

Inflation Report

February 2009



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/publications/inflationreport/infrep.htm.

The entire *Report* is available in PDF at www.bankofengland.co.uk/publications/inflationreport/2009.htm.

PowerPoint™ versions of the charts in this *Report* and the data underlying most of the charts are provided at www.bankofengland.co.uk/publications/inflationreport/2009.htm.

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Overview

The global economy has suffered a sharp and synchronised downturn. Business and household sentiment in many countries has deteriorated markedly, and the global banking and financial system has remained fragile. In the United Kingdom, an adjustment process is under way, as private saving rises and banks restructure their balance sheets. Reflecting both this and the deteriorating global picture, GDP contracted sharply in the fourth quarter of 2008. Business surveys pointed to a similar reduction in output in early 2009. Under the assumption that Bank Rate moves in line with market yields, the MPC's central projection is for output to contract further in the near term. Activity then recovers, reflecting the building stimulus from easing monetary and fiscal policy, the substantial depreciation of sterling, past falls in commodity prices, and actions by authorities at home and abroad to improve the availability of credit. The risks surrounding the central projection for GDP growth are judged to be weighted heavily to the downside.

CPI inflation fell to 3.1% in December. In the central projection, CPI inflation falls well below the 2% target in the medium term, as the drag from a substantial margin of spare capacity more than outweighs the waning impact on import and consumer prices from the lower level of sterling. The near-term path of inflation is uneven. That reflects two further factors: first, the marked fall in energy prices, which drags down sharply on inflation during 2009; and, second, the direct impact of the temporary cut in VAT, which pulls down inflation during 2009 but briefly pushes it back towards the target in early 2010. The balance of risks around the central projection for inflation is judged to be slightly on the downside.

Financial markets

The deteriorating global economic outlook exacerbated strains within financial and credit markets. Banks continued to restructure their balance sheets and remained reluctant to lend. On 19 January, the UK Government announced a further range of measures to improve conditions in the financial system and support lending growth. That package included the establishment of an Asset Purchase Facility (APF) operated by the Bank of England, aimed at increasing the availability of corporate credit. The APF also provides a framework for the MPC to purchase assets for monetary policy purposes should the Committee judge that to be useful to meet the inflation target.

Sterling has depreciated by 13% since the *November Report* and by more than a quarter since mid-2007. Part of that depreciation stems from the deepening cyclical downturn, with investors reducing their near-term expectations for Bank Rate relative to policy rates in other countries. It is also likely to reflect an increase in the perceived riskiness of sterling assets,

as well as being associated with the prospective rebalancing of the UK economy.

Many overseas central banks lowered official interest rates significantly. In the United Kingdom, the MPC has reduced Bank Rate by 3.5 percentage points since the beginning of November to 1%. Prior to the Committee's February decision, market participants expected Bank Rate to trough at around $\frac{3}{4}\%$ in mid-2009, substantially lower than envisaged at the time of the previous *Report*.

Global activity

The synchronised downturn in global demand and output has intensified since the previous *Report*. Official data and surveys suggest output in the advanced economies contracted markedly in the fourth quarter of 2008 and is likely to fall further in the first quarter. Emerging market economies slowed sharply, as world trade contracted abruptly and the availability of external financing tightened. Looking ahead, the outlook for global demand has worsened materially since November. This deterioration is likely to pull down on UK export growth in coming quarters, despite the substantially lower value of sterling.

Domestic activity

Mirroring the downturn in the world economy, the near-term outlook for UK activity worsened. Credit conditions tightened further, demand prospects became more uncertain and sentiment deteriorated. Businesses responded by cutting output, running down inventories, scaling back investment plans and shedding labour.

Consumer spending appears to have contracted sharply in 2008 Q4. Falling employment, lower financial wealth and tight credit conditions are likely to continue to bear down on consumers' expenditure in the near term. And households' desire to reduce indebtedness and increase savings will probably also weigh on consumption. In coming quarters, those factors are likely to more than offset the boost to households' spending power from past falls in commodity prices, the low level of Bank Rate and the temporary reduction in VAT.

The Committee's central projection is based on the tax and spending plans published in the Government's *Pre-Budget Report 2008*. Those plans, including the temporary reduction in VAT and the acceleration of capital projects, should help to support near-term demand.

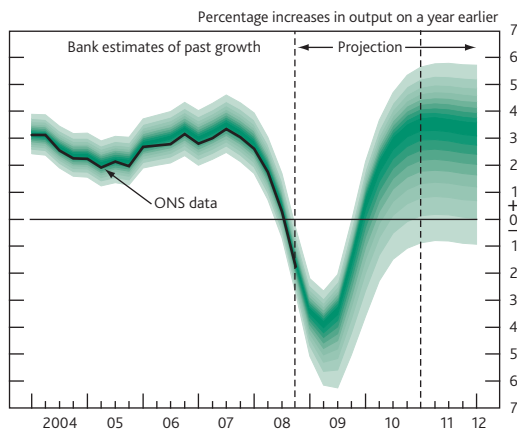
The outlook for GDP growth

GDP was estimated to have fallen by 1.5% in 2008 Q4, a substantially larger decline than envisaged at the time of the November *Report*. Subsequent industrial production data suggest that this estimate could be revised down. Evidence from business surveys and from the Bank's regional Agents

point to a broadly similar contraction in the first quarter of 2009.

The weakness in economic activity reflects not only the sharp downturn in global economic activity, but also a fundamental adjustment within the domestic economy as private saving rises and banks restructure their balance sheets. But there is a significant economic stimulus in train that will buttress economic activity. That stimulus reflects: the easing in monetary and fiscal policy; the substantial depreciation in sterling; past falls in commodity prices; and the actions taken by the authorities at home and abroad to stabilise the global banking system and increase the availability of credit.

Chart 1 GDP projection based on market interest rate expectations



The fan chart depicts the probability of various outcomes for GDP growth. To the left of the first vertical dashed line, the distribution reflects the likelihood of revisions to the data over the past; to the right, it reflects uncertainty over the evolution of GDP growth in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that the mature estimate of GDP growth would lie within the darkest central band on only 10 of those occasions. The fan chart is constructed so that outcomes are also expected to lie within each pair of the lighter green areas on ten occasions. Consequently, GDP growth is expected to lie somewhere within the entire fan on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the increasing uncertainty about outcomes. See the box on page 39 of the November 2007 *Inflation Report* for a fuller description of the fan chart and what it represents. The second dashed line is drawn at the two-year point of the projection.

Chart 1 shows the Committee's best collective judgement for four-quarter GDP growth, assuming that Bank Rate follows a path implied by market yields. The central view is that the authorities here and abroad will be successful in stabilising the global banking system, and that financial and credit markets will gradually return to more normal conditions. In the central projection, output continues to contract in the near term, as the weakening labour market and increased uncertainty weigh on consumption, businesses run down inventories and reduce investment, and the weakness in world demand inhibits export growth. The near-term contraction in GDP in the central projection is substantially deeper than envisaged in the November *Report*. Further out, GDP growth recovers as the impact of the sizable policy stimulus both at home and abroad is increasingly felt, the contribution from stockbuilding rises, and the lower value of sterling shifts both domestic and overseas expenditure towards UK suppliers. Nonetheless, a significant margin of spare capacity remains in the economy at the end of the forecast period.

The prospects for economic growth remain unusually uncertain, reflecting the exceptional economic and financial factors affecting the outlook. The risks around the central projection are judged to be weighted heavily to the downside. This in large part reflects the possibility that, over the forecast period, the authorities at home and abroad are only partially successful in improving the availability of credit and restoring business and consumer confidence.

Costs and prices

CPI inflation fell to 3.1% in December, driven by sharp falls in energy prices and the temporary reduction in VAT. And measures of households' near-term inflation expectations continued to fall back from their recent peaks.

Looking ahead, the weaker demand environment should act to moderate increases in prices and wages. Survey measures of pricing intentions have fallen sharply since the November *Report*. And the loosening in the labour market has been accompanied by a reduction in earnings growth. But the impact of the current slowdown on inflation is likely to be

dampened over the forecast period by weaker growth in the supply potential of the economy.

The outlook for inflation is also affected by the substantial depreciation in sterling over the past 18 months, which has significantly raised companies' import costs. In the short term, the weakness in demand means that businesses are likely to be forced to absorb some of the increased costs in lower profit margins and wages in order to support sales. Even so, higher import prices will probably continue to put upward pressure on consumer prices for some time. The speed and extent of this pass-through represent key uncertainties surrounding the inflation outlook.

The outlook for inflation

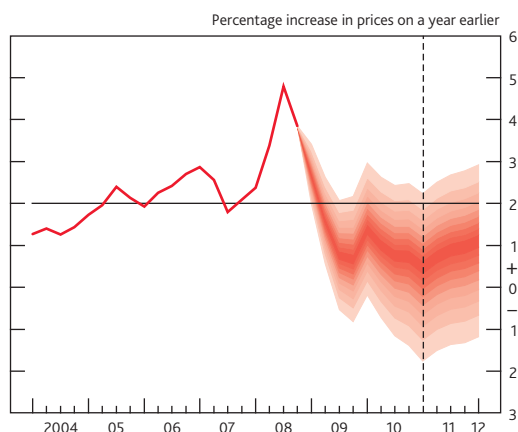
Chart 2 shows the Committee's best collective judgement of the outlook for CPI inflation, assuming that Bank Rate follows market yields. In the central projection, CPI inflation falls well below the 2% target in the medium term, as a substantial margin of spare capacity more than outweighs the waning impact on import and consumer prices from the lower level of sterling. The near-term path of inflation is uneven. That reflects two further factors: first, the marked fall in energy prices, which drags down sharply on inflation during 2009; and, second, the direct impact of the temporary cut in VAT, which pulls down on inflation during 2009 but pushes it back towards the target in early 2010. The central projection is more volatile than in the November *Report* in the near term, and a little weaker in the medium term.

The prospects for inflation, as for economic growth, remain unusually uncertain. There are significant risks on both sides of the inflation projection. On the downside, the main risk is that the recession may be more pronounced than in the central case, putting further downward pressure on inflation. On the upside, the main risk concerns the implications of sterling's depreciation for consumer prices. Overall, the balance of risks around the central projection for inflation is judged to be slightly on the downside. There is a range of views among the Committee on both the central projection and the balance of risks.

The policy decision

At its February meeting, the Committee noted that the recent easing in monetary and fiscal policy, the substantial depreciation in sterling, the falls in commodity prices and the UK authorities' actions to support lending would together provide a considerable stimulus to activity as the year progressed. Nevertheless, the Committee judged that there remained a substantial risk of undershooting the 2% CPI inflation target in the medium term at the existing level of Bank Rate. A further easing in monetary policy was therefore likely to be needed. At its February meeting, the Committee decided that an immediate reduction in Bank Rate of 0.5 percentage points to 1% was warranted.

Chart 2 CPI inflation projection based on market interest rate expectations

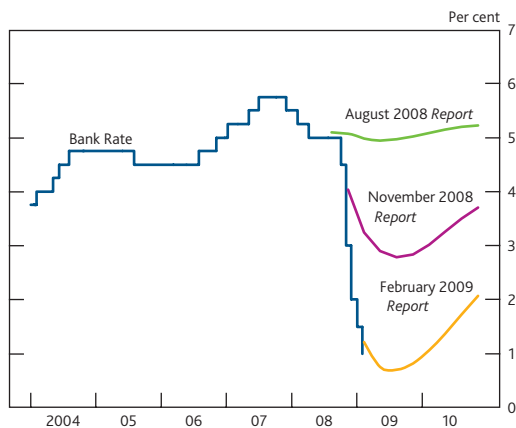


The fan chart depicts the probability of various outcomes for CPI inflation in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation over the subsequent three years would lie within the darkest central band on only 10 of those occasions. The fan chart is constructed so that outcomes of inflation are also expected to lie within each pair of the lighter red areas on 10 occasions. Consequently, inflation is expected to lie somewhere within the entire fan chart on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the 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 dashed line is drawn at the two-year point.

1 Money and asset prices

The MPC cut Bank Rate to 1%. The Government announced a package of measures to reinforce the stability of the financial system and support the supply of credit to companies and households. That package was a response to evidence that credit conditions continued to tighten, constraining production and spending. The sterling exchange rate has fallen by 13% since the *November Report* and by more than a quarter since the middle of 2007. Equity prices were little changed. Property prices fell further.

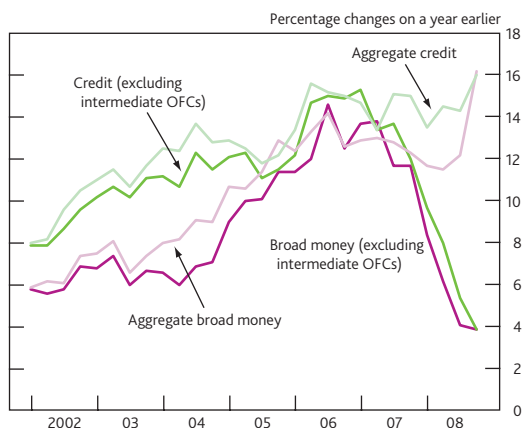
Chart 1.1 Bank Rate and forward market interest rates^(a)



Sources: Bank of England and Bloomberg.

(a) The February 2009, November 2008 and August 2008 curves are based on fifteen working day averages to 4 February, 5 November and 6 August respectively. At short maturities, the curves are based on overnight index swap (OIS) rates. At longer maturities, they are based on instruments that settle on Libor, adjusted for credit risk.

Chart 1.2 Broad money and credit^(a)



(a) The measures exclude the bank deposits of, and borrowing by, intermediate OFCs, such as: mortgage and housing credit corporations; non-bank credit grantors; bank holding companies; and other activities auxiliary to financial intermediation. Bank staff have also adjusted these measures for some additional intragroup business, based on anecdotal information provided by a small sample of banks. For more information, see Burgess, S and Janssen, N (2007), 'Proposals to modify the measurement of broad money in the United Kingdom: a user consultation', *Bank of England Quarterly Bulletin*, Vol. 47, No. 3, pages 402–14.

Since the *November Inflation Report*, the MPC has cut Bank Rate by 2 percentage points to 1% (**Chart 1.1**). The factors behind the MPC's decisions in December and January are summarised in a box on page 10. Prior to the MPC's February decision market participants expected rates to fall to around $\frac{3}{4}\%$ by the middle of this year before picking up gradually. Other central banks around the world have also continued to reduce rates: the policy rate in the euro area has been reduced by 1.75 percentage points since the *November Report*, and rates in the United States and Japan are now close to zero.

The low level of Bank Rate will stimulate the economy over time. But its low level and the severe dislocation of the financial system have implications for the transmission mechanism of monetary policy. These issues are discussed in greater detail in a box on pages 44–45. The flow of credit to companies and households remains critical to the outlook for activity and inflation. But the continued need for adjustment in the banking sector (Section 1.1) has contributed to a further tightening in credit conditions over the past three months (Section 1.2). On 19 January the Government announced additional measures designed to reinforce the stability of the financial system and to support the supply of credit to companies and households. But it will take time for those measures to have their full impact.

1.1 Developments in the banking sector

Since the summer of 2007, banks have been seeking to restructure their balance sheets, through injections of new capital, selling assets and cutting back on lending. The process of deleveraging became necessary following a period during which banks' balance sheets had grown rapidly relative to their capital bases.⁽¹⁾

(1) This process was discussed in the October 2008 *Financial Stability Report*.

Monetary policy since the November Report

The MPC's central projection in the November *Report*, under the assumption that Bank Rate followed a path implied by market yields prevailing prior to the MPC's November decision, was for a pronounced slowdown in domestic demand, pushing the economy into recession at the start of the forecast period. CPI inflation was projected to fall back sharply in the near term and to well below the 2% target in the medium term. The biggest risks to inflation stemmed from the uncertain depth and persistence of the slowdown in demand.

In the month leading up to the MPC's meeting on 3–4 December, there had been significant movements in financial market prices. International equity prices were lower. Sterling short-term interest rates had declined markedly, and by more than euro or dollar interest rates. The sterling effective exchange rate index (ERI) had fallen by over 6%, a larger depreciation than suggested by movements in interest rates at home and abroad.

The slowdown in the international economy had appeared to be remarkably synchronised. Many larger countries had experienced negative GDP growth in the third quarter. Business surveys were signaling falling output in many of the major developed economies in the fourth quarter, and sharply slowing growth in some of the larger emerging market economies.

In the United Kingdom, many business surveys were at historically low levels, consistent with a recession. A mapping from the surveys into GDP suggested falling output in both 2008 Q4 and 2009 Q1.

The bringing forward of some capital expenditure, the indexation of personal allowances and basic rate limits, and the reduction in the standard rate of Value Added Tax (VAT) in the Government's *Pre-Budget Report 2008* were likely to be helpful in offsetting some of the near-term downside risks to output growth. The temporary cut in VAT would lead to some volatility in inflation over the next two years. But the new fiscal plans were unlikely to have a significant effect on inflation beyond that period.

CPI inflation had fallen back, from 5.2% to 4.5%. Manufacturing input and output price data for October had registered record decreases. Oil and other commodity prices had continued to fall. Many survey measures of inflation expectations for 2009 had declined sharply.

Taking all the news together, the Committee agreed that a significant margin of spare capacity would open up over the next couple of years, and that without further policy action,

inflation would substantially undershoot the target in the medium term. The MPC voted unanimously to reduce Bank Rate by 1 percentage point to 2%.

In the month leading up to the Committee's meeting on 7–8 January, financial markets continued to be volatile. Sentiment in some markets had improved a little in the first few days of the year. International equity prices had risen on the month. The sterling ERI had depreciated sharply up to the end of 2008 and, despite a subsequent rebound, was nearly 3% lower than at the time of the December meeting, and 14% below its level at the time of the November *Report*.

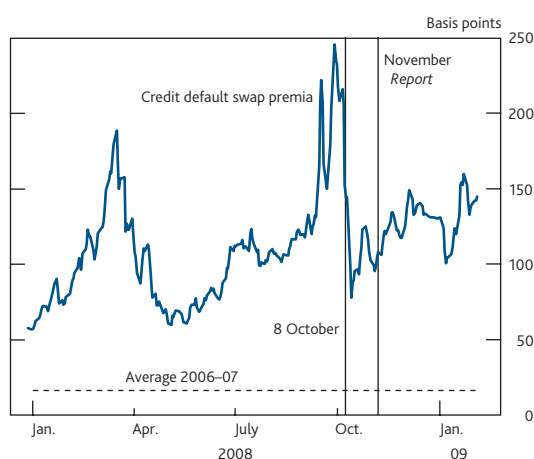
There had been a marked contraction in international trade, reflecting the sharp downturn in the international economy and possibly also reduced supply of trade credit. The Baltic Dry Index remained at a low level. US and euro-area exports were likely to have contracted in 2008 Q4, Japanese export volumes had fallen sharply in November and nominal export growth had slowed elsewhere in Asia.

The news on UK output in 2008 Q4 had been broadly consistent with the sharp contraction expected at the time of the December meeting. The forward-looking survey components suggested that there could be another large contraction in 2009 Q1. The latest Bank of England *Credit Conditions Survey* had revealed a further reduction in the availability of credit to both households and companies during Q4. Lenders expected to tighten credit further in the first quarter of 2009.

CPI inflation had fallen to 4.1% in November. A further decline was likely in December, partly reflecting the VAT change. Lower commodity prices and subdued demand meant it was likely that CPI inflation would fall towards, and possibly below, the 2% target during the first half of 2009. In the longer term, the depreciation in the sterling ERI would be associated with a change in relative prices rather than inflation, but there would be an upwards effect on the price level and therefore inflation for a period.

The news on the month had left the balance of risks to output and to inflation, relative to the target, to the downside. Most Committee members concluded that a cut in Bank Rate of 50 basis points was therefore appropriate. But for one member, the news on the month had been more decisively to the downside. Eight members of the Committee voted to cut Bank Rate by 50 basis points to 1.5%. One member preferred a reduction in Bank Rate of 100 basis points.

At its meeting on 4–5 February, the Committee voted to reduce Bank Rate by 0.5 percentage points to 1%.

Chart 1.3 Major UK banks' credit default swap premia^(a)

Sources: Markit Group Limited, Thomson Datastream, published accounts and Bank calculations.

(a) The blue line shows a weighted average of the credit default swap premia of ten major UK banks, weighted by each bank's share in total assets.

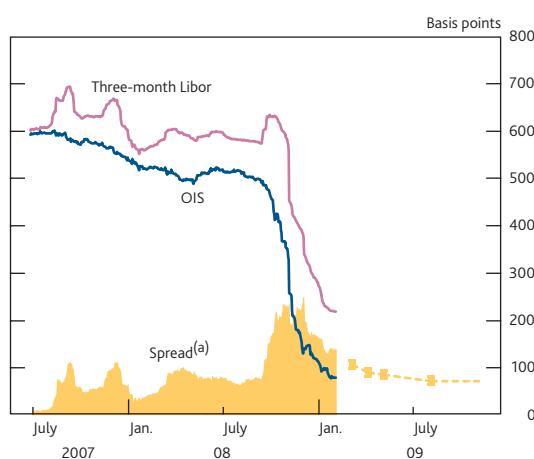
Table 1.A Credit Conditions Survey: defaults and loss given default

Net percentage balances^(a)

	Averages	2008			2009
	2007 Q2–2008 Q1	Q2	Q3	Q4	Q1 ^(b)
Secured lending to households					
Default rate	4	47	45	55	66
Loss given default	17	41	55	53	63
Lending to medium PNFCs					
Default rate	17	37	53	60	67
Loss given default	3	23	21	68	64

(a) Weighted responses of lenders. A positive balance implies increasing defaults and increasing losses given default.

(b) Banks' expectations for the following three months, reported in the 2008 Q4 survey.

Chart 1.4 Three-month interbank rates and spreads relative to future expected policy rates

Sources: Bloomberg and Bank calculations.

(a) Three-month Libor spread over equivalent-maturity overnight interest swap (OIS) rates. Dashed line shows average forward spreads derived from forward rate agreements over the fifteen working day averages to 4 February 2009.

Deleveraging by banks, combined with the withdrawal from the market of several lenders, has been manifested in a sharp reduction in underlying money and credit growth over 2008 (**Chart 1.2**). Although transactions between banks and other financial intermediaries (some of which take place within the same banking group) have risen sharply as interbank activity has fallen, boosting headline M4, these transactions are unlikely to affect nominal spending.⁽¹⁾ The annual growth of broad money and credit excluding these transactions has fallen from around 15% in mid-2006 to less than 4% in 2008 Q4. That compares with average broad money growth of nearly 8% since 1992.

Since the *November Report*, the macroeconomic outlook has deteriorated, sharply increasing uncertainty over future asset values. So, despite significant injections of new capital following the 8 October package, concerns over banks' abilities to absorb potential losses persisted. This was reflected in the relatively high price market participants continued to pay to hedge against banks defaulting (**Chart 1.3**). It was also reflected in lower credit availability, as banks continued to face rises in both defaults by borrowers and the average loss faced on each default (**Table 1.A**).

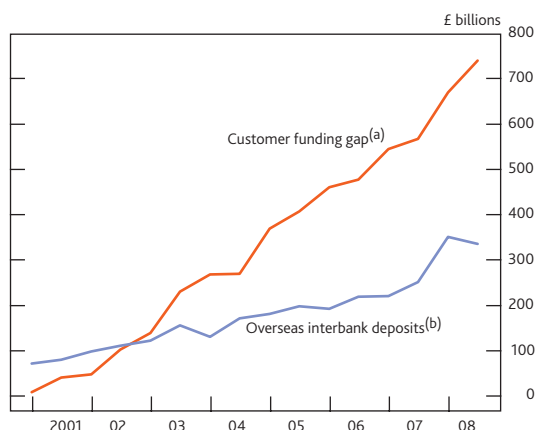
Banks' funding conditions remained tight, though there were signs of improvement in some markets. Three-month Libor fell back sharply as both expected policy rates and the spread over these rates declined, the latter unwinding some of its rise over the autumn (**Chart 1.4**). But market participants expected the Libor spread to remain above its pre-crisis level for the rest of this year at least, and the quantity of term unsecured wholesale funding available remained very low. However, refinancing past wholesale funding became somewhat easier as banks were able to issue unsecured debt under the Credit Guarantee Scheme (CGS) introduced in October.

Despite slightly improved conditions in some funding markets, term funding for banks remained scarce and expensive relative to earlier in this decade. In that period, wholesale funding, including non-bank and interbank flows from overseas, allowed banks to increase lending to customers at a faster rate than they took deposits from them (**Chart 1.5**). With foreign lenders now less willing to fill this customer funding gap, banks need to find alternative funding in order to support lending. In the longer term, banks are likely to increase their reliance on retail deposits. But the flow of deposits from UK households and companies to UK banks has been weak recently (**Chart 1.6**).

Given these continued constraints on banks and their impact on credit conditions (Section 1.2), on 19 January the Government announced a package of measures to reinforce

(1) For a discussion of these adjustments, see the box on page 16 of the August 2008 *Report*.

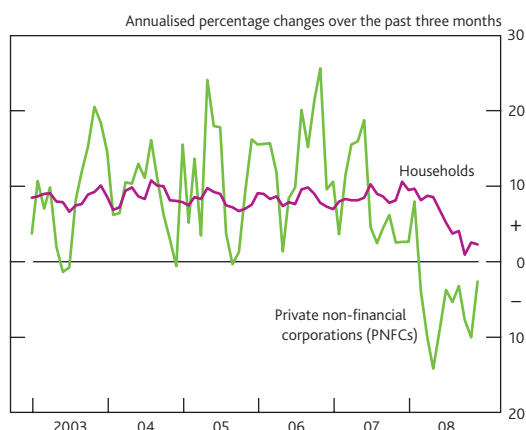
Chart 1.5 Major UK banks' customer funding gap and overseas interbank deposits up to 2008 H1



Sources: Bank of England, Dealogic, published accounts and Bank calculations.

- (a) Customer lending less customer funding, where customer refers to all non-bank borrowers and depositors.
 (b) Data exclude Nationwide.

Chart 1.6 Household and corporate deposits

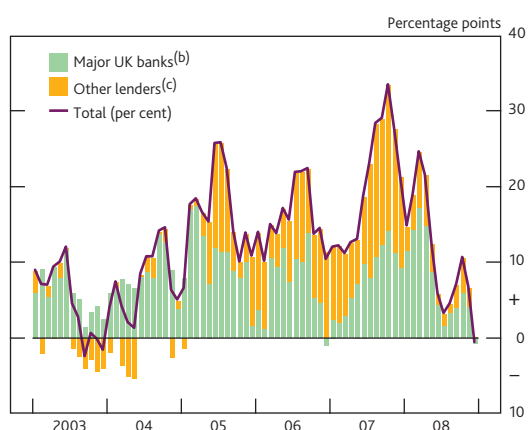


the stability of the UK financial system. The package is intended to lessen the extent to which restructuring of banks' balance sheets impacts on lending to companies and households in the near term. Banks' participation in some of the new facilities will be conditional on them agreeing to specific and quantified lending commitments.

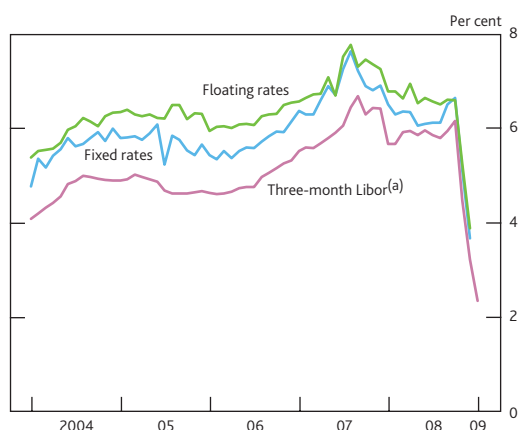
Some of the Government's measures are designed to reduce uncertainty about the adequacy of banks' capital. The Asset Protection Scheme will allow financial institutions to buy insurance against severe losses on certain assets. And the Financial Services Authority (FSA) has established a process through which banks can mitigate the procyclicality of capital requirements. First, the FSA has clarified that required bank capital requirements have not been increased. Second, the FSA has offered greater scope for banks to calculate their risk-weighted asset position on a basis which seeks to smooth through the cycle, rather than at a point in time.

Other measures are designed to improve banks' access to wholesale funding. The Government has extended the CGS drawdown period to the end of 2009. And the Bank has extended its discount window facility to twelve months to provide access to longer-term liquidity following the closure of the Special Liquidity Scheme to new borrowing at the end of January. In addition, a new scheme will help banks access new wholesale funding in securitisation markets. Starting in April (subject to state aid approval), the Government will provide full or partial guarantees on highly rated asset-backed securities including mortgages, corporate and unsecured debt.

A final set of measures is intended to ease credit conditions for households and companies directly. To support mortgage lending, Northern Rock will no longer pursue a policy of rapidly reducing its mortgage book — a policy which had been bearing down on overall secured lending (Section 1.2). And to increase the availability of corporate credit, the Government has authorised the creation of an Asset Purchase Facility, through which the Bank of England will purchase high-quality private sector assets, including corporate bonds and commercial paper. This facility is intended to increase liquidity and trading activity in certain UK financial markets and could stimulate issuance by corporate borrowers and the resumption of capital market flows. In the first instance, this scheme will be financed by the issuance of Treasury bills. But it provides a framework for the MPC to use asset purchases for monetary policy purposes, should the Committee judge that to be useful to meet the inflation target. These issues are discussed further in the box on pages 44–45.

Chart 1.7 Growth in loans to PNFCs^(a)

- (a) Annualised percentage changes over the past three months. Data are non seasonally adjusted.
 (b) This group comprises Abbey, Barclays, HBOS, HSBC, Lloyds TSB and Royal Bank of Scotland.
 (c) Calculated as a residual.

Chart 1.8 Effective rates on new corporate borrowing

Sources: Bank of England and Bloomberg.

- (a) Monthly average of daily data.

Table 1.B Effective interest rates on stock of loans^(a)

Per cent	Sep. 2008 (Nov. Inflation Report)	Nov. 2008	Dec. 2008	Changes since Nov. Inflation Report (basis points)
Households ^(b)	7.05	6.83	6.19	-86
of which:				
Secured	5.81	5.56	4.80	-101
Fixed	5.68	5.81	5.94	26
Variable	5.90	5.37	3.97	-193
Memo: SVR	6.95	6.34	5.38	-157
Corporates	6.85	6.09	5.13	-172
of which:				
Fixed	7.04	6.80	5.98	-106
Variable	6.67	5.57	4.46	-221
Overdrafts	6.94	5.74	4.89	-205
Memo:				
Bank Rate ^(c)	5.00	3.00	2.00	-300
Three-month Libor ^(d)	5.91	4.45	3.20	-271

Sources: Bank of England and Bloomberg.

- (a) Weighted average of interest rates paid on outstanding balances each month.
 (b) Includes secured borrowing, credit card borrowing, overdrafts and variable-rate products.
 (c) End-month observations.
 (d) Monthly averages.

1.2 Cost and availability of credit to companies and households

Credit conditions for households and companies tightened further at the end of last year. Intelligence from the Bank's regional Agents suggested that the combination of tight credit and the sharp weakening in demand have weighed on some companies' finances. The Government's measures are intended to ease credit conditions, but it is too soon to expect to see the impact on companies and households.

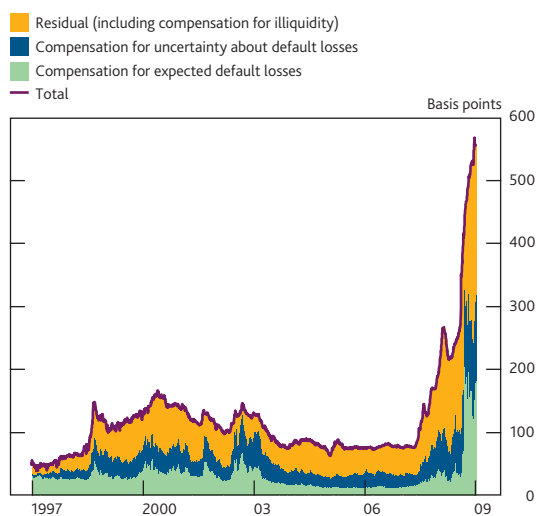
Corporate sector finances

Bank lending to non-financial companies slowed sharply over 2008. In part, this reflects a tightening in credit supply. Some lenders have left the UK market (**Chart 1.7**) — in particular there are currently fewer foreign lenders providing new finance to UK companies than a year ago. And major UK banks have, on average, also been reducing lending. That has impacted on some companies. For example, the Bank's regional Agents' contacts have reported tighter conditions for both new and previously agreed finance. In particular, an increasing number of companies report that credit lines have been withdrawn by banks.

For those companies which have been able to borrow from banks, the average rate charged on new lending fell by nearly 3 percentage points between September and December, following the reductions in Bank Rate (**Chart 1.8**). These new borrowing rates have moved broadly in line with Libor to date, suggesting little change in lending spreads. That is perhaps because only the least risky borrowers, typically paying the lowest rates, are currently able to borrow. Interest rates also fell for companies with outstanding debt. On average, effective variable rates were around 200 basis points lower in December than in September, as reductions in Bank Rate began to feed through (**Table 1.B**).

Companies also use non-bank sources for finance. Corporate debt issuance by investment-grade PNFCs incorporated in the United Kingdom picked up towards the end of 2008, and in January \$7 billion of debt was issued — the largest January figure since 2001. But that issuance was largely biased towards the most highly rated companies, and non-cyclical sectors such as utilities: other investment-grade companies continued to face difficulties accessing capital markets. And even for those companies which have been able to issue debt, conditions remained very tight. Spreads over government bond yields on high-quality corporate bonds, for example, have more than doubled since early September to over 5 percentage points. Part of that increase is likely to reflect increased compensation for possible default losses. But an illustrative decomposition suggests that it also reflects a significant increase in the premia required by investors to compensate for the illiquidity of corporate bond markets

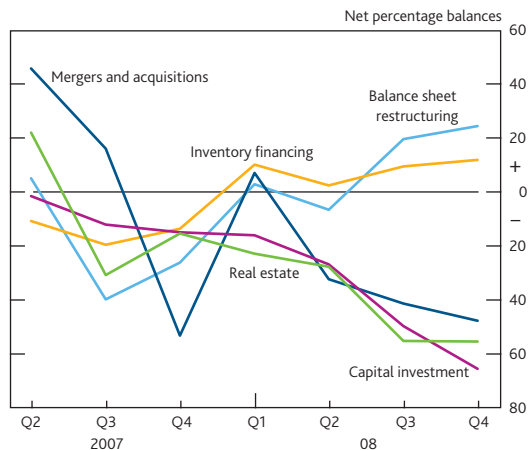
Chart 1.9 Estimated decomposition of sterling-denominated investment-grade corporate bond spreads^(a)



Sources: Bloomberg, Merrill Lynch, Thomson Datastream and Bank calculations.

(a) Option-adjusted spreads over government bond yields, decomposed into different factors using the model described in Webber, L and Churm, R (2007), 'Decomposing corporate bond spreads', *Bank of England Quarterly Bulletin*, Vol. 47, No. 4, pages 533–41.

Chart 1.10 *Credit Conditions Survey*: changes in demand for corporate lending by purpose^(a)



(a) Weighted responses of lenders. A positive balance indicates an increase in demand for lending for that purpose.

Table 1.C Lending to individuals

	Averages 1996 to 2007	2008		
		Oct.	Nov.	Dec.
Total lending	10.2	4.7	4.1	3.6
Secured	9.5	4.5	3.9	3.4
Consumer credit	13.8	5.4	5.1	5.0
of which, credit card	18.0	8.0	8.2	7.4
of which, other unsecured	12.5	4.5	4.2	4.2

(Chart 1.9). Markets for sub-investment grade companies remain effectively closed — there has been no issuance by a UK PNFC with a rating of BB or below since the onset of the financial crisis.

The extent to which tighter credit supply impacts on companies' behaviour depends in part on their demand for loans. Demand for funding capital projects has fallen back (Chart 1.10), as companies have revised down investment intentions, due to the weaker outlook for activity and corresponding reduction in pressures on capacity (Section 2). And there has also been a reduction in mergers and acquisitions activity and therefore in the associated borrowing.

But demand for other forms of lending, especially to finance day-to-day business, has increased as companies require more funding to ease cash-flow pressures. For example, respondents to the Bank's *Credit Conditions Survey* (CCS) reported an increase in demand for inventory finance, a form of working capital, over the past year (Chart 1.10). And as discussed in the box on page 15, some companies have experienced difficulties accessing trade credit and related products, potentially increasing their reliance on working capital finance from banks.

Overall, despite a reduction in demand for some types of credit, a range of surveys and anecdote around the turn of the year increasingly suggested that companies were reducing spending or production because of a tightening in the supply of finance from banks and other sources. For example, in a survey of 131 companies carried out by the CBI in January, current financing conditions had led to a reduction in capital investment over the past three months for 56% of respondents, with 31% having reduced output, and 37% having cut staff numbers.

Household sector finances

Growth in households' borrowing has slowed substantially over the past year (Table 1.C). In December, twelve-month growth in secured lending fell to 3.4%. Consumer credit growth, at 5% on a year ago, remains substantially weaker than rates seen over the past decade.

A significant part of the slowing in secured lending growth reflects a contraction in supply. Over the past year, some lenders have left the market, pulling down on overall credit growth (Chart 1.11). In part because these institutions specialised in lending to riskier customers, borrowers with higher loan to value requirements have faced the greatest tightening in credit conditions. But banks remaining in the market have also reduced the availability of secured lending to households with loan to value ratios below 75%, according to the latest CCS — in contrast to their expectations of an expansion in credit availability to these borrowers in the previous Survey.

Trade credit

Credit extended by one company to another, known as trade credit, is an important source of short-term financing for many businesses, and potentially provides a substitute for scarce bank credit. However, as this box outlines, companies are currently finding it difficult to protect themselves against the risks associated with extending credit to their trading partners. The subsequent reduction in trade credit in some sectors may be amplifying the current slowdown.

Trade credit and associated financial products

Trade credit allows companies to delay payment for their inputs, therefore shortening the period between paying for supplies and receipts from their own sales. Most companies in the supply chain will extend credit as a supplier and receive credit as a buyer.

The delay in receiving payment and the possibility that the customer may default means that extending credit is not costless for companies. But there are financial products which allow them to reduce some of these costs. Companies can obtain cash now for payments owed them, either by selling their invoices to a third party which then collects the debts (known as factoring), or by borrowing against outstanding bills (known as invoice discounting). For example, more than 40,000 companies used the invoice discounting or factoring services of members of the Asset Based Finance Association in 2008. Companies can also take out trade credit insurance, which repays some proportion of their initial bill if their creditors subsequently fail to pay. According to the Association of British Insurers (ABI), there were 13,700 policies covering £282 billion of turnover in 2007, equivalent to 10% of gross domestic output.

International trade, which poses further payment risks, is often supported by 'letters of credit' from importers' banks, which guarantee payments to their trading partners.

Recent developments

In a recession, companies are more likely to face cash-flow constraints, for example because it takes longer than expected to sell stocks. Some may respond by asking creditors to pay for goods more quickly, and/or by lengthening the period over which they settle their own debts. But not all companies will behave this way. In the past, larger companies with access to credit markets have sometimes relaxed trade credit terms to support their smaller suppliers, in order to ensure continuity of supply.⁽¹⁾ But when an economic slowdown is combined with a sharp reduction in the availability of bank credit, it may be more difficult for companies to provide that support. For example, during Japan's banking crisis trade credit did not substitute for bank credit, though it had done before the crisis.⁽²⁾

The time taken for UK companies to settle debts increased over 2008, according to factoring and invoice discounting companies. That is consistent with reports from the Federation of Small Businesses that around half its members faced an increase in payment times in the autumn of last year. In a survey of the Bank's regional Agents' contacts in November, nearly half reported that payment times for goods and services provided had increased. In the current slowdown, few larger companies seem to be planning to increase the trade credit they extend. For example, in the latest *Deloitte Chief Financial Officer Survey*, 96% of respondents said they were aiming to maximise their own cash flows in 2009.

If companies find that it is taking longer to receive payment for their sales, then they might increase their demand for factoring or invoice discounting services. But the extent to which that demand can be met, and the cost of borrowing, will depend on the supply of these products. The Bank's regional Agents have suggested that the availability of these products, particularly from non-banks, has tightened, with some providers unwilling to take on new clients and others withdrawing from the market.

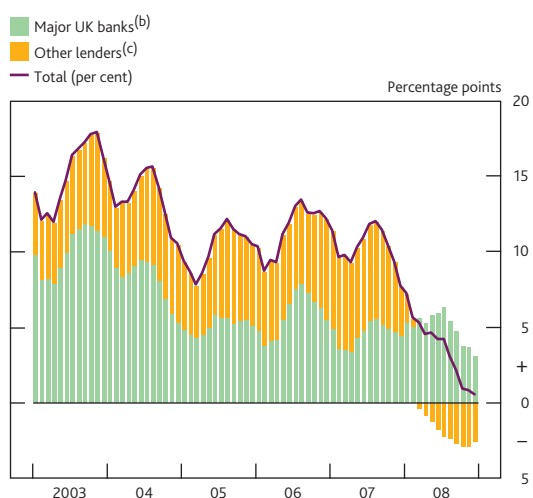
Recessions also increase the risk of a trading partner failing before they can settle debts. That will make companies less willing to trade with some buyers without the protection of insurance. The value of insurance claims in 2008 Q3 was 60% higher than a year earlier, according to the ABI. Consistent with that, 45% of companies in the Agents' November survey said they had experienced some rise in bad debts.

Although there are no official data on overall demand for credit insurance, reports from the Bank's Agents and other sources suggest that demand has increased since last summer. But at the same time, the supply of credit insurance is reported to have tightened. For example, in a CBI survey, conducted in January, 25% of respondents said that the availability of insurance had deteriorated over the past three months, and that had been reflected in higher costs, and lower credit limits and coverage.

These problems are not limited to the United Kingdom. Uncertainty about foreign counterparts has increased demand for letters of credit from UK importers and by UK exporters. That has reportedly increased the time taken to process requests, hindering trade. And the fees charged on letters of credit have risen. The *Pre-Budget Report 2008* included a temporary guarantee scheme to aid smaller exporters' access to export credit.

(1) Kohler, M, Britton, E and Yates, T (2000), 'Trade credit and the monetary transmission mechanism', *Bank of England Working Paper* no. 115.

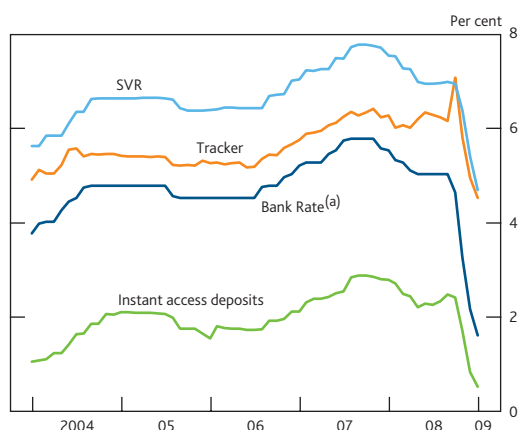
(2) Taketa, K and Udell, G F (2007), 'Lending channels and financial shocks: the case of small and medium-sized enterprise trade credit and the Japanese banking crisis', *Monetary and Economic Studies*, Vol. 25, No. 2, pages 1–44.

Chart 1.11 Growth in household net secured lending^(a)

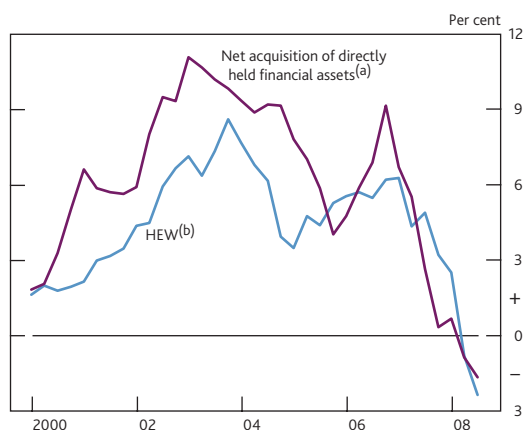
(a) Annualised percentage changes over the past three months. Data are non seasonally adjusted.

(b) This group comprises Abbey, Barclays, HBOS, HSBC, Lloyds TSB, Nationwide and Royal Bank of Scotland.

(c) Calculated as a residual.

Chart 1.12 Bank Rate and selected household quoted interest rates

(a) Monthly averages of daily data to January 2009.

Chart 1.13 HEW and financial asset accumulation

(a) Households' net acquisition of financial assets, excluding changes in assets held via insurance and pension funds. Four-quarter moving average measure as a percentage of households' post-tax income.

(b) Quarterly housing equity withdrawal as a percentage of post-tax income.

Interest rates offered by banks are a key influence on households' decisions over whether to take out a new loan. These quoted rates have fallen back since October (Chart 1.12). But the cost of loans has risen relative to Bank Rate or swap rates. That will in part reflect the dislocation in the financial system. But as a box on pages 44–45 discusses, it may also reflect the impact of low interest rates on banks' margins. Quoted deposit rates have fallen sharply.

It is also likely that demand for new finance has fallen as the economy has slowed and house prices have fallen. Some potential homebuyers may be delaying house purchases in anticipation of further house price falls (Section 1.3). And borrowers whose housing equity has already been eroded by house price falls, and who have become increasingly worried about their income prospects (Section 2), may be cautious about drawing down their remaining equity.

Increased caution about running down housing equity is likely to have played some role in the sharp fall in equity withdrawal by households (HEW) (Chart 1.13). But much of the fall in HEW is likely to be a by-product of other developments in the mortgage market. First, as fewer new loans are taken out, the number of households with the opportunity to withdraw equity when they move or remortgage falls. Second, the average value of equity withdrawn will tend to fall with house prices. And third, as lenders have cut back on loans at high loan to value ratios, that will tend to increase average equity injections, depressing aggregate HEW.

The implication for current consumer spending of lower HEW is not straightforward. A significant proportion of the equity withdrawn from the housing market accumulates with people either trading down or leaving the housing market altogether. These households would be more likely to save that cash than spend it straightaway — in fact HEW and changes in the accumulation of financial assets have been closely related in recent years (Chart 1.13). So it might take some time for the fall in equity withdrawal to feed through to consumption. However, for some households difficulties in accessing equity may make it harder to smooth through any weakness in their income (Section 2).

1.3 Asset prices and the exchange rate

Exchange rates

The sterling effective exchange rate (ERI) is markedly lower than at the time of the November Report. In the fifteen working days to 4 February it was 13% down on its November level. The fall of more than a quarter since mid-2007 is the sharpest over a comparable period since the breakdown of the Bretton Woods agreement in the early 1970s (Chart 1.14), and has more than reversed the late 1990s' appreciation.

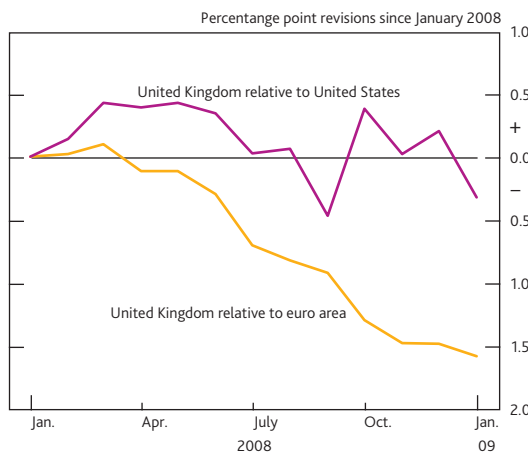
Chart 1.14 Sterling effective exchange rate^(a)



Sources: Bank of England and Thomson Datastream.

(a) The series is calculated from the IMF-based effective exchange rate between 1980 and 1975 and bilateral exchange rates against dollar, (synthetic) euro and yen prior to 1975. The latest observation is the average in the fifteen working days to 4 February.

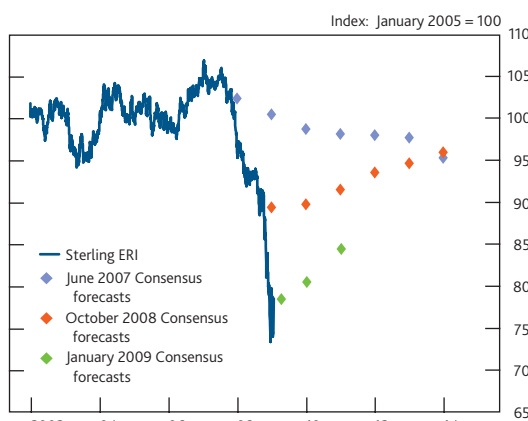
Chart 1.15 Consensus domestic demand growth forecasts for 2009^(a)



Sources: Bureau of Economic Analysis, Consensus Economics, Eurostat and ONS.

(a) Revisions since January 2008 to Consensus expectations for the weighted sum of investment and private consumption growth in the United Kingdom in 2009 less that in the other country.

Chart 1.16 Sterling ERI and Consensus expectations^(a)



Sources: Bank of England and Consensus Economics.

(a) Expectations for the ERI are derived from bilateral US dollar, euro and yen exchange rates, weighted by UK trade shares in 2006. Expectations in the June 2007 and October 2008 surveys are for year ends. Expectations in the January 2009 survey are for 3 months', 12 months' and 24 months' time.

Some of the fall since last summer probably reflects cyclical factors. Over the past year, the global outlook has deteriorated, with resultant downward revisions to interest rate expectations worldwide. But the downward revision to perceived UK prospects appears to have been greater than those in some other countries. For example, the Consensus forecast for UK domestic demand growth in 2009 has been revised down by more than that for the euro area (**Chart 1.15**). But it is difficult to explain the extent of the depreciation with cyclical news alone — movements in the UK yield curve relative to expected interest rates overseas can account for only a small part of the fall in sterling.

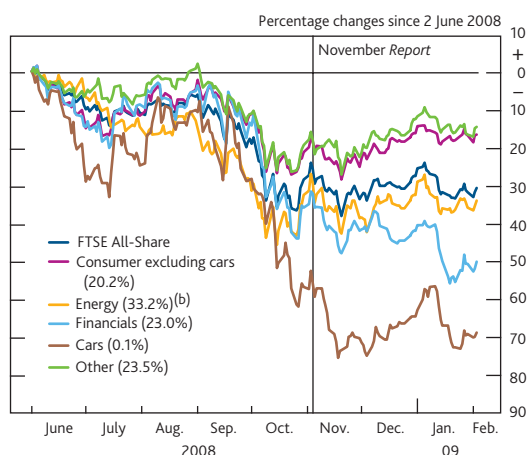
Some investors are likely to have reassessed their view of the long-term prospects for the United Kingdom and with it the sustainable level of sterling. For example, some investors may have lowered their view of sterling's sustainable level because they believe that UK growth will be particularly adversely affected by a persistent reduction in global demand for financial services. There was no evidence of a fall in long-term expectations in the October Consensus Economics survey (**Chart 1.16**), although that predated much of the recent downside news on the economic outlook. But in the January Consensus survey (which only asks about short-term prospects), economists continued to expect the sterling ERI to unwind some of its recent fall, consistent with broadly stable long-term expectations.

Although cyclical factors and a downgrade of views on the long-term prospects for the United Kingdom may account for some of the fall in sterling over the past 18 months, some is likely to reflect a rise in the sterling risk premium. That could be because investors believe that the risks to the UK outlook, and therefore to the return on UK assets, have increased, relative to those in other economies. An increase in the perceived risk associated with holding sterling assets relative to those denominated in other currencies means that investors will tend to require a higher return for holding sterling assets.

The outlook for the exchange rate remains highly uncertain — for example, the implied volatility of the sterling-dollar rate inferred from options remains around three times higher than its average level in 2002–07. But, as discussed in Section 5, the lower exchange rate, if it persists, should shift both domestic and overseas expenditure towards UK suppliers.

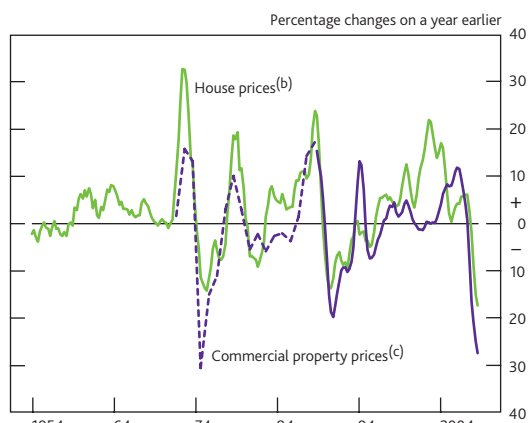
Equity prices

In the run-up to the *February Report*, the FTSE All-Share was around 1% below its level at the time of the *November Report*. Consequently, equity prices in the United Kingdom and other countries remain well below their levels in the early summer. The deteriorating outlook for activity weighed on equity prices across all sectors in the early autumn. But since the *November Report* there have been significant sectoral differences

Chart 1.17 Sectoral equity prices^(a)

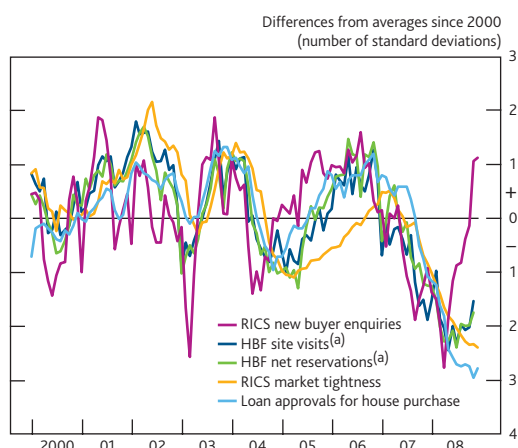
Sources: Thomson Datastream and Bank calculations.

- (a) The weight of each sector in the FTSE All-Share is shown in parentheses.
(b) Includes mining, oil and utilities.

Chart 1.18 Real property prices^(a)

Sources: Halifax, Investment Property Databank, Nationwide, ONS and Thomson Datastream.

- (a) Deflated using RPI index which has been calculated from annual inflation rates prior to 1987. Data are non seasonally adjusted.
(b) Average of the Halifax and Nationwide measures from 1983 onwards. Prior to that, the Nationwide measure alone is used. The published Halifax index has been adjusted in 2002 by the Bank of England to account for a change in the method of calculation.
(c) Annual data up to 1988 are shown in the dashed line. Thereafter quarterly indices are the average of monthly observations.

Chart 1.19 Indicators of housing market activity

Sources: Bank of England, Halifax, Home Builders Federation (HBF), Nationwide and Royal Institution of Chartered Surveyors (RICS).

- (a) HBF data have been seasonally adjusted by Bank staff.

(Chart 1.17). For example, the small fall in the FTSE All-Share since November is more than accounted for by the financial and car sectors. On average, other sectors' prices recovered somewhat, despite the worsening outlook for real activity.

Property markets

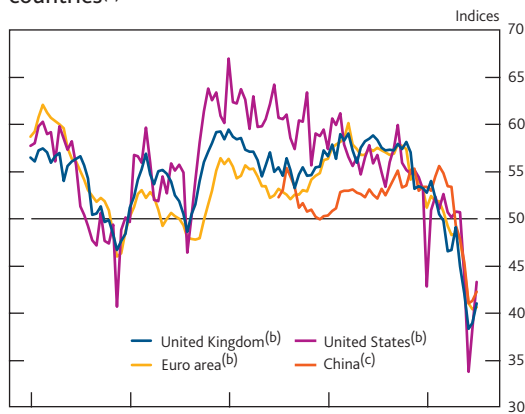
In January, the average of the Nationwide and Halifax measures of house prices was little changed, as Nationwide recorded a further fall and Halifax a rise. Such discrepancies in the monthly data are not unprecedented. House prices remain 18% below their peaks on both measures. Relative to consumer prices, the falls are comparable with those seen in the housing market downturns in the 1970s and 1990s (Chart 1.18). Indicators of housing market activity, which in the past have provided a good guide to near-term price trends, largely remain very weak. The Royal Institution of Chartered Surveyors has noted an increase in property viewings recently, but that has not led to increases in loan approvals or sales (Chart 1.19). The majority of indicators point to further price falls.

Commercial property prices have also weakened further since the November Report. Prices fell by 6% in December, and were 36% lower than their peak in June 2007. In real terms, annual property price inflation is around the lows seen in the 1970s and 1990s property market downturns (Chart 1.18). Commercial property prices began falling in 2007 as yields on property fell below the cost of funding investment. But the slowdown has been given greater impetus over the past few months as credit conditions have tightened and the economic slowdown has weighed on the outlook for commercial rents.

2 Demand

The synchronised downturn in global economic activity has intensified markedly since September, reflecting a widespread deterioration in household and business sentiment, and a reduction in the availability of credit. In the United Kingdom, real GDP is provisionally estimated to have fallen by 1.5% in Q4. Falling employment, tight credit conditions and lower household wealth have restrained consumer spending. And survey evidence suggests that business and dwellings investment have declined further. The weakness of activity is likely to be further amplified in the near term by companies reducing stocks.

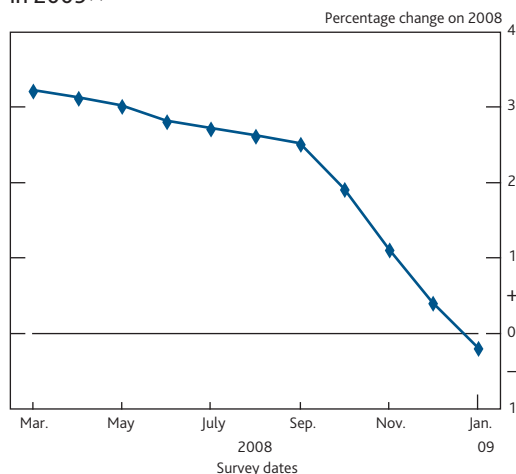
Chart 2.1 Business surveys of output in selected countries^(a)



Sources: Bloomberg, Bureau of Economic Analysis, CIPS/Markit, Eurostat, Institute for Supply Management and ONS.

- (a) A figure over 50 indicates rising output compared with the previous month, and a figure below 50 indicates falling output.
 (b) Manufacturing and services headline indices, weighted together using shares in real output.
 (c) Manufacturing index only.

Chart 2.2 Consensus forecasts for world GDP growth in 2009^(a)



Source: Consensus Economics.

- (a) The world GDP growth forecast includes 83 Consensus country forecasts. The average is calculated using 2007 GDP weights, converted at average 2007 exchange rates.

Global economic activity slowed during much of 2008, as consumer and business sentiment deteriorated, and deleveraging in the financial sector led to a tightening in credit conditions across the world. Since September, that synchronised downturn in activity has intensified markedly. Official data and business surveys suggest that demand fell very sharply in Q4 in the United Kingdom, the United States and the euro area.

Governments and central banks have responded to the sharp downturn with a variety of measures, including interest rate cuts, fiscal injections, and measures to improve conditions in the financial system and support lending growth. A key question for the MPC is the extent to which these actions will offset the factors pushing down on activity. The balance of these forces will determine the depth and persistence of the slowdown in both external demand (Section 2.1) and domestic demand (Section 2.2). A box on page 20 compares the stimulus to UK demand in the current and previous recessions.

2.1 External demand and UK trade

Business surveys point to a slowdown in global economic activity during 2008, which intensified markedly following the severe turmoil in global financial markets in late September and early October (Chart 2.1). The weakness of the incoming data has led to substantial downward revisions to forecasts for global activity in 2009 since September (Chart 2.2).

Consumer and business sentiment have deteriorated sharply. In part that is likely to reflect a further tightening in credit conditions (Chart 2.3). But it also reflects uncertainty about the economic outlook more generally. That has caused households to reduce spending, and businesses to cut back on production (Chart 2.1) and investment. Indicators of investment in advanced economies deteriorated sharply in the final months of 2008 (Table 2.A).

Economic stimulus in the current and previous recessions

The UK economy is in recession. The three previous UK recessions over the past 40 years have each lasted for more than a year, and output has taken a considerable period to recover to its pre-recession level (**Table 1**). Some of the forces pushing down on demand in the near term are unusually powerful: in particular, the ongoing stresses in financial markets — past episodes of which have tended to be associated with relatively severe recessions⁽¹⁾ — and the synchronised downturn in global demand and output. But there are also a range of factors currently in place that collectively should provide a more significant and prompt stimulus to activity than at similar stages of previous episodes.

Table 1 UK GDP in previous recessions^(a)

Date recession began	Output loss (per cent of GDP)	Number of quarters of falling output	Number of quarters to recover output drop ^(b)
1973 Q3	-3.3	6	14
1980 Q1	-4.6	5	13
1990 Q3	-2.5	5	13

(a) For the purposes of this box, recessions are defined as two consecutive quarters of falling output (at constant market prices) estimated using the latest data. The recessions are assumed to end once output began to rise, apart from the 1970s where two separate occasions of falling output are treated as a single recession.

(b) Number of quarters from the start of the recession until output regained its pre-recession level.

Official interest rates have been cut more significantly than at the early stage of previous UK recessions (**Table 2**). In part, that is because those three recessions were all associated with significant increases in inflation. That constrained policymakers' ability to loosen policy in the early stages of those recessions. In contrast, the relative stability of inflation in recent years, and the associated anchoring of inflation expectations, has enabled the MPC to cut Bank Rate very sharply as output growth has slowed. However, the boost from those interest rate cuts has been offset to some degree

Table 2 Economic stimulus at early stages of recent UK recessions^(a)

	1970s	1980s	1990s	2008
Changes on a year earlier (percentage points)				
Bank Rate ^(b)	4.0	3.0	-1.0	-3.5
Fiscal stance ^(c)	-3.3	0.6	0.2	-2.0
Percentage changes on a year earlier				
Sterling ERI ^(d)	-4	7	9	-22
Oil prices ^(e)	29	-6	16	-40

Sources: Bank of England, Bloomberg, HM Treasury and Thomson Datastream.

(a) Recessions are defined as in footnote (a) of **Table 1**. Data compare the second quarter of falling output in each recession with a year earlier.

(b) End-quarter observations. For example, the figure for 2008 is the change between the end of December 2007 and December 2008.

(c) The fiscal stance is proxied by the cyclically adjusted net government surplus as a percentage of GDP. Data are for the fiscal year during which the recession began. The figure for 2008 is based on an estimate for the 2008–09 fiscal year in the latest *Pre-Budget Report*.

(d) The series is based on the IMF-based effective exchange rate between 1980 and 1975 and bilateral exchange rates against dollar, (synthetic) euro and yen prior to 1975. Averages of final month of quarter.

(e) Brent sterling oil prices. Averages of final month of quarter.

by the ongoing severe dislocation in financial markets, which has adversely affected some aspects of the transmission mechanism of monetary policy (see the box on pages 44–45).

In addition to cuts in Bank Rate, fiscal policy and the exchange rate are also more supportive of activity than at the early stage of these previous recessions. And oil prices have fallen significantly, boosting households' spending power, although this followed the very large rise in oil prices between 2003 and mid-2008. Finally, a package of measures to improve conditions in the financial sector and support lending growth has been introduced (Section 1).

In forming an assessment of the outlook, the key judgement for the MPC is the full effect of this range of stimuli to the economy, and the extent to which they will offset the impact of the forces bearing down on spending. Section 5 discusses that judgement in detail.

(1) See for instance, IMF (2008), *World Economic Outlook*, October 2008.

Table 2.A Indicators of investment in the United States, euro area and Japan^(a)

Percentage changes, latest three months on previous three months	2008					
	Q1	Q2	Q3	Oct.	Nov.	Dec.
United States	-1.4	-1.7	-3.7	-9.1	-10.8	-14.3
Euro area	-1.7	-6.0	-4.0	-8.1	-14.2	n.a.
Japan	3.6	-1.4	-10.1	-14.7	-19.3	n.a.

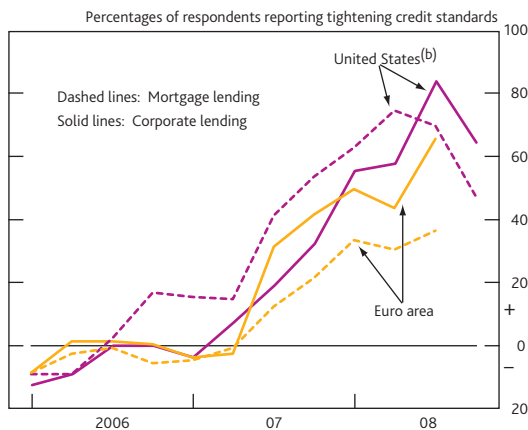
Sources: Census Bureau, Eurostat and Japanese Cabinet Office.

(a) US new orders of non-defence capital goods, euro-area industrial new orders for capital goods and Japanese machinery orders.

There has also been a particularly marked reduction in world trade flows: the IMF estimate that the value of world exports fell by around 10% in the three months to November, compared with the previous three months. In part, that is likely to have reflected a tightening in the supply of credit used to facilitate international trade (see the box on page 15). But in addition, the increasingly globalised nature of supply chains may mean that the slowdown in activity has been transmitted more rapidly across borders than in previous downturns.

Output growth has been slowing in the United States for some time, but the 1% fall in GDP in 2008 Q4 was the largest decline since 1982. Weakness in domestic demand has been exacerbated by a large fall in employment: non-farm payrolls declined by around 1.5 million in the three months to December.

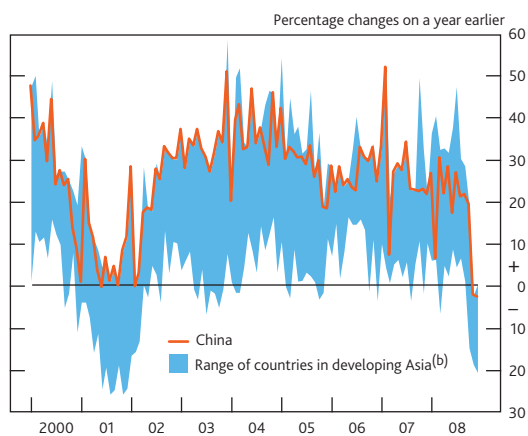
Chart 2.3 Bank lending surveys in the United States and euro area^(a)



Sources: ECB and Federal Reserve Board.

- (a) US Senior Loan Officer Opinion Survey and euro-area Bank Lending Survey.
(b) For mortgage lending, the net balance of respondents reporting tightening standards for prime mortgage lending is used from the April 2007 survey onwards. Prior to April 2007 the balance is for aggregate mortgage lending.

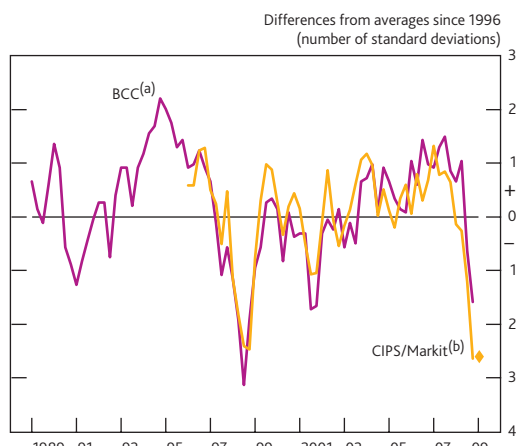
Chart 2.4 Exports in selected developing economies in Asia^(a)



Source: Thomson Datastream.

- (a) Nominal value of exports in dollar terms.
(b) Countries included are China, India, Indonesia, Malaysia, the Philippines and Thailand.

Chart 2.5 Survey indicators of UK manufacturing export orders



Sources: BCC and CIPS/Markit.

- (a) Net percentage balance of manufacturing companies saying that export orders increased on the quarter.
(b) Manufacturing companies saying that export orders increased this month compared with previous month. Quarterly averages. The diamond for 2009 Q1 is based on January data.

GDP in the euro area — the destination for around half of the United Kingdom's exports — looks to have fallen sharply in Q4, following more modest declines in activity in Q2 and Q3. Euro-area industrial production fell by 3.1% in the three months to November compared with the previous three months, the largest fall since the series began in 1990.

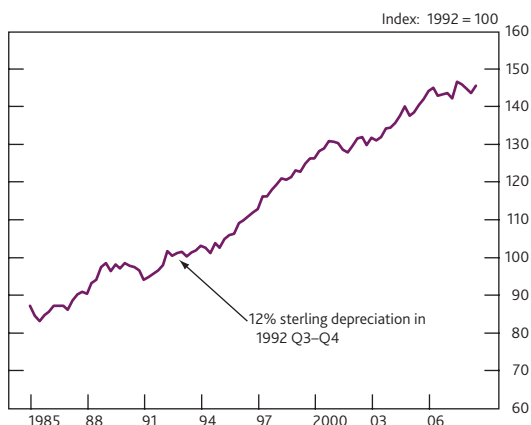
Recent data also point to a sharp slowdown in activity in the emerging and developing economies. For example, four-quarter Chinese GDP growth fell to 6.8% in 2008 Q4, the slowest rate of growth for seven years. Weak activity in developing economies partly reflects the slowdown in export demand (Chart 2.4).

In response to the global slowdown, central banks and governments have implemented or announced substantial monetary and fiscal actions, which should help to lessen the scale of the downturn. US authorities have lowered interest rates to close to zero, and a sizable fiscal package is planned. In the euro area, interest rates were cut by 1.75 percentage points during Q4, and EU governments have endorsed proposals to implement fiscal measures worth 1.5% of GDP in aggregate.

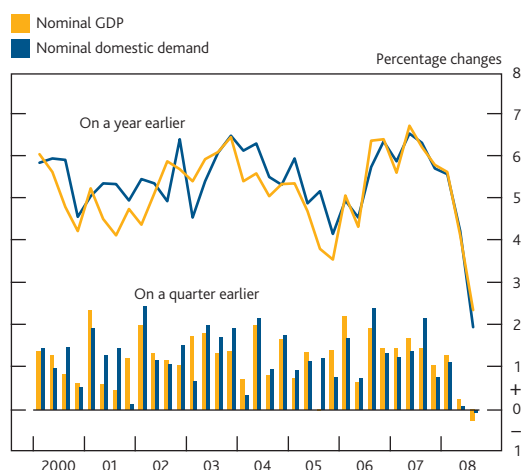
The global slowdown has weighed heavily on the demand for UK exports. Goods export volumes fell by 2.8% in October and 5.3% in November. And surveys of manufacturing export orders have also fallen sharply (Chart 2.5), suggesting continued weakness in export volumes in the near term.

The sterling exchange rate has depreciated by more than a quarter since mid-2007. That should help to support export growth over time. That depreciation is more than twice as large as in 1992, and following that fall, UK export volumes grew more rapidly than world imports for the subsequent four years. So far, it appears that UK exporters have, on average, responded to the lower level of sterling by boosting margins, rather than by cutting foreign currency prices. Sterling export prices rose by 14% in the year to Q3, while export volumes were broadly flat, despite positive growth in world import volumes. However, the boost to exporters' profitability should increase the supply of UK exports, and hence the United Kingdom's overall market share, over time.

Import volumes have fallen by 0.8% in the year to 2008 Q3. That partly reflects weak domestic demand. But that effect is being amplified by the decline in sterling, which should over time encourage UK households and businesses to purchase domestically produced goods and services rather than imports. Following the 1992 depreciation, import penetration — the ratio of imports to final expenditure — was broadly flat for three years, temporarily arresting a longer-term rise (Chart 2.6).

Chart 2.6 UK import penetration^(a)

(a) The volume of UK imports divided by the volume of total final expenditure. Both series have been adjusted to exclude the estimated impact of missing trader intra-community (MTIC) fraud.

Chart 2.7 Nominal demand^(a)

(a) At current market prices.

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

Percentage changes on a quarter earlier

	2007 average	2008		
		Q1	Q2	Q3
Household consumption ^(b)	0.9	1.0	-0.2	-0.1
Government consumption	0.4	2.0	0.7	0.6
Investment	1.0	-3.0	-0.9	-2.8
Final domestic demand	0.8	0.5	-0.1	-0.4
Change in inventories ^{(c)(d)}	0.0	0.2	-0.1	-0.4
Alignment adjustment ^(d)	0.0	-0.6	0.0	0.4
Domestic demand	0.9	0.1	-0.2	-0.4
'Economic' exports ^(e)	0.9	0.3	-0.7	0.5
'Economic' imports ^(e)	1.4	-0.6	-1.2	1.0
Net trade ^(d)	-0.2	0.3	0.2	-0.2
Real GDP at market prices	0.8	0.4	0.0	-0.6

(a) Chained-volume measures.

(b) Includes non-profit institutions serving households.

(c) Excludes the alignment adjustment.

(d) Percentage point contributions to quarterly growth of real GDP.

(e) Goods and services, excluding the estimated impact of MTIC fraud.

Despite the fall in imports, the United Kingdom continued to run a current account deficit over the past year. That means that national saving has been insufficient to finance domestic investment, and the United Kingdom has continued to borrow from abroad. To reduce that reliance on foreign borrowing, national saving would need to increase relative to national investment. The path of domestic demand will be a key influence on the speed and nature of that adjustment (Section 5).

2.2 Domestic demand

As in other countries, a deterioration in sentiment and a tightening in credit conditions have caused nominal demand growth to weaken markedly in the United Kingdom during 2008 (Chart 2.7). Real GDP fell by 0.6% in Q3, driven by a particularly marked fall in investment. The contribution from stockbuilding also declined, and household spending fell slightly (Table 2.B). Real GDP is provisionally estimated to have fallen by 1.5% in Q4, the largest fall since 1980.

Recent household spending data

Consumer spending fell in both Q2 and Q3 according to the latest official data (Table 2.B). Within that, some elements of spending were particularly weak. In particular, sharply lower spending on vehicles more than accounted for the total fall in consumption in Q3, despite comprising only 5% of household spending.

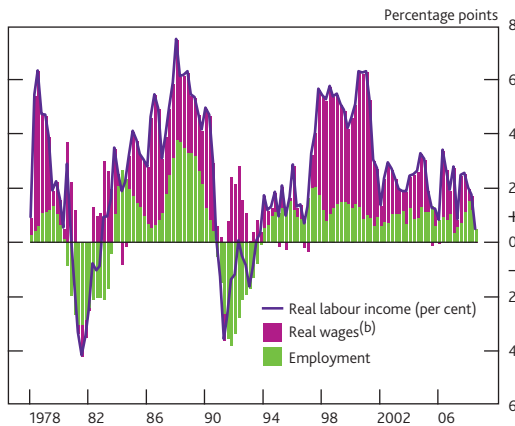
Monthly indicators generally point to a further contraction in household spending in Q4. Private new car registrations indicate that spending on vehicles contracted further. The Bank's regional Agents reported that spending on consumer services continued to shrink. And although retail sales volumes rose by 0.6% in Q4, there is greater uncertainty than usual around these estimates, given difficulties removing seasonal variation and accounting for price changes. The ONS estimates that annual growth in nominal retail spending, excluding seasonal adjustment, was -0.8% in December, broadly in line with survey data on retail spending, such as the *CBI Distributive Trades Survey* and the *BRC Retail Sales Monitor*.

Influences on household spending

The deterioration in labour market conditions is likely to have restrained household spending during the second half of 2008. Falls in employment (Section 3) are likely to have more than offset the boost to real income growth from lower commodity prices. Indeed, in previous recessions, sharp falls in employment were an important driver of lower real income growth (Chart 2.8).

In addition to its effects on the incomes of those who lose their jobs, rising unemployment has also weighed on consumer confidence more widely. In the GfK survey, unemployment

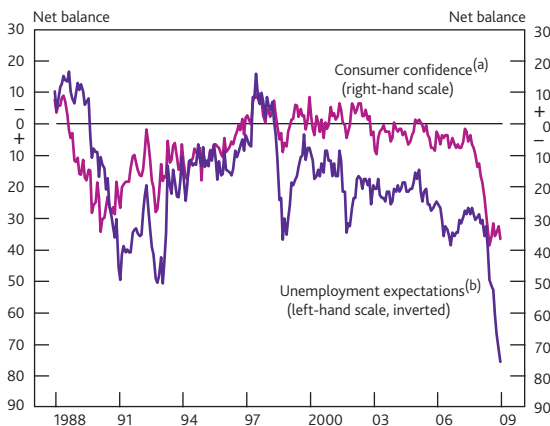
Chart 2.8 Contributions to four-quarter real labour income growth^(a)



Sources: ONS (including Labour Force Survey) and Bank calculations.

- (a) Wages and salaries plus mixed income deflated using the consumer expenditure deflator (including non-profit institutions serving households).
 (b) The contribution from real wages has been estimated by assuming that employment remained fixed over each four-quarter period.

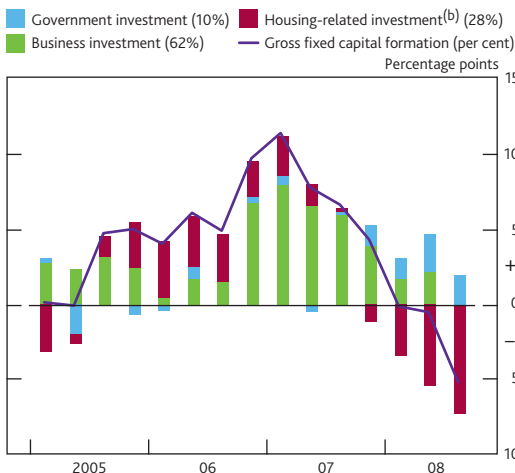
Chart 2.9 Indicators of consumer confidence



Source: Research carried out by GfK NOP on behalf of the European Commission.

- (a) Headline GfK measure. Data are non seasonally adjusted.
 (b) The GfK survey asks respondents how they expect unemployment to evolve over the next year.

Chart 2.10 Contributions to four-quarter growth in gross fixed capital formation^(a)



- (a) Chained-volume measures. The figures in parentheses show shares in the level of gross fixed capital formation in 2007.
 (b) Includes dwellings investment and costs associated with the transfer of ownership of buildings, dwellings and non-produced assets, primarily stamp duty on housing transactions and estate agents' fees.

expectations have worsened sharply since September (Chart 2.9). Increased uncertainty about job prospects may cause households to lower spending in order to reduce borrowing and build up savings: the household saving rate picked up a little during 2008 to 1.8% in Q3, but remained at a historically low level.

Some households are likely to have also reduced spending due to the further tightening in the availability of credit (Section 1). The impact of tighter credit conditions has been amplified by further weakness in the housing market, as house price falls have reduced the amount of housing equity homeowners can borrow against. And households have also seen steep falls in the value of their financial wealth. Net financial wealth fell by 15.4% in the year to Q3, and will have declined further since then, reflecting the large falls in equity prices in October.

Prospects for consumer spending in the near term have been boosted by the temporary reduction in VAT, and the substantial falls in Bank Rate. The reduction in VAT will encourage households to bring spending forward into 2009, and provide a temporary boost to purchasing power (see the box on page 31). The reductions in Bank Rate will boost consumer spending through a number of channels. First, they have significantly reduced the interest payments of many borrowers. They have also reduced the interest receipts of savers. But on average, borrowers are likely to have a larger propensity to consume out of current income than savers. Lower interest rates should further support consumption by raising household wealth through their impact on asset prices, and by increasing the incentive to spend now rather than save (see the box on pages 44–45 for a discussion of the effects of changes in Bank Rate).

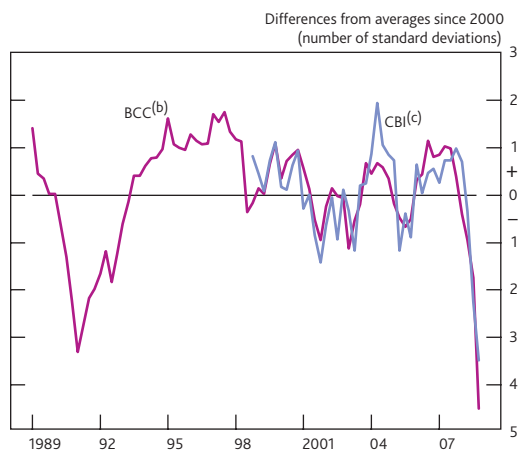
Weighing up these factors, the MPC judges that consumer spending is likely to remain weak for some time. Medium-term prospects for consumer spending are discussed in Section 5.

Investment and inventories

Whole-economy investment fell by 5.3% in the year to 2008 Q3. That decline can be more than accounted for by a fall in housing-related investment (Chart 2.10), reflecting the sharp downturn in house prices. This component of investment is likely to continue to detract from GDP growth in the near term: housing starts in 2008 Q3 were around half their level of a year earlier, the sharpest annual fall since the series began in 1980.

Business investment growth has also slowed. Sharp falls in commercial property prices have reduced investment in buildings. And spending on plant and machinery has also weakened. Investment intentions surveys point to further very marked falls in such investment in Q4 and beyond (Chart 2.11). Contacts of the Bank's regional Agents reported

Chart 2.11 Investment intentions (plant and machinery)^(a)



Sources: BCC, CBI, CBI/PwC and ONS.

- (a) Measures weight together sectoral surveys using shares in real business investment.
 (b) Net percentage balances of companies who say they have revised up their planned investment in plant and machinery over the past three months. Data are non seasonally adjusted.
 (c) Net percentage balances of companies who plan to increase investment in plant and machinery over the next twelve months.

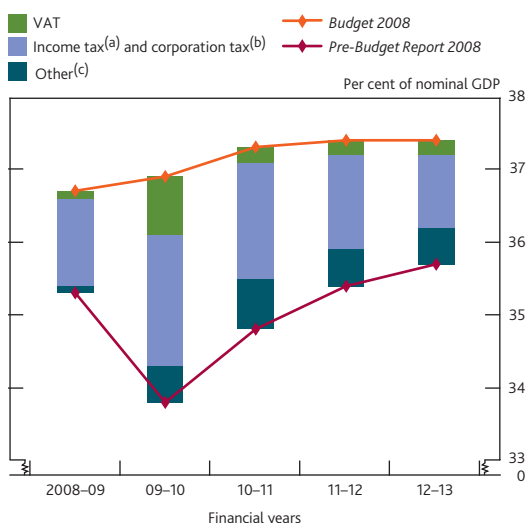
that the weak outlook for demand and increased uncertainty about the depth and duration of the slowdown are the main drivers of the marked reductions in investment plans.

Tight credit conditions also weighed on investment intentions. According to the CBI surveys of both the services and manufacturing sectors, the availability of external finance has become a more important factor curtailing investment plans since mid-2008.

In addition to investing in fixed capital, businesses also invest in stocks. The ONS estimates that stockbuilding detracted 0.4 percentage points from quarterly GDP growth in Q3. But despite this slower pace of stockbuilding, CBI surveys suggest that stocks remained above desired levels in the manufacturing and distribution sectors through Q4. That partly reflected the unexpected sharpness of the slowdown in demand. But it may also reflect a reduction in desired stock levels due to tighter credit conditions. Indeed, the Bank's regional Agents reported that concerns over stock levels have been exacerbated by doubts about the availability of inventory finance (Section 1).

A key influence on the near-term outlook for aggregate demand is the time it will take for companies to work off this excess of stocks above their desired levels. The effects on output of stock cycles can be significant. In the 1990s recession for example, lower stockbuilding accounted for around half of the sharp fall in GDP in 1990 H2, before that drag ended as the rate of de-stocking stabilised. The latest *CBI Quarterly Industrial Trends Survey* suggests that stocks fell in 2008 Q4, and were expected to fall further in Q1. The MPC judges that lower stockbuilding will continue to drag on GDP growth in the near term.

Chart 2.12 Revisions to government projections for tax receipts



Source: HM Treasury.

- (a) Income tax is net of tax credits and includes National Insurance contributions.
 (b) Non North Sea corporation tax.
 (c) Includes North Sea revenues, excise duties, other taxes and royalties, and rounding differences.

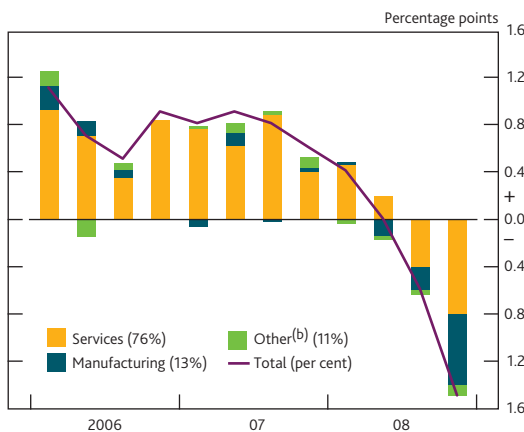
Government spending

Four-quarter growth in nominal government spending on consumption and investment fell to 7.7% in Q3, from 9.2% in Q2. The MPC has based its projections on the fiscal plans set out in *Pre-Budget Report 2008*. Those plans contained a substantial upward revision to public sector net borrowing. That increase partly reflects discretionary measures, such as the bringing forward of capital expenditure and a cut in the standard rate of VAT. But in large part it reflects the marked worsening in the economic outlook, which will increase some components of government expenditure such as benefit payments, and reduce tax receipts (Chart 2.12). The downward revision to projections for income and corporation tax receipts partly reflects expectations of weaker profits in the financial sector.

3 Output and supply

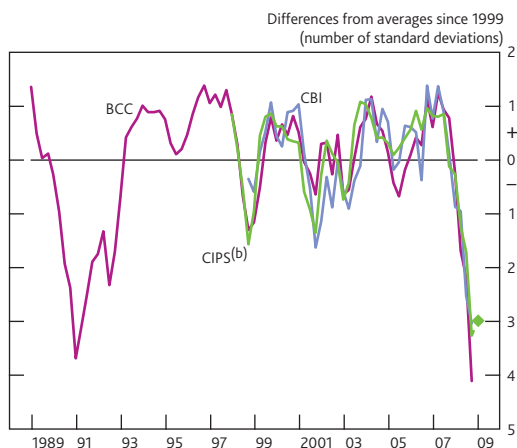
Output fell markedly during the second half of 2008. Global manufacturing output contracted particularly rapidly. Business surveys suggest that UK output continued to fall sharply in early 2009. Lower output has created a sizable margin of spare capacity, both within companies and in the labour market. Employment fell in the three months to November, pushing the unemployment rate to its highest in nearly a decade. And survey measures of employment intentions weakened markedly in Q4.

Chart 3.1 Contributions to quarterly GDP growth^(a)



- (a) Chained-volume measures, at basic prices. The figures in parentheses show shares in the level of nominal value added in 2007. Contributions do not sum to GDP due to rounding. The chart shows data consistent with January's preliminary GDP release. Production data were subsequently revised.
- (b) Includes agriculture, mining and quarrying, electricity, gas and water supply and construction.

Chart 3.2 Survey indicators of aggregate output growth^(a)



Sources: BCC, CBI, CBI/PwC, CIPS/Markit and ONS.

- (a) Three measures are produced by weighting together surveys from the BCC (manufacturing, services), the CBI (manufacturing, financial services, business/consumer services, distributive trades) and CIPS/Markit (manufacturing, services, construction) using nominal shares in value added.
- (b) The diamond for 2009 Q1 is based on January data.

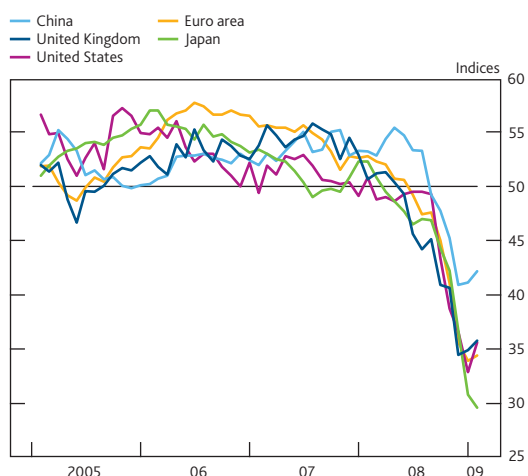
The UK economy is in recession. The marked contraction in output has created a sizable margin of spare capacity, with companies using their inputs less intensively and unemployment picking up. The degree to which spare capacity continues to build will depend on the depth and persistence of the fall in output, and the degree to which the recession also impairs the supply potential of the economy. This section considers these issues in turn.

3.1 Output

Output contracted substantially in 2008 H2, according to the latest official data (**Chart 3.1**). Output is estimated to have fallen by 1.5% in 2008 Q4, the largest quarterly fall since 1980. And subsequent industrial production data suggest that this estimate could be revised down. The fall in GDP was deeper than expected at the time of the *November Report*. The marked contraction in the official data in the fourth quarter corroborated the picture drawn by business survey data (**Chart 3.2**). The outlook for early 2009 has also deteriorated since the *November Report*. Although the CIPS/Markit output indices recovered a little in January, they remained at very low levels. And the BCC measures of optimism about sales in the year ahead fell sharply in Q4, consistent with further near-term weakness in activity.

The MPC has placed material weight on business surveys in forming its judgement about the near-term growth outlook. Recent survey measures have tracked official estimates particularly well relative to their past performance. It is possible that surveys have captured the influential role of declines in business sentiment on production at the current juncture. However, it is always difficult to map them into precise estimates of GDP growth. For example, surveys do not usually assess the size of cuts in production, only the proportion of companies that have cut output. As a result, the MPC also places weight on other information in forming its judgement about the near-term outlook, such as reports from

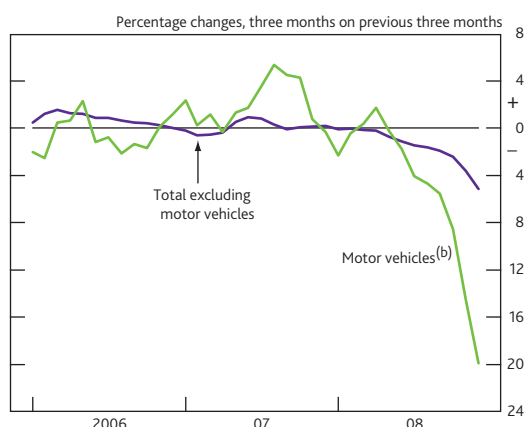
Chart 3.3 Manufacturing output indicators in selected countries^(a)



Sources: Bloomberg, CIPS/Markit, Institute for Supply Management and Thomson Datastream.

(a) Data are headline purchasing manager indices. A figure over 50 indicates rising output compared with the previous month, and a figure below 50 indicates falling output.

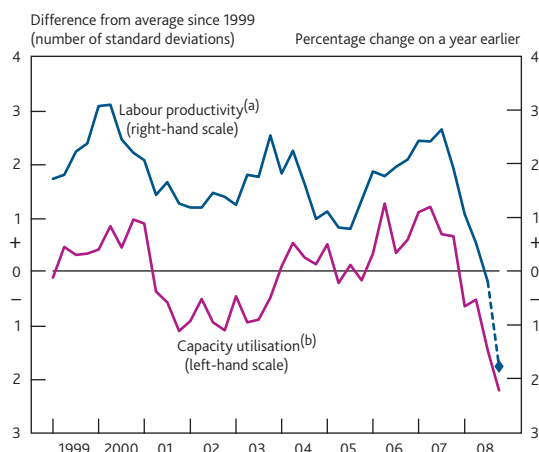
Chart 3.4 UK manufacturing output^(a)



(a) Chained-volume measures, at basic prices.

(b) Manufacture of motor vehicles, motor vehicle bodies, trailers and parts, and engine parts.

Chart 3.5 Labour productivity and capacity utilisation



Sources: CBI and ONS.

(a) GDP at constant market prices divided by LFS employment. The diamond for 2008 Q4 is based on the preliminary estimate for GDP growth and employment data in the three months to November.

(b) Balances from the CBI manufacturing, financial services, business/consumer services and distributive trades surveys, weighted together using nominal shares in value added.

the Bank's regional Agents. Many contacts told the Bank's Agents that they planned to cut production further in early 2009. The MPC's central judgement is that output in Q1 is falling at a broadly similar pace to that estimated in Q4. Output prospects beyond Q1, where survey indicators provide little guidance, are discussed in Section 5.

Output fell in both the service and manufacturing sectors in 2008 Q4 (**Chart 3.1**). The 1% fall in service sector output was the weakest quarterly outturn since 1979. Within the service sector, output fell most in the distribution, hotels and catering subsector. Overall business services and finance activity also fell in Q4. And within that, the continued strength in measured output in the financial services sector is difficult to reconcile with the severe dislocation in financial markets.

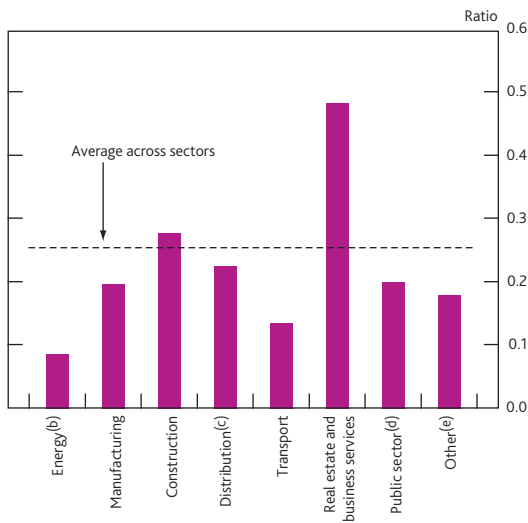
The reduction in manufacturing output was particularly marked in Q4, with output falling by 5.1%, the largest fall since 1974. The sharp deterioration in manufacturing conditions since September has been common across many parts of the world (**Chart 3.3**). In part, that reflects the marked deterioration in sentiment and tighter credit supply, which have pushed down global demand (Section 2). Within the UK manufacturing sector, vehicle production has been particularly heavily hit (**Chart 3.4**). That reflects markedly weaker household spending on cars over 2008 H2, both overseas — SMMT estimates that the majority of UK-produced vehicles are exported — and in the United Kingdom (Section 2). The unexpected severity of that downturn initially left producers with substantial excess stocks, according to contacts of the Bank's regional Agents. In order to reduce stocks to desired levels, contacts subsequently cut production by even more than demand had fallen, accentuating the near-term downturn.

3.2 Capacity utilisation within businesses

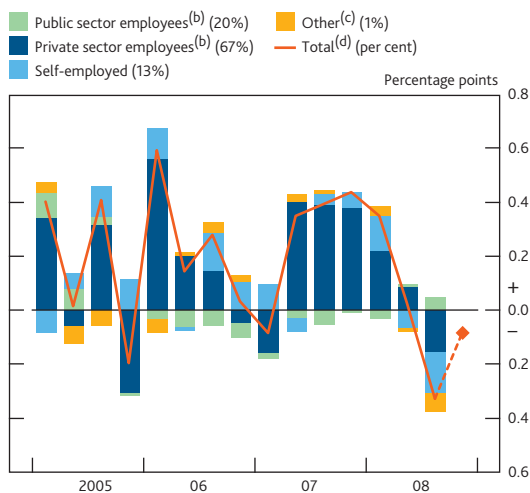
The cutbacks in output have substantially reduced the pressures on companies' existing capital and labour. According to the CBI surveys, capacity utilisation fell sharply in 2008 Q4, while estimates of labour productivity growth also suggest that businesses are using their inputs substantially less intensively (**Chart 3.5**). That has been associated with a significant reduction in pricing pressure (Section 4).

Weakness in output over the coming quarters will further raise the margin of companies' spare capacity. However, a number of factors are likely to weigh on companies' potential supply, in part offsetting that effect. The remainder of this subsection discusses these factors; influences affecting effective labour supply growth are discussed in Section 3.3.

The marked tightening in the supply of working capital, and in particular trade credit (see the box on page 15), has impaired

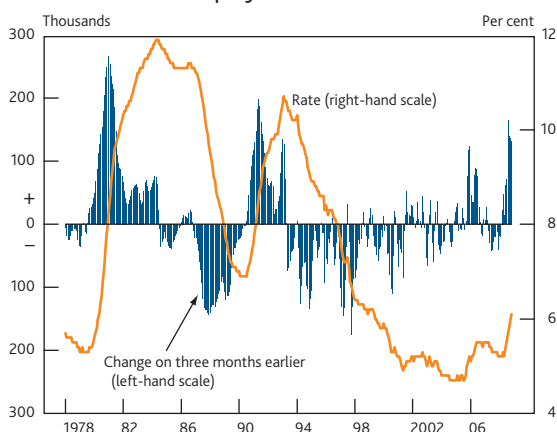
Chart 3.6 Capital sales relative to acquisitions^(a)

(a) At current prices. The ratio for each sector is an average over 2000–07.
 (b) Mining and quarrying, and electricity, gas and water supply.
 (c) Distribution, hotels and catering.
 (d) Education, health and social work.
 (e) Agriculture, forestry and fishing, and other community, social and personal service activities.

Chart 3.7 Contributions to quarterly LFS employment growth^(a)

Source: ONS (including Labour Force Survey).

(a) Figures in parentheses are shares in total employment in 2007 and do not sum to 100% due to rounding.
 (b) Data have been adjusted to be on a calendar-quarter basis.
 (c) Unpaid family workers and government-supported trainees.
 (d) The diamond shows employment growth in the three months to November.

Chart 3.8 LFS unemployment

Source: Labour Force Survey.

companies' ability to supply goods and services. In a recent survey carried out by the Bank's regional Agents, around a quarter of contacts said they had chosen to refuse potentially profitable orders as a result of tighter trade credit. There have also been widespread reports of increased delays in some businesses paying for goods and services supplied, reducing some companies' cash flow.

Higher corporate insolvencies during the downturn will also reduce potential supply, by increasing the rate of capital scrapping. Indeed, the corporate insolvency rate in England and Wales picked up further in 2008 Q4. In part offsetting that, some capital may be transferred to productive use elsewhere instead of being scrapped; sales of second-hand capital make up around a quarter of acquisitions (**Chart 3.6**). And two sectors particularly affected by the downturn so far — real estate and construction — have relatively high capital turnover.

Several other factors are also likely to reduce the economy's potential supply capacity over time. For example, weaker demand and tighter credit supply are likely to reduce capital accumulation. And they are also likely to reduce productivity growth to the extent that they reduce research and development spending and restrict market entry.

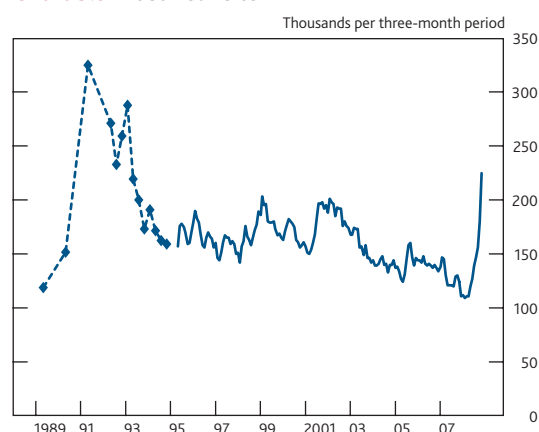
3.3 Labour market developments

Developments in the labour market are central to the outlook for output growth and inflation for two reasons. First, reduced employment is likely to push down household spending, as the incomes of those made unemployed falls sharply. That amplifies the downturn and reduces inflationary pressure. Second, weaker employment is likely to push down on labour costs, and so on prices. But the scale of that downward pressure on wages may be dampened by a reduction in the effective supply of labour.

Employment

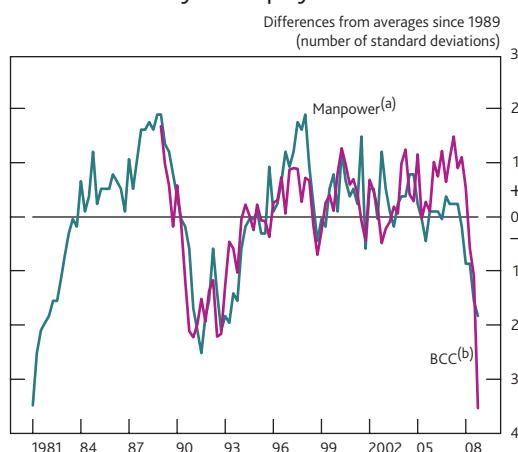
Official data on employment are only available up to November. LFS employment has fallen by nearly 100,000, or 0.3%, since mid-2008. Employment fell among both private sector employees and the self-employed in Q3 (**Chart 3.7**), as businesses responded to weakening demand prospects. By contrast, employment in the public sector, which is typically less sensitive to cyclical changes in demand, has been relatively stable.

The reduction in employment has been associated with a marked pickup in unemployment. On the LFS measure, unemployment continued to rise sharply in the three months to November, taking the unemployment rate to over 6%, its highest rate in nearly a decade (**Chart 3.8**). The claimant count measure picked up further in December.

Chart 3.9 Redundancies^(a)

Sources: ONS (including Labour Force Survey) and Bank calculations.

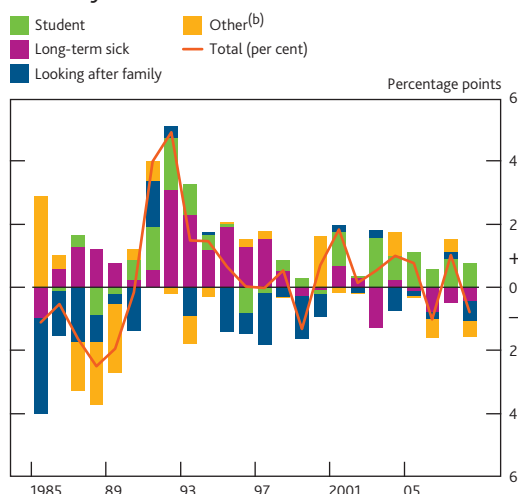
(a) Data prior to 1995 are based on ONS historical estimates of redundancies, and have been adjusted by Bank staff to account for a change in definition compared with the post-1995 figures.

Chart 3.10 Surveys of employment intentions

Sources: BCC, Manpower and ONS.

(a) Manpower whole-economy measure. Data prior to 1992 have been seasonally adjusted by Bank staff.

(b) Net percentage balance of companies expecting their workforce to increase over the next three months. The measure weights together the manufacturing and service sector balances using shares in total employment. Data are non seasonally adjusted.

Chart 3.11 Contributions to annual growth in economic inactivity^(a)

Source: Labour Force Survey.

(a) Data prior to 1992 are based on LFS microdata. Figures for 1992 are interpolated. Figures for 2008 are based on data up to 2008 Q3.

(b) Discouraged, retired, temporarily sick and other reason.

Companies have cut back markedly on hiring in response to weaker demand, with the number of job vacancies falling by around a quarter over 2008. Younger people have been particularly badly hit by the reduction in vacancies, in part because a higher proportion of that group are typically searching for employment relative to other cohorts. Indeed, unemployment rates among individuals under the age of 25 have picked up more sharply since the start of 2008 than those of other age groups.

Companies have also cut back on employment through increased redundancies. LFS self-reported data suggest that redundancies increased markedly up to November (**Chart 3.9**), contributing to a pickup in claimant count inflows. Moreover, redundancies of 20 people or more require a statutory consultation period of between one and three months, so redundancies are likely to be a lagging indicator of labour demand. Data on the number of such consultations are not published. However, contacts of the Bank's regional Agents expected redundancies to increase further during 2009.

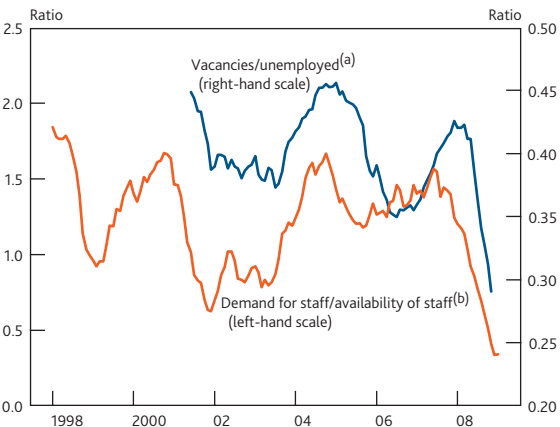
Reduced availability of working capital may accelerate the pace at which companies seek to cut back on labour costs, by restricting their cash flow. Indeed, surveys of employment intentions fell further in Q4, with the BCC indicator falling particularly sharply, to below its trough in the early 1990s (**Chart 3.10**). And the current employment balances from the CIPS/Markit surveys remained at low levels in January. The extent to which companies shed labour over the coming months will depend in part on the extent to which companies cut back hours worked per employee, and also on the flexibility of wages. A recent Agents' survey found that many companies expected settlements to be significantly lower in 2009 (Section 4). If realised, such wage flexibility could reduce their need to cut employment somewhat.

Labour supply and labour market tightness

Falling employment tends to reduce labour market tightness and hence wage pressure. But weaker labour supply growth may weigh against that effect. In particular, the scale of the downward pressure on wages depends in part on the extent to which people who lose their jobs leave the labour market rather than continuing to search for work. Labour market inactivity increased during the early 1990s recession (**Chart 3.11**). In the current downturn, a higher proportion of individuals may again stop searching for employment. And potential migrants may be discouraged from coming to the United Kingdom, or previous migrants to the United Kingdom may return home. A smaller pool of prospective employees reduces the downward pressure on wages from lower demand.

The effective supply of labour will also be reduced if some of those individuals that lose their jobs find it difficult to find new work because their skills have become less relevant to employers. That effect would be particularly significant either

Chart 3.12 Indicators of labour market tightness



Sources: KPMG/REC and ONS (including Labour Force Survey).

- (a) Number of vacancies divided by LFS unemployment. Vacancies exclude agriculture, forestry and fishing.
(b) The KPMG/REC demand for staff index divided by the KPMG/REC availability of staff index.

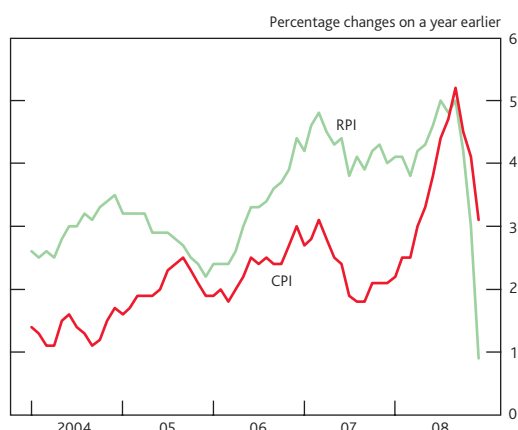
if the sectoral composition of jobs changed or if skills deteriorated. The Government has recently announced a number of further initiatives that aim to address these issues.

These factors are likely to take some time to affect the supply of labour. To date, measures of labour market tightness have declined markedly. The ratio of vacancies relative to the pool of unemployed individuals, for example, has fallen sharply since early 2008 (Chart 3.12). And the KPMG/REC indicator of the balance between the demand and availability of staff has also fallen. Both indicators confirm that the labour market has loosened substantially, reducing wage pressures (Section 4).

4 Costs and prices

CPI inflation fell to 3.1% in December, from 5.2% in September — the largest three-month fall since 1992. Much of that reflected the plunge in oil prices and the temporary cut in VAT. The significantly lower exchange rate is likely to put upward pressure on prices over time. Nevertheless, CPI inflation is expected to fall further in the near term as past falls in energy prices continue to feed through and the weakening in domestic demand weighs on companies' costs and margins. Several measures of near-term inflation expectations have fallen further.

Chart 4.1 Measures of consumer prices



CPI inflation has fallen substantially since September (Section 4.1). It is expected to decrease further in the near term, as recent falls in commodity prices feed through the supply chain (Section 4.2) and easing capacity pressures reduce companies' labour costs (Section 4.4) and weigh on their margins (Section 4.5). Those developments, together with the cut in VAT announced in the *Pre-Budget Report 2008*, mean that CPI inflation is likely to be significantly lower in the near term than expected at the time of the *November Report*.

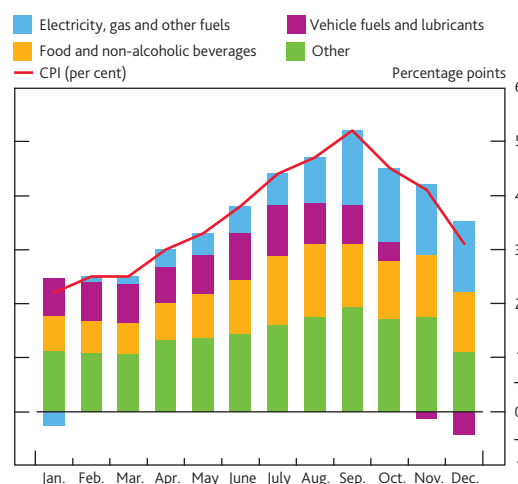
The lower sterling exchange rate will, however, give a further boost to import price inflation (Section 4.3), putting some upward pressure on the level of consumer prices. But the size and timing of this effect is uncertain. It will depend particularly on the extent to which companies facing higher imported costs bear down on their labour costs (Section 4.4) and accept lower margins in the face of weakening demand (Section 4.5).

4.1 Recent trends in consumer prices

The fall in CPI inflation from 5.2% in September to 3.1% in December (**Chart 4.1**) was the biggest three-month decrease since 1992. That mainly reflected both the pass-through of the sharp fall in oil prices since July to petrol prices (**Chart 4.2**) and the direct impact of the cut in VAT (see the box on page 31). But with CPI inflation lying more than 1 percentage point away from the 2% target at 4.1% in November, the Governor, on behalf of the Committee, wrote a further open letter to the Chancellor.⁽¹⁾

RPI inflation has fallen by much more than CPI inflation since September (**Chart 4.1**). That mainly reflected the reductions in the mortgage interest payments (MIPs) component of the RPI (**Table 4.A**), which is not included in the CPI. If Bank Rate were to follow the path implied by market yields, that would push

Chart 4.2 Contributions to CPI inflation^(a)



(a) Contributions to annual (non seasonally adjusted) CPI inflation.

(1) The letter is available at: www.bankofengland.co.uk/monetarypolicy/pdf/cpiletter081215.pdf.

The impact of the recent change in VAT on CPI inflation

In the *Pre-Budget Report 2008*, the Chancellor announced that the standard rate of VAT would be temporarily reduced from 17.5% to 15% from 1 December 2008 to 31 December 2009. That change has two effects on inflation. There is a sizable direct effect on the price level of those items in the CPI basket that are subject to standard rate VAT. In addition, there will be an indirect effect on inflation through the impact of the VAT reduction on aggregate demand. This box considers the likely scale of those two effects.

The maximum direct effect on the price level from the temporary VAT reduction would occur if the prices of all goods and services subject to the standard rate of VAT were reduced to reflect the 15% rate. That would represent a 2.1% reduction in price for those items. For example, a product originally costing £117.50 including VAT would be reduced to £115. Around 70% of the CPI basket is subject to the standard rate of VAT. Exceptions include most food items, which are exempt from VAT, and domestic energy bills, which are subject to a rate of 5%. The prices of these goods and services are unaffected by the VAT change, at least directly. That means that the maximum reduction in the level of the CPI from the VAT change is about 1.5% — the price reduction multiplied by the proportion of the CPI basket affected.

In practice, however, the direct effect on the CPI is likely to be somewhat less than this. Some companies may choose not to lower their prices if, for example, the cost of doing so is substantial. Other companies may choose to reduce prices, but by less than 2.1%. That would represent a boost to profits, providing that the decision does not result in a loss of market share to businesses that had lowered their prices by more. So the extent to which the VAT reduction is passed through depends partly on the cost of changing prices and on the extent of competition.

The timing with which lower VAT affects the CPI is also uncertain. It may take time for some companies to lower their prices. And the rise in prices when VAT reverts to its previous rate of 17.5% in January 2010 may also occur over several months. Recent experience suggests that some companies will raise their prices pre-emptively. When a 3 percentage point rise in German VAT in January 2007 was pre-announced thirteen months in advance, a material proportion of the eventual price rise was passed through in the months immediately preceding the implementation of the tax change.

The assumption underlying the central projection is that around half of the VAT cut was passed through in December 2008. That judgement is partly based on

information gathered by the ONS in the compilation of the December CPI index. It is assumed that this effect will not increase further during 2009. Prices are expected to return to their previous level by January 2010, with some companies raising prices pre-emptively. So overall, the reduction in VAT will reduce inflation through most of 2009, and boost inflation throughout 2010. But there are considerable uncertainties surrounding the magnitude and timing of the impact of the VAT cut on CPI inflation on both sides.

The reduction in VAT will also affect inflation indirectly via its impact on demand. Lower VAT is likely to increase demand in 2009 because it will encourage households to bring forward spending while the lower rate is in force. That effect might be expected to be largest in the months immediately preceding the date when VAT returns to its previous rate of 17.5%. In the case of the pre-announced rise in German VAT, there is evidence that households brought forward some spending into 2006 to benefit from the lower rate of tax. German consumer spending rose by 2.6% over the four quarters to 2006 Q4, and around half of that rise occurred in the last quarter. Consumer spending then fell back by 2.1% in 2007 Q1.

Lower VAT also represents a temporary boost to households' real incomes. That will have little effect on consumption if households base their spending decisions largely on expected lifetime income, or if households increase saving in anticipation of future tax rises. However if some households are credit constrained, or base spending decisions on current income, then this is another channel through which the VAT cut will increase spending in the near term.

Table 4.A Contributions to the wedge between annual RPI and annual CPI inflation^(a)

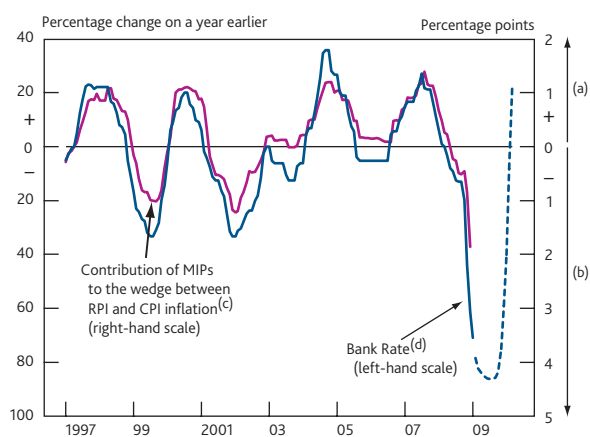
Percentage points

	Averages since 1997 ^(b)	Minimum since 1997	2008			
			Sep.	Oct.	Nov.	Dec.
Mortgage interest payments	0.2	-1.9	-0.5	-0.5	-0.9	-1.9
Other housing components	0.5	-0.7	-0.5	-0.6	-0.6	-0.7
Weights, coverage and formula effect	0.4	-0.5	0.8	0.8	0.4	0.4
Total	1.1	-2.1	-0.2	-0.2	-1.1	-2.1

(a) This wedge is calculated as annual RPI inflation minus annual CPI inflation. For further details on the calculation of these contributions, see Table 10 of the December ONS *Consumer Price Indices* release at www.statistics.gov.uk/pdfdir/cpi0109.pdf. The data are non seasonally adjusted.

(b) Averages of monthly data.

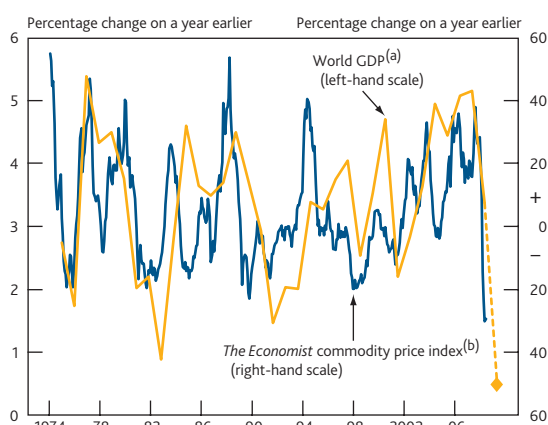
Chart 4.3 The contribution of mortgage interest payments (MIPs) to the wedge between annual RPI and annual CPI inflation



Sources: Bank of England, Bloomberg and ONS.

- (a) RPI inflation rising relative to CPI inflation.
 (b) RPI inflation falling relative to CPI inflation.
 (c) This wedge is calculated as annual RPI inflation minus annual CPI inflation.
 (d) The dashed line shows implied changes in Bank Rate between February 2009 and March 2010 if Bank Rate follows the path implied by market yields. This market yield curve is based on the fifteen working day average to 4 February. At short maturities, the curve is based on overnight index swap (OIS) rates. At longer maturities, it is based on instruments that settle on Libor, adjusted for credit risk.

Chart 4.4 Non-oil commodity prices and world GDP



Sources: IMF, *The Economist* and Thomson Datastream.

- (a) Taken from the IMF's *World Economic Outlook January 2009 Update*. The data are for each calendar year and calculated at purchasing power parity exchange rates. 2008 figure is an IMF estimate, and that for 2009, shown by the diamond, is an IMF projection.
 (b) The data are monthly averages of weekly data and denominated in dollars.

down further on RPI inflation relative to CPI inflation in the near term, by further reducing the contribution from MIPs to the RPI (Chart 4.3). Largely reflecting that lower contribution, annual RPI inflation is likely to turn temporarily negative in the next few months. The box on page 33 considers the economic effects of falls in the general level of prices.

4.2 Commodity prices and the near-term outlook for CPI inflation

Global commodity prices have fallen further since the November Report, as world growth has weakened (Chart 4.4). The impact on CPI inflation of these falls in commodity prices, which are typically denominated in dollar terms, will be dampened by the large depreciation of sterling. But that effect is not large enough to offset the downward impetus from the commodity price falls. Consequently, CPI inflation is likely to fall materially in the near term, and by more than expected in the November Report.

Oil prices have fallen sharply in the past three months. In the fifteen working days to 4 February, the price of Brent crude was \$44 a barrel, 31% lower than at the time of the November Report and 70% below its July peak (Chart 4.5). Oil futures prices for the next three years were 27% lower, on average, than in November. These falls suggest that the impacts of downward revisions to expected oil demand, in line with the worsening global economic outlook, have outweighed that of the recent large production cuts announced by OPEC. Nevertheless, professional forecasters, on average, expect oil prices to rebound to around \$60 a barrel by January 2010, broadly consistent with the upward-sloping oil futures curve. That suggests that forecasters are assuming that the recent OPEC production cuts, and the limited scope to raise non-OPEC supply, will, over time, heighten capacity pressures in the oil market and provide support to prices. Perhaps reflecting these significant but offsetting factors, uncertainty about future oil price movements, implied by options prices, is at elevated levels.

The price of motor fuel at the pump tends to move closely with oil prices in sterling terms, after a short lag. If oil prices were to follow the path implied by futures contracts, then the contribution of petrol and diesel prices to CPI inflation would be likely to fall a little further from its December level, and to continue to push down CPI inflation over the next few months.

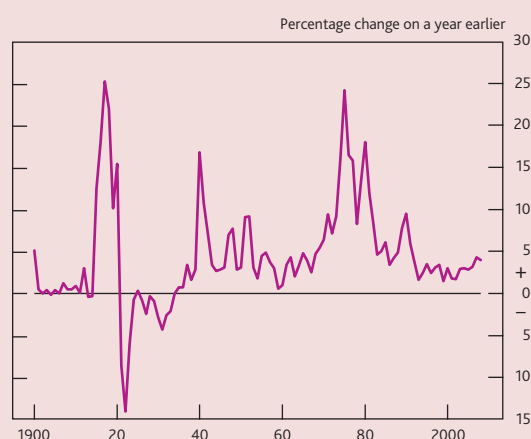
In the fifteen working days to 4 February, wholesale gas futures prices were 17% lower, on average, than assumed at the time of the November Report. Movements in those wholesale prices tend to take longer to pass through to retail gas and electricity prices than changes in oil prices. But given the falls in wholesale prices and the announcement by British Gas of future price reductions, the MPC's central projection is conditioned on a benchmark assumption that average retail

Deflation

Deflation is sometimes used to describe any fall in the general level of prices (as measured in the United Kingdom by the CPI, RPI or the GDP deflator), however short-lived. A more economically significant phenomenon, however, would be a sustained period of negative inflation.

The RPI is likely to fall temporarily over the coming months (Section 4.1). This period of negative retail price inflation would be unusual (**Chart A**) and predominantly reflects the much lower contribution from mortgage interest payments, following the recent large falls in Bank Rate. The MPC's central projection is for its target measure, annual CPI inflation, to remain above zero throughout the forecast horizon.

Chart A UK retail prices^(a)



(a) ONS composite price index. The data are for each calendar year.

This box discusses the economic effects of falls in broad-based measures of prices. It concludes that they are likely to be small when the price declines are modest and short-lived. Of greater concern would be sustained periods of negative inflation, like the periods of persistent deflation in the United Kingdom and the United States in the 1920s and early 1930s, and in Japan in the late 1990s and early 2000s. Those episodes were the result of significant and prolonged weakness in nominal aggregate demand relative to those economies' supply potential. But the likelihood of a period of persistent deflation in the United Kingdom is judged to be small.

What are the economic effects of deflation?

A period of falling prices can be a symptom of very weak economic activity. But falls in the general price level themselves may have additional economic effects.

For example, debt contracts are usually fixed in nominal terms. A period of falling prices not anticipated when such contracts were agreed would raise the real burden of the debt and

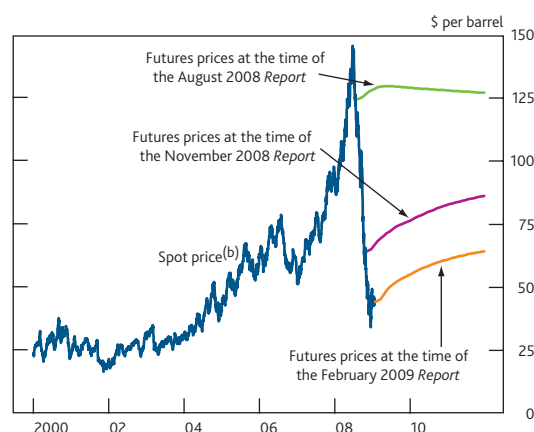
thereby redistribute wealth from debtors to creditors. If debtors, on average, have a higher marginal propensity to consume out of wealth than creditors, as is likely, then this would lower aggregate demand. The rise in real debt burdens would also make it harder for households and companies to service those debts. This may also amplify an economic slowdown. But both of these effects are likely to be very small for unanticipated falls in prices that are modest and short-lived.

Falling prices may also have effects via the labour market. The extent to which employment falls following a period of weak demand partly depends on the flexibility of nominal wages. If they were not very flexible, perhaps because some workers were unwilling to accept nominal pay cuts, then falling prices would raise some companies' real labour costs, which would prompt further labour shedding and amplify the fall in employment. The extent of nominal wage rigidity in the United Kingdom is uncertain. The proportion of freezes in pay settlements in 2008 H2 was about twice that in 2008 H1, but the number of pay cuts remained very small. However, a recent BCC survey suggested that about 10% of companies planned to implement nominal pay cuts in 2009. And there are other ways in which businesses can reduce their labour costs (for example, by reducing non-wage benefits). Therefore, the effect on employment of nominal wage rigidities when falls in aggregate prices are modest and short-lived is likely to be small.⁽¹⁾

Any large and persistent deviations of inflation from the MPC's 2% target pose a risk that medium-term inflation expectations could become de-anchored from levels consistent with the target. That might affect wage and price-setting decisions, increasing the probability that the deviation of inflation from target would persist. But the inflation target itself should help to anchor expectations, as it provides a commitment that the MPC will take whatever action is needed to return CPI inflation to 2% in the medium term. The broad stability of longer-term measures of inflation expectations (Section 4.6) gives some reassurance that expectations remain anchored at levels consistent with the target.

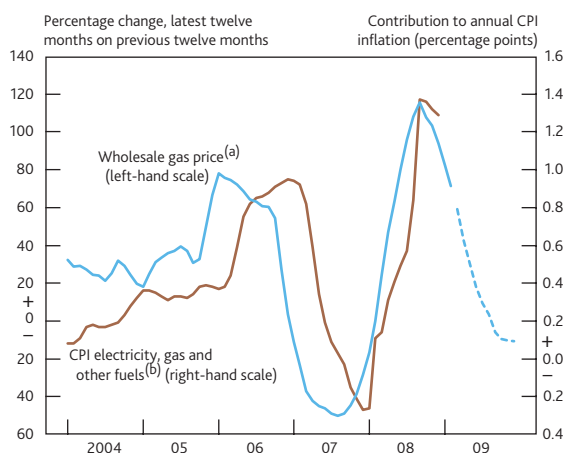
Periods of low inflation, associated with weak demand, may limit a central bank's ability to use conventional monetary policy to stabilise the economy. But if reductions in official interest rates do not prove sufficient to meet the inflation target, policymakers still have other options available to them to stimulate the economy, if necessary (see the box on pages 44–45 in this *Report*).

(1) See Nickell, S and Quintini, G (2003), 'Nominal wage rigidity and the rate of inflation', *Economic Journal*, Vol. 113, Issue 490, pages 762–81.

Chart 4.5 Oil prices^(a)

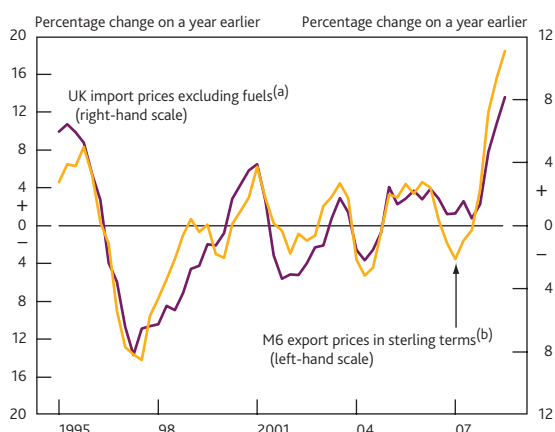
Sources: Bloomberg and Thomson Datastream.

(a) Futures prices for August 2008, November 2008 and February 2009 are averages during the fifteen working days to 6 August 2008, 5 November 2008 and 4 February 2009, respectively.
(b) Brent forward price for delivery in 10–21 days' time.

Chart 4.6 Wholesale gas and domestic energy prices

Sources: Bloomberg, International Exchange (www.theice.com), ONS and Reuters.

(a) One-day forward price of UK natural gas, monthly averages of daily data. Data for February and the futures curve are based on the fifteen working days to 4 February. The dashed line shows the estimated movements between March and December 2009, assuming that spot prices follow the futures curve.
(b) Data to December 2008.

Chart 4.7 UK import prices and foreign export prices^(a)

Sources: Bank of England, ONS and Thomson Datastream.

(a) Excluding the estimated impact of missing trader intra-community (MTIC) fraud.
(b) Domestic currency export prices of goods and services in Canada, France, Germany, Italy, Japan and the United States, weighted according to their share of UK imports in 2005, divided by the sterling effective exchange rate index.

gas and electricity prices fall by 7.5% in the spring, and by a similar amount later in the year. The impact of domestic energy prices on CPI inflation is expected to fall substantially in the near term as last year's large price increases drop out of the twelve-month comparison and the expected price falls take place (Chart 4.6).

Though broadly unchanged over the past three months, *The Economist* food price index in dollar terms remains around 30% below its July peak. Falls in global food prices in the second half of 2008 reflected the partial reversal of some of the factors behind their earlier sharp increases: energy prices have now fallen back and harvests have improved. If the lower global prices persist, the contribution from food prices to CPI inflation is likely to fall back this year.

4.3 Import prices and the near-term outlook for CPI inflation

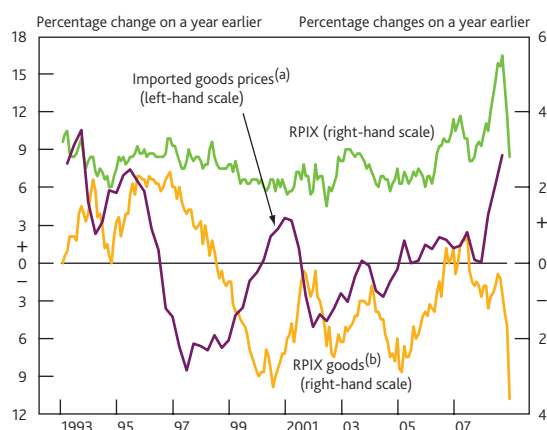
The further large depreciation in the sterling exchange rate will provide some boost to retail food and energy prices. But its total near-term impact on CPI inflation will also depend on how much of the fall in sterling is passed through to the prices of other imports, and the extent to which those higher import prices then feed through to higher consumer prices. This section considers developments at each of these stages.

The pass-through of the depreciation of sterling to import prices

Import prices excluding fuels rose by 8% in the year to 2008 Q3, the largest increase for fifteen years (Chart 4.7). The key factor behind that was the fall in the sterling exchange rate of 12%. But UK non-fuel import prices have risen by less than might be suggested by changes in their determinants, proxied by the export prices of the other G7 economies, converted into sterling terms (Chart 4.7). That could be because exporters to the United Kingdom thought that some of the fall in sterling would be temporary. Alternatively, they may simply take their time to pass on such a large exchange rate change into sterling prices.

A third potential explanation for the apparently lower-than-usual pass-through of the depreciation to import prices is that exporters to the United Kingdom may take into account the strength of UK demand, and domestic competitors' prices, when deciding what price to charge. Given the current weakness in UK domestic demand, overseas exporters may have absorbed some of sterling's fall in reduced margins, rather than allowing the sterling price of imports to respond fully.

Nevertheless, the further large fall in sterling since Q3 suggests that import price inflation will remain elevated. A key factor determining the near-term CPI inflation projection is how much upward pressure that will exert.

Chart 4.8 Measures of consumer and imported goods prices

(a) Excluding fuels, food, beverages and tobacco and the estimated impact of MTIC fraud.
 (b) Excluding food, alcohol, tobacco, petrol and oil.

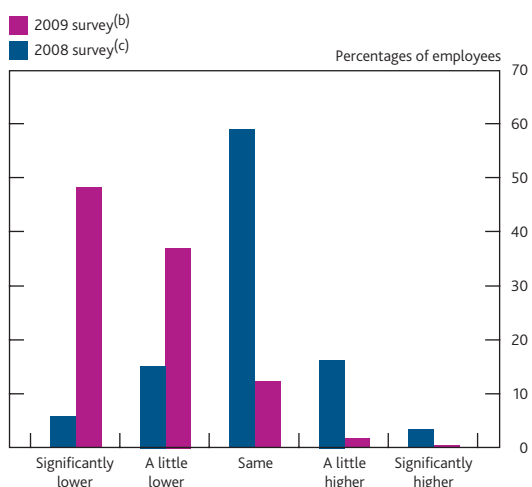
Table 4.B Private sector earnings^(a)

Percentage changes on a year earlier

	Averages since 2000	2008		2008		
		Q2	Q3	Oct.	Nov.	Dec.
(1) AEI regular pay	4.0	3.7	3.6	3.5	3.6	n.a.
(2) Pay settlements ^(b)	3.3	3.5	3.6	3.6	3.6	3.6
(1)–(2) Pay drift ^(c)	0.7	0.2	0.0	-0.1	0.0	n.a.
(3) Total AEI	4.0	3.6	3.1	3.2	2.9	n.a.
(3)–(1) Bonus contribution ^(c)	0.0	-0.1	-0.5	-0.3	-0.7	n.a.
Memo item: AWE^(d)	4.2	4.5	2.9	3.0	2.7	n.a.

Sources: Bank of England, Incomes Data Services, Industrial Relations Services, the Labour Research Department and ONS.

(a) Three-month moving average measures.
 (b) Average over the past twelve months.
 (c) Percentage points.
 (d) AWE data exclude arrears. Average is since March 2001.

Chart 4.9 Agents' survey: pay settlements^(a)

(a) The survey asked respondents: 'How does your likely average pay settlement in the next pay round compare with your average settlement last year?'. Responses are weighted by respondents' number of employees.
 (b) Based on 355 responses (covering nearly 840,000 employees) to a survey of companies by the Bank of England's regional Agents in December 2007 and January 2008.
 (c) Based on 362 responses (covering around 760,000 employees) to a survey of companies by the Bank of England's regional Agents in December 2008 and January 2009.

The impact of higher import prices on the near-term outlook for CPI inflation

In the past, the final prices of goods excluding food and fuels (a proxy for the most import-intensive items of consumer spending) have tracked imported goods prices excluding food and fuels, after a lag (see **Chart 4.8**, which shows the RPI, rather than the CPI, series because it has a longer back-run of component prices). This suggests that companies using imported inputs initially absorb some of the increases in their imported costs in lower margins, or partially offset them by pushing down on their labour and other costs (Section 4.4). But, eventually, they do tend to raise their prices somewhat as margins and labour costs recover. So, the upward effects on CPI inflation of higher import prices may take some time to feed through.

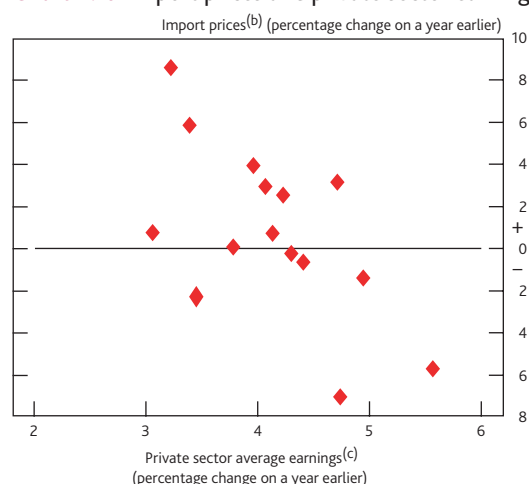
However, overall retail prices have not tended to move as closely with import prices as retail goods prices excluding food and fuels (**Chart 4.8**). This suggests that movements in other retail prices have partly offset changes in the prices of more import-intensive consumer goods. This may in part be because monetary policy has kept nominal demand growth relatively stable over much of this time. So, when retail goods prices have risen following an increase in import prices, households have had less income to spend on other items, putting downward pressure on their prices.

The deterioration in demand prospects may dampen the upward impact of higher import prices on CPI inflation in the near term. The weakening in demand means that companies facing higher imported costs may absorb part of that in reduced profit margins. They are also likely to be able to press down on their labour costs given the significant loosening in the labour market (Section 4.4). Such a muted effect on CPI inflation is consistent with the sharp shift down in measures of companies' pricing intentions (Section 4.5). But given the scale of the decline in sterling, the risks to inflation from this source lie to the upside (Section 5).

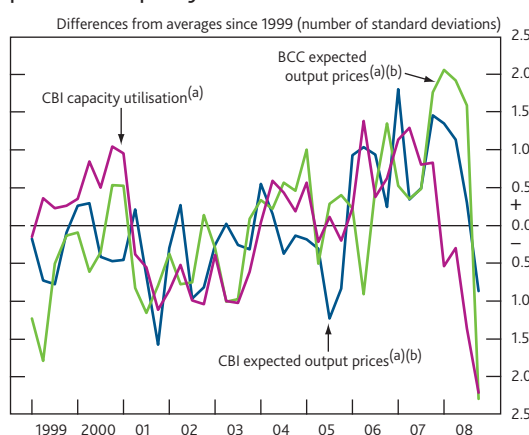
4.4 Labour costs

Annual private sector earnings growth fell in November according to both the average earnings index (AEI) and average weekly earnings (AWE) measures (**Table 4.B**), and were at their lowest rates since 2003. The balance of factors influencing the near-term outlook for earnings has shifted further to the downside since then.

The fall in private sector earnings growth over the past year was accounted for by lower contributions from bonuses. Bonus growth and regular pay drift (the two elements of earnings over and above basic pay settlements) have tended to track real activity quite closely, and so are likely to weaken further in the near term given the worsening economic outlook. In addition, the current dislocation in the financial

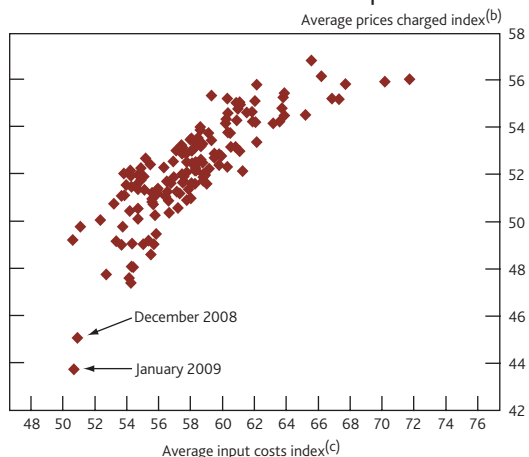
Chart 4.10 Import prices and private sector earnings^(a)

- (a) The data are for each calendar year. The sample period is 1993 to 2007.
 (b) Excluding the estimated impact of MTIC fraud.
 (c) Including bonuses.

Chart 4.11 Indicators of companies' expected output prices and capacity utilisation

Sources: BCC, CBI and ONS.

- (a) Balances from the CBI (manufacturing, business/consumer services and distributive trades) and the BCC (services and manufacturing) surveys are weighted together using nominal shares in value added. The BCC data are non seasonally adjusted.
 (b) Companies' expected price changes over the next three months, except for the CBI distributive trades survey which asks about companies' expected price changes for next month.

Chart 4.12 Service sector costs and prices^(a)

Source: CIPS/Markit.

- (a) The data are monthly. The sample period is July 1996 to January 2009. A reading above 50 indicates rising prices and costs this month compared with a month earlier, and vice versa.
 (b) Businesses are asked: 'Compare the average prices charged by your company this month with the situation one month ago'.
 (c) Businesses are asked: 'Is the average price paid by your company for all inputs this month higher, the same or lower than one month ago?'.

sector suggests that bonuses awarded in that sector over the coming months will be smaller than in 2008. That is likely to reduce aggregate earnings growth significantly in early 2009.

The other key component of earnings is pay settlements. The current rate of RPI inflation, and wage bargainers' expectations of inflation over the next year, are important factors often cited in negotiations over settlements. The recent falls in inflation and in measures of inflation expectations (Section 4.6), together with the slackening labour market, are likely to push down pay settlements substantially over 2009. Indeed, a recent survey by the Bank's Agents found that around half of respondents expected settlements in the next pay round to be significantly lower than in 2008, in marked contrast to the corresponding survey last year (Chart 4.9). If realised, that would lower earnings growth substantially during 2009.

The increase in companies' imported costs is also likely to push down on wage growth. Earnings growth has tended to be relatively weak during periods of high import price inflation, and vice versa (Chart 4.10). That may reflect businesses' efforts to reduce their labour costs in the face of higher non-wage costs and weakening profitability. As discussed in Section 4.3, this is one channel through which the impact of higher import prices on consumer prices may be dampened.

4.5 Companies' pricing decisions

Official and survey measures of manufacturers' output prices have fallen back since the November Report. And indicators of businesses' pricing intentions in both the manufacturing and services sectors have also shifted down sharply (Chart 4.11), notwithstanding companies' higher imported costs. In part, this is likely to reflect the pass-through of the large falls in commodity prices. But the CIPS/Markit services survey suggests that in recent months businesses have cut their prices quite sharply relative to their input costs (Chart 4.12).

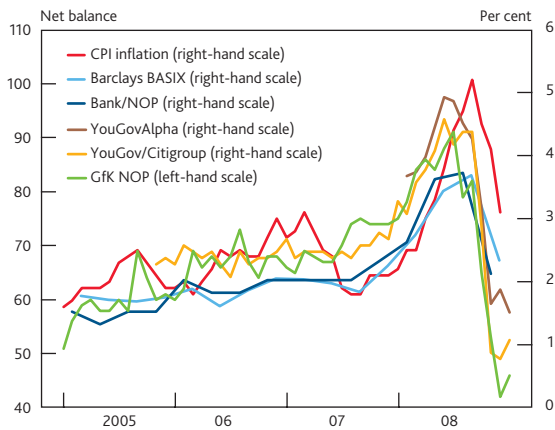
This apparent downward pressure on businesses' profit margins is likely to reflect the weakening in capacity pressures (Chart 4.11) and demand conditions. In a recent survey of price-setting behaviour in the United Kingdom carried out by the Bank, companies cited declining demand as the most important factor leading them to cut their prices.⁽¹⁾ Downward pressure on companies' margins is likely to continue into 2009, as survey indicators point to further falls in activity (Section 3).

4.6 Inflation expectations

There has been a further marked shift down in several measures of households' near-term inflation expectations since the November Report (Chart 4.13). In particular, two of

(1) See Greenslade, J and Parker, M (2008), 'Price-setting behaviour in the United Kingdom', *Bank of England Quarterly Bulletin*, Vol. 48, No. 4, pages 404–15.

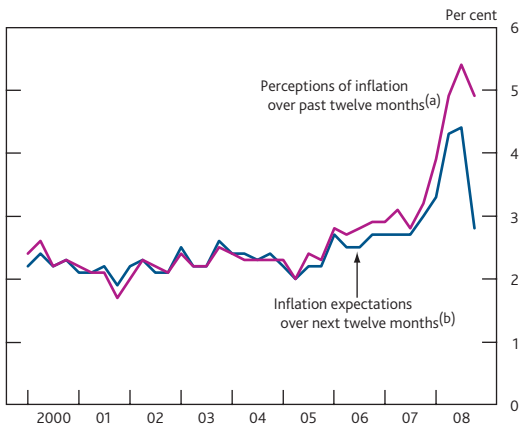
Chart 4.13 CPI and households' inflation expectations for the year ahead, scaled to match CPI inflation^(a)



Sources: The AlphaMonitor: consumer, YouGovAlpha, Bank of England, Barclays Capital, Citigroup, GfK NOP, research carried out by GfK NOP on behalf of the European Commission and YouGov.

(a) Survey-based measures (apart from GfK NOP) have been scaled to have the same mean as CPI inflation over a comparable time period. The questions ask about expected changes in prices over the next twelve months, but do not reference a specific inflation index. All measures are based on the median estimated price change, except GfK NOP which captures the weighted net balance expecting prices to increase.

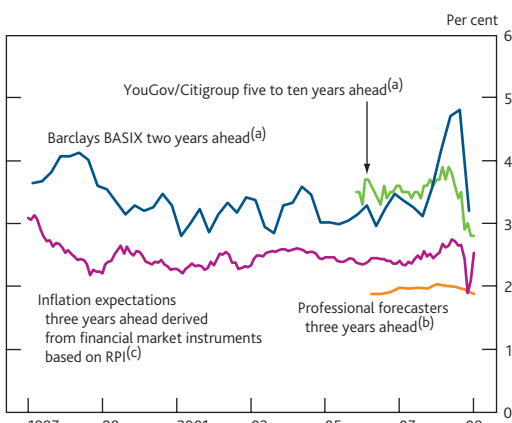
Chart 4.14 Inflation perceptions and expectations



Sources: Bank of England and GfK NOP.

(a) Median of respondents' view on how shop prices have changed over the past twelve months.
(b) Median of respondents' expected changes in shop prices over the next twelve months.

Chart 4.15 Inflation expectations beyond a year ahead



Sources: Bank of England, Barclays Capital, Citigroup, YouGov and Bank calculations.

(a) Median of respondents' expected change in prices.
(b) For details of the latest survey, see the box on page 50.
(c) For details of the measure, see Joyce, M, Sorensen, S and Weeken, O (2008), 'Recent advances in extracting policy-relevant information from market interest rates', *Bank of England Quarterly Bulletin*, Vol. 48, No. 2, pages 157–66.

the most recently updated measures (from the GfK and YouGov/Citigroup surveys) have now more than unwound their rises since mid-2007, and are below their average levels.

According to the Bank/NOP survey, households' expectations of inflation one year ahead have fallen more sharply than their perceptions of current inflation (**Chart 4.14**). This divergence may suggest households have been taking likely future economic developments into account when forming their expectations, rather than simply extrapolating forwards their perceptions of current inflation. The MPC also expects CPI inflation to fall from its current level in 2009 and by more than at the time of the *November Report* (Section 5).

The key question, though, is whether low inflation is expected to persist. If it were, that would make it more likely that the lower near-term expectations will be built into price and wage-setting decisions, and so exert further downward pressure on inflation. Some longer-term measures have also fallen in the past three months (**Chart 4.15**), but by much less than the near-term measures, and others are broadly unchanged. That may suggest that most of the near-term fall in inflation is expected to be temporary.

In particular, three of the longer-term measures are close to their average levels: the BASIX measure of households' expectations, expectations derived from financial markets, and professional forecasters' projections three years ahead. In contrast, the YouGov/Citigroup measure of households' expectations for five to ten years ahead has fallen to below its average level, but the short back-run of this series makes it difficult to judge what level is consistent with CPI inflation at the 2% target.

Overall, there is little firm evidence that longer-term inflation expectations have fallen below levels consistent with the 2% target in the medium term. But given the sharp fall in measures of households' near-term expectations, the MPC will continue to monitor measures of inflation expectations closely.

5 Prospects for inflation

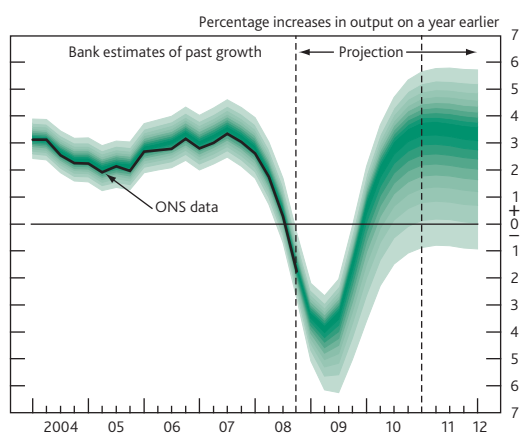
On the assumption that Bank Rate follows a path implied by market yields, the central projection is for GDP to contract sharply in the near term, and by more than assumed in the November *Report*. Further out, growth recovers, reflecting the substantial degree of stimulus from the easing in monetary and fiscal policy, the depreciation in sterling, past falls in commodity prices and actions by authorities at home and abroad to improve the availability of credit. CPI inflation falls well below the 2% target in the medium term, as the drag from the substantial margin of spare capacity more than outweighs the waning impact on import and consumer prices from the lower level of sterling. But the near-term path is uneven, reflecting sharp falls in energy prices, and the temporary reduction in VAT. The risks to growth are weighted heavily to the downside, reflecting in particular uncertainties over the pace at which the availability of credit improves and confidence returns. That also poses downside risks to inflation. But those risks are judged to be broadly matched by upside risks from the substantially lower level of sterling, leaving the overall balance of risks to inflation only modestly to the downside.

5.1 The projections for demand and inflation

The UK economy is undergoing a significant and sustained adjustment, as banks restructure their balance sheets, and the private sector cuts back on spending and increases saving. Monetary policy cannot — and should not — prevent necessary long-term adjustment: the challenge is to avoid excessive short-term movements in output and employment, while returning inflation to the 2% target.

Three forces shape the medium-term outlook for inflation: first, the pronounced deterioration in confidence, credit conditions and activity both at home and abroad, which threatens to pull inflation well below target. Second, the substantial stimulus from the greatly reduced levels of Bank Rate, sterling and commodity prices, expansionary fiscal policy and Government measures to support financial stability and lending, each of which will help to boost activity over time, but with varying scale and pace. And, third, the direct effects of the fall in sterling on import prices and CPI inflation. The projections presented here reflect the Committee's judgement of the balance between those forces.

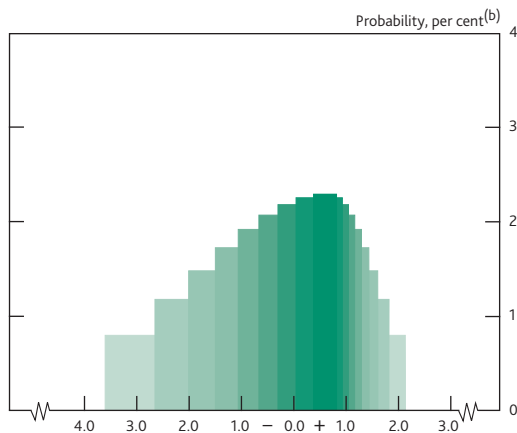
Chart 5.1 GDP projection based on market interest rate expectations



The fan chart depicts the probability of various outcomes for GDP growth. To the left of the first vertical dashed line, the distribution reflects the likelihood of revisions to the data over the past; to the right, it reflects uncertainty over the evolution of GDP growth in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that the mature estimate of GDP growth would lie within the darkest central band on only 10 of those occasions. The fan chart is constructed so that outcomes are also expected to lie within each pair of the lighter green areas on 10 occasions. Consequently, GDP growth is expected to lie somewhere within the entire fan on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the increasing uncertainty about outcomes. See the box on page 39 of the November 2007 *Inflation Report* for a fuller description of the fan chart and what it represents. The second dashed line is drawn at the two-year point of the projection.

Chart 5.1 shows the outlook for GDP growth, on the assumption that Bank Rate follows a path implied by market yields — dipping down to $\frac{3}{4}\%$ in mid-2009 before rising gradually to 3% by the end of the forecast period (see the box on page 41). Despite the yield curve being materially lower than assumed in the November *Report*, the near-term

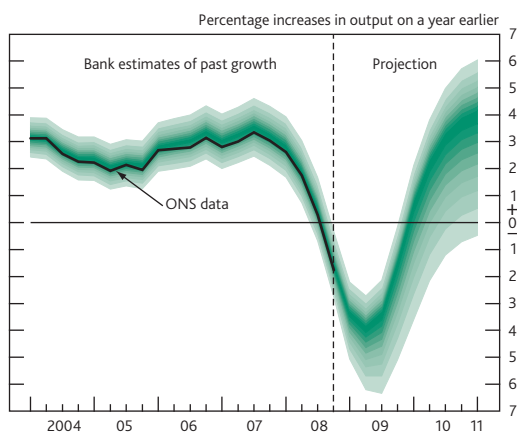
Chart 5.2 Projected probabilities of GDP growth outturns in 2010 Q1 (central 90% of the distribution)^(a)



(a) Chart 5.2 represents a cross-section of the GDP fan chart in 2010 Q1 for the market interest rate projection. The coloured bands have a similar interpretation to those on the fan charts. Like the fan charts, they portray the central 90% of the probability distribution. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that the mature estimate of GDP growth in 2010 Q1 would lie somewhere within the range covered by the histogram on 90 occasions. GDP growth would lie outside the range covered by the histogram on 10 out of 100 occasions.

(b) Average probability within each band. The figures on the y-axis indicate the probability of four-quarter GDP growth being within ± 0.05 percentage points of any given growth rate, specified to one decimal place.

Chart 5.3 GDP projection based on constant nominal interest rates at 1%



See footnote to Chart 5.1.

contraction in output is substantially deeper, as the weakening labour market and increased uncertainty weigh on consumption, businesses run down inventories and reduce investment, and the weakness in world demand hits exports. Further out, GDP growth recovers, as the impact of the substantial policy stimulus at home and abroad is increasingly felt, the lower level of sterling shifts both domestic and overseas expenditure towards UK suppliers, and the contribution from stockbuilding rises. But the level of GDP remains persistently lower than in the *November Report* throughout the forecast period.

The balance of risks to growth is weighted heavily to the downside, particularly in the near term (Chart 5.2). That reflects a number of factors, most importantly the outlook for credit growth, and the speed at which household and business confidence recovers around the world. The central view is that the authorities at home and abroad will successfully stabilise the global banking system, and that financial and credit markets will gradually return to more normal conditions. But the possibility that those actions prove only partly successful over the forecast period, leading to a more prolonged period of weak credit availability and spending, poses a significant downside risk to that projection. The timing of the recovery in GDP also depends on the speed with which companies adjust their inventories to more desired levels. In the central projection, that adjustment occurs relatively rapidly, pushing down on growth in the near term, but boosting the recovery further out. But there is a risk that the necessary adjustment in stocks is more drawn out, pushing out the point at which activity begins to recover. There are also risks to export growth from the possibility of a reversal in the degree of world economic integration. Chart 5.3 shows the GDP projection over the next two years on the alternative assumption that Bank Rate is held constant. Uncertainties over the operation of monetary policy at low interest rates are discussed in the box on pages 44–45. The risks to the GDP outlook more broadly are discussed in Section 5.2.

The economy's supply potential is assumed to grow less rapidly over the forecast period (Section 5.3), offsetting some of the impact of weaker demand growth on inflation. Nevertheless, on the assumption that Bank Rate follows market yields, the central projection is for CPI inflation to fall well below the 2% target in the medium term (Chart 5.4), as the downward pressures from the substantial margin of spare capacity more than outweigh the waning impact on import and consumer prices from the lower level of sterling. The near-term path for inflation is uneven. That reflects two further factors: first, the marked fall in energy prices, which pulls down sharply on inflation during 2009; and, second, the direct impact of the temporary cut in VAT, which holds inflation down in 2009 but pushes it temporarily back up in early 2010 when the cut is unwound. Looking through that

Chart 5.4 CPI inflation projection based on market interest rate expectations

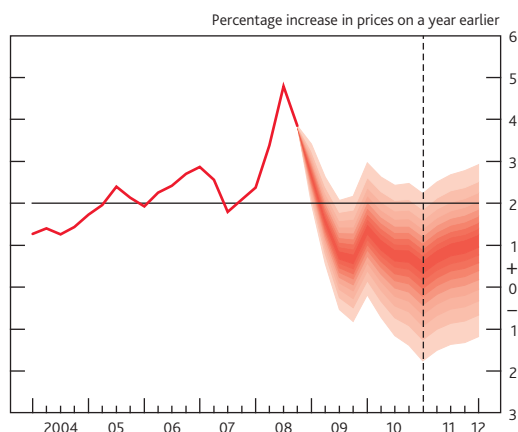
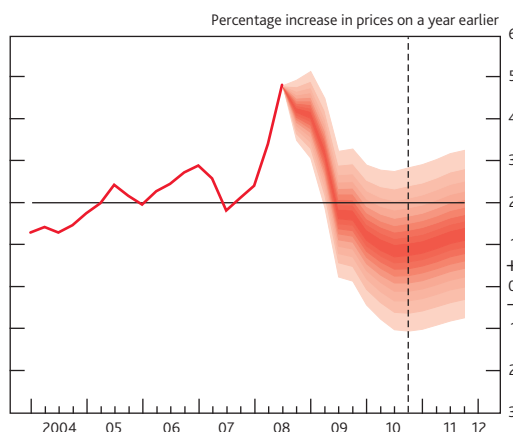
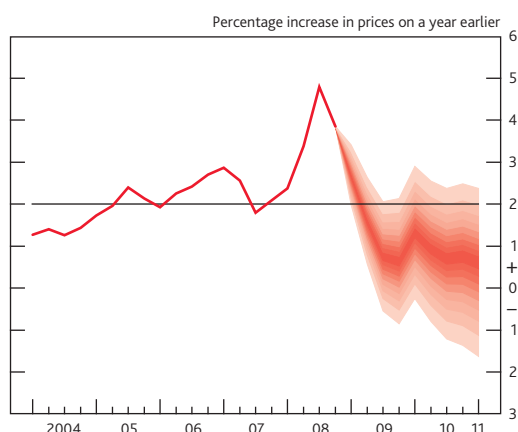


Chart 5.5 CPI inflation projection in November based on market interest rate expectations



Charts 5.4 and 5.5 The fan charts depict the probability of various outcomes for CPI inflation in the future. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation over the subsequent three years would lie within the darkest central band on only 10 of those occasions. The fan charts are constructed so that outcomes of inflation are also expected to lie within each pair of the lighter red areas on 10 occasions. Consequently, inflation is expected to lie somewhere within the entire fan charts on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the 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 dashed lines are drawn at the respective two-year points.

Chart 5.6 CPI inflation projection based on constant nominal interest rates at 1%



See footnote to Charts 5.4 and 5.5.

volatility, the medium-term outlook for inflation is a little weaker than in the November *Report* (Chart 5.5).

The uncertainties around the outlook for inflation are unusually large (Section 5.3). On the downside, the main risk is the possibility of a more pronounced recession, putting further downward pressure on wages and prices. The main upside risk is that more of the fall in sterling may get passed on into retail prices. Given the scale of the fall in sterling, that risk is judged to be significant, leaving the overall balance of risks to inflation only modestly to the downside. But there is a range of views among the Committee on both the central projection and the balance of risks. The inflation projection under constant interest rates for the next two years is shown in Chart 5.6.

5.2 Key risks to demand

How badly will the global recession hit UK exports?

Indicators of global trade and activity have weakened dramatically in recent months (Section 2). In the central projection, UK-weighted world trade is assumed to contract very sharply in 2009 — the weakest outlook for decades — as strained financial conditions and the synchronised decline in confidence pull down sharply on demand, and the reduced availability of trade credit affects supply. The developed economies remain at the centre of the projected slowdown, reflecting the severity of the dislocation in credit markets and the marked need for rebalancing in many countries. But growth in the emerging market economies is also assumed to slow further in the near term.

As in the United Kingdom, the depth and persistence of the global slowdown will depend critically on the balance between the sharp deterioration in confidence and credit conditions, and the efficacy of the policy response. In the central

Financial and energy market assumptions

As a benchmark assumption, the projections for GDP growth and CPI inflation described in **Charts 5.1** and **5.4** are conditioned on a path for official interest rates implied by market yields (**Table 1**).

Table 1 Conditioning path for Bank Rate implied by forward market interest rates^(a)

Per cent	2009				2010				2011				2012
	Q1 ^(b)	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
February	1.2	0.8	0.7	0.8	1.1	1.4	1.7	2.1	2.4	2.6	2.7	2.8	3.0
November	3.2	2.9	2.8	2.8	3.0	3.3	3.5	3.7	3.8	3.9	4.0	4.1	

(a) The data are fifteen working day averages of one-day forward rates to 4 February 2009 and 5 November 2008 respectively. The curves are based on overnight index swap (OIS) rates at shorter maturities and instruments that settle on Libor (adjusted for credit risk) at longer maturities.

(b) February figure for 2009 Q1 is an average of realised spot rates to 4 February, and forward rates thereafter.

In the period leading up to the MPC's February decision, the path implied by forward market interest rates was for Bank Rate to fall to around $\frac{3}{4}\%$ by mid-2009 before rising gradually. That was markedly lower than assumed in the *November Report*. However, these were only central estimates, and there remained significant uncertainty about the path of future short-term market interest rates.

The starting point for sterling's effective exchange rate index (ERI) in the MPC's projections was 76.2, the average for the fifteen working days to 4 February. That was 13.2% below the starting point for the November projections. Under the MPC's usual convention,⁽¹⁾ the ERI drops back very slightly to 76.1 by 2011 Q4.

The starting point for UK equity prices in the MPC's projections was 2075 — the average of the FTSE All-Share for the fifteen working days to 4 February. That was 1.1% below the starting point for the November projection. In the long run, equity wealth is assumed to grow in line with nominal GDP; in the short run, it also reflects changes in the share of profits in GDP.

Energy prices are assumed to evolve broadly in line with the paths implied by futures markets over the forecast period. Average Brent oil futures prices for the next three years were around 27% lower (in US dollar terms) than at the time of the *November Report*, and sterling wholesale gas futures were around 17% lower. The central projection is conditioned on a benchmark assumption that average gas and electricity prices faced by households and companies fall by some 7.5% in the spring, and by a similar amount later in the year.

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

projection, global demand is assumed to start recovering later in the year as efforts to stabilise banking and financial markets begin to bear fruit, and the effects of monetary and fiscal expansion are increasingly felt. But the recovery is too shallow to compensate for the sharp near-term decline in demand, and the level of global GDP at the end of the forecast period is markedly lower than assumed in the *November Report*. There are considerable uncertainties around the pace of this recovery. A key downside risk is that efforts to stabilise the global financial system take longer to work than assumed in the central case. There are also uncertainties about the relationship between world activity and world trade, posed for example by the possibility of greater protectionism in some regions.

In the central projection, the bleak near-term global outlook causes UK exports to contract sharply in 2009 — weaker than assumed in the *November Report*. Over time the very sharp depreciation in sterling should allow exporters to increase market share, helping to boost export growth as the world economy recovers. But that takes time to come on stream, as exporters initially take most of the benefit in the form of higher profit margins.

When will domestic credit conditions stabilise?

The outlook for credit conditions is one of the most important judgements underpinning the MPC's projection for GDP growth — but it is also among the most uncertain. Over the long term, UK banks need to restructure their balance sheets, reducing their overdependence on wholesale financing and realigning the scale of their loans relative to their deposit base. That in turn will require adjustment to private sector balance sheets — in part by the non-bank financial sector, but also through higher saving and lower spending by households and companies. The adjustment in banks' balance sheets could in principle occur gradually. But, so far, the reality has been different, as the burden of legacy exposures and heightened concerns about credit risk have led to a sharp reduction in the availability of credit to some households and companies. The measures announced by the Government on 19 January (Section 1), in addition to those announced in October last year, are aimed at easing that adjustment process and reducing the risk of further adverse feedback between deteriorating economic conditions and credit supply, by improving banks' resilience to asset impairment, providing assurance about access to funding and increasing the availability of market-based corporate credit.

In the months leading up to the January announcement, credit conditions had tightened further (Section 1). In the central projection, credit conditions are assumed to improve from this tighter starting point over time, as the Government's measures help to support the provision of credit. But overall credit conditions remain somewhat tighter than assumed in the November *Report*. That is more than accounted for by tighter conditions for households: corporate credit conditions are somewhat easier than assumed in November over much of the forecast period, as the new Asset Purchase Facility and other elements of the Government package are assumed to help improve conditions in corporate credit markets. But the risks around the central case lie to the downside, reflecting the possibility that actions to repair the functioning of the financial system and stabilise lending prove only partly successful over the forecast period, leading to a more prolonged period of subdued credit availability and spending.

How sharp will the contraction in domestic demand be?

The central projection embodies a significant contraction in domestic demand in the near term, as households and companies cut back sharply on investment and increase savings. But the medium-term outlook depends on the interplay between this adjustment process and the substantial degree of stimulus in the economy. Judging the balance between these factors is one of the key uncertainties in this projection.

A significant part of the projected near-term fall in GDP reflects a retrenchment in investment spending by households

and businesses. In the central projection, dwellings investment falls to a level about a third below its 2007 peak, reflecting lower house prices and tight credit conditions. Business investment contracts into the early part of 2010, reflecting the sharply lower pressures on capacity, increased uncertainty about near-term demand prospects and a greater focus on maintaining cash flow as the supply of working capital remains constrained. Investment spending begins to recover during the second half of the forecast period, as the substantial stimulus to demand works through and credit conditions improve. But the scale and pace of this recovery is relatively sluggish, reflecting the substantial margin of spare capacity.

Changes in companies' stock levels are assumed to amplify both the near-term decline in GDP growth and the subsequent recovery. In the central projection, a shortage of working capital and weak near-term prospects for final demand cause companies to run stocks down rapidly during 2009, pulling down sharply on growth. Further out, GDP growth is boosted as the rate of de-stocking eases, and companies eventually begin to rebuild stock levels. But there is considerable uncertainty about the depth and timing of this adjustment, and there is a risk that it may be more drawn out than assumed in the central projection, posing downside risks to the outlook.

One of the key developments in recent months has been a significant increase in labour shedding (Section 3). In the central projection, employment falls sharply in 2009, bearing down on household income and consumption. Tighter credit conditions, lower financial wealth and heightened macroeconomic uncertainty also weigh on consumer spending, inducing households to save more and borrow less. The boost to households' aggregate spending power from lower commodity prices, the low level of Bank Rate and the temporary reduction in VAT help to offset these factors to some degree. But they are insufficient to prevent a prolonged period of contraction in consumer spending. Further out in the projection, consumption picks up gradually towards its long-term average growth rate, as the persistent policy stimulus works through, and employment growth recovers. But there is a risk that this recovery may be more subdued, reflecting the possibility of tighter credit conditions, a more pronounced retrenchment by households, or a larger fall in employment.

Reductions in domestic spending are always partly absorbed in lower imports, moderating the impact on domestic output. But that effect is amplified significantly in this projection by the marked fall in sterling which, by raising the relative price of imports sharply, induces a significant degree of expenditure switching away from imports and towards UK-produced goods and services.

Monetary policy at low interest rates

The low level of Bank Rate and the severe dislocation of the financial system have implications for the transmission mechanism of monetary policy. But past reductions in Bank Rate have nevertheless provided a significant monetary stimulus. And the MPC has a range of unconventional policy tools at its disposal should further stimulus be needed to achieve the 2% inflation target. This box discusses those issues in greater detail.

How does Bank Rate affect activity and inflation?

The MPC's ability to influence the value of nominal spending and inflation in the economy, and hence achieve the inflation target, ultimately derives from the fact that the Bank of England is the sole supplier of sterling central bank money: banknotes and reserves held by the banking system at the Bank. Just as households use banknotes as a means of payment, reserves are used by commercial banks to settle payments with each other. Given that demand, the Bank as monopoly supplier could — acting on the MPC's behalf — set either the quantity of reserves, or the interest rate at which they are remunerated — known as Bank Rate. The MPC normally pursues the inflation target by setting Bank Rate. Those decisions, together with the MPC's commitment to achieve the inflation target and its communications about the economic outlook, also affect private sector expectations about the future level of Bank Rate and inflation.

The MPC's monetary policy actions influence activity and inflation through a wide range of different channels. They directly influence the short-term interest rates that banks and other financial market companies charge one another, which in turn affect: the amount of broad money and credit made available by banks, the interest rates they charge to households and companies on loans and pay on deposits, and the rates prevailing in capital markets. The MPC's actions influence longer-term interest rates and the prices of equities and other assets, in particular by affecting expectations about future policy and inflation. Policy actions affect the exchange rate — a particularly important channel in a small open economy like the United Kingdom. And they also have a direct influence on confidence and expectations more broadly. All of these factors in turn influence the spending of households and companies through changes in incomes, wealth, the incentive to save or spend, and the levels of money and credit. But the relative strength of these transmission channels is not constant over time, and depends on prevailing economic conditions, as has been evident over the past year.

Monetary policy over the past year

Since late 2007, Bank Rate has been reduced by 4.75 percentage points to 1%. That is the lowest level of

official interest rates since the Bank of England was established. And the reduction in rates has been more rapid than at the early stages of any of the previous three post-war recessions (see the box on page 20).

Many of the normal transmission channels have continued to operate (Section 1). Households and companies with longer-term variable-rate loans have in many cases benefited from much of the reduction in Bank Rate. The marked falls in expectations of future Bank Rate have helped to reduce longer-term risk-free yields. And the exchange rate has fallen by more than a quarter since mid-2007.

At the same time, the severe disruption in financial markets has adversely affected other aspects of the transmission mechanism. Interest rates offered by banks on new household borrowing have fallen by significantly less than the reduction in Bank Rate. And risk premia have risen sharply in interbank and capital markets since mid-2007, in part reflecting a necessary adjustment after a period in which risk was underpriced. Banks have imposed quantity restrictions on the amount of credit they are willing to extend. And investors have been increasingly reluctant to participate in capital markets, leading to substantial increases in illiquidity premia in some markets (such as those for investment-grade corporate bonds), and the virtual closure of others.

The net effect of these factors has blunted the impact of reductions in Bank Rate. But policy has by no means been impotent, reflecting the speed and scale of the reductions in Bank Rate and the continued operation of several key parts of the transmission mechanism. In the absence of cuts in Bank Rate, market yields would have been substantially higher than they are now.

The zero nominal bound to market interest rates

Nominal market interest rates cannot, however, fall below zero.⁽¹⁾ That is because no one would want to make a loan or hold a deposit at negative rates because they would be better off holding cash (which yields a zero rate). That constrains the amount of monetary stimulus that can be applied through changes in Bank Rate alone.⁽²⁾

Bank Rate itself has not reached zero. But its fall to historically low levels may already have begun to have an impact on the transmission mechanism. One reason why that arises is because banks maintain a spread between deposit rates (which tend to lie below Bank Rate) and lending rates (which tend to lie above Bank Rate) to cover the cost of providing banking services plus a profit margin (see for example **Chart 1.12** on page 16). If Bank Rate falls far enough to push average deposit rates to zero, any further reduction in lending rates would lead to a squeeze in that spread. The extent to which lending rates fall further at this point will depend on a number of factors.

They include the degree to which banks are contractually obliged to pass on Bank Rate cuts to existing customers (for example on some tracker mortgages), and the extent to which maintaining higher lending rates reduces market share. But any combination of lower spreads and lower pass-through is likely to reduce the strength of the monetary policy multiplier: lower spreads reduce bank earnings, which unless offset elsewhere will eat into banks' capital, reducing their lending capacity; and lower pass-through blunts the interest rate channel. It is difficult to quantify the scale of this effect with any certainty. But given the very low level of Bank Rate it seems likely that it is already operating to some degree.

Unconventional monetary policy tools

If movements in Bank Rate do not prove sufficient to meet the inflation target, the Asset Purchase Facility (APF) announced by the Government on 19 January provides a framework for supplementing the MPC's conventional policy instrument. The APF is a specially created fund, operated by the Bank but indemnified by the Government, providing for the large-scale purchase of financial assets. Its initial purpose is to help improve the availability of corporate credit through the targeted purchase of up to £50 billion of high-quality assets such as corporate bonds, commercial paper, and paper issued under the Credit Guarantee Scheme. These operations will be carried out by the Bank, and financed by the issuance of Treasury bills.⁽³⁾

The arrangements announced by the Government allow, however, for the possibility that the MPC may conclude that use of the APF could help to achieve the inflation target. In such circumstances, purchases by the APF would be financed by the creation of central bank reserves. This approach to monetary policy would continue to exploit the Bank's position as monopoly supplier of reserves. But instead of focusing on reducing the price of those reserves — as now — the MPC would focus on expanding their quantity, using the proceeds to purchase a range of financial assets, for example government securities and the private sector assets targeted by the current APF. Such operations would add to the monetary stimulus already in place from the low level of Bank Rate in two key ways:

- First, by increasing the supply of broad money, private sector spending should be stimulated, both directly (through the increase in money holdings of private sector asset sellers) and indirectly (through an expansion by banks of the supply of credit).
- Second, to the extent that the extra reserves are used to make targeted purchases of high-quality but temporarily illiquid assets issued by private sector borrowers — in a way similar to the operations currently being conducted by the Bank — they should help to provide greater confidence to

investors that they would be able to sell those assets should they need to, reducing illiquidity premia and stimulating trading activity. That in turn should make it easier for some types of company to issue new market-based credit, reducing their reliance on the banking sector.

There are uncertainties over the relative strength of these channels. One risk is that, if banks are concerned about their financial health, they may choose to hoard the increase in central bank reserves rather than expand the supply of credit, rendering the first channel partially ineffective. That happened to some extent in Japan in the earlier part of this decade, and underscores the importance of the major policy initiatives announced by the Government in October last year and January this year to improve the operation of UK banks. The strength of the second channel is also uncertain, both in terms of the impact of targeted asset purchases on illiquidity premia, and the extent to which that boosts new issuance. The Bank will gain early experience of the efficacy of this channel through its operation of the APF.

Regardless of how monetary policy is implemented, the objective for policy remains the inflation target. That means that, whatever the uncertainties about the strength of the transmission mechanism, the private sector should be assured that the MPC will take the steps necessary to bring inflation back to target. If the MPC were to adopt unconventional measures in the future, that commitment would be a crucial element in ensuring the efficacy of policy, helping (as now) to anchor inflation expectations and boost nominal spending.

(1) Strictly speaking, slightly negative market interest rates are possible — and occasionally observed — reflecting security and other servicing costs associated with large holdings of cash. But these costs are not large enough to force rates far below zero.

(2) For previous Bank analysis of this topic see, for instance, King, M (1999), 'Challenges for monetary policy: new and old', *Bank of England Quarterly Bulletin*, Vol. 39, No. 4, pages 397–415 and Yates, T (2003), 'Monetary policy and the zero bound to nominal interest rates', *Bank of England Quarterly Bulletin*, Spring, pages 27–37.

(3) Further details on the APF are available at www.bankofengland.co.uk/markets/apf/index.htm.

The MPC has based its projections on the tax and spending plans set out in the Government's *Pre-Budget Report 2008*. Those plans, including the temporary reduction in VAT and the acceleration of capital expenditure, help to support demand in the near term. Further out, they imply a diminishing contribution to demand as the fiscal position is consolidated.

5.3 Key risks to inflation

The extent to which weak demand growth bears down on CPI inflation depends on three further judgements: first, the strength of a number of specific factors bearing on the near-term outlook, notably lower energy prices and the temporary VAT cut; second, the extent to which lower sterling pushes up import and retail prices; and third, the extent to which weaker supply growth offsets the impact of weaker demand on inflation.

Risks to the near-term outlook from energy and VAT

In the central projection, CPI inflation falls significantly below the target in 2009. In part that reflects the decline in demand growth. But the key judgements underpinning the near-term inflation profile relate to energy prices and VAT. Wholesale oil and gas prices have again fallen significantly relative to the levels assumed in the previous *Report* (Section 4), pulling down the inflation projection in the near term. The assumptions underpinning the central projection are set out in the box on page 41. But further unanticipated movements in wholesale prices of the scale seen recently would have material implications for the projection. The projection is also sensitive to the assumptions about the price-level impact of the temporary VAT cut. As the box on page 31 explains, full pass-through of the cut would reduce the CPI by around 1.5%. Evidence so far available suggests that only around half of this effect came through in December; the central projection assumes no further pass-through of the cut in 2009. But information about retailers' actions and intentions remains scarce: if further pass-through does occur early in 2009, that could have a further significant downward effect on CPI this year.

There is a risk that low rates of inflation this year may get built into the medium-term inflation expectations of households and companies, posing a downside risk to the inflation outlook. That risk is not yet judged to be significant: the recent divergence between expectations of future inflation and perceptions of current inflation suggests that, on average, households form their expectations in a forward-looking way; and longer-term measures still appear broadly consistent with the inflation target, given the significant measurement issues (Section 4). But in view of the sharp reversal in shorter-term measures in recent months, the MPC is monitoring these data closely.

How big will the pass-through from lower sterling be?

The ERI starts the current projection 13% lower than in the November *Report*, and more than a quarter lower than in mid-2007. That is assumed to push import prices up sharply in the near term. In the central projection, the pass-through to CPI inflation is muted by the weakness in demand conditions, which causes domestic businesses to absorb a substantial part of the rise in import costs in lower profits and wages. The upwards pressure on inflation over the first two years of the projection is nevertheless stronger than assumed in the November *Report*, reflecting the further decline in sterling.

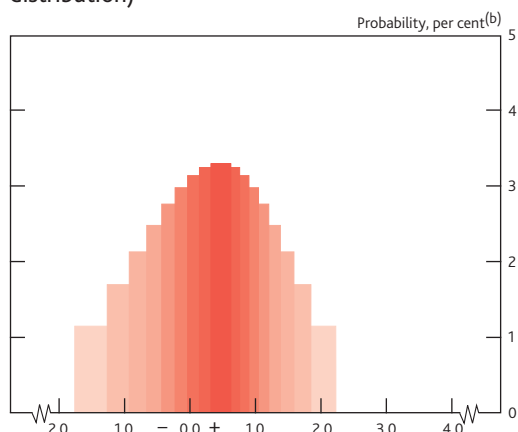
The scale of the depreciation since mid-2007 means that alternative judgements about the scale and pace of pass-through could have significant implications for the inflation projection. The degree of pass-through assumed in this projection is smaller than in the November *Report*, reflecting the evidence of limited price-level effects on CPI during 2008, and the weak near-term demand outlook. But there are substantial risks around this central case, reflecting uncertainties over: the causes of past falls in sterling, the future path of the exchange rate, and the sustainability of any squeeze in businesses' costs and profits. Given the scale of the decline in sterling, the risks to inflation from this source lie to the upside.

How rapidly will supply growth slow?

The subdued period of demand growth puts downwards pressure on wage growth and inflation over the forecast period, as the bargaining position of employees is eroded and companies selling in domestic markets are forced to absorb a greater proportion of their costs in temporarily lower margins. But, in the central projection, those pressures are assumed to be dampened somewhat by a substantial slowing in the growth of the economy's supply potential. Much of that occurs within companies, as weaker demand and tighter credit temporarily: reduces productivity growth, as funding for new business start-ups and within-company innovation is cut back; reduces the availability of working capital and trade finance; and impairs growth in the capital stock, through company failures, lower investment and capital scrapping. But a proportion also works through a temporary slowing in the growth of the effective labour supply, as some of those made unemployed find they do not have the right skills to pick up jobs quickly in other sectors, some are discouraged from searching for work, and some leave the United Kingdom.

The supply capacity of the economy is not directly observable, and it is impossible to quantify these effects with any precision. There are signs that wages are proving more flexible than in earlier downturns, and reforms in recent decades may mean that labour market dislocation is shorter-lasting than in past recessions. But supply capacity within companies may slow somewhat more rapidly in the near term, reflecting

Chart 5.7 Projected probabilities of CPI inflation outturns in 2011 Q1 (central 90% of the distribution)^(a)



(a) Chart 5.7 represents a cross-section of the CPI inflation fan chart in 2011 Q1 for the market interest rate projection. The coloured bands have a similar interpretation to those on the fan charts. Like the fan charts, they portray the central 90% of the probability distribution. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation in 2011 Q1 would lie somewhere within the range covered by the histogram on 90 occasions. Inflation would lie outside the range covered by the histogram on 10 out of 100 occasions. Chart 5.8 shows the corresponding cross-section of the November 2008 Inflation Report fan chart.

(b) Average probability within each band. The figures on the y-axis indicate the probability of inflation being within ± 0.05 percentage points of any given inflation rate, specified to one decimal place.

Chart 5.8 Projected probabilities in November of CPI inflation outturns in 2011 Q1 (central 90% of the distribution)^(a)

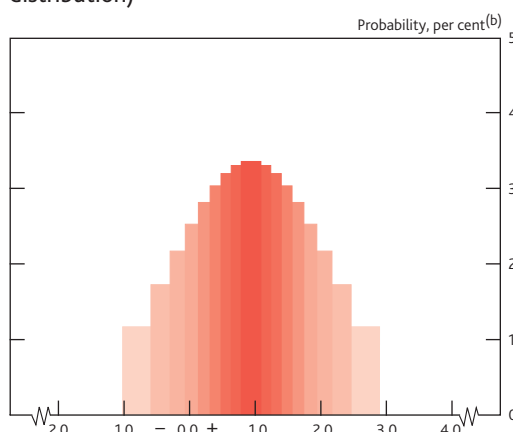
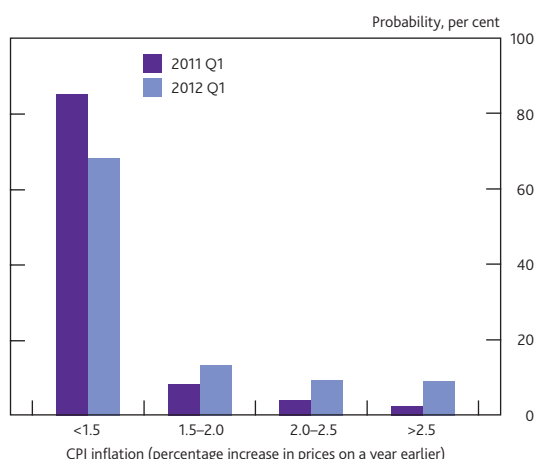
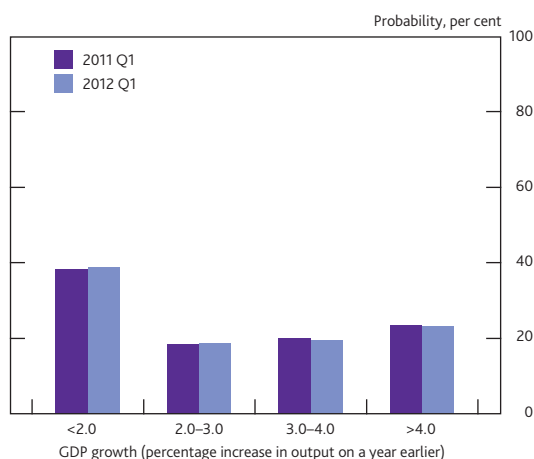


Chart 5.9 Frequency distribution of CPI inflation based on market interest rate expectations^(a)



(a) These figures are derived from the same distribution as Chart 5.4. They represent the probabilities that the MPC assigns to CPI inflation lying within a particular range at a specified time in the future.

Chart 5.10 Frequency distribution of GDP growth based on market interest rate expectations^(a)



(a) These figures are derived from the same distribution as Chart 5.1. They represent the probabilities that the MPC assigns to GDP growth lying within a particular range at a specified time in the future.

current constraints on credit. Overall, supply growth is somewhat weaker than assumed in the November *Report*. But there are risks on both sides of this central case, reflecting uncertainties both over the degree to which supply slows, and its implications for wage and price-setting.

5.4 The balance of risks

As discussed in Sections 5.1 and 5.2, the risks to growth lie heavily to the downside (Charts 5.1 and 5.2). That also implies downside risks to inflation; but there are also substantial upside risks from the lower level of sterling, leaving the overall balance of risks to inflation only a little to the downside (Chart 5.4). The spread of outcomes for CPI inflation at the two-year horizon is shown in Chart 5.7, and the equivalent outlook at the time of the November *Report* is shown in Chart 5.8. Charts 5.9 and 5.10 show frequency distributions for inflation and output at the two and three-year horizons.

To gauge the evolution of the balance of risks, the MPC will focus particularly on measures of money, credit and nominal demand. In assessing the risks to money and credit, and thus to nominal demand, the Committee will monitor the structure of banks' balance sheets, conditions in capital markets, and the cost and availability of funding to companies and households. In addition, the Committee will monitor surveys of household and business confidence, developments in the global economy, nominal earnings, the level and composition of unemployment, company creation and destruction rates, and inflation expectations.

5.5 The policy decision

At its February meeting, the Committee noted that the recent easing in monetary and fiscal policy, the substantial

depreciation in sterling, the falls in commodity prices and the UK authorities' actions to support lending would together provide a considerable stimulus to activity as the year progressed. Nevertheless, the Committee judged that there remained a substantial risk of undershooting the 2% CPI inflation target in the medium term at the existing level of Bank Rate. A further easing in monetary policy was therefore likely to be needed. At its February meeting, the Committee decided that an immediate reduction in Bank Rate of 0.5 percentage points to 1% was warranted.

Other forecasters' expectations

Every three months, the Bank asks a sample of external forecasters for their latest economic projections. This box reports the results of the most recent survey, carried out during January. The average central projection was for GDP to fall by 0.3% in the four quarters to 2010 Q1 before recovering to close to its long-run average growth rate (Table 1). The near-term profile is weaker than that reported three months ago, though growth recovers to the same rates further out. On average, CPI inflation was expected to be below target in 2010 Q1 and 2011 Q1, picking up towards the target in 2012 Q1. That is slightly weaker than expected three months ago.

Table 1 Averages of other forecasters' central projections^(a)

	2010 Q1	2011 Q1	2012 Q1
CPI inflation ^(b)	1.7	1.6	1.9
GDP growth ^(c)	-0.3	1.8	2.5
Bank Rate (per cent)	0.9	2.1	3.5
Sterling ERI ^(d)	80.1	85.7	87.8

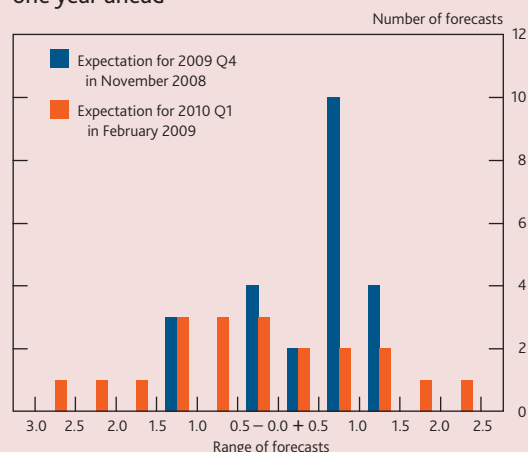
Source: Projections of outside forecasters as of 28 January 2009.

- (a) For 2010 Q1, there were 20 forecasts for CPI inflation, GDP growth and Bank Rate and 17 for the sterling ERI. For 2011 Q1, there were 19 forecasts for CPI inflation, GDP growth and Bank Rate and 16 for the sterling ERI. For 2012 Q1, there were 18 forecasts for CPI inflation, GDP growth and Bank Rate and 16 for the sterling ERI.
 (b) Twelve-month rate.
 (c) Four-quarter percentage change.
 (d) Where necessary, responses were adjusted to take account of the difference between the old and new ERI measures, based on the comparative outturns for 2006 Q1.

At the same time, the degree of stimulus underlying these forecasts was somewhat greater than assumed three months ago: on average Bank Rate over the next three years was expected to be around 1½ percentage points lower and the sterling ERI 6% lower.

The range of views across forecasters was wide, consistent with heightened uncertainty about the outlook. For example, projections for four-quarter GDP growth in 2010 Q1 spanned a range of almost 5 percentage points. And, unlike in November, there was no clear modal projection (Chart A).

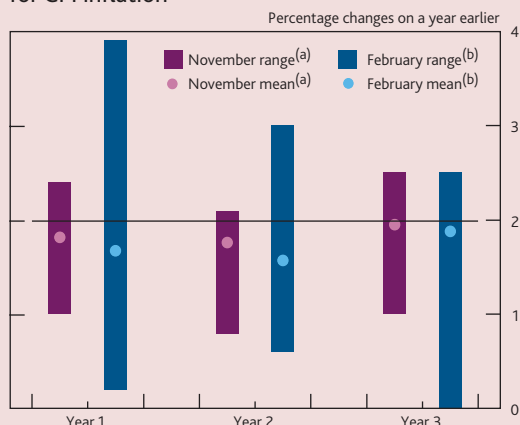
Chart A Distribution of GDP growth central projections one year ahead



Source: Four-quarter GDP growth forecasts of 23 outside forecasters as of 29 October 2008 and 20 outside forecasters as of 28 January 2009.

The range of views about the outlook for CPI inflation was also wider than at the time of the November 2008 Report (Chart B). Views about the likely path for Bank Rate in three years' time ranged from 0.8% to 5%.

Chart B Range of other forecasters' central projections for CPI inflation



Source: Projections of outside forecasters as of 29 October 2008 and 28 January 2009.

- (a) 23 forecasters provided assessments for 2009 Q4, and 19 provided assessments for 2010 Q4 and 2011 Q4.
 (b) 20 forecasters provided assessments for 2010 Q1, 19 for 2011 Q1 and 18 for 2012 Q1.

The Bank also asks forecasters for an assessment of the risks around their central projections for CPI inflation and GDP growth (Table 2). The likelihood of four-quarter GDP growth being below zero in a year's time was judged on average to be 57%, significantly greater than the 36% probability reported in the previous survey. However, the average likelihood of growth having recovered to 3% or more by the end of the projection was unchanged. The probability of inflation being more than a percentage point below target was judged to have increased since the previous survey, particularly in the near term.

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

CPI inflation							
Probability, per cent	Range:						
	<0%	0–1%	1–1.5%	1.5–2%	2–2.5%	2.5–3%	>3%
2010 Q1	13	18	22	21	14	7	6
2011 Q1	8	17	21	23	16	8	6
2012 Q1	7	10	14	25	24	12	7
GDP growth							
Probability, per cent	Range:						
	<-1%	-1–0%	0–1%	1–2%	2–3%	>3%	
2010 Q1		29	28	24	14	4	2
2011 Q1		6	12	20	27	21	13
2012 Q1		3	8	15	23	27	24

Source: Projections of outside forecasters as of 28 January 2009.

- (a) For 2010 Q1, 20 forecasters provided the Bank with their assessment of the likelihood of twelve-month CPI inflation and four-quarter GDP growth falling in the ranges shown above; for 2011 Q1, 19 forecasters provided assessments for CPI and GDP; for 2012 Q1, 18 forecasters provided assessments for CPI and GDP. The table shows the average probabilities across respondents. Rows may not sum to 100 due to rounding.

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Text of Bank of England press notice of 4 December 2008

Bank of England reduces Bank Rate by 1.0 percentage points to 2.0%

The Bank of England's Monetary Policy Committee today voted to reduce the official Bank Rate paid on commercial bank reserves by 1.0 percentage points to 2.0%.

In the United Kingdom, business surveys have weakened further and suggest that the downturn has gathered pace. Consumer spending and business investment have stalled, while residential investment has continued to fall. Activity indicators in the rest of the world have also weakened, though the further depreciation in sterling should moderate the impact of weaker global growth on the United Kingdom. And a number of fiscal measures to boost near-term demand are in train, both in the United Kingdom and overseas. Despite the actions taken to raise bank capital, ease funding and improve liquidity, conditions in money and credit markets remain extremely difficult. The Committee noted that it was unlikely that a normal volume of lending would be restored without further measures.

CPI inflation decreased to 4.5% in October. Cost pressures have also eased. Commodity prices continued to fall back. Pay growth remained subdued. And measures of inflation expectations fell back sharply. CPI inflation is likely to continue to drop back as the contributions from retail energy and food prices decline. The direct effect of the temporary reduction in Value Added Tax will also lower CPI inflation through much of next year, with a corresponding increase in inflation in 2010.

In the November *Inflation Report*, the Committee's projection for inflation showed a substantial risk of undershooting the 2% CPI inflation target in the medium term. The subsequent decline in market interest rates and the further depreciation in sterling have raised the profile for inflation since then. But the weaker outlook for activity in the near term and the further falls in commodity prices have lowered that profile. Although the temporary reduction in Value Added Tax will lead to some volatility in inflation over the next two years, the new fiscal plans are unlikely to have a significant effect on inflation beyond that horizon.

At its December meeting, the Committee judged that, at the existing level of Bank Rate and looking through the volatility in inflation associated with the movements in Value Added Tax, there remained a substantial risk of undershooting the 2% CPI inflation target in the medium term. Accordingly, the Committee determined that a further reduction in Bank Rate of 1.0 percentage points to 2.0% was necessary in order to meet the target in the medium term.

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

Text of Bank of England press notice of 8 January 2009

Bank of England reduces Bank Rate by 0.5 percentage points to 1.5%

The Bank of England's Monetary Policy Committee today voted to reduce the official Bank Rate paid on commercial bank reserves by 0.5 percentage points to 1.5%.

The world economy appears to be undergoing an unusually sharp and synchronised downturn. Measures of business and consumer confidence have fallen markedly. World trade growth this year is likely to be the weakest for some considerable time.

In the United Kingdom, business surveys suggest that the pace of contraction in activity increased during the fourth quarter of 2008 and that output is likely to continue to fall sharply during the first part of this year. Surveys of retailers and reports from the Bank's regional Agents imply that consumer spending has weakened. The outlook for business and residential investment has deteriorated. And the availability of credit to both households and businesses has tightened further, pointing to the need for further measures to increase the flow of lending to the non-financial sector. But the substantial depreciation in sterling over recent months may help to moderate the impact on UK net exports of the slowdown in global growth.

CPI inflation fell to 4.1% in November. Inflation is expected to fall further, reflecting waning contributions from retail energy and food prices and the direct impact of the temporary reduction in Value Added Tax. Measures of inflation expectations have come down. And pay growth remains subdued. But the depreciation in sterling will boost the cost of imports.

At its January meeting, the Committee noted that the recent easing in monetary and fiscal policy, the substantial fall in sterling and the prospective decline in inflation would together provide a considerable stimulus to activity as the year progressed. Nevertheless, the Committee judged that, looking through the volatility in inflation associated with the movements in Value Added Tax, there remained a significant risk of undershooting the 2% CPI inflation target in the medium term at the existing level of Bank Rate. Accordingly, the Committee concluded that a further reduction in Bank Rate of 0.5 percentage points to 1.5% was necessary to meet the target in the medium term.

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

Text of Bank of England press notice of 5 February 2009

Bank of England reduces Bank Rate by 0.5 percentage points to 1.0%

The Bank of England's Monetary Policy Committee today voted to reduce the official Bank Rate paid on commercial bank reserves by 0.5 percentage points to 1.0%.

The global economy is in the throes of a severe and synchronised downturn. Output in the advanced economies fell sharply in the fourth quarter of 2008, and growth in the emerging market economies appears to have slowed markedly. Business and household sentiment in many countries has deteriorated. The weakness of the global banking and financial system means that the supply of credit remains constrained.

In the United Kingdom, output dropped sharply in the fourth quarter of 2008 and business surveys point to a similar rate of decline in the early part of this year. Credit conditions faced by companies and households have tightened further. The underlying picture for consumer spending appears weak. Businesses have responded to the worsening outlook by running down inventories, cutting production, scaling back investment plans and shedding labour. The Committee welcomed the Government's latest measures to tackle the problems in the banking system, including the creation of an Asset Purchase Facility to buy high-quality corporate debt and similar assets.

CPI inflation fell to 3.1% in December. Pay pressures have diminished. But sterling has continued to depreciate, boosting the cost of imports. Inflation is expected to fall to below the 2% target by the second half of the year, reflecting waning contributions from retail energy and food prices and the direct impact of the temporary reduction in Value Added Tax. But the impact of changes in the rate of Value Added Tax, and the gradual pass-through of the depreciation in sterling, mean the path may be somewhat volatile.

At its February meeting, the Committee noted that, although the transmission mechanism of monetary policy was impaired, the past cuts in Bank Rate would in due course nevertheless have a significant impact. Together with the recent easing in fiscal policy, the substantial fall in sterling and past falls in commodity prices, that would provide a considerable stimulus to activity as the year progressed. Nevertheless, the Committee judged that there remained a substantial risk of undershooting the 2% CPI inflation target in the medium term at the existing level of Bank Rate. Accordingly, the Committee concluded that a further reduction in Bank Rate of 0.5 percentage points to 1.0% was warranted this month.

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

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

Glossary and other information

Glossary of selected data and instruments

AEI – average earnings index.

AWE – average weekly earnings.

CPI – consumer prices index.

CPI inflation – inflation measured by the consumer prices index.

ERI – exchange rate index.

GDP – gross domestic product.

LFS – Labour Force Survey.

Libor – London interbank offered rate.

M4 – UK non-bank, non-building society private sector's holdings of sterling notes and coin, and their sterling deposits (including certificates of deposit, holdings of commercial paper and other short-term instruments and claims arising from repos) held at UK banks and building societies.

OIS – overnight index swap.

RPI – retail prices index.

RPI inflation – inflation measured by the retail prices index.

RPIX – RPI excluding mortgage interest payments.

SVR – standard variable rate.

Abbreviations

ABI – Association of British Insurers.

APF – Asset Purchase Facility.

BCC – British Chambers of Commerce.

BRC – British Retail Consortium.

CBI – Confederation of British Industry.

CCS – Credit Conditions Survey.

CGS – Credit Guarantee Scheme.

CIPS – Chartered Institute of Purchasing and Supply.

ECB – European Central Bank.

EU – European Union.

FSA – Financial Services Authority.

FTSE – Financial Times Stock Exchange.

G7 – Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

GfK – Gesellschaft für Konsumforschung, Great Britain Ltd.

HBF – Home Builders Federation.

HEW – housing equity withdrawal.

IMF – International Monetary Fund.

M6 – Canada, France, Germany, Italy, Japan and the United States.

MIP – mortgage interest payment.

MPC – Monetary Policy Committee.

MTIC – missing trader intra-community.

OFCs – other financial corporations.

ONS – Office for National Statistics.

OPEC – Organization of the Petroleum Exporting Countries.

PNFCs – private non-financial corporations.

PwC – PriceWaterhouseCoopers.

REC – Recruitment and Employment Confederation.

RICS – Royal Institution of Chartered Surveyors.

SMMT – Society of Motor Manufacturers and Traders.

VAT – Value Added Tax.

Symbols and conventions

Except where otherwise stated, the source of the data used in charts and tables is the Bank of England or the Office for National Statistics (ONS) and all data, apart from financial markets data, are seasonally adjusted.

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.

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