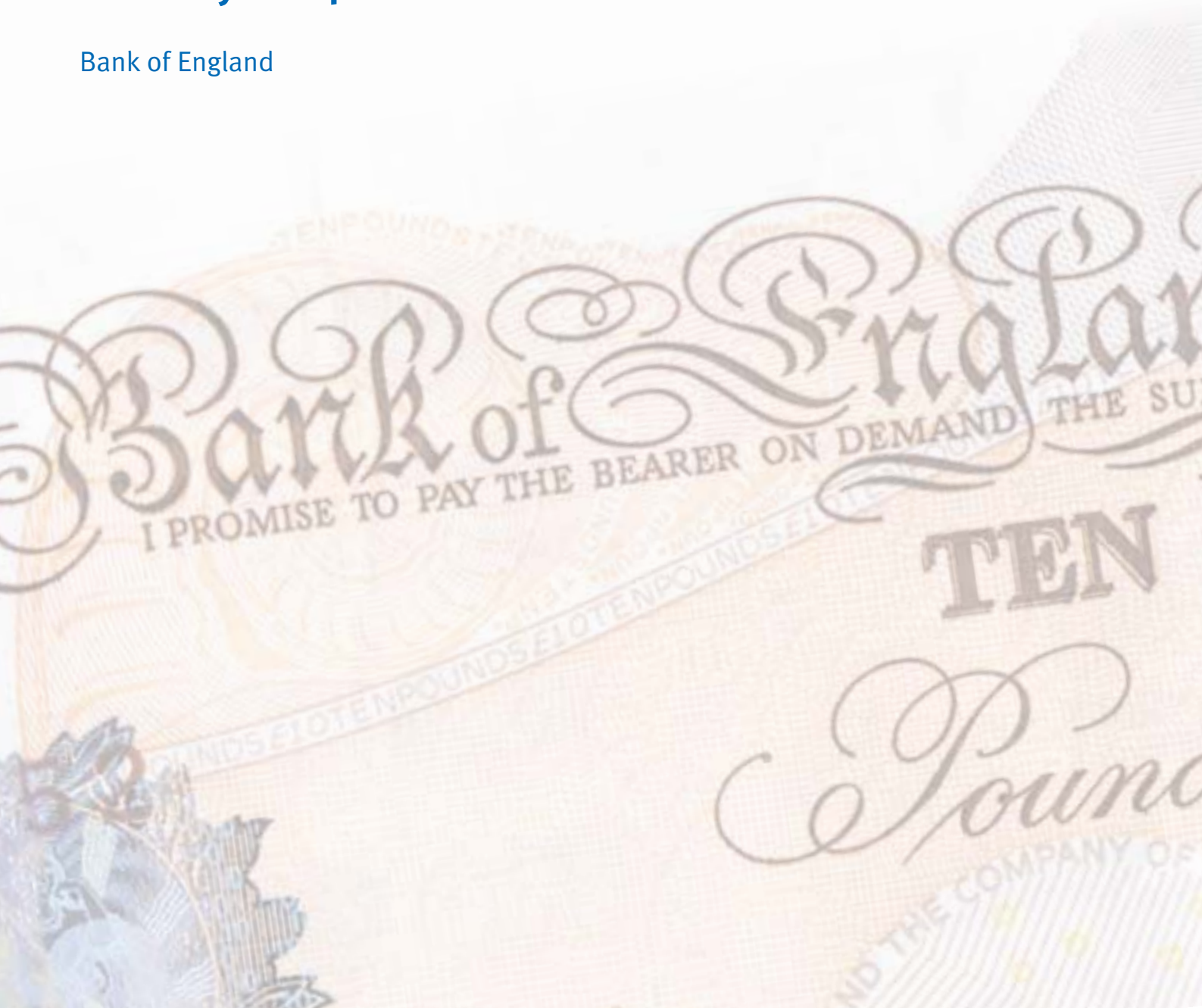




Inflation Report

February 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.

The Monetary Policy Committee:

Mervyn King, Governor

Rachel Lomax, Deputy Governor responsible for monetary policy

Andrew Large, Deputy Governor responsible for financial stability

Kate Barker

Charles Bean

Marian Bell

Richard Lambert

Stephen Nickell

Paul Tucker

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

Over the past three months, the global economic recovery broadened out and the dollar continued to fall. In the United Kingdom, output growth was above trend in the second half of 2003 and business surveys point to further strengthening in Q1. Consumer spending growth remains strong and there are signs that investment may soon start to revive. Sterling rose and that may act as a drag on net trade. The Committee's central projection, assuming the official interest rate is maintained at 4.0%, is for GDP growth above trend throughout the forecast period. Commodity prices in dollars rose sharply, though less so in sterling terms. Private sector earnings growth was subdued. Annual CPI inflation was 1.3% in December, below the new 2% target. CPI inflation is projected to move up to the target, as accumulating pressures on supply capacity add to a modest rise in import prices.

The global economic recovery has become more broadly based. In the United States, GDP growth in Q4 was estimated to have dropped back from its exceptional third-quarter pace, but remained strong. The dollar continued to depreciate, particularly against the euro and sterling. Following a period of stagnation, output rose again in the euro area, but domestic demand there has been weak. As such, the recovery remains vulnerable to further euro appreciation. Rapid growth in China has been leading the expansion in the rest of Asia. Reflecting the improving outlook, global equity prices continued to rise. The Committee expects the global recovery to continue, though the outlook in UK-weighted terms is only marginally stronger than in the November *Report*.

In the United Kingdom, GDP at market prices is provisionally estimated to have increased by 0.9% in the fourth quarter of 2003. Services experienced a pickup in growth and there are signs that the sectoral pattern of growth is becoming more even. Recent business surveys are consistent with the picture of a broad-based recovery and point to a further acceleration in activity in the first quarter of this year.

Private consumption growth moved further above trend in the third quarter. The sharp variations in households' spending that occur around Christmas and the New Year inevitably muddy the waters, but surveys suggest that this momentum has extended into the beginning of this year. Housing market activity has been steady and house prices have continued to rise at an unsustainably rapid rate. Total household borrowing growth has moderated a little. The prospect is for consumer spending to continue to grow strongly in the near term, but to

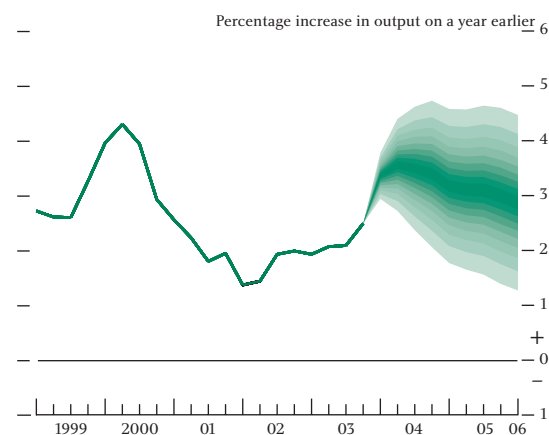
ease thereafter in the face of slower growth in disposable incomes and moderating house price inflation.

Private fixed investment dropped back in Q3, following the rebound in the previous quarter. Though quarterly movements have been volatile, the volume of business capital spending has been broadly flat over the past year. But the pickup in activity, increased underlying profitability and a sharp improvement in investment intentions point to some recovery in business investment over the coming year.

Public spending on goods and services in cash terms has been rising rapidly, but has been associated with much weaker growth in the estimated volume of expenditure. That may reflect the inherent difficulty in measuring output in parts of the public sector. So, while the nominal value of public expenditure can be projected forward with reasonable confidence, there is considerable uncertainty over how that will translate into the corresponding volume estimates. Although that has implications for the outlook for recorded GDP growth, it has little bearing on the outlook for CPI inflation. The *Pre-Budget Report* contained announcements of further modest increases in spending.

Since the beginning of the year, sterling has tended to move with the euro against the dollar. As a consequence the effective exchange rate for sterling when the forecast was finalised was more than 2% higher than in November. That has unwound part of the depreciation that occurred early in 2003 and, if sustained, will diminish the extent to which the global recovery contributes to a strengthening in UK net trade.

Chart 1
Current GDP projection based on
constant nominal interest rates at 4.0%

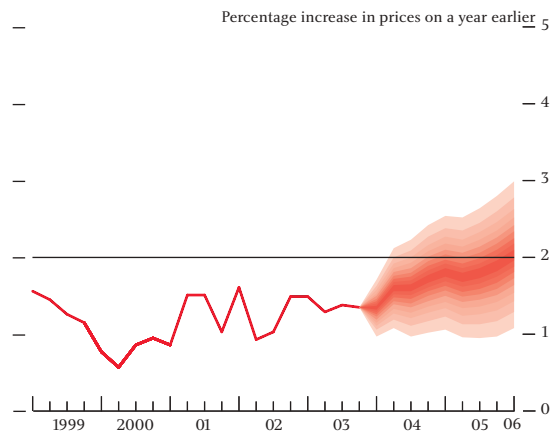


The fan chart depicts the probability of various outcomes for GDP growth in the future. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

Chart 1 shows the MPC's assessment of the outlook for four-quarter GDP growth, on the assumption that the official interest rate remains at 4.0%. Under the central projection, output growth picks up further above trend in the near term, sustained by continued strength in household expenditure, a pickup in public spending volume growth and a steady revival in business investment. The rate of expansion then eases back as consumer spending growth moderates. Overall, the outlook for GDP growth is stronger than expected in November during the first year of the projection, but is similar thereafter as the impact of the higher level of sterling works through to offset the somewhat greater momentum in domestic demand.

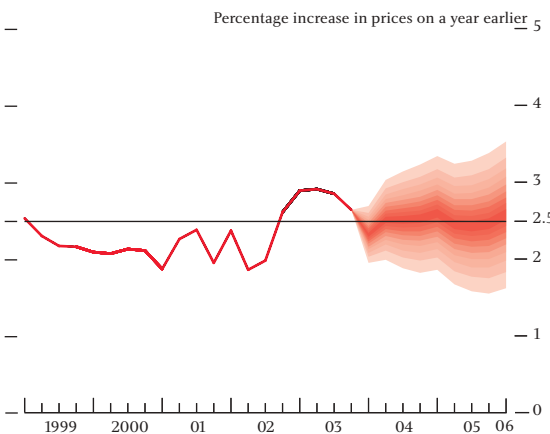
Imported cost pressures have increased slightly, but nevertheless stay muted. The dollar prices of oil and other commodities have risen sharply since the previous *Report*, though the increase is less marked in sterling terms. The prices of other goods and services traded internationally have been broadly flat. Domestic cost pressures have also risen a little, but

Chart 2
Current CPI inflation projection based on constant nominal interest rates at 4.0%



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.

Chart 3
Current RPIX inflation projection based on constant nominal interest rates at 4.0%



The fan chart depicts the probability of various outcomes for RPIX inflation in the future. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

remain subdued. Earnings growth in the private sector has been low, though settlements have edged up and there are signs of incipient labour market tightening.

In December, the Chancellor announced a new inflation target of 2% as measured by the annual rate of increase of the consumer prices index (CPI). Inflation on this measure was 1.3% in December. Inflation on the previous target measure of RPIX—which is constructed differently and incorporates a measure of owner-occupied housing costs—was 2.6%. The gap between the two has been unusually wide over the past year, but has started to narrow as house price inflation has moderated.

Chart 2 shows the Committee’s assessment of the outlook for CPI inflation. In the central projection, inflation moves up in the middle of this year, partly as a result of higher utility prices. Thereafter it continues to edge up to the 2% target as growing pressures on supply capacity add to a modest rise in import prices.

Chart 3 shows the corresponding projection for RPIX inflation. Under the central projection, this measure of inflation stays close to the old target of 2.5% throughout the forecast period, as the rising contribution from the factors that drive the pickup in CPI inflation is offset by an attenuating contribution from the housing cost element. The difference between the two central projections at the forecast horizon is around 0.5 percentage points. Compared with the November *Report*, the prospects for inflation are little changed, as the impact from stronger demand growth is offset by the disinflationary consequences of the higher exchange rate.

As usual there are considerable risks surrounding these projections. They mainly concern international exchange rate movements and their impact on UK export markets, the outlook for the household sector, the prospects for earnings, and potential supply. Relative to the central projection, 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 narrow.

At its February meeting, the Committee noted that, at the then official interest rate of 3.75%, CPI inflation, though currently below the 2% target, was set to move up to above the target at the forecast horizon and beyond. Given that outlook for inflation, the Committee judged that an increase of 0.25 percentage points in the official interest rate to 4.0% was necessary to keep inflation on track to meet the target.

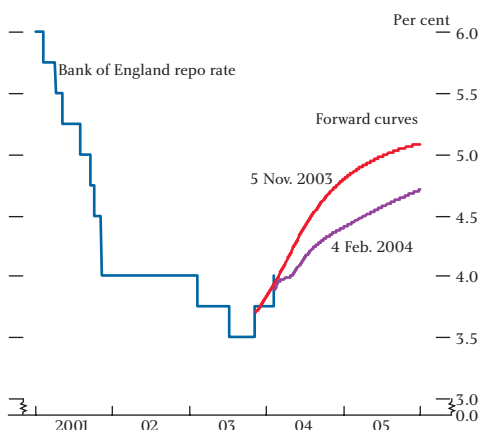
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The MPC increased the official interest rate by 0.25 percentage points to 4.0% on 5 February. The Reuters poll of economists in late January suggested that official interest rates were expected to increase to 4.5% by the end of the year. And the profile of UK short-term market interest rates on 4 February was consistent with that. Bond yields in the United Kingdom on 4 February suggested that market participants expected CPI inflation to be close to the target of 2% over the medium term. Between early November and early February the US dollar fell against the euro, the yen and sterling, probably linked to concerns about the sustainability of the US current account deficit. Sterling was stable against the euro, but the sterling ERI rose by just over 2%. Equity prices continued to increase in the United Kingdom and in most other countries. UK monetary data pointed to steady growth in nominal aggregate demand. House price inflation in the fourth quarter was broadly the same as in the third quarter, and remained well above earnings growth. Household borrowing remained strong, associated with the high level of house prices.

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



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

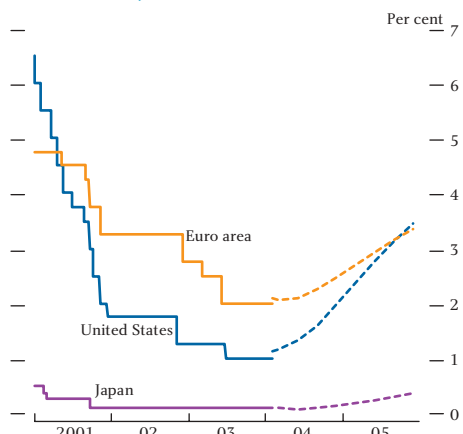
1.1 Asset prices

Short-term interest rates

On 5 February, the Monetary Policy Committee increased the official repo rate by 0.25 percentage points to 4.0%. Interest rates were also increased by 0.25 percentage points in November 2003, but left unchanged in December and January. A Reuters poll of economists taken between 27 and 29 January suggested that interest rates were expected to increase to 4.5% by the end of 2004, and to 4.7% by the end of 2005. The forward curve for the GC repo rate on 4 February suggested a similar profile (see Chart 1.1). The curve had shifted down by around 0.4 percentage points at the one and two-year horizons since the previous Report. The forward curve reflects market participants' expectations of future interest rates. But it may also reflect term premia, which compensate lenders for interest rate uncertainty. The downward shift in the curve since November may have been associated with a fall in term premia, as well as lower interest rate expectations. In contrast, the Reuters survey suggested little change in economists' expectations over the period.

Central banks in the United States, the euro area and Japan left official interest rates unchanged in the three months since the November Report. Futures contracts on 4 February suggested that official rates in the United States and the euro area were expected to start increasing in the second half of 2004, and that official rates in Japan might increase

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 February 2004.

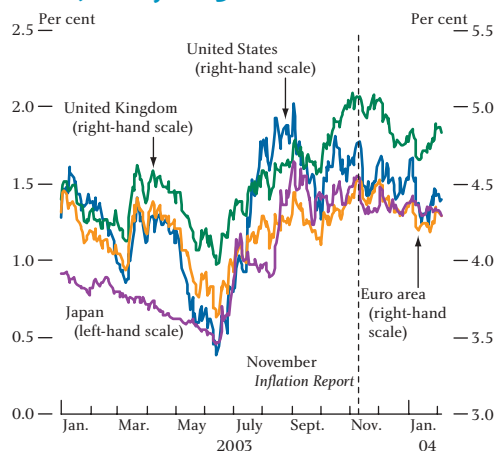
moderately next year (see Chart 1.2). The forward curves in all three countries had moved down by around 0.5 percentage points at the two-year horizon since the *November Report*, similar to the fall in the forward curve in the United Kingdom. The shifts in all four economies occurred at around the same times, apparently in response to developments in the United States, such as announcements by the Federal Open Market Committee, and weaker-than-expected US employment data.

Government bond yields

In the United Kingdom, the nominal yield on ten-year government bonds fell by 0.2 percentage points between early November and early February, reversing some of the increase in yields in October last year (see Chart 1.3). Bond yields also fell in other major economies, by a broadly similar amount as UK yields.

Around a quarter of the value of outstanding UK government bonds are indexed to inflation, measured by changes in the RPI. In the absence of risk premia, the expected return on index-linked bonds should be the same as on conventional bonds. So the difference between the real yield on index-linked bonds and the nominal yield on conventional government bonds contains information about RPI inflation expectations.⁽¹⁾ Because of the way that indexation is calculated, yields on bonds maturing before 2006 are less informative about expectations. Yield changes during the past three months suggest that expectations for RPI inflation were revised down for maturities between 2006 and 2010, but at longer horizons expectations rose a little. Bond yields did not change significantly on the day that the new CPI inflation target was announced, probably because the announcement was in line with market expectations.

Chart 1.3
World ten-year government bond yields since January 2003^(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. But for Japan, these are yields to maturity on conventional bonds.

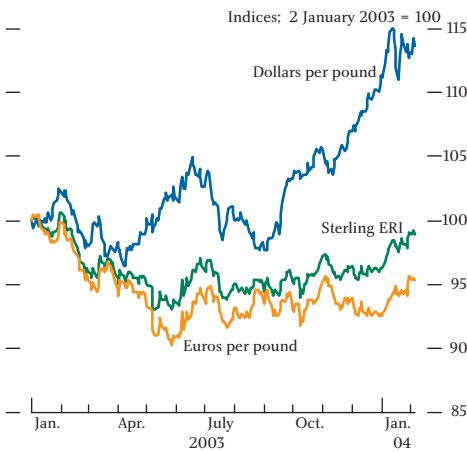
Yields on 4 February suggested that RPI inflation was expected to be around 2³/₄% between 2007 and 2010. Taking the past as a guide to the expected difference between RPI and CPI inflation (see the box on page 36 of this *Report*), this might suggest that market participants expected CPI inflation to be close to the 2% target in those years.

Exchange rates

The sterling effective exchange rate index (ERI) measures the UK exchange rate against a basket of other currencies, weighted according to their importance in determining UK trade. In the 15 working days to 4 February, the ERI averaged 102.8, up just over 2% on the equivalent average used in the *November Report*. Between these periods, sterling appreciated

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

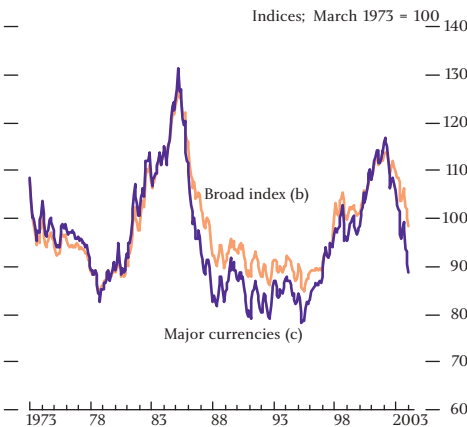
Chart 1.4
Cumulative changes in sterling exchange rates



7.9% against the US dollar, and 0.4% against the euro (see Chart 1.4).

In the two years to January 2004, the US dollar fell by around 30% against the euro, and by around 20% against the yen. But the US dollar broad ERI fell just 13% in real terms, reflecting smaller changes against many Asian currencies, and an appreciation against the Mexican peso. The level of the broad ERI in real terms in January was not particularly low by recent historical standards (see Chart 1.5).

Chart 1.5
US dollar real exchange rate index^(a)

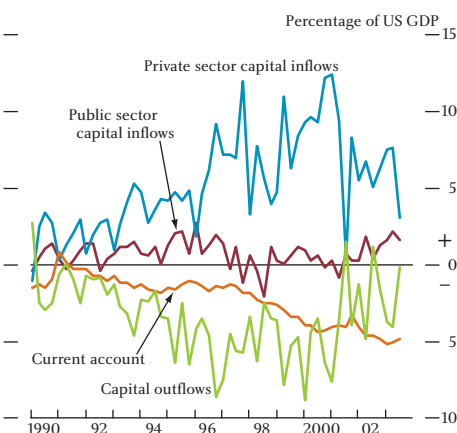


Source: US Federal Reserve.

- (a) Adjusted using relative movements in consumer prices.
- (b) Currently covers 26 countries or regions.
- (c) For Australia, Canada, the euro area, Japan, Sweden, Switzerland, and the United Kingdom.

It is not clear what caused these movements in the US dollar. They cannot be solely explained by revisions to expectations of interest rates. One plausible explanation for the appreciation and subsequent depreciation of the US dollar is the effect of technological advances that raised productivity growth there. In the short run, if overseas investors increase their demand for US assets in expectation of higher returns, that might cause the US dollar to appreciate. But in the long run, there might need to be a real depreciation in order to ensure sufficient world demand for the extra goods and services being produced in the United States as a result of the higher productivity. Consistent with that explanation, between 1996 and 2000 there was a strong flow of private sector foreign capital into the United States. And this flow of private funds fell back in 2001 (see Chart 1.6), around a year before the dollar started to decline.

Chart 1.6
United States international transactions

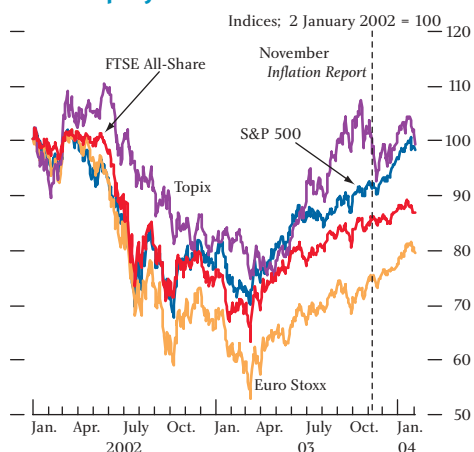


Source: US Bureau of Economic Analysis.

But another possible explanation is that the flow of private sector capital dried up because it was based on overly optimistic expectations for US productivity growth, or because the higher productivity growth that did occur had a smaller effect on US corporate profits than had been expected. There may be other equally plausible explanations. Whatever the underlying cause, market intelligence suggests that the decline in the dollar reflected increasing concern about the sustainability of the US current account deficit, given the change in the composition of capital flows.

In 2003, the weakness of private sector capital inflows into the United States was partially offset by an increase in official purchases of US assets (see Chart 1.6), largely by the Japanese, Chinese and other Asian central banks. This in part reflected the exchange rate policy in those countries, but it may also have reflected a desire to build up liquid foreign reserves. It is not clear how long this pattern of financing the US current account deficit will continue. There is, therefore, a risk of further falls in the US dollar. Even if that were to have little effect on the sterling ERI, there might be a significant impact on the UK economy. For example, a further loss of euro-area competitiveness could reduce growth in the euro area, which is a key destination for UK exports.

Chart 1.7
World equity indices in domestic currencies



Sources: Bank of England and Bloomberg.

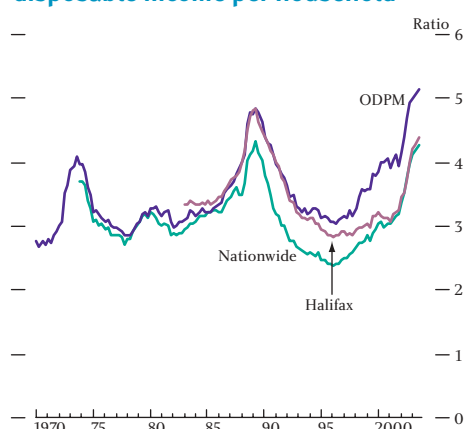
Table 1.A
The housing market^(a)

	2003				2004
	Q1	Q2	Q3	Q4	Jan.
Indicators of transactions					
HBF net reservations (b)	-32	-22	15	13	n.a.
Mortgage approvals (c)	96	101	114	123	n.a.
Particulars delivered (d)	124	107	109	110	n.a.
Monthly percentage changes in house prices					
Halifax	1.6	0.9	1.4	1.5	2.2
Nationwide	1.4	0.9	1.1	1.5	0.7

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

- (a) Quarterly data are averages of monthly observations. All data are seasonally adjusted.
- (b) Percentage balance of respondents reporting more net reservations than during the same month of the previous year.
- (c) The number of loans approved for house purchase (thousands).
- (d) The number of transactions in England and Wales registered with HM Land Registry (thousands).

Chart 1.8
Ratio of average house price to annualised disposable income per household^(a)



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

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

Equity prices

The FTSE All-Share index averaged 2213 in the 15 working days to 4 February—the starting assumption used in the MPC’s projection. That was an increase of 3.8% since the equivalent average used in the *November Report*. Between the same periods, in domestic currency terms, the S&P 500 index increased by 9.0%, and the Euro Stoxx index increased by 10.6%, while the Japanese Topix was unchanged (see Chart 1.7). The increases in equity prices might have reflected lower expected real interest rates. But they are also consistent with an upward revision to expectations of profits.

The property market

On a seasonally adjusted basis, indicators of the number of UK housing transactions suggest that activity in the fourth quarter was similar to that in the third quarter (see Table 1.A). At the time of the *November Report*, it appeared that demand in the housing market was picking up strongly in the third quarter. But following revisions to the loan approvals series, and some weakening in net reservations of new houses in the fourth quarter, the increase in activity now appears a little less marked.

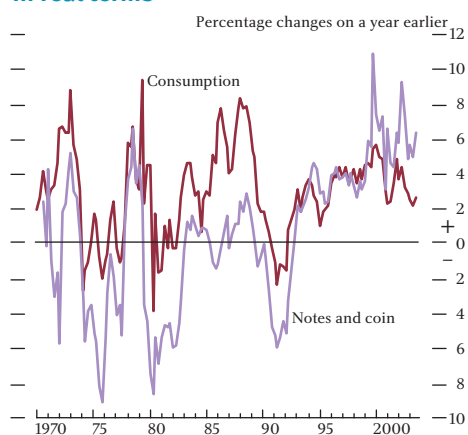
Although average house price inflation was lower in 2003 than in 2002, there has been little sign of deceleration in house prices through 2003. House prices increased somewhat more than 1% per month throughout 2003, except in the second quarter which may have been affected by lagged effects from the faltering in household confidence ahead of the war with Iraq. The current rate of house price inflation remains well in excess of earnings growth, and is not sustainable in the medium term.

The average level of house prices is high, relative to incomes (see Chart 1.8). Various factors might explain the increase in house prices, including higher population growth, lower unemployment rates and the transition to low inflation.⁽¹⁾ But their effect on house prices is difficult to evaluate, so there remains considerable uncertainty over what level of house prices is sustainable.

Commercial property values can give an indication of expected corporate demand, relative to supply. Recent developments in commercial property values might suggest some strengthening in demand. The annual growth of industrial property values was around 3% in recent months, a little stronger than in 2001 and 2002. Office property values continued to fall, but at a slower rate than at the start of 2003.

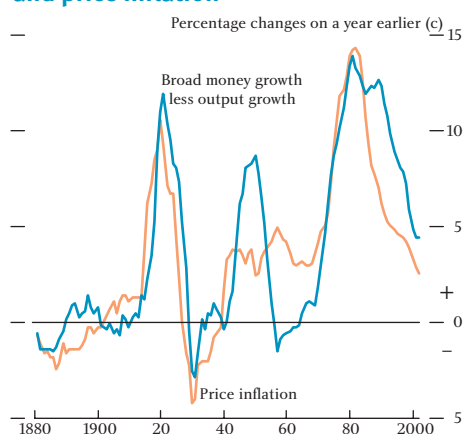
(1) For a more detailed discussion see page 6 of the *November 2003 Report* and the box on pages 8 and 9 of the *August 2002 Report*.

Chart 1.9
Household consumption and notes and coin in real terms^(a)



(a) Deflated by the household consumption deflator.

Chart 1.10
Broad money^(a) growth less output growth and price inflation^(b)



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

(a) Estimate of M4 deposits.
(b) RPI before 1976.
(c) Ten-year moving averages.

Table 1.B
Monetary aggregates^(a)

Percentage changes on a year earlier

	2003				2004
	Q1	Q2	Q3	Q4	Jan.
Notes and coin	6.7	6.3	7.9	7.3	7.5
M0 (b)	6.6	6.2	7.8	7.2	7.7
M4 (c)	7.4	8.2	6.5	6.8	n.a.
M4 lending (d)	10.8	11.4	10.6	11.5	n.a.

(a) Seasonally adjusted using a new method. See the December 2003 issue of *Monetary and Financial Statistics* for more details.
(b) M0 is a narrow measure of money, consisting of notes and coin and bankers' operational balances held at the Bank of England.
(c) M4 is a broader monetary aggregate. 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 (MFIs).
(d) Sterling lending by MFIs to the private sector (including financial corporations that are not MFIs). The effects of securitisations have been excluded.

1.2 Money, credit and balance sheets

Monetary aggregates

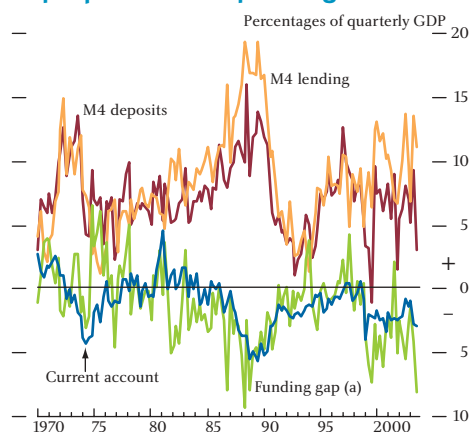
The stock of notes and coin in circulation grew by 7.3% in the fourth quarter of 2003 compared with a year earlier, similar to growth in the third quarter. Cash is largely used to undertake household consumption—around three quarters of notes and coins in circulation are held by households. And the growth rates of cash and consumption have tended to move together (see Chart 1.9). So continued strong growth in notes and coin might indicate that household consumption in the fourth quarter was reasonably strong.

But the strong growth in notes and coin also probably reflects a continuing response to lower interest rates. When interest rates are low, the benefit of holding wealth in interest-bearing accounts is reduced. So people respond by holding more of their wealth in liquid assets, such as cash, for greater convenience. The effect of interest rates on the demand for cash can be powerful and prolonged. For example, during the 1970s and 1980s, on average and in real terms consumption grew 4 percentage points per year faster than the stock of notes and coin, as households responded to high rates of interest by economising on their cash holdings (see Chart 1.9). Since around 1980, another reason for the relative weakness in growth of notes and coin has been a rising trend in the number of transactions carried out using cards and other non-cash methods of payment. That trend has probably continued in recent years, suggesting that the impact of low interest rates since 2000 on the demand for notes and coin has been more marked than the difference between growth rates of cash and consumption would suggest.

In the absence of velocity changes, broad money growth, in excess of output growth, must be associated with price inflation. As can be seen from Chart 1.10, this relationship has broadly held over the past 120 years. M4—a measure of broad money including bank and building society deposits held by the UK private sector—grew by 6.8% in the year to the fourth quarter of 2003 (see Table 1.B). This was little changed from growth in the third quarter, but weaker than in the first half of last year. Lending by UK banks and building societies to the private sector (excluding the effects of securitisations) grew by 11.5% in the year to 2003 Q4.

Since 1999, the flow of money from the private sector into bank and building society deposits (M4 deposits) has been significantly lower than the flow of money from UK banks and building societies to the private sector (M4 lending). The difference between the two flows—the funding gap—has

Chart 1.11
M4 deposits and M4 lending flows



(a) M4 deposits minus M4 lending.

averaged about 4% of GDP (see Chart 1.11). UK banks and building societies have bridged this gap by raising finance in various ways:⁽¹⁾ issuing equities and bonds, taking net deposits from non-residents, and securitising assets (typically mortgages which are packaged and used to back the issue of bonds by a special-purpose vehicle).

But how did the gap arise in the first place? Broadly speaking, transactions within the UK private sector cannot generate a funding gap, as they should affect borrowing and deposits in the same way. For example, if one household borrows to buy a house, the ultimate recipient of the cash will increase their deposits by the same amount as the original increase in borrowing or pay off some of their debt. A persistent funding gap implies that private sector borrowing is leaking out to some other sector. Since 1970, funding gaps have often been associated with current account deficits (see Chart 1.11), suggesting that eventually the borrowed money flows overseas, with the purchase of imports. But borrowed money would also leak from the private sector if it were used to buy financial assets from the government, banks or overseas sectors, or if the government ran a fiscal surplus.⁽²⁾ In recent years, the current account has been in persistent deficit, but the deficit has been smaller than might be implied by the funding gap. This suggests that some of the increase in private sector borrowing has been matched by the purchase of financial assets, rather than imported goods and services. Although that is true of the private sector in aggregate, it is unlikely that the same individuals or businesses who have increased their borrowing, have also purchased more financial assets.

Table 1.C
Lending to individuals^(a)

Percentage changes on a year earlier

	1995–	2003				Outstanding debt per person (b) (£)
	Average	Q1	Q2	Q3	Q4	
Unsecured lending	14.7	14.5	14.4	13.5	12.4	3,601
Secured lending	7.1	13.7	13.8	14.2	14.2	16,254

Flow as a percentage of household disposable income

Mortgage equity withdrawal	1.2	6.3	6.0	7.0	n.a.
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(a) Seasonally adjusted using a new method. See the December 2003 issue of *Monetary and Financial Statistics* for more details.

(b) In December 2003.

Household borrowing

Unsecured borrowing, which includes borrowing using credit cards, bank overdrafts, personal loans and hire purchase agreements, grew by 12.4% in the year to 2003 Q4. This represents a slowdown since the start of last year (see Table 1.C). The monthly data for December were particularly weak, showing growth of just 0.5% on the month—the weakest since March 1997. But lending data can be erratic, and especially difficult to interpret around Christmas time. It is too early to say whether the underlying trend in unsecured borrowing has turned down significantly.

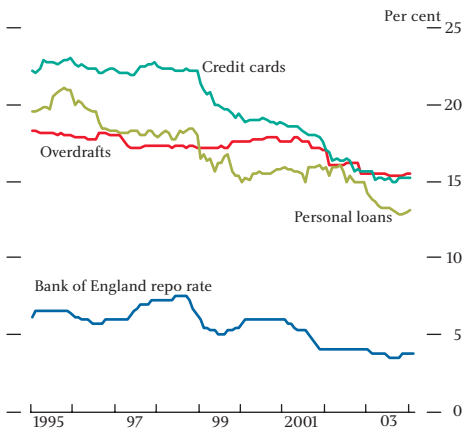
According to a survey commissioned by the Bank of England,⁽³⁾ it is largely households with relatively high

(1) See Speight, G and Parkinson, S (2003), 'Large UK-owned banks' funding patterns', *Bank of England Financial Stability Review*, December, pages 135–42.

(2) See Power, J and Andrews, P (2001), 'Explaining the difference between the growth of M4 deposits and M4 lending', *Bank of England Quarterly Bulletin*, Summer, pages 183–88.

(3) 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.

Chart 1.12
Interest rates^(a) on unsecured debt

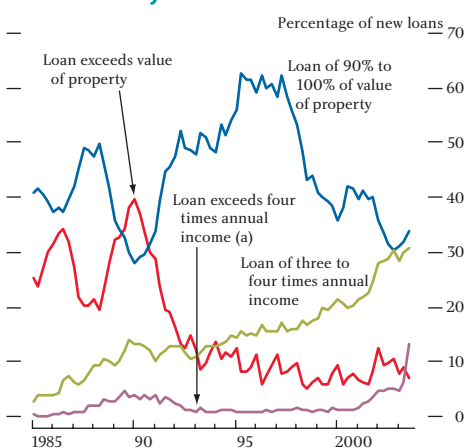


(a) A weighted sum of interest rates quoted by different lenders. The last data are for January 2004, so do not reflect the latest increase in the Bank of England repo rate.

incomes that have increased their unsecured borrowing. They may be less likely to have problems servicing their debts. But around 10% of households with unsecured debt say it is a 'heavy burden'. This proportion has been broadly constant since 1995. But those households have increased their borrowing more than other groups. And over the same period, there has been an increase in the number of personal insolvencies and credit card debt write-offs. This suggests that a small proportion of households have been borrowing more than they can afford to repay. And that is against a backdrop of low official interest rates, and falling interest rate spreads on unsecured debt (see Chart 1.12). If interest rates or retail spreads on unsecured debt were to rise, problems in servicing debts could increase. That could imply weaker aggregate consumption growth in the future.

The stock of individuals' debt secured on housing grew by 14.2% in the year to 2003 Q4. Growth picked up slightly through last year (see Table 1.C). And, in contrast to unsecured debt, there has been a considerable acceleration since the second half of the 1990s, associated with developments in the housing market.

Chart 1.13
Characteristics of new mortgages for first-time buyers



Sources: Bank of England and CML.

(a) These data overstate the increase in loan to income ratios since June 2003 due to a change in the treatment of extreme values.

Mortgage equity withdrawal—new borrowing secured on housing that is not spent improving or enlarging the housing stock—was 7.0% of household disposable income in 2003 Q3 (see Table 1.C). That was the highest level since 1988 Q3. Equity withdrawal is likely to have remained high in the fourth quarter, given the strong growth in secured borrowing. To some extent, the rise in house prices will automatically cause mortgage equity withdrawal to increase, for example by increasing the value of receipts from the sale of inherited properties.⁽¹⁾ And not all of these receipts feed into consumption in the short term. Nevertheless, the rise in equity withdrawal has probably supported household consumption to some extent.

Looking forward, what does the growth in secured borrowing imply for the risks to household consumption? Between 1985 and 1991, around 30% of loans taken out by first-time buyers exceeded the value of the property being bought. That was one factor leading to the large incidence of negative equity in the early 1990s. And part of the weakness of household spending in that period was due to households attempting to rebuild their housing equity. But in recent years buyers and lenders have been more cautious, with about 10% of new loans exceeding the property value, and a relatively low proportion with loan to value ratios between 90% and 100% (see Chart 1.13). Other things being equal, lower loan to value

(1) See the box on pages 8 and 9 of the November 2003 *Inflation Report* for a more detailed discussion.

The sensitivity of the economy to changes in interest rates

Changes to official interest rates can affect the economy through a number of channels,⁽¹⁾ and it is likely that the size of the effects will change over time. This box considers two developments that have probably changed the impact of interest rates: the move to an explicit inflation target, and the growth in household debt. As a result of these developments there is more than usual uncertainty about the effect that changing interest rates will have.

Inflation expectations play a key role in determining current inflation. When firms set prices, they have to take account of general price inflation expected in the future, otherwise they may inadvertently change their prices relative to their competitors. Similarly, wage bargainers must take account of the expected change in the cost of living when bargaining over pay.

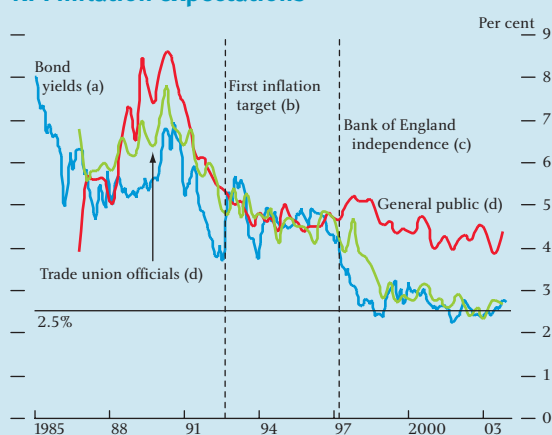
Monetary policy can have a powerful effect on inflation expectations. Without a credible inflation target, expectations of inflation may change in response to demand and supply shocks that affect current inflation. But the more credible the target, the less this will occur. So if inflation expectations are now better anchored, a given demand or supply shock will have a smaller effect on inflation. For that reason, a given change in interest rates would also have less effect on inflation, assuming that the impact on demand were unaffected.

However, changes in credibility may also alter the impact that a change in interest rates has on demand. When inflation expectations are fixed to the target, a change in nominal interest rates will be associated with an identical change in the expected real interest rate. When expectations are less entrenched, the real interest rate can change by more. For example, if a decrease in nominal interest rates raised expected inflation, that would reduce the expected real interest rate by more than the change in nominal rates. Furthermore, a credible inflation target may also help to anchor the exchange rate. For example, if a cut in interest rates caused inflation expectations to rise, that would probably generate a sharper fall in the exchange rate than if inflation expectations did not respond. So the impact on demand of a given change in official rates through both the exchange rate and real interest rate channels could be smaller when inflation expectations are well anchored.

The current monetary framework in the United Kingdom appears to have anchored inflation expectations to the target. Since May 1997, when the Monetary Policy Committee was given responsibility for achieving the inflation target, inflation

expectations implied by bond yields and, for example, by the Barclays surveys of trade union officials have come down. For the past six years or so they have been close to the inflation target. According to the Barclays survey of the general public, inflation expectations remain above target, but have tended to be lower than in the period before inflation targeting was adopted (see Chart A). An alternative survey of public inflation expectations, conducted by NOP on behalf of the Bank of England, suggests that at least since 1999, median expectations for price inflation have been close to 2.5%.⁽²⁾ There is then reasonably strong evidence that inflation expectations have been close to the target since 1997, despite the shocks that have occurred. By itself, that might imply that small unanticipated changes in interest rates will have less of an effect on inflation and output than before credibility was established.

Chart A
RPI inflation expectations



Sources: Bank of England and Barclays.

- (a) The difference between five-year forward, five-year yields on conventional and index-linked government bonds.
- (b) RPIX inflation between 1% and 4%, and in the lower half of that range by the end of that parliament.
- (c) With an RPIX inflation target of 2.5%.
- (d) The Barclays Basix quarterly survey.

But developments in households' finances in recent years may also have affected the sensitivity of the economy to changes in interest rates. Theory suggests that households base their spending decisions upon an assessment of their future expected income. So long as they have access to credit, they will not change their spending in response to changes in their current income that are perceived to be temporary. In contrast, for households without access to credit, changes in current income might have a one-for-one impact on their spending.

The strong growth in household debt may mean that a greater proportion of households have reached their

(1) See 'The transmission mechanism of monetary policy' (1999), *Bank of England Quarterly Bulletin*, May, pages 161–70.

(2) See 'Public attitudes to inflation' (2003), *Bank of England Quarterly Bulletin*, Summer, pages 228–34.

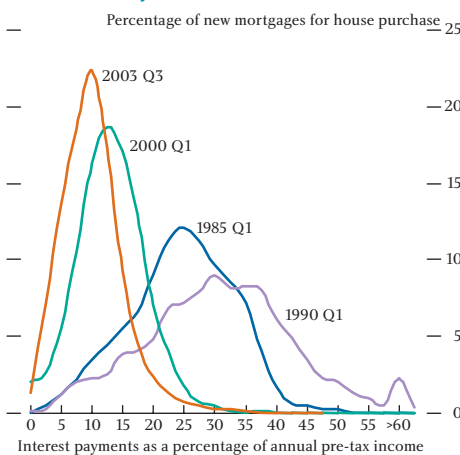
borrowing limits—where they are no longer willing, or even able, to borrow any more. That would imply that household consumption will be more closely linked to income than it has been in the past. Furthermore, the resources available for consumption—income net of tax and interest flows—have become more sensitive to a given change in interest rates as a direct result of the growth in debt. And that will be particularly true for households with large debts relative to their incomes, who may be the most likely to have limited access to further credit. So the growth in debt may have made consumption more sensitive to a given change in interest rates.

But other developments may have reduced the sensitivity of household spending to interest rates. The stock of household deposits has grown reasonably strongly in recent years. So a change in interest rates

will now have a more powerful effect on households' interest receipts, which will partly offset the effect on interest payments. And the fall in interest rate spreads on unsecured household debt suggests that some of the growth in borrowing reflects an increase in the supply of credit. So at least some households that previously faced credit constraints now have more access to credit, which may have reduced the sensitivity of their spending to changes in income flows.

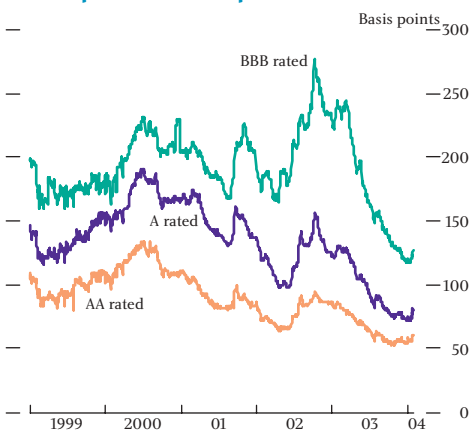
It is not clear whether the net effect of higher household debt and deposits, and better anchored inflation expectations has made the economy more, or less, sensitive to changes in interest rates. And this makes the MPC less certain about the likely size of the effect of an interest rate change on inflation and output.

Chart 1.14
Income gearing for new mortgages issued in different periods



Sources: Bank of England and CML.

Chart 1.15
UK corporate bond spreads^(a)



Source: Merrill Lynch.

(a) The difference between yields on corporate bonds and UK government bonds.

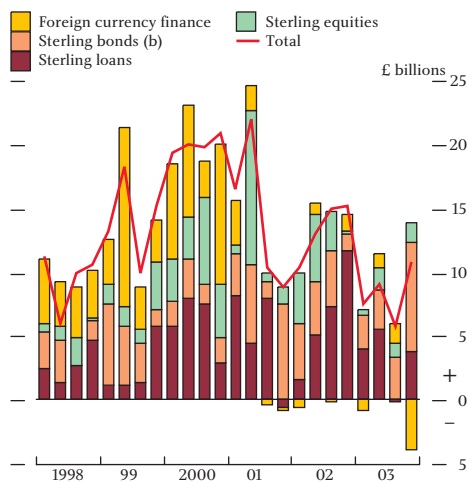
ratios reduce the probability that the mortgage holder will face negative equity in the future. However, if house prices were to fall, even if there were a relatively small incidence of negative equity, consumption growth would be likely to weaken, as households' collateral, and therefore their ability to borrow at low interest rates, would be reduced.

The high level of secured borrowing might also pose a risk to consumption if a significant proportion of households had difficulty servicing their mortgages. Since the 1980s there has been a trend increase in the size of new mortgages, relative to incomes for first-time buyers (see Chart 1.13). But despite this, mortgage interest payments on new mortgages have fallen, relative to incomes, given the current low level of interest rates (see Chart 1.14). And the number of mortgages in arrears is low by historical standards. So it would seem that, at current rates of interest, the large majority of mortgage holders are able to service their debts. But this might change if interest rates were to rise significantly. Indeed it is possible that consumption will be more sensitive to changes in interest rates, following the growth in household debt (see the box on pages 10–11 for more details).

Private non-financial corporations' (PNFCs') financing

In general, PNFCs' financial position appears to have improved through 2003. Equity prices have risen since their trough in March. Dividend payments have increased as profits have recovered. And there have been continued falls in corporate bond spreads (see Chart 1.15), suggesting that financial market participants judge that the risk of default has lessened. That has occurred despite the near failure in December of Parmalat, a large Italian firm, presumably because markets judged that there was little general news in that development.

Chart 1.16
PNFCs' total external finance^(a)



(a) Excluding the effects of securitisations. The components do not sum to the total in each quarter, because the total has been seasonally adjusted independently.
 (b) Includes commercial paper.

The annual growth rate of PNFCs' M4 deposits has picked up since 2002, and was 8.3% in 2003 Q4.

PNFCs raised £3.7 billion in sterling loans in the fourth quarter, after a small net repayment in the third quarter. There was also a sharp increase in money raised through bond issuance. PNFCs' total external finance was higher than in the third quarter, even though the total figure was depressed by repayments of foreign-currency debt (see Chart 1.16). The level of external finance raised in Q4 remained below the average between 1999 and 2002. But the increase in bond issuance, coupled with the improvement in PNFCs' financial position, could be consistent with a modest strengthening in business investment in the coming months.

Final domestic demand growth slowed in Q3, following above-trend growth in Q2. Consumption growth strengthened slightly, and it probably remained above trend in Q4. Investment fell in Q3, but the conditions appear to be in place for a steady recovery. A sharp swing in the contribution from stocks meant that overall domestic demand strengthened in Q3. Net trade made no contribution to GDP growth in Q3, as in the previous quarter. But there are signs that export growth may be picking up. There was a broad-based recovery in global activity in Q3, but uncertainty remains over its durability in some countries.

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

Percentage changes on a quarter earlier

	2001	2002	2003	Q1	Q2	Q3
	Average	Average				
Household consumption	1.1	0.7	1.0	-0.1	0.8	0.9
Government consumption	1.0	0.2	0.6	1.0	0.1	0.1
Investment	-0.4	1.2	1.0	-1.1	1.9	-0.5
of which, business	-1.5	0.0	0.5	-1.8	1.7	-1.2
Final domestic demand	0.9	0.7	0.9	-0.1	0.9	0.5
Change in inventories (b)	-0.1	0.2	0.6	-0.1	-0.4	0.3
Excluding alignment adjustment (b)	-0.1	0.1	0.2	0.0	-0.1	0.3
Domestic demand	0.7	0.8	1.5	-0.2	0.5	0.8
Exports	-0.7	-0.5	-4.9	2.5	-2.9	0.4
Imports	0.2	1.1	-0.9	1.5	-2.6	0.5
Net trade (b)	-0.3	-0.4	-1.1	0.2	0.0	0.0
GDP at market prices	0.5	0.5	0.5	0.2	0.6	0.8

(a) Chained volume measures.

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

2.1 Domestic demand

Final domestic demand grew by 0.5% in Q3, weaker than the 0.9% increase in Q2. This reflected a fall in investment (see Table 2.A). But a sharp increase in the contribution from inventories offset this slowdown, such that overall domestic demand growth strengthened in Q3. The profile of demand, relative to that of supply in an economy, is an important influence on inflationary pressures. Prices tend to rise more rapidly if there is a tendency for demand to outstrip supply. And the composition of demand can also be informative for inflation prospects. For example, short-term movements in volatile components, such as investment or stocks, might be less indicative of medium-term trends in overall demand.

Household consumption

Household consumption growth increased slightly in Q3, to 0.9%. But growth in real post-tax income was markedly stronger, at 1.5%, so that the saving ratio rose to 5.9%. And revisions to back data have left the saving ratio higher than previously estimated (see Chart 2.1).

Much of the strength of real consumption growth in Q3 came from durable goods, the consumption of which rose by 2.2%. Real spending on durable and semi-durable goods accounts for around a quarter of overall consumption, but its contribution to consumption growth in recent years has been far greater (see Chart 2.2). The ratio of spending on durables to non-durables in volumes terms has risen consistently over the past 40 years, rising even more rapidly in the past few years (see Chart 2.3). But in nominal terms, the ratio has been broadly flat. These diverging trends can be reconciled by the declining relative price of durable goods, which has

Chart 2.1
Household saving ratio

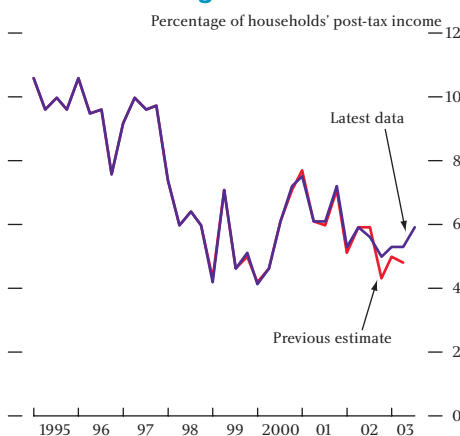
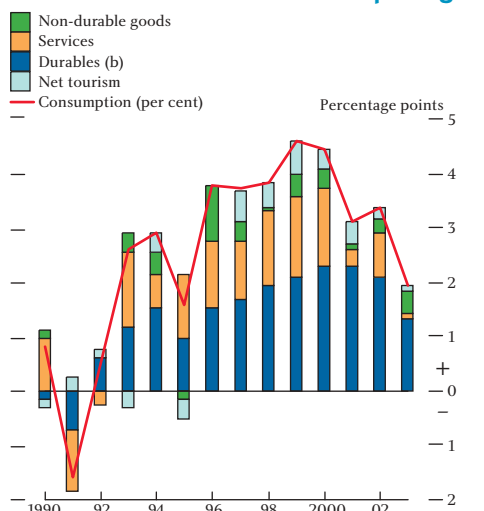


Chart 2.2
Contributions to annual consumption growth^(a)



(a) Figures for 2003 are based on the sum of the first three quarters of the year, scaled up to full-year totals.
(b) Includes durables and semi-durables.

Chart 2.3
Ratio of durables and semi-durables consumption to other consumption

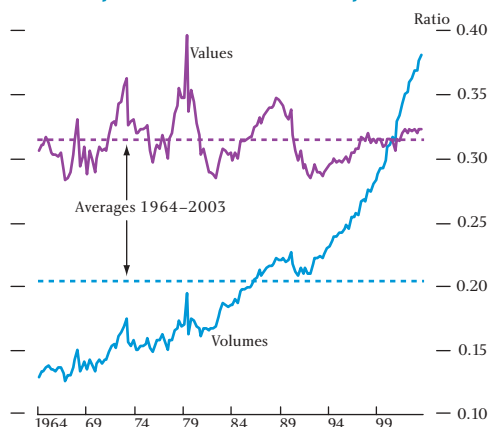
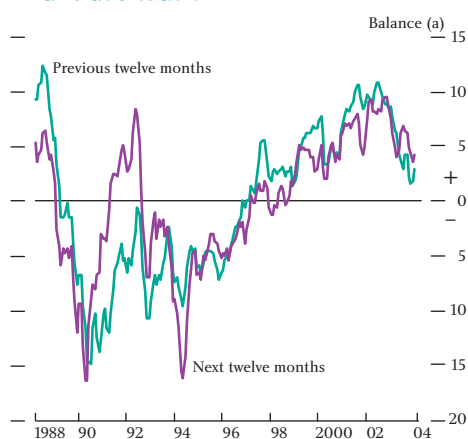


Chart 2.4
GfK consumer confidence: households' financial situation



Source: Martin Hamblin GfK.

(a) Three-month moving average of deviations from long-run average since 1988.

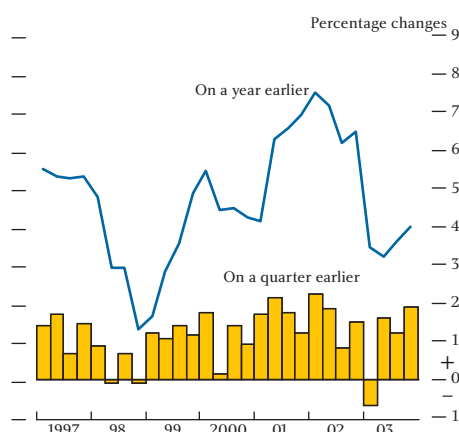
fallen on average by around 2½% per year during the past 40 years. The decline has been particularly sharp in recent years, possibly linked to the improvement in the terms of trade during that period.

The unusually sharp declines in the relative price of durables in the past few years have boosted real income growth. Real post-tax income, deflated by the household consumption deflator, has grown at an average annual rate of 3.0% since the end of 1995. But, using the GDP deflator, growth would have averaged just 2.5%. This has allowed real consumption to grow more rapidly than usual. But was this enough to explain the strong growth actually seen? Or has consumption grown too rapidly, implying some future sharp correction? Consumption depends on current and expected future income. Households may have extrapolated recent real income gains associated with the rapid decline in relative prices, which may not persist. Survey evidence on households' expectations of their financial situation suggests that they do indeed extrapolate past developments (see Chart 2.4). The decline in the saving ratio in the late 1990s might also suggest that households revised up their expected future income.

Other arguments are less supportive of the notion that consumption growth has been over-exuberant. The response of spending on durable goods to an increase in expected future income is likely to be larger than that of non-durables. Adjusting the stock of durable goods to a new desired level can imply large swings in spending. Yet the nominal ratio of durable to non-durable spending has been little changed in the past few years. That is in sharp contrast to the experience of the late 1980s when the ratio rose sharply, and fell back in the early 1990s. Expectations for the next twelve months may closely track consumers' assessment of their financial situation over the past twelve months. But consumption decisions should be based on expectations of income over a much longer horizon, and there is no available measure of those. On balance, it is impossible to be sure whether the strong consumption growth has been excessive. The risk of a future correction remains, and may intensify if consumption continues to grow at too strong a pace.

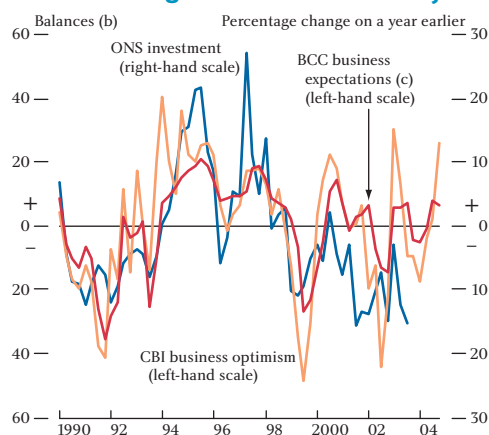
Indicators suggest consumption growth remained above trend in Q4. But it is difficult to assess trends in spending around Christmas and the New Year given the substantial seasonal variation. Retail sales growth picked up in Q4, to 1.9%, from 1.2% in Q3. This was the strongest growth since 2002 Q2 (see Chart 2.5). But growth in private new car registrations slowed. The CBI *Distributive Trades Survey* suggested retail sales growth remained robust in January. The recent strength of asset prices should also help to support consumption.

Chart 2.5
Retail sales^(a)



(a) Volume measure at 2000 prices.

Chart 2.6
Manufacturing investment and surveys^(a)



Sources: BCC, CBI and ONS.

- (a) The survey balances have been moved forward four quarters.
 (b) Deviations from averages since 1989.
 (c) Average of expected turnover and profitability balances.

Household net financial wealth grew by 2.3% in Q3. And equity prices continued to rise in Q4, as did house prices. Taking these factors together, the Committee has revised up its forecast of household consumption growth in the near term. But quarterly growth is expected to ease further ahead, towards its longer-term trend.

Government consumption

Real government consumption increased by 0.1% in Q3, the same as in the previous quarter. Nominal government consumption has grown rapidly in the past few years, increasing by over 50% since the end of 1997. But real spending growth has been much more subdued during that period, rising by just 12.6%. As a result, the government consumption deflator has increased rapidly, particularly in more recent years. Establishing the split of nominal spending between prices and volumes is difficult because much of the output associated with that spending is not marketed, so there are no observable prices. The ONS uses direct measures of outputs for much of government consumption, such as the number of medical operations. But such measures may not capture quality improvements. That makes the impact of government expenditure on real demand and supply difficult to assess. And it has led the ONS to commission a review of these measurement issues.⁽¹⁾

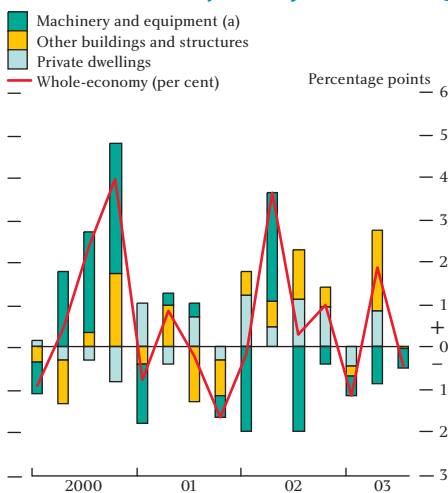
In the *Pre-Budget Report*, nominal public sector spending plans were revised up in the current fiscal year and in the subsequent two years. Much of this reflected increased benefit and interest payments. But final demand from the general government sector—consumption and investment—is also somewhat higher than in previous plans. That largely reflects the addition of a special reserve to the plans set in the 2002 Comprehensive Spending Review, to cover costs associated with Iraq and the war on terrorism. These new spending plans have been incorporated in the February *Inflation Report* projection, providing a modest additional stimulus to GDP growth compared with November.

Investment

Whole-economy investment fell by 0.5% in Q3, following a rise of 1.9% in the previous quarter. Business investment—around two thirds of whole-economy investment—fell by 1.2%. And this was mainly due to a 7.8% fall in manufacturing investment, the largest decline since 1980. Manufacturing investment has fallen by a third over the past three years. Although only around an eighth of business investment, it has contributed three quarters of the 6.4% decline in business investment

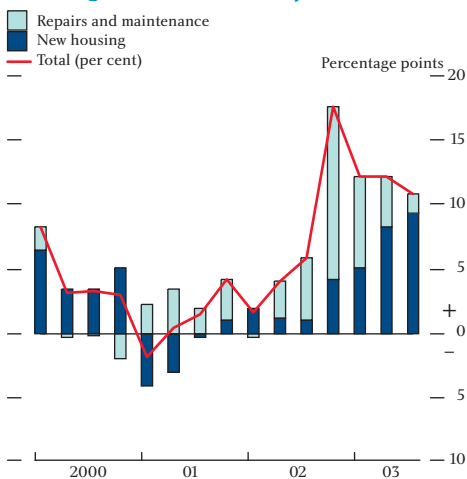
(1) See 'National Statistics review of government output measurement', ONS press release, 4 December 2003, available at www.nationalstatistics.gov.uk/pdfdir/nsr1203.pdf.

Chart 2.7
Contributions to quarterly investment growth



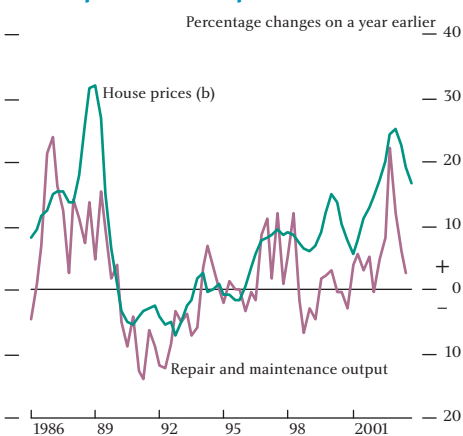
(a) Includes investment in intangible fixed assets.

Chart 2.8
Contributions to annual growth in private housing construction output



Source: Department of Trade and Industry.

Chart 2.9
House prices and improvements^(a)



Sources: Department of Trade and Industry, Halifax and Nationwide.

(a) Proxied by repair and maintenance output.
(b) Average of Halifax and Nationwide house price indices.

since the end of 2000. Part of this is likely to reflect the long-term decline in the share of manufacturing in UK output.⁽¹⁾ But part is also likely to be cyclical. Manufacturing output has begun to strengthen in recent months (see Section 3). And improving optimism about business conditions, as suggested by surveys, might indicate that the declines in manufacturing investment will ease (see Chart 2.6). Survey measures of manufacturing investment intentions also picked up sharply in Q4. Both the CBI and BCC balances rose to their highest levels since 1997.

By asset, the recent weakness in investment has reflected spending on machinery and equipment, which has declined for five consecutive quarters (see Chart 2.7). These declines have been offset by strong growth in investment in buildings and other structures, such as roads. But why has this element been so strong?

Private investment in dwellings includes improvements to existing property as well as new housing. Although ONS data on these subcomponents are not published, the DTI construction output data provide a proxy. Most of the strength of private housing construction in 2002 reflected increased repair and maintenance activity, which includes improvements (see Chart 2.8). Since then, growth in this component has eased. Repair and maintenance activity appears to be related to house prices (see Chart 2.9). Rising house prices raise the value of, and incentive for, home improvements. The relationship between new house building and house prices is less clear. This may be because planning restrictions and other lags have hampered new supply. Nevertheless, the expected slowdown in house price inflation may be associated with some easing in the growth of private investment in dwellings.

Leaving aside housing, most investment in buildings and structures is conducted by the corporate sector. The 2003 *Blue Book* showed that corporate investment in these assets fell in 2002. And this trend is likely to have continued in 2003. Indicators of commercial property values have improved modestly in recent months, possibly indicating some increase in demand for existing property. But new orders for private industrial and commercial construction work have remained weak. However, the weakness in corporate spending has been offset by strong growth in government investment. Plans for further large increases over the next two years suggest that this will be a persistent source of growth in construction-related investment.

(1) See the box on pages 20–21 of the February 2003 *Report* for a more detailed discussion of trends in manufacturing output.

Chart 2.10
Manufacturing stocks

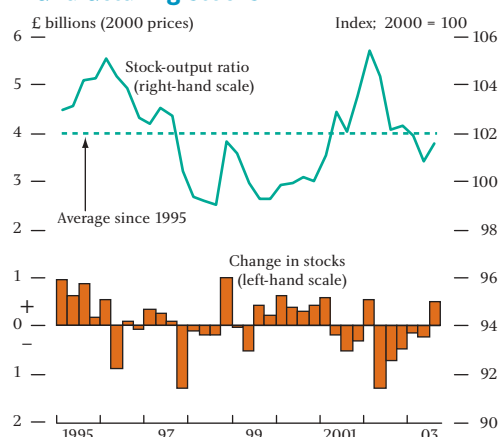
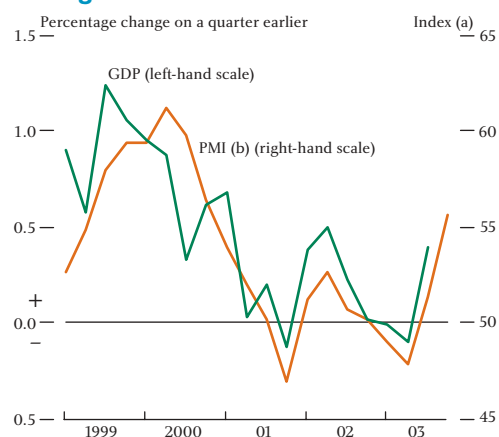


Chart 2.11
Euro-area GDP and surveys of purchasing managers



Sources: Eurostat and Reuters.

- (a) A level below 50 indicates a decline in activity; above 50 suggests an increase.
(b) Weighted average of the PMI monthly indices for manufacturing and services, using the relative magnitudes of value added in industry and services in 2002. Monthly readings have been averaged over each quarter.

Table 2.B
Contributions to euro-area GDP growth

Percentage point contributions to quarterly growth

	2001		2002		2003		
	Average	Average	Average	Q4	Q1	Q2	Q3
Household consumption	0.2	0.1	0.2	0.3	0.0	0.1	0.1
Government consumption	0.1	0.1	0.0	0.1	0.1	0.1	0.1
Investment	-0.1	-0.1	0.1	-0.2	-0.1	-0.1	-0.1
Final domestic demand	0.2	0.1	0.3	0.2	0.0	0.1	0.1
Change in inventories	-0.2	0.1	0.0	0.2	0.1	-0.5	-0.5
Domestic demand	0.0	0.2	0.3	0.3	0.1	-0.4	-0.4
Exports	-0.2	0.4	-0.1	-0.6	-0.4	0.8	0.8
Imports	0.4	-0.3	-0.2	0.2	0.1	0.0	0.0
Net trade	0.2	0.1	-0.3	-0.4	-0.2	0.8	0.8
GDP	0.2	0.3	0.0	0.0	-0.1	0.4	0.4

Source: Eurostat.

Investment estimates are subject to uncertainty, and are liable to revision. It is difficult, therefore, to draw firm conclusions about the recent measured weakness of investment. GDP measured by aggregating expenditure has been growing less rapidly than GDP measured by aggregating output or income in recent quarters. As a result, the statistical discrepancy—which aligns overall expenditure with the other measures of GDP—has built up to an unusually large level. This will be revised away in future years when the ONS reconciles the different measures. This could lead to upward revisions to aggregate expenditure. And in the past, these have mainly been through investment.⁽¹⁾

Looking forward, the conditions for a recovery in business investment generally appear to be in place. Profits grew strongly again in Q3. And the private non-financial corporate sector financial balance has been in surplus for the past six quarters. Investment intentions picked up sharply in the service sector as well as manufacturing in Q4, with the BCC survey balance at its highest level for over two years. Reflecting these factors, the Committee expects business investment to recover steadily.

Inventories

Stocks contributed 0.3 percentage points to GDP growth in Q3, reflecting a faster pace of inventory accumulation than in the previous quarter. Manufacturing stocks increased for only the second time in the past ten quarters. The de-stocking in previous quarters probably reflected attempts to reduce the high stock-to-output ratio (see Chart 2.10). The balance of firms stating that stocks of finished goods were more than adequate fell in Q4, according to the CBI Monthly Trends survey. That might suggest further de-stocking occurred, possibly involuntarily as companies were surprised by the strength of demand.

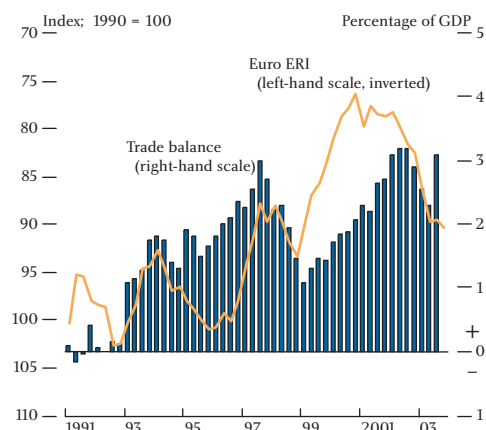
2.2 External demand and UK net trade

In the euro area, GDP grew for the first time in a year in 2003 Q3, rising by 0.4%. That was consistent with the pickup in survey measures of activity. And the manufacturing and service sector PMIs increased further in Q4. Both rose to their highest levels for around three years, suggesting that GDP growth remained solid in Q4 (see Chart 2.11). Is this the beginning of a sustained recovery in the euro area?

The composition of demand in Q3 raises concerns over the durability of the recovery. Final domestic demand growth remained weak (see Table 2.B). Household consumption was

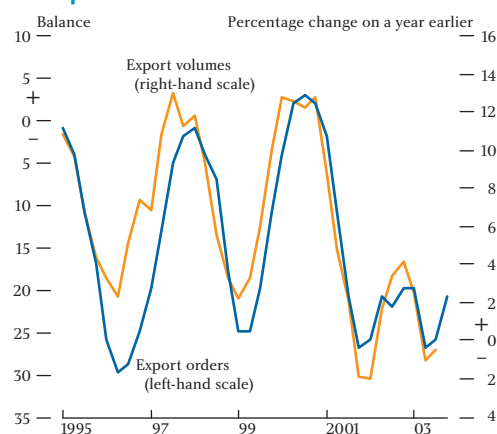
(1) See Castle, J and Ellis, C (2002), 'Building a real-time database for GDP(E)', *Bank of England Quarterly Bulletin*, Spring, pages 42–49 for a more detailed discussion of revisions to expenditure components.

Chart 2.12
Euro-area trade volumes and euro ERI



Sources: Bank of England and Eurostat.

Chart 2.13
Euro-area exports and industrial survey of export orders



Sources: European Commission and Eurostat.

Table 2.C
Contributions to US GDP growth

Percentage point contributions to quarterly growth

	2001 Average	2002 Average	2003 Q1	Q2	Q3	Q4 (a)
Household consumption	0.4	0.5	0.4	0.6	1.2	0.5
Government (b)	0.2	0.2	0.0	0.3	0.1	0.0
Private investment	-0.3	0.0	0.0	0.2	0.6	0.3
Change in inventories	-0.3	0.2	-0.2	0.0	0.0	0.2
Domestic demand	0.0	0.9	0.3	1.1	1.8	1.0
Net trade	0.0	-0.2	0.2	-0.3	0.2	0.0
GDP	0.0	0.7	0.5	0.8	2.0	1.0

Source: US Bureau of Economic Analysis.

(a) Advance estimate.
(b) Consumption and investment.

little changed on the quarter, and investment fell by 0.3%. A substantial negative contribution from inventories led to overall domestic demand falling by 0.4%, the largest decline since 1993. The strength of GDP in the third quarter entirely reflected the estimated 0.8 percentage point contribution from net trade, and in particular a 2.0% rise in exports. The rise in exports followed three consecutive quarters of decline.

The export-led recovery in Q3 is a little puzzling given the continued appreciation of the euro. Other things being equal, the rise in the value of the euro would have made euro-area exports less competitive. Net trade volumes tend to be inversely related to movements in the euro (see Chart 2.12). But the strong growth in exports in Q3 led to the net trade surplus rising from 2.3% of GDP to 3.1%, while the euro remained at its elevated level.

Euro-area surveys provide further evidence that exports picked up in the second half of 2003. The export orders balance in the European Commission's industrial survey has typically been a good indicator of export growth in the past (see Chart 2.13). The recovery in world demand may be offsetting the effects of the euro appreciation. But there remains a risk that the trade surplus in Q3 was erratic and will fall back. Without a pickup in domestic demand, this could lead the euro-area recovery to falter in the coming quarters.

There are a number of factors that should support euro-area domestic demand in the future. Interest rates remain low, and taxes were reduced at the beginning of 2004 in some countries. In addition, the appreciation of the euro should make imports cheaper, encouraging additional domestic spending. The Committee expects domestic demand to recover steadily.

In the United States, GDP grew by 1.0% in Q4, compared with a 2.0% rise in the previous quarter (see Table 2.C). Consumption growth slowed sharply, following exceptional growth in Q3, as the temporary effects from auto incentives and a one-off boost to the level of consumption from tax cuts unwound. Quarterly investment growth also slowed. Despite that, the level of investment in 2003 Q4 was almost 8% higher than four quarters earlier. Recent surveys have been very strong. In January, the ISM manufacturing index rose to its highest level since 1983. And the non-manufacturing index rose to its highest level since the series began in 1997.

US GDP growth in recent quarters has been supported by considerable monetary and fiscal stimulus. As these effects wane, demand growth is likely to ease. But recent

Chart 2.14
US employment and consumer confidence

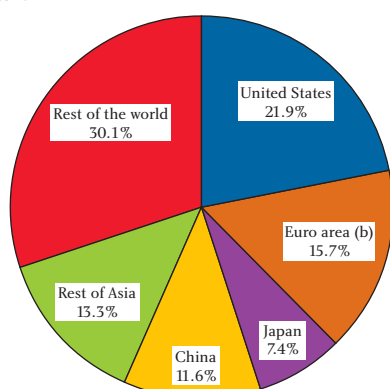


Sources: The Conference Board and US Bureau of Labor Statistics.

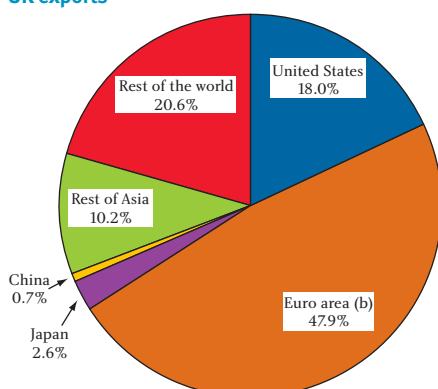
developments are generally more positive for a sustained recovery. The investment recovery broadened and consolidated during 2003. Furthermore, the dollar has continued to decline, boosting net trade prospects. The labour market has also begun to improve. Though employment, on the non-farm payrolls measure, was little changed in December, in the three months to November it rose by almost 250,000, the largest increase since January 2001. Moreover, the unemployment rate fell from a peak of 6.3% in June to 5.7% in December. An improvement in the labour market is likely to be a key factor in sustaining consumption growth, and was probably associated with the rise in consumer confidence in recent months (see Chart 2.14). The Committee expects growth in the United States to be slightly stronger in the near term than expected at the time of the November *Report*. Growth is expected to ease back from above trend further ahead.

Chart 2.15
Shares of world GDP and UK exports

World GDP^(a)



UK exports^(c)



Sources: IMF and ONS.

- (a) Shares of world output based on IMF purchasing power parity (PPP) exchange rates in 2000.
 (b) Excludes Greece, which did not join the euro area until the beginning of 2001.
 (c) Shares of total UK exports in 2000.

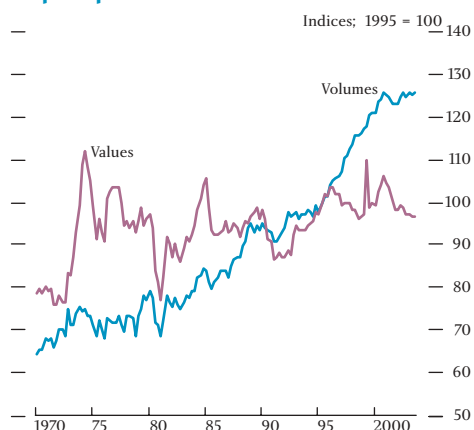
In Japan, real GDP grew by 0.3% in Q3. Revisions to back data reduced the strength of the recovery in the previous few quarters. But indicators for Q4 suggest continued growth. Export growth picked up sharply. And industrial production grew by 3.6% in Q4, the largest increase since 1987. In the rest of Asia, output growth bounced back in Q3 in most countries affected by SARS. Chinese GDP continued to grow rapidly, rising by 9.1% in 2003, the strongest growth since 1997. Asian output accounts for around a third of global GDP. But its direct influence on UK external demand is rather smaller (see Chart 2.15). The United Kingdom exports relatively little to Japan and China in particular. Although these two countries accounted for almost a fifth of world activity in 2000, they accounted for less than 4% of UK exports. This reflects the greater importance of the euro area, which accounts for almost half of UK exports.

Net trade made no contribution to UK GDP growth in Q3, as in the previous quarter. Export volumes rose by 0.4% on the quarter, while imports rose by 0.5%. These data remain affected by VAT missing trader intra-community (MTIC) fraud.⁽¹⁾ In Q3, more of these fraudulent activities were stopped, so underlying growth in both imports and exports was stronger than the recorded figures suggest.

Excluding MTIC fraud, import volumes rose by over 1% in Q3. This was similar to the rise in gross final expenditure (domestic demand plus exports). But imports have typically risen more rapidly than final expenditure in the past, while still following a similar profile. As a result, import penetration—the ratio of imports to final expenditure—has risen steadily over most of

(1) See the box on pages 18–19 of the August 2003 *Report* for a more detailed discussion of MTIC fraud.

Chart 2.16
Import penetration^(a)



(a) Ratio of imports to gross final expenditure. Both of these series have been adjusted to exclude the effects of VAT MTIC fraud.

Table 2.D
UK export outlook^(a)

	Series average (b)	2002					2003
		Q4	Q1	Q2	Q3	Q4	
BCC export orders							
Manufacturing	6.8	8	-3	4	-2	16	
Services	9.5	2	-9	-5	3	9	
CIPS export orders (c)							
Manufacturing	49.8	48	49	50	53	56	
CBI Industrial Trends (d)							
Expected export orders	7.7	-14	-13	-13	-13	17	
Export optimism	0.0	-22	-20	-9	-8	12	

Sources: BCC, CBI and CIPS.

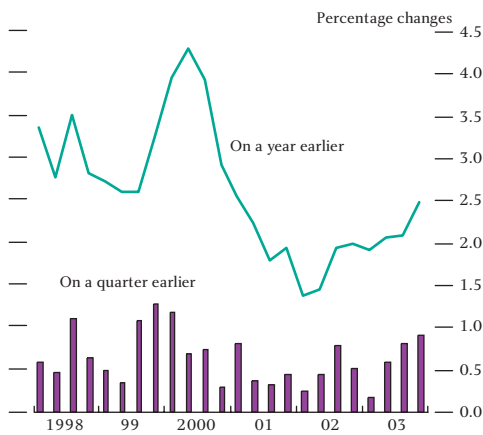
- (a) Percentage balances of respondents reporting 'higher' relative to 'lower', except CIPS, where a reading above 50 suggests increasing orders, and below 50 suggests falling orders.
- (b) Averages since 1989 for BCC, 1972 for CBI *Quarterly Industrial Trends* and 1996 for CIPS.
- (c) Average of monthly indices.
- (d) Expected orders relate to the next three months, from 2003 Q2, and to the next four months prior to that. Export optimism relates to the next year.

the past 30 years in volumes terms (see Chart 2.16). The falling relative price of imports appears to be the main factor underlying this increase. Import penetration in nominal terms has not changed much. In the past three years, however, import penetration in volumes terms has flattened off. Other economies, such as the United States and the euro area, have seen a similar pattern. One factor behind this may be the composition of demand. Investment, particularly ICT investment, tends to use a higher proportion of imports, and so has a greater influence on the profile of overall imports. The slightly stronger than usual increase in import penetration in the late 1990s, and the flattening off in the past three years, is consistent with the ICT cycle playing an important role in world trade. A strong recovery in ICT investment may, therefore, lead to more rapid growth in imports in the future.

The November *Report* noted that there was little sign of the depreciation of sterling at the start of 2003 having boosted UK exports. But the timing of any exchange rate effect can be variable. Excluding MTIC fraud, exports rose by around 1% in Q3. Monthly data for goods exports in October and November suggest that growth remained solid in Q4. And survey measures of export orders picked up sharply in Q4 (see Table 2.D). The CIPS export orders balance rose in November to its highest level since the survey began in 1996. And in Q4 the CBI *Quarterly Industrial Trends* survey balances for both expected export orders and export optimism rose to their highest level since 1995. Despite sterling's more recent appreciation, the Committee expects a solid recovery in export growth in the near term, reflecting the recovery in global demand.

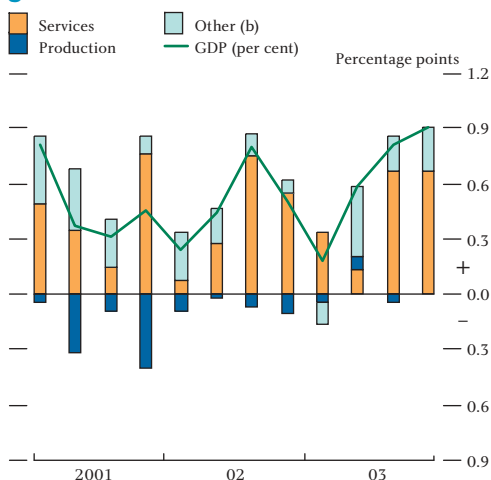
Whole-economy output growth picked up over the course of 2003 and indicators are consistent with vigorous growth in the near term. Total hours worked were broadly unchanged during 2003, but the outlook for employment remains positive. Estimates suggest that growth in the stock of capital—and the services it provides—continued to outpace growth in output. Productivity growth remained subdued, which may in part reflect cyclical weakness in capacity utilisation. But the Bank’s regional Agents report a recent rise in utilisation rates in the service sector. And in the labour market, there is some evidence of incipient tightening.

Chart 3.1
GDP^(a)



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

Chart 3.2
Sectoral contributions to quarterly GDP^(a) growth



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

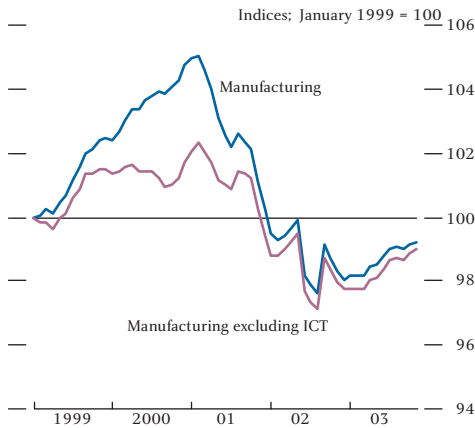
A key determinant of inflation is the balance between the actual output of businesses and organisations and the amount they could potentially supply while working at normal-capacity levels. The ONS estimates actual output each quarter, as discussed in Section 3.1 below. But potential supply is not easily measured. It depends on the amount and quality of inputs used in the production process, as well as the efficiency with which the inputs could be employed. These factors are examined in the remainder of Section 3.

3.1 Output

The preliminary estimate of whole-economy output—measured by the ONS as gross domestic product (GDP) at market prices—increased by 0.9% in 2003 Q4 (see Chart 3.1). That followed a rise of 0.8% in the previous quarter. A small part of this growth reflects the inclusion of indirect taxes in this output measure. Output estimated at basic prices strips out that effect, and consequently may provide a better indication of business activity. This measure has grown less quickly over the past two years (by 0.1 percentage points, on average, each quarter). And following revisions to past data in the December release of the National Accounts, its level in 2003 Q4 was a little lower than anticipated at the time of the November 2003 *Report*. Nonetheless, both measures show the same qualitative pattern: growth is estimated to have strengthened over the course of 2003, picking up from well below trend in early 2003 to slightly above trend in the latter half of the year.

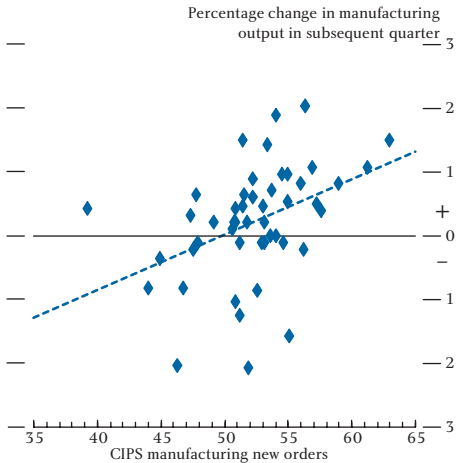
By sector, output growth in 2003 Q4 was largely driven by a continued strong contribution from services (see Chart 3.2). Services output growth rose to 1.0% in Q4, from 0.9% in the previous quarter. Although a detailed

Chart 3.3
Manufacturing output^(a)



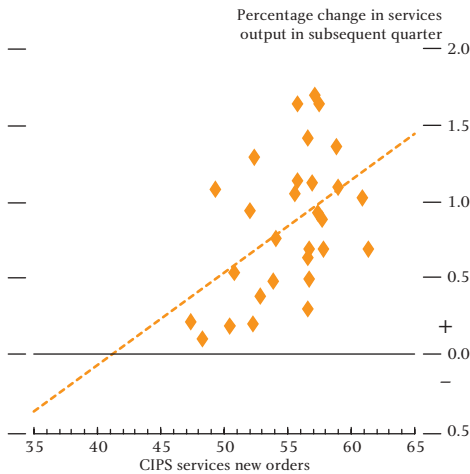
(a) Three-month moving average. Output in manufacturing excluding ICT was estimated by Bank staff using published ONS data.

Chart 3.4
Relationship between CIPS new orders and official output data for manufacturing^(a)



Sources: Bank of England, CIPS and ONS.
 (a) Correlation coefficient = 0.4 (over period 1991 Q3 to 2003 Q5). CIPS data are quarterly averages of monthly balances, where 50 indicates no change.

Chart 3.5
Relationship between CIPS new orders and official output data for services^(a)



Sources: Bank of England, CIPS and ONS.
 (a) Correlation coefficient = 0.5 (over period 1996 Q3 to 2003 Q4). CIPS data are quarterly averages of monthly balances, where 50 indicates no change.

sectoral breakdown of service sector output is not published at the time of the preliminary GDP release, the ONS publicly indicated that the Q4 strength in services was broadly based.

The preliminary estimate suggested industrial production was unchanged in 2003 Q4. Within that, manufacturing output may have risen slightly on the quarter, according to the ONS GDP press release. In previous years, developments in manufacturing have been driven by the information, communications and technology (ICT) sector. ICT output accounted for a large part of the sector's strength in 2000, and much of its decline the following year. But in 2003, output in manufacturing—both including and excluding the ICT sector—has gradually recovered (see Chart 3.3).

The preliminary GDP estimate provides only limited information on output in other industries. But it appears that in 2003 Q4, the positive contribution from the rest of the economy largely reflected further strong growth in construction. Output in the sector fell in the first quarter of 2003, but has since risen sharply. Growth was 2.0% in Q3 and ONS press briefing intimated a broadly similar rate in Q4. That is consistent with short-term indicators, such as the activity balance from the CIPS construction survey.

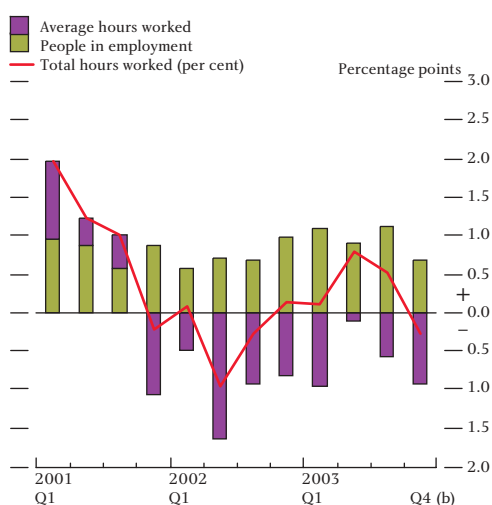
Looking ahead, the Bank makes use of a wide range of surveys to provide information about the near-term outlook for output growth. Based on past relationships, sectoral CIPS survey measures of new orders appear to be useful indicators of output growth in the near term. Recently, new orders measures have picked up, reaching levels that, on average in the past, have been consistent with output growth above trend. The dispersion of observations around the best-fit lines in Charts 3.4 and 3.5 indicates that the relationships are far from perfect. But the evidence from CIPS is consistent with other survey information. In January's *CBI Quarterly Industrial Trends Survey*, the manufacturing new orders balance rose to its highest level since 1996, reflecting developments in both domestic and export markets. And the latest BCC survey reports a similar improvement for manufacturing, as well as a further pickup in orders for the service sector. Overall, the Committee judges that further strong output growth is likely in the near term.

3.2 Factor inputs

Employment

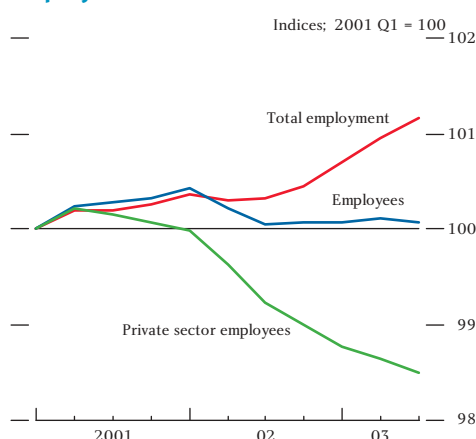
Official labour market data have been revised since the *November Report*, in light of updated ONS estimates of the UK population since 1992. These revisions are small, however,

Chart 3.6
Contributions to annual growth in total hours worked^(a)



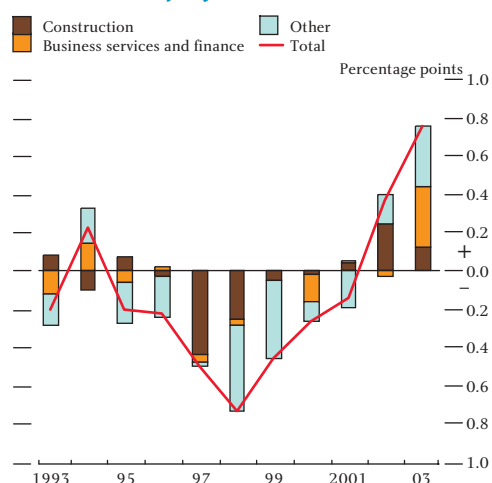
(a) Average hours worked is defined as total hours worked divided by the LFS measure of people in employment.
(b) 2005 Q4 figures refer to the period September–November 2003.

Chart 3.7
Employment^(a)



(a) 'Private sector employees' is calculated as the Workforce Jobs measure of all employees minus employees in 'Public administration, education and health'. Employees data exclude HM Forces and government-supported trainees.

Chart 3.8
Sectoral contributions to annual changes in the self-employment rate^(a)



(a) The fraction of the workforce that is self-employed. Contributions are based on Q3 data in each year.

given the relatively modest nature of the revisions to population estimates.

The latest data suggest that total hours worked were broadly unchanged during 2003 (see Chart 3.6). That reflects a rise in the number of people in employment being offset by a continuation of the trend decline in the average number of hours they work (a phenomenon discussed in recent *Reports*).

In 2001, rising employment was entirely accounted for by employee growth. That was largely due to rising numbers of public sector employees; the number of employees in the private sector changed little (see Chart 3.7). But in the two years to 2003 Q3, the number of employees was flat, as private sector losses have almost exactly offset further growth in the public sector. Instead, rising employment was driven by self-employment. The fraction of the workforce that is self-employed rose sharply—a development common to many sectors, but particularly pronounced in construction and business services (see Chart 3.8).

There are a number of possible explanations for the rise in self-employment. Relative returns to self-employment could have increased. Or following job losses in certain sectors, some workers may have been attracted to self-employment as an alternative to searching for another job. Alternatively, self-employment may simply be more feasible than in the past, as sharp rises in house prices have increased the collateral at workers' disposal and so reduced the credit constraints they face.

Looking ahead, the outlook for both public and private sector employment growth appears to be positive in the near term. The 2003 Budget noted that an increase in public sector employment of around 200,000 would be needed between 2003 and 2006, in order to deliver 2002 Spending Review commitments on public services. That implies a continued positive contribution from the public sector to total employment growth, albeit less marked than in recent years. As for the employment intentions of the private sector, the main surveys point to a pickup in jobs growth in the near term (see Table 3.A). Balances are at, or above, their long-run averages in the CBI, BCC and Manpower surveys. Although the relationship between such survey balances and future employment has been imprecise in the past, the latest survey information is consistent with evidence from regular discussions between the Bank's regional Agents and business contacts across the United Kingdom.

Capital

There is rather more uncertainty about capital estimates than most other data discussed in the *Report*. In part, this reflects

Table 3.A
Surveys of employment intentions^(a)

Percentage balances of employers planning to recruit staff

	Series average (b)	2002		2003			
		Q3	Q4	Q1	Q2	Q3	Q4
BCC							
Services	14	17	15	11	12	18	22
Manufacturing	3	5	1	-2	-4	3	5
CBI							
Manufacturing	-21	-22	-27	-33	-27	-25	-11
Manpower (c)							
Total	11	10	24	16	8	9	18

Sources: Bank of England, BCC, CBI and Manpower.

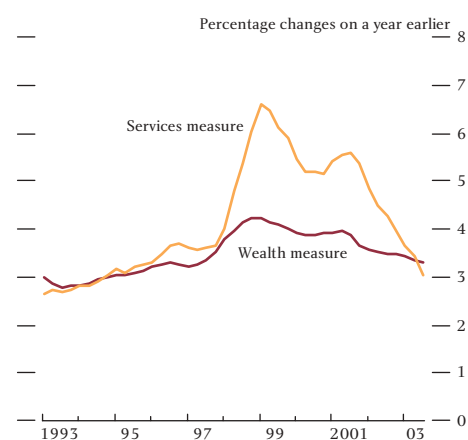
- (a) Seasonally adjusted by the Bank of England. Intentions for next three months (four months for CBI prior to 2003 Q2).
 (b) Averages since 1989 for BCC, 1979 for CBI and 1981 for Manpower.
 (c) Employment prospects.

the fact that capital series are not typically derived directly from surveys. Instead, they are constructed by cumulating past flows of investment and making a number of assumptions about the nature of capital assets. One key assumption relates to the rate at which different types of capital depreciate. ICT assets, for example, are typically thought to depreciate much more quickly than assets like buildings.

Such differences in the characteristics of assets mean that the method of aggregation matters. The appropriate method depends on the intended purpose of the aggregate capital measure. Previous *Reports* have described a measure of the physical value of capital. In this case, each item is weighted by its asset price. This 'wealth' measure may be relevant for balance sheet analysis.

An alternative approach is to derive a measure of the services provided by capital.⁽¹⁾ In theory, this involves weighting each item by either the benefit from an additional unit of capital or the amount it would cost to hire that capital (given that a profit-maximising business will tend to accumulate capital up to the point at which the marginal benefit equals the marginal cost of doing so). This cost can be proxied using estimates of the capital losses and depreciation costs that a firm owning and renting out an asset would need to cover in the rental price it charges. The rental price will tend to be high relative to the asset price when depreciation is high or the price of the asset is falling. And so this approach tends to give greater weight to items with these characteristics, such as computers. The capital services measure may be more relevant as a determinant of the current productive capacity of the economy.

Chart 3.9
Capital^(a)



(a) Both capital series exclude housing.

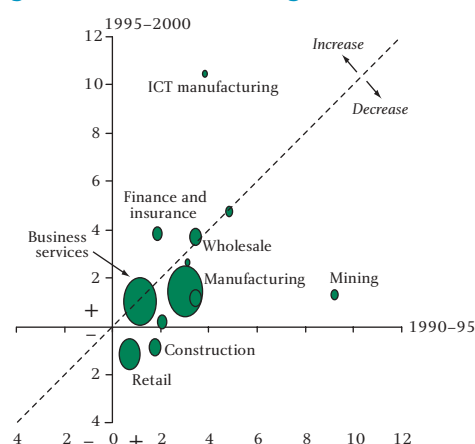
Chart 3.9 shows annual capital growth on two measures: the wealth measure shown in previous *Reports*; and a services measure that explicitly allows for the depreciation and price characteristics of computer, software and telecommunications equipment.⁽²⁾ In 2003, capital growth was similar on both measures. Although investment growth has been subdued (see Section 2), the level of investment remained sufficiently high for capital growth to continue to outpace growth in actual output. In previous years, however, the services measure tended to grow rather more quickly than the wealth measure, partly reflecting the strength of investment in ICT relative to other assets over that period.

This picture of more rapid capital growth would be consistent with potential output of the economy having been greater

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

(2) For further details, see Oulton, N and Srinivasan, S (2003), 'Capital stocks, capital services, and depreciation: an integrated framework', *Bank of England Working Paper no. 192*.

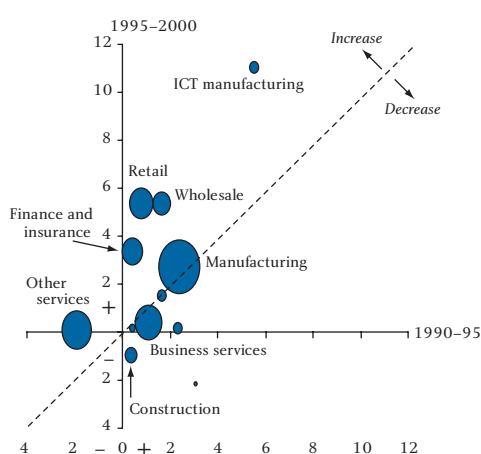
Chart 3.10
Private sector multi-factor productivity growth in the United Kingdom^(a)



Source: Basu, Fernald, Oulton and Srinivasan (2005).

(a) Excludes agriculture. Average annual growth, in per cent. The size of each circle corresponds to the size of the sector, as measured by current-price value added in 2000. Value-added productivity estimates are based on employment hours and capital services. Note that 'ICT manufacturing' is also included in 'Manufacturing'.

Chart 3.11
Private sector multi-factor productivity growth in the United States^(a)



Source: See Chart 3.10.

(a) See footnote to Chart 3.10.

than previously thought. That could, in part, explain the contrast—discussed in the November *Report*—between strong output growth at the turn of the millennium and subdued retail and consumer price inflation.

Productivity

The November *Report* discussed an apparent slowdown in whole-economy productivity growth since the mid-1990s. That was evident from estimates of not only growth in labour productivity, but also in multi-factor productivity (MFP)—a measure that explicitly allows for the role capital plays in output growth.⁽¹⁾

Productivity calculations are sensitive to different measures of the capital and labour inputs that are used in the production process. But estimates also depend on whether they cover productivity in the economy as a whole or only in the private sector. Subdued growth in whole-economy productivity in recent years could, in part, reflect fundamental difficulties in measuring public sector output (see Section 2). Measured productivity growth has tended to be more buoyant in the private sector. But even in the private sector, the qualitative pattern remains: productivity growth appeared to slow in the latter half of the 1990s and has been subdued more recently.

Recent research has investigated the sectoral breakdown of this apparent slowing of private sector productivity growth.⁽²⁾ Chart 3.10 shows average annual MFP growth by sector, over both the first and second halves of the 1990s (on the x-axis and y-axis respectively). Those sectors that lie above the 45-degree line experienced an increase in MFP growth; those that lie below the line experienced a decline, similar to the aggregate picture. The size of each circle represents each sector's share in the economy.

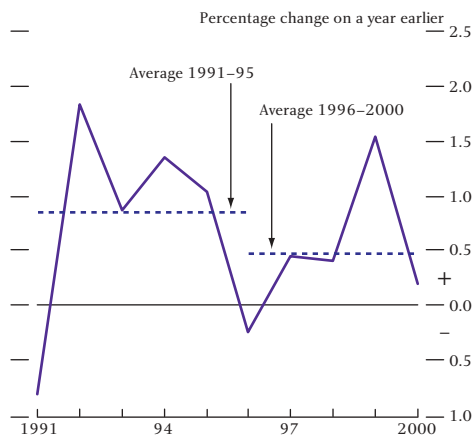
The chart indicates that the deceleration in productivity was fairly broad-based. Almost all sectors experienced stable or declining MFP growth. One exception is ICT manufacturing, which experienced a sizable pickup in MFP growth. But as the size of its circle in Chart 3.10 indicates, the sector remains a small part of the economy. This UK experience contrasts with that of the United States, where MFP growth picked up not only in ICT manufacturing, but also in several other sectors (see Chart 3.11).

One explanation for the slowing of UK productivity growth is the rapid growth of ICT investment in the latter half of the

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

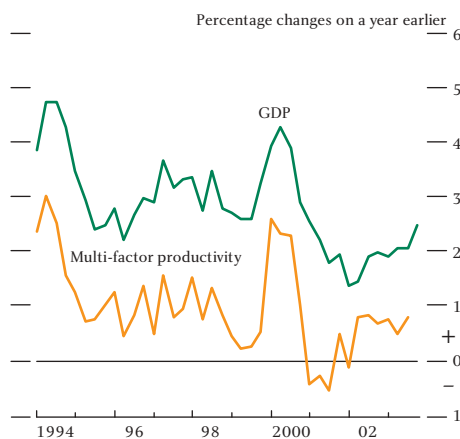
(2) See Basu, S, Fernald, J, Oulton, N and Srinivasan, S (2005), 'The case of the missing productivity growth: or, does information technology explain why productivity accelerated in the United States but not the United Kingdom?', NBER Working Paper no. 10010.

Chart 3.12
Labour quality



Source: O'Mahony, M and Van Ark, B (eds) (2003), *EU productivity and competitiveness: an industry perspective*, Enterprise Publications.

Chart 3.13
Whole-economy multi-factor productivity and GDP(a)



(a) Estimates are based on the chained volume measure of GDP at market prices, ONS employment hours data and the Bank of England capital services estimates shown in Chart 3.9.

1990s, as UK businesses took advantage of declining ICT prices—a by-product of rapid productivity gains in the ICT manufacturing sector. Such investments may be associated with a diversion of resources to reorganisation and learning, as discussed in the *November Report*. The impact of such ‘complementary investment’ would be an initial slowing of productivity growth as the investment took place; but a subsequent rise in productivity growth as efficiency gains are realised. And the contrast between rising productivity growth in the United States and a decline in the United Kingdom could in part be a matter of timing. Large-scale investment in ICT capital—and hence, according to this view, investment in associated ‘complementary capital’—took place earlier in the United States. And so the benefits to productivity may also have accrued sooner than in the United Kingdom.

The apparent slowing of UK productivity growth in the latter half of the 1990s may also reflect changes over time in labour quality. It is typically assumed in economic analysis that employees, and the hours they work, have similar characteristics. But their quality is likely to vary depending on the characteristics of the individual and the job. Chart 3.12 shows a measure of labour quality growth, based on workers’ educational attainment. According to this measure, the average quality of those in employment has tended to improve over time, but the rate of improvement slowed in the latter half of the 1990s. In part, that could reflect government policies, such as those discussed in Section 3.4, aimed at inducing relatively low-skilled workers back into the labour force. And adjusting for such changes in labour quality, the productivity growth slowdown may therefore appear less marked.

Looking ahead, a cyclical pickup in productivity growth might be expected. In the past few years, GDP growth has been relatively subdued (see Chart 3.13). And some of that recent weakness in productivity growth is likely to have reflected lower levels of capacity utilisation over that period.

3.3 Capacity utilisation

In the short run, businesses often face significant costs in adjusting the amount and quality of capital and labour at their disposal. As a result, their initial response to an unexpected rise in demand, say, could be to adjust the intensity with which they work their existing factor inputs. To the extent that this leads to businesses working above their normal-capacity levels, domestic inflationary pressures would tend to increase. For example, some workers could demand greater compensation for their increased effort. And some businesses may take the opportunity to raise their profit margins during the period of higher demand, increasing their prices more than in proportion to any increase in costs. For these reasons,

Table 3.B
Survey measures of capacity utilisation

Percentage balances of firms working at full capacity

	Series average (a)	2002		2003			
		Q3	Q4	Q1	Q2	Q3	Q4
Services							
BCC	32	36	39	36	35	37	39
Manufacturing							
BCC (b)	32	35	38	33	29	36	39
CBI	40	33	25	29	31	32	33

Sources: BCC and CBI.

- (a) Averages since 1972 for CBI manufacturing and 1989 for BCC.
(b) Includes agriculture, energy and construction.

measures of capacity utilisation may be informative about price pressures in the economy.

A direct measure of utilisation rates in the economy is provided by surveys. On the surface, businesses' responses to the BCC survey appear to suggest that utilisation rates are above normal in both services and manufacturing, whereas the CBI survey indicates that capacity utilisation in manufacturing has remained below normal levels in recent years (see Table 3.B).

Such survey information is difficult to interpret, however. The BCC surveys are not adjusted to ensure the weight given to each sector corresponds to its weight in the whole economy. And its 'manufacturing' survey includes responses from not only manufacturers, but also businesses in agriculture, energy, and the recently buoyant construction sector. More generally, evidence suggests that many businesses interpret survey questions of capacity in terms of capital, but not labour.⁽¹⁾

An alternative source of information is provided by the meetings that the Bank's regional Agents hold regularly with business contacts across the United Kingdom. These discussions provide an indication of how intensively businesses are using both capital and labour. In recent years, businesses have indicated that rates of utilisation have been at or slightly below normal levels. But in the past few months, there has been some evidence of a pickup in capacity utilisation in the service sector.

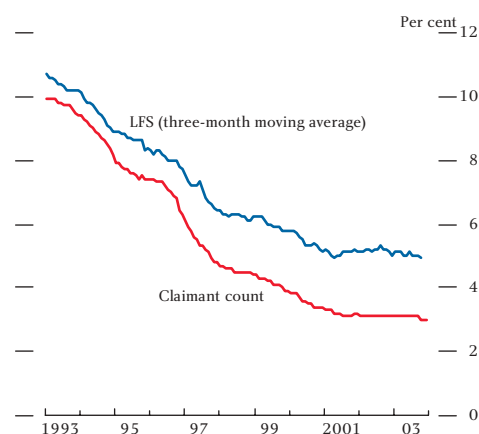
3.4 Labour market tightness

Inflationary pressures depend not only on developments in the markets for businesses' products, but also on the balance of supply and demand in the markets for the factor inputs used to produce those goods and services. In particular, a key influence is labour market tightness, the degree of imbalance between demand and supply in the labour market.

A commonly used indicator of tightness is the unemployment rate. This has fallen sharply over the past decade, on both LFS and claimant count measures (see Chart 3.14). And there was a further modest decline towards the end of 2003. Other things being equal, that would imply a pickup in wage pressures, which could feed through into higher prices elsewhere in the economy. But as discussed in Section 4, this has not occurred: both wage and price inflation have remained relatively subdued over this period.

In part, that could reflect the fact that the availability of labour depends not only on the level of unemployment, but

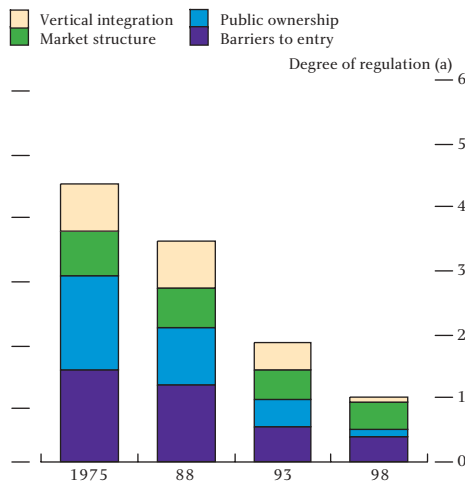
Chart 3.14
Unemployment rate^(a)



- (a) The LFS provides a household survey-based measure of those out of work, searching for a job and available to start work. The claimant count is an administrative record of the number of people claiming unemployment-related benefits.

(1) See Mann, R and Junankar, S (1998), '40 years on: How do companies respond to the CBI's Industrial Trends Survey?', *CBI Economic Situation Report*, November.

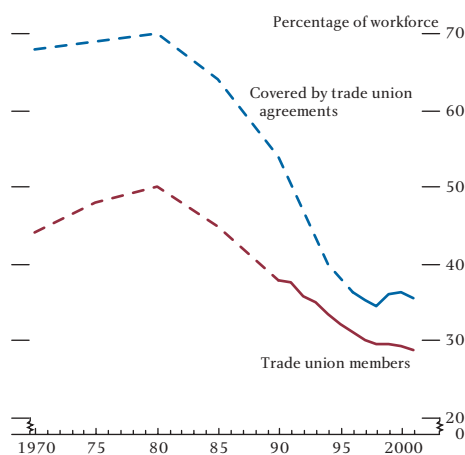
Chart 3.15
Regulation in selected industries



Source: Nicoletta, G and Scarpetta, S (2003), 'Regulation, productivity and growth', *Economic Policy*, Vol. 36, pages 11-72.

(a) Summary indicator is computed as a simple average of industry-level indicators for utilities, telecommunications and transportation industries, and ranges from 0 to 6 (increasing in the degree of regulation).

Chart 3.16
Trade unions(a)



Sources: Nickell, S and Quintini, G (2002), 'The recent performance of the UK labour market', *Oxford Review of Economic Policy*, Vol. 6(4), pages 26-35 and Brook, K (2002), 'Trade union membership', *Labour Market Trends*, July, pages 343-54.

(a) Data are annual from 1990 for membership and from 1996 for coverage. Earlier data are less frequent and interpolated. Membership data refer to employees in Great Britain; coverage data refer to Great Britain up to 1994, but to the United Kingdom thereafter.

also on the 'inactive' population, certain groups of which are just as likely to move into employment. The November *Report* discussed a more comprehensive measure of labour availability that takes into account the size and composition of the entire non-employed adult population. This measure has declined less dramatically than unemployment. But it is also possible that structural changes have lowered the level of both unemployment and total labour availability consistent with a given degree of wage pressure.⁽¹⁾

Such structural changes could take two forms. First, there may have been developments, not directly related to the structure of the labour market, that affect the level of demand for labour at a given real wage. For example, a rise in the degree of competition faced by businesses will tend to reduce the mark-up of the price they charge for their products over the wages they pay workers. Other things being equal, that implies an increase in the wage businesses are willing to pay relative to the price of their products. This rise in labour demand should be associated with a rise in employment and a decline in the sustainable level of unemployment or inactivity.

In practice, UK regulatory reform may well have achieved some success in removing barriers to competition. OECD research suggests that there was a steady decline in restrictions on competition in the 1980s and 1990s, as measured by a set of quantitative indicators of regulation in selected non-manufacturing industries (see Chart 3.15). And more recent legislation, such as the 1998 Competition Act which prohibits restrictive practices and abuses of dominant market position, would be expected to have similar effects.

Second, the structure of the labour market may have changed. An obvious change over many years is the decline of unionisation in the United Kingdom. Theory suggests that when trade unions and individual businesses bargain over wages, but employers determine employment, wages will tend to be higher than otherwise and employment probably lower, at least in those businesses. A decline in union bargaining power could thus lead to a rise in employment and a decline in the rate of unemployment or inactivity consistent with a given degree of wage pressure. Chart 3.16 shows that the number of workers in a trade union or covered by a trade union collective agreement declined sharply, as a share of the workforce, during much of the past two decades.

A further consideration is the design of the tax and benefit system. Evidence suggests that the level of unemployment benefits relative to wages, as well as the ease with which such

(1) See Cassino, V and Thornton, R (2002), 'Do changes in structural factors explain movements in the equilibrium rate of unemployment?', *Bank of England Working Paper* no. 153.

benefits can be claimed, has declined markedly since the late 1970s.⁽¹⁾ That should have provided an incentive to the unemployed to consider low-wage jobs they might otherwise have disregarded. Government programmes may also have helped by increasing the employability of the unemployed. Various New Deal programmes offer targeted assistance to the long-term unemployed in their search for work, as well as providing entry into training and employment schemes. Early evidence indicates some success for the longest-running of these programmes, the New Deal for Young People, in reducing youth unemployment.⁽²⁾

It therefore seems likely that there have been marked declines over time in both actual unemployment and the level of unemployment consistent with a given degree of wage pressure. Nevertheless, the most recent fall in unemployment does appear consistent with other evidence of increased labour market tightness. The latest BCC surveys, for example, indicate a pickup in the balance of firms experiencing recruitment difficulties. And that is consistent with the latest reports from the Bank's regional Agents, whose service sector business contacts have indicated further tightening of labour conditions in recent months.

(1) See Nickell, S and Quintini, G (2002), 'The recent performance of the UK labour market', *Oxford Review of Economic Policy*, Vol. 6(4), pages 26–35.

(2) See, for example, Wilkinson, D (2003), *New deal for young people: evaluation of unemployment flows*, Policy Studies Institute.

Whole-economy earnings growth remained broadly unchanged, and private sector earnings growth continued to be subdued. Oil prices and other commodity prices rose in dollar terms, but that partly reflected the depreciation of the dollar. Import price inflation remained muted. Manufacturers' input prices rose, and output price inflation continued to pick up. Survey evidence suggests that service sector input price inflation rose slightly in the latest data, but output price inflation was broadly unchanged. Since the November Report, the inflation target has changed from 2.5% for annual RPIX inflation to 2.0% for CPI inflation.

Chart 4.1
Whole-economy earnings^(a)

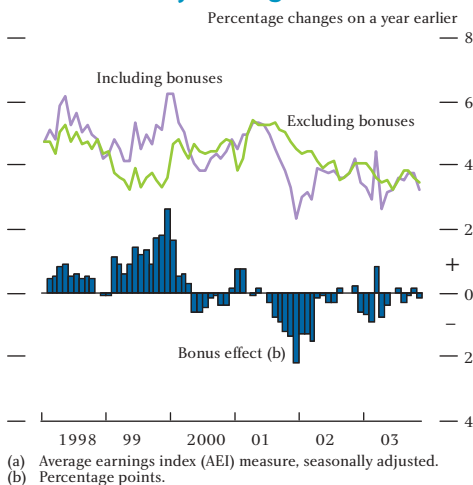
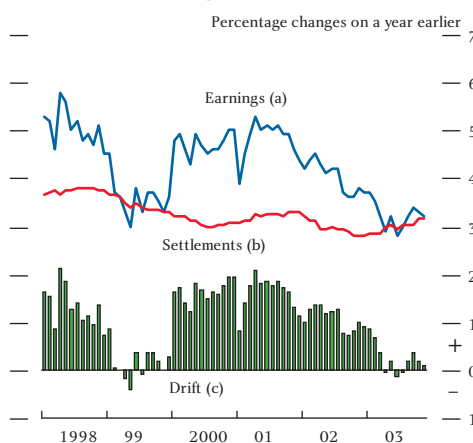


Chart 4.2
Private sector wage drift



4.1 Labour costs

Whole-economy earnings growth has remained broadly unchanged over the past three months (see Chart 4.1). The contribution from bonus payments to earnings growth has been minimal. But reports from the Bank's regional Agents suggest that bonus payments, particularly in the financial services sector, could rise substantially this year.

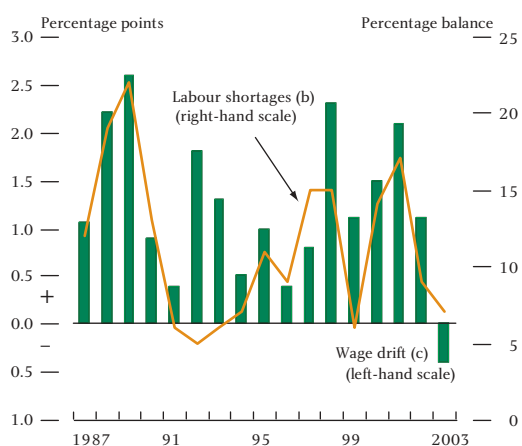
Over the past year, growth in private sector earnings has been significantly weaker than that in the public sector. However, private sector settlements have been edging up. The weakness of private sector earnings growth is mainly accounted for by below-average wage drift, the gap between pay increases and settlements. Chart 4.2 shows private sector earnings growth (excluding bonuses) alongside settlements and a measure of wage drift.

Wage drift reflects factors such as merit pay increases, but also changes in average hours worked.⁽¹⁾ It is possible that, faced with a cyclical downturn, firms find it easier to cut back on overtime and merit pay increases. Those may be more flexible and individual-based than settlements, which could be fixed for a year or more and are more likely to be driven by collective bargaining.

Chart 4.3 shows a different, longer-run measure of whole-economy wage drift together with a survey measure of labour shortages, as a proxy for cyclical movements in labour demand. Although the relationship is imprecise, it does suggest that drift is positively correlated with the cycle. So looking forward, drift could pick up if the labour market

(1) See page 34 of the August 2005 Report.

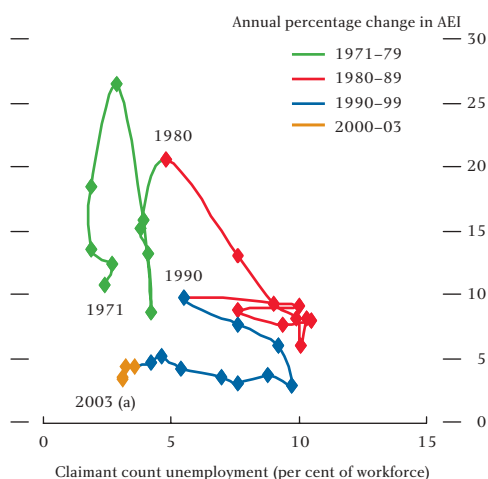
Chart 4.3
Wage drift and labour shortages^(a)



Sources: CBI, Industrial Relations Services (IRS) and ONS.

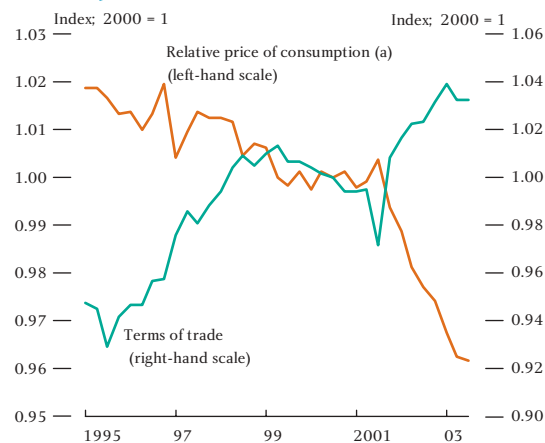
- (a) Based on April data in each year.
- (b) Percentage balance of manufacturing firms indicating skilled labour shortages limiting output.
- (c) Annual percentage change in the whole-economy AEI minus the median IRS settlement.

Chart 4.4
Unemployment and earnings growth



(a) Earnings growth in 2003 based on eleven months to November.

Chart 4.5
The terms of trade and the relative price of consumption^(a)



(a) Household expenditure deflator divided by the GDP deflator.

tightens. That would be consistent with evidence from the Bank’s regional Agents, who recently surveyed firms about pay prospects in 2004. A higher net balance of firms expected stronger pay growth than settlements growth, accordant with a pickup in wage drift.

Generally, low unemployment is thought to be an indicator of a tight labour market, and hence of wage pressure. But, as Chart 4.4 shows, there is no systematic relationship between the unemployment rate and nominal earnings growth. In part, that is due to the dramatic fall in price inflation since the 1970s. But over the past ten years, when inflation has been low and stable, unemployment has fallen with little discernible sign of upward pressure on earnings growth. Section 3 discusses some of the structural factors that may have affected the labour market over the past decade. But there have been other factors that may have moderated wage growth as well. One of these is the rise in the terms of trade.

The UK terms of trade measure the price of UK exports relative to the sterling price of goods and services imported into the United Kingdom. Since 1995, the terms of trade have risen by almost 10%, though it is unclear what has caused this rise, or indeed whether it will persist.⁽¹⁾ That is likely to have caused some of the fall in the prices of consumer goods and services relative to the prices of all goods and services produced in the United Kingdom (see Chart 4.5): UK consumers buy a mix of domestically produced and imported goods, but not exports.⁽²⁾ In turn, this will have raised workers’ real take-home pay—the real consumption wage—relative to the real cost of labour to firms. This may have restrained workers’ wage demands relative to what firms were willing to pay. As such, the pressure on wage growth for any given level of unemployment is likely to have been reduced. But the terms of trade would have to rise further in order to continue to restrain wage demands. Indeed, if the rise in the terms of trade were to reverse, this would put upward pressure on wages.

The real consumption wage is also affected by changes in taxation. The rise in employees’ National Insurance contributions (NICs) last year has reduced workers’ take-home income. It is possible that workers may try to compensate for this by demanding higher wages without a corresponding improvement in productivity. Although there has been little sign of this so far, it could put upward pressure on settlements over the next year. But if workers succeeded in raising their wages, in the longer term firms would be likely to reduce

(1) See Dury, K, Piscitelli, L, Sebastia-Barriol, M and Yates, T (2003), ‘What caused the rise in the UK terms of trade?’, *Bank of England Quarterly Bulletin*, Summer, pages 164–76.
 (2) Section 2 discusses the impact of the rise in the terms of trade on consumption volumes and values.

Chart 4.6
Non-wage labour compensation

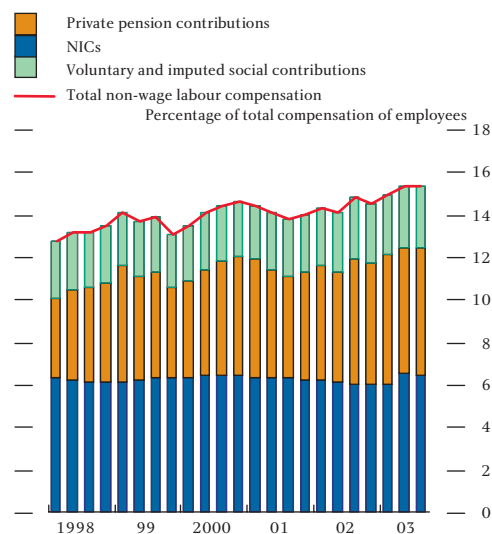
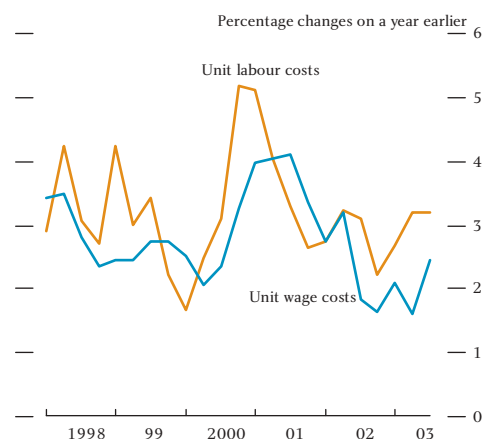


Chart 4.7
Unit cost measures



employment, so unemployment would rise and real wage growth would ease back.

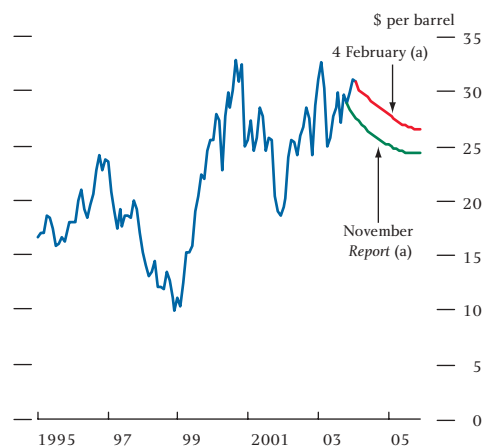
Wages are not the only component of labour costs. Non-wage compensation, such as employers' NICs and pension contributions, forms a significant proportion. Non-wage compensation as a share of total labour compensation has risen from around 13% in 1998 to about 15% in the latest data. And although the rise in NICs in April 2003 has had an effect, since 1998 most of the rise in non-wage labour compensation has been driven by a rise in private pension contributions (see Chart 4.6).⁽¹⁾

What effect might higher pension contributions have on firms' prices? Employees with defined-contribution pension schemes bear the risk of falls in the value of their pension fund themselves. But for employees with defined-benefit pensions, firms are obliged to provide the defined-benefit pensions in the future. So they must make up any shortfall arising from equity price falls, such as those seen in 2002. Firms are unlikely to finance the deficit by lowering wages, as these should reflect the balance of demand and supply in the labour market, which is probably unaffected by the pension fund deficit. The deficit is therefore likely to be met from profits. Part of the rise in pension contributions in recent years could reflect firms making up this shortfall, and that has affected measures of unit labour costs. But while the pension deficit is a cost for firms, it is not part of the marginal cost of production—the cost of producing an additional unit of output. And as it is marginal cost that is important for pricing decisions, the Committee does not expect these increased pension fund contributions to be passed on in higher prices.

The rise in pension fund contributions has resulted in unit labour costs growing faster than unit wage costs, which exclude these forms of compensation. Whole-economy unit labour costs grew by 3.2% in the year to 2003 Q3, compared with growth of 2.5% in unit wage costs (see Chart 4.7). But these headline data probably mask very different sectoral developments. In particular, private sector unit wage costs are likely to have been significantly weaker than public sector unit wage costs. This is due to higher earnings growth, and weaker measured productivity growth, in the public sector than in the private sector. But looking forward, both private sector and whole-economy unit wage costs are likely to rise if labour demand picks up and wages rise.

(1) For reasons why these contributions may currently be overestimated in the National Accounts see ONS (2004), 'Discussion note on insurance companies' recording of pensions transactions', available at www.statistics.gov.uk/about/methodology_by_theme/pensions_review.asp.

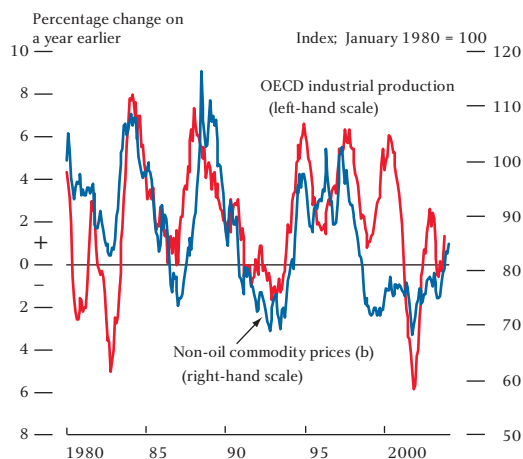
Chart 4.8
Brent oil futures



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

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

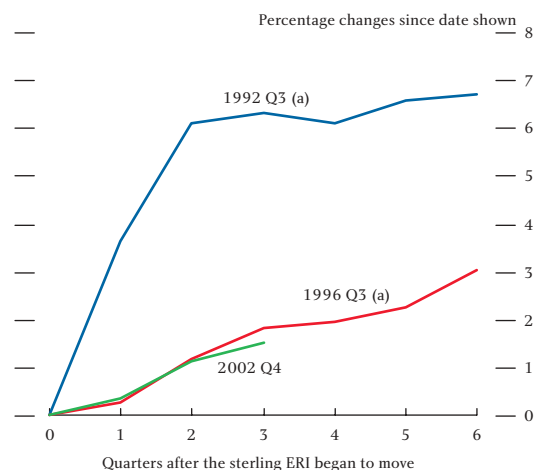
Chart 4.9
Non-oil commodity prices and world industrial activity^(a)



Sources: *The Economist* and Thomson Financial Datastream.

(a) The last observation in the chart for NOC prices is January 2004; for OECD industrial production it is October 2003.
(b) Shown in Special Drawing Right (SDR) terms, an IMF unit of account.

Chart 4.10
Movements in import prices



(a) Scaled by the size (and direction) of the change in the sterling ERI since 2002 Q4.

4.2 Commodity prices

In the 15 working days to 4 February, the price of Brent crude oil averaged \$31 per barrel, \$2 above the 15-day average to 5 November (the day the MPC finalised its November projections). But over the same period, in sterling terms the price of Brent crude oil fell a little. Indeed the rise in the dollar price of oil over a longer period also partly reflected the weakness of the dollar. At the start of 2004, the dollar price of oil was around 50% higher than at the start of 2002, when the dollar began to fall. In euro terms it was less than 10% higher, and in sterling terms the oil price rose by 23% over the same period. But the fact that the oil price rose in all three currencies suggests that other influences have been playing a role, such as the pickup in global activity. The profile of the futures curve in dollar terms over the next two years is downward sloping, though above that at the time of the *November Report* (see Chart 4.8).

Non-oil commodity (NOC) prices, as measured by *The Economist* price index, rose by 10% in dollar terms in Q4. Part of this rise reflected the depreciation of the dollar: in sterling terms, NOC prices rose by around 4% in Q4. Even so, over the past 20 years NOC prices have moved reasonably closely with world industrial production (see Chart 4.9). And the more recent rise in NOC prices appears to be consistent with the recovery in world activity.

4.3 Import prices

Global trade prices, as proxied by the local-currency export prices of the other ‘major six’ (M6) economies, have been broadly unchanged over the past year. As world activity gathers pace over the next year, it is possible that these trade prices will pick up in response.

As discussed in the *November 2003 Report*, there appears to have been little effect on UK import prices from the depreciation of sterling at the start of 2003. Sterling import prices were 1% higher than a year earlier in 2003 Q3. But the sterling ERI fell by 6.1% over the same period. Chart 4.10 shows the change in import prices since the end of 2002, together with those following the large exchange rate movements in 1992 and 1996. The recent behaviour of import prices has been broadly in line with the 1996 experience, which was more subdued than in 1992.⁽¹⁾ Any response of import prices to a movement in the sterling ERI will depend on why the exchange rate has changed. The relatively small change in import prices over the past year could partly reflect

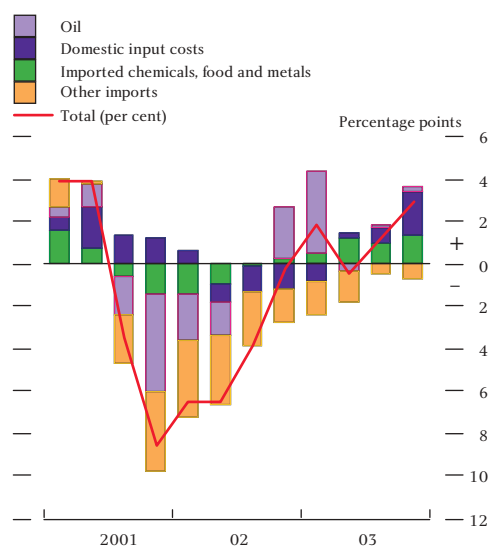
(1) In the year following all three movements in the sterling ERI, global trade prices, as measured by M6 export prices, were broadly unchanged, and so are unlikely to have driven movements in import prices.

the fact that firms believed some of the depreciation in sterling at the start of 2003 would be temporary: indeed, sterling has risen more recently.

The rise in import prices in the year to Q3 was driven by a 3.1% increase in the price of imported services. In contrast, the price of imported goods rose by just 0.4% over the same period. Within goods, the price of imported manufactured goods fell by 1.1%. But this was offset by rises in other goods prices, including a 4.1% rise in the price of imported basic materials. These are used as inputs to UK production.

4.4 Sectoral costs and prices

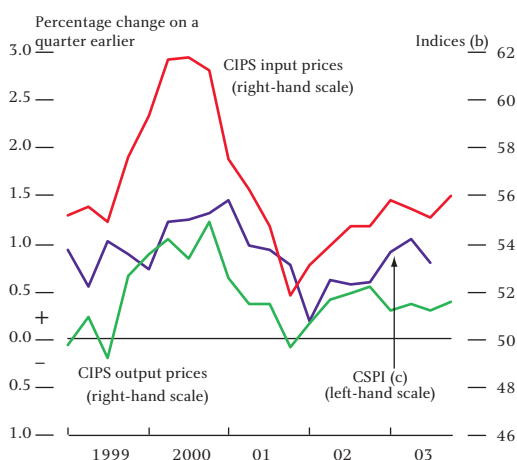
Chart 4.11
Contributions to manufacturers' annual input price inflation



Manufacturers' input prices rose by 2.9% in the year to 2003 Q4. Chart 4.11 shows the contributions to annual input price inflation by type of good. Imported inputs—in particular chemicals, food and metals—have recently made a positive contribution to input price inflation. This partly reflects the recent global commodity price rises feeding through into input prices in the United Kingdom. Domestic inputs, particularly domestically produced food, have also contributed to the recent rise in input price inflation. But in part that could reflect some domestic food prices, for example of grain, being determined in world markets.

Manufacturers' output prices rose by 1.6% in the year to 2003 Q4, compared with a 0.8% rise in the year to 2002 Q4. As discussed in the November *Report*, the pickup in output price inflation appears to have been transmitted down the supply chain to higher retail goods price inflation. Output price inflation in the manufacturing sector was significantly weaker than input price inflation in Q4. But margins may not have been squeezed. Reports from the Bank's regional Agents suggest that, in response to the rise in input prices, manufacturers are increasingly shopping around for cheaper suppliers in order to maintain margins. This may not be captured in official data. And other costs in the manufacturing sector have been falling. In particular, manufacturing unit wage costs fell by 1.9% in the year to November.

Chart 4.12
Service sector price inflation^(a)

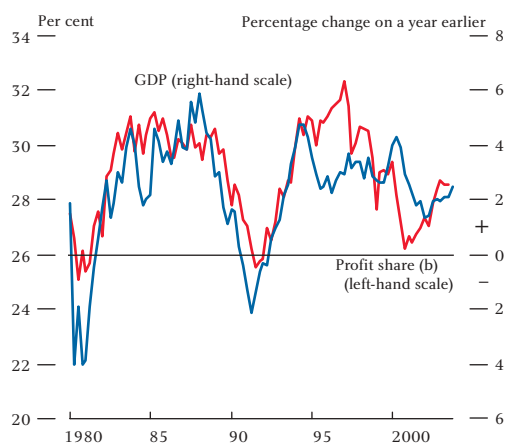


Sources: Bank of England, CIPS and ONS.

- (a) The last observation in the chart for CSPI is Q3; for CIPS it is Q4.
- (b) Three-month average; 50 = no change.
- (c) Seasonally adjusted by the Bank of England.

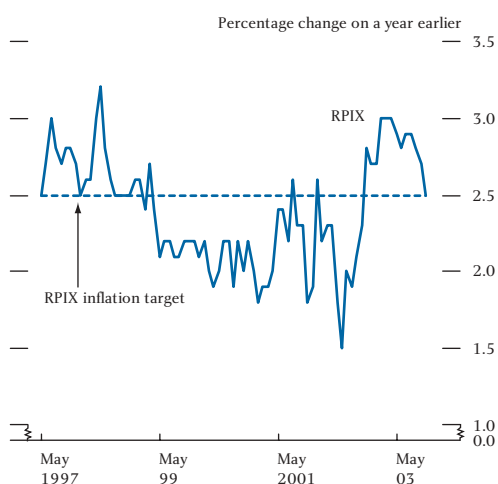
According to the CIPS survey, service sector input price inflation has picked up a little in recent months. But over the same period CIPS reports that service sector output price inflation has been broadly unchanged. The experimental corporate services price index (CSPI) suggests that quarterly inflation eased slightly in Q3 (see Chart 4.12). None of these measures is ideal: the CIPS measures are based on a relatively small sample and are diffusion indices, rather than inflation rates; and the CSPI currently excludes around half of its

Chart 4.13
A measure of the profit share^(a)



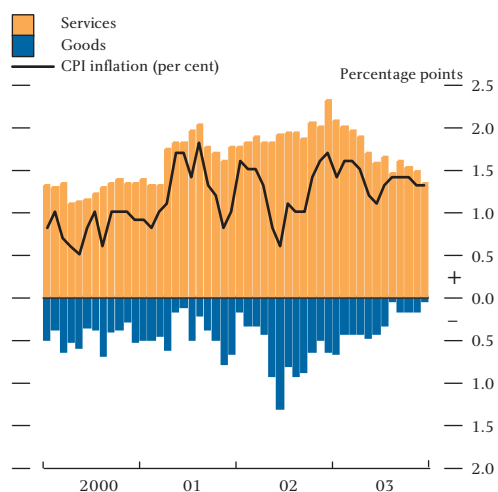
(a) The last observation in the chart for GDP is 2005 Q4; for the profit share it is 2003 Q3.
 (b) Gross operating surplus divided by the sum of gross operating surplus and compensation of employees.

Chart 4.14
RPIX inflation and the former inflation target^(a)



(a) Covers period from May 1997 to November 2005.

Chart 4.15
Contributions to annual CPI inflation



targeted sample. So it is hard to be confident about movements in service sector input and output prices.

One factor that could put upward pressure on output prices in both the manufacturing and service sectors is the markup of prices over costs. Prices and costs are determined by the interaction of demand and supply, partly through their effect on the markup, the difference between selling prices and production costs. A simple proxy for the markup is the profit share, which appears to be procyclical (see Chart 4.13). That has risen over the past year because of the recent strong growth in profits. If activity continues to accelerate then the markup might carry on rising, putting further upward pressure on prices.

4.5 Consumer prices

Since the time of the November *Report*, the inflation target has changed from 2.5% annual inflation as measured by RPIX to 2.0% annual inflation as measured by the consumer prices index, or CPI. The box on page 36 discusses this in more detail.

The 2.5% RPIX inflation target was introduced in May 1997. In the 79 months to November 2003 before the target changed, inflation was above target for 30 months and below target for 42 months (see Chart 4.14). Over the period as a whole, annual RPIX inflation averaged 2.4%.

Annual RPIX inflation fell to 2.6% in 2003 Q4, from 2.8% in Q3. Annual CPI inflation also fell slightly in Q4, to 1.3% from 1.4% in Q3. The gap between goods and services price inflation has narrowed over the past year. CPI services price inflation was 2.8% in December, the lowest since April 2000, while CPI goods price inflation was -0.1%. At 2.9 percentage points, the difference between the two was the lowest since August 1997. In the long term, services price inflation is likely to be higher than goods price inflation. This is because labour productivity growth in the services-producing sector is likely to be slower than in the goods-producing sector, which is more capital intensive and hence more able to exploit technological progress.

Over the past year, RPIX inflation has been boosted by housing depreciation and Council Tax, which are not included in the CPI. This is part of the reason why CPI inflation has been lower than RPIX inflation (see Charts 4.15 and 4.16). The charts also illustrate that the contribution from goods price inflation is weaker in the CPI than in RPIX. That is because the so-called ‘formula effect’, arising from the price-aggregation method, has the biggest impact on clothing

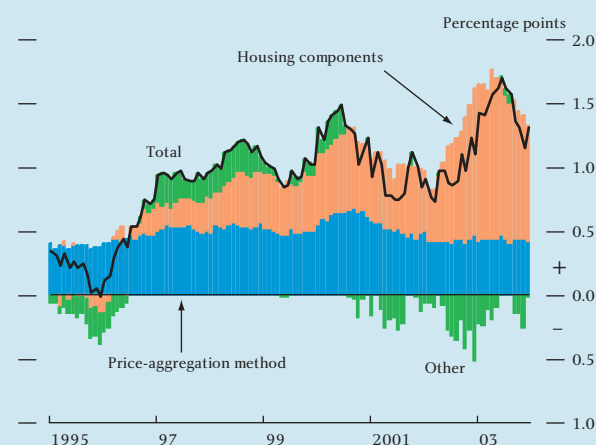
The new inflation target

On 10 December 2003, the Chancellor of the Exchequer announced that he was changing the inflation target from 2.5% for annual RPIX inflation to annual inflation of 2.0% as measured by the consumer prices index or CPI.⁽¹⁾ As with the former RPIX target, if inflation deviates by more than 1 percentage point from the target the Governor is obliged to write an open letter to the Chancellor explaining why, and how the MPC plans to bring inflation back to target.

Differences between CPI and RPIX

Differences between CPI and RPIX inflation arise because of differing composition and coverage, and the methods for aggregating the constituent prices. These were discussed in detail in the box on pages 38–39 of the May 2003 *Report*. Chart A shows the main differences between annual CPI and RPIX inflation in recent years.

Chart A
Contributions to the difference between annual RPIX and CPI inflation



Over the past two years, the largest difference has been due to housing costs, notably housing depreciation and Council Tax, both of which are included in RPIX but not in CPI. Housing depreciation is measured using a smoothed version of the ODPM house price index. So the house price rises in recent years have directly affected RPIX inflation. And the unusually high increase in Council Tax in 2003 also pushed up this inflation measure. Although CPI currently excludes both of these components, it is possible that an estimate of housing costs may be

incorporated in the future. But this may not take the same form as in RPIX.

The aggregation method also has an impact. RPIX uses arithmetic averages, while CPI uses geometric averages. This difference—the so-called ‘formula effect’—has on average accounted for 0.5 percentage points of the gap between annual RPIX and CPI inflation. The size of the formula effect depends largely on the degree of price dispersion in the base month relative to the rest of the year. The choice of January for the RPIX base month is therefore important, as there are seasonal sales in clothing and footwear and some household goods, and so prices tend to be more dispersed than at other times of the year.⁽²⁾

The ‘other’ component of the difference is fairly erratic, although it has generally been negative in recent years. That has been driven by two factors in particular. First, in RPIX new car prices are proxied by used car prices. But these have been falling relative to new car prices, which are directly included in CPI. This has lowered RPIX inflation relative to CPI inflation.

Second, prior to 2003 airfares were included in CPI, but not in RPIX. Because of the way RPIX is constructed, the introduction of airfares in 2003 temporarily boosted RPIX inflation for a year, relative to CPI inflation.

The economic impact of the target change

The move to the new inflation target involved both a change in the index for measuring inflation and a change in the level of the target. The change in the index is just a measurement issue. Underlying inflationary pressure in the economy is the same, regardless of the index used to measure it. But the new inflation target is likely to be consistent, in the long run, with measured RPIX inflation of around 2³/₄%, slightly higher than the old target of 2.5%. This estimate is based on the assumption that the housing depreciation and Council Tax components of RPIX increase at faster rates than 2.5% a year.⁽³⁾ Even so, this small change should not materially affect the economic decisions and behaviour of businesses and individuals.⁽⁴⁾

(1) The CPI was previously called the harmonised index of consumer prices (HICP).

(2) See ONS (2003), ‘The new inflation target: the statistical perspective’, available at www.statistics.gov.uk/cci/article.asp?id=688. If a different base month for RPIX were chosen, it is likely the formula effect would be smaller; this would lower annual RPIX inflation, rather than raise CPI inflation. The CPI base month is December.

(3) This also assumes the formula effect remains at its long-run average of 0.5 percentage points.

(4) See the Governor of the Bank of England’s speech at the Annual Birmingham Forward/CBI business luncheon in Birmingham on 20 January 2004, available at www.bankofengland.co.uk/speeches/speech211.pdf and Nickell, S (2003), ‘Two current monetary policy issues’, *Bank of England Quarterly Bulletin*, Winter, pages 504–17.

Chart 4.16
Contributions to annual RPIX inflation

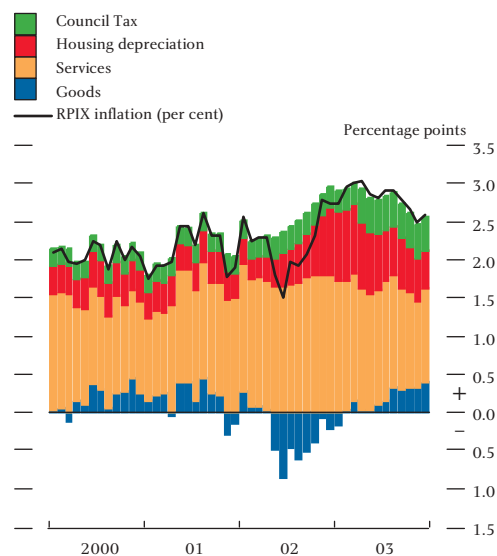
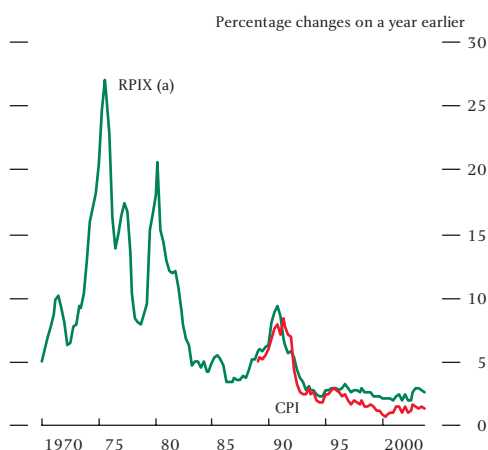
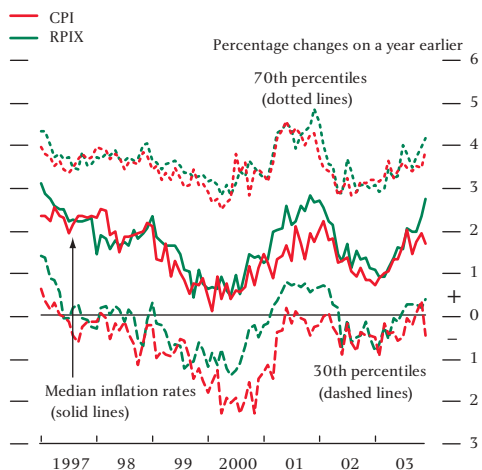


Chart 4.17
Annual CPI and RPIX inflation



(a) RPI before 1976.

Chart 4.18
Percentiles of the distribution of inflation rates in CPI and RPIX



and footwear and household goods prices (see the box on page 36).

Since 1989, the difference between the annual inflation rates of RPIX and CPI has averaged 0.7 percentage points. The change in the inflation target was a little smaller, at 0.5 percentage points. In contrast, the most recent difference was larger at 1.3 percentage points in December.

But it is important to view these numbers in a broader context. For the past ten years inflation has been very low and stable, compared with the preceding period (see Chart 4.17). In particular, annual RPIX inflation has never approached the high levels seen in the 1970s, nor even the 9% level experienced as recently as 1990. From this perspective, the magnitude of the change in the inflation target is very small.

As mentioned above, a large component of the current difference between the inflation measures is due to the inclusion of housing depreciation and Council Tax in RPIX. In fact, most of the difference between RPIX and CPI inflation is driven by a small number of prices. The majority of inflation rates of different subcategories within the RPIX and CPI baskets are very similar. Indeed, the raw price data are identical for most individual items. Chart 4.18 shows the median inflation rates of subcategories within the CPI and RPIX baskets, together with some inflation rates that are close to the median. Both the median and nearby inflation rates rose during the past year. And, importantly, this assessment is the same regardless of whether CPI or RPIX is examined. That is because housing depreciation and Council Tax have recently been in the upper tail of the RPIX distribution, while most clothing and footwear and household goods, where the formula effect is centred, have been in the lower tail of both the CPI and RPIX distributions.

Over the next six months, increases in utility prices are likely to affect the rates of both CPI and RPIX inflation. In particular, it is likely that the average increase in water prices this year will be markedly higher than in 2003. In addition, several electricity and gas companies have announced price increases that will take effect from early in 2004. These price rises are likely to push up both CPI and RPIX inflation over the next six months or so.

5 Monetary policy since the *November Report*

This section summarises the monetary policy decisions taken by the MPC since the November Report.⁽¹⁾ The Bank's repo rate was maintained at 3.75% in December and January. It was increased to 4.0% at the MPC's meeting in February.

The MPC's central projection in the *November Report* was for RPIX inflation to edge down in the near term and to stay close to target for the remainder of the forecast period. Imported and domestic cost pressures were expected to build gradually into the medium term. Quarterly GDP growth was projected to remain marginally above trend throughout the forecast period.

At its meeting on 3–4 December, the Committee noted that the US economy was growing particularly strongly. The euro-area recovery seemed to be materialising earlier than previously expected, though it was uncertain whether it would be any faster. The continuing weakness of domestic demand in the euro area, and the risks to recovery from possible further falls in the dollar, made it too early to assess its underlying strength. The Asian economies had rebounded from the SARS-related weakness.

In the United Kingdom, third-quarter growth had been revised upwards, though the composition of demand had been rather less balanced. House price inflation continued to exceed expectations, though housing market activity seemed less buoyant than previously thought. The labour market was tightening modestly, without evidence yet that earnings were rising more strongly than expected. So the medium-term outlook for RPIX inflation remained consistent with the *November Report* projection.

Most members agreed that a repo rate change in December was not necessary. The downside risks to the outlook had lessened, but the central projections had not altered significantly. The full implications of recent revisions to National Accounts data and of the *Pre-Budget Report* were still to be assessed. It also remained uncertain whether the eventual impact on the economy—and particularly on

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

households, given their high level of debt—of November's increase in the repo rate would match or exceed previous experience.

One member argued that the vulnerabilities arising from the continued build-up of household debt justified an increase in the repo rate in December.

Eight members voted to maintain the repo rate at 3.75%. One member preferred an increase of 25 basis points.

At its meeting on 7–8 January—the first since the switch in target—the Committee noted that the US economy had grown strongly and that developments in the euro area had been more encouraging since the November *Report*. But the impact of continuing dollar weakness on euro-area activity, and hence on external demand for UK output, was a key uncertainty.

In the United Kingdom, output growth was expected to be at or above trend in the second half of 2003, consumption was still growing steadily and house price rises again exceeded expectations. The November repo rate increase had so far not significantly affected consumer confidence, consumer demand or the housing market. The labour market appeared to be tightening modestly. Although CPI inflation was below target, it was expected to rise in early 2004, and demand growth was likely to provide gradual upward pressure over the medium term. The new inflation target did not warrant a change in the policy stance because, at the two-year horizon, the gap between CPI and RPIX inflation appeared to be broadly in line with the change in the numerical target.

Most members agreed that there was no need to change the repo rate in January. Though the news on activity since November had been broadly positive, there were few signs that costs and prices were rising more rapidly than envisaged and inflation expectations remained well anchored. Moreover, the current conjuncture contained material downside risks. The fall in the dollar could jeopardise recovery in the euro area and had been associated with a modest rise in the sterling ERI, implying downward pressure on UK activity and inflation. Higher indebtedness of UK consumers had increased uncertainty about the effect of monetary policy changes on consumption, so changes in interest rates should be gradual. Finally, the implications of the new target measure of inflation were best explored in the February *Report*.

Nevertheless, one member argued that a further rise in the repo rate was warranted to moderate the build-up in household debt and thus to reduce the risk of an abrupt adjustment in consumption later.

Eight members voted to maintain the repo rate at 3.75%. One member preferred an increase of 25 basis points.

At its meeting on 4–5 February, the Committee voted to increase the repo rate to 4.0%.

Output growth was above trend in the second half of 2003, and surveys point to a further strengthening in the near term. Thereafter the economy is projected to slow, but still maintain a fairly brisk pace. Annual CPI inflation should begin to rise during 2004. In the short term, that partly reflects a number of factors, such as planned utility price increases, that have a temporary impact on the overall inflation rate. But over the next two years inflation is likely to move up to the target as domestic supply constraints start to bite and import prices rise modestly. Compared with November, the more robust outlook for activity means that domestic inflationary pressures are stronger. But the higher value for the sterling exchange rate in this projection helps to offset their impact on prospective CPI inflation. Risks around the central projection are broadly balanced for both inflation and GDP growth.

6.1 World economy

The MPC expects the world economic recovery to continue in 2004 and 2005. The outlook for world economic activity has marginally improved since November.

Euro-area GDP grew by 0.4% in 2003 Q3, stronger than the flat profile for output projected for the November *Report*. Surveys suggest that there may have been a further slight pickup in growth during the final quarter of last year. But the appreciation of the euro, largely reflecting the dollar's fall, means that the recovery is unlikely to continue gathering momentum in early 2004, because net trade will probably act as a brake on growth. However, there are a number of factors that could support an improvement in domestic spending growth. Official interest rates remain low, and taxes were reduced in some countries at the beginning of 2004. Higher equity prices and lower market interest rates than in November should provide an additional impetus. So the MPC is projecting a somewhat firmer prospect for euro-area domestic demand. But that is likely to be balanced by the greater drag from net trade. Consequently, the outlook for GDP growth during the next two years remains broadly unchanged.

The near-term outlook in the United States is for very strong growth in output. This year, GDP is expected to increase at a rate well above its long-term average. High consumption growth should be sustained by expanding incomes, as labour demand revives and with tax rebates still in the pipeline. Rising profits, supported by strong productivity growth, and a

low cost of finance are likely to foster the continuing recovery in investment. Domestic spending growth may also be buttressed by the rise in equity prices during the past three months. The further decline in the dollar should provide some support for net trade. The MPC's latest projections incorporate a somewhat more vigorous short-term prospect for the US economy than envisaged in November. GDP growth is expected to fall back towards trend in 2005, as monetary policy tightens, and the impetus to the economy from fiscal policy subsides.

Recent data releases for Japan have revised away some of the strength from the recovery that was apparent in the GDP data available at the time of the November *Report*. Even so, the Committee's projection is little changed as it had already placed weight on other evidence, which suggested a slower pickup was in train. The picture remains one of continuing growth during the next two years. GDP growth is likely to maintain a lively pace in other Asian economies—similar to November's projection.

The outlook for UK export markets is for further recovery. Much of this was anticipated in November. So compared with that forecast, the new projection for UK-weighted world trade is only marginally stronger.

6.2 UK output and expenditure

Consumption grew by 0.9% in 2003 Q3, stronger than expected at the time of the November *Inflation Report*. Revisions to the data, published by the ONS in December, also mean that the past few years look different, with the slowdown now less pronounced than was apparent three months ago. Indeed, these data together with the recent outturns for retail sales and surveys suggest that consumption may have a little more near-term momentum than the MPC believed in November.

But real post-tax labour income growth is projected to ease. In part, that reflects an assumption by the MPC that income tax receipts as a proportion of GDP will rise during the next two years, in line with the Treasury's estimates from its *Pre-Budget Report* forecast.⁽¹⁾ The expected pickup in consumer price inflation (see below) should also help to reduce households' real income growth. And the MPC continues to believe that annual house price inflation will slow markedly to around zero in 2005. Consequently, the Committee judges that consumers' expenditure growth will drop back during 2004 to around its long-run average and remain there for the rest of the forecast period. Except for the stronger near-term picture, the broad

(1) See HM Treasury (2003), *Pre-Budget Report*, December, page 220.

outline of the projection for the household sector is similar to that in November.

Business investment is estimated to have fallen by 1.2% in 2003 Q3, compared with the moderate rise projected in the MPC's November forecast. But, if anything, indicators of corporate sector financial health have improved somewhat since November. Profits have continued to recover, and equity markets appear increasingly confident about future growth in profitability. Corporate bond spreads have narrowed. And indicators of investment intentions have rallied sharply. As a result, the Committee judges that the conditions are in place for a stronger upswing in business investment than projected in November.

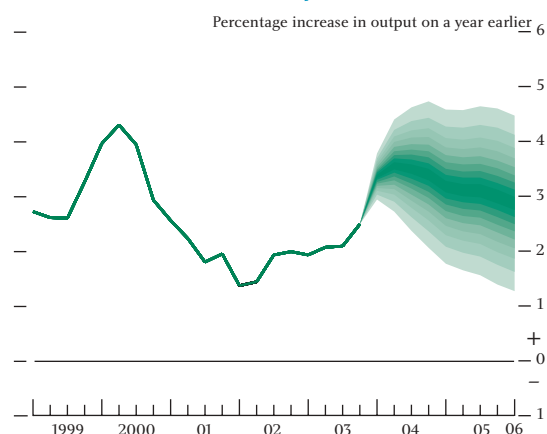
By convention, the MPC assumes that nominal government spending on goods and services will evolve in line with the Chancellor's latest projections. In the Chancellor's *Pre-Budget Report*, nominal government expenditure was projected to be higher than had been the case in his earlier Budget forecast.

The translation of that profile for nominal public spending into real public spending and output is not straightforward. As noted in Section 2, though nominal spending grew rapidly during the past few years, the ONS has reported much slower growth in the associated volume measure and a rapid rate of increase in the implied price deflator. That may reflect the inherent difficulty in measuring output in parts of the public sector. So although the nominal value of public expenditure can be projected forward with reasonable confidence, there is considerable uncertainty over how that will translate into the corresponding volume estimates. Fortunately, that uncertainty, though affecting the official estimates for GDP, has little bearing on the outlook for CPI inflation. In evaluating the impact of extra public spending on CPI inflationary pressures, what matters is the opportunity cost of the resources withdrawn from the private sector, not how effectively the resources are then used within the public sector.

Net trade made no contribution to GDP growth in Q3, in line with the projection in the November *Report*. Headline figures for trade continue to be affected by the closing down of VAT fraud.⁽¹⁾ Abstracting from that, export growth was probably quite strong in 2003 Q4, as the world economy improved further and as the effect of sterling's depreciation earlier in the year worked through. The continuing world recovery should help to ensure that exports grow at a healthy pace during the next two years. Imports should also regain some momentum, supported by strong domestic demand growth. The sterling ERI averaged 102.8 in the 15 working days to

(1) See the box on pages 18–19 of the August 2003 *Report* for a more detailed discussion of that fraud.

Chart 6.1
Current GDP projection based on constant nominal interest rates at 4.0%



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.

4 February, the starting point used for the MPC's central projection. Using the MPC's conventional approach⁽¹⁾ the level of sterling is assumed to depreciate to 99.9 by 2006 Q1—higher throughout than the level embodied in the November projection. The higher path for sterling means that the contribution to prospective GDP growth from net trade is a little weaker over the next two years than expected three months ago.

The Committee's latest projection for GDP growth at market prices is shown in Chart 6.1.⁽²⁾ It is based on the assumption that official interest rates are maintained at 4.0%.⁽³⁾ The four-quarter growth rate is projected to increase sharply at the beginning of 2004. Recent survey data are consistent with a pickup in quarterly growth. Revisions to 2003 Q3 and a higher expected outturn for 2003 Q4 also mean that the near-term profile for GDP growth in Chart 6.1 is somewhat stronger. Thereafter, the economy is likely to slow but still maintain a fairly brisk pace—broadly similar in the second year to November's projection.

6.3 The outlook for inflation

On 10 December 2003, the Chancellor announced a change in the MPC's target for the twelve-month inflation rate from 2.5% for RPIX to 2.0% for the consumer prices index (CPI). RPIX and CPI inflation are both affected by a combination of external and domestic pressures. Among the external influences, the price of oil was higher in dollar terms at the beginning of February than was implied by the November projection. But the profile of the futures curve, which is used to guide the MPC's projection, is slightly downward sloping during the next two years. In foreign-currency terms, the inflation rate of other goods and services that are sold to the United Kingdom should pick up as the world economy recovers. Overall, that represents a broadly similar outlook for world prices to that in November. However, these external influences are transmitted to the UK economy via the sterling exchange rate. During the past three months, sterling has appreciated by a little more than 2%, mainly against the dollar. And the higher value for the sterling ERI that is assumed throughout this forecast is one factor pushing down on the MPC's projection for UK inflation compared with three months ago.

The future path for inflation also depends on the balance between demand and supply in the domestic economy. Growth in the UK economy has been relatively slow in the past

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

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

(3) An alternative projection based on market interest rate expectations is shown in Chart 6.6 below.

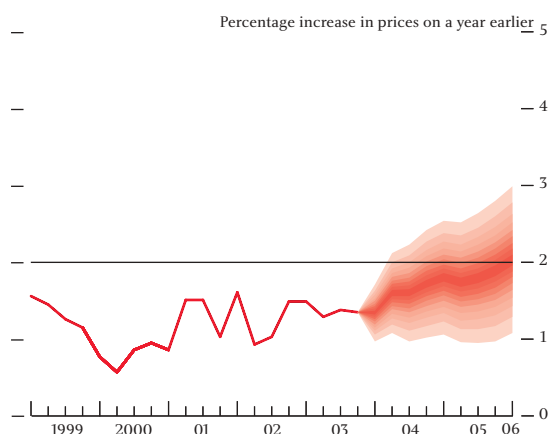
few years. And as a result, output has probably fallen below its potential level. Indeed, since the November *Inflation Report*, the level of GDP at basic prices has been revised down. The Committee believes that, because it excludes indirect taxes, this is a better measure of the volume of goods and services produced in the economy than GDP at market prices. The MPC has not revised down its estimate of potential output as a result of the new data, so the lower level of GDP at basic prices estimated by the ONS would be consistent with output being further below its potential level than the Committee believed in November. The Committee has also revised up marginally its assumption about future growth of potential output over the forecast period to reflect changes in its judgment about the likely evolution of the labour market.

Scant pressure on supply is apparent in recent outturns for the labour market. However, the projected above-trend GDP growth should translate into demand for extra labour. The Committee expects nominal earnings growth to rise in response. Labour productivity per person employed is projected to grow above its long-term annual average rate of around 2% through the forecast period. That should offset the impact of rising earnings on unit wage costs to some extent. In spite of that, unit wage cost growth is projected to rise into the medium term.

Some indicators (see Section 4) have suggested that price pressures have been edging up recently, though they remain reasonably subdued. And annual CPI inflation fell slightly to 1.3% in 2003 Q4, from 1.4% in Q3. The Committee's projection for CPI inflation is presented in Chart 6.2,⁽¹⁾ conditioned on the assumption that the official interest rate is maintained at 4.0%.⁽²⁾ Under the central projection, CPI inflation increases during 2004, as a number of factors, such as planned utility price increases, have a temporary impact on the overall inflation rate. Domestic inflationary pressures build throughout the next two years, accompanied in the latter part of the forecast period by the impact of increasing import prices as the world economy strengthens. So inflation continues to edge up towards the target through the second year of the projection.

Annual RPIX inflation fell in Q4 to 2.6%, from 2.8% in Q3. In order to facilitate a comparison with the outlook three months ago, Chart 6.3⁽³⁾ shows a forecast for RPIX inflation consistent with the projection for CPI inflation in Chart 6.2. That RPIX inflation projection is shown alongside the one that the Committee agreed for the November *Report* (see Chart 6.4) conditional on the assumption that interest rates were

Chart 6.2
Current CPI inflation projection based on constant nominal interest rates at 4.0%



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.

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

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

(3) Also shown as Chart 3 in the Overview.

Chart 6.3
Current RPIX inflation projection based on constant nominal interest rates at 4.0%

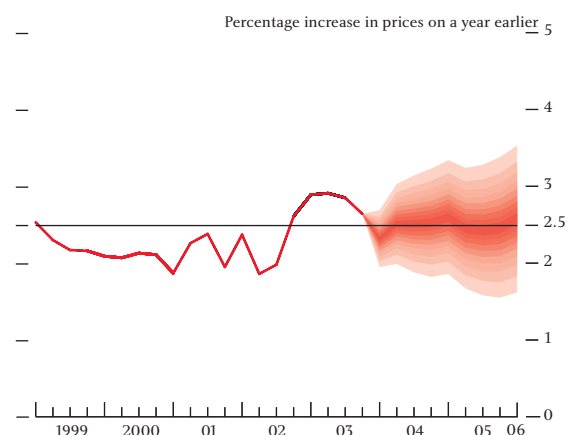
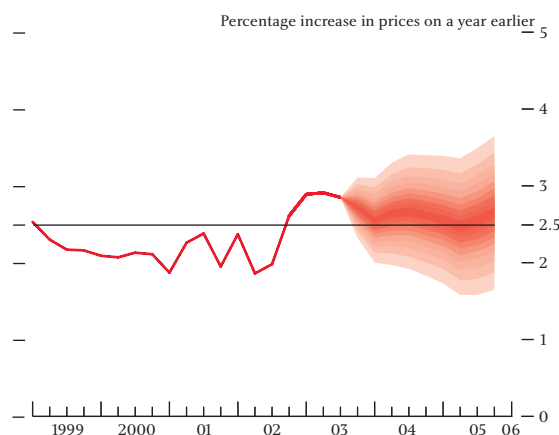


Chart 6.4
RPIX inflation projection in November based on constant nominal interest rates at 3.75%



The fan charts depict the probability of various outcomes for RPIX inflation in the future. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

maintained at 3.75%. Unlike CPI, RPIX is directly influenced by changes in house prices through its housing depreciation component.⁽¹⁾ As in November, RPIX inflation is projected to fall initially as the impact of house price increases on the index diminishes. RPIX inflation remains around 2.5% for much of the next two years, a similar profile to November. The impact of the stronger demand pressures on inflation is broadly offset by the higher level of sterling. With the contribution to RPIX inflation from the housing depreciation component expected to decrease to zero over the forecast period, the gap between RPIX and CPI inflation on the respective central projections is likely to narrow in two years' time to around 0.5 percentage points—the numerical difference between the inflation targets on the old and new measures.

The Committee's projections for CPI inflation and GDP growth conditioned on an estimate of financial markets' expectations for official interest rates are shown in Charts 6.5 and 6.6 respectively. That estimate of interest rate expectations, shown in Table 6.A, has been constructed from the 15-day averages of interest rates on government securities of the appropriate maturity. According to these estimates, the market expects interest rates to climb less steeply than it did in early November. Even so, the latest profile for market rates still slopes upward. Hence, the central projection for growth in Chart 6.6 is below that in the constant-rate version. The profile for CPI inflation is also lower, and less steep, under market interest rates, with the central projection just below the new target at the two-year horizon.

(1) See the box on page 36.

Chart 6.5
Current CPI inflation projection based on market interest rate expectations

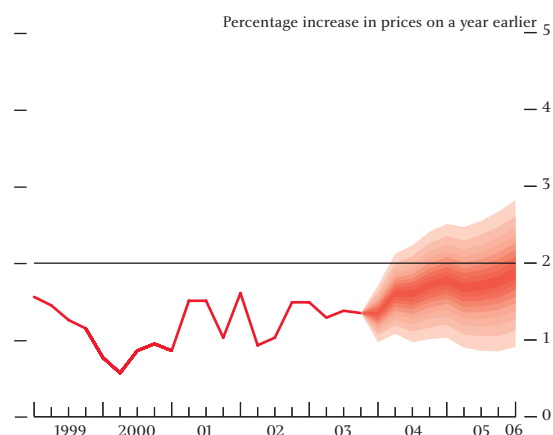


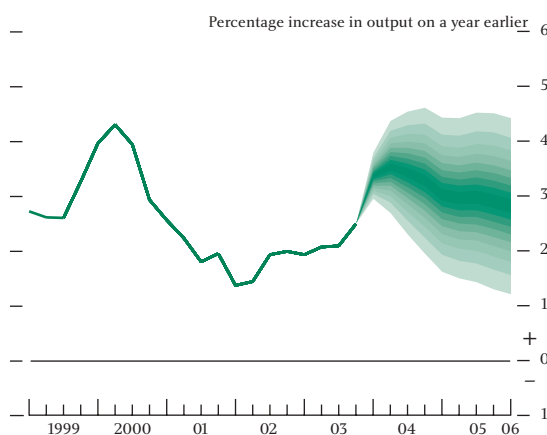
Table 6.A
Market expectations of the Bank's official interest rate^(a)

Per cent

2004				2005				2006
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
3.9	4.2	4.3	4.5	4.5	4.6	4.7	4.8	4.8

(a) Based on the interest rate available on gilt-edged securities, including those used as collateral in short-term repo contracts, plus a small upward adjustment to allow for the average difference between this rate and the Bank's official interest rate. The data are 15-day averages to 4 February 2004.

Chart 6.6
Current GDP projection based on market interest rate expectations



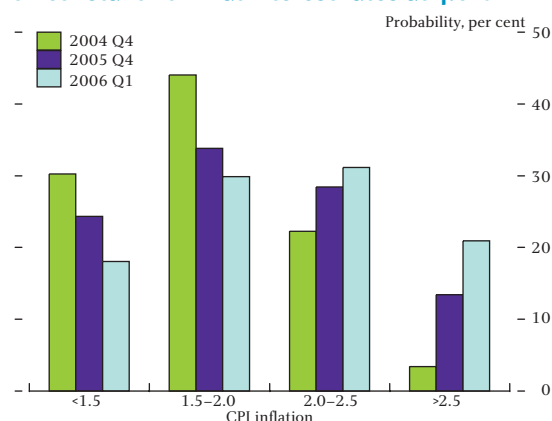
The prospects for output growth and inflation are, as always, uncertain. The fan charts illustrate the Committee's best collective assessment of the likelihood of possible outcomes, including judgments on the principal risks to the outlook. The width of the fan charts indicates how uncertain the Committee is about the prospects for the economy. It uses the experience of past forecast errors in making this judgment. As the Committee has agreed a forecast for CPI inflation for the first time to publish in this *Report*, there is no track record of forecast errors on which to base an estimate of uncertainty around the central projection. The MPC has provisionally decided that the errors made in forecasting RPIX inflation still provide a suitable yardstick by which to judge the likelihood of alternative future outcomes for CPI inflation. There has been little change to the level of the MPC's uncertainty about the outlook for GDP growth and inflation since November.

The Committee considers that there are a number of risks around the central projection. These chiefly concern the outlook for the world economy, the prospects for the UK household sector, earnings growth, and uncertainty about the degree of pressure on potential supply.

The continuing large current account deficit in the United States may prompt a further fall in the value of the dollar and a weaker outlook for world demand than is embodied in the central projection. Nevertheless, the Committee believes that there is less chance of the world recovery faltering than it did three months ago, as growth now seems more firmly based. So the downside risks from the world for UK activity prospects have diminished since November.

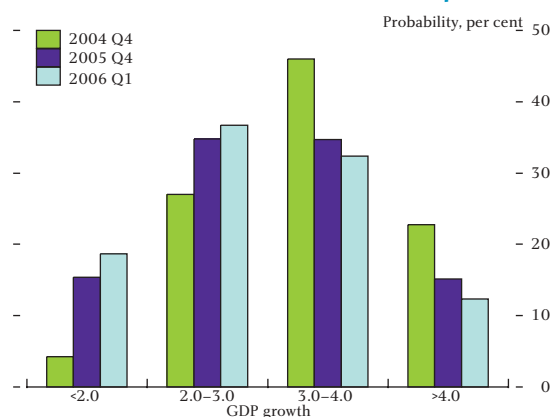
There are also risks to the outlook for UK household spending. The Committee may have underestimated the current momentum behind consumption growth and house price

Chart 6.7
The MPC's expectations for CPI inflation based on constant nominal interest rates at 4.0%^(a)



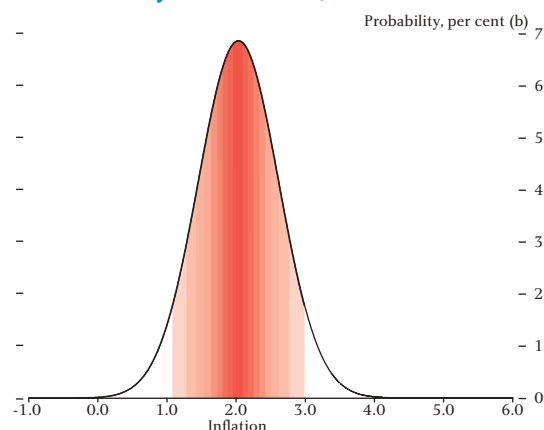
(a) These figures are derived from the same distribution as Chart 6.2. They represent the probabilities that the MPC assigns to CPI inflation lying within a particular range at a specified time in the future.

Chart 6.8
The MPC's expectations for GDP growth based on constant nominal interest rates at 4.0%^(a)



(a) These figures are derived from the same distribution as Chart 6.1. They represent the probabilities that the MPC assigns to GDP growth lying within a particular range at a specified time in the future.

Chart 6.9
Current projection for the percentage increase in CPI in the year to 2006 Q1^(a)



(a) This chart represents a cross-section of the fan in Chart 6.2 at the end of the forecast period. 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%.

inflation, which could give rise to stronger activity in the near term and thus higher inflation. But that would increase the chance of a sharper correction to house price inflation and consumption growth at a later date.

The rise in National Insurance contributions in 2003 has already reduced employees' take-home income. They may take the opportunity of the coming pay round to try to claw back some of that reduction in the form of higher money wages. That would raise inflationary pressures.

There is considerable uncertainty about the level of potential supply in the economy and its likely future development. The factors contributing to that uncertainty include: whether the recent fall in hours worked is structural or cyclical; the degree of labour market tightness consistent with stable wage pressure; the difficulty of assessing the margin of spare capacity within firms; and the responsiveness of labour supply, particularly in view of the forthcoming EU enlargement.

The Committee judges that the downside risks to activity have receded since November. The best collective judgment of the Committee is that the risks to the central projection for both GDP growth and CPI inflation are broadly balanced. The probabilities of various outcomes for CPI inflation and GDP growth are set out in Charts 6.7 and 6.8. The overall balance of risks to the inflation outlook at the two-year horizon is shown in Chart 6.9. Given the many uncertainties in the outlook, Committee members hold slightly different views on the most likely path for inflation and on the overall balance of risks.

At its February meeting, the Committee noted that at the then official interest rate of 3.75%, CPI inflation, though currently below the 2% target, was set to move up to above the target at the forecast horizon and beyond. Given that outlook for inflation, the Committee judged that an increase of 0.25 percentage points in the official interest rate to 4.0% was necessary to keep inflation on track to meet the target.

Other forecasters' expectations of CPI inflation and GDP growth

In January, the Bank asked a sample of external forecasters for their latest projections of CPI inflation (which became the targeted measure in December 2003), output growth, interest rates and the sterling ERI (see Table 1). The average forecast for CPI inflation is around the 2.0% target at the two-year horizon. Nearly two thirds of the forecasters expect inflation of between 1.8% and 2.1% (see Chart A). And, on average, the external forecasters see a 56% probability of CPI inflation being at or below 2.0% in two years' time (see Table 2). In the past, forecasters were asked for their projections of RPIX inflation, so that comparisons with previous forecasts are not possible.

By end-2004 and end-2005, GDP is projected, on average, to grow at around 2½%. That is almost the same as last November's projections.

On average, official interest rates are forecast to rise to 4.7% by end-2005. That is little changed compared with last November's external projections. Nearly two thirds of forecasters expect interest rates of between 4.3% and 5.2% (see Chart B) at the two-year horizon. The sterling ERI is expected to fall to 98.5 by end-2005—somewhat higher than the respective average forecasts last November.

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

	2003 Q4 (b)	2004 Q4	2005 Q4	2006 Q1
CPI inflation (c)	1.3	1.7	1.9	2.0
GDP growth (c)	2.5	2.6	2.5	2.4
Repo rate (per cent)	3.7	4.5	4.7	4.7
Sterling ERI (Index; 1990 = 100)	100.2	100.2	98.5	98.5

- (a) For 2004 Q4 and 2005 Q4, 25 forecasters provided the Bank with forecasts for CPI inflation, GDP growth and interest rates; and 22 gave ERI forecasts. For 2006 Q1, 23 forecasters provided forecasts for CPI inflation and interest rates; 22 gave forecasts of GDP growth; and 19 of the ERI.
 (b) Outturns. GDP growth is based on provisional ONS estimates for GDP at market prices. The repo rate and sterling ERI are daily averages.
 (c) Percentage changes on a year earlier.

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

CPI inflation

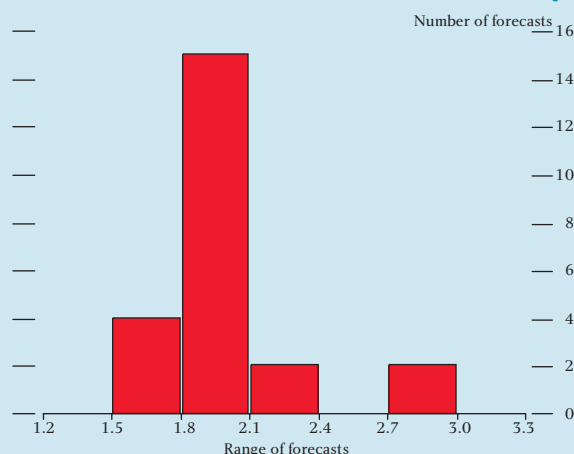
Probability, per cent	Range:					
	Less than 1.0%	1.0% to 1.5%	1.5% to 2.0%	2.0% to 2.5%	2.5% to 3.0%	More than 3.0%
2004 Q4	8	25	39	19	7	2
2005 Q4	7	17	33	25	13	5
2006 Q1 (b)	7	17	32	24	14	6

GDP growth

Probability, per cent (c)	Range:			
	Less than 1%	1% to 2%	2% to 3%	More than 3%
2004 Q4	5	20	47	29
2005 Q4	9	23	43	26
2006 Q1 (b)	10	25	41	24

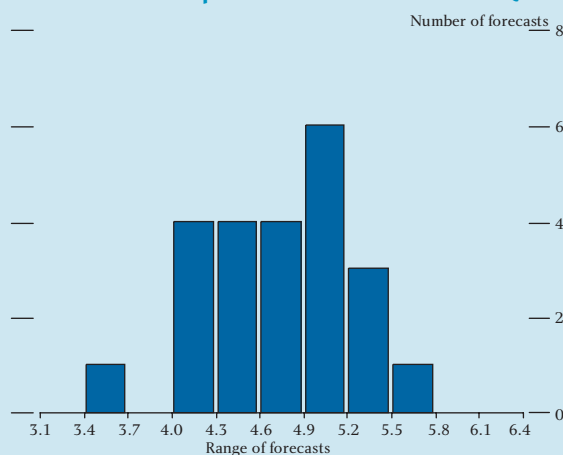
- (a) 25 forecasters provided the Bank with their assessment of the likelihood, at three time horizons, of expected twelve-month CPI inflation and four-quarter output growth falling in the ranges shown above. For example, on average, forecasters assign a probability of 7% to CPI inflation turning out to be less than 1.0% in 2005 Q4.
 (b) 25 forecasters.
 (c) Figures may not sum to 100 due to rounding.

Chart A
Distribution of CPI inflation forecasts for 2006 Q1



Source: Central projections of 23 outside forecasters as of 30 January 2004.

Chart B
Distribution of repo rate forecasts for 2006 Q1



Source: Central projections of 23 outside forecasters as of 30 January 2004.

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Bank of England

Agents' summary of business conditions

February 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-October 2003 and mid-January 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 and new orders have continued to improve steadily, with contacts expecting further recovery in the months ahead. But production levels remain below capacity.
- Construction output continued to grow rapidly. The dichotomy remained of strong demand from the public sector and weak activity in the private non-residential sector.
- Confidence in the housing market may have picked up after the start of the New Year. There were few signs that confidence had been dented by November's increase in the repo rate. Nonetheless, national house price inflation was expected to moderate in the coming months.
- The recovery in the service sector continued to gather pace and output was perhaps close to normal levels of capacity. Output growth in the business service sector increased sharply.
- Volume growth in retail sales recently may have been stimulated by lower retailers' prices and margins.
- Overseas demand continued to recover, with the United States and the Far East being the strongest markets. There were fewer signs of recovery in the euro area and the German market was particularly subdued.
- Investment intentions were around their highest level for nearly three years. Optimism was much improved in the business service sector. Manufacturers were still expecting to reduce capital spending slightly in the months ahead, but to a lesser extent than hitherto.
- Regional labour markets may have tightened a little further.
- Private sector settlements in the forthcoming pay round were, on average, expected to be close to the levels of a year earlier. Some further upward pressure on labour costs was likely from non-wage costs, such as employers' pension contributions.
- Upward pressure on input prices continued. But that was ameliorated to some extent by sterling's appreciation against the dollar, which reduced the sterling value of some commodities that are priced in dollars.

(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

Farming continued to benefit from the strength of the euro, both through its effect on subsidy payments and because of reduced overseas competition. Official data suggest there was a sharp pickup in coal production in 2003 Q4. The price competitiveness of domestic producers improved, assisted by increased wholesale prices. That could underpin demand for domestic coal in 2004. Looking further ahead, difficulties in securing planning permission for open-cast mines could affect output by harming cost competitiveness. Oil production continued to decline in 2003 Q4, which was partly the result of maintenance work in the North Sea.

Manufacturing

Although production remained below capacity, manufacturing output and new orders continued to improve. The recovery, which was becoming more broadly based, was expected to strengthen in the months ahead. Output growth was strongest in the consumer and intermediate goods sectors. Business confidence was most upbeat in those industries, such as food processing and building products, where the scope for international competition was limited by transport costs and other factors. By contrast, many manufacturers that are exposed to international competition were concerned about the depreciation of the dollar, which declined by about 10% against sterling during the reporting period. That reduced the competitiveness of UK producers not only relative to US firms, but also compared with businesses located in Asian countries that set their prices in dollars. (During the same period, sterling was little changed against the euro.) The capital goods sector, where overseas competition was strong, generally remained subdued.

Construction and housing

Agencies reported that construction output continued to grow rapidly. But the dichotomy remained of strong demand from the public sector and weak activity in the private non-residential sector. Some contacts thought that public sector projects would sustain growth in orders well into 2005, while NHS-related work could underpin many firms' order books for up to a decade ahead. By contrast, excess capacity of office space, particularly in Greater London, was not expected to clear until at least 2005. And some contacts were not anticipating a major upturn in demand for new commercial property until 2006. Overall, however, the

strength of public sector work, which for some contacts accounted for a large proportion of their order books, meant that an increasing number of businesses were faced with capacity constraints, in part the result of labour shortages.

House builders continued to report skill shortages and difficulties in securing planning permission, which was restricting the number of new housing developments. Prices of new houses increased strongly over the past year. Contacts suggested that, to some extent, this reflected a continuing trend of quality improvements to the average house. Prices of new houses had increased by much less on a like-for-like basis. The home improvements market was reported to be buoyant. In addition, some house builders were expecting to increase the number of completions in the year ahead, which was in part the result of very strong current reservations. This would be consistent with a growing demand for housing that was perhaps underpinned by expectations of further house price increases in 2004.

Consistent with that, the Agencies reported some signs of a pickup in confidence in the housing market after the start of the New Year. There were few signs that confidence had been dented by November's increase in the repo rate, or the possibility that interest rates could rise further or that house prices might fall. Nonetheless, contacts were expecting national house price inflation to moderate in the coming months. That was mostly the result of declining affordability, particularly for first-time buyers.

Services

The recovery in the service sector continued to gather pace and output was perhaps close to normal levels of capacity. Agencies reported that output growth in the business service sector had increased sharply since last spring and by early 2004 may have risen to its fastest rate for nearly three years. By comparison, output growth of consumer services may have been both slower and steadier recently.

Within business services, the recovery was spreading to financial services, including corporate finance and mergers and acquisitions related work, and to the provision of information technology (IT) services. Business confidence in the financial services sector was boosted by the recovery in world equity markets in 2003, which was associated with rising profits of financial companies. There was stronger growth in the outsourcing of IT services, as both public and private organisations looked for ways to cut costs. But contacts were more cautious in raising their budgets for

marketing and advertising, the return on which was perhaps less certain at the moment. In the consumer services sector, data for late 2003 indicated increased growth in the number of aeroplane passengers, while travel agents reported strong growth in holiday bookings for 2004.

DEMAND

Consumption

Agencies' reports painted a fairly uniform picture of brisk consumer demand immediately before Christmas and continuing into the winter sales, following a comparatively weak start to December. Overall, the growth of retail sales volumes appeared to have picked up in December as a whole, from the subdued rate in November indicated by official data. The price sensitivity of consumers seemed to have increased competition between retailers, resulting in a greater market share for, amongst others, the major supermarkets and internet retailers. That also may have forced some retailers to bring forward the timing of their winter sales to before Christmas, in order to stimulate demand and clear excess stocks. During December, there were some concerns that demand might slacken after Christmas, by which time consumers could be 'spent out'. In the event, most contacts were reasonably upbeat about the level of trading in the first half of January, suggesting some positive growth of retail sales volumes compared with December.

Exports and imports

Overseas demand continued to recover. Contacts reported that the United States and the Far East were still the strongest markets, consistent with the relatively rapid growth of GDP in those regions. There were fewer signs of recovery in demand in the euro area, and the German market was particularly subdued. The Agents' reports suggested that export margins declined quite sharply in the past three months. The dollar's depreciation required many exporters to cut margins to below normal levels in those markets where prices were set in dollars. Some contacts reported that exports to the United States were only profitable below an exchange rate of around \$1.60 to \$1.70. Above these levels, unless these contacts had hedged against the dollar's fall, they were forced to accept a loss to retain orders. There were particular concerns that the dollar's depreciation was giving already competitive Asian businesses an even greater price advantage, both in contacts' export markets and in the United Kingdom. For example, it appeared that imports of consumer goods were especially buoyant in the run-up to Christmas. Unless the dollar appreciated

somewhat against sterling, some contacts expected their order books to weaken. While the appreciation of the euro against sterling in early 2003 was of some help in attracting new orders, that was at least partly offset by the recent weakness of euro-area domestic demand. The Agencies reported further relocation of manufacturing capacity overseas. That would probably have deleterious effects on the goods trade balance in the short term. But it was also increasing exports of business services such as consultancies, which in some cases were employed to assist with the relocation.

Investment

Investment intentions were around their highest level for nearly three years. Manufacturers were still expecting to reduce capital spending slightly in the months ahead, but to a lesser extent than at the time of the previous *Report*. By contrast, the mood was much brighter in the business service sector. Many contacts were looking to increase their IT investment, encouraged by falling prices of IT hardware. Some stressed that modern IT systems are usually modular in design and are amenable to incremental improvement rather than requiring replacement of the entire system. That would be consistent with an increase in the productivity of IT investment, as firms would be more likely to replace only those parts of their systems that were obsolete.

EMPLOYMENT

Regional labour markets have tightened a little further. In 2003 Q4, employment growth may have increased and the Agencies estimated that skill shortages rose to their highest level for over two years. In the service sector, a broader range of contacts were expecting to increase their payrolls than at the time of the previous *Report*. Some recruitment agencies reported a strong end to the year, after weakness in 2003 Q3, with increased demand for people with skills in IT and telecommunications. Employment prospects were generally the brightest for those companies providing services to the public sector. Manufacturing continued to shed jobs, but at a slower rate. Job contraction in manufacturing continued to blight the attractiveness of working there, so that manufacturers found it difficult to recruit new staff. For some manufacturing contacts, the average age of their workforce had increased to over 50.

COSTS AND PRICES

Pay

Private sector settlements in the forthcoming pay round were, on average, expected to be close to the levels of a

year earlier. But some further upward pressure on labour costs was likely from non-wage costs, such as employers' pension contributions.

Factors that might put some upward pressure on private sector settlements included a slightly tighter labour market at the start of 2004 than a year earlier; last year's increases in Council Tax and employees' National Insurance and pension contributions; relatively high public sector pay rises in 2003 that could encourage some 'catch up' in the private sector in 2004; and the recent 7% increase in the National Minimum Wage that eroded differentials for lower-paid staff.

Even so, most contacts expected to resist those pressures successfully, so that the majority of settlements would remain in the range of 2%–4%. Workforces were thought to have a realistic view of what employers could afford. It was noted that many employers in the service sector were gradually moving away from a system of general pay awards, towards increases based on individual performance. Greater pay flexibility of this kind might be reflected in lower average pay settlements than in the past, but a larger degree of wage drift (measured by the difference between average earnings growth and pay settlements). In the financial services sector, bonus payments between December 2003 and March 2004 were expected to be around 10% higher on average than a year earlier.

Input prices

Upward pressure on input prices continued during the previous three months. But that was ameliorated to some extent by sterling's appreciation against the dollar, which

reduced the sterling price of some commodities that are priced in dollars.

Contacts were paying increasing attention to the efficiency of their procurement and purchasing systems. With sustained downward pressure on many manufacturers' output prices, often margins could only be maintained if unit costs were reduced. To that end, firms were increasingly adept at shopping around for cheaper suppliers, including the use of internet auctions for purchasing materials and other inputs. This suggests that official indices may overestimate the extent to which producer input prices have increased over the past year or so, as they do not take into account changes in firms' spending patterns.

Output and retail prices

Agencies reported that, for some retailers, margins fell sharply over the Christmas period. To some extent, that could reflect temporary seasonal factors. For instance, the relatively mild weather reduced the demand for winter clothing and necessitated price discounting by some retailers to clear their stocks. But the Agencies also reported greater competitive pressures on the high street (see above), so that some of the recent downward pressure on retail margins could be sustained. Also, the dollar's depreciation could result in further declines in the prices of clothing and footwear in the months ahead, as Far-Eastern businesses that set their prices in dollars are major suppliers in those markets. Against that, there were some signs of increased inflationary pressure recently, most notably in the regulated sector. For example, some contacts were concerned about the size of recent increases in their gas and electricity bills.

Text of Bank of England press notice of 4 December 2003

Bank of England maintains interest rates at 3.75%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 3.75%.

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

Text of Bank of England press notice of 8 January 2004

Bank of England maintains interest rates at 3.75%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 3.75%.

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

Text of Bank of England press notice of 5 February 2004

Bank of England raises interest rates by 0.25 percentage points to 4.0%

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

The Committee reviewed monetary and economic developments in the light of its latest quarterly projections for output and inflation, to be published in the February *Inflation Report*.

The world economic recovery has become more broadly based. In the United Kingdom, output growth in the second half of last year was above trend and business surveys point to a further pickup in the first quarter. Household spending and borrowing have been resilient, and the housing market remains strong.

Although sterling has appreciated, continued growth above trend means that inflationary pressures are likely to pick up gradually over the next couple of years. Against that background, and despite CPI inflation currently below the 2% target, the Committee judged that an increase of 0.25 percentage points in the repo rate to 4.0% was necessary to keep CPI inflation on track to meet the new 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 February.

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

Glossary and other information

Glossary of selected data

AEI: average earnings index.

CPI: consumer prices index.

CSPI: corporate services price index.

ERI: exchange rate index.

GDP: gross domestic product.

HICP: harmonised index of consumer prices.

LFS: Labour Force Survey.

MO: notes and coin in circulation outside the Bank of England and bankers' operational deposits at the Bank.

M4: UK non-bank, non building society private sector's holdings of notes and coin, plus all sterling deposits (including certificates of deposit) held at UK banks and building societies by the non-bank, non building society private sector.

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

PMI: purchasing managers' index.

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.

CBI: Confederation of British Industry.

CIPS: Chartered Institute of Purchasing and Supply.

CML: Council of Mortgage Lenders.

DTI: Department of Trade and Industry.

EU: European Union.

FTSE: Financial Times Stock Exchange.

GC: general collateral.

GfK: Gesellschaft für Konsumforschung, Great Britain Ltd.

HBF: House Builders Federation.

HM: Her Majesty's.

ICT: information, communications and technology.

IMF: International Monetary Fund.

IRS: Industrial Relations Services.

ISM: Institute for Supply Management.

IT: information technology.

M6: major six economies: Canada, France, Germany, Italy, Japan and the United States.

MFI: monetary financial institutions.

MFP: multi-factor productivity.

MPC: Monetary Policy Committee.

MTIC: missing trader intra-community.

NBER: National Bureau of Economic Research.

NHS: National Health Service.

NICs: National Insurance contributions.

NOC: non-oil commodity.

ODPM: Office of the Deputy Prime Minister.

OECD: Organisation for Economic Co-operation and Development.

ONS: Office for National Statistics.

PNFCs: private non-financial corporations.

S&P: Standard and Poor's.

SARS: severe acute respiratory syndrome.

SDR: special drawing rights.

VAT: value added tax.

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.