

# Inflation Report

May 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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## Overview

Economic growth in the United Kingdom has slowed, while inflation has remained subdued. Output in the first quarter is provisionally estimated to have been 2.5% up on a year earlier, and RPIX inflation was 1.9% in the year to March, slightly below the target rate of 2½%. Growth prospects in the rest of the world have continued to weaken, especially in the United States. Equity prices around the world fell sharply in February and March, but have since recovered somewhat, and the effective exchange rate for sterling has appreciated a little. At home, growth in final domestic demand in the first quarter appears to have held up, underpinned by strong consumption, but net trade has been a negative factor, contributing to sluggish output growth. Surveys suggest that business confidence has deteriorated. Unemployment has fallen, but some indicators suggest that the labour market may be close to a turning point. Recent high earnings growth is likely to prove erratic, and imported cost price pressures remain relatively muted.

Global economic prospects depend to a large degree on developments in the United States. Quarterly growth there in the first quarter was 0.5%, rather higher than expected, supported by resilient consumer spending. Nevertheless, the outlook is weaker than foreseen at the time of the February *Inflation Report*. Continued falls in business confidence, a deteriorating corporate financial position and evidence of surplus capacity all suggest that investment is likely to be subdued in the near future. Rising unemployment, lower equity prices and weak household balance sheets may dampen consumer spending. In the face of these developments, the Federal Reserve has cut official interest rates by a further 100 basis points since February, and Congress has agreed to a programme of tax cuts. Though policy relaxation is likely to foster recovery in US growth towards the end of the year, the risks there remain on the downside.

Prospects elsewhere have also worsened a little. The euro area has seen some decline in business confidence, but consumer confidence remains high, sustained by continuing growth in disposable incomes. Growth in output is expected to slow to around trend. In response to the weakened outlook, the European Central Bank has cut official interest rates by 25 basis points. In Japan, declining consumer and business confidence leave little prospect of significant domestically generated growth. The emerging market economies are also slowing in response to slower growth in their export markets.

Cuts in oil production mean that oil prices are expected to be slightly higher than in the February *Report*, but this should be offset by lower traded goods price inflation. The sterling exchange rate has risen against the euro, more than offsetting depreciation against the dollar. The starting-point for the effective exchange rate profile in the projections below is 105.8, nearly 2% higher than in the February *Report*.

Equity prices abroad and at home fell sharply in late February and March. Although they have recovered since, the starting-point for the profile for the FTSE All-Share index is still nearly 7% below the level assumed in the February *Report*. Moreover, the correction to equity prices was not confined to the high-technology sector, but was more broadly based. In the wake of this fall, and the deteriorating global economic picture, the MPC cut the Bank's official interest rate by 25 basis points at both its April and May meetings to reach 5.25%. Short-term money market rates imply that market participants expect a further modest fall in official interest rates later this year. Longer-term government bond yields, in contrast, have risen.

Narrow money growth has moderated a little, but broad money growth has remained robust, probably reflecting in part a portfolio shift to safer assets. Household credit growth has moderated only slightly, consistent with strong consumer spending and a pick-up in the housing market. Growth in corporate money holdings and borrowing show some signs of slowing.

Consumer spending in the fourth quarter rose by 0.6%, down from rates seen earlier last year. But strong growth in retail sales volumes and in private new car registrations point to higher consumption growth in the first quarter of this year. Rising financial wealth and robust growth in real disposable incomes have sustained strong consumption growth in recent years, but the fall in the value of equities and moderating income growth suggest that spending will ease over the course of this year.

A stronger-than-expected fiscal position since the Pre-Budget Report broadly offsets the cost of the new measures announced in the Budget, with no change in the Government's overall borrowing plans. Consequently, the Budget has little impact on the MPC's medium-term outlook for growth and inflation. However, revisions to tax rates on fuel and other specific duties imply slightly lower inflation for this year.

Upward revisions to the past data for business investment have now brought it into line with the relatively strong survey data on investment intentions observed last year. Business investment rose slightly more than 5% in the fourth quarter and

the level was considerably higher than expected in the February *Report*. Continued strength is expected in the near term, but lower equity prices and a more subdued and uncertain outlook suggest that investment growth will ease further ahead.

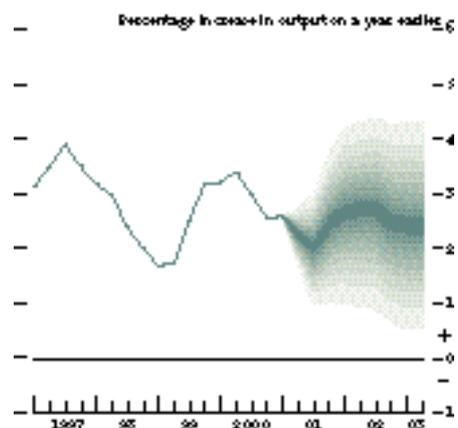
Exports grew 2.3% in Q4, enough to ensure a small positive net trade contribution to GDP growth. But exports to the United States fell sharply in March and surveys indicate that further weakness can be expected as the world economy slows. Over the next two years import growth can be expected to outstrip that of exports so that net trade is expected to make more of a negative contribution to growth than was expected in the February *Report*.

Output is provisionally estimated by the ONS to have risen only 0.3% in the first quarter, after just a 0.4% rise in the previous quarter. This is less than expected in the February *Report*, and below the trend rate of growth. Some of the shortfall is likely to be temporary reflecting special factors, such as the impact of foot-and-mouth disease, which have affected both demand and supply. But the weakness in output is difficult to reconcile with the expenditure-based estimate for fourth-quarter growth and with strong demand indicators in the first part of this year. As a consequence the current underlying rate of growth is more uncertain than usual.

The sectoral and regional evolution of output has been diverse. Agriculture has been suffering from the impact of foot-and-mouth disease. The recovery in manufacturing output has stalled as demand for the output of the high-technology industries has dropped, and slowing world growth and the strong exchange rate will continue to place this sector under pressure. Growth in the service sector has remained strong, although tourism and associated leisure activities in the rural areas are likely to have been adversely affected by the foot-and-mouth epidemic. Foot-and-mouth disease has had significant effects on specific regions and sectors, but the impact on the medium-term outlook for inflation should be limited.

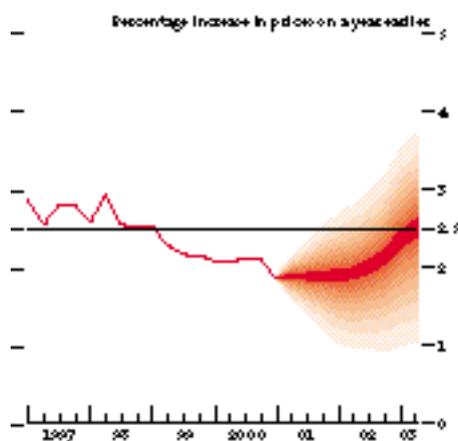
After appearing to stabilise at the end of last year, the labour market has probably tightened a little over the past three months. The LFS unemployment rate fell to 5.2% in February on the back of renewed employment growth, and employment intentions point to this growth continuing in the short term. The claimant count fell to 3.3% in March. The annual growth rate of the headline measure of average earnings rose sharply to 5.0% in February, but this large increase mainly reflects an erratic change in the timing of bonus payments. Wage settlements have risen only a little, and falls in headline inflation and inflationary expectations should help to offset the upward pressure from the tight labour market.

**Chart 1**  
**Current GDP projection based on**  
**constant nominal interest rates at 5.25%**



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 5.25%**



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

Labour productivity has been growing close to its long-run historic average rate and this is expected to continue over the forecast period. Provided earnings growth is moderate, this will ensure that labour cost pressures on inflation remain muted. Global price developments and a continued strong exchange rate also mean that imported inflationary pressures remain subdued.

Chart 1 shows the MPC's assessment of the outlook for GDP growth, on the benchmark assumption that the official interest rate remains at 5.25% over the forecast period. In the central projection, the impact of foot-and-mouth disease and slower consumption growth temporarily depress the annual growth rate, but thereafter strong public consumption and investment offset the deterioration in export prospects enough to keep growth at around trend. Moderating domestic demand growth subsequently leads to a modest deceleration in activity towards the end of the forecast period. The overall outlook for growth is a little softer than in the February Report.

Chart 2 shows the corresponding projection for RPIX inflation. In the central projection inflation stays around 2% throughout 2001. It then starts to pick up gently towards the target rate, as the moderating effect of past exchange rate appreciation wears off and pressures on supply generate a mild pick-up in wages and prices. Inflationary pressures are a little weaker than in the February Report, reflecting the impact of lower global growth partly offset by reductions in official interest rates. As then, some members prefer alternative assumptions about supply-side developments and international prospects. 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 remain on the downside, associated particularly with the risk of a deeper or more prolonged slowdown in the United States. Taking account of these risks, and in the light of the overall weakening of inflationary pressures, the Committee agreed at its May meeting that a further modest reduction in the official interest rate was necessary to keep inflation on track to meet the target.

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Money and credit data can provide useful indications about current and future spending in the economy and thus the degree of inflationary pressure. Narrow money growth has eased somewhat. Broad money growth has remained high, though below its peak of last year. Aggregate lending continues to rise rapidly, though the pace of growth has eased a little in recent months. Households' deposits and borrowing continue to grow quickly, though corporate deposits have been stable in the past two quarters. Overall, monetary and credit indicators are consistent with little change in the pace of nominal spending growth.

The MPC voted to cut the Bank of England's official repo rate by 25 basis points at its April meeting, and by a further 25 basis points to 5.25% at its May meeting. Official interest rates have been reduced by 100 basis points in the United States since the February *Inflation Report*, and were lowered by 25 basis points in the euro area on 10 May. Market participants have further lowered their expectations of future official rates in the major economies. In the United Kingdom, market interest rates imply expectations of a further reduction in official rates of around 25 basis points by the end of the year.

Equity prices have fallen sharply since February in the United Kingdom as well as in other markets, though there has been some recovery in recent weeks. Long-term UK government bond yields have risen over the past three months, but corporate bond yields are little changed. The sterling effective exchange rate has appreciated by around 2%.

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

Per cent

			3 months (a)	12 months
Notes and coin (b)	2001	Jan.	11.1	4.5
		Feb.	10.1	8.2
		Mar.	8.2	8.5
		Apr.	4.3	7.8
M4	2000	Q1	8.4	5.4
		Q2	8.8	6.8
		Q3	10.0	9.2
		Q4	5.5	8.2
	2001	Q1	9.4	8.4
M4 lending (c)	2000	Q1	13.4	10.7
		Q2	11.4	11.4
		Q3	14.3	13.1
		Q4	10.7	12.4
	2001	Q1	11.3	11.9

Source: Bank of England.

(a) Annualised.

(b) Growth rates based on an average of weekly observations in the month.

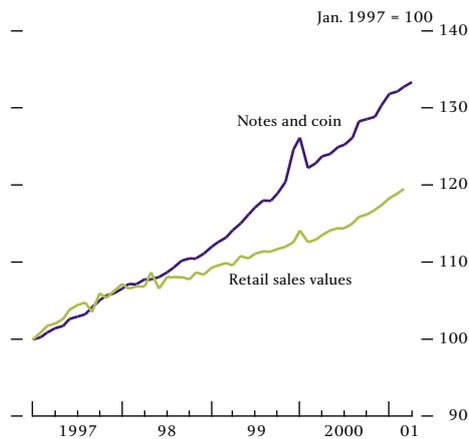
(c) Excluding securitisations.

## 1.1 Money and credit

### Narrow money

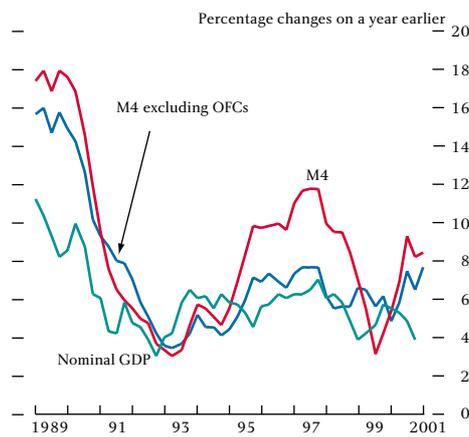
Notes and coin in circulation have increased at a more moderate rate in the past three months (see Table 1.A). But annual growth rates have risen, reflecting the end of downward distortions associated with increased cash holdings around the millennium date change. As notes and coin earn no interest they are primarily held by households for transaction purposes and so may contain information about retail sales trends. Notes and coin have risen more rapidly than retail

**Chart 1.1**  
Levels of notes and coin in circulation and retail sales



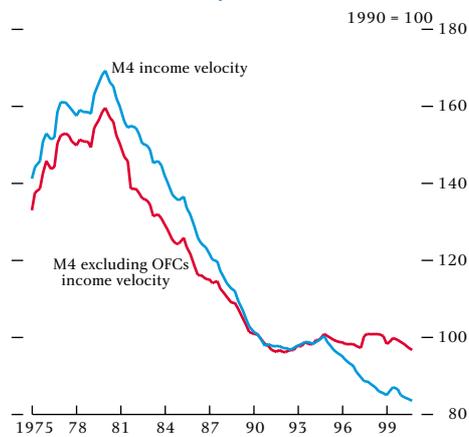
Sources: ONS and Bank of England.

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



Sources: ONS and Bank of England.

**Chart 1.3**  
M4 income velocity<sup>(a)</sup>



Sources: ONS and Bank of England.

(a) Defined as the ratio of nominal GDP to the stock of money.

sales values in recent years (see Chart 1.1), so that narrow money velocity has fallen, partly reflecting the reduction in the opportunity cost of holding money brought about by persistently low nominal interest rates and inflation. The recent easing of growth in notes and coin could partly reflect the transition to a low-inflation environment. But moderating growth in households' cash holdings may also indicate a prospective easing of retail sales growth from recent high rates.

**Broad money and credit**

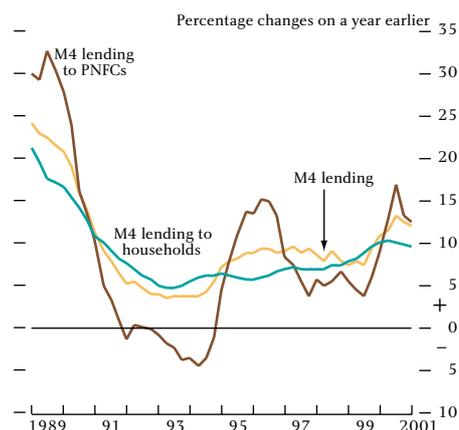
Broad money rose at an annual rate of 8.4% in 2001 Q1, little changed from the previous quarter. Other financial corporations' (OFCs) M4 deposits with the banking sector continued to rise more rapidly than those of households and private non-financial corporations (PNFCs). Growth in broad money excluding OFCs, whose money holdings are volatile, has increased (see Chart 1.2).

The usefulness of broad money measures as indicators of aggregate nominal spending depends on the predictability of the relationship between nominal expenditure and the stock of broad money. M4 has generally outpaced nominal GDP during the past two decades, so that the velocity of circulation of broad money has fallen (see Chart 1.3). In more recent years, that fall has reflected the rapid expansion of OFCs' balance sheets, with increased holdings of money required by OFCs to balance portfolios as equity wealth has risen. And OFCs' deposits are likely to have increased because of the expansion of their financial trading and intermediation business, such as that associated with the increased use by PNFCs of securities-based finance. Excluding OFCs' deposits, M4 velocity has been stable over the past decade.

Continued strong growth rates of broad money could indicate robust future spending growth. The likely relationship with domestic demand depends partly on how the accumulation of money balances differs from long-run holdings. Bank estimates do not suggest an excess of liquidity for households and PNFCs overall, given an estimate of the long-term relationship between deposits and variables such as incomes, wealth and deposit rates.<sup>(1)</sup> PNFCs' deposits have remained little changed in the past two quarters. And households' deposits may have risen recently because of the risk of losses on equities. So the recent rise in broad money growth may partly reflect shifts in the demand for money in asset portfolios, rather than increased short-term spending intentions.

(1) Thomas, R (1997), 'The demand for M4: a sectoral analysis, parts 1 and 2', *Bank of England Working Papers no. 61 and no. 62*, provide the economic framework for these models. Estimates of excess money holdings are subject to a large degree of uncertainty.

**Chart 1.4**  
Growth in M4 lending<sup>(a)</sup>



Source: Bank of England.

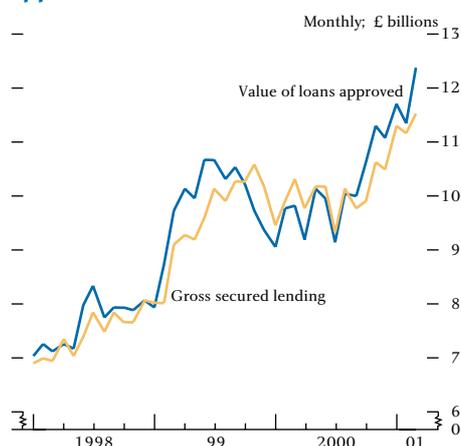
(a) Excluding securitisations.

Credit data may also provide early or corroborative indications of changing demand prospects. UK bank and building society lending to the UK private sector (M4 lending) continued to rise rapidly in 2001 Q1, and at a faster pace than deposits, though the pace of growth eased further from its peak in autumn 2000 (see Chart 1.4). Growth in borrowing by PNFCS and OFCs moderated slightly in the first quarter from high rates. The annual rate of household credit growth remained buoyant, and seems likely to support growth in nominal consumer spending.

### Household sector

Household M4 deposits rose by 7.6% in the year to 2001 Q1, the highest rate since 1997 Q4. That could indicate continued strong consumption growth. But households may have raised deposits for non-transactions purposes. Household deposits have risen in recent quarters from levels below an estimate of the long-run relationship with variables such as income, wealth and deposit rates. That could reflect a lagged adjustment in household deposits in order to rebalance portfolios following earlier rises in equity wealth. And households could have increased precautionary savings because of increased uncertainty about future economic prospects, though that is not supported by reported high levels of households' confidence in their expected financial situation. But households are likely to have increased their holdings of money because of equity price falls and increased uncertainty about future equity returns, linked to the increased volatility of the stock market in recent months. That is consistent with weak sales of retail unit trusts in Q1. So it seems likely that the rise in household money growth partly reflects factors other than plans for short-term consumption expenditure.

**Chart 1.5**  
Secured lending to individuals and loans approved

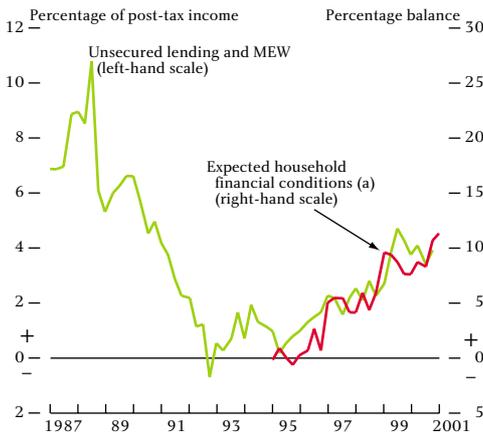


Source: Bank of England.

Total lending to individuals by banks, building societies and other specialist lenders rose by 8.8% in the year to 2001 Q1, a slightly lower rate of growth than in the previous quarter. Within the total, annual unsecured lending growth eased to 11.2% in the first quarter, but annual growth in secured lending, which accounts for some 80% of the outstanding stock of household debt, remained unchanged at 8.2%. Strong secured lending in 2001 Q1 was in line with the earlier rise in mortgage loan approvals. The number and value of loan approvals has risen further (see Chart 1.5), which should support future borrowing. The strength of borrowing is likely to have partly reflected recent falls in official rates, combined with relatively strong competitive pressures in the mortgage market.

The excess of secured lending over investment in housing is known as mortgage equity withdrawal (MEW). Bank estimates suggest that MEW rose to £2.8 billion in 2000 Q4, though it

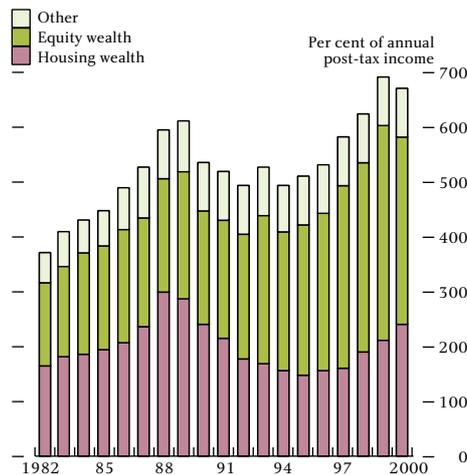
**Chart 1.6**  
**Total lending for consumption and expected household financial conditions**



Sources: ONS, GfK and Bank of England.

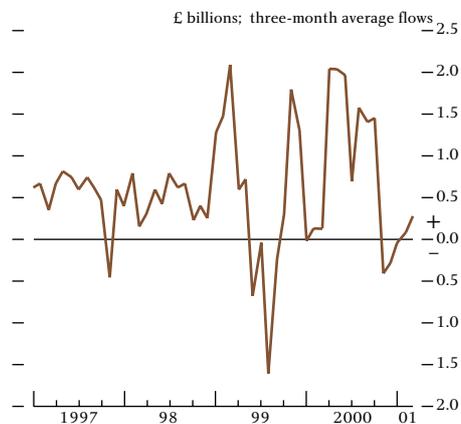
(a) Percentage balance of responses to the question: 'How do you think the financial situation of your household will change over the next twelve months: improve/remains the same/worsen?'

**Chart 1.7**  
**UK household wealth (a)**



(a) Housing wealth is calculated net of mortgage liabilities.

**Chart 1.8**  
**PNFCs' M4**



Source: Bank of England.

remained below levels reached during 1999. Net housing wealth rose in the fourth quarter from a high level, and is likely to support continued equity withdrawal. And recent innovations in mortgage products, such as the introduction of 'current account' mortgages, are likely to lower the costs of housing equity withdrawal further. Bank of England analysis of survey evidence<sup>(1)</sup> confirms that MEW has helped to fund consumption during the past two years.

MEW and unsecured lending together give an indication of the total borrowing available for consumption. Unsecured lending growth has eased from recent very high levels, probably partly reflecting the increased availability and falls in the cost of secured credit. Total borrowing available for consumption has often been closely correlated with households' expectations of their financial situation (see Chart 1.6). According to the GfK survey, households have become more confident of their future financial situation recently despite a weakening of their expectations about general economic prospects.

Households' desired borrowing levels will be affected by their wealth. Household wealth was broadly stable at a high level in 2000 (see Chart 1.7). Household wealth fell markedly in Q1, as the effect of equity price falls on wealth more than offset the effect of house price rises. That is likely to lead households to revise down both desired future consumption levels and the borrowing required to fund those consumption plans (see also [Section 2](#)).

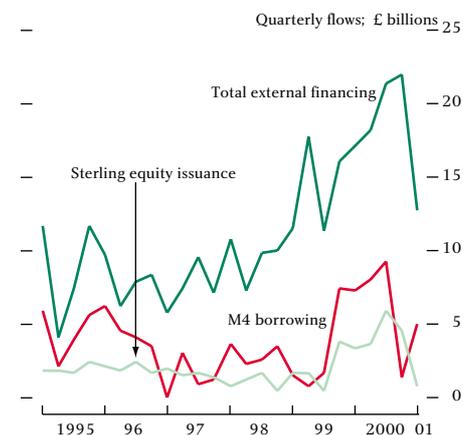
### Private non-financial corporations

PNFCs' deposits may contain forward-looking information about spending intentions, because corporations are likely to build up balances ahead of expenditure on fixed or financial assets. PNFCs' deposit flows have been highly volatile during the past two years or so (see Chart 1.8), partly reflecting high levels of mergers and acquisitions (M&A) activity, and PNFCs' preparations for the millennium date change. The strong rise in PNFCs' deposits growth during mid-2000 preceded stronger investment growth later in the year. But the level of deposits has remained broadly flat in Q4 and Q1, which could indicate a weakening investment outlook, and is consistent with evidence from the BCC survey of a deterioration of corporate cash flow in 2001 Q1.

Annual growth in PNFCs' bank borrowing (excluding securitisations) eased a little in 2001 Q1 to 12.5%, though the flow of borrowing rose after slowing in the fourth quarter. The fall in corporate borrowing flows in Q4 probably partly

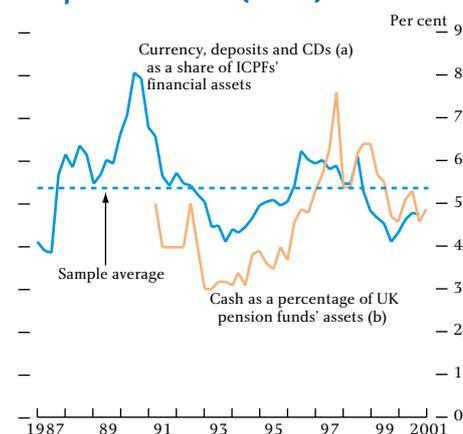
(1) See Davey, M, 'Mortgage equity withdrawal and consumption', *Quarterly Bulletin*, Spring 2001, pages 100-03.

**Chart 1.9**  
**PNFCs' external finance**



Source: Bank of England.

**Chart 1.10**  
**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.

reflected a run-down of inventories and a reduction of dividend payments. The rise in Q1 largely reflected an increase in lending to the services and construction sectors. The manufacturing sector continued to make net repayments of bank debt.

PNFCs have raised substantial funds from UK capital markets in recent years, so that their total external finance has risen markedly above the amount required to fund the difference between capital expenditure and 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. But PNFCs' total external finance was lower in the first quarter, following a fall in equity issuance (Chart 1.9). Share price falls will have reduced the attractiveness of equity finance to firms, other things being equal. And M&A activity slowed in 2001 Q1, which may also have lowered external financing requirements. High levels of external finance and declines in equity prices have increased corporate gearing measures (see Section 2). To the extent that recent equity price falls reflect downward revisions to expectations of corporate profitability, that could lead firms to review the sustainability of high corporate debt levels, and hence to lower future borrowing and investment.

### Other financial corporations

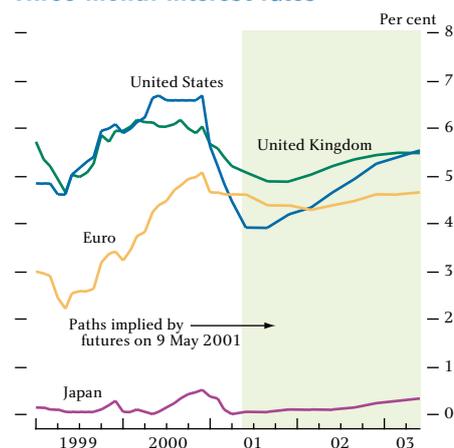
The annual growth rate of OFCs' deposits slowed in the first quarter. OFCs' money holdings are volatile, partly reflecting the financial intermediation and trading activities of some firms, such as securities dealers. Within the OFCs' total, holdings of money by institutional investors, such as insurance company and pension funds (ICPFs), are more likely to contain information about money available to be spent in the economy and on the purchase of financial assets in particular. Annual growth in ICPFs' deposits slowed in the first quarter, but remained positive. Combined with falls in equity prices, that is likely to have raised the cash share of ICPFs' portfolios, a possibility supported by the Merrill Lynch fund manager survey (see Chart 1.10). But that cash share remains at a relatively low level by historical standards, suggesting that ICPFs are not holding excess money balances likely to be spent on other financial assets in the near future.

## 1.2 Interest rates and asset prices

### Short-term interest rates

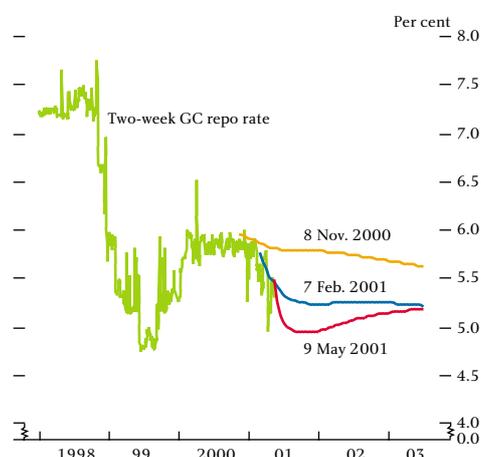
The MPC voted to cut the Bank's official rate by 25 basis points on 5 April. And on 10 May, the MPC voted to reduce the Bank's repo rate by a further 25 basis points to 5.25%. The US Federal Open Market Committee lowered its official

**Chart 1.11**  
**Three-month interest rates**



Sources: Bloomberg, LIFFE and Thomson Financial Datastream.

**Chart 1.12**  
**Two-week forward rates(a)**



Source: Bank of England.

(a) GC repo/gilt forward rates have been adjusted upwards by 15 basis points to reflect the average historical spread between the GC repo rate and the Bank's repo rate.

**Table 1.B**  
**Short-term RPIX inflation expectations(a)**

Per cent	2001			
	Jan.	Feb.	Mar.	Apr.
Consensus Forecasts (b)				
Average 2001	2.2	2.1	1.9	1.9
Average 2002	2.4	2.5	2.2	2.5
HM Treasury survey (c)				
2001 Q4	2.2	2.1	1.9	1.9
2002 Q4	2.4	2.5	2.3	2.3

Sources: Consensus Forecasts, HM Treasury survey of independent forecasters.

(a) Inflation rate expected to prevail during the period.  
(b) Mean of the responses.  
(c) Mean of new forecasts.

**Table 1.C**  
**Changes in ten-year government bond yields between 7 February 2001 and 9 May 2001**

Basis points; spot rates	Government bond yield
United Kingdom	26
United States	3
Euro area	23

Source: Bank of England.

rate by a further 100 basis points to 4.5%, cutting rates by 50 basis points on both 20 March and 18 April. The Bank of Japan has moved from targeting the overnight interest rate to targeting the level of reserves, and as a result the call rate has fallen to virtually zero. The ECB cut rates by 25 basis points on 10 May to 4.5%.

Three-month interest rate futures contracts continue to suggest that market participants expect official interest rates to decline further over the rest of the year in the United Kingdom and major overseas economies (see Chart 1.11). Indeed, market expectations of future short rates at the end of the year have fallen further, though some rebound in rates is expected next year.

The Bank performs the vast majority of its monetary operations through two-week sale and repurchase (repo) agreements. Prices of government bonds and gilt repo rates suggest that market expectations of the two-week interest rate prevailing at the end of the year have fallen by around 25 basis points since the February *Report*, but with little change after two years (see Chart 1.12).

Monetary policy seeks to influence spending by firms and households, and so to control inflation, primarily through its effect on short-term real interest rates. The impact on spending of nominal rate changes thus depends on developments in inflation expectations. Consensus forecasts for UK inflation have fallen since the February *Report* (see Table 1.B), but by less than the decline in short-term nominal interest rates. So short-term real interest rates have fallen during the past three months.

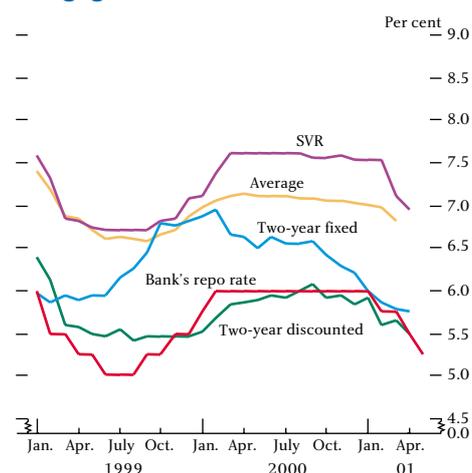
### Long-term interest rates

The average cost of borrowing for households and businesses also depends on longer-term interest rates. Despite lower expected short-term interest rates, long-term government bond yields have risen since February in the United Kingdom and the euro area, though are little changed in the United States (see Table 1.C). That is consistent with recent downward revisions to expectations of world growth and inflation having largely reflected changes in views about short-run prospects.

### Household borrowing rates

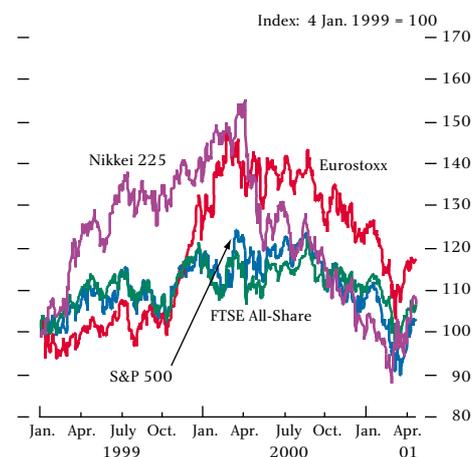
Expectations of future interest rates affect the cost of borrowing by households primarily via their impact on fixed-rate mortgages. Lenders typically set fixed-rate mortgages in relationship to swap rates at maturities in a two to five-year range. These rates have fallen further since the

**Chart 1.13**  
**Mortgage rates**



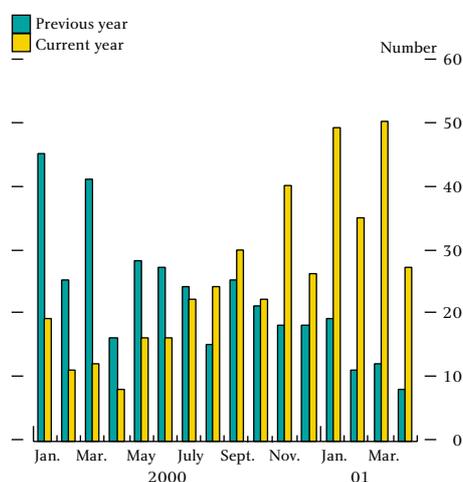
Sources: Bank of England and Moneyfacts.

**Chart 1.14**  
**International equity indices**



Source: Thomson Financial Datastream.

**Chart 1.15**  
**Number of downward profit warnings by UK companies**



Source: Bank of England.

February Report. Rates on most other types of mortgage are more closely linked to current official interest rates. On the data available to April, standard variable rates (SVRs) have fallen by more than the Bank's repo rate since the start of the year, possibly indicating increased competition and, ultimately, lower mortgage costs (see Chart 1.13). But recent cuts in SVRs have also been associated with reductions in discounts available on new variable rate lending, and some discounted products have been withdrawn from the market, so that average mortgage rates fell by only an estimated 19 basis points between January and March (see Chart 1.13). Average mortgage rates are likely to fall further, as more borrowers transfer to the new lower SVRs, and as the recent cuts in the repo rate are passed through.

**Corporate borrowing rates**

The cost of debt to companies depends on perceptions of the risk of default, the risk-free rate, and other factors such as bond market liquidity and inflation risks. Sterling corporate bond issuance is largely undertaken by firms with high credit ratings, for whom the perceived risks of default are likely to be small. That may help to explain why standard measures of sterling corporate yield spreads, measured for those bonds in a given investment grade, have remained relatively stable in recent quarters in the face of equity price falls. In fact, corporate spreads measured this way have fallen a little since the February Report, perhaps indicating a reduction in perceived corporate credit risks. Against that, the number of downgrades of corporate bond credit ratings relative to upgrades has risen in recent quarters. Corporate bond yields are little changed since February, as the decline in credit spreads has been offset by a rise in long-term government bond rates.

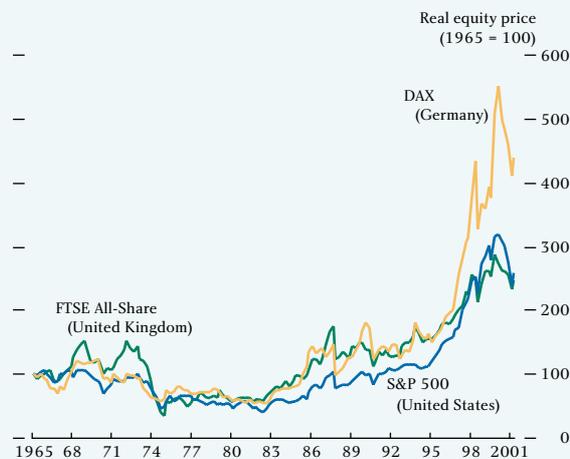
**Equity prices**

The FTSE All-Share index averaged 2831 in the 15 working days to 9 May, about 7% below the central projection made in February for 2001 Q2. Equity prices have also fallen significantly in the United States and euro area (see Chart 1.14), though as in the United Kingdom, they have recovered somewhat following the Federal Reserve's official interest rate cuts. The number of profit warnings issued by UK quoted companies rose to its highest level in the first quarter since the Bank started collecting these data in 1997, though the number fell back somewhat in April (Chart 1.15). Profit warnings also rose in the United States in the first quarter. So recent international equity price declines appear consistent with a further downward revision to investors' expectations of real dividend growth. The [box on pages 10–11](#) looks at recent equity price falls in a historical context, and the economic interpretation of recent declines.

## Recent movements in equity prices

Equity markets fell substantially during the first quarter of 2001, adding to the declines experienced in 2000. Between end-March 2000 and end-March 2001, the FTSE All-Share fell by 13%, the S&P 500 by 23%, and the Eurostoxx by 21%. But these declines have only partly offset the large real equity price increases experienced in the 1990s (see Chart A). And equity prices have recovered somewhat in recent weeks, offsetting part of the first-quarter reduction. Nevertheless, global equity indices remain well below the peaks reached in 2000. This box describes the recent movements and analyses the implications for UK economic prospects.

**Chart A**  
Real equity prices<sup>(a)</sup>



Source: Thomson Financial Datastream.

(a) Real equity prices are measured by deflating each equity index by the appropriate consumer price index.

A substantial part of the fall in the composite indices over the past year reflected an unwinding of the considerable share price increases in the technology, media and telecommunications (TMT) sector that occurred between 1997 and March 2000 (see Chart B). By the end of 2000, the out-performance of these sectors since 1997 had been almost entirely reversed. The falls in 2001 Q1 were more widespread across sectors. Equity indices, including and excluding the TMT sector, are now close to their levels at the start of 1999.

A fall in equity prices may reflect a rise in the excess return required by investors for holding wealth in equity, rather than in other, less risky, assets. In turn, this would increase the cost of equity finance faced by firms. This suggests that, since March 2000, the cost of equity finance has increased for TMT firms. Alternatively, the fall in stock prices may reflect a downward revision to expectations of profit growth. Other things being equal, this would reduce the expected return of a given investment project relative to its installation cost. In either case, the fall in equity prices may have caused firms, particularly in the TMT

sector, to scale back their investment plans. Further, equity price falls will have lowered household wealth. That is likely to lower households' planned consumption.

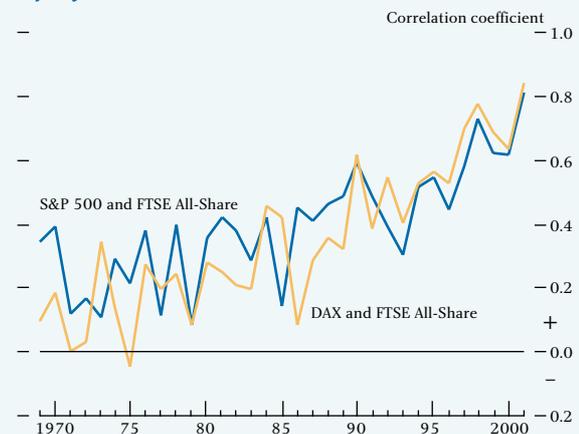
**Chart B**  
US and UK equity indices excluding technology, media and telecommunications (TMT)



Source: Thomson Financial Datastream.

The widespread fall in equity prices is consistent with downward revisions to international growth prospects; Consensus Economics' forecast for US GDP growth in 2001 was 1.7% in early April, down from 3% in December 2000. And these revisions have occurred despite the significant reductions in US interest rates. However, reflecting the differences in economic conditions in the United Kingdom, and in the euro area, revisions to GDP projections and to market expectations of the level of short-term interest rates have been much more moderate. But increasing capital market integration and increased capital flows mean that international equity markets tend to move more closely together than in the past (see Chart C). Trade links have grown over recent decades; and

**Chart C**  
Correlation between UK, US and German equity indices<sup>(a)</sup>



Source: Thomson Financial Datastream.

(a) Correlation between weekly returns on each index, calculated for each year.

overseas direct and portfolio investment by UK firms, and by foreign firms in the United Kingdom, has risen sharply, strengthening the linkages between equity markets.

The MPC has considered the potential downside risks from equity market falls for some time. And one source of information about expected equity price movements is the equity-index options market. Charts D and E show implied volatility for UK and US indices, and a measure of skewness. Implied volatility indicates how much uncertainty, or risk, there is about

**Chart D**  
Implied volatility



Sources: Bank of England, LIFFE and CME.

future equity movements, and skewness indicates where the balance of risks lies. Overall risk for both markets fell sharply after the first Federal Reserve rate cut in January. It then increased as equity markets fell again in March. But it is still lower than in 2000 when the large, mainly TMT sector, declines occurred. The close co-movement of the series indicates that

**Chart E**  
Skewness<sup>(a)</sup>



Sources: Bank of England, LIFFE and CME.

(a) Skewness reflects the balance of risks between a large increase and a large decline in the price. A negative skew indicates that the balance of risks is on the downside relative to the mean.

option market participants perceive uncertainty about the UK market to be closely related to uncertainty about the United States. The balance of risks, represented by the skewness statistic, has become less negative over the past year—but remains on the downside. But the general trend is clear—and not surprising: the more equity markets fall, the less likely future reductions will become relative to future rises.

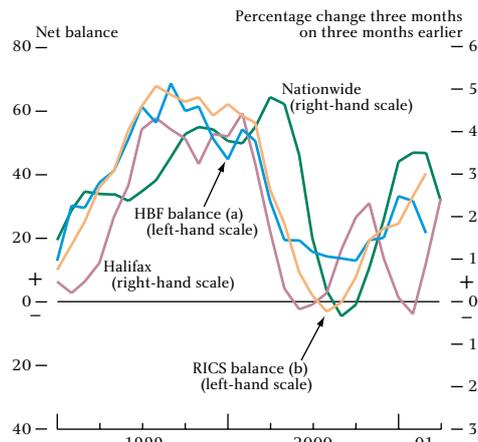
The downside risks, and overall uncertainty perceived by investors in equity markets, are a useful indicator for the MPC. In making its forecasts of future inflation and growth the MPC takes into account precisely these types of risk, not just to equity markets, but also to other key economic variables. As a result the fan chart projections are often asymmetric, depending on the MPC's judgment of the overall balance of risks to the outlook for inflation and growth.

At the time of the February *Report*, equity price falls had been largely concentrated in the technology, media and telecommunications (TMT) sector. Since that time, TMT share prices have declined further and, despite some recent recovery, have mostly reversed their outperformance of the rest of the market between 1997 and early 2000. For the corporate sector overall, equity price falls reduced the market valuation of capital relative to its replacement cost in the second half of 2000, and that decline is likely to have been amplified in 2001 Q1. That is consistent with a weakening in the outlook for corporate investment.

**Property prices**

House prices are a key determinant of personal sector wealth, and affect the ability of households to borrow on a secured basis for consumption. The annual growth rates of the two major house price indices have converged since February. The

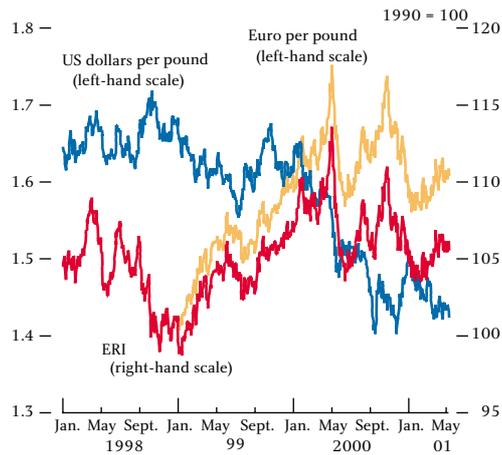
**Chart 1.16**  
**Nationwide and Halifax house price indices and RICS and HBF surveys**



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

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

**Chart 1.17**  
**Selected sterling exchange rates**



Source: Bank of England.

rate of increase in the year to April was 5.7% on the Halifax index and 6.6% on the Nationwide index. And the three-month growth rates of the two series were similar in April (see Chart 1.16). These indices, combined with recent evidence from the Royal Institution of Chartered Surveyors (RICS) and House Builders' Federation (HBF) surveys suggest that house prices continue to rise at a steady rate. Particulars delivered, a measure of completed home sales, have risen to their highest level in six months, and the outlook for housing activity remains positive, supported by rising net reservations of new properties and high levels of loan approvals.

**Exchange rates**

The sterling effective exchange rate index (ERI) has appreciated slightly since the February Report. The 15 working day average of the sterling ERI up to and including 9 May was 105.8, some 2% above the central path assumed in February. Sterling has depreciated against the dollar, by around 2%, but has risen by around 2% against the euro (see Chart 1.17). The euro has fallen by around 4% against the dollar since the February Report.

The rise in the dollar since February has been puzzling, as it has been associated with falls in US growth forecasts and short-term interest rate expectations relative to some of its major trading partners. One possible explanation is that uncertainty about global economic prospects outside the United States has increased since the previous Report. Equity prices in the euro area and Japan have fallen by more than in the United States, as measured from their peaks during 2000 (see Chart 1.14). And while Consensus Economics' growth projections for the United States have fallen further since February, growth projections have also been lowered markedly in other economies—notably in Japan and a number of emerging markets. That may have led global investors to increase their holdings of less risky assets, leading to capital inflows into liquid US markets, supporting the dollar.

But sterling, like the dollar, has appreciated against the euro since the February Report, and sterling short interest rates have fallen relative to the euro area. So part of the fall in the euro is likely to have reflected a rise in the perceived risks of holding euro-denominated assets, relative to those in other currencies.

**1.3 Summary**

Narrow money growth has eased somewhat. Broad money growth remains strong, though below earlier peaks. Aggregate lending growth has eased a little from high levels, with strong household credit growth supported by lower costs of secured

borrowing. Growth in non-financial companies' deposits and borrowing have shown signs of easing. Strong monetary indicators partly reflect higher demand for money in asset portfolios because of lower equity returns and increased volatility of those returns. But robust money and lending data suggest a relatively firm outlook for nominal demand.

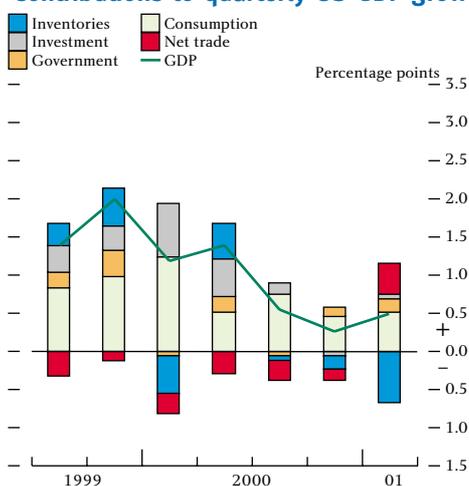
The official interest rate has been reduced by 50 basis points since February, and market expectations of future nominal short rates have fallen further. Equity prices have fallen substantially since the February *Report*. UK government bond yields have risen, though corporate bond yields are little changed. The sterling effective exchange rate has appreciated over the past three months, with appreciation against the euro more than offsetting depreciation against the dollar.

Unusual factors, such as severe weather, disruption to rail services and foot-and-mouth disease, have depressed output in the latest two quarters. Final domestic demand has been less affected, and was stronger than expected in 2000 Q4. Official data suggest that the discrepancy between output and final domestic demand was largely accounted for by a decline in inventories held by firms. Consumption appears to have been robust in Q1. But GDP growth was weaker than expected, as output in the high-technology sectors of manufacturing fell.

The sharp decline in equity prices reduced household net wealth in 2001 Q1, dampening the prospects for consumption. By contrast, business investment in Q4 was much stronger than anticipated in February, and investment intentions have held up. Global trade data available to February indicate little effect from the slowdown in the world economy, but non-EU data for March show a marked decline in exports to the United States. Looking forward, prospects for world activity have weakened further since the February *Report*. That is consistent with the widespread declines in equity prices, and is now becoming apparent in survey measures of orders and business confidence in the United Kingdom.

## 2.1 External demand

**Chart 2.1**  
Contributions to quarterly US GDP growth

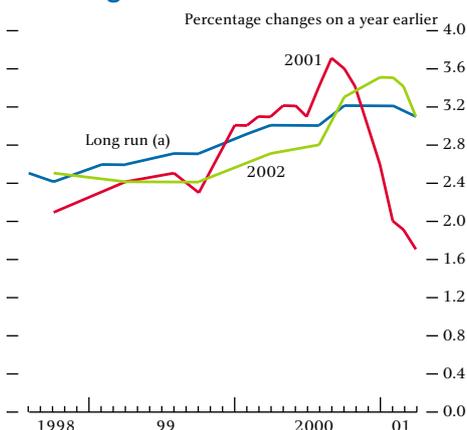


Source: US Bureau of Economic Analysis.

World GDP growth is expected to have slowed further in 2001 Q1. The United States is provisionally estimated to have grown by 0.5%, faster than expected and above growth in 2000 Q4. But that took the annual rate of growth down to 2.7%. The slowdown in activity can mainly be accounted for by weaker corporate expenditure on inventories and capital goods (see Chart 2.1). Growth in household consumption has remained relatively steady. Consensus Economics forecasts of US GDP growth in 2001 have been revised down further, to 1.7% in the April survey (see Chart 2.2), principally reflecting a weakening outlook for investment. The MPC also expects the slowdown to be more protracted than in the February *Report*.

The weaker short-term outlook in the United States is partly associated with the sharp decline in equity prices since the

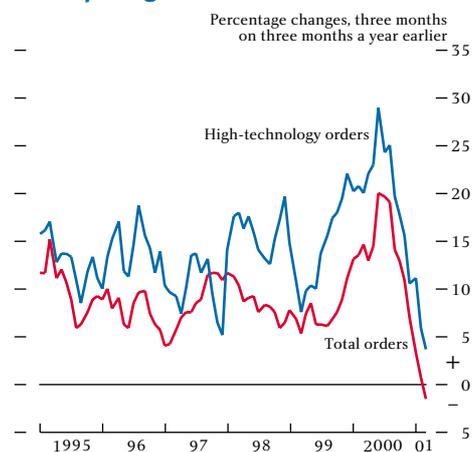
**Chart 2.2**  
**US GDP growth forecasts**



Source: Consensus Economics.

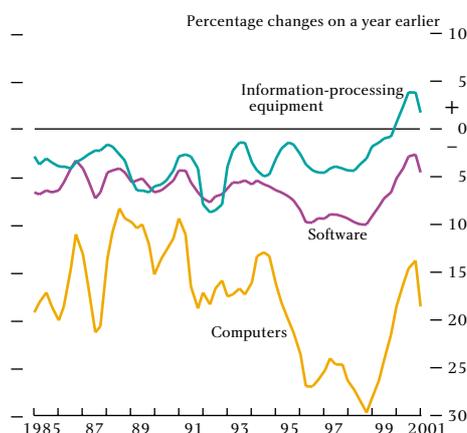
(a) Taken from the special surveys of long-run growth and trends in productivity and wages. The latest observation is the average annual growth rate expected for the period 2007–11.

**Chart 2.3**  
**US capital goods orders**



Source: US Census Bureau.

**Chart 2.4**  
**Relative price of ICT investment in the United States<sup>(a)</sup>**



Source: US Bureau of Economic Analysis.

(a) Relative price is defined as the price of investment goods relative to the GDP deflator, a measure of aggregate prices.

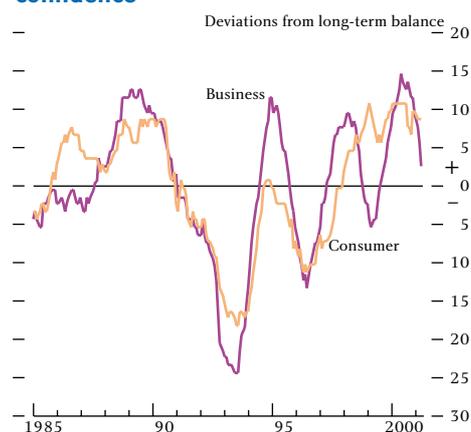
February *Report*. That has reduced the net wealth of the personal sector, which should lead to lower consumption. The unanticipated slowdown in sales growth during the second half of 2000 led to an increase in the business inventory-sales ratio. Industrial production fell sharply around the turn of the year as firms sought to reduce excess inventories, resulting in a marked decline in capacity utilisation. Lower share prices are consistent with lower expected future corporate profitability and/or an increase in risk premia and hence the cost of equity finance. There is also evidence of a tightening in lending criteria. Together these factors have contributed to the decline in capital goods orders (see Chart 2.3) and a weakening in the prospects for investment spending.

A relatively short-lived slowdown is still seen as the most likely outcome, given the significant cuts in official interest rates this year, the planned fiscal expansion, and favourable underlying productivity trends. In the Consensus Economics survey the mean long-run growth forecast has not been revised down significantly since last year, and remains around 0.5 percentage points above its level of two years ago. That suggests that some of the recent increase in productivity growth is perceived to be permanent. But the balance of risks remains on the downside. What happens to underlying productivity growth is central to the nature of the US slowdown. A downward shift in perceptions about future productivity growth would, by affecting expected future labour income and the prospective return on capital, have adverse effects on consumption and investment. Research suggests that around one half of the increase in labour productivity growth in recent years can be accounted for by greater accumulation of ICT capital per worker.<sup>(1)</sup> The incentive to purchase more ICT capital has come from the rapid decline in its relative price, following an increase in the rate of technical progress in the ICT capital-producing industries. This technical progress also contributed directly to the increase in whole-economy labour productivity growth. The relative price of ICT equipment has been falling less rapidly recently (see Chart 2.4), despite the downturn in orders, perhaps indicating a slowdown in the rate of technical progress in the ICT capital-producing industries. The associated slowdown in ICT capital accumulation could reduce productivity growth in the rest of the economy relative to its recent past.

GDP growth in the euro area in 2000 Q4 was close to that projected in the February *Report*, with weaker-than-expected growth in Germany offset by stronger outturns in the other euro-area economies. This year, industrial confidence has

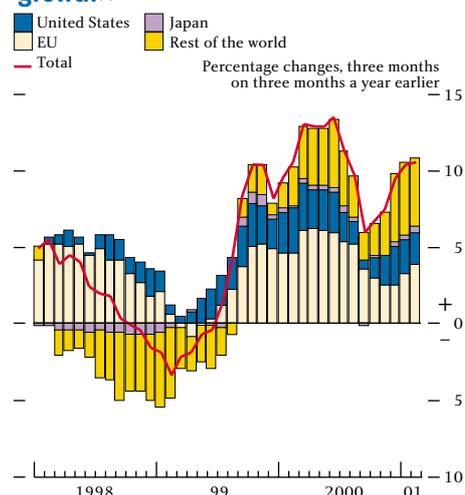
(1) See, for example, Oliner, S and Sichel, D (2000), 'The resurgence of growth in the late 1990s: is information technology the story?', *Journal of Economic Perspectives*.

**Chart 2.5**  
Euro-area business and consumer confidence



Source: European Commission.

**Chart 2.6**  
Contributions to UK goods export volume growth<sup>(a)</sup>



(a) Bank estimates. Volume data are not available on an individual country basis so values have been deflated by aggregate export prices.

**Table 2.A**  
UK export outlook<sup>(a)</sup>

	Series average (b)	2000			2001
		Q2	Q3	Q4	Q1
BCC export orders					
Services	12	14	14	15	8
Manufacturing	8	-7	7	0	1
CIPS export orders (c)					
Manufacturing	49.8	48.8	51.0	50.8	51.1
CBI Industrial Trends					
Export orders	-8	-18	-11	-1	-15
Export optimism	1	-18	-6	7	-16
DHL manufacturing export indicator					
Export confidence, next three months	32	34	34	32	34

Sources: BCC, CIPS, CBI and DHL.

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

weakened from high levels but consumer confidence remains buoyant, despite the decline in equity prices (see Chart 2.5). Households' direct exposure to equity price fluctuations is less in the euro area than in the United States, and consumption should be supported by recent tax cuts in Germany, France, and Italy. But overall, the MPC judges that prospects are a little weaker than expected in February.

The economic outlook for Japan has deteriorated. Growth in household expenditure remains weak despite some recovery in incomes. The higher saving ratio could reflect uncertainty about the effects of further corporate restructuring following the disposal of non-performing loans by the banking sector. Leading indicators of investment, which had been making a larger contribution to growth, have turned down. A counterpart to the decline in capital goods orders by companies in the United States has been a marked deceleration in industrial production and export volumes in Japan and much of the rest of Asia.

Overall, the current *Inflation Report* projections incorporate a weaker near-term outlook for UK trade-weighted export markets than in February. The easing in monetary policy in the major overseas economies should support activity further out. But the balance of risks, principally reflecting prospects in the United States, remains on the downside.

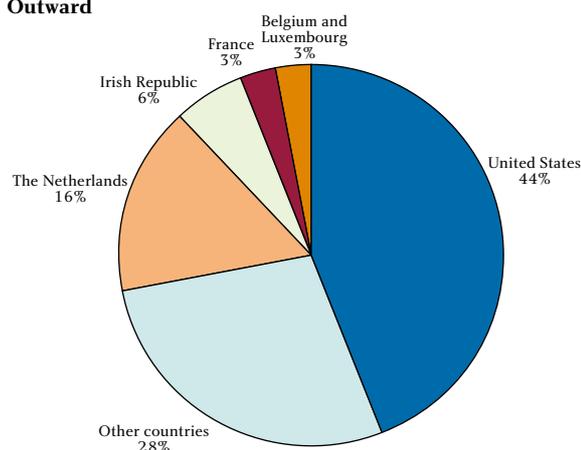
The net trade contribution to UK GDP growth in 2000 Q4 was slightly positive, and UK export volumes have continued to grow relatively quickly this year. Global trade data are available up to February. As shown in Chart 2.6, they do not indicate any appreciable decline in the contribution of the United States to total export volume growth. But in March, for which data are available only on trade outside the EU, there was a sharp decline in the value of exports to the United States. Though monthly trade data are volatile, weaker prospects have become evident in some survey measures of orders and confidence (see Table 2.A), and the sterling effective exchange rate has appreciated slightly since the previous *Report*. So, given the weaker outlook for growth in UK export markets, the MPC expects more moderate export growth than projected in February. Reflecting the relative strength of domestic demand, import volumes rose more quickly than export volumes in 2000. The contribution of net trade to GDP growth is still expected to be negative over the forecast period.

Linkages via trade in goods and services are not the only means by which a slowdown in the United States will affect the United Kingdom.<sup>(1)</sup> The United States accounts for a large share of the stock of inward foreign direct investment in the

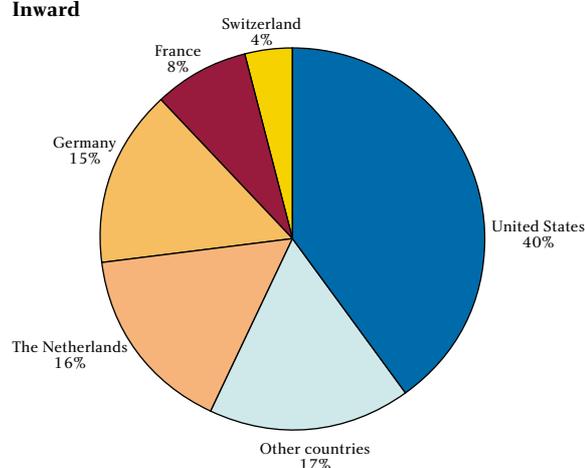
(1) See the box on pages 18 and 19 of the February 2001 *Inflation Report*.

**Chart 2.7**  
**Stock of UK direct investment by country<sup>(a)</sup>**

**Outward**



**Inward**



(a) Shares of total at end-1999. The five largest shares.

**Table 2.B**  
**GDP and expenditure components<sup>(a)</sup>**

Percentage changes on a quarter earlier

	Average for 1999	Average for 2000	2000	
			Q3	Q4
<b>Consumption:</b>				
Households	1.2	0.8	1.2	0.6
Government	1.0	0.7	1.4	0.3
<b>Investment</b>	1.3	0.8	1.2	2.6
of which, business investment	1.3	1.6	2.0	5.2
<b>Final domestic demand:</b>	<b>1.2</b>	<b>0.8</b>	<b>1.2</b>	<b>0.9</b>
Private (b)	1.3	0.8	1.2	1.1
Public (c)	0.7	0.9	1.2	0.4
<b>Change in inventories (d)</b>	-0.2	-0.1	-0.2	-0.7
Excluding alignment adjustment (d)	-0.2	0.1	-0.4	0.2
<b>Domestic demand</b>	<b>1.0</b>	<b>0.7</b>	<b>1.0</b>	<b>0.3</b>
Net trade (d)	-0.3	-0.1	-0.2	0.1
<b>GDP at market prices</b>	<b>0.8</b>	<b>0.6</b>	<b>0.8</b>	<b>0.4</b>

(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 of GDP.

United Kingdom, and similarly the United States is the most important location for UK outward foreign direct investment (see Chart 2.7). Lower profits or expected returns in the United States could lead US firms to cut back investment by their UK subsidiaries. And lower profits from their US operations could constrain investment by UK firms in their domestic market. This is discussed in the section on investment below.

## 2.2 Domestic demand

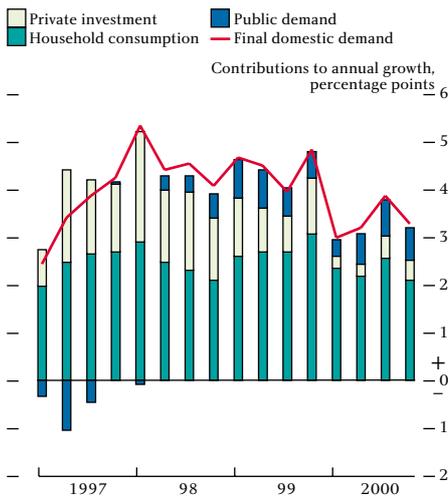
Quarterly output growth has slowed from 0.8% in 2000 Q3 to 0.4% in 2000 Q4, and a provisionally estimated 0.3% in 2001 Q1. Growth in private final domestic expenditure in Q4 was stronger than expected, as a sharp increase in business investment more than offset weaker-than-expected growth in consumption (see Table 2.B). But official estimates suggest that companies fulfilled much of that demand by reducing their inventories of goods. Growth in private final domestic demand has, however, moderated somewhat since 1999 (see Chart 2.8).

### Household sector consumption

Household consumption grew by 0.6% in 2000 Q4, less rapidly than assumed in the February *Report*. The slowdown in consumption growth can be accounted for by weaker consumption of services, partly reflecting the disruption to rail services. Growth in consumption of durable goods has remained relatively strong, so the share of durables in total consumption has been rising more rapidly recently (see Chart 2.9). Durable goods provide a flow of services over time, but durable goods consumption is measured in the National Accounts by spending on new purchases rather than the flow of services they provide. So any small change in the desired flow of services from durable goods could lead to a large change in measured spending. For that reason, movements in the share of durable goods in total spending may be indicative of confidence about future spending prospects.

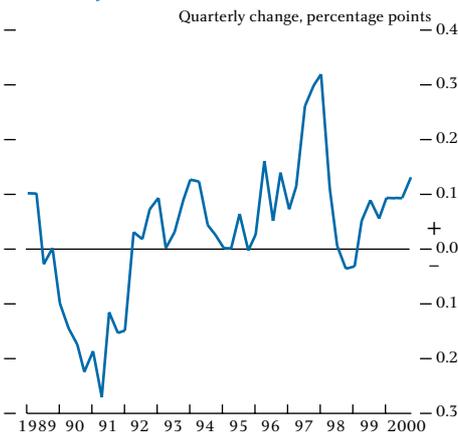
Goods purchased from retailers account for around 40% of total consumer spending, so monthly retail sales data provide an advance indication of the likely strength of consumption in 2001 Q1. Retail sales volumes grew by 1.5% in 2001 Q1 compared with 1.3% in 2000 Q4. Car registrations data indicate that spending on new cars, which is not included in retail sales, also grew more quickly in Q1. Spending on some domestic tourism-related services will have fallen because of restrictions on access to the countryside due to foot-and-mouth disease, but as a result expenditure is likely to have been switched to other goods and services. The possible

**Chart 2.8**  
Final domestic demand<sup>(a)</sup>



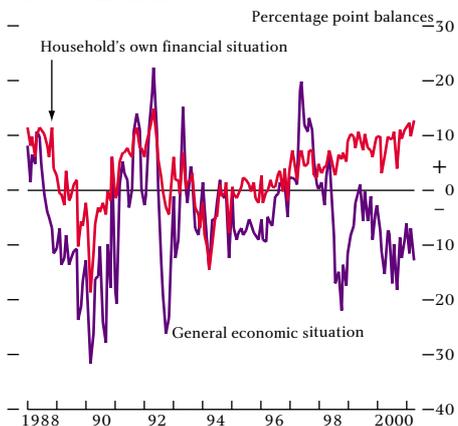
(a) At constant 1995 market prices. Components as defined in Table 2.B. Contributions do not sum exactly to the total as consumption by non-profit institutions and net acquisitions of valuables, which are included in total final domestic demand, are not shown.

**Chart 2.9**  
Share of durable goods in household consumption<sup>(a)</sup>



(a) At constant 1995 market prices. Four-quarter moving average.

**Chart 2.10**  
Consumers' confidence for the next twelve months



Source: GfK.

impact of the foot-and-mouth epidemic on activity and prices is discussed in the [box on page 19](#).

Surveys of consumer sentiment help to indicate the overall strength of consumer spending in the near term, because they are more timely than official data. Households' confidence in their own financial situation over the next twelve months has remained much higher than their confidence in the general economic situation (see Chart 2.10). Confidence in the general economic situation is likely to have been affected by the news about foot-and-mouth disease, the financial effects of which are concentrated on a relatively limited number of households. The continued high level of confidence that households have in their prospective financial situation is consistent with the strength of retail sales in Q1, and the relative strength of expenditure on durable goods mentioned earlier.

At any point in time consumption should reflect households' wealth and their expectations of their lifetime income. Expected future household income is unobservable and is often proxied in economic analysis by current real post-tax income. The February *Report* highlighted the puzzle that household consumption had been stronger than suggested by the historical relationship with these variables. Revisions to data, together with new econometric evidence suggesting a greater role for household wealth, have now largely resolved that puzzle. In Q4 post-tax income rose sharply reflecting higher winter fuel payments to pensioners and property income receipts. Together with the softening in consumption growth, that meant that the saving ratio rose sharply, to 5.5% (see Chart 2.11).

Some portion of the increase in income and hence in the measured saving ratio in Q4 is likely to have been temporary. But household net wealth is estimated to have fallen by almost 5% in 2001 Q1, as the decline in share prices more than offset continuing increases in house prices. That should reduce consumption relative to current income and so increase the rate of saving. In addition, share prices have been more volatile in recent months (see [Section 1](#)). If consumers are more uncertain about the potential future value of their equity holdings, they are likely to increase their saving out of current income and invest more in capital-certain assets. Consumers may also reallocate their existing wealth towards capital-certain assets, and consistent with that, household deposit growth has risen (see [Section 1](#)).

The unexpected decline in household wealth in 2001 Q1, together with weaker-than-expected consumption in 2000 Q4, has led the MPC to revise down the profile for consumption somewhat.

## The impact of foot-and-mouth disease on activity and prices

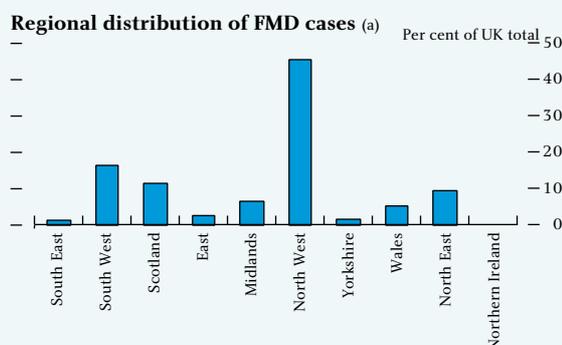
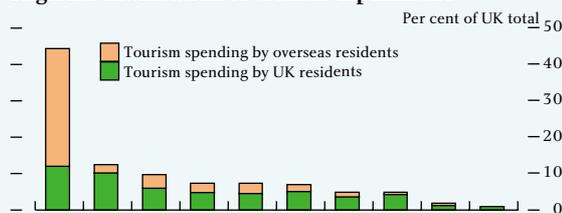
Foot-and-mouth disease (FMD) has had a severe impact on the agricultural sector and tourism in certain regions. This box assesses the impact of FMD on aggregate economic activity and prices.

The direct effect on GDP arising from the loss of livestock is small. That is partly because agricultural output only accounts for around 2% of GDP, and livestock farming alone just 0.5%. In addition, the treatment by the ONS in the National Accounts of the loss of livestock as a one-off catastrophic loss means that the impact on GDP in any quarter is likely to be small. Indeed, official estimates suggest that overall agricultural output rose in 2001 Q1.

The restrictions on access to the countryside are, however, likely to have a net negative impact on demand for tourism-related services. The ONS has indicated that output of the hotels and restaurants sector fell sharply in Q1. Hotels and restaurants account for around 3% of GDP, but other services will also be affected by lower tourist activity. According to the British Tourist Authority, gross spending by tourists, including day trips, is equivalent to around 7% of GDP. The impact on GDP depends importantly on the degree to which planned tourism expenditure in rural areas is switched to spending on tourism in other locations, or is spent on other goods and services. Day trips account for around one half of all tourism spending and such spending is likely to be switched to other goods and services. For longer holidays, some domestic residents will choose to travel abroad rather than in the United Kingdom, and some overseas visitors will be deterred from visiting the United Kingdom. The size of this effect will partly depend on the normal regional pattern of tourism spending. The chart shows that London and the South East account for around 45% of tourism spending (excluding day trips) by domestic and overseas residents in the United Kingdom, and the vast majority of spending by overseas residents. This region is dominated by London where tourism should be less affected by FMD. And according to the International Passenger Survey, around 40% of spending by overseas visitors is accounted for by trips made for business or study reasons, which are unlikely to be affected by foot-and-mouth. The ONS estimates that arrivals for holiday visits in the United Kingdom by overseas residents in March 2001 were only slightly below trend.

Overall, taking account of the direct impact on agriculture and tourism, and on associated businesses, the MPC expects FMD to depress GDP by less than 0.2% in the first half of the year with some recovery in the second half. The impact on regions where agriculture and tourism both make a significant contribution to the local economy, such as Cumbria,

Regional distribution of tourism expenditure



Sources: Regional Trends and Ministry of Agriculture Fisheries and Foods.

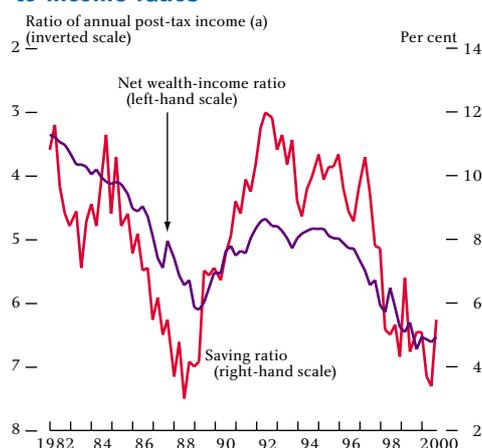
(a) Number of FMD cases as at 9 May. Data for tourism expenditure are for 1998. Note the mapping of tourism regions to standard economic regions is not exact.

Devon, Dumfries and Galloway, will be much greater. Employment in the distribution, hotels and restaurants sector accounts for around 20% of employment in these regions, about the same as for the United Kingdom as a whole. But the agricultural sector accounts for between 3% and 6% of employment in these regions, compared with around 1.5% for the economy as a whole. The impact on affected regions is being mitigated by Government compensation payments to farmers and measures to ease cash-flow constraints in other affected sectors.

The epidemic is also affecting retail prices. FMD has reduced both the supply of and the demand for UK-produced meat. The reduction in domestic supply has been met by increased imports. The need to secure additional supplies from overseas at short notice raised the prices of imported meat by around 20% in March, and the retail price of directly affected meat rose by around 6%. That increase is likely to be temporary as more supply becomes available from overseas and UK livestock production recovers. So the effect of lower domestic meat production on aggregate retail price inflation in the medium term is unlikely to be significant. The indirect effects of FMD, both on businesses further up the supply chain and on tourism, would tend to reduce demand relative to potential supply and hence lead to a slight weakening in aggregate inflationary pressures for a short period.

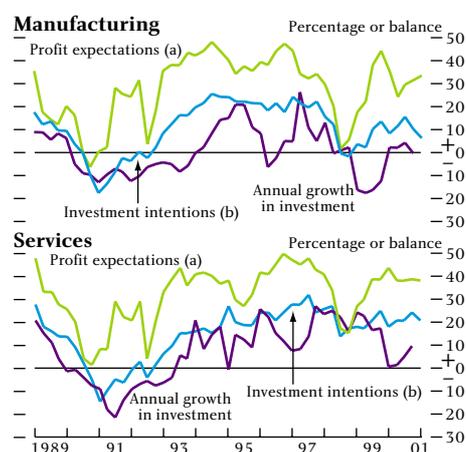
It is possible that, by affecting confidence in the general economic situation, the effects on activity and prices could be more significant in the near term. But they are likely to unwind once the epidemic ends. As a result, the prospects for aggregate output and inflation by the second year of the projection are little affected.

**Chart 2.11**  
Household sector saving and net wealth to income ratios



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

**Chart 2.12**  
Influences on investment



Sources: BCC and ONS.

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

**Table 2.C**  
Survey measures of investment intentions in the service sector<sup>(a)</sup>

Series	Series average (b)	1999		2000		2001
		H2	H1	H2	Q1	
BCC (plant and machinery)	15	23	20	23	21	
CBI/Deloitte & Touche (c)						
Consumer, business and professional services						
Land and buildings	-2	2	2	-7	-13	
Information technology	30	25	20	24	39	
Vehicles, plant and machinery	0	9	-4	4	-18	
CBI/PricewaterhouseCoopers						
Financial services						
Land and buildings	-12	-12	-20	-3	-9	
Information technology	39	36	44	36	26	
Vehicles, plant and machinery	-10	-11	-19	-18	-11	

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) Average of the responses for consumer, business and professional services weighted by value added.

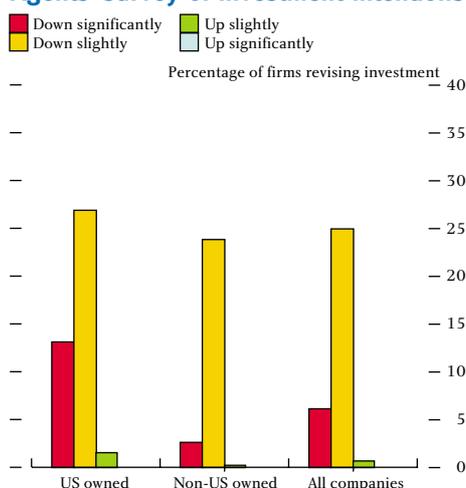
## Private sector investment

Whole-economy investment rose by 2.6% in 2000 Q4, with a much stronger than expected 5.2% increase in business investment. In the February *Report* some weight was put on the hypothesis that business investment during the first three quarters of 2000 had been weaker than expected due to a pause in investment following the millennium date change. The strong recovery in investment in Q4, upward revisions to investment in Q3, and downward revisions to investment earlier in 2000, lend more support to that hypothesis, rather than suggesting a slackening in the underlying demand for capital. The increase in investment in Q4 was accounted for by the service sector (see Chart 2.12), which encompasses three quarters of business investment; particularly the telecommunications, computing, and transport sectors. Surveys of the service sector carried out in February indicated that intentions to invest in ICT equipment remained buoyant (see Table 2.C). But profit warnings issued by companies in the ICT sector suggest that there are downside risks to those intentions. For the service sector as a whole, the BCC survey carried out during March indicated a weakening in cash flow in 2001 Q1, and the EULER Financial Trends survey showed a sharp drop in profitability. Weaker profits in Q1 could partly reflect the temporary effects of foot-and-mouth disease: expectations of future profitability remained high in the BCC survey, which is consistent with the continued strength of investment intentions. However, the more timely CIPS service sector survey for April indicated a decline in the degree of optimism about future business activity, attributed to the potential impact of slower growth in the United States.

Manufacturing investment, which accounts for around 15% of business investment, remains weak, and investment intentions have fallen further. Business optimism fell sharply in the April CBI Quarterly Industrial Trends survey. The divergence between manufacturing and service sector investment trends is likely to reflect a decline in the prospective return on capital in the manufacturing sector relative to that in the service sector. In 2000 Q4 the return on capital in manufacturing was 4.5%, its lowest level since 1993, compared with 15.1% in the service sector.

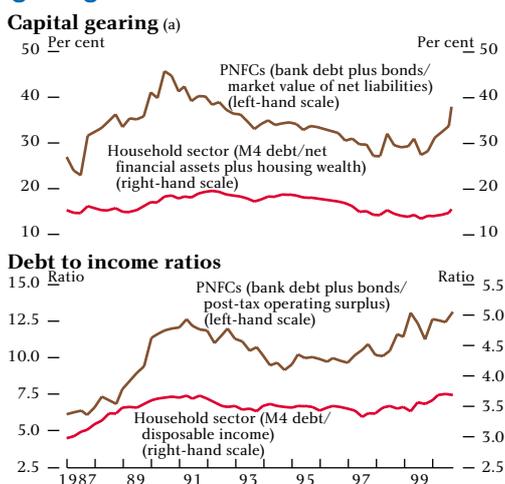
Given the much higher than expected level of business investment in 2000 Q4, the profile for business investment in the near term has been revised up since the February *Report*. But consistent with the decline in share prices and measures of business confidence, growth in investment is projected to weaken over the forecast period. One source of risk on the downside is a sharp reduction in investment by companies with strong links with the United States. A special survey by

**Chart 2.13**  
Agents' survey of investment intentions<sup>(a)</sup>



(a) Survey of 171 firms by the Bank's regional Agents conducted in April. Responses to the question: 'Have expectations of the level of investment been revised as a result of the slowdown in the United States?' Responses are weighted by turnover. Only one company responded 'up significantly'.

**Chart 2.14**  
Measures of corporate and household gearing



Sources: Bank of England and ONS.

(a) Includes an estimate for 2001 Q1 based on lending data and equity and house prices.

the Bank's regional Agents in March found that firms overall had revised down slightly their investment intentions as a result of the slowdown in the United States, and that the downward revisions were more pronounced for US-owned firms (see Chart 2.13). A deterioration in the profitability of US parent companies may have constrained the amount of finance available for investment projects in the United Kingdom, or an increase in their cost of capital may have raised the required rate of return. Moreover, an increase in the level of uncertainty will encourage all firms to delay investment projects, which, once implemented, are difficult to reverse.

Private sector investment in dwellings fell by around 9% in 2000 Q4, partly reflecting severe weather. Leading indicators of housing investment, for example the House Builders' Federation survey of net reservations on new houses, have risen in recent months. So the prospect is for some recovery in housing investment.

A downside risk to both private sector consumption and investment is that a shift in expectations about future labour income and the return on capital leads individuals and corporates to review the sustainability of their levels of indebtedness, and hence reduce their expenditure. Debt-to-income ratios for both sectors are historically high. But asset prices continue to embody relatively rapid expectations of growth in future income. So despite the equity price falls in Q1, measures of capital gearing for both sectors remain below levels reached in the early 1990s (see Chart 2.14). As discussed earlier, survey evidence suggests that consumers remain confident in their financial situation.

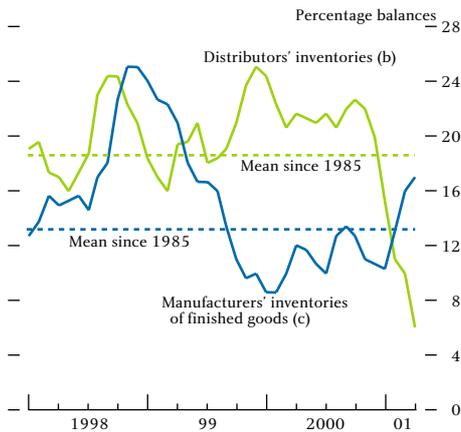
### Public sector demand

Government expenditure on goods and services rose by 0.4% in real terms in 2000 Q4, below the average growth rate during 2000. Government expenditure plans were revised up in the Budget, and assume quite rapid growth in future spending. But revisions to forecasts for revenues, based on past stronger-than-expected outcomes, mean that there has been little change in projected net public sector demand relative to the February Report.

### Inventories

The National Accounts indicate that in 2000 Q4 expenditure on inventories by companies directly surveyed by the ONS contributed positively to GDP growth (see Table 2.B). But together with data on the other expenditure components, that meant that measured aggregate expenditure grew much faster than estimated output in 2000 Q4. To reconcile quarterly growth in the different approaches to measuring GDP, the

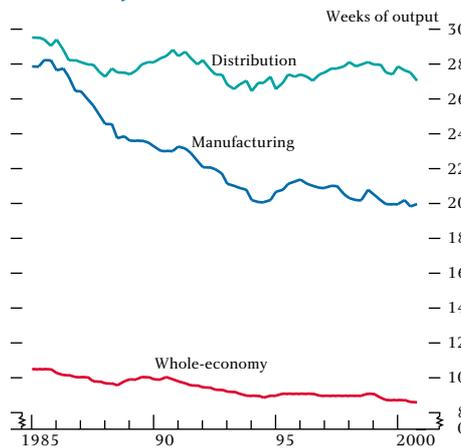
**Chart 2.15**  
**Survey evidence on inventories relative to desired levels<sup>(a)</sup>**



Sources: CBI Industrial Trends and CBI Distributive Trades surveys.

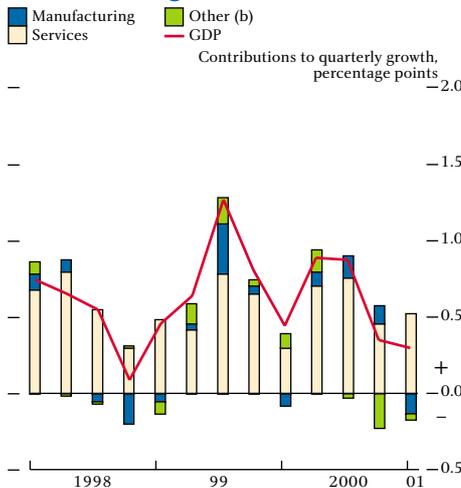
- (a) Three-month moving averages.
- (b) Response to the question: 'What is the position with regard to your volume of stocks in relation to expected sales, high/adequate/low?'
- (c) Response to the question: 'Do you consider that your present stocks of finished goods are more or less than adequate?'

**Chart 2.16**  
**Stock-output ratios<sup>(a)</sup>**



(a) At constant 1995 prices.

**Chart 2.17**  
**Sectoral GDP growth<sup>(a)</sup>**



- (a) Aggregate GDP is shown at constant 1995 market prices but sectoral output is measured at basic prices, so contributions may not add to the total.
- (b) Other includes construction, utilities, mining and quarrying, and agriculture. The contribution has been derived as a residual from the other components of GDP, as data for construction and agricultural output in 2001 Q1 are not yet available.

ONS includes an alignment adjustment in the aggregate measure of inventory investment. Including the alignment adjustment inventories declined, contributing -0.7 percentage points to GDP growth. The alignment adjustment is included in inventory investment because that component of expenditure is less reliably measured than other components. As more information becomes available it is possible that some of the adjustment will be allocated to other components of demand, or that output growth may be revised.

Short-run prospects for inventory investment are very difficult to assess. Firms hold inventories so that production is insulated from unanticipated fluctuations in sales or supplies. The CBI Distributive Trades survey indicates that inventories in the distribution sector have fallen relative to expected demand, following stronger-than-expected retail sales growth since the beginning of the year (see Chart 2.15). But the CBI Industrial Trends survey indicates that manufacturers' inventories have recently become more than adequate, following an unanticipated slowing in demand, so they will be seeking to reduce their inventory levels. Over the medium term, the MPC has maintained its assumption that companies will continue to seek cost savings through improved stock management techniques, and so the stock of inventories to output will continue to decline (see Chart 2.16).

## 2.3 Output

GDP rose by 0.4% in 2000 Q4, revised up slightly from the initial estimate of 0.3%. The previous *Report* highlighted that much of the slowdown in Q4 could be attributed to a decline in output of the more volatile sectors of the economy (see Chart 2.17), and so might be temporary. The preliminary estimate of GDP indicates that output growth in 2001 Q1 was slightly weaker, at 0.3%. Temporary factors have again depressed output: in particular foot-and-mouth disease (see the [box on page 19](#) for details), adverse weather, and continued disruptions to the rail network. But there has also been a decline in manufacturing output associated with the global decline in demand for ICT-related products.

Preliminary estimates suggest that the service sector grew by 0.7% in 2001 Q1, close to its average over the past two years. The ONS has indicated that lower output in the hotels and restaurants sector, which could be associated with the effect on tourism of foot-and-mouth disease, was broadly offset by stronger growth in the business services and finance sector. Looking forward, the March CBI/PricewaterhouseCoopers financial services survey indicated that growth in business volumes in Q2 is expected to be similar to that in Q1, but there has been a sharp drop in business confidence further

## Using surveys to assess service sector activity

The service sector accounts for approximately two thirds of whole-economy GDP. But the detail and timeliness of official data on the service sector are inferior to that for the goods production sector. For example, timely service sector output data are only published once a quarter, for 11 different sectors, whereas industrial production is published monthly for more than 20 industries. So the MPC draws heavily on survey information to improve its assessment of short-term trends in activity. Some survey responses are forward-looking. For example, information on orders in the current quarter can be useful in predicting output in the following quarter. The qualitative information in surveys can be transformed into a quantitative estimate of output, as measured by the ONS, using regression analysis.<sup>(1)</sup> Survey-based estimates of service sector output generated in this way using the BCC and CIPS surveys are shown in the chart.

Such estimates are relatively imprecise, so they are updated as the quarter progresses using information received from the Bank's regional Agents, and monthly official data related indirectly to service sector activity. For example monthly retail sales data can be used to make inferences about the output of the distribution sector. Large differences between past survey-based estimates and outturns, as occurred in 2001 Q1, are also taken into account.

In response to the need for more timely information on service sector activity, the ONS is currently developing a comprehensive monthly measure of service sector output. At present, this experimental

### Survey-based estimates of service sector output



monthly index lags the existing quarterly service sector data. But the ONS is improving its timeliness, and the ultimate aim is for it to be as timely as the monthly index of industrial production.<sup>(2)</sup> Most of the output information collected for the service sector is in current prices. So sector-specific data on prices are required to estimate the volume of services provided. The retail price index covers services sold to consumers, but around half of the output of the service sector derives from business-to-business transactions, or corporate services. The ONS is therefore developing additional indices on corporate services prices.

As the timeliness of the monthly official data improves this will help to complement advance information from surveys in assessing current trends in aggregate GDP.

(1) For a detailed discussion of the quantification of survey data, see Cunningham, A (1997), 'Quantifying survey data', *Quarterly Bulletin*, August, pages 292–300.

(2) See Pike, R and Reed, G, 'Introducing the experimental monthly index of services', *Economic Trends*, December 2000.

**Table 2.D**  
**Service sector output prospects<sup>(a)</sup>**

	Series average (b)	2000 Q5	Q4	2001 Q1
CIPS (c)				
Business expectations, next twelve months	77.4	74.6	75.0	75.1
Incoming business	56.4	56.6	56.7	56.7
BCC home orders, past three months	17	23	31	26
BCC business confidence (turnover), next twelve months	48	52	53	53
EULER order books (c)	65.8	53.7	62.2	49.7
CBI/Deloitte & Touche (d)				
Business optimism	6	11	-11	11
Volume of business, next three months	27	38	25	32
CBI/PricewaterhouseCoopers				
Financial services				
Business optimism	7	3	2	-22
Volume of business, next three months	23	16	22	27

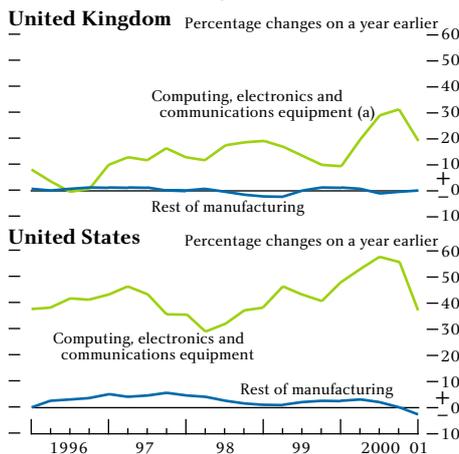
Sources: CIPS, BCC, EULER, CBI/Deloitte & Touche, and CBI/PricewaterhouseCoopers.

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

ahead (see Table 2.D). The negative impact of foot-and-mouth disease on immediate prospects in the service sector has been mentioned in a number of recent surveys. The BCC survey indicated some softening in the growth of new business, the EULER Financial Trends survey showed a sharp drop in the value of order books in Q1, and the April CIPS index of new orders fell sharply to 51.1 compared with the average of 56.7 in Q1. The temporary nature of foot-and-mouth effects is clear from the relative resilience of measures of optimism in the BCC and CIPS surveys. But the April CIPS survey did note some decline in optimism associated with the more persistent effects of the slowdown in the United States. The box above discusses how the MPC uses surveys to inform its assessment of trends in the service sector.

Manufacturing output fell by 0.7% in Q1, as output of the computing, electronics and communications equipment sectors declined by 6.5%. The trend in high-technology

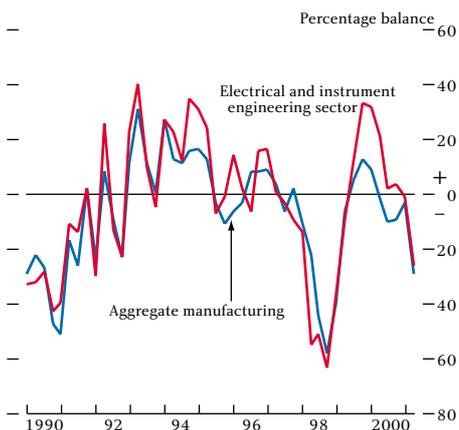
**Chart 2.18**  
**Manufacturing output**



Sources: ONS and US Bureau of Economic Analysis.

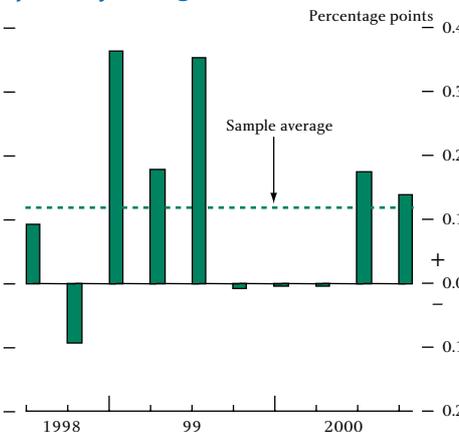
(a) Defined to be broadly comparable with the US computers and communications sector. Includes manufacture of computer, electronics and communications equipment, which together have a weight of 5% in aggregate UK manufacturing output.

**Chart 2.19**  
**Business optimism in the manufacturing sector**



Source: CBI Quarterly Industrial Trends survey.

**Chart 2.20**  
**Revisions to the preliminary estimate of quarterly GDP growth<sup>(a)</sup>**



(a) Shows revisions since the National Accounts moved to the ESA 95 system.

manufacturing output in the United Kingdom is similar to that in the United States (see Chart 2.18). Surveys point to further weakness of overall output. For example, the CIPS new orders index has fallen below the 50 no-change level for the first time since March 1999. The CBI Industrial Trends survey also showed a decline in actual and expected orders, and business optimism fell sharply. Optimism in the electrical and instrument engineering sector, which contains a high proportion of high-technology manufacturing, is at a similar level to that for manufacturing as a whole, though it has fallen much more sharply relative to its level a year ago (see Chart 2.19).

The sectors outside manufacturing and services in aggregate made a less negative contribution to growth than in 2000 Q4. The ONS has indicated that agricultural output rose slightly in 2001 Q1, despite the effects of foot-and-mouth disease: livestock production accounts for only around a quarter of agricultural output, and lower livestock production was offset by higher output in the rest of the agricultural sector. In contrast to indications from surveys, construction output is estimated by the ONS to have fallen. The degree of optimism in the construction sector recorded by the April CIPS survey remains higher than during 2000, suggesting more buoyant prospects.

As in 2000 Q4, estimates of expenditure and survey-based measures of output indicate a stronger picture than the preliminary measure of GDP for Q1. In recent years the initial measure of GDP has been subject to revision, generally in an upward direction (see Chart 2.20). Research by the ONS has confirmed that there has been a significant upward bias to GDP revisions.<sup>(1)</sup>

## 2.4 Summary

Output growth has been a little below trend in each of the latest two quarters. But output has been depressed by temporary factors: unusual weather, rail disruption, and foot-and-mouth disease. That has complicated the assessment of underlying prospects and the interpretation of recent surveys of business and consumer confidence. Final domestic demand growth has been less affected than output. Business investment was much stronger than expected in 2000 Q4 and investment intentions have not weakened much since then, despite the sharp decline in equity prices. The near-term profile for investment is higher than in the February Report. Consumption growth has remained strong. And households

(1) For example, see Symons, P, 'Revisions analysis of initial estimates of annual constant price GDP and its components', *Economic Trends*, March 2001, and Barklem, A, 'Revisions analysis of initial estimates of key economics indicators and GDP components', *Economic Trends*, March 2000.

remain relatively confident about their financial situation over the coming year. But the marked decline in overall net wealth in Q1 has led the MPC to revise down the projections for consumption. Overall, the prospects for private final domestic demand are slightly weaker than in February.

World demand is also projected to be weaker than expected at the time of the February *Report*. That mainly reflects a downward revision to expected growth in the United States following the equity price falls, and evidence that adjustment of the corporate sector to weaker demand may require greater cut-backs in capital expenditure. Weaker global demand for ICT capital goods has contributed to the decline in UK manufacturing output in 2001 Q1. There has also been a marked deterioration in prospects in Japan. The central projection is still for a relatively short-lived slowdown in global activity, with recovery aided by the easing of monetary policy in the major economies. But the risks to world activity remain on the downside.

Prospective UK GDP growth is a little lower than in the February projections. Mainly reflecting the international environment, the risks remain on the downside.

Labour utilisation has increased since the February *Report*. Total hours worked and LFS employment recovered quickly from their pause last autumn, though surveys suggest that underlying growth is slowing. Productivity is growing at a rate close to its average over the past 40 years. And LFS unemployment and the claimant count have fallen further, to new 25-year lows. There are nevertheless some signs that the labour market is stabilising and that skill shortages and recruitment difficulties have levelled off. Though earnings growth has risen substantially according to the latest data, this largely reflects unusual and erratic contributions from bonuses that are unlikely to persist. Moreover, pay settlements have edged up only a little in recent months and growth in unit wage costs remains largely subdued.

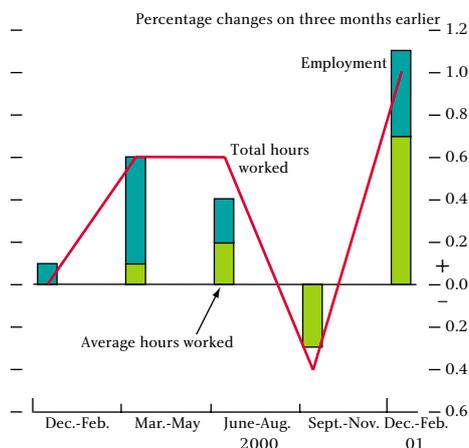
### 3.1 Employment and labour productivity

It seems likely that much of the slowdown in employment growth seen last autumn reflected a series of temporary factors such as the fuel supply interruptions, the rail disruption and severe flooding. Total hours worked, a broad measure of labour usage, rose by 1.0% in the three months to February (see Chart 3.1), following a 0.4% decrease in the three months to November. Average hours worked rose by 0.7% in the three months to February, reversing the decline in the autumn. And numbers employed rose by 113,000 (0.4%), following a small fall in the previous three months.

Recent data are consistent with firms resuming recruitment after an autumn pause and with those who left work for a time (such as those previously in temporary jobs) beginning to return to employment. Working hours may now be reverting to more normal levels after a period in which people worked fewer hours or took more days off. But it is unlikely that the effects of these temporary factors have unwound fully. The rail disruption continued into the New Year. And data released over the coming months will be affected by the foot-and-mouth crisis (discussed in the [box on page 19](#)), which may mean that the underlying trend in employment is still difficult to discern.

Data revisions further complicate the interpretation of employment growth. LFS employment measures the number

**Chart 3.1**  
Growth in LFS employment and hours worked<sup>(a)</sup>



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

**Table 3.A**  
**Components of population change<sup>(a)</sup>**

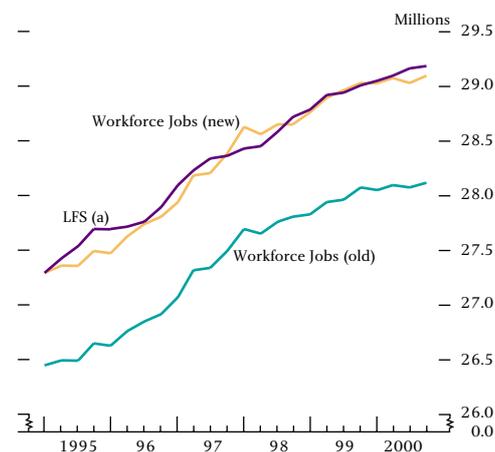
Thousands	Total (b)	of which:	
		Natural change (c)	Net migration
1989–94 (annual average)	207	135	69
1994–95	211	106	108
1995–96	196	77	110
1996–97	207	102	97
1997–98	223	100	115
1998–99	264	76	187

(a) Mid-year to mid-year.

(b) Includes changes in numbers of armed forces plus reconciliation adjustments.

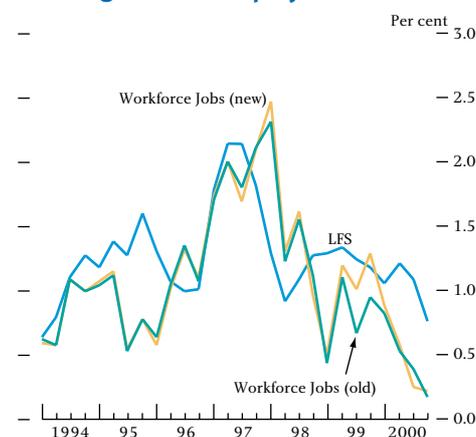
(c) Difference between registered births and registered deaths.

**Chart 3.2**  
**Workforce Jobs and LFS jobs estimate**



(a) All in employment plus number of people with second jobs.

**Chart 3.3**  
**Annual growth in employment**



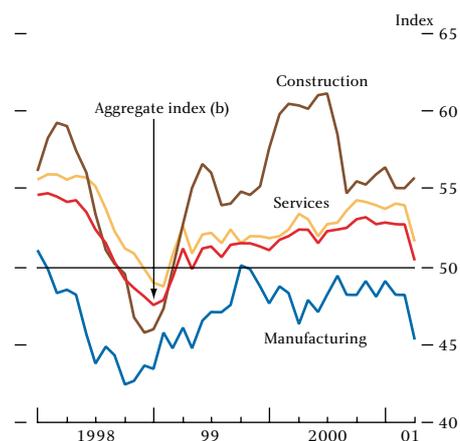
of people in work, based on the responses to a rolling three-month survey of a sample of households. Population data are used to weight or 'gross' individual survey responses to construct economy-wide estimates. Increased net migration has meant that population growth in 1998 and 1999 was greater than originally anticipated by the ONS (see Table 3.A). As a result, its estimate of the level of the population in 1999 and projections for growth since then have been revised upwards. Though LFS data since 2000 Q3 have been based on these new growth rates, they do not yet reflect the higher population level. Furthermore, historical data have not yet been revised to be consistent with the new projections and this has distorted quarterly and annual comparisons spanning the 2000 Q3 period. In preparing its forecast the MPC has as far as possible incorporated both the new population growth rates and estimates of the new population level. Since this leaves key rates (such as the employment and unemployment rates) unaffected, the broad interpretation of the labour market over the past two years is largely unchanged.

The Workforce Jobs measure of employment uses data on the number of jobs collected from a sample of firms on a single day towards the end of each quarter. The latest Labour Market Statistics release included sizable revisions to Workforce Jobs data as the ONS has moved to using a new survey, the Annual Business Inquiry (ABI), as the benchmark for annual information on employee jobs. The ABI has been developed to reduce duplication and increase the consistency across business surveys. Changing the survey has the effect of increasing the estimated level of Workforce Jobs by an average of 3.4% (881,000) since the series began in 1959.

These revisions help to reconcile data on Workforce Jobs with information on the number of jobs taken from the Labour Force Survey (see Chart 3.2). But LFS employment growth has nevertheless been higher than its Workforce Jobs counterpart in recent quarters (see Chart 3.3): the number of Workforce Jobs was 60,000 higher in 2000 Q4 than it had been a year earlier, while LFS employment grew by more than 210,000 over the same period.

While surveys undertaken by employers' organisations and companies suggest that employment has continued to increase in recent months, there is some indication that the growth rate has slowed. The CIPS employment indices for April recorded both a sharp fall in employment growth in the service sector and an increase in the rate of decline of manufacturing employment (see Chart 3.4). Forward-looking indicators also generally suggest a slowing in the pace of growth, particularly

**Chart 3.4**  
CIPS survey employment index<sup>(a)</sup>



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.B**  
Surveys of employment intentions<sup>(a)</sup>

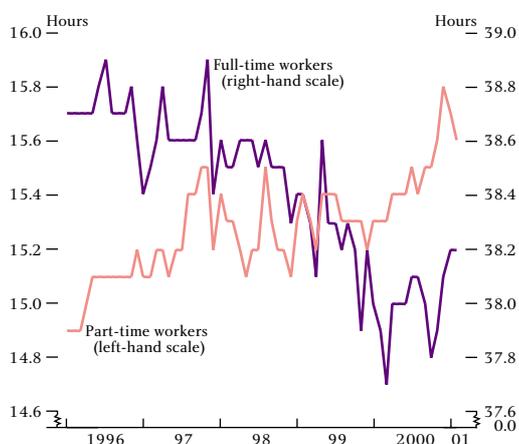
Percentage balance of employers planning to recruit in the next period (b)

Series	Series average (c)	2000				2001
		Q1	Q2	Q3	Q4	Q1
<b>Whole-economy</b>						
Manpower	11	14	14	18	21	19
<b>Services</b>						
BCC	14	25	28	28	29	21
CBI/Deloitte & Touche (d)	21	29	31	32	24	5
Manpower	13	18	16	21	27	23
<b>Manufacturing</b>						
BCC	3	3	11	9	8	11
CBI	-21	-15	-15	-7	-10	-21
Manpower	14	13	11	14	13	14

Sources: BCC, CBI, Deloitte & Touche and Manpower.

- (a) Seasonally adjusted by the Bank.
- (b) Next three months for all series except for CBI: next four months for CBI.
- (c) CBI from 1979; 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**  
Average hours worked per week<sup>(a)</sup>



(a) Main job only.

in the service sector (see Table 3.B), though the outlook for manufacturing is less clear.

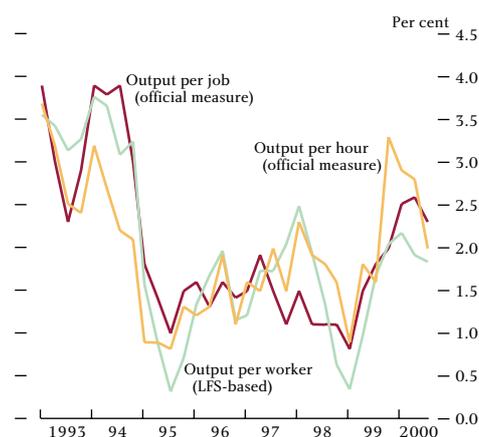
This picture of continued growth in numbers employed has accompanied a recovery in average hours worked, following three years of almost steady decline. Indeed, hours of both full-timers and part-timers have edged up over the past year (see Chart 3.5). This pattern is a break from recent trends, which have seen a gradual upward drift in the average hours worked by part-timers outweighing by falls in the average hours worked by full-timers, who form a larger proportion of the population. Longer part-time hours may represent a response by firms to increased recruitment difficulties. If firms cannot recruit as quickly as they otherwise would wish to, they may instead meet demand by increasing the hours worked by existing staff. This may manifest itself in longer hours worked by part-timers rather than by full-timers, either because of the structure of the affected industry (part-time workers are overwhelmingly concentrated in services), or because full-timers' hours are constrained by the Working Time Directive.

The supply capacity of the economy is boosted by growth in productivity as well as growth in employment. Annual productivity growth now looks to have been at or around its 40-year average in each quarter of last year. The official measure of productivity growth rose by 2.3% in the year to 2000 Q4 (see Chart 3.6). Though the revisions to Workforce Jobs—which forms the employment measure for this series—have lowered the measured level of productivity, the effect on its growth rate has been small. Since mid-1998, this measure has been above estimates of productivity based on LFS employment, largely because the LFS has recently tended to record faster employment growth than the Workforce Jobs measure. Annual growth in the LFS-based measure fell by 0.1 percentage points to 1.8% in 2000 Q4, compared with its long-run average rate of around 2%.

Estimates based on numbers employed can sometimes give a misleading impression of the evolution of productivity growth, since they take no account of changes in hours worked. The ONS has recently introduced an hours-based measure of productivity to help shed light on this. Annual productivity growth on this basis slowed to 2% in 2000 Q4 from a 2000 Q1 peak of more than 3%, as average hours fell more slowly during 2000 than in the previous three years. The Bank's LFS-based estimate of annual growth in output per hour tells a very similar story.

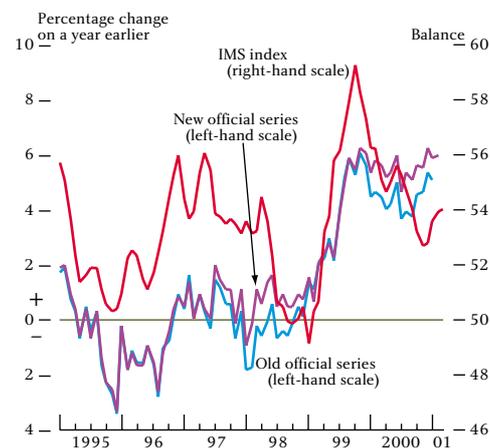
At a sectoral level, it now looks as if annual growth in manufacturing productivity has remained steady over the past 18 months, significantly above its long-run average rate. It had

**Chart 3.6**  
Whole-economy productivity growth



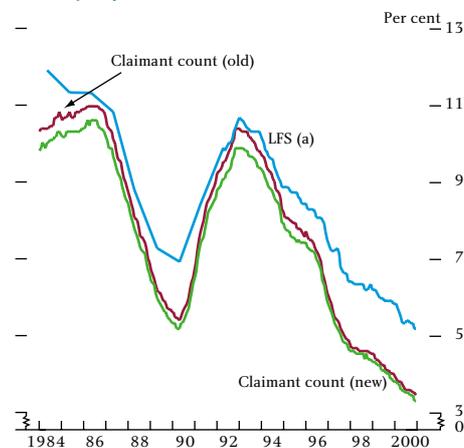
Sources: ONS and Bank of England.

**Chart 3.7**  
Output per filled job in manufacturing



Sources: ONS and Institute of Management Services.

**Chart 3.8**  
Unemployment rates



(a) Backward-looking three-month moving averages. Pre-1995 figures are based upon yearly observations.

previously appeared that growth had slowed from its 1999 Q4 peak but, following the Workforce Jobs revisions, the official measure of manufacturing productivity growth in 2000 has been revised up by up to 1.0 percentage point. Nonetheless, this stability is not reflected in the Institute of Management Services (IMS) survey-based index of manufacturing productivity growth, which fell sharply after a peak in autumn 1999 and has recovered only slightly in the most recent data (see Chart 3.7).

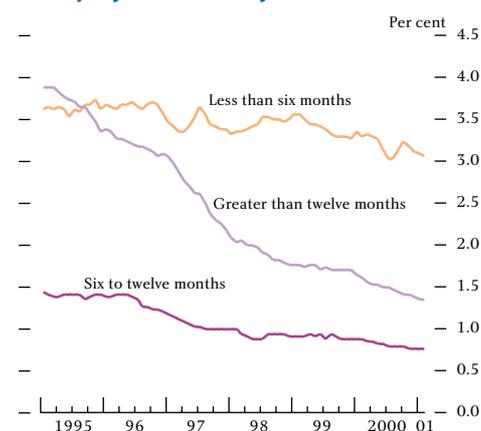
### 3.2 Unemployment and labour availability

The unemployment rate influences pay pressures in the economy through several channels. First, because people who are currently unemployed can potentially satisfy employers' demand for labour, they act as a restraining influence on the pay negotiations of people in work. Second, pay claims may take account of the expected costs of a potential period of unemployment. Such costs typically rise with the unemployment rate, because it then tends to become more difficult to obtain another job. Both of these effects suggest that a higher unemployment rate is usually associated with lower pay pressures.

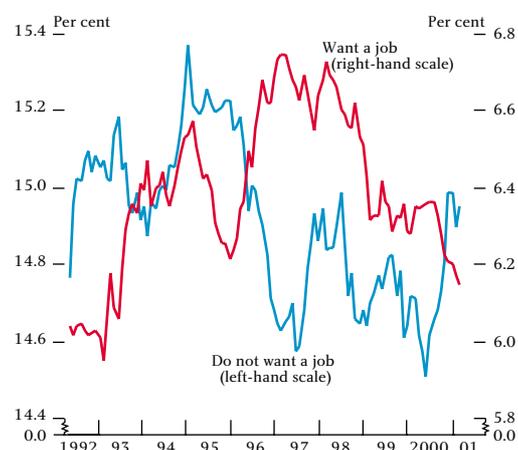
The MPC pays particular attention to the LFS measure of unemployment, which records the number of unemployed people who want a job, are searching for work and are available to start shortly. LFS unemployment has fallen in recent months, more than reversing a slight rise in unemployment recorded in the autumn. These falls reduced the LFS unemployment rate to 5.2%, the lowest rate recorded since the series began in 1984 (see Chart 3.8). The claimant count—a measure based on the number of people receiving unemployment benefits—has also fallen in recent months. The 50,000 decline in the three months to March reduced the claimant count unemployment rate to 3.3%, the lowest rate since September 1975. The denominator of the claimant count unemployment rate is the number of labour market participants, defined as the sum of Workforce Jobs and the claimant count. The recent revisions to Workforce Jobs have led to an average reduction of 0.3 percentage points in the claimant count unemployment rate across the full length of the series, though they do not fundamentally alter the profile.

The effect on pay pressures of a given level of, or change in, unemployment is likely to depend on its composition. Because the short-term unemployed tend to enter employment more easily than the long-term unemployed, they exert a greater restraining influence on pay negotiations. So a fall in short-term unemployment may have more impact on pay pressures than an equivalent decline in long-term unemployment. Long-term unemployment (defined here as

**Chart 3.9**  
Unemployment rate by duration



**Chart 3.10**  
Inactivity rate



**Table 3.C**  
Numbers of inactive who do not want a job, classified by reason<sup>(a)</sup>

	Thousands			Change on a year earlier		
	Summer 2000	Autumn 2000	Winter 2000-01	Summer 2000	Autumn 2000	Winter 2000-01
Looking after family	1,805	1,749	1,770	-65	-10	-15
Long-term sick/disabled	1,637	1,673	1,696	-45	21	54
Students	886	1,197	1,251	-9	71	27
All other reasons	399	396	383	46	66	60

(a) Not seasonally adjusted.

those unemployed for more than twelve months) has been falling since the mid-1990s (see Chart 3.9). The number of those unemployed for less than six months, even allowing for the temporary disruptions of the autumn, has fallen much more slowly. This may have been one contributor to the relatively benign outturns for earnings growth over recent years.

The pool of inactive people—those either not seeking work or not available to start—is another potential source of additional labour supply. Though, like the long-term unemployed, many of the inactive may not enter employment easily, they represent a much larger pool than the unemployed. Moreover the rate at which they become active may be affected by economic conditions and also has a bearing on pay determination.

The inactivity rate has been gradually declining for several years and reached a low of 20.9% in May 2000. Inactivity has, however, increased since then. Much of this may be a result of the temporary factors described in Section 3.1, as some people without jobs who previously declared themselves as looking for work may have stopped searching for a time. But it seems likely that there has indeed been an underlying increase in inactivity since last summer, particularly among those who say they do not want a job (see Chart 3.10).

While in practice some of those who say they do not want a job do in fact move into employment in the subsequent three months, this transition rate is much lower than for other categories of inactivity. Evidence from the Labour Force Survey suggests that, though there have been sizable increases in some of the smaller categories or those who give no information as to their status, the behaviour of students is also important in explaining the recent rise in inactivity. The number of students who do not currently want a job showed an annual increase in both autumn and winter 2000 (see Table 3.C). It remains to be seen whether this increase is temporary or represents an underlying change in behaviour.

The future path of inactivity will be affected by several factors. The currently inactive are more likely to be encouraged to participate if employment continues to grow or earnings growth picks up, because their potential job prospects then improve. And the increased incentives to seek work associated with Government initiatives such as the Working Families Tax Credit and the New Deal will also tend to raise participation. Demographic factors are also likely to play some role, as the gradual ageing of the population will, unless matched by later retirement, lead to a reduction in participation. Other factors affecting participation, such as educational qualification

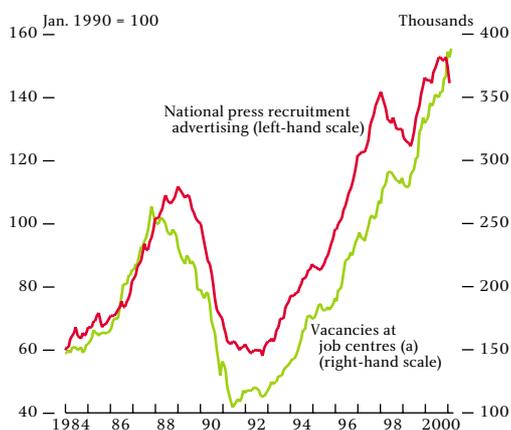
**Table 3.D**  
Surveys of labour availability<sup>(a)</sup>

Series	average (b)	2000				2001
		Q1	Q2	Q3	Q4	Q1
<b>BCC (c)</b>						
Services	50	61	60	66	64	66
Manufacturing	56	70	69	73	71	77
<b>Skilled/professional</b>						
CBI/Deloitte & Touche services (d)	28	29	27	33	33	31
CBI manufacturing (e)	11	14	15	16	19	17
<b>Unskilled/other</b>						
CBI/Deloitte & Touche services (d)	7	11	9	8	12	9
CBI manufacturing (e)	2	3	2	2	4	2

Sources: British Chambers of Commerce, CBI and Deloitte & Touche.

- (a) Seasonally adjusted by the Bank.  
 (b) CBI from 1979; BCC from 1989; CBI/Deloitte & Touche from 1998 Q4.  
 (c) Percentage of firms recording difficulty in recruiting staff over the past three months.  
 (d) Percentage of firms citing labour shortage as a factor likely to limit output over the next twelve months. Unweighted average of consumer services, and business and professional services.  
 (e) Percentage of firms citing labour shortage as a factor likely to limit output over the next four months.

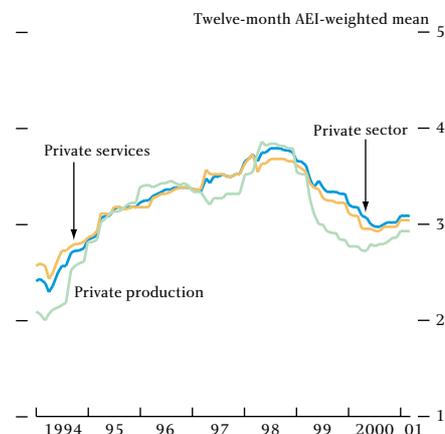
**Chart 3.11**  
Vacancies



Sources: ONS and Recruitment and Employment Confederation.

- (a) Adjusted to allow for the suspension of vacancy data from Northern Ireland and overcounting of unfilled vacancies.

**Chart 3.12**  
Private sector wage settlements



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

levels and the number of long-term sick, are also likely to have important effects on future trends in inactivity. While considerable uncertainty still exists, it remains the MPC's best collective judgment that the participation rate will resume its slow upward trend, albeit from a lower starting-point than previously judged.

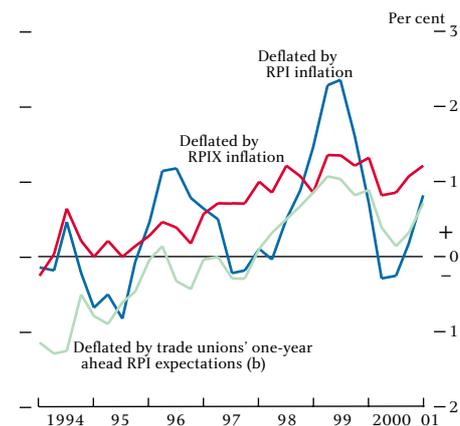
Despite the continued fall in unemployment, there are mixed signals coming from surveys of labour availability. The latest BCC survey reports a slight intensification of recruitment difficulties in both manufacturing and services (see Table 3.D), though the Recruitment and Employment Confederation (REC) reports the availability of agency staff worsening at a slower rate than was the case during the middle of last year. At the same time, both the latest CBI Industrial Trends Survey and the CBI/Deloitte & Touche Service Sector Survey record decreases in the extent to which shortages of all types of labour are limiting output. And contacts of the Bank's regional Agents also report a slight easing of skill shortages in recent months. Moreover, the number of vacancies advertised in the press has fallen back from its peak of last year, though this has yet to be reflected in vacancies at job centres (see Chart 3.11).

### 3.3 Earnings, settlements and unit wage costs

Wage settlements—changes in basic pay received by large groups of workers—remain an important component of earnings growth, despite the growing diversity in the way that firms reward employees. The Bank collects and weights information on settlements from various sources so that it is consistent with the sample of the Average Earnings Index (AEI). The average rate of increase recorded in settlements over the previous twelve months remained unchanged throughout 2001 Q1 at 3.1%. This is slightly higher than the 3.0% figure seen during last summer, but well below the averages for 1999 and the beginning of 2000 (see Chart 3.12). The average settlement taking effect in 2001 Q1 was 3.2%, which is marginally up on rates seen in the middle of last year. But April is a much more important month for settlements (notably because most public sector settlements take effect then), and initial indications are that rates may have picked up a little.

Pay negotiations over the coming months may also be affected by the uprating of the National Minimum Wage (NMW). The adult rate of the NMW is to be increased from £3.70 per hour to £4.10 per hour in October, an 11% increase for those affected. Though research by the Low Pay Commission suggests that the macroeconomic impact of the minimum

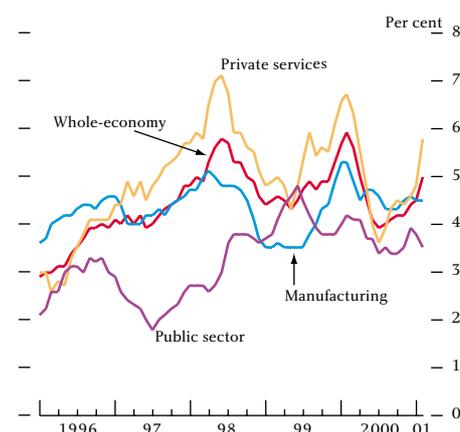
**Chart 3.13**  
Real whole-economy wage settlements<sup>(a)</sup>



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

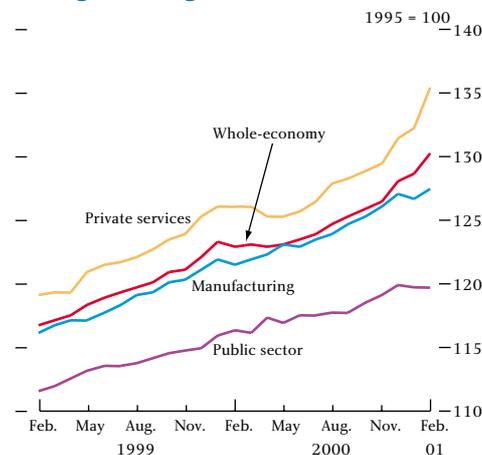
- (a) Twelve-month AEI-weighted mean wage settlement.
- (b) Lagged by one year.

**Chart 3.14**  
Headline growth in nominal earnings<sup>(a)</sup>



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

**Chart 3.15**  
Average Earnings Index



wage so far has been limited,<sup>(1)</sup> it remains unclear how the NMW has affected bargaining. Some employers may regard the uprating process as akin to a settlement for the low-paid, and only review pay rates when obliged to do so. At the same time other employers report that they have already increased their minimum rates in order to recruit and retain staff. And some firms have also reported a certain amount of pressure to restore wage differentials. Taking these factors into account, the Commission estimates that the October increase should lead to a rise in the wage bill of no more than 0.3%. The MPC agrees that the impact is likely to be small.

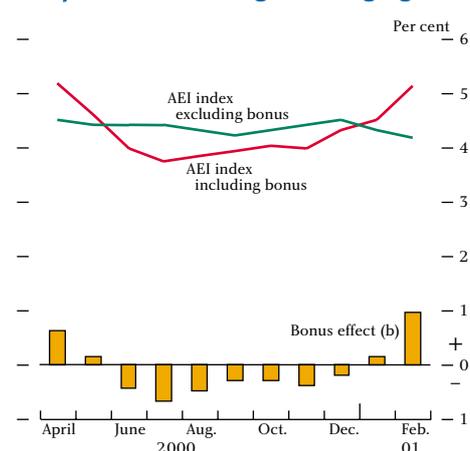
Wage negotiations are also influenced by expectations of inflation. If workers expect inflation to rise, then they will try to bargain for a higher annual increase. Falls in both inflation and inflation expectations over the past six months have not yet been reflected in lower nominal settlements and, as a result, real settlements have picked up somewhat (see Chart 3.13). If inflation expectations remain subdued, then there is reason to believe that there may be little further pressure on overall nominal earnings growth from settlements for the rest of the year.

But not all employees are covered by a company-wide settlement, and those that are will often receive merit increases, overtime payments or bonuses. The Average Earnings Index (AEI) combines these components into a comprehensive measure of pay. Earnings growth as measured by the AEI has been somewhat stronger in recent months than expected by the MPC at the time of the February Report. The AEI headline rate, a three-month moving average of annual earnings growth, rose from 4.4% in December and 4.5% in January to 5.0% in February (see Chart 3.14), the highest rate since March 2000. A sharp pick-up in earnings growth in private sector services drove whole-economy annual earnings growth up to 5.9% in February, 1.6 percentage points higher than the figure for the previous month. Manufacturing pay growth also rose in February, though pay growth in the public sector fell.

For two reasons, however, it is difficult to interpret recent AEI outturns. First, the large millennium-related payments made around the turn of last year distort any annual comparisons made with this period. One way around this problem is to examine the level of the AEI index rather than its annual growth rate. By looking at the levels of both the aggregate and the sectoral indices (Chart 3.15), the extent of the temporary deviation from trend around the millennium is evident. The pick-up in the private sector services' index in recent months is also noticeable.

(1) *The National Minimum Wage: Making a Difference*. Third Report of the Low Pay Commission, Vol. 1, March 2001.

**Chart 3.16**  
**Components of average earnings growth<sup>(a)</sup>**



(a) Three-month moving average, not seasonally adjusted.  
 (b) Percentage points.

**Table 3.E**  
**Components of earnings growth<sup>(a)</sup>**

	Whole-economy		Public sector		Manufacturing		Private sector services	
	Regular pay	Bonus effect (b)	Regular pay	Bonus effect (b)	Regular pay	Bonus effect (b)	Regular pay	Bonus effect (b)
2000								
Sept.	4.2	-0.2	3.4	-0.1	3.8	0.6	4.6	-0.5
Oct.	4.4	-0.5	3.4	-0.1	3.7	0.5	5.2	-1.0
Nov.	4.6	-0.5	3.8	-0.2	4.0	0.6	5.2	-1.0
Dec.	4.6	0.4	3.9	0.6	4.2	0.6	5.0	0.3
2001								
Jan.	3.8	0.6	3.6	-0.2	4.5	-0.8	3.4	1.6
Feb.	4.1	1.9	2.9	-0.2	4.5	0.4	4.3	3.3

(a) Annual percentage changes. Not seasonally adjusted.  
 (b) Percentage points.

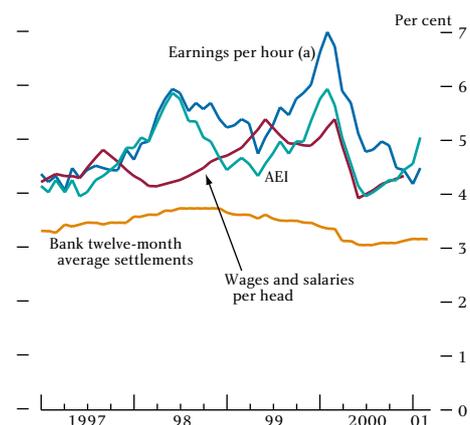
Second, erratic movements in the components of pay also cloud the picture. Though the composition of remuneration can change both across firms and over time, earnings growth can in general be expressed as a combination of growth in regular pay and the contribution from bonus payments (see Chart 3.16). Outturns for regular pay growth have been lower than those for the second half of last year, particularly in private sector services (see Table 3.E). Though regular pay growth for the whole economy rose by 0.3 percentage points to 4.1% in February, this was still 0.5 percentage points lower than the figures for November and December. But the more recent outturns should be treated with caution, as they are likely to have been affected by the millennium payments discussed above.

In contrast, the contribution of bonuses to whole-economy annual earnings growth (seasonally unadjusted) was 1.9 percentage points in February compared with 0.6 percentage points in January, and much higher than the negative contributions seen during the second half of last year (see Table 3.E). Within this, the private sector services bonus contribution doubled between January and February to 3.3 percentage points. Changes in the timing of bonus payments by a small number of firms in the financial services sector who paid substantially larger bonuses this year than last were responsible for much of this increase in the bonus contribution. Indeed firms which this year brought forward their bonus payments from March into February contributed 1.5 percentage points to whole-economy annual earnings growth in the year to February, with an offsetting effect on earnings growth likely to occur in March. The 'true' headline rate for February, which averages annual earnings growth across December, January and February, is therefore probably closer to 4.5% than the published figure of 5.0%. Looking forward, the CBI/PricewaterhouseCoopers survey indicates that business optimism in financial services has fallen sharply (see Section 2), so such large bonus contributions from this sector are unlikely to persist.

Other evidence on pay comes from the latest REC survey, which covers the segment of the market using recruitment and placement agencies. That indicates that growth in salaries for agency workers edged down further in recent months, although rates of increase are still above those seen during 1999.

Earnings per hour worked provide another perspective on pay developments. The Bank's estimate of annual growth in earnings per hour shows little of the recent increase seen in the AEI; indeed, it has fallen below the rate of growth in earnings per head for the first time since early 1998 (see

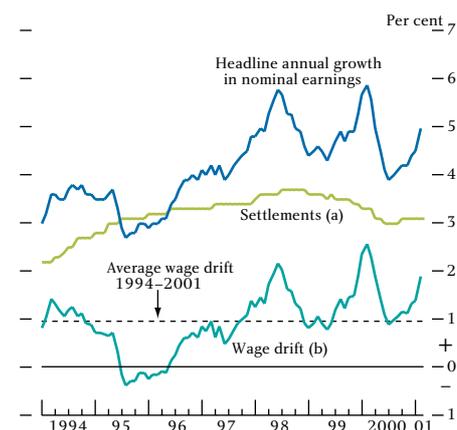
**Chart 3.17**  
Alternative indicators of pay



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

(a) Bank estimate.

**Chart 3.18**  
Settlements, nominal earnings growth and wage drift



Sources: ONS, Bank of England and Industrial Relations Services (IRS).

(a) Based on IRS data until 1994, then Bank of England, which draws on information from the CBI, Incomes Data Services, Industrial Relations Services, Labour Research Department and the Bank's regional Agents.  
(b) Differences between earnings growth and settlements.

Chart 3.17). Though bonus payments to salaried workers may be linked to hours worked over and above those contracted, increases in hours are more likely to be reflected in regular pay. It is hard therefore to draw a direct link between the latest outturns for average hours and the AEI. In any case, average hours are not measured with great precision and recent data on hours may still be affected by the temporary disruptions outlined in [Section 3.1](#).

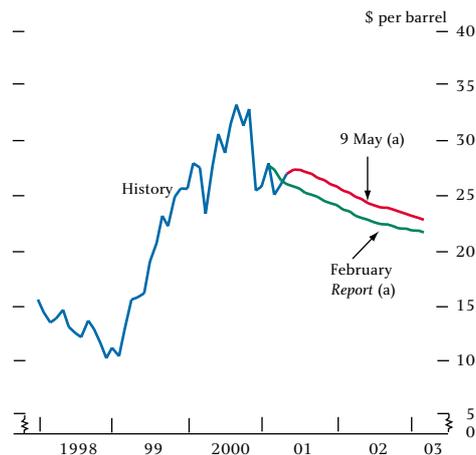
The portion of aggregate earnings growth not accounted for by settlements is often referred to as wage drift. Wage drift includes factors such as changes in overtime payments, bonuses, profit-related pay, individual merit awards, and compositional changes in the workforce. The combination of rising earnings growth and unchanged settlements since the middle of last year—even allowing for possible erratic factors in recent outturns—means that the decline in wage drift apparent since the end of 1999 has reversed in recent months (see Chart 3.18).

The small increase in wages and salaries growth in the National Accounts in Q4 coupled with a slowdown in output growth meant that the official measure of annual growth in nominal unit wage costs was 1.7%, 0.1 percentage points higher than in Q3. Alternatively one can construct an estimate of unit labour costs that uses LFS employment and the AEI to proxy the pay bill. This measure is growing at a slightly faster rate, but the profiles of the two series are similar. At a sectoral level, though, manufacturing unit wage costs have fallen in recent years. Labour and other costs of production are considered more fully in [Section 4](#).

### 3.4 Summary

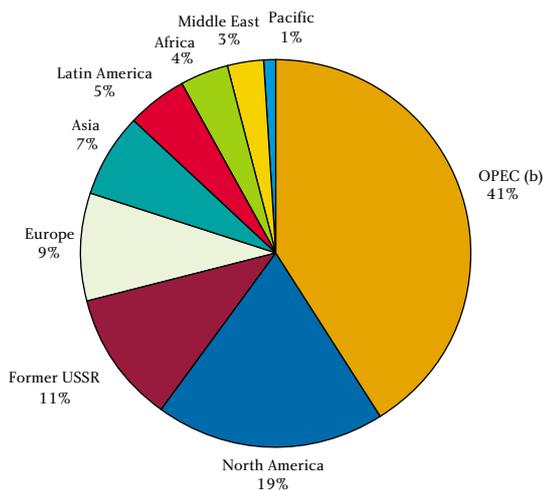
Following its pause in the autumn, employment growth has resumed and unemployment has continued to fall—to its lowest rate for over 25 years. Surveys suggest that employment may continue to grow, though perhaps at a slower rate. Some other indicators suggest that labour market may be near a turning point. There are tentative signs that recruitment difficulties may be stabilising and that the number of vacancies advertised in the press has turned down. And though headline earnings growth has increased sharply, the data are clouded by a number of erratic factors that have amplified recent outturns. Other indicators suggest that pay pressures remain quite muted. The rate of settlements has increased only slightly in the past six months. And annual growth in earnings per hour has fallen back from recent peaks. Furthermore, labour productivity seems to be growing at or around trend rates and growth in unit labour costs, though increasing, remains relatively subdued.

**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**  
**Sources of world crude oil supply<sup>(a)</sup>**



Source: International Energy Agency.

- (a) Shares are averages for 2000.
- (b) OPEC's share includes Iraq, whose production (5.4% of global supply) is not included in OPEC quotas.

Oil prices have changed little in recent months, while prices of other commodities have continued to fall. Previous declines in oil prices, together with falls in manufacturing unit wage costs, have reduced cost pressures in manufacturing. Manufacturing output price inflation has also slowed and survey measures of price expectations have fallen back. While service sector input price inflation shows signs of slowing, labour cost pressures there have risen. Service sector output price inflation rose further in Q4, but more recent evidence on the trend is mixed. Foot-and-mouth disease affected prices in March, and may continue to do so in the short term. RPIX inflation edged down to 1.9% in Q1, remaining below the Government's 2<sup>1</sup>/<sub>2</sub>% target.

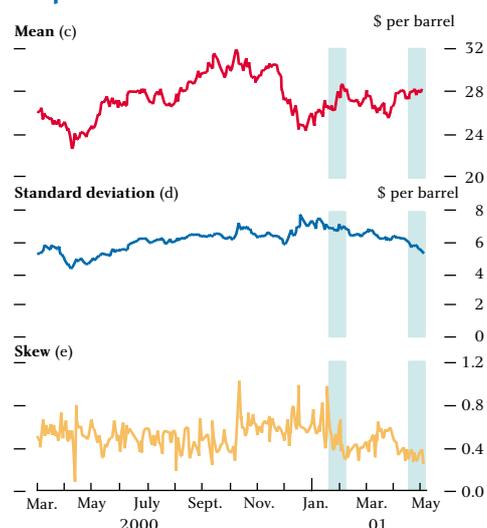
## 4.1 Raw materials and commodity prices

Oil prices have changed little on average since the February Report, whereas a small decline had been expected (see Chart 4.1). Oil prices fell somewhat after mid-February but edged back up in April. That rise was accompanied by an upward revision to market participants' mean expectation of oil prices for the next two years—the basis of the MPC's central projection—to \$1–\$2 per barrel above expectations at the time of the February Report. Oil prices are, however, still expected to decline.

The fall in oil prices in February and March probably reflected the prospect of lower world oil demand growth associated with slower global GDP growth. Consistent with this, the International Energy Agency (IEA) has revised down its projections of world oil demand growth in 2001 by around half a percentage point since the publication of the February Report. The subsequent rise in oil prices seems likely to be linked to the further cut in OPEC oil production quotas in April,<sup>(1)</sup> although IEA data show that OPEC production has fallen by less than intended. Moreover, OPEC accounts for less than half of global oil supply (see Chart 4.2) and OPEC production cuts this year have been partly offset by increased output of other producers. Market commentators have

(1) OPEC oil production quotas were cut by 1 million barrels a day with effect from 1 April, when a small cut by Mexico was also implemented. These cuts followed OPEC's 1.5 million barrels a day quota cut in February.

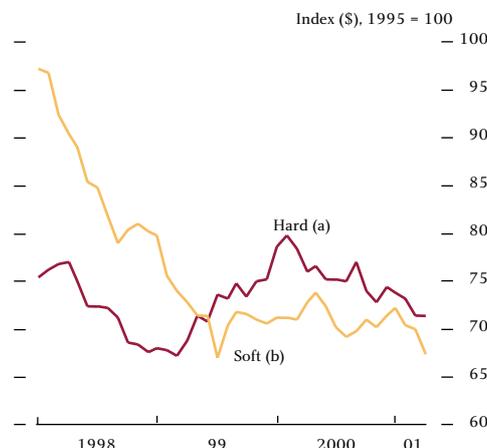
**Chart 4.3**  
**Information from option prices about the oil price six months ahead** (a)(b)



Sources: NYMEX and Bank of England.

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

**Chart 4.4**  
**Hard and soft commodity prices**



- (a) *The Economist* industrial commodity price index.
- (b) *The Economist* food commodity price index.

suggested that concerns about the low stocks of oil and pressures on global oil refining capacity also contributed to the oil price rise in April.

Market uncertainty about the path of oil prices, as measured by the standard deviation of the distribution for oil prices implied by option contracts, has fallen slightly since the time of the February *Report* (see Chart 4.3). The balance of risks has become slightly less skewed towards price rises.

World prices of ‘hard’ commodities (metals and non-food agricultural goods) have continued to fall in recent months (see Chart 4.4). This probably also partly reflects the downward reappraisal of world growth prospects, although the fact that prices have been falling for more than a year suggests that changing supply conditions have played some additional role. World prices of ‘soft’ commodities (food products) have fallen in recent months, after being relatively flat for more than a year. Soft commodity prices are less affected by fluctuations in demand conditions than hard commodity prices. So their recent falls seem more likely mainly to reflect supply factors.

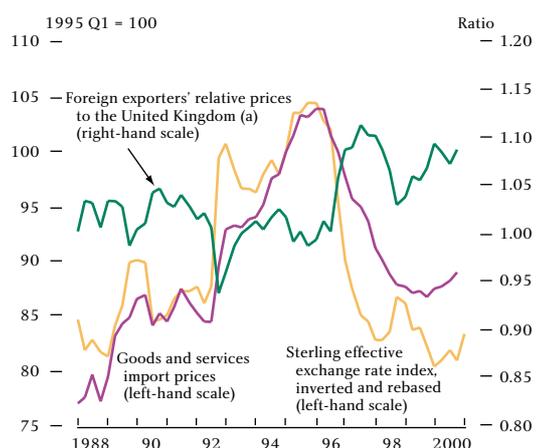
## 4.2 Import prices and the exchange rate

Import prices affect short-term inflationary pressures in the UK economy through several channels. First, they affect UK producers’ costs, which can then feed through to retail prices. Second, changes in the prices of imported consumer goods directly affect retail prices. Third, where imports are close substitutes for home-produced goods the price-setting behaviour of UK producers and retailers will tend to be affected by import price movements, although some foreign exporters are also likely to ‘price to market’—setting their sterling prices close to prevailing ones.

Sterling import prices of goods and services have been rising gently since the end of 1999—they were 2.6% higher than a year earlier in 2000 Q4 (see Chart 4.5). These rises follow the sharp falls in import prices between 1996 and 1999 that accompanied the appreciation of sterling.

As well as being affected by exchange rate movements, sterling import prices are determined by average world export prices in local currencies and the profit margin on overseas sales to the United Kingdom relative to sales in other markets. Previous *Reports* have discussed how the relative profitability of sales to the United Kingdom has increased in recent years. That may partly have reflected a perception that sterling’s appreciation, and hence the gains to foreign exporters from switching supplies to UK markets, would be short-lived. The MPC has maintained the assumption that foreign exporters’ profitability

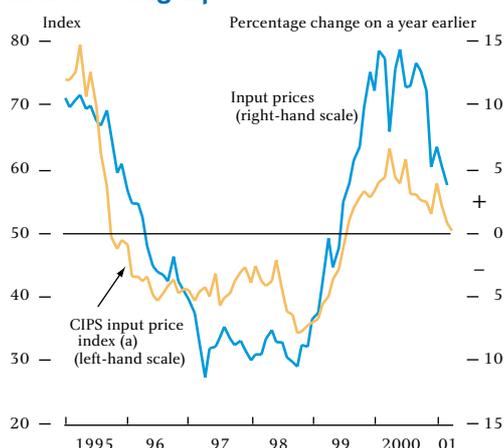
**Chart 4.5**  
**Foreign exporters' relative prices to the United Kingdom and the exchange rate**



Sources: ONS and Bank of England.

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

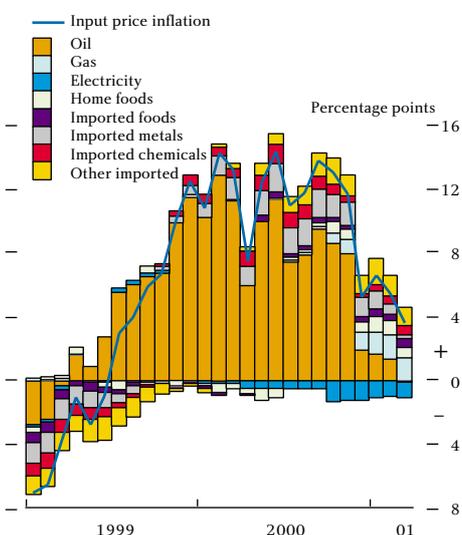
**Chart 4.6**  
**Manufacturing input costs**



Sources: ONS and CIPS.

(a) Input prices compared with the previous month. More than (less than) 50 suggests that input prices are rising (falling).

**Chart 4.7**  
**Contributions to annual producer input price inflation**



on sales to the United Kingdom relative to sales elsewhere will be gradually compressed, as competitive pressures erode any unusual profits. That relative margin, however, rose slightly in Q4—the 1.0% rise in sterling import prices contrasts with the small fall implied by exchange rate and world export price movements.

### 4.3 Costs and prices in manufacturing

Developments in manufacturing output prices provide information about short-term pressures on retail goods prices. The immediate prospect for manufacturing output prices is in turn heavily influenced by developments in manufacturers' costs, although the ability of manufacturers to determine their output prices is also constrained by the extent of competitive pressures in the markets for their products. And firms have incentives not to pass on fully cost increases they perceive to be temporary—for example because of the costs of changing prices or their desire to maintain long-term relationships with customers.

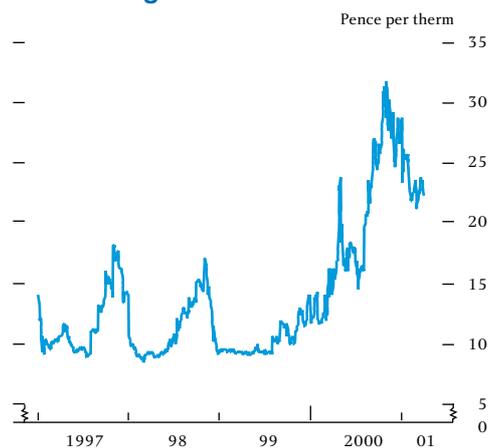
Materials and fuels account for around 30% of manufacturers' costs. Manufacturing materials and fuels input price inflation has fallen sharply in recent months (see Chart 4.6). The 3.7% annual inflation rate in March was the lowest since July 1999 and compares with a recent peak of more than 14% in June 2000. The CIPS survey also indicates a slowing of manufacturing input cost inflation, with the April observation suggesting only marginally rising input prices (see Chart 4.6). By contrast, the Q1 BCC survey continued to report a historically high balance of manufacturers citing raw material costs as putting upward pressure on prices.

Chart 4.7 shows that oil price movements were the main source of both the pick-up in input price inflation from 1999 and the slowdown in recent months.<sup>(1)</sup> Gas prices have also made a significant contribution to input price inflation over the past six months, reflecting the doubling of wholesale prices in 2000 (see Chart 4.8). The fall in wholesale gas prices in recent months, however, means that the contribution of gas prices to input price inflation seems likely to fall, although the pattern of contract renewals will affect the extent and timing.

Producer input prices are likely to be affected in the short term by the foot-and-mouth epidemic. The **box on page 19** discusses the main channels. The price of home-produced animals ('farmgate' prices) fell by 1.4% in March, indicating that demand contraction effects—reflecting the closure of slaughterhouses and the ban on exports—outweighed the

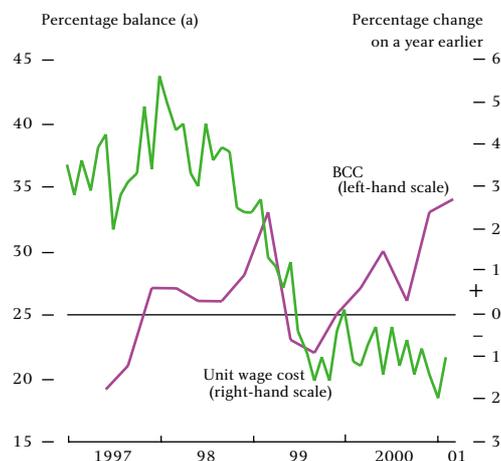
(1) The contribution of a particular component to input price inflation depends on its relative importance in manufacturers' costs and on the change in its price over the previous twelve months.

**Chart 4.8**  
**One-month gas futures**



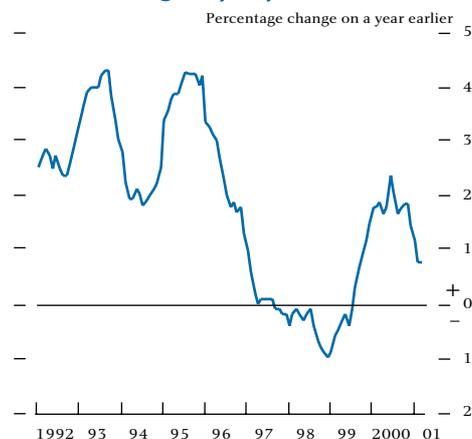
Source: International Petroleum Exchange.

**Chart 4.9**  
**Manufacturing wage costs**



(a) Balance of firms reporting pay settlements putting upward pressure on prices.

**Chart 4.10**  
**Manufacturing output price inflation<sup>(a)</sup>**



(a) Excluding excise duties.

supply contraction effects—the ban on livestock movements and culling of livestock. But the price of meat imports rose by more than 20% in March. This seems likely to reflect UK meat processors increasing their demand for foreign-supplied meat at short notice because of the reduced availability of UK supplies—with the sharp rise in prices reflecting either those incremental foreign supplies coming from higher cost sources than normal or the increased costs of providing such extra supplies at short notice, such as higher transport costs.

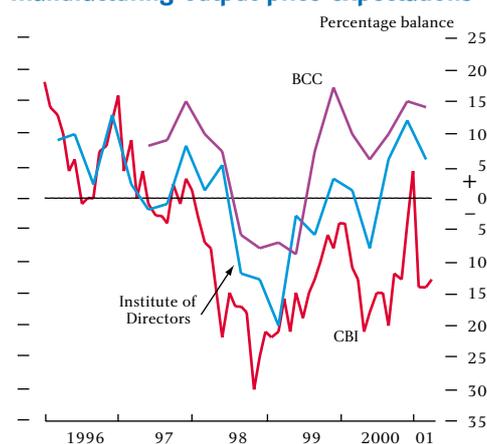
Unit labour costs account for nearly half of manufacturers' costs. Different information sources give conflicting signals on the pressure from labour costs on manufacturers' prices. On the one hand, ONS estimates suggest that manufacturing unit wage costs have continued to fall slightly in recent months (see Chart 4.9). By contrast, the latest BCC survey reported the highest proportion of firms citing pay settlements as putting upward pressure on prices in the survey's four-year history. The Committee places more weight on the more comprehensive ONS data.

Producer output price inflation has continued to slow in recent months as petroleum prices have fallen back (see Chart 4.10). The 0.8% rise in producer prices (excluding excise duties) in the year to March was the lowest rate of increase since September 1999. Meat prices rose by almost 1% on the month in March due to the effects of foot-and-mouth disease.

The February *Report* discussed how surveys of future price expectations at that time suggested greater upward pressure on prospective output prices, albeit with the caveat that those surveys had sometimes not been very accurate guides to subsequent price movements. Chart 4.11 shows that survey-based expectations of future output prices have fallen over the past three months. The CBI index has fallen most sharply, with the rise three months ago appearing erratic. The balances in the BCC and Institute of Directors (IoD) surveys have fallen by less and remain firmer than a year earlier, which is consistent with the results of a small survey of manufacturers conducted by the Bank's regional Agents in March.

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. In addition to the effects of materials and fuels inputs and unit labour costs discussed above, this weighted cost proxy takes account of movements in the prices of finished goods imports and bought-in services, which together account for around a

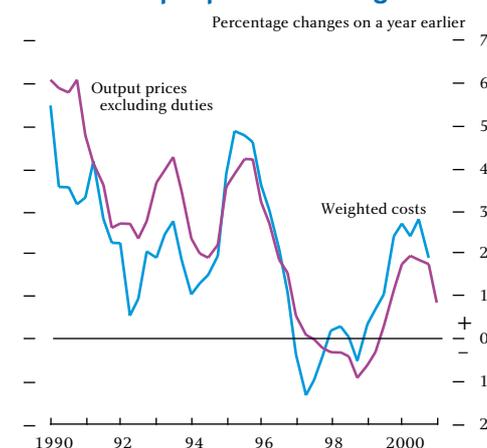
**Chart 4.11**  
Manufacturing output price expectations<sup>(a)</sup>



Sources: BCC, CBI and IoD.

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

**Chart 4.12**  
Producer output prices and weighted costs



**Table 4.A**  
Service sector costs

	Series average (a)	2000				2001
		Q1	Q2	Q3	Q4	Q1
CIPS input price index (b)	58.0	59.3	61.7	61.7	61.2	57.2
BCC raw materials prices (c)	16.5	21	22	18	20	21
BCC pay settlements (c)	25.9	31	33	23	28	32
Unit wage costs (estimated) (d)	3.1	4.8	1.8	1.6	2.1	n.a.

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

- (a) From 1997 Q2.  
 (b) A reading above 50 suggests rising prices, a reading below 50 suggests falling prices. The CIPS survey is monthly, and the quarterly values are shown as averages over the relevant three months.  
 (c) Percentage balance of respondents reporting pressures to raise prices from this factor.  
 (d) Percentage changes on a year earlier.

quarter of manufacturers' costs. Chart 4.12 shows that whereas output prices rose more quickly than weighted costs in the early 1990s, that pattern has been reversed since 1998. This suggests that manufacturing profitability rose in the early 1990s but has been squeezed in recent years. The falls in materials and fuels' input price inflation meant that weighted cost growth slowed markedly in 2000 Q4 and is likely to have fallen further in 2001 Q1. So, as in Q4, weighted cost growth seems likely to be close to output price inflation in Q1, implying little further squeeze on manufacturing profitability. Surveys provide mixed evidence on profitability in Q1 but both the BCC and IoD surveys indicate some expectations of improving profitability later in 2001, even though profit warnings by manufacturers have risen in recent months.

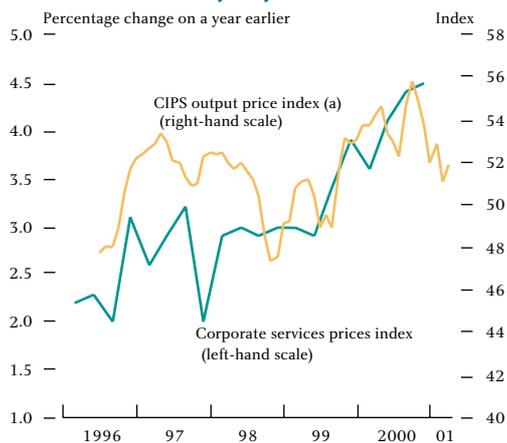
## 4.4 Costs and prices in the service sector

Service sector output prices can 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 affect retail prices indirectly through their impact on the cost of producing other goods and services in the basket.

Survey evidence suggests some weakening of input cost pressures in the service sector (see Table 4.A), although they remain stronger than in manufacturing. The CIPS input price balance continued to fall in Q1—to its lowest level in 18 months in March—although it rose slightly in April. The decline in Q1 mainly reflected lower fuel prices, including the effects of the duty cuts announced in the Budget (see Section 4.5). The March and April CIPS surveys, however, also reported that the foot-and-mouth epidemic was putting upward pressure on the costs of foodstuffs used by the catering sector. The latest BCC survey reported a slight rise in the proportion of service sector firms citing raw materials prices as putting upward pressure on prices.

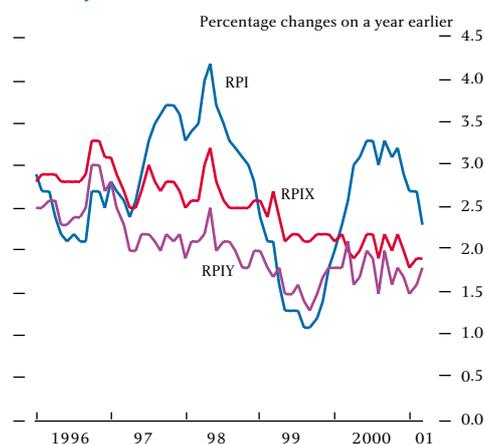
Labour costs account for a significantly higher proportion of costs in services than in manufacturing. And labour cost pressures appear to have risen in the service sector. The inflationary pressures generated by labour inputs—unit wage cost growth—depend on both earnings and productivity growth. Estimated service sector unit wage cost growth increased in 2000 Q4, as the rise in the ONS measure of services earnings growth was reinforced by a slight slowdown in estimated productivity growth. Unit wage cost growth did, however, remain below the average of the past few years. Looking forward, the further rise in service sector earnings growth in January and February 2001 suggests a further increase in services unit wage cost growth in Q1, although recent outturns seem likely to have been inflated by temporary factors (see Section 3). Surveys also suggest a rise in labour

**Chart 4.13**  
**Service sector output prices**



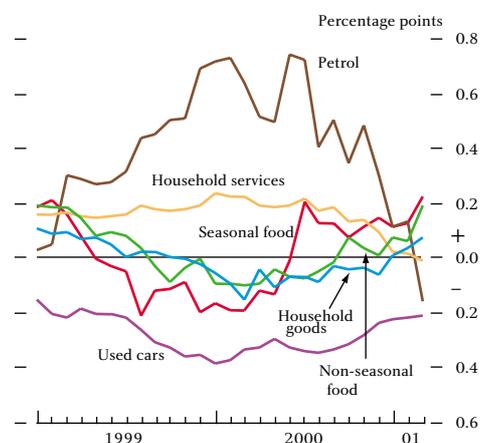
(a) Output prices compared with the previous month. More than (less than) 50 suggests that output prices are rising (falling).

**Chart 4.14**  
**Retail price inflation**



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

**Chart 4.15**  
**Selected contributions to annual RPIX inflation**



cost pressures: the BCC survey for 2001 Q1 reported a further increase in the proportion of service sector firms reporting wage costs as putting upward pressure on prices (see Table 4.A), and respondents to CIPS service sector surveys have reported rising wage costs as being the main factor putting upward pressure on input costs.

Service sector output price inflation rose further in Q4, but more recent evidence on the trend in inflation is mixed. Annual inflation measured by the ONS prototype corporate services prices index (CSPI) rose to 4.5% in Q4—the strongest outturn in the series' five-year history (see Chart 4.13). And there are signs of continuing pressures more recently: the latest BCC survey reported a historically high proportion of service sector firms expecting to raise prices and an above-average balance of firms expecting their profitability to rise over the next year. By contrast, CIPS surveys suggest that output price inflation has been substantially lower in recent months than in Q4 (see Chart 4.13)—the Q1 outturn was the lowest for 18 months—with respondents often quoting strong competition as limiting their ability to raise prices.

## 4.5 Retail prices

Annual RPIX inflation remains below the Government's 2½% target. The 1.9% rate recorded in Q1 (see Chart 4.14) followed rates of 2.1% in each of the previous four quarters. The first-quarter outturn was the lowest quarterly figure since the series started in 1976, but was in line with the central expectation at the time of the February *Report*.

As expected, the fall in RPIX inflation in Q1 largely reflected lower petrol prices associated with falls in oil prices. In March those effects were reinforced by the cut in road fuel duties announced in the 2001 Budget (see below). Chart 4.15 shows that the estimated contribution of retail petrol prices to inflation has fallen significantly over the past nine months. That development was reinforced in recent months by a large decline in the contribution from household services, as telephone call charges fell.

Partly offsetting those effects, several factors have put upward pressure on inflation in recent months: higher used car prices, reflecting a recovery in that market; a rise in seasonal food prices, due to adverse weather conditions; and an increase in non-seasonal food prices, reflecting the effects of the foot-and-mouth epidemic (see the [box on page 19](#)). Within the latter, retail prices of meat from species affected by the disease rose by 3%–10% in March, reflecting effects further down the supply chain (see [Section 4.3](#)). But prices of meat from species not affected by the disease also rose as

consumer demand switched towards them. The ONS estimates that higher meat prices added more than 0.1 percentage points to annual retail price inflation in March.

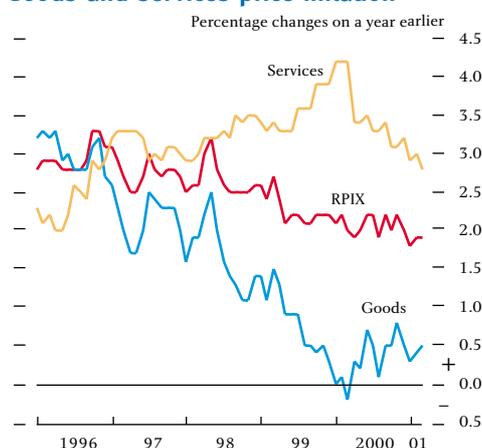
The foot-and-mouth epidemic may put some downward pressure on prices of retail services such as UK holidays, due to reduced demand by UK and foreign tourists, with any effects probably being most apparent during the tourist trade peak later in the year. The overall impact on RPIX inflation will be mitigated by consumers substituting away from countryside holidays into other types of UK holidays or other forms of retail spending. But these possible effects on retail services prices, combined with indications that retail meat prices have fallen from their mid-March peak and may eventually fall below pre-crisis levels because of the export ban, suggest that the impact of the foot-and-mouth epidemic may put some marginal downward pressure on RPIX inflation later this year.

Annual RPI inflation was 2.6% in Q1, down from 3.1% in Q4. RPI inflation declined by more than RPIX inflation over that period because of the mortgage rate reductions following the 25 basis point cut in the Bank's repo rate on 8 February and previous mortgage rate rises dropping out of the annual RPI comparison. This meant that RPI inflation was only 0.4 percentage points higher than RPIX inflation in March, the smallest such gap for 13 months. It seems likely that RPI inflation will fall below RPIX inflation over the coming months, as the effects of last year's abolition of MIRAS drop out of the RPI comparison and mortgage rates are reduced further following the successive 25 basis point cuts in the Bank's repo rate in April and May. RPIY inflation, which excludes the effects of indirect tax changes and mortgage interest payments, fell to 1.6% in Q1, down from 1.8% in Q3 and Q4.

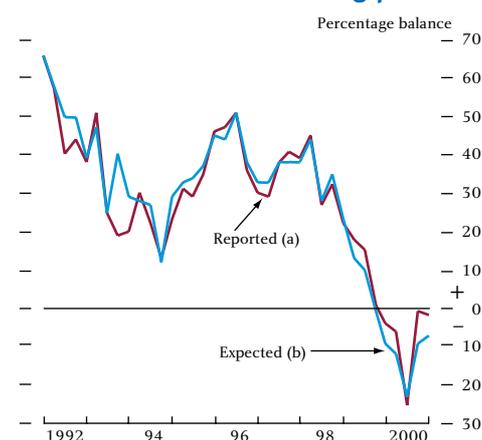
Examining inflation rates by product categories provides information on the varying pressures in different parts of retailing. Retail goods inflation was 2½ percentage points lower than retail services inflation in 2001 Q1—the same gap as in Q4 but less than earlier in 2000 (see Chart 4.16). Retail services inflation has been declining since early 2000, largely reflecting lower utility prices. Service sector inflation usually exceeds manufacturing inflation because average labour 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 may have depressed goods price inflation.

The February *Report* noted that several factors suggested a potential lessening of the downward pressure on retail goods prices. The recent evidence has been mixed. On the one

**Chart 4.16**  
**Goods and services price inflation**



**Chart 4.17**  
**CBI balance of retailers' selling prices**



(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.

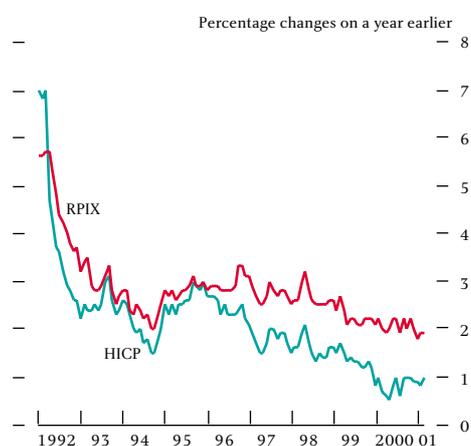
**Table 4.B**  
**Effect on RPIX inflation in 2001 of recent fiscal measures<sup>(a)(b)</sup>**

Date of effect	Change in tax or duty (c)	Effect of each measure (percentage points)	Cumulative effect (percentage points)
March	Road fuel	-0.15	-0.15
March	Tobacco	+0.04	-0.11
April	Air passenger duty	-0.03	-0.14
April	Road fuel	-0.11	-0.25
April	Tobacco	-0.20	-0.45
April	Alcohol	-0.04	-0.49
July	Extension of reduced vehicle excise duty	-0.06	-0.55

Source: ONS.

(a) Table shows direct effects of tax changes, assuming complete pass-through into retail prices and ignoring any possible knock-on effects.  
(b) Measures estimated to affect RPIX inflation by more than 0.02 percentage points.  
(c) The effects reflect the impact of measures implemented in the 2001 Budget relative to those implemented in the 2000 Budget, including timing variations.

**Chart 4.18**  
**HICP and RPIX**



hand, several developments point to stronger upward pressures: retail sales growth remains above trend; consumers' confidence in their own financial position remains firm; the latest IoD survey showed a rise in the net balance of distribution firms reporting price increases; the CBI balance of retail price expectations has edged up further (see Chart 4.17); and the Bank's regional Agents continue to report tentative signs of a lessening of downward pressure on retail goods prices, with a small survey in March showing a positive net balance of retailers expecting to raise prices by more in 2001 than in 2000. On the other hand, the appreciation of the sterling effective exchange rate, the fall in the MORI survey balance of consumer confidence and the marginal rise in the balance of retailers in the CBI survey experiencing price falls in Q1 suggest weaker pressures on retail goods inflation.

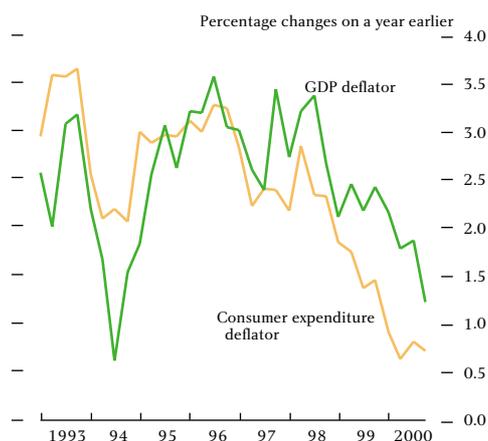
In addition to these potential pressures, several factors will affect RPIX inflation, and the gap between retail goods and retail services inflation, in coming months. Fiscal measures announced in the March Budget, together with the effects of measures implemented in the 2000 Budget dropping out of the annual comparison, will have a temporary effect on RPIX inflation. Table 4.B summarises ONS estimates of the profile of the direct effects in 2001, assuming that the measures are completely passed through to retail prices and ignoring any possible knock-on effects. Under these assumptions, it shows that the numerical effects of fiscal measures in the two Budgets detract just under 0.6 percentage points from annual RPIX inflation by July, with most of the effect coming through retail goods inflation. The Committee had, however, previously anticipated a substantial proportion of those effects.

The downward pressures on RPIX inflation from the petrol duty effects shown in Table 4.B will be partly offset by the recent rise in duty-exclusive petrol prices. And developments in utilities prices are likely to put upward pressure on retail services and RPIX inflation in the coming months. This will mainly reflect the cuts in utilities prices last spring dropping out of the annual comparison, but will be reinforced by the announced increases in utilities prices for this spring being implemented.

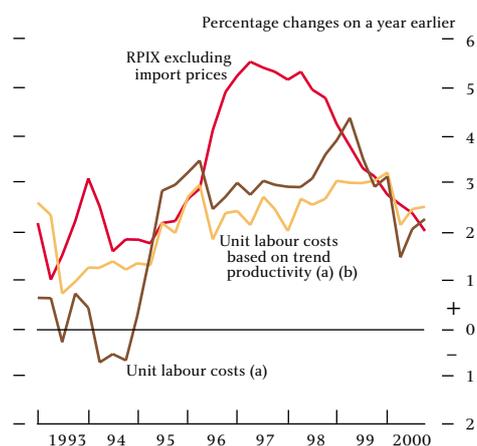
## 4.6 Other price indices

Inflation measured by the harmonised index of consumer prices (HICP) remained below RPIX inflation in Q1 (see Chart 4.18), with the HICP measure averaging 0.9%. HICP differs from RPIX in its coverage (including the treatment of housing costs) and the method used to translate individual price quotes into the inflation index (arithmetic means for RPIX, geometric means for HICP).

**Chart 4.19**  
Expenditure price indices



**Chart 4.20**  
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%.

The deflators for GDP and its expenditure components—calculated by comparing estimates of nominal and real spending—are indicators of inflationary pressures at a broader level of economic activity than the retail sector. In February the Committee judged that the deflator data then available for 2000 Q3 were giving exaggerated signals about falls in underlying inflationary pressures. That judgment is supported by the upward revisions to the deflators for Q3 since then.<sup>(1)</sup> The Committee judges, however, that the deflator data for Q4 shown in Chart 4.19 also understate trends in underlying inflation—the fall in the GDP deflator measure of whole-economy inflation partly reflects developments a year earlier, and the housing services proxy in the consumer expenditure deflator remains significantly below the retail price series with the closest comparable coverage.

Indicators of domestically generated inflation (DGI) provide some information on the pressures being exerted on prices by developments in domestic activity, as distinct from the influence of world prices and the exchange rate. Chart 4.20 shows that three estimates of DGI were all between 2% and 2½% in Q4, although the recent downward profile of RPIX excluding imports contrasts with the upward pressures apparent in the unit labour cost measures.

## 4.7 Summary

Oil prices have changed little in recent months, while expectations of future oil prices have been revised up slightly. Prices of other commodities have continued to fall in recent months, partly reflecting downward revisions to world growth prospects. Previous falls in oil prices, together with falls in manufacturing unit wage costs, have reduced cost pressures in manufacturing. Manufacturing output price inflation has also slowed, to roughly in line with the rate of increase of costs, and survey measures of price expectations have fallen back. Service sector input cost inflation shows signs of slowing, but labour cost pressures there have risen. Service sector output price inflation rose further in Q4, but more recent evidence on the trend is mixed. The foot-and-mouth epidemic affected prices in March and is likely to have a continuing short-term impact. As expected, RPIX inflation dipped to just below 2% in Q1. In the central projection inflation stays around 2% throughout 2001, before picking up towards the target in the second year of the projection.

(1) The annual rate of increase of the GDP deflator and the consumer expenditure deflator in 2000 Q3 were revised up by 0.3 percentage points and 0.2 percentage points respectively.

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## 5 Monetary policy since the February *Report*

This section summarises the economic developments and monetary policy decisions taken by the MPC since the February *Report*.<sup>(1)</sup> The Bank's repo rate was maintained at 5.75% in March, reduced to 5.5% in April, and reduced further to 5.25% in May.

In the February *Report*, the MPC's central projection was for RPIX inflation to stay around 2% during 2001, but to pick up to around the target at the two-year horizon. Annual real GDP growth was judged likely to dip towards 2% in the near term, and to recover to around trend in 2002. Relative to the central projection, some members preferred alternative assumptions about supply-side developments and about the extent and consequences of the US slowdown that, in combination, could lower the inflation profile by up to 1/2% at the two-year horizon.

At its meeting on 7–8 March, the Committee first discussed the Budget. There had been a briefing by the Treasury on the broad outline of the Budget prior to the meeting. The fiscal stance in the current year had turned out to be tighter than originally projected, but the outlook was not materially affected by this change and differed little from the projections contained in the February *Report*.

The latest UK National Accounts data release had confirmed that real GDP growth was estimated at 0.3% in 2000 Q4, but the expenditure composition had been revised and differed from the assumed pattern in the February *Report*. Investment growth in Q4 was well above that projected in February, and, though consumption growth for 2000 had been revised down, it remained robust at 0.7% in Q4 (though slightly lower than the February projection). Some rebound of GDP growth in 2001 Q1 was expected, owing to the abnormal effects of adverse weather and travel disruption in the previous quarter. Demand conditions appeared more robust than expected, but manufacturing output had fallen by 0.9% in January, possibly heralding a more sustained weakening of the high-technology sector.

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(1) The minutes of the February, March and April meetings are reproduced under a separate cover, published alongside this *Report*.

There continued to be robust growth in money and credit aggregates, but there were differences of view about the significance of these data for inflation prospects. Both mortgage rates and unsecured loan rates had fallen faster than the Bank's repo rate, partly as a result of greater competition in retail credit markets. Money market participants expected a further cut in the official rate over the next few months, but some medium-rated corporate bond spreads had widened since the start of the year. Equity prices had fallen sharply in February, reflecting concerns about the US slowdown and its international impact.

Outside forecasts of world growth had generally been lowered, especially for Japan and the United States. US data for Q4 gave mixed signals and were not as bad as previously feared. Consumer confidence had fallen sharply, but retail sales were strong in January and the Purchasing Managers Index (PMI) had recovered slightly. It seemed likely that the trough would be later than previously thought, but it was not clear if the slowdown would be more protracted than had been assumed. Euro-area growth appeared stable but lower than last year, and the economic problems of Turkey and Argentina had not had significant spillovers.

UK labour market data were hard to interpret, as both LFS employment and unemployment had fallen. Some of the employment fall could be explained by erratic factors, such as transport disruptions, affecting temporary employment. Reports from the Bank's regional Agents suggested a slight loosening of the labour market, but this was not yet evident in the aggregate data. There was still a modest upward trend in earnings but settlements were consistent with expectations.

Price expectation surveys were consistent with very gradually increasing inflationary pressures. Budget changes would reduce RPIX inflation in April but such short-term influences did not affect medium-term inflation prospects.

On the immediate policy decision, there were two main points of view. On the first view, while prospects for world demand growth were weaker, domestic demand growth seemed likely to be slightly higher than expected in February and confidence remained remarkably strong. On this view, an immediate cut in rates could not be justified, as there was a danger that consumer demand would grow even faster making a sharp tightening of policy necessary later. On the second view, important factors were a deterioration in the world outlook and a fall in equity prices. While domestic demand signals were mixed, the fall in manufacturing output may indicate that the global technology slowdown had spread to the United Kingdom. In addition, the sustained undershoot of the inflation target suggested that it was unlikely that projected

output growth could return inflation to target without further policy loosening. Hence an immediate cut was warranted. The Committee voted by 7 to 2 to leave the Bank's repo rate unchanged, with two members voting for a 25 basis point cut.

At its meeting on 4–5 April, the MPC first discussed equity prices. The FTSE All-Share index had fallen by 8% since the previous meeting and was 12% below the starting-level of the February projection. Equity markets had fallen sharply in many other countries. The relative strength of technology stocks since 1997 had been almost completely reversed, but recent weakness extended beyond the high-tech sectors. Despite the fall in US equity markets, the dollar had remained strong and the sterling effective exchange rate was also about 1% above its level in February. The falls in equity prices might over time be expected to restrain demand, and the strength of sterling would exert a dampening effect on inflation. But continued strength of money and credit aggregates and house prices would tend to underpin consumption, as would the fall in effective interest rates faced by borrowers.

US GDP growth in 2001 Q1 seemed likely to be at or slightly above the rate assumed in the February *Inflation Report*, and earlier fears about the downside risks had not yet materialised. However, lower equity prices and low confidence suggested that the recovery might be more sluggish than previously expected. Growth appeared to have slowed in the euro area, especially in Germany, though growth forecasts had been lowered only modestly. The prospects for the world economy as a whole seemed weaker than at the time of the February *Report*, though UK export markets, principally in Europe, were less affected than export markets worldwide.

UK real GDP growth in 2000 Q4 had been revised up from 0.3% to 0.4%. The strength of recent business investment growth appeared to be more consistent with the survey evidence than were earlier releases, and hence resolved a puzzle. Surveys were starting to show signs of an impact on export demand of the US slowdown and this would put pressure on the externally traded sector of the economy. Output indicators suggested slowing production, especially in manufacturing, but expenditure data suggested a rather stronger picture. Continuing strong consumer demand represented an upside risk to the forecast. At some point private domestic demand would need to slow and this could involve a sharp fall in the exchange rate. There was some uncertainty surrounding the wider impact of foot-and-mouth disease, which would clearly have some adverse impact on agricultural production. But most members of the Committee thought that, unless the tourism and confidence effects proved greater and more persistent than at present seemed likely, the impact into 2002 would be modest.

Employment had risen after several months of slow or slightly negative growth, and unemployment was down on both LFS and claimant count measures. There were few tangible signs in the data of any labour market easing, but the Bank's regional Agents reported early indications of easing in some areas and recruitment advertising had fallen. There was little indication so far of any worrying increase in settlements or earnings. But the MPC would continue to monitor pay growth carefully.

There would be several temporary influences on RPIX inflation in future months, including the timing and nature of Budget measures, the dropping out of utility price falls in April 2000, and the impact of foot-and-mouth disease. In light of this, the data would need careful interpretation, though there were few signs of rising price pressures in either manufacturing or services.

On the immediate policy decision, it was generally agreed that the inflation outlook was weaker than at the previous meeting and that a rate cut was warranted. The main issue was how large that cut should be. For most members, an immediate cut of 25 basis points was warranted, as a result of the world slowdown, equity price falls and foot-and-mouth disease. But it was important not to overreact and, in any event, domestic demand remained robust and money and credit aggregates were still growing fast. Lowering rates too far might risk exacerbating the imbalances between the domestic and external sectors. On a second view, while finely balanced, a 50 basis point cut could be justified by the danger of a deterioration in confidence at a time when inflationary pressures were weak. Such a cut would provide some insurance against the downside risks. On a third view, the case for a 50 basis point cut was more clear-cut. This position was adopted by those members who had sought a 25 basis point cut at the previous meeting. They had already been more pessimistic about world prospects than the central projection in the February *Report*, and recent falls in equity markets combined with forward-looking survey evidence had reinforced these concerns. A 50 basis point cut was needed this month to help sustain domestic demand and improve the prospects of returning to the inflation target, and it was possible that further cuts would be needed in future months even in the absence of further downside news. The Committee voted by 6 to 3 to reduce the Bank's repo rate by 25 basis points to 5.5%, with three members voting for a 50 basis point cut.

At its meeting on 9–10 May, the Committee voted to reduce the Bank's repo rate by 25 basis points to 5.25%.

## 6.1 The inflation projection assumptions

This *Report* was approved by the Monetary Policy Committee on 11 May. It provides the Committee's assessment of economic developments since February and prospects for the medium term. Projections of GDP growth and RPIX inflation are presented below in Charts 6.1 and 6.2, together with the uncertainties surrounding them. These projections are conditioned on the assumption that the Bank's repo rate remains unchanged at 5.25% during the next two years. Alternative projections based on the assumption that UK official interest rates move in line with an estimate of market expectations are shown in Charts 6.6 and 6.7. The main assumptions on which the projections are based are set out below.

The outlook for the world economy continued to weaken in the early months of this year. The extent and duration of the global slowdown and the pace of the subsequent recovery depend heavily on the prospects for the US economy. Although a moderation in the pace of activity in the United States was necessary, and was widely expected, following several years of exceptionally strong growth, the sharpness of the deceleration towards the end of last year was surprising. Equity prices fell substantially. Business and consumer confidence declined markedly. And lending conditions tightened as perceived credit risks increased. Firms reacted by cutting inventories and by scaling back investment plans drawn up on the basis of a stronger outlook for expected returns.

GDP growth in the United States in 2001 Q1 was 0.5%, a little above the previous quarter and the central projection in the February *Inflation Report*. Growth was underpinned by consumer spending, which to date has remained resilient. But near-term prospects are rather weaker than projected three months ago. The outlook for investment spending has worsened, given the deterioration both in profits and in the financial position of the corporate sector, together with reports of surplus capacity in a number of sectors. Equity prices fell sharply again in March and although they have

recovered ground over the past month the level remains below that in early February. Lower equity prices reduce the incentives to invest as well as lowering household wealth and dampening the outlook for consumer spending. Indicators of business and consumer confidence remain subdued and there are signs of a worsening in employment prospects as firms shed excess labour. The Federal Reserve has responded to the slackening in the pace of economic activity by cutting interest rates by a further 100 basis points since February—interest rates are 2 percentage points below the level at the start of the year.

The MPC has lowered the central projection for US GDP growth. After a quarter or two of slow but positive growth, the central projection is for a moderate recovery, as the rundown of surplus inventories ends and as excess capital is gradually worked off. Output growth will be supported by monetary and fiscal easing, and assuming that the favourable trend in underlying productivity continues, this too should improve the outlook for real incomes and profitability. Nonetheless, the slowdown is likely to be more protracted and the recovery more sluggish than projected three months ago.

Prospects for growth in other regions have also been revised down since the February *Report*, partly reflecting the weaker outlook for the United States and the widespread falls in equity markets. Business confidence in the euro area has fallen in recent months, with declining export prospects a contributory factor. But private domestic demand should continue to support growth. Consumer confidence remains high, bolstered by gains in employment and by tax cuts in the three largest economies at the start of the year. And high rates of capacity utilisation should help to limit the likely slowdown in private investment spending. The central projection is that GDP growth in the euro area is likely to ease to around trend in 2001. The outlook for Japan has deteriorated in recent months. Weaker international demand for high-technology products has depressed export growth, while consumer and business confidence have fallen, given heightened uncertainty about demand prospects and the impact of corporate and financial sector restructuring. Near-term prospects for emerging economies have also worsened over the past three months, reflecting the likelihood of a more pronounced slowdown in industrial country imports, and signs of financial strain in some countries.

The Committee's central projection is that global GDP growth will slow from close to 5% last year to around 3% in 2001, a downward revision of around half a percentage point since the February *Inflation Report*. Output growth, again on the central view, is likely to strengthen gradually during 2002 as

the US recovery gathers momentum, although there are many uncertainties surrounding that outcome. The slackening of global demand growth has applied a brake to the rapid expansion in world trade. World imports, weighted by UK trade shares, increased by almost 11% in 2000—the strongest growth for some 25 years. The central expectation is that world trade growth will slow to just over 6% this year—some half a percentage point lower than projected in February—and will remain around that rate in 2002.

The outlook for the world economy remains highly uncertain, and the Committee continues to judge that the risks around the most likely outcome are weighted to the downside. In particular, it is possible that the US downturn may prove more deep-seated than embodied in the current central projection. The US private sector financial deficit has risen to exceptional levels in recent years, as expectations of strong profit growth stimulated investment spending and fuelled the rapid increase in equity prices, which in turn raised household wealth and encouraged buoyant consumption and low rates of personal saving. The rise in the private sector deficit was in large part funded by foreign capital attracted by prospective high returns—the counterpart of a marked widening in the US current account deficit. These major internal and external financial imbalances pose a threat to the outlook. In particular, it is possible that households and companies will strive to improve their balance sheets more quickly than assumed in the central case. A rapid rise in the household saving ratio and large cutbacks in capital spending would reduce private demand substantially and prolong the downturn in US growth. Moreover, if there were to be further falls in asset prices and global demand, that would put additional pressures on corporate and household financial positions in a number of countries, and could affect international flows of capital.

Non-oil commodity prices have fallen in recent months as global demand prospects have been revised down. Drawing on evidence from futures markets, the central projection incorporates the assumption of a gentle rise in non-oil commodity prices over the next two years. The projected profile is well below that incorporated in the February *Report*. In contrast, the outlook for oil prices is a little stronger than projected three months ago. While spot oil prices have declined from their peaks last year, and are expected to fall further, the oil price profile over the next two years incorporated in futures markets is around \$1–\$2 per barrel higher than in the previous forecast, as a result of further cuts in OPEC production and low stock levels.

Inflationary pressures are moderating in the major overseas economies as the impulse from higher oil prices last year

dissipates and as capacity and labour utilisation decline in the United States and Japan. Nevertheless, recent outturns for producer and consumer price inflation in the United States and the euro area have been a little stronger than projected three months ago, and local currency export prices in the major overseas economies are also a little higher on average than expected. From this higher starting-point, traded goods price inflation is likely to fall a little faster than in the February projection. The intensification of competitive pressures associated with the weaker outlook for global growth, together with lower non-oil commodity prices, should more than offset the somewhat higher oil price profile.

The sterling effective exchange rate has appreciated a little over the past three months, as a rise in sterling against the euro has more than outweighed depreciation against the dollar. The sterling effective exchange rate index (ERI) averaged 105.8 in the 15 working days up to and including 9 May, consistent with bilateral sterling exchange rates of \$1.43 and 62 pence against the euro. This average forms the starting-point for the exchange rate profile assumed in the current projection. It is around 2% above the implied level for May in the February central projection. The sterling ERI is assumed to depreciate a little to 105.0 by 2003 Q2.

Equities are an important component of household wealth in the United Kingdom. Moreover, share prices are a key barometer of the outlook for corporate profits and have an important influence on the cost of capital to firms. As in the United States and the euro area, equity prices again fell sharply in the second half of February and in March—at the time of the Committee's policy meeting in early April the FTSE All-Share index was almost 12% lower than the starting-point incorporated in the February *Inflation Report*. In contrast to earlier falls, the latest decline was relatively widespread across industrial groups and was no longer concentrated in the technology, media and telecommunications sector. The drop in prices was associated with signs of increased pressures on corporate profits: the number of profit warnings in the United Kingdom in 2001 Q1 rose substantially. In recent weeks equities have recovered some of the loss, particularly following the cut in US interest rates in mid-April. Nonetheless, the FTSE All-Share index in the 15 working days to 9 May was some 7% below the central path assumed in the February *Report*. Reflecting the lower starting-point, the projected profile for financial wealth is well below the February path.

Housing market indicators remain quite strong. High levels of new loan approvals and increasing reservations of new houses suggest a positive outlook for activity. Moreover, house prices

have risen a little more quickly than expected three months ago. But there is no major change to the outlook: house prices are assumed to rise a little above the growth in earnings over the next two years.

The Committee has updated the assumptions on fiscal policy in the light of the March Budget. The public sector surplus in financial year 2000/01 was higher than projected in the November 2000 Pre-Budget Report (PBR) as tax revenues were above earlier expectations, and as spending on transfers was lower than assumed. The Treasury expects that the structural improvement in the public finances will be sustained in future years, and will broadly offset the cost of the new measures announced in the Budget. So there is little change to the overall fiscal outlook: current Treasury estimates of the cyclically adjusted net borrowing requirement as a share of GDP are identical to the November PBR forecast over the next three financial years. Given that the changes to aggregate revenue and spending projections are fully offsetting and distributional effects are judged to be relatively small, the Budget has little impact on the medium-term outlook for growth and inflation relative to previous expectations. There is, however, a temporary short-run effect on the inflation outlook from the Chancellor's decisions on rates of fuel and other specific duties. Relative to expectations in the February *Report*, the Budget measures on duties could lower inflation over the next year by around 0.2–0.3 percentage points.

## 6.2 The output and inflation projections

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GDP rose by 0.3% in 2001 Q1 according to the ONS preliminary estimate. As in 2000 Q4, output was depressed by special factors. Some of the distortions to fourth-quarter output from adverse weather and from disruptions to the rail network may have persisted into the New Year, and in addition the outbreak of foot-and-mouth disease has affected spending on tourism and agricultural output. Judgments on the quantitative impact of the various unusual factors are uncertain. Nonetheless, the first-quarter GDP estimate suggests that the underlying trend in output is a little weaker than projected in the February *Report*. RPIX inflation was 1.9% in March 2001 and consequently remains below target. The slight fall in inflation since the autumn was in line with expectations three months ago. The Committee reviewed the outlook for growth and inflation against this background.

Interpreting recent trends in demand and output is challenging not only because of the unusual distortions, but also because of the difficulties of reconciling indicators of demand and activity. The latest full National Accounts release

in March indicated that GDP grew by 0.4% in 2000 Q4, a little higher than the preliminary estimate, but in line with the second estimate published in February. Final domestic demand rose by 0.9%, above expectations in the February *Inflation Report*, as investment spending increased sharply—more than outweighing a weaker outturn for private consumption growth. And net trade made a small positive contribution to growth, broadly in line with expectations. To reconcile the picture of strong final demand growth and relatively weak production, the ONS estimates that a substantial proportion of demand was met by a run down of inventories. But estimates of changes in inventories by directly sampled firms suggest that stock holdings actually increased in Q4, and by more than in the previous quarter. The ONS has consequently introduced a statistical adjustment to the raw inventories data, which deducts 0.8 percentage points from GDP measured from the expenditure side in the fourth quarter. It is thus quite likely that there will be revisions to estimates of the demand components or to output (or both) as further information becomes available.

Estimates of the components of demand for 2001 Q1 are not yet available to set alongside the preliminary output-based estimate of GDP. Preliminary information based on limited monthly indicators, however, tentatively suggests that demand-side measures may again be rather stronger than the output estimate. Consumer spending indicators signal a relatively buoyant outturn and, although net trade is likely to detract from GDP growth, it also seems necessary to assume—somewhat contrary to survey evidence—either that a further sharp rundown in inventories has occurred or that there has been a marked fall-back in investment, in order to square the information from the demand and supply-side indicators. The additional uncertainty about the recent past complicates the forward-looking assessment.

Consumer spending rose by 0.6% in 2000 Q4, the slowest quarterly growth rate for more than a year and below the central projection incorporated in the February *Report*. However, some of the weakness reflects temporary factors, such as the disruption to the rail network, which was associated with an unusual drop in spending on transport services. As noted above, a range of indicators suggests that consumer spending growth rebounded in the early months of this year. In particular, retail sales volumes increased by 1.5% in 2001 Q1—the strongest quarterly growth since late 1997—while private new car registrations rose sharply. Moreover, indicators of improving housing market activity and buoyant household credit demand support a picture of relatively brisk consumption growth. It is quite likely, however, that some of

the higher spending on retail goods and vehicles may be displacing expenditure on services, as consumers spend less on hotels and catering as a result of the foot-and-mouth epidemic. Balancing these factors, spending growth in the first quarter may be close to the average pace last year.

The outlook for consumption depends on the trends in real income and wealth, as well as on labour market prospects—which have an important bearing on consumer confidence. Moreover, movements in interest rates alter the incentives to consume as well as affecting property income and wealth. Recent analysis by Bank staff suggests that consumer spending is more responsive to changes in wealth than judged earlier. Drawing on this evidence, it is now possible to account for recent developments in consumer spending that were previously difficult to explain.

In recent years, strong consumer spending growth has been supported by a rapid rise in wealth. This support is no longer in place. Household wealth was little changed last year as falls in financial wealth were balanced by increased housing wealth. Moreover, staff estimates are that household wealth fell by close to 5% in 2001 Q1, as the sharp drop in equity prices and financial wealth far outweighed the rise in house prices and housing wealth.

The Committee judges that consumer spending growth will slow markedly in the coming quarters, as households adjust to the weaker outlook for wealth and employment growth. However, growth in real earnings should remain resilient given the tightness of the labour market and continued productivity growth, which together with the impact of the recent cuts in interest rates should limit the extent of the deceleration in household spending. The central projection is that consumer spending growth will ease to a little below trend by the second half of this year and will then stabilise close to that level. Prospects are somewhat weaker than in the February projection.

Recent *Inflation Reports* noted the difficulties in reconciling the persistent weakness in business investment growth last year with evidence from business surveys and from econometric studies which signalled a stronger spending pattern. Extensive data revisions have eliminated this puzzle. The ONS has recently raised estimates of business investment substantially in the second half of 2000 and lowered estimates for the first half of the year. The profile is now consistent with an extended pause around the turn of the millennium, perhaps reflecting uncertainty surrounding possible failure of electronic equipment, followed by a rebound in spending. Business investment rose by more than 5% in 2000 Q4, and

the level of spending was more than 6% higher than the February projection.

Stronger momentum in investment spending is consistent with an upward revision to the near-term prospects since the February *Report*. Supporting that view, investment intentions remain buoyant in the service sector—some three quarters of business investment—and new orders for construction are strong. Other influences are likely to press down on investment growth. Weaker share prices and signs of a more protracted slowdown in global demand will lower the desired capital stock and reduce investment. Moreover, recent indications of additional pressures on cash flow and corporate profitability are likely to lower investment. And given that many investment projects are difficult and costly to reverse once in place, increased uncertainty surrounding future prospects may also lead companies to defer investment decisions until the outlook becomes clearer. Weighing these influences, the Committee considers that business investment growth is likely to be a little stronger over the next year and weaker in the second year than projected three months ago. This reflects the higher initial level of investment, the impact of weaker equity prices and a more subdued outlook for international and domestic demand. Whole-economy investment is likely to rise more quickly than business investment as government capital spending increases rapidly.

As noted above, when the ONS has difficulties balancing estimates of aggregate demand and output, a statistical adjustment is typically applied to the raw data for inventory investment, as these are judged to be relatively poorly measured. Such adjustments cloud the interpretation of recent trends. The large downward adjustment in 2000 Q4 is consistent with companies meeting quite rapid final demand growth by running down inventories, given the disruptions to production from adverse weather and travel delays. On this basis a further rundown in stocks in 2001 Q1 seems likely, given relatively weak output growth and indications of strong consumer spending. But it is hard to match this picture clearly to survey evidence. Although distributors' stocks are reported to have fallen, the latest CBI quarterly manufacturing survey notes a significant increase in stocks to above desired levels. While recognising the uncertain starting-point, the Committee maintains the assumption that companies will economise further on inventories over the medium term.

Export volume growth remained quite strong around the turn of the year as world trade growth slowed only gradually from the exceptional pace in the first half of 2000. But there was a

sharp fall in sales to the United States in March and a number of recent surveys report a turndown in orders and confidence. Export growth is likely to decline in the coming months reflecting the slowdown in world growth and the continuing strength of sterling. While some recovery is likely during 2002 as global growth strengthens, the outlook is rather weaker than in the February projection.

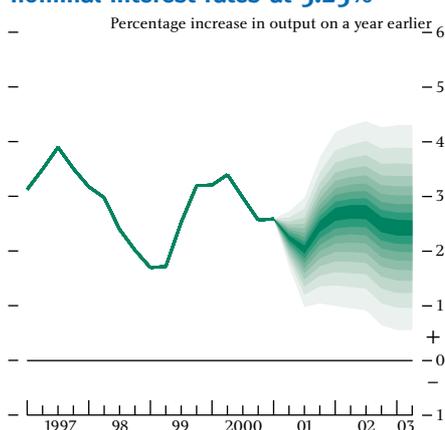
Import volumes have also continued to rise rapidly in recent months, although growth is likely to slow a little as demand growth eases. Near-term prospects are similar to those assumed in the February *Report*, but import growth may be a little lower in the second year of the projection, reflecting the more subdued outlook for domestic demand and exports.

Over the next two years, import volume growth is likely to outstrip that of exports. Net trade is likely to detract more from prospective short-term GDP growth than assumed in February, given the weaker outlook for global demand growth and the slightly higher profile for the exchange rate. The foot-and-mouth epidemic will also lead to lower exports and stronger imports in the near term.

Industrial sectors face divergent pressures. Manufacturing output has fallen in recent months as the downturn in global demand for information and communications technology equipment has led to a reduction in output in this previously fast-growing sector. Prospects for the manufacturing sector more generally have also worsened since February, as the weaker outlook for world demand and a slightly higher sterling exchange rate intensifies competition in traded goods markets. By contrast, growth in service sector output remains quite strong, supported by continued relatively rapid growth in final domestic demand. Forward-looking indicators of orders and business confidence signal some slowdown in service sector growth, consistent with the projected slackening of domestic spending. And there are clear signs that tourism and associated leisure activities in rural areas have been adversely affected by the foot-and-mouth epidemic. But service sector growth overall is likely to continue to surpass that in manufacturing, as firms selling predominantly to the domestic market and facing less external competition outperform those more immediately exposed to the international slowdown. Although construction output has been adversely affected by the exceptionally wet weather over the past six to nine months, prospects remain favourable, aided by the planned sharp rise in public sector investment spending.

The latest information from sectoral output data, business surveys, and reports from the Bank's regional Agents is

**Chart 6.1**  
**Current GDP projection based on constant nominal interest rates at 5.25%**



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.

consistent with a slowdown in underlying GDP growth over the past six months to around trend rates. The underlying position appears somewhat weaker than judged three months ago, principally reflecting the sharper-than-expected turnaround in the production of high-technology goods. But assessing the extent of any change in trend is complicated by the range of unusual and temporary factors that have affected activity in some sectors.

By contrast, money and credit growth remain quite rapid, consistent with a relatively buoyant outlook for nominal demand. Broad money growth remains around 8% on an annual basis, still close to the peak rates observed last summer. It is possible, however, that some of the recent strength in money demand may reflect an increase in precautionary holdings, given increased uncertainty about the prospects for equity prices. And although aggregate credit growth has eased back further, the increase in total M4 lending of close to 12% in the year to 2001 Q1 remains high by recent historical standards. Household credit growth has moderated only slightly. Corporate money holdings and borrowing show some signs of slower growth.

Drawing together the influences on demand components and output trends, the Committee's latest projection for real GDP growth over the next two years is shown in Chart 6.1.<sup>(1)</sup> This projection is conditioned on the assumption of unchanged UK official interest rates at 5.25%.<sup>(2)</sup> Four-quarter GDP growth slowed to around 2½% in 2000 Q4 and remained around that level in 2001 Q1, according to the preliminary estimate. The anticipated bounceback from the fourth-quarter rate did not occur, partly reflecting the persistence of unusual disruptions, but also indicating a moderation in underlying growth. The near-term outlook will continue to be affected by special factors, as the foot-and-mouth epidemic and its related effects will depress demand and output in 2001 Q2, with some recovery likely thereafter in the second half of the year. Given the various special factors, the four-quarter growth rate is likely to dip further in the short term and then recover as the unusual disruptions unwind. Abstracting from these effects, underlying growth over the next twelve months is likely to remain around trend. Weaker consumer spending growth and the worsening net trade position will depress activity, outweighing the stimulus to growth from the rapid rise in public spending. GDP growth is likely to stabilise close to trend in the second year of the projection as the world economy gradually recovers, counterbalancing the prospect of

(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.

some easing in business investment growth. The outlook for UK growth is a little weaker than in the February *Inflation Report*, principally reflecting the downward revisions to prospects for the world economy and for domestic consumer spending.

Previous *Reports* have noted the evidence of some improvement in the supply-side performance of the UK economy in recent years. In particular, upward pressures on real wages have been less in relation to the low level of unemployment than would have been predicted on the basis of the average relationship over the past 20 years. Moreover, outcomes for RPIX inflation have tended to be lower than expected, given the spell of above-trend growth in recent years, and historical estimates of the sustainable level of, and growth in, supply capacity. The weakness in inflation outturns in recent years reflects both the persistent strength of sterling and a more favourable profile for potential supply.

The Committee maintained the judgment that there will be continued downward pressure on inflation from improved supply-side performance. This judgment reflects a number of possible factors, including: structural improvements to the functioning of the labour market, which have reduced the sustainable level of unemployment; gains in underlying productivity; and an unusual strengthening of domestic and international competition—partly as a consequence of the high real exchange rate—which has put downward pressure on prices and spurred additional investment in raising corporate efficiency. As noted in February, it is difficult to distinguish clearly between the competing hypotheses because of their similar implications for the short-term relationship between activity and inflation.

The Committee developed the current projection for inflation against this background, taking into account: the latest trends in cost and price pressures in the United Kingdom; the prospects for nominal demand and potential supply; and the assumptions on international price trends and the sterling effective exchange rate.

Pay settlements have crept up a little in the early months of the year, partly reflecting the tightness of the labour market, which has put pressure on recruitment and retention, but also in response to the higher levels of RPI inflation in autumn 2000 than at the start of the previous year's pay round. However, RPI inflation has fallen in recent months and is likely to decline further, and most surveys of inflation expectations have recorded small falls since the February *Report*, which should help to contain any prospective nominal pay pressures. Trends in pay settlements do not provide corroboration of the

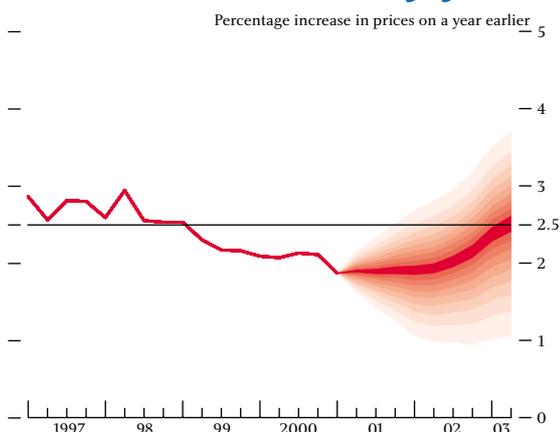
recent sharp pick-up in nominal earnings growth. Headline earnings growth rose to 5.0% in February, well above expectations three months ago. A key reason was that a relatively small number of financial sector firms advanced their payment of bonuses from March to February. As a result, the Committee judges that the recent rise in earnings growth is largely erratic and should unwind relatively quickly.

Employment rates have risen a little further in recent months, following the weather and travel-related autumn pause, and rates of unemployment have declined to new 25-year lows. Surveys of recruitment intentions are consistent with a further rise in employment, although at a slowing pace. Other indicators suggest that the labour market is near a turning point: surveys of skill shortages have stabilised at a high level, and indeed may be beginning to ease according to Bank Agents' contacts; and the number of vacancies advertised in the press has turned down from its end-year peak.

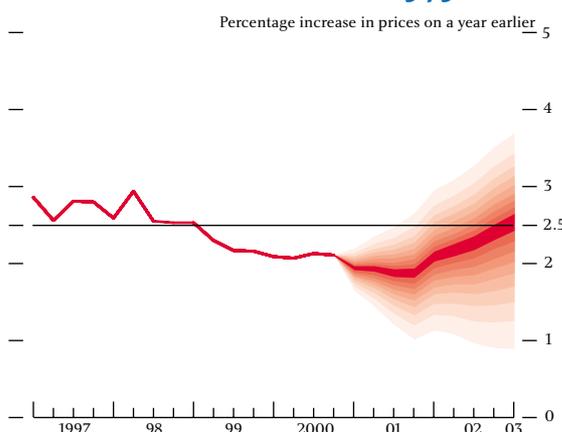
Pay prospects are affected by the number of people who are currently not in employment but are actively seeking work. New, higher, estimates of recent trends in population growth have been incorporated into the latest projection: increased numbers seeking work will tend to put downward pressure on pay. On the other hand, rates of active participation in the labour market in the second half of 2000 were lower than expected as there was an increase in numbers reporting that they did not want a job. The Committee continues to expect that labour market participation will increase over the next two years. But the projected rate of increase has been revised down in the light of the recent evidence, and the lower level of labour market participation adds to prospective pay pressures relative to the February *Report*. The upward influence of a slower rise in labour force participation is likely to be a little stronger than the downward influence of faster population growth.

The outlook for nominal earnings growth depends on the prospective pressures on labour utilisation, which will affect outcomes for real earnings, as well as on inflation expectations. Relative to the February projection, recent levels of real earnings are a little stronger than anticipated (even after discounting much of the recent pick-up as erratic), and labour utilisation is also somewhat above expectations three months ago. The corresponding upward pressure on pay should quickly fade, however, as weaker output growth will lower labour demand. Moreover, as noted above, recent surveys report that inflation expectations have edged down since February which will also contain nominal pay growth. The impact of the uprating of the National Minimum Wage to £4.10 per hour in October 2001 is likely to be small. Taking

**Chart 6.2**  
**Current RPIX inflation projection based on constant nominal interest rates at 5.25%**



**Chart 6.3**  
**RPIX inflation projection in February 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. See the box 'How fan charts are drawn', on page 52 of the February 1999 *Inflation Report*.

all the factors together, the Committee expects that nominal earnings growth will be relatively little changed from the February projection, once the recent spurt has unwound. Earnings growth is likely to drift up only slightly over the next two years.

Labour costs depend on productivity as well as earnings. The broad message from recent data is that productivity is currently rising close to its long-run trend rate. Although there may be a dip in early 2001 as output is suppressed by special factors, productivity growth is expected to remain around trend over the next two years. As a result, the outlook for the growth in unit wage costs will follow the profile for nominal earnings. Once the bonus-distorted outturns have unwound, unit wage cost growth may subsequently edge up a little, although labour cost pressures are likely to remain relatively muted.

Recent outturns for RPIX inflation have been in line with the central projection in the February *Inflation Report*. The outlook over the next quarter is also similar to expectations three months ago.

Conditional on the assumption that the official interest rate is maintained at 5.25%, the Committee's best collective projection for the twelve-month RPIX inflation rate over the next two years is shown in Chart 6.2.<sup>(1)</sup> It is presented

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

alongside the corresponding projection from the February *Report*, which was based on the assumption of constant interest rates at 5.75% (see Chart 6.3).

The central projection is that inflation will remain around current levels over the next twelve months or so, but will subsequently rise gradually to around the 2½% target level after two years. The underlying picture, as in previous *Reports*, is of a gentle rise in inflation in the medium term. Pressures on supply capacity prompt a limited pick-up in prices and wages, as the dampening effect of the rise in the exchange rate on import prices in recent years continues to fade.

The inflation profile is a little lower than in the February projection. The key downside forces affecting the projection in the medium term are: the weaker outlook for the global economy; the higher sterling exchange rate; and lower equity prices. These outweigh the principal upside influences of rather stronger-than-anticipated pressures in the labour market and the successive reductions in interest rates.

The fan charts illustrate the uncertainty surrounding the outlook for inflation and output growth and the balance of risks around the most likely outcome. As in February, the Committee considers that the balance of risks to inflation and growth prospects is weighted to the downside. Downside risks to global demand prevail in the near term, in particular if there were a more rapid correction of private sector financial imbalances in the United States than currently envisaged. But reflecting the significant downward revision to prospects incorporated in the central projection, the magnitude of the downside risk has been lessened somewhat. In the second year of the projection the risks to output growth are judged to be evenly balanced, but the downside risk to activity in the first year continues to affect the risks to inflation.

The overall balance of risks to inflation after two years is illustrated in Chart 6.4. The corresponding balance in the February projection is shown in Chart 6.5. The Committee's best collective assessment of the probabilities of various outcomes for inflation and GDP growth is presented in Table 6.A.

The probability distributions pictured in the fan charts provide an indication of the general uncertainty surrounding the most likely outcome, based on experience of previous forecasting errors, and offer a calibration of the Committee's collective judgment of the overall balance of risks. As in previous *Reports*, for a few key assumptions, some Committee

**Table 6.A**  
The MPC's expectations for RPIX inflation and GDP growth based on constant nominal interest rates at 5.25%<sup>(a)</sup>

**RPIX inflation**

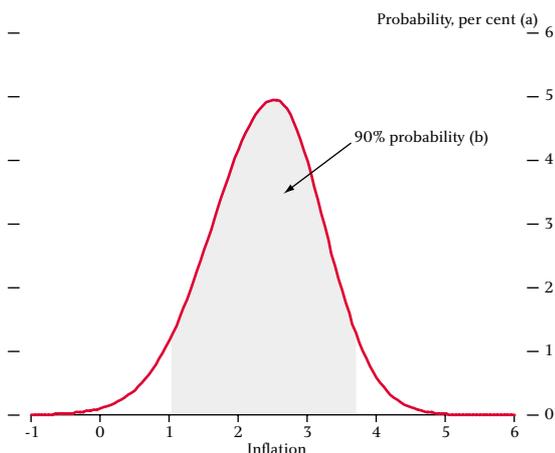
Probability, per cent	Range:					
	less than 1.5%	1.5% to 2.0%	2.0% to 2.5%	2.5% to 3.0%	3.0% to 3.5%	more than 3.5%
2001 Q4	17	45	33	5	<1	<1
2002 Q4	20	25	28	19	7	1
2003 Q2	14	17	23	23	15	8

**GDP growth**

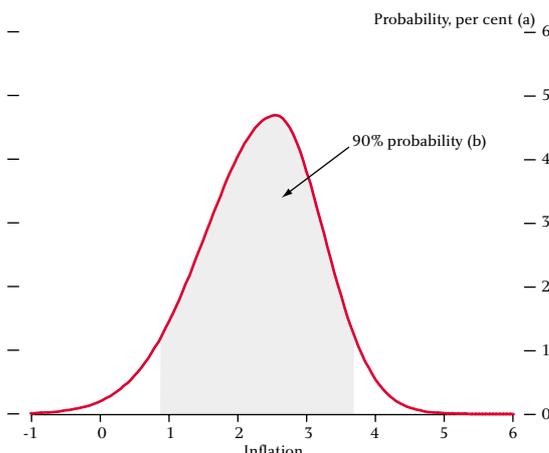
Probability, per cent	Range:					
	less than 0%	0% to 1%	1% to 2%	2% to 3%	3% to 4%	more than 4%
2001 Q4	<1	4	26	46	21	2
2002 Q4	1	7	23	35	25	9
2003 Q2	1	8	24	34	23	9

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

**Chart 6.4**  
Current projection for the percentage increase in RPIX in the year to 2003 Q2



**Chart 6.5**  
February projection for the percentage increase in RPIX in the year to 2003 Q1



Source: Bank of England.

- (a) Probability of inflation being within  $\pm 0.05$  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.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
<b>RPIX inflation</b>		
2002 Q2	-0.1	-0.1
2003 Q2	-0.25	-0.25
<b>GDP growth</b>		
2002 Q2	0.0	-0.15
2003 Q2	+0.1	-0.1

**Table 6.C**  
Market expectations of the Bank's official interest rate<sup>(a)</sup>

Per cent

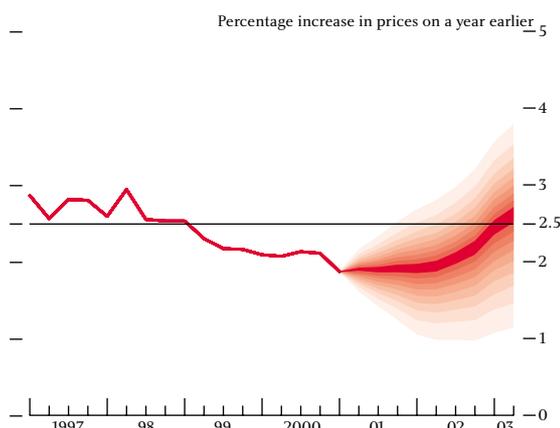
2001			2002				2003	
Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
5.3	5.1	5.0	5.0	5.1	5.1	5.2	5.2	5.2

(a) Based on the interest rate available on gilt-edged securities, including those used as collateral in short-term repurchase contracts, plus a small upward adjustment to allow for the average difference between this rate and the Bank's official interest rate. The data are 15-day averages to 9th May 2001.

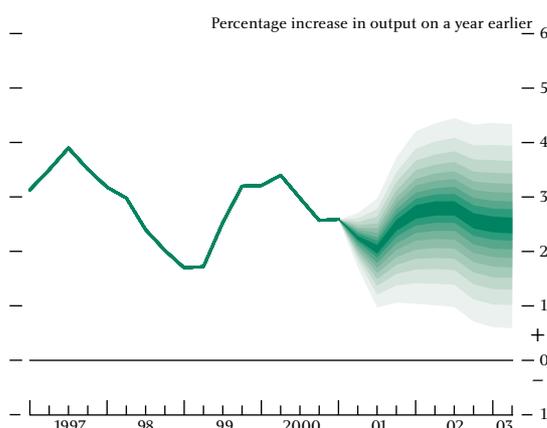
members prefer different judgments from those embodied in the fan charts. In particular, some Committee members judge that the outlook for the world economy is likely to be weaker than in the central projection, and also believe that UK inflation is likely to be more sensitive to the global slowdown than assumed in the central projection. In addition, some members expect that improvements in UK supply-side and labour market performance will place greater downward pressure on inflation over the next two years than assumed in the central case. A calibration of the major differences is presented in Table 6.B. Based on their best individual view, some Committee members judge that the profile for inflation at the two-year horizon could be up to  $\frac{1}{2}\%$  lower than in the central projection portrayed in Chart 6.2. Judgments on the balance of risks are a key component of the policy discussion and decisions. When forming their individual judgments of the appropriate setting for interest rates, Committee members place different weights on the various risks to the outlook.

Expectations of the likely path of future official interest rates have fallen since the February *Report*. Based on market interest rates, the Bank estimates that market participants expect official rates to fall to around 5% by the end of the year and to edge up a little over the subsequent 12 to 18 months (see Table 6.C). The Committee's projections based on the assumption that official rates follow market interest rate expectations are presented in Charts 6.6 and 6.7. Reflecting

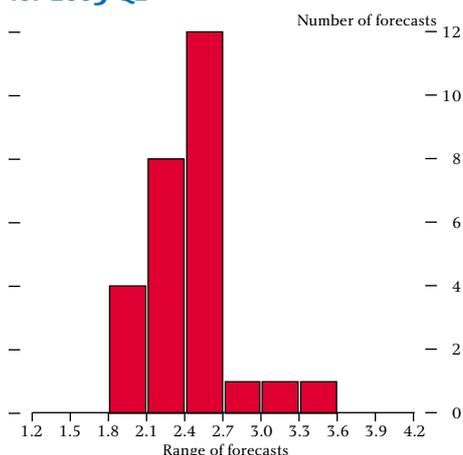
**Chart 6.6**  
Current RPIX inflation projection based on market interest rate expectations



**Chart 6.7**  
Current GDP projection based on market interest rate expectations



**Chart 6.8**  
Distribution of RPIX inflation forecasts for 2003 Q2



Source: Survey of 27 outside forecasters as of 27 April 2001.

**Table 6.D**  
Other forecasters' expectations of RPIX inflation and GDP growth<sup>(a)</sup>

**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	16	40	32	8	2	1
2002 Q4	10	19	37	21	8	4
2003 Q2	8	17	32	26	12	6

**GDP growth (b)**

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	9	32	42	13	2
2002 Q4	3	9	20	41	21	6
2003 Q2	4	9	20	40	21	6

(a) 27 other forecasters provided the Bank with their assessment of the likelihood, at three time horizons, of expected twelve-month RPIX inflation and four-quarter output growth falling in the ranges shown above. This table represents the means of the responses for each range. For example, on average, forecasters assign a probability of 8% to inflation turning out to be less than 1.5% in 2003 Q2.

(b) 26 forecasters.

the marginally lower level of interest rates, the prospects for both output growth and inflation are a little stronger than under the assumption of constant nominal interest rates.

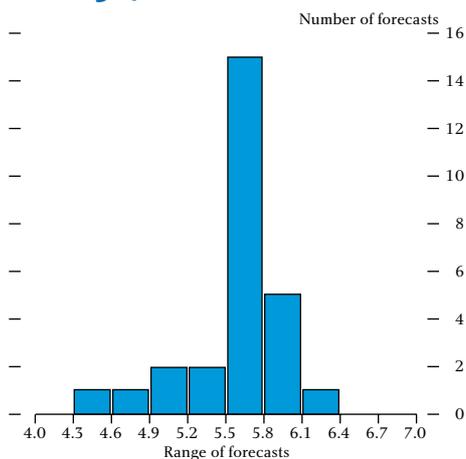
## 6.3 Other forecasts

In April, the Bank asked a sample of external forecasters for their latest projections of inflation and output. Based on this survey, the average forecast for the twelve-month rate of RPIX inflation in 2001 Q4 is 1.9% (with a range of 1.3% to 2.4%) rising to 2.3% in 2002 Q4 and 2.4% in 2003 Q2 (with a range of 1.8% to 3.3%). The distribution of central projections in 2003 Q2 is shown in Chart 6.8. Compared with the survey results in the February *Report*, the mean forecast for inflation in 2001 Q4 is 0.3 percentage points lower, while the average projection for inflation further out is unchanged. On average, external forecasters see a 57% probability of inflation being below 2.5% in 2003 Q2, and a 43% probability of it being above (see Table 6.D).

The forecasters' average projection for four-quarter GDP growth in 2001 Q4 is 2<sup>1</sup>/<sub>4</sub>% (with a range of 1<sup>1</sup>/<sub>4</sub>% to 3%), slightly lower than the average forecast reported in February. The mean projection for growth in 2002 Q4 is 2<sup>3</sup>/<sub>4</sub>% and is 2<sup>1</sup>/<sub>2</sub>% in 2003 Q2 (with a range of 1<sup>1</sup>/<sub>4</sub>% to 3<sup>1</sup>/<sub>4</sub>%).

The average forecast for the official interest rate is 5<sup>1</sup>/<sub>4</sub>% in 2001 Q4 (with a range of 4<sup>3</sup>/<sub>4</sub>% to 5<sup>3</sup>/<sub>4</sub>%), rising to 5<sup>1</sup>/<sub>2</sub>% by 2002 Q4 and remaining at that level in 2003 Q2 (with a range of 4<sup>1</sup>/<sub>2</sub>% to 6<sup>1</sup>/<sub>4</sub>%) (see Chart 6.9). This is 25 to 50 basis points lower than the mean expectation in February. On average, forecasters assume that the sterling ERI will be 103<sup>1</sup>/<sub>4</sub> in 2001 Q4 (with a range of 97<sup>1</sup>/<sub>2</sub> to 108<sup>1</sup>/<sub>2</sub>) and

**Chart 6.9**  
**Distribution of repo rate forecasts**  
**for 2003 Q2**

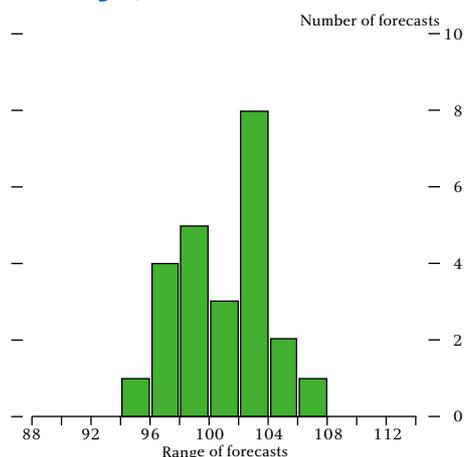


Source: Survey of 27 outside forecasters as of 27 April 2001.

then fall to  $100^{3/4}$  by 2003 Q2 (with a range of 95 to 107) (see Chart 6.10). The exchange rate projections are little changed.

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

**Chart 6.10**  
**Distribution of sterling ERI forecasts**  
**for 2003 Q2**



Source: Survey of 24 outside forecasters as of 27 April 2001.

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# Bank of England

## Agents' summary of business conditions

May 2001

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

- Comments from farming contacts during the period were dominated by the impact of foot-and-mouth disease (FMD). Signs that confidence in the agricultural sector was beginning to improve have now reversed. Elsewhere in the sector, the adverse effects of earlier poor weather on arable farming persisted.
- Manufacturing output growth slowed overall in recent months. The slowdown was particularly marked in the information, communications and technology (ICT) sector. Output growth in most other areas of manufacturing remained little changed. However, deteriorating confidence about future conditions was widespread across manufacturing firms during the period.
- Construction growth strengthened considerably in recent months, as firms worked to reduce backlogs caused by earlier weather-related delays. Underlying demand remained strong in most areas of construction.
- Service sector growth slowed during the period, in both business and consumer services. The slowdown in business services largely reflected weaker ICT and financial services activity. In consumer services, the knock-on effects of FMD resulted in a significant decline in UK tourism-related activity, particularly in rural areas.
- Annual growth in retail sales values increased compared with the previous *Agents' Summary*, although most Agencies suggested that this reflected substitution away from spending on leisure services in rural areas. New car sales to individuals strengthened further in most regions.
- Overall, export growth remained robust for most of the period, although many Agencies noted a slowdown in more recent weeks. In most cases, the slowdown reflected weaker demand from the United States. Import growth appeared to pick up further in many regions.
- Investment intentions appeared to weaken, in both manufacturing and services, during the period. Agencies reported a significant downward revision to investment plans by many high-tech firms. In some cases, this was already feeding through to current spending.
- Input price inflation continued to slow during the period. There was more evidence of manufacturers raising output prices compared with the previous *Agents' Summary*, although most prices remained flat. Agencies reported that retail goods price pressure was also slightly stronger during the period, with prices now generally stable compared with a year earlier, rather than falling as previously.
- Skill shortages eased slightly overall during the period from very high levels. Agents also suggested a softer picture of employment growth recently, driven by weaker demand in the ICT sector and financial services. Agents reported broadly unchanged manufacturing pay settlements, although non-settlement pay growth appeared to pick up a little in some regions (reflecting earlier productivity improvements). Some Agencies noted signs of slower earnings growth in some parts of the service sector late in the period.

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

## OUTPUT

### Primary production

Comments from farming contacts during the period were dominated by the impact of foot-and-mouth disease (FMD). Livestock output declined significantly compared with the previous *Agents' Summary*, although it was thought to be too soon to estimate the overall impact on sectoral output. In any case, contacts suggested that it was likely to be some time before the sector recovered. Many Agencies mentioned that signs that confidence in the sector was beginning to improve have now reversed. There were reports, however, that the banking sector was providing some support to farmers (eg introducing moratoriums on debt repayments and extending loan facilities).

Elsewhere in the sector, Agencies continued to report adverse effects of the earlier poor weather. In particular, delays to harvesting and planting of crops were still occurring due to the problem of waterlogged land.

### Manufacturing

Reports suggested that manufacturing activity slowed overall as the period progressed. This was particularly marked in the information, communications and technology (ICT) sector and so affected those regions more heavily dependent on these industries (such as Scotland and parts of southern England). This resulted from the rationalisation of worldwide production and a slowing in domestic demand for these goods. Moreover, the weakening in demand was unexpected in many cases. As a result, many firms reported some build-up in stocks. Confidence in the ICT sector deteriorated significantly during the period. Reflecting this, most firms have revised down their expectations of output and export growth in coming quarters.

In most regions, growth in other areas of manufacturing remained little changed. The strongest areas of activity appeared to be aerospace and pharmaceuticals. However, Agencies suggested that even some of those firms noticing little slowdown in orders to date were becoming increasingly concerned about the outlook for the coming months.

### Construction and housing

Construction output growth strengthened considerably as the period progressed, as firms worked to reduce backlogs caused by earlier weather-related delays. Underlying demand remained strong in most areas of construction, and even strengthened in several regions. Commercial activity remained robust in most regions, particularly in the retail sector. However, Agencies noted

that some activity (notably pipe-laying by utility companies) was delayed in rural areas due to FMD access restrictions.

Some Agencies noted that earlier expectations of a pick-up in public sector construction activity were beginning to be realised. Many Agencies also noted a strengthening in housebuilding in recent weeks.

Looking forward, while current orders were expected to sustain robust construction growth through the remainder of 2001, the outlook further ahead appeared to soften recently. Notably, a downturn in confidence of some ICT firms resulted in downward revisions to plans for the construction of new buildings.

### Services

Service sector growth slowed during the period—in both business and consumer services. The slowdown in business services growth largely reflected a downturn in demand for ICT services. Growth in financial services also slowed, mostly a reflection of weaker corporate finance (due predominantly to a downturn in M&A activity) and securities trading activity. In addition, the slowdown in the US economy and equity price falls during the period caused more caution regarding purchases of investment products by consumers. But some Agencies suggested that mortgage activity, particularly refinancing, strengthened during the period. Activity in other professional services remained strong (eg legal and accountancy services).

Growth in consumer services also slowed in recent months. This mostly reflected the adverse impact of FMD on tourism-related activities in rural areas. Related leisure activities in affected regions also recorded some decline in demand as a result of FMD (eg spending in local shops, pubs and restaurants). In addition, the slowdown in demand for tourism-related activities was exacerbated by a recent decline in corporate business—particularly from the United States.

Some Agencies noted that there were offsetting gains in some coastal and urban areas (see Consumer spending). However, Agencies suggested that, even at the aggregate level, overall activity was likely to be lower because of the effects on tourism—both inbound and outbound.

## DEMAND

### Consumption

Annual retail sales value growth increased compared with the previous *Agents' Summary*. However, rather than representing an underlying strengthening in household spending, Agencies suggested that it reflected a

temporary boost from FMD—as consumers substituted away from leisure spending in rural areas to spending on goods in urban areas. Many Agencies reported that some of the recent strength was driven by higher sales of furniture and home furnishings, partly reflecting the impact of earlier flood damage. In contrast, some weakening was reported in areas of earlier rapid growth, such as consumer electronics and mobile phones. New car sales to individuals strengthened further during the period in most regions, particularly during the March registration period.

Offsetting buoyant growth in spending on goods, growth in other areas of consumer spending was somewhat weaker during the period. Contacts suggested that spending on catering and related UK tourism spending was down significantly in rural areas. But growth in spending on overseas tourism services rose.

## Exports and imports

Overall, export volume growth remained robust for most of the period, although Agents noted a slowdown in more recent weeks—mostly reflecting weaker demand from the United States. Some firms in the automotive and ICT industries reported a marked deterioration in orders from the United States in recent weeks.

In contrast, export growth to other geographical markets, and for other goods, generally remained firm in most regions. Some Agencies reported a mixed view of demand from continental Europe, although the majority suggested that export growth remained steady. There were few reports of any slowdown in demand from Asia and the Middle East. However, isolated reports of a downturn in orders for equipment used in high-tech manufactures were cited.

Although export growth was robust during most of the period, the rate of growth in imports was relatively faster. Moreover, import growth appeared to rise further during the period in many regions. Agents confirmed that some of the strength in imports reflected the continued relatively rapid growth in domestic demand. In addition, it was suggested that a recent increase in demand for overseas travel had boosted imports further. In addition, much of the strength in imports was a reflection of further outsourcing from UK firms to foreign suppliers.

## Investment

Reports on investment intentions remained mixed across regions, although intentions appeared to weaken overall during the period. Agencies reported a significant downward revision in investment plans by many

high-tech manufacturing firms. In some cases, there was evidence of these revisions feeding through to current spending comparatively quickly. For example, some firms with US parents have enforced moratoriums on investment spending, or have delayed expansion plans until uncertainty about future prospects diminishes. In contrast, firms in other parts of manufacturing reported relatively little change to investment intentions, with many suggesting that investment spending was broadly on track with plans.

Most Agencies reported that investment spending in the service sector during the period remained robust and relatively stronger than in the manufacturing sector. However, in recent weeks, comments regarding investment plans softened somewhat. Many Agencies noted some downward revision to investment plans and increased caution about the impact of the US slowdown. It was noted that telecommunications firms were likely to curtail investment spending while they recovered the funding gap resulting from buying 3G licences and developing those products.

## COSTS AND PRICES

### Input prices

Input price inflation slowed further during the period. Most contacts suggested that, with the exception of a few commodities (eg gas), material costs were of little concern. Most prices were now broadly flat, although many firms reported falling prices for some inputs. Contacts continued to stress the much greater impact of administrative and regulatory costs. For example, many Agencies reported increases in commercial rents, business rates and insurance premia. In addition, the recent introduction of the Climate Change Levy (in April) was a significant concern to a number of contacts, particularly smaller companies.

### Output prices

On balance, there was more evidence of manufacturers raising output prices compared with the previous period. As a result, many firms reported some easing of margin pressure, particularly in export markets. But in most cases, any price rises were modest, and followed a sustained period of price freezes. Overall though, the majority of manufacturers suggested that considerable competitive pressures remained. In addition, comments from contacts in recent weeks suggested that downward pressure on manufacturers' prices would most likely intensify again in coming months, as a result of slowing world demand. Early signs of weakening prices in the ICT sector were reported by some Agencies.

Wholesale meat prices rose significantly in early March—as higher-cost imported meat was sourced to counteract the ban on the movement of domestic livestock. But prices had generally returned to pre-FMD levels by the end of the period.

By comparison, service sector output price increases remained relatively stronger than in manufacturing, although the pace of inflation appeared to slow recently.

### Retail prices

There were clear signs that the annual pace of decline in retail goods prices eased further and, by the end of the period, prices were reportedly broadly unchanged compared with a year earlier. Many retailers noted that continued strong volume growth resulted in less significant discounting during ‘sales’ periods than last year. Agencies reported that earlier significant increases in seasonal food prices (as bad weather restricted supply) were unlikely to unwind in the near term. In addition, there was some impact from FMD on food prices during the period. For example, retail meat prices rose in March, but eased back somewhat in April.

On balance, retail services inflation remained broadly stable overall compared with the previous period. Despite reports of poor demand for UK tourism-related activities, there were few reports of any decline in prices. But many Agencies suggested that strong demand for overseas holidays resulted in some price increases.

New car prices generally remained stable during the period, following a sustained period of falling prices. Contacts reported that it was unlikely that prices would fall further. Used car prices firmed somewhat, with several examples of modest price increases cited during the period. These increases reportedly reflected a shortage of stocks of one to two year old cars.

### Pay

Manufacturing settlements generally remained steady, suggesting that earlier concerns about higher settlements (notably in the southern regions) were mostly unfounded. Firms mentioned that concerns regarding job security had become a greater influence recently. Some Agencies suggested that non-settlement pay growth in the sector may have picked up slightly during the period. However, most firms suggested that these increases reflected productivity improvements (following earlier restructuring and rationalisation), rather than stronger underlying pay pressures.

Overall pay pressures in the service sector remained relatively stronger than in manufacturing. During most of the period, earnings growth remained little changed from the previous *Agents’ Summary*, although there were signs of slower growth in some industries late in the period. For example, many Agencies noted early signs of an easing in ICT services pay growth in recent weeks—reflecting weaker demand.

Pay pressures increased in the construction sector during the period. Demand for labour increased as firms worked to reduce significant backlogs and meet stronger underlying demand in the sector. Pay increases were significant in many cases, reflecting continued severe skill shortages in the sector.

Some contacts mentioned concern about the impact of the 10% increase in the National Minimum Wage in October this year. Agencies suggested that it would impact most significantly on the service sector (notably retail and hospitality) and could result in some knock-on increases to ensure the restoration of pay differentials. However, its overall impact was likely to be limited.

## EMPLOYMENT

On balance, skill shortages eased slightly during the period, after intensifying consistently since around mid-1999. This largely reflected weaker demand for labour in ICT services. However, most Agencies continued to stress that shortages in the construction sector remained acute, and may even have strengthened in some regions.

Evidence on employment growth was also softer during the period. Declines in manufacturing employment continued in almost all regions, and the pace of decline quickened in recent weeks in some regions. In addition, there were several announcements of significant redundancies in some areas of high-tech manufacturing (notably telecommunications), suggesting that employment conditions in manufacturing were likely to continue to weaken in coming months.

Service sector employment growth also slowed compared with the previous period in several regions—predominantly in ICT services. For example, several computing firms were told by US parents to take a more cautious approach to staffing. Others reported significant redundancies and employment freezes in recent weeks. Moreover, a downturn in demand for some financial services resulted in cutbacks in many regions. In addition, several Agencies suggested that the take-up of temporary staff for the summer tourist season was lower than usual, as a result of the adverse impact of FMD on demand in these industries.

## **Text of Bank of England press notice of 8 March 2001**

### **Bank of England maintains interest rates at 5.75%**

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 5.75%.

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

## **Text of Bank of England press notice of 5 April 2001**

### **Bank of England reduces interest rates by 0.25% to 5.5%**

The Bank of England's Monetary Policy Committee today voted to reduce the Bank's repo rate by 0.25% to 5.5%.

While growth in final domestic demand has remained firm, there are downside risks to UK activity from the slowdown in the global economy, the recent fall in equity markets and, in the short run, from foot and mouth disease. These developments could already have affected demand and output growth and may continue to do so, in particular through their impact on business and consumer confidence.

Inflation is currently somewhat below target, and is expected to remain so for a while. Price and cost pressures continue to be subdued. There is little sign of any easing yet in the labour market but, despite its tightness, settlements and earnings growth have so far remained moderate. In addition, the strength of sterling continues to exert a dampening effect on inflation.

Against this background, the Committee decided that a reduction of 0.25% in the Bank's repo rate was necessary to meet the inflation target looking further ahead. The Committee will continue to monitor the downside risks carefully.

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

## **Text of Bank of England press notice of 10 May 2001**

### **Bank of England reduces interest rates by 0.25% to 5.25%**

The Bank of England's Monetary Policy Committee today voted to reduce the Bank's repo rate by 0.25% to 5.25%.

The world economic prospect has on balance continued to weaken. The extent and duration of the slowdown remain uncertain. In the UK, final domestic demand has so far remained firm, but output growth in Q1 was slower than expected and there has been some weakening in business confidence. The labour market remains tight. While the latest data showed faster earnings growth, this was largely the result of temporary factors, and settlements remain broadly stable. More generally, price and cost pressures are subdued. As the Committee noted a month ago, inflation is currently somewhat below target, and is expected to remain so for a while.

Against this background, the Committee decided that this further reduction of 0.25% in the Bank's repo rate was necessary to meet the inflation target in the medium term.

The Committee's latest inflation and output projections will appear in the *Inflation Report* to be published on Wednesday 16 May. The minutes of the meeting will be published at 9.30 am on Wednesday 23 May.

## 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 by its yield relative to a benchmark asset and provides an index of the transactions services of money.

**ERI:** exchange rate 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 financial institutions (MFIs) to all UK residents other than the public sector and MFIs. M4 lending includes loans and advances as well as investments, acceptances and reverse repo transactions.

**RPI inflation:** inflation measured by the retail price index.

**RPIX inflation:** inflation measured by the RPI excluding mortgage interest payments.

**RPIY inflation:** inflation measured by the RPI excluding mortgage interest payments and the following indirect taxes: council tax, VAT, duties, car purchase tax and vehicle excise duty, insurance tax and airport tax.

### Abbreviations

**ABI:** Annual Business Inquiry.

**BCC:** British Chambers of Commerce.

**BRC:** British Retail Consortium.

**CBI:** Confederation of British Industry.

**CIPS:** Chartered Institute of Purchasing and Supply.

**CME:** Chicago Mercantile Exchange.

**CML:** Council of Mortgage Lenders.

**DAX:** Deutsche Börse AG German Stock Index.

**DHL:** DHL International (UK) Ltd.

**ECB:** European Central Bank.

**ESA:** European System of Accounts.

**EU:** European Union.

**FOMC:** Federal Open Market Committee.

**FTSE:** Financial Times Stock Exchange.

**GC:** general collateral.

**GDP:** gross domestic product.

**GfK:** Gesellschaft für Konsum, Great Britain Ltd.

**HBF:** House Builders' Federation.

**HMT:** Her Majesty's Treasury.

**ICPFs:** insurance companies and pension funds.

**ICT:** information and communications technology.

**IDS:** Incomes Data Services.

**IEA:** International Energy Agency.

**IMS:** Institute of Management Services.

**IoD:** Institute of Directors.

**IRS:** Industrial Relations Services.

**LFS:** Labour Force Survey.

**LIFFE:** London International Financial Futures and Options Exchange.

**M&A:** mergers and acquisitions.

**MEW:** mortgage equity withdrawal.

**MFIs:** monetary financial institutions.

**MORI:** Market and Opinion Research International.

**MPC:** Monetary Policy Committee.

**NHS:** National Health Service.

**NMW:** National Minimum Wage.

**NYMEX:** New York Mercantile Exchange.

**OFCs:** other financial corporations.

**ONS:** Office for National Statistics.

**OPEC:** Organisation of Petroleum Exporting Countries.

**PBR:** Pre-Budget Report.

**PNFCs:** private non-financial corporations.

**PMI:** Purchasing Managers Index.

**REC:** Recruitment and Employment Confederation.

**RICS:** Royal Institution of Chartered Surveyors.

**S&P:** Standard and Poor's.

**TMT:** Technology, media and telecommunications.

### 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.