

Pre-Budget Report & the Economy

December 2006

Research Centre

 Analysis

- The Chancellor's UK economic growth forecasts remain higher than Consensus. In 2006 the Treasury's forecast of 2.8% is 0.2% higher than the Consensus forecast, and in 2007 the Treasury's forecast of 3.0% is 0.6% higher.
- The Treasury revised its growth forecast for 2006 upwards, on the basis of stronger than expected manufacturing and investment spending. Household and government spending have both been revised downwards.
- The timing of the current economic cycle has been adjusted and this is now expected to end early in 2007. On this basis, the Chancellor will continue to meet his 'golden rule' that the current budget be zero or slightly positive over the cycle

Gordon Brown delivered what is widely expected to be his last Pre-Budget Report on Wednesday 6th December 2006. In his tenth year as Chancellor, Gordon Brown is widely expected to replace Tony Blair as Prime Minister next year. In this analysis of that Report, the Alliance Trust Research Centre focuses on the Treasury's new expectations for the global economy, the UK economy in particular and public finances, highlighting some of the assumptions behind these figures.

and global inflation is expected to remain high in the near term, above 2.0%, before falling back to 2.0% in 2008.

The updated forecasts for world trade growth suggest continued strength. World trade grew 7.25% in 2005, but the Treasury now estimates that this growth accelerated to 8.75% in 2006. Following this strength, world trade growth is expected to slow just slightly, to 7.5% in each of the next two years. Asia is expected to be the driving force behind this strength in trade activity. The UK's own export prospects appear stronger, given the recent improvement in activity in Europe. Expected growth in the UK's export markets in 2006 was revised higher by 0.5%, to 7.75%. In addition, the UK's export prospects for the following two years now appear to be better, given that the growth forecasts for these two years have also been revised higher, by 0.25%, to 6.5% and 6.25% respectively.

Global Economic Outlook

The Treasury increased its forecast of economic growth in the G7 area from 2.5% to 2.8%, in 2006, following growth of 2.5% in 2005. However, growth prospects for 2007 were revised down marginally, to 2.25%, before growth is expected to return to 2.5% in 2008 and 2009. Price developments in energy markets have added significantly to inflationary pressures over the last year,

G7 Economic Outlook

	Actual	Previous Forecast	New Forecast	Forecast	Forecast	Forecast
% Change	2005	2006	2006	2007	2008	2009
G7 Real GDP	2.5	2.5	2.75	2.25	2.5	2.5
CPI (Q4)	2.5	2.5	2.5	2.25	2.0	2.0
World Trade in Goods & Services	7.25	7.75	8.75	7.5	7.5	7.0
UK Export Markets	5.75	7.25	7.75	6.5	6.25	6.25

Contact

Shona Dobbie

Head of Research Centre

Alliance Trust PLC, Meadow House,
64 Reform Street, Dundee DD1 1TJ

Tel +44 (0)1382 201700

Fax +44 (0)1382 225133

Email contact@alliancetrust.co.uk

Web www.alliancetrust.co.uk

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Prospects for the UK Economy Fiscal Rules

The Treasury maintains an optimistic view of the UK economy. As expected, the economic growth forecast for 2006 was revised higher, to 2.75%. This was due to expectations of a more favourable performance from manufacturing. Growth in fixed investment has also been revised significantly upwards, to 6.0% in 2006, which appears to better reflect the survey evidence reported over the last few months. The final upward revision came in the case of the balance of payments, with the deficit being revised by £750m, to £32.0bn. It is worth noting that both export and import statistics have been severely affected by the ongoing missing trader intra-community (MTIC) VAT fraud. Excluding MTIC, export growth is expected to rise from 4.25% in 2005 to 6.0% this year, before cooling just slightly, to 5.25% in 2007 and 5.0% in 2008. Import growth, excluding MTIC, is expected to increase from 4% in 2005 to 6.25% this year, before slowing to 4.5% in both 2007 and 2008.

Not all of the major components of GDP have been revised upwards. Household consumption, for instance, is now expected to be weaker than had been forecast at the time of the Budget Report. Consumption is expected to grow just 2% in 2006, before increasing to a growth rate of 2.5% in each of the next 3 years. The savings ratio has also been revised lower in 2006, to 5.5%, but is then expected to increase to a level closer to 5.75% in each of the next three years. Government spending growth has also been revised down in 2006, from 2.5% to just 2.0%. This is considerably lower than the growth rate of 2.75% recorded in 2005. Government spending is now expected to grow by 2.5% in both 2007 and 2008.

UK Economic Prospects

	Actual 2005	Previous Forecast 2006	New Forecast 2006	Forecast 2007	Forecast 2008	Forecast 2009
% Change						
GDP	1.75	2-2.5	2.75	2.75-3.25	2.5-3.0	2.5-3.0
Manufacturing output	-1.0	0.5-1.0	1.25	1.75-2.0	1.75-2.25	1.75-2.25
Household consumption	1.5	2.0-2.5	2	2.25-2.75	2.25-2.75	2.25-2.75
Savings ratio	5.0	5.75	5.5	5.75	5.75	5.75
Government consumption	2.75	2.5	2.0	2.5	2.5	2.0
Fixed investment	2.75	1.75-2.0	6.0	5.25-5.75	3.25-3.75	3.25-3.75
Exports of Goods & Services*	4.25	n.a.	6.0	5.0-5.5	4.75-5.25	4.5-5.0
Imports of Goods & Services*	4.0	n.a.	6.25	4.25-4.75	4.25-4.75	4.0-4.5
Balance of Payments (£bn)	-27.5	-32.75	-32.0	-37.5	-38.75	-40.75
Inflation (CPI) Q4	2.25	2.0	2.5	2.0	2.0	2.0

* Excluding missing trader intra-community fraud (MTIC)

	Actual 2005/6	Previous Forecast 2006/7	New Forecast 2006/7	Forecast 2007/8	Forecast 2008/9	Forecast 2009/10
Economic Prospects						
Current Budget surplus/ deficit (£bn)	-15.1	-7.1	-7.9	-1	4	7
Cyclically adjusted surplus (% of GDP)	-1.0	0.4	-0.4	-0.1	0.3	0.5
Public Sector Net						
Borrowing (£bn)	37.5	35.8	36.8	31.0	27.0	26.0
Net borrowing as % of GDP (cyclically adjusted)	2.8	1.9	2.6	2.2	1.9	1.7
Public Sector Net Debt						
(% of GDP)	36.4	37.5	37.5	38.2	38.6	38.7
Deficit under Maastricht						
Definition as % of GDP						
(cyclically adjusted)	2.6	2.0	2.5	2.2	1.9	1.7
Debt Ratio re Maastricht						
Treaty (% of GDP)	42.7	43.9	43.7	44.1	44.2	44.2

Overall, the Treasury's forecasts for UK growth remain relatively optimistic, and do not appear to be factoring in any significant softening in global growth. Although inflation has been of some concern in recent months, the Treasury has maintained a relatively benign forecast for this variable.

Public Finances

The latest forecasts from the Treasury imply a slight deterioration in public finances. The current budget deficit had been expected to reach £7.1bn in the fiscal year 2006/7, but this Pre-Budget Report now estimates that this deficit will be £800m higher, at £7.9bn. As a result, the Treasury now expects the current budget deficit to move into positive territory in 2008/9, which is 12 months later than had been forecast previously. However, despite this delay, a budget surplus of £10bn is expected by 2010/11. The Treasury left the starting point of the current business cycle unchanged, but has

brought the end of the cycle forward by one year, to the beginning of 2007. On this new basis, the Chancellor still expects to meet his 'golden rule' measure, which requires that the current budget be zero or slightly positive over the cycle. During the current economic cycle, which is deemed to have commenced in the fiscal year 1997/98, there has been an average annual current budget surplus of 0.1% of GDP.

On the negative side, public sector net borrowing, as a share of GDP, is now not expected to improve as much as had been forecast at the time of the Budget Report. In that report, the Treasury had suggested that new borrowing would fall from 2.8% to 1.9% of GDP, but the Treasury now expects net borrowing to be as high as 2.6% of GDP in 2006, suggesting that the improvement has been limited to just 0.2%. Despite this disappointing progress, further improvements in the net borrowing/GDP ratio are still expected over the next 3 years, causing it to decline to just 1.7% by 2009/10. However, this rate of improvement is now less than had been predicted in the Budget Report in March.

Public sector net debt is now expected to rise by more than the Treasury had anticipated previously. The ratio of public sector net debt/GDP has been maintained at 37.5% of GDP in 2006, but this ratio is now expected to increase fairly steadily, to 38.7% by 2010/11. This is higher than the previous forecast of 38.4%, but still ensures that the Chancellor meets the 'sustainable investment' rule. This rule requires that public sector net debt remains lower than 40% of GDP.

Source: HM Treasury, Consensus Economics