Inflation Report

November 2001

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

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

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

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The Overview of this *Inflation Report* is available on the Bank's web site at www.bankofengland.co.uk/inflationreport/infrep.htm The entire *Report* is available in PDF format at www.bankofengland.co.uk/inflationrep/index.html

Overview

Despite a worsening global picture, growth in the United Kingdom has been close to trend and inflation has remained near the 2.5% target. Even before the terrorist attacks on 11 September, economic activity in the rest of the world was slowing by more than was anticipated in the August *Report*. But the impact on the United Kingdom has so far been offset by continued strong growth in domestic consumption. The contrast between the fortunes of the internationally exposed sectors on the one hand, and those focused on the domestic market on the other, consequently remains as marked as ever. The labour market, though still tight by historical standards, may be turning and earnings growth has been steady.

Global equity prices fell sharply during August and early September following unexpectedly weak economic indicators in the United States and elsewhere. This was accompanied by a general deterioration in confidence. The terrorist attacks in America administered a further adverse blow to confidence and have heightened uncertainty. In these circumstances, the reported fall of 0.1% in third-quarter US GDP was unexpectedly mild, but employment data and survey indicators paint a gloomier picture. Output in the euro area increased by just 0.1% in the second quarter and available indicators suggest that activity continued to stagnate in the third quarter. After contracting by 0.8% in the second quarter, economic prospects in Japan remain bleak. The steep decline in the global demand for high-technology goods in particular has had a pronounced impact on some emerging economies.

Oil and other commodity prices have weakened further in the face of falling demand. Spot oil prices have fallen some \$4–\$5 per barrel since August, although the futures curve has flattened. This weakness in commodity prices, allied to the disinflationary impact of slower growth, should outweigh any adverse cost consequences as businesses respond to the threat of further terrorist attacks.

In reaction to the deterioration in global prospects and declining inflationary pressures, monetary policy in the rest of the world has eased since the August *Report*. The Federal Reserve has cut official interest rates by 1.75 percentage points, and these are now 4.5 points below their level at the start of the year. The European Central Bank has lowered rates by 1.25 percentage points, making a total cut of 1.5 points this year. A significant discretionary fiscal stimulus is also planned for the United States. The relaxation in monetary and fiscal policy should help to foster recovery in global growth during the course of next year.

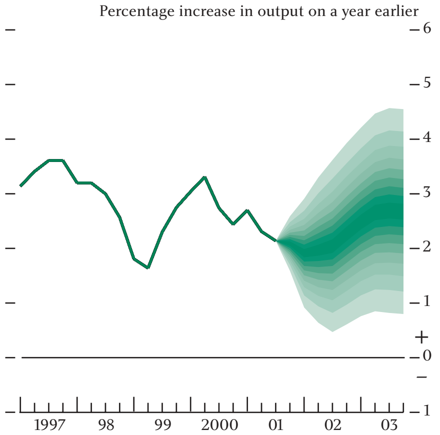
In the United Kingdom, consumers' expenditure is reported to have risen by 1.3% in the second quarter. An increase of 1.5% in retail sales volumes in the third quarter, together with vigorous growth in household money and credit, points to continued strong consumption growth in Q3. But earlier falls in equity prices, moderating house price inflation, lower consumer confidence and slowing real income growth suggest that consumer spending will decelerate. Public consumption grew by 0.7% in the second quarter and will continue to act as a stimulus to growth in the medium term.

The level of business investment for the recent past has been revised up, although the quarterly movements recorded over the past year remain erratic. The capital stock also appears higher on the revised data. Going forward, investment intentions have weakened in the face of deteriorating economic prospects and a worsening corporate financial position. In addition, the heightened uncertainty is likely to prompt some businesses to put planned investment expenditure on hold until the outlook becomes clearer. Private investment is therefore likely to weaken over the next few quarters, although this will be partly offset by a stronger contribution from the public sector.

A considerable proportion of the 1.4% increase in final domestic demand in the second quarter appears to have been met from inventories. Surveys suggest that stocks fell in the third quarter, but the inventory correction should end soon. This destocking was associated with a sharp fall in intermediate goods imports that helped to offset the drag on growth exerted by falling exports. Going forward, net trade is likely to depress growth until world economic activity begins to recover towards trend. The effective exchange rate for sterling has changed little since the August *Report*.

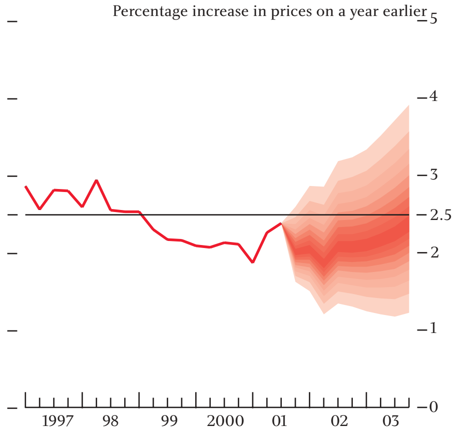
Output is provisionally estimated by the ONS to have risen by 0.6% in the third quarter, compared with an upwardly-revised 0.4% in the second quarter. The overall figure conceals continuing marked imbalances across and within sectors, which mirror the divergence between slowing world demand and firm domestic spending. Manufacturing contracted by 0.8%, with much of the decline attributable to the high-tech electrical and optical engineering industry, and business surveys point to the weakness continuing. In contrast, the service sector expanded by 0.8%, but survey data suggest that growth there may now be slowing.

Chart 1
Current GDP projection based on constant nominal interest rates at 4%



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 4%



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.

There are signs that the labour market may be turning. The LFS employment rate fell by 0.3 percentage points in the three months to August. The corresponding measure of the unemployment rate rose to 5.1% over the same period, although the claimant count continued to drift down into September. Some survey-based measures of labour shortage have eased, although they generally remain high by historical standards, and employment intentions have weakened a little. While firms may not shed scarce skilled labour in the face of a possibly temporary downturn, increased uncertainty associated with global developments is likely to inhibit new hiring.

Nominal earnings growth has been stable over the past three months, and wage settlements have been flat. While unit labour costs have edged up, the weakness in input prices and continued international competitive pressures have ensured that goods price inflation has remained negligible. In contrast, inflation in the more sheltered service sector remains close to 4%. Overall RPIX inflation ticked up to 2.6% in August before dropping back to 2.3% in September. Inflation is likely to stay below target in the near term, although monthly movements could be erratic as special factors unwind.

In the wake of the terrorist attacks, the MPC lowered the Bank's official interest rate by 0.25 points at an unscheduled meeting on 18 September. The Committee lowered the rate by a further 0.25 points at its scheduled October meeting, seeking to counteract the impact of the deteriorating global picture by sustaining domestic demand growth.

Chart 1 shows the MPC's assessment of the outlook for GDP growth, on the benchmark assumption that the official interest rate remains at 4%. In the central projection, growth dips a little next year as sluggish world activity and a slowdown in private final demand are only partly offset by stronger public spending and an end to destocking. It then picks up in the second year of the projection as global growth and domestic investment recover. Growth over the two years is broadly the same as in the August *Report*, as the effects of the cuts in official interest rates offset the consequences of deteriorating global conditions.

Chart 2 shows the corresponding outlook for RPIX inflation. In the central projection, inflation slips back to around 2% early next year before drifting back up towards the target at the forecast horizon. Although the broad outlook for output growth is similar to August, underlying inflationary pressures are a little weaker, reflecting lower input prices and a higher margin of spare capacity. Some members prefer alternative assumptions about supply-side developments and international prospects that generate an inflation profile that is either slightly higher or up to 0.5% lower at the forecast horizon.

Considerable uncertainties surround these projections. As in recent *Reports*, the possibility that the slowdown in the international economy may be deeper or more prolonged is a downside risk. And there is uncertainty about the speed at which consumption growth will moderate. Finally the exchange rate could fall sharply, possibly prompted by a widening current account deficit. In the Committee's judgment, the overall risks to growth are roughly balanced, although the overall risks to inflation are on the upside. Members take somewhat differing views on the likelihood of these various risks crystallising and thus on the overall balance of risks.

In reaching its decision at the November meeting, the Committee noted that the more subdued global outlook had weakened the outlook for UK growth and lowered prospective inflationary pressures. Without further action, there was a risk that inflation would significantly undershoot the target over the next two years and that activity would be lower than necessary. Taking into account the balance of risks, the Committee judged that a further reduction in interest rates would help support confidence and domestic spending, and thus maintain prospective inflation in line with the target in the medium term. The Committee accordingly voted to lower the official interest rate by 0.5 points, making a cumulative fall of 2 percentage points since the start of the year.

Contents

1 Money and asset prices 3

1.1 Asset prices 3

Interest rates 3

Equities 4

The exchange rate 6

Property prices 6

1.2 Money and credit 7

Aggregate money and credit 7

Household sector 7

Private non-financial corporations 9

Other financial corporations 9

1.3 Summary 10

2 Demand and output 11

2.1 External demand and UK net trade 11

2.2 Domestic demand 14

Household sector consumption 14

Investment demand 18

Public sector consumption 20

Inventories 20

2.3 Output 21

2.4 Summary 24

Boxes: Revisions to the National Accounts 16

Trends in ICT manufacturing in the United Kingdom 22

3 The labour market 25

3.1 Employment and employment intentions 25

3.2 Labour availability 27

3.3 Earnings and unit wage costs 30

3.4 Summary 32

4 Costs and prices 33

4.1 Commodity prices 33

4.2 Import prices 34

4.3 Costs and prices in manufacturing 35

4.4 Costs and prices in the service sector 36

4.5 Retail prices 37

4.6 Summary 39

5 Monetary policy since the August *Report* 40

6 Prospects for inflation 45

6.1 The inflation projection assumptions 45

6.2 The output and inflation projections 48

6.3 Other forecasts 58

Agents' summary of business conditions 60

Press Notices 64

Glossary and other information 66

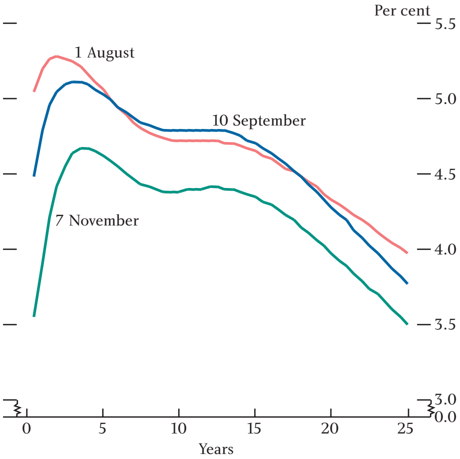
Money and asset prices 1

Since the August *Inflation Report*, official interest rates have been reduced by 1 percentage point in the United Kingdom, and by 1.75 and 1.25 points in the United States and the euro area respectively, reflecting the weaker global outlook, which worsened further after the terrorist attacks in the United States on 11 September. An assessment of the economic impact of the attacks has been central to the preparation of this *Report*. This section includes a discussion of the effects on financial markets. The aggregate demand and supply implications are discussed in Section 2, while the effects on the oil market are discussed in Section 4.

Short-term interest rate expectations have fallen, but interest rate uncertainty remains higher than in August. Equity prices around the world had fallen sharply before the attacks in the United States. They fell again in the immediate aftermath, when uncertainty rose steeply, but have recovered since to levels that prevailed before 11 September. Exchange rates have changed little, even after 11 September.

At home, the divergence persists between growth in households' money and credit on the one hand, and that of the corporate sector on the other. The annual growth rate of households' deposits eased back slightly in Q3 from the ten-year high observed in the second quarter, but remained supportive of robust consumer spending, at least in the near term. Total and secured lending to individuals grew at ten-year highs in Q3, underpinning and reflecting the strength of the housing market, as well as consumption. Non-financial companies' M4, M4 borrowing and total external finance weakened in Q3.

Chart 1.1
Nominal instantaneous forward interest rates[(a)(b)]



Source: Bank of England.

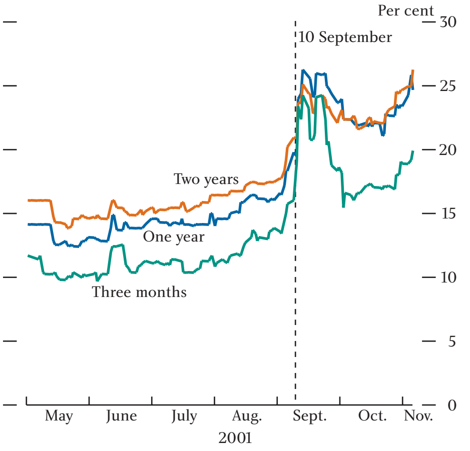
(a) A forward rate is the rate implied for a future period by comparisons of current shorter-term and longer-term rates. The rates shown are continuously compounded.
(b) Based on gilt yields of different maturities.

1.1 Asset prices

Interest rates

Since the August *Inflation Report*, the MPC has reduced the Bank's official repo rate by 0.25 percentage points on both 18 September and 4 October and by 0.5 points to 4% on 8 November. The US Federal Open Market Committee reduced its official target interest rate by 0.25 percentage points on 21 August, and by 0.5 points on 17 September, 2 October and 6 November to 2%. The European Central

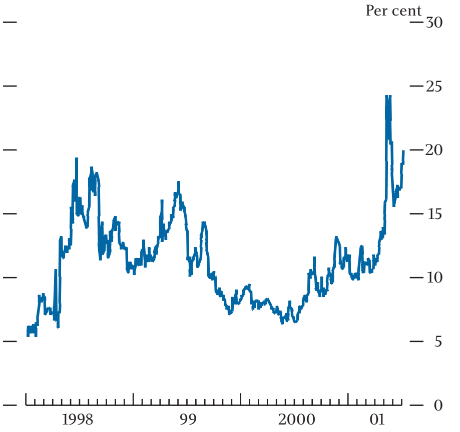
Chart 1.2
Term structure of implied volatility of short sterling futures[(a)]



Source: LIFFE.

(a) Three-month Libor; three months, one year and two years ahead.

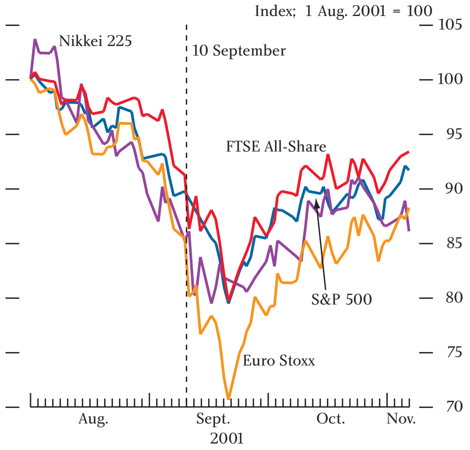
Chart 1.3
Implied volatility of three-month sterling futures[(a)]



Source: LIFFE.

(a) Three-month Libor; three months ahead.

Chart 1.4
International equity markets



Source: Bloomberg.

Bank also cut its repo rate: by 0.25 percentage points on 30 August and by 0.5 points on both 17 September and 8 November to 3.25%. The official rate reductions reflected weakness in the world economy, as well as attempts to counter the negative impact of the terrorist attacks on confidence and demand worldwide.

Expectations of future short-term sterling interest rates have fallen substantially since the August *Inflation Report* (see Chart 1.1), initially following the unexpected repo rate cut on 2 August and then the weaker-than-expected international economic news. Short-term interest rate expectations continued to fall after 11 September, associated with expectations of official rate cuts, but also a flight into liquidity and low-risk assets amid an increasingly uncertain global economic outlook. Nominal forward rates implied by assets with medium-term maturities rose before and immediately after 11 September. In part, this may have reflected a reassessment of government borrowing requirements in the light of the terrorist attacks. But by 7 November, longer-term forward interest rates had fallen well below August levels.

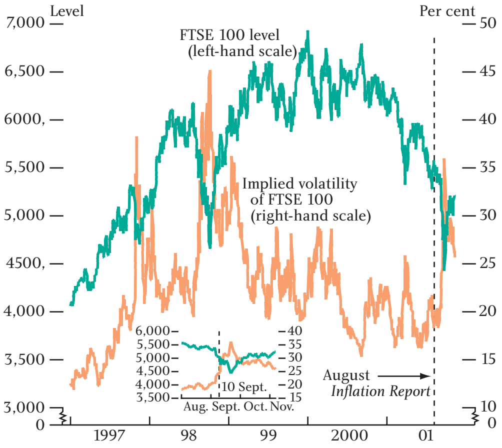
Uncertainty about future short-term UK interest rates, as measured by implied volatility[(1)] derived from options prices, rose gradually following the repo rate reduction on 2 August (see Chart 1.2), and continued to rise in the following weeks, reflecting growing uncertainty about future economic conditions. Implied volatility rose sharply after the attacks in the United States. The rise in implied volatility was slightly greater than that following the Long-Term Capital Management (LTCM) collapse in Autumn 1998 (see Chart 1.3). Implied volatility at the three-month horizon fell back to pre-attack levels during October, though it increased again more recently.

Equities

Equity prices worldwide had been falling before the attacks in the United States (see Chart 1.4), and market indices fell steeply immediately afterwards. These synchronised movements suggest that the major economies have been affected by factors common to them all. The Dow Jones index fell by 7% on 17 September after the New York Stock Exchange reopened; the wider S&P 500 and the Wilshire 5000 indices both dropped by 5%. Although this represented the biggest-ever one-day fall in points terms for the Dow Jones, in percentage terms it was small compared with the 19 October 1987 crash, when the index dropped by 23% in one day, and

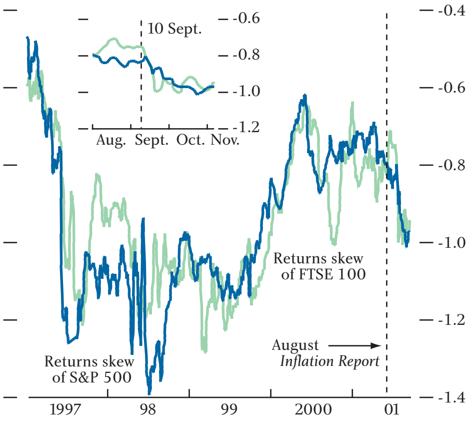
[(1)] Implied volatility is a measure of uncertainty about proportional movements in the three-month London interbank offered rate (Libor), here shown three months, one year and two years ahead. Derived from options prices on short sterling futures traded on the London International Financial Futures and Options Exchange (LIFFE).

Chart 1.5
FTSE 100 level and three-month implied volatility



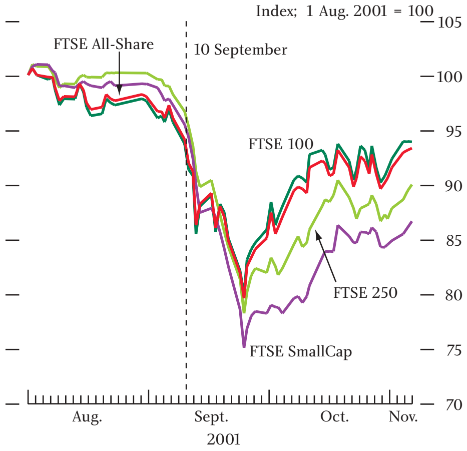
Sources: Bloomberg, LIFFE and Bank of England.

Chart 1.6
Skew on expected equity returns



Sources: Chicago Mercantile Exchange Inc., LIFFE and Bank of England.

Chart 1.7
UK equity markets



Source: Bloomberg.

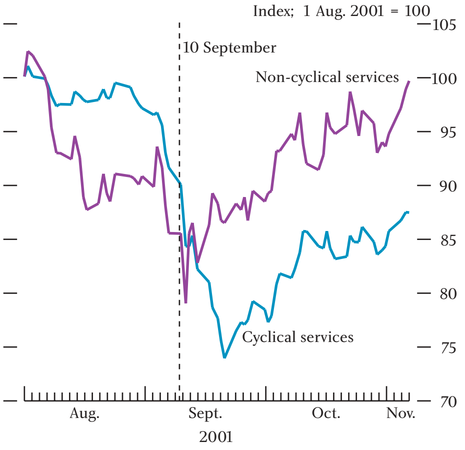
the S&P 500 fell by 20%. The main US equity indices fell further until they reached troughs on 21 September, with cumulative losses of 12% for the S&P 500 and the Wilshire 5000 since 10 September; similar to the cumulative fall of 12% and 13% respectively in the two weeks following Russia's default on its short-term debt and the subsequent LTCM crisis in August 1998. Most market indices recovered their post-11 September losses, but remained well below levels at the time of the August *Inflation Report*. The Euro Stoxx index reached a deeper trough than most other international indices (see Chart 1.4).

In the 15 working days to 7 November, the FTSE All-Share index was on average about 8% below the level for November implied by the August *Inflation Report* central projection. On 7 November the FTSE 100 closed 6% below its 1 August level and 25% below its end-1999 peak. The decline in UK equity prices since August partly reflects a fall in profit expectations. But it is also probably a function of a rise in the equity risk premium. The value of equities depends on the expected future stream of earnings, and on the rate at which these are discounted. When future earnings become more uncertain, potential buyers may raise their discount rate to reflect the increased risk. Hence they may only be prepared to pay a lower price for equities, even if profit expectations were unchanged. Volatility of the FTSE 100 index (an indicator of uncertainty), as implied by three-month options prices, had been rising before 11 September. But it then spiked up sharply (see Chart 1.5). Recently, implied volatility has returned close to pre-attack levels, while equity prices have recovered. A similar picture can be drawn for the S&P 500. This suggests that some of the fall in equity prices after 11 September and the subsequent bounceback were a function of changes in uncertainty.

The skew on expected equity returns, implied by three-month options prices, became more negative after 11 September, suggesting a greater probability of a fall in equity prices in the future (see Chart 1.6). That downside skew remains more negative than on 1 August. The MPC's central projection continues to assume that equity prices will rise in line with nominal GDP over the forecast period.

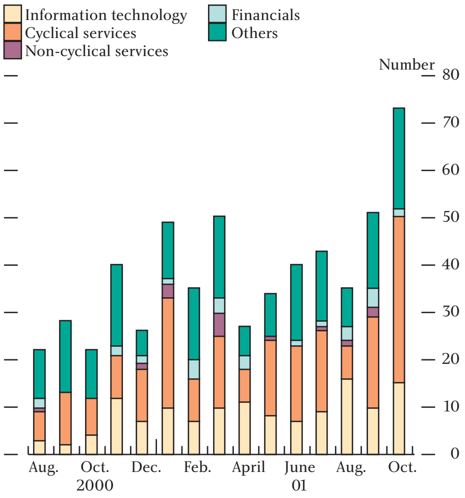
UK equity indices were falling at broadly similar rates before 11 September (see Chart 1.7). But following the attacks in the United States, the FTSE 100 index outperformed other indices and on 7 November it closed slightly above its pre-attack level. The SmallCap index has fallen further than the other main UK indices, and remains the weakest since the August *Report*. Some of the SmallCap index's relative deterioration is due to its sectoral composition. Cyclical services' equity prices fell

Chart 1.8
FTSE Actuaries sectoral indices



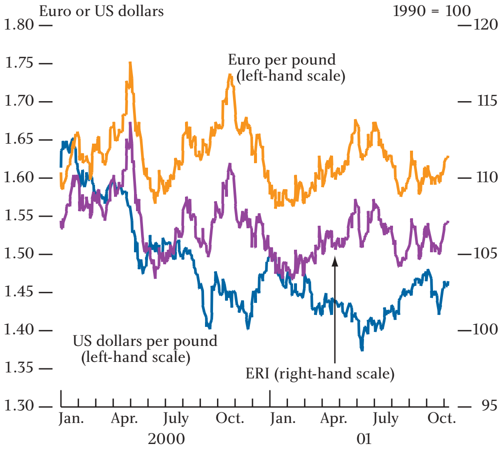
Source: Thomson Financial Datastream.

Chart 1.9
Profit warnings by sector



Sources: Reuters Business Briefing and Bank of England.

Chart 1.10
Sterling exchange rates



Source: Bank of England.

sharply after 11 September. They have recovered somewhat recently, but on 7 November they were still 3% below their 10 September level (see Chart 1.8). Cyclical services account for about 25% of the SmallCap index, compared with only 10% of the FTSE 100. This sector includes tourism, whose prospects were negatively affected by the terrorist attacks in the United States. Chart 1.9 shows that the number of profit warnings in that sector rose in September and October, although this may not only be due to the effects of the attacks. The best-performing sector since 11 September—non-cyclical services, whose index rose by 17% (see Chart 1.8)—accounts for about 15% of the FTSE 100, but only 2% of the SmallCap index.

The exchange rate

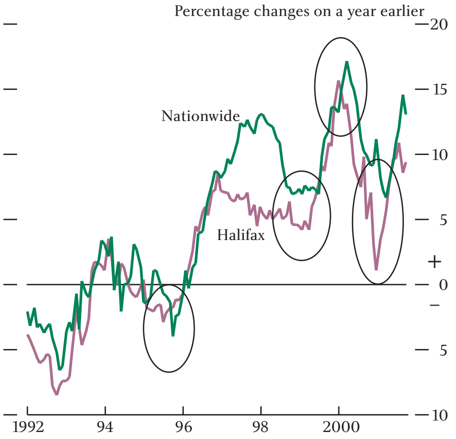
The sterling effective exchange rate (ERI) averaged 106.0 in the 15 working days to 7 November, which was about 0.4% below the level for November implied by the August *Inflation Report* central projection. The sterling ERI rose in the first half of the year (see Chart 1.10). Since then it has eased slightly, reflecting some rise in the euro, which carries a large weight in the sterling ERI. After 11 September, the major exchange rates have been relatively stable, perhaps reflecting the markets' perception that the attacks and subsequent developments would have a similar impact on many economies. October's Consensus Economics survey shows that independent forecasters expect the sterling ERI to depreciate steadily during the next two years. The MPC's central projection assumes that the sterling ERI will depreciate by around 3% over the forecast period.

Property prices

In line with expectations at the time of the August *Report*, house price inflation has remained high in recent months, although there appears to be tentative evidence that annual house price inflation may have now peaked. After rising significantly since the beginning of the year, the annual rate of increase in the Halifax measure of house prices declined slightly from 10.9% in August to 9.4% by October. Annual inflation also fell on the Nationwide measure in October, following five consecutive months of rising inflation. Of the two, it appears that the Halifax measure may give an earlier indication of turning points in annual inflation (see Chart 1.11).

The MPC continues to judge that annual house price inflation in the United Kingdom will ease back in coming quarters. Consistent with this, recent information from the Royal Institution of Chartered Surveyors' (RICS) survey shows a weakening in expectations of price rises over the next three

Chart 1.11
House price inflation



Sources: Halifax plc and Nationwide Building Society.

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

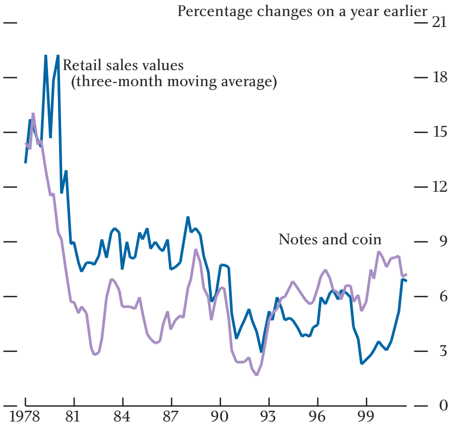
Percentage changes on a year earlier

	2000			2001		
	Q2	Q3	Q4	Q1	Q2	Q3
Notes and coin	7.7	8.8	4.7	8.2	7.1	6.7
M4	6.9	9.1	8.3	8.2	7.5	8.0
M4 lending (a)	11.5	13.2	12.6	11.9	11.3	9.9

Source: Bank of England.

(a) Excluding the effects of securitisations.

Chart 1.12
Notes and coin(a) and retail sales



Sources: Bank of England and ONS.

(a) Adjusted in 2000 and 2001 for Y2K effects and the September 2000 fuel crisis.

months. Indicators of activity earlier in the house-purchasing process also point to some slowing in the near term. Growth in the number of housing loan approvals has eased recently, while survey data from the House Builders' Federation indicate a slowdown in net reservations and site visits.

1.2 Money and credit

Aggregate money and credit

Notes and coin growth slowed to an annual rate of 6.7% in Q3 (see Table 1.A). There was a noticeable slowing in the first two weeks after 11 September. But it has since recovered and grew by 7.4% in the twelve months to October.

The growth of notes and coin has been a reasonable coincident indicator of growth in the value of retail sales for more than two decades (see Chart 1.12). This relationship has been quite stable over the period shown, although notes and coin has grown at a faster rate than retail sales since the early 1990s (ie the velocity of circulation has fallen). Previous *Reports* have suggested that the increased demand for narrow money may be related to lower nominal interest rates (as a result of persistently lower inflation expectations), which have reduced the opportunity costs of holding cash. Growth rates of narrow money and retail sales were similar in Q3, though it is too soon to say whether this marks the end of the fall in narrow money velocity.

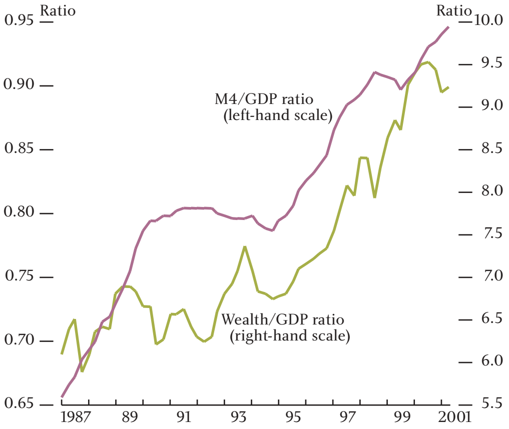
Broad money growth rose to an annual rate of 8.0% in Q3 (see Table 1.A), whereas annual aggregate credit growth weakened to 9.9%. Broad money has grown at a faster rate than nominal GDP since the early 1980s. The trend rise in the M4/GDP ratio (see Chart 1.13) is closely linked to the trend increase in the wealth/GDP ratio (where wealth is defined as the sum of financial assets held by households and companies plus gross housing wealth). As equity prices rise, households and companies, in the longer term, tend to increase their money holdings to rebalance investment portfolios.

Since 2000 Q4, the wealth/GDP ratio has fallen, as the decline in equity prices outweighed house price increases. But the M4/GDP ratio has continued to increase. This increase in the demand for money has largely come from the household sector.

Household sector

Households' M4 rose by 8.6% in Q3 compared with a year earlier; slightly less than the ten-year-high annual growth

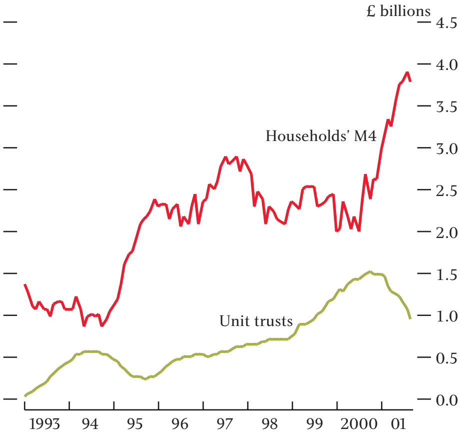
Chart 1.13
Wealth/GDP ratio and M4/GDP ratio[a]



Sources: Bank of England and ONS.

(a) Both series use the four-quarter moving sum of nominal GDP at market prices as the denominator.

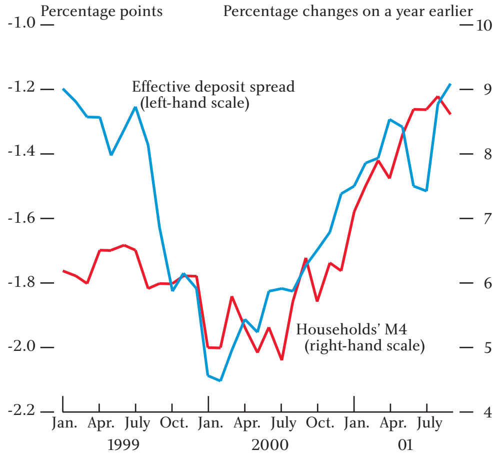
Chart 1.14
Monthly flow[a] in households' M4 and unit trust purchases



Sources: Bank of England and Association of Unit Trusts and Investment Funds.

(a) Twelve-month moving averages.

Chart 1.15
Households' M4 growth and effective deposit rate spread[a]



Source: Bank of England.

(a) Weighted average of sight and time deposit interest rates minus three-month market rates.

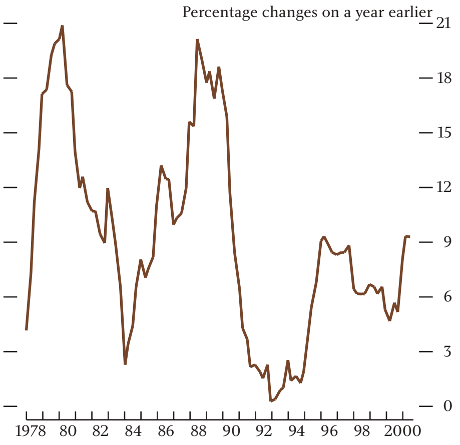
rate of 8.7% recorded in Q2. Large inflows into households' M4 may underpin further strength in consumption in the second half of 2001. But it would also appear that the fall in equity prices and the increased downside risk to future equity prices have prompted some households, probably temporarily, to move their savings out of shares and unit trusts into safer assets such as bank deposits (see Chart 1.14). Furthermore, banks' deposit rates have risen relative to other short-term market rates since early 2000 (see Chart 1.15), providing stronger incentives for households to hold larger M4 balances. This suggests that part of the strong recent M4 inflow is linked to a short-term redistribution of asset portfolios. Nevertheless, there is a risk that at some point these deposits will be spent directly on goods and services. They could also be reinvested in equities, which would help to support a recovery in prices, and could in turn underpin stronger consumer spending as households' financial wealth rises.

Households' Divisia (which weights M4 components by a measure of their liquidity) grew by 9.3% in the year to Q3, unchanged on Q2, but the highest rate since 1996 Q2 (see Chart 1.16). Divisia is generally a better indicator of future consumer spending than M4, but some of the growth in Divisia might also reflect portfolio motives.

Annual growth in M4 lending to households (excluding the effects of securitisations) rose to 10.5% in Q3 from 9.7% in Q2. Total lending to individuals, which includes data from non-bank specialist lenders that are not included in M4 lending, grew at a rate of 10.1% in the year to September, the highest since January 1991 (see Chart 1.17). Individuals' secured borrowing rose at a rate of 9.4% in the year to September, the highest since October 1991. Interest rates charged on secured lending have fallen gradually since early 2000 and may have contributed to the rise in secured lending growth.

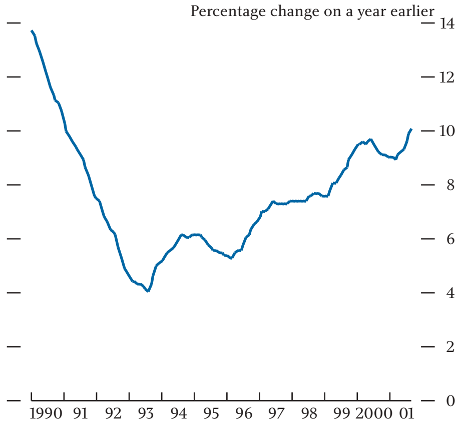
Mortgage equity withdrawal (MEW) is borrowing secured on the value of a house that is used to finance spending on goods and services other than housing. MEW was very strong at £5.0 billion in Q2, although as a percentage of households' disposable income it remained below levels observed in the late 1980s (see Chart 1.18). Prior to the mid-1980s, the withdrawal of housing equity had high transaction costs, since it required homeowners to move house. Chart 1.18 shows that MEW and net housing wealth did not move together during that period. The relationship has become closer since restrictions on building societies were removed and banks gained entry into the mortgage market in the mid-1980s, leading to an increase in competition. More recently new

Chart 1.16
Households' Divisia



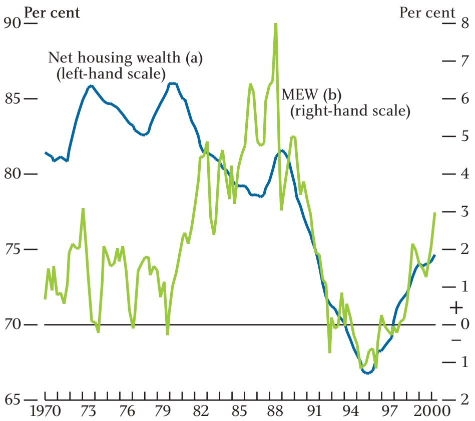
Source: Bank of England.

Chart 1.17
Total lending to individuals



Source: Bank of England.

Chart 1.18
Net housing wealth and mortgage equity withdrawal



Sources: ONS and Bank of England.

(a) Ratio of gross housing wealth net of secured M4 lending to gross housing wealth.
(b) Ratio of mortgage equity withdrawal to households' disposable income.

mortgage products, such as variable-repayment mortgages and flexible mortgages, have become available that further reduce the transaction costs of additional borrowing against the value of a house.[1] The continued strong increase in house prices since the mid-1990s has led to a sustained rise in net housing equity, which encouraged households to increase their MEW to finance non-housing consumption.

Total unsecured consumer credit increased at a rate of 12.9% in the year to September, compared with 11.9% in the year to June. Total lending for consumption (MEW plus unsecured lending) rose sharply in Q2 (by £9.4 billion compared with £6.7 billion in Q1), suggesting continued short-term resilience in consumption.

The strength in households' borrowing, combined with the series of interest rate reductions this year, has had little net effect on households' income gearing (see Chart 1.19). Income gearing (the ratio of interest payments to disposable income) remained stable in Q2 (around 8%) and below levels seen in the early 1990s. Provisional estimates (based on equity and house price developments) suggest that capital gearing (the ratio of the stock of total lending to individuals to net total household wealth) has increased in Q3, but it also remains slightly below levels in the early 1990s.

Private non-financial corporations

The contrast between money and credit growth in the household and corporate sectors persisted in Q3. Annual growth in private non-financial corporations' (PNFCs) M4 fell to 3.0% in Q3 from 5.9% in Q2. PNFCs' annual M4 borrowing growth fell to 7.1% in Q3 from 10.2% in Q2. The weakness in sterling bank borrowing was mainly due to manufacturing (which made net repayments over the past year), but was also evident in some parts of the service sector.

The flow of companies' total external finance, which includes non-bank capital market finance, was also lower at £14.1 billion in Q3, compared with £18.3 billion in Q2, though Q2 was boosted by a nearly £6 billion British Telecom rights issue. Credit spreads on corporate bonds have widened in all three major currencies. The latter may have reflected increased uncertainty among lenders about corporate earnings and the world economic outlook (see Chart 1.20).

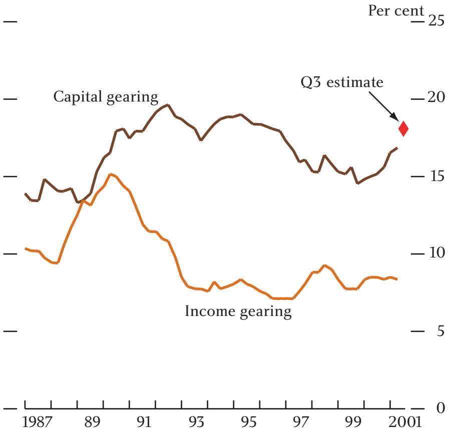
Other financial corporations

Other financial corporations' (OFCs') annual M4 growth rose to 10.1% in Q3, from 5.7% in Q2. Insurance companies and

[1] See 'Why house prices matter', by Aoki, K, Proudman, J and Vlieghe, G in the Winter 2001 *Bank of England Quarterly Bulletin*, published on 26 November.

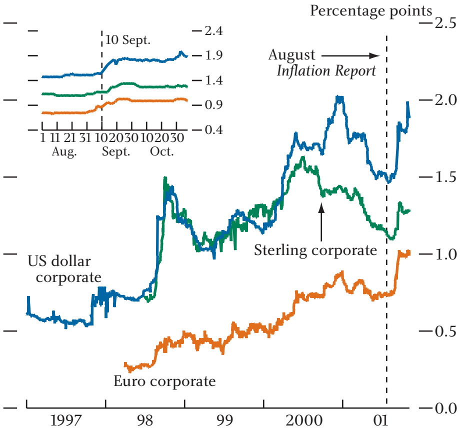
pension funds (ICPFs) account for almost 30% of OFCs' balances. ICPFs are important investors in equities, but they may increase the proportion of their asset portfolio held in bank deposits temporarily at times when they are concerned about stock market falls. The Q3 increase in OFCs' M4 growth may be associated with such concerns. Annual growth in M4 lending to OFCs (excluding the effects of securitisations) fell to 11.0% in Q3, compared with 16.3% in Q2.

Chart 1.19
Households' income and capital gearing



Sources: ONS and Bank of England.

Chart 1.20
Corporate bond index spreads[(a)]



Source: Merrill Lynch.

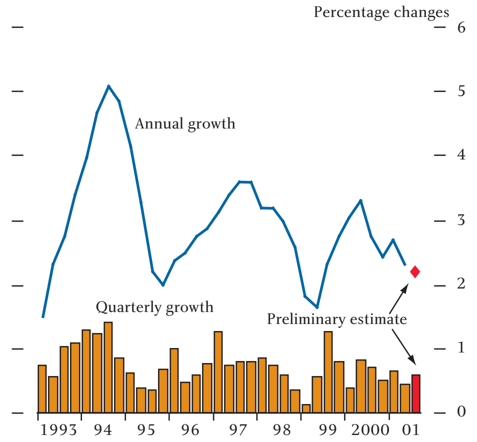
(a) Spread between corporate (BBB-rated and above) and respective government bond yields.

1.3 Summary

The period since the August *Inflation Report* has been characterised by monetary policy easing and increased volatility in equity markets worldwide. Official interest rates were reduced by 1 percentage point in the United Kingdom, by 1.75 points in the United States and by 1.25 points in the euro area. Short-term interest rate expectations fell, reflecting the weaker global outlook. Equity markets recovered most of their post-11 September losses, but remain well down on early August levels. The major exchange rates changed little. Household money and credit data remained strong, though PNFCs' M4, M4 borrowing and total external finance were weaker over the quarter.

Demand and output 2

Chart 2.1
GDP growth(a)



(a) At constant 1995 market prices.

Table 2.A
GDP and expenditure components(a)

Percentage changes on a quarter earlier

	Average for 1999	Average for 2000	2001	
			Q1	Q2
Consumption:				
Households	1.2	0.9	1.0	1.3
Government	0.6	0.2	1.0	0.7
Investment	0.2	1.9	-3.2	2.1
of which, business investment	*0.1*	*2.3*	*-5.1*	*2.5*
Final domestic demand:	**0.9**	**0.9**	**0.1**	**1.4**
Private (b)	1.0	1.0	0.0	1.3
Public (c)	0.3	0.7	0.6	1.4
Change in inventories (d)	0.0	-0.2	0.7	-1.0
Excluding alignment adjustment (d)	0.0	-0.1	0.5	-0.6
Domestic demand	**0.9**	**0.7**	**0.8**	**0.4**
Net trade (d)	-0.2	-0.1	-0.2	0.0
GDP at market prices	**0.7**	**0.6**	**0.6**	**0.4**

(a) At constant 1995 market prices.
(b) Private final domestic demand is defined as total final domestic demand excluding general government consumption and investment.
(c) Public final domestic demand is defined as the sum of general government consumption and investment.
(d) Percentage point contribution to quarterly growth of GDP.

There has been a further deterioration in the prospects for world growth since the August *Inflation Report*. The effect of the terrorist attacks on economic confidence compounded an already worsening outlook, particularly in the United States.

Revisions to the UK National Accounts suggest that the economy was stronger in the first half of 2001 than previously thought (see the box on pages 16–17). Final domestic demand grew by 1.4% in 2001 Q2 (see Table 2.A). But inventories made a substantial negative contribution to growth. Net trade was little changed between Q1 and Q2. GDP grew by 0.4% in 2001 Q2. Preliminary estimates suggest that GDP grew by 0.6% in Q3, above the Committee's central projection at the time of the August *Report*.

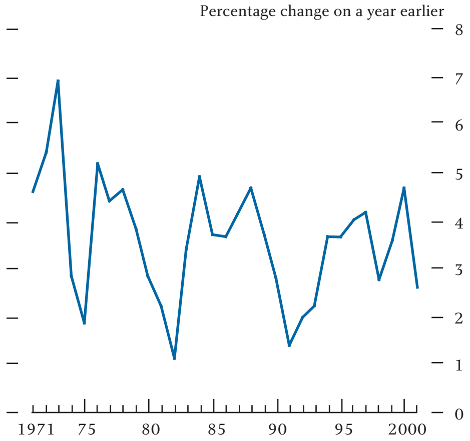
Monetary policy influences inflation through its effect on nominal expenditure. Nominal GDP grew by 4.6% in the year to 2001 Q2.

2.1 External demand and UK net trade

The outlook for world growth is worse now than in August. It had deteriorated even before the terrorist attacks in the United States. According to the International Monetary Fund's *World Economic Outlook*, finalised prior to 11 September, world GDP growth was expected to slow from 4.7% in 2000 to 2.6% in 2001. Even a reduction in growth of that magnitude would be the sharpest for almost 30 years (see Chart 2.2).

Signs of increasing weakness had been evident in the United States. In August, manufacturing employment fell sharply, despite evidence from the National Association of Purchasing Managers' (NAPM) survey that both output and orders were picking up. By September, there were signs that the slowdown had spread to other parts of the economy. The September employment data, which the Bureau of Labor Statistics noted were unlikely to have been greatly affected by the attacks, showed that service sector employment had fallen for the first time in more than a year. The preliminary University of Michigan index of consumer confidence, based on data collected before 11 September, had fallen to its lowest level

Chart 2.2
World GDP growth(a)



Source: IMF.

(a) Figure for 2001 is an IMF forecast from the October *World Economic Outlook.*

Table 2.B
Euro-area GDP and expenditure components

Percentage changes on a quarter earlier

	Average for 1999	Average for 2000	2001 Q1	Q2
Consumption	0.7	0.5	0.8	0.4
Investment	1.5	0.8	0.1	-0.4
Government	0.6	0.4	0.6	0.2
Change in inventories (a)	0.0	0.0	-0.6	0.2
Domestic demand	**0.8**	**0.6**	**0.0**	**0.3**
Net trade (a)	0.1	0.1	0.5	-0.2
GDP	**0.9**	**0.7**	**0.5**	**0.1**

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

since 1993. And in common with other countries, equity prices had declined substantially prior to the attacks (see Section 1).

Growth in the euro area slowed markedly, from 0.5% in 2001 Q1 to 0.1% in Q2. This was a much sharper slowdown than the Committee anticipated in August. And it was broadly based (see Table 2.B). Consumption grew by 0.4% in Q2 after growing by 0.8% in Q1, and investment fell by 0.4% in Q2 after rising by 0.1% in Q1. Net trade made a negative contribution to GDP growth. Economic developments in the euro area potentially have a larger direct impact on the United Kingdom than economic developments in the United States. That is because the euro area buys a much larger share of UK exports.

In Japan, GDP fell by 0.8% in Q2 after rising by 0.1% in Q1. Prospects for growth in many of the Asian emerging economies had been deteriorating for some time. Last year, Malaysia, the Philippines and Singapore together exported almost 20% of their output to the United States in the form of high-technology goods. They are likely to have been particularly affected by the reduction in the demand for such products that has been apparent throughout 2001.

Against this background of a worsening international environment, the possible additional consequences for the world economy of the terrorist attacks that took place in the United States on 11 September have been an important consideration for the Monetary Policy Committee. Some of these consequences, which are described below, will be very short-lived. Others may persist.

Some forms of economic activity were interrupted in the immediate aftermath. There were no commercial flights from, to, or within the United States until Friday 14 September. The New York Stock Exchange remained closed until Monday 17 September, and those Wall Street firms who were able to open before then did less business than usual. The lull in economic activity was probably much larger in the United States than elsewhere, but it is likely to have been present to some degree in many other economies.

Over the coming months, uncertainty, both about the effects that the attacks will have on economic conditions and about the scale and duration of the military response, may cause firms to postpone investment decisions, and consumers to postpone expenditure, particularly on more expensive items. But it is important to set this in the context of the substantial policy easing that has occurred in the major economies. A number of central banks had already reduced their official rates of interest in the weeks leading up to 11 September, and further reductions occurred in the aftermath (see Section 1). The United States has already announced an increase in government expenditure of $50 billion, or $^1/_2$% of annual GDP, and proposals have been made for a further substantial stimulus package. Although the full impact of the recent changes in monetary and fiscal policy may not be felt for some time, they are likely to offset at least some of the adverse consequences of the attacks for demand. Moreover, any reduction in demand that occurs purely in response to greater uncertainty is likely to be matched by corresponding increases if, or when, the uncertainty is resolved.

There is likely to be a permanent increase in expenditure on security measures. Fewer resources would then be available for the production of other goods and services. This would reduce the supply capacity of the economy.

Table 2.C
US GDP and expenditure components

Percentage changes on a quarter earlier

	Average for 1999	Average for 2000	2001 Q2	Q3 (b)
Consumption	1.3	1.0	0.6	0.3
Investment	1.6	1.5	-2.5	-2.2
Government	1.0	0.3	1.2	0.4
Change in inventories (a)	0.0	-0.1	-0.1	-0.1
Domestic demand	**1.3**	**0.9**	**0.1**	**-0.2**
Net trade (a)	-0.3	-0.2	0.0	0.1
GDP	**1.1**	**0.7**	**0.1**	**-0.1**

(a) Percentage point contribution to quarterly growth of GDP.
(b) Advance estimate.

Fears about the risk of future attacks may lead to a reduction in international trade for any given level of world GDP. With greater concerns about air safety, individuals are likely to take fewer trips abroad, reducing trade in services. International trade in goods could be depressed as insurance costs rise. But reductions in the price of oil, if sustained, may offset at least some of these effects.

The impact of the prevailing slowdown, in addition to the interruption to economic activity that occurred after the terrorist attacks, is evident in the latest GDP data for the United States, which show that output fell by 0.1% in Q3. Growth in consumption slowed, and investment fell for the second consecutive quarter (see Table 2.C). In October, the decline in US non-farm employment, at 415,000, was the largest in more than 20 years. Within this total figure, the reduction in manufacturing employment was broadly similar to reductions seen in recent months. But the reduction in service sector employment was much larger, reflecting substantial falls in employment in those sectors most severely affected by the terrorist attacks (see Table 2.D). The NAPM index of manufacturers' output fell from 51.3 in September to 40.9 in October, well below the neutral 50 level, and a separate NAPM survey pointed to sharp output reductions in sectors other than manufacturing. The NAPM stated that the terrorist attacks had reinforced earlier tentative decisions to reduce employment and other business commitments.

Table 2.D
Changes in US employment

Thousands

	2001 Q1 (a)	Q2 (a)	July	Aug.	Sept. (b)	Oct. (b)
Mining	3	3	2	2	-1	-2
Manufacturing	-78	-120	-69	-155	-90	-142
Construction	46	-22	3	-6	1	-30
Services	124	64	82	105	-123	-241
of which: air transport	*0*	*-2*	*-6*	*-1*	*-8*	*-42*
hotels	*5*	*-13*	*2*	*-10*	*-7*	*-46*
catering	*3*	*28*	*69*	*-30*	*-43*	*-42*
Total non-farm	96	-74	18	-54	-213	-415

Source: US Bureau of Labor Statistics.

(a) Average monthly change.
(b) Preliminary estimate.

By the time this *Report* was finalised, few comprehensive data were available for other major overseas economies that related to the period after 11 September. The west German IFO index of business confidence, based on results collected towards the end of the month, fell in September to its lowest level since

1993. The first of the monthly European Commission surveys to be conducted wholly after the attacks showed declines in both business and consumer confidence across the euro area as a whole in October.

Table 2.E shows that economic forecasters, as surveyed by Consensus Economics, have revised down their projections for growth in the major overseas economies in 2001 and 2002. Some of these revisions had occurred before 11 September, but the majority occurred afterwards.

Table 2.E
'Consensus' forecasts for GDP growth in 2001 and 2002

Annual percentage changes

		Survey date					
		2001 H1 (a)	9 July	13 Aug.	10 Sept.	25 Sept. (b)	8 Oct.
United States	2001	2.0	1.6	1.7	1.6	1.1	1.0
	2002	3.3	2.9	2.8	2.7	1.5	1.2
Euro area	2001	2.6	2.1	2.0	1.9	n.a.	1.7
	2002	2.8	2.6	2.5	2.4	n.a.	1.8
Japan	2001	1.1	-0.1	-0.2	-0.1	-0.5	-0.5
	2002	1.7	0.8	0.6	0.5	-0.5	-0.4
Non-Japan Asia (c)	2001	5.2	4.4	4.0	3.5	n.a.	3.0
	2002	6.0	5.8	5.6	5.3	n.a.	4.4

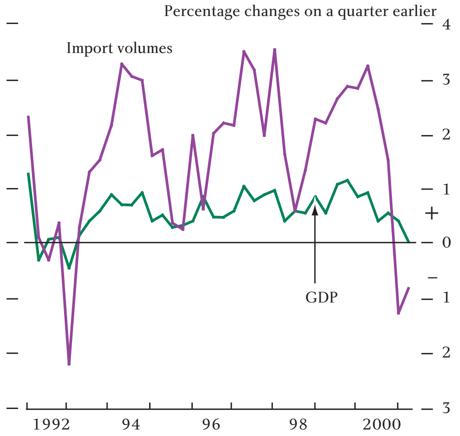
Source: Consensus Economics.

(a) Average of the monthly data.
(b) This survey was conducted in the aftermath of the terrorist attacks on the United States. It had a smaller sample size than usual, and no data relating to the euro area or non-Japan Asia were published.
(c) Non-Japan Asia includes Indonesia, Singapore, Malaysia, Thailand, the Philippines, China, Hong Kong, South Korea and Taiwan.

There was a large fall in UK imports of intermediate goods in the second quarter, associated with the slowdown in inventory accumulation. That accounted for most of the 2.1% fall in imports of all goods and services in Q2 which, in turn, broadly offset the 2.4% decline in UK exports. So net trade made a zero contribution to GDP growth in Q2. More recent data for trade in goods showed that import volumes fell by 1.5% in the three months to August, while export volumes fell by 1.9%.

Chart 2.3 shows that imports of goods and services by the United Kingdom's major trading partners fell in Q1, and again in Q2. The reduction in imports of high-technology goods was particularly acute. The more pronounced slowdown projected for the world economy should lead to a slower rate of growth in UK exports than the Committee had expected in August. Export growth may ease further still if the terrorist attacks offset some of the trend increase in the share of international trade in world GDP that has occurred in recent years. This would be unlikely to have a significant impact on net trade, since imports would be lower too, but would affect certain industries within the United Kingdom, such as travel and tourism (see below).

Chart 2.3
GDP and imports of the major economies(a)



Source: Thomson Financial Datastream.

(a) Euro area, the United States, Canada and Japan, UK trade-weighted. These countries together account for 70% of all UK exports of goods and services. Data for other countries are less timely.

2.2 Domestic demand

Household sector consumption

Table 2.F
Short-term indicators of household consumption

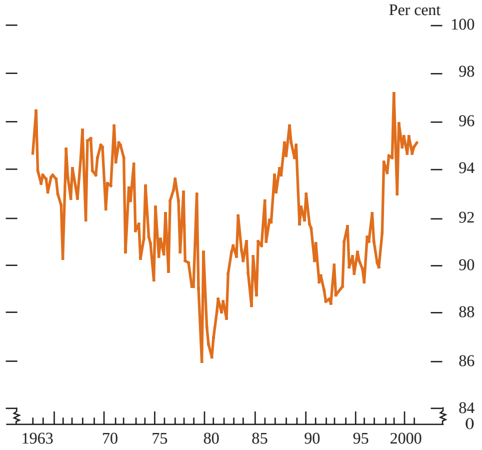
	2001				
	Q1	Q2	Q3	Sept.	Oct.
Quarterly comparisons					
Growth in retail sales (volumes, per cent)	1.6	1.7	1.5		
Annual comparisons					
Growth in retail sales (volumes, per cent)	4.7	6.1	6.2		
BRC sales growth (a) (values, per cent)	6.0	7.9	8.1	8.1	8.6
CBI Distributive Trades (b)	+33	+32	+49	+54	+19

Sources: ONS, BRC and CBI.

(a) Estimate of annual growth in sales values provided by the British Retail Consortium.
(b) Percentage balance of retailers reporting an increase in sales volumes over the past year.

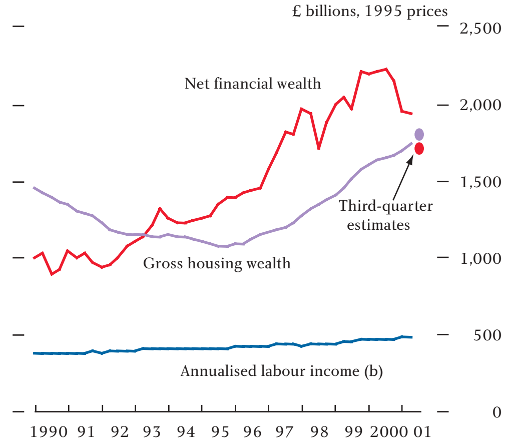
Since publication of the August *Inflation Report*, there have been upward revisions to consumption growth in Q1 (see the box on pages 16–17), and the latest estimate for consumption growth in Q2, at 1.3%, is higher than had been expected by the Committee. It would appear that strong consumption growth continued in Q3. Retail sales growth was 1.5% in Q3, compared with 1.7% in Q2 (see Table 2.F). In the CBI Distributive Trades survey for September, the balance of retailers reporting that sales volumes had risen over the past year was the largest since October 1996. The British Retail Consortium (BRC) reported that growth in the total value of retail sales rose from 7.9% in the year to Q2 to 8.1% in the year to Q3. The BRC noted that, while the number of visitors to retail outlets fell sharply in the days immediately following

Chart 2.4
Ratio of consumption to current income[a]



(a) Ratio of final consumption by households and non-profit institutions serving households to their current post-tax income.

Chart 2.5
Real household wealth and labour income[a]



Sources: ONS and Bank of England.

(a) Deflated by the household consumption deflator.
(b) Defined as four times quarterly labour income.

the terrorist attacks in the United States, by the end of the month sales had returned to levels seen before 11 September.

Despite upward revisions to current income in the latest set of National Accounts data that were larger than the upward revisions to consumption, the fraction of current income consumed by households in Q2 remained unusually large by historical standards (see Chart 2.4). When households have access to credit, and are not restricted to spending out of their current income and their accumulated savings, then consumption will depend on all the resources that households expect to have access to over their lifetimes. These resources will include not just current income, but current net financial wealth and the present value of expected future employment income. As discussed in the August *Report*, changes in current income have probably understated changes in expected lifetime resources, and that is likely to account for some of the increase in the ratio of consumption to current income.

Chart 2.5 shows that housing wealth has increased rapidly in recent years, and it is sometimes argued that changes in housing wealth will affect consumption in much the same way as changes in net financial wealth. But houses differ from financial assets because they typically provide the occupiers with a flow of housing services, which they then consume, rather than a flow of income. Whenever house prices rise, the price of housing services will rise in proportion. Unless homeowners can reduce their consumption of housing services, perhaps by trading down to a smaller house, they cannot realise the apparent gain in their housing wealth. The fact that not everyone can trade down at the same time means that increases in house prices are unlikely to have a significant direct impact on consumption.

Nevertheless, changes in house prices may affect consumption by changing the terms on which homeowners can borrow. In order to protect themselves against the risk of default, lenders will tend to offer a lower rate of interest on a loan secured against property than on an unsecured loan. Moreover, the rate they offer will tend to be lower still the greater is the net housing equity of the borrower. Other things being equal, house price increases will therefore tend to reduce the rate homeowners pay on borrowings and thus encourage current consumption.[1]

As discussed in Section 1, financial intermediaries have become more willing to lend money secured against housing, for purposes other than house purchase (this is an example of mortgage equity withdrawal, or MEW). So in recent years the

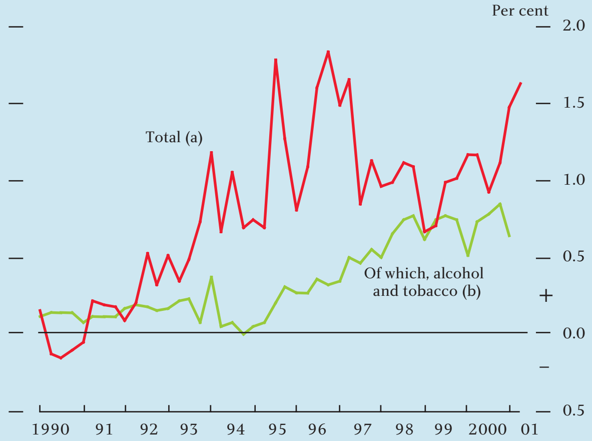
[1] See 'Why house prices matter', by Aoki, K, Proudman, J and Vlieghe, G in the Winter 2001 *Bank of England Quarterly Bulletin*, published on 26 November.

Revisions to the National Accounts

On 25 September, the ONS published a revised set of National Accounts. Results from the 1999 Annual Business Inquiry (ABI) were included, as well as the latest information on earnings from the Inland Revenue. The accounts are now fully balanced up to 1999, so that the output, income and expenditure approaches all give the same estimate of GDP, without the need for a statistical discrepancy. In addition to these normal revisions, a number of methodological changes were made. Some of the more important ones are listed below.

- Alcohol and tobacco smuggling were counted as part of economic activity for the first time. Separate measures of the expenditure on illegally imported alcohol and tobacco are not publicly available. But it is striking that much of the upward revision to household expenditure was accounted for by changes to the measure of all expenditure on alcohol and tobacco (see Chart A). The inclusion of alcohol and tobacco smuggling also raised imports, self-employment income and gross value added.

Chart A
Revisions to the level of household expenditure



(a) Percentage difference between estimate of total household expenditure released in September 2001 and estimate of total household expenditure released in August 2001.
(b) Revisions to expenditure on alcohol and tobacco as a proportion of the total household expenditure estimate released in August 2001.

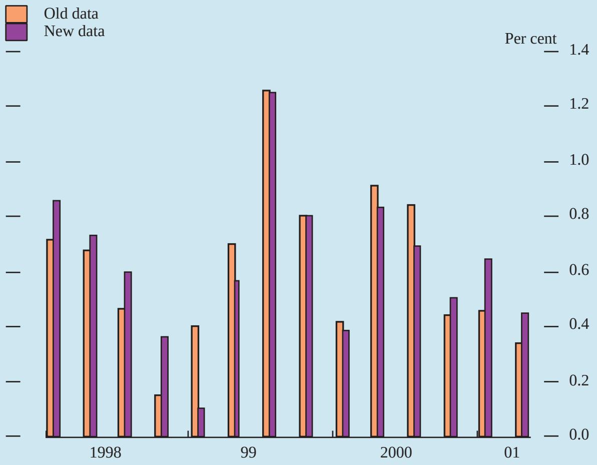
- Results from the first ABI, conducted in 1998, were used in place of a wide range of sector-specific inquiries. A new question allowed the ONS to obtain better estimates of the quantity of goods purchased by households direct from the manufacturer. This produced further significant upward revisions to the level of household expenditure.

- New estimates of price indices relating to computers were used, affecting data for investment, for imports and for exports.

- The ONS took further steps towards measuring real government expenditure by collecting data relating to outputs, rather than by collecting separate data on input values and prices.

The net result of all these changes is that the level of GDP has been revised back to 1948. The latest figure for GDP in 2001 Q2, published in the September Quarterly National Accounts release, was 1.0% higher than the figure published one month previously. Chart B shows how the revisions have affected the recent pattern of GDP growth.

Chart B
Revisions to quarterly GDP growth



GDP growth now appears to have been weaker across 2000 as a whole, but stronger in 2001 Q1 and Q2. The table below shows how the growth rates of output and expenditure components in 2001 Q1 and Q2 have been affected.

Sources of the revisions to quarterly GDP growth in 2001

Per cent

	Current estimate		Previous estimate	
	Q1	Q2	Q1	Q2
Expenditure approach				
Private sector consumption	1.0	1.3	0.6	1.2
Public sector consumption	1.0	0.7	0.8	0.8
Investment	-3.2	2.1	-2.7	0.0
Final domestic demand	0.1	1.4	0.0	0.9
Change in inventories (a)	0.7	-1.0	0.9	-0.7
Domestic demand	0.8	0.4	0.8	0.3
Net trade (a)	-0.2	0.0	-0.4	0.0
Output approach				
Agriculture	-2.3	-0.7	1.0	-0.6
Industrial production	-0.6	-1.1	-0.7	-1.1
of which, manufacturing	*-0.8*	*-2.0*	*-0.7*	*-2.0*
Construction	1.8	1.6	1.7	0.6
Services	1.1	0.9	0.9	0.8
GDP	**0.6**	**0.4**	**0.5**	**0.3**

(a) Percentage point contribution to GDP growth.

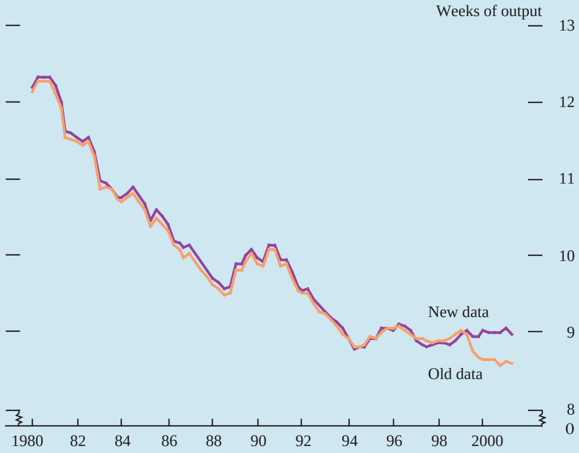
In those two quarters, output growth in the service sector is now stronger than previously estimated.

Sectoral imbalances in the first half of the year appear more pronounced than before, with faster growth coming from services rather than from manufacturing. Consumption and investment growth have both been revised up. But the household saving ratio in Q1 and Q2 is now higher, following substantial upward revisions to household income.

The ONS has revised its estimate of the change in inventories in 1999 from -£1.4 billion, to +£5.0 billion. Chart C shows that this revision has substantially altered the recent behaviour of the inventory-output ratio.

The *Blue Book* contained new data for the real non-housing capital stock. The implied depreciation rate of the real non-housing capital stock was lower, and the real non-housing capital stock was higher, and had been growing more quickly during the recent past, than had previously been apparent. While the GDP revisions meant that output was higher than had been thought at the time of the August *Report*, it seems that productive capacity was higher too.

Chart C
Revisions to the inventory-output ratio[(a)(b)]



(a) At constant 1995 prices.
(b) Numerator includes quarterly alignment adjustment.

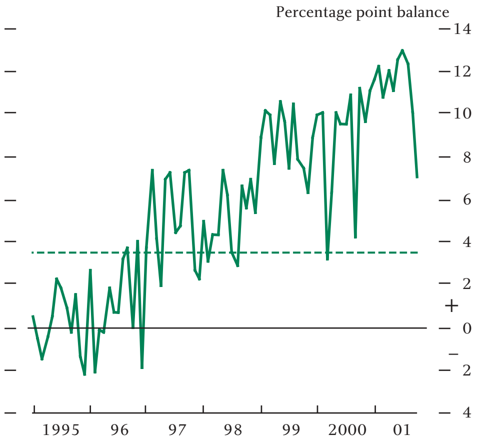
The implications of the National Accounts revisions for the inflation projection are discussed in Section 6.

indirect relationship between changes in house prices and consumption is likely to have strengthened (see Chart 1.18 on page 9 of this *Report*). The rise in MEW was equivalent to around two-thirds of the increase in consumption during the first two quarters of this year.

What is the outlook for consumption beyond Q3? The determinants of consumption appear weaker than at the time of the August *Report*. Households' current net financial wealth fell by 9% in 2001 Q1 and by 1% in 2001 Q2. Movements in equity prices, and households' net transactions with banks and building societies, suggest that it has fallen by a further 11% in 2001 Q3 (see Chart 2.5). These reductions in households' current net financial wealth are likely to put downward pressure on household consumption over the medium term. The extent of this downward pressure will depend, in part, on the importance of current net financial wealth in total lifetime resources. This is likely to vary from household to household, with age being an important factor. Chart 2.5 shows that, across the UK population as a whole, current net financial wealth has recently been around four times the size of all the labour income received during a single year. But the average household might expect to receive labour income for another 20 years or so. This means that, over time, changes in current and expected future labour income are likely to have a bigger impact on consumption than changes in current net financial wealth.[1]

[1] See Bakhshi, H (2000), 'The sensitivity of aggregate consumption to human wealth', *Bank of England working paper no. 108*.

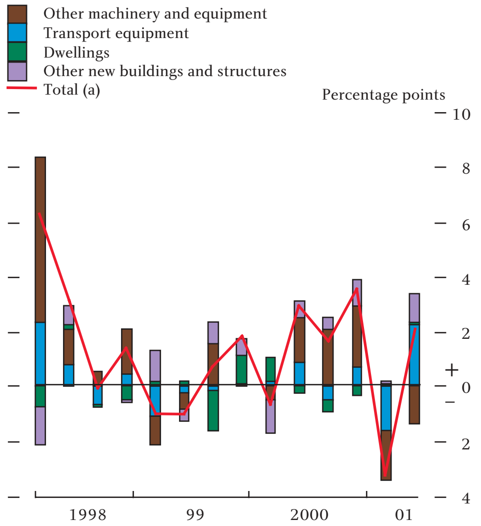
Chart 2.6
GfK measure of confidence in own finances(a)



Source: GfK.

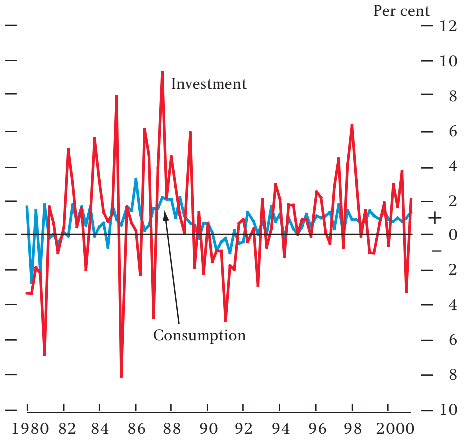
(a) Percentage point balance of respondents expecting the financial situation of their household to improve during the next twelve months. Dashed line represents average balance since 1988.

Chart 2.7
Contributions to quarterly investment growth by type of asset



(a) Includes investment in intangible fixed assets, which is not shown separately.

Chart 2.8
Quarterly growth rates of consumption and investment



On top of the reductions in current net financial wealth, the Committee judges that the near-term outlook for employment income is now weaker than at the time of the August *Report*. To the extent that households have a similar view, then this would put further downward pressure on prospective consumption over and above the effects from current net financial wealth. Perhaps reflecting the deterioration in these determinants of consumption, the GfK measure of households' confidence in their own future financial situation fell in August, September and again in October. It nevertheless remained well above its historical average value (see Chart 2.6). According to the CBI Distributive Trades survey, the balance of retailers reporting increased sales volumes in the year to October weakened significantly. However, the BRC reported that annual growth in retail sales values was 8.6% in October, greater than the average figure for Q3 (see Table 2.F). The MPC judges that growth in household expenditure is likely to slow towards the end of this year and into the next.

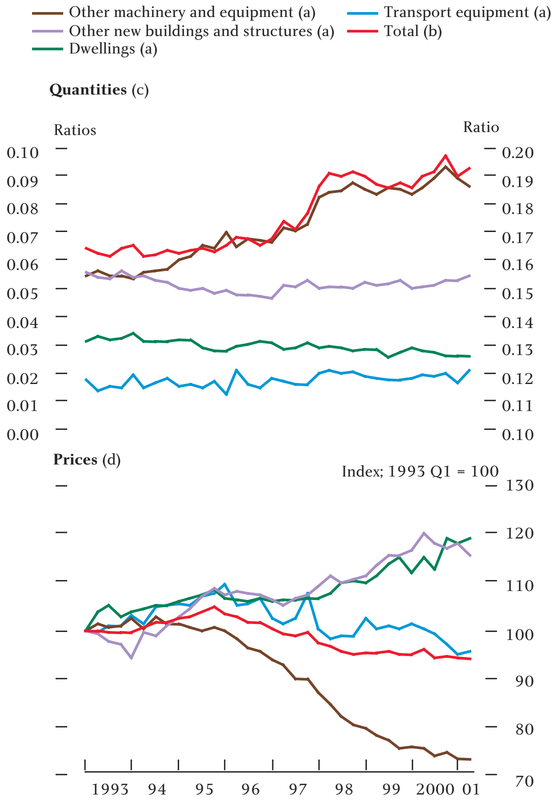
Investment demand

Whole-economy investment rose by 2.1% in Q2 after falling by 3.2% in Q1 (see Chart 2.7). The ONS states that much of the increase in investment in Q2 was due to a substantial rise in investment in both civil and military aircraft. No separate data are available on aircraft investment, although trade statistics show that aircraft imports rose by £1.1 billion in Q2, which was greater than the £1.0 billion increase in whole-economy investment. By its nature, investment is one of the more volatile components of domestic demand. It is much more volatile than consumption, for example (see Chart 2.8).

Firms can be expected to invest until the capital stock reaches its desired level, at which point the expected returns to any additional investment should exactly offset the expected costs. The top panel of Chart 2.9 shows that the investment-to-GDP ratio rose during the 1990s. Looking at the data on investment by asset type, it is apparent that all of the increase was accounted for by an increase in investment in 'other machinery and equipment'. This category includes all investment goods other than buildings and transport equipment. The bottom panel of Chart 2.9 shows that the price of these investment goods fell markedly during the 1990s, relative to the price of all goods and services produced in the United Kingdom, as measured by the GDP deflator. So it is likely that some of the strength in investment during the 1990s was due to a desire on the part of firms to raise the stock of these investment goods following a substantial fall in their relative price.

Though these falls in relative prices may continue, the near-term outlook is for weaker investment growth than in the

Chart 2.9
Quantities and prices of investment by type of asset



(a) Left-hand scale.
(b) Includes investment in intangible fixed assets, which is not shown separately. Right-hand scale.
(c) Ratio of investment in each type of asset to GDP.
(d) Price of each type of asset relative to the GDP deflator.

Table 2.G
Measures of investment intentions

	Average (a)	2000 Q4	2001 Q1	Q2	Q3
CBI Industrial Trends survey (b)					
Plant and machinery	1	-9	-7	-15	-28
Buildings	-16	-22	-23	-23	-29
BCC survey (c)					
Manufacturing	11	11	7	4	0
Services	15	24	21	17	11

Sources: BCC and CBI.

(a) Average balance since 1972 for the CBI survey and since 1989 for the BCC survey.
(b) Percentage balance of respondents who expected to authorise more capital expenditure in the next twelve months than in the past twelve months.
(c) Percentage balance of respondents who had revised up their plans for investment in plant and machinery during the past three months.

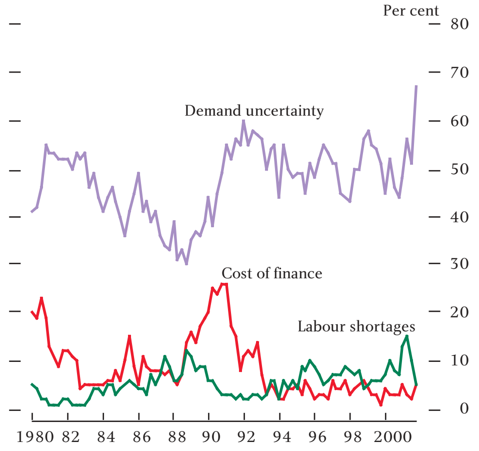
past few years. The average cost of funding investment has increased since August, because the higher cost of equity finance and the rise in corporate bond spreads taken together outweigh the impact of the reductions in official interest rates. Moreover, PNFCs' gross operating surplus, excluding the effects of the alignment adjustment, fell by 2.8% in Q2, pointing to a reduction in the availability of funds for internal finance. Following the terrorist attacks, further downward pressure on investment will come from a reduction in the expected returns to additional investment expenditure, most notably in the airline industry and other industries allied to travel and tourism.

Uncertainty is another factor relevant to the short-term investment outlook. Investment goods have two important characteristics. First, they tend to be large and indivisible. A firm may have to choose between building a new plant and raising capacity by 50% on the one hand, or doing nothing on the other. Second, investment goods cannot easily be resold. Taken together, these characteristics mean that investment decisions must be based not just on current demand conditions, but on demand conditions expected in the future. And when uncertainty about future demand conditions rises, firms will have an incentive to delay investment decisions, because making a costly mistake is more likely. In August, the Committee judged that the uncertain economic environment then would depress investment in the near term. But uncertainty has risen further following the terrorist attacks in the United States.

The most recent British Chambers of Commerce (BCC) survey was conducted largely before 11 September. The balance of service sector respondents to that survey who had revised up their plans for investment expenditure fell from 17 in 2001 Q2 to 11 in 2001 Q3 (see Table 2.G). That was the weakest outturn since 1993. The latest CBI Industrial Trends survey, conducted wholly after 11 September, showed a marked fall in the investment intentions of manufacturers. This survey also provides information on those factors that are likely to restrain investment expenditure. It showed that the proportion of firms citing uncertainty about demand as a restraining factor had risen to 67%, the highest outturn since that question was first asked (see Chart 2.10).

In October, the Bank's regional Agents asked around 200 of their business contacts to what extent their plans had been affected by the terrorist attacks of 11 September. With regard to investment, similar responses were received from firms in both the manufacturing and service sectors. Around half the respondents had not changed their plans for investment expenditure. Around one in four had revised down their plans

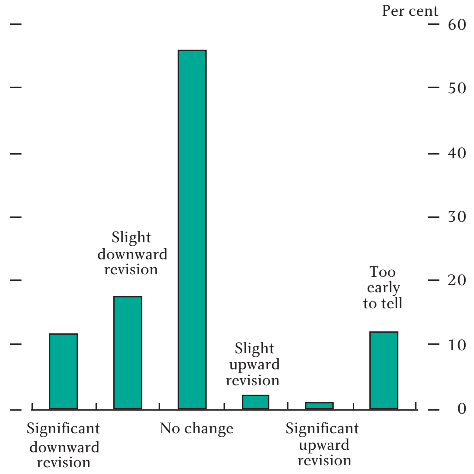
Chart 2.10
Factors limiting investment(a)



Source: CBI.

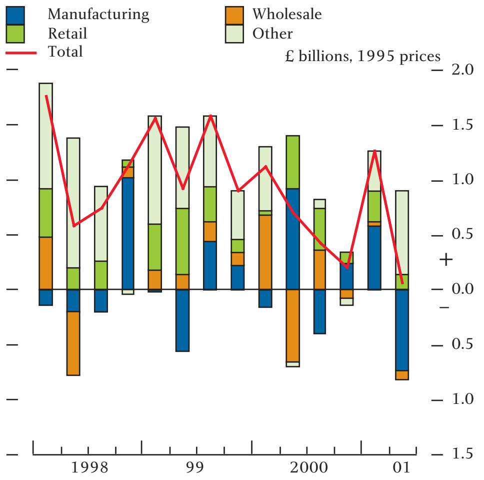
(a) Percentage of respondents to the CBI Industrial Trends survey citing each factor as something that was likely to limit capital expenditure authorisations over the next twelve months.

Chart 2.11
Changes to planned investment(a)



(a) The bars record the distribution of responses to a question about changes to planned investment during the next twelve months that had been made as a result of the terrorist attacks in the United States on 11 September. The responses were provided by around 200 business contacts of the Bank's regional Agents.

Chart 2.12
Change in inventories(a)



(a) Excluding a statistical alignment adjustment.

either slightly, or significantly. Most of the remainder replied that it was too early to tell what the effects would be (see Chart 2.11). A survey conducted by MORI on behalf of the CBI gave similar results.

The MPC judges that business investment is likely to weaken towards the end of this year and into the next, recovering subsequently.

Public sector consumption

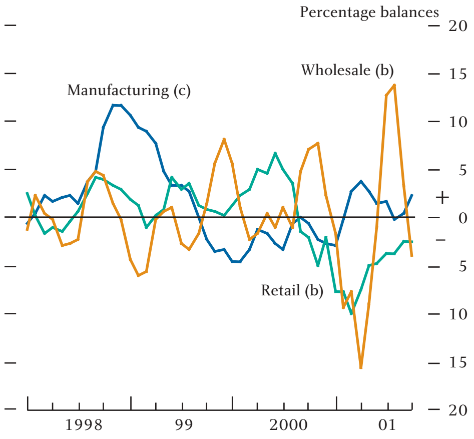
Growth in nominal government current expenditure on goods and services was 2.1% in Q2. That is close to the average quarterly growth rate implied by the March Budget forecast, which was for growth of 7.2% during the whole of the financial year 2001/02. The MPC uses the most recently published government spending plans, together with a projection for the government current expenditure deflator, to obtain projections for real government current expenditure. Real government current expenditure growth in Q2, at 0.7%, was weaker than expected. This *Report* was finalised before the contents of the November pre-Budget report were known to the Committee.

Inventories

Inventories held by firms at the end of Q2 were equal in value to almost nine weeks' of GDP. Holding inventories provides a safeguard against the risk that a firm is unable to meet orders, either when demand turns out to be stronger than expected, or when interruptions to supply prevent the delivery of further raw materials. But holding inventories is costly too, because they embody valuable resources on which the firm has yet to see any return. Balancing these costs and benefits, a firm's desired inventory holdings are likely to depend on: the expected levels of demand and supply; demand and supply uncertainty; the production technology; and the short-term cost of finance.

When demand turns out to be higher or lower than expected, inventories will fall or rise relative to their desired levels. At the time of the August *Report*, the MPC judged that the inventories built up by manufacturers during 2000 Q4 and 2001 Q1 were held involuntarily following a period of weaker-than-expected demand. It therefore seemed likely that manufacturers would seek to reduce planned output and run down those inventories at the earliest opportunity.
Chart 2.12 shows that manufacturers' inventories fell by £0.7 billion in Q2, contributing -0.6 percentage points to GDP growth in that quarter. Does that mean the inventory adjustment in manufacturing is complete? Data from the CBI Monthly Trends survey may provide some clues. Chart 2.13 shows that the balance of manufacturers who reported that

Chart 2.13
Survey data[a] on inventories



Source: CBI.

(a) Three-month averages. Each balance has been adjusted to have zero mean during the period 1985 to 2001.
(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 2.14
Contribution to quarterly growth in industrial production by type of product

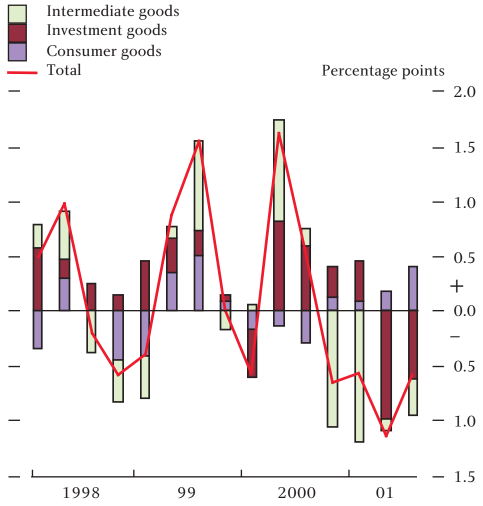


Table 2.H
Measures of business confidence[a][b]

	2000			
	Q1	Q2	Q3	Oct.
CBI Industrial Trends survey				
General business optimism	-29	-22	-54	
Export optimism	-16	-25	-53	
Expected orders (next four months)	-4	1	-25	
of which, export orders	*-8*	*-16*	*-34*	
CIPS services survey				
Business expectations (c)	75.1	72.7	67.9	63.3

Sources: CBI and CIPS.

(a) Figures in black were collected wholly or partly before 11 September. Figures in red were collected after 11 September.
(b) Numbers reported are survey balances unless otherwise stated. An increase suggests a rise in the proportion of respondents reporting 'higher' relative to 'lower'.
(c) Derived from responses to question: 'In twelve months' time do you expect overall activity at your business to be higher, the same or lower than now?' Readings below 50 indicate that activity is expected to decline.

inventory holdings were more than adequate was close to its historic average in 2001 Q3. It edged up in October, perhaps because demand again turned out to be weaker than expected. Results from the CBI Distributive Trades survey suggest that, during the three months to October, inventories held by both retailers and wholesalers were unusually low compared with sales. The MPC judges that inventories placed further downward pressure on GDP growth in Q3.

Improvements in technology have made firms better able to monitor changes in demand and supply conditions. It is likely that this accounts for much of the downward trend in the inventory-output ratio that began in the early 1980s. Following revisions to the National Accounts data, the downward trend in the inventory-output ratio now appears to have come to an end in the mid-1990s (see Chart C in the box on pages 16–17 of this *Report*). As a result, the Committee reconsidered its assumption about the future trend in the inventory-output ratio and concluded that it is more likely to be broadly flat than falling.

2.3 Output

The imbalances in the sectoral composition of output intensified in the second quarter, when above-trend growth of 0.9% in service sector output contrasted with a 2.0% fall in manufacturing output, the largest quarterly fall since 1991 Q1. Recent reductions in manufacturing output have been concentrated among firms producing high-technology goods. The box on pages 22–23 compares the performance of firms producing high-technology goods with other manufacturing firms in the United Kingdom and in the United States.

In the production industries, which include mining and the utilities in addition to manufacturing, the weakest performance has been among those firms that supply other businesses with investment goods or with intermediate goods. Producers of consumer goods have made positive contributions to growth in total production, reflecting the strength of household expenditure (see Chart 2.14).

Surveys conducted either wholly or partly before 11 September provided few signs of recovery in the manufacturing sector. There were signs, too, that output growth in some parts of the service sector might have started to slow. The August CBI/Deloitte & Touche survey had shown a sharp slowdown in business volumes among firms providing business and professional services. These include advertising agencies, accountants and legal firms. Surveys conducted after 11 September show a marked fall in business confidence (see Table 2.H).

Trends in ICT manufacturing in the United Kingdom

During the past two decades, the manufacturing sector in the United Kingdom has undergone considerable structural change. As in other advanced countries, manufacturing growth has been somewhat slower than the whole-economy average and hence manufacturing activity has fallen as a share of the total economy. In the United Kingdom, the manufacturing sector's share of GDP has declined from around one-third in 1970 to less than 19% in 2000.[1]

Recent trends in manufacturing

The strength of activity within manufacturing has varied greatly across industries, particularly in the past few years. In the five years to September 2001, UK manufacturing output grew by just over 1%. Within the total, information and communications technology (ICT)[2] production increased by almost 50%. Although this was not the only industry to record positive growth during this period, it was by far the single largest contributor to growth. More traditional sectors of manufacturing (notably textiles and basic metal production) continued their longer-term trend of decline. During the period, textile production fell by almost 30%.

UK manufacturing output has declined in each of the first three quarters of 2001. This is the largest downturn in manufacturing sector activity for ten years. But the recent downturn is unlike that experienced during the early 1990s—while the early 1990s downturn was relatively broadly based across most sectors of manufacturing, around three-quarters of the recent fall in output has been accounted for by the ICT sector.

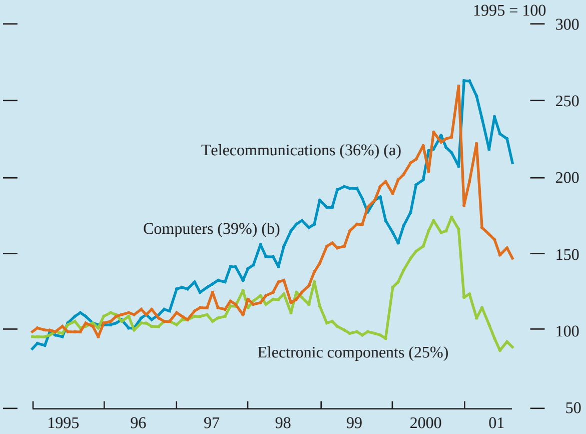
Trends within the ICT sector

As in most other industrialised countries, ICT output in the United Kingdom began growing rapidly around the mid-1990s. Most of these countries have also experienced a sharp downturn in this sector in 2001. By September, the level of ICT output in the United Kingdom had fallen by 27% since its peak at the end of last year. This is greater than in the United States, where ICT output also peaked in December 2000, but where output fell by only 15%.

When making comparisons with the United States, it is important to keep in mind that there are methodological differences in the way that these series are constructed. One significant difference is that the method used to quality-adjust data, so that improvements in the power and speed of computers are counted as extra output, is different in the United States. The differences generally mean that for any given nominal growth, more is usually attributed to real output growth, relative to the United Kingdom. This could partly account for the relatively smaller decline in ICT production in the United States.

In the United States, the downturn has been most severe in the production of electronic components (such as semi-conductors), which make up the bulk of US ICT production. Production of these goods has also fallen sharply in the United Kingdom, but the majority of the downturn has been driven by lower telecommunications equipment production. UK telecoms output has fallen by more than 40% since December (see Chart A). This compares with a fall of only around 14% in the United States. Moreover, telecoms production accounts for a significantly larger share of UK ICT production than in the United States.

Chart A
UK ICT output



Note: Figures in brackets are 1995 weights within ICT production.

(a) Telecommunications equipment plus TV and radio receivers.
(b) Computers plus office machinery.

Over the past few years, sales of mobile phones in the United Kingdom have risen sharply. The share of the population owning a phone has also increased markedly, from just 27% at the beginning of 1999 to 70% by May 2001,[3] so that finding new subscribers has become more difficult. It appears therefore that the sharp correction in UK telecoms production may reflect a downward reassessment by manufacturers of future demand. Falls in telecoms production of a similar magnitude have also occurred in the euro area, where mobile phone ownership is similarly high. It is

[1] At current prices.
[2] The ICT sector is taken to include the production of office machinery, computers, electronic components, telecommunications equipment, and television and radio receivers.
[3] Source: Oftel.

likely that the main reason why this has not been seen in the US data is that the proportion of mobile phone owners is significantly lower.

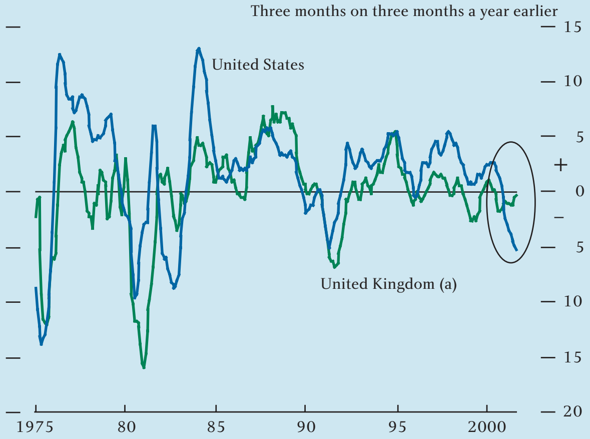
Trends in the rest of manufacturing

Despite the relatively larger fall in UK ICT production, the decline in overall manufacturing production has been less marked. Since December 2000, overall manufacturing output in the United Kingdom has fallen by 4.4%, compared with a fall of 5.1% in the United States.

One explanation for this is that the share of ICT production in the UK manufacturing output index is much smaller than the share of ICT in its US counterpart. In the UK index, ICT production accounts for just 6%[4] of total production, while in the US index it accounts for around 10%.[5]

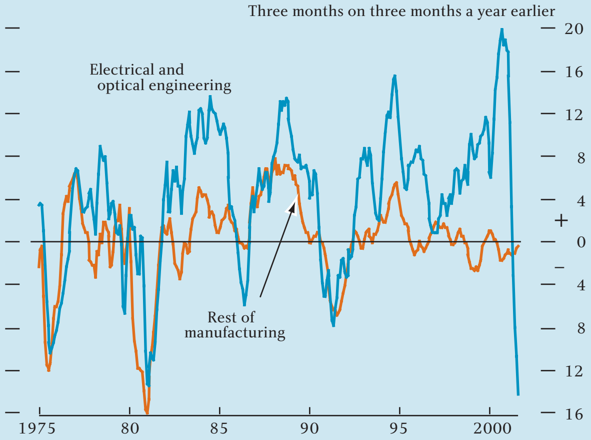
Second, and more significant, the performance of the rest of manufacturing in the United Kingdom has been relatively stronger than in the United States. Since December, the level of non-ICT manufacturing in the United Kingdom has fallen by around 1%, compared with a fall of 4% in the United States. Annual growth in non-ICT production has fallen sharply in the United States, and is now the weakest for ten years, whereas annual growth in the United Kingdom has not fallen significantly[6] (see Chart B). The implication appears to be that despite the sharp downturn in ICT production in the United Kingdom, this does not appear to have been accompanied by an associated downturn to date elsewhere in the sector (see Chart C).[7]

Chart B
Manufacturing excluding ICT



(a) Manufacturing, excluding electrical and optical engineering.

Chart C
UK manufacturing growth



[4] Index based on fixed 1995 weights.
[5] Current weights in 2000.
[6] Data for ICT output in the United Kingdom are not available prior to 1985, so figures shown are manufacturing output excluding the 'electrical and optical engineering' sector (of which ICT is a subset and the main driver).
[7] Chart C also shows electrical and optical engineering as a proxy for ICT production.

Table 2.I
Travel to and from the United Kingdom in 2000

		Number of trips (millions)	Expenditure (£ billions)	
			In destination country	On travel by air to and from destination country (a)
Exports	Travel by overseas residents to United Kingdom	25.2	12.8	4.7
	of which, from North America	*4.9*	*3.2*	*n.a.*
Imports	Travel by UK residents to overseas countries	56.8	24.3	4.6
	of which, to North America	*5.1*	*4.2*	*n.a.*

(a) This includes expenditure by non-UK residents on travel to and from the United Kingdom with UK carriers, and expenditure by UK residents on air travel to and from overseas countries with overseas carriers.

Industries that have been adversely affected by the terrorist attacks include travel and tourism. Table 2.I shows that last year overseas visitors spent £12.8 billion in the United Kingdom, equivalent to 1.5% of GDP. Within this total figure, £3.2 billion was spent by visitors from North America. The number of visitors from North America was already 7% lower in 2001 H1 than in 2000 H1. This probably reflected a combination of the economic slowdown in North America and the outbreak of foot-and-mouth disease in the United Kingdom. Fears about air safety are likely further to deter visitors from North America, and perhaps from other parts of the world, so year-on-year growth rates could be lower still in H2. The consequences for the trade balance are likely to be broadly offset by a reduction in the number of UK residents travelling to North America and elsewhere. But overall there will probably be a net reduction in expenditure on the UK tourist industry.

Preliminary estimates show that GDP grew by 0.6% in Q3. The only sectoral data available in the preliminary release were for the service industries, where output is estimated to have risen by 0.8% in Q3, following growth of 0.9% in Q2. Within services, the output of the distribution, hotels and catering sectors is estimated to have risen by 1.3% in Q3. The ONS suggests that much of the strength was in distribution, and in particular in retail and motor trades. This lends further weight to the view that consumption growth remained strong in Q3. Subsequently, the ONS has published Index of Production data. These showed that manufacturing output fell by 0.8% in Q3, the third consecutive quarterly fall.

2.4 Summary

The terrorist attacks in the United States on 11 September have exacerbated the deterioration in the outlook for world growth that had occurred during August and the early part of September. There were upward revisions to UK output growth in the first half of this year. Consumption growth was stronger than expected in Q2, and looks to have weakened only slightly in Q3. GDP growth picked up to 0.6% in Q3. Nevertheless, GDP growth year-on-year is likely to slow during the next twelve months, and quarterly growth rates in the near future are likely to be lower than expected in August. Exports will be weaker as a result of world developments. Uncertainty about demand prospects is likely to cause a number of investment plans to be delayed. This is supported by surveys, and by evidence from the Bank's regional Agents. Equity prices have fallen sharply since August, and this should put downward pressure on consumption.

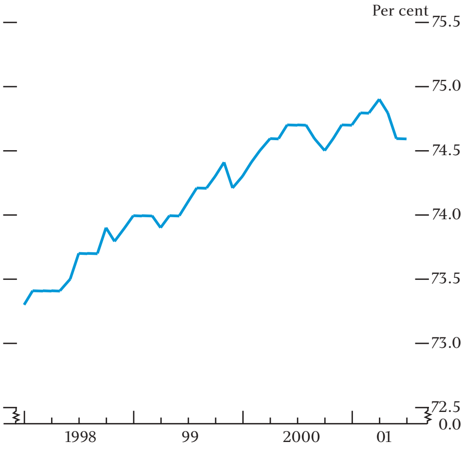
The labour market 3

There is some evidence that the labour market is turning. The number of people in employment fell in the three months to August. The unemployment rate has broadly stabilised while inactivity has continued to increase gradually. Firms are still reporting high levels of recruitment difficulties, although there are also some reports of an easing of skill shortages. Regular pay growth remains resilient, though bonus payments continue to exert a negative influence on overall earnings growth.

3.1 Employment and employment intentions

According to the Labour Force Survey (LFS), employment fell by 19,000 in the three months to August, the largest fall since 1993. This represents a marked change from the gains seen in previous quarters. The employment rate stood at 74.6% in the three months to August, down from a recent peak of 74.9% in March to May (see Chart 3.1).

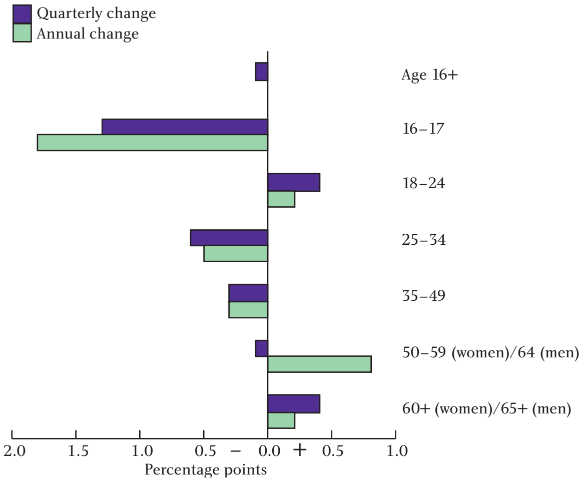
Chart 3.1
LFS employment rate[a]



[a] Percentage of population of working age.

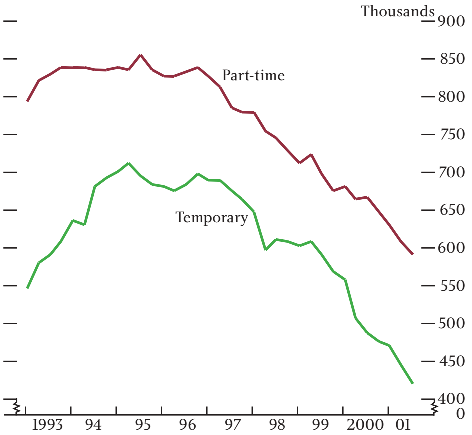
Some categories of employment have been increasing, though this may paradoxically imply that the labour market has slackened somewhat. The number of those at or over retirement age with a job rose by 39,000 in the three months to August. Typically when assessing the available supply of labour, economists focus on people who are of working age and without a job. But recent shifts in the age distribution of employment suggest that a more comprehensive measure of labour supply might be appropriate. Chart 3.2 shows the quarterly and annual changes in employment rates by age. It is important to use employment rates, because these adjust for the size of the relevant age group. The total employment rate has not changed over the past year. Employment rates have only risen for the over-50s and the 18–24 year olds, while both the very young and prime-age workers have seen a decline in employment rates. The rising employment rate of the retired suggests a recent source of labour supply to the market that is often ignored. This additional source of labour supply reduces wage pressure for a given level of labour demand.

Chart 3.2
Changes in LFS employment rate by age



Falls in some types of employment are not necessarily a sign of labour market weakness. Temporary employment fell by

Chart 3.3
Number of workers who cannot obtain their preferred employment[(a)]



(a) Number of part-time/temporary workers who responded that they were in this type of employment because they could not find full-time/permanent work.

Chart 3.4
Sources of the change in Q2 Workforce Jobs

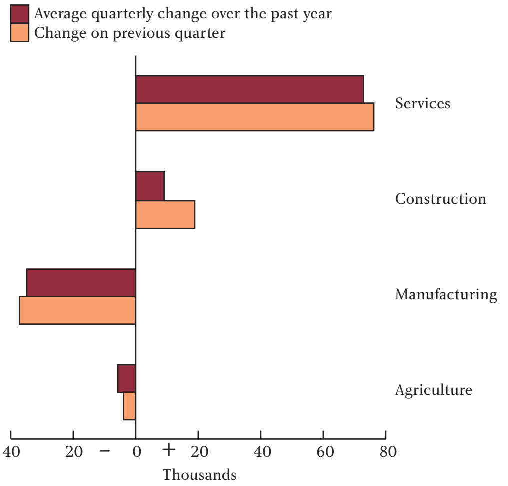
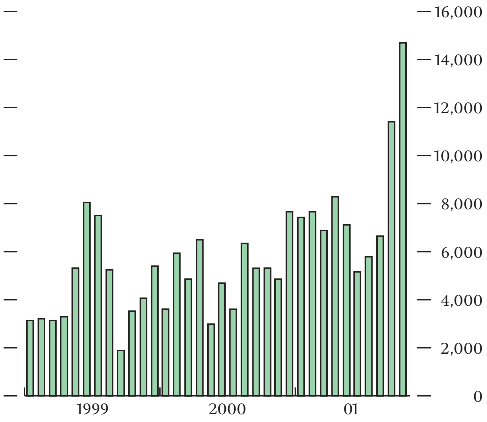


Chart 3.5
Announced layoffs by UK companies[(a)]



Source: Deutsche Bank.

(a) Total number of announced layoffs by UK companies obtained from a search of Reuters Business Briefing; three-month moving average.

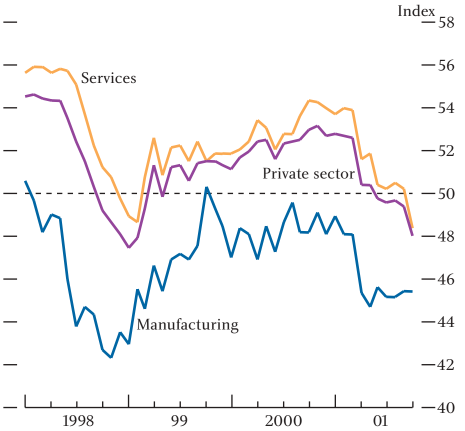
110,000 in the three months to August and part-time employment fell by 61,000. In the initial stages of a slowdown, it may be thought that employers are more likely to lay off these types of worker and retain full-time permanent staff who have higher levels of firm-specific experience and higher redundancy costs. However, temporary employment has been falling since mid-1997. As labour markets tighten, workers find it easier to obtain the type of job they desire. The LFS asks both part-time and temporary employees whether they are in such jobs because they could not find full-time or permanent alternatives. The number and proportion of such workers has declined for both types of employee for some years now (see Chart 3.3). So falls in the number of temporary and part-time workers may simply reflect movements into permanent and full-time work. Indeed the decline in temporary employment during the past year is of the same magnitude as the fall in the number of those who wanted a permanent job. Furthermore, in recent quarters there has, if anything, been a pick-up in the flow from temporary and part-time into permanent and full-time jobs for those who reported that they could not previously find such employment.

The latest release of the ONS' Workforce Jobs measure of employment shows continued employment growth in 2001 Q2. The number of jobs rose by 56,000 over the quarter, up 165,000 on a year earlier. The Workforce Jobs survey (WJS) measures the number of jobs, collected from a sample of firms on a single day toward the end of each quarter. The WJS gives the most reliable industrial breakdown of employment. The manufacturing sector continued to shed jobs, with a decline of 37,000 in the quarter (see Chart 3.4). In spite of the recent media attention to layoffs in the financial sector, a net 31,000 addition to employment was recorded in the second quarter.

Layoff announcements frequently represent the result of severe economic pressures affecting individual firms. Chart 3.5 shows the number of announced layoffs by UK companies obtained from a search of Reuters Business Briefing. While in no way comprehensive, it suggests that layoff announcements have increased noticeably in the past few months. The relationship between aggregate layoff announcements and movements in employment is, however, a complex one. Evidence from the United States suggests that in a sample of firms who are laying off workers, median employment falls by only 60% of the announcement. Furthermore, there is some suggestion that firms use layoffs to reduce employment selectively in less productive areas while increasing employment levels in more productive areas.[(1)] Though this

[(1)] See Chen, P, Mehrotra, V, Sivakumar, R and Yu, W (2001), 'Layoffs, shareholders' wealth, and corporate performance', *Journal of Empirical Finance*, Vol. 8, pages 171–99.

Chart 3.6
CIPS employment index[a]



Source: Chartered Institute of Purchasing and Supply.

[a] Respondents are asked to compare the level of employment at their unit with the situation one month ago. A reading above 50 indicates increasing employment.

Table 3.A
Surveys of employment intentions[a]

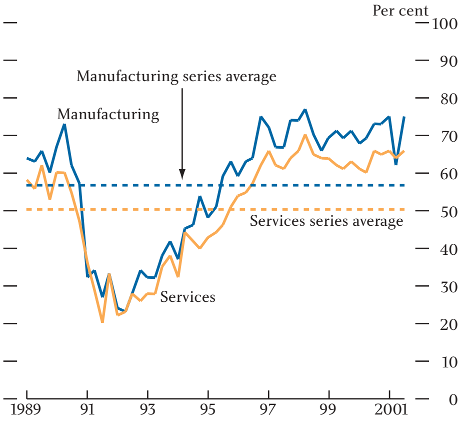
Percentage balance of employers planning to recruit staff

	Series average	2000 Q3	2000 Q4	2001 Q1	2001 Q2	2001 Q3
BCC (b)						
Services	14	28	29	21	19	16
Manufacturing	3	10	8	11	-1	-2
CBI (c)						
Manufacturing	-20	-7	-10	-21	-28	-26
Manpower (b)						
Total	11	18	21	18	14	17
Services	13	22	27	23	18	19
Manufacturing	14	14	13	14	9	13
Public	3	10	20	21	21	17

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

[a] Seasonally adjusted by the Bank of England.
[b] Next three months, average since 1989.
[c] Next four months, average since 1979.

Chart 3.7
BCC recruitment difficulties[a]



Source: British Chambers of Commerce.

[a] Percentage of firms recording difficulty in recruiting staff over the previous three months, conditional on trying to recruit.

evidence relates to a period of economic expansion and may not be directly comparable to a period of employment decline, it suggests that care needs to be taken in analysing layoff announcements. Furthermore, the relevant issue from an aggregate employment perspective is whether job destruction exceeds job creation. Focusing on layoff announcements misses all the new jobs that are being created. Since job destruction is more heavily concentrated among large firms while job creation is primarily among small firms, it may be that destruction gets more publicity than creation irrespective of the relative sizes of the two changes.[1]

Consistent with the fall in LFS employment, employer surveys suggest a slackening of demand in the labour market. Chart 3.6 shows that, according to the CIPS survey, private sector employment has been falling since the middle of the year. The services index dipped below the neutral 50 level in October for the first time in over two years to reach the lowest level since the series began in July 1996. Table 3.A indicates that manufacturing employment intentions have fallen during the past year. Though there was a very slight increase on the CBI measure in the latest quarter, the survey balances are below their historical averages. There has also been some weakening in private sector services, though the surveys remain above the series' averages. But public sector intentions remain buoyant.

However, even though employment has declined, recruitment difficulties remain high according to employer surveys. This is to be expected when unemployment is low and workers can be more selective in the employment opportunities that they seek and accept. The British Chambers of Commerce (BCC) survey for 2001 Q3 shows that firms in both manufacturing and services who are seeking to expand employment continue to report high levels of recruitment difficulties (see Chart 3.7). These difficulties remain at the levels witnessed over the past few years. But the Bank's regional Agents report that skill shortages have eased somewhat in recent months, though they remain at high levels. In a similar vein, the CBI Industrial Trends survey suggests that there has been an easing in skill shortages in manufacturing throughout the course of this year.

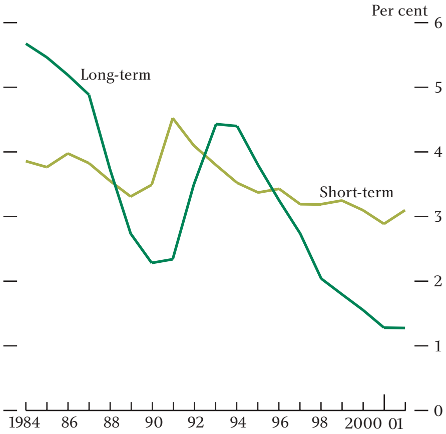
3.2 Labour availability

The International Labour Office (ILO) definition of unemployment counts the number of people who are searching for work, and are currently available to start.

[1] See Barnes, M and Haskel, J (2001), 'Job creation, job destruction and small firms: evidence for the United Kingdom', *mimeo*, Queen Mary College, University of London.

This measure for the United Kingdom rose by 53,000 in the three months to August and the ILO unemployment rate rose slightly to 5.1%. However, the claimant count continued to fall in September, with a drop of 4,900. This compares with an average monthly fall of 7,300 over the previous six months.

Chart 3.8
Short and long-term unemployment rates(a)



(a) Short-term unemployment defined as spells of less than six months. Long-term unemployment defined as spells of more than twelve months. Rates are calculated as a percentage of the economically active population.

The distribution of unemployment by duration has changed significantly during the past few years. Unemployment has fallen across all duration groups but the declines have been most concentrated among those with long current spells of unemployment. Chart 3.8 shows that in the three months to August, only 1.3% of the economically active population had been unemployed for more than twelve months. This is lower than the 2.3% rate seen in 1991, at the end of the 1980s expansion. In contrast, the unemployment rate of those unemployed for six months or less has declined only slightly in recent years, and has fallen only 1.4 percentage points from its 1991 peak. The decline in long-term unemployment is likely to have contributed to the muted response of wages to the tightening of the labour market. The long-term unemployed exert less downward pressure on wages than the short-term unemployed and so wages rise less strongly when the reduction in unemployment falls disproportionately upon the long-term unemployed. This may be because skills atrophy during unemployment, if long-term unemployment stigmatises workers or because the long-term unemployed lose contact with social networks that assist in discovering employment opportunities.

Table 3.B
Destination of leavers from the claimant count, more than 52 weeks' duration, January-September 2001

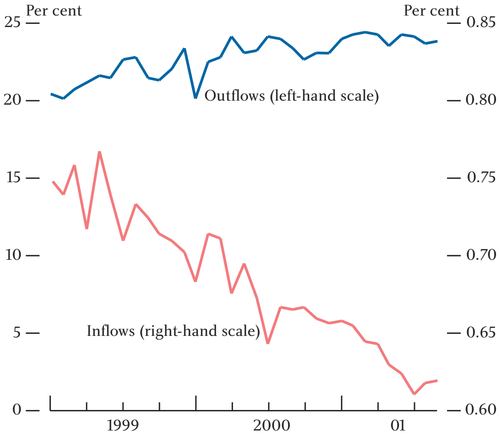
Per cent	
Found work	45.3
Gone abroad	4.1
Claimed income support	7.0
Claimed incapacity benefit	16.3
Government-supported training	16.5
Other	10.7

Source: Benefits Agency administrative system.

Not all those who leave long-term unemployment move into work. Data from the Benefits Agency show the destination of leavers from the claimant count by duration of claim. As Table 3.B shows, for those unemployed for more than 52 weeks, 45% left the claimant count to enter employment and 17% entered some form of government-sponsored training. But 16% left to claim incapacity benefit and 7% moved off the register to claim income support.

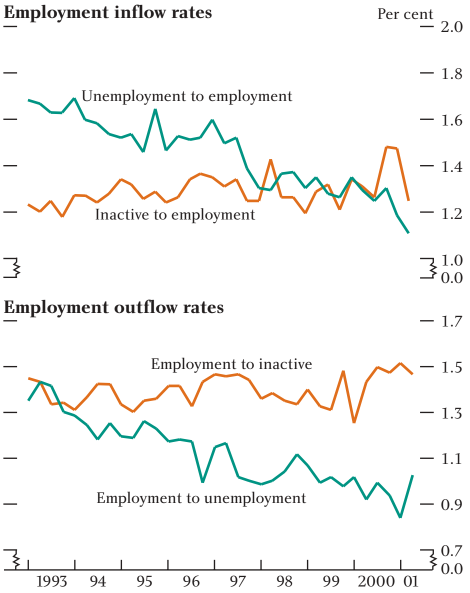
Much of the information on the labour market is presented in the form of stocks, for example the number of people unemployed. Underlying these stocks are flows into and out of a particular labour market status. For example, the monthly change in the unemployment stock is simply the difference between the number that flow into unemployment minus the number that flow out of unemployment. These flows can often give an early indication of changes in the labour market since flows can change direction with only minimal initial effects on the unemployment rate. As firms lay off more workers, flows into unemployment should pick up while outflows from

Chart 3.9
Claimant count inflow and outflow rates[(a)]



(a) Inflow rate is expressed as a percentage of the non-claimant-count working-age population. Outflow rate is expressed as a percentage of the claimant count.

Chart 3.10
Gross worker flows[(a)]



Source: LFS longitudinal data files.

(a) Percentage of population of working age. Seasonally adjusted by the Bank of England.

unemployment are also likely to decline as firms choose not to create new jobs or fill vacancies. The outflow rate shows no sign of decline but inflows into the claimant count have picked up slightly in recent months suggesting some loosening, though it is too early to claim that this marks a decisive turning point (see Chart 3.9).

There has also been an increase in the inflow into ILO unemployment from employment in the most recent period (see Chart 3.10, which shows the gross flows into and out of LFS employment, expressed as a percentage of the working-age population). The size of the gross flows in the labour market are often not appreciated. For example, during the past five years, ILO unemployment has fallen by an average of 40,000 per quarter. Given an average stock of 1.8 million over that period, this may at first sight suggest that the market for labour can be characterised as fairly static. Yet such a conclusion would be wrong. Data from the LFS show that over the same period, almost three quarters of a million people on average entered unemployment in a quarter, with equal numbers coming from employment and inactivity. Similarly, those in work each quarter included almost one million people who had been unemployed or inactive a quarter before. In the current upswing, as employment rose and unemployment fell, the flows into employment came increasingly from the inactive pool (see Chart 3.10). Similarly, the increased employment opportunities reduced the flow from employment to unemployment, while the flow to inactivity from employment remained broadly constant.

The inactive are those people who are out of work and who say that they either do not want or are not looking for another job. Despite that, people do move from inactivity to employment and so are a source of potential labour supply. Indeed, some groups such as students who currently say they are unavailable for work are more likely to find work than the unemployed on average. Aggregate inactivity rates have continued to rise, perhaps providing further evidence of labour market loosening. The LFS shows that 21.3% of the working-age population were inactive in the three months to August. This represents a rise of 0.3% on a year earlier. The rise has been particularly large among the 16–17 year olds whose inactivity rates have risen by 2.5 percentage points on a year earlier. This rise is associated with an increase in the proportion undertaking further education and so is likely to lead to a more skilled workforce in the long run. There have, however, also been small increases in inactivity among the 25–49 year olds. By contrast, the inactivity rate of those at or above retirement age has marginally declined over the past year, as their employment rate has risen.

Chart 3.11
Whole-economy, private and public sector headline wage growth

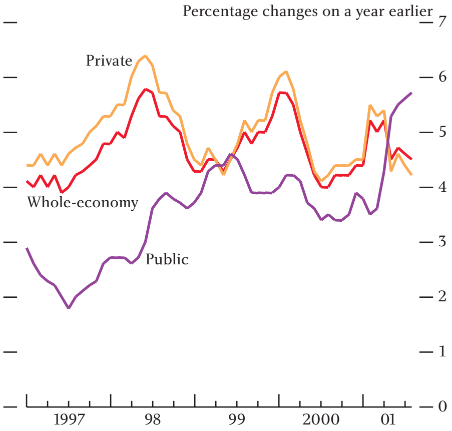
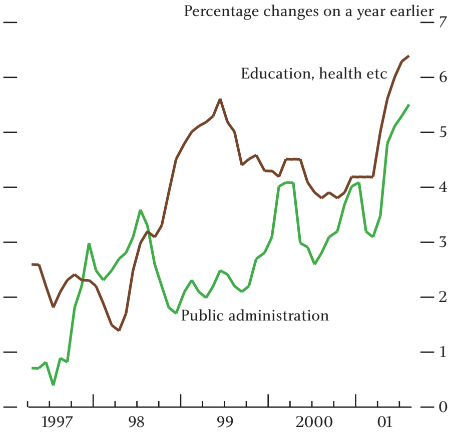


Table 3.C
Headline earnings growth

Percentage changes on a year earlier

	2001					
	March	April	May	June	July	August
Whole-economy	5.0	5.2	4.5	4.7	4.6	4.5
Public	3.6	4.3	5.3	5.5	5.6	5.7
Private	5.3	5.4	4.3	4.6	4.4	4.2
Services	5.2	5.3	4.3	4.5	4.4	4.2
Private services	5.6	5.6	4.0	4.3	4.0	3.8
Manufacturing	4.8	5.3	5.1	5.0	4.8	4.8

Chart 3.12
Growth in public sector regular pay[(a)]



(a) Not seasonally adjusted, three-month moving average.

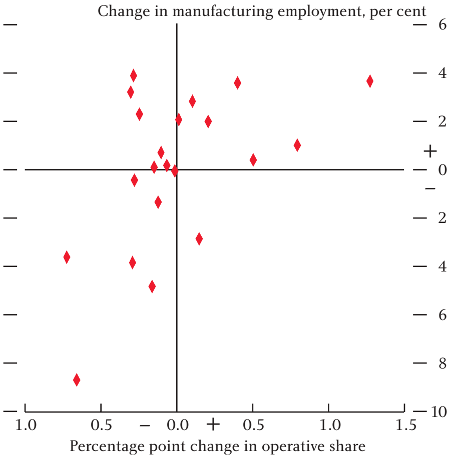
3.3 Earnings and unit wage costs

Overall wage growth in the economy remains reasonably stable at present in spite of the relatively tight labour market. Headline pay (a three-month moving average of the monthly data) increased by 4.5% in the twelve months to August (see Chart 3.11 and Table 3.C). The broad stability of wage growth masks robust growth in regular pay that is offset by significant downward pressure from bonus growth. The bonus element, which is probably the most flexible part of the pay packet, contributed -0.9 percentage points to the total growth in earnings. Though there is not a particularly strong correlation between bonus payments and corporate profitability, it seems likely that the bonus contribution will remain negative in the near term, given the recent declines in company profits.

Public sector pay continues to grow at a faster rate than in the private sector. Headline average earnings rose by 5.7% in the twelve months to August for the public sector compared with only 4.2% in the private sector (see Chart 3.11). This disparity has been a feature of the data for some months and if anything the differential is increasing. In the long run, wages for individuals with the same skill levels should be the same across sectors except for the payment of differentials that reflect factors such as non-pecuniary benefits and the working environment. If they were not, individuals would have an incentive to move sectors to obtain higher pay. These supply shifts would then work to eliminate any unwarranted differential. Part of the recent rise in public sector pay reflects special one-off increases for teachers, tied to the acceptance of performance-related pay, which have been backdated to September 2000. However, this is clearly not the only explanation. As Chart 3.12 makes clear, the rise in regular pay growth has occurred in public administration as well as education and health. Given the current tight labour market, the public sector may well have little alternative to raising rates of pay to retain existing staff and attract new workers as the sector seeks to expand employment. It is, however, unlikely that the current growth in the public sector will fuel significantly increased wage demands in the private sector. Indeed the evidence suggests that it is private sector wage growth that tends to lead the public sector. Then, from time to time, public sector pay growth exceeds that in the private sector as employees in the former sector attempt to 'catch up'.

Wage growth continues largely unabated in the manufacturing sector despite the sharp declines in output and employment in recent months. The most recent data show that headline growth in manufacturing wages was 4.8% in August compared with 3.8% in private services (see Table 3.C). Some of the explanation for this probably relates to the impact of the change in the composition of the workforce over the economic cycle. If groups with lower wages have a higher probability of being laid off in an economic downturn, then that would tend to give a countercyclical boost to average earnings. We can shed some light on this issue by looking at the behaviour of two groups of worker in manufacturing. The Census of Production categorises workers as either operatives or clerical/administrative. The former group is predominantly manual workers who earn much less than the latter group on average. Chart 3.13 shows the change in the share of operatives in manufacturing against the change in manufacturing employment over time. It is immediately clear that there is a positive relationship. So employment levels are more cyclical for manual workers in manufacturing than for non-manuals: as manufacturing employment declines, the share of total employment accounted for by manuals falls. Since these workers are paid less than non-manuals, the average wage per employed worker actually tends to rise in a downturn. This helps to explain why there is a negative correlation between annual growth in manufacturing employment and annual growth in real manufacturing wages.

Chart 3.13
Changes in operative share and manufacturing employment[(a)]

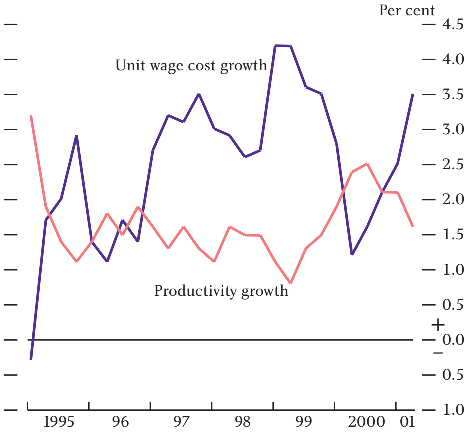


Source: Business monitor PA1002: annual census of production and construction, HMSO.

(a) Annual percentage changes, with mean growth rates subtracted, 1974–96.

The extent to which nominal wage growth is translated into price inflation depends, among other things, on the rate of productivity growth. If, for example, nominal wages grew at 4.5% and productivity grew at 2%, then unit wage costs would be growing at 2.5%. Growth in unit wage costs consistently greater than or below 2.5% would signal wage growth at odds with the inflation target. But movements in unit wage costs are often transitory, due either to short-term changes in wages or productivity growth. So it would be inappropriate to conclude that a number for unit wage cost growth different from 2.5% or nominal wage growth above or below 4.5% was necessarily out of line with the inflation target.

Chart 3.14
Whole-economy unit wage cost and productivity growth



Whole-economy productivity in 2001 Q2 grew at 1.6% compared with the same quarter a year ago (see Chart 3.14). This represented a decline from recent quarters. Whole-economy unit wage growth rose in 2001 Q2 to an annual rate of 3.5%. However, this partly reflected a particularly low outturn in the corresponding quarter of 2000. Indeed, unit wage costs rose only 0.1% in 2001 Q2 relative to Q1. In contrast, growth in unit wage costs in manufacturing has picked up in recent quarters, largely accounted for by a steep decline in productivity growth. Further discussion of this is contained in Section 4. Looking ahead, the MPC expects wage growth to remain broadly around its current levels, although a dip is expected in early 2002 reflecting the unwinding of exceptional bonus payments earlier this year.

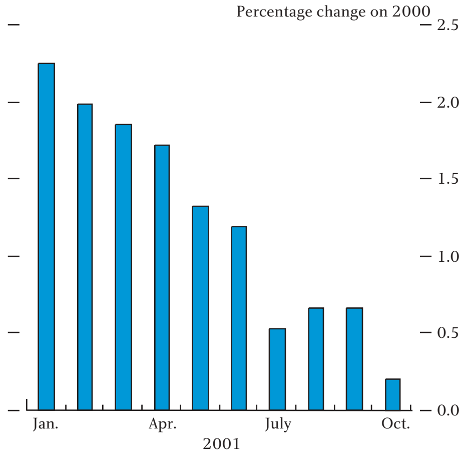
3.4 Summary

The labour market may be turning following a sustained period of growth. The working-age employment rate and the number of people in employment fell slightly in the three months to August. Unemployment is broadly flat while inactivity has risen somewhat. Wages remain relatively stable and the MPC expects underlying average earnings growth to change little in the near future. Employment intentions remain soft and the MPC expects the labour market to slacken in coming quarters.

Costs and prices 4

Oil prices are now significantly lower than assumed in the August *Inflation Report* projection, but uncertainty about near-term movements has increased markedly. Weaker prospects for global activity have also led to further falls in non-oil commodity prices. These are likely to feed through soon to lower materials prices for UK producers, which have already diminished considerably this year. However, overall cost pressures in manufacturing have risen as a result of a pick-up in unit labour cost growth. Despite this, manufacturers' output price inflation has recently continued its declining trend. Evidence from official and survey data suggests that cost and price pressures in the service sector have lessened recently. But despite these easing cost pressures, RPIX inflation rose slightly further in Q3, broadly in line with expectations at the time of the August *Report*.

Chart 4.1
Forecast of world oil demand in 2001



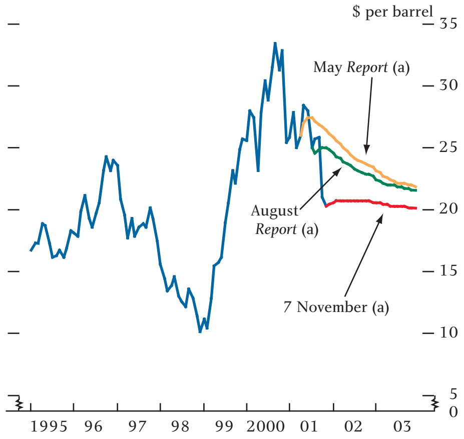
Source: International Energy Agency.

4.1 Commodity prices

After rising initially in response to the terrorist attacks in the United States, oil prices have since fallen back substantially as concerns about any negative impact on supply have been more than offset by the expected downward impact on demand. In the 15 working days to 7 November, the price of Brent crude averaged just over \$20, more than \$4 per barrel lower than expected at the time of the August *Report*. Oil prices are now more than one-third lower than a year ago, and are the lowest for more than two years.

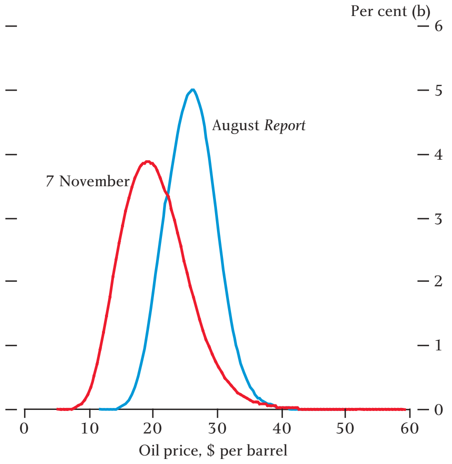
Following the terrorist attacks, initial concerns regarding the availability of oil subsided quickly as it became apparent that any response was likely to be concentrated on Afghanistan, which does not produce oil. Despite the oil price remaining below OPEC's target band for a sustained period, OPEC are yet to implement any supply reductions. Even before 11 September, expectations of growth in future demand for oil were falling as world industrial activity slowed. The terrorist attacks have served to exacerbate these trends, with forecasts of world demand now revised down even further (see Chart 4.1). In particular, the direct impact of lower airline traffic is expected to reduce demand for jet kerosene significantly.

Chart 4.2
Brent oil futures



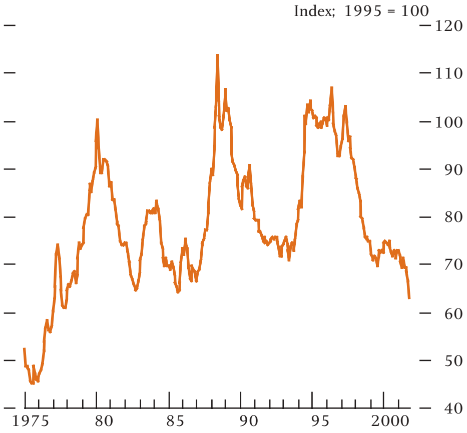
(a) Average of the 15 working days up to the finalisation of the MPC's projections.

Chart 4.3
Implied probability distributions of oil prices three months ahead[(a)]



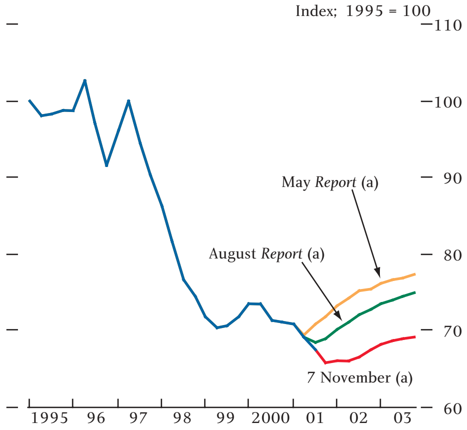
(a) Based on the price of West Texas Intermediate (WTI) crude, which usually trades at a premium of between $1 and $1.50 per barrel over Brent crude.
(b) Probability of price of oil being within 50 cents of any given price, expressed as a percentage.

Chart 4.4
Non-oil commodity prices[(a)]



(a) *The Economist* dollar index in nominal terms.

Chart 4.5
Non-oil commodity futures



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

The recent fall in oil prices contrasts with the sharp increase that occurred during the Gulf War—in the month after Iraq invaded Kuwait, prices had risen by more than $10 per barrel. The key difference with the current situation appears to reflect expectations of the impact on supply rather than demand. The oil demand conjuncture was similar, as world growth was also slowing rapidly in 1990. However, disruptions to supply were considered to be much more likely, as Iraq and Kuwait were both significant oil producers.

Market expectations of oil prices in two years' time are now around $1.50 lower than at the time of the August *Report*, though the profile of the futures curve has flattened considerably (see Chart 4.2). The MPC has revised down its central projection for the Brent oil price at the two-year horizon to just over $20 per barrel to reflect these developments.

Chart 4.3 shows the probability distributions for oil prices three months ahead implied by options contracts as at 7 November and at the time of the August *Report*. The distributions provide an indication of overall uncertainty, as well as skews in the distribution of risk on the downside or upside. Market uncertainty about oil prices three months ahead has almost doubled since August, and uncertainty about prices six months ahead has also increased markedly. And a significant increase in the positive skew of the distribution implies that the balance of risks is weighted firmly on the upside, although risks are more evenly balanced at the six-month horizon.

Weaker global growth prospects have led to larger-than-expected falls in world non-oil commodity prices in recent months. This is particularly true for metals prices, which have fallen by more than 20% since the beginning of the year. In October 2001, the *Economist* dollar non-oil commodity price index was at its lowest level for more than 23 years (see Chart 4.4). And market expectations of future prices have also been revised down markedly since the August *Report* (see Chart 4.5).

4.2 Import prices

Sterling import prices of goods and services in 2001 Q2 were considerably higher than expected in the August *Report*. The quarterly change in import prices rose from -0.7% in Q1 to 1.4% in Q2. Within the total, goods prices more than accounted for the rise. But this increase may overstate underlying trends in import prices. The main determinants of movements in import prices had pointed to relatively lower import price inflation in Q2. In particular, the average sterling effective exchange rate index (ERI) appreciated by around 2%

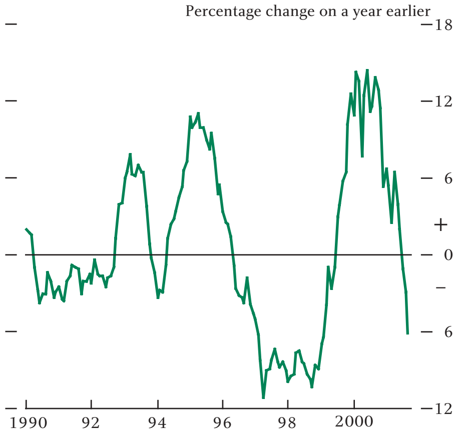
compared with the previous quarter, while world export prices were somewhat weaker than expected in the August *Report*. M6 export prices[1] declined by 0.1% in Q2, the first fall in more than two years.

The 1.4% increase in import prices in 2001 Q2 refers to a movement in an implied deflator. Such measures do not distinguish between changes in the prices of imported goods and changes in the composition of goods that are imported. So, even if prices were unchanged, and importers purchased a greater share of relatively more expensive goods, the implied deflator would rise. The ONS also publishes fixed-weight imported goods price indices, which isolate the impact of price changes (similar to domestic producer price indices). These data show that annual inflation of imported goods prices has slowed considerably since the beginning of this year. It is likely therefore that the sharp increase in the implied deflator reflects erratic changes in the composition of imports—specifically within imports of capital and intermediate goods—rather than any underlying price pressures. As such, the Committee judges that most of these compositional effects will unwind next quarter. Recent data on the imported goods price deflator for the first two months of Q3 are consistent with this view.

Looking ahead, the MPC's central projection continues to assume that world export price inflation remains weak over the forecast period. Indeed, the weaker prospects for global activity and recent falls in oil and other commodity prices mean that world export price inflation is expected to be more subdued than was projected in August. Given little change in the assumption for the sterling exchange rate, the profile of import prices over the forecast period is also somewhat lower than assumed in August.

4.3 Costs and prices in manufacturing

Chart 4.6
Manufacturing input price inflation

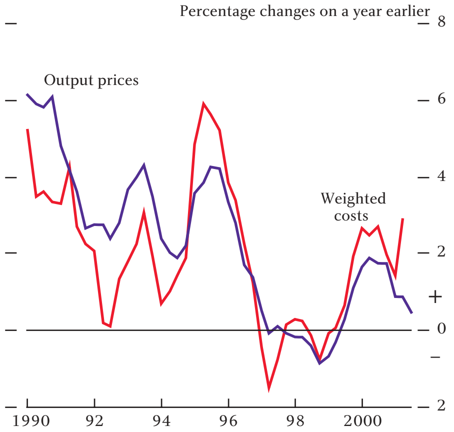


Pressures on manufacturers' materials prices have weakened further since the August *Report*. In September 2001, input prices were 6.2% lower than a year earlier, the largest decline since early 1999 (see Chart 4.6). Around half of the slowdown during 2001 reflects strong oil price rises last year dropping out of the annual comparison. Much of the remainder has resulted from lower prices for imported materials other than oil. Looking ahead, input prices should continue to fall in coming months, as recent lower oil and other commodity prices feed through.

Despite lower materials prices, a marked pick-up in unit labour cost growth (which accounts for almost half of manufacturers'

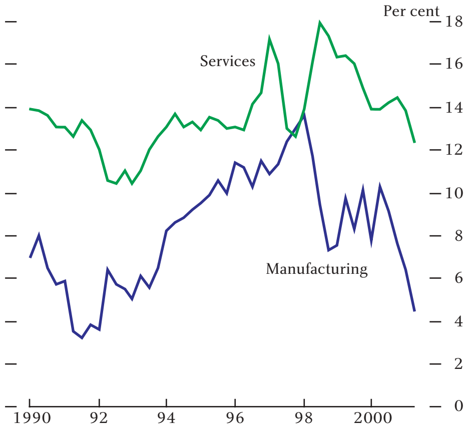
[1] The weighted average price, in local currency terms, of exports of goods and services from the G7 economies (excluding the United Kingdom), weighted according to trade flows with the United Kingdom.

Chart 4.7
Manufacturers' output prices and weighted costs



Sources: ONS and Bank of England.

Chart 4.8
Rates of return(a)



(a) Net operating surplus of companies as a share of net capital employed.

Table 4.A
Surveys of service sector prices

	2000		2001			
	Q3	Q4	Q1	Q2	Q3	Oct.
Backward-looking						
CIPS average costs index (a)	61.7	61.2	57.2	56.2	54.7	53.8
CIPS average prices charged index (a)	53.4	54.8	52.0	51.2	51.3	49.8
CSPI (b)	4.4	4.5	5.1	4.6	n.a.	n.a.
Forward-looking						
BCC prices balance (c)	23	32	32	18	16	n.a.
CBI & Deloitte Touche selling prices (d)	6	-4	2	14	-3	n.a.

(a) A reading above 50 suggests rising prices, a reading below 50 suggests falling prices. The CIPS survey is monthly, and the quarterly values shown are averages over the relevant three months.
(b) Corporate services price index (experimental index, including rent). Percentage change on a year earlier.
(c) Percentage balance of responses to the question: 'Over the next three months, do you expect the price of your services to increase/remain the same/decrease?'
(d) Percentage balance of responses to the question: 'Excluding seasonal variations, what are the expected trends for the next three months with regard to average selling prices?' Combination of consumer and business services responses.

costs) resulted in a rise in the annual rate of increase in estimates of manufacturers' overall costs in Q2 (see Chart 4.7). Annual unit wage cost growth rose from -0.5% in Q1 to 2.4% in Q2, mostly reflecting a sharp slowdown in productivity growth. It is not unusual for unit labour cost growth to rise temporarily following a fall in output. Firms tend to adjust their workforce in response to lower output only after some time, given the costs of recruiting, training and dismissing employees. As such, it is expected that the rise in manufacturing unit labour cost growth will not persist for long.

Despite the higher rate of increase in manufacturers' costs, output price inflation remained subdued in Q2—implying further downward pressure on manufacturers' profitability. The latest official data on corporate profitability support this. Reflecting the continued imbalances in the economy (see Section 2), significant disparities in profitability exist between the manufacturing and service sectors. Although service sector profitability has fallen back, it remains close to its historical average. For manufacturing, however, rates of return in 2001 Q2 were the lowest for nine years (see Chart 4.8).

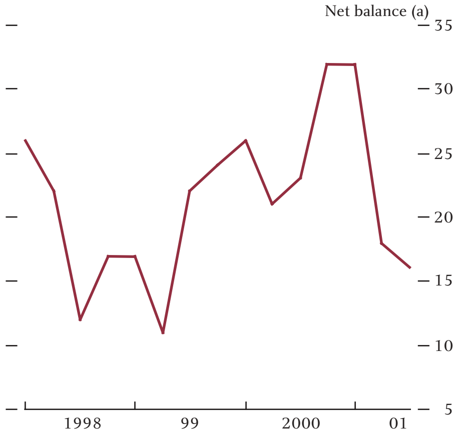
Manufacturers' output price inflation has slowed further since Q2. In the year to September 2001, output prices (excluding excise duties) rose by just 0.3% on a year earlier—the lowest rate for two years. Looking ahead, recent survey data indicate that output price inflation is likely to decline further. Both the BCC and CBI quarterly surveys showed falls in the net balance of manufacturing firms expecting to increase their output prices over the next few months. The CBI balance is now the lowest in the survey's 30-year history.

4.4 Costs and prices in the service sector

In contrast to the manufacturing sector, estimated annual service sector unit wage cost growth slowed in 2001 Q2. Unit labour costs account for the majority of service sector input costs, and represent a significantly larger proportion of the cost base than in manufacturing. Survey evidence also points to a recent reduction in cost pressures. The CIPS survey suggests that average cost pressures eased in the service sector in Q2, and have continued this trend more recently (see Table 4.A). Similarly, the BCC survey also indicated slightly weaker overall cost pressures in the sector in Q3.

Service sector output price inflation is also easing. Annual inflation measured by the ONS' experimental corporate services price index (CSPI) fell back to 4.6% in Q2, from 5.1% in Q1, driven mostly by lower inflation in transport-related industries. Though the CIPS survey index for average prices charged rose slightly in Q3, the October survey pointed to a

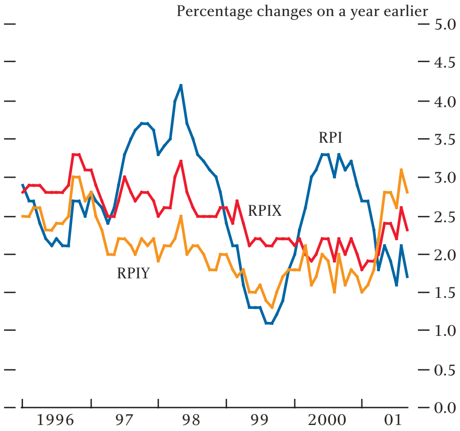
Chart 4.9
Expectations of service sector output prices



Source: BCC Quarterly Economic Survey.

(a) Percentage balance of responses to the question: 'Over the next three months, do you expect the price of your services to increase/remain the same/decrease?'

Chart 4.10
Retail price inflation



weakening in pressures, with increased competition reportedly restricting firms' ability to raise their prices. Consistent with this, the latest BCC and CBI & Deloitte Touche surveys suggest that service sector output price pressures and profitability will recede further in the next few months. The BCC balance is now the lowest for more than two years (see Chart 4.9).

4.5 Retail prices

Annual RPIX inflation rose slightly from 2.3% in Q2 to 2.4% in Q3. This was broadly in line with the outturn expected at the time of the August *Report*. Monthly movements in annual RPIX inflation have remained erratic recently, mostly reflecting significant movements in a few components during the second half of last year (notably petrol) dropping out of the annual comparison. Within the quarter, RPIX inflation rose by 0.4 percentage points in August to 2.6%, the first time inflation has exceeded the Government's 2.5% target since March 1999 (see Chart 4.10). Subsequently, RPIX inflation fell back to 2.3% in September. RPI inflation eased by 0.1 percentage points to 1.8% in Q3.

Annual RPIX inflation has risen by 0.5 percentage points over the past two quarters. RPIY inflation, which excludes indirect taxes and is therefore not affected by the current dampening effects on RPIX from changes in specific duties in the most recent Budget, has risen by an even greater extent. Since 2001 Q1, RPIY inflation has increased by 1.2 percentage points to 2.8% in 2001 Q3, the highest rate for almost five years.

In the medium term, the aggregate price level, and hence inflation, is determined by the interaction of aggregate nominal demand and supply. Changes in the relative demand for, and supply of, particular goods and services can lead to changes in relative prices. In the short run, these changes in relative prices can lead to changes in measured aggregate inflation because some prices respond more quickly than others. However, once all the relative prices adjust, and if aggregate demand and supply conditions are unchanged, then the aggregate price level, and therefore the inflation rate, should be unaffected. So changes in relative prices tell us little about underlying inflationary pressure. The Committee has judged that some of the recent movements in inflation have reflected relative price changes. Specifically, recent movements in inflation have been significantly affected by a small number of components—changes in motor vehicle, utilities and food prices have raised inflation considerably, although these upward effects were partially offset by duty changes in this year's Budget.

Chart 4.11
New and used car prices

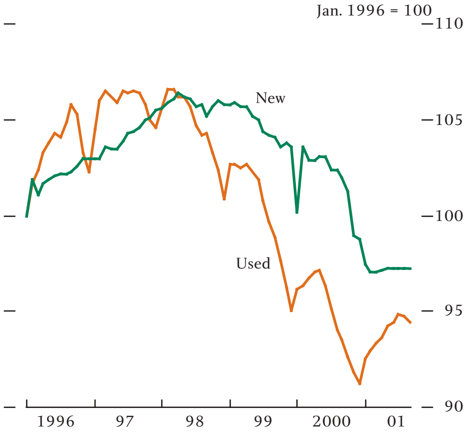
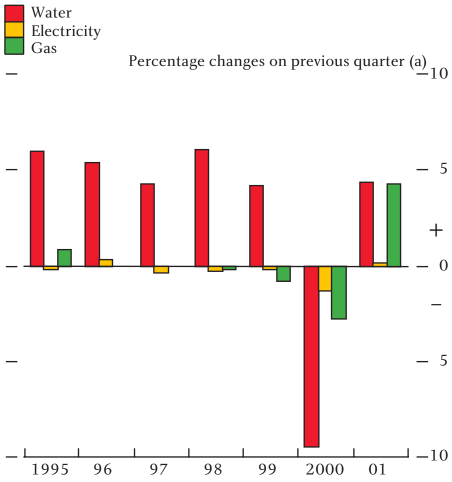


Chart 4.12
Utilities prices



(a) Refers to quarterly growth in Q2 of each year, as prices of these components are generally not changed at other times of the year.

The contribution of motor vehicle prices to annual inflation has risen strongly in recent quarters. It was the largest single contributor to the rise in annual inflation this year. Following the announcement and subsequent publication of the Competition Commission Report on UK new car prices, both new and used car prices fell significantly between mid-1998 and the end of 2000. However, it appears that the extent of the decline in used car prices[1] may have reflected exaggerated expectations of future reductions in new car prices—the decline in used car prices during this $2^1/_2$-year period was more than double that of new cars (see Chart 4.11). More recently, while new car prices have remained broadly unchanged since the beginning of the year, used car prices have increased considerably, possibly as earlier relationships between relative price levels re-establish themselves.

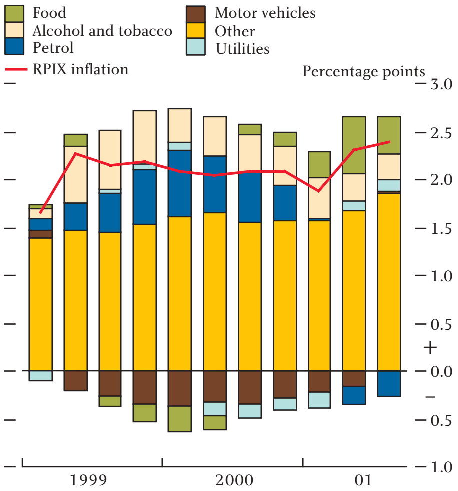
Utilities prices have also contributed significantly to the rise in RPIX inflation this year. This was broadly because unusually large reductions in water prices, and to a lesser extent electricity and gas prices, in 2000 dropped out of the annual comparison (see Chart 4.12). Going forward, if utilities prices continue to rise by a similar amount to this year, their contribution to inflation will remain broadly unchanged.

As discussed in the August *Report*, much of the unexpected rise in retail price inflation during Q2 reflected a sharp increase in food prices. Since then, seasonal food prices have fallen back much faster than expected. But relative seasonal food prices remain above levels suggested by longer-run trends, and are therefore expected to fall further in coming quarters, particularly given the weakness in world food prices. In addition, non-seasonal food prices, which typically lag movements in seasonal food prices, are also likely to ease back.

Looking ahead, because most of the recent upward pressure on inflation from used car prices is judged to be a reflection of exceptionally weak prices last year, this component is unlikely to provide much further upward impetus to inflation. And the contributions from food prices are expected to reduce inflation significantly in the near term. However, it is also important to take account of the temporary downward influence from duties, which will be partially unwound next year if they are raised in line with inflation. The unwinding of these temporary influences is likely to have an impact on the profile of inflation. Although it is difficult to be precise, these factors are likely to lead to downward pressure on inflation over the next two to three quarters as they unwind, but there may be further echo effects which add a little to twelve-month inflation subsequently.

[1] Although the weight of motor vehicles in the RPI basket includes the purchase of both new and used cars, only the prices of used cars are surveyed.

Chart 4.13
Contributions to annual RPIX inflation



As mentioned above, RPIX inflation was broadly as expected in Q3, despite the unexpectedly large falls in seasonal food prices. As Chart 4.13 shows, even excluding movements in some of the more erratic components, the contribution from the remaining RPIX basket has continued to rise recently. But why has this 'underlying' component of inflation risen when retailers' cost pressures have been easing? Movements in retail price inflation have historically been reasonably well correlated with movements in the main components of retailers' costs, namely producer prices, imported goods prices and unit labour costs. However, retailers' mark-up over cost will also vary, over time and across business cycles, meaning that divergences between retail price inflation and movements in retailers' costs are common. Retail price inflation was somewhat lower than suggested by cost developments from around mid-1999, possibly suggesting some downward pressure on retailers' profitability. It appears that the recent pick-up in retail price inflation relative to trends in overall cost pressures may provide some evidence that retailers' margins are beginning to recover—perhaps a reflection of the sustained strength of private consumption. Looking forward, it is likely that any further recovery in retailers' margins may be tempered by the expected slowdown in consumption growth in coming quarters. In addition, the more subdued outlook for domestic producer prices since August and expected reduced pressures for other components of retailers' costs all point to downward pressure on retail price inflation in the near term.

4.6 Summary

Oil and other commodity prices have fallen by more than expected, reflecting weaker prospects for world activity. These are likely to depress further the already declining trend of materials price pressures. Offsetting these lower costs, growth in manufacturers' unit labour costs has increased recently, although this rise is likely to be temporary. Reduced demand and significant excess capacity in manufacturing are continuing to restrain output price inflation, and survey evidence indicates little change to this trend in the near term. Survey and official data suggest that cost pressures in the service sector have eased recently, and here too, there is little evidence of upward pressure on output price inflation. Despite weaker cost pressures, annual RPIX inflation rose slightly to 2.4% in Q3. However, in the Committee's central projection, inflation falls back somewhat in the near term, as more subdued price pressures from the main components of retailers' costs feed through and as the net impact of a number of special factors unwinds.

5 Monetary policy since the August *Report*

This section summarises the economic developments and monetary policy decisions taken by the MPC since the August *Report*.[1] The Bank's repo rate was maintained at 5% at the Committee's regular meeting on 5–6 September then reduced to 4.75% at a special meeting on 18 September. The rate was reduced again to 4.5% in October, and then again to 4% in November.

The MPC's central projection in August was for RPIX inflation to slip back to around 2% in 2002 and edge up to the 2.5% target at the two-year horizon. Annual real GDP growth was thought likely to stay below trend in the near term, recover to around trend during 2002, and then moderate slightly towards the end of the forecast period. Risks to the outlook for growth were weighted to the downside; inflation risks were balanced in the first year and slightly to the downside in the second. Relative to the central projection, some members preferred alternative assumptions that together generated an inflation profile either slightly higher or up to 0.5% lower at the forecast horizon.

At its meeting on 5–6 September, the Committee first discussed the world economy. There were some signs that the downturn in the US economy might be coming to an end, with the prospect of gradual recovery into 2002. Growth in the euro area had been weaker than expected though there were mildly encouraging signs of some recovery ahead. But the outlook for Japan remained bleak.

In the UK economy consumption remained strong, reflected in the resilience of retail sales, household borrowing and the housing market. The labour market had continued to tighten, with unemployment falling and earnings growth rising. Investment was weaker than expected, as were recent indicators of output; manufacturing output had fallen while services output remained relatively strong. But there were signs of weakening consumer confidence and the fall in business confidence seemed to be spreading to the service

[1] The minutes of the August, September and October meetings, including the special September meeting, are reproduced under a separate cover, published alongside this *Report*.

sector. RPIX inflation had fallen due to a faster-than-expected unwinding of the recent sharp rise in seasonal food prices.

On the immediate policy decision, most members of the Committee thought that the repo rate should be unchanged. For some, there was little to alter the view that they had held in August, that 5.25% was the appropriate rate: though the downside risks remained, there was no sign of slower consumption growth or of the labour market reaching a turning point; the imbalances in the economy had worsened; past reductions in rates had not yet fully fed through; and US prospects looked slightly more encouraging. But a reversal of the previous month's reduction would imply an unrealistic degree of fine-tuning; it would also surprise the markets and might have a larger impact than such a small difference in interest rates warranted.

Most members who thought that the repo rate should remain unchanged judged that the current rate of 5% was appropriate. In their view, the outlook for growth and inflation was largely unchanged on the month. The main news was the apparent weakening of business confidence. They regarded the continued strength of consumption as the inevitable response to rate cuts earlier in the year that had sustained domestic demand in the face of the global slowdown. There was sufficient scope to provide a stimulus to demand if consumer confidence and spending fell; whereas a reduction in rates now would mean that a recovery in the world economy might entail a sharper increase in due course to keep inflation on track in the longer term. There were mixed views about the labour market picture. Some of the members in favour of maintaining the repo rate at 5% were surprised that employment had continued to grow, given that output growth had been below trend for several quarters. On this view, future policy decisions would be influenced by whether or not employment growth showed any sign of easing. Other members were less surprised at the lags between output and employment growth and noted that recent survey evidence showed some signs of easing in the labour market.

Another view was that a reduction of 25 basis points was justified. Prospects for world activity were weaker than expected. In the domestic economy, the manufacturing sector had weakened and there were signs of a slowdown in services activity. Though second-quarter consumption was stronger than expected, investment was weaker and final domestic demand was well below the projections of the August *Report*. On this view, the outlook for inflation over the next two years was significantly below target, which warranted an immediate reduction in the repo rate.

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

A special meeting of the Committee was convened on 18 September following the terrorist attacks in the United States and the monetary policy responses of the Federal Reserve, the European Central Bank and other central banks. US data released since the Committee's previous meeting for the period prior to the attacks had generally been weaker than expected. In the United Kingdom, retail sales and money data remained robust, although labour market data were somewhat softer. Inflation indicators were mixed; producer price inflation remained subdued, while annual RPIX inflation had increased to 2.6%, its highest rate for more than two years.

On the immediate policy decision, the Committee agreed that it was too soon to assess the long-term economic impact of the terrorist attacks. Global activity would clearly be weaker than previously expected, at least in the short term, but the likely balance between demand and supply and hence the impact on underlying inflationary pressure in the medium term was more uncertain.

The Committee discussed whether or not to postpone a change in interest rates to the October meeting to allow time for a more considered assessment based on additional information. The Committee agreed that though the scale of the impact of recent events on the UK economy was uncertain, the direction of the impact was clear and the associated risks were on the downside. Delaying a policy change until the next meeting risked denting confidence unnecessarily in the meantime; hence the Committee unanimously agreed on an immediate cut in rates.

Discussion moved to whether the appropriate cut in rates would be 25 or 50 basis points. Most members favoured a reduction of 25 basis points. This would signal the Committee's responsiveness to the change in economic conditions. This reduction would be less than those made by the Federal Reserve and other central banks, but that reflected the relative strength of the UK economy prior to the terrorist attacks. And the Committee would review its assessment at its October meeting, when more information on the implications of the terrorist attacks on the inflation outlook would be available.

Other members preferred a reduction of 50 basis points; these members had argued for an immediate rate cut at the previous meeting or thought that one would soon be necessary. Even before the terrorist attacks, the UK economy had appeared to be weaker than assumed in the August *Inflation Report* projections; an immediate reduction of 50 basis points now would be seen as a decisive response with only a negligible chance of reversal once a fuller assessment had been undertaken at the next scheduled meeting. A reduction of 25 basis points might be seen as overly cautious and could adversely affect business and consumer confidence.

The Committee voted by 7 to 2 to reduce the Bank's repo rate by 25 basis points, with two members voting for a 50 basis point reduction.

At its meeting on 3–4 October, the Committee first discussed the world economy. Data released after the Committee's regular September meeting but relating to the period prior to the terrorist attacks suggested that the near-term outlook for the US economy was weaker than was thought at the time of that meeting. And both activity and confidence had been reduced by the attacks, though it was still too early to assess the magnitude or duration of these effects and their overall impact on inflationary pressures. There was evidence of continued weakness in the euro area and Japan, and a slowdown in the Asian emerging economies. The oil price had risen temporarily following the terrorist attacks but had since fallen below its level at the September meeting; this would reduce inflationary pressure if sustained, as seemed likely given the weaker outlook for world activity.

The discussion of the domestic economy started with the recent *Blue Book* revisions to the National Accounts, which showed that consumption and investment had been stronger in the first half of the year, and the imbalances in the economy more pronounced, than previously thought. The capital stock had also been revised upwards, suggesting a higher level of potential output. The new estimate for consumption growth was consistent with recent data for retail sales and household borrowing. Recent survey evidence, which needed to be treated with particular caution given the likely immediate (but perhaps short-lived) effect on it of the terrorist attacks, was mixed but tended to suggest weaker activity ahead. The Committee noted that confidence effects were currently particularly important: consumer confidence had weakened and the prospects for consumption would also be adversely affected by the recent equity price falls, but the main effects were thought likely to be on business confidence. There were some signs that the labour market was close to a turning point. And at least part of the recent increase in RPIX inflation could be accounted for by temporary factors.

On the immediate policy decision, the Committee discussed the case for reducing interest rates to sustain confidence until the likely economic consequences of the terrorist attacks became clearer. All members of the Committee agreed that a reduction in the repo rate was warranted, given the increasingly evident weakness in the world economy, which would be reinforced and prolonged by the terrorist attacks.

The shock from the attacks would have both demand and supply elements, but the demand effects, which would tend to dampen inflationary pressures, were likely to predominate. Most members favoured a 25 basis point reduction. A larger reduction could damage rather than sustain business confidence. In any case, the Committee would be ready to respond to developments further ahead; more weakness in the world economy might warrant additional reductions in the repo rate in future, whereas signs of a recovery in the world economy might necessitate a rise in rates to contain domestic demand.

The other view favoured a 50 basis point reduction in rates. On this view, the weak data on the global economy that had emerged since the August *Inflation Report* confirmed that the projection for inflation had at the time been too high. The economic impact of the terrorist attacks was likely to be much stronger on demand than on supply, which implied downward pressure on inflation. And a reduction in the repo rate of 50 basis points would help to bolster business confidence which, according to recent reports from the Bank's regional Agents, had deteriorated sharply.

The Committee voted by 8 to 1 to reduce the Bank's repo rate by 25 basis points to 4.5%, with one member voting for a 50 basis point reduction.

At its meeting on 7–8 November, the Committee voted to reduce the Bank's repo rate by 50 basis points to 4%.

Prospects for inflation 6

6.1 The inflation projection assumptions

The Monetary Policy Committee approved this *Report* on 9 November. It provides the Committee's assessment of economic developments since August 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. The main assumptions on which the projections are based are described below.

The near-term prospects for the world economy have deteriorated since the August *Report*. The terrorist attacks in early September exacerbated an already worsening outlook, as output growth has slowed more sharply than expected in the major overseas economies in recent months. Business and consumer confidence have declined markedly, signalling a weaker outlook for private demand. Central banks have responded to the lessening of prospective inflation pressures by cutting interest rates further. Fiscal policy is also likely to cushion the downturn in demand through the operation of automatic stabilisers, amplified in some cases by discretionary relaxation. But the easing of monetary policy will take time to affect activity, so that the global downturn may be deeper than previously envisaged, and the projected recovery through next year may be delayed somewhat. Global GDP growth during 2001 and 2002 may be some $^1/_2$ to 1 percentage points per year below the expectations incorporated in the August *Report*. As activity gradually responds to the additional policy stimulus, growth is likely to return to around trend levels in 2003.

The weakening in global growth over the past year has been associated with a very sharp slowdown in the growth of world trade, as the downturn in output has been heavily concentrated in the output of high-technology goods, where there is considerable international specialisation of production. The slowdown in trade growth has been more acute than expected three months ago. Moreover, it is likely that one of the implications of the recent terrorist attacks in the United States will be a rise in security, insurance and transportation costs, which will moderate prospective trade growth further over the forecast period. Weighted by UK export market shares, world trade growth may slow to around 2½% this year—a downward revision of some 2 percentage points since the August *Report* and a striking reduction from the exceptional growth of more than 11% in trade volumes in 2000. On the central projection, trade growth next year may recover to around 3½%—well below the expected pace three months ago—strengthening to the 6%–7% range in 2003.

This picture continues to rely heavily on developments in the United States. Since August, US output has again fallen short of previous expectations and the near-term outlook has weakened further. Although there are signs that the inventory correction is well advanced, profits continue to fall. Cutbacks in capital spending continue and in recent months corporate retrenchment has extended to the labour market as companies have shed jobs. The combination of lower financial wealth, weaker labour market prospects, and the impact of the terrorist attacks on confidence is likely to dampen household spending further, which to date has been the mainstay supporting economic growth. But in response to the more subdued outlook for business investment and consumer spending, there has been a marked further loosening of monetary policy—US official interest rates now stand some 4.5 percentage points below the levels at the start of the year. Moreover, measures have been announced in response to the attacks on 11 September that are likely to provide some fiscal boost, and additional discretionary easing of fiscal policy is expected. Although the near-term prospects are weaker than judged three months ago, with output likely to fall slightly in the second half of this year, the central projection is for a gradual recovery in GDP growth during 2002 in response to the major policy stimulus.

GDP growth in the euro area slowed to 0.1% in 2001 Q2, well below expectations embodied in the August *Report*. Moreover, business and consumer sentiment have declined further in recent months, suggesting that near-term prospects remain subdued. Interest rates have been lowered by 1.5 percentage points so far this year, however, which should prompt some recovery in growth over the coming year. Japanese output fell substantially in 2001 Q2 and the near-term outlook remains bleak. Prospects in many emerging economies have also deteriorated in recent months given sluggish demand in the major overseas markets. A number of Asian economies have been particularly affected by the downturn in the global demand for high-technology capital goods over the past year.

Projected inflationary pressures in the major overseas economies have lessened in response to the weaker outlook for world activity. Spot oil prices have fallen significantly over the past three months, and, in the 15 working days up to and including 7 November, stood some \$4–\$5 per barrel below the August level. The futures curve, which guides the Committee's central projection, has flattened. The price of oil in two years' time is around \$1–\$2 per barrel lower than expected three months ago. Non-oil commodity prices have also declined by more than previously expected, and futures prices have softened. Weaker input prices and slower demand growth are likely to outweigh the impact of the terrorist attacks on costs. As a result, the local currency prices of traded goods purchased by UK consumers and producers are likely to be lower than assumed in August.

Sterling import prices also depend on the outlook for exchange rates. The sterling effective exchange rate (ERI) is little changed from levels assumed in the August *Report*. In the 15 working days up to and including 7 November, the ERI averaged 106.0, consistent with bilateral sterling exchange rates of \$1.45 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 1/2% below the implied level for November in the August central projection. The sterling ERI is assumed to depreciate slightly to 103.2 by 2003 Q4.

Global equity prices fell sharply during August and early September as a range of indicators signalled a weaker outlook for the world economy, and there was a further marked decline in the aftermath of the terrorist attacks on 11 September. Prices have subsequently recovered, but remain substantially lower than in early August. Indeed, in the 15 working days to 7 November the FTSE All-Share index was about 8% below the level assumed in the August *Report*. The Committee has maintained the assumption that UK equity wealth will rise in line with nominal GDP over the forecast period, from the lower-than-expected current level.

The UK housing market remained buoyant in 2001 Q3, supported by high levels of household borrowing. However, forward-looking indicators of activity and surveys of price expectations point to a slowdown in the coming months. House price inflation is projected to ease to a little below the growth rate of nominal earnings in the medium term.

No change has been made to the assumptions on UK fiscal policy. The Committee continues to base the projections on the Government's nominal public spending plans—for expenditure to rise robustly over the forecast period—and on Treasury estimates of effective tax rates on different components of income and expenditure. These assumptions will be updated in the light of the forthcoming Pre-Budget Report.

6.2 The output and inflation projections

The slowdown in UK GDP growth in recent quarters has been less pronounced than previously anticipated. According to the ONS preliminary output-based estimate, GDP rose by 0.6% in 2001 Q3, rather stronger than expected in the August *Inflation Report*. Four-quarter growth has slowed to 2.2%—just a little below trend. Major sectoral imbalances persist. Growth in the service sector moderated slightly in the third quarter, but remained above trend. Manufacturing output continued to fall, although at a slower pace than earlier in the year. Retail price inflation averaged 2.4% in 2001 Q3, very close to target, and broadly in line with the central projection three months ago.

The publication of the latest ONS National Income and Expenditure *Blue Book* in September introduced some significant data revisions which affect the interpretation of recent trends and of prospective inflationary pressures. The level of GDP has been revised up in recent years, and was 1% higher than previously estimated in 2001 Q2. GDP growth was revised up significantly in 1998 and down a little in the past two years, although growth in the first half of 2001 was also revised up slightly indicating greater impetus. The corresponding revisions to demand components show a stronger picture for household spending and for business investment. Inventory levels are also considerably higher than previously estimated, although the correction in stocks in 2001 Q2 was larger than earlier judged.

Although the levels of demand and output have been revised up, other indicators suggest that the pressure of demand on supply capacity in recent years was less than previously thought. In particular, the latest *Blue Book* data indicate that the non-residential capital stock was significantly higher than estimated formerly, and has been rising at a faster rate. In recent *Reports*, the Committee made some downward adjustments to the inflation projection to incorporate evidence supporting rather better supply-side performance than was implied by the unrevised data. The revised data suggest that these adjustments are no longer needed, and they imply a somewhat higher level and faster growth of the capital stock over the forecast period.

The latest data indicate that household spending growth has been even stronger than previously estimated. Consumer spending rose by 1.3% in 2001 Q2—well above expectations in the August *Report*—and there were upward revisions to growth in the previous two quarters. The latest ONS data incorporate sizable upward revisions to household income, which help to account for the previously somewhat puzzling strength of consumer spending in recent quarters.

A range of indicators suggests that consumer spending continued to rise briskly in the third quarter. Retail sales volumes rose by 1.5%. Private vehicle registrations increased sharply. Household money and credit growth remained rapid. And housing market activity and prices signalled continued buoyant demand. Nevertheless, the most recent monthly indicators point to a weakening in consumer confidence and to some prospective softening in household demand.

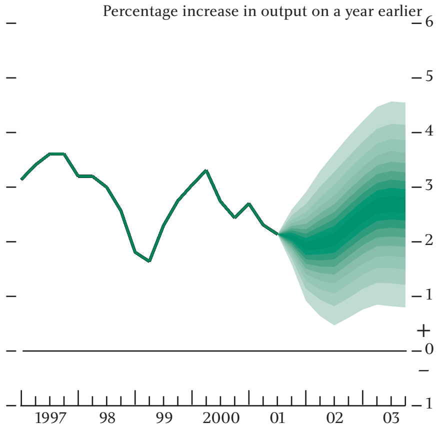
The Committee continues to expect that consumer spending will decelerate over the next twelve to eighteen months, in response to the sharp fall in financial wealth over the past year and to weaker growth in projected employment income as labour market conditions slacken. Near-term growth in spending may be rather higher than judged in August, reflecting the stronger momentum from the first half of the year. But growth is likely to slow subsequently, as the impact of the further substantial drop in equity prices and the weaker outlook for the world economy are counteracted by the additional support from lower UK interest rates.

Business investment data have been revised up by the ONS, and so the level of business investment in 2001 Q2 is now estimated to be some 3% above the August central projection. In contrast, the near-term outlook for further investment growth has deteriorated since the August *Report*. The weakening of global demand prospects has lowered the stimulus to invest, while the average cost of funding long-term investment has increased because the higher cost of equity finance and the rise in corporate bond spreads taken together outweigh the impact of the cuts in official interest rates since August. Corporate cash flow has worsened and capital gearing ratios have risen. Moreover, the rise in uncertainty surrounding future demand prospects provides an incentive for firms to postpone capital spending. Survey information and reports from the Bank's regional Agents suggest that a number of companies have put planned spending programmes on hold until the mist begins to clear. In the light of these considerations, the Committee has lowered the central projection for business investment. Over the next year, the level of investment is likely to fall back a little, although some rebound is likely in 2003, as the global outlook gradually improves, as recent interest rate cuts stimulate demand, and as deferred investment is gradually brought back on stream. The outlook for whole-economy investment is rather stronger than that for the business sector, given the continued sharp rise incorporated in public sector investment plans.

It seems likely that a considerable proportion of the marked increase in private final demand in 2001 Q2 was met by inventories, as firms sought to economise on stock-holding costs given growing financial strains and a weakening outlook for prospective demand. Survey evidence is consistent with a rundown in stocks in the third quarter as these forces continued. But some recovery in the contribution of stockbuilding to output growth is likely during the coming months as inventory correction gradually comes to an end. The upward revision to stock levels in recent years in the *Blue Book* means that the whole-economy stock-output ratio now appears to have been relatively stable in the recent past, rather than falling as previously estimated. The Committee has consequently altered the assumption for the medium-term trend in the stock-output ratio, and now assumes that it will remain broadly flat.

Both export and import volumes have fallen in recent months as world trade growth has stalled. Export prospects have deteriorated significantly reflecting the weaker outlook for global demand and trade volumes: surveys of export orders highlight particularly sharp falls for the manufacturing sector. Prospects for import growth are also somewhat weaker than judged likely in August, given recent trends and the likelihood that higher security and insurance costs will moderate the growth of world trade and encourage substitution to domestic supply at the margin. The downward revision to export prospects is likely to dominate, at least in the short run. The net trade contribution to growth is likely to be firmly negative over the next year, but should attenuate in the second year of the projection as world growth recovers.

Chart 6.1
Current GDP projection based on constant nominal interest rates at 4%



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.

Drawing together the information on the prospects for the components of demand and trends in output, the Committee's current projection for the four-quarter growth in real GDP is shown in Chart 6.1.[1] The projection is based on the assumption that official interest rates are maintained at 4%.[2] Four-quarter GDP growth is likely to dip a little further below trend over the next year, as subdued global demand and a slowdown in private final demand growth outweigh the continued robust growth of public spending and the impulse from the ending of the current phase of inventory correction. A gradual recovery to around or a little above trend levels is likely by the end of 2003, as global growth improves, as investment postponed because of heightened uncertainty is gradually undertaken, and as the impact of recent cuts in interest rates continues to work through. Over the next two years as a whole, GDP growth is likely to be broadly similar on average to the August projection, reflecting the countervailing forces on the upside of a stronger initial impetus and significantly lower interest rates, and on the downside from a weaker outlook for the world economy, lower equity prices and

[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.

heightened uncertainty following the terrorist attacks in early September.

A simple comparison of the four-quarter rates in the current projection with the August *Report* suggests that growth in the near future is higher than judged three months ago. At first sight this might appear surprising. But this is entirely the consequence of the fact that growth in 2001 has been rather higher than was projected three months ago—slowing to just a little below trend in the year to 2001 Q3. Quarterly growth rates in the near future are likely to be weaker than expected in August, reflecting the deterioration in the global economy and the more subdued prospects for investment.

RPIX inflation averaged 2.4% in 2001 Q3, broadly in line with the central expectation three months ago. However, the short-term outlook for RPIX inflation is a little weaker than expected in August, reflecting the recent sharp decline in global oil prices and the consequent expected fall in petrol prices. Forward-looking surveys report a further easing of cost and price pressures in both manufacturing and services industries.

Pay pressures appear to be relatively stable at present. Whole-economy settlements remain on average in the 3¼%–3½% range, while headline whole-economy earnings growth was 4.5% in August, broadly in line with expectations three months ago.

The outlook for nominal earnings growth depends on inflation expectations, and on productivity growth and the balance between demand and supply pressures in the labour market, which together affect the prospects for the growth in real earnings. Based on movements in the prices of conventional and index-linked government bonds, financial market participants have lowered their implicit estimate of expected inflation over the next few years since the August *Report*. In contrast, surveys of inflation expectations have edged up a little, although these remain relatively well anchored by the 2.5% inflation target.

There are signs that the labour market may be at a turning point. LFS employment was a little lower in the three months to August than in the previous three months, and LFS unemployment rose by some 50,000 on the same comparison. Nevertheless, the market remains tight. The claimant count has continued to decline and on this measure the unemployment rate is the lowest for 26 years. The latest BCC survey notes that recruitment difficulties remain at high levels, although other surveys and reports from the Bank's regional Agents suggest some easing of skill shortages.

A slackening of labour market pressures is likely in the coming months given the projected continuation of below-trend output growth. Recruitment intentions have eased. Nonetheless, given the costs of recruitment, training and redundancy payments, there are incentives for firms to try to retain their current workforce if a slowdown in demand is perceived as temporary. The downturn in UK GDP growth is relatively shallow in the central projection, which should limit the weakening in aggregate labour demand. The outlook for employment growth is, nevertheless, rather softer than in the August projection, in the light of the evidence that pressures on capacity are lower than previously estimated.

Nominal earnings growth during the next two years is likely to remain around current levels on average, although a dip is expected in early 2002 reflecting the unwinding of exceptional bonus payments earlier this year. Given weaker labour demand, unit labour costs are likely to rise less rapidly than projected three months ago.

One result of the terrorist attacks is that companies are likely to raise their spending on security and insurance. They may also adopt more costly production techniques in order to secure continuity of business. The diversion of resources will tend to lower the level of aggregate productivity and supply capacity and could thus add to inflationary pressure over the forecast period. The Committee has made a small adjustment to the international and the UK projection to reflect this possibility.

Bringing together the information on domestic and international cost and price trends, and the prospective demand pressures on plant and labour market capacity, the Committee's current projection for twelve-month RPIX inflation is presented in Chart 6.2.(1) The projection is conditioned on the assumption that official interest rates are maintained at 4% over the next two years.(2) It is shown alongside the corresponding projection from the August *Report*, which was based on constant official interest rates at 5% (see Chart 6.3).

On the central projection, RPIX inflation is expected to edge down a little in the coming months, to around 2% by the spring of next year, before drifting up slowly towards the target over the following 18 months or so. The monthly and quarterly profiles are likely to remain volatile, reflecting the unwinding of a number of special factors, such as the temporary spike in seasonal food prices earlier this year and the impact of changes in specific duties in the most recent

(1) Also presented as Chart 2 in the Overview.

(2) An alternative projection assuming that UK official interest rates follow market interest rate expectations is shown in Chart 6.6 below.

Chart 6.2
Current RPIX inflation projection based on constant nominal interest rates at 4%

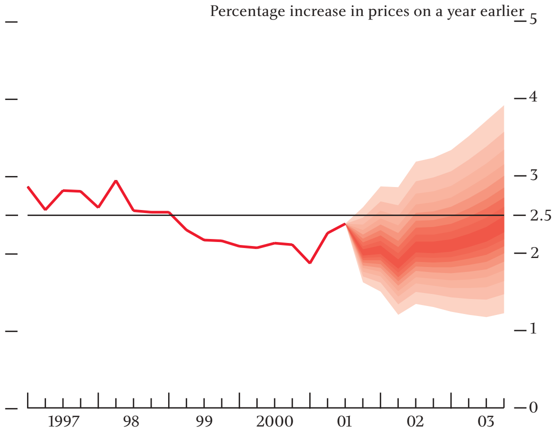
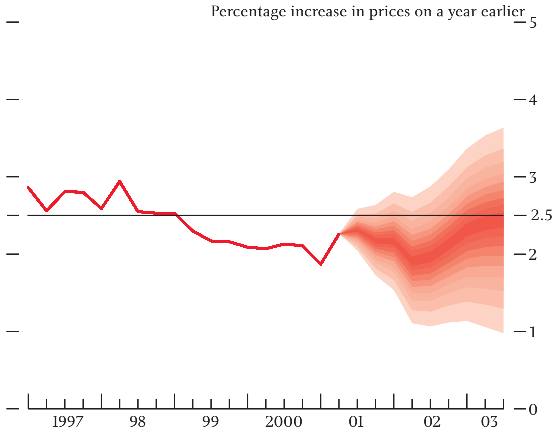


Chart 6.3
RPIX inflation projection in August based on constant nominal interest rates at 5%



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

Budget. Excluding these factors, the underlying picture is of broadly stable inflation. Domestic pressures on inflation ease slightly over the forecast period, reflecting the spell of below-trend output growth, while external pressures are muted in the near term, but then increase a little as the world economy recovers and as the dampening effect of the high exchange rate on import prices in recent years continues to wane.

After incorporating the 1 percentage point cut in UK interest rates over the past three months, the central projection for inflation is just a little softer than in the August *Report*. Relative to August, the weaker outlook for global growth and inflationary pressures, lower equity prices and the impact of the somewhat faster prospective growth of the capital stock are the main downside influences on UK inflation prospects. These are largely counterbalanced by the upward revision to the level of UK output—combined with signs of stronger-than-expected growth recently and the significant relaxation of UK monetary policy.

The outlook for output growth and inflation remains highly uncertain, and the fan charts depicted in Charts 6.1 and 6.2 embody an estimate of the variance of the possible outcomes based on evidence from earlier forecast errors. The Committee has maintained the same calibration of general uncertainty around the central projection as in August.[1] That assumes that there is no major additional sustained

[1] Reflecting the volatile short-term movements in inflation from month to month, a minor adjustment has been made to widen the range of possible outcomes for the inflation outlook for the first three quarters of the projection.

increase in economic and political uncertainty, linked to possible future repercussions of the terrorist attacks in the United States and the subsequent military response.

There are a number of major risks to the outlook, which have an important bearing on Committee members' interest rate decisions. Notwithstanding the downward revision to the central projection for global activity and prices, the Committee judges that the balance of risks around the international outlook remains weighted to the downside. In particular, the sharp fall in equity prices in recent months and the heightened uncertainty following the terrorist attacks in early September could prove to be catalysts for a more pronounced near-term correction to private final demand in the major overseas economies than implied by the central projection. Moreover, there is also a possibility that a diminished appetite for financial risk could have a disproportionate impact on growth prospects in some emerging market economies, reflecting their reliance on external finance. Restoring private sector confidence remains the key to the projected global recovery.

The imbalances within the UK economy remain acute, and continue to pose a threat to the outlook. Following the recent upward revisions to income, the household financial position appears a little stronger than judged in August. Capital gearing, though, remains at historically high levels. While interest-servicing pressures have been eased by the recent cuts in interest rates, there remains a possibility that households could raise precautionary saving rates at some point over the forecast period to rebuild balance sheet positions. The likelihood, timing and magnitude of such a change in saving behaviour is particularly hard to judge. Indeed, although there are substantial downside risks to consumption growth—and to output and inflation—from this source, there is also a significant probability that household spending growth could remain stronger for longer than currently projected, with a sharper correction subsequently. Under this latter scenario, output growth would be higher in the short run and the pressures on inflation over the next two years could be stronger than currently projected. Recognising the uncertainties surrounding the prospects for aggregate private final demand, and that there are risks of both stronger and weaker spending in the short-to-medium term, the Committee concluded that the risks to growth and inflation from this source were relatively evenly balanced over the forecast period.

One counterpart to the strong growth in final domestic demand in recent years has been a rising current account deficit, linked partly to the persistent strength of sterling.

Growth in the volume of imports has outstripped that of exports in each of the past five years, and this tendency is likely to be sustained into the forecast period on the current central projection. At some point, the growth in external debt could prompt a reassessment of the value of sterling. In consequence, the Committee continues to judge that the balance of risks is for a sharper depreciation than in the central case. A larger decline in the exchange rate would stimulate domestic output growth and thus raise pressures on capacity. There would also tend to be an additional boost to domestic prices from the higher level of import prices.

There remains considerable uncertainty on the level and prospective growth of supply capacity in the economy. The recent evidence from the ONS is consistent with a lower level of pressure on aggregate capacity than the unrevised data had indicated. Survey evidence also provides some support for this view. But any quantification in this area is necessarily imprecise. Producing estimates of the capital stock requires a considerable number of simplifying assumptions and approximations which may not hold. Moreover, gauging trends in prospective productivity growth is fraught with difficulty. And surveys of capacity utilisation do not produce accurate estimates: firms are typically asked whether or not they are working at full capacity, but they are not required to signal how much capacity may currently be idle. Recognising these uncertainties, the best collective judgment of the Committee is that there are significant risks that supply potential could differ in either direction from the estimate incorporated in the central projection.

The fan charts portrayed in Charts 6.1 and 6.2 show the centre of gravity of opinion on the Committee, in respect of both the individual assumptions that underlie the projections, and on the overall outlook and risks. In the fan charts, the risks are shown in combination. These risks are not independent. For example, a weaker world outlook would add to pressures on UK companies and households and would thus increase the chances of a sharper cutback in spending. And a pronounced slowdown in private final demand could provide the trigger for a marked fall in the sterling exchange rate. The overall risks around the central projection for GDP growth are judged to be evenly balanced in both years of the forecast, as the possibility of a weaker international outlook offsets the possible stimulus from a lower sterling exchange rate. Risks around the inflation outlook are weighted to the upside in both years, as the impact of a possible exchange rate depreciation on import prices outweighs the downside pressures from the likelihood of weaker global growth. The probabilities of various outcomes for inflation and GDP growth on the best collective judgment of the Committee are

Chart 6.4
Current projection for the percentage increase in RPIX in the year to 2003 Q4

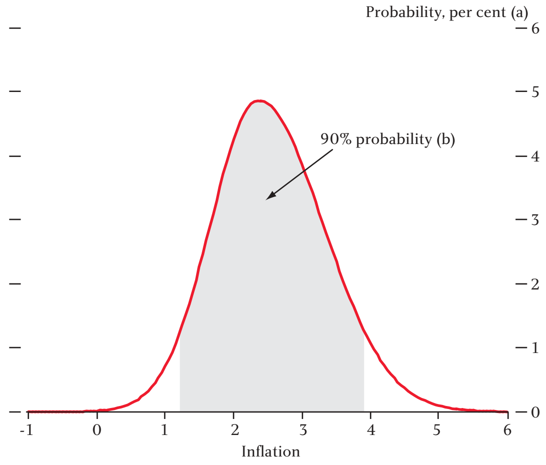
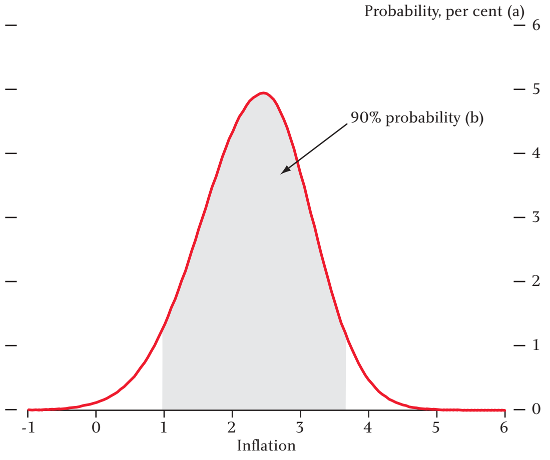


Chart 6.5
August projection for the percentage increase in RPIX in the year to 2003 Q3



Source: Bank of England.

(a) Probability of inflation being within ±0.05 percentage points of any given inflation rate, specified to one decimal place. For example, the probability of inflation being 2.5% (between 2.45% and 2.55%) in the current projection is close to 5%.

(b) The areas shaded light grey contain 90% of the probability, and are consistent with the widest bands shown in Charts 6.2 and 6.3. For further details see 'The *Inflation Report* projections: understanding the fan chart', February 1998 *Quarterly Bulletin*, pages 30–37, and the box on page 52 of the February 1999 *Inflation Report*.

Table 6.A
The MPC's expectations for RPIX inflation and GDP growth based on constant nominal interest rates at 4%[a]

RPIX inflation

Probability, per cent	Range:					
	Less than 1.5%	1.5% to 2.0%	2.0% to 2.5%	2.5% to 3.0%	3.0% to 3.5%	More than 3.5%
2001 Q4	1	38	51	9	<1	<1
2002 Q4	9	26	32	21	9	3
2003 Q4	9	16	24	22	16	13

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	<1	39	61	<1	<1
2002 Q4	1	9	29	37	19	4
2003 Q4	1	6	21	34	27	12

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

There were errors in the entries corresponding to 2001 Q4 and 2002 Q4 in Table 6.A in the August *Inflation Report*. A corrected version of the table is available on the Bank's web site at www.bankofengland.co.uk/inflationreport/augtable6a.pdf

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

Difference from central projection, percentage points

	Supply-side developments	Scale of world slowdown and impact on United Kingdom
RPIX inflation		
2002 Q4	-0.1	-0.1
2003 Q4	-0.2	-0.3
GDP growth		
2002 Q4	0.0	-0.1
2003 Q4	0.1	-0.1

presented in Table 6.A. An illustration of the overall balance of risks at the two-year horizon is provided in Chart 6.4, alongside the corresponding balance in the August *Report* (see Chart 6.5).

Given the many uncertainties, there are some differences of view among the Committee members both on certain key assumptions that underpin the central projection and on the balance of risks around the most likely outcome. In relation to the central projection, some members think that the downturn in the world economy could be deeper and more persistent and that the impact of weaker global inflationary pressures on UK price-setting could be more pronounced. In addition, some members believe that there is greater supply potential in the UK economy than currently assumed in the central projection which would place additional downward pressures on inflation. Based on their best individual assessments, some members judge that the central projection for inflation at the two-year horizon could be either a little higher or up to 0.5% lower than in the best collective projection shown in Chart 6.2. As in previous *Reports*, Table 6.B provides an illustrative calibration of the most substantial differences of view on the assumptions underlying the central projection.

Judgments on the balance of risks play an equally important role when individual members formulate their views on the appropriate level of interest rates. There is considerable uncertainty about the likelihood of the various risks materialising and their implications for the outlook for inflation and growth. As noted above, the centre of gravity on the Committee is that risks to output growth are evenly balanced and are weighted slightly to the upside for inflation. But there are differing views on the likelihood of particular risks crystallising, and thus on the overall balance of risks. Some members would attach rather greater weight to risks that might lead to additional upside pressures on activity and inflation over the forecast period, in particular to the prospect of a more substantial exchange rate depreciation, and the possibility that household spending could remain robust well into next year. Others would assign rather less weight to the likelihood and impact of an exchange rate fall and would attach rather greater weight to the probability of a sharper and more immediate retrenchment in household spending and business investment. In their view, the overall balance of risks to both growth and inflation is weighted to the downside.

Given signs that the world economy was weaker than projected in August, and concerns that the impact of the terrorist attacks in the United States would depress demand and inflationary pressures both internationally and domestically, the Committee lowered interest rates further to 4.75% on 18 September and 4.5% on 4 October. These reductions were designed to bolster business and consumer confidence and to encourage additional domestic spending to counteract the gloomier outlook for global demand, with the intention of maintaining prospective overall demand pressures broadly in line with domestic supply capacity, consistent with the inflation target.

There are, however, clear signs from business surveys and reports from Agents' contacts of a significant weakening in confidence in recent months. Some forward-looking indicators of household spending, such as consumer confidence and prospective housing market activity, have also softened. The near-term outlook for global demand has also deteriorated significantly over the past month, given the sharp rise in unemployment in the United States and substantial weakening in surveys of activity and confidence in the United States and the euro area.

The Committee analysed the impact of this news and assessed the implications for interest rates at the policy meeting on 7–8 November. The more subdued outlook for global activity and prices had weakened the outlook for UK growth and lowered prospective inflationary pressures. Cost and price pressures in the United Kingdom had softened, and consequently, maintaining interest rates at 4.5% ran the risk that inflation could significantly undershoot the target over the next two years, and thus that output and employment would be lower than necessary. Taking into account the uncertainties and risks, the Committee judged that the

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

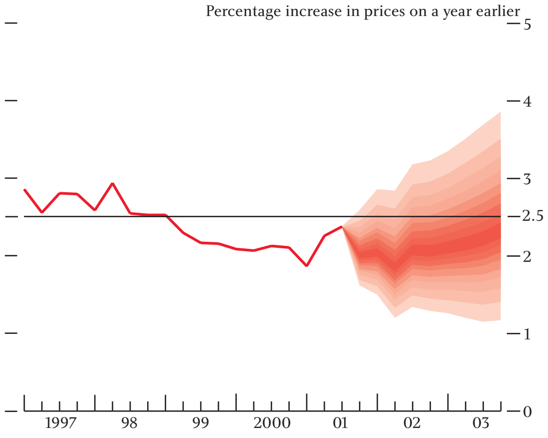


Chart 6.7
Current GDP projection based on market interest rate expectations

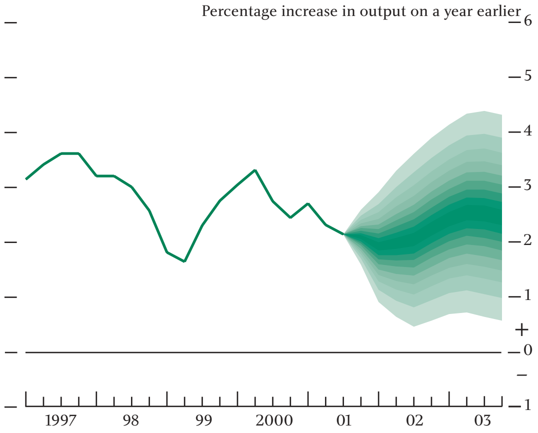


Table 6.C
Market expectations of the Bank's official interest rate[(a)]

Per cent

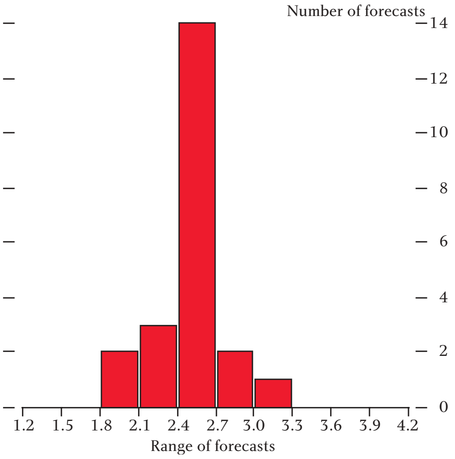
2001	2002				2003			
Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
4.3	4.0	4.0	4.2	4.4	4.5	4.7	4.8	4.8

(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 7 November 2001.

balance of evidence favoured a further reduction in interest rates to support confidence and domestic spending, and hence to maintain prospective inflation in line with the target in the medium term. The Committee consequently voted to cut interest rates by 0.5 percentage points to 4%. Official rates have been lowered by a cumulative 2 percentage points since the start of the year.

There has been a substantial fall in market expectations of the likely path of future official interest rates over the past three months, as prospective inflationary pressures have declined and central banks have responded by lowering rates. Based on financial market prices in the 15 working days up to and including 7 November, market participants attached a high weight to a further reduction in rates at the November meeting, although views differed on whether the cut would be 0.25 or 0.5 percentage points. A low point of 4% or a little below was expected by Spring 2002. Thereafter official rates were expected to edge up a little to around 4$^3/_4$% by the end of 2003 (see Table 6.C). The Committee's latest projections based on these market interest rate expectations are presented in Charts 6.6 and 6.7. These projections show a slightly weaker outlook for output growth and inflation than in the constant interest rate case. It should be noted, however, that market expectations of future interest rates fell during the 15 working day period and so expected rates on the eve of the policy decision were lower than this average.

Chart 6.8
Distribution of RPIX inflation forecasts for 2003 Q4



Source: Forecasts of 22 outside forecasters as of 26 October 2001.

6.3 Other forecasts

In October, the Bank asked a sample of external forecasters for their latest projections of inflation and output. Based on this survey, the average forecast for the twelve-month rate of RPIX inflation in 2001 Q4 was 2.3% (with a range of 2.0% to 2.6%)

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

RPIX inflation (a)

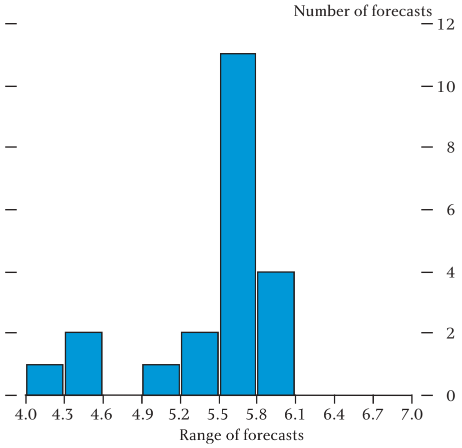
Probability, per cent	Range: Less than 1.5%	1.5% to 2.0%	2.0% to 2.5%	2.5% to 3.0%	3.0% to 3.5%	More than 3.5%
2001 Q4	4	17	49	26	4	1
2002 Q4	8	17	33	25	11	6
2003 Q4 (b)	7	14	32	27	13	7

GDP growth (c)

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	10	50	37	2	0
2002 Q4	3	10	29	39	16	3
2003 Q4 (d)	3	10	24	34	22	6

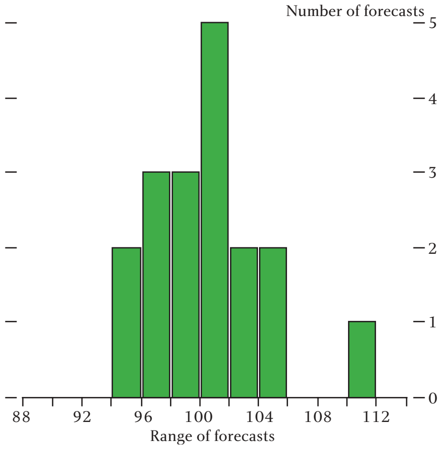
(a) 24 other forecasters provided the Bank with their assessment of the likelihood, at three time horizons, of expected twelve-month RPIX inflation and four-quarter output growth falling in the ranges shown above. This table represents the means of the responses for each range. For example, on average, forecasters assign a probability of 7% to inflation turning out to be less than 1.5% in 2003 Q4.
(b) 22 forecasters.
(c) 23 forecasters.
(d) 21 forecasters.

Chart 6.9
Distribution of repo rate forecasts for 2003 Q4



Source: Forecasts of 21 outside forecasters as of 26 October 2001.

Chart 6.10
Distribution of sterling ERI forecasts for 2003 Q4



Source: Forecasts of 18 outside forecasters as of 26 October 2001.

rising to 2.4% in 2002 Q4 and 2.5% in 2003 Q4 (with a range of 2.0% to 3.0%). The distribution of central projections in 2003 Q4 is shown in Chart 6.8. Compared with the survey results in the August *Report*, the average forecast for inflation in 2001 Q4 is unchanged, while average projections for inflation are slightly lower for 2002 Q4 and slightly higher for 2003 Q4. On average, external forecasters see a 53% probability of inflation being below 2.5% in 2003 Q4, and a 47% probability of it being above (see Table 6.D).

The forecasters' average projection for four-quarter GDP growth in 2001 Q4 is 2% (with a range of $^{3}/_{4}$% to 2$^{3}/_{4}$%). The average projection for growth in 2002 Q4 is 2$^{1}/_{2}$% and is 2$^{3}/_{4}$% (with a range of 1$^{1}/_{2}$% to 3$^{1}/_{2}$%) in 2003 Q4. The average forecast for four-quarter GDP growth in 2001 Q4 is slightly weaker than in August, but growth in 2003 Q4 is expected to be slightly stronger.

The average forecast for the official interest rate is 4$^{1}/_{4}$% in 2001 Q4 (with a range of 4% to 4$^{3}/_{4}$%) rising to 5% in 2002 Q4 and then 5$^{1}/_{2}$% in 2003 Q4 (with a range of 4% to 6%) (see Chart 6.9). This is lower than the August forecasts for 2001 Q4 and 2002 Q4 but close to the August forecast for 2003 Q4. On average, forecasters assume that the sterling ERI will be 104$^{3}/_{4}$ in 2001 Q4 (with a range of 102 to 106$^{1}/_{2}$) and will then fall to 101$^{3}/_{4}$ in 2002 Q4 and 100$^{1}/_{2}$ in 2003 Q4 (with a range of 95 to 110$^{1}/_{4}$). Compared with the August forecast this is marginally higher for 2001 Q4 but marginally lower for 2002 Q4 and 2003 Q4 (see Chart 6.10).

Bank of England
Agents' summary of business conditions

November 2001

This publication is a summary of monthly reports compiled by the Bank of England's Agents, following discussions with around 2,000 businesses in the period between mid-August and mid-October. 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.

- Poor weather earlier in the year has reduced crop yields, particularly wheat. Animal movements were restricted by renewed outbreaks of foot-and-mouth disease in some areas.

- Manufacturing output and orders fell further over the period, with export orders weakening most. Suppliers to the aerospace industry reported a downturn in future orders following the terrorist attacks in the United States on 11 September. Manufacturers of consumer goods for the domestic market generally maintained output and orders, but this was insufficient to offset the downturn elsewhere in the sector.

- Construction output growth remained robust, although there was increased uncertainty about future orders and less speculative development. Contacts expect public sector projects to sustain construction output in 2002.

- Growth in consumer services improved over the period, with strong demand for financial products such as credit cards and mortgages. Growth in spending on overseas holidays was also strong until 11 September, but is reported to have weakened since. Business services growth slowed quite sharply as companies reduced spending in areas such as business travel, advertising, consultancy and entertainment.

- Retail sales growth remained buoyant, apart from a dip in the few days after 11 September. New private car sales rose particularly strongly during September, the new registration month.

- Export orders declined further, with weaker demand from a wider range of countries. Import penetration increased from lower-cost overseas suppliers.

- Increased uncertainty, particularly following the events of 11 September, led to planned investments being deferred or cancelled. Generally, shorter and more certain payback periods were required.

- Input prices for raw materials and components were mostly flat or falling during the period. However, increases in indirect costs such as pension provision, regulatory compliance and insurance pushed up unit costs. Manufacturers' output prices were broadly stable, as was retail price inflation, although buoyant consumer demand resulted in less deep discounting in the summer sales than last year.

- The labour market slackened during the period. Employment growth in the service sector slowed, and no longer offset redundancies in manufacturing. Skill shortages declined, persisting mainly in specialist trades and certain localities. Pay pressures also eased, with fears about job security acting as a restraint.

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

OUTPUT

Primary production

Agricultural contacts reported that crop yields were lower than last year. Quality, particularly of wheat, has also been lower due to wet weather last winter and this spring. The sector was also hit by the re-emergence of foot-and-mouth disease (FMD) in some areas during the period. Many farmers have now received compensation but in some regions are delaying restocking. Inland Revenue moratoria on payments were expected to end soon, with an increased number of exits from farming expected to follow.

Some extractive industries reported increased demand during the period, including coal, for power stations, and aggregates, for construction.

Manufacturing

Output and orders continued to weaken. Low levels of demand were combined with a transfer of operations away from the United Kingdom by some companies. Export orders fell particularly sharply, reflecting both the economic downturn in the United States, Germany and the Far East, and contracts being lost to overseas competitors. The events of 11 September exacerbated the decline, particularly for exports of capital goods.

Information and communications technology (ICT) output stabilised following a steep decline in the second quarter. However, contacts reported that they do not expect a recovery in demand for ICT components until well into 2002. Output of machine tools and industrial vehicles also fell.

Output of consumer goods for the domestic market has remained relatively strong. Food and pharmaceuticals manufacturers generally maintained output and orders. Other relatively strong areas were cars, equipment for oil and gas exploration, defence, construction equipment, and health supplies. Output growth in the aerospace industry had been relatively strong, although after 11 September future orders for civilian aircraft were sharply reduced. This has had an impact on future orders for suppliers to the airline industry.

Construction and housing

Construction output growth remained strong throughout the period, although forward order books have shortened for most contacts. There were some reports of forward orders for hotels being cancelled following the events of 11 September. Retail, leisure and warehouse development continued to be strong, but Agencies reported slower demand for office and industrial space. Less speculative development of commercial property was planned owing to increased uncertainty about future demand.

Contacts expected the main driver of construction output growth in 2002 to be public sector infrastructure and Public Finance Initiative projects for roads, rail, schools, prisons and hospitals.

Demand for housing remained relatively robust, apart from a reported easing in demand at the top of the market. Contacts in many regions believe house prices may have stabilised. Uncertainty about future consumer confidence has joined delays in planning permission as a major concern for future housing starts.

Services

Since the previous *Agents' Summary*, growth in business services has slowed, while growth in consumer services output has picked up slightly.

Growth in business services had been slowing prior to 11 September, and the increased uncertainty following the terrorist attacks has led to widespread reports of companies cutting back on spending—including advertising, printing, consultancy and corporate entertainment. Prior to 11 September there were already reports of some business travellers switching to low-cost airlines and standard-class rail travel. After 11 September, business travel and conferences were reduced sharply, with an associated fall in corporate demand for hotels and exhibition facilities.

Professional services contacts saw a decline in mergers and acquisitions and flotation work, but increased demand for insolvency and rationalisation advice. Recruitment agencies and IT consultancies faced weaker demand throughout the period.

Growth in consumer services appeared to be strengthening prior to 11 September. Demand for consumer financial services, such as credit cards and mortgages, was strong, but there was little demand for equity-based ISAs. Although many rural leisure and tourist businesses continued to record weak turnover as a result of FMD, coastal and city tourism has been less affected. Overseas tourist numbers were down year-on-year before 11 September, and have fallen sharply since. Similarly, demand for overseas holidays fell sharply following the terrorist attacks.

DEMAND

Consumption

Robust growth in retail sales volumes was recorded, although contacts reported lower demand for big-ticket items in some regions towards the end of the period. Strong sales of electrical goods and designer clothing were reported by several Agencies.

Consumer spending on leisure attractions and in bars and restaurants was buoyant throughout most of the period. Some increase in demand for cruises and United Kingdom holidays was noted, with consumers switching away from foreign destinations.

Contacts reported continued strong growth in new car sales to the personal sector. Demand for fleet cars, however, was significantly lower than reported in the previous *Agents' Summary*, as some companies switched to offering a salary increase rather than a company car in anticipation of forthcoming tax changes. Lower fleet sales also reflected lower demand by car-hire companies due to the reduction in overseas tourist numbers.

Exports and imports

By the end of the period the downturn in export orders had deepened and widened to countries such as the Republic of Ireland, Malaysia, Sweden and Denmark. Demand for UK exports of consumer goods and services fell in the previously strong Middle Eastern market. German and US markets deteriorated further for exports of capital goods. Only the Chinese market was reported to be consistently strong. Following 11 September, contacts reported a marked decline in demand for exports of aerospace and travel goods, but an increase in export orders for military equipment.

Import penetration continued to increase, as some foreign companies experiencing weak demand in their home markets targeted the relatively strong UK market. There are reports that since 11 September some contacts are considering whether to relocate critical services, production and sourcing back to the United Kingdom. This would reverse a previously established trend of rising outsourcing to overseas suppliers.

Investment

Low profit levels in manufacturing, weak share prices and withdrawal of capital budgets by overseas parent companies all contributed to a deteriorating outlook for investment during the period. Investment freezes, deferrals and cancellations were widely reported following 11 September. This was true even of companies working at full capacity, and reflected increased uncertainty about future economic prospects. Investment intentions in hotels and civil aviation were cut back severely in the second half of the period. Contacts also reported that inward investment had declined substantially during the period.

Retail investment in new stores and refurbishments continued to be strong. Elsewhere, investments to improve productivity were going ahead but with more stringent requirements in terms of payback period and certainty of return on the investment.

COSTS AND PRICES

Input prices

Prices for raw materials, diesel and components were low or falling during the period. Increased use of Internet auctions and group purchasing also reduced costs, and importers benefited from the continued strength of sterling. In spite of lower raw materials prices, unit costs increased during the period due to rising regulatory, tax and insurance costs. Contacts cited financial, employment, pensions, and health and safety legislation as areas of increased regulatory costs. Businesses continued to note the impact of the climate change levy and higher business rates. Contacts also expected the forthcoming aggregates tax to raise the price of building materials. Insurance costs for commercial vehicles, property and employers' liability had risen significantly during the early part of the period. The collapse of Independent Insurance and the events of 11 September caused further rises in premia.

Output prices

Output price inflation remained subdued as manufacturers found increases in list prices had to be negotiated away in discounts to their bigger customers. In part, this downward pressure on prices has resulted from increased competition from lower-cost overseas suppliers. Some customers have requested pricing in euros, which makes comparisons between suppliers easier. Electronic chip prices and prices of some telecommunications components had continued to fall in an oversupplied world market.

Service sector inflation slowed, but remained positive throughout the period. Legal and accountancy fees increased, as did commercial insurance premia. Contacts reported that cleaning contract prices were increased as a result of the rise in the National Minimum Wage. Towards the end of the period, advertising and hotel rates were negotiated down by corporate customers as demand weakened.

Retail prices

Competition continued to suppress price rises in supermarkets. Prices of seasonal vegetables, particularly potatoes, fell during the period. Meat prices also gradually declined to around their pre-FMD levels. Bread prices rose, however, partly due to the increased cost of flour resulting from poor harvests.

Non-food retailers generally offered less deep discounts, sometimes over a narrower range of goods, in their summer sales. Retailers in some regions have not held the usual mid-season sales, as demand remained buoyant.

Overseas holiday prices, which had risen over the summer due to increased fuel prices, fell rapidly following the attacks in the United States.

A buoyant market for new cars, particularly in September with the new registration plate, meant that discounting was less prevalent. Used car prices remained reasonably stable throughout the period.

Pay

Pay pressures overall eased during the period, with fears about job security reported to be acting as a restraint on pay demands. Agencies reported that most pay deals in manufacturing were at or slightly above the rate of RPIX inflation, although pay freezes were also in place in some cases. Pay settlements in the service sector, which had been stronger than in manufacturing, were reported to be easing towards the end of the period. Professional and financial services contacts expected to pay much lower bonuses this year than last. Where skill shortages have continued, notably in the construction trade and in some professional services, pay growth has remained well above the rate of RPIX inflation.

Despite the easing in pay settlements, staff costs have risen during the period due to increased statutory entitlements, rising pension provision costs and the 40 pence per hour increase in the National Minimum Wage from October.

EMPLOYMENT

The labour market eased in most areas during the period. Three months ago, Agencies were reporting redundancies in manufacturing and slow growth in service sector employment, with skill shortages apparent in a variety of sectors. By the end of the three-month period, redundancies were also being reported in the service sector, and freezes on recruitment were not uncommon. In some cases, firms made temporary appointments due to caution about expanding their payroll. Initially unemployment increased only slowly because service sector employment was still growing, partly offsetting manufacturing redundancies. Also, some firms were hoarding labour in case the downturn proved temporary. Following the attacks in the United States, Agencies reported job cuts in airlines, suppliers to the airline industry, car rental and holiday companies.

Skill shortages declined over the period in most sectors, particularly IT. However, HGV drivers, construction workers and specialist engineers remained in short supply. There were also difficulties recruiting for unskilled jobs in particular localities. Towards the end of the period, retailers began recruiting extra staff for Christmas, and demand for security staff increased in response to a higher perceived threat from terrorism.

Text of Bank of England press notice of 6 September 2001

Bank of England maintains interest rates at 5.0%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 5.0%.

The minutes of the meeting will be published at 9.30 am on Wednesday 19 September.

Text of Bank of England press notice of 18 September 2001

Bank of England reduces interest rates by 0.25% to 4.75%

A special meeting of the Monetary Policy Committee was convened this morning by the Governor. At that meeting, the Committee voted to reduce the Bank's repo rate by 0.25% to 4.75%.

The Committee considered the reaction of financial markets to the tragic events of last week; it considered the Federal Reserve's decision to reduce interest rates yesterday, and the responses of other central banks to that move. Falls in stock markets around the world, and the likely impact on confidence, suggest a weaker outlook for global activity than appeared likely at the Committee's meeting earlier this month. It is too early to make an informed judgment about the scale of the impact on the UK economy. But the direction of that impact and the associated risks are clear. The Committee decided that an immediate reduction of interest rates was, therefore, appropriate. The Committee will have an opportunity at its scheduled meeting in October to assess more fully the impact of recent events and the prospect of meeting the inflation target in the medium term.

The minutes of today's meeting will be published, together with the minutes of the October meeting, on 17 October.

Text of Bank of England press notice of 4 October 2001

Bank of England reduces interest rates by 0.25% to 4.5%

The Bank of England's Monetary Policy Committee today voted to reduce the Bank's repo rate by 0.25% to 4.50%.

The Committee reviewed the information about economic and financial developments which had become available since its scheduled meeting on 5–6 September and the impact of the terrorist attacks in the United States on 11 September, taking into account its decision at the special meeting on Tuesday 18 September to reduce interest rates by 0.25%.

It now appears that, even before the terrorist attacks, the prospects for global activity were somewhat weaker than projected. In the United Kingdom, revised data show that consumption and final domestic demand in the first half of this year had been growing faster than previously thought, and remain stronger than in many other countries. Looking ahead, the consequences of the terrorist attacks for the UK and the world economy are still unclear. Early indications are that the direct impact on the UK economy will be less severe than in the United States. But the weaker world outlook and increased uncertainty have set back UK business and consumer confidence, and may, for a time, restrain business and household spending.

Against that background, the Committee concluded that a further reduction in interest rates of 0.25% was warranted to meet the inflation target.

The minutes of the meeting will be published at 9.30 am on Wednesday 17 October, together with the minutes of the special meeting held on Tuesday 18 September.

Text of Bank of England press notice of 8 November 2001

Bank of England reduces interest rates by 0.50% to 4.0%

The Bank of England's Monetary Policy Committee today voted to reduce the Bank's repo rate by 0.50% to 4.0%.

The Committee reviewed monetary and economic developments over the three months since the August *Inflation Report*. World economic activity had weakened further, and evidence on the outlook now suggests that the global slowdown may be somewhat deeper and longer than previously thought. World inflationary pressures, including commodity prices, are weaker.

In the United Kingdom, growth has so far remained close to trend. But reflecting the changed world outlook, the latest surveys of confidence and business activity have weakened. Meanwhile, cost and price pressures are somewhat more subdued.

Against this background, the Committee concluded that a cut in interest rates of 50 basis points was needed in order to meet the inflation target.

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

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

Glossary and other information

Glossary of selected data

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

Abbreviations

BCC: British Chambers of Commerce.
BRC: British Retail Consortium.
CBI: Confederation of British Industry.
CIPS: Chartered Institute of Purchasing and Supply.
ECB: European Central Bank.
EEF: Engineering Employers' Federation.
EU: European Union.
FTSE: Financial Times Stock Exchange.
GDP: gross domestic product.
GfK: Gesellschaft für Konsum, Great Britain Ltd.
HBF: House Builders' Federation.
ICPFs: insurance companies and pension funds.
ICT: information and communications technology.
ILO: International Labour Office.
IMF: International Monetary Fund.
LFS: Labour Force Survey.
LIFFE: London International Financial Futures and Options Exchange.
MEW: mortgage equity withdrawal.
MFIs: monetary financial institutions.
MPC: Monetary Policy Committee.
OFCs: other financial corporations.
ONS: Office for National Statistics.
OPEC: Organisation of Petroleum Exporting Countries.
PNFCs: private non-financial corporations.
RICS: Royal Institution of Chartered Surveyors.
S&P: Standard and Poor's.
Y2K: Year 2000.

Symbols and conventions

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