February 2005

Quarterly UK Economic Forecast

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Quarterly Economic Forecast

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The economic outlook over the next two years

Bumper bank profits imply higher interest rates

Double-digit moneygrowth cannot be reconciled with 2% inflation

The debate about the direction of UK interest rates is still not settled, but the pessimists (i.e., those – including Lombard Street research's UK service – expecting further rate rises) are taking comfort from the latest money supply trends. Although base rates have been at 4¾% since early August, the growth rates of bank credit and money remain too high. In the three months to January the annualised growth rates of M4 lending (before the effect of securitisations) and M4 itself were 13.4% and 10.4% respectively. The long-run similarity of the growth rates of money and nominal gross domestic product is one of the most reliable characteristics of nearly all economies, and it has certainly been a feature of the UK in recent decades. As 10% money growth cannot be reconciled with the 2% target inflation rate, the interest rate rise to 4¾% has not been enough. Some further increase in interest rates – probably to about 5 ½% - is needed.

Mortgage demand has slowed but not by enough

Surprise might be expressed that the increase in base rates (from 3½% to 4¾%) has not had greater effect in restraining credit. Mortgage demand - which takes a disproportionate amount of publicity - has been hit. Roughly speaking, the monthly total for net mortgage lending has been running at about two-thirds its level in late 2003/ early 2004. Although this may appear to be a significant change of gear, two points have to be made. First, in late 2003 and early 2004 the stock of mortgage credit was climbing at 15% a year. After the drop of a third, the growth rate has fallen to 10%. *But a 10%-a-year growth rate is still too high.*

Highly profitable banks will want to grow their assets (and so their M4 deposit liabilities) rapidly

Second, the banks have been successful in offsetting the decline in mortgage business by an expansion of non-mortgage business. As part of its statistical data gathering, the Bank of England requires banks to give them information about unused lending facilities. In the six months to December such facilities rose from £258.3b. to £278.0b. or, at an annualised rate, by 15.8%. Since this period largely overlaps with the higher base rate of 4¾% and unused mortgages represent a big part of total unused lending facilities, the message must be that banks were arranging new non-mortgage loans at a frantic pace in late 2004. As the new facilities are drawn down in early 2005, banks' balance sheets (and so M4) will continue to grow at about 10% a year. Critical in the background here is the remarkable profitability of the UK banking system. In 2004 the operating profits of HSBC went up by 24%, of the Royal Bank of Scotland by 15% and of Barclays by 20%. As all three were well-capitalised before their success last year, it is logical that they should want to grow their businesses strongly again in 2005. That is fine for their shared offers, but the immediate effect will be persistent rather high money supply growth and the wider macroeconomic consequences will include more bouyancy in domestic demand. Again the message is that higher interest rates are needed.

Professor Tim Congdon **28th February 2005**

Summary of main points of the

Quarterly Macroeconomic Forecast, February 2005

A satisfactory year ahead, but upward pressures on inflation persist

UK growth will benefit in 2005 from another good year for the world economy and rather high money supply growth in the UK itself. Upward pressures on inflation, apparently emanating from international commodity prices, will need to be countered by a rise in base rates.

Other key points

- **Our forecast is for UK output growth to be much the same - about 3% - in 2005 as in 2004. But the pattern of growth will be different, with consumption less strong and a smaller drag from negative net exports (i.e., the volume of imports rising faster than the volume of exports).**

- **The long-term Asian boom will continue to create immense opportunities for Western companies (including British companies) with specialist skills in the construction and maintenance of sophisticated infrastructure (such as power stations, drilling rigs and oil pipelines, and telephone networks).**

- **Despite the strong pound, UK exporters are reasonably sanguine. The balance on the export order books question in the CBI survey was minus 20 in the three months to January, similar to the average over the last 30 years of minus 18.5.**

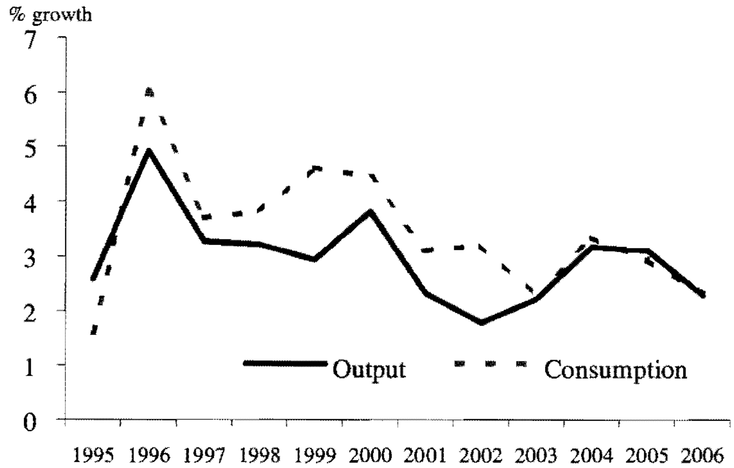
- **The buoyant world economy has boosted UK companies' overseas income. However, the UK's surplus on international investment income - which was £23b. in 2004 - is likely to be under £20b. in 2005. The current account deficit, which widened to almost 2½ per cent of GDP in 2004, will remain at about that size this year.** **(See p. 22.)**

- **Pay growth is edging up, despite significant net immigration, notably from Eastern Europe.** **(See p. 3.)** **In the background money supply growth of about 10% a year is a worry.** **(See pp. 8 - 9.)**

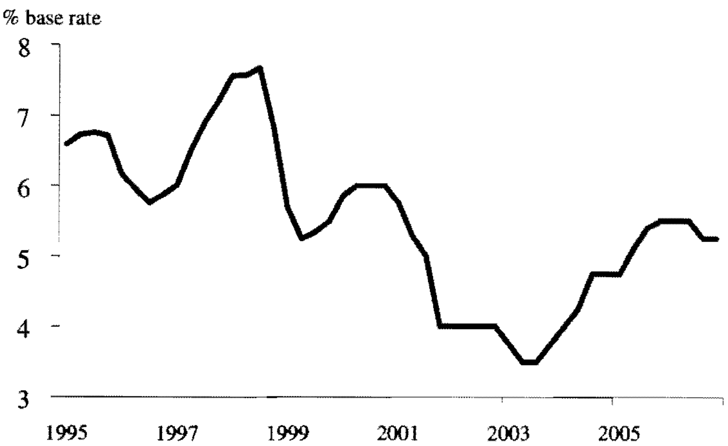
- **UK output is probably a bit above trend. Above-trend growth in 2005 implies upward pressure on inflation.** **(See pp. 21 - 2.)**

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

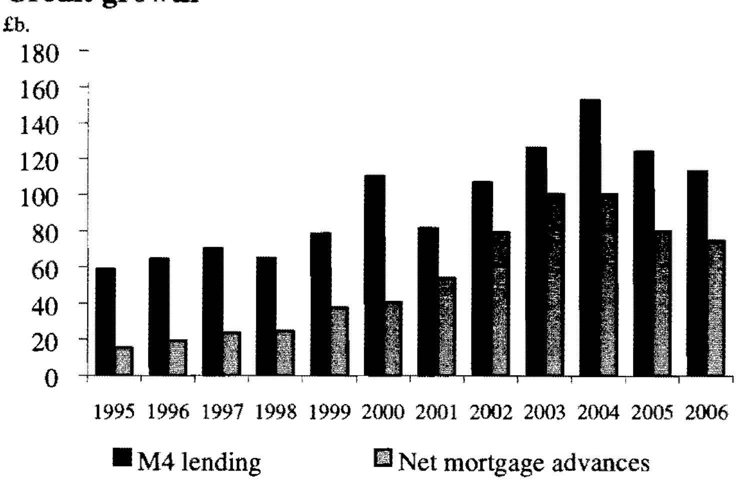
GDP growth and consumption



Interest rate assumption



Credit growth



In July 2003 the research paper (by Mr. Martin McMahon) in the Lombard Street Research *Monthly Economic Review* was on 'East European boost to UK trend growth?'. It suggested that – after the accession of 15 (mostly East European) countries to the European Union on 1st May 2004 – immigration might increase significantly. The verdict was that, "There must be a realistic chance that new inflows of migrant workers could top the 200,000 mark in coming years". Information is now emerging to confirm this conjecture. In the year to mid-2005 net immigration may reach 250,000, an all-time record.

How is that figure estimated? The latest official estimates of net immigration between 1998 and 2003 have an average value of at about 150,000. So the 150,000 figure was the underlying trend *before the effect of EU expansion from 1st May 2004.* Fairly reliable numbers are now becoming available on the scale of immigration from Eastern Europe since 1st May last year. According to the *Evening Standard* in a story based on official visitor statistics, "...a million visitors from eight [former Soviet bloc] countries arrived during May-December – double the total a year earlier. Nine out of 10 came for less than three months, but 92,000 planned to stay on to work, study or holiday." A high proportion of these will remain in the UK for several years.

So it is reasonable to project net immigration in the year to mid-2005 of about 250,000, an all-time record. How does this compare with history? In the decade to 2002 the net inflow was over one million people (i.e., 100,000 a year), markedly higher than in the previous decade when the net inflow was 240,000 people (i.e., 24,000 a year). By contrast, in the previous decade (i.e., the economically troubled period from the mid-1970s to the early 1980s) a net 430,000 left the UK. It is not silly to suggest that the prospect over the next five years is for a net inflow of almost a million. The UK's labour force (and so its trend rate of output growth) will be boosted, while over the long run there will be profound implications for the demand for housing, the requirement for infrastructure and the level of construction activity.

The economic outlook

1. The real side of the economy

Trend growth at least may be expected in early 2005. But with output at or above its trend level, inflation is already rising and is set to push higher this year. Higher interest rates will be required to slow GDP growth later in the year and in 2006.

As expected, the slowdown in Q3 proved to be temporary. Growth revived to 0.7% in the final quarter of 2004, a figure that may be revised higher judging by recent industrial production data. The result is that considerable growth momentum has been carried into early 2005. Leading indicators suggest that trend growth at least may be expected in the first half of the year, a view that is supported by recent monetary trends. (See p. 5.) The problem is that there is currently no spare capacity in the UK economy - output is at or perhaps slightly above its trend level. Any above-trend growth will therefore lead to supply-side bottlenecks and rising inflation. The Treasury continues to assert that there is a significant negative output gap at present, an assumption they need in order to forecast both strong growth (necessary to project buoyant tax revenues) and low inflation. No other economic commentator agrees with this assessment. Indeed, there is plenty of evidence of mild, but worrying inflation pressures already. Wage growth has ticked steadily higher and core producer prices are rising noticeably. The key issue is what level of interest rates will be required to slow output growth and address the inflation problem. At current interest rates, above-trend domestic demand growth is quite plausible. With exports also starting to revive at last, overall GDP growth is set to be balanced and strong. 2005 should be another good year for the economy, but inflation will be more of a problem than in recent years. After interest rates rise in response, 2006 should see the required slowdown.

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	*3.2*	*3.3*	*6.0*	*4.7*	*-0.2*
2005	*3.2*	*2.9*	*3.8*	*2.5*	*0.1*
2006	*2.3*	*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	0.9	1.8	-0.3	-1.7
2004	*3.8*	*1.9*	*4.3*	*-0.8*	*-2.3*
2005	*3.1*	*4.5*	*4.0*	*-0.1*	*-2.4*
2006	*2.1*	*4.0*	*3.2*	*0.1*	*-2.1*

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

Recent monetary trends have been mentioned by members of the Bank of England's Monetary Policy Committee as part of their justification for not cutting interest rates. Indeed, high credit growth argues for an increase in rates.

In the year to January 2005 M4 rose by 8.9%. This compares with an average annual rate of increase since the Bank of England received operational independence in 1997 of about 7%. The 7%-a-year rate of growth has been consistent with the official inflation target. Roughly speaking, prices have increased by 2% - 2 1/2% a year, output by 2 1/2% to 3% a year and the ratio of money to incomes has edged up by about 2% a year. If the ratio of money to incomes continues to rise at about 2% a year, 9%-a-year growth in the quantity of money implies an inflation rate of about 4%, which would clearly breach the official target. In this context Mr. Paul Tucker's decision to vote for a rate increase at the latest MPC meeting was understandable, although he was in a minority of one. The discussion on the MPC parallels a wider debate about the significance of recent money supply data, with some economists (such as Roger Bootle at Capital Economics) arguing that a housing downturn will undermine economic activity regardless of high M4 growth. The behaviour of credit will have a major bearing on the outcome. (When a bank extends a new loan, it creates a new bank deposit and deposits are money.) In the three months to January M4 lending (i.e., lending by banks and building societies) rose at an annualised rate of 13.4%. The buoyancy of credit demand is remarkable, given the backdrop of 4 3/4% base rates since early August. Apparently the rise in base rates from 3 1/2% to 4 3/4% has failed to deter borrowers.

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	8.2	3.1	5.2
2001	4.9	7.1	6.8	1.0	5.7
2002	4.1	8.6	7.3	2.6	4.7
2003	3.5	8.7	7.3	2.7	4.6
2004	*4.8*	*10.9*	*8.7*	*3.2*	*5.6*
2005	*5.3*	*8.2*	*7.2*	*3.3*	*3.9*
2006	*4.8*	*6.9*	*6.1*	*2.7*	*3.4*

	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

After a brief period of improvement in 2004, public borrowing may be rising again. Stronger corporate tax receipts should help finances, but the higher tax burden is encouraging avoidance. The Government is in danger of breaking the golden rule.

Public finances deteriorated alarmingly after the 2000 Comprehensive Spending Review (CSR) as the Government embarked on an ambitious programme of public spending in order to deliver major improvements in key public services. Borrowing moved from a surplus of almost 4% of GDP in 2000/01 to a deficit on the same scale in 2003/04 as spending soared and tax revenues grew only slowly. Last year saw some improvement, with receipts enjoying a cyclical rebound while spending growth was actually slowed quite sharply. Borrowing began to inch lower. But it did not last for long. Since the autumn, spending has once again risen more quickly than revenues. It is possible that the strong profits growth (in 2004) that has been reported recently by many companies (BP, ICI, Barclays, Rolls-Royce all had good results) will boost corporation tax receipts and help public finances, but the Chancellor was already projecting a 25.5% rise in such revenues in 2005/06. More fundamentally, the rising tax burden is encouraging avoidance and may mean that revenues grow more slowly in the future. For example, industry experts estimate that some £20b. of property assets have been shifted offshore since the start of 2004 as companies attempt to avoid new rules on stamp duty. Meanwhile, it may be politically difficult for the Government to stem spending growth in the run up to an election. On current trends it is quite plausible that they will break their own "golden rule" on borrowing in the present cycle. Taxes will need to rise or spending must be cut in 2005 and beyond to put public finances on a more sustainable footing.

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	2.2
2003/04	39.7	3.8	0.0	39.7	3.8
2004/05	*37.0*	*3.6*	*0.0*	*37.0*	*3.6*
2005/06	*35.0*	*3.2*	*0.0*	*35.0*	*3.2*

	Public sector financial deficit, £b.	Total managed expenditure, £b.	% increase in total managed expenditure	Current receipts, £b.	% increase in current receipts
1999/00	-13.7	343.6	3.3	356.5	6.7
2000/01	-14.9	367.7	6.8	379.9	6.6
2001/02	0.3	390.7	6.4	387.5	2.0
2002/03	23.0	419.1	7.3	393.2	1.5
2003/04	36.9	453.6	8.2	418.7	6.5
2004/05	*37.0*	*487.6*	*7.5*	*450.9*	*7.7*
2005/06	*35.0*	*521.7*	*7.0*	*487.0*	*8.0*

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. 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

After the boom year of 2004, the world economy will experience a more sedate pace of expansion in 2005. But - with output roughly at trend (i.e., with the output gap at zero) in the main industrial nations - there is no need to fear recession. Rapid growth in China will lead to further upward pressure on commodity prices.

Booms are often followed by busts. 2004 was certainly a boom year for the world economy, with output advancing by 5%, the highest figure since 1973. Fortunately, the leading industrial economies finished 2003 with output significantly beneath trend and - according to estimates prepared by Lombard Street Research's World Service - output at present is roughly at trend. Previous global recessions have typically been foreshadowed by tight labour markets and capacity shortages (and hence with rising inflation), and so with a positive output gap of about 2%. So the message is that a recession is not needed to pre-empt an inflationary spiral. Roughly trend growth in world output (i.e., 3 1/2%) seems a reasonable central view for 2005. The pattern of growth will resemble that in the last few years, with Asia (and particularly China) accounting for a disproportionate share of the extra output. China's role in boosting the demand for commodities has been much publicised, and it will remain a positive influence on the demand for oil, iron ore, copper and other basic materials both this year and next. It is striking that shipping freight rates - although off from all-time peaks - have opened 2005 at exceptionally high levels, implying that shipyards will be busy until at least 2007. One puzzle is that low dollar interest rates have not stimulated markedly faster credit and money growth in the USA. Perhaps the only major worry for the world economy in early 2005 is the large US payments deficit and the problem of financing it.

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

As base rates reached 4 3/4% in early August, the economy has now had over six months to adjust to the higher cost of money. Mortgage approvals have fallen, but not by enough to ensure moderate growth of credit and money. So far the increased budget deficit has been easily financed outside the banking system.

After the rise in base rates from 3 1/2% in late 2003 to 4 3/4% in August last year, some commentators predicted a crash in the housing market and a marked weakening in domestic demand. Our own econometric model instead envisaged a decline of a third in new mortgage credit. This may sound drastic, but it implied a fall in the growth rate of the stock of mortgage debt from 15% to 10%, *and 10% is still too high.* In the six months to December 2003 mortgage approvals averaged £26.6b. and net mortgage lending £9.1b.; in the four months to December 2004 (i.e., a period when 4 3/4% base rates had take full effect) they averaged £20.9b. and £7.0b. respectively. The numbers are therefore roughly consistent with the model *and, to repeat, they signal that interest rates have not risen enough to reduce the growth of mortgage debt to the 6% - 8% range which is consistent with lower money supply growth and target inflation over the medium term.* Of course other determinants of money supply growth need to be introduced into the analysis. The salient feature of late 2004 was the buoyancy of non-mortgage credit, as the well-capitalised and highly profitable UK banking system tried to expand its balance sheet. Having said that, the Debt Management Office has found it easy to sell government debt outside the banking system and the enlarged budget deficit has not posed a significant threat to monetary control. The banks continue to issue large quantities of covered bonds (i.e., non-monetary liabilities) to finance asset 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	-37.3	3.6	13.5	-20.1	96.9
2001	-2.8	3.9	7.7	8.4	71.9
2002	18.3	2.5	-9.2	11.0	93.0
2003	38.9	-13.4	-32.5	-7.0	102.2
2004	*40.9*	*-7.6*	*-26.3*	*7.0*	*130.6*
2005	*37.0*	*-5.0*	*-32.0*	*0.0*	*106.2*
2006	*33.0*	*-5.0*	*-32.0*	*-4.0*	*96.8*

	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	-30.9	10.7	70.8
2001	10.5	82.4	-10.8	-17.8	62.3
2002	14.6	107.7	-25.3	-22.5	70.9
2003	24.2	126.5	-20.5	-39.2	59.7
2004	*22.3*	*152.9*	*-66.9*	*-4.3*	*88.8*
2005	*18.1*	*124.3*	*-30.0*	*-10.0*	*84.3*
2006	*16.5*	*113.3*	*-30.0*	*-3.0*	*76.3*

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

A puzzle in the analysis of different sectors' recent money demand behaviour is that the household sector is holding more money than implied by equations which fitted the data until the late 1990s. At any rate, current money growth rates (of 9% - 10% a year) suggest strong corporate liquidity and firm asset prices in 2005.

Domestically-held money balances must be in the hands of households, companies or financial institutions. (They cannot be held by Martians.) So - with an aggregate M4 money growth rate of 8.9%, as recorded in the year to January - an increase in household sector money of 8.2% (again as actually recorded) - implies that the combined money holdings of companies and financial institutions rose more quickly than 8.9%. In fact, financial institutions' M4 advanced by 11.2%. Work at Lombard Street Research has demonstrated a clear relationship in the past between such money and asset price movements, and it is consistent with long-run behaviour that share prices have climbed by over 15% since mid-2004. (See, for example, the research paper on 'Money and asset prices' in the May 2004 issue of Lombard Street Research's *Monthly Economic Review.*) A strong argument can be made (see p. 8 opposite) that interest rates are not high enough to dampen the growth of bank balance sheets to the 6% - 8% area and that M4 will continue to rise at 9% - 10% a year. If the rise in personal incomes were to stay at about 5% a year, it seems unlikely that household sector money will increase by much more than 7% - 8% in 2005. So the excess money in the corporate and financial sectors will persist, helping corporate balance sheets and supporting rather high asset prices. The monetary background therefore remains positive for domestic demand, despite the tightening of monetary policy in early 2004.

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	28.2	403.1	108.6	539.8	6.0
2001	30.5	430.5	122.2	583.1	8.0
2002	31.9	463.4	134.4	629.6	8.0
2003	34.0	505.4	143.1	682.5	8.4
2004	*36.1*	*548.6*	*155.6*	*740.3*	*8.5*
2005	*38.4*	*584.6*	*165.8*	*788.8*	*6.6*
2006	*41.0*	*623.0*	*176.7*	*840.1*	*6.5*

	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	136.5	208.5	884.8	70.8	8.2
2001	144.0	215.3	942.4	62.3	6.8
2002	152.9	226.1	1,008.7	70.9	7.3
2003	167.2	231.4	1,081.1	59.7	7.3
2004	*179.7*	*255.6*	*1,175.5*	*88.8*	*8.6*
2005	*193.0*	*278.0*	*1,259.8*	*84.3*	*7.2*
2006	*203.0*	*293.0*	*1,336.1*	*76.3*	*6.1*

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

Declining mortgage equity withdrawal has prompted commentators to forecast a drop in consumer spending. Yet much of the released housing equity has been used to build up deposits. Buoyant UK stock markets have boosted net financial wealth.

Mortgage equity withdrawal fell for the third quarter in succession in Q3 to £12,397m., down 25% from the end-2003 peak. This should be no surprise given the decline in secured lending, but some commentators are associating the reduction in MEW as a sign that consumer spending will slow. This is incorrect. While releasing equity from housing wealth can indeed support consumption, *National Accounts* data indicates that the majority of MEW has simply been used to accumulate financial assets in the form of bank and building society deposits. This cushion of liquidity should support spending over the forecast horizon. The 5% rise in UK equity prices so far in 2005 (17% since July) will have boosted financial wealth and should also have a positive influence on the outlook for consumption. Approximately one-third of household net wealth is related to the stock market in the form of either direct share holdings or equity within life policies and pension funds. Despite the continued build-up of debt, the ratio of financial wealth (net of outstanding loans) to income has stabilised at 2.5 in 2004 and is expected to move up to around 2.7 once stock market gains are included. Although this is still some way off peaks in excess of 3.5 reached in the late 1990s, financial wealth is roughly in line with its long-run average. The stock of outstanding debt in the household sector has climbed to an all-time high of almost 150% of income. But advances in tangible wealth have seen the ratio of total net wealth to income rise to above 7 for only the second time on record.

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	3.63	741.6	1.11
2001	701.6	2,145.3	3.00	819.1	1.14
2002	722.4	1,803.5	2.48	933.6	1.28
2003	754.3	1,930.9	2.51	1,061.4	1.38
2004	*789.7*	*1,997.0*	*2.53*	*1,146.3*	*1.45*
2005	*830.8*	*2,221.0*	*2.67*	*1,226.6*	*1.48*
2006	*876.5*	*2,328.6*	*2.66*	*1,300.2*	*1.48*

	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	3.14	4,800.9	7.18	5.0
2001	2,249.1	3.14	4,695.1	6.56	6.5
2002	2,705.0	3.72	4,874.5	6.70	5.3
2003	3,009.9	3.92	5,355.0	6.97	5.7
2004	*3,332.0*	*4.22*	*5,787.5*	*7.33*	*5.6*
2005	*3,332.0*	*4.01*	*6,011.5*	*7.24*	*5.7*
2006	*3,332.0*	*3.80*	*6,119.1*	*6.98*	*6.3*

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

A crash in the housing market remains a distant prospect, with conditions simply not in place for a drastic fall in house prices. The robustness of activity in recent months should allow the MPC to raise interest rates again.

The risk of a crash in the UK housing market has diminished. Chances of a slump in the average cost of a home were always slim with interest rates at still-accommodative levels, unemployment low and the economy advancing at a healthy pace. Nonetheless, the tightening of monetary policy inevitably led to a decline in mortgage lending of approximately one third. More recently, this downward trend seems to have come to an end, with mortgage approvals edging up in December. A simple model comprising of mortgage approvals and the RICS balance of sales to stocks suggests that annual house price inflation will stabilise at around 5% in coming months. Should the model remain an accurate forecasting tool, the robustness of the housing market will provide the Bank of England with some confidence to continue tightening monetary policy, with interest rates reaching 5¼% or even 5½% by the end of the year. As a result house prices are expected to be stable over the forecast horizon. Minimal or non-existent house price inflation will allow the ratio of house prices to earnings to move to a more sustainable level as income growth pushes towards 5%. (The ratio has already edged down from its mid-2004 peak of 5.63 to 5.5 in November.) Until a few months ago, the HPER was the foundation to most discussion of the housing market. Commentators were in agreement that the asset was overpriced, but the magnitude and duration of any adjustment period was a moot point. Expect earnings growth to do much of the work and fair value (HPER of around 4) not to be attained for a number of years.

The use of mortgage funds

	Mortgage rate, %.	Net mortgage advances, £b.	Government grants, £b.	Equity withdrawal, £b.	Investment in housing, £b.
2000	7.6	40.8	1.3	12.1	27.4
2001	6.6	54.2	3.2	21.2	29.8
2002	5.7	79.5	4.8	40.2	34.5
2003	5.5	100.7	5.1	55.1	40.5
2004	*6.3*	*100.5*	*2.8*	*41.0*	*46.2*
2005	*6.9*	*80.2*	*2.8*	*38.0*	*49.1*
2006	*6.8*	*75.0*	*2.8*	*36.0*	*51.9*

	Composition of housing investment, £b.:			End year house prices, £.	Ratio of house prices to earnings
	New houses	Council house purchases	Home improvements		
2000	18.4	1.3	8.7	82,188	3.34
2001	18.2	1.8	9.6	93,544	3.66
2002	18.4	2.0	14.1	117,206	4.33
2003	19.0	2.0	19.5	135,444	5.08
2004	*19.5*	*2.0*	*24.7*	*151,623*	*5.55*
2005	*20.1*	*2.0*	*27.0*	*151,623*	*5.28*
2006	*20.1*	*2.0*	*29.8*	*151,623*	*5.00*

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.

Household sector outlook

3. The pattern of consumption

Retail sales were flat in Q4. But continued strong income growth, buoyant UK stock markets and a cushion of liquid assets will support consumption in 2005. The probability of more interest rate hikes remains high.

Retail sales growth rebounded in January, advancing by 0.9% on the month and regaining most of December's 1.0% fall. The outlook for consumer spending continues to concern policy makers, with the Bank of England again attributing "considerable risks" to their forecast for household consumption growth. The main downside threat is, of course, the housing market. But with fears of a crash in house prices abating there should be scope for more certainty within MPC forecasts. Real disposable incomes grew by 4.0% in the year to Q3 and average earnings growth has continually edged higher to stand at 4.5% in the year to December. The labour market is undoubtedly tight and reports of skill shortages should lead to stronger increases in wages. Buoyant UK stock markets have boosted household financial wealth and consumer confidence rebounded strongly in the second half of 2004. The accumulation of bank and building society deposits over the last couple of years (an average of £13,000m. per quarter since 2003) is also supportive of healthy consumption growth. Admittedly, the fall in residential property transactions will reduce expenditure on 'big-ticket' items and goods associated with house purchases, but the favourable condition of personal sector finances will ensure there is no collapse. Indeed, if households believe the MPC is through tightening monetary policy there must be a risk of consumer spending growth accelerating, supported by higher incomes and gains in financial wealth. The MPC may have to start preparing markets for another interest rate hike in the Spring.

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	670.7	2.3	586.0	1.9
2004	*693.1*	*3.3*	*602.4*	*2.8*
2005	*713.4*	*2.9*	*618.6*	*2.7*
2006	*729.9*	*2.3*	*632.2*	*2.2*

	Durable goods consumption		Household sector	Car registrations
	£b., 2001 prices	% growth	borrowing., £b.	'000s
2000	69.6	8.7	68.3	2,219
2001	77.4	11.2	76.5	2,460
2002	80.6	4.0	109.6	2,564
2003	84.8	5.2	135.4	2,579
2004	*90.7*	*7.0*	*135.0*	*2,567*
2005	*94.8*	*4.5*	*108.0*	*2,560*
2006	*97.6*	*3.0*	*101.3*	*2,500*

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

Higher interest rates have been insufficient to induce positive financial savings, with households prefering tangible investments. A cooler housing market and further interest rate hikes will challenge this choice.

Despite an increase to interest rates of 125 basis points, the household sector continues to run a financial deficit. The financial saving ratio - net lending / borrowing expressed as a percentage of total resources - was -1.9% in Q3. The last time households had a positive financial saving ratio was in the final quarter of 2001 when interest rates were actually below the current level at just 4.17%. This apparent inconsistency is evidence that personal sector tastes have shifted from financial to tangible saving in the form of houses. According to the Investment Management Association, sales of unit trusts and open-ended investment companies are expected to have fallen by 40% in 2004. The slide in demand for Isas has been even more dramatic, with sales only £1.9b. in the first 11 months of 2004, against £3.3b. in the previous year and the record of £10.9b. in 2000. Households were also net sellers of mutual fund shares in Q3, only the second time this has occured in the last nine years. Investment in bricks and mortar has taken up the slack (the aggregate savings ratio is largely unchanged over the last five years), with tangible savings currently at 8.0% of total resources, slightly down from 8.3% in Q2 2004 and below the high of 9.0% (Q1 1989), but still well above its long-run average. The combination of a cooler housing market - with prices broadly flat over the next two years - and higher interest rates may challenge households' preference for tangible investment. Financial savings will become less negative as a result, but positive territory is some way off.

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	5.1
2001	7.2	2.4	4.7	3.1	6.5
2002	3.0	1.6	1.4	3.2	5.3
2003	4.4	1.9	2.4	2.3	5.8
2004	*4.7*	*1.5*	*3.2*	*3.3*	*5.6*
2005	*5.2*	*2.0*	*3.1*	*2.9*	*5.8*
2006	*5.5*	*2.5*	*2.9*	*2.3*	*6.4*

	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	730.7	692.3	38.5	-1.1	6.8
2003	765.6	721.8	43.8	-1.1	7.4
2004	*801.6*	*757.1*	*44.5*	*-1.9*	*8.0*
2005	*843.2*	*794.8*	*48.5*	*-1.7*	*8.1*
2006	*889.5*	*833.4*	*56.1*	*-1.2*	*8.1*

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

Mortgage approvals appear to have stabilised, perhaps in response to growing interest-rate complacency. But further rate hikes in 2005 may slow profits growth from last year's record levels.

The downward momentum in the housing market appears to have halted towards the end of 2004. Bank of England data show mortgage approvals ticking up in January. There may be some distortion in the data resulting from a switch in regulation to the FSA, but interest-rate complacency may have boosted confidence amongst prospective house buyers. Mortgage approvals from building societies are flat over the last three months. Growing competition from "specialist" lenders has seen building societies' share of the mortgage market decline to just 18%. Indeed, "specialist" lenders overtook building societies as the second biggest type of mortgage provider (according to share of the outstanding stock of mortgage debt) in Q3, doubling its market share to 19% since 2001. Similarly, the banking sector's share of the mortgage market has also fallen, from 72% to 62% in the last five years. However, banks continue to report record profits, with Barclays registering a 20% jump in their gross operating surplus in 2004. Much of this was a result of buoyant overseas activity, but there was also a large contribution from a reduction in the provision for bad and doubtful debt to its lowest level since 2000. Barclays admit that this is likely to be a one-off boost to profits, with official data showing a marginal rise in the number of mortgage possession actions. Figures are still well down on levels reached in the early 1990s, but with further interest rate hikes necessary in 2005 a more prudent approach may be advisable. Lenders with greater exposure to secured lending will experience a sharper slowdown in profit growth.

The pattern of mortgage lending

	Net mortgage lending by: Building societies, £b.	Banks, £b.	Other lenders, £b.	Total net mortgage advances, £b.
2000	9.0	19.6	12.2	40.8
2001	6.8	30.8	16.6	54.2
2002	11.0	48.2	20.3	79.5
2003	18.8	47.3	34.6	100.7
2004	*17.1*	*42.1*	*41.3*	*100.5*
2005	*13.2*	*31.0*	*36.0*	*80.2*
2006	*12.0*	*30.0*	*33.0*	*75.0*

	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	630.6	773.7	2,869.0	27.0
2004	*160.2*	*714.0*	*874.2*	*3,176.0*	*27.5*
2005	*173.4*	*781.0*	*954.4*	*3,176.0*	*30.1*
2006	*185.4*	*844.0*	*1,029.4*	*3,176.0*	*32.4*

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

UK life companies and pension funds have made a large asset allocation switch from equities to bonds since the peak of the bull market in late 1999. This switch may now be complete. Cash holdings have risen more quickly in recent months, which - as in past cycles - has helped asset prices.

In the 1980s and 1990s the UK's long-term savings institutions were an outlier in international comparisons. Their holdings of equities, expressed as a %age of total assets, were unusually high. Since then changes in the tax system (such as the end of the imputation system of corporation tax and dividend tax credits) and different regulations have encouraged a big switch towards bonds. 2004 saw continued heavy net buying of bonds, despite meagre yields. (The [real] yield on index-linked gilts was under 2% for most of the year.) At the low point in March 2003 share prices were roughly 45% down on the peak in late 1999. A wider macroeconomic consequence was that several years of rapid house price inflation could occur without total wealth advancing all that strongly. Consumption increased, but the positive wealth effect from rising asset prices was weaker than in, for example, the late 1980s. Share prices have done well since early 2003, originally because of the favourable military resolution of the Iraq conflict but more recently because of faster growth in financial sector liquidity. (See p. 9.) Rather high aggregate M4 growth in the 9% - 10% area was a feature of late 2004 and was associated with financial sector M4 climbing at over 10% a year. Compared with the explosions in financial institutions' money in the boom phase of past boom-bust cycles, this is moderate, but the numbers need to be watched.

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	826.8	308.6	203.3	84.3	134.0
2002	697.0	262.3	215.8	84.3	142.1
2003	754.4	285.3	231.7	87.8	183.4
2004	*815.8*	*331.9*	*252.6*	*93.9*	*211.3*
2005	*872.0*	*367.9*	*271.9*	*99.7*	*220.7*
2006	*931.2*	*405.4*	*286.5*	*106.3*	*231.6*

	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	1464.8	-10.0	66.4	-7.0	4.3
2003	1602.9	14.0	60.2	-10.9	3.8
2004	*1762.1*	*7.6*	*53.6*	*-11.0*	*3.0*
2005	*1891.0*	*7.3*	*58.8*	*9.7*	*3.1*
2006	*2024.9*	*7.1*	*63.9*	*8.6*	*3.2*

Figures until 2003 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. Capital gearing has continued to improve despite strong corporate bond issuance in Q4. Credit demand is a little subdued, but should soon revive.

Corporate balance sheets remain in good condition, with our estimate of the liquidity ratio (M4 deposits divided by M4 lending) at 0.62 in Q4. This is significantly above the long-run average of 0.58, but slightly down from the recent peak of 0.64. The buoyancy of the ratio bodes well for future business investment spending and company distributions over the forecast horizon. Deposit growth has slowed from double-digit rates in August to a 14-month low of 7.2% in the year to December and credit demand remains fairly subdued, running at a three-month annualised rate of just 3.0% in December. But the 7.4% increase in sterling unused credit facilities in 2004 suggests that appetite for corporate loans will revive soon. An increasingly popular source of finance is via the capital markets, with the outstanding stock of corporate bonds now broadly similar to that of loans from UK MFIs at £250b. However, corporate activity in the capital markets was minimal in the middle of 2004, with companies reducing their bond liabilities by 1.6% between April and October. More timely data suggest that net bond issuance revived in Q4, with almost £5b. of bonds sold in the three-month period. This is some way short of the £8.9b. recorded in the corresponding quarter of 2003, but narrowing corporate bond spreads may provide sufficient upward momentum into 2005. Capital gearing (the ratio of non-equity liabilities to equity capital) improved from 91% in 2003 Q1 to 76.7% in Q3 and is sure to have moved lower as stock markets continued their recovery into Q4, removing a possible obstacle to further borrowing.

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	1,228.7	329.3	444.0	12.4	10.1
2003	1,419.9	411.8	486.7	25.1	9.6
2004	*1,578.3*	*457.1*	*528.1*	*11.0*	*8.5*
2005	*1,674.6*	*498.3*	*580.9*	*9.0*	*10.0*
2006	*1,766.7*	*535.7*	*627.4*	*7.5*	*8.0*

	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	1.29
2001	1,083.9	920.9	72.65	57.37	1.18
2002	1,144.6	1,028.6	74.16	83.71	1.11
2003	1,286.1	1,093.2	84.62	76.99	1.18
2004	*1,363.3*	*1,169.7*	*86.57*	*74.11*	*1.16*
2005	*1,446.4*	*1,245.7*	*85.78*	*74.39*	*1.16*
2006	*1,526.0*	*1,320.5*	*85.38*	*74.74*	*1.15*

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 have continued to advance at a rapid pace supporting generous distributions. Prospects for 2005 remain upbeat with sustained output growth at trend rates or above. Accelerating wages may put pressure on margins.

The gross operating surplus of private non-financial corporations rose by 2.3% in Q3 against 2.9% growth in the previous quarter. GDP growth rebounded in Q4 to 0.7% and domestic conditions are expected to remain supportive for profits in 2005. Healthy profits have enabled firms to continue to raise distributions, with dividend payments up by 15.5% in Q3. Similarly, share buy-backs soared in 2004 and are sure to have beaten the record of £11.8b. set in 2000, with the total of the first three quarters already £10.1b. These figures cover both financial corporations and PNFCs. But whilst payout behaviour is broadly similar, OFC profits fell by 11% in Q3, largely due to weaker secured lending activity. Reviving merger and acquisition activity could boost financial profits in 2005, with such deals normally transferring liquidity from the corporate sector - currently quite high - to the financial sector. Overall business spending should also benefit from above-average corporate sector liquidity, although capital expenditure intentions on the CBI survey have weakened of late. However, evidence from both the CBI and BCC on capacity utilisation indicate that firms are operating at above-average levels. In these instances, capital expenditure has tended to increase. It is possible that companies are concerned about pressure on margins from rising labour costs. Mervyn King recently stated that accelerating wages represent the “major upside risk to inflation”. Average earnings growth (excluding bonus payments) reached 4.5% and could rise further, dampening prospects for investment spending.

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	73.5	77.5	66.2	26.1
2002	186.7	66.1	61.6	64.4	24.2
2003	200.4	72.0	71.3	65.2	23.5
2004	*217.4*	*74.2*	*72.8*	*69.8*	*25.8*
2005	*230.5*	*77.1*	*77.1*	*74.9*	*27.6*
2006	*244.3*	*80.2*	*81.8*	*80.4*	*29.5*

	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	5.9	-16.1
2002	102.2	1.7	97.1	2.0	3.6
2003	112.0	2.8	97.3	2.4	14.3
2004	*122.5*	*2.0*	*104.1*	*0.4*	*19.2*
2005	*127.0*	*2.0*	*112.3*	*1.5*	*14.5*
2006	*131.6*	*2.0*	*118.5*	*1.7*	*12.5*

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

Oil and gas output in 2004 is likely to be 17% lower than the peak year in 2000. But strong prices mean that profits are set to reach a new record, implying a helpful boost to the Treasury in the form of a higher tax-take.

North Sea output of oil and gas may have peaked five years' ago, but 2004 looks set to see a new record for profitability as companies benefit from the steep rise in oil prices seen over the last two years. National Accounts data shows that North Sea firms made gross operating profits of almost £16b. in the first three quarters of 2004. With the oil price averaging $45 a barrel in the final three months of the year (compared with $35 in the first nine months), profits for the year as a whole will probably exceed £22b. The bonanza from high oil prices should therefore mean that the North Sea sector, which has a weight of only around 3% in total GDP, will generate some 12% of non-financial corporate profits. The benefit is also helping the Treasury who should receive between £5b. and £6b. in tax revenues in 2004. High oil prices look set to be with us for a while yet - they have averaged $45 so far this year and have risen noticeably in recent weeks - suggesting that the tax-take will remain high in 2005. Meanwhile, the reduction in output has meant that the UK's trade surplus in oil has slipped sharply despite higher prices. From £5.7b. in 2002 and £4.1b. in 2003, the surplus fell to just £1.5b. in the first three quarters of last year. The days when the oil sector provided a huge boost to Britain's balance of payments seem to be over. Although most of the known North Sea fields are now mature, higher oil prices have stimulated additional investment. BP recently announced that it is increasing exploration activity and intends to invest £4b. in the area between now and 2008.

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	30.4
2001	206.3	24.4	126.9	1.44	26.2
2002	201.0	24.8	123.9	1.50	24.9
2003	190.8	28.6	131.4	1.64	25.1
2004	*181.0*	*38.5*	*158.7*	*1.82*	*28.7*
2005	*173.0*	*37.0*	*157.3*	*1.76*	*27.2*
2006	*170.0*	*30.0*	*136.4*	*1.65*	*23.2*

	Taxable profits, £b.	Total tax bill, £b.	Operating costs, £b.	Exploration costs, £b.	Fixed investment, £b.
2000	21.3	5.0	4.4	0.3	3.1
2001	20.3	4.5	4.3	0.4	4.0
2002	19.3	4.1	4.6	0.4	4.0
2003	19.0	3.9	4.5	0.3	3.7
2004	*22.1*	*5.7*	*4.5*	*0.4*	*4.3*
2005	*18.7*	*5.4*	*4.5*	*0.3*	*5.1*
2006	*15.9*	*4.2*	*4.5*	*0.3*	*4.5*

Figures until 2003 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

The stocks cycle has been fairly muted in recent years. Identifying stockbuilding trends is not helped by the way it is treated in the National Accounts. But higher stockbuilding looks likely to boost GDP growth slightly in 2005.

Stockbuilding is probably the most volatile component of GDP. Nevertheless, changes in stockbuilding often have a significant influence on growth trends, especially at cyclical turning points. In the major downturns (1975, 1980 and 1990) the change from stockbuilding to de-stocking has typically subtracted around 1% from overall GDP growth. Conversely, at cyclical peaks (1973, 1988, 1994) it has often boosted annual growth by 0.5% or more. In recent years, the stocks cycle has been less marked, a reflection of both the more stable macro-economic background and improved stock management techniques. (The stock-output ratio, for example, has fallen almost continuously over the last 20 years.) Forecasting trends in official stockbuilding figures is not helped by the fact that National Statistics uses the stocks series as a "catch-all residual" term that is adjusted to ensure that the different measures of GDP (income, output and expenditure) all sum to the same total. Quarterly movements can therefore be exceptionally volatile still. However, these adjustments cancel out over the year. What does seem clear is that, despite a good year for domestic demand growth, 2004 saw very subdued stockbuilding. Surveys are not absolutely conclusive, but both manufacturers and retailers have reported stock levels in recent months as being low relative to demand. Although the impact may not be as great as it has been in the past, the stocks cycle looks likely to be a positive influence on GDP in 2005, adding perhaps as much as 1/4% to overall growth.

Companies' fixed investment and stockbuilding

	Total investment £b., current	Deflator for investment, 2001 = 100	Total investment real change, %	Private, non-financial corporations, £2001b.
2000	107.1	100.0	3.6%	96.4
2001	105.1	100.0	2.6%	98.0
2002	104.0	101.0	2.7%	96.1
2003	101.0	103.3	2.2%	94.2
2004	*107.3*	*106.7*	*6.0%*	*97.6*
2005	*116.0*	*110.6*	*3.4%*	*101.5*
2006	*122.4*	*114.5*	*2.0%*	*103.5*

	North Sea companies £2001b.	Financial corporations £2001b.	Total change in inventories, £2001b.	Stock/output ratio
2000	3.1	10.8	5.3	0.144
2001	4.0	7.2	6.2	0.144
2002	4.0	6.8	2.5	0.139
2003	3.6	3.6	2.5	0.134
2004	*4.3*	*3.0*	*0.4*	*0.129*
2005	*4.1*	*3.4*	*1.5*	*0.127*
2006	*3.1*	*3.4*	*1.8*	*0.123*

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

Employment growth over the last year has been entirely concentrated in the public sector, suggesting that the recent cyclical revival in productivity growth will not continue. Wage inflation and unit costs are set to push higher in 2005 and 2006.

Private sector productivity growth has seen a worthwhile revival in recent quarters. Having averaged around 2% between 1996 and 2003, it rose to above 3% in the year to Q3 as output has rebounded, while employment increased more slowly. In the February *Inflation Report* the Bank of England stressed that they believed a significant part of the rise was probably cyclical as companies have responded to stronger demand - at least initially - by adjusting the intensity of use of labour resources rather than changing the numbers employed or their hours of work. But this cannot continue indefinitely. Indeed, preliminary data for Q4 show a sharp increase in total hours worked, suggesting that the above-trend rise in GDP was achieved through higher inputs rather than a further productivity gain. More fundamentally, recent rises in employment have been heavily concentrated in the public sector where productivity growth is notoriously lower. The official workforce in employment series showed an increase of 88,000 jobs in the year to Q3. But the rise within public administration, education and health (mostly, but not exclusively public sector workers) was 157,000, implying a fall in private employment. There must be worries that productivity growth will disappoint over the forecast period. Meanwhile, wage pressures are already rising in the tight labour market. Underlying (i.e., ex-bonus) earnings growth has risen to 4.5% from 3.5% a year ago. If domestic demand remains robust in early 2005, as looks likely, then wage inflation and unit labour costs will push higher this year and next.

The labour market

	Workforce, total, m.	Workforce jobs, m.	Unemployment, total, m.	Unemployment rate, %
2000	30.642	29.602	1.040	3.4
2001	30.798	29.840	0.958	3.1
2002	30.930	29.991	0.939	3.0
2003	31.312	30.396	0.916	2.9
2004	*31.277*	*30.446*	*0.831*	*2.7*
2005	*31.336*	*30.526*	*0.810*	*2.6*
2006	*31.316*	*30.476*	*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	*2.7*	*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

CPI inflation has risen noticeably in recent months. With output at or perhaps above its trend level, inflation pressures will build over the forecast period, a view with which even the cautious Bank of England seems to agree.

Inflation trends are worrying. As forecast on these pages three months ago, inflation has risen more quickly than the Bank had been expecting. CPI inflation was 1.2% last October, but 1.6% in December and January. Although this is still well below the 2% target, it is widely expected - even by the Bank of England - to rise further during the course of 2005. Indeed, the Bank's projections that acompanied the February *Inflation Report* showed it moving significantly above target in two years' time. Since the assumption behind the projections is that interest rates rise in line with market projections, and futures markets are discounting a peak in rates of 5% at most, the right implication to draw must be that the market is being too optimistic about rates. The fundamental influence on the change in inflation is the level of the output gap - the difference between trend and actual GDP. With output close to - or perhaps even a little above - its trend level currently, and growth set to remain strong for at least a few quarters yet, inflation pressures will continue to build in 2005. A further adverse impact on inflation outcomes over the forecast period could come from import prices. Since sterling's sharp appreciation in 1996, falling prices of goods, many of them imported, have been a powerful deflationary influence that helped keep RPIX inflation comfortably below the old 2.5% target. But import prices rose sharply in the second half of last year, a sign of rising inflation globally, a trend that the Bank highlighted as one of the upside risks to inflation in 2005 and 2006.

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	1.3	4.5
2001	2.0	1.0	1.0	2.4	3.1
2002	2.6	2.6	1.5	1.5	3.7
2003	2.6	2.7	1.3	2.1	3.9
2004	*2.3*	*3.3*	*1.4*	*1.0*	*4.5*
2005	*2.6*	*2.3*	*2.0*	*2.0*	*5.1*
2006	*2.7*	*2.5*	*2.2*	*2.5*	*5.4*

	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	97.9
2004	*148,647*	*13.8*	*111.8*	*102.0*	*99.0*
2005	*149,390*	*5.0*	*115.0*	*100.0*	*101.0*
2006	*149,390*	*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

Euroland growth slowed further in Q4. But there are encouraging signs for UK exporters. France is benefiting from a housing boom, whilst continued corporate restructuring in Germany may assist a rebound in investment spending.

Prospects for the UK's net trade position are inextricably linked to the health of Euroland, with roughly a half of all UK exports sold to the region. Q4 GDP growth in the area was just 0.2%, the weakest since the first half of 2003. France and Germany represent more than 20% of demand for UK goods, but their fortunes have diverged of late, with output advancing by 0.8% and contracting by 0.2% respectively. Domestic demand in France is benefiting from a buoyant housing market. The resultant boost to household wealth is likely to have helped consumer spending rise by 1.2% in Q4, the fastest pace of growth for almost four years. Conversely, German private demand remains steadfastly weak, unable to register a quarterly rise of more than 0.1% since 2002. Corporate sector health is more encouraging for UK exports after German firms spent the last few years restructuring balance sheets. The corporate sector financial balance is now roughly 0.5% of GDP in comparison to a deficit of 6% of GDP in 2000. Business investment could rebound as a result and capital goods orders did indeed revive in Q4. This may have contributed to December's 4.1% jump in UK exports to the EU, following a 1.5% fall over the previous three months. However, the strength of UK domestic demand has resulted in continued buoyant import growth, advancing by 2.1% in Q3 and 2.0% in Q4. Further hikes to interest rates in 2005 will help to slow domestic demand and improve the UK's balance of payments on goods and services.

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	267.0	286.6	-19.6	5.1
2001	272.4	299.8	-27.4	11.6
2002	273.7	304.8	-31.1	22.0
2003	279.7	311.5	-31.8	23.1
2004	*283.9*	*323.9*	*-40.1*	*25.0*
2005	*302.6*	*340.3*	*-37.7*	*25.0*
2006	*322.6*	*357.5*	*-34.9*	*25.0*

	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	-17.6	-1.69	0.1	4.1
2003	-9.9	-18.6	-1.69	0.9	1.8
2004	*-12.0*	*-27.1*	*-2.33*	*1.9*	*4.3*
2005	*-12.0*	*-29.7*	*-2.41*	*4.5*	*4.0*
2006	*-12.0*	*-26.9*	*-2.07*	*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 widened in 2004 and is expected to remain at around 2% to 2½% of GDP over the forecast period. But is not approaching the alarming levels reached in the late 1980s, or those currently being seen in the US.

The UK's balance of payments deficit totalled £21b. in the first three quarters of 2004 and, although exports did pick up modestly in the final three months of the year, it is set to exceed £27b. for the year as a whole, or around 2.3% of GDP. The last time that the deficit was so large in money terms was in 1989 at the peak of the "Lawson" boom. At that stage it represented well over 5% of GDP and financing the deficit required significant banking inflows. Such flows are volatile and can swiftly be reversed, putting pressure on the currency. In recent years there have been no such problems, but if the deficit were to rise much more, doubts about how it might be financed could emerge. Direct and portfolio investment flows - both into and out of the UK - recovered in 2003 and 2004 as faith in the global economic recovery took root. The revival in international mergers and acquisitions activity has been a more recent phenomenon. According to data compiled by National Statistics, foreign companies made acquisitions in the UK amounting to almost £30b. in 2004, the highest since the boom year of 2000 and more than three times the total in 2003 of £9.3b. With UK companies making acquisitions abroad of £20b. in 2004, the implied net capital inflow was a useful source of finance for the current account deficit. The UK balance of payments should not be a major policy issue in 2005 and 2006, unlike in the USA, where reliance on massive purchases of government debt by foreigners looks unsustainable and may help explain much of the fall in the dollar in recent years.

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	-55.5	9.7	8.5
2003	-1.1	1.6	-31.4	16.9	1.7
2004	*20.0*	*0.0*	*7.1*	*27.1*	*0.0*
2005	*-10.0*	*0.0*	*29.7*	*29.7*	*0.0*
2006	*0.0*	*0.0*	*11.4*	*26.9*	*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 nine years, although this would be helped by a fall in the trade-weighted exchange rate. Global economic growth should moderate towards trend in 2005 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 2005 to slow domestic demand. Oil prices are expected to slip slightly 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	103.0	1.88	2.8
2005:2	3.2	5.0	102.0	1.84	2.9
2005:3	3.2	8.2	101.0	1.78	3.2
2005:4	2.8	7.2	101.0	1.75	3.5
2006:1	2.6	6.1	100.0	1.70	4.0
2006:2	2.4	5.1	98.0	1.65	4.2
2006:3	2.4	4.1	98.0	1.65	4.2
2006:4	2.4	4.1	97.0	1.65	4.1

	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	45.0	1,100	23,000
2005:2	64.6	31,275	42.0	1,100	22,400
2005:3	61.1	31,285	38.0	1,100	20,000
2005:4	63.0	31,300	35.0	1,100	22,600
2006:1	67.5	31,300	32.0	1,100	22,400
2006:2	64.6	31,290	32.0	1,100	22,000
2006:3	65.0	31,280	32.0	1,100	19,500
2006:4	63.0	31,280	32.0	1,100	22,000