Inflation Report

February 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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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/inflationreport/index.htm

Overview

In the United Kingdom, growth has slowed to around trend, while inflation has remained subdued. Output in the fourth quarter is provisionally estimated to have been 2.4% higher than a year ago, while RPIX inflation was 2.0% in the year to December, a little below the target rate of $2\frac{1}{2}$%. Growth in the rest of the world is now beginning to slacken, particularly in the United States where the deceleration in activity has been sharper than expected. The euro has recovered against the dollar and the effective exchange rate for sterling has declined. At home, output growth in the fourth quarter is likely to have been depressed somewhat by special factors that may unwind in the first part of this year. Private consumption growth has remained buoyant, while the level of private investment has been fairly flat. Although export growth has remained strong, it has been more than matched by higher growth in imports. Employment has levelled off and the unemployment rate has remained at a 25-year low. The labour market remains tight, although to date this has not led to a significant increase in earnings growth. Recent above-trend growth in productivity has held down unit labour costs and import prices have barely changed.

World output is likely to have grown at its highest rate for more than a decade in 2000, underpinned by strong growth in the United States. With the US unemployment rate falling to a 30-year low and signs of upward pressure on inflation, some reduction in the pace of US growth was both necessary and predicted. But with quarterly growth of just 0.3% in the fourth quarter, and consumer and business sentiment weakening sharply, growth is slowing more rapidly than expected. The US Federal Reserve cut official interest rates by a total of 100 basis points during January, and the financial markets expect further cuts in the near future. Although growth in the first half of the year is likely to be very weak, the relaxation in monetary policy, together with prospective fiscal easing, a somewhat weaker dollar and continuing strong underlying productivity growth should bring about a return to moderate growth in the latter part of the year.

In the euro area, growth has also slowed a little. But the strengthening of the euro and a fall in oil prices since November's *Report* will help to contain inflationary pressures, and firm consumption should underpin steady growth. The mild recovery in Japan may be petering out, while prospects for the emerging market economies depend heavily on developments in their major export markets, especially the United States. The impact on UK economic growth of the overall deterioration in global economic prospects is expected to be moderate.

But it is possible that the pause in US growth may be deeper or more prolonged than expected, leading to further falls in equity prices and a tightening of credit conditions in the United States and abroad. A more severe slowdown could also have adverse effects on confidence in other countries, including the United Kingdom. Consequently the MPC judges that the risks from the global environment are weighted firmly on the downside.

Output in the United Kingdom is provisionally estimated by the ONS to have risen by 0.3% in the fourth quarter, compared with 0.7% in the previous quarter. Some of this slowdown is likely to be temporary. Overall the MPC judges that the underlying growth rate of the economy is close to its trend rate. Growth in the services sector has slowed a little, but remains robust. The recovery in manufacturing has continued, driven especially by the high-technology industries, and survey evidence suggests this will continue, despite the slowdown in the United States.

Growth in consumer spending in the third quarter was unchanged from Q2 at 1.0%. Strong growth in retail sales volumes and in private new car registrations all point to a continuation of this robust growth into Q4. Consumer confidence remains strong and the MPC expects that consumer spending will continue to grow briskly, although past declines in financial wealth and slowing employment growth point to a moderate deceleration. Government consumption is set to grow strongly under plans already announced.

Investment outturns have continued to be weaker than expected. The business component declined slightly in the third quarter, despite relatively strong survey data on investment intentions. The MPC continues to take the view that some of this weakness is likely to be temporary.

Exports grew strongly in Q3, but were outpaced by increased imports so the net trade contribution to GDP growth was negative. Survey measures of export orders remain resilient, but export growth can be expected to slow as the world economy slows. The exchange rate has weakened against the euro, but strengthened against the dollar and the yen. The average value of the effective exchange rate index for sterling in the 15 working days to 7 February was 104.0, which is the starting-point for the exchange rate profile in the Committee's projections described below. That is a little over 3% lower than November's starting value and will mitigate the impact of the slowdown in the rest of the world.

Underlying growth in narrow money continues to be rapid, but broad money growth has slowed a little. Growth in lending to households remains brisk—consistent with continued buoyant consumer spending—but that to non-financial companies has now eased somewhat, partly reflecting reduced acquisition of financial assets.

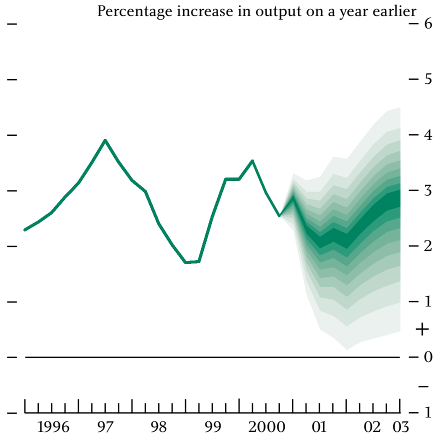
The Bank's official interest rate was cut to 5.75% at the Committee's February meeting, having been kept at 6% for a year. Short-term money market rates, which provide a guide to market expectations of future official interest rates, have declined since the November *Report*. Long-term government bond yields have also fallen. Equity prices have declined, especially in the high-technology sectors.

The labour market remains tight. LFS employment fell slightly in the three months to November though the underlying trend appears flat, and the LFS unemployment rate was unchanged at 5.3%. Nevertheless employment intentions remain strong, especially in the service sector, and vacancies remain at very high levels. Survey data and intelligence from the Bank's regional Agents also suggest that companies continue to experience difficulties in recruiting skilled labour. The growth rate of the headline measure of average earnings edged up from an annual rate of 4.0% in August to 4.2% in November, with a somewhat faster pick-up in the regular pay component. Wage settlements also edged up slightly. But the majority of settlements occur between January and April and the MPC will be closely monitoring developments in this area.

The resurgence in the growth of labour productivity that began in 1999 has continued, with productivity per hour rising at around 3% per annum, a little above its average over the past 40 years. The combination of higher productivity coupled with moderate earnings growth meant that whole-economy wage costs per unit of output were just 1.4% higher in Q3 than a year earlier. Import prices were flat as the effects of sterling depreciation and rising world export prices were offset by a reduction in foreign exporters' margins. Although cost pressures are muted, some survey data and reports from the Bank's Agents indicate an increase in the proportion of firms expecting to raise output prices, particularly in manufacturing.

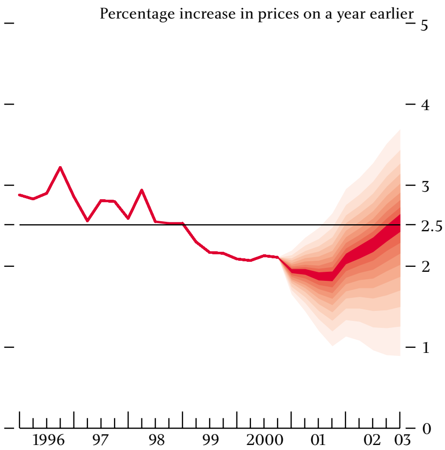
Chart 1 shows the MPC's assessment of the outlook for GDP growth, on the benchmark assumption that the official interest rate remains at 5.75% over the forecast period. In the central projection, the annual growth rate dips to around 2% during the second half of this year reflecting the deterioration in global prospects, slowing consumption and continued weakness in investment growth, offset by a stronger contribution from the public sector. Thereafter growth recovers to around its trend

Chart 1
Current GDP projection based on constant nominal interest rates at 5.75%



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 5.75%



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.

rate underpinned by a recovery in investment and stronger export growth as world activity recovers. The near-term outlook for growth is somewhat softer than in the November *Report*.

Chart 2 shows the corresponding projection for RPIX inflation. In the central projection inflation stays around 2% throughout 2001 but then starts to pick up, reaching the target rate at the forecast horizon. Inflationary pressures are a little weaker than in the November *Report*, reflecting the impact of lower growth and energy prices. As in November, some members prefer alternative assumptions about supply-side developments, while some members also prefer an alternative assumption about the extent and consequences of the US slowdown. In combination these could lower the inflation profile at the forecast horizon by up to $^{1}/_{2}$%.

Considerable uncertainties surround these projections. In the Committee's judgment, the risks to growth and inflation are presently clearly on the downside, stemming in particular from the risk of a deeper or more prolonged slowdown in the United States. Different Committee members place somewhat different weights on the significance of this, and other risks, to the outlook. Taking account of these risks, and in the light of the overall weakening of inflationary pressures, the Committee agreed at its February meeting that a modest reduction in the official interest rate was necessary to keep inflation on track to meet the target.

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Money and financial markets 1

Since the November *Report*, broad money growth has eased from its recent peak, reflecting a slower rate of increase in deposits held by corporations. Aggregate lending continues to rise at a rapid rate, and more quickly than deposits. Growth in lending to private non-financial corporations has eased, from high levels, partly reflecting reductions in their net purchases of financial assets. Household deposit and credit growth remains robust, with lending growth supported by falls in the cost of borrowing. But the Divisia measure of nominal household deposit growth has moderated. Narrow money continues to increase at a rapid underlying rate, and at a faster pace than retail sales values.

The MPC voted to cut the Bank of England's official repo rate by 25 basis points at its February meeting, the first change in rates for a year. Official interest rates have been cut by 100 basis points in the United States, but remain unchanged in the euro area. Markets expect official interest rates to be cut further in the United States and to fall in the euro area this year. In the United Kingdom, market prices embody expectations of a further fall in rates of around 50 basis points during 2001. Long-term government and corporate bond yields have declined further. Equity prices have fallen since November, reflecting reductions in share prices in high-technology sectors. The sterling effective exchange rate index has declined, with depreciation against the euro more than offsetting appreciation against the dollar in trade-weighted terms.

1.1 Money and credit

Money and credit data provide useful indications about current and future spending in the economy and thus, for a given supply capacity, the degree of inflationary pressure generated by nominal demand.

Narrow money

Notes and coin in circulation have continued to rise rapidly, although annual growth rates for narrow money have been distorted downwards by the increase in cash holdings around the time of the millennium change (see Table 1.A). As notes

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

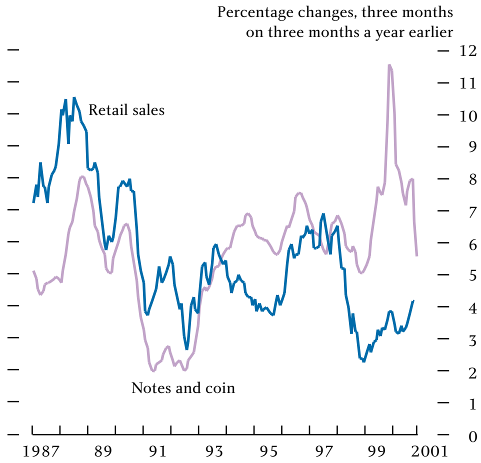
Per cent

			3 months (b)	12 months
Notes and coin (c)	2000	Oct.	10.0	8.1
		Nov.	8.9	7.1
		Dec.	6.0	4.6
	2001	Jan.	10.4	4.4
M4	1999	Q4	9.7	4.1
	2000	Q1	8.3	5.4
		Q2	8.6	6.8
		Q3	10.0	9.1
		Q4	5.0	8.0
M4 lending (d)	1999	Q4	13.4	9.3
	2000	Q1	13.0	10.7
		Q2	11.6	11.4
		Q3	14.5	13.1
		Q4	10.8	12.5

Source: Bank of England.

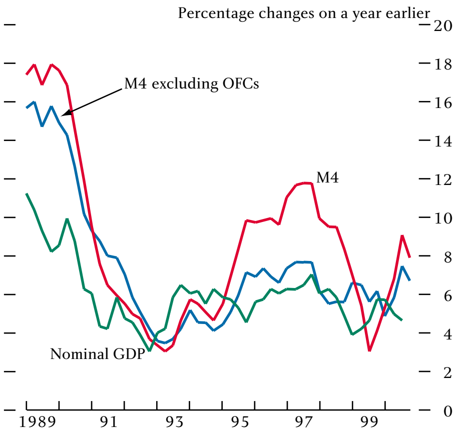
(a) Seasonally adjusted.
(b) Annualised.
(c) Growth rates based on an average of weekly observations in the month.
(d) Excluding securitisations.

Chart 1.1
Growth rates of notes and coin and retail sales values



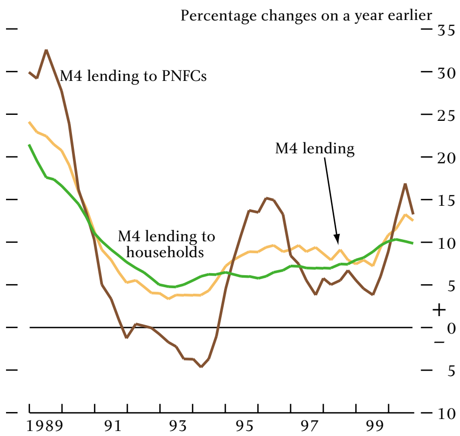
Sources: ONS and Bank of England.

Chart 1.2
Growth in M4, M4 excluding OFCs, and nominal GDP



Sources: ONS and Bank of England.

Chart 1.3
Growth in M4 lending



Source: Bank of England.

and coin earn no interest they are primarily held by households for transaction purposes and so may contain information about retail sales trends. However, notes and coin continue to grow more rapidly than retail sales values (see Chart 1.1). That decline in the velocity of circulation of narrow money in recent years may reflect the reduction in the opportunity cost of holding money brought about by lower nominal interest rates and inflation. But robust underlying growth in notes and coin is consistent with the recent rise in retail sales growth.

Broad money and credit

Annual growth in sterling deposits held by the UK private sector (M4) slowed to 8.0% in the fourth quarter (see Table 1.A). Deposits held by other financial corporations (OFCs) rose less rapidly than in recent quarters. Growth in M4 excluding OFCs, which tends to be more closely related to total spending on goods and services in the economy than aggregate M4, has also eased back somewhat from a high level (see Chart 1.2).

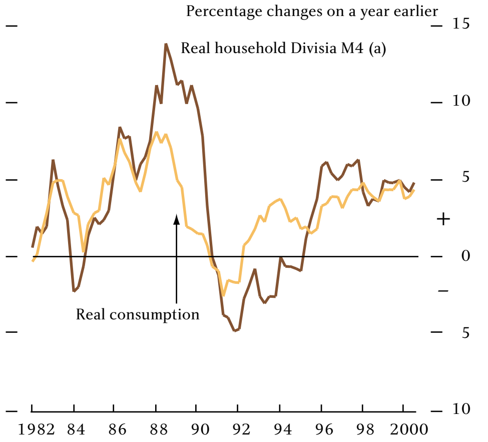
UK bank and building society sterling lending to the UK private sector (M4 lending) remained strong in 2000 Q4, though growth has slowed a little since the third quarter (see Chart 1.3). Household credit growth remained buoyant, and lending to OFCs continued to rise rapidly. Growth in private non-financial corporations' (PNFCs') borrowing eased from the strong rate seen in the third quarter.

The flow of M4 lending continues to exceed that of sterling deposits placed with UK banks and building societies by the UK private sector. Recently, much of the gap has been accounted for by higher public sector deposits, which have been boosted by buoyant public finances and government receipts from the sale of third-generation mobile telecommunications licences. Payments were completed in the third quarter, and in 2000 Q4 deposits from other sources, particularly those from overseas, accounted for the gap.

Household sector

Households' M4 deposits rose by 6.1% in the year to 2000 Q4, a slightly slower rate than in the previous quarter. An indicator of deposits likely to provide better information on spending trends is the household Divisia M4 index, which weights money components by a measure of their liquidity. Chart 1.4 shows that real households' Divisia money growth has been quite closely correlated with real consumption growth in recent years. Real household Divisia M4 growth has remained strong in recent quarters, consistent with recent robust consumption growth. Data on real Divisia money are

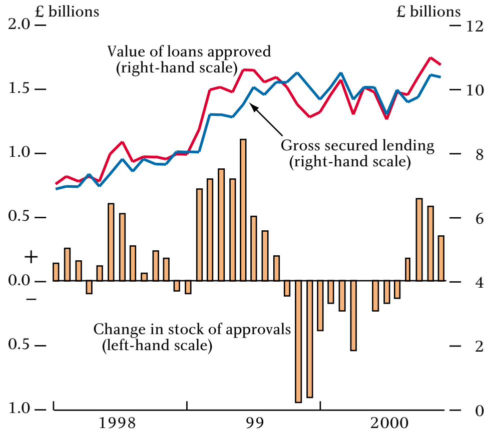
Chart 1.4
Real consumption and real households' Divisia M4



Sources: ONS and Bank of England.

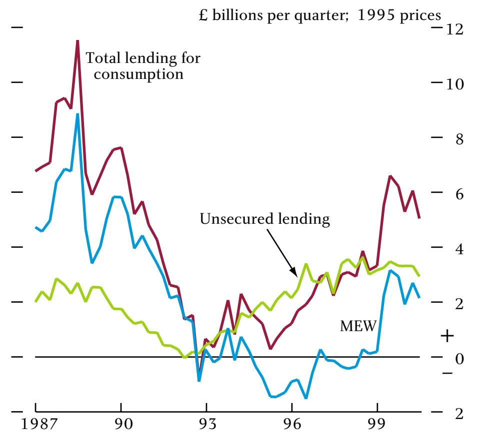
(a) Deflated by the consumer expenditure deflator.

Chart 1.5
Secured lending to individuals and loans approved



Source: Bank of England.

Chart 1.6
Lending for consumption



Source: Bank of England.

only available to 2000 Q3: nominal household Divisia M4 growth eased in Q4, suggesting that the pace of nominal consumption growth is moderating.

Total lending to individuals by banks, building societies and other specialist lenders continues to rise rapidly, although the pace has slowed a little from its peak last year. Both secured and unsecured borrowing growth remain strong. Rapid borrowing growth in recent years has been associated with a marked decline in the saving ratio.

Secured lending growth remains robust, though continues to moderate from its peak during last year. For most of last year, secured loan approvals were below gross new secured lending, leading to a rundown of the stock of unused mortgage approvals that had built up in 1999 (see Chart 1.5). But in 2000 Q4, the number and value of loan approvals picked up. That is likely to support future secured borrowing and housing market activity.

That part of secured lending not used to fund investment in housing is known as mortgage equity withdrawal (MEW). Bank estimates suggest that MEW fell a little in Q3 to £2.4 billion, though it remains strong compared with recent years (see Chart 1.6). And net housing wealth remains high, which is likely to support continued equity withdrawal (see Chart 1.7). Furthermore, recent innovations in mortgage products may lower the fixed and marginal costs of borrowing against housing wealth, which could encourage further MEW.

MEW and unsecured lending together provide an estimate of the total borrowing available for consumption, though these funds may also be spent on financial assets. Unsecured borrowing continues to account for more than half of total borrowing available for consumption (see Chart 1.6). Unsecured lending may have been stimulated by the effects of increased competition in the provision of finance, which has reduced the rates faced by borrowers relative to the Bank's repo rate in the past two years. This is discussed in greater detail in the box on page 6.

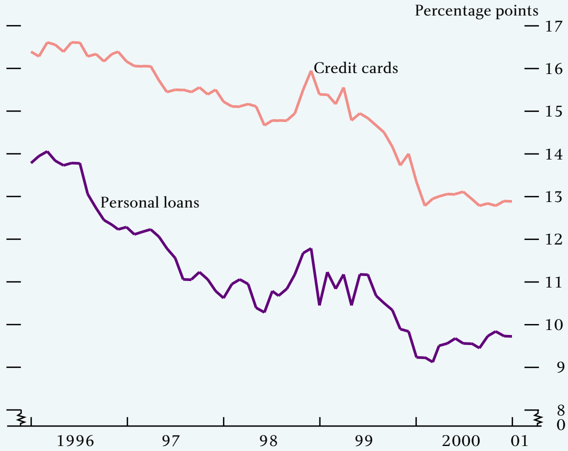
Household debt has risen to a record share of disposable income (see Chart 1.8). That may partly reflect rapid increases in household wealth, which are likely to have led households to raise consumption levels, financed by increased borrowing against capital gains. Households' debt relative to their wealth has fallen to low levels in recent years. Households' desired debt levels will also partly depend on interest rates on borrowing. Income gearing, ie interest payments relative to income, has fallen back from its recent

Structural change in the retail credit markets and household consumption

One of the channels through which monetary policy affects aggregate demand is the effect on interest rates on credit extended to households. Competition in retail credit markets has intensified in recent years which, together with product innovation, may have widened the availability of credit and reduced its price. These structural changes may help to explain the recent strength of consumption growth, and could affect the behaviour of consumption in future.

UK retail credit markets in recent years have changed markedly. The retail finance sector has seen a large number of new entrants, particularly into the market for credit cards and unsecured loans. In the mortgage market, the prevalence of 'lock-in' clauses in mortgage contracts has fallen. A wider range of mortgage products has become available, with more firms offering variable-repayment mortgages and the facility for lump-sum withdrawals against net housing equity. And some lenders have introduced 'current account' mortgages, where funds can be borrowed or invested at a single rate without pre-arrangement, subject to limits based on the loan to value ratio, offering even greater flexibility.

Selected quoted retail borrowing rates: spreads over the Bank's repo rate



Sources: Bank of England and Moneyfacts.

Some of these changes may have reflected increased competition in retail lending markets, which would be expected to lower the spread of retail lending rates relative to the Bank's repo rate. The chart shows that in recent years, this spread has indeed fallen in unsecured credit markets. So increased competition in credit markets may have led to a lower cost, and wider availability, of household credit. That may have allowed households that were previously credit constrained to move closer to their optimal consumption levels, contributing to the recent strength of borrowing and consumption growth.

In the mortgage market, there has been little change in the spread of the standard variable rate over the repo rate. But discounts on variable-rate mortgages have risen, and during 2000 overall stood at their highest recorded level. And discounted mortgages have risen markedly as a share of total new mortgage lending in recent years, to more than half. Remortgaging has increased as a share of total mortgage lending, perhaps reflecting a reduction in the prevalence of 'lock-in' clauses in mortgage contracts. This suggests that households may be refinancing to reduce their costs of borrowing.

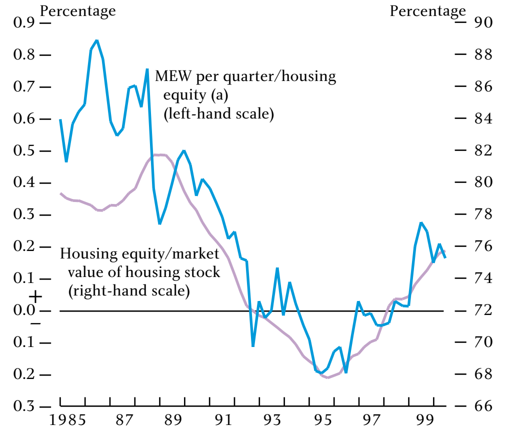
One notable feature of retail credit markets has been the rapid increase in the use of flexible mortgage products. A recent survey by MORI for the Council of Mortgage Lenders (CML) shows that 16% of respondents now have mortgages with at least some degree of flexibility, defined as those mortgages offering under-payments, daily or monthly interest calculation, and the option of a payment holiday. The take-up of flexible mortgages is likely to rise further though the extent of that increase is unclear. In Australia, current account mortgages, or their close equivalent, are estimated to now make up more than two thirds of the mortgage stock, after being introduced during the mid-1990s.

Increasing flexibility of mortgages may lower the cost and increase the availability of secured finance. This may already be taking effect, though MEW is in line with its historical relationship with net housing wealth (see Chart 1.7). Increased mortgage flexibility could also have more permanent effects on consumption behaviour, for example by allowing greater smoothing of consumption in the face of income variability. But again, the effects are uncertain, as increased use of flexible mortgages may make the marginal cost of borrowing more sensitive to house price changes, which will affect the amount that households may borrow on a secured basis.

Implications

Structural change in retail credit markets has reduced the relative costs and increased the availability of finance in recent years. That may have allowed previously credit-constrained consumers to move closer to their optimal consumption levels, perhaps contributing to recent strong borrowing and consumption growth. Increasing flexibility of mortgages may also have longer-term implications for consumption behaviour, but these effects are uncertain. The MPC will continue to monitor consumer credit and mortgage markets as they develop.

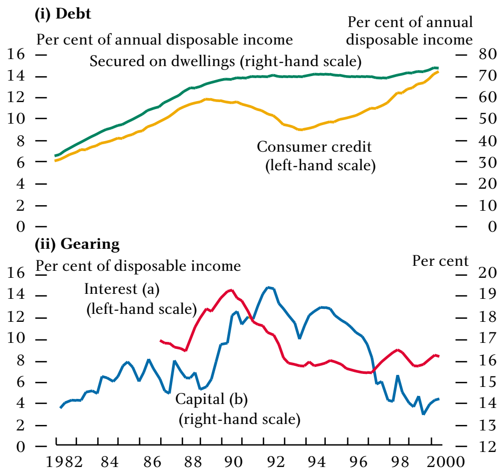
Chart 1.7
Mortgage equity withdrawal (MEW) and the housing equity ratio



Sources: ONS and Bank of England.

(a) Housing equity is defined as the market value of the housing stock minus the value of debt secured on houses.

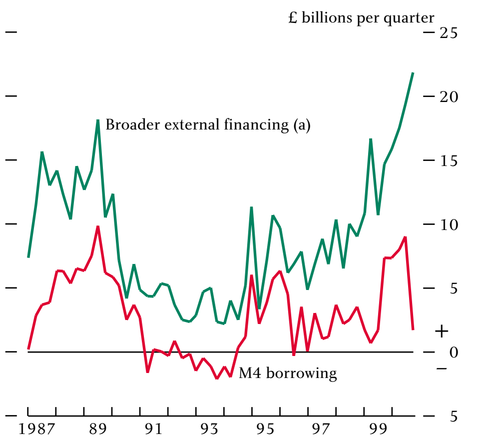
Chart 1.8
Household debt and gearing



Sources: ONS and Bank of England.

(a) Defined as gross interest payments.
(b) Defined as the stock of lending to the household sector as a share of housing and net financial wealth.

Chart 1.9
PNFCs' external finance



Sources: ONS and Bank of England.

(a) M4 borrowing plus capital issues and foreign currency borrowing from banks and building societies.

peak in autumn 1998 (see Chart 1.8). That will have reflected the lower official interest rates prevailing since that time. But the effects of increased competition in retail lending markets will also have allowed households to increase debt levels while maintaining low levels of income gearing.

Private non-financial corporations

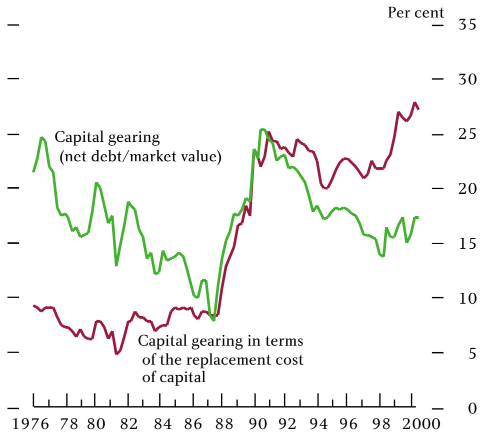
Annual growth in private non-financial corporations' (PNFCs') M4 deposits fell to 8.8% in the year to Q4, from 12.4% in 2000 Q3, as a number of large deposits made in Q3, associated with corporate disposals and acquisitions, were unwound. Slowing growth in corporate deposits does not seem to have reflected a weakening of cash flows in the corporate sector. For example, the British Chambers of Commerce survey for 2000 Q4 showed a rise in the balance of firms reporting that cash flow had improved on the previous quarter.

The growth in PNFCs' bank borrowing slowed to an annual rate of 13.3% in 2000 Q4 from 16.8% in the previous quarter. The quarterly flow of bank borrowing fell sharply from very high levels during recent quarters (see Chart 1.9). During the past two years, PNFCs' broader external finance has risen substantially above the amount required to fund the difference between PNFCs' capital expenditures and their available internal funds. That divergence has reflected high levels of expenditure on financial assets, such as the acquisition of other companies, some overseas, and of mobile telecommunications licences. A slower rate of growth of corporate borrowing in Q4 probably reflected, in turn, a fall in funding requirements for the acquisition of financial assets following the completion of telecommunications licence payments. However, PNFCs' broader external financing remained at a very high level in Q4 (see Chart 1.9).

The recent pattern of corporate financing might shed light on the slowdown in investment during the past year, despite surveys reporting strong investment intentions (see Section 2.2). One possibility is that the need to fund purchases of financial assets has diverted cash flows that might otherwise have been used to finance capital expenditures. And corporates' increased reliance on external finance may have raised the effective cost of capital for the corporate sector. However, this is likely to have been partly offset by the fall in corporate bond yields seen during the past year, driven by reductions in risk-free interest rates.

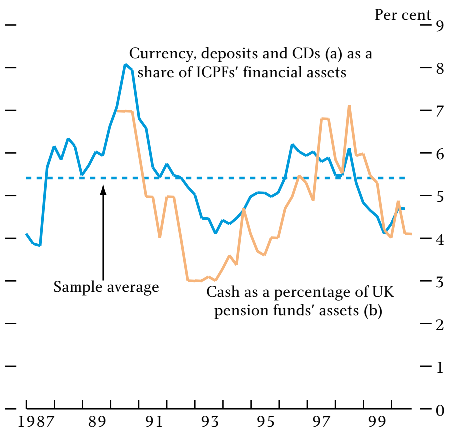
At the aggregate level, outstanding corporate debt remains low relative to the market valuation of corporate capital. A downward revision to expectations of corporate profit growth and a fall in equity prices could increase the gearing burden

Chart 1.10
Measures of PNFCs' gearing



Sources: ONS and Bank of England.

Chart 1.11
Money as a share of UK insurance company and pension funds' (ICPFs') assets



Sources: ONS and Merrill Lynch.

(a) Certificates of deposit.
(b) Merrill Lynch Fund Managers Survey.

on this basis. Moreover, other measures of corporate gearing are less benign (see Chart 1.10). Capital gearing, measured as the stock of outstanding corporate debt relative to the replacement cost of capital, has risen to record levels. Equity prices have fallen since the November *Report*, consistent with downward revisions to expected future corporate profits growth. The telecommunications sector, which has accounted for a large share of the recent build-up of corporate debt, has experienced particularly marked falls in equity prices and rises in bond yield spreads. That may reflect downward revisions to market expectations of prospective returns from investing in new technology.

Other financial corporations

As with private non-financial corporations, OFCs' deposits growth slowed in 2000 Q4, though the annual rate of increase remained strong. Part of the rise in OFCs' deposits during the past year has been accounted for by securities dealers, whose balance sheets are affected by their financial intermediation business and so have no obvious immediate implications for nominal spending.

Institutional investors' balance sheets are more likely to contain information about money available to be spent in the economy, and on the purchase of financial assets in particular. An increase in deposits held by institutional investors has accounted for the majority of the increase in OFCs' deposits over the past year.(1) Institutional investors' desired holdings of cash in their portfolios are likely to depend on the expected rate of return relative to other assets. A rise in institutional investors' deposits might reflect a desire to rebalance portfolios because of increased concerns about prospective returns from investment in the stock market. Chart 1.11 shows that the cash share of institutional investors' portfolios remains at a low level. But the Merrill Lynch survey of fund managers continues to report plans to place cash into other assets, including UK equities. M4 borrowing by OFCs remained strong in the year to 2000 Q4.

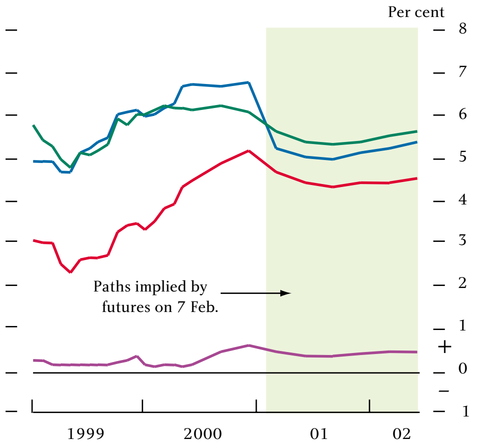
1.2 Interest rates and asset prices

Short-term interest rates

The MPC voted to cut the Bank's official repo rate by 25 basis points to 5.75% on 8 February. The US Federal Open Market Committee reduced its official rate by 100 basis points in January to 5.5%. Official rates in the euro area have remained unchanged since the November *Report*, at 4.75%.

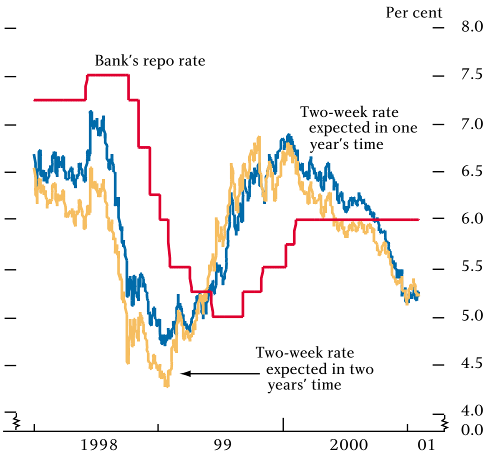
(1) Institutional investors are defined as UK insurance company and pension funds (ICPFs), investment and unit trusts, money market mutual funds, and institutions engaged in other fund management activities.

Chart 1.12
Three-month interest rates



Sources: Bloomberg, LIFFE and Thomson Financial Datastream.

Chart 1.13
Banks' repo rate and two-week rates expected in one and two years' time(a)



Source: Bank of England.

(a) Forward rates are derived from GC repo rates and gilts, adjusted upwards by 15 basis points to reflect the average historical spread between the GC repo rate and the Bank's repo rate.

Table 1.B
Changes in ten-year government bond yields to 7 February 2001

Basis points

	Since:	
	1 Jan. 2000	8 Nov. 2000
United Kingdom	-69	-43
United States	-143	-57
Euro area	-64	-41
Japan	-40	-43

Source: Bank of England.

Market expectations of future short rates in the United Kingdom and major overseas economies have been revised downwards since November, particularly markedly in the United States. Three-month interest rate futures contracts suggest that markets now expect official interest rates to fall significantly in 2001 for all the major economies outside Japan (see Chart 1.12). Lower expected interest rates reflect weaker growth prospects, particularly in the United States, and the associated reduction in inflationary pressures. But market expectations of a gentle rise in US short interest rates in the latter part of 2001 are consistent with expectations of a relatively quick recovery of US GDP growth.

The Bank performs the vast majority of its monetary operations via two-week sale and repurchase agreements. Chart 1.13 shows estimates of two-week interest rates expected to prevail in one and two years from now, as implied by the prices of government bonds and gilt repo rates. Official interest rate expectations measured in this way have fallen during the past year, though they have stabilised in recent weeks. These data, combined with evidence from other markets, suggest that markets expect rates to fall a further 50 basis points by the end of the year.

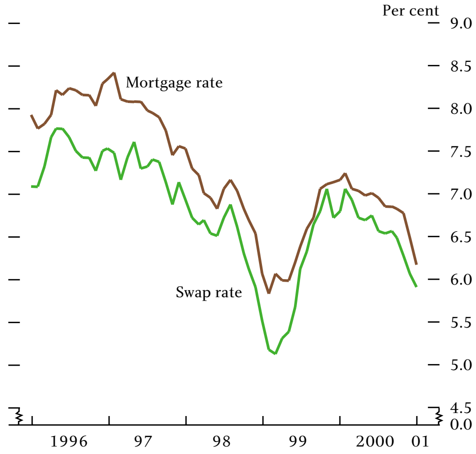
Long-term interest rates

Long-term interest rates, measured by those at the ten-year horizon, have fallen during the past year, with further reductions since the November *Report* as expected future short interest rates have declined. Long-term government bond yields have also fallen in the United States, euro area and Japan at this maturity (see Table 1.B).

Real interest rates

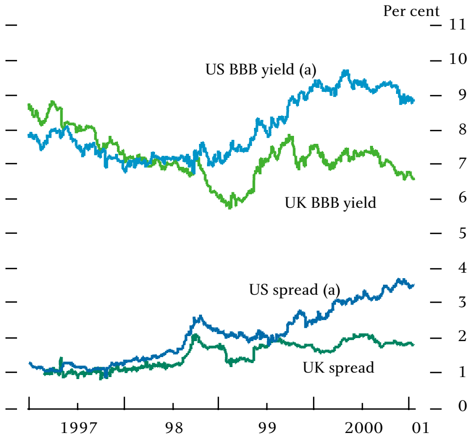
Consensus forecasts of inflation for the major economies over the next two years have changed little in recent months, so it seems likely that falls in expected future nominal short interest rates reflect lower expectations of future real short interest rates. Further, estimates of long real yields from inflation-linked bonds have fallen. Market expectations of world real interest rates will reflect expectations regarding the balance of global savings and investment. Recent falls in equity markets suggest a downward revision to expected real rates of return, consistent with a weaker outlook for global investment demand. And lower equity prices may have led to expectations of somewhat higher savings out of current income, because of the weakening of household balance sheets. During the past three months short-term world growth forecasts have been lowered, largely due to the effects of weakening short-term prospects for US GDP growth, and US investment in particular. So recent falls in international real

Chart 1.14
Quoted five-year average fixed mortgage and swap interest rates



Sources: Bank of England and Moneyfacts.

Chart 1.15
Yields and spreads of ten-year BBB-rated corporate par yields over government bond yields



Source: Bloomberg.

(a) US industrial corporate bonds.

interest rates may reflect expectations of lower short-term world demand growth, perhaps related to a reassessment of real rates of return from investment.

Household borrowing rates

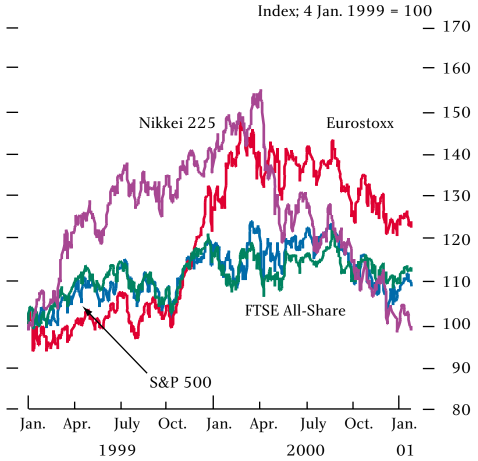
Longer-term interest rates affect the cost of borrowing in the household sector primarily through their impact on fixed-rate mortgages. Lenders typically set fixed-rate mortgages in relation to swap rates. Like long bond yields, swap rates reflect market expectations of the future path of short-term interest rates, and have fallen during the past year. As a result, fixed mortgage rates have fallen markedly (see Chart 1.14) while the repo rate has remained unchanged. That will have reduced the marginal cost of secured borrowing.

Unsecured interest rates have changed little in recent months. But comparing retail rates over a longer period, a striking feature is the marked decline in credit card and personal loan rates, both in absolute terms and relative to the official repo rate. That may reflect increased competition between lenders. Nonetheless, unsecured borrowing rates remain much higher than secured rates, reflecting the higher risk to the lender. So the cost of financing consumption through borrowing will also depend on whether funds are obtained on a secured or unsecured basis. As noted earlier, the increase in house prices in recent years has raised the average level of housing equity, while innovation in the mortgage market, such as increased scope for lump-sum withdrawals against housing equity, may have lowered the cost of borrowing for consumption on a secured basis. So recent years have probably seen reductions in the marginal cost of financing consumption through either secured or unsecured borrowing, relative to the Bank's repo rate. The box on page 6 looks further at the effect of structural change in retail markets.

Corporate borrowing rates

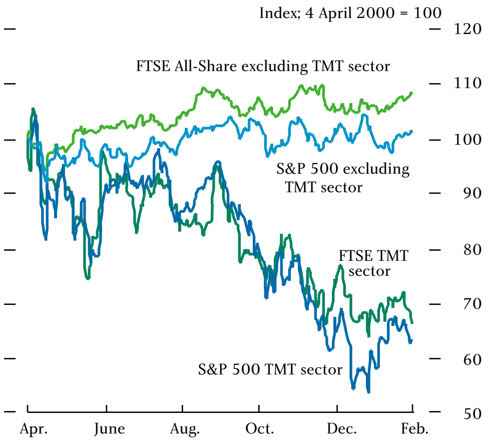
The cost of debt to companies depends on perceptions of credit and other risks, as well as the risk-free interest rate. Corporate bond yield spreads have been little changed in recent months, so that reductions in risk-free interest rates have led to a decline in corporate bond yields (see Chart 1.15). In contrast, in the United States, corporate spreads have risen since the November *Report*, though they have fallen back somewhat following the first of the two Federal Reserve official interest rate cuts in January. However, the rise in corporate spreads has been more than offset by reductions in US risk-free interest rates, so that US corporate bond yields have fallen (see Chart 1.15).

Chart 1.16
International equity indices



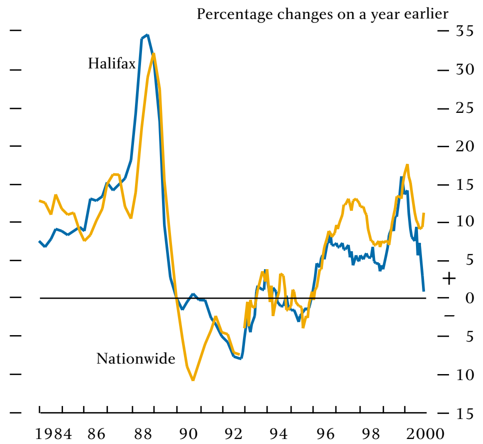
Source: Thomson Financial Datastream.

Chart 1.17
US and UK equity indices excluding technology, media and telecommunications (TMT)



Sources: Thomson Financial Datastream and Bank of England.

Chart 1.18
House price inflation



Sources: Nationwide Building Society and Halifax plc.

Equity prices

The FTSE All-Share index averaged 3015 in the fifteen working days to 7 February, about 3% below the central projection made in November for 2001 Q1. UK fund managers' outlook on UK corporate profitability has become less favourable, consistent with a downward revision to investors' expectations of real dividend growth. And the number of profit warnings issued by UK quoted companies has risen. The box on page 12 looks at the information contained in profit warnings.

Share prices have also fallen in the other major markets since the November *Report* (see Chart 1.16), though have recovered somewhat in the United States following the first of the two reductions in the US official interest rate. There have been particularly sharp falls in share prices of companies operating in the high-technology sectors. Indeed, excluding companies operating in these sectors, share prices have been broadly stable in the United Kingdom and United States (Chart 1.17). This suggests that recent equity price falls are particularly linked to revisions to expected real returns in the information and communications technology (ICT) sector, partly reversing some of the exceptional upward movement over previous years. Rising productivity growth in the ICT sector has accounted for a large proportion of the pick-up in US productivity growth in recent years. And the ICT sector accounts for a larger share of both output and equity market capitalisation in the United States than in the United Kingdom or the euro area. So weaker prospects for the ICT sector might be expected to have a greater effect on GDP growth in the United States than in Europe.

Property prices

Measures of annual house price inflation have diverged significantly in recent months (see Chart 1.18), partly reflecting the difficulties and uncertainties of measuring average house price changes over time, given variation in the mix of houses purchased and their location. The rate of increase for the year to January was 0.9% on the Halifax index and 11.2% on the Nationwide index, the widest divergence in the growth rates of the two series since the monthly Nationwide index began in 1991. Combining the information from these indices with recent trends in the Royal Institution of Chartered Surveyors' survey suggests that house price rises have slowed over the past year to a steadier pace. Particulars delivered, a measure of completed home sales, have weakened further: in the three months to December they dropped to the lowest level for two years. But the balance of housebuilders reporting an increase in net reservations of new homes relative to twelve months previously rose to around zero in November

Analysing UK profit warnings

There has been an increase in 'profit warnings' in both the United Kingdom and the United States, as companies alert shareholders that current profits are falling short of earlier expectations. In January 2001 there were 48 warnings in the United Kingdom, the highest monthly total since the Bank started recording information systematically in 1997. This box describes how information on UK company profit warnings is monitored.

The Bank has constructed a database containing information on UK profit warnings since July 1997.(1) These 'warnings' relate to negative trading statements, which are subsequently reported in the press as profits warnings. Each press report is categorised to obtain quantitative information on the sources and causes of profit warnings.

Profit warnings might provide advance information on movements in important macroeconomic variables. But with less than four years of data, during which there were no major turning-points in the business cycle, it is too early to draw firm conclusions. Nonetheless, the reaction of share prices suggests that profit warnings do provide new information to equity market investors. Company share prices fell on average by 14% in the day following an announcement.(2) In 2000 Q4 share prices of companies in the information and communications technology sectors (ICT) fell by 40% after issuing a warning. Over the same period other firms' share prices fell by 8% after an associated warning.

Chart 1 shows that the number of warnings rose throughout the latter half of 2000, though until January 2001 remained below those seen in 1998. Chart 2 shows information on the source of the shocks. Warnings in the IT sector have been increasing. In 2000 Q4, this sector accounted for 26% of the total, despite the fact that these companies make up just 10% of firms in the FTSE All-Share index.

The causes of lower-than-expected profits are also collated. There was a large increase in the number of firms mentioning Russia and the Asian crisis as sources of profit shortfalls in 1998. More recently, a relatively large number of firms have cited firm and industry-specific factors, and fewer have cited 'domestic demand'. The diversity of reasons being offered is consistent with an economy undergoing structural change, so the implications for aggregate macroeconomic prospects are unclear. A new (but temporary) reason emerged in 2000 Q4. 11 of the 76 firms that provided explanations for their warnings cited 'the petrol crisis', and several of these also blamed the weather.

The Bank will continue to monitor this source of information on the health of the UK corporate sector. Its value as a leading indicator for general macroeconomic prospects cannot yet be assessed. But it undoubtedly offers a rich and timely source of information on past and current changes affecting the corporate sector.

Chart 1
Number of profit warnings

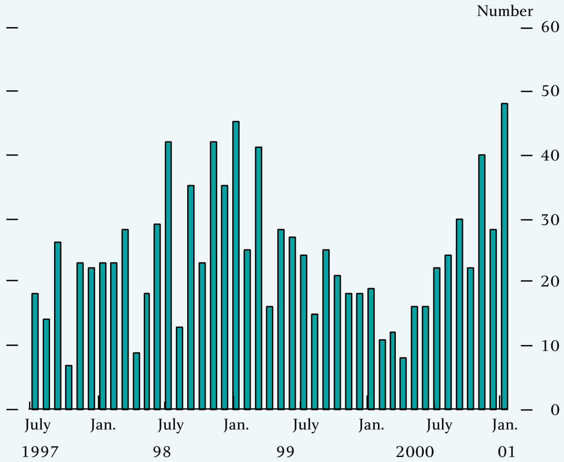
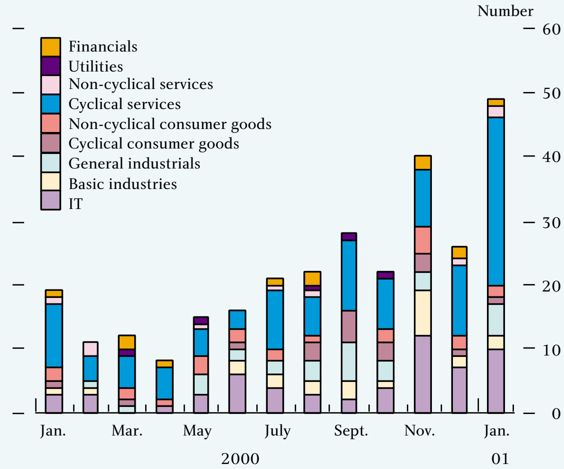
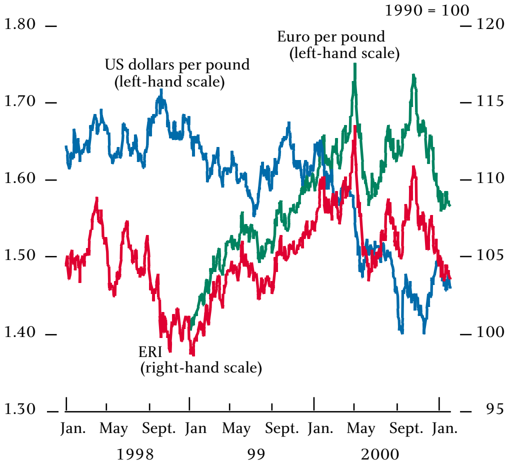


Chart 2
Profit warnings by sector



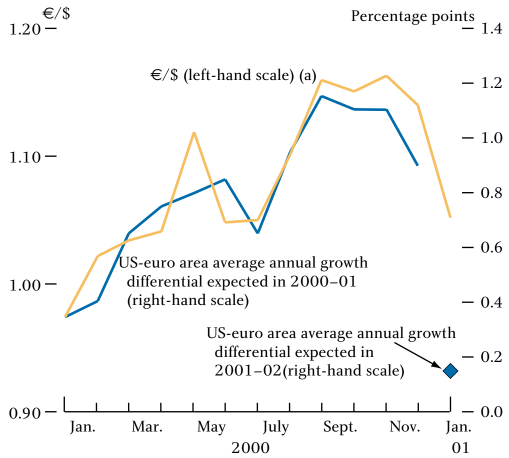
(1) The primary source of data is Reuters Business Briefing. To our knowledge, there is not a database on US profit warnings that offers the same depth of information as the Bank's database for the United Kingdom. There are headline figures reported in the press. These are usually based on revisions to analysts' earnings expectations rather than 'profit warnings' as we define them.
(2) Over the sample period July 1997 to January 2000.

Chart 1.19
Selected sterling exchange rates



Source: Bank of England.

Chart 1.20
Consensus forecasts for US-euro area growth differential and euro/dollar exchange rate



Sources: Consensus Economics and Bank of England.

(a) Exchange rate as at the time of the Consensus Economics survey. A rise denotes an appreciation of the dollar against the euro.

and December, having been negative since April 2000 and as low as -28 in July. And, as discussed earlier, the number of loan approvals has risen. That would be consistent with some increase in housing market activity in the months ahead.

Exchange rates

The euro has risen by around 8% against the dollar since the November *Report*. Sterling has also risen against the dollar, by around 2%, but has depreciated by around 6% against the euro (see Chart 1.19). The sterling effective exchange rate index (ERI) has depreciated since the November *Report*. The 15 working-day average of the sterling ERI up to and including 7 February was 104.0, some 3% below the central path assumed in November.

The fall in the dollar against the euro follows a period of sustained dollar appreciation, during which forecasts of growth in the United States rose relative to the euro area. In recent months, expectations of real GDP growth in the United States have fallen relative to the euro area (see Chart 1.20), largely due to downward revisions to expectations of US investment growth. That has been associated with a reduction in estimates of expected US real short interest rates relative to the euro area. So the recent sharp fall in the dollar is likely to have reflected some reassessment of the prospects for US GDP growth and interest rates. Recent announcements of merger and acquisitions (M&A) deals suggest that capital flows into the United States from M&A-related activity, and outflows from the euro area, have slowed markedly from the high levels seen during the earlier appreciation of the dollar. That would be consistent with a weakening in perceptions of US corporate profitability.

Similarly, the recent fall of the dollar against sterling is likely to reflect downward revisions to expectations of GDP growth and interest rates in the United States relative to the United Kingdom. But the recent appreciation of the euro against sterling is less likely to be explained by a change in relative growth prospects. Those forecasters surveyed by Consensus Economics have revised down their projections for growth in the United Kingdom and euro area by broadly similar amounts during the past three months. And longer-term interest rates have fallen by broadly similar amounts in both the United Kingdom and euro area. An alternative explanation for the recent appreciation of the euro against sterling is that investors have become less concerned about the risks of holding euro assets relative to those in sterling.

1.3 Summary

Narrow money continues to increase rapidly. Broad money growth has eased back from recent peaks. Aggregate lending growth remains rapid, with strong household credit growth supported by falls in the cost of borrowing for consumption. The rate of increase of lending to PNFCs has slowed from a high level.

The official interest rate has been cut by 25 basis points, and both expectations of future nominal short-term interest rates and long-term interest rates have fallen. It seems likely that UK and international real short-term and long-term interest rates have fallen, reflecting downward revisions to world growth projections. Equity prices have been weaker than expected in the November *Report*, probably reflecting a downward revision to expected future profits. UK corporate spreads have changed little so that corporate bond yields, like risk-free rates, have fallen. The sterling effective exchange rate has depreciated over the past three months, with depreciation against the euro more than offsetting appreciation against the dollar.

Demand and output 2

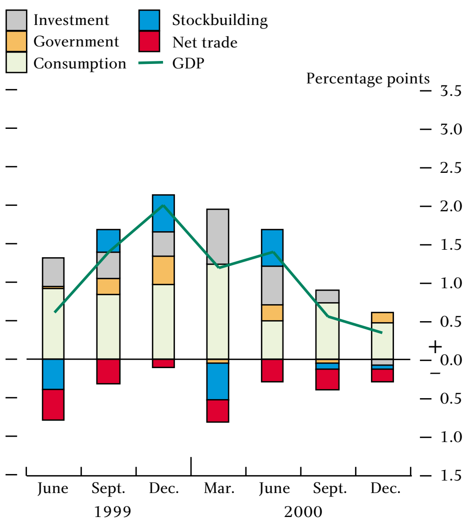
Inflation prospects are affected by the level of nominal demand relative to the supply capacity of the economy. Annual growth in nominal GDP slowed to 4.6% in 2000 Q3, below the average annual rate of growth during 1998 and 1999. That partly reflects a decline in price inflation. But growth in real output also moderated during 2000.

Preliminary estimates suggest that real GDP grew by 0.3% in 2000 Q4, taking annual growth down to 2.4%, close to estimates of long-run growth in the supply capacity of the economy. But output in Q4 was depressed by unusual weather and disruptions to rail services. Growth in household consumption was stronger than anticipated through 2000, and measures of consumer confidence remain relatively high. Investment, however, has continued to fall short of expectations. The contribution of net trade to GDP growth in 2000 Q3 was less negative than projected, and survey measures of export orders remained resilient in Q4. But world activity has slowed more quickly than anticipated, mainly reflecting developments in the United States.

2.1 External demand

World GDP growth slowed in the second half of 2000, and by more than expected in the November *Report*. The slowdown has been sharpest in the United States (see Chart 2.1). US GDP is provisionally estimated to have risen by 0.3% in 2000 Q4, taking the annual rate of growth down to 3.5%, compared with a rate of just over 6% in 2000 Q2. Some slowing of growth in the United States had been expected for some time, as output had been growing more quickly than the likely supply capacity could sustain in the long run. But recent data on the real economy, as well as declines in asset prices and confidence indicators, have prompted downward revisions to forecasts for US GDP growth this year (see Chart 2.2).

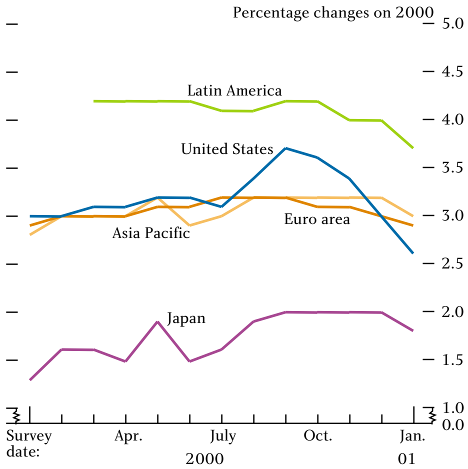
Chart 2.1
Contributions to quarterly US GDP growth



Source: United States Bureau of Economic Analysis.

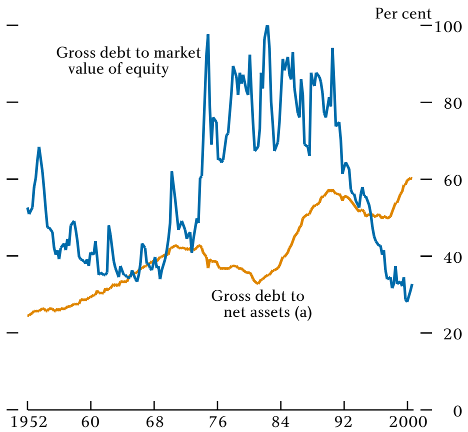
The slower growth in GDP and revisions to Consensus forecasts for the United States are mainly accounted for by weaker investment, particularly in information and communications technology (ICT) equipment. That is consistent with a reappraisal of the expected returns from

Chart 2.2
Evolution of Consensus forecasts for 2001 GDP growth



Source: Consensus Economics.

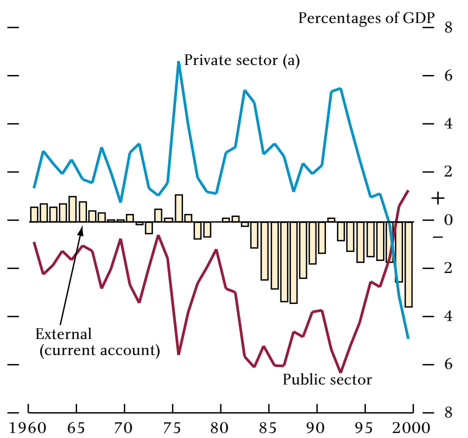
Chart 2.3
US corporate sector leverage



Source: Board of Governors of the Federal Reserve System: 'Flow of Funds Accounts of the United States'.

(a) Net financial assets plus tangible assets at replacement cost.

Chart 2.4
US sectoral balances



Source: Board of Governors of the Federal Reserve System: 'Flow of Funds Accounts of the United States'.

(a) Includes a statistical adjustment to reconcile the financial and non-financial accounts.

investment in new technology, or the degree of uncertainty about those returns, which led to the sharp decline in share prices during 2000 (see Section 1). Share prices, particularly for firms in the technology, media and telecommunications sector, had been at exceptionally high levels relative to corporate earnings. The decline in market values has raised some measures of corporate sector capital gearing. Although aggregate corporate gearing measured using market values was still relatively low in 2000 Q3, debt was at historically high levels relative to the estimated replacement cost of corporate assets (see Chart 2.3), and the flow of borrowing by companies has been high relative to their earnings. This deterioration in the financial position of firms has been reflected in a rise in US corporate bond yield spreads, particularly in the sub-investment grade sector, suggesting that lenders perceive higher default probabilities. Survey information suggests that loan officers at commercial banks have reacted by tightening lending standards. Tighter credit conditions, together with a re-evaluation of the expected returns on capital, can be expected to lead firms to reduce their gearing levels by cutting back further on investment expenditure.

The decline in share prices has been associated with a marked deterioration in measures of US consumer confidence. That may lead consumers to increase their saving out of current income, possibly quite sharply, since increases in asset prices over recent years have been accompanied by a decline in the US household sector saving ratio to record lows. Lower saving by households combined with very high levels of business investment account for the record private sector financial deficit, which measures the imbalance between private domestic saving and investment (see Chart 2.4).

Some rebuilding of household saving, together with weaker corporate investment, is likely to be associated with a period of below-trend growth in the United States. Output growth in 2001 H1 is likely to be depressed as inventories are run down, but should then recover. Asset prices have risen somewhat since the cuts in official interest rates by the Federal Reserve, and corporate bond issuance has picked up. A fiscal expansion is also possible, and exports are likely to benefit from the depreciation of the dollar. Underlying productivity trends are expected to remain favourable. However, the MPC judges that the balance of risks around this central projection is firmly on the downside. That downside risk is also evident in Consensus forecasts: in the January survey the average central projection was for growth of 2.6% in 2001, but the average probability attached by respondents to GDP growth being at or below that rate was just over 60%.

Growth in euro-area activity has also eased a little more than expected in the November *Report*, and euro-area business surveys indicate a further moderation in output growth. But private consumption in the euro area is expected to be supported by the income tax cuts in Germany, France, and Italy. Unemployment is falling and the decline in oil prices will boost consumers' purchasing power. Consistent with these factors, consumer confidence remains at very high levels. And measures of capacity utilisation suggest that investment should remain relatively robust. The much more modest downward revisions to forecasts of activity in the euro area relative to those for the United States (see Chart 2.2) may have been reflected in the appreciation of the euro against the dollar (see Section 1).

Recent data for Japan suggest that output growth remains subdued, with consumption restrained by weak growth in household incomes, renewed declines in asset prices, and continuing retail price deflation. Growth in industrial production in other Asian and in Latin American economies has slowed. Overall, revisions to forecasts of GDP growth outside the United States have been moderate (see Chart 2.2). But there is considerable uncertainty about the impact of a slowdown in the United States on other economies. The potential channels relevant to the UK economy are discussed in the box on pages 18–19.

The current *Inflation Report* projections incorporate a relatively moderate slowdown in activity outside the United States. Some factors, that had been acting to restrain world demand, have reversed since the November *Report*: oil prices have fallen, and estimates of real risk-free interest rates have declined sharply, partly in anticipation of further cuts in official interest rates. Growth in UK export markets can be proxied by the increase in UK trade-weighted world import volumes. The weight of the euro area in this measure is approximately three times that of the United States. But UK export markets are projected to grow more slowly than expected in November and the MPC judges that the balance of risks is firmly on the downside.

Demand for UK exports depends on their relative price as well as the prospects for world demand. The nominal sterling effective exchange rate has depreciated by around 3% since the November *Report*, which will support export volumes. The combination of a depreciation against the euro area, the United Kingdom's major export market, with an appreciation against the dollar, in which many raw materials are priced, may be particularly beneficial for UK exporters' price competitiveness in the short run. Surveys indicate resilience in export orders in recent months (see Table 2.A). In 2000 Q3 export volumes of goods and services were 4.9% higher than a

Table 2.A
UK export outlook(a)

	Series average (b)	2000 Q1	Q2	Q3	Q4
BCC export orders					
Services	12	10	14	14	13
Manufacturing	9	8	-7	7	0
CIPS export orders (c)					
Manufacturing	49.7	51.9	48.8	51.0	50.7
CBI industrial trends					
Export orders	-13	-8	-18	-11	-1
DHL manufacturing export indicator					
Export confidence, next three months	32	38	34	34	32
EEF export orders	-1	0	-9	1	3

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

(a) Numbers reported are percentage balances of respondents reporting 'higher' relative to 'lower'.
(b) BCC since 1989; CIPS since 1996; CBI since 1975; 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.

Recent global developments and the UK economy

World GDP prospects have weakened in recent months, as the US economy has slowed more sharply than expected. This box assesses the likely impact on the UK economy.

International transmission channels and the UK economy

For given interest rates and exchange rates, a reduction in global growth reduces the demand for UK goods relative to supply capacity—and thereby weakens inflationary pressures. A reduction in demand growth in the United States will lower exports from other countries and hence will spill over to the rest of the world. UK activity will be affected not only by the direct impact of lower demand for imports into the United States, but also by lower demand in other markets. Given UK trade patterns, such influences are important (see Table 1).

Table 1
UK exports of goods and services by region

Per cent of GDP in 1999

Total	North America	European Union	Rest of world
25.9	5.0	13.7	7.3

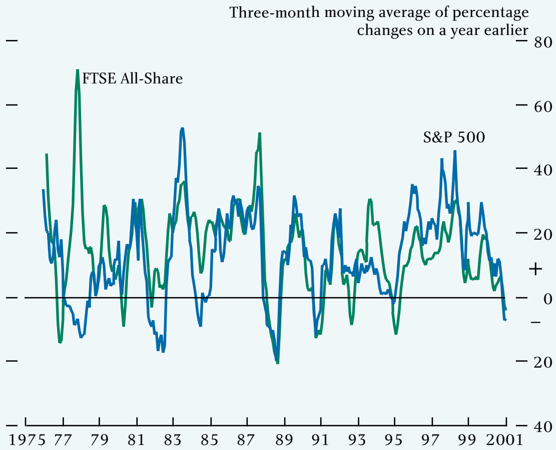
A decline in global demand will reduce global inflationary pressure. Commodity prices and the prices of manufactured goods and services will be lower than otherwise, reducing the price of imports in the United Kingdom. Weaker global demand may also increase the competitive pressure on UK producers in domestic and international markets.

The pattern of changes in demand and prices across countries may be affected by exchange rate movements. The dollar has fallen substantially since the November *Inflation Report*. Currency appreciation against the dollar has amplified the disinflationary impact of weaker US demand in some cases, for example in the euro area. But in others, where exchange rates are closely linked to the dollar such as Argentina, China and Hong Kong, competitiveness in third markets may have improved, reducing the impact of lower US demand. In recent months, the sterling effective exchange rate has depreciated, and this may partly mitigate the impact of weaker world activity on the demand for and prices of UK goods.

Over time, a reduction in demand pressures relative to global supply capacity may be offset by a loosening of the macroeconomic policy stance. Market expectations of the level of future interest rates have fallen since November, with a particularly sharp reduction in the United States where official interest rates were lowered by 100 basis points in January.

Financial markets may play an important role in the transmission mechanism. US equity prices have fallen sharply since their peak in March 2000, particularly for high-technology firms. A fall in US equity prices reduces wealth and therefore the expenditure of both US and non-US residents holding these assets. US-owned firms may rein back on investment in other countries, including the United Kingdom, where they have a significant presence. UK financial markets are highly integrated within the global economy, and around 25% of UK overseas securities holdings are held in the United States. Furthermore, given the close integration of capital markets, equity prices have fallen in other countries, including in the United Kingdom (see Chart A). It is possible that activity in financial markets will fall if sentiment weakens. But it is important to remember that, under the assumption that financial markets process information efficiently, current asset prices will already fully embody news about recent developments and prospects.

Chart A
US and UK equity prices



Financial institutions may tighten lending criteria to potential borrowers they perceive to have become more risky. Spreads on high-yielding US corporate bonds increased markedly in the second half of 2000, though they eased back following the Federal Reserve's first rate cut at the beginning of January. A similar pattern was seen for spreads on emerging market debt, since lower expected borrowing costs may reduce credit risk. European banks have played an important role in financing the high rate of investment growth in the United States in recent years. Yet to the extent that relatively few of those European banks with the highest concentration of US assets have extensive UK-based operations, the impact on the UK economy of any tightening of credit conditions by these banks will be relatively limited. There are few signs to date of any marked tightening in credit conditions in the United Kingdom.

Consumer and business confidence indicators have weakened markedly in the United States in recent months. Could this change in sentiment lead to a marked change in confidence in other countries over and above any decline linked to weaker global demand? An increase in business uncertainty could reduce corporate investment, which is lumpy and costly to reverse. And a loss in consumer confidence could lead consumers to raise precautionary savings and to lower expenditure.

In practice, although broad movements in US and UK confidence measures are correlated, there is much less correlation in terms of high-frequency changes in the recent past (see Charts B and C). Linkages through trade and financial markets mean that some spillover is quite likely, particularly to business sentiment. But there is little sign to date of an additional channel of transmission through a major change of confidence.

Chart B
US and UK business confidence

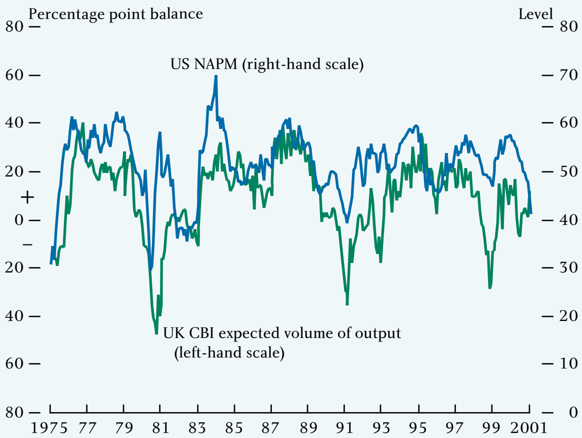
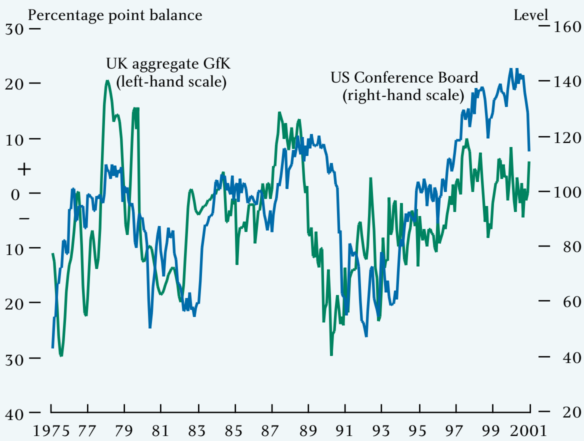


Chart C
US and UK consumer confidence



Moreover, the likelihood of a recovery in US growth in the second half of 2001 and the marked differences in the relative positions of the US and UK economies weaken the argument that the UK economy is likely to slow sharply this year.

US consumer confidence grew sharply during the 1990s and at its peak in September 2000 the Conference Board measure was well above historic norms. In contrast, the GfK measure of UK consumer confidence was at the same time close to its historic average. *A priori*, since UK confidence measures did not follow US confidence sharply upwards, there is no clear reason why they should necessarily follow the recent sharp reductions in the United States, though a wider or more prolonged weakening of the world economic outlook may prompt a sharper downward movement in UK confidence measures.

Quantifying the overall impact on the United Kingdom

Models of the global and UK economies suggest that a temporary reduction in US growth of around 1 percentage point combined with a moderate reduction in UK equity prices may, assuming no change in interest rates or exchange rates, result in a reduction in UK inflation of between 0.2 and 0.4 percentage points after two years.(1) The bulk of the impact comes through the effects on world demand and prices, with the decline in UK net financial wealth from the reduction in equity prices having a relatively smaller impact.

Risks

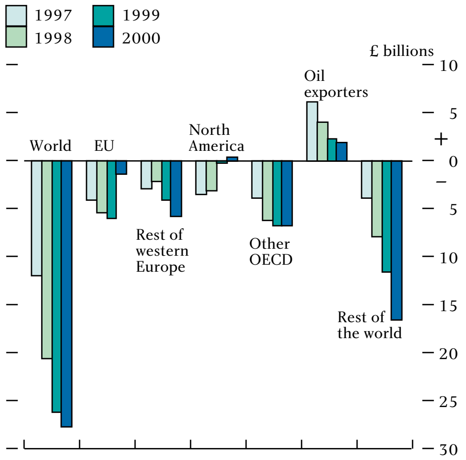
The analysis is based on the broad assumption that the transmission channels are in line with average historic relationships. The risks in terms of the transmission to the United Kingdom are mainly on the downside. Risks to US growth prospects clearly lie to the downside of the central projection. Moreover, in the event of a more pronounced US downturn, the transmission channels discussed above would be stronger and could become amplified by stronger credit channel and confidence effects, as these may be disproportionately powerful in the case of severe shocks which cause financial institutions, companies and households to alter their behaviour.

Conclusion

There are many uncertainties both on the outlook for the US and the global economy, and on the impact of the change in global prospects in the United Kingdom. The central projection assumes that US growth will recover in the second half of 2001, but risks around this assumption are weighted firmly to the downside. The weaker outlook for the international economy has lowered prospects for growth and inflation in the United Kingdom. Quantifying the potential effects is very difficult and, given the uncertainties, the Committee will monitor developments closely.

(1) Simulations reported in this box were conducted using the National Institute's NIGEM, the IMF's Multimod world model and the Bank of England's medium-term macroeconomic model of the UK economy.

Chart 2.5
UK goods trade balances(a)



(a) World and EU figures for 2000 are based on scaled up monthly data available to November.

Table 2.B
GDP and expenditure components(a)

Percentage changes on a quarter earlier

	Average for 1999	2000 Q1	Q2	Q3
Consumption:				
Households	1.2	0.7	1.0	1.0
Government	1.0	-0.8	3.3	0.7
Investment	1.3	-0.8	0.7	-0.5
of which, business investment	*1.3*	*-0.2*	*0.5*	*-0.2*
Final domestic demand	**1.2**	**0.2**	**1.3**	**0.8**
Private (b)	1.3	0.4	0.7	0.8
Public (c)	0.7	-0.8	4.1	0.3
Change in inventories (d)	-0.2	0.1	0.2	0.2
Excluding alignment adjustment (d)	*-0.2*	*0.9*	*-0.3*	*-0.1*
Domestic demand	**1.0**	**0.3**	**1.4**	**1.0**
Net trade (d)	-0.3	0.2	-0.5	-0.3
GDP at market prices	**0.8**	**0.4**	**1.0**	**0.7**

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

year earlier whereas total import volumes rose by 8.4%. A combination of stronger-than-expected exports and weaker imports meant the contribution of net trade to GDP growth in Q3 was less negative than projected in the November *Report*. And monthly data indicate that the contribution could be positive in Q4, with a pick-up in the growth rate of goods exports to the non-EU area.

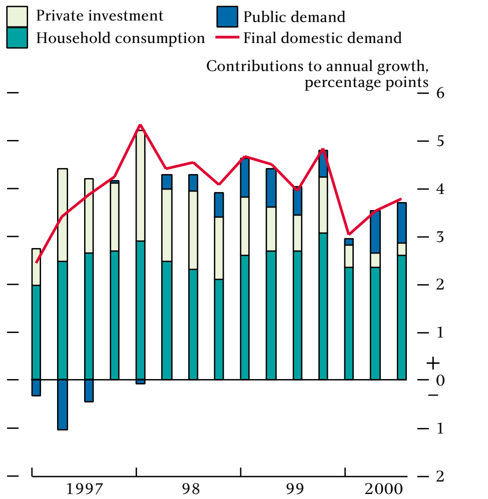
Over the past three years the appreciation of sterling against the euro area has accounted for most of the appreciation of the trade-weighted sterling effective exchange rate. Yet over that period the United Kingdom's trade balance has actually improved against the rest of the EU, mainly reflecting a lower goods trade deficit (see Chart 2.5). The deterioration in the overall goods trade balance is largely accounted for by an increase in the deficit with countries outside the OECD and OPEC regions, principally Asia. In part that reflects the effects of the Asian crisis in 1997/98 on those countries' demand for UK goods. But more recently the deficit has widened because of increasing imports to the United Kingdom from those countries. By commodity type it is imports of intermediate and capital goods that have risen most rapidly, suggesting that UK manufacturers have been attempting to mitigate the downward pressure on profitability by sourcing parts and capital equipment from cheaper locations. That hypothesis is also supported by reports from the Bank's regional Agents.

The MPC expects UK export growth to be a little weaker than in the November projections, as lower growth in UK export markets more than offsets the effect of the recent depreciation of the sterling effective exchange rate. Together with continued relatively robust growth in domestic demand, which will sustain quite rapid growth in imports, that implies that net trade will continue to make a negative contribution to GDP growth over the forecast period.

2.2 Domestic demand

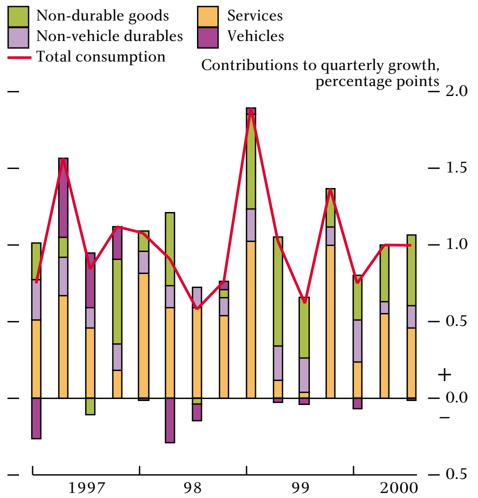
Final domestic demand grew by 0.8% in 2000 Q3 (see Table 2.B). Private final domestic demand growth in Q3 was close to that projected in the November *Report*, as strong growth in private consumption was offset by weaker-than-projected growth in private investment. Growth in public expenditure was weak, but from a higher base, as the estimated level of public expenditure was revised upwards in the latest set of National Accounts. The level of private final domestic demand has not been revised much. Growth in private final domestic demand remains above trend, though below the rates of increase seen in 1999. Chart 2.6 shows that the slowdown has been accounted for by slower growth in private investment, in particular business investment.

Chart 2.6
Final domestic demand(a)



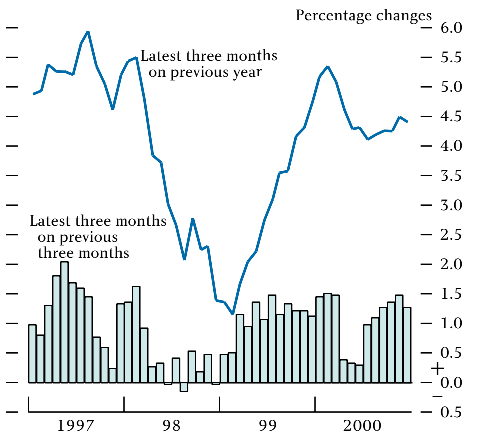
(a) At constant 1995 market prices. Public demand is defined as general government consumption and investment, and investment by NHS trusts. Private investment is defined as business investment and private sector investment in dwellings. Contributions do not sum exactly to the total as consumption by non-profit institutions and net acquisitions of valuables are not shown.

Chart 2.7
Household consumption expenditure growth(a)



(a) At constant 1995 market prices.

Chart 2.8
Growth in retail sales volumes



Household sector consumption

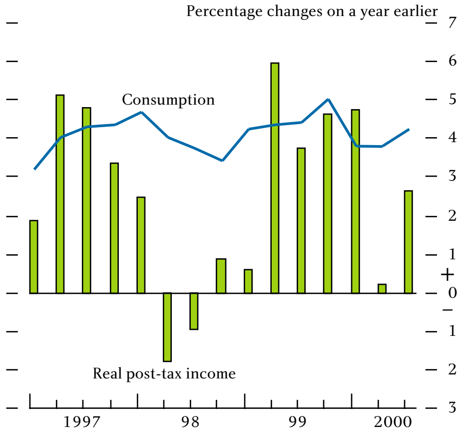
Household consumption grew by 1.0% in 2000 Q3. Spending grew more quickly during 2000 than projected, and has been revised up in the latest set of National Accounts for the period since 1999 Q1. Consumption has been strong, despite persistent weakness in spending on vehicles over the past two years (see Chart 2.7). An explanation for the latter is that consumers have delayed purchases of vehicles in anticipation of price reductions, in the light of the recent review of car retailing by the Competition Commission. Following the report, car producers were required to offer retailers volume-related discounts, equivalent to those offered to fleet buyers, by 1 December 2000. According to the HICP index, new car prices fell in 2000 Q4 at their fastest annual rate since 1997. New registrations data from the Society of Motor Manufacturers and Traders suggest that, with prices having adjusted to increased competition, expenditure on vehicles recovered in Q4: private registrations rose by 27% compared with a year earlier. Furthermore, the CBI Distributive Trades survey indicates that motor traders' sales rose in December and January compared with a year ago, the first annual increases since September 1999.

Some increase in spending on vehicles may represent a substitution away from spending on other goods and services. But growth in retail sales, which exclude purchases of vehicles, remained robust in Q4 (see Chart 2.8) and into January according to the CBI Distributive Trades survey. Surveys suggest that growth in expenditure on services remained firm in Q4. Money and credit data are also consistent with relatively buoyant outturns for household consumption growth in Q4 (see Section 1). Preliminary information on services and energy output in Q4 does, however, suggest that consumption of energy and transport services may have been temporarily depressed by the unusual weather and disruptions to the rail network.

For some time consumption has been stronger than would have been suggested by developments in official interest rates, household income, wealth, and proxies for confidence. There are a number of possible reasons for this. One is that rates of interest faced by consumers have diverged from their usual relationship with the short-term official interest rate set by the MPC. As discussed in the box on page 6 in Section 1, competition in the retail lending market appears to have intensified, and that has partly offset the impact of past increases in the official interest rate.

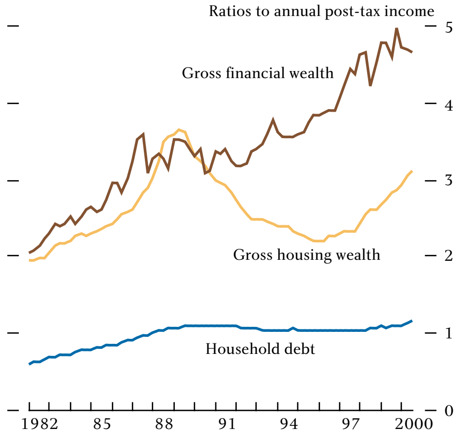
Household consumption should be related to the present value of current and expected future household income, or human wealth. Human wealth is unobservable, but in

Chart 2.9
Real household post-tax income and consumption(a)



(a) Deflated by the household consumption deflator.

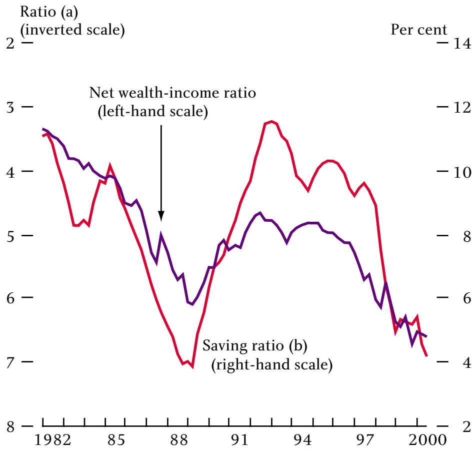
Chart 2.10
Household assets and liabilities(a)



Sources: ONS and Bank of England.

(a) Using a four-quarter moving sum of income.

Chart 2.11
Household sector saving and net wealth to income ratios



Sources: ONS and Bank of England.

(a) Using a four-quarter moving sum of income.
(b) Four-quarter moving average.

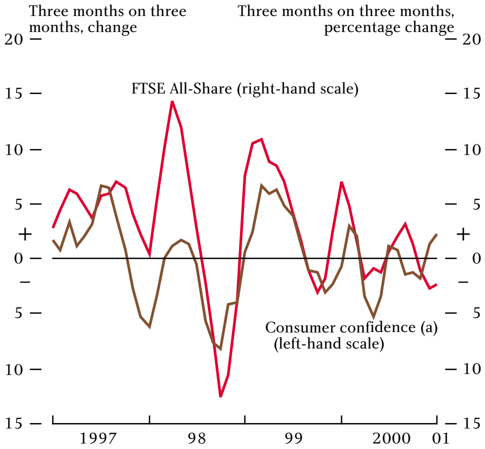
economic modelling it is often proxied by current real post-tax household income. Growth in real post-tax income has been volatile in recent quarters and, on average, much slower than consumption (see Chart 2.9). Forward-looking consumers will tend to smooth the impact of volatile current income on consumption by adjusting their saving or borrowing. And changes in current income would be a poor proxy for movements in human wealth if consumers believe that their incomes are likely to grow more quickly in the future because of an increase in productivity growth associated with supply-side improvements in the economy. Alternatively, consumers could have become more certain about future labour income, following persistent declines in unemployment, and so have reduced the level of precautionary saving.

Household consumption should also be related to the level of financial wealth. Higher expected future growth in profits related to supply-side improvements may have been one factor supporting the sharp increase in financial wealth in recent years. House price increases have also boosted gross wealth relative to household debt (see Chart 2.10). Chart 2.11 shows that the proportion of current income that consumers save tends to be related to the level of net wealth relative to income. It could be that changes in wealth are exerting a more powerful or more rapid effect on consumption than in the past, for example because it is easier to borrow against housing wealth following innovations in the mortgage market.

Households' observable wealth has changed little since the end of 1999 as increases in house prices have been offset by lower financial asset prices. Weaker share prices were associated with a moderation in aggregate measures of consumer confidence during 2000 (see Chart 2.12), but confidence rebounded sharply in January this year. Aggregate measures of consumer confidence mask quite different expectations by households of their own financial situation relative to their view of prospects for the economy as a whole. As shown in Chart 2.13, consumers remain very optimistic about their own financial situation over the next twelve months, which is corroborated by robust credit demand.

Given the stronger-than-projected outturns for consumption during 2000, and the resilience of households' confidence in their own financial situation, the MPC has revised up its projections relative to the November *Report*. But the MPC continues to expect consumption growth to moderate over the forecast period as the impetus from wealth gains fades and labour income growth slows, and the balance of risks is thought to be on the downside.

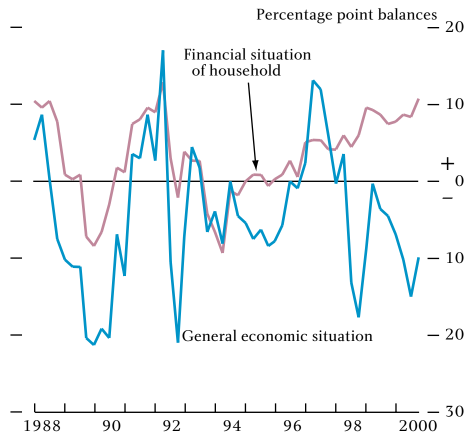
Chart 2.12
UK consumer confidence and share prices



Sources: GfK and Thomson Financial Datastream.

(a) GfK headline measure.

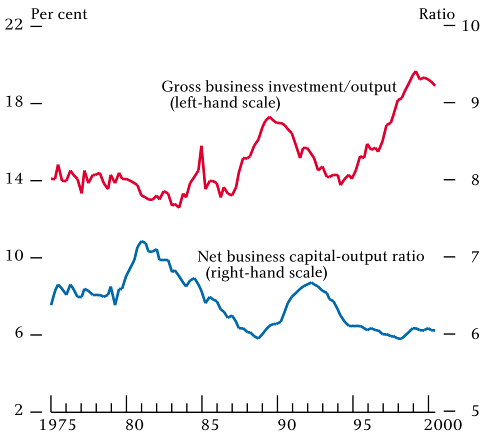
Chart 2.13
Consumers' expectations for the next twelve months[(a)]



Source: GfK.

(a) Quarterly averages of monthly responses.

Chart 2.14
Business sector investment and the stock of capital relative to output[(a)]



Sources: ONS and Bank of England.

(a) Business sector output is defined as GDP minus output of the public administration and defence, education, and health and social work sectors. At constant 1995 prices.

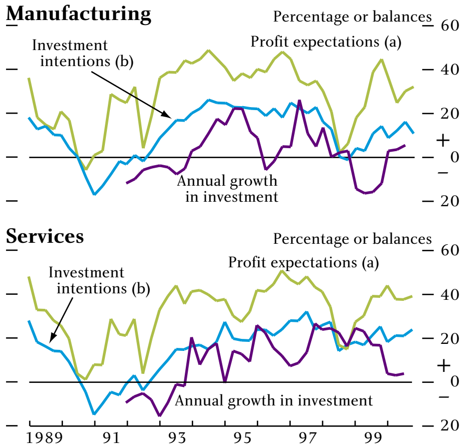
Private sector investment

Whole-economy investment fell by 0.5% in 2000 Q3. In contrast to consumption, investment growth has continued to be weaker than projected. Within the private sector, business investment fell by 0.2% in 2000 Q3. But investment is a volatile component of GDP: the standard deviation of quarterly growth in investment over the past quarter-century has been more than twice that for consumption. In recent years the level of gross business sector investment has been far higher, relative to business sector output, than during the past quarter-century (see Chart 2.14). The historical relationship with output alone might suggest the prospect of weaker investment. But the increase in the investment-output ratio in recent years can in part be explained by a rapid decline in the relative price of capital goods, in particular ICT capital goods. The relative price has fallen because of technical progress in the equipment-producing industries, and is therefore likely to persist. That should help maintain the investment-output ratio at a relatively high level. Related to this, a greater share of gross investment is accounted for by ICT capital goods than in the past, which are estimated to have a higher rate of depreciation than other types of capital goods. So, compared to the past, a higher level of gross investment is required to maintain a given net capital-output ratio. Consistent with that, ONS estimates suggest that the net business capital-output ratio remains relatively low (see Chart 2.14).

The incentive for firms to invest depends on the expected return on new investment projects relative to the cost of capital. As discussed in Section 1, a sharp decline in risk-free interest rates has reduced the cost of debt finance during 2000, even for the less creditworthy corporates. And, according to the BCC survey, expectations about profitability over the next twelve months have recovered significantly since 1998, even in the manufacturing sector. The average return on existing capital in the manufacturing sector has approximately halved since 1998, to around 5%, but the expected return from new capital equipment may be significantly higher if it embodies new technology that facilitates improved productivity. Together with survey evidence suggesting relatively high levels of capacity utilisation, that may explain why the balance of firms revising up their investment plans has risen since 1998, in both the manufacturing and service sectors (see Chart 2.15).

Overall it is difficult to reconcile the survey evidence on investment plans with the recent comparatively weak growth in investment expenditure, especially by the service sector. Various factors may have affected the time scale over which those plans are implemented. Uncertainty about the ability of ICT equipment to cope with the date change to 2000 may

Chart 2.15
Influences on investment



Sources: BCC and ONS.

(a) Balance of responses to the question: 'Do you believe that over the next twelve months profitability will improve/remain the same/worsen?'
(b) 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?'

Table 2.C
Factors cited by firms as likely to limit capital expenditure over the next twelve months(a)

	Series average (b)	1999 average	2000 average
Inadequate net rate of return			
Services (c)	44	38	51
Manufacturing	43	50	53
Shortage of internal finance			
Services (c)	25	25	23
Manufacturing	20	16	18
Inability to raise external finance			
Services (c)	8	9	7
Manufacturing	3	6	4
Cost of finance			
Services (c)	9	8	9
Manufacturing	9	3	4
Uncertainty about demand/sales			
Services (c)	48	51	42
Manufacturing	47	51	48
Shortage of labour			
Services (c)	15	13	19
Manufacturing	5	6	10

Sources: CBI Industrial Trends and CBI/Deloitte & Touche.

(a) Percentage of firms citing each factor in response to the question: 'What factors are likely to limit your capital authorisations over the next twelve months?'
(b) Since 1979 for manufacturing; since November 1998 for services.
(c) Unweighted average of the responses for consumer, business and professional services.

Table 2.D
Survey measures of investment intentions in the service sector(a)

	Series average (b)	1999 H1	1999 H2	2000 H1	2000 H2
BCC (plant and machinery)	15	18	23	20	23
CBI/Deloitte & Touche (c)					
Consumer, business and professional services					
Land and buildings	-2	-1	-3	1	-5
Information technology	28	41	24	21	19
Vehicles, plant and machinery	1	2	4	-4	4
CBI/PricewaterhouseCoopers					
Financial services					
Land and buildings	-13	-24	-12	-20	-3
Information technology	39	34	36	44	36
Vehicles, plant and machinery	-10	-10	-11	-19	-18

Sources: CBI/Deloitte & Touche and CBI/PricewaterhouseCoopers and BCC.

(a) Percentage balance of firms revising up their investment intentions.
(b) Since 1989 for BCC and CBI/PricewaterhouseCoopers; since November 1998 for CBI/Deloitte & Touche.
(c) Unweighted average of the responses for consumer, business and professional services.

have led to a bunching of ICT investment in advance of the new millennium. Firms may also have taken the opportunity to replace complementary capital equipment at the same time. So the current weak growth in investment may be the consequence of unusually strong investment in the quarters leading up to 2000. It could also be that the sharp rise in the price of oil during 1999 and much of 2000 led to an increase in uncertainty about the prospects for world growth. This may have led some firms to postpone investment. And uncertainty about the outlook for world demand has increased again in recent months following the downturn in the United States. Finally, adverse weather is likely to have delayed construction projects.

High levels of M&A expenditure and the purchase of the third-generation mobile telecommunications licences may have temporarily lowered available resources, although recent CBI surveys do not indicate that a shortage of internal finance has been a particular constraint on investment in the services or manufacturing sectors (see Table 2.C). According to the BCC, cash flow has been improving in the service sector since 1999, reaching its highest level for three years in 2000 Q4. Monetary data indicate that the corporate sector increased its deposits rapidly through 2000, which also suggests healthy liquidity. There is some evidence that shortages of skilled labour became more of a constraint on investment plans during last year, but still for relatively few firms (see Table 2.C).

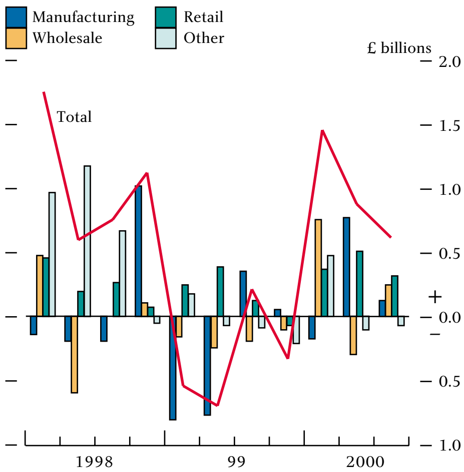
The interpretation that investment expenditure has only temporarily fallen below intentions is supported by a survey carried out by the Bank's regional Agents in January. In the survey the balance of firms said that they had invested less than planned in 2000. And the most frequently cited reason was delays in implementing plans, sometimes due to labour constraints. Very few cited the availability or cost of finance as a constraint. The balance of firms plan to invest more in 2001 than in 2000.

There may be issues of measurement affecting both surveys and the official data. As discussed in previous *Reports*, difficulties in adequately capturing quality improvements may mean that the price of investment goods is overstated and hence the volume understated. So the accumulated stock of capital may be higher than previously assumed. Alternatively, surveys of the aggregate service sector, for example the BCC survey, may not be adequately capturing sharp changes in investment in information technology by particular parts of the service sector. For example, the decline in IT investment intentions apparent in the CBI/Deloitte & Touche survey (see Table 2.D) has occurred mainly in consumer services. But the survey still indicated positive intentions in 2000 Q4.

Investment in private sector dwellings rose by 0.8% in 2000 Q3. Investment in dwellings has been supported by the rise in house prices in recent years. But the CIPS construction survey and new orders data indicated a moderation in house construction activity during 2000, with some increase evident only in very recent months. So growth in dwellings investment may weaken in the near term, although the recent upturn in housing activity could feed through to investment once dwellings are completed later in the year.

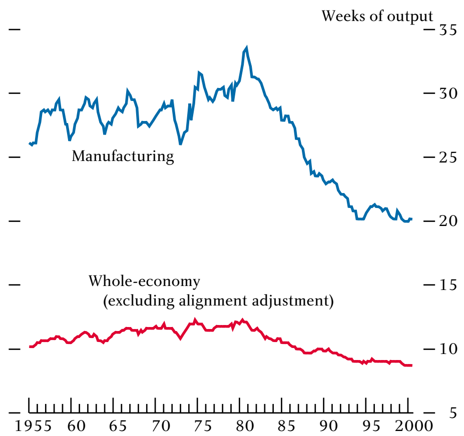
Overall the MPC continues to expect some recovery in the growth rate of private sector investment, based on survey evidence for business investment. But the near-term profile for private investment is lower than projected in the November *Report*, as successive weak outturns suggest that some of the temporary factors leading to weaker growth are likely to be more persistent than previously thought. Information from asset prices suggests that the outlook for corporate profits has deteriorated or become more uncertain, and the number of profit warnings has picked up (see the box on page 12 in Section 1). If the high level of uncertainty about global prospects persists, firms may begin to revise down their investment plans. To reflect this possibility the MPC has assumed that on balance there is a downside risk to the projection for investment.

Chart 2.16
Change in inventories[(a)]



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

Chart 2.17
Stock-output ratios[(a)]



(a) At constant 1995 prices.

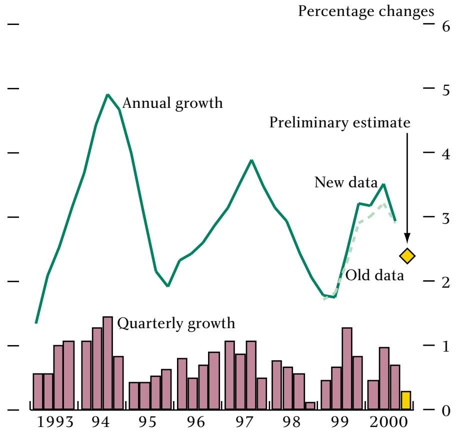
Public sector demand

Real government consumption rose by 0.7% in 2000 Q3, and in the National Accounts there were significant upward revisions to real government consumption since 1999. Government investment fell by 4.8% in Q3. Nominal spending plans, together with the MPC's forecast for inflation, continue to imply robust growth in real government spending over the forecast period.

Inventories

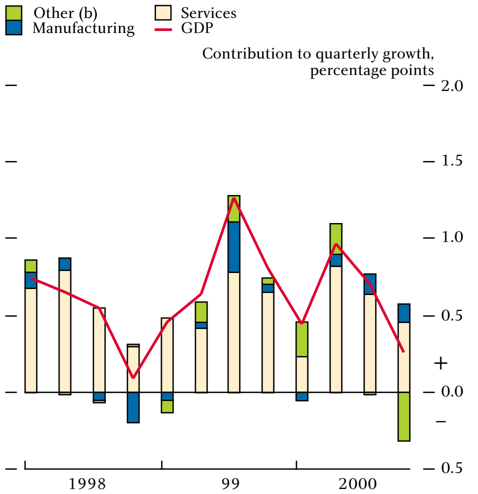
According to the headline measure, inventory investment contributed 0.2 percentage points to GDP growth in 2000 Q3. But that estimate included a statistical adjustment used to align the expenditure and output measures of the National Accounts. Excluding the alignment adjustment, inventories have been rising during 2000, but at a declining rate (see Chart 2.16). So the underlying data suggest that inventory investment made a negative contribution to GDP growth in Q3 (see Table 2.B). Over recent quarters the aggregate stock-output ratio has continued to decline, if less rapidly than during the 1980s (see Chart 2.17). The MPC has maintained its assumption that companies will continue to seek cost savings through improved stock management techniques, and so the ratio of inventories to output will

Chart 2.18
GDP growth(a)



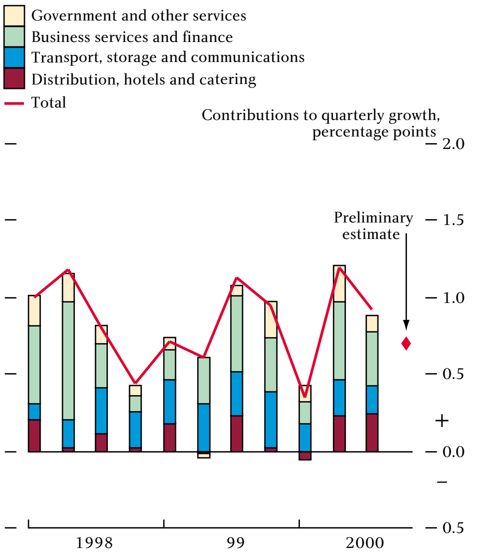
(a) At constant 1995 market prices.

Chart 2.19
Sectoral GDP growth(a)



(a) At constant 1995 basic prices.
(b) Other includes construction, the utilities, mining and quarrying, and agriculture. The contribution has been derived as a residual from the other components of GDP as data for construction and agriculture output in Q4 are not yet available.

Chart 2.20
Service sector output growth(a)



(a) At constant 1995 basic prices. Contributions do not sum to the total due to rounding.

decline over the medium term. The preliminary data on output in 2000 Q4, together with indications of a pick-up in expenditure on cars, suggest that inventories of cars may have fallen sharply in Q4.

2.3 Output

The National Accounts release on 21 December revised up past estimates of GDP. As a result, the level of measured output in 2000 Q3 was 0.3 percentage points higher than previously estimated. Growth in Q3 was unrevised at 0.7%. According to the preliminary estimate, GDP rose by 0.3% in 2000 Q4, the slowest quarterly growth rate since 1998 Q4, taking the annual growth rate down to 2.4% (see Chart 2.18). But as shown in Chart 2.19, growth was mainly depressed by sharp declines in the output of sectors outside manufacturing and services, which comprise construction, the utilities, mining and quarrying, and agriculture. These are relatively volatile components of GDP.

Preliminary estimates suggest that service sector output rose by 0.7% in 2000 Q4, less than in the previous quarter, but close to the average quarterly growth rate over the past two years (see Chart 2.20). The breakdown of service sector output available for Q3 indicates that growth in the transport and communications sector remained very strong, up 6.9% on a year earlier, reflecting strong sales of telecommunications services. The ONS has indicated that the transport sector accounted for some of the slowdown in Q4, because of the disruption to rail services. But lower growth in the business services and finance sector was more important; in particular, output of the computing services sector is estimated to have been broadly flat since 2000 Q2, following rapid growth in the lead-up to the new millennium. That is consistent with some easing in the volume of work done by business and professional service sector firms, and optimism about their business situation, reported in the November CBI/Deloitte & Touche survey (see Table 2.E). In the financial services industry, the December CBI/PricewaterhouseCoopers survey indicated an overall picture of strong growth in business volumes. Looking at the service sector as a whole, the CIPS and BCC surveys indicated that growth in incoming new business rose in Q4, and business optimism remains high.

Manufacturing output continued to grow in Q4, with output rising by 0.5%. Forward-looking surveys and reports from the Bank's regional Agents point to steady growth in the near term, despite the expected slowdown in aggregate world demand (see Table 2.F). The previous *Report* highlighted the divergence in output growth between the high-technology sectors and the rest of manufacturing. Those patterns remained in Q4 (see Chart 2.21), and the latest Engineering Employers Federation

Table 2.E
Service sector output prospects(a)

	Series average (b)	2000 Q1	Q2	Q3	Q4
CIPS (c)					
Business expectations, next twelve months	77.5	77.5	75.4	74.6	75.0
Incoming business	56.4	56.9	56.6	56.6	56.7
BCC business confidence, next twelve months	47	56	56	52	53
BCC home orders, past three months	17	21	31	23	31
CBI/Deloitte & Touche (d)					
Business optimism	6	8	11	7	-10
Volume of business, next three months	23	26	33	36	23
CBI/PricewaterhouseCoopers Financial services					
Business optimism	7	36	-6	3	2
Volume of business, next three months	23	33	30	16	22

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

(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 November 1998 for CBI/Deloitte & Touche; CIPS since 1996.
(c) Average of seasonally adjusted monthly indices. A reading above 50 suggests expansion, a reading below 50 suggests contraction.
(d) Unweighted average of the responses for consumer, business and professional services.

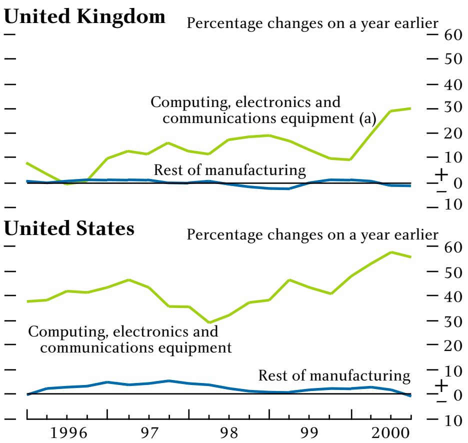
Table 2.F
Manufacturing output prospects(a)

	Series average (b)	2000 Q1	Q2	Q3	Q4
CBI total new orders, past four months	-1	-4	-8	-9	4
CBI volume of output, next four months	8	1	3	3	14
CBI business optimism	-5	-2	-10	-9	-3
CIPS new orders index, past month (c)	52.9	52.4	51.6	52.1	52.5
BCC home orders, past three months	6	15	5	11	12
EEF volume of new orders, past three months	6	6	-8	5	10

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 2.21
Manufacturing output



Sources: ONS and United States Bureau of Economic Analysis.

(a) Defined to be broadly comparable with the US computers and communications sector. Includes manufacture of computer, electronics and communications equipment, which together account for about 5% of UK manufacturing output.

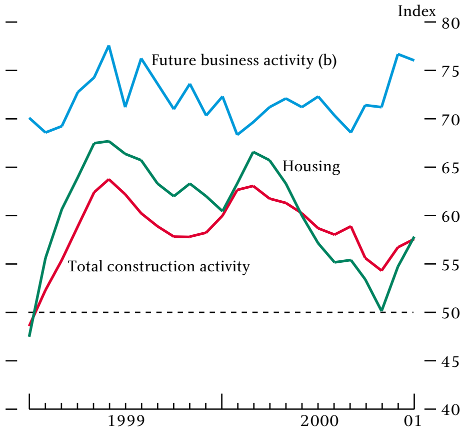
survey indicated that new orders in high-technology sectors such as electronics and electrical equipment improved in Q4. However, looking forward, in the January CBI Industrial Trends survey the balance of firms in the office machinery and data processing equipment sector expected new orders to decline, even though a large positive balance had experienced an increase in new orders over the past four months.

The utilities, mining and quarrying, agriculture, and construction sectors, where output tends to be more volatile, together made a small negative contribution to GDP growth in Q3, as construction sector output fell sharply. And overall output in these sectors fell more significantly in Q4. Output of the utilities, agriculture, and construction sectors was adversely affected by unusual weather. Mining output was also unusually weak. Construction output has fallen since spring 2000 as millennium-related projects were completed and adverse weather delayed projects. The expected return from housing construction may also have declined as house price inflation moderated earlier in the year. But the CIPS survey of construction indicates an upturn in activity in recent months and optimism about future business activity has been increasing for some time (see Chart 2.22), in part because of an expected increase in public sector infrastructure investment.

2.4 Summary

Annual growth in real GDP slowed to 2.4% during 2000, close to trend. But the extent of the slowdown has probably been exaggerated by temporary factors affecting output in Q4. Private final domestic demand, while growing less rapidly than during 1999, has remained robust. Household consumption growth remains brisk and has continued to be stronger than suggested by its historical relationship with income and wealth. Surveys indicate that households remain relatively confident about their own financial situation. So the MPC has revised up its central projection for consumption, but continues to expect some slowdown in consumption growth as wealth gains diminish and real income growth slows. The strength of consumption has been offset by weaker-than-expected business investment. Surveys of investment plans continue to suggest a prospective pick-up in investment, with business confidence remaining firm. But the global economic outlook has weakened and become more uncertain, which may lead firms to delay their investment further. The MPC has revised down its projection for investment in the near term, although a recovery in 2002 is still expected. Overall, in the near term, growth in domestic demand is projected to be a little weaker than in November before recovering towards the end of the forecast period. But

Chart 2.22
CIPS construction survey(a)



Source: CIPS.

(a) A reading above 50 suggests expansion, a reading below 50 suggests contraction.
(b) Not seasonally adjusted.

the risks to both consumption and investment are seen as being on the downside.

World demand is projected to be weaker than assumed in November, principally reflecting developments in the United States, so growth in UK export markets is likely to be slower than expected in the November *Report*. The US economy is expected to recover relatively quickly, but the balance of risks to world activity lie firmly on the downside. So near-term prospects for UK output have weakened since the November *Report*, and the MPC judges that the balance of risks is on the downside.

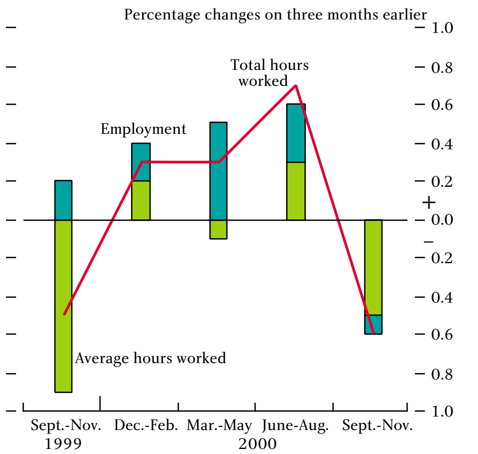
The labour market 3

Inflationary pressures in the labour market remain relatively muted despite high levels of labour utilisation. Recent data offer somewhat mixed signals about near-term prospects. Surveys suggest that labour demand remains firm. But employment and total hours worked fell in the three months to November, perhaps partly reflecting the temporary impact of fuel shortages, flooding and rail disruption. Unemployment rose marginally on the LFS measure, and the inactivity rate increased, although claimant count unemployment fell slightly. But rates of unemployment remain near 25-year lows and skill shortages continue to be widely reported. Nevertheless, average earnings growth has edged up only slightly since the previous *Report*, and rising productivity continues to contain unit wage cost growth.

3.1 Employment and unemployment

Following several years of rapid growth, employment appears to have levelled off at a high rate in recent months. Indeed, LFS employment—a measure of the number of people in work—fell by 25,000 (-0.1%) in the three months to November 2000 (see Chart 3.1), the first decline on a comparable three-month basis since 1993. Within the total, there was a rise in employment in jobs which workers viewed as permanent. But that was more than offset by declines in other components of employment, such as temporary employees—which includes casual and agency workers and those on fixed-term contracts—and the self-employed.

Chart 3.1
Growth in LFS employment and hours worked(a)



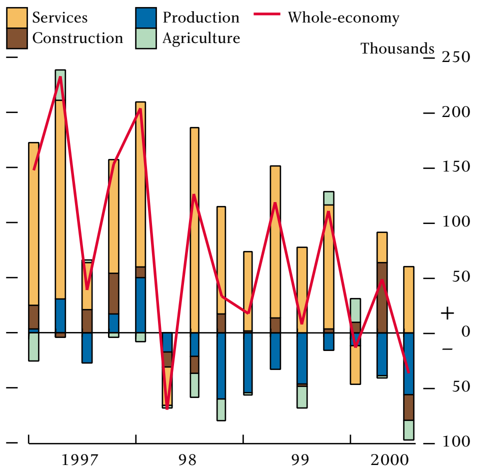
(a) Growth of employment plus growth of average hours worked may not equal growth of total hours worked because of rounding.

Total hours worked is potentially a better measure of labour usage than numbers in employment, as it includes changes in overtime, flexible hours arrangements and the balance between part-time and full-time workers. Total hours worked fell more rapidly than numbers in employment in the three months to November, reflecting a further decline in LFS estimates of average hours worked (see Chart 3.1). Moreover, recent falls in both employment and total hours worked may have been understated by official data due to the introduction of new population estimates in the calculation of LFS employment. For example, the ONS estimates that underlying LFS employment fell by 49,000 (-0.2%) in the three months to

November, 24,000 more than suggested by the official data.[1] Weaker employment would reduce estimates of total hours worked correspondingly.

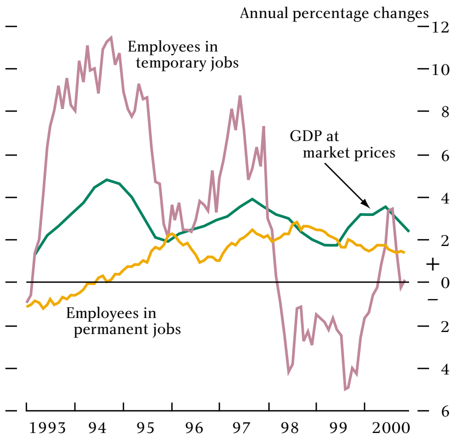
The Workforce Jobs survey provides an alternative measure of employment. Unlike the LFS measure, which is based on a rolling survey of household employment over a three-month period, the Workforce Jobs measure records the number of jobs in different firms on a single day towards the end of each quarter. The sampling method means that the Workforce Jobs measure tends to be more variable than the three-month LFS employment estimates and it is accordingly assigned slightly less weight by the MPC. The number of Workforce Jobs fell by 38,000 (-0.1%) in 2000 Q3. In line with recent trends, the number of service sector jobs continued to rise, but that was more than outweighed by fewer jobs in other sectors (see Chart 3.2). In particular, the number of construction jobs recorded the largest decline for four years, although reports from the Bank's regional Agents suggest that this was partly weather-related.

Chart 3.2
Quarterly changes in Workforce Jobs



Falls in labour usage mirror the recent slowdown in GDP growth (see Section 2). Temporary employment accounts for a relatively small proportion of overall employment but may be particularly sensitive to changes in GDP growth. One reason might be that when demand is rising but prospects are uncertain, risk-averse employers prefer initially to employ temporary workers rather than undertake more costly search for, and investment in, permanent staff. Similarly, when demand is easing, firms may recruit fewer new temporary employees, or release existing temporary workers, before reducing demand for permanent staff. In addition, on the employee side, the decision to search for temporary work may be particularly responsive to changing economic prospects. As Chart 3.3 shows, growth in the number of temporary employees has often varied with changes in GDP growth and has indeed slowed recently in line with output growth. However, structural factors, such as rising labour market participation by female workers, have also played an important role in the growth of temporary employees.

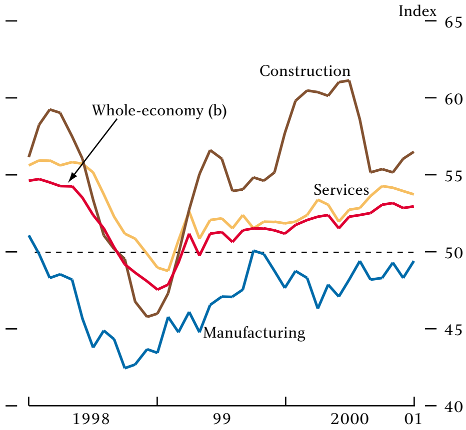
Chart 3.3
Employees and GDP growth



Equally there are signs that erratic factors, rather than more sustained cyclical influences, may partly explain recent declines in labour usage. The latest LFS employment data cover the period of autumn 2000 most likely to have been affected by fuel supply interruptions, rail disruption and severe flooding. These disruptions may have made it more difficult for firms to recruit temporary (or casual) workers, or

(1) The impact of new population estimates on LFS data is described in more detail in the National Statistics *Labour Market Statistics, First Release*, January 2001. LFS data in this *Report* are based on official published estimates unless otherwise stated.

Chart 3.4
CIPS survey employment index(a)



Source: Chartered Institute of Purchasing and Supply.

(a) A reading above 50 suggests expansion of employment, a reading below 50 suggests contraction.
(b) Weighted index of data on manufacturing, services and construction.

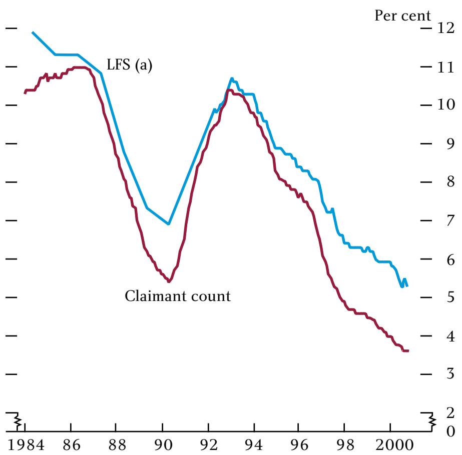
Table 3.A
Surveys of employment intentions(a)

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

	Series average (c)	1999 Q3	Q4	2000 Q1	Q2	Q3	Q4
Whole-economy							
Manpower	10	15	14	14	14	18	21
Services							
Manpower	12	15	13	19	16	21	27
BCC	13	21	21	25	28	28	29
CBI/Deloitte & Touche (d)	23	12	43	29	31	32	24
Manufacturing							
Manpower	14	14	12	13	11	14	13
BCC	3	6	12	4	11	9	8
CBI	-16	-15	-10	-15	-13	-7	-10

(a) Seasonally adjusted by the Bank.
(b) Next three months for all series except for CBI; next four months for CBI.
(c) CBI from 1972; Manpower from 1981 (whole-economy) or 1988 (sectoral); BCC from 1989; CBI/Deloitte & Touche from 1998 Q4.
(d) Unweighted average of consumer services, and business and professional services.

Chart 3.5
Unemployment rates



(a) Backward-looking three-month moving averages. Pre-1993 figures based upon yearly observations.

encouraged firms to release existing temporary staff. The disruptions may also have had a marked impact on total hours worked if employees spent less time in the workplace because of longer journey times to and from work. Fuel shortages may have had a particularly important effect on the Workforce Jobs measure of employment: the ONS has indicated that this survey took place during the fuel supply disruptions last September.

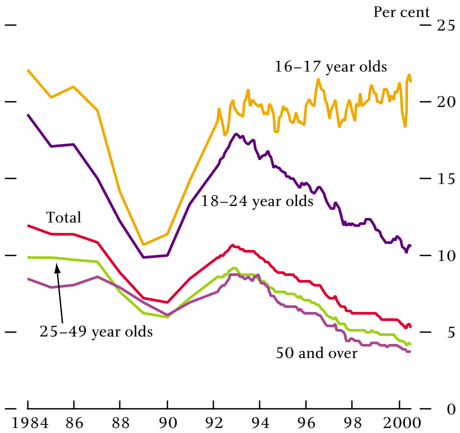
Other indicators provide little evidence of a fall in employment. For example, the CIPS employment index remains well above the no-change level of 50 (see Chart 3.4). Sectoral CIPS indices suggest that strong employment growth in services continues to outweigh falling employment in manufacturing. In addition, the construction index has picked up in recent months, perhaps suggesting that the fall in Q3 in the Workforce Jobs measure of construction jobs was temporary. The latest BCC survey indicated strong growth in service sector employment in the fourth quarter. In the manufacturing sector, although the BCC survey reported a positive balance of firms increasing employment, the CBI survey continues to indicate falling employment.

Forward-looking surveys of employment intentions suggest that the demand for labour in the service sector remains robust (see Table 3.A). Indeed, the Manpower and BCC surveys of service sector recruitment intentions are at their highest levels since the late 1980s, although the latest CBI/Deloitte & Touche survey noted some easing in employment plans particularly in the consumer services sector. However, as Table 3.A shows, recent surveys have generally reported a slight weakening in employment intentions among manufacturing firms.

Unemployment is an important indicator of the balance of labour demand relative to its effective supply. Unemployment has declined markedly since 1993 but has changed little since the November *Report*. Claimant count unemployment—a measure based on the number of people receiving unemployment benefits—fell by 25,900 in the three months to November 2000, and by a further 2,600 in December. In recent months, claimant count unemployment has fallen less rapidly than earlier in 2000, mainly due to a decline in the number of people leaving the claimant count, rather than by an increase in the number of people joining it. In the past, it has often been higher numbers flowing into unemployment, rather than a fall in those leaving it, that have accompanied sustained rises in unemployment. The claimant count unemployment rate remained at 3.6%, the lowest rate since 1975 (see Chart 3.5).

The LFS measure of unemployment—which estimates the number of individuals who want a job and are searching for and available for work—rose marginally in the three months to November, although the LFS unemployment rate was unchanged to the nearest decimal point (see Chart 3.5). An alternative source of potential labour supply measured by the LFS survey is the pool of inactive people. In recent months inactivity has risen, contrasting with a gradually declining trend since the mid-1990s. But much of the rise has been in individuals who reported that they were inactive because they did not want a job. On average people in this category of inactivity have tended to enter employment at a relative low rate. So potential labour supply is likely to have increased by less than if the rise in inactivity was composed of people who want a job, but are not searching for, or available to start, work.

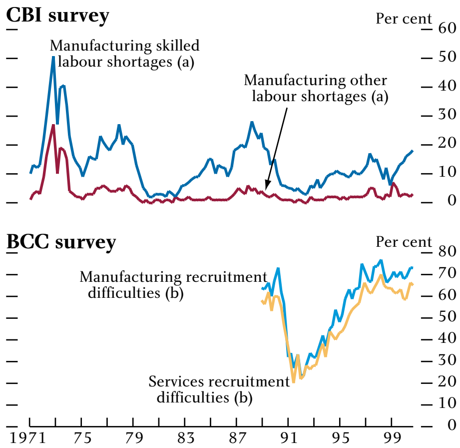
Chart 3.6
Unemployment rates by age group(a)



(a) Backward-looking three-month moving averages. Pre-1993 figures based upon yearly observations.

The recent slight rise in LFS unemployment was more than accounted for by an increase in unemployment among those aged under 25. By contrast, unemployment in older age categories has continued to fall. Higher unemployment among the young might convey less information about overall labour market tightness and wage pressure than a rise in unemployment of older workers. As Chart 3.6 shows, unemployment rates among the young, particularly 16–17 year olds, are more erratic than those of other age categories. That partly reflects irregular flows of young employees to and from training schemes and other educational activities. These erratic changes make it harder for the ONS to seasonally adjust these data and mean that short-run changes in youth unemployment are unlikely to provide decisive signals about the direction of aggregate unemployment. In addition, although shifts in youth unemployment may affect wage rates for young workers, they are likely to have a more muted impact on overall wage pressures. That will be particularly true in sectors where bargaining power is generally more concentrated among older workers, perhaps reflecting their longer tenure and higher on-the-job skills and experience.

Chart 3.7
Skill shortages and recruitment difficulties

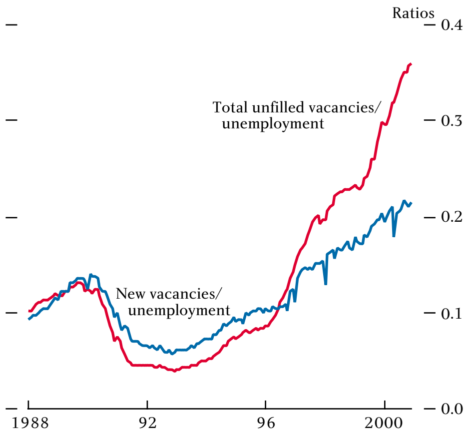


Sources: British Chambers of Commerce and Confederation of British Industry.

(a) Percentage of firms citing shortages of skilled or other labour as a factor likely to limit output over the next four months.
(b) Question: 'Did you experience any difficulties over the past three months in finding staff in the following categories: skilled manual, technical/professional, managerial/clerical and un/semi-skilled?'

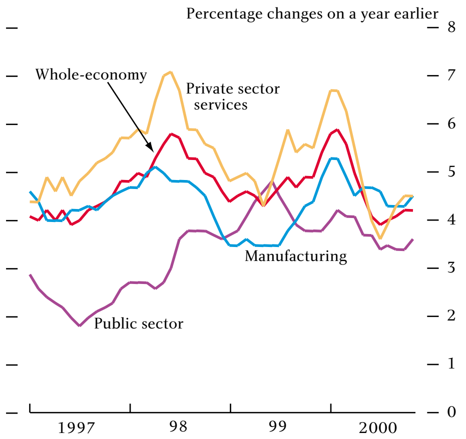
Consistent with the evidence from unemployment on the balance of labour demand and supply, skill shortages continue to be widely reported. For example, the latest CBI quarterly industrial trends survey recorded the highest percentage of manufacturing firms citing skilled labour shortages as a constraint on output since 1989 (see Chart 3.7)—skill shortages were a particular constraint in some capital goods industries. Other surveys by the BCC (see Chart 3.7) and CBI/Deloitte & Touche indicate that recruitment difficulties and skill shortages remain high in the service sector. The widespread nature of these shortages suggests that they may

Chart 3.8
Ratios of Jobcentre vacancies to unemployment(a)



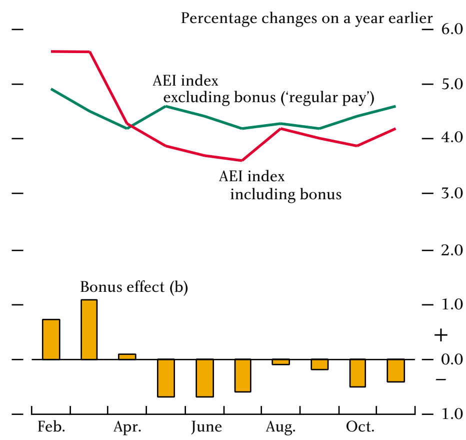
(a) Claimant count unemployment.

Chart 3.9
Headline growth in nominal earnings(a)



(a) Annual growth in backward-looking three-month average of the AEI.

Chart 3.10
Components of average earnings growth(a)



(a) Not seasonally adjusted.
(b) Percentage points.

stem from a lack of workers with specific skills that are in demand across a broad range of industries, and not just greater mismatch between labour demand and supply across sectors. That interpretation is supported by recent reports from the Bank's regional Agents and the Recruitment and Employment Confederation (REC), which have noted particular shortages of IT, engineering and professional services staff.

Job advertising data corroborate other evidence of robust labour demand. For example, the latest REC survey reported that the index of Press Recruitment Advertising was at its highest ever level in December 2000, although growth had eased slightly on the month. Chart 3.8 shows two measures relating Jobcentre vacancies to unemployment. They also suggest that labour demand remains strong but give mixed signals about recent trends. Total unfilled vacancies have risen further relative to unemployment, reflecting a rising stock of vacancies and declining claimant count unemployment. But existing unfilled vacancies are more likely to be filled by the newly-unemployed than by people already out of work, who may have already exhausted their search of existing vacancies. However, both categories of the unemployed can potentially fill new vacancies. In contrast to the rise in the measure based on existing vacancies, the ratio of new vacancies to unemployment has fallen marginally from its peak in September 2000, reflecting a slight decline in vacancy notifications over the past three months (see Chart 3.8).

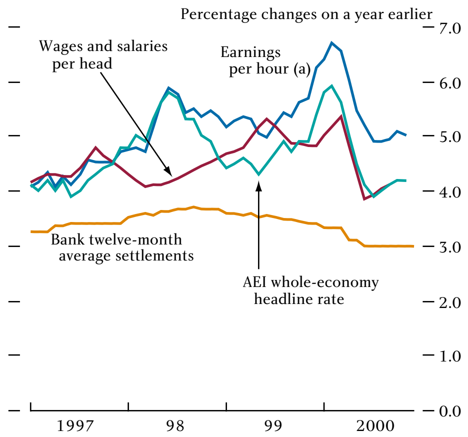
3.2 Earnings and settlements

Nominal earnings growth, as measured by the Average Earnings Index (AEI), has edged up slightly in recent months. Whole-economy headline average earnings growth rose from a four-year low of 3.9% in July 2000 to 4.2% in October and November, mainly reflecting an increase in earnings growth in private sector services (see Chart 3.9). Earnings growth in manufacturing and in the public sector has also risen marginally in recent months.

Average earnings growth can be decomposed into growth in regular pay and a contribution from bonuses. ONS estimates of this split are not seasonally adjusted, and—because of a discontinuity in the series at the start of 1999—are only available on a consistent basis since February 2000. Whole-economy regular pay growth has exceeded AEI growth since May 2000 (see Chart 3.10) mainly because bonuses in private sector services have made up a smaller proportion of total pay than in the equivalent months a year earlier. As discussed in the November *Report*, the current weakness of service sector bonuses is surprising given continued strong output growth and widespread evidence of skill shortages in the sector. It may reflect somewhat weaker service sector profitability for much of last year and higher thresholds set in 1999 for performance-related pay awards in 2000.

At the time of the November *Report*, the MPC's best collective judgment was that some of the recent weakness in earnings growth had reflected temporary factors that would unwind. In recent months whole-economy regular pay growth has edged up, consistent with that view, although bonus effects have remained negative. Looking forward, bonuses may make a more negative contribution to average earnings growth in coming data releases, as the previous year's baseline will include exceptional payments rewarding work over the millennium period. The Committee also took the view in November that subdued earnings growth partly reflected the impact of improvements in the functioning of the labour market, which had lowered the level of unemployment consistent with stable earnings pressures. The MPC has maintained this assumption in its latest projections.

Chart 3.11
Alternative indicators of pay



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

(a) Bank estimate.

Alternative indicators of pay suggest broadly similar trends to the AEI (see Chart 3.11). Wages and salaries per head paid to households, which are published as part of the National Accounts and are based partly on the AEI, edged up to 4.1% in 2000 Q3, broadly in line with earnings per head as measured by whole-economy AEI growth. Another way of examining pay developments is to consider earnings per hour worked. Only indicative estimates are available as average hours are measured imprecisely and the calculations do not adjust for compositional changes across different sectors. Earnings on this basis have followed a similar trend to other indicators, but have risen much faster over the past two years, due to a fall in average hours worked (see Chart 3.11). However, this measure will have been erratically high in recent months, relative to the AEI, if fuel supply and weather-related disruptions in the autumn of 2000 depressed average hours without an equivalent loss in pay. Other evidence on pay from the latest REC survey, which covers the segment of the market using recruitment and placement agencies, indicated that growth in salaries for permanent and temporary workers edged down further in recent months, although rates of increase remain relatively rapid.

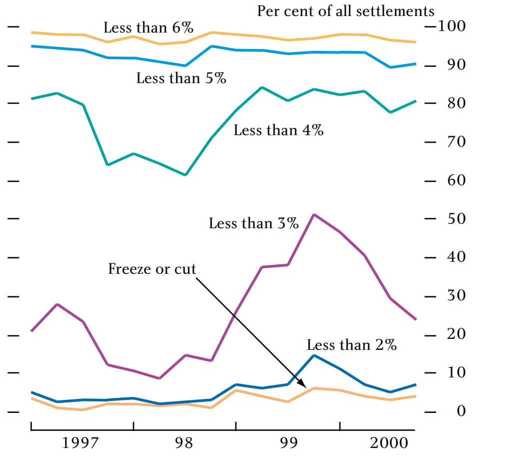
Remuneration methods vary widely across employers. Many firms seek to recruit, reward, motivate and retain staff using performance-related pay, such as bonuses or other merit awards, which tend to be reflected in the difference between basic wage settlements and AEI growth. In addition, the Bank's regional Agents have recently noted greater use of means of retaining and recruiting workers that are not generally captured in the AEI, such as adjustments to benefit entitlements, employment conditions or flexibility in hours.

Despite growing diversity in the way that firms reward employees, settlements—the basic wage increases awarded to employees—still form a core component of overall remuneration in many firms. The Bank collects information on such settlements from the CBI, Incomes Data Services (IDS), Industrial Relations Services (IRS), the Labour Research Department and the Bank's regional Agents. These settlements are then weighted to match the pattern of employment in the AEI sample. In December 2000 the average settlement recorded over the previous twelve months was 3.0%, unchanged since June 2000 (see Chart 3.11). However, the average settlement recorded over the previous three months has edged up from about 3.0% last summer to around 3.2% in December, and the proportion of settlements set at 3% or below has declined further (see Chart 3.12). Around 60% of all annual pay settlements by numbers of employees covered are typically agreed in January and April. Early indications for January settlements, based on a limited sample, point to a further slight rise. Although these and other settlements in the current wage round will not necessarily foreshadow future trends in average earnings growth, which may reflect unanticipated events between settlement dates, they are likely to offer an important reading on current and future earnings pressures.

High labour utilisation and widespread skill shortages are likely to exert upward pressure on settlements and earnings growth. However, because pay rates are generally fixed for a specific period, wage bargainers may also take into account expectations of future labour market conditions. As discussed earlier, recent labour market quantities data suggest that there has been no further tightening in the market, although there is uncertainty surrounding the impact of temporary disruptions. In recent GfK consumer confidence surveys, the balance of households expecting unemployment to rise has edged up slightly. And forecasters surveyed by Consensus Economics and members of the Treasury panel of independent forecasters now expect little change in unemployment over the next year, whereas previously they were forecasting further falls (see Chart 3.13). So although the desire to set wages to reflect current and prospective retention and recruitment difficulties in a tight market may be a strong upward influence on wages for some time, these pressures may no longer be intensifying.

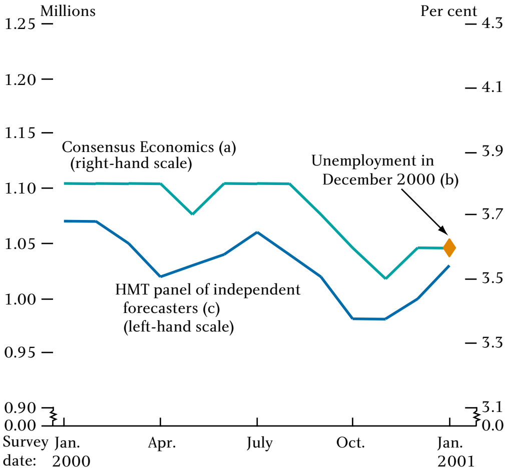
Wage negotiations may also be affected by current and expected rates of inflation. Employers need to control their labour costs per employee relative to the prices of the goods

Chart 3.12
Distribution of settlements over the past three months



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

Chart 3.13
Forecasts for unemployment in 2001



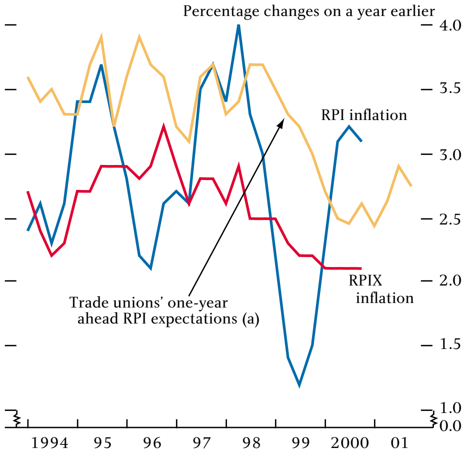
Sources: Consensus Economics and HM Treasury.

(a) Claimant count unemployment rate for 2001.
(b) Claimant count unemployment was 1.04 million (3.6%) in December 2000.
(c) Claimant count level for 2001 Q4.

and services they sell domestically and overseas. Recent surveys and reports from the Bank's regional Agents suggest that competitive pressures remain an important constraint on firms' pricing behaviour and consequently a downward influence on pay settlements. However, as noted in Section 4, some, but not all, surveys have suggested that the proportion of firms planning to raise prices has risen somewhat in recent months.

Employees and trade unions, on the other hand, are concerned with maintaining (or enhancing) the quantity of goods and services that can be purchased with their earnings. So they will be concerned about growth in nominal wages relative to their expectations of future retail price inflation. According to the Barclays Basix survey, inflation expectations of trade unions leaders have fallen markedly over the past three years, perhaps reflecting both increased monetary policy credibility and lower actual rates of inflation (see Chart 3.14). However, these expectations have risen slightly over the past year, possibly due to rising oil prices and higher outturns for headline RPI inflation. And recently RPI inflation has been higher than trade unions had anticipated a year ago, reducing real wages relative to expectations at that time. Expectations of higher future inflation and attempts by employees to compensate for lower-than-expected real income in the past might place upward pressure on forthcoming settlements. But in the absence of further rises in interest rates, RPI inflation will decline relative to RPIX inflation as previous rises in mortgage interest payments (following increases in official interest rates from September 1999 to February 2000) drop out of annual comparisons. So it is possible that cost of living pressures on nominal wage agreements will decline further ahead.

Chart 3.14
Actual and expected inflation



Sources: ONS and Barclays Basix survey.

(a) Lagged by one year.

Data over coming months will help to resolve some of the uncertainty about the relative importance of these factors. However, the latest CBI *Pay Databank Report* on their sample of settlements provides some survey evidence on important influences in recent wage negotiations (see Table 3.B). Upward pressures on settlements from recruitment and retention considerations appear more important in the service sector than in manufacturing firms. In addition, cost of living concerns have become a particularly important upward pressure in recent negotiations in both sectors. However, price competition and weak profits continue to exert downward pressure on settlements, particularly in manufacturing firms. The survey also notes that comparisons with other firms in the same industry remain an important consideration in wage negotiations.

Table 3.B
Influences on CBI pay settlements(a)

Percentage balance reporting factor as a 'very important' upward pressure, unless otherwise indicated

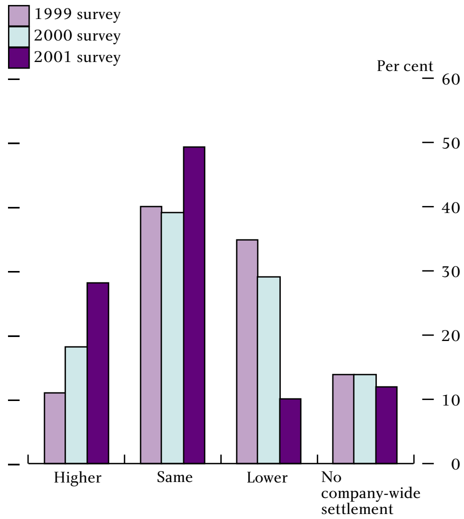
	Services		Manufacturing	
	Level 2000 H2	Change since 1999 H2	Level 2000 Q3	Change since 1999 Q3
Cost of living	37	+39	37	+36
Recruitment/retention	27	+4	12	+19
Productivity	1	-9	12	+8
Ability to adjust prices	-19	-5	-49	0
Profits	-5	3	-22	+20
Orders	-1	+2	-5	+17
Industry comparisons (b)	38	+7	20	-5

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

(a) Provisional.
(b) Percentage citing industry comparisons as 'very important'.

Forward-looking surveys provide mixed evidence on forthcoming settlements. The IRS survey of pay prospects for

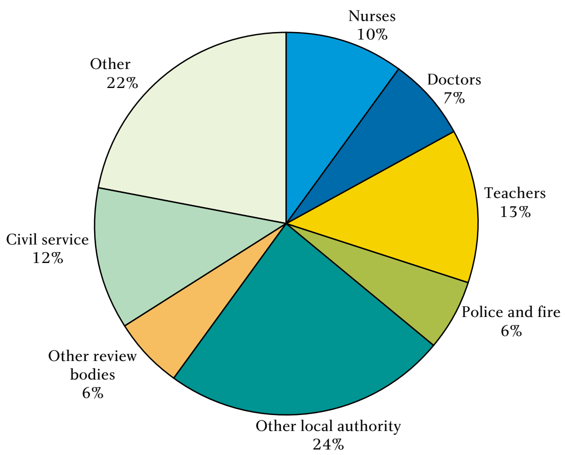
Chart 3.15
Bank regional Agents' surveys of settlements prospects(a)



Source: Bank of England's regional Agents.

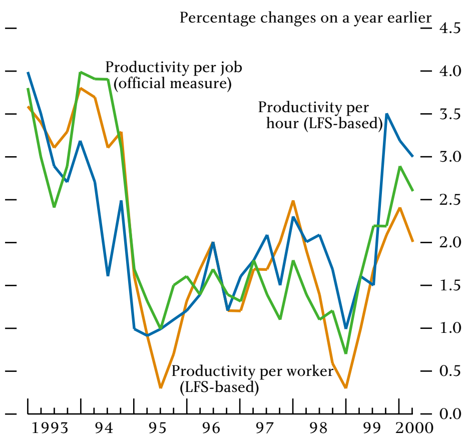
(a) Percentage of respondents reporting that settlements were expected to be higher, same or lower than in the previous year.

Chart 3.16
Public sector wage bill



Source: HM Treasury. Pay bill shares shown relate to 1997, the latest year for which complete data are currently available.

Chart 3.17
Whole-economy labour productivity growth



Sources: ONS and Bank of England.

2001 suggested that settlements would remain broadly stable. By contrast, the IDS survey projected that most settlements would be in the 3% to 4.5% range, somewhat higher than recent rates. In addition, the Bank's regional Agents conducted a survey of around 170 contacts (covering about 350,000 employees) in December 2000. Around half the respondents expected settlements to be at the same levels as last year, and a quarter expected them to be higher (see Chart 3.15). Recruitment difficulties were reportedly the most important upward pressure on pay.

In the public sector, recently announced settlements for NHS staff and teachers have been somewhat higher than a year earlier. However these settlements alone are unlikely to have a marked impact on overall earnings growth. Employees covered by these agreements account for slightly less than a third of the public sector wage bill (see Chart 3.16), and in turn the public sector accounts for only around a fifth of the aggregate AEI.

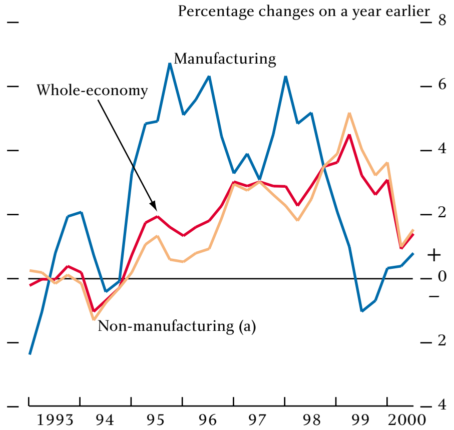
3.3 Labour productivity and unit wage costs

The supply capacity of the economy is increased by growth in productivity, as well as growth in the labour force. And productivity growth, alongside growth in real earnings, determines the extent of inflationary pressure generated in the labour market.

The official ONS measure of productivity per job, based on the Workforce Jobs measure of employment, rose by 2.6% in the year to 2000 Q3 (see Chart 3.17), somewhat lower than in the second quarter but still above its average growth rate over the past 40 years. However, upward revisions to output data, discussed in Section 2, mean that the recent recovery in productivity growth has been a little stronger than previously thought.

Productivity calculated using LFS estimates of employment rose less rapidly, reflecting faster growth in LFS employment than Workforce Jobs over the past year. But productivity per hour increased strongly, reflecting declining average hours worked, although that might partly reflect a larger temporary impact of fuel supply and other disruptions on hours worked than on output. It is also possible that LFS-based estimates may slightly understate recent productivity growth because LFS employment data do not yet fully reflect the latest information on population growth, as discussed earlier. Moreover, the previous *Report* noted that increased activity in sectors of the economy using information and communications technology (ICT) had made output and productivity harder to measure in recent years. In particular, it is difficult to capture improvements in the quality of ICT and

Chart 3.18
Unit wage cost growth



Sources: ONS and Bank of England.

(a) Based on official measures of whole-economy and manufacturing unit wage cost growth.

thereby calculate appropriate price indices to convert nominal output data into real output estimates. Any underestimate of the effects of quality change on these prices would have led to an understatement of output and productivity growth in recent years.

The pick-up in productivity growth over the past year, in conjunction with slower nominal earnings growth than in 1999 and early 2000, has been reflected in subdued unit wage cost growth, particularly in the manufacturing sector where productivity has grown most rapidly (see Chart 3.18). Labour and other costs of production are considered more fully in Section 4.

3.4 Summary

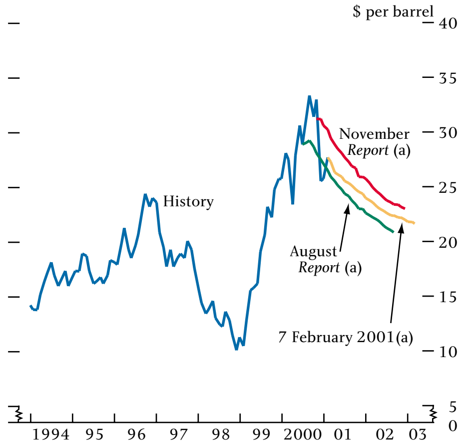
High labour utilisation and widespread evidence of skill shortages suggest that the labour market remains tight. Recent falls in employment, and marginal rises in LFS unemployment, suggest that conditions may no longer be tightening, although the impact on the latest data of fuel supply and other disruptions is uncertain. Employment intentions and high vacancy levels suggest that the demand for labour remains robust. Earnings growth has edged up slightly since the November *Report*. But continued strong productivity growth has contained unit wage cost growth.

Looking forward, there are mixed signals about pressures on settlements in the current wage round and prospects for earnings growth remain uncertain. The MPC judges that the most likely outcome is that earnings growth will remain around, or a little above, recent rates over the next two years. In addition, there is a risk that earnings could be stronger than in the central projection given the continued tightness of the labour market. But in the central case, with near-trend productivity growth, unit wage cost pressures are likely to remain relatively muted.

Costs and prices 4

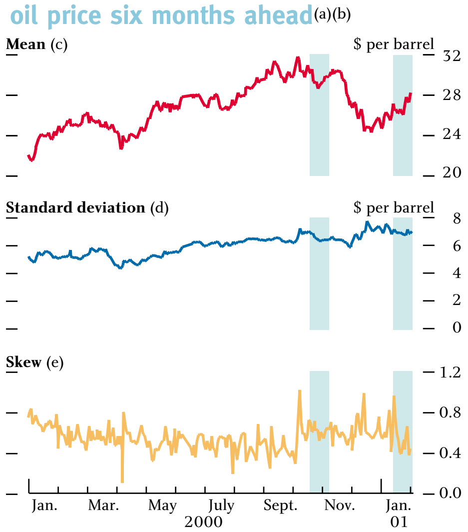
The prices of oil and other commodities have fallen in recent months. This, together with continuing moderate unit wage cost growth, has reduced cost pressures, although these remain relatively high in the service sector. Manufacturing output price inflation has fallen slightly, but surveys report an increase in the proportion of firms expecting to raise prices. Service sector output price inflation has edged up and some, but not all, surveys indicate further prospective pressures. Several surveys and contacts of the Bank's regional Agents provide some evidence that the downward pressure on retail goods prices is lessening. However, RPIX inflation was lower than expected in 2000 Q4, only partly reflecting lower-than-anticipated petrol prices, and remains below the Government's 2½% target.

Chart 4.1
Brent oil futures



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

Chart 4.2
Information from futures prices about the oil price six months ahead(a)(b)



Sources: NYMEX and Bank of England.

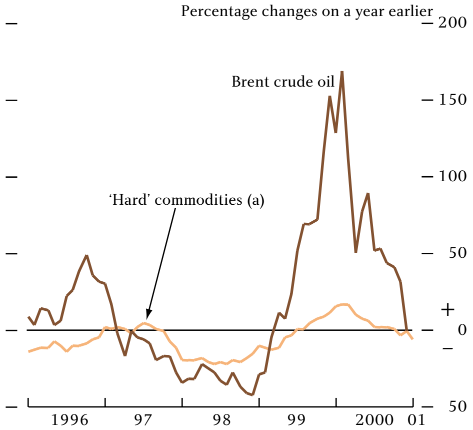
(a) Derived from option prices for West Texas Intermediate oil (WTI). Prices for WTI tend on average to be around $1 per barrel higher than those for Brent crude oil.
(b) Shaded area show 15 working day periods up to the finalisation of the November and February projections.
(c) The expected price in six months' time.
(d) The spread of views about the expected price in six months' time.
(e) Skewness reflects the balance of risks between a large increase and a large decline in oil price. A positive skew indicates that the balance of risks is on the upside relative to the mean.

4.1 Raw materials and commodity prices

Oil prices have been lower in recent months than expected at the time of the November *Report*, after rising substantially over the past two years (see Chart 4.1). Although prices have been volatile, the price of Brent crude averaged just under $28 per barrel in the 15 working days to 7 February, around $3 per barrel lower than expected in November and compared with a monthly peak of more than $33 per barrel in September. Market participants' mean expectation of the profile of oil prices over the next two years has also shifted down over the past three months, to midway between the levels seen around the publication times of the August and November *Reports*. The MPC has, in line with those movements, revised down its central projection for the Brent oil price at the two-year horizon to around $22 per barrel. Market uncertainty about the path of oil prices, as measured by the standard deviation of the distribution for oil prices implied by futures contracts, has remained high in recent weeks (see Chart 4.2). The skew of the distribution suggests that the balance of risks is still judged by market participants to be on the upside of the downward-sloping central projection, although to a slightly lesser extent than a few months ago.

Recent oil price movements, and changes in expected future prices, have reflected both demand and supply factors,

Chart 4.3
Prices of 'hard' commodities and oil



(a) *The Economist* industrial commodity price index.

although it is difficult to determine their relative importance accurately. The downward revisions to expected world growth, and hence the demand for oil, probably played a large role in the recent oil price falls. Indeed, the International Energy Agency revised down its projections of growth in world oil demand in 2001 by around 0.3 percentage points between December and January. But these price falls also partly reflected signs of stronger supply, such as reported increases in oil production capacity and a stronger-than-expected build-up of stocks in the OECD area (although stocks remain low by historical standards). The stabilisation of oil prices in January reflected expectations of prospective cuts in OPEC oil production, confirmed on 17 January as a reduction of 1.5 million barrels a day with effect from 1 February.

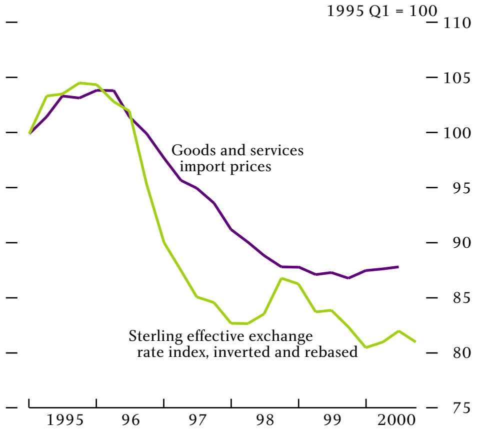
One way of inferring the relative role of demand and supply factors in oil price movements is to compare such movements to changes in the prices of other commodities that respond to world demand conditions. Prices of 'hard' commodities such as metals are more affected by world growth than 'soft' commodities such as food products, because demand for them is more affected by fluctuations in industrial production and GDP. Hard commodity prices have changed by substantially less than oil prices over the past two years (see Chart 4.3), suggesting that oil-specific supply developments have played an important role in oil price movements. But oil and hard commodity prices have generally moved in similar directions in recent years. This suggests that unforeseen changes in world demand, such as the recent downward revisions to expected world growth, are likely to have been an important common factor affecting a broad range of commodities. Indeed, the recent downward revision to world growth prospects has been associated with a fall in expected future hard commodity prices as well as future oil prices.

As well as being affected by world demand conditions, commodity price movements may influence world growth.[1] In particular, sharp commodity price rises tend to depress world growth by reducing the real income, and hence consumption, of commodity-importing countries—which in the short term tends not to be completely offset by increased consumption of commodity-producing economies, whose real incomes increase with commodity price rises.

Because oil is, like many commodities, denominated in US dollars, its effect on UK input prices also depends on the sterling-dollar exchange rate, at least in the short run. Movements in the sterling-dollar rate have tended to reinforce the volatility of dollar oil price movements in recent months:

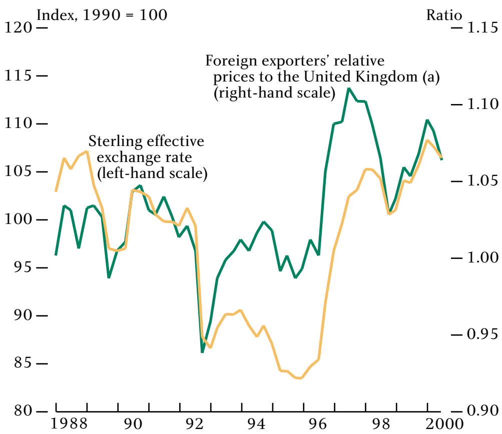
(1) The box on page 15 of the November 2000 *Inflation Report* examines the effects of oil prices on economic activity.

Chart 4.4
UK sterling import prices and the exchange rate



Sources: ONS and Bank of England.

Chart 4.5
Foreign exporters' relative prices to the United Kingdom and the exchange rate



Sources: ONS and Bank of England.

(a) Estimated as sterling import prices (ie the sterling price of exports to the United Kingdom) divided by average sterling export prices of the major six overseas economies.

dollar oil price falls have often coincided with sterling appreciating against the dollar, and *vice versa*.

The large fall in sterling oil prices in December contributed to a significant decline in the Bank's sterling commodity price index, with the annual rate of increase dropping to less than half the rate experienced earlier in the year. The annual rate of inflation of the Bank's non-oil commodity price index rose further in recent months because of higher agricultural prices, which were only partly offset by lower metals prices.

4.2 Import prices and the exchange rate

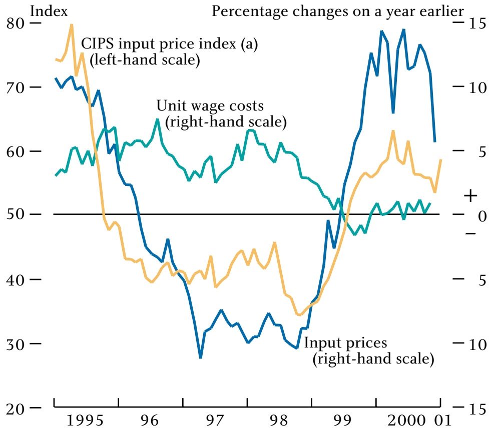
Sterling import prices of goods and services rose by 0.1% in Q3, to lie 0.6% higher than a year earlier[1] (see Chart 4.4). Sterling import prices are affected by several factors: the sterling exchange rate; average world export prices in local currencies; and the profit margin on overseas sales to the United Kingdom relative to sales to other markets. The sterling effective exchange rate depreciated by 1.2% in Q3, while world local currency export prices rose by 0.5% in UK trade-weighted terms. So the negligible rise in import prices in Q3 suggests a reduction in foreign exporters' relative margins on sales to the United Kingdom (see Chart 4.5). That relative margin has widened in recent years, which may have reflected a perception that the appreciation of sterling over this period would prove temporary and so the gains to foreign exporters from switching supplies to UK markets would be short-lived and would not exceed the costs of doing so. The MPC has maintained the assumption that foreign exporters' relative margins on sales to the United Kingdom will be gradually compressed, as increased competitive pressures erode any unusual profits. Looking forward, lower commodity prices and slower world output growth will tend to be associated with weaker world output prices in local currencies than expected at the time of the November *Report*.

4.3 Costs and prices in manufacturing

Developments in manufacturing output prices may contain information about pressures on retail goods prices. Manufacturing output prices are in turn affected by developments in manufacturers' costs. Manufacturers' profitability varies when prices change at different rates to costs, although the extent to which firms can determine their output prices depends on the extent of competitive pressures in the markets for their products. Moreover, firms may not

(1) These rates of change are based on data in the Q3 National Accounts. Data subsequently released, which revised some of the components, give slightly different rates of change. But these are subject to further revisions and are less comparable with the deflators discussed in Section 4.6.

Chart 4.6
Manufacturing costs



Sources: ONS and CIPS.

(a) Survey responses to question asking how prices compare with the same month a year ago. Readings above 50 suggest that prices are rising, readings below 50 indicate falling prices.

Chart 4.7
Manufacturing output price inflation

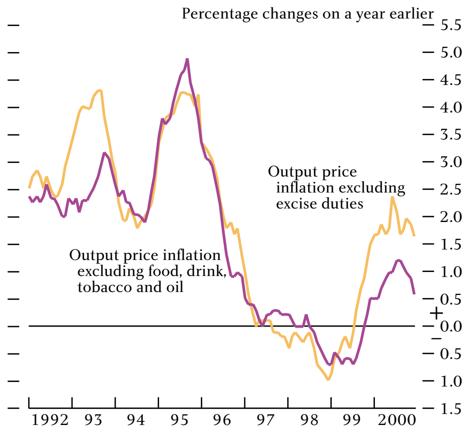
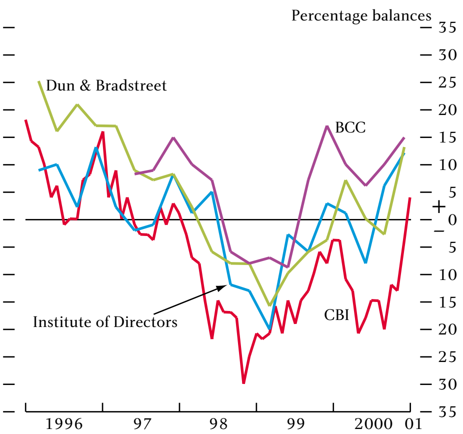


Chart 4.8
Manufacturing output price expectations(a)



Sources: BCC, CBI, Institute of Directors and Dun & Bradstreet.

(a) Balance of manufacturers expecting to raise prices minus those expecting to reduce prices. Next four months for CBI, next three months for BCC, Institute of Directors and Dun & Bradstreet.

pass on cost increases they perceive to be temporary—either because of costs of changing prices or their desire to maintain long-term relationships with customers.

Materials and fuels are important components of manufacturers' costs. The annual rate of increase of manufacturing materials and fuels input prices slowed to 5.7% in December (see Chart 4.6), the smallest rise since August 1999. That slowdown largely reflected falling prices of oil inputs, although their annual rate of increase remained high. By contrast, gas input prices rose markedly in 2000 Q4—prices were 33% higher than a year earlier in December—as contracts under review took account of the doubling of wholesale gas prices over the previous year. The rate of increase of materials input prices has slowed in recent months, due to lower prices of imported materials such as metals and chemicals. Surveys, however, provide less evidence of a slowing in manufacturers' input costs. Although CIPS surveys in 2000 H2 reported an easing of input cost inflation, this was partly reversed in January. And the Q4 BCC survey continued to show a historically high balance of manufacturers citing raw materials costs as putting upward pressure on prices.

Unit labour costs form a major component of manufacturers' costs. Manufacturing unit wage costs growth has remained low in recent months (see Chart 4.6), as continuing strong productivity growth has counterbalanced a slight rise in annual manufacturing earnings growth (see Section 3). Nevertheless, the latest BCC survey reported the highest balance of firms citing pay settlements as putting upward pressure on prices in the survey's four-year history.

Producer output prices (excluding excise duties) rose by 1.6% in the year to December (see Chart 4.7), the slowest rate of increase for a year, as petroleum products' prices fell. And output prices excluding food, drink, tobacco and oil rose at their lowest annual rate for ten months in December. The continued low outturn suggests that there have not been any significant second-round effects from the sharp rise in oil prices over the past two years. And the lower oil prices of recent months reduce the likelihood of such effects.

Survey evidence, however, suggests potentially greater upward pressure on output prices in coming months. Several surveys have recently reported, for the first time in several years, positive balances of manufacturers expecting to raise their prices (see Chart 4.8). These expectations of rising output prices may be linked to the depreciation of sterling and to improvements in manufacturing confidence and order levels observed in recent months (see Sections 1.2 and 2.3). These surveys have, however, often not been very good guides to future output price movements. And, working against higher prices, recent BCC surveys have reported a rise in the proportion of manufacturers concerned about competitive pressures (although the balance remained below the levels of 1999).

An approximate indicator of pressures on manufacturing profitability can be calculated by comparing output price developments with movements in the various components of manufacturers' costs, suitably weighted. Delays in the availability of some costs components mean, however, that the indicator is less timely than the prices data. Moreover, the weights underlying the proxy for costs are based on input proportions in 1990 and so may no longer be accurate. Bearing these caveats in mind, estimated weighted costs have risen more quickly than output prices in recent years (see Table 4.A)—implying strong downward pressures on manufacturing profitability. Such pressures are also apparent in the Dun & Bradstreet and the Institute of Directors' surveys. By contrast, recent BCC surveys have shown a rise in the proportion of manufacturers expecting profitability to improve over the next year, although that proportion remained substantially below the levels in mid-1999.

Table 4.A
Manufacturers' costs and prices

Percentage changes on a year earlier

	1999		2000			
	Q3	Q4	Q1	Q2	Q3	Q4
Weighted costs (a)	1.0	2.6	3.1	3.0	3.4	n.a.
Unit labour costs (46.8%)	-0.8	-0.4	0.1	0.7	0.8	n.a.
Materials and fuels (30.1%) (b)	4.0	9.8	12.8	11.7	12.1	9.7
Imports and finished goods (6.9%)	-1.1	0.0	0.0	0.0	1.1	n.a.
Bought-in services (16.2%)	3.3	3.6	1.3	-0.1	0.5	n.a.
Output prices (excluding duties)	0.3	1.2	1.7	2.0	1.9	1.8

Sources: ONS and Bank of England.

(a) Percentages shown in brackets reflect weights of components, derived from 1990 input-output tables for the United Kingdom.
(b) Includes imports of semi-finished goods.

4.4 Costs and prices in the service sector

Service sector output prices are affected by developments in costs and the extent of competitive pressures in the markets for services. These prices can in turn contain useful information about retail price inflation: services have a weight of more than a third in the RPI basket and corporate service output prices can also indirectly affect retail prices by influencing the cost of producing goods and services in the RPI basket.

Survey evidence suggests continuing strong cost pressures in the service sector, although they appear less pronounced than in early 2000. The CIPS input price index continued to exceed its post-1996 average in Q4 (see Table 4.B), although it was slightly lower then than its peak in September and it fell further in January. Respondents cited lower fuel prices as underlying the easing. By contrast, the 2000 Q4 BCC survey reported a slight increase in the proportion of firms citing raw materials prices as putting upward pressure on prices, although the balance remained below the levels in 2000 H1. The BCC survey also showed an increase in the proportion of firms reporting wage costs as putting upward pressure on prices. Those pay pressures are also apparent in official data: annual service sector earnings growth has edged up in recent months. But because of continuing strong estimated productivity growth, unit wage cost growth remained subdued at around $1^1/_2$% in the year to 2000 Q3, compared with rates of more than 4% in 1999.

Table 4.B
Service sector costs and prices

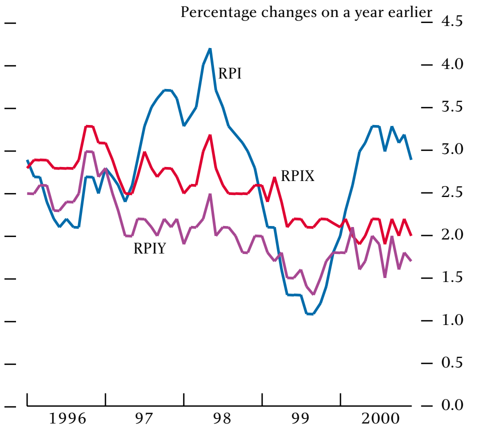
	1999		2000			
	Q3	Q4	Q1	Q2	Q3	Q4
Costs						
CIPS input price index (a)	54.8	57.6	59.3	61.7	61.7	61.2
BCC raw materials prices (b)	16	19	21	22	18	20
BCC pay settlements (b)	25	28	31	33	23	28
Unit wage costs (estimated) (c)	4.2	4.0	4.2	1.3	1.4	n.a.
Prices						
Corporate services price index (c)	3.3	3.9	3.6	4.1	4.4	n.a.
CIPS selling price index (a)	49.2	52.6	53.6	54.1	53.4	54.9
BCC price expectations (d)	22	24	26	21	23	32

Sources: CIPS, BCC , ONS and Bank of England.

(a) 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 over the relevant three months.
(b) Percentage balance of respondents reporting pressures to raise prices from this factor.
(c) Percentage changes 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?'.

Output price inflation in the service sector shows some signs of rising (see Table 4.B). The annual rate of increase of the ONS prototype Corporate Services Price Index (CSPI) rose from 4.1% in Q2 to 4.4% in Q3, the strongest rate in the series' five-year history. Similarly, the Q4 BCC survey reported the highest proportion of firms expecting to raise prices in the series' four-year history. And a significant proportion of respondents continued to expect their profitability to rise over the next year. But, working in the opposite direction, the proportion of respondents citing competitive pressures as a concern rose to its highest level for 18 months (although that proportion was significantly lower than in manufacturing). The CIPS survey also provides mixed signals on the trend in service sector prices—the balance of firms reporting price increases rose to the highest level in its four-year history in Q4, but edged down in December and January. Moreover, the Dun & Bradstreet survey balances of expected prices and profits declined in 2001 Q1.

Chart 4.9
Retail price inflation



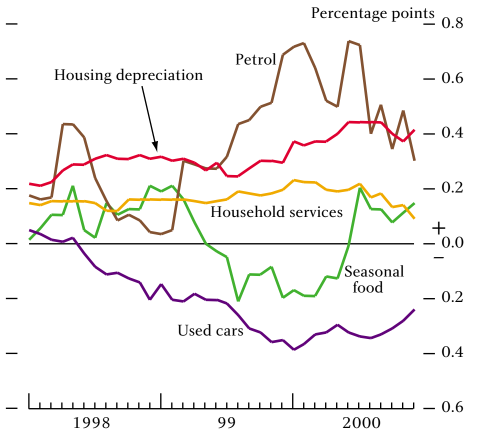
RPIX = Retail price index excluding mortgage interest payments.
RPIY = RPIX excluding VAT, local authorities' taxes and excise duties.

4.5 Retail prices

Annual RPIX inflation remains below the Government's 2½% target. The 2.1% rise recorded in Q4 (see Chart 4.9) was the same as in the previous three quarters but lower than expected at the time of the November *Inflation Report*. This news was one of the factors leading to a downward revision to the projection for RPIX inflation. Section 6 discusses this in more detail.

The lower-than-expected RPIX outturn reflected lower-than-anticipated prices of household services, housing depreciation, used cars and petrol—with the latter linked to lower-than-expected crude oil prices. Chart 4.10 shows the estimated contributions of these components to RPIX inflation, which also takes account of the weights of the components in the RPIX basket of goods and services. It also shows that the contribution of seasonal food prices has moved from negative to positive in recent months. That reflected the exceptionally wet weather in 2000 H2 putting upward pressure on seasonal food prices.

Chart 4.10
Selected contributions to annual RPIX inflation



Although the recent trend in RPIX inflation has been very stable, averaging 2.1% in each quarter of 2000, it has recently been volatile from month to month around this trend. The 2.0% rate in December follows August's 1.9% figure and 2.2% rates in September and November. This monthly volatility, and that of other inflation measures, reflects the sharp movements in retail petrol prices and abrupt changes in seasonal food prices.

Annual RPI inflation fell to 2.9% in December. That reflected previous rises in mortgage rates dropping out of the annual

Chart 4.11
Goods and services price inflation

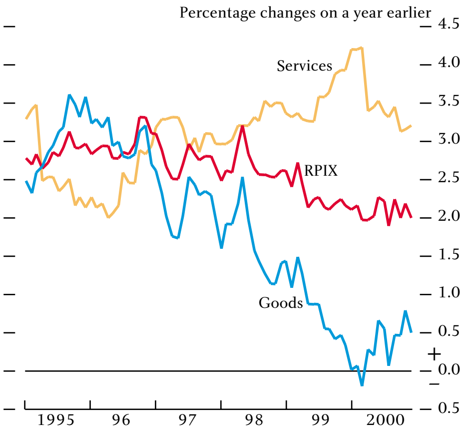
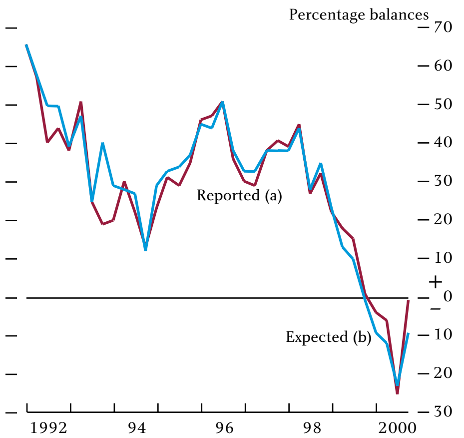


Chart 4.12
CBI balance of retailers' selling prices



Source: CBI.

(a) Balance of retailers reporting higher prices over the previous month minus those reporting lower prices.
(b) Balance of retailers expecting to raise prices over the next month minus those expecting to reduce prices.

comparison, as well as increased discounts on variable-rate mortgages and lower rates on new fixed-rate mortgages (see Section 1.2). These factors meant that the gap between RPI and RPIX inflation fell to its lowest level in nine months. Moreover, given the reduction in the Bank's repo rate on 8 February, RPI inflation is likely to dip below RPIX inflation in coming months. RPIY, which excludes the effects of indirect tax changes and mortgage interest payments, was 1.8% higher than a year earlier in Q4, unchanged from the Q3 figure.

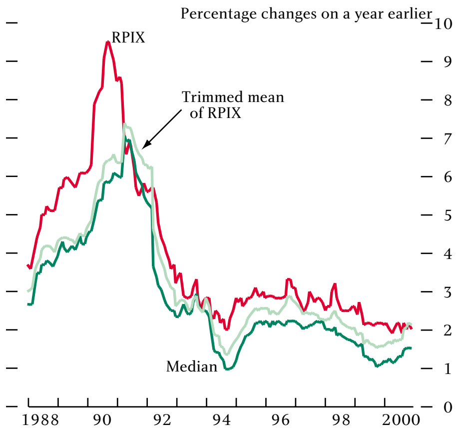
Examining inflation rates by product categories provides information on the varying pressures in different parts of retailing. The gap between goods and services price inflation narrowed in 2000, but remains wide by historical standards (see Chart 4.11). Service sector inflation usually exceeds manufacturing inflation because labour accounts for a higher share of costs in services than in manufacturing and average productivity growth is lower in services than in manufacturing. But previous *Reports* have discussed how that divergence has been unusually pronounced in recent years—perhaps reflecting the appreciation of the exchange rate and an associated increase in the degree of competition in the goods sector, which tend to depress goods price inflation. The gap narrowed with the November rise in goods price inflation. But that rise reflected higher petrol prices, which were largely reversed in December.

The depreciation of the exchange rate in recent months, combined with the continued firmness of retail sales growth and consumer confidence, may be associated with a lessening of downward pressure on retail goods prices. Consistent with this, the November CBI distributive trades survey reported the lowest balance of retailers experiencing price falls for a year (see Chart 4.12), while the proportion of firms expecting future price cuts also dropped significantly. The Bank's regional Agents also report tentative signs of a lessening of downward pressure on retail goods prices. And the Q4 Institute of Directors survey reported a positive balance of retailers expecting prices to rise, with the balance being the strongest for a year. However, other surveys suggest weaker price pressures. Recent Dun & Bradstreet surveys have reported a deterioration of retailers' price expectations. And the annual rate of increase of the BRC shop price index fell to its lowest level in five months in January, after edging up towards the end of 2000.

Annual retail services price inflation fell from 3.4% in Q3 to 3.1% in Q4, the lowest quarterly figure since 1998 Q1. That fall reflected lower inflation of both shop services and non-shop services. Annual utility price inflation continued to be negative following the sharp price cuts agreed between regulators and the utilities for 2000 Q2. Retail services inflation did, however, edge up to 3.2% in December because of higher vehicle tax and insurance prices. This is consistent with the increase in the balance of consumer service firms reporting price increases in recent CBI/Deloitte & Touche surveys. And utility prices seem likely to exert less of a negative influence later this year, as the 2000 Q2 price cuts drop out of the annual comparison. Indeed, the recent large rises in wholesale gas prices and, to a lesser extent, producer gas input prices seem likely to put upward pressure on the retail gas component of utility prices.(1) So the gap between goods and services price inflation may remain wide.

4.6 Other price indices

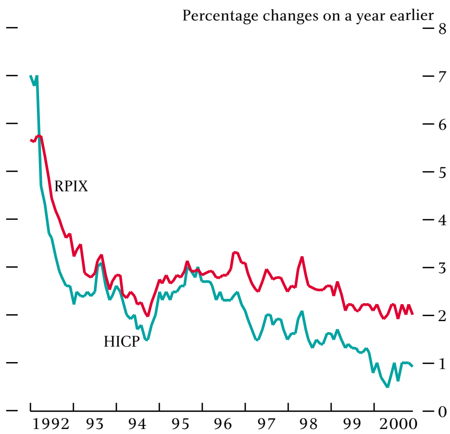
Chart 4.13
Trimmed mean of RPIX inflation(a)



(a) The trimmed mean measure of RPI inflation is calculated by removing the largest 15% and smallest 15% of the weighted monthly price changes in the components of the RPI. The calculation takes account not only of the size of price changes in different items that are included in the RPI basket, but also the weights of each item in the index.

Measured inflation can be influenced by volatile items and extreme movements in individual components. Such movements can, because of their temporary nature, distort the signals on underlying trends in inflation. So it is useful to construct measures of inflation that exclude such movements. There are, however, several potential approaches, each with their strengths and weaknesses. One measure is the median inflation rate of the weighted components of the RPIX basket. As has been the case in recent years, the median inflation rate lay below RPIX in 2000 Q4 (see Chart 4.13). The gap between RPIX and median inflation has, however, narrowed in recent quarters. This suggests that the distribution of price changes across RPIX components has become less skewed towards large positive changes. A similar picture emerges from the trimmed mean inflation rate, which excludes the highest and lowest 15% of weighted price changes in RPIX. Trimmed mean inflation was virtually identical to RPIX inflation in Q4, suggesting that sharp price changes are not affecting the assessment of underlying trends.

Chart 4.14
HICP and RPIX



The harmonised index of consumer prices (HICP) is another indicator of UK inflation. Annual HICP inflation was 0.9% in Q4, up from 0.8% in Q3 and 0.6% in Q2 (see Chart 4.14). Previous *Reports* have discussed the main differences between RPIX and HICP. These are differences in coverage (including the treatment of housing costs) and the method used to translate individual price quotes into the aggregate index (arithmetic means for RPIX, geometric means for HICP).

It is useful to examine inflation developments at a broader level of economic activity than the retail sector because such developments can contain information that enhances the understanding of current and future trends in RPIX inflation.

(1) Regulatory agreements governing retail gas prices expire in April 2001, after which prices will be determined by competition between suppliers, mirroring changes in the retail electricity market twelve months earlier.

Chart 4.15
Expenditure price indices

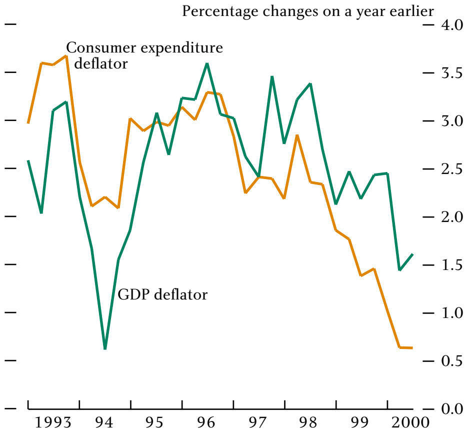


Chart 4.16
Revisions to consumer expenditure deflator

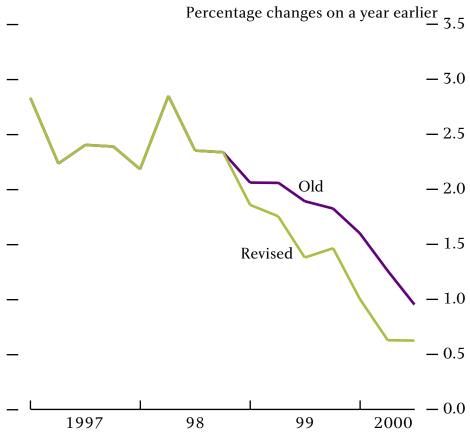
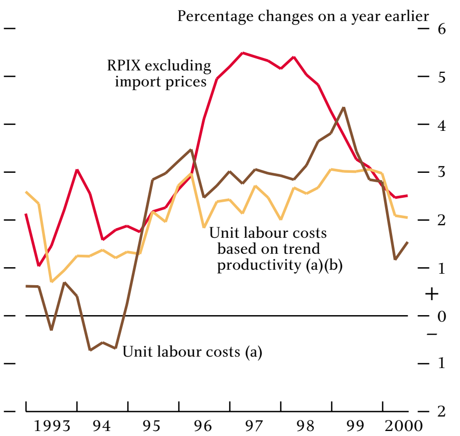


Chart 4.17
Measures of domestically generated inflation



(a) Using National Accounts measures of employee compensation and productivity growth.
(b) Constructed using long-run trend productivity growth of 2%.

Such developments may also provide indications of potential imbalances in the economy. The deflators for GDP and its expenditure components—calculated by comparing estimates of nominal and real spending—are indicators of such inflationary pressures. The rate of increase of the GDP deflator has declined sharply over the past two years (see Chart 4.15), and the Q3 outturn was lower than expected. This steep fall in whole-economy inflationary pressures mainly reflected movements in the deflator for consumer expenditure (a wider measure of household spending than retail sales). Indeed, the 0.6% annual rise of the consumer expenditure deflator in Q3 was the lowest for more than 40 years.

The level and rate of increase of the GDP deflator over the past two years were revised down in the Q3 National Accounts release. This reflected large downward revisions to the consumer expenditure deflator (see Chart 4.16). Several factors suggest, however, that the revised data may be giving exaggerated signals about trends in inflation pressures.

First, an important factor driving the revisions was a lower estimate of the rate of increase of imputed rents—the notional value that house-owners pay for the services provided by their houses. Another way of proxying such services is through housing depreciation. And this has been rising substantially more quickly than the revised imputed rents series. Second, the revised consumer expenditure deflator is rising substantially more slowly than the retail price series with the closest coverage (RPIX excluding council tax), whereas the two series usually move closely together. This reflects the rates of increase of components such as prices of leisure goods and leisure services being substantially weaker in the deflator data than in the RPI data. These differences may be reduced with further data releases—unlike the RPI data, the deflators are subject to further revisions. The Committee judges that the lower-than-expected deflator figures corroborate the picture from the RPIX data of lower inflationary pressures, rather than signalling additional weakness.

It is useful to try to distinguish the effects of the domestically generated component of inflation from the influences of world prices and the exchange rate, particularly when the latter two are changing by large amounts. Indicators of domestically generated inflation (DGI) provide some information on the pressures being exerted on prices by developments in domestic activity. Again there are many ways of estimating these pressures, each with their strengths and weaknesses. Chart 4.17 presents three measures. Growth of whole-economy unit labour costs edged up slightly in Q3 as productivity growth slowed slightly (see Section 3.3). But because productivity growth remained above its long-run trend, unit labour cost growth based upon trend productivity growth continued to exceed measured unit labour cost growth. The annual rate of increase of RPIX excluding import prices, which had been declining for several years, rose slightly to 2.5% in Q3—a higher rate than for the labour cost measures.

4.7 Summary

Prices of oil and hard commodities have fallen in recent months. This partly reflects downward revisions to expected world output growth, to which previous commodity prices rises contributed. Lower input prices, combined with continued subdued unit wage cost growth, suggest that the rate of increase of manufacturers' costs has slowed, although survey measures provide more mixed signals. Manufacturing output price inflation has also slowed and remains lower than the rate of increase of costs. But surveys indicate higher future output prices. Surveys suggest that service sector costs have risen strongly, although less quickly than early in 2000. Service sector output price inflation has edged up and some, though not all, surveys point to further potential rises. Several surveys and contacts of the Bank's regional Agents suggest that the downward pressure on retail goods inflation is becoming less pronounced. However, RPIX inflation was lower than expected in Q4 and remains below the Government's $2^1/_2$% target. In the central projection inflation stays around 2% throughout 2001 but then starts to pick up, reaching the target rate at the two-year forecast horizon.

Monetary policy since the November *Report* 5

This section summarises the economic developments and monetary policy decisions taken by the MPC since the November *Report*.(1) The Bank's repo rate was maintained at 6% in December and January. In February it was cut to 5.75%

In the November *Report*, the MPC's central projection was for RPIX inflation to stay slightly below the 2½% target during 2001, but to edge up to around the target at the two-year horizon. Annual real GDP growth was judged likely to slow towards its trend rate in 2001, and to remain around trend in 2002. Relative to the central projection, some members preferred alternative assumptions about supply-side and labour market developments that, in combination, could raise or lower the inflation profile by up to ¼% at the two-year horizon.

At its meeting on 6–7 December, the Committee first discussed the world economy, particularly the United States. There was growing evidence of a slowdown in the US economy. Equity prices had fallen, and the NASDAQ index of high-technology stocks had dropped by 45% since March. Business and consumer confidence had weakened. Downside risks to US growth had increased since November but moderate growth was still more likely than a recession. Euro-area GDP growth was lower in Q3 than in Q2, though inflation was above 2%. Lower oil prices and a stronger euro might help to reduce inflationary pressure. There was a danger that a US slowdown might adversely affect emerging market economies, but Consensus growth forecasts had been revised down only a little for these countries for 2001. Falls in long-term interest rates in the major industrial countries during the month might have reflected a reduction of longer-term growth prospects.

In the domestic economy, money and credit data remained strong. Unsecured lending growth to households appeared to be supporting stronger-than-expected consumption, but rapid lending growth to PNFCs was a puzzle, given the weakness in business investment growth. Interest rate expectations had

(1) The minutes of the November, December and January meetings are reproduced under a separate cover, published alongside this *Report*.

fallen sharply since the previous meeting, and the sterling ERI was about 2% below the path assumed in November.

GDP growth was 0.7% in Q3, in line with the preliminary estimate, but consumption growth was higher than expected, while investment and government spending growth were lower than expected. Important issues were whether consumption would decelerate as fast as assumed in the November projections and, in the opposite direction, whether investment would grow as rapidly. Leading indicators suggested a slowdown of UK growth continuing into 2001, but some members did not think that these contained much incremental information.

Employment data suggested that the labour market remained tight but might be turning, and there was no change to the rate of increase of earnings. The Committee agreed that it would be important to monitor settlements in the new year closely, to see how far, if at all, the tight labour market led to pressure for higher wage rises.

RPIX inflation had fallen back to 2% in October, though the provisional estimate was for some recovery in November. The short-term prospects were for RPIX inflation to remain below target, despite the recent strength of oil prices. Most measures of domestically generated inflation were at or below 2$^{1}/_{2}$%.

In considering the immediate policy decision, the Committee noted that the world economy was probably slowing faster than had been expected. Domestic news was mixed. Consumption was still growing faster than expected, but investment and government consumption had been weaker than expected. There were two broad views within the Committee. On one view, while uncertainty had increased since November, the balance of news was not sufficient to justify a rate change. While the slowdown in the world economy would restrain UK economic activity, there was little sign of a reduction in the pace of domestic consumption growth. On the second view, the major news on the month was the sharper-than-expected slowing of world demand, which reduced prospective UK inflation. RPIX inflation had been below target for 18 months, and might stay there for another two years without some policy easing. A small rate cut was justified by the weakening external environment and would help sustain business and consumer confidence. The Committee voted by 7 to 2 to leave the Bank's repo rate unchanged.

At its meeting on 10–11 January, the MPC again started with a discussion of developments in the world economy. There was further evidence of a sharper-than-expected US slowdown and the FOMC had cut their policy rate by 50 basis points in early January. The consensus view was that some slowdown had been desirable and that modest growth was likely to resume later in the year. Some Committee members, however, saw some risks of a more pronounced and sustained slowdown. Prospects for growth in Japan seemed to have weakened and some other Asian economies had also slowed. But the cut in US interest rates and the lower oil price would help many countries to sustain activity. The recovery of the euro and lower oil prices would reduce inflationary pressure in the euro area and had improved confidence. There were downside risks to the UK economy from the slowing of world activity, but it was not yet clear how likely any of the more pessimistic scenarios were.

There was little news in the recent UK GDP data, but it did support earlier releases indicating that household consumption growth was faster than expected while investment and government consumption growth had been slower than expected. It was possible that there were measurement problems relating to price deflators for both private consumption and investment. It was also possible that any government underspending relative to announced plans would be made up in later periods.

Growth in lending to households, especially consumer credit, remained high, though lending to non-financial companies had slowed. The housing market appeared to have stabilised, with the period of rapid price rises coming to an end. Current house price inflation appeared broadly in line with projections made at the time of the November *Report*. The sterling ERI had fallen by $2\frac{1}{2}$% since November but by only 0.4% on the month, though this masked a bigger depreciation against the euro, partly offset by a significant appreciation against the dollar and yen.

Labour market data suggested no further tightening, but showed no clear signs of loosening either. Neither was there much news on earnings or settlements. The growth of earnings was much as had been anticipated and there were few signs of settlements rising in response to the tight labour market.

The sterling oil price was more than 20% lower than in November and the futures price was below the November projection at a two-year horizon. The GDP deflator had risen by only 0.7% in 2000 Q3 and its annual increase had been revised down to 1.6%, considerably below the November projection. If the data were correct, this might suggest that the pace at which the economy could grow without giving rise to inflationary pressures had increased.

On the immediate policy decision, there were two broad sets of views. On one view, while there were downside risks from the slowdown in the world economy in general and the US economy in particular, UK domestic demand remained robust, money and credit growth remained buoyant, and there was no pressing need to change rates. On this view it would be sensible to wait for clearer evidence that the labour market and the pace of consumption were easing before lowering rates. On another view, an immediate cut of 25 basis points was appropriate. One perspective was that it was important to head off a potential fall in confidence that might be hard to reverse later. With RPIX inflation below target, this would insure against downside risks without putting the medium-term inflation target in jeopardy. Another perspective was that the news on world activity, commodity prices (including oil) and equity prices were together indicating a significant weakening of inflationary pressures, and there was little prospect of inflation returning to target without a lowering of the official rate in the near future. The Committee voted by 5 votes to 4 in favour of leaving the Bank's repo rate unchanged at 6%.

At its meeting on 7–8 February, the Committee voted to cut the Bank's repo rate to 5.75%.

Prospects for inflation 6

6.1 The inflation projection assumptions

The Monetary Policy Committee approved this *Report* on 9 February. It provides the Committee's assessment of economic developments since November and prospects for the medium term. Projections of GDP growth and RPIX inflation over the next two years are presented 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 5.75% during the next two years. Alternative projections conditioned on the assumption that UK official interest rates follow market interest rate expectations are shown in Charts 6.6 and 6.7. The key assumptions on which the projections are based are described below.

World growth prospects have weakened since the November *Report* as the US economy has decelerated sharply. A slowdown from the exceptional rates of output growth in the United States in the first half of 2000 was widely expected and indeed was desirable given signs of growing financial imbalances and strains on capacity. Indicators available three months ago were signalling a moderation in growth. But subsequent developments have revealed a much softer near-term outlook. GDP growth in 2000 Q4 slowed to 0.3%, well below expectations three months ago. Equity prices, particularly of high-technology stocks, fell substantially towards the end of the year, and business and consumer confidence declined sharply. Industrial output has fallen in recent months and there are some signs of excess inventories, particularly in the vehicles sector. The Federal Reserve responded to the fall in demand by lowering interest rates by 50 basis points on 3 January and by a further 50 basis points on 31 January.

The abrupt change in conditions followed a number of years of very strong economic growth in the United States, which was underpinned by high levels of investment and rapid gains in productivity. Equity prices increased sharply, raising personal wealth and thereby supporting rapid growth in consumer spending. Overseas investors were encouraged by prospects of high returns in the United States: large capital inflows put upward pressure on the dollar and helped to finance a widening private sector financial deficit. Although the rise in productivity growth provided a strong foundation, there were clear signs in recent years that the valuation of equities was becoming increasingly stretched, particularly for high-technology stocks, and that internal and external imbalances in the economy were rising. The Federal Reserve responded to indicators of growing pressure on supply capacity by raising interest rates during 1999 and early 2000. Signs that prospective growth was weakening and that profit growth discounted in equity markets would be hard to achieve may have led to a reappraisal of future investment returns and an associated tightening of credit conditions. As investor sentiment changed, equity markets and the dollar fell back markedly.

The most likely prospect, in the view of the Committee, is that after a period of barely rising output in the first half of this year, growth in the US economy will gradually recover. Cuts in interest rates, together with a weaker dollar and a prospective fiscal easing, should help to rebuild confidence. Indeed, in support of this view, financial markets have recovered a little in recent weeks following the reductions in interest rates. As excess capacity and stocks are worked off, and if productivity trends continue to be favourable, a resumption of moderate growth appears the most likely outcome.

The weaker outlook for the US economy will depress global demand and dampen growth prospects in other economies. However, under the central expectation of a rebound in US growth in the second half of this year, the impact may be relatively muted. In the euro area, growth has slowed a little from above trend rates and business confidence has weakened somewhat, but the outlook for consumer spending remains favourable, supported by employment growth, cuts in taxes and the recent fall in oil prices. Overall, the euro-area economy appears relatively well placed to weather the slowdown in external demand. The Japanese economy is less well positioned, but the fall in the yen exchange rate may provide some protection. A very muted cyclical recovery supported by improving corporate profitability remains the most likely outcome, although risks have shifted to the downside. A number of emerging economies depend quite heavily on exports to the United States and growth prospects have consequently weakened. However, under the assumption that the US downturn is quite shallow, and providing there is no disturbance to the flow of capital, the outlook for the emerging economies remains broadly positive.

The central projection for world GDP growth is for a slowdown from just under 5% in 2000—the strongest rate for well over a decade—to around $3\frac{1}{2}$% in 2001, some half a percentage point lower than the growth rate projected in November, but still above the average pace over the past 20 years. Prospects for UK export markets have weakened correspondingly. Growth in UK-weighted export markets is most likely to slow from around $10\frac{1}{2}$% in 2000 to just under 7% in 2001 and to 6% in 2002—a downward revision of around one percentage point this year and three quarters of a percentage point next year from the central case embodied in the November *Report*.

The outlook for the global economy is particularly uncertain at present given the major change in US prospects in recent months. The Committee considers that the risks around the central projection are clearly on the downside. The US economy remains vulnerable to further adverse shocks, and it is possible that cuts in interest rates may be slower to restore business and consumer confidence than currently assumed. Moreover, a weaker outlook for the United States could have more pronounced effects on the prospects for other countries, including the United Kingdom. In addition to the effects of weaker external demand on trade and overseas investment returns, possible renewed falls in US equity prices would be likely to spill over to prices and activity in other financial markets, and a general tightening of global credit conditions could lead to disruptions to domestic and international capital flows. Business and consumer confidence could also suffer a further jolt.

The weaker outlook for global demand has lowered prospective inflationary pressures. Oil prices have fallen over the past three months, reversing the increases in the late summer and early autumn. As well as downward revisions to world growth prospects, reports of a higher-than-expected build-up of oil stocks in the OECD area in the summer and early autumn, and upward revisions to estimates of production capacity, helped to reduce oil prices towards the end of last year. OPEC announced cuts in production in January, which together with unusually cold weather in the United States and Europe provided some subsequent support to the price. Nonetheless, in the fifteen working days to 7 February, Brent crude was trading some \$3 per barrel below the central expectation in November. A further fall is incorporated in futures market prices, which the Committee continues to assume provide the best guide to price prospects. Market participants' expectations of oil prices in two years' time are around \$1 per barrel lower than assumed in the November *Report*. Prospects for 'hard' non-oil commodity prices, such as metals, have also weakened over the past three months, as forecasts of world industrial output growth have been revised down. But futures markets incorporate a slightly stronger profile for 'soft' commodity prices—principally foodstuffs—than projected in

November, leaving the outlook for non-oil commodity prices overall little changed.

Producer and consumer price inflation in the major overseas economies are likely to be weaker than anticipated three months ago, reflecting the lower profile for oil prices as well as the reduced pressure of demand. Expectations of the level of future official interest rates have fallen as a result. The easing of monetary policy will support future activity and limit the decline in prospective inflation. But prices of globally traded goods over the next two years are likely to be softer than projected in the November *Report*.

The sterling effective exchange rate index (ERI) has depreciated since the November *Report*. Foreign exchange markets have been volatile over the past three months as the euro has risen markedly against the dollar and the yen. The ERI has fallen as the depreciation against the euro has considerably outweighed the appreciation of sterling against the dollar and the yen in trade-adjusted terms.

The ERI averaged 104.0 in the 15 working days up to and including 7 February, consistent with bilateral sterling exchange rates of $1.46 and 64 pence against the euro. This forms the starting-point for the exchange rate profile assumed in the current projection. It is just over 3% below the starting-point of 107.5 in the November *Report* and the implied level of 107.4 for February in the November central projection. The sterling ERI is projected to decline a little to 102.9 by 2003 Q1.

Equity prices have an important influence on the cost of capital and on the valuation of household wealth. Prices fell sharply around the turn of the year in all major equity markets, including in the United Kingdom, with a particularly pronounced drop in the value of high-technology stocks. Equities have recovered some ground in recent weeks following the cuts in US interest rates. But the FTSE All-Share index in the 15 working days to 7 February was some 3% below the central path projected in the November *Report*. The Committee has retained the assumption in the central projection that equity wealth increases from the current level in line with nominal GDP. The profile for financial wealth over the forecast period is weaker than in November, reflecting the lower starting-point.

Forward-looking indicators of activity in the housing market have strengthened a little in recent months after softening through much of last year. Alternative indicators of house price inflation have pointed in different directions in recent months, illustrating the uncertainties in assessing trends. But, taking all the evidence together, there seems to be relatively little change to housing market prospects. As in the November projection, house prices are likely to rise a little faster than earnings over the next two years.

There has been no change to the assumptions on fiscal policy in the current *Report*. The Committee continues to base the central projection for the volume of public spending on the Government's published cash plans, as outlined most recently in the November 2000 Pre-Budget Report (PBR), modified by the Committee's assessment of the prospects for inflation. Revenue assumptions are based on HM Treasury's latest published estimates of average tax rates in the PBR, which are then applied to the Committee's economic projections. The Committee will revisit the fiscal policy assumptions in the light of the forthcoming Budget.

6.2 The output and inflation projections

GDP growth slowed to 0.3% in the fourth quarter, according to the ONS preliminary release. The estimate was lower than projected in the November *Report*, and was also below updated estimates incorporating subsequent information from surveys. Although temporary factors account for a good part of the surprise, the release suggests that underlying output growth is a little softer than expected three months ago. RPIX inflation was 2.0% in December, and so remains below target. Recent outturns have been lower than projected. The Committee reviewed the prospects for output and inflation against this background.

Recent data on demand and output are quite hard to interpret. The latest full National Accounts release, combining information on both demand and output, was published in December. In that release, GDP growth in the third quarter was 0.7%, in line with the preliminary estimate published in advance of the November *Report*. The level of output was revised up a little over the past two years and updated estimates of the components of demand were provided. Improved data led to a marked upward revision to the level of public sector demand. There was little change to estimates of aggregate private final demand, although within the overall total, consumer spending was revised up while business investment was revised down. These revisions amplify the tendency in recent quarters for consumer spending outturns to lie above expectations and for business investment outturns to fall short of projected levels.

Recent *Reports* have emphasised that a marked slowdown in the pace of private final demand growth will be necessary to provide room for the transfer of resources to meet the planned increase in public spending, without exerting excess pressure on overall supply capacity in the economy. Interpreting the recent trend in private final demand is hampered by offsetting movements in the consumer spending and investment components relative to expectations.

Data on the components of demand are not yet available for the fourth quarter to match the preliminary output-based GDP estimate. So it is too early to draw firm conclusions on whether the weaker-than-expected outturn signals a softer tone for either private or public final demand, or whether the slowdown in growth reflects a run-down of inventories. As monthly trade figures are consistent with a stronger-than-expected net trade contribution to fourth-quarter output growth, they compound the difficulties of interpretation. More broadly, it is difficult to gauge how much weight should be placed on the preliminary estimate. The slowdown in growth was partly accounted for by a sharp decline in mineral and oil extraction and by a reduction in energy output—both of which are likely to be erratic influences. Moreover, it is possible that overall activity was depressed temporarily by the exceptionally wet weather and by the disruptions to the rail network. Reflecting these factors, the underlying trend in output appears rather stronger than indicated by the preliminary estimate, and some bounce-back in early 2001 appears likely.

As noted above, consumer spending continues to exceed expectations. Household expenditure rose by 1% in the third quarter and was more than 4% up on a year earlier. More recent indicators suggest continued strength. Retail sales volumes rose strongly in the fourth quarter and new car registrations increased sharply following implementation of the recommendations of the Competition Commission. Household credit growth remains brisk. And consumer confidence has risen in recent months, according to the GfK survey. Although it is possible that spending on services has been affected by travel and weather disruptions, the underlying picture for consumer spending remains robust.

Consumer spending growth in recent quarters has been faster than indicated by its average historical relationship with such variables as household income, wealth, official interest rates and consumer confidence. A number of factors may account for this. For example, financial innovation and an increase in competition have increased the availability of both secured and unsecured credit, and reduced the cost of borrowing relative to official interest rates. That may have enabled households to smooth consumption and to unlock gains from increased wealth more effectively than in the past. It is also possible that high rates of employment combined with perceptions of greater economic stability are leading to a more pronounced reduction in precautionary saving rates than implied by average relationships in the past.

The Committee continues to expect a slowdown in consumer spending in the coming quarters. The impetus from earlier gains in wealth is gradually fading and real household income growth is slowing as employment rates level off. The central projection is that consumer spending growth slows steadily through 2001 to around trend as the household saving ratio rises a little from low levels. The broad pattern is similar to that in November although, reflecting the judgment that some of the recent unexpected strength may persist, the profile for consumer spending is higher than in the previous *Report*. Risks to the spending outlook are weighted to the downside, as households may choose to rebuild their savings more quickly.

Whole-economy fixed investment declined by 0.5% in 2000 Q3, a much weaker outturn than expected three months ago. Business investment—some three quarters of the total—fell slightly and was little changed from the level at the end of 1999. Although the volume of business capital spending remains relatively high in relation to output and the capital stock, a more buoyant picture for investment was expected on the basis of information from surveys and econometric relationships. Indeed, successive outturns have failed to meet the levels projected three months earlier in each of the past three *Inflation Reports*. Moreover, the level of business investment over the previous 18 months was revised down in the December 2000 National Accounts release.

Does the weaker-than-expected level of business investment in recent quarters reflect temporary factors that may affect the timing of capital spending, or does it indicate a more fundamental change in investment prospects? Companies undertake investment to bridge the gap between the level of the desired capital stock and their current stock. As the capital stock is large in relation to the current level of investment, a relatively small change in the level of the desired capital stock may lead to a large change in investment plans. But the level of the desired capital stock cannot be observed. Consequently, any estimates of the gap between the actual and desired capital stock can be based only on uncertain evidence from surveys and indirect proxies based on average empirical relationships between investment and factors that may potentially influence the desired capital stock. Such proxies are unlikely to be very accurate and, moreover, the timing of investment itself is likely to be affected by a range of elements such as the availability of finance or capital goods themselves, and the degree of confidence in economic prospects. Higher levels of uncertainty about the future are likely to lead to delays in investment spending.

Reviewing the evidence, the Committee decided to assign some weight to both temporary and more lasting factors. Companies may have brought forward more investment in advance of the millennium date change than previously thought. Also, investment may have been delayed by shortages of skilled labour and by adverse weather conditions affecting the construction sector in particular. Cash flow may have been affected temporarily by mergers and acquisitions activity and by the financing of third-generation mobile telecommunication licences. Investment intentions in the service sector—some three quarters of business investment—remain at high levels, and support some upturn in capital spending on the basis of the past relationship between the surveys and actual spending. On the other hand, the persistence of the weaker-than-expected investment outturns provides some evidence that the gap between the actual and desired capital stock may be less than previously anticipated. Moreover, the near-term international outlook has weakened and equity prices have fallen. The central projection for business investment has been lowered since the November *Report*. The Committee judges that business investment growth is likely to remain relatively subdued this year as firms delay capital spending, but that it may then recover as international prospects improve and as the outlook for UK growth strengthens. Whole-economy investment is expected to rise more strongly than business investment, bolstered by rapid growth in public sector capital spending. Given the uncertain environment and the possibility that recent outturns could reflect more persistent weakness, risks to the investment outlook are weighted to the downside.

Inventories are held by companies to smooth production schedules, by providing a cushion to absorb sudden changes in demand for their output or disruptions to the supply of raw materials. Stocks rose in the first three quarters of 2000, although there were few signs of a major overhang at the aggregate level given available information from surveys and long-run trends. However, given the weak preliminary estimate for output growth and the tentative evidence on the other demand components, it is possible that there was a run-down of inventories in the fourth quarter. In particular, it is likely that the surge in new car registrations was at least partly met by drawing on stocks. The Committee has made no change to the assumption that aggregate inventory holdings will continue to fall gradually as a share of output in the medium term as companies continue to seek ways of economising on stock-holding costs.

Export volumes have risen rapidly in recent quarters, boosted by very strong growth in world trade. There are signs that export growth moderated in the second half of 2000, as world trade growth passed its peak. Surveys indicate resilience in export orders in recent months. Future orders will depend on the countervailing influences of the slowdown in global growth, and the recent depreciation of sterling, which has eased competitive pressures somewhat, particularly in European markets. The Committee judges that export volumes are likely to grow less quickly over the next two years than projected in November.

Import volumes have increased even faster than exports in recent years reflecting robust growth in demand in the United Kingdom and the strength of sterling. Import penetration has risen rapidly. Even so, there are signs that UK producers have been more successful in holding onto domestic markets in recent quarters than past statistical relationships imply. The Committee has retained the assumption that this tendency will persist. The depreciation of sterling over the past three months will also dampen prospective import demand. Import volume growth is likely to slow a little through 2001 as domestic demand growth eases. Nonetheless, the growth in import volumes is expected to remain above that of exports, and may strengthen a little during the second year of the projection as domestic demand growth edges up.

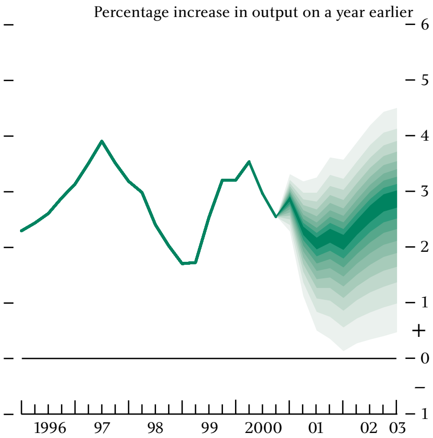
The net trade contribution to GDP growth is likely to be a little more negative over the forecast period than assumed in the November *Report*. The downward revision to world growth prospects, together with a slightly stronger outlook for overall domestic demand growth, outweighs the impact of the lower profile for the sterling exchange rate.

Recent evidence from business surveys and reports from the Bank's regional Agents are consistent with growth around or even a little above trend, supporting the view that underlying growth remains firmer than indicated by the preliminary GDP estimate for 2000 Q4. Service sector growth has slowed somewhat, but surveys remain relatively strong, with signs of weakening in some surveys balanced by a more robust pattern for sales and orders in others. Manufacturing output is rising only slowly, with growth concentrated particularly in high-technology sectors. Recent surveys are consistent with a continuation of that trend. Construction activity has been affected by the adverse weather, but sentiment remains positive—underpinned by the prospective increase in infrastructure investment. Although it is quite possible that survey responses have not yet adjusted fully to the weaker near-term outlook for global growth, to date they do not indicate any marked change in UK output prospects since the November *Report*.

Nominal GDP at market prices increased by 1.4% in the third quarter, a faster pace than in the previous two quarters, although the annual growth rate has slowed over this period to 4.6%. Monetary indicators are consistent with a relatively robust outlook for nominal demand. Broad money growth has eased a little from the peak rates in the summer but remains around 8% on an annual basis. Aggregate credit growth has also slackened from a ten-year high, but growth over the past year remains above 12%. Buoyant household credit and rapid underlying growth in narrow money holdings are consistent with a relatively firm near-term outlook for consumer spending, although the growth of households' Divisia money holdings is moderating, signalling some easing in the pace of consumption growth. After rising quickly for several quarters, there was a marked slowdown in the growth of both PNFCs' deposits and borrowing in the fourth quarter. The recent pattern of growth in corporate cash holdings and credit seems to be linked quite closely to the acquisition of financial assets rather than providing a strong indication of future trends in new capital spending. The aggregate balance sheet for PNFCs appears to be quite sound, although increased reliance on external funds and a rise in capital gearing suggest that the vulnerability to adverse shocks has risen somewhat in recent quarters. Moreover, profit warnings have increased. While there are few signs from surveys that the cost or availability of finance is a major constraint on output or capital spending at present, the increase in vulnerability is consistent with the risks to the investment outlook lying on the downside of the central projection.

Drawing the picture together, the outlook for real GDP growth over the next two years is shown in Chart 6.1.(1) This projection is conditioned on the assumption of unchanged UK official interest rates at 5.75%.(2) On the revised data, four-quarter GDP growth peaked at 3.5% in the second quarter of 2000 and has subsequently slowed to 3.0% in the third quarter and to 2.4% in the fourth according to the preliminary estimate. The most recent outturn was a little weaker than projected in the November *Report*, although, as noted above, it is likely that special factors have exaggerated the extent of the underlying deceleration. Output growth may well bounce back somewhat in 2001 Q1 as those elements unwind. But growth over the remainder of the year is likely to dip a little below trend rates as consumer spending growth slows, as business investment growth remains subdued, and as the net trade position weakens. These elements outweigh the stimulus from strong public spending growth. Thereafter, growth is projected to edge up to around, or a little above, trend as business investment strengthens, as consumer spending growth stabilises, and as world output and trade growth recover. The near-term outlook for growth is rather

Chart 6.1
Current GDP projection based on constant nominal interest rates at 5.75%



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.

(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.

weaker than projected three months ago.(1) But, based on the central assumptions, the most likely prospect is for some rebound in growth in the second year of the projection.

As noted in the November *Report*, there is some evidence that the supply-side performance of the UK economy has strengthened in recent years. For example, outturns for nominal variables such as wages and prices have tended to be somewhat lower than projected on the basis of historical relationships between indicators of nominal demand pressures and estimates of potential supply capacity. In particular, the pressure on earnings growth associated with a particular level of unemployment has been less than in the past.

The Committee maintained the assumptions on supply-side performance from the November projection (see pages 58–61 of the November *Report*). The Committee will continue to study developments carefully in order to enhance its assessment of supply-side behaviour and prospects.

Against this background, the Committee developed the current inflation projection by examining trends in cost and price pressures in the United Kingdom, given the prospects for nominal demand and output and the assumptions on world prices and the sterling effective exchange rate.

Nominal earnings growth has edged up to around $4^1/_4$%. Recent outturns are broadly in line with expectations three months ago. Pay pressures remain weaker than would be expected on the basis of the past statistical relationship with prices, productivity, and unemployment, and the recent data provide further support for the judgments made in past *Inflation Reports* that the flexibility of the labour market has improved in recent years. These judgments have been maintained in the current projection.

Labour utilisation remains very high, although the labour market no longer appears to be tightening. Employment has fallen slightly in recent months and unemployment has stabilised, though surveys of employment intentions remain strong and so it is too soon to conclude that pressures are starting to ease. Moreover, the number of inactive people—that is those not in employment who are currently not searching for, or available to start, work—has increased in recent months. Skill shortages remain widespread and on some surveys have intensified in recent months. Vacancies remain at very high levels. As the rate of unemployment remains around the lowest level for 25 years, many firms continue to face difficulties in recruiting suitable staff.

(1) In the November *Inflation Report*, there was a minor error in the depiction of the variance of the GDP projection in the first year. A corrected version of the fan chart is available on the Bank's web site www.bankofengland.co.uk/inflationreport/irfanch.htm

Nominal pay pressures are affected by developments in inflation as well as by factors that influence real earnings growth. Inflation expectations have fallen substantially in recent years, as inflation outturns have remained low and credibility that monetary policy will sustain low inflation has increased. However, there has been a slight rise in trade union expectations of future inflation over the past year, which may reflect higher outturns for RPI inflation. The CBI *Pay Databank Report* notes a rise in pressures from cost of living increases on pay settlements compared with a year ago, which could generate upward pressure on settlements in the near term. But this is likely to be only a temporary influence. RPI inflation is falling quickly as past rises in mortgage interest payments drop out of the previous year's baseline, and underlying inflation remains low.

There are some indications that recruitment and retention difficulties are putting upward pressure on pay, but there are only limited signs of any significant pick-up to date. Private sector settlements have edged up a little in recent months.

The Committee concluded that there was relatively little change to the outlook for real earnings growth since the November *Report*. As recent inflation outturns have been a little below expectations and nominal earnings growth broadly in line with them, real earnings growth has turned out slightly stronger than anticipated. That gain is likely to unwind quickly and the somewhat weaker prospects for short-term output growth should also dampen real wage pressures marginally. Taken together with a weaker outlook for near-term price pressures, nominal earnings growth is likely to be a little softer than in the November *Report*. A temporary dip in nominal earnings growth is likely in the coming months as bonuses are likely to fall short of the exceptional levels paid around the turn of the millennium. Earnings growth is likely to return subsequently to around current rates, or a little above, reflecting the continued tightness of the labour market. Given that tightness, risks to the earnings outlook are weighted to the upside.

Cost pressures from the labour market depend on productivity growth as well as earnings. Following several years of relatively subdued outturns, whole-economy productivity growth has strengthened in recent quarters and is now above the long-run trend calculated as the average over the past 40 years. Faster productivity growth, combined with a slowdown in earnings growth from the levels in 1999 and early 2000, has led to a substantial drop in the annual rate of growth of unit wage costs to around $1\frac{1}{2}$%. Productivity is expected to grow at around trend over the next two years. Given nominal earnings growth just a little above recent rates, unit wage costs might rise a little quicker than in recent quarters, although pressures are likely to remain relatively muted.

Recent outturns for RPIX inflation have been below expectations at the time of the November *Inflation Report*, when the pass-through of higher oil prices was judged likely to lead to a temporary spike in inflation in the fourth quarter. In the event, RPIX inflation was 2.1% in 2000 Q4, identical to the rate in each of the previous three quarters. Some of the overprediction of inflation may be accounted for by lower-than-expected cost pressures, for example as oil prices dropped back, but it also seems to be the case that restraining factors on prices themselves were a little stronger than judged three months ago. Other indicators of inflation, such as that based on the GDP deflator, are also signalling weaker-than-expected price trends, although erratic factors probably account for some of the weakness. The lower starting-point for price inflation affects the outlook for nominal earnings and thus has some downward impact on the prospects for inflation over the next two years.

On the other hand, some, but not all, recent surveys of price trends report an increase in the proportion of firms planning to raise prices in the coming months, particularly in the manufacturing sector. At the same time, surveys indicate that competitive pressures remain intense, which could imply that plans to raise prices will be thwarted. The Committee will monitor the interplay between plans and outturns closely.

Drawing all the influences together, the Committee's best collective projection for the twelve-month RPIX inflation rate, conditional on the assumption that nominal interest rates remain unchanged at 5.75%, is presented in Chart 6.2.(1) It is displayed alongside the projection from the November *Report*, which was predicated on the assumption of constant interest rates at 6% (see Chart 6.3).

The most likely outcome is that inflation will dip a little further below target in early 2001 as the decline in oil prices feeds through, and will increase subsequently to around the target after two years. As in previous projections, inflation rises a little in the medium term because of pressures on domestic supply capacity which stimulate modest increases in prices and wages.

The profile for inflation is lower than in the November projection. The principal downside forces on inflation relative to the November *Report* are: the weaker outlook for global activity and prices; the impact of the softer-than-expected

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

Chart 6.2
Current RPIX inflation projection based on constant nominal interest rates at 5.75%

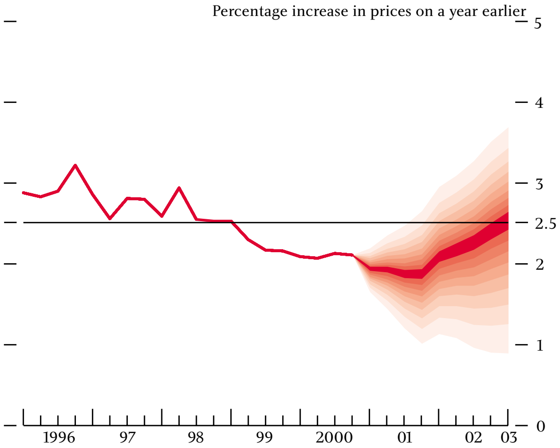
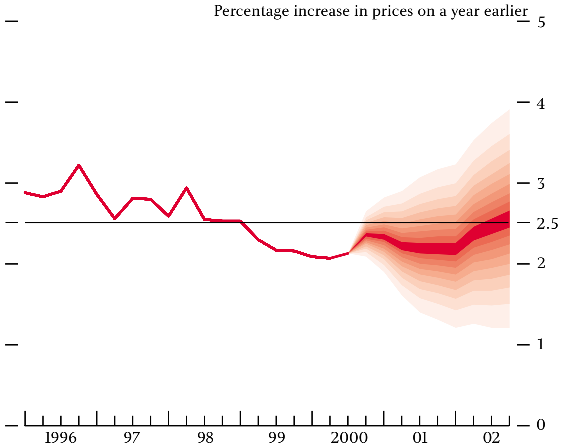


Chart 6.3
RPIX inflation projection in November based on constant nominal interest rates at 6%



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*.

outturns for both growth and inflation in the United Kingdom in the most recent quarter; and the lower path for business investment. These effects outweigh the main upside influences of a weaker exchange rate profile, an upward revision to consumer spending prospects, and the lower level of interest rates.

The fan charts depict the uncertainty surrounding the prospects for inflation and output growth and the balance of risks around the most likely outcome. The Committee judges that the risks to both output growth and inflation are weighted to the downside. The largest risk is that of a sharper slowdown in world activity than embodied in the central projection, most likely to be associated with a deeper and more prolonged downturn in the United States. Weaker world demand would lower the demand for UK exports and would reduce global inflationary pressures. In such a case, asset prices would also tend to fall, activity in financial markets could contract, and business and consumer confidence in the United Kingdom could decline significantly, accentuating the fall in demand. Inflation pressures in the United Kingdom would then fall, although it is likely that the impact would be partly mitigated by a more rapid depreciation of the sterling ERI than in the central projection. Independent of the risk of lower global demand, the Committee judges that there is a risk that private final demand could slow by more than in the central projection. That would also dampen prospects for both output growth and inflation. These downside risks substantially outweigh the upside risk that earnings could be stronger than in the central projection, given the tightness of the labour market.

Chart 6.4
Current projection for the percentage increase in RPIX in the year to 2003 Q1

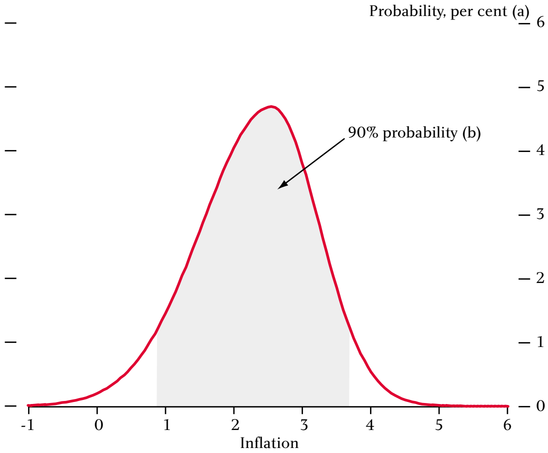
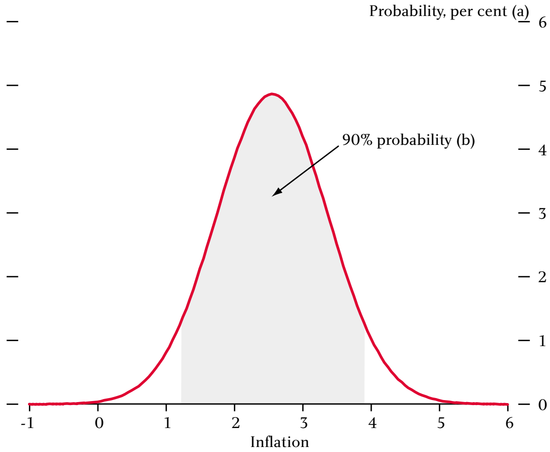


Chart 6.5
November projection for the percentage increase in RPIX in the year to 2002 Q4



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 just under 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*.

Table 6.A
The MPC's expectations for RPIX inflation and GDP growth based on constant nominal interest rates at 5.75%(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	25	38	29	8	1	<1
2002 Q4	19	19	25	22	12	4
2003 Q1	18	17	22	22	14	7

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	13	32	36	14	1
2002 Q4	3	10	22	31	25	9
2003 Q1	3	9	21	31	26	10

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

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

Difference from central projection, percentage points

	Change in UK supply-side and labour market performance	Scale of world slowdown and impact on United Kingdom
RPIX inflation		
2002 Q1	-0.1 to +0.1	-0.1
2003 Q1	-0.25 to +0.2	-0.25
GDP growth		
2002 Q1	0.0	-0.15
2003 Q1	+0.1 to -0.1	-0.1

Maintaining a similar judgment on the degree of overall uncertainty surrounding prospects as in the November *Report*, Chart 6.4 illustrates the overall balance of risks to inflation at the two-year horizon. Chart 6.5 shows the corresponding balance from the November projection. The Committee's best collective judgment of the probabilities of various outcomes for inflation and GDP growth is shown in Table 6.A.

As emphasised in the previous *Report*, when forming their individual judgments of the appropriate setting for interest rates, Committee members draw on their assessment of the likely prospects for inflation and output, placing particular emphasis on the uncertainties and risks. The probability distributions portrayed in the fan charts provide an indication of the general uncertainty around the most likely outcome, drawing on experience from earlier forecasting errors, and provide a calibration of the Committee's collective assessment of the overall balance of risks. However, for certain key assumptions, some Committee members prefer to make different judgments from those incorporated in the fan charts. Committee members continue to hold different views on the impact and scale of improvements in supply-side and labour market performance. And given the considerable uncertainties at present on both the outlook for the global economy and on the impact of the change in the international environment on economic prospects in the United Kingdom, individual Committee members hold different views on the most likely outcome and on the magnitude of the potential risks. The major differences in their preferred alternative assumptions are calibrated in Table 6.B, but there are also

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

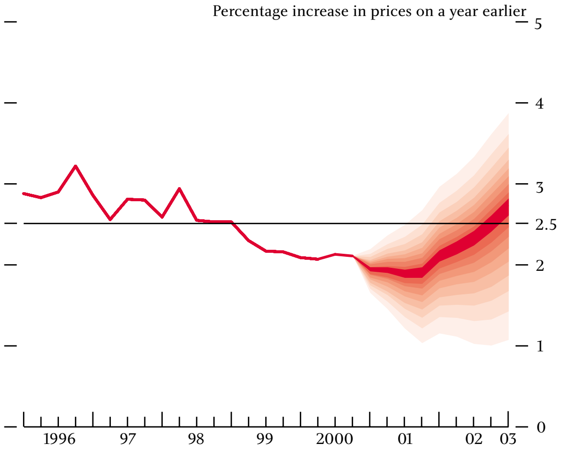


Chart 6.7
Current GDP projection based on market interest rate expectations

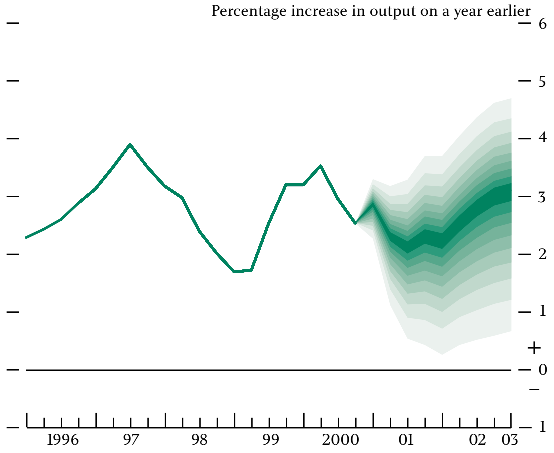


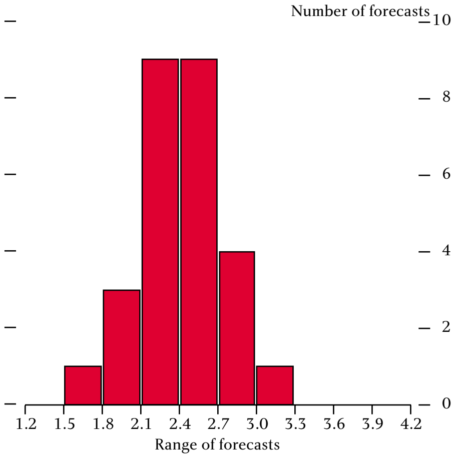
Table 6.C
Market expectations of the Bank's official interest rate(a)

Per cent

2001				2002				2003
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
5.8	5.4	5.3	5.2	5.3	5.3	5.3	5.3	5.3

(a) Based on the interest rate available on gilt-edged securities, including those used as collateral in short-term repo 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 7 February 2001.

Chart 6.8
Distribution of RPIX inflation forecasts for 2003 Q1



Source: Survey of 27 outside forecasters as of 7 February 2001.

small differences with respect to other assumptions. As a result, some Committee members consider that the profile for inflation at the two-year horizon could be up to 1/2% lower than in the central projection shown in Chart 6.2. Assessments of the balance of risks are an essential element in the policy discussion and decisions. Committee members take different views on the weight to attach to the individual risks described above. Some members believe that the downside risks taken as a whole could be larger or smaller than shown in Chart 6.2.

Although there is no unique quantification of financial market participants' views on the likely course of future official rates, it is clear that there has been a substantial lowering of the expected path since the November *Report*. Drawing on estimates derived from rates of interest on gilt-edged securities, including those used as collateral in short-term repo contracts, the latest evidence suggests that the market expects official rates to decline over the next six months or so to around 5.25% and to remain around this level over the following twelve to eighteen months (see Table 6.C). The Committee's projections under the assumption that official rates fall in line with market expectations are shown in Charts 6.6 and 6.7. Reflecting the lower interest rate trajectory, the prospects for both output growth and inflation are higher under this assumption than in the projections based on constant nominal interest rates.

6.3 Other forecasts

In early February, the Bank asked a sample of external forecasters for their latest projections of inflation and output. Based on this survey, the mean forecast for the twelve-month rate of RPIX inflation in 2001 Q4 was 2.2% (with a range of

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

RPIX inflation

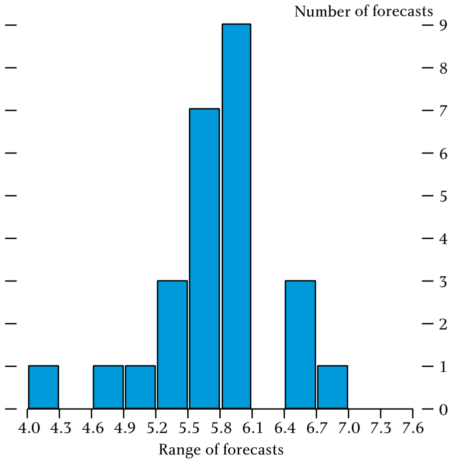
Probability, per cent	Range: less than 1.5%	1.5% to 2.0%	2.0% to 2.5%	2.5% to 3.0%	3.0% to 3.5%	more than 3.5%
2001 Q4	7	28	45	15	4	1
2002 Q4	7	17	39	26	8	3
2003 Q1	6	15	35	30	10	4

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	6	25	47	18	2
2002 Q4	3	8	23	48	15	4
2003 Q1	4	8	20	45	17	5

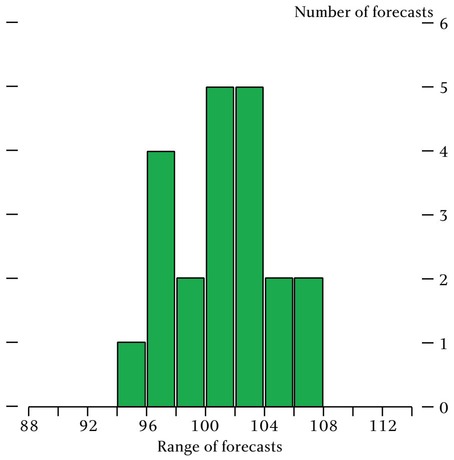
(a) 18 other forecasters provided the Bank with their assessment of the likelihood, at three time horizons, of expected twelve-month RPIX inflation and four-quarter output growth falling in the ranges shown above. This table shows the mean of the responses for each range. For example, on average, forecasters assign a probability of 6% to inflation turning out to be less than 1.5% in 2003 Q1.

Chart 6.9
Distribution of repo rate forecasts for 2003 Q1



Source: Survey of 26 outside forecasters as of 7 February 2001.

Chart 6.10
Distribution of sterling ERI forecasts for 2003 Q1



Source: Survey of 21 outside forecasters as of 7 February 2001.

1.7% to 2.5%), rising to 2.4% in 2003 Q1 (with a range of 1.5% to 3.1%). The distribution of central projections in 2003 Q1 is shown in Chart 6.8. Compared to the survey results in the November *Report*, the mean forecast for inflation at the two-year horizon is a little lower, and the dispersion of forecasts has increased. On average, external forecasters see a 44% probability of inflation being above 2.5% in 2003 Q1, and a 56% probability of it being below (see Table 6.D). The forecasters' average projection for four-quarter GDP growth in 2001 Q4 was $2^1/_2$% (with a range of $1^1/_2$% to $3^1/_4$%), unchanged from the average forecast reported in November. The average projection for growth in 2003 Q1 was also $2^1/_2$% (with a range of 1% to $3^1/_4$%).

The mean forecast for the official interest rate has fallen by 25 basis points since November (see Chart 6.9). The mean forecast is $5^3/_4$% in 2001 Q4 (with a range of 5% to $6^1/_4$%) and is also $5^3/_4$% in 2003 Q1 (with a larger range of 4% to $6^3/_4$%). On average, forecasters assume that the sterling ERI will be 103 in 2001 Q4 (with a range of $96^3/_4$ to $110^1/_2$) and then fall to 101 (with a range of 95 to 106) by 2003 Q1 (see Chart 6.10).

The implications of the latest projections for the stance of monetary policy are discussed in the Overview at the beginning of this *Report*.

Bank of England
Agents' summary of business conditions

February 2001

This publication is a summary of monthly reports compiled by the Bank of England's Agents,(1) following discussions with around 1,700 businesses in the period between mid-October and mid-January. 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.

- Manufacturing output growth picked up moderately during the period in most regions—predominantly reflecting a further improvement in external demand. Although confidence in the sector remained low, continued increases in orders and the recent weakening of sterling against the euro led to some improvement in sentiment.

- Construction growth slowed considerably during the period, as wet weather delayed activity in many regions. Reflecting strong underlying demand, a rebound in growth was expected in coming months, particularly from the public sector.

- Service sector growth remained broadly steady during recent months. Most areas of business services continued to record strong growth. Consumer services activity remained more moderate, with little improvement in demand for domestic tourism-related activity.

- Annual growth in retail sales values was little changed from the previous period. New car sales to individuals recovered significantly, following a sustained period of weak demand.

- Export volume growth strengthened further in most regions. Demand from the United States generally remained strong, although some contacts noted a slowdown in orders in recent weeks. Growth in exports to markets in the Middle East and Asia improved. Sales to Europe remained relatively more subdued, although confidence improved to some extent as a result of the recent weakening of sterling against the euro.

- There was little change to the trend of weak investment intentions in the manufacturing sector reported in previous *Agents' Summaries*. Service sector investment intentions remained robust, although there was little evidence of any strengthening.

- Input price inflation eased back during the period, as the impact of the recent fall in the oil price began to feed through. On balance, manufacturers' output prices appeared to stabilise during the period, following a sustained period of downward pressure. As a result, many manufacturers reported some rebuilding of margins. Similar trends were also evident further up the supply chain, with many Agencies reporting that annual retail goods price deflation eased compared with the previous period. The price level of new cars appeared to stabilise towards the end of the period.

- Skill shortages remained intense in most regions, although they did not worsen. Agents continued to suggest little change to the benign picture of pay outturns reported in recent *Agents' Summaries*, although concern about the upcoming pay round had perhaps become more widespread. There was little change in employment trends. Service sector employment continued to rise steadily, while manufacturing employment declined further.

(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

Agricultural sector output was reported to have declined during the period. There were widespread reports that flooding in many areas had significantly affected the harvesting and planting of many crops. Root crops (notably potatoes) were the worst affected. In addition, the inability of some farmers to plant spring crops has affected the prospects for future harvests.

Milk production remained below quota. However, there were reports that the increase in the wholesale price of milk during the period had eased pressure on margins to some extent. There were reports that fishing output was down considerably on a year ago.

Manufacturing

Reports suggested that manufacturing output growth continued to strengthen moderately throughout the period in most regions. In most cases, this was predominantly driven by a further recovery in export growth. Growth in demand from domestic firms remained broadly unchanged. Although confidence in the sector remained low, continued increases in order books and the recent weakening of sterling against the euro led to some improvement in sentiment. In addition, most contacts suggested that there had been little adverse impact from the slowdown in economic activity in the United States to date.

The divergence between the performance of industries within manufacturing remained a prominent theme. Most Agencies continued to report that high value added industries, such as electronics and telecommunications, continued to record the strongest growth. Growth in these industries outweighed declining output in more traditional industries such as automotive-related and basic metal processing, which are particularly concentrated in Wales, the Midlands and the North.

Construction and housing

Overall, construction growth was reported to have slowed considerably in recent months, as recent wet weather delayed activity in many regions. However, contacts expect the slowdown to be temporary, with underlying demand said to have remained strong. Contacts in most regions expect public construction activity to pick up strongly in coming quarters. However, there was some uncertainty surrounding the expected timing of this spending.

Most Agencies suggested that residential construction activity had now stabilised at a lower level. The earlier slowdown in residential construction was particularly noticeable in the southern regions of the United Kingdom, where activity had been relatively stronger. While underlying demand remained strong, many Agencies suggested that the pace of growth was unlikely to increase significantly, given continued supply-side constraints (notably skill shortages).

Services

Service sector growth was reported to have remained broadly steady during recent months, although at a somewhat slower pace than in previous quarters. During recent months, business services growth was maintained, although some Agencies suggested that mergers and acquisitions activity had slowed. Accountancy and legal firms continued to report the strongest demand, but most firms reported that skill shortages were constraining growth. Distribution activity picked up, and IT-related service activity also strengthened again following the post-millennium slowdown. Many Agencies reported that activity in the transport sector was adversely affected by rail disruptions and bad weather during the period. But this was offset by increased demand for air and road transport.

Consumer services growth remained weaker than in business services, but appeared to stabilise during the period. There was little evidence of any improvement in domestic tourism-related activity, following a downturn in demand during the summer. Confidence in the sector remains low. Leisure services growth remained firm in most regions, particularly for restaurants, pubs and fitness centres.

DEMAND

Consumption

On balance, annual retail sales value growth was little changed compared with the previous period. Some Agencies noted some easing in the early part of the period, mostly as a result of temporary factors. But the majority of contacts noted that annual growth picked up strongly during the Christmas period. As a result, stocks were run down and many retail contacts suggested that there was now little stock overhang. Overall, consumer confidence was said to have remained relatively steady in most regions. Many contacts reported stronger volume growth for clothing, following a sustained period of weak demand. Sales of electronic items, particularly mobile phones, televisions and DVD players, recorded the strongest growth.

Growth in most other areas of consumer spending was little changed during the period, although there were some reports of a temporary downturn during the period of extreme flooding. Strong growth in spending on overseas travel continued, though this was partly offset by lower spending on domestic travel.

New car sales to individuals recovered significantly, following a sustained period of weak demand. Sales of used cars also improved in many cases, though to a lesser extent. Many motor vehicle traders suggested that consumers probably now perceive that prices are unlikely to fall much further.

Exports and imports

Export volume growth strengthened further in most regions, reflecting stronger world demand. Most regions reported that demand from the United States remained robust (particularly for electronics), although there were isolated reports of some slowdown in orders in more recent weeks. However, while contacts reported some concern about the future impact of the slowdown in economic activity in the United States, many firms believed the impact would be limited, and offset mostly by stronger growth in other markets. During the period, export growth to markets in the Middle East and Asia improved further. But sales to Europe remained relatively more difficult. However, many manufacturers noted some improvement in margins in recent weeks, following the weakening of sterling against the euro. Looking forward, the exchange rate movement, if maintained, is expected to result in a pick-up in volume growth to the euro area in coming quarters, as exports become relatively more competitive.

Import demand remained brisk during the period, although the pace of growth was little changed from the previous period.

Investment

There was little change to the trend of weak manufacturing investment intentions reported in previous *Agents' Summaries*. The only exception appeared to be in 'high-tech' industries. Manufacturers in traditional manufacturing industries continued to report a steady decline in capacity as a result of rationalisation and relocation to plants overseas (particularly in Eastern Europe and Asia). In many cases, lower profitability meant that cash flow was constrained. Several contacts reported that investment spending rarely exceeded depreciation.

By contrast, service sector investment remained much stronger than manufacturing, although there was little evidence of any change in trend during the period. Investment intentions remained robust in almost all regions, with IT spending said to be a priority for most firms. Reflecting this, there were reports of a strengthening in IT investment in some regions. Firms continued to report high levels of investment in offices, as well as continued investment in the leisure and retail sectors (particularly refurbishment).

COSTS AND PRICES

Input prices

Input price inflation eased considerably during the period. This was largely due to a pass-through of the lower world oil price in recent months to oil-related products. Many contacts believe this will continue to feed through to lower input prices in coming months. However, this was not common to all contacts, with many still reporting increases as a result of the earlier oil price rise. Gas prices continued to be mentioned by several Agencies as another source of price pressure.

Regulation costs were still regularly mentioned as a concern, particularly the Climate Change Levy (effective from April 2001).

Output prices

Manufacturers' output prices appeared to stabilise during the period, following a sustained period of downward pressure. Agencies reported that many manufacturers were now increasingly able to resist price cuts, in favour of unchanged prices. In addition, many firms reported some easing of margin pressure, particularly in export markets.

By comparison, service sector price increases remained relatively stronger, though the pace of inflation was broadly unchanged from the previous period in most cases.

Retail prices

There were clear signs that the annual pace of decline in retail goods prices eased during the period. Many retailers noted that continued strong volume growth resulted in less significant discounting during the January 'sales' than last year. However, there was some indication that discounting for clothing had deepened again recently. In addition, many Agencies noted significant increases in seasonal food prices, as bad weather restricted the supply of many products.

On balance, service sector inflation appeared to stabilise during the period. Within services, some hotels and leisure services reported stronger price increases recently. But elsewhere, there were some signs of easing.

During the period, most Agencies noted a continued slowing in annual house price inflation. However, after recording falls in the level of house prices in parts of the South in the previous period, prices appeared to have risen again recently (although at a much slower pace than last year). In other regions, the level of house prices continued to rise modestly.

The price of new cars stabilised during the period, following a sustained period of steadily falling prices. Contacts reported that it was now unlikely that prices would fall much further. Evidence on used car prices was mixed, although the majority of Agencies reported that prices in this market had also stabilised.

Pay

Agencies continued to suggest little change to the benign picture of pay outturns reported in recent *Agents' Summaries*. Generally, settlements remained at around 2%–3% in the manufacturing sector, although there were some isolated reports of rather higher increases as the period progressed. Looking forward, many manufacturing contacts voiced concern about the possibility of higher settlements in the upcoming pay round—most notably in the southern regions. Total earnings growth in the sector remained subdued, reflecting lower overtime payments.

Similarly, overall pay pressures in the services sector also remained little changed, although they remained considerably stronger than in manufacturing. Pay increases in professional services, such as accountancy and IT, continued to record the strongest growth. Looking forward, there were signs that public sector services settlements could rise in coming months. The picture on bonuses was unclear across the regions. However, there was further evidence that underlying pay growth was being mitigated by the increased use of non-wage benefits, such as flexible working hour arrangements.

EMPLOYMENT

Skill shortages remained acute in most regions during the period, although there was little evidence that they had intensified. Shortages remained mostly confined to professional and skilled workers, although there were increased reports (particularly from the southern regions) of difficulty in recruiting lower-skilled workers, such as retail, hotel and cleaning staff, in recent months.

There was little change to trends in employment growth. Manufacturing employment continued to decline at a similar pace to the previous period in most regions. Increases in employment in many 'high-tech' industries continued to be more than offset by considerable falls in the remaining sectors. Most Agencies suggested that there was no expectation of these trends changing in the near future.

Growth in the services and construction sectors continued at a steady pace, but still appeared to be constrained by the limited availability of suitably skilled labour. In many cases, firms (particularly in London) have mitigated the impact of labour shortages to some extent through the increased recruitment of overseas workers.

Text of Bank of England press notice of 7 December 2000

Bank of England maintains interest rates at 6.0%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 6.0%.

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

Text of Bank of England press notice of 11 January 2001

Bank of England maintains interest rates at 6.0%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 6.0%.

The minutes of the meeting will be published at 9.30 am on Wednesday 24 January 2001.

Text of Bank of England press notice of 8 February 2001

Bank of England reduces interest rates by 0.25% to 5.75%

The Bank of England's Monetary Policy Committee today voted to reduce the Bank's repo rate by 0.25% to 5.75%.

The Committee's latest inflation and output projections will appear in the *Inflation Report* to be published on Wednesday 14 February.

The minutes of the meeting will be published at 9.30 am on Wednesday 21 February.

Glossary and other information

Glossary of selected data

AEI: Average Earnings Index.
CSPI: corporate services price index.
DGI: domestically generated inflation.
Divisia money: a measure of the money stock in which each component is weighted according to an estimate of its likely use for transactions.
ERI: exchange rate index.
FEPI: final expenditure price index.
HICP: Harmonised Index of Consumer Prices.
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 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.
TPI: tax and price index.

Abbreviations

BCC: British Chambers of Commerce.
BRC: British Retail Consortium.
CBI: Confederation of British Industry.
CIPS: Chartered Institute of Purchasing and Supply.
CML: Council of Mortgage Lenders.
cob: close of business.
DETR: Department of the Environment, Transport and the Regions.
DHL: DHL International (UK) Ltd.
ECB: European Central Bank.
EEF: Engineering Employers' Federation.
EU: European Union.
FOMC: Federal Open Market Committee.
FTSE: Financial Times Stock Exchange.
GC: generalised collateral.
GDP: Gross domestic product.
GfK: Gesellschaft für Konsum, Great Britain Ltd.
HMT: Her Majesty's Treasury.
ICPFs: insurance companies and pension funds.
ICT: information and communications technology.
IDS: Incomes Data Services.
IMF: International Monetary Fund.
IRS: Industrial Relations Services.
IT: information technology.
LAPFs: life assurance and pension funds.
LFS: Labour Force Survey.
LIFFE: London International Financial Futures and Options Exchange.
M&A: mergers and acquisitions.
MEW: mortgage equity withdrawal.
MFR: Minimum Funding Requirement.
MORI: Market and Opinion Research International.
MPC: Monetary Policy Committee.
NAPM: National Association of Purchasing Managers.
NASDAQ: National Association of Securities Dealers Automated Quotations system.
NHS: National Health Service.
NIESR: National Institute of Economic and Social Research.
NYMEX: New York Mercantile Exchange.
OECD: Organisation for Economic Co-operation and Development.
OFCs: other financial corporations.
ONS: Office for National Statistics.
OPEC: Organisation of Petroleum Exporting Countries.
PBR: Pre-Budget Report.
PNFCs: private non-financial corporations.
PSNB: public sector net borrowing.
PSNCR: public sector net cash requirement.
REC: Recruitment and Employment Confederation.
RICS: Royal Institution of Chartered Surveyors.
S&P: Standard and Poor's.
TMT: Technology, media and telecommunications.
UIP: uncovered interest parity.

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.