Inflation Report

August 2010

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.

The Monetary Policy Committee:
Mervyn King, Governor
Charles Bean, Deputy Governor responsible for monetary policy
Paul Tucker, Deputy Governor responsible for financial stability
Spencer Dale
Paul Fisher
David Miles
Adam Posen
Andrew Sentance
Martin Weale

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/2010.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/2010.htm.

Contents

Overview

The recovery continued in the United Kingdom, with output growth across the first half of 2010 close to its historical average. But the level of economic activity remained well below its pre-crisis peak. The revival in the world economy also proceeded, albeit unevenly. The UK recovery is likely to continue, underpinned by the considerable monetary stimulus, further growth in global demand and the past depreciation of sterling. But the risks to growth remain weighted to the downside. Spare capacity is likely to persist over the forecast period, although its extent will depend on the strength of demand and the evolution of supply, both of which are uncertain.

CPI inflation remained well above the 2% target, elevated by temporary effects stemming from higher oil prices, the restoration of the standard rate of VAT to 17.5% and the past depreciation of sterling. And the forthcoming increase in the standard rate of VAT to 20% will add to inflation throughout 2011. As these effects wane, downward pressure on wages and prices from the persistent margin of spare capacity is likely to pull inflation below the target. But the pace and extent of that moderation in inflation are impossible to predict precisely. Under the assumptions that Bank Rate moves in line with market rates and the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion, inflation is a little more likely to be below the target than above it during the second half of the forecast period, although those risks are broadly balanced by the end.

Financial and credit markets

Since the May *Report*, the MPC has held Bank Rate at 0.5% and maintained its stock of purchased assets at £200 billion. Financial market conditions remained strained, although they eased a little following publication of the results of the CEBS stress tests on EU banks. Market participants revised down further their expectations of the near-term path of Bank Rate. Ten-year gilt yields fell, as did equity prices, while corporate bond spreads widened. The sterling effective exchange rate rose.

UK banks continue to face a number of challenges related in particular to their need to refinance substantial levels of maturing funding. Credit conditions improved a touch, though less so than earlier in the year, while the stock of bank lending to companies fell further. Annual broad money growth remained weak.

Demand

The expansion in global demand and world trade continued, but the pace of recovery remained uneven. Growth was strong in Asia but was slower in the euro area, which is the United Kingdom's most important trading partner. The fiscal consolidation measures announced in some countries could dampen growth prospects unless accompanied by offsetting strength in private sector spending.

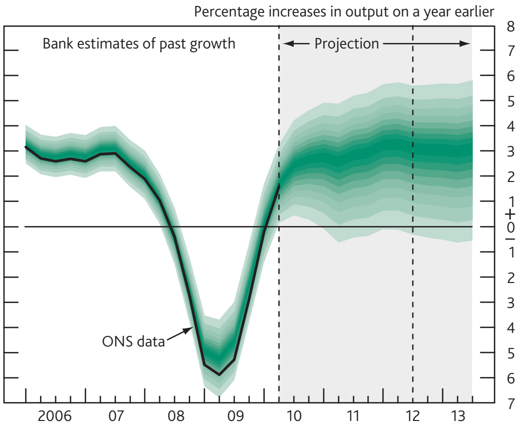
The United Kingdom's recent trade performance appears disappointing. Despite the substantial depreciation in sterling, net trade is estimated by the ONS to have reduced UK growth in each of the past three quarters, although business surveys and manufacturing output were perhaps consistent with a stronger net trade performance. The lower level of sterling should support an improvement in net trade but it seems to be taking time for UK companies to switch resources towards the production of tradable goods and services.

Both households and companies increased their saving net of investment sharply during the financial crisis, as the economic outlook deteriorated, uncertainty increased and credit became less available. The prospects for demand depend on the extent to which these high rates of net saving persist.

The level of households' consumption spending fell by 5% during the recession, but appears to have stabilised in recent quarters. Business spending rebounded in the first quarter of 2010. Business investment increased sharply and the pace of de-stocking eased. The level of capital expenditure remained substantially below its pre-recession peak, and the significant levels of corporate net saving over recent years suggest that many companies have funds available to invest, should they wish to do so. But weak orders and unused capacity are likely to deter investment and reports from the Bank's Agents are consistent with only a gradual recovery in capital expenditure.

A significant fiscal consolidation has begun. The Committee's projections are conditioned on the plans set out in the June *Budget*, which embodied a somewhat faster and larger reduction in borrowing than in the March *Budget*.

Chart 1 GDP projection based on market interest rate expectations and £200 billion asset purchases



The fan chart depicts the probability of various outcomes for GDP growth. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion throughout the forecast period. 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 outturns are also expected to lie within each pair of the lighter green areas on 10 occasions. In any particular quarter of the forecast period, GDP is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions GDP growth can fall anywhere outside the green area of the fan chart. Over the forecast period, this has been depicted by the light grey background. In any quarter of the forecast period, the probability mass in each pair of the identically coloured bands sums to 10%. The distribution of that 10% between the bands above and below the central projection varies according to the skew at each quarter, with the distribution given by the ratio of the width of the bands below the central projection to the bands above it. In **Chart 1**, the ratios of the probabilities in the lower bands to those in the upper bands are approximately 6:4 at Years 1, 2 and 3. 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.

The outlook for GDP growth

GDP was provisionally estimated to have risen by 1.1% in 2010 Q2. The pattern of growth over recent quarters is likely to have been affected by a number of temporary factors. Growth across the first half of 2010 was close to its historical average. A number of surveys suggested that business and consumer confidence had softened recently.

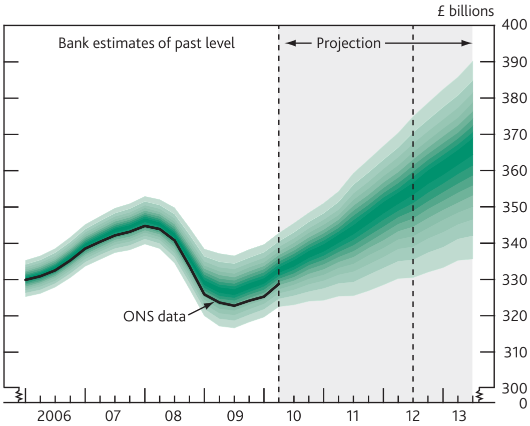
Chart 1 shows the Committee's best collective judgement for four-quarter GDP growth, assuming that Bank Rate follows a path implied by market interest rates and the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion. The considerable stimulus from monetary policy, together with a further expansion in world demand and the past depreciation of sterling, should sustain the recovery. But the strength of growth is likely to be tempered by the continuing fiscal consolidation and the persistence of tight credit conditions.

There are some key uncertainties surrounding the prospects for demand growth. The strength of domestic demand will depend on the continuing impact of the highly accommodative monetary stance and on the behaviour of private sector saving, particularly in response to the substantial fiscal consolidation and the constraints on the supply of bank lending. Improvement in net trade will depend on the vigour of the global recovery and the degree of rebalancing prompted by sterling's past depreciation.

The Committee judges that the recovery is likely to continue. The most likely outcome for GDP growth is lower than in the May *Report*, reflecting the softening in business and consumer confidence, the faster pace of fiscal consolidation and a slower improvement in credit conditions. But the downside risks around this central projection are judged to be smaller than in May, due in part to the fiscal measures announced in the June *Budget* reducing the chances of a sharp rise in long-term interest rates.

Chart 2 shows the Committee's best collective judgement for the level of GDP, corresponding to the distribution of GDP growth shown in **Chart 1**. Output is likely to remain well below the level implied by a continuation of its pre-crisis trend throughout the forecast period.

Chart 2 Projection of the level of GDP based on market interest rate expectations and £200 billion asset purchases



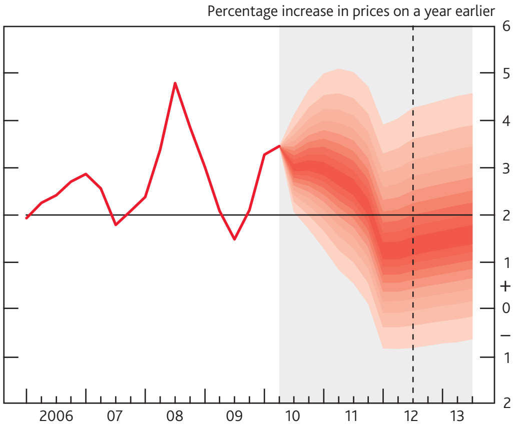
Chained-volume measure (reference year 2006). See the footnote to **Chart 1** for details of the assumptions underlying the projection for GDP growth. The width of this fan over the past has been calibrated to be consistent with the four-quarter growth fan chart, under the assumption that revisions to quarterly growth are independent of the revisions to previous quarters. Over the forecast, the mean and modal paths for the level of GDP are consistent with **Chart 1**. So the skews for the level fan chart have been constructed from the skews in the four-quarter growth fan chart at the one, two and three-year horizons. This calibration also takes account of the likely path dependency of the economy, where, for example, it is judged that shocks to GDP growth in one quarter will continue to have some effect on GDP growth in successive quarters. This assumption of path dependency serves to widen the fan chart.

Costs and prices

CPI inflation was 3.2% in June. That was well above the 2% inflation target and suggested that inflation in the near term was likely to be higher than anticipated in the May *Report*. The high rate of inflation reflects temporary effects stemming from increased oil prices, the restoration of the standard rate of VAT to 17.5%, and the past depreciation of sterling. The increase in the standard rate of VAT to 20% in January 2011 will add to inflation throughout 2011. Despite inflation being above the target for much of the past four years, measures of inflation expectations appeared broadly consistent with meeting the inflation target in the medium term.

Surveys continued to suggest that there was a margin of spare capacity within companies, although on some measures this gap was starting to close. Unemployment was stable but continued to point to a sizable degree of slack in the labour market. Despite above-target inflation, earnings growth remained subdued.

Chart 3 CPI inflation projection based on market interest rate expectations and £200 billion asset purchases

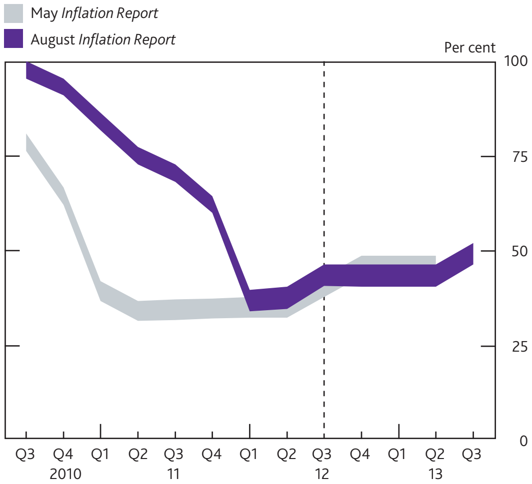


The fan chart depicts the probability of various outcomes for CPI inflation in the future. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion throughout the forecast period. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation in any particular quarter would lie within the darkest central band on only 10 of those occasions. The fan chart is constructed so that outturns of inflation are also expected to lie within each pair of the lighter red areas on 10 occasions. In any particular quarter of the forecast period, inflation is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions inflation can fall anywhere outside the red area of the fan chart. Over the forecast period, this has been depicted by the light grey background. In any quarter of the forecast period, the probability mass in each pair of the identically coloured bands sums to 10%. The distribution of that 10% between the bands above and below the central projection varies according to the skew at each quarter, with the distribution given by the ratio of the width of the bands below the central projection to the bands above it. In **Chart 3**, the ratios of the probabilities in the lower bands to those in the upper bands are approximately 4:6 in Years 2 and 3; the upward skew is slightly smaller in Year 1. 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.

The outlook for inflation

Chart 3 shows the Committee's best collective judgement for the outlook for CPI inflation, based on the same assumptions as **Chart 1**. Inflation is likely to remain above the 2% target for longer than judged likely in May, in large part reflecting the increase in the rate of VAT to 20% in 2011. As the temporary effects adding to inflation drop out of the twelve-month comparison, downward pressure on wages and prices from the

Chart 4 Assessed probability inflation will be above target



The August and May swathes in this chart are derived from the same distributions as **Chart 3** and **Chart 5.7** on page 39 respectively. They indicate the assessed probability of inflation being above target in each quarter of the forecast period. The width of the swathe at each point in time corresponds to the width of the band of the fan chart in which the target falls in that quarter, or, if the target falls outside the coloured area of the fan chart, the width of the band closest to the target. The bands in the fan chart illustrate the MPC's best collective judgement that inflation will fall within a given range. The swathes in **Chart 4** show the probability within the entire band of the corresponding fan chart of inflation being close to target; the swathes should not therefore be interpreted as a confidence interval.

persistent margin of spare capacity is likely to bring inflation below the target for a period.

The Committee cannot be sure of the extent to which inflation will moderate. Businesses' costs and prices depend on the degree of spare capacity, both within companies and in the labour market, and therefore in part on the strength of demand. The impact of the recession on the evolution of supply will also be a key influence. Companies that temporarily adjusted their operating practices in response to the fall in demand may bring some capacity back on stream. But, over time, if weakness in demand were to persist, that might lead to some capacity being scrapped and individuals losing skills. Slack in the labour market will tend to bear down on earnings growth. But the size of that effect is uncertain, as it is also possible that earnings growth could recover as productivity picks up. Further out, inflation may remain higher than otherwise if the current period of above-target inflation causes medium-term inflation expectations to rise. Any further pressure on prices from the past depreciation of sterling, or substantial movements in energy prices, would also affect inflation.

There is a range of views among Committee members regarding the relative strength of these factors. **Chart 4** shows the probability of inflation being above the 2% target along with the corresponding probability implied by the May *Report* projections. On balance, the Committee judges that, conditioned on the monetary policy assumptions described above, inflation is somewhat more likely to be below the target than above it during the second half of the forecast period, although those risks are broadly balanced by the end.

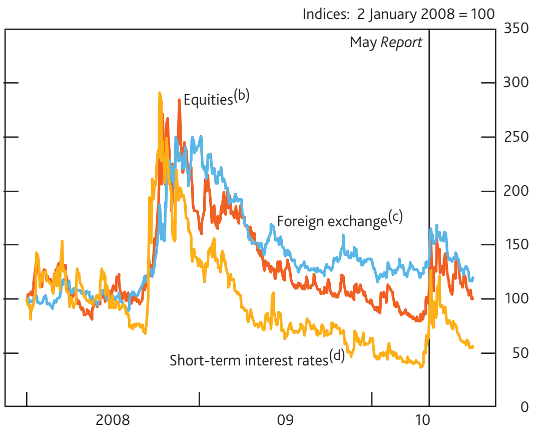
The policy decision

At its August meeting, the Committee judged that the recovery was likely to continue. The forthcoming increase in VAT was expected to keep CPI inflation above the 2% target until the end of 2011, after which inflation was likely to fall back, reflecting the persistent margin of spare capacity. In the light of that outlook, the Committee judged that maintaining Bank Rate at 0.5% and maintaining the size of the programme of asset purchases financed by the issuance of central bank reserves at £200 billion was appropriate to meet the 2% CPI inflation target over the medium term. But the prospects for inflation were highly uncertain and the Committee stood ready to respond in either direction as the balance of risks evolved.

1 Money and asset prices

The MPC maintained Bank Rate at 0.5% and the stock of asset purchases financed by the issuance of central bank reserves at £200 billion. Market participants have revised down their expectations for Bank Rate since the May *Report*. Conditions in global financial markets remained strained, reflecting concerns about sovereign debt and deficits, and the pace of economic recovery. Equity prices declined and corporate bond spreads widened. Ten-year UK gilt yields fell, while the sterling effective exchange rate appreciated. Bank lending to businesses and households remained weak in 2010 Q2, as did four-quarter broad money growth.

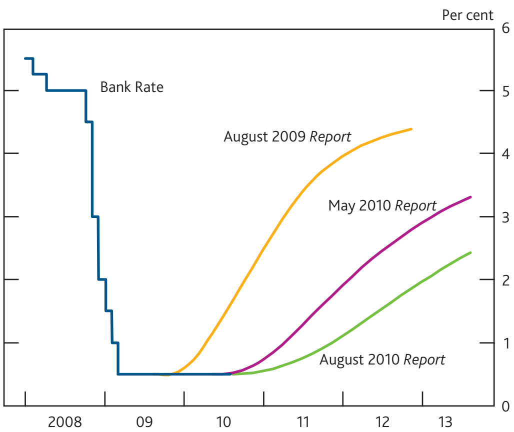
Chart 1.1 Indicators of market uncertainty[a]



Sources: Bloomberg, Chicago Mercantile Exchange, Euronext.liffe, Tradition-ICAP and Bank calculations.

(a) Three-month option-implied volatilities.
(b) Average of FTSE 100, S&P 500 and Euro Stoxx 50.
(c) Average of sterling-US dollar, euro-US dollar and sterling-euro exchange rates.
(d) Average of three-month short sterling, euro-dollar and Euribor.

Chart 1.2 Bank Rate and forward market interest rates[a]



Sources: Bank of England and Bloomberg.

(a) The August 2009, May 2010 and August 2010 curves are estimated using overnight index swap (OIS) rates in the fifteen working days to 5 August 2009, 7 May 2010 and 4 August 2010 respectively.

Some financial market stresses have persisted over the past three months. That is likely to have reflected continuing concerns among market participants about the ability of some euro-area countries to achieve necessary fiscal consolidation, alongside anxieties about the pace of global economic recovery. Indicators of uncertainty across a range of international markets increased sharply at the beginning of the period, but have since fallen back (**Chart 1.1**). Some asset prices have fallen since the run-up to the May *Report*, although UK gilt yields have declined and the sterling effective exchange rate has appreciated (Section 1.1).

Uncertainty about the scale of the banking sector's exposure to sovereign debt contributed to a deterioration in the wholesale funding conditions facing banks, although conditions have eased slightly in recent weeks (Section 1.2). Credit conditions for businesses and households remained tight and the gradual easing in conditions for some larger companies slowed (Section 1.3). Four-quarter broad money growth remained weak (Section 1.4).

1.1 Financial markets

UK monetary policy

Since the May *Report*, the MPC has maintained Bank Rate at 0.5% and the stock of asset purchases financed by the issuance of central bank reserves at £200 billion. The reasons behind the MPC's decisions in June and July are discussed in the box on page 10.

In the period running up to the MPC's August decision, market participants' interest rate expectations for the next two years, estimated from overnight index swap (OIS) rates, were on average around 0.6 percentage points lower than in May 2010, and around 2.5 percentage points lower than in August 2009 (**Chart 1.2**).

Monetary policy since the May *Report*

The MPC's central projection for GDP growth in the May *Report*, under the assumptions that Bank Rate followed a path implied by market interest rates and that the stock of purchased assets financed by the issuance of central bank reserves remained at £200 billion, was for the recovery in economic activity to continue to gather strength. Under the same assumptions, the MPC judged that inflation was likely to remain above the target for the rest of the year before falling back below the target for the remainder of the forecast period.

Indicators received over the course of the month preceding the MPC's meeting on 9–10 June suggested that economic activity had continued to recover, broadly as Committee members had expected at the time of the May *Report*. The evidence pointed towards underlying GDP growth at only a little below its historical average during the first half of 2010.

Financial market stresses had persisted during the month. Heightened concerns among financial market participants about the sustainability of government deficits and debt levels, particularly in certain euro-area countries, had prompted the announcement of accelerated fiscal consolidation by several governments. In the absence of additional support to demand from elsewhere, it was likely that these events would dampen the prospects for growth in key UK export markets. Concerns about the exposures of financial institutions to sovereign governments had increased funding costs for many banks, and the risks of further fragility had risen.

Although CPI inflation had fallen in May to 3.4%, near-term inflation prospects remained elevated. Survey-based measures of households' short-term inflation expectations had risen sharply on the month, but evidence regarding long-term measures was more mixed.

For some members, developments in inflation indicated that the balance of risks had moved marginally to the upside. Other members placed marginally more weight on developments in financial markets and, for them, the balance of risks had shifted to the downside. Most members thought that the changes in the balance of risks were insufficient to warrant a change in the stance of monetary policy. But one member thought it was appropriate to begin to withdraw some of the exceptional monetary policy stimulus. Seven members voted to keep Bank Rate at 0.5% and maintain the stock of asset purchases at £200 billion. One member voted for a 25 basis point rise in Bank Rate.(1)

Data over the month running up to the MPC's meeting on 7–8 July implied that the prospects for GDP growth had probably deteriorated a little. Although consistent with growth, a range of survey-based measures of activity had weakened, both in the United Kingdom and overseas. Conditions in international financial markets had remained stressed and companies' access to capital markets impaired. The gradual easing in credit conditions to UK households and companies, which had been under way for several months, had appeared to slow.

Near-term inflation prospects had also worsened. Although CPI inflation had fallen again in June to 3.2%, it was likely to be higher during the remainder of 2010 than envisaged in the May *Report* central projection, as the impact of the past increases in indirect taxes, oil prices and depreciation of sterling offset the downward pressure from spare capacity. And the increase in the standard rate of VAT to 20% announced in the June *Budget* was likely to add to inflation, particularly in 2011. In the light of this outlook, there was a risk that the private sector's expectations of inflation over the medium term would rise. There was so far little to suggest that households' longer-term inflation expectations had increased materially. And indicators of pay growth had remained subdued.

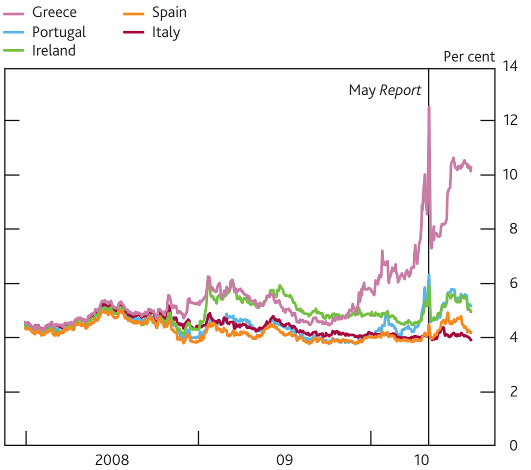
There were arguments for a modest easing in the stance of monetary policy. The softening in the medium-term outlook for GDP growth would put further downward pressure on inflation. But there were also arguments in favour of a modest tightening in policy. The resilience of inflation over recent months had suggested that the downward impact of spare capacity could be weaker than expected and there was a risk that medium-term inflation expectations would rise.

On balance, most members thought it was appropriate to leave the monetary stance unchanged. For them, the weight of evidence continued to indicate that the margin of spare capacity was likely to bear down on inflation and bring it back to the target once the impact of temporary factors had worn off. Seven members voted to maintain the current stance of monetary policy. One member voted to increase Bank Rate by 25 basis points.(1)

At its meeting on 4–5 August, the Committee voted to maintain Bank Rate at 0.5%. The Committee also voted to maintain the stock of asset purchases financed by the issuance of central bank reserves at £200 billion.

(1) The Committee consisted of only eight members at the meetings in June and July.

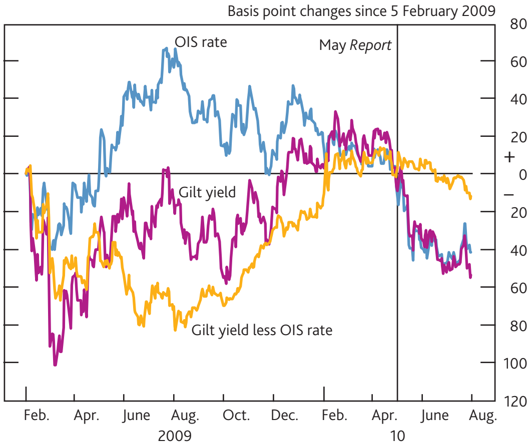
Chart 1.3 Selected euro-area ten-year government bond yields(a)



Source: Bloomberg.

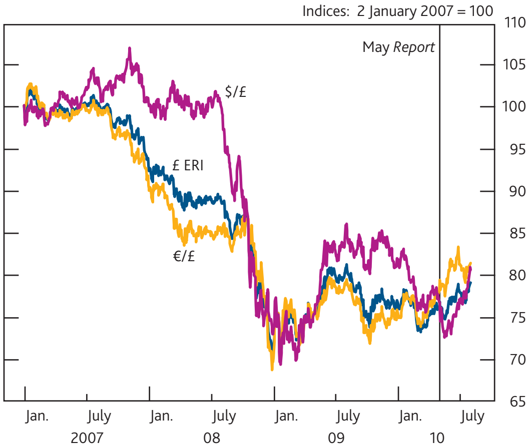
(a) Yields to maturity on ten-year benchmark government bonds.

Chart 1.4 Ten-year nominal spot gilt yield and equivalent-maturity OIS rate



Sources: Bloomberg and Bank calculations.

Chart 1.5 Sterling exchange rates



Government bonds

Government bond yields in Greece and some other euro-area countries have remained elevated over the past three months (**Chart 1.3**), as have bid-ask spreads — an indicator of liquidity in those markets. That followed a period in the run-up to the May *Report* during which market participants' concerns about the sustainability of fiscal positions in some euro-area countries heightened significantly. In response, the European Council and Member States in conjunction with the IMF and ECB put in place a substantial package of support, including the creation of a European Financial Stabilisation Mechanism and a European Financial Stability Facility. In parallel, the ECB commenced purchases of euro-area government bonds under its Securities Market Programme.

In contrast, yields on UK gilts and other highly liquid government bonds have fallen over the past three months: on average, in the fifteen working days to 4 August, ten-year gilt yields were about 0.6 percentage points lower than at the time of the May *Report* (**Chart 1.4**). That was slightly less than the fall in ten-year US Treasury yields over that period, but slightly more than the fall in equivalent German and French government bond yields.

Gilt yields in part reflect market participants' expectations of the path of Bank Rate. Changes in equivalent-maturity OIS rates provide an indication as to how those expectations have shifted. OIS rates suggest that the recent falls in gilt yields have been associated with downward revisions to the expected future path of Bank Rate (**Chart 1.4**).

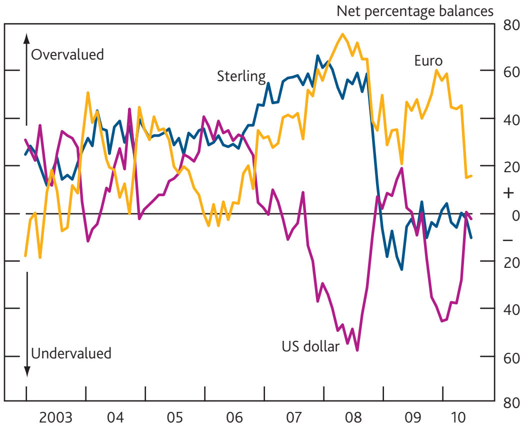
The UK fiscal consolidation set out in the June *Budget* (Section 2) is likely to have affected gilt yields through a number of channels. To the extent that the *Budget* process led market participants to revise down their expectations for monetary policy, it may, in part, explain the decline in OIS rates. But it may also explain the slight fall in gilt yields relative to OIS rates over the past three months (**Chart 1.4**). For example, the confirmation in the June *Budget* of a somewhat faster and larger fiscal consolidation may have led some market participants to perceive that the risk of a significantly higher supply of gilts in the future had receded, putting downward pressure on yields.

Exchange rates

In the run-up to the August *Report*, the sterling effective exchange rate index (ERI) was 2.5% higher than at the time of the May *Report*, reflecting 3.4% and 1.8% appreciations against the euro and the US dollar respectively (**Chart 1.5**). That appreciation could relate, in part, to a diminution of concerns about the UK fiscal situation, and therefore a reduction in the risk premia attached to sterling assets.

A range of indicators suggests that market participants view the risks around future movements in the sterling effective

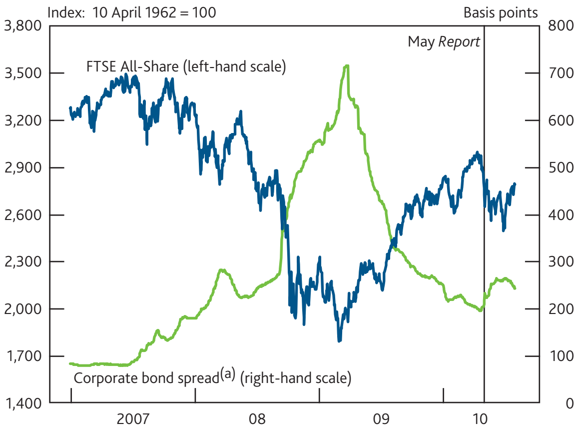
Chart 1.6 Fund manager survey of currency valuations[(a)]



Source: Bank of America/Merrill Lynch *Fund Manager Survey Global*.

(a) The survey asks: 'Based on current fundamentals, do you think the currency is overvalued, fairly valued or undervalued?'. The net percentage balance is calculated as the percentage reporting 'overvalued' less the percentage reporting 'undervalued'.

Chart 1.7 FTSE All-Share and sterling investment-grade corporate bond spread



Sources: Bank of America/Merrill Lynch and Thomson Reuters Datastream.

(a) Option-adjusted spread over equivalent-maturity government bonds.

Chart 1.8 Sterling non-bank investment-grade corporate bond spreads less CDS premia[(a)]

Sources: UBS Delta and Bank calculations.

(a) The data are based on individual corporate bond spreads (relative to asset swaps) less their corresponding CDS premia. The maturity of the bonds used in this calculation may not necessarily match the maturity of the corresponding CDS premia, as data are typically only available for five-year CDS. The chart shows a five-day moving average median measure.

exchange rate as broadly balanced on average. For example, information derived from option prices implies roughly similar probabilities of a large fall or a large rise in the effective exchange rate. And sterling continues to be perceived as broadly fairly valued according to the balance of investors responding to the latest Bank of America/Merrill Lynch *Fund Manager Survey Global*, as has been the case since mid-2009 (**Chart 1.6**). On average, respondents surveyed by Consensus Economics continue to expect a slight appreciation of sterling over coming years.

Equities and corporate bonds

International equity and corporate bond markets have remained weak since the May *Report*. That reflected the continuation of concerns about sovereign debt and deficits as well as renewed anxieties about the pace of global economic recovery. For example, in the fifteen working days to 4 August, the FTSE All-Share was 5% below its level in the fifteen working days to 7 May, while spreads on sterling-denominated investment-grade corporate bonds increased by 0.5 percentage points over that same period (**Chart 1.7**). Those movements were, however, relatively small compared with the weakening in these markets seen during the worst of the financial crisis.

Concerns about sovereign debt and deficits and the pace of global recovery may have affected international equity and corporate bond markets in a number of ways. Market participants could have revised down their expectations for economic growth and, in turn, reduced their central forecasts for corporate earnings. So far, analysts surveyed by the Institutional Brokers' Estimate System have made only small downward revisions to their estimates for corporate earnings growth in the United States, euro area and the United Kingdom in 2011, and have tended to revise up their estimates for earnings growth in 2010 by similar amounts. But investors may have become more worried about severe downside risks. For example, an estimate of the equity risk premium — the excess return demanded by investors to compensate for uncertainty[(1)] — has risen since the May *Report*.

The functioning of the sterling secondary corporate bond market has not deteriorated significantly since the May *Report*. For example, the difference between corporate bond spreads and credit default swap (CDS) premia — an indicator of illiquidity premia — has been broadly unchanged over the past three months (**Chart 1.8**). That stands in contrast to developments during the extended period of intense uncertainty in late 2008 when illiquidity premia rose sharply on concerns that it would be difficult to sell on bonds in the

(1) See 'Interpreting equity price movements since the start of the financial crisis', *Bank of England Quarterly Bulletin*, 2010 Q1, pages 24–33, for more details on the Bank's approach to estimating the equity risk premium.

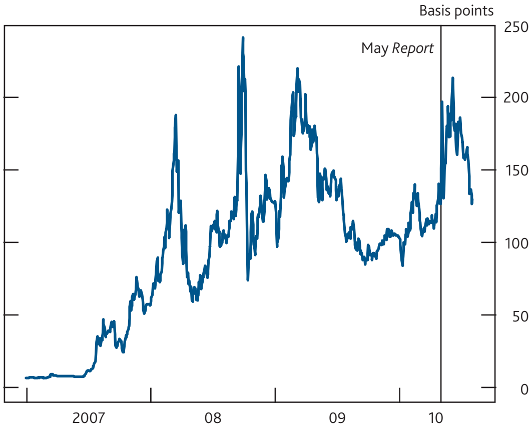
future. Since May, the Bank has continued to act as a backstop buyer and seller of high-quality corporate bonds, on behalf of the Treasury and financed by the issuance of Treasury bills.

Anxieties in global financial markets, and the accompanying periods of increased uncertainty (**Chart 1.1**), may nevertheless have made it harder for banks and non-financial businesses to raise funds in capital markets during the past three months (Sections 1.2 and 1.3).

1.2 The banking sector

As discussed in the June 2010 *Financial Stability Report*, UK banks continue to face a number of challenges in respect of their funding and capital positions, including those related to sovereign debt exposures.(1) For example, UK banks have counterparty relationships with European banks that have large exposures to the countries where fiscal concerns have been most acute. The intensification of those concerns in May could, in part, explain the sharp rise in indicators of the risks associated with exposure to banks — such as CDS premia — at that time (**Chart 1.9**).

Chart 1.9 Major UK banks' CDS premia(a)

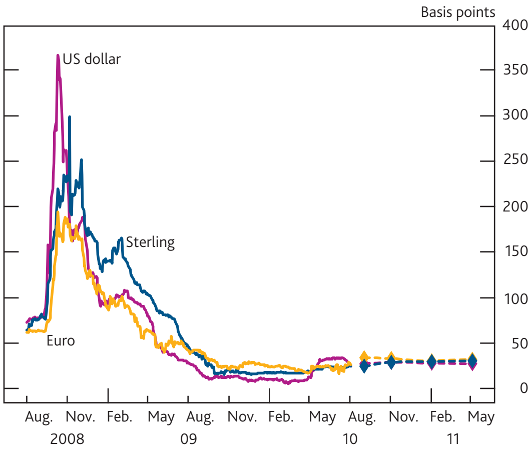


Sources: Markit Group Limited, Thomson Reuters Datastream and Bank calculations.

(a) The data show a weighted average of the CDS premia (at five-year maturity) of Banco Santander, Barclays, HSBC, Lloyds Banking Group and Royal Bank of Scotland, weighted by each bank's share in total assets.

CDS premia have since fallen back, particularly in recent weeks, although premia remain higher than in 2009 H2 and 2010 Q1. Those latest declines coincided with the publication of the results of Europe-wide stress tests carried out by the Committee of European Banking Supervisors, in co-operation with the ECB, European Commission and the EU national supervisory authorities, and the release of detailed information on banks' exposures to European government debt. The stress-test results suggested that the major UK banks have sufficient capital to absorb plausible future shocks to the macroeconomic environment. The declines in CDS premia also coincided with the announcement of an amended international capital and liquidity reform package agreement by the Groups of Governors and Heads of Supervision of the Basel Committee on Banking Supervision.

Chart 1.10 Three-month interbank rates relative to future expected policy rates(a)



Sources: Bloomberg, British Bankers' Association and Bank calculations.

(a) Three-month Libor rates less equivalent-maturity OIS. Dashed lines show the average forward spreads derived from forward rate agreements over the fifteen working days to 4 August.

Funding

Wholesale funding conditions for the major UK banks worsened following the escalation of euro-area fiscal concerns in the run-up to the May *Report*. That tightening was most evident in the unsecured senior debt market and primary unsecured issuance has also been weak. Issuance of secured debt has held up a little better — for example, Royal Bank of Scotland launched an inaugural covered bond in June — but has been weaker than prior to the financial crisis.

Three-month Libor-OIS spreads have also risen slightly since mid-April (**Chart 1.10**), although those spreads remain well below the elevated levels seen during the worst of the financial

(1) See www.bankofengland.co.uk/publications/fsr/2010/fsr27.htm.

crisis. Stresses in short-term wholesale funding markets may, in part, have been alleviated by the significant injections of central bank liquidity since 2009.

Major UK banks are likely to attempt to reduce their dependence on wholesale funding by seeking to attract more retail deposits and by disposing of some assets. But they will still need to refinance a significant concentration of funding falling due over the coming years, including that supported by the official sector.(1) That may raise future funding costs for some banks, particularly if recent stresses in financial markets were to persist. Higher funding costs are likely to have implications for the interest rates charged on business and household loans (Section 1.3). For example, recent reports from major UK lenders suggest that some upward pressure on lending spreads for larger corporates was expected if funding costs remained elevated.

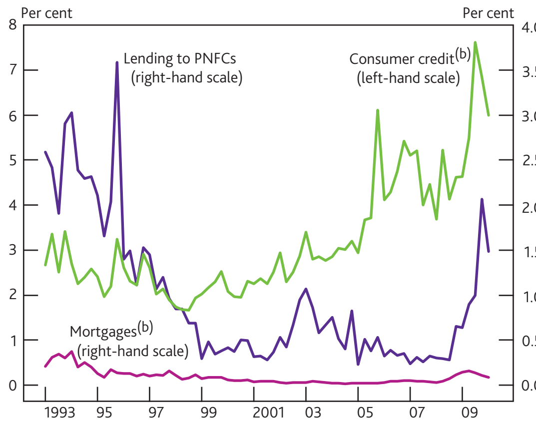
Capital

The resilience of the banking system should determine the willingness of investors to refinance banks' maturing wholesale funding and the price at which that refinancing is likely to be available. As discussed in the June 2010 *Financial Stability Report*, UK banks' capital ratios have improved over the past year. And, since then, some major banks have announced higher earnings growth in their interim results.

That improvement in profitability is, in part, likely to have reflected a decline in banks' losses on loans to UK companies and households, after a period during which losses increased significantly. For example, write-off rates on lending to private non-financial corporations (PNFCs) fell in 2010 Q1 (**Chart 1.11**), broadly consistent with the decline in corporate liquidations reported since late 2009 (Section 3).(2) And write-off rates on household loans have fallen for a number of quarters (**Chart 1.11**). Lenders responding to the 2010 Q2 *Credit Conditions Survey* reported lower default rates on loans to households, and to medium and large PNFCs.

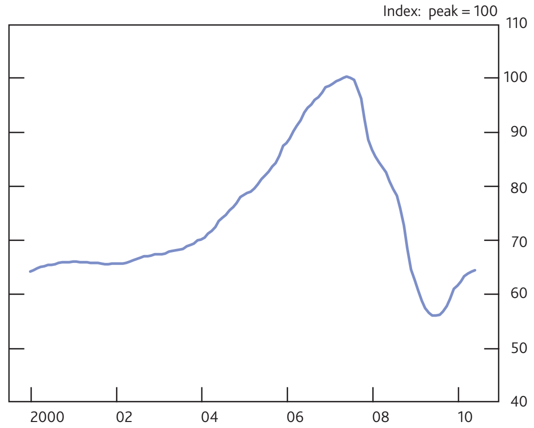
The commercial real estate sector remains a key risk for the banking sector, accounting for almost half of the stock of all loans by UK-resident lenders to UK PNFCs. Commercial property values have risen by 15% since their trough around a year ago (**Chart 1.12**). But that recovery has reportedly been driven by investor demand for prime properties with little appetite for lower-quality investments. And prices remain about 35% below their mid-2007 peak. So far, banks appear to have accommodated, to some degree, breaches of loan to value covenants by companies that have continued to service their loans. But, if banks were to become less willing to show forbearance, that could lead to a rise in reported losses.

Chart 1.11 Write-off rates(a)



(a) On loans by UK monetary financial institutions. These figures are calculated as annualised quarterly write-offs divided by the corresponding loans outstanding at the end of the previous quarter. Unless otherwise stated, loans in both sterling and foreign currency, expressed in sterling terms. Non seasonally adjusted.
(b) Sterling loans only.

Chart 1.12 Commercial property prices(a)

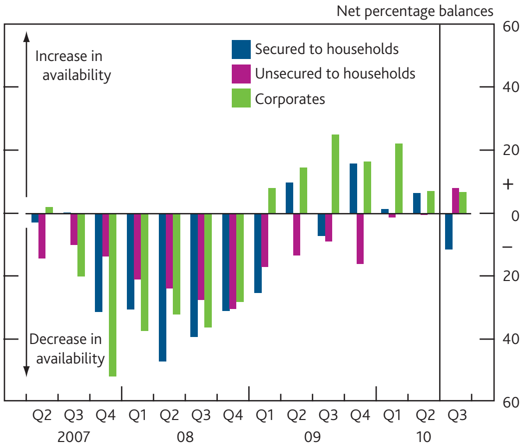


Sources: Investment Property Databank and Thomson Reuters Datastream.

(a) The data are non seasonally adjusted.

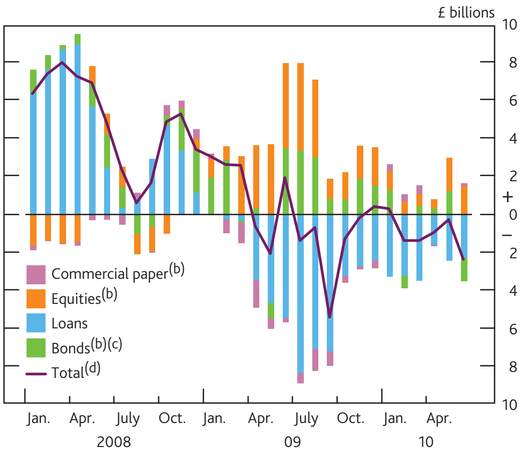
(1) See, for example, the discussion on pages 50–52 of the June 2010 *Financial Stability Report*.
(2) See the box 'Explaining corporate liquidations' on pages 32–33 of the June 2010 *Financial Stability Report*.

Chart 1.13 *Credit Conditions Survey*: credit availability[(a)]



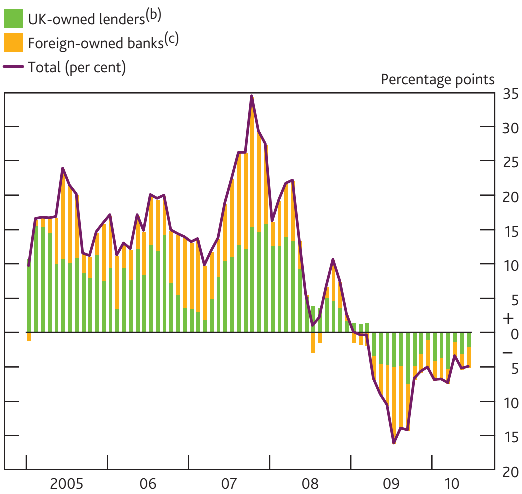
(a) Weighted responses of lenders. A positive balance indicates that more credit was available over the past three months. The bars to the right of the vertical line show lenders' expectations for the next three months at the time of the 2010 Q2 *Credit Conditions Survey*.

Chart 1.14 PNFCs' net finance raised[(a)]



(a) Three-month moving averages. Includes sterling and foreign currency funds.
(b) Non seasonally adjusted.
(c) Includes stand alone and programme bonds.
(d) Owing to the method of seasonal adjustment of this series, the total may not equal the sum of its components.

Chart 1.15 Contributions to growth in loans to UK PNFCs over the past three months (annualised)[(a)]



(a) Includes sterling and foreign currency loans.
(b) Includes Banco Santander.
(c) Calculated as a residual.

1.3 Credit conditions

Credit conditions for households and businesses remained tight relative to their immediate pre-financial crisis levels. Lenders responding to the 2010 Q2 *Credit Conditions Survey* reported some continued easing in credit conditions, although the pace at which they increased corporate credit availability slowed (**Chart 1.13**). Looking ahead, lenders expected secured household credit availability to worsen over the next three months (**Chart 1.13**). It is difficult to judge the likely evolution of credit conditions, and the extent to which financial market developments will affect their path.

Corporate credit conditions

Overall, PNFCs raised less finance than they repaid in 2010 Q2, reflecting reductions in the stock of bank loans and little net capital market issuance (**Chart 1.14**). Businesses have consistently repaid more bank loans than they have taken out over the past 18 months, although the pace of net repayment has eased of late.

The tightening in the supply of bank credit since the start of the financial crisis is likely to be an important factor explaining the weakness of corporate credit growth. Lenders responding to the *Credit Conditions Survey* have, over the past 18 months, however, reported that the amount of bank credit available to companies increased somewhat, although the pace of increase slowed in the latest *Survey* (**Chart 1.13**). Lenders continued to report falling spreads on loans to medium and large PNFCs in that same *Survey*. Although it is difficult to disentangle the influence of supply from demand, those developments are consistent with a somewhat less tight supply of credit to some businesses than during the worst of the financial crisis. Demand from larger companies for corporate loans has, in contrast, remained weak over the past year, according to reports from the Bank's Agents.

The withdrawal of foreign lenders from the United Kingdom has played a key role in the weakness of corporate lending.[(1)] A declining stock of loans by foreign-owned UK-resident banks accounted for a significant part of the fall in overall lending in 2009 (**Chart 1.15**). But contacts of the Bank's Agents reported that a number of foreign banks had recently entered, or re-entered, the UK market. And net syndicated loan issuance by non-resident lenders appears to have picked up a little.

Companies' demand for bank credit depends on a number of factors, including the cost and availability of alternative sources of finance.[(2)] Larger businesses raised slightly less net

(1) For further information, see the boxes 'Provision of banking services to the UK economy by foreign-owned banks' on page 16 of the June 2010 *Financial Stability Report*, and 'Recent trends in syndicated lending' on page 8 of the July 2010 *Trends in Lending*.
(2) The range of finance options for different-sized businesses is discussed in more detail in the Department for Business, Innovation and Skills and HM Treasury *Green Paper* 'Financing a private sector recovery', 26 July 2010.

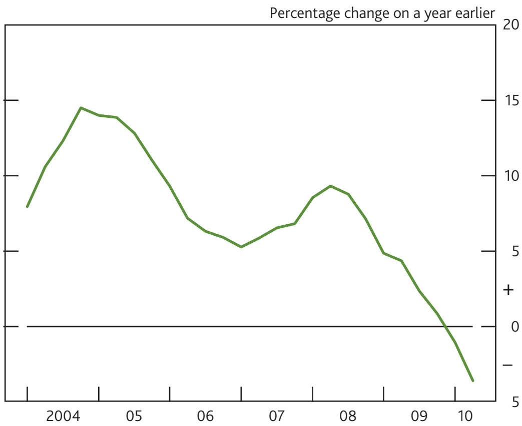
Table 1.A PNFCs' equity and debt issuance[(a)]

£ billions

	Averages		2009		2010	
	2003–08	2009	Q3	Q4	Q1	Q2
Equities						
Net issuance	-0.7	2.6	1.0	2.0	0.6	1.5
Gross issuance	*0.8*	*2.7*	*1.0*	*2.0*	*0.8*	*1.8*
Repayments	*1.5*	*0.0*	*0.0*	*0.0*	*0.2*	*0.3*
Corporate bonds[(b)]						
Net issuance	1.1	1.5	0.9	1.6	0.5	-1.2
Gross issuance	*2.6*	*4.3*	*2.8*	*3.5*	*2.4*	*1.3*
Repayments	*1.5*	*2.8*	*1.9*	*2.0*	*2.0*	*2.6*
Commercial paper						
Net issuance	0.0	-0.6	-0.8	-0.4	0.5	0.1
Gross issuance	*4.4*	*3.3*	*2.1*	*1.1*	*3.0*	*2.0*
Repayments	*4.4*	*3.9*	*2.8*	*1.5*	*2.6*	*1.8*

(a) Averages of monthly flows of sterling and foreign currency funds. Due to rounding, net issuance may not equal gross issuance minus repayments. Data are non seasonally adjusted.
(b) Includes stand alone and programme bonds.

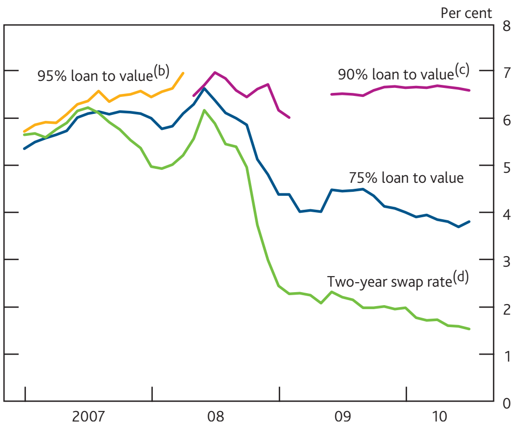
Chart 1.16 Loans to small businesses[(a)]



Sources: British Bankers' Association and Bank calculations.

(a) Term lending and overdraft borrowing provided by seven major UK lenders to UK commercial businesses with an annual bank account turnover of up to £1 million.

Chart 1.17 Two-year fixed quoted mortgage rates and swap rates[(a)]



Sources: Bank of England and Bloomberg.

(a) Sterling only. The Bank's quoted interest rate series comprise of data from up to 30 UK monetary financial institutions. End-month rates. Non seasonally adjusted.
(b) Series finishes in April 2008, as thereafter only two or fewer products have been offered.
(c) Series is only available on a consistent basis back to May 2008, and is not published for March-May 2009 as only two or fewer products were offered in that period.
(d) Monthly averages of daily data.

finance from the capital markets in 2010 Q2 than in Q1, and considerably less than the quarterly average in 2009. That was driven largely by the weakness of net corporate bond issuance (**Table 1.A**). Turbulence in financial markets, and the higher cost of issuing in capital markets (Section 1.1), are likely to have reduced issuance somewhat. But market contacts also reported that the weakness of bond issuance in part reflected the strength last year, which meant that some corporates had already funded themselves. Moreover, recent data from Dealogic suggest that gross corporate bond issuance by UK PNFCs picked up sharply in July.

Small companies are likely to be relatively more dependent on bank finance, as it is harder for them to access capital markets. Credit conditions for small businesses remained tighter than for larger companies, judging by evidence in the *Credit Conditions Survey* and reports from the Bank's Agents. The stock of loans to small businesses fell on a year earlier in 2010 Q2, according to the British Bankers' Association (**Chart 1.16**), although that is, in part, likely to have reflected weak demand for credit.

Household credit conditions

The total stock of loans to individuals was broadly unchanged in 2010 Q2. That reflected pronounced weakness in the growth of the stock of both loans secured on dwellings and consumer credit relative to their historic averages.

In contrast to the reported increases in corporate credit availability, lenders responding to the *Credit Conditions Survey* reported little significant change in the availability of secured credit to households, and a further slight deterioration in unsecured credit availability over the past year (**Chart 1.13**). Lenders reported that they expected secured household credit availability to worsen over the next three months in the 2010 Q2 *Survey*, in part reflecting expectations that wholesale funding conditions would tighten over that period.

Recent developments in the mortgage market suggest that lenders have tightened the availability and raised the cost of higher-risk loans. For example, the Financial Services Authority's *Product Sales Database* suggests that the share of high loan to value (LTV) lending fell over the year to 2010 Q1. And the spread between higher and lower-LTV mortgage rates has remained much wider than its pre-crisis level (**Chart 1.17**) — a time when lenders did not appear to be discriminating markedly between borrowers with different risk profiles.

Housing market activity has stabilised around recent low levels, with volumes of transactions and mortgage approvals broadly unchanged over 2010 H1 (**Table 1.B**). Some forward-looking indicators have, however, weakened. For example, survey evidence from the Royal Institution of Chartered Surveyors (RICS) and the Home Builders Federation (HBF) suggests that new buyer enquiries relative to new seller

Table 1.B Housing market indicators[(a)]

	Averages[(b)] since 2000	2010 Q1	Apr.	May	June	July
Activity						
Property transactions (000s)[(c)]	104	72	79	70	76	n.a.
Mortgage approvals (000s)[(d)]	93	48	50	49	48	n.a.
RICS sales to stock ratio[(e)]	0.38	0.27	0.28	0.27	0.25	n.a.
RICS new buyer enquiries[(f)]	-2	-4	9	8	-5	n.a.
RICS new instructions[(f)]	3	10	11	22	27	n.a.
HBF net reservations[(g)(h)]	-5	11	9	-9	-15	n.a.
HBF site visits[(g)(h)]	-14	-4	-14	-19	-19	n.a.
Prices[(i)]						
Halifax[(j)]	0.6	-0.1	-0.1	-0.5	-0.6	0.6
Nationwide	0.6	0.4	1.1	0.4	0.0	-0.5
Average of lenders' indices	0.6	0.2	0.5	0.0	-0.2	0.1
Communities and Local Government	0.6	0.9	0.4	0.7	n.a.	n.a.
Land Registry	0.6	0.8	0.2	0.2	0.1	n.a.

Sources: Bank of England, Communities and Local Government, Halifax, Her Majesty's Revenue and Customs, Home Builders Federation, Land Registry, Nationwide, Royal Institution of Chartered Surveyors and Bank calculations.

(a) Averages of monthly data. All series are net percentage balances unless otherwise stated.
(b) Except for property transactions, which is an average since April 2005, and Communities and Local Government house prices, which is an average since March 2002.
(c) Number of residential property transactions with value £40,000 or above.
(d) Loan approvals for house purchase.
(e) Ratio of sales recorded over the past three months relative to the level of stock on estate agents' books at the end of the month.
(f) Compared with the previous month.
(g) Compared with a year earlier.
(h) Seasonally adjusted by Bank staff.
(i) Growth on a month earlier.
(j) The published Halifax index has been adjusted in 2002 by Bank staff to account for a change in the method of calculation.

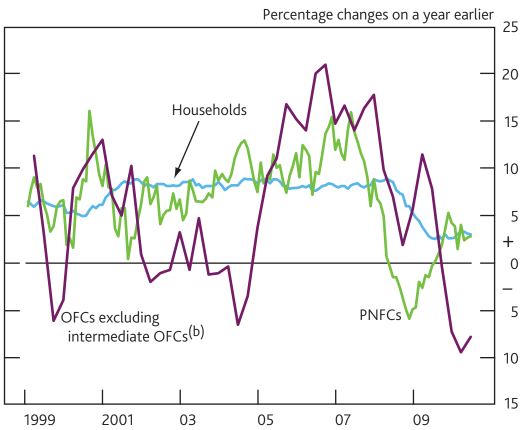
Table 1.C Broad money and bank credit[(a)]

Percentage changes on a year earlier

	Averages[(b)] 1997–2008	2009 Q3	2009 Q4	2010 Q1	2010 Q2
Broad money	7.9	1.9	0.9	0.9	0.9
Bank credit	10.1	0.4	1.5	1.8	-0.2

(a) The series are constructed using headline M4 and M4 lending (excluding securitisations) growth prior to 1998 Q4, and M4 and M4 lending (excluding securitisations) growth excluding the deposits of and lending by intermediate other financial corporations (OFCs) thereafter. Intermediate OFCs are: mortgage and housing credit corporations; non-bank credit grantors; bank holding companies; and those carrying out other activities auxiliary to financial intermediation. Banks' business with their related 'other financial intermediaries' is also excluded, based on anecdotal information provided to the Bank of England by several banks. Data are non seasonally adjusted.
(b) Averages of quarterly data.

Chart 1.18 Sectoral broad money[(a)]



(a) Monthly data, unless otherwise specified.
(b) Based on quarterly data. For the definition of intermediate OFCs see footnote (a) in **Table 1.C**. Data are non seasonally adjusted.

instructions for all types of property, and the number of site visits and reservations for new homes have fallen. The average of the Halifax and Nationwide price indices has been broadly stable over recent months (**Table 1.B**).

1.4 Money

The four-quarter growth rates of broad money and bank credit remained extremely weak in 2010 Q2 relative to recent averages (**Table 1.C**). Those trends reflect, in part, the severe monetary squeeze precipitated by the financial crisis: as banks tightened the supply of credit, fewer loans have been advanced, reducing deposit growth.

The weakness in the four-quarter growth rate of broad money stands in contrast to a significant increase in seasonally adjusted money holdings in 2010 Q2. But that recent strength may be misleading, as it is possible that there has been a change in the pattern of seasonal variation in the deposits of financial corporations.[(1)] Alternative methods of seasonal adjustment that take account of that issue point to weaker quarterly growth in 2010 Q2 but stronger growth in 2009 Q4. To the extent that the four-quarter growth rate is not affected by those uncertainties, the continuing weakness of money on a year earlier may be more informative about underlying trends.

The weakness in recent data has been driven by the running down of deposits by non-bank financial institutions (**Chart 1.18**). That may, in part, reflect the strength of UK banks' net long-term debt and equity issuance over the past year: when purchased by non-bank investors, such issuance will bear down on their deposits, as well as on aggregate broad money. Household and PNFC broad money growth also remained weaker than their recent averages (**Chart 1.18**).

(1) As set out in the June 2010 'Sectoral breakdown of aggregate M4 and M4 lending' *Bank of England Statistical Release*, the seasonal adjustment method currently in use for these data is under review.

2 Demand

The recovery in UK demand continued in the first half of 2010. GDP increased by 0.3% in 2010 Q1 and is provisionally estimated to have increased by 1.1% in Q2. Growth in the first quarter was driven by a sharp increase in business investment and a boost from stockbuilding. But net trade reduced growth substantially. The June *Budget* contained a number of announcements on government expenditure and receipts and embodied a somewhat faster and larger reduction in public sector net borrowing than that contained in the March *Budget*. The recovery in the world economy continued, but downside risks remain, particularly in some of the United Kingdom's largest export markets.

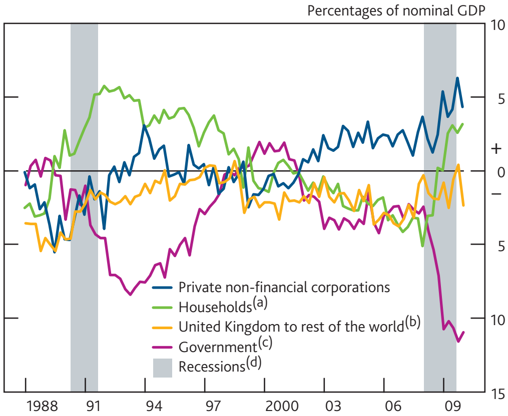
Table 2.A Expenditure components of demand[(a)]

Percentage changes on a quarter earlier

	Averages		2009		2010
	1997–2008	2009 H1	Q3	Q4	Q1
Household consumption[(b)]	0.7	-0.9	-0.3	0.6	-0.1
Government consumption	0.6	-0.4	0.6	0.1	1.5
Investment	0.9	-7.4	3.0	-1.7	4.5
of which, business investment	*1.2*	*-10.5*	*-0.4*	*-3.6*	*7.8*
of which, dwellings investment[(c)]	*0.3*	*-5.7*	*1.7*	*-5.8*	*-2.4*
Final domestic demand	**0.7**	**-1.8**	**0.4**	**0.2**	**0.9**
Change in inventories[(d)(e)]	0.0	0.0	0.0	0.2	0.6
Alignment adjustment[(e)]	0.0	0.2	-0.4	0.3	-0.3
Domestic demand	**0.7**	**-1.6**	**-0.1**	**0.6**	**1.2**
'Economic' exports[(f)]	0.9	-4.7	0.6	4.0	-1.7
'Economic' imports[(f)]	1.2	-5.1	1.2	4.4	1.6
Net trade[(e)(f)]	-0.1	0.2	-0.2	-0.2	-0.9
Real GDP at market prices	**0.6**	**-1.5**	**-0.3**	**0.4**	**0.3**

(a) Chained-volume measures.
(b) Includes non-profit institutions serving households.
(c) Whole-economy dwellings investment.
(d) Excludes the alignment adjustment.
(e) Percentage point contributions to quarterly growth of real GDP.
(f) Goods and services, excluding the estimated impact of missing trader intra-community (MTIC) fraud.

Chart 2.1 Financial balances by sector



(a) Includes non-profit institutions serving households.
(b) Net lending by the United Kingdom to the rest of the world is equivalent to the sum of the current and capital accounts of the balance of payments.
(c) Excludes public corporations.
(d) Recessions are defined as at least 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.

GDP rose by 0.3% in Q1. That reflected a 1.2% increase in domestic demand driven, in large part, by a sharp increase in business investment and a reduction in the pace of de-stocking (**Table 2.A**). Net trade reduced growth substantially in 2010 Q1. The latest set of National Accounts contained revisions to GDP and its components as part of the ONS's annual *Blue Book* process. Those revisions are discussed in the box on page 19. GDP was provisionally estimated by the ONS to have increased by 1.1% in 2010 Q2.

Financial balances have moved sharply over the past two years (**Chart 2.1**). Government net borrowing has risen significantly and at the same time households and private non-financial companies have increased their saving net of investment. A major fiscal consolidation is in prospect and, as public sector net borrowing declines, offsetting adjustments will need to take place in the financial balances of other sectors. Those adjustments are likely to have implications for consumption and investment (Section 2.1) and UK net trade (Section 2.3). Net trade will depend, in part, on developments in the world economy. The world economy has continued to recover but downside risks remain, particularly in some of the United Kingdom's largest export markets (Section 2.2).

2.1 Domestic demand

Nominal demand

Monetary policy affects inflation through its impact on nominal demand. Nominal demand fell sharply during the recession but increased at close to its ten-year average growth rate in 2009 H2. Growth picked up further in 2010 Q1, to its highest rate since before the start of the financial crisis. Much of that growth reflected increases in the GDP deflator; growth in real activity remained subdued (**Chart 2.2**).

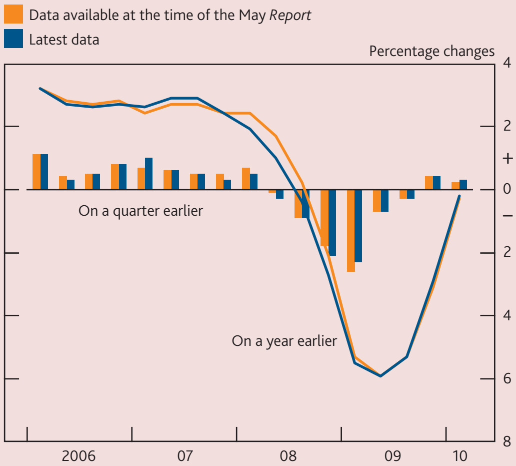
Revisions to the National Accounts

The ONS publishes GDP estimates on a quarterly basis. These estimates are usually revised over time as additional information becomes available. In addition, the ONS conducts a more comprehensive exercise, typically once a year, which improves the quality of the estimates by assimilating a much wider range of information. The results of these exercises are published in the *Blue Book*, which in 2010 included revisions to GDP and its components back to 2006 and for the first time balanced estimates of output, income and expenditure for 2008. The revisions contained in the 2010 *Blue Book* are relatively small.

As a result of the revisions, four-quarter GDP growth is somewhat weaker in 2008 than previous estimates suggested (**Chart A**). The revisions have left the level of GDP in 2009 Q4 0.5% lower than at the time of the May *Report*. But, overall, the broad shape of the recession is little changed.

On the expenditure side of the accounts, final domestic demand was revised down in 2008, with the contributions of consumption and investment to GDP growth both revised down by 0.3 percentage points (**Table 1**). The household saving ratio is now estimated to have been a little higher over 2006–08, but similar in 2009.

Chart A GDP at market prices(a)



(a) Chained-volume measures.

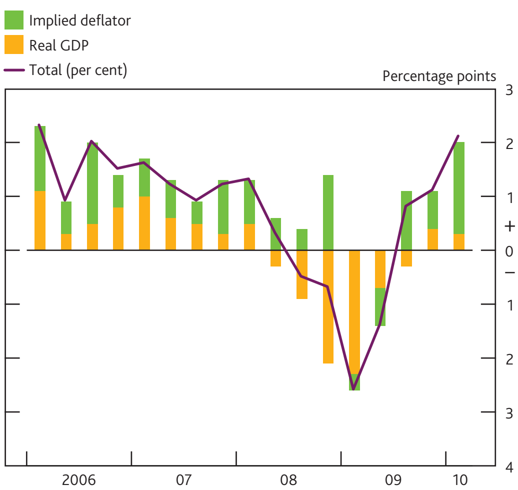
Table 1 Revisions to GDP, selected expenditure components and the household saving ratio since the May *Report*(a)

Percentage points

	2006	2007	2008	2009	Cumulative change in level since 2005 Q4 (per cent)
GDP(b)	-0.1	0.1	-0.6	0.0	-0.5
Household consumption(c)	0.2	0.0	-0.3	-0.1	-0.2
Government consumption	0.0	0.0	-0.2	-0.2	-3.0
Investment	0.0	0.0	-0.3	0.0	-0.7
'Economic' exports(d)	0.0	0.1	0.0	0.0	0.2
'Economic' imports(d)	0.1	0.0	-0.2	-0.1	-1.2
Net trade(d)	-0.2	0.1	0.2	0.1	n.a.
Household saving ratio(e)	0.5	0.4	0.5	0.0	n.a.

(a) Percentage point revisions to contributions to calendar-year GDP growth at market prices (chained-volume measures), unless otherwise stated.
(b) Percentage point revisions to calendar-year GDP growth at market prices.
(c) Including non-profit institutions serving households.
(d) Excluding the estimated impact of MTIC fraud.
(e) Percentage point revisions to the household saving ratio, which is measured as savings as a percentage of households' total post-tax income (not adjusted to account for the impact of Financial Intermediation Services Indirectly Measured (FISIM)).

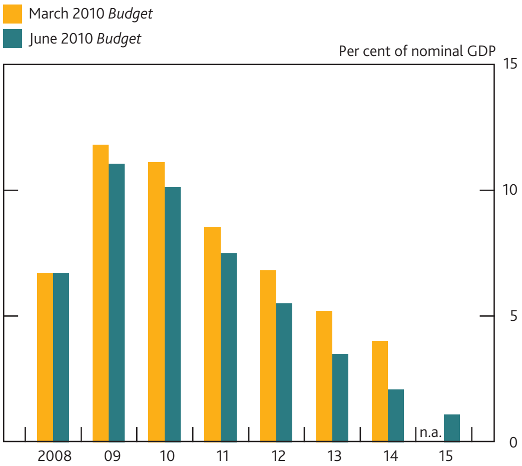
Chart 2.2 Contributions to quarterly growth in nominal GDP(a)



(a) At market prices. Contributions may not sum to total due to rounding.

It is difficult to judge what that strength in nominal demand implies for the outlook. The data may indicate that demand for UK output has increased in recent quarters, but that the boost to the volume of goods and services sold has been limited by temporarily high rates of price inflation: for example, some of the rise in the deflator in 2010 Q1 is likely to reflect the restoration of the standard rate of VAT to 17.5%. In that case, stronger nominal spending growth may persist. But there are other possibilities. For example, nominal spending growth may have been boosted by higher prices, if households and companies took time to reduce their purchases of goods and services as inflation rose. In that case, as households and companies adjust, it is possible that nominal demand growth will fall back. The strength in the GDP deflator is discussed in Section 4. The remainder of this section considers developments in real activity.

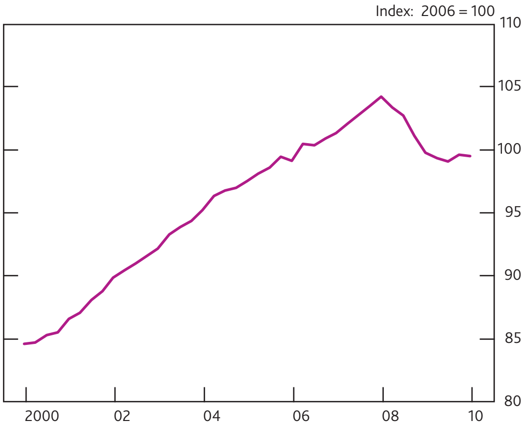
Chart 2.3 Public sector net borrowing[(a)]



Sources: HM Treasury, Office for Budget Responsibility and ONS.

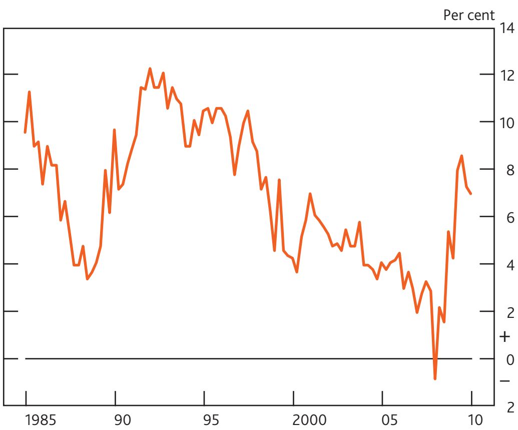
(a) The chart shows financial year net borrowing excluding the temporary effects of financial interventions. The 2008 bars are data outturns. The 2009 bars are an estimate in the March *Budget* and a data outturn in the June *Budget*. All other bars are projections. There was no projection for 2015/16 in the March *Budget*.

Chart 2.4 Household consumption[(a)]



(a) Chained-volume measure. Includes non-profit institutions serving households.

Chart 2.5 Household saving ratio[(a)]



(a) Percentage of household post-tax income (not adjusted to account for the impact of FISIM).

Government spending and fiscal policy

The UK economy faces a significant fiscal consolidation. As discussed in the box on page 21, that is to be achieved primarily through reduced public sector expenditure — which includes spending on goods and services, benefit payments and employee costs — as a share of GDP, with higher taxes playing a smaller role. The measures announced in the June *Budget* are projected to lead to a somewhat faster and larger reduction in the deficit in coming years than projected in the March *Budget* (**Chart 2.3**).

The direct impact of the fiscal consolidation is likely to have some dampening effects on demand. Some households' disposable income is likely to be reduced or grow more slowly as a result of the consolidation, and some companies are likely to face lower public sector demand for their goods and services. But those effects may be offset, to some degree, if the consolidation improves investor confidence and reduces the risk of a significant rise in long-term interest rates.

Recent household spending data

Household consumption fell by 0.1% in 2010 Q1, following a rise of 0.6% in 2009 Q4. That pattern is likely to reflect, at least in part, the impact of temporary factors including the restoration of the standard rate of VAT to 17.5% at the start of 2010 and the heavy snowfall in January.[(1)] In addition, the car scrappage scheme provided a larger boost to growth in 2009 Q4 than in 2010 Q1. In the absence of those temporary factors, spending growth would probably have been somewhat stronger at the beginning of 2010. Indicators of spending suggest that consumption is likely to have picked up in 2010 Q2.

Influences on consumption

Household spending fell by around 5% during the recession (**Chart 2.4**). Income growth was relatively resilient over that period, so the fall in spending was associated with a sharp rise in the household saving ratio from very low rates (**Chart 2.5**) such that by 2010 Q1 the saving ratio was broadly in line with its historical average. The prospects for consumption growth will depend on a number of influences.

Four-quarter real post-tax labour income growth weakened a little in 2010 Q1 (**Chart 2.6**). Pre-tax labour income growth picked up sharply but, in part, that reflected a strong contribution from bonus payments, which is unlikely to persist (Section 4). And the strength of labour income growth in Q1 was more than offset by weaker net transfers and higher price inflation.

Households have become more pessimistic about the outlook for income in recent months. Surveys suggest that they expect little improvement in their financial situation over the coming twelve months and unemployment expectations have

(1) The box on page 27 of the May 2010 *Report* discusses those influences in more detail.

Fiscal consolidation and measures announced in the June 2010 *Budget*

The UK economy is facing a significant fiscal consolidation over the coming years. The June 2010 *Budget* contained a number of measures on public sector expenditure and receipts which, taken together, are projected to lead to a somewhat faster and larger reduction in public sector net borrowing compared with the plans contained in the March 2010 *Budget*.

The fiscal framework

The Government announced that the fiscal objective is to achieve cyclically adjusted current balance by the end of the rolling five-year forecast period, which in the June *Budget* is 2015/16. That has been supplemented by a target to achieve falling public sector net debt as a percentage of GDP at a fixed date of 2015/16. The Government's fiscal policy decisions are to be based on independent forecasts for the economy and the public finances produced by the Office for Budget Responsibility.

Fiscal consolidation

In the June *Budget*, public sector net borrowing was projected to decline from around 11% of GDP in 2009/10 to around 1% of GDP in 2015/16. Public sector expenditure, as a share of GDP, was projected to fall by around 8 percentage points over that period. And current receipts, as a share of GDP, were expected to rise by around 2 percentage points (**Table 1**).

Table 1 *Budget* projections for public sector current receipts and expenditure(a)

Percentages of nominal GDP

	2009	2010	2011	2012	2013	2014	2015
Public sector current receipts							
June *Budget*	36.6	37.2	38.0	38.4	38.7	38.8	38.7
March *Budget*	36.1	36.9	38.0	38.3	38.4	38.3	n.a.
Total managed expenditure							
June *Budget*	47.5	47.3	45.5	43.9	42.2	40.9	39.8
March *Budget*	47.9	48.1	46.5	45.0	43.5	42.3	n.a.

Sources: HM Treasury and Office for Budget Responsibility.

(a) Public sector expenditure excludes the temporary effects of financial interventions. Data are for financial years.

The measures announced in the June *Budget* are projected to lead to a somewhat faster and larger reduction in public sector net borrowing compared with the March *Budget*. As well as accounting for the majority of the overall projected decline in net borrowing, reductions in expenditure also account for the majority of the downward revisions to the projections since the March *Budget*. The share of expenditure is expected to be 1.4 percentage points lower by 2014/15 with current receipts projected to be 0.5 percentage points higher (**Table 1**).

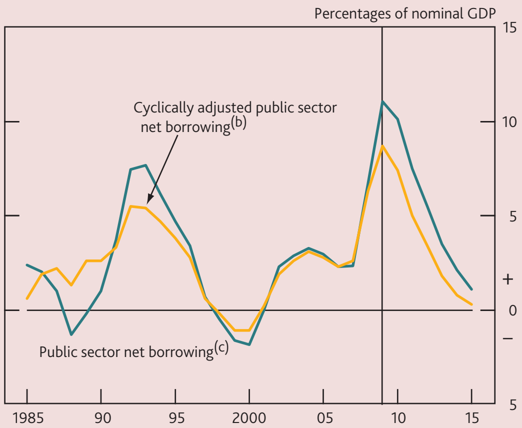
Tax and total managed expenditure measures announced in the June *Budget*

The main measures included an increase in the standard rate of VAT to 20% from January 2011. That increase will add to CPI inflation for a period (Section 4). On the expenditure side, benefits, tax credits and public sector pensions are to be indexed to the CPI rather than RPI from 2011/12 and public sector pay is to be frozen for two years from 2011/12 except for those earning less than £21,000 a year. Further details on how the fiscal consolidation is to be achieved are expected to be published in the *Spending Review* on 20 October 2010.

The projected consolidation and the consolidation in the 1990s

While large by historical standards, the projected decline in public sector net borrowing between 2009/10 and 2015/16, at around 10 percentage points of GDP, is broadly similar in size to the decline in the 1990s, although the peak in borrowing in the early 1990s was significantly lower (**Chart A**). And the projected decline in cyclically adjusted public sector net borrowing, which takes account of the stage of the economic cycle, is around 2 percentage points larger than the estimated decline in the 1990s.

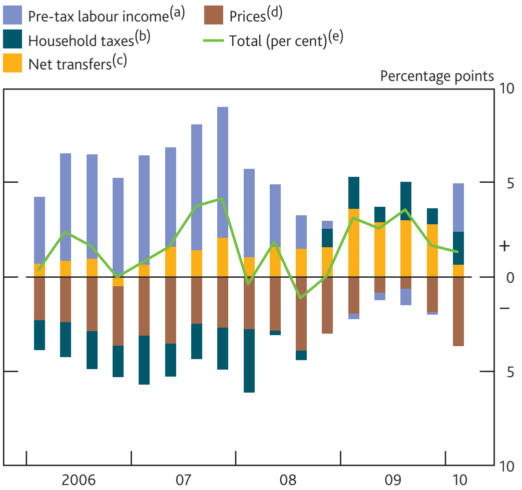
Chart A Public sector net borrowing(a)



Sources: HM Treasury, Office for Budget Responsibility and ONS.

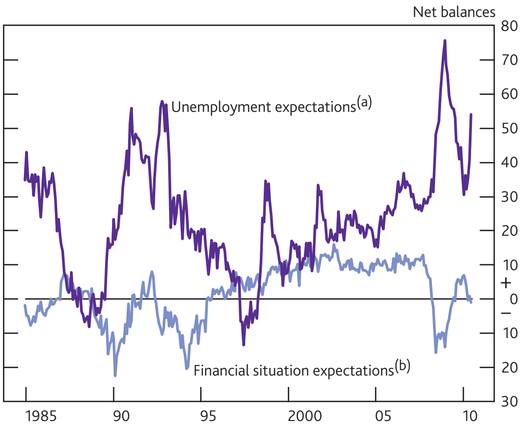
(a) Measures exclude the temporary effects of financial interventions. Data are for financial years. Observations to the right of the vertical line are projections.
(b) Cyclically adjusted net borrowing is based on the Office for Budget Responsibility's view of trend output from 2009 Q4 onward, and HM Treasury's estimates prior to that.
(c) Projections for public sector net borrowing come from the Office for Budget Responsibility's *Budget Forecast*. Data for 2009/10 and earlier are based on ONS data.

Chart 2.6 Contributions to four-quarter growth in real post-tax labour income



(a) Wages and salaries plus mixed income.
(b) Household taxes include income tax and Council Tax.
(c) General government benefits minus employees' National Insurance contributions.
(d) Calculated as a residual.
(e) Nominal post-tax labour income divided by the consumer expenditure deflator (including non-profit institutions serving households).

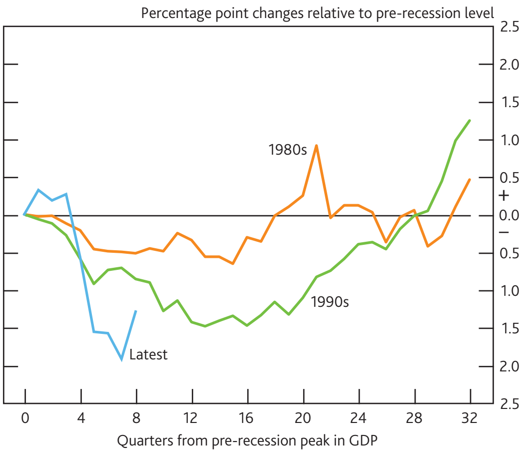
Chart 2.7 Survey measures of households' expectations of unemployment and their financial situation



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

(a) The question asks how households expect the number of people unemployed to change over the next twelve months. A positive balance means households expect unemployment to rise.
(b) The question asks how households expect their financial situation to change over the next twelve months. A positive balance means households expect their financial situation to improve.

Chart 2.8 Business investment to GDP ratio(a)



(a) Chained-volume measures. Recessions are defined as in footnote (d) of **Chart 2.1**.

risen sharply in recent months, having fallen through 2009 (**Chart 2.7**).

Fiscal tightening could weigh on household spending growth through a number of channels. The increase in the standard rate of VAT to 20% in January 2011 will reduce households' purchasing power, although some households may bring forward spending into 2010, providing a temporary boost to consumption. The freeze on public sector pay and the prospective reductions in public sector employment will reduce the income of some households. Income is also likely to be affected by slower growth in benefit payments. But there is considerable uncertainty about how households will respond to the consolidation, and so the size of the impact on spending. For example, some households may have already adjusted their spending in anticipation of the fiscal tightening. Section 5 discusses the impact of the fiscal consolidation on households.

Tight credit conditions and concerns over debt could weigh on spending. Household credit conditions are significantly tighter now than they were prior to the financial crisis, and that could constrain some households' ability to maintain consumption in the face of falls in income. In addition, some households' concerns about their debt levels may have risen, given lower house prices and therefore lower housing equity: that may lead them to increase their saving or reduce their borrowing.

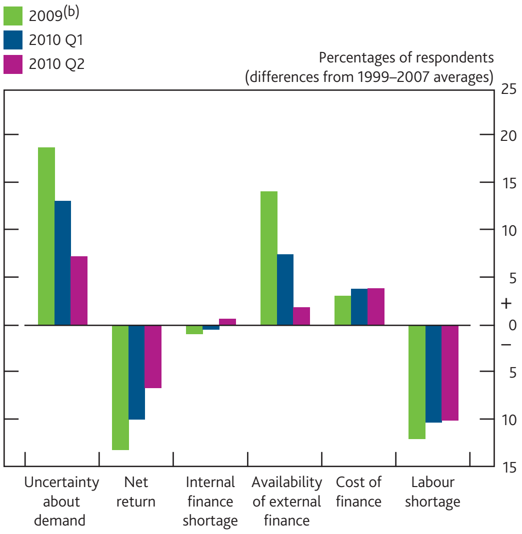
Consumption will, however, be supported by the accommodative stance of monetary policy, which will boost the disposable income of some households. And spending may also be supported by the past recovery in equity prices, which have risen significantly since their troughs in early 2009. Overall, it is likely that consumption will grow at a modest rate in coming quarters. But uncertainty about the outlook remains.

Investment

Business investment, which accounts for roughly 60% of total investment, is reported to have increased by around 8% in 2010 Q1. But it remained around 18% below its pre-recession level and the cumulative fall has been large relative to those in past recessions (**Chart 2.8**). Some of that weakness in investment may have reflected the increased cost of imported plant and machinery, following sterling's depreciation. But it is also likely to have reflected weak demand for companies' output, tight credit conditions and heightened uncertainty. Developments in those factors will determine the strength of the recovery.

Responses to business surveys suggest that the demand outlook has become less of a constraint on investment plans in 2010 H1, although it is expected to continue to weigh on spending (**Chart 2.9**). And given the extent of spare capacity, many companies may be able to expand output without the need for significant investment. Consistent with that, reports

Chart 2.9 Factors likely to hold back investment(a)



Sources: CBI, CBI/PwC and ONS.

(a) Measures weight together sectoral surveys (manufacturing, financial services, consumer/business services) using shares in real business investment. Companies are asked for their twelve-month forecast of factors likely to limit capital expenditure authorisations. Financial services companies are not asked to distinguish between a shortage of internal and availability of external finance, so their single response is used for both questions.
(b) Average of the responses to the four surveys carried out in 2009.

Table 2.B Surveys of investment intentions (plant and machinery)(a)

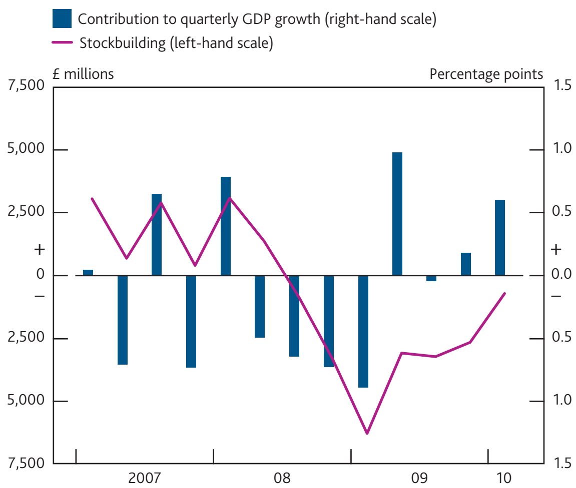
Net percentage balances

	Averages		2009		2010	
	1999–2007	2008	H1	H2	Q1	Q2
Manufacturing						
BCC	11	-3	-34	-10	-6	7
CBI	-15	-34	-40	0	1	2
Services						
BCC	16	-4	-20	-6	-5	2
CBI	-6	-24	-46	-22	-15	-14

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

(a) Net percentage balances of companies who say they have increased planned investment in plant and machinery over the past three months (BCC), or revised up planned investment in plant and machinery over the next twelve months (CBI). BCC data are non seasonally adjusted and cover the manufacturing and services sectors. CBI data cover the manufacturing, financial, retail and consumer/business services sectors. The CBI services surveys are weighted together using shares in real business investment.

Chart 2.10 Stockbuilding(a)



(a) Chained-volume measures. Excluding the alignment adjustment.

from the Bank's Agents suggest that investment remains focused on improving efficiency, reducing costs and replacing assets, rather than expanding capacity.

In 2010 Q2, fewer survey respondents cited the availability of external finance as a constraint on investment than in 2009. But the cost and availability of finance remain more of a constraint than in the years before the financial crisis (**Chart 2.9**). The availability of bank finance to the corporate sector has been improving for some time, although the pace of improvement eased in 2010 Q2 and conditions remain tight compared with pre-financial crisis levels (Section 1). So as demand recovers and more companies attempt to access finance to fund investment, it remains possible that bank credit could become more of a widespread constraint again.

Some companies will be able to fund investment by raising finance in capital markets, however. That is likely to be easier for larger companies, which account for the majority of investment spending. In addition, many companies tend to fund investment from internal finance. Private non-financial companies have been running a substantial financial surplus for a number of years, and this increased further during the recession (**Chart 2.1**). That means many companies may have funds available to finance investment should they wish to do so.

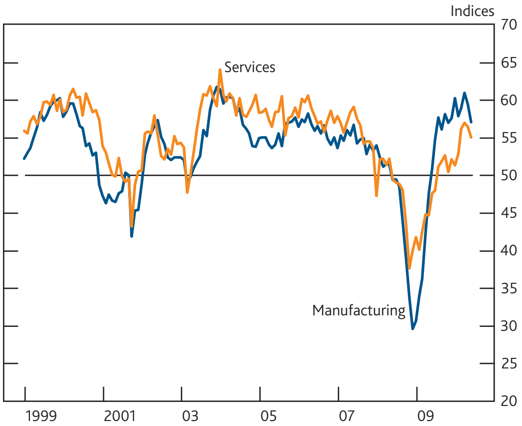
Investment projects are often difficult and costly to reverse, so heightened uncertainty may have led some companies to delay spending. Uncertainty has probably dissipated somewhat since the height of the financial crisis. But some businesses may remain unsure about growth prospects in key export markets, or about the impact of the UK fiscal consolidation on the demand for their goods and services.

Surveys of investment intentions have improved markedly since 2009 H1, particularly in the manufacturing sector (**Table 2.B**). But service sector balances remain below their historical averages. Overall, surveys suggest a relatively subdued outlook for business investment. And reports from the Bank's Agents are consistent with a gentle recovery in investment rather than robust growth.

Stockbuilding

Stockbuilding contributed 0.6 percentage points to GDP growth in 2010 Q1 (**Chart 2.10**). Stockbuilding has provided considerable support to growth over the past year as the pace of de-stocking has eased. It is likely that de-stocking will come to an end in coming quarters, providing a further small contribution to growth. But it is difficult to judge what level of stocks, relative to output, companies will want to hold in future. The stock-output ratio remains below its pre-recession level. Companies may want to operate with that lower stock-output ratio indefinitely. But should they decide to return to a higher ratio, that would provide further support to growth.

Chart 2.11 Survey measures of global output growth(a)



Sources: JPMorgan Chase & Co. and Markit Economics.

(a) Based on the results of surveys in 29 countries. These countries account for an estimated 84% of global GDP. A figure over 50 indicates rising output compared with the previous month, and a figure below 50 indicates falling output. The services balance is business activity and the manufacturing balance is output.

Table 2.C Euro-area survey measures of consumer confidence, manufacturing output and services business activity

	Averages(a)				
	1999–2008	2009	2010		2010
			Q1	Q2	July
Consumer confidence	-10	-25	-17	-17	-14
Services business activity(b)	54.3	46.8	52.8	55.8	55.8
Manufacturing output(b)	53.4	44.6	57.6	58.4	58.7

Sources: European Commission and Markit Economics.

(a) Averages of monthly data.
(b) A figure above 50 indicates rising business activity/output compared with the previous month, and a figure below 50 indicates falling business activity/output.

2.2 External demand

The world economy has continued to recover although surveys suggest that world growth has softened a little (**Chart 2.11**). The recovery has been uneven across countries and downside risks remain, particularly in some of the United Kingdom's key export markets.

The euro area

In early May, the European Council and Member States in conjunction with the IMF and ECB announced a package of support measures aimed at alleviating the problems some euro-area countries faced in financing their deficit and debt (Section 1). Although yields on some euro-area countries' sovereign debt subsequently fell back, they remain elevated relative to their levels at the beginning of 2010, suggesting that market concerns about fiscal positions persist. Those concerns also led to a tightening in funding conditions for euro-area banks, although conditions have improved somewhat in recent weeks. Perhaps related to the initial deterioration in funding markets, the latest ECB survey of bank lending suggests that credit conditions for companies tightened by more in 2010 Q2 than they had in the preceding few quarters.

Euro-area GDP increased by 0.2% in 2010 Q1. Since then, survey indicators of consumer confidence and activity in the manufacturing and service sectors have been broadly stable (**Table 2.C**). That could indicate that market concerns over sovereign debt have, to date, had little impact on the real economy, although it is possible that these measures would have been stronger in the absence of financial market uncertainty. But risks to the outlook remain. For example, some countries have announced measures to cut their fiscal deficits. That could dampen growth prospects but, as in the United Kingdom, their impact on demand will depend on the private sector response.

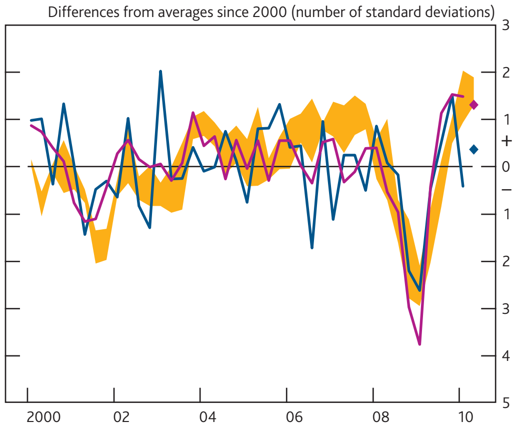
The United States

The US recovery has continued, but some indicators point to a slackening in the pace of growth. US GDP increased by 0.6% in 2010 Q2 following growth of 0.9% in Q1. Part of the recovery has reflected a temporary boost from stockbuilding. But final domestic demand has also increased in recent quarters. To some extent, that is likely to have reflected a temporary stimulus from fiscal policy. The outlook will depend, in part, on the evolution of the labour market. Although unemployment edged down in June, it remains elevated: that may act as a drag on consumer spending in coming months. In addition, the housing market remains depressed and that too could weigh on consumption.

Asia

Activity continued to expand strongly in many parts of Asia. Japanese GDP rose by 1.2% in 2010 Q1, the second successive

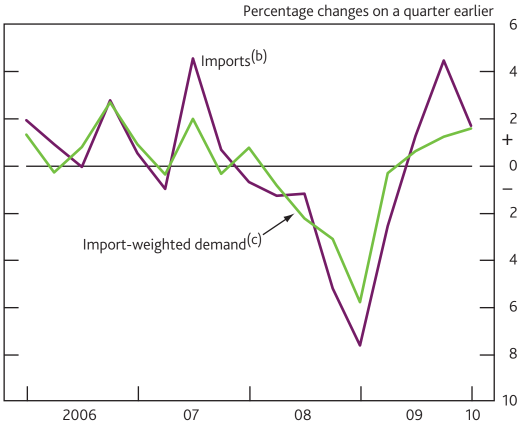
Chart 2.12 UK goods exports, surveys of export orders and world imports of goods(a)



Sources: BCC, CBI, CIPS/Markit, CPB Netherlands Bureau for Economic Policy Analysis, ONS and Bank calculations.

(a) Data are to 2010 Q2. For UK goods exports and world goods imports the 2010 Q2 data points are estimates based on the three months to May.
(b) Includes measures of manufacturing export orders from BCC, CBI and CIPS/Markit. BCC data are non seasonally adjusted.
(c) Country data are weighted by shares in world imports.
(d) Excluding the estimated impact of MTIC fraud.

Chart 2.13 UK imports and import-weighted demand(a)



Sources: ONS and Bank calculations.

(a) Chained-volume measures.
(b) Excluding the estimated impact of MTIC fraud.
(c) Calculated by weighting household consumption (including non-profit institutions serving households), whole-economy investment (excluding valuables), government spending, stockbuilding (excluding the alignment adjustment) and exports (excluding the estimated impact of MTIC fraud) by their respective import intensities. Import intensities are estimated using the *United Kingdom Input-Output Analytical Tables, 1995*.

quarter of robust growth. A large part of that strength reflected a boost from exports. Four-quarter growth in Chinese GDP was around 10% in 2010 Q2, and four-quarter growth in Indian GDP was around 9% in 2010 Q1. But surveys suggest that the pace of growth in some Asian economies may have slowed in recent months.

2.3 Net trade

Net trade, which is influenced by both demand conditions abroad relative to those in the United Kingdom and by the sterling exchange rate, will be an important determinant of the strength of the UK recovery. Despite a depreciation in the sterling exchange rate of around 25% since mid-2007, net trade is estimated by the ONS to have reduced UK growth in each of the past three quarters, with a particularly large drag in 2010 Q1 (**Table 2.A**).

Mirroring trends in global trade, UK exports rose by almost 5% in the second half of 2009. But they fell by 1.7% in 2010 Q1. Within that, services exports fell by almost 3%, which appears, in large part, to have been related to weakness in financial services. Goods exports fell by 1%. It is likely that some of the weakness in Q1 goods exports was related to the heavy snowfall in January, which disrupted the transportation of some goods; goods exports increased somewhat in the three months to May. Survey data were consistent with a stronger picture in Q1 and are consistent with a significant increase in goods exports in 2010 Q2 (**Chart 2.12**). It is possible that official data may be revised up at some point. But the CIPS survey points to a softening in manufacturing export orders growth in June and July.

UK imports increased by 1.6% in 2010 Q1, broadly in line with the rise in import-weighted demand (**Chart 2.13**). But since the middle of 2009, imports have increased by 7% compared with a 3% increase in weighted demand. The majority of the increase in imports since mid-2009 relates to increased imports of intermediate goods and vehicles, and may be related to the easing in the pace of de-stocking and the car scrappage scheme. But it remains somewhat puzzling that imports have not been weaker given the rise in import prices (Section 4), which should dampen import demand.

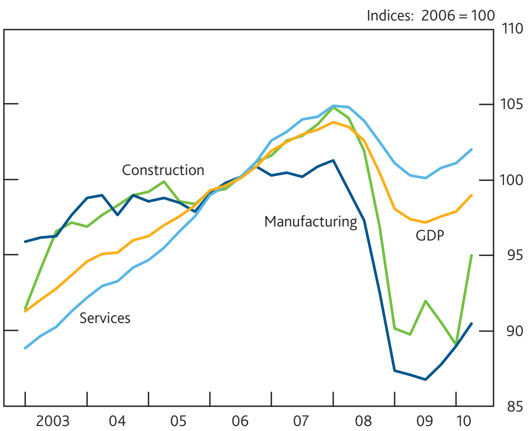
Rebalancing of demand towards UK-produced goods and services will take time. The depreciation has boosted exporters' margins, which over time, should encourage an expansion in supply.(1) And domestic companies may need to build a presence in some of the markets currently supplied by imports.(2) Moreover, current uncertainty about the demand outlook may cause some companies to delay expanding capacity. Section 5 discusses the outlook for net trade.

(1) See the box on page 24 of the February 2010 *Report* for more details.
(2) The box on page 25 of the May 2010 *Report* discusses recent developments in UK imports.

3 Output and supply

Output growth rose sharply in 2010 Q2 to 1.1%, but some of this rise in growth is likely to prove temporary. Employment increased in the three months to May, suggesting that labour market conditions may be starting to improve. The effective supply capacity of the economy is likely to have been impaired by the recession. Nevertheless, there remains a substantial margin of spare capacity, although there are tentative signs that the degree of spare capacity within companies may be starting to shrink.

Chart 3.1 GDP and sectoral output[(a)]



(a) Chained-volume measures. GDP is at market prices. Indices of sectoral output are at basic prices. The chart shows data consistent with the Q2 preliminary GDP release. Production data were subsequently revised.

Table 3.A Survey indicators of output growth

	Averages 1999–2007	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 July
Manufacturing						
BCC[(a)]	13	-10	3	1	30	n.a.
CBI[(b)]	-3	-8	11	1	24	n.a.
CIPS[(c)]	53.3	54.0	57.1	60.5	60.1	58.5
Services						
BCC[(a)]	25	-1	-2	6	12	n.a.
CBI[(b)(d)]	15	-2	-18	0	0	n.a.
CIPS[(c)]	55.7	54.2	56.8	56.4	55.0	53.1
Construction						
CIPS[(c)]	56.5	47.1	46.7	50.1	58.4	54.1

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

(a) Percentage balance of respondents reporting domestic sales to be 'up' relative to 'down' over the past three months. Data are non seasonally adjusted.
(b) Percentage balance of respondents reporting the volume of business to be 'up' relative to 'down' over the past three months.
(c) A reading above 50 indicates increasing business activity/output this month relative to the situation one month ago. Quarterly data are averages of monthly indices.
(d) CBI financial services, business/consumer services and distributive trades surveys are weighted together using nominal shares in value added.

Output growth increased sharply in 2010 Q2, although some of this increase in growth is likely to prove temporary. Averaged across the first half of 2010, growth was close to its long-run average rate (Section 3.1). The recent increase in employment suggests that labour demand may be starting to recover. But there remains a considerable amount of slack in the labour market (Section 3.2). Companies' effective supply capacity is likely to have fallen in the recession. A substantial degree of spare capacity within companies nevertheless remains, although there are signs that it may be starting to close (Section 3.3).

3.1 Output

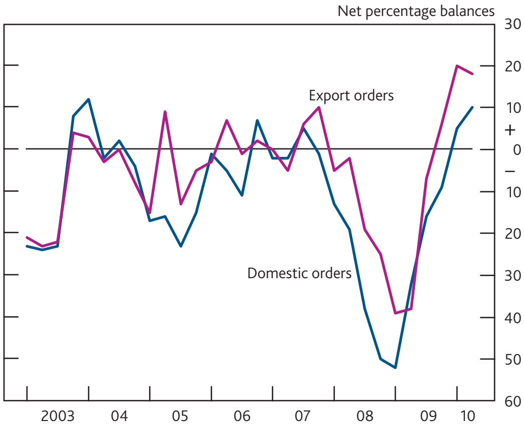
Quarterly GDP growth was provisionally estimated to be 1.1% in 2010 Q2, a substantial increase from 0.3% growth in Q1, and stronger than the MPC's central expectation at the time of the May *Report*. Averaging across the first half of the year, growth was close to its historical average rate, but the level of output remains approximately 5% below its pre-recession peak (**Chart 3.1**).[(1)]

The growth rate in Q2 probably overstates the underlying current strength of the recovery. In particular, construction sector output grew by 6.6% in Q2, contributing 0.4 percentage points to GDP growth. But that rise in part reflected bad weather in January, which depressed output at the start of the year and therefore boosted Q2 growth. The CIPS construction activity index also suggests that construction activity has recovered somewhat, but that index was only slightly higher than its pre-recession average in Q2 (**Table 3.A**).

Manufacturing and service sector output both rose strongly on the quarter. Since the trough in GDP, manufacturing output has grown more strongly than services output (**Chart 3.1**). In part, that may be because manufacturing output fell by more than service sector output during the recession.

(1) The box on page 19 describes recent National Accounts revisions.

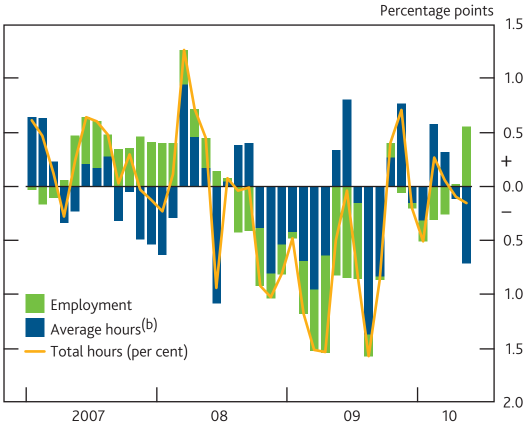
Chart 3.2 Manufacturing domestic and export orders[a]



Source: CBI.

(a) Percentage balance of respondents reporting the volume of orders to be 'up' relative to 'down' over the past three months.

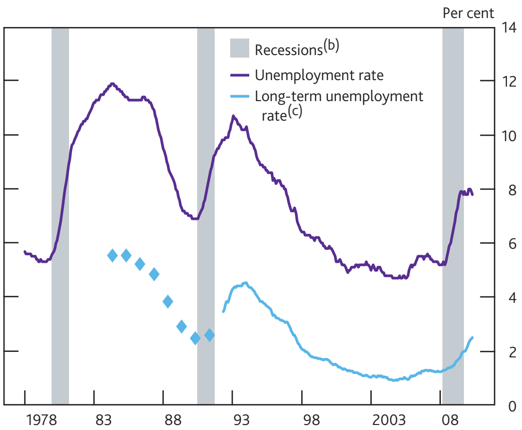
Chart 3.3 Contributions to growth in total hours worked[a]



Source: Labour Force Survey.

(a) Contributions to percentage changes in total hours on previous non-overlapping quarter. Rolling three-month measures.
(b) Average hours are defined as total hours divided by employment.

Chart 3.4 Unemployment rates[a]



Source: ONS (including the Labour Force Survey).

(a) Rolling three-month measures, unless otherwise stated.
(b) Recessions are defined as at least 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.
(c) Defined as those people who have been unemployed for more than twelve months divided by the economically active population. Data prior to 1992 are based on non seasonally adjusted, annual LFS microdata. These annual observations correspond to the March–May quarter.

Two particular factors may be supporting manufacturing output, relative to services, in the recovery. One is the inventory cycle: as inventories are more prevalent in manufacturing than in services, so the boost to growth from the easing in the pace of de-stocking over the past year is likely to have been larger in the manufacturing sector. But that boost to growth will be only temporary. Second, the recovery in exports may also be playing a role. Manufacturing is more export-intensive than services, and surveys suggest that export orders within manufacturing have recovered more strongly than domestic orders (**Chart 3.2**).

GDP growth is likely to slow in Q3. In part, that is because Q2 growth was erratically strong. But there are also signs that underlying growth may be weakening. Business confidence has fallen across a range of surveys and the CIPS/Markit business activity indices fell back across all sectors in July (**Table 3.A**). The index for the service sector is now back below its pre-recession average level. In contrast, the manufacturing output index remains well above its pre-recession average, despite the recent fall.

3.2 Labour demand and supply

Recent developments in employment

The labour market has stabilised in recent quarters, and there are signs of some recovery in employment in the latest data. According to the Labour Force Survey (LFS), employment rose sharply in the three months to May (**Chart 3.3**), increasing by 160,000 compared with the three months to February. Unemployment fell by 34,000 over the same period. The LFS unemployment rate has been relatively flat at around 8% since mid-2009 (**Chart 3.4**).

The size of the recent increase in employment may exaggerate the underlying strength of labour demand. Average hours fell back in the three months to May compared with the previous non-overlapping quarter (**Chart 3.3**), in part because much of the rise in employment reflected an increase in the number of part-time jobs. The fall in average hours broadly offset the rise in employment, so that total hours worked were little changed in the three months to May (**Chart 3.3**).

Other indicators are consistent with the labour market showing signs of improvement. Workforce Jobs rose slightly in Q1, and claimant count unemployment has been falling gradually since November 2009. Most surveys of employment intentions have improved (**Table 3.B**). And the number of vacancies has increased since late 2009, though it remains well below pre-recession levels.

Prospects for employment

The outlook for employment depends crucially on the strength of the recovery in demand. But it also depends on the extent to which companies are able to meet higher demand with

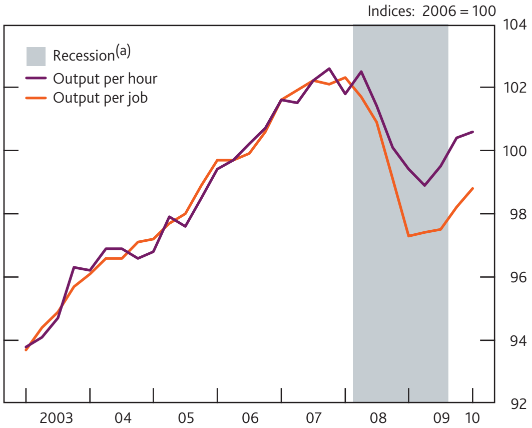
Table 3.B Surveys of employment intentions(a)

	Averages since 1999	2009 Q3	2009 Q4	2010 Q1	2010 Q2
BCC(b)	15	3	3	6	11
CBI(b)	1	-8	-1	-15	1
Agents(c)	0.3	-1.7	-0.8	0.0	0.5
Manpower(b)	11	-1	1	1	1

Sources: Bank of England, BCC, CBI, CBI/PwC, Manpower and ONS.

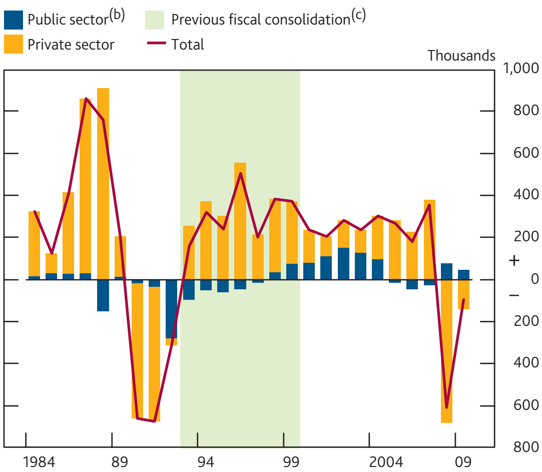
(a) Measures for the Bank's Agents (manufacturing and services), the BCC (manufacturing and services) and the CBI (manufacturing, financial services, business/consumer services) are weighted using employment shares from Workforce Jobs. The BCC data are non seasonally adjusted. The Manpower data cover the whole economy.
(b) Net percentage balance of companies expecting their workforce to increase over the next three months.
(c) End-quarter observation. The scores refer to companies' employment intentions over the next six months.

Chart 3.5 Measures of productivity



(a) Recessions are defined as in **Chart 3.4**.

Chart 3.6 Annual changes in employment(a)



Sources: HM Treasury and ONS (including the Labour Force Survey).

(a) Total employment change is Q2 to Q2. Public sector changes are June to June. The private sector change is defined as the difference between the whole economy and public sector changes. The dates on the chart show the year that the change in employment is from, for example, 1999 represents the change in employment between 1999 Q2 and 2000 Q2. Changes for the year from 2009 Q2 are changes to 2010 Q1 for total employment and to March 2010 for public sector.
(b) Total general government employees (excludes public sector corporations). Prior to 1991 changes in general government employment are estimated using Workforce Jobs data. Changes in public and private sector employment are affected by reclassifications of organisations between the public and private sectors. In particular, the transfer of further education college and sixth-form school employees from the public to the private sector in April 1993 accounts for a significant part of the fall in public sector employment between June 1992 and June 1993.
(c) The fiscal consolidation shown here is defined as the period over which cyclically adjusted public sector net borrowing was falling as a proportion of GDP (1993/94 to 1999/2000). Changes in employment between 1993 Q2 and 2000 Q2 are defined as taking place during the fiscal consolidation.

their existing workforce. As discussed in previous *Reports*, the total fall in employment in the recession was proportionally smaller than the fall in output. That is in part because of cuts in hours. But total hours fell by less than in previous recessions, which may suggest that there has been a greater desire on the part of employers to retain employees with valuable company-specific skills in anticipation of the recovery. In addition, the smaller fall in employment in the recent recession may reflect greater flexibility in real wages than in previous recessions. Developments in wages (Section 4) will continue to influence companies' employment decisions.

As the economy recovers, companies may be able to meet higher demand by raising the hourly productivity of employees retained during the recession, or by increasing their hours worked. ONS data on average hours are probably an imperfect guide to developments in hours worked. But output per hour, as measured by the ONS, is still 2% below its pre-recession peak despite recent rises (**Chart 3.5**). And average hours are estimated to be around 1% lower over the same period, although the rate of decline has eased since late 2009.

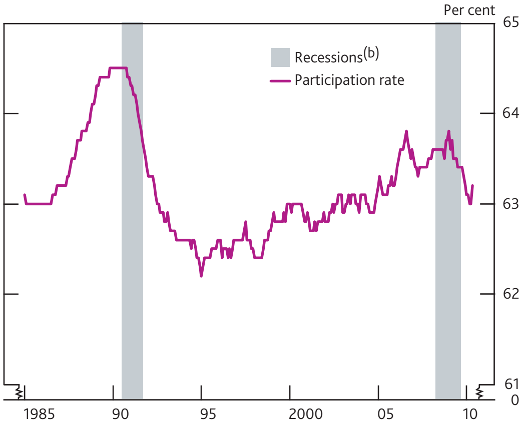
The prospects for employment in the medium term also depend on developments in the public sector. Public sector employment increased somewhat during the recession (**Chart 3.6**), but that support is unlikely to continue. The scale of the prospective fiscal consolidation means that substantial falls in public sector employment are likely: the Office for Budget Responsibility projects that public sector employment will fall by approximately 600,000 between April 2011 and April 2016, with around half of the job losses occurring over the first three years of this period.

The overall impact on employment of a reduction in public sector employment will depend, in large part, on how many new jobs are created in the private sector. But it will also depend on whether those previously employed in the public sector have the skills to fill the vacancies available and whether they are willing and able to move between different regions in order to find work. During the fiscal consolidation in the 1990s, overall employment grew strongly as public sector employment fell — although that followed a sharp decrease in private sector employment in the recession that preceded the consolidation (**Chart 3.6**).

Labour supply

There are a number of channels through which labour supply may have been affected by the recession. A higher level of unemployment may increase competition for the jobs that are available and therefore reduce the likelihood of getting a job for those who are searching. That may discourage some people from participating in the labour market and dissuade migrants from coming to the United Kingdom, although relative unemployment rates across countries may also affect migration. And effective labour supply may fall if extended

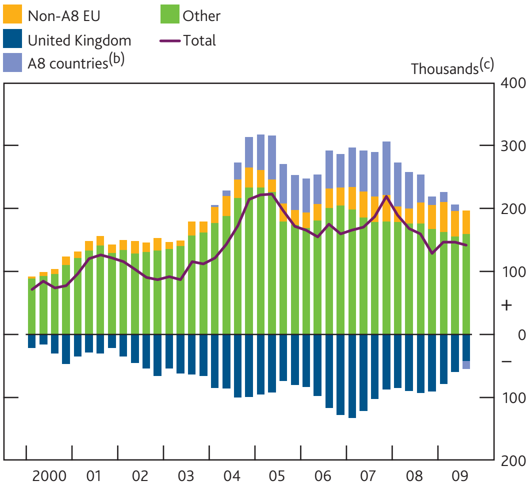
Chart 3.7 Participation rate(a)



Source: ONS (including the Labour Force Survey).

(a) Percentage of the 16+ population. Rolling three-month measure.
(b) Recessions are defined as in **Chart 3.4**.

Chart 3.8 Estimates of long-term net inward migration by citizenship(a)



Source: ONS International Passenger Survey.

(a) Data are non seasonally adjusted. 2009 data are provisional, and are available to 2009 Q3.
(b) Prior to 2004, net inward migration from the A8 is included in the non-A8 EU bar, because the split between net inward migration from A8 and other EU countries is not available. The A8 countries are the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.
(c) Rolling four-quarter sum.

Table 3.C Selected indicators of labour market pressure

	Averages since 1998	2009 Q4	2010 Q1	2010 Q2
Vacancies/unemployed ratio(a)	0.37	0.19	0.19	0.20
Recruitment difficulties				
Agents' scores(b)	0.8	-3.3	-2.8	-1.9
BCC(c)	60	49	43	53
CBI skilled staff(d)	24	14	11	13
CBI unskilled staff(d)	6	1	2	2

Sources: Bank of England, BCC, CBI, CBI/PwC and ONS (including the Labour Force Survey).

(a) Number of vacancies divided by LFS unemployment. Vacancies exclude agriculture, forestry and fishing. The figure for 2010 Q2 is an estimate based on data in the three months to May. Average is since June 2001.
(b) Recruitment difficulties in the most recent three months compared with the situation a year earlier. End-quarter observations.
(c) Recruitment difficulties over the past three months. Non seasonally adjusted. Manufacturing and services balances are weighted by shares in employment.
(d) Averages since 1998 Q4. Balances of respondents expecting skilled and unskilled labour to limit output/business over the next three months (in the manufacturing sector) or over the next twelve months (in the financial, business and consumer service sectors), weighted by shares in employment.

periods of unemployment reduce people's ability to retain or acquire the skills sought by employers.

The participation rate — the number of people working or seeking work, as a percentage of the adult population — fell by 0.7 percentage points over the year to 2010 Q1, but it rose in the three months to May compared with the three months to February (**Chart 3.7**). The fall in participation during the recent recession is much smaller than the decline in the previous recession, although there had also been a much larger increase in participation in the period preceding that recession.

Net inward migration has continued to boost labour supply growth, although it appears to have slowed during the recession (**Chart 3.8**). The slowdown has been primarily related to lower net migration from the A8 Accession countries. The recently announced cap on non-EU migrants may constrain future levels of migration. The number of work visas awarded to skilled non-EU migrants will be limited to 24,100 between July 2010 and April 2011, a reduction of 5% on the previous year. But the temporary cap excludes students and dependents of existing migrants who, according to ONS estimates, accounted for around two thirds of all non-EU migrants arriving in the United Kingdom in 2008.

Long-term unemployment has continued to increase in recent months, but the rate remains lower than in the mid-1980s and early 1990s (**Chart 3.4**). That suggests that the loss of skills in the labour force that can occur following long periods of unemployment may be less than in the aftermath of previous recessions. But long-term unemployment may continue to increase even as the economy recovers.

Labour market tightness

The balance between demand and supply is an important determinant of the degree of inflationary pressure in the economy. The overall extent of spare capacity depends on both the degree of slack in the labour market and on the amount of unused capacity within companies.

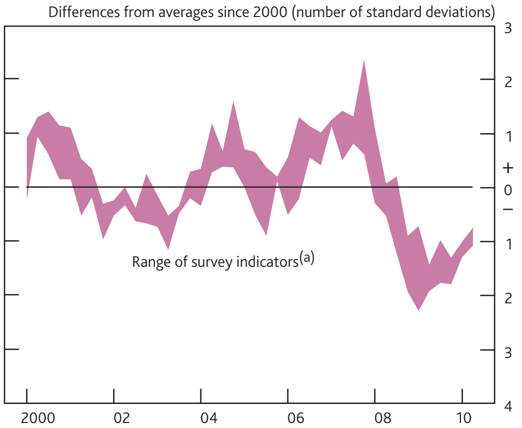
The amount of slack in the labour market increased markedly over the course of the recession. In recent quarters, there has been a modest rise in reported recruitment difficulties in some surveys of labour availability, suggesting that some companies perceive that the degree of slack is lessening (**Table 3.C**). But these survey balances are still below historic averages, as is the ratio of vacancies to unemployment — another measure of labour market slack.

3.3 Capacity pressures and companies' supply capacity

Spare capacity within companies

As with the labour market, survey evidence suggests that a significant degree of spare capacity also opened up within

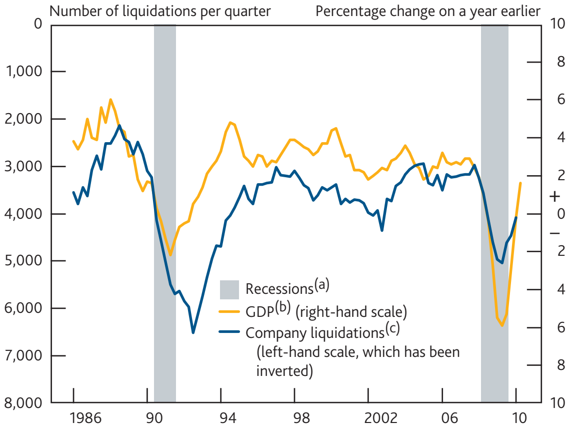
Chart 3.9 Survey measures of capacity utilisation



Sources: Bank of England, BCC, CBI, CBI/PwC and ONS.

(a) Three measures are produced by weighting together surveys from the Bank's Agents (manufacturing and services), the BCC (manufacturing and services) and the CBI (manufacturing, financial services, business/consumer services, distributive trades) using shares in nominal value added. The BCC data are non seasonally adjusted.

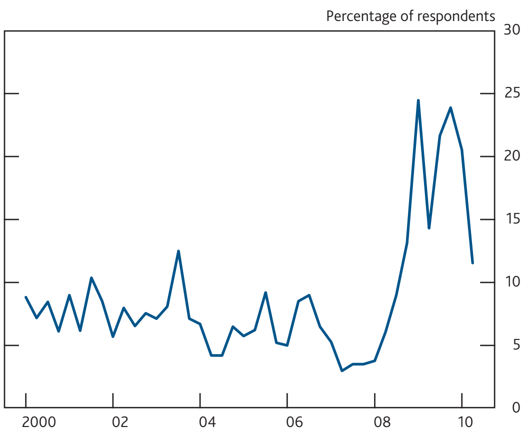
Chart 3.10 Company liquidations in England and Wales and GDP



Sources: The Insolvency Service and ONS.

(a) Recessions are defined as in **Chart 3.4**.
(b) Chained-volume measure at market prices. The latest observation is 2010 Q2.
(c) The latest observation is 2010 Q1. Changes to legislation, data sources and methods of compilation mean the statistics should not be treated as a continuous time series. Since the Enterprise Act 2002, a number of administrations have subsequently converted to creditors' voluntary liquidations. These liquidations are excluded from the headline figures published by The Insolvency Service and excluded from the chart.

Chart 3.11 Credit and finance as a constraint on output[(a)]



Sources: CBI and ONS.

(a) This measure is produced by weighting together balances for the manufacturing sector and the business/consumer service sector using shares in nominal value added. Manufacturing companies are asked: 'What factors are likely to limit output over the next three months?'. Service sector companies are asked: 'What factors are likely to limit your ability to increase the level of business over the next twelve months?'.

companies in the recession (**Chart 3.9**). There are tentative signs that the margin of spare capacity within companies is starting to close as demand recovers, although capacity utilisation remains below historical average rates.

Companies' supply capacity

A number of indicators suggest that companies' effective supply capacity is likely to have fallen during the recession.[(1)] For example, the capacity utilisation rates implied by surveys appear to have fallen by less than implied by the fall in demand alone. But, as supply is not directly observable, the extent of the fall in effective supply is necessarily uncertain.

Effective supply capacity is likely to have been impaired by the impact of tight credit conditions. Restricted access to credit may have made it more difficult or expensive for companies to access the working capital required for day-to-day operations. That could have limited their ability to meet demand and consequently reduced their effective supply capacity. Companies' effective supply capacity will also have fallen if they made temporary reductions in the scale of their operations that are costly to reverse, for example by closing down some production lines.

The lower level of investment (Section 2) will have reduced growth in the capital stock and in turn supply growth. The increase in company liquidations (**Chart 3.10**) may have also led to some capital being scrapped as businesses became insolvent, although liquidations rose by much less than in the early 1990s recession.

There is mixed evidence on recent developments in supply. Corporate liquidations have fallen back (**Chart 3.10**). And fewer companies are currently citing credit as a constraint on output (**Chart 3.11**). But pressures on supply chains — for example difficulties sourcing components — may, in a few sectors, now be affecting some companies' ability to meet demand. Contacts of the Bank's Agents have reported signs of strains in global supply chains in sectors such as automotives and electrical components. Overall, survey evidence that spare capacity within companies closed a little in 2010 H1 (**Chart 3.9**) suggests that supply may be currently growing more slowly than demand.

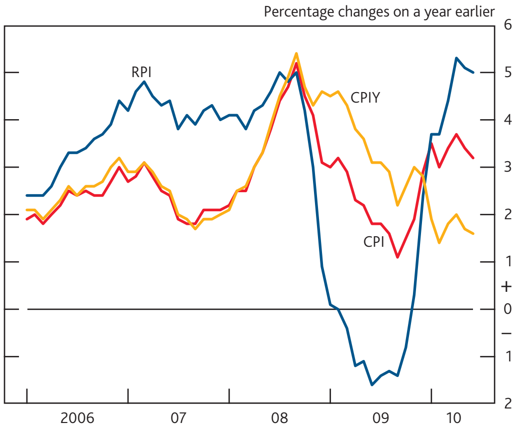
It is hard to judge how supply will evolve as the economy recovers. For example, difficulties accessing working capital may intensify as companies seek to expand. And companies may reverse temporary reductions in capacity, or alternatively scrap capacity permanently, depending on the strength of the recovery in demand. Section 5 discusses the outlook for supply.

(1) For a more detailed discussion see Benito, A, Neiss, K, Price, S and Rachel, L (2010), 'The impact of the financial crisis on supply', *Bank of England Quarterly Bulletin*, Vol. 50, No. 2, pages 104–14.

4 Costs and prices

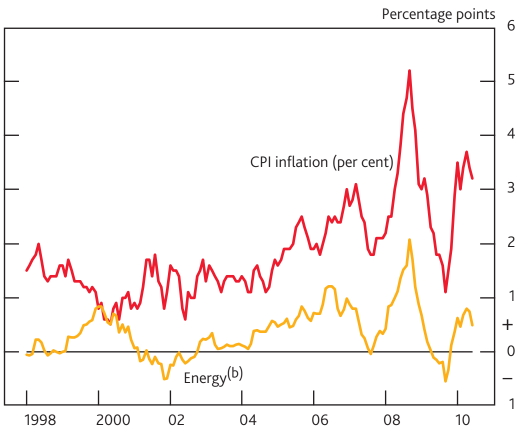
CPI inflation was 3.5% in 2010 Q2, well above the 2% target. Inflation is likely to fall in the near term, as upward pressure from past increases in oil and import prices wanes. But inflation is likely to remain above the target for longer than was anticipated at the time of the May *Report*, in large part because of the forthcoming increase in the standard rate of VAT to 20%. Earnings growth remains weak. Although a number of measures of households' short-term inflation expectations have risen, inflation expectations remain at levels that appear broadly consistent with inflation being around the target in the medium term.

Chart 4.1 Measures of consumer prices[(a)]



(a) Data are non seasonally adjusted.

Chart 4.2 CPI and the contribution of energy to twelve-month CPI inflation[(a)]



(a) Data are non seasonally adjusted.
(b) Fuels and lubricants, and electricity, gas and other fuels.

CPI inflation has remained well above the 2% target, and was 3.5% in 2010 Q2 (Section 4.1). That follows a year in which inflation has been higher than the MPC had anticipated. As discussed in the box on pages 48–49, in part that reflects higher energy prices. But some combination of other factors — including greater pass-through than previously assumed of import prices and VAT to consumer prices, and weaker downward pressure on inflation from the fall in demand — have probably also played a role in explaining the resilience of inflation.

The crucial issue for monetary policy is the extent to which elevated inflation is likely to persist. The increase in the standard rate of VAT in January 2011 will add to inflation throughout 2011. More generally, the evolution of inflation will reflect developments in companies' other costs, in particular labour costs (Section 4.2), and energy and import prices (Section 4.3). Companies' pricing decisions, given those costs, will also be a key driver of inflation (Section 4.4). In part, pricing decisions will depend on companies' inflation expectations; Section 4.5 discusses measures of inflation expectations.

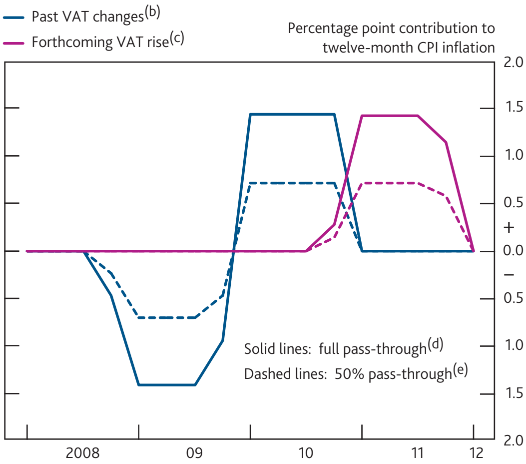
4.1 Consumer prices

CPI inflation

CPI inflation has remained above the 2% target, and was 3.5% in 2010 Q2 (**Chart 4.1**). That was slightly higher than the MPC anticipated at the time of the May *Report*. With April's CPI inflation outturn of 3.7% lying more than 1 percentage point away from the target, the Governor, on behalf of the Committee, wrote an open letter to the Chancellor.[(1)] There remains a high probability that the Governor will need to write further open letters to the Chancellor in the coming months.

(1) The letter is available at www.bankofengland.co.uk/monetarypolicy/pdf/cpiletter100517.pdf.

Chart 4.3 Stylised illustrations of the contribution of changes in VAT to twelve-month CPI inflation(a)



Sources: ONS and Bank calculations.

(a) Data are shown at a quarterly frequency.
(b) Past changes in VAT are as follows: cut from 17.5% to 15% in December 2008; and rise from 15% to 17.5% in January 2010. The share of prices subject to VAT is based on the 2009 CPI basket. The examples make the simplifying assumption that companies only adjust their prices in the months in which VAT was changed.
(c) Forthcoming VAT rise is from 17.5% to 20% in January 2011. The share of prices subject to VAT is based on the 2010 CPI basket. The examples make the assumption that one third of affected companies raise their prices pre-emptively by the end of 2010.
(d) All prices subject to the standard rate of VAT vary in response to the changes in VAT.
(e) The prices of half of the CPI basket subject to the standard rate of VAT vary in response to the changes in VAT.

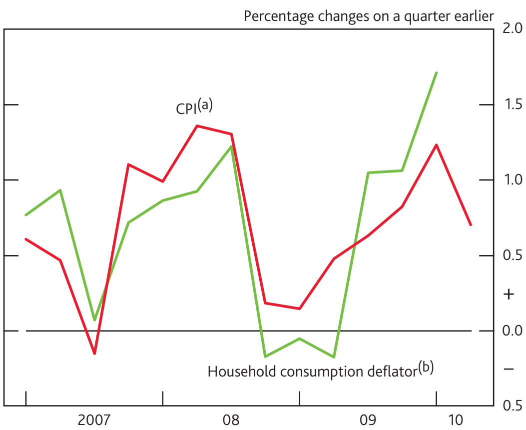
Table 4.A Contributions to the wedge between annual RPI and annual CPI inflation(a)

Percentage points

	Averages since 2005	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	*Memo: changes over year to 2010 Q2*
Mortgage interest payments	0.0	-2.6	-2.6	-2.0	-0.4	0.2	2.8
Other housing components	0.3	-0.6	-0.5	-0.1	0.3	0.5	1.1
Weights, coverage and formula effect	0.0	-0.1	0.2	0.7	0.9	1.0	1.2
Total	**0.3**	**-3.4**	**-2.9**	**-1.5**	**0.7**	**1.7**	**5.1**

(a) The wedge is calculated as annual RPI inflation less annual CPI inflation. For further details on the calculation of these contributions, see Table 4 of the June ONS *Consumer price indices* release at www.statistics.gov.uk/pdfdir/cpi0710.pdf. The ONS revised the methodology used to estimate the wedge in July 2010. This breakdown is only available since 2005. Components may not sum to the total wedge due to rounding. Averages of monthly data.

Chart 4.4 CPI and the household consumption deflator



(a) Seasonally adjusted by Bank staff. The latest observation is 2010 Q2.
(b) At market prices, excluding non-profit institutions serving households. The latest observation is 2010 Q1.

Over the past three years, a series of sharp movements in relative prices have led to more volatile inflation than in the preceding ten years. Energy prices have accounted for much of that volatility, and have raised inflation over much of the past year (**Chart 4.2**). The continued pass-through of higher import prices following the depreciation of sterling from mid-2007 has also raised inflation over the past year. Both of these effects are likely to wane, reducing the degree of upward pressure on prices.

The impact of VAT on CPI inflation

The volatility in CPI inflation over 2008–10 also reflects changes in VAT, with the restoration of the standard rate of VAT to 17.5% adding to inflation since January. It is unclear by how much that change has boosted CPI inflation. CPIY, a measure of CPI that excludes taxes, has been weak relative to CPI, but that mechanically excludes all of the direct impact of changes in indirect taxes at the date when they become effective (**Chart 4.1**). It is difficult to judge precisely the degree to which companies did in fact pass through the changes in VAT, but evidence from the ONS suggests that around half of the cut in VAT in December 2008, and the subsequent reversal in January 2010, was passed through into consumer prices. **Chart 4.3** illustrates how the changes in VAT since December 2008 would have affected twelve-month CPI inflation under different assumptions about the degree of pass-through.

The rise in the VAT rate to 20%, due on 4 January 2011, will add to inflation throughout 2011 (**Chart 4.3**). Initial reports from the Bank's Agents suggest that the tax rise is likely to result in close to full pass-through, probably because the change is expected to be permanent. As a result, VAT is likely to add to inflation to a greater extent in 2011 than during 2010. Based on evidence following past changes in VAT, the MPC's latest projections are conditioned on the benchmark assumption that around a third of affected companies raise their prices by the end of 2010, pre-empting the VAT rise. The rise in VAT is the key reason why inflation is likely to moderate less quickly than anticipated at the time of the May *Report*.

Other measures of consumer prices

RPI inflation has been more volatile than CPI inflation in recent years (**Chart 4.1**). The sharper rise in RPI inflation relative to CPI inflation over the year to 2010 Q2 mainly reflects the impact of cuts in Bank Rate in late 2008 and early 2009 on mortgage interest payments dropping out of the twelve-month RPI calculation from 2009 Q4 (**Table 4.A**). In addition, rising house price inflation has pushed up the housing component of the RPI. But there has also been a larger wedge between the measures resulting from the ways in which the two indices are compiled.

Another measure of consumer price inflation is the household consumption deflator. The consumption deflator has picked up markedly since 2009 Q2 (**Chart 4.4**). The pickup in

Table 4.B Private sector earnings[(a)]

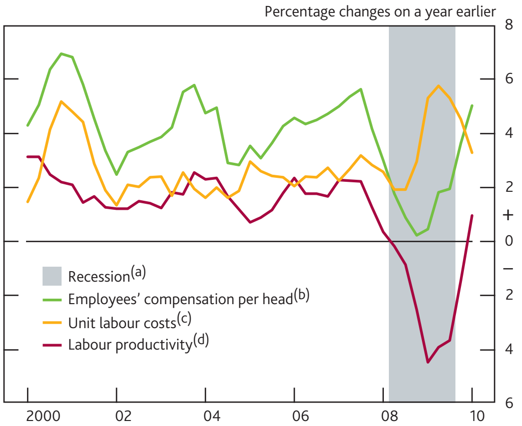
Percentage changes on a year earlier

	Averages since March 2001	2009 H1	2009 H2	2010 Q1	2010 May[(b)]
(1) AWE regular pay	3.5	1.9	0.4	1.2	0.7
(2) Pay settlements[(c)]	3.2	3.1	2.0	1.6	1.7
(1)–(2) Regular pay drift[(d)]	*0 3*	*-1.2*	*-1.7*	*-0.4*	*-0.9*
(3) Total AWE	**3.6**	**-1.8**	**0.0**	**4.2**	**0.7**
(3)–(1) Bonus contribution[(d)]	*0.1*	*-3.7*	*-0.4*	*3.0*	*-0.1*

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

(a) Based on quarterly data, unless otherwise stated.
(b) Data in the two months to May.
(c) Average over the past twelve months, based on monthly data.
(d) Percentage points.

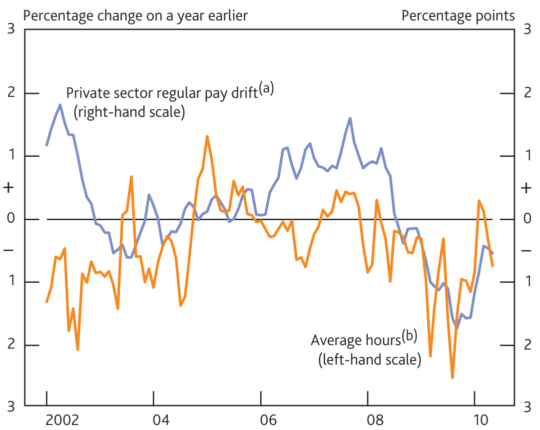
Chart 4.5 Employees' compensation, labour productivity and unit labour costs



Source: ONS (including the Labour Force Survey).

(a) A recession is defined as at least two consecutive quarters of falling output (at constant market prices) estimated using the latest data. The recession is assumed to end once output began to rise.
(b) Employees' compensation at current prices divided by LFS employees.
(c) Employees' compensation at current prices divided by chained-volume measure of GDP at market prices.
(d) Chained-volume measure of GDP at market prices divided by LFS employment.

Chart 4.6 Private sector regular pay drift and average hours



Sources: Bank of England, Incomes Data Services, Industrial Relations Services, the Labour Research Department and ONS (including the Labour Force Survey).

(a) Calculated as the difference between AWE regular pay growth (latest three months on a year earlier) and pay settlements (averaged over the past twelve months).
(b) Rolling three-month measure.

household consumption deflator growth since early 2009 accounts for most of the rise in GDP deflator growth over that period. And it has coincided with a marked increase in nominal GDP growth (Section 2).

4.2 Labour costs

Recent developments

In contrast to strong price inflation, total average weekly earnings (AWE) wage growth, although higher than last year, has been subdued in recent months (**Table 4.B**). Within overall earnings, pay settlements have remained weak, with increases occurring in the more flexible elements of pay. Bonuses were particularly strong in Q1. In part, that reflected bonuses in the financial sector. But, in part, bonuses may also have been strong because some employers brought forward bonus payments ahead of the introduction in April of the top 50% tax rate on income. Consistent with that, the data available so far for Q2 suggest that bonus growth eased. Reports from the Bank's Agents suggest that some companies have paid bonuses instead of higher basic pay, perhaps reflecting worries about the strength of the recovery.

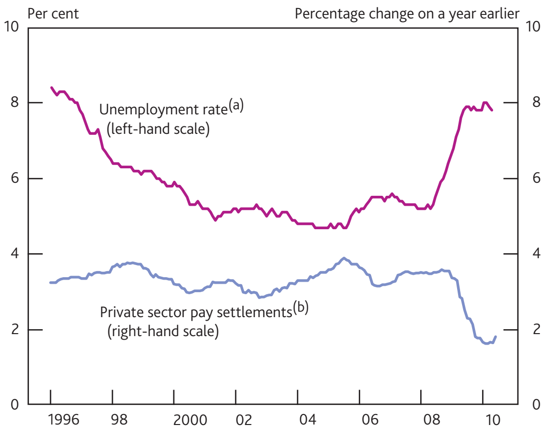
Earnings growth is relevant for companies' pricing decisions in that it affects their costs. Earnings are typically quoted per person, but labour costs per unit of output reflect changes in both earnings per employee and labour productivity. During the recession, employment contracted less sharply than output, so productivity fell. Productivity growth has rebounded in recent quarters, more than offsetting rising earnings growth. So four-quarter growth in unit labour costs fell in Q1 despite the sharp bonus-related rise in compensation (**Chart 4.5**).

Influences on wage growth

Companies cut back on flexible elements of pay during the recession in part by adjusting working patterns to match weaker demand. In particular, pay bills fell as companies reduced hours worked. Such downward pressure on earnings growth may have eased in recent months. Regular pay drift — the difference between regular pay growth and pay settlements, which captures changes in earnings related to working patterns — has picked up a little in recent quarters. Consistent with that, the rate of decline in average hours has eased (**Chart 4.6**). As average hours recover, that is likely to raise output per person. The effect of that on unit labour costs will depend on the evolution of pay per hour. For example, if increased hours result in more overtime working, that could push up unit costs.

Spare capacity in the labour market is likely to restrain wage growth and hold down the growth in companies' costs. Indicators suggest that there remains significant slack in the labour market. And any future public sector job reductions are likely to add to the degree of slack (Section 3). That is likely to

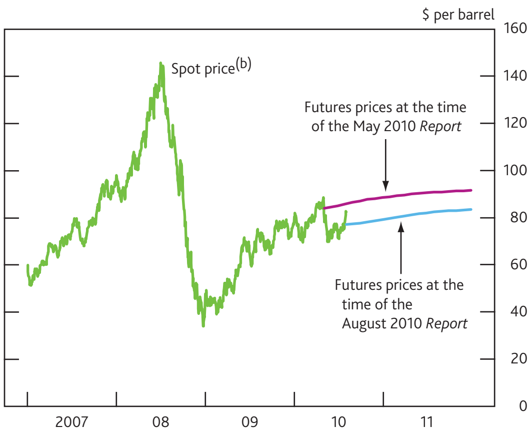
Chart 4.7 Unemployment rate and private sector pay settlements



Sources: Bank of England, Incomes Data Services, Industrial Relations Services, the Labour Research Department and ONS (including the Labour Force Survey).

(a) LFS unemployment rate, rolling three-month measure. The latest observation is May 2010.
(b) Average over the past twelve months. The latest observation is June 2010.

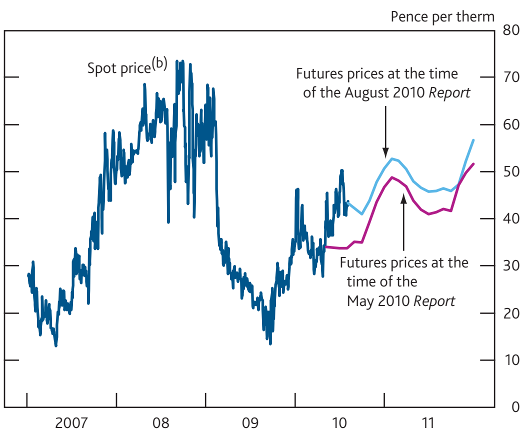
Chart 4.8 Oil prices[(a)]



Source: Bloomberg.

(a) Futures prices for May and August are averages during the fifteen working days to 7 May and 4 August respectively.
(b) Brent forward price for delivery in 10–21 days' time.

Chart 4.9 Wholesale gas prices[(a)]



Sources: Bloomberg and Thomson Reuters Datastream.

(a) Futures prices for May and August are averages during the fifteen working days to 7 May and 4 August respectively.
(b) One-day forward price of UK natural gas.

discourage employees from pushing for higher wages. Indeed, the marked increase in unemployment during the recession was associated with weaker pay settlements (**Chart 4.7**).

Elevated inflation, and the associated moderate rise in survey measures of households' inflation expectations over the past year (Section 4.5), may put upward pressure on pay growth and so companies' costs over time. According to the 2009 *Industrial Relations Services Pay Prospects Survey*, just over two thirds of businesses take account of a measure of inflation during pay negotiations, although a smaller proportion explicitly link settlements and inflation. The Bank's Agents have reported few signs of upward pressure on pay settlements from this source to date.

Overall, it is likely that earnings growth will remain subdued in the coming quarters, and that unit labour cost growth will weaken. Prospects for pay growth are discussed further in Section 5.

4.3 Energy and import prices

Energy prices

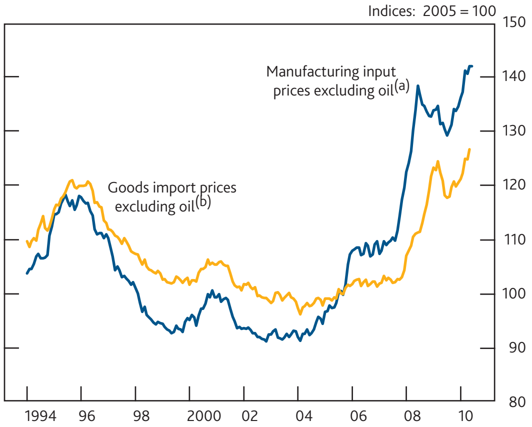
Oil prices affect companies' costs — most directly the costs of petrol retailers — and hence CPI inflation. US dollar Brent oil spot prices fell through much of May, leaving prices around 8% lower in the run-up to the August *Report* than at the time of the May *Report* (**Chart 4.8**). So upward pressure on CPI inflation from fuel prices is likely to wane in the near term.

In part, both the rise in oil prices over the past year and their more recent weakness reflect developments in global demand prospects. Oil prices were supported through much of the past year as prospects for a recovery in economic activity improved. Expectations that the recovery would be led by Asia in particular supported prices, as demand in developing Asia tends to be relatively oil-intensive.[(1)] The recent falls in oil prices may in part reflect anxieties about the pace of the global economic recovery, given continued concerns about the sustainability of fiscal positions in some advanced economies, and expectations of further tightening in monetary policy in some emerging economies.

Domestic gas and electricity prices have reduced annual CPI inflation since September 2009. In part, movements in domestic gas and electricity prices reflect changes in wholesale energy prices. Wholesale gas futures prices out to end-2011 have risen by around 10% since the time of the May *Report* (**Chart 4.9**). The MPC's latest projections are conditioned on the assumption that domestic gas prices rise by around 5% in the first half of 2011, and there is a risk of a somewhat larger rise (see the box on page 42).

(1) See Saporta, V, Trott, M and Tudela, M (2009), 'What can be said about the rise and fall in oil prices?', *Bank of England Quarterly Bulletin*, Vol. 49, No. 3, pages 215–25.

Chart 4.10 Imported goods and manufacturing input prices (excluding oil)



(a) Data are non seasonally adjusted. The latest observation is June 2010.
(b) Data are non seasonally adjusted and include missing trader intra-community fraud. The latest observation is May 2010.

Table 4.C Goods and services prices[a]

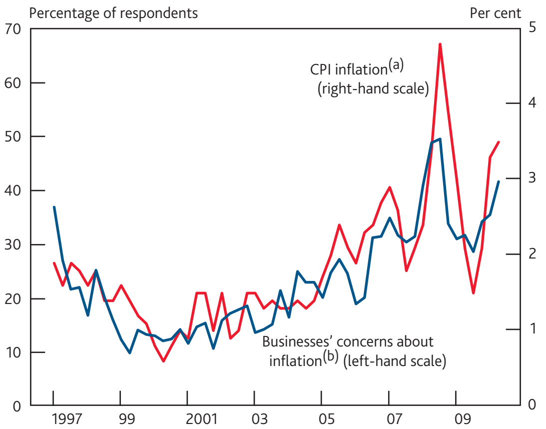
Percentage changes on a quarter earlier

	Averages			2010	
	1998–2007	2008	2009	Q1	Q2
CPI					
Non-energy industrial goods[b]	-0.5	-0.6	0.5	0.5	0.2
Services	0.9	1.1	0.6	1.3	1.0
Output prices					
Manufacturing excluding petrol and food products	0.2	1.3	0.7	1.1	1.6
Services[c]	0.5	0.7	-0.1	0.7	n.a.

Sources: ONS and Bank calculations.

(a) Averages are based on quarterly data. Data have been seasonally adjusted by Bank staff.
(b) CPI goods excluding food, non-alcoholic beverages and tobacco, fuels and lubricants, and electricity, gas and other fuels.
(c) Based on the Services Producer Price Index, which is an experimental index and is not classified as a National Statistic.

Chart 4.11 CPI inflation and survey measure of businesses' concerns about inflation



Sources: BCC and ONS.

(a) Quarterly data.
(b) Companies are asked: 'Is inflation more of a concern to your business than three months ago?'. Manufacturing and service sector responses are weighted together using shares in nominal value added. Data are non seasonally adjusted.

Import prices

Import prices have raised companies' costs in recent years. For example, imported goods prices were around 25% higher than their 2007 level in May, contributing to the high level of manufacturers' input prices (**Chart 4.10**). The rise in import prices since 2007 in large part reflects the substantial depreciation of sterling over that period. Import prices are likely to be boosted in the near term by sharp rises in agricultural commodity prices, which market contacts attribute in large part to poor harvests.

4.4 Companies' pricing decisions

Companies' pricing decisions are a key determinant of inflationary pressure. In response to higher import costs (Section 4.3), higher taxes and increases in the cost of credit (Section 1), businesses may initially accept lower profit margins. But, over time, they are likely to either reduce other costs, or increase the prices charged to their customers. At the same time, weak demand has also encouraged companies to cut costs, including labour costs (Section 4.2), in order to hold down prices and hence stimulate demand. It is difficult to judge the net impact of these two forces on pricing decisions.

Differences between goods and services price inflation may indicate how companies have adjusted prices in response to higher import costs and weak demand. The rise in CPI non-energy industrial goods price inflation relative to services price inflation between 2008 and 2009 (**Table 4.C**) is consistent with some of the rise in import prices feeding through into consumer prices, given that goods are more import-intensive than services. Non-energy industrial goods price inflation fell back a little in Q2, perhaps suggesting that upward pressure from import prices has begun to wane.

Services price inflation picked up in 2010 H1, after weakening markedly during 2009 (**Table 4.C**). In part, the pickup in services price inflation in 2010 H1 is likely to reflect temporary factors. Quarterly inflation in Q1 was boosted by the rise in VAT. And airfares contributed significantly to the rise in H1, in part reflecting past rises in oil prices. Higher services price inflation may also reflect the moderate pickup in earnings growth (Section 4.2). The renewed rise in services price inflation remains somewhat puzzling, however. And a key question for the inflation outlook is the extent to which spare capacity, and in particular labour market slack, exerts downward pressure on prices (Section 5).

Profit margins in the United Kingdom in the past have tended to fall back during periods of weak demand, putting downward pressure on prices. But, as discussed in previous *Reports*, margins appear to have been unusually resilient during the recent recession. In part, that may reflect the sharp rise in sterling export prices since the depreciation of sterling. A recent survey by the Bank's Agents found that exporters

Table 4.D Survey measures of households' inflation expectations[(a)]

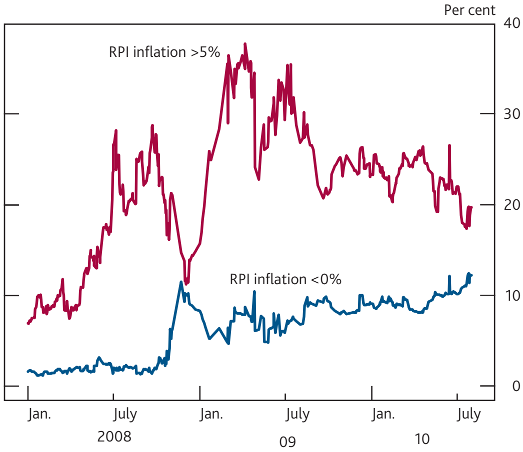
Per cent

	Averages since 2000	2008	2009 H1	2009 H2	2010 Q1	2010 Q2	2010 July
Expectations (number of years ahead)							
YouGov/Citigroup[(b)] (1)	2.5	3.3	1.6	1.9	2.3	2.7	2.7
Barclays Basix (1)	2.9	4.0	2.3	2.5	2.8	3.4	n.a.
Bank/NOP (1)	2.5	3.7	2.3	2.4	2.5	3.3	n.a.
Barclays Basix (2)	3.2	3.7	2.9	3.0	3.2	3.8	n.a.
Barclays Basix[(c)] (5)	3.9	n.a.	3.8	3.8	3.8	4.1	n.a.
YouGov/Citigroup[(b)] (5–10)	3.4	3.5	3.0	3.1	3.2	3.1	3.3
Memo:							
CPI inflation	1.9	3.6	2.6	1.8	3.3	3.5	n.a.

Sources: Bank of England, Barclays Capital, Citigroup, GfK NOP, ONS and YouGov.

(a) The questions ask about expected changes in prices, but do not reference a specific price index. All measures are based on the median estimated price change. Averages are based on quarterly data, unless otherwise specified.
(b) Averages since 2005. Based on monthly data.
(c) Average since 2008 Q3.

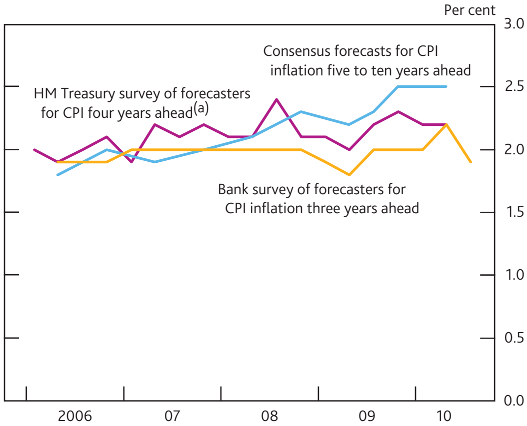
Chart 4.12 Weight on high and low RPI inflation outturns implied by options[(a)]



Sources: Bloomberg, Royal Bank of Scotland and Bank calculations.

(a) Probability that RPI inflation will be below zero or greater than 5% based on the average probability distribution of annual RPI outturns for six to seven years ahead implied by options.

Chart 4.13 Selected forecasters' inflation expectations



Sources: Bank of England, Consensus Economics and HM Treasury.

(a) Taken from *Forecast for the UK economy: a comparison of independent forecasts*. Based on the average of medium-term projections published in February, May, August and November.

typically reported higher margins relative to normal than those reported on domestic production. But concerns over maintaining short-run cash flow in the face of tight credit conditions are also likely to have played a role.

It is possible that higher inflation expectations have encouraged some companies to raise prices over the past year, rather than accepting lower margins or pushing down other costs. But there are no available direct measures of companies' inflation expectations, so it is difficult to assess the extent to which that has occurred. For example, although the proportion of companies reporting that they are more concerned about inflation has picked up over the past year (**Chart 4.11**), that may reflect the rise in actual inflation rather than a persistent increase in inflation expectations.

4.5 Inflation expectations

A number of measures of households' near-term inflation expectations have picked up in recent quarters (**Table 4.D**). In part, those increases may reflect the rise in actual inflation.[(1)] But the MPC also revised up its projection for the most likely path of inflation one year ahead, by a broadly similar amount to households, over the first half of this year, reflecting temporary boosts from oil prices and a fall in sterling.

Measures of medium-term inflation expectations have been more stable than their short-term equivalents (**Table 4.D**). Indeed, unlike most short-term measures, longer-term measures remain close to their average rates. The MPC's latest projections for inflation are discussed in Section 5.

Market-based indicators of inflation expectations — the gap between nominal and real yields on gilts and those measured from inflation swaps — suggest that financial market participants' longer-term inflation expectations have edged down in recent months. RPI options imply that the weights placed on the possibility of both low and high inflation outturns have remained elevated in recent months (**Chart 4.12**), suggesting that market participants remain unusually uncertain about the outlook for inflation.

Surveys of forecasters provide another indicator of inflation expectations. A range of forecasts suggest that medium-term expectations have been little changed in recent quarters, and only the Consensus measure is significantly above its average since 2006 (**Chart 4.13**).

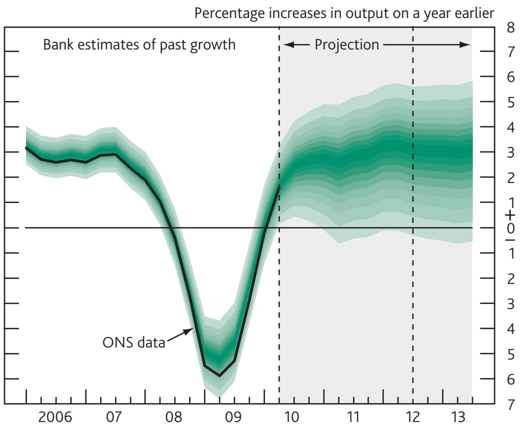
Overall, inflation expectations remain at levels that appear broadly consistent with inflation being around the target in the medium term. But the MPC will continue to monitor developments in inflation expectations closely.

(1) See the box on page 37 of the May 2010 *Report*.

5 Prospects for inflation

Nominal spending and real output have both continued to recover. But real output remains significantly below its pre-crisis peak. The strength of the recovery will depend on whether private sector saving falls back as fiscal policy tightens, and on the support to net trade from the lower level of sterling and the recovery in global demand. CPI inflation is likely to remain above the target throughout 2011, given the forthcoming increase in VAT. Further ahead, downward pressure on wages and prices from persistent spare capacity is likely to cause inflation to fall below the target for a period. But the extent to which inflation will moderate is uncertain. Under the assumptions that Bank Rate moves in line with market interest rates and the stock of assets purchased through the issuance of central bank reserves remains at £200 billion, inflation is a little more likely to be below the target than above it during the second half of the forecast period, although those risks are broadly balanced by the end.

Chart 5.1 GDP projection based on market interest rate expectations and £200 billion asset purchases



The fan chart depicts the probability of various outcomes for GDP growth. It has been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion throughout the forecast period. 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 outturns are also expected to lie within each pair of the lighter green areas on 10 occasions. In any particular quarter of the forecast period, GDP is therefore expected to lie somewhere within the fan on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions GDP growth can fall anywhere outside the green area of the fan chart. Over the forecast period, this has been depicted by the light grey background. In any quarter of the forecast period, the probability mass in each pair of the identically coloured bands sums to 10%. The distribution of that 10% between the bands above and below the central projection varies according to the skew at each quarter, with the distribution given by the ratio of the width of the bands below the central projection to the bands above it. In **Chart 5.1**, the ratios of the probabilities in the lower bands to those in the upper bands are approximately 6:4 at Years 1, 2 and 3. 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.

5.1 The projections for demand and inflation

The significant risks to inflation, in both directions, continue to present a substantial challenge for monetary policy. Persistent spare capacity is likely to bear down on inflation throughout the next three years, and may push it significantly below the target later in the forecast period. But inflation has continued to be heavily affected by movements in relative prices, such as the prices of energy and of imported goods and services, and a further sustained period of above-target inflation is in prospect following the increase in VAT due at the beginning of 2011. There is a risk that inflation expectations could rise as a consequence: that could feed through into the setting of prices and wages. In setting the stance of monetary policy, the MPC seeks to balance the risks to the outlook for inflation in the medium term.

Chart 5.1 shows the outlook for real GDP growth, on the assumption that Bank Rate follows a path implied by market interest rates. That chart, along with all the others describing the MPC's projections shown in this section, is conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion throughout the forecast period.

Underlying the projection is a substantial fiscal consolidation. The reduction in the public sector deficit will need to be matched by some combination of lower private sector financial saving, and an improvement in the United Kingdom's current account position. Those developments should be supported by the considerable stimulus from monetary policy, and a continuing boost to net trade from the past depreciation

Chart 5.2 Projected probabilities of GDP growth in 2011 Q3 (central 90% of the distribution)(a)

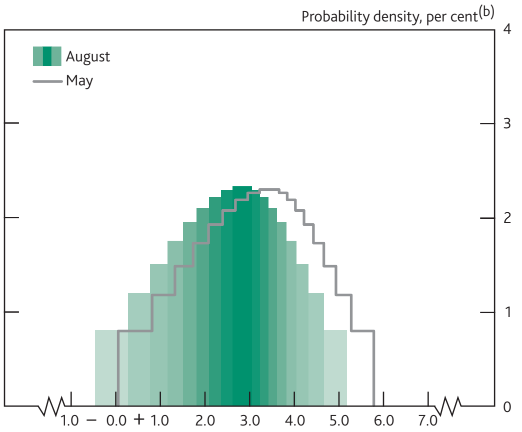
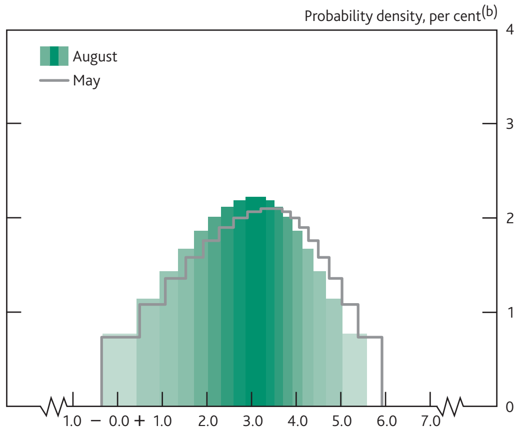


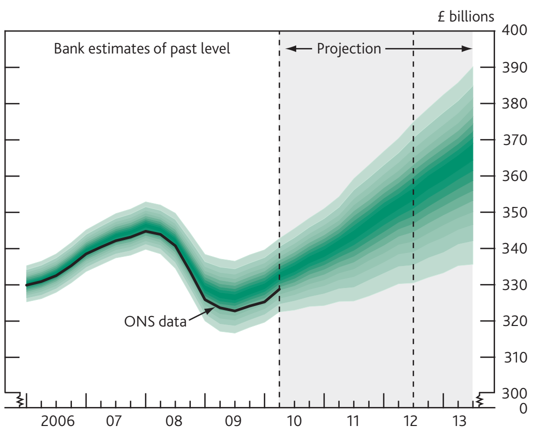
Chart 5.3 Projected probabilities of GDP growth in 2012 Q3 (central 90% of the distribution)(a)



(a) **Charts 5.2** and **5.3** represent cross-sections of the GDP growth fan chart in 2011 Q3 and 2012 Q3 for the market interest rate projection. They have been conditioned on the assumption that the stocks of purchased assets financed by the issuance of central bank reserves remain at £200 billion throughout the forecast period. The coloured bands in **Charts 5.2** and **5.3** 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 GDP growth in 2011 Q3 and 2012 Q3 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. The grey outlines in **Charts 5.2** and **5.3** represent the corresponding cross-sections of the May 2010 *Inflation Report* fan chart, which was conditioned on the same assumption about the stock of purchased assets financed by the issuance of central bank reserves.

(b) Average probability within each band; the figures on the y-axis indicate the probability of growth being within ±0.05 percentage points of any given growth rate, specified to one decimal place. As the heights of identically coloured bars on either side of the central projection are the same, the ratio of the probability contained in the bars below the central projection, to the probability in the bars above it, is given by the ratio of the width of those bars.

Chart 5.4 Projection of the level of GDP based on market interest rate expectations and £200 billion asset purchases



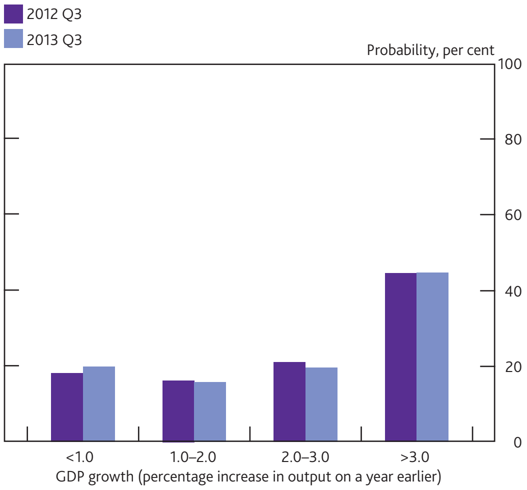
Chained-volume measure (reference year 2006). See the footnote to **Chart 5.1** for details of the assumptions underlying the projection for GDP growth. The width of this fan over the past has been calibrated to be consistent with the four-quarter growth fan chart, under the assumption that revisions to quarterly growth are independent of the revisions to previous quarters. Over the forecast, the mean and modal paths for the level of GDP are consistent with **Chart 5.1**. So the skews for the level fan chart have been constructed from the skews in the four-quarter growth fan chart at the one, two and three-year horizons. This calibration also takes account of the likely path dependency of the economy, where, for example, it is judged that shocks to GDP growth in one quarter will continue to have some effect on GDP growth in successive quarters. This assumption of path dependency serves to widen the fan chart.

of sterling. But the risks to growth are judged to be weighted to the downside, given the possibility that the boost from the lower level of sterling could take longer to materialise, and that tight credit conditions and elevated private sector saving could be a bigger drag on growth. There is a range of views among Committee members over the extent to which those factors will restrain demand.

The outlook for four-quarter growth is rather weaker than in the May *Report* (**Charts 5.2** and **5.3**). Output grew rapidly in the second quarter of 2010. But some of that acceleration is likely to prove temporary, and several recent surveys suggest a softening in business and household confidence, and so a possible weakening in growth in the second half of the year. Further ahead in the forecast period, the most likely outcome for growth is also a little weaker than in May, despite a lower assumed path for Bank Rate. That reflects a judgement that credit conditions are likely to ease more gradually than previously projected, following a recent slowing in their rate of improvement (Section 1), and the somewhat faster pace of fiscal consolidation. That more rapid fiscal consolidation, however, also reduces the risk of any sharp increase in longer-term interest rates and therefore the downside risks to growth in the latter part of the forecast period. That means that by the second year of the forecast, the overall distribution for growth is only slightly lower than in the May *Report* (**Chart 5.3**).

Despite steady growth over the forecast period, output is likely to remain substantially below the level implied by a continuation of its pre-crisis trend (**Chart 5.4**). That reflects, in part, the significant reduction in the effective supply capacity of the economy that appears to have been a feature of this recession. But output is also likely to remain below the supply capacity of the economy throughout the forecast period.

Chart 5.5 Frequency distribution of GDP growth based on market interest rate expectations and £200 billion asset purchases[(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.

Chart 5.5 shows frequency distributions for GDP growth at the two and three-year horizons. It suggests that at both those horizons, there is a slightly higher than one-in-three chance that four-quarter growth will be below 2%, and less than a one-in-two chance that it will have risen above 3%.

Chart 5.6 shows the outlook for CPI inflation, on the assumption that Bank Rate follows a path implied by market interest rates. **Chart 5.8** shows the corresponding probability of inflation being above the 2% target, and the probability implied by the May *Report* projection. Inflation is likely to remain above the 2% target for longer than projected in May (**Chart 5.7**), reflecting slightly higher-than-expected outturns for inflation, the likelihood of a rise in domestic gas prices (see the box on page 42), and, most substantially, the forthcoming increase in VAT, which is likely to add more than 1 percentage point to CPI inflation throughout most of 2011. The Committee has increased the width of the fan chart in the near term, given the large movements in relative prices such as energy and other commodity prices in recent years, and the resulting increase in the volatility of inflation over that period.

Further ahead, CPI inflation is likely to fall below the target, as persistent spare capacity weighs on companies' costs and prices. But there are substantial risks around that outlook, in both directions. A weaker recovery in demand would result in more spare capacity and greater downward pressure on inflation. But the impact of weak demand depends on the extent to which lower output and tight credit conditions affect the economy's supply capacity. In addition, above-target inflation in the recent past, which is projected to persist in the near term, could cause medium-term inflation expectations to rise. There is a range of views among Committee members about the strengths of these various factors. On balance, the

Chart 5.6 CPI inflation projection based on market interest rate expectations and £200 billion asset purchases

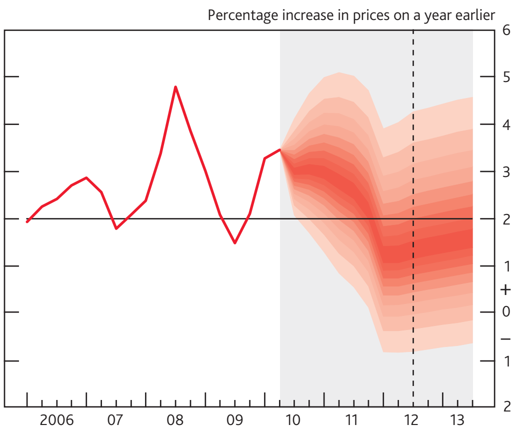
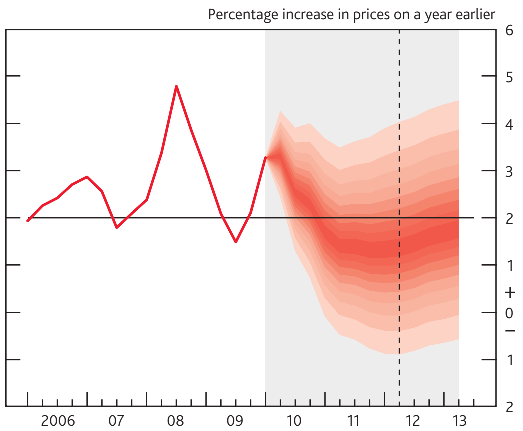
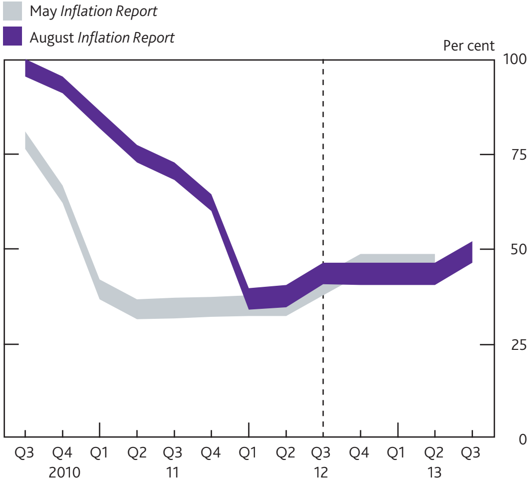


Chart 5.7 CPI inflation projection in May based on market interest rate expectations and £200 billion asset purchases



Charts 5.6 and **5.7** depict the probability of various outcomes for CPI inflation in the future. They have been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion throughout the forecast period. If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation in any particular quarter would lie within the darkest central band on only 10 of those occasions. The fan charts are constructed so that outturns of inflation are also expected to lie within each pair of the lighter red areas on 10 occasions. In any particular quarter of the forecast period, inflation is therefore expected to lie somewhere within the fans on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions inflation can fall anywhere outside the red area of the fan chart. Over the forecast period, this has been depicted by the light grey background. In any quarter of the forecast period, the probability mass in each pair of the identically coloured bands sums to 10%. The distribution of that 10% between the bands above and below the central projection varies according to the skew at each quarter, with the distribution given by the ratio of the width of the bands below the central projection to the bands above it. In **Chart 5.6**, the ratios of the probabilities in the lower bands to those in the upper bands are approximately 4:6 in Years 2 and 3; the upward skew is slightly smaller in Year 1. Those skews are larger than those in **Chart 5.7**. 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 5.8 Assessed probability inflation will be above target



The August and May swathes in this chart are derived from the same distributions as **Charts 5.6** and **5.7** respectively. They indicate the assessed probability of inflation being above target in each quarter of the forecast period. The width of the swathe at each point in time corresponds to the width of the band of the fan chart in which the target falls in that quarter, or, if the target falls outside the coloured area of the fan chart, the width of the band closest to the target. The bands in the fan chart illustrate the MPC's best collective judgement that inflation will fall within a given range. The swathes in **Chart 5.8** show the probability within the entire band of the corresponding fan chart of inflation being close to target; the swathes should not therefore be interpreted as a confidence interval.

Committee judges that, conditioned on the monetary policy assumptions described above, inflation is a little more likely to be below the target than above it during the second half of the forecast period, although those risks are broadly balanced by the end.

Charts 5.9 and **5.10** show the spread of outcomes for CPI inflation at the one and two-year horizons, and the equivalent spreads at the time of the May *Report*. The Committee's best collective judgement is that, relative to the most likely outcome, the risks to inflation are skewed to the upside, because the sustained period of above-target inflation that is in prospect might cause inflation expectations to rise: in the second half of the forecast period, those upside risks are a little larger than in May. But even with those upside risks, there is a roughly three-in-five chance that inflation will be below the target by the two-year horizon. **Chart 5.11** shows frequency distributions for inflation. The Committee judges that, given the scale of the risks in both directions, at both the two and three-year horizons there is only around a one-in-four chance that inflation will be within 0.5 percentage points of the 2% target.

5.2 Key judgements and risks

The recession was accompanied by a substantial increase in the public sector deficit, matched by an increase in the financial surplus of the private sector — the saving of UK companies and households, less the amount that they invest in physical assets. Based on the measures contained in the June *Budget*, the fiscal deficit is projected to fall sharply over the forecast period (see the box on page 21). That will need to be matched by some combination of a lower private sector

Chart 5.9 Projected probabilities of CPI inflation outturns in 2011 Q3 (central 90% of the distribution)(a)

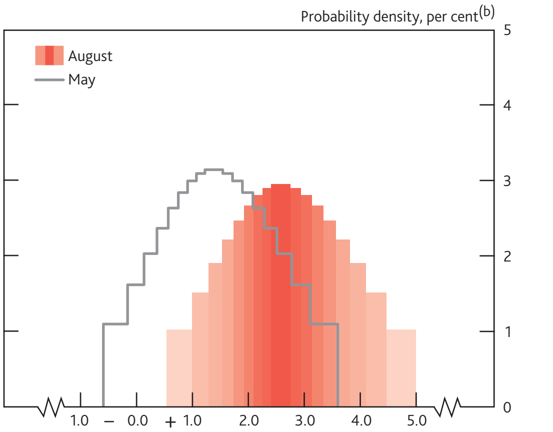
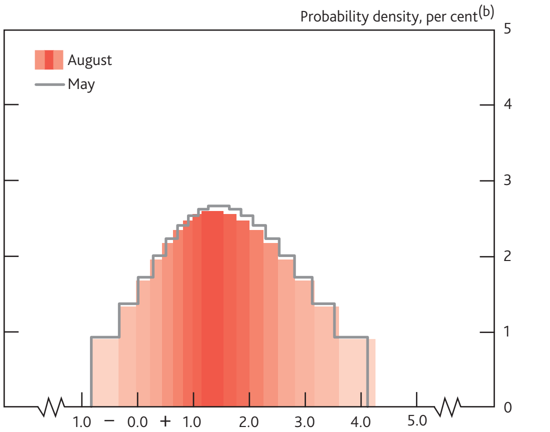


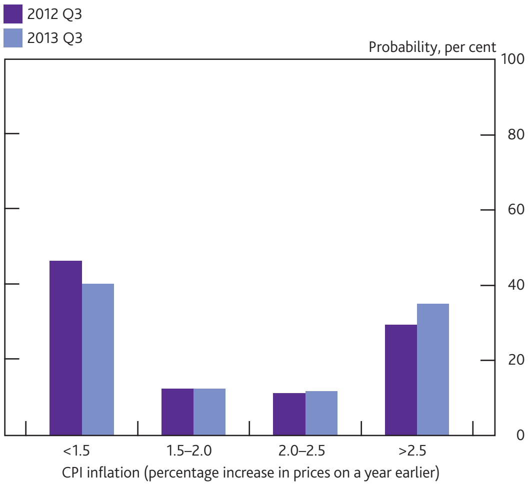
Chart 5.10 Projected probabilities of CPI inflation outturns in 2012 Q3 (central 90% of the distribution)(a)



(a) **Charts 5.9** and **5.10** represent cross-sections of the CPI inflation fan chart in 2011 Q3 and 2012 Q3 for the market interest rate projection. They have been conditioned on the assumption that the stock of purchased assets financed by the issuance of central bank reserves remains at £200 billion throughout the forecast period. The coloured bands in **Charts 5.9** and **5.10** 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 Q3 and 2012 Q3 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. The grey outlines in **Charts 5.9** and **5.10** represent the corresponding cross-sections of the May 2010 *Inflation Report* fan chart, which was conditioned on the same assumption about the stock of purchased assets financed by the issuance of central bank reserves.

(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. As the heights of identically coloured bars on either side of the central projection are the same, the ratio of the probability contained in the bars below the central projection, to the probability in the bars above it, is given by the ratio of the width of those bars.

Chart 5.11 Frequency distribution of CPI inflation based on market interest rate expectations and £200 billion asset purchases(a)



(a) These figures are derived from the same distribution as **Chart 5.6**. They represent the probabilities that the MPC assigns to CPI inflation lying within a particular range at a specified time in the future.

financial surplus and an improvement in the current account balance. But that could happen in a number of ways. Households and companies could reduce their saving or increase investment, boosting demand. Alternatively, private sector net saving may remain elevated — perhaps if credit conditions improve more slowly. In that case, weakness in domestic demand would restrain growth, but would also bear down on imports, reducing the current account deficit. So private sector and external financial balances, and the forces that drive them, will be key to the strength of the recovery in demand, and therefore the extent to which spare capacity persists over the forecast period.

How will private sector saving evolve?

The rise in the private sector financial surplus reflected increases in both the corporate sector surplus, as companies cut back sharply on their capital expenditure, and the household sector balance, as the household saving rate rose sharply from its pre-recession level.

The Committee's central judgement is that the private sector financial surplus is likely to fall back gradually throughout the forecast period, supporting demand. In part, that should reflect some reduction in the corporate sector surplus from its recent, unusually high, level. It is likely that some companies have delayed investment plans until the demand outlook, including the impact of the fiscal consolidation, becomes clearer, so capital spending should be boosted as the recovery in demand gathers pace and uncertainty dissipates. Investment might receive further support if the recovery in demand is weighted towards particular sectors, for example export-oriented ones, which require new capacity. And corporate saving might also fall back through higher dividend or real wage growth, which should provide some support to household demand.

Some factors may continue to generate elevated corporate sector surpluses, however. The weak level of demand, relative to its pre-recession peak, will limit many companies' incentive to invest in new capacity. It may take some time before the impact of the fiscal consolidation on individual companies becomes clear. And recent high corporate sector surpluses may have reflected some companies repaying bank debt, or building up cash buffers, in anticipation of a continued lack of availability or high cost of credit in future.

The pace at which the private sector surplus falls will also depend on the evolution of the household sector financial surplus. The pickup in household saving may have reflected, in part, elevated uncertainty about the depth and duration of the recession, which may recede as the recovery continues. Further, households may have temporarily increased their saving as they adjusted their spending to weaker expected incomes — both if they expect the recession to have a persistent effect on the output of the economy and so their

Financial and energy market assumptions

As a benchmark assumption, the projections for GDP growth and CPI inflation described in **Charts 5.1** and **5.6** are conditioned on a path for Bank Rate implied by market interest rates (**Table 1**). In the period leading up to the MPC's August decision, the path implied by forward market interest rates was for Bank Rate to remain close to 0.5% until 2011 Q1. Bank Rate was assumed to rise thereafter, with the path 0.8 percentage points lower, on average, over the remainder of the forecast period than assumed in the May *Report*.

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

Per cent

	2010		2011				2012				2013		
	Q3[(b)]	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
August	0.5	0.5	0.6	0.7	0.8	1.0	1.2	1.4	1.6	1.9	2.1	2.2	2.4
May	0.5	0.6	0.8	1.1	1.4	1.7	2.0	2.3	2.6	2.8	3.0	3.2	

(a) The data are fifteen working day averages of one-day forward rates to 4 August and 7 May 2010 respectively. The curves are based on overnight index swap (OIS) rates.
(b) August figure for 2010 Q3 is an average of realised spot rates to 4 August, and forward rates thereafter.

The August projections are conditioned on an assumption that the total stock of asset purchases financed by the creation of central bank reserves remains at £200 billion throughout the forecast period, the same total scale of purchases assumed in the May projections.

The starting point for sterling's effective exchange rate index (ERI) in the MPC's projections was 81.4, the average for the fifteen working days to 4 August. That was 2.5% above the starting point for the May projections. Under the MPC's usual convention,[(1)] the exchange rate is assumed to be broadly unchanged in 2012 Q3, and is higher throughout the forecast period than assumed in May.

The starting point for UK equity prices in the MPC's projections was 2728 — the average of the FTSE All-Share for the fifteen working days to 4 August. That was 4.9% below the starting point for the May 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 9% lower (in US dollar terms) than at the time of the May *Report*. Wholesale gas futures prices were around 6% higher over the forecast period. There is considerable uncertainty about the scale and pace of the pass-through of changes in wholesale energy prices to the prices of gas and electricity faced by households and companies. But the August projections are conditioned on a benchmark assumption of around a 5% rise in domestic gas prices in the first half of 2011, with a risk of a somewhat larger rise.

(1) The convention is that the sterling exchange rate follows a path which is half way between the starting level of the sterling ERI and a path implied by interest rate differentials.

future incomes, and also given the possibility of higher future taxes. Once that adjustment in spending is complete, the saving rate may fall back.

It is possible that there may be some further upward pressure on household saving, however. Some households may not yet have adjusted to the reductions in government spending and increases in taxes that will be necessary to reduce the fiscal deficit. And some households may need to increase their saving to reduce their indebtedness and to make adequate provision for their retirement.

Overall, the Committee judges it likely that the household saving rate will fall somewhat over the forecast period. Nonetheless, household consumption growth is likely to remain below its historical average rate until at least the second half of the period. Together with some decline in the corporate sector surplus, reductions in the household saving rate should support demand, providing some offset to the falling fiscal deficit. But the risks around demand are weighted to the downside: in particular, the impact of the fiscal consolidation, and some households' concerns over their indebtedness, may bear down further on consumption growth in coming years.

Will further financial sector deleveraging hold back the recovery?

A gradual easing in credit conditions should enable some pickup in credit growth and support a decline in the private sector financial surplus. But the pace at which spreads between market interest rates and Bank Rate have been narrowing seems to have slowed, and the MPC believes that credit conditions are likely to improve somewhat more gradually than was judged likely in May.

A greater drag from tight conditions continues to pose a downside risk to activity. Improvements in the supply of credit may not keep pace with companies' demand for loans, for example as the recovery increases their need for working capital. And it is possible that the easing in credit conditions may stall, for example if banks were to feel under market pressure to restructure their balance sheets more rapidly than would be required to meet future regulatory capital and liquidity requirements.

How rapidly will the United Kingdom's current account position improve?

The fiscal consolidation will also need to be accompanied by some improvement in the United Kingdom's external balance. That should be supported by the past depreciation of sterling and the continuing recovery in global demand, and the Committee judges that the current account is likely to move towards surplus over the forecast period. But net trade has been weak in recent quarters (Section 2), and the risks around the support to output from the lower level of sterling are weighted to the downside.

The recent weakness in net trade may, in part, reflect measurement difficulties: export surveys and the strength of manufacturing output are consistent with a somewhat stronger export performance recently. Nonetheless, it may take some time for the fall in the exchange rate to boost net trade. For example, UK exporters may not want to invest in new markets while the outlook for global demand is so uncertain. And it may take time for domestic companies to develop the supply capacity needed to produce goods and services that are currently imported. Those constraints may persist well into the forecast period.

In addition, the recoveries in the United Kingdom's largest export markets remain fragile. In the United States, labour and housing markets remain depressed, and some indicators point to a weakening in growth in the second half of 2010. In the euro area, market participants' concerns about fiscal debt and deficits in some countries persist. And a number of euro-area countries have announced measures to cut fiscal deficits:

unless accompanied by offsetting strength in private sector spending, that is likely to dampen demand for UK exports.

How much downward pressure will weak demand exert on inflation?

Output is likely to remain below its pre-recession trend throughout the forecast period. How much downward pressure that exerts on inflation will depend on the evolution of spare capacity, both within companies and in the labour market, and on the response of costs and prices to that spare capacity (see the box on pages 48–49, which discusses how these and other factors have influenced inflation, compared with the judgements underlying the MPC's projections in the May 2009 *Report*).

How will companies' supply capacity evolve?

The degree of spare capacity within companies, and the downward pressure it has exerted on inflation, appears to have been attenuated by some features of the recent sharp recession. Working capital became harder to obtain, reducing some companies' effective supply capacity, and perhaps encouraging them to focus on maintaining short-term cash flow rather than reducing prices to boost future demand. And some companies may have responded to the sharp falls in demand by temporarily scaling back their operations, so reducing their overall costs, but creating near-term impediments to re-expanding production, and therefore moderating their incentive to cut prices.

The Committee's central judgement is that some of those disruptions to effective supply are likely to unwind over the forecast period, as credit conditions ease and stronger demand leads companies to reverse some of the changes to their operating processes. But the extent of that unwind is uncertain. If demand remains weak, companies may wait for longer before bringing capacity back on stream, with some of that capacity being permanently scrapped. And effective supply may also recover more slowly if a rebalancing of demand, for example towards export-intensive sectors, requires new investment to expand capacity.

How strongly will real and nominal wages grow?

Inflation will also be influenced by the evolution of companies' costs, including labour costs. Wage growth has been extremely subdued, reflecting downward pressure from a number of factors.

Sterling's past depreciation is likely to have been one factor that has put downward pressure on real wage growth. Companies faced higher imported costs: in order to preserve profit margins, they needed to respond either by raising their prices, or by bearing down on other costs, including labour costs. In the event, much of the adjustment appears to have come through higher prices, rather than lower nominal earnings, perhaps because companies expected the MPC to accommodate the price-level impact of the depreciation. The Committee's central judgement is that much of the adjustment has now occurred. But an upside risk to inflation in the early part of the forecast period is that some further adjustment is still to come, and that it occurs through higher prices.

The increased level of unemployment has also probably restrained earnings growth. A considerable degree of labour market slack is likely to persist for a while. Given the proportionately smaller falls in employment than in output, many businesses should be able to re-expand production without significant hiring. And reductions in public sector employment, particularly in the latter part of the forecast period, are likely to restrain overall employment growth. Labour market slack is therefore likely to weigh on earnings growth throughout the forecast period, putting continued downward pressure on inflation.

The weakness of wage growth may also have been linked to the unusually low rate of productivity growth during the recession, however. Companies and employees may together have agreed to reduce pay growth temporarily while demand was weak, to avoid lay-offs, for example. So, as companies continue to expand production and productivity recovers from its recent trough, there is likely to be some pickup in earnings growth.

The Committee's central judgement is that, although earnings growth is likely to rise gradually as productivity growth recovers, persistent slack in the labour market will keep earnings growth below its pre-recession average rate for most of the forecast period. And, once one-off cost increases — such as higher imported costs and increased VAT — have passed, that will curb the rate at which companies' overall costs rise, supporting some increase in corporate margins, but also leading to a period of below-target inflation. It is difficult, however, to identify precisely the relative contributions of high unemployment and low productivity to the recent weakness in wages. So the extent to which slack in the labour market will bear down on companies' costs over the forecast period, and therefore the downward pressure that it will exert on inflation, is uncertain.

Will medium-term inflation expectations rise?

Inflation has tended to exceed the target in the recent past, and is likely to continue to do so in the near term. CPI inflation has averaged 2.8% over the past three years. The forthcoming VAT increase is likely to keep inflation above the target throughout 2011. And other factors pose upside risks to inflation. In the near term, there may be further pressure on prices from the past depreciation of sterling, and recent rises in some agricultural commodity prices might also add to this. And throughout the forecast period, robust growth in emerging economies might cause energy and other commodity prices to rise.

A prolonged further period of above-target inflation could, in turn, cause medium-term inflation expectations to rise. That could affect companies' pricing decisions and put upward pressure on nominal earnings growth, making it more difficult to bring inflation back down, despite the presence of persistent spare capacity. These concerns are reflected in the upside skew to the inflation projection.

5.3 Summary and the policy decision

The outlook for GDP growth remains highly uncertain. The strength and sustainability of the recovery will depend on the extent to which the prospective fiscal consolidation is matched by lower private sector saving net of investment, and on how rapidly the past depreciation of sterling and the global recovery improve the United Kingdom's trade balance. There is a range of views among Committee members over how much those factors will support demand. On balance, the Committee judges that, conditioned on market interest rates, four-quarter growth is most likely to be a little above its historical average rate throughout the forecast period. But the risks around that judgement are skewed to the downside.

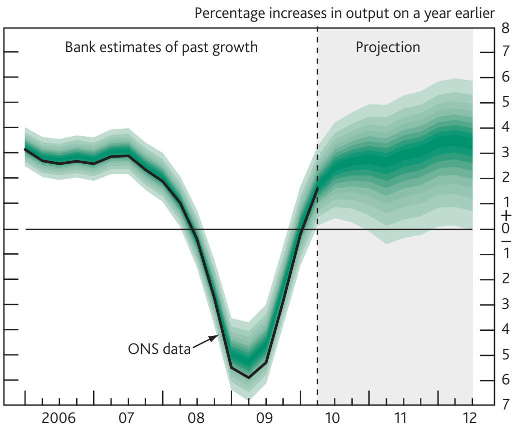
CPI inflation is likely to remain elevated throughout the first half of the forecast, boosted by the forthcoming increase in VAT. Once the effects of higher VAT have dropped out of the twelve-month comparison, inflation is likely to fall below the target, as persistent spare capacity continues to weigh on costs and prices. But there are substantial risks relative to the target in both directions, and there is a range of views among Committee members about those risks. On balance, the Committee judges that, conditioned on market interest rates, inflation is a little more likely to be below the target than above it during the second half of the forecast period, although those risks are broadly balanced by the end.

Charts 5.12 and **5.13** show the GDP and CPI inflation projections for the next two years under the alternative assumption that Bank Rate is held constant at 0.5%. Under that assumption, the outlook for growth is a little stronger, particularly in the second year of the projection. That faster growth leads to a slightly stronger outlook for inflation, so that the risks around the target are broadly balanced by the end of the second year of the forecast.

In evaluating the outlook for growth, the Committee will focus on: the evolution of private sector and external financial balances, and the forces that are driving them; the impact of the fiscal consolidation, including on corporate and household confidence; developments in financial markets and the banking sector, including the growth of money and credit; and the pace and composition of the global recovery.

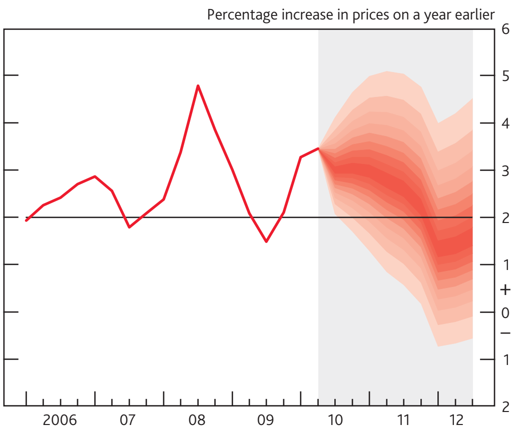
In monitoring those factors likely to affect inflation, the Committee will in addition focus on: evidence regarding the

Chart 5.12 GDP projection based on constant nominal interest rates at 0.5% and £200 billion asset purchases



See footnote to **Chart 5.1**.

Chart 5.13 CPI inflation projection based on constant nominal interest rates at 0.5% and £200 billion asset purchases



See footnote to **Chart 5.6**.

evolution of supply, and the associated margin of spare capacity in the economy; the response of earnings and prices to that spare capacity; and measures of inflation expectations.

At its August meeting, the Committee judged that the recovery was likely to continue. The forthcoming increase in VAT was expected to keep CPI inflation above the 2% target until the end of 2011, after which inflation was likely to fall back, reflecting the persistent margin of spare capacity. In the light of that outlook, the Committee judged that maintaining Bank Rate at 0.5% and maintaining the size of the programme of asset purchases financed by the issuance of central bank reserves at £200 billion was appropriate to meet the 2% CPI inflation target over the medium term. But the prospects for inflation were highly uncertain and the Committee stood ready to respond in either direction as the balance of risks evolved.

The MPC's recent forecasting record

This box, part of a series published each August, compares recent outturns for growth and inflation with the MPC's projections. Four-quarter GDP growth over most of the past year has been broadly as anticipated in May 2009. But CPI inflation in 2010 Q2 was 3.5%: the MPC attached only a small probability to inflation being this high a year earlier. Examining where data outturns have fallen within the forecast distribution, and the reasons for that, aids the MPC's understanding of how the economy is evolving and informs subsequent projections.

Inflation over the past year has been affected by a number of factors, including weak demand, the 25% fall in sterling since mid-2007, higher energy prices and changes in VAT. The mapping between such factors and inflation is difficult to identify precisely. And given the scale of the movements seen recently in these factors, small variations in the assumed mapping make a material difference to how the strength of inflation can be explained. The MPC's central judgement is that around one third of the difference between the outturn for CPI inflation in 2010 Q2 and the May 2009 central projection reflects higher-than-expected energy prices. The remainder of the difference reflects some combination of greater upward pressure from the past depreciation of sterling, less downward pressure from weak demand, and higher pass-through from VAT than previously assumed. The impacts of these factors are discussed in more detail in the second half of this box.

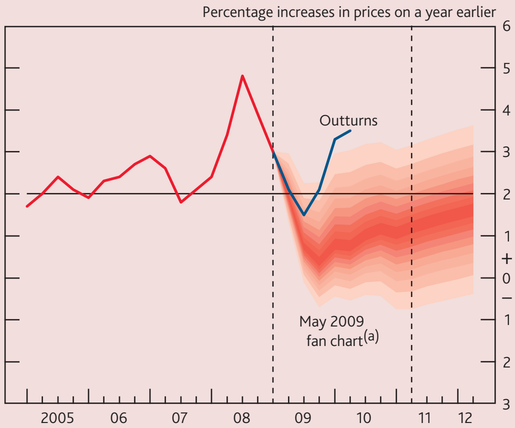
The May 2009 projections and outturns

The MPC's projections for growth and CPI inflation are probability distributions rather than point forecasts, and are shown as fan charts. The coloured area of the fan covers 90% of the probability distribution, so over a run of years roughly 10% of outcomes could be expected to lie outside this area. Each pair of identically coloured bands captures 10% of the distribution. The central darkest band contains the single most likely path.

The May 2009 central projection was for CPI inflation to fall back below the target during that year, in part driven by declining contributions from food and energy prices, and to remain below the target throughout the forecast period, as the downward pressure from the substantial margin of spare capacity more than offset the upward pressure from the restoration of the standard rate of VAT to 17.5% and the past depreciation of sterling.

CPI inflation fell between 2009 Q1 and 2009 Q3, but by less than anticipated in the May 2009 central projection. Since then, CPI inflation has risen sharply and in 2010 Q2 inflation was 3.5% — above the red area of the May 2009 fan chart (**Chart A**). External forecasters also attached a small probability to such an outturn: a Bank survey conducted in April 2009 found that, on average, forecasters assigned a probability of 5% to a CPI outturn of 3% or more in 2010 Q2.

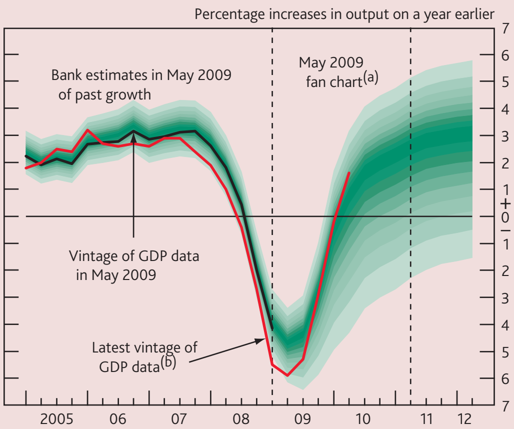
Chart A CPI inflation



(a) Based on market interest rate expectations and the assumption that the stock of purchased assets reached £125 billion and remained there throughout the forecast period. See footnote to **Chart 5.6** for information on how to interpret the fan chart.

Four-quarter GDP growth in 2010 Q2 was higher than the May 2009 central projection (**Chart B**). But since May 2009, the ONS has revised down its estimates of GDP growth in 2007, 2008 and 2009 Q1 (**Chart B**), so that the level of GDP in 2010 Q2 was somewhat lower than the May 2009 central projection. The strength of inflation, therefore, is unlikely to reflect higher-than-expected economic activity.

Chart B GDP



(a) Based on market interest rate expectations and the assumption that the stock of purchased assets reached £125 billion and remained there throughout the forecast period. See footnote to **Chart 5.1** for information on how to interpret the fan chart.
(b) Revisions to early estimates of GDP growth account for the gap between the red and black lines prior to the fan chart.

Why have CPI outturns been higher than the May 2009 central projection?

In 2010 Q2, CPI inflation was 2.8 percentage points higher than the May 2009 central projection. Around a third of that difference is likely to reflect stronger-than-expected energy prices. In 2010 Q2, US dollar oil prices were nearly 30% higher than the level implied by futures curves at the time of the May 2009 *Report*, pushing up retail petrol prices. In addition, the May 2009 forecast incorporated a judgement that retail gas and electricity prices would decline by around 15% in 2009 H2, following earlier sharp falls in wholesale prices. But energy bills were not cut until 2010, and the cuts were smaller than expected, at around 5%. Higher energy prices may also have added to inflation indirectly, via higher costs for many businesses.

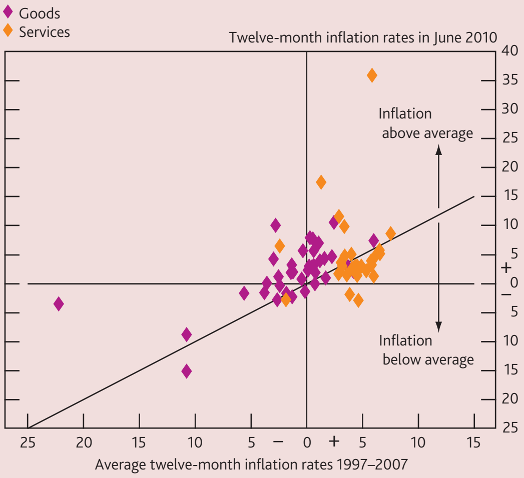
Inflation has also been raised by the restoration of the standard rate of VAT to 17.5% in January 2010. This tax rise was known in May 2009: the assumption underlying the May 2009 central projection was that around half of the VAT rise would be passed through into consumer prices. But it is possible that its impact may have been greater or smaller than that (see **Chart 4.3** on page 32). As a metric, if VAT had instead been passed through in full, that would account for around 0.7 percentage points of the gap between CPI inflation and the May 2009 central projection in 2010 H1.

Higher energy prices, and additional pass-through from VAT, do not, therefore, appear to account for all the unexpected strength in inflation. It is therefore likely that the net impact of the 25% depreciation of sterling since mid-2007 pushing inflation up on the one hand, and the weakness of demand pulling it down on the other, was different to that assumed in May 2009.

In May 2009, the MPC expected the exchange rate (which had depreciated between mid-2007 and early 2009) to continue to put upward pressure on inflation over the next year. But there was uncertainty about the extent to which businesses would respond by raising prices, or by pushing down other costs such as wages. The impact of the depreciation on prices appears to have been substantial. For example, **Chart C** shows that the June 2010 inflation rates of the majority of goods, which tend to be more import-intensive than services, were above their average during the decade preceding sterling's depreciation. Such outturns are consistent with pass-through having been greater than expected, and possibly accounts for between ½ and 1½ percentage points of the difference between CPI inflation in 2010 Q2 and the May 2009 central projection.

The sharp fall in demand that has occurred as a result of the financial crisis should reduce inflation. But sharp falls in demand also tend, over time, to be associated with some impairment of the economy's supply capacity, tempering the degree of spare capacity that emerges, and reducing the downward pressure on inflation.

Chart C CPI components[a]



(a) The chart contains data for 69 CPI components. Food and non-alcoholic beverages, fuels and lubricants, and electricity, gas and other fuels have been excluded. Due to data availability, the average inflation rates for five components are calculated since December 2000, while one component is calculated since December 2001. Data are non seasonally adjusted.

The recent recession may have had a more immediate adverse impact on effective supply than the MPC anticipated in May 2009, so that a smaller margin of spare capacity has emerged. Among other factors, that may reflect the impact of restrictions on the availability of working capital (Section 3). Consistent with a smaller margin of spare capacity, some surveys of capacity utilisation do not seem to have fallen by as much as the fall in output would have suggested.

In addition, the impact of a given margin of spare capacity on prices may have been smaller than anticipated. One possibility, consistent with reports from the Bank's Agents, is that businesses have focused on maintaining short-run cash flow during the recent recession, perhaps in response to the reduced availability of credit, rather than investing in building market share by setting lower prices. Overall, outturns over the past year suggest that a smaller-than-expected drag from weak demand could account for between ¾ and 1¾ percentage points of the difference between CPI inflation in 2010 Q2 and the May 2009 central projection.

In summary, around one third of the difference between the outturn for CPI inflation in 2010 Q2 and the May 2009 central projection is likely to reflect higher energy prices. The remainder of the difference reflects some combination of greater upward pressure from the depreciation of sterling, less downward pressure from weak demand, and higher pass-through from VAT than assumed in May 2009. Given the scale of the movements involved, small differences in assumptions can lead to very different interpretations of why inflation did not evolve as expected.

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 July.

On average, CPI inflation was expected to be above the 2% target in 2011 Q3, but slightly below target in the following two years (**Table 1**). Compared with three months ago, the range of views about inflation at the one-year horizon has shifted towards higher outcomes (**Chart A**). In part, that is likely to reflect the announced rise in the standard VAT rate to 20% in January 2011. On average, respondents expected inflation to be 1.9% at the three-year horizon.

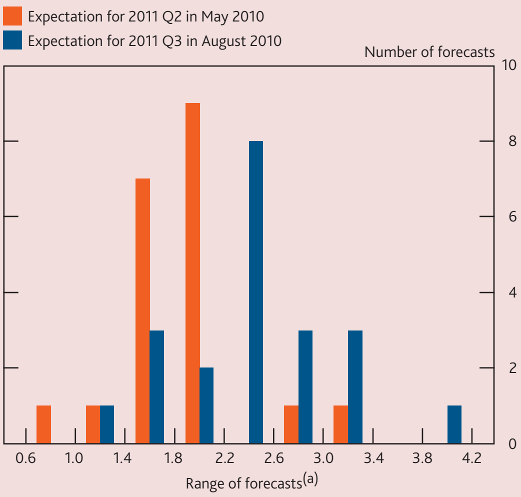
Table 1 Averages of other forecasters' central projections[(a)]

	2011 Q3	2012 Q3	2013 Q3
CPI inflation[(b)]	2.4	1.8	1.9
GDP growth[(c)]	2.0	2.3	2.5
Bank Rate (per cent)	1.2	2.1	3.2
Sterling ERI[(d)]	81.9	82.5	83.9

Source: Projections of outside forecasters as of 22 July 2010.

(a) For 2011 Q3, there were 21 forecasts for CPI inflation, GDP growth and Bank Rate and 17 for the sterling ERI. For 2012 Q3 and 2013 Q3, there were 18 forecasts for CPI inflation, GDP growth and Bank Rate and 15 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.

Chart A Distribution of CPI inflation central projections one year ahead

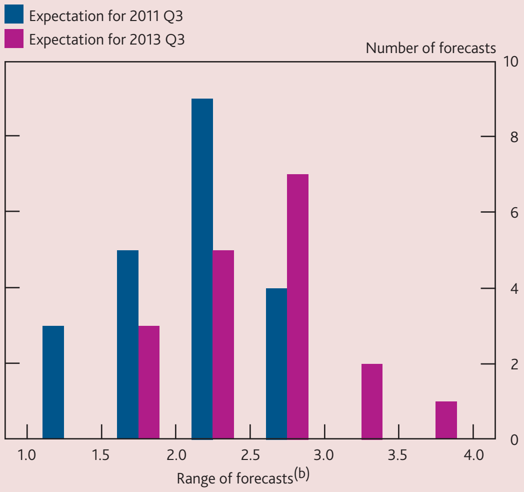


Sources: Projections of 20 outside forecasters as of 26 April 2010 and 21 outside forecasters as of 22 July 2010.

(a) A projection that is on the boundary of these ranges is classified in the higher bucket. For example, a 1.8% projection is included within the 1.8% to 2.2% bucket.

On average, forecasters expected four-quarter GDP growth to be 2.0% at the one-year horizon, rising to 2.5% by 2013 Q3. Expectations at the one and two-year horizons were slightly lower than three months ago. There were a range of views, both in the near term and further out (**Chart B**).

Chart B Distribution of GDP growth central projections[(a)]



Source: Projections of outside forecasters as of 22 July 2010.

(a) For 2011 Q3 there were 21 forecasts. For 2013 Q3 there were 18 forecasts.
(b) A projection that is on the boundary of these ranges is classified in the higher bucket. For example, a 2.0% projection is included within the 2.0% to 2.5% bucket.

Most forecasters expected Bank Rate to have risen by 2011 Q3, with further increases expected in the following two years. Expectations for Bank Rate over the next three years were, on average, lower than three months ago. On average, the sterling ERI was projected to appreciate gradually.

The Bank also asks forecasters for an assessment of the risks around their central projections for CPI inflation and GDP growth (**Table 2**). Respondents thought, on average, that there was around a 60% chance that inflation would be above target in 2011 Q3. But in 2012 Q3, there was around a 60% chance that inflation would be below the target. The probability distribution for four-quarter GDP growth at all horizons was little changed since the May *Report*.

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%
2011 Q3	2	5	12	20	24	20	18
2012 Q3	4	10	18	27	23	13	6
2013 Q3	3	9	15	26	25	14	8

GDP growth

Probability, per cent	Range:					
	<-1%	-1–0%	0–1%	1–2%	2–3%	>3%
2011 Q3	3	6	14	29	36	13
2012 Q3	3	6	12	24	34	21
2013 Q3	3	7	12	22	31	26

Source: Projections of outside forecasters as of 22 July 2010.

(a) For 2011 Q3, 21 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 2012 Q3 and 2013 Q3, 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.

Index of charts and tables

Charts

Tables

Text of Bank of England press notice of 10 June 2010
Bank of England maintains Bank Rate at 0.5% and maintains the size of the Asset Purchase Programme at £200 billion

The Bank of England's Monetary Policy Committee today voted to maintain the official Bank Rate paid on commercial bank reserves at 0.5%. The Committee also voted to maintain the stock of asset purchases financed by the issuance of central bank reserves at £200 billion.

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

Text of Bank of England press notice of 8 July 2010
Bank of England maintains Bank Rate at 0.5% and the size of the Asset Purchase Programme at £200 billion

The Bank of England's Monetary Policy Committee today voted to maintain the official Bank Rate paid on commercial bank reserves at 0.5%. The Committee also voted to maintain the stock of asset purchases financed by the issuance of central bank reserves at £200 billion.

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

Text of Bank of England press notice of 5 August 2010
Bank of England maintains Bank Rate at 0.5% and the size of the Asset Purchase Programme at £200 billion

The Bank of England's Monetary Policy Committee today voted to maintain the official Bank Rate paid on commercial bank reserves at 0.5%. The Committee also voted to maintain the stock of asset purchases financed by the issuance of central bank reserves at £200 billion.

The Committee's latest inflation and output projections will appear in the *Inflation Report* to be published at 10.30 am on Wednesday 11 August.

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

Glossary and other information

Glossary of selected data and instruments

AWE – average weekly earnings.
CDS – credit default swap.
CPI – consumer prices index.
CPI inflation – inflation measured by the consumer prices index.
CPIY – consumer prices index excluding indirect taxes.
ERI – exchange rate index.
Euribor – euro interbank offered rate.
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.

Abbreviations

A8 Accession countries – Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.
BCC – British Chambers of Commerce.
CBI – Confederation of British Industry.
CEBS – Committee of European Banking Supervisors.
CIPS – Chartered Institute of Purchasing and Supply.
ECB – European Central Bank.
EU – European Union.
FISIM – Financial Intermediation Services Indirectly Measured.
FTSE – Financial Times Stock Exchange.
GfK – Gesellschaft für Konsumforschung, Great Britain Ltd.
HBF – Home Builders Federation.
IMF – International Monetary Fund.
LTV – loan to value.
MPC – Monetary Policy Committee.
MTIC – missing trader intra-community.
OFCs – other financial corporations.
ONS – Office for National Statistics.
PNFCs – private non-financial corporations.
PwC – PricewaterhouseCoopers.
RICS – Royal Institution of Chartered Surveyors.
S&P – Standard & Poor's.
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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