the economy further. Inflation has increased since the 2009 Pre-Budget Report, in line with the forecast, although higher than

[1] The UK forecast is consistent with National Accounts and balance of payments statistics to the third quarter of 2009 released by the Office for National Statistics (ONS) on 22 December 2009, and the second estimate of GDP growth in the fourth quarter released on 26 February 2010. This release also contained revisions to earlier quarters of 2009, which the Treasury has carried through to other National Accounts series that the ONS has not yet revised, in particular sectoral saving and borrowing. A fully consistent National Accounts data set will be published by the ONS on 30 March 2010. A detailed set of charts and tables relating to the economic forecast is available in Budget 2010: the economy and public finances – supplementary material on the Treasury's internet site. 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.

anticipated at Budget 2009 reflecting a more rapid pass-through of strong import prices and a pick-up in oil prices in 2009.

B.6 The Budget 2010 growth forecast is largely unchanged from the 2009 Pre-Budget Report. However, the nature of the global credit shock and world downturn, and the scale of the international macroeconomic and financial policy response, have highlighted the inherent difficulties in economic forecasting. The size and scale of the unexpected global shocks have called into question the empirical models upon which economic forecasts are based, requiring more judgement to assess the distribution of risks, and take account of the high degree of uncertainty.

THE WORLD ECONOMY

Global recovery

B.7 After successive shocks from the commodity markets and global financial system, G20 policy action and unprecedented co-ordination has helped to stabilise financial markets and demand, boosting short-term global prospects. However, the nascent recovery remains fragile and there is a marked difference in the pace of recovery between advanced and emerging economies.

B.8 The return to growth has largely been driven by two common factors in most countries outside Asia: government stimulus measures and a turn in the inventory cycle. While interventions have helped to improve conditions in financial markets, expansionary monetary and fiscal policies have helped to stabilise demand and firms have been able to reduce stocks at a slower pace, helping to boost growth. This impetus from inventories may be uneven but it is likely to continue well into 2010, as will the effects of both monetary and fiscal stimulus.

B.9 The capacity of private demand to drive growth will be key in determining prospects for the global economy and recent data show tentative signs of a recovery. The global manufacturing purchasing managers survey compiled by JP Morgan reached a five and a half year high in early 2010 and world trade in goods has risen sharply. According to the CPB Netherlands Bureau for Economic Analysis, world trade grew by 6 per cent in the fourth quarter of 2009, the fastest quaterly growth since records began in 1991. Improvements in the global economy have also been reflected in global financial markets with the gains made during 2009 being consolidated since the 2009 Pre-Budget Report – world stock prices remain over 60 per cent above their February 2009 level, helping to underpin confidence.

B.10 Maintaining confidence and reducing uncertainty will be essential to the continued recovery in private sector demand. Recent events have shown how quickly risk appetite can be reversed and how fragile financial market sentiment in the recovery can be.

Credit conditions

B.11 Despite improvements in global financial markets, credit conditions in the advanced economies remain tight. Lending standards remain restrictive and the demand for loans is weak.

Commodity prices

B.12 Having risen earlier in 2009, commodity prices have remained relatively stable since the 2009 Pre-Budget Report. With a high degree of spare capacity and a stable outlook for demand, oil prices have remained in $70–$85 per barrel range, close to their level since mid 2009. Demand for oil will remain dependent on the shape and pace of the global recovery. Currently, markets are well supplied with inventories, and spare capacity remains at a comfortable level.

World outlook

B.13 In contrast with the synchronised nature of the downturn, the global recovery has been characterised by a divergence in the growth rates of advanced and emerging economies. While some degree of divergence is usual given different levels of trend growth, the speed at which economies are expected to return to pre-crisis growth rates differs – many emerging economies have already done so, while many advanced economies are not expected to grow consistently at or above trend rates until 2011.

Euro area

B.14 The euro area grew by 0.4 per cent in the third quarter of 2009, but growth then slowed to 0.1 per cent in the final quarter and overall growth in the second half of 2009 was lower than expected in the 2009 Pre-Budget Report. While the recovery in world trade continued to support euro area exports, domestic demand was subdued and investment was especially weak.

B.15 Across euro area countries an uneven picture is emerging. In part this reflects the significant challenges facing some of the region's economies which continue to face difficult adjustments as imbalances unwind – associated, in particular, with rapid pre-crisis growth and a steady erosion of their competitiveness against euro area partners over recent years. Divergence also reflects differences in the withdrawal of stimulus measures across countries and the different timing of inventory cycles.

B.16 Recent data have sent mixed messages over the strength of the euro area recovery, which remains a key uncertainty for the UK economic forecast. Industrial production rose by 2 per cent on a quarterly basis in the fourth quarter of 2009 after 0.8 per cent in the previous quarter, and there has been a steady rise in confidence indicators into 2010. However, growth in industrial new orders slowed to 1.1 per cent in the fourth quarter following a 7.7 per cent rise in the previous quarter and retail sales remain subdued.

B.17 The euro area is forecast to grow by ¾ per cent in 2010, driven primarily by improvements in global demand supporting moderate export growth. Domestic consumption is expected to remain subdued, weighed down by further weakening in the labour market and relatively low wage growth against a backdrop of slowly rising inflation. Growth of around 1¾ per cent is expected in 2011 as domestic demand begins to gather momentum.

United States

B.18 The US economy returned to growth in the second half of 2009, following four consecutive quarters of contraction. The inventory cycle and government stimulus measures have been the principal drivers of the recovery in output. Over half of the stimulus package announced at the start of 2009 has yet to be spent, with the composition changing towards infrastructure spending and away from government transfers during 2010. Consistent with a significant improvement in financial conditions and rapid growth in the manufacturing sector, consensus growth forecasts for the US economy have risen in recent months.

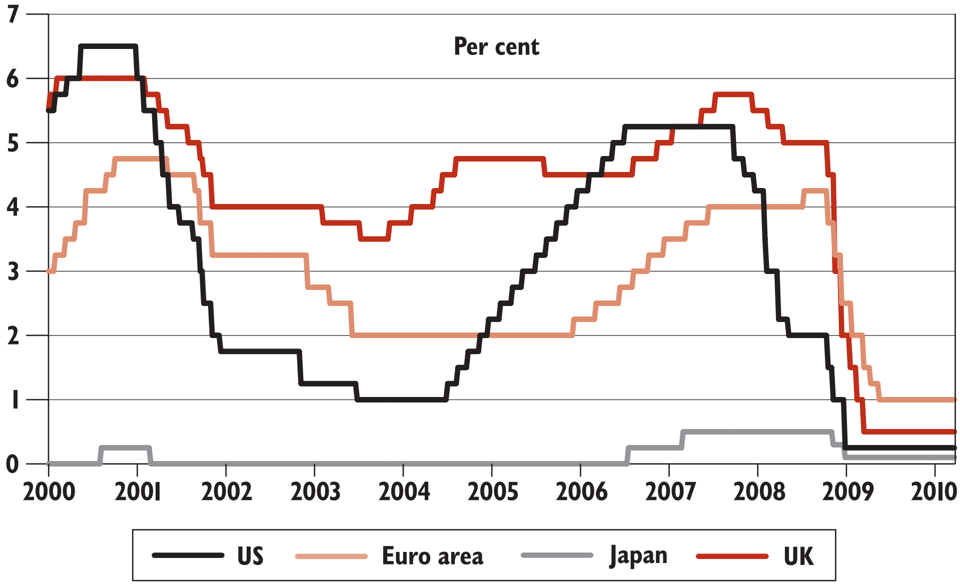
B.19 However, risks to growth remain for the world's largest economy and the UK's largest single-country export market. The labour market continues to weaken, albeit at a greatly reduced pace compared with the first half of 2009, and prospects for job creation remain heavily dependent on bank lending to smaller firms. The housing market has also shown mixed signs, with prices stabilising but activity remaining volatile with substantial excess supply. According to consensus forecasts, the US economy is set to grow by 3.1 per cent in 2010 and 3.0 per cent in 2011.

Asia

B.20 For Asian economies, growth prospects continue to be strongly influenced by the performance of the Chinese economy. China, already one of the world's largest exporters, is set to become the largest economy in the region, overtaking Japan, in 2010[3]. China grew by 10.7 per cent in the final quarter of 2009 compared with a year earlier driven by strong investment growth related to the stimulus package. This has also led to robust import growth in China with trade flows in Asia outperforming those in other regions. Elsewhere in emerging Asia, growth has also been strong. India, despite poor monsoon rainfall, grew by 6 per cent in the fourth quarter of 2009 compared with a year earlier.

B.21 The Japanese economy has benefited from the quick rebound in the rest of Asia. Since the second quarter of 2009, net exports have been the main contributor to growth, with exports to China up by 30 per cent in the second half of 2009 compared with the first half of the year. The effect of five fiscal stimulus packages has also helped to support the Japanese economy. According to consensus forecasts, Japan is set to grow by 1.9 per cent in 2010 and 1.6 per cent in 2011.

Chart B1: Official interest rates in the major advanced economies



Source: Bank of Japan, Federal Reserve, ECB and the Bank of England.

World economy forecast

B.22 The Budget forecast for growth in the world economy remains largely unchanged from the 2009 Pre-Budget Report, although growth in the euro area and UK export markets is somewhat weaker. The world economy is estimated to have contracted by 1 per cent in 2009, the largest annual fall in the post war-era. This is broadly in line with the Budget 2009 forecast. The world economy is forecast to grow by 3¼ per cent in 2010, rising to 4¼ per cent in 2011 and 2012. Almost 80 per cent of global growth in 2010 is likely to be generated by emerging economies with the G7 economies set to experience a more modest rebound, growing by 1¾ per cent in 2010, 3 per cent in 2011 and 3¼ per cent in 2012. Consistent with below trend growth in 2010 and downward pressure on prices from large negative output gaps, G7 inflation is forecast to remain subdued.

[3] Based on market exchange rates. It is already larger on a Purchasing Power Parity basis.

Table B1: The world economy

	Percentage change on a year earlier, unless otherwise stated				
			Forecast		
	2008	2009	2010	2011	2012
World GDP	3	-1	3¼	4¼	4¼
Major 7 countries[1]:					
Real GDP	¼	-3½	1¾	3	3¼
Consumer price inflation[2]	1¾	¾	1	1½	1¾
Euro area GDP	¾	-4	¾	1¾	2¼
World trade in goods and services	2¾	-12¼	4½	5½	7¼
UK export markets[3]	2½	-12	2½	3½	6¼

[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 those countries in the UK's total exports.*

Box B1: The pattern of global growth and UK trade

UK trade with emerging economies has increased markedly over the past decade. For example, UK exports of goods and services to Brazil, Russia, India and China accounted for 5 per cent of total UK trade in 2008, double that in 2000. Despite this strong growth, other advanced economies still remain the UK's main trading partners: the euro area and US account for 43 and 17 per cent of exports of goods and services respectively.

The global economic recovery that began in 2009 is expected to strengthen in 2010. In contrast to the synchronised nature of the downturn, there is forecast to be a significant degree of divergence in the pace of recovery across countries and regions, with emerging economies expected to grow much faster than advanced economies. Several countries in the euro area are expected to experience a weak recovery due to a sustained erosion of their competitiveness in recent years.

This expected pattern of growth is captured in the Treasury's forecast for UK export markets which weights together other countries' imports of goods and services according to the importance of those countries in the UK's total exports. UK export markets are therefore expected to grow slower than world trade over the forecast horizon, especially in 2010 and 2011. This, in turn, is fully reflected in the forecast for UK exports, set out in Table B7.

There are clear downside risks to growth in advanced economies. If these were to materialise, they would be likely to exert additional downward pressure on UK export markets for a sustained period. However, despite the UK's relatively limited direct trade links with Asia, third country effects could be important. Growth in Asia has improved prospects for commodity exporters and helped to generate positive export growth in major UK trading partners. Chinese imports from Europe grew by 7 per cent in the third quarter of 2009 and imports from advanced economies as a whole grew by 35 per cent. This should translate into growth in demand for UK exports either directly if UK goods and services are used in the production of exports to emerging markets, or indirectly if increased exports lead to increased incomes and hence demand in the UK's key trading partners.

World trade and UK export markets

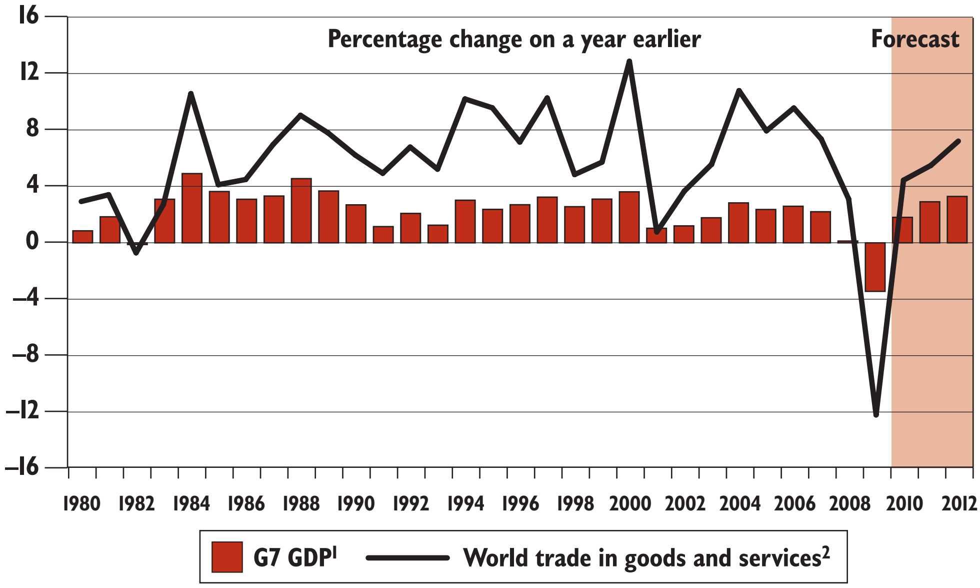
World trade

B.23 Following the collapse in world trade during late 2008 and early 2009, trade volumes have stabilised. Much of this stabilisation has been driven by the rebound in goods trade over recent quarters as firms have reduced the pace of inventory liquidation and global industrial production has increased. While trade growth in the last three months of 2009 has been concentrated to some extent in emerging Asia (growing by 10 per cent), trade in advanced economies grew at 4 per cent – the second fastest quarter of advanced economies' trade growth since 1994. After an estimated fall of 12¼ per cent in 2009, growth in world trade is forecast to be 4½ per cent in 2010, rising to 5½ per cent in 2011 and 7¼ per cent in 2012.

UK export markets

B.24 As Box B1 discusses, the uneven global recovery and weakness in some EU Member States has implications for the growth in UK export markets. The growth in UK export markets is therefore set to be significantly lower than world trade, growing by 2½ per cent and 3½ per cent in 2010 and 2011 respectively, before picking up to 6¼ per cent in 2012, closer to world trade growth.

Chart B2: G7 GDP and world trade



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

Box B2: Government policy on EMU

The Government's policy on membership of the single currency was set out by the former Chancellor in his statement to Parliament in October 1997. In principle, the Government is in favour of UK membership; in practice, the economic conditions must be right. The determining factor is the national economic interest and whether, on the basis of an assessment of the five economic tests, the economic case for joining is clear and unambiguous. An assessment of the five economic tests was published in June 2003. This concluded that: "a clear and unambiguous case for UK membership of EMU has not at the present time been made".

The Chancellor's statement to the House of Commons on 9 June 2003 on UK membership of the single currency set out a reform agenda of concrete and practical steps to address the policy requirements identified by the assessment of the five economic tests. This Budget sets out progress on the Government's reform agenda, including continued efforts to maintain the flexibility of labour, capital and product markets in the UK.

In his statement to the House of Commons on 9 June 2003, the former Chancellor committed the Government to an annual review of progress. The Government does not propose a euro assessment to be initiated at the time of this Budget. The Treasury will again review the situation at Budget time next year, as required by the Chancellor's June 2003 statement.

THE UK ECONOMY

Overview of recent developments

GDP growth **B.25** The UK economy stabilised in the second half of 2009, following a substantial fall in output in the wake of the global financial crisis. The cumulative decline in output through the recession is estimated at around 6 per cent, similar to the loss in output seen in the 1980s recession, but greater than that in the early 1990s. Through 2009, the pace of decline eased as the substantial policy stimulus fed through into the economy, and global and domestic confidence picked up. In line with the Budget 2009 and 2009 Pre-Budget Report forecasts, the UK economy returned to growth in the fourth quarter of the year. The Office for National Statistics (ONS) estimate GDP to have risen by 0.3 per cent, as government consumption continued to support the economy and household consumption rose. Nominal GDP rose by 1.9 per cent in the second half of 2009, although in the fourth quarter it remained 3 per cent below its pre-recession peak in the second quarter of 2008. Nominal GDP did not fall in the 1980s and 1990s recessions.

B.26 Although bad weather has complicated the assessment, a range of measures suggest output continued to recover at the start of 2010. Consumer and business confidence measures have improved, and labour market indicators have started to stabilise at a relatively early stage in the recovery. The latest estimate from the National Institute of Economic and Social Research (NIESR) suggests output rose by 0.3 per cent over the three months to February[4].

Inflation **B.27** Consumer price inflation has increased from its trough of 1.1 per cent in September 2009, as expected in the 2009 Pre-Budget Report forecast. CPI inflation peaked at 3.5 per cent in January 2010, falling to 3.0 per cent in February. An increase in CPI inflation due to the reversal of the pre-announced VAT rate cut in January 2010 was expected. Fuel prices have also added to inflation. While the overall rate of inflation has risen significantly over recent months, this masks a divergence in the path of services and goods price inflation largely reflecting the downward effect of domestic disinflationary pressure on services prices and the upward effect of sterling's depreciation on goods prices. This is discussed further in Box B3.

B.28 RPI inflation has also increased markedly since the 2009 Pre-Budget Report, turning positive in November 2009, and exceeding CPI inflation in January 2010 for the first time since April 2008. The increase in RPI inflation reflects the same factors influencing CPI inflation, but the RPI has also been boosted by house price increases in 2009 and the large cuts in mortgage rates falling out of the annual comparison.

Credit conditions **B.29** Credit conditions have continued to improve since the 2009 Pre-Budget Report, although as in other advanced economies, they remain tight compared to pre-recession levels. The spread of interbank lending rates over market expectations of policy rates has fallen substantially from its high of more than 200 basis points in October 2008 to an average of 18 basis points since February 2010.

B.30 The lower level of Bank Rate has helped to reduce the absolute cost of lending faced by households and companies. For example, the Bank of England's measure of the effective rate on new corporate loans has fallen from its peak of 7½ per cent in 2007 to around 2 per cent in January this year. However, as discussed at the 2009 Pre-Budget Report the spreads over Bank Rate and LIBOR for new secured lending to households and credit to small and medium-sized companies widened during the financial crisis, as credit and liquidity risks

[4] www.niesr.ac.uk/gdp/GDPestimates.thp

rose and risk was re-priced. In recent months, spreads have shown signs of stabilisation, but they remain at elevated levels.

B.31 Lending to households and companies was subdued in 2009, but weak credit growth is not uncommon in downturns. In recent months, lending has shown signs of stabilisation. In the final quarter of 2009, the flow of net secured lending to households increased by nearly £4 billion, the highest quarterly increase since the third quarter of 2008, and net sterling lending flows to Private Non-Financial Corporations (PNFCs) rose by nearly £2 billion, following large falls earlier in the year. For PNFCs, these falls were largely offset by net capital issuance, as conditions in capital markets improved. In particular, yields on corporate bonds, rated lower than AA, have fallen substantially since early 2009. See Box B6 for further discussion on developments in the structure of corporate finance.

B.32 The latest Bank of England's *Credit Conditions Survey* reports that the availability of both secured credit to households and credit companies increased in the final quarter of 2009. The Bank's *Trends in Lending Report* in March suggests that the availability of credit to firms and households has continued to improve, possibly reflecting an improvement in lenders' expectations of mortgage and corporate distress: the *Report* noted that mortgage arrears and write-off rates on corporate loans were lower than expected by lenders and write-off rates on corporate loans and mortgages have risen by less than in the 1990s recession.

Labour market

B.33 In spite of the steep decline in employment seen in the first half of 2009, the labour market has been more resilient than many expected. The rate of unemployment has stabilised and is below that seen at the end of previous recessions. Since the 2009 Pre-Budget Report, employment has continued to decline but at a much lower rate, redundancies have fallen back sharply and vacancies have picked up slightly. Unemployment has fallen and in February the claimant count saw its largest decline since the end of 1997, bringing the claimant count back to its lowest level since July 2009. Average earnings growth has continued to slow over the past year, reflecting firms' response to weak demand.

THE ECONOMY FORECAST

B.34 Economic forecasting inevitably involves judgement about both the uncertain path of future events and the current position of the economy. While the severe short-term downside risks have receded since Budget 2009, the nature and scale of the global recession means that forecasts remain subject to more than normal degrees of uncertainty.

Growth cycle approach

B.35 The Treasury's approach to forecasting macroeconomic developments, set out in detail in Budget 2007[5], accords with the growth cycle approach favoured by many policymakers. The essential building blocks of this approach are estimates of the 'trend' level and rate of growth of output, and analysis of cyclical movements around that trend, the 'output gap'[6]. The trend output projection provides the medium-term anchor for the forecast. The current mechanical output gap estimate, and an assessment of the economy's momentum based on analysis of individual output, income and expenditure components of activity, informs the judgement on the path of the economy back towards trend. At a time when large shocks have hit the economy and are likely to have reduced the level of trend, or potential, output these estimates and analyses are particularly challenging. For Budget 2010, the Treasury has maintained its usual forecast ranges, which represent alternative assumptions about the supply-side performance of the economy, not forecast uncertainties.

[5] See paragraph B.30 to B.35 of Budget 2007.

[6] 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 economic activity and employment.

Assessment of trend growth

B.36 The global financial crisis has substantially increased the uncertainties surrounding the outlook for trend output. In principle, there are a number of different ways in which the shock could affect the path of trend output, largely related to the impact on the price and supply of credit. A change in the relative size of the financial sector may also impact on trend output in the event that its contribution to total productivity falls. This is discussed in more detail in Box B4.

B.37 In addition, lower net migration would tend to imply a weaker outlook for the trend population component of trend output. Recent International Passenger Survey (IPS) data continue to point to more subdued levels of net inflows, with provisional estimates of long-term net migration falling to 147,000 in the year to June 2009 from 168,000 in the year to June 2008. Administrative data provide further support for a slowdown in net migration, with applications from A8 nationals to the Worker Registration Scheme (WRS) falling by a third between 2008 and 2009 while National Insurance numbers allocated to non-UK nationals fell back in the third quarter of 2009 compared to a year earlier.

Budget 2010 assumptions

B.38 Table B2 sets out the Budget 2010 assumptions for trend output. The Budget 2010 forecast assumes a reduction to the level of trend output of just over 5 per cent between mid-2007 and mid-2010, reflecting a downward adjustment to the trend productivity component of around 4¾ per cent and a downward adjustment to the trend population component of around ½ per cent. This adjustment means that trend output grows by just under 1 per cent a year between 2007Q3 and 2010Q3. Beyond mid-2010, trend output growth is assumed to return to 2¾ per cent, in line with the rate observed over the second half of the most recently completed economic cycle. The downward adjustment to trend output of just over 5 per cent remains well within the range of external estimates. This judgement continues to remain subject to significant uncertainty and it will be kept under review.

Table B2: Contributions to trend output growth[1,2]

	Estimated trend rates of growth, per cent per annum, unless otherwise stated					
	Trend output per hour worked[3, 4]		Trend average hours worked[4]	Trend employment rate[4]	Population[5]	**Trend output**
	Underlying (1)	Unadjusted (2)	(3)	(4)	(5)	(6)
1986Q2 to 1997H1						
Budget 2009	2.13	1.95	-0.11	0.36	0.26	**2.47**
PBR 2009 and Budget 2010	2.13	1.95	-0.11	0.36	0.26	**2.47**
Over the recent past						
1997H1 to 2001Q3						
Budget 2009	3.12	2.87	-0.46	0.50	0.52	**3.45**
PBR 2009 and Budget 2010	3.12	2.88	-0.46	0.50	0.52	**3.45**
2001Q3 to 2006H2						
Budget 2009	2.12	2.07	-0.26	0.11	0.75	**2.68**
PBR 2009	2.23	2.18	-0.26	0.11	0.75	**2.80**
Budget 2010	2.21	2.16	-0.24	0.10	0.76	**2.80**
Projection[6]						
2006H2 onwards						
Budget 2009	2.25	2.3	-0.25	-0.10	0.80	**2¾**
Level effect: from 2007Q3 to 2010Q3[7]	*–4½*	*–4½*	*0*	*0*	*–½*	***–5***
PBR 2009	2.23	2.3	–0.20	–0.15	0.80	**2¾**
Level effect: from 2007Q3 to 2010Q3[7]	*–4½*	*–4½*	*0*	*0*	*–½*	***–5***
Budget 2010[8]	2.23	2.3	–0.20	–0.15	0.80	**2¾**
Level effect: from 2007Q3 to 2010Q3[7,8]	*–4¾*	*–4¾*	*0*	*0*	*–½*	***–5¼***

[1] Treasury analysis based on judgement that 1986Q2, 1997H1, 2001Q3 and 2006H2 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.

Full data definitions and sources are set out in Annex A of 'Trend growth: new evidence and prospects', HM Treasury, December 2006."

[2] Interim projections between Budget 2002 and the 2008 Pre-Budget Report are set out in 'Budget 2008: the economy and public finances - supplementary material', and the 2008 Pre-Budget Report.

[3] 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.

[4] 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 so the decomposition assumes that average hours worked lag output by just one quarter, though this lag is harder to support by econometric evidence.

[5] UK resident household basis (LFS). Population aged 16 and over.

[6] Neutral case assumptions for trend from 2006H2.

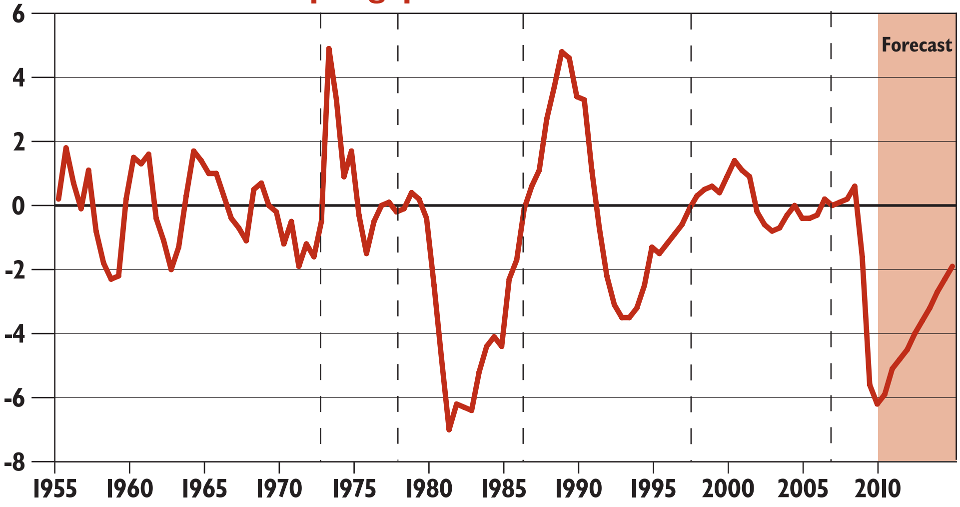
[7] Adjustment reflecting a phased reduction to the level of trend output between mid-2007 and mid-2010.

[8] Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2006H2 are anchored.

Assessment of the output gap

B.39 The output gap is the difference between actual output and the estimated trend, or potential, level of output. Taken together with the Budget 2010 trend output assumptions, the latest National Accounts data imply that a significant negative output gap opened up over the course of 2009, reaching over 6 per cent by the end of 2009.

Chart B3: The output gap[1,2]



[1] Mechanical output gap estimates on a semi-annual basis, based on the latest National Accounts data and expressed as actual output less trend output as a percentage of trend output (non-oil basis). Estimates post-1972 based on the Treasury's assessment of on-trend points using a broad range of economic indicators as set out in 'Evidence on the economic cycle', published alongside the 2008 Pre-Budget Report. Estimates prior to 1972 derived using a Hodrick-Prescott filter as sufficient data from the cyclical indcators monitored by the Treasury are not available to assess on-trend points for this period.

[2] Vertical lines indicate start and end-cycle points as identified by HM Treasury.

B.40 Evidence drawn from a range of cyclical indicators is used to inform the latest assessment of the cyclical position of the economy. In general, these indicators suggest that the economy fell below trend during the second half of 2008 and that the degree of spare capacity increased markedly from the end of 2008. Some survey indicators suggest that there was some moderation in the degree of spare capacity in the second half of 2009. The degree of slack implied varies across indicators and there remains significant uncertainties surrounding current estimates of the output gap:

- the British Chambers of Commerce (BCC) capacity utilisation indicator for services remained flat over the second half of 2009, following falls to below their long-term averages over late 2008 and early 2009. The manufacturing sector indicator has picked up from lows in the first half of 2009. Consistent with the BCC survey, capacity utilisation indicators from the Confederation of British Industry (CBI) and the Bank of England's Regional Agents show some small increases in the latter part of 2009, but tend to suggest more spare capacity than the BCC indicators; and

- demand for labour also fell, with the number of vacancies declining from a peak of almost 700,000 in early 2008 to around 430,000 in the third quarter of 2009. The ILO unemployment rate has increased from 5.5 per cent in the second half of 2006 to 7.8 per cent in the second quarter of 2009. Since then, the number of vacancies has picked up slightly through the fourth quarter of 2009 and into early 2010, and the unemployment rate has remained broadly flat. While a number of survey indicators of recruitment conditions registered small rises over 2009, they continue to point to a substantial degree of slack in the labour market. Significant reductions in average hours worked, partly reflecting a shift towards part-time work, also suggests that some spare capacity exists within employment.

B.41 Survey based cyclical indicators would tend to suggest a smaller but still substantial output gap opened up over the course of 2009. The difference between these alternative approaches and the Treasury's mechanical estimates of the output gap could reflect a number of factors:

- the size and timing of the overall impact of the financial crisis on trend output is very uncertain (the risks section at the end of the chapter provides a further discussion);
- the degree to which the survey indicators of the cyclical position of the economy are affected by shorter-term supply constraints, including, for example, temporary constraints on working capital that might be expected to dissipate as the economy recovers; and
- there may be potential measurement issues associated with both the survey indicators and official data. In particular, survey indicators typically capture the number of firms operating below capacity, but may not necessarily capture the depth of the fall in resource utilisation within individual firms during a downturn. Any revisions to National Accounts data would change the size of mechanical output gap estimates.

GDP and inflation forecasts

Forecasting judgement

B.42 The Budget 2010 economic forecast is underpinned by the following assumptions:

- the G20 continues to deliver on policy commitments which are effective, and support a robust recovery in the world economy. UK export market growth is notably weaker than world trade, especially in 2010 and 2011, reflecting the relatively slower recovery in the UK's largest trading partner, the euro area;
- fiscal policy supports the level of economic activity through 2010, before tightening from 2011 onwards to ensure sound public finances and facilitate the rebalancing of private and public sector contributions to demand;
- through the course of 2010 the price of credit continues to return closer to historical norms, adjusted for a general repricing of risk, and credit availability continues to improve;
- the positive impact of the monetary policy stimulus will continue to support demand in the economy throughout the forecast horizon, with market expectations suggesting Bank Rate will remain historically low; and
- the shape of the recovery in the UK economy reflects an orderly adjustment in the sectoral financial balances, and a rebalancing between domestic and external demand supported by sterling's depreciation.

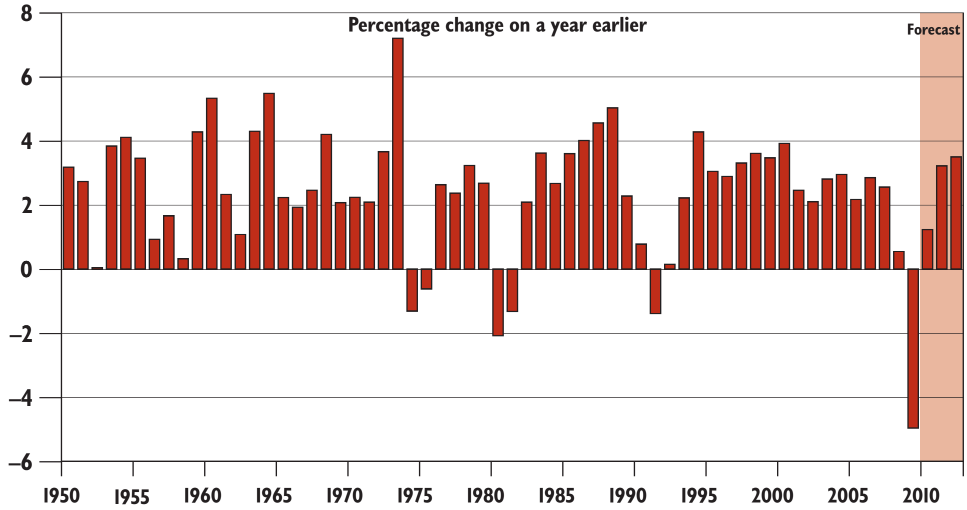
Uncertainty in the forecast

B.43 Given the impact of the global financial market shock and the scale of the global macroeconomic and financial policy response, these judgements and assumptions are subject to great uncertainty, as discussed in Box B7. To represent the uncertainty in the Treasury's economic forecasts, the average absolute forecast errors from past forecasts are presented alongside the latest forecasts, as in Table B9. The average absolute error for year-ahead forecasts has risen significantly since Budget 2009, reflecting the substantially larger fall in output in 2009 than was forecast in Budget 2008, and it is now similar in magnitude to the average absolute forecast error following the 1990s recession. Key uncertainties around the central forecast are discussed further in the text on economic developments and prospects and in the section on forecast risks, at the end of the chapter.

GDP growth

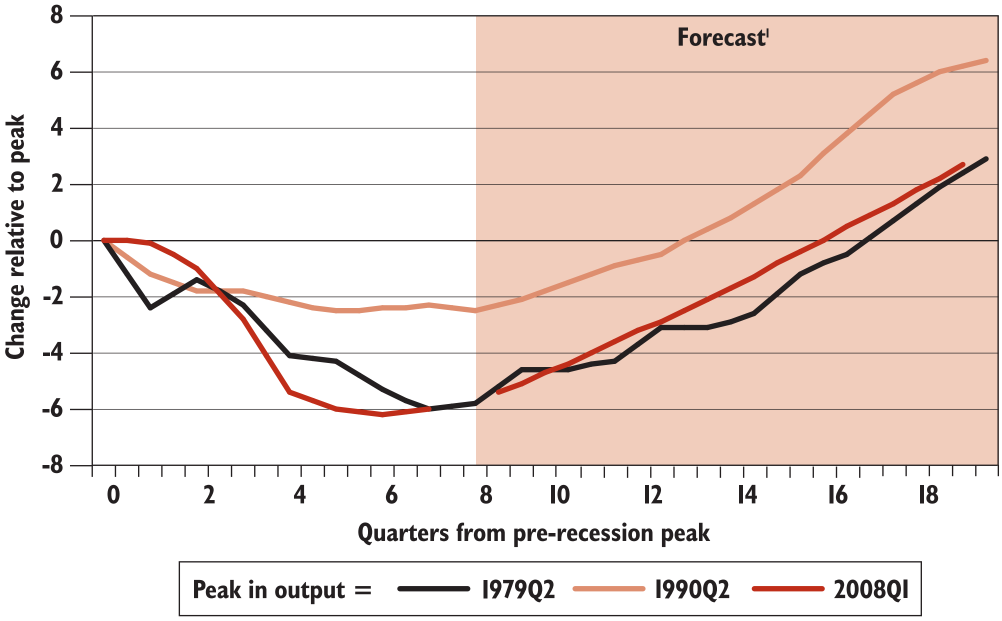
B.44 Recent downward revisions to data by the ONS suggest that GDP fell by 5 per cent in 2009. Budget 2009 and the 2009 Pre-Budget Report forecast a return to growth by the end of the year. In line with this, GDP is currently estimated to have risen by 0.3 per cent in the final quarter of 2009. Reflecting this and recent developments, the GDP growth forecast for 2010 remains unchanged from the 2009 Pre-Budget Report, with GDP forecast to rise by 1 to 1½ per cent. This is in line with the average of independent forecasts compiled by the Treasury in March.

Chart B4: Gross domestic product (GDP)



B.45 GDP growth is forecast to rise to 3 to 3½ per cent in 2011, as easier credit conditions and the ongoing impact of previous policy measures support strengthening global and domestic demand. This is slightly lower than the 2009 Pre-Budget Report forecast, reflecting a weaker outlook for the UK's main trading partner, the euro area. GDP growth is then forecast to be 3¼ to 3¾ per cent in 2012. This forecast is towards the top end of external forecasts, and the range is just above the Bank of England's mean forecast of around 3 per cent in 2011 and 2012. These growth rates are broadly in line with those seen in the recovery period following the recessions in the 1980s and 1990s, as seen in Chart B5. Despite a forecast for strong growth rates in 2011 and 2012, the level of real GDP is forecast to remain below its pre-recession peak until the first half of 2012.

Chart B5: The path of GDP through recoveries in the 1980s and 1990s



[1] Forecast for 2008Q1 curve only, showing average semi-annual GDP relative to peak from 2010H1.

CPI inflation

B.46 In the near term, CPI inflation is expected to remain above the target, reflecting the impact of the VAT change. Fuel prices and the pass-through of sterling's depreciation will have a positive but declining impact on inflation over the coming year, while the lagged effect of the large degree of spare capacity becomes a more dominant influence. Consequently, inflation is expected to weaken and reach 2 per cent by the end of 2010 and then to fall further through the first half of 2011, as the negative output gap continues to exert downward pressure and the effect of the VAT change drops out of the annual comparison.

B.47 CPI inflation is expected to rise back to target by the end of 2012, as the economy continues to grow at above trend rates, consistent with the Bank of England's February *Inflation Report* mean forecast. Although a degree of spare capacity is expected to remain throughout the forecast, the resulting downward pressure on inflation is expected to be offset by the effect of the monetary policy framework anchoring inflation expectations close to the inflation target. The impact of the output gap on inflation is considered further in a forthcoming Treasury Economic Working Paper.[7]

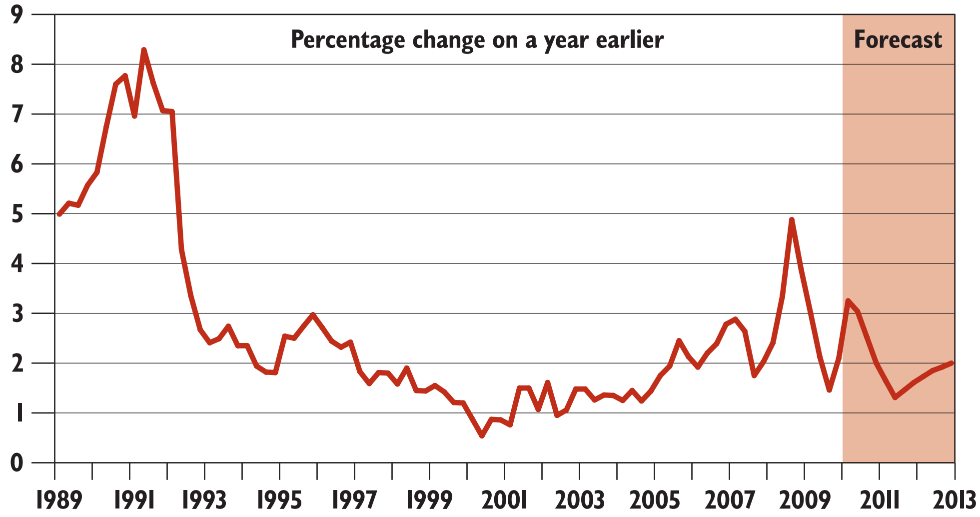
RPI inflation

B.48 Although following a similar path to CPI inflation over the forecast, RPI inflation is subject to upward pressure from rising house prices and the large falls in mortgage interest payments (MIPs) falling out of the annual comparison. These components will provide some counterweight to the downward pull on inflation from the large degree of spare capacity through 2010 and 2011. As part of the annual update of the basket of goods and services that underpin CPI and RPI by the ONS, the UK Statistics Authority has decided to implement a change to the interest rate measure used in the calculation of mortgage interest payments in

[7] *Inflation and the output gap*, HM Treasury, Treasury Economic Working Paper no. 6

the RPI from a Standard Variable Rate to an Average Effective Rate[8]. This change is expected to result in a smoother RPI series in the long run.

Chart B6: CPI[1]



[1] Outturns until 2009Q4; the average of January and February CPI inflation for 10Q1 and forecasts for every second quarter from 2010Q2 to 2012Q4

Table B3: Summary of UK forecast

				Forecast	
	2008	2009	2010	2011	2012
GDP growth (per cent)[1]	½	–5	1 to 1½	3 to 3½	3¼ to 3¾
CPI inflation (per cent, Q4)	4	2	2	1½	2

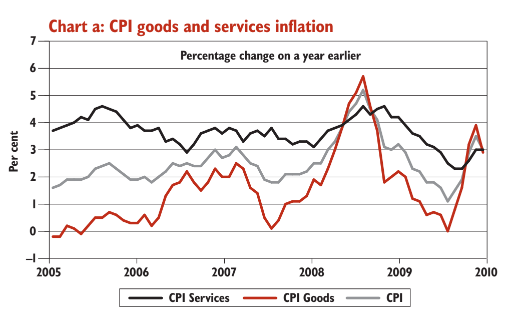
[1] See footnote to Table B9 for explanation of different growth assumptions.

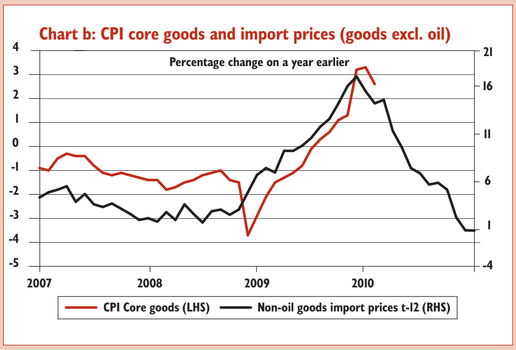
[8] The ONS public consultation document on this change and the response to the consultation may be viewed on: http://www.ons.gov.uk/about/consultations/measurement-of-mortgage-interest-payments-within-the-retail-prices-index--2009-/index.html. The Average Effective Rate was first used in the February 2010 RPI, which was published on 23 March 2010. As the RPI is never revised, past indices will remain the same. Analysis by the ONS has shown that the AER is less responsive to changes in interest rates compared with the SVR so the mortgage interest payments based on the SVR are generally more volatile than one based on more complete coverage.

Box B3: CPI goods and services inflation

Goods currently constitute around 55 per cent of the total CPI basket, while services make up the remaining 45 per cent.

CPI inflation stayed close to target between 1997 and 2007, as low CPI goods price inflation, on average zero over this period, was offset by higher CPI services price inflation, averaging around 3.7 per cent. More recently, this difference has narrowed, averaging 1.1 percent since January 2008 (Chart a), as services CPI inflation has declined markedly and goods price inflation has picked up.





The recent weakness in services CPI inflation is likely to reflect both subdued service sector earnings growth and the wider effects of domestic disinflationary pressure from the large degree of spare capacity in the economy. Despite the recent increase in services CPI inflation as a consequence of the standard rate of VAT returning to 17.5 per cent, the underlying trend in CPI services inflation is expected to remain on a downward trajectory over the next year as the lagged effect from the large negative output gap becomes more dominant.

'Core' goods, which exclude volatile factors such as energy and food, may give a better indication of the underlying inflationary pressure acting on goods prices. As Chart b illustrates, the rate of core goods CPI inflation has been relatively strong recently, reflecting the lagged effects of sterling's depreciation on import prices. Analysis in a forthcoming Treasury Economic Working Paper[a] suggests the lag from the full effect of a change in import prices to feed through to consumer prices is around 1 year. So, as illustrated in Chart b, the pass through from import prices to consumer goods prices may now have peaked, and it is expected to have a declining influence on the annual rate of core goods price inflation over 2010. The reversal of the VAT cut has also fed through to higher goods price inflation in recent months. This effect will remain in the annual comparison throughout 2010, but will contribute to an anticipated steep decline in goods price inflation as it drops out of the annual comparison in early 2011.

[a] *Inflation and the output gap*, HM Treasury, Treasury Economic Working Paper no. 6, forthcoming on the Treasury website.

UK OUTLOOK IN DETAIL

Shape of the recovery

Table B4 sets out the contributions to growth through the forecast period by expenditure component. Government spending is forecast to continue to contribute positively to growth in the near term, supporting the smooth adjustment towards a more balanced economy. Private sector demand is expected to recover through 2010, boosted by the significant macroeconomic stimulus that remains in place. As uncertainty declines and credit conditions continue to ease, all components of private sector demand are expected to strengthen. Consumption is forecast to contribute 1¾ per cent to growth in 2011 and 2012 and business investment rebounds from the low levels in 2009 contributing ¾ and 1 percentage points respectively. The past depreciation of sterling and the recovery in world demand provide the conditions for the rebalancing of demand between domestic and external sources and so net trade is forecast to contribute a further ¾ percentage points to GDP growth in 2011 and 2012. This is broadly in line with the positive contribution seen in

1994 and 1995, following a sterling depreciation of 18 per cent, less than the 25 per cent depreciation seen since July 2007.

Table B4: Contributions[1] to GDP growth[2]

	Percentage points, unless otherwise stated					
	Average			Forecast		
	2000 to 2007	2008	2009	2010	2011	2012
GDP growth, per cent	**2¾**	**½**	**–5**	**1 to 1½**	**3 to 3½**	**3¼ to 3¾**
Main contributions						
Private consumption	1¾	½	–2	¼	1¾	1¾
Business investment	¼	0	–2	–½	¾	1
Dwellings investment[3]	¼	–½	–½	0	¼	¼
Government[4]	¾	1	¾	¼	–¾	–¾
Change in inventories	0	–½	–1¼	1¼	½	0
Net trade	–¼	½	¾	¼	¾	¾

[1] *Based on central case. For the purpose of projecting public finances, forecasts are based on the bottom of the GDP forecast range.*

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

[3] *The sum of public corporations and private sector investment in new dwellings and improvement to dwellings.*

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

Sectoral composition of output

Services

B.49 Output in the services sector fell by 3¾ per cent in 2009. Output fell across all sub-sectors. In particular, "business services and finance", the largest component of services, fell by 4.7 per cent over the year, as output in financial intermediation fell by close to 6 per cent. The pace of decline in total services eased significantly through the second and third quarters, following a sharp fall at the start of the year. A broad-based recovery saw growth turn positive in the final quarter of the year and the latest services PMIs indicate growth in the current quarter, with February's level the highest since January 2007. Services sector output is expected to rise in 2010, before picking up strongly in 2011 and 2012.

Manufacturing and construction

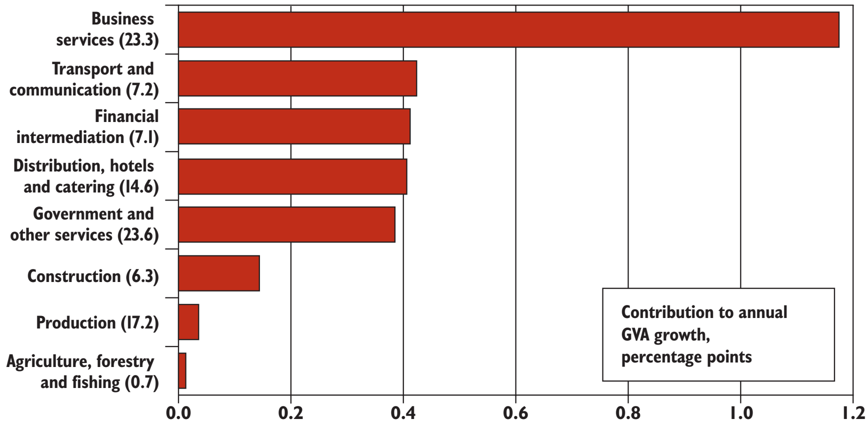
B.50 Manufacturing output fell by 10½ per cent in 2009. Following the unprecedented collapse in world trade and confidence, with a sharp tightening of credit conditions, output contracted sharply in the first quarter. Thereafter, output broadly stabilised, before rising by 0.8 per cent in the final quarter of the year, supported by a pick-up in export volumes. In recent months, private sector surveys have risen, with the manufacturing PMI in February remaining at a 15 year high, and export orders having strengthened markedly. Manufacturing output is expected to continue recovering in 2010, growing by 1½ to 2 per cent over the year, in part reflecting firms replenishing depleted stocks and the recovery in global demand. Output is then forecast to rise strongly in 2011 and 2012, as external and domestic private sector demand continue to recover and the effects of sterling's depreciation continue to feed through. The current forecast is in line with the latest Engineering Employers Federation (EEF) forecast for output to increase by 1.5 per cent in 2010, rising to 3.6 per cent in 2011.

B.51 Output in the construction sector fell by 9¼ per cent in 2009. In the first quarter of 2009, output was 13 per cent below its previous peak, but the ONS data suggest output expanded in both the second and third quarters, reflecting strong growth in public sector construction. Yet private sector construction output remains weak, leading to a further fall for the sector as a whole in the latest quarter. Going forward, debt accumulated within the sector over the past decade may hamper growth. However, medium-term prospects should benefit from the expected recovery in business and housing investment.

Box B4: Sectoral growth in the recovery

Over the last economic cycle from 1997 to 2006 real gross value added (GVA) grew on average by around 3 per cent a year, with a relatively balanced contribution across the sectors (Chart a). Business services, a diverse sector that includes for example legal services, computer services and advertising, accounted for the largest share of growth.

Chart a: Composition of output growth (1997 to 2006)



Percentage shares of output in 2005 in parentheses

In the future, the sectoral sources of growth are likely to be different, reflecting relative price adjustments and the changing pattern of demand. Some sectors are expected to contribute less to growth in the next few years:

- financial intermediation – while the financial sector is expected to recover, it is assumed to make up a smaller share of the economy for the foreseeable future;
- government and other services – with ongoing fiscal consolidation the government sector is expected to detract from growth; and
- construction and real estate (part of business services) – both of these sectors built up high levels of debt over the last cycle, which is likely to limit growth.

Other sectors are expected to continue to contribute strongly or to contribute more than in the past:

- manufacturing (the majority of production) – with a rebalancing of demand supported by the significant depreciation of sterling, manufacturing is expected to contribute more strongly to growth than over the last cycle;
- transport and communication – the Government has set ambitious targets for renewing Britain's infrastructure, including updating the UK's communications infrastructure to the standards required of a modern digital economy. In this context this sector is expected to continue making a strong contribution to growth; and
- business services – the UK has a comparative advantage in a number of business services, helping it to maintain its position as the world second largest exporter of commercial services. Led by exports, this sector is expected to continue to contribute strongly to growth.

Changes in sectoral composition may also have implications for trend output[a]. In particular, to the extent that the financial sector has generally seen higher than average levels of measured productivity, a reduction in the relative size of the sector will have an effect on trend productivity as resources are allocated towards other sectors. For example, a reduction in the financial sector's share of GVA from its 2008 level of around 8 per cent to 7 per cent would reduce the level of whole economy productivity by around ½ per cent, based on relative levels of GVA per worker in 2008. This effect might be partially offset if resources were reallocated towards other sectors with above-average productivity, such as manufacturing, or if there were also shifts away from sectors that have typically had relatively low levels of measured productivity, such as the government sector.

[a] Details of the Treasury's trend output assumptions are set out in the trend output section.

Labour market

B.52 In spite of the steep decline in employment seen in the first half of 2009, the labour market has been more resilient than most forecasters had expected. The rate of unemployment is below that seen at the end of the previous recessions and a number of indicators started to show signs of recovery as early as the middle of 2009. Flexibility has been a key driver of the resilience in the labour market. While the relative cost of labour rose in the 1990s recession, real hourly labour costs – the nominal cost of labour relative to companies' prices – has remained broadly flat in the recession, as workers and firms have agreed on lower settlements or pay freezes to maintain employment. Sizeable gross labour market flows, a characteristic of the UK labour market, have largely remained: over the last six months more than 2 million people have moved off the claimant count, aided by Jobcentre Plus.

Employment and unemployment

B.53 Conditions in the labour market have been fairly stable since autumn 2009. While employment has continued to decline, firms are not laying off full-time employees at the same pace as over the first three quarters of 2009. Having risen to more than 300,000 per quarter through the first half of 2009, redundancies have fallen back sharply. The number of vacancies has picked up slightly in the last few months, primarily driven by stronger private sector demand. This is in line with a number of private business surveys of employment intentions that are consistent with moderate rates of employment growth in early 2010.

B.54 ILO unemployment fell by 33,000 in the three months to January 2010 and the unemployment rate has now remained broadly constant at just below 8 per cent since the middle of 2009. The number of people claiming Jobseekers Allowance has fallen in three of the last four months, surprising markets. In February, the claimant count saw its largest decline since the end of 1997, bringing the claimant count back to its lowest level since July 2009. The level of inactivity has risen to 8.2 million in the three months to January 2010, but the inactivity rate is now only slightly above its average over the last decade. An increase in the number of inactive students more than accounts for the increase in total inactivity. Excluding students, the level of inactivity is lower than at the start of 2008 and the rate is only slightly above the record low seen in the first quarter of 2009.

Average earnings

B.55 The Average Weekly Earnings (AWE) measure replaced the Average Earnings Index (AEI) as the main monthly National Statistic for earnings in January 2010. The AWE differs from the AEI in that it also captures effects on earnings from shifts in the composition of employment, such as employees moving from low to relatively high paid industries. In addition, the AWE is the first monthly indicator of the level of earnings, disaggregated across different sectors and industries. Abstracting from methodological differences, both series have recorded broadly similar trends in earnings growth since 2001.

B.56 Average earnings growth has continued to slow over the past year, as firms tempered real labour cost growth in light of weak nominal demand. Regular pay drift – the component of earnings growth that is linked to factors such as overtime – has weighed on earnings growth through the recession. While the negative drag from pay drift started to ease going into the second half of 2009, average pay settlements – the regularly negotiated element of earnings growth – have fallen back to record lows. Nearly a third of all settlements in the year to March 2010 were pay freezes, far in excess of the usual proportion of pay freezes since 1998[9]. The employment component of the AWE suggests that a shift in the composition of employment to relatively lower paid industries has also weighed down on average earnings growth. AWE regular pay growth has slowed by more than half to 1.4 per cent in the three

[9] Income Data Services Pay Online settlements database.

months to January 2010 compared with the same period last year. Lower bonuses, in particular in the financial sector, have exacerbated the slowdown in total pay growth.

Prospects **B.57** The claimant count is projected to peak at just under 1¾ million around the middle of 2010. An increasing number of survey measures of employment intentions have started to point towards a recovery in labour demand, a trend supported by the recent rise in the number of vacancies. However, surveys of both employers' and employees' pay settlement expectations suggest further moderate earnings growth in 2010. As the economy recovers and the UK's flexible labour and product markets enable firms to take up opportunities in a more balanced economy, employment is forecast to rise. The claimant count is projected to fall back to around 1¼ million by the end of 2012 and consistent with this, the ILO unemployment rate is also expected to decline.

Households and consumption

B.58 Household consumption is the largest expenditure component of demand, accounting for around 63 per cent of nominal GDP in 2009. Between 2001 and 2008, the share of consumption in GDP remained stable, but consumption grew faster than household income. As a result the saving ratio fell. Since the start of the recession in 2008, household incomes have continued to grow strongly, but consumption has weakened, resulting in a sharp rise in the saving ratio.

Table B5: Household sector[1] expenditure and income

	Percentage change on a year earlier, unless otherwise stated					
	Average			Forecast		
	2000 to 2007	2008	2009	2010	2011	2012
Household consumption[2]	3	1	–3	0 to ½	2¼ to 2¾	2½ to 3
Real household disposable income	2¼	1½	4¼	2 to 2½	1 to 1½	1¼ to 1¾
Saving ratio[3] (level, per cent)	4¼	1½	7¾	9¼	8	6¾

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

[2] *Chained volume measures.*

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

Disposable income **B.59** Households' disposable income grew strongly in 2009, as lower mortgage payments and support from taxes and benefits have offset weak wages and salaries growth. Low inflation, in part due to the temporary cut in the VAT rate, also helped bolster real income growth.

B.60 As some of these contributions weaken through 2010, household disposable income is forecast to continue to grow, but at a slower rate. Income growth is expected to ease further in 2011 as the contribution of the automatic stabilisers diminishes, before rising wages and employment boost income growth in 2012. Further support to incomes comes from dividends distributed to households.

Consumer spending **B.61** Despite continued growth in disposable income, real household consumption fell by 3.1 per cent in 2009, reflecting a sharp fall in the first half of the year, as households cut back on discretionary spending. Consumption then stabilised in the third quarter of 2009, as the pace of decline in services eased and durable goods consumption rose; this possibly reflects the Government's car scrappage scheme and the growing impact of the temporary reduction in the standard rate of VAT, as households brought forward consumption from the beginning of 2010.

B.62 The combined effect of falling consumption and rising incomes led to a steep rise in the saving ratio, to 8.6 per cent in the third quarter of 2009.

B.63 Household consumption rose by 0.4 per cent in the final quarter of the year. Retail sales volumes, which constitute a third of consumption, rose by 0.5 per cent over the quarter and 3.3 per cent over the year, in contrast with the early 1990s recession when sales volumes declined. Retail sales fell in January. However, the British Retail Consortium's (BRC) retail sales monitor reported signs that sales may have strengthened in February. Spending on household goods recovered, which is likely to be linked to the growth in property transactions in the second half of the year.

Prospects **B.64** Consumer spending is forecast to be weak in the first half of 2010 reflecting the VAT change and a forecast rise in the saving ratio. Consumption growth strengthens over the course of the year, as the accommodative stance of monetary policy remains in place. Recent increases in asset prices have led to a significant rise in the ratio of net financial wealth to income, which combined with rising confidence should also serve to support consumption this year.

B.65 The saving ratio is expected to remain high through 2010, before falling through 2011, as uncertainty in the macroeconomic outlook continues to ease and the labour market improves, reducing households' precautionary saving. As the saving ratio declines, consumption is forecast to grow, by 2½ per cent in 2011 and 2¾ per cent in 2012, more slowly than GDP so that the consumption share of GDP declines through the forecast.

Risks **B.66** Risks remain over the outlook for consumption. Households might cut consumption more sharply as they seek to rebuild their net wealth, following asset price declines. Households have already made an adjustment to their financial balances, but further adjustment may arise if credit conditions remain constrained or income uncertainty rises. On the other hand, as confidence improves the saving ratio could fall back more quickly than assumed.

Housing

B.67 According to the Communities and Local Government (CLG) house price index, average house prices fell by 13.6 per cent from their peak in late 2007 to their trough in the second quarter of 2009. Prices subsequently rose by 5.4 per cent in the second half of 2009. Survey data from the Royal Institute of Chartered Surveyors suggests that while stocks of properties for sale remain low compared with historical averages, demand from new buyers has picked up leading to house price increases in 2009 despite property transactions being around half the level in 2007. Indeed, the fragility of the housing market was demonstrated by February's house price indices, with both the Nationwide and Halifax reporting falls, following strong increases from last spring. Transactions also fell back slightly at the beginning of 2010. This may be due in part to the end of the stamp duty holiday for some properties on 31 December 2009, with some transactions having been brought forward in advance of the change.

Prospects **B.68** The Treasury is using the median of the independent forecasts as the basis of its assumption for projecting house prices. This assumption implies prices will grow moderately in both 2010 and 2011, before returning to their long-run average growth rate of 5 per cent.

B.69 There are several measures to gauge the sustainable level of house prices, such as the house price-earnings ratio.[10] This ratio fell sharply with the fall in house prices and has picked up only marginally recently. Relating this ratio to a long-run value requires

[10]See *Budget 2010: The Economy and Public Finances Supplementary Material*, HM Treasury, March 2010.

an assumption about its long-run trend as there is no reason to suppose the ratio will be constant in the long run. A simple linear trend would suggest prices are relatively close to their long-run relationship with earnings. However, given the ratio has departed from such trends for long periods, such estimates offer little guide to short-term price movements. For a further discussion of the house-price earnings ratio, see Box B5.

Box B5: Assessing long-run house prices

Demographic changes, supply constraints, credit conditions and households' willingness to devote more of their income to housing may have led to a higher house price–earnings ratio over time. Other factors may also have played a role, such as the respective paths of interest rates and unemployment, which will have affected demand and supply through forced sales and repossessions. In the 1990s, a large number of repossessions increased the unsold stock of properties and put further downward pressure on prices. Supported by government policy measures, repossessions in this recession so far have been much lower than originally forecast by the Council of Mortgage Lenders (CML) and significantly less than in the 1990s recession. Outturns for unemployment have also been far lower than expected by many external forecasters.

The ratio of interest rates to income provides a measure of the cost of financing house purchase. A reduction in effective interest rates over the last two years has lowered this ratio. As the CML have noted, there has also been some move towards variable rates as current mortgage deals have expired. This may increase the sensitivity of the housing market to interest rate increases, although that may also coincide with households increasing their demand for fixed rate deals.

Alternative estimates of the long-run tendency in house prices can be made by comparing them with rental prices. If rents are significantly cheaper than the cost of owner occupied housing then there is an incentive for owners to move into rents accommodation. In the long run, prices should equalise. Looking at rents and house prices suggests that house prices were not significantly overvalued at the beginning of 2010. However, this analysis is predicated upon regular financial conditions. The continued restrictions on mortgage availability in the wake of the financial crisis may have lowered the level of house prices to rents in the short run.

Overall, there are a wide range of factors that impinge on house prices and the implications of their interaction are very uncertain. However, a number of different approaches would suggest that house prices are not currently very far from their longer-term trends.

Investment in dwellings

B.70 Dwellings investment fell sharply over the course of 2008 and into the first half of 2009, as tight availability of mortgage finance and expectations of further falls in house prices constrained activity. Reflecting sharp falls at the beginning of the year, investment in dwellings is forecast to fall by 19¼ per cent in 2009, despite positive growth in the third quarter. The latest data suggests the rate of annual decline has eased and growth in dwellings investment is forecast to pick up progressively over the forecast horizon as credit conditions improve and uncertainty subsides.

Companies and investment

B.71 Business investment is critical to determining the future supply potential by increasing the physical capital available with which to produce goods and services. In 2008, business investment accounted for around 10 per cent of nominal GDP, but it fell to just over 8 per cent in 2009 given its significantly steeper fall over the year relative to GDP. The role of investment in the economy may be greater than suggested by conventional measures of the capital stock, given the importance of investment in intangible assets in the UK's knowledge-intensive economy[11].

[11] *Intangible investment in Britain's productivity*, HM Treasury, Treasury Economic Working Paper No.1, October 2007.

Company finances

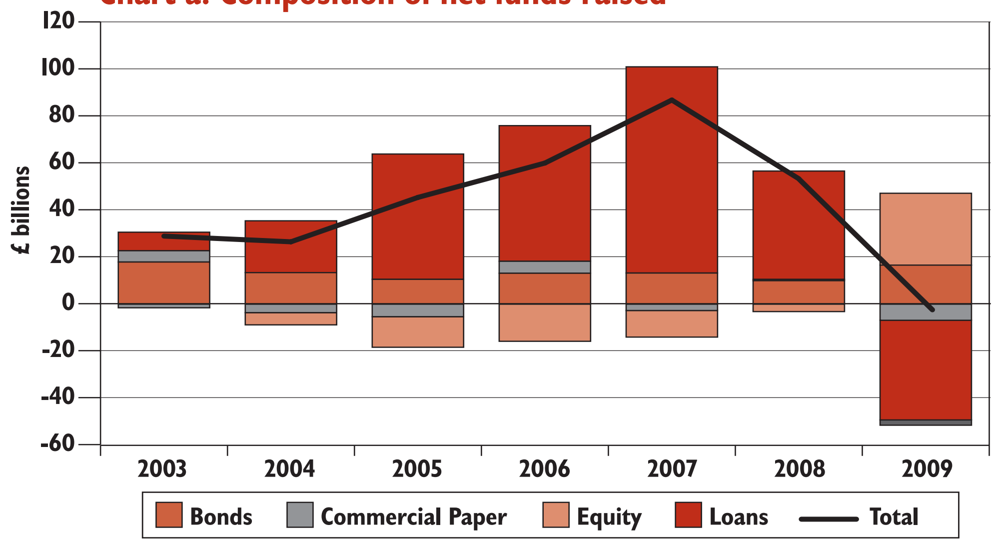
B.72 Companies finance investment internally, using the cashflow generated by their activities, or externally, either through bank lending or by issuing equity and debt to investors. In the UK, nearly two-thirds of business investment is funded through retained earnings and so the relative financial health of the sector entering the recession, together with a recent rise in profits, should help to support investment in the recovery. The flow of bank lending to companies was weak in 2009, but evidence from the latest CBI quarterly services sector survey suggests tight constraints on access to finance for investment have eased, while access to other sources of finance for larger companies has improved, as rising confidence and reduced uncertainty has helped to lower the cost of raising equity and debt. Survey evidence from the Bank of England's *Trends in Lending Report* suggests that some orderly restructuring of balance sheets is taking place as firms gradually reduce their reliance on bank debt.

Box B6: Funding for corporates

In recent years, UK Private Non-Financial Corporations (PNFCs) have relied more heavily on debt and particularly bank loans relative to other types of finance, such as equity or bonds. The commercial real estate sector, with its large proportion of fixed assets, has typically employed more gearing than the rest of the corporate sector, but this increased to even higher levels before the crisis as commercial property prices rose rapidly and interest rates remained low. The expansion of private equity businesses and increases in company share buybacks prior to the crisis also contributed to a significant change in corporate capital structures, reflected in the significant increase in net funds raised from loans, while net equity flows remained negative (Chart a). Following the financial crisis this trend reversed abruptly.

In 2009, the net flow from loans turned sharply negative. However, this has been offset by a significant increase in capital market issuance, as rising equity prices and falling corporate bond yields eased access to non-bank funding channels. In 2009, £41 billion was raised through all currency net bonds, net commercial paper and net equity issuance, with net equity issuance alone accounting for £32 billion of the rise. With ongoing difficulties in raising loan finance, equity markets have emerged as an important source of finance for medium-sized companies, while larger companies have been able to issue corporate bonds as well. Chapter 3 sets out the areas the Government has identified to encourage the development of non-bank lending channels for a wider range of companies.

Chart a: Composition of net funds raised



Source: Bank of England.

Business investment **B.73** Business investment fell very steeply in 2009, with the provisional estimate of a 19 per cent fall by far the largest since records began. The contraction was sharp across all private sectors, with the largest fall of over 32 per cent in the construction sector.

B.74 Manufacturing and service sector surveys conducted by the CBI continue to suggest that uncertainty over demand prospects is the key factor holding back investment. However, investment intentions have picked up at an earlier stage in comparison with previous recoveries, indicative of a recovery in investment this year given the typical historical two-quarter lag between the pick-up in investment intentions and actual investment.

Table B6: Gross fixed capital formation

	Percentage change on a year earlier					
	Average			Forecast		
	2000 to 2007	2008	2009	2010	2011	2012
Whole economy[1]	4	–3½	–14½	–2¾ to –2¼	4½ to 5	9 to 9½
of which:						
Business[2,3]	3½	1¼	–19	–5¼ to –4¾	9¼ to 9¾	11½ to 12
Private dwellings[3]	4¼	–11½	–19¼	¼ to ¾	7½ to 8	10¼ to 10¾
General government[3]	5¼	17¾	16½	–2½	–19	–8½

[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.*

Prospects **B.75** Business investment is forecast to stabilise in the first half of this year, before rising gradually as the positive impact of significant macroeconomic stimulus continues, credit conditions ease further and uncertainty subsides. After base effects have unwound, business investment is then forecast to pick up strongly in 2011 and 2012. This reflects the judgement that easing in credit conditions and strengthening global and domestic demand encourage firms to reinstate investment plans placed temporarily on hold prior to the recession, rebuild their depreciated capital stocks and take advantage of new opportunities. But despite the strong business investment growth forecast beyond 2010, the level of business investment is expected to remain below its pre-recession peak level throughout the forecast horizon.

Risks **B.76** Despite firms in aggregate appearing to be in a strong financial position, future business investment may be constrained if the supply of credit in the recovery fails to meet demand. This is particularly the case for loans to the commercial property sector, which account for around 50 per cent of outstanding PNFC bank loans. In the near term, business investment may also be dampened if firms continue to pay down debt to help restructure balance sheets given concerns about a sustained recovery in demand.

Government

B.77 Real government expenditure – consumption and investment – continued to rise through the recession, supporting the economy as demand in the private sector declined. Government consumption rose by 2 per cent over the year as a whole in 2009 and is forecast to rise by 1¼ per cent in 2010. As private sector demand strengthens and financial sector conditions continue to improve, fiscal policy will tighten gradually, with a substantial part coming from lower government consumption and investment. This can be seen in the negative contributions to growth in 2011 and 2012, shown in Table B4.

Trade and balance of payments[12]

Exports **B.78** Having fallen by over 13 per cent between the second quarter of 2008 and the second quarter of 2009, UK export volumes increased in the second half of 2009, alongside the recovery in global demand and trade. The growth in exports in the three months to January eased, but survey evidence points to rising volumes in the coming months. The BCC *Report* for the final quarter of 2009 recorded an increase in both the export sales and orders balances, with a notably strong rise in the manufacturing sector. The manufacturing exports balance in the PMI manufacturing survey rose in February, to its highest level since January 1996. Consistent with current weak global demand for financial services, UK services exports remain subdued, growing by 0.8 per cent in the final quarter of 2009.

Sterling and export prices **B.79** Since its peak in the middle of 2007, sterling has depreciated by around 25 per cent. As seen previously, the depreciation is expected to boost future export volumes as UK export companies reduce the price of their goods in foreign markets and increase market share. Due to factors such as fixed contracts and concerns over credit availability, this effect is expected to take time to feed through. Indeed, the rise in import and export prices since mid 2007 have been broadly comparable, suggesting some exporters may be raising profit margins rather than trying to gain market share. This effect is more pronounced in EU exports, where the rise in export prices has been greater than goods destined for other regions. However, as firms increase their output and new firms enter the market in response to higher profit margins, export volumes are expected to pick up. For example, the Bank of England's Regional Agents suggest businesses expect a rise in exports in 2010.

Prospects **B.80** Export growth is forecast to be positive in 2010, and rise over the forecast horizon as the recovery in world demand strengthens. Reflecting the weaker forecast for euro area growth, export growth in 2011 has been revised down since the 2009 Pre-Budget Report.

Imports **B.81** Import volumes declined by 12 per cent in 2009, reflecting a sharp fall in the first half of the year. The rate of decline then eased, with growth of 4 per cent resuming in the final quarter of the year. Both goods and services trade volumes have fallen, but goods volumes recovered strongly in the second half of 2009, possibly supported by the Government's car scrappage scheme with passenger cars constituting nearly half of the rise in total imports.

[12] The volume of exports and imports in the economic forecast abstracts from the effects of activity related to Missing Trader Intra-Community fraud (MTIC), by making a neutral assumption that the adjustment for MTIC-related activity remains constant throughout the forecast horizon at the latest quarterly estimate, and that trade grows in line with underlying determinants. For a fuller explanation of the effect of MTIC-related activity on trade in recent years, see paragraphs B.76 to B.82 of Budget 2008. All figures cited in this section and those reported in Table B7 relate to export and import growth excluding the MTIC adjustment.

Table B7: Trade in goods and services

	Percentage points, unless otherwise stated					
	Average			Forecast		
	2000 to 2007	2008	2009	2010	2011	2012
Volumes (excluding MTIC)[1]						
Exports	4½	1	–11	2¾ to 3¼	4 to 4½	5¼ to 5¾
Imports	5¼	–½	–12	2 to 2½	1½ to 2	2¾ to 3¼
Prices[2]						
Exports	1	12½	2¾	¾	¾	1¼
Imports	1	11¼	3¾	2¾	2½	2
Terms of trade[3]	0	1	–1	-2	–1½	–¾
Goods and service balance (£ billion)	–32¼	–38¼	–33¼	–40¼	–37½	–30½

[1] *Table B9 contains figures including the effects of MTIC-related activity. The forecast is therefore based on the neutral assumption that the level of MTIC-related activity stays flat at the latest quarterly estimate throughout the forecast.*

[2] *Average value indices.*

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

Prospects

B.82 Following the large decline in 2009, import volumes are forecast to rise by around 2¼ per cent in 2010, partly reflecting an expected recovery in consumer spending and the rebuilding of inventories. Imports are then expected to rise by around 1¾ per cent in 2011 and by around 3 per cent in 2012, less than the rise in GDP, as the past depreciation of sterling encourages consumers and firms to substitute towards relatively cheaper domestically produced goods.

Net trade

B.83 Net trade contributed positively to growth in the first half of 2009, but due to the decline in the financial service surplus, which is expected to be temporary and an increase in the trade deficit on cars due to EU and UK car scrappage schemes, net trade subtracted from growth in the second half of the year.

B.84 Net trade is forecast to contribute positively to GDP growth throughout the forecast period as shown in Table B4. Net trade's contribution rises from ¼ per cent in 2010 to ¾ per cent in 2011 and 2012, reflecting the past depreciation of sterling. This is slightly lower than the contribution assumed by some external forecasters, such as NIESR, who expect a greater degree of rebalancing between domestic and external demand.

Risks

B.85 The depreciation of sterling should support a rebalancing of demand towards external demand, but the contribution from net trade depends on the pace and strength of the world recovery and the extent to which a lower level of sterling promotes substitution towards UK goods and services. As noted above, several countries within the UK's largest trade partner, the euro area, face a possibly protracted period of adjustment. Another uncertainty is the extent to which UK exporters use the depreciation of sterling to increase profit margins rather than market share.

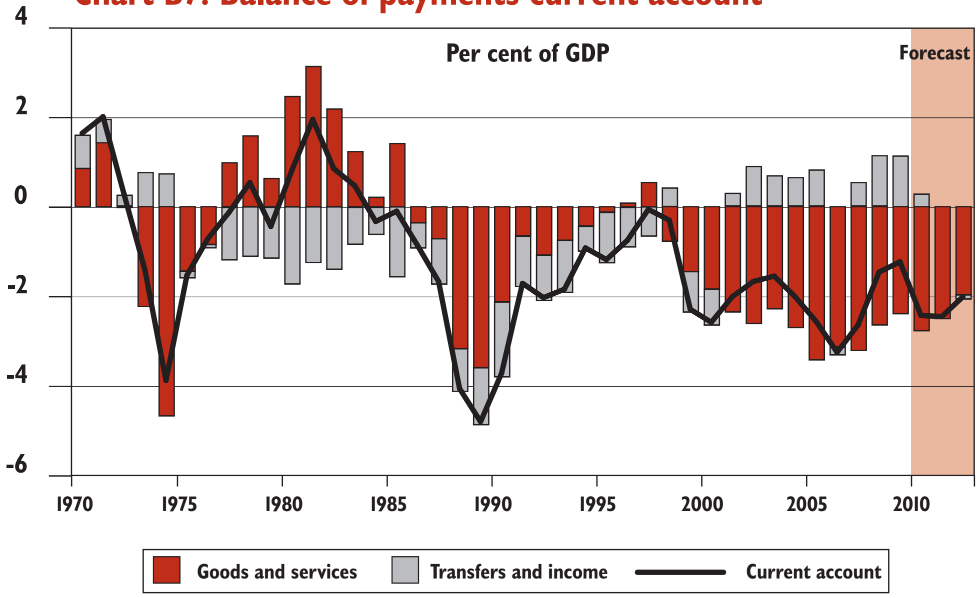
Current account balance

B.86 Recent revisions to the balance of payments data revealed that the UK's net income surplus was higher than previously estimated in the last quarter of 2008 and the first three quarters of 2009. As the net income surplus offsets the trade and transfer payments deficits in the current account, these upward revisions to net income show that the current account deficit was narrower than previously estimated in the first half of 2009 and remained stable at 1.3 per cent of GDP in the third quarter of the year.

B.87 A large improvement in the investment income balance, largely due to transactions and write-downs following the financial crisis, helped to narrow the current account in

2008 and 2009. These temporary factors are expected to recede in 2010 meaning the current account deficit is forecast to widen to 2½ per cent of GDP. Thereafter, the current account is forecast to narrow as the trade deficit falls as a percentage of GDP.

Chart B7: Balance of payments current account



UNCERTAINTY AND FORECAST ISSUES AND RISKS

Independent forecasts

B.88 The average of independent forecasts for growth in 2010 remains unchanged since the 2009 Pre-Budget Report at 1.3 per cent, but it is 1 percentage point higher than forecast at Budget 2009. In terms of components, external forecasts for domestic demand growth have been revised up since the Pre-Budget Report, offset by a slight downward revision to the contribution from net trade.

B.89 The average of independent forecasts for growth in 2011 within the March *Forecasts for the UK economy* stood at 2.1 per cent, only marginally higher than at the time of the 2009 Pre-Budget Report and below the bottom of the Budget range. However, these summary figures mask a wide range of views among forecasters:

- In the February 2010 *Inflation Report*, the Bank of England's mean forecast was for growth of around 1¼ per cent in 2010 and 3 per cent in 2011 – the bottom of the Budget forecast range for that year – and 2.9 per cent in 2012. The modal forecast was for growth of around 3½ per cent in 2011 and 2012;
- The IMF's *World Economic Outlook Update*, published in January, forecast growth of 1.3 per cent in 2010 and 2.7 per cent in 2011, revised up by 0.4 and 0.2 percentage points respectively compared with the October 2009 *World Economic Outlook*;
- Since December, there has been little change to most City forecasters' expectations for GDP growth. However, where revisions have been made, they have tended to be positive: Barclays Capital have revised up their growth forecast by around ¼ percentage point in 2011 to 2.3 per cent; HSBC by

around ½ percentage point in both 2010 and 2011 to 2.2 and 2.7 per cent; and RBS Global Banking and Markets by nearly 1 percentage point in 2011, to 2.7 per cent.

B.90 The range of views on the composition of demand in 2011 remains wide. For example, the National Institute of Economic and Social Research's (NIESR) January *Economic Review* forecast GDP growth of 1.1 per cent in 2010 and 2 per cent in 2011. Growth in 2011 was revised up from 1.5 per cent in their October *Review*, largely on account of an upward revision to private consumption. However, at 1 per cent, NIESR's latest forecast for consumpton growth remains below the consensus of 1.5 per cent, whereas its forecast net trade contribution of 1.3 per cent for the year is well above the average of independent forecasts (0.4 per cent).

B.91 CPI inflation at the end of 2009 was above external forecasters' expectations. At Budget 2009, the average of independent forecasts was for inflation to fall to 0.7 per cent in the final quarter of 2009, compared with an outturn of 2.1 per cent. On average, external forecasters expect CPI inflation to register 2.1 per cent in the final quarter of 2010, before falling back below the target to 1.8 per cent by the end of 2011.

B.92 Claimant count unemployment rose to 1.6 million at the end of 2009, almost half a million lower than the average of independent forecasts at Budget 2009. The range of forecasts for unemployment is fairly wide but, on average, external forecasters expect the claimant count to rise slightly, to around 1.7 million by the end of 2010, and to remain close to that level through 2011.

Table B8: Budget and independent forecasts[1]

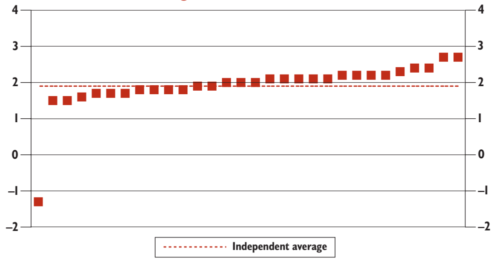
	Percentage change on a year earlier, unless otherwise stated					
	2010			2011		
		Independent			Independent	
	Budget 2010	Average	Range	**Budget 2010**	Average	Range
GDP growth	1 to 1½	1.3	0.7 to 2.2	3 to 3½	2.1	0.9 to 3.4
CPI (Q4)	2	2.1	1.4 to 3.8	1½	1.8	0.0 to 3.3
Current account (£ billion)	–35	–23.8	–49.5 to –10.0	–36	–22.8	–54.4 to –5.0
Claimant unemployment (Q4, millions)	1¾	1.7	1.44 to 2.10	1½	1.7	1.35 to 2.30

[1] *'Forecasts for the UK economy: A comparison of independent forecasts', March 2010.*

Box B7: Uncertainty around current forecasts

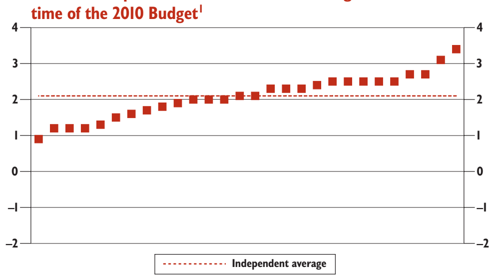
The economic forecast remains subject to very significant uncertainty. To an extent, this is evident in the wide range of external views on GDP growth over the coming years, ranging from 0.9 to 3.4 per cent in 2011. The variance of independent forecasts remains high, particularly with respect to trends prior to the intensification of the financial crisis through the autumn of 2008.

Chart a: Independent forecasts for 2009 GDP growth at the time of the 2008 Budget[1]



[1] 'Forecasts for the UK economy: A comparison of independent forecasts', March 2010.

Chart b: Independent forecasts for 2011 GDP growth at the time of the 2010 Budget[1]



[1] 'Forecasts for the UK economy: A comparison of independent forecasts', March 2010.

However, the spread of forecasts is not a measure of likely outcomes, but the dispersion of central opinions: each forecaster may have their own expected distribution of outcomes around their stated central forecast.

The Bank of England publishes its growth forecast as a probability distribution, reflecting the Monetary Policy Committee's (MPC) collective judgements about the risks to the forecast[a]. Its modal, or 'most likely', GDP growth projection is broadly in line with the current Budget forecast over 2010-2012. However, the MPC currently judges the balance of risks around this projection to lie to the downside. As such, the mean projection for growth, the probability-weighted average of alternative outcomes, is significantly below the modal projection in the Bank of England's February Inflation Report, by 0.1 percentage points in 2010 Q4, rising to 0.7 percentage points in 2012 Q4.

The Bank also surveys a range of external forecasters each quarter, asking for an assessment of the risks around their central projections[b]. The broad profile of those responses accords with its own view of risks. On average, other forecasters also attach more weight to downside risks, although the distribution has shifted upwards, consistent with the likelihood of extreme tail-risks diminishing.

Forecast errors in the HM Treasury Budget GDP growth forecast are given in the table below. It shows the absolute error (i.e. without regard to sign) in the current year and a year ahead was about ¾ percentage point in the 10 years to 2007. Adding the large errors for 2008 and 2009 increases this year-ahead error to 1¼ percentage points. The average error is close to zero for the current year, and for the year ahead up to 2007, indicating an absence of bias. But it has moved to –¾ percentage point for the year ahead after adding in the large errors in 2008 and 2009.

Budget forecast errors for GDP growth[1,2]

	Current year	Year ahead
Absolute Error (1998-2007)	¾	¾
Absolute Error (1998-2009)	1	1¼
Average Absolute Error (1998-2007)	¼	¼
Average Absolute Error (1998-2009)	0	–¾

[1] *Figures in parentheses refer to the year of annual growth, such that errors for (1998-2007) relate to in-year forecast errors between the Budgets of 1998 and 2007 and year-ahead forecast errors between the Budgets of 1997 and 2006.*
[2] *Positive average errors reflect annual growth being higher than forecast.*

[a] See *'The Inflation Report projections: Understanding One Fact Chart'*, Britten E., Fisher P. and Whitley, J., Bank of England Quarterly Bulletin, February 1998, for a detailed explanation of the MPC's fact charts.
[b] www.bankofengland.co.uk/publications/inflationreport/irprobab.htm

Forecast issues and risks

B.93 This section discusses the key risks and uncertainties surrounding the forecast.

Actual and trend output

B.94 A key issue for the economic forecast concerns the outlook for trend output. Trend, or potential, output can only be estimated: it is not observable directly. Measurement issues relating to survey measures of spare capacity, as well as the possibility of future revisions to National Accounts data, mean that uncertainty about the output gap and the level of trend output is unlikely to be resolved for some time. It also remains unclear to what extent trend output is currently being affected by temporary supply constraints or more permanent factors.

B.95 Further uncertainties surround the size of the assumed trend output adjustment, described in paragraph B.37. The Treasury's assumed downward adjustment to trend output of just over 5 per cent is broadly in line with assumptions made by a number of external organisations: in their latest Economic Review, NIESR assume a permanent output adjustment of around 4 per cent;[13] while the OECD's latest Economic Outlook assumes an average trend output adjustment of 3½ per cent across the OECD.[14]

B.96 Nevertheless the size of this adjustment remains an open question. For example, a recent assessment produced by Barclays for the Institute for Fiscal Studies' (IFS) Green Budget presented downward adjustments to trend output ranging from 5 to 10 per cent.[15] Recent analysis also points to variation in the estimates of previous financial crises on trend output. An OECD assessment suggests that financial crises are associated with a downward adjustment to the level of trend output of around 1½ to 4 per cent.[16] Recent IMF analysis, using a different approach, points to a wide variation in the estimated output loss from previous financial crises, with one loss averaging around 10 per cent after seven years compared to a 'pre-crisis trend'. Applying the IMF's methodology to current UK data,[17] and comparing it with the Budget 2010 projection for the level of output would imply an output loss that would be broadly in line with the IMF estimated average loss from previous financial crises (Chart B8). The IMF's estimated average output loss of 10 per cent cannot be directly compared to the Treasury's trend output adjustment of just over 5 per cent as they are based on different estimates of the pre-crisis trend.

[13] *Prospects for the UK economy*, Kirby, S., Barrell, R., Foley-Fisher, N., in NIESR Economic Review Vol.211, February 2010.

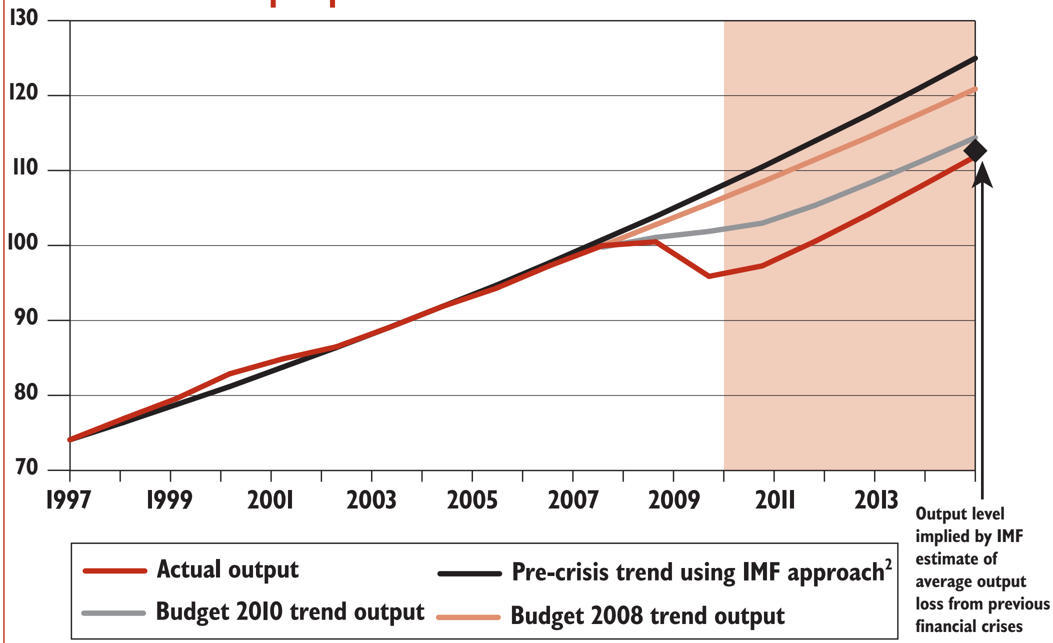
[14] *OECD Economic Outlook No.86* (Preliminary edition), OECD, November 2009.

[15] *IFS Green Budget*, IFS, January 2010.

[16] *The Effect of Financial Crises on Potential Output: New Empirical Evidence from OECD Countries*, Furceri, D. and Mourougane, A. OECD Economics Department Working Paper No.699, 2009.

[17] The IMF's 'pre-crisis trend' for output growth is derived by extrapolating forward the average rate of growth between ten and three years prior to the crisis, and comparing this with the actual level of output seven years after the crisis. See *World Economic Outlook October 2009: Sustaining the Recovery*, IMF, October 2009. For the current projection period, the IMF 'pre-crisis trend' has therefore been constructed by extrapolating forward the UK's average growth rate of non-oil GVA between 1997 and 2004 (around 3 per cent), which is compared to the projected level of output in 2014 to derive the implied output loss. Estimates devised on a non-oil GVA basis to allow comparisons with the HMT trend output assumptions.

Chart B8: Output profiles[1]



[1] 100=actual output (non-oil GVA) in 2007. IMF pre-crisis trend constructed by extrapolating forward the UK's average growth rate of non-oil GVA between 1997 and 2004 (around 3 per cent).
[2] Estimates presented on a non-oil GVA basis to allow comparisons with the Treasury's trend output assumptions.

B.97 Uncertainty also surrounds the medium-term outlook for the trend growth rate. For example, the assessment produced by Barclays for the IFS Green Budget assumes a persistent increase in structural unemployment. By contrast, the OECD assumes no permanent change in the UK's structural unemployment rate relative to pre-crisis levels,[18] consistent with evidence suggesting countries with less restrictive employment protection legislation are unlikely to see significant increases in structural unemployment following an economic downturn.[19] This view is supported by the absence of a notable pick-up in structural unemployment following the previous recession,[20] as well as the limited evidence so far of significant structural displacement in the labour market.[21]

B.98 Further out, additional uncertainties surround the prospects for trend population growth. Demographic changes are likely to imply a slower rate of 16+ population growth beyond the middle of this decade, although the effect of changes in the composition of the population on trend employment growth will also depend partly on the prospects for the labour market participation rates of older age groups.

B.99 The outlook for trend output also has significant implications for inflation. If the degree of spare capacity in the economy is smaller than assumed, as implied by some survey measures, then the downside risk to the inflation forecast from the large degree of spare capacity may be less pronounced. Further, there is uncertainty over the relationship between

[18] *OECD Economic Outlook No.86 (Preliminary edition)*, OECD, November 2009.

[19] See *How do Institutions Affect Structural Unemployment in Times of Crises?*, Furceri, D. and Mourougane, A., OECD Economics Department Working Papers No.730, OECD, 2009. The paper finds no significant impact of economic downturns on structural unemployment in economies with below-average Employment Protection Legislation (EPL), a category that includes the UK.

[20] For example, OECD estimates suggest that the UK Non-Accelerating Inflation Rate of Unemployment (NAIRU) was broadly flat through the course of the early 1990s recession, and subsequently fell through the remainder of the decade.

[21] For example, off-flow rates from the claimant count have remained above those seen in the previous recession helping to mitigate against flows into long-term unemployment (ONS and the Department for Work and Pensions, 2010).

the output gap and inflation, although a forthcoming Treasury Economic Working Paper confirms the existence of a well-determined effect.

World recovery

B.100 The past depreciation of sterling and a strong recovery in the global economy underpin the forecast, with net trade contributing positively to growth over the forecast horizon. As such, the Budget 2010 GDP growth forecast depends on developments in UK export markets. Although forecasts for the world economy have stabilised, in line with those for the UK, there is still a high degree of uncertainty over the outlook.

B.101 In the near term, should the effects of exceptional policy stimulus and the pass through of confidence to private demand be larger than anticipated, this may provide a higher boost to growth than is implied by the forecast. On the downside, persistent unemployment, continued weakness in the financial sector and the provision of credit could result in lower growth than forecast.

B.102 In the medium term, the strength and sustainability of the global recovery will depend on domestic policy choices across the world and their implications for future global imbalances. Some rebalancing between external and domestic demand, particularly within the euro area would mean a broader and more sustainable recovery in trade overall. However, international policy actions should help to mitigate some of these risks. For example, the Government has called for a EU Compact for Jobs and Growth to promote strong, sustainable and balanced growth across Europe to help mitigate these risks in the years ahead; the EU will discuss proposals to promote growth at the forthcoming spring and June European Councils.

Credit conditions in the recovery

B.103 The Budget 2010 forecast assumes that credit conditions continue to ease through 2010, such that the cost and supply of credit supports the recovery.

B.104 Credit conditions have eased since the height of the financial crisis, as the global macroeconomic policy stimulus and domestic measures introduced by the Government and Bank of England have helped to reduce risk premia. Recent recoveries in asset prices have boosted banks' balance sheets and combined with lower bond yields, have supported corporate capital issuance. There is a risk that the future supply of credit is constrained by concerns over the availability of bank funding and the cost of refinancing existing funding following the collapse of the shadow banking system and the general repricing of risk. The authorities will continue to monitor developments in funding markets as banks continue to restructure their balance sheets and reduce their reliance on short-term wholesale funding.

Speed and extent of private sector deleveraging

B.105 The level of household debt rose substantially in the last decade, as households mainly used debt to finance house purchase and other assets. Household balance sheets have weakened in the recession due to falling asset prices, which has served to lower the ratio of net assets to income. These factors, together with the tightening of credit conditions and past increases in asset price volatility, may have contributed to the significant adjustment already under way, as demonstrated by the sharp rise in the saving ratio in 2009.

B.106 A key uncertainty for the Budget 2010 economic forecast is the pace and extent to which households continue to rebuild their balance sheets. Should consumption fall back more sharply as households save more to try to increase net wealth, this would weaken overall demand and hamper the recovery. To illustrate this point, if the saving ratio were to rise by 1 percentage point more than forecast in 2010 due to lower consumption, this would reduce GDP growth by ½ percentage point, taking into account the partial offset from lower imports. The overall effect could be larger, particularly if firms reacted to weaker demand by cutting staff, leading to a potential feedback from lower employment to weaker demand.

B.107 However, these risks need to be weighed against current conditions: the historically low level of interest rates, which has reduced the cost of servicing debt; the rebound in asset prices; improved confidence; and the signs of stabilisation in the labour market. These factors should help to smooth any further adjustment over the course of the forecast period.

B.108 The relatively high concentration of debt in the real estate and finance sectors poses a wider risk as concerns, over refinancing and potential losses on commercial property loans may weigh down on the supply of credit in the recovery. However, the corporate sector as a whole is well-positioned, having entered the recession in a relatively healthy financial position. Firms appear to have managed their financial and cash positions well through the recession, with the corporate liquidity ratio having risen from historic lows to around 50 per cent by the end of 2009, and with net capital and income gearing ratios now back down to low levels by historical standards.

Table B9: Summary of economic prospects[1]

	Percentage change on a year earlier, unless otherwise stated						
			Forecast[2,3,4]			Average errors from past forecasts[5]	
	2008	2009	2010	2011	2012	2010	2011
Output at constant market prices							
Gross domestic product (GDP)	½	–5	1 to 1½	3 to 3½	3¼ to 3¾	¾	1½
Manufacturing output	–2¾	–10½	1½ to 2	3½ to 4	3½ to 4	1¾	3¼
Expenditure components of GDP at constant market prices[6]							
Domestic demand	0	–5¼	¾ to 1¼	2¼ to 2¾	2½ to 3	½	1½
Household consumption[7]	1	–3	0 to ½	2¼ to 2¾	2½ to 3	½	1¼
General government consumption	2½	2	1¼	–1½	–2	1	½
Fixed investment	–3½	–14½	–2¾ to –2¼	4½ to 5	9 to 9½	2¾	4
Change in inventories[8]	–½	–1¼	1¼	½	0	¼	¼
Exports of goods and services[9]	1	–11	2¾ to 3¼	4 to 4½	5¼ to 5¾	2¼	5½
Imports of goods and services[9]	–½	–12	2 to 2½	1½ to 2	2¾ to 3¼	2¾	4¼
Balance of payments current account							
£ billion	–22	–18	–35	–36	–30	11¾	10
Per cent of GDP	–1½	–1¼	–2½	–2¼	–1¾	¾	¾
Inflation							
CPI (Q4)	4	2	2	1½	2	¾	½
Producer output prices (Q4)[10]	5½	2¼	2½	1¼	2	1½	1½
GDP deflator at market prices	3	1½	2¾	1½	2¼	¼	½
Labour market							
Claimant count (Q4, millions)[11]	1	1½	1¾	1½	1¼		
Money GDP at market prices							
£ billion	1448	1396	1449 to 1454	1514 to 1526	1598 to 1619	11¼	21½
Percentage change	3½	–3½	3¾ to 4¼	4½ to 5	5½ to 6	¾	1½

[1] The forecast is consistent with output, income and expenditure data for the fourth quarter of 2009, released by the Office for National Statistics on 26 February 2010. See also footnote 1 on the second page of this Chapter.

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

[3] As in previous Budget and Pre-Budget Reports, the economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral assumption for the trend rate of output growth 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 the past 10 spring forecasts. 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 2010 and 2011. The CPI average has been derived from only five years of data.

[6] Further detail on the expenditure components of GDP is given in Table B10.

[7] Includes households and non-profit institutions serving households.

[8] Contribution to GDP growth, percentage points.

[9] Exports levels up to and including 2010 are distorted by MTI, though published growth rates are unaffected.

[10] Excluding excise duties.

[11] The claimant count is projected to be around 1¼ million and 1 million in 2013Q4 and 2014Q4 respectively.

Table B10: Gross domestic product and its components

	£ billion chained volume measures at market prices, seasonally adjusted									
	Household consumption[1]	General government consumption	Fixed investment	Change in inventories	Domestic demand[2]	Exports of goods and services	Total final expenditure	*Less* imports of goods and services	*Plus* statistical discrepancy[3]	GDP at market prices
2008	852.9	282.7	232.2	0.9	1370.0	361.5	1731.5	401.1	–0.3	1330.1
2009	826.5	288.4	198.3	–15.2	1299.2	322.0	1621.2	352.5	–4.6	1264.1
2010	827.2 to 829.8	292.1	193.0 to 193.6	–0.8 to 0.1	1311.6 to 1315.6	331.2 to 332.2	1642.7 to 1647.7	359.9 to 361.0	–5.1	1277.7 to 1281.6
2011	846.4 to 853.2	288.0	201.9 to 203.5	4.6 to 6.9	1341.0 to 1351.6	344.8 to 347.5	1685.7 to 1699.1	364.9 to 367.8	–5.1	1315.6 to 1326.1
2012	868.6 to 879.7	282.0	219.9 to 222.8	4.4 to 8.0	1374.8 to 1392.5	363.2 to 367.9	1738.1 to 1760.4	374.6 to 379.4	–5.1	1358.4 to 1375.9
2008 1st half	428.6	140.3	118.9	4.8	693.2	183.2	876.4	205.2	0.1	671.3
2nd half	424.3	142.4	113.3	–3.9	676.8	178.3	855.1	196.0	–0.4	658.8
2009 1st half	413.8	143.2	100.7	–8.2	650.1	160.1	810.2	174.6	–2.1	633.6
2nd half	412.8	145.1	97.6	–7.0	649.1	161.9	811.0	178.0	–2.5	630.5
2010 1st half	412.2 to 412.9	146.3	96.1 to 96.3	–1.7 to –1.4	652.9 to 654.1	163.8 to 164.1	816.7 to 818.2	179.7 to 180.1	–2.6	634.4 to 635.5
2nd half	415.1 to 416.8	145.8	96.9 to 97.3	0.9 to 1.5	658.7 to 661.5	167.3 to 168.1	826.0 to 829.5	180.2 to 180.9	–2.6	643.3 to 646.0
2011 1st half	420.3 to 423.1	144.7	99.0 to 99.6	2.2 to 3.2	666.2 to 670.7	170.6 to 171.7	836.8 to 842.4	181.4 to 182.7	–2.6	652.8 to 657.2
2nd half	426.1 to 430.0	143.3	102.9 to 103.8	2.4 to 3.7	674.7 to 680.9	174.2 to 175.8	848.9 to 856.7	183.5 to 185.2	–2.6	662.8 to 668.9
2012 1st half	431.6 to 436.7	141.7	107.5 to 108.8	2.3 to 3.9	683.1 to 691.8	179.0 to 181.1	862.1 to 872.1	185.9 to 188.0	–2.6	673.7 to 681.5
2nd half	436.9 to 443.1	140.3	112.4 to 114.0	2.1 to 4.1	691.7 to 701.4	184.3 to 186.9	876.0 to 888.3	188.7 to 191.3	–2.6	684.7 to 694.4
	Percentage change on a year earlier[4,5]									
2008	1	2½	–3½	–½	0	1	¼	–½	0	½
2009	–3	2	–14½	–1¼	–5¼	–11	–6¼	–12	–¼	–5
2010	0 to ½	1¼	–2¾ to –2¼	1¼	¾ to 1¼	2¾ to 3¼	1¼ to 1¾	2 to 2½	0	1 to 1½
2011	2¼ to 2¾	–1½	4½ to 5	½	2¼ to 2¾	4 to 4½	2½ to 3	1½ to 2	0	3 to 3½
2012	2½ to 3	–2	9 to 9½	0	2½ to 3	5¼ to 5¾	3 to 3½	2¾ to 3¼	0	3¼ to 3¾

[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.