Inflation Report

February 2002

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

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

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

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Mervyn King, Deputy Governor responsible for monetary policy
David Clementi, Deputy Governor responsible for financial stability
Christopher Allsopp
Kate Barker
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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

Growth in the United Kingdom has moderated in the wake of the world economic slowdown. Exports and investment have fallen, but strong growth in private and public consumption has helped to mitigate the impact of the global downturn on the economy. The labour market has eased a little and earnings growth has edged down. Inflation has been close to, if a little below, the 2.5% target.

Growth slowed in all the major industrialised countries in 2001. Annual growth in the OECD in Q3 was the lowest for a decade, and this lacklustre performance is likely to have been repeated in Q4. The synchronised downturn in demand has been concentrated particularly in the high-tech sector.

However, there have been some positive signs recently, particularly in the United States, which against expectations is reported to have recorded marginal growth in Q4 after contracting in the previous quarter. Orders are up and confidence measures have rebounded from their post-11 September drop. And the near-term yield curve has steepened, perhaps suggesting that financial market participants are more optimistic that recovery is on the way. But the continuing imbalances remain a threat to the medium-term outlook.

The euro area experienced negligible growth in Q3 and available indicators suggest that activity may have weakened further in Q4. But here too, forward-looking business confidence measures show signs of a turnaround and the yield curve has steepened. The Japanese economy has continued to contract, but there is evidence that the slowdown in the emerging Asian economies may be ending as the demand for high-tech goods starts to revive. There has been little sign of contagion from the crisis in Argentina. Overall the near-term prospects for world output are slightly weaker than expected in the November *Inflation Report*—mainly reflecting outturns in the euro area—but the prospect is still for a steady recovery during the latter part of this year and beyond.

Oil prices are marginally weaker than projected in the November *Report*. But the prices of other hard commodities, having weakened in the autumn, have strengthened somewhat and computer chip prices have risen. These are also consistent with an improving outlook for global activity.

In the United Kingdom, growth has been sustained through the continued strength of domestic demand, helping to offset the weakness in exports brought about by the global slowdown. Domestic demand decelerated during 2001, reflecting falling investment and lower stockbuilding as business confidence declined and financial pressures on companies intensified. But even so, growth in domestic demand in Q3 was around its long-run historical average, having grown at well above that rate over the previous five years.

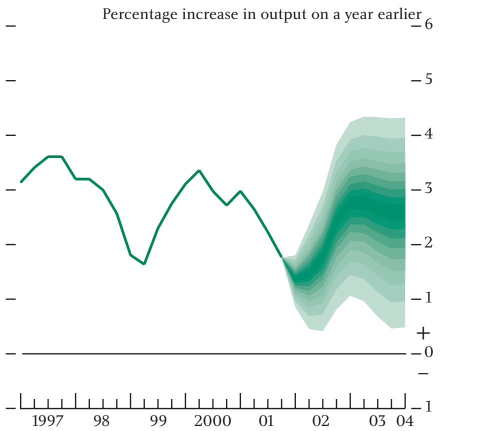
The consumer continues to be the main engine of domestic demand growth. Household spending was up 1.1% in Q3, underpinned by particularly strong growth in purchases of durables. Retail sales rose strongly in Q4, but survey data suggest that spending on services may have slowed at least temporarily. Overall consumers' expenditure is likely to have decelerated a little, but nevertheless remains robust. The MPC expects that past falls in equity wealth and slowing real income growth will tend to moderate consumer spending over the course of this year and next, and there is a possibility that high and rising levels of consumer debt might cause a sharper slowdown. Public consumption grew by 0.7% in Q3, and government spending will remain a stimulus to growth over the forecast period.

Business investment fell by 1.6% in Q3. Investment intentions have weakened and some measures are at their lowest since the early 1990s. That deterioration is likely to reflect the global slowdown, in which case capital formation should recover as the world economy revives. But it is possible that some recent capital expenditure may have been the consequence of past over-optimism, in which case investment may remain a little more subdued until the excess capacity is worked off. The MPC expects investment to remain weak in the near term, but to recover as growth picks up.

GDP at market prices is provisionally estimated to have risen by just 0.2% in Q4, but the level of GDP is still nearly 2% higher than a year ago. The divergent pattern of demand growth continues to be reflected in the disparate fortunes of individual sectors. Manufacturing output fell by 1.7%; though the hard hit high-tech electrical and optical engineering industry continued to contract sharply, there was also evidence of more widespread declines in other parts of manufacturing. In contrast, service sector output expanded by 0.9%, an increase on the growth rate in the previous quarter.

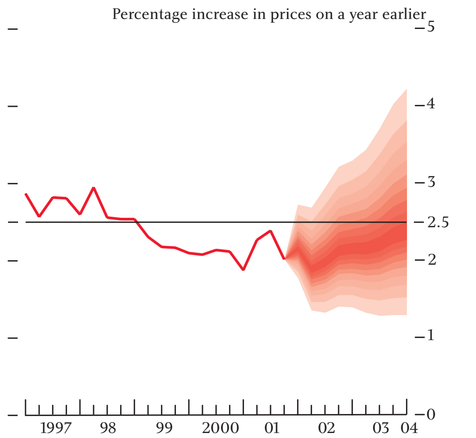
Employment edged up during the three months to November, but a decline in overtime meant that there was a slight fall in total hours worked. Manufacturing employment continues to fall, but this has been offset by the strength of labour demand

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.

elsewhere. Unemployment has begun to rise, but the increase has so far been limited and the ILO measure of the unemployment rate was unchanged at 5.1% in the three months to November. Survey-based measures of labour shortage have on balance eased a little. The combination of lower average hours and continued recruitment suggests that some firms may be taking the opportunity to fill existing vacancies in the expectation of a recovery in growth.

Headline earnings growth ticked down to 4.2% in November. Changes in the amount and timing of bonuses mean that earnings growth may be erratically low in the coming months. But productivity has decelerated more than earnings during 2001, so that unit wage cost growth edged up. That is a normal phenomenon during a slowdown and would be unlikely to persist were growth to pick up.

RPIX in the fourth quarter was 2.0% higher than a year earlier. The weakness in input prices and continued international competitive pressures ensured that goods prices fell, but inflation in the more sheltered service sector remains close to 4%. RPIX inflation is likely to run slightly below target in the near term, although monthly movements are likely to remain erratic, reflecting various one-off factors.

To keep inflation on track going forward, the MPC has sought to offset the impact of the global downturn by reducing official interest rates in order to bolster domestic spending and thus to maintain the balance of demand and supply. The MPC reduced rates by a total of 2 percentage points during 2001, but has kept rates unchanged since November. The effective exchange rate for sterling is a little higher than at the time of the November *Report*.

Chart 1 shows the MPC's assessment of the outlook for GDP growth, on the benchmark assumption that the official interest rate remains at 4.0%. In the central projection, four-quarter growth slips further in the first half of this year, reflecting sluggish world activity and reduced corporate spending. It then rises to around trend as renewed global growth, a recovery in domestic investment and higher public spending outweigh the impact of a moderation in consumer spending. Growth over the two years is very similar to that in the November *Report*.

Chart 2 shows the corresponding outlook for RPIX inflation. In the central projection, inflation bumps along at around 2% through this year, before drifting back up to close to the target during the second year. The inflation profile is very close to that in the November *Report*. Some members prefer alternative assumptions about supply-side developments and the effect of global disinflationary pressures that generate a profile that is either slightly higher or up to around $^{1}/_{4}$ percentage point 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 more prolonged remains a downside risk. And there is uncertainty about the speed and timing of any moderation in consumption growth. Finally a correction of the domestic imbalances could be associated with a sharp fall in the exchange rate, constituting an upside risk to prices. Relative to the central projection, the Committee judges that the overall risks to growth are weighted to the downside but that the overall risks to inflation are on the upside, reflecting the impact of a possible exchange rate fall on import prices. Members take somewhat differing views on the likelihood of these various risks crystallising and thus also on the overall balance.

At its February meeting, the Committee noted that the central projection for inflation was close to and a little below target, but rising at the forecast horizon. Taking into account the uncertainties and the balance of risks, the Committee judged that at the present juncture it was appropriate to leave official interest rates unchanged.

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Money and asset prices 1

Aggregate money and credit slowed in Q4. Nevertheless, they remained consistent with a firm short-term outlook for activity. In particular, households' borrowing rose at an annual rate of 11%, suggesting further resilience in consumer spending and house prices. Growth in corporate bank deposits and borrowing was more muted, but picked up in Q4. Many indicators of corporate financial health have deteriorated over the past year, with corporate balance sheets weakening during that period. Insolvencies reached a seven-year high in 2001. Interest rate spreads on corporate bank borrowing over risk-free rates were higher at the end of 2001 than a year earlier, though they fell slightly between November and December. By contrast, spreads on corporate bonds have fallen since September. The yield curve derived from interest rates on government debt instruments has steepened since the previous *Report*, possibly reflecting financial markets' increased optimism about future economic activity. The FTSE All-Share and FTSE 100 indices have been broadly unchanged since the November *Report*. Sterling has fallen against the dollar, but has changed little against the euro. A sharp rise against the yen contributed to the small appreciation of the sterling ERI.

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

Percentage changes on a year earlier

	2000		2001			
	Q3	Q4	Q1	Q2	Q3	Q4
Notes and coin	9.0	4.0	8.3	7.3	6.8	8.2
M4	8.9	8.3	8.2	7.5	8.0	6.7
M4 lending (a)	13.2	12.6	11.9	11.3	10.0	8.9

Source: Bank of England.

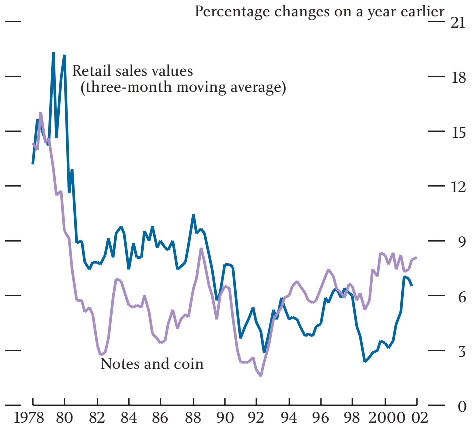
(a) Excluding the effects of securitisations.

1.1 Money and credit

Aggregate money and credit

The growth of notes and coin rose to an annual rate of 8.2% in Q4 (see Table 1.A), higher than that of retail sales values (see Chart 1.1). Through most of the 1990s narrow money grew much more quickly than retail sales. Previous *Reports* have suggested that the strong demand for cash may have been related to the move to low inflation and low nominal interest rates in the United Kingdom. That reversed a longer-run trend where households had economised on the use of cash. So the current vigorous growth in M0 (which rose at an annual rate of 7.9% in January) may partly be associated with previous interest rate reductions, as well as indicating continued strength in retail sales.

Chart 1.1
Notes and coin(a) and retail sales

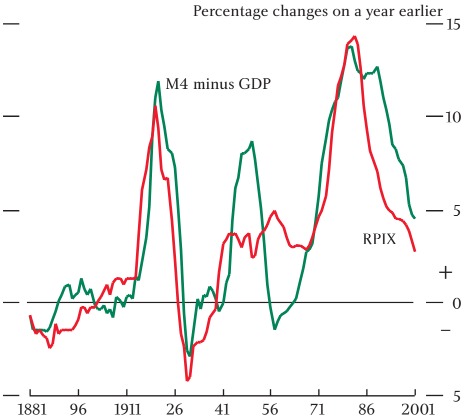


Sources: ONS and Bank of England.

(a) Adjusted in 2000 and 2001 for Y2K effects, September 2000 fuel crisis and winter fuel payments since November/December 1999.

In the absence of velocity changes, broad money growth in excess of real output growth ultimately must be associated with inflation. Chart 1.2 shows that over the past 120 years

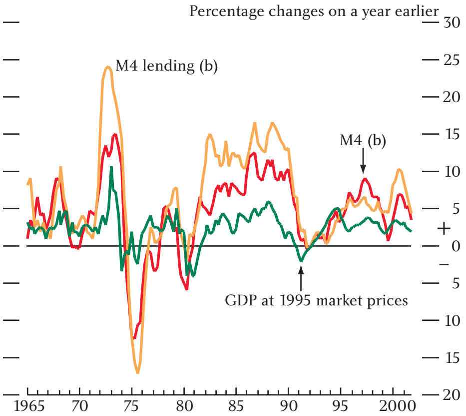
Chart 1.2
RPIX(a) inflation(b) and growth of M4 in excess of real GDP(b)



Sources: Capie, F and Webber, A (1985), *A monetary history of the United Kingdom, 1870–1982, Volume 1: data, sources, methods*, Allen and Unwin, London; Feinstein, C H (1972), *National income, expenditure and output of the United Kingdom, 1855–1965*, Cambridge University Press, Cambridge; Bank of England and ONS.

(a) RPI until 1975.
(b) Ten-year moving averages.

Chart 1.3
Real M4, real M4 lending(a) and real GDP



Sources: ONS and Bank of England.

(a) Including the effects of securitisations.
(b) Deflated by GDP deflator.

Table 1.B
Banks' and building societies' quoted interest rates(a)

		Level Jan. 2002 Per cent	Change since early Oct. 2001 (b)	Change since Jan. 2001 (b)
Secured lending (c) rates:	Standard variable	5.36	-0.71	-2.20
	Two-year discounted rate	4.17	-0.40	-1.73
	Two-year fixed	5.37	-0.16	-0.63
Unsecured lending (c) rates:	Credit card (d)	17.75	-0.60	-0.90
	Personal loan	15.88	-0.01	0.02
Savings rates:	Time deposit	2.45	-0.73	-1.95
	Instant access	0.50	-0.34	-1.33
Repo rate		4.00	-0.75	-2.00

Sources: Moneyfacts and Bank of England.

(a) Quoted rates are rates for new business, except standard variable rates.
(b) Percentage points.
(c) Secured lending accounted for around 80% of the outstanding stock of total lending to individuals in Q4 and the remainder was unsecured.
(d) Includes rates charged on store cards.

and across different monetary regimes excess broad money growth (broad money growth minus real output growth) and retail price inflation have tracked each other reasonably well. The 1940s and early 1950s were one exception to this rule, as rationing and wage and price controls temporarily kept inflation at bay, despite fast growth in broad money. And in the 1980s and 1990s financial liberalisation may have boosted monetary growth relative to inflation.

Though broad money growth fell to an annual rate of 6.7% in Q4 (see Table 1.A), it was still much higher than the preliminary estimate of growth in real output of 1.9%. Annual growth in M4 lending (including the effects of securitisations) also slowed, to 7.5% in Q4. In real terms, aggregate M4 is estimated to have been 3.3% higher in Q4 than a year earlier (see Chart 1.3). The annual growth rate of real M4 lending is estimated to have fallen to 4.1% in Q4. Nevertheless, these money data appear to remain consistent with a resilient outlook for activity in the near term.

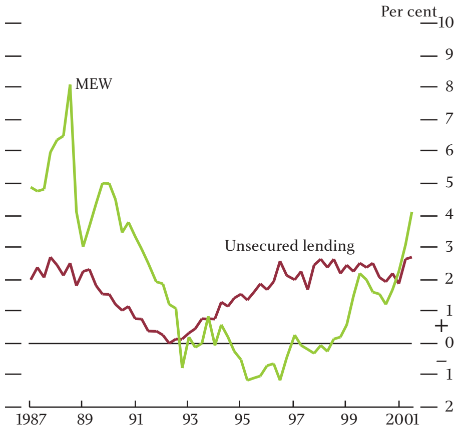
Household sector

Annual growth in households' M4 declined slightly from 8.4% in Q3 to 8.0% in Q4, whereas households' Divisia (which weights M4 components by a measure of their liquidity) grew at an annual rate of 9.2%, similar to Q3. Money is held on deposit by households either as a means to finance short-term spending plans or as longer-term savings. So the persistent robustness in households' Divisia might suggest that strong consumption growth will be sustained in the short term. However, it is also possible that recent inflows into households' bank and building society deposits reflect their relative attractiveness as a risk-free savings vehicle. Volatile stock markets and narrowing interest rate differentials with other short-term assets may have increased the flow of funds into banks and building societies.

M4 lending to households (excluding the effects of securitisations) rose by 11.0% in Q4 compared with a year earlier. Total lending to individuals, which includes data from non-bank specialist lenders that are not included in M4 lending, increased by 10.9% in the year to December, the highest growth since 1991 Q1. Secured lending to individuals grew by 10.2% in the year to December and was the highest since 1991 Q2.

The rise in secured lending growth has partly been stimulated by reductions in interest rates. Table 1.B shows that the pass-through in 2001 to the standard variable rate charged on secured lending has been more than the 2 percentage point cut in the official repo rate, though two-year discounted and

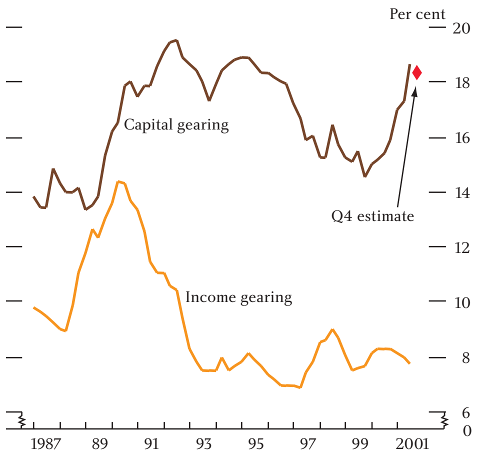
Chart 1.4
Lending for consumption[(a)]



Sources: ONS and Bank of England.

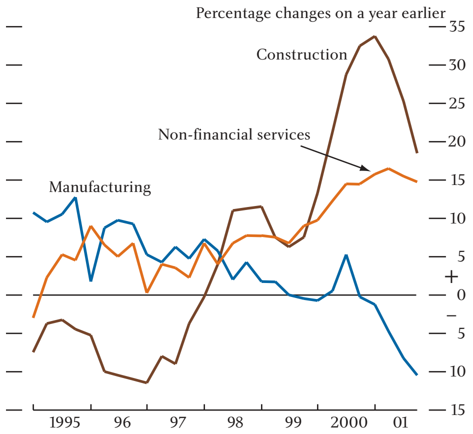
(a) As a proportion of households' disposable income.

Chart 1.5
Households' income and capital gearing



Sources: ONS and Bank of England.

Chart 1.6
Industrial breakdown of sterling bank lending[(a)]



Source: Bank of England.

(a) The industrial breakdown data are not directly comparable with PNFCs' M4 borrowing.

fixed rates have fallen by less. Similarly, the 0.75 percentage point reduction in the repo rate since early October had almost completely been passed on to the standard variable rate by end-January (see Table 1.B), but not fully to other secured rates.

Mortgage equity withdrawal (MEW) is the excess of households' net new borrowing secured on the value of houses over their expenditure on new house purchases and home improvements. It is predominantly used to finance consumer spending on goods and services, although it may also be used to purchase financial assets or to pay off debt.[(1)] MEW was around £7.0 billion in Q3 and reached its highest level since 1990 Q2 as a proportion of households' disposable income (see Chart 1.4). The value of loan approvals rose to a record high in December, suggesting that MEW may have increased further, underpinning continued strength in consumption. Unsecured consumer credit grew at an annual rate of 14.0% in the year to December, despite relatively small cuts (or even increases) in interest rates charged since early 2001 (see Table 1.B).

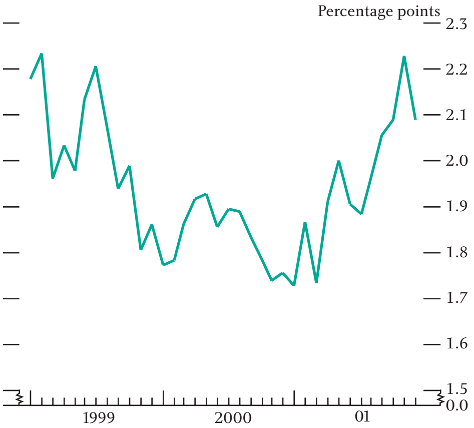
Households' capital gearing (the ratio of individuals' debt to the sum of households' financial assets and housing wealth net of financial liabilities) has been rising since 1999 Q4, but provisional estimates suggest that it fell slightly in Q4 (see Chart 1.5), based on the small recovery in stock markets and house price increases. Last year's interest rate reductions more than offset the effect of strong households' borrowing on income gearing (the ratio of interest payments to households' disposable income), which was just below 8% in Q3, similar to the average of the past eight years. This might suggest that, on average, households are comfortable with current debt levels, as servicing costs remain low. Of course, were interest rates to rise, income gearing could rise quickly again, because most households' borrowing is against variable interest rates.

Private non-financial corporations

Private non-financial corporations' (PNFCs') annual M4 growth rose to 6.8% in Q4 from 2.9% in Q3. Growth in PNFCs' M4 borrowing (excluding the effects of securitisations) slowed through much of last year. Chart 1.6 shows that the manufacturing sector and (to a lesser extent) construction accounted for this slowdown. But in Q4 PNFCs' M4 borrowing strengthened to an annual growth rate of 8.5%, though it was still well below rates recorded in early 2001. However, part of the recent pick-up in annual growth was due to the

(1) See Davey, M (2001), 'Mortgage equity withdrawal and consumption', *Bank of England Quarterly Bulletin*, Spring, pages 100–03 for an overview of sources and uses of withdrawn housing wealth.

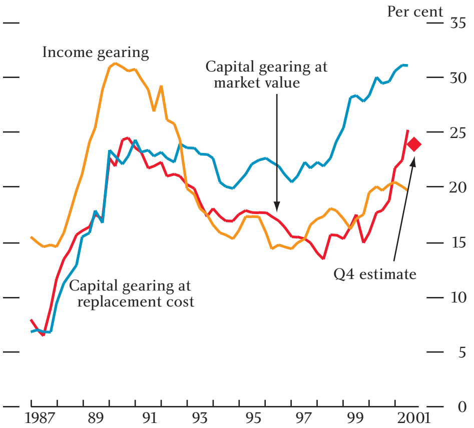
Chart 1.7
Bank lending spread[(a)] for PNFCs



Source: Bank of England.

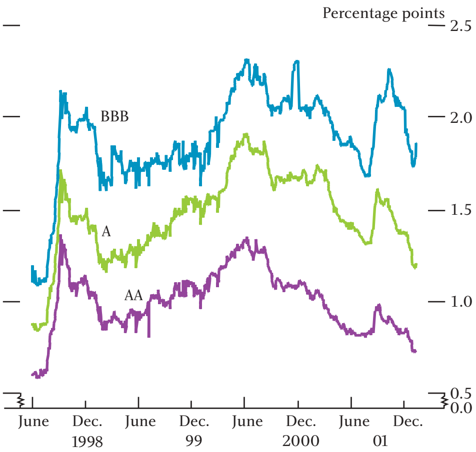
(a) Weighted average of interest rates on overdrafts and other loans minus Bank's repo rate.

Chart 1.8
Corporate income and capital gearing



Sources: ONS and Bank of England.

Chart 1.9
UK corporate bond spreads[(a)]



Source: Merrill Lynch.

(a) Spreads over UK government par yield curve.

exceptional weakness in the flow of PNFCs' M4 borrowing in 2000 Q4.

Despite the general fall in interest rates during the past year, spreads (the difference between banks' effective lending rates and the repo rate) on bank lending to PNFCs rose by about 0.3 percentage points (see Chart 1.7). In principle, higher margins on corporate lending can reflect either a weakening of banks' financial positions, making it more difficult for banks to fund these loans, or a deterioration in companies' financial health.[(1)] It is unlikely that, in this instance, higher spreads have been associated with problems originating in banks' balance sheets. December's *Financial Stability Review* shows that the major UK banks remain highly profitable and well capitalised. The quality of their assets has remained high, although some decline in corporate loan performance is expected in the near future.[(2)]

This suggests that spreads rose because banks downgraded their assessment of companies' creditworthiness, possibly in light of the rise in corporate capital gearing until Q3 (see Chart 1.8) and the deterioration in profitability of most PNFCs. But bank lending spreads fell in December, perhaps reflecting some reduction in uncertainty and an improved outlook for future economic activity.

The flow of companies' total sterling and foreign currency external finance, which includes non-bank capital market finance, fell to £10.0 billion in Q4 from £13.1 billion in Q3. This was largely due to the redemption of foreign currency bonds, whereas sterling corporate bond issuance more than doubled. Although sterling corporate bond yields rose during Q4 as a result of higher medium-term interest rates, corporate bond spreads narrowed for a wide range of borrowers (see Chart 1.9), suggesting that capital markets' concerns about future corporate solvency may have abated somewhat. In January 2002 corporate bond yields decreased and spreads on AA and A-rated bonds fell to their lowest level for more than two years. Part of the recent narrowing of spreads on sterling corporate bonds may have been associated with strong demand for AA-rated bonds, as corporate pension funds anticipated the introduction of a new accounting standard (FRS 17), which requires them to discount their pension liabilities using the yield on these bonds. This increase in demand may also have lowered spreads on sterling-denominated bonds of lower rating if they are perceived as close substitutes. The fall in spreads on dollar

(1) The relationship between financial positions of lenders and borrowers and the cost of finance is discussed in Hall, S (2001), 'Credit channel effects in the monetary transmission mechanism', *Bank of England Quarterly Bulletin*, Winter, pages 442–48.
(2) See 'The financial stability conjuncture and outlook, VIII. The UK financial sector', *Bank of England Financial Stability Review*, December 2001.

and euro-denominated bonds was less pronounced. Spreads on BBB-rated bonds rose in early February, as concerns about US corporate accounting practices affected UK bonds.

The decline in the flow of PNFCs' total external finance and the fall in nominal interest rates contributed to a modest fall in corporate income gearing in Q3 (see Chart 1.8), despite lower corporate profitability. But PNFCs' capital gearing at replacement cost was well above its level in the early 1990s. Capital gearing at market value rose to record levels in Q3, and is estimated to have fallen slightly in Q4, as a result of some recovery in equity prices. The Department of Trade and Industry, however, reported that business insolvencies reached a seven-year high in 2001.

Other financial corporations

The annual growth rate of other financial corporations' (OFCs') M4 fell to 3.4% in Q4, compared with 10.4% in Q3, and was the main reason for the slowdown in aggregate M4. Movements in OFCs' money and credit probably have fewer direct implications for UK economic prospects than developments in other sectors' borrowing and deposits. Previous *Reports* have discussed how the influence of OFCs' deposits on the wider economy is primarily through asset prices.

But there are two other channels through which OFCs' balance sheets may have implications for the real economy. First, OFCs offer financial intermediation services, which may contribute to the efficiency of the financial system and may lower the cost of capital to firms.(1) Second, some OFCs (in particular leasing companies) borrow from banks and building societies in order to purchase capital equipment, which they subsequently lease to PNFCs. M4 lending to OFCs (excluding the effects of securitisations) slowed sharply in the second half of last year. It rose at an annual rate of 4.1% in Q4, compared with 16.5% in Q2. The recent weakening in OFCs' borrowing may have added to the difficulty that some PNFCs face in attracting external funds. The stock of bank borrowing by leasing companies rose by only 0.3% in Q4 compared with a year earlier, possibly consistent with continued weakness in investment.

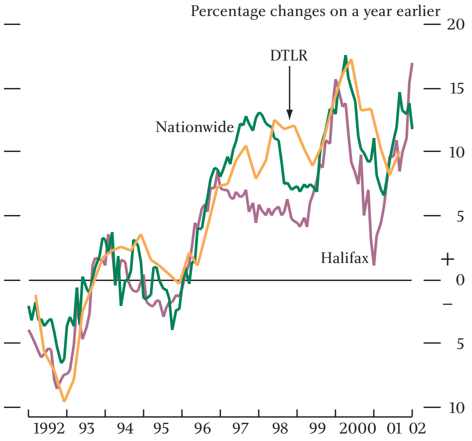
1.2 Asset prices

Property prices

The November *Report* suggested that house price inflation might have peaked around the Summer of 2001. But since

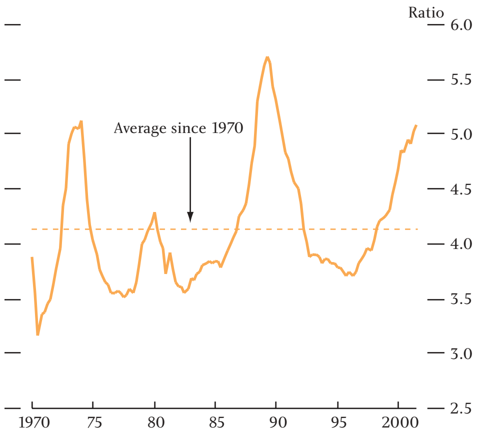
(1) Chrystal, K A and Mizen, P (2001), 'Other financial corporations: Cinderella or ugly sister of empirical monetary economics?', *Bank of England Working Paper no. 151*, discusses the impact of OFCs' borrowing on the corporate sector at greater length.

Chart 1.10
House price inflation



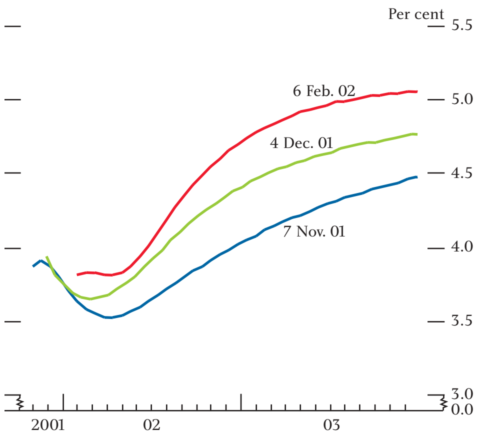
Sources: DTLR, Halifax plc and Nationwide Building Society.

Chart 1.11
Ratio of DTLR house prices to average annual earnings



Sources: DTLR and ONS.

Chart 1.12
GC repo/gilt[(a)] two-week forward[(b)] curve



Source: Bank of England.

(a) General collateral (GC) repo rates refer to the rates for sale and repurchase agreements in which any gilt stock may be used as collateral.
(b) A forward rate is the rate implied for a future period by comparisons of current shorter-term and longer-term rates.

then there has been evidence pointing to a further pick-up in the housing market. The Department of Transport, Local Government and the Regions (DTLR) index of house prices rose by 10.0% in the year to Q3, a higher rate than in Q2 (see Chart 1.10). The Halifax measure of annual house price inflation has been rising since October and reached 16.8% in January. The Nationwide index of house prices was 11.7% higher in January than a year earlier. Forward-looking indicators also suggest near-term resilience in the housing market. The Royal Institution of Chartered Surveyors' (RICS') survey for December showed a sharp increase in the number of estate agents expecting prices to rise in the next three months. The number of loan approvals for house purchases continued to recover from the weakness in September, indicating a possible resurgence in activity. The buoyancy of the housing market led to a further rise in the ratio of house prices to earnings above its long-run average in Q3 (see Chart 1.11). The MPC has raised its near-term assumption for house price inflation since the November *Report*, but expects a slowdown to around the growth rate of nominal earnings in the medium term.

Interest rates

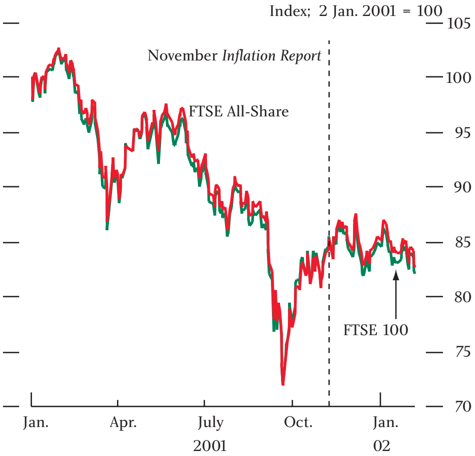
The MPC has kept the Bank's repo rate at 4.0% since the November *Report*. The US Federal Open Market Committee reduced its official target interest rate by 0.25 percentage points on 11 December to 1.75%, reflecting continued concern about the weakness in the US economy. Official interest rates in the other major economies remained unchanged.

Expectations of future short-term sterling interest rates rose from mid-November onwards, except at the very short horizon (see Chart 1.12), in line with the steepening of the short end of the yield curve in the United States and the euro area. This suggests that investors have become more optimistic about a global economic recovery. The rise in sterling interest rates at maturities beyond three months mainly reflected an increase in real rates, following stronger-than-expected UK and US data.

Forward interest rates, such as those in Chart 1.12, need not coincide with the market's expectation of the future official repo rate, partly because of the existence of term premia. Forward rates in the money market tend to be higher than subsequent outturns for the official repo rate, and the discrepancy is greater for longer-maturity forward money market rates (out to two years).[(1)] Term premia represent the

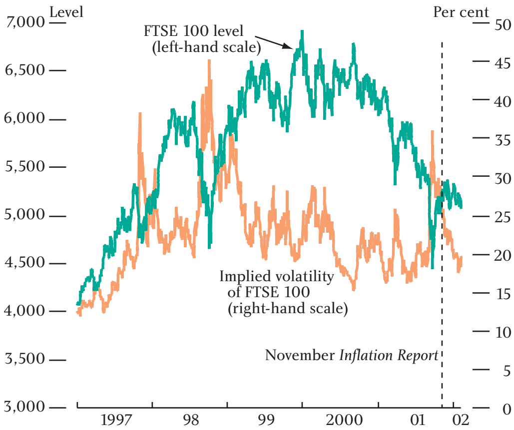
(1) See Brooke, M, Cooper, N and Scholtes, C (2000), 'Inferring market interest rate expectations from money market rates', *Bank of England Quarterly Bulletin*, November, pages 392–402 for more details. This article also shows that (for technical reasons) the spot rate on two-week generalised collateral (GC) repo transactions is on average about 0.15 percentage points lower than the spot two-week policy rate.

Chart 1.13
UK equity markets



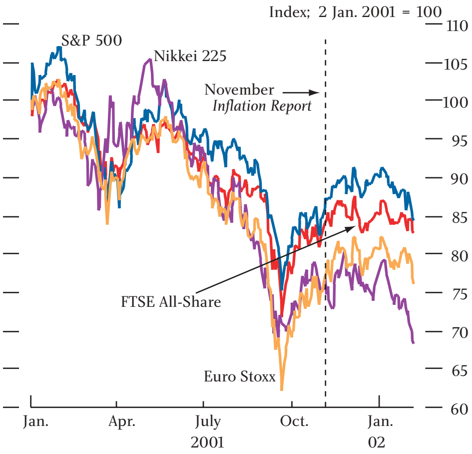
Sources: London Stock Exchange and Bloomberg.

Chart 1.14
FTSE 100 level and three-month implied volatility



Sources: Bloomberg, LIFFE and Bank of England.

Chart 1.15
International equity markets



Source: Bloomberg.

compensation that lenders require for the risk of capital losses when they invest in longer-maturity money market assets. It suggests that some of the steepness of the yield curve can be explained by term premia and not simply a rise in expected official rates.

Nominal sterling forward rates implied by assets with maturities up to ten years have risen gradually since the November *Report*. In part, this may have been a result of an improvement in expectations about global long-term economic growth. Some of the rise may also have been due to investors reducing their holdings of long gilts, which they had built up strongly in previous months as official interest rates fell.

Equities

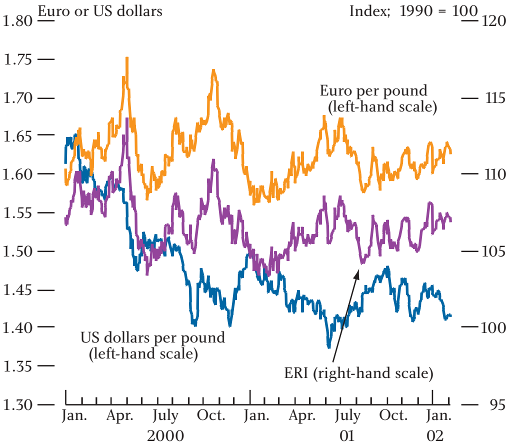
When UK equity prices reached their trough on 21 September the FTSE All-Share index had been falling for more than twelve months, the longest decline since 1972–74 and the deepest fall (35%) from peak to trough since the October 1987 crash. In broad terms, the FTSE All-Share and the FTSE 100 indices have steadied since the November *Report* (see Chart 1.13). The path of equity prices over the past three months seems to have been the result of a number of countervailing forces. Four-year-ahead profit growth expectations from the Institutional Brokers Estimate System (IBES) for the companies listed in the FTSE 100 rose slightly in January. But they remained well below November's levels. By themselves, the fall in profit expectations since the November *Report* would suggest reduced future dividend growth and hence lower equity prices. The steepening of the yield curve and the implied higher real rates of return now demanded on assets of longer maturities would also have put downward pressure on equity prices by raising the discount rate. But perhaps acting to offset that effect, higher real rates may also reflect an increase in long-term real growth expectations which could in turn have a positive effect on equity prices. Uncertainty, as measured by the implied volatility in three-month option prices on the FTSE 100 index, has declined further since November (see Chart 1.14). The associated reduction in the riskiness of returns has probably helped to support equity prices over the past three months.

International equity markets have followed very similar patterns over the past three months (see Chart 1.15), suggesting that they have been influenced by similar factors. The Nikkei 225 index fell particularly sharply in January, as concerns about the quality of Japanese banks' balance sheets rose.

The exchange rate

In the 15 working days to 6 February the average sterling effective exchange rate (ERI) was 1.3% higher than the average level implied for February in the November *Report's* central projection. Sterling suffered its largest one-day fall against the euro on 2 January, which was partly due to the general strength of the euro following the introduction of euro notes and coin, and the unwinding of some transitory factors that had contributed to sterling's appreciation during December. Sterling more than recovered its losses in the following weeks. It rose sharply against the yen, which fell to a three-year low against the dollar in January. The overall strength of sterling may have been associated with the sharper rise in short-term interest rate expectations for the United Kingdom than in most other economies. Sterling has fallen, however, against the dollar, reflecting still more acute rises in short interest rate expectations in the United States (see Chart 1.16). The MPC's central projection assumes a depreciation of the sterling ERI of around 2% over the forecast horizon.

Chart 1.16
Sterling exchange rates



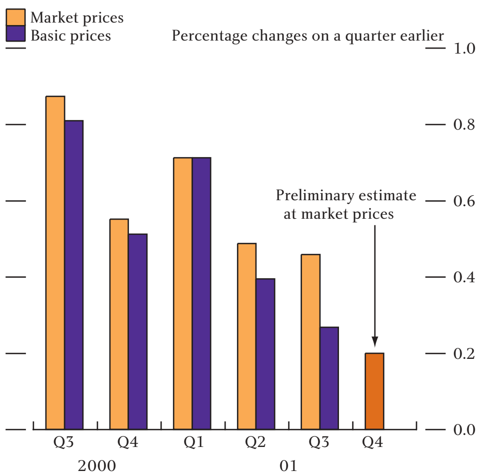
Source: Bank of England.

Demand and output 2

Annual growth in real GDP at market prices slowed to 2.2% in 2001 Q3. Imbalances between the household and corporate sectors have continued to widen. Consumer spending has grown rapidly and looks set to remain resilient in the near term, whereas investment outturns and prospects are weak. Outside the United Kingdom, the slowdown in activity has been more pronounced and, accordingly, UK export volumes have fallen sharply. UK imports have also declined markedly recently, partly mitigating the effect of weaker exports on GDP growth. Looking ahead, near-term prospects for the external environment are slightly more subdued than incorporated in the November central projection. Preliminary estimates suggest that UK GDP grew by 0.2% in 2001 Q4, somewhat lower than expected in November. Sectoral imbalances in the United Kingdom have intensified. The difference between the annual rates of output growth in the manufacturing and service sectors was at a 20-year high in the fourth quarter. GDP growth in the first quarter of 2002 is expected to be rather more muted than assumed in November.

2.1 Gross domestic product

Chart 2.1
GDP growth



Revisions to National Accounts data suggest that the level of economic activity in the United Kingdom was a little higher than previously thought during 2000 and the first half of 2001, although the slowdown in the second half of 2001 was rather more pronounced than expected in November. UK GDP at market prices rose by 0.5% in 2001 Q3, taking four-quarter growth down to 2.2%, slightly below its average rate during the past 40 years. Quarterly growth in GDP at basic prices, which excludes the effects of taxes and subsidies on products, was weaker at 0.3% (see Chart 2.1). The divergence in Q3 reflected a shift in the composition of GDP towards goods and services with higher associated tax rates. The difference in growth rates was large by recent standards and is not expected to persist. GDP at market prices(1) is provisionally estimated to have increased by 0.2% in Q4, taking the four-quarter growth rate down to 1.9%. This was weaker than the Committee had expected in November. However, the fourth-quarter outturn probably

(1) An estimate of GDP at basic prices is not provided in the preliminary release.

Table 2.A
GDP and expenditure components(a)

Percentage changes on a quarter earlier

	Average 1999	Average 2000	2001 Q1	Q2	Q3
Consumption:					
Households	1.2	0.9	0.8	1.1	1.1
Government	0.6	0.3	1.7	0.8	0.7
Investment	0.2	1.9	-3.3	2.4	-2.1
of which, business investment	*0.1*	*2.3*	*-5.2*	*2.5*	*-1.6*
Final domestic demand	**0.9**	**1.0**	**0.1**	**1.2**	**0.5**
Change in inventories (b)	0.0	-0.2	0.6	-0.7	0.1
Excluding alignment adjustment (b)	*0.0*	*-0.1*	*0.5*	*-0.6*	*0.2*
Domestic demand	**0.9**	**0.8**	**0.7**	**0.6**	**0.6**
Exports	2.1	2.4	1.7	-2.0	-3.6
Imports	2.5	2.6	1.4	-1.5	-2.7
Net trade (b)	-0.2	-0.2	0.0	-0.1	-0.2
GDP at market prices	**0.7**	**0.7**	**0.7**	**0.5**	**0.5**

(a) At constant 1995 market prices.
(b) Percentage point contribution to quarterly growth of GDP.

Chart 2.2
Contributions to annual changes in domestic demand

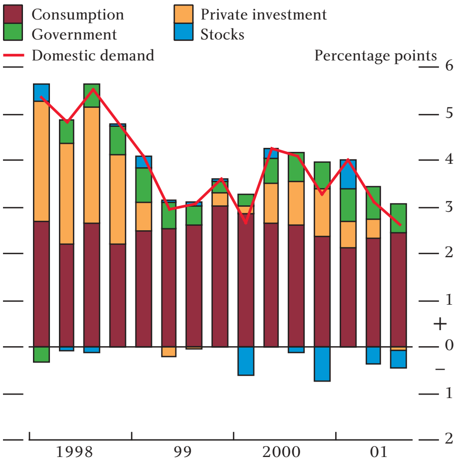


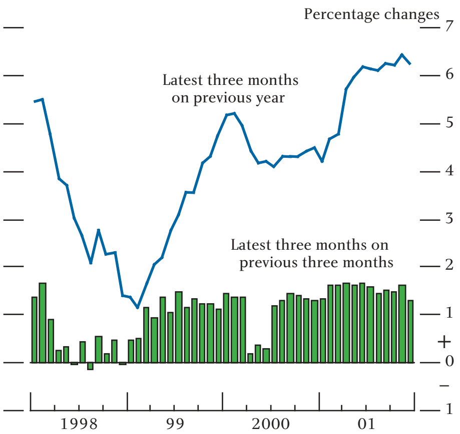
Table 2.B
Household consumption

Percentage changes on a year earlier

	Average 1999	Average 2000	2001 Q1	Q2	Q3
Goods	5.0	4.8	4.6	6.0	6.2
Durable goods:	8.6	7.3	12.4	13.4	13.1
Vehicles	*4.6*	*-0.7*	*12.2*	*10.7*	*13.7*
Other durables	*12.0*	*13.5*	*12.5*	*15.3*	*12.7*
Other goods	3.9	4.0	2.0	3.4	3.8
Services (a)	3.5	3.3	1.8	1.2	1.4
Total consumption	**4.3**	**4.1**	**3.3**	**3.7**	**4.0**

(a) Including net tourism.

Chart 2.3
Volume of retail sales



exaggerates the underlying slowdown of UK growth, as output of the more volatile oil and gas sector was exceptionally weak.

2.2 Domestic demand

Domestic demand grew by 0.6% in 2001 Q3 (see Table 2.A), in line with the November *Inflation Report* projection. Annual growth in domestic demand slowed to 2.6% in Q3, close to its 40-year average rate, following above-average growth over the previous five years. Chart 2.2 shows that a deterioration in private investment spending and reduced stockbuilding by firms accounted for the recent slowdown. In contrast, household consumption growth has remained surprisingly strong and public sector demand continues to grow solidly.

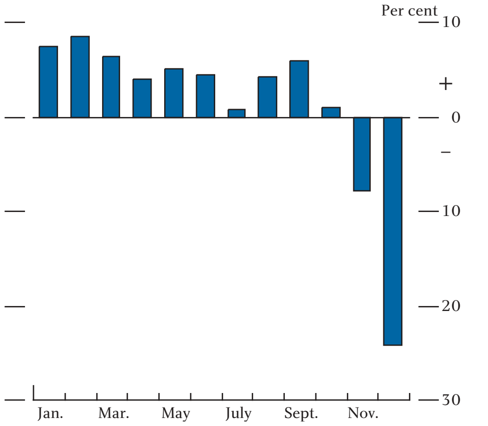
Household sector consumption

Consumers' expenditure rose by 1.1% in 2001 Q3, slightly above expectations at the time of the November *Report*. More timely indicators suggest that consumer spending remained vigorous in the fourth quarter, although growth is likely to have slowed. In the main, that is because growth in household spending on services, which has been subdued for some time (see Table 2.B), is likely to have softened further, reflecting temporary distortions related to the terrorist attacks in the United States. Such a slowdown is supported by the November CBI/Deloitte & Touche service sector survey, which showed a weakening in consumer services sales volumes. In addition, official data showed a fall in UK residents' spending on overseas tourism services in Q4.

In contrast, there is little evidence of any significant moderation in spending on goods. Annual retail sales growth remained around a 13-year high at 6.2% in Q4 (see Chart 2.3). During the quarter, retail sales volumes rose by 1.3%, well above the average rate during the past 15 years. This was a slightly slower pace than in earlier quarters of 2001, mostly as a result of a particularly weak December outturn. Despite anecdotal and survey evidence of strong December sales, retail sales volumes fell by 0.3%, the first decline in 20 months. However, the seasonally unadjusted data showed a rise of 23.5%. There is inevitable uncertainty in adjusting for the seasonal effect of spending at that time of the year (see Chart 2.4), and so the December figures may be a less precise indicator of underlying trends. Evidence from the CBI Distributive Trades and GfK consumer confidence surveys suggests that retail spending growth remained resilient in January. Private motor vehicle registrations data implied continued brisk growth in spending on motor vehicles during Q4.

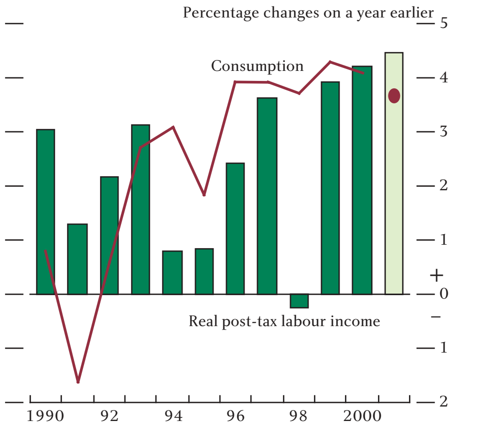
Consumption should reflect current and expected real income, as well as households' wealth. Annual growth in real post-tax

Chart 2.4
Seasonal adjustment factors of retail sales volumes(a)



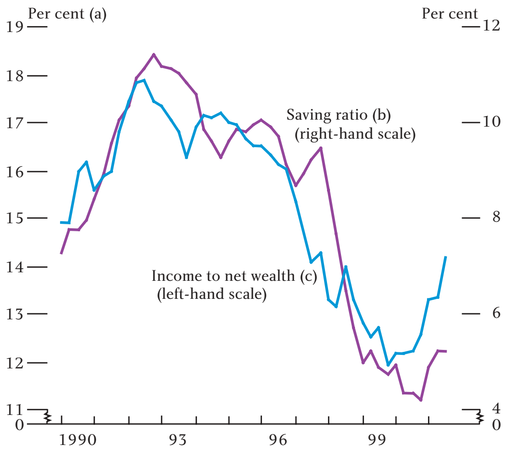
(a) Adjustment made to the level of non seasonally adjusted retail sales data in each month to obtain seasonally adjusted data. Average of past five years.

Chart 2.5
Real household post-tax labour income and consumption(a)(b)



(a) Deflated by the household consumption expenditure deflator.
(b) 2001 figures include only the first three quarters.

Chart 2.6
Household sector saving ratio and net wealth



(a) Using a four-quarter moving sum of income.
(b) Four-quarter moving average.
(c) Net wealth is gross housing and financial wealth less gross financial liabilities.

labour income has remained strong in recent years, and has been above growth in consumption during 2001 (see Chart 2.5). But although strong growth in real disposable incomes has provided a sustained boost to consumption recently, the proportion of current income that consumers save remains at a historically low level, after falling considerably between 1997 and 1999. Saving tends to be inversely related to the level of wealth (see Chart 2.6). So the earlier falls in the saving ratio could be explained by the rapid increase in household wealth that occurred during this period. The saving ratio has risen only slightly in recent quarters, despite the significant falls in household wealth that have occurred during 2001. However, lags of several quarters between movements in wealth and consumption are not unusual, as consumers wait to see whether the changes in wealth are likely to persist.

Real total net wealth has fallen by around 10% since the end of 2000, although this masks divergent trends between asset types—real net financial wealth fell by more than 20% during the first three quarters of 2001, whereas housing wealth continued to rise rapidly. The various channels by which increased housing wealth affects consumption have been discussed in earlier *Reports*. But perhaps the most significant effect comes by providing consumers with greater access to secured borrowing. As Section 1 points out, strong mortgage equity withdrawal in recent quarters implies that rising house prices have continued to provide a considerable boost to consumption.

One characteristic of the recent consumption data has been the unusual pattern of durables spending. Despite its small share (around 15% of consumption), spending on durable goods has accounted for much of the strength in household spending during 2001. Part of this can be explained by delayed expenditure on motor vehicles, following an unusually subdued period during 1999–2000. But growth in spending on other durables, such as household goods, has also been substantial (see Table 2.B and Chart 2.7). In contrast, growth in spending on other goods and services is currently around its lowest rate for six years. Growth in durables consumption has historically been quite closely related to GDP growth (see Chart 2.8). Such strength at this stage of the economic cycle is particularly unusual—the last time durables growth was this strong was in 1988 when GDP growth was higher than at any time during the past 30 years or so.

Durable goods are conceptually different to other types of consumer goods. Indeed, as they provide consumers with a stream of services over a number of future periods, they have many attributes of an asset. The rise in durables expenditure

Chart 2.7
Consumer spending

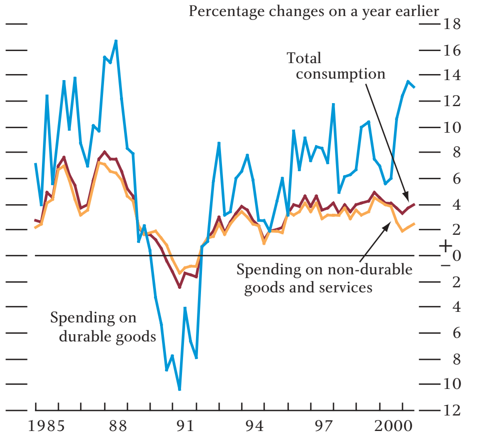


Chart 2.8
GDP and durables spending

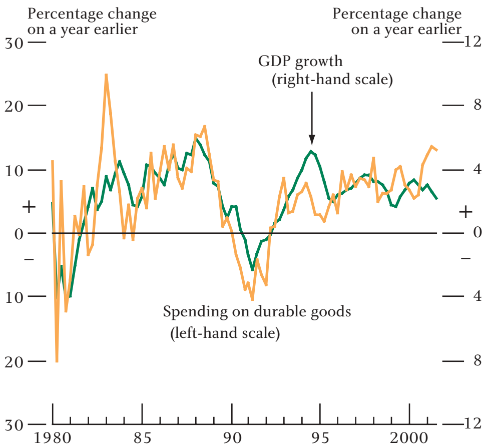
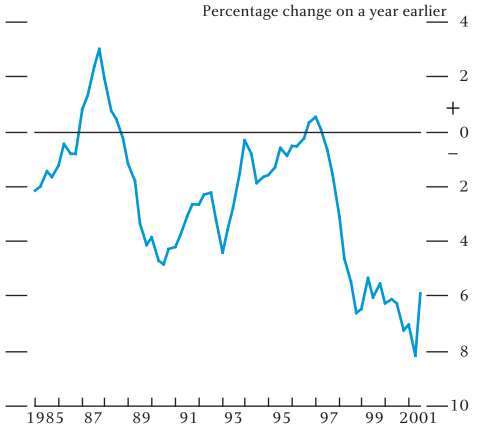


Chart 2.9
Relative price of durable goods(a)



(a) Relative to other consumer goods and services prices.

could be a result of the significant reductions in interest rates during 2001—the relatively lower returns available on financial assets compared with earlier periods may have encouraged some substitution into real assets.

Relatedly, the strength of durables expenditure may be a consequence of falls in the price of these goods relative to other goods and services consumed by households. Although the relative price of durables has been on a declining trend for several decades, prices have fallen considerably more quickly during the past few years (see Chart 2.9). This may be partly explained by the appreciation of sterling from late 1996, as durables are likely to be more import-intensive than other goods and services.

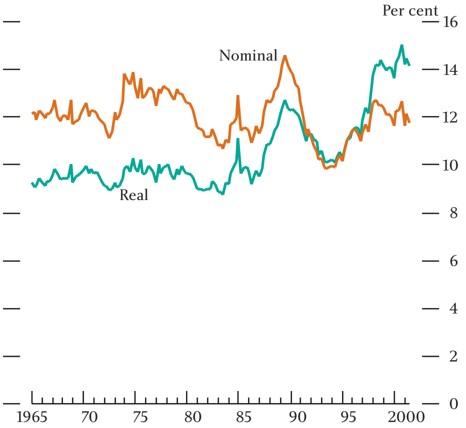
As in the November central projection, the MPC expects consumption growth to moderate from its recent high levels, reflecting earlier falls in financial wealth and softer labour market conditions, offsetting the effects of lower interest rates. However, the Committee judges there to be greater momentum in recent house price inflation than earlier thought. Consumption growth is projected to be slightly stronger during the next two years than in the November *Report*.

Investment demand

Whole-economy investment fell by 2.1% during 2001 Q3, largely accounted for by a 1.6% fall in business investment. This was weaker than assumed in the November *Inflation Report* projections. Annual growth in business investment has declined significantly since the end of 2000. The downturn has been broadly based, with investment growth slowing sharply in both the manufacturing and service sectors.

Average annual growth in business investment was more than three times that of GDP growth between 1996 and 2000. Consequently, the ratio of business investment volumes to GDP increased sharply over this period. This ratio has fallen back during 2001 to the levels of two or three years ago, but remains high by historical standards (see Chart 2.10). It is important to recognise that much of the earlier rise was associated with a sustained downward trend in the relative price of investment goods. This relationship is consistent with economic theory: as the relative price of capital declines, firms want to use proportionately more capital in the production process. Reflecting these relative price falls, the business investment to GDP ratio in current prices is currently around its long-run average level, having risen by a lesser extent than the ratio in real terms during the late 1990s. The downward trend in the relative price of investment goods is likely to persist in the near future.

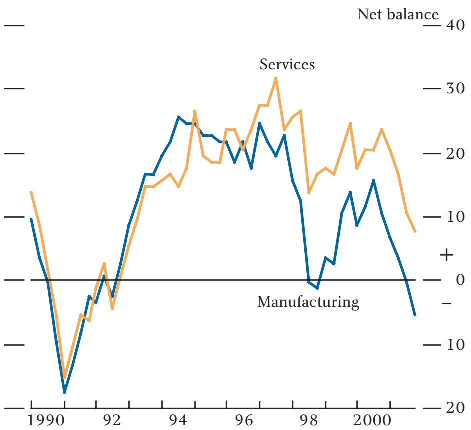
Chart 2.10
Business investment to GDP ratios



But it is possible that some of the strong growth in investment during the past few years represented 'over-investment', as firms based investment decisions on overly optimistic expectations of future demand or the productivity of capital, particularly of ICT equipment. So the decline in investment may represent firms attempting to work off that excess capacity. It is also possible that the recent falls reflect the typical pattern of investment and other corporate expenditure during a cyclical downturn, as firms respond to lower capacity utilisation and rising financial pressures. Survey data from the BCC and CIPS suggest that capacity utilisation has fallen in recent quarters. And corporate expenditure on components of business services such as advertising has also declined (see the box on pages 16–17).

An alternative explanation for the recent weak investment outturns is that, although the underlying demand for capital may have remained strong, certain factors have led firms to postpone investment. The August 2001 *Report* noted that increased uncertainty about global economic prospects could have led firms to delay investment plans. And the events of 11 September may have resulted in firms becoming less sure still about the future and deferring even more capital spending. Reports from the Bank's regional Agents suggest that uncertainty has indeed been a drag on investment recently.

Chart 2.11
BCC investment intentions[a]



Source: BCC.

(a) Percentage balance of respondents who had revised up their plans for investment in plant and machinery during the past three months.

The Committee expects business investment to weaken further in the near term, and by more than assumed in November. This view is consistent with recent survey data on investment intentions, which are perhaps the best short-run indicators of investment, as they provide direct information on firms' plans.[1] The 2001 Q4 BCC survey suggests that firms' planned investment has continued to deteriorate in both the manufacturing and service sectors (see Chart 2.11). Looking further ahead, the Committee continues to expect factors such as the recovery in global demand, the impact of earlier interest rate cuts and the resumption of deferred investment to result in some improvement in investment growth towards the end of 2002.

Public sector spending

Real government consumption rose by 0.7% in 2001 Q3, while government investment fell by 6.1%. The Government's Pre-Budget Report of 27 November included updated forecasts of public spending and tax receipts. Over the next two years, these imply marginally higher levels of public spending, and somewhat lower levels of tax receipts, than in

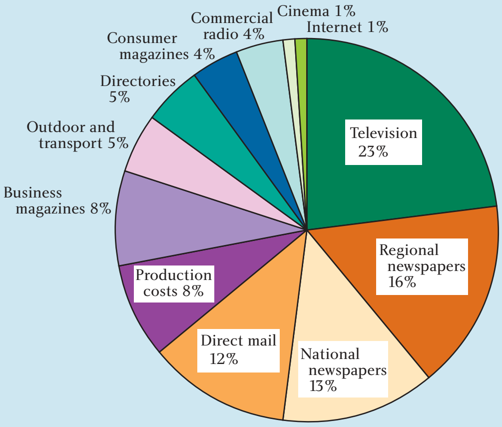
(1) See Larsen, J and Newton-Smith, R (2001), 'Using surveys of investment intentions', *Bank of England Quarterly Bulletin*, Summer, pages 189–94 for further details.

The advertising industry

Last year, firms cut their advertising budgets sharply. This box looks at recent developments in the advertising industry, and considers what they might tell us about the wider economy.

In 2000, the advertising industry employed almost 100,000 people. In that same year, companies spent £17 billion on advertising, equivalent to almost 2% of GDP. Chart A shows how this total amount was spread across different forms of advertising. More money was spent on television advertising, which represented 23% of the total, than on any other medium. The next most important share was regional newspapers. Expenditure on direct mail was almost as large as expenditure on national newspaper advertising.

Chart A
Shares in total advertising expenditure in 2000



Source: The NTC Research/Advertising Association *Advertising Statistics Yearbook* 2001.

More timely, though less comprehensive, quarterly data are also available.(1) These show that growth in total advertising expenditure slowed markedly last year, so that by 2001 Q3 total advertising expenditure was 4.8% lower than a year earlier (see the table). In the year to 2001 Q3, expenditure on television advertising and on advertising in business magazines showed the largest falls. Expenditure on advertising in consumer magazines and on direct mail advertising continued to grow. According to the latest Bellwether Report,(2) companies on balance made further downward revisions to their current advertising budgets in 2001 Q4.

Can the performance of the advertising industry tell us anything about developments in other industries? To answer this question, it is necessary to consider why firms advertise. The aim of an advertisement is to

Growth in nominal expenditure on advertising by medium

Percentage changes on a year earlier

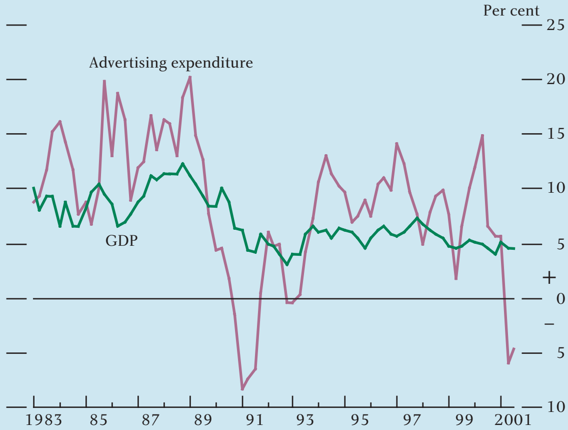
	2000 Q4	2001 Q1	Q2	Q3
National press	8.4	10.7	-12.2	-9.9
Regional press	12.3	6.8	2.2	1.3
Consumer magazines	4.8	8.1	5.3	4.5
Business magazines	8.4	9.9	-5.9	-11.2
Television	1.5	-2.3	-15.0	-11.6
Direct mail	3.7	9.5	7.6	6.0
Total (a)	**6.0**	**5.8**	**-6.1**	**-4.8**

Source: The NTC Research/Advertising Association *Quarterly Survey of Advertising Expenditure.*

(a) The total line includes growth in expenditure on commercial radio and outdoor and transport advertising, in addition to the items listed above.

carry a positive message about a firm's product. Over time, this flow of positive messages will build to create a stock of public goodwill towards the product. The amount of goodwill a firm wants to buy will depend on the economic cycle. In a cyclical downturn, the returns to owning a popular brand can be relatively small, because expenditure by customers is low. The converse is true in an upturn. Small changes in a firm's desired stock of purchased goodwill can have large effects on advertising expenditure, either as firms spend rapidly to push the stock of goodwill up, or as firms cut advertising budgets when returns are low. That is why advertising, like investment, is more volatile than many other forms of expenditure (see Chart B).

Chart B
Annual growth in nominal advertising expenditure and nominal GDP



Sources: ONS and the NTC Research/Advertising Association *Quarterly Survey of Advertising Expenditure.*

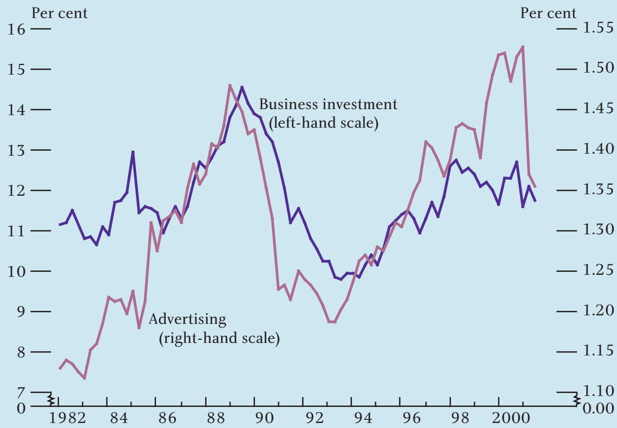
Money spent on advertising today could reasonably be expected to influence customer perceptions for several periods ahead. So a firm's decision to

(1) The data in Chart A are taken from the *Advertising Statistics Yearbook* 2001, published by NTC Research/Advertising Association. These same two organisations also publish the *Quarterly Survey of Advertising Expenditure*. Data in the latter publication exclude all production costs, in addition to expenditure on directory, cinema and Internet advertising. In 2000, these accounted for 15% of all expenditure on advertising.
(2) Published in January 2002 by NTC Research/Institute of Practitioners in Advertising.

advertise will depend not just on current conditions, but also on expectations about the future path of the economic cycle. A firm would have little incentive to build up a popular brand now, if customers' expenditure was expected to weaken. This suggests that advertising expenditure might have leading indicator properties. Statistical tests provide only weak evidence that advertising expenditure contains information about GDP one quarter ahead. But there is stronger statistical evidence that advertising expenditure contains information about business investment several quarters ahead. This leading relationship is clear in Chart C, which compares nominal advertising expenditure and nominal business investment to GDP ratios.

Chart C should not be misinterpreted as providing evidence that movements in advertising expenditure cause business investment to change. What is more plausible is that advertising expenditure and business investment depend on a similar set of variables, including firms' beliefs about the prospects for economic activity, and about the cost of finance. That advertising expenditure appears to lead business investment might be explained by the fact that it is easier for firms to vary their advertising expenditure than it is to change fixed capital spending. Fixed capital spending typically has a longer payback period and requires a longer-term commitment than expenditure on advertising.

Chart C
Nominal advertising and nominal business investment to GDP ratios



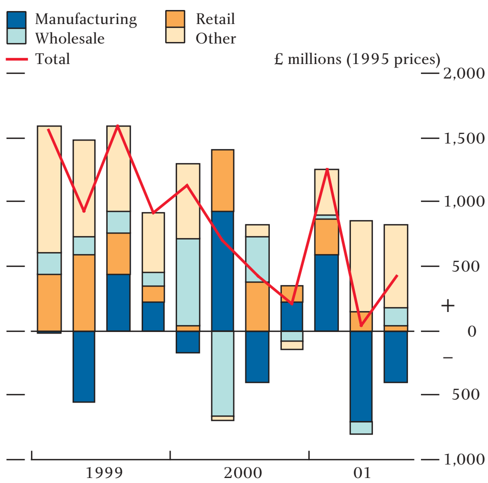
Sources: Bank of England, ONS and the NTC Research/Advertising Association *Quarterly Survey of Advertising Expenditure.*

the Budget. These nominal spending plans, together with the MPC's forecast for inflation, continue to imply strong growth in real government spending over the forecast period.

Inventories

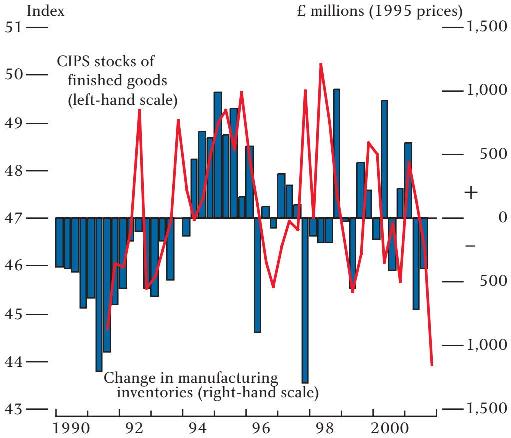
At the time of the November *Report*, the MPC judged that inventory changes had slightly reduced GDP growth in Q3. Similar to developments in other major economies, this assumed a further unwinding from a period of involuntary stockbuilding that occurred at the beginning of the year, particularly in the manufacturing sector. However, the contribution from inventories (excluding the alignment adjustment) was slightly positive in Q3. Inventories of 'other' industries, particularly in the motor trade and construction sectors, continued to increase significantly, and although there was further destocking in the manufacturing sector, it was to a lesser extent than in the previous quarter (see Chart 2.12). Survey evidence suggests that inventory correction was still not complete in the manufacturing sector in Q4. For example, the CIPS survey indicated a significant run-down in manufacturers' inventories in Q4 (see Chart 2.13), and the index fell to its lowest level in the survey's ten-year history in January. Similarly, the CBI Quarterly Industrial Trends survey suggests that manufacturers expect further substantial destocking in Q1. The MPC judges that inventories are likely to have reduced GDP growth slightly in the fourth quarter, but should provide a small positive boost as the inventory correction unwinds.

Chart 2.12
Changes in inventories[(a)]



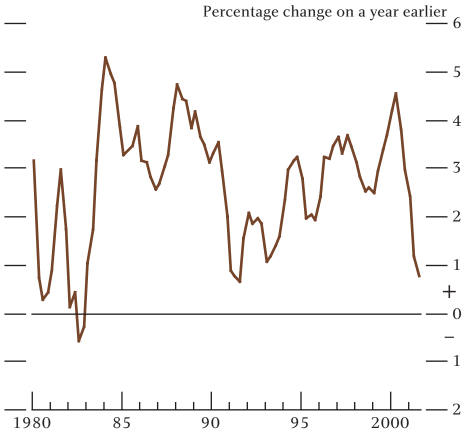
(a) Excluding a statistical alignment adjustment.

Chart 2.13
Manufacturing inventories



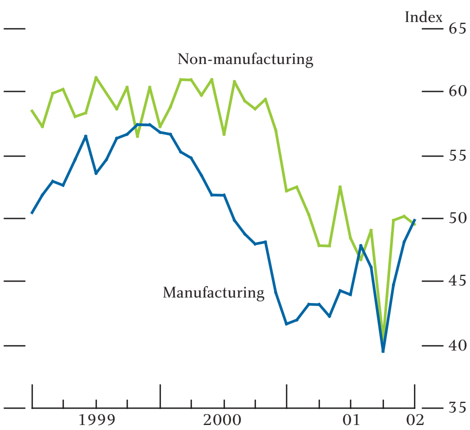
Sources: CIPS and ONS.

Chart 2.14
OECD GDP growth



Source: OECD.

Chart 2.15
US PMI surveys



Source: Institute for Supply Management (formerly NAPM).

Over the longer run, the Committee has maintained the assumption that the trend of a broadly flat inventory-output ratio, seen in the second half of the 1990s, will continue.

2.3 External demand and UK net trade

Growth in the United Kingdom's major trading partners slowed further in 2001 Q3. Annual GDP growth in the OECD economies was only 0.8% in Q3, similar to its cyclical trough in the early 1990s (see Chart 2.14).

The slowdown has been sharpest in the United States. However, GDP growth of 0.1% during the fourth quarter was slightly above the November *Inflation Report* projection. Private consumption growth was considerably stronger than expected and was the main contributor to GDP growth in Q4. But that strength was largely the result of an exceptional boost from motor vehicle sales, which should unwind in the first quarter of 2002.

In the November *Inflation Report*, the MPC judged that most of the adverse effects of 11 September on US demand would be relatively short-lived. Recent indicators, including business and consumer confidence surveys, have confirmed this view. Most measures have recovered to pre-September levels after deteriorating significantly following the terrorist attacks (see Chart 2.15). And the latest evidence suggests that the trough of the industrial production cycle may have now been reached. US ICT production stabilised in Q4, after falling by an average of 6% in each of the previous quarters of 2001. Moreover, a rebound in manufacturing orders has been reported and there are indications that the inventory correction is almost complete.

The MPC continues to believe that a relatively short-lived slowdown is the most likely outcome in the United States, with the recovery underpinned by considerable monetary and fiscal policy stimulus already in the pipeline, together with favourable underlying productivity trends.

The euro area recorded negligible GDP growth in 2001 Q3, in line with the projections contained in the November *Report*. Available indicators suggest that output contracted in the fourth quarter, somewhat weaker than expected in November. Although business expectations and consumer sentiment have recovered in recent months, most indicators remain below pre-September levels, suggesting that activity will stay subdued in the first quarter of 2002. Looking further ahead, the MPC continues to assess that activity should recover in the second half of this year.

Table 2.C
UK export outlook(a)

	Series average (b)	2001 Q1	Q2	Q3	Q4
BCC export orders					
Manufacturing	7	1	1	-21	-20
Services	11	8	1	1	-8
CIPS export orders (c)					
Manufacturing	49.3	51.1	48.3	45.5	44.8
CBI industrial trends					
Manufacturing export orders	-9	-15	-20	-32	-36
DHL manufacturing export indicator					
Export confidence, next three months	32	34	26	24	19
EEF export orders (d)	-3	-2	-8	-19	-31

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

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

Chart 2.16
Domestic demand

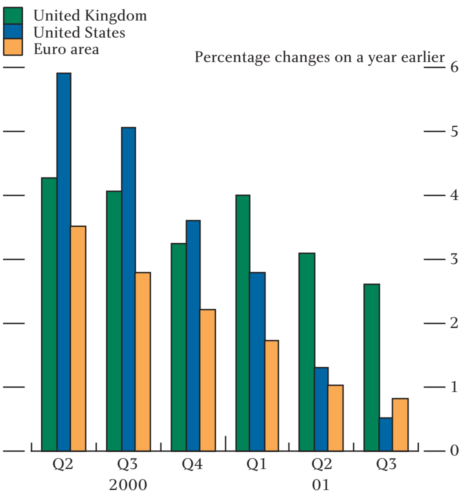
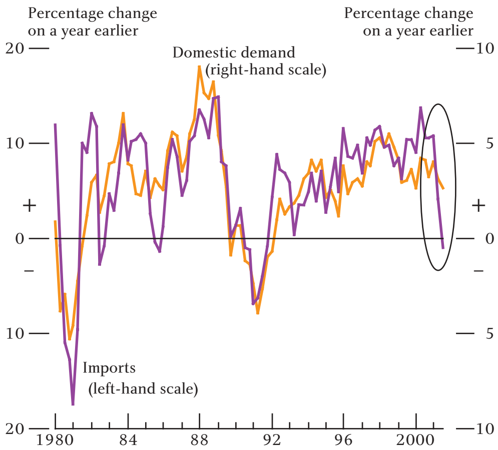


Chart 2.17
UK domestic demand and imports



Output has continued to fall in Japan, with GDP declining by 0.5% in Q3, in line with the MPC's expectations. However, the Committee's view is that near-term activity will be weaker than assumed in November. Private consumption has declined sharply and is expected to fall further. The outlook for investment is even more depressed. Moreover, concerns about the stability of the financial system have increased. Weaker global growth has had a significant impact on other Asian economies, although recent developments suggest that the rate of decline in those countries is now moderating.

As in November, the current *Inflation Report* projections incorporate a recovery in world activity during the course of 2002, predominantly reflecting the significant macroeconomic policy stimulus in the pipeline and the positive boost to growth as the inventory correction unwinds. However, recent developments suggest that near-term activity is likely to be rather weaker than anticipated in the November central projection, particularly in the euro area.

Reflecting the sharp downturn in world activity, demand for UK exports has fallen significantly. In 2001 Q3, UK export volumes fell by 3.6%, the largest one-quarter fall for ten years. And the weakness of activity in the United Kingdom's main trading partners is likely to have depressed exports further around the turn of the year. In corroboration, surveys indicate a worsening in export orders and confidence in Q4 (see Table 2.C).

Net trade is influenced by growth in overseas demand relative to the United Kingdom. The slowdown in the other major economies has been more pronounced than in the United Kingdom (see Chart 2.16). This relative strengthening of UK domestic demand might suggest a more negative contribution from net trade to UK growth. But the opposite has occurred in recent quarters—the net trade contribution has become slightly less negative, as UK imports have also declined significantly. The magnitude of the fall in import volumes is unusual given historical relationships (see Chart 2.17).

Part of the weakness in import volumes may be explained by the fact that the downturn in UK domestic demand growth is mostly accounted for by reduced business investment, which tends to have a comparatively high import concentration. It is perhaps also relevant that the slowdown has been particularly acute in plant and machinery investment. Although data are not directly available on the import content of such investment, it is likely to be higher than average. Most other investment is in buildings and the import component of construction output is particularly low. This explanation

Chart 2.18
Contributions to annual changes in import volumes

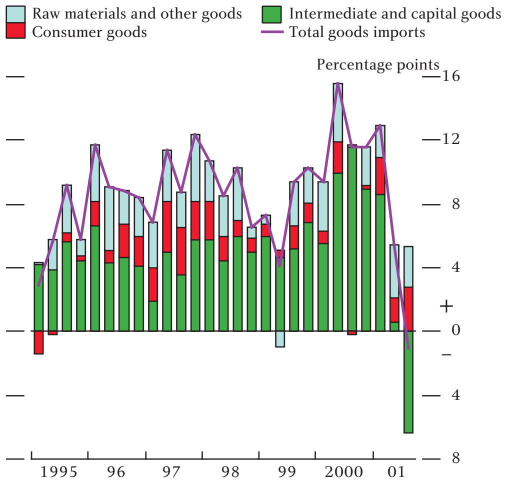


Chart 2.19
Manufacturing and service sector output growth

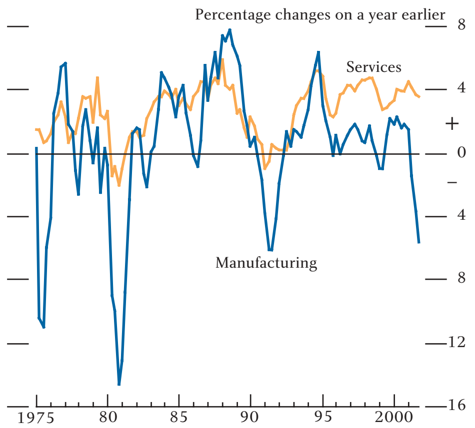


Table 2.D
Service sector output prospects(a)

	Series average (b)	2001 Q1	Q2	Q3	Q4
CIPS (c)					
Business expectations, next twelve months	76.2	75.1	72.7	67.9	66.2
Incoming business	55.6	56.7	52.3	49.3	48.3
BCC business confidence, next twelve months	47	53	49	44	44
BCC home orders, past three months	17	26	19	14	10
CBI/Deloitte & Touche (d)					
Business optimism	-4	11	-12	-43	-58
Volume of business, next three months	17	32	3	-13	-30

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

(a) Numbers reported are percentage balances of respondents reporting 'higher' relative to 'lower'.
(b) Since 1989 for BCC and CBI/PricewaterhouseCoopers; CIPS since July 1996; since November 1998 for CBI/Deloitte & Touche.
(c) Average of seasonally adjusted monthly indices. A reading above 50 suggests expansion, a reading below 50 suggests contraction.
(d) Combined responses for consumer, business and professional services. Data provided by CBI.

appears to be supported by a more detailed examination of the trade data. The fall in imports can almost entirely be accounted for by intermediate and capital goods, particularly ICT equipment (see Chart 2.18). In contrast, imports of consumer goods have continued to rise rapidly, reflecting the strength of household consumption. Imports of consumer goods (including motor vehicles) were 17% higher than a year earlier in Q3.

The MPC judges that the recent marked falls in import volumes will not persist. Import growth is likely to pick up as domestic demand strengthens. And reflecting the near-term weakness of external demand, the net trade contribution to GDP growth is expected to remain negative throughout the two-year projection. However, the drag on GDP growth from net trade is expected to attenuate somewhat during 2003 as world activity rallies.

2.4 Output

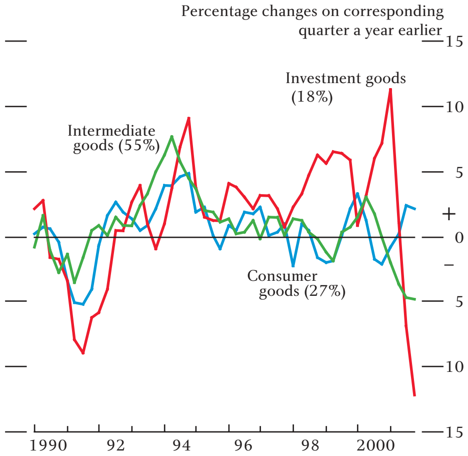
Preliminary estimates suggest that UK output rose by 0.2% in Q4, somewhat below expectations at the time of the November *Report*. The significant imbalances in the sectoral composition of growth, which have existed for some time, have intensified further. By 2001 Q4, the differential in annual growth rates of output in the service and manufacturing sectors was around 9 percentage points—the largest since the early 1980s (see Chart 2.19).

Service sector growth picked up to 0.9% in Q4, following growth of 0.6% in Q3. This renewed strength was somewhat at odds with survey evidence. Both the BCC and CIPS surveys suggested a slowdown in service sector growth during Q4. And most forward-looking indicators are consistent with this more subdued picture of activity persisting in the near term (see Table 2.D).

Manufacturing output declined by 1.7% in Q4, the fourth consecutive quarter of falling output. Recent trends in the pattern of industrial production (which also includes output of the mining and utilities industries) reflect the divergences between strong consumer spending and relatively weaker corporate sector demand. In particular, while annual growth of investment and intermediate goods output has fallen sharply, growth of consumer goods production remains positive (see Chart 2.20).

Survey evidence suggests that manufacturing output is likely to continue falling in the first quarter of 2002, although firms have become a little more confident about conditions further ahead. For example, although considerably more pessimistic

Chart 2.20
Industrial production



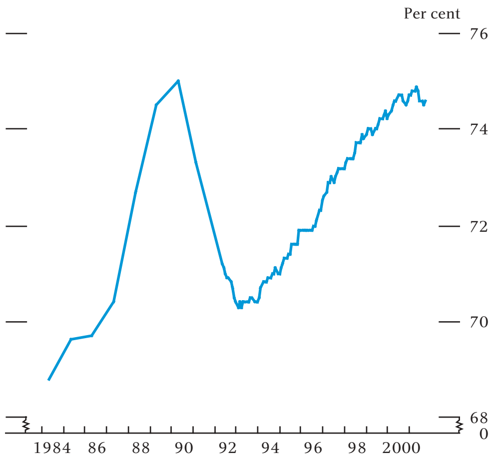
than a year ago, the January 2002 CBI Quarterly Industrial Trends survey reported some recent improvement in manufacturers' optimism regarding their business situation and export prospects for the next twelve months.

3 The labour market

The labour market remains tight, and any easing so far has been moderate. The employment rate has fallen from its mid-2001 peak and unemployment has started to rise. Total hours worked fell slightly in the latest data, but numbers in employment rose. The inactivity rate has fallen back a little, reversing part of its recent rise. Earnings growth has slowed, especially in the private sector where bonuses have been lower than in the previous year. Unit wage cost growth was higher in 2001 than in 2000, but fell back slightly in the latest data. The MPC expects earnings growth to slow slightly this year, as labour market pressure abates a little further.

3.1 Employment

Chart 3.1
LFS employment rate(a)



(a) Percentage of population of working age.

Employment as measured by the Labour Force Survey (LFS) reached its highest level in the three months to November 2001. This reflected a record number of people above the state pension age in employment, as well as a rise in employment of those of working age. Nevertheless, the working-age employment rate remained a little below its recent peak (see Chart 3.1).

The employment rate is the level of employment divided by the population of working age. The latest available population data are for mid-2000; figures after that are based on projections of the working-age population. The Government Actuary's latest population projections, published in November, estimated that the working-age population grew by 0.7% between mid-2000 and mid-2001, the fastest rate for nearly 20 years. A higher working-age population increases the supply capacity of the economy, allowing employment, and hence output, to rise without upward pressure on wages.

In recent years a substantial and rising share of the increase in the total UK population has come from net inward migration, which by the late 1990s accounted for twice as much as the increase from births outnumbering deaths. Net migration inflows in 1998 and 1999 reached record levels, at around 190,000 a year. The latest population projections assume that net migration will add 135,000 a year to the UK population over the coming decade, compared with the previous

Chart 3.2
Average hours worked per week

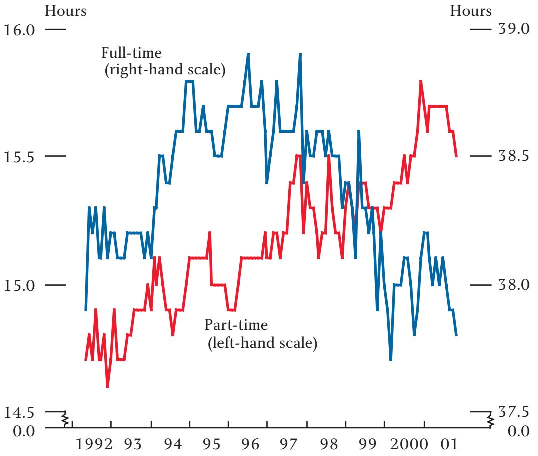


Chart 3.3
Total hours worked per week and employment

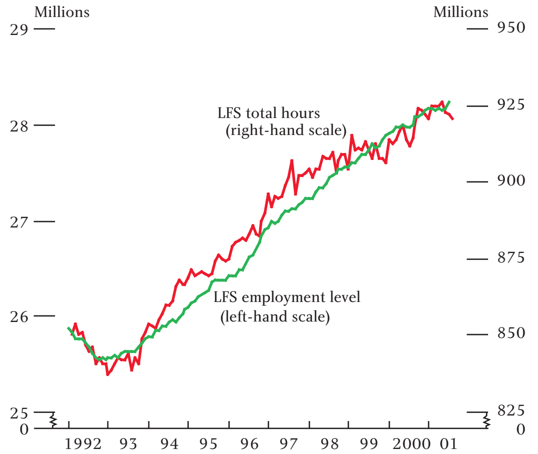
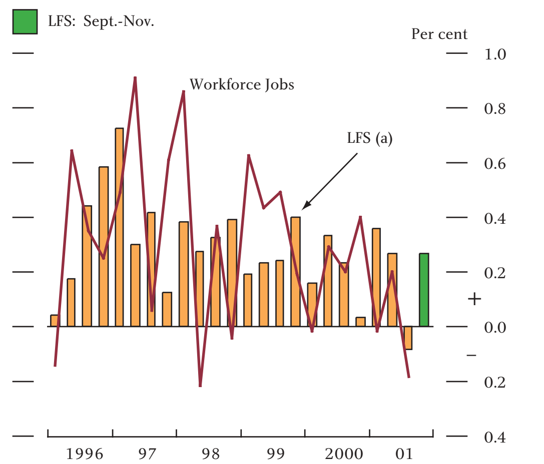


Chart 3.4
Quarterly growth in employment



(a) LFS data for three months ending March, June, September and December.

assumption of 95,000 a year. Population growth over the next few years may consequently be a little higher than previously thought, although such estimates are inevitably highly uncertain and net migration is likely to be affected by a range of factors, including the economic cycle.

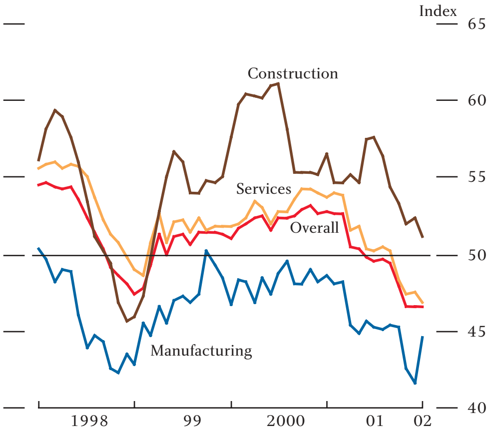
The LFS data do not yet, however, take account of the most recent estimates of UK population or projections of population growth. These are expected to be incorporated in April and will increase estimates of both the level and the growth rate of the working population, with revisions going back to mid-1998. However, other LFS variables will also be raised in line with the new population estimates, so the employment, unemployment and inactivity ratios should be largely unaffected.

Total hours worked is a better measure of labour usage than numbers in employment. We might expect to see changes in hours worked earlier in the cycle than changes in employment, as it is easier for firms to adjust working hours than numbers employed. For example, both employment and hours worked started rising around the same time in 1993, but the pick-up in hours was initially more rapid. Average weekly hours worked by both full-time and part-time workers have fallen during the past year (see Chart 3.2). The fall in average hours in the latest three-monthly data mainly reflects a reduction in overtime working, with a decrease in the numbers working overtime and also in their average overtime hours.

Increases in both employment and the proportion of full-time workers during the past year have meant that total hours worked (see Chart 3.3) has been relatively stable, although falling slightly in the three months to November. Nevertheless, total hours worked remains at a high level, and is not yet signalling a clear downturn in the labour market.

Workforce Jobs data are another indicator of labour usage, based on a survey of employers rather than the LFS survey of households. The latest Workforce Jobs data show a sharp drop in 2001 Q3 (see Chart 3.4), concentrated in manufacturing, which accounted for 44,000 of the 45,000 quarterly decrease. Manufacturing jobs have fallen for 14 successive quarters since early 1998, although such a sustained decline is not unusual: manufacturing jobs fell in 66 out of 93 quarters since the Workforce Jobs data began in 1978. In most developed countries the share of manufacturing in total output has been on a downward trend for a considerable time. Combined with higher productivity growth on average in manufacturing than in the other sectors of the economy, this

Chart 3.5
CIPS employment index(a)



Sources: CIPS and Bank of England.

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

Table 3.A
Surveys of employment intentions(a)

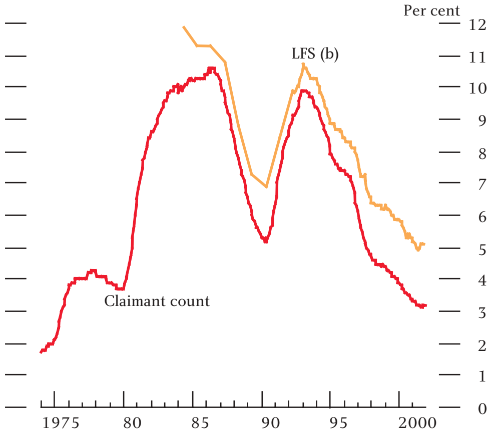
Percentage balance of employers planning to recruit staff

	Series average	2000 Q4	2001 Q1	Q2	Q3	Q4
BCC (b)						
Services	14	29	21	19	16	13
Manufacturing	3	8	11	-1	-3	-7
CBI (c)						
Manufacturing	-21	-10	-21	-28	-26	-39
Manpower (b)						
Total	11	18	21	19	14	17
Services	13	22	27	23	18	19
Manufacturing	13	14	13	14	9	13
Public	3	10	20	21	21	17

Sources: BCC, CBI and Manpower.

(a) Seasonally adjusted by the Bank of England.
(b) Next three months, average since 1989 for BCC; 1981 for Manpower total; and 1988 for other Manpower.
(c) Next four months, average since 1979.

Chart 3.6
Unemployment rate(a)



(a) Rates calculated as a percentage of the economically active population.
(b) Annual data before 1992, then backward-looking three-month moving averages.

means that manufacturing employment will be likely to fall much more often than total employment.

Service sector jobs in 2001 Q3 were virtually unchanged on the previous quarter, although there were falls in some parts. Total service sector jobs were 1% higher in 2001 Q3 than a year earlier, the slowest annual growth since March 1996.

Revisions to the Workforce Jobs data following the annual benchmarking exercise have brought them more in line with the LFS data, especially in 2000 where the Workforce Jobs data had previously indicated weaker growth in employment than the LFS estimates. Workforce Jobs are measured on a single day in the final month of each quarter, so it is not surprising that the series is more volatile than LFS employment, which is an average over three months. A large part of the apparent difference between the LFS employment and Workforce Jobs measures in 2001 Q3 is explained by a fall in the number of second jobs, which reduces the number of jobs but would not affect the LFS estimates of the number of people in employment. The number of people with second jobs has been on a downward trend since mid-1999.

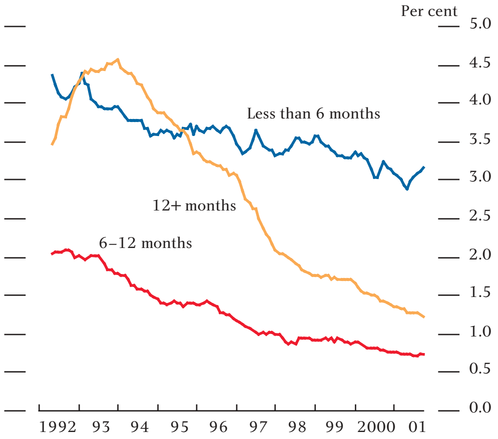
Surveys of employers continue to suggest that labour demand pressures may have eased. The CIPS survey (see Chart 3.5) has shown falling employment in the service sector since September, although the survey covers neither distribution nor government services, which may have seen rising employment. As the largest sector, the service sector index has the highest weight in the CIPS index for the overall economy. Although the construction index saw a sharp decline in the second half of 2001, it is still above the 'neutral' level of 50, suggesting that employment is probably still rising. Manufacturing remains the weakest sector, although the January survey showed some recovery from the low balances in late 2001. The Bank's regional Agents report continuing job losses in manufacturing and slower growth in service sector employment.

Looking forward, surveys of service sector employment intentions have drifted down to around, or a little above, their long-run averages (see Table 3.A), which suggests that employment there will continue to rise in the short term, although at a slower rate than in the recent past.

3.2 Labour availability

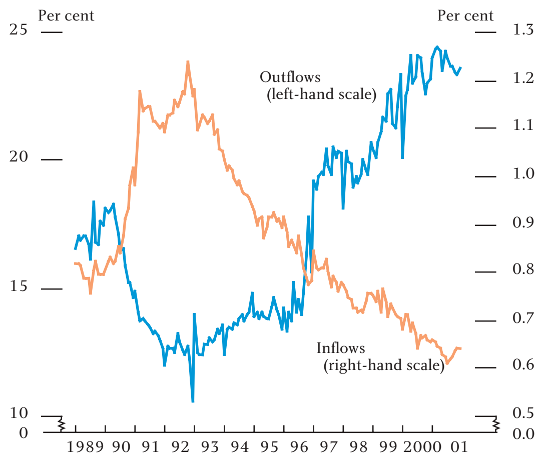
Unemployment has picked up on both the claimant count measure and the LFS one, which uses the International Labour Office (ILO) definition of unemployment (see Chart 3.6). LFS unemployment started rising, albeit slowly, from a low point in

Chart 3.7
LFS unemployment(a)



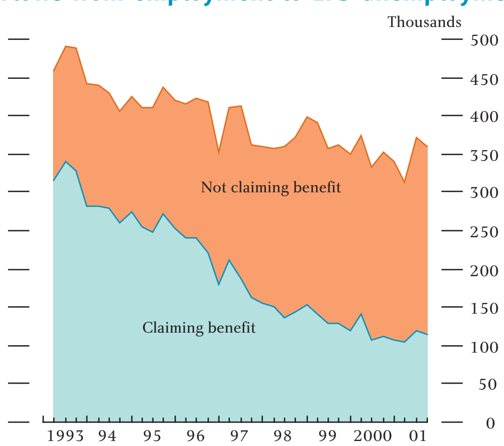
(a) Rates are calculated as a percentage of the economically active population.

Chart 3.8
Claimant count inflow and outflow rates(a)



(a) Monthly inflow rate is expressed as a percentage of the non-claimant-count working-age population. Monthly outflow rate is expressed as a percentage of the claimant count.

Chart 3.9
Flows from employment to LFS unemployment(a)



(a) Quarterly flows, which may therefore exclude very short spells in LFS unemployment.

late Spring 2001. The claimant count did not start to rise until October. It has now risen in three consecutive months for the first time since late 1992, although the monthly increases have been very small. Chart 3.7 shows that higher short-term unemployment (up to six months) lies behind the increase in LFS unemployment, while long-term unemployment (more than twelve months) has continued to fall. This is usual at this stage in the economic cycle, as inflows into unemployment start to pick up.

Inflows into unemployment often indicate turning points in the labour market: for instance, claimant count inflows started to rise at the start of 1990 (see Chart 3.8), five months before unemployment started to increase. But it is changes in outflows from unemployment that have tended to be more important for determining the level of unemployment in the longer run.

The sustained growth that followed the early 1990s recession has been associated with a decline in both inflows into, and outflows from, claimant count unemployment. Fewer people would be expected to move into unemployment during an upswing, as there would be fewer job losses and it would be easier for people to find a replacement job before starting to claim benefit. Outflows from unemployment fell for much of the period between 1993 and 2001. But that was simply because there were fewer people who could potentially leave unemployment as the number of jobless declined. The chances of leaving unemployment increased: Chart 3.8 shows a rising proportion of claimants flowing out of unemployment during that period. The recent pick-up in claimant count unemployment has come from both an increase in the inflow rate and a reduction in the outflow rate, although the outflow rate rose slightly in December. However, the changes in inflows and outflows have been very mild compared with those in 1990 and 1991, and do not indicate a sharp change in labour market conditions.

The LFS measure of unemployment records the number of people searching for work over the past four weeks and available to start work within two weeks. An increasing share of the gross flows from employment into this measure has come from those becoming unemployed but not claiming benefit (see Chart 3.9). The rising share of non-claimants in inflows helps to explain why LFS unemployment has fallen less than the claimant count, and has started to rise earlier. In recent years, those moving from employment to unemployment but not claiming benefit have on average found employment more quickly than benefit claimants. In part this may reflect typical characteristics of non-claimants, such as higher levels of education. But in some cases it may also

Table 3.B
Surveys of labour shortages and recruitment difficulties

	Series average (a)	2000 Q4	2001 Q1	Q2	Q3	Q4
CBI labour shortages (b)						
Skilled	14	18	17	15	13	8
Unskilled	3	3	2	3	4	2
BCC recruitment difficulties (c)						
Manufacturing	57	73	75	62	75	66
Services	51	65	66	64	66	60

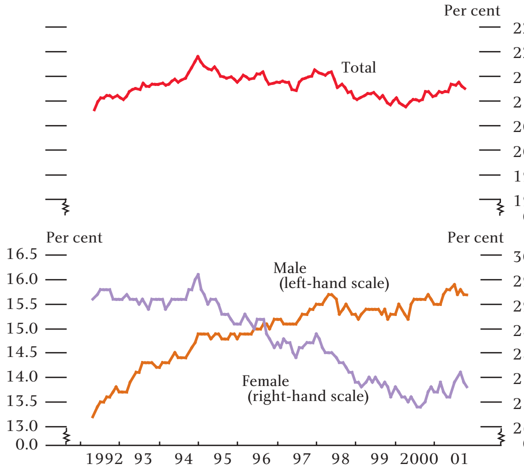
Sources: CBI and BCC.

(a) CBI average from 1972 and BCC from 1989.
(b) Percentage of firms citing labour shortages as a constraint on output over the next four months.
(c) Balance of firms experiencing recruitment difficulties.

reflect non-claimants possibly being willing to accept jobs at lower pay, because they are not receiving benefits, than similar people on the claimant count. The effect of non-claimants' greater likelihood of leaving unemployment has been outweighed recently, however, by their higher share of inflows. So non-claimants have accounted for an increasing share of LFS unemployment: nearly 60% of the LFS unemployed do not claim benefits. Given that non-claimants appear to have a greater chance of getting a job quickly than claimants, a higher proportion of non-claimants within total unemployment should, other things being equal, help to moderate wage pressure.

Unemployment nevertheless remains at low levels and surveys of labour shortages and recruitment difficulties suggest only a very moderate easing of the labour market so far (see Table 3.B). Although manufacturing employment has been falling for some time, the CBI Industrial Trends survey suggests that shortages of skilled workers in manufacturing only dropped significantly below the long-run average in 2001 Q4. The BCC survey suggests that the number of firms experiencing recruitment difficulties remains above average for both manufacturing and services, although there has been a fall in the number of firms trying to recruit. The Bank's regional Agents report that skill shortages have eased in recent months, but continued recruitment difficulties remain in some areas, such as construction and transport.

Chart 3.10
Inactivity rates(a)



(a) Percentage of the respective population of working age.

The LFS classifies as inactive those people who do not have a job but do not meet the ILO definition of unemployment. The inactivity rate has risen since mid-2000, for both men and women (see Chart 3.10), although changes from month to month remain volatile and there has been some fall-back in inactivity rates in the most recent months. The increase in the female inactivity rate has reversed only a little of its trend decline over the second half of the 1990s, when rising female participation broadly offset the rising male inactivity rate. Table 3.C shows that the biggest contribution to the recent increases in both male and female inactivity has come from those saying that they do not want a job. So rising inactivity has probably exerted little downward pressure on wages.

Table 3.C
Working-age inactivity, September to November 2001

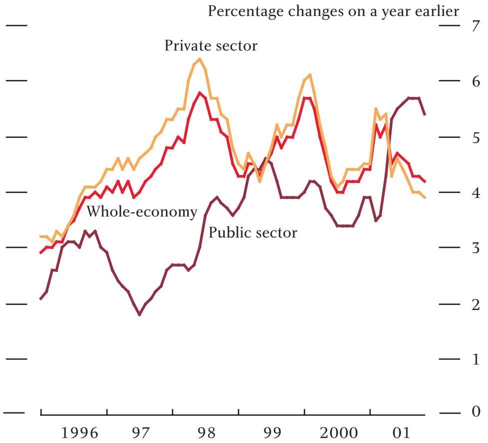
Thousands, seasonally adjusted

	Men	Change on a year earlier	Women	Change on a year earlier
Does not want job	**2,075**	**26**	**3,453**	**41**
Wants job but not seeking in past four weeks	**852**	**-3**	**1,205**	**7**
Discouraged worker	22	-8	14	-3
Long-term sick	446	-17	300	9
Looking after family/home	73	9	579	18
Student	128	9	123	9
Other	182	4	189	-25
Seeking work but not available to start in next two weeks	**96**	**2**	**109**	**-5**
Students	50	7	46	10
Other	46	-5	64	-14

3.3 Earnings and unit wage costs

Nominal earnings growth has eased despite the continuing low level of unemployment. Headline average earnings growth, which is a three-month average, fell during 2001 (see Chart 3.11) and the private sector headline rate fell to 3.9% in November, its lowest figure for more than five years. Earnings growth was especially weak in the manufacturing sector, but public sector earnings growth has remained high. The

Chart 3.11
Headline average earnings growth(a)



(a) Three-month average of average earnings growth.

Chart 3.12
Average earnings in the private and public sectors

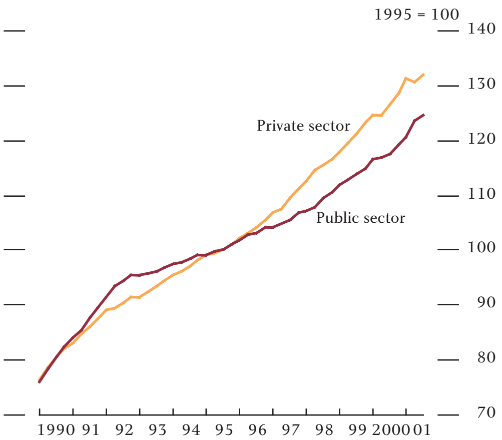


Table 3.D
Earnings growth

Percentage changes on a year earlier

	2001 Aug.	Sept.	Oct.	Nov.
Average earnings (a)				
Whole-economy	4.3	4.3	4.4	3.7
Public	6.3	5.7	5.7	4.8
Private	3.8	4.0	4.1	3.4
Services	3.9	4.2	4.4	3.9
Private services	3.1	3.7	4.0	3.6
Manufacturing	4.6	4.4	4.0	2.7
Regular pay (b)				
Whole-economy	5.2	5.0	5.0	4.6
Public	6.2	5.8	5.7	4.8
Private	5.0	4.9	4.8	4.6
Services	5.2	5.1	5.1	4.8
Private services	4.9	4.8	4.8	4.8
Manufacturing	4.9	4.7	4.4	3.8

(a) Monthly figures, not seasonally adjusted. These are likely to be more volatile than the headline rate, which is a three-month average, seasonally adjusted.
(b) Regular pay growth excludes the effect of bonuses, not seasonally adjusted.

backdated performance-related pay deal for teachers explains some, but by no means all, of the high growth rate. Earnings growth in the public sector lagged behind the private sector for most of the 1990s (see Chart 3.12). Private sector workers may be less inclined to seek to match current public sector increases if those are seen as recovering ground after a period of slower growth.

Bonuses paid in recent months have been well below those paid a year earlier. Earnings growth this year may well continue to be depressed by lower bonuses, held in check by factors such as the less buoyant economy and lower corporate profitability. The effect of lower bonus payments reduced annual average earnings growth in November by 0.9 percentage points for the whole economy and by 1.1 percentage points in manufacturing, where average earnings growth dropped to 2.7%, its lowest figure since the average earnings data began in 1981. Even excluding the effect of bonuses, there was still a sharp fall in manufacturing regular pay growth in November (see Table 3.D).

The influence of bonuses on earnings growth can also be affected by changes in the timing of payments. For instance, in 2001 some firms switched the timing of bonuses from March to February. Bonus payments added 2.7 percentage points to average earnings growth in February 2001 (although there was less effect on the headline rate, which is a three-month average). If the timing of these bonuses this year reverts to March, it would significantly reduce twelve-month and headline earnings growth in February, though it would boost twelve-month earnings growth in March and headline earnings growth in May (when the high figure in February 2001 drops out of the comparison). A large number of bonuses are paid between December and March. Any changes in the amount and timing of bonuses could make earnings growth erratically low in some of these months. In the near term, earnings growth excluding the effect of bonuses may give a better guide to underlying labour market conditions.

Pay settlements in the last three months of the year typically cover around only 5% of employees. So they have little aggregate impact other than as a signal of the state of the market in the approach to January and April, when the majority of settlements take place. Settlements have been broadly stable during the past year, even though labour market pressures have apparently been easing and RPI inflation has been falling. Recent settlements have included an increasing number of low awards or pay freezes, noted by both the CBI pay survey and the Bank's regional Agents. The CBI survey also reports increases in the number of firms, especially in

Chart 3.13
Real earnings growth

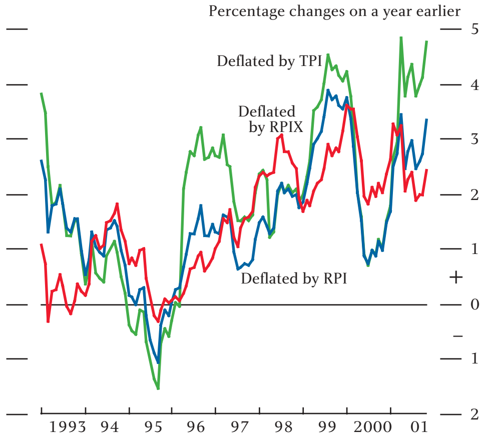
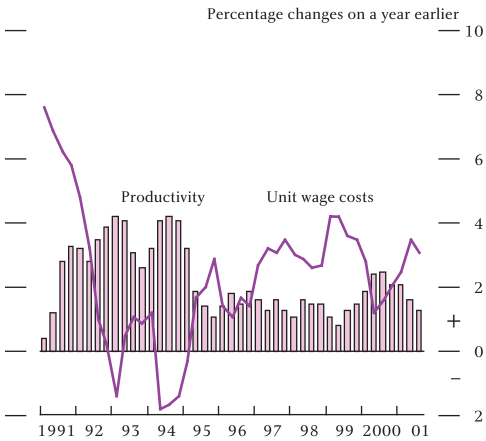


Chart 3.14
Annual growth in whole-economy productivity(a) and unit wage costs



(a) Defined in terms of whole-economy Workforce Jobs.

manufacturing, citing low profits or orders as 'very important' downward pay pressures. Reports from the Bank's regional Agents suggest that pay settlements this year may be a little lower on average than in 2001. However, settlements are an incomplete guide to likely pay growth, which also reflects other important influences such as merit pay, overtime working and bonuses. The growing importance of these other components of remuneration, emphasised by Agents' contacts, may mean that total earnings growth weakens by less than settlements this year.

Awards announced for workers covered by the public sector Pay Review Bodies, effective from April, have mostly been between $3^1/_2$% and $3^3/_4$%. The paybill effect, which takes account of factors such as changes to salary structures and special payments, is estimated to be a little higher than last year at just over 4%. The Pay Review Bodies cover just over a third of the public sector wage bill, although their outcomes may also affect settlements in closely related areas of the public sector.

The effect of lower taxes on the purchasing power of people's pay may have helped to restrain nominal earnings growth. Chart 3.13 shows that recent real earnings growth is markedly higher if deflated by the tax and price index (TPI) instead of the RPI or, especially, RPIX. TPI inflation measures the increase that would be needed in an average person's gross income to purchase a standard basket of goods. It allows for the effect of changes in direct taxes and social security contributions, as well as the prices, mortgage rates and indirect taxes that are included in the RPI. The lower rate of increase of the TPI reflects factors such as the introduction of the Children's Tax Credit, many of which are likely to drop out of the annual growth rate of the TPI in April.

The influence of wage pressure on price inflation depends on productivity. Chart 3.14 shows that whole-economy productivity growth has slowed during the past year. As changes in employment tend to lag changes in output, lower rates of productivity growth are quite normal for this stage of the cycle, and reflect the combination of slowing output growth and broadly stable employment. With productivity growth falling faster than earnings growth, unit wage costs have been growing at a higher rate than in 2000, although they have slowed a little in the latest quarterly data. As a largely cyclical effect, it is less likely that this would feed through into higher inflation, because the normal behaviour of firms would be to absorb higher unit wage costs temporarily, and to reduce wages or employment if output fails to recover sufficiently. Manufacturing productivity in November 2001 was 0.7% lower than a year earlier, though low earnings growth offset the effect on unit wage cost growth, which at 3.4% was only a little higher than the whole-economy figure.

Looking ahead, the MPC's central projection is for the gradual labour market easing to continue. Although some very low earnings growth rates might be seen in the first few months of 2002, overall growth in the year as a whole is likely to be only slightly lower than in 2001. That would reflect both lower bonuses and lower regular pay growth. The slackening of labour market pressures is likely to be moderate, and earnings growth is expected to recover a little next year.

4 Costs and prices

Global inflationary pressures remain subdued. Overall, the spot price of crude oil has changed little since publication of the November *Inflation Report*. There have been some increases in the prices of other commodities, but they remain close to historic lows. The reduction in sterling import prices, at 2.2% in Q3, was larger than had been expected. The prices that manufacturers pay for their raw materials and fuel inputs continued to fall, though manufacturers' costs increased overall, reflecting strong growth in unit labour costs. As expected, retail price inflation fell sharply in the fourth quarter of last year, largely because of the weakness in petrol prices. Overall, RPIX inflation is likely to run slightly below the 2.5% target during 2002, although movements from month to month are likely to remain erratic.

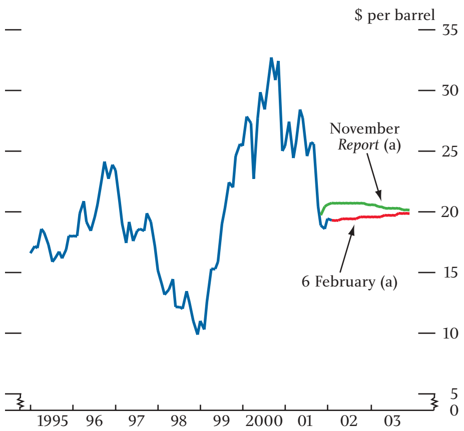
4.1 Commodity prices

There has been little net movement in the spot price of oil since the November *Inflation Report*. In the 15 working days up to 6 February, the spot price of Brent crude averaged around $19 per barrel, just over $1 per barrel lower than had been expected when the Committee finalised the November projection.

Commodities that can be stored for a period of time, such as oil, are often described as hard commodities. The prices of these hard commodities depend largely on expectations about future demand and supply. For most of last year, changes in expected future demand dominated the oil market, with prices falling as the prospects for world activity worsened. Prices had eased before the terrorist attacks of 11 September, and they fell more sharply in the aftermath.

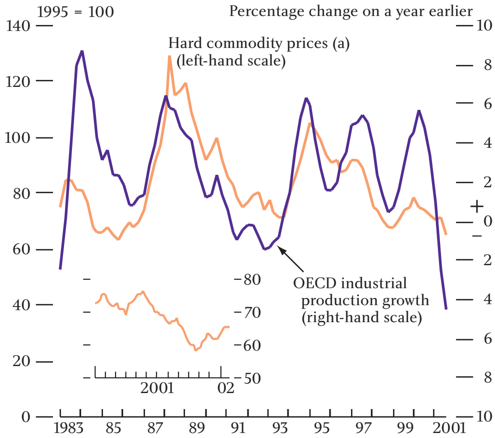
Towards the end of 2001, OPEC announced plans to cut production after the oil price had remained below its reference range of $22 to $28 per barrel for a number of weeks. Changing expectations about future supply then began to influence the oil price. At the end of December, OPEC confirmed that the proposed cuts would be implemented from the beginning of this year. Five non-OPEC members also made commitments to reduce their output. But the upward effect on prices has been muted, owing to a

Chart 4.1
Brent oil futures



(a) Average during the 15 working days up to the time at which the MPC finalised its projections.

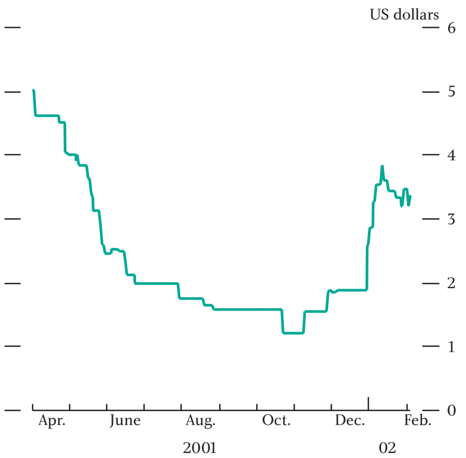
Chart 4.2
Non-oil hard commodity prices and world industrial activity



Sources: IMF, OECD, *The Economist* and Bank of England.

(a) Main chart runs from 1983 Q1 to 2001 Q3 and shows *The Economist* all-industrials dollar index, which excludes oil prices, deflated by weighted G7 manufacturing export prices. Inset chart runs from January 2001 to January 2002 and shows *The Economist* all-industrials dollar index alone.

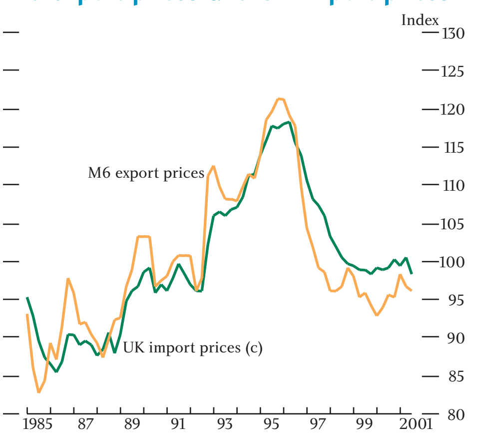
Chart 4.3
Computer memory prices(a)



Sources: Bloomberg and Converge Inc.

(a) Price of 128 megabytes of PC 100 DRAM (dynamic random access memory).

Chart 4.4
M6 export prices and UK import prices(a)(b)



(a) Each series is presented as an index that averages 100 during the period 1985 Q1 to 2001 Q3.
(b) The M6, or major six, countries are Canada, France, Germany, Italy, Japan and the United States. All prices are measured in sterling.
(c) Deflator for imported goods and services implied by UK National Accounts data.

combination of doubts that the lower production targets would be met by all countries, and a larger-than-expected increase in US oil stocks. Market expectations of oil prices over the next year have edged down since the November *Report*, though they were little changed at the two-year horizon (see Chart 4.1).

The prices of hard commodities other than oil tend to vary procyclically with world industrial activity, which suggests that changes in demand have previously been more important for prices than changes in supply (see Chart 4.2). The prices of these commodities fell sharply in the early autumn, but have edged up since the November *Report*, perhaps indicating an improvement in the prospects for world industrial activity. The demand for soft commodities, such as food, is less sensitive to world industrial activity. The prices of these commodities are more likely to be influenced by changes in supply, for example in response to changing weather conditions. There has been a moderate increase in food commodity prices during the past three months.

Computer memory prices have some of the characteristics of commodity prices in that they can react quickly to changes in the perceived balance between supply and demand. Computer memory prices fell dramatically last year during the ICT-related slowdown in the world economy. Though they declined slightly at the beginning of 2002, they remained considerably higher than the low points of last autumn (see Chart 4.3).

4.2 Import prices

The average sterling price of UK imports fell by 2.2% in Q3. The magnitude of the fall was surprising. The average price of all exports from the major six (M6) economies, a timely proxy for world export prices, fell by 0.9% in Q3. At the same time, sterling depreciated, on an effective basis, by 0.3%. Balancing the two effects, it might be tempting to conclude that sterling import prices should have fallen by only 0.6%. But the change in M6 export prices is not always a reliable guide to the change in UK import prices, even when exchange rate movements are taken into account (see Chart 4.4).

Why is it that UK import prices do not move together with M6 export prices measured in sterling? One explanation is that the basket of goods and services whose prices are measured by M6 export prices will differ from the basket of goods and services whose prices are measured by UK import prices. So for that reason alone, it is not surprising that the two series do not move exactly in tandem.

Another explanation is that exporters are pricing to market. The term 'pricing to market' describes the behaviour of an exporter who sets his or her own price, taking into account the prices charged by suppliers of similar, but distinct, goods in the foreign country. When the foreign currency appreciates, the exporting firm will often find that it can make a higher profit if it does not allow the full effect to pass through into a lower foreign currency price for its product. So the foreign currency price will tend to fall, but not by the full extent of the appreciation. The exporting firm will then sell fewer units, but make more on each unit sold, than in the case of full exchange rate pass-through. The ability of the exporting firm to avoid cutting the foreign currency price, and to enjoy an increased profit margin, will depend on the extent to which its product is perceived as different, and on the size of any set-up costs and other restrictions that prevent rival firms entering the market. It is also possible that the expected duration of the appreciation is important. The cost to rivals of switching supplies into the foreign country may appear too great if the exchange rate change is not expected to persist. These considerations suggest that, if sterling were to depreciate at some future date, then UK import prices might rise by less than the full extent of the depreciation.

4.3 Costs and prices in manufacturing

There have been further reductions in the cost to manufacturers of their raw material and fuel purchases since publication of the November *Report*. In the year to December, the prices of these inputs fell by 6.6%, with reductions in the price of crude oil contributing -4.9 percentage points. Estimates of manufacturers' input costs published by the ONS now include the effects of the Climate Change Levy (CCL). The CCL added 0.9 percentage points to input price inflation in the year to December.

Table 4.A
Manufacturers' weighted costs

	Base weight (a)	Annual percentage change				
		2000	2001			
		Q4	Q1	Q2	Q3	Q4
Raw materials and fuel (including semi-finished manufactured imports)	0.30	10.3	4.9	4.8	-2.9	-8.3
Imports of finished manufactures	0.07	2.3	1.1	1.2	-2.3	n.a.
Bought-in services	0.16	0.2	2.1	2.9	3.2	n.a.
Unit labour costs	0.47	-1.5	-0.4	2.3	4.0	n.a.
Weighted costs		**1.8**	**1.4**	**3.0**	**1.7**	**n.a.**
Output prices (b)		1.9	0.9	0.9	0.5	-0.3

(a) Share in total costs in 1990. Weights for subsequent periods are derived by assuming that the relative quantities of each input remain the same, even as relative prices change.
(b) Excluding excise duties.

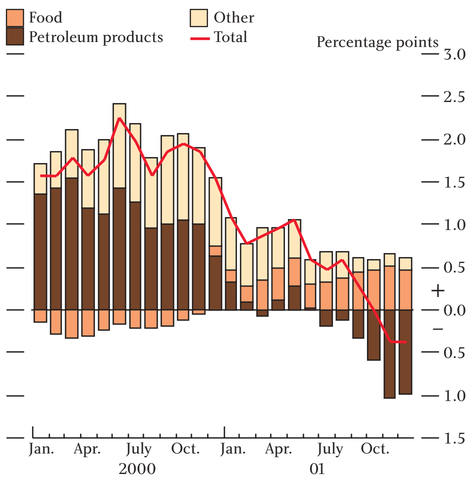
The prices of raw materials and fuel can change quite significantly from one month to the next. But raw materials and fuel account for only around a third of manufacturers' total costs. Unit labour costs, and the cost of bought-in services such as transport and the rental of buildings, account for most of the remainder. Table 4.A shows that unit labour costs in manufacturing rose by 4.0% in the year to Q3, compared with a figure of 2.3% in the year to Q2. Weighting the different components, manufacturers' total costs are estimated to have risen by 1.7% in the year to Q3.

The prices that manufacturers charged for their output, excluding the effects of excise duties, rose by 0.5% in the year to 2001 Q3. That was less than the estimated increase in their

Chart 4.5
Rates of return(a)

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

Chart 4.6
Contributions to annual producer output price inflation(a)



(a) Excluding excise duties.

Table 4.B
Measures of service sector costs and prices

	2000 Q4	2001 Q1	Q2	Q3	Q4	2002 Jan.
Backward-looking						
CIPS average costs index (a)	61.2	57.4	56.2	54.7	51.8	53.7
CIPS average prices charged index (a)	54.8	52.5	51.5	51.4	49.6	51.1
CSPI (b)	4.6	5.4	5.0	4.4	n.a.	n.a.
Forward-looking						
BCC prices balance (c)	32	32	18	16	20	n.a.
CBI & Deloitte Touche selling prices (d)						
Consumer services	16	15	4	23	-34	n.a.
Business and professional services	-12	-3	17	-13	-16	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 ?'

total costs and so implied further downward pressure on manufacturers' profitability. Official data on corporate profitability support this view. The rate of return on capital in manufacturing industry rose by 0.1 percentage point to 4.3% in Q3, but remained substantially below the rate a year earlier (see Chart 4.5).

Manufacturers' output price inflation has weakened further beyond Q3. In the year to Q4, manufacturers' output prices including excise duties fell by 1.0%. That was the largest annual reduction since comparable data were first collected in 1958. The series excluding duties fell by 0.3%. Chart 4.6 shows that lower prices charged for petroleum products more than accounted for the fall, though there has been a general trend of declining inflation in most industries. The one exception has been the food production industry, where the rate of output price inflation rose steadily for most of last year.

4.4 Costs and prices in the service sector

Service sector unit wage cost growth is estimated to have slowed in the year to 2001 Q3. Labour costs account for the majority of total weighted costs in the service sector, and make up a larger part of the overall cost-base than in manufacturing. According to the CIPS services survey, which excludes both retail and wholesale distribution, input cost pressures eased in Q4 but then picked up again in January (see Table 4.B). Increases in fuel costs and insurance premia were reported by a number of firms.

Service sector output price inflation looks to have eased further in the second half of last year. The ONS' experimental corporate services price index (CSPI) rose by 4.4% in the year to Q3, compared with an increase of 5.0% in the year to Q2. According to the CIPS services survey, the number of firms reporting output price rises was broadly equal to the number of firms reporting output price falls in Q4. But output price rises became more widespread in January, as firms sought to pass on earlier cost increases following an improvement in demand. Forward-looking measures offer mixed signals. Providers of consumer services responding to the November CBI/Deloitte & Touche survey were particularly pessimistic about demand prospects going forward, and expected to reduce their selling prices in response. But the survey was conducted between late October and mid-November, when confidence was unusually low. A more recent survey from the British Chambers of Commerce showed an increase in the balance of respondents who planned to raise their selling price during the next three months.

Chart 4.7
Retail price inflation

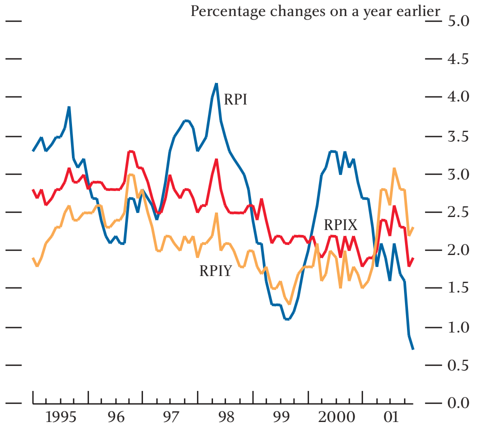


Chart 4.8
RPIX goods and services price inflation

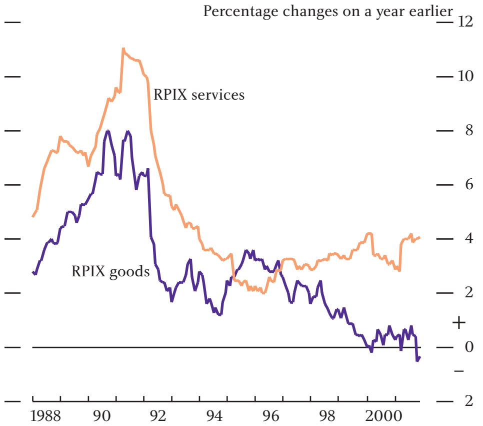
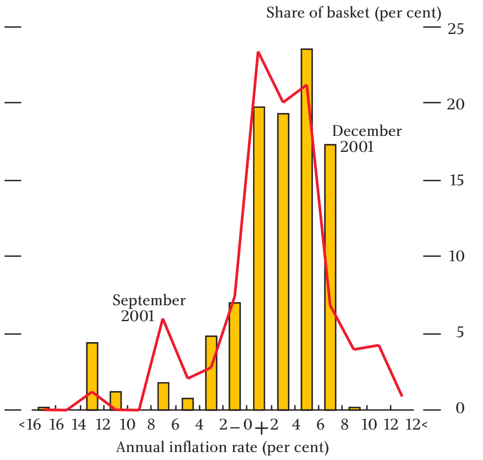


Chart 4.9
Distribution of annual RPIX inflation rates



4.5 Retail prices

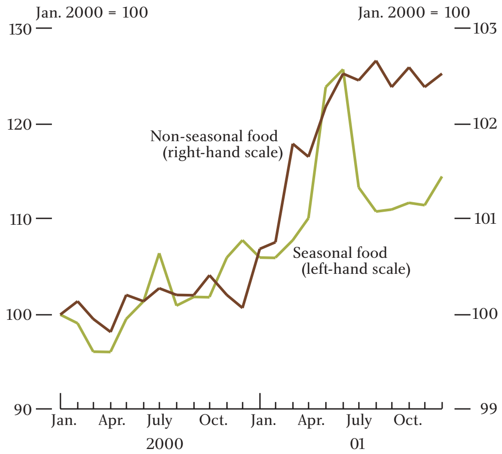
Retail price inflation fell significantly in Q4 (see Chart 4.7). The targeted measure—the twelve-month percentage change in RPIX—was unaltered at 2.3% in October. It fell to 1.8% in November and then edged up to 1.9% in December. Annual RPI inflation, which additionally includes the effects of changes in mortgage interest payments, was 0.7% in December, the lowest rate in more than 40 years. The gap between RPIX and RPI inflation reflects the easing of monetary policy that has taken place during the past year. Annual RPIY inflation, which removes the effects of changes in indirect taxation from the RPIX measure, was 2.3% in December. The harmonised index of consumer prices (HICP) measure rose by 1.0% in the year to December, compared with an increase of 1.3% in the year to September.

There has been a marked distinction between the rates of change of RPIX goods prices, which fell by 0.3% in the year to December, and RPIX services prices, which rose by 4.1% during the same period (see Chart 4.8). Technological advances mean that productivity tends to grow faster in the manufacturing sector, which is relatively capital-intensive, than in the service sector. The need, over time, to maintain parity between wage rates across different sectors means that service sector output prices are likely to rise more rapidly than manufacturing output prices. Although the correspondence between RPIX goods prices and manufacturing output prices will be imperfect, it is striking that RPIX services price inflation has exceeded RPIX goods price inflation by an average of 2.1 percentage points since separate data for goods and services were first published in 1988. That is very close to the average gap between productivity growth in the manufacturing and service sectors during the same period.

More than half of the sharp fall in RPIX inflation between September and December last year was due to the influence of one component—petrol prices. This is clear from Chart 4.9 which shows, for those months, the distribution of annual price changes for 77 component price series that make up the RPIX basket. The weight a price change has in each distribution reflects its weight in the index. The distribution of price changes was close to symmetric in September, but it had become less so by December. In the year to December, there were a number of large price falls, indicated by the three bars lying to the left of the main distribution. The largest of these three bars includes petrol prices, which fell by 12.9%. Prices other than petrol in the RPIX basket rose, on average, by 2.6% in the year to December.

The Committee judges that there may be a modest increase in annual RPIX inflation during 2002 Q1. Some of this projected increase reflects new information received since the November *Report*. For example, a number of suppliers of domestic gas, who are no longer subject to government regulation, raised their prices in January. Last year, prices were increased in April, and by a smaller amount. But more of the projected increase in inflation in Q1 is a consequence of reductions in retail petrol prices that took place at the start of last year dropping out of the annual comparison.

Chart 4.10
Food prices



Price changes that took place last year also affect the Committee's projection beyond Q1, and are judged likely to cause significant month-to-month movements in the annual rate. It is assumed that the downward pressure on RPIX inflation resulting from cuts in fuel and vehicle excise duties and the freezing of alcohol duties announced in the March 2001 Budget will soon come to an end. But the resulting boost to RPIX inflation, which will be larger in Q2 than in Q1, is likely to be broadly offset by a weaker contribution from non-seasonal food prices. Assuming that these prices change little during the coming months, then the impact of increases in non-seasonal food prices in the first half of last year will drop out of the annual comparison. Seasonal food prices rose sharply between February and June last year. Much of the increase, concentrated in May, reflected the adverse supply consequences of poor weather conditions towards the end of 2000 (see Chart 4.10). These price increases from last year are likely to put temporary downward pressure on RPIX inflation in the second quarter of 2002 as they affect the annual comparison once again.

5 Monetary policy since the November *Report*

This section summarises the economic developments and monetary policy decisions taken by the MPC since the November *Report*.(1) The Bank's repo rate was maintained at 4% in December, January and February.

The MPC's central projection in November was for RPIX inflation to slip back to around 2% early in 2002 before drifting up towards the target at the two-year forecast horizon. Annual real GDP growth was projected to dip a little in the near term and then pick up in the second year of the forecast period. Risks to the growth outlook were roughly balanced and risks to the inflation outlook were on the upside. Members had differing views on the likelihood of the various risks crystallising and thus on their overall balance.

At its meeting on 4–5 December, the Committee first discussed the world economy. The US economy remained in recession, with little sign yet that the prospective recovery had begun. The euro area was weaker than expected, and the outlook in Japan remained bleak, though there were some signs of improvement elsewhere in Asia.

In the domestic economy, consumption continued to be strong, underpinned by vigorous growth in real incomes and household borrowing, and a resilient housing market. It seemed unlikely that consumption would slow abruptly, given that households' income gearing was relatively low, borrowing remained high, and the labour market was still comparatively tight. The imbalance between the household and corporate sectors was continuing to widen. Investment was weaker than expected, and surveys pointed to further weakness in the short term, with many investment decisions deferred until early 2002. Price pressures were muted, and oil prices had been surprisingly weak, though looked likely to pick up gently in the medium term.

On the immediate policy decision, most members thought that the repo rate should be maintained at 4%. This would balance the risk of doing too little to support domestic demand, and so allowing output growth to dip further below trend and

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

inflation to fall further below target, with the risk of overstimulating demand and allowing households to build up excessive levels of debt, which could create difficulties in meeting the inflation target in the medium term if this led to a sharp correction in consumer spending. A number of factors contributed to this view. Confidence seemed to have stabilised and perhaps even to have improved. Investment looked likely to remain weak in the short term, but it was unclear whether this would persist in the medium term, when decisions postponed following the 11 September terrorist attacks would be taken. Surveys suggested that the current weakness of price pressures was likely to continue. And the effects of recent policy action needed time to work through fully to the economy.

Another view was that the subdued inflation outlook warranted an immediate reduction of 25 basis points. Domestic price and wage pressures were weaker than the central projection in the November *Report*. The prospects for the global economy were not encouraging either: indicators of weaker price pressures pointed to global disinflation and general excess capacity; prices of finished goods, and not just of oil, were weaker, which would affect the medium-term outlook for UK inflation. A reduction in interest rates was needed to keep inflation on track to meet the target in the medium term, and would help to strengthen business confidence and hence investment and employment.

The Committee voted by 7 to 2 to leave the Bank's repo rate unchanged at 4%, with two members preferring a 25 basis point cut.

At its meeting on 9–10 January, the Committee began by discussing the world economy. There were early signs that economic recovery in the United States in the second half of 2002 might be in prospect, though there were still considerable uncertainties associated with this outlook. The picture for the euro area was mixed, and the Japanese economy remained weak. It was encouraging, however, that there had so far been little contagion from recent developments in Argentina, and several of the emerging market economies in Asia were showing signs of recovery.

In the UK economy, consumption growth remained strong and retail sales even stronger, reflecting rapid growth in household borrowing and house prices. The labour market had continued to ease slightly, though perhaps less rapidly than expected; and average earnings growth had changed little since July. Other pressures on inflation were unusually weak and RPIX inflation was a little below target: the manufacturing sector remained particularly weak, though prices of retail services were more buoyant.

On the immediate policy decision, the Committee agreed that interest rates should remain unchanged. There would be a case for a further reduction in rates if it were thought likely that domestic consumption would slow before the world economy recovered, for example as a reaction to rising unemployment and increasing household indebtedness. Alternatively, if consumption did not slow soon enough, or sharply enough, a rise in interest rates might be needed to keep inflation on track. It was not clear which of the two risks to the central scenario was more likely to occur, therefore leaving rates unchanged now was consistent with meeting the inflation target going forward. Over the next month the Committee would be able to gain more information on global economic prospects and the current UK wage round, and would be able to make a fuller assessment of recent economic developments when preparing the February *Inflation Report* projections.

Some Committee members noted that the worsening imbalances between demand and supply in the UK economy were of particular concern; these were unsustainable and could lead to a sharp correction, either in the exchange rate in response to a widening current account deficit, or in domestic demand as consumers retrenched in the face of their indebtedness. Though inflationary pressures were subdued at present, a cut in interest rates now would worsen the imbalances and could make it more difficult to keep inflation on target in the medium term.

Other members judged that the choice between reducing interest rates by 25 basis points and leaving them unchanged was finely balanced. Recent *Inflation Report* projections for inflation had been too high and the impact of global disinflation had been underestimated. Though the balance of news on the world economy on the past month had been on the upside, the strength and robustness of the recovery were uncertain. UK output growth was likely to remain below trend for some time and inflation consequently to remain below target. On this view, it seemed likely that a further cut in rates would be needed soon to bring inflation back to target. However, it was preferable to make no change to the repo rate this month and to take account of all the relevant information in the February *Inflation Report* projections.

The Committee voted unanimously to maintain the Bank's repo rate at 4%.

At its meeting on 6–7 February, the Committee voted to maintain the Bank's repo rate at 4%.

Prospects for inflation 6

6.1 The inflation projection assumptions

The Monetary Policy Committee approved this *Report* on 8 February. It contains the Committee's assessment of economic developments since November and prospects for the medium term. Projections of GDP growth and RPIX inflation are provided below in Charts 6.1 and 6.2, together with the uncertainties surrounding them. The main assumptions on which the projections are based are outlined below.

Global economic activity has remained weak in recent months. Aggregate GDP in the major overseas economies fell slightly in 2001 Q3, and there may have been a further small contraction in the fourth quarter, even though US output increased marginally. Companies have cut back further on capital spending and inventories, given pressures on profits and uncertainty surrounding prospective demand. Moreover, underlying consumer spending also appears to have slowed in the second half of last year. Global activity seems likely to have been a little softer around the turn of the year than assumed in the November central projection.

But forward-looking indicators of world output point more clearly to an upturn during 2002. Business and consumer confidence have strengthened in recent months, particularly in the United States. Yield curves have steepened and corporate credit spreads have narrowed somewhat, suggesting that financial market participants are more optimistic about growth prospects. And macroeconomic policy remains supportive of a revival in growth.

The timing and speed of the global recovery continue to depend heavily on developments in the United States. Recent indicators suggest that activity may be around a turning point. Inventory correction appears well advanced. The rate of decline in employment may have slowed. Orders have picked up, and the rebound in business and consumer confidence is consistent with a gradual recovery in consumer spending and a renewed rise in investment as surplus capacity is eventually worked off. Although there is considerable uncertainty about the outlook, the central projection remains that there will be a gradual recovery in US growth during this year and next, prompted by the major relaxation of monetary policy and the fiscal stimulus during 2001.

Demand in the euro area is particularly important to UK growth prospects, given the pattern of trade. Recent monthly indicators paint a rather weaker picture for current activity than projected three months ago, although there are increasing signs of a prospective upturn in the coming months. The Committee continues to expect euro-area growth to quicken during this year and next, although near-term output prospects are a little more sluggish than judged likely in November. There has also been a further downward revision to prospects for activity in Japan, where the near-term outlook remains bleak. Output growth in emerging markets has also slowed a little more than expected three months ago, given the rather sharper downturn in world trade, but the prospect remains for a gradual recovery as activity in the major economies improves. There is little sign of contagion from the financial crisis in Argentina.

Although many risks remain, the Committee continues to expect global GDP to strengthen over the course of the year, returning to around trend growth in 2003 on the central projection. But reflecting the slightly weaker starting-point, average growth in 2002 may be some $^1/_4$ to $^1/_2$ percentage points below the November central projection. World trade growth slowed to a standstill last year, which is also rather weaker than expected three months ago. On the central projection, UK-weighted trade may rise by around $2^1/_2$% this year—around 1 percentage point below the November projection—accelerating to the 6%–7% range in 2003.

Global inflationary pressures remain subdued. Spot oil prices fell further towards the end of last year, given downward revisions to projected oil demand, although prices subsequently stabilised following announced cutbacks in production. In the 15 working days up to and including 6 February, spot oil prices were around $1 per barrel below the November level. The futures curve is now broadly flat, and the price of oil expected in two years' time is little different from the November projection. *The Economist* index of non-oil commodity prices in dollar terms dropped in the early autumn to its lowest level since 1977. Prices have begun to edge up in recent months, however, and futures prices are a little higher than at the time of the November *Report*. The net impact of these influences, together with the news that recent outturns for manufactured goods prices have been a little lower than expected, suggests that the local currency prices of internationally traded goods are likely to be slightly weaker than assumed in November.

Prospects for sterling import prices also depend on the outlook for exchange rates. The sterling effective exchange rate (ERI) is slightly higher than the levels assumed in the November *Report*. The ERI averaged 107.1 in the 15 working days up to and including 6 February, consistent with bilateral sterling exchange rates of $1.42 and 61 pence against the euro. This average is around 1% above the implied level for February in the November central projection, and forms the starting-point for the current projection. The sterling ERI is assumed to depreciate gently to 104.6 by 2004 Q1 on the central projection.

Global equity prices have been relatively stable over the past three months, following the sharp drop to the late-September lows and the subsequent partial recovery during October and early November. In the 15 working days to 6 February, the FTSE All-Share index was some 1% above the level assumed in November. The Committee continues to assume that equity prices increase in line with nominal GDP over the forecast period.

The UK housing market has strengthened in recent months, and house prices rose last year at their quickest rate since 1988. Loan approvals and mortgage borrowing suggest continued buoyancy in the near term. The Committee has consequently raised the near-term assumption for house price inflation, but continues to assume that house price growth will ease to around the growth rate of nominal earnings in the medium term.

The Committee has revised the assumptions on UK fiscal policy in the light of the November Pre-Budget Report (PBR). The MPC's projections continue to be based on the Government's nominal public spending plans and on Treasury estimates of effective tax rates on different components of income and expenditure. Public spending is planned to rise robustly over the forecast period. Projected spending growth was raised a little in the PBR, principally reflecting additional expenditure on pensions. Effective tax rates in recent quarters have been lower than estimated in the March Budget, although the Treasury judges that much of the reduction is cyclical. The net effect of incorporating the PBR is to boost demand slightly over the next two years. The impact on the inflation outlook is negligible.

6.2 The output and inflation projections

The decline in GDP growth in the second half of 2001 was sharper than projected in November. According to the ONS preliminary estimate, GDP rose by 0.2% in 2001 Q4, with the four-quarter growth rate dipping below 2%. The fourth-quarter outturn probably exaggerates the underlying slowdown in UK growth, as oil and gas extraction was exceptionally weak, and as companies and households may have raised precautionary saving and deferred spending temporarily, given the heightened uncertainty in the immediate aftermath of the terrorist attacks in the United States. Nonetheless, there appears to be a little less current momentum in growth than expected three months ago.

Imbalances within the economy remain pronounced. Firms that are heavily dependent on global demand and that are particularly exposed to international competition continue to face very difficult trading conditions. For example, manufacturing output fell by 1.7% in 2001 Q4 and was some $5^1/_2$% below the levels of late 2000. But the impact of the global slowdown and continued sterling strength on overall demand and output in the United Kingdom has been mitigated by the substantial relaxation of monetary policy and by the pick-up in growth in public spending. The easing of policy is supporting continued relatively robust growth in domestic demand, albeit at a less rapid pace than in recent years. So financial pressures on firms primarily servicing domestic customers remain much less than on those supplying external markets. For example, output in the service sector grew by 0.9% in 2001 Q4 according to the ONS preliminary estimate, and stood some $3^1/_2$% higher than a year earlier. The divergence between output growth in services and manufacturing over the past year is the widest since 1981.

Final domestic demand continues to be bolstered by rapid growth in household spending. Consumer spending rose by 1.1% in 2001 Q3 and was around 4% higher than a year previously. More recent indicators suggest continued strength. Although the growth in spending on household services may have eased a little, retail sales volumes have continued to rise swiftly. Expenditure on durable goods, including new cars, has been particularly robust. Money and credit indicators signal buoyant spending growth, with mortgage equity withdrawal in the second half of 2001 at its highest level since 1990 as a percentage of household income. Consumer confidence has recovered from the post-11 September dip, and housing market indicators also point to improvements in household sentiment.

Reflecting these developments, the near-term outlook for consumer spending is a little stronger than projected in November. But the Committee continues to expect that household spending growth will slow over the course of the next year or so, reflecting earlier reductions in financial wealth and a weakening in real income growth, as labour market conditions ease. Household debt relative to income is at record levels and capital gearing has been rising, although, given current interest rates, income gearing is relatively low. As in November, there is considerable uncertainty on both the timing and pace of the projected slowdown. Nevertheless, the central projection is that consumer spending growth will decelerate towards the end of the year and will stabilise a little below long-run trend rates thereafter.

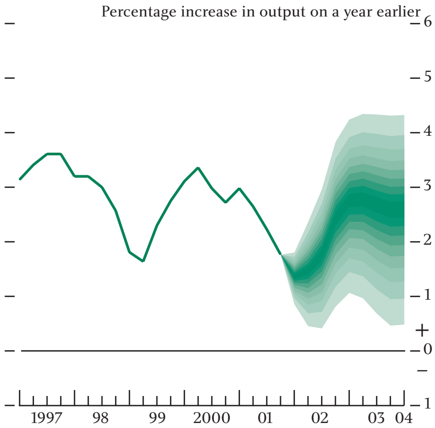
Business investment fell in 2001 Q3 and was around 2% below the projected level in November. In recent years, the volume of business investment has risen substantially as a proportion of output, stimulated by rapid falls in the relative price of capital goods which may continue. However, capacity utilisation rates have fallen recently, consistent with the cyclical slowdown in demand. It is also possible that over-optimistic expectations of future returns may have led to excess capital in some firms, which may take time to work off. Many financial indicators have deteriorated over the past year, with corporate balance sheets continuing to weaken. These financial pressures may act to restrain investment, although corporate income gearing remains moderate. The latest CBI Industrial Trends Survey and financial market indicators point to some reduction in uncertainty from the high levels following the terrorist attacks in September, although surveys of investment intentions have weakened further. Given these signs, the Committee judges that business investment may fall further in the near term, although some recovery remains likely thereafter, as the world economy improves and uncertainty diminishes as a result. The near-term outlook for whole-economy investment is rather stronger because of the sharp increase in planned government capital spending.

Inventory investment made little contribution to output growth in 2001 Q3, as further cuts in manufacturing stocks were offset by a continued build-up of inventories in other sectors. Business surveys report that manufacturing firms are continuing to shed stocks, given the intense pressures on profitability and the desire to pare costs. The adjustment to lower inventory levels is dampening current output, and, once the correction ends, there will be a corresponding boost. The aggregate impact is likely to be small, however, and the Committee has maintained the judgment that the ratio of whole-economy stocks to output is likely to be broadly flat at around present levels over the forecast period.

Export volumes have fallen in recent months as world activity has stalled, and as the demand for traded goods in particular may have contracted for a short spell. Surveys of export orders suggest continued weakness in the short term. Nonetheless, export volumes should gradually recover during 2002 and beyond as global demand revives.

The adverse impact of declining exports on aggregate activity has been partly offset by a reduction in import volumes. Cuts in imports have been particularly concentrated in lower purchases of information and communications technology equipment, given the substantial decline in demand in that sector. However, the decline in import volumes has been less than that of exports, and hence the net trade contribution to GDP growth remained negative in 2001 for the sixth successive year. Import volumes are likely to rise over the forecast period, reflecting the continued growth in domestic demand, although the pace may slacken towards the end of the period as the projected growth in domestic demand moderates slightly. The net trade contribution to UK GDP growth is likely to remain negative over the forecast period, attenuating gradually as world growth strengthens.

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 output, the Committee's current projection for four-quarter growth in GDP is shown in Chart 6.1.(1) The projection is based on the assumption of unchanged official interest rates at 4%.(2) Four-quarter growth is likely to slip further in the first half of this year, reflecting the weak near-term outlook for the world economy and reductions in corporate spending. Growth is likely to rebound subsequently to around trend rates, supported by the recovery in global demand, a pick-up in public spending growth and an upturn in business investment. Together these outweigh the impact of the projected slowdown in consumer spending. Relative to the November projection, growth is weaker in the near term, with a rather stronger rebound in late 2002 and early 2003. On average, GDP output growth over the next two years is similar to the November projection and is close to the average over the past 40 years.

The implications of the growth outlook for inflation prospects depend on the estimated pressure of demand on potential supply capacity. That remains highly uncertain. As noted in previous *Reports*, gauging the current level of supply capacity consistent with stable inflationary pressures, and its likely evolution over the forecast period, is hazardous. While data on hours worked provide a guide to current labour usage, judging potential supply is very difficult. For instance, recent estimates suggest that the growth in the UK working-age population has been somewhat faster than previously thought because of higher net immigration. It is possible that this trend might continue, although it is also possible that net immigration might slow, given the recent weakening of activity growth in the United Kingdom and a prospective recovery in demand overseas. Moreover, defining and producing an

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

estimate of the overall capital input is particularly challenging, given uncertainties surrounding, and recent revisions to, estimates of the depreciation, scrapping and aggregation of different types of capital. And even if good measures of factor inputs were available, there would still remain considerable uncertainty surrounding both the utilisation levels consistent with stable inflation and the sustainable growth in productivity. Survey evidence may provide a rough guide to current pressures. Indicators of utilisation suggest that pressures on supply capacity are easing and, although employment rates remain very high, average hours worked have fallen. Extrapolating estimates of supply potential into the future is particularly difficult. Recognising that there are major risks, the Committee incorporated the judgment in the central projection that potential output will rise in line with the long-run historical trend in GDP growth.

RPIX inflation has slowed in recent months, in large part reflecting the fall in oil prices in the second half of last year. Inflation averaged 2.0% in 2001 Q4, broadly in line with expectations three months ago. The recent slowdown has been concentrated in goods price inflation, which was slightly negative in December. Inflation in services remained around 4%. Reflecting the imbalances within the economy, the gap between services and goods price inflation is unusually wide at present. Goods price inflation is likely to remain subdued in the short term—input and output price trends in manufacturing are very weak, and surveys report additional downward pressure on prices. The near-term outlook for services prices is harder to read. The weight of recent evidence points to some lessening of cost and price pressures over the past year, although the latest BCC and CIPS surveys report a slight rise in the proportion of firms increasing prices.

Pay pressures remain muted. Headline whole-economy average earnings growth slowed to 4.2% in November from 4.5% three months earlier, with a slight reduction in regular pay growth as well as continued downward pressure from lower bonuses. There are tentative indicators from surveys and from the Bank's regional Agents that pay settlements in the 2002 pay round may be a little lower on average than in 2001, although Agents' contacts also emphasise the importance of other components of remuneration and suggest that overall pay growth per head in the private sector is likely to weaken only minimally this year. Public sector pay growth is likely to remain robust.

Earnings prospects depend on the demand for labour relative to available supply. The labour market has eased modestly since the mid-2001 peak, as unemployment has edged up from its lowest rate for more than 25 years, and as reports of labour shortages have diminished somewhat. Total hours worked have fallen. Surveys of near-term employment intentions point to a further softening in labour demand in the coming months, with quite rapid falls in manufacturing employment not wholly offset by continued recruitment in the public and private services sectors. Productivity growth has slowed below trend recently as firms typically take time to adjust their demand for labour in response to a change in demand conditions. As a consequence, there may be some correction in employment levels over the forecast period. But, against this, given the costs of recruitment, training and redundancy payments, companies have incentives to retain experienced employees if the perceived decline in demand for their output is limited and temporary. So, given the central projection of only a relatively shallow downturn in activity in the United Kingdom, with prospective growth in output around trend over the next two years, the Committee continues to judge that the labour market is likely to loosen only moderately.

Earnings growth also depends on inflation expectations. Most surveys of inflation expectations have drifted down a little in recent months, and suggest that inflation will slightly undershoot the target during the next twelve months. That may act to dampen nominal earnings growth. Surveys and expectations of inflation implied in financial market contracts continue to suggest that inflation expectations are relatively well anchored by the $2\frac{1}{2}$% inflation target in the medium term.

The outlook for nominal earnings growth is broadly similar to November. Pay growth is likely to drop temporarily to low levels in early 2002, unwinding the bonus-related spike in earnings in early 2001. But earnings growth should rebound quickly and is likely to remain around recent rates subsequently.

Reflecting the likely trends in cost and price pressures, the Committee's current projection for twelve-month RPIX inflation is shown in Chart 6.2.(1) The projection is based on the assumption that official interest rates remain at 4% over the next two years.(2) It is presented alongside the corresponding projection from the November *Report*, which was also conditioned on constant interest rates at 4% (see Chart 6.3).

On the central projection, RPIX inflation is likely to remain close to current levels over the next year or so, edging up a little thereafter towards the target by the two-year horizon and

(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%

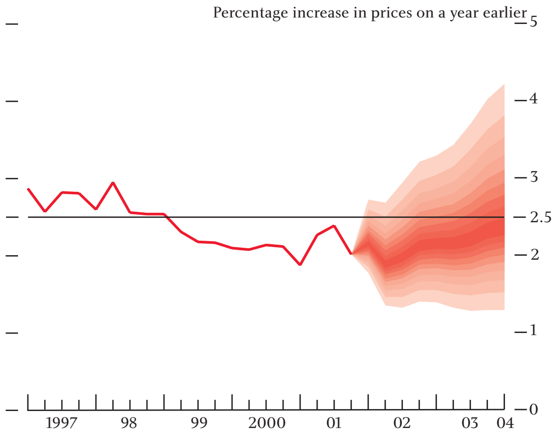
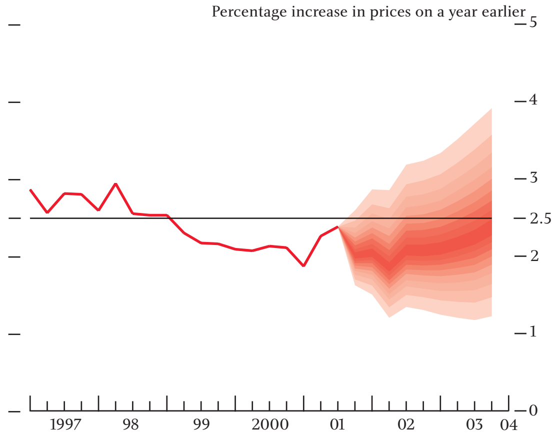


Chart 6.3
RPIX inflation projection in November based on constant nominal interest rates at 4%



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. See the box 'How fan charts are drawn', on page 52 of the February 1999 *Inflation Report*.

beyond. As emphasised in previous *Reports*, the monthly and quarterly inflation profiles are likely to remain erratic, reflecting the unwinding of a number of one-off influences, such as the impact of measures on specific duties in the March 2001 Budget and volatile movements in the prices of oil and of food over the past year. Abstracting from these influences, the underlying picture remains one of broadly stable inflation over the next two years. Domestic pressure on inflation is likely to ease slightly, reflecting below-trend growth towards the end of last year and in early 2002. But this is likely to be counterbalanced by a gentle rise in external pressures as the world economy gradually recovers and as the dampening effect on import price inflation in recent years from the high sterling exchange rate continues to fade. The central projection is very close to that in the November *Report*.

Given the manifest uncertainties in the prospects for output growth and inflation, the fan charts illustrated in Charts 6.1 and 6.2 incorporate an estimate of the variance of the possible outcomes, drawing on evidence from earlier forecast errors.

As noted in the November *Report*, there are a number of major risks to the outlook, which have an important influence on Committee members' interest rate decisions. Although recent outturns and the near-term outlook for global demand and prices have been a little weaker than expected, the more positive forward-looking indicators have led the Committee to reduce the weight attached to the downside risks to world prospects. Nonetheless, the balance of risks to the central projection for the world economy remains modestly on the downside, particularly reflecting high levels of private sector and external debt in the United States. Further retrenchment by either corporates or households to repair balance sheets could act as a brake on the projected recovery.

The imbalances within the UK economy have intensified over the past year, as the world economy has slowed and monetary policy has been relaxed to provide a compensating stimulus to domestic demand. That is reflected in the relatively favourable outturns for GDP growth and unemployment compared with the other major economies in 2001. Consumer spending growth has risen by close to 4% per annum for each of the past six years—well above a sustainable long-run rate. And the net trade contribution to GDP growth has been negative throughout this period, contributing to a widening current account deficit.

Given the imbalances, the Committee considers that there is a risk of a sharp retrenchment in domestic spending at some point. In particular, high and rising levels of household and corporate debt are a source of vulnerability in the event of a shock to income or a substantial change in interest rate expectations. There is a risk that a downturn in expectations about future prospects for income and growth could lower spending by households and firms. Although debt-servicing costs have been reduced by the cuts in nominal interest rates over the past year, the potential impact of such an event could be reinforced by an associated fall in asset prices, and the consequential decline in the value of collateral, which might precipitate a sharper rise in saving as households and corporates attempt to reduce their debt burden. In that event, domestic demand growth could fall well below trend, putting marked downward pressure on output growth and inflation. The likelihood and timing of such a potential correction is very difficult to judge—it could take place during the forecast period or beyond, or not at all should the debt build-up unwind only gradually. As well as downside risks in the medium term, there are also upside risks to consumption and hence inflation in the short run should households continue to borrow at recent rates. One cost of such a stronger short-run performance would be an increased likelihood of a sharp correction subsequently. The balance of opinion on the Committee is that the downside risks to private sector spending are likely to dominate over the forecast period.

Were such a correction to private spending to materialise, there is a risk of an associated fall in the sterling exchange rate. There are also downside risks to the sterling exchange rate profile from the steady widening of the current account deficit and from the possibility of a recovery in the euro at

Chart 6.4
Current projection for the percentage increase in RPIX in the year to 2004 Q1

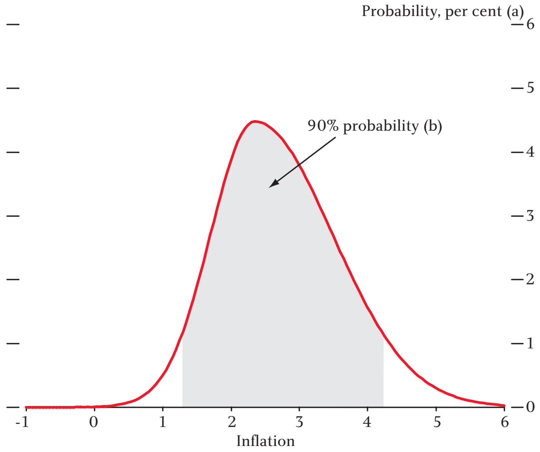
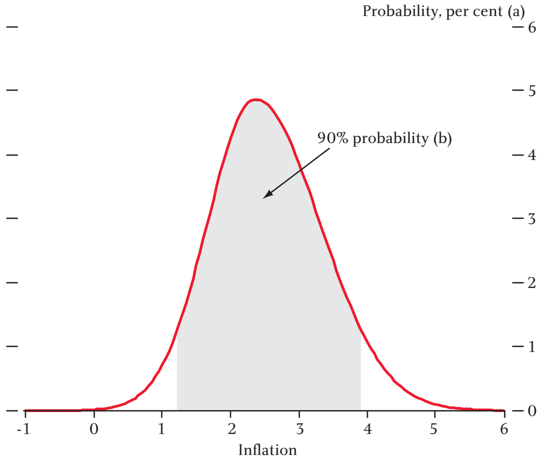


Chart 6.5
November projection for the percentage increase in RPIX in the year to 2003 Q4



Source: Bank of England.

(a) Probability of inflation being within ±0.05 percentage points of any given inflation rate, specified to one decimal place. For example, the probability of inflation being 2.5% (between 2.45% and 2.55%) in the current projection is around 4½%.
(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%
2002 Q4	6	25	35	23	9	2
2003 Q4	7	16	24	22	16	16
2004 Q1	7	15	22	21	16	20

GDP growth

Probability, per cent	Range: Less than 1%	1% to 2%	2% to 3%	More than 3%
2002 Q4	8	28	41	24
2003 Q4	12	24	33	32
2004 Q1	12	23	33	32

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

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

Difference from central projection, percentage points

	Supply-side	Impact of world slowdown on UK inflation
RPIX inflation		
2003 Q1	-0.1	0.0
2004 Q1	-0.2	-0.2
GDP growth		
2003 Q1	0.0	0.0
2004 Q1	0.1	0.1

some stage. Although there remains considerable uncertainty on the timing, magnitude and impact of a change in the exchange rate, which would depend on the prevailing circumstances, a more pronounced depreciation would of itself tend to raise sterling import prices and place upward pressure on UK output growth and inflation relative to the central projection.

The calibration of the various risks shown in the fan charts represents the best collective judgment of the Committee, taking the risks together. Relative to the central projection, the risks to the outlook for GDP growth over the next two years are weighted to the downside, as the risks to the outlook for private final demand and global demand prospects outweigh the possible stimulus from a lower exchange rate profile. The balance of risks to the inflation outlook, relative to the central projection, lies on the upside, as the prospect of a faster exchange rate depreciation and the associated adjustment to the level of import prices is the dominant influence. The probabilities of various outcomes for inflation and output growth on the best collective judgment of the Committee are presented in Table 6.A. The overall balance of risks at the two-year horizon is shown in Chart 6.4, alongside the corresponding balance in the November *Report* (see Chart 6.5).

Given the many uncertainties, there are some differences of view among the Committee on the key assumptions incorporated in the central projection and on the balance of risks around the most likely outcome. In terms of the central projection, Table 6.B presents an illustrative calibration of the most significant differences of view. In particular, some members consider that the disinflationary impact of lower world price inflation on UK price-setting may be underestimated. Further, some members believe that the high volume of investment in recent years and the impact of earlier labour market reforms are consistent with a higher level of supply potential in the UK economy than currently embodied in the central projection. That would put additional downward pressure on inflation. There is a narrow range of views among the Committee about the central projection for inflation at the two-year horizon, with individual members judging that it could be either a little higher or up to around 1/4% lower than shown in Chart 6.2.

Opinions on the balance of risks are a key consideration when individual members are forming judgments on the appropriate level of interest rates. There is considerable uncertainty on both the likelihood of various risks materialising and of their potential impact on the outlook. In particular, there is a range of views among the Committee on the risks to the outlook for private final demand, the sterling exchange rate and the world economy. Some members would attach additional weight to risks that could lead to upside pressures on output and to stronger upward pressure on inflation than incorporated in the fan charts. Other members would place additional emphasis on risks that would lead to greater downward pressure on activity and inflation than embodied in the fan charts.

Notwithstanding these differences of emphasis, the most likely outcome, based on the assumption that interest rates are maintained at 4%, is that output growth will be close to trend over the next two years, with inflation remaining close to and a little below target, but rising at the two-year horizon. Acknowledging the uncertainties and risks, the Committee

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

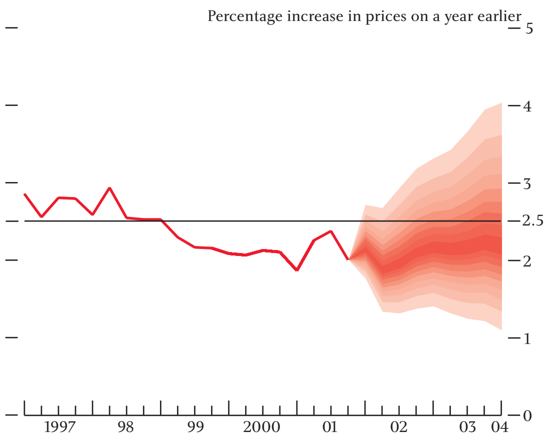


Chart 6.7
Current GDP projection based on market interest rate expectations

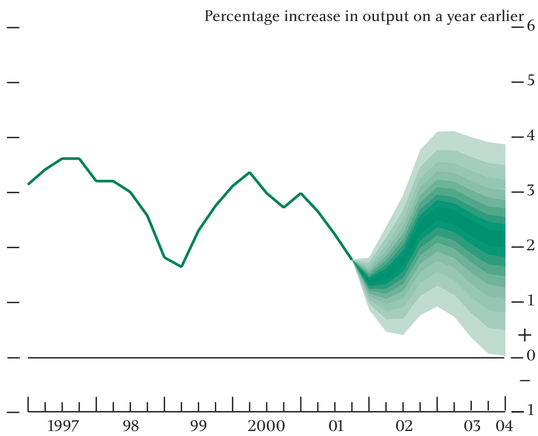


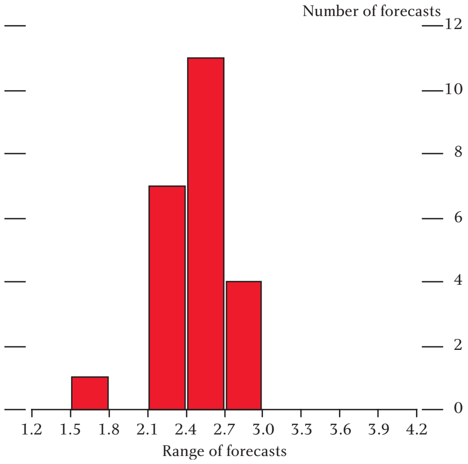
Table 6.C
Market expectations of the Bank's official interest rate(a)

Per cent

2002				2003				2004
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
4.0	4.1	4.4	4.8	5.0	5.1	5.2	5.2	5.3

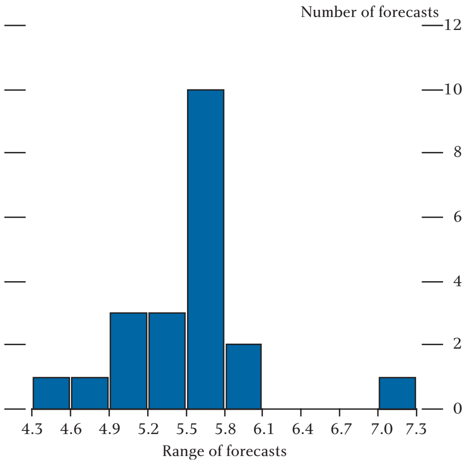
(a) Based on the interest rate available on gilt-edged securities, including those used as collateral in short-term repurchase contracts, plus a small upward adjustment to allow for the average difference between this rate and the Bank's official interest rate. The data are 15-day averages to 6 February 2002.

Chart 6.8
Distribution of RPIX inflation forecasts for 2004 Q1



Source: Forecasts of 23 outside forecasters as of 25 January 2002.

Chart 6.9
Distribution of repo rate forecasts for 2004 Q1



Source: Forecasts of 21 outside forecasters as of 25 January 2002.

decided to maintain interest rates at 4% at its policy meeting on 6–7 February.

Market expectations of the likely path of future official interest rates have risen since November. Based on financial market prices in the 15 working days up to and including 6 February, market participants judged that rates would remain around current levels in the first half of this year, and gradually drift up thereafter. Based on the same approach as in previous *Reports*, official rates could edge up to 5% or a little above over the next year or so (see Table 6.C). The Committee's latest projections based on these interest expectations are presented in Charts 6.6 and 6.7, and indicate a weaker outlook for output growth and inflation than in the constant interest rate fan charts. As noted in Section 1 of the *Report*, however, there is a possibility that the current approach to generating market interest rate expectations may somewhat exaggerate the expected levels, because of the risk premium required by lenders as compensation for the risk of capital losses when they invest in longer-term assets.

6.3 Other forecasts

In January, 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 2002 Q4 was 2.2% (with a range of 1.6% to 2.8%), rising to 2.4% in 2004 Q1 (with a range of 1.6% to 2.9%). The distribution of central projections in 2004 Q1 is shown in Chart 6.8. Compared with the survey results in the November *Report*, the average forecast for inflation at the two-year horizon is slightly lower, and the dispersion of forecasts has widened. On average, external forecasters see a 59%

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

RPIX inflation (a)

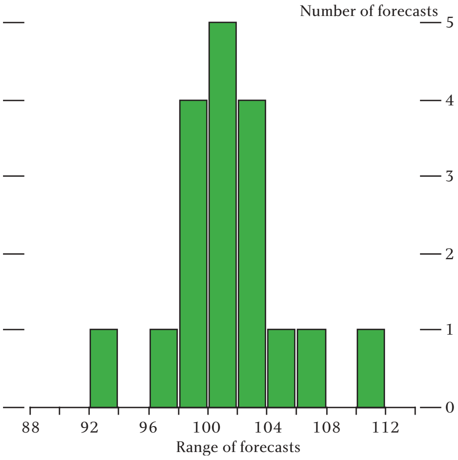
Probability, per cent	Range: Less than 1.5%	1.5% to 2.0%	2.0% to 2.5%	2.5% to 3.0%	3.0% to 3.5%	More than 3.5%
2002 Q4	7	24	41	19	7	2
2003 Q4	5	19	36	25	10	5
2004 Q1 (b)	6	18	34	25	11	5

GDP growth (b)

Probability, per cent	Range: Less than 1%	1% to 2%	2% to 3%	More than 3%
2002 Q4	12	25	41	22
2003 Q4	12	23	41	25
2004 Q1 (c)	12	21	43	25

(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 6% to inflation turning out to be less than 1.5% in 2004 Q1.
(b) 23 forecasters.
(c) 22 forecasters.

Chart 6.10
Distribution of sterling ERI forecasts for 2004 Q1



Source: Forecasts of 18 outside forecasters as of 25 January 2002.

probability of inflation being below 2.5% in 2004 Q1, and a 41% probability of it being above (see Table 6.D).

The forecasters' average projection for four-quarter GDP growth in 2002 Q4 is $2^1/_2$% (with a range of 2% to $3^1/_2$%), little changed from the average forecast reported in November. The average projection for growth in 2004 Q1 is also $2^1/_2$% (with a range of 2% to 3%).

The average forecast for the official interest rate is $4^3/_4$% in 2002 Q4 (with a range of 4% to $5^1/_2$%), rising to $5^1/_2$% in 2004 Q1 (with a range of $4^1/_2$% to $7^1/_4$%). This is 25 basis points lower than the average of November forecasts for 2002 Q4 but close to the average November forecast at the two-year horizon (see Chart 6.9). On average, forecasters assume that the sterling ERI will be $103^1/_4$ in 2002 Q4 (with a range of 99 to $108^1/_4$) and will then fall to $101^1/_4$ in 2004 Q1 (with a range of 94 to $110^1/_4$) (see Chart 6.10).

Bank of England
Agents' summary of business conditions

February 2002

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-November and mid-January. It provides information on the state of business conditions, from firms across all sectors of the economy. The report does not represent the Bank's own views, nor does it represent the views of any particular firm or region. The Bank's Monetary Policy Committee uses the intelligence provided by the Agents, in conjunction with information from other sources, to assist its understanding and assessment of current economic conditions.

- Manufacturing output and orders continued to fall over the period, with little sign of recovery. Output of consumer goods for the domestic market remained quite buoyant, but was insufficient to offset the downturn elsewhere.

- Construction output growth stabilised at a high rate, with no sign of any slowing. The housing market remained strong.

- Service sector output growth increased a little. There was a slight recovery of growth in business services, which had previously been easing, but companies continued to cut back on non-essential spending. Growth in consumer services continued to rise, and confidence in the tourism industry improved.

- Robust retail sales growth was reported in the run-up to Christmas and in the 'sales' afterwards. Spending was very strong on a wide range of goods. Contacts reported continued rapid growth in new car sales to the personal sector.

- Export markets deteriorated further. Exports to the United States fell the most, but European markets, particularly Germany, were also weak. Import penetration continued to increase as a result of lower-cost supplies from overseas.

- Investment intentions continued to weaken in both the manufacturing and service sectors. Agencies reported that many investment decisions had been deferred, largely due to uncertainty about the world economic climate.

- Most raw materials prices fell. However, many non-materials costs continued to rise, notably insurance. Manufacturers' output prices were broadly stable. Retail goods prices were also little changed, although buoyant consumer demand meant that Christmas discounting began later, and was on a narrower range of stock than in the previous year. Service price inflation was broadly stable.

- The Agencies reported a slight easing in the labour market. Manufacturing redundancies increased. By the end of the period, there were also reports of lay-offs and recruitment freezes in the financial and business services and travel sectors, although employment in retailing continued to rise. Overall pay pressure moderated.

(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

Prospects for the agricultural sector appeared to have improved slightly since the previous *Agents' Summary*, but the sector continues to face numerous challenges. Contacts reported a recovery in some meat prices, following the easing of foot-and-mouth disease (FMD) related restrictions. Autumn planting for cereal crops had been more successful than a year earlier, when wet weather had restricted sowing, but it was expected that this would lead to falls in the prices of these products. Surplus production of milk was putting downward pressure on dairy prices.

Manufacturing

Output and orders continued to decline, with little sign of recovery. The slowdown in world demand and increased competition from Eastern Europe and Asia were reported to be the main constraints on output. Demand for capital goods had fallen most rapidly, largely due to cuts in investment expenditure by manufacturers. In some cases, orders had been cancelled, sometimes leading to an increase in stocks. There were further reports of production being moved out of the United Kingdom.

Output of the information and communications technology (ICT) industry continued to decline, despite occasional reports of an improvement in output of IT equipment. However, for the industry as a whole, no general improvement in output or orders was expected until mid-2002.

Aerospace output fell after 11 September. Agents reported that a sharper downturn was likely in the early part of 2002, as orders adjusted fully to the sharp decline in demand for civil aircraft.

Output of consumer goods for the domestic market remained relatively robust. The food and pharmaceuticals industries generally maintained output and orders. Other relatively strong areas were cars and construction equipment.

Construction and housing

Construction output continued to grow, with no clear sign of any slowing. There were, however, some reports of construction work on luxury hotels being cancelled following the events of 11 September. Retail, leisure and warehouse development remained buoyant, but Agencies continued to report declining demand for commercial and industrial property development.

There were further reports of strong growth in public sector construction. School, hospital and road repairs were frequently cited as areas of high activity. Labour shortages and planning delays remained the main constraints on construction sector output.

Demand for housing was robust over the period, and this was expected to continue throughout 2002. But there were occasional reports of weakening demand at the top end of the market.

Services

Since the previous *Agents' Summary*, services growth has increased slightly.

There were sharp falls in the growth of business services following 11 September, but this slowing had eased by the beginning of 2002, and some contacts reported that activity would recover further over the coming months. Companies continued to cut back on discretionary spending such as advertising, printing and consultancy. Spending on corporate entertainment over the Christmas period was reported to have been lower in 2001 than in 2000. Corporate demand for hotels remained weak, as did the demand for business travel.

Professional services contacts saw a further decline in mergers and acquisitions and flotation work, but demand for insolvency and restructuring work increased.

Growth in consumer services remained robust. Demand for outdoor leisure increased over the period, due to mild autumn weather and the ending of FMD. Although visitor numbers from abroad were expected to remain weak, contacts believed that there would be some offset in the form of stronger demand for domestic holidays from UK residents. Demand for consumer credit continued to strengthen.

DEMAND

Consumption

Rapid retail sales growth was seen, both immediately before Christmas and in the 'sales' afterwards. The number of customers in stores and spending per customer were both reported to have been higher during the 2001 Christmas period than a year earlier. There was little sign of any further slowing in demand for big-ticket items, as noted in the previous *Agents' Summary*.

Consumer spending on leisure attractions and in bars and restaurants remained buoyant throughout the period. But this strength was driven by domestic spending, rather than by overseas visitors. Spending on overseas holidays increased, except for holidays to the United States.

Contacts reported continued strong growth in new car sales to the personal sector. However, demand for fleet cars continued to decline. Car-hire firms said that they had reduced their fleets due to a fall in the number of overseas tourists and businessmen visiting the United Kingdom.

Exports and imports

Export markets have deteriorated further since the previous *Agents' Summary*. Most notably, Agencies reported that exports to the United States declined over the period. Sales to Europe were also weak, especially to Germany, but did not fall as sharply as those to the United States. Sales to Eastern Europe and the Middle East were reported to have increased. Exporters did not expect any significant improvement in total export sales before the second half of 2002.

Import penetration continued to increase. Manufacturers increasingly purchased components and sub-assemblies from overseas, causing a rise in imports of unfinished goods. Moreover, firms continued to move production abroad to take advantage of lower costs, causing a rise in imports of finished goods that were previously produced in the United Kingdom. Several Agencies reported that EU exporters had targeted the United Kingdom recently due to weaker demand in other markets, such as the United States.

Investment

Investment intentions continued to deteriorate in both manufacturing and services, largely reflecting uncertainty following the events of 11 September. Agencies stated that firms had become far more cautious about investment, and many decisions had been deferred, particularly by firms with US parents.

Where investment had taken place, it had mainly been to increase efficiency or to comply with regulations (and offset the effect of taxes such as the Climate Change Levy). Investment aimed at increasing capacity was rare. Several contacts stated that investment during 2002 was unlikely to outpace depreciation.

The main industries intending to maintain or increase investment compared with 2001 were retail, pharmaceuticals and food processing.

COSTS AND PRICES

Input prices

Most materials prices fell over the period. In many cases, this reflected further outsourcing of inputs to overseas suppliers and more effective purchasing arrangements. Oil price falls had fed through to energy, polymer and chemicals costs. There were slightly fewer examples of price increases for construction materials. But prices are expected to increase further in April 2002, when the Aggregates Tax takes effect.

Some non-materials costs continued to increase over the period. The most common concern was the rising cost of insurance, and many contacts stated that they had accepted higher excesses and lower cover in order to keep cash outlays down. Commercial rent and regulation costs increased further.

Airfreight costs fell following 11 September, but more recently have increased slightly, due to a reduction in capacity. Business travel prices continued to fall.

Output prices

Output price inflation in the manufacturing sector remained subdued. Agencies reported very little opportunity for contacts to increase prices, largely due to intense competitive pressure. This was particularly true for sectors heavily exposed to competition from overseas manufacturers. Price increases were typically only possible for new or customised products.

Service sector inflation continued to slow. Experience within the sector was quite mixed. Firms affected by 11 September, such as hotels and airlines, cut prices over the period, and prices of advertising and consultancy also fell. However, some professional firms were able to increase charges for specialist services (although not for routine work).

Retail prices

Retail goods prices were broadly flat over the period, with deflation in some areas. The lower cost of many imported goods had often been passed on to consumers. But where prices had fallen, contacts expected an easing in the rate of deflation throughout 2002.

Discounting over the Christmas period began later than usual because of strong consumer demand. When it had begun, discounting was as deep as in the previous year, but applied to a narrower range of stock. This was partly due to tighter stock control throughout 2001.

New car prices were stable during the period. Many car rental firms sold part of their fleet following 11 September, causing a fall in used car prices.

Service price inflation remained broadly stable, although there were significant variations within the sector. Prices in pubs and restaurants increased, due to buoyant demand. But several Agencies reported that hotels had been unable to increase prices.

Pay

There was a sustained easing in overall pay pressure during the period, with fears about job security said to be restraining 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 had also continued to ease, but remained stronger than in manufacturing. Settlements in both sectors were reported to have been lower than in the previous year.

Agencies noted a further shift away from across-the-board pay settlements towards local discretionary pay, in order to target performance. In many cases, it had been necessary to vary pay settlements within firms, in order to restore differentials following the increase in the National Minimum Wage in October. Bonuses were reported to have been lower this year than last, particularly in professional services. Many contacts were concerned about the rising cost of pensions, and were reviewing their expenditure in this area.

Where skill shortages persisted, notably in the construction trade, pay growth remained well above the rate of RPIX inflation.

EMPLOYMENT

Manufacturing redundancies increased in most areas during the period. Some of the redundancies that were announced at the end of 2001 were expected to take effect over the next few months. But several Agencies reported that manufacturers were retaining a stock of skilled staff in case of an upturn in the near future.

Service sector employment continued to be more robust than that of the manufacturing sector. But many Agencies reported redundancies and employment freezes in financial and business services and the travel sector. Recruitment agencies noted fewer vacancies for telecommunications specialists and hotel and catering staff. Contacts also reported reduced graduate recruitment. However, there was continued strong employment growth in retailing and in the public sector.

Skill shortages continued to ease in some sectors over the period, although they remain a concern for many contacts. Skilled construction workers, HGV drivers and some professional services workers remained in particularly short supply.

Text of Bank of England press notice of 5 December 2001

Bank of England maintains interest rates at 4.0%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 4.0%.

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

Text of Bank of England press notice of 10 January 2002

Bank of England maintains interest rates at 4.0%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 4.0%.

The minutes of the meeting will be published at 9.30 am on Wednesday 23 January.

Text of Bank of England press notice of 7 February 2002

Bank of England maintains interest rates at 4.0%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 4.0%.

The Committee's latest inflation and output projections will appear in the *Inflation Report* to be published on Wednesday 13 February.

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

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

Abbreviations

BCC: British Chambers of Commerce.
BRC: British Retail Consortium.
CBI: Confederation of British Industry.
CCL: Climate Change Levy.
CIPS: Chartered Institute of Purchasing and Supply.
DHL: DHL International (UK) Ltd.
DTLR: Department of Transport, Local Government and the Regions.
EEF: Engineering Employers' Federation.
FTSE: Financial Times Stock Exchange.
GDP: gross domestic product.
GfK: Gesellschaft für Konsum, Great Britain Ltd.
ICT: information and communications technology.
ILO: International Labour Office.
IMF: International Monetary Fund.
ISM: Institute for Supply Management.
IT: information technology.
LFS: Labour Force Survey.
MEW: mortgage equity withdrawal.
MPC: Monetary Policy Committee.
NAPM: National Association of Purchasing Managers.
OECD: Organisation for Economic Co-operation and Development.
OFCs: other financial corporations.
ONS: Office for National Statistics.
OPEC: Organisation of Petroleum Exporting Countries.
PBR: Pre-Budget Report.
PNFCs: private non-financial corporations.
RICS: Royal Institution of Chartered Surveyors.
S&P: Standard & 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.