02.07.2015

MPC MEMBERS

COPIES OF THE JULY 2015 PRE-MPC MEETING PRESENTATIONS

In advance of the MPC meeting, please find attached copies of all presentations given at the July 2015 Pre-MPC meeting.

Monetary Policy COO Division (TS-02)
2 July 2015

1: Financial Markets

Financial Markets

July 2015 Pre-MPC
FED, MFAD & SMD

Plan

- Recent market developments:
  - Greece
  - Policy expectations and exchange rates
  - Bond markets and inflation expectations
- Previous US tightening cycles (and what may be different this time)

Summary table

	Levels			Changes to cob 1 July	
	May IR 15 day average	June MPC (03 Jun 2015)	Latest (01 Jul 2015)	Since June MPC	Since May IR average
UK 1-year, 1-year OIS rate	0.88	0.96	1.14	18 bps	26 bps
UK 10-year gilt yield	1.84	2.19	2.16*	-3 bps*	31 bps*
£ ERI	90.4	90.5	93.1	2.8%	3.0%
FTSE All Share	3784	3787	3616	-5.0%	-4.9%

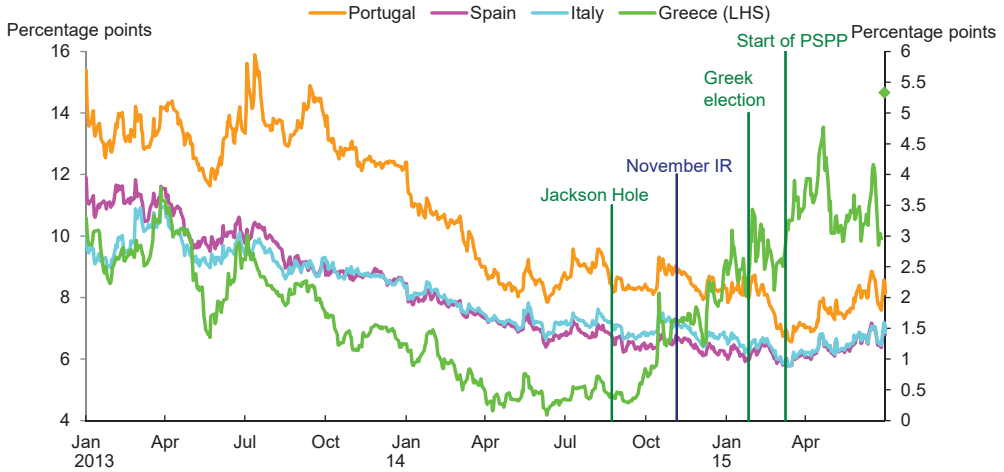
* Gilt data to cob 30 Jun

- UK wages data part of the reason for increases in UK short rates and sterling.
- But foreign developments, especially Greece, the main focus for global markets.

Greece

- Referendum called for 5 July
- No payment to IMF on 30 June
- Capital controls/bank holidays/ELA
- Stock market and trading platforms suspended

10 year EA periphery spreads to Bunds since 2013

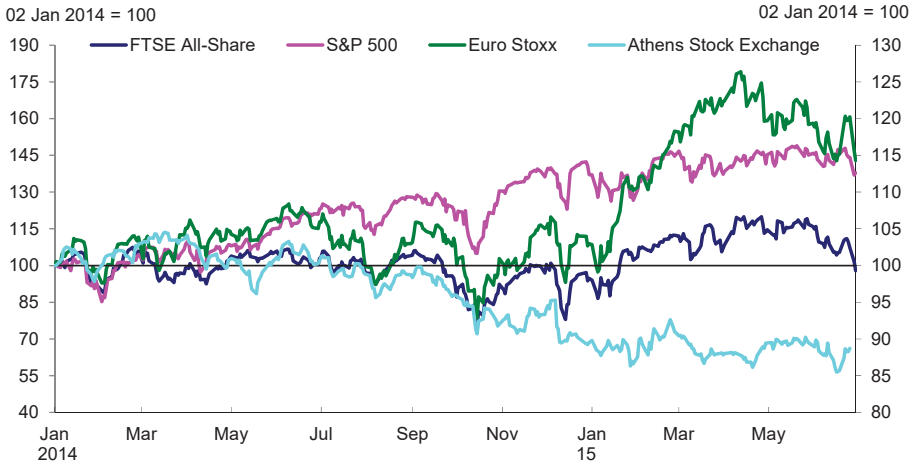


- Greek bond market effectively closed since the weekend; other peripheral spreads wider on the month but not hugely so.
- Euro effective exchange rate little changed.

Equities since May IR (local currency)

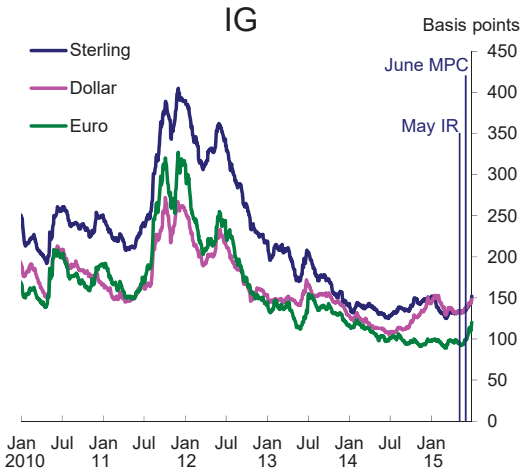
- Some volatility in equity markets reflecting concerns about Greece.

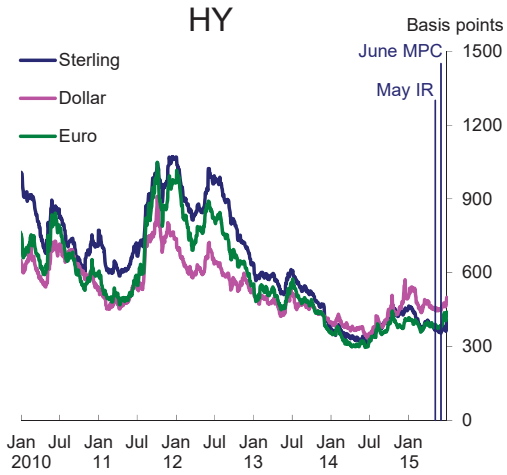
Equities (local currency)



- But not huge falls in the context of previous moves.
- ASE closed since 26 June.

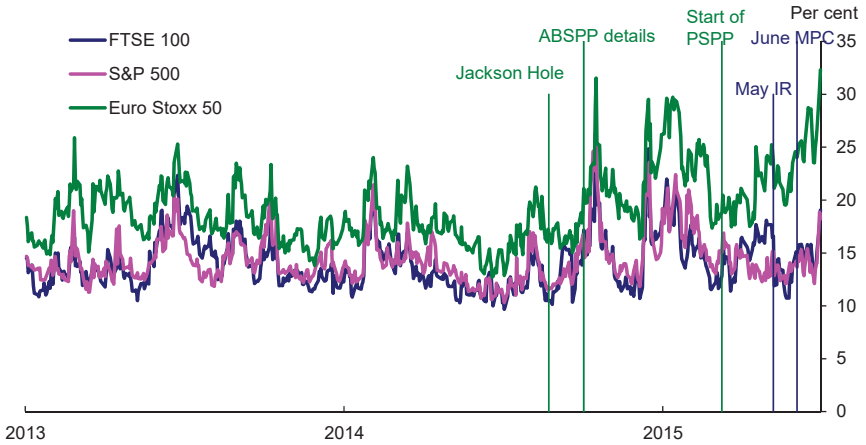
Corporate bond spreads





- Corporate spreads a little wider, but not dramatically so.

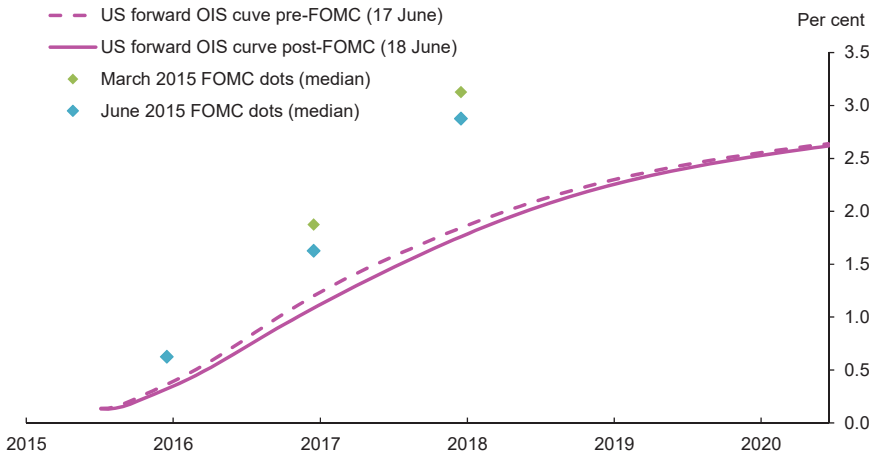
Equity market implied volatilities



- Euro area implied volatilities higher, but less change for UK/US.
- Liquidity has been thin this week across all markets, but trading generally orderly.

Short term interest rates

FOMC rate forecasts and US curve

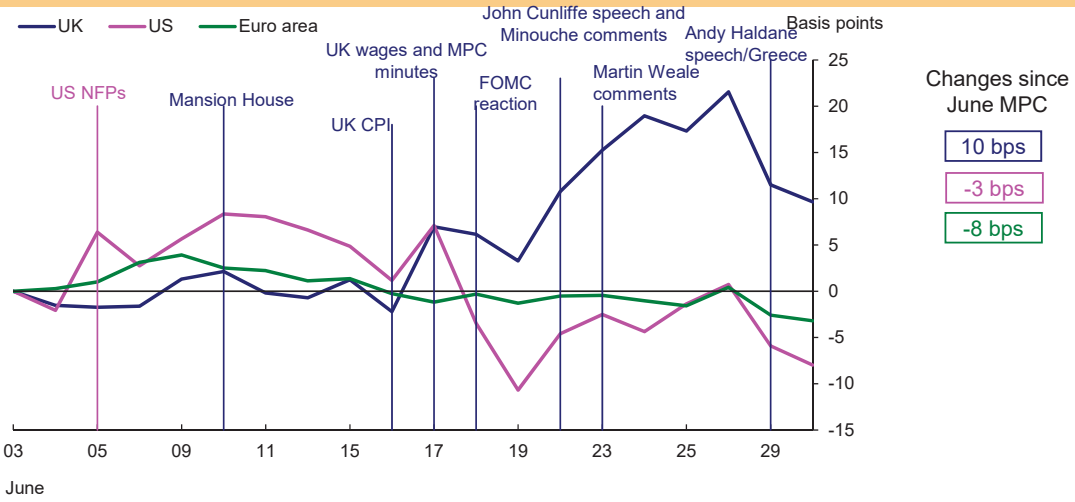


- FOMC member forecasts revised down in June
- US short rates fell

Timing of the US first rate rise (+ 25bps above market rates)

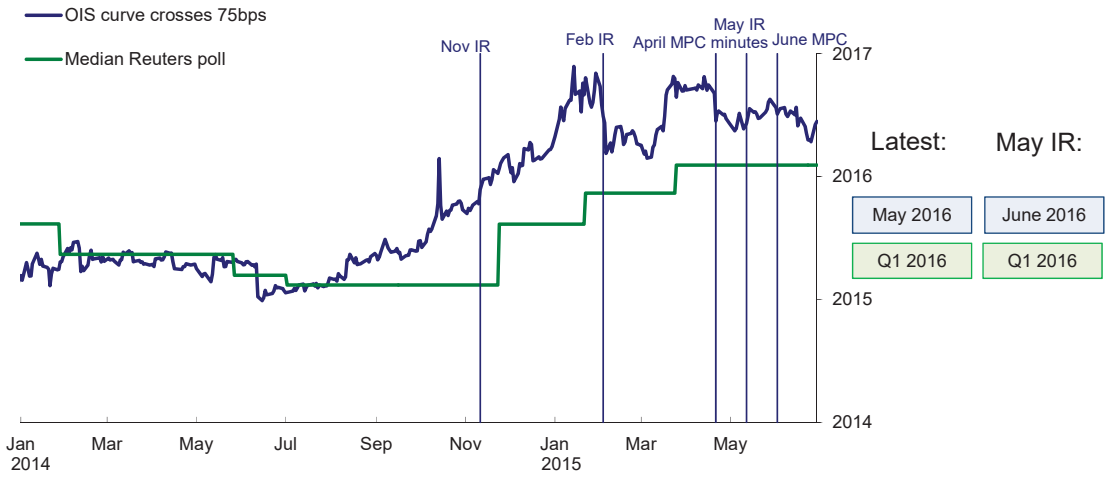
- Curve crossed 35bps in December 2015 at June FOMC.
- But contacts suggest September not ruled out.

1y1y OIS rates since June MPC



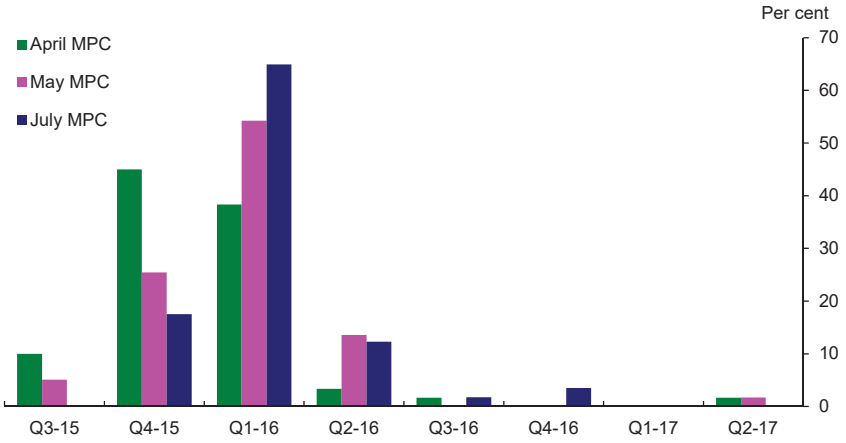
- UK rates up on wages data and MPC comments.
- Rates fell on Greek news.

Timing of the UK first rate rise



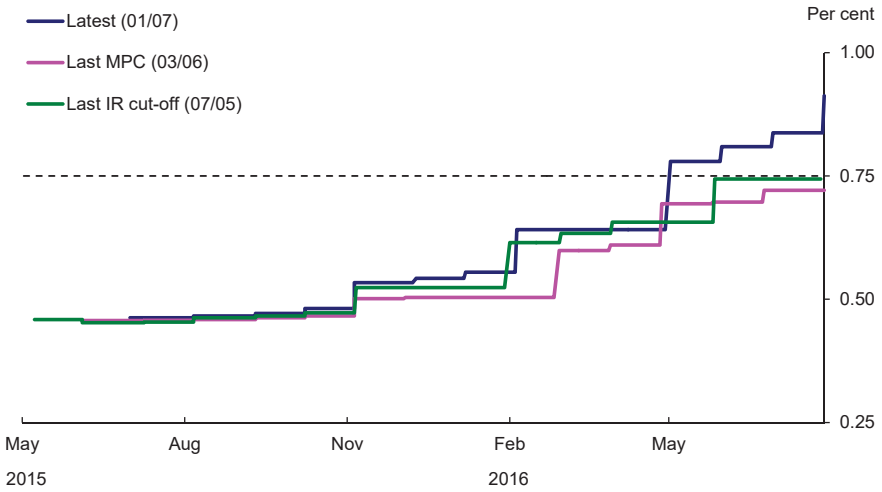
- Gap in timing relative to Reuters has narrowed.
- See

Reuters expected timing of UK first rate rise



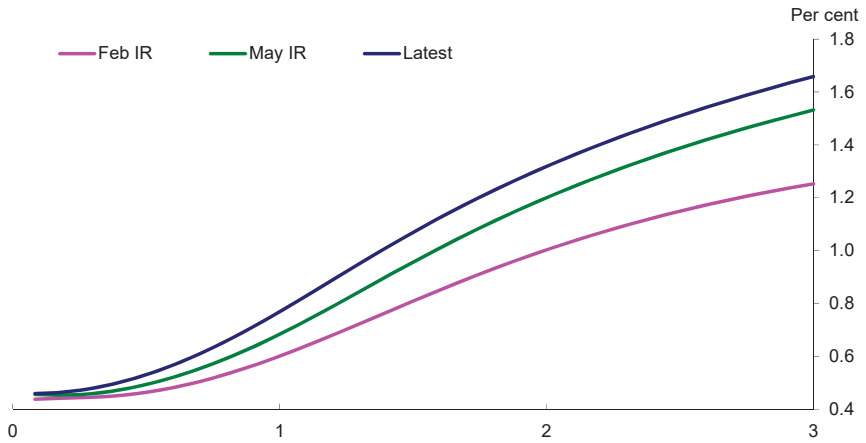
- More consensus around Q1 rate rise.
- Smaller proportion expecting a rate rise in 2015.

MPC “meeting-to-meeting” OIS swaps



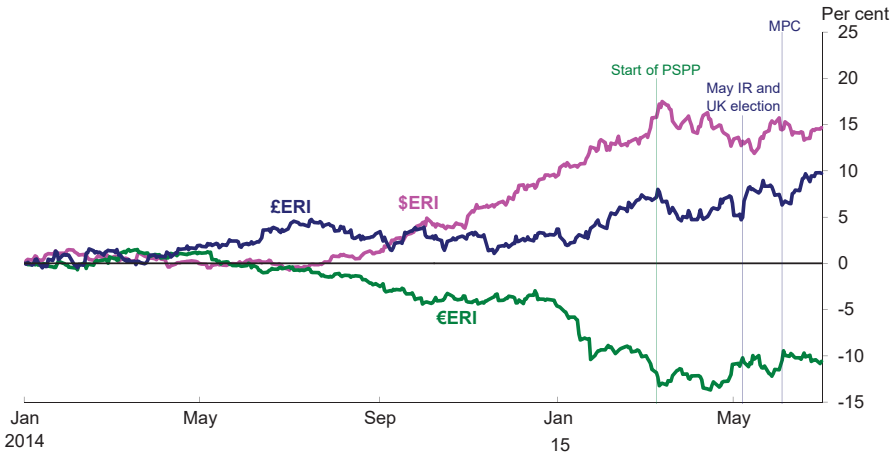
- Some weight attached to a February rate rise.

UK OIS curves



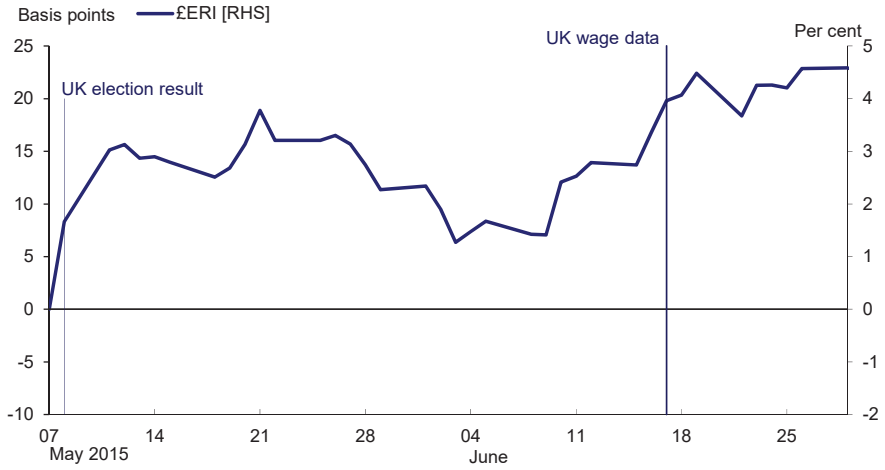
- Implied pace of tightening has increased.
- Level of rates at 3 year horizon higher on the month. (But 3y forwards were 2.3% a year ago.)

Cumulative changes in key exchange rates since start of 2014



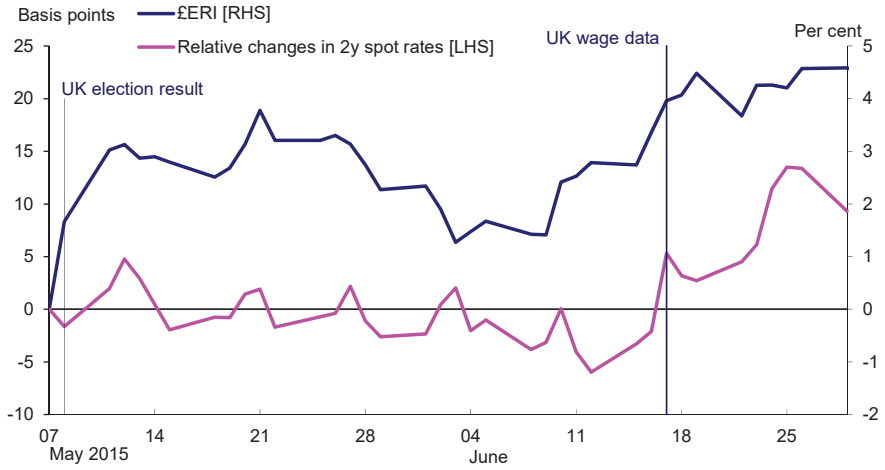
- Sterling has appreciated by 3% since May IR 15 day average.

Sterling ERI



- Sterling jumped after the election.
- Further increases following wages data.

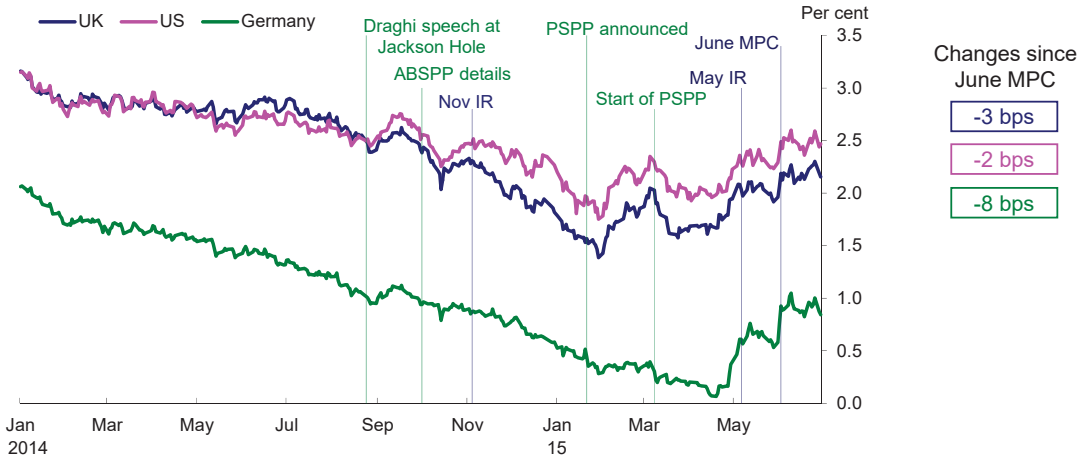
Sterling ERI with interest rate differentials



- Focus back to interest rate differentials.

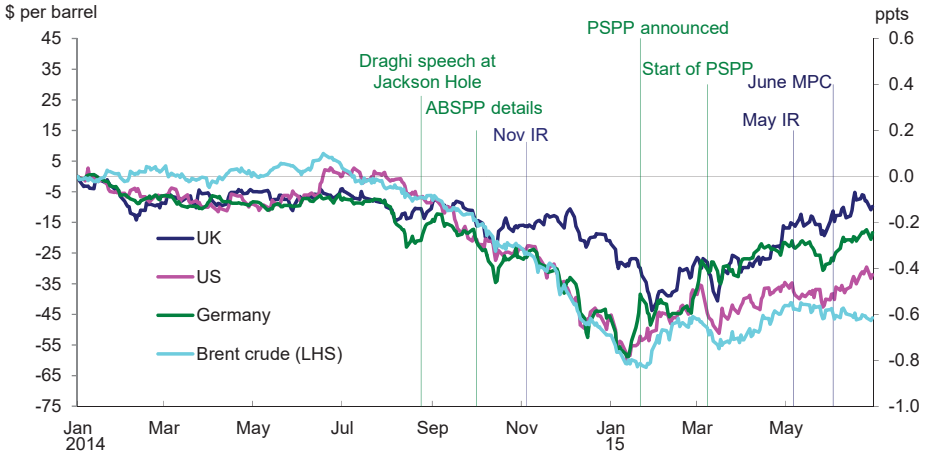
Bond markets

10-year spot government bond yields since 2014



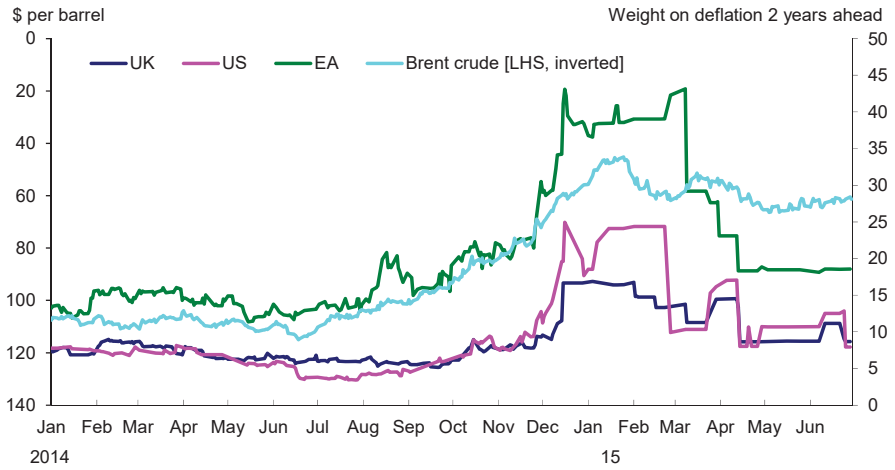
- Small moves since June MPC.
- But worth reflecting on past few months – can't just appeal to a 'technical' correction.
- Market participants' views on the impact of ECB QE on UK rates:

Cumulative changes in 10-year spot inflation swap rates and oil price



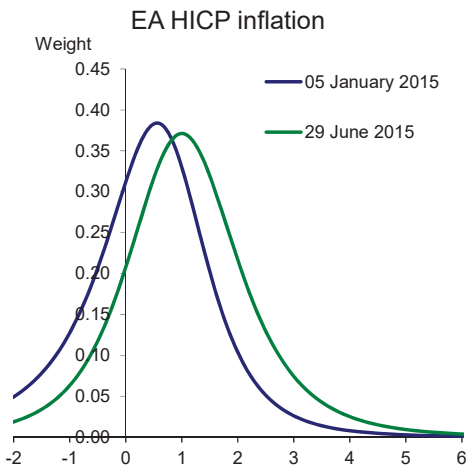
- Steadily improving inflation outlook since around February.
- Combination of ECB QE announcements and rising oil price.

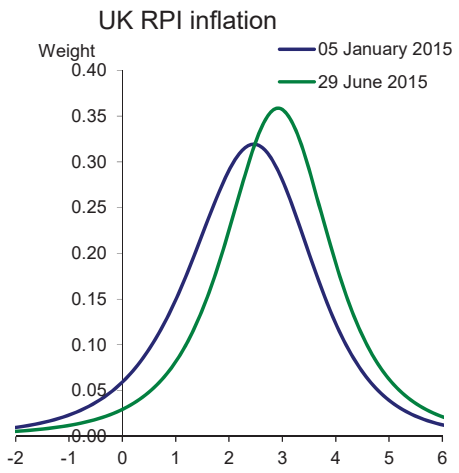
Implied deflation probabilities from option prices and oil price



- Implied deflation risks peaked January/February.

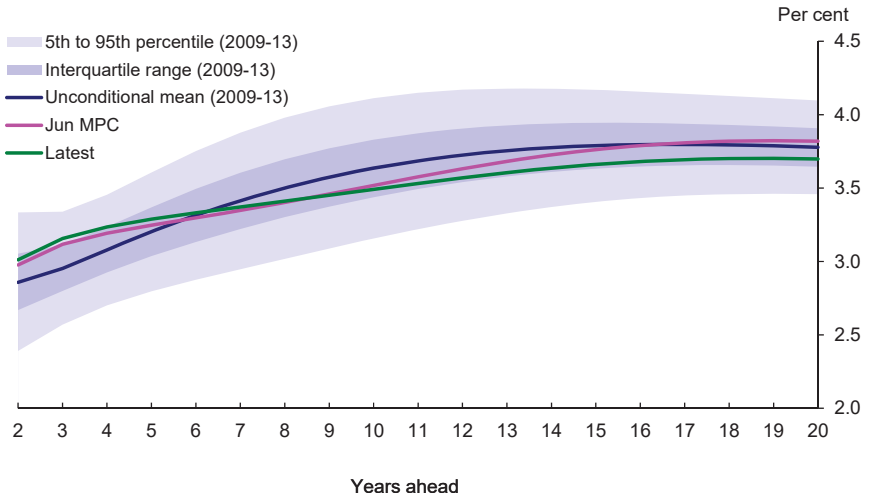
Option-implied inflation distributions, 2 years ahead





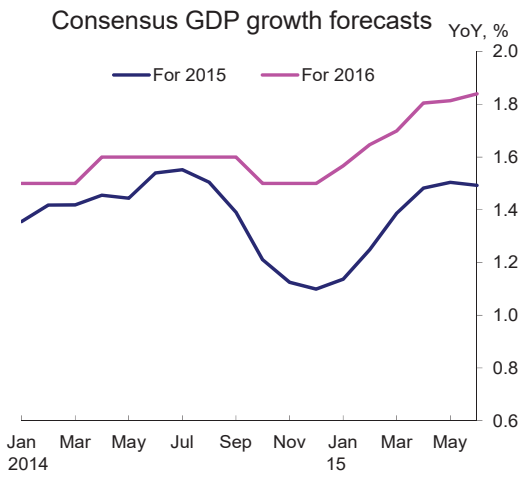
- Euro area and UK implied inflation distributions have now shifted to the right.

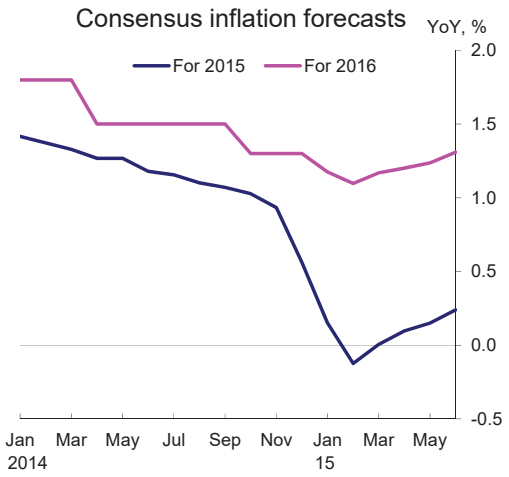
Term structure of UK inflation swap rates



- Curve a little above historical averages at shorter horizons.

Consensus expectations for euro area growth and inflation





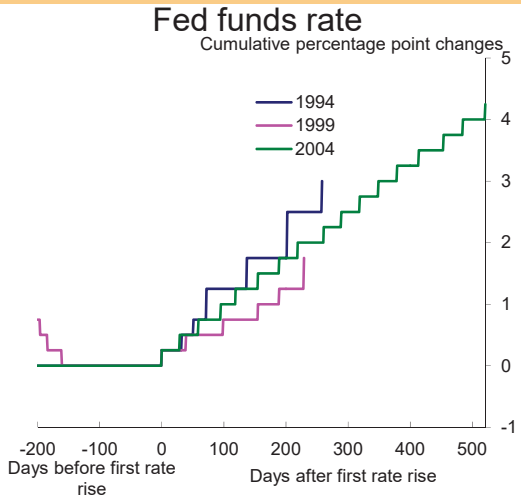
- Economists' expectations for the euro area economy have improved during 2015.

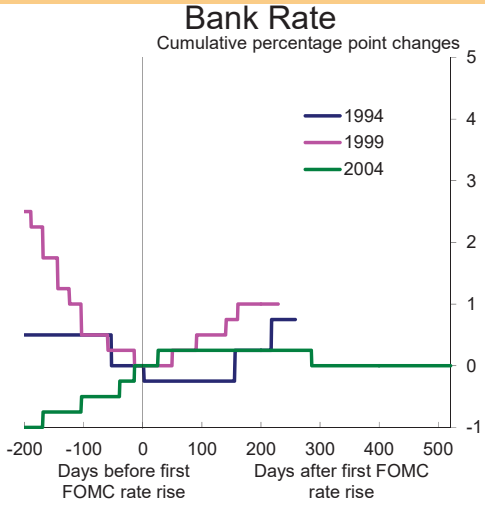
Summary of recent developments

- Greek concerns but not widespread alarm across financial markets.
- UK policy expectations have come forward and the market curve has moved up following wages data.
- Sterling has appreciated further.
- Higher bond yields over recent months partly a correction but also improved macro outlook including reduced deflation risk.

Past US tightening cycles

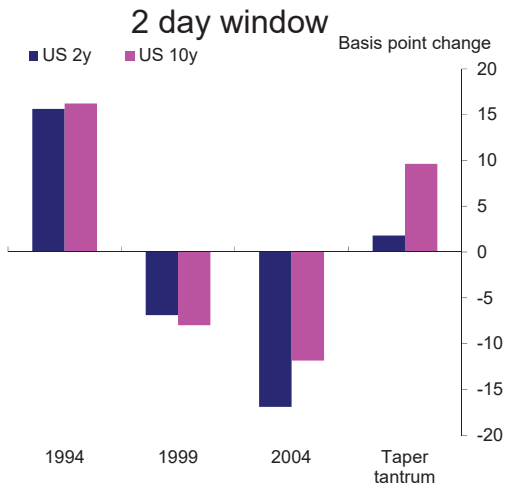
Previous US tightening cycles

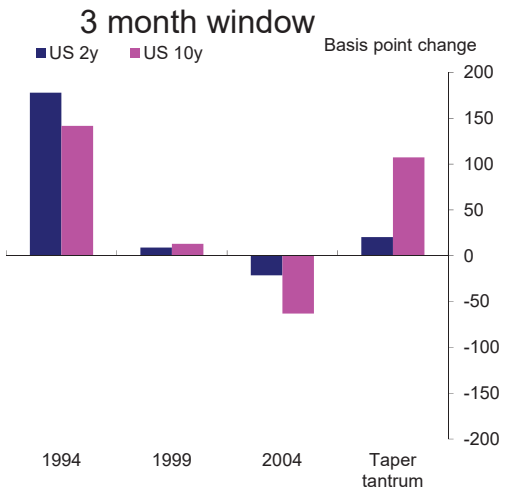




- UK and US cycles coincided in the 1999 episode.
- Se

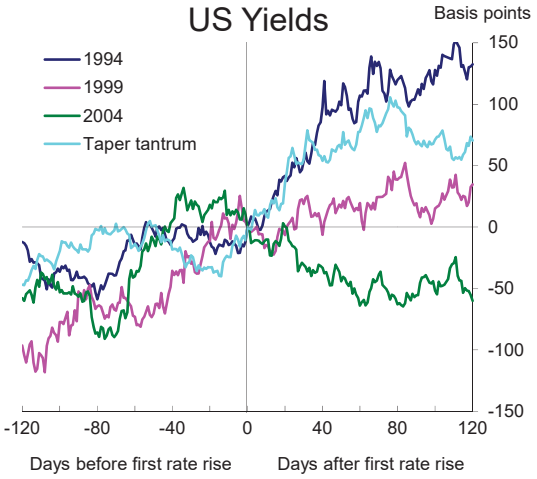
Changes in 2 and 10 year bond yields





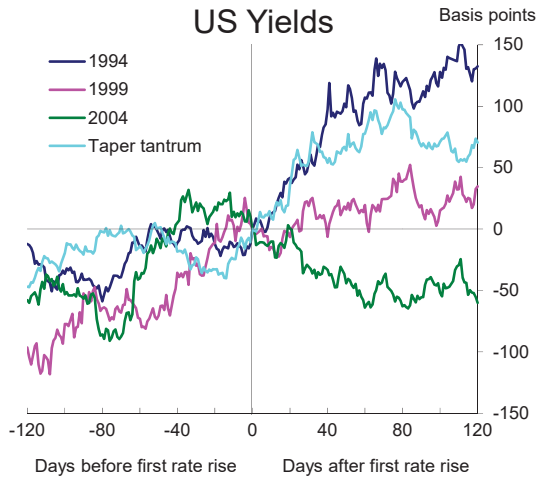
- 1994 cycle and taper tantrum similar, but very different from the 1999 and 2004 cycles.

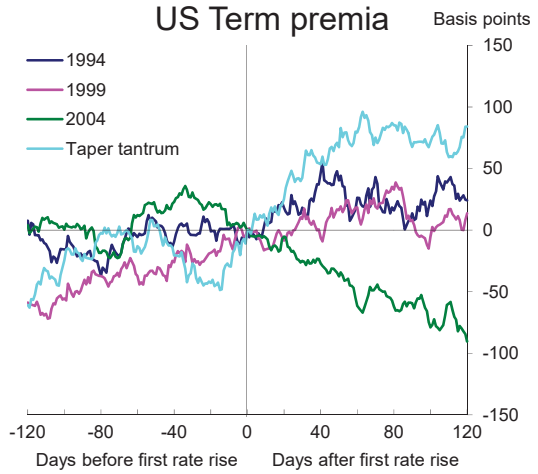
10 year US bond yields before and after...



- Yields generally rose in the run-up to the first tightening.

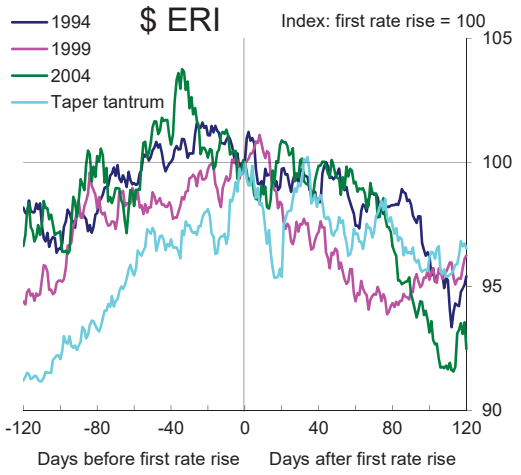
10 year US bond yields and term premia before and after..





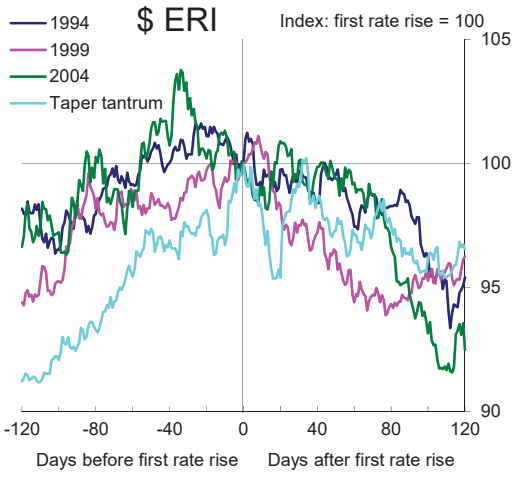
- Yields generally rose in the run-up to the first tightening.
- Term premia generally flatter in the run-up. Heterogeneous response thereafter.

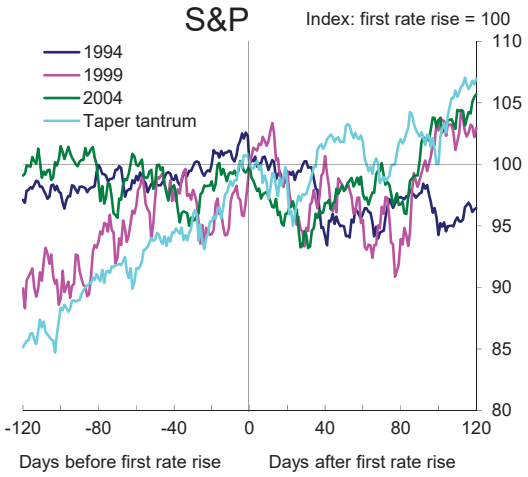
US dollar before and after...



- The dollar tended to rise in the run-up and then fall.

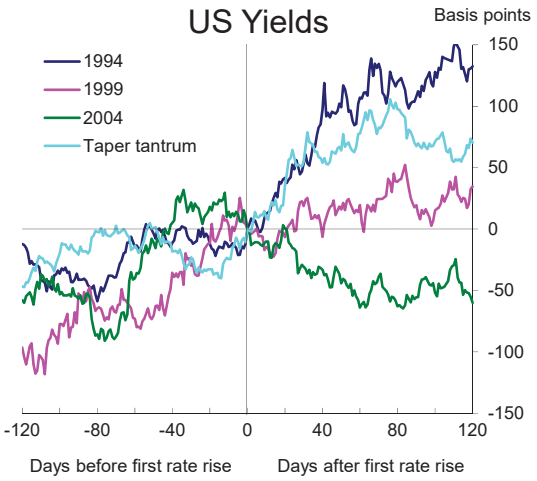
US dollar and US equity prices before and after...

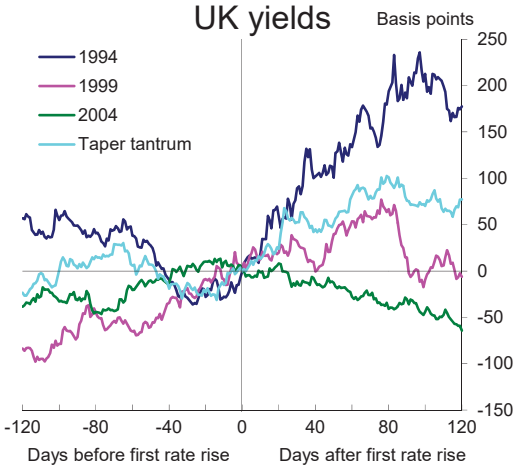




- The dollar tended to rise in the run-up and then fall.
- Equities didn't experience large sustained falls.

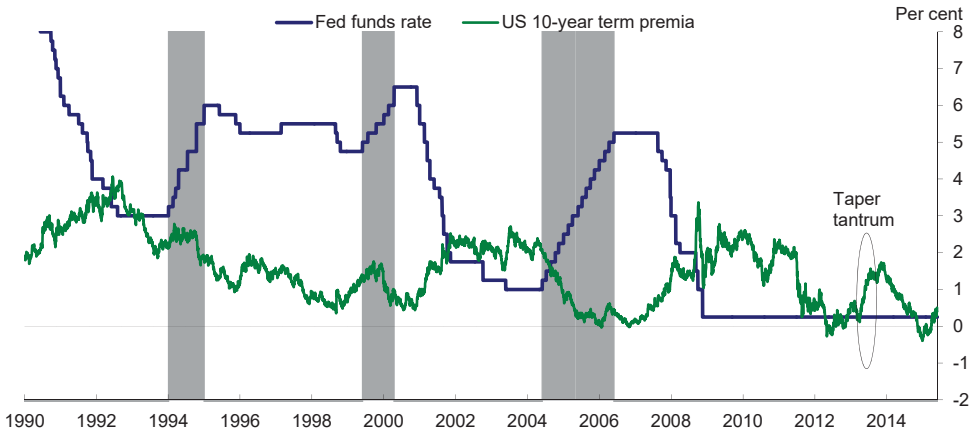
10 year US and UK bond yields before and after...





- UK yields closely correlated with US yields.

US 10-year term premium and Fed funds rate



- US term premium only spiked in the taper tantrum.
- But the current levels of term premia are low by historical standards.

Summary on past US cycles

- CB communications part of the reason for different outcomes across cycles.
- Upward adjustment in yields and USD in lead-up; USD fell after first rate hikes.
- Term premia and volatilities haven't always spiked; VIX didn't in any episodes.
- Likely to be spillovers to UK assets, particularly via bond yields.
- But many factors are different now: Central bank balance sheets: Low levels of term premia; Reduced market liquidity; Lift-off from ZLB will be a regime change.

Summary

- Greek concerns, but not widespread alarm across financial markets.
- UK policy expectations have come forward and the market curve has moved up following wages data.
- Sterling has appreciated further.
- Higher bond yields over recent months partly a correction but also improved macro outlook including reduced deflation risk.
- Asset price moves in past US cycles heterogeneous, partly due to extent of surprise. Yields and USD rose in the lead up. Mixed experience on term premia and volatilities; but both at low levels now. Many other factors also different now.

2: Money, Credit and Nominal Trends

MONEY, CREDIT AND NOMINAL TRENDS
July 2015

Plan for today

- Quarterly update on credit conditions
- Recent developments in the UK housing market
- Inflation expectations

Plan for today

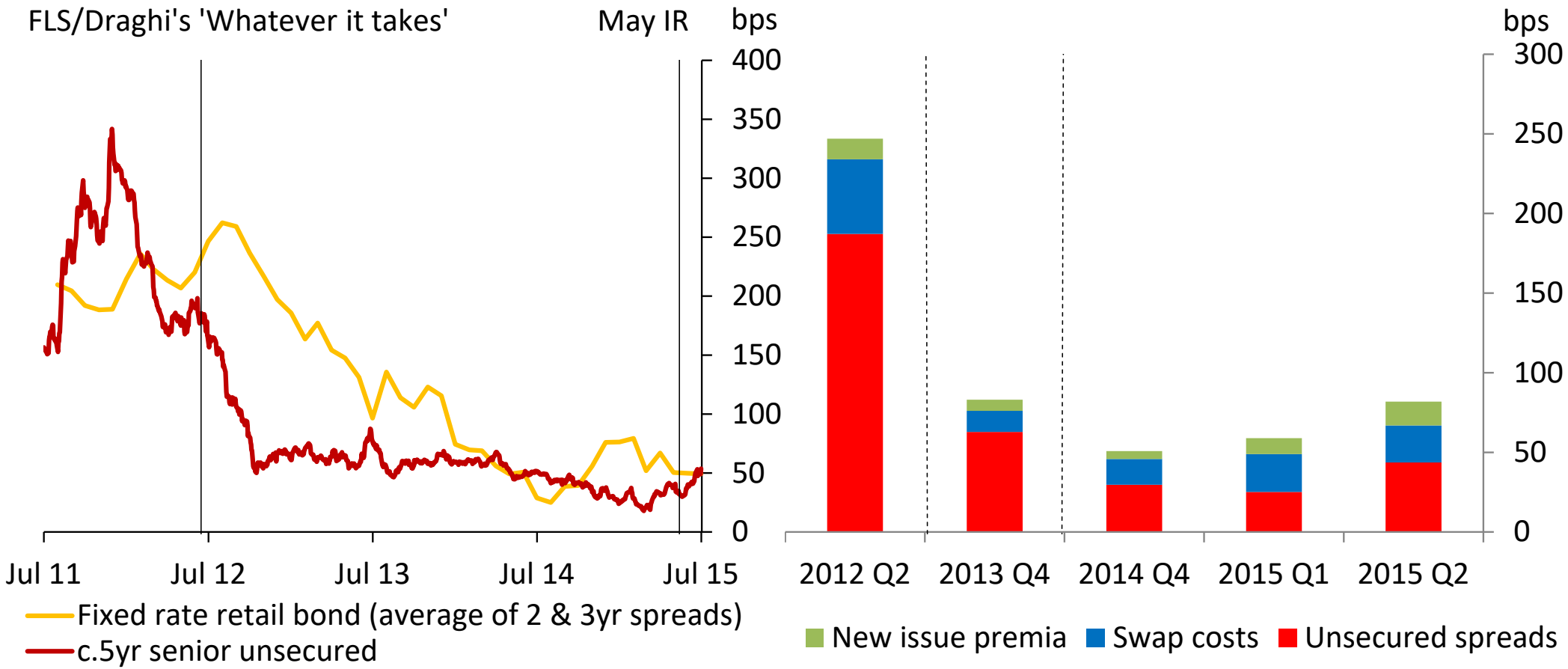
- **Quarterly update on bank lending conditions**
- Recent developments in the UK housing market
- Inflation expectations

Quarterly update on bank lending conditions

- **Bank funding costs**

Bank wholesale funding costs have been edging up…

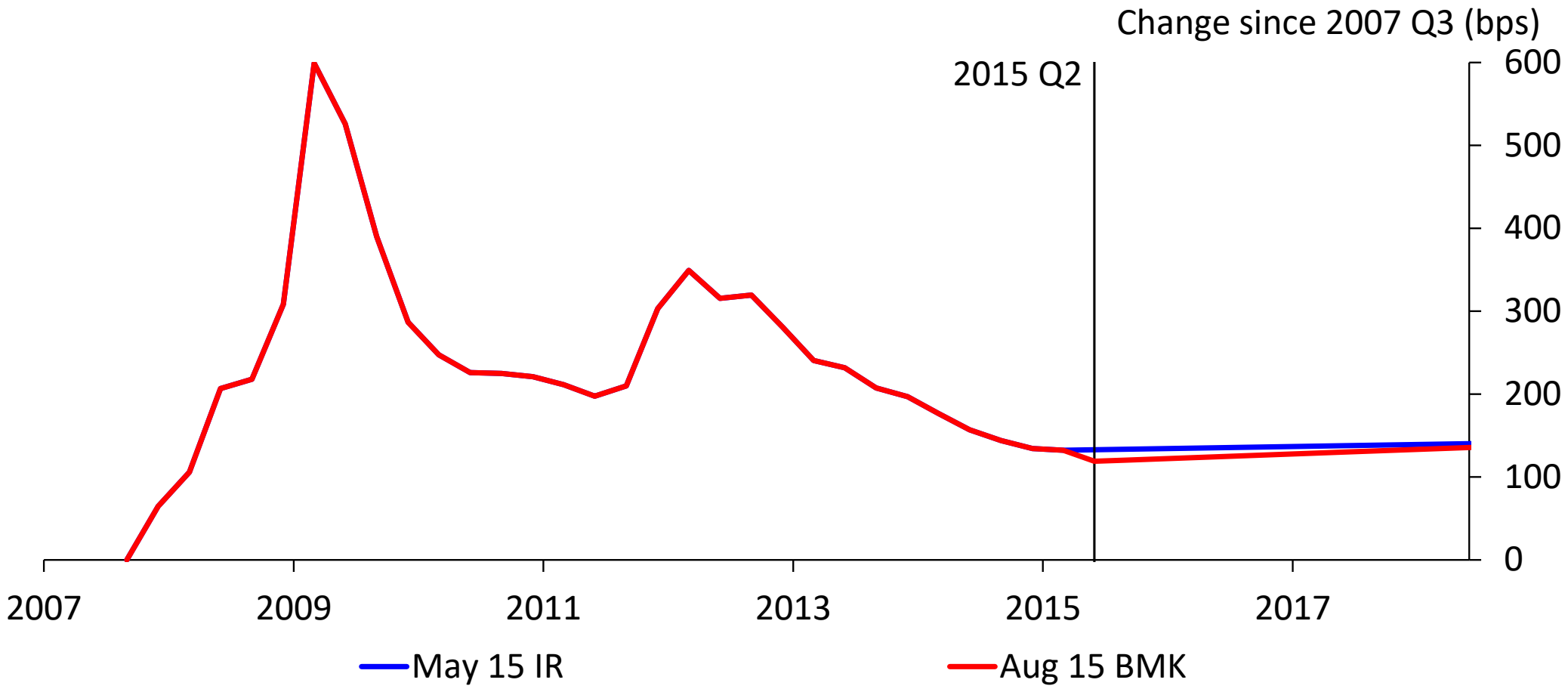
Indicative measures of Bank funding costs



Quarterly update on bank lending conditions

- Bank funding costs have edged up, but impact of moves so far on real economy likely to be modest
- **Corporate credit conditions**

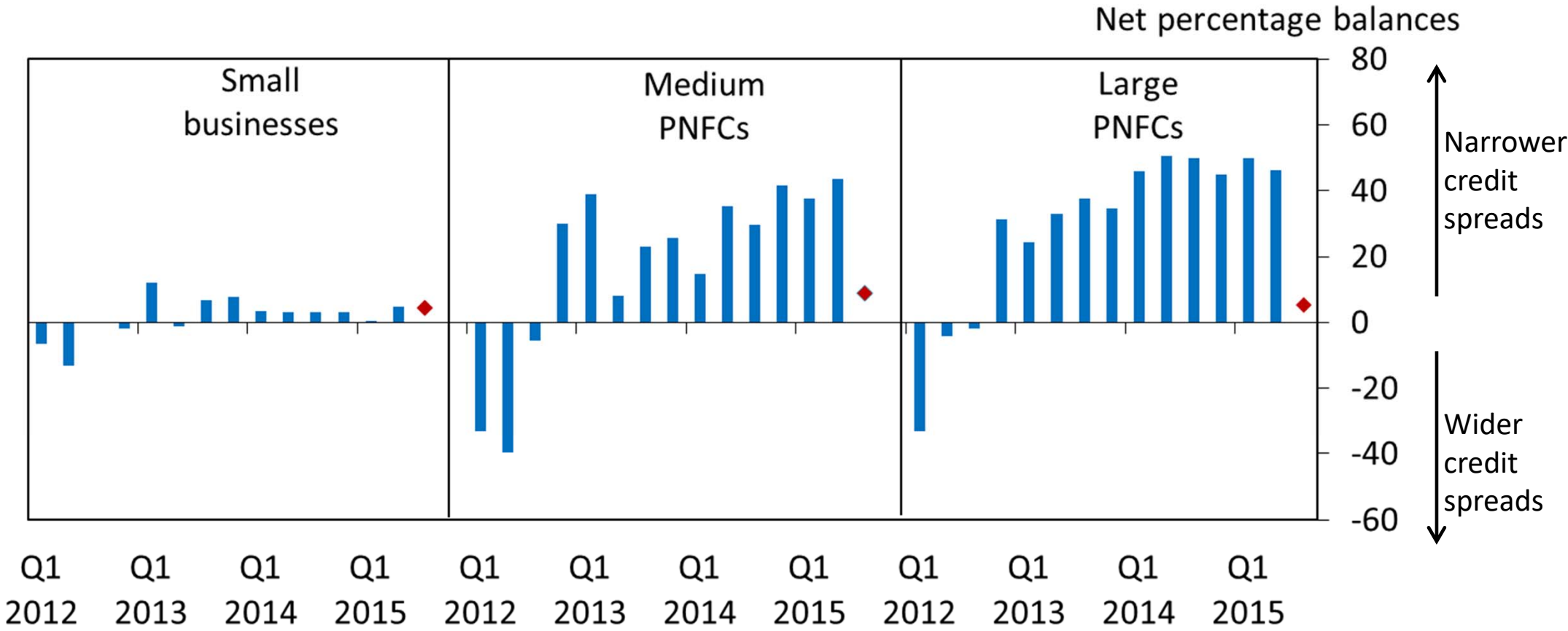
Corporate credit conditions have continued to ease…



… though less so for smaller companies

Credit Conditions Survey 2015 Q2 - credit spreads by firm size

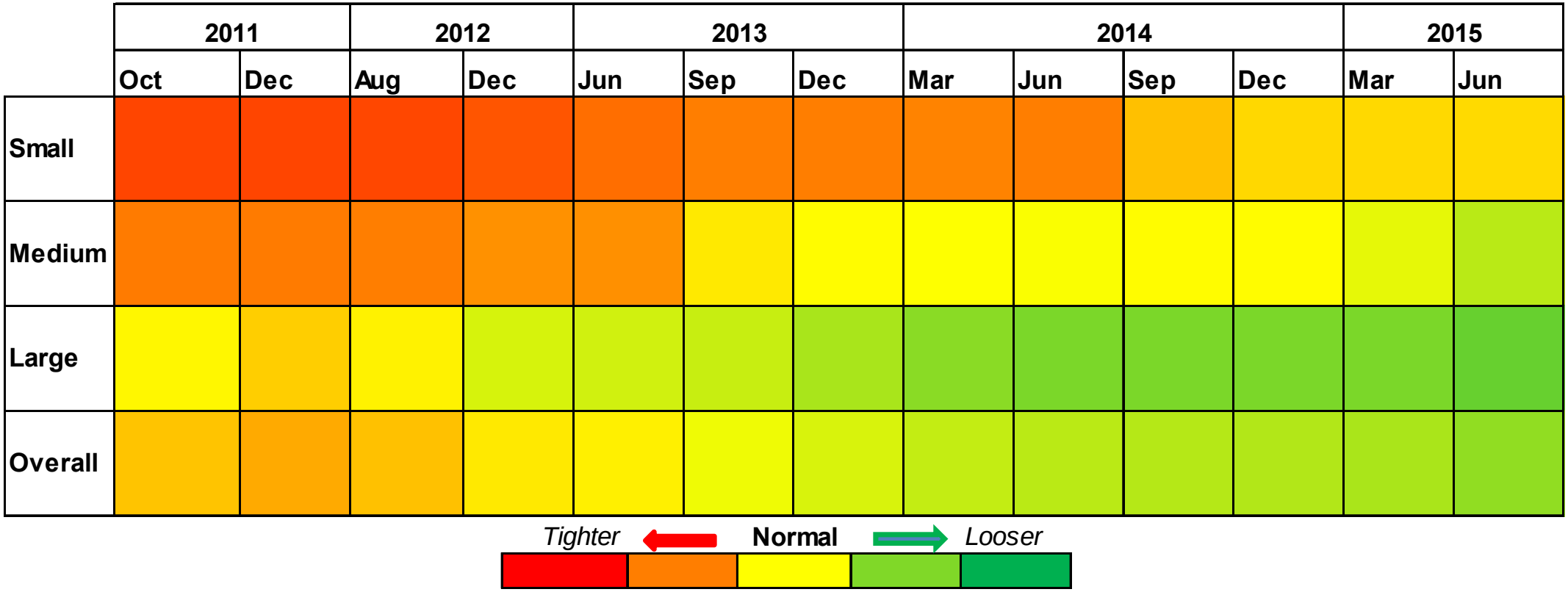
Confidential until 13th July



Blue bars show the responses over the previous 3 months, red diamonds expectations for next 3 months.

Agents corroborate differentiation by size…

Corporate credit conditions heatmap based on Agents' assessments

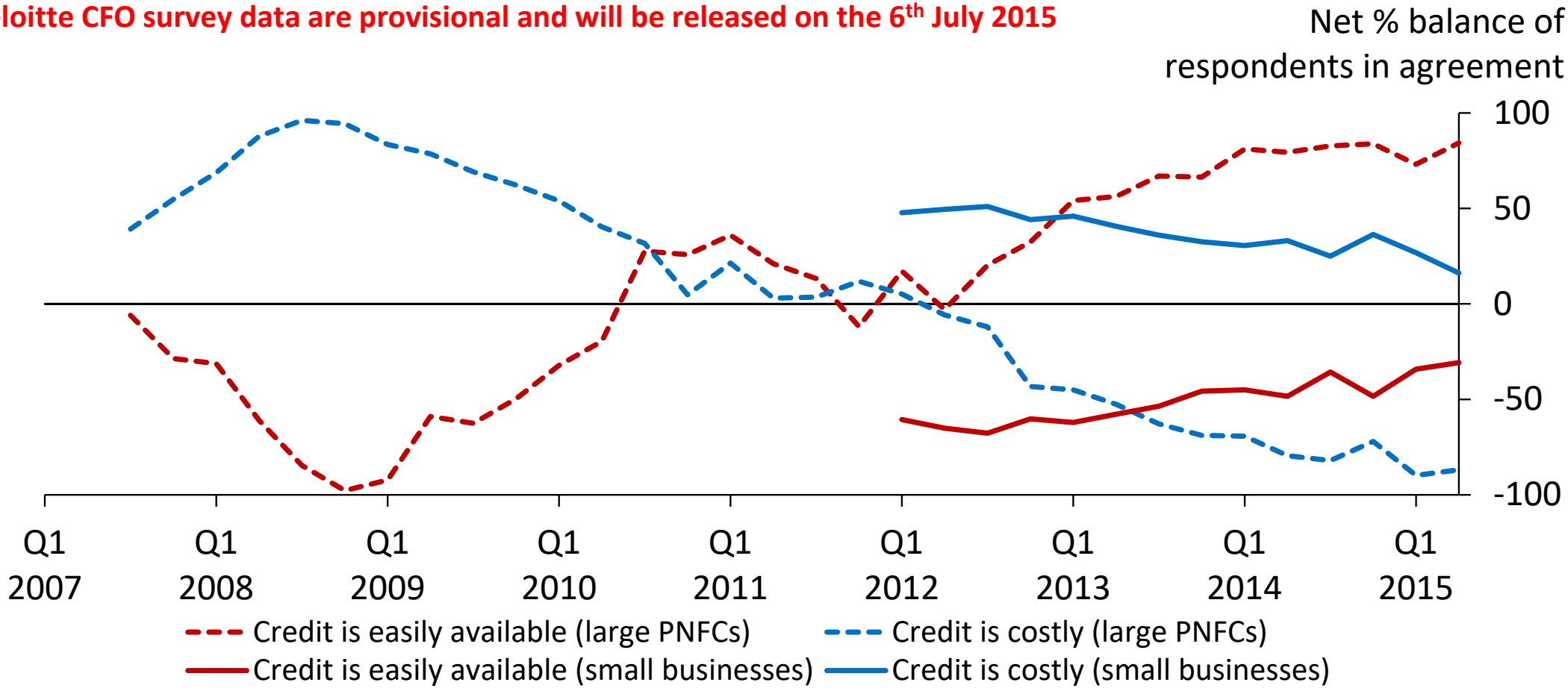


This mapping is based on individual Agencies' national assessments of corporate credit availability, weighted by the gross value added of their regions or countries. Overall availability is an average of small, medium and large corporate credit availability weighted by estimates of the share of bank lending by company size.

…as do companies themselves.

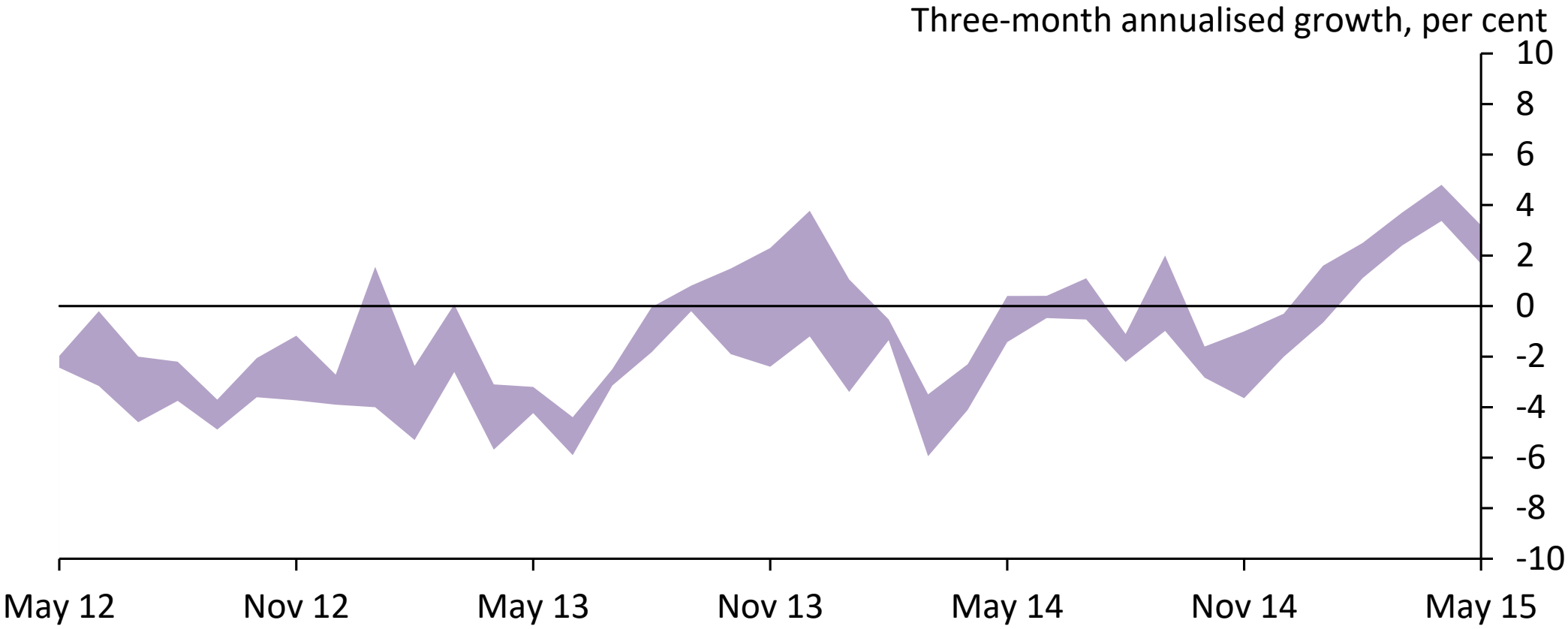
Deloitte CFO and Federation of Small Businesses survey results on credit conditions

Deloitte CFO survey data are provisional and will be released on the 6th July 2015



Easing in credit conditions finally translating into a pickup in lending to companies…

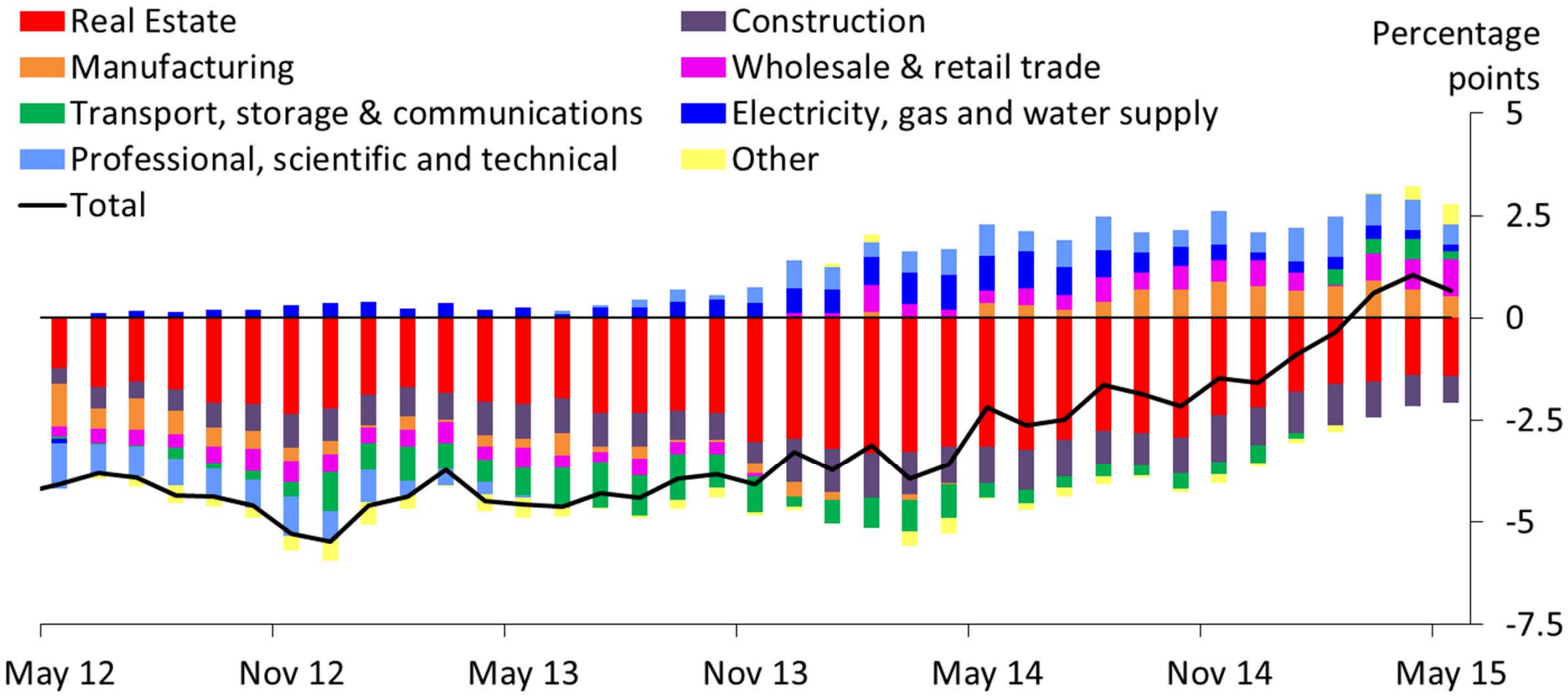
Growth in measures of lending to PNFCs*



*Swathe includes: PNFC M4L (SA), sterling loans to PNFCs (SA) and all currency loans to PNFCs (SA).

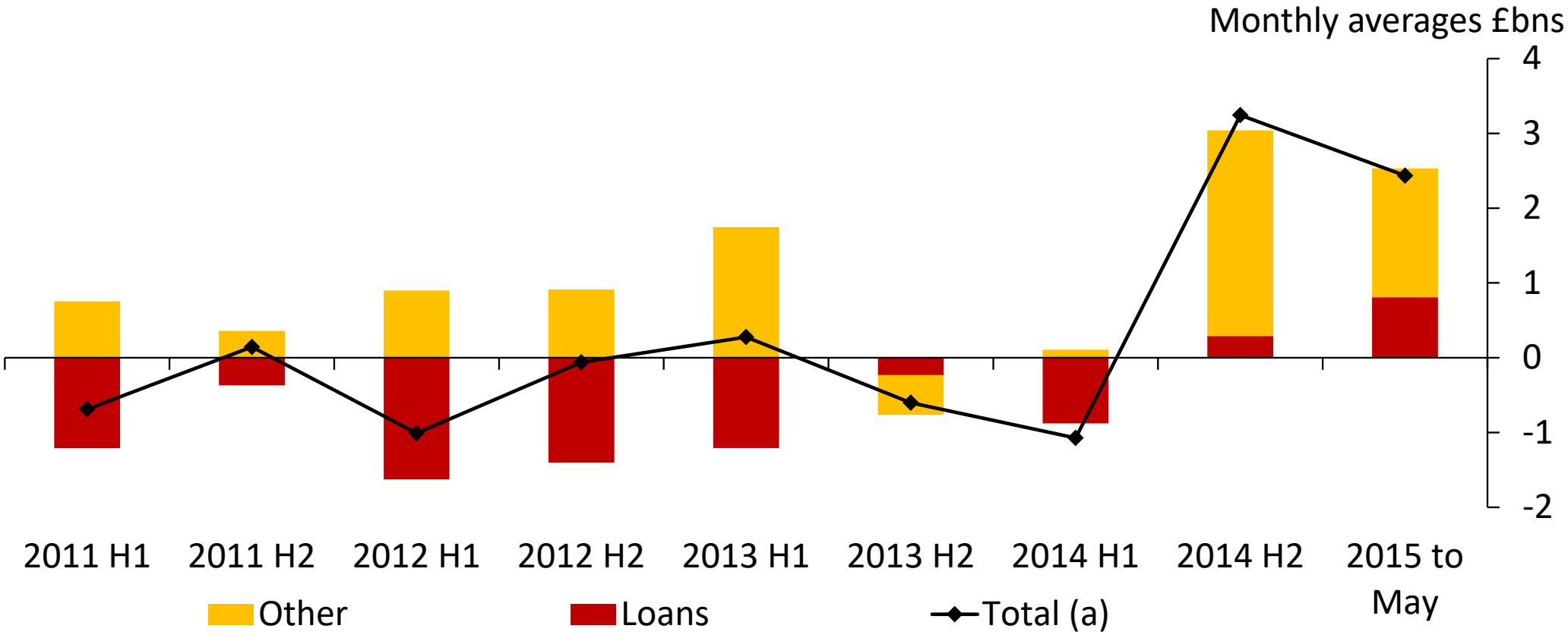
…which looks broad-based.

Contributions to 12m growth in lending to businesses, by industry



Net finance raised solid so far in 2015

Monthly averages of net finance raised

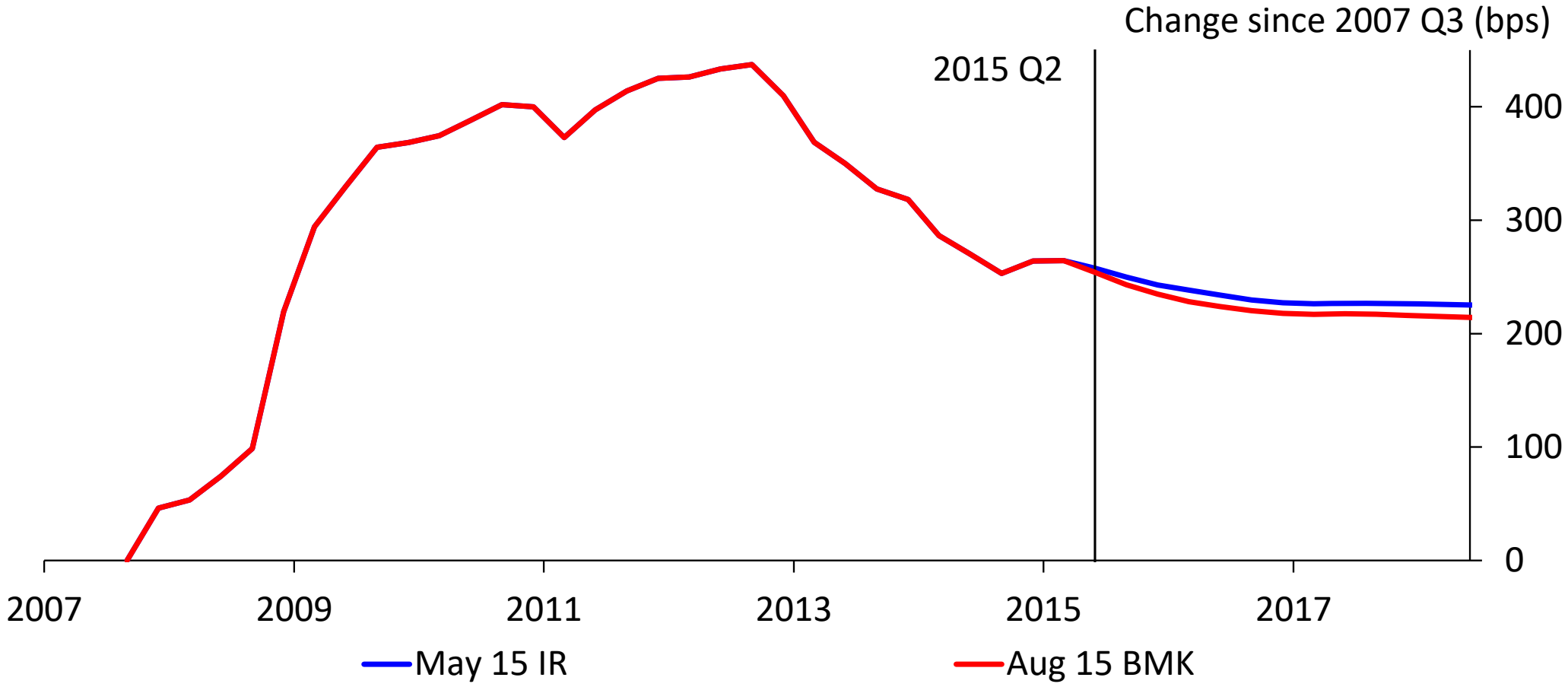


(a) Owing to the seasonal adjustment methodology, this series may not equal the sum of its components.

Quarterly update on bank lending conditions

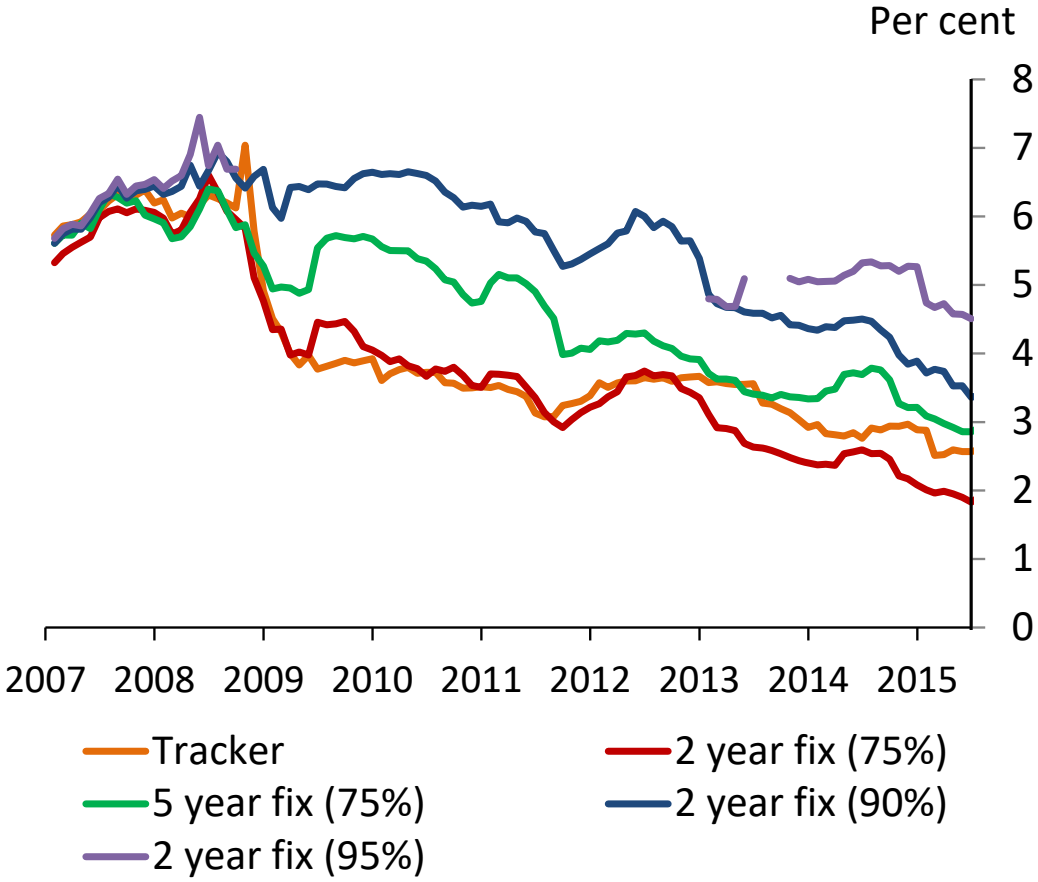
- Bank funding costs have edged up, but impact on real economy from moves so far likely to be modest
- Corporate credit conditions continue to ease, but improvement for small companies a slow process
- **Household credit conditions**

Projection for household credit spreads a little lower than in May

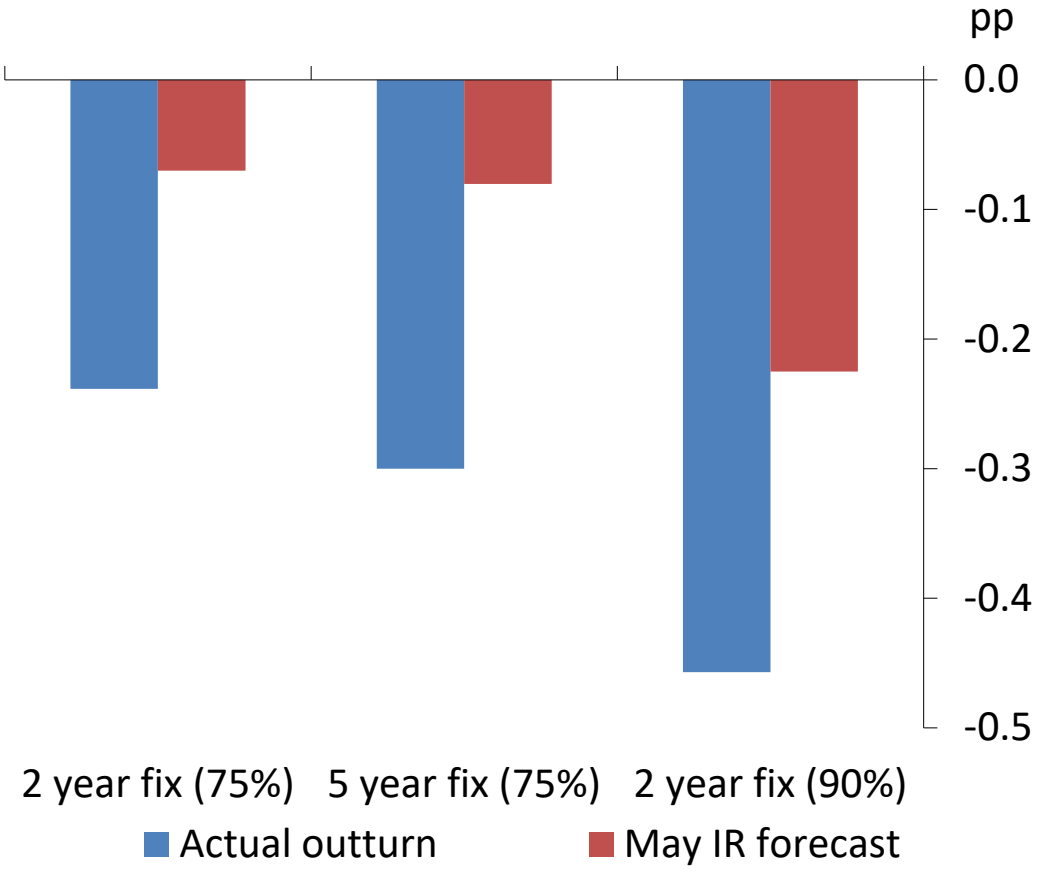


Mortgage rates continue to fall

Quoted mortgage rates

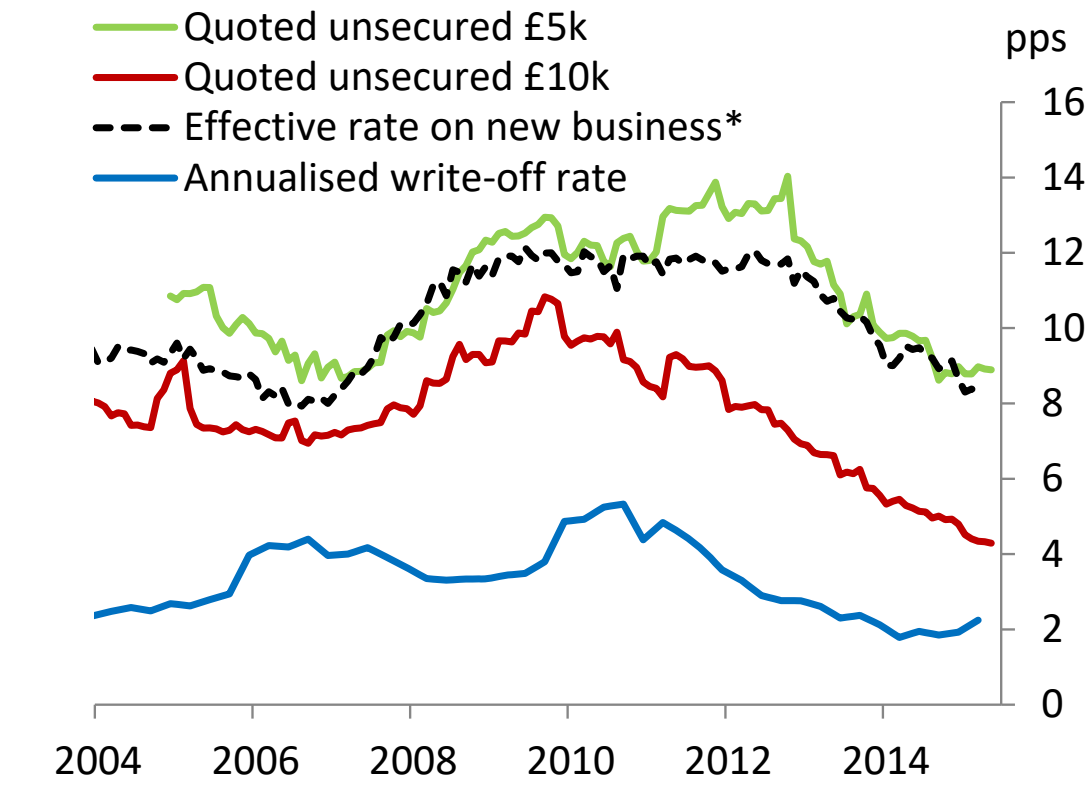


Secured spreads, change since 2015 Q1



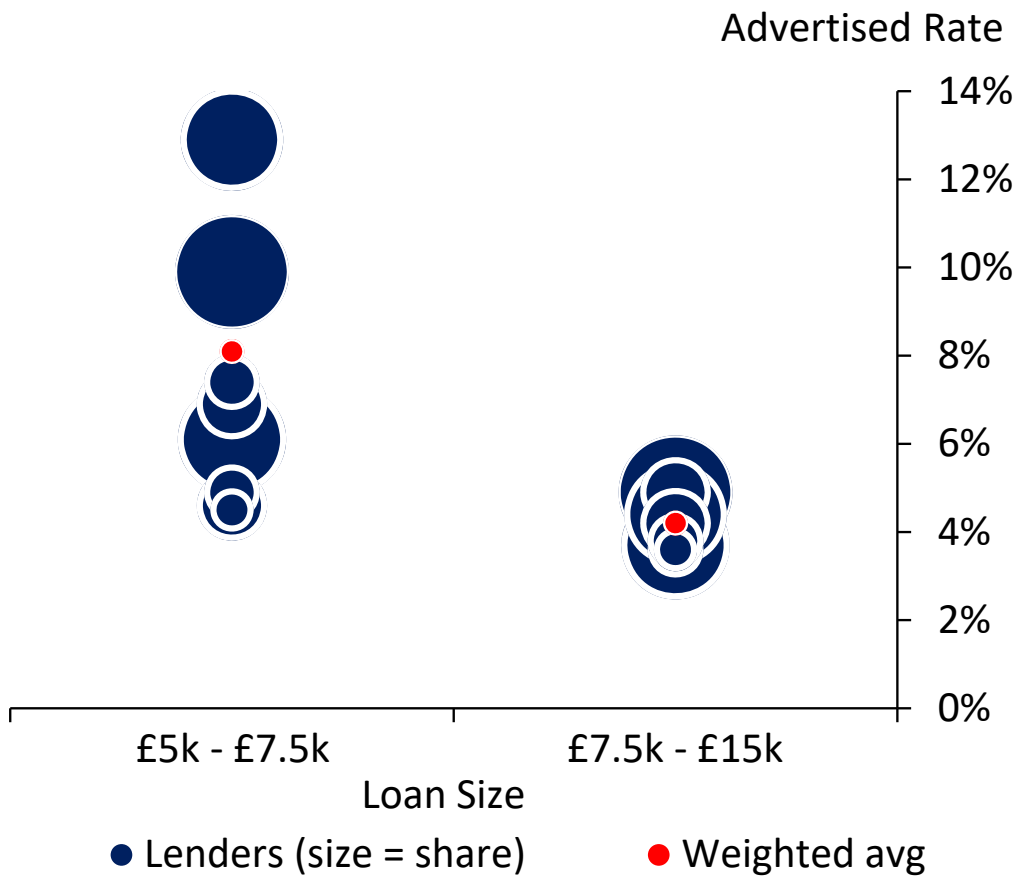
Personal loan rates continue to ease

Personal loan and write-off rates



* 1-5 year fixed

Personal loan rates by lender



Quarterly update on bank lending conditions

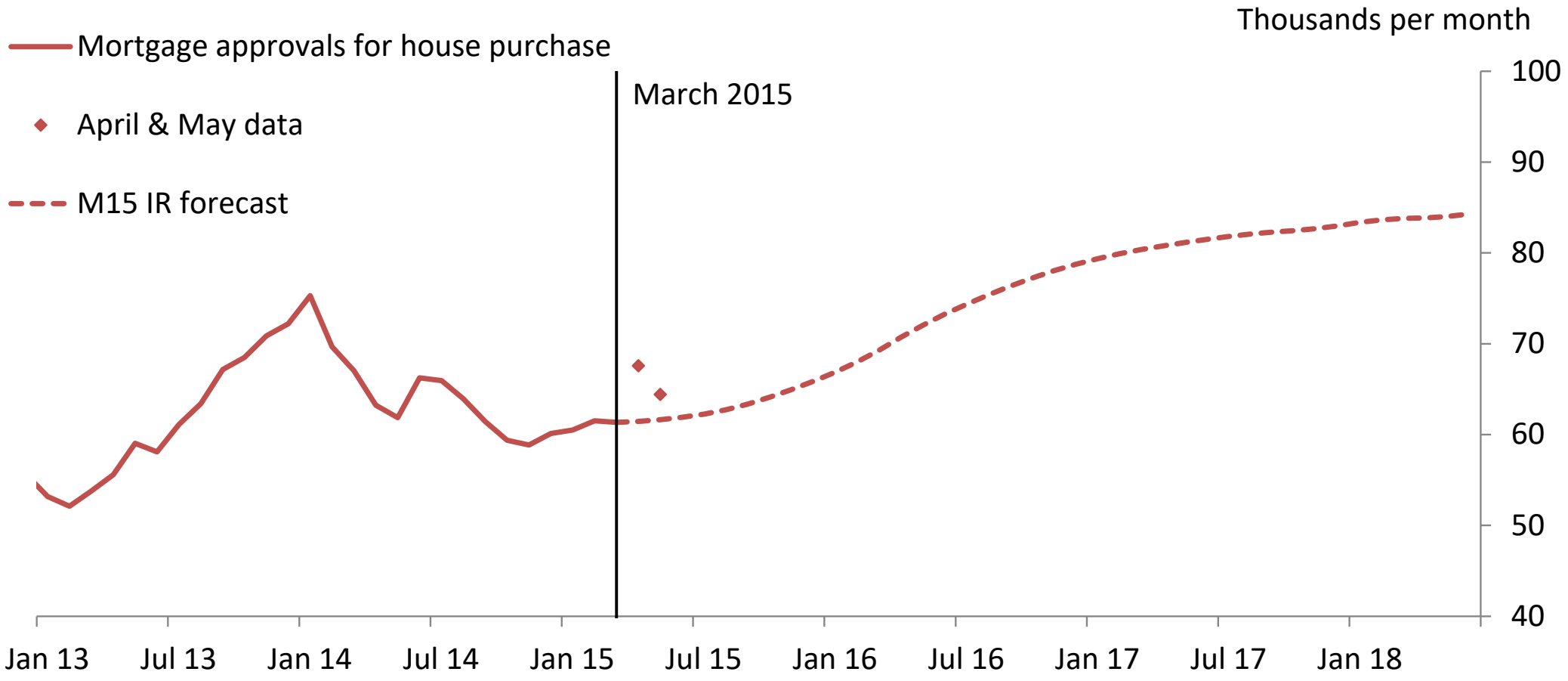
- Bank funding costs have edged up, but impact on real economy from recent moves likely to be modest
- Corporate credit conditions continue to ease, but improvement for small companies a slow process
- Household credit conditions: rates on mortgages and personal loans continue to fall

Plan for today

- Quarterly update on credit conditions
- **Recent developments in the UK housing market**
- Inflation expectations

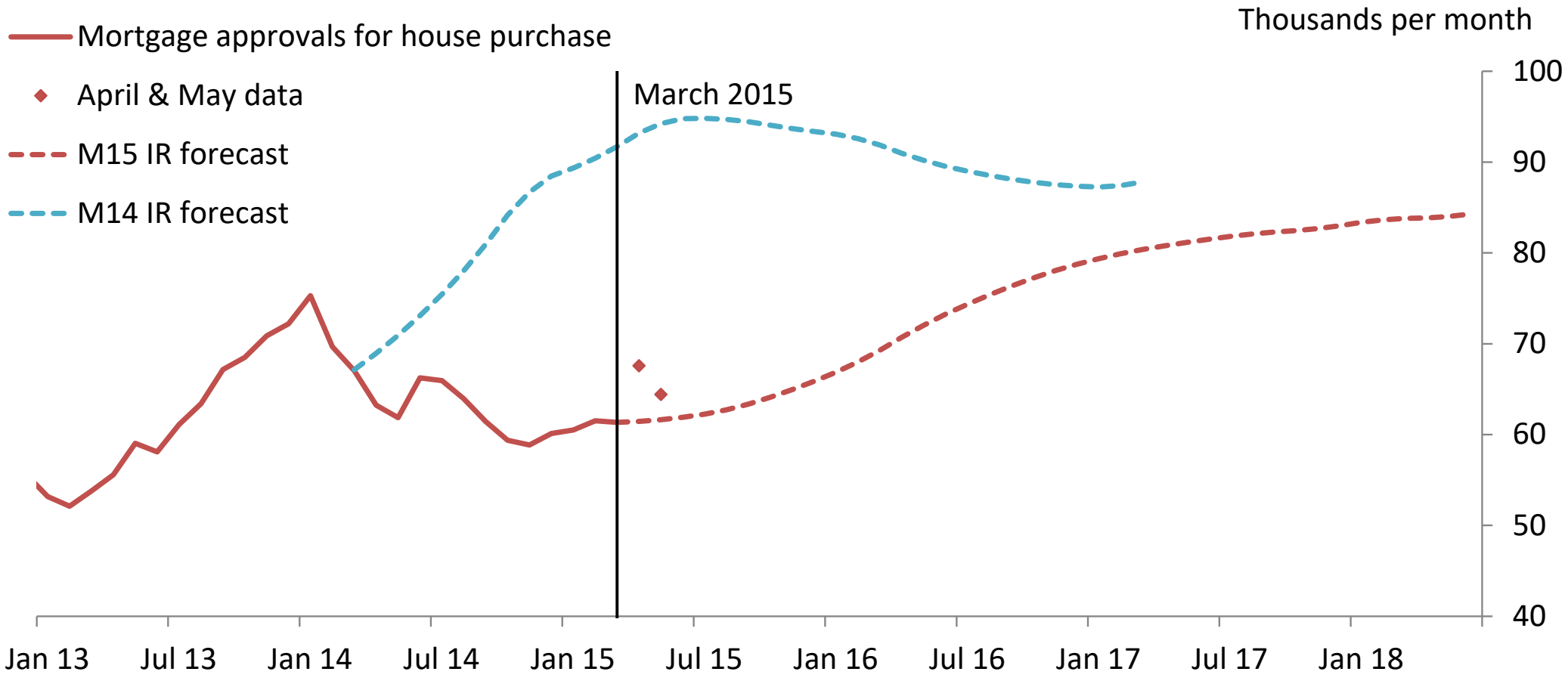
Mortgage approvals are above May 15 forecast…

Mortgage approvals for house purchase, SA



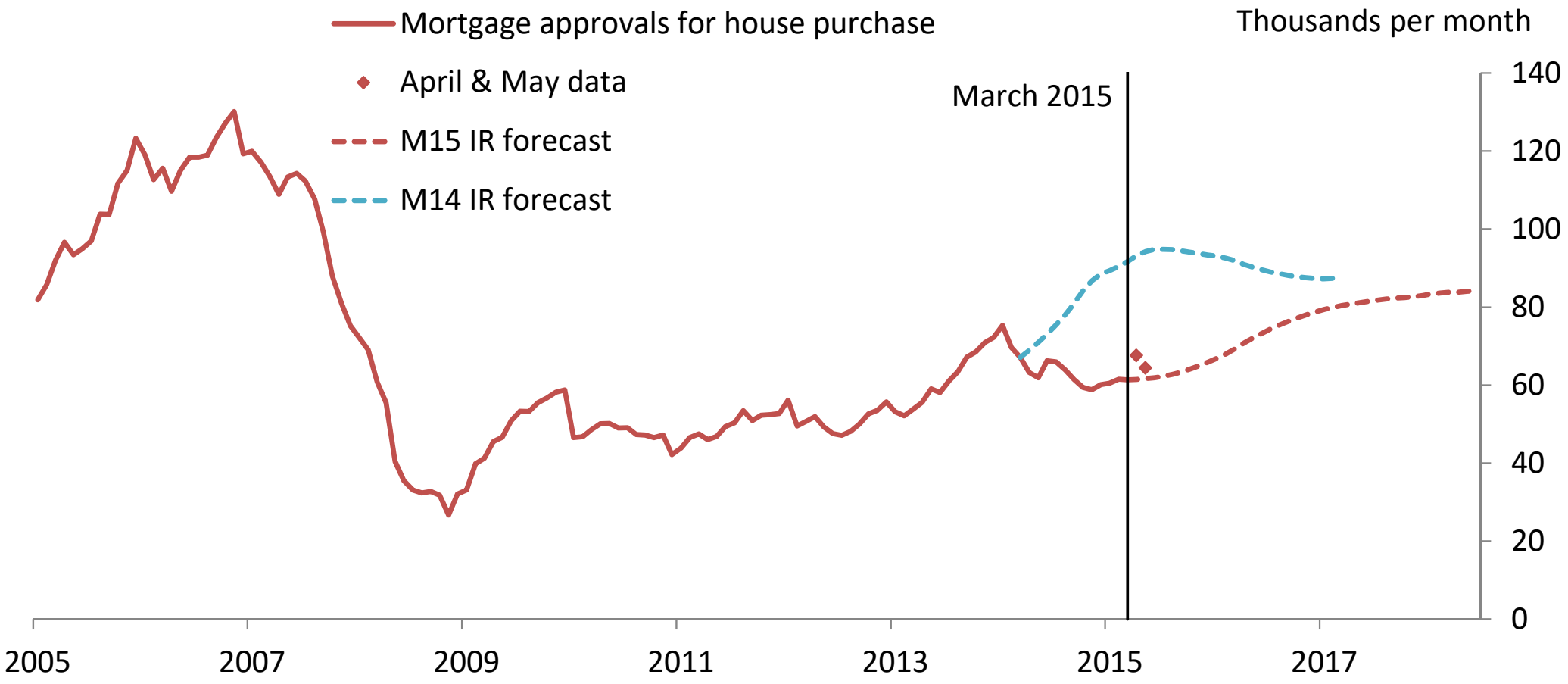
…but remain far below May 14 projection

Mortgage approvals for house purchase, SA



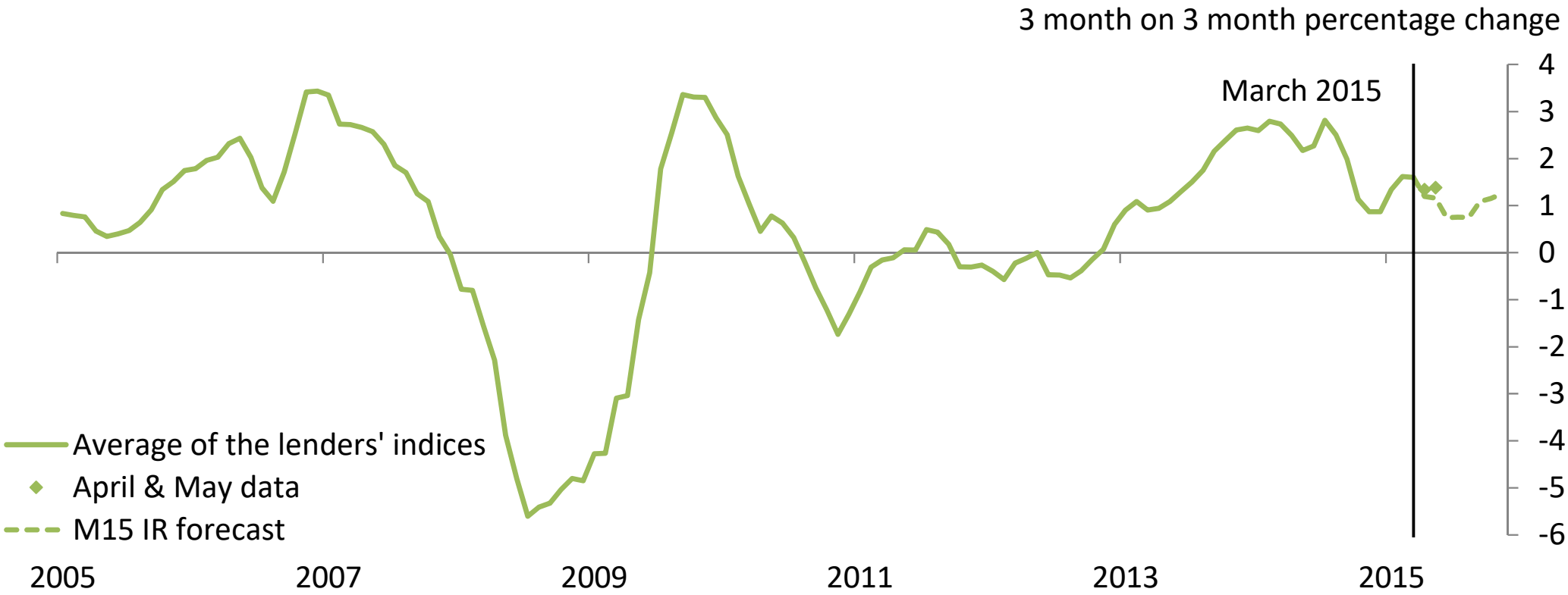
Latest moves not large relative to past experience

Mortgage approvals for house purchase, SA



Prices data also a touch stronger than expected…

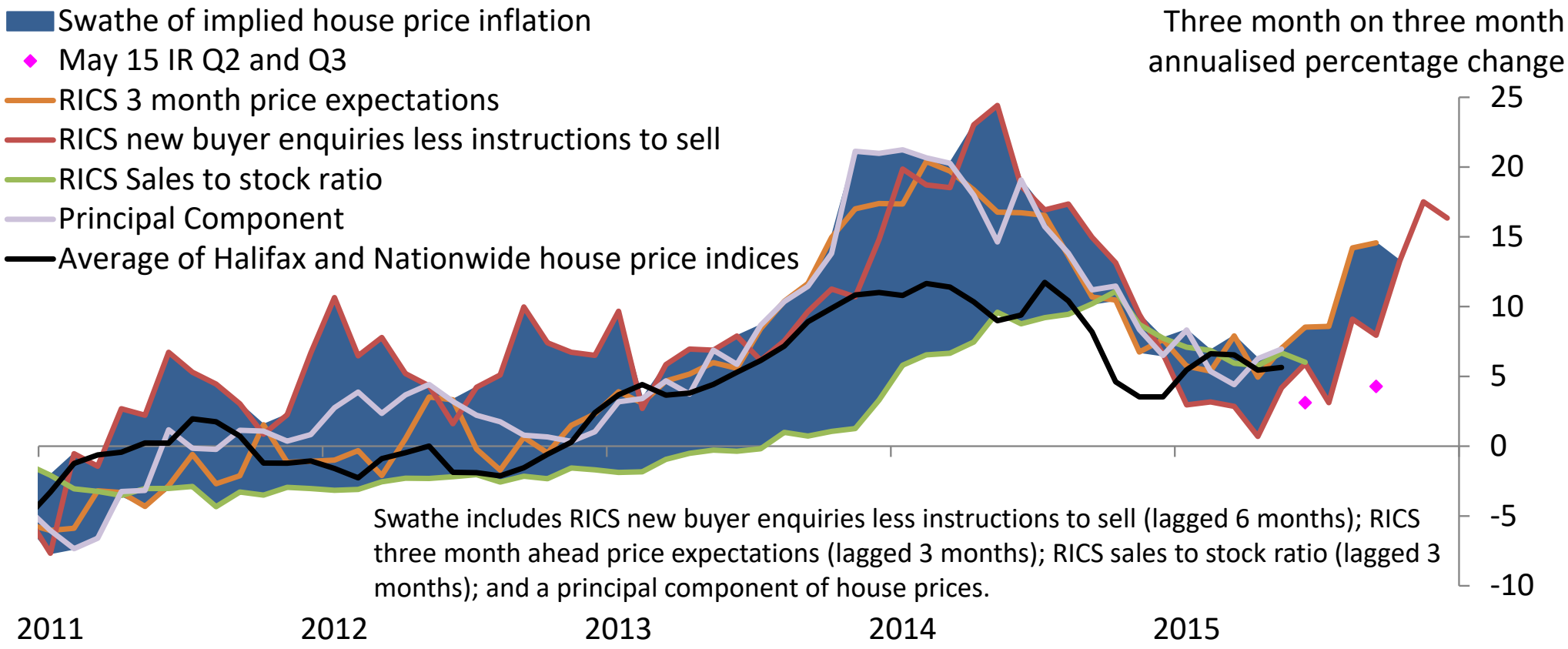
Average of lenders' house price indices



- Monthly rises in the average of the lenders' indices were 1.3% in April and 0.1% in May. Nationwide index fell by 0.2% in June

...and indicators suggest upside risk to near-term forecast

Swathe of leading indicators of house price inflation



Swathe includes RICS new buyer enquiries less instructions to sell (lagged 6 months); RICS three month ahead price expectations (lagged 3 months); RICS sales to stock ratio (lagged 3 months); and a principal component of house prices.

June data are provisional and confidential until Thursday 9 July

What lies behind this pickup in the housing market?

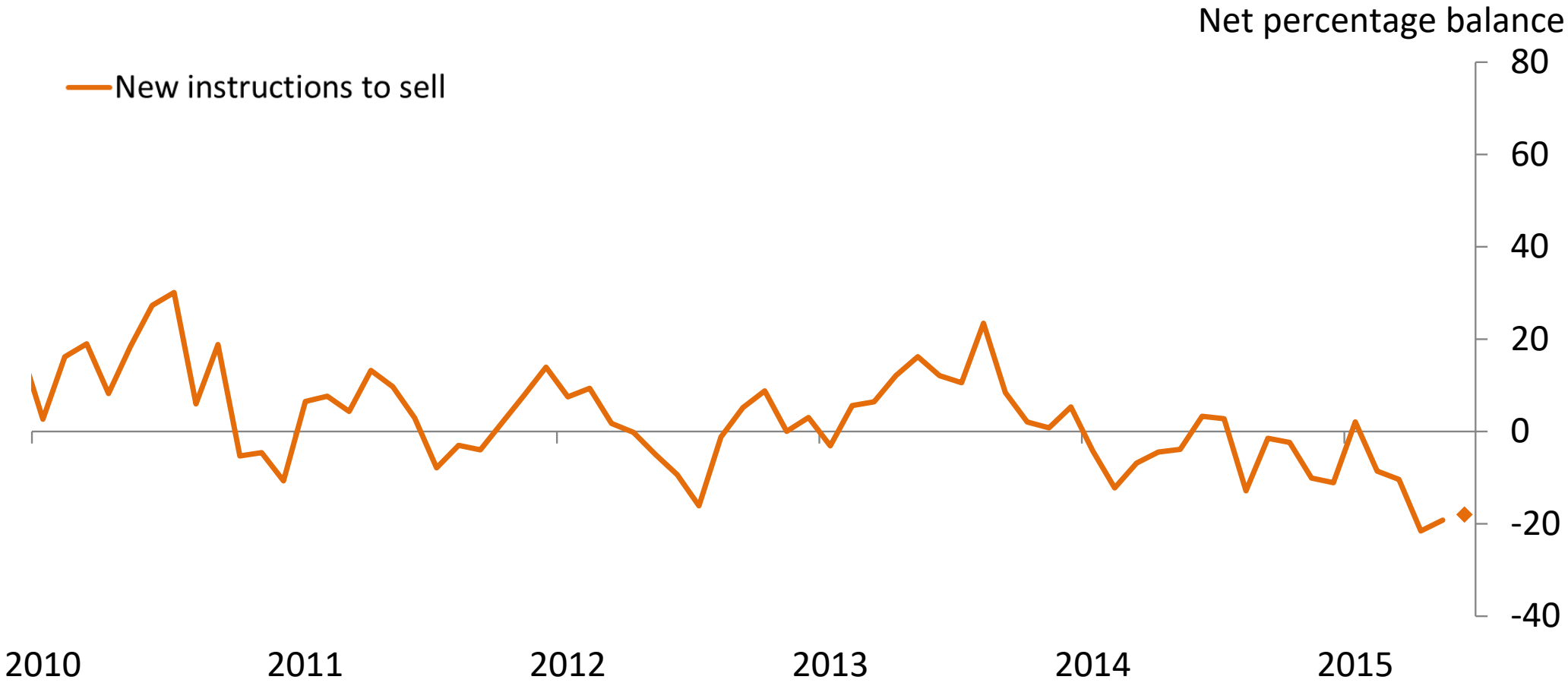
What lies behind this pickup in the housing market?

- Conditions conducive to some pickup in activity and price growth

Secondary market supply remains relatively tight

RICS residential market survey

June data are provisional and confidential until Thursday 9 July



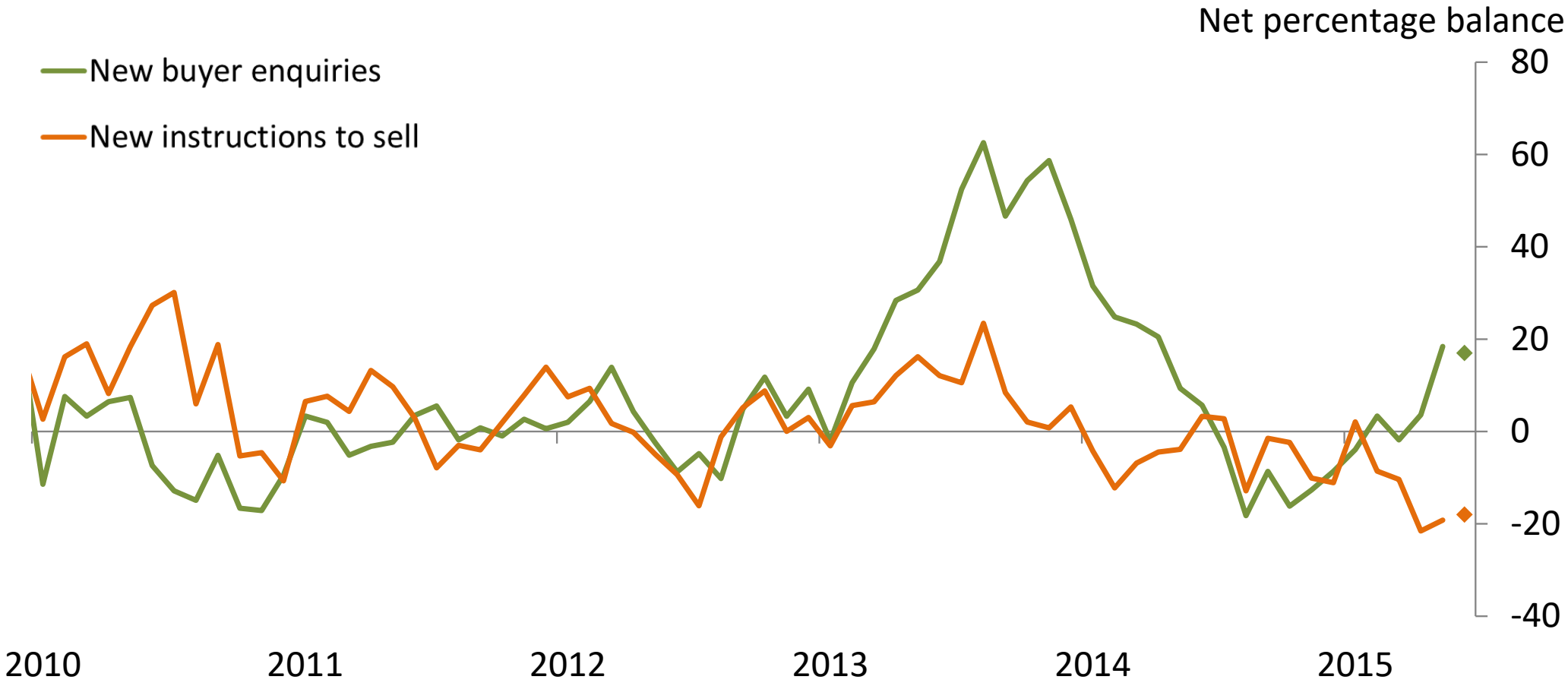
What lies behind this pickup in the housing market?

- Conditions conducive to some pickup in activity and price growth
- No ‘silver bullet’ to explain exact timing of pickup, but can identify a recent increase in demand

New buyer enquiries have picked up relative to instructions to sell

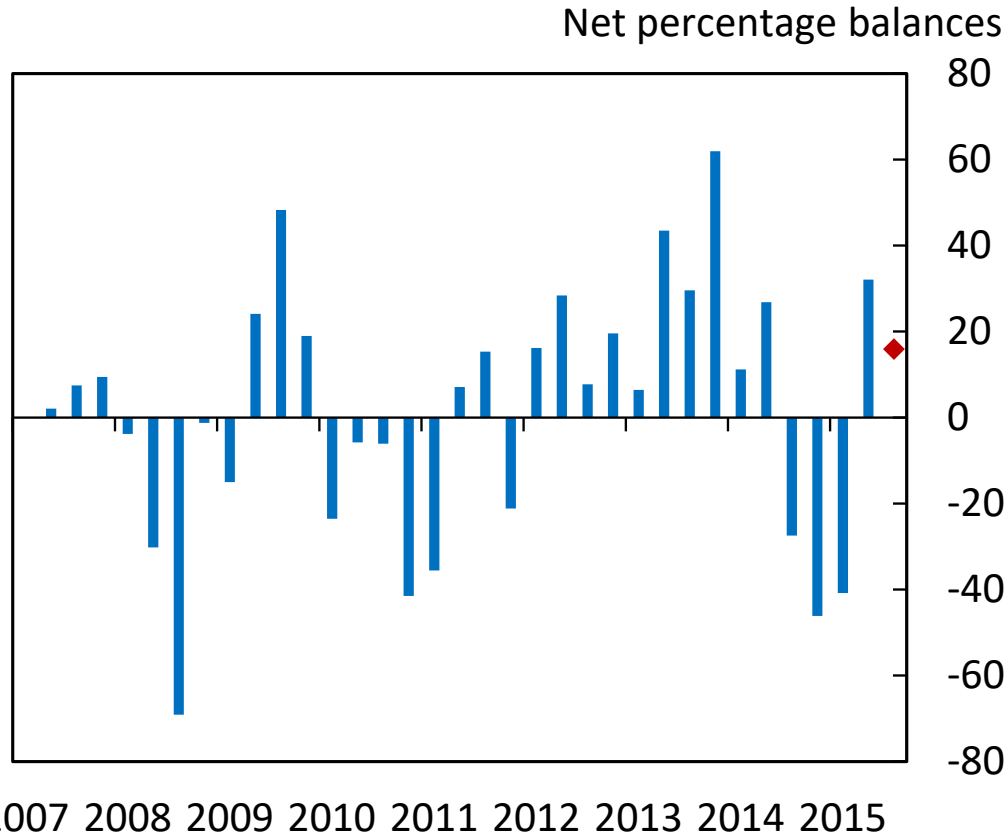
RICS residential market survey

June data are provisional and confidential until Thursday 9 July



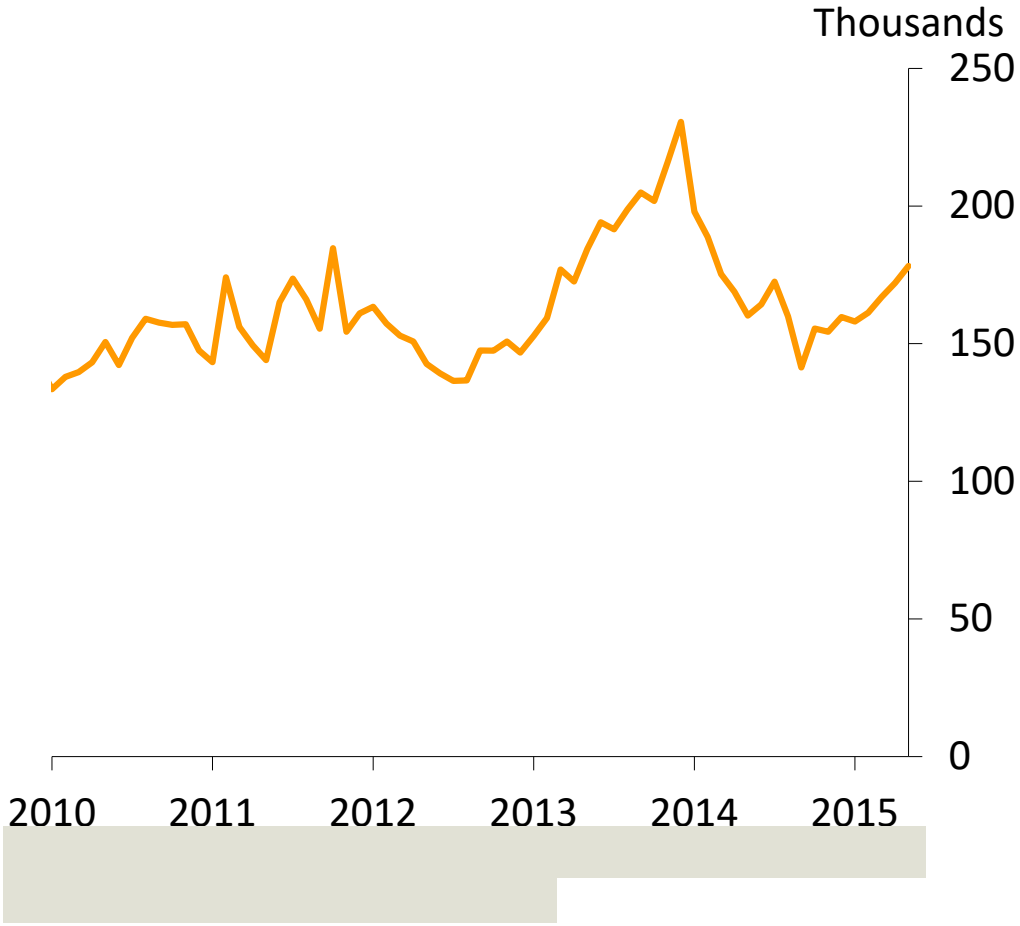
Other indicators also suggest that demand has picked up

CCS balance: demand for secured lending



Blue bars show the responses over the previous 3 months, red diamonds expectations for next 3 months.

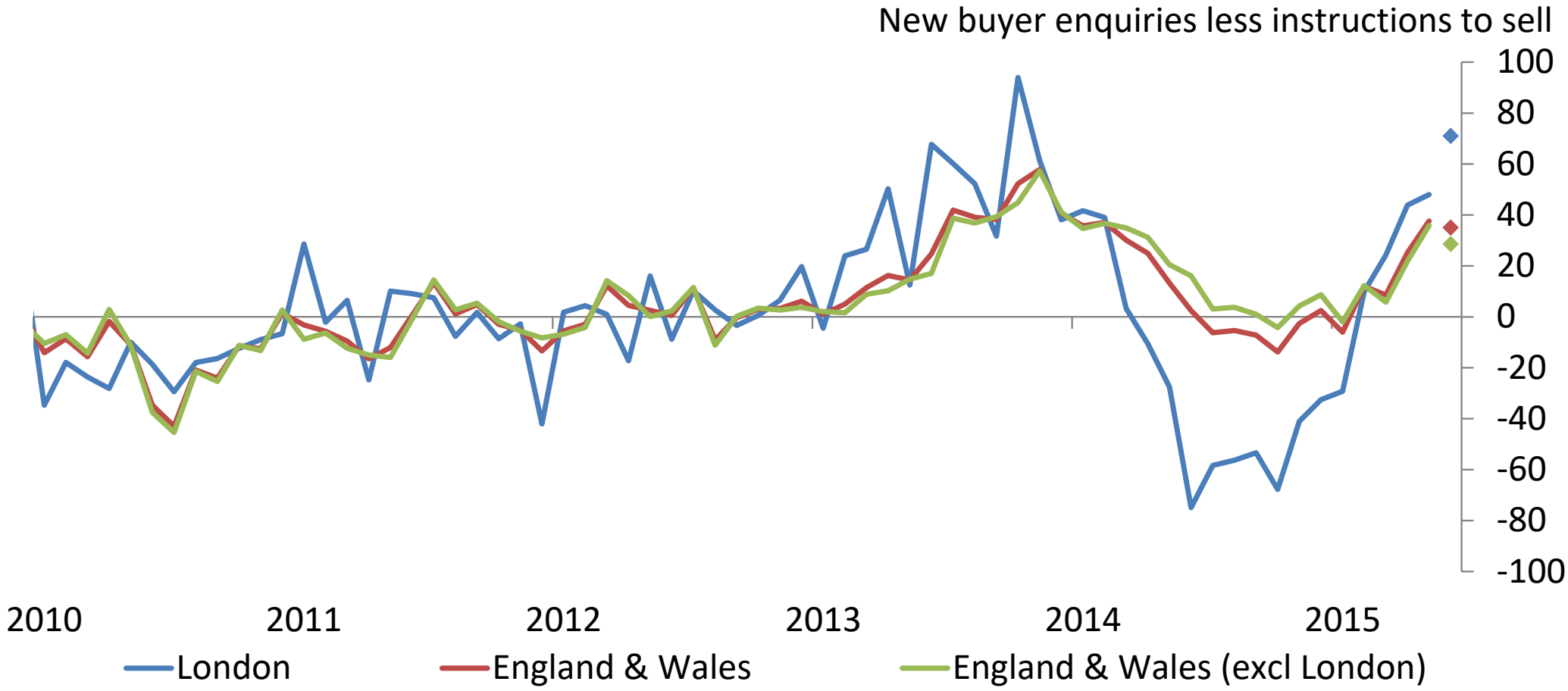
Mortgage applications



Pickup most marked in London, but evident elsewhere

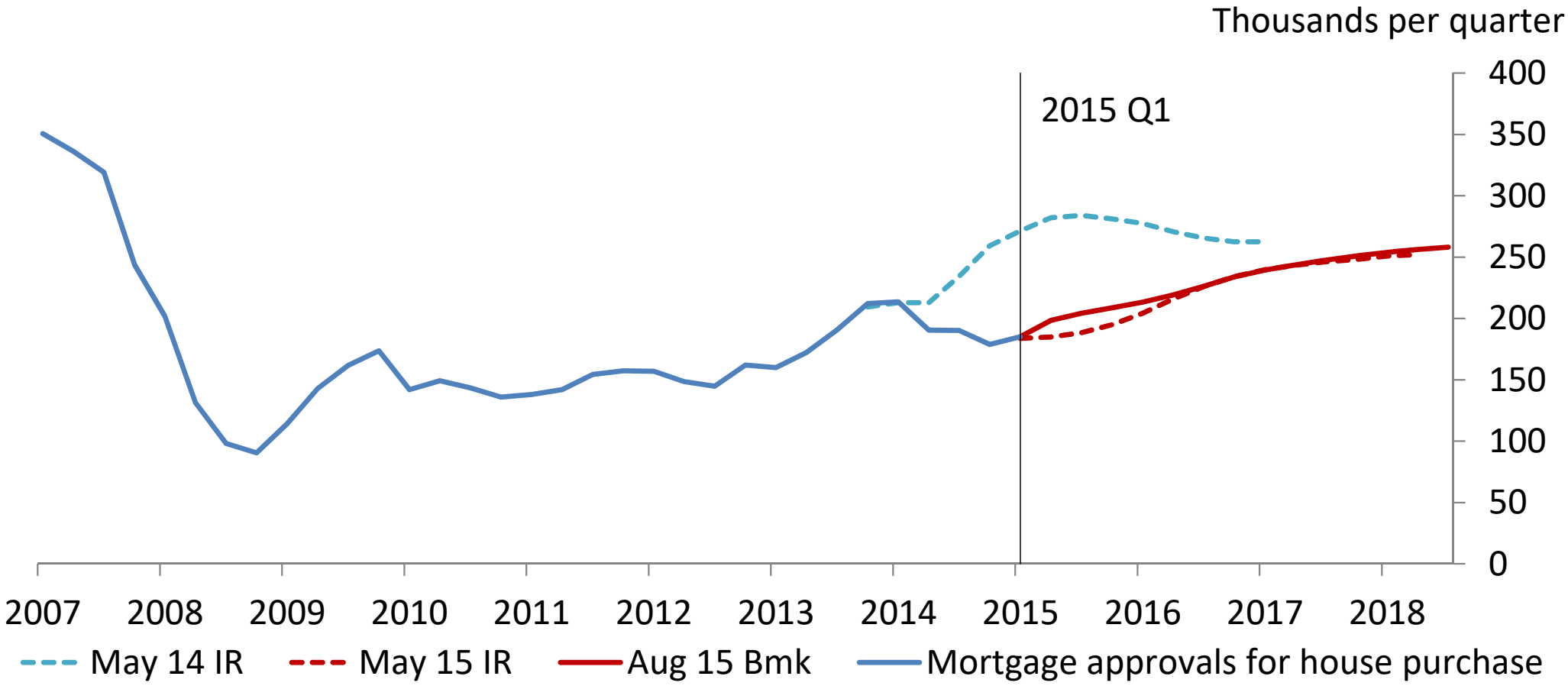
RICS residential market survey

June data are provisional and confidential until Thursday 9 July



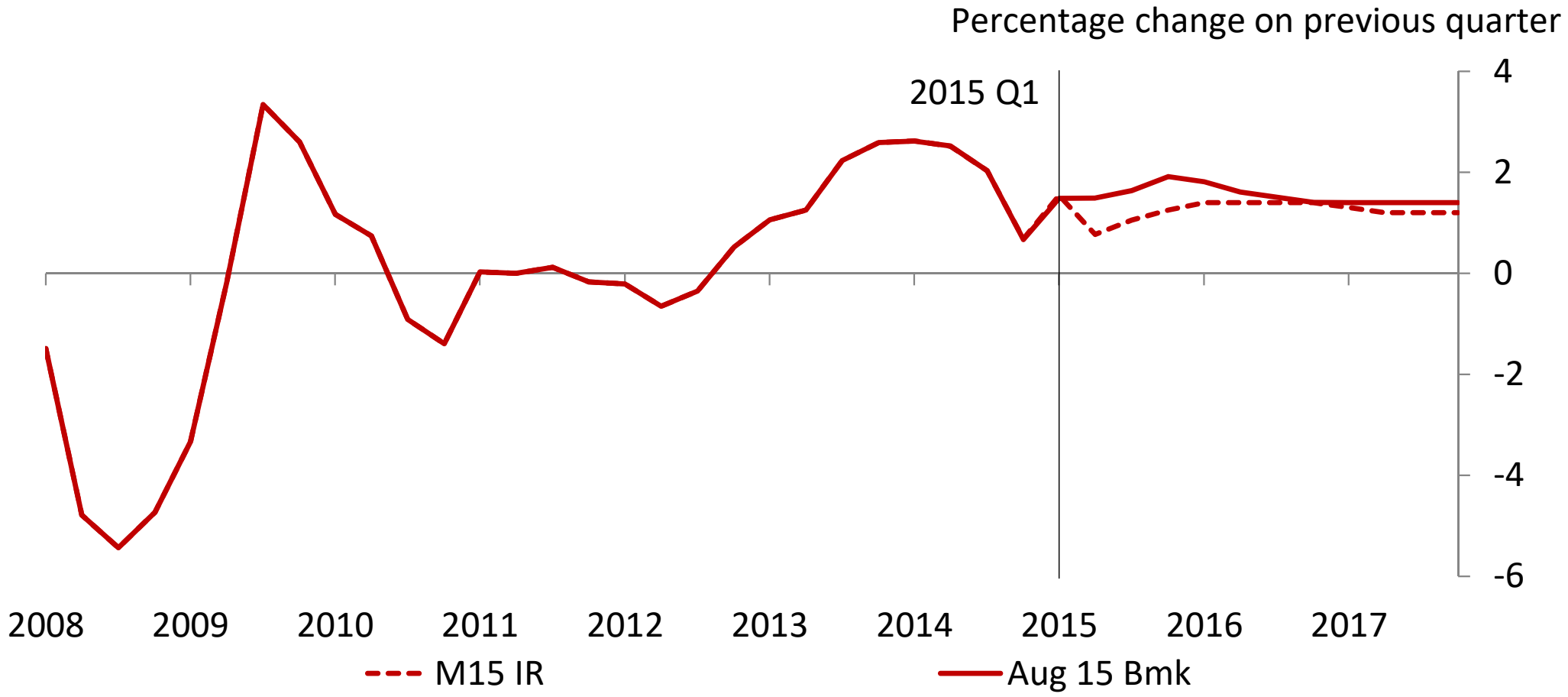
Near term approvals forecast slightly stronger

Mortgage approvals for house purchase, SA

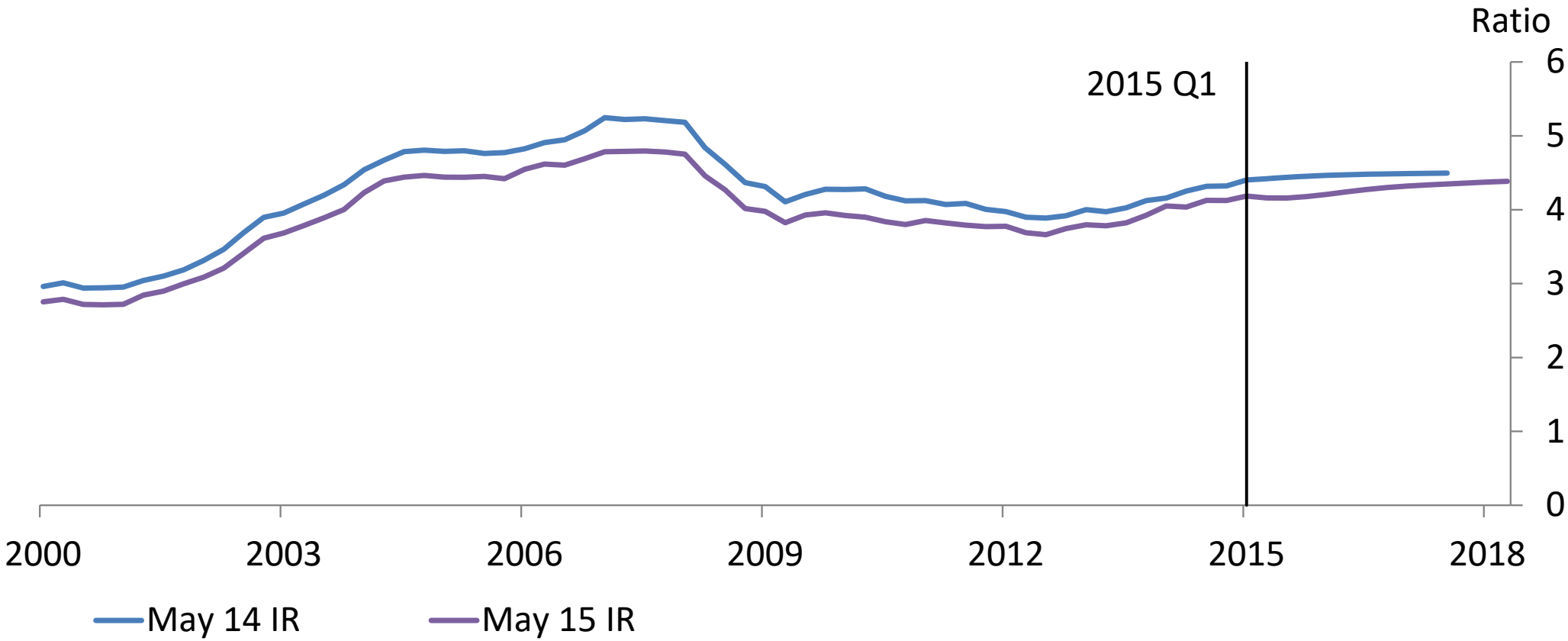


Prices forecast also revised up relative to May 15

Average of the lenders' house price indices

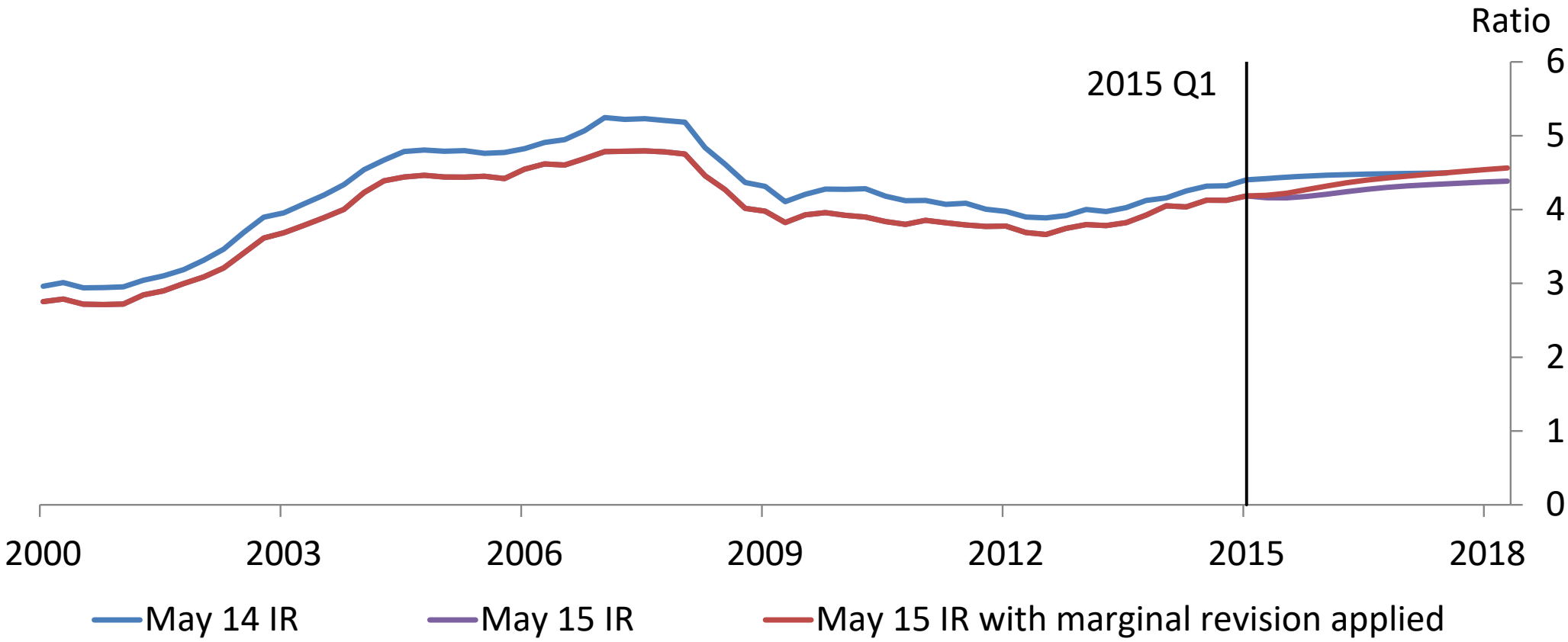


Ratio of house prices to disposable income



- Based on the average of the lenders' house price forecast.

Ratio of house prices to disposable income



- Based on the average of the lenders' house price forecast.

What lies behind this pickup in the housing market?

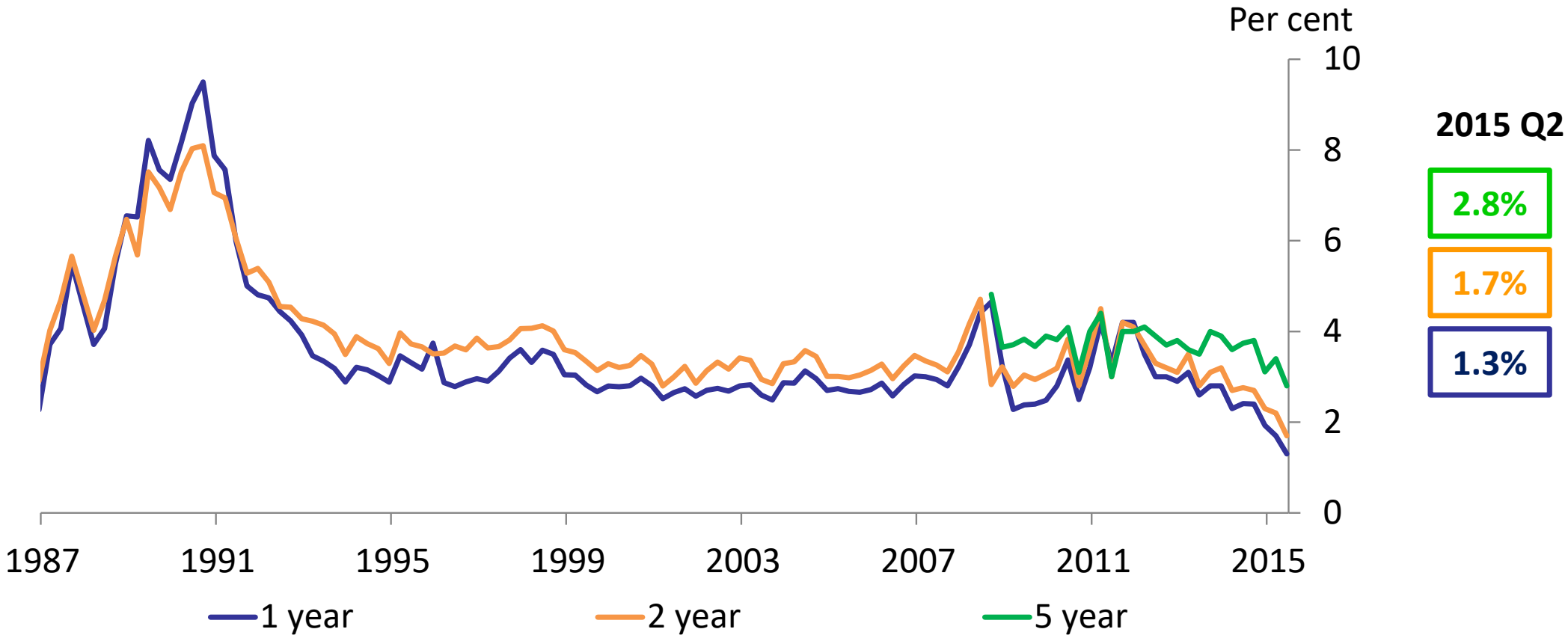
- Conditions conducive to some pickup in activity and price growth
- No ‘silver bullet’ to explain exact timing of pickup, but can identify a recent increase in demand
- Have revised up near-term forecasts for mortgage approvals and house prices, but not yet taken a strong steer further ahead

Plan for today

- Quarterly update on credit conditions
- Recent developments in the UK housing market
- **Inflation expectations**

Barclays Basix expectations fell to record lows in 2015 Q2

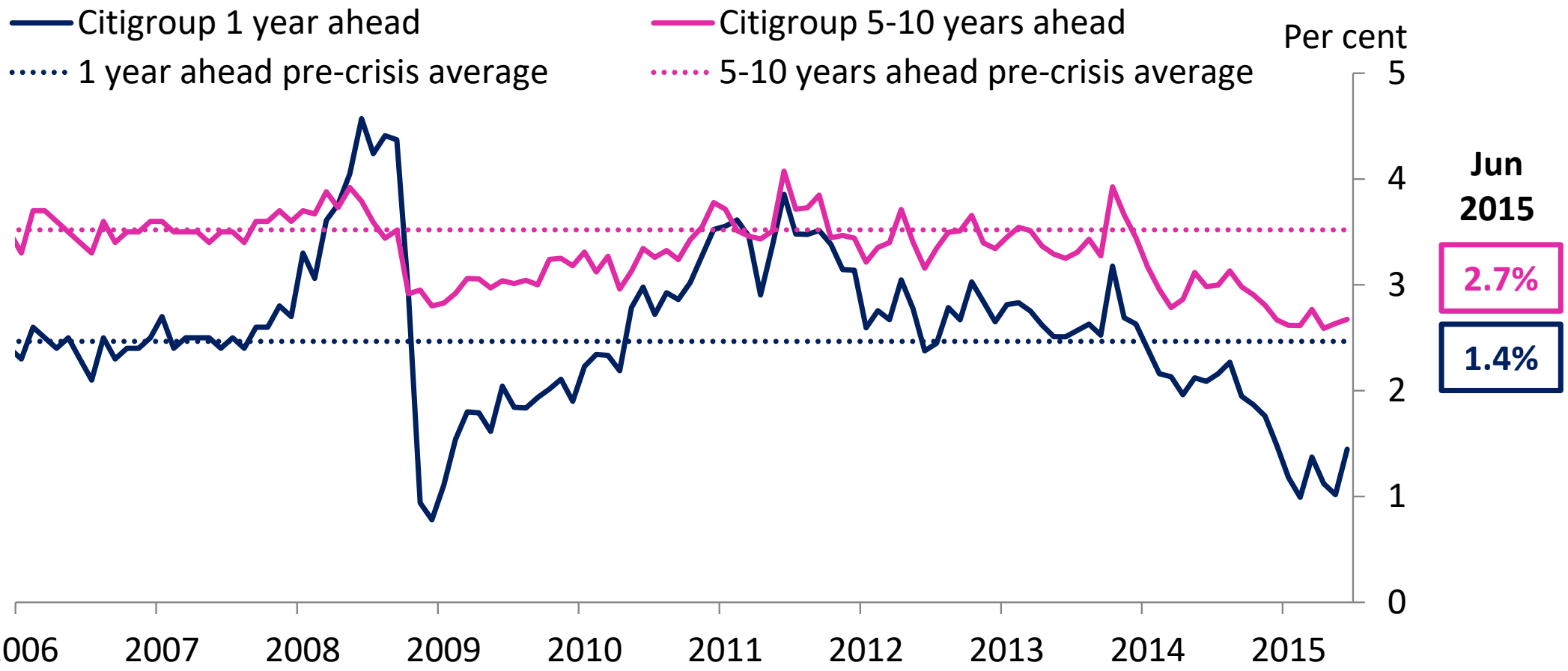
Barclays Basix survey of household inflation expectations*



* Survey question: *"What do you expect the rate of inflation to be over the next twelve months and over the next five years?*

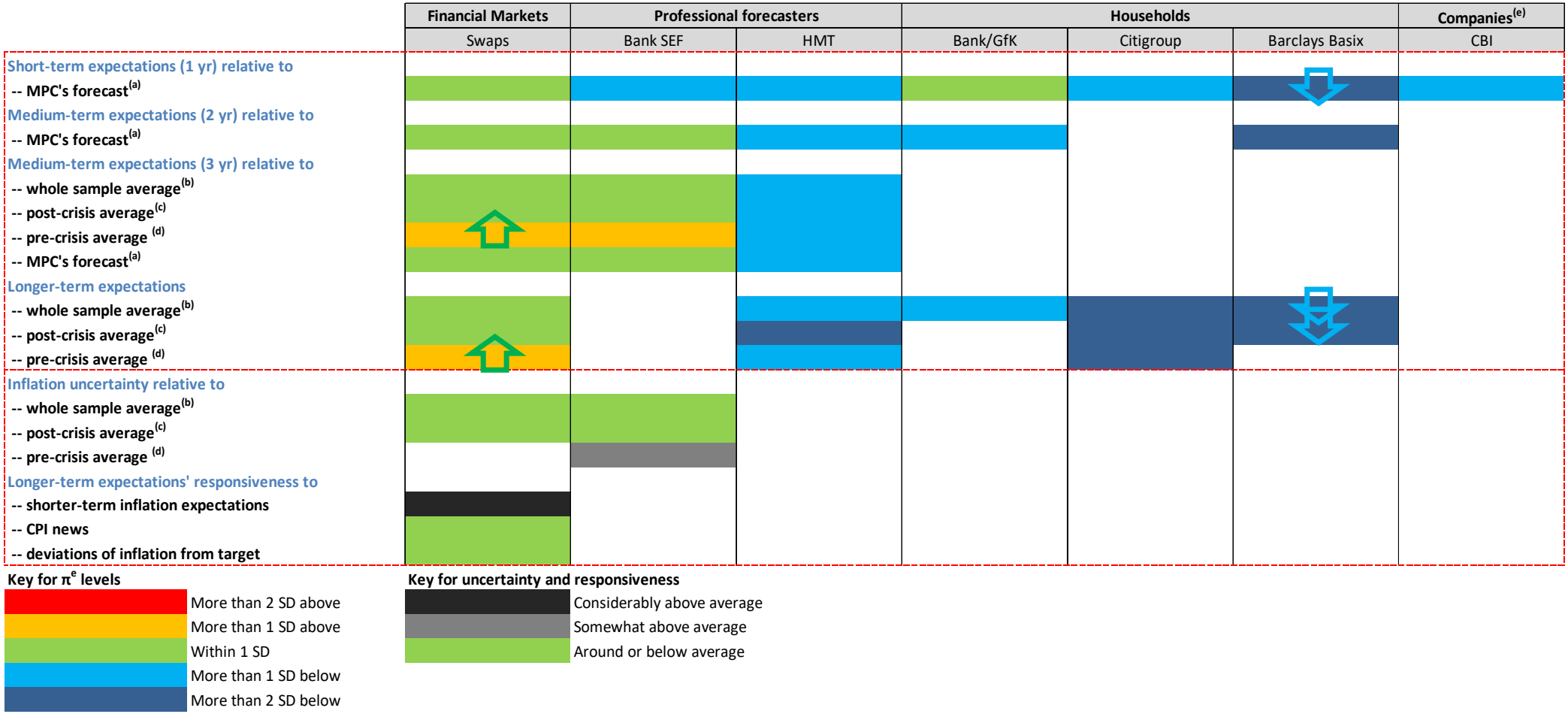
Citigroup inflation expectations ticked up

Citigroup survey of household inflation expectations*



* Survey question: *"How do you expect consumer prices of goods and services will develop over the next one and five to ten years respectively?"*

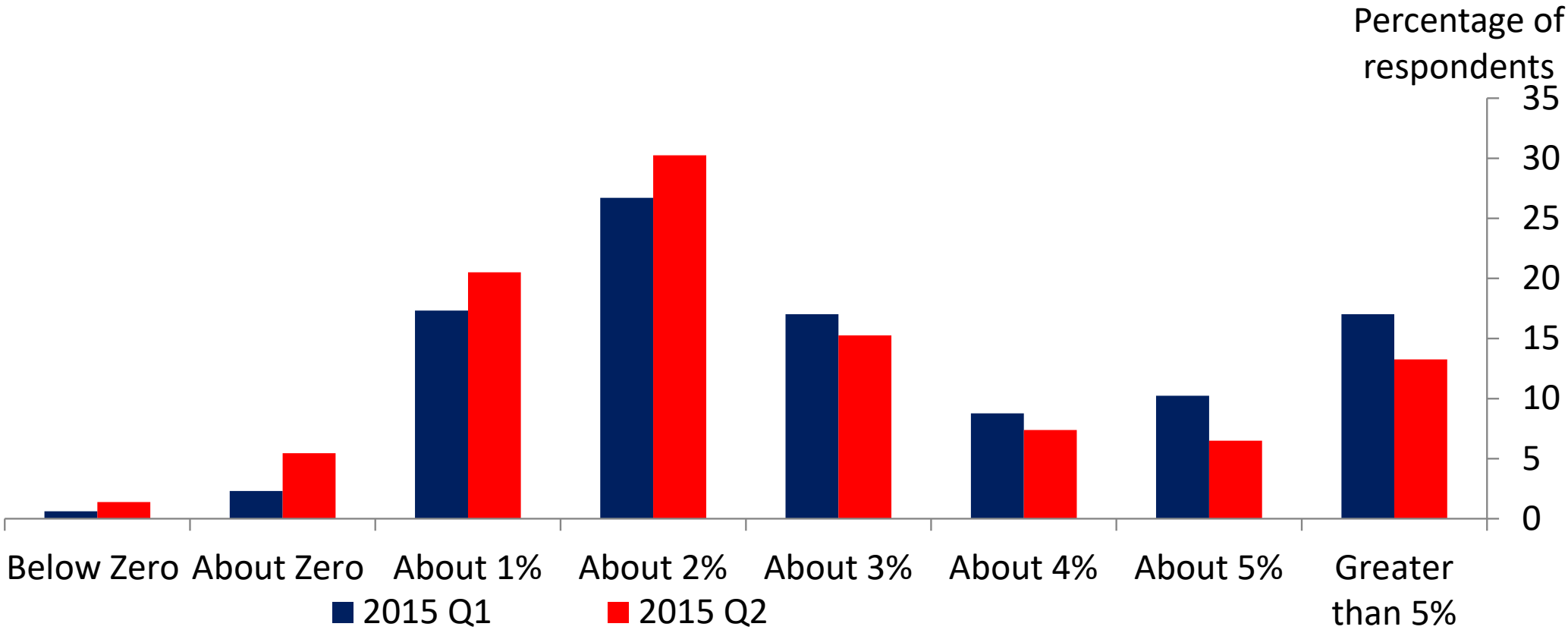
Latest heatmap



See *Quarterly Bulletin 2015 Q2* article "Do inflation expectations currently pose a risk to inflation?"

Distribution of households' inflation expectations

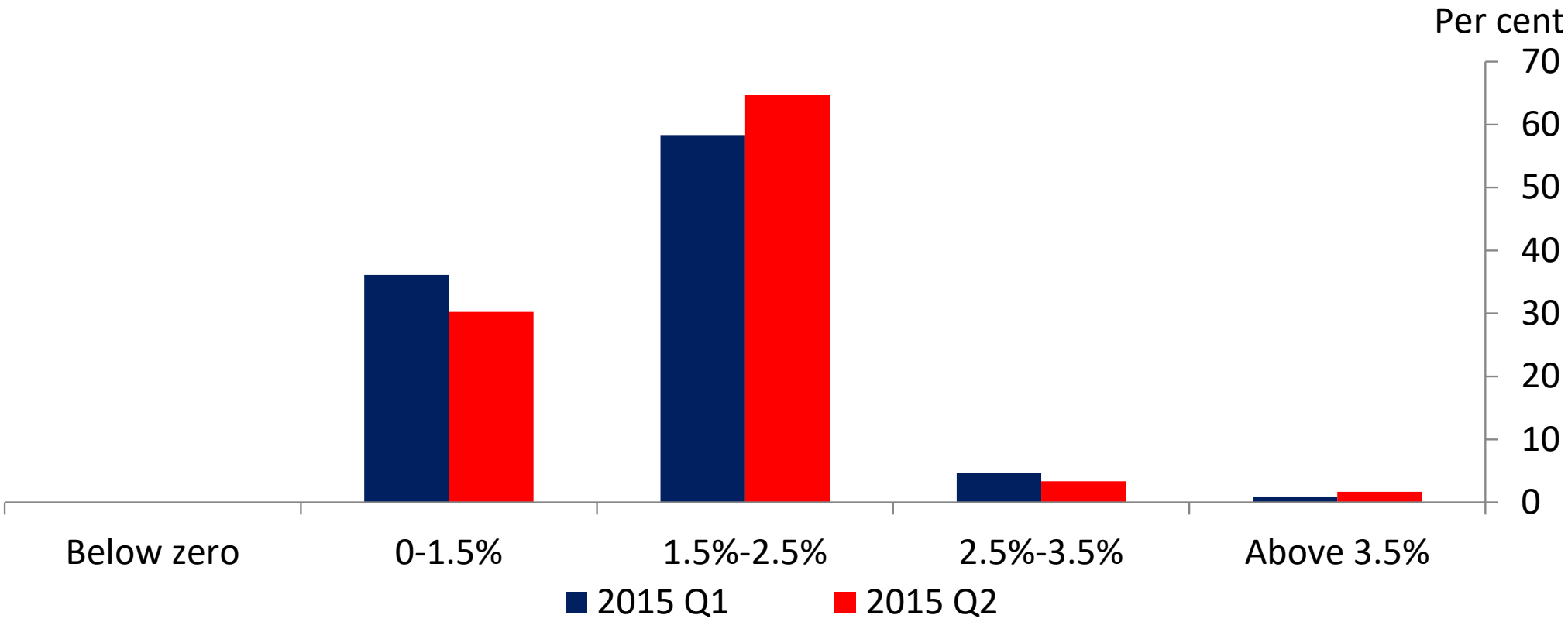
Barclays Basix survey - distribution of 2 year ahead expectations*



* Survey question: *"Can you tell me what you expect the rate of inflation to be over the next twelve months/ the following 12 months/in five years' time?"*

Distribution of CFOs' inflation expectations

Deloitte CFO survey - distribution of 2 year ahead CPI expectations*

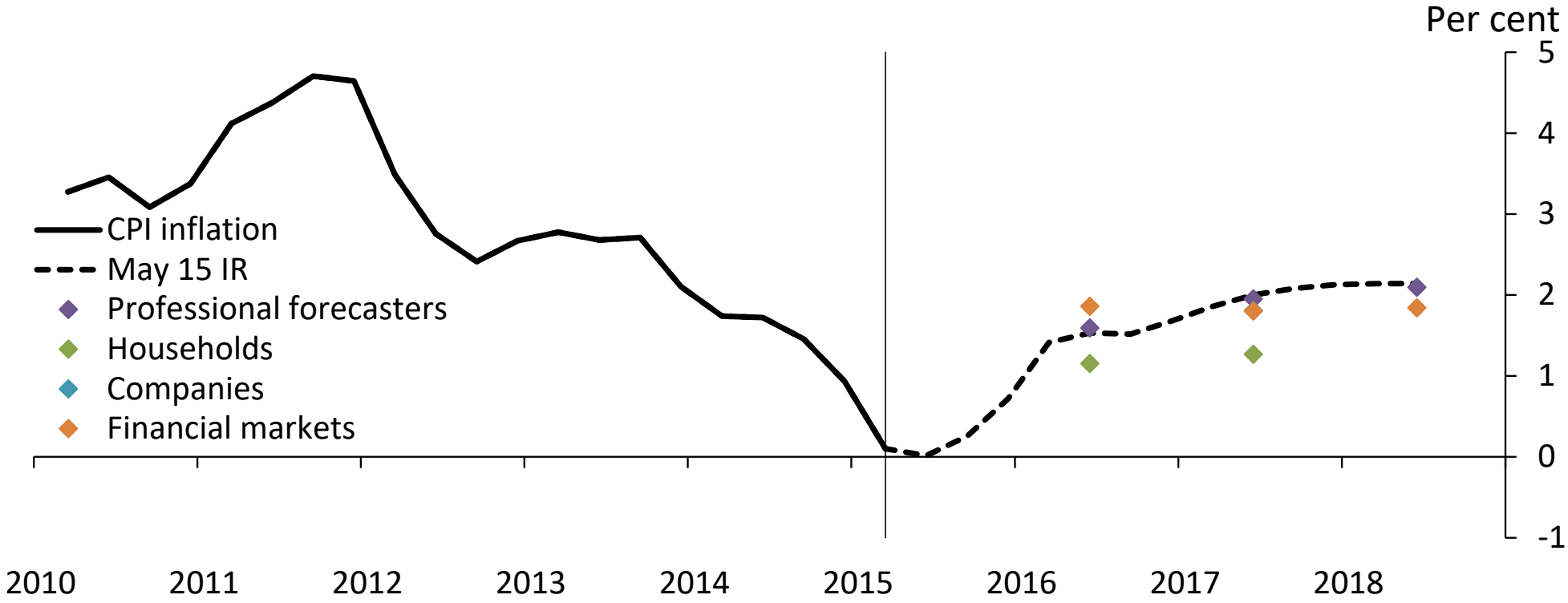


* Survey question: *"The UK CPI inflation rate stood at -0.1% in April. Where do you think CPI inflation will be in two years' time?"*

2015 Q2 data are provisional and confidential until Monday 6 July

Term structures of inflation expectations

Implied expectations of CPI inflation



*Households = Bank/GfK; Professionals = SEF; Companies = Deloitte CFO; Financial markets = Inflation swaps. Forecasts are 2015 Q2. 1pp is subtracted from households' expectations (average wedge between perceived inflation and CPI). The OBR's March 2015 forecast of the RPI-CPI wedge is subtracted from inflation swaps. If market expectations of the path of Bank Rate have changed since March 2015, the wedge and implied CPI expectations could be different.

Deloitte CFO data are provisional and confidential until Monday 6 July

Summary

- Credit conditions have eased further, and should continue to support growth
- Housing market shows some signs of warming up, and we have nudged up our near-term forecasts
- Inflation expectations heatmap remains ‘cool’

3: Global Environment

Bank of England
International Directorate

Global Environment
Pre-MPC July 2015

Outline

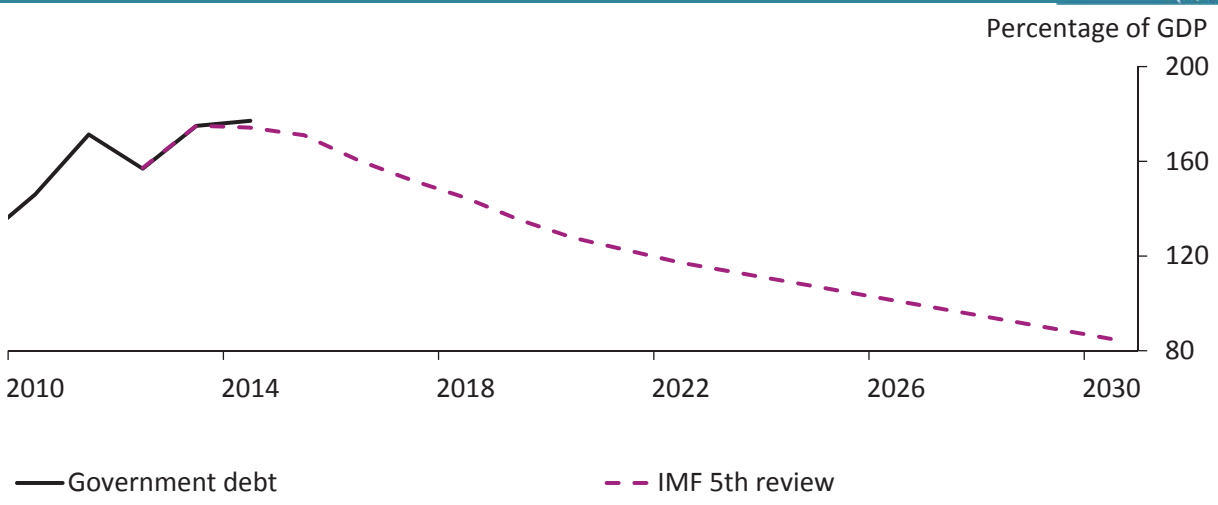
- Greece
- Signs of synchronised global weakness?
  - *Euro area*
  - *US*
  - *Asia*
  - *World trade*
- Commodities

Greece

Greece: next steps and trigger points

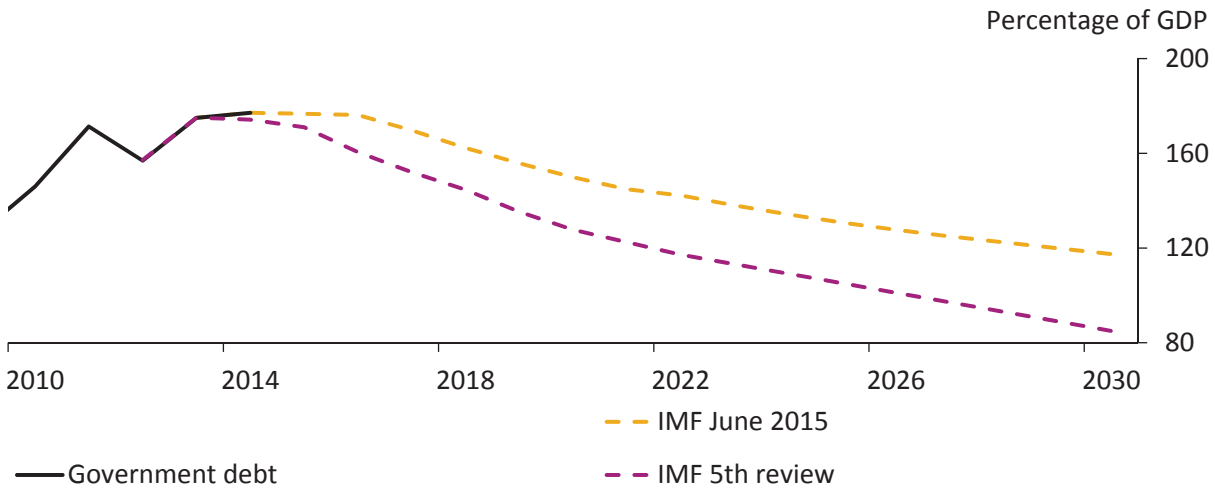
- Next key payment dates:
  - T-bills 10 July (€2bn)
  - ECB payment 20 July (€3.5bn)
- Banks running out of funding despite controls
- Following the referendum on 5 July:
  - Yes vote: but debt sustainability concerns remain
  - No vote: € exit?

Greece: debt sustainability



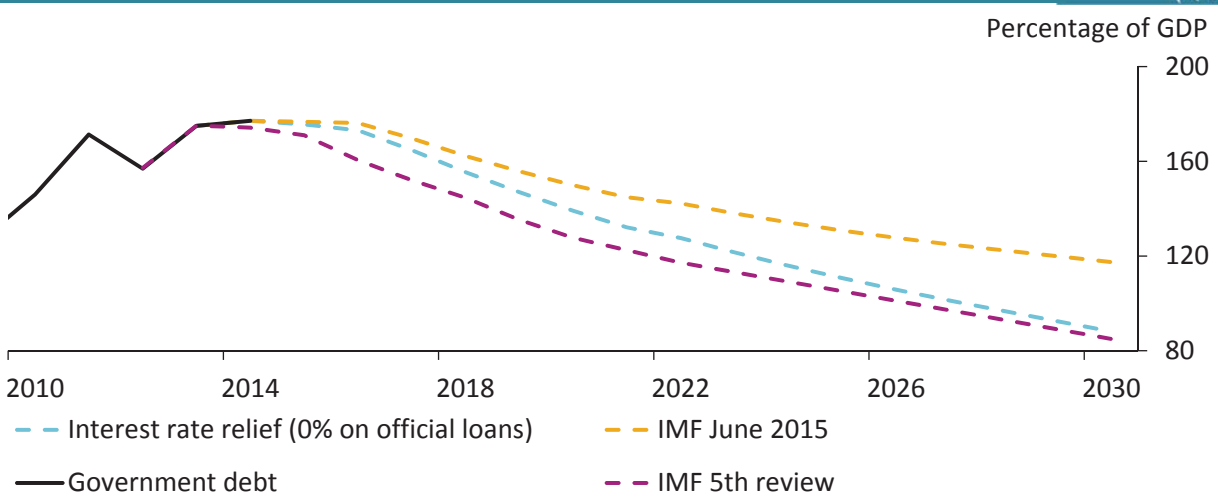
- IMF's 5th Review (June 2014): debt reaches 128% of GDP by 2020.

Greece: debt sustainability



- Updated benchmark scenario: debt only reaches 150% by 2020.

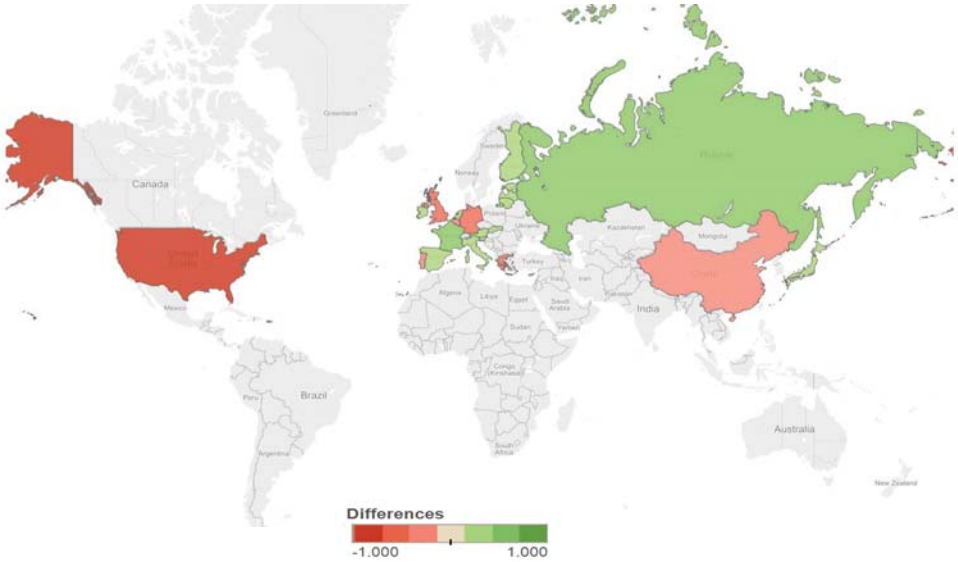
Greece: debt sustainability



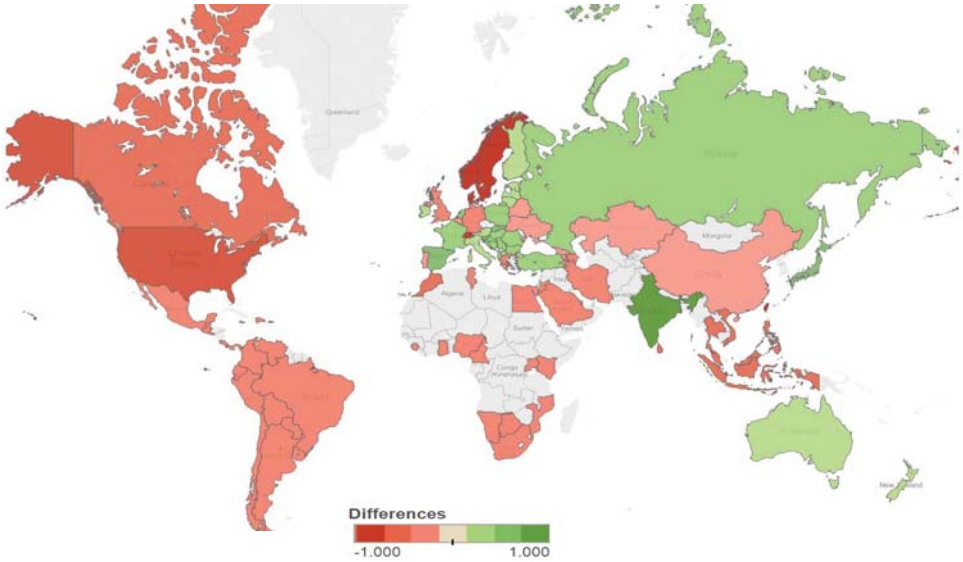
- Interest rate relief up to 2020 reduces ratio to 139%. See

World growth

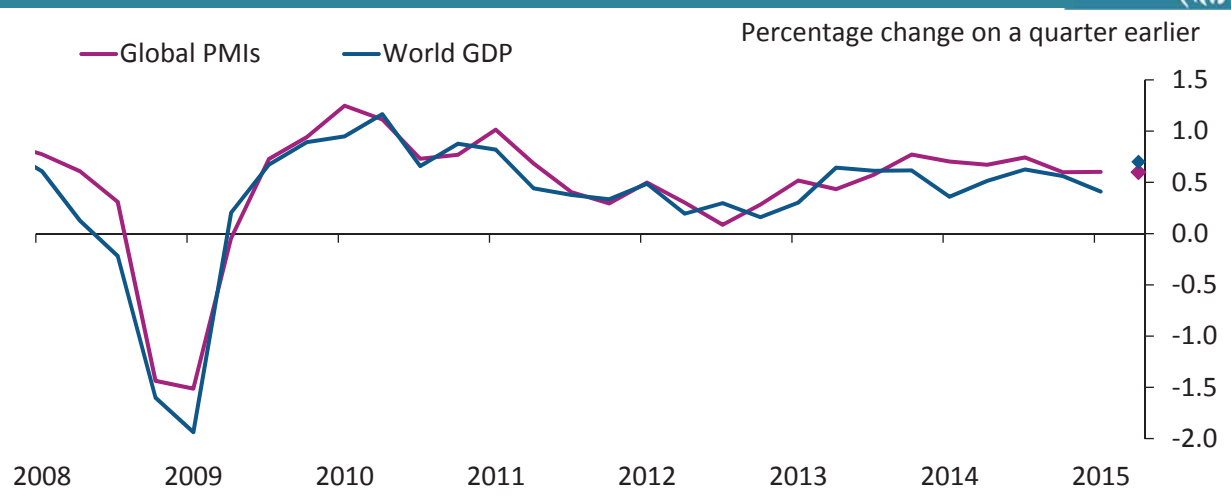
World GDP growth: Q1 errors



World GDP growth: Q1 errors



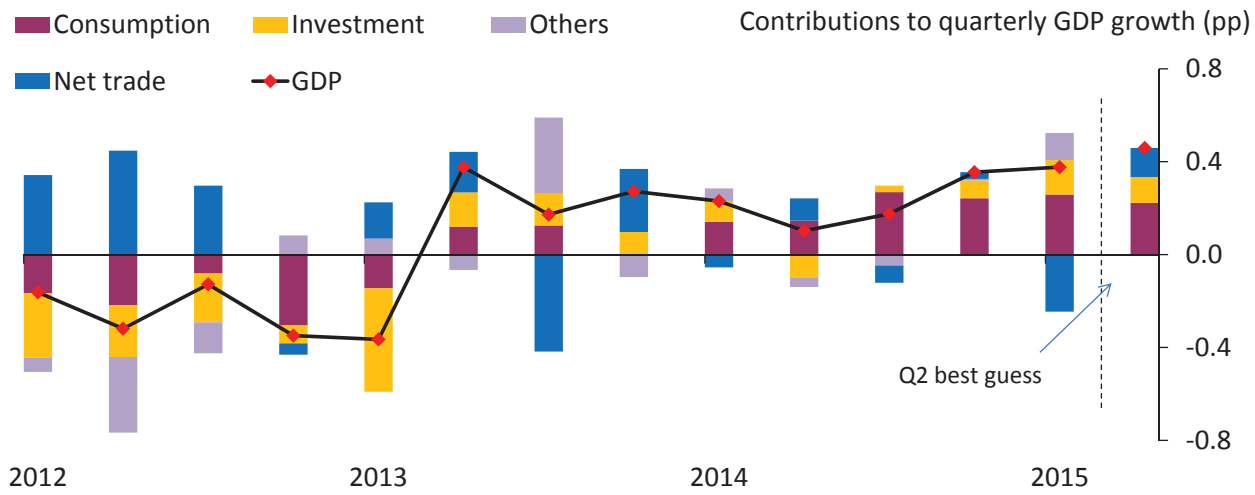
World GDP growth (UK-wtd) and PMIs



- World GDP growth fell slightly to 0.4% in Q1, but nowcast suggests modest pick-up in Q2.

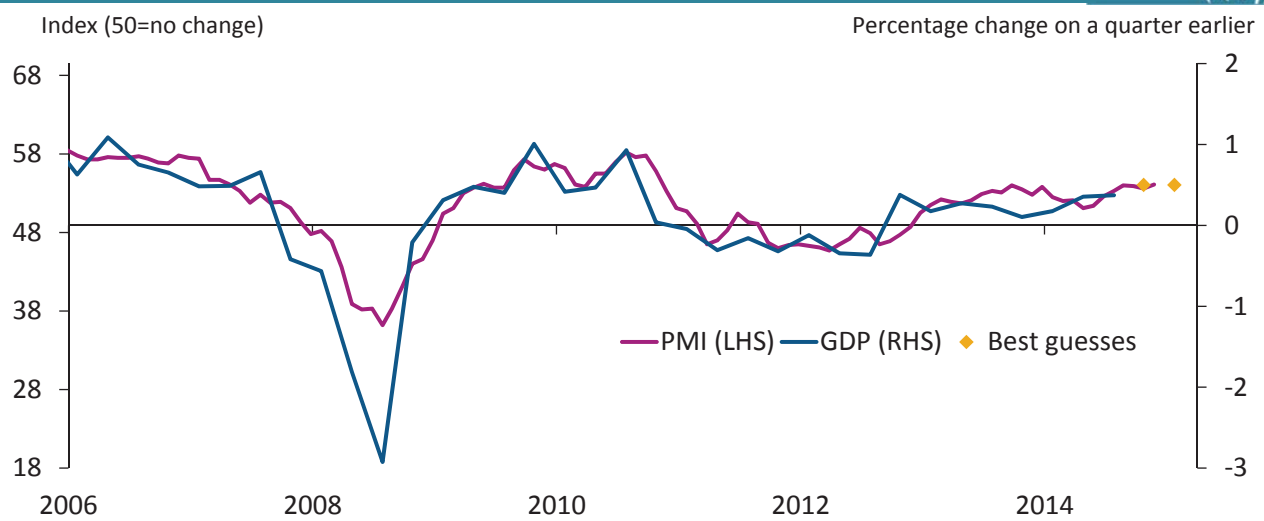
Euro area

Euro-area GDP: expenditure breakdown



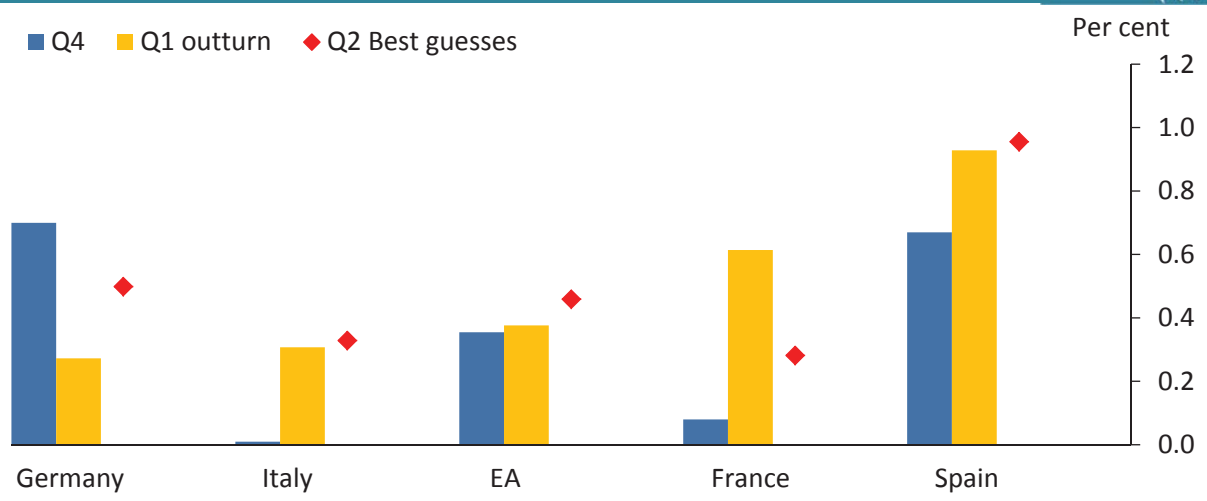
- Strong domestic demand in Q1, particularly consumption, though net trade was weak.

Euro area PMIs and GDP growth



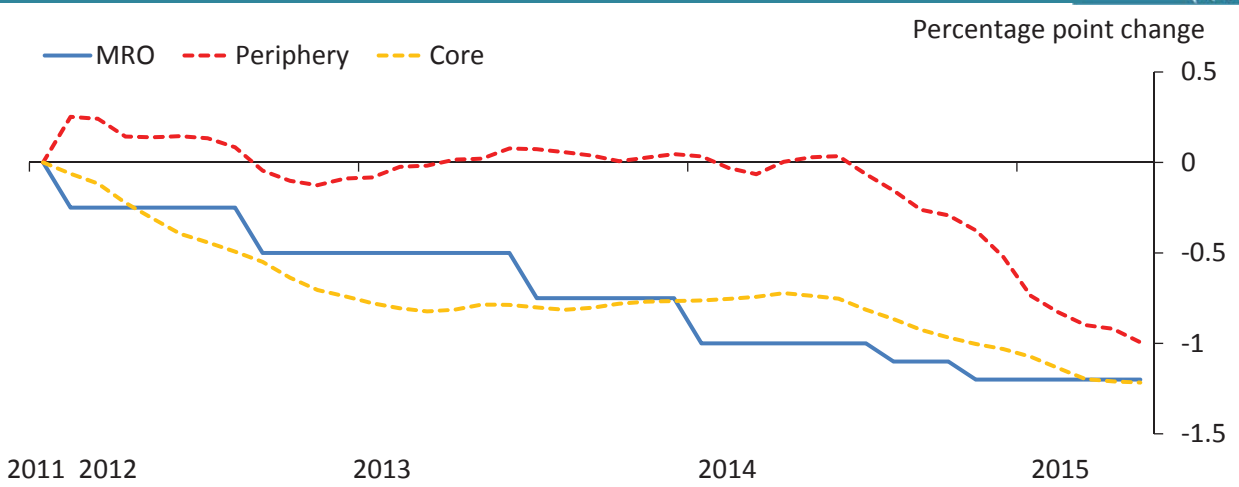
- PMIs point to GDP growth of 0.5% in Q2, unchanged from last month.

Euro-area GDP: split by country



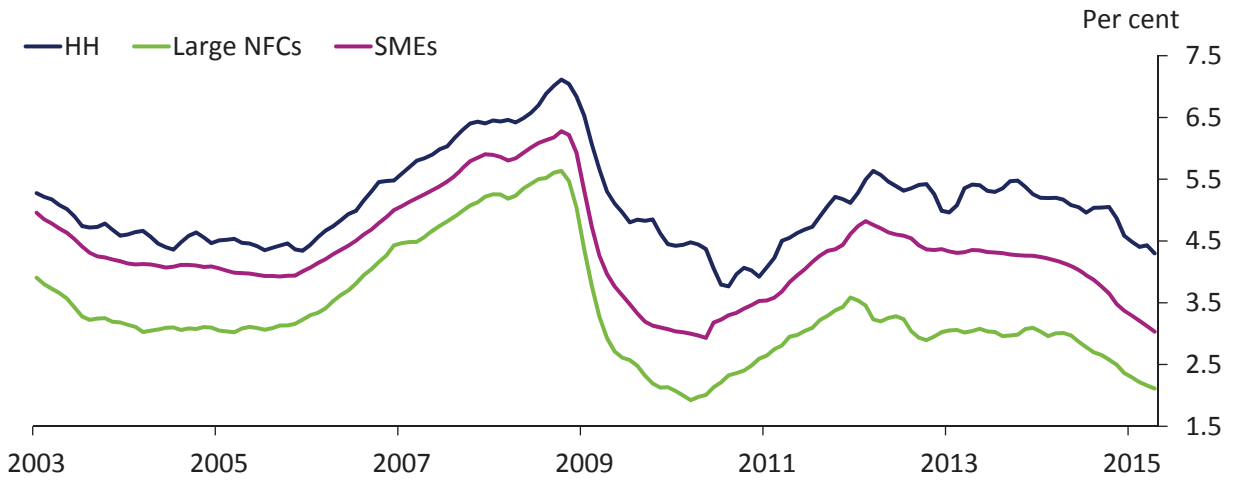
- We expect an (offsetting) unwind of erratics in France and Germany in Q2.

€A: Pass-through to bank lending rates



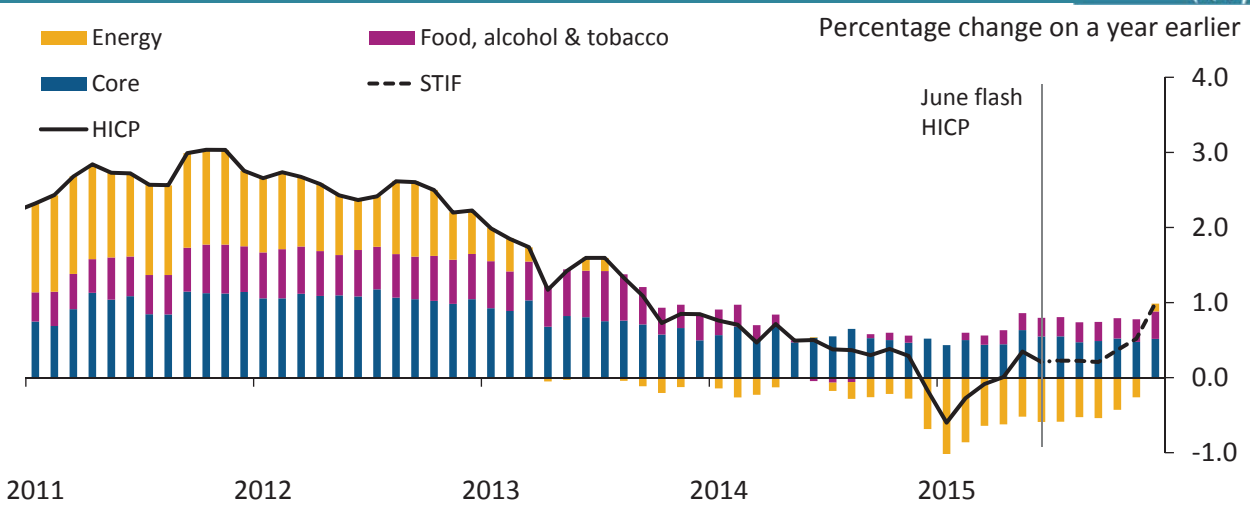
- Monetary policy pass-through in the periphery has improved noticeably since mid-2014.
- S

€A periphery bank lending rates by sector



- Improvements in bank lending rates visible across all sectors, particularly for SMEs.

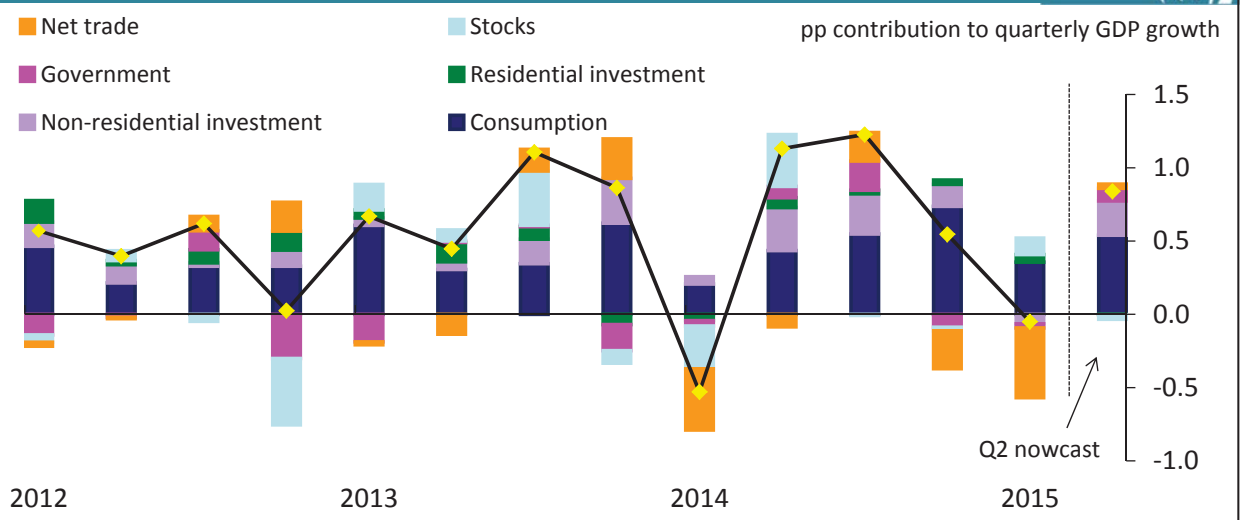
Euro-area HICP inflation



- Headline inflation for June came out in line with expectations at 0.2% (as did core).

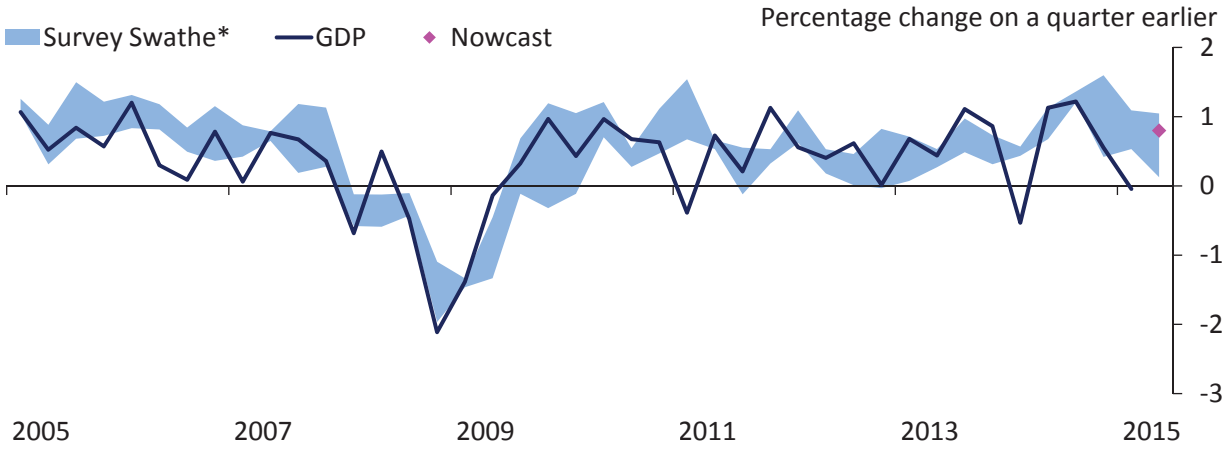
US

US GDP: expenditure split



- Q1 GDP growth revised up by 0.1pp to 0.0%. See note on

US GDP and survey swathe



*Federal Reserve surveys: New York Empire State Manufacturing, Philadelphia Fed Business Outlook survey, Weighted Richmond Fed Manufacturing & Services surveys.

- Q2 nowcast: 0.8%, though manufacturing-based surveys point to lower.

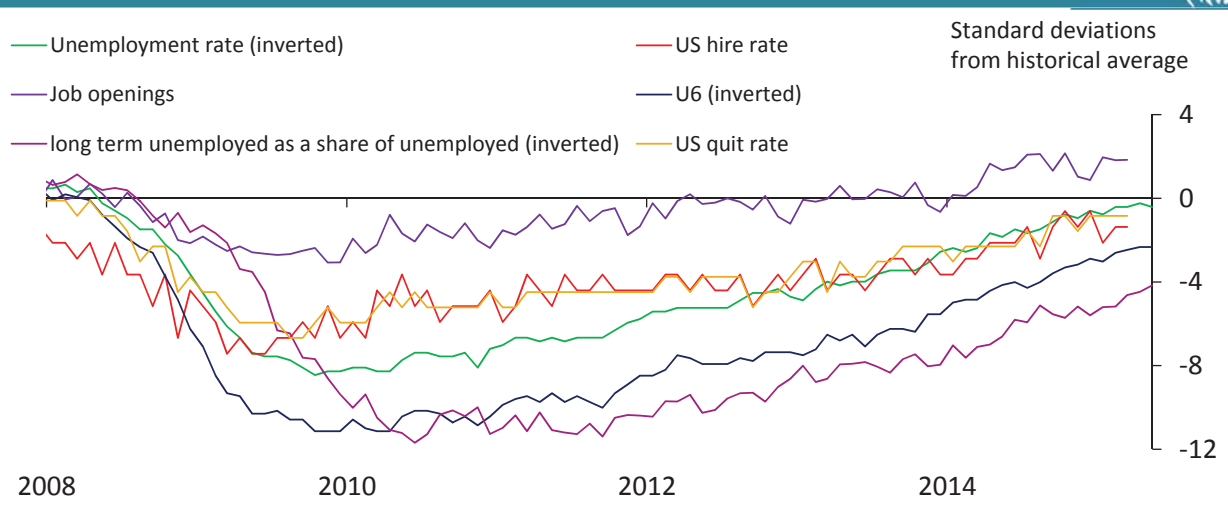
FOMC interest rate expectations 'dot plot'

- Median expectation still two interest rate increases this year…but mean has fallen.

FOMC Statement

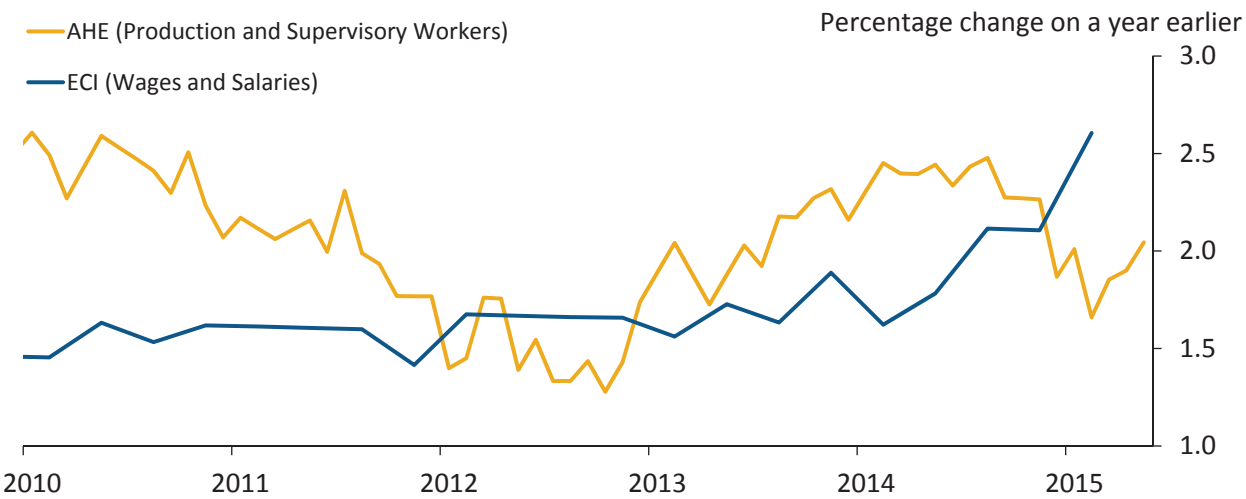
"The Committee anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term."

US labour market: broader measures of slack



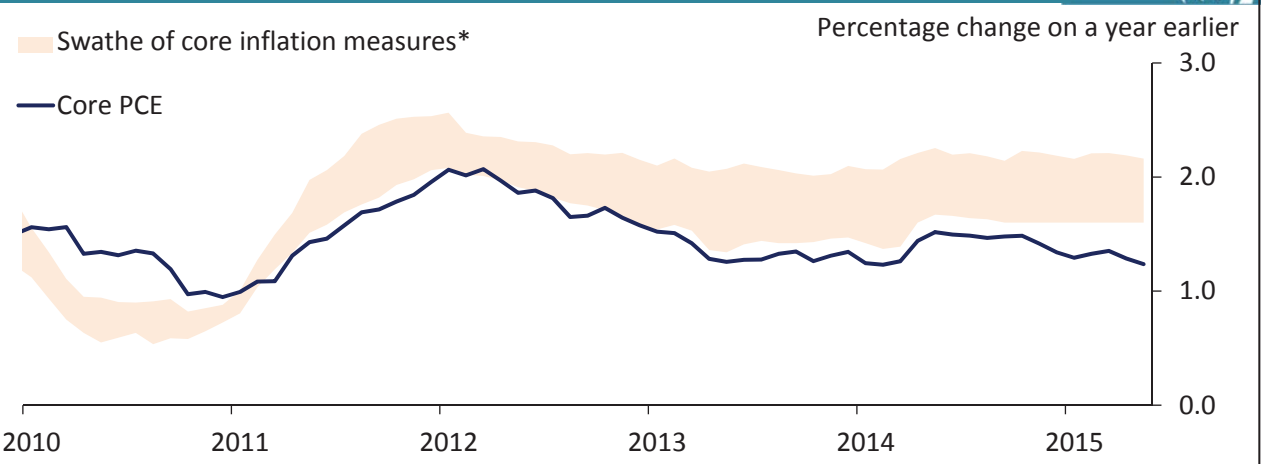
- All measures suggest slack is narrowing but different read on level of slack.

US wages: AHE and ECI measures



- Both measures increasingly suggest wages are picking up.

US inflation: core CPI and core PCE

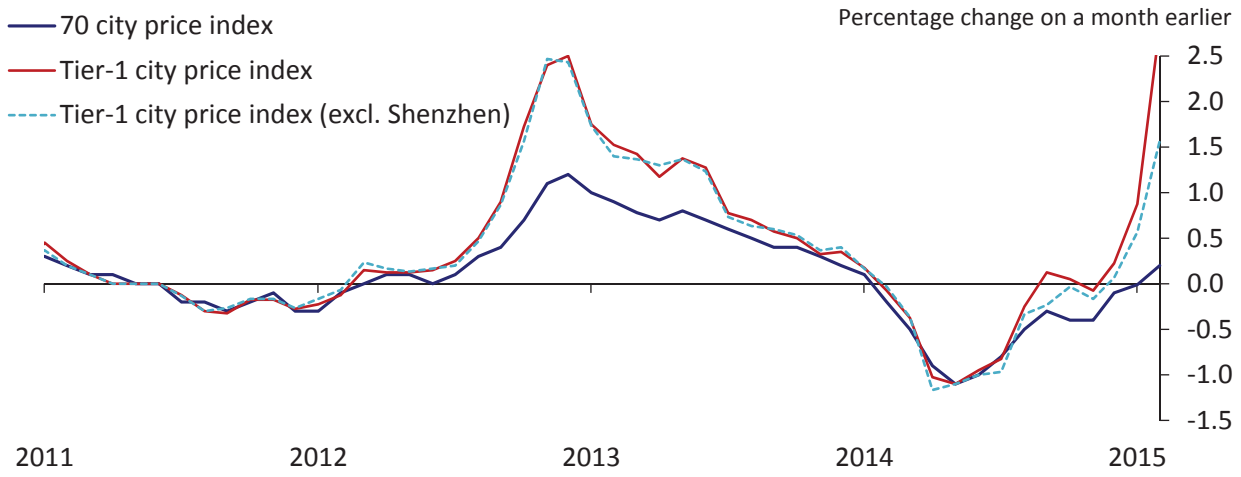


*Swathe includes core CPI, Cleveland Fed Median CPI, Cleveland Fed Trimmed Mean CPI & Dallas Fed Trimmed Mean PCE

- FOMC might place more weight on wider range of measures as core PCE diverges.

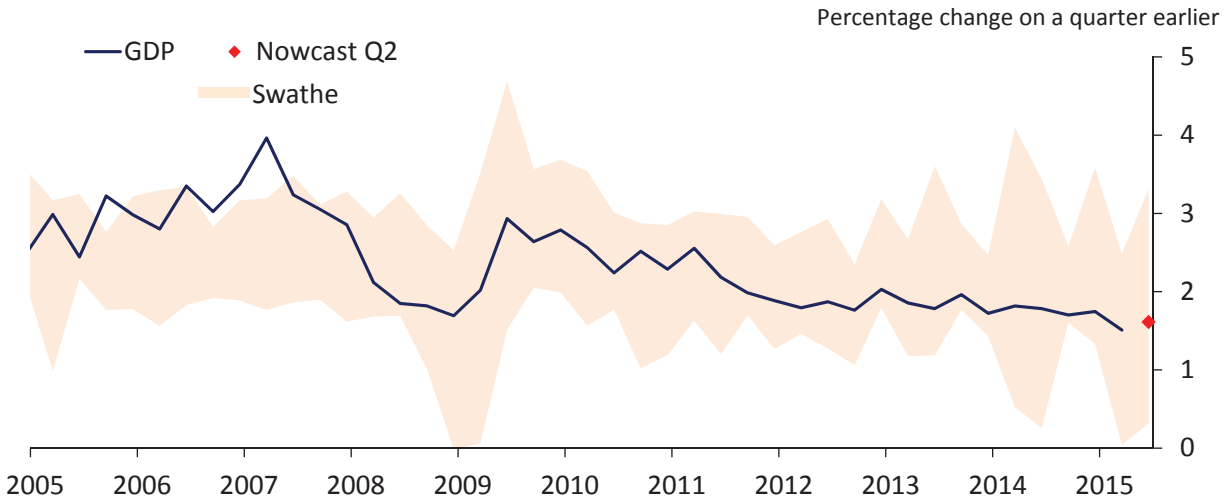
China

China property market



- Prices in Tier 1 cities increased by 1.5% on the month – even stripping out Shenzhen.

Chinese GDP and swathe of indicators



- Growth stabilised somewhat in Q2, at 1.6%, up a touch from Q1.

Chinese equity prices

- Shanghai share index fell by 20% in the past week – but increase in past year was 150%.

Chinese policy actions this month

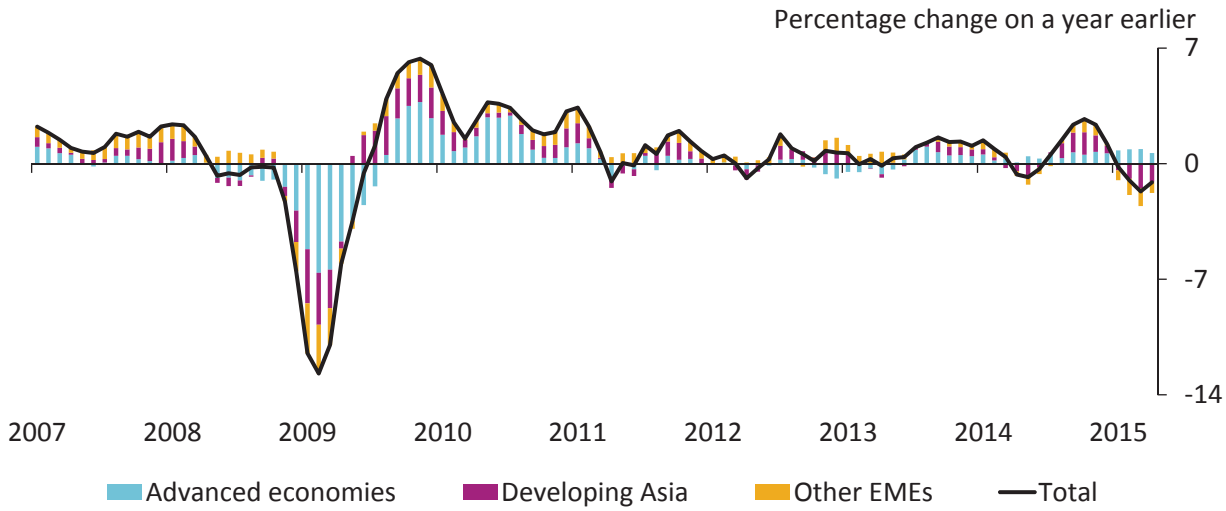
- Draft proposal to allow pension funds to invest in stocks
- PBoC cut interest rates by 25bp and cut reserves ratio by 50bp
- State Council proposal to remove loan-to-deposit cap
- Quota for local government debt swaps doubled, to support infrastructure spending
- Measures to supply long-term funding to policy banks

See

World trade

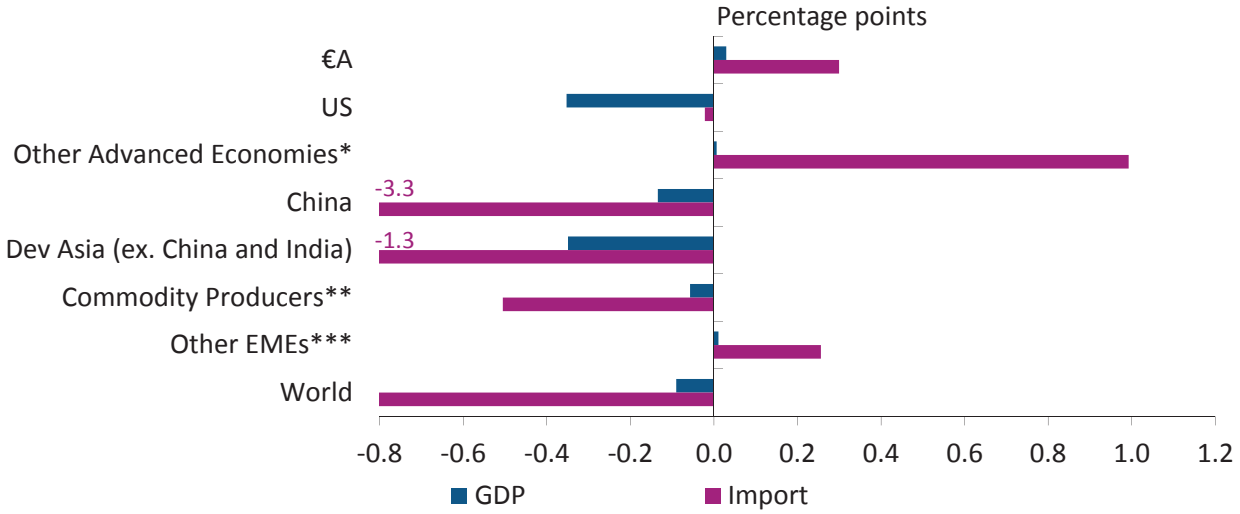
- See "What should we make of the recent weakness in world trade? "

Contributions to CPB world goods trade



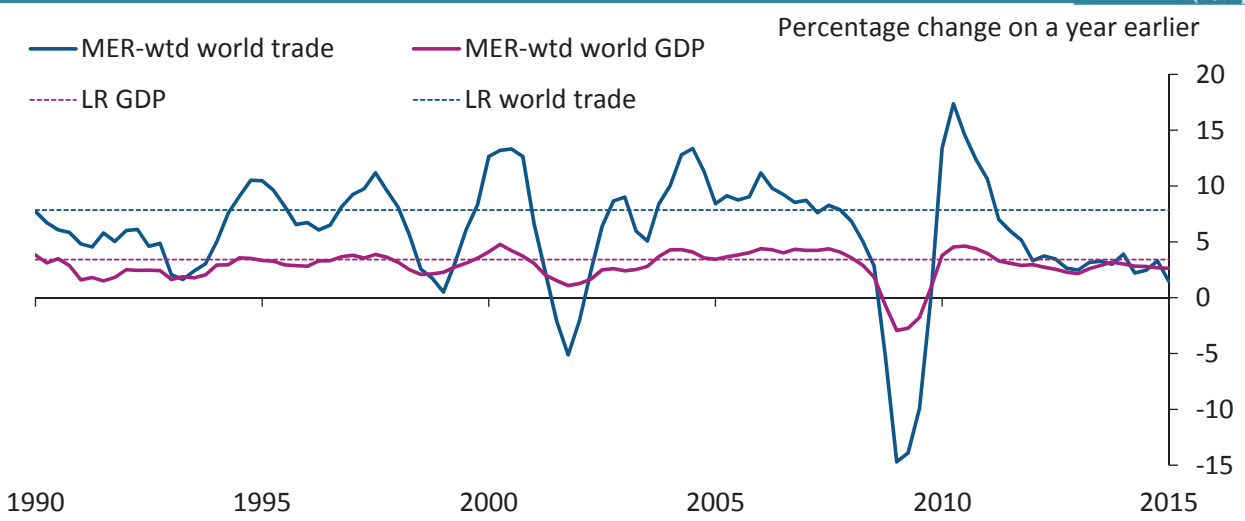
- Imports to developing Asia made major contribution to weak world goods trade.

News in GDP and trade growth in 2015 H1



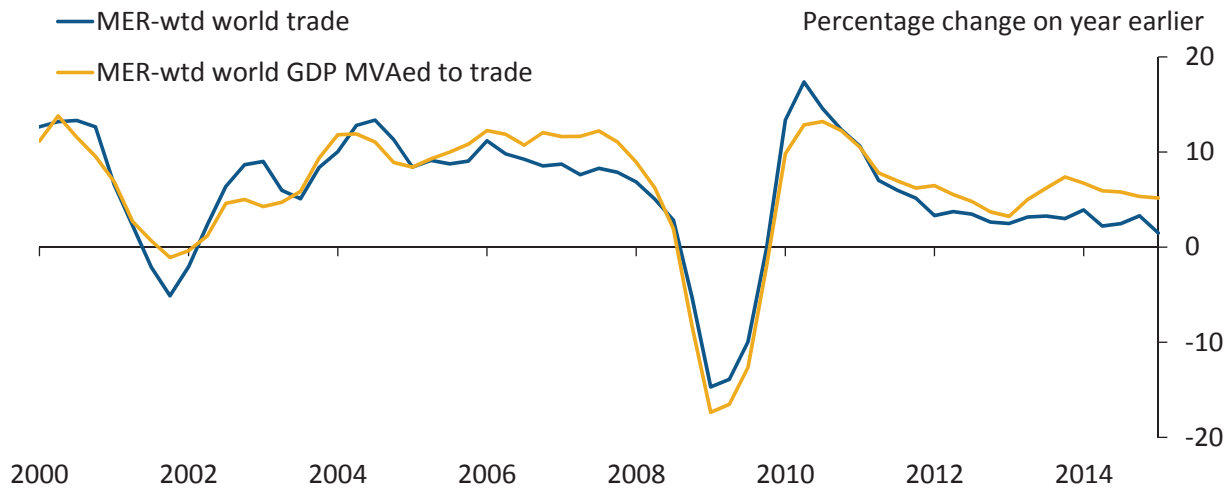
- News in world trade relative to Feb IR has been concentrated in emerging Asia.

World GDP and trade (MER-weighted)



- World trade has been weaker relative to its past than world GDP.

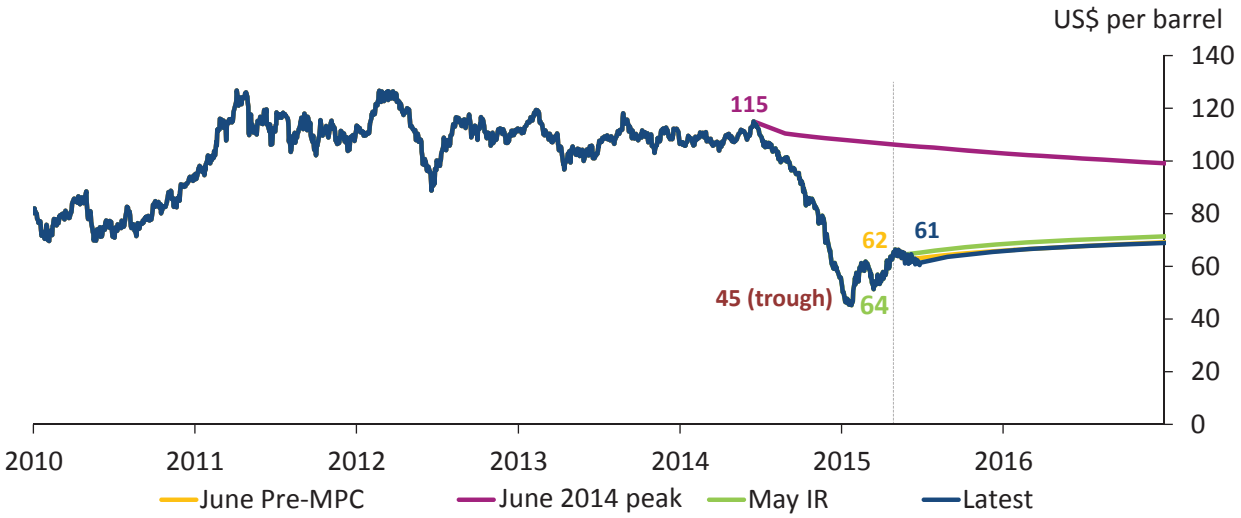
World GDP and trade: mean-variance-adjusted



- …but, adjusted for different variances, weakening in trade looks more in line with GDP.

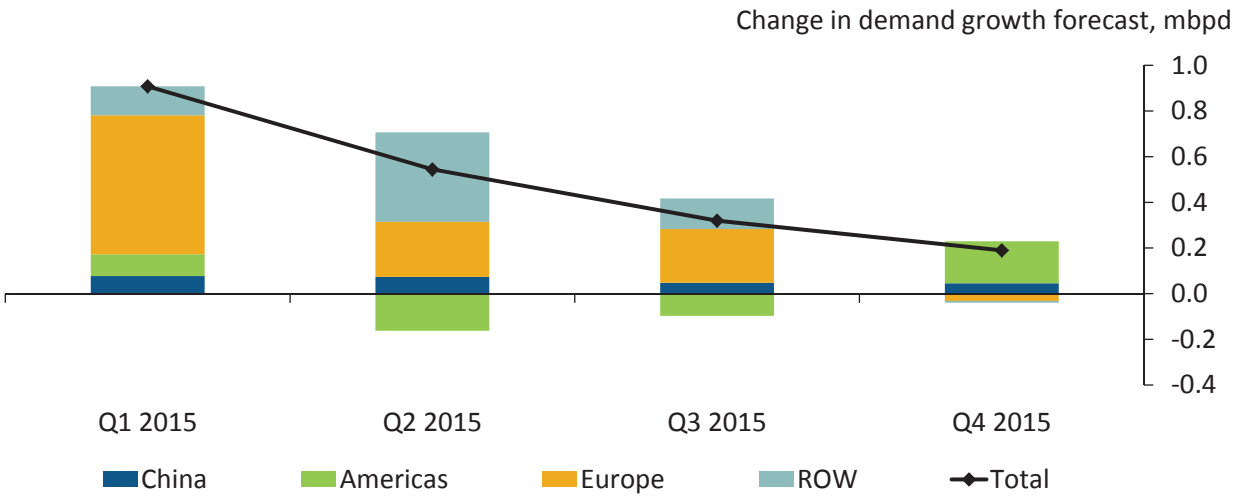
Commodities

Oil price and futures curve



- Spot oil prices have fallen 1% since June Pre-MPC (2% across the futures curve).

Changes in oil demand forecast since Jan '15



- IEA revised up 2015 global demand growth to 1.4mbpd (January estimate: 0.9mbpd)

Key messages

- Expecting modest pick-up in world growth in Q2 after weak Q1
- Euro area growth sustained by fairly robust domestic demand
- US: expect strong bounceback in growth in Q2
- Stable Chinese growth increasingly reliant on policy action
- Slowdown in world trade more pronounced than in global activity, particularly in emerging Asia
- Oil prices slightly lower; excess of supply still weighing on prices

End

4: Demand and Output

Demand and Output

July 2015

DSI and UK Teams

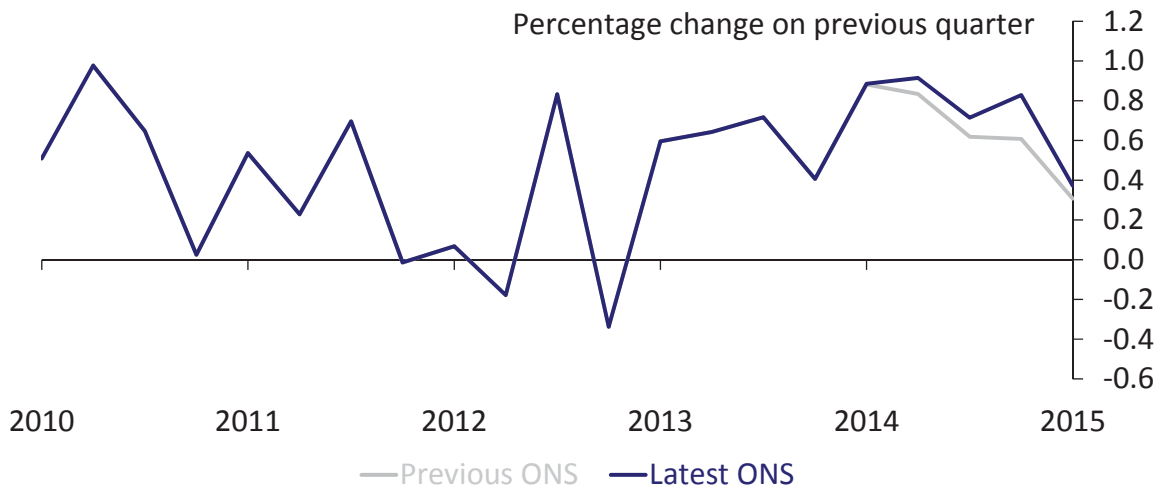
Outline

1) Output in Q2 and Q3
2) Mini demand stocktake

Outline

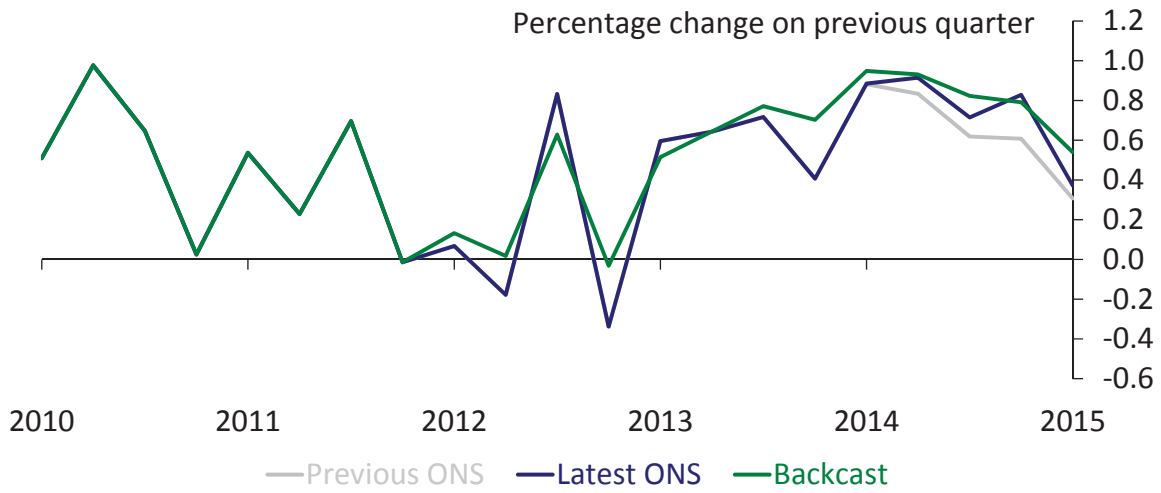
1) Output in Q2 and Q3
2) Mini demand stocktake

Real GDP



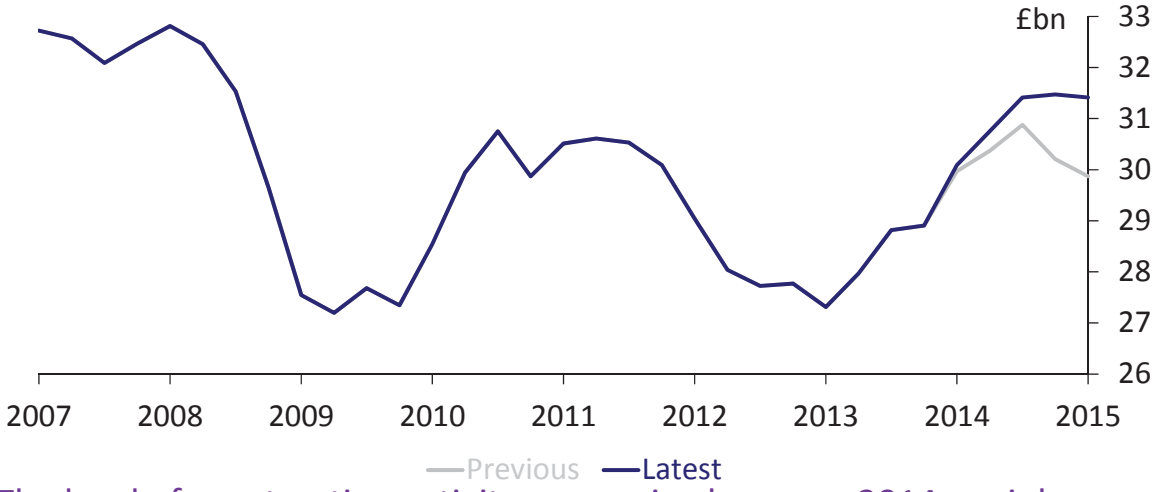
- Real GDP growth in Q1 was revised by 0.1pp to 0.4%, as expected. The level of GDP was revised up by 0.5pp.

Real GDP backcast



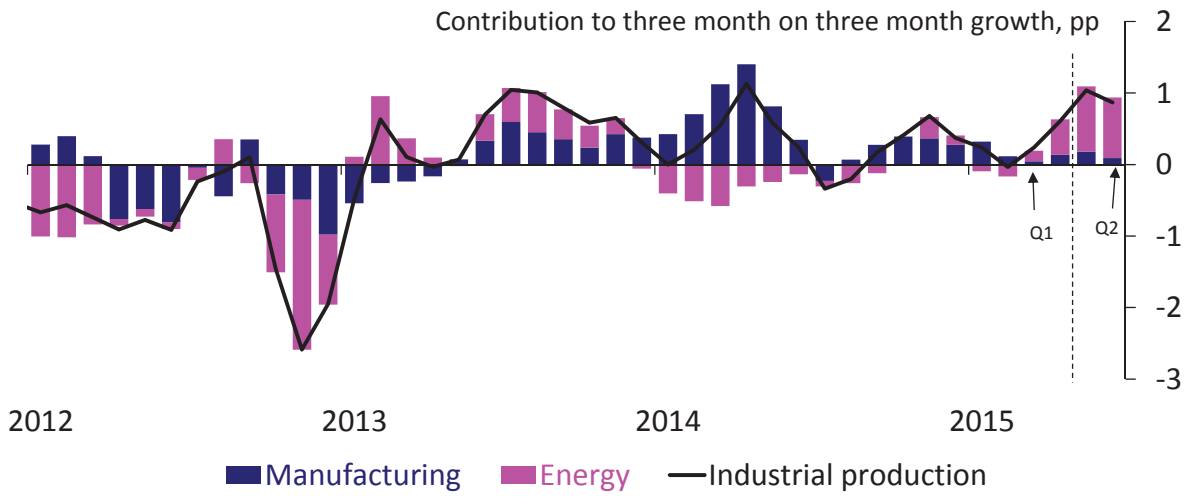
- The ONS revised annual growth in Q1 up by 0.5pp, to 2.9%. Our backcast estimate has been revised up by 0.4pp, to 3.1%.

Construction output



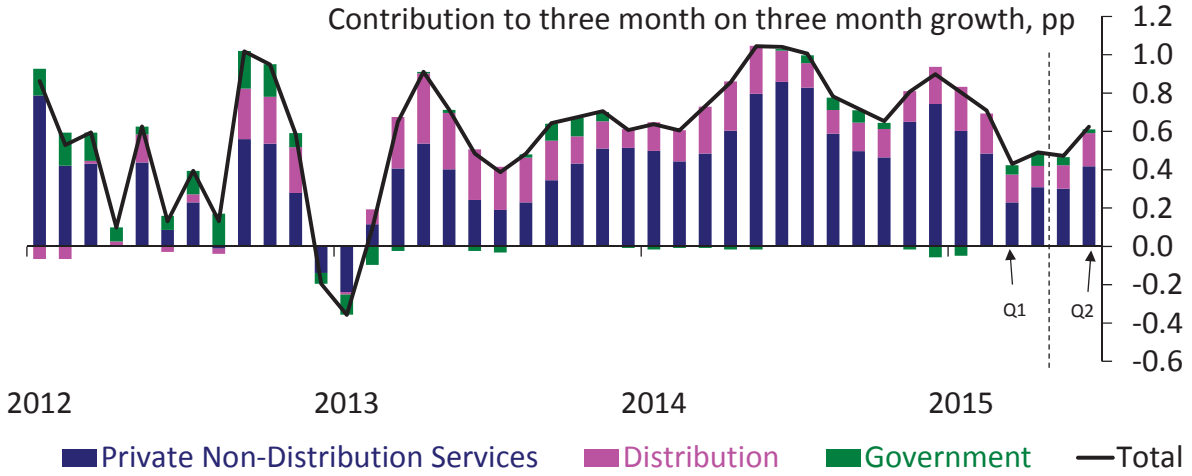
- The level of construction activity was revised up over 2014, mainly as a result of the introduction of new construction price indices

Index of Production



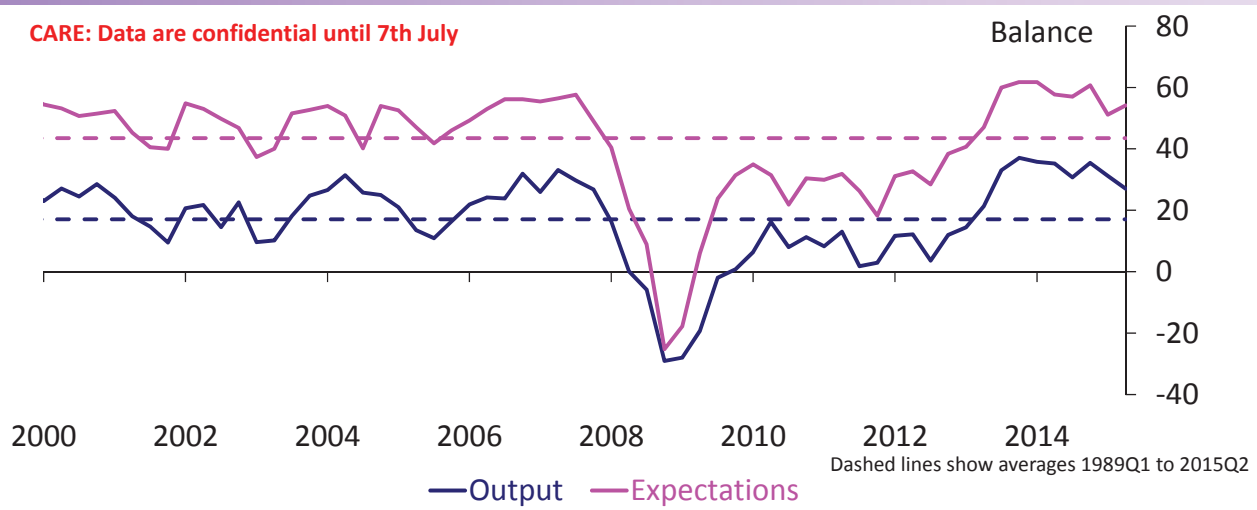
- Production growth is picking up, mainly owing to oil & gas extraction

Index of Services



- Business services and finance were responsible for the Q1 slowdown. We still expect growth to recover somewhat in Q2.

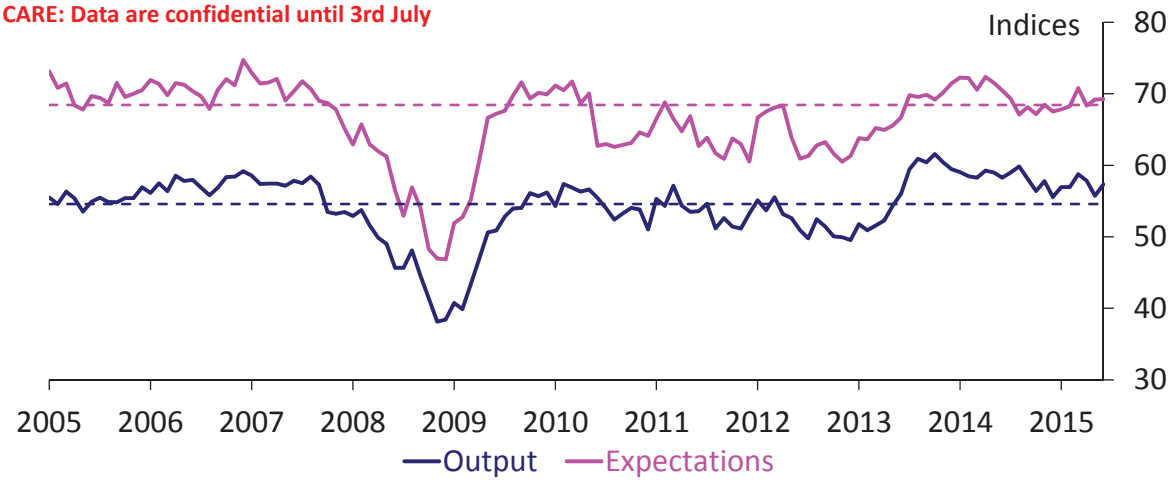
BCC composite survey



- The output composite ticked down, but expectations remain high

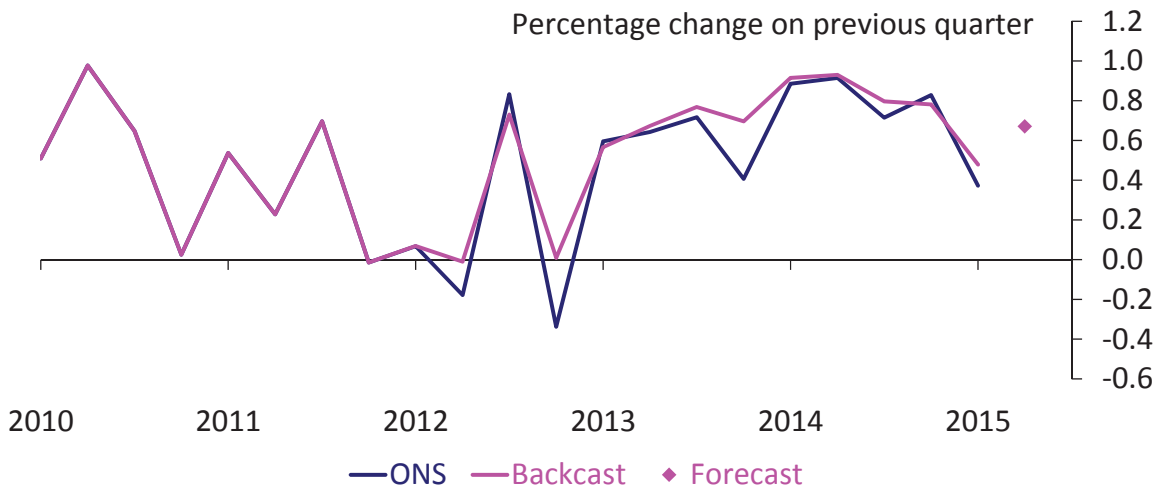
Markit/CIPS composite survey

CARE: Data are confidential until 3rd July



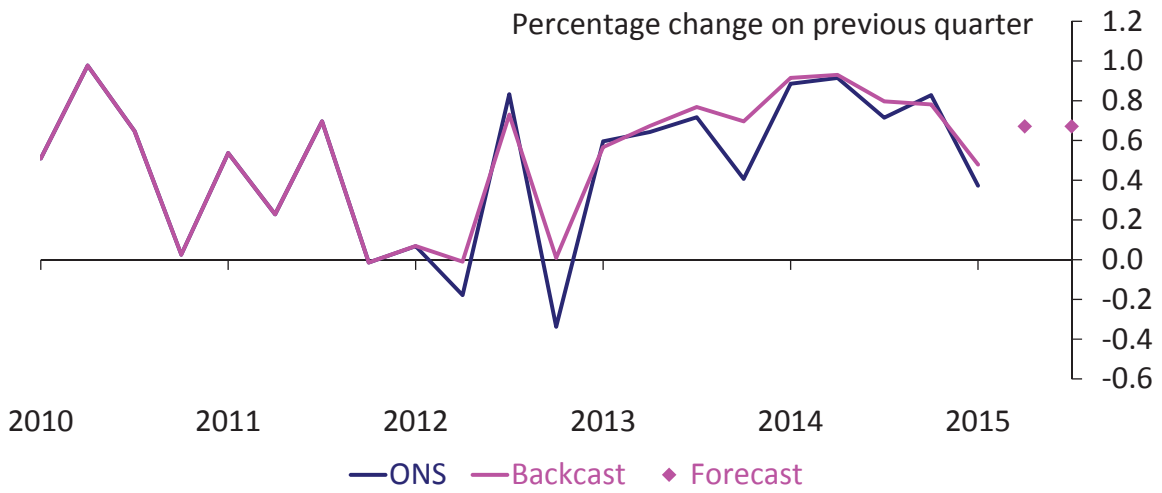
- Markit/CIPS output increased in June. Expectations remained around average.

Q2 nowcast



- We still expect GDP growth to have been 0.7% in Q2

Q3 forecast



- And growth in Q3 is also expected to be 0.7%

Outline

1) Output in Q2 and Q3
2) Mini demand stocktake

Real GDP by expenditure in Q1

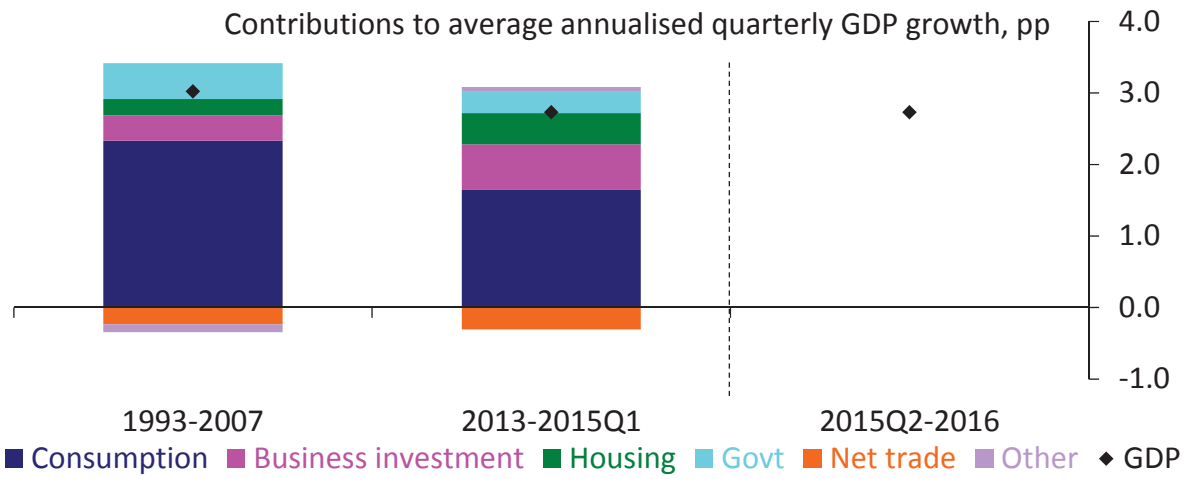
Q1 expenditure breakdown

	2nd Release	QNA	Revision	May IR
Consumption	0.6	0.9	0.4	0.7
Business investment	1.7	2.0	0.3	0.8
Housing investment	1.6	2.4	0.8	-1.0
Private final domestic demand	0.8	1.2	0.4	0.6
Government	0.6	1.0	0.3	-0.1
Other (inc stockbuilding)*	0.5	-0.2	-0.8	0.3
Net trade *	-0.9	-0.6	0.2	-0.5
GDP	0.3	0.4	0.1	0.5^

*contribution to GDP growth

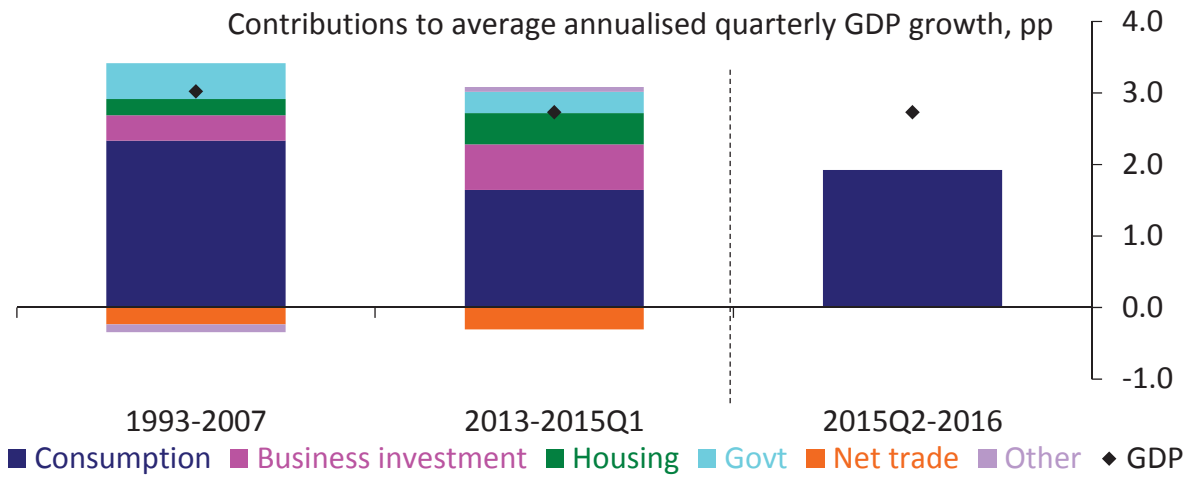
^final GDP growth

Past contributions to GDP growth



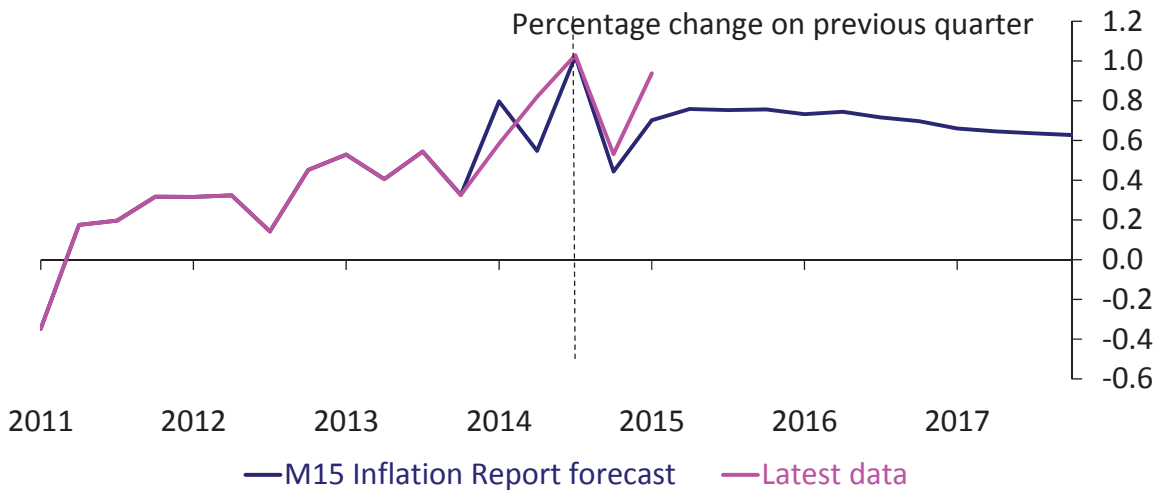
- Business and housing investment have made out-sized contributions to growth over the past two years

Household consumption projections (May IR)



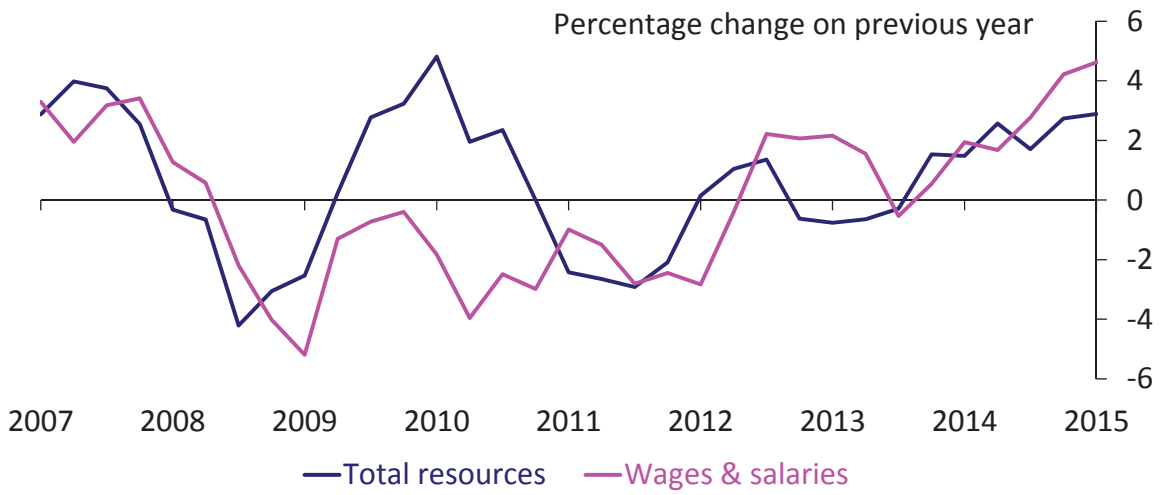
- Consumption growth picks up a little further

Household consumption



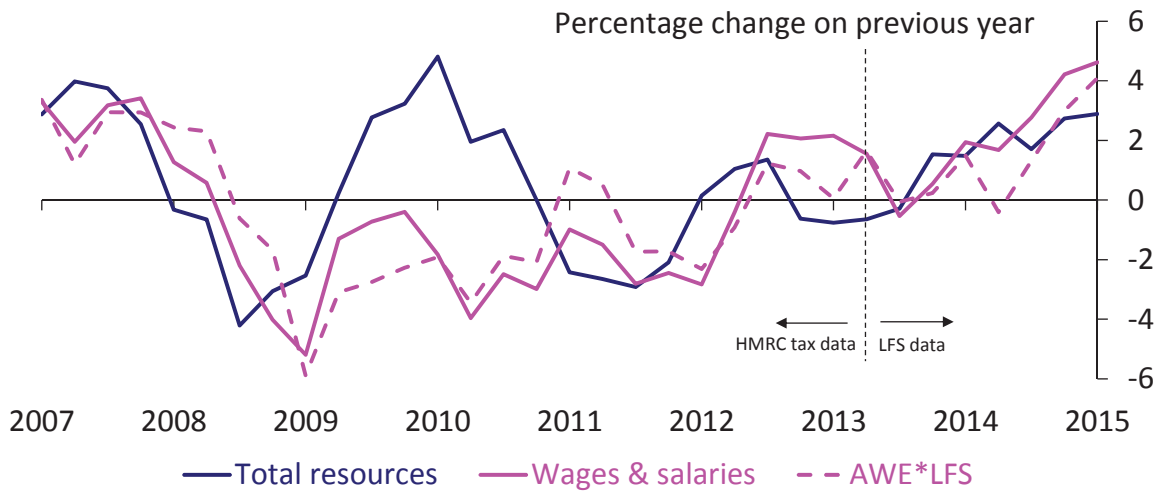
- Consumption grew by 0.9% in Q1, 0.2pp higher than in the May IR

Real household income



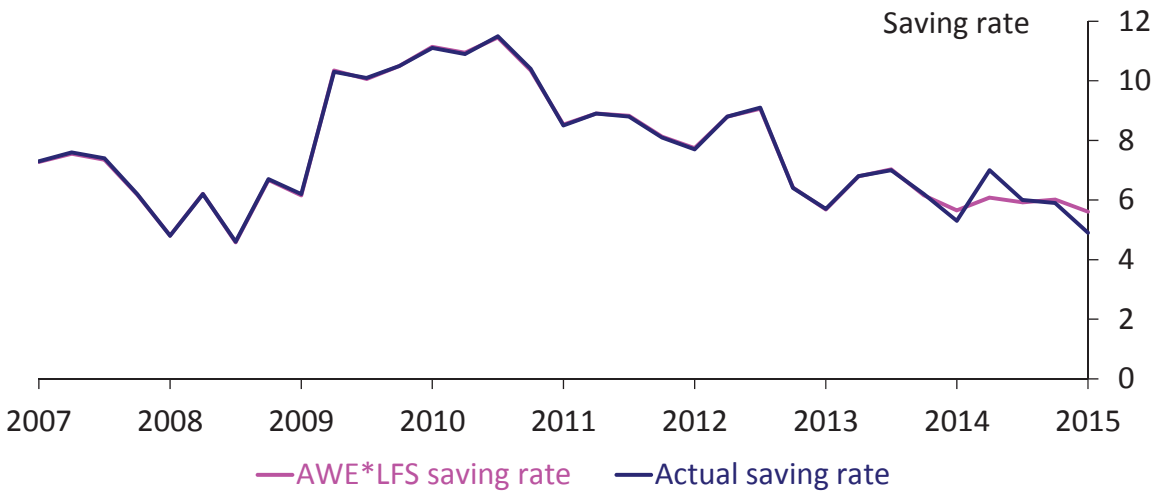
- Growth in wages and salaries has picked up strongly in recent quarters, but the level in Q1 was 0.3pp lower than expected in the May IR. Total income was 0.6pp lower.

Real household income and AWE*LFS proxy



- Growth in pay looks a little lower when you multiply average weekly earnings by LFS employees

Saving ratio with AWE*LFS proxy

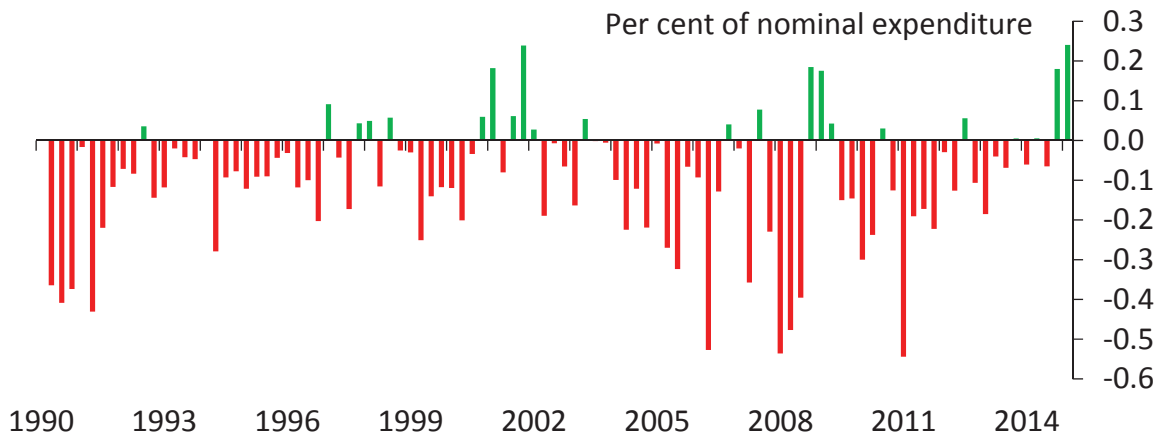


- The saving ratio is a lot flatter if you replace wages and salaries with AWE*LFS over 2014/15

Boost to consumption from lower energy prices

- In the May IR, the lower oil price was expected to increase the level of consumption in Q4 by 0.1% and by 0.3% in Q1. This was based on a range of estimates from time series models and COMPASS and would imply an MPC out of the direct boost to real income of around 0.8.

Purchasing power gain



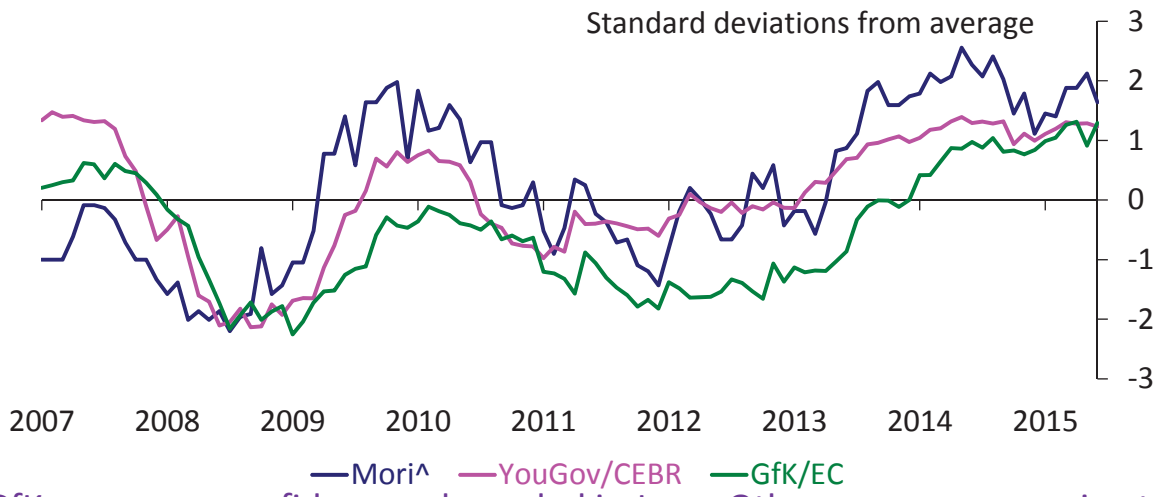
- Since Q3 the income available for consumption after fuel and energy has increased by 0.4%. This doesn't include the indirect supply-chain effects.

Boost to consumption from lower energy prices

- In the May IR, the lower oil price was expected to increase the level of consumption in Q4 by 0.1% and by 0.3% in Q1. This was based on a range of estimates from time series models and COMPASS and would imply an MPC out of the direct boost to real income of around 0.8.

- Using a range of counterfactuals, we now estimate that the level of consumption in Q1 appears to have been boosted by between 0.2%-0.4%. This is consistent with an MPC out of the direct boost to real income between 0.5 and 1.

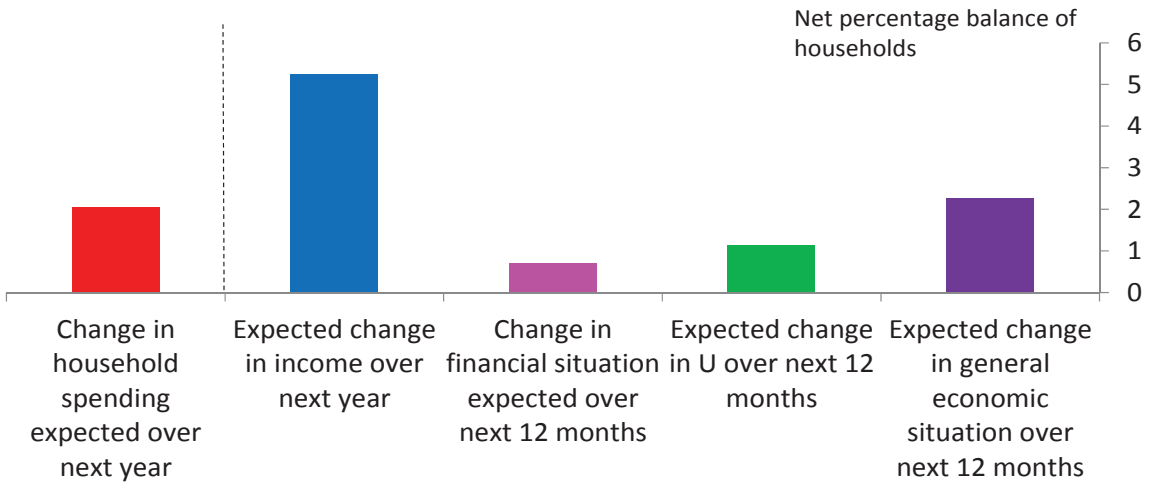
Consumer confidence indicators



- GfK consumer confidence rebounded in June. Other measures remain at similarly high levels.

^Mori question: Do you think that the general economic condition of the country will improve, stay the same, or get worse over the next 12 months?

Households are positive about the next 12 months



See for more detail

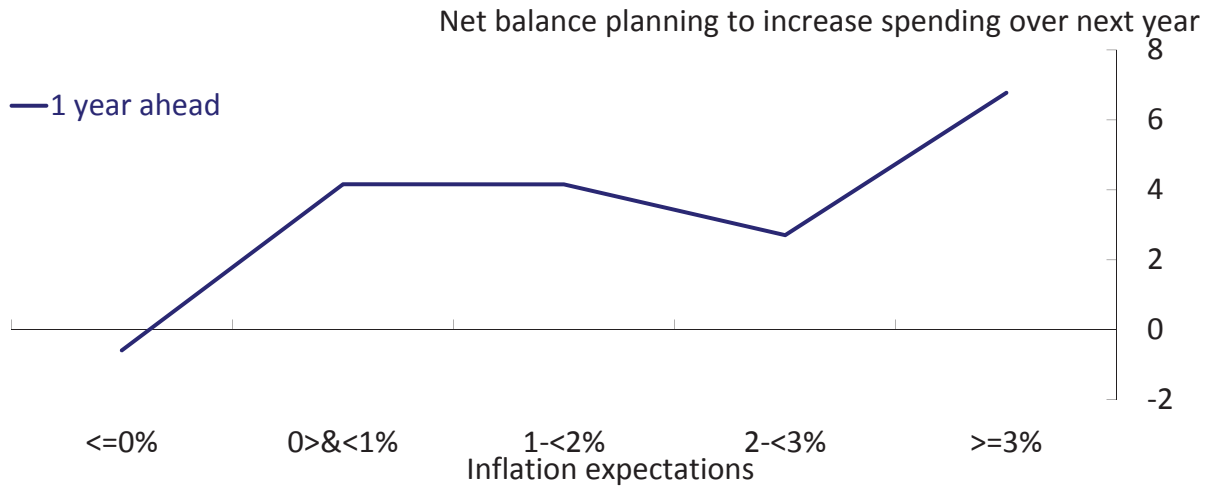
Relationship between household expectations and spending

	Expected movement over next 12 months		
	Decrease	Stay the same	Increase
Income	-11	9	17
Personal financial situation	-1	6	17
General financial situation	2	4	15
Unemployment	8	4	11
House prices	8	0	11

Numbers refer to net percentage balance of households who raised spending over the past 12 months.

- Households' income and personal financial situation are well-correlated with the change in their spending over the past 12 months.

Relationship between inflation expectations and spending

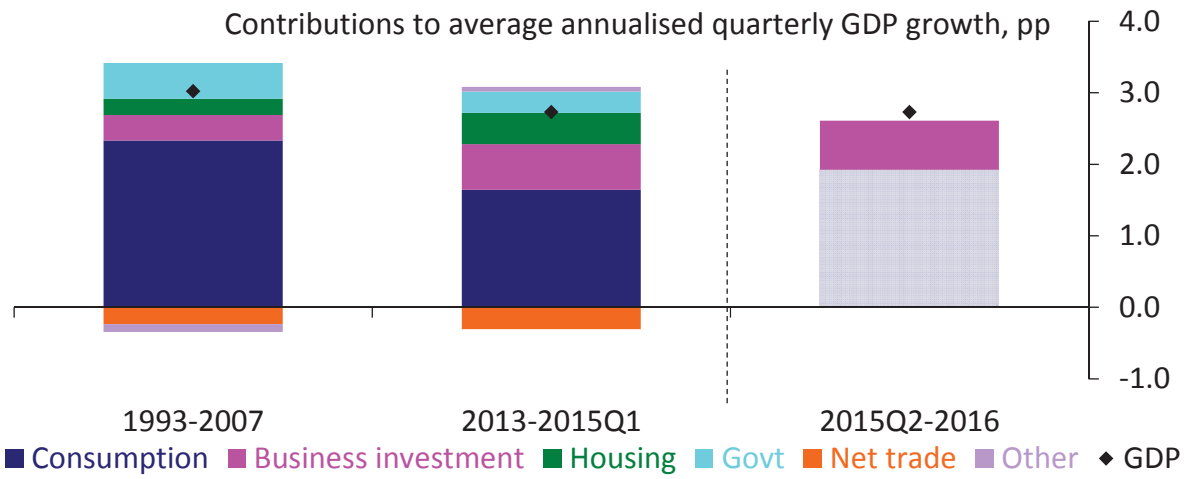


- Some evidence of a positive relationship between 1 year ahead inflation expectations and spending, but less so at longer horizons

Consumption summary

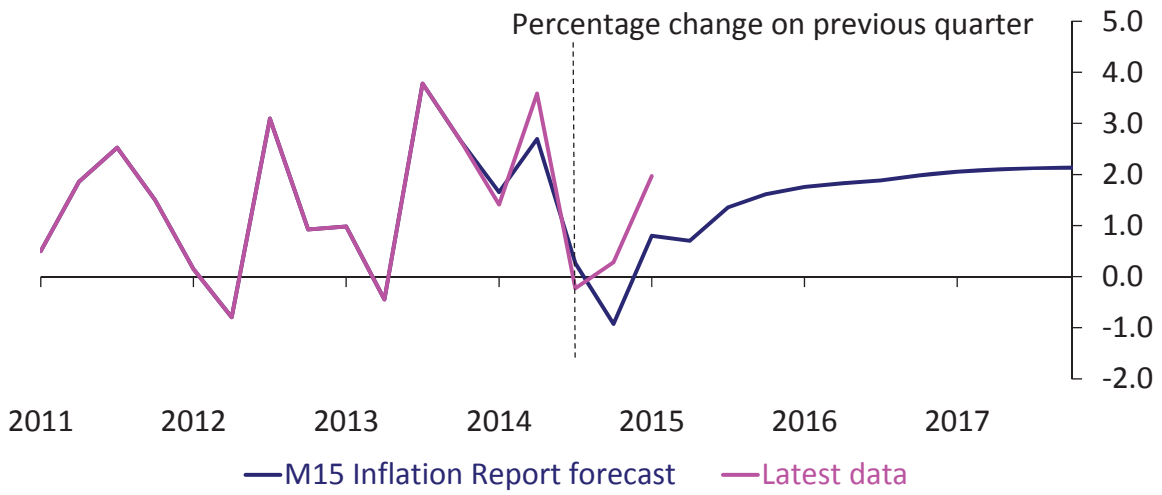
	News relative to 2015 monitoring judgements in May IR	Key factors consistent with central projection in May IR
Consumption	Stronger in Q1, broadly unchanged thereafter	Continuing pickup in real wage, income and productivity growth Some fall in the saving ratio, reflecting ongoing support from monetary policy?

Business investment projections (May IR)



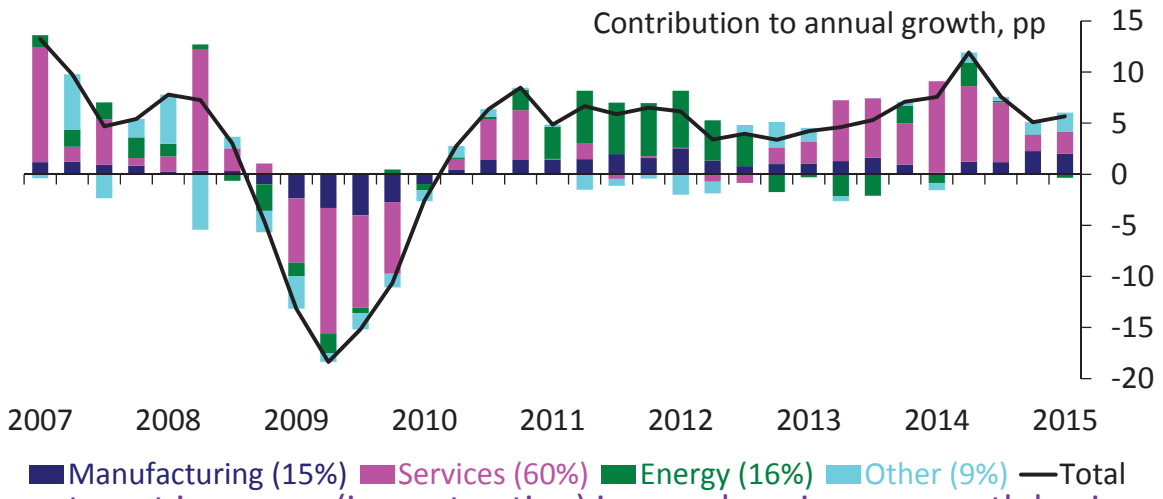
- Business investment growth continues apace, and makes a greater contribution to GDP growth than it did pre-crisis

Business investment



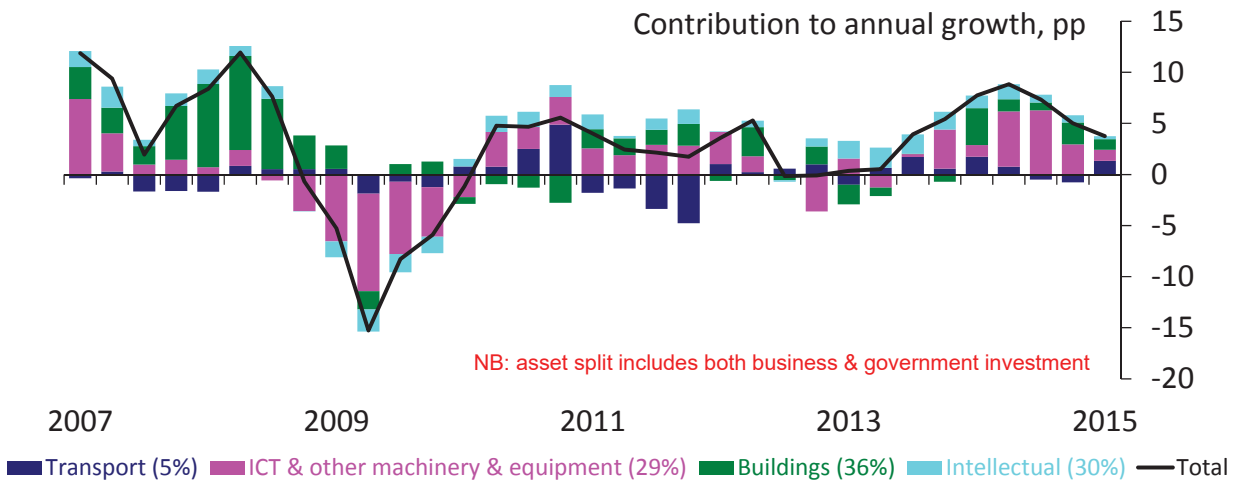
- Business investment grew by 2.0% in Q1. Annual growth was 5.7%.

Business investment by sector



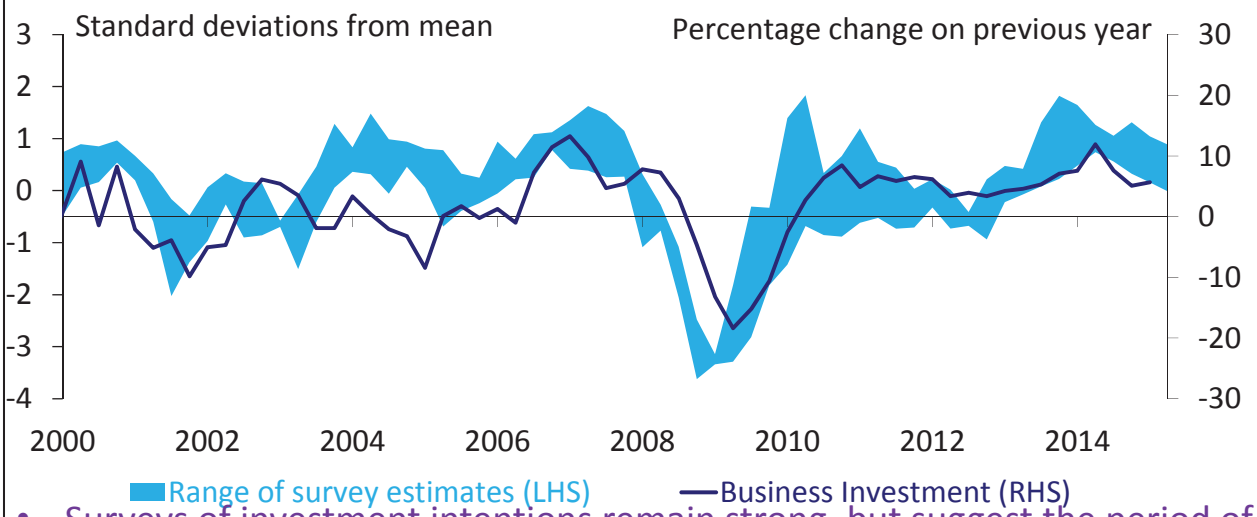
- Investment in energy (inc. extraction) is now dragging on growth having supported growth over 2011/12

Investment by asset



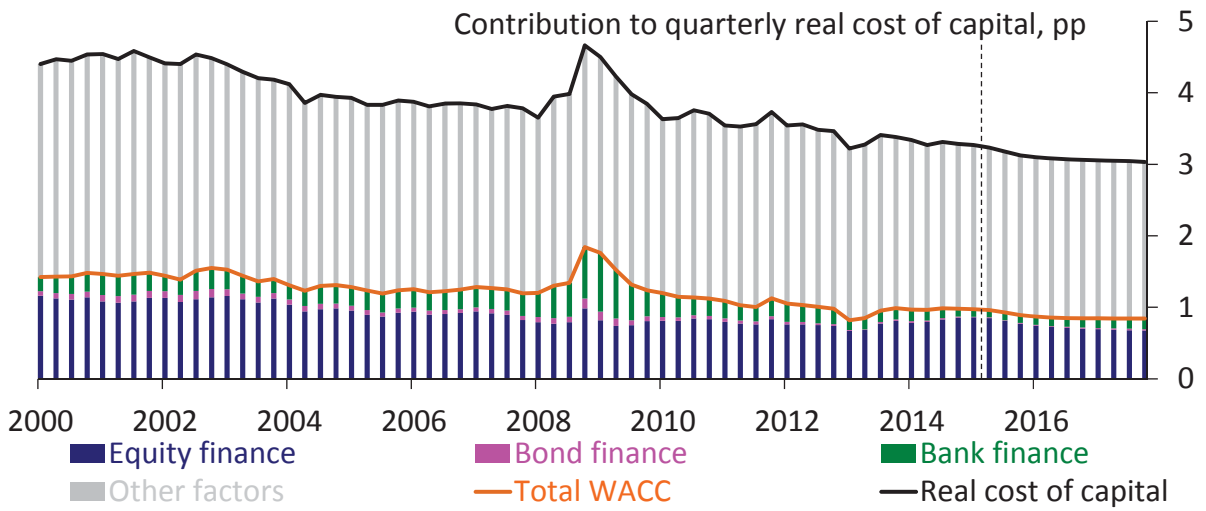
- Investment in ICT and other equipment drove the fall in investment in 2009, and has underpinned the recovery since 2013

Investment intentions surveys



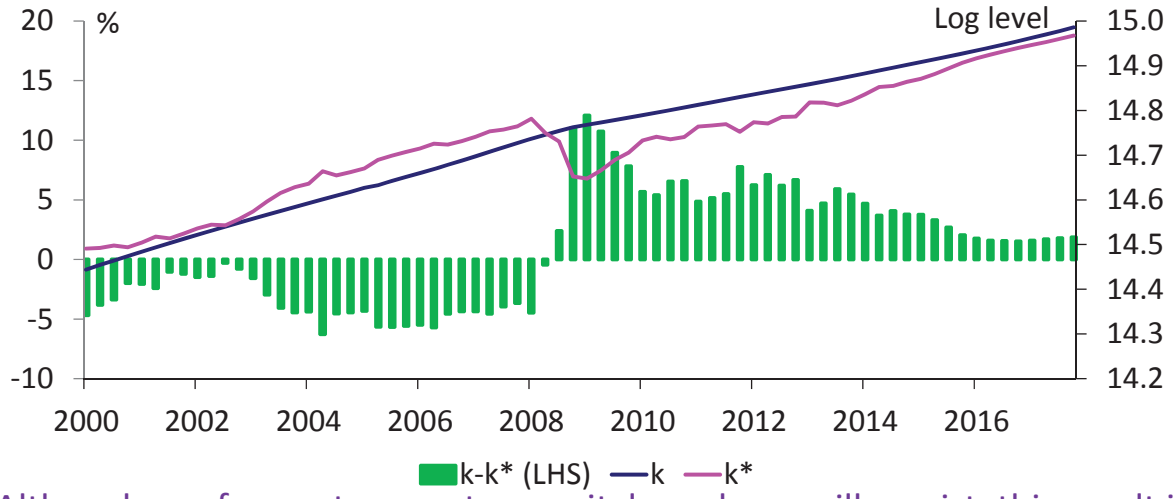
- Surveys of investment intentions remain strong, but suggest the period of fastest growth may be behind us

Real user cost of capital



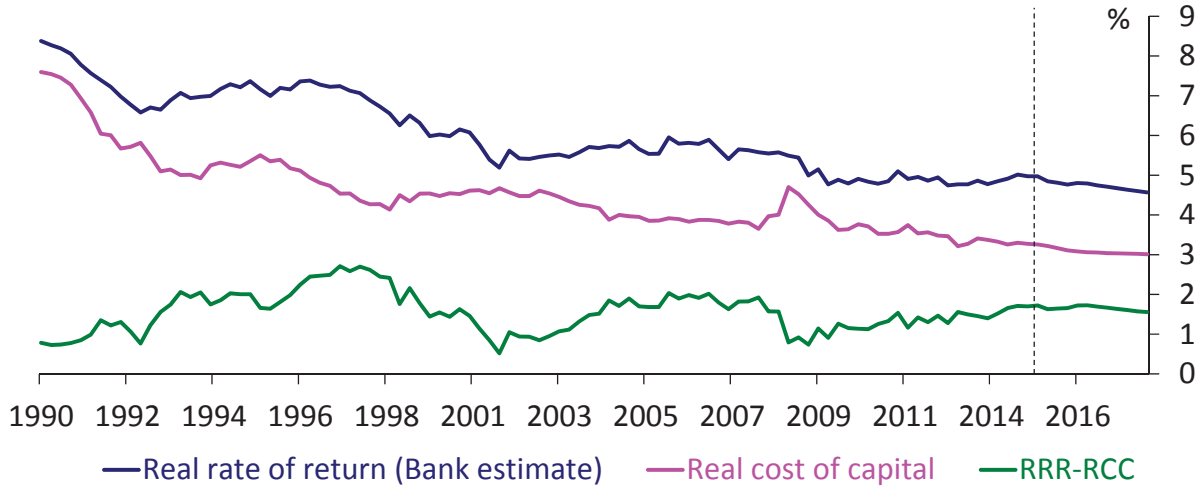
- The user cost of capital continues to fall over the forecast

Capital stock overhang



- Although our forecast suggests a capital overhang will persist, this result is sensitive to the elasticity of substitution between capital and labour

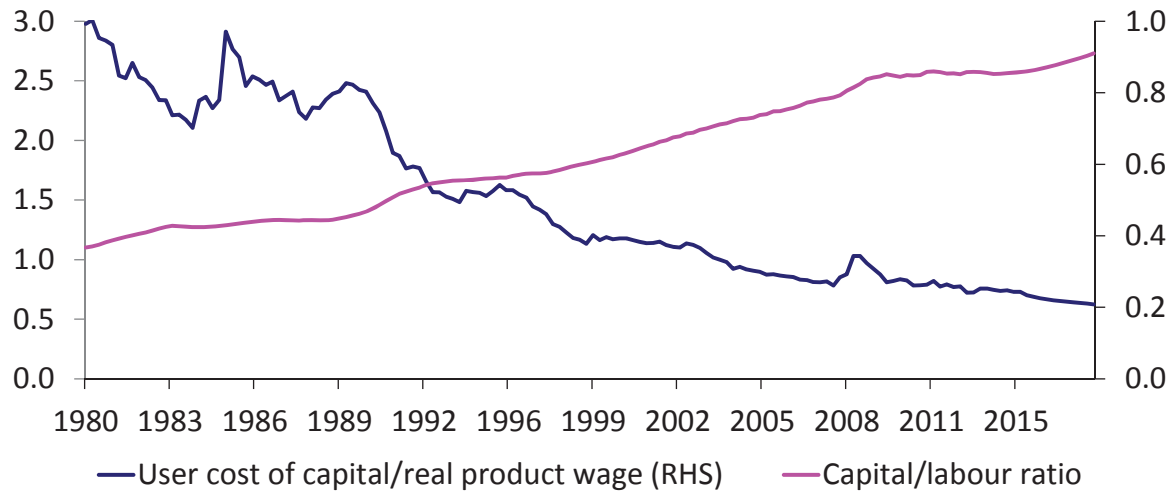
Rate of return and cost of capital



- The gap between returns and cost is not unusually large at the moment

RRR is calculated as a measure of gross operating surplus divided by the Bank's estimate of capital stock, deflated by the GDP deflator

Relative factor prices

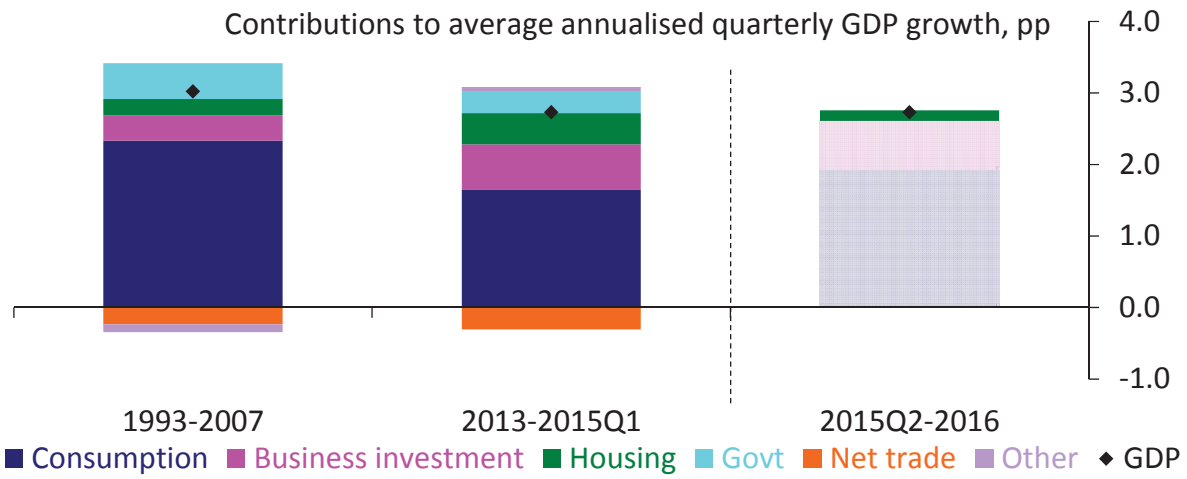


- The relative cost of capital falls gradually over the forecast

Business investment summary

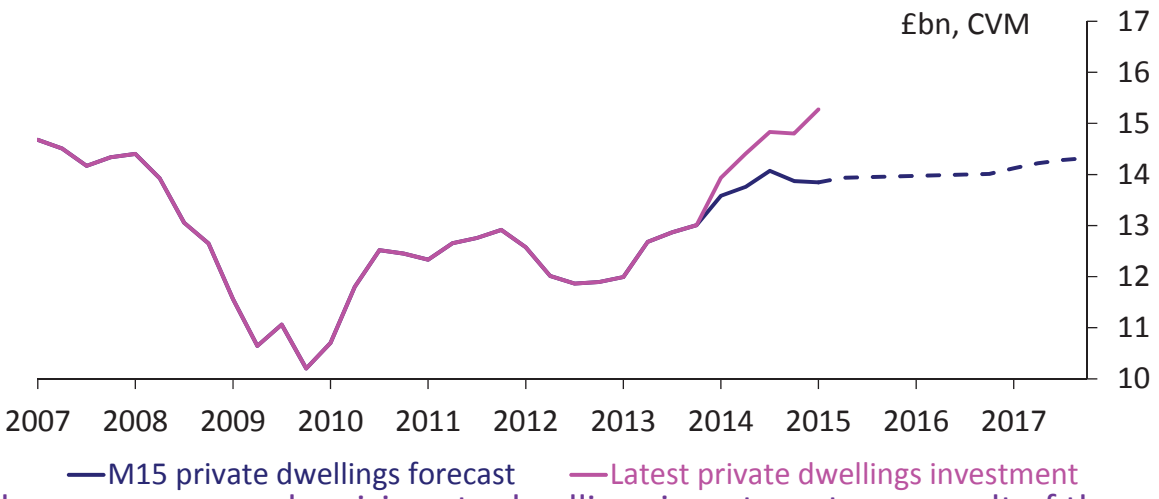
	News relative to 2015 monitoring judgements in May IR	Key factors consistent with central projection in May IR
Consumption	Stronger in Q1, broadly unchanged thereafter	Continuing pickup in real wage, income and productivity growth Some fall in the saving ratio, reflecting ongoing support from monetary policy?
Business investment	**Stronger in Q1, broadly unchanged thereafter**	**Profits and broader growth momentum** **Further falls in the real user cost of capital** **Continuing low levels of economic uncertainty**

Housing investment projections (May IR)



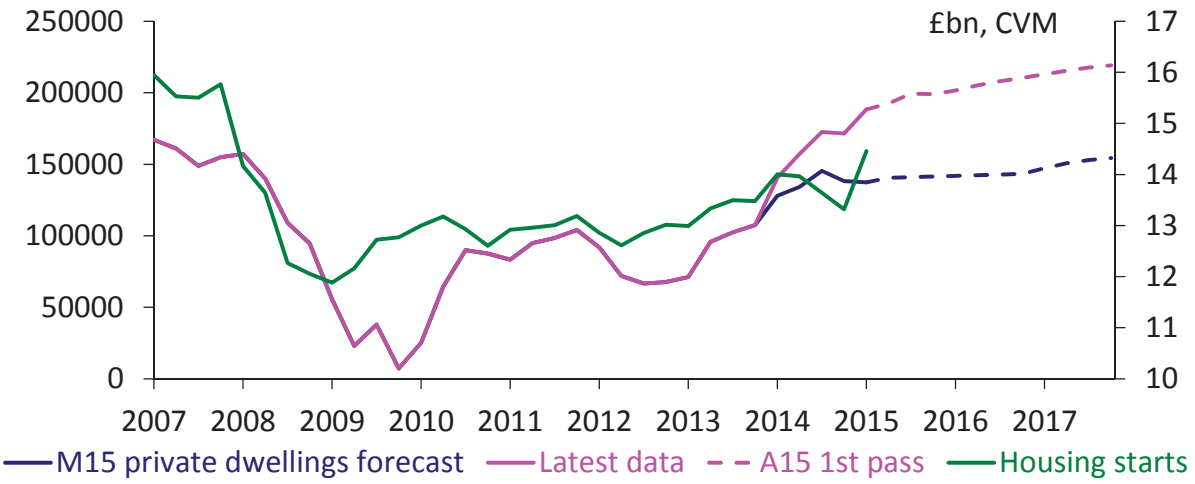
- Housing investment growth slowed down over the next three years

Private dwellings investment



- There were upward revisions to dwellings investment as a result of the new construction price indices

Private starts and dwellings investment forecast

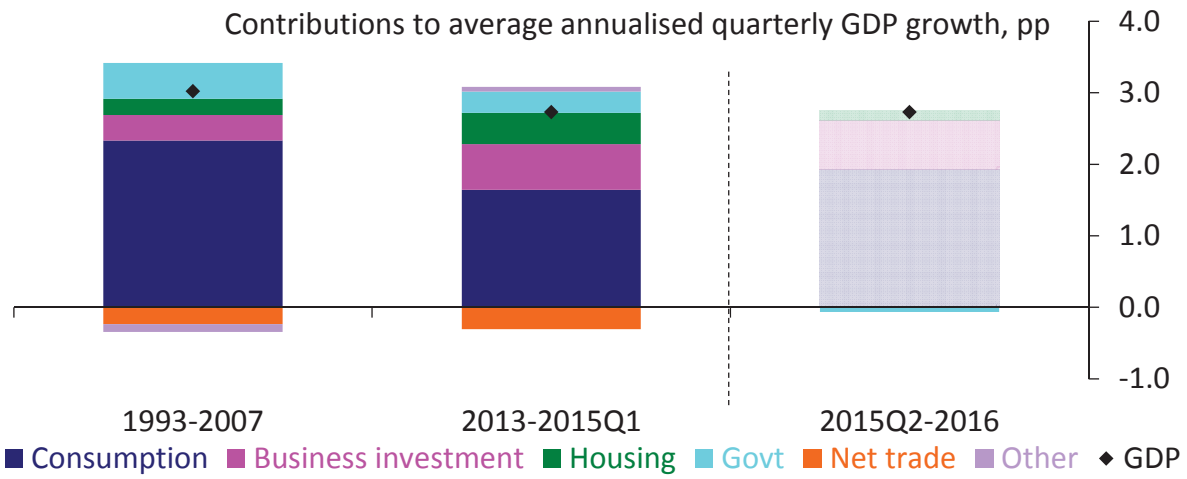


- We have revised up our forecast for housing investment, and now expect it to grow by 6½% in 2015, up from 1%.

Housing investment summary

	News relative to 2015 monitoring judgements in May IR	Key factors consistent with central projection in May IR
Consumption	Stronger in Q1, broadly unchanged thereafter	Continuing pickup in real wage, income and productivity growth Some fall in the saving ratio, reflecting ongoing support from monetary policy?
Business investment	Stronger in Q1, broadly unchanged thereafter	Profits and broader growth momentum Further falls in the real user cost of capital Continuing low levels of economic uncertainty
Housing investment	**Stronger**	**Strong near term outlook for house price inflation and housing transactions** **Possible upside risks here?**

Government spending projections (May IR)

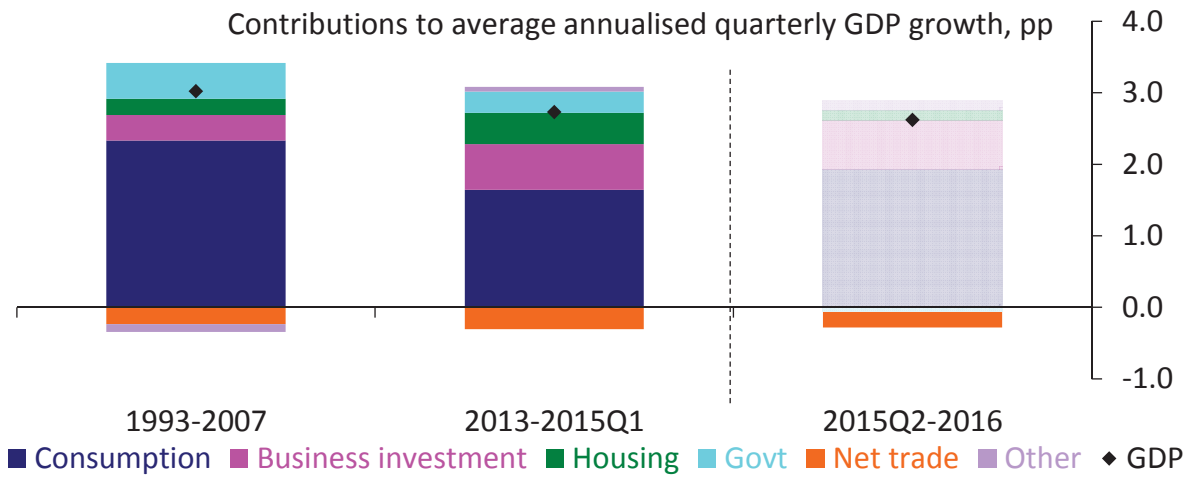


- Fiscal consolidation means real government spending does not contribute to growth

July Budget preview

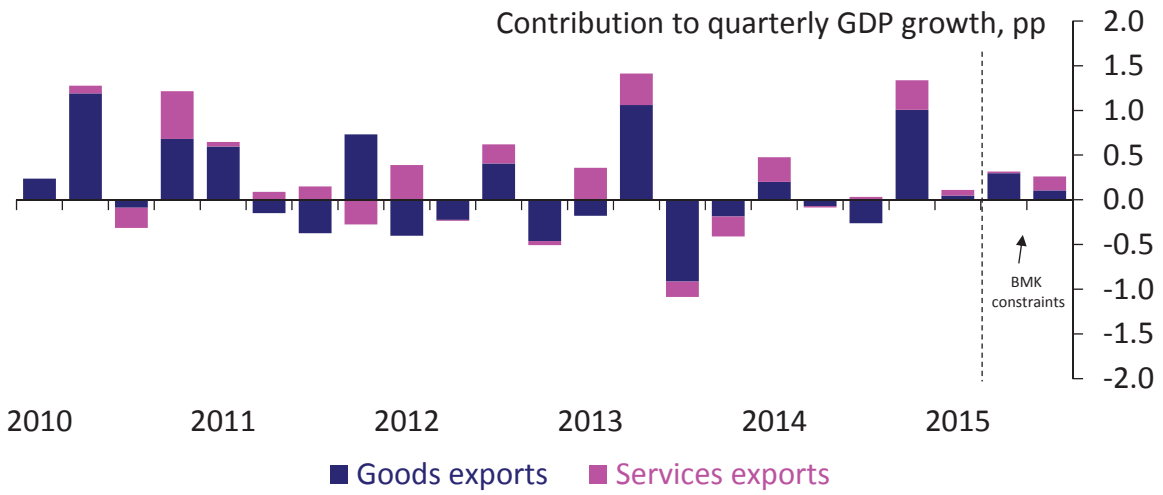
- Recent public finance data on track or slightly better than OBR projections
- Some additional small in-year day to day spending cuts announced for 2015-16
- Likely change in fiscal framework to focus on achieving an overall budget surplus in 'normal' times – defined by HM Treasury and assessed by the OBR
- Under Coalition government plans, overall budget surplus was forecast to be achieved by 2018-19 in March Budget, and we do not expect the overall scale of the consolidation to be materially different to these plans after the July Budget
- The £12bn of cuts in welfare spending proposed by the Conservative government is likely to require fewer, but still substantial, cuts in other areas of current spending

Net trade projections (May IR)



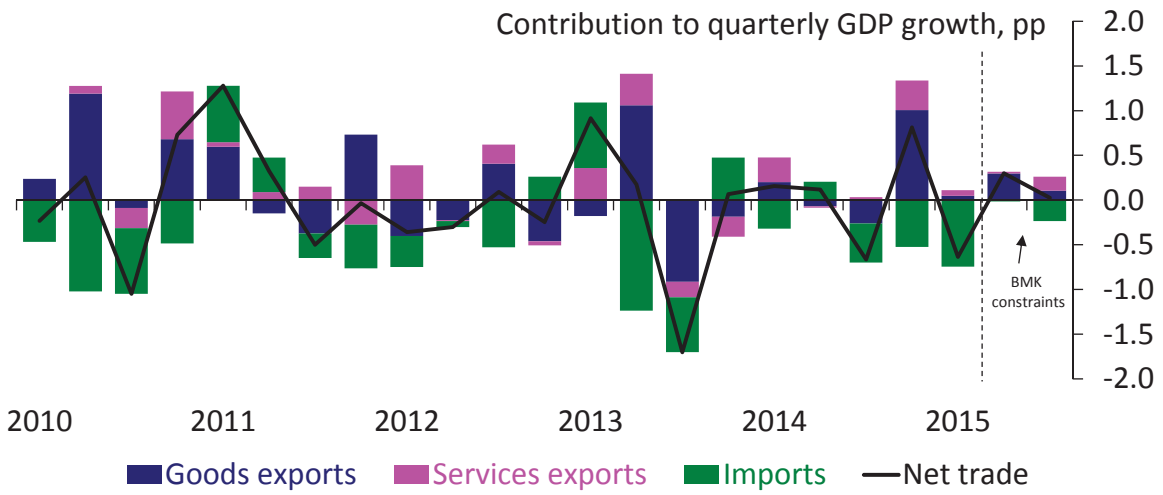
- Imports expected to grow faster than exports, as they did pre-crisis

Goods and services exports



- Export growth was muted in Q1 after a strong Q4

Net trade

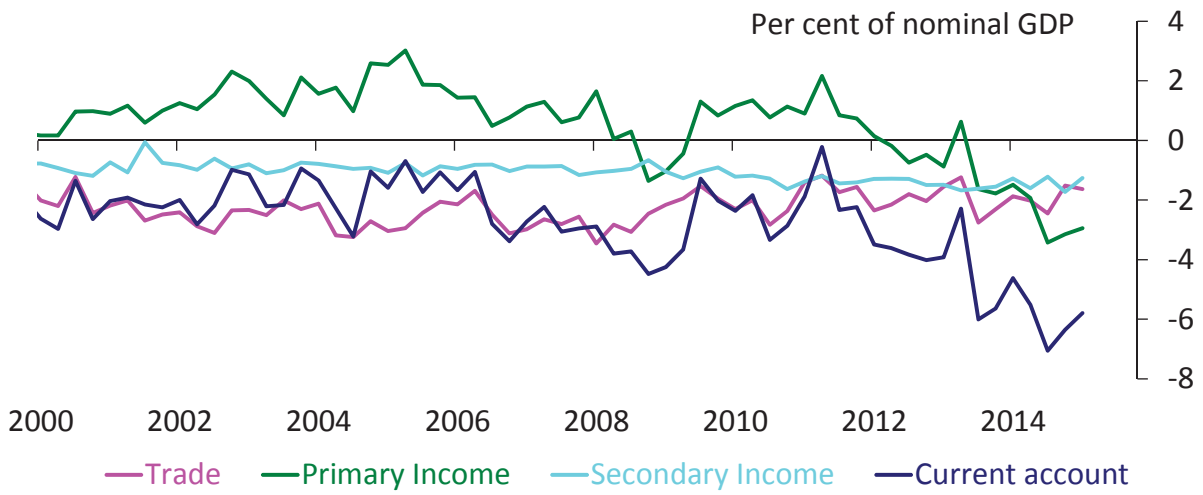


- Imports dragged on growth in Q1, causing net trade to make a negative contribution to growth

Exports summary

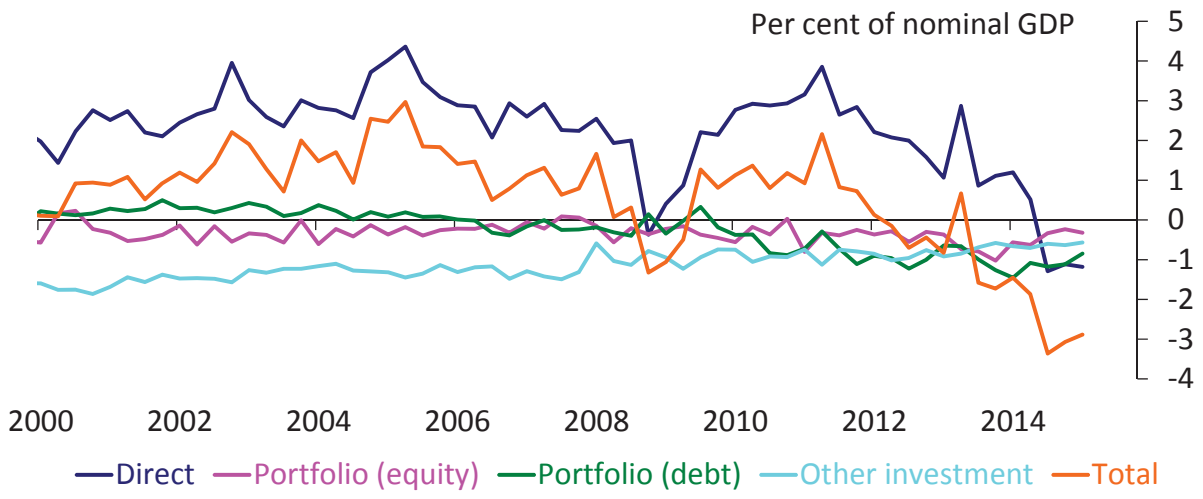
	News relative to 2015 monitoring judgements in May IR	Key factors consistent with central projection in May IR
Consumption	Stronger in Q1, broadly unchanged thereafter	Continuing pickup in real wage, income and productivity growth Some fall in the saving ratio, reflecting ongoing support from monetary policy?
Business investment	Stronger in Q1, broadly unchanged thereafter	Profits and broader growth momentum Further falls in the real user cost of capital Continuing low levels of economic uncertainty
Housing investment	Stronger	Strong near term outlook for house price inflation and housing transactions Possible upside risks here?
Exports	**Broadly unchanged**	**Steady and solid growth in UK weighted world trade** **Likely downside risks around export share given latest exchange rate news and implicit strength assumed in financial services exports**

Current account of the balance of payments



- The current deficit was 5.8% of nominal GDP in 2015 Q1. 2014 Q3 is now the largest deficit on record at 7.1% of nominal GDP.

Primary income balances



Key messages

1) Output in Q2 and Q3: No changes to forecasts but some downside risks
2) Mini demand stocktake: key monitoring judgements on track

END

5: Costs and Prices, Supply

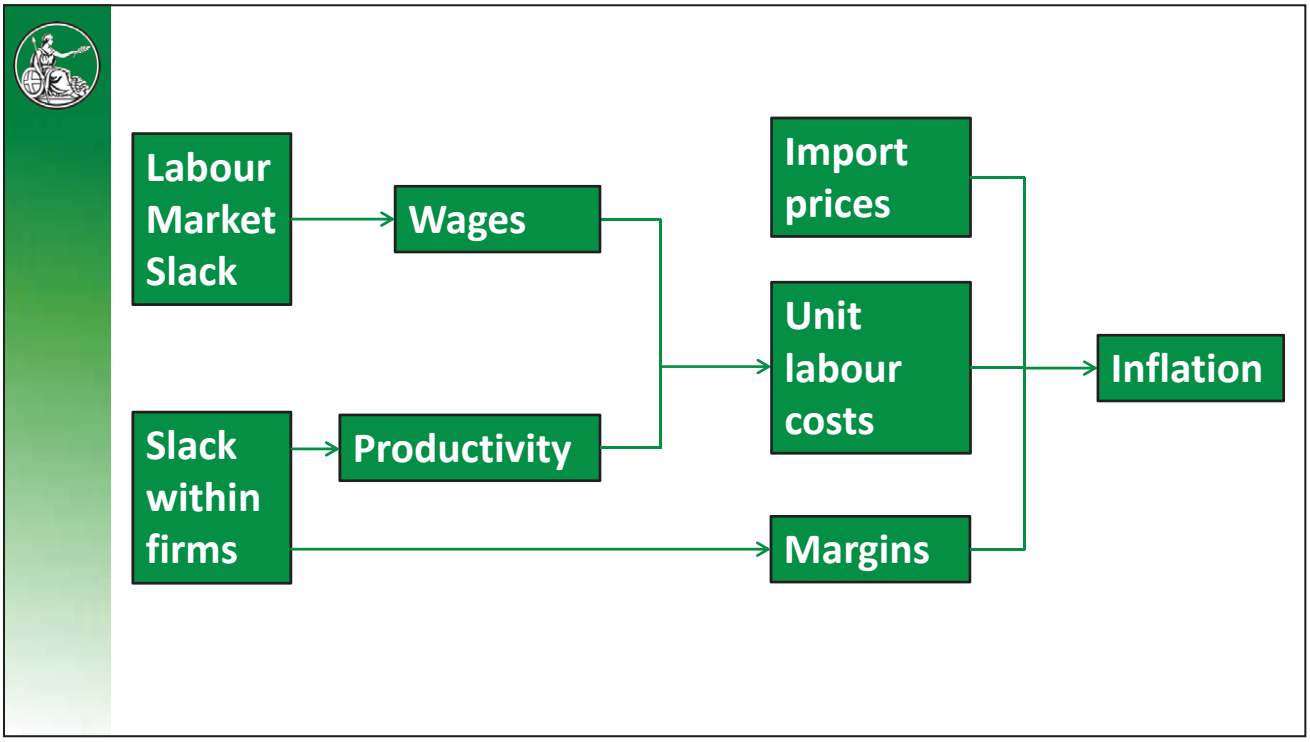
Costs, Prices and Supply

02 July 2015

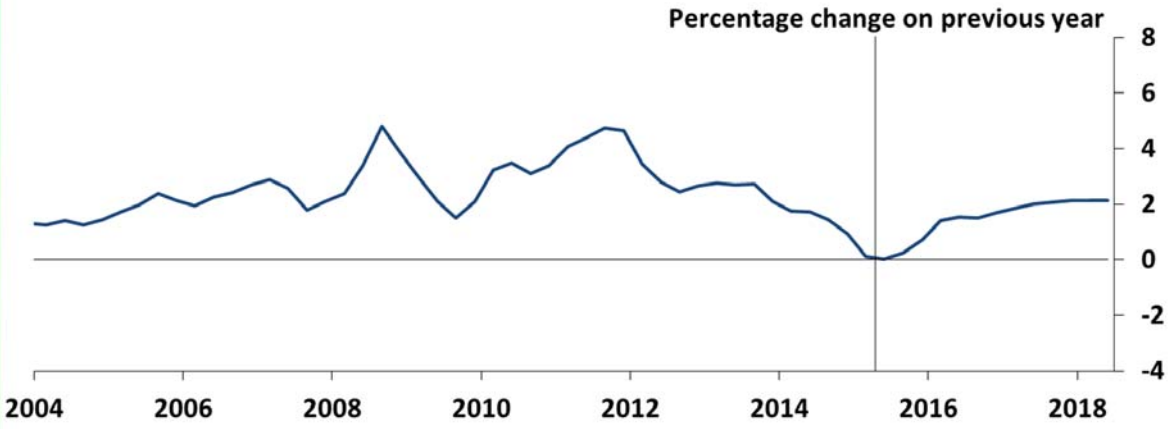
Structural Economic Analysis Division

Key Question

- **How confident are we that inflation will pick up to target within two years?**

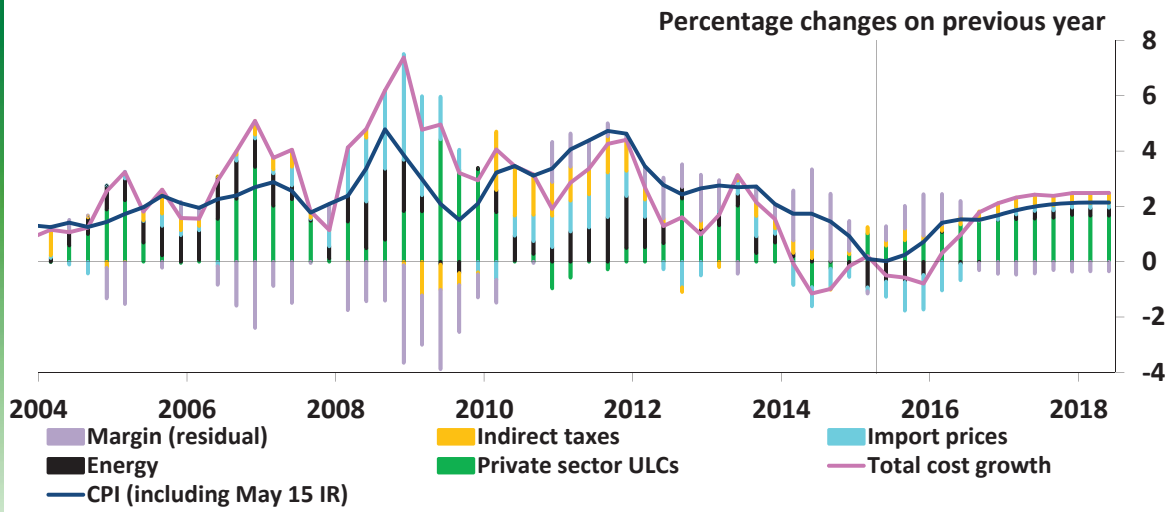

Labour Market Slack
Wages
Slack within firms
Productivity
Import prices
Unit labour costs
Margins
Inflation

May *IR* CPI Inflation profile

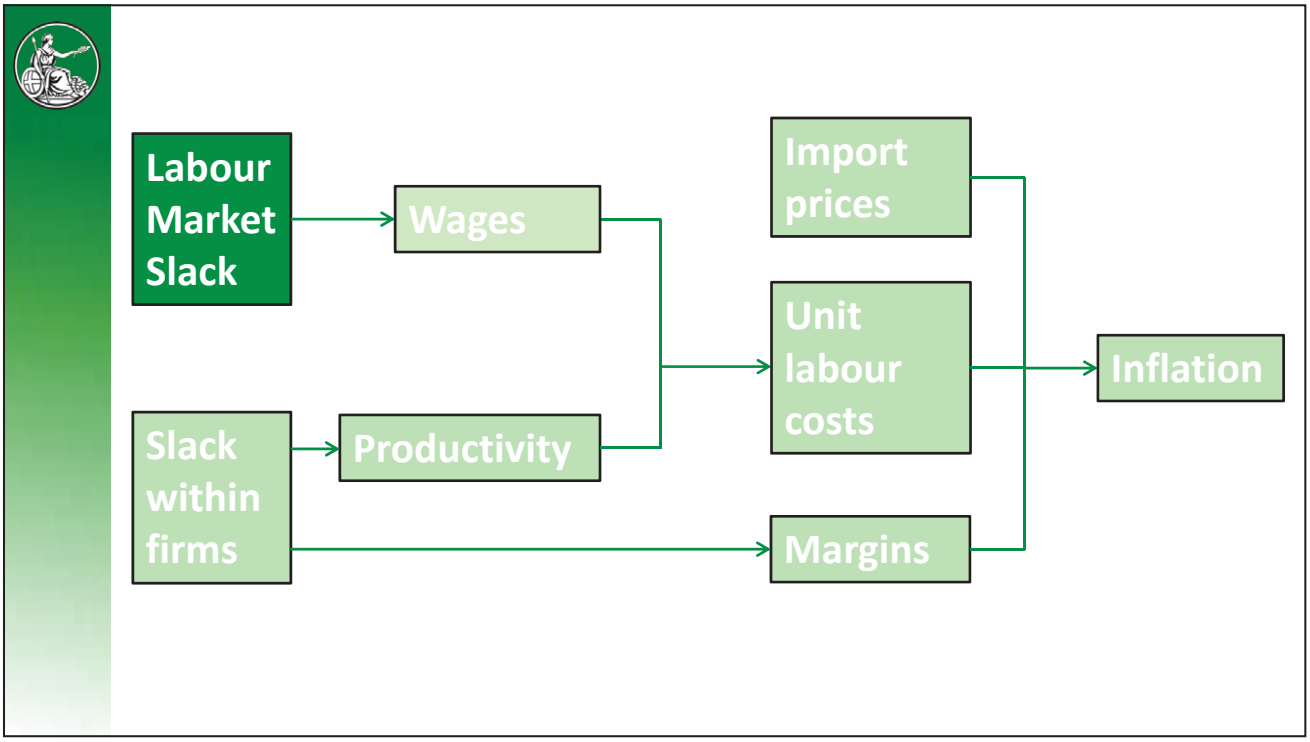


- May *IR* forecast had inflation picking up to target by mid 2017

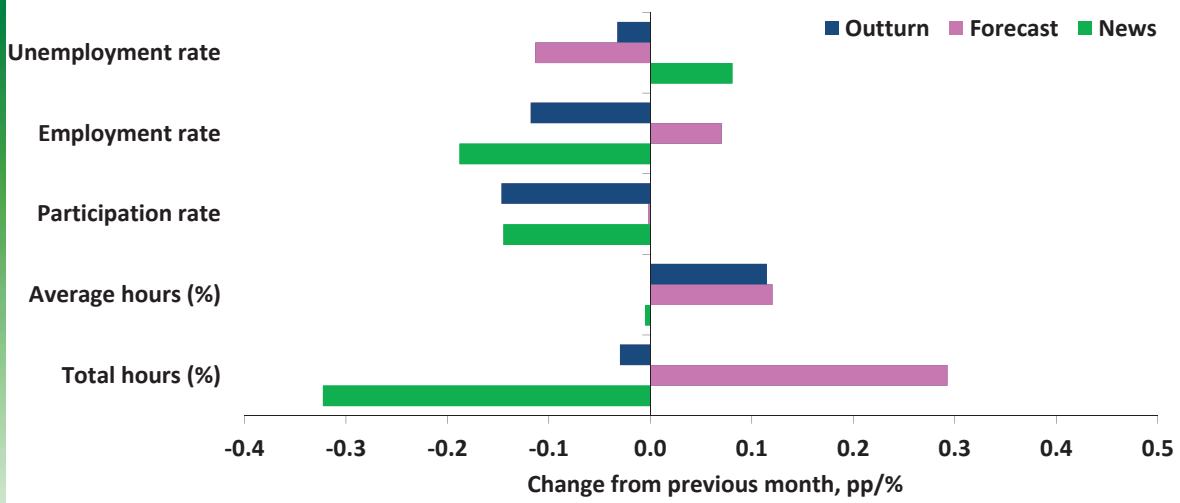
May *IR* Inflation decomposition



- **The key to this pick-up are wages and import prices**

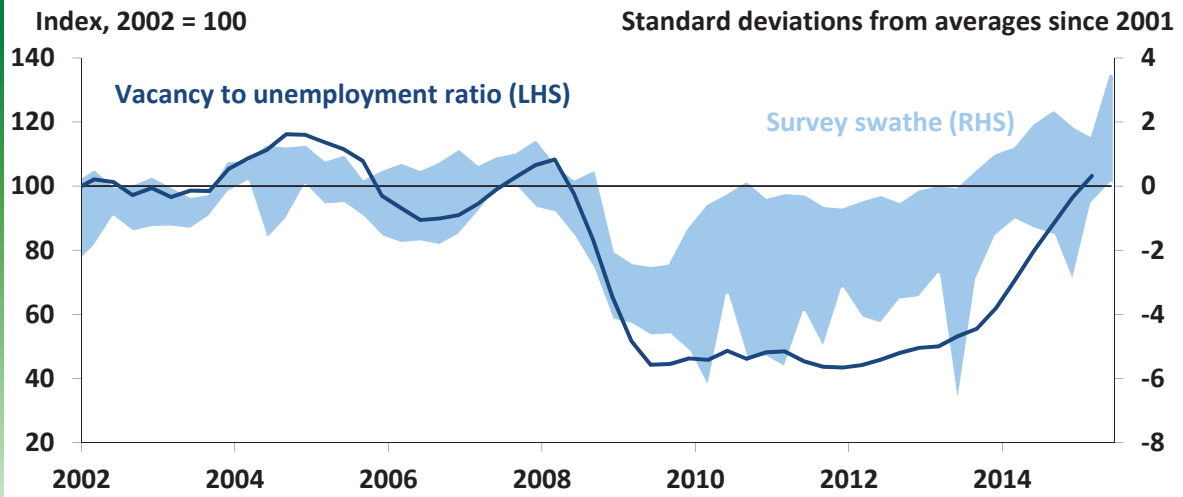

Labour Market Slack
Wages
Slack within firms
Productivity
Import prices
Unit labour costs
Margins
Inflation

News in labour market quantities

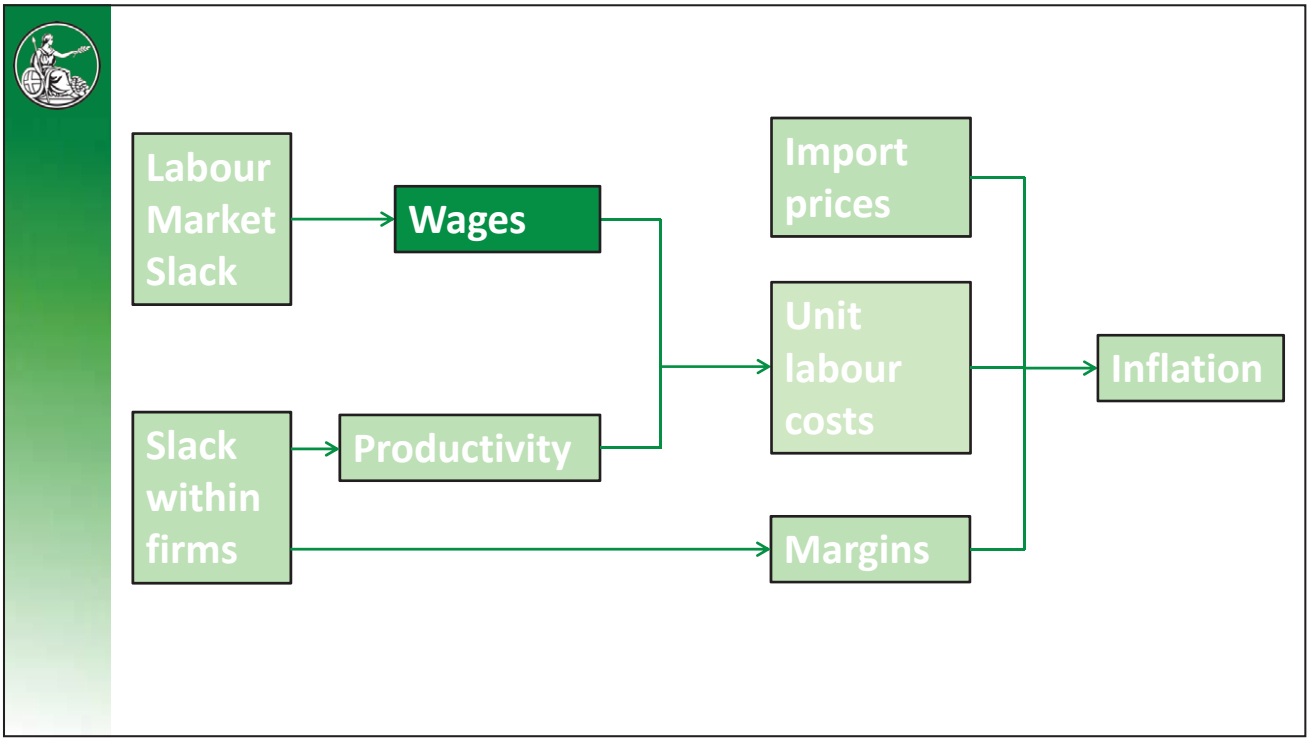


- Some downside news in total hours

Labour market tightness



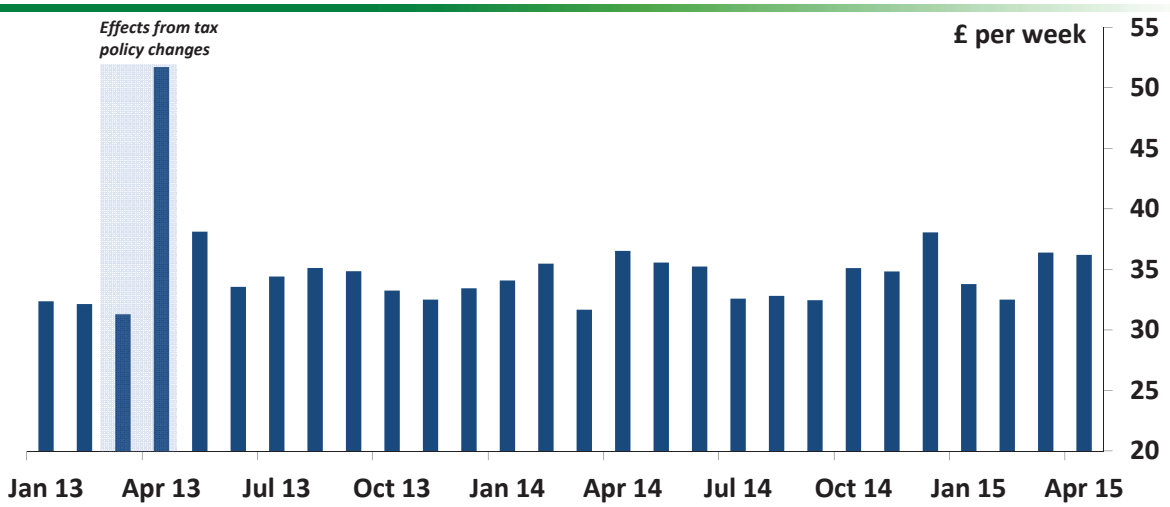
- Vacancy to unemployment ratio back to its pre-crisis average


Labour Market Slack
Wages
Slack within firms
Productivity
Import prices
Unit labour costs
Margins
Inflation

Total pay growth

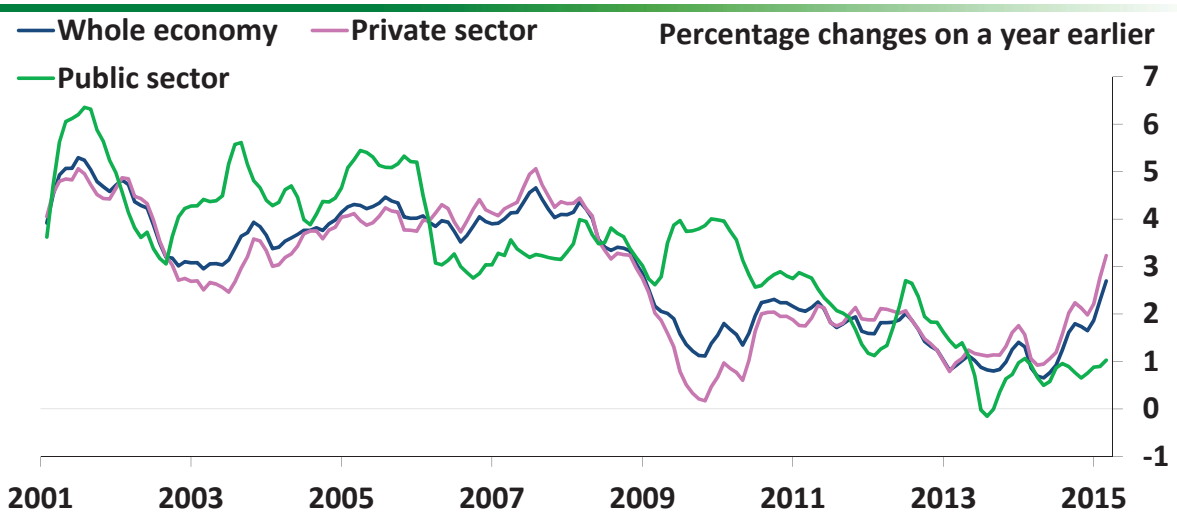
- **Chunky upside news on wage growth (0.7pp) …**

Private sector bonuses



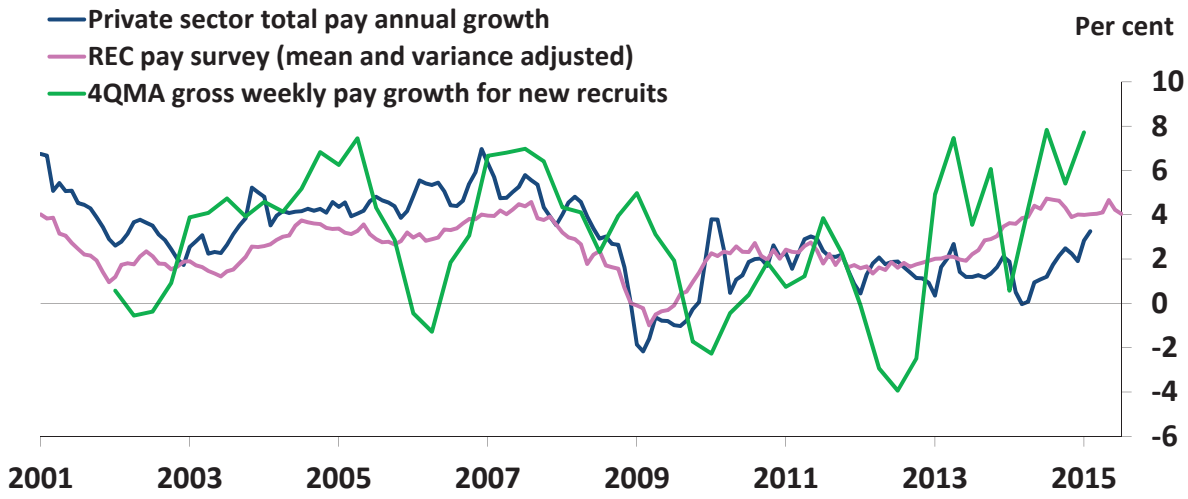
- … mainly reflecting news in bonuses
- But no obvious reason to unwind this news

Regular pay growth



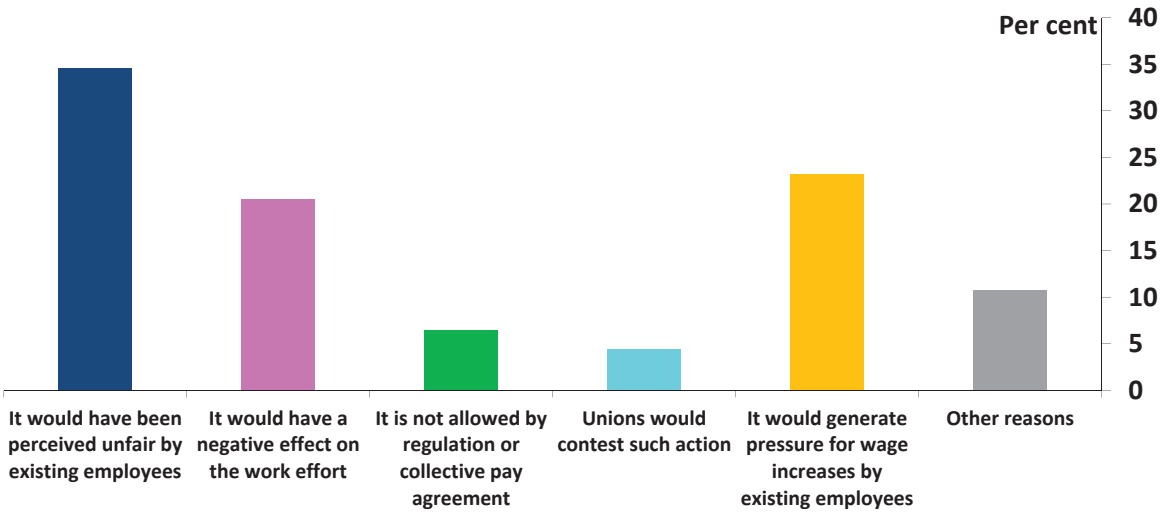
- Private-sector regular pay growth has been rising for a while and now stands at 3.2%

Pay growth for new recruits



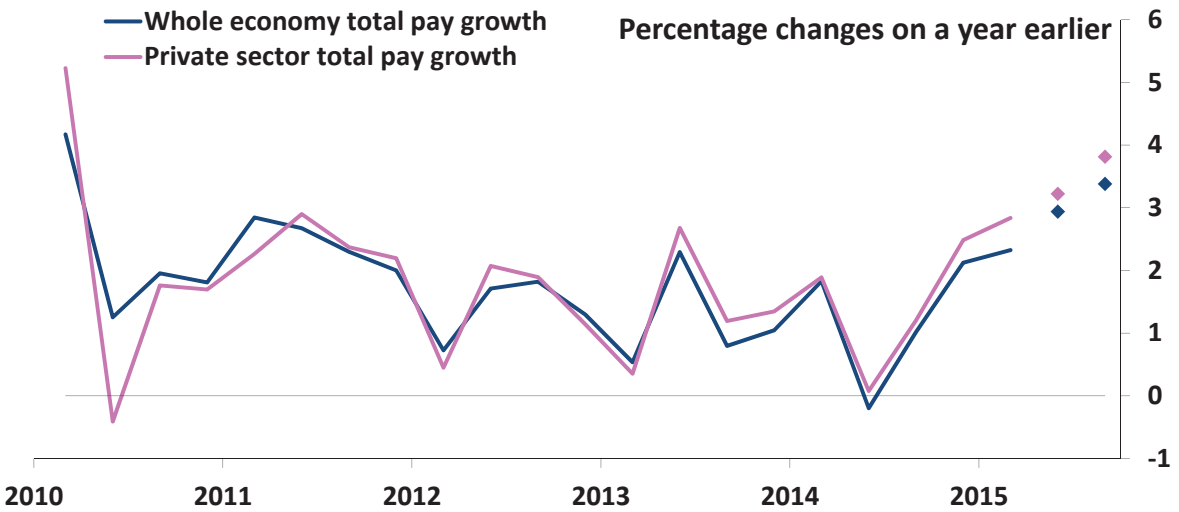
- Pay growth of new recruits remains strong

Why not pay new recruits more?



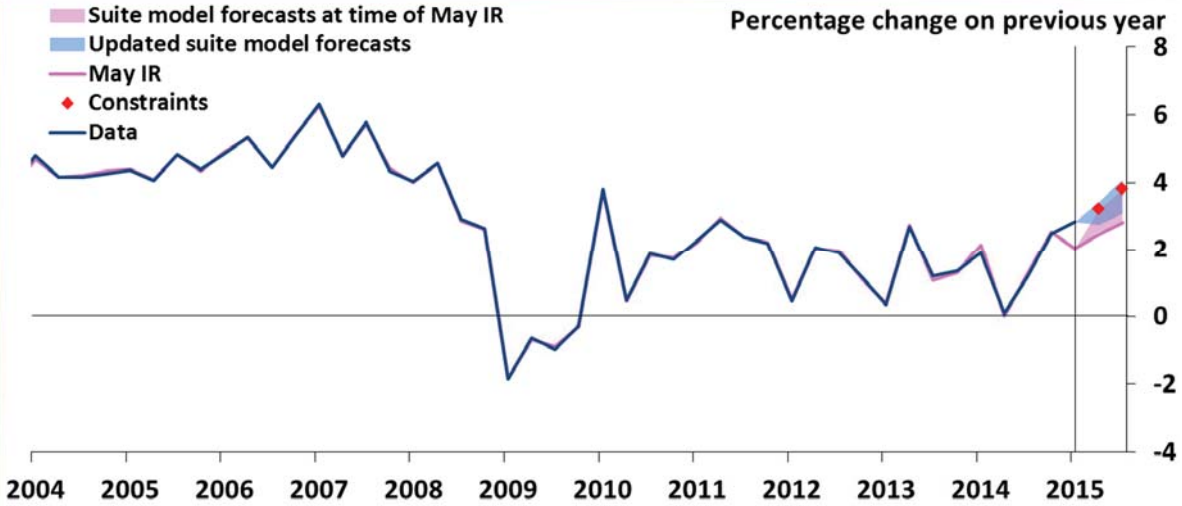
- 60% of firms set wages of new workers in line with existing workers

Total pay growth constraints

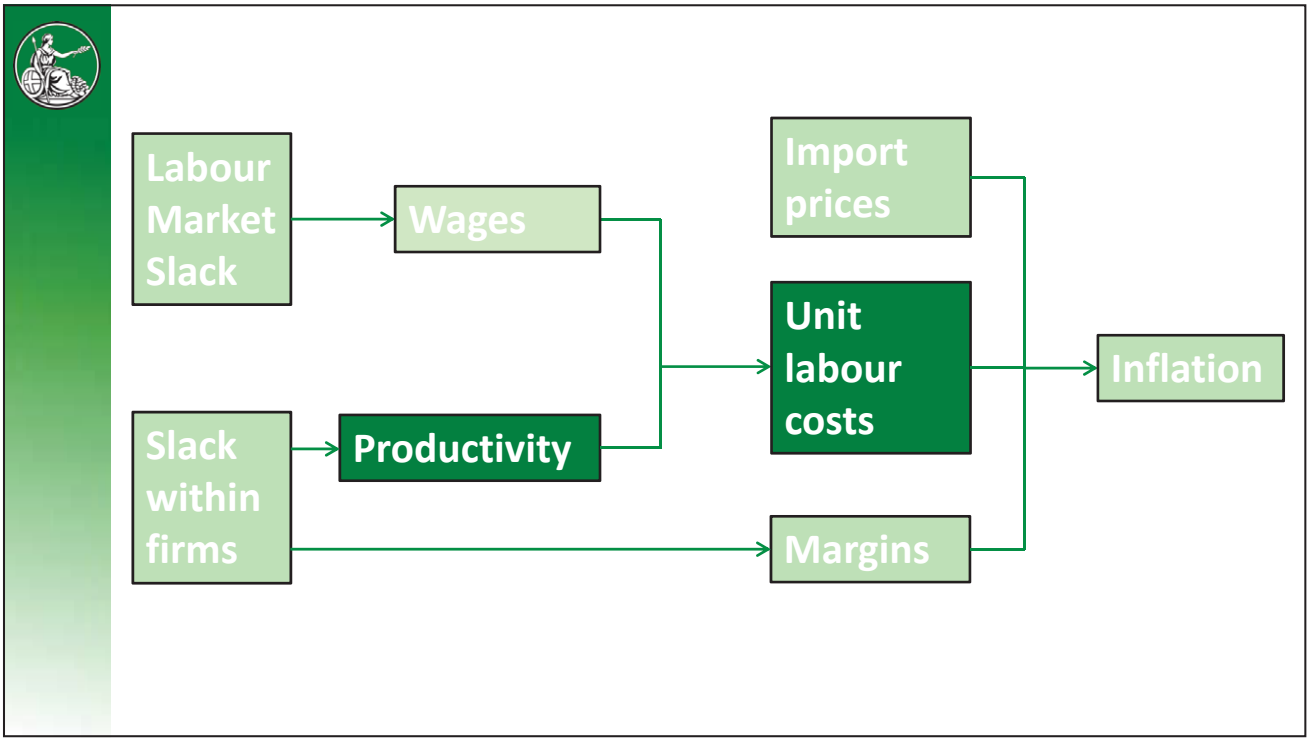


- Now expect whole economy total pay growth at 3.4% and private-sector pay growth at 3.8% in 2015 Q3

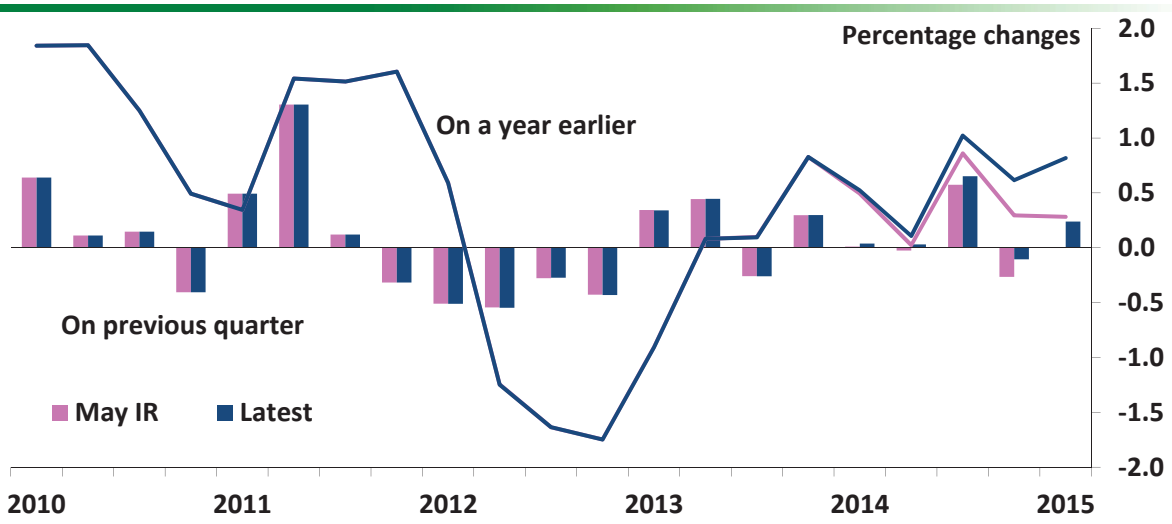
Private sector wage suite forecasts



- Although wage growth higher in near term …
- … not clear this implies higher wage growth in medium term

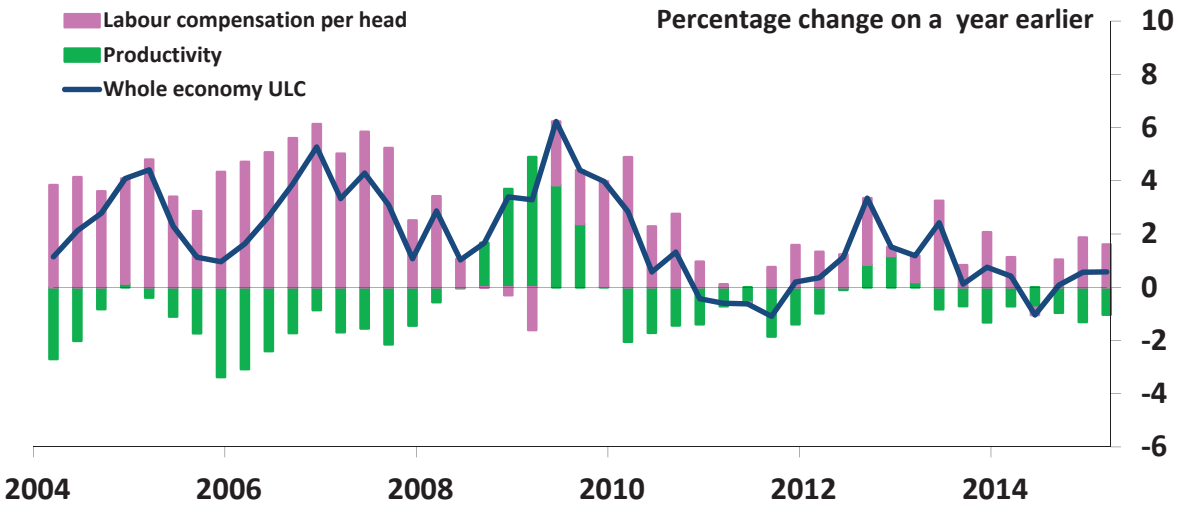

Labour Market Slack
Wages
Slack within firms
Productivity
Import prices
Unit labour costs
Margins
Inflation

Productivity growth



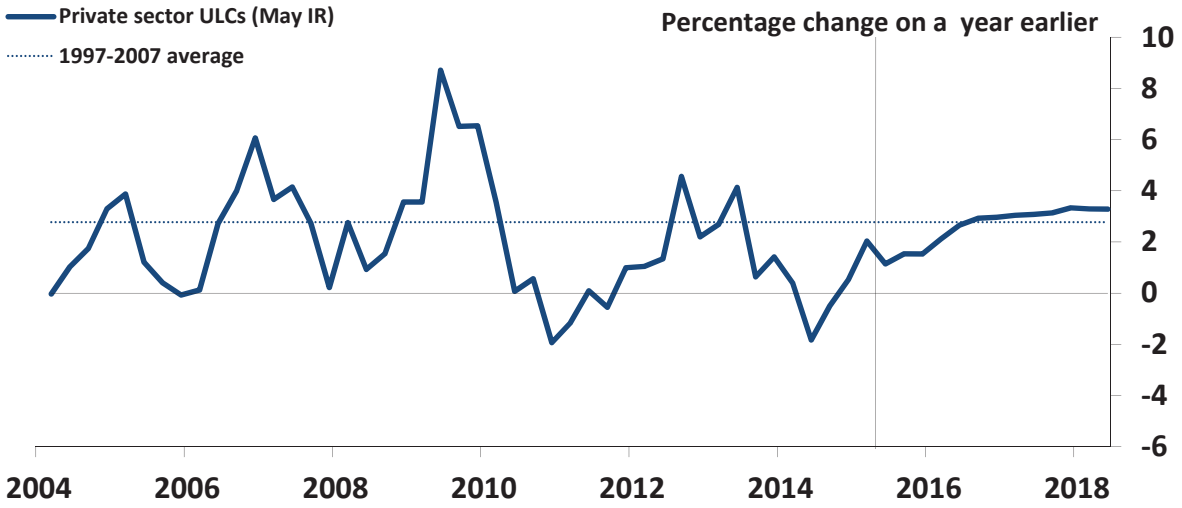
- **Productivity growth in year to Q1 revised up to 0.8%**

Annual growth in whole-economy ULCs



- **Whole-economy unit labour costs rose by 0.6% in year to Q1**

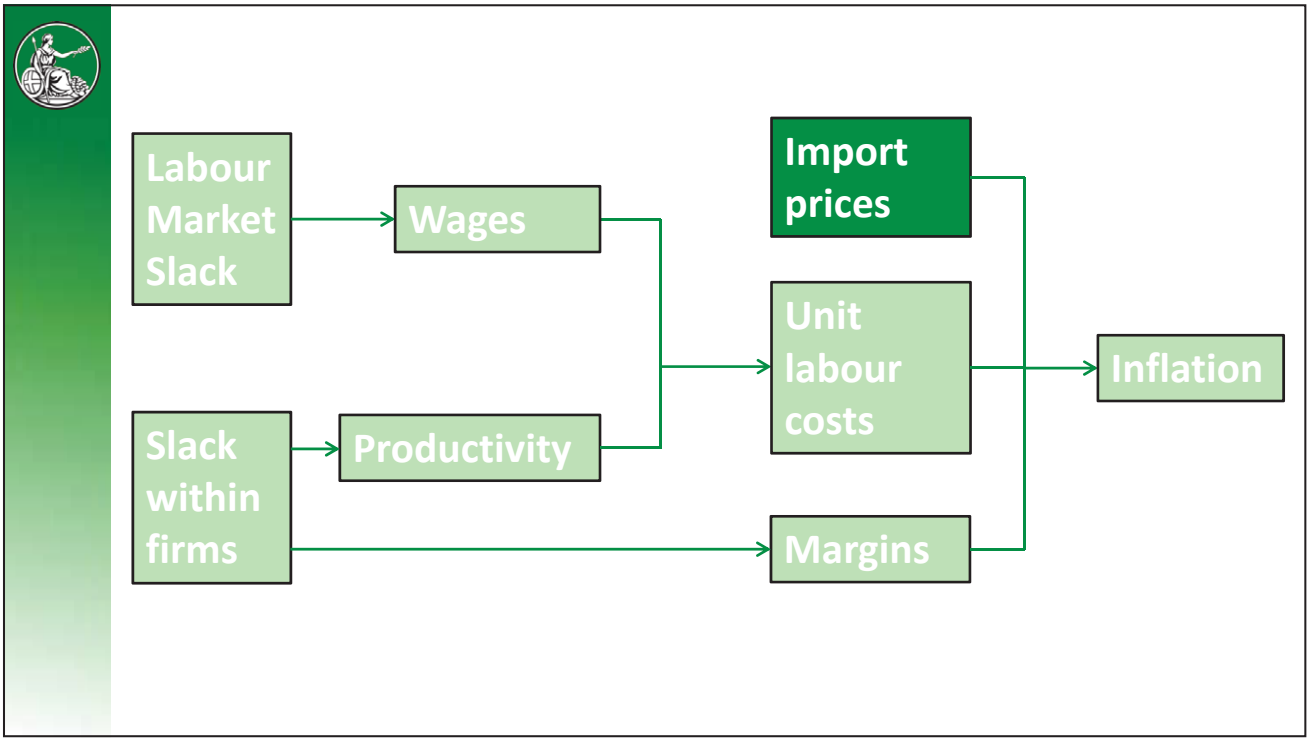
Annual growth in private sector ULCs



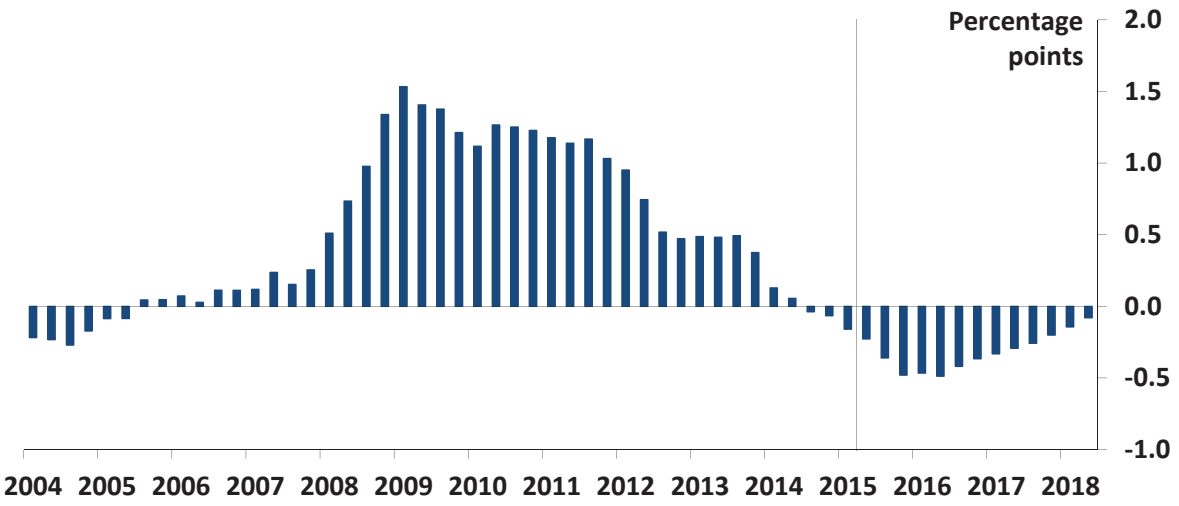
- In May *IR* forecast, private-sector unit labour costs pick up strongly as inflation returns to target

Wages and unit labour costs summary

- **Substantial news to headline pay growth**
  - Mainly, but not all, in bonuses
- **Have locked the news into our updated constraints**
- **In the medium term need ULC growth to pick up strongly**

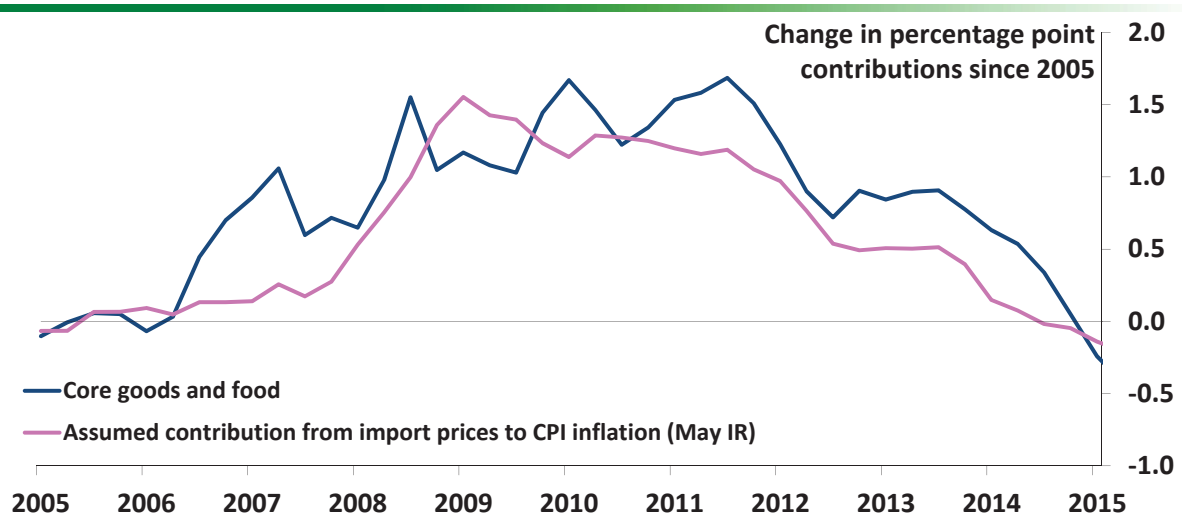

Labour Market Slack
Wages
Slack within firms
Productivity
Import prices
Unit labour costs
Margins
Inflation

Import price contributions over the forecast



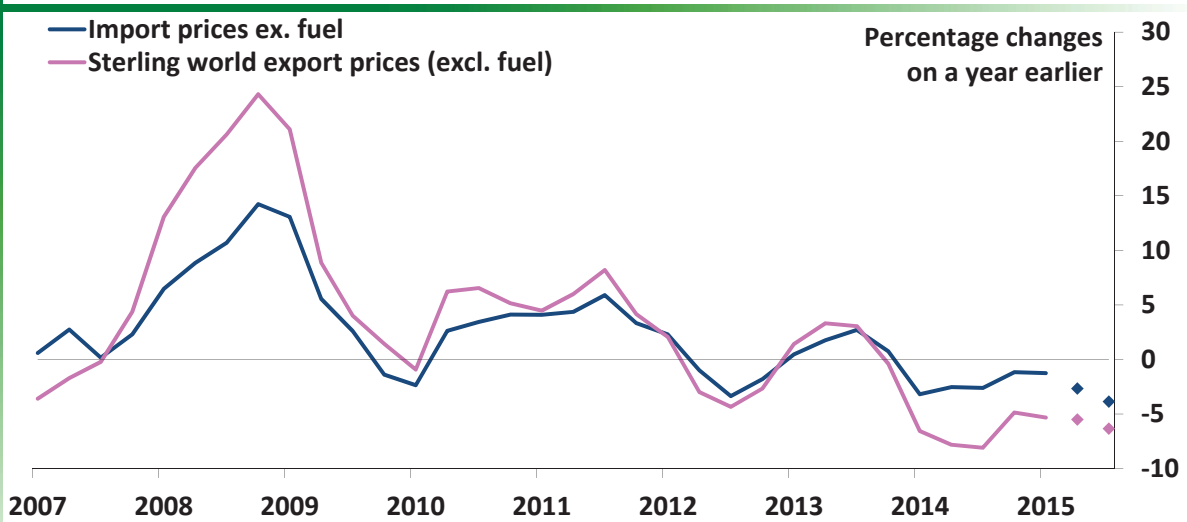
- Import prices drag down on inflation throughout the forecast

Import price contributions and outturns



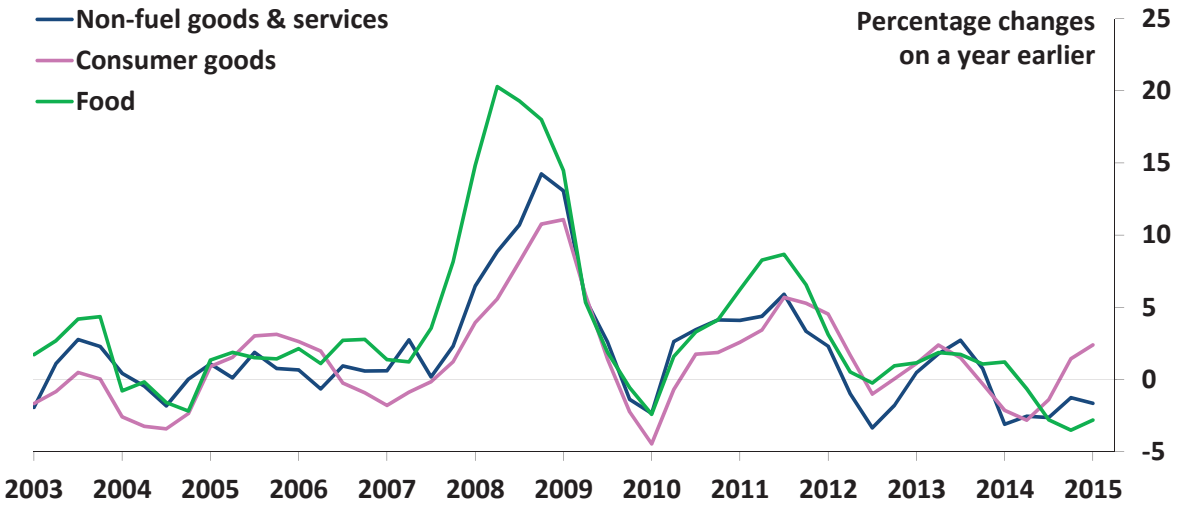
- Assumed import price effects in line with contribution of core goods and food

Sterling pass-through to import prices



- Appreciation has not had as large an effect on import prices as we might have expected

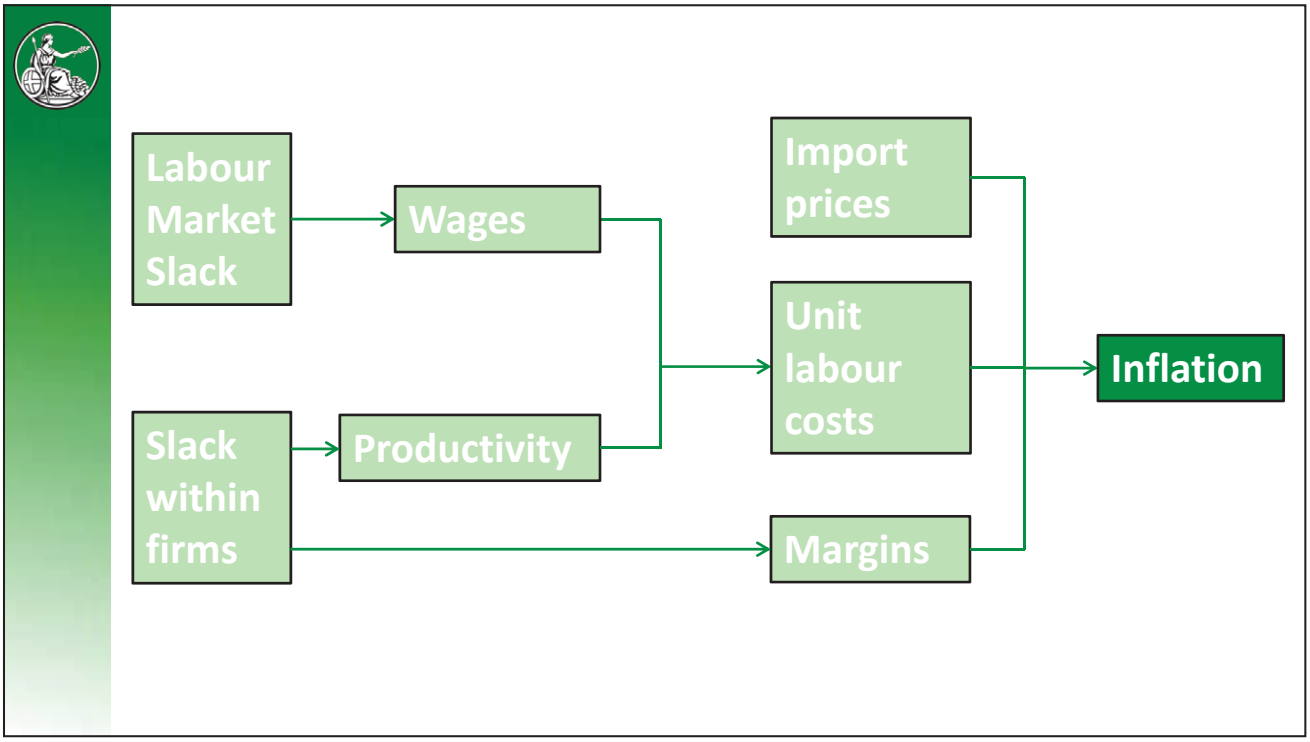
Disaggregate import deflators



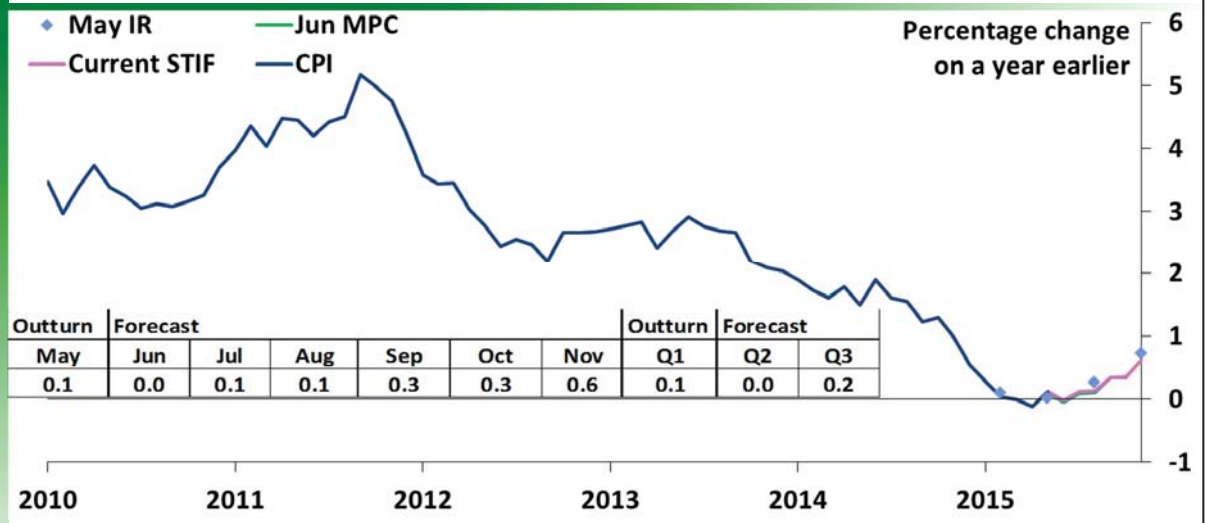
- Divergence between deflators is unusually large

Import prices summary

- Upside risk to inflation relative to our treatment of past import price moves …
- … but more downward pressure to come from the appreciation of sterling since May


Labour Market Slack
Wages
Slack within firms
Productivity
Import prices
Unit labour costs
Margins
Inflation

Short-Term Inflation Forecast

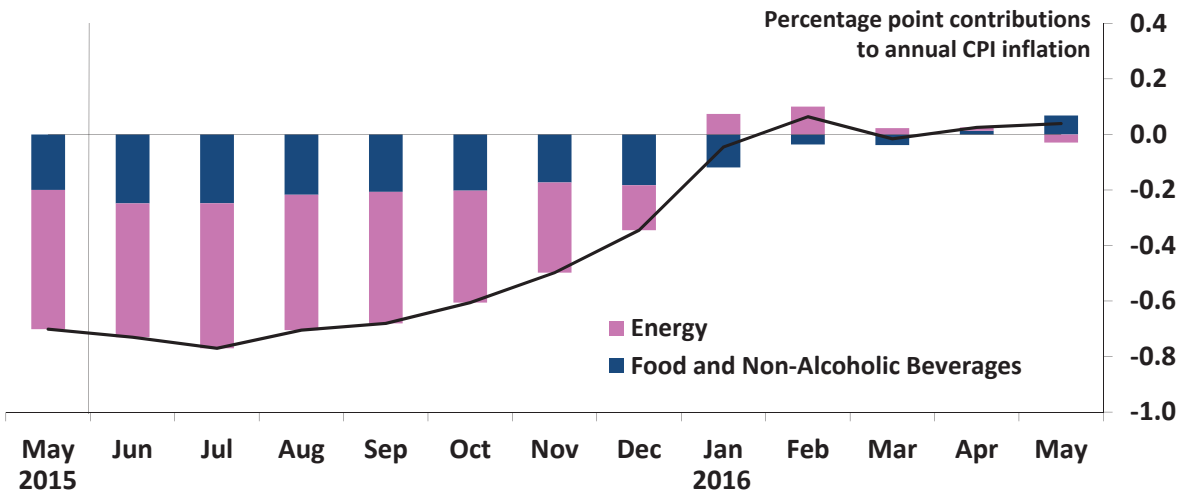


Outturn	Forecast						Outturn	Forecast	
May	Jun	Jul	Aug	Sep	Oct	Nov	Q1	Q2	Q3
0.1	0.0	0.1	0.1	0.3	0.3	0.6	0.1	0.0	0.2

- No news in the STIF
- Forecasts based on supply chain pressures in line (See note)

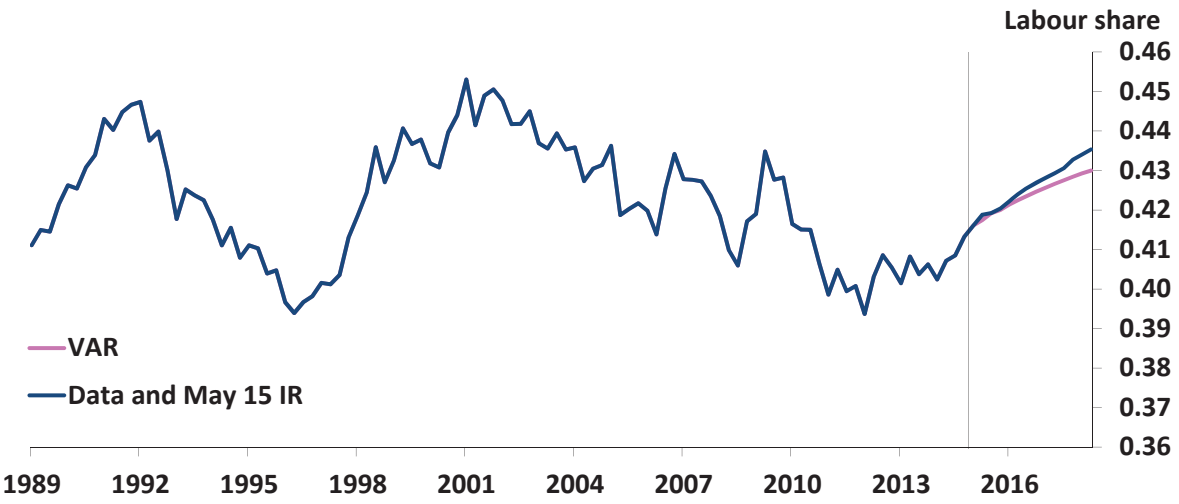
29

Contributions of Food and Energy



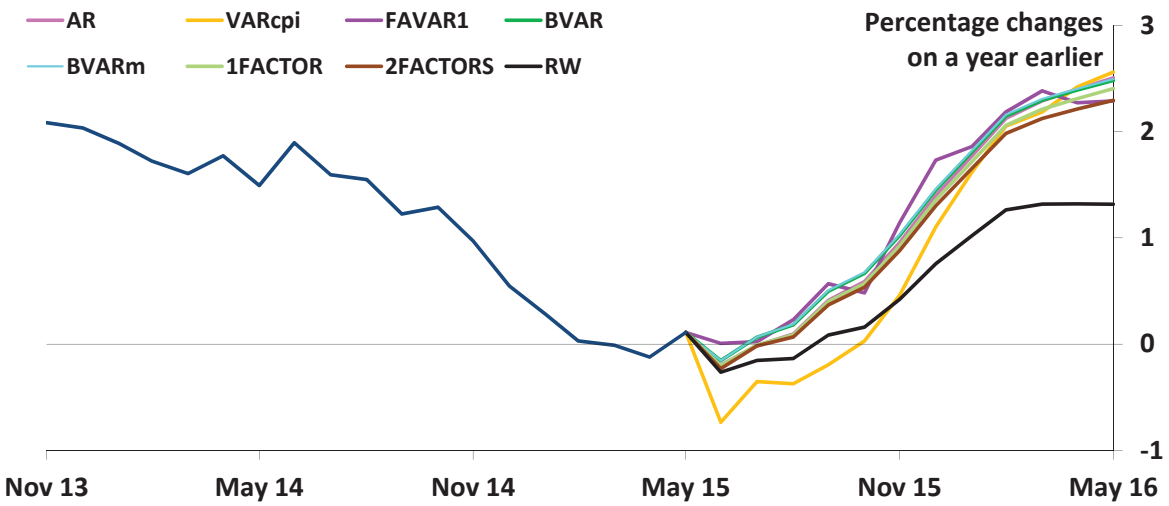
- Last year's food and energy price falls dropping out of the annual figure imply a 0.7pp pick up in CPI inflation

Labour share over the forecast



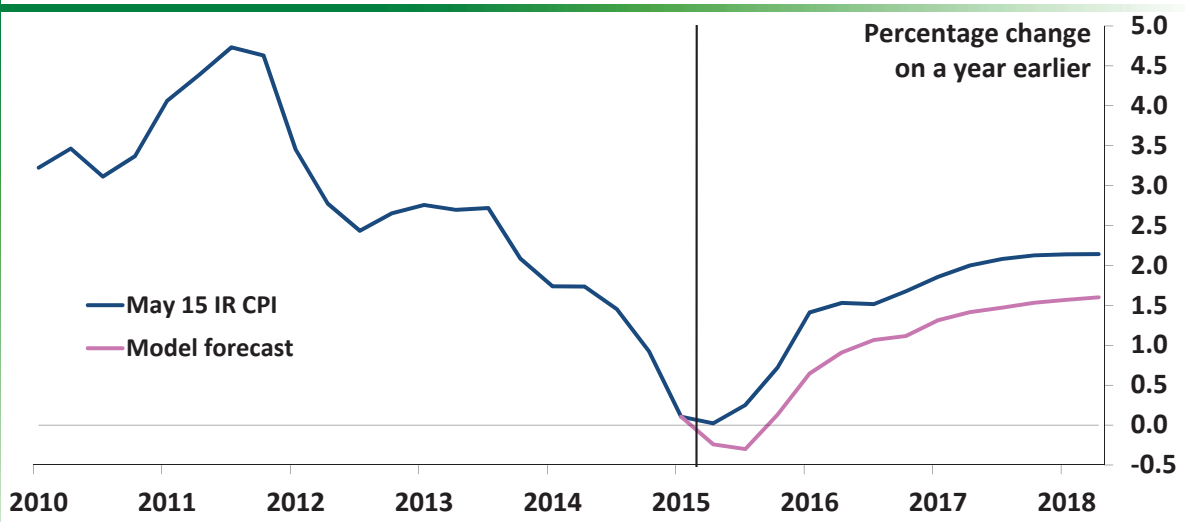
- Labour share (of gross output) expected to rise strongly as inflation rises back to target

Statistical suite projections



- Statistical suite models suggest quick pick up in inflation to target

VECM forecast



- VECM forecast lower than May IR on account of real wage being low relative to long-run equilibrium

Summary

- **How confident are we that inflation will pick up to target within two years?**
  - Reasonably, but there are risks on both sides
- **Wages need to pick up strongly**
  - Recent strength supportive of this
- **Import prices dragging down on inflation**
  - Risks on both sides

END

6: Agents' Update

Agents' Update

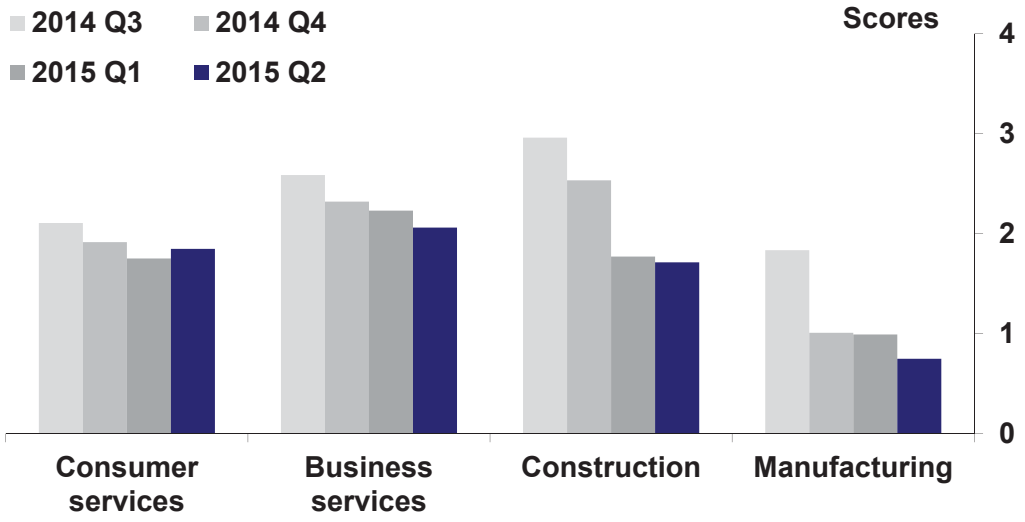
2nd July 2015

Agency for the West Midlands
Inflation Report & Agency Intelligence Division

Outline

1. Quarterly output
2. Labour market

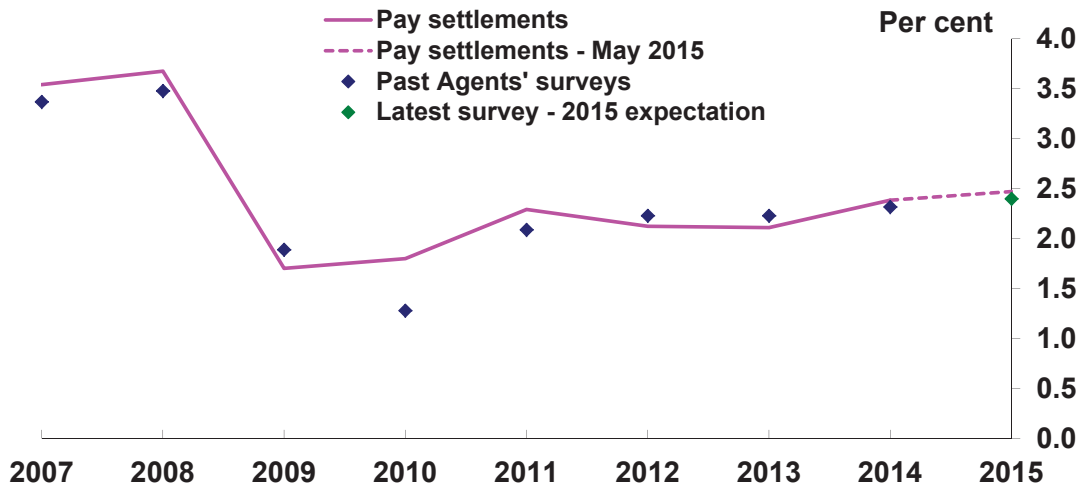
Agents' Output Growth Scores: Q-o-Q



- Stabilisation and slight softening of growth in H1

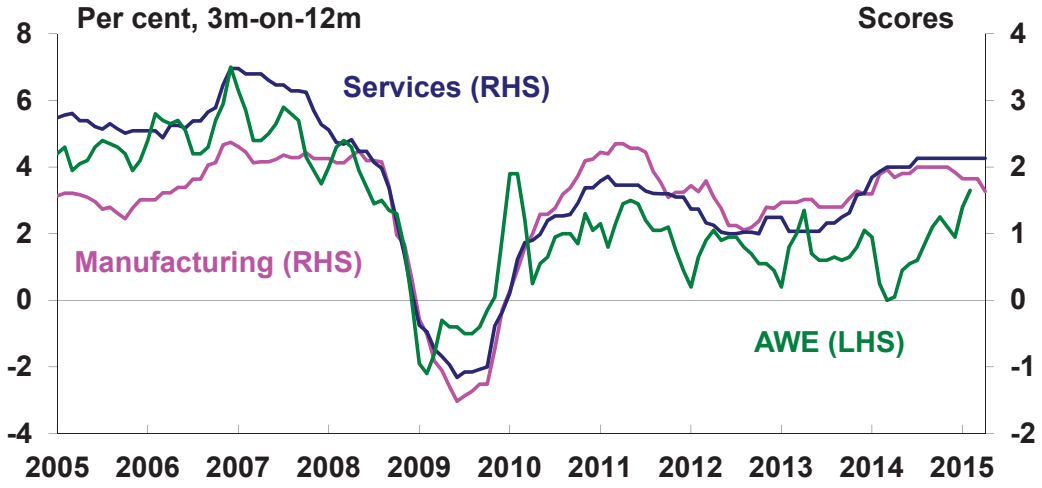
Labour Market Update

Agents' January Pay Survey



- Pay settlements were expected to be slightly higher in 2015

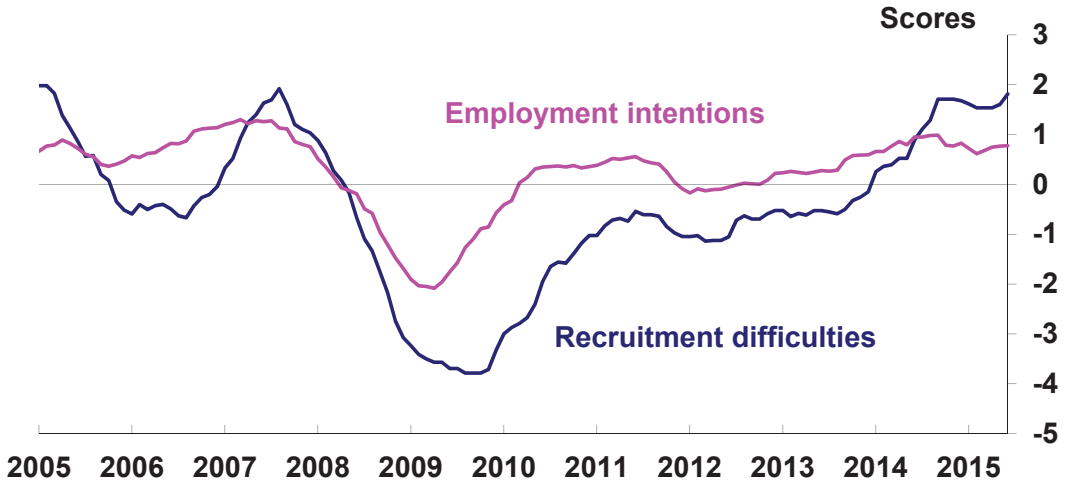
Agents' scores and AWE data



- Narrative of slow upward labour cost growth intact in Agents' scores

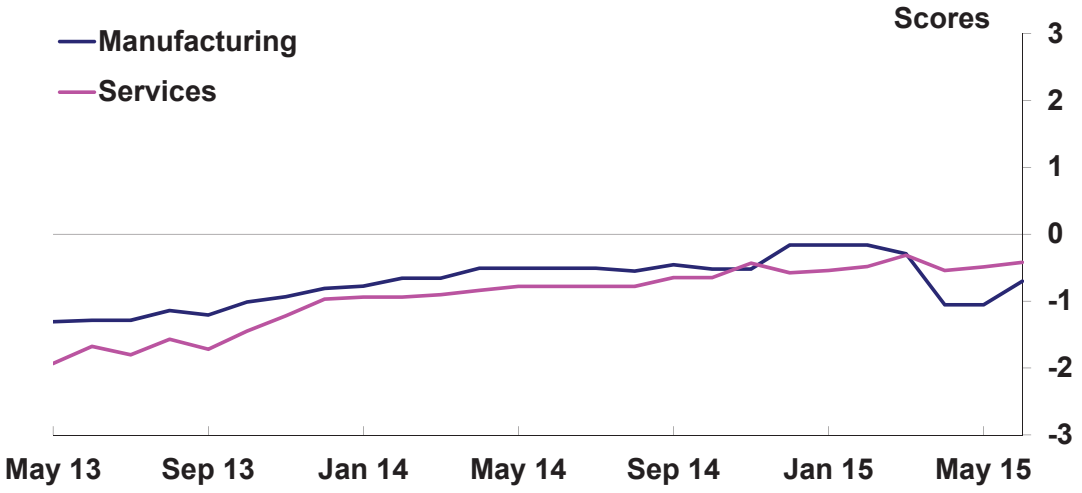
See

Labour market tightness



- Recruitment difficulties at highest level since August 2007
- Employment intentions recovering

Competitive pressure on margins



- Contacts still working to return margins to normal, sustainable levels
- Affordability weighing down on wage settlements

Remedies & risks for wage pressure

- Target salary increases on key skill sets
- Skew recruitment towards entry-level staff
- Increase automation, productivity, near and off-shoring
- Make on-going use of migrant labour
- Accept increasing participation of older staff
- (Low CPI inflation?)

Summary

- Output growth softened slightly in H1 2015
- Labour cost growth is inching up as the labour market tightens
- But, as yet, no expectation of any sharp rise in labour costs over the coming year
- Rising recruitment difficulties off-set so far by need to protect and increase margins

02/07/2015

/2015

02/07/2015

02/07/2015