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Quarterly UK Economic Forecast

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Quarterly Economic Forecast

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The economic outlook over the next two years

Are UK interest rates high enough?

View based on money trends vs. view based on "look at everything"

An interesting debate has opened up in the last few weeks between monetary and non-monetary approaches to forecasting the UK economic outlook. The central conclusion of the monetary analysis is that, because money supply growth has been rising and is now almost 10% a year, the prospect is for continued buoyancy in domestic demand in early 2005, excessive pressure on the nation's resources and the risk of above-target inflation in late 2005. The punch-line for policy-makers and markets is that base rates at 4 3/4% will not be sufficient to keep inflation under control. By contrast, non-monetary analysts take a relaxed view of the situation, believing that the rise in base rates so far announced has imposed enough restraint in the housing market and on consumer spending for inflation to remain on track.

Three points - 1. Growth rates of money and nominal GDP are related

It will be several months before this debate is resolved by the data. But three points will be made here to explain key elements in the monetary analysis. The first is perhaps routine, but has to be stated. Although the growth rates of money and nominal gross domestic product may not be identical, they are related in the long run. If the decade to the second quarter of 2004 is chosen (somewhat at random), the annual growth rates of M4 and nominal GDP averaged 7 1/2% and 5 1/2% respectively. The numbers are different, but they are within striking distance of each other. The 2% gap may or may not continue, but - if it did - the annual growth rates of nominal GDP consistent with 9% - 10% M4 growth would be 7% - 8%. These could not be reconciled with an inflation rate at the target rate of 2%. Either money growth has to decelerate or inflation will exceed target. At current interest rates banks are finding it easy to add assets and to grow their balance sheets at annual rates of about 10%. Unless this situation changes (and there is no obvious reason why it should), interest rates are too low. Secondly, evidence of a slowdown in growth is not enough. As the level of output is probably a smidgeon above trend, trend growth is the maximum compatible with stable inflation. If the quarterly growth rate of demand moderates from the 1%-per-quarter seen over the last year to, say, 0.7% - 0.8% a quarter, that is welcome, but growth would still be above the economy's trend rate (usually put at about 0.6% a quarter).

2. Slowdown must be to a trend or beneath-trend growth rate

3. The housing market is *not* the whole economy

Finally, recent commentary has fallen into the habit of equating "the state of the housing market" with "the state of the economy". This is a mistake. While housing is the largest type of wealth owned by most people, investment in dwellings is a small part of demand. (In 2003 gross fixed capital formation in dwellings was £35.3b., compared with total GDFCF of £173.6b.) Housing matters enormously to consumer confidence, but large parts of the economy are more sensitive to other developments (oil prices, exchange rates, utility prices, etc.). Company investment is more volatile - and so more important to the cycle - than the personal sector's investment in houses. Over the last 40 years companies' investment plans have been influenced by their balance-sheet strength, including their money holdings. At present corporate liquidity is in great shape.

Professor Tim Congdon **25th November, 2004**

Summary of main points of the

Quarterly Macroeconomic Forecast, November 2004

A satisfactory year ahead, but inflation is rising

The hectic pace of global expansion in the year to mid-2004 is unlikely to be repeated in 2005, but at least trend growth of world output (3 1/2% or so) is to be expected. UK domestic demand continues to benefit from high money growth. Upward pressures on inflation will need to be countered by a rise in base rates.

Other key points

- **Central banks around the world - including the Bank of England - believe that the oil price surge in 2003 and 2004 will not continue in 2005, and are therefore sanguine about inflation in late 2005. But shipping freight rates and base metal prices have been buoyant in recent months, while early 2005 will see higher steel prices raising industrial costs.**

- **The UK's exports have disappointed in 2004, partly because of its dependence on sluggish European markets, but net exports ought to make a positive contribution to GDP growth in 2005. (See p. 22.)**

- **Domestic demand will stay strong at least until mid-2005, partly because high money supply growth is helping balance sheets and asset prices throughout the economy. Mortgage demand is weakening, but only after a major boom, and still higher interest rates are needed to dampen credit growth. (See p. 5 and p. 8.)**

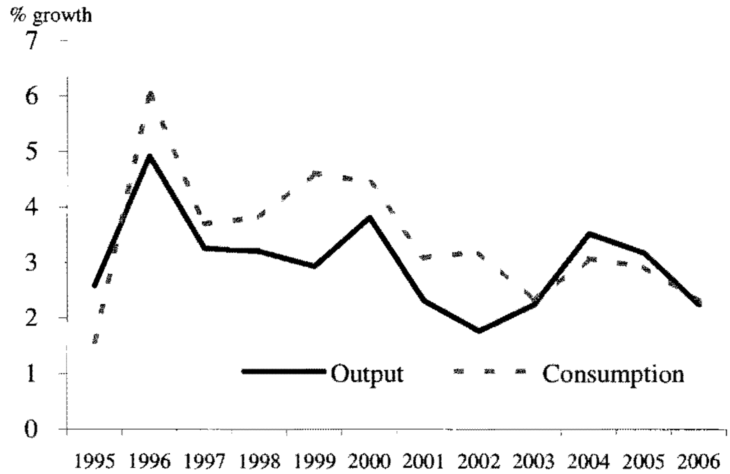
- **Company profits have done well in 2004, helped by a cyclical rebound in productivity. (See p. 17.) The high oil price has also benefited the UK's large oil majors (BP and Shell) and companies involved in North Sea activity. (See p. 18.)**

- **Despite a tight labour market, pay growth has risen only moderately. Immigration may be part of the explanation, particularly from East European countries following their accession to the European Union in May. (See p. 20.)**

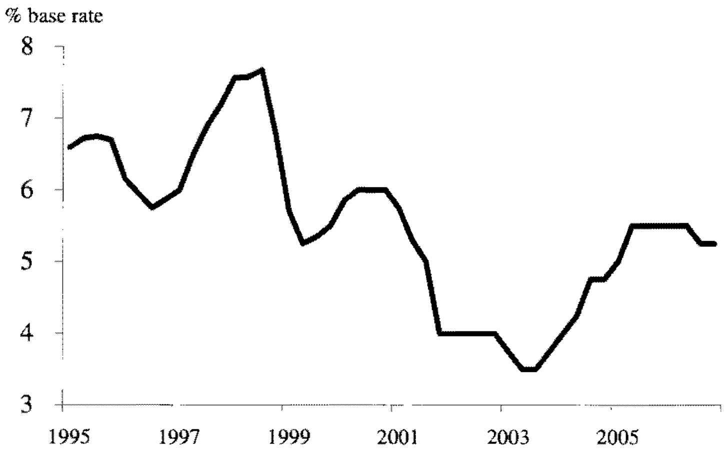
- **Beneath-trend growth is to be expected in the UK from mid-2005, probably with base rates about ½ - 1% higher than today.**

This forecast was prepared by Professor Tim Congdon, Martin McMahon, Mark Richards and Stewart Robertson.

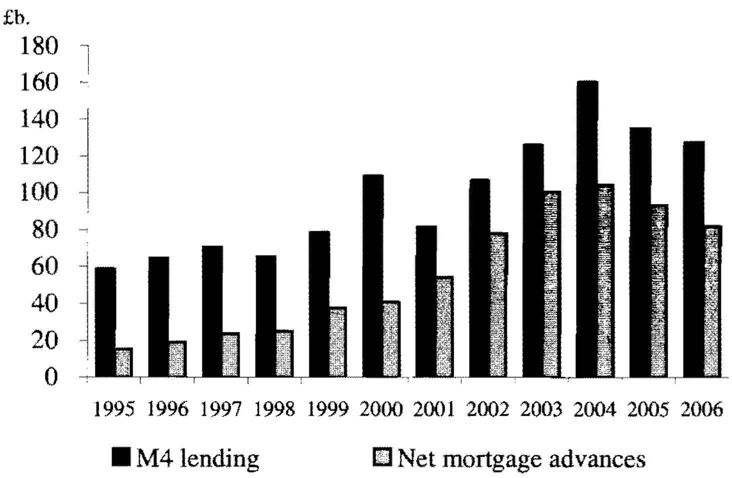
GDP growth and consumption



Interest rate assumption



Credit growth



A key influence on an economy's trend rate of growth is the rate of increase in employment, which in turn is heavily influenced by demographics and migration. The importance of demographics is obvious and relatively easy to forecast, with the number of people of working age changing as people born between 16 and 22 years ago replace retirees. The effect of migration is more uncertain and difficult to predict, but usually is much smaller. However, at present the UK is a significant net recipient of immigrants. Indeed, 2004 is likely to see the highest net immigration ever.

Net immigration has been running at 150,000 - 175,000 a year since 1999. This year the figure could well exceed 200,000, which would be the highest ever. The critical new factor is an influx of workers from Eastern Europe following the accession of ten new states to the European Union in May. The UK was the only large existing EU member state not to impose a seven-year transitional period limiting the employment of workers from the new members. The government expected that 13,000 Eastern European workers would register for work permits in 2004. In fact, the number from May to October was 91.000. As a proportion of these registrants had already been working the UK before May, the message is that the extra numbers from Eastern Europe may be of the order of 50,000 a year.

The UK's working-age population is about 40m. and total employment is just over 28m. The majority of immigrants are of working age and most of them want employment. The implication is that net immigration may be adding about 1/2% a year to UK employment, although the precise number depends on the assumptions adopted. The addition to the trend growth rate of the UK's output is probably lower than this (at, say, 0.3% a year), because the immigrant workers would typically have a lower skill level than people born in the UK. 0.3% may sound small, but it is significant when making estimates of the output gap (i.e., the difference between actual and trend output). The state of the labour market is central in calculating the output gap. According to National Statistics (using methodology favoured by the International Labour Office), the unemployment rate in the three months to August was 4.7%, down 0.2% on the previous three months and down 0.4% from a year earlier. So - despite the influx of new workers from abroad - the labour market has been tightening and output may be a shade above trend. A cross-check on this conclusion is provided by business surveys, with the quarterly survey from the Confederation of British Industry being particularly useful because it has a long history and a reliable track record. According to the October survey, a net 17% of companies reported that shortages of skilled labour were a constraint on output, somewhat higher than the long-run average.

The economic outlook

1. The real side of the economy

The weak Q3 growth estimate is not the start of an extended period of low growth. Early 2005 is set to see above-trend growth and rising inflation. Higher interest rates will eventually bring about the necessary slowdown in late 2005 and 2006.

The slowdown in GDP growth in Q3 (to 0.4% from 0.9% in Q2, if official figures are to be believed) is likely to be temporary. Even the Bank of England has assumed a more plausible +0.6% in the quarter in its most recent projections. Growth in the final three months of the year is set to be stronger, which would make 2004 the best year for the UK economy since the boom time of 2000. Talk of a significant slowdown in domestic demand in 2005 looks misplaced. Although consumer spending growth has slowed slightly in recent months and the housing market will cool further, a major retrenchment in consumption is implausible at current interest rates. Household balance sheets remain in very good health (see. p. 10), employment has continued to rise and wage growth has picked up modestly. Meanwhile, business investment has recovered and construction activity has stayed strong, implying that investment overall will make a large contribution to overall GDP growth. This year should see the biggest rise in domestic fixed capital formation since 1998. Exports have been somewhat sluggish, given the strength of world growth, but are starting to revive. Above all, recent monetary trends (see p. 5) argue insistently against a major slowdown in early 2005. The momentum being carried into next year should ensure another year of 3%+ GDP growth. The strength of the economy, along with rising inflation pressures, will mean interest rates going up further than is generally expected. Only after this will we see the necessary slowdown to below-trend growth for a period.

Real GDP growth and its components

	GDP, expenditure measure, %	Private consumption, %	Fixed investment, %	Government consumption, %	Change in stockbuilding % of GDP
2000	3.8	4.6	3.6	2.3	-0.1
2001	2.3	2.9	2.6	2.6	0.1
2002	1.8	3.3	2.7	3.8	-0.4
2003	2.2	2.3	2.2	3.5	0.0
2004	*3.5*	*3.1*	*6.1*	*3.4*	*0.1*
2005	*3.2*	*2.9*	*4.0*	*2.2*	*0.0*
2006	*2.2*	*2.3*	*2.0*	*1.4*	*0.0*
	Domestic demand %	**Exports of goods and services, %**	**Imports of goods and services, %**	**Net exports % of GDP**	**Current balance % of GDP**
2000	3.8	9.4	9.1	-0.1	-2.5
2001	2.9	2.9	4.9	-0.7	-2.3
2002	2.9	0.1	4.1	-1.2	-1.7
2003	2.5	0.1	1.3	-0.4	-1.9
2004	*3.7*	*3.0*	*3.7*	*-0.3*	*-1.7*
2005	*2.9*	*5.0*	*3.8*	*0.1*	*-1.3*
2006	*2.1*	*4.0*	*3.2*	*0.1*	*-1.0*

Figures until 2003 are taken from *Economic Trends*, various tables; figures thereafter are forecast. The growth rates are derived from a forecast of GDP at market prices in 2001 prices. All figures refer to real changes (i.e., in 2001 prices), except for the current balance, which is expressed in current prices.

2. The monetary side

Real money growth of 6% or 7% argues strongly against a major slowdown in domestic demand growth in early 2005. Until credit growth is slowed through higher interest rates, the monetary backdrop remains favourable for growth.

The monetary backdrop is even more favourable to short-term growth prospects than it was at the time of the last *Quarterly Economic Forecast* in August. At that time, base rates were 4¾%, M4 was growing at annualised rates of 8% or so and credit growth was running at 10% to 11%. Today, interest rates are still 4¾%, but monetary and lending growth have pushed up to around 10% and 12% respectively. With inflation staying subdued for the moment, real M4 is rising at an underlying rate of 7% or more. This is not the setting for a significant slowdown in domestic demand growth. Strong money growth will boost liquidity and bolster balance sheets across all sectors of the economy (see p. 9). In particular, corporate liquidity (the ratio of deposits to borrowing for private, non-financial corporations) has risen noticeably in recent months, reaching 63% in September from 59% a year ago. Over the last forty years this ratio has provided a useful guide to domestic demand trends subsequently, largely because it has often anticipated movements in business investment, one of the more volatile components of GDP. A fairly reliable rule-of-thumb is that a figure of below 50 points to static domestic demand, whereas one in the high 60s suggests a full-scale boom. The present value is therefore consistent with above-trend increases in domestic demand in late 2004 and early 2005. Higher inflation next year will reduce real M4 somewhat, but until money and credit growth is stemmed through higher interest rates, the outlook is for further robust GDP growth.

Key monetary variables

	Clearing bank base rate, %	Growth rate of lending, %	Growth rate of M4,%	Increase in retail price index, %	Growth rate of real money, %
2000	6.0	11.2	8.4	3.1	5.2
2001	4.9	7.1	6.6	1.0	5.7
2002	4.1	8.6	7.0	2.6	4.4
2003	3.5	8.6	5.6	2.7	4.9
2004	*4.5*	*11.7*	*9.0*	*3.2*	*5.9*
2005	*5.0*	*8.8*	*6.7*	*3.3*	*3.5*
2006	*5.3*	*7.7*	*5.6*	2.7	2.8

	Velocity of circulation of M4	Change in velocity, %	Change in effective exchange rate, %	Increase in average earnings, %	Increase in house prices, %
2000	1.08	-2.9	3.7	4.4	9.3
2001	1.06	-1.9	-1.6	3.3	13.8
2002	1.04	-1.7	0.1	4.2	25.3
2003	1.03	-0.4	-5.6	3.8	15.6
2004	*1.00*	*-3.1*	*1.6*	*4.6*	*12.0*
2005	*1.00*	*-0.5*	*-4.6*	*4.8*	*-5.0*
2006	*1.00*	*-0.1*	*-1.0*	*4.7*	*0.0*

Figures until 2003 are taken from a variety of sources; figures thereafter are forecast. Clearing bank base rate is average for the year. All other figures relate to end-year. Velocity is annual rate GDP divided by the money stock. Real money is nominal money adjusted for change in retail prices.

The policy environment

1. The UK

Tax revenues are enjoying a cyclical upswing, while government spending growth is being squeezed. But the public sector deficit should remain above 3% of GDP both this financial year and next.

A cyclical upswing in tax receipts and bumper North Sea revenues are supporting public finances. Central government cash receipts were 5.8% up in the seven months April to October 2004 compared to a year earlier. Corporation tax, which inlcudes tax on North Sea profits, recorded the strongest growth with expansion of 12.5% over the period. Meanwhile, spending growth has slowed sharply, with central government cash outlays only 3.1% higher. *Spending Review* 2004 projections had been for a 6.8% rise in total managed expenditure this financial year. Concerns about the state of the public finances appear to be leading to a squeeze on spending. Speculation has been mounting that the Chancellor may fail to meet his "golden rule", namely for the current budget to record a surplus over the economic cycle. The current budget is in deficit to the tune of £17.2b. so far this financial year compared to the Chancellor's *Budget 2004* projection of an £11.0b. deficit for the year as a whole. Spending plans may need to be reined in further over the forecast horizon if the Chancellor is to meet his target. The public sector net cash requirement has edged down on a rolling twelve month basis in recent months although it continues to hover above 3% GDP. Similar totals are expected over the forecast horizon. The Government's wasteful recuritment drive over the past few years is undermining productivity growth. Output per hour in the industries classified as public adminsistration, defence, education, health and social work has been more or less flat over the past three years.

Public sector net cash requirement

	Public sector net cash requirement, £b.	PSNCR, % of GDP	Privatisation proceeds, £b.	PSNCR less privatisation proceeds, £b.	PSNCR less privatisation proceeds, % of GDP
1999/00	-9.6	-1.1	0.6	-8.2	-0.9
2000/01	-37.2	-3.9	0.1	-36.7	-3.9
2001/02	3.3	0.3	0.6	4.0	0.4
2002/03	22.5	2.2	0.0	22.5	2.1
2003/04	39.7	3.8	0.0	39.7	3.8
2004/05	*36.0*	*3.3*	*0.0*	*36.0*	*3.3*
2005/06	*35.0*	*3.0*	*0.0*	*37.0*	*3.0*

	Public sector financial deficit, £b.	Total managed expenditure, £b.	% increase in total managed expenditure	Current receipts, £b.	% increase in current receipts
1999/00	-15.2	350.6	0.9	357.1	6.3
2000/01	-15.4	364.9	4.1	383.0	7.3
2001/02	0.5	391.8	7.4	390.7	1.8
2002/03	25.2	421.0	7.5	397.0	1.8
2003/04	34.8	460.0	9.3	420.0	6.0
2004/05	*37.0*	*490.0*	*6.5*	*450.0*	*7.1*
2005/06	*35.0*	*522.0*	*6.5*	*480.0*	*6.7*

Figures until 2003/04 are taken from *Public Sector Finances*; figures thereafter are based on the *Budget 2004*, the *Spending Review 2004* and our own assumptions. PSNCR is expressed as a percentage of GDP at current market prices. Total managed expenditure includes debt interest. PSNCR in both 1997/98 & 1998/99 is reduced by £2.6b. due to windfall tax. In 2000/01 it is assumed that the entire £22.5b. proceeds of mobile phone auction is received. Current receipts exclude this revenue.

2. International

World economic growth should moderate towards trend in 2005. Higher interest rates will be needed to dampen above-trend GDP growth. But, with output only a touch above trend and inflationary pressures mild, tightening will be modest.

This year the global economy has enjoyed its strongest performance since 1973, with annual GDP growth likely to approach the 5% mark. Expansion in the G7 economies has been robust, with even the laggard Euro-zone enjoying above-trend output growth in the first half of the year. But the global economy is now much more than the traditional industrial nations. Growth in China and some other medium-sized economies such as Russia and India has been impressive. Russian GDP expanded by 7.4% in the year to Q2 2004 and Indian GDP by 8.2%. OECD estimates suggest that there is a small negative output gap in the OECD as a whole, implying a degree of spare capacity. But at current interest rates, above-trend GDP growth should continue into 2005. Shipping freight rates, a sensitive demand indicator, have kept on soaring in recent months. The emergence of small positive output gaps is expected to provoke some upward pressure on inflation, requiring higher interest rates next year. Indeed, output is probably already above-trend in the Asian economies that have been in the vanguard of the global boom. However, a sharp slowdown in the global economy next looks unlikely. G7 interest rates are likely to rise only modestly, with positive output gaps relatively small and inflationary pressures mild. OECD economic growth is forecast to moderate towards trend next year and over the forecast horizon. The slowdown in China and the wider Asian region may be more pronounced.

The international environment

	OECD real GDP growth	OECD consumer price inflation	OECD producer price inflation	Non-oil commodity price growth	Nominal oil price, $ per barrel
2000	3.8	2.6	3.8	-7.9	28.4
2001	0.8	2.3	0.7	-4.0	24.4
2002	1.9	2.5	-0.6	0.6	24.8
2003	2.1	2.5	1.0	7.1	28.6
2004	*3.5*	2.5	*3.4*	*18.7*	*38.5*
2005	*3.1*	*2.8*	*3.4*	*6.4*	*35.0*
2006	2.5	2.4	2.9	*5.3*	*30.0*

	Real oil price, 2000 prices	Three month Euro$ rate	Dollar/sterling exchange rate	Sterling effective rate, 1990 = 100	Sterling real effective exchange rate
2000	28.4	6.5	1.52	107.5	107.8
2001	24.0	3.8	1.44	105.9	107.8
2002	24.3	1.8	1.50	105.8	106.1
2003	27.6	1.2	1.64	100.2	100.6
2004	*36.3*	*1.5*	*1.82*	*103.8*	*104.7*
2005	*31.5*	2.7	*1.77*	*100.0*	*100.9*
2006	26.2	3.3	*1.60*	*98.0*	*98.7*

Figures until 2003 are taken from publications issued by the OECD and IMF, and *Economic Trends*. OECD real GDP growth is a weighted average of all OECD countries. The oil price is for North Sea Brent. Real oil price is nominal oil price in dollar terms deflated by OECD producer prices. Commodity prices are measured by the IMF's world, non-fuel index. Inflation figures are OECD total.

Monetary trends

1. Determinants of monetary growth

Mortgage credit growth has slowed modestly and should decline further in coming months. But a 5% interest peak is unlikely to slow it to a sustainable rate. The impact of rapid lending growth on M4 has been partly neutralized by bond issues.

Credit growth has continued to soar throughout 2004, despite the rise in interest rates to 4¾% from 3½% in autumn 2003. In the six months to October M4 lending rose at an annualised rate of 11.5%. Twelve months earlier (before any interest rate rise) the comparable figure was 10.4%. On the face of it, higher interest rates have yet to have any impact on the appetite for debt. Total lending is likely to exceed £160b. in 2004, by far the largest figure ever and double the amount just three years ago. Mortgage credit growth within the M4 sector has slowed modestly (from about 12% to 10%) and is set to dip further in coming months according to recent approvals numbers. But the experience of the last decade suggests that a base rate of 5% would only slow the underlying growth rate of mortgage borrowing to around 8% to 9%, still too high for comfort. A peak of nearer to 6% would be required to slow the pace of expansion to a more sustainable 6%. Rapid credit growth would have had a more significant impact on monetary growth were it not for the fact that banks have financed a considerable proportion of the expansion of their assets by issuing bond liabilities. There must be considerable doubts about whether they will be able to continue to do so on the present scale in future. Meanwhile, non-household lending growth, which appears much less sensitive to interest rates, has picked up recently. Sterling unused credit facilities, a leading indicator of corporate loan demand, suggest this trend will continue. Interest rates will need to rise in 2005 to stem excessive credit and money growth.

Credit counterparts to broad money growth

£b.	Public sector borrowing	External finance of public sector	Sales/purchases (-/+) of public sector debt	1. Public sector contribution to M4	Bank lending to private sector
2000	-37.6	3.6	13.6	-20.4	96.9
2001	-2.9	23.6	-11.2	8.4	69.7
2002	17.1	2.5	-8.1	11.0	92.4
2003	39.3	-13.4	-32.8	-6.9	101.5
2004	*35.0*	*-8.0*	*-32.0*	*-5.0*	*129.7*
2005	*34.0*	*-5.0*	*-32.0*	*-3.0*	*109.4*
2006	*32.0*	*-4.0*	*-32.0*	*-4.0*	*103.5*

	Building society lending	2. Total lending to private sector	3. Change in non-deposit liabilities	4. External transactions	Change in M4
2000	14.4	111.2	-30.8	5.7	65.7
2001	10.5	80.2	-10.3	-20.3	58.0
2002	14.5	106.9	-25.3	-25.2	67.4
2003	24.1	125.7	-20.5	-39.0	59.3
2004	*30.8*	*160.5*	*-80.0*	*20.0*	*95.5*
2005	*26.0*	*135.4*	*-30.0*	*-25.0*	*77.4*
2006	*24.5*	*128.0*	*-30.0*	*-25.0*	*69.0*

Figures until 2003 are taken from *Financial Statistics*, Table 3.1F and from the Bank of England; figures thereafter are forecast. Bank and building society lending is to the private sector in sterling terms. Public sector contribution to M4 is equal to the sum of the first three columns, while total lending to the private sector is equal to the sum of bank and building society lending. Change in M4 = 1 + 2 +3 + 4.

2. Sectoral breakdown of monetary growth

Aggregate M4 growth of around 10% means that 8% growth of household deposits can now be reconciled with strengthening liquidity in the corporate and financial sectors. A domestic demand slowdown in early 2005 looks unlikely.

Household holdings of M4 have continued to grow by around 8% to 9% a year, a pace of increase that has now been sustained for more than three years. But total M4 is now growing faster (9.8% in the year to October), implying stronger liquidity elsewhere. Over the last twelve months the deposits held by both private, non-financial corporations (PNFCs) and other financial corporations (OFCs) have grown at double-digit rates. If household money balances grow in line with incomes in the future, as is plausible, then non-household deposits will rise at 12% to 15% annual rates if aggregate M4 continues to grow by 9% to 10% a year. The Bank of England, and others, dismiss the significance of financial sector money, claiming that any connection between it and both economic activity and inflation is too complex and unreliable to be of any analytical use. But there is a reasonable relationship between financial sector money and asset prices over the medium term. Two of the major financial bubbles in the past (1972/3, 1987/8) were preceded by exceptionally strong growth of financial sector money (40%+ rates of increase). Trends today are nothing like as alarming, but if financial sector deposits grow by close to 10% a year (it could be much higher), as looks likely, then financial asset prices will receive significant liquidity support. The knock-on beneficial wealth effects will stimulate spending elsewhere in the corporate and household sectors. A domestic slowdown is very unlikely with current rates of monetary growth.

Sectoral composition of bank and building society deposits

	Notes and coin, £b.	Bank deposits personal £b.	Building society deposits, personal £b.	1. M4 holdings household sector, £b.	% growth of household sector M4 deposits
2000	26.6	402.3	108.3	537.2	6.1
2001	28.9	430.2	122.3	581.4	8.2
2002	31.2	464.2	132.0	627.3	7.9
2003	33.6	500.4	142.3	676.3	7.8
2004	*36.3*	*540.2*	*153.6*	*730.1*	*7.9*
2005	*38.6*	*574.9*	*163.4*	*776.9*	*6.4*
2006	*41.1*	*611.8*	*173.9*	*815.0*	*4.9*

	2. M4 holdings, private non-financial corporations, £b.	3. M4 holdings financial corporations £b.	M4 total, £b.	Change in M4 total, £b.	% growth of M4
2000	136.6	208.7	882.5	65.7	8.4
2001	144.0	215.7	941.1	58.0	6.5
2002	152.8	226.7	1,006.8	67.4	6.9
2003	165.5	221.3	1,063.1	59.3	5.6
2004	*182.6*	*245.9*	*1,158.6*	*95.5*	*9.0*
2005	*195.0*	*264.0*	*1,235.9*	*77.4*	*6.7*
2006	*210.0*	*280.0*	*1,305.0*	*69.0*	*5.6*

Figures until 2003 are taken from *Financial Statistics*, tables 3.1D, 3.1G, 4.2B and from *Monetary and Financial Statistics*; figures thereafter are forecast. All figures relate to sterling deposits, not seasonally adjusted. Note that M4 = 1+2+3 and that the change in M4 on p.9 is not the same as that on p.8 because of discrepancies in official data. M4 data has been affected by changes in the

Household sector outlook

1. The balance sheet

Debt may have ballooned to a record level relative to income, but so too has wealth. Much of the increase in financial liabilities has been matched by the accumulation of financial assets.

The importance of analysing both sides of the household sector's balance sheet cannot be overstated. Most attention remains focused on the high levels of debt and tends to ignore the simultaneous building-up of assets. True, debt may have soared to a record level relative to incomes, but wealth has also risen to an all-time high. Strong gains in house prices have boosted tangible wealth, while a return to reasonable stock market performance has helped financial wealth. Household balance sheets are in good health, a fact confirmed by the GfK index of consumer confidence. Although the headline measure has fallen from 0% in January to -6% in October (the average for the last decade is -1.5%), declines have been driven solely by people's perception of how the economy has performed over the last twelve months and their expectations for the year ahead. When asked about personal finances, respondents are much more upbeat, with results ranging between +7% and +10% in 2004. The incurrence of financial liabilities has been matched by the acquisition of financial assets. In the past three quarters, households have increased their financial liabilities by £101 b., but the equivalent to 96% of this sum has been used to accumulate financial assets, mostly in the form of deposits (£51b.). Furthermore, there is still reasonable scope for households to continue to increase debt levels, with the ratio of mortgage debt to the value of the housing stock below its long-run average.

Highlights of the household sector's balance sheet

	Gross disposable income £b.	Net financial wealth	Ratio of net financial wealth to GDI £b.	Total financial liabilities, ("debt"), £b.	Debt to income ratio
2000	654.6	2,423.4	3.70	741.6	1.13
2001	701.6	2,145.3	3.06	819.1	1.17
2002	722.5	1,805.1	2.50	931.6	1.29
2003	751.9	2,023.7	2.69	1,052.6	1.40
2004	*791.8*	*2,107.9*	*2.66*	*1,168.3*	*1.48*
2005	*835.3*	*2,201.1*	*2.64*	*1,261.8*	*1.51*
2006	*879.6*	*2,291.6*	*2.61*	*1,337.5*	*1.52*

	Total tangible assets, £b.	Ratio of tangible assets to GDI.	Total net wealth, £b.	Ratio of wealth to GDI.	Savings ratio
2000	2,100.3	3.21	4,523.7	6.91	5.1
2001	2,249.1	3.21	4,394.4	6.26	6.5
2002	2,705.0	3.74	4,510.1	6.24	5.3
2003	3,009.9	4.00	5,033.6	6.69	5.6
2004	*3,473.1*	*4.39*	*5,581.0*	*7.10*	*6.6*
2005	*3,373.0*	*4.04*	*5,574.1*	*6.67*	*7.0*
2006	*3,442.9*	*3.91*	*5,734.6*	*6.52*	*7.3*

Figures until 2003 are taken from *Financial Statistics and the Blue Book*; figures thereafter are forecast. GDI numbers are fourth quarter multiplied by 4; balance sheets are end-year. Holding of ordinary shares (directly or indirectly via insurance policies and pension funds) account for over half of net financial wealth, and ordinary shares and houses dominate net wealth.Dwellings represents 85% to 90% of total tangible assets. Revaluations therefore have a much larger effect on changes in stocks than financial flows.

2. The housing market

The housing market is undoubtedly cooling, with price falls now expected in 2005. However, a "crash" remains unlikely, with economic growth strong, interest rates still low and only a small rise in the number of homes on the market.

The ongoing decline in mortgage approvals points to slower house price inflation in coming months (see p.14). The latest RICS housing market survey also confirms that conditions have cooled, with the ratio of houses sold to the number of homes on estate agents' books below its long-run average for the first time in more than four years. A 30% drop in the number of sales has been the main force behind the fall in the ratio. But, while stocks of unsold homes are also up, they are still less than half of the number reached at the time of the 1990 crash in house prices. With no "rush for the exit sign", house prices are unlikely to fall dramatically. As interest rates are still low by historical standards, the "trigger" for a crash seems absent. Moreover, it is conceivable that buy-to-let investors - a group many feared would dump their properties on the market when interest rates rose - are increasingly viewing houses as long-term investments to replace conventional savings products. The rise in the tangible saving ratio is part testament to this idea (see p.13). Our central forecast is that base rates will reach 5½ % by end-2005, with most tightening taking place in the latter half of the year as the MPC acts to dampen the increased threat of inflation. As a consequence, house prices are expected to be broadly flat in coming months, but to fall by around 5% in 2005 as higher base rates take hold. Further out, the period of adjustment towards a more sustainable house-price to earnings ratio will continue, but will not involve a slump in house prices.

The use of mortgage funds

	Mortgage rate, %.	1. Net mortgage advances, £b.	2.Government grants, £b.	3. Equity withdrawal, £b.	4. Investment in housing, £b.
2000	7.6	40.7	2.8	16.3	27.4
2001	5.7	54.2	2.8	27.2	29.8
2002	5.6	78.1	2.8	47.8	34.5
2003	5.6	100.5	2.8	63.5	40.5
2004	*6.3*	*104.4*	*2.8*	*61.0*	*47.8*
2005	*7.0*	*93.5*	*2.8*	*42.4*	*45.4*
2006	*6.8*	*82.0*	*2.8*	*42.4*	*45.4*

	Composition of housing investment, £b.: New houses	Council house purchases	Home improvements	End year house prices, £.	Ratio of house prices to earnings
2000	18.4	1.3	13.2	82,188	3.76
2001	18.2	1.8	12.5	93,544	4.05
2002	18.4	2.0	14.4	117,206	4.87
2003	19.0	2.0	17.8	135,444	5.43
2004	*19.5*	*2.0*	*18.8*	*154,401*	*5.93*
2005	*20.1*	*2.0*	*19.8*	*146,685*	*5.40*
2006	*20.1*	*2.0*	*19.8*	*146,685*	*5.16*

Figures until 2003 are taken from *the National Accounts (the Blue Book)* and the Nationwide house price index; figures thereafter are forecast. Mortgage rate is lenders' variable rate, average for the year. All figures are in current prices. Average house price and house price/earnings ratio relate to year end. 1= 4 + 3 - 2.

Household sector outlook

3. The pattern of consumption

The MPC's observation of a decline in the link between house prices and spending ignores the effect of financial wealth. Strong advances in total wealth in 2004 support above-trend consumption growth, but house price falls will take their toll next year.

November's *Inflation Report* cast some doubt on the resilience of the relationship between house price inflation and consumption growth. The MPC noted that although annual house price gains had accelerated to 20%, household spending growth had actually slowed. Deterioration in the rolling ten-year correlation coefficient of the two series from 0.8 in 2001 to 0.2 is offered as evidence as to the uncertainty of future consumption growth should house prices fall. This analysis seems to ignore that it is *total* wealth that drives consumption growth, not just *tangible* (i.e. housing, mostly) wealth. Since 2001, the two components of total wealth have diverged as house prices have soared and equity prices fallen. In the three years to end-2003 tangible wealth advanced at an annualised rate of 12.7%, but was partly offset by an annualised 5.8% drop in net financial wealth. Total wealth still grew by 3.6% per annum, but represented a marked slowdown from an average of 10.9% in the previous three years. The moderation in consumption growth should not have surprised the Bank. So far in 2004 house prices and equities have risen by 12% and 8% respectively, ensuring that consumption growth will be above-trend this year. Some momentum will carry through into 2005, with the Bank's own model of consumption estimating wealth effects to last for a number of quarters. Further out, robust income growth and modest stock markets will support spending, but the increasing possibility of house price falls in 2005 (see p.11) will inevitably hamper growth.

Consumption patterns

	Total household consumption		Non-durable goods consumption	
	£b., 2001 prices	% growth	£b., 2001 prices	% growth
2000	616.5	4.4	546.9	3.9
2001	635.6	3.1	558.1	2.1
2002	655.9	3.2	575.3	3.1
2003	671.0	2.3	586.6	2.0
2004	*691.7*	*3.1*	*603.1*	*2.8*
2005	*711.9*	*2.9*	*619.3*	*2.7*
2006	*728.3*	*2.3*	*633.0*	*2.2*

	Durable goods consumption		Household sector	Car registrations
	£b., 2001 prices	% growth	borrowing., £b.	'000s
2000	69.6	8.7	68.3	2,337
2001	77.4	11.2	76.5	2,578
2002	80.6	4.0	108.2	2,682
2003	84.4	4.7	127.5	2,646
2004	*88.6*	*5.0*	*134.1*	*2,727*
2005	*92.6*	*4.5*	*119.1*	*2,807*
2006	*95.4*	*3.0*	*103.6*	*2,871*

Figures until 2003 are taken from *Economic Trends*, Table 2.6 and other sources: figures thereafter are forecast. Household sector borrowing is the sum of bank and building society lending to households and various forms of consumer credit. Data are net, indicating the change in indebtedness after deducting repayments.

4. The pattern of saving

Household savings have increased as a share of disposable income, buoyed by an increase in the tangible saving ratio. Financial savings remain negative, but more hikes to interest rates next year should see this turn positive.

In the second quarter of 2004 total household saving was 6.2% of gross disposable income. The ratio has edged up in recent quarters and is now above the 5.6% average of the last five years. Much of the increase has been due to the rise in the tangible saving ratio (largely investment in housing) that has more than offset declines in financial savings. Soaring house prices have encouraged households to devote more of their income towards housing investment. Thus, as house price inflation declines and turns negative in 2005, one could reasonably expect a lower tangible saving ratio. This is only partly true, with the level of house prices also having an influence. A regression using both of these variables (R squared of 0.85) estimates that the tangible saving ratio will indeed decline with a house price fall of -5%. But, since house prices will still be at a high level, there will only be a marginal decline in the portion of income allocated for housing investment. Further support for a robust tangible saving ratio lies in the argument that people view houses as an alternative long-term saving. This argument is confirmed in a recent Prudential survey that found 62% of people are planning on using the cash in their homes to supplement their pension. The financial saving ratio remains negative, but has approached zero as monetary policy has been tightened. However, recent history suggests that base rates of 5½ % are required to induce households into financial surplus. This meets our central forecast and expect a positive financial saving ratio by the end of 2005.

The pattern of savings

	% growth in gross disposable income. in nominal terms	% rise in consumer deflator	% growth in GDI, in real terms	% growth in consumption in real terms	Saving ratio
2000	7.2	1.1	6.1	4.4	5.0
2001	7.2	2.4	4.7	3.1	6.5
2002	3.0	1.6	1.4	3.2	5.3
2003	4.1	1.8	2.2	2.3	5.5
2004	*4.7*	*1.5*	*3.7*	*3.1*	*6.5*
2005	*5.0*	*2.0*	*3.4*	*2.9*	*6.8*
2006	*5.0*	*2.5*	*2.7*	*2.3*	*7.1*

	Total resources £b.	Consumption expenditure, £b.	Household savings, £b.	Financial saving as % of TR	Tangible saving as % of TR
2000	659.8	626.5	33.3	-0.5	5.9
2001	705.6	659.9	45.7	0.7	6.2
2002	730.8	692.3	38.6	-1.1	6.8
2003	763.2	721.1	42.2	-1.1	7.1
2004	*806.5*	*754.4*	*52.1*	*-0.5*	*7.6*
2005	*850.0*	*791.9*	*58.1*	*-0.3*	*7.3*
2006	*894.3*	*830.4*	*63.9*	*+0.3*	*7.0*

Figures until 2003 are from Table 14.8D of *Financial Statistics*; figures thereafter are forecast. Total resources (TR) is the sum of gross disposable income and the change in net equity of households in pension funds, which is mostly employers' pension contributions. Financial saving is defined as the household sector's financial surplus. Sum of financial and tangible saving is total saving.

Financial institutions' behaviour

1. The outlook for mortgage lenders

The decline in mortgage approvals suggest that house price inflation will continue to slow. But interest rates of 4¾% will leave mortgage credit growth at about 10% a year. Mortgage lenders face intense competition and narrower margins.

Evidence of the slowdown in the housing market has mounted in recent weeks. Both of the major house price indices fell in October and annual rates of inflation have dipped to 15% from peaks of over 20% in the summer. With mortgage approvals having fallen sharply since May (by 15% in value terms, 30% in volume) this trend will continue in coming months. But further declines in approvals are less certain. Analysis of previous tightening cycles demonstrates that a base rate peak of 5% is consistent with mortgage lending increasing by around 10% per annum. The three-month annualised growth rate has fallen from 16% at the end of 2003 to 12.5%, but is still too high to be consistent with the inflation target. To slow mortgage credit growth to a more acceptable 7% or 8%, recent experience suggests that an interest-rate peak of closer to 6% than 5% will be required. Meanwhile, lenders' profitability should remain healthy, with the interest rate margin on mortgages actually widening by 50 basis points in the last three months. Periods of rising interest rates are usually associated with declining banking sector profits, but growing optimism amongst markets has caused the three-month interbank rate to edge down, whilst lenders have been edging mortgage rates upwards. Banks remain well-capitalised and will seek to increase the size of their loan book in order to maintain high rates of return. Alternative uses for capital may also come to the fore, with further consolidation in the industry one possibility. Options are limited in the UK, increasing the likelihood of cross-border deals.

The pattern of mortgage lending

	Net mortgage lending by: Building societies, £b.	Banks, £b.	Other lenders, £b.	Total net mortgage advances, £b.
2000	9.1	19.0	12.6	40.7
2001	6.9	30.6	16.7	54.2
2002	11.0	48.5	18.5	78.1
2003	18.8	47.3	34.4	100.5
2004	*18.5*	*41.8*	*44.1*	*104.4*
2005	*15.5*	*38.0*	*40.0*	*93.5*
2006	*12.0*	*35.0*	*35.0*	*82.0*

	Stock of mortgage lending to the personal sector by: Building societies, £b.	Other (mainly banks), £b.	Total, £b.	Value of the housing stock, £b.	Mortgage debt/ housing stock, %
2000	107.2	428.1	535.3	1,967.9	27.2
2001	113.6	476.8	590.5	2,116.5	27.9
2002	124.2	545.8	670.0	2,568.1	26.1
2003	143.1	630.8	773.8	2,869.0	27.0
2004	*162.4*	*715.9*	*878.2*	*3,326.8*	*26.4*
2005	*179.7*	*792.1*	*971.7*	*3,213.8*	*30.2*
2006	*194.8*	*858.9*	*1,053.7*	*3,267.1*	*32.3*

Figures until 2003 are taken from *Financial Statistics* and various tables in UK *National Accounts* (the "Blue Book"). Figures for net mortgage lending are flows of business; total lending is stock of lending outstanding. Net lending equals gross lending minus repayments. Before 1995, building societies held over 60% of the mortgage market. But between 1995 and 1997 the building societies' sector was reduced by two-thirds by de-mutualisation of societies, either through take-over or conversion to a plc.

2. The institutions' asset allocation

Our estimate of the institutional liquidity ratio is below its long-run average, a level that is forecast to persist in 2005 and 2006. But higher bond weightings arguably imply the need for lower cash holdings. LAPF's are assumed to absorb the majority of net gilt issuance over the forecast horizon.

Revisions to institutional investment data have pushed down our estimate of the institutional liquidity ratio to 3.2%, below its long-run average of 3 3/4%. Assuming stable medium-term cash preferences, the current low level of the ratio is unhelpful for asset prices. However, an asset allocation shift towards greater bond weightings in recent years may imply that the LAPFs require lower cash holdings on a permanent basis. (To the extent that bonds match liabilities more closely, arguably institutions need less liquidity.) The LAPFs are expected to remain the main purchasers of gilts over the forecast horizon, funding the Government's borrowing needs of over 3% of GDP in both 2005 and 2006. Bond weightings should continue to edge up accordingly. Meanwhile, institutional cash piles are expected to benefit from high corporate payouts in 2005. Buoyant corporate balance sheets could also stimulate acquisition activity which often transfers cash from buying corporations to institutional shareholders. Higher interest rates later in 2005 should dampen aggregate M4 growth, with an ensuing impact on institutional cash. The institutional liquidity ratio is assumed to remain near current levels over the forecast horizon. Despite favourable performance over the past few years, commercial property remains a low proportion of most institutional portfolios. However, institutional interest in commercial property has revived, with net investment of £300m. in Q2, the first quarterly increase for a year.

Assets of long-term savings' institutions

	UK company securities, £b.	Overseas securities, £b.	Public sector debt, £b.	Property £b.	Other long term assets, £b.
2001	826.9	308.6	203.3	84.6	133.9
2002	697.0	262.3	215.8	84.3	146.8
2003	*806.9*	*315.5*	*226.6*	*86.0*	*183.6*
2004	*863.3*	*350.9*	*245.0*	*93.5*	*193.7*
2005	*922.8*	*388.2*	*260.0*	*95.0*	*204.4*
2006	*985.5*	*427.6*	*270.0*	*97.0*	*215.6*

	Total holdings		Short-term assets		
	£b.	% increase on preceding period	£b.	% increase on preceding period	Liquidity ratio, %
2001	1627.7	-3.7	70.7	-9.8	4.3
2002	1471.9	-10.0	65.8	-7.0	4.5
2003	*1677.3*	*14.0*	*58.6*	*-10.9*	*3.5*
2004	*1805.0*	*7.6*	*58.6*	*0.0*	*3.2*
2005	*1932.8*	*7.1*	*62.5*	*6.7*	*3.2*
2006	*2061.7*	*6.7*	*66.0*	*5.6*	*3.2*

Figures until 2002 are taken from *Financial Statistics*; figures thereafter are forecast. Long-term savings institutions include life insurance and pension funds and long-term funds of insurance companies. General funds of insurance companies are not included. Figures relate to end-period (month, quarter, year) and market values. They are not directly comparable with net financial wealth statistics on p. 10. because of statistical reviews by NS.

Corporate sector prospects

1. The balance sheet position

Corporate balance sheets are awash with cash. But debt remains high relative to equity and interest payments are large relative to profits, suggesting that further balance-sheet restructuring may be needed in the medium term.

Our estimate of the corporate sector liquidity ratio (M4 deposits/M4 lending) is 0.64, a ten-year high. The measure's long-run average is about 0.58. Balance sheets awash with liquidity auger well for corporate sector activity in the year ahead. Business investment is already surging, a trend that is expected to persist in 2005. (See p.19.) The oulook for distributions is similarly upbeat. Nevertheless, alternative measures of corporate balance sheet strength are less favourable and may pose a threat to demand in the longer run. Capital gearing (the ratio of non-equity liabilities to equity capital) remains high by historical standards at 0.79. While this is down from the record 0.89 reached in Q1 2003, the downward adjustment was caused entirely by rebounding stock markets. Companies have continued to issue debt, with both short-term and long-term liabilities increasing. The outstanding stock of short-term borrowing was up by 19% in the eight quarters to Q2 2004, with long-term loans 30% higher. Strong growth of sterling unused credit facilities suggests that corporate borrowing growth will accelerate in the year ahead. Debt levels are high relative to profits with outstanding loans 4.2 times the gross operating surplus of private non-financial corporations. The multiple for non-equity liabilities in total (i.e., including bond debt) is even higher at 5.5. These figures also ignore pension fund liabilities which arguably should be treated as corporate liabilities. A period of balance sheet restructuring may be needed in the medium term.

Measures of companies' balance sheet strength

	Equity capital market value, £b.	Bank deposits £b.	Bank borrowing £b.	% growth of bank deposits	% growth of bank borrowing
2000	1,880.0	270.3	363.4	19.8	14.0
2001	1,605.2	292.9	403.2	8.4	11.0
2002	1,259.7	329.3	428.0	12.4	6.2
2003	1,443.1	411.8	470.1	25.1	9.8
2004	*1,544.1*	*454.2*	*509.6*	*10.3*	*8.4*
2005	*1,636.7*	*486.0*	*553.4*	*7.0*	*8.6*
2006	*1,726.7*	*520.1*	*597.1*	*7.0*	*7.9*

	Gross financial assets, £b.	Non-equity liabilities, £b.	Liquidity ratio (Deposits/loans)	Capital gearing Ratio of non-equity liabilities to equity capital	Gross financial assets as ratio of non-equity liabilities
2000	1,079.3	830.7	74.39	44.18	1.30
2001	1,083.9	920.9	72.65	57.37	1.18
2002	1,110.9	1,020.8	76.94	81.03	1.09
2003	1,269.9	1,127.6	87.61	78.14	1.13
2004	*1,371.5*	*1,195.3*	*89.14*	*77.41*	*1.15*
2005	*1,460.6*	*1,290.9*	*87.83*	*78.87*	*1.13*
2006	*1,555.6*	*1,394.2*	*87.10*	*80.74*	*1.12*

Figures until 2003 are taken from *United Kingdom Economic Accounts*; figures thereafter are forecast. Bank deposits and borrowing include *foreign currency* stocks and do not match figures elsewhere for *sterling* deposits and loans. Gross financial assets and liabilities exclude trade credit.

2. Profitability and investment

Corporate profits should continue to benefit from the cyclical upswing in productivity growth and subdued wage inflation in 2005. Expected further depreciation of the trade-weighted exchange rate should also support profitability.

UK corporate profits are soaring, despite the strength of the pound against the dollar and rising producer input costs. The gross operating surplus of private non-financial corporations gained a further 2.4% in Q2 to stand over 11% up on the year. This was the fastest rate of increase since early 1997, the peak of the last profits cycle. Admittedly, high oil prices have produced a bonanza for the North Sea sector, boosting the overall total. (See p.18.) But the gross trading profits of the non-oil, non-financial sector have also been buoyant, jumping 10% in H1 2004 on H1 2003 levels. While the gross operating surplus of non-financial corporations has risen from its Q1 2002 trough to 19.3% of GDP by Q2, the measure's long-run average is 20.3% suggesting that there is scope for further improvement. The net rate of return on capital employed in the non-oil, non-financial sector drifted up to 12.9% in Q2, its highest level since 1999. The peak in previous cycles was over 14%. One source of relief for margins is expected to come from a falling exchange rate over the forecast horizon. The recent 4% drop of the sterling trade-weighted exchange rate is a favourable development. Underlying domestic conditions are expected to remain supportive for profits in 2005, with wage growth relatively subdued and private sector productivity growth firm and exceeding that of real wages. Nevertheless, with global and UK economic growth expected to moderate over the forecast horizon, corporate profit growth should follow suit and may already have passed its peak.

Company finances

£b.	1. Gross operating surplus	2. Property income received	3.Dividend payments	4. Interest and other payments	5. Taxes on income
2000	184.0	60.6	55.8	70.0	26.2
2001	183.9	73.6	77.5	66.2	26.1
2002	186.7	66.8	62.6	66.2	24.5
2003	201.5	72.6	70.6	67.1	24.1
2004	*218.7*	*74.8*	*74.4*	*72.0*	*25.6*
2005	*231.8*	*77.8*	*78.9*	*77.2*	*27.6*
2006	*241.0*	*80.9*	*83.6*	*82.8*	*29.0*

	6. Gross disposable income	7. Capital transfers	8. Gross fixed capital formation	9. Change in inventories	10. Net borrowing (-) or lending (+)
2000	92.1	0.4	96.3	5.5	-10.1
2001	87.2	1.6	98.0	6.0	-16.1
2002	99.9	1.7	97.1	2.0	1.2
2003	111.9	3.0	96.7	2.4	15.0
2004	*121.7*	*2.0*	*104.8*	*4.0*	*14.0*
2005	*126.7*	*2.0*	*113.0*	*3.0*	*11.2*
2006	*127.0*	*2.0*	*119.3*	*2.0*	*5.4*

Figures until 2003 are taken from *Financial Statistics*, tables 14.3A, 14.3B and 14.3C; figures thereafter are forecast. They relate to private, non-financial companies (PNFCs), not to PNFCs and financial corporations combined, but include both the North Sea sector and property companies. 6 = 1 + 2 - 3 - 4 - 5; 10 = 6 + 7 - 8 - 9.

Corporate sector prospects

3. North Sea companies

North Sea profits and Treasury revenues have been boosted by high oil prices in 2004, a pattern that should persist in the new era of oil prices $30-a-barrel or above. Exploration activity on the UK Continental Shelf is already being stimulated.

Surging oil prices have boosted North Sea profits and Treasury revenues. The gross trading profits of the UK Continental Shelf sector were up 28.9% in Q2 on levels a year earlier. Strong performance continued into Q3 as oil prices soared to $50 per barrel. BP recently announced its pro-forma result for Q3 which was up 43% on the year. These figures relate to global performance, but are suggesttive of the bonanza being enjoyed by the North Sea operators. The Government's tax take is also benefiting. North Sea tax revenues in the financial year 2003/2004 totalled £4.3b. With profits likely to end the year more than doubled, the tax take could reach £10.0b. in 2004/2005. This would be the highest figure since 1985/1986. While UK Continental Shelf production is past its peak, tax revenues are likely to exceed levels recorded throughout the 1990s for much of the current decade. The rapid industrialisation and integration of China, India and other emerging countries into the world economy suggests that the era of $20-$25-a-barrel oil prices is over. $30+ oil prices should stimulate additional investment on the UK Continental Shelf. The UK Offshore Operators' Association reports strong evidence of a revival in exploration activity this year with 32 new wells drilled in H1 2004 compared to 45 in the whole of 2003.The higher the price of oil, the more economically feasible it becomes to extract less accessible or smaller yielding fields. The windfall to the Exchequer and boost to the UK balance of payments may prove prolonged. The net oil trade surplus averaged 0.5% of GDP over the past decade.

North Sea companies' income, costs and taxes

	Oil and gas output m. of tonnes oil equivalent	Oil price $ per barrel	Oil price £ per tonne	Sterling/dollar exchange rate, $	Value of oil and gas, £b.
2000	216.4	28.3	140.8	1.52	22.8
2001	206.3	24.4	126.9	1.44	21.8
2002	202.3	24.8	123.9	1.50	21.8
2003	193.2	28.6	131.4	1.64	19.7
2004	*179.5*	*38.5*	*158.7*	*1.82*	*21.3*
2005	*175.0*	*37.0*	*157.3*	*1.76*	*21.1*
2006	*170.6*	*30.0*	*136.4*	*1.65*	*18.8*

	Taxable profits, £b.	Total tax bill, £b.	Operating costs, £b.	Exploration costs, £b.	Fixed investment, £b.
2000	16.7	5.0	4.4	0.3	3.1
2001	14.9	4.5	4.3	0.4	4.0
2002	13.7	4.1	4.6	0.4	4.0
2003	13.6	4.1	4.5	0.4	3.7
2004	*15.6*	*9.4*	*4.5*	*0.4*	*4.5*
2005	*15.5*	*8.0*	*4.5*	*0.4*	*4.5*
2006	*13.1*	*4.5*	*4.5*	*0.4*	*3.5*

Figures until 2002 are taken from the official Department of Trade and Industry "Brown Book", ***Energy Trends*, *Petroleum Economist*** and official sources; figures thereafter are forecast, but with heavy reliance on the Brown Book, industry sources and newspaper cuttings. Oil output, profits, costs and taxes are totals for year; oil prices and exchange rate are average for the year.

4. Investment and stockbuilding

Buinsess investment is expected to continue growing strongly in 2005. The IT replacement cycle is underway, while strong private commercial and industrial construction orders imply firm building activity ahead.

Business investment has rebounded over the past five quarters, a trend that is expected to continue in 2005. Business investment volumes rose by 5.9% in the year to Q2 2004, while in current price terms business investment was 5.7% higher. The proximity of the figures implies that the business investment deflator has been broadly stable over the past year. The prices of business investment goods had plunged by a cumulative 12.8% from Q2 1996 peak to Q1 2003 trough. Prices are expected to rise over the forecast horizon. While business investment spending has rebounded over recent quarters, it remains low as a share of GDP at only 9.9% in Q2. The measure's long-run average is 11.9% suggesting that there is plenty of scope for growth over the forecast horizon. Corporate balance sheets have ample cash (see p.16), while a rise in sterling unused credit facilities indicates a likely surge in corporate borrowing. The outlook for corporate profits also remains reasonable. Business investment is near record lows as a share of private corporations' gross operating surplus, indicating ample cash-flow to finance investment. The information technology replacement cycle is also under way. Much IT spending took place in the run-up to the Millenium and equipment is now due for replacement. National Statistics figures report that spending on software and hardware combined was 15.8% up in Q2 2004 on Q2 2003 levels. Private commercial and industrial construction orders were 14.1% higher in the first three quarters of 2004 than the same period in 2003, implying firm building activity in the year ahead.

Companies' fixed investment and stockbuilding

	Total investment £b., current	Deflator for investment, 2000 = 100	Total investment real change, %	Private, non-financial corporations, £2000b.
2000	107.1	100.0	4.6%	96.3
2001	105.2	100.0	-1.9%	97.9
2002	104.0	101.0	-2.1%	96.1
2003	102.8	103.0	-3.0%	93.8
2004	*109.6*	*105.7*	*4.0%*	*99.1*
2005	*118.6*	*109.6*	*4.4%*	*103.1*
2006	*125.0*	*113.5*	*2.0%*	*105.2*

	North Sea companies £2000b.	Financial corporations £2000b.	Total change in inventories, £2000b.	Stock/output ratio
2000	3.1	10.8	5.3	0.144
2001	4.0	7.2	2.9	0.144
2002	4.0	6.7	1.4	0.139
2003	3.6	6.0	2.8	0.134
2004	*4.3*	*4.6*	*3.5*	*0.130*
2005	*4.1*	*5.2*	*3.0*	*0.125*
2006	*3.1*	*5.2*	*3.0*	*0.121*

Figures until 2003 are taken from various ONS publications; figures thereafter are forecast. Total investment at current prices includes investment by financial corporations, so is not comparable with figures on p.17 covering only private, non-financial corporations. Stock/output ratio is value of stocks held at year-end divided by annual GDP at current market prices.

Labour market and inflation

1. Employment and productivity

Recent productivity performance has been encouraging, but may have been largely cyclical. Demand for labour remains strong and the tight labour market is likely to lead to rising wage pressures in 2005.

Productivity growth has picked up markedly in recent quarters. Official data shows that output per employed worker rose by 2.9% in the year to Q3, with output per hour worked rising at an annual rate of more than 3%. While it is quite normal for productivity to enjoy a cyclical rebound as growth recovers, the strength of recent numbers has led some - including the Bank of England - to suggest that trend productivity growth may have increased. Trend GDP growth may also be being boosted by additions to the labour force from strong migration into the UK, especially from Eastern Europe. Together, these factors could help explain why the tight labour market has not yet resulted in more noticeable wage pressures. But several worries remain. Overall employment growth has slowed a little recently, from about 1% a year to perhaps 3/4% a year. But this is still outpacing the increase in the working-age population and is consistent with further falls in unemployment. If these trends continue over the coming year, as looks likely, then wage inflation will rise. A plausible explanation for the recent pattern of productivity growth is that private companies "hoarded" labour in the recent downturn and have therefore, until now, not needed to hire more people as the economy revived. This would explain the sub-2% (and sometimes sub-1%) figures between 2001 and 2003 and also the recent upward spike. But demand for labour appears to be strengthening according to Manpower surveys and vacancies data, suggesting that productivity growth could now slow.

The labour market

	Workforce, total, m.	Workforce jobs, m.	Unemployment, total, m.	Unemployment rate, %
2000	30.640	29.600	1.040	3.4
2001	30.787	29.829	0.958	3.1
2002	30.878	29.939	0.939	3.0
2003	31.226	30.310	0.916	2.9
2004	*31.250*	*30.410*	*0.840*	*2.7*
2005	*31.300*	*30.490*	*0.810*	*2.6*
2006	*31.280*	*30.440*	*0.840*	*2.7*

	Productivity, whole economy, %	Productivity, manufacturing, %	Unit labour costs, whole economy, %	Real earnings, %
2000	2.1	6.3	3.3	3.3
2001	1.0	0.5	3.3	1.0
2002	0.7	3.1	2.1	2.5
2003	2.0	5.9	2.4	2.3
2004	*2.6*	*3.5*	*1.9*	*2.4*
2005	*2.0*	*2.0*	*2.6*	*2.4*
2006	*1.5*	*2.0*	*3.3*	*2.1*

Figures until 2003 are taken from Tables 4.1, 4.2 and 4.7 of *Economic Trends*; figures thereafter are forecast. All figures are seasonally adjusted and relate to final quarter. The workforce equals workforce in employment plus total unemployed.
Real earnings is increase in money average earnings adjusted for increase in consumer spending deflator.

2. Inflation trends

Inflation is likely to rise over the forecast period and this may happen more quickly than the Bank is expecting. Upward pressures on inflation are already visible and they will become more apparent in 2005 and 2006.

Even the relaxed Bank of England expects inflation to be on a gently rising trend over the next two or three years. But it is starting from a low base with CPI inflation of 1.2% in October. Moreover, according to the Bank's projections, it converges safely on the 2% target towards the end of 2006. So no-one seems very worried. This may be complacent. Upward pressures on inflation are evident in utility costs, steel prices and surging base metal prices. These could push CPI inflation higher more quickly than the Bank is expecting. The key point is that, as the Bank admits, there is little or no spare capacity in the economy at present. If domestic demand continues to grow above its trend rate in late 2004 and in 2005, bottlenecks and shortages will intensify, leading to rising inflation. With interest rates at or close to current levels, above-trend increases in demand are the most likely prospect. (See p.4.) In the usual fashion, inflation signs are first seen at the factory-gate level. Producer price inflation (for outputs) reached 3.5% in October, the highest rate for almost eight years. Moreover, this cannot be dismissed as being simply due to higher oil and commodity prices. "Core" producer price inflation is also running at an eight-year high. An additional concern is the currency which has fallen by almost 5% on a trade-weighted basis since the summer. If the pound were to decline further over the forecast period, the inflation problems would be exacerbated. Looking further ahead, if inflation is to be controlled on a medium-term basis, money growth must be slowed to a more sustainable rate of 6% to 7%.

Measures of price pressure

	Underlying retail price index, %	Retail price index, %	Consumer price index, %	Consumption price deflator, %	Average earnings, %
2000	2.1	3.1	0.9	1.2	4.5
2001	2.0	1.0	1.0	2.4	3.1
2002	2.6	2.6	1.5	1.4	3.7
2003	2.6	2.7	1.3	2.0	3.9
2004	*2.3*	*3.3*	*1.4*	*1.5*	*4.5*
2005	*2.6*	*2.3*	*2.0*	*2.0*	*4.6*
2006	*2.7*	*2.5*	*2.2*	*2.5*	*4.8*

	House prices, £	House prices, %	Foreign producer prices, 1995 = 100	Sterling effective rate, 1990 = 100	Sterling import prices, 2001 = 100
2000	81,655	9.5	106.8	107.6	102.2
2001	92,486	13.2	105.2	106.3	97.5
2002	115,544	24.8	106.3	106.1	97.0
2003	130,621	15.5	107.6	100.1	98.1
2004	*148,647*	*13.8*	*111.8*	*102.0*	*98.3*
2005	*141,214*	*-5.0*	*115.0*	*100.0*	*101.0*
2006	*141,214*	*0.0*	*118.4*	*98.0*	*103.2*

Data refer to final quarter of each year. Figures until 2003 are taken from NS, OECD and Nationwide publications; figures thereafter are forecast. Average earnings numbers do not refer to the underlying trend. Real house prices are nominal prices deflated by the RPI. Foreign producer prices refer to the OECD area excluding high inflation countries.

The balance of payments

1. Export and import trends

The UK's major export markets have not fully participated in the global boom. But export growth should still be better than official data show. Net trade's 0.2% contribution to Q3 GDP growth should set the trend for next year.

Official data show that net exports added approximately 0.2% to GDP growth in Q3. Export volumes rose 2.8% in the quarter, whilst imports were more sluggish at 1.6%. However, the performance of UK exports still seems a little disappointing against the backdrop of a booming world economy. The OECD forecasts that aggregate GDP growth in its member states will reach 3½% this year, the highest rate of increase since 2000. The IMF goes further, estimating that world growth (i.e. including non-OECD countries) will be an impressive 5%, the strongest since 1976. Here lies a possible explanation for mediocre export performance. World output growth is not equal to that in the UK's export markets. Weighting countries' growth relative to their share of UK exports provides a better indication of expected trade activity. On this basis, the rate of increase in output is below 3%, with relatively weak activity in the Eurozone (the destination for 60% of all UK exports) dragging down the overall figure. Recent history shows 3% output growth approximates to an annual increase in exports of 5%. Q3's number clearly exceeds this on an annualised basis (11.6%) and is by itself encouraging. But the increase in the year to date compared to the first nine months of 2003 is a paltry 0.2%. The steady recovery in manufacturing production (60% of all manufactures are sold overseas) and firm CBI export orders suggest that annual export growth should be closer to 5%. Net exports will make a positive contribution to 2005 GDP.

Current account

	Exports of goods and services, £b. current prices	Imports of goods and services, £b. current prices	1. Goods and services balance, £b.	2. Balance on income, £b.
2000	264.8	285.8	-21.0	5.2
2001	272.4	299.8	-27.4	11.7
2002	272.6	312.0	-39.3	21.5
2003	272.9	315.9	-43.0	22.1
2004	*281.2*	*327.8*	*-46.5*	*28.0*
2005	*295.2*	*340.2*	*-45.0*	*28.0*
2006	*307.0*	*351.1*	*-44.1*	*28.0*

	3. Transfers balance £b.	Current balance £b.	Current balance % of GDP	% growth, exports in real terms	% growth, imports in real terms
2000	-9.8	-24.1	-2.53	9.4	9.1
2001	-6.6	-22.4	-2.25	2.9	4.9
2002	-8.6	-18.2	-1.74	0.1	4.1
2003	-9.9	-20.4	-1.86	0.1	1.3
2004	*-11.0*	*-20.0*	*-1.72*	*3.0*	*3.7*
2005	*-11.0*	*-16.6*	*-1.34*	*5.0*	*3.8*
2006	*-11.0*	*-13.5*	*-1.04*	*4.0*	*3.2*

Figures until 2003 are taken from *Economic Trends*, various pages, and the NS trade figures press release; figures thereafter are forecast. Current balance = 1 + 2 + 3. Balance on income is balance on interest, profits and dividends plus compensation of employees.

2. How the current account position is financed

The current account deficit has been relatively small in recent years and there have been no major problems in financing it. This contrasts sharply with the US where there is heavy reliance on banking inflows to fund the worryingly large deficit.

The UK's current account deficit has remained remarkably stable over the last five years, fluctuating within a very narrow range of £18b. to £24b., or between 1¾% and 2¾% of GDP. A deficit of around £20b. may be expected for 2004 and our forecast shows it falling steadily over the next two or three years. The trade deficit is assumed to narrow slightly, while the UK is expected to continue to benefit from a large investment income surplus. This totalled £22b. in 2003 and has amounted to £13.5b. in the first half of this year alone. Financing of the deficit has not been a major problem in recent years and there has been no undue reliance on "hot" banking inflows (which can reverse swiftly and cause sharp movements in the currency) as was the case in the late 1980s. The UK's situation also contrasts markedly with that in the US. The American current account deficit now amounts to almost 6% of GDP and is still rising. The US relies heavily (to the tune of more than £1b. a day) on capital inflows, notably heavy foreign purchases of government debt to fund the deficit. In the first nine months of the year net purchases of US Treasury bonds and notes by foreigners amounted to more than $300b., after an annual total of $278b. in 2003. (The US current account deficit is likely to exceed $650b. this year.) The weakness of the dollar over the last couple of years is clearly tied up with these trends and casts grave doubt on their sustainabilty. The UK, on the other hand, does not have such problems and the balance of payments is unlikely to be a significant policy concern over the forecast period.

Transactions in UK external assets and liabilities

£b.	Direct and portfolio investment: in the UK by non-residents	abroad by UK residents *	1. Balance on direct and portfolio investment	UK bank borrowing from overseas	UK bank lending to overseas **
2000	245.1	176.5	68.6	199.2	231.8
2001	85.5	83.3	2.2	124.5	129.0
2002	70.4	37.7	32.7	90.0	57.5
2003	101.0	53.2	47.8	170.9	172.0
2004	*100.0*	*100.0*	*0.0*	*130.0*	*110.0*
2005	*90.0*	*80.0*	*10.0*	*90.0*	*100.0*
2006	*75.0*	*60.0*	*15.0*	*75.0*	*75.0*

	2. Balance on banking flows	3. Change in official reserves	4. Other financing	Identified capital flows	Balancing item
2000	-32.6	-3.9	-5.6	26.5	-2.4
2001	-4.4	3.1	24.2	25.0	-2.6
2002	32.5	0.5	-55.9	9.7	8.5
2003	-1.1	1.6	-29.6	18.7	1.7
2004	*20.0*	*0.0*	*0.0*	*20.0*	*0.0*
2005	*-10.0*	*0.0*	*16.6*	*16.6*	*0.0*
2006	*0.0*	*0.0*	*-1.5*	*13.5*	*0.0*

Figures until 2003 are taken from *Economic Trends, The Blue Book* and the NS balance of payments press release; figures thereafter are forecast. Identified capital flows = 1 + 2 + 3 + 4. The balancing item is the difference between the current balance and identified capital flows. * = excluding portfolio investment abroad by UK banks. ** = including portfolio investment abroad by UK banks.

Summary of assumptions

UK GDP growth will continue at above-trend rates in H1 2005 with interest rates at 4 3/4%. While the housing market is slowing, healthy household balance sheets will support firm consumption. Mortgage interest payments are manageable, net wealth-to-income at record levels and real incomes growing reasonably. Business investment is already rebounding, a trend that is expected to continue, while government spending growth should also stay firm. Net exports are likely to contribute to GDP growth for the first time in eight years given expected further depreciation in the trade-weighted exchange rate. Global economic growth should moderate towards trend next year in the wake of modest policy tightening. With UK output already a touch above its trend level, more above-trend GDP growth will lead to the emergence of inflationary pressures. UK interest rates will need to rise further in H2 2005 to slow domestic demand. Oil prices are expected to slip over the forecast horizon.

The main assumptions:

	Banks' base lending rate %	3 month interbank rate %	Mortgage interest rate %	Bank and building society deposit rate %	Government securities 20 year yield %
2004:4	4.75	4.85	6.1	3.3	4.6
2005:1	4.75	4.90	6.1	3.3	4.8
2005:2	5.00	5.10	6.4	3.7	5.0
2005:3	5.25	5.35	6.7	3.9	5.2
2005:4	5.50	5.60	6.9	4.1	5.5
2006:1	5.50	5.50	6.9	4.1	5.5
2006:2	5.25	5.20	6.7	3.9	5.5
2006:3	5.00	5.05	6.4	3.7	5.3
2006:4	5.00	5.05	6.4	3.7	5.2

	OECD real GDP growth %	Non-fuel dollar commodity prices %	Sterling effective rate 1990 = 100	Dollar/pound rate	3 month Eurodollar rate %
2004:4	3.3	12.7	101.8	1.82	2.2
2005:1	3.2	4.4	101.0	1.80	2.4
2005:2	3.2	5.0	100.0	1.80	2.6
2005:3	3.2	8.2	100.0	1.75	2.9
2005:4	2.8	7.2	99.0	1.70	3.1
2006:1	2.6	6.1	99.0	1.65	3.1
2006:2	2.4	5.1	98.0	1.65	3.3
2006:3	2.4	4.1	98.0	1.65	3.3
2006:4	2.4	4.1	97.0	1.65	3.5

	General government consumption £b.	Labour force thousands	Oil price $/barrel	North Sea ICCs operating costs £m.	North Sea oil output m. tonnes
2004:4	61.6	31,250	45.0	1,100	23,100
2005:1	64.0	31,265	40.0	1,100	23,000
2005:2	64.6	31,275	38.0	1,100	22,400
2005:3	61.1	31,285	36.0	1,100	20,000
2005:4	63.0	31,300	34.0	1,100	22,600
2006:1	67.5	31,300	30.0	1,100	22,400
2006:2	64.6	31,290	30.0	1,100	22,000
2006:3	65.0	31,280	30.0	1,100	19,500
2006:4	63.0	31,280	30.0	1,100	22,000