Convergence Programme for the United Kingdom:

submitted in line with the Stability and Growth Pact

December 2008

HM TREASURY

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Contents

1 Introduction

1.1 The Government has submitted programmes under the Stability and Growth Pact for each of the last ten years. The Stability and Growth Pact requires Member States to provide information on economic developments in their country, for the purposes of the multilateral surveillance procedure under Articles 99 and 104 of the EU Treaty (ex Articles 103 and 104c).

1.2 This regular annual Convergence Programme updates the UK's 2007 Convergence Programme to reflect the latest Government forecasts for the economy and the public finances, which were published in the Pre-Budget Report on 24 November 2008[1]. The public finance projections in the Pre-Budget Report have a different status to those included in the Budget – they are an interim forecast update. This update therefore also takes account of Budget 2008[2]. The updated Programme is subject to the usual UK Parliamentary scrutiny and approval under Section 5 of the European Communities (Amendment) Act 1993.

Facing global challenges

1.3 The Government's long-term goal is to secure and maintain macroeconomic stability, in order to promote a strong economy and achieve its objective of a fair society where there is security and opportunity for all.

1.4 Chapter 2 outlines how over the last year major shocks have hit the economies of every country in the world. While commodity prices have recently eased, the credit shock has intensified into the worst global financial crisis for generations, a crisis that is being addressed by a global policy response of unprecedented scale and scope. The current economic and fiscal climate is exceptionally challenging. While economic prospects are subject to significant uncertainty, it is clear that the UK, like many advanced economies has moved into recession.

1.5 The UK economy has slowed as credit conditions tightened and high food and energy prices squeezed household incomes and company profits. The combined effects of these shocks has been to push the UK economy into recession and inflation to a 16-year high. Due to lower commodity prices, inflation has started to ease, but growth is forecast to be negative in 2009. From the second half of 2009, the economy is forecast to begin to recover, with growth picking up further in 2010 and 2011.

1.6 The macroeconomic framework introduced in 1997, means that the UK is facing these shocks from a solid foundation. Credible medium-term objectives and mechanisms for short-term flexibility mean that the Bank of England and the Government can deliver the necessary support to the economy without compromising their respective commitments to low inflation and sound public finances.

[1] 2008 Pre-Budget Report, HM Treasury, November 2008

[2] Budget 2008, HM Treasury, March 2008

Policy Response

1.7 Chapters 3 and 4 outline in detail the Government's and the Bank of England's response to the global shocks.

1.8 The Bank of England has reduced interest rates to a 50-year low, providing monetary policy support to the economy.

1.9 The Government's immediate priority is to continue to support the economy through these difficult times. A starting point of low public debt, and action being taken to ensure sound public finances over the medium term, provide flexibility for fiscal policy to support the economy now, acting to support monetary policy. The 2008 Pre-Budget Report announced that the Government will support families and businesses, including by:

- temporarily reducing the VAT rate to 15 per cent with effect from 1 December 2008 to 31 December 2009; and
- bringing forward £3bn of capital spending from 2010-11 to 2008-09 and 2009-10, the years when the impact of the shock is likely to be the strongest.

1.10 Over the medium term, the Government's fiscal policy objective is to ensure the sustainability of the public finances, in order to protect economic stability and long-term growth. The 2008 Pre-Budget Report therefore, set out plans for a sustained fiscal consolidation from 2010-11, when the economy is expected to be recovering and able to support a reduction in borrowing.

The case for a concerted international fiscal response

1.11 The case for concerted fiscal action has been endorsed by the leaders of the G20 countries. On 15 November 2008 they declared that they:

- had agreed to work together to restore global growth; and
- would "*use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability*".

1.12 The combined effect of coherent actions taken across countries will be more effective than each country acting alone. Decisive concerted action by the world's leading economies will also provide a strong signal to the private sector of the willingness of governments to act effectively together. An effective international response does not mean that all countries should take identical actions. Instead, fiscal actions need to be tailored to the situation of each country, taking account of existing levels of public debt.

The macroeconomic framework

1.13 The Government's macroeconomic framework has been designed to ensure that policymakers have the flexibility to respond appropriately to shocks.

1.14 The Government's fiscal policy objectives remain unchanged:

- 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 automatic stabilisers to help smooth the path of the economy

1.15 To achieve its objectives, the Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full. Consistent with the *Code for Fiscal Stability*, the Government is setting a temporary operating rule: to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once global shocks have worked their way through the economy in full.

1.16 Chapter 3 contains a detailed discussion of the UK's macroeconomic framework.

Public Finances

1.17 Developments in the economy and financial markets since the 2007 Convergence Programme have significant implications for the public finance projections. Table 1.A provides a summary of the 2008 Pre-Budget Report projections for key fiscal aggregates, which are discussed more fully in Chapter 4.

Table 1.A: Summary of fiscal projections

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Public sector net borrowing (PSNB)	2.6	5.3	8.0	6.8	5.3	4.1	2.9
Total change since Budget	*0.0*	*2.4*	*5.5*	*4.8*	*3.7*	*2.8*	-
Impact of discretionary measures on PSNB [1]	*0.0*	*0.6*	*1.1*	*-0.3*	*-0.9*	*-1.3*	*-1.6*
Surplus on current budget	-0.5	-2.8	-5.3	-4.7	-3.3	-2.2	-1.1
Cyclically-adjusted surplus on current budget	-0.8	-2.8	-4.4	-3.4	-2.3	-1.6	-1.0
Public sector net investment	2.1	2.5	2.7	2.1	2.0	1.9	1.8
Public sector net debt[2]	36.3	41.2	48.2	52.9	55.6	57.1	57.4

[1] *Including changes in forecasting assumptions on spending growth in 2011-12, 2012-13 and 2013-14.*

[2] *Debt at end March; GDP centred on end March; excluding financial sector interventions.*

1.18 The fiscal projections set out in the 2008 Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a share of the economy by 2015-16 when the global shocks will have worked through the economy in full. They imply, as the economy emerges from the downturn, an adjustment in the cyclically-adjusted current balance of over 0.5 per cent of GDP a year from 2010-11.

1.19 Public sector net borrowing (PSNB) increases from 2.6 per cent of GDP in 2007-08 to 8.0 per cent in 2009-10, reflecting the impact of the economic downturn on receipts, in particular from the financial and housing sectors, the effect of the automatic stabilisers and the action the Government is taking to support the economy. Of this around 1.1 per cent of GDP is as a result of discretionary action to support the economy. PSNB then declines to 2.9 per cent of GDP by 2013-14 as the economy recovers and the Government takes action to ensure the sustainability of the public finances.

1.20 Public sector net debt (PSND) increases over the forecast period, in particular in 2009-10 and 2010-11, reflecting the additional borrowing in these years, then begins to stabilise at just over 57 per cent by 2013-14.

Sustainability for the long term

1.21 The analysis in chapters 3 and 4 sets out how the Government will ensure sustainability in the medium term. In addition, the Government must also ensure that fiscal policy is sustainable in the long term. Chapter 5 discusses some of the socio-economic challenges facing the public finances in the long term, including demographic changes.

Quality of public finances

1.22 Over the last ten years, record levels of investment coupled with reform have generated real and enduring improvements in Britain's schools, hospitals and other public services. The Government will maintain high levels of investment, reprioritise spending to support the economy through the downturn and take forward an ambitious extension of its plans to increase value for money. More details are contained within Chapter 6.

Stability and Growth Pact

1.23 European economies have all been affected by the unprecedented global economic shocks, and several European member states are already in recession. Fiscal policy has an important role to play in these exceptional circumstances. The 2005 revision of the Pact allows better account to be taken of cyclical conditions, and places greater emphasis on improved flexibility in exceptional circumstances. The Government welcomed these reforms and has since emphasised the importance of applying the additional economic judgement the revisions allow.

1.24 The Government's objectives of smoothing the path of the economy in the short term while ensuring sound public finances over the medium term are consistent with the October European Council Conclusions, which confirmed that the Stability and Growth Pact should be applied in a manner that reflects current exceptional economic circumstances. The objectives are also consistent with the Commission's 26 November Communication, "A European Economic Recovery Plan". This recognises that a budgetary expansion, which may lead some Member States to breach the 3% GDP deficit reference value, is justified in these extraordinary circumstances. It further states that corrective action will have to be taken in time frames consistent with the recovery of the economy.

Economic reform in Europe

1.25 The Government set out progress against key elements of the UK's comprehensive programme of structural reform, including measures being taken in the areas covered by the UK's country-specific recommendations prepared by the Council of the European Union, in the 2008 UK National Reform Programme[3]. The main reform actions are summarised in Annex C, taken from the 2008 National Reform Programme and updated to take into account the announcements made in the 2008 Pre-Budget Report.

Annex A & Annex B

1.26 Annex A provides details of the financial impact of the 2008 Pre-Budget Report and Budget 2008 policy decisions. Annex B provides supplementary information.

[3] *Lisbon Strategy for Jobs and Growth: UK National Reform Programme*, HM Government, September 2008

2 Economic outlook

Global economic shocks

2.1 Between the summer of 2007 and summer 2008, the world economy progressively suffered from the unprecedented confluence of two major economic shocks. The global financial markets shock was triggered in July 2007. What began as a disruption to the functioning of specific credit and money markets has spread and intensified to the extent that all financial markets have been affected and financial institutions and financial systems around the world have been put under severe pressure. As a result, credit conditions facing households and companies have tightened very significantly. The availability of credit has been restricted, the terms on lending tightened, and the price of private credit has soared relative to official policy rates and government borrowing costs, factors that have caused growth in advanced and emerging economies to slow significantly.

2.2 The effect of restricted credit on household and company spending was exacerbated by a surge in global commodity prices in the first half of 2008 that put strong upward pressure on food and energy prices around the world. Stresses in financial markets intensified dramatically in September and October, with a number of large and small financial institutions across a broad range of advanced and emerging economies receiving government support, in conjunction with unprecedented generalised support for banking systems across the world. As output growth has slowed in response to these shocks, commodity prices have fallen sharply, thereby removing one of the factors detracting from world growth prospects.

The world economy

2.3 Global economic prospects have been hit hard since summer 2007, and particularly since Budget 2008. The credit shock described above caused credit conditions to tighten across advanced economies and growth to slow. The surge in commodity prices in the first half of 2008 lifted inflation, squeezing real incomes and pushing many advanced economies into recession. The escalation of the global banking crisis in recent months has increased uncertainty over prospects for growth in advanced economies and the risk of contagion to emerging markets. But the global financial policy response has limited the downside risks from systemic banking collapse, and an increasing number of countries have eased monetary policy and announced fiscal stimulus measures. At the same time, lower commodity prices should provide support for real incomes next year.

2.4 Against the backdrop of major economic shocks, world growth is forecast to have slowed to 3½ per cent in 2008 and to fall to just 2 per cent in 2009. That would represent a serious slowdown from the 4¾ per cent expansion in 2007, reflecting slower domestic demand growth in advanced economies and weaker trade growth around the world. Growth across the G7 economies is forecast to have slowed to 1 per cent this year, and to turn negative in 2009, the first year of contraction since 1982. Many advanced economies are already experiencing falling output, with the euro area and Japan in recession.

2.5 The outlook for world trade has deteriorated in line with world growth prospects, exacerbated by the effect of the global financial crisis on the availability of trade finance. UK export markets are expected to grow more slowly than world trade as advanced economies, particularly the euro area and US, make up a larger proportion of UK export markets.

Table 2.A: The World Economy

	Percentage change on a year earlier, unless otherwise stated				
		Forecast			
	2007	**2008**	**2009**	**2010**	**2011**
World GDP	4¾	3½	2	3¾	4½
Major 7 countries [1]:					
Real GDP	2¼	1	-¾	1½	2½
Consumer price inflation[2]	3	2¾	1¼	2	2
Euro area GDP	2¾	1	-1	1	1¾
World trade in goods and services	7	5¼	2	4¼	7
UK export markets[3]	6½	3¾	½	3¼	6

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

[2] *Per cent, Q4.*

[3] *Other countries' imports of goods and services weighted according to the importance of imports from the UK in those countries' total imports.*

2.6 Inflation, which picked up in the first half of 2008 following the surge in commodity prices, is expected to moderate quickly towards the end of the year. G7 inflation is forecast to hit an 8-year low of 1¼ per cent by late 2009. The inflation outlook for emerging economies is less clear, as many currencies have depreciated rapidly and a number of monetary policy frameworks are not yet well established.

2.7 Receding inflation risks in the G7 countries have provided greater scope for monetary easing. On 8 October, six major central banks, including the Federal Reserve, European Central Bank (ECB) and Bank of England, announced a coordinated ½ percentage point interest rate cut. Subsequently, the Federal Funds rate was cut further to 1 per cent, down from a peak of 5¼ per cent prior to the onset of the global credit shock, and official interest rates have been reduced to 2½ per cent in the euro area, 0.3 per cent in Japan and 2 per cent in the UK.

Prospects for UK economic growth

Recent developments

2.8 In 2006 and 2007, GDP grew by 2¾ and 3 per cent respectively. Reflecting the impact on the economy of the major shocks it has faced, growth has slowed progressively as credit conditions tightened and real incomes were squeezed by high commodity prices. Quarterly GDP growth in the first half of 2007 averaged 0.8 per cent, before slowing progressively to average 0.6 per cent in the second half and 0.1 per cent in the first half of 2008. In the third quarter, GDP contracted by 0.5 per cent, the first fall in output since 1992, with negative growth across most sectors of the economy. The distribution sector experienced the largest contraction, consistent with discretionary spending having been held back as consumer sentiment weakened and real incomes were squeezed.

2.9 Private sector business surveys weakened further in October, suggesting that output in the final quarter of 2008 is likely to fall again, placing the UK economy in technical recession. Surveys of purchasing managers compiled by the Chartered Institute of Purchasing and Supply indicate that output growth in the manufacturing, construction and services sectors was very weak. Similarly, the Economic Sentiment Indicator compiled by the European Commission fell to its lowest level since 1991.

2.10 In common with experience across the world, UK inflation increased during 2008 as the surge in global commodity prices fed through to retail prices of food, petrol and diesel, and household energy bills. In the UK, CPI inflation increased from 2.2 per cent in December 2007 to a peak of 5.2 per cent by September 2008 before falling back to 4.5 per cent in October. Movements in prices of goods that are most closely linked to global commodity prices accounted for virtually all of the increase: food price inflation increased from 6 per cent in December to a peak of 14½ per cent in August; petrol and diesel price inflation increased from 17 per cent to a peak of 26 per cent in July; and household energy price inflation increased from -7 per cent to 39 per cent in October.

2.11 Since the onset of the global credit shock in summer 2007, the Monetary Policy Committee (MPC) of the Bank of England has cut Bank Rate by a cumulative 2¾ percentage points, from 5¾ per cent to 3 per cent. On 8 October, the MPC cut rates by ½ a percentage point as part of a globally coordinated interest rate cut, and then on 6 November it reduced Bank Rate by a further 1½ percentage points to 3 per cent. This was followed by a further cut of 1 percentage point on 4 December to 2 per cent, the lowest rate since 1951. With inflationary pressures easing and weaker near-term UK growth prospects, financial markets have increasingly come to expect further monetary policy easing. This trend has been evidenced by the lowering of external forecasters' expectations of Bank Rate by the middle of 2009 to around 1½ per cent.

Trend growth

2.12 As with other aspects of economic forecasting, recent economic shocks, in particular the global financial crisis, have generated uncertainties over prospects for trend output, the assessment of which plays a central role in the Treasury's approach to forecasting. There are a number of channels through which the global credit and commodity price shocks could reduce the level of trend output. In light of commodity price developments since July 2008, credit related channels are the most likely to have persistent effects to trend output. Table 2.B presents estimates of trend output growth and its decomposition to the second half of 2006, and the Treasury's projections thereafter. For the 2008 Pre-Budget Report, to take account of the likely negative effect of the credit shock on trend output, a phased reduction to the trend level of productivity (and therefore the trend level of output) of about 4 per cent has been assumed over the two years from mid-2007, a period consistent with the credit conditions assumption that underpins the economic forecast more generally. This adjustment is within the range of external estimates of the impact of the shocks to credit and energy markets on medium-term potential output, though it is a key forecasting judgement around which there is very considerable uncertainty. The Treasury will continue to keep its trend output assumptions under review.

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

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

[1] *Treasury analysis based on judgement that 1986Q2, 1997H1, 2001Q3 and 2006H2 were on-trend points of the output cycle. Figures independently rounded. Trend output growth is estimated as growth of non-oil gross value added between on-trend points for the past, and by projecting components forward.*

[2] *Interim projections between Budget 2002 and PBR 2007 are provided in an expanded table in 'Budget 2008: the economy and public finances - supplementary material'.*

[3] *The underlying trend rate is the unadjusted trend rate adjusted for changes in the employment rate, i.e. assuming the employment rate had remained constant. Column (1) = column (2) + (1-a).column (4), where a is the ratio of new to average worker productivity levels. The figure is consistent with this ratio being of the order of 50 per cent,*

[4] *The decomposition makes allowances for employment and hours worked lagging output. Employment is assumed to lag output by around three quarters, so that on-trend points for employment come three quarters after on-trend points for output, an assumption which can be supported by econometric evidence. Hours are easier to adjust than*

[5] *UK resident household basis. Population aged 16 and over.*

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

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

[8] *Adjustment to trend growth reflecting a phased reduction to the level of trend output of around 4 per cent between mid-2007 and mid-2009.*

Economic cycle and the output gap

2.13 The 2008 Blue Book revisions to recent National Accounts data were relatively small, with non-oil GVA growth in both 2006 and 2007, of 3 per cent, still estimated to have been at an above-trend rate. Since the beginning of 2008, growth has slowed to below-trend rates of 0.3 per cent and 0.0 per cent in the first two quarters of the year, before falling to -0.5 per cent in the third quarter. Taken together with the 2008 Pre-Budget Report assumptions on trend output, this would imply that the economy was recently operating close to trend, with an output gap of around zero in the third quarter of 2008.

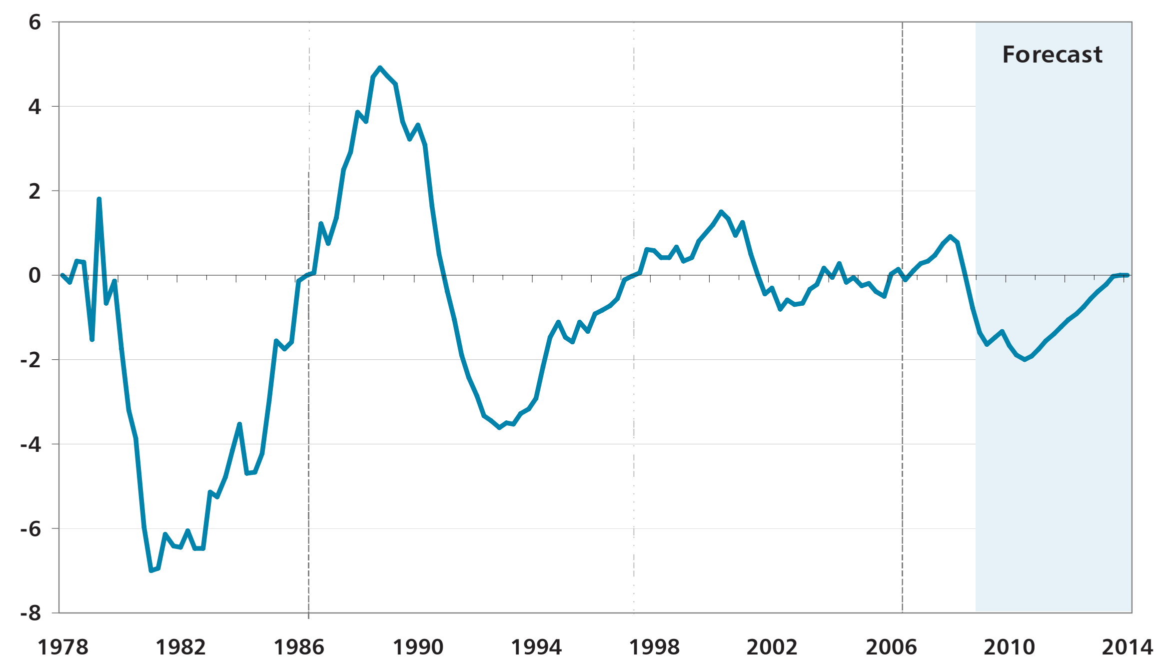
2.14 Evidence from the broad range of cyclical indicators monitored by the Treasury continues to support the Budget 2008 assessment that the economy passed up through trend during the second half of 2006, marking the end of the economic cycle judged to have started in the first half of 1997.

2.15 The Comptroller and Auditor General has audited this judgement. Taking all the evidence available as a whole, he judged that it is reasonable to conclude currently that the second half of 2006 marked the end date of the most recently completed economic cycle, and recommended, given the uncertainties in dating economic cycles, including looking ahead and the impact new data might have in the future, that the Treasury keep this assessment under review.

2.16 The cyclical indicators suggest the economy remained above trend during 2007 before falling back towards trend during the first half of 2008.

2.17 The Treasury's forecasting judgements on the impact of the credit shock on trend output are subject to significant uncertainty. 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 economic downturn. In terms of cyclical pressures, signals conveyed by the Bank's Regional Agents and the BCC and CBI quarterly business surveys do not deliver a clear picture of the degree of slack that has been generated by slowing growth over the past year. The evidence from the cyclical indicators is in general supportive of the assessment that the economy was recently operating close to trend, but clear uncertainties remain.

Chart 2.A: Output gap[1,2]



1 Mechanical output gap estimates based on the latest National Accounts data and the Treasury's trend output assumptions, expressed as actual output less trend output as a percent of trend output (non-oil basis). The Treasury's assessment of the cyclical position of the economy draws on evidence from a broad range of economic indicators, as set out in 'Evidence on the economic cycle', published alongside the 2008 Pre-Budget Report.

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

Source: HM Treasury.

Prospects for credit conditions

2.18 As was the case at Budget 2008, the key forecasting assumption underpinning the 2008 Pre-Budget Report forecast concerns prospects for the unwinding of tight credit conditions and normalisation of banking and financial markets. As set out above, conditions in global markets deteriorated dramatically in September and October. Following unprecedented global policy action in recent weeks, money markets have stabilised and the risk of systemic failure of the global financial system looks to have receded, but global credit markets have remained severely strained with stock markets falling sharply and some markets remaining closed.

2.19 Despite extensive government support for financial systems worldwide, it will take time for conditions to normalise, and recent experience is likely to mean that 'normal' credit conditions will be materially less accommodative than they were in the years to mid-2007. The 2008 Pre-Budget Report forecast is therefore conditioned on the assumption that credit conditions will remain tight in 2008, and ease slowly through 2009 before stabilising in 2010 at a level where risk is more appropriately priced. This assumption is consistent with a view that the value of underlying property collateral will have stopped falling around the end of 2009 and that lower policy interest rates and funding costs will enable banks to lend profitably, bolstering their capital positions. These developments should allow lenders to return to a normal process of intermediating funds from savers to borrowers, while pricing risk competitively, but more warily, so as to avoid the mistakes of recent years. The Government's comprehensive package of measures to support the banking system should limit the downside risks to this assumption, enhancing prospects for credit conditions to ease over the coming year.

GDP growth forecast

2.20 Lower commodity prices and easing inflation are set to support real incomes in 2009, sterling has depreciated, and monetary and fiscal policy have both been eased to support the economy through the downturn. Together these factors lay the foundations for recovery. Uncertainty remains over how effectively the global financial crisis can be resolved and therefore how soon the financial system can resume its normal function of intermediating funds from savers to borrowers, in order efficiently to finance investment, house purchase and consumption and spread concentrations of risk.

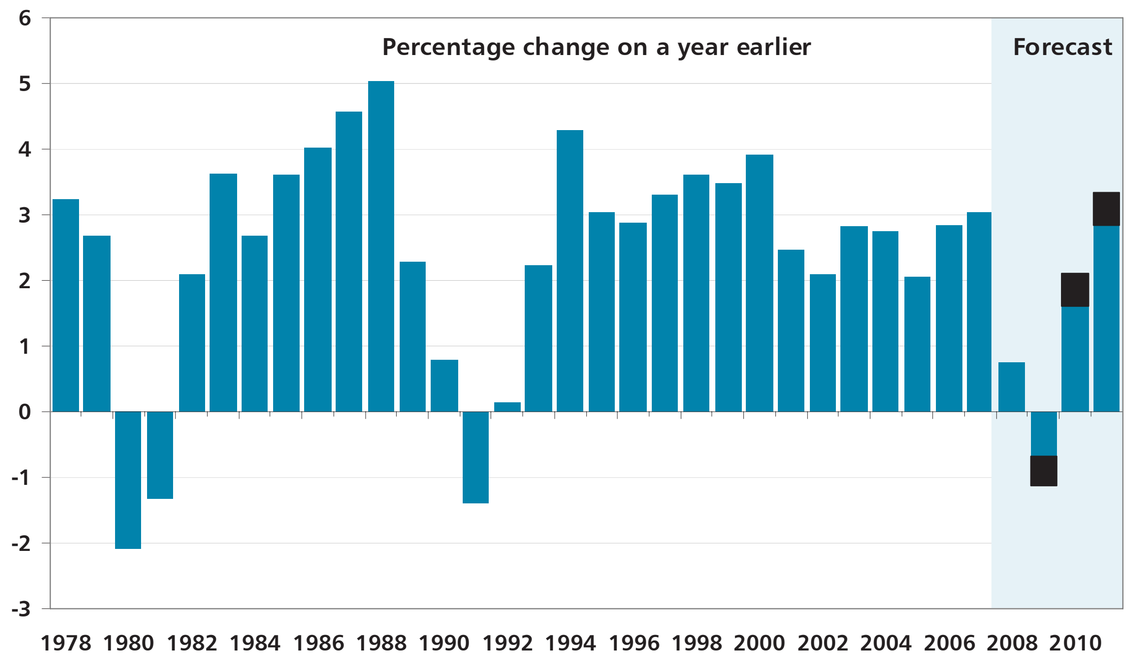
2.21 Having slowed progressively over the past year, GDP is forecast to fall by a ¼ per cent on a year earlier in the second half of 2008, leaving output in 2008 as a whole up ¾ per cent on a year earlier. The recession is forecast to continue into the first half of 2009, before GDP growth begins to recover in the second half of the year as credit conditions start to ease and the boost to real incomes from lower commodity prices, the stimulus from monetary and fiscal policy, and the effects of sterling's depreciation, take hold.

2.22 Growth in 2009 as a whole is forecast to be negative, at –1¼ to –¾ per cent. The effect of fiscal stimulus, particularly the temporary cut in the VAT rate and bringing forward of public investment to 2008-09 and 2009-10, in addition to other measures, is assumed to reduce the extent of the downturn by around ½ a percentage point. The UK also has relatively powerful automatic stabilisers, which will operate in full to support the economy.

2.23 Credit conditions are assumed to settle at a new norm in 2010, such that the process of efficient credit allocation is restored and the UK's flexible markets can adjust more effectively to changed economic circumstances. As lagged effects feed through, including from fiscal and monetary stimulus and from the depreciation of sterling, growth is expected to pick up progressively through 2010 and 2011 to a little above trend rates. Experience of past recoveries points to the possibility that, once recovery has taken hold, growth could continue at strong rates for a number of years as spare capacity is brought back into productive use. For example, GDP growth averaged 3¼ per cent a year in the five years from 1982 and again in the five years from 1993.

2.24 Chart 2.B shows the evolution of GDP. Table B.9 in Annex B compares the 2008 Pre-Budget Report GDP growth forecast with that of Budget 2008.

Chart 2.B: Gross Domestic Product (GDP)[1]



1 Shaded areas on bars represent forecast ranges.

Source: HM Treasury

Inflation

2.25 CPI inflation fell from 5.2 per cent in September to 4.5 per cent in October, suggesting September marked the peak. Global commodity prices have fallen sharply since the summer, which should feed through to consumer prices for petrol, food and household energy with varying lags. Energy prices contributed more than 2 percentage points to CPI inflation in September 2008, which means that even if energy prices were to remain unchanged from that level, by September 2009 they would subtract around 1 percentage point from the annual rate of inflation. In addition, with output contracting there is a degree of spare capacity opening up that will progressively reduce domestically generated inflationary pressure.

2.26 Commodity price developments and the emergence of a negative output gap would suggest that inflation will decline rapidly from above 5 per cent to reach the target rate by the middle of 2009, although the pass-through from sterling's depreciation will exert upward pressure. In addition, the temporary reduction of the VAT rate from 17½ per cent to 15 per cent from December 2008 is expected to put further downward pressure on inflation as businesses pass the cut through to prices. The forecast assumes that due to the competitive nature of the UK retail sector, especially during the coming downturn, the majority of the VAT rate cut will be passed through to consumer prices, but that prices will be reduced progressively rather than immediately. This is in line with international evidence. As a result, these factors mean that CPI inflation is forecast to fall below 1 per cent in the second half of 2009.

2.27 Unlike the initial cut in the VAT rate, the subsequent pre-announced increase back to 17½ per cent will be anticipated by businesses and consumers, so the forecast assumes that businesses will smooth the pass-through of this change during the normal process of reviewing prices as other costs and demand factors evolve. Inflation is forecast to move a little above the

2 per cent inflation target following the reversal of the VAT rate cut and as the lagged effects of sterling depreciation on import prices continue to feed through, before returning to target in 2011 as the still negative output gap exerts downward pressure.

Employment

2.28 Strong output growth in 2007 fed through to strong employment growth, with employment rising by more than 100,000 a quarter from the second quarter of 2007 to the first quarter of 2008. As output growth has slowed, employment flattened in the second quarter and fell by around 100,000 in the third quarter.

2.29 Unemployment has begun to increase, with the Labour Force Survey (LFS) measure of the unemployment rate rising from 5¼ per cent to 5¾ per cent over recent months. The more timely claimant count measure has risen by 186,000 since the start of the year, though from a very low level: January 2008 was the first time since mid-1975 that the claimant count had fallen below 800,000.

Consumption

2.30 Real household disposable income is estimated to have been flat in 2007, as negative growth in non-wage income, particularly net interest and dividend payments, offset the impact of strong employment growth on total wages and salaries. Sluggish real disposable income growth continued in the first half of 2008, as the commodity-price related pick-up in inflation squeezed real incomes further. The effects of lower commodity prices and the temporary cut in the rate of VAT should support real income growth in 2009, which is forecast to pick up to ½ to 1 per cent. As the recovery takes hold from 2010, a strengthening labour market is expected to take over as the main driver of real income growth as inflation returns to close to target and the effects of fiscal stimulus recede.

2.31 Private consumption grew by 3 per cent in 2007, in line with GDP growth as a whole. Consumer spending continued to grow strongly in the first quarter of 2008 before contracting slightly in the second quarter. The breakdown of consumer spending in the second quarter shows clearly how the global economic shocks impacted UK consumers, with spending on housing and transport-related durable goods falling by around 5 per cent on the previous quarter, while spending on discretionary services like recreation and restaurants was down by around 3 per cent.

2.32 Consumer spending is forecast to decline in 2009, reflecting various factors. Apprehension over labour market prospects and increased saving from the very low level of 2008 are likely to put downward pressure on consumer spending. The temporary cut in the rate of VAT, by boosting real purchasing power as it is passed through to lower prices and by incentivising purchases before the lower rate reverses, is expected to increase the volume of spending relative to the level that would have prevailed in the absence of such a cut. The forecast assumes that around half of the increase in real purchasing power will feed through to an increased volume of spending and half to the adjustment of household finances.

2.33 As real incomes recover further and credit conditions normalise, consumer spending is forecast to grow by 1¼ to 1¾ per cent in 2010, and then to continue to grow at rates slightly below that of the whole economy as households continue to adjust their finances. This pattern of growth, with a gradual rise in the household saving ratio, will support the rebalancing of demand in the UK from domestic to external sources.

Investment

2.34 Business investment grew strongly between 2005 and 2007, by more than 4 per cent a year in 2005 and 2006 and almost 10 per cent in 2007, a pattern consistent with the economy having passed up through trend in the second half of 2006. In the first half of 2008, business investment contracted by 1 per cent on a year earlier as uncertainty over demand prospects increased. The contraction was broadly based across sectors.

2.35 With company finances under pressure, near-term demand prospects weakening and credit conditions remaining tight, business investment is set to contract relatively sharply in 2008 and 2009. In keeping with the strongly cyclical nature of investment, after falling 1 per cent in 2008 and 7¾ to 8¼ per cent in 2009, business investment is forecast to begin recovering in 2010 as credit conditions normalise and demand uncertainties recede, and to grow strongly in 2011.

2.36 Between 2000 and 2007, investment in dwellings increased from around 2¾ per cent to 4 per cent of GDP in nominal terms, with around half of the rise accounted for by strong growth in house prices. As such, while real activity has been relatively strong, growing by 8½ per cent in 2006 and 5 per cent in 2007, the UK has not witnessed the kind of housing construction boom that took place in some countries, notably the US, Ireland and Spain.

2.37 Prospects for housing investment have been adversely affected by the impact of the global credit shock on the UK housing market. After contracting 7¾ per cent on a year earlier in the first half of 2008, investment is forecast to fall 9½ per cent in 2008 as a whole and by a further 11 to 11½ per cent in 2009. However, with the fundamental drivers of demand for housing – principally the rate of household formation – still in place, and credit conditions assumed to settle at a new norm, housing investment is expected to recover from later in 2010.

Trade and the balance of payments

2.38 Annual growth in recorded exports and imports of goods and services has been distorted by activity related to missing trader intra-community fraud (MTIC), which significantly inflated the value of measured goods trade in the first half of 2006. Since the second half of 2006, Government measures to tackle MTIC fraud have led to a sharp fall in estimated MTIC-related activity, to a low level.[1] The economic forecast abstracts from MTIC effects by making a neutral assumption that the adjustment for MTIC-related activity remains constant throughout the forecast at the latest quarterly estimate, and that trade grows in line with underlying determinants.

2.39 Growth in the measured volume of goods and services exports, excluding the MTIC adjustment, is estimated to have eased from 8 per cent in 2006 to 1¼ per cent in 2007. It seems possible that this exaggerates the extent of the genuine slowdown between those years, reflecting difficulties in applying the MTIC adjustment. With MTIC-related activity estimated to have been stable for more than a year, growth rates in the first half of 2008 should be subject to somewhat reduced uncertainty. On current estimates, the volume of exports of goods and services grew 2½ per cent on a year earlier in the first half of the year.

2.40 In the near term, prospects for UK export growth are likely to be dictated by the downturn in key export markets, notably the euro area, so that export growth is likely to be weak in 2008

[1] In view of the inevitable measurement difficulties involved in adjusting for MTIC-related activity, the ONS continues to advise in its monthly trade releases that comparisons of trade volumes and prices "should be treated with a great deal of caution". Consistent with the view set out in paragraph B.77 of Budget 2008, it remains hard to reconcile the trade data for 2006 and 2007 with evidence from private business surveys and domestic demand growth in the UK's main trading partners.

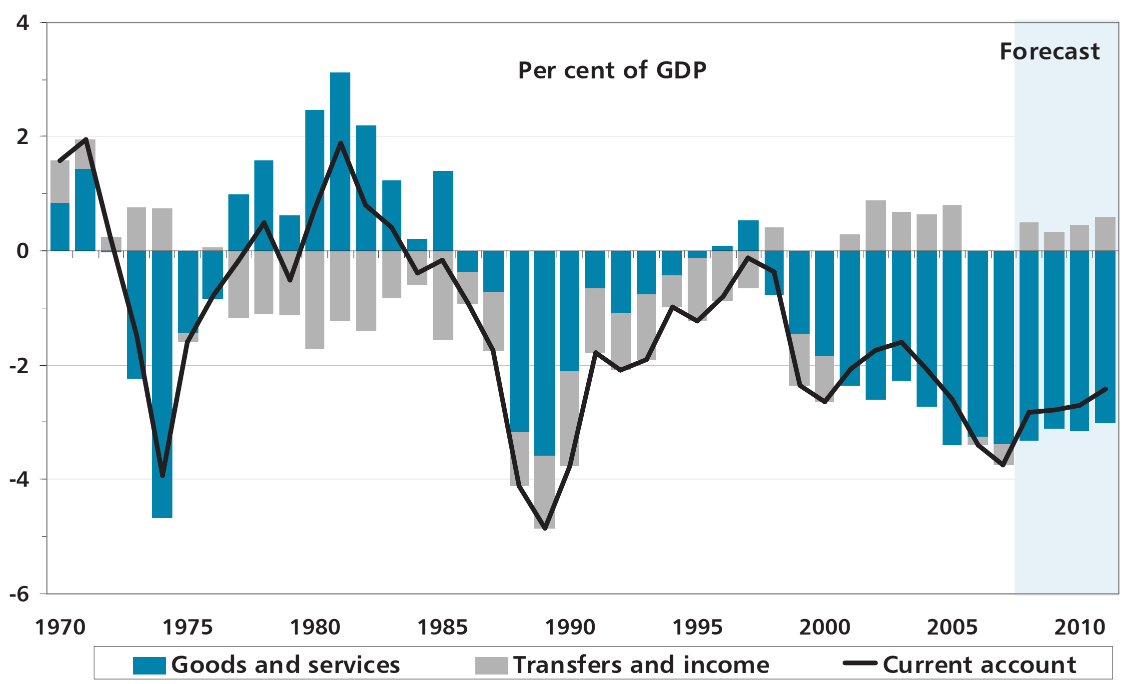
and 2009 despite the support from sterling's depreciation. The forecast for UK export market growth in 2009 has been revised down by almost 6 percentage points since Budget 2008 to ½ a per cent. Export volumes growth in 2009 is forecast to be 0 to ½ per cent, but as growth in the UK's export markets recovers and the effects from sterling gradually encourage more companies to pursue export opportunities, growth is forecast to pick up in 2010 and further in 2011.

2.41 Growth in the measured volume of goods and services imports, excluding the MTIC adjustment, shows a similar pattern to exports, with strong growth in 2006, of 6¾ per cent, followed by slower growth of 3½ per cent in 2007. In the first half of 2008, the volume of goods imports grew by 2¼ per cent on a year earlier, having fallen on a quarterly basis since the final quarter of 2007. By contrast, the volume of services imports grew by 6 per cent on a year earlier following strong quarterly growth in the first quarter of 2008.

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

2.43 Overall, the UK's current account deficit was 3¾ per cent of GDP in 2007. After temporarily narrowing to 1½ per cent in the first quarter of 2008, it returned to 3 per cent of GDP in the second quarter. The balance of domestic demand growth in the UK and overseas, supported by the effects of sterling's depreciation, should lead to the current account deficit narrowing in the second half of 2008 and 2009. The balance is forecast to remain broadly stable thereafter, with 2007 expected to have marked the peak for the current account deficit.

Chart 2.C: Balance of payments current account



Source: HM Treasury

Independent forecasters

2.44 Since Budget 2008, the average of independent forecasts for GDP growth in 2008 has been revised down from 1.7 per cent to 0.9 per cent, close to the 2008 Pre-Budget Report forecast. With independent forecasters expecting contractions in private consumption and investment in 2009, forecasts for GDP growth next year have been revised down progressively and significantly, from 1.9 per cent at the time of Budget 2008 to -0.9 per cent. Since August 2008, this downward trend has quickened as the independent average has fallen from 0.9 per cent to -0.9 per cent. Following the pick-up in inflation this year, forecasts for CPI inflation in the final quarter of 2008 have risen to 4.5 per cent. However, inflation is expected to fall back over the coming year, moving below target by the end of 2009. The average of independent forecasts for 2010 and 2011 show inflation at or close to target.

2.45 Among external forecasters that produce medium-term growth forecasts, expectations are for a relatively sluggish recovery in 2010 and 2011, with the independent average somewhat below the Pre-Budget Report forecast ranges for those years at 1.2 and 2.4 per cent respectively. Illustrating the uncertainty surrounding the timing and strength of the recovery, the range of independent growth forecasts for 2010 is over 1 percentage point wider than that for 2009 despite there being a smaller number of forecasters in the sample.

Summary of economic prospects

Table 2.C: Summary of economic prospects[1]

	Percentage change on a year earlier, unless otherwise stated					
		Forecast[2, 3, 4]				Average errors from past forecasts[5]
	2007	2008	2009	2010	2011	2009
Output at constant market prices						
Gross domestic product (GDP)	3	¾	-1¼ to -¾	1½ to 2	2¾ to 3¼	¾
Manufacturing output	¾	-1¼	-3¼ to -2¾	1 to 1½	1¾ to 2¼	1¼
Expenditure components of GDP at constant market prices						
Domestic demand	3¾	¾	-2 to -1½	1½ to 2	2½ to 3	1
Household consumption[6]	3	1½	-1½ to -1	1¼ to 1¾	2¼ to 2¾	1
General government consumption	1¾	2¾	2¾	1	0	1
Fixed investment	7	-4½	-8¼ to -7¾	2¼ to 2¾	6½ to 7	2¾
Change in inventories[7]	¼	0	-¼ to 0	0	0	¼
Exports of goods and services[8]	-4½	¾	¼ to ¾	3¼ to 3¾	5¼ to 5¾	3
Imports of goods and services[8]	-1¾	½	-2½ to -2	2½ to 3	4 to 4½	2¾
Exports of goods and services (excluding MTIC)	1¼	¾	0 to ½	3¼ to 3¾	5¼ to 5¾	-
Imports of goods and services (excluding MTIC)	3½	½	-2¾ to -2¼	2½ to 3	4 to 4½	-
Balance of payments current account						
£ billion	-52½	-41¾	-41	-41½	-39¼	12¼
Per cent of GDP	-3¾	-2¾	-2¾	-2¾	-2½	¾
Inflation						
CPI (Q4)	2	3¾	½	2¼	2	-
Producer output prices (Q4)[9]	4	6	2	2½	2	1¼
GDP deflator at market prices	2¾	3½	1¾	2½	2¾	½
Money GDP at market prices						
£ billion	1401	1461	1469 to 1477	1529 to 1545	1615 to 1640	12
Percentage change	6	4¼	½ to 1	4 to 4½	5½ to 6	¾

1 The forecast is consistent with the preliminary estimate data for the third quarter of 2008, released by the Office for National Statistics on 24 October 2008.

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

3 As in previous Budget and Pre-Budget Reports, the economic forecast is presented in terms of forecast ranges, based on alternative assumptions about the supply-side performance of the economy. The mid-points of the forecast ranges are anchored around the neutral assumption for the trend rate of output growth of 2¾ per cent. The figures at the lower end of the ranges are consistent with the deliberately cautious assumption of trend growth used as ther basis for projecting the public finances, which is a ¼ percentage point below the neutral assumption.

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

5 Average absolute errors for year-ahead projections made in autumn forecasts over the past 10 years. The average errors for the current account are calculated as a per cent of GDP, with £ billion figures calculated by scaling the errors by forecast money GDP in 2009.

6 Includes households and non-profit institutions serving households.

7 Contribution to GDP growth, percentage points.

8 Figures upto and including 2008 are distorted by MTIC.

9 Excluding excise duties.

3 Overall policy framework, institutions and objectives

Objectives of economic policy

3.1 The Government's objective is to build a strong economy and a fair society, where there is opportunity and security for all. Key elements in the Government's long-term economic strategy are:

- maintaining macroeconomic stability;
- ensuring financial stability;
- supporting business and raising the sustainable rate of productivity growth;
- providing employment opportunity for all;
- ensuring fairness;
- improving public services; and
- addressing environmental challenges.

3.2 These objectives are consistent with the objectives of the European Community as set out in Article 2 of the Treaty. They are also consistent with the Lisbon Strategy, the Integrated Guidelines, and with a prudent interpretation of the EU Stability and Growth Pact.

3.3 As outlined in detail in the previous chapter, over the past year major shocks have hit the economies of every country in the world. While commodity prices have recently eased, the credit shock has intensified into the worst global financial crisis for generations, a crisis that is being addressed by a global policy response of unprecedented scale and scope. These developments mean economic prospects are subject to exceptional uncertainty, but it is clear that the UK, like many advanced economies, has moved into recession.

3.4 The Government's macroeconomic framework has been designed to ensure that policymakers have the flexibility to respond appropriately to shocks. Transparency and a commitment to medium-term goals mean that the Bank of England and the Government can deliver the necessary support to the economy without compromising their respective objectives of low inflation and sound public finances over the medium term.

3.5 The economic downturn caused by these major economic shocks will have a large and persistent impact on the public finances. In the face of such adverse developments, it is important to focus on the purpose of the fiscal framework – to support economic growth by delivering economic stability – and to ensure that fiscal policy decisions are appropriate to achieve this.

3.6 The Government's objectives for fiscal policy in the face of these shocks remain unchanged:

- 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.

3.7 In order to ensure sound public finances over the medium term, fiscal policy has been set on the basis of delivering a balanced cyclically-adjusted current budget and a declining debt to GDP ratio once the global shocks have worked their way through the economy in full. A starting point of low public debt and the action the Government is taking to ensure fiscal sustainability over the medium term mean borrowing can be allowed to rise to enable the Government to support families and businesses in the short term, including through discretionary action.

Policy response to exceptional circumstances

3.8 The Government's immediate priority is to continue to support the economy through these difficult times and support needs to be tailored to the particular problems that the economy is facing. Supporting the economy in its recovery from these exceptional events will benefit not only current but also future generations.

3.9 The Bank of England has reduced interest rates to a 50-year low, providing monetary policy support to the economy. Responsible and sustainable management of the public finances requires stabilising the financial sector and supporting the long-term growth of the economy. This means allowing borrowing to increase in the short term, but ensuring a sustainable path for the public finances in the medium term, in addition to the measures the Government has undertaken to maintain financial stability and protect depositors, which are outlined in Box 3.A.

Box 3.A: Ensuring financial stability

Since July 2007, the global economy has experienced levels of financial instability not seen for generations. The causes of this instability are varied and global. They include both macroeconomic factors, such as global financial imbalances, and microeconomic factors, such as the failure of banks to manage financial risk. The trigger for the instability was the downturn in the US housing market, the 'subprime' end of which was a feature of many of the financial products that had been created in recent years. The instability grew steadily, peaking in the weeks following the collapse of Lehman Brothers, a US investment bank, in September 2008.

The Government's objectives for addressing these threats to the financial system have been consistent, and focused around the need to:

- support stability and restore confidence in the financial system;
- protect depositors' money; and
- safeguard the interests of taxpayers.

In September 2008, the crisis intensified and it became clear that not just individual institutions but the entire banking system was at risk of collapse. That would have had devastating consequences for UK households and businesses. The Government therefore intervened decisively to prevent systemic collapse. First, to address concerns about liquidity, at least £200 billion was made available to the Bank of England's existing Special Liquidity Scheme. Second, to address concerns about solvency, at least £50 billion was committed to a Bank Recapitalisation Fund. Third, to address concerns about funding, a credit guarantee scheme was established. These measures and their likely impact on the public finances are discussed in more detail in Chapter 4.

Other governments around the world have followed with similar steps and market reactions have been generally positive. However, markets remain fragile and volatile. The Government remains committed to taking action to meet its objectives.

Looking to the future, and given the global nature of this instability, the Government's international priorities include:

- as the 2009 Chair of the G20, making rapid progress on priority issues for the future of the international financial regulatory system;
- ensuring that the EU learns the lessons from the crisis, in particular regarding supervision and deposit protection arrangements for banks operating across borders; and
- reviewing the long-term opportunities and challenges for the UK's crown dependencies and overseas territories as financial centres.

Within the UK, the Government's immediate priorities include:

- continuing to monitor the financial system to ensure it is able to support the wider economy, including through appropriate levels of lending to businesses and households;
- strengthening the Banking Bill to enhance the Authorities' ability to deal with banking group holding companies and the insolvency of investment firms; and
- introducing measures to facilitate the raising of equity capital.

Fiscal policy response

3.10 In current economic circumstances, it is more important than usual for fiscal policy to play a role in supporting economic activity. In general, monetary policy is the primary tool for managing demand in the economy, while fiscal policy supports monetary policy through the automatic stabilisers, helping to smooth the path of the economy. However, while there have been encouraging signs that monetary easing is being passed through to interest rates paid by households and businesses, it is likely that monetary policy may be less effective than normal in stimulating economic activity at present, in particular due to constraints on the availability of credit. Given this, fiscal policy should play a more active, complementary role because it is able to support growth, and people's incomes and purchasing power, directly. In this way, fiscal policy can support monetary policy to limit the extent and duration of the downturn.

3.11 The case for a concerted international response to the current downturn is set out in *The case for a concerted international fiscal response*[1], published alongside the 2008 Pre-Budget Report, and summarised in the box below.

Box 3.B: The case for a concerted international fiscal response

The case for concerted fiscal action has been endorsed by the leaders of the G20 countries. On 15 November they declared that they:

- had agreed to work together to restore global growth; and
- would "use fiscal measures to stimulate domestic demand to rapid effect, as appropriate, while maintaining a policy framework conducive to fiscal sustainability".

A simple, but nonetheless powerful, argument for concerted fiscal action is that this is a global crisis, and therefore requires a global solution. The combined effect of coherent actions taken across countries will be more effective than each country acting alone. In open economies, such as the UK, a proportion of any stimulus will be spent on imports. A concerted stimulus among major trading partners would increase trade flows in both directions.

Decisive concerted action by the world's leading economies will also provide a strong signal to the private sector of the willingness of governments to act effectively together. This should raise the private sector's expectations of the economic outlook, and help to reduce the risk of an adverse feedback between low expectations, cautious spending and weak outcomes.

An effective international response does not mean that all countries should take identical actions. Instead, fiscal actions need to be tailored to the situation of each country, taking account of existing levels of public debt.

However, the effectiveness of international fiscal actions will be enhanced if they are concerted, and conform to the "timely, targeted and temporary" principles described in Chapter 4.

[1] *The case for a concerted international fiscal response*, HM Treasury, November 2008

3.12 The 2008 Pre-Budget Report announced that the Government will support families and businesses, including by:

- temporarily reducing the VAT rate to 15 per cent with effect from 1 December 2008 to 31 December 2009; and
- bringing forward £3bn of capital spending from 2010-11 to 2008-09 and 2009-10, the years when the impact of the shock is likely to be the strongest.

3.13 Further support announced for pensioners, families with children and all taxpayers with modest and middle incomes, including those affected by the removal of the 10 pence starting rate of tax in Budget 2007, and to support businesses, will also help to mitigate the impact of the economic downturn. Further detail on these measures is set out in Chapter 4.

3.14 Discretionary action of £16 billion will deliver a fiscal stimulus package of around 1 per cent of GDP in total in 2009-10, in addition to the support provided by measures in 2008-09. A number of advanced economies have announced fiscal support packages of similar magnitude in recent months.

3.15 The economic forecast has made realistic assumptions – informed by the experience of other changes in VAT both in the UK and abroad – on the extent to which a cut in VAT is passed on in the form of lower prices. The forecast assumes that, over time, the majority of the reduction in VAT will be passed on to consumers through lower prices, and that households will spend around half of the increase in real disposable income that results. The increase in public investment will deliver a direct increase in economic activity. Overall, GDP growth in 2009 is forecast to be around ½ a percentage point higher than it would be in the absence of the discretionary action that the Government has taken.

Ensuring medium-term sustainability

3.16 By acting quickly and decisively to provide support to the economy when it needs it most, fiscal action – working alongside monetary policy – can help to reduce the impact on individuals and households of the financial markets shock and the risk of a deeper or more prolonged recession. This action will be financed by borrowing in the short term.

3.17 Over the medium term, the Government's fiscal policy objective is to ensure the sustainability of the public finances, in order to protect economic stability and long-term growth. Fiscal policy has been set on the basis of delivering a balanced cyclically-adjusted current budget and a declining debt to GDP ratio once the global shocks have worked through the economy in full. The 2008 Pre-Budget Report set out measures which put the public finances on a path to achieve a balanced cyclically-adjusted current budget and a declining debt to GDP ratio by 2015-16.

3.18 A full account of the 2008 Pre-Budget Report projections for the public sector finances is given in Chapter 4, and summarised in Table 1.A. In summary:

- public sector net borrowing (PSNB) increases from 2.6 per cent of GDP in 2007-08 to 8.0 per cent in 2009-10, reflecting the impact of the economic downturn on receipts, in particular from the financial and housing sectors, the effect of the automatic stabilisers and the action the Government is taking to support the economy. Of this around 1.1 per cent of GDP is as a result of discretionary action to support the economy.

- PSNB then declines to 2.9 per cent of GDP by 2013-14 as the economy recovers and the Government takes action to ensure the sustainability of the public finances In 2013-14, the action the Government is taking reduces net borrowing by 1.6 per cent of GDP; and
- Public sector net debt (PSND) increases over the forecast period, in particular in 2009-10 and 2010-11, reflecting the additional borrowing in these years, then begins to stabilise at just over 57 per cent by the end of the forecast period.

The Macroeconomic framework

3.19 The Government's macroeconomic framework, introduced in 1997, was designed to maintain macroeconomic stability. Stability helps individuals, businesses and the Government to plan effectively for the long term, improving the quantity and quality of investment in physical and human capital, and helping to increase productivity.

3.20 The role of the macroeconomic framework in supporting strong and stable economic performance over the past decade has been acknowledged by international institutions, such as the IMF[1], as providing a strong foundation to weather global challenges.

3.21 The Government remains committed to this framework and the objectives enshrined within it. However, in the face of exceptional global economic challenges, it is important to consider the way that the framework is implemented, to ensure it continues to the deliver the Government's objectives of stability, growth and employment.

Monetary policy framework

3.22 The primary objective of monetary policy is to deliver price stability. The monetary policy framework introduced in 1997 provides full operational independence for the Monetary Policy Committee (MPC) in setting interest rates to meet the Government's target of 2 per cent for the 12-month increase in the Consumer Prices Index (CPI), which applies at all times.

3.23 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.

Performance of the framework

3.24 Since its introduction in 1997, the monetary policy framework has successfully delivered inflation that has been low and stable by historical and international standards:

- CPI inflation has averaged 2.3 per cent since CPI was made the operational target for monetary policy in December 2003, closely in line with the 2 per cent target;
- on average, the UK has had one of the lowest inflation rates in the G7 so far this decade. This compares with the period from 1980 to 1997 when UK inflation was the second highest of all G7 economies; and
- UK long-term interest rates have averaged 5.1 per cent since 1997 compared with an average of just over 9 per cent in the previous decade.

[1] 2008 IMF Article IV Consultation Concluding Statement of the Mission to the United Kingdom

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