



Inflation Report

August 2004

Bank of England



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In order to maintain price stability, the Government has set the Bank's Monetary Policy Committee (MPC) a target for the annual inflation rate of the Consumer Prices Index of 2%. Subject to that, the MPC is also required to support the Government's objective of maintaining high and stable growth and employment.

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

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

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

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The Overview of this *Inflation Report* is available on the Bank's web site at www.bankofengland.co.uk/inflationreport/infrep.htm.

The entire *Report* is available in PDF at www.bankofengland.co.uk/inflationrep/index.html.

Overview

The world economic recovery has broadened. In the United Kingdom, output growth picked up to above trend in Q2. Official data suggest only moderate growth in consumer spending in the first quarter, but other indicators point to rather greater momentum. There are tentative signs that the housing market is starting to cool. Investment continued to grow briskly. The Committee's central projection, on the benchmark assumption that official interest rates follow a path implied by the market yield curve, is for continued robust GDP growth in the near term. The rate of expansion then moderates, dipping below trend for a while. The labour market remains tight and some indicators suggest that domestic price pressures have increased. Annual CPI inflation climbed to 1.6% in June, largely reflecting a strong contribution from petrol prices. On the central projection, CPI inflation drops back in the near term and then gradually moves up in response to pressures on supply, flattening off at around the 2% target after two years.

The international economy

The world economic upswing has broadened. Euro-area output growth firmed in the first quarter, though it may have eased back a touch in Q2. In Germany, growth continued to be largely accounted for by exports, but there were signs of firmer domestic spending elsewhere in the euro area. In the United States, output growth slowed in the second quarter. That reflected a deceleration in consumers' expenditure, which seems likely to prove temporary. In June, the FOMC raised the official interest rate for the first time since 2000, to 1.25%. The Japanese economy continued to expand briskly in the first quarter and nominal demand picked up strongly, suggesting that the era of deflation may shortly end. There are signs that Chinese growth may be slowing, though the pace of expansion nevertheless remains rapid. Compared with the *May Report*, the Committee judges the overall outlook for UK export markets to be broadly unchanged.

Tensions in the Middle East and concerns about Russian supply pushed the spot price of oil up to around \$40 per barrel. The futures curve also moved up, suggesting that higher oil prices are expected to persist. But the price of oil relative to that of industrialised countries' output remained well below the peak levels experienced in the 1970s. Moreover, the major industrialised economies are less sensitive to high oil prices than 30 years ago.

After rising sharply through the latter half of last year and early 2004, the price of non-oil commodities stabilised. The foreign

currency prices of other internationally traded goods and services edged up, with some further pickup likely as higher materials costs work through and global spare capacity is eroded. Overall, the outlook for international export prices is marginally stronger than in May.

Activity in the United Kingdom

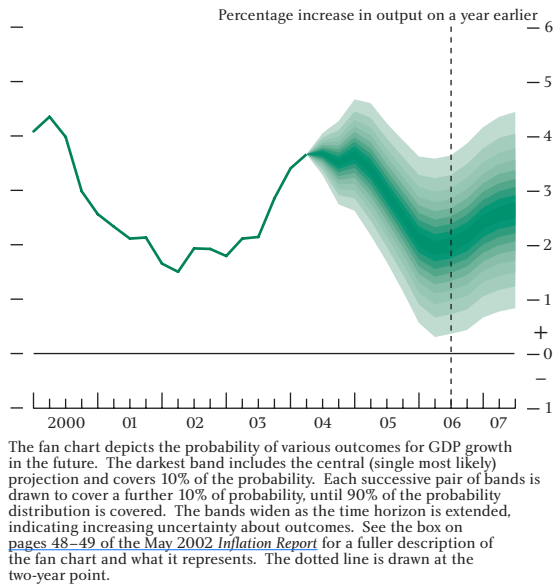
In the United Kingdom, the 2004 *Blue Book* contained upward revisions to the estimates of past GDP growth. Those revisions were mainly associated with significantly faster growth in public sector output, in part the result of improved measures of health output. But what matters for inflationary pressure is the amount of resources the government absorbs, not how productively they are used. Overall, the *Blue Book* revisions did not lead to a material change in the Committee's assessment of the total demand for resources in the economy, so leaving its assessment of inflationary pressure largely unaltered. Output is provisionally estimated by the ONS to have risen by 0.9% in Q2, with industry and services sharing equally in the expansion. Business surveys point to a similar rate of expansion in the third quarter.

Revised ONS data suggest that consumer spending decelerated through the second half of 2003 and grew by just 0.6% in Q1, reflecting particular weakness in expenditure on services and net tourism. The weak first-quarter outcome is somewhat puzzling in the light of other indicators and it is possible that there was rather more momentum in consumption than currently suggested by the official data. Retail sales continued to grow rapidly in Q2, but private car registrations fell and business surveys suggest some easing in spending growth in the future. House price inflation appears to have peaked and several indicators of housing market activity point to further moderation. The Committee expects consumer spending to decelerate gradually as house price inflation slows.

Investment grew strongly, rising 1.7% in the first quarter. Housing investment was up sharply and the recovery in capital spending by businesses since early 2003 continued apace. Investment intentions point to further growth in business investment, though the resurgence may be less vigorous than in previous recoveries.

Sterling rose moderately against all the major currencies, but the effective rate remained within the narrow range it occupied during 2000–02. At its June meeting, the MPC raised the repo rate by 0.25 percentage points to 4.5%.

Chart 1
Current GDP projection based on market interest rate expectations



The outlook for growth

Chart 1 shows the MPC's assessment of the outlook for four-quarter GDP growth over a three-year period on the benchmark assumption that official interest rates follow a path implied by the market yield curve.⁽¹⁾ Under the central projection, output growth remains above trend in the near term, sustained by continued buoyancy in public consumption and private investment coupled with steady growth in household spending. The rate of expansion then moderates, dipping below trend for a while, as domestic demand growth slows in response to lower house price inflation, past increases in official interest rates, the prospective rises in official interest rates implied by the yield curve and the reduced stimulus from fiscal policy. The outlook for GDP growth for the next two years is broadly unchanged from the May projection.

Costs and prices

Employment fell in the three months to May, but that followed an unusually large rise in the previous three months and may represent sampling error. Other indicators suggest that the labour market remains tight. Vacancies rose and unemployment remained at an historical low. And, according to business surveys, labour demand continued to strengthen. Earnings growth fell sharply, though that reflected the unusually strong bonuses which boosted the growth rate at the start of the year. Settlements and annual growth in regular pay per head edged up but growth in regular pay per hour remained flat, limiting the impact on labour costs.

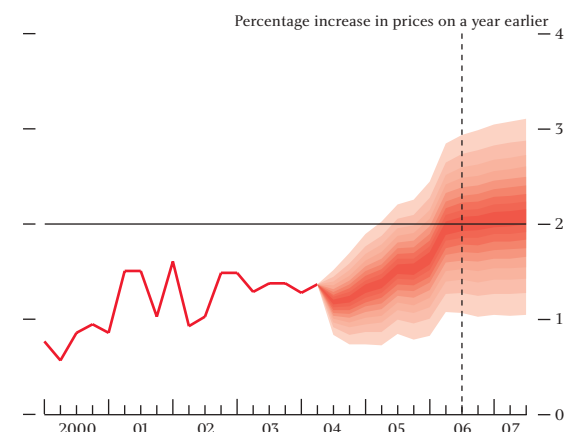
Some other cost pressures also picked up. Higher prices for fuel and raw materials were manifested in higher input prices. But the price of imported goods and services fell, reflecting the appreciation of sterling since the start of this year.

Manufacturers' annual output price inflation strengthened and surveys suggest that services sector price inflation picked up. Capacity utilisation has been rising in both sectors. The Committee believes that the overall demand pressures relative to supply capacity in the private sector are likely to generate upward pressure on prices in due course.

CPI inflation rose sharply, reaching 1.6% in June. That was mainly the result of the recent rise in petrol prices set against their weakness a year earlier. Inflation is likely to fall back in the near term, reflecting some moderation in the strong contribution from petrol prices and temporary weakness in the contributions of some other components of the index, including

(1) The assumed path for official interest rates is shown in [Table 6.A on page 40](#).

Chart 2
Current CPI inflation projection based
on market interest rate expectations



The fan chart depicts the probability of various outcomes for CPI 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. The dotted line is drawn at the two-year point.

food. Inflation according to the previous target measure, RPIX, was 2.3% in June.

The outlook for inflation

Chart 2 shows the Committee's assessment of the outlook for CPI inflation, assuming that official interest rates move in line with the market yield curve. In the central projection, inflation drops back in the near term and gradually increases thereafter in response to pressures on supply and moderating downward pressure from import prices, reaching the 2% target around two years ahead. Inflation then flattens off, reflecting the attenuation in capacity pressures resulting from the slackening in demand growth during the second year of the projection. The profile for the next two years is broadly similar to that in the *May Report*.

As usual there is considerable uncertainty surrounding the central projections. The main risks around the central projections relate to the prospects for house prices and consumption, the pressure of demand on supply and the outlook for earnings, and the world economy. Relative to the central projections, the Committee judges that the overall risks to growth and inflation are broadly balanced. There is a range of views among members, though the differences are small.

The policy decision

At its August meeting, the Committee noted that, although inflation was likely to fall back in the near term, the central projection under the assumption that official interest rates moved up in line with the market yield curve was for inflation to rise gradually thereafter, stabilising at the target after about two years. Given that outlook for inflation, and bearing in mind the considerable risks and uncertainties, the Committee judged that an immediate increase of 0.25 percentage points in the official interest rate to 4.75% was necessary to keep inflation on track to meet the target in the medium term.

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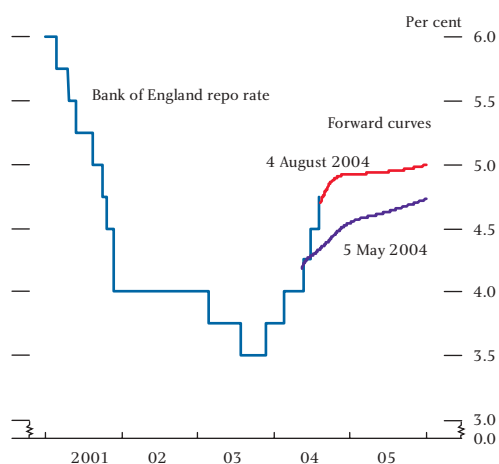
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Money and asset prices

1

The MPC increased the official interest rate by 0.25 percentage points to 4.75% on 5 August; the repo rate was previously increased in June. UK short-term market rates rose between early May and early August, and there was a moderate rise in the sterling ERI. Equity prices fell in the major economies. Household borrowing and deposits continued to rise strongly, although the rate of unsecured borrowing growth did fall. House price inflation remained high, but indicators pointed to easing in the near term.

Chart 1.1
Bank of England repo rate and GC repo/gilt^(a)
two-week forward curve^(b)



- (a) A general collateral (GC) repo rate is the rate that one financial institution pays to borrow money from another against the collateral of any stock of gilts.
(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. No adjustment is made to allow for the average difference between the two-week GC repo rate and the Bank's official interest rate.

1.1 Asset prices

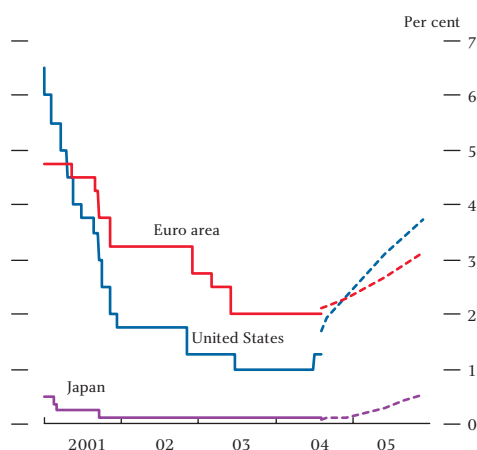
Short-term interest rates

The Monetary Policy Committee increased the official interest rate by 0.25 percentage points to 4.75% on 5 August; the repo rate was also increased in June by 0.25 percentage points, but left unchanged in July. Relative to the *May Report*, market expectations of future short-term interest rates appear to have risen: a forward curve derived from market repo contracts and government bonds has shifted up by around 0.4 percentage points out to the end of 2004, but rather less further out (see Chart 1.1).

The forward curve reflects market expectations of future nominal interest rates. But forward rates might differ from expected future rates if market participants demand risk premia. These time-varying premia can be thought of as compensation for uncertainty about the path of future interest rates, or for holding positions that could, at times, be difficult to unwind. By contrast, those sorts of risk should not affect survey evidence on respondents' expectations for future interest rates. Recently, forward rates have been broadly consistent with survey evidence, suggesting that any risk premia have been relatively small and fairly stable. A poll of economists taken by Reuters in late July suggested that, on average, respondents expected the official repo rate to rise to 5.0% by the end of 2004 and 5.15% by the end of 2005.

The economic impact of official interest rate movements depends, in part, on how they affect the interest rates faced by households and companies. Between November 2003 and June 2004, only around half of the 1 percentage point rise in the UK official interest rate passed through to effective interest rates—the average rates paid by companies and households on the stock of their borrowing. More timely

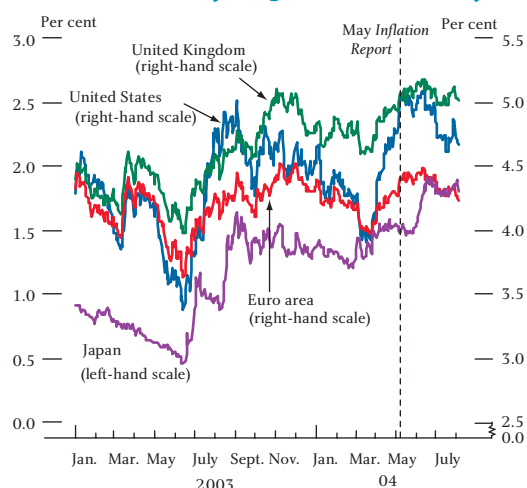
Chart 1.2
Official interest rates and forward interest rates in major economies^(a)



Sources: Bank of England and Bloomberg.

(a) Solid lines are official interest rates. Broken lines represent annualised three-month interbank interest rates implied by futures contracts on 4 August 2004.

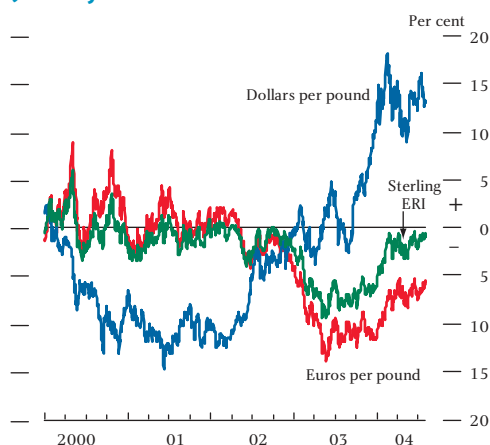
Chart 1.3
International ten-year government bond yields^(a)



Sources: Bank of England and Bloomberg.

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

Chart 1.4
Changes in sterling exchange rates since January 2000^(a)



(a) Cumulative percentage changes since 3 January 2000.

information on effective interest rates is not available, although banks' and building societies' advertised rates did pick up further in July.

Official interest rates were left unchanged in the euro area and Japan during the past three months and futures contracts continued to point towards relatively gradual rises in rates over the coming 18 months (see Chart 1.2). By contrast, the FOMC raised the official US interest rate in June by 0.25 percentage points to 1.25%, the first rate increase since 2000. And futures contracts on 4 August pointed towards a series of further increases in the United States during the remainder of 2004 and throughout 2005.

Government bond yields

From mid-March to early May, nominal yields on ten-year government bonds rose in the United Kingdom and most other major economies (see Chart 1.3). Real yields also rose. But subsequent movements have been more modest: by early August, both nominal and real yields—and correspondingly, implied inflation expectations—were at similar levels to those prevailing in early May.

In Japan, nominal yields on ten-year government bonds rose significantly in June (see Chart 1.3). Real yields on index-linked bonds—first issued earlier this year—also increased, but the rise was modest and rather short-lived. Correspondingly, implied inflation expectations have picked up somewhat, amid evidence of strengthening economic recovery (see Section 2).

Exchange rates

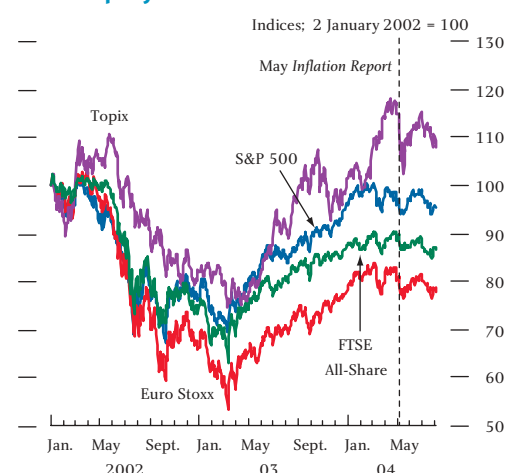
The sterling effective exchange rate index (ERI) rose moderately between early May and early August. The ERI averaged 106.2 in the 15 working days to 4 August, 1.5% higher than in the equivalent period leading up to the May Report.

In recent months, the sterling ERI has been broadly stable, moving within the relatively narrow range it occupied during most of 2000 to 2002 (see Chart 1.4). And based on evidence from options prices, market participants appear to expect that stability to continue. This picture contrasts with the more marked movements of sterling bilateral exchange rates and, indeed, the ERIs of other major currencies since May.

Equity prices

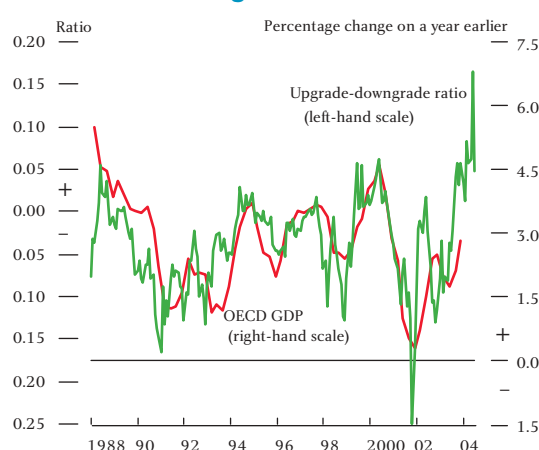
By early August, equity indices in the major economies were lower than in early May (see Chart 1.5). In the United Kingdom, the FTSE All-Share averaged 2170 in the

Chart 1.5
World equity indices in domestic currencies



Sources: Bank of England and Bloomberg.

Chart 1.6
Revisions to earnings forecasts^(a) and OECD GDP^(b)



Sources: IBES, OECD and Thomson Financial Datastream.

- (a) Balance of equity analysts' upgrades minus downgrades to earnings forecasts over the next twelve months, for companies in the FTSE world index as a proportion of all companies covered.
(b) Volume measure of GDP.

Table 1.A
House price inflation^(a)

	2003 Average	2004 Q1	April	May	June	July
Monthly percentage changes in house prices						
Halifax (b)	1.2	2.1	1.9	2.2	1.2	1.3
Nationwide	1.2	1.6	2.0	1.7	0.8	2.1
Net balances						
RICS price balance (c)	7	41	45	43	17	n.a.
RICS price expectations (d)	2	34	31	18	-7	n.a.

Sources: Bank of England, Halifax, Nationwide and RICS.

- (a) Quarterly and annual data are averages of monthly observations. All data are seasonally adjusted.
(b) The published index has been adjusted by Bank staff to account for a change in the method of calculation.
(c) Net balance of chartered surveyors reporting house price rises over the past three months.
(d) Net balance of chartered surveyors expecting house price rises over the next three months.

15 working days to 4 August. That was some 4.1% below the equivalent starting point for the May *Inflation Report* projections—broadly in line with the falls in the other major economies. The United Kingdom's relative performance was a little stronger in common-currency terms, however, given the modest appreciation of sterling since the May *Report*.

Since the beginning of the year, the Japanese Topix has tended to rise, in line with evidence of strengthening economic recovery. But the other major equity indices have changed little, or even fallen, over the period as a whole. That may appear surprising. Company earnings in the major economies have rallied. And at least until very recently, sentiment about future earnings appeared to have brightened: there was a rise in the balance of upgrades less downgrades in equity analysts' near-term earnings forecasts in the first half of the year, consistent with the general improvement in the outlook for the world economy (see Chart 1.6). This should have had a positive impact on the major indices, as equity prices depend on expectations of future earnings. But valuations also depend on the rate at which investors discount those earnings.⁽¹⁾ And so the rises in real interest rates earlier this year would have acted to depress equity prices.

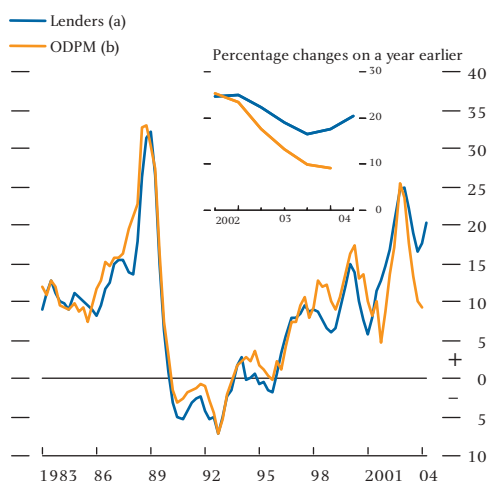
The housing market

Monthly house price measures have provided mixed signals since the May *Report*. The Halifax index suggests that house price inflation was steady in June and July at about 1¼%, below the rates of early 2004 (see Table 1.A). The backward-looking prices balance in the RICS survey fell in June, and the price expectations balance turned negative. But the Nationwide index suggests that house prices rose by over 2% in July, a larger rise than in the previous month.

Uncertainty about the trend in house price inflation reflects, in part, the nature of housing: no two houses are identical; they are infrequently traded; and their prices are only observed when sold. As a result, the prices of individual houses are not always easy to gauge. And even when transactions do occur, it can be difficult to estimate an aggregate price for housing that fully adjusts for changes over time in the types of houses that are bought and sold. In a given month, the level of house prices could be overestimated, for example. That would result in a high estimate of monthly house price inflation. If the level of house prices were then accurately measured in the subsequent period, that would lead to a low estimate of monthly house price inflation. Such volatility means that several months of data are usually necessary to establish whether there has been a change in

(1) See Panigirtzoglou, N and Scammell, R (2002), 'Analysts' earnings forecasts and equity valuations', *Bank of England Quarterly Bulletin*, Spring, pages 59–66.

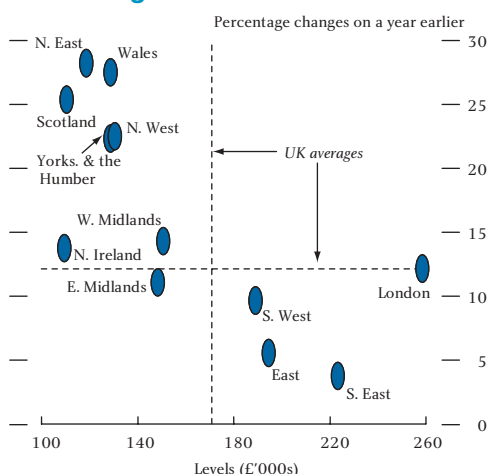
Chart 1.7
House price measures



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

- (a) The lenders' measure is calculated from the average of the Halifax and Nationwide quarterly indices, adjusted by Bank staff for a change in the method of calculation of the Halifax index.
(b) Quarterly data, published on an experimental basis since 2002 Q1.

Chart 1.8
ODPM measure of house prices across the United Kingdom^(a)



Source: ODPM.

- (a) Data are for May 2004 and published on an experimental basis.

trend house price inflation, and so less short-term measures may be a better guide. Three-month on three-month rates of house price inflation have eased on both the Halifax and Nationwide measures—an indication, perhaps, that house price inflation has peaked.

One less timely house price measure—the Office of the Deputy Prime Minister (ODPM) index—has actually pointed to a lower rate of house price inflation for some time. The divergence between the ODPM and the main lenders' indices (see Chart 1.7) partly reflects differences in underlying data and in the stages of the house-buying process at which prices are recorded. But it also reflects the fact that different indices represent different concepts.⁽¹⁾ In particular, the ODPM index measures the price of a representative group of houses. By contrast, the lenders' indices measure the price of a single representative house. As such, the ODPM index tends to put greater weight on relatively expensive houses than the Halifax and Nationwide indices. Over the past year, house price inflation has tended to be lower in areas with more expensive houses (see Chart 1.8). And as a consequence, the ODPM approach has produced lower estimates of house price inflation than the lenders' indices.

House prices could affect future household spending, given that higher house prices increase the collateral at homeowners' disposal, facilitating more or cheaper borrowing.⁽²⁾ By its nature, the ODPM measure should be indicative of movements in the value of the housing stock and so the total amount of collateral at the household sector's disposal. But changes in collateral are only likely to have an impact on the consumption of credit-constrained households—those who cannot consume as much as they would like because they cannot borrow enough against their future income. Such households are perhaps less likely to own expensive properties. And so the lenders' indices, which attach relatively more weight to cheaper types of houses, may in practice be a better guide to the likely impact of house prices on consumption.

Looking ahead, housing market activity could provide a guide to the near-term outlook for house price inflation. During periods of changing market conditions, uncertainty about the market value of individual homes is particularly acute and asking prices may adjust only slowly. Accordingly, a fall in demand might initially be met by a decline in transactions, as sellers struggle to find buyers willing to pay the asking price.

(1) See Thwaites, G and Wood, R (2003), 'The measurement of house prices', *Bank of England Quarterly Bulletin*, Spring, pages 38–46.

(2) See Aoki, K, Proudman, J and Vlieghe, G (2002), 'House prices, consumption, and monetary policy: a financial accelerator approach', *Bank of England Working Paper no. 169*.

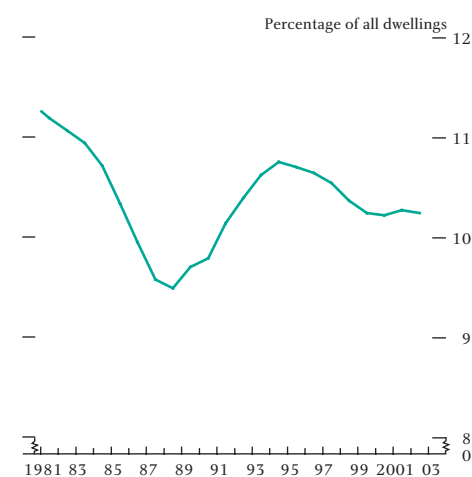
Table 1.B
Housing market activity^(a)

	2003 Average	2004 Q1	April	May	June
HBF net reservations (b)	-7	28	18	11	-14
HBF site visitors (c)	-11	9	11	-16	-15
Mortgage approvals (d)	114	126	122	124	114
Land transaction returns (e)	112	149	150	152	155
RICS sales to stocks ratio (f)	0.43	0.55	0.55	0.53	0.50

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

- (a) Quarterly and annual 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) Percentage balance of respondents reporting more site visitors than during the same month of the previous year.
 (d) The number of loans approved for house purchase (thousands).
 (e) The number of transactions in England and Wales registered with HM Land Registry (thousands). The series was formerly known as particulars delivered.
 (f) Average sales per surveyor divided by the average stock of unsold properties per surveyor.

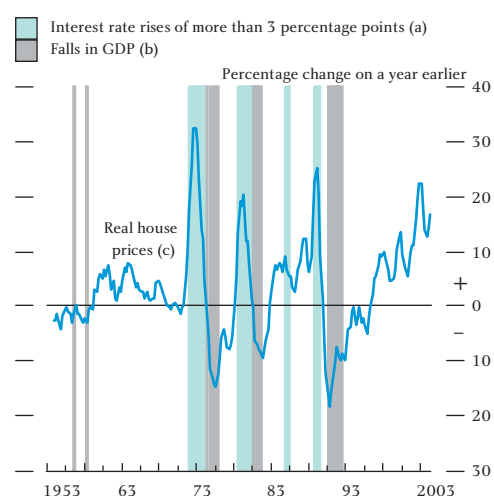
Chart 1.9
The size of the private rented sector^(a)



Source: ODPM.

- (a) Based on data for England, which are more timely than the corresponding data for the United Kingdom. Data are end-year up to and including 1990, and end-March thereafter.

Chart 1.10
Real house prices and macroeconomic conditions



Sources: Bank of England, Nationwide and ONS.

- (a) Periods in which the (end-period) Bank of England official interest rate was more than 3 percentage points higher than a year earlier. Data are annual prior to 1975, and quarterly thereafter.
 (b) Periods of negative annual (four-quarter) growth in the chained volume measure of GDP at market prices.
 (c) Real house prices calculated as non seasonally adjusted Nationwide house price measure divided by RPIX (RPI prior to 1975).

But as sellers take on board the new information about the state of the market, house prices would then begin to adjust. The easing in several indicators of housing market activity in recent months (see Table 1.B) points towards a slowing of house price inflation in the near term.

The degree of any slowdown is likely to depend, to some extent, on property investment demand. As discussed in June's *Financial Stability Review*, buy-to-let mortgages have become increasingly common in recent years. But this phenomenon has not been associated with any marked expansion of the private rented sector (see Chart 1.9), consistent with a shift in its composition away from company landlords and towards individual landlords holding rather fewer properties.

Many of those individual landlords could lack experience of holding property investments under differing housing market conditions. So, looking forward, one uncertainty is their likely behaviour during a period of slowing house price inflation. In June and July, the Bank's regional Agents conducted a survey of participants in the buy-to-let market. The survey suggested that most individuals who had invested in the housing market were financially healthy, had relatively low loan to value ratios, and were long-term investors. In itself, that suggests investors might be inclined to hold on to their properties during any house price inflation slowdown, rather than withdrawing from the market and exacerbating its decline. But that conclusion is by no means certain.

Over the past 50 years, it has been unusual for nominal house prices to fall. But at times, real house price falls have been masked by periods of high overall inflation. Chart 1.10 shows that, since the early 1950s, there have been three episodes in which real house prices—nominal house prices deflated by retail prices—have fallen markedly. In each case, those substantial declines have occurred following periods of sharp interest rate rises; and they have broadly coincided with periods of very weak activity and rising unemployment. The MPC does not judge this to be the most likely outcome for the macroeconomy over the forecast period. But there are great uncertainties surrounding the future outlook for house prices.

1.2 Money, credit and balance sheets

Monetary aggregates

Narrow money growth has remained broadly steady since the May Report. And broad money growth has also changed little: annual growth in M4—largely consisting of notes and coin and the sterling deposits of the household sector, private

Table 1.C
Monetary aggregates^(a)

Percentage changes on a year earlier

	2003 Average	2004 Q1	April	May	June	July
Notes and coin	7.0	7.0	5.6	5.3	6.3	6.0
M0 (b)	6.9	7.1	5.7	5.3	6.4	5.6
M4 (c)	7.3	7.7	7.1	8.0	7.8	n.a.

(a) Seasonally adjusted. 2003 figures are averages of quarterly data.

(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 broad money aggregate. Its principal components are the UK private sector's holdings of sterling notes and coin, and its holdings of sterling deposits (including repos) with UK monetary financial institutions.

non-financial corporations (PNFCs) and other financial corporations (OFCs)—remained close to 8% in 2004 Q2 (see Table 1.C).

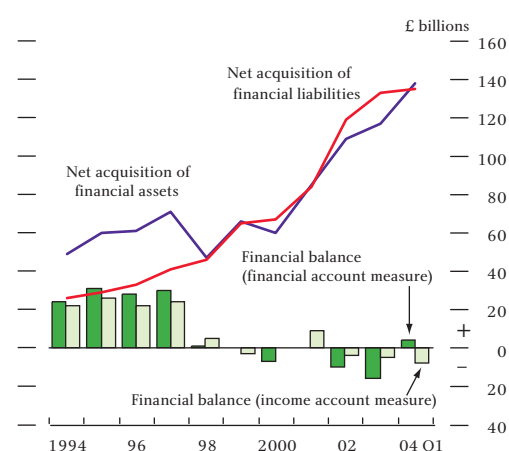
Historically, there has been a reasonably close relationship between M4 and nominal demand. But at times, M4 has provided misleading signals of demand pressures in the economy. In part, that reflects volatile movements in the broad money holdings of OFCs. These sometimes reflect portfolio allocation decisions that have only very indirect effects on demand in the economy.

Excluding OFCs, M4 growth rose in 2004 Q2 to 9.2%, its highest rate since the early 1990s. That could indicate that households or non-financial companies are temporarily holding greater money balances than they would ideally like—and they may run down some of those excess holdings by purchasing goods or assets. But the rise could also reflect desired portfolio adjustments to balance sheets in either sector, with limited implications for near-term spending.

Table 1.D
Lending to individuals

	2003 Q1	Q2	Q3	Q4	2004 Q1	Q2
Percentage changes on a year earlier						
Unsecured lending	14.5	14.4	13.3	12.1	12.2	11.8
Secured lending	14.0	14.2	14.7	15.0	15.2	15.3
Flow as a percentage of household income						
Mortgage equity withdrawal	6.8	6.5	7.5	8.9	8.0	n.a.

Chart 1.11
Households' financial balance^(a)



(a) Data are non seasonally adjusted, with the exception of the income account measure of the financial balance. All 2004 Q1 data are annualised.

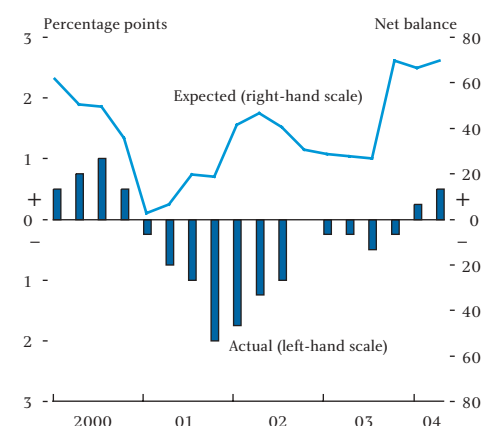
Households

Individuals' borrowing has risen rapidly since the late 1990s. The stock of borrowing secured on housing—which includes some types of equity withdrawal (see the box on pages 10–11)—has risen by around three quarters over the past five years. And secured borrowing growth has remained strong: the annual rate rose to over 15% in the first half of 2004 (see Table 1.D). Unsecured borrowing has also risen rapidly—by almost 90% since 1999. But growth has fallen back more recently. Annual growth fell below 12% in 2004 Q2, the lowest rate for more than three years.

In aggregate, the rise in debt over the past five years has not, primarily, been associated with the household sector's financing of current consumption. As indicated by the relative flatness of the saving ratio over that period, increased spending on goods and services has been broadly matched by increases in the disposable income available to households. Instead, the rise in aggregate debt levels has been accompanied by increased acquisitions of financial assets. Households' holdings of cash and sterling deposits have grown strongly, for example. And as a result, the financial balance of the household sector—a measure of household acquisitions of assets less their borrowing—has remained relatively small (see Chart 1.11). In other words, the rise in debt levels has been one facet of an expansion, rather than necessarily a deterioration, in household balance sheets.⁽¹⁾

(1) This may be closely related to developments in the housing market. See Bean, C (2004), 'Some current issues in UK monetary policy', [speech to the Institute of Economic Affairs on 28 July 2004](#).

Chart 1.12
Actual and expected interest rate changes^(a)



Sources: Bank of England and NOP.

(a) Data to May 2004. Actual change refers to the change in the Bank of England repo rate over the previous twelve months. Expected change is the net balance of survey respondents expecting interest rates (on things such as mortgages, bank loans and savings) to rise in the next twelve months.

This expansion means that a given change in interest rates will now have a greater impact on the costs households face in servicing debt, and a greater impact on the receipts they earn. Those effects could offset each other. But if savers respond less to changes in disposable income than borrowers, then the balance sheet expansion could have implications for how aggregate consumption responds to rising interest rates (see [the box on pages 10–11 of the February 2004 Report](#)).

That impact on consumption would tend to be greater if, at the time of borrowing, households had expected interest rates to remain low or even fall further. But throughout the past four and a half years of Bank of England/NOP surveys, more respondents have expected interest rates to rise over the coming twelve months than to fall—even during periods when official interest rates were being cut (see Chart 1.12). And in recent surveys, the net balance expecting further rises in interest rates has been at its highest level since the survey began in 1999.⁽¹⁾ This could indicate that households have typically taken at least some prospective interest rate increases into account when deciding to borrow.

The balance sheet expansion could also have implications for how households' consumption might respond to other developments, through its effect on the amount of collateral available to households. In general, a position of low debt relative to housing assets provides households with a form of precautionary savings in case of any future falls in income, and enables them to borrow more and at cheaper rates than would otherwise be the case. But if net asset positions were to deteriorate—due to a fall in house prices, for example—then households might decide to reduce consumption. Such effects could be particularly marked if households fell towards or into negative equity, where their outstanding debt exceeds the value of their housing assets.

Falls in collateral are likely to have their greatest effect on households' spending when they coincide with declines in cash flow. A decline in house prices could cause a household's net worth to fall—but if there were no need to increase borrowing, the impact on consumption might be limited. Similarly, a healthy collateral position might allow a household to avoid cutting back on expenditure and, instead, borrow to smooth its spending through a temporary period of unemployment. But when collateral and cash-flow positions deteriorate together, households are more likely to make significant revisions to spending plans.

(1) Results from this survey are discussed in the latest of an annual series of articles: Janssen, N (2004), 'Public attitudes to inflation', *Bank of England Quarterly Bulletin*, Summer, pages 194–202.

Mortgage equity withdrawal and consumption: new survey evidence

Mortgage equity withdrawal (MEW) is the part of secured borrowing not invested in the housing stock. MEW has risen steadily since 1996 and in 2004 Q1 was equivalent to 8% of households' post-tax income. MEW reflects a range of activities, which are likely to have very different implications for consumers' expenditure.⁽¹⁾ In this box, some recent findings from data in the Survey of English Housing (SEH) are outlined.⁽²⁾ These provide new information on different types of MEW and their relation to consumers' expenditure.

Table 1 summarises the ways in which individuals can withdraw equity. A distinction can be made between those methods that increase the indebtedness of the household withdrawing the equity, such as remortgaging and overmortgaging, and those that do not, namely last-time sales and trading down. The propensity to consume the funds is likely to differ depending on whether the household has borrowed the money or not.

Table 1
Types of gross withdrawals^(a)

Per cent	Type	Description
36	Last-time sales	Seller does not buy a new property. Proceeds released from housing market.
25	Trading down	Seller moves to cheaper property, reducing the mortgage by less.
12	Overtmortgaging	Moving owner-occupier increases mortgage by more than the difference in house prices.
27	Remortgaging	Borrower takes new mortgage increasing debt without moving properties.
	Further advance / second mortgage	Borrower raises further advance on an existing mortgage or takes second mortgage.

(a) Remortgages and second advances are merged together.

Different types of gross withdrawal

Table 1 indicates the relative importance of the various ways of withdrawing equity based on data for 2002. Withdrawals are considered on a gross basis, whereas the Bank's measure of MEW referred to above measures funds withdrawn net of injections.

The survey is not ideally suited to measuring some components of equity withdrawal, in particular last-time sales. Last-time sales covered directly by the survey are based on those who sell a property and move into rental accommodation. For the numbers quoted in this box, the raw data have been scaled up

according to previous evidence of Holmans (2001) on how such last-time sales relate to total last-time sales.⁽³⁾ On that basis, last-time sales is the largest component of gross withdrawals, accounting for 36% of the total sum extracted.

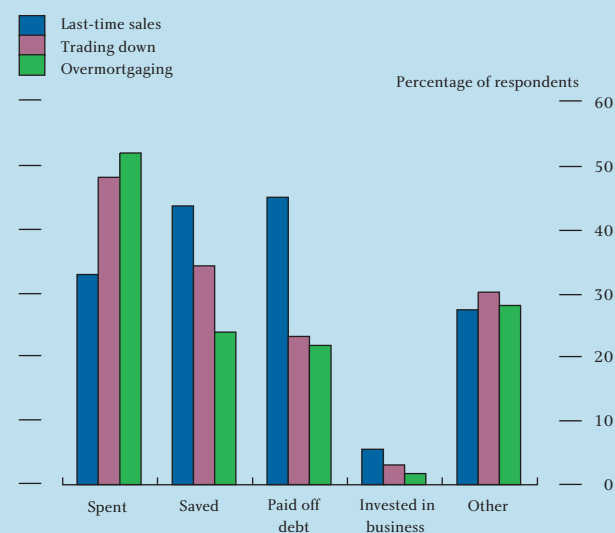
Remortgaging and trading down each account for around a quarter of total gross equity withdrawal; overmortgaging accounts for 12%. These data suggest that within gross withdrawals only about 40% of the total represents funds that have been borrowed by the households withdrawing the equity.

Uses of funds raised

The key issue for the impact of MEW on the macroeconomy is the extent to which these funds are spent. SEH respondents indicate what they did with the withdrawn equity. Chart A shows responses for households involved in a last-time sale, trading down or overmortgaging. The following points stand out. First, last-time sellers are more likely to pay off debt or save the equity, than spend it. Second, those who borrow are more likely to spend the funds.

The survey asked respondents to list on what they had spent the money. Responses of last-time sellers, over-mortgagors and those who trade down are combined as the blue bars in Chart B. The survey did

Chart A
Uses of withdrawn equity: last-time sales, trading down and overmortgaging^(a)



Source: Survey of English Housing.

(a) Respondents can choose more than one category.

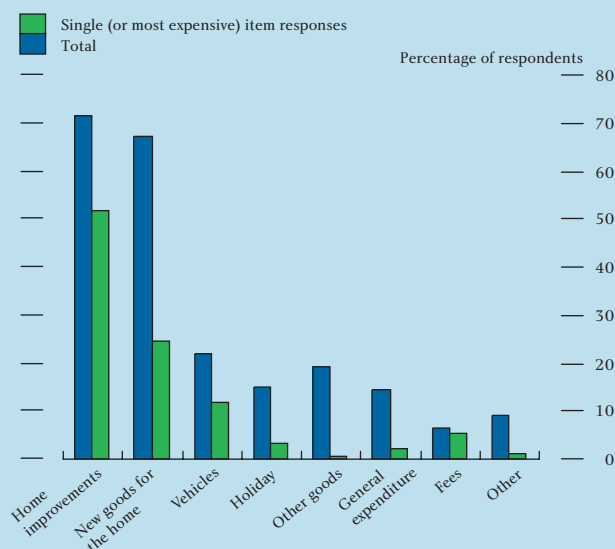
(1) See pages 8–9 of the November 2003 *Inflation Report*.

(2) The SEH is an annual household survey conducted for the ODPM by the National Centre for Social Research. The 2003 survey carried out between Q2 and Q4 covered almost 15,000 households in England. The 2003 survey included questions on MEW for the first time. Households were asked about MEW activity over the previous five years with the most recent complete calendar year of data being for 2002.

(3) Holmans, A E (2001), 'Housing and mortgage equity withdrawal and their component flows', *A Technical Report*, Council of Mortgage Lenders.

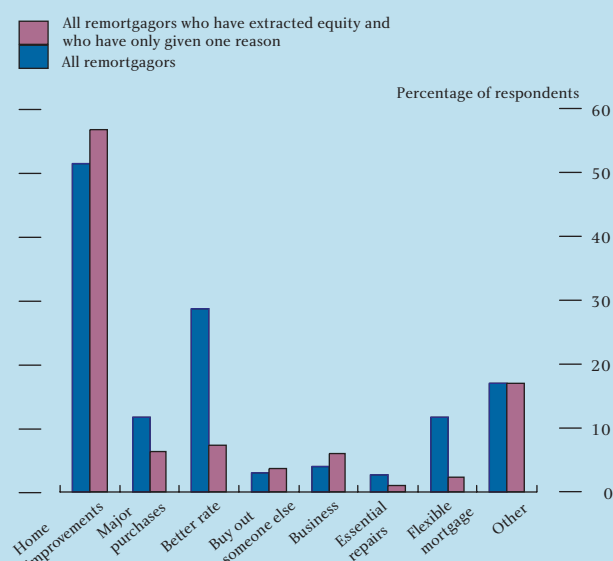
not ask how much was spent in each category. The green bars present the responses for those who cite one item, or the most expensive item if more than one response is given. That should give a better feel for the most important forms of expenditure. About 50% of respondents said they either spent all the proceeds on home improvements, or mentioned that it was the most expensive item.

Chart B
How the proceeds were spent



Those who have remortgaged or taken out further advances were also asked their reason for doing so (see Chart C). The responses for the sample who cite only one reason are also shown. Borrowing in order to finance home improvements was the single most important motivation, mentioned by over half of those who remortgaged. Securing a better mortgage rate was the next most common motivation. Unfortunately the present survey design makes it difficult to obtain a precise estimate of the proportion of funds that is spent.

Chart C
Motivation for remortgaging

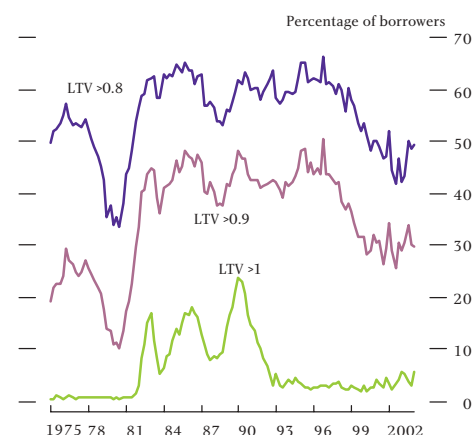


Conclusion

The survey suggests that, in the short term at least, a substantial proportion of funds released from housing equity is unlikely to be spent. Where funds are spent, the survey data suggest that home improvements are the most important item of spending. Formally, home improvements are not consumer spending. They instead form part of housing investment in the National Accounts, although in practice some home improvements (eg a self-installed new kitchen) may be picked up in consumption. When comparing the survey results with the MEW figures regularly published by the Bank of England, it is important to keep in mind that the survey asked people about gross withdrawals, whereas the Bank's MEW data measure withdrawals net of injections of equity, such as home improvements. So by definition net MEW, if accurately measured, cannot be spent on home improvements. This survey suggests, however, that a substantial proportion of MEW is not spent on consumption.

That occurred in the early 1990s, as sharp interest rate rises preceded marked increases in unemployment and falls in house prices (see Chart 1.10). But collateral appears to be rather stronger now, and households are perhaps better able to withstand any potential cash-flow problems. Among new mortgage borrowers—a potentially vulnerable group, given the sharp rise in their loan to income ratios in recent years—there has been a marked fall in the proportion of mortgages at high loan to value ratios. That implies such households possess a greater amount of housing collateral than in the past. And this is also the case for those whose debt-servicing

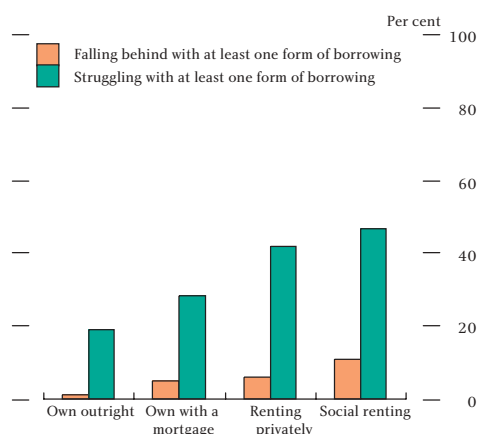
Chart 1.13
Loan to value (LTV) ratios of new secured borrowers with high debt-servicing costs^(a)



Sources: Bank of England and CML.

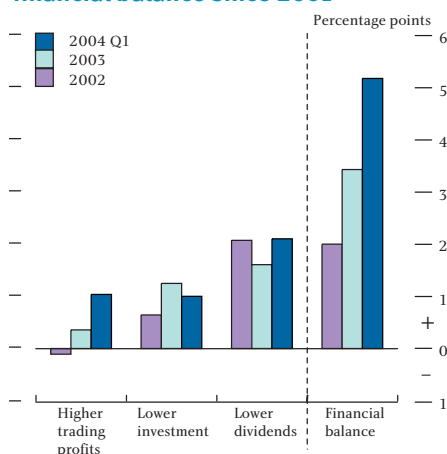
(a) Defined as the 25% of new secured borrowers with the highest debt-servicing costs (calculated as mortgage payments as a percentage of household income). Data are interpolated between 1977 Q4 and 1979 Q1, and between 1991 Q4 and 1992 Q4.

Chart 1.14
Housing tenure and debt



Source: Nuttall, S (2004), 'Household borrowing in Britain', *Financial Services Authority Consumer Research Paper*, forthcoming.

Chart 1.15
Contributions to the improvement in PNFCs' financial balance since 2001^(a)



(a) Contributions of selected factors to the cumulative change in the financial balance as a share of GDP, relative to 2001, excluding the alignment adjustment where relevant. For example, the positive bar for investment in 2004 Q1 means the fall in investment since 2001 had made a positive contribution to the financial balance; the fact that the 2003 bar is larger indicates that investment in 2004 Q1 was greater than the quarterly average in 2003.

costs have been relatively high as a proportion of their income (see Chart 1.13).

Instead, any financial problems seem more likely to be concentrated among non-homeowners, as discussed in the June *Financial Stability Review*. Those in rented accommodation—which accounts for around 30% of all dwellings—appear much more likely than homeowners to be in arrears or struggling with their borrowing commitments (see Chart 1.14). That points to a minority of households in difficulty. But evidence suggests that the numbers involved have not changed markedly since the mid-1990s.⁽¹⁾

Companies

Corporate balance sheets have strengthened further since the May *Report*, as companies have increasingly spent less than their income. PNFCs' financial balance—the income, less expenditure, of private non-financial corporations—rose in 2004 Q1 to its highest level (as a share of GDP) in a little over a decade. To secure that more positive financial balance, investment expenditure and dividend payments were initially pared back; but, more recently, it has been boosted by a pickup in trading profits (see Chart 1.15).

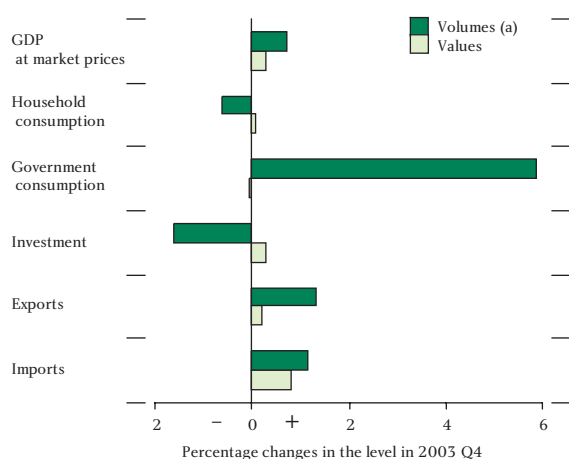
In part, companies have used that money to build up liquid assets. PNFCs' holdings of M4 money—largely cash and sterling deposits—rose by 12.5% in the year to 2004 Q2, compared with annual growth of close to 4% two years earlier. And companies have also cut their levels of gross debt relative to their assets. As a result, PNFCs' capital gearing, measured as net debt as a proportion of the market value of the sector, declined in 2004 Q1 to its lowest level in two years. But it remains at an historically high level.

Bank discussions with companies suggest that for some, the rise in liquidity reflects precautionary motives. For others, factors like a lack of suitable investment opportunities have been important (see June's *Financial Stability Review*). But overall, companies were typically comfortable with current debt levels. As such, they are likely to continue to increase investment spending. Nevertheless, companies may still feel cautious about taking on much more debt, given their outstanding commitments. So any future growth in investment is likely to be moderate (see Section 2).

(1) See Tudela, M and Young, G (2003), 'The distribution of unsecured debt in the United Kingdom: survey evidence', *Bank of England Quarterly Bulletin*, Winter, pages 417–27.

The latest National Accounts suggest a rather different pattern of growth in real domestic demand than implied by the data available at the time of the May Report. Consumption growth now appears to have slowed in the second half of 2003. And it remained slightly below its long-run average in 2004 Q1. However, there are doubts about these data. In particular, it is not clear why household spending on services and net tourism was so weak. Business investment continued to recover in Q1. Stockbuilding has been weak, and may pick up in the short run. In the euro area, there was a welcome strengthening of consumption growth in Q1, though German household confidence remained fragile. But UK exports to the euro area have yet to recover significantly. US growth dipped in Q2, but that is unlikely to be the beginning of a sustained slowdown. The US current account deficit remained large, despite the past depreciation of the dollar.

Chart 2.1
Revisions to demand components of GDP



(a) Calculated using the difference in cumulated growth since 1990 Q4 before and after the revisions, as volumes levels before and after the revisions are not directly comparable.

Table 2.A
Expenditure components of demand^(a)

Percentage changes on a quarter earlier

	Averages		2003			2004
	2002	2003	Q2	Q3	Q4	Q1
Household consumption	0.8	0.5	0.9	0.8	0.6	0.6
Government consumption	0.6	1.4	0.7	1.6	2.1	1.2
Investment	1.7	0.4	0.9	1.1	1.9	1.7
of which, business	1.5	-0.3	2.9	0.2	2.0	1.9
Final domestic demand	0.9	0.7	0.9	0.9	1.1	0.9
Change in inventories (b)(c)	-0.1	0.0	-0.3	0.0	0.1	-0.3
Alignment adjustment (c)	0.1	0.0	-0.4	0.3	0.3	0.0
Domestic demand	0.8	0.7	0.2	1.3	1.5	0.7
Exports	-0.3	1.1	-2.2	0.2	1.6	-0.9
Imports	1.0	0.9	-3.3	1.4	3.1	-0.8
Net trade (c)	-0.4	0.0	0.4	-0.4	-0.5	0.0
GDP at market prices	0.5	0.7	0.7	0.9	1.0	0.7

(a) Chained volume measures.
(b) Excludes the alignment adjustment.
(c) Percentage point contributions to quarterly GDP growth.

The National Accounts published on 30 June by the ONS included major revisions, as part of the annual *Blue Book* process. New data from annual surveys were incorporated. And the weights used to construct volume measures of expenditure and output for recent years were updated. The measurement of the volume of government consumption has also been improved. As a result of these changes, the level of GDP was 0.7% higher in 2003 Q4 than in the previous estimate. That largely reflected upward revisions to real government consumption (see Chart 2.1). But other elements of demand were also revised, and in particular both household consumption and investment were revised down. Overall, the revisions had little implication for the MPC's assessment of future CPI inflation.

2.1 Domestic demand

The new National Accounts suggest a different pattern of real growth in the recent past compared with data available at the time of the May *Inflation Report*. In the latest data, final domestic demand growth was stable at around 0.9% a quarter between 2003 Q2 and 2004 Q1 (see Table 2.A). Data available in May had suggested greater momentum, with quarterly growth picking up consistently through 2003 to reach 1.3% in 2003 Q4.

Household consumption

Consumption is estimated to have grown by 0.6% in 2004 Q1, somewhat below expectations in the May *Report*, and slower than the average growth since 2000. Furthermore, growth in

Chart 2.2 Household consumption and the saving ratio

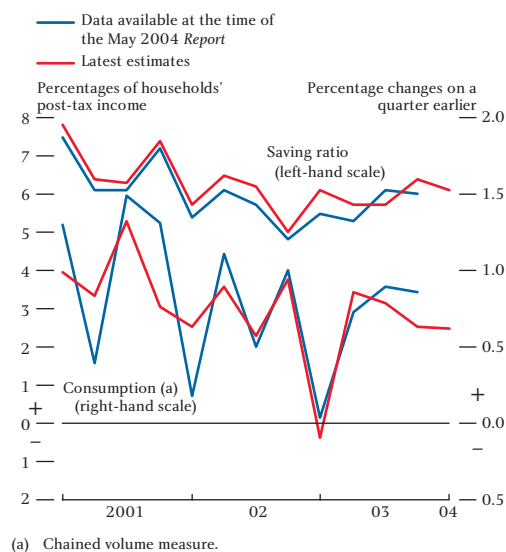
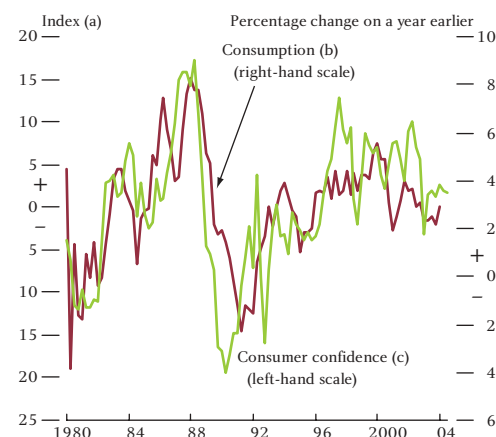


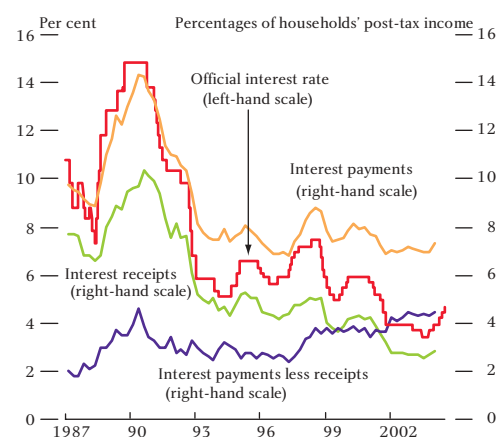
Chart 2.3 Household consumption and consumer confidence



Sources: Martin Hamblin GfK and ONS.

- (a) Relative to the average since 1974. The index has been seasonally adjusted by the Bank of England.
 (b) Chained volume measure.
 (c) 2004 Q3 based on July data only.

Chart 2.4 Household sector interest payments, receipts and the official interest rate



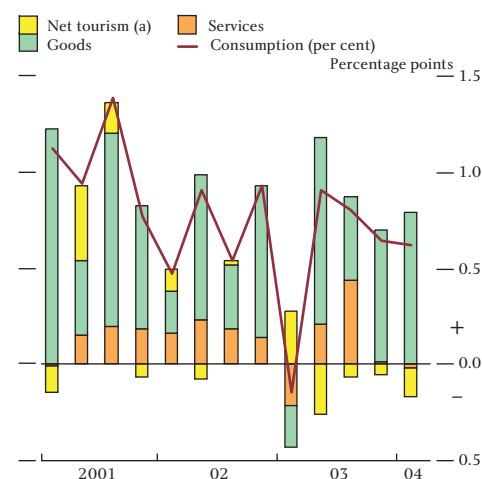
the second half of 2003 has been revised down (see Chart 2.2) in both real and nominal terms, due to new information from expenditure surveys. In May, the MPC expected consumption to slow gradually during 2004 and 2005. Taking the data at face value, the slowdown may already have started in 2003. But how reliable is this conclusion?

Households' real post-tax income grew by 0.7% on average between 2003 Q2 and 2004 Q1. That would be consistent with modest growth in consumption. Revisions to the income data were broadly similar to those for consumption, so the saving ratio was little changed (see Chart 2.2). According to the GfK survey, consumer confidence over the past year has been below levels recorded between 1997 and 2002. That would also offer some support for the ONS estimates of consumption. Although consumer confidence has tracked the broad swings in consumption growth, it has been a less reliable indicator of changes in growth between one year and another (see Chart 2.3).

Over the past nine months, the MPC has raised interest rates by 1.25 percentage points. Is it possible that part of the recent estimated weaker growth in consumption reflected actual or expected increases in interest rates? Section 1 highlighted that expectations of rate increases may have picked up sharply late last year. That may have dampened consumption growth. But actual net interest payments were broadly flat as a share of income in the 18 months to 2004 Q1 (see Chart 2.4). It can take some time before changes in official rates feed through fully into the rates actually paid by households (see Section 1). So if there has been an effect on spending from interest rate rises, it probably relates more to the impact on households' expectations than directly on income.

Doubts about the apparent slowdown in the data arise partly from the composition of consumption growth. According to the ONS, aggregate household spending in 2003 Q4 and 2004 Q1 was depressed by weak growth in spending on services and a negative contribution from net tourism (see Chart 2.5). Growth in the consumption of goods remained strong. The fact that retail sales—a monthly measure of goods bought in the shops—have grown rapidly is still consistent with the National Accounts measure of consumption. But the weakness in the consumption of services is more puzzling, given that service sector output has grown strongly in recent quarters. That includes those sectors that experienced the weakest consumer spending, such as restaurants and hotels, and transport services. Business surveys and contacts of the Bank's regional Agents have also suggested robust service sector growth. The strong output growth in the service sector casts doubt on the weak estimate

Chart 2.5
Contributions to quarterly consumption growth



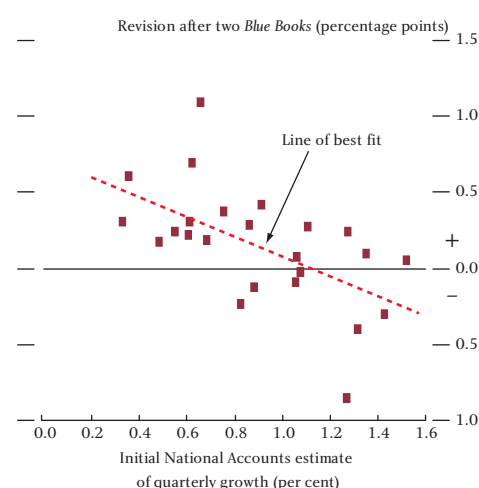
(a) Consumption in the National Accounts is defined as spending by UK residents. Net tourism, spending by UK residents abroad minus that by overseas visitors in the United Kingdom, is added to overall consumer spending within the United Kingdom to achieve this.

for the consumption of services in the ONS data. However, it is not conclusive evidence. Divergences between services output and household consumption of services often occur, as services are also bought by companies, the government and overseas customers.

Net tourism has reduced consumption growth in each of the past four quarters and by 0.15 percentage points in 2004 Q1. That contrasts with the previous strong upward trend in net tourism since the mid-1990s. Tourist expenditure is likely to be one of the more difficult elements of consumption to measure accurately. But one possible explanation is that net tourism was driven up by the appreciation of sterling in 1996–97 and down by the subsequent depreciation early in 2003. Or it could be that the Iraq war discouraged UK residents from travelling, and spending, overseas in 2003. These factors have since unwound, though, so any such effects are likely to be short-lived.

Monetary and asset price indicators, discussed in Section 1, do not point to a slowdown in consumer spending around the turn of the year. House price inflation remained strong, and growth in secured lending continued to increase. Growth in unsecured lending, which should be more closely related to household spending, did slow, but growth rates remained high.

Chart 2.6
Revisions to consumption growth since 1997



The ONS is likely to make further revisions to the estimates of consumption growth as more information becomes available. Chart 2.6 shows that, since 1997, consumption growth has tended to be revised up once the estimates have been through two *Blue Book* processes, especially if the initial estimates of growth were low. Further revisions occur after the second *Blue Book* process, but these will often reflect methodological changes, rather than new information. The pattern of revisions is less clear when these are included.

None of this evidence is conclusive. But taking it all together, the MPC judges that aggregate consumption may have grown a little more quickly in the recent past than suggested by the latest National Accounts.

Indicators of consumption in Q2 have been mixed. Retail sales growth remained robust at 1.9%, the same as in the previous quarter. But private new car registrations fell sharply compared with a year earlier. And consumer confidence has remained relatively weak. Looking beyond Q2, the *CBI Distributive Trades Survey* indicated that retail sales growth slowed in July. And most housing market indicators have eased ([see Section 1](#)).

Government consumption

The Atkinson review is presently investigating how to improve the measurement of government services.⁽¹⁾ A substantial amount of new information has been employed to estimate public sector health output more accurately (see Section 3 for more details). That has led to large upward revisions to estimates of real government consumption. For example, average quarterly growth in government consumption in 2003 has been revised up to 1.4% from 0.8%. But, as discussed in Section 3, the changes to ONS measurement of real government consumption did not change the MPC's assessment of inflationary pressure. The quantity of resources absorbed by the government is the more relevant factor. Nominal government consumption was little changed as a result of the revisions, though changes within the composition of nominal spending suggest that the government's overall demand for resources may have been higher than previously thought.

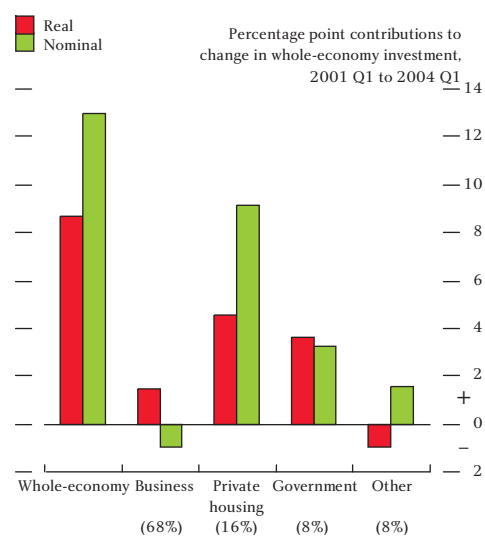
The Chancellor announced the results of the latest *Government Spending Review* on 12 July. The plans for overall public sector spending are very similar to those announced in the Budget and incorporated in the May *Inflation Report* projections.

Investment

Whole-economy investment continued to grow healthily, up by 1.7% in 2004 Q1, after a similar increase in the preceding quarter. The investment data were revised in the latest National Accounts, but the overall pattern of growth was very similar to that implied by the data available in May. Within the aggregate, private investment in housing, including home improvements, continued to grow strongly, up 6.6% in 2004 Q1. Government investment fell in Q1, but quarterly changes tend to be volatile. Over the past few years it has increased sharply. Developments in these two components have played a significant role in the growth in investment since the beginning of 2001 (see Chart 2.7). Looking forward, growth in private sector housing investment is likely to slow as activity in the housing market eases back. But the plans outlined in the 2004 *Spending Review* suggest government investment will continue to increase rapidly this year.

The recovery in business investment since early 2003 continued apace, with a quarterly increase of 1.9% in 2004 Q1. Nevertheless, the level of investment remained below the previous peak in 2000 Q4. Business investment growth can be volatile. It is the capital stock, and the services

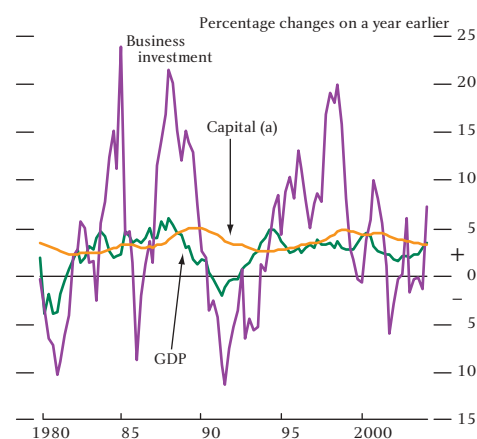
Chart 2.7
Contributions to whole-economy investment
by different sectors^(a)



(a) Figures in parentheses are percentages of whole-economy investment in 2001.

(1) The interim report is available at: www.statistics.gov.uk/about/methodology_by_theme/atkinson/downloads/atkinson.pdf.

Chart 2.8
Business investment, GDP and capital



(a) Bank of England estimate of business sector capital stock.

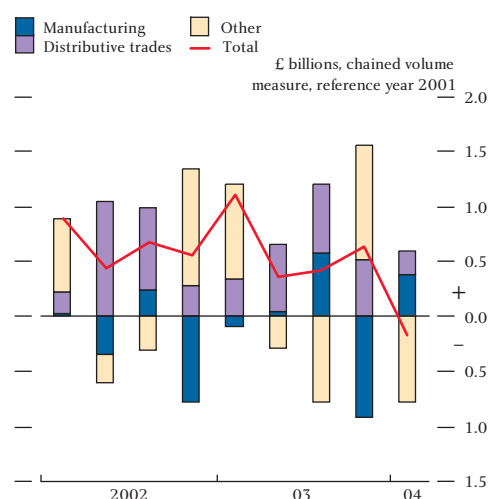
Table 2.B
Indicators of future investment

	Average since 1989	Average in 1997	2003		2004	
			Q3	Q4	Q1	Q2
Surveys of investment intentions (a)						
BCC service sector	15	28	13	18	18	21
BCC manufacturing	10	25	4	18	10	9
CBI manufacturing	-7	12	-14	6	-1	0
Financial indicators						
CBI/PwC financial services (b)	31	57	0	10	15	35
CBI distributive trades	-1	9	8	9	18	29
Financial indicators						
PNFCs' profits (c)	19.1	20.8	18.7	18.6	18.9	n.a
FTSE All-Share (d)	1.6	4.8	6.3	4.6	5.3	0.5
Capital gearing (e)	23.3	18.2	34.2	30.4	29.4	n.a

Sources: BCC, Bloomberg, CBI and ONS.

- (a) Percentage balances of respondents reporting 'higher' relative to 'lower'.
 (b) Investment in information technology.
 (c) Gross operating surplus, excluding the statistical alignment adjustment, as a percentage of nominal GDP.
 (d) Percentage change on a quarter earlier.
 (e) PNFCs' net debt divided by market valuation of assets.

Chart 2.9
Stockbuilding^(a)



(a) Excluding the statistical alignment adjustment.

it provides (see Section 3), that determines how much a firm can produce, not investment itself. And because the quarterly flow of investment is small relative to the capital stock, even large changes in investment will have only a modest immediate impact on the aggregate capital stock. So small revisions to firms' desired level of capital during the ups and downs of the economic cycle can lead to large swings in investment growth.

Since 1980, each period of retrenchment in business investment has been followed by a sharp increase. On three occasions annual investment growth has been around 20% or more during the recovery phase (see Chart 2.8). Though the pickup in 1984–85 was fuelled by changes in tax allowances, the rates of increase in the late 1980s and 1990s might indicate that investment growth will increase sharply over the coming year. But several factors suggest that the recovery may be more subdued this time. First, the slowdown in investment was more muted than in previous cycles. Second, although surveys of investment intentions have recovered in recent quarters, they are not generally as firm as they were in 1997, for example, just ahead of the previous investment boom (see Table 2.B). Third, the financial backdrop, although improving, may still be a restraint on investment growth. Profits have increased rapidly over the past two years, but they remain low as a share of GDP compared with the late 1990s. And although share prices have recovered somewhat, and corporate balance sheets have improved (see Section 1), capital gearing remains high. That may deter some firms from further borrowing. In the MPC's central projection, business investment is expected to grow slightly faster than GDP in the near term.

Inventories

The latest National Accounts data suggest that stocks declined slightly in 2004 Q1, detracting 0.3 percentage points from GDP growth. It is rare for whole-economy stocks actually to fall—that last occurred in 1996. However, the fall in stocks occurred in the 'other sectors' category (see Chart 2.9). That includes service sector stocks, which are particularly hard to measure, so the decline may just be erratic, or it could be revised away in the future. Firms hold stocks partly as a buffer against unexpected increases in demand. So the decline in Q1, if genuine, could imply a boost to output in the future as firms rebuild stocks.

Imports

Imports are estimated to have fallen by 0.8% in 2004 Q1 after rising by 3.1% in the preceding quarter (see Table 2.A). Since 1999, imports and exports have been inflated by so-called 'missing trader intra-community' VAT fraud. But fraudulent activity is estimated to have fallen off in Q1, reducing import

Table 2.C
Euro-area expenditure components of demand^(a)

Percentage changes on a quarter earlier

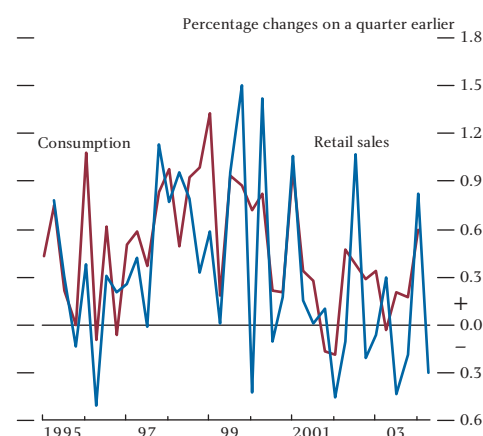
	Averages		2003			2004
	2002	2003	Q2	Q3	Q4	Q1
Household consumption	0.2	0.2	0.0	0.2	0.2	0.6
Government consumption	0.6	0.5	0.5	0.7	0.4	-0.2
Investment	-0.4	0.0	-0.1	0.1	0.8	0.2
Final domestic demand	0.2	0.2	0.1	0.3	0.4	0.4
Change in inventories (b)	0.1	0.1	0.0	-0.4	0.4	0.0
Domestic demand	0.3	0.3	0.0	-0.1	0.8	0.4
Exports	0.8	0.1	-0.8	2.3	0.3	1.5
Imports	0.9	0.4	-0.3	1.0	1.4	0.9
Net trade (b)	0.0	-0.1	-0.2	0.5	-0.4	0.3
GDP	0.3	0.2	-0.1	0.4	0.4	0.6

Source: Eurostat.

(a) Volume measures.

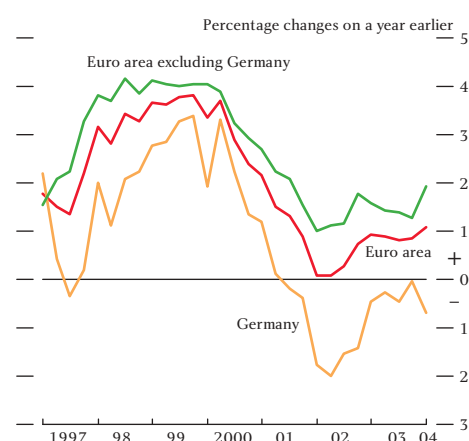
(b) Percentage point contributions to quarterly GDP growth.

Chart 2.10
Euro-area consumption and retail sales



Source: Eurostat.

Chart 2.11
Euro-area final domestic demand



Source: Eurostat.

growth. Excluding these effects, imports were flat on the quarter. Imports are expected to grow robustly in the coming quarters, reflecting the strength of final demand.

2.2 External demand and UK exports

The euro area

There were promising signs in 2004 Q1 that the recovery in the euro area was becoming more firmly established. GDP grew by 0.6% in Q1, the largest increase for three years. Household consumption also grew by 0.6%, considerably stronger than average growth in 2002 and 2003 (see Table 2.C). Consumption in Germany was flat on the quarter. But that was still an improvement, after three consecutive quarters of declines. And growth in many other euro-area countries picked up sharply. However, euro-area retail sales in Q2 were weak, suggesting some deceleration in consumption (see Chart 2.10). And consumer confidence remained low in the second quarter.

Euro-area GDP growth in Q1 was boosted by a sharp increase in the net trade contribution. That mainly reflected strong growth in German exports, which rose by 4.6%. The recovery in German GDP in recent quarters has been more reliant on net trade than in the rest of the euro area (see Chart 2.11). So a risk is that the stimulus from external demand in Germany will fade. However, the signs are encouraging. The pickup in exports was broadly based. And Germany appears to be benefiting from the upturn in global investment as it specialises in the production of capital goods. They accounted for around 45% of German goods exports in 2003, compared with 17% for the United Kingdom, for example. In the MPC's central projection, strong external demand in Germany is expected to lead to a gradual improvement in the labour market and a recovery in domestic demand later this year.

The United States

US GDP growth dropped back to 0.8% in the second quarter, rather lower than the average growth rate in 2003. That mainly reflected a sharp slowdown in consumption growth to 0.3%, compared with 1.0% in the previous quarter (see Table 2.D). However, the weakness of consumption growth is likely to prove temporary. Consumer confidence picked up strongly in June and July, after a dip earlier in the year. And the recent increases in employment should support household spending. The recovery in private investment continued in Q2, with the annual growth rate at its highest since 1998. Rising profits and increasing pressures on capacity should provide further impetus to investment in the near term. However, investment growth may ease in 2005 as temporary fiscal incentives are set to expire.

Table 2.D
US expenditure components of demand^(a)

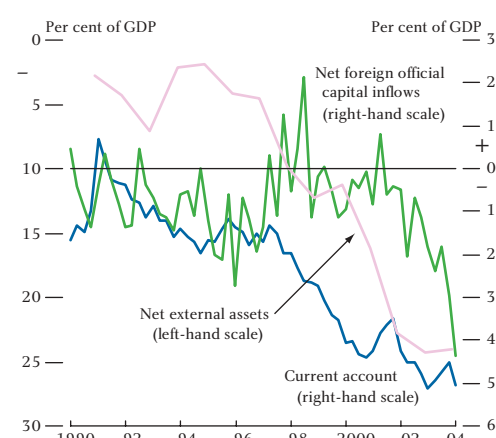
Percentage changes on a quarter earlier

	Averages		2003		2004	
	2002	2003	Q3	Q4	Q1	Q2
Household consumption	0.6	0.9	1.2	0.9	1.0	0.5
Government (b)	0.9	0.6	0.0	0.4	0.6	0.6
Private investment	-0.5	2.5	4.2	2.5	1.1	2.7
Final domestic demand	0.5	1.1	1.4	1.0	1.0	0.7
Change in inventories (c)	0.3	0.0	0.1	0.1	0.3	0.1
Domestic demand	0.8	1.1	1.6	1.1	1.2	0.7
Exports	0.9	1.5	2.7	4.1	1.8	5.1
Imports	2.3	1.2	0.7	4.0	2.6	2.3
Net trade (c)	-0.2	0.0	0.2	-0.2	-0.2	0.0
GDP	0.6	1.1	1.8	1.0	1.1	0.8

Source: US Bureau of Economic Analysis.

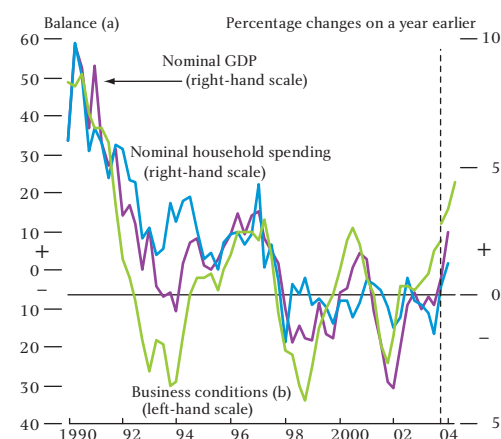
- (a) Chained volume measures.
(b) Consumption and investment.
(c) Percentage point contributions to quarterly GDP growth.

Chart 2.12
US external transactions



Source: US Bureau of Economic Analysis.

Chart 2.13
Indicators of Japanese recovery



Source: Thomson Financial Datastream.

- (a) Relative to average since 1990.
(b) Expected conditions over the next three months, from the Tankan survey of large enterprises. There is a discontinuity in the data between 2003 Q4 and 2004 Q1 due to a change in method. The results for 2003 Q4 are shown, therefore, on both bases.

Questions remain over the long-run sustainability of the US recovery. The US current account deficit increased in 2004 Q1 to 5.1% of GDP, from 4.5% in the previous quarter. That took the deficit back to the level in 2003 Q1, which was a post-war record. And that is despite the global recovery and the depreciation of the dollar over the past two years.

Official net capital inflows were almost sufficient to fund the entire US current account deficit in 2004 Q1 (see Chart 2.12). These net inflows, largely to purchase US government securities, amounted to 4.4% of US GDP in Q1, up from an average of 2.3% in 2003. But it is not clear how long that pattern of financing the deficit will continue. Despite the persistent current account deficit, the net external asset position—a measure of the stock of US foreign debts—was broadly flat in 2002 and 2003. Revaluations of assets, mainly reflecting the depreciation of the dollar, offset the effect of the deficits on the net asset position. But should the deficits persist, there is a risk that the dollar will depreciate further, and domestic demand growth may slow.⁽¹⁾

Asia

The Japanese economy continued to expand briskly in 2004 Q1. Real GDP increased by 1.5%, after increasing by 1.8% in 2003 Q4. That compares with average real quarterly growth of just 0.4% since 1990. Nominal GDP growth in 2004 Q1 was the strongest since 1996, at 1.0%. In general, a broad range of indicators now point to a persistent economic recovery (see Chart 2.13). And compared with previous short-lived recoveries in the 1990s, private demand has played a larger role, suggesting the current upturn is more sustainable. That is also consistent with the general increases in equity prices and bond yields in Japan since early 2003 (see Section 1).

Outside Japan, strong growth in most Asian economies appears to have continued in the first half of 2004. China reported GDP growth of 9.6% in Q2 compared with a year earlier, slightly weaker than in Q1. And given that output was depressed in Q2 last year by the effects of SARS, there appear to be some signs of slowing in China. Industrial production growth has also fallen back this year.

UK exports

According to ONS data, UK export volumes fell by 0.9% in 2004 Q1, after rising in the previous two quarters. That was due to a 3.3% fall in exports of goods; exports of services increased sharply on the quarter. Although export growth—like import growth—was depressed by the decline in fraud in

(1) See the box on pages 14–15 of the May 2002 *Inflation Report* for a more detailed discussion of global imbalances.

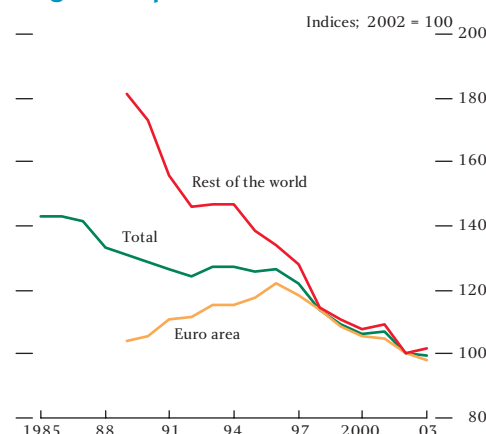
Table 2.E
UK export orders^(a)

Series	average (b)	2003			2004	
		Q2	Q3	Q4	Q1	Q2
BCC export orders						
Manufacturing	7	4	-2	16	17	21
Services	10	-5	3	9	7	12
CIPS export orders (c)						
Manufacturing	50	50	53	55	54	54
CBI industrial trends						
Export orders	-9	-23	-22	4	3	-3
Export optimism (d)	0	-9	-8	12	13	3

Sources: BCC, CBI and CIPS.

- (a) Percentage balances of respondents reporting 'higher' relative to 'lower', except CIPS, where a reading above 50 suggests increasing orders, and below 50 suggests falling orders.
 (b) Averages since 1989 for BCC, 1972 for *CBI Quarterly Industrial Trends* and 1996 for CIPS.
 (c) Average of monthly indices.
 (d) Optimism over export prospects for the next twelve months.

Chart 2.14
UK goods export shares^(a)



Sources: IMF, ONS and Thomson Financial Datastream.

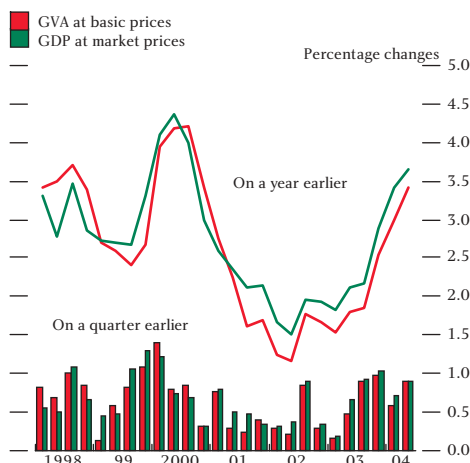
- (a) UK export volumes divided by a weighted sum of overseas import volumes. The deflators for UK exports to the euro area and the rest of the world are proxied by the deflators for exports to the EU and non-EU respectively. The estimated effects of missing trader intra-community (MTIC) fraud have been excluded.

Q1, underlying exports were still surprisingly weak. A fall of around 6% in goods exports to non-EU countries was recorded, while goods exports to EU countries were broadly flat. That is puzzling given the strong growth in demand in the United States, and much of Asia. It is also inconsistent with surveys, which have suggested a recovery in export orders (see Table 2.E). The most likely explanation is that the decline in exports to non-EU countries reflects teething problems with HM Customs and Excise's new data-processing system and understates true growth.

UK exports have generally risen less rapidly than world imports for some time, leading to a persistent decline in export share. Over the longer term this is likely to have reflected growing trade within Asia, as regional supply chains have developed, which has not affected UK exports. Over the past few years, however, the UK share of euro-area goods imports has also declined (see Chart 2.14). That is likely to reflect, in part, the appreciation of sterling against the euro during much of that period. But the share continued to decline in 2002 and 2003, when part of the appreciation unwound. That may be explained by greater trade integration among the euro-area countries following EMU. But more intense international competition, for example from eastern Europe, could also be a factor. Looking forward, the MPC expects exports to grow broadly in line with external demand over the coming year. But there is a risk that the downward trend in the UK export share will continue.

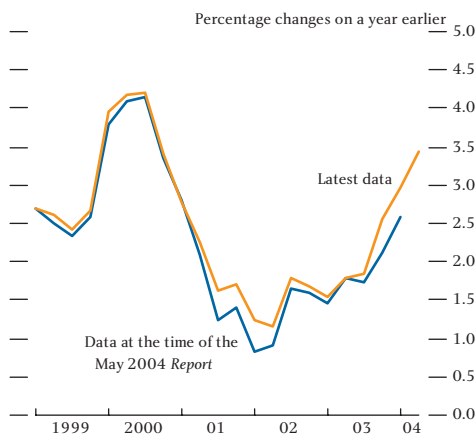
Whole-economy output growth picked up in the latest data: gross value added at basic prices rose by 0.9% in the second quarter. Recently revised data suggest that output growth was stronger over the past three years than had been apparent at the time of the May Report. That largely reflected revisions to government output. But the revisions to whole-economy growth did not affect the MPC's overall assessment of the total demand for resources in the economy, which matters for inflationary pressure. Employment fell in the three months to May, but that could be due to volatility in the data, rather than representing a genuine decline. Survey measures suggest that the degree of spare capacity in the economy has fallen. The labour market remained tight.

Chart 3.1
GVA at basic prices and GDP at market prices^(a)



(a) Chained volume measures. Annual growth in GVA at basic prices for 2004 Q2 has been estimated using the published quarterly growth rate of 0.9%.

Chart 3.2
GVA at basic prices^(a)



(a) Chained volume measures. At the time of the May Report, annual growth in GVA at basic prices for 2004 Q1 was estimated using the published quarterly growth rate of 0.6%. In the latest data, annual growth for 2004 Q2 has been estimated using the published quarterly growth rate of 0.9%.

3.1 Output

Output growth picked up in 2004 Q2. According to the preliminary estimate, gross value added (GVA) at basic prices was 0.9% higher than in the previous quarter (see Chart 3.1). That followed a rise of 0.6% in 2004 Q1. Gross domestic product (GDP) at market prices also grew by 0.9% in Q2. Service sector output and industrial production both grew by 0.9%.

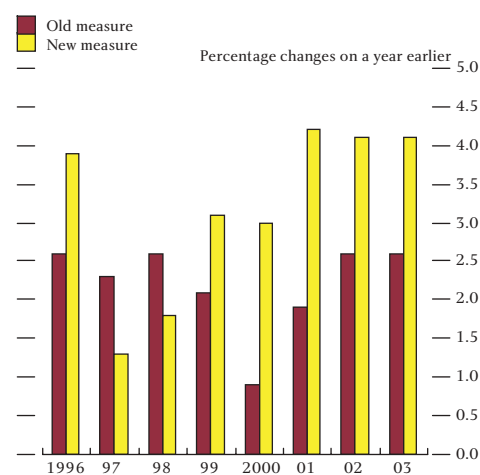
Since the time of the May *Inflation Report*, the profile of GVA growth in recent years has been revised. In particular, growth since 2001 is now estimated to have been somewhat higher (see Chart 3.2). Part of the revision was due to new data for NHS output.

In recent years, public sector spending has risen strongly. Despite that, measured output growth in the public sector had been puzzlingly low. In response to this, the National Statistician announced a review of government output and productivity data,⁽¹⁾ which is focusing on the health and education sectors in particular. The ONS has subsequently published a new measure of NHS output.

This new measure includes services that were excluded from the old one, such as NHS Direct and Walk-in Centres. It is also based on more detailed output data: the new measure distinguishes between 1,700 different treatment types, compared with 16 in the old one. That enables changes in the case mix to be measured more accurately. In the old measure, a cataracts operation and a liver transplant were both given

(1) The review is led by Sir Tony Atkinson of Oxford University. The interim report is available at: www.statistics.gov.uk/about/methodology_by_theme/atkinson/downloads/atkinson.pdf.

Chart 3.3
NHS output^(a)



(a) Defined as the chained volume measure of general government final consumption on health care.

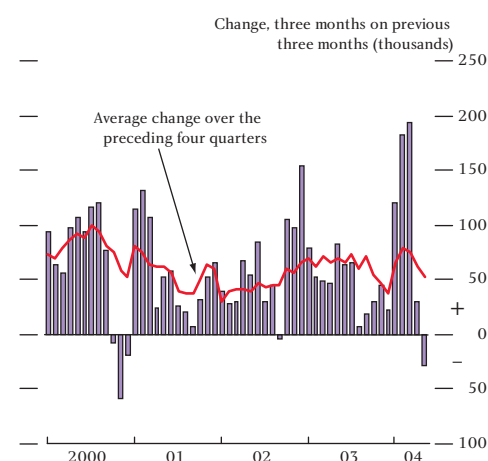
the same weight. But the latter is far more complicated and takes up considerably more resources. Under the new measure, a liver transplant is given more weight than a cataracts operation.

The new measure raised the growth rate of NHS output in most years since 1996 (see Chart 3.3). In turn, that raised estimates of whole-economy output growth. There were other revisions in the National Accounts. For instance, growth in private services output was reported to have been even stronger than previously thought. But the new measure of NHS output accounted for a substantial part of the revision to whole-economy output growth—for example, over half of the revision to growth in 2001. Any further measurement changes arising from the Atkinson Review could also affect these data.

However, the measurement of public sector output does not affect the MPC's judgment about the degree of inflationary pressure in the economy. That depends on the balance between the demand for marketed goods and services compared with their availability. In assessing the impact of public spending on inflationary pressure, it is more appropriate to look at the quantity of resources absorbed by the government. That consists of the goods and services it buys from the private sector and the labour it employs.⁽¹⁾ The revisions to GVA did not materially affect the MPC's overall assessment of the total demand for resources in the economy.

Survey evidence points to robust growth in activity in Q3. The BCC survey balances for new orders in the service sector—the largest component of whole-economy output—picked up in Q2. The balance for domestic manufacturing orders fell, as did the new orders balance for manufacturing in the *CBI Quarterly Industrial Trends Survey*. However, the July CIPS surveys reported strong growth in manufacturing output and new orders, and further growth in service sector activity.

Chart 3.4
Changes in LFS employment



3.2 Factor inputs

Labour

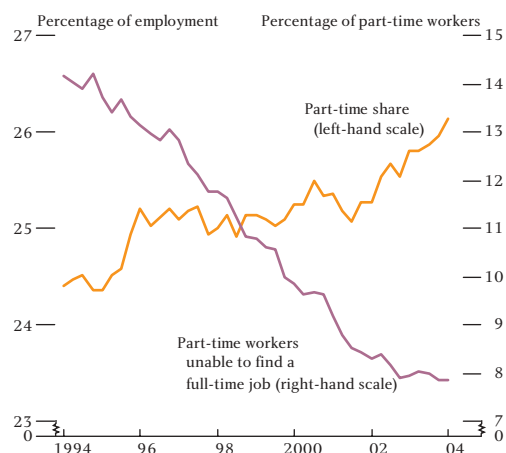
According to the household-based Labour Force Survey (LFS), employment fell by 29,000 in the three months to May, compared with the previous three months. That was the first fall in employment since 2002, and the largest since 2000. But the sampling error around these data is large, and the recent pattern of employment growth has been quite volatile: in the three months to February employment rose sharply by 183,000 (see Chart 3.4). Smoothing through this volatility may give a better picture of underlying employment growth.

(1) This is discussed in the box on pages 24–25 of the *May Report*.

The employer-based Workforce Jobs measure of employment rose by 15,000 in Q1. That rise was more than accounted for by the public sector;⁽¹⁾ private sector employment fell in Q1. This seems odd in light of survey evidence for the private sector, for example from the CIPS. Those data pointed to a rise in private sector employment in Q1. The fall is also hard to square with evidence from job vacancies (see Section 3.4). Survey evidence also suggests that private sector employment rose in Q2. The employment balance in the July *CBI Quarterly Industrial Trends Survey* was the highest since 1995. And most survey measures of employment intentions have picked up, pointing to further employment growth in the second half of 2004.

The recent Government *Spending Review* announced a planned net reduction of around 70,000 Civil Service posts over the next four years. But it also stated that the Government intended to increase the 'front-line workforce' in the public sector by 250,000 over the same period.⁽²⁾ So the total impact of these announcements would be a further rise in public sector employment, albeit at a slower rate than in the past three years.

Chart 3.5
Part-time work



Previous *Inflation Reports* have discussed the average number of hours each person works. This has fallen in recent years, and indeed over a much longer period of time.⁽³⁾ Part of the fall reflects a reduction in the number of hours full-time employees work. But some is due to the rise in part-time employment. On average, people in part-time employment work less than half the number of hours that full-time workers do. And over the past ten years, the number of part-time workers has risen, relative to the number of full-timers (see Chart 3.5). So the rise in the part-time share of employment has pushed down average hours worked in the economy as a whole.

The rise in the part-time share could directly reflect people choosing to work fewer hours. The LFS asks people their reasons for working part time: the proportion of part-timers who could not find a full-time job has fallen over the past ten years, and has remained low recently (see Chart 3.5).

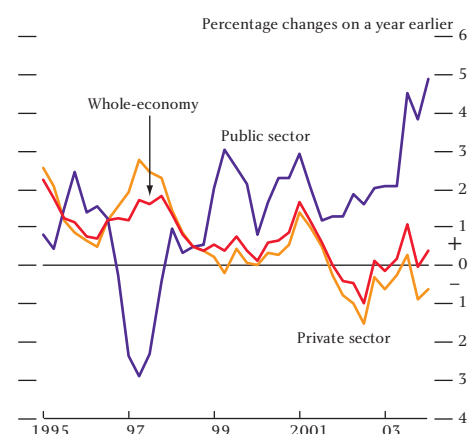
In general, a rise in part-time work could be due to several factors. In a tight labour market, firms may have to be more responsive to employees' working preferences, especially when recruiting. Otherwise it may be hard to hire and retain staff.

(1) 'Public sector' is defined as the public administration, education and health sectors. This includes some private sector employment.

(2) See the 2004 *Spending Review*, available at: www.hm-treasury.gov.uk/spending_review/spend_sr04/spend_sr04_index.cfm.

(3) See for example pages 23 and 25 of the May 2004 *Report*.

Chart 3.6
Total hours worked^(a)



(a) Based on LFS microdata. The data have been adjusted to correspond to calendar quarters.

Government initiatives could also have an effect. For instance, the 2002 Employment Act gave people the formal right to ask to change their working patterns. This included reducing their hours, for example by job-sharing. And an employer may only refuse a request where there is a 'recognised business ground' for doing so.⁽¹⁾ The sectoral mix of the economy also matters. Some industries, such as retailing, have a higher concentration of part-time work than others. So a shift in employment between sectors could affect the part-time share.

The part-time share could continue to rise over the next few years. If workers were to move from full-time to part-time work, that might imply more inflationary pressure as labour supply falls, although this could be offset by weaker income and consumption. On the other hand, the increased availability of part-time work may encourage more people to enter the labour force, which could reduce inflationary pressure.

The recent weakness of private sector employment relative to the public sector has been coupled with a sharper slowing in average hours worked in the former. Hence growth in total hours in the private sector has been much weaker than in the public sector over the past five years (see Chart 3.6). And for the economy as a whole, growth in total labour inputs (measured in hours) has been weak.

Capital

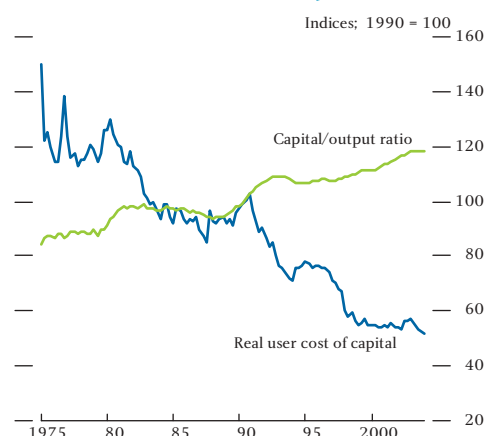
As well as labour, the evolution of capital is a key factor in assessing the supply potential of the economy. The capital data described in this *Report* are constructed by the Bank of England.⁽²⁾ They are compiled by adding up past investment flows, and using a number of assumptions about asset lives. It takes large changes in the flow of investment to have a significant immediate impact on capital, and so the former is more volatile than the latter (see Section 2).

The capital stock has grown more rapidly than output during the past 30 years. Theory suggests that firms' desired amount of capital may grow faster than output if the real user cost of capital—the cost to the firm of using buildings, plant and machinery—falls. The real user cost depends partly on the cost of financing investment spending. But it also depends on depreciation, and the relative price of capital: that is, the price of investment goods compared with the price of the firm's output.

(1) For more information see the DTI booklet 'Flexible working: the right to request and the duty to consider', available at: www.dti.gov.uk/er/individual/flexwork-pl520.pdf.

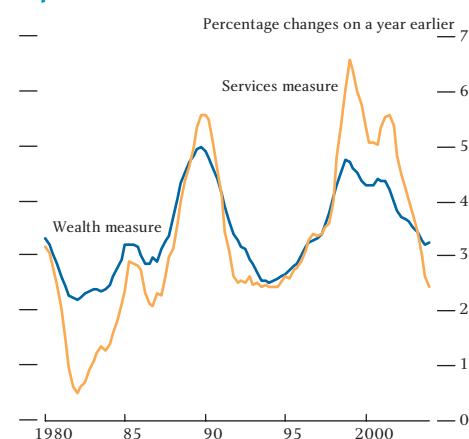
(2) The method is described in Oulton, N and Srinivasan, S (2003), 'Capital stocks, capital services, and depreciation: an integrated framework', *Bank of England Working Paper no. 192*.

Chart 3.7
Measures of the capital/output ratio
and the real user cost of capital^(a)



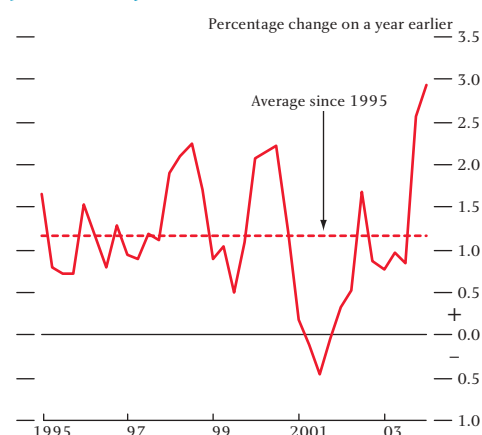
(a) The capital stock and real user cost series are for the business sector. Both series are described in Ellis and Price (2003).

Chart 3.8
Capital measures^(a)



(a) Both capital measures are for the business sector. The services measure identifies computer, software and telecommunications equipment separately.

Chart 3.9
An estimate of private sector multi-factor
productivity^(a)



(a) Based on a measure of private sector output, the private sector total hours series in Chart 3.6, and the business sector measure of capital services in Chart 3.8.

Previous research⁽¹⁾ at the Bank of England has looked at the relationship between the user cost and the capital/output ratio. Chart 3.7 shows an aggregate measure of the cost of capital based on that work: it has indeed fallen over the past 30 years, at the same time that the capital/output ratio has risen. The majority of the fall in the real user cost has been driven by the fall in the relative price of capital, which has been discussed in previous *Reports*. The MPC judges that the relative price is likely to keep on falling over the next few years, so the capital stock may continue to grow faster than output.

The capital stock is a wealth measure, as it weights together different types of capital by their asset prices. But in terms of inflationary pressure, it may be more appropriate to consider the flow of productive services from capital. The February *Report* described a measure of this flow of services: it weighted together different capital assets by their rental prices, rather than their asset prices.⁽²⁾ Chart 3.8 shows the growth in two measures of capital: a wealth measure and a services measure. In the late 1990s the services measure grew faster than the wealth measure. So between 1998 and 2002, the capacity of the economy may have grown more quickly than suggested by the wealth measure of capital. That could explain some of the weakness in inflationary pressure during that period. But over the past year, the services measure has grown less rapidly, implying slower growth in the supply potential of the economy.

Productivity

The productive potential of the economy depends on the amount of labour and capital employed. It also depends on the efficiency with which these factors are used, or their productivity.

Previous *Reports* have discussed a measure of multi-factor productivity (MFP) growth. That reflects both the rate of technological progress—the improvement in the efficiency with which labour and capital are combined in production—and capacity utilisation, the intensity with which factor inputs are used.⁽³⁾ Over the past year, MFP growth in the private sector has picked up, consistent with a rise in capacity utilisation (see Chart 3.9).

3.3 Capacity utilisation

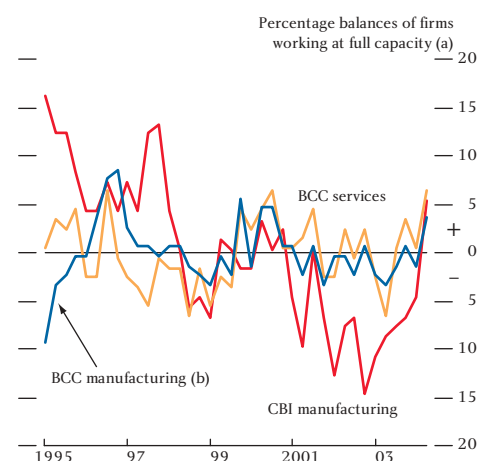
The amount of short-term inflationary pressure in the economy is heavily influenced by the degree of capacity

(1) See Ellis, C and Price, S (2003), 'UK business investment: long-run elasticities and short-run dynamics', *Bank of England Working Paper no. 196*.

(2) For more details see Oulton, N (2001), 'Measuring capital services in the United Kingdom', *Bank of England Quarterly Bulletin*, Autumn, pages 295–309.

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

Chart 3.10
Survey measures of capacity utilisation



Sources: BCC and CBI.

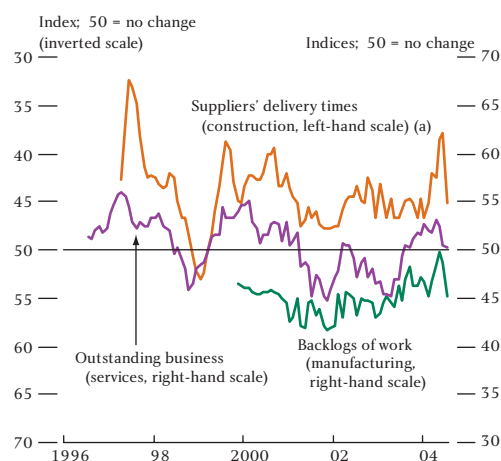
- (a) Differences from series averages since 1995.
(b) Includes agriculture, energy and construction.

utilisation in the private sector. Over the past year, the demand for private sector goods and services has picked up somewhat. In contrast, total hours worked in the private sector have been weak. And at the same time, growth in the productive flow of services from capital has slowed. This picture of stronger demand and weaker growth in factor inputs suggests that capacity utilisation has risen. By itself, that implies that the degree of underlying inflationary pressure in the economy may have picked up.

During the past twelve months, evidence on capacity utilisation from the *CBI Quarterly Industrial Trends* and BCC surveys has been somewhat mixed. But in 2004 Q2, all three measures of capacity utilisation picked up (see Chart 3.10); the CBI measure was at its highest since the January 1998 survey. And reports from the Bank's regional Agents also point to rising capacity utilisation over the past year.

Outstanding business, or unfilled orders, can also provide some information on capacity utilisation. When these are rising, demand is running ahead of supply, and so capacity utilisation is likely to be rising. And when outstanding business is falling, demand is running behind supply—so capacity utilisation is likely to be falling.

Chart 3.11
Outstanding business, backlogs of work and suppliers' delivery times



Source: CIPS.

- (a) A reading below 50 indicates a lengthening in suppliers' delivery times.

The CIPS publishes indices on outstanding business and backlogs of work for the service and manufacturing sectors. Over the past year the services measure has indicated increases in outstanding business, consistent with a rise in capacity utilisation (see Chart 3.11). But in recent months the index has fallen back to around the 'no change' level of 50. The CIPS reports that backlogs of work in the manufacturing sector have fallen continuously since the end of 1999. The rate of decline slowed in 2004 Q2, but in July a bigger fall in backlogs was reported.

Suppliers' delivery times can also be informative about capacity pressures. Increases in delivery times are likely to limit output growth in the short term, as firms may not have the materials they need to produce their goods. Such shortages could increase the degree of inflationary pressure in the economy. Since January more manufacturing firms have cited the lack of materials as a factor limiting output in the *CBI Quarterly Industrial Trends Survey*, although the total number is still relatively low. The CIPS manufacturing survey has reported that suppliers' delivery times have lengthened, especially in recent months. The CIPS also reports that delivery times in the construction sector have lengthened continually since 1999. This was particularly pronounced in 2004 Q2 (see Chart 3.11). But in July the rise in delivery times was more modest.

Chart 3.12
The breakdown of the working-age population in 2003

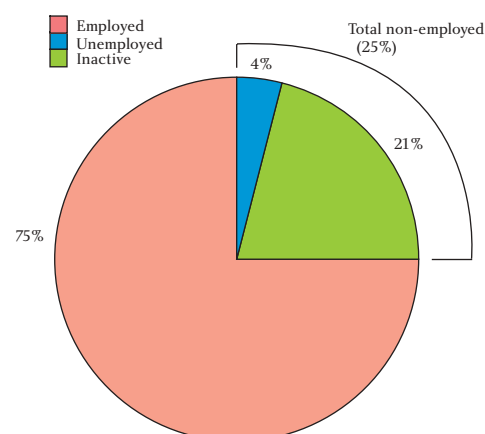


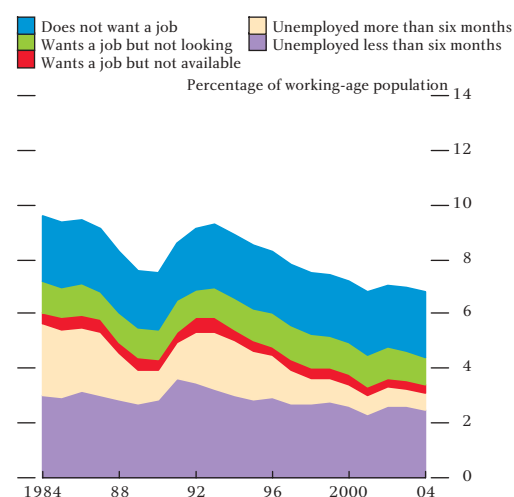
Table 3.A
Probability of becoming employed in the next three months^(a)

Per cent

Non-employed group	1993	2003
Unemployed less than six months	30.1	38.0
Unemployed more than six months	12.7	15.7
Wants a job but not looking	6.8	6.8
Wants a job but not available	20.9	24.2
Does not want a job	4.8	5.5

(a) Data are calendar-year averages of quarterly data. Transition rates are for the working-age population, based on LFS microdata.

Chart 3.13
A weighted measure of non-employment^(a)



(a) Data are shown for the spring quarter in each year, and are for the working-age population.

3.4 Labour market tightness

Inflationary pressures are also affected by the degree of slack in the labour market. One gauge of that is unemployment. The claimant count unemployment rate was 2.7% in June, the lowest rate for almost 30 years. The LFS measure stood at 4.8% in the three months to May, a similar historical low.

Though low unemployment rates suggest that the labour market is currently tight, firms also recruit from the so-called inactive population. That consists of people who have not been seeking work recently, or who are not available for it. Chart 3.12 shows the breakdown of the population of working age: the total non-employed stock is much higher than just the unemployed. That means there is still a large pool of labour that could potentially be tapped to meet increases in labour demand. Indeed, previous *Reports* have noted that flows from inactivity to employment have sometimes been larger than those from unemployment. Rising participation among people of retirement age has also increased the amount of labour available to firms. And any rise in the mandatory retirement age could have a similar effect.

But some types of the non-employed are more likely to find work than others. Someone who is looking for work and ready to start is more likely to move into employment than someone who does not want a job. Over the past ten years, the transition rates—the likelihood of becoming employed—of most non-employed groups have risen (see Table 3.A). Part of that probably reflects the cyclical position of the UK economy. But it could also be due to government policies such as the New Deal and Working Tax Credit, which have increased the incentive to work. The increased availability of part-time work could have had a similar effect.

These transition rates should be taken into account when gauging the degree of slack in the labour market, rather than weighting each group of the non-employed equally. Typically, more weight should be placed on the unemployed than the inactive, as the former are more likely to find work. Chart 3.13 presents such a weighted measure of non-employment. Each of the five non-employed groups has been weighted by the average of its 1993 and 2003 transition rates from Table 3.A, relative to the probability that someone unemployed for six months or less will find a job. So the number of people who have been unemployed less than six months is unaffected by this weighting. However, the large number of inactive people not wanting a job has been scaled down considerably. On this measure, the labour market also appears to be tight.

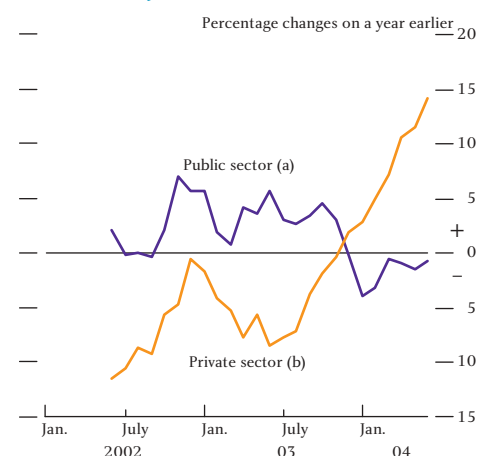
Table 3.B
Survey evidence on labour market tightness

	Long-run average (a)	2003 average	2004 Q1	Q2	July
Availability of agency staff (b)					
REC: Permanent	49.4	55.6	45.9	39.0	40.2
REC: Temporary	49.4	54.3	45.9	41.7	42.6
Recruitment difficulties (c)					
BCC: Manufacturing (d)	58.3	65	64	66	n.a.
BCC: Services	52.3	60	63	55	n.a.
Factors likely to limit output (c)					
CBI: Skilled labour	13.3	11	10	13	n.a.
CBI: Other labour	3.3	3	3	7	n.a.

Sources: BCC, CBI and REC.

- (a) Averages since 1997 for REC data, 1989 for BCC and 1972 for the CBI survey.
 (b) Indices, 50 = no change. Quarterly data are averages of monthly observations.
 (c) Percentage balance of firms.
 (d) Includes agriculture, energy and construction.

Chart 3.14
Vacancies by sector



- (a) Defined as the public administration, education and health sectors. This includes some private businesses.
 (b) Defined as whole economy excluding the public administration, education and health sectors. This includes some public businesses.

Overall, survey evidence suggests that the labour market may have tightened somewhat since the time of the *May Report* (see Table 3.B). Data from the Recruitment and Employment Confederation (REC) survey show that the availability of agency staff has continued to decline. The latest BCC survey reported a rise in the recruitment difficulties balance for manufacturing, although the service sector balance fell. The July *CBI Quarterly Industrial Trends Survey* reported a rise in skilled and unskilled labour shortages limiting manufacturing output. And in their regular visits to businesses around the country, the Bank's regional Agents have also noted that skill shortages have become more pronounced.

Data on job vacancies give an indication of firms' demand for labour. If firms are finding it hard to recruit suitable staff, then the stock of vacancies may rise. That is consistent with a tight labour market. Since the end of last year, annual growth in vacancies has turned positive. That reflects a rise in the number of private sector vacancies. In particular, the number of vacancies in the finance and business services sector grew by 30% over the past year. The number of vacancies in the public sector has fallen slightly (see Chart 3.14).

It may be hard for firms to fill these vacancies without a pickup in private sector earnings growth. But firms could react to the tight labour market by recruiting from abroad. Net migration has made a positive contribution to the UK population in recent years. However, official data suggest that the number of people moving for work-related reasons is small compared with changes in employment, though there is considerable uncertainty around those data.⁽¹⁾ To the extent that inward migration continues, further increases in labour demand may be met without firms having to raise wages. Immigration could also restrain wage demands from existing employees. If workers believe their employer is likely to recruit from abroad, they may be less willing to push for higher pay.

(1) See the box on page 30 of the *May 2004 Report*.

Some of the evidence on firms' costs and prices implies that inflationary pressures have picked up. In the labour market, growth in private sector regular pay per job strengthened further and pay settlements continued to edge up. But growth in regular pay per hour has been broadly flat since the end of last year. Oil prices rose further during the past three months. But other commodity prices were little changed. Import prices fell in Q1. In the manufacturing sector input and output price inflation rose. And surveys point to increased costs and prices both in that sector and in services. Consumer price inflation rose steadily during the past three months. But the annual rate masks some shorter-run weakness in inflation. The Committee expects the CPI inflation rate to ease back in the near term.

Chart 4.1
Whole-economy earnings^(a)

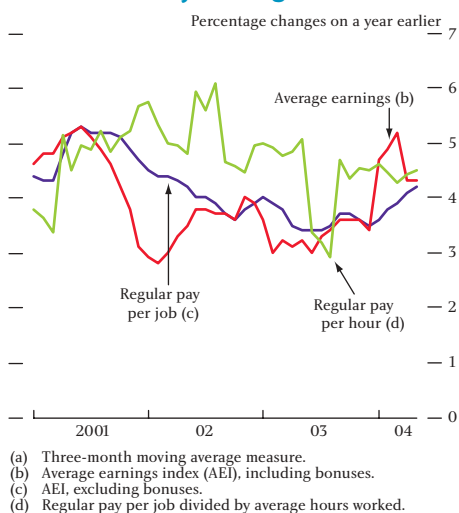
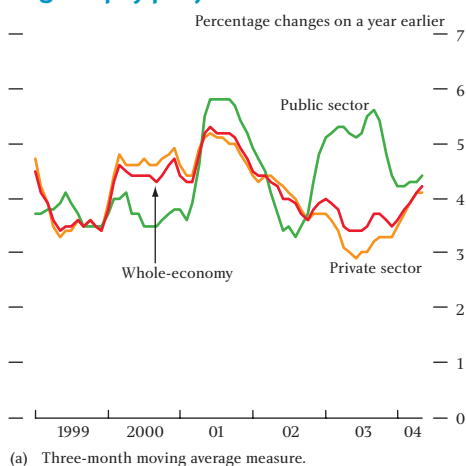


Chart 4.2
Regular pay per job^(a)



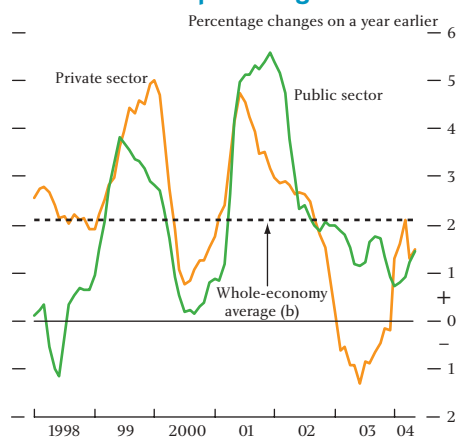
4.1 Labour costs

Annual whole-economy earnings growth fell in the three months to May compared with the three months to February (see Chart 4.1). But the earlier three-month period was boosted by a very strong contribution from bonus payments in January. Annual regular pay growth, which excludes those bonus payments, has picked up since the beginning of this year.

Regular pay growth is typically presented in per job terms at a monthly frequency. But firms can vary the amount of labour each employee supplies by changing the number of hours they work, often in response to cyclical demand pressures. So for some employees, regular pay growth can fluctuate either if hours worked change, or if pay per hour changes. Growth in pay per hour is currently higher than growth in pay per job (see Chart 4.1). That is not unusual as average hours worked have tended to fall since the late 1990s. But since 2003 Q4 growth in regular pay per hour has been broadly flat. So if hours worked are accurately measured, that suggests that pay pressures from the labour market have not increased.

The goods and services that are contained in the CPI basket are almost entirely produced by the private sector. So earnings in the private sector are more likely to be indicative of near-term inflationary pressures than whole-economy earnings. Chart 4.2 shows that annual private sector regular pay growth has risen steadily since the second half of 2003, but was unchanged for the most recent data in May.

Chart 4.3
The real consumption wage^(a)

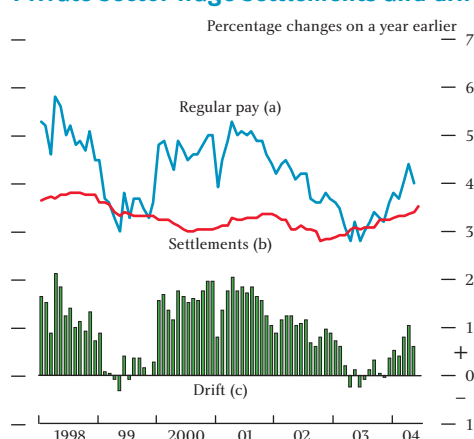


(a) Average earnings index, including bonuses, divided by the tax and price index, three-month moving average.
(b) Average whole-economy consumption wage growth since 1988.

Why might earnings growth have risen? Earnings indices provide an indication of trends in pre-tax nominal pay. But employees are more concerned about their real take-home pay than earnings. The real consumption wage, which is defined as earnings adjusted for taxes and prices, indicates trends in real take-home pay. For private sector workers, growth in the real consumption wage fell sharply between 2001 Q2 and 2003 Q2 (see Chart 4.3). That reflected the slowdown in earnings growth during that period but also more specifically the effects of increased National Insurance contributions (NICs) and Council Tax rates in 2003. For public sector workers the rise in earnings growth muted the negative impact from those increased contributions and taxes. So some of the recent rise in private earnings could reflect employees successfully achieving recovery in their real take-home pay either through improved pay packages or working more hours.

If workers were successfully negotiating improved pay packages then pay settlements should have risen during the past year. Chart 4.4 shows that private sector pay settlements have edged up since the beginning of 2003. It is possible to identify a subset of firms whose settlements can be matched with the pay deals they made a year earlier. Unlike the full set of private sector settlements, in 2004 to date 'matched' settlements do not appear to have increased compared with those made in 2003. Reports from the Bank's regional Agents suggest that pay is becoming increasingly dislocated from settlements, for instance through rising use of performance-related pay. So private sector settlements information should only be broadly indicative of trends in basic pay.

Chart 4.4
Private sector wage settlements and drift



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

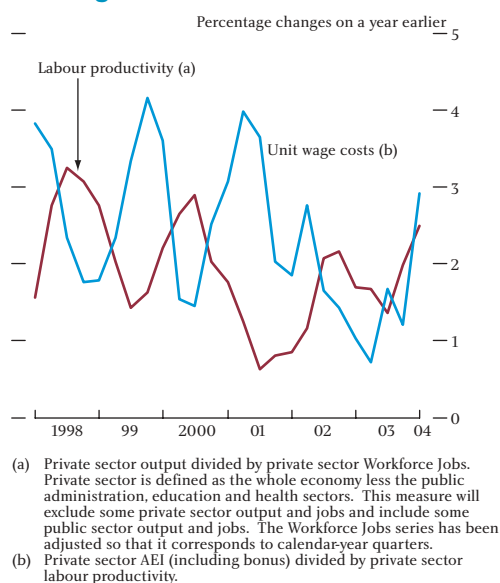
(a) Average earnings excluding bonuses, monthly index.
(b) Twelve-month AEL-weighted mean.
(c) Percentage points.

Chart 4.4 also shows that the strength of actual private sector regular pay growth is largely accounted for by wage drift, the gap between pay increases and settlements. Wage drift tends to be positive over the long run. But it is also related to the cycle. For example, if labour market conditions are tight, firms may need to pay more than originally anticipated in the settlement in order to retain staff. Or if demand increases unexpectedly then firms might respond by raising production and increasing the numbers of overtime hours worked.

Vacancies and survey data suggest that private sector labour shortages have become more pronounced (see Section 3.4). Moreover, reports from the Bank's regional Agents have mentioned recruitment and retention difficulties as a factor contributing to increased pay growth. That is consistent with rising pay drift. But it could also have driven increased pay settlements in the private sector.

The extent to which increased wage costs are passed through to inflation depends on firms' productivity and how easily they

Chart 4.5
Private sector labour productivity and unit wage costs

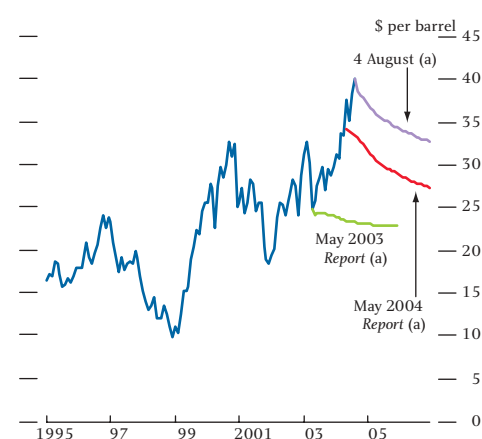


can maintain their profit margins. Increased earnings growth might not feed through to higher consumer price inflation if it were accompanied by higher productivity growth. Chart 4.5 shows a measure of unit wage costs and labour productivity in the private sector. For most of the past two years annual growth in private sector unit wage costs has hovered between 1% and 2%, lower than growth in the preceding years. That reflects both subdued earnings growth as well as some recovery in productivity growth. The weakness of unit wage cost growth suggests that underlying inflationary pressures from the private sector labour market have been subdued.

In Q1, unit wage costs picked up sharply, largely as a result of the increased bonus payments paid during that quarter. But unit wage cost growth should fall back in Q2 as the effect of those bonus payments drops out of the annual growth rate.

Do surveys currently provide any indication of increased inflationary pressures from labour costs? The evidence is mixed. The BCC asks both manufacturing and service sector firms whether wage settlements are a source of pressure to raise prices. According to that survey, the proportion of service sector respondents in 2004 Q1 who cited wage settlements as a source of price pressure rose to its highest level since that part of the survey began in 1997 Q2. In Q2, the proportion fell back, but it still remained above its average level. In contrast, in the manufacturing sector, the proportion fell in both Q1 and Q2. And it was slightly below its average level in Q2.

Chart 4.6
Brent crude 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.

4.2 Commodity prices

Oil prices continued to rise. In the 15 working days to 4 August, the price of Brent crude oil averaged a little over \$40, about \$6 higher than the average used as the starting point for the May *Inflation Report* projections. Tensions in the Middle East and concerns about Russian supply have pushed the spot price up recently.

In dollar terms, oil prices were over 50% higher than they had been in May 2003 (see Chart 4.6). During that time the futures curve has also risen. And both Consensus Forecasts and US Government projections of future oil prices have increased (see Table 4.A). So market participants and other observers expect higher oil prices to persist in the near term. Why might they have revised up their expectations? Positive news about world demand is likely to have played a role. During the past year the International Energy Agency (IEA) has increased its estimate for world oil demand in 2004 by nearly 3%. That largely reflects increased demand from

Table 4.A
Oil price forecasts^(a)

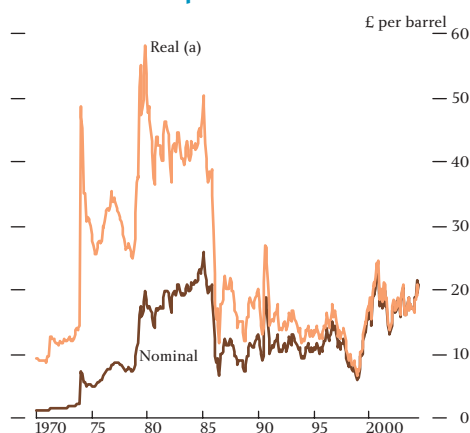
\$ per barrel

	2003 May	2004 Jan.	April	July
Consensus twelve months ahead (b)	24	28	30	32
EIA 2005 Q4 projection	n.a.	28	29	37

Sources: Consensus Economics and the Energy Information Administration (EIA). The EIA is a statistical agency of the US Department of Energy.

(a) West Texas Intermediate oil.
(b) Mean projection.

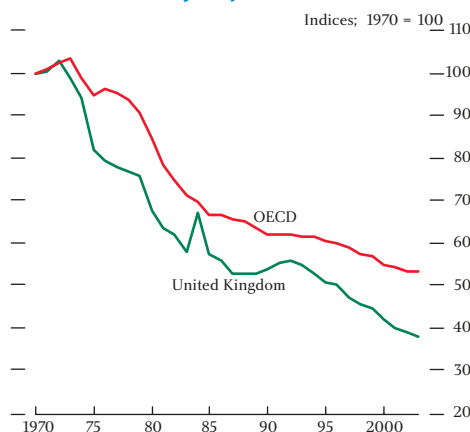
Chart 4.7
Brent crude oil prices



Sources: ONS and Thomson Financial Datastream.

(a) In 2003 prices. Monthly oil price has been deflated by RPIX (RPI prior to 1975).

Chart 4.8
The oil intensity of production^(a)



Sources: Energy Information Administration, ONS and Thomson Financial Datastream.

(a) Ratio of oil demand to GDP volumes.

non-OECD countries. At the same time spare capacity has been falling.

What is the impact of higher oil prices on the UK economy? Oil is used in the production process. So increases in the oil price affect firms' costs. Sterling oil prices are currently only slightly below peaks reached in the mid-1980s (see Chart 4.7). But it is unlikely that current fluctuations in the price will have the same impact on firms' costs as they did 20–30 years ago. That is because the share of oil in firms' total costs is much lower now than in the past. That reflects two factors.

First, the sterling price of oil relative to the general level of UK prices and costs (proxied by retail prices) is much lower now than in the past (see Chart 4.7). So for a given amount of oil used in the production process, nominal fluctuations in the price would need to be substantially higher than they were in the 1970s and 1980s for those movements to have the same impact on UK firms' total costs.

Second, during the past 30 years the oil intensity of production has fallen substantially in the United Kingdom and in other industrialised countries (see Chart 4.8). As oil is now a much less important input into the production process, for a given rise in oil prices, the effect on firms' total costs will be lower than in the past.

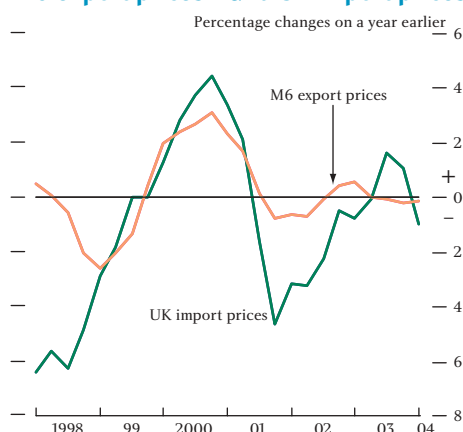
Fluctuations in oil prices also affect CPI inflation, and hence UK households' real income more directly, through their impact on retail petrol prices. That is discussed in [Section 4.5](#).

In the year to April, the dollar price of non-oil commodities, as measured by *The Economist* price index, increased by over 30%. Although all non-oil commodities saw some increase in their prices, metals prices rose by over 50% during that period. But since April the dollar price of non-oil commodities has fallen a little, while metals prices have been broadly flat. Previous *Reports* have shown that metals price inflation tends to track OECD industrial production. So recent movements could imply some softening in the outlook for global demand. However, it is also possible that previous sharp rises in commodity prices simply reflected exaggerated optimism about the prospects for industrial activity.

4.3 Global costs and prices

Inflationary pressures from internationally traded goods and services have been muted recently. In Q1, global trade prices, as proxied by the local-currency export prices of goods and services in the other major six (M6) economies, edged up a

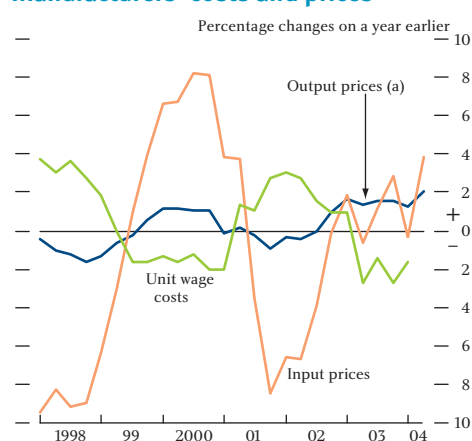
Chart 4.9
M6 export prices^(a) and UK import prices



Sources: ONS and Thomson Financial Datastream.

(a) In local currency. 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
Manufacturers' costs and prices



(a) Excluding excise duties.

little.⁽¹⁾ But during the past three years those prices were little changed, despite increased cost pressures from commodity prices and the recovery in global demand (see Chart 4.9). Between 2003 Q4 and 2004 Q1 the sterling ERI appreciated by nearly 4%, putting downward pressure on prices charged to UK importers. Consistent with those movements, import prices fell in Q1. The moderate appreciation of sterling since Q1 should exert further downward pressure on import prices in the near term.

4.4 Sectoral costs and prices

The prices of consumer goods and services depend on the costs of various inputs used in their production as well as the profit margins added to those costs. Inflationary pressures can emerge in the industries involved in the production and the distribution of those goods and services.

Input prices measure the costs of materials and fuels used in the manufacturing sector. Since mid-2002, annual input price inflation has been on an upward trend (see Chart 4.10). In 2004 Q2 annual input price inflation rose to 3.8%. That rise mainly reflected the impact of higher oil prices.

But materials and fuels represent only one component of manufacturers' total costs. Labour costs are also important. And unit wage cost growth in the manufacturing sector has been remarkably subdued since the beginning of 1999, averaging -0.2% per year compared with 2.5% in the private sector as a whole (see Charts 4.5 and 4.10). That reflects higher productivity growth in the manufacturing sector as wages have grown broadly in line with those in the private sector as a whole. Unit wage cost growth has been falling since 2002 Q1 and has been negative for the past year. So that suggests that cost pressures in manufacturing are still weak. Nevertheless, the *CBI Quarterly Industrial Trends Survey* suggests that cost pressures in manufacturing may be emerging; in Q2 the balance of manufacturers expecting unit costs to increase rose to its highest level since 1995 Q4.

Output prices measure the prices at which manufacturers sell their output to the UK non-manufacturing sector (primarily distribution and the rest of the service sector). Manufacturing output price inflation has drifted up steadily since mid-2001 (see Chart 4.10). In 2004 Q2, annual output price inflation (excluding excise duties) rose to 2.1%, the highest rate of increase since 1996 Q2. That chimes with the CIPS survey for output prices; the average balance in Q2 rose to its highest level since those data were first collected in 1999 Q4. And looking forward, manufacturers expect higher output price

(1) The M6 consists of Canada, France, Germany, Italy, Japan and the United States.

Chart 4.11
Manufacturers' profits

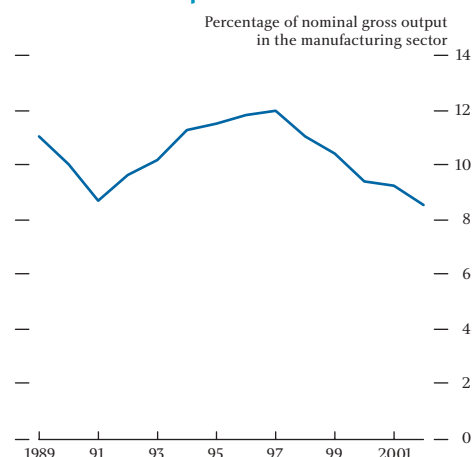


Table 4.B
Service sector costs and prices

	2002 Average	2003 Q3	2003 Q4	2004 Q1	2004 Q2	2004 July
Backward-looking						
CIPS input prices (a)	54.1	55.0	56.0	56.1	60.1	58.4
CIPS output prices (a)	51.6	51.1	51.5	52.1	54.4	53.4
CSPI (b)	1.9	3.1	2.8	2.4	n.a.	n.a.
Forward-looking						
BCC prices balance (c)	23	18	27	28	26	n.a.

Sources: BCC, CIPS and ONS.

- (a) Averages of monthly indices. A reading above/below 50 suggests rising/falling prices.
 (b) Corporate services price index. Percentage change on a year earlier.
 (c) Net percentage balance of firms expecting prices charged to rise over the next three months.

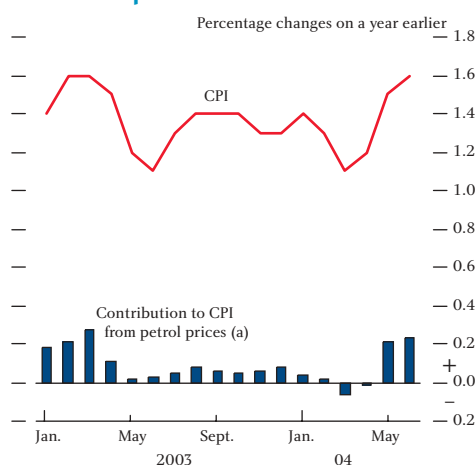
inflation to persist in the near term: in Q2, the CBI survey balance for expected prices rose to +6, its highest level since 1996 Q4.

During the past two years, manufacturing sector output prices have risen by more than both input prices and unit wage costs. That might reflect manufacturers attempting to rebuild profit margins after they were squeezed during the late 1990s and early 2000s (see Chart 4.11).

In the service sector, survey data suggest that cost and price pressures have risen, but that is not corroborated by the official data. Comprehensive information on service sector input and output prices is scant. The rate of increase in the ONS experimental corporate services price index (CSPI), which in principle should capture business-to-business service sector output price inflation, eased further in Q1 (see Table 4.B). But that index currently excludes almost half of its targeted sample. Trends in the CIPS survey for output price inflation are markedly different. In Q2 the backward-looking balance for average prices charged by service sector firms rose to 54.4, the highest reading since 2000 Q4. The index fell slightly in July, but continues to indicate rising prices. Looking forward, according to the BCC survey, the net balance of service sector firms expecting price rises in the near term remains high. The CIPS survey also collects information on firms' input costs (which include both raw materials and labour). According to that survey, input prices increased sharply in Q2. That is likely to reflect higher materials costs, but also increasing wage costs in the service sector.

4.5 Consumer prices

Chart 4.12
Consumer prices

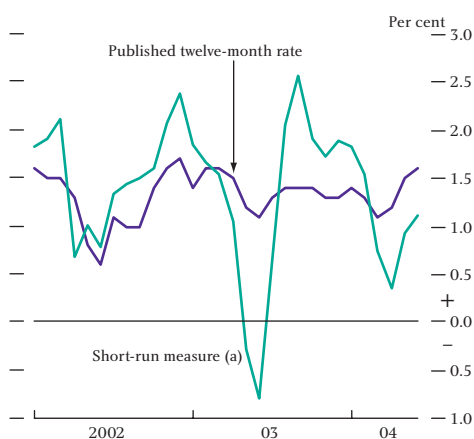


(a) Percentage points.

CPI inflation rose steadily during the past three months, from 1.1% in March to 1.6% in June. Even though petrol only represents about 3% of the CPI basket of goods and services, about 0.3 percentage points of the rise in inflation reflected the direct effects of increased crude oil prices on retail petrol prices (see Chart 4.12). That contribution to the increase in the annual rate reflected both recent rises in fuel prices, but also the effects of falling fuel prices a year ago.

The annual CPI inflation rate includes information about developments in the price level twelve months ago, as well as more timely developments. Chart 4.13 shows a shorter-run measure of inflation based on the change in the price level during the previous three months. The rate is annualised so that it is comparable with the published twelve-month rate. Notwithstanding the recent rise in fuel prices, this shorter-run measure of inflation has fallen since the end of last year, and is currently below the published annual rate. The fall in the

Chart 4.13
Measures of CPI inflation^(a)



(a) Three-month rate annualised. CPI seasonally adjusted by the Bank of England.

short-run measure in part reflects movements in food prices: food price inflation has eased since the end of last year. Barring a sharp rise in the short-run measure to well above the current published twelve-month rate, the published rate should ease back. The MPC expects that CPI inflation will fall in the near term, but will pick up thereafter as increased cost pressures are passed along the supply chain.

This section summarises the monetary policy decisions taken by the MPC since the May Report.⁽¹⁾ The Bank's repo rate was increased to 4.5% at the MPC's meeting in June. It was maintained at 4.5% in July and increased to 4.75% in August.

The MPC's central projection in the *May Report* under constant interest rates was for CPI inflation to move up in the near term. Thereafter, it increased gradually as pressures on supply capacity built, moving above the 2% target towards the end of the forecast period. Output growth was projected to pick up to well above trend in the near term and to ease back subsequently.

At the time of the Committee's meeting on 9–10 June, euro-area growth had strengthened and the recoveries in the United States and Asia seemed well established. Oil prices had risen sharply in 2004, but the impact on the UK economy was likely to be modest.

Sterling had risen by over 2%, reflecting movements in relative interest rates. ONS estimates of GDP growth for Q1 had been lower than expected, given survey evidence, but indicators of output growth in Q2 had been robust. Evidence on the strength of household spending was mixed and there were tentative indicators that housing market activity might be easing, though house price inflation had been stronger than the Committee had expected in May. Labour market conditions were tightening, both in terms of employment and earnings. The near-term outlook for CPI inflation was little changed.

The Committee discussed several arguments for a 25 basis point increase in the repo rate. For most members, the projections in the *May Report* could have warranted a rise of 50 basis points at that time. That would have helped to reduce the risk that inflationary pressures would gather momentum, though it might have been mistaken for a change in the Committee's strategy. Since then, the Committee had explained the change in the economic outlook in the *May Report* and the *Minutes* of its May meeting, so that a further

(1) The *Minutes* of the May, June and July meetings (which set out the full discussion) are reproduced under a separate cover, published alongside this *Report*.

repo rate increase would now be understood as a response to the more robust outlook. The balance of risks had moved towards the upside, and inflation expectations derived from financial markets had risen a little. It was important that monetary policy responded to ensure that inflation expectations remained in line with the target. For some members, the prospect of higher domestic debt-service levels and personal income gearing reinforced the need for a repo rate increase. A further increase might encourage a more prudent approach towards incurring higher levels of debt, and so help to contain the vulnerability of demand to subsequent shocks.

The Committee also considered possible arguments for keeping interest rates unchanged. The Q1 National Accounts and 2004 *Blue Book* data would be published at the end of June. The three earlier repo rate increases had not yet taken their full effect. Consumer confidence, the housing market and manufacturing could all be more fragile than the Committee believed.

Overall, the Committee favoured a repo rate increase of 25 basis points, though for one member the decision was finely balanced. The Committee voted unanimously to increase the repo rate to 4.5%.

At its meeting on 7–8 July, the Committee noted that financial markets had fully anticipated the 25 basis point rise in US official interest rates. The world economic upswing remained on track. Euro-area growth continued to gather momentum, and US growth continued, though perhaps slightly less briskly than before. The recovery in Japan seemed well established and the rest of Asia was growing strongly.

UK output and demand growth appeared to have continued at around, or a little above, trend in the first half of the year and there appeared to be little, if any, spare capacity. Strong manufacturing output growth in April and May suggested that the ONS estimates of GDP growth in 2004 Q2 might be stronger than for Q1. The estimated level of GDP had been revised upwards in the *Blue Book*, but that was more than accounted for by higher estimates of real government output and did not materially alter the Committee's view of inflationary pressures. The weaker ONS estimate of real consumption growth in Q1 was difficult to reconcile with other indicators and the Committee judged that it might have been a little faster than currently estimated. But there were also signs of more moderate consumption growth in Q2 and further tentative signs of a slowdown in the housing market, although house prices were above the level projected in the *May Report*. Overall, the broad economic outlook had

not changed much since the *May Report*, though the immediate prospect for domestic demand was perhaps a little weaker.

The Committee discussed possible arguments for increasing the repo rate by 25 basis points. The central projection in the *May Report* based on market interest rates showed inflation at the forecast horizon a little above target, and it was likely that the repo rate would need to rise further. The case for moving cautiously was less relevant now that the interest rate cycle had clearly turned. The labour market continued to tighten gradually, but inflation expectations seemed well anchored.

The Committee thought the arguments for keeping interest rates unchanged were more persuasive. The recent increases reflected a movement at least as fast as implied by the market yield curve in the *May Report*, so there was no argument for a third successive rise. An unexpected rate increase, in the absence of significant news on the month, might prompt an unwarranted re-evaluation of the Committee's strategy by market participants. The *August Report* would provide an opportunity to evaluate the news since May more fully and to consider further some key issues, such as the recent and prospective evolution of consumption and the pressure of government demand on resources.

The Committee voted unanimously to maintain the repo rate at 4.5%.

At its meeting on 4–5 August, the Committee voted to increase the repo rate to 4.75%.

In the MPC's central projection, assuming that official interest rates follow a path implied by the market yield curve, GDP continues to grow vigorously during the first year. A deceleration in final domestic demand slows the economy during the second year. CPI inflation dips in the near term. Pressures of demand on supply push up CPI inflation during 2005 and 2006 to meet the 2.0% target after two years, remaining close to target thereafter. The profiles for GDP growth and CPI inflation during the next two years are broadly similar to the ones published in the May Report.

6.1 World economic activity

The world economic upswing has broadened, with recovery in the euro area now more evident than three months ago. The MPC believes that growth in international economic activity is likely to remain robust.

The euro area

In the euro area, there were promising signs that the upturn has become more firmly established. In particular, consumption growth rose quite sharply in 2004 Q1. The strength of consumption in many euro-area countries suggests that the recovery is broadly based. The investment pickup has continued: investment has grown for three consecutive quarters. The recovery in German domestic demand is likely to lag behind, but that should not undermine the upturn in the rest of the euro area. Buoyant world trade will probably also provide some stimulus to euro-area growth and employment. Overall, the outlook is for firm GDP growth, supported by a stimulative monetary policy.

The outlook for the euro area is broadly similar to that in May. Even so, the recent outturns have led the Committee to judge that some of the downside concerns have eased and that overall the risks are more balanced than in May.

The United States

The prospect is for further strong US GDP growth in the second half of 2004, despite the weakening in the second quarter. Surveys are consistent with a pickup in the third quarter. Near-term consumption growth is likely to be supported by greater certainty over job prospects, as employment rises further. Investment will probably remain

strong until the end of this year, supported by fiscal incentives and a narrowing margin of spare capacity. The Committee expects output growth to fall back in 2005, as the impetus from monetary and fiscal policy is gradually removed.

Asia

In Japan, the outlook is for sustained recovery. Consumption growth will probably remain strong in the near term. Consumer confidence has been rising sharply. Improving corporate balance sheets, alongside increasing business optimism and a recovering stock market, should help to provide the impetus for an extended upturn in business investment. Net trade is also likely to make a positive contribution to growth, supported in part by strong Chinese demand. Chinese growth eased slightly in the second quarter, and is likely to slow a little further in the near term. Nevertheless, China should continue to grow rapidly.

UK overseas markets

The United Kingdom's export markets are likely to expand at a brisk pace. Compared with the *May Report*, the outlook for growth in these markets is broadly unchanged.

6.2 The interest rate assumptions

Since it was established in 1997, the MPC has published a projection in the *Inflation Report* based on unchanged official rates. From 1998, the MPC has also produced a projection using an assumed path for official interest rates estimated from market yields on government liabilities. Both of these projections provide information about the Committee's outlook for growth and inflation. But, as the [box on pages 42–43](#) explains, there are many circumstances in which the projection under market rates provides a more helpful picture of the outlook.

The projection described immediately below is conditioned on a path for official interest rates implied by market yields, rather than on unchanged rates as in previous *Reports*. That path, which is set out in Table 6.A, is slightly higher than the equivalent one in the *May Report*.

The MPC has also decided to publish projections, based on market rates, that look three years ahead, rather than two as in previous *Reports*. Some developments may have their full implications for inflation only after two years. When this has been material in the past, attention has been drawn to the slope of the projection at the two-year horizon. The Committee believes that transparency will be enhanced by

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

Per cent

August

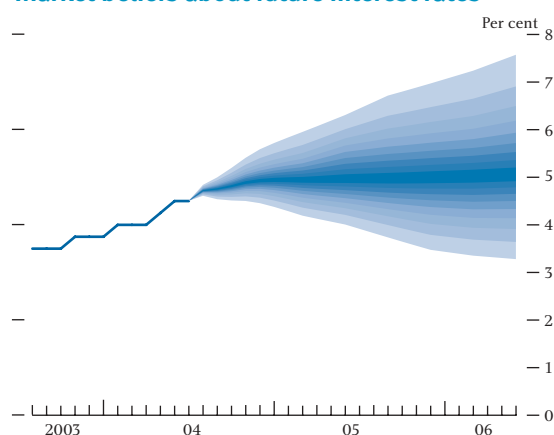
2004		2005				2006				2007		
Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
4.6	4.9	4.9	4.9	5.0	5.0	5.0	5.1	5.1	5.1	5.2	5.2	5.2

May

2004		2005				2006	
Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
4.5	4.6	4.7	4.8	4.8	4.9	4.9	5.0

(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 estimated average difference between this rate and the Bank's official interest rate. This adjustment was lower in August than in May, reflecting more recent trends in the data. The data are 15-day averages to 4 August 2004 and 5 May 2004 respectively.

Chart 6.1
Market beliefs about future interest rates



The mode of the fan chart is the market rate profile for 4 August equivalent to the rates shown in Table 6.A. The distribution around that path is constructed using the prices of options on three-month Libor futures contracts traded on LIFFE. There are no contracts traded beyond June 2006, so the chart only goes out to that point rather than the three years shown in the GDP and inflation fan charts. The chart is only indicative of market expectations because it is based on a different, though related, instrument to the Bank's repo contracts. The distribution has been estimated on the assumption that investors are risk-neutral.

showing a projection for the third year. The Committee will continue to publish the projections based on constant rates, though only out to two years.

It is important to stress that the market rate path does not represent the MPC's forecast of official interest rates, rather it is a simple benchmark assumption on which to base the projections for GDP growth and CPI inflation. There is a high probability that official interest rates will not follow this path. Financial markets may judge economic prospects differently from the MPC. And in any event, given the great uncertainties, the economy will almost certainly not evolve in the way either the MPC or the markets expect. It is possible to generate a fan chart (see Chart 6.1), which uses information from options prices to provide an approximate indication of markets' beliefs about the relative likelihood of different future levels of official interest rates. The fan chart is constructed so that there is a 10% probability of rates being in the central darkest band, and then each lighter shade of blue represents a further 10% so that the shaded area covers 90% of the probability. The chart suggests that a wide variety of outturns is possible.

6.3 UK output and expenditure

Household consumption

In the latest official data, growth in consumers' expenditure slowed to just below its long-run average rate in 2003 Q4 and 2004 Q1. While the MPC judges that household spending probably had more momentum than these data imply, some slowing is to be expected given that official interest rates have risen by 1.25 percentage points since November 2003.

In particular, there are signs that the housing market may be beginning to cool. House prices have continued to rise rapidly. But measures of housing market turnover have started to slow, and there is some evidence in forward-looking surveys that house price inflation may be about to ease. There are a number of reasons why the sustainable house price to earnings ratio may be higher than in the past.⁽¹⁾ But it is hard to believe that the current ratio can be sustained. It is therefore likely to fall back at some point in the future. That would happen if house prices were to rise more slowly than earnings for a period of time, or through a fall in house prices. The MPC's central projection is for house price inflation to slow sharply during the forecast period—a similar profile to May—although there are great uncertainties surrounding that view.

The Committee explained in the *May Report* that high and rising house price inflation in the recent past had been

(1) These reasons are discussed on pages 43–44 of the *May 2004 Inflation Report*.

The interest rate assumptions in the projections

The *Inflation Report* presents projections of GDP growth and inflation conditional on two alternative benchmark paths for official interest rates. One assumes that interest rates are held at their existing level throughout the forecast period. The other assumes that interest rates follow a path implied by the yield curve for government securities. This box explains some features of the assumptions and clarifies the nature of the associated projections.

The impact of monetary policy depends not only on the current level of official interest rates but also people's expectations of their level in the future. For instance, if official interest rates are changed today, that will have a more pronounced effect on asset prices (including the exchange rate) and on demand if the change is expected to persist than if it is expected to be temporary. And if the policy framework is credible, then people are likely to expect that official interest rates will be continuously adjusted in order to meet the inflation target over a suitable time frame.

When inflation is at the target and the economy is operating at potential with growth near trend, it is natural for the private sector to expect official interest rates to persist around their current level and the yield curve to be relatively flat. But if the economy were, say, operating below potential with inflation below target, then official interest rates would most likely have been reduced in order to stimulate the economy and push inflation up to target. People would then be expecting official interest rates to increase in due course as spare capacity dwindled and inflation returned to target. Maintaining interest rates unchanged indefinitely in this case would therefore correspond to unexpected behaviour on the part of the MPC.

When the MPC constructs its projections under unchanged official interest rates, people are assumed to believe that any deviation from the path they expect is purely temporary and that the MPC will subsequently revert to setting interest rates in order to achieve the target. They therefore experience a sequence of 'surprises' as—against expectation—official interest rates are maintained. And each time people are surprised in this way, asset prices are assumed to respond appropriately. In contrast, when official

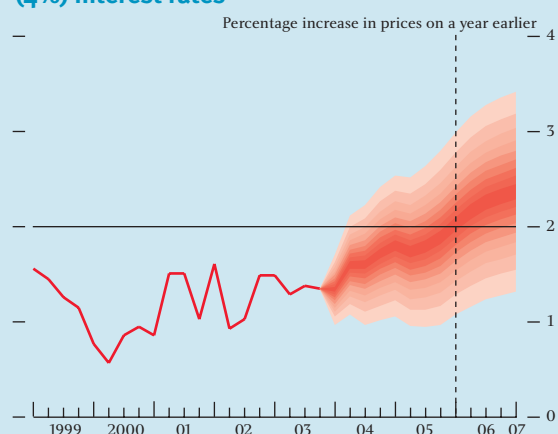
interest rates follow a path implied by the yield curve, there is not the same need to make subsequent adjustments to asset prices as the movements in official rates are already discounted into asset prices and expectations are broadly fulfilled.

Projections conditioned on either benchmark assumption for interest rates can be used to illustrate the MPC's assessment of economic prospects. But when official interest rates are unusually high or low, the assumption that official rates remain unchanged over the forecast period becomes less plausible and the behaviour of inflation and growth as one moves beyond the conventional two-year horizon a correspondingly less helpful guide to the outlook. Moreover, maintaining official interest rates constant in these circumstances will eventually lead inflation to move systematically away from target as the forecast horizon is extended.

This is illustrated in two inflation fan charts adapted from the February 2004 *Inflation Report* (chosen because the short-term yield curve was more steeply sloped then than now). To make the point clearly, the projections have also been extended mechanically into a third year (the Committee did not agree a projection for the third year for that *Report*). Under the constant interest rate assumption (see Chart A), the central projection for inflation is taking off quite sharply in the third year, as continuing above-trend growth puts increasing pressure on supply capacity. By contrast, under the market interest rate assumption (see Chart B), the central projection for inflation settles around the target as higher interest rates choke off the excessive demand growth.

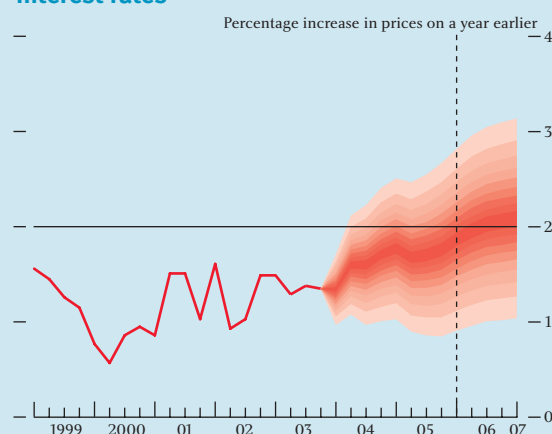
Of course, the central projection for inflation will not always return to target under the market interest rate assumption. For instance, market participants may hold a different view about economic prospects than the MPC. Or they may think that policy will not, in fact, be set to achieve the target. But assuming that official interest rates follow the path implied by market expectations is likely to provide a more helpful benchmark than assuming that rates are left unchanged.

Chart A
February 2004 CPI projection under constant (4%) interest rates



It should also be stressed that the profile for official interest rates derived from the market yield curve merely offers a convenient benchmark assumption. Even if market participants and the MPC have a common view about the economic outlook, the MPC may decide that it is

Chart B
February 2004 CPI projection under market interest rates



appropriate for official interest rates to follow a different path from that implied by the yield curve in order to achieve its *Remit*. Moreover, as emphasised in the main text, the economy is most unlikely to evolve along the path described by the central projection.

associated with more subdued consumption growth than in previous periods. So it seemed possible that a sharp decline in house price inflation would not imply a substantial weakening of household spending. Nevertheless, the MPC believes that a housing market turnaround would restrain future consumer spending to some extent. And with real household disposable income no longer rising so rapidly, consumption is likely to grow at just below its long-run average rate for much of the next two years. Compared with May, prospective consumption growth is a little weaker in the first year, but broadly the same further out.

Business investment

The recovery in business investment since early 2003 continued. Further growth is likely, as recent indicators of investment intentions suggest. Recoveries in investment during the past 25 years have typically seen four-quarter business investment growth of around 20% or more. The MPC does not expect such a surge to be repeated during the current upturn. The slowdown in investment was more muted than in previous cycles. Moreover, corporate debt remains high relative to assets and income. So firms may be less willing to borrow during the coming years and that may limit companies' investment spending growth. The MPC expects investment to grow a little faster than GDP during the forecast period. Compared with May, business investment growth is marginally stronger in the near term, but weaker further out.

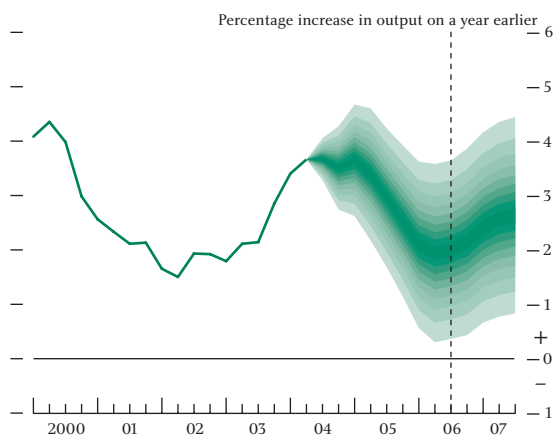
Net trade

The recovery in exports apparently faltered in 2004 Q1, when volumes were estimated to have fallen by 0.9%. But it seems likely that a good part of this recorded fall could be attributed to a decline in fraud-related activity and teething problems associated with HM Customs and Excise new data-processing systems. Abstracting from these factors, it is likely that a recovery in exports is in train. That view is supported by surveys, which have all turned around during the past year. Exports are expected to grow reasonably steadily throughout the forecast period, broadly in line with the forecast for growth in UK export markets. Import growth is expected to be strong in the near term, before slowing in the second year of the projection—a similar pattern to final domestic demand growth. The impact of net trade on GDP growth is likely to be negligible during the forecast period.

Government spending

In forming its projection, the MPC assumes that nominal government spending will grow broadly in line with the Chancellor's plans. The latest plans were announced in the [2004 Spending Review](#) that was presented to Parliament in July. These imply continued rapid growth in real government spending into 2005, after which it is projected to grow at a more moderate rate. Although government spending plays a role in the shape of the profile for output, the Committee's projection for this component of aggregate demand is little changed from May. The Committee judges that the impact of government spending on the outlook for inflation is best captured by its effect on the demand for resources in the economy and not by the official estimate of output.

Chart 6.2
Current GDP projection based on market
interest rate expectations



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. The dotted line is drawn at the two-year point.

The outlook for GDP

Chart 6.2 shows the projection for four-quarter GDP growth on the assumption that official interest rates follow the path implied by the market yield curve. After growing by 3.7% in the year to 2004 Q2, the central projection is for four-quarter GDP growth to remain above trend in the near term, but then to dip below it during the second year of the projection as final domestic demand growth moderates. The profile for GDP growth during the next two years is broadly similar to the one the MPC published in May.

6.4 The outlook for inflation

Oil prices have continued to rise and are likely to add to cost pressures in the near term. Although other commodity prices have flattened off or fallen since the spring, they are still much higher than a year earlier. However, the impact of these

commodity price changes on CPI inflation in the medium term is likely to be small.

The export prices of the United Kingdom's major trading partners have been broadly flat during the past few years. As the world economy continues to recover, these prices should pick up. But their rise is likely to be gradual; increasing competition on world markets may help to restrain price rises of internationally traded products.

UK import prices fell in Q1. That is probably accounted for by the rise in the sterling exchange rate since the start of the year, as other countries' export prices expressed in their own currencies were generally stable or rising. Import price rises are likely to be much more subdued than domestic inflation in the early part of the forecast. In part, that reflects a further impact from sterling's earlier rise and the low rate of global trade price inflation. But import prices recover in the second year of the projection. World export price inflation gathers pace, and sterling depreciates gradually over the forecast period. In the 15 working days to 4 August, the sterling ERI averaged 106.2, the starting point used in the MPC's central projection, and under the MPC's conventional approach,⁽¹⁾ sterling is assumed to depreciate to 103.3 by 2006 Q3.

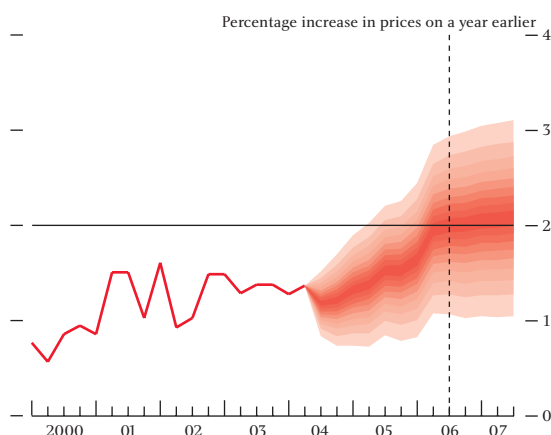
While import prices play a significant role, the future path for UK inflation predominantly depends on the balance between the demand for marketed goods and services and the resources that are available in the United Kingdom to produce them.⁽²⁾ The MPC makes judgments about that balance based on conditions in the labour market and the degree of spare capacity within the private sector.

The labour market appears to be tight. The unemployment rate is at its lowest level for almost 30 years, and some surveys suggest increasing recruitment difficulties. But underlying growth in employees' average earnings has been only edging up. Furthermore, when expressed in terms of pay per hour, growth has been relatively flat. Despite the strong expansion of the economy that the MPC envisages for the next twelve months, employment is unlikely to grow much faster than the total pool of available labour. So the labour market may not tighten markedly. And given the limited response of earnings so far to the already apparent tightness in the labour market, the MPC judges that earnings growth is not likely to be much higher over the forecast period than during recent years. Nevertheless, unit labour cost growth is likely to pick up somewhat over the next few years—a similar profile to May.

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

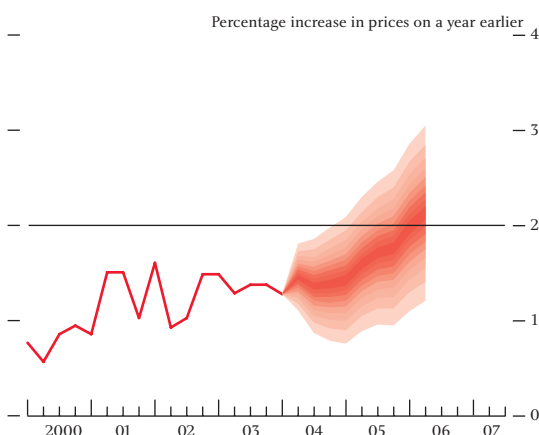
(2) See the box on [pages 24–25 of the May 2004 Inflation Report](#).

Chart 6.3
Current CPI inflation projection based
on market interest rate expectations



The fan charts depict the probability of various outcomes for CPI 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. The dotted line in Chart 6.3 is drawn at the two-year point.

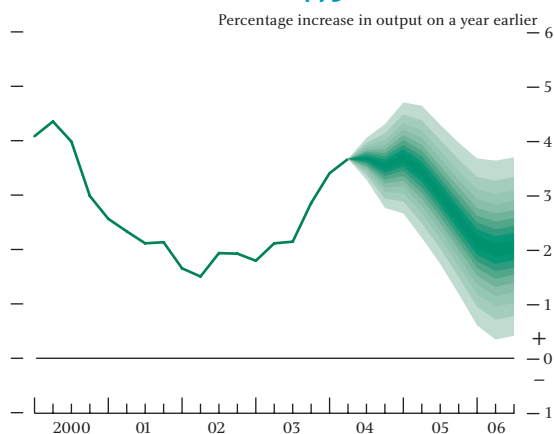
Chart 6.4
CPI inflation projection in May based
on market interest rate expectations



Surveys and reports from the Bank's regional Agents are consistent with the MPC's view that the demand for marketed goods and services is high relative to firms' capacity to produce them, and that pressures on supply have intensified during the past three months. The growth in demand projected for the first year of the forecast means that firms' capacity pressures will be felt more keenly. But as demand growth slows further out some of that pressure will ease.

The Committee's projection for CPI inflation, also assuming that official interest rates follow the path implied by the market yield curve, is shown in Chart 6.3. After an initial slowdown, CPI inflation picks up steadily to meet the target around the two-year point. Thereafter, the inflation profile stabilises close to the target. Temporary weakness in some consumer prices, together with moderation of the strong contribution from petrol prices, pushes down the twelve-month CPI inflation rate in the near term. But as those effects die away, the impact of domestic demand pressures becomes more apparent. The weakness of import prices limits the pickup in CPI inflation during the first year. But that effect attenuates through the rest of the forecast period. The CPI projection for the first two years is broadly similar to May (see Chart 6.4).

Chart 6.5
Current GDP projection based on constant
nominal interest rates at 4.75%

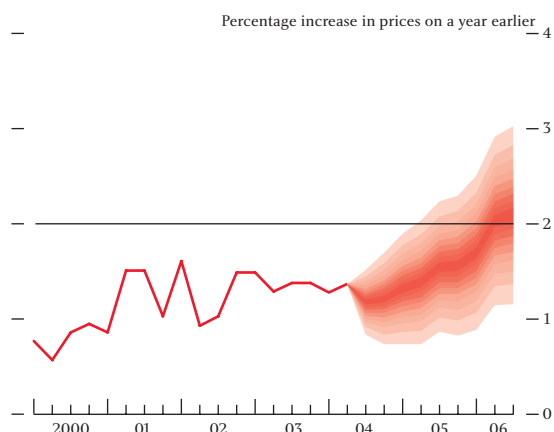


The fan chart depicts the probability of various outcomes for GDP growth in the future. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of probability, until 90% of the probability distribution 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.

6.5 Projections based on constant interest rates

The Committee's projections for GDP growth and CPI inflation conditioned on a constant interest rate at 4.75% are shown in Charts 6.5 and 6.6 respectively. These charts show projections only up to a two-year forecast horizon. The profile

Chart 6.6
Current CPI inflation projection based on
constant nominal interest rates at 4.75%



The fan chart depicts the probability of various outcomes for CPI 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.

for growth in Chart 6.5 is marginally stronger than the projection based on market rates shown in Chart 6.2. The difference between the market curve and the constant rate assumption during most of the next two years is small. The marginal extra demand growth under constant rates cumulates into a slightly more significant difference in the level of demand between the two projections. That, and the lower exchange rate path under constant interest rates, pushes up inflation a little more than under market rates (see Chart 6.6).

6.6 Risks around the central projection

The central projection is only one of many possible outcomes and the prospects for output growth and inflation are, as always, uncertain. The fan charts illustrate the Committee's best collective assessment of the probabilities attached to possible outcomes, including judgments on the principal risks to the outlook. The width of the fan charts indicates how uncertain the Committee is about the prospects for the economy. There has been little change since May to the level of the MPC's uncertainty about the outlook for GDP growth and inflation during the next two years.

The main risks around the central projection relate to the prospects for house prices and consumption, the pressure of demand on supply and the outlook for earnings, and the world economy.

The house price to earnings ratio has risen further during the past three months. The MPC thinks it is likely that this ratio is above a sustainable level. But the Committee remains uncertain what that sustainable level is, and how quickly any adjustment towards it might occur. Nevertheless, the MPC believes that there is a risk of a sharper correction to house price inflation than is implied by the central projection. Another key uncertainty for the Committee with respect to the housing market is the impact of movements in house prices on consumption. The weaker association between house prices and consumption in the past few years has led the MPC to judge that the relationship may also be less strong in the future when house price inflation slows. There is a risk that the MPC has underestimated the potential downward impact on consumption from a sharp slowing in house price inflation. So overall the risks from the housing market to GDP growth and CPI inflation are on the downside.

The Committee is uncertain about how consumer and other product prices will react to strong demand growth. CPI inflation has been stable and below 2% since May 1998, despite significant variation in firms' capacity utilisation during that period. It is possible that increasing competition in the distribution sector, and further up the supply chain, has

put downward pressure on margins and so restrained price increases. The Committee may have underestimated the extent to which that effect was important in the past and the likelihood of it persisting into the future. That would represent a downside risk for inflation.

The low inflation numbers might reflect, to some extent, strong underlying productivity growth that is difficult to discern in the data. The efficiency gains associated with investment in ICT that have given rise to strong productivity growth in the United States might also have begun to be experienced by the UK economy following its own ICT investment boom in the late 1990s.⁽¹⁾ Stronger sustainable productivity growth in the future than the MPC has assumed could represent a downside risk to the inflation projection, but an upside risk to GDP growth.

It is also possible that the subdued price rises over the recent past have led people to expect low inflation in the future. Persistently low inflation expectations could result in a slower pickup in inflation towards target.

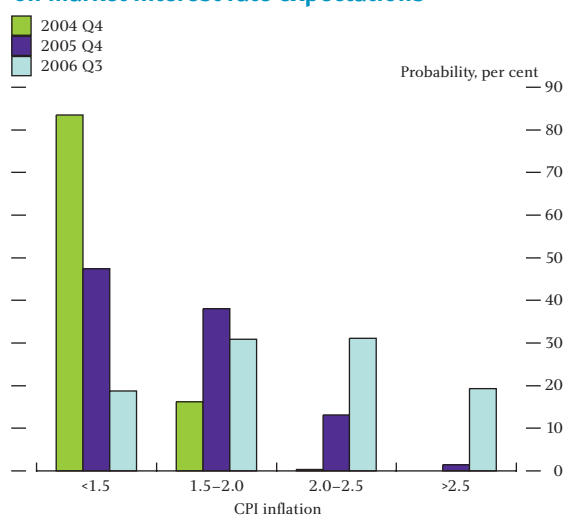
But equally, prices could respond more quickly to rising demand than is implied by the central projection. The Committee may have mistaken what is in reality a cyclical downturn in some goods producers' margins over the recent past for a permanent fall. So as the upturn in the economy continues, these margins may increase by more than the MPC currently anticipates.

Low inflation during the recent past also reflects subdued wage growth. Despite the apparently tight labour market, earnings growth has responded only sluggishly. And in constructing its central projection the MPC judged that labour cost pressures build gradually. But the MPC believes that the balance of risks to this judgment probably lies on the upside, pointing to higher CPI inflation than in the central projection.

A key risk to the world outlook could arise from the US economy. The US current account deficit is historically high. At some stage that must correct and such a correction would probably be associated with substantial exchange rate movements. That could represent a downside risk to activity in the United Kingdom. The implications for CPI inflation would depend on the reaction of the sterling exchange rate.

Another risk to the world economy is the oil market. With capacity already quite stretched, any disruption to supply

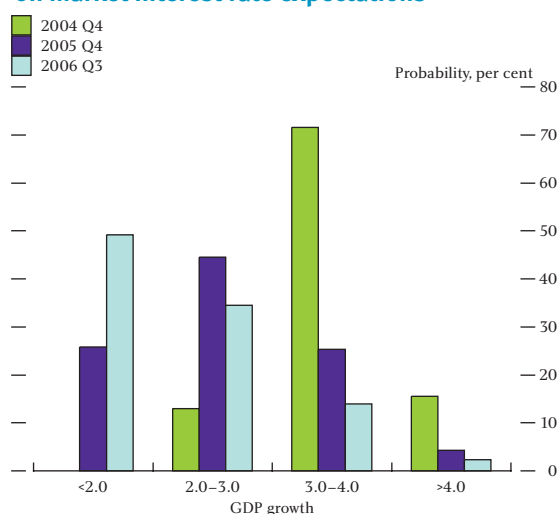
Chart 6.7
The MPC's expectations for CPI inflation based on market interest rate expectations^(a)



(a) These figures are derived from the same distribution as Chart 6.3. They represent the probabilities that the MPC assigns to CPI inflation lying within a particular range at a specified time in the future.

(1) See pages 25–26 of the February 2004 *Inflation Report* for a discussion of these issues.

Chart 6.8
The MPC's expectations for GDP growth based on market interest rate expectations^(a)



(a) These figures are derived from the same distribution as Chart 6.2. They represent the probabilities that the MPC assigns to GDP growth lying within a particular range at a specified time in the future.

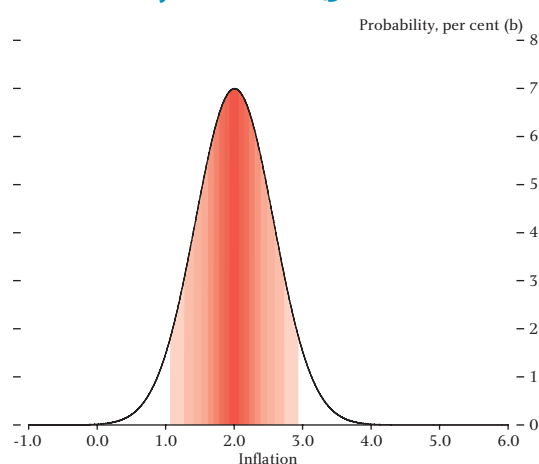
could lead to a further marked increase in prices. That may not have a big direct impact on the UK economy. But some other economies are more vulnerable to oil price rises, and that may adversely affect external demand.

Taking all the risks together, the best collective judgment of the Committee is that they are broadly balanced for both GDP growth and CPI inflation. The probabilities of various outcomes for CPI inflation and GDP growth under the market interest rate assumption are set out in Charts 6.7 and 6.8. The overall balance of risks to the inflation outlook at the two-year point is shown in Chart 6.9, alongside the corresponding balance in May. There is a range of views among members, though the differences are small.

6.7 The policy decision

At its August meeting, the Committee noted that, although inflation was likely to fall back in the near term, the central projection under the assumption that official interest rates moved up in line with the market yield curve was for inflation to rise gradually thereafter, stabilising at the target after about two years. Given that outlook for inflation, and bearing in mind the considerable risks and uncertainties, the Committee judged that an immediate increase of 0.25 percentage points in the official interest rate to 4.75% was necessary to keep inflation on track to meet the target in the medium term.

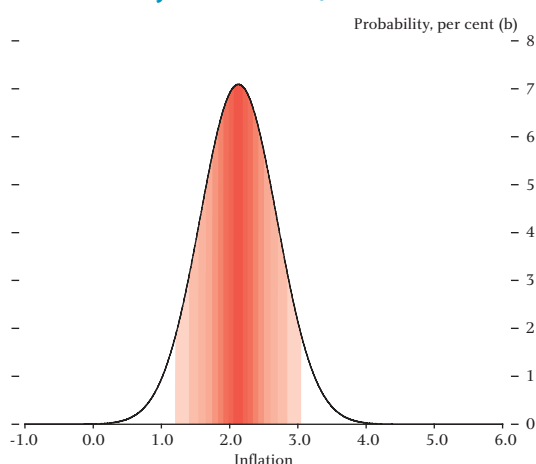
Chart 6.9
Current projection for the percentage increase in CPI in the year to 2006 Q3^(a)



(a) These charts represent a cross-section of the fan chart at the end of the respective forecast periods for the market interest rate projections. As with the fan charts themselves, the shaded areas represent 90% of the distribution of possible outcomes for CPI 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 ± 0.05 percentage points of any given inflation rate, specified to one decimal place. For example, the probability of inflation being 2.0% (between 1.95% and 2.05%) in the current projection is around 7%.

Chart 6.10
May projection for the percentage increase in CPI in the year to 2006 Q2^(a)



The MPC's forecasting record

Interest rate changes take time to affect growth and inflation. Hence the MPC's inflation projection is a major input to policy decisions. An evaluation of short-term forecast errors is an integral part of the Committee's forecast process.

In December 2003, the Chancellor announced a new inflation target of 2%, as measured by the annual rate of increase of the Consumer Prices Index (CPI). From February 2004, the *Inflation Report* has included the MPC's forecasts for CPI inflation. There have been too few CPI inflation projections to conduct a meaningful analysis of their accuracy. The remainder of this box, therefore, assesses how well past projections have served as a guide to the outturns for RPIX inflation and output growth.

The Committee's projections are conditioned on assumptions about key influences such as the world economic outlook and exchange rate prospects, and about structural economic relationships. Given the inherent uncertainty in these economic judgments, the Committee presents its forecasts as probability distributions in the form of fan charts. It is the distribution of possible outcomes that is crucial for monetary policy.

The previous assessment of the MPC's forecasting record was published in the August 2003 *Inflation Report*. This box updates that analysis with four more projections and outturns for RPIX inflation and GDP growth. First, outturns are compared with the Committee's fan chart distributions, and then with the associated central projections.

The fan charts showed the MPC's projections in the form of probability distributions for inflation and GDP growth during the following two years. If the forecast distribution is correctly estimated then, over a large number of years, 10% of inflation and output growth outturns would be expected to lie in the central darkest band, and 10% in each pair of outer bands.

Table 1 shows how many outturns for RPIX inflation and GDP growth have fallen within the central 30% and 50% bands of the MPC's market interest rate based fan charts. For inflation, half the outturns have fallen within the central 30% of the fan charts for both one-year-ahead and two-year-ahead projections. Just over half of inflation outturns fell within the central 50% bands for projections one year ahead, and more than three quarters at the two-year horizon. For both one-year-ahead and two-year-ahead forecasts of GDP growth, about a third of outturns have fallen in the central 30% of the fan charts. Around two fifths

of GDP growth outturns have fallen in the central 50% bands for forecasts one year ahead, and two thirds at two years ahead.

Table 1
Dispersion of outturns relative to fan chart probability distributions^(a)

	Number of outturns	Number in central 30% bands	Number in central 50% bands
RPIX inflation			
One year ahead	22	10	13
Two years ahead	18	9	14
Annual GDP growth			
One year ahead	22	6	9
Two years ahead	18	6	11

(a) Calculated for the market rates fan charts published from February 1998 to May 2003.

RPIX inflation outturns have then generally been slightly closer to the centre of the MPC's fan charts than was anticipated, particularly for two-year-ahead forecasts. While the dispersion of GDP growth outturns has been broadly in line with the MPC fan charts. But this analysis is based on a small number of outturns, from which it is difficult to draw firm conclusions.

An important facet of the MPC's forecast performance is whether the central projections have, on average, tended to be above or below the outturns, that is, whether there is evidence of forecast bias. The presence of bias may indicate that there is information that the MPC could use to improve its future forecasting performance. Here, outturns are compared with forecasts of the mean, rather than the mode, from each fan chart. The former better summarises, on the balance of probabilities, the MPC's expectations. On average, forecasts for the mean have tended to lie a little above the modal (single most likely) forecasts for inflation, and a little below for GDP growth.

The analysis published in August 2003 showed that the MPC's one-year-ahead RPIX inflation forecast errors averaged close to zero, but there was a tendency to overpredict inflation at the two-year horizon; on average outturns were 0.3 percentage points lower than forecast. These results have not changed substantially with the inclusion of four further outturns, as seen in Table 2.

By contrast, the average errors of the MPC's GDP growth forecasts have altered noticeably. Previously, one-year-ahead projections underestimated output growth by 0.3 percentage points. That underprediction has increased to 0.5 percentage points. The analysis in August 2003 showed that on

Table 2
Average errors of forecasts for the mean^(a)

	Size of sample	RPIX inflation	Annual GDP growth
One year ahead	22	0.0	0.5
Two years ahead	18	-0.5	0.2

(a) Calculated for the market rates fan charts published between February 1998 and May 2003. The error is calculated as outturn minus forecast. Similar calculations for projections for the mean and mode based on constant nominal interest rates are published on the Bank of England web site at www.bankofengland.co.uk.

average forecasts two years ahead had slightly overestimated output growth. Now two-year-ahead projections of output growth are, on average, slightly below the outturns.

Two factors are responsible for the change in the average GDP growth forecast errors since the previous analysis: the increase in the number of forecasts in the sample; and revisions to output data. The annual growth of GDP is now estimated to have been 0.3 percentage points higher, on average, over the past six years. These data revisions account for almost the entire change in the average error of GDP growth projections one year ahead and approximately half the change in the average error at two years ahead.

Since August 2003 the number of forecasts analysed has increased by four, and all have underestimated output growth at the two-year horizon. Of these projections, the forecast published in February 2002 has an especially sizable two-year-ahead error. That largely reflected stronger than expected private consumption. The inclusion of the additional

projections accounts for the remaining increase in the average error at the two-year horizon.

Another aspect of the MPC's forecasting record is the average absolute size of its forecast errors. Table 3 shows these errors for inflation and GDP growth, comparing outturns with the Committee's market interest rate based forecasts for the mean. On average, the absolute difference between the outturns and the MPC's one-year-ahead inflation projections is 0.3 percentage points, and 0.4 percentage points for its two-year-ahead forecasts. In common with the average errors of the inflation projections, shown in Table 2, these results are substantially unchanged from those reported in August 2003.

Table 3
Average absolute errors of forecasts for the mean^(a)

	Size of sample	RPIX inflation	Annual GDP growth
One year ahead	22	0.3	0.9
Two years ahead	18	0.4	0.8

(a) Calculated for the market rates fan charts published from February 1998 to May 2003.

Annual GDP growth outturns have been on average 0.9 percentage points away from the MPC's one-year-ahead projections, and 0.8 percentage points away from the two-year-ahead projections. As with the average errors described in Table 2, the increase in the average absolute errors, relative to the analysis published in August 2003, can be ascribed to revisions and the addition of four more observations.

Other forecasters' expectations of CPI inflation and GDP growth

In July, the Bank asked a sample of external forecasters for their latest projections of CPI inflation, output growth, interest rates and the sterling ERI (see Table 1).

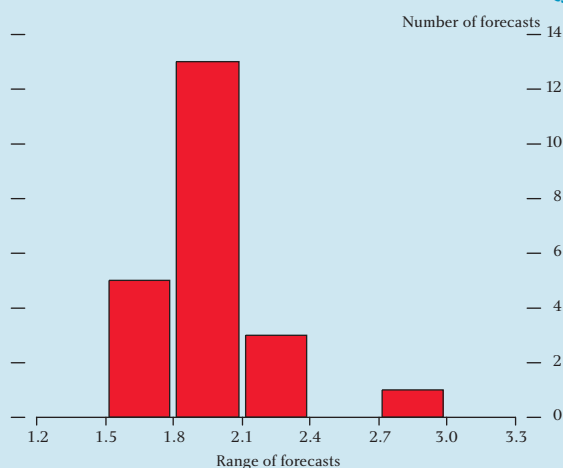
Table 1
Average external forecasts of CPI inflation, GDP growth, interest rates and the ERI^(a)

	2004 Q2 (b)	2004 Q4	2005 Q4	2006 Q3
CPI inflation (c)	1.4	1.6	1.9	1.9
GDP growth (c)	3.7	3.0	2.4	2.4
Repo rate (per cent)	4.2	5.0	5.1	4.9
Sterling ERI (Index; 1990 = 100)	105.2	104.7	102.1	101.1

- (a) For 2004 Q4 and 2005 Q4, 24 forecasters provided the Bank with forecasts for CPI inflation, GDP growth and the repo rate; and 20 gave ERI forecasts. For 2006 Q3, there were 22 forecasts of CPI inflation, GDP growth and the repo rate; and 17 forecasts for the ERI.
(b) Outturns. GDP growth is based on preliminary ONS estimates for chained volume GDP at market prices. The repo rate and sterling ERI are daily averages.
(c) Percentage changes on a year earlier.

The average forecast is for CPI inflation to rise from its outturn of 1.4% in 2004 Q2 to 1.6% in 2004 Q4 and just below the 2.0% target in 2005 Q4 and 2006 Q3. These average projections for CPI inflation are very similar to those discussed in the *May Report*. Over half of the forecasters expect inflation of between 1.8% and 2.1% in 2006 Q3, and none of these forecasts are more than one percentage point above or below the target (see Chart A).

Chart A
Distribution of CPI inflation forecasts for 2006 Q3



Source: Central projections of 22 outside forecasters as of 30 July 2004.

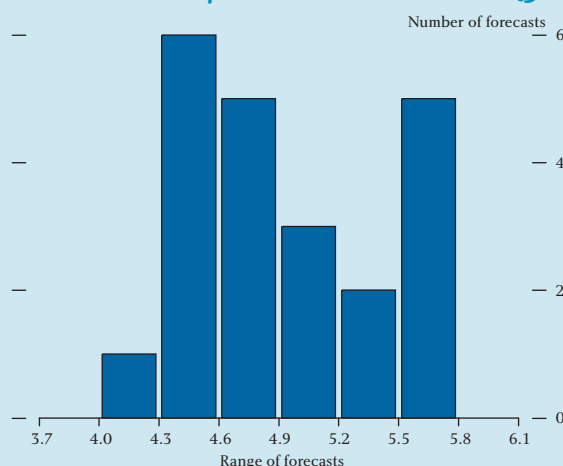
The average forecast is for GDP growth to decline over the next two years, with four-quarter growth falling from its 2004 Q2 preliminary outturn of 3.7% to 3.0% in 2004 Q4 and 2.4% in 2005 Q4 and 2006 Q3. These average projections for GDP growth are also very similar to those reported in May.

These forecasts assume, on average, that official interest rates rise to around 5.0% between 2004 Q4

and 2006 Q3 (see Table 1). That average interest rate projection is a little higher than in the *May Report*, though it is broadly the same as market participants' average expectation of interest rates (see Table 6.A on page 40 of this *Report*).

Over the past year, the range of central forecasts for official interest rates has become more polarised. Chart B shows that of the group's interest rate projections at the two-year horizon, 12 (or over half) of the 22 are either below 4.6% or above 5.5%. By contrast, in May a similar number of forecasters projected official interest rates at the two-year horizon at each of five different intervals and last August the majority of the interest rate projections was clustered around the centre of the distribution.

Chart B
Distribution of repo rate forecasts for 2006 Q3

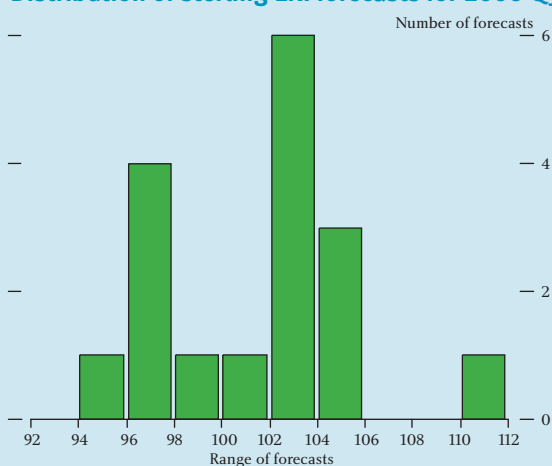


Source: Central projections of 22 outside forecasters as of 30 July 2004.

The forecasts assume, on average, that the sterling ERI falls from its outturn of 105.2 in 2004 Q2 to 102.1 in 2005 Q4 and 101.1 in 2006 Q3 (see Table 1). Using its conventional approach, the Committee projects the sterling ERI to fall to 103.3 by 2006 Q3 which is slightly above the average of the external forecasts. By contrast with their interest rate projections, the external forecasters' expectations for the sterling ERI at the two-year horizon are a little more clustered around the average than has been the case in the past year (see Chart C). Even so, the forecasts are still quite diverse, with one forecaster projecting an ERI at the two-year horizon nearly 10% lower than its 2004 Q2 outturn, while another projects the ERI over 5% higher.

Apart from providing their central projections, the external forecasters also provide the Bank with information on the likelihood of a range of possible outcomes for CPI inflation and GDP growth (see

Chart C
Distribution of sterling ERI forecasts for 2006 Q3



Source: Central projections of 17 outside forecasters as of 30 July 2004.

Table 2). On average, the external forecasters see a 60% probability of CPI inflation being within half a percentage point of 2.0% in two years' time, with a 24% probability of inflation below 1.5% and a 16% probability of inflation above 2.5%. Those probabilities have become slightly more balanced since May, with the external forecasters seeing a little more upside and slightly fewer downside risks to inflation at the two-year horizon than three months ago.

Table 2
Other forecasters' expectations of CPI inflation and GDP growth^(a)

CPI inflation

Probability, per cent (b)	Range:					
	Less than 1.0%	1.0% to 1.5%	1.5% to 2.0%	2.0% to 2.5%	2.5% to 3.0%	More than 3.0%
2004 Q4	5	26	45	19	4	2
2005 Q4	4	16	37	29	10	4
2006 Q3 (c)	6	18	35	25	11	5

GDP growth

Probability, per cent (b)	Range:			
	Less than 1%	1% to 2%	2% to 3%	More than 3%
2004 Q4	2	10	41	47
2005 Q4	8	23	44	25
2006 Q3 (c)	9	28	41	21

(a) 24 forecasters provided the Bank with their assessment of the likelihood, at three time horizons, of expected twelve-month CPI inflation and four-quarter output growth falling in the ranges shown above. For example, on average, forecasters assign a probability of 4% to CPI inflation turning out to be less than 1.0% in 2005 Q4.

(b) Figures may not sum to 100 due to rounding.

(c) 22 forecasters.

On average, the forecasters see a 41% probability of GDP growth being between 2% and 3% in two years' time, with a 37% probability of GDP growth below 2% and a 21% probability of GDP growth above 3%. According to the external forecasters, the downside risks to GDP growth have increased since May, while the upside risks have fallen.

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Bank of England

Agents' summary of business conditions

August 2004

This publication is a summary of monthly reports compiled by the Bank of England's Agents,⁽¹⁾ following discussions with around 2,000 businesses in the period between mid-April and mid-July 2004. It provides information on the state of business conditions, from firms across all sectors of the economy. The report does not represent the Bank's own views, nor does it represent the views of any particular firm or region. The Bank's Monetary Policy Committee uses the intelligence provided by the Agents, in conjunction with information from other sources, to assist its understanding and assessment of current economic conditions.

- Manufacturing output continued to increase. Most businesses were cautiously optimistic about the prospects of further expansion, but sentiment remained fragile.
- Construction output growth was strong, underpinned by public sector demand.
- Housing demand and house price inflation moderated, but with quite strong regional variations. Recent interest rate increases and the perceived risks of future house price falls reduced the confidence of house buyers.
- Output in the service sector accelerated. But the pace of expansion may have slowed towards the end of the period.
- Annual growth in retail sales was fairly buoyant in May and June, but may have eased more recently. Reasons cited for the slowdown included past interest rate increases, the softer housing market and the poor weather.
- Export sales and orders rose further. An increasing number of contacts saw signs of recovery in their exports to western Europe.
- Investment intentions gradually continued to improve. Contacts had less spare capacity, profitability was improving and the cost of finance remained relatively low.
- The labour market remained tight. Faced with staff shortages, some contacts were increasing the average hours of their employees.
- Wage pressures were building slowly.
- Firms' materials costs accelerated early on during the period, but showed signs of stabilising later on. The rising cost of energy was an increasing concern.
- A growing number of manufacturing contacts raised prices, on account of pressure on their margins and strengthening demand. Consumer price increases, however, were muted by continuing strong competition.

(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

Arable prices had fallen since the beginning of the year, though contacts reported that arable volumes would be affected by the poor weather in the first half of July. Prices of dairy products remained weak. There was concern that UK milk output could decline in the medium term, as reforms to the Common Agricultural Policy (CAP) reduced EU support payments linked to production. That uncertainty was fostering consolidation and diversification within farming. For example, a few dairy farmers were leaving the industry, while others were likely to move from milk to beef production. But most farmers were still considering their options. North Sea oil and gas production fell, despite recent high prices.

Manufacturing

Manufacturing output continued to rise in the latest three months. Companies supplying the information technology (IT) and telecommunications sectors reported a significant upturn in orders. Traditional industries such as metals and engineering, where international competition was particularly strong, were seeing the slowest recovery.

Most manufacturers reported adequate capacity in the United Kingdom. Where the amount of spare capacity was low, the majority of contacts planned to introduce new production shifts or increase the average hours worked by their employees. Larger firms planning to invest in new plant and machinery were often looking to do so overseas.

Some firms had rebuilt stocks of intermediate or finished goods in anticipation of further recovery in demand in the second half of the year and the possibility of supply shortages. But not all manufacturers were confident about prospective demand and several Agencies noted a mood of caution. Although many contacts were making profits at their recent higher levels of activity, those profits were often being squeezed by falling margins. That was partly the result of rising costs of wages and materials (see below). So any unexpected reduction in demand could push these companies back into making losses.

Construction and housing

Contacts indicated that the growth of construction output may have picked up in the latest three months. Activity was underpinned by work for the public sector and, to a lesser extent, for the retail and distribution

sectors. Office development was more subdued on account of overcapacity of office space, although in some regions speculative building had reappeared recently.

Most Agencies reported some softening in the housing market in June and July. After allowing for normal seasonal influences, housing market activity slowed. Completions were taking longer and more transactions were breaking down. More homeowners were putting properties onto the market as they anticipated a turning point in demand and prices. With greater housing supply relative to demand, house price inflation seemed to be easing. Contacts believed that past interest rate increases and the media's recent focus on the risks of future house price falls were reducing the confidence of house buyers. Some house builders reported that site visits and reservations were much lower recently and that new house price inflation was falling. Others were more nervous about developing large sites.

But conditions in the housing market were not uniform. Most Agencies reported that demand for less expensive properties was still buoyant, especially in regions where average house prices were relatively low. Even in those regions where the average level of house prices was higher, the majority of contacts was not expecting house prices to fall, rather that the rate of increase was likely to ease further in the months ahead.

In the buy-to-let market, conditions varied from region to region. But overall, the Agencies reported that investor demand was waning slowly, especially for those investors with larger portfolios of properties. Contacts noted that rental yields were either flat or falling, the risk of capital losses was rising and recent increases in interest rates had increased the cost of finance.

Services

Taking the period as a whole, the Agencies reported further acceleration of services output throughout the sector. But growth may have slowed in the final month of the period. Capacity utilisation increased in the latest three months and was probably greater than normal.

The growth of activity was strongest in business services. Outside London, turnover in business financial services was growing strongly. And there were increasing signs of recovery in business discretionary spending, on advertising for example. By contrast, in the City of London there were tentative signs that demand for corporate financial services and related activities may have weakened towards the end of the period. Mergers and acquisitions (M&A) activity remained fairly subdued

and the initial public offering market was fragile, partly on account of weaker world equity markets. The decline in confidence appeared to be fairly widespread among investment banks and lawyers engaged in M&A activities. That was partly because the recovery in M&A volumes was weaker than expected. And there were concerns about the outlook for growth in the euro area.

Several Agencies noted a slowdown in the growth of consumer services output towards the end of the period, following a marked pickup in growth in May and June. In June, the European football championships may have provided a temporary boost to consumer spending on items such as take-away food and alcoholic drinks. And the strength of the housing market earlier in the year resulted in a strong pipeline of work for estate agents, conveyancers and mortgage lenders. In July, those activities may have weakened, on account of an easing of the housing market earlier in the summer. The poor early summer weather may have reduced spending on leisure and tourism.

DEMAND

Consumption

After allowing for seasonal influences, contacts reported that the value of retail sales accelerated in May and early June. As with consumer services, growth may then have eased slightly.

In the first two months of the period under review, most contacts saw little evidence of retrenchment by consumers. That view was supported by robust discretionary spending on big-ticket items, including cars, jewellery and furniture. It appeared that the pickup in house price inflation in the spring had buoyed consumer confidence. Retail sales also received a fillip from the European football championships and the impending Olympic Games. Demand for widescreen televisions was particularly strong.

In the month to mid-July, several Agencies reported a slight slowdown in the growth of retail sales. That was reflected in some retailers discounting stock earlier and deeper than last year. Reasons cited by contacts for an apparent easing in demand included the effect of past interest rate increases on households' disposable incomes and the poor summer weather. Sales of new cars may have weakened. Looking forward, some retailers expected consumer demand to decelerate and were destocking as a result. Many homeowners had mortgages with introductory interest rates that were due to expire soon. For those homeowners, mortgage interest rates were set to rise significantly this year.

Exports and imports

Most goods exporters remained fairly optimistic and their recent orders were somewhat stronger than suggested by the latest official data. Demand strengthened further, especially in the United States but also in eastern Europe and the Middle and Far East. And more contacts reported that exports to western Europe had started to recover, although German markets remained weak. Even so, many firms were nervous about the outlook for their overseas orders and profitability, especially in markets where prices were set in dollars.

The Agencies' reports suggested that imports rose as a share of domestic demand and grew faster than exports. Contacts reported that more of their domestic customers had adopted global sourcing of products as a means of driving down costs. The relocation of manufacturing activity overseas continued. And some contacts had stopped manufacturing in the United Kingdom altogether and instead were importing finished goods from countries with cheaper labour costs. With most of their activities revolving around marketing and after-sales service, they had largely converted into wholesaling businesses. That too resulted in the substitution of imports for domestic production.

Investment

The investment intentions of both manufacturers and service sector firms continued to recover. For most contacts, spare capacity was declining, profitability was improving and the cost of finance remained relatively low. However, investment continued to be constrained by concern about the sustainability of recovery in manufacturing and continuing cash demands arising from pension fund restructuring. Manufacturers typically focused their investment on raising labour productivity and reducing the number of employees. That was associated with increased IT investment, with many contacts looking to improve cost competitiveness and their communications with customers. In the service sector, more firms were looking to increase capacity, especially in the retail and distribution sectors. But some retail contacts reported a shortage of suitable building locations, which inhibited their planned expansion.

EMPLOYMENT

Most regional labour markets tightened further in the latest three months. A consequence of that in some regions was an increase in staff turnover as employees looked for higher paying jobs. For example, some retail contacts reported losing staff to higher paying financial

institutions. Skill shortages were particularly evident in the construction industry. Apart from raising wages, firms sought to ease labour shortages by investing in labour-saving technology (see above), increasing the average hours of their employees (including more overtime working) and greater use of migrant workers and temporary staff.

COSTS AND PRICES

Pay

Wage pressures were building slowly. Employees' pay expectations increased, in part because the tightness of the labour market resulted in greater competition among employers for staff. Also, wage differentials in lower paying industries were being eroded by large past and prospective increases in the National Minimum Wage. As a result, some contacts' wage negotiations were more protracted than usual. Even so, pay pressures were not usually a cause for concern and were mostly viewed as symptomatic of the increasing strength of the economy. That strength was also evident in growing company profits. Many contacts were increasingly using systems that linked pay directly to performance, so that the increase in their wage costs could be controlled better relative to turnover and profits.

Input prices

Manufacturers' materials costs accelerated in the first two months of the period under review. But several Agencies noted that those cost pressures eased a little in July. For most contacts, materials represented only a small proportion of their total costs and cost increases could be absorbed without significantly reducing profit margins.

Contacts cited large increases in the prices of oil-related products (including plastics) and metals, particularly steel—the price of which for some contacts had been increasing by about 15%–25% per quarter. Rising demand for, and prices of, materials was partly attributed to the strength of the Chinese economy and to precautionary stockbuilding by companies as they sought to mitigate the risks of emerging shortages and

further price rises. A growing imbalance between demand and supply for some commodities was increasing delivery times.

More recently, contacts noted that the prices of some metals started to ease and concerns about oil prices were a little less than at the start of the period. The easing of metals prices may have been partly on account of a slowdown of China's economic growth recently and contacts reported that Chinese companies' demand for shipping had started to level off.

Several Agencies reported double-digit increases in gas and electricity prices, which were of increasing concern to contacts. But not all input prices were rising. Contacts indicated that the prices of electronic products, including computer hardware and telecommunications equipment, continued to fall, in some cases by over 10% a year.

Output and retail prices

Higher rates of increase of wages and materials costs were putting modest upward pressure on price inflation. Manufacturers were more likely to raise prices if their use of materials accounted for a relatively high proportion of total costs, so that they faced the largest cost increases. Even so, those companies were often unable to pass on these cost increases in full so that their profit margins were reduced. For service sector contacts, price increases were more easily achieved on account of accelerating demand and relatively little overseas competition. For many of those contacts, profit margins improved.

Nevertheless, competitive pressures often remained intense. Some manufacturing contacts noted that their ability to raise prices was restricted by competition from European suppliers, which were exporting more to the United Kingdom due to the sluggishness of their other EU markets. Competition was perhaps most fierce in the retail sector, particularly in electronic goods where the major supermarkets were trying to gain market share and consumers were increasingly making purchases via the internet to achieve the lowest prices.

Text of Bank of England press notice of 10 June 2004

Bank of England raises interest rates by 0.25 percentage points to 4.5%

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 is continuing. In the United Kingdom, official data and business surveys suggest that output growth remains around, or above, trend. Household spending, public consumption and investment have all grown strongly and the housing market remains buoyant. The labour market has tightened further.

CPI inflation has been below the 2% target, but cost pressures are rising. As indicated in the May *Inflation Report*, a small and diminishing margin of spare capacity means that inflationary pressures are likely to continue building. Against that background, the Committee judged that a further increase of 0.25 percentage points in the repo rate to 4.50% was necessary to keep CPI inflation on track to meet the target in the medium term.

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

Text of Bank of England press notice of 8 July 2004

Bank of England maintains interest rates at 4.5%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 4.5%.

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

Text of Bank of England press notice of 5 August 2004

Bank of England raises interest rates by 0.25 percentage points to 4.75%

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

Output growth has been robust and business surveys point to continued expansion. Although the housing market remains buoyant, there are now signs that it is starting to ease, and the growth of consumption may be moderating. Investment and public sector consumption have both grown strongly and demand in UK export markets continues to pick up.

CPI inflation reached 1.6% in June. It is likely to fall back in the near term, but underlying cost pressures have risen. With demand already high relative to the supply capacity of the economy, continued strong growth is likely to lead to rising inflationary pressures. Against that background, the Committee judged that an increase of 0.25 percentage points in the repo rate to 4.75% was necessary to keep CPI inflation on track to meet the 2% target in the medium term.

The Committee's latest inflation and output projections will appear in the *Inflation Report* to be published on Wednesday 11 August.

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

Glossary and other information

Glossary of selected data

AEI: average earnings index.
CPI inflation: inflation measured by the consumer prices index.
CSPI: corporate services price index.
ERI: exchange rate index.
GDP: gross domestic product.
GVA: gross value added.
LFS: Labour Force Survey.
Libor: London interbank offered rate.
M0: notes and coin in circulation outside the Bank of England and bankers' operational deposits at the Bank.
M4: UK non-bank, non building society private sector's holdings of notes and coin, plus all sterling deposits (including certificates of deposit) held at UK banks and building societies by the non-bank, non building society private sector.
MEW: mortgage equity withdrawal.
MFP: multi-factor productivity.
RPI inflation: inflation measured by the retail prices index.
RPIX inflation: inflation measured by the RPI excluding mortgage interest payments.

Abbreviations

BCC: British Chambers of Commerce.	LTV: loan to value.
CAP: Common Agricultural Policy.	M6: major six economies: Canada, France, Germany, Italy, Japan and the United States.
CBI: Confederation of British Industry.	M&A: mergers and acquisitions.
CIPS: Chartered Institute of Purchasing and Supply.	MPC: Monetary Policy Committee.
CML: Council of Mortgage Lenders.	MTIC: missing trader intra-community.
DTI: Department of Trade and Industry.	NHS: National Health Service.
EIA: Energy Information Administration.	NICs: National Insurance contributions.
EMU: European Monetary Union.	ODPM: Office of the Deputy Prime Minister.
EU: European Union.	OECD: Organisation for Economic Co-operation and Development.
FOMC: Federal Open Market Committee.	OFCs: other financial corporations.
FTSE: Financial Times Stock Exchange.	ONS: Office for National Statistics.
GC: general collateral.	OPEC: Organization of the Petroleum Exporting Countries.
GfK: Gesellschaft für Konsumforschung, Great Britain Ltd.	PNFCs: private non-financial corporations.
HBF: House Builders Federation.	PwC: PricewaterhouseCoopers.
HM: Her Majesty's.	REC: Recruitment and Employment Confederation.
IBES: Institutional Brokers' Estimate System.	RICS: Royal Institution of Chartered Surveyors.
ICT: information, communications and technology.	S&P: Standard and Poor's.
IEA: International Energy Agency.	SARS: severe acute respiratory syndrome.
IMF: International Monetary Fund.	SEH: Survey of English Housing.
IT: information technology.	VAT: value added tax.
LIFFE: London International Financial Futures and Options Exchange.	

Symbols and conventions

Except where otherwise stated, all data are seasonally adjusted and the source of the data used in charts and tables is the Bank of England or 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.