

# B

## THE ECONOMY

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 an already weakened world economy, precipitating a steep and synchronised global downturn.

In late 2008, world trade and manufacturing contracted very sharply as confidence evaporated and the availability of credit was further curtailed. World GDP fell, and is forecast to contract by 1¼ per cent in 2009, the first full-year decline in the post-war period. World trade is forecast to drop by more than 10 per cent, by far the largest post-war annual fall. The UK, like other advanced economies, has seen a steep fall in output, with GDP down 1.6 per cent in the final quarter of 2008 and industrial production down 4.5 per cent, each the sharpest fall since the early 1980s.

Faced with these exceptional challenges, governments around the world have utilised all available policy levers to support their economies. Banking systems have been recapitalised and action taken to ensure access to finance for creditworthy borrowers. Interest rates have been cut to historic lows, a number of central banks have adopted quantitative easing to boost demand further, and governments have set expansionary fiscal policies. The Budget 2009 forecast is underpinned by the assumptions that G20 authorities deliver on policy commitments and that financial conditions ease as a result. As this policy stimulus takes hold, the world economy is forecast to grow by 2½ per cent in 2010, picking up further to 4¼ per cent in 2011.

In the UK, the Government has undertaken a set of measures to improve the flow of credit to creditworthy borrowers, and significant macroeconomic policy stimulus is in place. A combination of discretionary fiscal action and the automatic stabilisers is delivering fiscal support worth 4 per cent of GDP in 2009-10. Bank Rate has been cut to ½ per cent, and a £75 billion programme of quantitative easing is under way. In addition, lower commodity prices and the depreciation of sterling help provide the conditions for a rebalanced recovery.

The Budget 2009 economic forecast reflects the balance of key forecasting considerations relating to the negative effect of the global financial crisis and private sector retrenchment, and the positive effect of large-scale macroeconomic stimulus, both domestically and internationally, on growth. The economic forecast is for:

- UK GDP to contract by 3½ per cent in 2009. As macroeconomic stimulus builds and credit conditions ease, the economy is forecast to pick up progressively through 2010 and 2011, with annual growth of 1¼ per cent in 2010, supported by net exports, picking up to 3½ per cent in 2011, as the significant degree of spare capacity begins to be brought back into productive use, helped by the UK's flexible markets; and
- CPI inflation to fall to 1 per cent by the end of 2009 and to remain below target during 2010, as the lagged effects of sterling depreciation and monetary policy are more than offset by downward pressure on prices from spare capacity and lower energy prices. Inflation is forecast to return close to target during 2011 as the lagged effects of monetary policy easing build.

The forecast is presented within ½ percentage point ranges, based on alternative assumptions about supply-side performance of the economy, with the public finance projections based on the lower end of the range where GDP is forecast to contract by 3¾ per cent in 2009 before recovering to 1 per cent in 2010 and 3¼ per cent in 2011. The forecast ranges are not designed to reflect the very significant uncertainties around these forecasts. The key risks include the pace and balance of the global recovery, effectiveness of global policy stimulus, availability of sufficient credit growth to support recovery, and intensity of private sector retrenchment.

## INTRODUCTION<sup>1,2</sup>

**B.1** This chapter discusses recent economic and financial market developments, and provides updated forecasts for the UK and world economies in the period to 2011. It begins with an overview of the global economic shocks of 2007 and 2008, and their implications for world economic developments and prospects, which provides the global context for developments and prospects in the UK economy. The chapter then outlines the UK economic forecast, before concluding with a more detailed discussion of sectoral issues, components of growth, and the forecast issues and risks that are addressed throughout.

## THE WORLD ECONOMY

### Global shocks and world downturn

**Global economic shocks** **B.2** The world economy was hit by a succession of shocks during 2007 and 2008, beginning with the tightening of global credit conditions as disruption gripped financial markets. The effect of constrained credit on households and businesses was exacerbated by the squeeze on real incomes caused by a surge in commodity prices in the middle of 2008. As commodity prices subsequently fell, the failure of Lehman Brothers in the US triggered an intensification of credit market stress into the worst global financial crisis for generations.

**Synchronised global downturn** **B.3** With global demand already weakened by the impact of credit restrictions and high commodity prices, the loss of confidence across the global financial system and among households and businesses around the world precipitated a steep and synchronised global downturn. Figures compiled by the Netherlands Bureau of Economic Policy Analysis suggest that world trade volumes have fallen almost 17 per cent since September 2008. JPMorgan estimates that in the final quarter of 2008, global manufacturing fell at an annualised rate of 21 per cent and world GDP at nearly 7 per cent.

**B.4** Almost every major advanced economy is currently in recession, with output falling particularly sharply in those economies most reliant on exports. Out of 51 countries reporting components of growth for the final quarter of 2008, over two thirds saw double-digit annual falls in exports. At the same time, a growing number of emerging and developing economies have experienced sharp slowdowns or recession. The International Labour Organisation of the United Nations predicts that global unemployment could increase by 38 million by the end of 2009. As the financial crisis intensified, borrowers in many emerging markets found it increasingly difficult to access international capital markets, with a number of countries approaching the IMF and other international financial institutions for emergency support.

**B.5** The interaction between global financial markets and the wider economy is a key factor influencing the depth and duration of the world recession, and the timing and strength of the recovery. In the early stages of the credit shock, growth prospects were dominated by the state of global financial markets and the implications for credit conditions faced by households and businesses. As the downturn has deepened, the nature of the relationship has evolved, with weakness in the wider economy adversely affecting the financial system through the credit quality of loans, further impacting on credit conditions and financial markets.

<sup>1</sup> The UK forecast is consistent with National Accounts and balance of payments statistics to the final quarter of 2008 released by the Office for National Statistics (ONS) on 27 March 2009. A detailed set of charts and tables relating to the economic forecast is available in *Budget 2009: 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).

<sup>2</sup> 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.

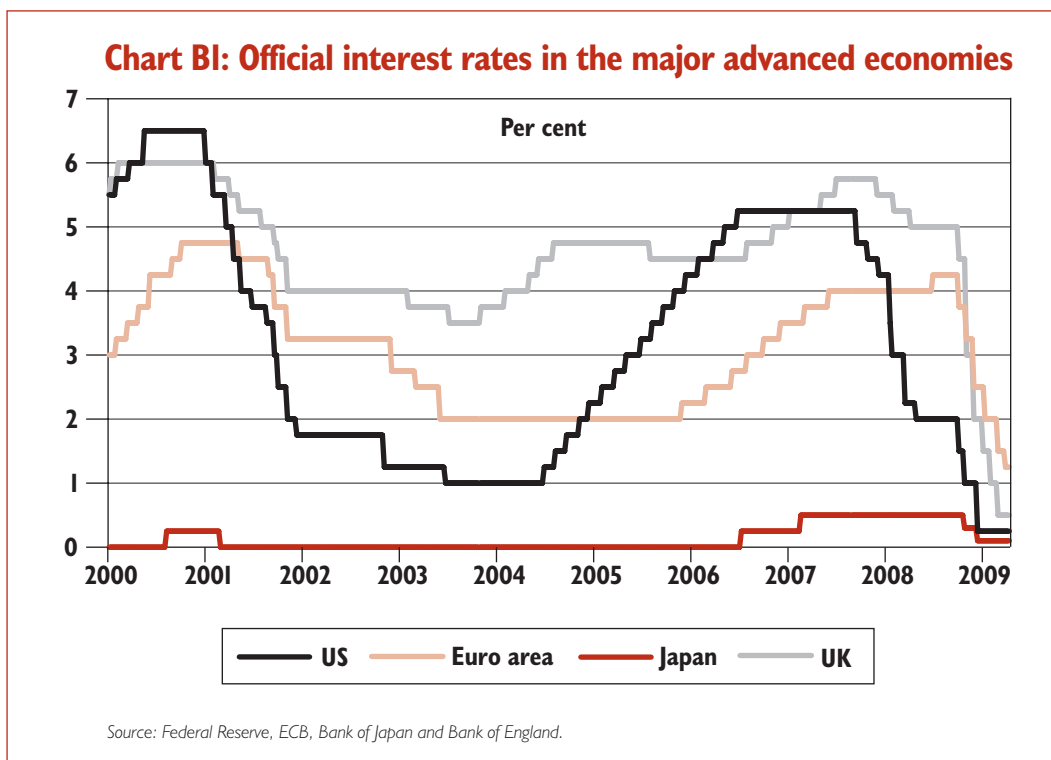
**Global financial markets** **B.6** Box A1 of the 2008 Pre-Budget Report set out the sequence of events that led the disruption in specific credit markets linked to US subprime mortgages to spread and intensify into the worst global financial crisis for generations. Following the failure of Lehman Brothers in the US in September 2008, global asset prices fell sharply. While the value of world stock markets is currently around that at the time of the Pre-Budget Report, it is down by around half, or \$30 trillion, from its peak in 2007. Spreads on corporate bonds in advanced economies and emerging market government bonds have started to ease from the highs of recent months. Meanwhile, with investors anxious to reduce exposure to private sector risk, yields on the safest assets, particularly advanced economies' government bonds, have fallen sharply.

**Credit conditions** **B.7** Surveys of credit conditions in the major economies suggest that the tightening of credit conditions facing households and firms has slowed. In the US, the Federal Reserve's senior loan officer opinion survey showed that credit conditions in the final quarter of 2008 had stabilised relative to the previous quarter. Surveys conducted by the ECB and Bank of Japan showed that credit conditions continued to tighten.

**Oil and other commodity prices** **B.8** The dramatic rise and fall of commodity prices through 2008 was set out in Box A2 of the 2008 Pre-Budget Report. Since that time, commodity prices have generally remained low by the standards of recent years, reflecting falling demand in advanced economies and, more recently, emerging markets. The price of Brent crude oil, the European standard, currently stands at around \$50 a barrel, down 65 per cent from its peak in mid-2008. The price of oil has remained low despite OPEC's successive cuts in its production quota since September 2008. Prices of metals and agricultural commodities have fallen to well below their summer 2008 peaks.

## Global policy response and prospects for recovery

**Global policy response** **B.9** Faced with the exceptional challenges posed by the global financial crisis and synchronised downturn in the world's economies, governments around the world have utilised all available policy levers to support their economies. Banking systems have been recapitalised and action taken to ensure that the presence of impaired assets on banks' balance sheets does not limit access to finance for creditworthy borrowers. To support demand, interest rates have been cut to historic lows, a number of central banks have introduced quantitative easing policies, and governments have adopted expansionary fiscal policies. At the London Summit, G20 leaders agreed a global plan for recovery and reform, and recognised that "*acting together strengthens the impact and the exceptional policy actions announced so far must be implemented without delay.*" The Budget 2009 forecast is underpinned by the assumption that G20 authorities deliver on policy commitments and that they are effective.



**Prospects for the global economy**

**B.10** With a sharp recession taking place in the world's economies, global forecasts are marked by very significant uncertainties and risks. World GDP is forecast to fall by 1¼ per cent in 2009, the first full-year contraction in the post-war period. Advanced economies are expected to contract most sharply, with G7 GDP forecast to fall by 4 per cent this year. Emerging economies are expected to continue growing, but at a greatly reduced pace, highlighting how closely aligned prospects in emerging and advanced economies have become in a world economy characterised by integrated global supply chains. As the global policy response takes hold and credit conditions start to ease, the world economy is forecast to begin to recover towards the end of 2009, with growth picking up through 2010 and 2011.

**Table BI: The world economy**

	Percentage change on a year earlier, unless otherwise stated				
	2007	2008	Forecast		
			2009	2010	2011
World GDP	5	3¼	-1¼	2½	4¼
Major 7 countries <sup>1</sup>					
Real GDP	2¼	½	-4	¾	3
Consumer price inflation <sup>2</sup>	3	1¾	-½	1	1¾
Euro area GDP	2¾	¾	-4¼	¼	2
World trade in goods and services	7¼	2½	-10¾	¼	6½
UK export markets <sup>3</sup>	6½	2	-8¾	-1	4¾

<sup>1</sup> G7: US, Japan, Germany, France, UK, Italy and Canada.

<sup>2</sup> Per cent, Q4.

<sup>3</sup> Other countries' imports of goods and services weighted according to the importance of imports from the UK in those countries' total imports.

## Advanced economies

**Euro area B.11** The euro area has been hit hard by weakness in domestic confidence and labour markets, and by falling global trade, affecting domestic and external sources of demand. Net exports subtracted significantly from growth in the final quarter of 2008, while weak demand and the effects of housing corrections in some Member States caused investment to fall sharply. Euro area GDP contracted 1.6 per cent in the final quarter of 2008, while industrial production fell more than 18 per cent in the year to February.

**B.12** Euro area GDP is forecast to fall 4¼ per cent in 2009, and recover gradually from the start of 2010. Deteriorating labour markets, tight lending conditions and continued lack of confidence are likely to weigh on private consumption in the near term. Investment is set to drop sharply reflecting the weakness of global demand and restricted access to finance. Global factors and the euro's appreciation also suggest that net exports will continue to subtract from growth. Reflecting the worsening outlook, the consensus forecast for euro area GDP growth in 2009, which stood at 2.0 per cent at the beginning of 2008 and -0.2 per cent at the time of the 2008 Pre-Budget Report, has been revised down a further 3.2 percentage points to a contraction of 3.4 per cent. The consensus forecast for 2010 suggests a subdued recovery with growth of 0.3 per cent.

### Box B1: 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.

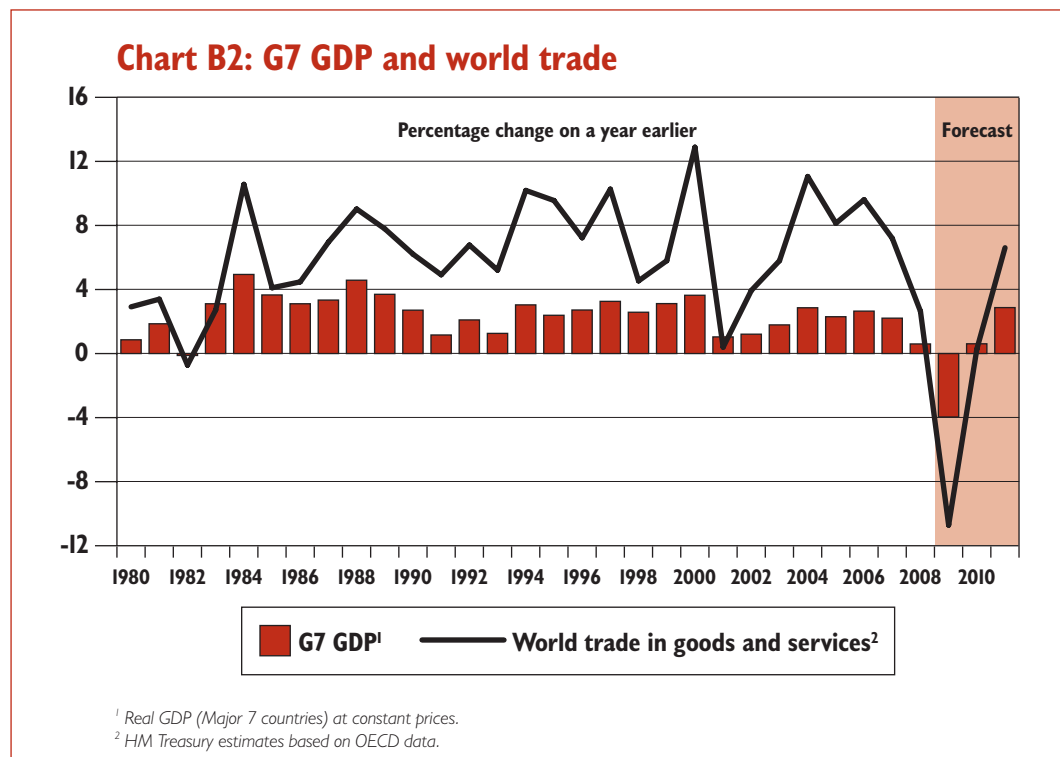
**United States B.13** The adjustment of private consumption in the US has led other advanced economies, and has so far been the most severe. Equities are an important component of US households' financial wealth, and feature heavily in consumption decisions. Since mid-2007, falls in equity prices have reduced household financial wealth by over \$4 trillion, equivalent to 40 per cent of annual household disposable income. Retail sales declined by 10 per cent in the year to February 2009, as the saving ratio increased from close to zero to 4¼ per cent.

**B.14** Businesses have responded to weakening demand by cutting back investment, reducing demand for credit and bearing down on other costs. This has included shedding 5 million jobs, pushing the unemployment rate up from 5 per cent to 8½ per cent, since December 2007. Job losses have dealt a further blow to consumer confidence, increasing the precautionary motive for saving. GDP fell 1.6 per cent in the final quarter of 2008.

**B.15** Monthly indicators suggest the US economy was similarly weak in early 2009. Industrial production fell 5.4 per cent in the first quarter. The consensus forecast for US GDP growth in 2009, which stood at 2.7 per cent at the beginning of 2008 and -0.6 per cent at the time of the 2008 Pre-Budget Report, has been revised down a further 2.1 percentage points to a contraction of 2.7 per cent. However, the consensus forecast is for growth in 2010, reflecting the impact of a policy response of unprecedented scale and scope partially offsetting the weakness in private demand. The weak outlook for near-term activity combined with falls in commodity prices mean that the consensus forecast for US inflation in 2009 as a whole is negative, at -0.3 per cent.

**Japan B.16** Although the Japanese economy was relatively insulated from the tightening in credit conditions in the early stages of the credit shock, the subsequent effect on confidence and global demand has had a powerful impact. In February 2009, export volumes contracted by an unprecedented 45½ per cent on a year earlier, with shipments to all regions falling sharply. Unemployment in Japan has now reached 4½ per cent, and there are signs that domestic demand is also weakening. GDP fell by 3.2 per cent in the final quarter of 2008.

**B.17** Japan is likely to experience the deepest recession among the G7 economies, with GDP possibly contracting as sharply in the first quarter of 2009 as in the final quarter of 2008. The pace at which prospects have deteriorated is evident from movement in the consensus forecast for 2009 GDP growth, which stood at 2.0 per cent at the beginning of 2008 and -0.1 per cent at the time of the 2008 Pre-Budget Report, but has since been revised down a further 6.2 percentage points to a contraction of 6.3 per cent. External forecasts also show the considerable uncertainty over Japanese growth prospects, ranging from -4.2 per cent to -8.7 per cent for 2009.



## Emerging markets

**B.18** Contracting domestic demand in advanced economies has hit emerging markets. Steep declines in exports, particularly in a number of Asian countries, has highlighted how closely aligned prospects in emerging and advanced economies have become in a world economy characterised by integrated global supply chains. Prospects for recovery in emerging markets are therefore in large part dependent on the success of policy interventions in advanced economies delivering a recovery in global demand.

**B.19** Since the intensification of the global financial crisis in September 2008, public and private sector borrowers in emerging markets have found it increasingly difficult to access international capital markets. This has led to a number of emerging markets approaching the IMF and other international financial institutions for emergency support, and it is likely that further countries will require emergency funding. In view of this, at the London Summit leaders agreed to a tripling of the IMF's resources to \$750 billion and endorsed reforms to the IMF's lending instruments, including the creation of a new Flexible Credit Line (FCL), which will operate as a type of insurance policy for strongly performing economies, mainly among emerging market countries. Mexico and Poland have been the first countries to seek voluntary access to the FCL.

### Box B2: Global imbalances and emerging market capital flows

Over the past 20 years, global trade and financial integration has been accompanied by a steady increase in global current account imbalances. These imbalances peaked in 2006, following a sustained period of historically strong rates of world GDP and trade growth.

The financial flows associated with these current account imbalances were characterised by funds moving from some emerging and oil-producing economies to advanced economies with large liquid capital markets, and indirectly to emerging Europe.

The intensification of the global financial crisis in September 2008 and the associated rise in global risk aversion caused a general flight into dollar-denominated assets. In many cases, financial institutions' desire to bolster domestic capital positions in advanced economies prompted the sale of emerging market investments. This led to a sharp reversal in international flows of capital. Indeed, the Institute of International Finance forecasts that capital flows to emerging markets in 2009 will be down 80 per cent from their 2007 peak.

This capital flight exposed serious weaknesses in emerging market financial systems, particularly in countries with a high dependence on cross-border credit and a large degree of foreign currency-denominated domestic lending. Coupled with reduced export demand and sizeable short-term external debt, the reduction in capital inflows contributed to the sharp deterioration in the economic and financial situation in emerging markets.

Emerging Europe has been the hardest hit due to its dependence on short-term external financing through the banking system, often provided by parent banks in western Europe. Latin America and Asia have also been affected, especially after the fall in commodity prices and world trade.

The evolution of imbalances in the medium term will depend on how the crisis and the response to it affects the long-term saving and investment behaviour of the private and public sectors globally. Already the US current account deficit has narrowed and the US household saving ratio has increased. OECD analysis suggests that current account imbalances will continue to reduce into 2010.

**Emerging Europe and Russia B.20** Emerging Europe has been particularly affected by the financial crisis given the region's strong trade and financial links with western Europe. Growth slowed sharply in most countries, with some entering deep recessions, and currencies came under pressure. Several countries in the region have already received external financial assistance. While the economic and financial situation in emerging Europe is not homogeneous – some economies are on a more sound economic footing than others – further contraction in economic activity is expected across the region, and more countries are likely to require external financial support.

**B.21** In Russia, as with emerging Europe, capital flight led to significant currency depreciation. However, in addition, the fall in commodity prices, particularly oil and gas, has had a significant effect on the public finances. A managed exchange rate regime and relatively high inflation have constrained monetary policy. As a result, the consensus forecast is for the Russian economy to contract by 1.5 per cent in 2009, with recovery particularly dependent on global demand and commodity prices.

**Emerging Asia B.22** The decline in global trade has perhaps had its greatest impact on emerging Asia. A number of countries, including Thailand, Malaysia and the Philippines, have seen exports fall by between 20 and 40 per cent. Sound macroeconomic policy reform and the accumulation of foreign exchange reserves mean that emerging Asia is less exposed to financial crisis than in previous years.

**China B.23** Rapid growth over a sustained period means that China now accounts for more than 10 per cent of world GDP.<sup>3</sup> The weakness of China's main export markets in the US and Europe is acting as a drag on activity, which has led to rising unemployment and slowing consumption, investment and industrial production growth. The consensus forecast for Chinese GDP growth in 2009 is around 7 per cent, which would represent a significant slowing from the peak of 13 per cent in 2007.

**B.24** In November 2008, in response to slowing growth, the Chinese government announced a large fiscal package worth an estimated 4 per cent of GDP, focused on investment in infrastructure and earthquake reconstruction. Although growth in the first quarter of 2009 was the lowest since 1992 at just over 6 per cent on a year earlier, strong growth in fixed asset investment suggests fiscal support is starting to take effect. A further boost to the Chinese economy is being provided by monetary policy. With inflation turning moderately negative, the People's Bank of China cut interest rates and relaxed administrative controls on credit growth. Together, these factors represent an important upside risk for growth in the rest of this year, both for China and for the world as a whole.

**India B.25** Prospects for the Indian economy are also key to medium-term global growth. Domestic demand in China and India could provide an important driver of recovery. However, in the near term, the global financial crisis is exacerbating a cyclical downturn that was already underway. India is less export-focused than China, but has been affected more significantly through a decline in investment. This trend is unlikely to be reversed until global credit conditions ease. India entered the downturn with a large budget deficit, and this has limited the government's ability to respond with counter-cyclical fiscal policy as the crisis has developed. The authorities have greater room to loosen monetary policy, but risk aversion in the banking sector currently limits the effectiveness of the monetary transmission mechanism. The consensus forecast is for Indian GDP growth to weaken significantly in 2009 to around 5 per cent.

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<sup>3</sup> When measured at 'purchasing power parity' exchange rates, a measure most suitable for aggregating global GDP when considering the growth of global living standards. When measured at market exchange rates, a measure more appropriate for considering the size of global markets, China's share of world GDP is closer to 7 per cent.

**Latin America B.26** Latin America is particularly exposed to spillover effects from developments in the US economy, and the decline in commodity prices. Problems in accessing external finance pose serious risks to some countries, making it very likely that growth in 2009 will be weaker than in 2008 for the majority of countries in the region. However, the creation of the IMF's FCL may provide support to some countries. Those most heavily exposed to developments in advanced economies are at the greatest risk of experiencing outright declines in output.

### World trade and UK export markets

**World trade B.27** The nature of the global downturn has meant the impact on world trade flows has been particularly large. The loss of confidence among households and businesses has had a direct impact on demand, particularly for heavily-traded durable goods and capital equipment, while the financial crisis has curtailed the availability of the forms of credit and insurance that facilitate world trade. The relative importance of trade finance and falls in demand in explaining the weakness of trade volumes vary across regions, with trade finance considered to have been more of a factor in parts of Asia as set out in Box B3. At a global level, the sharp fall in global output is consistent with world trade volumes that are forecast to contract by more than 10 per cent in 2009, by far the biggest annual fall in the post-war period. World trade volumes are forecast to pick up through 2010, and grow by 6½ per cent in 2011, closer to the average of the past 30 years.

**UK export markets B.28** UK export markets, a measure of world trade that is weighted to reflect the geographical pattern of UK trade, have typically grown more slowly than world trade overall. This reflects the large contributions of emerging markets to world trade growth, while a greater share of UK export demand is from slower growing advanced economies. In 2009, UK export markets are set to contract less sharply than world trade, reflecting the sharper contraction in emerging market trade to which the UK is less exposed. UK export markets are forecast to contract by 8¾ per cent in 2009, a downward revision of almost 10 percentage points compared with the 2008 Pre-Budget Report forecast. In 2010, the rebound in world trade is expected to be focused among emerging and developing economies, so that UK export markets are forecast to decline further.

**Box B3: World trade and global manufacturing**

World trade has fallen dramatically, particularly across advanced economies, Asia and Latin America. The steep decline primarily reflects the significant weakening of domestic demand around the world as economies have been hit by successive shocks to credit and commodity prices. This demand shock was transmitted along the complex global supply chains that have evolved in recent years, where production processes involve many stages in different countries. It was exacerbated by restricted access to trade financing and elevated exchange rate volatility caused by the global financial crisis.

The sharp drop in world goods trade reflected a similarly dramatic decline in global manufacturing and demand for commodities. The transport and electronics sectors have been particularly badly hit, with JPMorgan estimating global motor vehicle production is currently down 13 per cent since the first half of 2008, while world semiconductor billings have fallen almost 30 per cent. In addition, the International Energy Agency estimates global oil demand declined in 2008 and projects it will decline again in 2009, which would be the first consecutive annual falls since the early 1980s. Demand for industrial metals also contracted in 2008.

The drop in world trade seems to have been amplified by restricted access to trade finance. Possible factors driving this include: retrenchment by banks seeking to repair balance sheets, elevated perceptions of counterparty and country risk, and increased cost of finance. Although there is some evidence that credit restrictions have played a role, considerable uncertainty remains over their importance relative to the broader demand shock. A recent IMF survey of private sector trade credit developments suggested that this had been factor in emerging markets, particularly in Asia. The G20 have moved to address this issue by making available \$250 billion of support for trade finance over the next two years, the successful implementation of which will help trade to rebound as global demand recovers. Chapter 4 sets out the UK Government’s support for exporters.

**THE UK ECONOMY**

**The Treasury’s approach to economic forecasting**

**B.29** Economic forecasting inevitably involves judgement about uncertain future events and their domestic and international consequences. Given the nature of the global credit shock, the steep and synchronised world downturn, and the scale of the international macroeconomic and financial policy response, all of which have intensified since the 2008 Pre-Budget Report, the judgements on which the Budget 2009 forecast are based are subject to exceptional uncertainty.

**Growth cycle approach B.30** The Treasury’s approach to forecasting macroeconomic developments, set out in detail in Budget 2007, accords with the growth cycle approach favoured by many policymakers. The essential building blocks of this approach are the estimates of the ‘trend’ level and rate of growth of output, and analysis of cyclical movements around that trend, the ‘output gap’. The trend output projection provides the medium-term anchor for the forecast on the supply side. The current output gap, and an assessment of the economy’s momentum based on analysis of output, income and expenditure components of activity, informs the judgement taken on the demand-side path of the economy back towards trend.

**Treatment of uncertainty in the forecast B.31** The Treasury has in the past adopted two approaches to treating uncertainties in economic forecasts. Firstly, the absolute average forecast errors from past forecasts have always been presented alongside the latest forecasts, as in Table B9 of this chapter. Secondly, uncertainties relating to the world economy and financial markets, the balance of demand and supply, individual components of demand, and policy developments, have been discussed in the text on economic developments and prospects. The Treasury has considered alternative

approaches, described in Box A3 of the 2008 Pre-Budget Report, concluding that a more extensive focus on key judgements, and how prospects may vary, was the most appropriate method of presenting the exceptional uncertainties surrounding forecasts at present. The forecast ranges used to present the economic forecast represent alternative assumptions about the supply-side performance of the economy, not forecast uncertainties. The external forecasts reviewed in more detail at the end of this chapter also give a sense of the magnitude of current forecast uncertainties.

## Overview of recent developments

**B.32** Since the 2008 Pre-Budget Report, the impact of the financial crisis on the UK and world economies has been more severe than forecast. Despite the decisive interventions of governments in the UK and around the world containing the crisis, its effects on confidence and demand have been far worse than expected.

**Credit conditions B.33** The Bank of England's latest *Credit Conditions Survey*, published on 2 April, reported a slight easing in the availability of credit to companies during the first quarter of 2009, and expectations of further easing in the second quarter. The availability of credit to households continued to tighten, although it was expected to ease in the coming months. The latest Bank of England data show that while effective interest rates paid by households and companies have not fallen by the same amount as some wholesale interest rates, they have declined significantly, with effective rates on:

- all outstanding loans to companies down by 3.2 percentage points since September 2008, to 3.7 per cent;
- secured lending to households down by 1.7 percentage points to 4.1 per cent, driven by a 2.9 percentage point decline for outstanding floating rate mortgages to 3.0 per cent; and
- unsecured personal loans to households lower by 1.3 percentage points at 7.3 per cent.

**Credit growth B.34** The Bank's new *Trends in Lending* report drawing on data collected on behalf on the Lending Panel, and described in Chapter 3, suggests that restricted supply of credit from lenders and weaker demand for credit from borrowers have contributed to a slowing of lending growth. The flow of net lending to UK private non-financial companies has markedly declined from an average of £5¾ billion a month in 2007 to an average repayment of £½ billion in the second half of 2008. However, growth of lending to companies turned positive in January and February 2009, and companies have increasingly returned to capital markets to raise funds, with bond issuance in particular having picked up. Secured lending to households has slowed sharply, in large part reflecting a withdrawal from new lending by specialist lenders and a reduction in the number of higher loan-to-value mortgages. Bank data show that secured lending to households increased by an average of £7¼ billion a month in 2007, which fell to £3½ billion a month in the second half of 2008 and £2¾ billion in the first two months of 2009. Mortgage lenders on average expect an increase in overall credit availability during the coming quarter.

**GDP growth B.35** UK GDP growth has slowed sharply reflecting the cumulative impact of the succession of shocks that hit the global economy during 2007 and 2008. As credit conditions tightened and commodity prices squeezed real incomes, the economy entered recession, contracting 0.7 per cent in the third quarter of 2008. In the final quarter of the year, the intensification of the global financial crisis caused a loss of confidence and further reduction in the availability of credit that led to a sharp 1.6 per cent drop in GDP, in line with falls in activity across advanced

economies, and much greater than that forecast in the 2008 Pre-Budget Report. Overall, GDP and growth slowed from 3 per cent in 2007 to ¾ per cent in 2008.

**B.36** Monthly output indicators and private business surveys suggest that the first quarter of 2009 saw a similarly sharp fall in output to that seen at the end of 2008. Industrial production fell by 2.7 per cent in January and 1.0 per cent in February, while service sector output was down by 1.3 per cent in the three months to January. On average, the purchasing manager surveys compiled by the Chartered Institute of Purchasing and Supply indicate some slowing in the rate of decline of activity during the first quarter of 2009, though the surveys remain at historically very low levels. The preliminary ONS estimate for GDP growth in the first quarter will not be published until Friday 24 April.

**Inflation B.37** Consumer price inflation peaked at 5.2 per cent in September 2008. As commodity prices have fallen, inflation has eased in line with the Pre-Budget Report forecast. CPI inflation was 2.9 per cent in March, while RPI inflation was -0.4 per cent. The unusually large difference between these two measures mainly reflects the impact of monetary policy easing on the cost of servicing mortgages, with the mortgage interest payment component of RPI inflation falling more than 40 per cent on a year earlier.

**B.38** Within CPI inflation, the price of petrol and the first effects of recently announced cuts in household energy bills have subtracted from overall inflation. Food price inflation has eased from its peak last summer, but remained high, partly reflecting the impact of sterling depreciation on the cost of imported food products.<sup>4</sup> Goods prices excluding food and energy fell by 3.7 per cent in the year to December, and have since risen, but still registered an annual fall of 1.5 per cent in March. Services price inflation peaked in December 2008, and has since eased to 3.9 per cent.

**Nominal demand growth B.39** With inflation easing and real GDP contracting sharply, growth of money GDP – the value of final goods and services produced across the economy – has slowed significantly. In 2008, money GDP grew by 3 per cent, the smallest increase in the post-war period, with the economy contracting in nominal terms in the third and fourth quarters. The biggest contributor to the downturn in nominal demand was investment, particularly in dwellings where the price and volume of investment have both fallen sharply.

**Labour market developments B.40** As the economy turned down through 2008, and companies' finances came under pressure, the labour market weakened. Unemployment has increased relatively sharply, particularly in recent months. While the employment rate has fallen over the past year, the impact of the downturn on the level of total employment has been more muted than that on full-time employee jobs. The Workforce Jobs Survey points to manufacturing, distribution and business services as the sectors where the number of jobs has fallen most. By contrast, employment in the education, health and social work sectors continues to grow. Economic inactivity has remained broadly stable, and has continued to fall once growth in the number of students is taken into account.

**B.41** Average earnings growth has slowed over the past year, particularly measures that include bonus payments. The experimental Average Weekly Earnings data point to a very sharp fall in earnings in the financial sector, which were down 27 per cent on a year earlier in January 2009 due to a 53 per cent fall in average bonus payments.

**Property markets B.42** The impact of the credit shock on the UK's property markets remains severe, with residential and commercial property prices continuing to fall and activity in both markets reaching historically low levels. House prices, according to the main lenders' indices, have

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<sup>4</sup> At the producer level, the price of imported meat products increased by 18 per cent in the year to March 2009 and imported fruit and vegetables by 33 per cent.

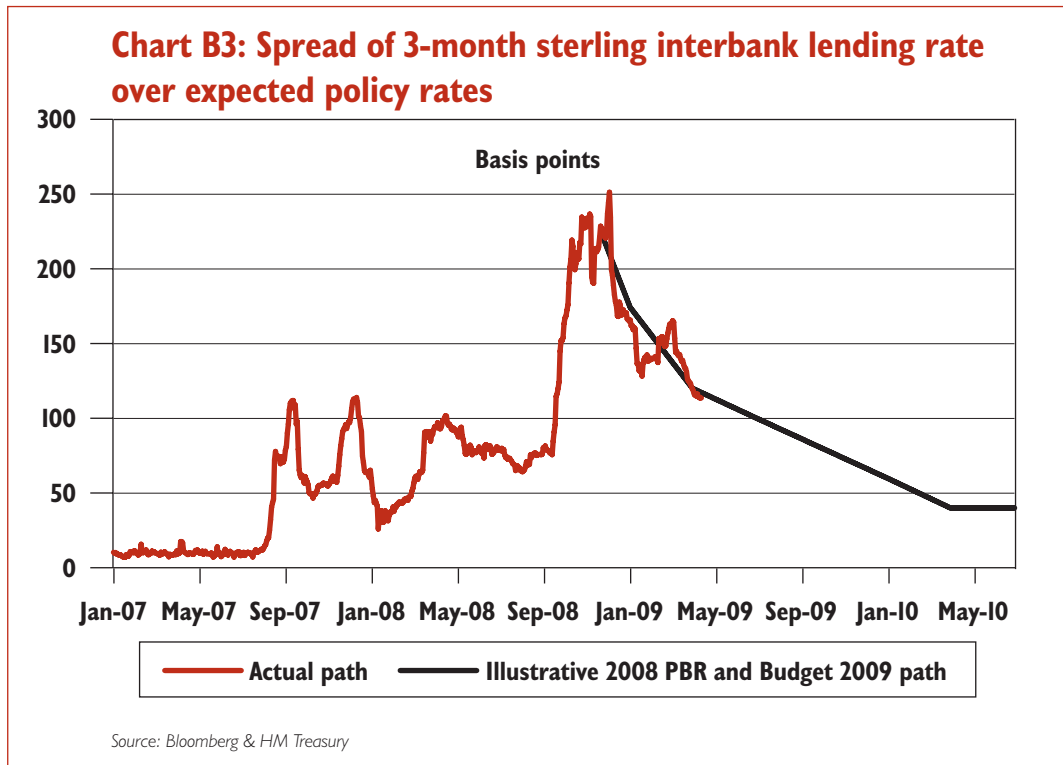
fallen by around 20 per cent since peaking in late 2007, while commercial property prices have declined by more than 40 per cent. The volume of property transactions has fallen by around two thirds over the same period. Mortgage approvals in February 2009 were 11,000 up from their low of 27,000 in November 2008, but remain at historically low levels, down 93,000 from their November 2006 peak.

**Sterling B.43** Since the disruption to global financial markets began in July 2007, sterling has depreciated by around 25 per cent in effective terms. That depreciation has been associated with a wide range of factors, including monetary easing, disruption in the financial sector, downward revisions to UK growth prospects, and higher risk premia demanded on sterling assets.

### Prospects for credit conditions

**Forecasting judgement B.44** The 2008 Pre-Budget Report forecast was conditioned on the assumption that credit conditions would ease slowly through 2009 and stabilise in 2010. This forecasting judgement was illustrated using the spread between interbank lending rates and expected policy rates, noting that this measure can capture only the price dimension of factors influencing credit conditions, and in illiquid markets is likely to be an imperfect indicator of that dimension. For example, sterling corporate bond spreads, another indicator of the price of credit for companies, have not followed the same path since the Pre-Budget Report, with corporate bond yields having typically fallen by less than government bond yields, increasing the spread.

**B.45** Since the Pre-Budget Report, further action to address problems in the financial system, described in Chapter 3, has delivered further easing of interbank lending spreads, consistent with the Pre-Budget Report assumption. In addition, the latest Bank of England *Credit Conditions Survey* points to the expectation among lenders that credit conditions will ease in the coming three months, again consistent with the Pre-Budget Report assumption. The Budget 2009 economic forecast is therefore conditioned on an unchanged assumption that credit conditions will ease slowly through 2009 and stabilise in 2010 at a level where risk is more appropriately priced. The forecast assumes that the Government's interventions to improve the flow of credit in the economy ensure that a sufficient volume of credit will be available to support economic recovery.



### Assessment of trend growth

**B.46** This section sets out the revised Budget 2009 forecast assumptions on trend output, which build on the judgement taken at the 2008 Pre-Budget Report that the global credit shock would lead to a permanent loss of trend output of around 4 per cent by mid-2009. This was highlighted as a key forecasting judgement around which there was very considerable uncertainty, and which would be kept under review.

**Global credit shock and trend output**

**B.47** The 2008 Pre-Budget Report noted that there are a number of ways in which the global credit shock could affect trend output, including the effect of a higher cost of credit on the level of capital and the impact of a reduction in the supply of credit on the efficient allocation of resources.<sup>5</sup> Box B4 draws on a range of external commentary and analysis, much of which has been published since the Pre-Budget Report, that has provided further evidence to inform the Treasury’s approach.

<sup>5</sup> See Box A4 of the 2008 Pre-Budget Report.

**Box B4: Analysis of recent economic shocks and the supply-side**

Box A4 of the 2008 Pre-Budget Report set out a number of ways in which the global credit shock might affect the prospects for trend output. In particular, increases in risk premia are likely to increase the cost of capital. As set out in OECD analysis,<sup>a</sup> this is likely to bring about a downward adjustment in the stock of capital in the economy, and so a reduction in the capital to labour ratio, reducing the level of trend productivity.

The potential impact of the global credit shock on the sustainable level of the capital stock has been identified by a number of external commentators. In its latest *Economic Review*, the National Institute for Economic and Social Research (NIESR) suggest that “*The recent downturn has been associated with a rise in risk premia and hence a reduction in the equilibrium capital stock... In gauging the long-run sustainable level of output, we have to estimate how much the equilibrium capital stock will change*”.<sup>b</sup> NIESR estimate that the increase in risk premia may reduce the level of sustainable output by around 2 per cent. Similarly, the European Commission has noted that “*both the increase in the capital cost and a tightening of credit to private households is expected to have a medium-run effect on the capital stock*”.<sup>c</sup>

More generally, a reduced supply of credit is likely to impair the pivotal role that the financial system plays in intermediating funds from savers to investors and spreading concentrations of risk. Recent OECD analysis notes that the financial market shock could adversely affect trend productivity through “*impairing the efficient allocation of capital*”.<sup>d</sup>

In addition, financial sector employment, earnings and profits are expected to fall as a result of the global financial crisis. While the sector is expected to resume stronger growth, it is likely to make up a smaller share of the economy for the foreseeable future, reducing its contribution to whole economy productivity. In particular, to the extent that the financial sector has generally observed higher than average levels of measured productivity, a reduction in the relative size of the sector will have implications for the level of trend productivity as resources are reallocated to other sectors. Recent estimates produced by NIESR<sup>e</sup> suggest that the adjustment of the financial sector may reduce the sustainable level of whole economy output by around 2 per cent.

<sup>a</sup> *The implications of supply-side uncertainties for economic policy*, OECD Economic Outlook No.83, June 2008.

<sup>b</sup> *Prospects for the UK Economy*, Kirby, S., Barrell, R. and Pillonca, V. in NIESR Economic Review Vol.207, January 2009.

<sup>c</sup> *Economic Forecast*, European Commission, Autumn 2008.

<sup>d</sup> *The Macroeconomic Consequences of Banking Crises in OECD Countries*, Haugh, D., Olivaud, P. and Turner, D., OECD Working Paper No.683, March 2009.

<sup>e</sup> *Commentary: Growth prospects and financial services*, Weale, M. in NIESR Economic Review Vol.207, January 2009.

**B.48** For the 2008 Pre-Budget Report, a phased reduction in the level of trend productivity, and therefore the level of trend output, of 4 per cent was assumed. Since then, it has become clear that the impact of the global financial crisis on economic activity has been more severe than expected, which could have further implications for trend output. In particular, it is likely that the effects of the financial market shock on trend productivity, as set out in Box B4, have intensified relative to the assessment set out in the 2008 Pre-Budget Report, suggesting that a somewhat larger adjustment to trend productivity would be appropriate.

**Trend population growth B.49** The Pre-Budget Report also noted uncertainties around prospects for trend population growth related to prospects for net migration. While recent outturns have been somewhat above the assumption of 190,000 a year set out by the Treasury alongside the 2006 Pre-Budget Report, a sharper recession may be associated with significantly weaker net migration over the next few years. Net migration into the UK has typically fallen following previous recessions, and while estimates for net migration in 2008 are not yet available, recent administrative data relating to

National Insurance applications from overseas nationals and applications to the Worker Registration Scheme from A8 citizens<sup>6</sup> point to a slowdown in gross inflows during 2008.

**B.50** It is unclear whether such a reduction would be indicative of cyclical or more structural factors, but, while net migration flows are likely to recover over the medium term, it is unlikely that they would fully offset the reduction in the trend population level brought about by weaker net inflows in the shorter term. Accordingly, the Treasury has adjusted down the population component of trend output by around ½ per cent over the three years between mid-2007 and mid-2010. This adjustment brings the Treasury's net migration assumption for this period broadly into line with the average level of net migration underpinning the ONS 2006-based low migration variant population projection,<sup>7</sup> and is consistent with recent estimates of the impact of a weaker outlook for economic activity on net inflows.<sup>8</sup>

### Forecasting judgement

**B.51** Table B2 sets out the Treasury's Budget 2009 projection for trend output. Taken together, the projections for the underlying trend output components imply a downward adjustment to the trend level of output of around 5 per cent between mid-2007 and mid-2010, a period broadly consistent with the credit conditions assumption that underpins the economic forecast more generally. This judgement is subject to considerable uncertainty, and will be kept under review. Beyond this period of adjustment, trend growth is projected to continue at 2¾ per cent a year, as the capacity of the flexible and open UK economy to reallocate resources and grow from this reduced level of trend output remains intact.

**B.52** This adjustment is within the range of external estimates of the impact of the global credit shock on medium-term potential output. In the Institute for Fiscal Studies' Green Budget, it stated "*the credit crunch will reduce the productive potential of the economy by about 4 per cent*", noting that "*there are upside risks too. In particular, there may be positive supply-side responses to the shocks, which would reduce the loss of productive potential*".<sup>9</sup> Recent analysis by NIESR suggests that the shock may have reduced the level of trend output in the UK by around 4 per cent, taking into account both the impact on sustainable output of higher risk premia and the adjustment of the financial sector.<sup>10</sup> Research by the OECD suggests that the shock may have reduced trend output by around 3 to 6 per cent in the euro area and 1½ to 2 per cent in the US,<sup>11</sup> although it is not clear the extent to which the authorities in these countries have taken into account the impact on the supply-side.<sup>12</sup>

<sup>6</sup> The 'A8' refers to the eight Central and Eastern European countries – the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia – that joined the EU in May 2004 alongside Cyprus and Malta, whose citizens already had the right to work in the UK.

<sup>7</sup> See [www.gad.gov.uk](http://www.gad.gov.uk). The ONS will publish updated (2008-based) population projections in autumn 2009.

<sup>8</sup> *Projections of migration inflows under alternative scenarios for the UK and world economies*, Department for Communities and Local Government, April 2009.

<sup>9</sup> *The IFS Green Budget*, Institute for Fiscal Studies, January 2009.

<sup>10</sup> *Prospects for the UK Economy*, Kirby, S., Barrell, R. and Pillionca, V., and *Commentary: Growth prospects and financial services*, Weale, M., in NIESR Economic Review Vol.207, January 2009. NIESR estimate that the increase in risk premia may reduce the level of sustainable output by around 2 per cent, while the adjustment of the financial sector may reduce sustainable output by a further 2 per cent.

<sup>11</sup> *The implications of supply-side uncertainties for economic policy*, OECD Economic Outlook No.83, June 2008.

<sup>12</sup> For example, the US administration has maintained an average growth assumption of around 2.7 to 3 per cent over the medium term in forecasts published since 2007. See *Economic Report of the President*, available at <http://www.gpoaccess.gov/eop/download.html>

**Table B2: Contributions to trend output growth<sup>1,2</sup>**

	Estimated trend rates of growth, per cent per annum, unless otherwise stated					
	Trend output per hour worked <sup>3,4</sup>		Trend average hours worked <sup>4</sup>	Trend employment rate <sup>4</sup>	Population <sup>5</sup>	Trend output
	Underlying	Unadjusted				
	(1)	(2)	(3)	(4)	(5)	(6)
<b>1986Q2 to 1997H1</b>						
Budget 2008	2.12	1.93	-0.11	0.37	0.26	<b>2.46</b>
PBR 2008 and Budget 2009	2.13	1.95	-0.11	0.36	0.26	<b>2.47</b>
<b>Over the recent past</b>						
<b>1997H1 to 2001Q3</b>						
Budget 2008	2.86	2.61	-0.45	0.49	0.51	<b>3.17</b>
PBR 2008 and Budget 2009	3.12	2.87	-0.46	0.50	0.52	<b>3.45</b>
<b>2001Q3 to 2006H2</b>						
Budget 2008	2.26	2.21	-0.31	0.09	0.75	<b>2.76</b>
PBR 2008 and Budget 2009	2.12	2.07	-0.26	0.11	0.75	<b>2.68</b>
<b>Projection<sup>6</sup></b>						
<b>2006H2 onwards</b>						
Budget 2008	2.25	2.30	-0.25	-0.1	0.8	<b>2¾</b>
PBR 2008	2.25	2.30	-0.25	-0.1	0.8	<b>2¾</b>
Level effect: 2007Q3 to 2009Q3 <sup>7</sup>	-4	-4	0	0	0	<b>-4</b>
Budget 2009 <sup>8</sup>	2.25	2.30	-0.25	-0.1	0.8	<b>2¾</b>
Level effect: 2007Q3 to 2010Q3 <sup>8,9</sup>	-4½	-4½	0	0	-½	<b>-5</b>

<sup>1</sup> 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.

<sup>2</sup> Interim projections between Budget 2002 and PBR 2007 are provided in an expanded table in 'Budget 2008: the economy and public finances – supplementary material'.

<sup>3</sup> 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.

<sup>4</sup> The decomposition makes allowances for employment and hours worked lagging output. Employment is assumed to lag output by around three quarters, so that on-trend points for employment come three quarters after on-trend points for output, an assumption which can be supported by econometric evidence. Hours are easier to adjust than employment, and the decomposition assumes that average hours worked lag output by just one quarter, though this lag is harder to support by econometric evidence.

<sup>5</sup> UK resident household basis. Population aged 16 and over.

<sup>6</sup> Neutral case assumptions for trend from 2006H2.

<sup>7</sup> Adjustment reflecting a phased reduction to the level of trend output of around 4 per cent between mid-2007 and mid-2009.

<sup>8</sup> Underlying trend assumptions around which the mid-points of the GDP forecast growth ranges from 2006H2 are anchored.

<sup>9</sup> Adjustment reflecting a phased reduction to the level of trend output of around 5 per cent between mid-2007 and mid-2010.

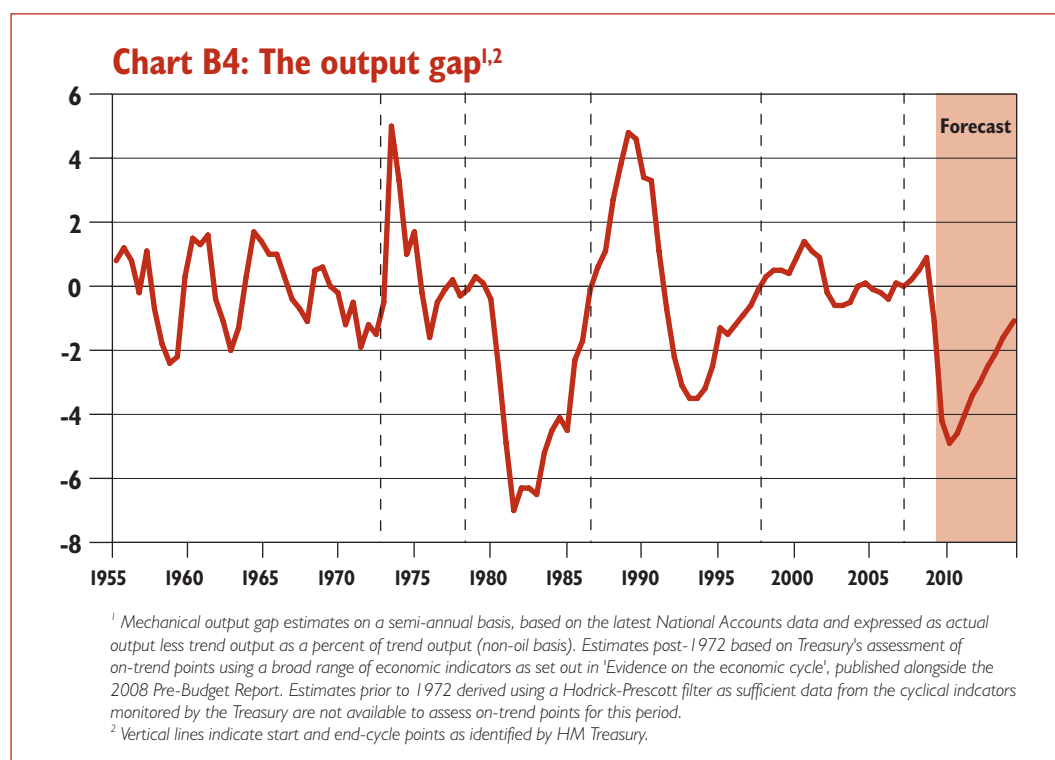
## Assessment of the output gap

**Latest National Accounts data B.53** Since the 2008 Pre-Budget Report, minor revisions to ONS estimates of non-oil GVA growth from 2007, and the release of estimates for the final quarter of 2008, indicate that growth slowed to below-trend rates in the first half of 2008, before contracting sharply in the second half of the year. Taken together with the Budget 2009 trend output assumptions, this implies a negative output gap of around 2 per cent had opened up by the end of 2008.

**Evidence from the cyclical indicators B.54** Given the degree of judgement inherent in the forecasting assumption on trend output, there is a significant degree of uncertainty surrounding the current mechanical estimates of the output gap. Evidence drawn from the cyclical indicators monitored by the Treasury has therefore been used to corroborate the latest assessment of the cyclical position of the economy. The cyclical indicators suggest the economy fell back towards trend during

the first half of 2008 and below trend during the second half of the year, to a degree consistent with the output gap implied by the latest data and Budget 2009 trend output assumptions:

- capacity utilisation indicators from the British Chambers of Commerce moved slightly below their long-term averages by the end of 2008, while those from the Confederation of British Industry (CBI) and the Bank of England's Regional Agents are consistent with a larger degree of spare capacity having opened up. It is possible that survey indicators may currently overstate the degree of spare capacity if companies have yet to adjust expectations of normal levels of operation to the possible impact of the global financial crisis on the wider economy; and
- survey indicators of recruitment conditions reported further falls in the final quarter of 2008, suggesting that a significant degree of slack in the labour market has opened up. The unemployment rate has increased from 5¼ per cent at the end of 2007 to 6¼ per cent at the end of 2008, and has risen further in 2009. Demand for labour has dropped, with the number of vacancies in the economy declining from the peak of almost 700,000 in early 2008 to below 500,000.



**GDP forecast**

**Macroeconomic stimulus**

**B.55** Since the global financial crisis hit, and in light of the range of evidence that has built since the Pre-Budget Report of its severe impact on the economy, the Bank of England has cut Bank Rate by a total of 4½ percentage points to ½ a per cent, the lowest rate in the 315-year history of the Bank. As set out in Chapter 2, with Bank Rate approaching zero, the Government authorised the use of a new instrument by the Bank, to provide further monetary policy support to the economy and ensure that the Government's 2 per cent inflation target can be met. This allows the Bank to influence the quantity of money in the economy through the purchase of government debt and private sector assets. In March, the Monetary Policy Committee initiated a three-month programme to purchase £75 billion of assets. Public sector

net borrowing has also increased significantly to provide support for the economy through discretionary fiscal action and the full operation of the automatic stabilisers. From 2.4 per cent of GDP in 2007-08, public sector net borrowing increased to 6.3 per cent of GDP in 2008-09, cushioning the economy from the impact of a similarly large downward adjustment to private sector borrowing.

**Forecasting judgement B.56** The Budget 2009 economic forecast reflects the balance of key forecasting considerations relating to the strength of the negative effect of the global financial crisis and private sector retrenchment, and the positive effect of large-scale macroeconomic support, both domestically and internationally, on growth. The effects of lower commodity prices and sterling depreciation will further support demand. The forecast is also underpinned by the assumption that G20 authorities deliver on policy commitments and that they are effective, so that the world economy is forecast to grow by 2½ per cent in 2010, picking up further to 4¼ per cent in 2011.

**B.57** In the near term, the negative effects of the steep downturn in global and domestic demand will dominate, with prospects for 2009 revised down substantially since the 2008 Pre-Budget Report. The forecast is based on the judgement that the effects of macroeconomic stimulus increasingly to take hold, driving recovery in demand and output in the UK and globally.

**Table B3: Summary of UK forecast**

	2007	2008	Forecast		
			2009	2010	2011
<b>GDP growth (per cent)<sup>1</sup></b>					
Upper end of forecast range			-3¼	1½	3¾
<b>Economic forecast</b>	<b>3</b>	<b>¾</b>	<b>-3½</b>	<b>1¼</b>	<b>3½</b>
Forecast underpinning public finance projections			-3¾	1	3¼
<b>CPI inflation (per cent, Q4)</b>	<b>2</b>	<b>4</b>	<b>1</b>	<b>1</b>	<b>2½</b>

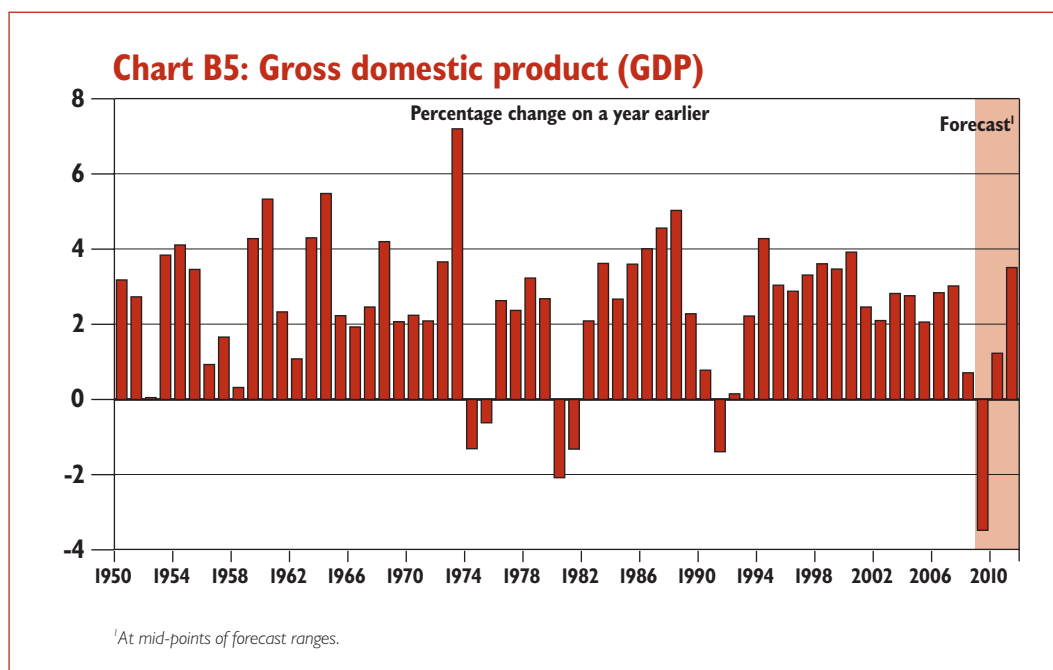
<sup>1</sup> See footnote to Table B9 for explanation of different growth assumptions.

**GDP growth B.58** GDP growth slowed to ¾ per cent in 2008, in line with the 2008 Pre-Budget Report forecast, but the contraction of 1.6 per cent in the final quarter was steeper than expected. The Pre-Budget Report forecast was consistent with GDP contracting by around ¾ per cent in the final quarter. With output contracting more sharply than expected at the end of 2008, and private business survey indicators suggesting a similar rate of contraction in the first quarter of 2009, GDP in 2009 as a whole is set to fall sharply. The Budget 2009 economic forecast is for a contraction of 3½ per cent, much worse than the 1 per cent contraction forecast in the Pre-Budget Report.

**B.59** The depth of the recession is therefore forecast to be greater than previously expected but, with significant further policy support, both domestically and internationally, the conditions for sustained recovery are judged to be in place. GDP is forecast to contract sharply in the first half of 2009, by 4 per cent on a year earlier, to stabilise in the second half of the year, and then to pick up progressively through 2010 and 2011 as credit conditions normalise and the lagged effects of significant monetary policy support and the depreciation of sterling take hold. For the economic forecast, GDP growth is forecast to pick up to 1¼ per cent in 2010 as a whole, and to above-trend rates of 3½ per cent in 2011.

**B.60** The forecast is presented in Table B3 within ½ percentage point ranges, based on alternative assumptions about supply-side performance of the economy. The public finance

projections are based on the lower end of the range, where GDP is forecast to contract by 3¼ per cent in 2009, before recovering to 1 per cent in 2010 and 3¼ per cent in 2011.



**Comparison with past recessions B.61** By comparison with the recessions of the early 1980s and early 1990s, the current downturn is forecast to be much deeper than that of the early 1990s, but not as deep as that of the early 1980s. In total, GDP is forecast to have contracted by 4½ per cent by late 2009, compared with a fall of 6 per cent in the early 1980s and 2½ per cent in the early 1990s.

**B.62** Comparing the expected shape of the current recession with past recessions is of limited value without also considering the ways in which the causes of each, and the policy response to them, differ:

- the shocks that caused the current recession hit when the UK economy was judged to be operating close to trend, inflation was close to target and interest rates were below 6 per cent. This contrasts with the late 1970s oil price shock, and the late 1980s overheating domestic economy, which generated high inflation and, because inflation expectations were poorly anchored, high wage inflation. In order to bring inflation under control, interest rates were raised sharply, peaking at 17 per cent in 1980 and 15 per cent in 1990; and
- the degree of macroeconomic stimulus in place at an early stage of the current recession is of a different order of magnitude to that in either the 1980s or 1990s recessions. Compared with the month prior to the first quarter of falling GDP, sterling oil prices are down 50 per cent, Bank Rate has been cut 4½ percentage points and sterling has depreciated by around 16 per cent, each well in excess of the change over the first nine months of the previous two recessions. In addition, the increase in public sector net borrowing has been significantly larger, providing greater support to the economy at a time when the private sector is retrenching.

**B.63** The extent of macroeconomic stimulus, and the assumption that this stimulus progressively takes hold during 2009 and 2010, underpins the Budget 2009 forecast for an earlier, more sustained and stronger recovery than seen in the 1980s or 1990s. Experience of those recoveries points to the possibility that recovery can deliver strong growth rates for a

number of years as spare capacity is brought back into productive use. For example, as Chart B5 shows, GDP growth was strong in the five years from 1982 and again in the five years from 1993, averaging 3¼ per cent a year. While there is considerable uncertainty over the extent to which the current downturn will ultimately prove to have been the result of cyclical or structural factors, it is clear that considerable spare capacity is likely to have emerged during the second half of 2008 and 2009.

## Inflation forecast

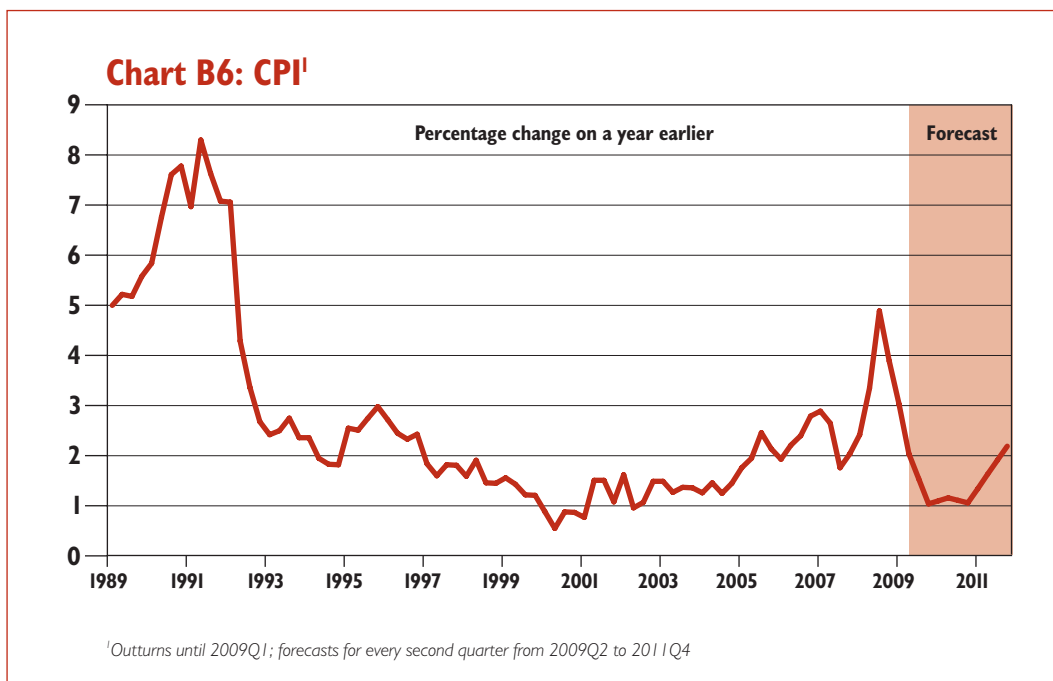
**B.64** Inflation will be subject to a number of strong forces over the forecast horizon, with the large negative output gap exerting significant downward pressure on prices and wages, while the lagged effects of sterling's depreciation will put upward pressure on import costs, and monetary policy remains extremely supportive. Very low interest rates are also having a significant impact on the RPI measure of inflation, which includes mortgage interest payments. Given these strong opposing influences, the inflation forecast is subject to significant uncertainty.

**CPI inflation B.65** CPI inflation is forecast to continue to ease through 2009, moving well below target by the end of the year as the downward pressure from increasing spare capacity and lower energy prices more than offsets upward pressure from the pass-through of higher import prices, and before the lagged effects of recent monetary policy easing fully take hold. Recent evidence suggesting that an increased proportion of companies have decided to freeze pay in 2009 is indicative of the likely impact of spare capacity on inflationary pressure.<sup>13</sup> CPI inflation is projected to pick up slightly through late 2009 and early 2010 as the forecast assumes retailers will smooth the pass-through of the pre-announced return of the VAT rate to 17½ per cent as other cost and demand factors evolve. CPI inflation is forecast to remain below target during 2010 when the negative output gap is forecast to peak, though downward pressure on inflation is countered by monetary policy support further taking hold. CPI inflation is forecast to return close to target during 2011 as the lagged effects of monetary policy easing, described in Box B5, are assumed to have their maximum impact.

**RPI inflation B.66** As well as being subject to the same influences as CPI inflation, the RPI measure of inflation will be subject to additional downward pressures during 2009. Further declines in house prices and the lagged feed-through from Bank Rate to mortgage rates will put downward pressure on the measures of housing depreciation and mortgage interest payments included in the RPI. As a result, RPI inflation is forecast to fall further, to -3 per cent in September, but to move back above zero in 2010 as these additional downward pressures recede.

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<sup>13</sup> The IRS pay databank reported 25 per cent of pay deals recorded for January and February 2009 were pay freezes, considerably higher than the previous full-year peak of 9 per cent in 1993, although it is important to note that historical comparisons based on nominal pay deals will not properly reflect developments in real earnings over time.



**Box B5: The Asset Purchase Facility and the economic forecast**

The Monetary Policy Committee (MPC) of the Bank of England announced on 5 March 2009 that, in addition to setting Bank Rate at ½ per cent, it would start to inject money directly into the economy in order to meet the inflation target. The MPC decided that the Bank should purchase £75 billion worth of assets, including gilts and private sector assets, through the Asset Purchase Facility (described further in Chapter 2).

For the purpose of the economic forecast, it has been necessary to make judgements on the impact of quantitative easing on nominal GDP growth. The MPC stated in the minutes of its March 2009 meeting that the February *Inflation Report* projections “suggested a shortfall in nominal GDP of at least 5 per cent”. The Budget 2009 forecast adopts the forecasting assumption that the MPC’s decision to purchase £75 billion of assets, just over 5 per cent of money GDP in 2008, is successful in raising nominal GDP by approximately that amount over the normal horizon over which monetary policy affects inflation and GDP growth.

These forecast judgements are subject to significant uncertainty given the unconventional nature of the policy. Implicitly, these uncertainties can be disaggregated into three steps between asset purchases by the Bank of England, which will increase the quantity of ‘base money’, and nominal GDP:

- the extent to which an increase in ‘base money’, via an increase in commercial banks’ reserves at the Bank of England, feed through to broader lending growth, expressed in terms of the ‘marginal money multiplier’, which will be affected by the Government’s direct interventions in the financial system to improve the flow of lending to creditworthy borrowers;
- the extent to which nominal spending in the economy responds to growth in broader measures of credit, expressed in terms of the ‘velocity of money’; and
- the speed with which these effects take hold, which could differ from the typical lags between changes in Bank Rate and the rate of inflation and GDP growth.

## UK DEMAND AND OUTPUT IN DETAIL

### Rebalancing and macroeconomic adjustment

**B.67** The tightening of credit conditions facing households and companies, and the depreciation of sterling since mid-2007, provide the conditions for a significant rebalancing of demand in the UK economy. This macroeconomic adjustment is likely to entail increased saving by households, increased investment by companies as they respond to new opportunities, and a rebalancing of domestic and external demand. In the near term, it will involve a significant stock-adjustment cycle in the company sector, and a substantial increase in public sector net borrowing, as set out in Chapters 2 and C, that will have the effect of smoothing the private sector adjustment to a more balanced economy.

**B.68** Developments in the second half of 2008 suggest that this adjustment may be taking place at a more rapid pace than expected. Compared with the 2008 Pre-Budget Report forecast, the second half of 2008 saw a slightly larger than expected fall in consumer spending but a slightly smaller than expected fall in investment. Reflecting the downturn in world trade, both exports and imports fell sharply, but imports fell further, beginning to rebalance demand between domestic sources and net exports. In terms of the contributions to growth, the largest difference between the Pre-Budget Report forecast and the latest ONS estimates was in inventory accumulation. Firms have cut inventories substantially, especially in the final quarter, pointing to a relatively swift downward adjustment of production and inventories in the face of falling demand, indicative of a flexible economy responding quickly to changed circumstances.

**B.69** Table B4 sets out the contributions to growth through the forecast period. In the near term, there is a significant positive contribution from government spending, both consumption and investment, during 2009 and 2010. In 2011, government gives way to private sector sources of demand, as consumption and business investment pick up. Net exports are forecast to contribute positively throughout the forecast, as the rebalancing of demand between domestic and external sources continues. Over the forecast horizon, the positive contribution to growth from net trade is similar to that seen between 1993 and 1995, a period that also followed a significant sterling depreciation.

**Table B4: Contributions<sup>1</sup> to GDP growth<sup>2</sup>**

	Percentage points, unless otherwise stated					
	Average 2000 to 2006	2007	2008	Forecast		
				2009	2010	2011
<b>GDP growth, per cent</b>	<b>2¾</b>	<b>3</b>	<b>¾</b>	<b>-3¾ to -3¼</b>	<b>1 to 1½</b>	<b>3¼ to 3¾</b>
<b>Main contributions</b>						
Private consumption	2	2	1	-2	¼	2¼
Business investment	¼	1	0	-1¼	-½	1
Dwellings investment <sup>3</sup>	¼	0	-¼	-½	-¼	¼
Government <sup>4</sup>	¾	½	1	1	¼	-¾
Change in inventories	0	¼	-½	-1	1	0
Net trade	-¼	-¾	¼	½	½	½

<sup>1</sup> Based on central case. For the purpose of projecting public finances, forecasts are based on the bottom of the GDP forecast range.

<sup>2</sup> Components may not sum to total due to rounding and omission of transfer costs of land and existing buildings and the statistical discrepancy.

<sup>3</sup> The sum of public corporations and private sector investment in new dwellings and improvement to dwellings.

<sup>4</sup> The sum of government consumption and general government investment.

## Households and consumption

**B.70** Household consumption is the largest expenditure component of demand, accounting for just over 64 per cent of nominal GDP in 2008. Having trended lower over the preceding five years, the share of nominal consumer spending in total demand increased slightly during 2008 as energy and food prices rose sharply, and tighter credit conditions and demand uncertainty weighed on investment spending.

**Table B5: Household sector<sup>1</sup> expenditure and income**

	Percentage change on a year earlier, unless otherwise stated					
	Average 2000 to 2006	2007	2008	Forecast		
				2009	2010	2011
Household consumption <sup>2</sup>	3	3	1¼	-3¼ to -2¾	0 to ½	3 to 3½
Real household disposable income	2¾	¼	2¼	-1¼ to -¾	¼ to ¾	2¾ to 3¼
Saving ratio <sup>3</sup> (level, per cent)	4¾	2¼	2	4½	5	5½

<sup>1</sup>Including non-profit institutions serving households.

<sup>2</sup>Chained volume measures.

<sup>3</sup>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.71** Real disposable income growth picked up from ¼ per cent in 2007 to 2¼ per cent in 2008, which, on current estimates, is significantly above the 2008 Pre-Budget Report forecast. Real income growth was reported to have been particularly strong in the final quarter of 2008. The latest National Accounts data suggest that monetary policy easing, the increased income tax personal allowance, and the automatic stabilisers, have begun to provide significant support for household income as the recession impacts on growth of employment and earnings. Overall, nominal disposable income is estimated to have grown by £14½ billion on a year earlier, of which wages and salaries contributed £4½ billion, lower net interest payments £4½ billion, and the combination of higher net social transfers, both public and private, and lower tax payments £8 billion.<sup>14</sup>

**B.72** Real disposable income is forecast to contract in 2009, reflecting the balance of strong upward and downward influences. Monetary and fiscal support, and the operation of the automatic stabilisers, will lift incomes, but will be more than offset by weakness in labour income, particularly in the financial sector. Real income growth is forecast to pick up in 2010 and 2011, as labour income recovers.

**Consumer spending B.73** Consumer spending growth slowed from 3 per cent in 2007 to 1¼ per cent in 2008, slightly below the 2008 Pre-Budget Report forecast. Consumer spending began contracting in the second quarter of the year, and fell ¾ per cent in the second half of 2008 compared with the first half. In volume terms, relatively steep declines were seen in discretionary items such as cars, down 8¾ per cent on a year earlier, furniture and household goods, 5½ per cent, and restaurants and hotels, 2¼ per cent, and in those items where prices had increased most substantially such as food, 2½ per cent, and vehicle fuels, 5 per cent.

**Saving ratio B.74** With consumer spending having declined progressively through 2008, and estimated real income growth picking up, the saving ratio is currently estimated to have risen rapidly from a low of -1¼ per cent in the first quarter to 4¾ per cent by the final quarter of the year. On average, the saving ratio in 2008 was 2 per cent, above the 2008 Pre-Budget Report forecast. As noted in the Pre-Budget Report, estimates of the saving ratio can be revised quite heavily as

<sup>14</sup> The difference between the sum of these three sources of income and the total is largely accounted for by households' gross operating surplus and mixed income, which fell in the year to the final quarter of 2008.

new data on income and spending become available. The pace and extent of the adjustment currently reported are therefore subject to considerable uncertainty.

**Prospects B.75** Consumer spending is forecast to continue contracting in 2009, and by 3 per cent in the year as a whole. With the temporary cut in the standard rate of VAT to be reversed in January 2010, consumers are assumed to bring forward some spending from early 2010 to late 2009 in order to capitalise on lower prices. Consumer spending is therefore forecast to dip early in 2010 before recovering through the year. This forecast recovery is towards the upper end of external forecasts, reflecting a judgement that monetary policy stimulus and support to incomes from discretionary fiscal action and the automatic stabilisers will feed through to a stronger recovery in consumer spending than some forecasters assume. However, in 2010 and 2011, growth of consumer spending is still forecast to be slightly below that of GDP as a whole, reflecting the ongoing rebalancing of domestic demand in the economy as households adjust their finances and increase saving to more sustainable rates. As such, the saving ratio is forecast to pick up further in 2010 before settling close to the average ratio of the past 20 years in 2011.

## Housing

**House prices B.76** A range of factors will affect prospects for house prices. In terms of affordability, the 20 per cent decline in prices since late 2007 reported by the main lenders has reduced the ratio of house prices to average incomes while the sharp reduction in interest rates has fed through to lower mortgage interest payments. Total household sector interest payments were only 3.4 per cent of disposable income in the final quarter of 2008, the lowest since at least 1987.<sup>15</sup> However, the availability of credit remains constrained with average deposits made by first-time buyers at historical highs.

**B.77** On average, external forecasters expect the adjustment in house prices to continue this year, predicting house prices to be down by 12 per cent on a year earlier by the end of 2009. (Most forecasts refer to the lenders' indices rather than the official CLG measure.) There is a broad range of views over prospects for 2010, with the average independent forecast pointing to house prices stabilising during the year. Consistent with the 2008 Pre-Budget Report assumption, house prices are expected to recover through 2010 and are then assumed to grow at rates slightly above average earnings growth, supported by buyers who have delayed purchases returning to a housing market characterised by restricted supply.

**Investment in dwellings B.78** Dwellings investment grew by 2¾ per cent in 2007 as a whole, reflecting strong growth at the start of the year but declines in activity thereafter. As the availability of mortgage lending tightened through 2008, and expectations of further house price falls formed, dwellings investment contracted sharply through 2008, by 10¾ per cent in the year as a whole, including 4¾ per cent quarterly falls in the third and fourth quarters of the year. With turnover in the housing market particularly weak in 2008, household spending on the costs associated with house purchase – surveyors' fees, estate agents' commissions, etc – fell very sharply, down 46 per cent on a year earlier to the lowest level since 1986. As orders for housing construction continue to fall, dwellings investment is forecast to be particularly weak in 2009 and to contract further into 2010. Despite this significant decline, the adjustment in dwellings investment is forecast to be somewhat smaller than that experienced in the early 1990s recession.

## Companies and investment

**B.79** On conventional measures, business investment accounts for around 10 per cent of nominal GDP, but its role in the economy extends beyond that, affecting future growth by

<sup>15</sup> Detailed UK National Accounts sectoral income and expenditure data are available from 1987.

raising the amount of physical capital available to each worker with which to produce goods and services. It is a feature of firms' investment spending that it typically exhibits much larger cyclical fluctuations than other components of demand.

**Company finances B.80** Companies can finance investment internally, using the cashflow generated by their operations, or externally, either through bank lending or by issuing equity or debt to investors. Internal sources of finance came under increasing pressure during 2008, with private non-financial corporations' gross operating surplus falling 2 per cent in nominal terms in the second half of the year and bank deposits falling by 6½ per cent between February and December. The flow of lending to companies was on average negative during the second half of the year, while the cost of raising equity or debt finance from financial markets increased significantly. The most recent data for early 2009 show deposit balances and the flow of lending increasing moderately, while corporate bond issuance has increased, although at relatively high spreads over government bond yields.

**B.81** The Bank of England's latest *Credit Conditions Survey* suggests that the very tight credit conditions facing companies may be beginning to ease, while effective interest rates on bank lending to companies have fallen. The Bank's Asset Purchase Facility should, over time, help ease the cost of debt finance for companies, particularly larger companies that are able to issue highly-rated securities. While these factors suggest that credit conditions might become less of a constraint on investment and output, the latest surveys from the CBI suggest the negative impact of credit-related factors on activity is currently large.

**Business investment B.82** Following strong growth of almost 10 per cent in 2007, business investment was flat in 2008 as a whole. On current estimates, by the final quarter of 2008 business investment had declined 4½ per cent on a year earlier. The contraction was particularly sharp in the construction and distribution sectors, with negative growth rates of 37 per cent and 11½ per cent respectively. Manufacturing and service sector surveys conducted by the CBI suggest that uncertainty over demand prospects is the key factor holding back investment, while access to external sources of credit and the availability of internal finance have also been material factors.

**B.83** In the near term, the positive impact of significant macroeconomic stimulus and Government interventions are expected to be dominated by factors depressing investment, particularly uncertainty over demand prospects. Business investment is forecast to contract by 11¼ per cent in 2009. As policy measures take hold, including the temporary investment incentive, and credit conditions ease, partly through measures to ease access to finance for creditworthy borrowers, investment is forecast to recover through 2010 and to grow strongly in 2011 as companies take advantage of new opportunities in a rebalanced UK economy.

**Table B6: Gross fixed capital formation**

	Percentage change on a year earlier					
	Average 2000 to 2006	2007	2008	Forecast		
				2009	2010	2011
Whole economy <sup>1</sup>	3¼	6¾	-3	-11¼ to -10¾	-3¼ to -2¾	6¼ to 6¾
of which:						
Business <sup>2,3</sup>	2¼	9¾	0	-11½ to -11	-4¾ to -4¼	9 to 9½
Private dwellings <sup>3</sup>	4½	2¾	-10¾	-19 to -18½	-12¾ to -12¼	8 to 8½
General government <sup>3</sup>	5¼	6½	17¼	1½	2	-16¾

<sup>1</sup> Includes costs associated with the transfer of ownership of land and existing buildings.

<sup>2</sup> Private sector and public corporations' non-residential investment. Includes investment under the Private Finance Initiative.

<sup>3</sup> Excludes purchases less sales of land and existing buildings.

**Inventories B.84** The downturn in activity in the second half of 2008 prompted companies to undertake a significant adjustment in their stock of inventory. On current estimates, inventories were cut by over £4 billion in the final quarter of 2008, and subtracted 1.6 percentage points from GDP growth in the quarter. Reductions in inventories are forecast to subtract 1 percentage point from growth in 2009 as a whole. As GDP growth is affected by changes in inventory accumulation, rather than changes in the stock of inventory, as the rate of stock adjustment slows and inventories are brought to a desired level, inventory adjustment is forecast to contribute positively to GDP growth. Inventories are therefore forecast to contribute 1 percentage point to growth in 2010.

## Trade and the balance of payments<sup>16</sup>

**B.85** The depreciation of sterling provides the conditions for a rebalancing of domestic and external sources of demand, so that net exports contribute positively to growth. As set out in Box A6 of the 2008 Pre-Budget Report, that rebalancing is likely to be driven by a combination of export competitiveness and import substitution effects, with import substitution expected to dominate while global demand remains weak.

**Exports of goods and services B.86** Export volume growth slowed progressively during 2008 before, in a pattern repeated around the world, contracting sharply in the final quarter. In the year as a whole, the volume of goods and services exports was unchanged on a year earlier. As global trade contracted in the final quarter of the year, the volume of UK exports fell by 3¼ per cent on the previous quarter. Consistent with the global financial crisis having a greater impact on physical goods that require access to credit in order to transport, and with spending on consumer durables and capital equipment falling most sharply, goods exports fell 6¾ per cent while services exports held up. On current estimates, the volume of services exports increased 1 per cent in the final quarter of the year. In value terms, 10 per cent growth of services exports in the final quarter was almost entirely accounted for by a 30 per cent increase in financial services exports, pointing to the possibility of measurement difficulties as the global financial crisis elevated the levels of volatility in financial markets.

**B.87** With world trade forecast to contract sharply in 2009, and GDP in the euro area forecast to fall 4¼ per cent, UK export volumes are forecast to decline by 8¾ per cent in the year as a whole. As the world economy recovers in 2010 and 2011, export growth is forecast to pick up. The depreciation of sterling is assumed to allow the UK to gain export market share through the forecast horizon.

**Imports of goods and services B.88** Import volumes declined marginally in 2008 as a whole, by ½ a per cent on a year earlier, reflecting small falls in the first three quarters of the year followed by a sharp 5¾ per cent drop in the final quarter. As with exports, goods volumes were hit harder than services. Estimated growth in the value of financial services imports in the final quarter was strong, at 13 per cent on the previous quarter.

**B.89** With consumer spending and business investment forecast to contract in 2009 and 2010, the volume of imports is also expected to fall. In line with the recovery in domestic demand, but tempered by the effect of sterling's depreciation on consumers' incentives to substitute domestically produced goods and services for imports, import volumes growth is forecast to pick up through 2010 and 2011.

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<sup>16</sup> The volume of exports and imports in the economic forecast abstracts from the effects of activity related to Missing Trader Intra-Community fraud (MTIC), which significantly inflated the value of measured goods trade in early 2006, 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.

**Net exports B.90** Having subtracted from growth through 2007, net exports contributed positively in each quarter of 2008, with the contribution rising to 0.7 percentage points in the final quarter. In the year as a whole, net exports accounted for a  $\frac{1}{4}$  percentage point of overall GDP growth of  $\frac{3}{4}$  per cent. In 2009, with imports forecast to contract more sharply than exports, net trade is forecast to add  $\frac{1}{2}$  percentage point to GDP growth. Further ahead, the depreciation of sterling is expected to support a rebalancing between domestic and external demand as the UK and world economies recover, with net trade continuing to contribute positively to growth in 2010 and 2011.

**Table B7: Trade in goods and services**

	Percentage points, unless otherwise stated					
	Average 2000 to 2006	2007	2008	Forecast		
				2009	2010	2011
<b>Volumes (excluding MTIC)<sup>1</sup></b>						
Exports	4 $\frac{3}{4}$	1 $\frac{1}{2}$	0	-8 $\frac{3}{4}$ to -8 $\frac{1}{2}$	$\frac{3}{4}$ to 1 $\frac{1}{4}$	4 $\frac{3}{4}$ to 5 $\frac{1}{4}$
Imports	5 $\frac{1}{2}$	3 $\frac{3}{4}$	- $\frac{1}{2}$	-9 $\frac{1}{4}$ to -9	- $\frac{3}{4}$ to - $\frac{1}{4}$	2 $\frac{1}{4}$ to 2 $\frac{3}{4}$
<b>Prices<sup>2</sup></b>						
Exports	1	2 $\frac{1}{2}$	12 $\frac{3}{4}$	2 $\frac{1}{4}$	1 $\frac{1}{4}$	2 $\frac{1}{2}$
Imports	1	1	11 $\frac{1}{4}$	5	4	2 $\frac{3}{4}$
Terms of trade <sup>3</sup>	0	1 $\frac{1}{2}$	1 $\frac{1}{4}$	-2 $\frac{1}{2}$	-2 $\frac{1}{2}$	- $\frac{1}{4}$
<b>Goods and service balance (£ billion)</b>	-30 $\frac{3}{4}$	-47 $\frac{1}{4}$	-44	-49 $\frac{1}{2}$	-56 $\frac{1}{4}$	-49 $\frac{3}{4}$

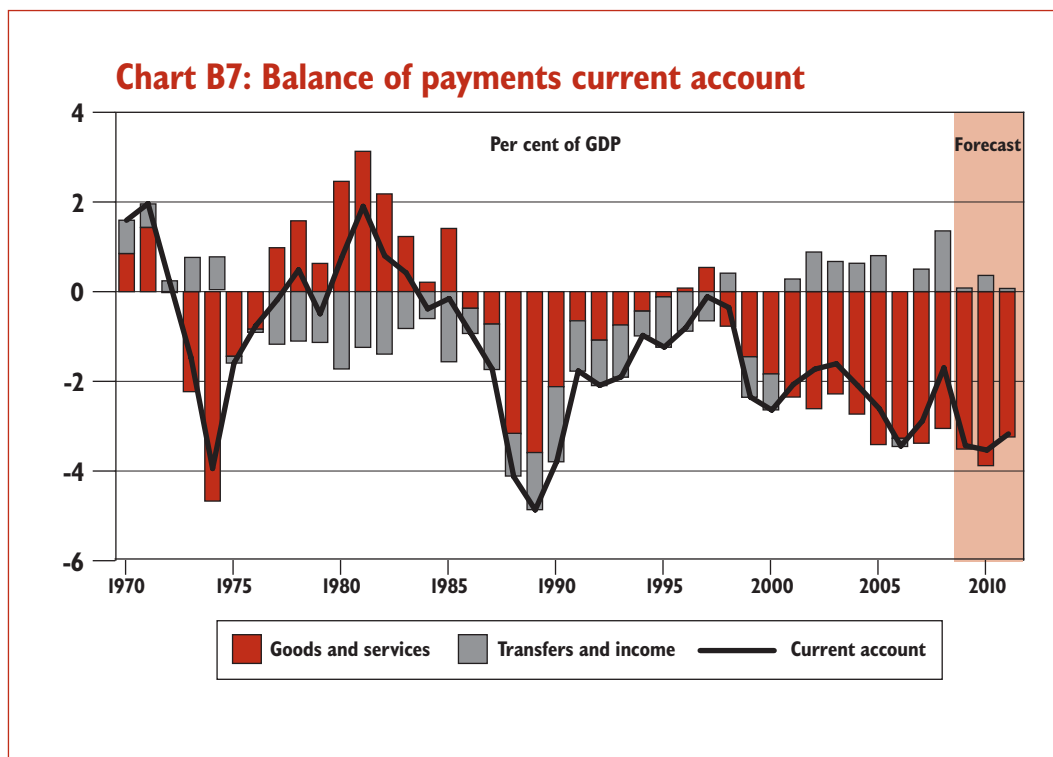
<sup>1</sup> Table B9 contains figures including the effects of MTIC-related activity. The forecast is therefore based on the neutral assumption that the level of MTIC-related activity stays flat at the latest quarterly estimate throughout the forecast.

<sup>2</sup> Average value indices.

<sup>3</sup> Ratio of export to import prices.

**Current account balance B.91** On current estimates, the UK's current account deficit narrowed from 3 $\frac{1}{2}$  per cent of GDP in 2006 and 3 per cent in 2007 to 1 $\frac{3}{4}$  per cent in 2008. Much of the improvement reflected flows related to the financial services industry, adding considerable uncertainty to the underlying trend in the current account balance. For example, while the deficit on trade in goods remained stable at 6 $\frac{1}{2}$  per cent of GDP, the services trade surplus increased from 3 per cent to 3 $\frac{1}{2}$  per cent of GDP due to the rapid growth of financial services exports. The income surplus increased by  $\frac{3}{4}$  percentage points to 2 $\frac{1}{4}$  per cent of GDP due to a large increase in the foreign direct investment (FDI) income surplus to 4 $\frac{1}{2}$  per cent that was partially offset by the balance on portfolio investment earnings turning negative. Measured flows of FDI-related earnings have been affected by the large losses incurred by the world's financial institutions reducing the cross-border flow of repatriated profits. Between the second quarter of 2007, before the credit shock hit, and the final quarter of 2008, FDI-related credits fell from 6 $\frac{1}{2}$  per cent of GDP to 2 $\frac{1}{4}$  per cent while FDI-related debits fell from 3 $\frac{3}{4}$  per cent of GDP to - $\frac{1}{2}$  per cent, the first aggregate loss on record, driven by losses made by foreign banks and securities dealers operating in the UK.

**B.92** As temporary factors related to the financial crisis recede, the income surplus is likely to decline and so the current account deficit is forecast to increase to 3 $\frac{1}{2}$  per cent of GDP again in 2009. Beyond 2010, the deficit is forecast to narrow reflecting the balance of domestic demand in the UK and globally, supported by the lagged import substitution and export competitiveness effects of sterling depreciation.



**Foreign direct investment B.93** Inward and outward flows of FDI to the UK declined substantially in 2008, particularly in the second half of the year as the global credit shock intensified. Comparable figures for the world are not yet available, but are likely to be dominated by cross-border investment flows related to capital raised by financial institutions. For example, FDI flows to the US increased by 37 per cent in 2008, with all of this growth accounted for by increased flows to the financial sector. Relative to GDP, the UK continues to be home to the largest stock of FDI among G7 economies, and to have the largest outward stock of FDI assets. Sterling's depreciation has increased the sterling value of the UK's overseas assets, narrowing the UK's net international liability position to less than 5 per cent of GDP, down from 21 per cent a year earlier and the lowest level since 1996.

## Output sectors

**Services B.94** The services sector grew by 1½ per cent in 2008 as a whole, having slowed progressively since mid-2007 and contracted in the second half of 2008. By the final quarter of 2008, services output was ½ per cent down on a year earlier, though there was contrasting performance across different sub-sectors. With credit availability and lack of confidence constraining the purchase of consumer durables, output fell by 17 per cent on a year earlier in the motor trades sector<sup>17</sup> and by 10 per cent in wholesale distribution. The broad 'other business services' sector also contracted sharply. By contrast, retail distribution output remained 3 per cent up on a year earlier, while on current estimates financial intermediation grew by 3½ per cent.

**Construction B.95** Construction output has been hit by the adjustment in the residential and commercial property markets. The sector grew by a ¼ per cent in 2008 as a whole, but output was down 5¾ per cent on a year earlier by the final quarter. The breakdown between types of construction work shows that the falls were concentrated in private industrial, commercial and residential new building, with repair and maintenance work declining by less. Private sector construction orders remained subdued in the first two months of 2009. The bringing forward of public

<sup>17</sup> The motor trades sector comprises services related to motor vehicles, including sales, maintenance and repair, and the sale of petrol and diesel. The sector accounted for around 2 per cent of nominal GVA in 2007.

investment spending into 2009-10 should provide some offsetting demand for the construction sector in the near term, while medium-term prospects should benefit from the forecast recovery in business and housing investment described above.

**Manufacturing B.96** Manufacturing output contracted throughout 2008, falling by 2½ per cent in the year as a whole. In common with advanced and emerging economies around the world, UK manufacturers were hit hard by the loss of confidence and steep falls in world trade in recent months. Manufacturing output fell by 5 per cent in the final quarter of 2008 and a further 3¾ per cent in the first two months of 2009. In line with a broad range of indicators across countries, the decline in manufacturing output in the UK over the past year illustrates the effects of weak confidence and restricted credit on demand for major items. While manufacturing output as a whole was down 14 per cent on a year earlier by February 2009, production of capital equipment was down 17 per cent and consumer durables 21 per cent. Government interventions in the UK and globally to restore the flow of credit in the economy, and to support trade finance in particular, should bolster the manufacturing sector. As such, while manufacturing is forecast to fall by 12½ per cent in 2009 as a whole, output is forecast to recover in 2010. This is in line with the April 2009 CBI forecast for a 12 per cent fall in 2009, recovering to ½ per cent growth in 2010.

## Independent forecasts

**B.97** Since the 2008 Pre-Budget Report, the average of independent forecasts for GDP growth in 2009 has been revised down significantly, from -0.9 per cent to -3.4 per cent, in line with the Budget 2009 forecast range. The average has now fallen by more than 5 percentage points since Budget 2008. A comparison of prominent forecasts published around the time of the Pre-Budget Report and more recently illustrates the extent to which the steep downturn of recent months, and its implications for growth in 2009 as a whole, has taken all forecasters by surprise:

- in the November 2008 *Inflation Report* the Bank of England mean forecast was for GDP growth of around -1.3 per cent in 2009 and 1.7 per cent in 2010; in the February 2009 *Inflation Forecast* the mean forecast was revised down to around -3.7 per cent in 2009 and 1.0 per cent in 2010;<sup>18</sup>
- the OECD's November 2008 *Economic Outlook* forecast GDP would contract by 1.1 per cent in 2009; the March 2009 *Economic Outlook Interim Update* forecast a contraction of 3.7 per cent;
- in their *Economic & Business Outlook* for November 2008, the CBI forecast a contraction of 1.7 per cent in 2009; the April 2009 forecast is for a 3.9 per cent contraction;
- the Ernst & Young Item Club Autumn 2008 forecast, published in October, was for a 1.0 per cent contraction in 2009; the Spring 2009 forecast, published in April, is for a fall of 3.5 per cent; and
- since last November, among City forecasters included in the Treasury's *Comparison of independent forecasts*, Goldman Sachs have revised their 2009 GDP growth forecast down from -0.4 to -2.6 per cent; HSBC from -1.7 to -3.8 per cent; Citigroup from -1.6 to -4.5 per cent; and Deutsche Bank from -0.5 to -4.0 per cent.

<sup>18</sup>Based on market interest rates. Forecasts based on the Bank of England's estimates of past growth and derived from the four-quarter growth rates published on the Bank of England's website.

**B.98** The average independent forecast for GDP growth in 2010 has also been revised down, to 0.3 per cent from 1.2 per cent at the time of the Pre-Budget Report. These changes have been driven by large downward revisions to the outlook for investment and private consumption. While the majority of independent forecasters expect positive growth next year, around a third forecast GDP to contract for a second consecutive year in 2010. Different forecasts will reflect different weights being placed on the drag to growth from private sector retrenchment and the global downturn, and the boost to growth from macroeconomic policy, lower commodity prices and the depreciation of sterling. Different forecasters are also likely to predicate their forecasts on different paths for the normalisation of credit conditions.

**B.99** The contrast between individual independent forecasts illustrates the range of views held. For example, compared with the Budget 2009 forecast, Goldman Sachs forecast a milder recession in 2009 and a somewhat stronger rebound in 2010, of 1.5 per cent. By contrast, Citigroup forecast a deeper downturn in 2009, followed by a slower medium-term recovery. The OECD's recent forecast for 2009 is within the Budget forecast range, but they forecast a slower recovery in 2010, with GDP expected to fall 0.2 per cent. This is just a snapshot of external views and, like all forecasters, these institutions will be constantly reviewing economic developments.

**B.100** Inflation has eased since the Pre-Budget Report and forecasts for CPI inflation in the final quarter of 2009 average 0.7 per cent, implying further falls to come. Few forecasters expect CPI inflation to be negative at the end of 2009. CPI inflation is then expected to pick up through 2010 as the economy begins to recover, with the independent average at 1.6 per cent by the end of the year. The broad range of forecasts for 2010, spanning 3.7 percentage points, illustrates the uncertainty surrounding current forecasts. At the same time in 2007, forecasts for CPI inflation at the end of 2008 were in a narrow range of 0.9 percentage points.

**Table B8: Budget and independent<sup>1</sup> forecasts**

At time of:		Percentage change on a year earlier					
		2009			2010		
		Budget 2008	2008 PBR	Budget 2009	Budget 2008	2008 PBR	Budget 2009
GDP	<b>HM Treasury</b>	2¼ to 2¾	-1¼ to -¾	-3¾ to -3¼	2½ to 3	1½ to 2	1 to 1½
	<b>Independent:</b>						
	average	1.9	-0.9	-3.4	2.6	1.2	0.3
	range	-1.3 to 2.7	-2.1 to 0.4	-4.5 to -1.3	1.7 to 3.3	-1.0 to 2.6	-1.2 to 2.5
CPI (Q4)	<b>HM Treasury</b>	2	½	1	2	2¼	1
	<b>Independent:</b>						
	average	2.0	1.7	0.7	2.1 <sup>2</sup>	1.8 <sup>2</sup>	1.6
	range	1.3 to 3.3	0.7 to 2.6	-0.8 to 1.8	1.5 to 3.6 <sup>2</sup>	1.2 to 2.6 <sup>2</sup>	0.1 to 3.8

<sup>1</sup> Taken from 'Forecasts for the UK economy: A comparison of independent forecasts', February 2008, March 2008, November 2008 and April 2009.

<sup>2</sup> CPI independent forecasts for 2010 made in 2008 are drawn from the medium-term forecasts and so refer to the annual average rather than Q4.

## SUMMARY OF FORECAST ISSUES AND RISKS

**B.101** All economic forecasts remain subject to exceptional uncertainties across a broad range of factors, including the resolution of the global financial crisis and its impact on confidence and activity, and the implementation and effectiveness of the unprecedented global policy response to the downturn. Uncertainties over the way in which factors affecting growth and inflation unfold are compounded by uncertainties over the intensity of their impact. That distinction has been illustrated clearly by the large downward revisions to all forecasts since the time of the Pre-Budget Report, which have typically reflected errors in judging the extent to which the financial crisis would damage confidence and activity, rather than further unanticipated deterioration in financial markets from the crisis conditions of September and October 2008.

## World demand and the global policy response

**Short-term prospects** **B.102** The falls in trade, production and GDP around the world in the final quarter of 2008 were much steeper than expected. Private business survey indicators suggest a similar rate of contraction in the first quarter of 2009, with that rate easing more recently. A key uncertainty over near-term prospects relates to the extent of inventory adjustment taking place in manufacturing and retail sectors, and the extent to which the sharp falls in production have been more, or less, than sufficient to offset the sharp drop in demand. In addition, business surveys, which typically report the breadth rather than depth of output falls, may be less useful as indicators of GDP growth during a period of unusually rapid adjustment.

**Global policy response and recovery** **B.103** Prospects for recovery in advanced economies are closely linked to the delivery and effectiveness of macroeconomic stimulus. Monetary policy stimulus is largely in place already, but there are uncertainties over the effectiveness of historically low interest rates in encouraging spending when confidence has been severely affected by the global financial crisis. If confidence remains low, consumers may increase saving for precautionary reasons and businesses may continue to cut back investment due to uncertainties over demand; if confidence is quickly restored, supportive financing conditions could deliver a more rapid rebound in spending. A significant proportion of planned global fiscal support is yet to be delivered. The Budget forecast is based on the assumption that it will be delivered as planned, so delays or reversals could represent a risk that the recovery will be weaker or later than forecast. As with monetary policy, there is uncertainty over the effectiveness of stimulus measures, relating to the degree to which they encourage private sector spending. There is also a longer-term risk from the balance of the global recovery.

**Global financial system** **B.104** Policy interventions by governments and central banks around the world appear to have stabilised financial systems, such that the risk to the wider economy from system-wide banking sector problems has been reduced. However, the global financial system continues to present significant risks to the economic forecast, with the efficacy of macroeconomic policy support depending to an extent on the degree to which increased private sector demand is met by the supply of credit to creditworthy borrowers. The economic forecast is predicated on credit conditions easing through 2009, for which there is only tentative evidence. If this financial crisis leads to a permanent decline in global capital flows, then it would jeopardise past gains from financial globalisation, and prevent a quick recovery of the global economy.

**Protectionism** **B.105** Protectionism is another risk to global economic prospects and to lifting developing countries out of poverty. As the world downturn deepens and job losses increase, there is a risk that countries retreat to protectionism or trade-distorting subsidies in a counter-productive attempt to support their domestic economies. Further economic cooperation will help to boost trade and investment flows to the benefit of global growth. At the London Summit, the G20 committed not to repeat the historic mistakes of protectionism in previous eras.

## UK economy

**B.106** In a world downturn precipitated by common global economic shocks, similar uncertainties apply to the UK forecast as to the world forecast: the effectiveness of macroeconomic policy support and interventions to improve the flow of credit to creditworthy borrowers, the degree to which consumer and business confidence can be restored, and uncertainties over the extent of inventory adjustment in the near term. The following paragraphs set out how these general uncertainties, and other risks specific to developments in the UK, relate to the economic forecast.

**The Asset Purchase Facility and nominal demand** **B.107** As set out in Box B5, the impact of the Asset Purchase Facility on nominal demand represents a key forecast uncertainty. The forecast is based on the judgement that the £75 billion programme of asset purchases will raise money GDP by approximately the same amount and bring inflation back up to target. However, in the absence of historical precedent for advanced economies successfully employing such measures, there are clearly very large uncertainties around this judgement. It is possible that inflation could react sooner or by more than assumed, or that demand for and supply of credit remain weak, limiting the impact of asset purchases on nominal demand.

**Bank lending** **B.108** While the Bank of England's recent *Credit Conditions Survey* and *Trends in Lending* report suggest credit conditions may be beginning to ease, the capacity of financial institutions to supply sufficient credit to support economic recovery remains an important risk to the forecast. That risk is diminished by the Government's comprehensive interventions to improve the flow of credit to creditworthy borrowers, described in Chapter 3.

**Trend output and the cyclical position** **B.109** The Budget 2009 forecasting judgement on the impact of the credit shock on trend output is very uncertain. This has implications for assessing the balance between cyclical demand and potential supply, and hence prospective inflationary pressures and the labour market implications of the recession. If the shock has a greater adverse impact than assumed, demand pressures are likely to bite sooner than expected, putting upward pressure on inflation earlier. Conversely, if the shock has had a smaller impact on trend output, then a larger degree of spare capacity will open up as output contracts, placing additional downward pressure on inflation.

**Consumer spending and business investment** **B.110** The macroeconomic adjustments that have been triggered by the global credit shock have already delivered an increase in the household saving ratio, and a reduction in household consumption and investment in dwellings. The degree to which households will further increase saving to rebuild their finances, and the speed with which any further adjustment takes place, are subject to considerable uncertainty. These uncertainties present risks to the consumer spending and dwellings investment forecasts. Businesses have reduced investment in the face of demand uncertainty so that, despite profits falling in the second half of the year, in aggregate the corporate sector continues to run a surplus. Investment is forecast to fall sharply in 2009 and 2010, before recovering strongly. There are upside and downside risks to this forecast related to the impact of household sector adjustments on demand, the availability of credit and restoration of business confidence.

**Trade and sterling** **B.111** The depreciation of sterling is expected to support the net export contribution to GDP through import substitution and export competitiveness effects. In the near term, prospects for export growth will be dominated by trends in global demand and will be subject to the uncertainties set out above. As global demand recovers, the extent to which UK exporters are able to maintain market share is uncertain. The availability of credit to finance investment in the production of tradable goods and services represents a key uncertainty.

## Interactions between forecast risks

**B.112** The interaction between these factors points to the possibility that a more positive or intensifying negative feedback could generate upside or large downside risks to the UK and world economic forecasts. On the upside, the interaction between restored confidence and private sector spending could reinforce the effectiveness of the substantial macroeconomic stimulus already in place, reducing the extent of the recession and the expected losses for financial institutions, thereby easing credit conditions even more quickly than assumed. If this played out across many countries, world trade could rebound very strongly, with positive implications for UK export and GDP growth.

**B.II3** On the downside, the interaction between restricted access to credit and weakness in private sector spending could further exacerbate the downturn, increasing losses for financial institutions, and so causing further tightening of credit conditions and damage to consumer and business confidence. Again, if a similar pattern was seen across many countries, the impact on UK prospects could be further amplified. Such scenarios illustrate the broad risks around all economic forecasts at present.

**Table B9: Summary of economic prospects<sup>1</sup>**

	Percentage change on a year earlier, unless otherwise stated						
	2007	2008	Forecast <sup>2,3,4</sup>			Average errors from past forecasts <sup>5</sup>	
			2009	2010	2011	2009	2010
<b>Output at constant market prices</b>							
Gross domestic product (GDP)	3	¾	-3¾ to -3¼	1 to 1½	3¼ to 3¾	¾	¾
Manufacturing output	¼	-2¾	-12¾ to -12¼	¼ to ¾	2 to 2½	1¾	2
<b>Expenditure components of GDP at constant market prices<sup>6</sup></b>							
Domestic demand	3½	¾	-4 to -3½	½ to 1	2½ to 3	¾	¾
Household consumption <sup>7</sup>	3	1¼	-3¼ to -2¾	0 to ½	3 to 3½	¾	1
General government consumption	1½	3½	4¾	1	-1¼	1	¾
Fixed investment	6¾	-3	-11¼ to -10¾	-3¼ to -2¾	6¼ to 6¾	2¼	2
Change in inventories <sup>8</sup>	¼	-½	-1	1	0	¼	¼
Exports of goods and services <sup>9</sup>	-4¼	0	-9 to -8½	¾ to 1¼	4¾ to 5¼	2½	4¼
Imports of goods and services <sup>9</sup>	-1½	-½	-9½ to -9	-¾ to -¼	2¼ to 2¾	3	3
Exports of goods and services (excluding MTIC)	4¾	0	-8¾ to -8½	¾ to 1¼	4¾ to 5¼	-	-
Imports of goods and services (excluding MTIC)	5½	-½	-9¼ to -9	-¾ to -¼	2¼ to 2¾	-	-
<b>Balance of payments current account</b>							
£ billion	-40¼	-24½	-48½	-51	-48¾	11¾	9½
Per cent of GDP	-3	-1¾	-3½	-3½	-3¼	¾	¾
<b>Inflation</b>							
CPI (Q4)	2	4	1	1	2¼	½	¾
Producer output prices (Q4) <sup>10</sup>	4	5½	-½	¼	1½	1¼	1¾
GDP deflator at market prices	2¾	2¼	1½	1 ¼	2¼	½	½
<b>Money GDP at market prices</b>							
£ billion	1,401	1,443	1,411 to 1,415	1,443 to 1,454	1,525 to 1,544	12¾	11¼
Percentage change	6	3	-2¼ to -2	2¼ to 2¾	5¾ to 6¼	1	¾

<sup>1</sup> The forecast is consistent with the quarterly National Accounts and balance of payments data for the fourth quarter of 2008, released by the Office for National Statistics on 27 March 2009. See also footnote 1 on the second page of this chapter.

<sup>2</sup> All growth rates in tables throughout this Chapter are rounded to the nearest ¼ percentage point.

<sup>3</sup> 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 trend output. 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.

<sup>4</sup> 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.

<sup>5</sup> Average absolute errors for current year year-ahead projections made in spring forecasts over the past 10 years. The average errors for the current account are calculated as a per cent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2009 and 2010. CPI average derived from past five years only.

<sup>6</sup> Further detail on the expenditure components of GDP is given in Table B10.

<sup>7</sup> Includes households and non-profit institutions serving households.

<sup>8</sup> Contribution to GDP growth, percentage points.

<sup>9</sup> Figures up to and including 2008 are distorted by MTIC.

<sup>10</sup> Excluding excise duties.

Table B10: Gross domestic product and its components

£ billion chained volume measures at market prices, seasonally adjusted										
	Household consumption <sup>1</sup>	General government consumption	Fixed investment	Change in inventories	Domestic demand <sup>2</sup>	Exports of goods and services	Total final expenditure	Less imports of goods and services	Plus statistical discrepancy <sup>3</sup>	GDP at market prices
<b>2007</b>	819.2	252.5	226.5	6.4	1305.1	350.7	1655.8	391.1	1.6	1266.3
<b>2008</b>	830.3	261.2	219.5	1.0	1313.3	350.9	1664.2	388.9	0.0	1275.3
<b>2009</b>	804.1 to 806.5	273.4	195.1 to 195.7	-10.8 to -10.0	1261.7 to 1265.6	319.8 to 320.7	1581.5 to 1586.3	352.4 to 353.5	-0.3	1228.8 to 1232.5
<b>2010</b>	804.6 to 811.0	276.4	189.0 to 190.5	-0.4 to 1.8	1269.5 to 1279.6	322.2 to 324.8	1591.8 to 1604.4	350.1 to 352.9	-0.3	1241.4 to 1251.2
<b>2011</b>	829.0 to 839.6	272.6	200.6 to 203.2	0.2 to 3.7	1302.4 to 1319.1	337.7 to 342.0	1640.1 to 1661.2	358.1 to 362.8	-0.3	1281.7 to 1298.1
<b>2007 1st half</b>	405.6	125.6	112.2	2.1	645.9	173.2	819.1	191.3	0.8	628.6
<b>2nd half</b>	413.6	126.9	114.2	4.3	659.2	177.5	836.7	199.8	0.8	637.8
<b>2008 1st half</b>	416.9	129.4	111.9	4.1	662.9	177.7	840.6	198.2	0.1	642.5
<b>2nd half</b>	413.4	131.8	107.6	-3.1	650.4	173.2	823.6	190.7	-0.1	632.8
<b>2009 1st half</b>	403.7 to 404.4	135.1	100.5 to 100.7	-7.1 to -6.8	632.2 to 633.4	161.4 to 161.7	793.6 to 795.1	177.8 to 178.1	-0.1	615.7 to 616.9
<b>2nd half</b>	400.4 to 402.1	138.2	94.5 to 94.9	-3.7 to -3.2	629.5 to 632.2	158.3 to 159.0	787.8 to 791.2	174.6 to 175.4	-0.1	613.1 to 615.7
<b>2010 1st half</b>	400.1 to 402.8	138.5	93.6 to 94.2	-0.3 to 0.7	631.9 to 636.1	159.6 to 160.6	791.4 to 796.8	174.6 to 175.8	-0.1	616.7 to 620.9
<b>2nd half</b>	404.5 to 408.2	137.9	95.4 to 96.3	-0.2 to 1.1	637.7 to 643.5	162.7 to 164.2	800.3 to 807.7	175.6 to 177.2	-0.1	624.6 to 630.4
<b>2011 1st half</b>	411.2 to 415.9	137.0	98.6 to 99.7	-0.1 to 1.5	646.6 to 654.1	166.8 to 168.8	813.4 to 822.9	177.8 to 179.9	-0.1	635.5 to 642.9
<b>2nd half</b>	417.8 to 423.7	135.6	102.0 to 103.4	0.3 to 2.2	655.7 to 665.0	170.9 to 173.3	826.6 to 838.3	180.3 to 182.9	-0.1	646.1 to 655.3
Percentage change on a year earlier <sup>4,5</sup>										
<b>2007</b>	3	1½	6¾	¼	3½	-4¼	1¾	-1½	¼	3
<b>2008</b>	1¼	3½	-3	-½	¾	0	½	-½	-¼	¾
<b>2009</b>	-3¼ to -2¾	4¾	-11¼ to -10¾	-1	-4 to -3½	-9 to -8½	-5 to -4½	-9½ to -9	0	-3¾ to -3¼
<b>2010</b>	0 to ½	1	-3¼ to -2¾	1	½ to 1	¾ to 1¼	¾ to 1¼	-¾ to -¼	0	1 to 1½
<b>2011</b>	3 to 3½	-1¼	6¼ to 6¾	0	2½ to 3	4¾ to 5¼	3 to 3½	2¼ to 2¾	0	3¼ to 3¾

<sup>1</sup> Includes households and non-profit institutions serving households.<sup>2</sup> Also includes acquisitions less disposals of valuables.<sup>3</sup> Expenditure adjustment.<sup>4</sup> For change in inventories and the statistical discrepancy, changes are expressed as a percent of GDP.<sup>5</sup> 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.