2 MAINTAINING MACROECONOMIC STABILITY

The Government's macroeconomic framework and promotion of flexible and open labour, product and capital markets continues to deliver sustained economic growth with low inflation. The economy has grown for 60 consecutive quarters and inflation is close to target. This macroeconomic stability puts the UK in a strong position to respond to global economic challenges, and to take advantage of the opportunities of the coming decade. The 2007 Pre-Budget Report and Comprehensive Spending Review provides for further investment in public services to help equip the country for change while entrenching the macroeconomic stability needed to enable the UK to prosper in the increasingly competitive global economy.

In 2007, the UK economy has continued to perform strongly, with GDP growth in the first half of the year reaching 3¼ per cent on a year earlier, towards the upper end of the Budget 2007 forecast range. Reflecting the combination of momentum in the economy, but higher interest rates than markets expected at the time of Budget 2007, the 2007 Pre-Budget Report economic forecast is for GDP growth of 3 per cent in 2007, slowing to 2 to 2½ per cent in 2008, before strengthening to trend at 2½ to 3 per cent in 2009 and 2010.

The 2007 Pre-Budget Report projections for the public finances 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, ensuring the Government is meeting the golden rule. Beyond the current cycle, the current budget moves clearly into surplus; and**
- **public sector net debt is projected to remain low and stable over the forecast period, stabilising below 39 per cent of GDP and so meeting the sustainable investment rule.**

THE MACROECONOMIC FRAMEWORK

2.1 The Government's macroeconomic framework is designed to maintain long-term economic stability. Stability allows business, 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. Economic stability provides the essential backdrop for addressing the priorities identified as part of the 2007 Pre-Budget Report and Comprehensive Spending Review (2007 PBR and CSR), enabling the Government to address the key social, economic and environmental challenges of the next decade.

2.2 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 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, and continue to deliver unprecedented growth and stability. As the OECD recently noted, the UK economy's "strong performance is not only due to the willingness to embrace the opportunities offered by globalisation, but also to sound institutional arrangements for setting monetary and fiscal policy".[2]

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

[2] *OECD Economic Surveys: United Kingdom*, OECD, September 2007.

Monetary policy framework

2.3 The monetary policy framework introduced in 1997 is based on four key principles:

- clear and precise objectives. 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 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;
- 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.

2.4 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.

Performance of the monetary policy framework

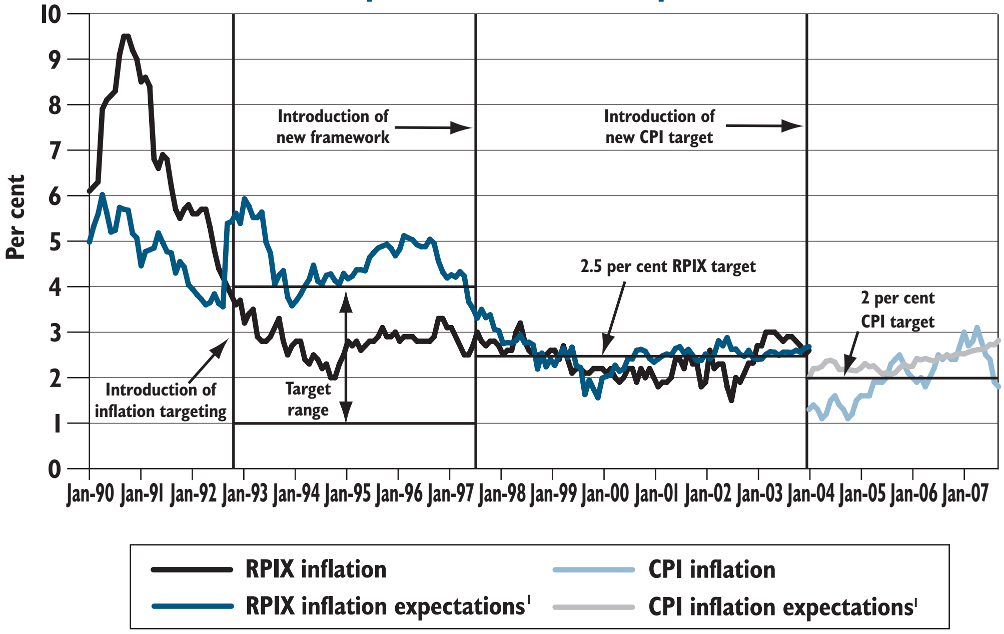
2.5 The monetary policy framework has improved the credibility of policy making and continues to deliver clear benefits. Since the new framework was introduced:

- 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 $2^1/_2$ per cent, the longest period of sustained low inflation for the past 30 years; and
- inflation expectations have remained close to target following the switch to a 2 per cent CPI target. CPI inflation has averaged 2 per cent since 2003 and has moved away from its target by more than 1 percentage point on only one occasion;
- on average the UK has had the lowest inflation in the G7 so far this decade, with the exception of Japan, which has been through a protracted period of deflation. By contrast, in the 1980s and 1990s, the UK had one of the highest inflation rates among the major economies; and
- long-term interest rates have averaged 5 per cent compared with an average of just over 9 per cent in the previous economic cycle. Alongside the UK's macroeconomic stability in recent years, the effective exchange rate has also been relatively stable. The sterling effective exchange rate remains close to levels at Budget 2004.

2.6 Responding to reduced spare capacity and above-trend growth, and with inflation above target, the MPC raised interest rates on five occasions between August 2006 and July 2007, to reach their present level of $5^3/_4$ per cent. Inflation has come down swiftly since peaking in March, at 3.1 per cent, and is expected to remain close to target over the forecast horizon.

2.7 In April 2007, the Governor of the Bank of England wrote the first open letter since the inception of the MPC. The open letter system is an integral part of the macroeconomic framework. It requires the Governor to explain to the Chancellor the reasons for any deviation in inflation of more than one percentage point above or below target, plus the action the MPC proposes to take, the expected duration of the deviation and how the proposed action meets the remit of the MPC. The MPC's forward-looking approach has been a cornerstone of economic policy since 1997. The Chancellor, in his response, underlined that the Government will continue to support the MPC in the forward-looking decisions it takes in the future.

Chart 2.1: Inflation performance and expectations



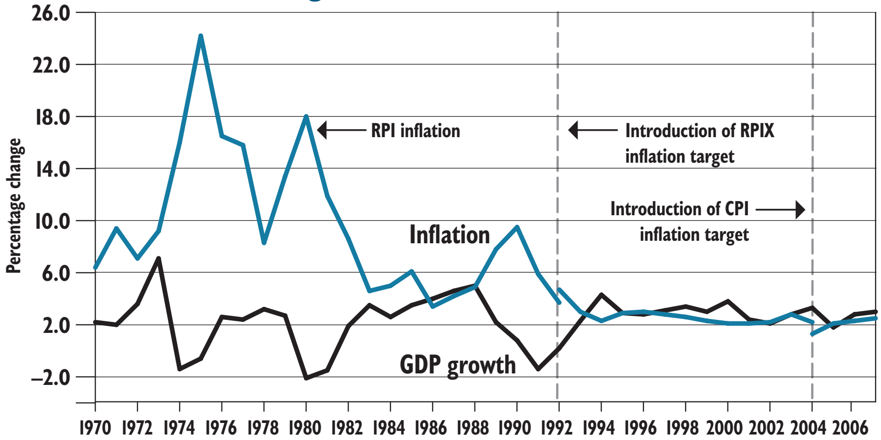
[1] *Implied expectations of average RPI inflation ten years ahead are derived from the difference between yields on nominal and index-linked government bonds. Implied CPI inflation expectations are derived from these RPI expectations and stylised assumptions about expected differences between RPI and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

Source: ONS, Bank of England and HM Treasury.

Box 2.1: UK macroeconomic stability

The Government's frameworks for monetary and fiscal policy have helped to deliver an unprecedented decade of growth and stability for the UK economy. Since 1997, GDP growth has averaged 2.9 per cent while inflation has averaged 1.6 per cent, compared with average growth of 2.3 per cent in the previous decade and average inflation of 4.1 per cent.

Annual real GDP growth and inflation



Note: Inflation measured by RPI until 1992, then RPIX until 2003, and CPI to present. 2007 CPI is average Jan-Aug 07.
Source: ONS and HM Treasury

Both the monetary and fiscal frameworks are underpinned by flexibility:

- **the monetary framework gives the independent MPC the flexibility to respond to events in a forward-looking manner. For example, the open letter system, outlined above, creates a transparent approach to significant deviations of inflation from its target level, giving the MPC an opportunity to respond sensibly to particular economic shocks; and**
- **the fiscal rules are set over the economic cycle, allowing the automatic stabilisers to operate fully to help dampen economic cycles. This flexibility in fiscal policy, along with a context of low and stable borrowing and debt, has enabled fiscal policy to contribute to macroeconomic stability. The IMF noted the "shallowness of the UK growth slowdown during the last global downturn",[a] which they attributed in part to fiscal responsiveness.**

Policy reforms that have increased the responsiveness of the economy also contribute to resilience. The OECD recently noted that the "United Kingdom's open and flexible approach to economic policy is reflected in support for free trade, openness to foreign direct investment (FDI), a willingness to open its labour markets to citizens from new EU countries that joined in May 2004, and the adoption of regulatory policies that promote efficiency and economic resilience."[b] The 2007 PBR and CSR reports on progress made on enhancing flexibility.

The flexibility introduced by macroeconomic policy and microeconomic reforms since 1997 has allowed the UK economy to withstand a number of global challenges, with policymakers responding proactively in the face of significant risks. During the Asian, Russian and Long Term Credit Management (LTCM) crises of 1997 and 1998, UK GDP growth remained robust; following the bursting of the dotcom bubble after 2000 and in the aftermath of the terrorist attacks of 11 September 2001, the UK economy continued to expand while many other major economies experienced recession. The UK economy is the only G7 economy to have avoided any quarters of negative output growth this decade.

[a] *Concluding statement to the 2007 Article IV mission to the UK*, IMF, March 2007.
[b] *OECD Economic Surveys: United Kingdom*, OECD, September 2007.

Performance of the monetary policy framework

2.8 It is important that the macroeconomic policy framework continues to evolve to maintain its status at the forefront of international best practice. In line with the principles of transparency and accountability, which underpin the monetary policy framework, the Chancellor announced to the Treasury Select Committee (TSC) on 14 June 2007 three important changes to the process by which external appointments are made to the MPC:

- the timetable for appointing a new external member will now be pre-announced well before an existing member's term is due to come to an end, providing greater clarity and certainty about the appointments process;
- there will be an invitation of 'expressions of interest' from potential candidates, enhancing openness in the process without limiting the field of candidates to individuals that come forward in response to the invitation; and
- in inviting expressions of interest, additional criteria on the kind of candidate the Chancellor is seeking will be published, providing greater transparency on the Chancellor's thinking on the skills required in a specific appointment.

2.9 In addition, to reinforce transparency and increase parliamentary scrutiny, new appointees to the MPC will now be subject to a TSC confirmation hearing before they take up a post on the Committee. This will apply to all appointees to the MPC, including for the Governor and Deputy Governors of the Bank of England.

Reforms to the statistical system

2.10 Statistics make a crucial contribution to the operation of the macroeconomic framework. Following the commitment made by the Chancellor in November 2005, and a full public consultation, legislation for the reform of the UK statistical system has been successfully delivered. The Statistics and Registration Service Act 2007[3], which gained Royal Assent in July, establishes an independent Statistics Board, reporting directly to Parliament, responsible for promoting and safeguarding the quality and comprehensiveness of all official statistics that serve the public good, wherever produced in government. The Board will have a statutory duty to set professional standards in a Code of Practice, and to assess independently statistics against this Code. The Board will also replace Ministers as the top layer of governance for the Office for National Statistics. The Government intends that the new system will be up and running in Spring 2008.

Fiscal policy framework

2.11 The Government's fiscal policy framework is based on the five key principles set out in the *Code for fiscal stability*[4] – 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.

2.12 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

[3] Further details, including the Act and associated documentation, can be found on the HM Treasury website at http://www.hm-treasury.gov.uk.
[4] *Code for fiscal stability*, HM Treasury, 1998.

- 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.

2.13 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.

Performance of the fiscal policy framework

2.14 Since 1997, fiscal policy has resulted in low and stable borrowing, in contrast to previous UK experience. In the 1986-87 to 1997-98 economic cycle, net borrowing reached nearly 8 per cent of GDP, and averaged 3.1 per cent of GDP. During the current economic cycle, net borrowing has averaged 1.0 per cent of GDP and at its peak reached just 3.3 per cent of GDP. The fiscal framework has successfully supported economic stability by allowing the automatic stabilisers to operate, as set out in more detail in Chart 2.4. The fiscal framework has also protected an historically unprecedented increase in public sector net investment, while net debt has been maintained at a low and sustainable level.

Public spending framework

2.15 The fiscal rules underpin the Government's public spending framework. The golden rule states that, over the economic cycle, the Government will only borrow to invest. Departments are therefore given separate resource and capital allocations, which ensures that public investment is not crowded out by short-term current spending pressures. 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. Chapter 3 sets out the next stage of development in the public spending and performance management framework for the 2007 Comprehensive Spending Review period to drive increased value for money and the delivery of key outcomes.

Financial stability framework

2.16 The framework for co-operation on financial stability between the Bank of England, the Financial Services Authority (FSA) and HM Treasury is set out in the 2006 *Memorandum of Understanding*.[5] The Memorandum of Understanding between the three authorities defines the roles and responsibilities of each in maintaining financial stability, in responding to operational disruptions to the financial sector, and for financial crisis management.

2.17 The Standing Committee on Financial Stability, comprising the Chancellor, the Governor of the Bank of England and the Chairman of the FSA, meets monthly (at Deputies level) to discuss individual cases and developments relevant to financial stability, focusing on risks to the financial system. The Committee regularly reviews the key systemic risks to the UK's financial intermediaries and infrastructure and coordinates the three authorities' response and contingency plans. As set out in more detail in Chapter 4, the authorities have

[5] The full text of the 2006 Memorandum is available at www.hm-treasury.gov.uk

worked together as appropriate, in line with their responsibilities, during the period of disruption in global financial markets.

RECENT ECONOMIC DEVELOPMENTS AND PROSPECTS

2.18 The UK's macroeconomic performance continues to be strong and stable. GDP in the UK has now expanded for 60 consecutive quarters, the longest expansion since quarterly National Accounts began in the mid-1950s.

The economic cycle

2.19 Since Budget 2007, upward revisions to estimates of non-oil GVA growth in 2006, combined with estimates of 0.8 per cent growth in each of the first two quarters of 2007, show the UK economy to have been growing at slightly above-trend rates for seven consecutive quarters through to mid-2007. Evidence from the broad range of cyclical indicators monitored by the Treasury, the latest National Accounts data and the Treasury's trend output assumptions imply output passed through trend towards the end of 2006 and that a small positive output gap, of around a $^1/_4$ per cent, has opened up. However, it is too soon to assess whether or not the economic cycle has ended.

Economic prospects

2.20 As reported in Budget 2007, the UK economy grew by $2^3/_4$ per cent in 2006. GDP growth in the first half of 2007 was towards the upper end of the Budget 2007 forecast range for the year as a whole, at $3^1/_4$ per cent on a year earlier. Private sector business surveys suggest the economy carried significant momentum into the second half of 2007. In light of such evidence, the 2007 Pre-Budget Report forecast is for GDP growth of 3 per cent in the year as a whole, in line with the Budget 2007 forecast. The world economy is expected to remain robust in 2007, growing by 5 per cent, with emerging markets continuing to expand rapidly. Growth in the G7 economies in 2007 is expected to slow to 2 per cent, due in particular to the ongoing slowdown in the US.

2.21 The MPC has raised Bank Rate by more than financial markets expected at Budget time, which can be expected to impact on growth in 2008. In addition, disruption in financial markets has meant economic prospects have become more uncertain, and events need to unfold further before the impact on the economy can be rigorously quantified. For the purposes of the economic forecast, it has been assumed that there will be some feed-through to tighter credit conditions and to household and company spending in the short term. Growth in the G7 economies is expected to remain moderate, at 2 per cent, in 2008.

2.22 Against this backdrop, GDP growth in 2008 is forecast to slow to 2 to $2^1/_2$ per cent, below its trend rate. The economy is forecast to strengthen, returning to trend in 2009, with growth forecast to be in the range of $2^1/_2$ to 3 per cent from then onwards.

Table 2.1: Summary of UK forecast[1]

	Outturn	Forecasts			
	2006	2007	2008	2009	2010
GDP growth (per cent)	$2^3/_4$	3	2 to $2^1/_2$	$2^1/_2$ to 3	$2^1/_2$ to 3
CPI inflation (per cent, Q4)	$2^3/_4$	2	2	2	2

[1] *See footnote to Table A9 for explanation of forecast ranges.*

2.23 CPI inflation is forecast to remain close to the 2 per cent inflation target throughout the forecast horizon reflecting the offsetting effects of a number of factors. These include upward cost pressures from food and oil prices, and downward pressures from the ongoing effect of monetary policy tightening over the past year and below-trend growth in 2008.

Risks **2.24** The disruption in global financial markets has meant economic prospects have become more uncertain. It presents clear risks to the economic forecast, though these are judged to be broadly balanced. Considerable uncertainty surrounds the timing and extent to which the disruption might affect the wider economy, and the longer it persists, the greater the risk of it detracting from growth. However, the UK economy has proved resilient to a number of shocks over the past decade, demonstrating the success of the Government's macroeconomic framework and the promotion of open and flexible labour, product and capital markets. As such, growth could also slow by less than expected.

Box 2.2: Inflation and pay

The UK economy is experiencing both an unprecedented period of growth and its longest period of sustained low and stable inflation since the 1960s. Low inflation has provided the platform for record employment levels, higher investment, productivity and economic growth.

Over the recent past, inflation has been boosted by temporary, unforeseen shocks: increases in energy prices, driven by developments in the oil market and, in particular, a tight wholesale gas market during late 2005 and early 2006. On top of this, food price inflation was pushed higher by the effects of the unusually hot UK summer in 2006 and, more recently, global supply and demand pressures.

Seasonal food and energy price inflation rates tend to be more volatile than headline inflation. Stripping out these short-term influences, underlying 'core' inflation (excluding energy and seasonal food) has remained low and generally under 2 per cent.

In contrast to periods of higher inflation in previous decades, the credibility of the UK's monetary policy framework has kept inflation expectations anchored and earnings growth has remained subdued. The Government has demonstrated its commitment to this by delivering overall headline awards for Pay Review Body groups in 2007-08 that average 1.9 per cent. Headline inflation has fallen back from its peak earlier in the year and currently stands at 1.8 per cent. The Treasury's forecast is for inflation to remain around its 2 per cent target, in line with the view of external forecasters.

There remains a risk of second-round effects of higher inflation feeding into inflation expectations and higher average earnings growth. It is therefore important that public sector pay settlements continue to be consistent with the achievement of the Government's inflation target of 2 per cent, as set out in Chapter 3.

Box 2.3: The impact of the financial sector on the economy and public finances

As outlined in more detail in Annex A, financial market disruption has had an impact on UK and global financial markets. Such events have the potential to impact on the wider economy through the price and availability of credit for companies and individuals, which could dampen private consumption and investment growth. It is not yet clear what the extent or duration of any impact might be. For the purposes of the Pre-Budget Report economic forecast, it has been assumed that there will be some feed-through to tighter credit conditions and to household and company spending in the short term.

The performance of the financial sector also impacts on the public finances, most directly through financial company corporation tax and income tax and NICs on bonuses, where receipts from the sector are significant. While the effect on the public finances of current global financial market disruption is uncertain, the projections for the public finances in this Pre-Budget Report allow for an impact on receipts from corporation tax and income tax and NICs, along with other factors.

The financial sector is not only important in terms of its impact on the wider economy, but also as a successful industry, one in which Britain is a global leader. Financial companies' share of UK GDP and of overall corporate profits has been on an upward trend for over two decades. The sector has successfully weathered major financial disruption in the past, such as the Russian debt default and Long Term Credit Management (LTCM) related disruption of 1998 and the global stock market falls in 2001.

The innovation and responsiveness of the City, against the backdrop of a stable UK economy, puts it in a strong position to adapt to global changes. The UK not only has a comparative advantage in financial services, but also in the wider business services sectors, including areas such as computer and information services and other business services.[a] Chapter 4 provides further detail on the financial sector's strength and global competitiveness.

[a] *Productivity in the UK 6: Evidence and Progress*, HM Treasury, 2003.

RECENT FISCAL TRENDS AND OUTLOOK

2.25 Under the *Code for fiscal stability*, the Government is committed to publishing a Pre-Budget Report at least three months prior to the Budget. As described previously, one of the roles of the Pre-Budget Report is to increase transparency, including by presenting an interim forecast update on the outlook for the economy and public finances ahead of the next Budget. The projections for the public finances presented below take into account the fiscal effects of all decisions announced in this Pre-Budget Report or since Budget 2007 including the overall fiscal impact of the final Comprehensive Spending Review settlement, in accordance with the *Code for fiscal stability*.

Outturn for 2006-07

2.26 The deficit on the current balance in 2006-07 is £4.7 billion lower than expected at the Budget, as shown in Table 2.2. This is lower in 2006-07 due to continued success in tackling MTIC fraud and growth in consumer expenditure feeding through to higher-than-expected VAT payments. The deficit is also reduced by lower government expenditure than expected at the Budget, in particular spending by local authorities. The 2006-07 outturn for net borrowing is £3.9 billion lower than the Budget 2007 estimate.

2.27 From 2005-06 to 2006-07 the deficit on the current balance fell by £9.3 billion, or 0.8 per cent of GDP. Net borrowing in 2006-07 fell by 0.7 per cent of GDP compared with 2005-06. The fall in borrowing is slightly less than the fall in the current deficit, due to the 0.1 per cent of GDP rise in net investment in 2006-07.

Table 2.2: Fiscal balances compared with Budget 2007

	Outturn[1]	Estimate[2]			Projections		
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Surplus on current budget (£ billion)							
Budget 2007	**–9.5**	**–4.3**	**3**	**6**	**9**	**13**	
Effect of revisions and forecasting changes	4.7	–3.6	–6½	–4	–1½	–1	
Effect of discretionary changes	0	–0.4	–½	1	1½	1½	
2007 Pre-Budget Report	**–4.7**	**–8.3**	**–4**	**3**	**9**	**14**	**20**
Net borrowing (£ billion)							
Budget 2007	**35.0**	**33.7**	**30**	**28**	**26**	**24**	
Changes to current budget	–4.7	4.0	7	2½	0	–1	
Changes to net investment	0.8	0.4	0	0	2	2	
2007 Pre-Budget Report	**31.0**	**38.0**	**36**	**31**	**28**	**25**	**23**
Cyclically-adjusted surplus on current budget (per cent of GDP)							
Budget 2007	–0.5	–0.3	0.2	0.4	0.6	0.8	
2007 Pre-Budget Report	**–0.2**	**–0.7**	**–0.2**	**0.3**	**0.6**	**0.8**	**1.1**
Cyclically-adjusted net borrowing (per cent of GDP)							
Budget 2007	2.5	2.4	2.0	1.8	1.6	1.4	
2007 Pre-Budget Report	**2.2**	**2.8**	**2.4**	**1.9**	**1.7**	**1.5**	**1.3**
Net debt (per cent of GDP)							
Budget 2007	37.2	38.2	38.5	38.8	38.8	38.6	
2007 Pre-Budget Report	**36.7**	**37.6**	**38.4**	**38.8**	**38.9**	**38.8**	**38.6**

Note: Totals may not sum due to rounding.

[1] The 2006-07 figures were estimates in Budget 2007.

[2] The 2007-08 figures were projections in Budget 2007.

Estimates for 2007-08 and 2008-09

2.28 The rise in borrowing compared with Budget 2007 projections is concentrated in 2007-08 and 2008-09, driven in part by recent financial market disruption and the consequent impact on the economy, as described in Box 2.3. Other factors which reduce receipts in 2007-08 compared to the Budget are a fall in North Sea revenues, as a result of lower-than-expected gas prices, and a series of one-off corporation tax repayments. In 2008-09 receipts are also lower due to reduced oil production forecasts. Table 2.2 shows that by the end of the projection period, borrowing and the current surplus return to close to their Budget levels, as the impact of temporary factors diminishes, with spending growing in line with GDP and as discretionary measures introduce a modest tightening.

2.29 With output close to or at trend throughout the projection period, the profile of cyclically-adjusted borrowing is very similar to that of headline PSNB. The cyclically-adjusted deficit peaked at 3.2 per cent of GDP in 2004-05, declined in 2005-06 and fell sharply in 2006-07. Both the cyclically-adjusted and the main measure of net borrowing are expected to rise in 2007-08 before falling in every year of the projection period, reaching 1.3 per cent of GDP in 2012-13. The rise in 2007-08 is driven by the same short-term negative impacts on receipts from the financial sector and gas prices described above. Cyclically-adjusted borrowing is slightly higher than the main aggregate in 2007-08 because the economy appears to be slightly above trend in this year.

2.30 Cyclical adjustment cannot take account of non-cyclical temporary shocks to the public finances, nor cyclical shocks with different impacts than those experienced in the past. Therefore to the extent that cyclical adjustment is not taking account of the impact of temporary financial market disruption, structural PSNB may be lower than Pre-Budget Report projections suggest.

Table 2.3: Public sector net borrowing compared with Budget 2007

	Outturn[1]	Estimate[2]	Projections			
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Budget 2007 (£ billion)	**35.0**	**33.7**	**30**	**28**	**26**	**24**
Changes since Budget 2007						
Total economic and other forecasting effects	-3.9	4.0	6½	4	1½	3
Total before discretionary measures	**31.0**	**37.6**	**36**	**32**	**27**	**27**
Discretionary measures	**0**	**0.4**	**½**	**-1**	**½**	**-1½**
2007 Pre-Budget Report	**31.0**	**38.0**	**36**	**31**	**28**	**25**

Note: Figures may not sum due to rounding.

[1] The 2006-07 figures were estimates in Budget 2007.

[2] The 2007-08 figures were projections in Budget 2007.

2.31 Details of changes to the receipts forecast, the estimate for spending for 2007-08 and changes to the annual managed expenditure forecast are set out in Annex B. Later chapters provide more detail on the firm departmental spending plans for the years 2008-09, 2009-10 and 2010-11 fixed by the 2007 CSR.

Discretionary policy changes

2.32 In considering the impact of additional discretionary policy changes on the fiscal position, the Government has taken into account the following factors:

- the importance of ensuring the strict fiscal rules are met over the cycle;
- its broader, medium-term objectives for fiscal policy, including the need to ensure sound public finances and that spending and taxation impact fairly both within and between generations; and
- the need to ensure that fiscal policy supports monetary policy.

2.33 Consistent with the requirements of the *Code for fiscal stability*, the updated projections take into account the fiscal effects of all decisions announced in this Pre-Budget Report or since Budget 2007. This includes:

- an addition of £2 billion to total public sector net investment, in 2010-11, to take forward vital capital investment in public services;
- ensuring that all married couples and civil partners automatically benefit from double the standard inheritance tax allowance;
- reforming capital gains tax by introducing a single rate of 18 per cent, ensuring a more sustainable system that is straightforward and internationally competitive; and
- action to protect tax revenues and further modernise the tax system, including a number of measures to tackle tax avoidance.

PERFORMANCE AGAINST THE FISCAL RULES

Table 2.4: Summary of public sector finances

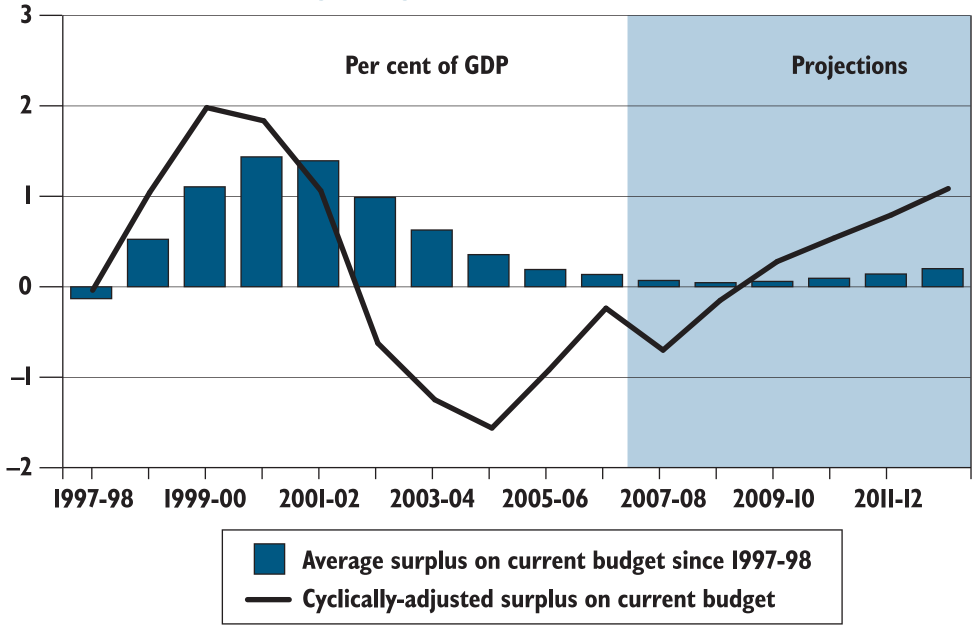
	Per cent of GDP						
	Outturn	Estimate	Projections				
	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Fairness and prudence							
Surplus on current budget	–0.4	–0.6	–0.3	0.2	0.6	0.8	1.1
Average surplus since 1997-98	0.1	0.1	0.0	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	–0.2	–0.7	–0.2	0.3	0.6	0.8	1.1
Long-term sustainability							
Public sector net debt[1]	36.7	37.6	38.4	38.8	38.9	38.8	38.6
Core debt[1]	35.8	36.9	37.6	38.0	38.1	38.1	37.9
Net worth[2]	26.0	25.3	24.1	23.4	22.8	22.5	22.4
Primary balance	–0.7	–1.0	–0.9	–0.4	–0.1	0.2	0.3
Economic impact							
Net investment	2.0	2.1	2.2	2.2	2.3	2.3	2.3
Public sector net borrowing (PSNB)	2.3	2.7	2.5	2.0	1.7	1.5	1.3
Cyclically-adjusted PSNB	2.2	2.8	2.4	1.9	1.7	1.5	1.3
Financing							
Central government net cash requirement	2.8	2.7	2.6	2.4	2.0	2.0	1.6
Public sector net cash requirement	2.7	2.4	2.4	2.3	1.8	1.8	1.5
European commitments							
Treaty deficit[3]	2.6	2.9	2.8	2.4	2.1	1.8	1.6
Cyclically-adjusted Treaty deficit[3]	2.4	3.0	2.7	2.3	2.1	1.8	1.6
Treaty debt ratio[4]	43.4	43.9	44.8	45.1	45.3	45.2	44.9
Memo: Output gap	*–0.1*	*0.2*	*–0.3*	*0.0*	*0.0*	*0.0*	*0.0*

[1] Debt at end March; GDP centred on end March.
[2] Estimate 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 **2.34** 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 it is therefore an important indicator of intergenerational fairness. 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, in 1997-98.

2.35 The deficit on the current budget fell by £9.3 billion from 2005-06 to 2006-07, falling from 1.1 per cent of GDP to 0.4 per cent of GDP. The deficit on the current budget increases slightly in 2007-08 to 0.6 per cent of GDP before reaching surplus in 2009-10. From 2009-10 onwards, the surplus on the current budget strengthens, reaching 1.1 per cent in 2012-13. The average surplus on the current budget since the start of the 1997-98 cycle is positive in every year of the projection period. The economy appears to have passed through trend in the final quarter of 2006. On this basis, and based on cautious assumptions, the Government would have met the golden rule with a margin of £18 billion, higher than estimated at the Budget.

Chart 2.2: Meeting the golden rule



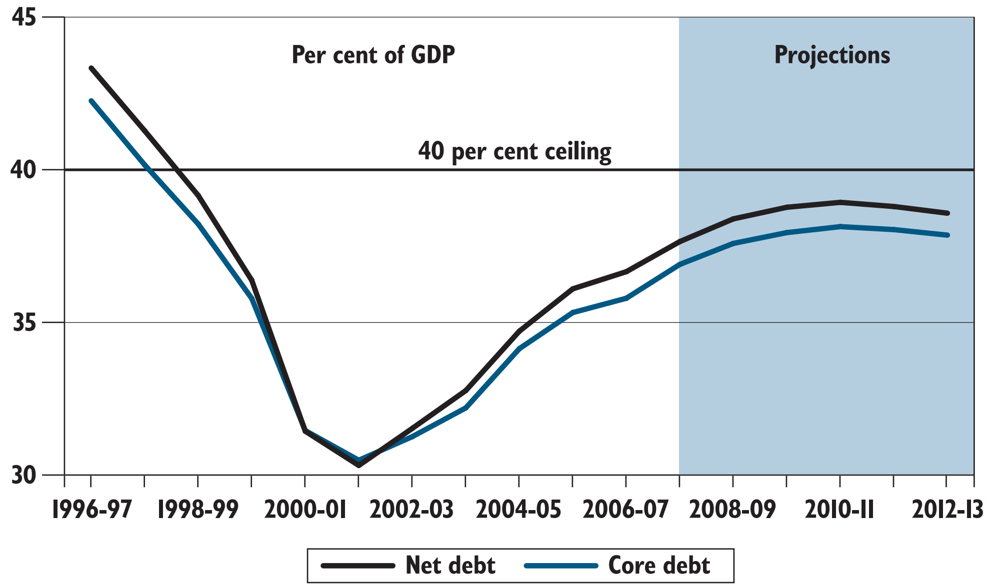
Source: HM Treasury.

2.36 With the economy appearing to have passed through trend in the final quarter of 2006, Pre-Budget Report projections show that the current budget moves into surplus in 2009-10, with the surplus rising to 1.1 per cent of GDP by 2012-13. At this early stage, and based on cautious assumptions, the Government is therefore on course to meet the golden rule in the next economic cycle.

Sustainable investment rule

2.37 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. Chart 2.3 shows that despite output having been generally below trend since 2001, net debt remains below 39 per cent of GDP and starts to decline by the end of the projection period, reaching 38.6 per cent of GDP in 2012-13. Therefore the Government meets its sustainable investment rule while continuing to borrow to fund increased long-term capital investment in public services. Chart 2.3 also illustrates projections for core debt, which excludes the estimated impact of the economic cycle on public sector net debt.

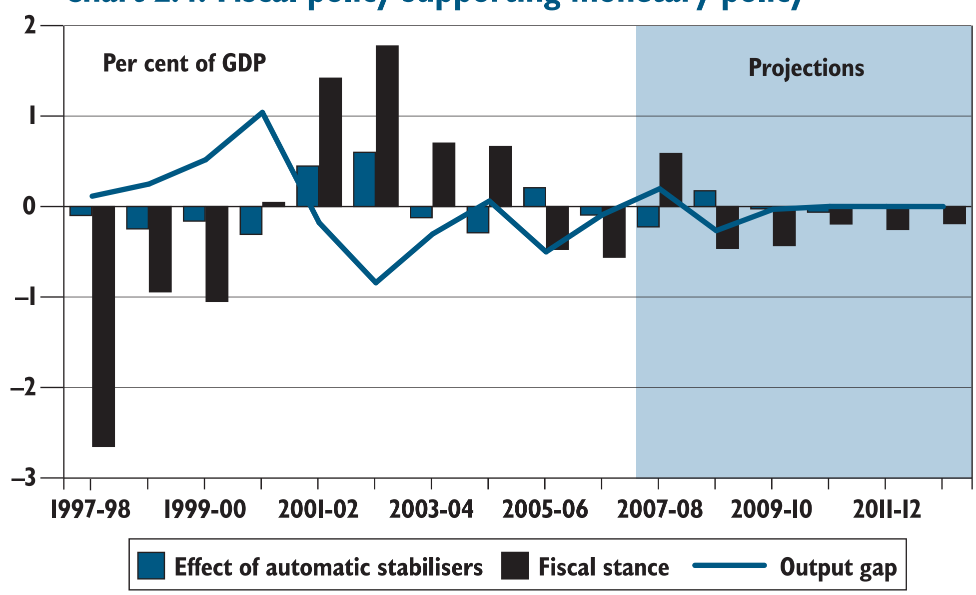
Chart 2.3: Meeting the sustainable investment rule



Source: ONS and HM Treasury.

Economic impact 2.38 While the primary objective of fiscal policy is to ensure sound public finances, fiscal policy 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. These can be broken down into changes due to the effects of the automatic stabilisers and those due to the change in the fiscal stance, as illustrated in Chart 2.4.

Chart 2.4: Fiscal policy supporting monetary policy



Note: The fiscal stance equals the annual change in the cyclically-adjusted PSNB. The effect of the automatic stabilisers equals the change in the cyclical component of PSNB, i.e. the difference between PSNB and the cyclically-adjusted PSNB.

Source: HM Treasury.

2.39 During the late 1990s, the fiscal stance and the automatic stabilisers tightened at a time when the economy was above trend. As the economy moved below trend in 2001, the automatic stabilisers and the fiscal stance supported the economy. With the output gap closing and the economy appearing to have passed through trend in the final quarter of 2006, the fiscal stance was tighter in 2005-06 and 2006-07 and further tightening of the fiscal stance is forecast over the projection period, except in 2007-08. Pre-Budget Report projections show the public finances accommodating the impact of financial market disruption with borrowing increasing in 2007-08 and with modest discretionary fiscal loosening in 2007-08 and 2008-09 helping to smooth the path of the economy. From 2008-09 borrowing falls year on year, supported by discretionary fiscal tightening from 2009-10,the impact of which builds towards the end of the projection period.

European commitments

2.40 The Government supports a prudent interpretation of the Stability and Growth Pact as reflected in reforms to the Pact agreed in March 2005. 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 this Pre-Budget Report, which show the Government is meeting its fiscal rules over the cycle, maintaining low debt and sustainable public finances, combined with sustainable increases in public investment, are fully consistent with a prudent interpretation of the Pact.

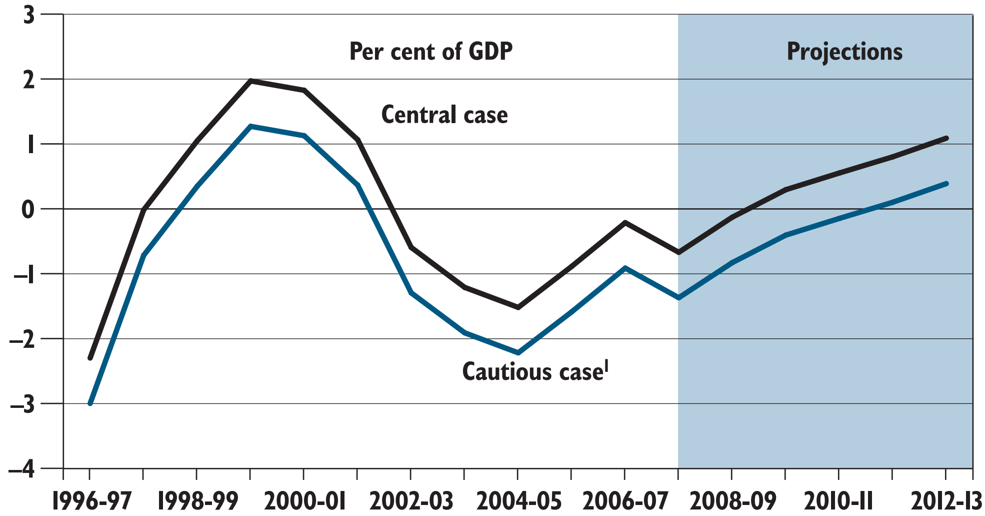
Dealing with uncertainty

2.41 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. In order to create a safety margin against uncertain events, the Government bases the public finance projections on deliberately cautious assumptions, which are audited by the National Audit Office. The degree of caution in these assumptions increases over the projection period. For example, the public finances forecasts are based on an assumption that trend growth is $^1/_4$ percentage point lower than the neutral trend growth assumption used in the economy forecast. By the end of the projection period, in 2012-13, this implies that the level of GDP in the public finances forecast is $1^1/_4$ per cent below the neutral level.

2.42 The 2007 *End of year fiscal report*, published alongside this report, examines fiscal trends in recent years and forecast performance, measured in terms of accuracy and caution. Overall since 1997, the Treasury's year-ahead borrowing forecasts have been more cautious than prior to the introduction of the macroeconomic framework.

2.43 In addition to basing the public finance forecasts in the Pre-Budget Report and Budget on cautious assumptions, including one of lower trend growth, it is also sensible to test the robustness of these projections. The projections are 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. This addresses an important source of potential error, from misjudging the position of the economy in relation to the trend level of output. Chart 2.5 illustrates the projections for this cautious case and shows that the cyclically-adjusted balance will be in surplus at the end of the projection period.

Chart 2.5: Cyclically-adjusted surplus on current budget



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

LONG-TERM FISCAL SUSTAINABILITY

2.44 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 set out in the *Code for fiscal stability*.

2.45 Since 2002 the Government has published the Long-term public finance report on an annual basis to provide a comprehensive analysis of long-term socio-economic and demographic developments, and their likely impact on the public finances, based on the most up to date information available. The population projections provided by the Office for National Statistics (ONS) are central to this analysis. Given that the ONS will publish its 2006-based population projections on 23 October, the next Long-term public finance report will be published at a later date.

2.46 The most recent assessment, published in the 2006 *Long-term public finance report*, shows that the UK fiscal position is sustainable over the long term. The UK is in a strong position relative to other developed countries to face the challenges of an ageing society. A further discussion of long-term fiscal sustainability is included in Annex B.