

# Inflation Report

November 2003

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

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

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

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

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## Overview

*The global economic recovery appears to be gaining momentum, though the pattern is uneven. Output growth in the United Kingdom was close to trend in the second and third quarter. Estimates of output growth at the turn of the millennium have been revised up and the demand mix altered. The Committee's central projection, with official interest rates unchanged at their new level of 3.75%, is for quarterly GDP to grow a little faster than trend throughout the forecast period. Annual RPIX inflation has remained above the target, at 2.8% in the third quarter. Private sector pay pressures have been subdued and the impact on import prices from sterling's depreciation earlier this year has so far been modest. Although the influence of house prices on inflation is likely to diminish, underlying inflationary pressures are expected to build gradually into the medium term. At the new higher level of interest rates, the central projection is for RPIX inflation to remain around the target over the forecast period.*

There are signs that global economic growth is strengthening, though the pattern of recovery remains uneven. Output in the euro area has been broadly flat though forward-looking indicators suggest that a revival in growth may be in prospect. Growth in the United States picked up to well above trend in Q3 and surveys suggest a strong performance is in prospect for the final quarter. Despite a significant policy stimulus, there remains some uncertainty about the sustainability of the US recovery. The data for GDP point to strong growth in Japan, though other indicators are more ambiguous. Domestic demand appears to have grown strongly in the rest of Asia. Because of the weakness in the euro area, the outlook in UK-weighted terms is marginally softer than in the August Report.

Equity prices have continued to recover in most markets. Short and long-term interest rates in the euro area and the United States are little changed since August, though the UK yield curve has shifted up. There have been further movements in bilateral exchange rates, and the dollar has continued to decline. The effective exchange rate for sterling has appreciated modestly.

The growth pause in the United Kingdom at the beginning of this year now appears to have been short-lived: GDP is estimated to have increased by 0.6% in both the second and third quarter. Service sector output growth, which dipped in the first half of the year, has recovered and construction appears buoyant, though manufacturing remained flat. Business surveys are consistent with an improving outlook.

Consumers' expenditure growth returned to trend in the second quarter and robust retail sales growth points to a similar outturn in Q3. But that is lower than the rates of growth seen in recent years. Housing market activity has picked up and quarterly house price inflation, which had been easing, has edged up. High levels of secured and unsecured borrowing continue to support household consumption. The outlook is for household spending growth to remain close to trend, a somewhat stronger prospect than in August.

Fixed investment recovered in the second quarter, unwinding the weak performance at the start of the year. Better business conditions, a pickup in profits and improving investment intentions point to further growth in capital spending by businesses, but low capacity utilisation in some sectors and high corporate debt are likely to temper any recovery.

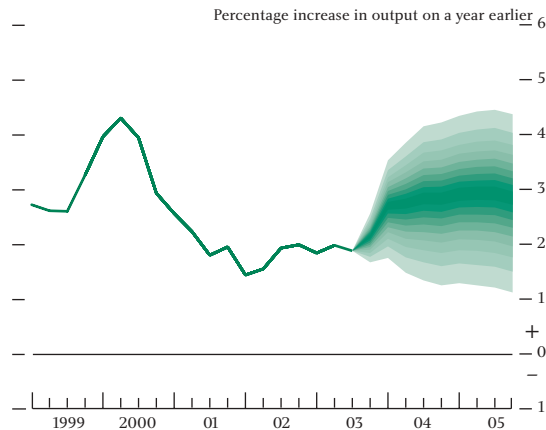
Public spending in cash terms has continued to rise rapidly, though real spending grew only moderately in Q2. That may reflect the inherent difficulties in measuring public sector output accurately.

The ONS has revised up the growth of output around the turn of the millennium. The current level of GDP is consequently rather higher than previously thought. The pattern of real demand growth over the past has also been revised. Consumer spending is now believed to have risen somewhat less rapidly, investment to have grown more strongly and net trade to have been less of a drag. But the overall picture of the pattern of demand in the UK economy over the past few years—growth near trend, with strong domestic demand growth offsetting external weakness—is qualitatively unaffected by the revisions.

Chart 1 shows the MPC's assessment of the outlook for four-quarter GDP growth, on the assumption that the official interest rate remains at 3.75%. Under the central projection, quarterly GDP growth remains marginally above trend throughout the forecast period. The broad picture is one of steady growth in consumer spending, combined with strong growth in public expenditure and a modest expansion in business investment. The profile for GDP growth is rather stronger than that in the *August Report*.

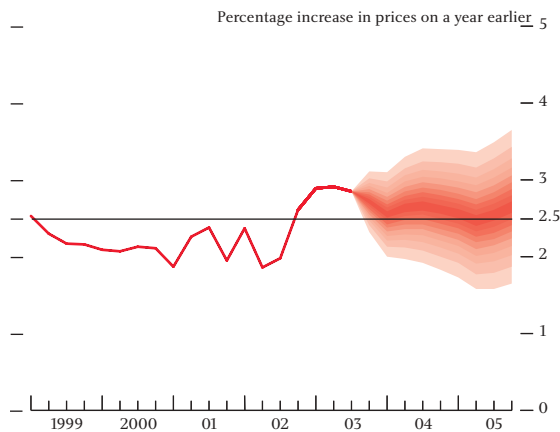
Annual RPIX inflation has continued to run a little above the 2.5% target, edging down to 2.8% in September. Inflation measured by the harmonised index of consumer prices (HICP) was 1.4%. The gap between the two measures has been unusually wide over the past year, reflecting the inclusion of housing costs in RPIX. That gap has begun to narrow.

**Chart 1**  
**Current GDP projection based on**  
**constant nominal interest rates at 3.75%**



The fan chart depicts the probability of various outcomes for GDP growth in the future. 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 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 on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

**Chart 2**  
**Current RPIX inflation projection based**  
**on constant nominal interest rates at 3.75%**



The fan chart depicts the probability of various outcomes for RPIX inflation in the future. 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 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 on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

Imported inflationary pressures have been muted. Oil prices are little changed, though non-oil commodity prices have risen. Internationally traded goods prices have been stable and sterling’s depreciation earlier this year has not so far had a significant impact on import costs.

Domestic cost pressures also remain subdued. Though public sector pay growth has been strong, there has been little sign of any pickup in the private sector. Unemployment remains low and there are indications that the labour market may be starting to tighten. The strengthening in activity is likely to raise earnings growth, but a corresponding cyclical recovery in productivity should limit the impact on unit labour costs.

Unlike the past data for GDP, RPIX inflation was unrevised. So either potential output must have been higher than previously believed or the combined effect of other influences on inflation must have been more benign. The Committee has assumed that the factors that have been bearing down on inflation will persist through the forecast period. The data revisions consequently have little impact on the Committee’s assessment of prospective inflationary pressures.

Chart 2 shows the Committee’s assessment of the outlook for RPIX inflation. In the central projection, inflation edges down further in the near term, reflecting the diminishing impact of housing costs, and then stays close to target for the remainder of the forecast period. Imported and domestic cost pressures are building gradually into the medium term. The profile is somewhat higher than in the August *Report*. There is a range of views among members, though the differences are relatively narrow.

As always there are considerable risks surrounding these projections. They mainly concern the outlook for the world economy, the prospects for the UK household sector, the implications of the revised GDP data for inflationary pressure, and the prospects for earnings. Relative to the central projection, the Committee judges that the overall risks to growth are slightly on the downside and those to inflation are broadly balanced. Compared with the August *Report*, those risks are now more evenly balanced.

At its November meeting, the Committee noted that, although some of the factors keeping inflation above target in recent months were expected to unwind, underlying inflationary pressures were projected to build gradually into the medium term. Given the outlook for inflation, the Committee judged that a modest increase of 0.25 percentage points in interest rates to 3.75% was necessary to keep inflation on track to meet the target.

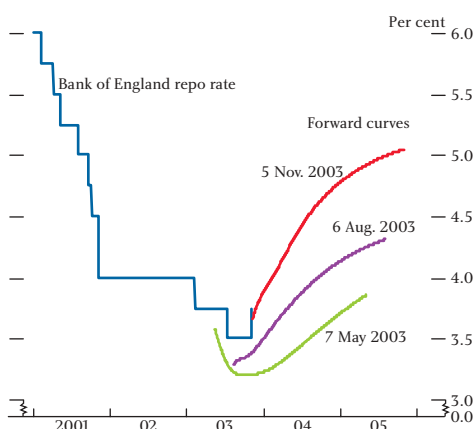
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The MPC increased interest rates by 0.25 percentage points to 3.75% on 6 November. The profile of UK short-term interest rates has steepened since May, and is consistent with expectations of increasing official interest rates. Bond yields have risen in the United Kingdom, and have picked up sharply in Japan, but have changed little in the United States and the euro area. There have been moderate increases in equity prices in most major countries, including the United Kingdom, and a larger rise in Japan. The sterling ERI has increased a little over the past three months, while the US dollar has fallen against most currencies. In the United Kingdom, housing demand appears to have picked up in the third quarter, house price inflation remained high, and household borrowing has continued to grow strongly.

**Chart 1.1**  
Bank of England repo rate and GC repo/gilt<sup>(a)</sup>  
two-week forward curves<sup>(b)</sup>



Source: Bank of England.

- (a) A general collateral (GC) repo rate is the rate that one financial institution pays to borrow money from another when it effectively offers any gilt as a security against default.
- (b) The two-week rate implied for a future period by comparison of shorter-term and longer-term interest rates available on a given date.

## 1.1 Asset prices

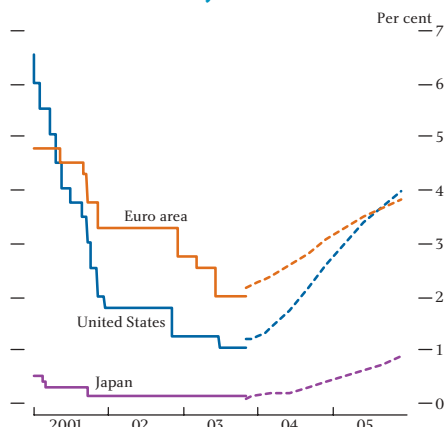
### Short-term interest rates

On 6 November, the Monetary Policy Committee increased the repo rate by 0.25 percentage points to 3.75%; in the previous three months official interest rates had not been changed. On 5 November, the general collateral (GC) repo/gilt forward curve suggested that market participants expected interest rates to rise in 2004 and 2005. The forward curve has steepened since May (see Chart 1.1). But that steepness has probably overstated the expected increases in the official repo rate, as it partly reflected term premia to compensate lenders for interest rate uncertainty.<sup>(1)</sup> A poll of economists taken by Reuters on 28 and 29 October suggested that, on average, respondents expected the official repo rate to be 3.7% at the end of 2003, increasing to 4.4% by the end of 2004.

Central banks in the United States, the euro area and Japan have left official interest rates unchanged during the past three months. Futures contracts suggest that in the United States and the euro area interest rates are expected to be broadly constant for around six months. Thereafter, interest rates are expected to increase (see Chart 1.2). The futures curve for the United States in early November was slightly lower than in early August, and the curve for the euro area was largely unchanged. The futures curve for Japan suggests that rates are expected to remain low through 2004, but expectations for rates in 2005 have been revised up since August.

(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.

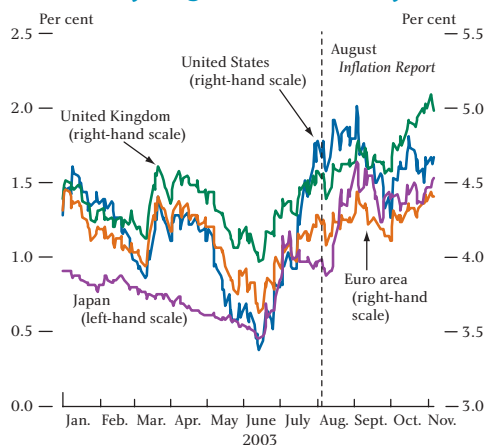
**Chart 1.2**  
**Official interest rates and forward interest rates in some major economies<sup>(a)</sup>**



Sources: Bank of England and Bloomberg.

(a) Solid lines are official interest rates. Broken lines represent annualised three-month interest rates implied by futures contracts on 5 November 2003.

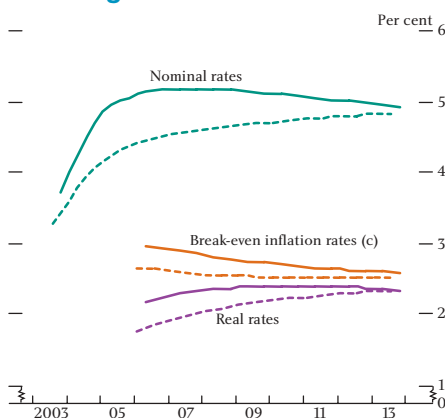
**Chart 1.3**  
**World ten-year government bond yields<sup>(a)</sup>**



Sources: Bank of England and Bloomberg.

(a) For the United Kingdom, the United States and the euro area, these are estimates of the yield on a synthetic, zero coupon bond, derived from yields on conventional bonds. For Japan, these are yields on conventional bonds.

**Chart 1.4**  
**Forward curves<sup>(a)</sup> in August and November<sup>(b)</sup> from UK government bonds**



Source: Bank of England.

(a) The expected path of one-month interest rates implied by comparison of shorter-term and longer-term interest rates.  
 (b) Solid lines represent forward curves on 5 November, and dashed lines represent curves on 6 August.  
 (c) The rate of RPI inflation in the future required to equalise yields on conventional and index-linked bonds.

**Government bond yields**

The yield on a conventional government bond reflects market expectations of nominal interest rates over the lifetime of that bond. In the United Kingdom, between early August and early November, the nominal spot yield on ten-year government bonds increased by 0.5 percentage points to 5.0% (see Chart 1.3). Chart 1.4 shows how the corresponding forward curves have changed over this period. The increases in nominal forward rates were largest at the one-year horizon—around 0.7 percentage points—while the nominal forward rate in 2013 was almost unchanged.

Roughly half of the increase in nominal yields reflects higher break-even inflation rates<sup>(1)</sup> (see Chart 1.4). That might be associated with speculation that the proposed change from an RPIX to an HICP inflation target will raise RPI inflation in the medium term. It could, in part, reflect higher expectations of RPI inflation, relative to RPIX inflation, due to changed forecasts for the path of interest rates. But it is also consistent with greater uncertainty about future RPI inflation. Nevertheless, at the ten-year horizon, implied RPI inflation expectations remain close to 2.5%.

Ten-year government bond yields in the United States on 5 November were little changed from the time of the August Report, while they increased by 0.2 percentage points in the euro area (see Chart 1.3). Yields on Japanese government bonds increased by 0.6 percentage points over the period, consistent with market participants revising up their expectations of growth and inflation in Japan. Nevertheless, yields on Japanese bonds remained around 3 percentage points lower than in other major economies.

**Equity prices**

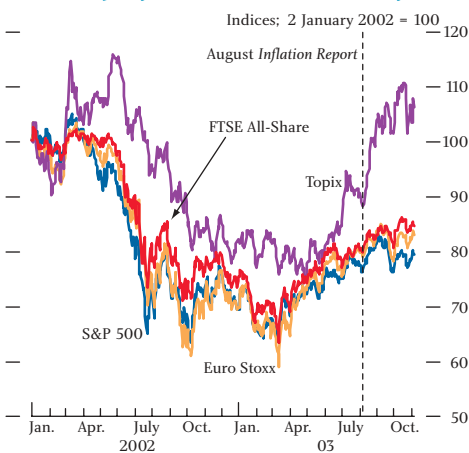
Since the August Report, equity prices in the major economies have risen, although to varying degrees (see Chart 1.5). Equity prices increased moderately in the United States and the euro area over the period, with some volatility around the time of the publication of the G7 finance ministers' communiqué on 20 September. There was a larger increase in Japanese equity prices, corroborating evidence from the bond market of higher expected growth there.

In the 15 working days to 5 November, the FTSE All-Share index averaged 2131—the starting assumption used in the MPC's projection. This was an increase of 5.5% compared with the equivalent average used in the August Report, and was up

(1) See Scholtes, C (2002), 'On market-based measures of inflation expectations', *Bank of England Quarterly Bulletin*, Spring, pages 67–77, for a description of how these are derived.



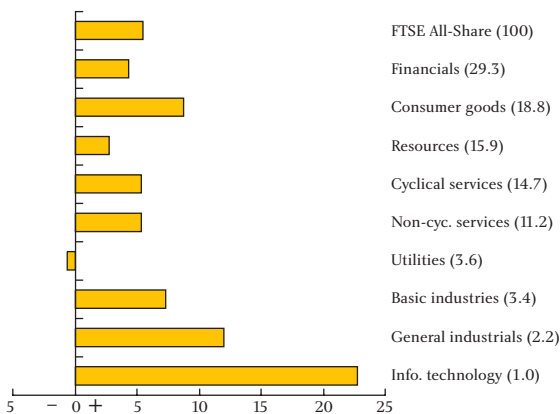
**Chart 1.5**  
World equity markets since January 2002<sup>(a)</sup>



Sources: Bank of England and Bloomberg.

(a) All equity price indices have been converted into sterling.

**Chart 1.6**  
FTSE All-Share sectoral indices: percentage change since the August Inflation Report<sup>(a)</sup>



Note: Figures in parentheses are weights in the FTSE All-Share based on market values on 6 August 2005.

Source: Bloomberg.

(a) Average share price in the 15 working days to 5 November, compared with that in the 15 working days to 6 August.

**Chart 1.7**  
Sterling ERI



Source: Bank of England.

34% from its most recent trough on 12 March. The increase was fairly broadly based, with similar rises in nearly all sectors. But equity prices of companies operating in the information, communications and technology (ICT) sector increased particularly sharply over this period (see Chart 1.6), suggesting a large upwards revision to the prospects for their profits (see Section 2, pages 16–17 for a discussion of the role of the ICT sector in the world investment cycle).

**Exchange rates**

The sterling effective exchange rate index (ERI) measures the UK exchange rate against a basket of other currencies, weighted according to their importance in determining UK trade. In the 15 working days to 5 November, the ERI averaged 100.7, up 2.1% on the equivalent average used for the August Report. Between these periods, sterling appreciated by 2.2% against the euro and 4.9% against the US dollar, but fell by 4.0% against the yen.

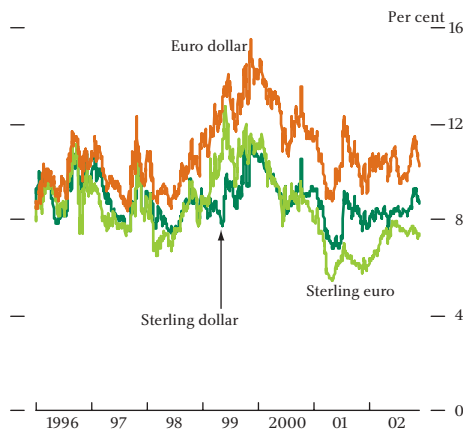
Since April 2003, the sterling ERI has been quite stable, fluctuating by less than 3% around 99 (see Chart 1.7). Options contracts suggest that the expected volatility of sterling bilateral rates against the dollar and the euro remains a little below recent average levels, and is lower than that for the euro dollar exchange rate (see Chart 1.8). That might indicate continued stability of the ERI in the short term. Furthermore, recent Consensus Economics surveys suggest that respondents judge sterling bilateral exchange rates to be broadly sustainable.

Since early 2002, the main international development in exchange rates has been the fall of the US dollar—down around 20% against the euro and 15% against the yen. The continuing large US current account deficit may have caused financial markets to revise down their estimates of the sustainable dollar exchange rate. The depreciation of the dollar against other currencies might be associated with some reduction in the US current account deficit in the future. But that will also depend upon the relative growth of domestic demand in the United States, Europe and Asia.

**House prices and the housing market**

Indicators of housing market activity suggest that housing demand strengthened in the third quarter. At the start of the year net reservations of new houses and mortgage approvals fell back. Particulars delivered, which register when a transaction has been completed and so lag the early indicators, fell in the second quarter (see Table 1.A). But

**Chart 1.8**  
Six-month implied volatility of bilateral exchange rates



Sources: British Bankers' Association and Citibank.

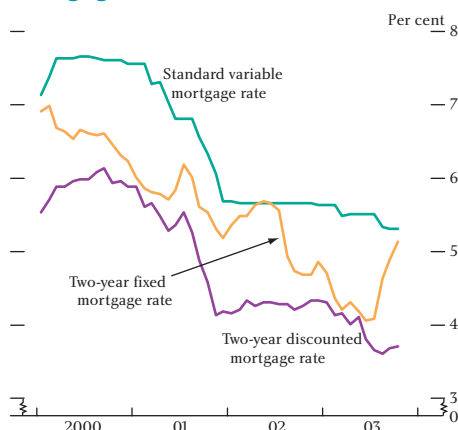
**Table 1.A**  
The housing market<sup>(a)</sup>

	2002 Q4	2003 Q1	Q2	Q3	Oct.
Indicators of transactions					
HBF net reservations (b)	9	-32	-22	14	n.a.
Mortgage approvals (c)	117	101	102	124	n.a.
Particulars delivered (d)	130	124	107	108	n.a.
Monthly percentage changes in house prices					
Halifax (e)	2.2	1.5	0.9	1.4	1.2
Nationwide	1.6	1.3	0.8	1.0	2.0

Sources: Bank of England, Halifax, House Builders Federation, Inland Revenue and Nationwide.

- (a) Quarterly data are averages of monthly observations. All data are seasonally adjusted.
- (b) Percentage balance of respondents reporting more net reservations than during the same month of the previous year.
- (c) The number of loans approved for house purchase (thousands), adjusted for the number of working days each month.
- (d) The number of transactions in England and Wales registered with HM Land Registry (thousands).
- (e) The published index has been adjusted by the Bank of England to account for a change in the method of calculation.

**Chart 1.9**  
Mortgage interest rates



Source: Bank of England.

mortgage approvals increased in Q3, and net reservations also recovered. That might have been in reaction to the reduction in interest rates by the MPC in July, which fed through into slightly lower variable mortgage rates (see Chart 1.9). But it might also have been a response to reduced uncertainty following the end of formal hostilities in Iraq.

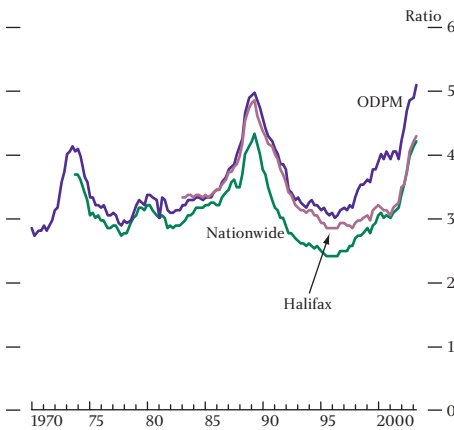
House price inflation has been well above earnings growth. That is clearly not sustainable in the medium term. The Nationwide index of house prices has increased by around 1% per month (or 13% on an annualised basis) in recent months, and the Halifax index has suggested larger increases. Furthermore, according to both indices, the rate of increase picked up a little between Q2 and Q3 (see Table 1.A). That is consistent with the apparent strengthening in demand from the indicators of housing transactions.

House prices have risen significantly, relative to average household income, since 1997 (see Chart 1.10). There are several factors that may have increased the effective demand for housing. Population growth has risen. The macroeconomic environment has been more stable with smaller fluctuations in interest rates and a lower unemployment rate. As a result, households and lenders may have revised upwards their assessment of the manageable level of mortgage debt relative to income. The low rate of general inflation, compared with the 1970s and 1980s, implies a significant reduction in nominal interest rates and hence reduced debt-servicing costs in the early years of a mortgage. That might also have increased the demand for, and supply of, mortgages for cash-constrained households.<sup>(1)</sup> Some borrowers may have lowered their expectations for real interest rates, given the historically low level of implied real rates in the UK bond market. And some households may have revised up their expectations of income growth. Despite the increases in demand for housing, the response of supply appears to have been limited—for example the number of new homes built each year has been broadly flat. So the higher demand has largely served to raise house prices.

It is difficult to evaluate the impact of these influences on house prices with any confidence, and so there is considerable uncertainty over what level of house prices is sustainable. Latest data suggest that house prices have increased faster than expected in the *August Report*, and as a consequence the MPC has raised its central projection for house price inflation in the near term.

(1) See Hamilton, R (2003), 'Trends in households' aggregate secured debt', *Bank of England Quarterly Bulletin*, Autumn, pages 271–80 and the box on pages 8–9 in the *August 2002 Report* for more discussion of these issues.

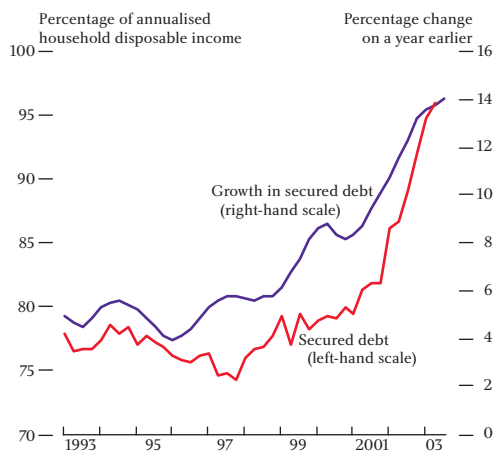
**Chart 1.10**  
Ratio of average house price to annualised disposable income per household<sup>(a)</sup>



Sources: Bank of England, Halifax, Nationwide, ODPM and ONS.

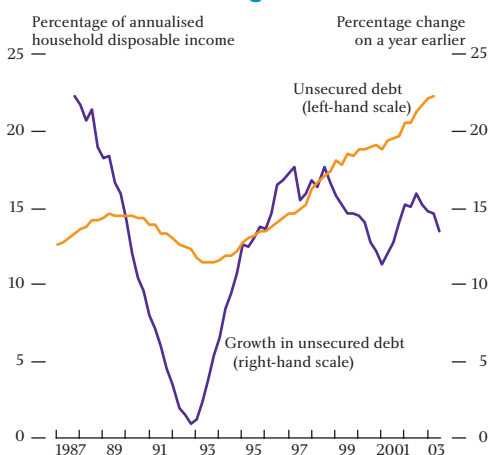
(a) Disposable income in the United Kingdom, divided by the number of households in Great Britain.

**Chart 1.11**  
Net secured lending to individuals



Sources: Bank of England and ONS.

**Chart 1.12**  
Net unsecured lending to individuals



Sources: Bank of England and ONS.

## 1.2 Money, credit and balance sheets

### Household borrowing

As a result of developments in the demand for housing and the supply of mortgages, the growth rate of secured debt has picked up sharply, to around 14% over the past year (see Chart 1.11). The stock of outstanding mortgage debt increased from 76% of household income in 1997 Q1, to 96% in 2003 Q2. Related to this, mortgage equity withdrawal (MEW)—new secured borrowing, less spending to maintain or augment the housing stock—also increased sharply. As discussed in the box on pages 8–9, the increase in MEW is partly a result of households actively raising finance by increasing the value of their mortgages on their existing homes. But a significant proportion of the rise in MEW reflects increased borrowing by first-time buyers and others moving to more expensive properties, resulting in higher equity withdrawal by last-time sellers and those who are moving to cheaper properties.

Unsecured borrowing—through credit cards, overdrafts, and other loans—has grown by around 15% per year since 1995 (see Chart 1.12), enough to raise the level of nominal consumption by about 2%. The growth in borrowing has raised the stock of unsecured debt owed to UK lenders from 11% of household income in 1993, to over 22% in 2003; this increase is smaller than the cumulative impact of the lending flows, because of debt write-offs, and the sale of securitisations to overseas institutions. Outstanding credit card debt has grown particularly quickly, from 2% of income in 1993, to almost 7% in 2003. There has been an increase in the use of credit cards for transactions by individuals who pay off their outstanding balances each month. But measured credit card debt, as reported here, largely captures balances that are not paid off each month.

How significant is the growth in household debt? In principle, households should care about their net worth, which reflects the level of their debts, but also the value of their assets. Net worth affects how much income households receive, how protected they are from unexpected changes to that income, how much wealth they will have to live on once they have retired, and how much they may bequeath to future generations. If net worth were to fall below desired levels, households might save more to rebuild their balance sheets. But in aggregate, household net worth has been broadly flat over the past year, and is high compared with most of the past 16 years. Although the stock of debt has increased sharply in recent years, the fall in equity prices between 1999 and 2003 and the increase in house prices

## Mortgage equity withdrawal and household consumption

Mortgage equity withdrawal (MEW) occurs whenever, in aggregate, the household sector increases borrowing secured on housing assets without spending the proceeds on improving or enlarging the housing stock. In 1997, MEW was close to zero, but it has increased since then to around 6% of household income. This box describes how MEW is generated, and considers the extent to which the current high level of MEW might be funding consumption.

Mortgage equity withdrawal occurs in a variety of ways. A caricature is that MEW measures increases in secured borrowing taken out to fund consumption. But MEW is the net result of various types of injections and withdrawals of equity (see Table 1). In order to assess the implications of the recent high levels of MEW, it is important to understand why it has increased.

**Table 1**  
**Ways of withdrawing and injecting housing equity**

<b>Withdrawals</b>	
Last-time sales	A seller does not buy a new property, so the proceeds of the sale are released from the housing market.
Trading down	A seller moves to a cheaper property but reduces the mortgage by less, to leave a cash sum.
Over-mortgaging	A moving owner-occupier increases their mortgage by more than the difference between the old and new house prices.
Remortgaging	A borrower takes a new mortgage and increases their debt without moving properties or improving the property to the same extent.
Further advances and second mortgages	A borrower raises a further advance on an existing mortgage or takes a second mortgage without improving the property to the same extent.
<b>Injections</b>	
First-time purchases	The deposit paid by first-time buyers.
Under-mortgaging	A mover increases their mortgage by less than the difference between the old and new house price.
Under-remortgaging	A borrower takes a new mortgage, without moving properties, and reduces their debt.
Repayments of mortgage debt	Regular repayments of principal and the redemption of mortgages, except on sale or remortgaging.
Home improvements	Home improvements paid for with non-secured funds.

One way for MEW to occur is if someone inherits a house, sells it, and deposits the proceeds (last-time sales in Table 1). In this example, the household that receives the cash has not changed the amount that it has borrowed. In the housing chain that culminates in the last-time sale, it is the first-time buyer, and other households moving to more expensive properties, that have increased their borrowing. The proceeds from last-time sales are unlikely to be spent immediately on consumption. Beneficiaries are more likely to invest the proceeds and spend them over the

remainder of their lives, or even bequeath them to future generations.

A significant proportion of the increase in MEW since 1997 is probably attributable to increased proceeds from last-time sales. Since 1997, house prices have increased by around 100% on average, and so the amount of housing equity owned by older generations should also have, at least, doubled. The number of last-time sales each year is largely driven by demographic factors, so is unlikely to have changed significantly. Therefore the value of equity withdrawal from last-time sales might also have doubled since 1997. Gross equity withdrawal from this source was estimated to have been 3% of household income in 1997,<sup>(1)</sup> so the increase since then is likely to have been significant. However, first-time buyers' deposits, which are equity injections, have also risen in line with house prices. That will have partially offset the effect on MEW from last-time sales.

Some of the increase in MEW since 1997 has reflected discretionary withdrawals. As house prices, and housing equity, have increased, homeowners have been able to raise greater levels of finance than before, and at lower interest rates than on unsecured debt. There is no direct measure of gross discretionary equity withdrawals. But the value of mortgage approvals, excluding those for house purchase or remortgaging, should be indicative. It increased from 2% of household income in 2000 Q2, to 4% in 2003 Q2, which suggests that discretionary withdrawals have increased significantly in recent years.

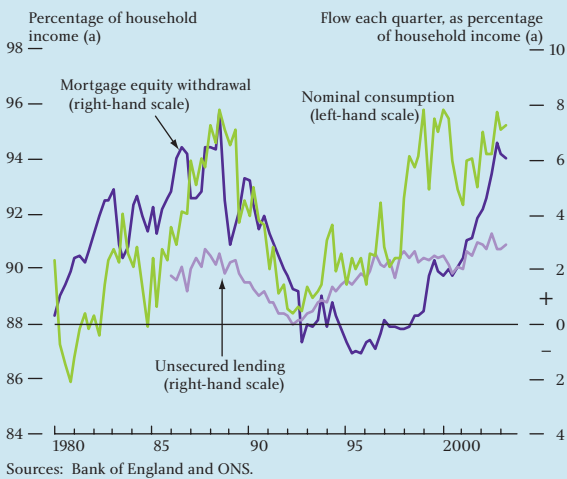
A household that actively chooses to withdraw equity is likely to have a specific purpose for the money.<sup>(2)</sup> This might be to fund home improvements, in which case it would not strictly be defined as MEW, as there is an offsetting injection of equity (see Table 1). The funds might also be used to pay off unsecured debt. But it is likely that some proportion of the equity that households actively choose to withdraw is used to purchase, for example, expensive items like cars or holidays.

One way to assess the extent to which recent increases in MEW have funded consumption is to compare the behaviour of the two series over time. Since 1980, there has been some relationship between changes in MEW and changes in the level of consumption relative to income (see Chart A). In 1997 and 1998, consumption increased relative to income with little change in MEW. But during this period, households

(1) Holmans, A E (2001), *Housing and mortgage equity withdrawal and their component flows: a technical report*, Council of Mortgage Lenders.

(2) See Davey, M (2001), 'Mortgage equity withdrawal and consumption', *Bank of England Quarterly Bulletin*, Spring, pages 100–03.

**Chart A**  
**Household consumption and borrowing**



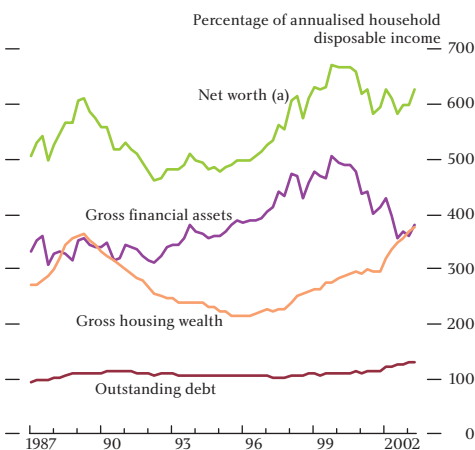
Sources: Bank of England and ONS.

(a) Defined by the ONS as 'Total available households' resources'.

received large windfalls from building society demutualisations, and their income slowed sharply as income tax payments increased, apparently due to the introduction of self-assessment. Since 2001, the increase in consumption, relative to income, has occurred at the same time as, and has been of similar magnitude to, the increase in MEW.

To conclude, it is not clear to what extent the current high levels of MEW have funded consumption. There is some evidence of discretionary increases in MEW, and some of this has probably been spent on consumption. But some of the increase in MEW since 1997 has been a consequence of higher house prices mechanically raising the proceeds from last-time sales. These are likely to be spent over the lifetimes of the recipients, or else bequeathed.

**Chart 1.13**  
**Households' assets and debts**



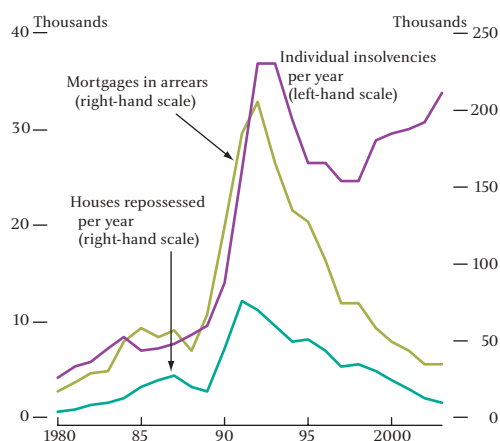
(a) Financial assets plus housing wealth less outstanding debt.

since 1997 have had much larger effects on net worth (see Chart 1.13).

But that may understate the importance of changes in debt, at least for perceived net worth. Most financial assets are held indirectly through pension funds, so changes in their value might have a small impact on perceptions of net worth, especially for households with pension rights not tied directly to asset prices. It is also not clear that rises in house prices should cause households to be wealthier in aggregate. Households that are yet to buy homes, or who wish to buy more expensive homes, face a higher prospective cost of living. Some households, particularly in older generations, have made large windfall gains. But they may not be better off if they feel obliged to make larger gifts or bequests to compensate their children for the higher cost of housing. Furthermore, the value of financial and housing wealth is inherently uncertain—prices can change. But debt is not subject to revaluation in the same way. So households may place more weight on their debts when judging their net worth.

Households also care about the resources available for immediate consumption, which will be affected by their debt-servicing costs. In aggregate, these were stable, relative to income, between 1993 and 2002, as the impact of higher borrowing was offset by lower nominal interest rates. The number of households with mortgage arrears, and those facing repossession of their houses, has been falling, and is low historically, suggesting that households have been able to service their debts without too much difficulty. Perhaps relating to increased unsecured borrowing by low-income

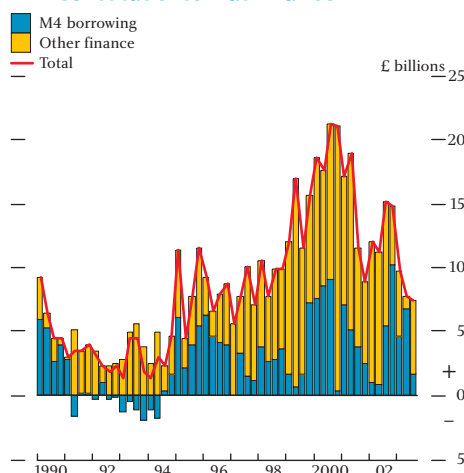
**Chart 1.14**  
**Household sector financial distress<sup>(a)</sup>**



Sources: CML and ODFPM.

(a) 2003 figure is for 2003 H1. This has been annualised for insolvencies and repossessions.

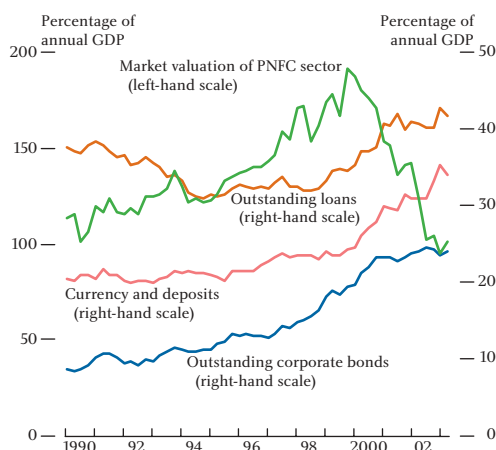
**Chart 1.15**  
**PNFCs' total external finance<sup>(a)</sup>**



Sources: Bank of England and ONS.

(a) Excluding the effects of securitisations.

**Chart 1.16**  
**PNFCs' balance sheet**



households, the number of individual insolvencies each year has been increasing since 1997 (see Chart 1.14). But the numbers involved are small relative to the total population.

### Private non-financial corporations' (PNFCs') borrowing

PNFCs' borrowing from UK banks and building societies—M4 borrowing (excluding the effects of securitisations)—grew by 9.4% in the year to 2003 Q3, somewhat slower than in Q2, reflecting a weak flow in the latest quarter. But use of other forms of finance was quite strong in Q3, so the total external finance raised was a similar amount in Q3 as in Q2 (see Chart 1.15).

PNFCs' capital gearing—the ratio of their outstanding debt to the market valuation of their capital—is high by historical standards. This largely reflects the sharp reduction in the market valuation of the PNFC sector since 1999. But it also reflects the strong increases in borrowing and bond issuance between 1998 and 2001 (see Chart 1.16).

There is little indication that, in aggregate, PNFCs have had difficulty servicing their debts, given the low level of interest rates and the recent growth in profits. Moreover, the spreads on corporate bonds have continued to fall, possibly implying that bond holders judge the risk of default to be lower. PNFCs' deposits have been increasing, relative to GDP, implying reasonable cash flow. Some of the increase in corporate debt could be a reaction to greater macroeconomic stability, or lower interest rates, and may be sustainable. But because high capital gearing makes companies more vulnerable to adverse developments, it is possible that they will continue to seek to improve their balance sheets. This could imply cutting back dividend payments, issuing more shares, or restraining expenditure on capital or labour.<sup>(1)</sup>

### Monetary aggregates

The stock of notes and coin in circulation grew by 7.9% in the year to 2003 Q3 (see Table 1.B). The increase in growth during 2003 is consistent with strengthening nominal demand through the year. M4 deposits includes bank and building society deposits held by households and firms, as well as notes and coin. In aggregate, M4 deposits' growth has picked up a little over the past year, and at over 7%, it is somewhat stronger than nominal GDP growth.

The increase in growth in M4 deposits since mid-2002 has largely been driven by other financial corporations (OFCs). But growth in OFCs' deposits can move erratically from year to

(1) For recent research on this see Bunn, P and Young, G (2003), 'Balance sheet adjustment by UK companies', *Bank of England Quarterly Bulletin*, Autumn, pages 315–26.

**Table 1.B**  
**Monetary aggregates<sup>(a)</sup>**

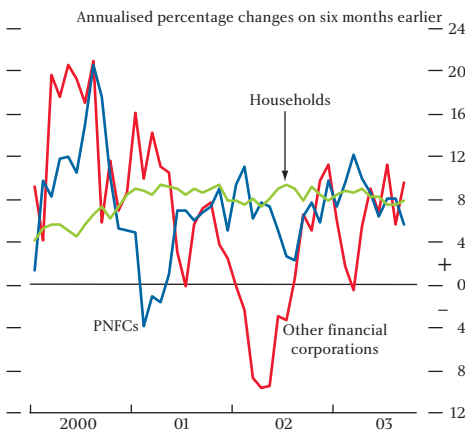
Percentage changes on a year earlier

	2002	2003			
	Q4	Q1	Q2	Q3	Oct.
Notes and coin	5.8	6.5	6.9	7.9	7.3
M0 (b)	5.8	6.4	6.8	7.8	7.3
M4 (c)	7.1	7.1	8.1	7.4	n.a.

Source: Bank of England.

- (a) Seasonally adjusted.
- (b) M0 is a narrow measure of money, consisting of notes and coin and bankers' operational balances held at the Bank of England.
- (c) M4 is a broader monetary aggregate, equal to holdings of sterling notes and coin, sterling deposits held at UK monetary financial institutions (MFIs) by the UK private sector (excluding MFIs' own deposits), liabilities arising from repos and estimated holdings of sterling bank bills.

**Chart 1.17**  
**M4 deposits by sector**



Source: Bank of England.

year (see Chart 1.17), partly as financial companies change their desired portfolio mix between deposits and other assets.

PNFCs' deposits have been growing strongly since late-2002, but the six-month growth rate slowed in recent months. Nevertheless, at around 6% on an annualised basis, growth remains buoyant, suggesting strong cash flow in the corporate sector. Household deposits increased by around 6% per year between 1998 and 2000, but growth has picked up to around 8% since then. This may have reflected households deciding to hold more of their savings in bank deposits rather than equities, due to greater perceived risk of falls in equity prices. It could also have been associated with the increase in MEW, and in particular higher receipts from last-time sales in the housing market described in the box on pages 8–9. But some households may have been choosing to build up their liquid assets in order to fund purchases in the future. So the growth in households' deposits might also be associated with stronger near-term nominal spending.

Final domestic demand recovered in Q2 following weak growth in Q1. Nevertheless, consumption growth has slowed in recent quarters compared with the previous few years. Business investment picked up in Q2, after the weakness at the start of the year. And net trade made a positive contribution to GDP growth for a second consecutive quarter in Q2. The 2003 Blue Book contained major revisions. GDP growth is now estimated to have been stronger in 1999 and 2000 than was thought at the time of the August Report. And there has been some change in the balance of demand with consumption growth weaker and investment and net trade stronger than previously estimated. GDP growth in the first half of 2003 has also been revised up. There have been increasing signs of a recovery in global demand, particularly in the United States and Japan. But the euro area has remained weak.

**Table 2.A**  
Expenditure components of demand<sup>(a)</sup>

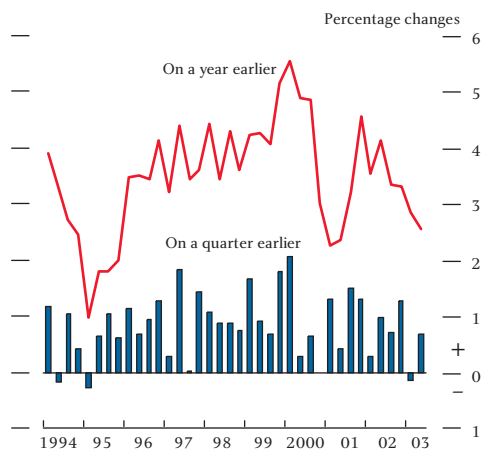
Percentage changes on a quarter earlier

	2001	2002	Q3	Q4	2003	
	Average	Average			Q1	Q2
Consumption:						
Household	1.1	0.8	0.7	1.3	-0.1	0.7
Government	1.0	0.1	0.3	0.5	2.6	0.5
Investment	-0.4	1.1	0.2	0.7	-0.7	1.5
of which, business	-1.3	-0.1	-2.9	0.6	-0.2	2.0
<b>Final domestic demand</b>	<b>0.9</b>	<b>0.7</b>	<b>0.6</b>	<b>1.0</b>	<b>0.2</b>	<b>0.8</b>
Change in inventories (b)	-0.1	0.1	0.2	0.4	-0.3	-0.3
Excluding alignment adjustment (b)	-0.1	0.1	0.0	0.2	0.0	-0.1
<b>Domestic demand</b>	<b>0.7</b>	<b>0.8</b>	<b>0.8</b>	<b>1.4</b>	<b>-0.1</b>	<b>0.5</b>
Exports	-0.7	-0.4	-1.0	-4.6	2.9	-2.6
Imports	0.2	0.9	-0.5	-1.0	1.7	-2.5
Net trade (b)	-0.3	-0.4	-0.1	-1.0	0.2	0.1
<b>GDP at market prices</b>	<b>0.5</b>	<b>0.5</b>	<b>0.7</b>	<b>0.5</b>	<b>0.2</b>	<b>0.6</b>

(a) Chained volume measures.

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

**Chart 2.1**  
Household consumption



## 2.1 GDP and domestic demand

Real GDP increased by 0.6% in 2003 Q2, much stronger than the 0.2% rise in Q1. The 2003 *Blue Book* and Q2 National Accounts contained major revisions. These are discussed in a box on pages 14–15 of the *Report*. The revised data show that final domestic demand growth picked up in Q2, reflecting stronger consumption and investment (see Table 2.A).

Domestic demand fell in Q1 for the first time since 1999 Q2, but the subsequent recovery suggests that the weakness was only temporary. The preliminary estimate suggests that GDP growth was 0.6% in Q3 (see Section 3).

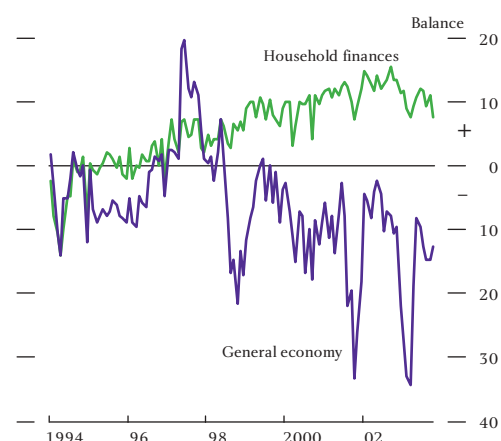
### Consumption

Household consumption in Q2 increased by 0.7%, following a fall of 0.1% in the previous quarter (see Chart 2.1). The rally in Q2 suggests that the first-quarter weakness was temporary, and may have reflected a pause in spending in the build-up to hostilities in Iraq. That would be consistent with the survey data for consumer confidence in Q1. Concerns over Iraq appeared to cause a dip in people's perceptions of the general economic outlook, but had much less impact on their impressions of their own personal situation (see Chart 2.2). The weak consumption outturn in Q1 may also have reflected difficulties in seasonally adjusting the consumption data, as unadjusted spending varies sharply around Christmas.<sup>(1)</sup> And consumption growth was strong in 2002 Q4.

(1) See the box on page 17 of the May 2002 *Report* for a more detailed discussion of seasonal adjustment.

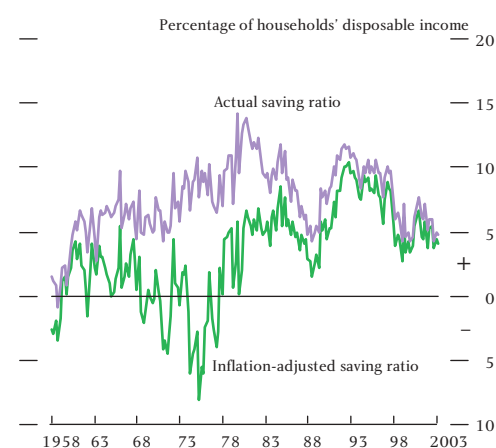


**Chart 2.2**  
GfK consumer confidence: situation over the next twelve months



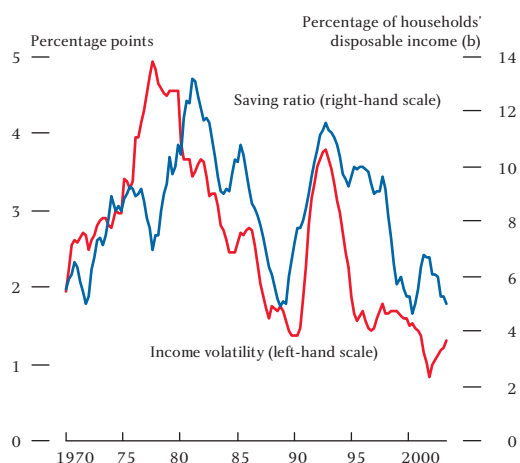
Source: Martin Hamblin GfK.

**Chart 2.3**  
Household saving ratio



Sources: Bank of England and ONS.

**Chart 2.4**  
Household saving ratio and income volatility<sup>(a)</sup>



(a) Measured as a rolling five-year standard deviation of annual growth rates of wages and salaries deflated by the household consumption deflator.  
(b) Four-quarter moving average.

Despite the pickup in consumption in Q2, underlying growth appears to have slowed in recent quarters. In the year to 2003 Q2, growth returned to around trend, averaging 0.6% per quarter. By comparison, average quarterly growth since the end of 1995 was 0.9%. Indicators suggest little further slowing. Retail sales increased by 1.2% in Q3, only slightly weaker than the 1.5% rise in Q2. And SMMT private car registrations were 3.7% higher than a year earlier in Q3, the strongest annual growth since 2002 Q2. The CBI *Distributive Trades Survey* indicator of retail sales rose sharply in October, to its highest level since April 2002.

The slowdown in consumption growth in recent quarters could reflect in part slowing income growth. Annual growth in real household post-tax income slowed to 1.4% in Q2, well below the average annual rate from 1995 onwards of 2.9%. The saving ratio declined in Q2 to 4.8%, from 5.0% in Q1, remaining low by historical standards. This might imply that consumption growth should slow further, in order to return saving towards its longer-run average. But such an adjustment of spending may not be necessary. Higher inflation reduces the real value of nominally denominated assets. Nominal interest rates therefore tend to be higher when inflation is higher to compensate for the expected capital loss. So a part of household income and saving simply reflects this element. The saving ratio will therefore tend to be higher when inflation is higher. Allowing for this effect, the current saving ratio does not look low by historical standards (see Chart 2.3).<sup>(1)</sup>

In addition to current income, expected future income is a key determinant of consumption. But it is also likely to be influenced by the degree of uncertainty surrounding those expectations. If households are more uncertain about their future income, because there is a higher risk of becoming unemployed for example, they may wish to build up additional wealth as a buffer against unfavourable changes in their circumstances in the future. Since the mid-1990s income volatility has been low, which may have reduced households' perceptions of income uncertainty in the future and led to a reduction in the saving ratio (see Chart 2.4). Macroeconomic stability may therefore allow households to sustain the current level of saving and increased indebtedness (see Section 1). But if the current saving ratio reflects unrealistic expectations of future income growth, or of its likely volatility, consumption may slow more sharply as these expectations are disappointed.

Household wealth is another key factor in determining consumption. Rising equity prices in Q2 boosted net financial wealth, which rose by 10.4% during the quarter, following

(1) See Davey, M (2001), 'Saving, wealth and consumption', *Bank of England Quarterly Bulletin*, Spring, pages 91–99 for a more detailed discussion.

## Revisions to the National Accounts

The Q2 Quarterly National Accounts released on 30 September contained significant methodological changes, as well as the usual round of annual revisions. There were three main sources of revisions:

- These data were the first to be compiled using annual chain-linking. The weights used to aggregate GDP components are now updated more frequently, so that they more accurately reflect changes in the composition of GDP over time.<sup>(1)</sup>
- For series that are still calculated using weights that are updated less frequently—lower-level disaggregated price and volumes series—the base year for recent data has been moved from 1995 to 2000.
- New data from annual surveys and improved data sources have been incorporated. These include estimates for missing trader intra-community (MTIC) VAT fraud on imports.<sup>(2)</sup>

The level of GDP at current market prices in 2003 Q2 is now 0.4% higher than previously estimated (see Table 1). Volumes levels before and after the revisions are not strictly comparable. But the cumulative growth of real GDP between 1948 and 2003 Q2 is now estimated to have been 0.9 percentage points higher.

**Table 1**  
Revisions to demand components of GDP

Percentage changes to the level in 2003 Q2

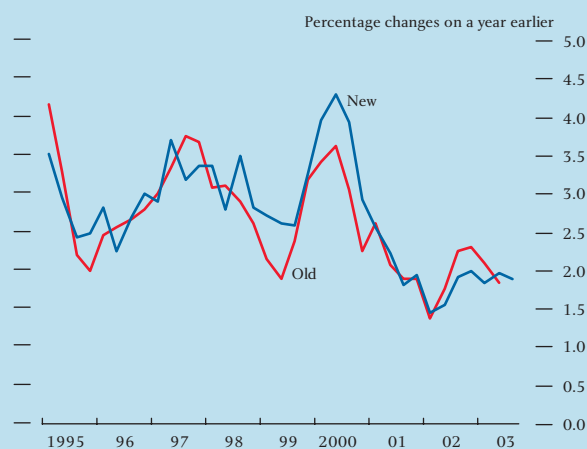
	Values	Volumes (a)
Consumption:		
Household (b)	0.1	-2.5
Government	1.6	-3.9
Investment	4.0	12.7
Domestic demand	0.4	-1.8
Exports	0.7	1.2
Imports	1.3	-2.2
GDP	0.4	0.9

(a) Calculated as the difference in cumulated growth since 1948 before and after the revisions. Volumes levels before and after the revisions are not directly comparable.

(b) Does not include non-profit-making institutions serving households.

The main revisions to GDP volume growth occurred in 1999 and 2000, with growth significantly stronger in both years. But growth was revised down slightly in 2002 (see Chart A). Average annual growth during the period 1997–2002 has been revised up by 0.2 percentage points to 2.7%. And cumulative GDP

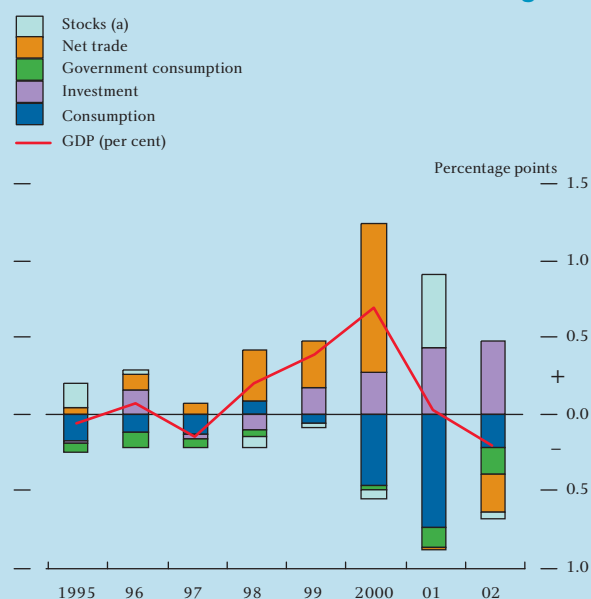
**Chart A**  
GDP volumes



growth in the first two quarters of 2003 is now estimated to have been 0.8%, almost twice the rate of increase estimated at the time of the August Report.

There have also been significant changes to the individual demand components within GDP. Table 1 shows that the cumulative growth in investment volumes is now estimated to have been much higher, while those of household and government consumption have been revised down. Real domestic demand growth is lower overall, but this has been more than offset by upward revisions to net trade volumes. Revisions to the level of the real demand components mainly reflect changes to growth rates

**Chart B**  
Contributions to revisions in annual real GDP growth



(a) Includes net acquisition of valuables.

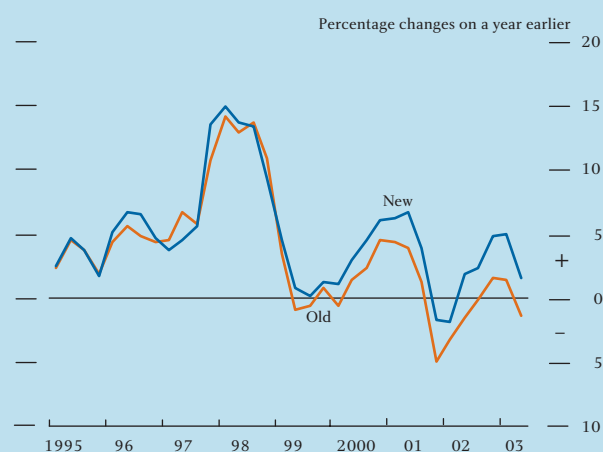
(1) See the box on pages 14–15 of the May Report for a description of chain-linking.  
(2) See the box on pages 18–19 of the August Report for details of these revisions.

since 1997 (see Chart B). The revisions to the components in current-price terms have been much smaller, and often in the opposite direction. This indicates that new information on prices and the methodological changes have played the largest role in the revisions to volumes.

Average annual household consumption growth during 1995–2002 has been revised down by 0.3 percentage points to 3.8%. But the picture of above-trend growth for most of the post-1995 period remains. Weaker nominal consumption growth in 2000, combined with stronger post-tax income growth, pushed up the saving ratio in 2000 relative to the previous estimate. But stronger nominal consumption growth after 2000 means the saving ratio is little changed from the previous estimate by 2003 Q1.

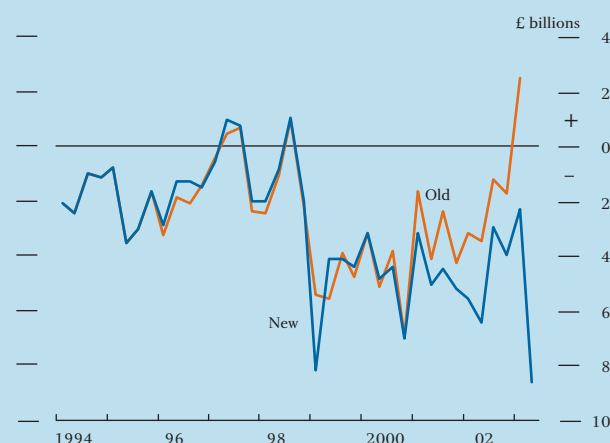
As the box in the *May Report* noted, the introduction of annual chain-linking was expected to lead to lower growth of most demand components. And yet the overall revisions to investment have raised growth. This reflected upward revisions to volumes growth of the disaggregated components of investment before they were chain-weighted. In part this was caused by the upward revisions to the value of investment. But there were also downward revisions to price indices unrelated to chain-weighting. And weaker increases in prices imply stronger growth in volumes. These changes more than offset the effects of chain-weighting. The revisions do not change the overall pattern of investment growth in recent years, but generally lead to a stronger profile (see Chart C).

**Chart C**  
Whole-economy investment volumes



The stronger contribution from the volume of net trade to GDP growth reflects both upward revisions to export volumes and downward revisions to import

**Chart D**  
Current account balance



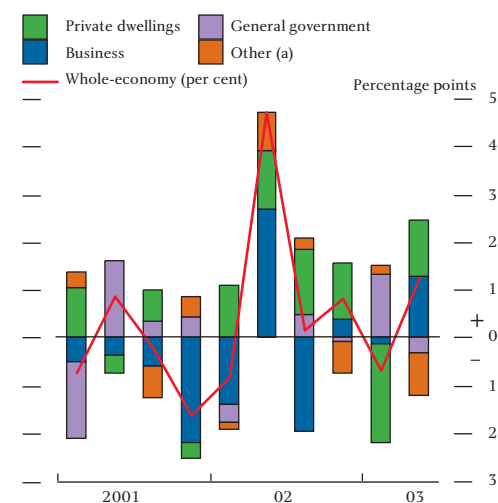
volumes. The inclusion of estimates for MTIC fraud led to upward revisions to the value of imports from 1999 onwards. Higher import values due to MTIC fraud also led to a downward revision to the current account balance. The current account was previously estimated to have moved into surplus in 2003 Q1, but is now estimated to have remained in deficit (see Chart D).

The diverging revisions to the volumes and value numbers for trade are reconciled by the fact that the import price deflator has been revised up by more than the export deflator. As a result of these revisions, the rise in the terms of trade since 1995 is now estimated to have been 10.0%, compared with 14.4% in the previous vintage of data. The rise in the terms of trade increased the purchasing power of UK households, and is likely to have been an important factor in the strength of consumption growth since 1995. The new data suggest it may have been slightly less of an influence, although consumption growth has also been revised down.

On the output side of the National Accounts, the upward revision to GDP was mainly accounted for by stronger manufacturing output growth. Service sector growth was revised down slightly. The revisions also introduced greater volatility into service sector growth: it picked up more strongly in 1998 and 2000, but has been weaker since 2000.

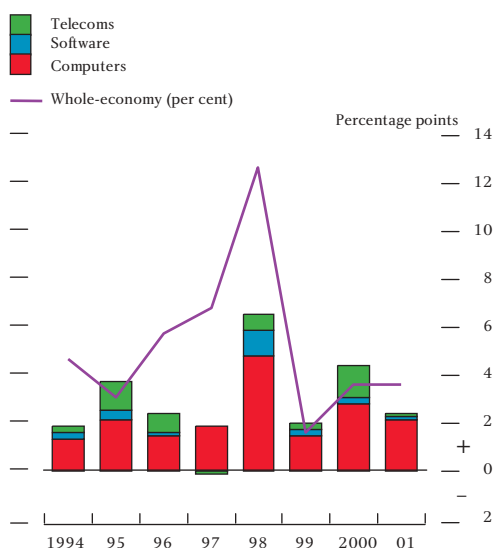
The revisions suggest that the pickup in GDP growth in 1999 and 2000 was somewhat stronger than previously thought. And there have been significant changes in the demand mix. But the main features of the economy over the past few years remain the same, with strong consumption offset by weak net trade. Section 3 considers the implications of the revisions for supply.

**Chart 2.5**  
Contributions to quarterly whole-economy investment growth



(a) Investment by NHS trusts and transfer costs of non-produced assets.

**Chart 2.6**  
Contribution of ICT investment<sup>(a)</sup> to annual whole-economy investment growth



Sources: Bank of England and ONS.

(a) ICT investment values data are deflated using producer price indices, except for software. As there is no producer price index for software, the deflator for non-transport machinery and equipment is used as a proxy.

sharp falls in recent years. And house prices have continued to rise (see Section 1). These factors, along with stronger-than-expected indicators for consumption growth in Q3, have led the Committee to a somewhat stronger near-term profile for consumption growth than in August.

### Government spending

Government consumption volumes increased by 0.5% in Q2. This was despite a fall in defence spending from its high Q1 level. Measuring real government output is difficult (see Section 3), leading to uncertainty over the split between volumes and prices for government consumption. Nominal spending continued to grow strongly in Q2, with the annual rate at its highest level since 1981.

Real investment by general government fell by 3.6% in Q2. However, this followed a sharp rise in Q1, leaving investment in Q2 still substantially higher than a year earlier.

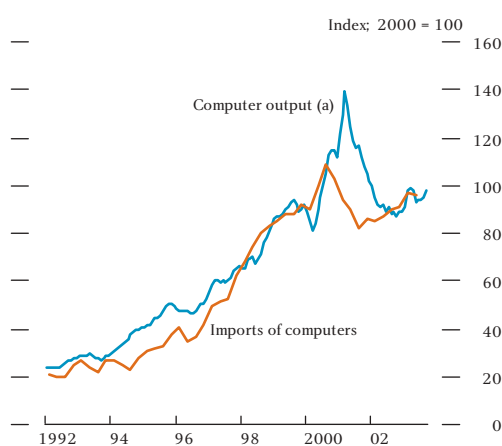
### Investment

Whole-economy investment showed a similar profile to household consumption in the first half of the year, with weakness in Q1 followed by a recovery in Q2. The revised National Accounts show that real business investment growth since 1999 was considerably stronger than previously thought. Nevertheless, it fell in each quarter between 2000 Q4 and 2002 Q1, and growth has since been relatively subdued (see Chart 2.5). Although business investment rose by 2.0% in Q2, it was still 0.7% lower than a year earlier. Private sector investment in dwellings bounced back somewhat in Q2 from the sharp fall in Q1. But it remained below its high level at the end of 2002.

There may be a number of factors limiting the recovery in companies' investment spending. Capital gearing remains high (see Section 1), there has been little sign of pressures on physical capacity at this stage (see Section 3) and pension fund deficits may be diverting cash away from other uses.

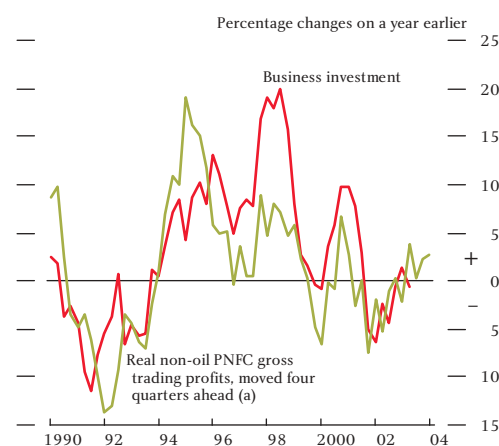
But forward-looking indicators have improved. The BCC and CBI surveys show that investment intentions picked up in Q3. And reports from the Bank's regional Agents have also suggested an improving outlook for investment. Information, communications and technology (ICT) played an important role in the strong investment growth of the late 1990s and the subsequent downturn, in the United Kingdom (see Chart 2.6) and in other countries (see Section 2.2 below). It is possible that it will also feature heavily in any prospective recovery. Data on UK ICT investment are only available annually and with a considerable lag. So it is unclear what has happened to

**Chart 2.7**  
Production and imports of computer equipment



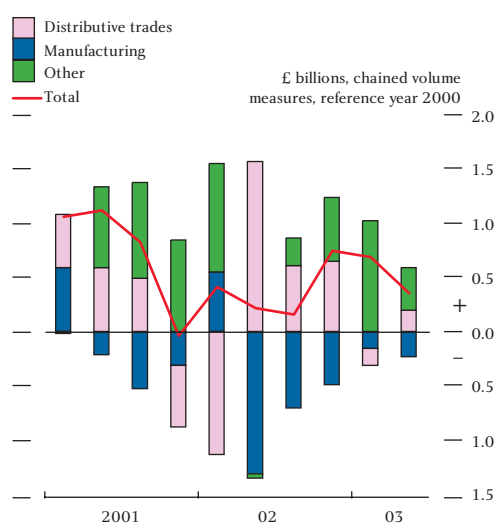
(a) Three-month moving average.

**Chart 2.8**  
Profits and investment



(a) Excludes the statistical alignment adjustment and deflated by the GDP deflator.

**Chart 2.9**  
Stockbuilding<sup>(a)</sup>



(a) Excludes the statistical alignment adjustment.

ICT investment recently. However, figures for the production and imports of computers suggest some recovery might be under way (see Chart 2.7). And equity prices of ICT companies have risen strongly (see Section 1), possibly an indication of improved demand prospects for the sector.

Another positive factor for investment is the recovery in profits. Excluding oil companies, whose profits are erratic, and the statistical alignment adjustment (which is added to this component of income to ensure the same growth of the income and output measures of GDP), private non-financial corporations' gross trading profits rose by 1.9% in Q2. Higher profits help companies to finance future investment projects, particularly those companies that find it difficult or expensive to obtain external finance. Growth in profits tends to lead movements in business investment, so the latest rise may signal a stronger recovery in investment over the next year (see Chart 2.8). Taking these factors together, the Committee expects business investment to continue recovering, albeit moderately.

## Inventories

Stocks, excluding the statistical alignment adjustment (which is added to this component of expenditure to ensure the same growth of the expenditure and output measures of GDP), detracted 0.1 percentage points from GDP growth in Q2, reflecting a slower pace of inventory accumulation than in Q1. Manufacturers continued to reduce stocks in Q2, the eighth decline in the past nine quarters (see Chart 2.9). But the reductions have become smaller compared with 2002, perhaps indicating the stocks adjustment in the manufacturing sector is coming to an end. The contribution from the distributive trades sector has diminished in 2003, possibly reflecting the slowdown in consumption growth.

## 2.2 External demand and UK net trade

There have been few signs of a recovery in the official output and expenditure data for the euro area. GDP fell by 0.1% in Q2, weaker than the flat profile for output in the previous two quarters (see Table 2.B), and the first decline since 2001 Q4. A smaller contribution to GDP growth from domestic demand compared with Q1 more than offset an improvement in the net trade contribution (see Table 2.C). This reversed the pattern in the previous two quarters. The weakness of domestic demand in Q2 was largely due to a slowing of consumption growth, to 0.2% from 0.6% in Q1. Official data on output and expenditure in Q3 generally point to continuing weakness. Industrial production in the euro area has been volatile from month to month but the trend has remained flat. And euro-area retail sales fell slightly in August. German retail

**Table 2.B**  
**GDP growth in the major economies**

Percentage changes on a quarter earlier

	2001	2002		2003		
	Average	Average	Q4	Q1	Q2	Q3
Euro area	0.2	0.3	0.0	0.0	-0.1	n.a.
of which, Germany	0.1	0.1	0.0	-0.2	-0.1	n.a.
France	0.2	0.3	-0.2	0.1	-0.3	n.a.
Italy	0.2	0.2	0.3	-0.2	-0.1	n.a.
United States (a)	0.0	0.7	0.3	0.4	0.8	1.7
Japan	-0.6	0.6	0.6	0.6	1.0	n.a.

Sources: Eurostat, Japanese Cabinet Office and US Bureau of Economic Analysis.

(a) Advance estimate for 2003 Q3.

**Table 2.C**  
**Contributions to euro-area GDP growth**

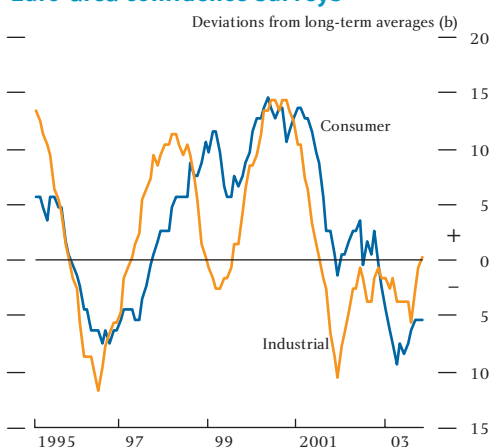
Percentage point contributions to quarterly growth

	2001	2002		2003		
	Average	Average	Q3	Q4	Q1	Q2
Consumption:						
Household	0.2	0.1	0.2	0.2	0.3	0.1
Government	0.1	0.1	0.1	0.0	0.1	0.1
Investment	-0.1	-0.1	0.0	0.1	-0.2	0.0
Change in inventories	-0.2	0.1	-0.1	0.0	0.5	0.1
<b>Domestic demand (a)</b>	<b>0.0</b>	<b>0.2</b>	<b>0.2</b>	<b>0.3</b>	<b>0.5</b>	<b>0.3</b>
Net trade	0.2	0.1	0.1	-0.3	-0.5	-0.4
<b>GDP (a)</b>	<b>0.2</b>	<b>0.3</b>	<b>0.2</b>	<b>0.0</b>	<b>0.0</b>	<b>-0.1</b>

Source: Eurostat.

(a) Components may not sum to totals due to rounding.

**Chart 2.10**  
**Euro-area confidence surveys<sup>(a)</sup>**



Source: European Commission.

(a) Each survey reports the average balance of a number of questions covering different aspects of consumer and industrial confidence.  
(b) Long-term averages are for the period January 1990 to October 2003.

**Table 2.D**  
**Contributions to US GDP growth**

Percentage point contributions to quarterly growth

	2001	2002		2003		
	Average	Average	Q4	Q1	Q2	Q3 (a)
Consumption:						
Household	0.5	0.5	0.3	0.3	0.7	1.1
Government	0.2	0.2	0.2	0.0	0.3	0.0
Investment	-0.2	0.0	0.2	0.0	0.3	0.5
Change in inventories	-0.4	0.3	0.1	-0.2	-0.2	-0.2
<b>Domestic demand (b)</b>	<b>0.0</b>	<b>1.0</b>	<b>0.7</b>	<b>0.2</b>	<b>1.1</b>	<b>1.6</b>
Net trade	0.0	-0.2	-0.4	0.2	-0.3	0.2
<b>GDP (b)</b>	<b>0.0</b>	<b>0.7</b>	<b>0.3</b>	<b>0.4</b>	<b>0.8</b>	<b>1.7</b>

Source: US Bureau of Economic Analysis.

(a) Advance estimate.  
(b) Components may not sum to totals due to rounding.

sales fell 0.7% in Q3. But French spending on manufactured goods bounced back in September, following a large fall in August.

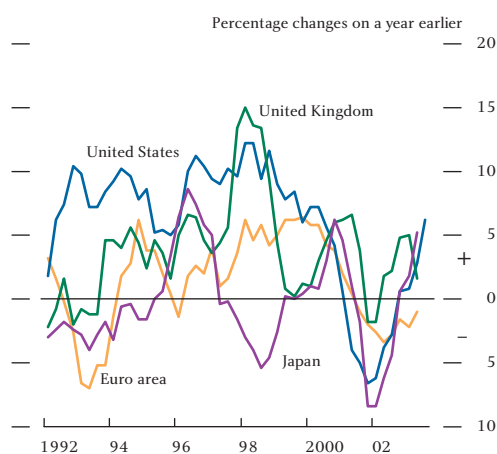
So what might have held back the recovery in the euro area? The initial easing in early 2001 was mainly focused on investment and exports, associated with the global slowdown and a synchronised investment cycle across many countries (see below). In addition, unexpected rises in the prices of food and imports (especially oil) reduced real incomes and most likely depressed consumption. GDP growth picked up in 2002, but this appears to have been due to temporary factors such as investment incentives and post-flood reconstruction work. More recently, the appreciation of the euro appears to have reduced net trade.

Forward-looking indicators suggest a more positive outlook for Q3 and beyond in the euro area. Consumer confidence has recovered steadily from a dip in Q1, and business confidence has risen to around its long-term average (see Chart 2.10). The west-German IFO business climate index has risen for six consecutive months, driven largely by an increase in the expectations component. And survey measures of activity in Q3 also improved, suggesting euro-area GDP did not fall again in that quarter. The euro-area manufacturing and services PMIs were both above 50 in September, the first time since August 2002. And both indices rose further in October. In the absence of more negative developments, euro-area GDP growth should strengthen, helped by the global recovery. And monetary policy remains accommodative. But largely based on the continued weakness of the official data, the Committee judges that prospects in the euro area have worsened somewhat in the short run compared with the *August Report*.

In the United States, GDP growth increased to 1.7% in Q3, only the second time such strong growth has been recorded in the past 15 years. That mainly reflected the strength of domestic demand, and in particular consumption (see Table 2.D). Household consumption rose by 1.6% in Q3, compared with 0.9% growth in the previous quarter. But that partly reflected a temporary boost from finance incentives on auto sales. And the income tax cuts that came into effect in July are likely to have led to a one-off increase in the level of consumption. So consumption growth is likely to slow in Q4. Another factor likely to limit consumption growth in the future is the recent rise in long-term interest rates, which has led to a sharp decline in mortgage refinancing activity.

Despite the reasonably strong growth in demand during the past two years, the labour market has remained weak, limiting growth in households' income and consumption.

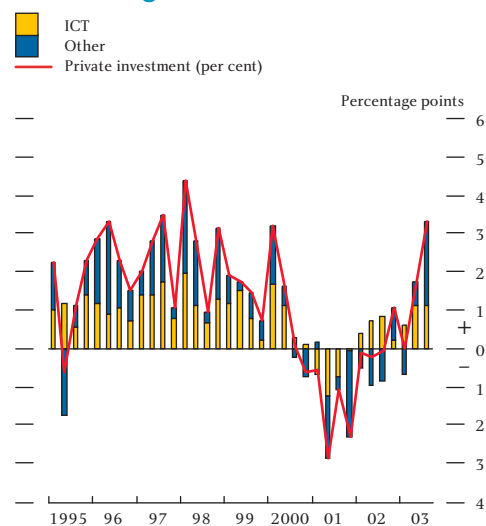
**Chart 2.11**  
Whole-economy investment<sup>(a)</sup>



Sources: Eurostat, Japanese Cabinet Office, ONS and US Bureau of Economic Analysis.

(a) Except for the United States which is private sector investment.

**Chart 2.12**  
Contributions to quarterly US private investment growth



Source: US Bureau of Economic Analysis.

Employment, according to the non-farm payrolls measure, has fallen by around one million since the end of the recession in November 2001. And the unemployment rate has increased by 0.5 percentage points. The combination of a recovery in output and falling employment can be accounted for by the strength of labour productivity growth. In the short run this is boosting profits, which should aid a recovery in investment. But over the medium term, the benefits should also spread to households' income through higher real wages.

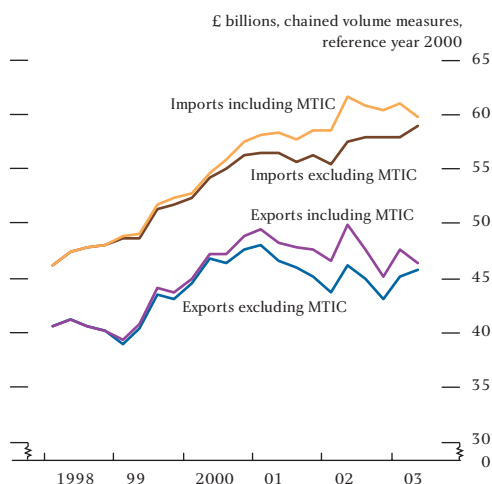
US private investment increased by 3.3% in Q3, the strongest growth since 1998 Q1. Over the most recent cycle, changes in investment have been synchronised across countries (see Chart 2.11). This may reflect the increasing importance of international supply chains and greater openness, which increase the importance of global demand for investment. But changes in perceived productivity gains from investment in ICT may also be a factor. ICT investment in the United States played a substantial role in the most recent investment cycle there (see Chart 2.12). It grew at around three times the rate of total private investment during the period 1995–2000, and fell sharply the following year. The recent recovery in ICT investment, to above the previous 2000 Q4 peak, may reflect upward revisions to expected productivity gains from ICT investment. Or it may constitute replacement of equipment installed in preparation for the millennium date change. In either case, these factors may apply elsewhere, leading to a pickup in other countries, including the United Kingdom.

The pickup in growth in the United States has been somewhat stronger than projected at the time of the *August Report*. The Committee expects growth to ease from its Q3 rate. But continued fiscal stimulus, along with higher equity prices, low interest rates and a weaker dollar are likely to keep GDP growth above trend in the near term.

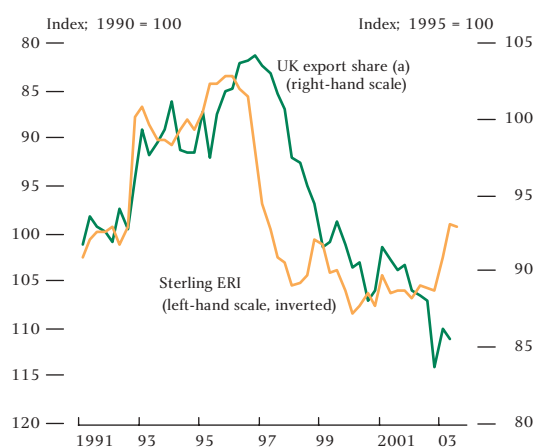
In Japan, GDP has grown for six consecutive quarters, and annual growth in Q2 was the highest in the G7 at 3.0%. But strong reported real growth was mainly the result of estimated falls in the GDP deflator, which have been larger than those for other price measures. Nominal GDP grew by just 0.2% in the year to Q2. And other indicators of real output, such as the all-activity index, suggest less robust growth. In the rest of Asia, the US recovery is likely to have boosted many countries' exports. But it is their domestic demand that is important for UK export prospects. That had grown strongly in recent years until the outbreak of SARS earlier this year, and is likely to have recovered from that temporary weakness.

Overall, the Committee judges that the near-term outlook for world GDP growth is little changed. Growth is expected to

**Chart 2.13**  
**Trade in goods**



**Chart 2.14**  
**UK export share<sup>(a)</sup> of major six trade and the sterling ERI**



Sources: Bank of England and ONS.

(a) Ratio of volume of UK exports excluding MTIC fraud to UK-weighted imports of the major six economies (Canada, France, Germany, Italy, Japan and the United States).

have strengthened in the second half of this year. There have been small upward revisions to the forecasts for some regions. But these have been offset by further expected weakness in the euro area. And the greater importance of the euro area for UK exports suggests a somewhat softer outlook for UK external demand.

Net trade contributed 0.1 percentage points to UK growth in Q2, slightly less than in Q1. There were sharp falls in both exports and imports on the quarter, although this reflected a reduction in missing trader intra-community (MTIC) VAT fraud.<sup>(1)</sup> MTIC fraud leads to higher levels of imports and exports as goods are repeatedly imported and re-exported. But only the exports are recorded by HM Customs and Excise. The ONS trade data now include an estimate of the fraudulent imports, raising the overall level of imports since 1999 (see Chart 2.13). But as some of these fraudulent activities were closed down in Q2, both exports and imports fell. Excluding MTIC-related trade, exports and imports of goods and services were little changed on the quarter.

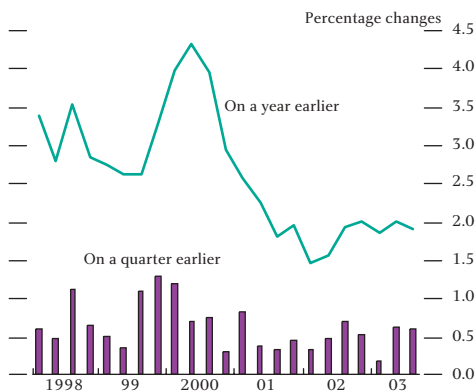
The share of UK total exports, excluding MTIC fraud, in the imports of other G7 countries fell back slightly in Q2, following an increase in Q1 (see Chart 2.14). There does not yet appear to have been an impact on exports from sterling's depreciation at the beginning of the year, which made UK exports less expensive in foreign-currency terms. The effect of a movement in the nominal exchange rate will depend on the underlying reasons for it. The UK export share rose following the depreciation in 1992, and then fell back when sterling appreciated in 1996 and 1997. The speed of the adjustment has varied, however, with the response in 1992 being much more rapid than in 1996–97. One reason for this difference may be the perceived permanence of the exchange rate movements during those two episodes. There may be fixed costs to changing the level of sales in a particular market, so exporters only adjust production once the exchange rate movement is perceived to be persistent. The effect of the recent depreciation on UK export volumes, therefore, may be yet to work through. Monthly trade data for July and August suggest a moderate increase in goods export volumes in Q3. But survey measures of export orders in Q3 were mixed.

(1) See the box on pages 18–19 of the August Report for a more detailed discussion of MTIC fraud. Fraudsters import goods VAT-free, sell them to companies inclusive of VAT, and disappear before paying the VAT to HM Customs and Excise. The goods are then re-exported and the process is repeated.



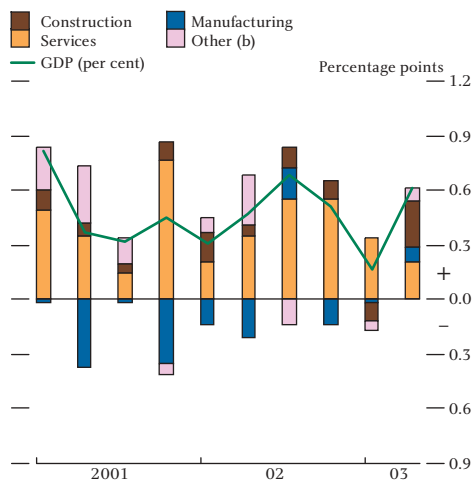
Whole-economy output growth is estimated to have strengthened since early 2003. According to the ONS preliminary estimate, GDP growth was 0.6% in 2003 Q3—in line with Q2 and well above growth of 0.2% in Q1. Total hours worked have remained broadly flat. The number of people in employment has risen in recent years, whereas the number of hours they work has, on average, declined. Estimates suggest that capital stock growth has continued to ease, and measures of labour productivity growth have remained at or slightly below their historic averages. Revisions to estimated GDP growth over the past imply that capacity utilisation may be higher, on certain measures, than previously thought. But overall, capacity pressures appear at or below normal levels, and the low level of unemployment may overstate the degree of tightness in the labour market.

**Chart 3.1**  
GDP<sup>(a)</sup>



(a) Chained volume measure of GDP at market prices.

**Chart 3.2**  
Sectoral contributions to quarterly GDP<sup>(a)</sup> growth



(a) Chained volume measure of GDP at market prices.  
(b) Includes non-manufacturing production, agriculture, and the difference between GDP at market prices and gross value added at basic prices.

## 3.1 Output

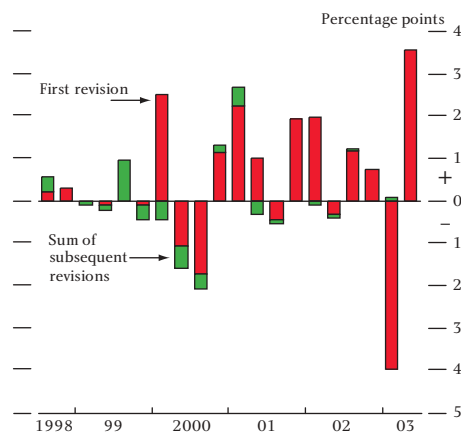
GDP reflects the total supply of output by businesses and public organisations during a given period. In the September release of the National Accounts, the ONS estimated that GDP volumes at market prices increased by 0.6% in 2003 Q2 (see Chart 3.1). This followed weaker growth of 0.2% in Q1.

Services output growth is estimated to have declined to 0.2% in 2003 Q2 (from 0.5% in Q1). That contrasts with the stronger picture from the CIPS survey of service sector business activity in Q2, but was broadly in line with the weakness suggested by the BCC survey.

The easing of service sector growth in 2003 Q2 was more than offset by developments in the manufacturing and construction sectors, however (see Chart 3.2). Manufacturing output rose by 0.5% in Q2, compared with a fall of 0.1% in Q1. And construction output is now estimated to have risen by some 4.4% in Q2, the largest rise since 1987 Q3. This followed a 1.8% decline in Q1.

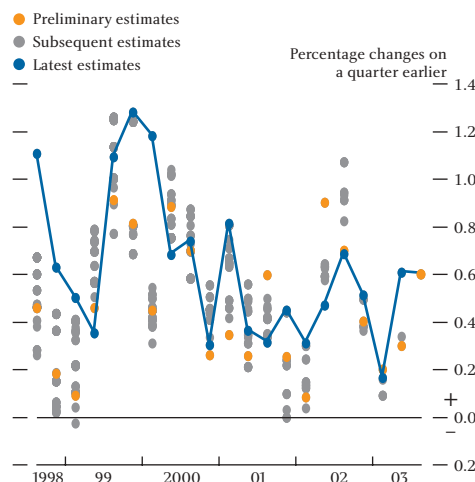
Construction output now appears to have risen by substantially more in 2003 Q2 than the ONS original estimate of a 0.8% rise. First revisions are often large for this sector, mostly reflecting the partial nature of information available to the ONS at the time of initial estimates. Much more detailed information about construction activity is available when the ONS publishes its first revised estimates in the quarterly National Accounts, and subsequent revisions have tended to be small (see Chart 3.3). So the recent volatility will not necessarily be revised away in future releases,

**Chart 3.3**  
Revisions to quarterly construction output growth estimates<sup>(a)</sup>



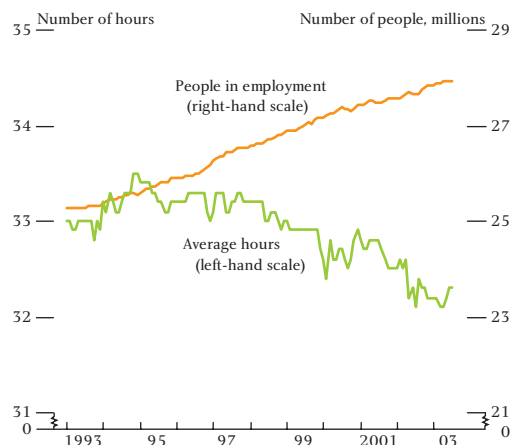
(a) 'First revision' is the first ONS revised estimate minus the initial estimate. 'Sum of subsequent revisions' is the current estimate minus the first revised estimate. Note that there has been less scope for revisions to data published recently.

**Chart 3.4**  
GDP growth estimates<sup>(a)</sup>



(a) Chained volume measure of GDP at market prices. Growth rates have been calculated from the published levels.

**Chart 3.5**  
Employment and average hours<sup>(a)</sup>



(a) LFS employment and hours data expressed as three-month moving averages.

although, as discussed in the *August Report*, other indicators have pointed towards a rather more steady pattern of growth in the sector.

The preliminary ONS estimate for 2003 Q3 suggests that GDP growth was 0.6%, in line with Q2. Within this, total service sector output is estimated to have risen by 0.7% and, according to index of production data published in early November, manufacturing output was unchanged on the quarter.

Estimates of GDP growth are often revised as the ONS incorporates new information or, less frequently, adopts methodological changes (see the box on pages 14–15). Chart 3.4 shows all official estimates for the period since the ONS began publishing preliminary estimates of GDP at market prices. Preliminary estimates have been revised up by an average of 0.1 to 0.2 percentage points over this period.<sup>(1)</sup> And, at times, revisions have been large. It is therefore necessary for the MPC to judge the likelihood of the latest vintage of data being revised, as discussed in recent MPC minutes. However, other evidence, such as the CIPS business surveys, is broadly consistent with the preliminary estimate for the third quarter.

### 3.2 Factor inputs

The supply capacity of the economy depends on the labour and capital employed by businesses and public sector organisations in the production process, as well as the efficiency with which these inputs are employed.

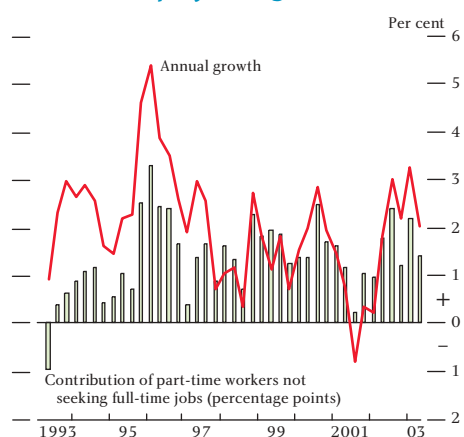
#### Employment

In late October, the ONS published updated estimates of the level and growth of the UK population from 1992. As discussed in the *November 2002 Report*, revisions to population estimates imply revisions to official labour market data such as employment, since Labour Force Survey (LFS) data are scaled up using household population estimates. These revisions will be contained in official statistics due to be published on 12 November. But they are likely to be small, given the modest size of the revisions to population estimates.

Total hours worked have been broadly flat in the past few years, as a rise in the number of people in employment has coincided with a decline in the average hours they work (see Chart 3.5). These divergent trends may be related, reflecting structural changes in the economy. Legislation in the form of the EU Working Time Directive is likely to have reduced the

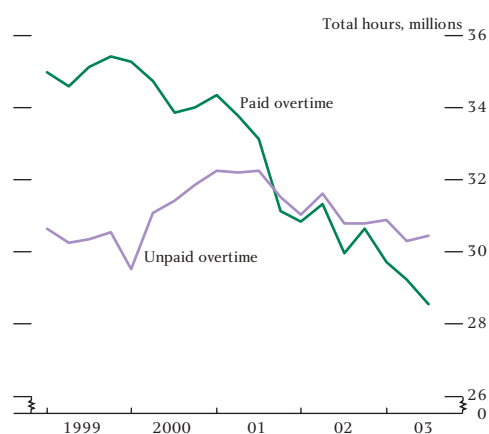
(1) For discussion of historic revisions to GDP, and its components, see Castle, J and Ellis, C (2002), 'Building a real-time database for GDP(E)', *Bank of England Quarterly Bulletin*, Spring, pages 42–49.

**Chart 3.6**  
Part-time employment growth<sup>(a)</sup>



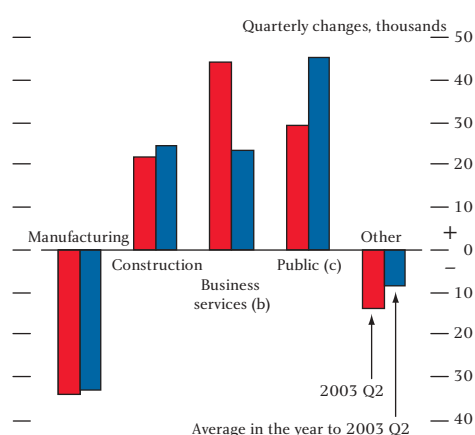
(a) LFS measure of employed and self-employed.

**Chart 3.7**  
Overtime hours<sup>(a)</sup>



(a) LFS hours data.

**Chart 3.8**  
Employment by sector<sup>(a)</sup>



(a) Workforce Jobs measure of employment.  
(b) Business services and finance.  
(c) Public administration, education and health. This includes both public and private sectors.

average hours of certain workers, for example. There may also have been changes in the availability of, and demand for, part-time work. According to the LFS, the recent rapid growth in part-time employment (discussed in the August Report) is largely accounted for by workers who are not seeking full-time jobs (see Chart 3.6). That could imply that businesses are employing more people because their staff increasingly wish to work fewer hours, or that there is greater availability of part-time jobs that some workers prefer.

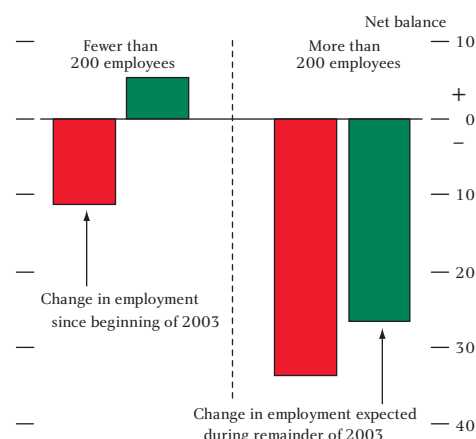
Some of the decline in average hours of recent years could be cyclical, however. Significant hiring and firing costs may have encouraged firms to hoard labour, retaining workers as demand growth eased, but reducing the hours they work. This would most likely be reflected in overtime hours, which can be adjusted quickly and relatively costlessly following a weakening of demand. Over the course of the past two decades, unpaid overtime has tended to rise, while paid overtime has fallen somewhat. But in recent years, there have been declines in both unpaid and paid overtime hours (see Chart 3.7).<sup>(1)</sup> That is consistent with some of the decline in average hours reflecting weakening demand growth. More recently, there has been a modest rise in both unpaid overtime hours and average hours. That could reflect demand growth returning to trend, but is difficult to interpret given the month-to-month volatility in hours worked.

The official Workforce Jobs survey of employers suggests that, by sector, the strength of employment over the past quarter (and indeed over the past year) has been driven by growth in the public, construction and business service sectors (see Chart 3.8). That has been partly offset by job losses in manufacturing, although there does not appear to have been a uniform experience throughout the sector. According to an informal survey of the private sector by the Bank's regional Agents, employment in small manufacturing businesses has fallen more modestly so far this year than in larger manufacturing firms, and may actually rise throughout the remainder of the year (see Chart 3.9).

Overall, firms told the Bank's Agents that employment growth was set to strengthen during the remainder of 2003. That is broadly consistent with other survey evidence in 2003 Q3. For example, BCC employment intentions balances for services and manufacturing were broadly in line with the average of the past decade, a period in which total employment rose strongly.

(1) Trends in overtime hours are discussed in Shortall, F (2002), 'Working time in the United Kingdom: evidence from the Labour Force Survey', *Bank of England Quarterly Bulletin*, Summer, pages 192–202. For discussion of alternative indicators of labour hoarding, see Felices, G (2003), 'Assessing the extent of labour hoarding', *Bank of England Quarterly Bulletin*, Summer, pages 198–206.

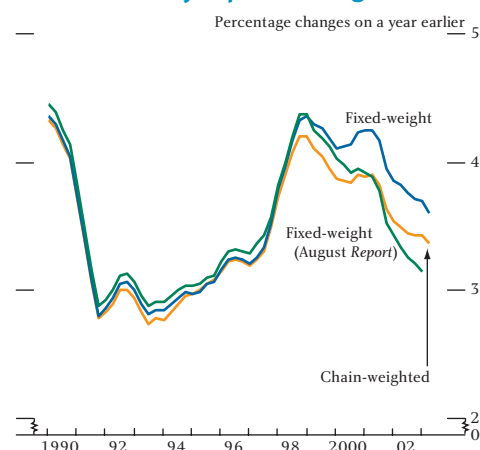
**Chart 3.9**  
**Manufacturing employment in 2003 by firm size<sup>(a)</sup>**



Source: Bank of England.

(a) Firms' responses are weighted by employment to derive a net percentage balance. A zero balance indicates no change in the level of employment. Survey was conducted by the Bank of England's regional Agents in September 2003.

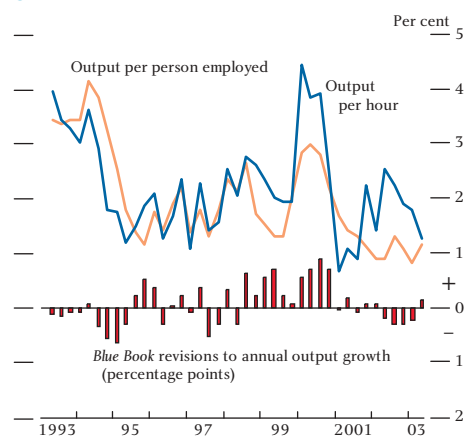
**Chart 3.10**  
**Whole-economy capital stock growth<sup>(a)</sup>**



Source: Bank of England.

(a) The 'fixed-weight' and 'chain-weighted' series are based on the latest National Accounts investment data. 'Fixed-weight (August Report)' is the series presented in the August Report, based on the data available at that time. All capital stock series exclude housing.

**Chart 3.11**  
**Annual whole-economy labour productivity growth<sup>(a)</sup>**



(a) Based on LFS employment and hours data.

## Capital

The *May Report* discussed how estimates of the aggregate capital stock—a measure of the physical quantity of capital—may be constructed. Bank of England staff aggregate together estimates of the stock of different classes of asset, which are derived from published investment data and assumptions about the characteristics of these assets. This allows the MPC to examine the sensitivity of capital estimates to different assumptions.<sup>(1)</sup>

By their nature, capital measures are sensitive to revisions to asset-level investment series and changes in the way data are aggregated. In the latest National Accounts, the ONS revised up sharply whole-economy investment estimates: cumulative growth over the past decade is now estimated to have been 12.7% higher than previously thought. This tends to raise estimates of capital growth over that period—but by much less than the investment revision, given that aggregate flows of investment represent only a small proportion of total capital. And the effect has tended to be offset by chain-weighting of capital, in line with the change in method used by the ONS to aggregate the underlying investment data. Chart 3.10 shows the impact of chain-weighting and investment revisions on a measure of the capital stock.

## Productivity

The revisions in the latest National Accounts imply that over the past five years, annual average growth rates of both GDP and labour productivity have been around 0.2 percentage points higher than previously estimated (see Chart 3.11). But the qualitative pattern discussed in previous *Reports* remains: both output per person employed and output per hour appear to have been growing at or slightly below their historic averages in recent years (although the latter has been growing more rapidly than the former given the decline in average hours discussed above).

However, rather stronger labour productivity growth might have been expected, given the high rate of increase in the amount of capital at workers' disposal in the latter half of the 1990s (see Chart 3.10). A productivity measure that explicitly recognises the role capital plays in output growth is multi-factor productivity growth. This measure reflects rates of technological progress (a term used to describe the rate of improvement in the efficiency with which labour and capital are combined) and capacity utilisation (the intensity with which factor inputs are worked). The estimates in Table 3.A

(1) For further details, see Oulton, N and Srinivasan, S (2003), 'Capital stocks, capital services, and depreciation: an integrated framework', *Bank of England Working Paper no. 192*. The ONS also publishes capital estimates: its measure suggests a broadly similar profile for capital stock growth in recent years.

**Table 3.A**  
**Labour and multi-factor productivity<sup>(a)</sup>**

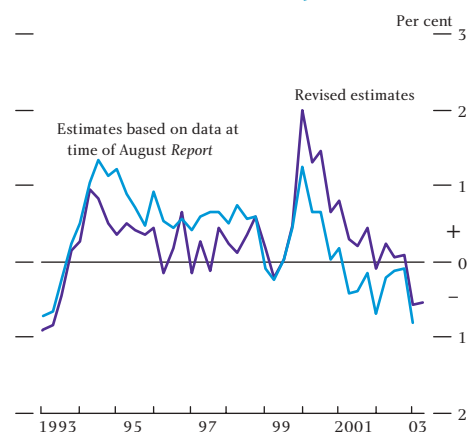
Average annual growth rates, per cent

	1991 Q1– 1995 Q4 (i)	1996 Q1– 2000 Q4 (ii)	2001 Q1– 2003 Q2 (iii)	1990s' deceleration (b) (iv) = (ii) – (i)
<b>Labour productivity growth</b>				
Based on:				
persons in employment	2.6	2.0	1.2	-0.7
employment hours	3.2	2.3	1.6	-0.9
<b>Multi-factor productivity growth</b>				
Based on:				
persons in employment	1.4	1.2	0.5	-0.2
employment hours	1.9	1.5	0.6	-0.4

(a) Based on LFS employment and hours data, and Bank of England chain-weighted capital stock estimates.

(b) Percentage points. Deceleration figures may not equal the difference between (ii) and (i) due to rounding.

**Chart 3.12**  
**A measure of whole-economy capacity utilisation derived from a production function<sup>(a)</sup>**



Sources: Bank of England and ONS.

(a) Deviation from estimated trend. The construction of this series is described on pages 26–27 of the May 2003 *Report*. Note that these estimates are based on chain-weighted capital stock data rather than the fixed-weight data used in previous *Reports*.

suggest that multi-factor productivity growth has been slowing since the first half of the 1990s (albeit less markedly than before the latest National Accounts revisions).<sup>(1)</sup> But this could reflect either a slowing rate of technological progress or declining rates of capacity utilisation. The next section discusses how these separate effects may be disentangled.

### 3.3 Capacity utilisation

Capacity utilisation reflects the short-run balance between the demand for, and supply of, goods and services in the economy. And as such, estimates may provide information about pressures on prices. But in practice, capacity utilisation is difficult to measure.

The *May Report* described one method of estimating capacity pressures. This involves comparing estimates of actual output with the notional amount of output that could be produced, given existing quantities of labour and capital and a constant rate of technological progress. Based on the latest National Accounts data, the resulting series suggests that capacity utilisation has been slightly weaker than normal over the past year (see Chart 3.12). But the capacity utilisation estimates are higher than those reported in the *August Report*. This reflects the upward revisions to output growth outweighing the impact of upward revisions to investment on estimates of capital and, hence, the economy's short-term supply potential.

How reliable is this latest estimate of capacity utilisation? The above approach is based on the assumption that the slowdown in multi-factor productivity growth entirely reflects changes in capacity utilisation rather than in the rate of technological progress, which is assumed to be constant. But that is unlikely in practice. Investment in research and development (R&D) may well lead to an irregular pattern of innovations, for example. And if the aggregate impact of such developments is large, then the capacity utilisation estimates above may be misleading.

Furthermore, the rate of technological progress may have declined in recent years, rather than having been constant over time. That could reflect shifts in the economy's structure towards sectors, such as services, where productivity tends to grow relatively slowly.<sup>(2)</sup> However, this argument can be overplayed. For example, businesses may outsource activities like accountancy services that are cheaper to buy than produce in-house. That will tend to raise productivity in these

(1) The construction of these estimates, sometimes referred to as the 'Solow residual', is described on pages 26–27 of the May 2003 *Report*.

(2) This idea stems from the unbalanced growth model of Baumol, W J (1967), 'Macroeconomics of unbalanced growth: the anatomy of urban crisis', *American Economic Review*, Vol. 57, pages 415–26.

businesses and in the economy as a whole, regardless of whether the sector providing the intermediate service is characterised by high or low productivity growth. Moreover, certain intermediate sectors, such as financial and business services, face intensive competitive pressures and are characterised by high, not low, productivity growth.<sup>(1)</sup> Such factors tend to offset the impact of a shift in resources towards service sectors with lower productivity growth, like hotels and restaurants.

The capacity utilisation estimate could also be unreliable if changes in multi-factor productivity growth are related to the sharp rise in investment in the latter half of the 1990s (see Chart 2.6). Investment in ICT assets, for example, may be associated with activities that are necessary for organisations to benefit fully from the adoption of new technologies and generate efficiency gains in the future. These may include restructuring of business practices and provision of computer and software training for workers. But such activities may depress output before businesses reap the full benefit. And so output and multi-factor productivity growth may be lower in periods when ICT investment takes place. Recent research suggests that such effects can be long-lasting, and may partly explain the slowdown in multi-factor productivity growth.<sup>(2)</sup>

This phenomenon may be particularly pertinent to the public sector. For example, the recent strong growth in government spending may, in part, reflect investment in IT or other projects. These projects may also be associated with activities yielding future productivity gains that are not reflected in current output. This could be exacerbated by fundamental difficulties in measuring public sector output. Many services that the government provides are, by their very nature, non-marketable. And so nominal government expenditure cannot be split into output and prices as straightforwardly as most private sector spending. Output in the health sector, for example, is proxied by the cost and incidence of different types of treatment. But such measures will not directly capture changes in the quality of treatment, such as increasing success and survival rates.<sup>(3)</sup>

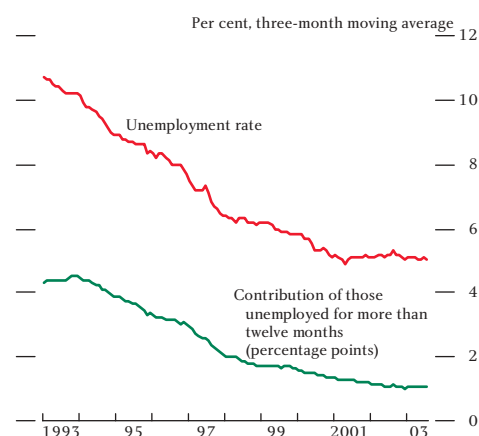
Given the strong assumptions underlying the above capacity utilisation estimate, the MPC also examines a wide range of alternative evidence. As discussed in the *August Report*, recent

(1) See Oulton, N (2001), 'Must the growth rate decline? Baumol's unbalanced growth revisited', *Bank of England Working Paper no. 107*. The author presents evidence that, in an arithmetic sense, the shift to financial and business services raised multi-factor productivity growth in the United Kingdom by 0.1 percentage points per annum between 1979 and 1995.

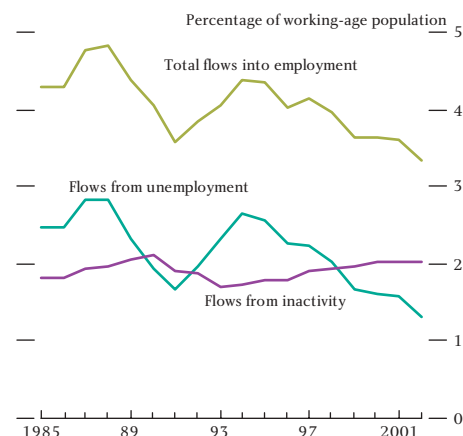
(2) Basu, S, Fernald, J, Oulton, N and Srinivasan, S (2003), 'The case of the missing productivity growth: or, does information technology explain why productivity accelerated in the United States but not the United Kingdom?', *NBER Working Paper*, No. 10010.

(3) See Pritchard, A (2003), 'Understanding government output and productivity', *Economic Trends*, July.

**Chart 3.13**  
LFS unemployment rate

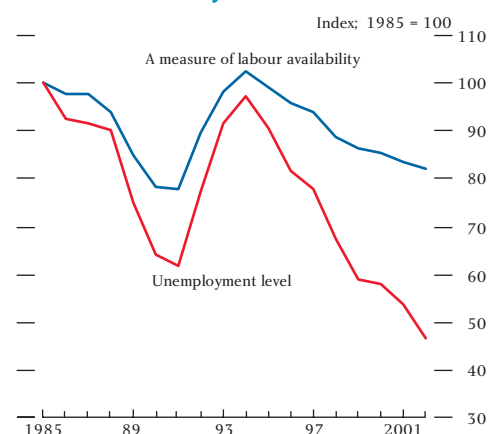


**Chart 3.14**  
Flows from non-employment to employment<sup>(a)</sup>



(a) LFS annual data.

**Chart 3.15**  
Labour availability measures<sup>(a)</sup>



(a) Annual LFS and Bank of England data.

survey evidence from the Bank's Agents and the CBI is broadly consistent with utilisation rates being at or slightly below normal levels. By itself, that would suggest firms may be able to increase output with their existing workforce, and price pressures may remain muted in the near term. But other factors may also be important. The next section considers one such factor: the balance between demand and supply in the labour market.

### 3.4 Labour market tightness

Labour market tightness refers to the degree of imbalance between demand and supply conditions in the labour market. Measures of tightness may be informative about pressures on wages that could feed through into prices elsewhere in the economy. A commonly used indicator is the unemployment rate. Chart 3.13 shows that the LFS measure of the unemployment rate has fallen sharply over the past decade. More recently, unemployment has been broadly unchanged.

Unemployment may provide a misleading indication of labour availability, however. Certain individuals who are 'inactive'—those of working age who are neither students, nor in or actively seeking employment—are as likely to move into employment as certain categories of the unemployed.<sup>(1)</sup> And even though individuals are more likely, on average, to move into employment from unemployment than from inactivity, the size of the inactive population is such that it can make a substantial contribution to employment growth. Indeed, Chart 3.14 shows that, in recent years, flows from inactivity have actually been larger than those from unemployment.

This suggests that any comprehensive measure of labour availability needs to take into account not only the unemployment rate, but the size and composition of the entire non-employed adult population. Recent Bank research provides one such measure. Different groups within the non-employed are weighted together by their predicted rates of transition into employment. The resulting index suggests that labour availability is still above its previous trough in 1990—a rather different picture from that suggested by the level of unemployment (see Chart 3.15).<sup>(2)</sup>

A more comprehensive measure might also take into account net inflows of migrants. Foreign workers newly entering the labour market are often required to apply to the UK government for permission to work, and so the number of application approvals may be a useful indicator of net inflows

(1) See Jones, J, Joyce, M and Thomas, J (2003), 'Non-employment and labour availability', *Bank of England Quarterly Bulletin*, Autumn, pages 291–303.

(2) Jones *et al* (2003). The authors present alternative indices of labour availability; Chart 3.15 shows the measure that includes students.

**Chart 3.16**  
**Number of applications approved for work permits<sup>(a)</sup> and first permissions<sup>(b)</sup>**



Sources: ONS and Overseas Labour Service/Work Permits (UK).

- (a) Work permits allow non-EEA foreign workers, living outside the United Kingdom at the time of application, to enter the country and work (in a particular job for a particular employer for a set period of time) as specified in the application.
- (b) First permissions are similar to work permits, but are granted to those without work permits who already live in the United Kingdom.

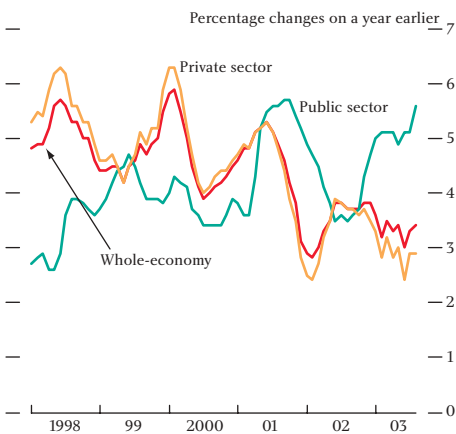
from abroad. Chart 3.16 shows that there has been a sharp rise in the number of approvals in recent years. That partly reflects a rise in approvals for those taking up jobs in health and medical services; the sector now accounts for around a quarter of approvals. That might suggest an important role for overseas workers in meeting increased employment demand from the public sector in the United Kingdom.

Interpretation of any of these tightness measures is difficult, however, given that their relationship with wage pressures is likely to have changed over time as the structure of the labour market has changed. For example, the introduction of programmes such as the New Deal may have increased the employability of the long-term unemployed. Indeed, the decline in unemployment in recent years has been largely accounted for by a decline in those unemployed for over twelve months (see Chart 3.13). Such changes could have lowered not only actual unemployment or inactivity, but also the level consistent with a given degree of wage pressure.



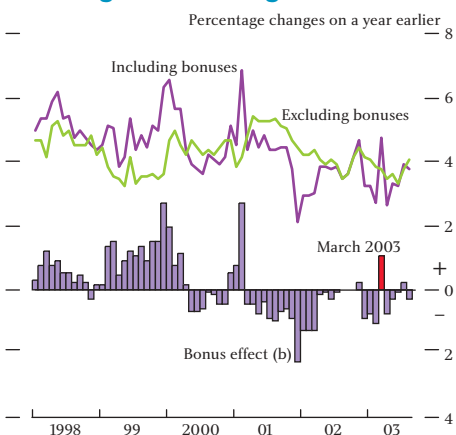
*Public sector earnings growth has remained strong, and there has continued to be little sign of an acceleration in private sector earnings. Oil prices fell in the first half of September but have subsequently recovered to levels similar to those seen at the time of the August Report. So far, sterling's depreciation at the start of the year does not appear to have had much of an impact on import prices. Manufacturers' output price inflation has risen steadily during the past two years, while survey evidence indicates that service sector output price inflation was largely unchanged over that period. Annual RPIX inflation remained above the target and was broadly as expected in Q3.*

**Chart 4.1**  
**Headline average earnings growth<sup>(a)</sup>**



(a) Three-month moving average of the annual rate of growth of the seasonally adjusted ONS average earnings index.

**Chart 4.2**  
**Whole-economy average earnings growth including and excluding bonuses<sup>(a)</sup>**



(a) ONS average earnings index measure, not seasonally adjusted.  
(b) Percentage point contribution to annual growth of whole-economy earnings including bonuses.

## 4.1 Labour costs

Whole-economy headline earnings growth has hovered just above 3% throughout 2003 (see Chart 4.1), and has remained below 4% since October 2001, despite historically low unemployment. Within the headline data, public sector earnings growth has continued to outstrip that of private sector earnings.

The drag on earnings growth from lower bonuses has diminished in recent months. Different sectors pay bonuses at different times in the year, so monthly changes in aggregate bonus payments can reflect sectoral differences rather than conditions in the economy as a whole. In addition, changes in the timing of bonus payments from year to year can cause volatility in the monthly series: this was the case in March, when bonus payments may have been brought forward prior to the increase in National Insurance contributions (see Chart 4.2). These factors make it difficult to be confident about underlying trends in the series.

Public sector actual pay growth has been volatile in recent months, partly due to some bonuses having been paid at a later time than in the previous year, which has had an impact on the profile of earnings growth. But regular pay growth, which excludes bonuses, has also been volatile, rising to 6.9% in August (see Table 4.A). Pay in the public sector is mainly determined by a small number of key settlements, which each cover a large group of workers. A delay in the timing of any of these settlements can therefore have a material impact on the rate of public sector regular pay growth. Once the settlement is agreed, workers also receive the backdated increase in their pay as a lump sum. The delay last year in the settlement for

**Table 4.A**  
**Average earnings growth**

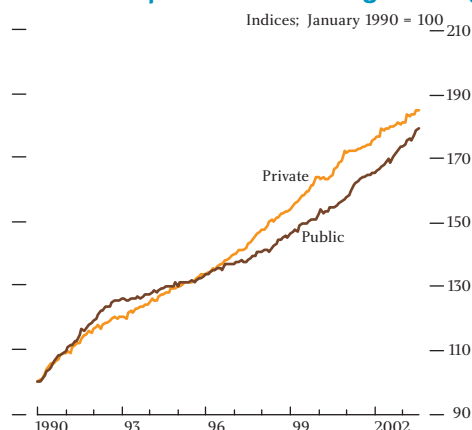
Percentages changes on a year earlier

	2003				
	May	June	July	Aug.	Sept.
<b>Headline (a)</b>					
Whole economy	3.4	3.0	3.3	3.4	n.a.
Public	4.9	5.1	5.1	5.6	n.a.
Private	3.0	2.4	2.9	2.9	n.a.
<b>Actual</b>					
Whole economy	3.1	3.2	3.6	3.5	n.a.
Public	4.6	5.4	5.3	6.1	n.a.
Private	2.8	2.6	3.2	2.8	n.a.
<b>Regular (b)</b>					
Whole economy	3.6	3.3	3.7	4.0	n.a.
Public	5.2	5.0	5.9	6.9	n.a.
Private	3.2	2.9	3.1	3.3	n.a.
<b>Settlements (c)</b>					
Whole economy	3.1	3.0	3.1	3.1	3.1
Public	3.3	3.3	3.3	3.3	3.3
Private	3.1	3.0	3.1	3.1	3.1

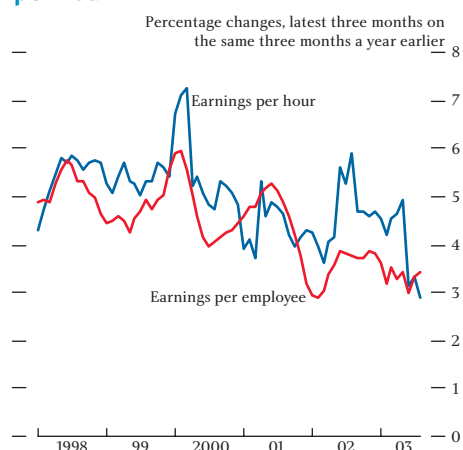
Sources: ONS and the Bank of England wage settlements database, that draws on information from the CBI, Incomes Data Services, Industrial Relations Services, Labour Research Department and the Bank's regional Agents.

- (a) Three-month (backward) average of actual rate.
- (b) Regular pay does not include bonus payments. It is not seasonally adjusted.
- (c) Twelve-month AEI-weighted mean.

**Chart 4.3**  
**Private and public sector average earnings**



**Chart 4.4**  
**Earnings per employee and earnings per hour**



local authority workers is currently boosting the annual comparison in regular pay, and the pickup in July and August reflected delayed settlements in the health sector this year.

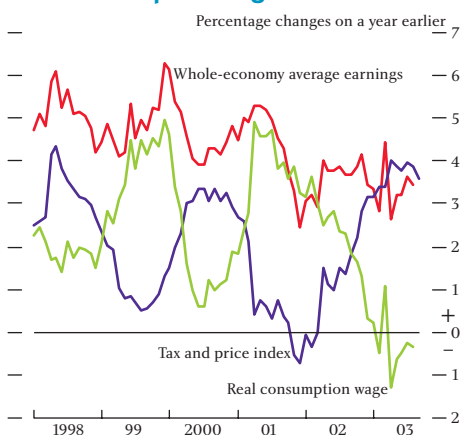
Headline pay growth in the public sector has exceeded that in the private sector since September 2002. The relative strength of public sector earnings growth is probably related to the increase in the public sector share of employment, since the Government has needed to raise relative pay in order to recruit, retain and motivate more workers, for example nurses and teachers. The relative demand for labour in different sectors tends to be reflected in differences between sectoral rates of pay growth. But what is more important for retail price inflation is whether private sector earnings growth will also increase in response to the strong growth in public sector earnings.

The recent strength in public sector earnings growth could feed through into higher private sector earnings growth if private sector workers care about their earnings relative to the public sector, for example if they are concerned with their position in the wage distribution. Or if public sector labour demand has created a shortage of applicants for private sector vacancies, this might also push up private sector wage inflation.

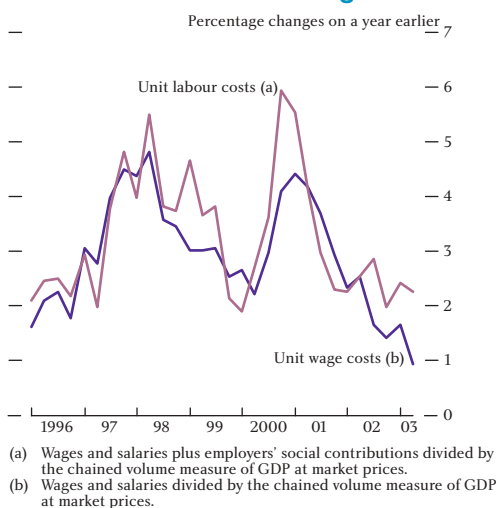
However, private sector earnings had outpaced those in the public sector for most of the previous decade (see Chart 4.3). So the recent strength of public sector earnings could just reflect the restoration of previous relative pay structures; private sector workers may recognise this and not try to restore differences. In addition, part of the increase in public sector employment has been met from abroad (see Section 3). So any reduction in the number of private sector applicants is likely to have been smaller than if the public sector had only recruited UK residents. That may have reduced the upward pressure on private sector pay.

The decline in whole-economy average hours worked described in Section 3 had driven a wedge between growth in pay per employee and that in pay per hour (see Chart 4.4). The gap between these pay measures has closed in the latest data, but this is partly due to the Jubilee's temporary impact on hours last year affecting the annual comparison. Part of the decline in average hours in recent years is likely to have been cyclical, for example fewer overtime hours. So average hours could rise in the future if overtime hours increase, and growth in pay per employee could rise above that in pay per hour. But part of the fall in hours could have been caused by structural changes, such as the implementation of the Working Time Directive and individuals choosing to enjoy more leisure

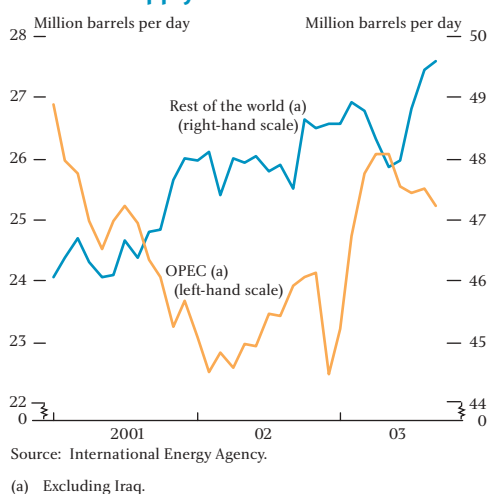
**Chart 4.5**  
**Real consumption wage**



**Chart 4.6**  
**Unit labour costs and unit wage costs**



**Chart 4.7**  
**World oil supply**



as their income rises.<sup>(1)</sup> In the longer term, the consequent fall in effective labour supply could imply more upward pressure on wage growth.

The adult rate of the National Minimum Wage increased from £4.20 to £4.50 in October 2003, a rise of 7.1%. The MPC continues to believe that the macroeconomic impact of this increase is likely to be small.

Workers care about their take-home pay relative to the prices of goods and services they spend it on. One measure of this is the real consumption wage, defined as earnings adjusted for the tax and price index (TPI), which measures the average pre-tax income needed to buy a fixed basket of goods and services. TPI inflation has recently been higher than earnings growth (see Chart 4.5), partly reflecting increases in National Insurance contributions (NICs) and Council Tax rates, which implies that the real consumption wage has fallen. This recent weakness of workers' real take-home pay might raise wage demands in the forthcoming bargaining round.

Despite the employers' NICs increases in April, unit labour cost growth has remained stable over the past year. But that is because growth in unit wage costs, which excludes employers' NICs, has recently been subdued (see Chart 4.6).

## 4.2 Commodity prices

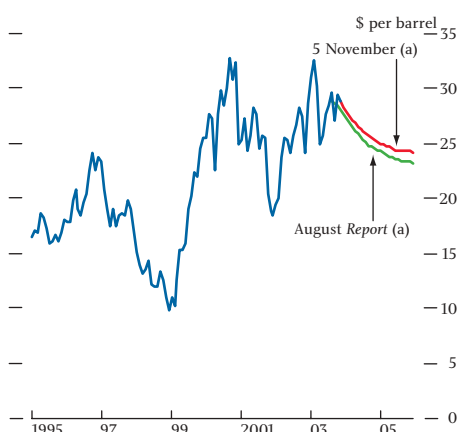
Brent crude oil prices fell from about \$30 a barrel at the end of August to around \$26 a barrel in mid-September. On 24 September OPEC announced a reduction of 900,000 barrels per day in its production quotas (which currently exclude Iraq), starting from 1 November.

OPEC's announcement of a cut in supply was likely to have been an attempt to support the oil price in response to the rise in non-OPEC production (see Chart 4.7). In addition, Iraqi oil production, after remaining at less than half its pre-war levels throughout the summer, has recently started to recover.

Since the September OPEC meeting, the spot price in dollars has risen. In the 15 working days to 5 November, the price of Brent crude averaged \$29 per barrel, similar to the 15-day average to 6 August (the day the MPC finalised its August projections). The profile of the futures price over the next two years is broadly similar to that at the time of the August Report (see Chart 4.8). During the past three months sterling has appreciated against the dollar, so the sterling oil price has fallen since the time of the August Report.

(1) See pages 25 and 27 of the May 2003 Report.

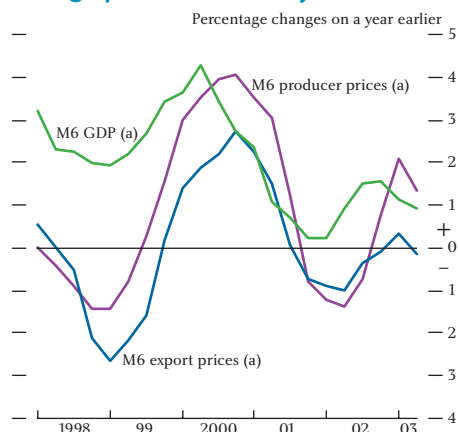
**Chart 4.8**  
**Brent oil futures**



Sources: Bank of England, Bloomberg and Thomson Financial Datastream.

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

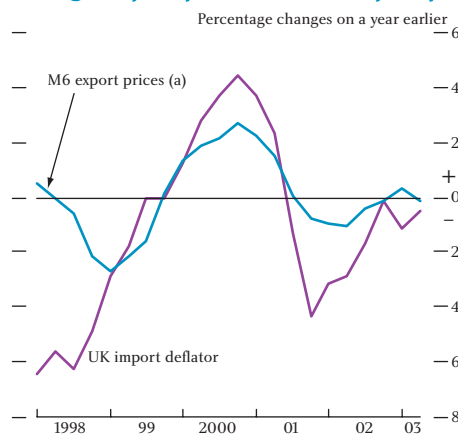
**Chart 4.9**  
**Foreign prices and activity**



Sources: Bank of England and Thomson Financial Datastream.

(a) M6 defined as Canada, France, Germany, Italy, Japan and the United States. Countries are weighted by their weights in the sterling ERI.

**Chart 4.10**  
**Foreign export prices and UK import prices**



Sources: Bank of England, ONS and Thomson Financial Datastream.

(a) M6 defined as Canada, France, Germany, Italy, Japan and the United States. Countries are weighted by their weights in the sterling ERI.

Non-oil commodity (NOC) prices, as measured by *The Economist* price index, rose by 2.4% in Q3 in dollar terms, more strongly than expected in the *August Report*. But this masks a stronger pickup in NOC prices since the time of the *August Report* of around 12%. Over this period all three of the major subcomponents of the index have risen: foods, metals and non-food agricultures. Such a broad-based rise might be consistent with the continuing global recovery. It could also reflect the depreciation of the dollar since August (see Section 1). If world demand for, and supply of, NOCs were unchanged, then the dollar price of NOCs would be expected to have risen to offset the dollar depreciation. The rise in NOC prices since the previous *Report* has been less pronounced in sterling terms.

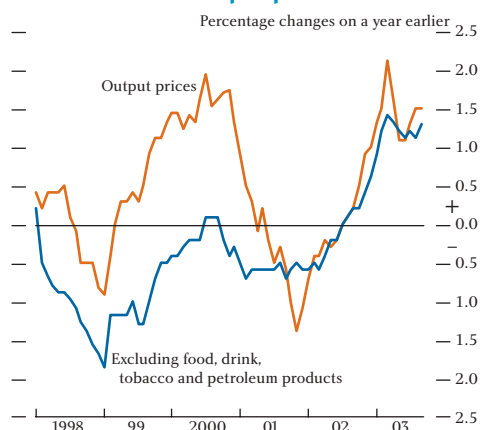
### 4.3 Import prices

During the past two years global trade prices, as proxied by the local-currency export prices of the G7 economies excluding the United Kingdom (referred to here as the 'major six' or M6 countries), have stabilised somewhat. M6 export price inflation fell in 2001, together with M6 producer price inflation, following the world slowdown (see Chart 4.9). If the recovery in global activity gathers pace over the next year, M6 export price inflation may also start to pick up.

The sterling effective exchange rate fell at the start of 2003, although it has been fairly stable since April. But in the latest data there remains little sign of a substantial effect on UK import prices from sterling's fall at the start of the year. The depreciation in sterling should raise the price of UK imports relative to the world price. Local-currency M6 export prices are an imperfect measure of global trade prices, but so far this year UK import price inflation has remained below M6 export price inflation (see Chart 4.10).

In the long run, the price of UK imports should follow the world price in common-currency terms, and hence movements in the exchange rate should be passed through to UK import prices. But there are reasons why the pass-through could be delayed in the short term. First, there may be some short-term inflexibility in import prices: foreign exporters to the United Kingdom could set prices in sterling terms for fixed periods and may not yet have been able to change them, for instance if prevented from doing so by contractual arrangements. Second, changing prices is often costly, for example catalogues may have to be reprinted. So firms may have delayed doing so if they did not expect the fall in the exchange rate to persist, as they would have expected to have to reverse any change at a later date. Pass-through may therefore be delayed until firms believe that the exchange rate movement is a permanent one.

**Chart 4.11**  
**Manufacturers' output prices**



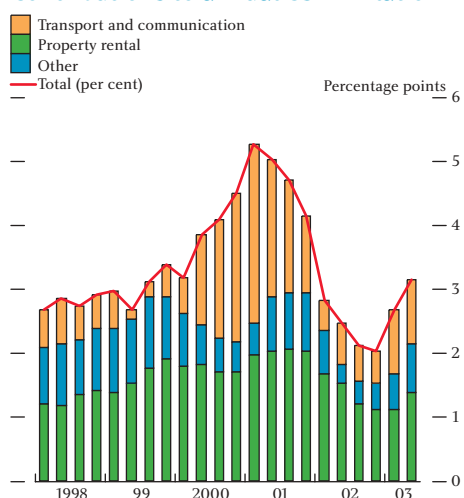
**Table 4.B**  
**Measures of service sector costs and prices<sup>(a)</sup>**

Series	average (b)	2002		2003		
		Average	Q1	Q2	Q3	Oct.
<b>Backward-looking</b>						
CIPS average cost index	56.7	54.1	55.8	55.4	55.0	56.0
CIPS average prices charged index	51.5	51.6	51.1	51.4	51.1	51.4

Source: CIPS.

- (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) Average since July 1996.

**Chart 4.12**  
**Contributions to annual CSPI inflation**



Either of these reasons could explain why the data do not yet appear to show a response to sterling's depreciation at the start of this year.

## 4.4 Sectoral costs and prices

Since the *August Report*, the ONS has rebased the producer price indices (PPIs) from 1995 to 2000. Despite the revisions resulting from this rebasing, the broad picture remains unchanged: manufacturers' input price inflation has picked up during the past two years after prices fell in 2001. Manufacturers' input prices rose by 1.3% in Q3, following a fall of 1.5% in Q2. According to the Bank's regional Agents upward pressure on input price inflation has continued more recently, partly due to strong increases in a few costs such as electricity and gas prices.

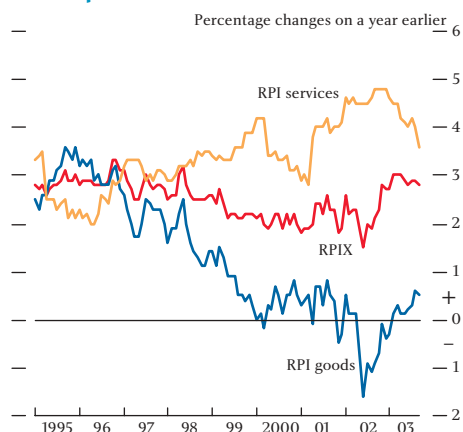
Manufacturing output price inflation also picked up in 2002. In the past, sharp changes in headline output price inflation have sometimes reflected the more erratic components of the index, such as tobacco and petroleum. This was the case in 2000 when headline annual output price inflation reached almost 2%, but excluding erratic items it peaked at just above zero (see Chart 4.11). However, the gap between headline and non-erratic output price inflation has been smaller over the past two years than in 2000, indicating that the rise in headline output price inflation is more broad-based than three years ago. The broad-based nature of this rise suggests that the pickup in manufacturers' output price inflation reflects an increase in underlying inflationary pressure during the past two years.

The CIPS services input price balance has generally been a little higher this year than in 2002 (see Table 4.B). In contrast, the CIPS services output price balance has been broadly flat over the past two years, indicating stable inflation. Annual services output price inflation, as measured by the experimental corporate services price index (CSPI), rose to 3.1% in Q2 from 2.7% in Q1 (see Chart 4.12). This was mainly due to a stronger contribution from the property rental component of the index. But at the moment the CSPI only covers about half of its targeted sample, and excludes items such as insurance premia and accountancy costs.

## 4.5 Retail prices

Annual RPIX inflation fell slightly to 2.8% in Q3, broadly as expected in August. The contribution of households' housing costs to annual RPIX inflation remained high at 1.1 percentage points in Q3. The gap between goods and

**Chart 4.13**  
**Retail prices**



services price inflation continued to narrow, with goods price inflation rising to 0.6% in August, from a low point of -1.6% in June 2002. The timing of that upward movement in goods price inflation broadly coincided with the rise in manufacturers' input and output price inflation. In contrast, retail services price inflation rose to almost 5% in 2002, and has only fallen back this year (see Chart 4.13). One way to examine the different movements in goods and services price inflation is to look at the distribution of inflation rates for individual components within these categories.

**Chart 4.14**  
**Distribution of retail goods price inflation rates**

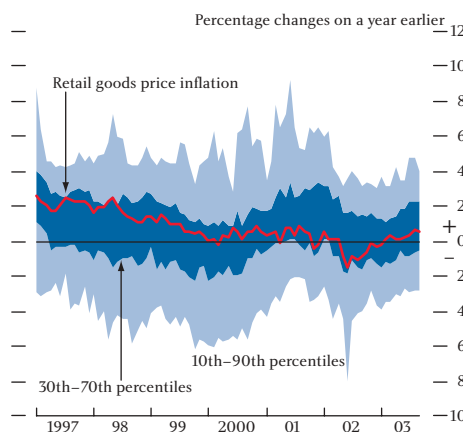
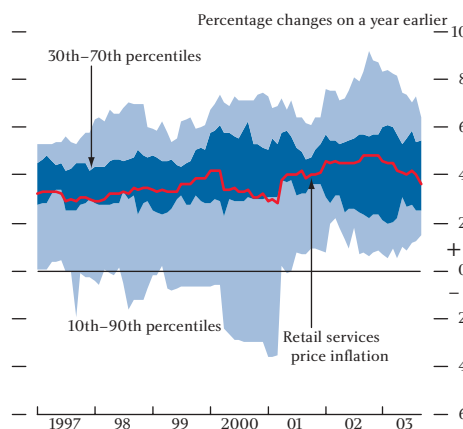


Chart 4.14 shows the distribution of inflation rates for different types of goods within the RPI goods index. The darker central band of the distribution represents the inflation rates that are close to the median—the middle of the distribution. The lighter bands represent those inflation rates that are further away from the median. Both the dark and light bands rise after the middle of last year, indicating that the inflation rates of a broad range of goods picked up in line with the rise in headline goods price inflation.

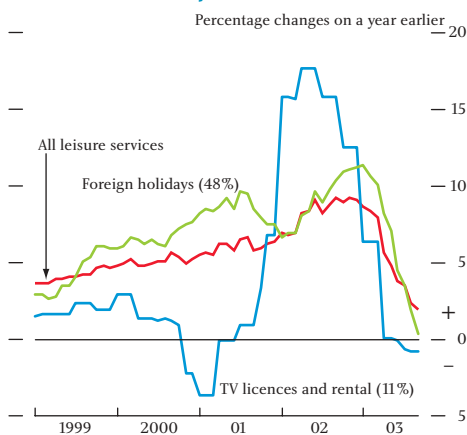
**Chart 4.15**  
**Distribution of retail services price inflation rates**



In contrast, Chart 4.15 shows the distribution of individual inflation rates in the RPI services basket. Within services, the rise and subsequent fall in RPI service price inflation over the past year is only evident in the upper tail of the distribution. This suggests that the movement in services inflation could have reflected movements in just a few services prices, rather than a broad-based movement as was the case for RPI goods inflation. In particular, these changes are centred in the leisure services component of the RPI.

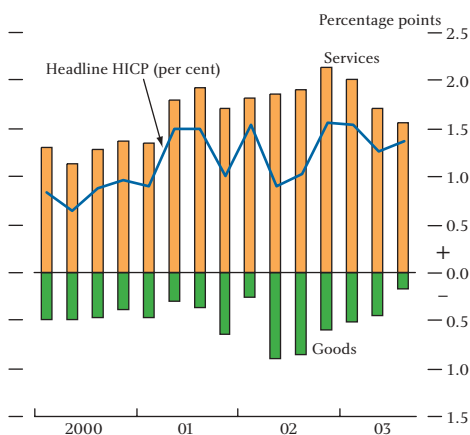
Within leisure services, two sector-specific movements can help explain the rise and subsequent fall in headline services price inflation. The first sector-specific movement appears to have been a one-off increase at the start of 2002 in the price of television licences and rentals, which includes subscriptions to cable and satellite television channels. That resulted in a higher inflation rate in the prices of those services for one year (see Chart 4.16). The second movement related to foreign holiday price inflation, which has fallen dramatically since the start of 2003: demand for foreign holidays may have declined as a result of fears about the outbreak of SARS and the Iraq war. Abstracting from these sector-specific effects, underlying retail services price inflation has been flatter than the headline numbers would suggest. The challenge for policy-makers is to 'look through' these sector-specific effects and focus on underlying inflationary pressure.

**Chart 4.16**  
**Leisure services prices**



Annual HICP inflation rose slightly to 1.4% in Q3 (see Chart 4.17), narrowing the gap between RPIX and HICP inflation. Previous *Reports* have discussed the difference between these two inflation measures in detail, noting that the largest component of the current gap is due to the inclusion of owner-occupied housing costs and Council Tax in RPIX.<sup>(1)</sup> As house price inflation eases, the gap between RPIX and HICP inflation should narrow further.

**Chart 4.17**  
**Contributions to annual HICP inflation**



(1) See the box on pages 38–39 of the May 2003 *Report*.

## 5

Monetary policy since the *August Report*

*This section summarises the monetary policy decisions taken by the MPC since the August Report.<sup>(1)</sup> The Bank's repo rate was maintained at 3.5% in September and October. It was increased to 3.75% at the MPC's meeting in November.*

The MPC's central projection in the *August Report* was for RPIX inflation to slip below target around the turn of the year. It was expected to remain under 2.5% through 2004, before edging higher to be close to the target at the two-year horizon. Output growth was expected to recover, averaging around trend over the forecast period.

At its meeting on 3–4 September, the Committee agreed that the outturns for recently published data were broadly consistent with the projections in the *August Inflation Report*, though the balance of risks might now be rather different.

Most members thought that the world recovery was broadly in line with their central expectations. If anything, the implications for UK external demand were a little weaker, given disappointing euro-area data. But for some members, forward-looking survey data suggested that the euro area would match expectations in the second half of the year. For most members, the near-term downside risks appeared to have receded, and the projected recovery seemed to be more assured, though uncertainty about the strength and durability of the US recovery remained.

The downside UK news since the *August Report* was that the estimate of output in the second quarter had not been revised up. Nevertheless, the disjunction between the output and expenditure indicators made future revisions likely. Indicators for the third quarter were consistent with the projection of a quick return to trend.

Consumption growth in the second quarter was surprisingly strong, and several indicators suggested that this strength had continued into the third quarter. This raised the possibility that consumption growth had been temporarily weak in the first quarter and that the projected profile might be

(1) The minutes of the August, September and October meetings (which set out the full discussion) are reproduced under a separate cover, published alongside this *Report*.



understated, particularly in the near term. If so, the current level of interest rates might provide more stimulus to domestic demand than needed to keep demand in line with the economy's supply capacity in the medium term.

Recent data on costs and prices suggested little change in the prospects for RPIX inflation in the medium term. Pay pressures remained muted and, given sterling's depreciation since last autumn, imported goods and services were the more likely current source of inflationary pressures.

It was particularly difficult to assess the current state of the UK economy, given the great uncertainties surrounding recent GDP data. Data releases in the coming month and information on third-quarter output and demand might reduce that uncertainty.

The Committee voted unanimously to maintain the repo rate at 3.5%.

At its meeting on 8–9 October, the Committee noted that the US recovery was broadly on track, though uncertainty remained over the resilience of consumption and the sustainability of the pickup in business investment. The US yield curve reflected expectations of continued expansionary fiscal and monetary policy. In the euro area, the contrast between weak data outturns and strengthening business surveys continued. It was unclear whether recovery had been delayed or whether a more extended period of subdued growth was now in prospect. Overall, the near-term prospects for UK external demand were slightly weaker than before.

In the United Kingdom, data revisions had raised the estimate of the recent path of aggregate demand. But their impact on inflation prospects would depend on the extent to which potential output had also been higher than previously thought. Although some members thought that the net effect of the revisions would be to raise the Committee's projection of inflation, others preferred to wait for further analysis ahead of the November *Inflation Report* before drawing firm conclusions.

House prices, housing market activity and mortgage borrowing all suggested that consumption growth would moderate more slowly than expected. The ratio of house prices to earnings seemed likely to peak at a higher level than projected in August. The corporate sector had been investing and building up stocks more than previously believed. Overall, the prospects for domestic demand appeared stronger than in August.

Some members argued that an increase in the repo rate was appropriate, because inflation was likely to be above target in two years' time, mainly due to higher domestic demand. Others considered that, since the July rate reduction, the balance of risks to inflation had become more weighted to the upside.

But most members were less confident that inflation would exceed the target in the medium term, or that the balance of risks had changed substantially. A premature rise in the repo rate might choke off the improvement in business conditions. The coming forecast round would help to shed more light on the evolution of potential supply and the relationship between activity and inflation.

Five members voted in favour of maintaining the repo rate at 3.5%. Four members preferred an increase of 25 basis points.

At its meeting on 5–6 November, the Committee voted to increase the repo rate by 0.25 percentage points to 3.75%.

*Output growth in the United Kingdom was weak in 2003 Q1, but picked up to around trend in the following two quarters. Quarterly GDP growth is projected to be a little above trend throughout the forecast period—a slightly stronger outlook than in August. RPIX inflation was 2.8% in 2003 Q3—broadly as envisaged three months ago. Inflation is expected to decline from its current level as the uplift from temporary factors subsides. But the strength of demand at home and abroad means that underlying inflationary pressures gradually start to build, so that inflation remains close to the target throughout the forecast period. Given the outlook for more robust activity, those pressures are stronger than expected in August. Risks around the central projection for output growth are weighted slightly to the downside, while those for inflation are broadly balanced.*

## 6.1 World economy

The MPC's central projection for overall world economic activity is little altered since the *August Report*. But the prospects for different regions have changed.

Euro-area GDP stagnated in the three quarters to 2003 Q2. And official data releases are consistent with a weaker outturn in Q3 than the Committee had expected. But there have been some indications of a recovery in recent business survey data. Official interest rates have remained low. And despite the appreciation of the euro against a basket of currencies since early 2002, the recovery in the rest of the world should help to stimulate euro-area exports. The Committee expects growth in the euro area to return to around trend in 2004, but the prospects are somewhat weaker than in August.

The outlook for the US economy has improved since the *August Report*. That partly reflects recent data, which have been stronger than the MPC anticipated in August. In addition, the Iraq-related fiscal package, announced by President Bush on 17 September, may provide a modest boost to domestic demand growth in 2004, on top of the previously announced fiscal measures. Monetary policy is also likely to continue to stimulate US aggregate demand, and the 5% decline in the dollar since August should give a fillip to net trade. The Committee expects US growth, on the central projection, to be above trend in 2004, before easing back in 2005, as the impact of the fiscal stimulus wanes and monetary policy returns towards a more neutral setting.

There have also been signs of a recovery in Japan. Real GDP increased by 1% in the second quarter of 2003, though other indicators give different signals about the strength of the economy. Growth is expected to continue, but at a more moderate pace. In the rest of Asia, the Committee expects growth to rise in 2004 compared with 2003. That reflects the abating impact of SARS on domestic demand in those countries, and also a view that the recovery in the United States will spur increased exports from the Asia region.

The slower recovery in the euro area means that there is a more protracted pickup for UK export markets in the forecast than expected in August. World trade growth, weighted to take account of the importance of different trading partners for UK economic activity, is expected, in the central projection, to reach a rate of around 6%–7% in 2004, and to rise further in 2005.

## 6.2 UK output and expenditure

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New National Accounts data were published in September, and contained significant revisions (see the box on pages 14–15). The cumulative growth in real GDP since the end of 1997 is around 1 percentage point higher than in earlier data releases.

By contrast, real growth in consumption since 1995 was revised down. Nevertheless, the picture remains one of above-trend increases for most of that period. Consumption fell marginally in 2003 Q1, possibly reflecting a spending pause ahead of the war in Iraq. Household spending recovered in the second quarter to grow at 0.7%. Despite that pickup, underlying growth in consumption appears to have slowed. In the year to 2003 Q2, growth averaged 0.6%, compared with an average quarterly rate of 0.9% since the end of 1995.

Although spending has been slowing, it has not done so as rapidly as the Committee expected in August. Retail sales growth has held up, with volumes growing by 1.2% in Q3. Household borrowing growth has continued undiminished. And increases in household deposits and cash holdings are consistent with firm near-term spending growth.

After falling back in the first half of the year, house price inflation and activity appear to have picked up in Q3. The supply of housing changes slowly and so price movements tend to reflect shifts in demand. Increases in the demand for housing services often reflect improved expectations of household incomes or reduced uncertainty about the future, and thus indicate likely trends in households' other spending. Moreover, by raising the value of housing collateral and improving access to loans at a lower interest rate, higher house prices may directly stimulate consumption. In light of recent

outturns, the MPC has revised up its central projection for house price inflation, so that it slows more gradually during the next two years.

Equity prices have increased by more than assumed at the time of the *August Report*. The FTSE All-Share index averaged 2131 in the 15 working days to 5 November. That means that the level of households' financial wealth is higher than in August.

For these reasons, the prospects for consumer spending are somewhat stronger than in the *August Report*. On the central projection, the pace of quarterly consumption growth slackens marginally, remaining close to trend into the medium term.

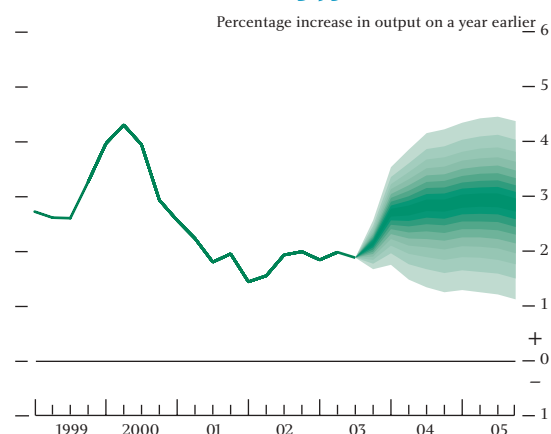
The National Accounts data released in September contained significant revisions to growth in business investment from around the turn of the millennium. The MPC weighed a number of factors when judging the outlook for business investment. On the downside, company debt levels remained high and, despite a recovery in equity prices, many businesses continued to face pension fund deficits. So repairing balance sheets might be a greater priority for some firms than investing in plant or premises. And unused physical capacity in certain sectors may also help to dampen any recovery.

But there are a number of positive factors underlying the investment projection. Profits have been improving, and that may prompt a more optimistic assessment of future profitability. Higher company income can also stimulate investment by providing a cheaper source of finance than external sources. Surveys of investment intentions have picked up. And reports from the Bank's regional Agents have suggested an improving outlook for investment. On balance, the MPC believes that the prospect for business investment spending is brighter than it was three months ago. The volume of business investment is expected, over the forecast period, to rise, on average, at around the same rate as GDP.

Nominal government spending is assumed to grow in line with the Chancellor's plans, as outlined in last April's Budget. Real government spending growth is also likely to be vigorous.

Export growth is projected to recover from the low levels seen over the past few years. In the MPC's projection, sterling's depreciation early in 2003 and the expected further recovery of the world help to stimulate foreign demand for UK output. But initially that growth is likely to be weaker than anticipated in August, as UK export markets in the euro area expand more slowly in the near term. Import growth should also pick up given the outlook for strong domestic demand. Higher domestic demand growth than in the *August Report* means that

**Chart 6.1**  
**Current GDP projection based on constant nominal interest rates at 3.75%**



The fan chart depicts the probability of various outcomes for GDP growth in the future. 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 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 on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

imports rise more quickly in the current projection. Drawing exports and imports together, net trade detracts from growth in the early part of the forecast. But that drag on UK activity is likely to dwindle, with its contribution becoming slightly positive by the end of the projection.

The Committee's latest projection for four-quarter GDP growth is shown in Chart 6.1.<sup>(1)</sup> It is based on the assumption that official interest rates are maintained at 3.75%.<sup>(2)</sup> On the central projection, even with quarterly growth a little above trend, the four-quarter rate remains relatively subdued in the near term as previous weakness continues to affect the annual comparison. With almost unchanged momentum in the quarterly figures, the four-quarter profile picks up in 2004, as the effect of the exceptionally low growth figure in 2003 Q1 drops out of the calculation. Thereafter, on the central projection, GDP grows at slightly above the historic trend rate of the past 40 years. Compared with August, the near-term outlook for GDP growth until the end of 2004 is similar. In the second year, the prospect for UK activity is more buoyant than projected in August.

### 6.3 The outlook for inflation

Inflation prospects are affected by both external influences and domestic pressures. Spot oil prices have returned to levels prevailing in early August. And, as in the *August Report*, the prospect remains that oil prices will gradually decline during the next two years, using the futures price as a guide. Oil-price influences aside, external pressures on UK inflation are likely to build gradually over most of the forecast period. The sterling effective exchange rate index averaged 100.7 in the 15 working days to 5 November, the starting point used for the MPC's central projection. That was slightly above the level implied by the August projection. Using the MPC's conventional approach,<sup>(3)</sup> the sterling ERI is assumed to depreciate moderately to 97.4 by 2005 Q4 on the central projection. Though the exchange rate has appreciated slightly since August, the full effect of the larger depreciation since the beginning of the year on import prices and prices charged by domestic competitors is still to be felt. And the recovery in the world economy should very gradually begin to push up international prices during the next two years. But weaker projected activity in the euro area points to less imported inflationary pressures in the United Kingdom compared with the *August Report*.

The outlook for inflation also depends upon the balance between demand and supply in the domestic economy.

(1) Also shown as Chart 1 in the Overview.

(2) An alternative projection based on market interest rate expectations is shown in Chart 6.5 below.

(3) See the box 'The exchange rate in forecasting and policy analysis', on page 48 of the November 1999 *Inflation Report*.

Output growth has been revised up. And the revisions to investment have only limited implications for estimates of the capital stock. Other things being equal, that would have implied greater pressure on capacity and more inflation. But RPIX inflation data were not revised. So there must have been additional factors weighing down on inflation during the past couple of years.

The capacity or potential output of the economy could have been greater than the Committee had thought. That could be because the labour market has become more flexible or competitive pressures on firms could have increased, for example. Both of these developments would have represented permanent improvements to the supply-side of the economy. The Committee believes that the factors which have been bearing down on inflation are likely to persist into the forecast period. Consequently, the Committee has judged that the upward revisions to past GDP growth have little impact on inflationary pressure during the next two years.

The Committee expects nominal earnings growth to rise as the demand for labour picks up. The cyclical rebound in labour productivity growth that is expected in the early part of the forecast period is likely partially to offset the impact of rising earnings growth on prices. But unit labour costs growth is projected to increase into the medium term.

RPIX inflation was 2.8% in 2003 Q3, slightly above target and broadly as envisaged at the time of the *August Report*. As explained in previous *Reports*, transitory influences—particularly a strong contribution from housing depreciation—have been boosting RPIX inflation recently. Underlying domestic inflationary pressures have been noticeably weaker than is suggested by the headline rate. HICP inflation, which excludes the costs of owner-occupied housing and Council Tax, was 1.4% in the third quarter.

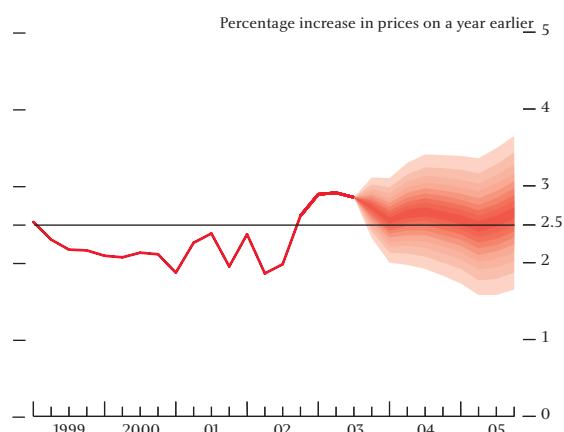
The Committee's latest projection for twelve-month RPIX inflation is presented in Chart 6.2.<sup>(1)</sup> The projection is conditional on the assumption that official interest rates are maintained at 3.75%.<sup>(2)</sup> It is shown alongside the corresponding projection in the *August Report*, which was based on constant interest rates at 3.5% (see Chart 6.3). Under the current central projection, inflation edges down in the near term and then stays close to target for the remainder of the forecast period.

The initial decline in RPIX inflation is less abrupt than projected in August, as house price inflation, and hence the

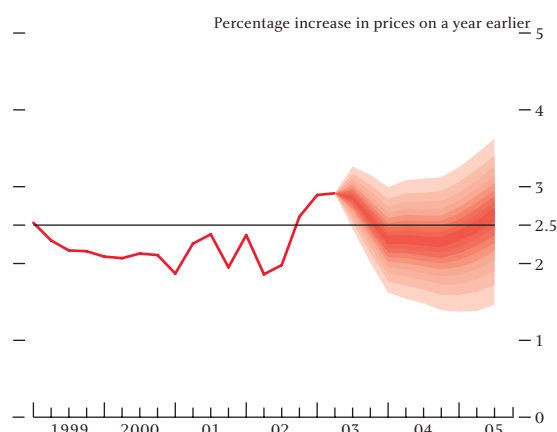
(1) Also shown as Chart 2 in the Overview.

(2) An alternative projection based on market interest rate expectations is presented in Chart 6.4 below.

**Chart 6.2**  
**Current RPIX inflation projection based on constant nominal interest rates at 3.75%**



**Chart 6.3**  
**RPIX inflation projection in August based on constant nominal interest rates at 3.5%**



The fan chart depicts the probability of various outcomes for RPIX inflation in the future. 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 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 on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

impact of housing depreciation, eases more slowly. Underlying inflationary pressures build gradually throughout the forecast period as quarterly output growth is projected to be above trend for the next two years. External influences also begin to contribute to the increase in underlying inflation. The full impact of sterling's depreciation earlier this year is still to be felt and thereafter the rise in world export prices is likely to help lift RPIX inflation slightly. RPIX inflation stays close to target throughout the forecast period with waning transient effects offsetting waxing underlying pressures.

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

Per cent

2003	2004				2005			
Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
3.7	4.1	4.4	4.7	4.8	5.0	5.1	5.1	5.2

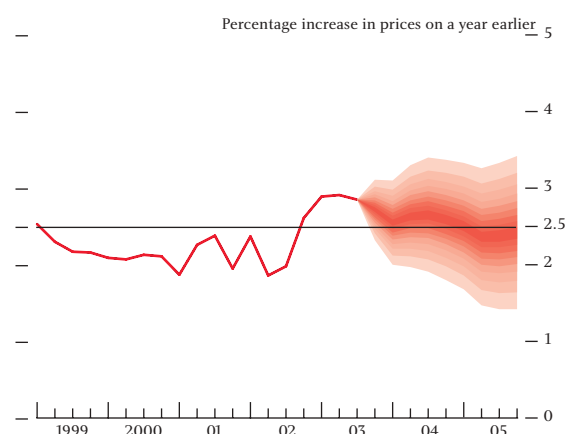
(a) Based on the interest rate available on gilt-edged securities, including those used as collateral in short-term repo contracts, plus a small upward adjustment to allow for the average difference between this rate and the Bank's official interest rate. The data are 15-day averages to 5 November 2003.

Based on the 15 working-day average to 5 November, financial market expectations of the likely path of official interest rates have risen noticeably compared with the corresponding average used in the *August Report* (see Table 6.A). These expectations were formed before the Committee raised interest rates on 6 November. The Committee's latest projections conditioned on those 15-day averages are shown in Charts 6.4 and 6.5. The profile for growth, on the central projection, is lower and rather flatter than in the constant-rate version. Consequently, the profile for RPIX inflation is also a little lower.

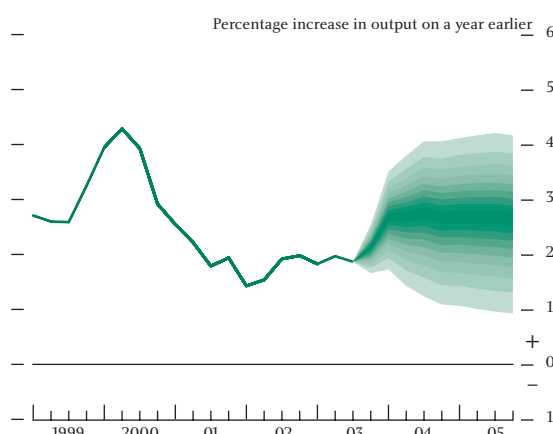
The prospects for output growth and inflation are uncertain. The fan charts illustrate the Committee's best collective assessment of the likelihood of possible outcomes, including judgments on the principal risks to the outlook. The width of the fan charts indicates the Committee's degree of uncertainty about the prospects for the economy. The Committee draws on the experience of past forecast errors in making this judgment. There has been little change in the degree of uncertainty since August.



**Chart 6.4**  
Current RPIX inflation projection based on market interest rate expectations



**Chart 6.5**  
Current GDP projection based on market interest rate expectations



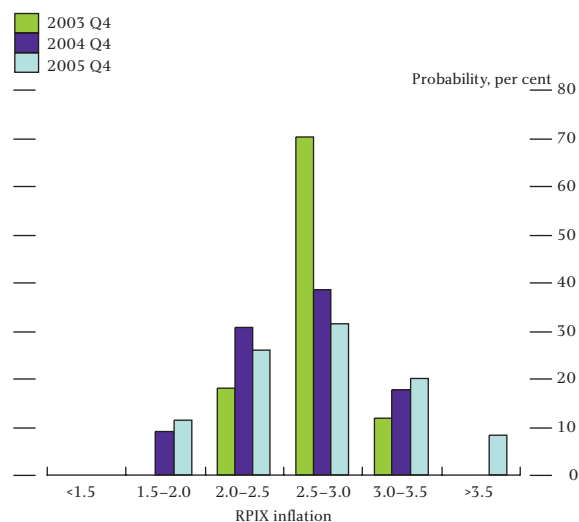
The Committee considers that there are a number of risks to the economic outlook embodied in the central projection. These concern mainly the outlook for the world economy, the prospects for the UK household sector, the implications of revised GDP data for inflationary pressure, and the prospects for earnings growth.

As discussed in previous *Reports*, international imbalances pose a downside risk to the world outlook.<sup>(1)</sup> In particular, the large current account deficit in the United States may prompt a further depreciation of the dollar, and possibly an associated scaling back of US domestic demand. Moreover, a falling dollar would limit the growth in exports of the United States' main trading partners. Another risk is that the euro area may take longer to recover than is currently assumed in the central projection. Realisation of those risks to the world economy would change the outlook for UK export demand and GDP growth relative to the central projection. The MPC believes that, overall, the risks from the world to UK activity remain slightly on the downside. Their implications for UK inflation would depend on the extent of any related change in the sterling exchange rate.

There are risks to the outlook for UK household spending. First, the sustainable level of house prices is highly uncertain. The longer house price inflation continues to exceed growth in average household incomes, the greater the additional upward pressure on spending and inflation in the near term, and the greater the chance of a sharp adjustment in house prices and thus to spending further ahead. Second, it is possible that consumers may have assumed that the rapid increases in real incomes experienced over recent years may persist. As households' real income growth slows, any such expectations

(1) See the box 'Imbalances in the global economy: sources and potential implications', on pages 14–15 of the May 2002 *Inflation Report* for a fuller discussion.

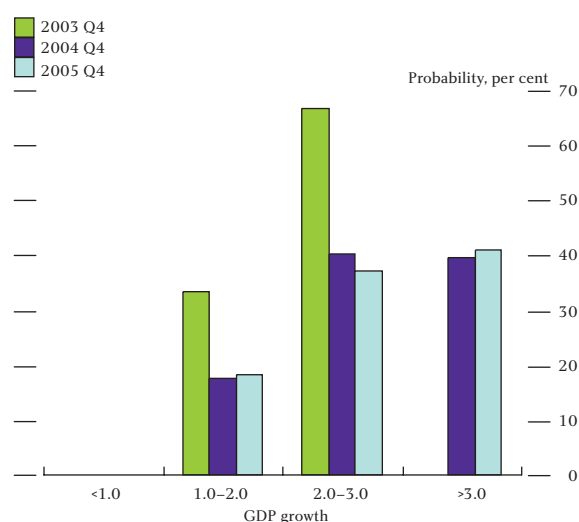
**Chart 6.6**  
**The MPC's expectations for RPIX inflation based on constant nominal interest rates at 3.75%<sup>(a)</sup>**



Source: Bank of England.

(a) These figures are derived from the same distribution as Chart 6.2. They represent the probabilities that the MPC assigns to RPIX inflation lying within a particular range at a specified time in the future. Because of the difficulties in precisely quantifying low-probability events, probabilities of less than 5% are not shown in this chart.

**Chart 6.7**  
**The MPC's expectations for GDP growth based on constant nominal interest rates at 3.75%<sup>(a)</sup>**



Source: Bank of England.

(a) These figures are derived from the same distribution as Chart 6.1. They represent the probabilities that the MPC assigns to GDP growth lying within a particular range at a specified time in the future. Because of the difficulties in precisely quantifying low-probability events, probabilities of less than 5% are not shown in this chart.

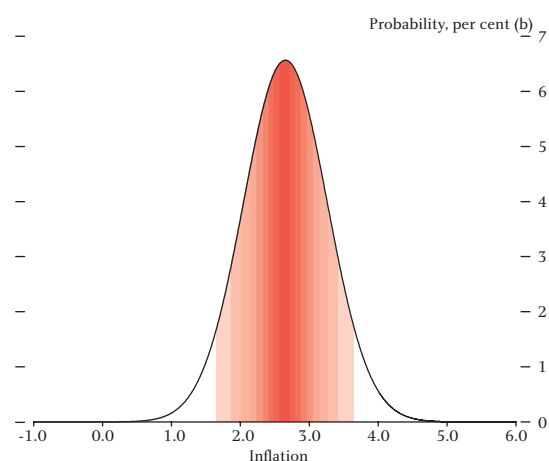
may seem less plausible and trigger a further slowing in spending over and above that embodied in the central projection.

The interpretation of the recent revisions to GDP also poses risks to the inflation outlook. It is possible that the faster growth in the past may be indicative of a more rapid rate of underlying productivity growth, which will continue into the future. That might imply lower inflationary pressure than in the central projection. Alternatively, it is possible that the high level of sterling in the second half of the nineties may have exerted more downward pressure than previously thought, the effect of which would disappear over the forecast period. In that case inflationary pressures would be higher than in the central projection.

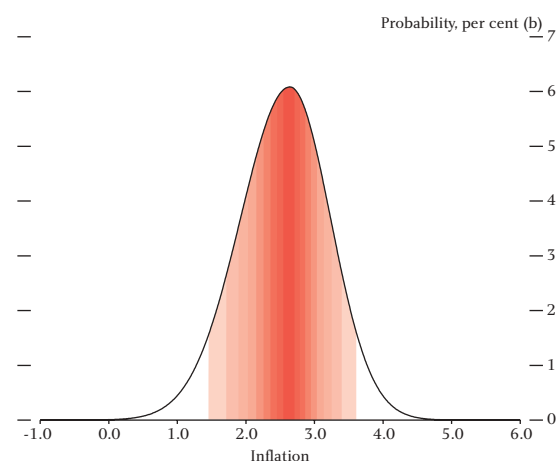
There are short-term upside risks to inflation from earnings growth. The fall in the real purchasing power of employees' wages, described in Section 4 on page 31, could generate higher upward pressure on settlements during the next bargaining round as people try to resist the squeeze in the real value of their take-home pay.

The best collective judgment of the Committee is that the overall balance of risks to the central projection for GDP growth is weighted slightly to the downside over the next two years, though less so than in August. The risks to RPIX inflation are broadly balanced. The probabilities of various outcomes for RPIX inflation and GDP growth are set out in Charts 6.6 and 6.7. The overall balance of risks to the

**Chart 6.8**  
**Current projection for the percentage increase**  
**in RPIX in the year to 2005 Q4<sup>(a)</sup>**



**Chart 6.9**  
**August projection for the percentage increase**  
**in RPIX in the year to 2005 Q3<sup>(a)</sup>**



Source: Bank of England.

- (a) These charts represent a cross-section of the fan chart at the end of the respective forecast periods. As with the fan charts themselves, the shaded areas represent 90% of the distribution of possible outcomes for RPIX inflation in the future. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands covers a further 10%. There is judged to be a 10% chance that the outcome will lie outside the shaded range. For further details on how the fan charts are constructed see the box on pages 48–49 in the May 2002 *Inflation Report*.
- (b) Probability of inflation being within  $\pm 0.05$  percentage points of any given inflation rate, specified to one decimal place. For example, the probability of inflation being 2.5% (between 2.45% and 2.55%) in the current projection is around 6%.

inflation outlook at the two-year horizon is shown in Chart 6.8 alongside the corresponding balance in August (see Chart 6.9). Given the many uncertainties in the outlook, there are some differences in view on the central projection, particularly regarding the amount of spare capacity in the economy and the speed with which underlying inflation picks up in the medium term. Nevertheless, the range of opinion is relatively narrow.

At its November meeting, the Committee noted that, although some of the factors keeping inflation above target in recent months were expected to unwind, underlying inflationary pressures were projected to build gradually into the medium term. Given the outlook for inflation, the Committee judged that a modest increase of 0.25 percentage points in interest rates to 3.75% was necessary to keep inflation on track to meet the target.

## Other forecasters' expectations of RPIX inflation and GDP growth

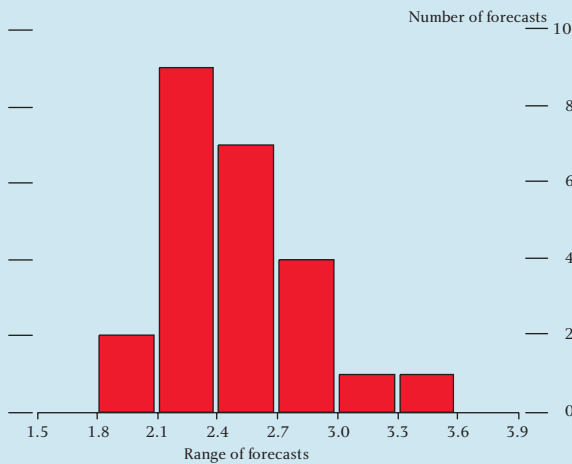
In October, the Bank asked a sample of external forecasters for their latest projections of inflation and output growth. Based on the results of this survey, the average forecast for twelve-month RPIX inflation in 2003 Q4 is 2.7% (with a range of 2.2%–2.9%). The average forecast is for RPIX inflation to fall to 2.4% in 2004 Q4, before picking up to reach 2.5% by 2005 Q4 (when the range widens to 1.9%–3.3%). The average forecast for inflation at the two-year horizon is a little higher than the corresponding one in the *August Report*. The greatest number of respondents expect RPIX inflation to be between 2.1% and 2.4% in two years' time (see Chart A). The table shows that, on average, the external forecasters see a 52% probability of inflation being at or below 2.5% in 2005 Q4.

On average, the forecasters expect four-quarter GDP growth in 2003 Q4 to reach 2.0% (with a range of

1.5% to 2.6%), 0.3 percentage points higher than expected in August. By end-2004 and end-2005, GDP is projected, on average, to grow close to trend. The average forecast for GDP growth in 2005 Q4 is 2.4% (with a range of 1.1% to 3.3%), below the two year ahead expectation in August.

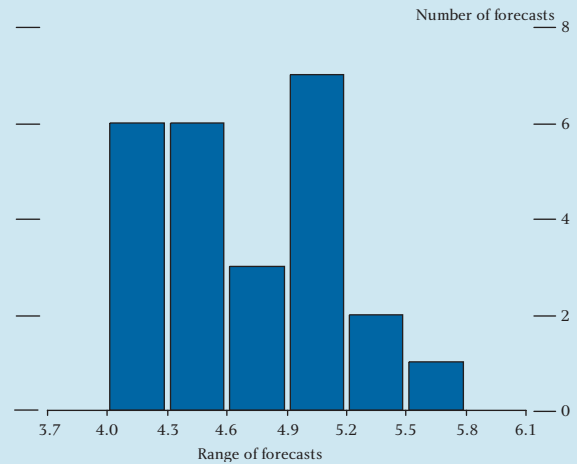
The average forecast for the official interest rate rises from 3.7% in 2003 Q4 (with a range from 3.5% to 3.75%) to 4.7% in 2005 Q4 (ranging between 4.0% and 5.5%). Though the projection at the two-year horizon is higher than that in August, it is well below the market's estimated expectation of 5.2% (see Table 6.A). On average, the sterling ERI is expected to fall from 100.1 in 2003 Q4 to 96.9 by 2005 Q4 (ranging from 90 to 108), a somewhat sharper decline than the average forecast in August, albeit from a higher base.

**Chart A**  
Distribution of RPIX inflation forecasts for 2005 Q4



Source: Central projections of 24 outside forecasters as of 31 October 2003.

**Chart B**  
Distribution of repo rate forecasts for 2005 Q4



Source: Central projections of 25 outside forecasters as of 31 October 2003.

### Other forecasters' expectations of RPIX inflation and GDP growth<sup>(a)</sup>

#### RPIX inflation

Probability, per cent	Range:					
	Less than 1.5%	1.5% to 2.0%	2.0% to 2.5%	2.5% to 3.0%	3.0% to 3.5%	More than 3.5%
2003 Q4	1	3	26	58	11	1
2004 Q4	6	15	35	28	12	4
2005 Q4 (b)	7	15	30	26	15	7

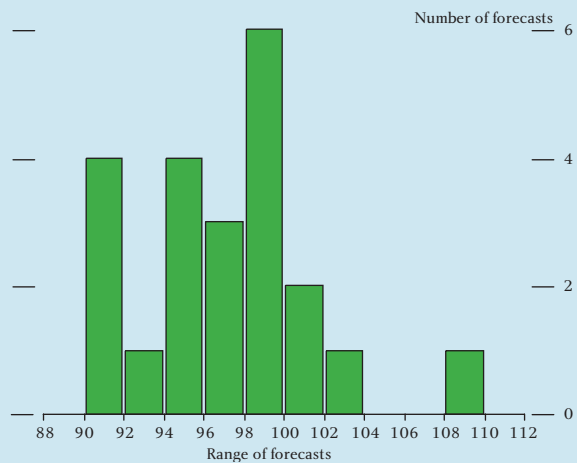
#### GDP growth

Probability, per cent	Range:			
	Less than 1%	1% to 2%	2% to 3%	More than 3%
2003 Q4	3	45	51	3
2004 Q4	8	24	42	26
2005 Q4 (b)	9	29	40	22

(a) 27 other forecasters provided the Bank with their assessment of the likelihood, at three time horizons, of expected twelve-month RPIX inflation and four-quarter output growth falling in the ranges shown above. This table represents the means of the responses for each range. For example, on average, forecasters assign a probability of 6% to inflation turning out to be less than 1.5% in 2004 Q4.

(b) 24 forecasters.

**Chart C**  
Distribution of sterling ERI forecasts for 2005 Q4



Source: Central projections of 22 outside forecasters as of 31 October 2003.

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# Bank of England

## Agents' summary of business conditions

November 2003

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

- A muted recovery in manufacturing has begun. In aggregate, Agencies reported in mid-October the strongest growth of manufacturing output since early 2001. However, some contacts were concerned that orders had not revived more quickly and that the nascent recovery might prove to be short-lived. The information, communications and technology (ICT) sector had shown only a modest pickup.
- Construction output growth remained above trend, underpinned by strong public sector demand. The residential housing market picked up in most regions during late summer, but there were some tentative signs in a few regions that the market might have slackened a little in October. The balance between supply and demand improved in most regions, partly the result of more properties coming onto the market.
- The service sector showed further improvement, although growth of activity remained below its average of recent years. Business service providers in the financial sector were generally not expecting a significant recovery until next year.
- Retail sales growth remained around trend in most regions. However, there may have been a modest slowdown in the final month of the period.
- UK overseas trade continued a gradual recovery. Trade with the Middle and Far East showed the strongest growth. The recovery in US export markets was patchy so far and largely confined to particular sectors, including defence and ICT. European markets overall showed few signs of recovery, but some exporters gained market share, owing to the appreciation of the euro.
- Investment intentions also improved, both in manufacturing and services. But there was little evidence of higher capital spending, other than on projects financed by the public sector.
- The labour market tightened a little in most regions. Manufacturing employment was beginning to stabilise, but some contacts were concerned that further redundancies would be necessary unless the recovery strengthened. Services employment accelerated a little, helped by strong growth of public sector jobs. Skill mismatches and shortages increased.
- There were relatively few pay settlements in the past three months and these were mostly little changed on a year earlier. The 7.1% increase in the National Minimum Wage in October did not have a significant effect on wage costs across the economy as a whole. But the number of pay disputes increased.
- Input price inflation increased, perhaps to its highest rate since early 2001. Price rises were largely confined to a few inputs, such as utilities and food stuffs, although these increases were typically in double digits. Strong competition in most markets served to prevent these additional costs feeding through into higher producer output prices and retail prices.

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(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

Agencies reported that farm incomes rose significantly this year. Higher revenues were largely the result of higher world prices (as drought reduced yields for several crops) and a lower sterling exchange rate against the euro, rather than increased output. Exchange rate movements also increased the competitiveness of, and demand for, domestic coal. Exploration activity in the North Sea, already low, was expected to fall further in the fourth quarter.

### Manufacturing

Manufacturing output was beginning a modest recovery. Agencies' reports in mid-October suggested that manufacturing output was growing at its fastest rate since early 2001. However, there was some concern that orders were not reviving more quickly and that the nascent recovery may prove to be short-lived. There were no obvious signs of a pickup in desired stock levels, which might have been expected if manufacturers were confident of a sustained recovery in their order books. Agencies reported that the demand for capital goods remained weak. This too suggested that firms were continuing to work well below capacity. Reports of the relocation of capacity overseas continued, which could affect the strength of the recovery of domestic production, should demand accelerate.

The main areas where demand was strongest were consumer goods, products used in the construction industry and supplies to the public sector, including the NHS. There were signs of a small improvement in the ICT sector. But it appeared that this improvement so far was much weaker than in the United States.

### Construction and housing

Agencies reported that, in most regions, the construction industry continued its recent strong growth, helped by long order books from the public sector and a buoyant housing market. With firms increasingly focused on these markets, it appeared that output might continue to grow at above trend rates, at least in the short term. Demand for new office space was weak, especially in the oversupplied market in the South East.

Demand by the public sector was wide-ranging, including projects to build affordable housing, hospitals,

prisons, universities and schools, roads and other large infrastructure schemes that were in the pipeline, such as the modernisation of the London Underground. Some contacts reported that these projects were progressing more smoothly than in the past, although in some regions there continued to be delays.

In the late summer, the housing market appeared to have strengthened in most regions, and the deceleration of house prices lessened somewhat. That may have been partly associated with continuing difficulties for housebuilders in securing planning permission, which was restricting the number of new housing developments. In London and the South East, contacts reported stronger demand from first-time buyers and a shortening of the time that properties remained unsold. This suggested that buyers' concerns of a future sharp fall in prices may have lessened. It appeared that the general economic uncertainty earlier in the year may have temporarily subdued the housing market. As confidence recovered in the summer, that pent-up demand was unleashed, resulting in perhaps a temporary spurt in housing market activity. By mid-October, most Agencies reported a better balance between supply and demand in the secondary market. There was some evidence that the housing market might have cooled a little in a few regions, including the South East. In those regions, more properties were being placed on the market and there were tentative signs of weaker demand, including less activity of first-time buyers. That was helping to reduce inflationary pressure.

### Services

The service sector strengthened during the period under review. Agencies' reports in October suggested that the growth in turnover of business services increased to its fastest rate for over two years, helped by strong public sector demand. Nonetheless, growth was probably below its average of recent years. This was partly the result of a subdued recovery in some financial services, ICT, advertising and consultancy. A more robust pickup was expected in 2004, as private sector demand strengthened both at home and abroad. Turning to consumer services, the rally in the housing market in the summer continued to support activity for lenders and legal firms. Apart from in London, the tourism industry generally performed strongly, owing partly to the seasonally warm weather in the early autumn, which encouraged domestic holiday trips by UK residents.

## DEMAND

### Consumption

Agencies' reports suggested that, in aggregate, retail sales growth remained around trend during the late summer, after a period of weakness earlier in the year. That picture was also consistent with a continuing strong appetite of households for new borrowing. There were significant changes in the pattern of consumer demand, largely associated with the warm weather. But the weather may also have boosted the overall level of consumption, for example by increasing the number of domestic tourists in the United Kingdom. Several Agencies reported buoyant consumer spending at tourist resorts, which continued into September. But in mid-October, reports suggested some weakening of annual retail sales growth. Some car dealers reported that their stocks of new cars had risen recently and that demand might weaken in 2004.

### Exports and imports

There was a gradual, if modest, recovery in overseas trade in the past three months. That mostly reflected increased trade with the Far East, especially China, and more recently the Middle East, following the lessening of the disruptions associated with the war in Iraq. Exports to the United States also picked up a little, although that was patchy and mostly confined to specific sectors such as defence, 'prestige' cars and ICT. There were few signs of recovery in euro-area markets. Where exports had risen, this was mostly the result of a larger market share of UK producers, arising from the appreciation of the euro.

For many contacts in the manufacturing sector, competition from China remained intense. This maintained downward pressure on margins, but also resulted in a steady relocation of UK capacity to countries where labour costs are cheaper, including China. Consequently, UK exports of intermediate goods to these countries increased, in addition to higher UK imports of finished goods. Relocation of capacity so far was mostly for low value-added goods. However, competition from China now also affected some goods with higher value added. That was associated with some relocation of these activities away from the United Kingdom. Competition from the Far East was also increasing in those service sector activities that are internationally mobile.

## Investment

Investment intentions improved steadily in the past three months, although that was not yet reflected in a recovery in capital spending. Investment continued in productive capacity that had been relocated overseas. The impetus for investment in the United Kingdom was often greater efficiency, compliance with regulatory requirements and the reduction of labour costs, rather than increasing capacity. In the services sector, Agencies reported that investment in ICT was recovering, if only slowly. That was partly the result of rising public sector investment, for example by the NHS.

## EMPLOYMENT

There was some tightening of the labour market in most regions. Overall, Agencies reported that employment growth was at its fastest rate for two years. There was a more moderate rate of contraction of manufacturing employment, together with some acceleration of jobs in the service sector. The latter was partly the result of continued job expansion in the public sector. The degree of tightness of some regional labour markets was causing increasing problems of skills mismatch and shortages in some sectors. Filling vacancies for skilled workers in the construction sector was particularly difficult. Many contacts were increasingly dependent on migrant labour or agency staff to fill vacancies.

## COSTS AND PRICES

### Pay

The past three months have been a relatively quiet period for new pay settlements. Contacts reported that there was little change to settlements in this period. Only a comparatively small number of contacts were affected significantly by the 7.1% increase in the National Minimum Wage in October. However, there was a somewhat more widespread increase in pay disputes. That may have reflected employees' expectations of higher pay growth in the coming year, against the backdrop of low unemployment; recent rates of RPI inflation that were higher than a year earlier; and higher rates of employee National Insurance and pension contributions and Council Tax.

### Input prices

Agencies noted that there was some upward pressure on input prices. That degree of inflationary pressure was last seen in early 2001, when ONS data indicated that

producer input prices were increasing at an annual rate of about 4%. Contacts reported large price increases for a few selected goods and services. Gas and electricity prices increased significantly when contracts were renewed. These increases were likely to have a staggered effect, as more firms' utilities contracts came up for renewal. Other large cost increases included prices of some metals, food stuffs and freight charges. Insurance premia also increased sharply, though by less than last year. Concern remained about the increase in costs due to compliance with regulatory requirements and other overheads.

For most contacts, material costs made up a relatively small proportion of their total costs. So far, the input price increases had mostly been absorbed within firms' margins, or were dissipated by finding cheaper suppliers. For example, some contacts switched from suppliers pricing in euros to those pricing in dollars. Overall, margins remained under pressure.

## Output and retail prices

Agencies reported that, in contrast to input prices, inflationary pressures for firms' output prices and in the retail sector generally remained quite weak. Where pressures were mounting, these were largely confined to industries operating at high rates of capacity utilisation, such as construction, or where margins were so low that input price increases could not be absorbed indefinitely, such as for some food stuffs. But mostly, the picture remained fairly benign, in part the result of strong competition from overseas suppliers. The picture was a little different in the service sector, including business services, where a somewhat stronger recovery enabled some firms to push through price increases. The relatively low level of activity continued to drive down prices for some financial services, such as investment banking and stockbroking.

## **Text of Bank of England press notice of 4 September 2003**

### **Bank of England maintains interest rates at 3.5%**

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 3.5%.

The minutes of the meeting will be published at 9.30 am on Wednesday 17 September.

## **Text of Bank of England press notice of 9 October 2003**

### **Bank of England maintains interest rates at 3.5%**

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 3.5%.

The minutes of the meeting will be published at 9.30 am on Wednesday 22 October.

## **Text of Bank of England press notice of 6 November 2003**

### **Bank of England raises interest rates by 0.25 percentage points to 3.75%**

The Bank of England's Monetary Policy Committee today voted to raise the Bank's repo rate by 0.25 percentage points.

The global economic recovery appears to be gathering momentum, though the pattern is uneven. After slowing at the start of the year, growth in the United Kingdom has picked up and credit growth remains strong. Business surveys suggest the recovery is becoming more broad-based. Neither household spending nor the housing market have slowed by as much as the Committee expected. Underlying inflationary pressures are therefore likely to build gradually as demand strengthens and sterling's depreciation earlier this year feeds through. Against that background, the Committee judged that a modest increase of 0.25 percentage points in official interest rates was required to keep prospective RPIX inflation in line with the target of 2.5%.

The Committee's latest inflation and output projections will appear in the *Inflation Report* to be published on Wednesday 12 November.

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

## Glossary and other information

### Glossary of selected data

**AEI:** average earnings index.

**CSPI:** corporate services price index.

**ERI:** exchange rate index.

**GDP:** gross domestic product.

**HICP inflation:** inflation measured by the harmonised index of consumer prices.

**LFS:** Labour Force Survey.

**MO:** 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 banks and building societies to the UK non-bank, non building society private sector. M4 lending includes loans and advances as well as investments, acceptances and reverse repo transactions.

**MEW:** mortgage equity withdrawal.

**PMI:** purchasing managers' index.

**PPI:** producer price index.

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

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

**TPI:** tax and price index.

### Abbreviations

**BCC:** British Chambers of Commerce.

**CBI:** Confederation of British Industry.

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

**CML:** Council of Mortgage Lenders.

**EEA:** European Economic Area.

**EU:** European Union.

**FTSE:** Financial Times Stock Exchange.

**G7:** group of seven major economies: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

**GC:** general collateral.

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

**HBF:** House Builders Federation.

**ICT:** information, communications and technology.

**IFO:** Institut für Wirtschaftsforschung an der Universität München.

**IT:** information technology.

**M6:** major six economies.

**MPC:** Monetary Policy Committee.

**MTIC:** missing trader intra-community.

**NBER:** National Bureau of Economic Research.

**NHS:** National Health Service.

**NICs:** National Insurance contributions.

**NOC:** non-oil commodity.

**ODPM:** Office of the Deputy Prime Minister.

**OFCs:** other financial corporations.

**ONS:** Office for National Statistics.

**OPEC:** Organization of the Petroleum Exporting Countries.

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

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

**SARS:** severe acute respiratory syndrome.

**SMMT:** Society of Motor Manufacturers and Traders.

**VAT:** value added tax.

### 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.