Inflation Report

August 2001

The *Inflation Report* is produced quarterly by Bank staff under the guidance of the members of the Monetary Policy Committee. It serves two purposes. First, its preparation provides a comprehensive and forward-looking framework for discussion among MPC members as an aid to our decision making. Second, its publication allows us to share our thinking and explain the reasons for our decisions to those whom they affect.

Although not every member will agree with every assumption on which our projections are based, the fan charts represent the MPC's best collective judgment about the most likely paths for inflation and output, and the uncertainties surrounding those central projections.

This *Report* has been prepared and published by the Bank of England in accordance with section 18 of the Bank of England Act 1998.

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Mervyn King, Deputy Governor responsible for monetary policy
David Clementi, Deputy Governor responsible for financial stability
Christopher Allsopp
Kate Barker
Charles Bean
Stephen Nickell
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The Overview of this *Inflation Report* is available on the Bank's web site at www.bankofengland.co.uk/inflationreport/infrep.htm The entire *Report* is available in PDF format at www.bankofengland.co.uk/inflationrep/index.html

Overview

Economic activity in the rest of the world has continued to weaken since the May *Inflation Report*. Growth in the United Kingdom has slowed further below trend in the wake of the global slowdown, although domestic demand, underpinned by strong private and public consumption, has held up. The juxtaposition of weakening global conditions and firm domestic demand has intensified divergences within the economy, with output declining in the internationally exposed sectors, but continuing to grow steadily in the more sheltered sectors. The labour market remains tight and unemployment has continued to fall. The underlying rate of earnings growth appears to have edged up a little. RPIX inflation has picked up to near the $2^1/_2$% target, although the increase in part reflects special factors.

Global economic prospects continue to depend heavily on developments in the United States, where output in the second quarter rose by 0.2%, close to that projected by the MPC at the time of the May *Report*. The Federal Reserve has lowered official interest rates by a further 75 basis points and, together with cuts in personal taxation, the relaxation in policy should foster a gentle pick-up in growth towards the end of this year. Prospects elsewhere have, though, worsened since May. The decline in US demand for high-technology capital goods has had a larger-than-expected impact on production elsewhere, especially in Asia, and there have also been steep falls in the demand for high-technology equipment in other countries. But more importantly for the United Kingdom, domestic demand in the euro area—and particularly in Germany—has softened as increased consumer price inflation has temporarily eroded real income growth. This has compounded the effects of the slowdown in external demand. Growth in the euro area is likely to remain sluggish in the near future before recovering next year.

Oil prices are slightly lower than in May, although futures prices are little changed, while non-oil commodity prices have also weakened. Continuing the trends seen earlier in the year, sterling has risen further against the euro while depreciating against the dollar. The starting-point for the effective exchange rate profile in the Committee's projections is around 1% higher at 106.7.

Consumer spending in the first quarter is reported to have risen by 0.6%, rather less than might have been expected from other indicators of household demand. But a quarterly rise of 1.6% in retail sales volumes in Q2, together with robust growth in household money and credit, and in house prices—all of which are growing at annual rates close to 10%—points to strong consumption growth in the second quarter. Rising financial wealth and steady growth in real disposable income have sustained strong consumption growth in recent years, but the fall in the value of equities and moderating real income growth suggest that spending should decelerate somewhat going forward. Public consumption grew by 0.8% in the first quarter and is set to continue to grow faster than potential output over the medium term.

Recent movements in investment have been difficult to interpret. Business fixed investment is reported to have fallen by 5% in the first quarter, reversing the steep rise seen at the end of last year and considerably weaker than expected in May. Though some decline in investment spending was to be expected following the deterioration in global economic prospects, it is likely that some of these quarter-to-quarter movements will prove to be erratic. However, deteriorating business confidence, declining profitability and decelerating corporate bank borrowing suggest that the contribution of business investment to growth is likely to remain weak. Stockbuilding is reported to have added almost 1 percentage point to first-quarter GDP growth, but part of this was due to the statistical alignment adjustment. Most of the remainder is likely to have been unplanned and inventory accumulation is likely subsequently to drop back.

The juxtaposition of firm growth in domestic demand and slowing external demand meant that import growth outstripped that of exports in the first quarter so that net trade reduced GDP growth by 0.4 percentage points. The negative contribution from net trade is likely to have been repeated in the second quarter.

Output is provisionally estimated by the ONS to have risen by just 0.3% in the second quarter, down from 0.5% in the first quarter. Although some adverse impact from foot-and-mouth disease was expected, growth was nevertheless a little weaker than projected in the May *Report*. The overall figure conceals marked sectoral imbalances that mirror the dichotomy between firm domestic demand and slowing external demand. Services slowed, but still recorded growth of 0.6%. By contrast, monthly data for April and May suggest that manufacturing, which fell during the first quarter, is likely to have contracted by around 2%. The bulk of this decline is due to a sharp downturn in the previously dynamic ICT sector.

The labour market has tightened a little despite output growth moderating to below trend. Employment has continued to grow somewhat faster than the population of working age and inactivity has also risen. The unemployment rate has consequently continued to fall, reaching 4.9% on the LFS measure in the three months to May. Vacancies remain high, although survey-based measures of labour shortage have eased somewhat. Employment intentions have also moderated, although they are still positive overall. That suggests that employment growth may slow.

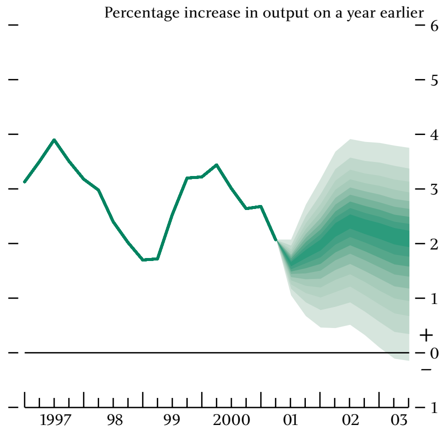
Wage settlements and regular pay growth have edged up a little reflecting the tight labour market, though headline average earnings growth has slipped back as the effect of unusual bonus payments unwinds. And productivity growth has moderated as output growth has slowed, raising unit labour costs. But other inflationary pressures in the supply chain have eased since the May *Report* as commodity prices have weakened. RPIX inflation has been somewhat higher than expected, reaching 2.4% in May and June. The increase was in part a consequence of special factors, including an unusual increase in food prices that is unlikely to persist.

Chart 1 shows the MPC's assessment of the outlook for GDP growth, on the benchmark assumption that the official interest rate remains at 5% over the forecast period. In the central projection, the impact of the global slowdown, subdued investment and a gentle recovery in the saving ratio keep the annual growth rate somewhat below trend for the rest of this year. Thereafter, recovery in the world economy, strong public consumption and an end to inventory correction lead the growth rate to pick up modestly to near trend before moderating slightly. The overall outlook for growth is a little weaker than in the May *Report*. The domestic imbalances are corrected relatively slowly in this projection.

Chart 2 shows the corresponding outlook for RPIX inflation. In the central projection, inflation slips back to around 2% early next year and then edges back up again towards the target at the forecast horizon. Inflation is likely to remain somewhat volatile from month to month due to the unwinding of various special factors. However, inflationary pressures are generally a little weaker than in May. Some members prefer alternative assumptions about supply-side developments and international prospects that generate an inflation profile that is either slightly higher or up to $^1/_2$% lower at the forecast horizon.

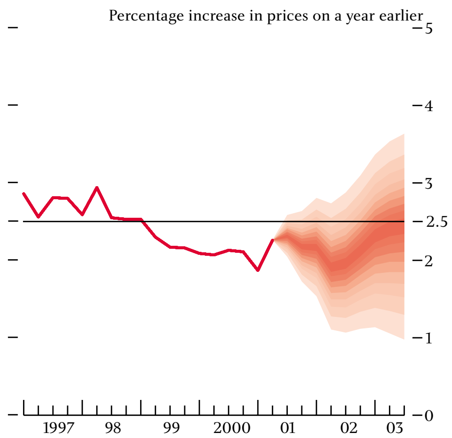
Considerable uncertainties surround these projections. The possibility that the slowdown in the international economy may be deeper or more prolonged remains a downside risk. And there is also the threat of a sharper rise in the personal saving ratio and more pronounced corporate retrenchment. Finally the exchange rate could fall sharply, possibly triggered by the

Chart 1
Current GDP projection based on constant nominal interest rates at 5%



The fan chart depicting the probability distribution for output growth is rather like a contour map. At any given point during the forecast period, the depth of shading represents the height of the probability density function over a range of outcomes for output. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of the probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes.

Chart 2
Current RPIX inflation projection based on constant nominal interest rates at 5%



The fan chart depicting the probability distribution for inflation is rather like a contour map. At any given point during the forecast period, the depth of shading represents the height of the probability density function over a range of outcomes for inflation. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of the probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes.

crystallisation of the risks to the world economy or to domestic demand. In the Committee's judgment, the overall risks to growth continue to be on the downside. But a fall in the exchange rate would raise inflationary pressures and so makes the overall risks to inflation rather more evenly balanced. Again some members take somewhat differing views on the likelihood of these risks materialising and their impact.

The MPC maintained the Bank's official interest rate at 5.25% at its June and July meetings in the light of conflicting news on external and domestic demand. At its August meeting the Committee noted both the reduction in medium-term inflationary pressures and the balance of risks incorporated in its projections. In discussing the appropriate policy response, the Committee reflected on the danger of over-stimulating domestic demand, thus exacerbating the imbalances. But it also noted that delaying any policy response risked deepening the downturn and pushing inflation below target. In the light of all these considerations the Committee voted in favour of a modest reduction in the official interest rate of 25 basis points in order to keep inflation on track to meet the target in the medium term.

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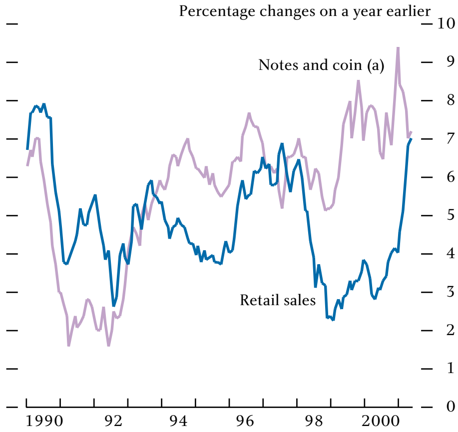
Money and asset prices 1

Chart 1.1
Narrow money and retail sales values



Sources: ONS and Bank of England.

(a) Adjusted in 2000 and 2001 for Y2K effects and winter fuel payments.

Table 1.A
Growth rates of notes and coin, M4 and M4 lending

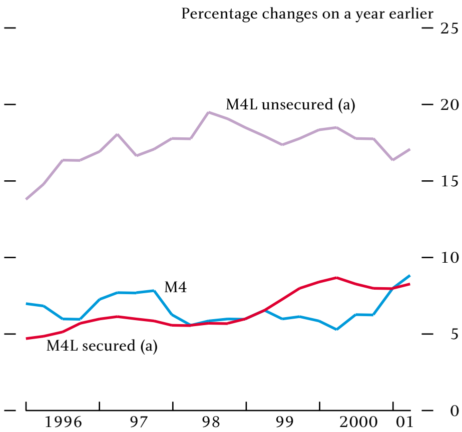
Percentage changes on a year earlier

	2000				2001	
	Q1	Q2	Q3	Q4	Q1	Q2
Notes and coin	8.4	7.8	8.7	4.5	8.2	7.1
M4	5.4	6.9	9.3	8.4	8.4	7.6
M4 lending (a)	10.8	11.5	13.2	12.5	11.9	11.4

Source: Bank of England.

(a) Excluding the effects of securitisations.

Chart 1.2
Growth rates of household M4 and M4L—secured and unsecured



Source: Bank of England.

(a) Excluding the effects of securitisations.

Developments in money and credit indicators during 2001 Q2 reflected the more general imbalances in the UK economy that are a recurring theme throughout this *Report*. Household money and borrowing growth rose, while corporate money and borrowing growth slowed. The latter outweighed the former so that growth of overall money and credit aggregates eased slightly. Asset prices echoed the imbalances theme with further weakness of equity prices accompanied by strong property prices. Sterling is slightly higher than at the time of the May *Report*, but it has experienced temporary episodes of both strength and weakness during the quarter. Prior to the MPC's August meeting, market expectations of nominal interest rates for the next few years were higher than in May, but were broadly unchanged over longer horizons. The Bank's repo rate was unchanged in June and July, but it was cut by 25 basis points to 5% in August.

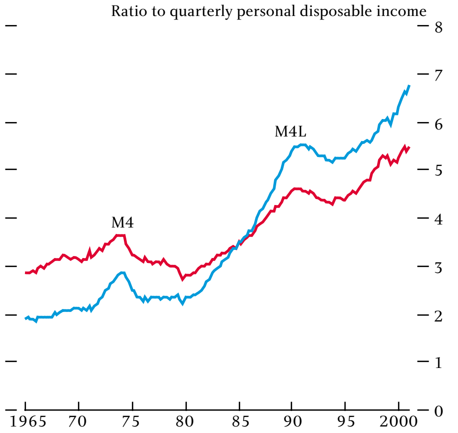
1.1 Money and credit

Aggregate money and credit

Notes and coin growth slowed slightly in Q2, but adjusting for the abnormal expansion in the run-up to the year-end in 1999 (and the echo effect a year later) it has generally been around 7%–8% for the past three years (see Chart 1.1). There has been a steady decline over the recent past in the velocity of circulation of notes and coin (measured as the ratio of retail sales values to the stock of notes and coin). This is partly due to lower nominal interest rates associated with lower inflation expectations reducing the opportunity cost of holding cash. However, the recent surge in retail sales growth accompanied by relatively steady growth rates of notes and coin may be the first sign that this declining velocity trend is over.

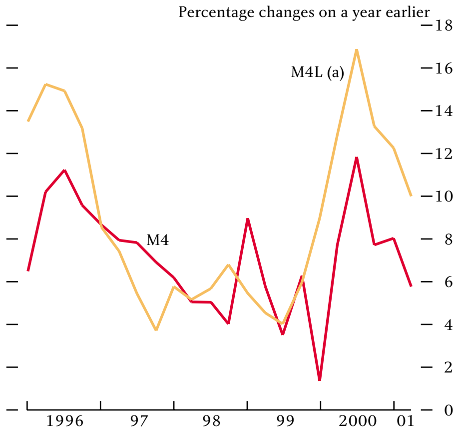
Broad money and credit growth both slowed in Q2, as shown in Table 1.A. But a moderate slowdown in both aggregates concealed substantial differences in movements of some of their components. In particular, there were notable divergences in money holding and borrowing behaviour between households and companies.

Chart 1.3
Ratio of household M4 and M4L to disposable income



Sources: ONS and Bank of England.

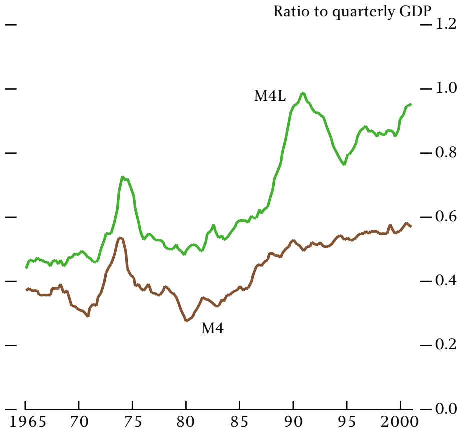
Chart 1.4
Growth rates of PNFCs' M4 and M4L



Source: Bank of England.

(a) Excluding the effects of securitisations.

Chart 1.5
Ratio of PNFCs' M4 and M4L to GDP



Sources: ONS and Bank of England.

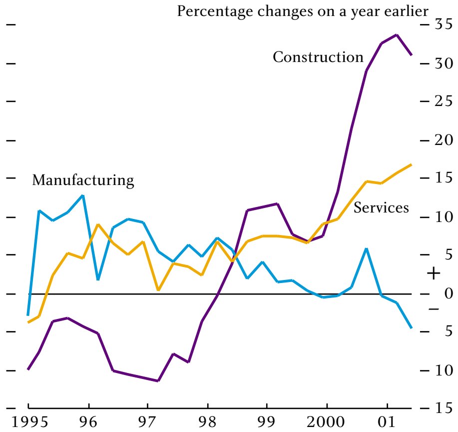
Household sector

Growth rates of household sector M4 and M4 lending (M4L) were strong in Q2 (see Chart 1.2), but the causes and implications of the movements in money and credit aggregates are not the same. Holdings of M4 were 8.8% higher in Q2 compared with a year earlier, up sharply from average growth rates of around 6% in 2000. One possible reason for this strong growth is that households have substituted into deposits as a safe asset at a time when equity markets have been weak. This is supported by evidence suggesting that retail unit trust sales were weak in the first half of this year. Money acquired for portfolio reasons could be used to finance spending in future, but equally it could lead to purchases of equities and other risky assets once prospects improve. It is also possible that households are building up money balances in order to finance future spending. So the strength of household M4 could have positive implications for future consumption growth.

Lending to households remained strong in Q2. Annual household M4 lending growth rose to 9.7% in Q2 from 9.4% in Q1. After slowing in the second half of last year, M4 lending secured on housing picked up in Q2 to an annual growth rate of 8.1%, while unsecured M4 lending growth also rose slightly to 17%. Total lending to individuals, which includes data from non-bank specialist lenders that are not included in M4 lending, increased in the three months to the end of June at an annualised rate of 10.4%, the highest rate since 1990. The strength of household lending has been supported by the interest rate cuts in the first half of this year and will probably help to support consumer spending and house prices (discussed further below).

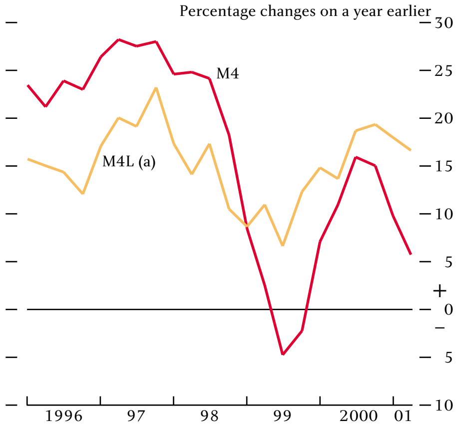
Chart 1.3 shows the stock of household M4 and M4 lending relative to personal disposable income. Both display an upward trend and both rose after the 'competition and credit control' reform in 1971 and the financial liberalisation of the early 1980s. In the 1960s and 1970s, households were net lenders to the banking system, but during the 1980s their borrowings increased substantially and by the end of the 1980s debt to the banking system exceeded deposits. During much of the 1990s the gap between deposits and debt remained broadly constant, but the stock of debt has increased more rapidly than deposits over the past three years. That raises questions about whether households have become too indebted, an issue that is addressed in the box on pages 6–7.

Chart 1.6
Industrial breakdown of growth in sterling bank lending



Source: Bank of England.

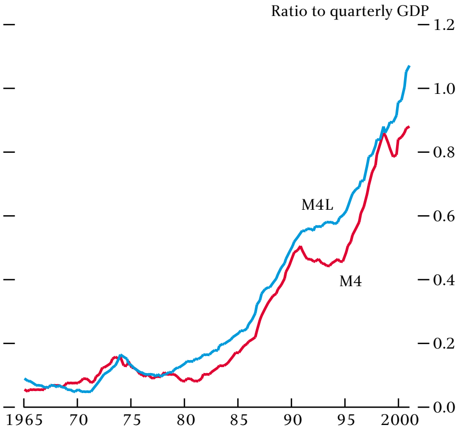
Chart 1.7
Growth rates of OFCs' M4 and M4L



Source: Bank of England.

(a) Excluding the effects of securitisations.

Chart 1.8
Ratio of OFCs' M4 and M4L to GDP



Sources: ONS and Bank of England.

Private non-financial corporations

In contrast to households, there has been an underlying slowdown in the deposits and bank borrowings of private non-financial corporations (PNFCs). Growth in PNFCs' broad money holdings slowed in Q2 to an annual rate of 6% from 8.1% in Q1 (see Chart 1.4). Indeed, it is likely that PNFCs' deposit growth would have slowed even more sharply but for some large, probably temporary, deposits. M4 lending to PNFCs also slowed, to an annual growth rate of 10% in Q2 from 12.2% in Q1. However, PNFCs' non-bank external finance was stronger in Q2 than Q1, boosted by the nearly £6 billion BT rights issue.

As Chart 1.5 shows, the stock of M4 lending to PNFCs has shown much greater variation over the past two decades than M4 deposits, though both lending and deposits increased rapidly in 1971–72 following the 'competition and credit control' reforms. There was a substantial surge in bank borrowing in the late 1980s, while deposits grew only moderately. The recent slowdown in corporate borrowing from banks may be linked to weaker economic prospects looking ahead and a reduction in investment plans. The box on pages 6–7 analyses whether corporate indebtedness is currently associated with financial distress. In broad terms, debt levels are historically high and capital gearing has increased (especially for the most indebted firms). Income gearing has risen, but remains below its previous peak.

A feature of bank lending to PNFCs, which is also indicative of the imbalances affecting the economy, is the contrasting behaviour of lending to different industrial sectors (see Chart 1.6). Growth of lending to the manufacturing sector was strong in the mid-1990s but it has fallen since and became negative in 2001. In contrast, lending to the service sector has grown at an increasing rate over the past two years. Even more notable has been the recent growth of bank lending to the construction sector. This was negative for several years up to 1997, but has grown especially rapidly since 2000 Q1.

Other financial corporations

Other financial corporations' (OFCs) M4 and M4 lending growth also slowed in Q2, though the latter was slowing from very high growth rates in recent quarters (see Chart 1.7). The slowdown of OFCs' borrowing shown here is consistent with some financial institutions such as securities dealers reducing their leveraged positions against a backdrop of falls in equity markets and the general slowdown in world activity. It is also consistent with leasing companies reducing their activity as investment slows. Deposits held by fund managers may have

The financial position of households and companies[1]

A common tendency in recent business cycles has been that, during a long upturn, households and firms may come to believe that incomes and asset prices will continue to rise strongly. As a result they tend to increase borrowing to finance consumption and/or to invest in assets. If these expectations are not fulfilled, their debt positions may at some stage become unsustainable, either because debt-service costs rise relative to incomes or underlying asset values fall. They then cut back spending in order to restore financial health, but the general spending cuts lead to falling growth and rising unemployment, which reinforces the need for further cutbacks.

The UK economy has experienced a sustained period of growth since 1992. Property prices have risen substantially over this period, as had equity prices until March 2000. In the past year or so equity prices have fallen sharply, however, so it is natural to ask whether the equity price falls so far have generated sufficient deterioration in the financial position of households and firms to prompt sharp spending cutbacks.

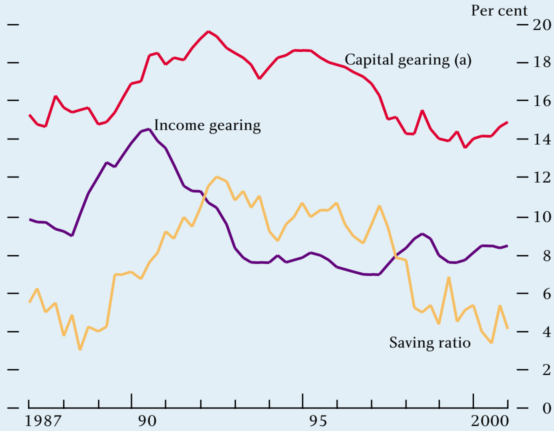
Households

The ratio of gross household debt to disposable income reached an all-time high in 2001 Q1 (see Chart 1.3 on page 4) and, given that borrowing is growing faster than incomes, seems likely to rise even higher. However, there are few signs that this high level of debt is causing significant financial difficulties that might lead consumers to cut back spending plans severely.

Income gearing (the ratio of interest payments to disposable income) for households has edged up only a little and remains well below the levels seen in the 1989–92 period (see Chart A). Capital gearing (the ratio of M4 debt to net total wealth) has risen in the past year but remains below levels seen in 1989–96. Net financial wealth has fallen in recent quarters along with equity prices, but this has been offset by rises in house prices. So total net wealth appears to have fallen by at most a small amount, and remains close to an all-time high (see Chart 2.6 on page 14).

Another indicator of financial health of households is the percentage of mortgage holders whose repayments are more than six months in arrears. This has fallen very considerably from its peak in 1992, and shows no signs of reversing, with the latest data (2001 H1) being at the lowest level since 1983 (see Chart B).

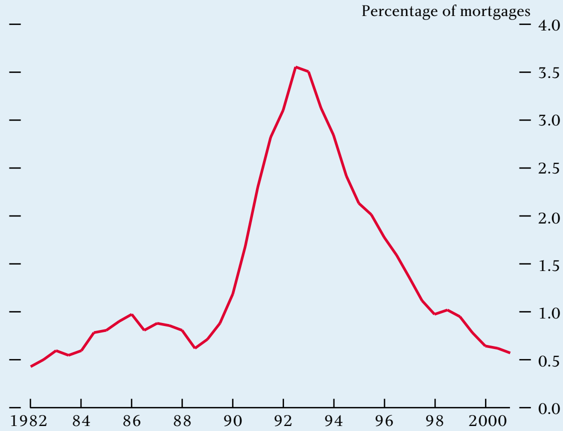
Chart A
Household sector gearing and the saving ratio



Sources: ONS and Bank of England.

(a) Data for 2001 Q1 based on an estimate of household wealth.

Chart B
Percentage of mortgages more than six months in arrears



Source: Council of Mortgage Lenders.

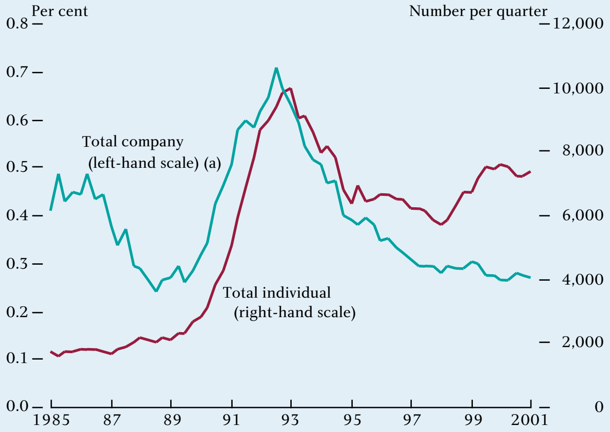
The number of personal bankruptcies has also been steady over recent quarters, having risen in 1998–99. This level is well below the peaks seen in the early 1990s (see Chart C). Overall, therefore, the household sector does not appear to be facing financial problems at present. Debt is high but interest payments are at reasonable levels. Equity prices have fallen but rises in house prices have maintained wealth at high levels. Consumer confidence fell slightly in July, but balances relating to prospects over the next twelve months for households' financial position have risen in June and July, after falling in May.

Private non-financial corporations (PNFCs)

The debt to profits ratio of the company sector has risen recently (see Chart D). This is now at slightly higher levels than reached during the 1990–92

(1) See also *Financial Stability Review*, Issue 10, Bank of England, June 2001, pages 74–82.

Chart C
Insolvencies in England and Wales

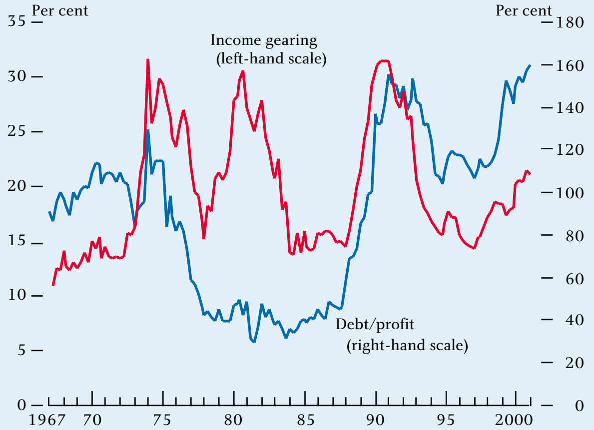


Source: DTI.

(a) As a percentage of active companies.

recession. Income gearing, shown in the same chart, has also been rising in recent quarters, but it remains well below the peaks accompanying the past three recessions.

Chart D
PNFCs' debt to profits ratio and income gearing



Sources: ONS and Bank of England.

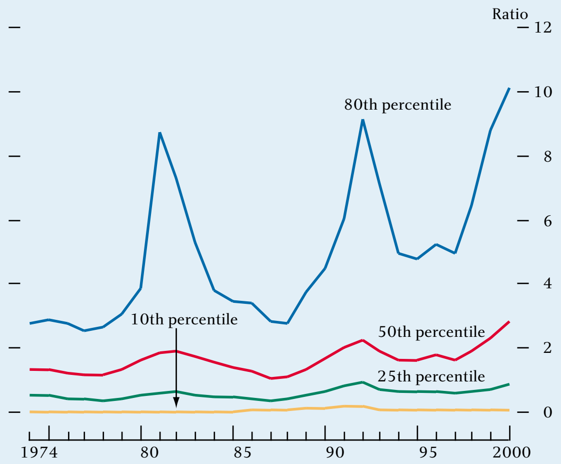
PNFCs' capital gearing (Chart E) has risen sharply in recent quarters, when measured using the market value of assets, as this measure reflects recent falls in equity prices. When measured using replacement cost, recent increases have been only modest, but this measure is currently at an all-time high.

Another indicator relating to corporate financial health can be obtained from the distribution of debt to profits ratios among quoted firms (see Chart F). This shows that the 20% of firms with the highest debt to profits ratios have reached levels that on this indicator are higher than levels reached around the time of the past two recessions. This build-up of debt

Chart E
PNFCs' capital gearing

Sources: ONS and Bank of England.

Chart F
Distribution of debt to profits ratio of quoted non-financial UK companies[(a)(b)(c)]



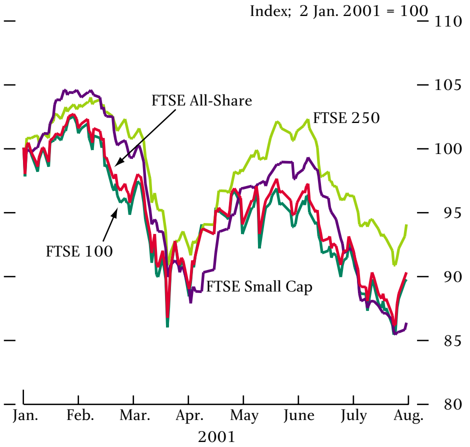
Sources: Thomson Financial Datastream and Bank of England.

(a) Ratio of gross debt to earnings before interest and tax.
(b) Figures for 2000 are provisional, based on the accounts of 1,107 quoted non-financial companies.
(c) Companies with negative profits have their debt to profits ratio recorded in the 95th percentile of the distribution excluding such observations.

has taken place over the past three years. It suggests that, while most firms are in good financial shape, there may be a significant percentage that is more vulnerable. So far this increased indebtedness of some firms does not appear to have led to an increase in company failures. There has, for example, been no pick-up in company insolvencies in the past few quarters (see Chart C), though many survey indicators of corporate confidence have fallen in recent months.

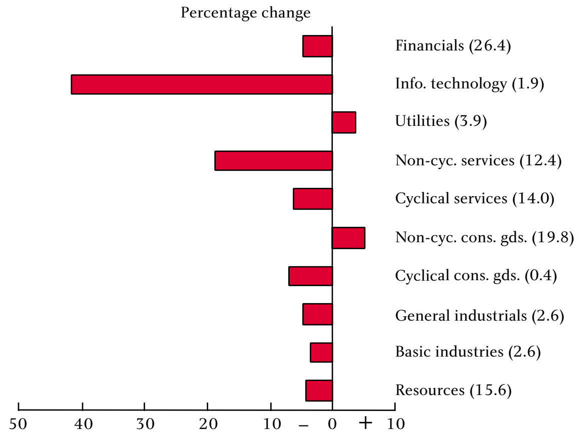
Overall, it seems that signs of weakening in financial position are more apparent for the corporate sector than for households.

Chart 1.9
UK equity markets



Source: Thomson Financial Datastream.

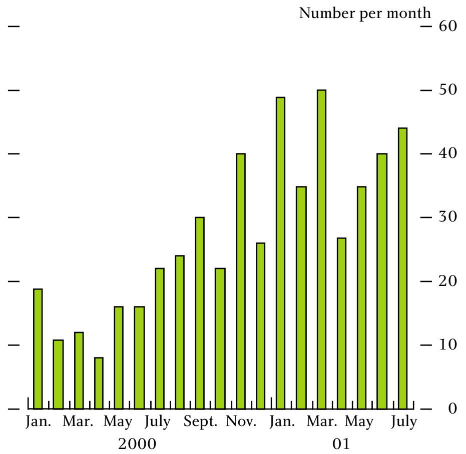
Chart 1.10
FTSE All-Share sectoral indices: percentage changes since the May *Inflation Report*



Note: Numbers in brackets are weights based on market value.

Source: Bloomberg.

Chart 1.11
Number of profit warnings by UK companies



Source: Bank of England.

been reduced to preserve target cash ratios as the overall value of portfolios shrank.

Both OFCs' money and bank borrowing have grown very rapidly relative to nominal GDP since the financial liberalisation of the early 1980s (see Chart 1.8). However, movements in OFCs' money and credit data probably have fewer implications for UK economic prospects than developments in other sectors' borrowing and deposits. It is possible, for example, that changes in the pattern of financial intermediation might lead to OFCs contracting (expanding) their balance sheets as their bank deposits and bank lending simultaneously reduced (increased), while having no impact on the non-financial sector of the economy.

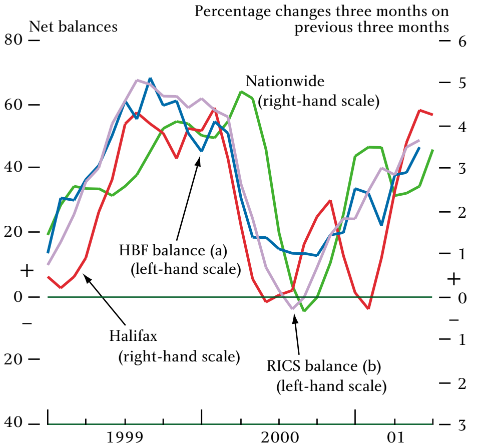
1.2 Asset prices

Equities

UK equity prices recovered in April and May from the lows seen in March, but since early June equity markets have fallen back considerably (see Chart 1.9). The 15-day average of the FTSE All-Share index was about 8% lower in the period up to 1 August than up to 9 May. Falls between the time of the previous *Report* and 1 August were evident in all major sectors of the index (see Chart 1.10) except for non-cyclical consumer goods and utilities. The declines were largest in information technology (a small sector heavily influenced by Marconi, which fell by 73%) and non-cyclical services (which includes telecoms). International equity markets also fell over this period. The US S&P 500 index fell by about 3%, the DJ Euro Stoxx index fell by 7% and the Japanese Nikkei index fell by 15%. The recovery in equity markets generally in Q2 up to early June reflected greater optimism about the prospects for avoiding a recession in the United States. But the further dip in world share prices was connected to a series of announcements, especially in the high-technology sectors, about falls in sales and investment, as well as of profit warnings and job cuts. Indeed there has been a steady rise in the number of profit warnings in the United Kingdom recently (see Chart 1.11). Moreover, the number of UK quoted companies issuing profit warnings was considerably higher in the first half of 2001 than in 2000.

The falls in equity markets have implications for economic prospects in the United Kingdom and around the world. Equity price falls are partly a reflection of downgrades of the prospects for growth in corporate profits, but weaknesses in equity markets can also make it harder for firms to raise capital and therefore have a negative effect on investment in physical assets. However, there are few signs of any survey evidence of increased difficulties in raising finance, though there are some

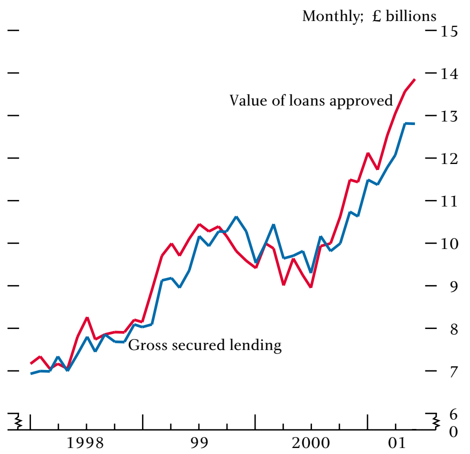
Chart 1.12
Nationwide and Halifax house price indices and RICS and HBF surveys



Sources: Halifax plc, HBF, Nationwide Building Society and RICS.

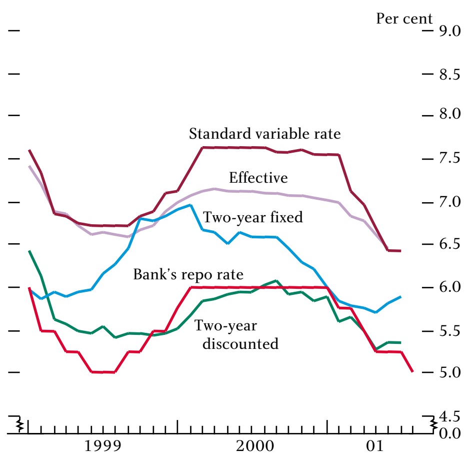
(a) Net balance of housebuilders reporting house price rises over the past month.
(b) Net balance of chartered surveyors reporting house price rises over the past three months.

Chart 1.13
Secured lending to individuals and loans approved



Source: Bank of England.

Chart 1.14
Mortgage rates



Sources: Bank of England and Moneyfacts.

signs of slowing investment growth. Lower equity prices also reduce household wealth and so could lead to lower consumer spending than would otherwise have occurred. But consumer spending has yet to slow in response to the decline in financial wealth. Consumption and investment are discussed further in Section 2.

Property prices

In contrast to falling equity prices, UK house prices appear to be accelerating, with all the main indices suggesting prices rising at an annual rate of around 10% in the year to July (see Chart 1.12). Loan commitments have also picked up sharply (see Chart 1.13). Some of the rise in loan demand in 2000 reflected a rising proportion of remortgaging activity. The proportion (by value) of loan approvals that were intended for remortgaging rose from 26% in December 1999 to 37% a year later, but this has fallen back to 28% in June 2001. So most of the recent increase in loan demand reflects demand for housing or other forms of spending rather than just for refinancing to secure a cheaper mortgage, and this could give further support to house prices and consumption in the near term. The rise in house prices to date will have partly offset the impact of lower equity prices on household wealth in Q2, but the official wealth data for Q2 are not yet available.

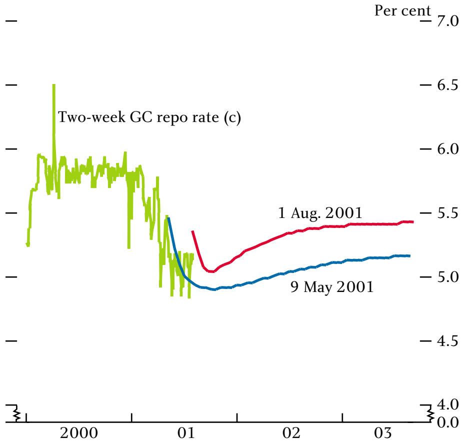
1.3 Interest rates and the exchange rate

Interest rates

The Bank's repo rate was maintained at 5.25% in June and July, but there were some notable shifts in market rates. Retail variable mortgage rates fell in May and June but then levelled off, largely reflecting the completion of pass-through from the three official repo rate reductions earlier this year (see Chart 1.14). The quoted standard variable rate has fallen by more than the official repo rate, reflecting a few special offers by some big lenders. However, the take-up rate of some of these offers has so far been limited. The effective rate has fallen a little less than the Bank's repo rate. The effective rate is actual mortgage interest payments as a percentage of the value of loans outstanding. Fixed mortgage rates rose slightly in June and July, reflecting a pick-up of longer-term yields and associated swap rates. Lower mortgage rates have contributed to the strength of the housing market and have also helped to finance consumption through mortgage equity withdrawal (MEW), which amounted to around 2% of household income in Q1. Consumer confidence surveys (which are correlated with MEW) and the lending data suggest that MEW could have been at least as strong in Q2.

Expectations of interest rates in the near future, as reflected in the pattern of market rates, picked up quite sharply in

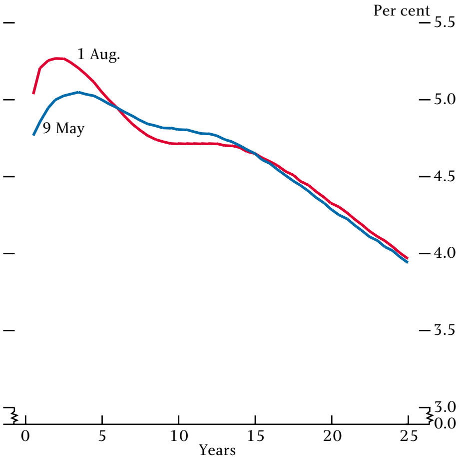
Chart 1.15
Two-week forward rates(a)(b)



Source: Bank of England.

(a) A forward rate is the rate implied for a future period by comparisons of current shorter-term and longer-term rates.
(b) General collateral (GC) repo/gilt forward rates have been adjusted upwards by 15 basis points to reflect the average historical spread between the GC repo rate and the Bank's repo rate.
(c) GC repo rates refer to the rates for sale and repurchase agreements in which any gilt stock may be used as collateral.

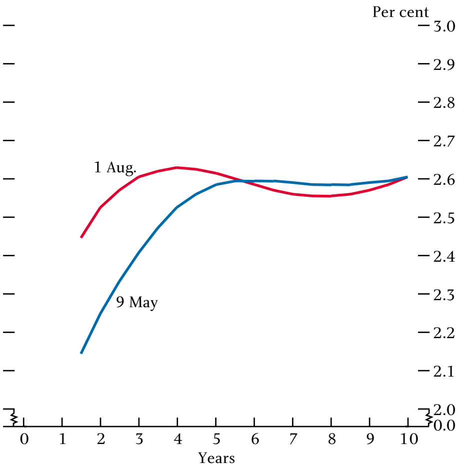
Chart 1.16
Nominal forward interest rates(a)(b)



Source: Bank of England.

(a) See Chart 1.15, footnote (a).
(b) Based on gilt yields of different maturities.

Chart 1.17
One-year inflation forwards(a)



Source: Bank of England.

(a) See Chart 1.15, footnote (a).

mid-June when an unexpectedly high RPIX inflation figure was released. Subsequent data on consumer credit and retail sales reinforced the market perception that further cuts in the official rate were less likely and that rates may start to rise again before too long. Rate expectations fell back somewhat during July, but expected official interest rates for the next two years remained around 25 basis points higher at the time of the MPC's August meeting than they had been in May (see Chart 1.15). However, interest rate expectations between five and ten years ahead were slightly lower on 1 August than in May, and beyond ten years ahead they were unchanged (see Chart 1.16). Near-term market rates fell following the cut in the Bank's repo rate to 5% on 2 August.

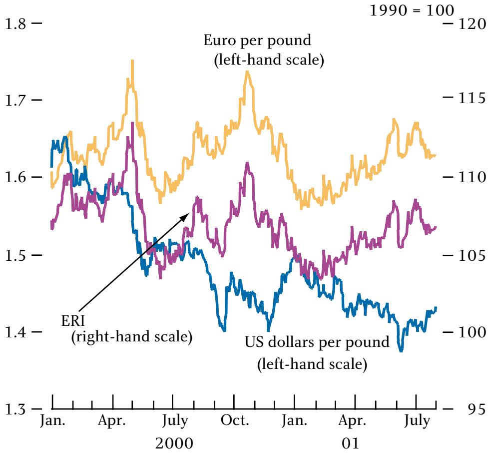
Comparisons of yields on nominal and indexed government debt enable estimates to be made of the real interest rate and of implied inflation expectations. Between the May *Report* and the August MPC meeting there had been no change in expected real interest rates up to five years ahead, and so the upward shift in short-term nominal interest rate expectations implied that financial markets' inflation expectations had risen in the near term (see Chart 1.17). However, inflation expectations on this measure were lower for periods more than five years ahead, and at most horizons were closer to the 2.5% inflation target. Care needs to be taken in deriving inflation expectations from comparisons of nominal and index-linked gilts, as the latter trade in a relatively thin market that may be influenced by a small number of transactions.

Private sector wholesale interest rates have moved broadly in line with rates on government securities since the May *Report*. This applies equally to interest rate swaps and to corporate bond rates. A rise in swap spreads could reflect market perceptions of increased credit risk in money markets (where banks are the main participants), and rises in corporate bond spreads could reflect greater concerns about the financial health of major companies. So the fact that these spreads over gilts are little changed suggests that market participants are not displaying increased concern about the financial health of banks or other companies.

The exchange rate

The sterling effective exchange rate (ERI) averaged 105.8 in the 15 working days to 9 May. In the 15 working days to 1 August it averaged 106.7 and so the August projections are based on a slightly higher rate than those for May (see Chart 1.18). The sterling ERI trended upwards during the first half of 2001, but it has fluctuated around a flat trend since June. Bilateral exchange rates with respect to the United Kingdom's main trading partners have also fluctuated around a steady level in the past two months after following a

Chart 1.18
Selected sterling exchange rates



Source: Bank of England.

trend up to June, with sterling rising against the euro and falling against the dollar.

1.4 Summary

Monetary aggregates provided conflicting signals about inflation prospects. Aggregate broad money and lending growth slowed as a result of weaker company data, but household money and credit remained buoyant. In asset markets, house prices continued to be strong while equity prices showed further weakness. Short-term interest rate expectations rose, but longer-term interest rate expectations remained broadly unchanged. Implied inflation expectations moved closer to the inflation target. Sterling rose further against the euro and fell slightly against the US dollar. The sterling ERI was slightly higher in August than in May. The MPC reduced the Bank's repo rate by 25 basis points to 5% on 2 August.

2 Demand and output

Table 2.A
GDP and expenditure components(a)

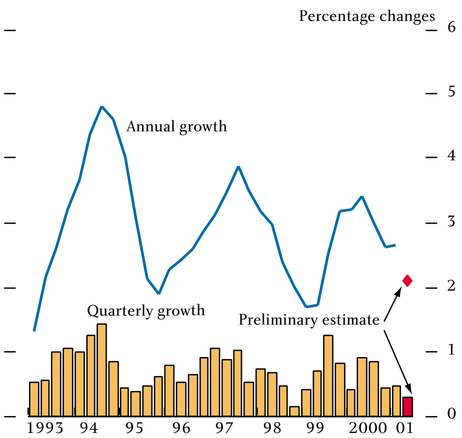
Percentage changes on a quarter earlier

	Average for 1999	Average for 2000	2000 Q4	2001 Q1
Consumption:				
Households	1.2	0.8	0.6	0.6
Government	1.0	0.5	-0.4	0.8
Investment	1.3	1.0	3.1	-2.7
of which, business investment	*1.3*	*1.3*	*4.3*	*-5.0*
Final domestic demand:	**1.2**	**0.8**	**0.9**	**0.0**
Private (b)	1.3	0.8	0.9	-0.3
Public (c)	0.7	1.0	0.9	1.0
Change in inventories (d)	-0.2	-0.1	-0.6	0.9
Excluding alignment adjustment (d)	-0.2	0.1	0.2	0.5
Domestic demand	**1.0**	**0.7**	**0.3**	**0.8**
Net trade (d)	-0.3	-0.1	0.1	-0.4
GDP at market prices	**0.8**	**0.7**	**0.4**	**0.5**

(a) At constant 1995 market prices.
(b) Private final demand is defined as the sum of household consumption, consumption by non-profit institutions, business investment, private sector investment in dwellings, and acquisitions less disposals of valuables.
(c) Public final demand is defined as general government consumption and investment, and investment by NHS trusts.
(d) Percentage point contributions to quarterly growth of GDP.

Real GDP rose by 0.5% in 2001 Q1, with strong growth in service sector activity offsetting falls in manufacturing output. Domestic demand continued to grow more rapidly than output, which was associated with a further weakening of the net trade position. The composition of domestic demand growth was, however, somewhat different from recent quarters. The ONS estimated that the change in stockbuilding was the same size as the total increase in domestic demand. Investment fell sharply, whereas the May *Report* had expected continued growth. The outturn for consumption was also weaker than the MPC anticipated. Preliminary estimates suggest that real GDP grew by 0.3% in 2001 Q2, reducing four-quarter growth to 2.1%. That slowdown appears to have primarily reflected further falls in manufacturing output associated with weak demand for high-technology goods. Weakness in the high-technology sectors has been a global phenomenon, which has played an important role in the worsening of the international demand environment in recent months. While prospects for the United States are little changed, the outlook for growth in the euro area and Asia appears lower than previously expected.

Chart 2.1
GDP growth(a)



(a) At constant 1995 market prices.

2.1 Gross domestic product

UK GDP rose by 0.5% in 2001 Q1 (see Table 2.A) taking four-quarter growth to 2.7%, compared with a recent peak of 3.4% in mid-2000 (see Chart 2.1). Domestic demand continued to grow more rapidly than GDP. Service sector output growth strengthened, while manufacturing output fell sharply. GDP is provisionally estimated to have risen by 0.3% in Q2, reducing four-quarter growth to 2.1%.

2.2 Domestic demand

The composition of the 0.8% rise in domestic demand in 2001 Q1 was different from the recent past. Final domestic demand is estimated to have been flat, after rising by 0.9% in the previous quarter. Within that, private sector investment fell unexpectedly, household consumption growth was weaker than projected in the May *Report*, and public sector demand continued to grow rapidly. The ONS estimated that there was

Chart 2.2
Contributions to quarterly consumption growth

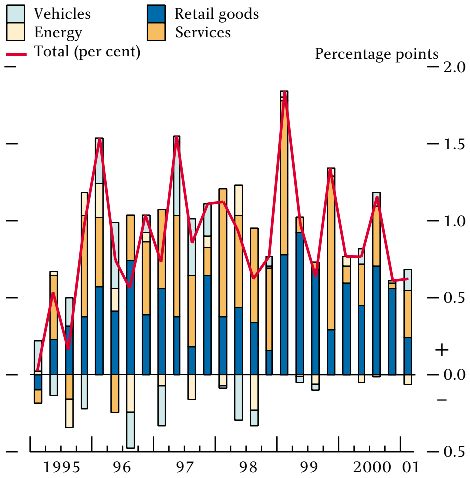


Chart 2.3
Retail goods and retail sales

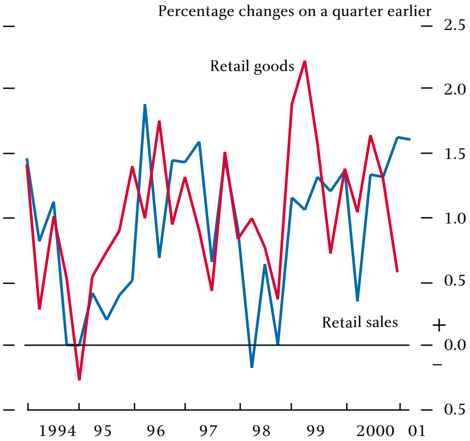
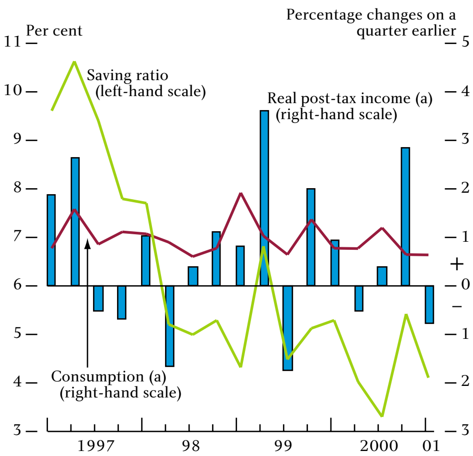


Chart 2.4
Real household post-tax income, consumption and saving ratio



(a) Deflated by the household consumption deflator.

a large turnaround in stockbuilding by firms, which was the same size as the total increase in domestic demand.

The trend over recent years for domestic demand to grow more quickly than GDP continued in 2001 Q1. The counterpart of that tendency has been consistently negative net trade contributions to GDP growth and a widening trade deficit—which reached more than 2% of GDP in 2001 Q1. The box on pages 52–53 examines the trade imbalance, its links with other imbalances in the economy, and the potential implications of those imbalances for inflation.

Household sector consumption

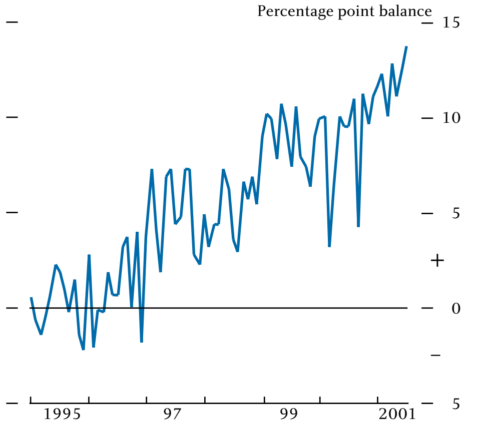
Consumers' expenditure has grown rapidly in recent years (see Chart 2.2), reflecting large increases in household wealth and steady growth in real disposable incomes. The National Accounts measure of household consumption expenditure rose by 0.6% in 2001 Q1 (see Table 2.A), close to its 40-year average and the same as in the previous quarter, but weaker than the MPC had expected. The strong consumption growth for Q1 anticipated in the May *Report* reflected the continued strength in many of its determinants, and the rapid growth of the more timely, but less broad, retail sales volumes data. Retail sales usually follow a similar profile to consumer spending on goods sold by retailers (see Chart 2.3), which is a component of the National Accounts measure of household consumption (see Chart 2.2). Divergences between the two series mostly reflect differences in data sources.(1) But the gap was particularly acute in 2001 Q1, when retail goods consumption slowed markedly. The Committee judges that some of that divergence may be eliminated by the growth of household consumption in 2001 Q1 being revised upwards in future data releases.

That judgment reflects other indicators, which on balance suggest stronger consumption growth in Q1 than recorded in the National Accounts. For example, the CBI Distributive Trades survey and the British Retail Consortium retail sales monitor both point to high sales growth in Q1.

Households' real post-tax disposable income fell in Q1, which might initially be interpreted as suggesting lower consumption growth. But Chart 2.4 shows that consumption growth is considerably less variable than disposable income—consumers tend to smooth their consumption profile by absorbing erratic income changes in their savings. Such smoothing reflects consumption being more closely related to households' expectations of the future path of income. And

(1) The National Accounts measure is based on several surveys of households and firms whereas the retail sales data are derived from a less detailed survey of retailers.

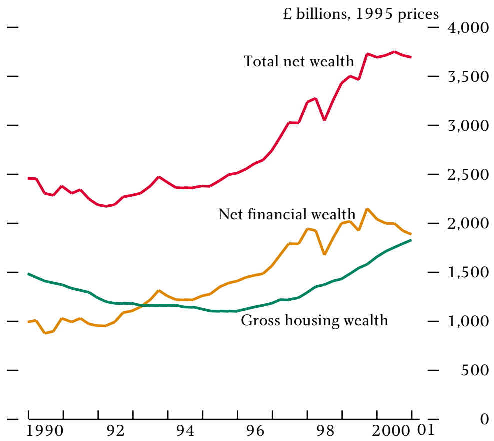
Chart 2.5
Consumers' confidence in their future financial situation(a)



Source: GfK.

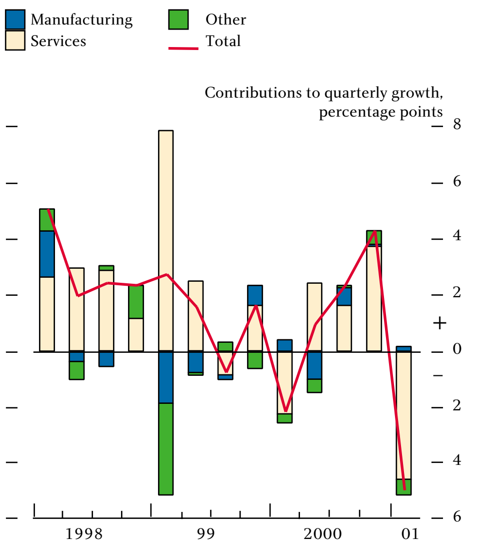
(a) Percentage point balance of respondents expecting the financial situation of their household to improve over the next twelve months.

Chart 2.6
Real household wealth(a)



(a) Deflated by the household consumption deflator.

Chart 2.7
Business investment growth



surveys suggest that consumers became more confident about their future financial situation in Q1 and Q2 (see Chart 2.5), with the sustained strength of consumer borrowing and rapid rises in house prices (see Section 1) similarly suggesting strong consumer confidence. Their optimism may not persist, however—surveys suggest that employers have revised down their future recruitment plans in recent months (see Section 3).

Consumption has grown more rapidly than real post-tax income in recent years, which has been associated with a decline in the saving ratio (see Chart 2.4) and a rise in households' debt to income ratios. The box on pages 6–7 discusses household balance sheet developments. Though the household debt to income ratio is currently historically high, the box shows that low interest rates and high asset prices mean that income and capital gearing ratios are less stretched by historical standards.

The further rapid growth of retail sales volumes in Q2 and continued strength of survey-based measures suggest that consumption remained robust. Retail sales may, however, have been temporarily boosted by substitution out of the consumption of services, such as tourism, because of the foot-and-mouth epidemic.

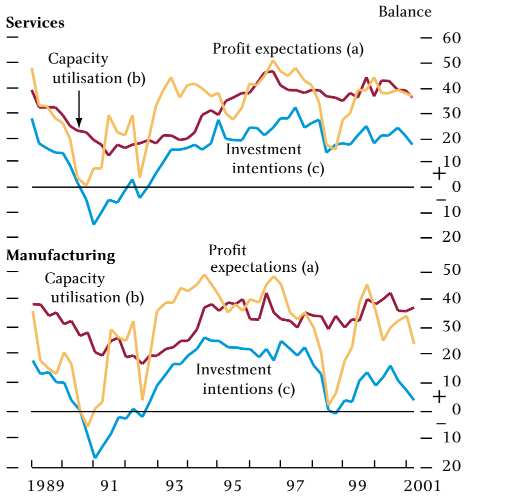
The Committee continues to expect consumption to grow at a lower and more sustainable rate over the next two years than it has over the past five. It believes that the support previously given by rapid growth in financial wealth (see Chart 2.6) will die away and that growth in labour income will slow. The Committee judges that, on balance, recent developments point to a slightly weaker profile for consumption in the second year of its projections than in the May *Report*.

Investment demand

The investment component of final domestic demand was significantly weaker than expected in 2001 Q1. The ONS estimates that whole-economy investment fell by 2.7%, after rising strongly in 2000 Q4 (see Table 2.A). The business investment component was particularly weak—falling by 5.0%—largely accounted for by lower service sector investment (see Chart 2.7). This, combined with downward revisions to estimates for 2000 as a whole, meant that the level of business investment in Q1 was substantially below that projected in the May *Report*. Government investment, by contrast, rose rapidly in Q1.

The lumpy nature of large investment projects means that investment tends to be a volatile component of GDP, which

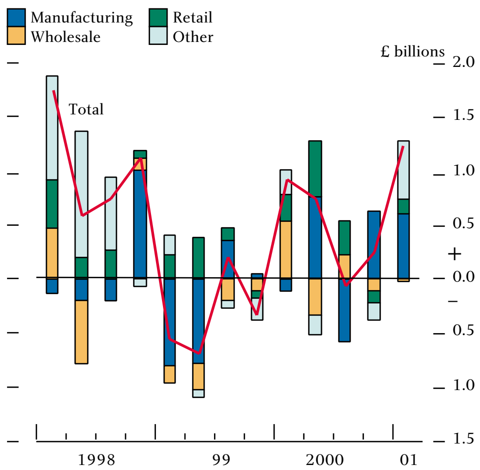
Chart 2.8
Influences on investment



Source: BCC.

(a) Percentage balance of responses to the question: 'Do you believe that over the next twelve months profitability will improve/remain the same/worsen?'
(b) Percentage balance of responses to the question: 'Are you currently operating at full capacity/below full capacity?'
(c) Percentage balance of responses to the question: 'Over the past three months, which changes have you made in your investment plans for plant and machinery: revise upwards/no change/revise downwards?'

Chart 2.9
Change in inventories(a)



(a) At constant 1995 prices, excluding a statistical alignment adjustment.

makes it difficult to interpret short-term movements. Examining other indicators of investment can help clarify matters. Those indicators appear inconsistent with a sharp slowdown in service sector investment (see Chart 2.8). As a result the Committee decided, in constructing its projections, that it was appropriate to smooth the levels of investment in 2000 Q4 and 2001 Q1 by averaging the two volatile outturns.

The Committee judged that the capital stock was closer to its desired level than previously thought. Prospects for global and UK output growth have weakened since May. And falls in equity prices may have been associated with a reduction in investment incentives, as well as causing a further deterioration of corporate balance sheets (see the box on pages 6–7). The Committee also judged that the more uncertain world environment may depress investment in the near term. Many investment decisions are not easily reversed without substantial costs. So when a firm invests it gives up the chance to wait for new information that might affect the desirability or timing of that investment. That lost option is an opportunity cost, which should be included in the overall cost of investing. The value of the option, and hence the cost of investing, increases with greater uncertainty. So firms have greater incentives to delay investment projects when uncertainty rises.[1] Bringing these factors together, the Committee adopted a lower profile for the level of investment over the next two years than in the May *Report*.

Public sector consumption

Government current expenditure on goods and services rose by 0.8% in 2001 Q1. Public sector consumption is expected to grow strongly during the next two years, reflecting Government spending plans.

Inventories

The headline measure of inventory investment made a 0.9 percentage point contribution to GDP growth in 2001 Q1, to be the main source of domestic demand growth. Almost half of that contribution, however, reflected the change in the statistical adjustment used to reconcile the expenditure and output measures of the National Accounts. The Committee places less weight on the alignment adjustment component than on the inventory behaviour of firms directly surveyed by the ONS, although the latter is measured less accurately than other expenditure components.

The substantial rise in measured inventory holdings over the past six months of data has largely been in the manufacturing

(1) See Dixit, A K and Pindyck, R S (1994), 'Investment under uncertainty', Princeton University Press.

Chart 2.10
Domestic demand, import volumes and import penetration

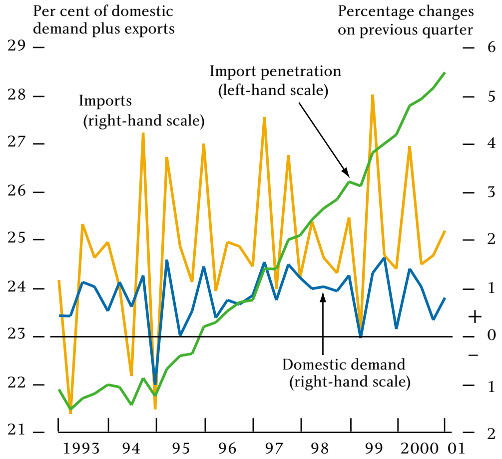


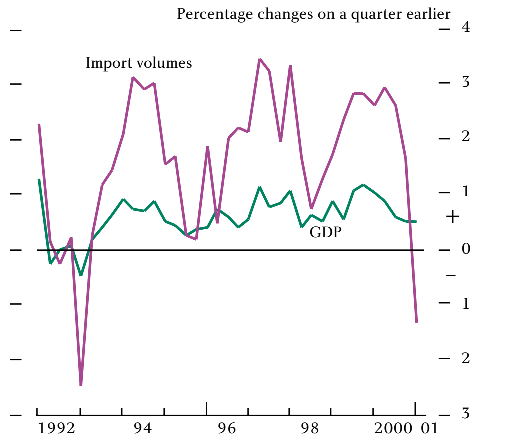
Table 2.B
Composition of UK import volume growth(a)

Percentage changes on a quarter earlier

	1999 average	2000 H1 average	2000 H2 average	2001 Q1
Imports of goods and services	2.3	2.7	1.6	2.2
Contributions of:				
Manufactured goods	0.8	0.7	0.5	0.0
of which: Semi-finished goods	*0.0*	*0.2*	*-0.4*	*1.6*
Consumer goods	*0.0*	*0.2*	*0.1*	*0.1*
Intermediate goods	*0.8*	*0.7*	*0.5*	*0.0*
Capital goods	*0.5*	*0.6*	*0.8*	*0.1*
Other	*-0.6*	*-1.0*	*-0.5*	*-1.8*
Non-manufactured goods	1.1	1.7	0.7	1.9
Services	0.4	0.3	0.4	0.3

(a) Contributions may not sum to totals because of rounding.

Chart 2.11
GDP and imports of the major economies(a)



(a) Euro area, United States, Canada and Japan, UK trade-weighted. These countries together account for 67% of UK exports. Data for other countries are less timely.

sector (see Chart 2.9). That build-up of stocks probably reflected the unexpected slowdown in demand for manufactured goods: surveys, including one by the Bank's regional Agents in June, suggest that the inventory accumulation in Q1 was largely involuntary. Surveys suggest some reduction in manufacturers' stocks in Q2, though there is evidence of stock levels rising in retailing and wholesaling. The Committee expects inventory adjustment by firms to reduce GDP growth in the near term.

The MPC has reconsidered its assumption about the stock-output ratio in the future, by re-examining trends in inventories held by different sectors in the recent past. It has maintained the assumption that further improvements in stock management techniques will facilitate reductions in the stock-output ratio in the medium term. But the decline is less steep than assumed in May.

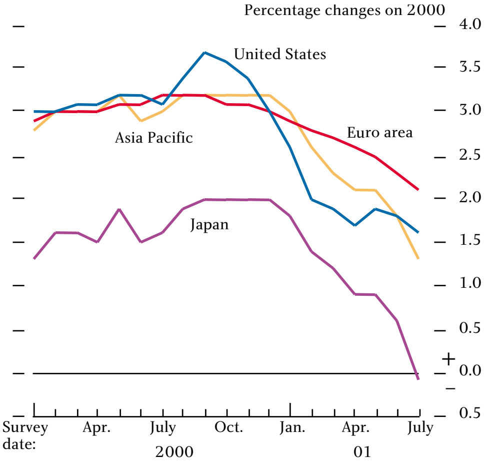
2.3 Net trade and external demand

The effects on the trade balance of the rapid growth in domestic demand over recent years operate primarily through import volumes. Growth of import volumes, however, consistently outstripped that of domestic demand during this period. That has been associated with a significant rise in import penetration (see Chart 2.10). Strong growth in the imports of intermediate and capital goods has played an important role in the increases in import volumes (see Table 2.B). This suggests that UK manufacturers may have been attempting to mitigate the downward pressure on their profitability associated with the strength of sterling by sourcing parts and capital equipment from cheaper locations. That tendency was, however, less apparent in 2001 Q1 as growth of capital goods imports slowed sharply. Moreover, there were large falls in the volume of capital goods imports in April and May.

Demand conditions for UK exporters deteriorated markedly in 2001 Q1 as import volumes of the major economies fell steeply, alongside continuing subdued GDP growth (see Chart 2.11). The turnaround in major economies' import volumes in Q1 is estimated to have been the largest for seven years and was particularly pronounced for high-technology goods. Together with recent developments in the United Kingdom's major trading partners, that caused the Committee to revise down its projections for world trade growth in the remainder of 2001 by a substantial amount.

Economic forecasters, surveyed by Consensus Economics, have in recent months revised down significantly their expectations of world GDP growth in 2001 (see Chart 2.12). While forecasts for the US economy have changed little over the past

Chart 2.12
Evolution of 'Consensus' forecasts for 2001 GDP growth



Source: Consensus Economics.

Table 2.C
US GDP and expenditure components

Percentage changes on a quarter earlier

	Average for 1999	Average for 2000	2001 Q1	Q2
Consumption	1.3	1.0	0.7	0.5
Investment	1.6	1.5	0.5	-2.2
Government	1.0	0.3	1.3	1.3
Change in inventories (a)	0.0	-0.1	-0.8	0.0
Domestic demand	**1.3**	**0.9**	**0.1**	**0.2**
Net trade (a)	-0.3	-0.2	0.2	0.0
GDP	**1.1**	**0.7**	**0.3**	**0.2**

(a) Percentage point contributions to quarterly growth of GDP.

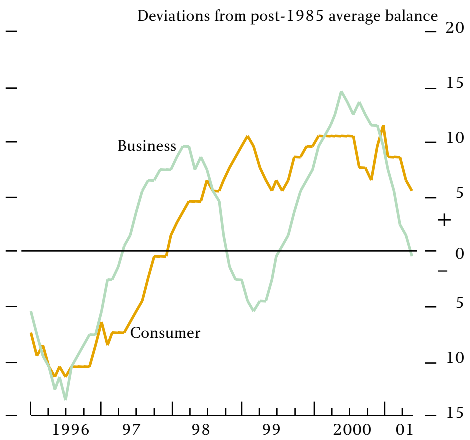
Table 2.D
Euro-area GDP and expenditure components

Percentage changes on a quarter earlier

	Average for 1999	Average for 2000	2000 Q4	2001 Q1
Consumption	0.7	0.5	0.3	0.4
Investment	1.4	0.9	0.2	-0.4
Government	0.4	0.5	0.6	0.4
Change in inventories (a)	0.0	0.0	0.1	-0.1
Domestic demand	**0.8**	**0.6**	**0.4**	**0.1**
Net trade (a)	0.1	0.2	0.2	0.5
GDP	**0.8**	**0.7**	**0.6**	**0.6**

(a) Percentage point contributions to quarterly growth of GDP.

Chart 2.13
Euro-area confidence



Source: European Commission.

quarter, the outlook is for lower growth in the euro area and in Asia.

The US economy grew by 0.2% in Q2, after expanding by 0.3% in Q1 (see Table 2.C). This reduced four-quarter growth to 1.3% in Q2, the lowest rate for nearly ten years. Developments in the corporate sector have been important in the slowdown in growth in recent quarters. Private sector investment has weakened, and experienced its biggest fall for more than ten years in Q2. Investment in high-technology capital has declined the most rapidly, mirroring developments in manufacturing output. This was also associated with a large fall in imports of capital goods, which played an important role in the steep declines in US import volumes in the first half of 2001. The corporate sector adjustment was also manifested in the pronounced reduction in firms' inventory holdings in the same period.

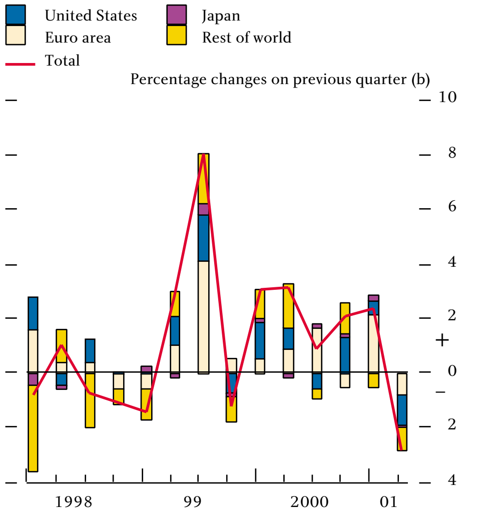
Private sector consumption has slowed from the rapid growth rates in 1999 and 2000, but the adjustment has, so far, been less pronounced than in the corporate sector. That comparative resilience of consumption probably reflects the impact of cuts in official interest rates and anticipated reductions in personal taxation, which have been associated with consumer confidence stabilising.

The Committee continues to expect the United States to recover gradually, underpinned by looser monetary and fiscal policy and favourable underlying productivity trends. But the balance of risks remains on the downside: productivity prospects could deteriorate, with adverse effects on prospective corporate profits and labour income. Another, potentially related, risk is that the large financial deficits of firms and households could provoke further spending slowdowns. The impact of developments on labour market prospects, and hence consumer sentiment, are likely to be important for the US outlook.

Euro-area GDP rose by 0.6% in 2001 Q1 (see Table 2.D). Though that was in line with the MPC's expectations, developments in the expenditure components point to an underlying slowdown in activity. The trade sector was the main source of growth, but as in the United States in Q1 this reflected import volumes falling sharply. Domestic demand rose only marginally.

The continued weakness in the household consumption component of domestic demand may indicate that higher-than-expected inflation has temporarily outweighed the effects of tax cuts on consumer confidence (see Chart 2.13). Euro-area private sector investment fell for the

Chart 2.14
Contributions to UK goods export volume growth(a)



(a) Bank estimates. Volume data are not available on an individual country basis so values have been deflated by aggregate export prices.
(b) Final observations show growth in the three months to May 2001 compared with the previous three months.

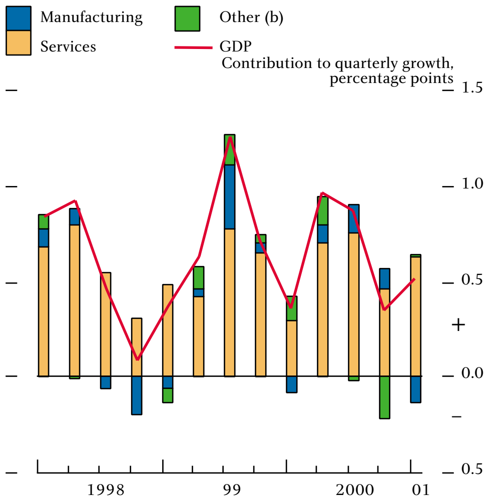
Table 2.E
UK export outlook(a)

	Series average (b)	2000 average	2001 Q1	Q2
BCC export orders				
Manufacturing	8.3	2.0	1.0	1.0
Services	11.4	12.8	8.0	1.0
CIPS export orders (c)				
Manufacturing	49.7	50.6	51.1	48.5
CBI industrial trends				
Export orders	-8	-10	-15	-20
Export optimism	1	-8	-16	-25
DHL manufacturing export indicator				
Export confidence, next three months	32	34.5	34	26
EEF export orders	-1.2	-1.3	-2.0	-8.0

Sources: BCC, CIPS, CBI, DHL and EEF.

(a) Numbers reported are percentage balances of respondents reporting 'higher' relative to 'lower'.
(b) CBI since 1972; CIPS since 1996; BCC since 1989; DHL since 1993; EEF since 1994.
(c) Average of seasonally adjusted monthly indices. A reading above 50 suggests expansion, a reading below 50 suggests contraction.

Chart 2.15
Sectoral GDP growth(a)



(a) Aggregate GDP is shown at constant 1995 market prices but sectoral output is measured at basic prices, so contributions may not add to the total.
(b) Other includes construction, utilities, mining and quarrying, and agriculture.

first time in four years in Q1 as business confidence declined (see Chart 2.13) in the wake of weak industrial production. Sharp declines in orders for capital and consumer goods suggest that subdued industrial production and investment growth will continue in the short term.

In the light of these developments, the Committee revised down its projection for euro-area GDP growth in 2001. Some Committee members consider that the risks to growth in the euro area are weighted to the downside, independent of the US outlook.

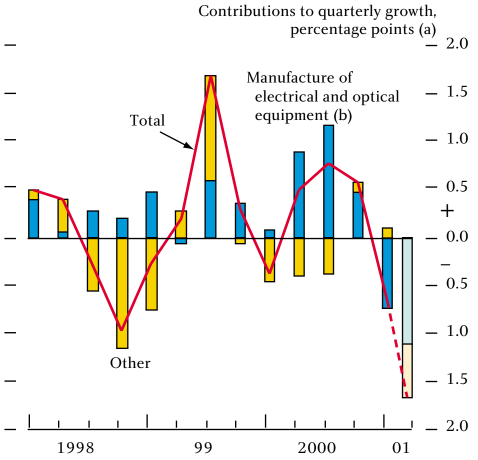
Prospects for Japan have also deteriorated. The sharp fall in the demand for high-technology goods depressed export volumes and industrial production in the first two quarters of 2001. Those developments reinforced the negative effects on GDP of ongoing consumption weakness. Government spending was the only component supporting GDP growth in Q1. Industrial production and export volumes of the other Asian economies have also declined markedly because of the lower demand for high-technology goods.

The weakening of the international environment led to a decline in the growth of total UK export volumes in Q1. Combined with the continued strong import volume growth, this meant that net trade made a -0.4 percentage points contribution to quarterly GDP growth in Q1, following an average quarterly contribution of -0.3 percentage points in the previous five years. Monthly data suggest that growth of goods export volumes continued to decline in the first two months of Q2 (see Chart 2.14). But the effects on the trade balance will be partly offset by the slowing of import volumes also apparent in the monthly data. Looking ahead, survey-based measures of the prospects for exports have been revised down further in recent months (see Table 2.E).

2.4 Output

The 0.5% rise in GDP in 2001 Q1 was more than accounted for by strong growth of service sector output, with manufacturing output falling sharply (see Chart 2.15). Though the service sector has been the main source of output growth for several years, the sectoral growth imbalance was particularly marked in Q1. That reflected the high-technology component of the manufacturing sector being adversely affected by the slowdown in global demand for such goods. Even though high-technology companies account for only an eighth of manufacturing output, they were the main source of growth in 2000 (see Chart 2.16), as other manufacturing firms continued to be adversely affected by the high sterling

Chart 2.16
Contributions to manufacturing growth



(a) Final observations show growth in the three months to May 2001 compared with the previous three months.
(b) Proxy for high-technology companies' output.

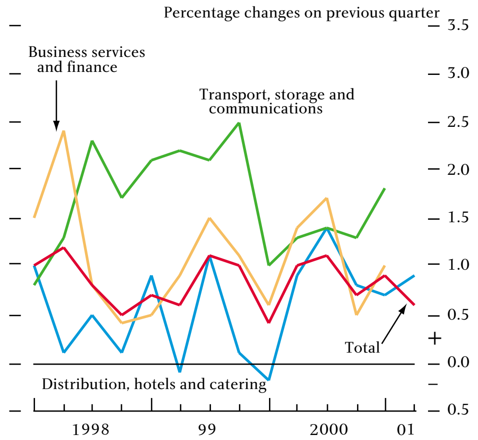
Table 2.F
Manufacturing output prospects(a)

	Series average (b)	Average for 2000	2001 Q1	Q2
CBI total new orders, past four months	3	-4	-1	-6
CBI domestic new orders, past four months	-3	-6	-14	-12
CBI volume of output, next four months	8	5	-2	3
CBI business optimism	-4	-6	-29	-22
CIPS new orders index, past month (c)	52.7	52.3	52.4	48.0
BCC home orders, past three months	6	11	8	-5
EEF volume of new orders, past three months	6	3	3	-7

Sources: BCC, CIPS, CBI and EEF.

(a) Numbers reported are survey balances unless otherwise stated. An increase suggests a rise in the proportion of respondents reporting 'higher' relative to 'lower'.
(b) CBI since 1975; CIPS since 1992; BCC since 1989; EEF since 1994.
(c) Average of seasonally adjusted monthly indices. A reading above 50 suggests expansion, a reading below 50 suggests contraction.

Chart 2.17
Service sector growth(a)



(a) The only published data for service sector output for 2001 Q2 in the preliminary GDP release was for aggregate services output and the distribution, hotels and catering component.

exchange rate. By contrast, high-technology companies' output fell by 4.3% in Q1.

Prospects for the manufacturing sector are likely to depend on the future path of the exchange rate, developments in world trade and the demand for high-technology goods. Most, but not all, survey indicators are more pessimistic about prospects than they were in Q1 (see Table 2.F), and the overall picture continues to be weak.

Overall service sector output growth strengthened in Q1 (see Chart 2.17). Distribution, hotels and catering weakened slightly. But that was offset by strong growth in business services and finance, and by a bounceback in the transport, storage and communications component of services after the travel disruptions in 2000 Q4. The utilities, mining and quarrying, agriculture and construction sectors together made a small contribution to GDP growth in Q1 (see Chart 2.15).

Preliminary estimates show that GDP rose by 0.3% in Q2. That reduced four-quarter GDP growth to 2.1%, the slowest for two years. The only sectoral output data in the preliminary release is for services, which are estimated to have grown by 0.6% on the quarter following the 0.9% rise in Q1. An ONS briefing suggests that flat output of the hotels and catering sector partly explained that slowdown, perhaps reflecting the impact of the foot-and-mouth epidemic. But surveys suggest that a more broadly-based slowdown in service sector activity is likely in the second half of 2001 (see Table 2.G), with some evidence of slowing domestic orders reinforcing declining export orders (see Table 2.E). Monthly industrial production data suggest that the slowdown in GDP growth in Q2 mainly reflected further declines in manufacturing output, which fell at its fastest rate in nearly ten years in the three months to May. As in Q1, that was driven by sharp declines in high-technology manufacturing output (see Chart 2.16), although the output of other manufacturers also fell.

2.5 Summary

Growth in UK GDP has slowed to below trend. But the economy continues to experience imbalances. Domestic demand growth remained above trend in Q1, which was associated with a further widening of the trade deficit. The imbalance between strong service sector output growth and weakness of manufacturing output has intensified, with the latter largely reflecting global developments.

Prospective UK GDP growth is somewhat lower than in the May projections, particularly in the short term. Global trade

Table 2.G
Service sector output prospects(a)

	Series average (b)	Average 2000	2001 Q1	2001 Q2
CIPS (c)				
Business expectations, next twelve months	77.4	75.6	75.1	72.7
Incoming business	56.5	56.7	56.7	52.3
BCC home orders, past three months	16.8	17	26	19
BCC business confidence (turnover), next twelve months	47.5	48	53	49
EULER order books (c)	65.8	60	49	53
CBI/Deloitte & Touche consumer and business services (d)				
Business optimism	6.2	6.2	11	-12
Volume of business, next three months	26.6	26.6	32	3
CBI/PricewaterhouseCoopers Financial services				
Business optimism	6.7	7	-22	3
Volume of business, next three months	23.2	23	27	20

Sources: CIPS, BCC, CBI/Deloitte & Touche, CBI/PricewaterhouseCoopers and EULER Trade Indemnity.

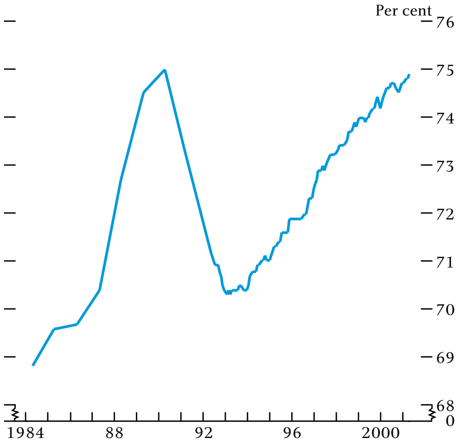
(a) Numbers reported are survey balances unless otherwise stated. An increase suggests a rise in the proportion of respondents reporting 'higher' relative to 'lower'.
(b) Since 1989 for BCC and CBI/PricewaterhouseCoopers; since 1998 for CBI/Deloitte & Touche; CIPS since 1996; EULER since 1992.
(c) Average of seasonally adjusted monthly indices. A reading above 50 suggests expansion, a reading below 50 suggests contraction.
(d) Average of the responses for consumer and business and professional services weighted by value added.

volumes have fallen and world activity prospects have deteriorated, mainly in the euro area and Asia. Business investment growth is likely to be weaker than previously thought, and firms are under pressure to reduce stocks. Underlying consumption growth has remained strong, but should slow as the support given by strong financial wealth growth fades, and labour income growth slows. As a consequence, four-quarter GDP growth may ease further in the second half of the year, before recovering in 2002.

The labour market 3

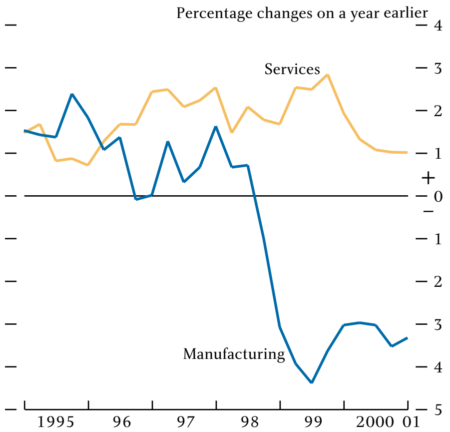
Growth in employment continues to exceed growth in the population of working age. Near-term employment intentions have weakened, but probably remain positive for the economy as a whole. Unemployment has continued to fall. Though firms continue to report recruitment difficulties and high levels of skill shortages, these problems have eased somewhat in recent months. Wage settlements and regular pay growth have edged up. This and slower productivity growth have increased unit labour cost inflation. But given the apparent tightness of the labour market, wage pressure remains low by historical standards.

Chart 3.1
LFS employment rate(a)



(a) Percentage of population of working age. Pre-1993 figures based on yearly observations.

Chart 3.2
Employment growth

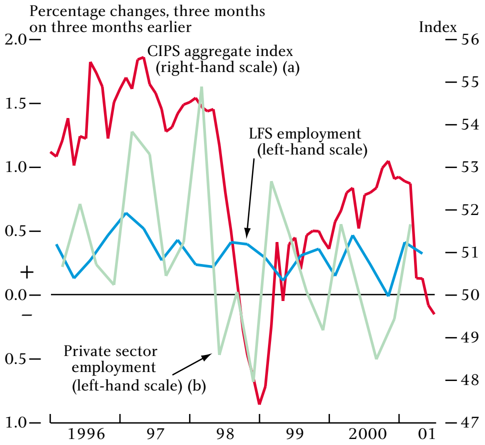


3.1 Employment and employment intentions

Employment as measured by the Labour Force Survey (LFS) continues to increase more quickly than the population of working age (see Chart 3.1), and total hours worked, a broader measure of labour usage, is also on an upward trend. But employment as measured by the Workforce Jobs survey fell slightly in 2001 Q1. The Workforce Jobs survey measures the number of jobs, collected from a sample of firms on a single day towards the end of each quarter. The LFS measures the number of people in work, based on the responses to a rolling three-month survey of a sample of households. So the LFS measure tends to be less volatile. The MPC therefore places more weight on the LFS measure of aggregate employment, but the Workforce Jobs survey gives the most reliable industrial breakdown of employment. The differing fortunes of the manufacturing and service sectors of the economy, discussed in Section 2, are also apparent when looking at employment across sectors (see Chart 3.2).

Surveys suggest that employment growth has eased recently. For example, in the BCC services survey the percentage balance of respondents reporting an increase in employment over the previous three months was 15 in Q2, compared with an average of 22 during 2000. And the more timely CIPS aggregate employment index has fallen sharply to just below the no-change level (50) for the first time since 1999. That reflects a weakening in survey responses in both the manufacturing and the service sectors. But the CIPS index does not move very closely with whole-economy employment

Chart 3.3
CIPS employment index and growth in employment



Sources: Chartered Institute of Purchasing and Supply and ONS.

(a) A reading above 50 suggests an increase on the previous month, a reading below 50 suggests a decrease. Weighted average of indices for manufacturing, private services and construction.
(b) Defined as Workforce Jobs employment minus employment in the public administration, education, health, retail and wholesale sectors, to be comparable to the coverage of the CIPS survey.

Table 3.A
Surveys of employment intentions(a)

Percentage balance of employers planning to recruit in the next period (b)

	Series average (c)	2000 Q2	Q3	Q4	2001 Q1	Q2
Whole-economy						
Manpower	11	14	18	21	19	14
Services						
Manpower (all private)	13	16	21	27	23	18
BCC (all private)	14	28	28	29	21	19
Consumer, business and professional services (d)	22	32	32	23	7	9
Financial services (e)	-14	-19	10	10	-7	9
Manufacturing						
Manpower	13	11	14	13	14	9
BCC	3	11	9	8	11	-1
CBI	-21	-13	-7	-10	-21	-28

Sources: Manpower, BCC, CBI/Deloitte & Touche, CBI/PricewaterhouseCoopers and CBI Quarterly Industrial Trends.

(a) Seasonally adjusted by the Bank.
(b) Next three months, except CBI, which is next four months.
(c) Manpower from 1981 (whole-economy) or 1988 (sectoral); BCC from 1989; CBI/Deloitte & Touche from 1988; CBI/PricewaterhouseCoopers from 1990; CBI Industrial Trends from 1979.
(d) Average of consumer, business and professional services from the CBI/Deloitte & Touche survey weighted by value added.
(e) CBI/PricewaterhouseCoopers survey.

as measured by the LFS (see Chart 3.3). That may partly reflect the fact that the CIPS index does not include the public sector or the private distribution sector, though even after excluding these sectors from the official employment data the relationship is not close. The Recruitment and Employment Confederation (REC) survey, which covers placements by recruitment consultancies, has indicated a fall in demand for permanent placements very recently, particularly in executive/professional and IT/computing categories. Though there are some exceptions, forward-looking surveys also suggest a slowing in the pace of growth of employment in the service sector and further marked declines in manufacturing employment (see Table 3.A). But for the economy as a whole, surveys indicate that employment intentions probably remain positive.

3.2 Unemployment and labour availability

The extent to which the desire to hire more workers affects wage pressure partly depends on the available supply of labour. One measure of that is the number of people who are searching for work, and are currently available to start. This is captured by the LFS measure of unemployment. LFS unemployment fell by 82,000 in the three months to May compared with the three months to February, a larger decline than experienced on average over the past four quarters, taking the unemployment rate down to 4.9% from 5.2%. The claimant count—a measure based on the number of people receiving unemployment benefits—fell by 22,300 in the three months to June, a little less than the average decline over the past year. But, according to the ONS, that probably reflects the effect of the introduction of Joint Claims, which means that both members of certain couples are now required to register in order to be eligible for the Jobseekers' Allowance and so are counted as separate claimants.

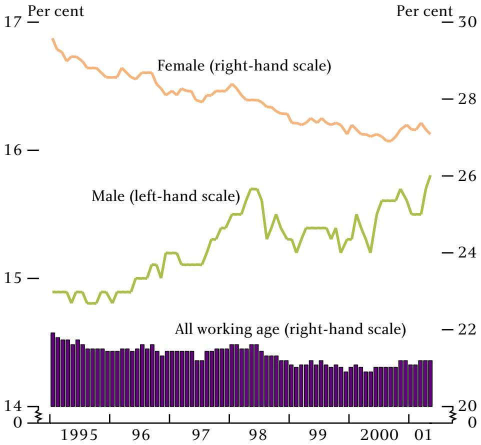
Around two-thirds of the decline in unemployment in the latest quarter was accounted for by those who had been unemployed for six months or less. By contrast, since 1995, the decline in short-term unemployment has accounted for less than a fifth of the overall decline in unemployment. The effect on pay pressures of a given level of, or change in, aggregate unemployment is likely to depend on its composition in terms of duration. Those who have been unemployed for only a short time tend subsequently to enter employment more easily than those who have been unemployed for longer periods. There are two possible reasons. First, evidence on flows into and out of employment suggests that people with higher education and training levels are likely to have least difficulty finding a job. So the pool of long-term unemployed will tend to consist disproportionately of people with lower skill levels on average. Second, for individuals with a given initial level of skills, the experience of being unemployed may progressively reduce the chance of finding a job; either because those skills are lost or become obsolete, or because employers use unemployment history, as well as other characteristics, as a signal of quality. So the short-term unemployed exert a greater restraining influence on pay negotiations than the long-term unemployed. A decline in aggregate unemployment would therefore reduce the restraining influence by a greater amount when it is concentrated among the short-term unemployed.

The pool of inactive people of working age—those who want a job but are not currently available to start nor actively searching, and those who say they do not want a job—is another potential source of labour supply. There has been an increase in inactivity since summer 2000. Both male and—perhaps more significantly—female inactivity rates have risen. This contrasts with the trend decline in female inactivity of recent years (see Chart 3.4). The LFS asks respondents why they are not active in the labour market. Chart 3.5 shows that the turnaround in the aggregate inactivity trend can be accounted for by a change in the number of people saying they are inactive because they are students, they are sick, or they have family commitments. Recent labour market reforms may have been a factor. For example, the Working Time Directive introduced paid leave entitlements for temporary workers. By raising the fixed costs of employment, that could have reduced the supply of short-hours jobs that are suitable for students or those with family responsibilities. Data on the distribution of average hours worked indicate a decline in the proportion of short-hours jobs.

The future path of inactivity will be affected by several factors. For example while Government initiatives such as the Working Families Tax Credit and the New Deal aim to raise participation, the ageing of the population will tend in the longer term to work in the opposite direction, as a greater share of the population enters early retirement. Though considerable uncertainty exists, it remains the MPC's judgment that the inactivity rate will resume the slow downward path that has been apparent since around the mid-1990s but from a rather higher level than had previously been expected.

Each category of person not in a job has very different prospects of gaining employment, so changes in the unemployment or the inactive total may not always be an effective guide to changes in labour availability. A complementary measure can be calculated by weighting different categories of the non-employed together, according to their average experience of moving into employment in the

Chart 3.4
Inactivity rates(a)



(a) Percentage of population of working age.

Chart 3.5
Changing reasons for inactivity

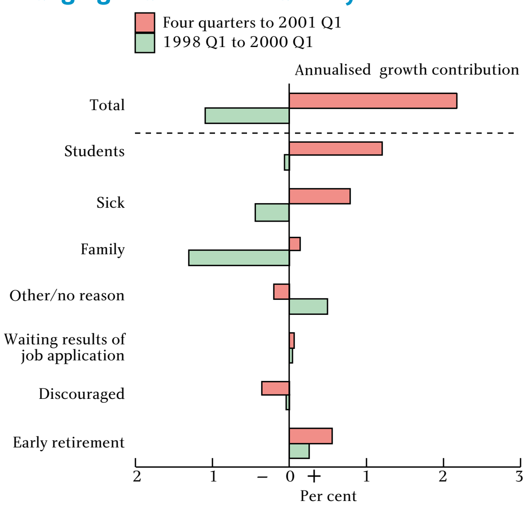
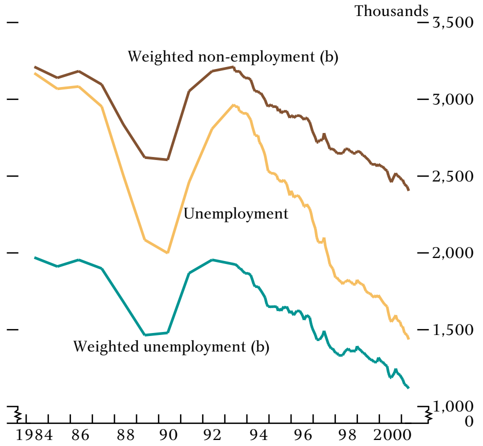


Chart 3.6
Measures of labour availability(a)



Sources: ONS and Bank of England.

(a) Pre-1993 figures based on yearly observations.
(b) The weighted non-employment/unemployment series are weighted averages of the number of people in different categories of inactivity and unemployment. The weights are based on the average proportion in each category who found employment in the next three months, relative to the proportion of the short-term unemployed who found employment in the next three months. So the short-term unemployed have a weight of one and the long-term unemployed and inactive have lower weights.

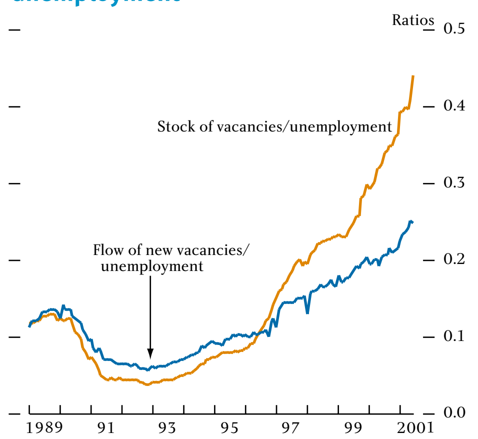
Table 3.B
Surveys of labour shortages(a)

	Series average (b)	2000 Q2	Q3	Q4	2001 Q1	Q2
BCC (c)						
Services	50	60	66	64	66	64
Manufacturing	56	70	73	71	76	63
Skilled/professional						
Consumer, business and professional services (d)	34	31	43	32	36	48
Financial services (e)	20	27	40	34	37	26
Manufacturing (f)	11	16	17	19	17	15
Unskilled/other						
Consumer, business and professional services (d)	8	8	9	12	8	15
Financial services (e)	9	18	24	19	19	16
Manufacturing (f)	2	3	2	3	2	3

Sources: BCC, CBI/Deloitte & Touche, CBI/PricewaterhouseCoopers and CBI Quarterly Industrial Trends.

(a) Seasonally adjusted by the Bank.
(b) BCC from 1989; CBI/Deloitte & Touche from 1998; CBI/PricewaterhouseCoopers from 1990; CBI Industrial Trends from 1979.
(c) Percentage of firms recording difficulty in recruiting staff over the previous three months.
(d) Percentage of firms citing labour shortage as a factor likely to limit output over the next twelve months. Average of consumer, business and professional services from the CBI/Deloitte & Touche survey weighted by value added.
(e) Percentage of firms citing labour shortage as a factor likely to limit output over the next twelve months from the CBI/PricewaterhouseCoopers survey.
(f) Percentage of firms citing labour shortage as a factor likely to limit output over the next four months from the CBI Industrial Trends survey.

Chart 3.7
Ratio of Jobcentre vacancies to unemployment(a)



(a) Claimant count unemployment.

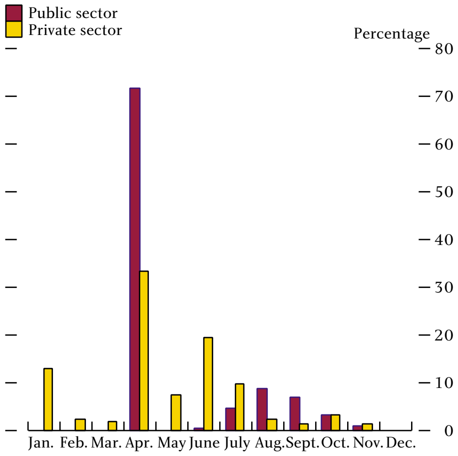
next period. Such a weighted non-employment measure may give a better indication of how easy it would be to replace those currently in employment, and hence their bargaining power. In the first half of the 1990s weighted unemployment fell less sharply than the unemployment total, because the decline in unemployment was concentrated among the long-term unemployed who have a relatively low probability of finding a job. Partly because some long-term unemployed ceased to search actively for work, the increase in inactivity over that period also meant that the decline in weighted non-employment was relatively modest. At present, weighted unemployment and non-employment measures are below their previous troughs in 1990, though by much less than headline unemployment (see Chart 3.6).

Surveys that ask firms about recruitment difficulties and skill shortages can help to measure changes in the demand for labour relative to its availability, ie the degree of labour market tightness. The REC survey reports that the availability of agency staff at recruitment consultancies is no longer falling, as it has done since June 1999. And the Bank's regional Agents have reported a slight easing in the extent of skill shortages since the beginning of the year, though they remain at a high level. Table 3.B indicates that recruitment difficulties and skill shortages have eased in the manufacturing sector, but not universally in the service sector.

The ratio of vacancies to unemployment is also a potential indicator of labour market tightness: the more vacancies there are relative to the numbers of people looking for work, the harder it is likely to be to fill them. Chart 3.7 shows that the stock of Jobcentre vacancies continues to rise relative to the stock of unemployed, though the sharp increase in June is partly attributable to a reorganisation of the way that vacancies are processed.(1) There are several other more persistent weaknesses with this measure. Evidence suggests that the unemployed take only around one month on average to search the existing stock of Jobcentre vacancies. So for those who remain unemployed for longer than a month, the existing stock of Jobcentre vacancies is less likely to contain suitable opportunities than the flow of new vacancies—the existing stock of vacancies is more relevant to those who have just become unemployed. So an alternative measure of labour market tightness using Jobcentre vacancies can be calculated by comparing the *flow* of new vacancies with the stock of unemployed. The added benefit of this measure is that it is less affected by the recent administrative changes. This ratio

(1) The Department of Work and Pensions is gradually introducing a new vacancy listing service called 'Employer Direct'. The ONS expects that during the transition, notification of vacancies filled may be less timely, raising the measured stock of those unfilled.

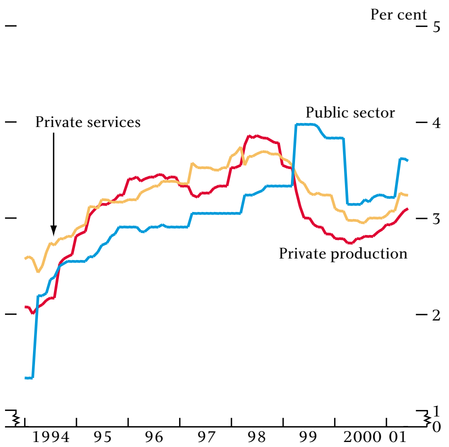
Chart 3.8
Distribution of settlements in 2000(a)



Sources: CBI, Incomes Data Services, Industrial Relations Services, Labour Research Department, and the Bank's regional Agents.

(a) Percentage of employees covered by the Bank's database reaching a settlement in each month.

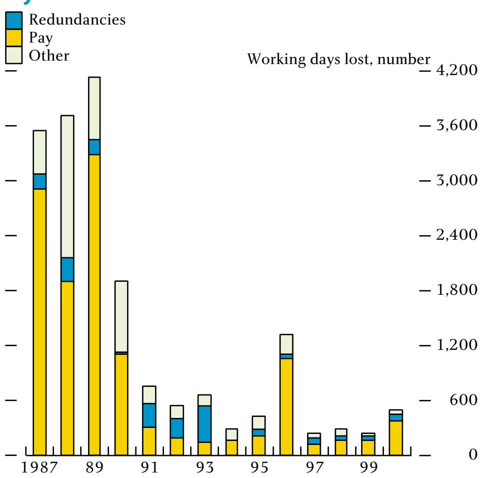
Chart 3.9
Wage settlements(a)



Sources: CBI, Incomes Data Services, Industrial Relations Services, Labour Research Department, and the Bank's regional Agents.

(a) Twelve-month AEI-weighted mean.

Chart 3.10
Working days lost in labour disputes by reason



Source: *Labour Market Trends*, June 2001.

fell slightly in June (see Chart 3.7). A drawback with both measures is that the ONS estimates that Jobcentre vacancies account for only around a third of total vacancies. Jobs, particularly white-collar ones, tend to be advertised through other media such as the press and the Internet. According to the REC survey, press advertising for jobs in June was around 20% below its level a year earlier. A further potential weakness, as explained in the box on page 26, is that the relationship between vacancies and unemployment can also be affected by longer-term structural changes in the labour market.

3.3 Settlements, earnings and unit wage costs

Wage settlements are changes in basic pay received by large groups of workers. Basic pay remains the most important component of earnings: according to the New Earnings Survey, basic pay accounted for around 90% of total earnings in 2000. The Bank collects information on settlements from various sources and weights it together so that it is broadly consistent with the sample of the Average Earnings Index (AEI). The AEI-weighted average settlement over the twelve months to June was 3.4%, a little above its level during 2000. That partly reflects the effect of higher public sector settlements this year than last. April is the most important month in the pay round (see Chart 3.8), with around 70% of public sector employees settling in that month. Settlements in the private services and production sectors have also edged up over the past year (see Chart 3.9).

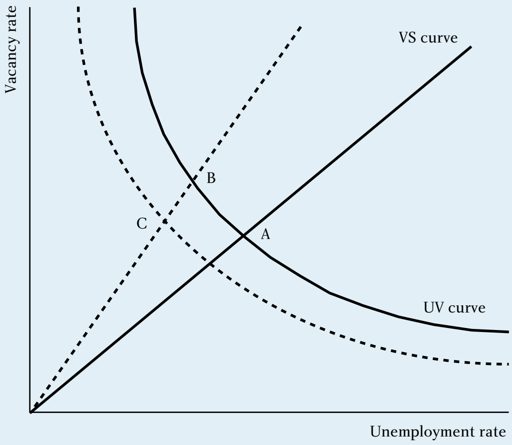
Settlements will to some extent reflect the relative bargaining power of trade unions. Over the longer horizon that bargaining power has fallen. The proportion of workers covered by trade union collective agreements has halved from its peak of 70% in 1980, and this decline has been almost matched by the fall in union membership. The strike rate has declined considerably: the number of working days lost per employee during the 1990s was only around 10% of that in the previous decade. But from a shorter-term perspective, the number of working days lost through labour disputes in 2000 was at its highest since 1996 (see Chart 3.10). Labour disputes do not always reflect pay pressures in the labour market: in the early 1990s disputes tended to be about redundancies. But disputes about pay accounted for the vast majority of working days lost in 2000.

Wage negotiations are also affected by expectations of inflation. Different rates of price inflation are relevant to workers and firms when they are bargaining over nominal wages. Workers care about the quantity of goods and services

Unemployment and vacancies

The ratio of vacancies to unemployment is often used to indicate the degree of imbalance between demand and supply in the labour market, or labour market tightness.(1) In simple terms, vacancies represent demand for additional labour and the unemployed represent the pool of labour available to meet that demand. If the number of vacancies rises relative to the stock of unemployed then, other things equal, there would tend to be upward pressure on wages. But some of the rise in the ratio of vacancies to unemployment during the 1990s may reflect structural improvements in the labour market.

Chart A

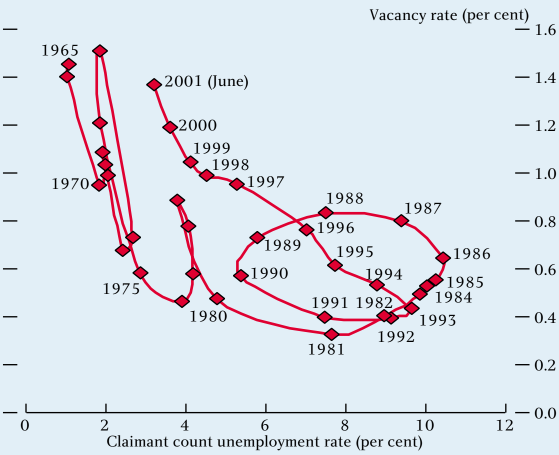


The different effects of increased demand for labour and structural improvements in the labour market can be illustrated using the diagram above. The unemployment-vacancy (UV) curve, sometimes known as the Beveridge curve, shows for a given flow of people into unemployment, the level of vacancies required to keep the overall stock of unemployment stable. For a given flow into unemployment, the UV curve will shift to the left if the unemployed search harder for work, or employers become more willing to take them on, or the vacancies and the unemployed become better matched to each other. This is because, for a given stock of vacancies, the flow out of unemployment into jobs will be higher and so the stock of unemployed will fall.

The number of vacancies created by firms will depend on the profits generated by taking on additional workers. High unemployment tends to reduce real wages, which makes it more profitable for firms to create vacancies. This vacancy-supply relationship is the VS curve in the diagram. As the demand for labour rises during a business cycle, the VS curve pivots to the left, and the ratio of vacancies to unemployment will increase (a move from A to B). But structural improvements in the labour market will also pivot the VS to the left. For example, if the unemployed search harder, firms will find it easier to find workers and so it will be more profitable to open up job vacancies. Structural improvements in the functioning of the labour market therefore lead to movements in both the VS curve and the UV curve to a point such as C. Unemployment falls relative to vacancies and so, as in the case of a cyclical increase in the demand for labour, the ratio of vacancies to unemployment rises.

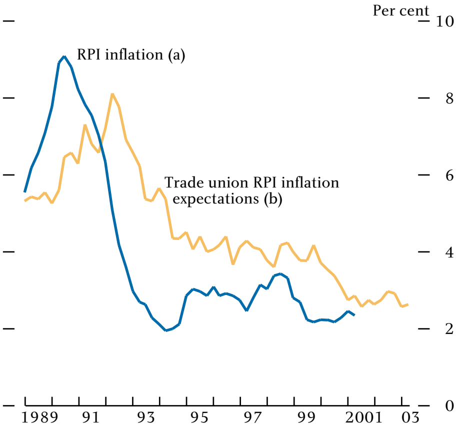
We can assess the contribution of structural change to increases in the vacancy-unemployment ratio by plotting unemployment against vacancies over time (see Chart B). Cyclical shifts in the demand for labour generate movements along a fixed downward-sloping line, whereas structural improvements in the labour market cause plots of unemployment and vacancies to shift to the left. We can see that a pronounced shift to the right occurred between the mid-1970s and the mid-1980s, indicating a structural worsening. But since the mid-1980s there appears to have been a shift back to the left. That may reflect, among other things, recent changes to the benefits regime aimed at increasing the incentives to search for work. Government initiatives such as the Working Families Tax Credit and the New Deal will also tend to improve the matching of the unemployed to vacancies. And weaker employment protection laws may have made firms less cautious about filling vacancies.(2) So it seems plausible that some of the increase in the vacancy-unemployment ratio in recent years reflects structural improvements as well as a tightening of the labour market.

Chart B
Unemployment plotted against the stock of vacancies, 1965–2001



(1) See, for example, Pissarides, C (2000), 'Equilibrium unemployment theory'.
(2) For a discussion of these factors see Nickell, S, (2001),'Has UK labour market performance changed?', Bank of England *Quarterly Bulletin*, Autumn, forthcoming.

Chart 3.11
Trade union inflation expectations



Source: Barclays Basix survey.

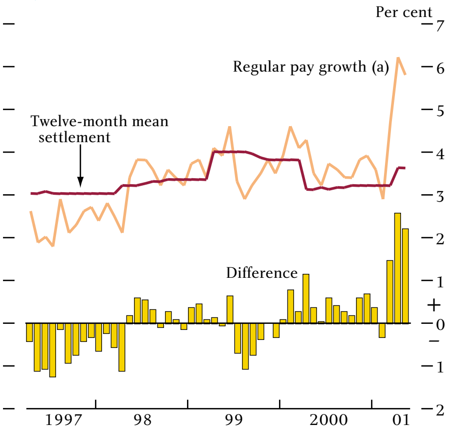
(a) Average annual rate of change in RPI over the previous two years.
(b) Expected average annual rate of change in RPI over the next two years (led two years).

Table 3.C
Regular pay growth(a)

	Whole-economy	Public sector	Manufacturing	Private sector services
2000				
November	4.6	3.8	4.0	5.2
December	4.6	3.9	4.2	5.0
2001				
January	3.8	3.6	4.5	3.4
February	4.1	2.9	4.5	4.3
March	4.8	4.7	4.6	5.0
April	5.3	6.2	5.2	5.1
May	5.1	5.8	5.2	4.7

(a) Annual percentage changes. Not seasonally adjusted.

Chart 3.12
Pay growth in the public sector



(a) As a result of a change in the AEI survey questionnaire concerning bonuses, this series is subject to a discontinuity between January and February 2000. But as bonuses are relatively unimportant in the public sector the effect is small.

they can purchase and so retail prices, which encompass the costs of domestically produced and imported goods and services, are most relevant to them. Chart 3.11 shows how trade unions' expectations of retail price inflation have fallen during the 1990s and have recently been very close to outturns for inflation and the RPIX inflation target of 2.5%. They also expect the average rate of inflation over the next two years to be around 2.5%. If inflation expectations remain anchored on the target rate, unexpected short-term movements in inflation are less likely to lead wage bargainers to change their nominal wage demands, which will contribute to more stable inflation, output and employment over time.

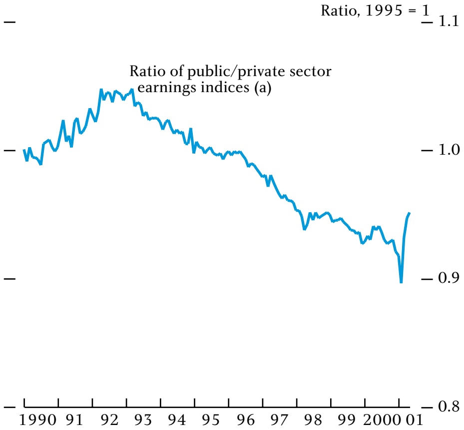
Firms care about the difference between the wages they pay and the prices at which they can sell their goods and services. Changes in these prices can differ from movements in the aggregate retail price index for many reasons. One reason would be differing movements in domestic prices and import prices. For example, the appreciation of sterling since 1996, by putting downward pressure on import prices, has tended to reduce retail price inflation relative to the rate of increase in the price of domestically produced goods and services. So real wages as perceived by workers have been growing more quickly than real wages seen from the employers' point of view. That has acted to reduce the pressure on nominal wage growth for any given level of unemployment, but only temporarily while import prices adjust to the higher level of the exchange rate.

Higher settlements feed through directly to regular pay growth, which has picked up in the public and private sectors since the beginning of the year (see Table 3.C). As well as company and industry-wide settlements, regular pay growth incorporates the effects of individually-tailored pay increases, which will reflect performance and particular skill shortages.

The difference between regular pay growth and settlements is unusually large in the public sector at present (see Chart 3.12). That reflects special one-off increases for teachers, tied to the acceptance of performance-related pay, which have been backdated to September 2000. The payment of these arrears is likely to distort public sector pay growth in the short term. Overall, according to the Average Earnings Index, public sector pay has grown less rapidly than private sector pay over the past five years (see Chart 3.13). The recent increases in public sector pay have been made specifically to address the increasing signs of skill shortages. Settlements for medical staff were also higher than a year ago.

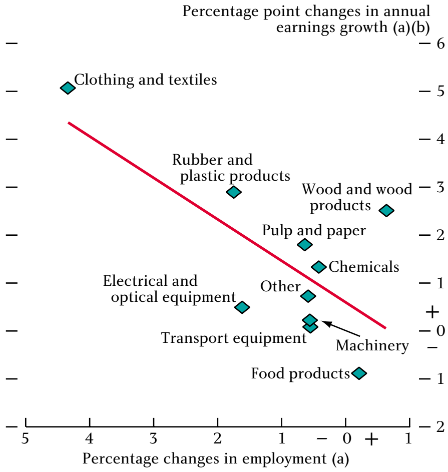
Some employers may regard the uprating of the minimum wage as akin to a settlement for the low-paid. In June 2001

Chart 3.13
Relative public sector earnings



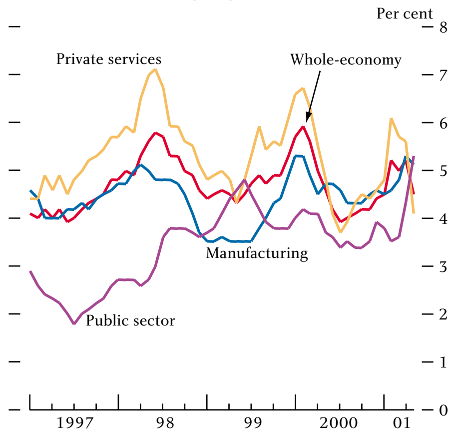
(a) Ratio of Average Earnings Indices, 1995 = 100.

Chart 3.14
Manufacturing earnings growth and employment by sector



(a) December 2000 to May 2001.
(b) Based on the Average Earnings Index excluding bonus payments (three-month moving average).

Chart 3.15
Headline earnings growth



the Government agreed to an increase in the National Minimum Wage for employees aged 18–21 from £3.20 to £3.50 in October 2001, and to £3.60 in October 2002. Together with the already announced uprating of the adult rate (to £4.10 in October 2001), the Low Pay Commission estimates that this will increase the aggregate wage bill by up to 0.2%. The MPC agrees that the impact on aggregate pay is likely to be small.

Regular pay growth has picked up in manufacturing. Given the deterioration in output and employment prospects in the sector, that might seem surprising. But many of those employed in manufacturing have skills that could also be used elsewhere in the economy, and so to recruit and retain those staff, wages need to compete with those offered elsewhere. In fact regular pay growth in the manufacturing sector currently *exceeds* that in the private service sector (see Table 3.C). That may be because the decline in employment in the manufacturing sector has been concentrated among those with least experience and hence on relatively low wages. The Average Earnings Index measures the change in the wage bill per head. So if a firm reduces the proportion of relatively low-paid employees the wage bill per head will rise. Chart 3.14 provides some evidence for this effect: average earnings growth has increased more in those sectors where employment has fallen. And the ONS has said that there is some evidence of firms laying off temporary, low-paid, workers.

Incorporating the effects of bonuses, headline pay growth (a three-month moving average of the monthly data) picked up across the public, manufacturing and private service sectors between mid-2000 and April 2001 (see Chart 3.15). In 2001 Q1, headline earnings growth, at 5%, was a little stronger than projected in the May *Inflation Report*. The headline measure has fallen back since then, to 4.5% in May. That partly reflects the February figure, which was boosted by large financial sector bonuses (normally paid in March) dropping out of the three-month moving average. But a large negative contribution from bonuses in May also reduced the headline measure. Bonus payments should partly be related to past corporate profitability. Official data up to 2001 Q1 indicate a slowdown in the rate of growth in profits, and survey information for 2001 Q2 also indicates a weakening in profitability.

Firms may initially react to lower realised profits by reducing bonus payments. But if prospective profitability weakens that may also put downward pressure on wage settlements or employment. That is evident in the manufacturing sector (see Table 3.D). But in the service sector, recruitment and retention needs are putting upward pressure on settlements,

Table 3.D
Influences on pay settlements

Percentage balance reporting factor as a 'very important' upward pressure

	Services		Manufacturing	
	Level 2001 H1 (a)	Change since 2000 H2	Level 2001 H1 (a)(b)	Change since 2000 H2 (b)
Cost of living	15	-18	19	-15
Recruitment/retention	40	+12	9	+3
Productivity	12	+6	8	-1
Ability to adjust prices	-13	+7	-41	+2
Profits	-3	+2	-27	-10
Orders	-2	-1	-14	-7

Source: CBI *Pay Databank Report*, July 2001.

(a) Provisional.
(b) Average of quarterly balances.

Chart 3.16
Whole-economy unit wage costs

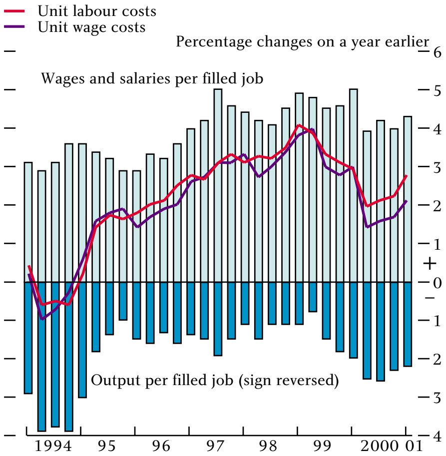
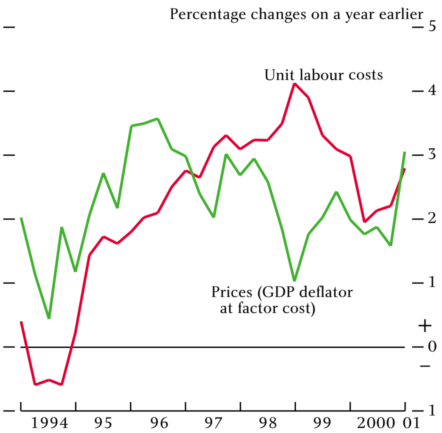


Chart 3.17
Output prices and unit labour costs



and that pressure appears to have intensified since the second half of 2000.

The extent to which wages can rise relative to the prices charged by firms depends partly on how productive labour is. Productivity growth has fallen a little in recent quarters, as output growth has slowed. Annual growth in whole-economy output per head was 2.2% in 2001 Q1, close to its 40-year average. The slight decline in productivity growth, together with the increase in growth in wages and salaries per head, raised growth in unit wage costs (see Chart 3.16). Unit labour costs, which include non-wage labour costs such as National Insurance and pension fund contributions, rose a little more quickly. Given the tight labour market, the real cost of hiring the labour necessary to produce a given quantity of output has risen in recent years. In other words, unit labour costs have risen more quickly than output prices, raising real unit labour costs and lowering the share of profits in GDP (see Chart 3.17).

Looking ahead, the MPC's central projection is for further moderation in output growth. Employment typically adjusts to output with a lag, and so weaker output will put further upward pressure on unit labour costs in the short run. Firms are likely to counteract this by reducing bonus payments and lowering pay offers, as well as gradually reducing hours worked and employment. A lower level of labour market utilisation will also tend to dampen prospective growth in earnings relative to prices.

3.4 Summary

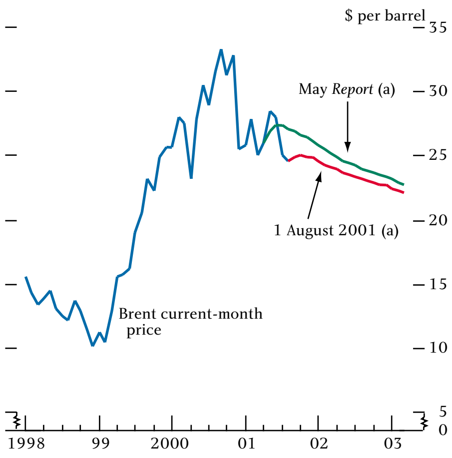
The level of labour market utilisation remains high and growth in employment still exceeds growth in the population of working age. Consistent with this, firms continue to report a high level of recruitment difficulties and skill shortages, though they have abated recently. Wage settlements and regular pay growth have edged up. Together with the decline in productivity growth, that has led to an increase in unit labour cost inflation, putting downward pressure on corporate profitability. Looking ahead, employment intentions for the immediate future have weakened, reflecting lower profitability and a deteriorating outlook for demand, but probably remain positive for the economy as a whole.

4 Costs and prices

Retail price inflation in 2001 Q2 was somewhat higher than expected at the time of the May *Report*, mainly reflecting unexpectedly strong food price increases. There have, however, also been some signs of a more broadly-based pick-up in inflation. But most evidence suggests that price pressures lower down the supply chain have eased further since the May *Report*. Oil prices have declined and weaker global activity has led to further falls in the prices of other commodities. This has put downward pressure on UK manufacturers' input prices. And despite stronger recent unit labour cost growth, the annual rate of increase in manufacturers' overall costs continues to fall, while manufacturers' output price inflation has remained subdued. Evidence on the service sector is more mixed. Official data suggest a pick-up in both labour cost growth and output price inflation in Q1. In contrast, various surveys indicate that cost and price pressures in the sector weakened during Q1, and have eased further in Q2.

4.1 Commodity prices

Chart 4.1
Brent oil futures

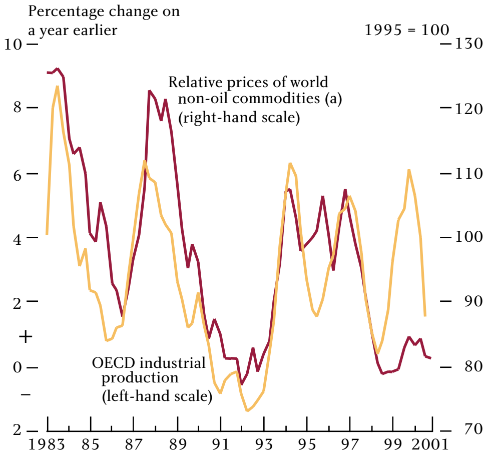


(a) Average of the 15 working days up to the finalisation of the MPC's projections.

Oil prices have fallen since the May *Report*, and by more than expected. The price of Brent crude fell steadily from a peak of just under $30 in mid-June to reach its lowest level this year of $23.60 in mid-July. The stronger-than-expected decline in prices appears to have been driven by a combination of both supply and demand factors. During the period, the International Energy Agency made significant downward revisions to its forecasts of world oil demand, while data were released indicating a considerable rise in stocks of crude oil and gasoline in the United States. Prices recovered slightly in late July, as OPEC members elected to cut output by 1 million barrels a day in an effort to halt the decline in prices. In the 15 working days to 1 August, prices averaged a little under $25, some $2 per barrel lower than expected in May. The futures curve continues to point to the price of oil falling in the medium term, though the expected profile has shifted down only slightly since May (see Chart 4.1). Consequently, the MPC has revised down its central projection for oil prices to reflect these developments.

World non-oil commodity prices have also declined in recent months, driven mainly by weaker metals and food prices. The

Chart 4.2
World commodity prices and industrial activity



(a) *The Economist* non-oil commodity price index relative to G7 manufacturers' export prices.

Chart 4.3
Contributions to quarterly changes in sterling goods import prices

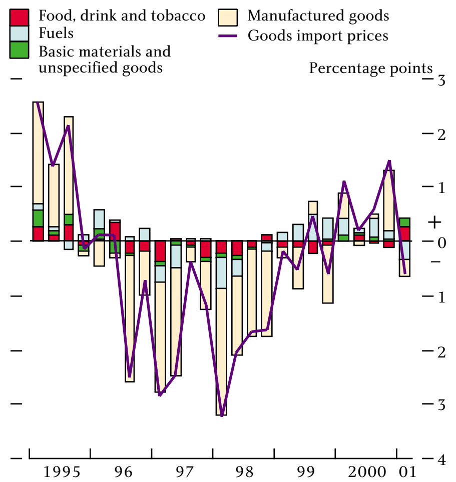
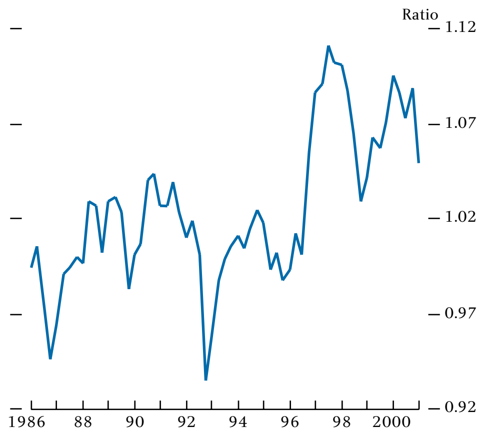


Chart 4.4
UK import prices relative to world export prices



Sources: ONS and Bank of England.

relative price of these commodities tends to move pro-cyclically with world activity. However, this relationship has been less marked more recently (see Chart 4.2). As world growth increased following the 1997–98 financial crisis, the recovery in world commodity prices was considerably weaker than in earlier upturns. During this period, agricultural prices continued to decline, while the pick-up in prices of industrial commodities, which typically have the strongest association with world activity, was also relatively less significant. This may be because much of the increase in world industrial production during 1999 and 2000 was concentrated in high-technology sectors, whose use of commodities is less intensive than traditional manufacturing. Conversely, with the recent downturn in world industrial production mainly reflecting weaker activity in these high-technology sectors, this may imply that any fall in commodity prices will also be relatively less marked than in earlier downturns.

4.2 Import prices and the exchange rate

Sterling import prices fell by 0.4% in Q1, and were considerably weaker than expected in the May *Report*. Within the total, goods prices more than accounted for the fall. This reflected lower manufactured goods prices and weaker world oil prices in Q1 (see Chart 4.3). Offsetting this to some extent was a strong pick-up in imported food prices—notably meat prices. As the May *Report* suggested, this probably resulted from firms switching to higher-cost foreign sources than normal, as domestic supply was restricted following the outbreak of foot-and-mouth disease.

The main determinants of movements in import prices had pointed to a further increase in Q1. In particular, the average sterling effective exchange rate index (ERI) in Q1 depreciated by around 3% compared with the previous quarter. In addition, although the increase in world export prices in Q1 was slightly lower than expected, they continued to rise at a broadly similar pace to earlier quarters. Previous *Reports* have discussed how the relative profitability of sales to the United Kingdom has increased in recent years. Price differentials between UK imports and goods and services traded in world markets do not tend to persist, as competitive forces work to diminish any unusual profits. Reflecting this, the MPC believes that the differential will be gradually reduced. The latest data suggest that this differential fell back noticeably, and by more than expected, in Q1 (see Chart 4.4).

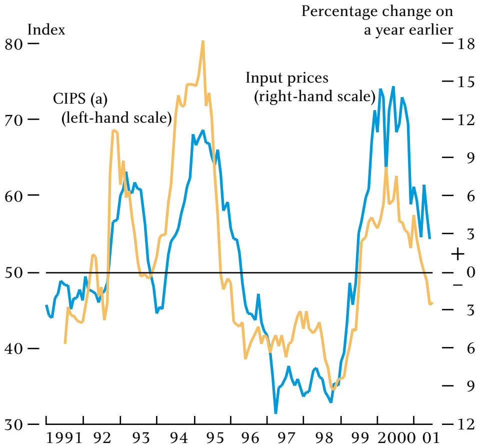
Consistent with the downturn in global activity, the MPC's central projection continues to assume that world export price inflation, and consequently import price inflation, slows over the next year. However, the weak Q1 outturn, together with the recent higher-than-expected level of the sterling ERI, means that the profile of import price inflation over the forecast period is somewhat lower than assumed in May.

4.3 Costs and prices in manufacturing

Manufacturers' input price inflation has eased a little further since the May *Report*, though the monthly profile has been volatile. The annual rate of inflation was 2.6% in June, much lower than the average of more than 10% during the second half of last year. Since the beginning of this year, around three-quarters of the slowdown has resulted from much weaker imported price inflation. Some of the easing also reflects strong oil price rises last year dropping out of the annual comparison. And other energy prices have also fallen—in particular, after rising by around 50% in 2000, the level of gas prices has fallen back by around 10% from its February peak.

These weaker price pressures were offset to some extent by higher costs of food inputs, from both imported and domestic sources, despite declining world food prices. As mentioned in earlier *Reports*, while UK food prices are influenced by world prices, agricultural products are additionally affected by local supply-side shocks. In particular, domestic food input prices began rising late last year, mainly reflecting flood-related declines in UK yields of some agricultural crops. And, as Section 4.2 explains, this was exacerbated by the upward effects of foot-and-mouth disease on imported meat prices. These higher food prices have had significant effects on retail prices. The transmission from prices of food inputs to retail food prices is generally relatively rapid, since food is subject to less processing than many other retail goods.

Chart 4.5
Input price inflation



Sources: ONS and CIPS.

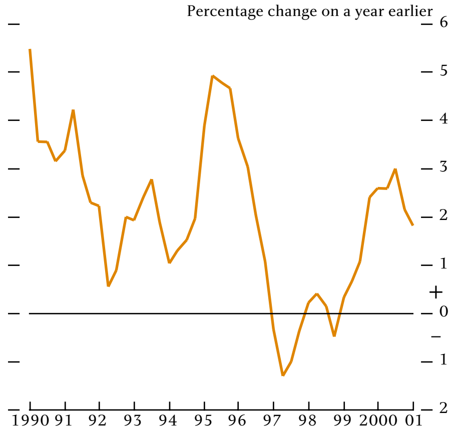
(a) A reading above 50 suggests rising prices, a reading below 50 suggests falling prices.

Consistent with the official data, survey evidence also points to weakening overall materials costs. The CIPS manufacturing survey input price index has fallen steadily to reach its lowest level for around two years in July (see Chart 4.5). This is despite the introduction of the Climate Change Levy from April 2001, which resulted in higher energy costs for some manufacturers.(1)

During much of 2000, manufacturing productivity rose rapidly as output increased while employment declined. Productivity growth outpaced earnings growth, leading to falls in manufacturers' unit labour costs. But with the significant downturn in manufacturing output since the turn of the year, productivity growth has slowed. Combined with a rise in

(1) The levy is chargeable on the industrial and commercial supply of fuels—mainly electricity, natural gas and coal—and is applied at a specific rate per nominal unit of energy use. It does not apply to oil and petroleum products, as these are already subject to excise duty. Energy-intensive industries may be eligible for a reduction of up to 80% of the levy. Published ONS input price indices do not yet include the impact of the levy, but DTI estimates suggest that it may have increased overall input prices by around 1% by June.

Chart 4.6
Manufacturers' weighted costs



Sources: ONS and Bank of England.

Chart 4.7
Output price inflation

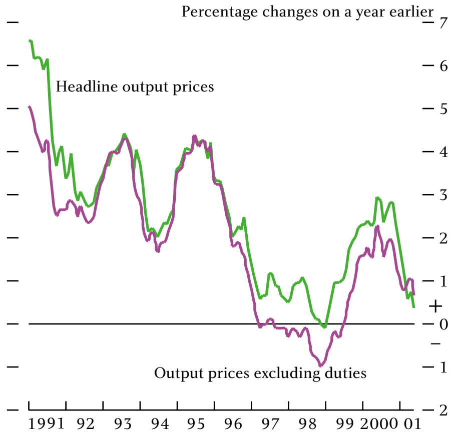


Table 4.A
Surveys of service sector prices

	2000 Q2	Q3	Q4	2001 Q1	Q2	Q3 (a)
Backward-looking						
CIPS average costs index (b)	61.7	61.7	61.2	57.2	55.9	54.1
CIPS average prices charged index (b)	54.1	53.4	54.8	52.0	50.9	50.3
CSPI (c)	4.1	4.3	4.3	5.0	n.a.	n.a.
Forward-looking						
BCC prices balance (d)	21	23	32	32	18	n.a.

(a) July survey only.
(b) A reading above 50 suggests rising prices, a reading below 50 suggests falling prices. The CIPS survey is monthly, and the quarterly values shown are averages of the relevant three months.
(c) Corporate services prices index. Percentage change on a year earlier.
(d) Percentage balance of responses to the question: 'Over the next three months do you expect the price of your services to increase/remain the same/decrease?'

earnings growth (see Section 3), unit labour costs increased significantly in Q1. However, despite stronger unit labour cost growth, weaker materials price inflation resulted in the annual rate of increase in overall costs falling further (see Chart 4.6).

But manufacturers' costs continued to rise faster than prices charged, suggesting further downward pressure on manufacturers' profitability. Manufacturers' output price inflation has slowed significantly since late last year. Within the total, most of the slowdown reflects weaker petroleum-related product price inflation, although there is also evidence of a more broadly-based easing across most manufacturing industries. In the year to June 2001, output prices (excluding excise duties) rose by just 0.7%. Headline output price inflation (including duties) has slowed by an even greater extent (see Chart 4.7), as oil-price-related falls were combined with a significant reduction in petrol duties in March's Budget. Looking ahead, reports from the Bank's Agents suggest that downward pressures on manufacturers' output prices remain. Consistent with this, recent survey data indicate that output price inflation is likely to ease further. Both the BCC and CBI quarterly surveys showed further falls in the net balance of manufacturing firms expecting to increase their output prices over the next few months.

4.4 Costs and prices in the service sector

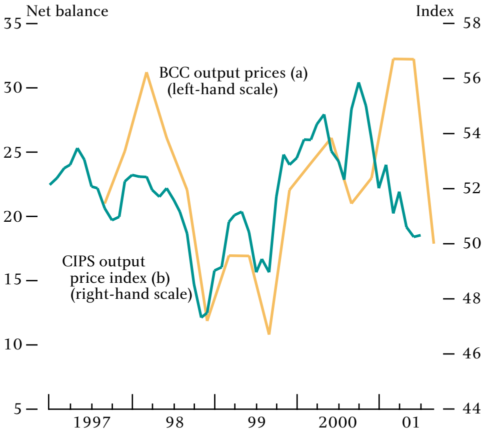
Annual unit wage cost growth in the service sector is estimated to have increased slightly in 2001 Q1, though it remained below the average of the past few years. Since then, preliminary estimates show that service sector output growth slowed in Q2, though weaker growth in service sector earnings in April and May 2001 (see Section 3) suggest that annual unit wage cost growth is likely to have eased back more recently.

Survey evidence, however, points to a more muted picture of cost pressures. The CIPS survey suggests that cost pressures weakened in the service sector in Q1, and eased further more recently (see Table 4.A). Firms cited weaker upward wage pressures as one of the main factors responsible for this easing. Similarly, the BCC survey also indicated weaker wage pressure in the sector in Q2.

The evidence on service sector output price inflation is also mixed. Annual inflation measured by the ONS's experimental corporate services prices index (CSPI) rose to 5.0% in Q1, the highest since the series began in 1996.[1] The highest rates of

(1) 'Corporate services' are those services purchased by businesses from other businesses to support them in their usual line of activity. Although coverage of the index is gradually being expanded, the ONS estimates that the index currently accounts for only around 50% of the sector.

Chart 4.8
Service sector output prices



(a) Percentage balance of responses to the question: 'Over the next three months, do you expect the price of your services to increase/remain the same/decrease?'
(b) A reading above 50 suggests rising prices, a reading below 50 suggests falling prices.

Chart 4.9
Retail price inflation

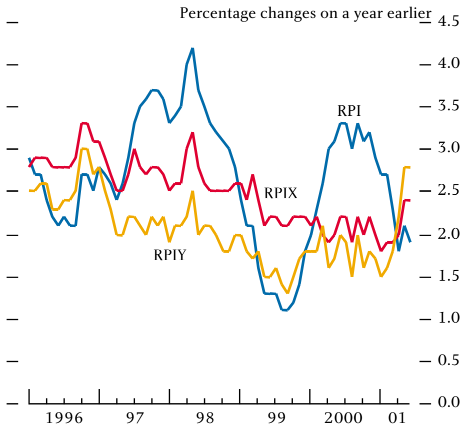
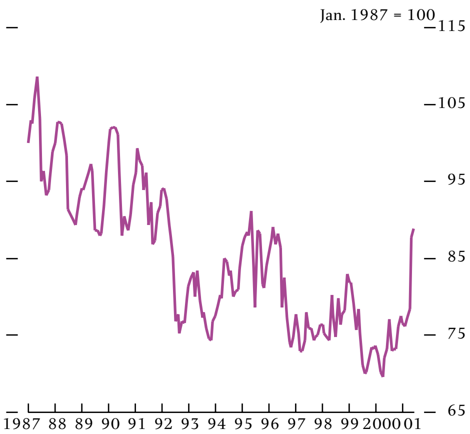


Chart 4.10
Relative seasonal food prices(a)



(a) Relative to RPIX excluding seasonal food prices.

inflation continued to be recorded in the transport-related industries, namely road freight transport and business air travel. Price movements in these industries are typically closely related to oil price changes. As such, inflation might be expected to ease in coming quarters as the decline in oil prices since late last year and the reduction in fuel duties in this year's Budget are passed through.

The CIPS services survey also implies strong fuel-price-related output price inflation in the transport sector, though the survey suggests that overall output price pressures in the service sector weakened in Q1, and have slowed further in Q2 (see Chart 4.8). Looking ahead, the latest BCC survey suggests that output price pressures will ease further in the three months to September, with the balance of service sector firms expecting to raise prices now at a two-year low.

4.5 Retail prices

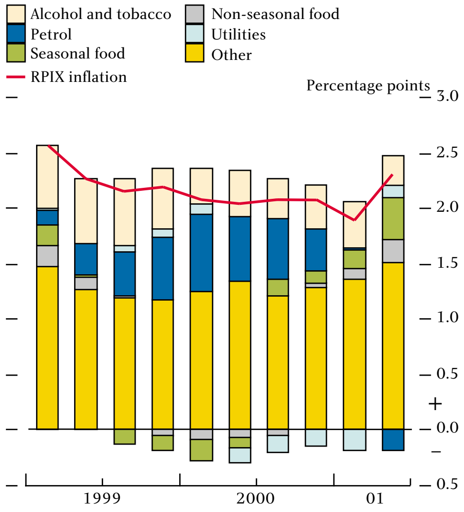
Annual RPIX inflation rose from a historical low of 1.9% in Q1 to 2.3% in Q2—somewhat higher than the steady outturn expected at the time of the May *Report*. Within the quarter, RPIX inflation rose by 0.4 percentage points between April and May to reach a two-year high of 2.4% (see Chart 4.9). This was the largest one-month rise in the annual inflation rate for three years. Subsequently, inflation remained unchanged in June.

As anticipated, RPI inflation fell below RPIX inflation during the period, as earlier reductions in mortgage interest rates fed through and as the effects of the abolition of MIRAS last year dropped out of the annual comparison. Annual RPI inflation averaged 1.9% in Q2, down from 2.6% in the previous quarter.

From a monetary policy perspective, it is important to identify and understand the sources of movements in the aggregate inflation rate, to determine whether they are likely to be temporary or more persistent. The unexpected rise in retail price inflation during Q2 largely reflected a sharper-than-anticipated increase in the contribution of food prices. In particular, seasonal food prices rose strongly in Q2 to be 21% higher than a year earlier—the highest annual increase since 1984. As a result, the relative level of seasonal food prices is now unusually high, particularly given its historical downward trend (see Chart 4.10). Moreover, non-seasonal food prices, which typically lag movements in seasonal foods, have also picked up strongly.

As expected, the contribution to annual RPIX inflation from utilities prices rose markedly in Q2, as last year's significant price cuts were not repeated (see Chart 4.11). Together, the contribution of food and utility prices (around 16% of the

Chart 4.11
Contributions to annual RPIX inflation



RPIX basket) rose from 0.1 percentage points in Q1 to 0.7 percentage points in Q2. These rises were offset to some extent by a fall in the contribution from petrol prices. The contribution from petrol prices has declined considerably in recent quarters, as last year's strong oil-price-related rises have begun to drop out of the annual comparison. As predicted in the May *Report*, there were also downward effects in Q2 from changes in the duty paid on petrol, alcohol and tobacco relative to last year. Consequently, the RPIY measure of inflation, which excludes these indirect tax effects, rose by a much greater extent than RPIX inflation: from 1.6% in Q1 to 2.6% in Q2—the highest rate for more than four years and the largest quarterly increase in the annual RPIY inflation rate since the series began in 1987. Annual HICP inflation has also risen sharply, by 0.8 percentage points since January to reach 1.7% in June.

It is apparent from the above discussion that recent movements in retail price inflation have been significantly affected by a few components. Movements in some of these components (eg seasonal food and some energy prices) can generally be thought mainly to reflect supply-side factors, rather than underlying inflationary pressures. As such, the Committee judges that most of the recent increase in inflation is unlikely to persist. Part of it is likely to be reversed as earlier food price rises begin to drop out of the annual comparison. And although the timing is particularly uncertain, if food prices fall back from their current relatively high levels, the downward effect on inflation will be magnified. However, in the opposite direction, the current dampening effect from changes in specific duties in this year's Budget is expected to unwind partially if duties are raised in line with inflation next year. Looking ahead, monthly movements in aggregate annual inflation are likely to continue to be significantly affected by movements in a few volatile components. The profile of the annual inflation rate will be additionally influenced by base effects from erratic monthly movements in the index during the second half of last year.

Notwithstanding effects from these erratic factors, the Committee judges that some of the recent rise in inflation also reflects a more broadly-based pick-up. As Chart 4.11 shows, even excluding movements in certain volatile components, the contribution from the remaining RPIX basket has also risen slightly in recent quarters. But looking ahead, evidence of weaker price pressures further down the supply chain, discussed earlier in this section, implies that this upward trend is unlikely to persist.

Consistent with recent higher inflation outturns, the May CBI Distributive Trades survey showed a significant rise in the

Table 4.B
Surveys of retail prices

	2000			2001		
	Q2	Q3	Q4	Q1	Q2	Q3
CBI distributive trades (reported) (a)	-6	-25	-1	-2	14	n.a.
CBI distributive trades (expected) (b)	-12	-23	-9	-7	4	n.a.
GfK price expectations (c)	72	80	77	76	83	65 (d)
Basix general public expectations one year ahead (e)	3.8	4.2	4.1	3.5	3.7	n.a.
Bank's general public expectations one year ahead (f)	2.4	2.2	2.4	2.1	2.2	n.a.

(a) Percentage balance of responses to the question: 'How do your average selling prices compare with those in the same month a year earlier?' Question refers to the middle month of each quarter.
(b) Expectation one month ahead of reported prices balance.
(c) The GfK survey is monthly, and the quarterly values shown are averages of the relevant three months. Question asked: 'By comparison with what is happening now, do you think that in the next twelve months prices will rise?'
(d) July survey only.
(e) Question asked once every three months: 'Can you tell me what you expect the rate of inflation to be over the next twelve months?'
(f) Question asked once every three months: 'How much would you expect prices in the shops generally to change over the next twelve months?'

balance of retailers reporting higher selling prices, to +14 from -2 in February, though there is some evidence to suggest that a small part of this rise may be seasonal (see Table 4.B). Survey results show that the strongest increase was among food retailers. Providing supportive evidence for the rise in inflation being mostly temporary, the balance is expected to fall back to +4 in the near term.

Most surveys of the general public's expectations of inflation have also risen slightly. In the latest Basix survey, the general public's expectations of inflation one year ahead rose in Q2, but they remain lower than throughout 2000. A recent survey for the Bank of England shows a similar trend, though expectations are at a relatively lower level. It should be noted that, with the exception of the monthly GfK survey, all other surveys were undertaken before the release of May's official RPI data, showing the strong rise in inflation. The GfK survey also suggested a pick-up in consumers' inflation expectations in Q2. More recently, however, the July survey indicated a significant fall in inflation expectations, with the balance now at its lowest level for almost two years.

4.6 Summary

Oil prices have fallen since the May *Report* and by more than expected. Prices of other world commodities have also fallen further, reflecting the slowdown in world activity. Although manufacturers' unit labour costs have risen considerably recently, the annual rate of increase of their overall costs continues to slow. Manufacturers' output price inflation has remained subdued, and survey evidence suggests that this trend will continue in the near term. The cost picture in the service sector has been mixed, but here too, surveys provide little evidence of any upward pressure on output prices. Although remaining below the Government's $2^1/_2$% target, annual RPIX inflation rose unexpectedly to 2.3% in Q2. Erratic factors account for much of the unexpected rise. Although there has also been some evidence of a more broadly-based pick-up in retail price inflation recently, the weaker price pressures lower down the supply chain suggest that this upward trend is unlikely to persist. In the Committee's central projection, inflation stays around current levels in the short run, before falling back later this year and through the first half of 2002, and then subsequently edging back up again towards the target rate.

Monetary policy since the May *Report* 5

This section summarises the economic developments and monetary policy decisions taken by the MPC since the May *Report*.(1) The Bank's repo rate was maintained at 5.25% in June and July, and was reduced to 5% in August.

The MPC's central projection in May was for RPIX inflation to stay at about 2% in 2001, but to increase to around the $2^1/_2$% target at the two-year horizon. Annual real GDP growth was thought likely to fall to about 2% in the near term, recover to just above trend during 2002, and then fall slightly towards the end of the forecast period. Relative to the central projection, some members preferred alternative assumptions about supply-side developments and the international outlook that, in combination, could lower the inflation profile by up to $^1/_2$% at the two-year horizon.

At its meeting on 5–6 June, the Committee first discussed the world economy. Consumption in the United States remained surprisingly resilient, despite the downturn in manufacturing. Growth in the euro area was weaker than expected and showed signs of slowing further.

A key feature of the UK data, as in the United States, was the continued strength of consumption. That was reflected in strong growth in both retail sales and household borrowing, supported by a robust housing market and a pick-up in earnings growth. But output growth had slowed, especially in the sectors exposed to international trade. RPIX inflation was somewhat below target and was projected to remain so in the short term. If the slowdown in world activity and the strength of sterling persisted this would have dampening effects on inflation further ahead, but policy to offset these effects would tend to stimulate consumption further. And this could worsen the imbalances between strong demand and weak production and between sectors exposed to external competition and those sheltered from it.

On the immediate policy decision, there were two points of view. One view was that the prospects for a US recovery had

(1) The minutes of the May, June and July meetings are reproduced under a separate cover, published alongside this *Report*.

improved slightly since the previous meeting and, though the euro-area economy was weaker than expected, the overall outlook for world activity was little changed on the month. And the uncertainties about the current state of the domestic economy and the possible risks to the outlook from the imbalances meant that more information was needed about how domestic demand would evolve. On this view, interest rates should remain unchanged.

The other view was that world prospects were not encouraging and that the balance of risks to the domestic outlook was on the downside; though consumption was strong, there was evidence of weakening in the service sector, a survey by the Bank's regional Agents suggested that further destocking was likely, corporate price expectations were lower, and falling RPI inflation would probably dampen earnings growth later in the year. On this view, the outlook for the UK economy was weaker than at the previous meeting and the inflation outlook more benign, warranting an immediate cut in rates.

The Committee voted by 8 to 1 to leave the Bank's repo rate unchanged, with one member voting for a 25 basis point cut.

At its meeting on 4–5 July, the Committee first discussed the domestic outlook. It was puzzling that household consumption growth had not shown more of a rebound in the ONS data; it was estimated to have grown in the first quarter by no more than in the previous quarter, when it had been affected by bad weather and transport-related disruptions. Many of the other consumption indicators suggested a buoyant picture for consumer spending, however. Retail sales continued to grow strongly, consistent with rising consumer confidence and strong data on money, credit and the housing market. The labour market remained tight, though it was unclear whether the market had reached a turning point or would continue to tighten. But manufacturing production had weakened and stockbuilding had risen sharply, with investment declining steeply. RPIX inflation had risen, though this largely reflected a temporary increase in the price of seasonal foods.

In discussing the world economy, the Committee noted that developments in the United States were if anything a little brighter than had been feared; by contrast there was evidence of further slowdown in the euro area and Japan. Given the importance of the euro area to UK exporters, and the continued strength of sterling, the prospects for net trade had worsened.

On the immediate policy decision, most members of the Committee agreed that the month's news pointed to continued strength in consumption, buoyancy in the labour market and a somewhat higher-than-expected short-term inflation outlook. The continued imbalances between the domestic and the internationally exposed sectors had increased the risk of an eventual downward adjustment in the exchange rate, but there were different views on the policy implications: some members thought that the current policy decision should take account of the possible future exchange rate adjustment because this affected the inflation outlook. Others questioned whether policy should be anticipating possible future exchange rate movements, since their timing was so uncertain and policy could react if and when a depreciation occurred. In either case the news on the month meant that there was no need for any immediate change in interest rates.

Another view was that the Bank's repo rate should have been reduced at the Committee's previous meeting, and that this reduction was still warranted. Output growth had recently been below trend. Equity prices had fallen, suggesting that confidence was weakening, investment had slowed and there was a risk of further destocking, and GDP growth was likely to be below trend for the third consecutive quarter. Though the housing market and retail sales remained strong, there were few signs of increasing inflationary pressure in the labour market, and the recent increase in RPIX inflation largely reflected temporary factors. There was mixed evidence from the world economy; the outlook was still uncertain in the United States and had worsened elsewhere, and the world prices of oil and metals had fallen recently. And if the short-term interest rate were kept higher now because of the expected exchange rate risk arising from the imbalances in the UK economy, this might cause sterling to be stronger than it would be otherwise and thus risk exacerbating the imbalances.

The Committee voted by 8 to 1 to leave the Bank's repo rate unchanged, with one member voting for a 25 basis point cut.

At its meeting on 1–2 August, the Committee voted to reduce the Bank's repo rate by 25 basis points to 5%.

6 Prospects for inflation

6.1 The inflation projection assumptions

The Monetary Policy Committee approved this *Report* on 3 August. It presents the Committee's assessment of economic developments since May and prospects for the medium term. Projections of GDP growth and RPIX inflation are provided below in Charts 6.1 and 6.2, together with the uncertainties surrounding them. These projections are based on the assumption that the Bank's repo rate remains unchanged at 5%. Alternative projections conditioned on the assumption that UK official interest rates follow an estimate of market expectations are shown in Charts 6.6 and 6.7. The key assumptions on which the projections are based are outlined below.

Global economic prospects continue to depend heavily on the outlook for the United States. Industrial production in the United States has continued to fall in recent months and pressures on the sector remain intense. Investment has declined, and a combination of falling profits and low capacity utilisation suggests a weaker near-term outlook for capital expenditure than projected in May. But, overall, GDP growth has been broadly in line with the previous central projection, as the strength of consumer spending has continued to surprise. Supported by the substantial easing of monetary policy and by cuts in personal taxation, US economic growth should gradually recover over the forecast period as inventory correction comes to an end and as surplus capacity is worked off. Although the outlook remains highly uncertain, the Committee judges that there has been little change to the most likely prospect for the United States since May.

By contrast, near-term growth prospects in other regions have worsened since the May *Report*. Weaker demand for high-technology capital goods in the United States has had a larger impact on international production than earlier judged. Moreover, the effects have been amplified by corresponding reductions in demand for high-technology goods in other countries, leading to pronounced falls in global output of the information and communications technology sector.

The outlook for domestic demand growth in the euro area has deteriorated in recent months, compounding the softening in external demand. Business and consumer confidence have declined further. It is possible that the recent adverse movement in the terms of trade has sapped confidence, as higher-than-expected consumer price inflation has—at least temporarily—eroded real income growth. GDP growth in the euro area this year is likely to slow to around 2%, edging up thereafter as activity gradually responds to the expected strengthening in US demand and assuming euro interest rates continue to ease in line with market expectations. The Japanese economy remains very weak and appears to be moving into recession. Falling global demand for high-technology goods has lowered export growth, and business confidence has continued to deteriorate. Recovery appears more distant than previously judged. Growth prospects for the emerging economies have also diminished as the demand for manufactured goods and components has fallen, in turn reducing the demand for basic commodities.

Reflecting the weakening in the outlook outside the United States, the Committee has lowered the central projection for global GDP growth in 2001 to around 2¾%, a downward revision of close to half a percentage point since the May *Inflation Report*. Growth is then likely to edge up. The slowdown in world trade in recent months has been particularly marked. As the production of high-technology manufactured equipment is highly integrated internationally, changes in demand have a pronounced impact on trade flows. Weighted by UK export market shares, world trade growth this year may slow to around 4%—a downward revision of some 2 percentage points since the May *Report* and a very sharp slowdown from the exceptional pace of 11% growth last year. On the central projection, trade growth picks up to the 5%–6% range in 2002.

The international outlook remains uncertain and the Committee continues to judge that the balance of risks around the central projection is weighted to the downside. The large financial imbalances in the United States are a major source of vulnerability. And recent downward revisions to estimates of productivity growth in recent years increase the risk that the sustainable improvement in productivity growth may be a little less than previously believed. The extent of the overhang of spare capacity and the timing of a likely recovery in investment are particularly uncertain. Moreover, additional retrenchment by the corporate sector could further weaken labour market conditions and thus soften the resilience of consumer spending. Given high levels of debt, companies and households remain exposed to the possibility of further falls in asset prices. Independently from the US outlook, some

Committee members consider that risks to the growth projection for the euro area are weighted to the downside. In addition, spreads on emerging market debt over US Treasuries have widened in recent months, signalling an increase in perceived risks, although there are marked differences across countries and market participants continue to discriminate clearly between the prospects in different economies.

Non-oil commodity prices have fallen further in recent months as prospects for world activity have weakened. Based on information from futures markets, the central projection retains the assumption that there will be a mild recovery in prices over the forecast period. Oil prices are also slightly weaker than expected three months ago, but medium-term prospects are little changed.

Headline consumer price inflation in the euro area and in the United States has been above previous expectations in recent months. High energy prices are a common factor, supplemented in the euro area by a sharper-than-expected rise in food prices and the fall in the exchange rate. But the impulse from higher oil prices last year is beginning to fade, and higher food prices are unlikely to persist. Moreover, underlying inflationary pressures are likely to moderate in the major overseas economies as capacity utilisation declines and labour market pressures ease. As in the May projection, traded goods price inflation is likely to slow over the next twelve months and to remain at negligible rates thereafter.

The sterling effective exchange rate has appreciated a little further since the May *Report*, as a rise in sterling against the euro has more than outweighed a small fall against the dollar. In the 15 working days up to and including 1 August, the sterling effective exchange rate index (ERI) averaged 106.7, consistent with bilateral sterling exchange rates of $1.42 and 61 pence against the euro. This average forms the starting-point for the exchange rate profile assumed in the current projection. It is around 1% above the implied level for August in the May central projection. The sterling ERI is assumed to depreciate a little to 104.7 by 2003 Q3.

Sterling import prices fell by 0.4% in 2001 Q1, against expectations of a rise. Reflecting the lower starting-point and the higher exchange rate profile, the central projection for import prices is a little weaker than in May.

Equity prices have fallen substantially again over the past three months, with the FTSE All-Share index in the 15 working days to 1 August some 9% below the central path assumed in the May *Report*. Although equities are a major component of household wealth, the weaker-than-expected outturn for share prices has little effect on the projection for consumer spending, as the impact has been almost exactly offset by recent ONS estimates indicating that the level of financial wealth in the early part of this year was well above previous projections. In consequence, the projected profile after 2001 Q3 is little changed from May.

The housing market has strengthened in recent months with annual house price inflation rising to around 10%. Forward-looking indicators such as loan approvals and reservations of new houses suggest continued near-term buoyancy. House prices may rise a little faster over the next year than judged likely in May. But there is no change to the assumption that prices will grow broadly in line with earnings in the medium term.

Fiscal policy assumptions are unchanged from the May *Report*. The Committee continues to base the projections on announced government nominal spending plans and estimates of effective tax rates drawn from the latest Budget forecast. Public spending is planned to rise more quickly than GDP over the projection period.

6.2 The output and inflation projections

GDP growth has slowed in recent quarters. According to the ONS preliminary estimate, output rose by 0.3% in 2001 Q2—lowering the four-quarter growth rate to 2.1%. Underlying output growth is weaker than projected in May as the downturn in manufacturing production has been sharper than previously anticipated. RPIX inflation has risen to 2.4%—well above expectations three months ago, and taking inflation close to the target. A spurt in seasonal food prices largely accounts for the unexpected pick-up. But there has also been a slight upturn in underlying retail price inflation in recent months. The Committee reviewed the prospects for growth and inflation against this background.

The latest ONS estimates point to some differences in the composition of demand from that expected three months ago. In particular, business investment fell substantially in 2001 Q1, more than reversing the marked increase in the fourth quarter. Consumer spending growth was also lower than predicted on the basis of other indicators of household demand. With the net trade position weakening as expected, the rise in GDP in the first quarter was associated with a substantial, unforeseen, contribution from inventories. Part of this rise in stockbuilding reflected a positive statistical adjustment to the inventories data, which might subsequently be reallocated to another component of demand as more information becomes available. Nevertheless, estimates from firms directly sampled by the ONS are consistent with a significant increase in stocks in 2001 Q1. Survey evidence suggests that much of that increase was involuntary.

Imbalances within the economy have widened in recent months. Firms heavily dependent on external demand and exposed to extensive international competition have borne the brunt of the international slowdown. Manufacturing output fell by 0.7% in 2001 Q1 and monthly data for April and May suggest that it may have fallen by around 2% in the second quarter. The drop in global demand for high-technology equipment has led to a particularly marked cutback in output of computers, electronic components and telecommunications equipment, although production elsewhere in manufacturing has also decreased as external demand has slowed. Manufacturing firms are cutting output to bring production into line with a lower level of demand as well as to shed excess stocks that built up earlier in the year. Business surveys and reports from the Bank's regional Agents confirm the weakening trend in activity. By contrast, firms selling predominantly into domestic markets and facing less international competition have encountered strong demand conditions. Service sector output and construction activity grew robustly in 2001 Q1. But there are some signs of a subsequent easing, with service sector growth slowing to 0.6% in 2001 Q2 according to the preliminary ONS estimate. In part, slower growth may reflect the severe, but temporary, impact of the foot-and-mouth epidemic on tourism and associated services in rural areas. However, recent business surveys and Agents' reports also point to a more broadly-based softening in demand for services, perhaps in turn linked to the pressures on companies most exposed to falling external demand.

Domestic spending continues to be supported by buoyant household demand. Although the latest ONS estimate of growth in consumption in 2001 Q1 suggests some softening in spending growth, other indicators paint a stronger picture, which has persisted into the second quarter. Retail sales volumes rose by 1.6% in 2001 Q2 and were 6% higher than a year ago. Household money and credit data signal brisk growth in spending. Consumer confidence remains firm. And a strong housing market also indicates household optimism.

The May projection assumed that consumer spending would decelerate in the second half of this year to around or a little below trend, as the impulse from rapid growth in financial wealth in previous years waned and as weaker external demand dampened growth in real household incomes. Does the current buoyancy of consumer sentiment challenge this assessment? The outlook for growth in output and real income has weakened a little since May. While the housing market may be a little stronger in the short term, providing additional collateral for borrowing, the support from previous gains in financial wealth continues to fade in line with the previous projection. So, while recognising that recent developments add to the uncertainty, particularly on the exact timing of a slowdown, the Committee judges that the broad pattern of a weakening outlook for consumer spending growth to a little below historic trend rates remains the most likely outcome. Consistent with this assessment, consumer confidence is likely to fall back in the coming months as labour market conditions slacken in response to the slowdown in output growth. The medium-term prospects for consumer spending are slightly weaker than in May.

There are risks to the near-term outlook in both directions. Given the current momentum, there is clearly a possibility that consumer spending growth remains rapid, financed in part by a further increase in household debt. But although balance sheets are supported by high levels of wealth, and the current average level of income gearing does not pose an immediate threat, household debt is already at a high level in relation to aggregate income. A change in consumer sentiment could consequently lead to a marked correction in spending at some point as households increase precautionary savings and strengthen their balance sheets. Given this picture, the Committee judges that risks to the medium-term outlook for the growth in consumer spending are weighted to the downside.

Recent trends in business investment are hard to interpret, adding considerably to the difficulties of formulating a projection. According to the latest ONS estimate, business investment fell by 5% in 2001 Q1, more than unwinding the sharp increase seen in the previous quarter. The estimated level of business investment is fully 7% below the central projection in the May *Report*. But quarterly movements in investment are highly volatile. Firms undertake investment to bridge the gap between their current and their desired level of capital. The desired level of capital cannot be directly observed and will vary over time as companies revise their estimates of future demand and of the profitability of meeting it. Moreover, the timing of investment itself is affected by a range of factors including the degree of uncertainty surrounding future prospects: a rise in uncertainty creates incentives for companies to delay capital spending.

Given the volatility and measurement uncertainty, the Committee decided to smooth recent estimates of investment to provide a better guide to underlying trends. Adopting this approach, there has clearly been some decline in the level of investment relative to expectations three months ago.

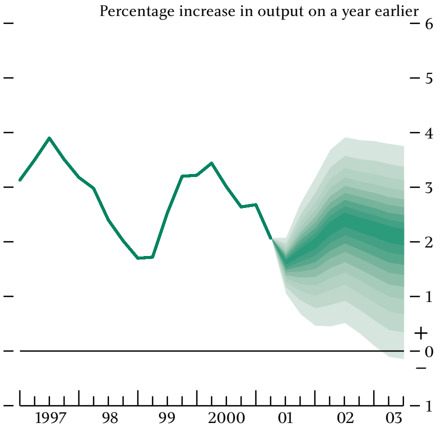
Moreover, underlying investment prospects have weakened somewhat, given survey evidence and signs of increased pressures on corporate profits, gearing, and cash flow. And greater uncertainty surrounding international prospects may also have led to some postponement of investment. As a result, the Committee has lowered the central projection for the level of business investment substantially since the May *Report*. From a lower starting level, business investment is likely to rise less rapidly than GDP over the forecast period. The outlook for whole-economy investment remains rather stronger than for the business sector alone, as public sector capital spending is planned to rise swiftly. But reflecting growing financial pressures on companies, risks to the central projection for investment growth are weighted to the downside.

It seems likely that a substantial proportion of the unexpected rise in inventories in 2001 Q1 was involuntary, as companies took time to adjust production levels in response to the weakening of external demand and to the lower domestic demand for capital goods. The latest CBI Quarterly Industrial Trends survey suggests that manufacturing companies have succeeded in paring stock levels in the second quarter. But the survey also indicates that firms continue to regard inventory levels as excessive and intend to shed additional stocks in the third quarter. The expected correction in inventories helps to account for the weakening in the short-term profile for GDP growth since the May projection. The Committee has maintained the judgment that companies will economise further on stockholdings in the medium term, although the projected decline in the stock-output ratio is less steep than assumed in May.

The slowdown in the world economy has been associated with a pronounced deceleration in trade volumes. Indeed, excluding oil and erratic items, the volume of goods exports fell by 3% in the three months to May compared with the previous three months. Export prospects have worsened over the past three months, reflecting the weaker outlook for international demand and the appreciation of sterling. After a trough in 2001 Q2, export growth is likely to pick up moderately over the forecast period as world trade growth revives.

Import growth has also slowed. Pressures to reduce stocks and the weaker demand for capital goods have been associated with a slight contraction in goods import volumes in recent months. Nonetheless, trends in import volumes remain stronger than those for exports and thus net external demand continues to detract from growth in UK output. A weaker near-term outlook for UK domestic demand growth has prompted the Committee to lower the central projection for import growth since the May *Report*. The downward revision has largely counterbalanced the change in export prospects. So, as in the previous projection, the net trade contribution to GDP growth is likely to remain negative, attenuating over the forecast period as the world economy recovers and as the impact of the recent appreciation of the exchange rate gradually fades.

Chart 6.1
Current GDP projection based on constant nominal interest rates at 5%



The fan chart depicting the probability distribution for output growth is rather like a contour map. At any given point during the forecast period, the depth of shading represents the height of the probability density function over a range of outcomes for output. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of the probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes.

Bringing together the information on demand components and output trends, the Committee's latest projection for real GDP growth is shown in Chart 6.1.(1) The projection is conditioned on the assumption that UK official interest rates are maintained at 5%.(2) Growth has slowed more sharply than projected three months ago. The near-term outlook is also weaker than in the May *Report*, reflecting the more pronounced slowdown in the world economy, lower demand for capital goods, and associated pressures on firms to prune surplus stocks. Four-quarter GDP growth may ease further in the second half of this year. Some pick-up in the rate of growth is likely next year as the inventory adjustment comes to an end, as public spending strengthens, and as the world economy gradually recovers. But growth may then slow again as final domestic demand continues to soften because of moderating growth in private and public consumption. GDP growth over the next two years as a whole is likely to be only a little below trend.

As noted in previous *Reports*, a range of evidence points to an improvement in the supply-side performance of the UK economy in recent years. In particular, pressures on real wages and on RPIX inflation have been less than implied by average relationships over the past 20 years, when compared with the current low level of unemployment and historically-based estimates of the pressure of demand on supply capacity. The Committee retained the judgment that favourable supply-side trends will continue to exert downward pressure on inflation over the forecast period.

Recent outturns for RPIX inflation have been higher than expected three months ago. Inflation picked up from 1.9% in March to 2.4% in May and remained at that level in June. Much of the unexpected rise is due to an extraordinary increase in seasonal food prices, in turn linked to adverse weather. Although higher food prices may persist for a while, they are likely to return to more normal levels, and in particular should provide downward impetus to the twelve-month inflation rate in a year's time if not before. But there are also some signs of slightly stronger underlying retail price inflation than previously envisaged. Surveys report an

(1) Also shown as Chart 1 in the Overview.
(2) An alternative projection assuming that UK official interest rates follow market interest rate expectations is shown in Chart 6.7 below.

increase, from a low level, in the balance of retailers raising prices, as sales growth has remained strong. On the other hand, surveys of price trends earlier in the supply chain have fallen in recent months, in manufacturing and services alike, partly reflecting the decline in commodity prices. These surveys suggest some lessening of prospective pressures on retail price inflation.

Recent trends in pay have been a little stronger than expected at the time of the May *Report*. The twelve-month whole-economy mean wage settlement edged up to 3.4% in June, a rise of 0.3 percentage points since the start of the year. Estimates of whole-economy regular pay growth have also increased slightly to around 5%. However, the contribution of bonuses to earnings growth has turned negative in recent months. As a result, whole-economy headline average earnings growth has fallen to 4.5% in May from rates of 5% and above in earlier months, as the exceptionally strong bonus payments in February distorted the trend. Given likely pressures on profitability as output growth slows, it is possible that the contribution of bonuses will remain negative in the coming months.

The labour market has tightened a little further since the May *Report*. The latest Labour Force Survey reports a further increase in the employment rate in recent months. Combined with a further unexpected decline in labour market participation, unemployment fell substantially. The LFS unemployment rate dipped below 5%, while the claimant count measure indicates that unemployment is at the lowest level for 26 years. In addition, the number of new vacancies notified to Jobcentres has increased further. Forward-looking indicators of recruitment intentions have fallen back, however, and there are some reports of a slight easing in skill shortages and increased availability of labour, which may indicate that the labour market is nearing a turning point.

Although recent employment and unemployment data suggest that the labour market is currently slightly tighter than projected in May, prospects for employment have weakened given the more subdued outlook for activity. Employment growth may fall a little short of the rise in the labour force, and by the end of this year and beyond the labour market is likely to be a little slacker than assumed three months ago. Given the costs of recruitment, training and redundancy payments, firms are likely to retain labour if a slowdown in demand is perceived as temporary. It generally takes time for companies to adjust their demand for labour to a more persistent reduction in output—firms are likely to counteract the upward pressure on unit costs by decreasing pay offers and bonus payments, as well as by gradually reducing hours worked

Chart 6.2
Current RPIX inflation projection based on constant nominal interest rates at 5%

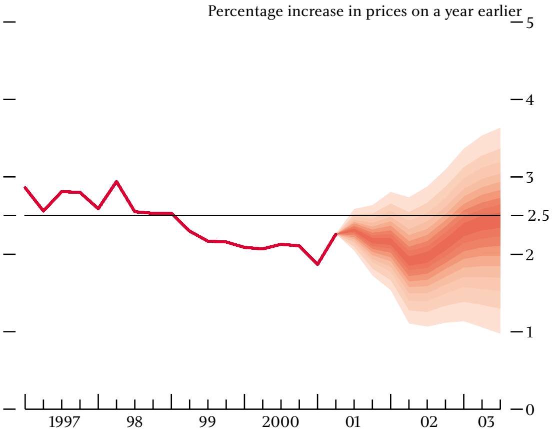
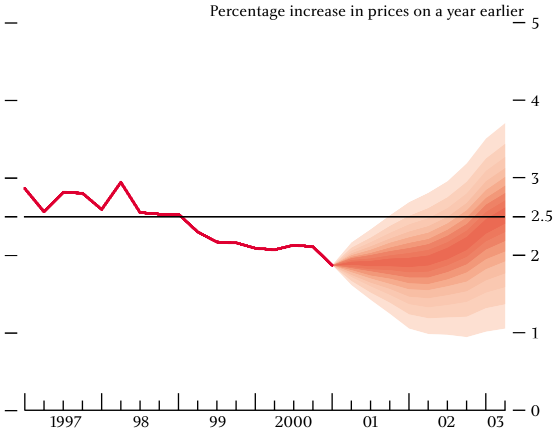


Chart 6.3
RPIX inflation projection in May based on constant nominal interest rates at 5.25%



The fan chart depicting the probability distribution for inflation is rather like a contour map. At any given point during the forecast period, the depth of shading represents the height of the probability density function over a range of outcomes for inflation. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of the probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes. See the box 'How fan charts are drawn', on page 52 of the February 1999 *Inflation Report*.

and employment. As a result, the Committee has lowered the central projection for real earnings growth over the forecast period.

Prospects for nominal earnings growth depend on inflation outturns and expectations as well as on the influences on real earnings. The recent pick-up in RPIX inflation has been associated with a slight rise in inflation expectations estimated from a range of sources such as most surveys, external forecasts, and prices embodied in financial contracts. But most estimates continue to indicate that inflation is likely to remain below the target over the next twelve to eighteen months, and medium-term expectations remain fairly well anchored by the $2^1/_2$% inflation target. Indeed, nominal earnings growth over the next two years is likely to be weaker than anticipated in May. Although the starting-point for price and earnings inflation is slightly higher, this influence is more than outweighed over the forecast horizon by the weaker prospects for real earnings growth.

Based on the assumptions set out above, and conditional on an unchanged official interest rate at 5%, the Committee's latest projection for the twelve-month RPIX inflation rate is shown in Chart 6.2.[1] It is presented alongside the corresponding projection from the May *Report*, which was based on the assumption of constant interest rates at 5.25% (see Chart 6.3).

(1) Also presented as Chart 2 in the Overview. An alternative projection assuming that UK official interest rates follow market interest rate expectations is shown in Chart 6.6 below.

Reflecting the higher starting-point, and recognising that higher food prices could persist for a while, the near-term outlook for RPIX inflation is likely to be a little stronger than anticipated in May. But the impact of the supply disruption on the inflation rate is temporary. Even if food prices remain at current levels—which is unlikely—there will be an offsetting downward impact on the annual inflation rate in Spring 2002. However, in the opposite direction, the current dampening effect from changes in specific duties in the most recent Budget will partially unwind next year if duties are raised in line with inflation.

On the central projection, RPIX inflation is likely to drift a little lower in the coming quarters, slipping back to around 2% in Spring 2002. Inflation may then edge up slowly towards the target. The monthly and quarterly pattern is likely to remain volatile as the unwinding of the various special factors is a major influence. Stripping out the special factors, the underlying picture is of broadly stable inflation. Current pressures on supply capacity induce a slight pick-up in prices and wages, as the dampening effect of the increase in the exchange rate on import prices in recent years abates. But, given the prospective easing of pressures on supply capacity and the further slight appreciation of the sterling exchange rate in recent months, the increase in inflation is likely to be slower than expected in the May *Report*. RPIX inflation may remain a little below target over the next eighteen months, but rises close to the target thereafter.

The medium-term prospects for inflation are slightly weaker than projected three months ago. The principal downside influences are the more subdued outlook for the world economy and for domestic capital spending, together with the weaker profile for import prices. These factors just outweigh the principal upside influences of a higher starting-point for price and wage inflation, an initially tighter-than-expected labour market and the lower level of interest rates.

The fan charts provide an illustration of the uncertainty surrounding the prospects for inflation and output growth and the balance of risks around the central projection. There remain many uncertainties in the outlook, and the Committee maintained the same subjective judgment on the variance of the fan chart—a calibration of general uncertainty—as in the May *Report*.

The international environment remains a major source of downside risk. In particular, global demand could be weaker if financial pressures on companies in the United States lead to a more prolonged downturn in investment, coupled in turn with a worsening labour market and a pronounced correction in household spending. Moreover, it is possible that the slowdown in the euro area could be sharper than in the central projection if the weakening in business and consumer confidence prompts a substantial rise in precautionary savings. Financial strains in some emerging economies are a further source of vulnerability.

The imbalances in the UK economy also pose significant risks to the outlook (see the box on pages 52–53). Rapid growth of private final domestic demand in recent years has been associated with a widening private sector financial deficit and a build-up of corporate and household debt. The current account deficit has widened correspondingly. There are some signs of increased financial strains within the corporate sector, particularly in manufacturing industry where the rate of return on capital has dropped from well over 10% to below 4% in only three years. The central projection for investment has been lowered, reflecting growing indications of financial pressures, but it is possible that corporate retrenchment could be much sharper. The aggregate household sector financial position is rather stronger. Relatively low interest-servicing charges and high levels of wealth are helping to support the increase in household debt. Nevertheless, the high and rapidly rising level of debt remains a threat. A break in consumer sentiment, triggered for example by a reassessment of future real income growth and/or a marked deterioration in the labour market, could subsequently lead to a sharp rise in desired savings and a pronounced slowdown in spending at some point.

A third major source of risk is that the sterling exchange rate could depreciate more quickly than in the central projection, for example if there was a financial market reassessment of the value of the euro or of the sustainability of the UK external deficit. An exchange rate fall would raise import prices directly, although the extent of this rise would depend crucially on the pricing behaviour of foreign suppliers. The implications for underlying inflationary pressure in the United Kingdom would depend on the factors causing the depreciation and the impact on inflation expectations and earnings behaviour. The outlook for net trade would improve, but the deterioration in the terms of trade would tend to dampen real personal income growth and hence consumer spending in the short run.

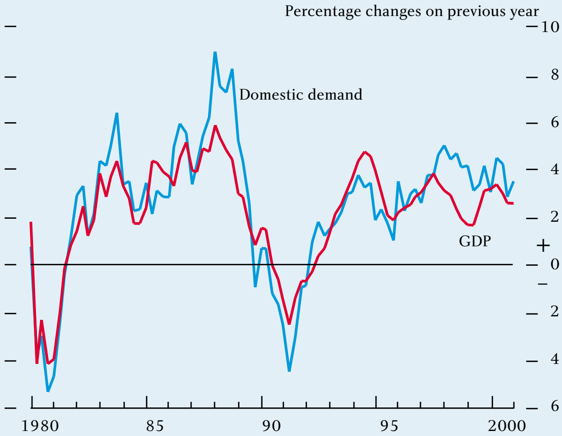
The three main sources of risk may be related. For example, a deterioration in world growth prospects could be associated with a reappraisal of prospective real income growth in the United Kingdom. And such a weakening could provide the catalyst for a reassessment of the value of the sterling exchange rate. But each risk could materialise independently.

Imbalances in the UK economy: sources and potential implications

The UK economy has been stable over the past five years, with annual GDP growth averaging 2.8% and inflation remaining close to the Government's $2^1/_2$% target. Several interrelated economic imbalances have, however, developed within that overall stability. This box examines those imbalances and their potential implications for inflation. The box on pages 6–7 (Section 1) considers the associated developments in the balance sheets of households and firms.

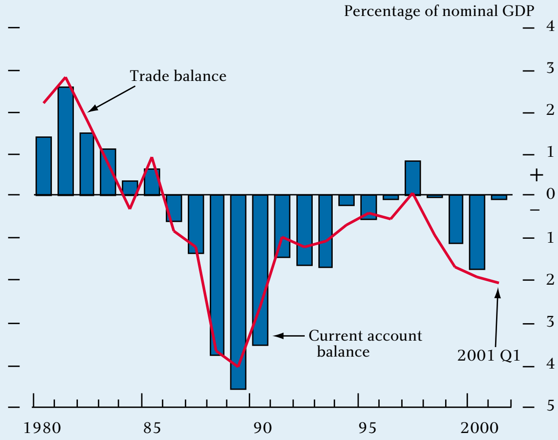
A key aspect of the imbalances has been the rapid growth of domestic demand compared with output. Annual growth in domestic demand volumes over the past five years has been, on average, 0.9 percentage points higher than GDP growth (see Chart A). The gap that has developed between the two series since 1996 amounted to almost 5% of GDP in 2001 Q1. Domestic demand growth has previously exceeded output growth for sustained periods. The difference that built up in the late 1980s amounted to around 6% of GDP. The current divergence has been smaller on average each quarter, but more prolonged.

Chart A
GDP and domestic demand



One counterpart to demand growing more quickly than output has been increasing trade and current account deficits. Chart B shows that the trade deficit reached just over 2% of GDP in 2001 Q1. The increase in the trade deficit is smaller than the gap that has developed between the domestic demand and GDP volumes. The reason is that the terms of trade—the ratio of export prices to import prices—have improved since 1996. So if sterling were to depreciate, and as a consequence the terms of trade were to worsen, that would initially lead to a larger trade deficit.

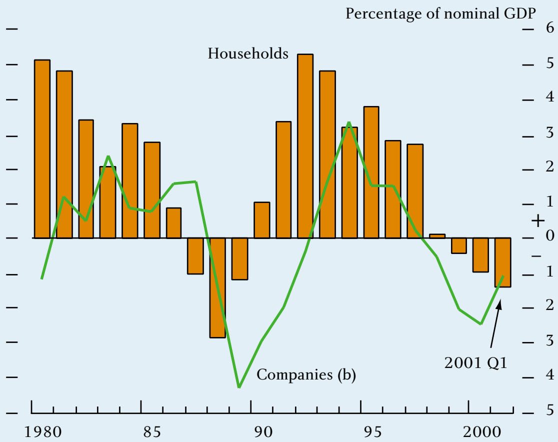
Chart B
Current account and trade balances(a)



(a) Annual data, apart from 2001 Q1.

As the government sector has been in surplus since 1998, the proximate source of the recent current account and trade deficits has been the UK private sector (companies and households) spending in excess of its income (see Chart C). That private sector financial deficit underlies the rising proportion of debt in the household and corporate sector balance sheets discussed in the box on pages 6–7.

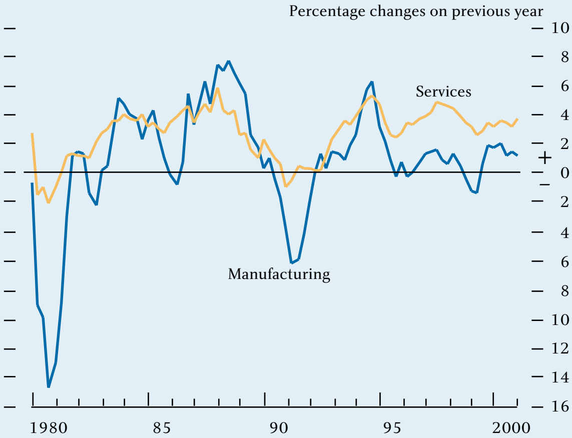
Chart C
Net financial balances of households and companies(a)



(a) Annual data, apart from 2001 Q1.
(b) Private non-financial companies, financial companies and public corporations.

Another manifestation of the imbalances affecting the economy has been the weakness of sectors exposed to international competition versus the strength of sectors less exposed—either because they export a small proportion of their output or foreign firms do not compete with them in UK markets. This dichotomy is highlighted, albeit somewhat imperfectly, by the fact that average annual service sector output growth over the past five years was 3 percentage points higher than in manufacturing (see Chart D).

Chart D
Manufacturing and services output



There are many possible explanations for the imbalances. The MPC has focused on two in preparing its forecast, though that does not imply they are the only reasons. One possibility is that there has been an upward revision to expected future UK output. In this case the strength of consumption and, until recently, investment would reflect households and firms raising their expenditure in line with higher expected future income, and borrowing to meet the temporary funding shortfall. Some of the appreciation in sterling could reflect the perception that there has been an associated increase in the relative rate of return on UK assets. If this revision to expected future output were the main source of the imbalances, the key issue for the MPC's forecast would be the extent to which the expectations were subsequently realised. If expectations were fulfilled, then the imbalances would tend to fade as output began to rise more quickly than domestic demand, and debt would be gradually repaid. But if the expectations proved unrealistic then domestic demand growth would slow as income expectations were revised down, which would again be associated with shrinking imbalances and debt repayment. The latter form of adjustment could be quite abrupt if sentiment and asset prices were to subside sharply.

Another possibility is that sterling has appreciated for reasons unconnected with revisions to views about prospective UK output. Several hypotheses have been proposed. Sterling's appreciation has been predominantly against the euro. So some have suggested that the ultimate cause lies not in the United Kingdom, but in the euro area. Exchange rates move when the perceived risks of holding currencies change. And it is possible that uncertainty about the new currency, and how it would be managed by a group of nation states, could well have raised the perceived risk of holding the euro. That may have led to a fall in its value against all currencies, including sterling. Another possible reason for the euro's weakness could be that investors believe relative output prospects in the euro area have worsened compared with previous beliefs. If the perceived risk of holding the euro were to fall, or investors were to revise up their views on the future rate of return on euro assets, sterling could depreciate.

In its central projection, the MPC judges that there will be some limited correction in the imbalances. Consumption and investment growth are projected to be weaker in the forecast than over the recent past. That partly reflects a judgment that households and companies have been too optimistic about their prospective income, and will have to rein in their spending slightly over the future. In assessing the risks to the central projection, the Committee believes that a more substantial revision to income prospects by the UK private sector is possible. That could lead to a steeper fall in spending growth during the next two years. On its own, such a development would depress activity and inflation compared with the central projection. But the Committee judges that an exchange rate depreciation could also occur as investors reappraise the future rate of return on UK assets, or their view of the euro. That would raise the price level during the next two years. In terms of measured inflation that might be enough to offset the impact of the risk from lower activity. There are differing views on the possible timing and magnitude of these developments, and of their effect on inflation. There are also several opinions on how they might emerge and what other events would be associated with them.

Chart 6.4
Current projection for the percentage increase in RPIX in the year to 2003 Q3

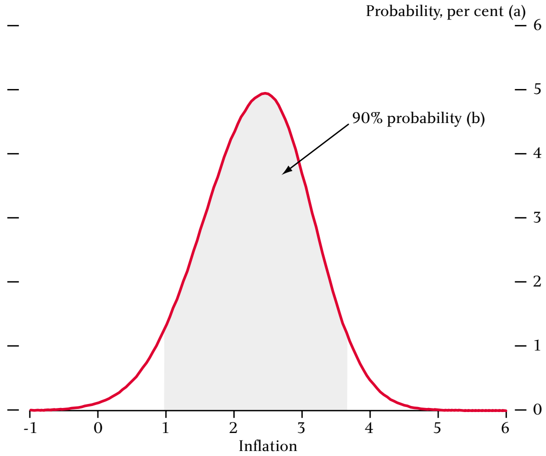
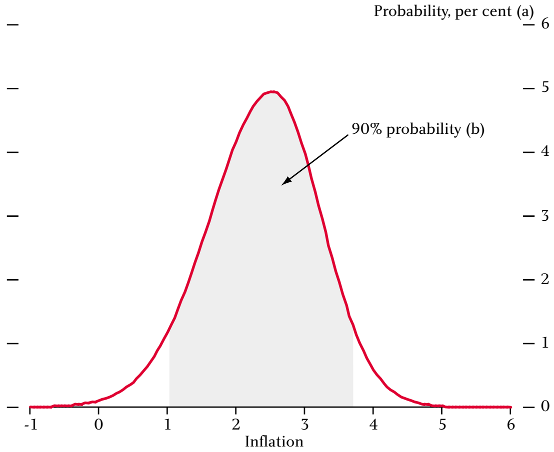


Chart 6.5
May projection for the percentage increase in RPIX in the year to 2003 Q2



Source: Bank of England.

(a) Probability of inflation being within ±0.05 percentage points of any given inflation rate, specified to one decimal place. For example, the probability of inflation being 2.5% (between 2.45% and 2.55%) in the current projection is close to 5%.
(b) The areas shaded light grey contain 90% of the probability, and are consistent with the widest bands shown in Charts 6.2 and 6.3. For further details see 'The *Inflation Report* projections: understanding the fan chart', February 1998 *Quarterly Bulletin*, pages 30–37, and the box on page 52 of the February 1999 *Inflation Report*.

There is considerable uncertainty on the likelihood, magnitude and timing of the risks occurring.

Bearing this in mind, an illustration of the overall balance of risks is provided in Chart 6.4. It is presented alongside the corresponding balance in the May projection (see Chart 6.5). The risks to output growth are on the downside in both years, reflecting the possibility of weaker external and domestic demand. The risks to RPIX inflation are balanced in the first year and slightly on the downside in the second, as the price level effect of the exchange rate fall partly offsets the impact of weaker output growth. The probabilities of various outcomes for inflation and GDP growth are shown in Table 6.A.

Table 6.A
The MPC's expectations for RPIX inflation and GDP growth based on constant nominal interest rates at 5%(a)

RPIX inflation

Probability, per cent	Range: Less than 1.5%	1.5% to 2.0%	2.0% to 2.5%	2.5% to 3.0%	3.0% to 3.5%	More than 3.5%
2001 Q4	4	29	47	18	1	<1
2002 Q4	14	21	29	23	10	3
2003 Q3	16	18	24	22	13	6

GDP growth

Probability, per cent	Range: Less than 0%	0% to 1%	1% to 2%	2% to 3%	3% to 4%	More than 4%
2001 Q4	2	14	41	36	7	<1
2002 Q4	5	15	29	33	16	3
2003 Q3	7	17	30	30	13	2

(a) These figures are from the same distributions as the GDP and inflation fan charts, Charts 6.1 and 6.2.

The probability distributions pictured in the fan charts and set out in Table 6.A represent the outlook based on the best collective judgment of the Committee on the key assumptions, prospects and balance of risks. When forming their individual judgments of the appropriate setting for interest rates, Committee members place different weights on the timing and magnitude of the various risks to the outlook set out above, and on the potential implications for monetary policy. For example, some Committee members would assign a higher weight to the probability of a significant exchange rate depreciation than calibrated in the fan chart. Moreover, as in previous *Reports*, some Committee members prefer different judgments on certain key assumptions incorporated in the

Table 6.B
Possible effects on RPIX inflation and GDP growth of the alternative assumptions

Difference from central projection, percentage points

	Degree of spare capacity	Scale of world slowdown and impact on United Kingdom
RPIX inflation		
2002 Q3	-0.2	-0.2
2003 Q3	-0.2	-0.3
GDP growth		
2002 Q3	0.0	-0.1
2003 Q3	0.0	-0.1

Table 6.C
Market expectations of the Bank's official interest rate[(a)]

Per cent

2001		2002				2003		
Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
5.2	5.2	5.3	5.4	5.5	5.5	5.5	5.5	5.5

(a) Based on the interest rate available on gilt-edged securities, including those used as collateral in short-term repurchase contracts, plus a small upward adjustment to allow for the average difference between this rate and the Bank's official interest rate. The data are 15-day averages to 1 August 2001.

central projection. In particular, some Committee members consider that the central projection for the world economy is likely to be weaker than assumed in the fan charts, and that UK inflation may be more responsive to the global slowdown than assumed in the central case. In addition, some members believe that there might be less prospective inflationary pressure, because the degree of spare capacity is greater than has been assumed in the central projection. Based on their best individual assessments, some Committee members consider that the central projection for inflation at the two-year horizon could be either a little higher or up to $^1/_2$% lower than in the projection presented in Chart 6.2. Illustrative calibrations of the most substantial differences are shown in Table 6B.

Faced with a weakening external environment and an associated dampening of prospective inflation pressures, the Committee lowered interest rates on three occasions in the first half of the year. The aim of the reduction in rates was to bolster domestic demand in order to keep overall aggregate demand in the economy in line with supply potential, and thereby maintain prospective inflation in line with the target. At its meeting on 1–2 August, the MPC reviewed the outlook for inflation and growth based on different assumptions for monetary policy. Although highly uncertain, the outlook for aggregate demand and output growth had weakened since the previous change in policy in May, given the weaker prospects for world economic activity and signs of greater pressure on corporate spending. At the same time, consumer spending growth remained strong, supported in part by the earlier cuts in interest rates, and there was as yet little sign of the projected slowdown. If the slowdown did not materialise, then a further policy stimulus could risk over-stimulating domestic demand, thus exacerbating the imbalances. On the other hand, leaving policy unchanged would increase the risk that inflation would remain below target and that overall demand and output growth would be weaker than necessary. Delaying an easing of policy risked deepening the downturn. Weighing the balance of risks, the Committee voted to reduce interest rates to 5% in order to keep inflation on track to meet the $2^1/_2$% inflation target in the medium term.

Market expectations of the likely path of future official interest rates rose between the May *Report* and the August MPC meeting. Based on financial market prices in the 15 working days up to and including 1 August, market participants were expecting that official interest rates would remain around prevailing levels for the remainder of this year, with the possibility of a further small cut over this period. Expectations were that official interest rates would

Chart 6.6
Current RPIX inflation projection based on market interest rate expectations

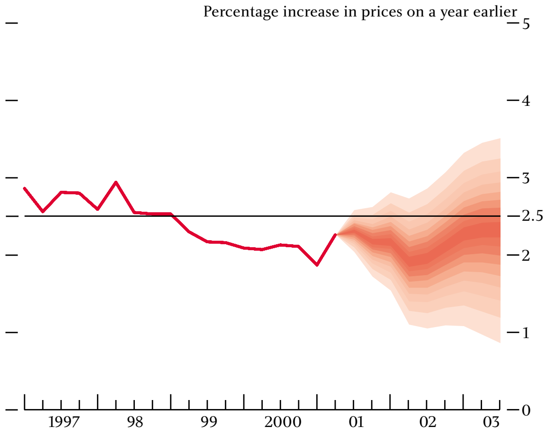


Chart 6.7
Current GDP projection based on market interest rate expectations

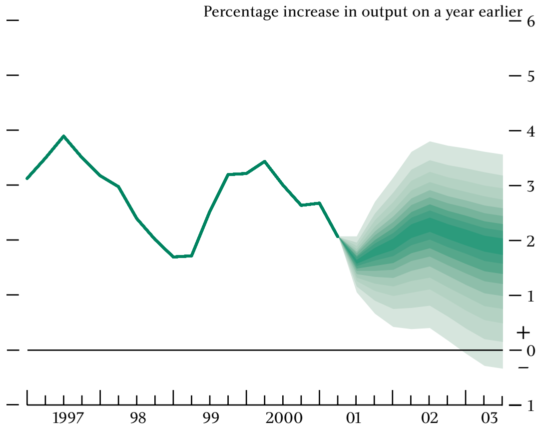
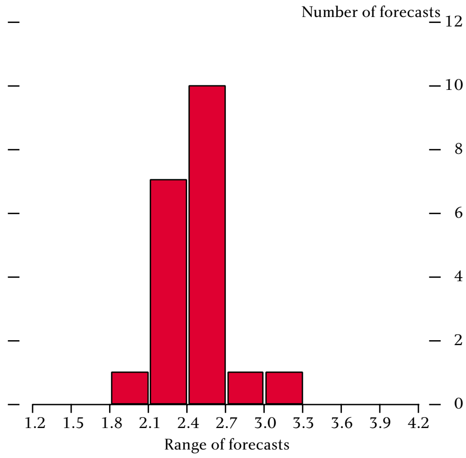


Chart 6.8
Distribution of RPIX inflation forecasts for 2003 Q3



Source: Forecasts of 20 outside forecasters as of 27 July 2001.

Table 6.D
Other forecasters' expectations of RPIX inflation and GDP growth(a)

RPIX inflation

Probability, per cent	Range: Less than 1.5%	1.5% to 2.0%	2.0% to 2.5%	2.5% to 3.0%	3.0% to 3.5%	More than 3.5%
2001 Q4	6	20	41	24	6	3
2002 Q4	7	15	35	27	12	4
2003 Q3 (b)	7	15	36	26	11	5

GDP growth

Probability, per cent	Range: Less than 0%	0% to 1%	1% to 2%	2% to 3%	3% to 4%	More than 4%
2001 Q4	3	10	39	39	7	2
2002 Q4	3	8	21	40	23	5
2003 Q3 (b)	3	8	23	43	17	5

(a) 22 other forecasters provided the Bank with their assessment of the likelihood, at three time horizons, of expected twelve-month RPIX inflation and four-quarter output growth falling in the ranges shown above. This table represents the means of the responses for each range. For example, on average, forecasters assign a probability of 7% to inflation turning out to be less than 1.5% in 2003 Q3.
(b) 20 forecasters.

subsequently increase by around 50 basis points over the following eighteen months (see Table 6.C and Chart 1.15). The Committee's latest projections based on these market interest rate expectations are shown in Charts 6.6 and 6.7. Following the announcement of the reduction in interest rates on 2 August, near-term market interest rates fell.

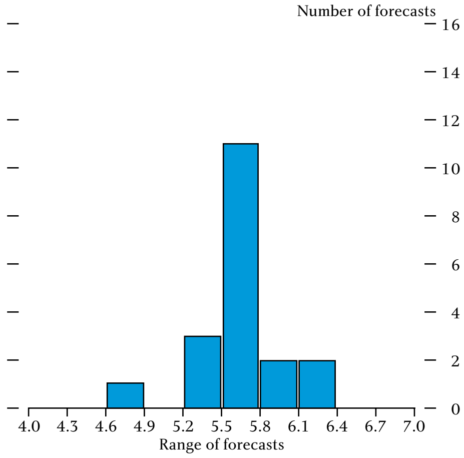
6.3 Other forecasts

In July, the Bank asked a sample of external forecasters for their latest projections of inflation and output. Based on this survey, the average forecast for the twelve-month rate of RPIX inflation in 2001 Q4 was 2.3% (with a range of 1.7% to 2.6%), rising to 2.5% in 2002 Q4 and 2.4% in 2003 Q3 (with a range of 2.0% to 3.0%). The distribution of central projections in 2003 Q3 is shown in Chart 6.8. Compared with the survey results in the May *Report*, the average forecast for inflation in 2001 Q4 is 0.4 percentage points higher, while the average projection for inflation further out is broadly unchanged. On average, external forecasters see a 58% probability of inflation being below 2.5% in 2003 Q3, and a 42% probability of it being above (see Table 6.D).

The forecasters' average projection for four-quarter GDP growth in 2001 Q4 is 2% (with a range of $1^1/_2$% to $2^1/_2$%), slightly lower than the average forecast reported in May. The average projection for growth in 2002 Q4 is $2^3/_4$% and is $2^1/_2$% (with a range of $1^3/_4$% to $3^1/_4$%) in 2003 Q3.

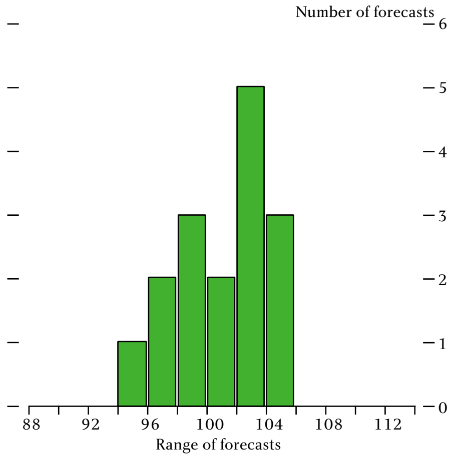
The average forecast for the official interest rate is $5^1/_4$% in 2001 Q4 (with a range of $4^3/_4$% to $5^3/_4$%), rising to $5^1/_2$% in 2002 Q4 and remaining at that level in 2003 Q3 (with a range of $4^3/_4$% to $6^1/_4$%) (see Chart 6.9). This is almost unchanged

Chart 6.9
Distribution of repo rate forecasts for 2003 Q3



Source: Forecasts of 19 outside forecasters as of 27 July 2001.

Chart 6.10
Distribution of sterling ERI forecasts for 2003 Q3



Source: Forecasts of 16 outside forecasters as of 27 July 2001.

from the mean expectation in May. On average, forecasters assume that the sterling ERI will be 104½ in 2001 Q4 (with a range of 100 to 107) and will then fall to 102 in 2002 Q4 and 101 in 2003 Q3 (with a range of 95 to 105¼) (see Chart 6.10). The average profile is about 1% higher than in May.

The MPC's forecasting record

The MPC's inflation projection is a key input to policy decisions because interest rate changes take time to affect inflation.(1) This box assesses how well past projections have served as a guide to the outturns for inflation and output growth.

Each time the MPC prepares a forecast, members assess the new information and analyse the possible lessons. Thus an evaluation of short-term forecast errors is an integral part of the Committee's forecast process.

The Committee's projections are conditioned on assumptions about economic variables such as the world economy and the exchange rate, and about structural economic relationships. However, given the inherent uncertainty in these economic judgments, the Committee presents its forecasts as a probability distribution rather than as a single projection.

The fan charts show the MPC's assessment of the probability distributions for inflation and GDP growth over the following two years. The darkest band includes the central (single most likely or modal) projection and covers 10% of the probability. Each successive pair of bands covers a further 10% of this estimated distribution, and the total shaded area covers 90%. Thus, over a large number of years, we would expect 10% of inflation and output growth outturns to lie in the central darkest band. We would expect a similar number of observations to lie in each pair of bands, and 10% of outturns to lie outside the shaded area.

At present the MPC publishes two sets of fan charts. The first is based on the assumption of constant official interest rates. The second assumes that official interest rates follow a path implied by financial market expectations. The Committee does not attempt to form a collective view of the likely future path of interest rates. It instead focuses on communicating its views on the possible outturns for inflation and output under these two assumptions. Projections based on constant official rates are useful in explaining how the Committee expects the economy to develop as a result of past shocks, in the absence of any monetary policy response. That provides a helpful benchmark to guide the policy assessment. But in practice some future policy response may occur, and the fan charts based on market interest rate expectations allow for the possibility of such a response. In what follows the discussion is confined to comparing outturns for GDP growth and inflation with published fan charts based on market interest rate expectations.(2)

How might forecast errors be related over time? Once a forecast has been made, any shock is likely to affect outturns for inflation and growth for more than one quarter. Consequently, for any given projection, forecast errors are likely to persist until the effects of the shock die away, or there is another offsetting shock. Furthermore, successive projections made before the shock is observed are likely to give rise to errors in the same direction. This property is likely to be all the more evident when projections are presented as four-quarter rates of change, because persistent shocks to the level of output or prices will affect calculated growth rates for a year.

It is useful to assess where outturns have been relative to the MPC's fan chart probability bands. Table 1 describes how many outturns for inflation and output growth have been within the central 30% and 50% bands for the ten market rate fan charts published between February 1998 and May 2000. For the inflation projections, half of the time the outturn has been within the central 30% of the fan chart one year from the starting-point, and a third of the time it has been within the central 30% of the fan chart two years ahead. For GDP growth, the results are similar over the one-year-ahead horizon, but at two years, two-thirds of the outturns have been in the central 30% of the distribution.

Table 1
Dispersion of outturns relative to fan chart probability distributions(a)

	Number of outturns	Number in central 30% bands	Number in central 50% bands
RPIX inflation			
One year ahead	10	5	6
Two years ahead	6	2	4
Annual GDP growth			
One year ahead	10	4	6
Two years ahead	6	4	5

(a) Calculated for the market rate fan charts published between February 1998 and May 2000.

The width of the fan charts reflects the MPC's uncertainty about the future, drawing on the Bank's forecast errors made over the previous ten years as a guide. To date, outturns for both GDP and inflation have generally been closer to the MPC's central projection than might have been expected based on

(1) See the box on page 67 of the November 2000 *Inflation Report* for a discussion of the role of the forecast in monetary policy.
(2) Tables showing the alternative comparison with the constant interest rate fan charts can be found on the Bank of England's web site at www.bankofengland.co.uk

past experience. But the sample of observations is very small.

Another way to assess how large MPC forecast errors have been is to calculate average absolute errors comparing outturns with the Committee's mean projections, which reflects both the central (modal) projection and the Committee's assessment of the balance of risks (see Table 2).

Table 2
Average absolute forecast errors of mean projections(a)

	Size of sample	RPIX inflation	Annual GDP growth
One year ahead	10	0.4	0.8
Two years ahead	6	0.7	0.5

(a) Calculated for the market rate fan charts published between February 1998 and May 2000.

The table shows that actual inflation differed by, on average, 0.4 percentage points from the Committee's one-year-ahead mean projection, and 0.7 percentage points from the two-year-ahead mean projection. For these projections, the average absolute error forecasting inflation is a little larger for the mean than for the modal projection. This is because the main risk to inflation cited by the Committee for much of this period was that the sterling exchange rate might depreciate, causing additional upward pressure on inflation. As it turned out, sterling tended to be stronger than expected.

On average, outturns for GDP growth have been 0.8 percentage points away from the Committee's one-year-ahead projection and 0.5 percentage points away from the two-year-ahead projection. In general, the longer the forecast period, the more uncertain the forecast, but for this small sample, the average absolute forecast error has been larger for one-year-ahead projections than for two-year-ahead projections. On average, there has been little difference between the Committee's mean and modal projections for GDP growth.

As well as assessing the absolute size of forecast errors, it is important to ask whether the Committee's forecasts have been systematically biased in any way. Table 3 reports calculated average forecast errors for GDP and inflation. Over a large sample of forecasts, if the MPC's forecast errors were unbiased they should average close to zero, as any positive errors would tend to be offset by negative errors at other times.

The table shows that, on average, inflation has tended to be lower than expected by the MPC while GDP growth has been higher. But the sample of forecasts made by the MPC is much too small to find any conclusive evidence of bias.

Table 3
Average errors of mean projections(a)

	Size of sample	RPIX inflation	Annual GDP growth
One year ahead	10	-0.2	0.8
Two years ahead	6	-0.7	0.1

(a) Calculated for the market rate fan charts published between February 1998 and May 2000. The error is calculated as outturn minus forecast.

There have been several factors that can help to account for the underprediction of GDP growth. The principal component of expenditure that was stronger than expected was household consumption, although private investment was also somewhat stronger. In contrast, net trade was more negative than had been expected, partly reflecting the surprising strength of the sterling exchange rate. Particularly for the forecasts that most underestimated GDP growth (those published between August 1998 and May 1999), the unexpected strength of consumption reflected stronger-than-expected increases in both equity and house prices and, more generally, a greater resilience in private expenditure than suggested by measures of confidence. It was also related to the impact of the $2\frac{1}{2}$% reduction in interest rates in late 1998 and early 1999, which was sharper than embodied in successive market rate assumptions. A further possible factor was that over this period there was a tendency for ONS initial estimates of output to understate the level of activity that is now believed to have occurred.

The MPC's errors in forecasting inflation up to one year ahead have been close to zero on average, but for the small sample of two-year-ahead projections, inflation has tended to be lower than expected. Preliminary investigations suggest two major causes. First, the unexpected strength of the sterling exchange rate meant that import prices were considerably weaker than the MPC had anticipated. Second, the level of unemployment consistent with stable inflation now appears to have been lower than originally assumed.

Partly in response to the analysis of the causes of weaker-than-expected inflation, the Committee reassessed the likely persistence of the strength of sterling, and revised its judgment about the supply-side performance of the economy. In particular, the Committee lowered the estimate of the equilibrium level of unemployment on a number of occasions. There continues to be a great deal of uncertainty around these judgments. And the MPC will monitor economic developments carefully in order to assess the potential implications for the outlook.

Bank of England
Agents' summary of business conditions

August 2001

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with around 1,700 businesses in the period between mid-April and mid-July. It provides information on the state of business conditions, from firms across all sectors of the economy. The report does not represent the Bank's own views, nor does it represent the views of any particular firm or region. The Bank's Monetary Policy Committee uses the intelligence provided by the Agents, in conjunction with information from other sources, to assist its understanding and assessment of current economic conditions.

- Comments from farming contacts continued to be dominated by the impact of foot-and-mouth disease (FMD). Elsewhere in the sector, earlier poor weather continued to have an adverse effect on crop yields.

- There was a continued fall in manufacturing activity, which accelerated towards the end of the period. The slowdown remained most severe in the information, communications and technology (ICT) sector, although there was some evidence that the deterioration had become more widespread. Confidence in the sector continued to decline.

- Construction output growth eased slightly over recent weeks, following a surge in growth at the beginning of the period as firms worked to reduce backlogs caused by earlier weather-related delays. But growth remained robust and confidence in the sector was strong.

- Growth in business services continued to slow, mainly caused by a further weakening in ICT and financial services. But growth in consumer services improved over the period, largely due to a modest recovery in leisure services following the earlier FMD-related decline.

- There was continued strong growth in retail sales, although the rate of growth stabilised over the period. Growth of new and used car sales remained robust.

- There was a significant downturn in export growth over the period and many Agencies noted that export volumes had declined. The slowdown reflected weaker demand from the United States and also from Europe.

- Investment intentions weakened further. Manufacturing investment intentions declined, and there were signs of slowing in the growth of service sector intentions. Greater caution about the impact of the US slowdown was a major factor.

- Input price inflation was flat to slowing. Manufacturers' output prices were broadly stable, but there were occasional reports of falling prices in recent weeks. Retail price inflation picked up slightly. The mid-season 'sales' began later than usual this year and there was some evidence that discounting was less deep than last year.

- Employment growth continued to slow, particularly towards the end of the period. Manufacturing employment declined further and recruitment in services slowed. There was a modest easing in skill shortages. Pay growth in manufacturing remained moderate and although growth in the service sector was relatively stronger, there were some signs of a slowing compared with the previous *Agents' Summary*.

(1) The Bank of England has Agencies for Central Southern England, the East Midlands, Greater London, the North East & Cumbria, the North West, Northern Ireland, Scotland, the South East & East Anglia, the South West, Wales, the West Midlands, and Yorkshire & the Humber.

OUTPUT

Primary production

Comments from farming contacts during the period continued to be dominated by the impact of foot-and-mouth disease (FMD). However, towards the end of the period, contacts reported that the easing of movement restrictions on livestock was having a positive effect, and there were tentative signs that a recovery from the worst of the crisis had begun in some regions. But the discovery of new cases continued in other regions, and contacts stressed that it would be some time before the sector would recover.

Elsewhere in the sector, Agencies continued to report that the delays to crop planting caused by bad weather earlier in the year would cause crop yields to be lower than usual.

Manufacturing

Reports pointed to an accelerated decline in manufacturing activity over the period, as the fall in activity spread beyond the information, communications and technology (ICT) sector. Some Agencies reported that manufacturing output volumes had fallen recently, and there was a widespread view that orders to the sector were falling or at best unchanged. Capacity utilisation therefore continued to fall and the level of stocks had increased slightly by the end of the period. Confidence in the sector had fallen, reflecting greater uncertainty caused by the world slowdown.

The ICT sector remained the main driver of the deterioration in activity, and orders continued to fall—particularly from the United States. Expectations of output during the year were revised down, due both to the decline in orders and also the high levels of stock remaining in the sector, as the weakening in demand had generally been unexpected. However, there was little change in the rate of deterioration of ICT activity over the period.

There was some evidence that the weakening in manufacturing activity over recent months was more widespread than at the time of the previous *Agents' Summary*. Declining output and orders in the engineering and automotive sectors were more commonly cited. The strongest activity continued to be reported in the aerospace and pharmaceutical industries.

Construction and housing

Construction output growth was reported to have eased slightly as the quarter progressed, following a surge at the beginning of the period as firms worked to clear backlogs caused by earlier weather-related delays. However, activity remained robust and confidence in the sector was strong. By the end of the period, there was no mention of additional delays to construction projects caused by FMD access restrictions.

Residential construction growth remained strong, reflecting high levels of demand. There were continued widespread reports of an increase in public sector construction activity, mainly for projects such as schools and hospitals. However, industrial construction growth remained broadly flat over the period, and retail construction growth appeared to be slowing—particularly in recent weeks.

Looking ahead, there was continued concern about future growth in the construction sector. This was largely due to supply-side constraints, particularly planning restrictions and a shortage of skilled labour.

Services

Growth slowed in business and financial services but picked up in consumer services. The slowdown in business services growth was largely caused by a continued weakening in demand for ICT services, as firms were less prepared to commit to such projects. However, the rate of the slowdown seemed to have eased compared with that reported in the previous *Agents' Summary*, and the level of activity remained strong.

Growth in financial services also slowed slightly, due to recent falls in equity prices and the US slowdown. This resulted in lower mergers and acquisitions activity. However, the decline in business financial services may have been partly offset by stronger growth in consumer demand for financial services, particularly mortgage lending. Activity in other professional services remained broadly flat, although there were tentative signs of easing in some regions.

Growth in consumer services picked up over the period, after a sustained easing since mid-2000. The improvement was largely driven by a modest degree of recovery from the recent FMD-related decline in UK tourism. Although inward tourism remained very weak, some providers of outdoor leisure services reported an improvement in business. There was also a pick-up in demand for hotel services in some urban and coastal areas, but bookings remained below their usual level for the time of year.

DEMAND

Consumption

Growth of retail sales volumes remained strong, although the annual rate of growth stabilised over the period. Spending in department stores improved, with continued strong growth in sales of furniture. Growth in sales of ladies fashion clothing was particularly strong, following the recent improvement in weather conditions. However, partly offsetting this, some Agencies suggested that fine weather had led to a decline in the number of customers over recent weeks. This year's mid-season 'sales' started later than usual in most regions, due to continued robust consumer demand. But price discounting had begun by the end of the period. Growth of new and used car sales remained buoyant, and an acceleration of sales volumes is expected during the autumn new registration period.

Spending on overseas tourism continued to rise over the period. UK tourism and leisure spending showed some recovery from FMD-related declines, but levels remained below those of last year.

Exports and imports

There was a significant downturn in export growth over recent months, compared with the previous *Agents' Summary*. Many Agencies suggested that export volumes had fallen recently, and that there had been a particular downturn in orders, reflecting a dampening in world prospects. Orders from the United States continued to fall, particularly to the ICT sector. However, there does not seem to have been any increase in the rate of decline recently. Some Agencies suggested that for certain products, notably aerospace goods, demand from the United States remained strong.

Growth in exports to Europe deteriorated notably over recent months, and some Agencies suggested that the level of export volumes and orders had declined. This was mainly due to the strength of sterling relative to the euro, but also as a result of the slowdown in demand. Germany was viewed as a particularly weak market throughout the period and, more recently, France was also mentioned as an area of concern.

Import volumes continued to grow. Agencies suggested that this reflected the strength of sterling relative to the euro. There was also continued outsourcing from UK firms to foreign suppliers, in order to benefit from lower prices.

Investment

Investment intentions appeared to weaken over the period in both the manufacturing and service sectors. Manufacturing investment plans deteriorated further, reflecting the fall in output and orders in the sector. Agencies continued to suggest that the most significant downward revision to investment plans occurred in the high-technology sector, mainly due to the slowdown in the United States. However, towards the end of the period there were some signs that the deterioration could have become more widespread. Investment intentions for US-owned firms had weakened most notably. The Climate Change Levy was cited as a potential reason for future investment in the efficient use of energy. Over recent weeks, there were signs that some of this investment had already started.

Most Agencies reported that the level of service sector investment spending plans was robust, but that the rate of expansion had eased. Where a slowing in service sector investment growth was reported, it mainly reflected deferrals of IT expenditure, due to greater caution about the impact of the US slowdown.

COSTS AND PRICES

Input prices

Input price inflation was flat to slowing over the period. There were some signs that upward pressure on gas prices had eased over recent weeks. Fuel prices remained a concern, however, as did rents and insurance premia. There were also reports of increasing prices of glass and plastic packaging. Regulatory costs, particularly the Climate Change Levy, remained the main area of concern for contacts. There were isolated reports of higher input prices due to the weakness of sterling relative to the dollar.

Output prices

Output price inflation in manufacturing remained low over the period, and recent reports pointed to flat to falling prices. This reflected lower output and orders. There were widespread reports of downward pressure on prices due to the strength of sterling relative to the euro. Increasing downward pressure on output prices was particularly notable in the aerospace industry towards the end of the period. However, some contacts, particularly in the southern regions, reported that prices remained firm. Firms operating in niche markets and those supplying to the construction industry found it much easier to raise their prices.

Output price inflation in the service sector remained strong and stable overall. Agencies noted that advertising prices were lower, and that the price of IT services also seemed to have eased. But the price of professional services appeared to remain strong, and there were occasional reports of increasing legal and accountancy fees.

Retail prices

Retail price inflation appeared to pick up slightly over the period. In particular, the mid-season 'sales' were reported to have begun later than usual in most regions, and many retailers suggested that discounting was either less deep than last year, or was on a narrower range of goods. There were also continued increases in the price of seasonal foods, particularly potatoes, due to a shortage of supply caused by earlier bad weather. There was very little sign of any easing in price rises. Towards the end of the period, some Agencies also reported that increases in wheat prices had fed through into flour prices and could soon cause increases in the prices of bread and pasta.

Both new and used car prices remained broadly stable over the period. Contacts suggested that new car prices would increase following the introduction of the new registration plate in autumn.

Overall, retail services inflation remained broadly stable compared with the previous period. Many Agencies suggested that there had been an increase in insurance premia. Reports regarding hotel room rates were mixed, with some contacts cutting prices to maintain occupancy levels. But there were signs in some regions of price increases outside rural areas. Inflation in overseas holiday prices remained strong.

Pay

Manufacturing earnings growth had remained stable, at modest rates. Increases in pay growth were confined to areas of skill shortages. However, growth of construction earnings remained robust, driven by strong demand and skill shortages in the sector.

Pay pressure in the service sector remained significantly higher than in the manufacturing sector. However, there were tentative signs of an easing in earnings growth in some regions. This predominantly reflected developments in the ICT sector, where pay pressures continued to ease due to weaker demand. Towards the end of the period, there were isolated reports of stronger growth in financial services pay.

Contacts increasingly mentioned the possible impact of the 10% increase in the National Minimum Wage in October this year. However, reports suggested that pay increases would be confined largely to lower-pay areas of services such as hotel, restaurant and cleaning staff. There was less concern in southern regions than elsewhere in the United Kingdom about the National Minimum Wage.

EMPLOYMENT

Employment growth fell throughout the period. Manufacturing employment continued to decline, but at a faster rate, with a greater incidence of redundancies compared with the previous period. The ICT production sector remained a particularly weak area, but falls in manufacturing employment appeared to become more widespread.

Service sector employment growth continued to slow, particularly during the later part of the period. The slowdown was driven largely by a sustained easing in the recruitment of IT staff. However, there were also further signs of a possible easing in the recruitment of financial services staff. Agencies continued to report that the take-up of temporary staff for the summer tourist season was lower than usual, as a result of the adverse impact of FMD on demand in the tourism industry.

Skill shortages continued to ease over the period, following significant increases at the end of last year. However, most Agencies continued to stress that shortages in the construction sector remained acute.

Text of Bank of England press notice of 6 June 2001

Bank of England maintains interest rates at 5.25%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 5.25%.

The minutes of the meeting will be published at 9.30 am on Wednesday 20 June.

Text of Bank of England press notice of 5 July 2001

Bank of England maintains interest rates at 5.25%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 5.25%.

The minutes of the meeting will be published at 9.30 am on Wednesday 18 July.

Text of Bank of England press notice of 2 August 2001

Bank of England reduces interest rates by 0.25% to 5.0%

The Bank of England's Monetary Policy Committee today voted to reduce the Bank's repo rate by 0.25% to 5.0%.

The Committee reviewed monetary and economic developments in the context of the projections to be published in the August *Inflation Report*. Indicators of world economic activity have been weaker than expected over the past few months. This and the persistent strength of sterling are adding to the pressures on the externally exposed sectors of the UK economy, and at the same time there are signs of weakening investment growth. By contrast, retail spending, household borrowing and the housing market are still robust, partly supported by recent reductions in interest rates. On balance, the outlook, although highly uncertain, is for aggregate demand and output growth to be weaker than previously projected.

Although RPIX inflation has picked up in recent months, that partly reflects erratic factors, and underlying price and cost pressures are expected to remain subdued. Monetary policy needs to balance the weaker external environment by sustaining domestic demand growth. The Committee decided to reduce interest rates by 0.25% in order to keep inflation on track to meet the 2½% inflation target in the medium term.

The Committee's latest inflation and output projections will appear in the *Inflation Report* to be published on Wednesday 8 August.

The minutes of the meeting will be published at 9.30 am on Wednesday 15 August.

Glossary and other information

Glossary of selected data

AEI: Average Earnings Index.
CSPI: corporate services prices index.
ERI: exchange rate index.
M0: notes and coin in circulation outside the Bank of England and bankers' operational deposits at the Bank.
M4: UK non-bank, non building society private sector's holdings of notes and coin, plus all sterling deposits (including certificates of deposit) held at UK banks and building societies by the non-bank, non building society private sector.
M4 lending: sterling lending by UK monetary financial institutions (MFIs) to all UK residents other than the public sector and MFIs. M4 lending includes loans and advances as well as investments, acceptances and reverse repo transactions.
RPI inflation: inflation measured by the retail price index.
RPIX inflation: inflation measured by the RPI excluding mortgage interest payments.
RPIY inflation: inflation measured by the RPI excluding mortgage interest payments and the following indirect taxes: council tax, VAT, duties, car purchase tax and vehicle excise duty, insurance tax and airport tax.

Abbreviations

BCC: British Chambers of Commerce.
BRC: British Retail Consortium.
CBI: Confederation of British Industry.
CIPS: Chartered Institute of Purchasing and Supply.
DHL: DHL International (UK) Ltd.
DTI: Department of Trade and Industry.
ECB: European Central Bank.
EEF: Engineering Employers' Federation.
EU: European Union.
FTSE: Financial Times Stock Exchange.
GC: general collateral.
GDP: gross domestic product.
GfK: Gesellschaft für Konsum, Great Britain Ltd.
HBF: House Builders' Federation.
ICT: information and communications technology.
LFS: Labour Force Survey.
LPC: Low Pay Commission.
MEW: mortgage equity withdrawal.
MFIs: monetary financial institutions.
MIRAS: Mortgage Interest Relief At Source.
MORI: Market and Opinion Research International.
MPC: Monetary Policy Committee.
NHS: National Health Service.
NMW: National Minimum Wage.
OECD: Organisation for Economic Co-operation and Development.
OFCs: other financial corporations.
ONS: Office for National Statistics.
OPEC: Organisation of Petroleum Exporting Countries.
PNFCs: private non-financial corporations.
REC: Recruitment and Employment Confederation.
RICS: Royal Institution of Chartered Surveyors.
S&P: Standard and Poor's.
Y2K: Year 2000.

Symbols and conventions

Except where otherwise stated, the source of the data used in charts and tables is the Office for National Statistics (ONS).
n.a. = not available.
Because of rounding, the sum of the separate items may sometimes differ from the total shown.
On the horizontal axes of graphs, larger ticks denote the first observation within the relevant period, eg data for the first quarter of the year.