2 MAINTAINING MACROECONOMIC STABILITY

The UK economy is currently experiencing its longest unbroken expansion on record, with GDP now having grown for 50 consecutive quarters. With volatility in the UK economy at historically low levels and now the lowest in the G7, the domestic stability delivered by the Government's macroeconomic framework puts the UK in a strong position to respond to the global economic challenges of the next decade.

World growth in 2004 recovered to its strongest rate for nearly 30 years and remains robust. For 2004 as a whole, UK GDP rose by 3.1 per cent, its fastest rate of growth for four years, consistent with the 3 to 3½ per cent forecast range that the Government maintained since the 2002 Pre-Budget Report. Growth has also been more balanced as business investment accelerated in 2004 and private consumption continued to grow at sustainable rates. As world growth retains much of its momentum and with UK business and consumer confidence strong, GDP is expected to grow by 3 to 3½ per cent in 2005 as the remaining slack in the economy is absorbed and the output gap is closed around the end of the year. Growth is then expected to be 2½ to 3 per cent in 2006, in line with the economy's trend rate.

The Budget 2005 projections for the public finances are broadly in line with the 2004 Pre-Budget Report and show that the Government is meeting its strict fiscal rules:

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

THE MACROECONOMIC FRAMEWORK

2.1 The UK economy is currently experiencing its longest unbroken expansion since quarterly national accounts data began, with GDP now having grown for 50 consecutive quarters. With volatility in the UK economy at historically low levels and now the lowest in the G7, the domestic stability delivered by the Government's macroeconomic framework puts the UK in a strong position to respond to the global economic challenges of the next decade.

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

2.3 The macroeconomic framework is based on the principles of transparency, responsibility and accountability.[1] The monetary policy framework seeks to ensure low and stable inflation, while fiscal policy is underpinned by clear objectives and two strict rules that ensure sound public finances over the medium term while allowing fiscal policy to support

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

monetary policy over the economic cycle. The fiscal rules are the foundation of the Government's public spending framework, which facilitates long-term planning and provides departments with the flexibility and incentives they need to increase the quality of public services and deliver specified outcomes. These policies work together in a coherent and integrated way.

Monetary policy framework

2.4 Since its introduction in 1997, the monetary policy framework has consistently delivered inflation close to the Government's target and allowed the Bank of England's Monetary Policy Committee (MPC) to mitigate the impact of global events on the UK economy. The framework is based on four key principles:

- clear and precise objectives. While the primary objective of monetary policy is to deliver price stability, the adoption of a single, symmetrical inflation target ensures that outcomes below target are treated as seriously as those above, so that monetary policy also supports the Government's objective of high and stable levels of growth and employment;
- full operational independence for the MPC in setting interest rates to meet the Government's target. **The Government reaffirms in Budget 2005 the target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI),** which applies at all times;
- openness, transparency and accountability, which are enhanced through the publication of MPC members' voting records, prompt publication of the minutes of monthly MPC meetings, and publication of the Bank of England's quarterly Inflation Report; and
- credibility and flexibility. The MPC has discretion to decide how and when to react to events, within the constraints of the inflation target and the open letter system. If inflation deviates by more than one percentage point above or below target, the Governor of the Bank of England must explain in an open letter to the Chancellor the reasons for the deviation, the action the MPC proposes to take, the expected duration of the deviation and how the proposed action meets the remit of the MPC.

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

Fiscal policy framework

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

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

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

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

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

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

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

Public spending framework

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

Financial stability framework

2.10 A single statutory body for financial regulation, the Financial Services Authority (FSA), was set up in 1998 as part of a new tripartite structure for overseeing the UK financial system, with distinct roles for the Treasury, the Bank of England and the FSA. A Memorandum of Understanding[3] in 1997 established a framework for co-operation between these three bodies on financial stability. The Bank of England is responsible for the stability of the financial system as a whole, including the payments infrastructure. The FSA is responsible for the authorisation and supervision of financial institutions including banks, for supervising financial markets and securities clearing and settlement systems, and for regulatory policy. The Treasury has responsibility for the overall institutional structure of regulation and the legislation that governs it.

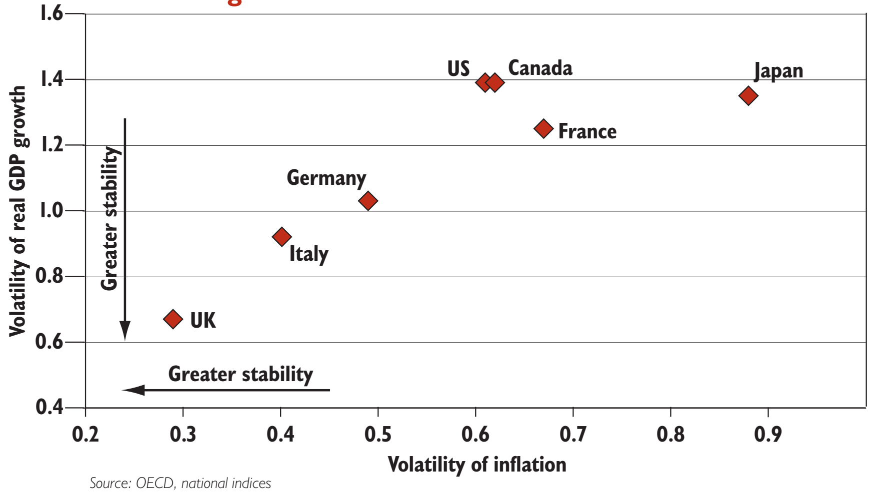
2.11 A Standing Committee, comprising the Chancellor, the Governor of the Bank of England and the Chairman of the FSA, meets monthly (at Deputies level) to discuss financial stability, focusing on risks deemed to have systemic consequences. The Committee regularly reviews the key systemic risks to the UK's financial intermediaries and infrastructure and coordinates the three authorities' contingency plans. In the event of a crisis, it would meet at short notice and co-ordinate any necessary action by the authorities.

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

Box 2.1: Macroeconomic stability in the UK

The UK has experienced unprecedented macroeconomic stability since the introduction of the new macroeconomic framework in 1997, with the volatility of real GDP growth and inflation now at their lowest sustained levels since quarterly national accounts data began. The UK has been the most stable of all G7 economies since 1997, with volatility in real GDP growth and inflation around half that of the average of the other economies in the G7. From being one of the most volatile economies in the G7, the UK is now the most stable.

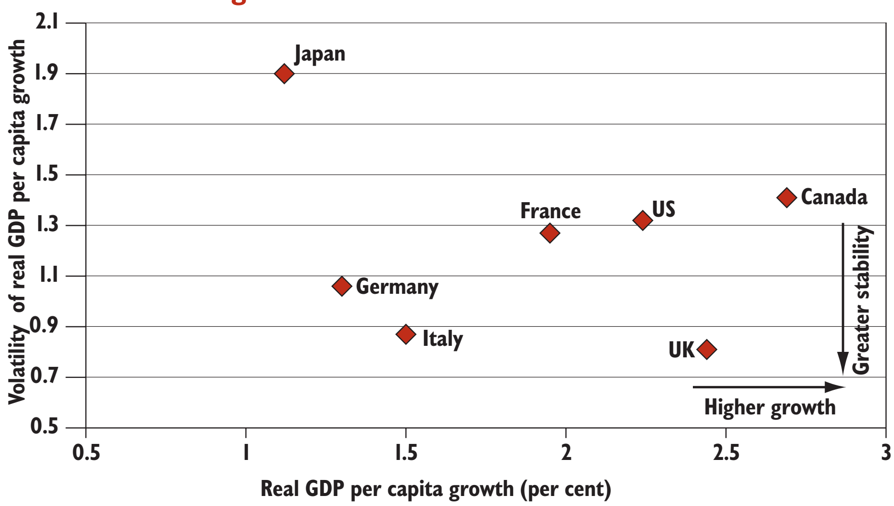
Volatility[a] of real GDP growth and inflation in the G7, 1997-2004 average



Source: OECD, national indices

This domestic stability has been achieved alongside strong economic growth, with the UK real GDP per capita growth rate over a third higher than the average of the other G7 economies since 1997. As the International Monetary Fund has noted: "*Macroeconomic performance in the United Kingdom during the past decade has been strong and steady. Standing out among G7 countries, the United Kingdom has enjoyed relatively rapid and stable per capita growth.*" [b]

Growth and volatility[a] of real GDP per capita in the G7, 1997-2004 average



Source: World Economic Outlook, IMF, September 2004

[a] Volatility is measured by the standard deviation.
[b] *IMF UK Article IV Report*, March 2005.

PERFORMANCE OF THE FRAMEWORK

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

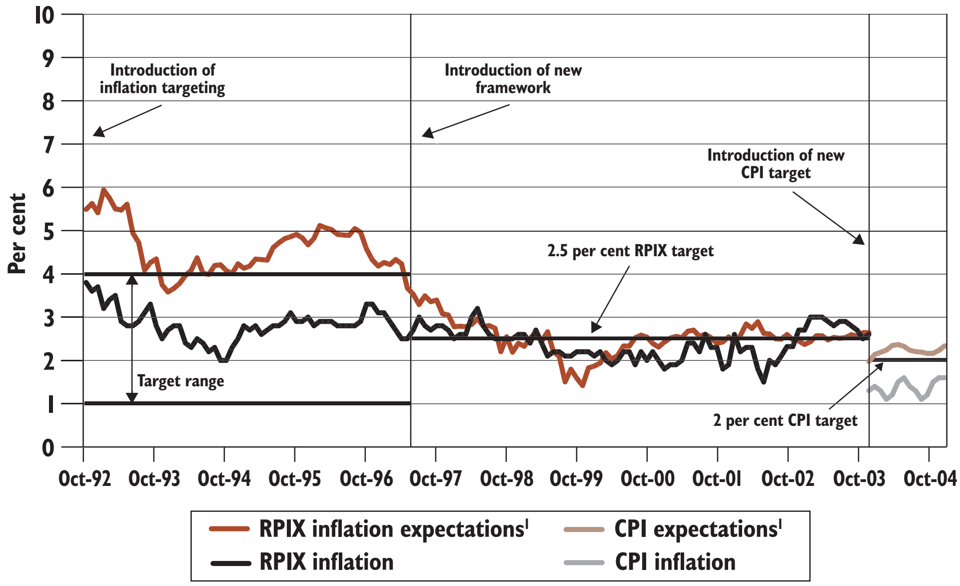
Monetary policy

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

- the annual increase in inflation up to December 2003, when RPIX was used as the inflation target measure, remained close to the target value of 2½ per cent, the longest period of sustained low inflation for the last 30 years; and
- inflation expectations have remained close to target following the switch from a 2½ per cent RPIX target to a 2 per cent CPI target. CPI inflation has been within 1 percentage point of its target since its inception in December 2003.[4]

2.14 The monetary policy framework has also dealt successfully with unexpected economic events. The MPC responded quickly and decisively to the global slowdown during 2001 and to the events of 11 September 2001, cutting interest rates a total of nine times from 6 per cent to 3½ per cent. This helped to keep output relatively close to its trend level, while ensuring that inflation remained close to target. Consistent with its forward-looking and pre-emptive approach to lock in stability and low inflation, as growth strengthened, the MPC raised interest rates on five occasions between November 2003 and August 2004 to reach 4¾ per cent.

Chart 2.1: Inflation performance and expectations



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

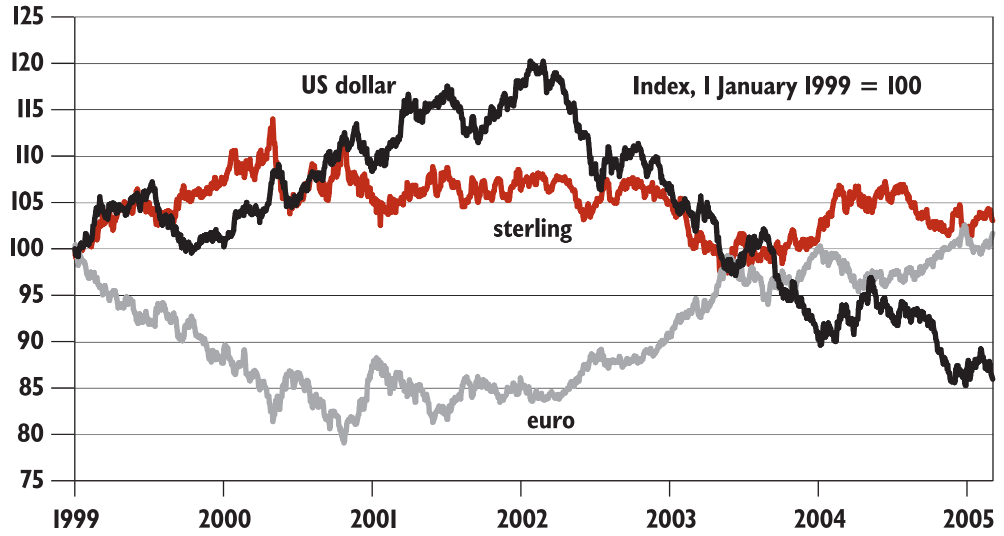
2.15 Low inflation expectations and a period of entrenched macroeconomic stability have helped long-term spot interest rates remain at historically low levels, averaging 4.8 per cent over the last year. Over the current economic cycle, provisionally judged to have begun in mid-1999, long-term spot interest rates have averaged just under 5 per cent, compared with

[4] In January 2005, the difference between RPIX and CPI inflation fell to 0.5 per cent. This narrowing of the difference between the two measures is broadly as was expected when the new inflation target was introduced in December 2003.

an average of over 9 per cent in the cycle running from mid-1986 to mid-1997. Low long-term interest rates reduce the Government's debt interest payments, free up resources for public services and help to promote investment throughout the economy. Ten-year forward rates, which abstract from cyclical influences, remain at or below those in the US and the euro area.[5] Ten-year forward rates have fallen slightly in the UK over the year from 4.8 per cent in March 2004 to 4.5 per cent. This compares with a rate of 8 per cent in April 1997 before the introduction of the new macroeconomic framework.

2.16 The sterling effective exchange rate remains close to levels at Budget 2004. Alongside the UK's macroeconomic stability in recent years, the effective exchange rate has also been relatively stable, as seen in Chart 2.2. Indeed, since the introduction of the euro in 1999, the volatility of sterling's effective exchange rate has been under half that of the euro and around a third that of the US dollar.

Chart 2.2: Movements in leading effective exchange rate indices since 1999



Fiscal policy

2.17 The Government has taken tough decisions on taxation and spending to restore the public finances to a sustainable position. Between 1996-97 and 2000-01, the fiscal stance was tightened by around 4 per cent of GDP, supporting monetary policy during a period when the economy was generally above trend. In more recent years, fiscal policy has supported monetary policy as the economy has been below trend: between 2000-01 and 2003-04, the fiscal stance eased by around 3 per cent of GDP. Public sector net debt was also reduced from 44 per cent of GDP in 1996-97 to around 31 per cent of GDP in 2002-03. As Chart 2.3 and Box 2.6 show, since 1997 the UK's public finances have compared favourably with other countries and they remain in a fundamentally sound long-term position.

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

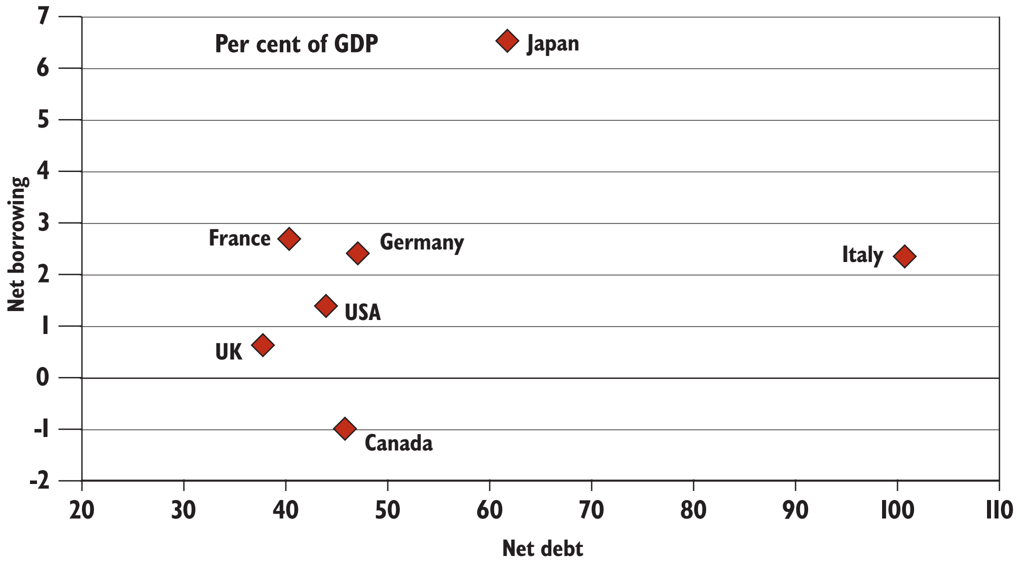
- current spending to increase by an annual average of 2.5 per cent in real terms over 2006-07 and 2007-08;

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

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

2.19 The overall spending limits set in Budget 2004 and confirmed in the 2004 Spending Review remain sustainable and fully consistent with the fiscal rules.

Chart 2.3: Public finances in the G7, average 1997 to 2004



Source: OECD Economic Outlook 76, December 2004

Box 2.2: Government policy on EMU

The Government's policy on membership of the single currency was set out by the 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: "*since 1997, the UK has made real progress towards meeting the five economic tests. But, on balance, though the potential benefits of increased investment, trade, a boost to financial services, growth and jobs are clear, we cannot at this point in time conclude that there is sustainable and durable convergence or sufficient flexibility to cope with any potential difficulties within the euro area.*" The Chancellor's statement to the House of Commons on 9 June 2003 on UK membership of the European single currency set out a reform agenda of concrete and practical steps to address the policy requirements identified by the assessment. The Budget reports on progress, including:

- the introduction in December 2003 of a symmetric inflation target as measured by the Consumer Prices Index (CPI). CPI inflation has been within 1 percentage point of its target since its inception;
- reforms to address both supply and demand in the housing market through implementing a programme of change to increase supply and responsiveness of the housing market as recommended in the Barker review and action taken in response to the Miles review on the mortgage market, described further in Chapter 3; and
- reforms at national, regional and local level to enhance the flexibility of labour, capital and product markets in the UK. Chapters 3 and 4 provide further detail.

The Government also publishes twice-yearly reports on euro preparations. The *Report on euro preparations, December 2004*, sets out the progress that has been made across the economy since the last report in April 2004. On the Stability and Growth Pact, the Government continues to emphasise the need for a more prudent interpretation of the Pact as described in Box 2.4 and *The Stability and Growth Pact: A Discussion Paper*, published alongside Budget 2004. The Government also remains committed to the EU's Lisbon strategy on economic reform, launched in March 2000, and will continue to work with Member States and the EU institutions to build on progress so far and to accelerate the pace of reform in order to meet the Lisbon challenge. In December 2004, the Chancellor and the Finance and Economics Ministers of Ireland, the Netherlands, Luxembourg, Austria and Finland launched a joint initiative, *Advancing Regulatory Reform in Europe*, establishing regulatory reform as a key priority of the six EU Presidencies through to the end of 2006.

In his statement to the House of Commons on 9 June 2003, the 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.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

Recent economic developments

2.20 The Government's macroeconomic framework allowed the UK economy to remain resilient in the face of the challenges and uncertainties that affected the world economy between 2001 and 2003. The UK is the only major economy not to have experienced a single quarter of negative GDP growth during this period.

2.21 As expected the global economy gathered pace last year. World output growth in 2004 was at its strongest for nearly three decades as a result of improved economic developments in most advanced economies as well as a number of major emerging economies. Strong G7 growth in 2004 was driven principally by robust growth in the US, Canada and UK. There was also a solid contribution to growth from Japan in 2004 and some improvement in the euro area, although growth in these countries remains low relative to that of many other advanced economies, and Japan, Germany and Italy, all saw output fall in the latter part of the year. Nevertheless strong growth in a number of advanced and emerging economies means world growth has retained much of its momentum going into 2005.

Table 2.1: Summary of world forecast

	Percentage change on a year earlier unless otherwise stated			
		Forecasts		
	2004	2005	2006	2007
Major 7 countries[1]				
Real GDP	3¼	2½	2½	2½
Consumer price inflation[2]	2½	2¼	1¾	1¾
Euro area				
Real GDP	1¾	1½	2¼	2¼
World trade in goods and services	8¾	8¼	7¾	7¼
UK export markets[3]	7½	7½	7	6¾

[1] *G7: US, Japan, Germany, France, UK, Italy and Canada.*
[2] *Per cent, Q4.*
[3] *Other countries' imports of goods and services weighted according to their importance in UK exports.*

2.22 UK GDP has now grown for 50 consecutive quarters, the longest unbroken expansion on record. UK GDP is currently estimated to have risen by 3.1 per cent in 2004 as a whole, the fastest for four years and consistent with the 3 to 3½ per cent forecast range that the Government maintained unchanged from the 2002 Pre-Budget Report. Growth dipped to slightly below its assumed trend rate in the third quarter, strengthening in the final quarter of the year.

2.23 Stronger expansion at the end of 2004 has been accompanied by recent rises in manufacturing output, and supported by both the continued momentum of domestic demand, in particular business investment, and increasing signs of strong external demand translating into more vigorous export growth. Private sector business survey indicators in recent months have generally supported the view that robust growth of UK output and activity is expected to continue into 2005.

Box 2.3: UK Presidencies of the G7/8 and EU

Far-reaching and fundamental changes in technology, production and trading patterns are shifting the balance of global economic activity, and supporting the rise of the large emerging economies. These changes bring with them challenges and opportunities for all economies. The UK sees its leadership of the G7/8 and EU this year as an opportunity to address the key challenges of international poverty reduction; structural economic reform; fairer trade; and climate change.

G7 Finance Ministers and Central Bank Governors met in London on 4-5 February 2005. In response to these challenges, they discussed the importance of all countries playing their part to achieve balanced and sustainable growth; agreed proposals to improve the operation of the oil market; and set out plans to help developing countries achieve the Millennium Development Goals by 2015. Further information is set out in Chapter 5 and at www.g7.gov.uk. Further, recognising the need for greater and wider partnerships, the G7 held an informal meeting with key emerging economies and continued its productive dialogue with the Chinese authorities. As G7 and G20 Presidencies, the UK and China will continue to work closely together.

Long-term global economic challenges and opportunities for Europe, published alongside Budget 2005, examines the implications for Europe of the far-reaching changes likely to affect the global economy over the coming decade, and sets out the associated policy challenges. Meeting these will require sustained action over the long term. The UK will aim to use its EU Presidency in the second half of 2005 to develop a consensus on the need for a more Global Europe which, by becoming more outward-looking and embracing greater flexibility in labour, product and capital markets, delivers high employment for its citizens; and steps up to its global responsibilities. In particular, working closely with EU institutions and Member States, the UK will seek to:

- foster enterprise and innovation in Europe – driving forward the regulatory reform agenda to improve the quality of Commission impact assessments and to simplify and reduce burdens in the existing stock of regulation;
- establish a more dynamic single market – working to achieve progress on a single market in services, and towards a future strategy on financial services which focuses more on implementation and enforcement of existing legislation and use of non-legislative alternatives such as proactive competition policy;
- promote high employment across Europe – encouraging further action by Member States to develop and implement active labour market strategies to help the unemployed and inactive find work and policies to raise skills levels and improve adaptability among the workforce;
- create a more outward-looking Europe – encouraging the EU to show leadership on fairer trade to work towards an ambitious and pro-poor agreement in the Doha Development Agenda WTO negotiations; and strengthening bilateral economic relations, particularly with the US, through a new EU-US economic cooperation partnership; and
- encourage Europe to play a leadership role in meeting global challenges – increasing resources to help meet the Millennium Development Goals, and tackling climate change.

Economic prospects

2.24 Recent economic developments are broadly as envisaged in the 2004 Pre-Budget Report and so the Budget 2005 forecast is very similar. With the world economy still expanding strongly, and business and consumer confidence having regained strength, the recent momentum of UK GDP growth is expected to carry through into 2005. Renewed growth at above trend rates is therefore expected for much of 2005, as robust domestic demand growth is bolstered by continued strong growth in external demand for UK output. However, with the output gap narrowing further and monetary policy having undergone a tightening of 125 basis points since November 2003, growth is expected gradually to ease back to its trend rate later in the year, with the current economic cycle coming to a close around the end of 2005. Fiscal policy should continue to support monetary policy with the overall impact of fiscal policy moving back towards a more neutral position as the economy returns to trend.

2.25 Going forward, CPI inflation is expected to rise gradually during 2005 from its current level of 1.6 per cent as strong global growth feeds through in further upward pressure on import prices. The credibility of the Government's monetary policy framework, through its effect in anchoring inflation expectations, is also expected to contribute in returning inflation to target.

Table 2.2: Summary of UK forecast[1]

		Forecast		
	2004	2005	2006	2007
GDP growth (per cent)	3	3 to 3½	2½ to 3	2¼ to 2¾
CPI inflation (per cent, Q4)	1¼	1¾	2	2

[1] *See footnote to Table B9 for explanation of forecast ranges.*

Composition of UK growth

2.26 In recent years, GDP growth has become more balanced, with the composition having shifted away from private consumption, and investment and export growth picking up.

2.27 Real private consumption growth in 2004, at just over 3 per cent, was stronger than in 2003. This largely reflects a particularly strong rise of over 1 per cent in the first quarter – in contrast to an unusually weak beginning to the previous year. In the remainder of 2004, private consumption growth progressed at a little below its long-run average. The position of household balance sheets and recent increases in interest rates are expected to keep consumer spending growth at rates close to that of incomes over the forecast horizon. Therefore private consumption is expected to continue growing at sustainable rates, rising by 2¼ to 2¾ per cent this year and by 2 to 2½ per cent in 2006, slightly below forecast rates of GDP growth.

2.28 Investment growth has strengthened significantly during the past two years, as corporate sentiment has risen on the back of improved global demand. In 2004, business investment grew by just under 5½ per cent, its strongest performance for six years. Investment growth in 2004 was stronger than expected either at the time of the 2003 Pre-Budget Report or Budget 2004. Going forward, business investment is expected to continue growing at robust rates, but at a slightly slower pace than in 2004, as companies, with relatively supportive balance sheets, continue to respond to strong demand growth. High levels of profitability are expected to offer further support to expanding capital outlays. Business investment is therefore forecast to rise by 4¼ to 4¾ per cent in 2005 and by 3½ to 4¼ per cent in 2006.

2.29 Export growth strengthened in 2004. Following a fall in the first quarter which coincided with a sharp drop in UK export market growth, export volume growth in the final three quarters of 2004 averaged $1^{3}/_{4}$ per cent a quarter. The recent momentum of export growth is expected to carry through into 2005, supported by further robust demand in the world economy. Export volumes of goods and services are forecast to rise by 6 to $6^{1}/_{2}$ per cent this year and by $6^{1}/_{4}$ to $6^{3}/_{4}$ per cent in 2006, implying rates of underlying growth close to those already seen in recent quarters and similar to the 2004 Pre-Budget Report projections. Import growth is also expected to follow a similar path to that set out in the Pre-Budget Report, growing a little more slowly than exports. The trade balance is expected to remain broadly flat over the forecast horizon, with net trade making a broadly neutral contribution to GDP growth.

Risks

2.30 On balance there has been a reduction in the risks surrounding the forecast since the Pre-Budget Report. The global outlook remains a key influence on UK prospects. The risks to the global outlook of higher oil prices have diminished since the time of the Pre-Budget Report given the robustness of growth in the face of high prices in 2004, with increasing recognition that high oil prices have been driven primarily by strong demand. The risks relating to exchange rates and a disorderly adjustment to the world's current account imbalances remain unchanged since the Pre-Budget Report. In the medium term, structural reform would help to rebalance growth and facilitate the unwinding of imbalances.

2.31 UK house prices continue to pose risks in both directions, although increasingly the evidence since the Pre-Budget Report points to an orderly moderation in house price inflation and recent signs of some emerging revival in sentiment suggest that the downside risks are smaller than at the time of the Pre-Budget Report.

2.32 The forecast also continues to face upside risks from investment. For example, growth of business investment could exceed expectations going forward given current robust rates of demand growth and with supportive corporate financial conditions.

The economic cycle

2.33 On the basis of the Government's provisional judgement on the dating of the current and past economic cycles, the economy completed a full, though short, cycle between the first half of 1997 and mid-1999. The current economic cycle began in mid-1999 when actual output moved above its trend level. In the second half of 2001, the economy moved below trend with actual output remaining below its trend level since then. The economy is expected to return to trend around the end of 2005, in line with the forecast in the 2004 Pre-Budget Report.

Caution and the public finances

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

2.35 For Budget 2005, the Comptroller and Auditor General has audited the assumption relating to unemployment. The review concluded that the assumption was reasonable and cautious.

2.36 The public finances continue to be based on a deliberately cautious assumption for trend output growth that is a $^{1}/_{4}$ percentage point lower than the Government's neutral view. The Comptroller and Auditor General will be invited to audit this assumption once the current cycle has ended, currently projected to be around the end of 2005, around which time information relating to an additional on-trend point will be available.

RECENT FISCAL TRENDS AND OUTLOOK

2.37 Budget 2005 presents the Government's annual fiscal forecast and updates the 2004 Pre-Budget Report interim projections.[6]

2.38 The Budget 2005 projections are broadly in line with the 2004 Pre-Budget Report interim projections, locking in the Government's prudent fiscal stance. Underpinned by a strong and stable economy, receipts growth has strengthened through the year, with estimated growth in tax receipts in 2004-05 as projected in the Pre-Budget Report. Growth in corporation tax receipts has exceeded expectations. Where there are changes to the Pre-Budget Report projections, these are modest and are primarily explained by timing effects relating to expenditure; the projections in the medium term are broadly unchanged.

2.39 The estimated 2004-05 outturn for public sector net borrowing is £34.4 billion, compared with £34.2 billion projected in the 2004 Pre-Budget Report and £32.9 billion projected in Budget 2004. For the public sector current budget, the estimated 2004-05 outturn shows a deficit of £16.1 billion compared with projected deficits of £12.5 billion and £10.5 billion in the 2004 Pre-Budget Report and Budget 2004 respectively. This is significantly lower than the deficit on the public sector current budget of £20.4 billion in 2003-04 as the impact of the strengthening economy has fed through to receipts. On the basis of cautious, audited assumptions, the Government is meeting its strict fiscal rules over the economic cycle.

2.40 Table 2.3 shows projections for public sector net borrowing compared with those presented in the 2004 Pre-Budget Report. It disaggregates the differences into those relating to net taxes and national insurance contributions and other forecasting effects. It also includes the impact of discretionary measures. In this Budget, the Government provides a further £340 million for the special reserve in 2004-05 and £400 million for the special reserve in 2005-06, continuing to make prudent provision for the costs of the military conflict in Iraq and its other international obligations.

Non-discretionary changes in receipts

2.41 Net taxes and national insurance contributions have strengthened through 2004-05, and are estimated to have grown at 7.3 per cent on the previous year, as forecast in the Pre-Budget Report. Income tax receipts have grown in line with expectations, with robust growth in the financial sector reflected in higher bonus payments. Improving corporate profitability and higher oil prices have boosted corporation tax receipts, which have strengthened since the Pre-Budget Report. VAT receipts have been lower than expected, in part due to slower growth in nominal consumers' expenditure.

2.42 With the economy retaining its momentum as it moves back to trend, the public finances are expected to strengthen further in 2005-06. In addition to strong underlying growth in corporation tax receipts, NAO-audited assumptions for oil prices and equity prices contribute to expected continued growth in tax receipts.

[6] The Budget 2005 fiscal projections take account of the February outturns for receipts, spending and borrowing. The Office for National Statistics/HM Treasury Public Sector Finances Release with provisional estimates of the public finances for February 2005 will be issued on 18 March 2005. Further details are provided in Chapter C of the *Financial Statement and Budget Report*.

Table 2.3: Public sector net borrowing compared with the 2004 Pre-Budget Report

£ billion	Estimate	Projections				
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
PBR 2004	**34.2**	**33**	**29**	**28**	**24**	**22**
Net taxes and national insurance contributions	**-0.1**	**1**	**0**	**–1½**	**–½**	**0**
Other forecasting effects	**-0.1**	**–2**	**0**	**½**	**1**	**–½**
Total before discretionary measures[1]	**34.1**	**32**	**29**	**27**	**24**	**22**
Discretionary measures[2]	0.3	–½	0	½	–½	½
Budget 2005	**34.4**	**32**	**29**	**27**	**24**	**22**

[1] *Totals may not sum due to rounding.*

[2] *Discretionary measures include tax compliance and anti-avoidance measures announced in Budget 2005.*

Non-discretionary changes in spending

2.43 Other forecasting effects include offsetting impacts of higher current expenditure and lower than expected net investment in 2004-05. While the estimated outturn for Total Managed Expenditure (TME) in 2004-05 is £1.1 billion lower than projected in the 2004 Pre-Budget Report, the estimated outturn for 2004-05 Resource Departmental Expenditure Limits (DEL) is £269 billion, £2.0 billion higher than projected in the 2004 Pre-Budget Report, including the further £340 million for the special reserve in 2004-05.

2.44 Higher current expenditure in 2004-05 is in part due to a timing effect relating to net payments to the EU, with higher than expected payments in 2004-05 being offset by lower expected payments in 2005-06. There has been additional expenditure in 2004-05 to meet the UK's international commitments as well as use by departments of end-year flexibility to meet the Government's priorities including health and education. Use of end-year flexibility has enabled departments to smooth their expenditure for 2004-05, the year with the lowest overall planned spending growth of the 2002 Spending Review period.

BUDGET DECISIONS

2.45 The Budget is the definitive statement of the Government's desired fiscal policy settings. In making its Budget decisions the Government has considered:

- the need to ensure that, over the economic cycle, the Government will continue to meet its strict fiscal rules;
- its fiscal policy objectives, including the need to ensure sound public finances and that spending and taxation impact fairly both within and between generations; and
- how fiscal policy can best support monetary policy over the economic cycle.

2.46 Against this backdrop, and building on steps already taken, Budget 2005 announces further decisions to lock in stability and invest in the UK's future, including:

- a long-term programme of investment to deliver twenty-first century facilities in primary schools, and new measures to boost the development of skills in young people;
- a commitment to increase the child element of the Child Tax Credit in line with average earnings up to 2007-08;

- free local area bus travel for all people over the age of 60 and disabled people from April 2006, and an additional payment guaranteeing that council tax paying households with someone over 65 will receive £200 towards the cost of council tax;
- a doubling of the stamp duty land tax zero-rate threshold from £60,000 to £120,000 for all residential property transactions;
- further reforms to modernise the tax system, including better aligning North Sea corporation tax payments with payments for petroleum revenue tax; and a number of measures to tackle tax fraud and avoidance;
- deferral of the inflation-based increase in main fuel duties to 1 September 2005, in response to sustained volatility in oil prices; and
- a further £340 million for the special reserve in 2004-05 and £400 million in 2005-06 for military operations in Iraq and the UK's other international obligations.

2.47 Table 1.2 lists the key Budget policy decisions and their impact on the public finances, including resetting the AME margin. Further details are set out in Chapter A of the *Financial Statement and Budget Report*.

MEDIUM-TERM FISCAL PROJECTIONS

2.48 Table 2.4 compares the projections for the current balance, net borrowing and net debt with those published in Budget 2004 and in the 2004 Pre-Budget Report. Changes in the fiscal balances are disaggregated into those attributable to revisions or forecasting changes and discretionary measures. It includes the impact of all Budget decisions in accordance with the *Code for fiscal stability*. Further detail is provided in Chapter C of the *Financial Statement and Budget Report*.

2.49 The revised outturn for 2003-04 shows the deficit on the current budget to be £0.9 billion lower than in Budget 2004, and £0.7 billion lower than in the 2004 Pre-Budget Report. The outturn for 2003-04 for net borrowing is £2.1 billion lower than shown in Budget 2004, and £0.6 billion higher than in the 2004 Pre-Budget Report.

Table 2.4: Fiscal balances compared with Budget 2004 and the 2004 Pre-Budget Report

	Outturn[1]	Estimate[2]	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Surplus on current budget (£ billion)							
Budget 2004	**–21.3**	**–10.5**	**–5**	**0**	**4**	**9**	
Effect of revisions and forecasting changes:	0.2	–1.2	–1	1	0	–1	
Receipts[3]	–2.8	–3.5	–3	–2	–1	–1	
Current expenditure[4]	3.0	2.3	2	3	1	1	
Effect of discretionary changes	0.0	–0.8	0	0	0	0	
PBR 2004	**–21.1**	**–12.5**	**–7**	**1**	**4**	**9**	**12**
Effect of revisions and forecasting changes:	0.8	–3.2	1	0	1	0	1
Receipts[3]	0.2	–1.3	–2	–1	0	–1	0
Current expenditure[4]	0.5	–1.9	3	1	1	1	1
Effect of discretionary changes	0.0	–0.3	0	0	0	0	0
Budget 2005	**–20.4**	**–16.1**	**–6**	**1**	**4**	**9**	**12**
Net borrowing (£ billion)							
Budget 2004	**37.5**	**32.9**	**31**	**27**	**27**	**23**	
Changes to current budget	–0.2	2.0	1	–1	1	1	
Forecasting changes to net investment	–2.5	–0.6	1	2	0	0	
Discretionary changes to net investment	0.0	–0.1	0	0	0	0	
PBR 2004	**34.8**	**34.2**	**33**	**29**	**28**	**24**	**22**
Changes to current budget	–0.8	3.6	–1	0	–1	0	0
Forecasting changes to net investment	1.4	–3.4	0	0	0	0	0
Discretionary changes to net investment	0.0	0.0	0	0	0	0	0
Budget 2005	**35.4**	**34.4**	**32**	**29**	**27**	**24**	**22**
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2004	–1.0	–0.2	–0.2	0.0	0.3	0.7	
PBR 2004	–1.0	–0.4	–0.4	0.1	0.3	0.6	0.8
Budget 2005	**–1.0**	**–0.8**	**–0.3**	**0.1**	**0.3**	**0.6**	**0.8**
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2004	2.4	2.1	2.3	2.1	1.9	1.6	
PBR 2004	2.2	2.2	2.5	2.2	2.0	1.6	1.5
Budget 2005	**2.3**	**2.4**	**2.4**	**2.2**	**2.0**	**1.6**	**1.5**
Net debt (per cent of GDP)							
Budget 2004	33.2	34.4	35.3	35.9	36.3	36.4	
PBR 2004	32.9	34.3	35.4	36.2	36.8	37.0	37.1
Budget 2005	**32.8**	**34.4**	**35.5**	**36.2**	**36.8**	**37.1**	**37.1**

Totals may not sum due to rounding.
[1] The 2003-04 figures were estimates in Budget 2004.
[2] The 2004-05 figures were projections in Budget 2004.
[3] Further details given in table C7.
[4] Includes depreciation.

2.50 The estimated surplus on the current budget in 2004-05 is lower compared with the 2004 Pre-Budget Report, reflecting higher current expenditure than previously projected, as discussed above. As receipts strengthen over the projection period, the surplus on the current budget rises in line with projections in the 2004 Pre-Budget Report. The estimated net borrowing in 2004-05 and later years is broadly unchanged compared with the 2004 Pre-Budget Report.

2.51 Table 2.4 also sets out the underlying structural position of the fiscal balances, adjusted for the impact of the economic cycle on the public finances.[7] Cyclically-adjusted, the deficit on the current budget and net borrowing are a little higher in 2004-05 compared with the 2004 Pre-Budget Report and Budget 2004 projections. After 2004-05, they return to levels in line with projections in the 2004 Pre-Budget Report and Budget 2004. At 1.5 per cent of GDP by the end of the projection period, cyclically-adjusted net borrowing is consistent with net debt stabilising at 37 per cent of GDP.

[7] Details of the Treasury's approach to cyclical adjustment can be found in Annex A of the 2003 *End of year fiscal report*.

Box 2.4: The Stability and Growth Pact

There has been significant discussion recently of issues surrounding macroeconomic frameworks in Europe, particularly of the Stability and Growth Pact (SGP). The introduction of the SGP in the late 1990s represented a major step forward in recognising the importance of long-term budgetary discipline and as a framework for coordination by Member States of their fiscal policies. The UK has supported the principle of a strong SGP, recognising that fiscal sustainability is a prerequisite for macroeconomic stability, and that collective fiscal co-ordination is desirable within an integrated economic community, and essential for a successful monetary union. However the operation of the SGP has highlighted a number of issues that need to be addressed. The slowdown in the global and European economies in recent years tested its effectiveness in supporting both stability and growth, and the implementation of the SGP's Excessive Deficit Procedure (EDP) for a number of countries highlighted problems surrounding its operation and design.

As set out in *The Stability and Growth Pact: A Discussion Paper*, published alongside Budget 2004, the UK Government has consistently argued for reform to promote a prudent interpretation of the SGP. A prudent interpretation would take into account:

- **the economic cycle – by allowing the automatic stabilisers to operate fully and symmetrically over the cycle, fiscal policy can support monetary policy in smoothing the path of the economy, so providing the flexibility to take the right decisions over the cycle;**
- **sustainability – taking into account that low debt levels enhance the sustainability of the public finances, allowing greater room for the automatic stabilisers to operate, and providing a sound basis for investment in public services. Assessment of sustainability should also take into account the long-term budgetary impact of ageing populations, such as that set out in Annex A and in the *2004 Long-term public finance report*; and**
- **public investment – recognising that public investment contributes to the provision of high-quality public services and can help to underpin a flexible, high productivity economy.**

Proposals for reform are being discussed in Europe. These proposals are an important step forward, with increased attention to the economic cycle, debt levels, and country specific circumstances. However, much will depend on implementation. It is also essential to recognise the importance of national frameworks and national ownership of fiscal policy.

ADHERING TO PRINCIPLES

2.52 Table 2.5 presents the key fiscal aggregates based on the five themes of fairness and prudence, long-term sustainability, economic impact, financing and European commitments. The table indicates that, after allowing for non-discretionary changes to receipts and spending and taking into account the Budget decisions, the Government is meeting both its fiscal rules.

Table 2.5: Summary of public sector finances

	Per cent of GDP						
	Outturn	Estimate[1]		Projections			
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Fairness and prudence							
Surplus on current budget	–1.8	–1.4	–0.5	0.0	0.3	0.6	0.8
Average surplus since 1999-2000	0.5	0.1	0.1	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	–1.0	–0.8	–0.3	0.1	0.3	0.6	0.8
Long-term sustainability							
Public sector net debt[1]	32.8	34.4	35.5	36.2	36.8	37.1	37.1
Core debt[1]	31.6	32.8	33.8	34.5	35.2	35.6	35.7
Net worth[2]	24.7	22.1	19.9	18.9	18.2	18.4	18.0
Primary balance	–1.5	–1.3	–0.9	–0.5	–0.2	0.1	0.3
Economic impact							
Net investment	1.3	1.6	2.1	2.3	2.3	2.3	2.3
Public sector net borrowing (PSNB)	3.2	2.9	2.6	2.2	2.0	1.6	1.5
Cyclically-adjusted PSNB	2.3	2.4	2.4	2.2	2.0	1.6	1.5
Financing							
Central government net cash requirement	3.5	3.7	3.2	2.6	2.3	2.1	2.2
Public sector net cash requirement	3.5	3.2	2.8	2.4	2.1	1.8	1.8
European commitments							
Treaty deficit[3]	3.2	2.9	2.6	2.2	2.0	1.7	1.6
Cyclically-adjusted Treaty deficit[3]	2.3	2.3	2.4	2.2	2.0	1.7	1.6
Treaty debt ratio[4]	39.5	41.0	42.0	42.4	42.8	42.9	42.9
Memo: Output gap	–1.2	–0.7	–0.1	0.0	0.0	0.0	0.0

[1] At end March; GDP centred on end March.
[2] At end December; GDP centred on end December.
[3] General government net borrowing on a Maastricht basis.
[4] General government gross debt on a Maastricht basis.

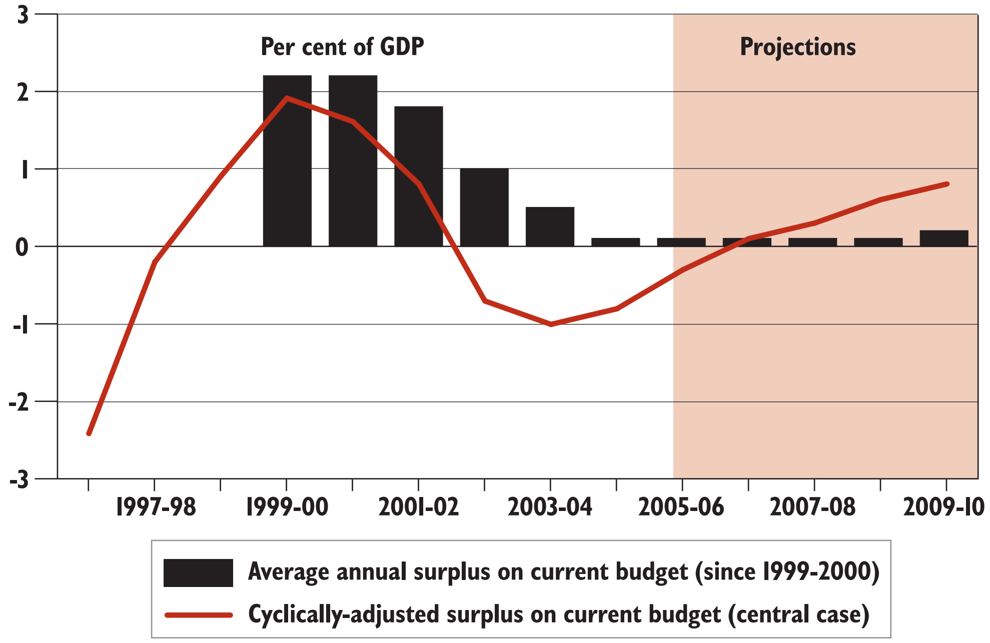
Golden rule

2.53 The current budget balance represents the difference between current receipts and current expenditure, including depreciation. It measures the degree to which current taxpayers meet the cost of paying for the public services they use and is therefore an important indicator of intergenerational fairness. The current budget strengthens through the projection period, returning to surplus in 2006-07 and showing a surplus of 0.8 per cent of GDP by 2009-10.

2.54 The golden rule is set over the economic cycle to allow fiscal policy to support monetary policy in maintaining stability through the operation of the automatic stabilisers. Progress against the rule is measured by the average annual surplus on the current budget as a percentage of GDP since the cycle began.

2.55 The average surplus on the current budget since 1999-2000, which on the Government's provisional judgement is the start of the current cycle, is positive in every year of the projection period. The economy is projected to return to trend during 2005-06, meaning that over the whole cycle the average annual surplus on the current budget would be 0.1 per cent of GDP, unchanged since Budget 2004. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £6 billion in this cycle, including the AME margin.

Chart 2.4: Meeting the golden rule

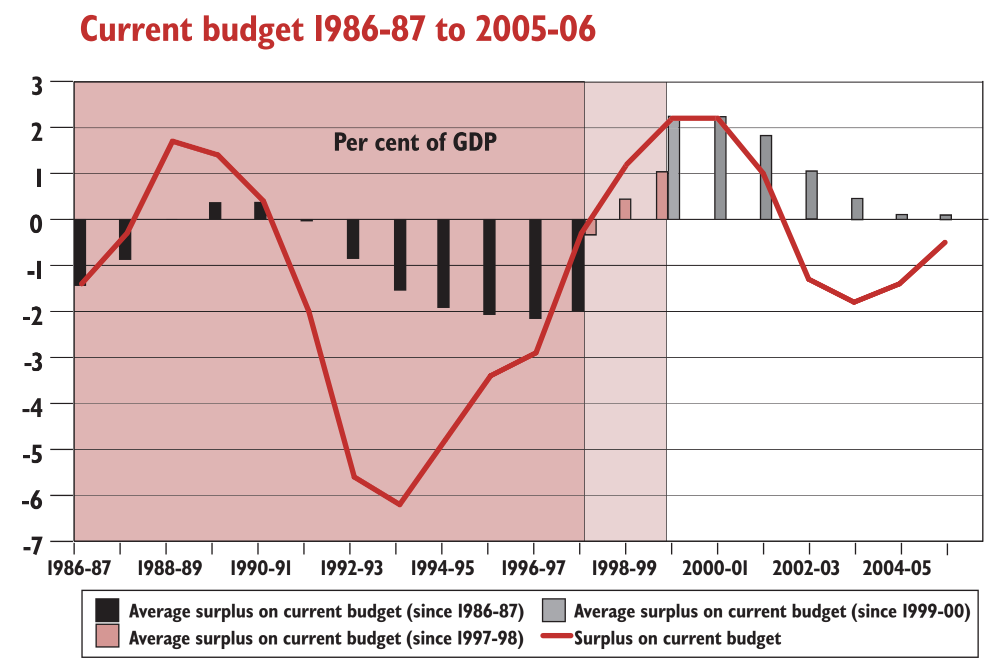


2.56 The economy is projected to return to trend around the end of 2005. With the economy assumed to be on trend from then on, the projections show, based on cautious assumptions, that the average surplus on the current budget over the period 2005-06 to 2009-10 is over a $^1/_4$ per cent of GDP. Based on cautious assumptions, the Government is therefore on course to meet the golden rule from 2005-06 to the end of the projection period.

Box 2.5: The current budget in past and current cycles

The current budget represents the difference between current receipts and current expenditure including depreciation. The golden rule is met if the average annual surplus on the current budget expressed as a ratio to GDP is in balance or surplus over the economic cycle.[a]

Since the mid-1980s, there have been three economic cycles: the first running from mid-1986 to the first half of 1997; a short cycle which began in the first half of 1997 and, on the basis of the Government's provisional judgement, is estimated to have ended in mid-1999; and the current economic cycle beginning in mid-1999 and currently projected to end in 2005-06. The chart shows that the golden rule was met in the short cycle between the first half of 1997 and mid-1999, and is being met in the current cycle. The golden rule would not have been met in the cycle running from mid-1986 to the first half of 1997, during which period there was an average annual deficit on the current budget of nearly 2 per cent of GDP.



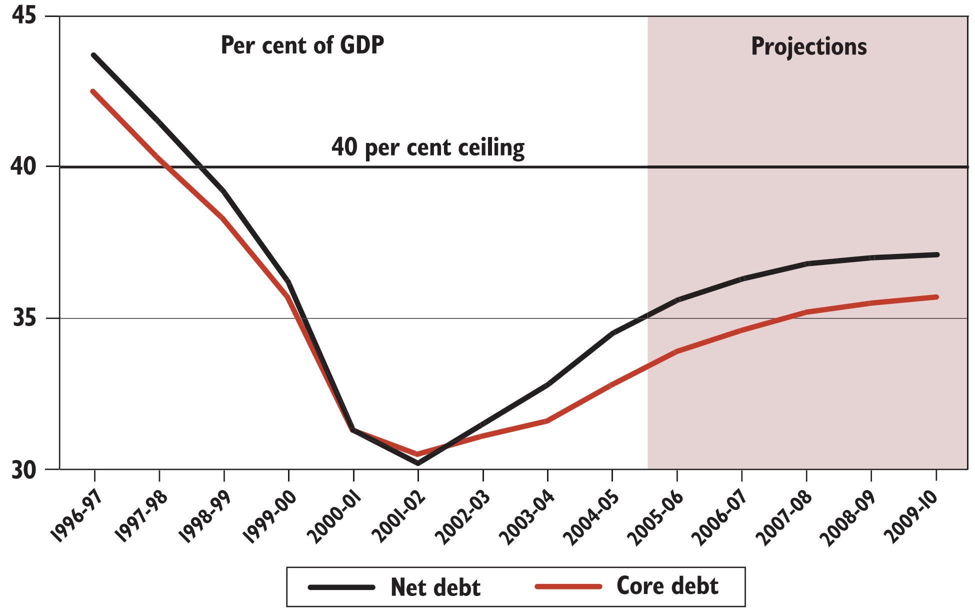
[a] The rationale for the Government's fiscal rules and their measurement is discussed in detail in Chapter 9 of *Reforming Britain's Economic and Financial Policy*, Balls and O'Donnell (eds.), 2002.

Sustainable investment rule

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

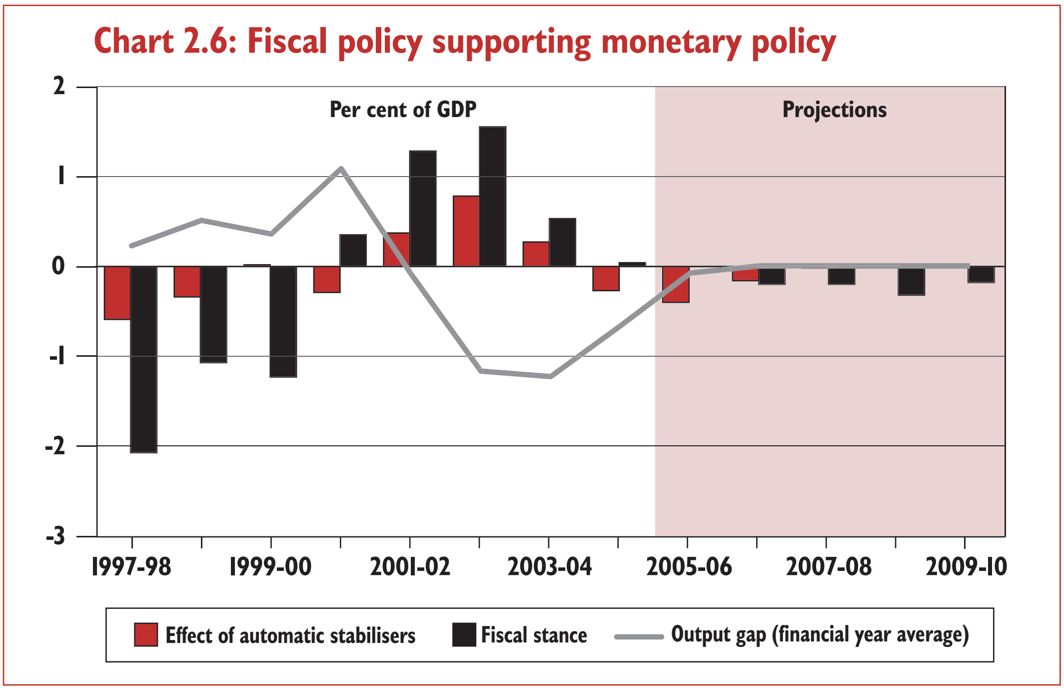
2.58 Chart 2.5 shows that, despite a sustained period of weakness in the world economy between 2001 and 2003, net debt is expected to remain low and stable, stabilising at 37 per cent of GDP by the end of the projection period, well below the 40 per cent level. Therefore, the Government comfortably meets its sustainable investment rule. Chart 2.5 also illustrates projections for core debt, which excludes the estimated impact of the economic cycle on public sector net debt. Core debt is projected to rise to 35½ per cent of GDP as the Government borrows modestly to fund increased long-term capital investment in public services. This is consistent with the fiscal rules, and with the key objective of intergenerational fairness that underpins the fiscal framework.

Chart 2.5: Meeting the sustainable investment rule

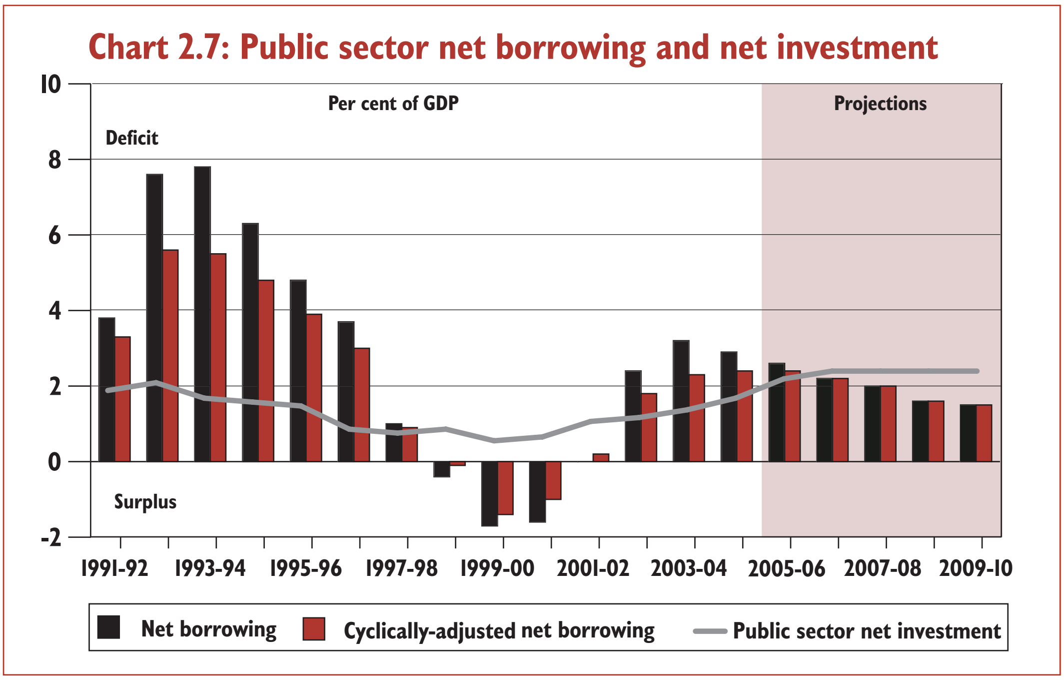


Economic impact

2.59 While the primary objective of fiscal policy is to ensure sound public finances, it also affects the economy and plays a role in supporting monetary policy over the cycle. The overall impact of fiscal policy on the economy can be assessed by examining changes in public sector net borrowing (PSNB). Chart 2.6 shows how the fiscal stance and automatic stabilisers have helped to support monetary policy.



2.60 During the late 1990s, the fiscal stance tightened at a time when the economy was above trend, supported by the automatic stabilisers. As the economy moved below trend, fiscal policy continued to support monetary policy in helping to deliver economic stability, through the automatic stabilisers and an easing of the fiscal stance. Subsequently as the economy returns to trend the fiscal stance moves back to a more neutral position, locking in the fiscal stance projected in Budget 2004 and the 2004 Pre-Budget Report. This is the appropriate stance for this stage of the economic cycle, when the economy is just below or at trend. This allows moderate borrowing for sustained public investment, to address the UK's historical under-investment in front-line public services, while maintaining debt at a low and sustainable level. Cyclically-adjusted net borrowing is projected to fall gradually by nearly 1 per cent of GDP by the end of the projection period. A significant loosening of the fiscal stance in the near term, such as through a large discretionary fiscal stimulus, would be inappropriate given the current cyclical position of the economy and could undermine the UK's recent economic stability.



2.61 The overall impact of fiscal policy on the economy is made up of changes in:

- the fiscal stance - that part of the change in PSNB resulting from changes in cyclically-adjusted PSNB; and
- the automatic stabilisers - that part of the change in PSNB resulting from cyclical movements in the economy.

2.62 Between Budgets and Pre-Budget Reports, the fiscal stance can change as a result of a discretionary measure to:

- achieve a desired change in the fiscal stance; or
- accommodate or offset the impact of non-discretionary factors (non-cyclical or structural changes to tax receipts or public spending).

2.63 Table 2.6 explains how these concepts relate to the projections in the Budget. It shows the changes in both the fiscal stance and the overall fiscal impact between Budget 2004 and the 2004 Pre-Budget Report, and the changes since the Pre-Budget Report. Budget 2005 locks in the fiscal stance over the medium term, with a modest tightening in 2005-06.

Table 2.6: The overall fiscal impact[1]

	Per cent of GDP						
	Outurn[2]	Estimate[3]	Projections				
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Change from Budget 2004 to PBR 2004							
Post Budget and PBR policy decisions	0.0	0.1	0.0	0.0	0.0	0.0	–
+							
non-discretionary factors	–0.3	0.1	0.2	0.1	0.0	0.1	–
=							
CHANGE IN FISCAL STANCE	–0.3	0.1	0.2	0.1	0.1	0.0	–
+							
automatic stabilisers	0.0	0.0	0.0	0.0	0.0	0.0	–
=							
OVERALL FISCAL IMPACT	–0.2	0.1	0.2	0.1	0.1	0.0	–
Change from PBR 2004 to Budget 2005							
Budget measures	0.0	0.0	0.0	0.0	0.1	0.0	0.0
+							
non-discretionary factors	0.1	0.1	–0.1	0.0	–0.1	0.0	0.0
=							
CHANGE IN FISCAL STANCE	0.1	0.1	–0.1	0.0	0.0	0.0	0.0
+							
automatic stabilisers	–0.1	–0.1	0.0	0.0	0.0	0.0	0.0
=							
OVERALL FISCAL IMPACT	0.0	0.0	–0.1	0.0	0.0	0.0	0.0

[1] *All numbers represent the impact of changes on public sector net borrowing. A negative number represents fiscal tightening.*

[2] *The 2003-04 figures were estimates in Budget 2004.*

[3] *The 2004-05 figures were projections in Budget 2004.*

Financing

2.64 The forecast for the central government net cash requirement (CGNCR) for 2004-05 is £42.9 billion, an increase of £3.2 billion from the 2004 Pre-Budget Report forecast. Allowing for a £0.1 billion increase in financing due to the Debt Management Office's (DMO) secondary market purchases of gilts means that the net financing requirement for 2004-05 is now expected to be £55.7 billion, an increase of £3.3 billion from the 2004 Pre-Budget Report forecast. This increased financing requirement is being met by a £2.0 billion increase in the forecast stock of Treasury's bills, resulting in a £1.3 billion reduction in the forecast level of DMO's short-term cash position at end-March 2005.

2.65 The forecast for the CGNCR for 2005-06 is £40.2 billion. With redemptions of £14.5 billion, and an estimated forecast net contribution of £3.5 billion from National Savings & Investments, the forecast net financing requirement for 2005-06 is £51.2 billion. The financing requirement will be met by:

- gross gilts issuance of £53.5 billion; and
- a reduction in the Treasury bill stock of £1.0 billion by end March 2006; and
- £1.3 billion increase in the DMO's short-term cash position by end March 2006.

2.66 Full details and a revised financing table can be found in Chapter C. Further details can be found in the *Debt and Reserves Management Report 2005-06* which has been published today.

European commitments

2.67 The Government supports a prudent interpretation of the Stability and Growth Pact, as described in Box 2.4 and *The Stability and Growth Pact: A Discussion Paper*, published alongside Budget 2004. This takes into account the economic cycle, the long-term sustainability of the public finances and the important role of public investment. The public finance projections set out in Budget 2005, which show the Government is meeting its fiscal rules over the cycle, low debt and sustainable public finances, combined with sustainable increases in public investment, are fully consistent with the prudent interpretation of the Pact.

Dealing with uncertainty

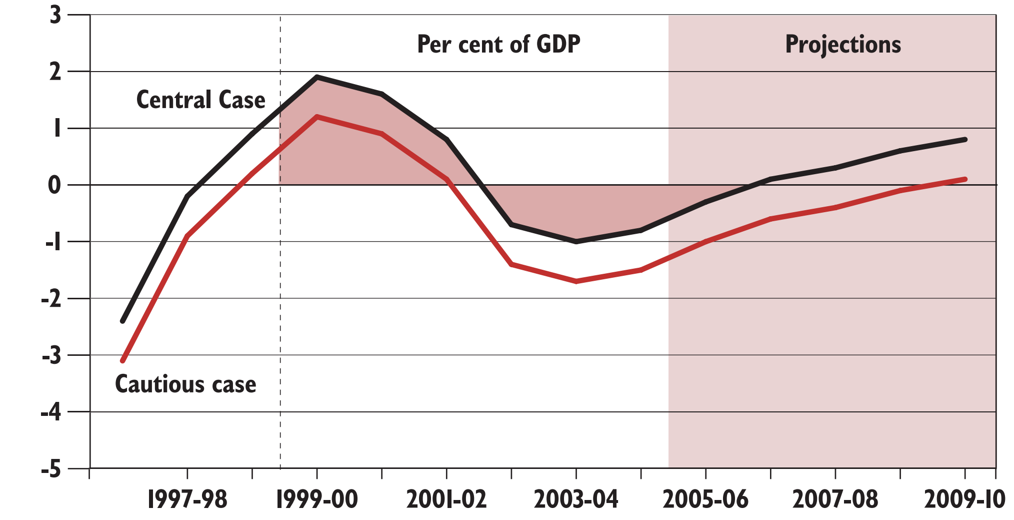
2.68 Forecasts for the public finances are subject to a considerable degree of uncertainty, in particular the fiscal balances, which represent the difference between two large aggregates. The use of cautious assumptions audited by the NAO builds a safety margin into the public finance projections to guard against unexpected events. The degree of caution in the assumptions underpinning the public finance projections increases over the projection period. For example, to accommodate potential errors arising from misjudgements about the trend rate of growth of the economy in the medium term, the Government bases its public finance projections on a trend growth assumption that is a $^1/_4$ percentage point lower than its neutral view. This implies that the level of GDP used in the public finance forecast is 1.3 per cent below the neutral view by 2009-10.

2.69 A second important source of potential error results from misjudging the position of the economy in relation to this trend. To minimise this risk, the robustness of the projections is tested against an alternative scenario in which the level of trend output is assumed to be one percentage point lower than in the central case. Chart 2.8 illustrates the projections for this cautious case.

2.70 The Government has used the cautious case and cautious, audited assumptions to build a safety margin against unexpected events. This was combined with the decision to consolidate the public finances when the economy was above trend, which resulted in low debt. This has allowed the Government to safeguard the increase in investment in priority public services, allow the automatic stabilisers to work in full during the period of global economic uncertainty that began in 2000 and meet in full the UK's international commitments, while continuing to meet the fiscal rules.

2.71 The Government is, on the basis of cautious, independently audited assumptions, meeting the golden rule in the central case. In the cautious case, the projections show that this safety margin is being rebuilt by the end of the projection period as the current budget moves into surplus and the cyclically-adjusted surplus in the cautious case also moves back into surplus. In the meantime, the Government will remain vigilant to the risks and continue to base projections of the public finances on cautious assumptions.

Chart 2.8: Cyclically-adjusted surplus on current budget



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

LONG-TERM FISCAL SUSTAINABILITY

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

2.73 An analysis of long-term fiscal sustainability is presented in Annex A. The analysis shows that given the projected profile for tax revenues and transfers, current public consumption can grow at around the same rate as that assumed for GDP after the medium term while meeting the Government's golden rule. Public sector net investment can also grow broadly in line with the economy without jeopardising the sustainable investment rule.

2.74 These illustrative long-term fiscal projections yield similar conclusions to those presented in the Government's 2004 *Long-term public finance report*, published alongside the 2004 Pre-Budget Report. The report demonstrates that the UK fiscal position is sustainable in the long term on the basis of current policies and that the UK is in a strong position relative to many other developed countries to face the challenges ahead.

Box 2.6: Public Finances in the G7

The table below compares the projections presented in Budget 2005 with those for other G7 countries, as forecast by the OECD. While care needs to be taken when comparing numbers internationally, the UK performs well, with debt and deficits among the lowest in the G7, and below the average for the G7 as a whole. Over the medium term, low and falling deficits in the UK contrast with high and persistent deficits in a number of our major industrialised competitors. This relatively favourable fiscal position, alongside a higher potential growth rate than some of our major competitors, means the UK is well placed to respond to the global economic challenges of the next decade.

Public finances in the G7

Per cent of GDP	Estimate	Projections	
	2004-05	2005-06	2006-07
United Kingdom			
Public sector net borrowing (PSNB)	2.9	2.6	2.2
Cyclically-adjusted PSNB	2.4	2.4	2.2
Net debt	34.4	35.5	36.2
Public sector net investment	1.6	2.1	2.3
	2004	2005	2006
France			
Net borrowing	3.7	3.1	2.9
Cyclically-adjusted net borrowing	3.1	2.5	2.4
Net debt	46.1	47.6	48.7
Germany			
Net borrowing	3.9	3.5	2.7
Cyclically-adjusted net borrowing	2.6	2.3	1.9
Net debt	54.7	57.1	58.0
Italy			
Net borrowing	2.9	3.1	3.6
Cyclically-adjusted net borrowing	2.7	3.0	3.7
Net debt	96.2	95.8	95.5
Canada			
Net borrowing	–1.1	–1.2	–1.0
Cyclically-adjusted net borrowing	–1.2	–1.1	–1.0
Net debt	31.1	28.1	25.7
Japan			
Net borrowing	6.5	6.4	6.3
Cyclically-adjusted net borrowing	6.3	6.4	6.6
Net debt	84.4	90.1	94.7
USA			
Net borrowing	4.4	4.1	4.2
Cyclically-adjusted net borrowing	4.2	4.0	4.2
Net debt	44.3	45.7	47.6
G7 average[1]			
Net borrowing	3.3	3.1	3.0
Cyclically-adjusted net borrowing	2.9	2.8	2.9
Net debt	55.9	57.1	58.1

Source: For comparability, data for countries excluding UK from OECD Economic Outlook 76 (December 2004). Net borrowing refers to general government financial balances, net debt refers to general government net financial liabilities.

[1] Unweighted average (financial year figures used for UK).