



Inflation Report

November 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 judgement about the most likely paths for inflation and output, and the uncertainties surrounding those central projections.

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

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

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

Overview

Global growth has remained strong despite higher oil prices. In the United Kingdom, consumer spending growth moderated and the housing market slowed, while investment accelerated and sterling fell. Output growth is estimated by the ONS to have dipped sharply in Q3, though business surveys suggest a more modest easing. In the Committee's central projection, assuming official interest rates follow a path implied by market yields, four-quarter GDP growth lies close to trend over the forecast period. Pay growth remained subdued, though other cost pressures increased. Annual CPI inflation fell to 1.1% in September. On the central projection, inflation picks up next year, reflecting the pressure of demand on supply and higher import and energy costs. Inflation then rises more slowly, reaching the 2% target after two years, and continues to rise a little thereafter.

The international economy

Since the *August Report*, spot oil prices have exceeded \$50 per barrel and are substantially higher than at the start of this year. The recent sharp increase reflects continued tensions in the Middle East, strong demand growth, and weather-related and other disruptions to supply. The associated increase in futures prices suggests that higher oil prices are likely to persist into the medium term, though the real price of oil remains well below previous historic peaks. Coupled with the reduced oil intensity of economic activity, that suggests the adverse impact on world economic prospects should be relatively limited. Moreover, market interest rates declined internationally and equity prices rose, which should help to offset the impact of higher oil prices on aggregate demand.

Though output growth in the industrialised countries eased in the spring, global growth in 2004 is likely to approach rates last seen nearly thirty years ago. Euro-area output growth moderated slightly in Q2, but remained close to trend, and business surveys point to a similar pace of expansion in the subsequent quarter. After easing in the second quarter, GDP growth in the United States picked up a little, underpinned by resurgent consumer spending and healthy growth in investment. In Asia, China remains a significant expansionary force and the available indicators point to continued recovery in private sector demand in Japan, despite a sharp dip in GDP growth in Q2. Global growth is expected to moderate slightly next year, partly reflecting the higher oil price, but the prospect is for continued steady growth thereafter. The Committee judges the outlook for UK export markets to be broadly similar to that in the *August Report*.

The foreign currency prices of internationally traded goods and services picked up, reflecting the impact of higher energy and materials prices and the erosion of spare capacity. As a consequence, the outlook for international export prices is rather stronger than in August.

Demand in the United Kingdom

In the United Kingdom, the past few years have been characterised by a vigorous expansion in public spending, robust growth in private consumption and weakness in investment and net trade. Some rebalancing in the composition of demand now appears to be in prospect. Revised data suggest that, after brisk growth in the first quarter, consumers' expenditure rose by 0.6% in Q2. Sales data and reports from retailers point to a similar rate of expansion through the second half of this year.

House price inflation has declined a little more sharply than anticipated in August. The MPC's central projection implies that house prices may fall modestly for a period. But the outlook for house prices is extremely uncertain. Lower house price inflation should restrain household spending growth, though the Committee believes that currently the link between house prices and consumers' expenditure is probably somewhat weaker than past relationships suggest.

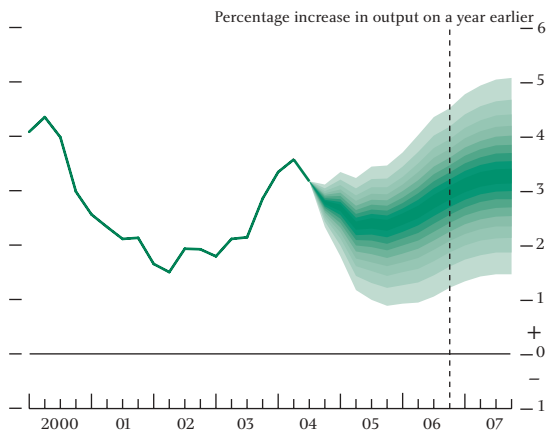
The revival in investment continued. Capital expenditure by businesses rose 2.6% in Q2, the fifth consecutive quarter of expansion. Although business confidence slipped back and some indicators of investment intentions weakened, higher profits and ample corporate liquidity point to continued healthy growth in capital spending by businesses.

The effective exchange rate for sterling has depreciated by nearly 4% since August, returning it to levels seen at the start of this year. The fall cannot be attributed solely to movements in relative market interest rates and may also have reflected concerns about the trade deficit. The lower value of sterling will help to boost the contribution to growth of net trade.

The outlook for GDP growth

Quarterly GDP growth is provisionally estimated by the ONS to have dipped to just 0.4% in Q3, reflecting a sharp contraction in the industrial sector. But business surveys and reports from the Bank's regional Agents suggest that manufacturing continued to expand, albeit at a more moderate rate than previously. The Committee has given some weight to this survey information when assessing the underlying pace of economic expansion.

Chart 1
Current GDP projection based on market interest rate expectations



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

Chart 1 shows the MPC's assessment of the outlook for four-quarter GDP growth under the assumption that official interest rates evolve according to market expectations. Under the central projection, output growth eases slightly below trend next year and then gradually picks back up. The early part of the forecast period is characterised by strong growth in government consumption and private investment, offset by a continuing drag from net trade. Public spending and private investment subsequently decelerate, but that is offset by a turnaround in the net trade contribution driven by the lower sterling exchange rate. Household spending growth eases a little and then recovers. Overall, the increase in GDP over the next two years is broadly the same as in the August projection, though the dip in growth occurs earlier and is rather less pronounced. Downside news on the near-term demand for UK output is offset by the expansionary impact of the decline in sterling, lower market interest rates and higher equity prices.

Costs and prices

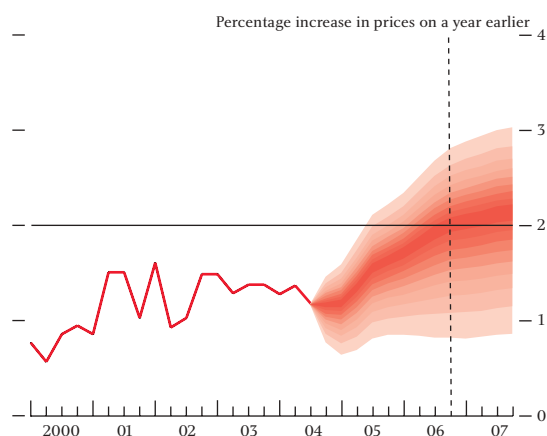
Official data continue to suggest weak employment growth through this year. That is surprising given the above-trend growth in output and the decline in average hours worked. While the associated increase in productivity may reflect the normal cyclical unwinding of labour hoarding, it could also indicate a pickup in the underlying rate of productivity growth. Or it could reflect difficulty in finding suitable workers in a labour market where the unemployment rate stands at a 29-year low. Despite the tight labour market, pay pressures remained subdued. Settlements have changed little over the past year and though annual growth in regular pay per head edged up, there are signs that it may be stabilising. The apparent absence of inflationary pressures emanating from within the labour market may reflect the beneficial impact of past structural reforms and increased reliance on migrant workers to relieve staff shortages.

But other cost pressures picked up. Apart from higher oil prices, other energy and metals prices rose, though the cost of agricultural commodities fell. The price of manufacturers' inputs increased at its fastest annual rate for nearly four years and manufacturers' output price inflation also drifted up. Business surveys suggest continued upward pressure on output prices is likely. In contrast, service sector inflation appears stable.

The price of imported goods and services increased, reflecting the pickup in global trade prices. The recent depreciation of sterling is likely to accentuate this tendency.

CPI inflation eased to 1.1% in the year to September, reflecting in particular weakness in the prices of food and transport

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



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

services. Consumer price inflation has been unusually low in recent years. In part, that reflects the increased exploitation of the gains from international trade and the consequent downward pressure on the price of some consumer goods. But it may also reflect increased competition and structural change in the UK distribution sector. Inflation prospects depend to a degree on whether these trends will continue.

The outlook for inflation

Chart 2 shows the Committee's assessment of the outlook for CPI inflation, also assuming that official interest rates move in line with market yields. On the central projection, inflation picks up next year, reflecting the pressure of demand on supply and higher import and energy costs. Inflation then rises more slowly, reaching the 2% target after two years, and continues to rise a little thereafter. The profile is similar to that in the *August Report*.

As usual there are considerable risks surrounding the central projections. Particular uncertainties relate to: the oil market; the evolution of the global current account imbalances; the prospect for house prices and the associated impact on consumption; wages; and the reaction of prices to demand and cost pressures. Relative to the central projection, the Committee judges that the overall risks to growth and inflation are somewhat to the downside. There is a range of views among members, though the differences are small.

The policy decision

At its November meeting, the Committee noted that, under the central projection, growth was near trend with inflation reaching the 2% target after two years and continuing to rise a little thereafter. There were considerable uncertainties surrounding these projections and the balance of risks was somewhat to the downside. In the light of this outlook, the Committee judged that no change in the current level of the official interest rate was necessary to keep inflation on track to meet the target in the medium term.

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The MPC has left the official interest rate unchanged since the August Report. But market interest rates have fallen. The sterling ERI has declined by around 4% since August. Equity prices have risen, despite the higher oil price. House price inflation has eased. Narrow money growth has edged lower, but broad money growth has strengthened. Household borrowing growth remained strong.

1.1 Asset prices

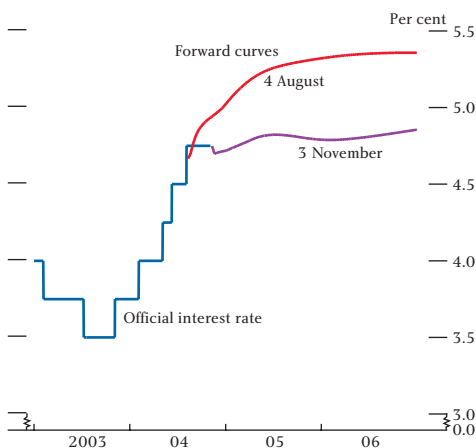
Short-term interest rates

The Monetary Policy Committee (MPC) has operational responsibility for meeting the Government's inflation target. It does this by setting the short-term interest (repo) rate at which the Bank of England deals in the money markets. Since the August Report, the Committee has left the official interest rate unchanged at 4.75%.

Market expectations for the path of official interest rates over the next few years have fallen by around 0.5 percentage points since the August Report. Three months ago, market participants were expecting further rises in official rates, according to estimates derived from short-term market interest rates. But on 3 November, participants expected the official interest rate to remain broadly unchanged over the next two years (Chart 1.1). The latest Reuters poll of selected economists also suggests that respondents expected lower interest rates over the next twelve months than they did in August. On average, economists expected rates to be around 4.8% at the end of 2005, down from over 5% three months ago.

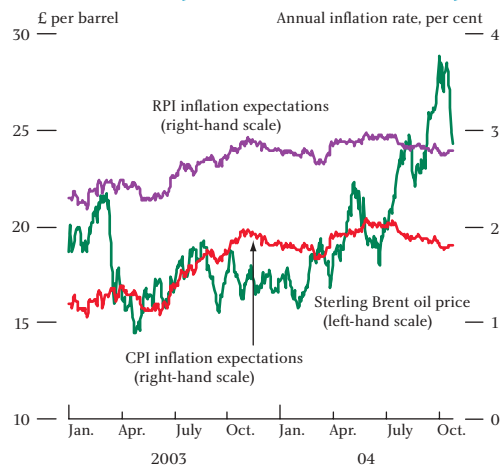
The ECB and the Bank of Japan have also left official interest rates unchanged since the August Report. In contrast, the FOMC raised the official US interest rate twice during the same period, to 1.75%. Futures contracts on 3 November pointed to gradual rises in rates in the euro area and Japan over the next two years. But market participants expected a more rapid tightening of policy in the United States, including a 25 basis point rise at the meeting on 10 November.

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



(a) The forward curves have been derived from instruments that settle on the London interbank offered rate (Libor). That includes the market rates on futures, swaps, interbank loans and forward rate agreements, adjusted for credit risk.

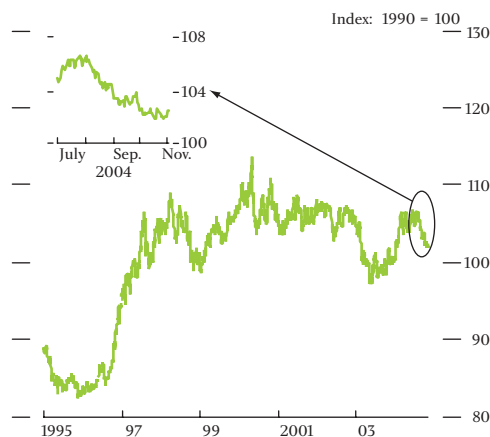
Chart 1.2
UK inflation expectations^(a) and the oil price



Sources: Bank of England and Thomson Financial Datastream.

(a) Implied expectations of average RPI inflation three to six years ahead are derived from the difference between yields on nominal and index-linked government bonds. Implied CPI inflation expectations are derived from these RPI inflation expectations and stylised assumptions about expected differences between RPI and CPI inflation in the medium term. In particular, it is assumed that effective mortgage rates change in line with market interest rate expectations; both mortgage debt and housing depreciation grow by 4.5% per year; Council taxes grow at their average rate since the inception of the MPC; and geometric averaging lowers CPI inflation by 0.5 percentage points relative to RPI inflation.

Chart 1.3
The sterling ERI



Longer-term interest rates and inflation expectations

Government bond yields offer a guide to market expectations of the official interest rate over the medium to long term. Medium-term rates have declined over the past three months. Between early August and early November, UK nominal forward rates three to five years ahead fell by around 35 basis points. And there were similar falls in the other major economies. But the fall in long-term rates in the United Kingdom has been less pronounced: UK forward rates ten years ahead fell by less than 10 basis points. At the same maturity, falls in the United States, and to a lesser extent the euro area, were somewhat larger. Measures of real yields, based on index-linked bonds and inflation swaps, have also fallen in all three economies.

The difference between yields on nominal and index-linked government bonds provides an indication of the inflation expectations held by participants in financial markets. In the United Kingdom, such measures have remained broadly unchanged over the past year, despite the rise in the oil price: Chart 1.2 shows implied inflation expectations for RPI and CPI in three to six years' time. There has also been little movement in survey evidence on inflation expectations.

Market-based measures of inflation expectations in the euro area have also remained broadly stable. Measures of US inflation expectations have picked up a little at the shorter end of the curve, possibly in response to the higher oil price, but remain relatively low. Economists' forecasts for US inflation in 2005 are little changed from August.

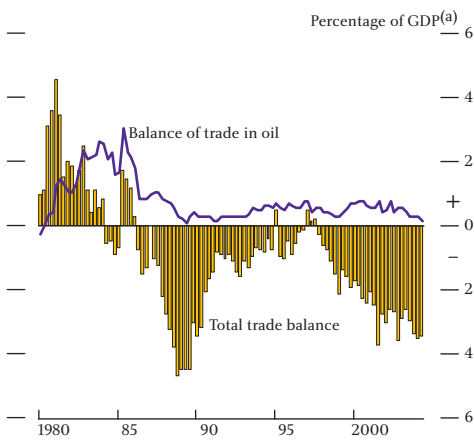
Exchange rates

The sterling effective exchange rate index (ERI) is a measure of the UK exchange rate against a basket of other currencies, weighted according to their importance in UK trade. In the fifteen working days to 3 November, the sterling ERI averaged 102.1. That was the starting point in the MPC's projections, and was 3.9% below the equivalent average at the time of the *August Report* (Chart 1.3).

The fall in sterling could reflect several factors. In the absence of risk premia, market participants expect future changes in exchange rates to equalise returns across different currencies. So, other things being equal, an unexpected fall in UK interest rates should lead to an immediate sterling depreciation. Participants would then expect a faster appreciation than before — or a slower depreciation — to compensate for the lower returns on sterling-denominated assets.⁽¹⁾ The UK yield

(1) For more information see Brigden, A, Martin, B and Salmon, C (1997), 'Decomposing exchange rate movements according to the uncovered interest rate parity condition', *Bank of England Quarterly Bulletin*, November, pages 377–89.

Chart 1.4
UK trade balances



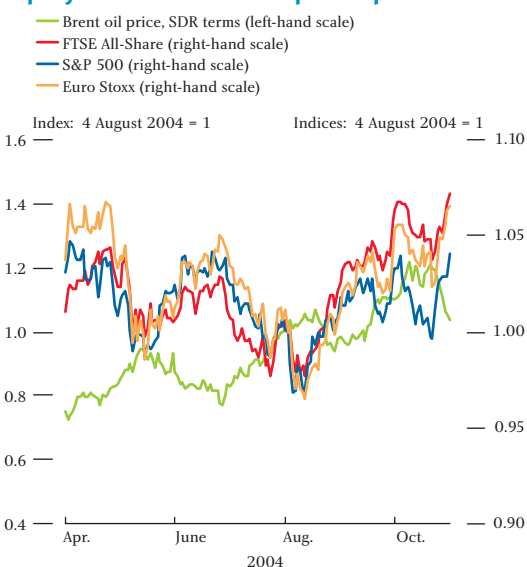
curve has fallen compared with other major economies since August, particularly at the short end. But this decline is not enough to explain the size of the fall in the sterling exchange rate.

Alternatively, the depreciation could reflect a rise in the risk premium associated with sterling, compared with other currencies. But it is hard to find corroboratory evidence from option prices for such an increase in the risk premium. Sterling's depreciation could also reflect longer-term factors. In particular, market participants may have become more concerned about the sustainability of the UK trade deficit, which has averaged more than 3% of GDP during the past year. These concerns may have been exacerbated by the modest underlying pace of recovery in UK exports (see [Section 2](#)) and the United Kingdom's declining trade surplus in oil (Chart 1.4).

Equity prices

The FTSE All-Share index averaged 2301 in the 15 working days to 3 November — the starting assumption used in the MPC's latest projections. That was 6.0% higher than the corresponding average at the time of the *August Report*. There have been smaller rises in euro-area and US equity indices since August, and the Japanese Topix fell.

Chart 1.5
Equity indices^(a) and the spot oil price



Sources: Bank of England and Thomson Financial Datastream.

(a) In domestic currency terms.

Between May and August this year, equity prices in the United Kingdom, the United States and the euro area moved in the opposite direction to the oil price (Chart 1.5). That suggests that financial market participants interpreted the higher oil price as a negative influence on profitability. But during September, both the oil price and the FTSE All-Share rose. What could have driven the pickup in UK equities?

Equity prices are affected by the future earnings that investors expect to receive. The fall in sterling should increase the sterling value of foreign currency earnings of UK companies. It should also improve the competitiveness of UK companies selling abroad, raising profitability. Earnings per share have risen a little since August. However, evidence from IBES shows that long-term earnings expectations have edged lower. Overall, changes in the prospects for earnings do not appear to be able to account for the full extent of the rise in equity prices.

Equity prices are also affected by the rate at which market participants discount future earnings. If this discount rate falls, equity prices should rise. UK real yields have fallen since August, which should lower the discount rate. In addition, it is possible that investors now perceive equities to be less risky.

Any fall in the risk premium would also lower the discount rate, and boost equity prices.

The housing market

According to the Halifax and Nationwide indices, house price inflation has begun to ease (Table 1.A). For the first time in three years, both measures reported modest falls in house prices in October: the Nationwide index fell by 0.4%, and the Halifax index by 1.1%.

Different housing market indicators record activity or prices at different points in the house-buying process, as shown in Chart 1.6. The Halifax and Nationwide price indices for October relate to offers made around a month earlier, and those buyers are likely to have begun searching in the summer. Activity and price indicators at the start of the purchase timeline weakened in early summer, and remain weak now. In fact, a whole series of indicators along the purchasing chain

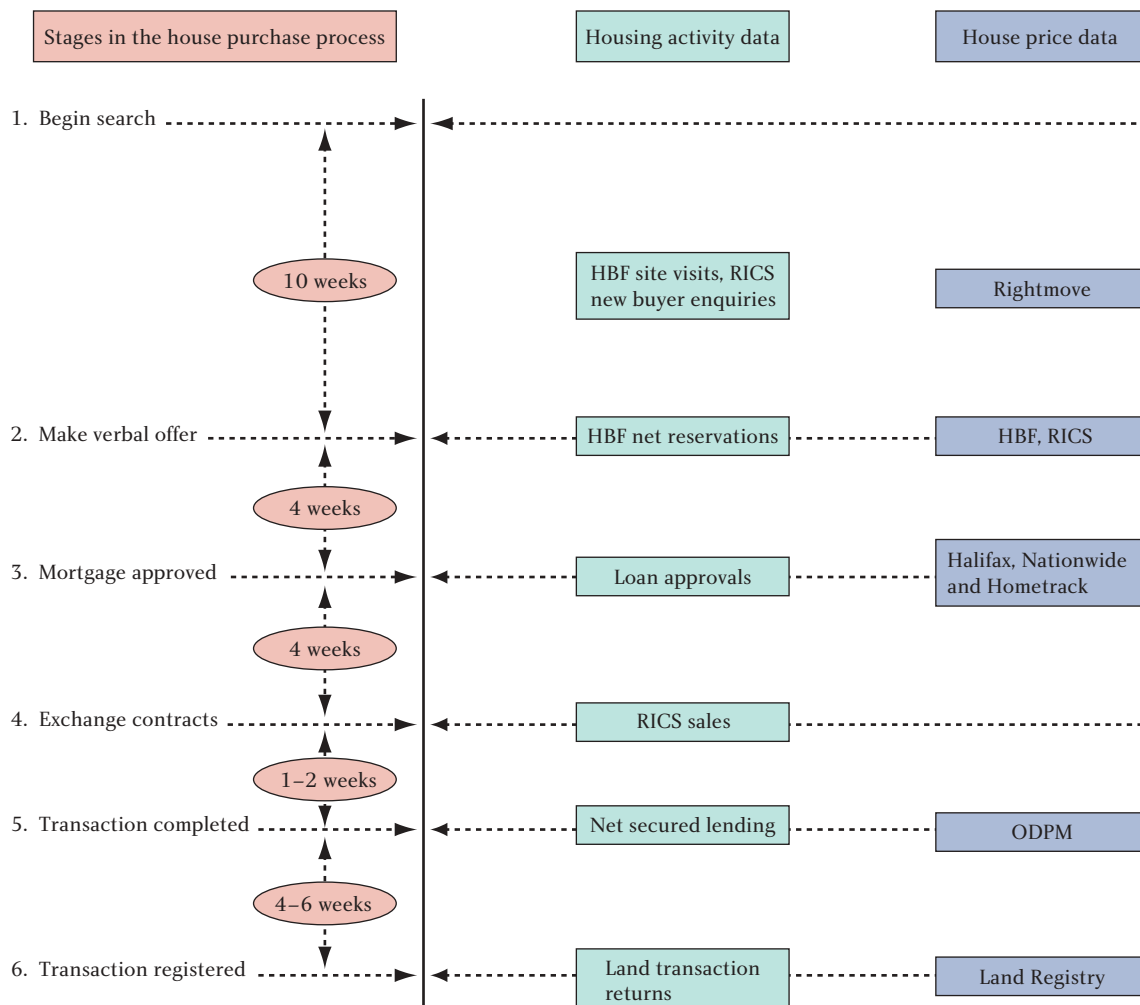
Table 1.A
Measures of house price inflation^(a)

| Per cent | 2004 | | | | | |
|----------------------------------|------|------|------|------|------|------|
| | Q1 | Q2 | July | Aug. | Sep. | Oct. |
| Short-run measure ^(b) | | | | | | |
| Halifax | 23.4 | 26.9 | 23.7 | 16.4 | 11.3 | 4.4 |
| Nationwide | 19.0 | 23.8 | 20.9 | 17.5 | 14.4 | 7.3 |
| Twelve-month inflation rate | | | | | | |
| Halifax | 18.5 | 21.6 | 22.0 | 19.3 | 19.7 | 16.4 |
| Nationwide | 16.2 | 19.0 | 20.3 | 18.9 | 17.8 | 15.3 |

Sources: Bank of England, Halifax and Nationwide.

(a) Quarterly data are averages of monthly observations.
(b) The annualised percentage change during the latest three months compared with the previous three months.

Chart 1.6
The house purchase timeline^(a)



Sources: Bank of England and DETR Housing Research Report No. 91.

(a) All timings are approximate: they are mainly based on DETR research published in 1998, and could have changed since then.

Table 1.B
Housing market indicators^(a)

| Activity | Average since 2004 | | | | | |
|--|--------------------|------|------|------|------|------|
| | 2000 | Q1 | Q2 | July | Aug. | Sep. |
| HBF net reservations ^(b) | 6 | 39 | 10 | -19 | -31 | -32 |
| HBF site visits ^(b) | -1 | 23 | -6 | -32 | -36 | -34 |
| RICS sales ^(c) to stocks ^(d) ratio | 0.47 | 0.54 | 0.51 | 0.47 | 0.44 | 0.41 |
| RICS new buyers enquiries ^(d) | -5 | 16 | -22 | -34 | -36 | -30 |
| RICS new instructions ^(d) | 6 | 15 | 8 | 4 | 20 | 20 |
| Mortgage approvals for house purchase (000s) | 108 | 125 | 118 | 99 | 95 | 89 |
| Land transaction returns (000s) ^(e) | 126 | 149 | 154 | 154 | 147 | 152 |
| Prices | | | | | | |
| HBF house prices ^(d) | 38 | 56 | 49 | 21 | -4 | -4 |
| RICS house prices ^(c) | 29 | 41 | 35 | 3 | -12 | -30 |
| RICS price expectations ^(c) | 18 | 34 | 14 | -3 | -14 | -27 |

Sources: Bank of England, House Builders Federation (HBF), Inland Revenue and Royal Institution of Chartered Surveyors (RICS).

- (a) All series are net percentage balances unless otherwise stated. Data for 2004 Q1 and Q2 are averages of monthly data.
 (b) Compared with a year ago.
 (c) During the past three months/expected over the next three months.
 (d) Compared with the previous month.
 (e) The number of transactions in England and Wales registered with the Land Registry. These include some commercial property transactions, and so may give a misleading picture of the residential property market. Before the start of 2004, the series was called particulars delivered and included fewer commercial property transactions.

Chart 1.7
The Bank of England's official interest rate and measures of mortgage rates

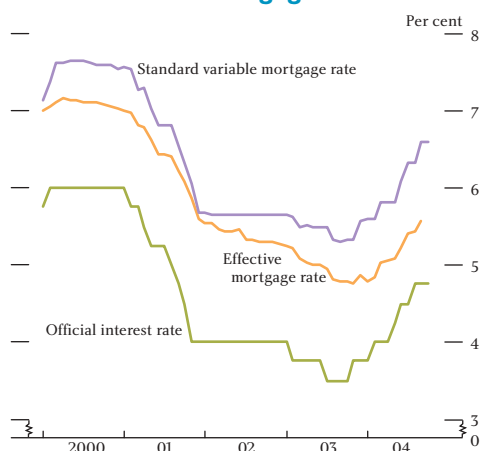


Table 1.C
Lending to individuals

| | 2005 | | | | 2004 | | |
|--|------|------|------|------|------|------|------|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 |
| Percentage changes on a year earlier | | | | | | | |
| Unsecured lending | 14.5 | 14.4 | 13.2 | 12.1 | 12.2 | 11.9 | 11.9 |
| Secured lending | 14.0 | 14.2 | 14.7 | 15.0 | 15.2 | 15.3 | 14.5 |
| Flow as a percentage of household income | | | | | | | |
| Mortgage equity withdrawal | 6.7 | 6.7 | 7.6 | 8.8 | 7.8 | 7.5 | n.a. |

(Table 1.B) confirms the picture of a slowing housing market. However, the extent of the prospective slowdown in house price inflation remains uncertain.

1.2 Money, credit and balance sheets

Households

The impact of the increases in the Bank of England's official interest rate depends in part on the pass-through to other banks' and building societies' rates. Over the past year, the standard variable rate on mortgages has risen broadly in line with the Bank of England's official interest rate. However, the effective rate — the average rate paid on the outstanding mortgage stock — has risen by less (Chart 1.7). That is largely due to fixed-rate mortgages, which are not affected by changes in the official interest rate.

Rates on some forms of unsecured borrowing, such as large personal loans, have continued to fall over the past year. Once special offers are included, the effective rate on credit card borrowing has also probably fallen. These falls are likely to reflect continued strong competition among lenders.

The narrowing of the gap between secured and unsecured rates could encourage households to take out a larger fraction of borrowing on an unsecured basis. Annual growth in unsecured borrowing remained broadly unchanged at around 12% in Q3 (Table 1.C). Growth in secured lending was 14.5% in Q3, somewhat weaker than in Q2 but still high by historical standards. And secured borrowing growth is likely to stay relatively high over the medium term, even if house price inflation remains relatively subdued, because the level of house prices has risen so much in recent years.⁽¹⁾

Over the past year, there are some signs that banks and building societies have become more cautious in their secured lending to the household sector. Loan to value ratios on new mortgages have fallen, and discussions between the Bank of England and major lenders indicate that this decline has been partly driven by stricter lending criteria. Reports from the Bank's regional Agents suggest that lenders are also applying stricter criteria to buy-to-let investors. This effective tightening in the supply of credit could be a factor behind the easing in the housing market.

Mortgage borrowing for purposes other than house purchase or remortgaging has fallen back both in value and volume terms over the past year. This is a part — but not all — of

(1) See Hamilton, R (2003), 'Trends in households' aggregate secured debt', *Bank of England Quarterly Bulletin*, Autumn, pages 271–80.

Chart 1.8
Take-up of long-maturity mortgages^(a)



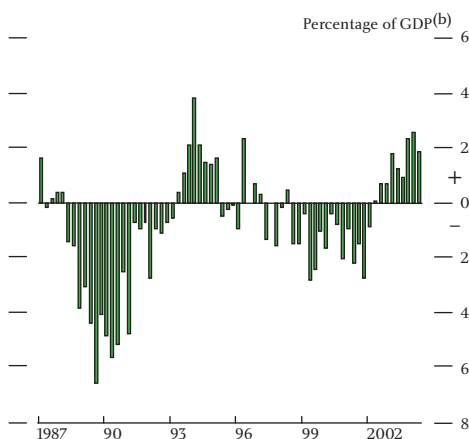
Source: CML.

(a) Data include lending for house purchase and remortgaging, and have been interpolated in 1978 and 1992.

mortgage equity withdrawal. Out of all secured borrowing, these loans are most likely to be spent on goods and services.⁽¹⁾

Recently borrowers have been extending the maturity of their debt. The take-up of long-maturity mortgages has risen (Chart 1.8). And the duration of some forms of unsecured debt, such as personal loans, has also lengthened. That could indicate that debtors may be struggling to meet repayments, and have extended duration as a means of coping. But that sits oddly alongside mortgage arrears, which have remained low. And although repossession actions rose in 2004 Q3, part of that could reflect changes to the bankruptcy laws made in April: for the first time, these set a limit on the amount of time trustees have to repossess bankrupt individuals' homes.

Chart 1.9
PNFCs' financial balance^(a)



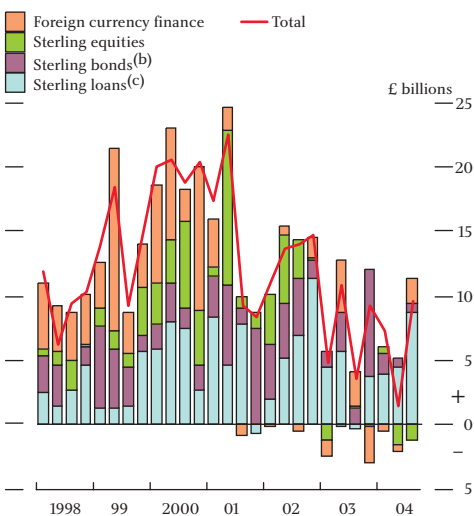
(a) Excluding statistical alignment adjustment.
(b) At current factor cost.

There are other reasons why the duration of debt may have risen. For example, households may deliberately be choosing to take longer to repay borrowing. That would allow them to borrow more, for a given monthly repayment. So longer-duration mortgages may simply reflect higher house prices.

Are companies ready to spend?

Capital gearing measures for companies rose sharply at the end of the 1990s. But in recent years, companies have reduced their outstanding debt. That is consistent with the positive financial balance of private non-financial corporations (PNFCs), which shows that for the past two years, revenues and other income have exceeded spending on items such as investment and dividends (Chart 1.9).

Chart 1.10
PNFCs' total external finance^(a)



(a) Excluding securitisations. The components do not sum to the total in each quarter because the total has been seasonally adjusted independently.
(b) Includes commercial paper.
(c) From monetary financial institutions (MFIs).

Are there signs that this behaviour is coming to an end?

Dividends rose sharply in 2004 Q2, by 14%. But the profile of dividends has recently been volatile: on average they fell by 14% in each of the two preceding quarters. Perhaps more informative is PNFCs' investment spending, which has risen in each of the past three quarters by an average of 1.9%.

The financial balance is also equal to the difference between the build-up of financial assets and externally generated finance. PNFCs' total external finance — bank borrowing and funds raised in financial markets — picked up strongly in 2004 Q3 (Chart 1.10), after falling back over the past two years. That is consistent with stronger investment spending in the near term.

(1) See Benito, A and Power, J (2004). 'Housing equity and consumption: insights from the Survey of English Housing', *Bank of England Quarterly Bulletin*, Autumn, pages 302-09.

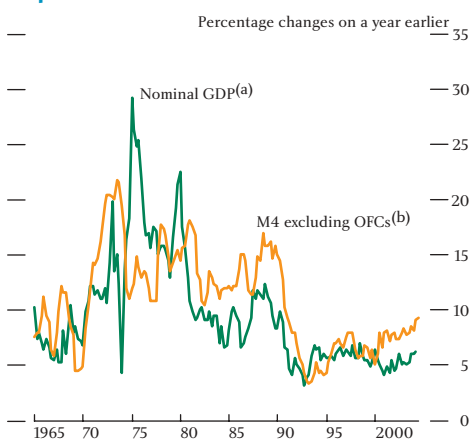
Table 1.D
Monetary aggregates

Percentage changes on a year earlier

| | 2005 | | 2004 | | |
|----------------------------------|------|-----|------|-----|------|
| | Q4 | Q1 | Q2 | Q3 | Oct. |
| Notes and coin | 7.3 | 7.0 | 6.3 | 5.8 | 6.0 |
| M0 ^(a) | 7.2 | 7.1 | 6.4 | 5.8 | 5.9 |
| M4 ^(b) | 7.3 | 8.0 | 8.2 | 9.3 | n.a. |
| M4 excluding OFCs ^(c) | 8.4 | 8.3 | 9.2 | 9.2 | n.a. |

- (a) M0 is a narrow measure of money, consisting of notes and coin and bankers' operational balances held at the Bank of England.
 (b) M4 is a broad 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 MFIs.
 (c) Other financial corporations.

Chart 1.11
M4 and nominal GDP



- (a) At market prices.
 (b) Calculated on a quarterly basis.

Table 1.E
Sectoral monetary aggregates

Percentage changes on a year earlier

| | 2005 | | 2004 | | |
|-------------------------|------|-----|------|------|------|
| | Q3 | Q4 | Q1 | Q2 | Q3 |
| Households' M4 deposits | 8.1 | 8.4 | 8.1 | 8.4 | 8.7 |
| PNFCs' M4 deposits | 7.1 | 8.3 | 8.7 | 12.4 | 11.4 |
| Households' Divisia | 8.1 | 9.1 | 8.9 | 9.0 | 9.5 |
| PNFCs' Divisia | 0.7 | 6.7 | 9.1 | 11.8 | 10.2 |

Monetary aggregates

Narrow money growth has eased a little in recent months. The annual growth rate of M0 fell to 5.8% in Q3, from 6.4% in Q2 (Table 1.D), consistent with weaker growth in retail sales (see Section 2). Twelve-month growth was 5.9% in October.

Annual growth in M4, a broader monetary aggregate, picked up to 9.3% in Q3, from around 8% during the first half of the year. This measure includes other financial corporations' (OFCs') holdings of broad money, which can be volatile. But the pickup in broad money growth is still apparent when OFCs are excluded from the measure of M4, although the rise occurs earlier.

The rise in M4 deposits could reflect portfolio demand. Savings rates have risen over the past year, particularly for internet-based accounts. So money holdings may have become more attractive to investors, relative to other assets.

But the pickup in M4 growth could also be related to prospects for economic activity. In the long run, broad money may be expected to grow at a similar rate to nominal spending and GDP.⁽¹⁾ And although the empirical relationship is far from precise, strong growth in M4 has tended to accompany strong growth in nominal GDP (Chart 1.11). This recent rise in liquidity could reflect companies and households increasing money balances in anticipation of spending on goods and services. Divisia measures of money weight the components of M4 according to how useful they are for transactions, so less weight is placed on components that are typically held for portfolio reasons. And the recent pickup in money growth is also evident in these Divisia measures (Table 1.E). So it is possible that the stronger growth in broad money may presage stronger nominal demand growth in the short term.

(1) See the box on pages 8–9 of the May 2003 Report.

UK domestic demand growth fell back in 2004 Q2. Consumption growth moderated and the near-term outlook appears a little weaker than at the time of the August Report. By contrast, the business investment recovery appears to have become more firmly established. And some further rebalancing in the composition of demand appears to be in prospect. In the other major economies, GDP growth eased in Q2. But US activity picked up a little in the third quarter. And in the euro area and Japan, indicators point to continued recovery. UK exports are estimated to have rebounded in Q2 — but the underlying pace of recovery has been modest against the backdrop of strong global demand.

Table 2.A
Expenditure components of real GDP^(a)

Percentage changes on a quarter earlier

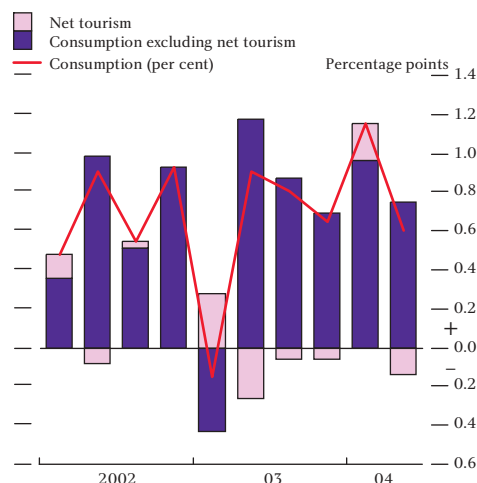
| | Averages | | 2003 | | 2004 | |
|---|------------|------------|------------|------------|------------|------------|
| | 2002 | 2003 | Q3 | Q4 | Q1 | Q2 |
| Household consumption | 0.8 | 0.5 | 0.8 | 0.6 | 1.1 | 0.6 |
| Government consumption | 0.6 | 1.4 | 1.6 | 2.1 | 0.8 | 0.4 |
| Investment | 1.7 | 0.4 | 1.1 | 1.9 | 1.6 | 2.4 |
| of which, business | 1.5 | -0.3 | 0.2 | 2.0 | 0.9 | 2.6 |
| Final domestic demand | 0.9 | 0.7 | 0.9 | 1.1 | 1.2 | 0.8 |
| Change in inventories ^{(b)(c)} | -0.1 | 0.0 | 0.0 | 0.1 | -0.1 | -0.1 |
| Alignment adjustment ^(c) | 0.1 | 0.0 | 0.3 | 0.3 | -0.1 | 0.1 |
| Domestic demand | 0.8 | 0.7 | 1.3 | 1.5 | 1.0 | 0.8 |
| Exports | -0.3 | 1.1 | 0.2 | 1.6 | -1.0 | 1.5 |
| Imports | 1.0 | 0.9 | 1.4 | 3.1 | 0.5 | 1.1 |
| Net trade ^(c) | -0.4 | 0.0 | -0.4 | -0.5 | -0.4 | 0.0 |
| GDP at market prices | 0.5 | 0.7 | 0.9 | 1.0 | 0.7 | 0.9 |
| Memo: | | | | | | |
| Nominal GDP at market prices | 1.2 | 1.4 | 2.1 | 1.4 | 1.1 | 1.4 |

(a) Chained volume measures.

(b) Excludes the alignment adjustment.

(c) Percentage point contributions to quarterly GDP growth.

Chart 2.1
Contributions to quarterly household consumption growth^(a)



(a) Chained volume measures.

The profile of demand, relative to supply, is a key influence on inflationary pressures in the economy. Nominal GDP rose strongly in the year to 2004 Q2. Real GDP growth was correspondingly robust, but is provisionally estimated to have slowed in Q3 (see Section 3). The composition of demand is also important: examination of individual types of spending permits a more accurate assessment of the near-term outlook for aggregate demand.

2.1 Domestic demand

Domestic demand growth fell back to 0.8% in 2004 Q2, following growth of 1.0% in Q1 and even stronger growth in the latter half of 2003 (Table 2.A). Slackening consumer spending growth accounted for the Q2 deceleration. By contrast, there were further signs that the recovery in business investment had gained momentum.

Household consumption

The latest National Accounts suggest that household consumption rose moderately in 2004 Q2, by 0.6%. But spending in Q1 was revised up sharply compared with the data available in August, and is now thought to have risen by over 1%. Taken together, consumption in the first half of the year was broadly in line with the MPC's assessment at the time of the August Report.

Most of the Q2 easing of growth reflected net tourism (Chart 2.1), a small but volatile component of consumer spending. Net tourism represents spending by UK residents abroad, less spending by overseas visitors to the United Kingdom. At the time of the August Report, this component was estimated to have fallen in Q1. But net tourism is now

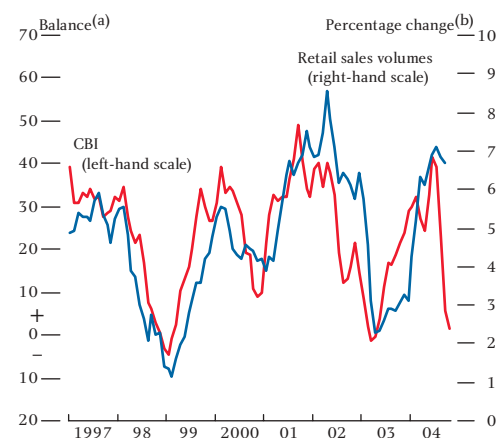
Table 2.B
Indicators of consumption^(a)

| | Correlation ^(b) | Average 2004 | | | | |
|--|----------------------------|--------------|------|------|------|------|
| | | 2003 | Q1 | Q2 | Q3 | Oct. |
| Percentage changes on a quarter earlier | | | | | | |
| Retail sales | 0.6 | 0.8 | 1.9 | 1.9 | 1.1 | n.a. |
| Real disposable income | 0.2 | 0.8 | 1.0 | 1.4 | n.a. | n.a. |
| Unsecured borrowing | 0.5 | 2.9 | 3.2 | 2.9 | 2.9 | n.a. |
| House prices ^(c) | 0.5 | 4.0 | 5.3 | 5.6 | 2.9 | 1.5 |
| Balances | | | | | | |
| CBI retail sales ^(d) | 0.6 | 14.4 | 27.0 | 41.3 | 5.7 | 1.3 |
| GfK consumer confidence | 0.6 | -4.5 | -1.7 | -2.8 | -4.9 | -6.2 |
| Interest rate expectations ^(e) | 0.1 | 37.5 | 66.0 | 69.0 | 71.0 | n.a. |

Sources: Bank of England, CBI, GfK, Halifax, Nationwide, NOP and ONS.

- (a) For retail sales, CBI retailers' reported sales and GfK consumer confidence, quarterly data are averages of monthly data.
 (b) Contemporaneous correlation of each indicator with quarterly growth in the chained volume measure of consumption between 1987 and 2004, except for interest rate expectations (which begins in 1999 Q4).
 (c) Calculated from the average of Halifax and Nationwide quarterly indices, adjusted by Bank staff for a change in the method of calculation of the Halifax index. October figure refers to three-month on three-month house price inflation.
 (d) Balance of respondents in the CBI Distributive Trades Survey reporting retail sales higher than a year earlier. October figure refers to three-month moving average.
 (e) Net balance of Bank of England/NOP survey respondents expecting interest rates (on mortgages, bank loans, savings etc) to rise in the next twelve months.

Chart 2.2
Retail sales and CBI distributive trades



Sources: CBI and ONS.

- (a) Three-month moving average of the balance of respondents reporting retail sales higher than a year earlier.
 (b) Three months on three months a year earlier.

thought to have risen sharply in Q1 and then fallen back in Q2.

Many indicators of consumption have slowed since the August Report (Table 2.B). Given their past correlation with consumption (see first column of table), could these indicators provide evidence that consumption growth has softened further and that the near-term outlook for consumption has eased?

Some of the indicators in Table 2.B provide timely information about recent spending behaviour. Official estimates suggest that retail sales growth eased in Q3, for example. And the CBI Distributive Trades Survey indicator of retail sales, which pointed to weaker growth in Q3 than the official estimate, remained relatively subdued in October (Chart 2.2). That would be consistent with a declining contribution to household consumption growth from retail goods, which account for around two fifths of total consumer spending. But this weakness does not necessarily extend to other types of consumer spending for which information is less timely.

Households plan their expenditure today on the basis of a long-run view about their future income. Indicators such as consumer confidence may contain information about those perceptions. The GfK measure of consumer confidence — which has correlated reasonably well with spending growth over the past few decades — was weak in October, at -6.2 (Table 2.B). But in recent years, high frequency movements in consumer confidence have tended to be poorly related to consumption.⁽¹⁾ So month to month, or even quarter to quarter, changes in consumer confidence do not seem to be a reliable guide to spending developments.

For some households, credit constraints mean that they cannot consume as much today as they would like. Changes in current income are likely to be particularly important for these consumers. Since late 2003, households' real disposable income has risen by 1% or more per quarter. That buoyancy should be supportive of spending in the near term.

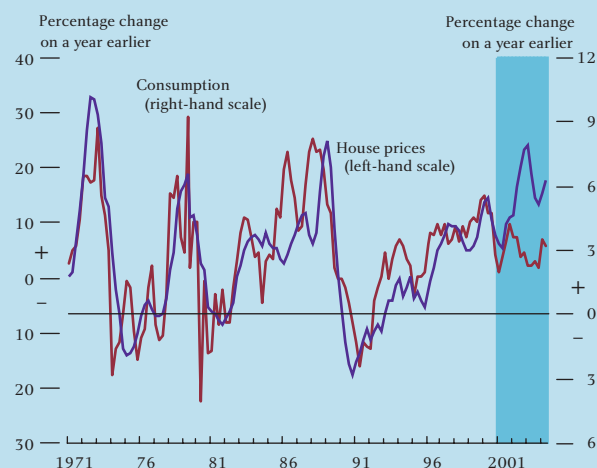
Other households are more able to borrow against future income. And the extent of their borrowing can be a useful guide to the strength of current and near-term spending. Within secured borrowing, further advances appear to have weakened this year, as discussed in Section 1. But unsecured borrowing rose by 2.9% in Q3 (Table 2.B), close to the average rise over the past year. So developments in household borrowing do not unambiguously point to a softening outlook for consumption growth.

(1) See Berry, S and Davey, M (2004), 'How should we think about consumer confidence?', *Bank of England Quarterly Bulletin*, Autumn, pages 282–90.

House prices and consumer spending

House prices and consumer spending have often moved together in the past. But as Charts A and B show, that empirical association has been less apparent in recent years (see shaded areas). This box examines why.

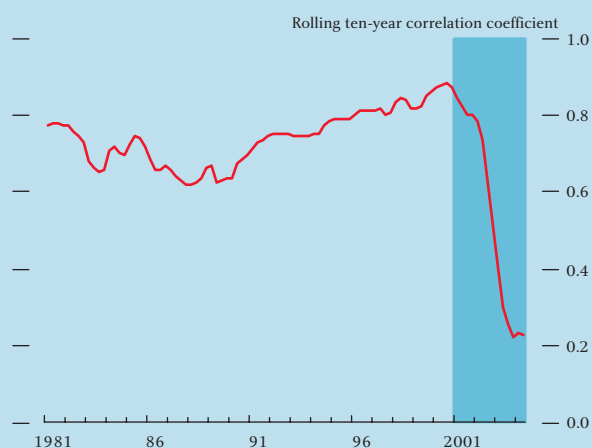
Chart A
Real house prices^(a) and consumption^(b)



Sources: Bank of England, Nationwide and ONS.

- (a) Real house price measure, calculated as the nominal Nationwide series deflated by the consumption expenditure deflator.
 (b) Chained volume measure of consumption.

Chart B
Correlation between annual real house price inflation^(a) and annual consumption growth^(b)



Sources and footnotes: see Chart A.

What explains the past empirical association?

Increases in household wealth tend to be associated with increases in consumer spending. But housing differs markedly from many other assets held by households. Houses provide an essential service — shelter. And they tend to be sold to other UK households, rather than traded internationally. These

characteristics have important implications for the relationship between house prices and consumer spending.⁽¹⁾

When house prices rise, households could sell their homes to realise the capital gain. To maintain the services they receive from housing, however, they would have to purchase a house of equivalent value. Those who do not wish to receive the same housing services could trade down and use the proceeds to finance increased consumption. But any gains for those trading down or even leaving the housing market will be offset by the corresponding extra outlay for UK households that are trading up or buying for the first time. As a result, a rise in house prices does not make UK households wealthier in aggregate. So the relationship between house prices and consumer spending is less direct than for many other assets.

What could explain the past empirical association between consumption and house price inflation? One explanation is that higher house prices enable more or cheaper borrowing by raising the collateral at households' disposal. So past increases could have eased credit constraints and facilitated higher consumer spending.

A second explanation is that house prices and consumption moved together because they were affected by similar factors. For example, an improvement in households' optimism about economic prospects — and their own future income — would have led not only to higher consumer spending, but also increased demand for housing and hence higher house prices.

Why might the association have changed?

Both of these influences may have become less important over the past few years. House price rises in the latter half of the 1990s increased the amount of equity at households' disposal. And access to unsecured borrowing at favourable rates also increased. So by the beginning of the current decade, credit constraints faced by households might already have loosened. If that were the case, recent rises in house prices (and hence in collateral) could have had less impact on consumption than in the past.

Moreover, in recent years, consumer spending and house prices may not have been driven higher by a common factor, such as higher income expectations.

(1) See Nickell, S (2004), 'Household debt, house prices and consumption growth', *Bank of England Quarterly Bulletin*, Autumn, pages 383–89. For further details, see also Aoki, K, Proudman, J and Vlieghe, G (2001), 'Why house prices matter', *Bank of England Quarterly Bulletin*, Winter, pages 460–68.

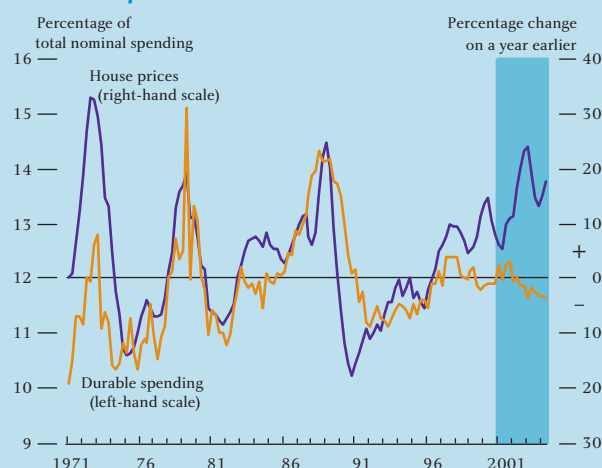
Households may have expected the moderate wage growth of recent years to continue. And given equity price falls earlier this decade, expected non-labour earnings are also unlikely to have picked up markedly. Consumer spending has increased broadly in line with disposable income during the past few years, and that too seems consistent with broadly stable income expectations.

Further evidence is provided by spending on durables.⁽²⁾ An increase in income expectations would tend to raise not only house prices, but also the stock of durables that households wish to hold — and adjustment to that new desired level would require a large initial swing in spending. Durable spending might also be closely related to house prices if credit constraints are particularly binding. Purchases of large ticket durable goods are perhaps more likely than other items to be financed by borrowing — and house price rises could facilitate that borrowing.

Chart C shows that the share of durable spending in total nominal consumer spending moved broadly in line with house price inflation for many years. But more recently, the durables spending share has remained close to its long-run average, while house price inflation picked up markedly. This could suggest that income expectations have been broadly stable and credit constraints less binding than in the past.

If income expectations have been broadly stable, what can explain the recent behaviour of house prices? The *May Report* highlighted a variety of factors. Demand for housing has continued to be boosted by the rate of household formation, which has tended to exceed the limited response of supply over the past

Chart C
Real house prices^(a) and the share of durable spending in consumption



Sources and footnote: see Chart A.

two decades. Investment demand may also have risen, as some households decided to use housing as a retirement savings vehicle, in light of concerns over future pension provision and the value of endowment mortgages. But it remains hard to believe that factors like these can fully account for the rapid rise in house prices over the past few years.

Conclusion

The association between house prices and consumer spending has weakened in recent years. The MPC judges that it is likely to be less strong in the future, too. In the absence of any significant downward revision to households' income expectations — something that would tend to depress both consumption and house prices — spending growth is therefore expected to ease only moderately despite a sharp slowing in house price inflation.

(2) See Power, J (2004), 'Durable spending, relative prices and consumption', *Bank of England Quarterly Bulletin*, Spring, pages 21–31.

Spending decisions also depend on the returns that households could obtain from postponing consumption and saving instead. So the current and expected level of interest rates is a further consideration. Over the past year, average interest rates received on household deposits — as well as the average rate paid on the stock of household debt — have increased. And, at least until recently, households appeared to expect further rises. According to the August Bank of England/NOP survey, the net balance of respondents expecting rates to rise over the coming twelve months was the highest since the survey began in 1999.

The cooling housing market could also have implications for consumer behaviour. Historically, there has been a close

empirical association between house price inflation and consumer spending growth for much of the past few decades. But, as discussed in the [box on pages 12–13](#), a slowdown in house price inflation need not necessarily be associated with a sharp consumer spending deceleration. What matters is why house price inflation is weakening.

Overall, the MPC judges that, although a number of indicators have weakened, the near-term outlook for consumption has probably eased only modestly since the August Report.

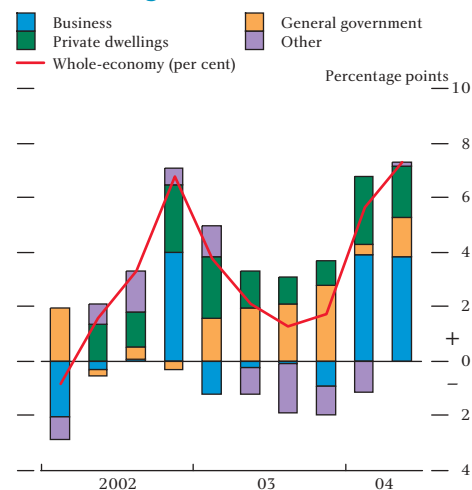
Government consumption

Real government consumption growth is estimated by the ONS to have fallen in 2004 Q2 to 0.4%, the weakest rate in two years. But as discussed in recent Reports,⁽¹⁾ real government consumption is not the most relevant measure for assessing the impact of government spending on future inflation.

Government spending tends to affect inflationary pressure through two distinct channels. First, the government buys goods and services from the private sector. That adds to overall demand for private sector outputs. Second, the government employs factors of production, such as labour, that would otherwise have been available to the private sector. That reduces potential private sector supply. In recent years, a summary measure of the government's demand for resources that captures the influence of these channels has grown more quickly than ONS estimates of government output.

The government's current plans imply further strong growth of nominal spending into 2005. And the quantity of resources absorbed by the government is expected to rise accordingly.

Chart 2.3
Contributions to annual whole-economy investment growth^(a)



(a) Chained volume measures.

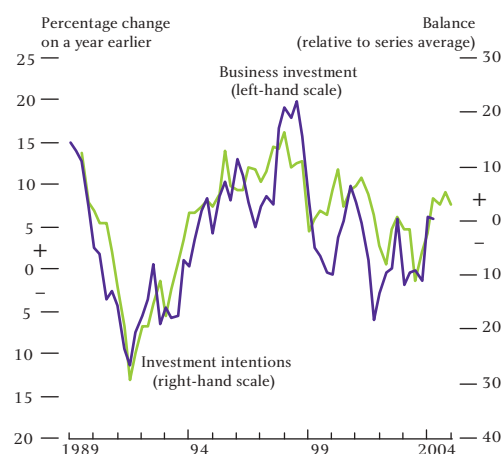
Investment

Whole-economy investment rose strongly in 2004 Q2, by 2.4%. This followed a rise of 1.6% in the previous quarter. In recent years, growth has been driven by government investment and private investment in housing (Chart 2.3), which together account for less than a third of the investment total. Government investment made another strong contribution in Q2, rising 8.1% following a fall in the previous quarter. But housing investment fell by 2.7%.

Looking forward, the spending plans outlined in the 2004 Spending Review point to further strong growth in government investment in 2005. But the MPC expects the contribution of housing to aggregate investment growth to moderate, as activity in the housing market weakens further.

(1) For further details, see the box on pages 24 and 25 of the May 2004 Report.

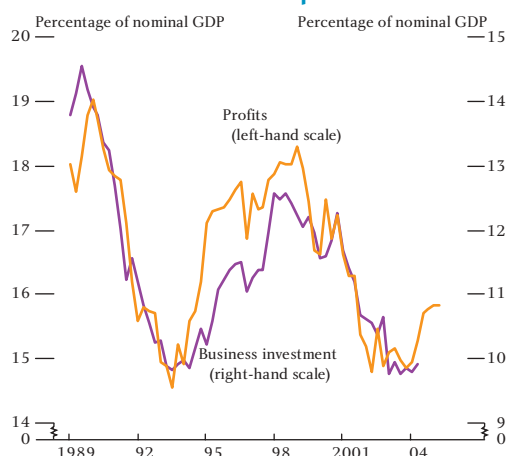
Chart 2.4
Business investment and BCC investment intentions^(a)



Sources: BCC and ONS.

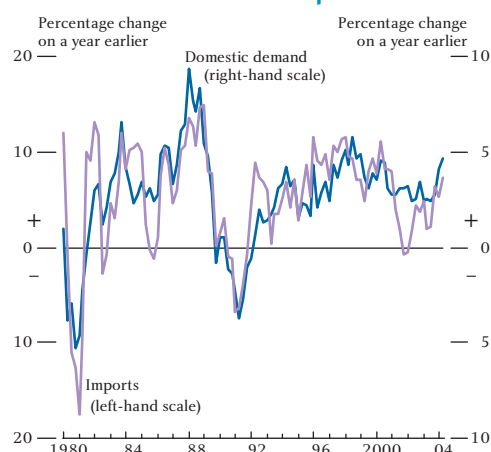
(a) Average of BCC survey measures of investment intentions in the manufacturing and service sectors, weighted by their respective shares in aggregate investment in 2001, minus the average since the series began in 1989. The series is shifted forward two quarters since the survey question relates to future investment.

Chart 2.5
Business investment and profits^(a)



(a) Profits of private non-financial companies, excluding oil companies and the alignment adjustment. The series is shifted forward four quarters to reflect its leading relationship with business investment.

Chart 2.6
Domestic demand^(a) and imports^(b)



(a) Chained volume measure.
 (b) Chained volume measure of imports of goods and services, excluding the impact of 'missing trader intra-community' (MTIC) fraud.

Investment by the business sector accounts for around two thirds of whole-economy investment, but has until recently played a minor role in its recovery. The latest estimates suggest that business investment rose by 2.6% in 2004 Q2, however, and has expanded in each of the past five quarters.

The business investment recovery therefore seems to have become more firmly established and the outlook is for further healthy growth in the near term. Survey measures of investment intentions in the manufacturing and service sectors picked up throughout 2003. Since then, balances from the BCC survey have remained a little above their long-term averages (Chart 2.4). That is consistent with evidence from the Bank's regional Agents, although the latest *CBI Quarterly Industrial Trends Survey* did point to a weakening in manufacturing investment intentions.

The pickup in business investment is likely to be related, in part, to improved corporate financial conditions. Over the past two years, companies have strengthened their balance sheets by spending less than their income (Chart 1.9). That may have been related to concerns over high debt levels. But the upturn in profits (Chart 2.5) should help companies fund investment projects without recourse to external finance. And the overall improvement in financial conditions is likely to support continued recovery in investment in the near term.

In light of these developments, the MPC has reassessed the outlook for business investment. The Committee has been persuaded that growth may be somewhat stronger over the coming year than was anticipated in August. But at current high levels of debt, companies may be wary of too much further borrowing. So, as discussed in the *August Report*, business investment growth is still expected to be less rapid than in previous upturns.

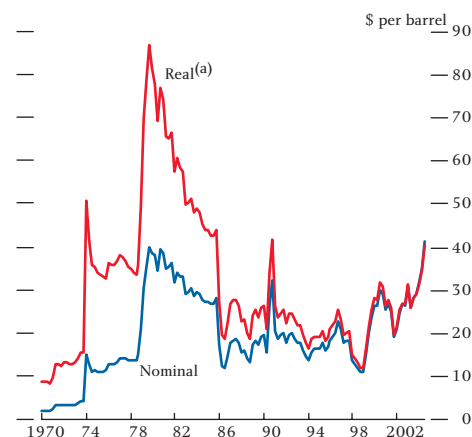
Inventories

Stocks were estimated to have been broadly unchanged in 2004 Q2, following a modest rise in the preceding quarter. That change in the rate of inventory accumulation reduced GDP growth by 0.1 percentage points in Q2.

Imports

Imports are estimated to have increased strongly in 2004 Q2, by 1.1%. The pickup in growth in recent quarters is consistent with the strength of domestic demand over the past year (Chart 2.6). Monthly estimates of goods imports indicate that further strong growth occurred in Q3. This could suggest that domestic demand continued to grow strongly in the third

Chart 2.7
Brent crude oil prices



Sources: Thomson Financial Datastream and US Bureau of Economic Analysis.

(a) In 2005 prices. Oil price has been deflated by the US consumer expenditure deflator.

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

Percentage changes on a quarter earlier

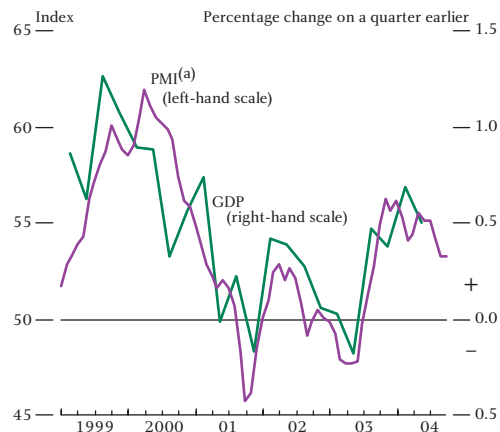
| | Averages | | 2003 | | 2004 | |
|--------------------------------------|------------|------------|------------|------------|------------|------------|
| | 2002 | 2003 | Q3 | Q4 | Q1 | Q2 |
| Household consumption | 0.3 | 0.1 | 0.2 | 0.0 | 0.7 | 0.3 |
| Government consumption | 0.7 | 0.4 | 0.6 | 0.5 | 0.1 | 0.5 |
| Investment | -0.3 | 0.0 | 0.1 | 0.9 | -0.1 | 0.1 |
| Final domestic demand | 0.2 | 0.2 | 0.3 | 0.3 | 0.4 | 0.3 |
| Change in inventories ^(b) | 0.0 | 0.2 | -0.3 | 0.7 | -0.1 | 0.0 |
| Domestic demand | 0.3 | 0.4 | 0.0 | 1.1 | 0.3 | 0.3 |
| Exports | 0.9 | 0.1 | 2.6 | 0.3 | 1.6 | 3.1 |
| Imports | 0.9 | 0.6 | 1.3 | 2.1 | 0.5 | 2.8 |
| Net trade ^(b) | 0.0 | -0.2 | 0.5 | -0.6 | 0.4 | 0.2 |
| GDP | 0.3 | 0.2 | 0.5 | 0.4 | 0.7 | 0.5 |

Sources: Eurostat and Thomson Financial Datastream.

(a) Volume measures.

(b) Percentage point contributions to quarterly GDP growth.

Chart 2.8
Euro-area GDP and surveys of purchasing managers



Sources: Eurostat, Reuters and Thomson Financial Datastream.

(a) Weighted average of the PMI monthly indices for manufacturing and services, using the relative magnitude of value added in industry and services in 2003. A level below 50 indicates a decline in activity; above 50, an increase.

quarter and that business investment, which is import intensive, recovered further.

2.2 External demand and UK exports

World GDP has increased rapidly in recent quarters. And in 2004 as a whole, growth is expected to approach rates last seen in the mid-1970s. The United Kingdom exports around a quarter of its output, so is sensitive to the strength of world demand.

Looking ahead, global demand prospects could be dampened by recent oil market developments. When the oil price rises, it depresses the real incomes of households and companies in net oil-importing countries. Spending by these economies is thought to be more sensitive to changes in income than spending by oil-exporting economies. So the net impact of an oil price rise is to restrain world demand. Rising oil prices can also increase uncertainty about the future economic outlook and that, too, can affect the spending behaviour of households and companies.

But the importance of oil in production has declined in recent decades (Chart 4.5). And the real price of oil is lower than in previous oil price spikes (Chart 2.7). So despite increased oil prices, and in light of recent rises in equity prices and falls in short-term market interest rates, the outlook for the world economy in 2005 remains robust.

The euro area

Recovery continued in the euro area in 2004 Q2. GDP growth was 0.5% (Table 2.C), broadly as anticipated at the time of the *August Report*. But growth was a little weaker than in Q1, as household consumption growth slowed to a modest 0.3%. Some indicators, such as purchasing managers' indices of business conditions (Chart 2.8), suggest GDP growth may be a little weaker still in the near term. Continued recovery is expected nonetheless.

Questions remain over the sustainability of recovery in Germany. There, recent GDP growth has been driven by net trade. Indeed, domestic demand has actually detracted from overall growth during the past year. But the export-led recovery is expected to feed gradually through into stronger domestic demand. And even if weakness were to persist, recent experience suggests this would be unlikely, in itself, to derail the euro-area recovery.

The United States

US GDP rose by 0.9% in 2004 Q3, following a rise of 0.8% in the previous quarter (Table 2.D). The pickup in growth was

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

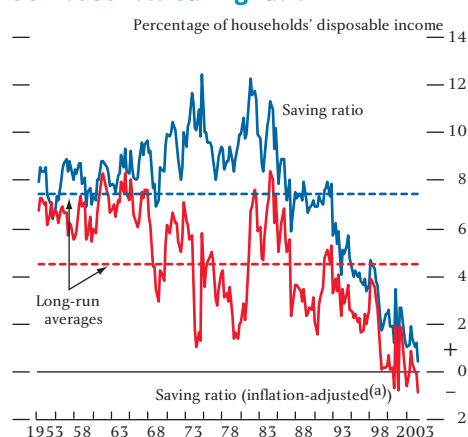
Percentage changes on a quarter earlier

| | Averages | | 2003 | | | 2004 |
|--------------------------------------|------------|------------|------------|------------|------------|------------|
| | 2002 | 2003 | Q4 | Q1 | Q2 | Q3 |
| Household consumption | 0.6 | 0.9 | 0.9 | 1.0 | 0.4 | 1.1 |
| Government ^(b) | 0.9 | 0.6 | 0.4 | 0.6 | 0.6 | 0.3 |
| Private investment | -0.5 | 2.5 | 2.5 | 1.1 | 3.3 | 2.1 |
| Final domestic demand | 0.5 | 1.1 | 1.0 | 1.0 | 0.9 | 1.1 |
| Change in inventories ^(c) | 0.5 | 0.0 | 0.1 | 0.3 | 0.2 | -0.1 |
| Domestic demand | 0.8 | 1.1 | 1.1 | 1.2 | 1.0 | 1.0 |
| Exports | 0.9 | 1.5 | 4.1 | 1.8 | 1.8 | 1.3 |
| Imports | 2.3 | 1.2 | 4.0 | 2.6 | 3.0 | 1.9 |
| Net trade ^(c) | -0.2 | 0.0 | -0.2 | -0.2 | -0.3 | -0.2 |
| GDP | 0.6 | 1.1 | 1.0 | 1.1 | 0.8 | 0.9 |

Sources: Thomson Financial Datastream and US Bureau of Economic Analysis.

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

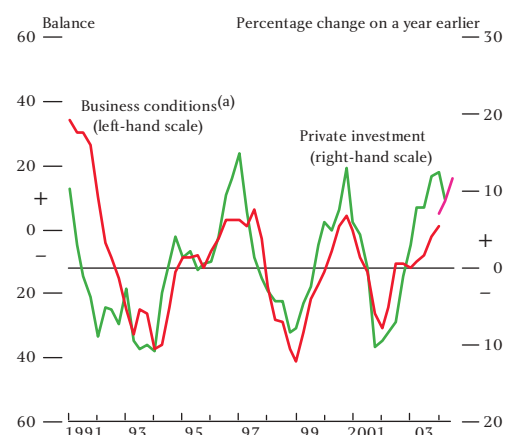
Chart 2.9
US household saving ratio



Sources: Bank of England, Thomson Financial Datastream, US Bureau of Economic Analysis and US Federal Reserve Board.

- (a) Removes the part of net interest income that compensates for the erosion of the real value of wealth by inflation.

Chart 2.10
Business conditions and private investment in Japan



Source: Thomson Financial Datastream.

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

driven by consumer spending. As the MPC expected, household consumption growth rose sharply on the quarter, to 1.1% — an indication perhaps that the impact of rising oil prices has been relatively muted (see above). Private investment rose less strongly in Q3, but growth continued at a healthy pace, in part encouraged by fiscal incentives.

Consumption growth is likely to remain strong in the near term. Survey evidence is consistent with a pickup in employment and that should support consumption growth for a while. But, as Chart 2.9 shows, the household saving ratio is at an historically low level — even allowing for distortions, like inflation, that affect comparisons across time.⁽¹⁾ That is not expected to persist indefinitely.

Overall, the near-term outlook is for strong growth in the United States, which should support activity internationally. But US consumption growth could slow sharply if households decided to strengthen their balance sheets sooner than anticipated. And a risk to the world outlook arises from that and other imbalances in the United States and elsewhere. With the government running a large fiscal deficit, the US national saving ratio — a measure of saving by the private sector and government in financial and physical assets, less depreciation on existing physical assets — is low. Its counterpart is the current account deficit. And that widened to 5.7% of GDP in Q2, a post-war high.

Asia

The Japanese economy continued to expand in 2004 Q2, but at a much less brisk pace than in the previous three months. GDP growth fell back to 0.3%, from a rate of 1.6% in Q1. The contribution of consumption and private investment declined, and government spending growth was at its weakest since 2000. But looking ahead, a range of indicators — such as Tankan survey measures of business conditions (Chart 2.10) — point to continued growth in the near term.

Elsewhere in Asia, demand growth has remained strong. In China, GDP was estimated to have risen by 9.1% in the year to 2004 Q3. And in the near term, activity in China is likely to make a further marked contribution to world GDP growth. In light of such strong growth, the People's Bank of China raised its key lending and deposit rates in October, the first increases since 1995.

UK exports

UK export volumes are estimated to have risen by 1.5% in 2004 Q2, following a 1.0% fall in the previous quarter. This

(1) For a discussion of such measurement issues, see Cotis, J-P, Coppel, J and de Mello, L (2004). *Is the US prone to 'over-consumption'?*, presented at the Federal Reserve Bank of Boston economic conference on 'The macroeconomics of fiscal policy'. Available at www.oecd.org/dataoecd/53/57/33604019.pdf.

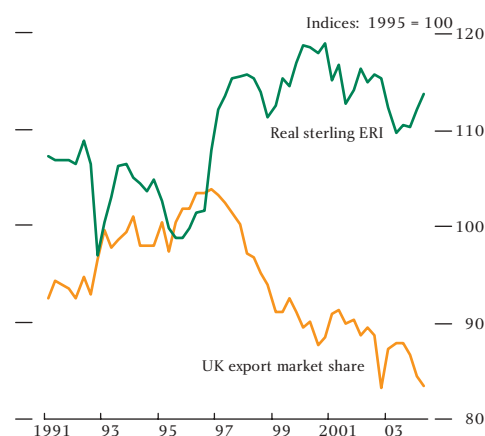
Table 2.E
UK export orders^(a)

| Series | average ^(b) | 2003 | | 2004 | | |
|---------------------|------------------------|------|----|------|----|----|
| | | Q3 | Q4 | Q1 | Q2 | Q3 |
| BCC | | | | | | |
| Manufacturing | 7 | -2 | 16 | 17 | 21 | 7 |
| Services | 10 | 3 | 9 | 7 | 12 | 10 |
| CIPS ^(c) | | | | | | |
| Manufacturing | 50 | 53 | 55 | 54 | 54 | 51 |
| CBI | | | | | | |
| Manufacturing | -9 | -22 | 4 | 3 | -3 | 0 |

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 and 1996 for CIPS.
- (c) Average of monthly indices.

Chart 2.11
UK export market share^(a) and the real sterling ERI^(b)



Sources: ONS and Thomson Financial Datastream.

- (a) Ratio of volume of UK exports, excluding MTIC fraud, to weighted sum of imports of the major six economies (Canada, France, Germany, Italy, Japan and the United States).
- (b) Nominal sterling ERI deflated by UK export prices relative to the export prices of the major six economies (based on their respective weights in the sterling ERI).

apparently irregular pattern of growth could reflect teething problems with HM Custom and Excise's new data-processing system.

The underlying pace of recovery has been modest against the backdrop of strong global demand. And survey indicators suggest it may remain so in the near term (Table 2.E). For some time, UK exports have tended to grow less rapidly than world imports and the United Kingdom's share of export markets has declined. In part, that is likely to reflect growing Asian trade (both within Asia, and between Asian countries and other major economies), as discussed in the *August Report*. But exchange rate developments have also been important.

The United Kingdom's export market share declined markedly in the latter half of the 1990s, following the appreciation of sterling (Chart 2.11). For services, market share appears to have subsequently recovered — perhaps consistent with a favourable shift in preferences towards UK services.⁽¹⁾ But the decline in the manufacturing export market share continued, despite evidence that companies attempted to maintain price competitiveness by tightening profit margins (see [page 34 of the August Report](#)). In part, this could reflect the withdrawal of some UK companies from export markets in the face of continued pressure on margins.

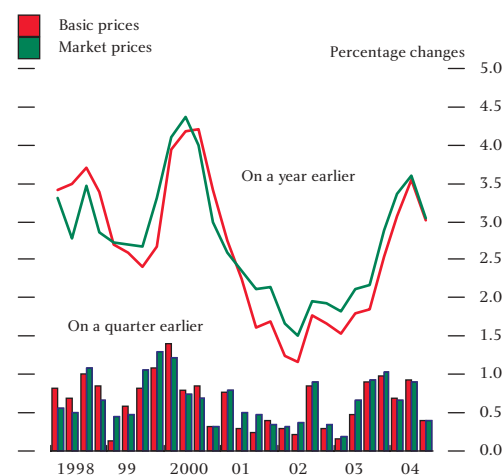
The MPC has reassessed the outlook for export growth in light of the continued decline in UK export market share. Although strong external demand growth and the recent depreciation of sterling should support export growth in the near term, the pace of recovery is expected to be more subdued than anticipated in August.

As a result, net trade is likely to continue to detract from GDP growth in the coming quarters. In itself, that would imply a widening in the current account deficit. But as discussed in the *May Report*, the trade balance is just one component of the current account. And in recent years, deficits on trade have been partially offset by another component, net income flows. So the current account deficit has not been particularly large by historic standards or compared with other countries.

(1) See Dury, K, Piscitelli, L, Sebastia-Barriel, M and Yates, T (2003), 'What caused the rise in the UK terms of trade', *Bank of England Quarterly Bulletin*, Summer, pages 164–76.

Output growth slowed following a strong start to 2004. The ONS reported that GDP growth dipped to 0.4% in the third quarter, although survey data suggest a somewhat stronger outturn. The fraction of the population employed by the private sector fell over the past year and there was a sharp pickup in private sector productivity growth. The economy appeared to be operating at, or above, normal capacity, and there seemed to be little slack in the jobs market. Despite this, wage growth remained steady.

Chart 3.1
Gross domestic product at basic and market prices^(a)



(a) Chained volume measures. Annual growth of GDP at basic prices for 2004 Q3 has been estimated using the preliminary estimate of quarterly growth.

Table 3.A
The manufacturing sector

| | Long-run average ^(a) | 2004 | | | |
|---|---------------------------------|------|------|------|------|
| | | Q1 | Q2 | Q3 | Q4 |
| Balances | | | | | |
| CIPS output ^(b) | 53.3 | 56.7 | 56.6 | 55.2 | n.a. |
| BCC domestic orders ^(c) | 8 | 8 | 17 | 10 | 15 |
| CBI past output trends ^(d) | -1 | 15 | 7 | 6 | n.a. |
| CBI output expectations ^(e) | 6 | 21 | 12 | 6 | 14 |
| Percentage change on a quarter earlier | | | | | |
| ONS manufacturing output | 0.2 | -0.2 | 1.2 | -1.0 | n.a. |

Sources: BCC, CBI, CIPS and ONS.

- (a) Averages are calculated since 1991 Q3 in each case.
- (b) Data refer to the average of the three CIPS monthly balances.
- (c) This series is shifted forwards one quarter since the survey question is likely to relate to future output.
- (d) This series is recorded in the quarter before the relevant CBI survey was published.
- (e) This series is recorded in the quarter that the relevant CBI survey was published.

3.1 Output

Whole-economy output growth slowed in 2004 Q3. According to the preliminary estimate, GDP at basic prices was 0.4% higher than in the previous quarter, the slowest rate of growth since 2003 Q1. That followed a rise of 0.9% in 2004 Q2 (Chart 3.1).

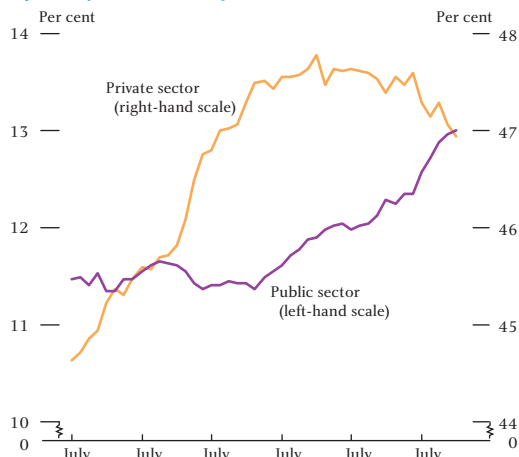
Service sector output growth appeared to have peaked in 2003 Q4, at 1.2%. Since then, output growth in this sector has slowed, easing a further 0.1 percentage points between Q2 and Q3 to 0.8%. Survey data point to slower growth in the second half of 2004 than the first. But service sector growth is still likely to be above its long-run average in 2004 H2.

Industrial production — which includes manufacturing, mining & quarrying and energy supply — fell 1.4% between Q2 and Q3. The decline partly reflected temporary disruptions caused by maintenance work in the oil and gas industries. Within industrial production, the manufacturing sector posted a quarterly fall of 1.0%. But survey data still suggest modest growth in the second half of 2004 (Table 3.A). Reports from the Bank's regional Agents also indicate that manufacturing output continued to grow in Q3. The MPC has put some weight on this information in judging that GDP grew more quickly in Q3 than ONS data presently suggest.

3.2 Labour and productivity

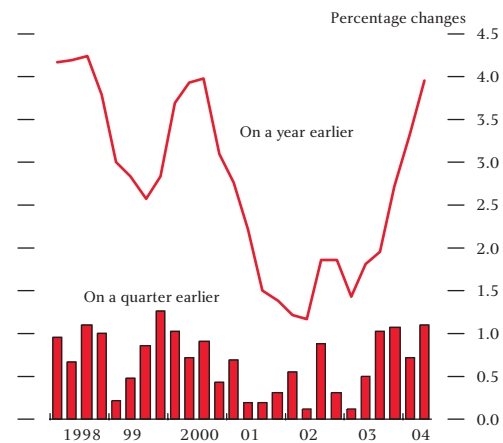
Official data suggest weak employment growth through 2004. In the three months to August, the whole-economy employment rate was 59.9%, according to the household-based Labour Force Survey. This was just 0.1 percentage points higher than in the same three months a year earlier. And the fraction of the population employed by

Chart 3.2
The fraction of the adult population^(a) employed by the private and public sectors^(b)



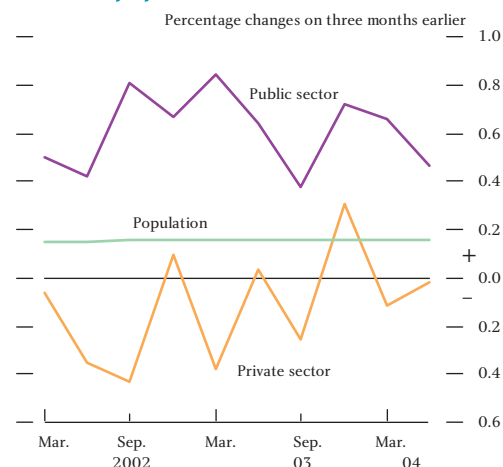
(a) Defined as the number of people aged 16 and above in the household population of the United Kingdom.
 (b) Based on LFS microdata.

Chart 3.3
Private sector output at basic prices^(a)



(a) Chained volume measure, defined as GDP minus the output of the public administration, education and health and social work sectors.

Chart 3.4
Public and private sector employee jobs^(a) and the adult population^(b)



(a) Workforce Jobs data. These refer to employment in the last month of each calendar quarter. The public sector is defined as the sum of the public administration, education and health and social work sectors.
 (b) Population data are as defined in Chart 3.2. These data refer to the three-month periods centred on the last month of each calendar quarter.

the private sector fell by 0.3 percentage points over the same period (Chart 3.2). Given the strength of output in the private sector over the past year (Chart 3.3), this is surprising.

Data on the number of employee jobs in the private sector, based on ONS surveys of firms, offer an alternative perspective on the state of the labour market. And these Workforce Jobs data also suggest employment growth in the private sector has failed to keep pace with population growth over the recent past (Chart 3.4). But employment growth in the public sector has consistently outstripped population growth over the past few years.

Total hours worked fell in the private sector over the year to 2004 Q2, reflecting a fall in average hours worked. That was despite the growth in private sector output over the past year, and implies that the private sector workforce has become more productive. Indeed, annual growth in private sector output per hour (or labour productivity) was 4.8% in Q2 — almost 2.5 percentage points higher than its recent average (Chart 3.5).

When employers expect a downturn in demand to be temporary they tend not to reduce the size of their workforce. Firing workers, only to replace them when demand recovers, is costly. Instead, companies work their employees less intensively while demand is weak, so productivity temporarily falls. If employers had been hoarding labour in this way during the downturn earlier this decade, that might explain why they did not need to hire new workers when demand recovered. Equally, if employers did not expect the recent strength of demand to persist, or if they were unable to hire additional workers, they might have used their existing workers more intensively than usual. So the recent pickup in productivity may simply reflect cyclical — and therefore temporary — factors.

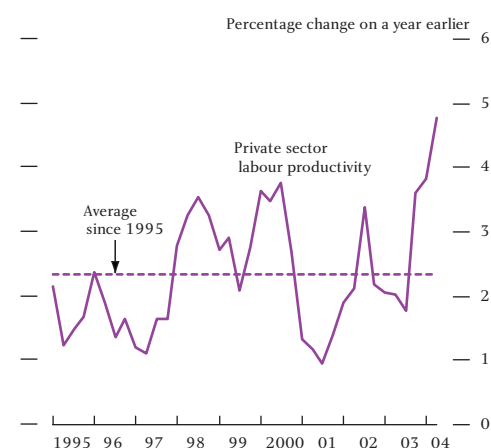
At least some of the recent pickup in labour productivity growth reflects cyclical factors. But the above-average rate of productivity growth could also be the realisation of higher sustainable, or trend, productivity growth.

Has trend labour productivity growth increased?

Trend labour productivity growth reflects predominantly two factors: the pace of capital deepening, and the rate of technical progress.

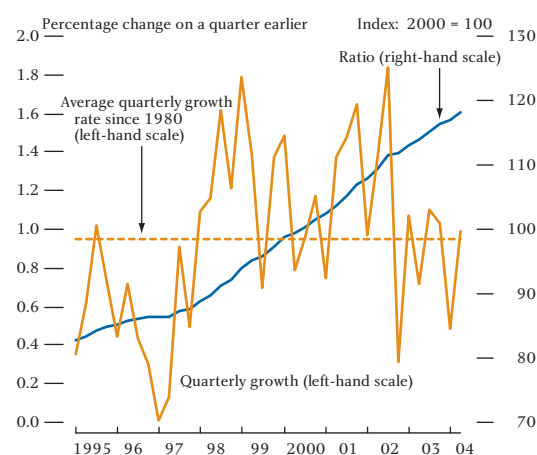
An increase in the amount of capital available to each worker — capital deepening — will lead to an increase in the amount of output that can be produced each hour. So if the underlying pace of capital deepening has increased, that could

Chart 3.5
Output per hour worked in the private sector^(a)



(a) Data on private sector output are as defined in Chart 3.3. Data on private sector hours worked are based on LFS microdata.

Chart 3.6
The level and quarterly growth in the private sector capital^(a)/labour^(b) ratio



(a) Services measure.

(b) Private sector hours worked, as used in Chart 3.5.

lead to a corresponding increase in the trend rate of labour productivity growth. But the recent pace of capital deepening has been relatively modest (Chart 3.6). This would seem to suggest that the trend rate of labour productivity growth ought to have slowed, not increased.

However, capital deepening may not immediately lead to increases in labour productivity. When companies make large investments in new capital, they may have to reorganise production processes and retrain workers. In the short run, that inhibits production. But in the long run, more output can be produced by each worker with the extra capital. So rapid capital deepening around the turn of the millennium could have led to a pickup in trend productivity growth more recently.

Trend productivity growth will also rise if the rate of technical progress increases. Technical progress describes any improvement in the production process that enables more output to be produced from the same amount of capital and labour. But it is impossible to be sure that the rate of technical progress has increased, and if it has, when the increase occurred.

What is clear is that some of the recent rise in private sector productivity growth reflects an increase in effort. In other words, at least some of the rise indicates an increase in factor utilisation.

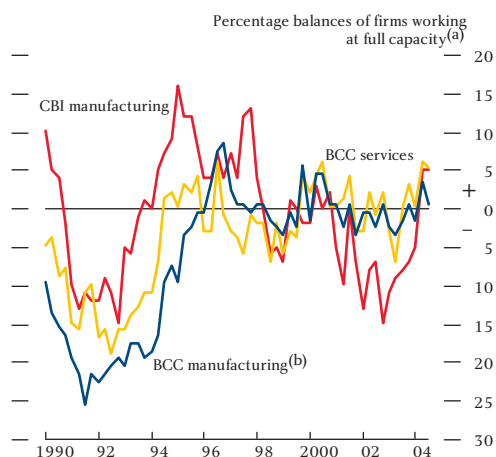
3.3 Factor utilisation

If companies are operating above normal levels of capacity and trying to squeeze more output from the labour and capital they employ, then the marginal costs of production will rise. And as a result, companies are more likely to raise prices.

One approach to assessing the degree of factor utilisation is to use surveys which ask managers directly whether they are operating at full capacity. If a large proportion report that they are operating above capacity, then this would tend to suggest that factor utilisation is fairly high.

A drawback of this approach is that what matters for inflationary pressures is the extent to which firms on average are using their capital and labour above or below *normal* levels. To give an indication of that, current survey data can be compared against an historical average that is calculated over some arbitrary time period. But that can give a misleading impression of what is 'normal'. For example, the BCC survey, which only began in 1989, will almost always tend to suggest that firms are currently operating above normal levels if the

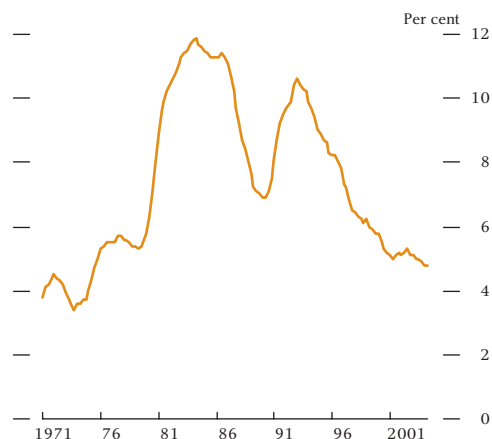
Chart 3.7
Survey measures of private sector factor utilisation



Sources: BCC and CBI.

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

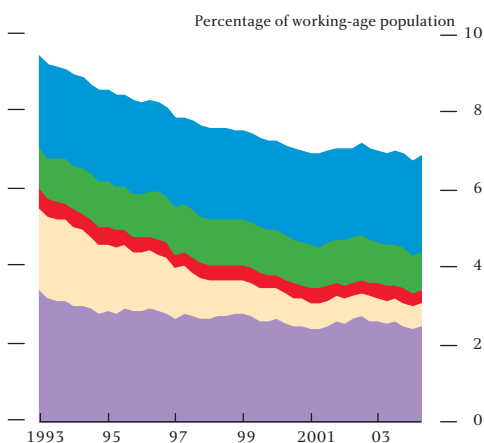
Chart 3.8
The unemployment rate^(a)



(a) LFS measure. Data before 1992 Q2 are currently published on an experimental basis. Data are shown for calendar quarters.

Chart 3.9
A weighted measure of non-employment^(a)

■ Inactive: does not want a job
■ Inactive: wants a job but not looking
■ Inactive: wants a job but not available
■ Unemployed: more than six months
■ Unemployed: less than six months



(a) See page 27 of the August 2004 Report for details on the construction of this measure. Data are shown for calendar quarters.

average includes the very weak data during the downturn in the early 1990s.

Current survey data suggest that companies in both manufacturing and services are operating close to or above normal levels of capacity, even when compared with average survey balances since 1995 (Chart 3.7). The Bank's Agents also report that pressures on capacity remain higher than normal.

Both survey data and reports from the Bank's regional Agents suggest that factor utilisation rates have increased in the private sector and that companies are operating at, or above, normal levels. That implies that there may be greater inflationary pressures in the near future.

3.4 Labour market tightness

Inflationary pressures partly reflect the extent to which private sector businesses are working their inputs above normal levels. But they also reflect the degree of slack in the labour market.

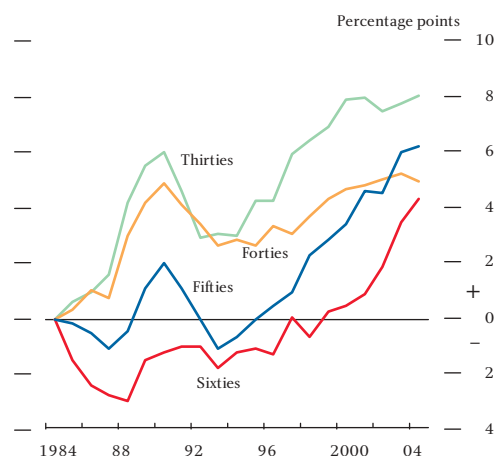
A standard measure of labour market tightness is the unemployment rate. In the three months to August the unemployment rate was 4.7%, and it had not been this low since 1975 (Chart 3.8).

Typically, one would expect a low and falling unemployment rate to be associated with faster wage growth. But as Section 4 of this Report discusses, there have been few signs of wage pressure in the labour market in recent years. What could explain this?

One possibility is that the unemployment rate gives a misleading indication of the tightness of the labour market. Not all job vacancies are filled by the unemployed. Vacancies are also filled by people who are classified as economically inactive, because they are out of work and either not looking for a job or are unavailable to start work straight away. So the degree of slack in the labour market should reflect the number of people who are inactive as well as the number of people who are unemployed.

The amount of slack in the labour market also depends on how hard the non-employed are looking for jobs. The previous Report discussed a measure of labour market tightness that controls for changes in the average search intensity of the non-employed by weighting different groups according to their probability of finding work. This measure has fallen less sharply than the unemployment rate in recent years (Chart 3.9).

Chart 3.10
Cumulative changes in employment rates by
age group since 1984^(a)



(a) Based on LFS microdata. Data are shown for the spring quarter (March to May) in each year.

A further explanation is that structural changes in the economy are likely to have led to a fall in the number of job seekers consistent with a given degree of wage pressure (as discussed in the [February 2004 Report](#)). For example, redesign of the tax and benefit system has encouraged people out of work to search more intensively for jobs. Moreover, the fraction of the workforce that is covered by union agreements has fallen, and declining unionisation typically leads to a reduction in the number of job seekers consistent with non-inflationary wage claims.⁽¹⁾

Net inflows of migrants have accounted for the lion's share of recent population growth. The increasing importance of migration as a source of population growth — and labour supply — could also explain why the relationship between wage pressure and measures of labour market tightness may have changed. Firms do not have to raise wages so aggressively if it is easy to hire workers from abroad.

Finally, the composition of employment could also be important. Since the late 1990s, the employment rate has increased most for those in their fifties and sixties (Chart 3.10). The implications of this for wage pressure depend on whether the rising number of older workers reflects a relative shift in labour demand or in labour supply. If demand for older workers has increased then this may stoke up wage growth. But if the supply of older workers has increased, then wage pressures may ease.

There are good reasons to believe that there has been an increase in the supply of older workers, at least in the recent past. The sharp fall in equity prices from late 2000 to early 2003 reduced the expected pension income of those in defined contribution schemes, and individuals' stock of wealth more generally. Earlier declines in annuity rates, which determine the annual income that a given stock of wealth can purchase, could also have affected expected retirement income. So individuals may have decided to continue working to provide for greater consumption in retirement.

In recent years, wage growth — and hence inflation — appears to have become less sensitive to changes in the number of people looking for work. Part of this improvement in the short-run trade-off between inflation and unemployment may be temporary, but some is likely to be permanent. The Committee judges that the rate of unemployment consistent with a given degree of wage pressure is lower now than it was in the late 1990s, in part reflecting structural changes in the jobs market.

(1) Nickell, S and van Ours, J (2000), 'The Netherlands and the United Kingdom: a European unemployment miracle?', *Economic Policy*, Vol. 15 (30), pages 135–80.

On the domestic front, there has been little news in earnings growth during the past three months. Inflationary pressures from the labour market remain relatively subdued. But the prices of oil, gas and metals, which are determined internationally, have all risen since the previous Report. Manufacturers' input and output price inflation have both moved higher and UK import prices have also increased. Consumer price inflation fell during the past three months. The MPC expects CPI inflation to remain weak for the rest of 2004, but to pick up thereafter.

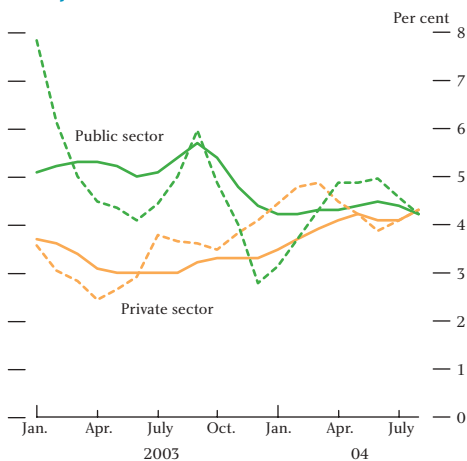
Table 4.A
A summary of trends in whole-economy pay

| | 2003 | | 2004 | |
|---------------------------------------|------|------|------|------|
| | Nov. | Feb. | May | Aug. |
| Whole-economy earnings ^(a) | | | | |
| Twelve-month rate ^(b) | 3.6 | 4.9 | 4.3 | 3.9 |
| Short-run measure ^(c) | 3.6 | 6.1 | 3.4 | 2.4 |
| Regular pay ^(a) | | | | |
| Twelve-month rate ^(b) | 3.6 | 3.8 | 4.2 | 4.3 |
| Short-run measure ^(c) | 3.7 | 4.6 | 4.5 | 4.1 |
| Pay settlements | | | | |
| Twelve-month mean ^(d) | 3.2 | 3.3 | 3.1 | 3.2 |

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

- (a) The whole-economy earnings and regular pay series are the average earnings indices, including and excluding the bonus element respectively.
 (b) Percentage change in the index between the latest three months and the same three months a year earlier.
 (c) Annualised percentage change in the index between the latest three months and the previous three months.
 (d) Annual pay settlements effective during the previous twelve-month period.

Chart 4.1
Growth in regular pay per job^(a) in the private and public sectors



- (a) Average earnings index excluding bonus payments. The solid lines indicate the percentage change in regular pay between the latest three months and three months a year earlier. The dashed lines indicate the annualised percentage change in regular pay between the latest three months and the previous three months.

4.1 Labour costs

Indicators of pay pressures have remained subdued since the previous Report.

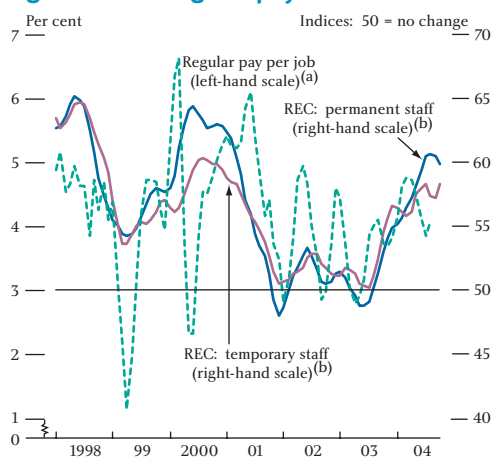
Annual growth in whole-economy average earnings fell by 0.4 percentage points to 3.9% in the three months to August compared with the three months to May. That decline in growth reflected a weaker bonus contribution. Growth in regular pay, which excludes bonuses, edged up to 4.3% between May and August (Table 4.A).

Annual pay growth is affected by developments in earnings twelve months ago, as well as more recent changes. As a result, the annual rate can mask information about the latest trends in growth. Shorter-run measures can be constructed based on changes in earnings during the latest three months compared with the previous three months. On that basis, growth in regular pay per job has also fallen back since the previous Report (Table 4.A).

Developments in private sector earnings are more important than whole-economy earnings for assessing near-term inflationary pressures from the labour market. That is because the goods and services in the CPI basket are mainly produced by the private sector. Chart 4.1 shows that the recent weakening in the shorter-run measure of growth reflects developments in public sector pay. Private sector earnings growth has risen a little.

Other indicators of earnings suggest that pay pressures across the economy as a whole have stabilised. Basic pay settlements have been flat during the past six months (Table 4.A). The

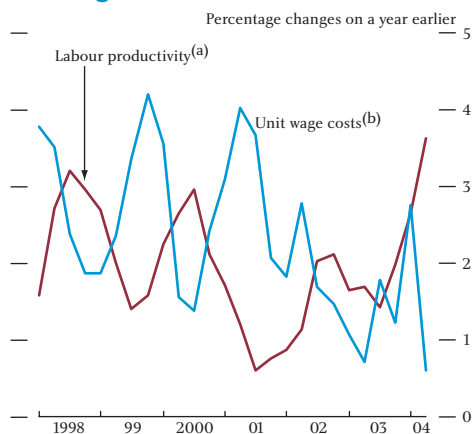
Chart 4.2
Earnings of employees placed by recruitment agencies and regular pay



Sources: ONS and Recruitment and Employment Confederation.

- (a) Annualised percentage change in regular pay in the latest three months compared with the previous three months.
(b) Three-month moving average of the monthly balance. A reading above 50 indicates rising pay.

Chart 4.3
Private sector labour productivity and unit wage costs



- (a) Private sector output divided by private sector Workforce Jobs. Private sector is defined as the whole economy less the public administration, education, health and social work sectors. The Workforce Jobs series has been adjusted so that it corresponds to calendar-year quarters. This measure of productivity differs from that in Chart 3.5 as it is based on output per job rather than output per hour.
(b) Private sector AEI (including bonus) divided by private sector labour productivity.

REC survey of agency pay, which has a reasonable correlation with the official data, suggests that pay inflation has remained broadly unchanged (Chart 4.2). And in their most recent monthly reports, the Bank's regional Agents have noted that pay pressures have been muted.

Measures such as the unemployment and the weighted non-employment rates suggest that the labour market is tight by historical standards. Typically, that should lead to rising earnings growth. Yet, annual wage growth has remained relatively low recently, hovering around 4%. Section 3.4 set out some possible reasons why earnings growth has remained weak despite the apparently tight labour market — for example, increased migration and redesign of the tax and benefits system.

Inflationary pressures in the labour market and the outlook for earnings

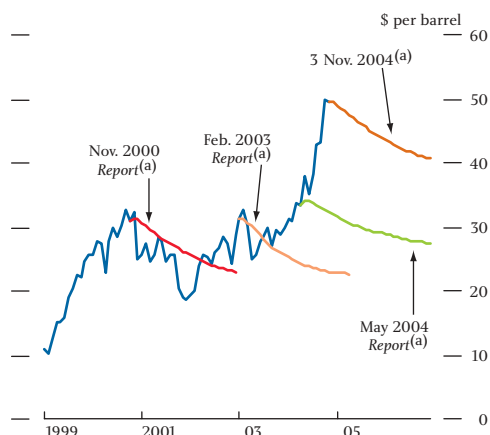
Inflationary pressures from the labour market depend on labour costs per unit of output. Labour costs per unit of output are mainly determined by pay per job and output per job (labour productivity). So weak headline earnings growth could be inflationary if it were accompanied by low productivity growth.

As outlined in [Section 3.2](#), measures of private sector productivity growth have picked up during the past year. That, together with relatively subdued earnings growth, means that annual growth in private sector unit wage costs slowed to less than 1% in Q2 (Chart 4.3). So currently there is little near-term pressure from wage costs on CPI inflation. The Q3 survey from the BCC corroborates that view, finding that fewer manufacturing and service sector companies were citing pay settlements as a source of pressure to raise prices.

In the near term, one source of pay pressures could be the 7.8% rise in the National Minimum Wage rate which took effect in October. In their discussions around the country, the Bank's regional Agents have noted that some firms foresee mounting cost pressures from that increase. And for the most recent data in October, the REC survey has also pointed to upward impetus from the minimum wage on the pay of temporary contract staff. However, the Low Pay Commission has estimated that the impact of the minimum wage on aggregate earnings is likely to be small even when pay differential effects are included.⁽¹⁾

(1) See pages 32–33 of the [May 2004 Report](#) for a discussion of the impact of the increase in the National Minimum Wage on earnings.

Chart 4.4
Brent oil futures



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

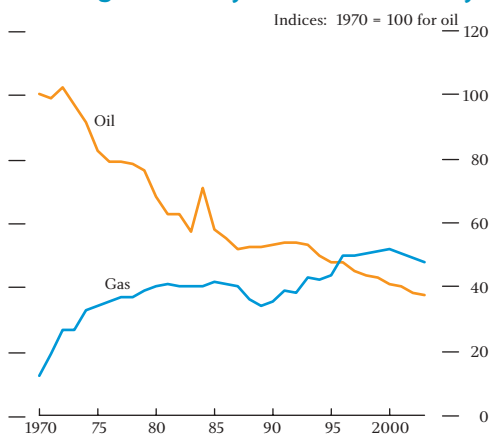
(a) Average during the fifteen working days up to the time at which the MPC finalised its projections.

4.2 Commodity and other raw materials prices

Oil prices have risen further since the previous *Report*. In the fifteen working days to 3 November the price of Brent crude oil averaged over \$49 — about \$9, or 23%, higher than in August. Some of the increase in Brent prices since August probably reflects the effects of continued tensions in the Middle East, as well as weather-related disruption to refineries in the Gulf of Mexico. Chart 4.4 shows that during the past eighteen months, oil prices have persistently risen. Futures prices, which the MPC uses to guide its projections, have also increased. This is in contrast to previous oil price spikes in 2000 and 2003 where the futures curve tended to fall back to the \$22–\$24 level. The [box on pages 28–29](#) assesses how the behaviour of the futures curve may help identify the types of shocks that have affected the oil market.

The [previous Report](#) noted that the oil intensity of economic activity had fallen markedly in the United Kingdom during the past thirty years. That partly reflects a general reduction in the amount of energy needed to produce a unit of UK output. But it also reflects a shift away from oil to other energy sources. Natural gas has become increasingly important for the United Kingdom — the amount of gas used to produce UK output is much higher now than thirty years ago. And since the late 1990s it has become more important than oil (Chart 4.5).

Chart 4.5
Oil and gas intensity of economic activity^(a)



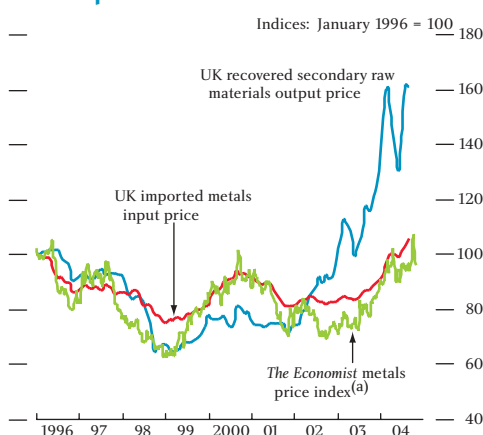
Sources: DTI and ONS.

(a) Ratio of inland consumption of petroleum and gas for energy use (millions of tonnes of oil equivalent) to GDP.

Like oil prices, wholesale natural gas prices have generally risen during the past two years. In October, the price of natural gas traded on the International Petroleum Exchange was about a third higher than a year earlier. That could reflect common influences, such as increased energy demand, affecting both gas and oil markets. Moreover, by encouraging substitution towards other energy sources, increasing oil prices could indirectly push up gas prices. On the retail side, major gas and electricity distributors have recently announced price increases citing rising wholesale prices. [Sections 4.4](#) and [4.5](#) assess the impact of increased gas prices on business costs and consumer prices.

The price of non-oil commodities, as measured by *The Economist* price index, has fallen by around 6% during the past three months. That reflects declines in food and other agricultural products prices (which together account for about three quarters of the index). Metals prices were higher than three months ago. More generally, Chart 4.6 shows that metals prices had started to resume their upward trend following a lull during the early summer. But they have fallen back in the most recent data. [Previous Reports](#) have

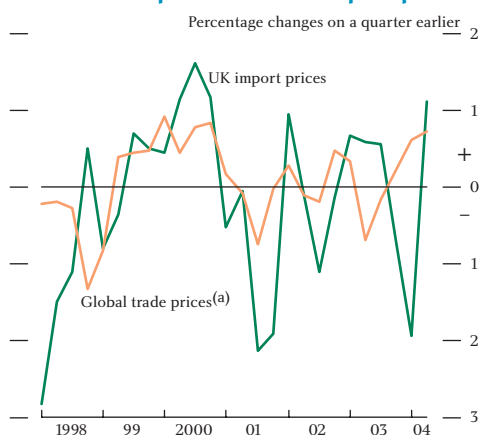
Chart 4.6
Metals prices



Sources: ONS and Thomson Financial Datastream.

(a) In sterling terms.

Chart 4.7
Global trade prices and UK import prices^(a)



Sources: ONS and Thomson Financial Datastream.

(a) In local currency terms. Global trade prices are a weighted average of export prices in the major six economies.

Table 4.B
A summary of manufacturers' costs and prices

| | 2003 | 2004 | | | |
|-----------------------------------|------|------|------|------|------|
| | | Q1 | Q2 | Q3 | Oct. |
| Costs | | | | | |
| Input prices ^(a) | 1.2 | -0.3 | 4.2 | 5.4 | n.a. |
| Unit wage costs ^{(a)(b)} | -1.5 | -1.8 | -1.0 | 0.2 | n.a. |
| CIPS ^(c) | 52.7 | 61.5 | 64.5 | 66.2 | 73.5 |
| Output prices | | | | | |
| Aggregate ^(a) | 1.4 | 1.3 | 2.2 | 2.8 | n.a. |
| Intermediate goods ^(a) | 2.1 | 2.8 | 3.0 | 4.4 | n.a. |
| CIPS ^(c) | 49.8 | 52.7 | 55.5 | 54.8 | 55.4 |

Sources: CIPS and ONS.

(a) Percentage changes on a year earlier.

(b) The Q3 unit wage cost observation is approximated using July and August data only.

(c) The quarterly observations are averages of the monthly balances. A reading above/below 50 implies rising/falling costs/prices. The 2003 observation is the average of the monthly balances.

documented that movements in metals prices are synchronised with global industrial production. But the general strength of metals prices is also likely to be specifically associated with increased demand from China: Chinese demand accounted for most of the growth in global steel consumption in 2002 and 2003. Chart 4.6 shows that imported metals prices and the price of recovered secondary raw materials (mainly scrap metal) produced by firms follow movements in global metals prices. Section 4.4 discusses the impact of rising metals prices on both the costs and output prices of businesses.

4.3 Global costs and prices

The previous *Report* noted that the prices of internationally traded goods and services had edged higher. That momentum has been maintained (Chart 4.7). In Q2, global trade prices, as proxied by the local currency export prices of goods and services in the other major six economies rose by 0.7%.⁽¹⁾ This was the largest quarterly increase since 2000 Q4. In part, the rise probably reflected increases in commodity and other raw materials prices that are filtering through the supply chain.

UK import prices also rose in Q2. That should put upward pressure on consumer prices. And this impetus is likely to be maintained in the near term given rising global trade prices and the recent fall in sterling (see Section 1.1).

4.4 Sectoral costs and prices

Businesses use raw materials, capital, and labour to produce their output. The price of output depends on the costs of those inputs as well as the margin that firms can charge over costs. This section assesses costs and prices in the manufacturing and service sectors, with the aim of identifying the parts of the supply chain in which inflationary pressures are emerging.

Manufacturing sector

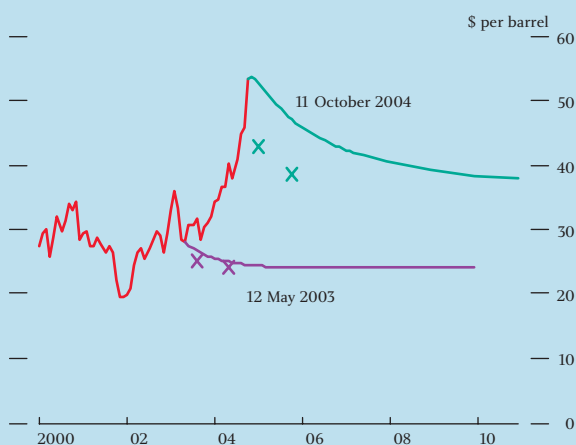
Manufacturing input prices measure the cost of materials and fuels used in that sector. In Q3, manufacturers' input prices rose by over 5% compared with a year earlier, the fastest rate of increase since 2000 Q4. The CIPS input price index reached a nine and a half year high in October (Table 4.B). The current strength of input price inflation mainly reflects the impact of rising crude oil prices, although rising metals prices have also been a factor. Excluding crude oil, the recent

(1) The other major six economies are Canada, France, Germany, Italy, Japan and the United States.

The economics of the oil futures market

Oil prices have risen steadily since May 2003. As outlined in Section 4.2, the Brent futures curve has also risen, in contrast to previous oil price spikes in 2000 and 2003 where futures prices tended to fall back to the \$22–\$24 level. Brent futures are traded for delivery up to about two years ahead. Chart A shows that the far futures price (about six years ahead) of West Texas Intermediate (WTI), another high quality crude oil, has also risen. Does this mean that the shocks affecting the oil market are different from the past? And does the current level of the futures curve mean that market participants believe that higher oil prices will persist?

Chart A
Oil futures curve for West Texas Intermediate oil^(a)



Sources: Bloomberg and Consensus Economics.

(a) The crosses indicate the three-month and one-year-ahead Consensus Economics forecasts for the WTI oil price in May 2003 and October 2004. They are end-month forecasts. The futures curves are those that prevailed on the dates of the Consensus surveys.

The economic information in oil futures

The futures price of a non dividend-paying financial asset should be determined by its current spot price compounded by the risk-free interest rate. If that were not the case, an arbitrage opportunity would exist.⁽¹⁾ But the relationship between the current spot price and the futures price is more complicated in the oil market. Prices are not typically arbitrated as they would be for simple financial assets. That is because oil is both a consumption good — whose production and future demand is uncertain — as well as an asset.

For some companies, holding physical stocks of oil can be more valuable than holding a contract for future delivery of crude oil. For example, oil refiners might prefer to hold physical stocks if they were

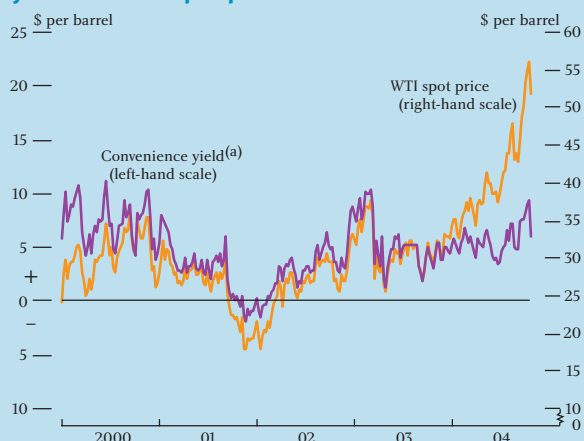
worried about disruption to future deliveries. In other words, there is an option value to holding oil relative to futures. The value of this option is known as the ‘convenience yield’.

If companies prefer to hold oil stocks rather than futures contracts, the spot price compounded by the risk-free interest rate should be higher than the futures price. For this reason, the futures curve is often downward sloping. Futures curves tend to become more downward sloping (or the convenience yield rises) at times of temporary supply disruptions or high volatility in oil prices. That is because oil held in storage becomes more valuable as a hedge against those disruptions. That increases the demand for physical stocks of oil and pushes up the spot price relative to the futures price. So analysis of movements in the convenience yield can give an indication of the types of shocks affecting the oil market.

Recent developments in oil prices

Chart B shows an estimate of the convenience yield and the spot oil price of WTI. The chart shows that the convenience yield and the oil price rose sharply before the start of the hostilities in Iraq in 2003. That probably reflected a temporary inventory-led increase in demand in anticipation of possible supply shortages. But as the war started and the threat of disruption eased, the convenience yield and the spot price both fell back.

Chart B
An estimate of the one-year-ahead convenience yield and WTI spot prices



Sources: Bank of England and Bloomberg.

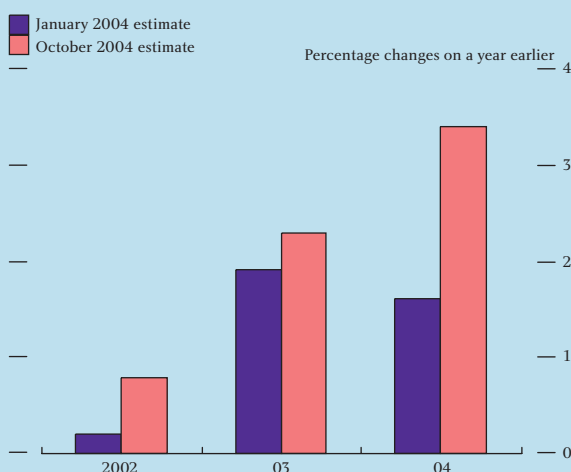
(a) The convenience yield is calculated as the WTI spot price compounded by the one-year ahead US risk-free rate (derived from the government liability curve) less the one-year ahead WTI futures price. This estimate implicitly includes the costs of oil storage. The spot oil price is an end-week observation.

(1) If the futures price were less than the spot price compounded by the risk-free rate, an individual who agreed to buy the asset at the futures price could make a riskless profit. This could be done by selling the asset today, investing the proceeds at the risk-free rate and using the money to buy back the asset when the futures contract matures.

Rises in oil prices during the past year and a half have not been matched by similar increases in the convenience yield. That suggests that current oil market developments are different from those of eighteen months ago.

One possibility is that both futures prices and spot prices are reacting to more persistent shocks. On the supply side, the market may have become more concerned about long-lasting future shortages due to geopolitical instability in some of the major oil-producing regions. Those concerns might have more pronounced effects on prices given falling estimates of OPEC's spare capacity. On the demand side, there have been substantial upward revisions to growth in world oil demand during the past year (Chart C), particularly from non-OECD countries such as China. If a higher level of demand is expected to persist, that should lead to increased spot and futures prices.

Chart C
World oil demand



Source: International Energy Agency.

Futures prices and expectations

The rise in the futures curve may therefore indicate that the market believes that the current shock to the oil price is more persistent than previous episodes. But does the futures curve show an accurate expectation of future spot prices?

In general, true expectations of future spot prices will embody information about the expected return that the asset will generate. Risky assets typically command a premium in addition to the risk-free rate. In principle, this premium depends on how well income from that asset can hedge against general market risk or future economic prospects. For example, the worse the asset is as a hedge against

disappointing economic growth, the greater is the premium that investors will require to hold it.

The difficulty with inferring true expectations of future spot prices from the futures curve is that the curve typically does not embody these risk premia. In the case of oil, the sign of the risk premium can vary. This is because oil can be a good or bad hedge against developments in the world economy depending on the types of shocks affecting the market.

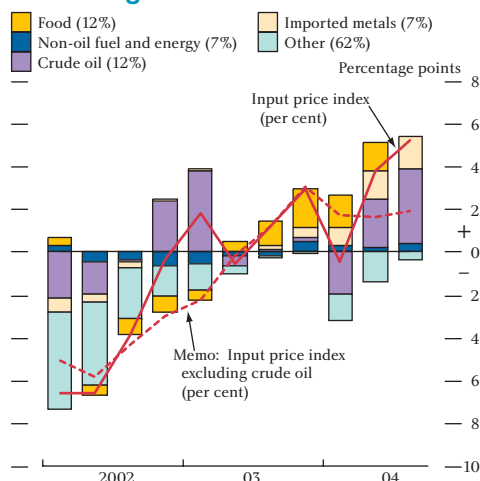
One solution to this problem is to look at oil price forecasts made by professional economists. In principle, these are true expectations and so should embody developments in the risk premium. Chart A shows that, at the three and twelve-month horizon, the rise in the futures curve has been accompanied by higher oil price forecasts. So that suggests that expectations have risen and that some of the recent increase in the spot price is expected to persist.

Chart A also shows that, unlike in May 2003, professional economists' forecasts are lower than the prices implied by the futures curve. One explanation for this is that the risk premium has become negative. That might occur if a negative supply shock affected the oil market. Such negative supply shocks are typically associated with economic downturns and higher oil prices. In that case, holding oil would be a good hedge against disappointing economic growth. This would increase investors' desire for oil, thereby increasing the current spot price, but driving down the expected future return.

However, using surveys to infer market expectations and hence risk premia also has drawbacks. In general, surveys suffer from timing and small sample problems, which could render the forecasts unreliable. These problems are likely to become more acute at times when uncertainty about oil prices has increased. Indeed, the standard deviation of economists' forecasts has more than doubled between May 2003 and October 2004, suggesting that uncertainty about the mean forecast is greater than in the past.

The key message to take from this analysis is that both the futures curve and economists' forecasts of expected future prices have risen during the past eighteen months. That suggests the market believes that at least some of the rise in oil prices will persist. [Section 2.2](#) discusses the wider economic impact of higher oil prices.

Chart 4.8
Manufacturers' input prices and contributions to annual growth



Note: The data are not seasonally adjusted. The numbers in brackets indicate the weight of each subcomponent in the overall index.

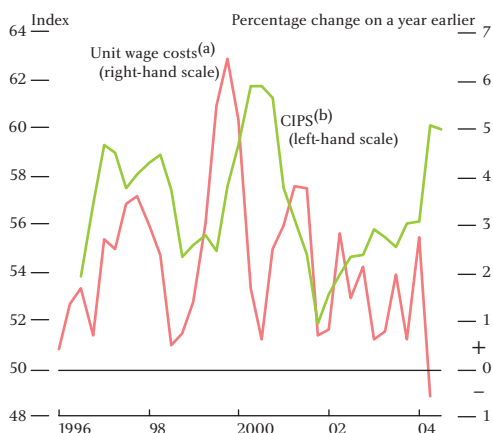
profile of input price inflation is much lower and flatter than the aggregate index (Chart 4.8).

As discussed in Section 4.2, wholesale gas prices have risen sharply. So far, there has only been a moderate impact on the input price index from higher non-oil fuel and energy costs. That is because measured energy prices only started to rise materially for the most recent data in September and because the weight of that component in input prices is low. The Bank's Agents have suggested that many companies entered into long-term contracts with gas suppliers when prices were weak. So the effects of price increases on manufacturers' costs as a whole are likely to be staggered as contracts are renewed.

Input prices do not include labour costs. But these are an important element of overall manufacturers' costs. As outlined in Section 4.1, private sector unit wage cost growth weakened in Q2. Within the private sector, manufacturing unit wage cost growth remained negative. Partial data on manufacturing sector unit wage costs are available for Q3. They imply a slight pickup in costs (see Table 4.B).

Manufacturing output or factory gate prices measure the prices at which that sector sells its goods to distributors and other service sector businesses. Output price inflation has risen steadily during 2004. That rise predominantly reflects two factors. First, higher crude oil prices have fed through to the price of petroleum products. And, second, intermediate and capital goods output price inflation has picked up. Indeed, in Q3, output price inflation for intermediate goods rose to its highest annual rate since 1995 Q4. Some of that rise is likely to reflect conditions in world markets. For example, as outlined in Section 4.2, the price of scrap metal — an intermediate output produced by UK manufacturers — has risen. Barring any reductions in firms' margins, rising output price inflation should filter its way through the supply chain and put upward pressure on CPI inflation.

Chart 4.9
Service sector costs



(a) Private services unit wage costs are approximated by dividing private services average earnings by an estimate of productivity in that sector.
 (b) A reading above/below 50 indicates rising/falling costs. The CIPS survey is monthly; quarterly averages are shown in this chart.

Service sector

Both official data and survey information continue to send mixed messages about costs and prices in the service sector. Annual productivity growth in the private services sector has trebled during the past three quarters, while wage growth has remained subdued. So that means that annual growth in unit wage costs has eased. Indeed, in Q2 unit wage cost growth in services slowed to -0.6%. But according to the CIPS, service sector input price inflation (which includes labour costs) has increased markedly in 2004 to date (Chart 4.9). One explanation for these diverging trends is that

non-labour costs such as energy and raw material costs have risen.

Given these conflicting messages on service sector costs, has service sector output price inflation risen? According to the ONS's experimental corporate services price index (CSPI), a measure of business-to-business output prices, annual output price inflation was unchanged in Q2 at 2.4%. And during the recent past, the CIPS output price balance has also indicated broadly stable inflation. Nevertheless, the CIPS survey balances are higher than last year.

Chart 4.10
CPI and RPIX

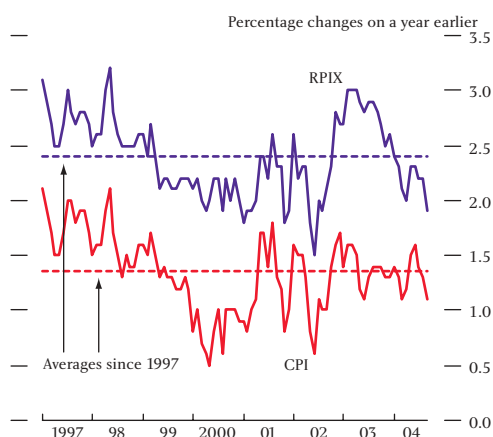


Chart 4.11
An estimate of the private sector profit share^(a)



(a) PNFCs' gross operating surplus (excluding the alignment adjustment) divided by private sector nominal GDP. Private sector nominal GDP approximated by whole-economy GDP at market prices less nominal government consumption.

4.5 Consumer prices

CPI inflation fell steadily during the past three months from 1.6% in June to 1.1% in September. Despite the acceleration in output prices, that fall was driven by declining goods price inflation, in particular by continuing weakness in food prices.

Longer-term trends in CPI inflation

The current low rate of CPI inflation is not unusual. Since 1997, CPI inflation has averaged around 1.3%, 0.7 percentage points below the current inflation target (Chart 4.10). Why has inflation been so low?

One possibility relates to monetary policy and the previous inflation target. In December 2003, the Chancellor changed the inflation target from 2.5% RPIX inflation to 2% CPI inflation. There are material differences between RPIX and CPI.⁽¹⁾ For example, housing costs are not included in CPI. As house prices have risen rapidly, the housing component has generally pushed up RPIX inflation during the past seven years. So monetary policy had to restrain other prices so as to meet the target. Indeed, RPIX inflation has averaged about 2.4% during the past seven years, close to the old inflation target.

A second explanation for low CPI inflation is that businesses' cost growth has been weak. As outlined in [Section 4.1](#), rising productivity growth and slow earnings growth have meant that private sector unit wage cost growth has generally been subdued recently. So that could have contributed to recent low inflation outturns.

A third possibility is that the degree of competition in the United Kingdom has increased and has acted to push down firms' margins. Data on profit margins are limited. Chart 4.11 shows an estimate of the profit share. This fell during the late 1990s and early 2000s, although it has risen since then.

(1) See the [box on page 36 of the February 2004 Report](#) for a discussion of the differences between CPI and RPIX.

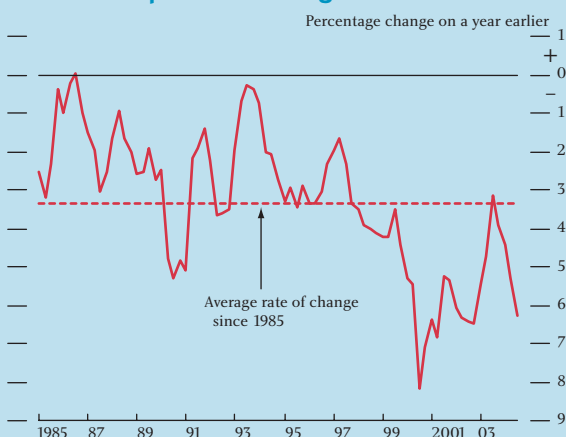
Why have UK clothing prices fallen so steeply?⁽¹⁾

Clothing and footwear prices have been falling since the early 1990s. But the most marked decline in prices occurred in the three years to 2002, when on average they fell by more than 7% each year. And so far in 2004, the pace of deflation has quickened again. This box explores why clothing prices have fallen so much, and whether this phenomenon will persist.

The price of clothing and footwear relative to other retail prices has persistently fallen during the past fifty years. As the production of clothing is labour intensive, one explanation for the price falls is that production has been shifting to economies where labour is comparatively more abundant and cheaper. Data on world exports support that view. The share of developing countries' clothing exports in world clothing exports rose from less than 25% in the 1960s to over 70% in 2000.

But Chart A shows that the size of the relative price declines has become much more pronounced since the late 1990s. That might be related to an increased pace of trade liberalisation in the clothing and textile industry during that period. Traditionally, rich economies have used quotas to restrict clothing imports. But in 1995, the EU, Canada, Norway and the United States agreed that clothing and textile import quotas should be phased out over a ten-year period.

Chart A
The relative price of clothing and footwear^(a)

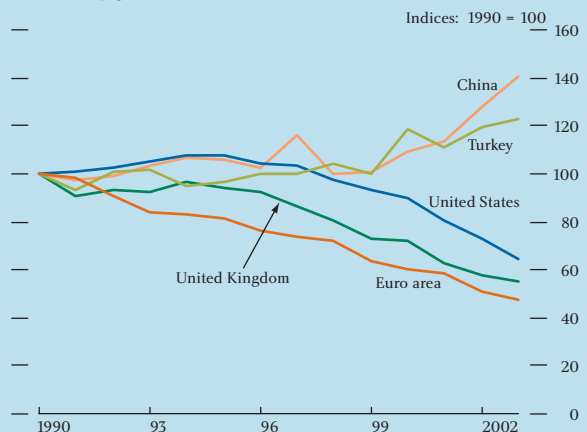


(a) Ratio of clothing and footwear RPI to aggregate RPI. Both RPI series have been seasonally adjusted by the Bank of England.

Since then, clothing production has fallen markedly in the richer economies (Chart B). The change in trend

is particularly noticeable for the United Kingdom and the United States. At the same time, production in emerging markets such as China and Turkey has picked up sharply. Indeed, according to the World Trade Organisation, the share of Chinese clothing exports in global clothing exports has risen by about 50% since the mid-1990s.

Chart B
Clothing production^(a)



Source: Thomson Financial Datastream.

(a) Volume measures.

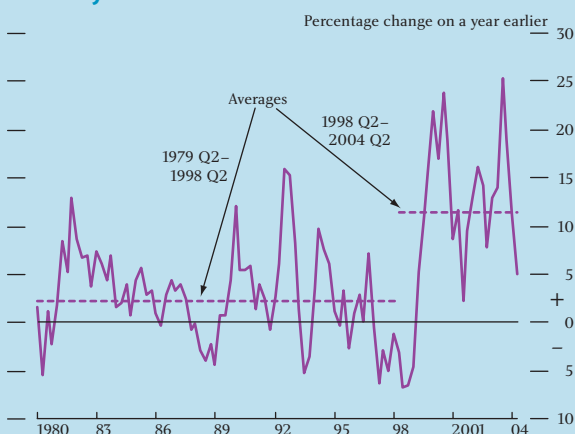
The increased pace of liberalisation will have pushed down directly on UK clothing prices through increased imports. But competition may also have forced structural change in UK clothing production.

That appears to be the case. Although there has been some slowdown in the most recent data, productivity growth in the dwindling UK clothing production industry has picked up extremely sharply since the late 1990s (Chart C). That could reflect clothing manufacturers with high nominal unit costs being forced out of business. Moreover, the profit share in the UK textiles industry fell by just over one third between 1997 and 2002. So both these factors suggest that competition has forced the UK clothing industry as a whole to reduce nominal unit costs and margins.

Another factor behind weaker clothing price inflation is structural change in the UK distribution sector for clothing. Department of Trade and Industry data imply that the number of small wholesalers in the sectors that cover clothing has fallen by about one quarter between 1997 and 2003. That is in line with anecdote which suggests that increased competition

(1) This box draws on a number of sources including: Nordàs, H K (2004), 'The global textile and clothing industry post the Agreement on Textiles and Clothing', *World Trade Organisation Discussion Paper no. 5*; *International Trade Statistics*, World Trade Organisation; 'The future of the textiles and clothing sector in the enlarged Europe' (2003), *Commission of the European Communities Staff Working Paper no. 1345*; 'Evolution of trade in textile and clothing worldwide — trade figures and structural data' (2003), *Commission of the European Communities Staff Working Paper no. 1348*; Broadbent, B (2004), 'Households yet to benefit from outsourcing', *Goldman Sachs Euroland Weekly Analyst*, Issue No: 4/30; and *Small and medium enterprise statistics for the UK*, Department of Trade and Industry.

Chart C
Labour productivity in the UK clothing production industry^(a)

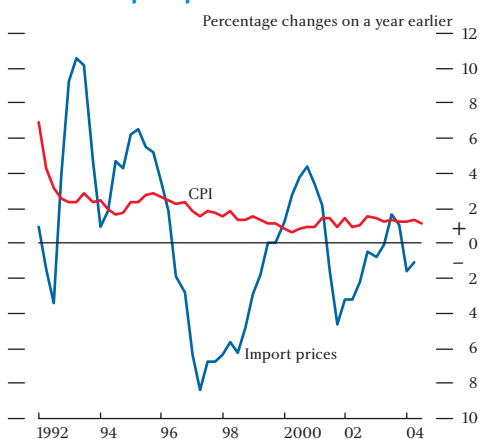


(a) Labour productivity calculated as output per employee job in the clothing manufacturing industry. The employee jobs series has been adjusted so that it corresponds with calendar-year quarters.

has forced out independent distributors of clothing in recent years. Clothing is also increasingly available in non-specialised stores such as supermarkets which have access to global procurement systems. All these changes should reduce distribution costs. And, as long as the retail sector is competitive, lower costs should be passed onto the consumer in the form of lower prices.

Will clothing prices continue to decline rapidly? There are good reasons to believe that prices will carry on falling in the medium term. By the beginning of 2005, remaining quotas on clothing and textile imports should have been lifted. That should stimulate more production, and more imports, from lower cost clothing producers. There could also be further gains in distribution sector productivity, if, for example, supermarkets continue to make inroads into clothing. Both these factors should continue to exert downward pressures on prices.

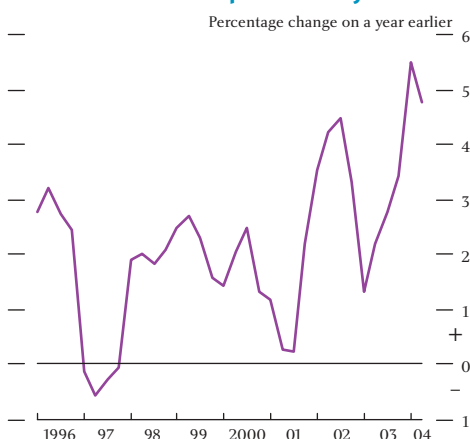
Chart 4.12
CPI and import prices



Increased competition may have put downward pressure on prices during the earlier period. The car market is a good example of how increased competition affected prices. Car prices fell sharply around the time of the Competition Commission inquiry into the industry in 1999 and 2000.⁽¹⁾

It may be that the United Kingdom has benefited more from international trade in recent years than previously. During the past seven years, import prices have generally risen more slowly than CPI and so have acted as a drag on inflation (Chart 4.12). That could partly reflect the appreciation of sterling in 1996 and 1997. But it could also reflect the effects of increased specialisation in global trade. If UK imports have become more geared towards products that are produced much more cheaply abroad, that will act to reduce import prices. And the effects on CPI would be even more pronounced if, at the same time, the import share in consumer goods had increased.

Chart 4.13
Distribution sector productivity^(a)



(a) Labour productivity is approximated as output per employee job in the distribution sector. The employee job series has been adjusted so that it corresponds to calendar-year quarters.

Another possibility is that there has been structural change in the distribution sector. The adoption of new technologies such as bar coding, improved inventory management techniques and industry reorganisation could have boosted productivity growth in that sector. That should help to reduce costs and ultimately price inflation, if productivity gains were passed through to the consumer. But productivity growth in the distribution sector has only picked up since 2001 (Chart 4.13). So although that can help explain current low inflation, it cannot explain the earlier weakness.

(1) See page 37 of the May 2004 Report.

Ultimately, it is likely that these factors have acted in combination to keep CPI inflation low. But trade, technology and competition shocks are unlikely to affect all consumer goods and services in the same way. In order to isolate their impact it is instructive to consider developments in particular industries. A good example is clothing where prices have fallen sharply in recent years. The box on [pages 32–33](#) analyses why those prices have fallen so much and whether that price deflation will persist.

The short-term outlook for consumer price inflation

Looking forward, recently announced gas and electricity price increases as well as rising petrol prices should put immediate upward pressure on CPI. But the MPC expects that the current weakness in inflation will persist until the end of 2004. Thereafter, CPI inflation is likely to pick up as cost increases already in the pipeline, the depreciation of sterling and domestic capacity pressures all help to lift consumer prices.

This section summarises the monetary policy decisions taken by the MPC since the August Report.⁽¹⁾ The Bank's repo rate was maintained at 4.75% in September, October and November.

The MPC's central projection in the August Report, under the assumption that official interest rates followed a path implied by the market yield curve, was for UK GDP to grow vigorously during the first year, but then to moderate. CPI inflation was forecast to dip in the near term, but then to rise, settling close to the 2% target after two years.

At the time of the Committee's meeting on 8–9 September, that outlook for robust GDP growth remained intact. But it seemed that the pace of UK growth in Q3 might be a little slower than had been envisaged, although it was too soon to judge with any certainty. The recent labour market data had also been surprisingly weak, though inflationary pressures were still evident in the supply chain.

Downside risks had perhaps increased. First, future US economic growth might be weaker if consumption growth picked up less briskly from the second quarter. Second, there were further signs of a cooling in the UK housing market. This might mean a greater risk of a more abrupt correction to house price inflation, and the Committee might have underestimated the potential for an associated downward impact on consumption. But sterling had depreciated over the month. If that persisted, it would probably add to inflationary pressures, which would tend to offset the slightly weaker news on activity.

The Committee considered the arguments for keeping the repo rate unchanged at 4.75%. August's 25 basis points increase in the repo rate reflected a movement at least as fast as that implied by the market rate curve on which the August projections had been based, and the news about economic activity since then was, on balance, slightly weaker. Medium-term inflation expectations appeared to remain well anchored to the target. On that basis, no change in official rates was necessary.

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

Some members also considered arguments for raising the repo rate by 25 basis points. The economy was likely to continue to grow at or above trend. With little or no remaining spare capacity, this would put gathering pressures on supply. A lower exchange rate and a shift down in the money market yield curve would have added to inflationary pressure. Taken as a whole, members did not find these arguments sufficient to justify a rise in the repo rate, and the Committee voted unanimously to maintain the repo rate at 4.75%.

At its meeting on 6–7 October, the Committee noted that there were signs that UK output had been growing less strongly in the third quarter than previously expected. Activity and inflation in the housing market were easing. The labour market, although tight, had not tightened further. Consumer price inflation had fallen further below target.

But there had been further falls in sterling and UK market interest rates, and a rise in equity prices. These would all tend to support activity and inflation. And growth in unsecured lending and broad money had increased.

In the global economy, it was likely that activity growth in the United States and Japan would pick up from the slower rates in Q2, although US indicators in Q3 were mixed and perhaps less buoyant than expected. Germany aside, the euro area seemed likely to maintain growth at around its trend rate, and prospects in non-Japan Asia looked strong. The further rise in the oil price was unlikely to persist in full, although there were substantial risks to this outlook.

Members concluded that no change in the repo rate was appropriate. While the impact of the latest data on output and demand would probably be on the downside in the near term, financial market developments, and in particular the fall in the exchange rate, would be supportive. There were also several puzzles in the current conjuncture — for example between the apparent tightness of the labour market and modest pay pressures, and between gradually accelerating broad money and nominal GDP, and low and stable consumer price inflation. These issues added to the uncertainty of the outlook for inflation, and the Committee would be able to consider them further during the November *Inflation Report* round.

The Committee voted unanimously to maintain the repo rate at 4.75%.

At its meeting on 3–4 November, the Committee also voted to maintain the repo rate at 4.75%.

Under the MPC's central projection, which assumes that official interest rates follow a path implied by market yields, GDP is projected to grow at around trend rates over the next two years. The profile is weaker in the short term compared with the August Report, but stronger further out. CPI inflation picks up next year as cost increases already in the pipeline, the depreciation of sterling, and domestic capacity pressures all help to lift consumer prices. Inflation then rises more slowly, reaching the 2% target after two years, and continues to rise a little thereafter. The profile is broadly similar to that in the August Report. Key risks around the central projection for CPI inflation relate to: the world economy; the prospects for house prices and the impact on consumption; wages; and the reaction of prices to demand and cost pressures.

6.1 World economy

Oil

Spot prices for Brent oil climbed above \$50 per barrel during October. They have fallen back more recently, but remained substantially higher than at the start of the year. The associated increase in futures prices suggests that higher oil prices may persist into the medium term. Oil price spikes in the 1970s had long-lasting effects on world price inflation and were followed by severe downturns in world activity. However, oil is a much less important input for production now, and the real price of oil is considerably below its levels then. Consequently, the impact of the current oil price on global growth and inflation is likely to be relatively modest.

World activity

World economic growth in 2004 will probably prove to be exceptionally strong. Some easing from this rapid pace is likely in 2005, as policy tightening and the high price of oil help to slow activity. But thereafter growth is expected to stabilise. The outlook is broadly similar to August. The higher oil price compared with three months ago is likely to dampen activity, but higher equity prices and lower market interest rates are likely to provide an offsetting boost.

The euro area

The euro area seems to have entered a period of steady growth. Underpinned by buoyant world demand, net trade is expected to make a positive contribution to growth during the next three years. German domestic demand growth is likely to

pick up over the forecast period, supported by income tax cuts in January 2005 and the boost to domestic incomes from export growth. In the rest of the euro area, the recovery in domestic demand is already in train. Overall, GDP growth in the euro area is likely to remain close to trend rates.

The United States

US GDP looks set to grow strongly in 2004. After dipping in 2004 Q2, consumption growth picked up in Q3. Private sector investment spending has grown strongly during recent quarters, bolstered by buoyant profits and by fiscal incentives that are due to expire at the end of 2004. GDP growth is projected to slow during the next two years, as the stimulus from monetary and fiscal policy is gradually removed.

Asia

The main impetus to growth in the Asian economies during the forecast period is likely to come from China. The Chinese economy has grown at a rapid pace for over a decade, and shows little sign of significant slowing. Continued recovery is forecast in Japan, despite the sharp dip in GDP growth in 2004 Q2. Rising consumer and business confidence is consistent with resilient private domestic demand in the near term. Net trade is also likely to contribute to the Japanese recovery.

UK overseas markets and world trade prices

Echoing developments in world activity, UK export markets have been expanding rapidly in 2004. But growth is likely to moderate somewhat over the forecast period. The outlook is broadly similar to that in August.

The rising price of oil and other raw materials has begun to push up producers' costs around the world as well as the prices that they charge for their exports. World capacity pressures are also giving some impetus to price increases. The prices of goods and services traded on world markets are likely to continue to rise during the forecast period, and at a slightly faster rate in the near term than projected in August.

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

Per cent

November

| 2004 | | 2005 | | 2006 | | | | 2007 | | | | |
|------|-----|------|-----|------|-----|-----|-----|------|-----|-----|-----|-----|
| Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.7 | 4.8 | 4.8 | 4.8 | 4.8 |

August

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

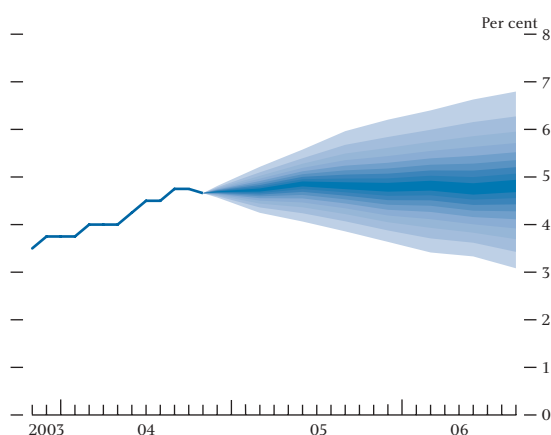
(a) The data are fifteen-day averages to 3 November 2004 and 4 August 2004 respectively. The rates used for the November projection have been derived from instruments that settle on the London interbank offered rate. That includes the market rates on futures, swaps, interbank loans and forward rate agreements, adjusted for credit risk. In August and before, the MPC based estimates of market expectations on the implied forward market interest rates derived from gilt-edged securities and general collateral repo contracts. But special market factors currently affecting gilts at short maturities mean that these rates appear less indicative of the markets' expectation of future official rates than they have been. The MPC may change the way it estimates market expectations from time to time, as shifting market conditions can alter the relative advantages of using different methods.

6.2 The interest rate assumptions

The projection described below is conditioned on a path for official interest rates implied by market yields (Table 6.A). That path provides a convenient benchmark assumption on which to condition the MPC's projections.⁽¹⁾ As always, there is a negligible probability that official interest rates will follow that profile. It is possible to generate a fan chart (Chart 6.1),

(1) See the box 'The interest rate assumptions in the projections', on pages 42–43 of the August 2004 Report.

Chart 6.1
Market beliefs about future interest rates



The mode of the fan chart is the market rate profile for 3 November, consistent with the measure of interest rates shown in Table 6.A. The distribution around that path is constructed using the prices of options on three-month Libor futures contracts traded on LIFFE. The chart has been drawn so that there is a 10% probability of rates being in the central darkest band, and then each lighter shade of blue represents a further 10% so that the shaded area covers 90% of the probability. There are no contracts traded beyond September 2006, so the chart only goes out to that point rather than the three years shown in the GDP and inflation fan charts. The chart is only indicative of market expectations because it is based on a different, though related, instrument to the Bank's repo contracts. The distribution has been estimated on the assumption that investors are risk-neutral.

which uses information from options prices to provide an approximate indication of the markets' uncertainty about the future levels of interest rates. The chart suggests that market participants believe that a wide variety of outturns is possible.

6.3 UK output and expenditure

Household consumption

The ratio of house prices to earnings has risen sharply during the past three years and is likely to be above a sustainable level. More recently, house price inflation has declined a little more sharply than the MPC anticipated in August. Indeed, according to some measures, house prices have fallen. The MPC judges that the ratio of house prices to earnings will decline during the forecast period. The adjustment could be protracted: house prices could stagnate or rise more slowly than earnings. The MPC's central projection, however, implies that house prices may fall modestly for a period, a somewhat weaker prospect than in August. But the outlook for house prices is extremely uncertain.

The box on pages 12–13 explains how, in the recent past, the association between house price inflation and consumption has been less strong than in earlier years. As noted in [previous Reports](#), that has led the MPC to expect that a less buoyant housing market would not imply a substantial weakening of household spending. Consumer spending growth will probably moderate slightly in the near term, and then gradually recover. That represents a weaker outlook in the near term compared with August, largely resulting from the lower house price projection. But further ahead, the consumption profile is somewhat higher: lower short-term interest rates and higher equity prices provide greater support for household spending than in the August projection.

Business investment

The business investment recovery has strengthened and is set to continue. Corporate profits picked up further and liquidity has increased. The Bank's regional Agents report that investment intentions have remained firm, even if some of the recent survey indicators have been more mixed. The MPC expects business investment to grow at a brisker pace than it projected three months ago. Even so, the MPC believes, as in August, that the high levels of corporate debt will act as a drag on investment over the forecast period, so that investment will not grow as rapidly as it did in previous upturns.

Net trade

Sterling has depreciated since the August Report. In the fifteen working days to 3 November, the sterling ERI averaged

102.1, the starting point used in the MPC's central projection — nearly 4% below the equivalent average in August. Under the MPC's usual convention,⁽¹⁾ the exchange rate is assumed to depreciate to 99.6 by 2006 Q4, around 3¹/₂% lower than in the August projection. The lower value for sterling coupled with strong external demand should support export growth over the forecast period.

Other things being equal, weaker sterling would tend to be associated with a stronger profile for UK export growth than in August. But the Committee's current projection for export growth is below where it was three months ago. Despite the rapid expansion in the world economy in 2004, UK export growth has been only moderate. The MPC has reassessed its forecast in light of the continued decline in the United Kingdom's export share. The change in judgement more than offsets the boost provided by the fall in sterling and implies a more subdued pace of future export growth than anticipated in August.

Imports are expected to grow at a fairly steady pace throughout the forecast period, underpinned by firm domestic demand. But import growth is expected to be weaker than anticipated in August. A higher profile for import-intensive investment spending helps to support import growth, but that is likely to be more than offset by the impact of the lower value of sterling.

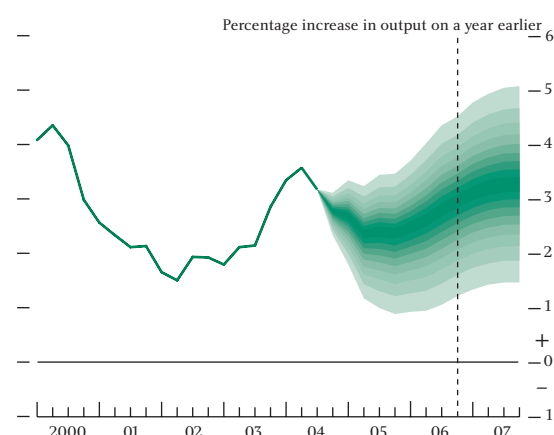
Taking exports and imports together, net trade is likely to detract from output growth in the first year of the forecast, but to make a positive contribution further out. That is a weaker projection in the near term than anticipated in August, but stronger in the second and third years.

Government spending

In forming its projections, the MPC assumed that nominal government spending will grow broadly in line with the Chancellor's plans. The latest plans were announced in the *2004 Spending Review* that was presented to Parliament in July. The pace of nominal spending growth slows over the forecast period. While government output affects the path of GDP, the Committee believes that the impact of the government sector on the outlook for inflation is best captured not by its output, but by its demand for labour and for private sector products ([see page 14 of this Report](#)). A measure of the government's demand for these resources is expected to grow more quickly over the forecast period than the ONS measure of government output.

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

Chart 6.2
Current GDP projection based on market
interest rate expectations



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

The outlook for GDP

Chart 6.2 shows the projection for four-quarter GDP growth on the assumption that official interest rates follow a path implied by market yields. In the central case, four-quarter growth softens in the first year of the forecast to a little below its long-run average rate. Growth then picks up during 2006, and continues to recover throughout the rest of the forecast.

Recent data outturns have prompted a change in view about the near-term prospects since August. Even though the MPC judges that the ONS preliminary estimate for GDP growth in Q3 somewhat overstates the slowdown in activity, a weakening has also been apparent in business surveys and in reports from the Bank's Agents. But growth is projected to be stronger further out than in the *August Report* because higher equity prices and lower profiles for official interest rates and for the exchange rate all help to boost activity relative to the projection three months ago.

6.4 The outlook for inflation

The outlook for CPI inflation is heavily influenced by the balance between the demand for private sector output and the resources available to produce it. That, in turn, depends on the degree of spare capacity within the private sector and on conditions in the labour market. Private sector output has grown at a brisk rate for much of the past year, and it seems likely that, on average, companies are close to, or even above, their normal levels of capacity utilisation. Surveys and reports from the Bank's Agents are consistent with that view. In the MPC's central projection, growth over the next two years remains close to its long-run trend rate, despite the near-term softness. So a shortage of spare capacity is likely to put upward pressure on inflation throughout the forecast period.

Employment is likely to grow marginally more quickly than the total pool of available labour during the next three years. That implies a further tightening of the labour market, and so earnings and unit labour cost growth will probably rise. Compared with the August projection, there is little change to the Committee's judgement about prospective wage growth over the forecast period as a whole.

Developments in world prices and movements in the sterling exchange rate also affect the outlook for UK inflation. Higher raw material prices and larger increases in world export prices are likely to boost UK inflation in the short term. The recent depreciation of sterling will amplify that effect as it will tend to raise the domestic prices of imported goods and services.

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

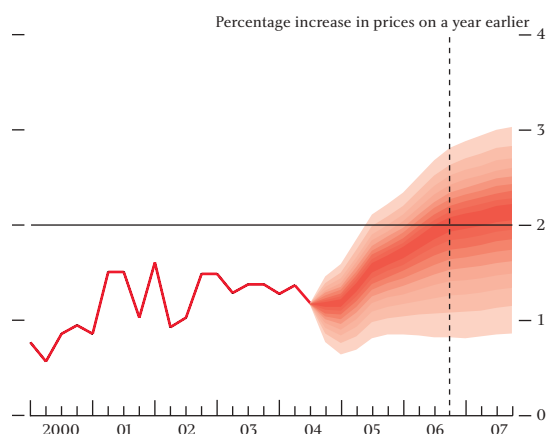
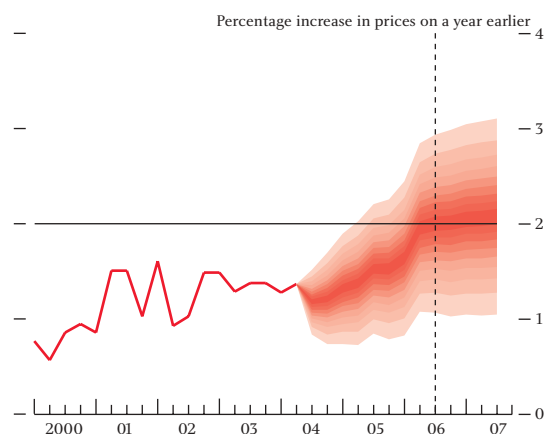


Chart 6.4
CPI inflation projection in August based on market interest rate expectations



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

The Committee's projection for CPI inflation, assuming that official interest rates follow a path implied by market yields, is shown in Chart 6.3. CPI inflation picks up, reaching the 2% target after two years, and continues to rise a little thereafter. A limited margin of spare capacity, pricing pressures already working through the supply chain, and the decline in the value of sterling give upward impetus to consumer prices in the first year. Demand pressures are still evident in the second year of the forecast. But the direct effects of higher oil prices and the depreciation of sterling on the inflation rate moderate. The profile for inflation is broadly similar to that in the August *Report*. The impact on the forecast of weaker-than-expected news on activity since the August *Report* has been offset by a higher oil price, a weaker exchange rate, a lower profile for market interest rates, and higher equity prices.

6.5 Risks around the central projection

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

The main risks around the central projection relate to the world economy; the prospects for house prices and their

impact on consumption; the outlook for wages; and the reaction of prices to demand and cost pressures.

A key risk to the world economy is the oil market. Oil prices have risen further since the *August Report*. It is possible that the MPC has underestimated the impact that such a rise could have in pushing up inflation around the world, and in depressing activity.

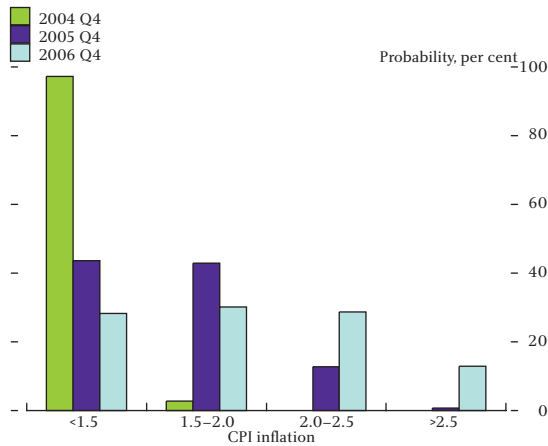
Another risk to the outlook could arise from large current account imbalances around the world. In particular, the US national saving ratio is historically low and the current account deficit is correspondingly high. At some stage a correction is likely. That might represent a downside risk to world activity and hence to activity in the United Kingdom.

In the United Kingdom, house prices appear to be moving towards a more sustainable level relative to earnings. But the MPC remains uncertain what that sustainable level is, and how quickly any adjustment towards it might occur. It could be quite protracted with broadly stable house prices for a long period. That would represent an upside risk to the MPC's central projection. Alternatively, house prices could adjust downwards more rapidly than the Committee has assumed in its central case.

Another key uncertainty for the Committee with respect to the housing market is the impact of movements in house prices on consumption. The weaker association between house prices and consumption in the latest upturn than in earlier years has led the MPC to judge that the relationship may also be less strong as house price inflation slows. There is a risk that the downward impact on consumption from a sharp slowing in house price inflation is larger than in the central projection. So overall the risks from the housing market to GDP growth and CPI inflation are on the downside.

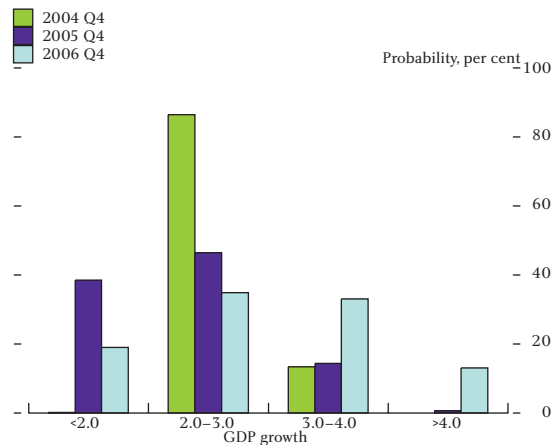
There are a number of risks relating to how a particular path for demand will affect inflation. One risk relates to wages. Wage growth has been unusually subdued, given the low level of unemployment. Part of the explanation probably lies in the impact of government reforms spanning the past twenty-five years that have changed the relationship between wage growth and unemployment. Other factors may have changed the relationship more recently. Additional inward migration or delayed retirement, for example, may have helped to keep wages in check during the past few years. But the MPC remains uncertain about the importance of different factors in explaining the low outturns for earnings growth, and about how long-lasting some of the effects will be.

Chart 6.5
The MPC's expectations for CPI inflation based on market interest rate expectations^(a)



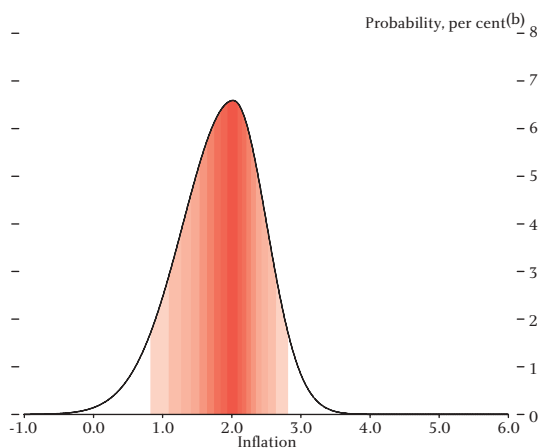
(a) These figures are derived from the same distribution as Chart 6.3. They represent the probabilities that the MPC assigns to CPI inflation lying within a particular range at a specified time in the future.

Chart 6.6
The MPC's expectations for GDP growth based on market interest rate expectations^(a)



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

Chart 6.7
Current projection for the percentage increase in CPI in the year to 2006 Q4^(a)



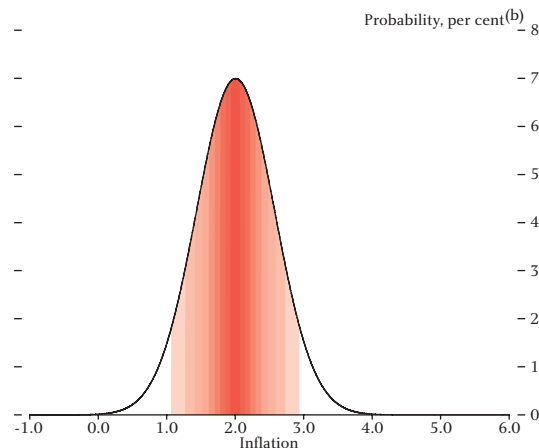
(a) These charts represent a cross-section of the fan chart at the end of the respective two-year periods for the market interest rate projections. As with the fan charts themselves, the shaded areas represent 90% of the distribution of possible outcomes for CPI inflation in the future. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands covers a further 10%. There is judged to be a 10% chance that the outturn 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.

Another set of risks around the central projection for inflation relates to how retailers and other distributors respond to incipient cost pressures and the strength of demand. Goods price inflation at the factory gate has been rising for three years. The recent depreciation of sterling is likely to put further upward pressure on these prices and the prices of imported consumer goods. And the strength of demand suggests that pressures are likely to continue mounting throughout the forecast period. The MPC has assumed that some of the cost and price increases will eventually be passed through to the consumer. However, CPI inflation has been low and stable despite significant variation in costs and demand during the past six years. It is possible that distributors have responded to domestic cost and competitive pressures by reducing their profit margins, by raising their productivity or by sourcing from cheaper producers abroad. In constructing its central projection, the MPC may have underplayed the extent to which distributors would respond in that way in the future. That represents a downside risk to the CPI inflation forecast.

But equally, prices could react more quickly to rising costs and demand. The Committee may have misjudged the degree to which the recent subdued CPI inflation reflected a temporary squeeze on margins or some other short-lived factor. That misjudgement would imply an upside risk to CPI inflation.

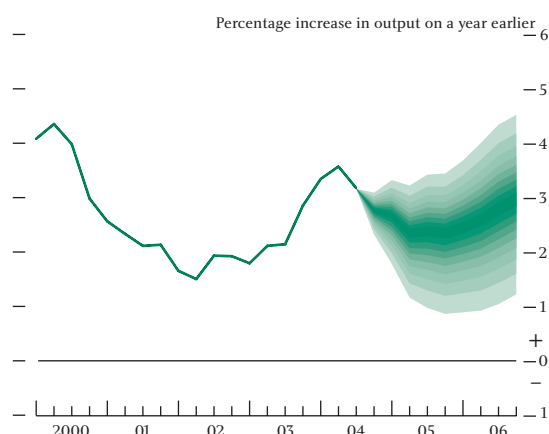
The best collective judgement of the Committee is that the risks to both GDP growth and CPI inflation are on the downside, largely reflecting the Committee's view of the outlook for the housing market and the impact of house prices on consumption. The probabilities of various outcomes for

Chart 6.8
August projection for the percentage increase in CPI in the year to 2006 Q3^(a)



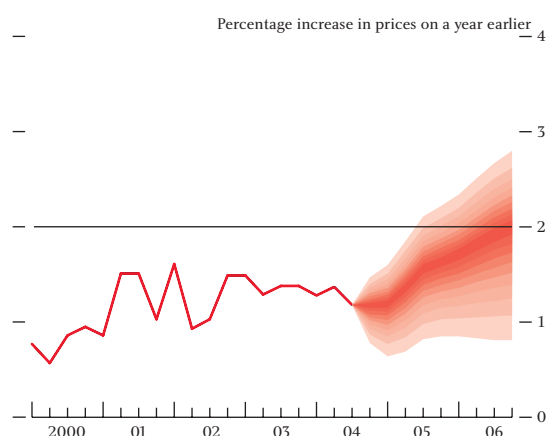
(b) Probability of inflation being within ± 0.05 percentage points of any given inflation rate, specified to one decimal place. For example, the probability of inflation being 2.0% (between 1.95% and 2.05%) in the current projection is around 7%.

Chart 6.9
Current GDP projection based on constant nominal interest rates at 4.75%



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

Chart 6.10
Current CPI inflation projection based on constant nominal interest rates at 4.75%



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

CPI inflation and GDP growth under the market interest rate assumption are set out in Charts 6.5 and 6.6. The overall balance of risks to the inflation outlook at the two-year point is shown in Chart 6.7, alongside the corresponding balance in August. There is a range of views among members, though the differences are small.

6.6 Projection based on constant interest rates

The Committee's projections for GDP growth and CPI inflation conditioned on a constant interest rate at 4.75% are shown in Charts 6.9 and 6.10 respectively. These charts show projections only up to a two-year forecast horizon. The profiles for growth and inflation are almost identical to the ones based on market rates. The market yield curve underlying the projections in Charts 6.2 and 6.3 is flat and similar to the constant rate assumption.

6.7 The policy decision

At its November meeting, the Committee noted that, under the central projection, growth was near trend with inflation reaching the 2% target after two years and continuing to rise a little thereafter. There were considerable uncertainties surrounding these projections and the balance of risks was somewhat to the downside. In the light of this outlook, the Committee judged that no change in the current level of the official interest rate was necessary to keep inflation on track to meet the target in the medium term.

Other forecasters' expectations of CPI inflation and GDP growth

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

Table 1
Average of other forecasters' projections of CPI inflation, GDP growth, interest rates and the ERI^(a)

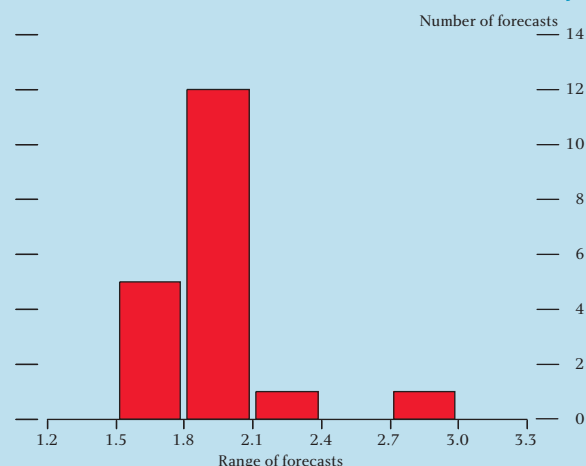
| | 2004 Q3 ^(b) | 2004 Q4 | 2005 Q4 | 2006 Q4 |
|-------------------------------------|------------------------|---------|---------|---------|
| CPI inflation ^(c) | 1.2 | 1.4 | 1.8 | 1.9 |
| GDP growth ^(c) | 3.0 | 2.9 | 2.4 | 2.5 |
| Repo rate (per cent) | 4.7 | 4.8 | 4.9 | 4.8 |
| Sterling ERI (Index: 1990 = 100) | 104.8 | 102.4 | 100.0 | 99.2 |

Sources: Bank of England, ONS and central projections of outside forecasters as of 29 October 2004.

- (a) For 2004 Q4 and 2005 Q4, 23 forecasters provided the Bank with forecasts for CPI inflation, GDP growth and the repo rate; and 20 gave ERI forecasts. For 2006 Q4, there were 19 forecasts of CPI inflation, GDP growth and the repo rate; and 16 forecasts for the ERI.
- (b) Outturns. GDP is the preliminary ONS estimate for chained volume GDP at market prices. The repo rate and sterling ERI are daily averages.
- (c) Percentage changes on a year earlier.

On average, CPI inflation was expected to rise from the latest outturn of 1.2% in 2004 Q3 to 1.4% in 2004 Q4 and just below the 2.0% target in 2005 Q4 and 2006 Q4. These projections for CPI inflation are a little lower, on average, than those discussed in the *August Report*. Two thirds of the sample are between 1.8% and 2.1% in 2006 Q4, and all are within 1 percentage point of the target (Chart A).

Chart A
Distribution of CPI inflation forecasts for 2006 Q4



Source: Central projections of 19 outside forecasters as of 29 October 2004.

External forecasters also provide the Bank with information on the likelihood of a range of possible outcomes for CPI inflation and GDP growth (Table 2).

On average, the external forecasters see a 57% probability of CPI inflation being within half a percentage point of 2.0% in two years' time, with a 25% probability of inflation below 1.5% and an 18%

Table 2
Other forecasters' expected probability distributions for CPI inflation and GDP growth^(a)

| CPI inflation | Probability, per cent ^(b) Range: | | | | | |
|------------------------|---|--------------|--------------|--------------|--------------|----------------|
| | Less than 1.0% | 1.0% to 1.5% | 1.5% to 2.0% | 2.0% to 2.5% | 2.5% to 3.0% | More than 3.0% |
| 2004 Q4 | 12 | 52 | 27 | 6 | 2 | 0 |
| 2005 Q4 | 8 | 21 | 39 | 22 | 8 | 2 |
| 2006 Q4 ^(c) | 7 | 18 | 32 | 25 | 13 | 5 |

| GDP growth | Probability, per cent ^(b) Range: | | | |
|------------------------|---|----------|----------|--------------|
| | Less than 1% | 1% to 2% | 2% to 3% | More than 3% |
| 2004 Q4 | 1 | 10 | 52 | 37 |
| 2005 Q4 | 8 | 25 | 44 | 24 |
| 2006 Q4 ^(c) | 10 | 25 | 41 | 24 |

Source: Projections of outside forecasters as of 29 October 2004.

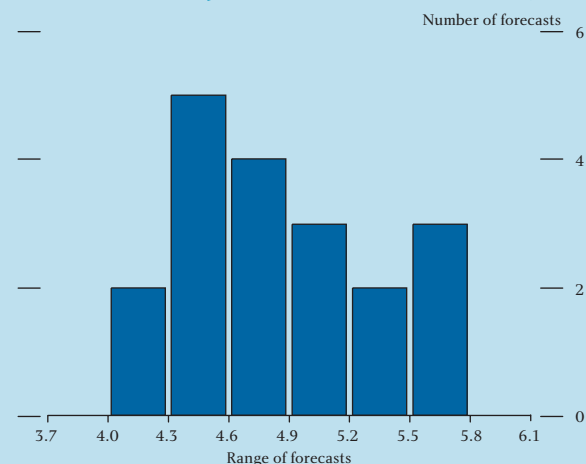
- (a) 23 forecasters provided the Bank with their assessment of the likelihood, at three time horizons, of expected twelve-month CPI inflation and four-quarter output growth falling in the ranges shown above. For example, on average, forecasters assign a probability of 8% to CPI inflation turning out to be less than 1.0% in 2005 Q4.
- (b) Figures may not sum to 100 due to rounding.
- (c) 19 forecasters.

probability of inflation above 2.5%. That represents slightly more upside risk to inflation than in August.

Turning to GDP, the average point forecast for four-quarter growth declines over the next year, from the 3.0% outturn in 2004 Q3, to 2.4% by 2005 Q4 (Table 1). On average, forecasters see a 41% probability of GDP growth being between 2% and 3% in two years' time, with a 35% probability of growth below 2%, and 24% for growth above 3% (Table 2). That is very similar to the numbers reported in August.

Projections of official interest rates rise to 4.9%, on average, by 2005 Q4 (Table 1). That is 0.2 percentage points lower than the average reported in August. Forecasts for 2006 Q4 range between 4% and 5.6% (Chart B). That range is the

Chart B
Distribution of repo rate forecasts for 2006 Q4

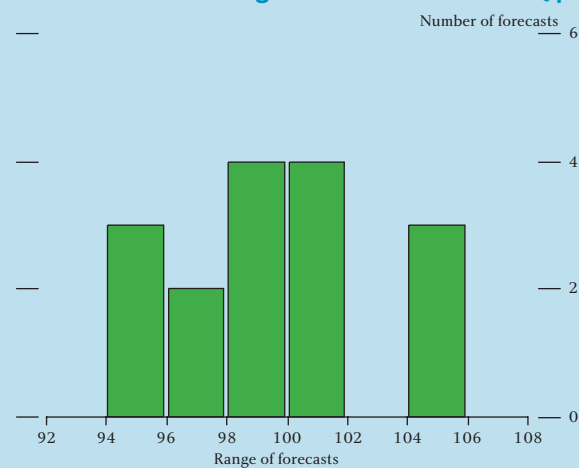


Source: Central projections of 19 outside forecasters as of 29 October 2004.

same as in August, but there are fewer forecasts at the upper end.

The sterling ERI in external forecasts is assumed to fall to 99.2, on average, by 2006 Q4 (Table 1). The average path is around 2% lower than expected in August, probably reflecting falls in sterling in recent months. Using its conventional approach, the Committee assumes that the sterling ERI falls to 99.6 by 2006 Q4: very similar to the average of the external forecasts. At the two-year horizon, external forecasts for the exchange rate range between 94.1 and 105.4 (Chart C). That is a somewhat tighter range of expectations than a year ago. For example, in November 2003 two-year-ahead forecasts ranged between 90.0 and 108.0.

Chart C
Distribution of sterling ERI forecasts for 2006 Q4



Source: Central projections of 16 outside forecasters as of 29 October 2004.

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Bank of England

Agents' summary of business conditions

November 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-July and mid-October 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.

- Annual growth in nominal retail spending appeared to have slowed further. But retail sales volume growth was sustained by extensive price discounting. Some contacts have attributed this easing in expenditure to concerns about the weakening housing market.
- Export growth slowed, perhaps related to weakness in US demand.
- The gradual recovery in investment spending has continued. Contacts who have invested have done so mainly to improve efficiency, though retailers have expanded capacity as well.
- Manufacturing output growth slowed and contacts expected a further slowing in the near term.
- Strong demand from the public and retail sectors continued to boost construction output.
- The slowdown in the housing market intensified. Contacts expected a recovery in activity levels next year if interest rates were to stay on hold.
- Consumer services companies reported a gradual slowdown in activity during the past three months, though business services continued to experience strong growth.
- The labour market remained tight, though employment growth levelled off. Skill shortages persisted, mainly in parts of the service sector and in construction.
- Pay pressures remained muted, except where skill shortages were acute.
- Capacity utilisation has increased, mainly in the service sector, but also in manufacturing where some domestic capacity has been closed.
- Input prices rose rapidly, partly reflecting the expiry of existing energy and metals contracts.
- Manufacturers' output prices have risen faster than in the first half of the year, as contacts recovered some of their higher costs from customers. But downward pressure on consumer goods prices continued and consumer services price inflation has changed little.

(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.

DEMAND

Consumption

Several Agencies reported a further easing in the annual growth rate of retail sales values, with retailers attempting to maintain volume growth through extensive price discounting. Some contacts attributed the easing in expenditure to a growing sense of caution among consumers. That was probably related to concerns about the weakening housing market and the effects of past interest rate increases on disposable income, in addition to Council Tax increases and, more recently, rising prices of utilities and petrol. Spending on housing-related durables such as furniture has declined in most regions despite a fall in prices, but the ongoing decline in the relative price of electronic durables continued to boost sales.

Though the used-car market was a little stronger than a year earlier, possibly reflecting an unusually large gap between the prices of new and used cars, the fall in demand for new cars from the high level last year may be another sign of households' retrenchment. Private registrations in September were generally lower than car dealers had anticipated; they expected difficult trading conditions ahead and a continuation of price discounting to achieve sales targets. Likewise, some retailers have already started to offer pre-Christmas discounts, though most contacts expected a further slowdown in consumer spending to be only modest and gradual.

Exports and imports

Contacts reported that export growth had faltered. They attributed this easing to lower-than-expected demand from the United States. The strongest growth continued to originate from China, the Far and Middle East, and Eastern Europe, especially for capital goods. Contacts reported that demand from EU markets had improved slightly, though the recovery in orders from Germany still lagged behind the rest of the euro area.

The trend towards increased sourcing of services, parts and finished manufactures from the low labour cost economies in Eastern Europe and Asia continued. Substitution of cheaper imports for domestically produced goods persisted in consumer durables in particular, such that imports of consumer goods remained close to last year's high levels. Looking forward, manufacturing contacts continued to report that their strategic options included future closure of their UK operations and increased reliance on overseas production.

Investment

The gradual recovery in investment spending continued and investment intentions have remained firmer than in the first half of the year. Manufacturing and service sector contacts who invested continued to do so primarily to increase productivity, to achieve cost reductions, and to comply with regulatory requirements. As part of this efficiency drive, companies have raised their spending on upgrading of information technology (IT) hardware and software. But contacts in the retail and distribution sector have tended to invest in order to expand capacity and to improve management of their supply chains, as well as to upgrade existing stores.

OUTPUT

Primary production

The wet summer weather caused problems for arable farmers, with difficulties in harvesting resulting in a poorer quality of crop, lower yields and increased costs of drying in some cases.

Output of the oil sector continued to decline, despite the ongoing rise in prices. Some companies have raised the cost benchmark for profitable investment. Uncertainty about the future price of oil remained high, with oil industry contacts suggesting that the equilibrium price could be around \$30 a barrel or perhaps higher.

Manufacturing

Manufacturing output continued to increase over the past three months, but at a slower rate than in the first half of the year. That largely reflected weaker growth in domestic demand. Output of consumer electronics, aerospace, telecommunications and capital goods in general still rose strongly. And the Agencies reported that some contacts have benefited from growth in market share, reflecting the loss of domestic capacity by their competitors, though underlying demand in their markets has changed little.

Amid signs that the Chinese economy has slowed slightly from its earlier rapid growth rate, concerns about potential supply disruptions related to the availability of raw materials such as oil and steel have dissipated somewhat. But intense competition from low cost economies — partly due to dollar weakness — and the rising cost of materials continued to compress margins. Contacts expected a further slowdown in output in the near term, reflecting more modest growth in the global economy next year and weaker confidence in domestic

markets as past interest rate increases started to have a bigger impact on activity. Nevertheless, the Agencies have found no evidence that a sharp decline in manufacturing output is about to take place.

Construction and housing

Construction output continued to grow rapidly, driven by strong demand from the public sector — especially health and education — and the retail and distribution sector. Some contacts noted that public sector demand had started to tail off towards the end of the period. At around the same time, demand for new office space has picked up in several regions, though existing surplus capacity has suppressed rental yields, especially in and around London. Forward orders for the construction sector as a whole remained strong. Apart from spending in health, education, retail and distribution, this reflected demand for social housing and utility companies' investment in infrastructure.

The weakening in the housing market intensified in most regions. Most contacts believed that the successive interest rate increases in May and June and the associated media attention triggered a change in buyers' sentiment, with the August rate rise having had a further dampening effect. Concerns about future house price corrections, rather than reduced affordability, may also have made buyers reluctant to commit.

Despite offering increased sales incentives, house builders have experienced a decline in activity to levels that are traditionally more normal. Some have started to target incentives at the lower priced segment of the market, which has hitherto continued to sell well.

In the secondary market, estate agents have received more instructions to sell, stocks of unsold properties have risen and transactions have declined considerably compared with a year ago. A few estate agents have announced job cuts as a result. Asking, as well as transactions, prices have fallen in most areas, though they remained higher than a year ago. Agencies in some of the outer parts of the country, however, have reported that asking prices and sales have stabilised after a period of strong growth. Most contacts expected the number of transactions to remain low until early next year, but a recovery in levels of activity thereafter if interest rates were to stay on hold.

The number of investors in buy-to-let property has declined steadily from the high levels at the start of the year, with rents flat or falling modestly. Some Agencies have noted a tightening in credit terms for buy-to-let finance.

Services

The Agencies reported a gradual slowing in service sector output growth during the past three months, which has in turn led to a modest softening in confidence. The slowdown was largely attributable to consumer services, where property-related services such as estate agents and mortgage lenders were affected by the weakening housing market. But remortgaging remained an area of strength for many mortgage lenders. The domestic travel and leisure market continued to report lower sales volumes and spending than in 2003, partly due to the poor weather this summer. Airports and budget airlines, however, reported higher passenger numbers than a year earlier.

Business services in general — and professional services in particular — continued to report the strongest growth in activity. In and around London, however, the lack of recovery in mergers and acquisitions (M&A) activity and in stock market flotations has dampened confidence among some contacts in the financial sector. A few other Agencies have reported strong demand for corporate transactions work, as well as for advisory services on corporate governance and new health and safety and employment regulations. Providers of IT services have benefited from companies' increased willingness to invest in IT in order to improve efficiency. Companies have also increased their spending on travel and hotel accommodation, which may reflect generally high levels of corporate confidence.

EMPLOYMENT

The labour market remained tight, but overall employment growth appeared to have levelled off, consistent with the easing in output growth reported over the past three months.

Most Agencies continued to report skill shortages in professional services, though pressures have eased a little in the South East where growth has peaked, but activity has remained at a high level. IT and logistics companies also faced increasing recruitment difficulties. Skill shortages have reportedly become more prominent and acted as a constraint on output growth in construction, encouraging some companies to recruit from the new EU accession countries.

Prospects for employment growth have probably peaked in most regions, partly reflecting contacts' intentions to cut costs.

CAPACITY UTILISATION

Capacity utilisation has increased during the past three months, mainly in the service sector, but also in manufacturing where some domestic capacity has been closed or relocated overseas. Despite these higher utilisation rates, many contacts have been reluctant to increase capacity in the United Kingdom. With pressure on margins and persistent dollar weakness acting as constraints on some firms, they have tried to meet capacity problems by increased sourcing overseas, by subcontracting to manage their workload or even by turning down orders.

COSTS AND PRICES

Pay

Despite the tightness of the labour market, pay pressures have remained muted, with most settlements around 3%. Some of that weakness may have reflected employees' feelings of job insecurity, particularly in manufacturing, which may have tempered wage bargainers' demands. Low rates of consumer price inflation in recent years may also have been a factor. But in sectors with acute skill shortages, settlements have tended to be higher or performance-related pay has become more prominent. Contacts also reported paying higher salaries for new recruits than for those they replaced, reflecting the tight labour market for specific skills.

The higher National Minimum Wage (NMW) has narrowed pay differentials, leading some contacts to expect more prolonged negotiations for near-term settlements. Others have indicated that they will reduce employees' working hours to offset the higher wage. Several companies have moved back their annual pay awards to October, to align them with future increases in the NMW.

Input prices

The costs of manufacturers' raw materials have risen sharply over the past three months. Record oil price

levels, higher utility prices and past increases in the prices of steel and other metals have put further upward pressure on costs, as existing supply contracts expired. Until recently, some firms had mitigated the past surge in input prices, because they had entered into three-year contracts for electricity and gas supply in 2001, when prices had reached a trough. But when these contracts were due for renewal, energy costs rose abruptly by up to 70%. For similar reasons, some larger manufacturers (with long supply contracts) reported that they had not yet paid higher steel prices, though they were likely to have to do so from early next year.

Price rises for oil-related inputs, such as plastics and polymers, have also started to affect margins. Several contacts noted the rising costs of regulation and renewed increases in employers' liability insurance premia, although there had been an easing of some other insurance costs following past rapid increases.

Output and consumer prices

Output prices have risen somewhat faster than in the first half of the year, as contacts have passed through some of the higher costs of raw materials to their customers. With competitors facing similar cost increases, a number of manufacturing contacts have been able to raise output prices. Tighter margins may soon force other companies to follow suit, despite strong resistance to price increases from customers. But where competitive pressures from low cost countries were acute, the scope for price rises remained limited. In the service sector, logistics companies and some airlines have become more successful at sustaining fuel surcharges.

Intense competition among retailers and increased sourcing from low cost economies continued to put downward pressure on margins and prices in the consumer goods sector, with contacts trying to increase productivity and improve distribution systems to offset this. Consumer services price inflation has changed little.

Text of Bank of England press notice of 9 September 2004

Bank of England maintains interest rates at 4.75%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 4.75%.

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

Text of Bank of England press notice of 7 October 2004

Bank of England maintains interest rates at 4.75%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 4.75%.

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

Text of Bank of England press notice of 4 November 2004

Bank of England maintains interest rates at 4.75%

The Bank of England's Monetary Policy Committee today voted to maintain the Bank's repo rate at 4.75%.

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

Glossary and other information

Glossary of selected data

AEI: average earnings index.

CPI inflation: inflation measured by the consumer prices index.

CSPI: corporate services price index.

ERI: exchange rate index.

GDP: gross domestic product.

LFS: Labour Force Survey.

Libor: London interbank offered rate.

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.

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.

DETR: Department of the Environment, Transport and the Regions.

DTI: Department of Trade and Industry.

ECB: European Central Bank.

EU: European Union.

FOMC: Federal Open Market Committee.

FTSE: Financial Times Stock Exchange.

GfK: Gesellschaft für Konsumforschung, Great Britain Ltd.

HBF: House Builders Federation.

HM: Her Majesty's.

IBES: Institutional Brokers' Estimate System.

IT: information technology.

LIFFE: London International Financial Futures and Options Exchange.

M&A: mergers and acquisitions.

MFI: monetary financial institutions.

MPC: Monetary Policy Committee.

MTIC: missing trader intra-community.

NMW: National Minimum Wage.

ODPM: Office of the Deputy Prime Minister.

OECD: Organisation for Economic Co-operation and Development.

OFCs: other financial corporations.

ONS: Office for National Statistics.

OPEC: Organization of the Petroleum Exporting Countries.

PNFCs: private non-financial corporations.

REC: Recruitment and Employment Confederation.

RICS: Royal Institution of Chartered Surveyors.

S&P: Standard and Poor's.

SDR: special drawing rights.

WTI: West Texas Intermediate.

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.