June 2005

Quarterly UK Economic Forecast

Lombard Street Research

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Quarterly Economic Forecast

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The economic outlook over the next two years

Does money matter? And if so, how much does it matter in the UK in late 2005?

Money trends vs. non-monetary indicators

Early 2005 has been an unusual period for the UK economy. Monetary and non-monetary data have been giving sharply divergent messages about the future of economic activity. As noted by the Bank of England in its latest *Inflation Report*, broad money growth in the year to March 2005 "reached its highest annual rate since July 1998". Although the Bank itself is (as always) rather equivocal about the significance of money growth for demand, the recent high rates of increase are plainly more supportive of spending than low rates of increase. On the other hand, non-monetary data has generally been weak. The official estimate of the growth in gross domestic product in the first quarter was only 0.5%, with marked sluggishness in domestic demand. Further, reliable leading indicators support a downbeat view on the second half. Business surveys in the manufacturing sector have deteriorated in recent months, partly in the backwash from the feeble continental European economies. Meanwhile the housing slowdown runs its course, with house prices in 2005 so far being virtually unchanged on their level at the end of 2004. (Between December 2004 and May 2005 the Nationwide house price index rose 1.5%, while the Halifax index was down less than 0.1%.) The end of the house price boom has been accompanied by poor retail sales, particularly on such goods are carpets and furniture.

Retail sales are *not* the whole economy

Newspaper headlines about High Street gloom have been eye-catching and seem to be having a preponderant influence on sentiment in the sterling money markets. Whereas the market expectation in January and February 2005 was that May's general election would be followed by a base rate increase, the dominant view now is that a base rate cut will be announced before the end of the year. But economists should not be misled by the stereotypical view that "spending in the shops" is the bulk of the nation's expenditure. Retail sales in fact represent less than 20% of domestic demand. A better guide to the current state of the economy is provided by employment data. In the quarter to March employment is estimated to have been 87,000 higher than in the previous quarter, implying an annual rate of gain of over 300,000. With total employment at 28.6m., an annual increase of 300,000 would of course be more than 1%. This would be similar to the average experience since the early 1990s and is inconsistent with reports of beneath-trend growth. As for the Q1 GDP number, there have numerous examples in recent years of the early Q1 GDP estimates being too low. The debate about what has happened to the UK economy so far in 2005 is not settled yet.

"Too much money chasing too few assets" in late 2005?

What about the remainder of 2005? High aggregate money growth since early 2003 has finally led to a marked upturn in financial sector money, which advanced at an annualised rate of 23.4% in the three months to March. That is consistent with anecdotal reports that private equity funds and potential investors in commercial property have abundant "cash on the sidelines", and are finding it difficult to invest their funds because they feel that companies, buildings and land are over-valued. In past cyclical episodes this sort of pattern - of "too much money chasing too few assets" - has often been the prelude to asset price buoyancy and above-trend demand growth.

Professor Tim Congdon **9th June 2005**

Summary of main points of the

Quarterly Macroeconomic Forecast, June 2005

Satisfactory year for UK economy, despite consumer slowdown

Consumer spending has been weaker than expected in our February 2005 forecast, but steady employment growth argues that overall demand is expanding at close to a trend rate. Market expectations of a base rate cut jar with unduly high money supply growth.

Other key points

- **Rapid Asian growth has kept energy and commodities in short supply. Oil prices in the first half of 2005 were 10% - 15% up on the 2004 average, deflecting spending power from the leading industrial nations (where consumer demand has suffered) to the oil producers.**

- **Nevertheless, 2005 will see roughly trend growth in the output of the world as a whole (i.e, both the OECD and the rest of the world). Demand buoyancy in the wider dollar area (i.e., including much of Asia as well as the USA) is relevant to the direction of US interest rates.**

- **The Eurozone economies - with trend growth already crippled by over-regulation and high taxation - have been hit by cyclically high oil and commodity prices. Weakness in these economes has had an adverse impact on UK business surveys, especially in the manufacturing sector.**

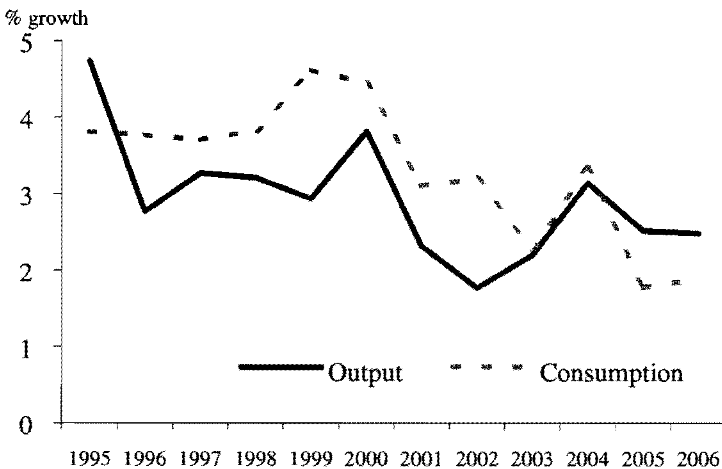
- **The rise in base rates to 4 ¾% in August 2004 has successfully checked the housing boom and led to the long-overdue UK consumer slowdown. The number of loans for house purchase fell from 133,000 in November 2003 to 77,000 a year later, but - interestingly - it recovered to 95,000 in April 2005. (See pp. 10 -11 and p. 14.)**

- **At current interest rates, the annual rate of M4 growth is likely to remain at close to double digits. That will help corporate liquidity and boost the cash holdings of financial institutions, with a positive effect on asset prices. (See p. 15.)**

- **UK output at present appears to be roughly at its trend level (i.e., the output gap is zero). (See p. 4 and pp. 20 - 21.)**

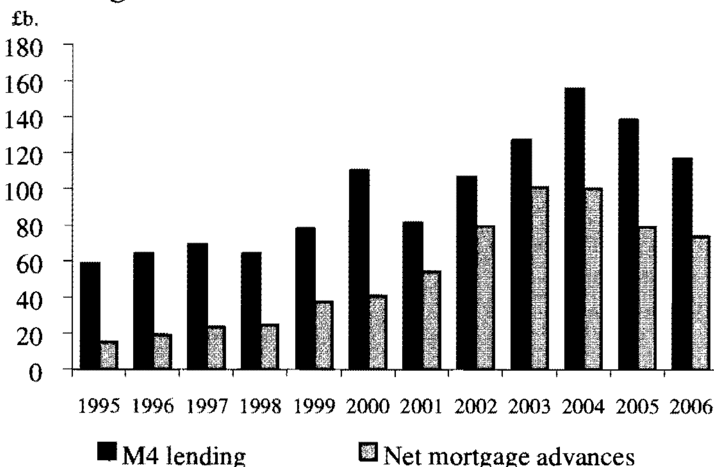
This forecast was prepared by Diana Choyleva, Tim Congdon and Mark Richards.

GDP growth and consumption



Interest rate assumption

Credit growth



A serious analytical problem in the advanced industrial nations with large public sectors is that productivity in the various types of government employment is difficult to measure. Because - typically - such government services as education and health are not marketed, the true levels of "output" and "output growth" have to be estimated by somewhat arbitrary methods. Some economists, notably Bacon and Eltis in their 1976 study of *Britain's Economic Problem: Too Few Producers*, have argued that public sector employment should be restrained, because much of it is not "productive" in the same way as private sector employment.

The Bacon-and-Eltis thesis was an important influence on the Conservative government from 1979 to 1997. For example, in the 20 years to 1979 local government employment climbed from 1.781m. to 2.997m., or at a compound annual rate of 2.6%. By contrast, in the 18 years to 1997 it fell to 2.593m., with a compound annual rate of decline of 1.0%. But, since the election of the current Labour government in 1997, growth has resumed. At the end of 2003 local government employment stood at 2.815m. and the compound annual rate of growth since 1997 had been 1.4%. The upturn in public sector employment is obvious in many other items of evidence. The Conservatives could not prevent a significant gain in employment in "health, education and public services". In their 18 years of power this category of employment saw a compound annual growth rate of just above 0.8%. But in the first seven years of New Labour its compound annual growth rate was 1.9%.

Of course, health and education output are an essential part of output. Even so they are labour-intensive and characterised by poor productivity growth. The slowdown in economic growth across Europe since the 1960s may therefore be partly explained by the reduced importance of manufacturing, and the expansion in public sector output and employment. Given these patterns, the high growth of public sector employment in the last five years does seem likely to lead to slower growth of productivity and output. In the four years 2001 to 2004 the average annual growth rate of whole-economy output per head was in fact under 1%, whereas in the 1990s it was over 2%.

The economic outlook

1. The real side of the economy

Output growth is forecast to run at about its trend rate of 2½% in 2005. Consumer spending has lost steam and should stay relatively subdued. With the level of output currently close to potential, domestic inflationary pressures are unlikely to be an immediate problem.

The second *National Accounts* estimate placed real GDP growth at 2% on a quarterly annualised basis in Q1, down from 2.7% in the previous quarter. Domestic demand contributed 0.15 percentage points to growth, while net exports added 0.36 percentage points. Over the past nine years net exports have consistently subtracted from growth. If sustained, a rebalancing of the economy, with domestic demand growing slower than output, will be beneficial for the UK in the medium term. Consumer spending has weakened significantly, as income growth and the housing market have slowed, after 2004's base rate rises. But household balance sheets remain strong, suggesting that private consumption is unlikely to collapse this year. Currently, there is a dichotomy between the real economy and the monetary data. Our leading indicators paint a rather unsatisfactory picture of below-trend growth this year. The main weakness stems from the housing-related and manufacturing-related indicator components. But broad money growth remains high, implying general balance-sheet health and above-trend output growth later in 2005. On balance, domestic demand is still likely to expand slightly above potential through strong investment spending and government consumption. Meanwhile, UK's main trading partner, Euroland, is unlikely to grow faster than the UK. With the pound overvalued against Asian currencies another year of negative net exports seems on the cards. Our estimate is that the economy is operating at about its trend level, although the output gap was marginally positive in Q1. Business surveys also point towards emerging capacity constraints. If growth stays around trend, the output gap will continue to be slightly positive. Domestic inflationary pressures are unlikely to be a major problem this year.

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	2.3	3.2	0.0
2004	3.1	3.3	5.6	4.7	-0.2
2005	*2.5*	*1.8*	*4.9*	*3.2*	*0.1*
2006	*2.5*	*1.9*	*4.2*	*3.0*	*-0.1*

	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	2.4	0.9	1.9	-0.4	-1.7
2004	3.8	3.0	5.2	-0.8	-2.2
2005	*2.6*	*2.6*	*3.0*	*-0.3*	*-1.9*
2006	*2.4*	*2.2*	*2.0*	*0.0*	*-1.5*

Figures until 2004 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

Annual money growth has accelerated to reach double-digits. Demand for credit has shifted away from households to the corporate sector, as banks remain eager to lend. Highly liquid balance sheets throughout the economy remain supportive of domestic demand.

Heady rates of broad money growth provide the major reason to be optimistic over UK growth prospects. M4 advanced by 10.5% in the year to April, the fastest pace for some nine years. Interest rates of 4¾% may have been sufficient to calm the rampant housing market and consumer spending, but so far monetary policy has been unable to slow rapid money growth. Periods of strong money growth imply highly liquid balance sheets which in turn tend to boost domestic demand. In order to achieve the inflation target over the medium term, broad money should increase at approximately 7% a year. This represents output growth of 2½% plus 2% - 2½% inflation and an increase in the ratio of money to incomes of about 2%. Consequently, double-digit money growth implies higher inflation. But, while the Bank of England continues to ignore money supply trends in setting interest rates, policy is likely to be unchanged in coming months. This is likely to result in continued strong rates of credit growth, the main factor in determining broad money developments. (When a bank extends a new loan, it creates a new bank deposit and deposits are money.) Household demand for credit has slowed in line with the cooling housing market, but banks appear to have been successful in extending new loans to other sectors of the economy. Lending to private non-financial corporations increased at its fastest pace in four years in the twelve months to April and demand for credit remains strong. Banks are extraordinarily well-capitalised at present and will remain eager to lend over the forecast horizon. Money supply movements argue that base rates need to be raised. Broad money is expected to grow by 9% in 2005, but should slow thereafter in response to another interest rate hike later this year.

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	11.4	8.3	3.0	5.4
2001	5.1	7.1	6.8	1.8	4.7
2002	4.0	8.5	7.3	1.7	5.4
2003	3.7	8.7	7.2	2.9	4.3
2004	4.4	10.9	8.9	3.0	6.0
2005	*4.8*	*9.1*	*9.2*	*3.2*	*6.0*
2006	*4.7*	*7.1*	*7.1*	*2.9*	*4.2*

	Velocity of circulation of M4	Change in velocity, %	Change in effective exchange rate, %	Increase in average earnings, %	Increase in house prices, %
2000	1.07	-2.9	1.8	4.5	9.9
2001	1.05	-1.8	-1.6	4.4	13.2
2002	1.03	-1.8	1.2	3.6	24.9
2003	1.02	-1.6	-3.5	3.4	15.7
2004	0.98	-3.3	4.9	4.4	14.5
2005	*0.95*	*-3.5*	*-1.0*	*4.6*	*0.0*
2006	*0.93*	*-1.5*	*0.0*	*4.9*	*0.0*

Figures until 2004 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

The Treasury's growth projections seem optimistic. Proposed intervention in the housing market could be viewed as an attempt artificially to boost house prices and consumption. Possible PFI reallocation by official statisticians would threaten the Chancellor's fiscal rules.

The post-election period has been far from quiet for Mr. Gordon Brown. The *Financial Times* carried an article on its front page (May 20th), stating that the Office for National Statistics had made the decision to reallocate those loans associated with Private Finance Initiatives to the public sector. Such a move would inevitably endanger the Chancellor's fiscal rules of keeping government borrowing below 40% of GDP. In the event, the ONS hastily issued a refusal of any change in PFI treatment, but their reaction only served to highlight the sensitivity of the debate over the public finances. The official measure of net borrowing has improved, standing at £33.9b. in the year to April down from a recent peak of £41.2b. However, the alternative measure of borrowing – the public sector net cash requirement – has fallen by much less, £39.3b. against a peak of £41.3b. The annual growth rate of tax receipts has finally begun to outpace expenditure. Revenues grew by 7.5% in the last financial year against a 4.6% increase in current expenditure. But with national income in 2005 unlikely to meet the Treasury's growth forecast of between 3% and 3½%, a projected 8.2% rise in tax receipts in 2005/06 seems optimistic. The Treasury's proposed plan to subsidise first-time house buyers up to 25% of the purchase price could sceptically be viewed as an attempt further to fuel the housing market just as it appears to have cooled. This would provide a boost to consumption and increase the possibility of Mr. Brown meeting his growth projection. However, the housing market requires a period of stability and further distortions are undesirable. Another prospective change in policy, enabling residential property to be included within self-invested pension plans, may also boost house prices. (See p.11.)

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	-8.5	-0.9	0.5	-8.0	-0.9
2000/01	-37.2	-3.9	0.1	-37.1	-3.9
2001/02	3.4	0.3	0.7	4.0	0.4
2002/03	24.1	2.3	0.0	24.2	2.3
2003/04	39.5	3.7	0.0	39.5	3.7
2004/05	38.6	3.4	0.0	38.6	3.4
2005/06	*36.0*	*3.0*	*0.0*	*35.0*	*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	-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 200/05 are taken from *Public Sector Finances*; figures thereafter are based on the *Budget 2005*, 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

World output will advance more slowly in 2005 and 2006 than in 2004. US growth seems set to weaken, while Euroland and Japan are no growth locomotives. China's current account surplus has ballooned, crowding out the rest of the world.

2004 saw the world economy expand at a strong above-trend rate. Even so, most economies continue to operate at or slightly below capacity. With demand not in excess of supply, policy does not need to be tightened sharply and bring about a world recession. Euroland's and Japan's economies should continue to expand, but growth is likely to be at best around trend. These countries, however, are not growth locomotives, with trend output growth rates no higher than half of that of the US and less than a quarter of China's. The two world growth locomotives – the US and China – have currently overheated. Our World Service estimates that the US has a 1.5% positive output gap, while wage growth appears to be rising. The Fed needs to tighten policy even further at a time when the economy is waning of its own accord. A significant growth slowdown is on the cards later in the year and into 2006. China has already begun its hard landing. Domestic demand growth has faltered. Buoyant exports are the only thing keeping the economy going. China is crowding out the rest of the world, with its current account surplus exploding. There is no support coming from demand in the rest of Asia, where growth is mainly export-led. On the face of it, the consequences for the UK economy may not appear negative. World demand may not be a strong support to growth, but net exports have been subtracting from growth since 1996 without causing too much hardship. Meanwhile, the increasing Asian savings glut is supportive of asset prices and the pound. If the external environment weakens, the Bank of England would have to lower rates to stimulate the domestic economy. The financial imbalances are likely to worsen, storing trouble for the future.

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	3.9	4.0	4.8	4.5	28.4
2001	1.1	3.5	1.5	-4.1	24.5
2002	1.6	2.6	0.5	0.8	25.0
2003	2.2	2.5	1.8	7.1	28.9
2004	3.6	2.4	3.5	18.6	38.2
2005	*2.2*	*2.6*	*3.0*	*6.3*	*43.0*
2006	*1.4*	*2.0*	*2.3*	*-2.0*	*38.0*

	Real oil price, 2000 prices	US 3-month CD rate	Dollar/sterling exchange rate	Sterling effective rate, 1990 = 100	Sterling real effective exchange rate
2000	28.4	6.5	1.52	100.9	100.0
2001	24.1	3.7	1.44	99.2	99.5
2002	24.5	1.7	1.50	100.4	101.7
2003	27.8	1.2	1.63	96.9	98.0
2004	35.5	1.6	1.82	101.6	103.3
2005	*36.1*	*3.0*	*1.80*	*101.0*	*103.0*
2006	*33.5*	*2.5*	*1.80*	*101.0*	*103.0*

Figures until 2004 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. The Sterling effective exchange rate is the Bank of England's measure, introduced in March 2005.

Monetary trends

1. Determinants of monetary growth

Credit growth remains in double digits and will not reach a more sustainable growth rate unless monetary tightening is resumed. Other influences on broad money may alter over the forecast horizon, with banking sector bond issuance unlikely to repeat 2004's record.

In recent decades the main determinant of monetary growth has been lending to the private sector. Borrowers and lenders have had 10 months to adjust to base rates of 4¾%, yet the pace of credit growth remains in double digits. Mortgage lending has slowed to a more sustainable annual growth rate of 7.5%, but non-mortgage credit demand remains buoyant. In particular, the growth of lending to private non-financial corporations has accelerated to a four-year high. While the MPC remains concerned over consumer spending, interest rates seem unlikely to change in coming months. Indeed, some forecasters are expecting an imminent loosening of monetary policy. This only seems plausible if consumption growth slips even further and the housing market deteriorates further. But, with mortgage approvals edging up in recent months, there is support for both house prices and consumption. Our view is that rapid money growth will boost domestic demand in the second half of 2005, prompting the Bank of England to raise interest rates to 5% late in the year. Whether this will be sufficient to attain rates of credit and money growth consistent with the inflation target (around 7%) is debatable. In previous cycles, interest rates of above 5% have been required. However, such tightening seems unlikely should doubts over the domestic economy persist. Other influences on monetary trends are also worth noting. It seem unlikely that banks and building societies will repeat 2004's record issuance of non-deposit liabilities, that reduced the stock of M4 by £67.5b. or 6%. Public sector borrowing should ease slightly over the forecast horizon. But buoyant demand for gilts from both institutional and overseas investors should result in the public finances having a minimal impact on broad money developments.

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	-38.2	3.6	13.5	-21.1	96.6
2001	-4.5	3.9	7.7	7.8	72.8
2002	16.8	2.5	-9.1	10.6	93.2
2003	38.1	-13.4	-32.6	-7.8	102.1
2004	40.4	-2.4	-31.7	6.6	131.7
2005	*37.0*	*-8.0*	*-30.0*	*-1.0*	*118.7*
2006	*33.0*	*-6.0*	*-28.0*	*-1.0*	*100.7*

	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	69.9
2001	10.4	83.0	-10.8	-17.8	62.2
2002	14.5	107.7	-25.3	-22.5	70.5
2003	24.0	126.2	-20.5	-40.2	57.5
2004	22.1	154.0	-67.5	1.2	94.4
2005	*19.9*	*138.6*	*-25.0*	*-4.0*	*108.6*
2006	*16.8*	*116.9*	*-20.0*	*-4.0*	*91.9*

Figures until 2004 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

Household money growth remains above 8%, suggesting a shift in the desired level of money holdings. Households probably have excess money, which should help demand. Financial sector money growth is positive for asset prices.

In a rare discussion of monetary trends, the Bank of England's May *Inflation Report* noted the sustained buoyancy of household sector M4 growth, advancing at around 8% since 2001. This easily outstrips 5% nominal spending growth over the same period. The difference in growth rates (i.e. the change in the ratio of household money to income) has a number of explanations. Increased competition in retail banking has raised interest rates on deposit accounts, encouraging flows into such accounts. The three-year bear market in equities – although now at an end – may have induced an upward shift in households' desired cash holdings. There is also the suggestion that money is being balanced in portfolios relative to housing wealth, as opposed to goods and services or financial products. This not only keeps the money within the household sector, but also serves to bid up house prices. Higher house prices also increase the required deposit for purchasing a house, offering another explanation for strong household sector money growth. Despite these arguments, the Bank concurs that the rapid accumulation of bank deposits could be used to finance consumption over the forecast horizon. The Bank of England is more dismissive of non-household money growth. In particular, money held by financial corporations is deemed, "unlikely to be informative about the near-term outlook for nominal private sector demand." Financial sector money growth has accelerated in recent months, rising by 17.1% in the year to April. Strong financial sector money is supportive of asset prices. When asset prices strengthen, the wealth of agents throughout the economy increases and this raises their propensity to consume out of income, thereby boosting domestic demand.

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	682.4	8.4
2004	36.1	547.9	155.6	739.6	8.4
2005	*39.0*	*592.0*	*168.1*	*799.1*	*8.0*
2006	*42.1*	*639.7*	*181.6*	*861.7*	*7.4*

	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	68.9	8.3
2001	144.0	215.3	942.4	59.9	6.8
2002	152.9	226.2	1,008.7	69.0	7.3
2003	167.2	231.6	1,081.1	58.4	7.2
2004	179.2	259.2	1,177.9	95.8	8.9
2005	*197.1*	*290.3*	*1,286.5*	*108.6*	*9.2*
2006	*208.9*	*307.7*	*1,378.4*	*91.9*	*7.1*

Figures until 2004 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.

Household sector outlook

1. The balance sheet

Balance sheets remain healthy, with debt to wealth at a comfortable level. Household money growth remains strong, but the desire to hold real balances seems to have risen. Housing wealth has been preserved, as house prices have not yet clearly come down.

Household sector balance sheets remain healthy, even though debt has risen sharply over the past four years. Debt reached 1.53 times disposable income in the fourth quarter from 1.10 in the first quarter of 2001, after staying flat around 1.06 times between 1987 and 1998 and being on a mild upward trend in 1998-2000. Meanwhile, household net wealth has also increased substantially, up to 7.57 times disposable income in the fourth quarter from 5.47 in 1995. Net wealth came down in 2001, as financial wealth was hurt by the correction of the stock market, but it has resumed its upward trend since then. However, while the nominal value of the debt is fixed, the value of household wealth can change. Domestic conditions alone are supportive of the UK stock market, but if US equities fall sharply, the UK is unlikely to escape the blow. UK equities have increased by 2.3% so far in 2005. Around 60% of household wealth is in tangible assets, mostly housing. Housing wealth has more or less been preserved, as house prices have not yet clearly come down. *Halifax* and *Nationwide* data show house prices stable at the moment, but the *Hometrack* house price index is down since the end of last year. A crash in the housing market remains a distant prospect, but prices are likely to fall. The current consumer spending slowdown suggests that changes in house prices may be a more important determinant of consumption than the level of house prices. The annual growth of real household money balances has hovered around 6% since 2001 compared with 3.6% in the previous five years. It seems that households' desire to hold real money balances has increased. One reason for this could be higher house prices, requiring a larger initial deposit. Even so, this cushion of liquidity could be used to spend more.

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	722.4	1,803.5	2.50	933.6	1.29
2003	755.3	1,934.0	2.56	1,061.4	1.41
2004	784.3	2,060.0	2.62	1,211.6	1.54
2005	*817.3*	*2,042.6*	*2.50*	*1,293.0*	*1.58*
2006	*854.8*	*2,163.8*	*2.53*	*1,374.9*	*1.61*
	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	4,800.9	7.33	5.1
2001	2,249.1	3.21	4,695.1	6.69	6.5
2002	2,705.0	3.74	4,874.5	6.75	5.3
2003	3,009.9	3.99	5,358.1	7.09	5.8
2004	3,487.4	4.45	5,977.7	7.62	5.6
2005	*3,536.0*	*4.33*	*6,038.5*	*7.39*	*7.0*
2006	*3,585.6*	*4.19*	*6,235.0*	*6.29*	*8.7*

Figures until 2004 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 has stabilised in recent months. Indicators from the early stage in the house purchase chain have flattened and mortgage approvals have edged up. At current interest rates, the stock of mortgage debt is likely to grow by about 10% a year.

The annual rate of house price inflation has slowed in May to 5.5% on the Nationwide measure and 3.2% on the Halifax measure from 19.4% and 21.4% respectively a year earlier. Since the start of the year the Nationwide measure shows house prices up by 4%, but the Halifax measure shows them down by 1% and the Hometrack measure – down by 0.6%. The tightening of monetary policy has dampened housing activity, with the number of mortgage approvals down by 42% between November 2004 and December 2003. But mortgage approvals have rebounded this year, up by 23% from their trough in November to April. Indicators of activity early in the house purchase chain are showing signs of stability. Site visits and reservations on new homes have flattened recently and the RICS survey of new buyer enquiries has steadily risen. Current interest rates do not seem enough to restrain mortgage borrowing growth to rates consistent with trend broad money growth. The growth of secured M4 lending slowed to 5.6% in the year to April from 10.9% a year ago, but at 11.2% total secured lending growth remains relatively strong. Current mortgage approvals numbers argue for secured lending growth to stay around 10.5% in coming months. Base rates of around 6% are needed to bring the growth of mortgages to a more sustainable 6%. But while monetary data have been buoyant, real sector indicators have continued to display signs of weakness, staying the Bank of England's hand. Chances of a sharp fall in the average cost of a home with still-accommodative interest rates and the economy expanding at a reasonable pace do not seem big. If house prices stay relatively flat or fall slightly, with earnings forecast to continue to expand at about 4.6%, the house-price-to-earnings ratio will slowly decline to a more sustainable level.

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	21.3	29.8
2002	5.6	79.5	4.8	40.3	34.5
2003	5.6	101.0	5.1	55.1	40.5
2004	6.6	100.3	2.8	47.5	46.4
2005	*6.6*	*79.0*	*2.8*	*27.0*	*47.3*
2006	*6.3*	*74.0*	*2.8*	*30.0*	*48.5*

	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	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	152,623	5.57
2005	*20.1*	*2.0*	*27.0*	*152,623*	*5.33*
2006	*20.1*	*2.0*	*29.8*	*152,623*	*5.08*

Figures until 2004 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

Household consumption growth rebounded slightly in Q1 2005, but remained weak. Consumption is unlikely to expand at a faster rate than output in the next couple of years, as the economy rebalances. The weakness has been particularly clear with retail spending.

Consumer spending grew by 0.3% in the first quarter, slightly above the 0.2% posted in the previous quarter, but much slower than the average quarterly rate of 0.6% over the past two years. Consumer spending expanded at a faster rate than output in the nine years to 2004, but this could not continue for ever. A re-balancing of the economy is needed, with household spending growing less than output for a few years. Higher interest rates, slower real income growth and a weaker housing market have checked the strong expansion of consumer spending. Mortgage payments as a share of gross disposable income rose to 7.3% in the fourth quarter of last year, the highest since mid-1992. The low two-year mortgage deals, offered by financial institutions in the summer of 2003, are coming to an end, likely to push these payments higher even without further hikes of the base rate. But the Bank of England estimates that the impact is unlikely to be large. Real disposable income growth slowed in the second half of last year, but still robust employment and earnings growth suggests that it should remain relatively buoyant this year and into next. The housing market has stabilised and at current interest rates a substantial fall of house prices is unlikely. But households should raise their savings over the next few years and maybe achieve a financial surplus by 2006. The main weakness of consumer spending has come from a fall in consumer spending on goods, while spending on services has continued to expand at a strong pace. Purchases of furnishings and household appliances fell sharply, hit by the fall in housing transactions. Retail sales data for April show consumer spending growth stayed subdued, with spending on household goods continuing to decline.

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	670.8	2.3	585.9	1.8
2004	693.2	3.3	603.1	2.9
2005	*705.5*	*1.8*	*613.9*	*1.8*
2006	*718.8*	*1.9*	*625.6*	*1.9*

	Durable goods consumption		Household sector	Car registrations
	£b., 2001 prices	% growth	borrowing., £b.	'000s
2000	69.6	8.7	68.3	2,222
2001	77.4	11.2	76.5	2,460
2002	80.6	4.0	109.6	2,564
2003	84.9	5.4	126.3	2,579
2004	90.1	6.2	127.8	2,567
2005	*91.6*	*1.6*	*101.5*	*2,608*
2006	*93.2*	*1.8*	*97.4*	*2,655*

Figures until 2004 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 not driven up household savings so far. But they have slowed the housing market, taking its toll on spending. Savings should rise, as "total resources" are boosted by strong earnings and pension contributions.

The household sector savings ratio was 5.6% in 2004, compared with an average rate of 7.5% over the past twenty years. It came down from 10% in 1995. Consumer spending growth at 5.6% in 1995-2004 outstripped the growth of total resources which was 5.2% during the same period. Meanwhile the surge in house prices lured households into investing their money in tangible assets, leaving households' financial balance in deficit in five of the past six years. Higher interest rates have not resulted in higher savings so far. But they have dampened housing market activity and may have discouraged households from preferring to invest in tangible assets, mainly housing. Households' investment is forecast to rise at a much slower rate in the next two years – 2.3% on average, after increasing at an average annual rate of 14% over the previous four years. The growth of total resources is expected to accelerate, driven not only by a strong expansion of gross disposable income, but also by a surge in pension contributions. The outlook for household spending seems uncertain. But on balance, although it should recover later this year, consumption is likely to grow at a slower rate than in the past few years. Hence, household savings are projected to pick up, reaching 8.7% of total resources in 2006. As a result, households will be able to achieve a positive financial balance of 1.7% of total resources by 2006, for the first time since 0.7% in 2001 and commensurate with the long-term average of 1.6%. However, if interest rates come down in 2006 in response to weak global growth and the pound staying strong, then the housing market could re-accelerate. In this scenario households could overextend themselves, storing bigger problems for the medium term.

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	4.8	3.1	6.5
2002	3.0	1.6	1.4	3.2	5.3
2003	4.6	1.9	2.6	2.3	5.8
2004	3.8	1.3	2.6	3.3	5.6
2005	*4.2*	*1.8*	*2.4*	*1.8*	*7.0*
2006	*4.6*	*2.0*	*2.6*	*1.9*	*8.7*

	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	5.6
2001	705.6	659.9	45.7	0.7	5.8
2002	730.7	692.3	38.5	-1.1	6.4
2003	766.5	721.8	44.8	-1.0	6.9
2004	800.2	755.2	45.0	-1.9	7.5
2005	*841.1*	*782.5*	*58.6*	*-0.2*	*7.2*
2006	*890.6*	*813.3*	*77.4*	*1.7*	*7.0*

Figures until 20034 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

Banks and building societies have reined in secured lending, but so-called "specialist lenders" increased mortgage credit to record levels in Q1. Mortgage approvals slumped in late 2004, but are rising in all three groups. Predictions of imminent interest rate cuts appear premature.

Until de-mutualisation in the mid-1990s, building societies were the major provider of secured finance, with approximately 55% market share. Since then the loan books of banks and lenders outside the M4 sector (i.e. neither bank nor building society) have overtaken those of building societies. An interesting feature of the recent slowdown in the housing market is the wide variation in lending behaviour by these three parties. Net secured lending by banks peaked in Q2 2004 at £14.6b., but has declined sharply to £3.9b. in Q1 2005. Similarly, building societies have reduced mortgage lending from a peak of £6.1b in Q4 2003 to £3.2b. In stark contrast, "other lenders" increased their secured lending to an all-time high of £15.1b. in Q1. There are a number of conclusions one can reach from this analysis. "Other lenders" may be so eager to gain market share that they have been slow to react to a turning point in the housing market. Alternatively, banks may be increasingly concentrating on other areas of credit demand that are unavailable to "specialist lenders", such as lending to the corporate sector. However, the pattern of mortgage approvals – one of a steady upward trend since the turn of the year – is repeated across all lender groups, suggesting similar attitudes towards secured lending. The disparity in the net lending figures could reflect a switch away from banks as many fixed-rate deals come up for renewal and borrowers search for the best deal. (It should also be noted that specialist lenders will inevitably have to fund their own loan portfolio with borrowing from the banking sector.) Some commentators are now predicting an imminent cut in interest rates. However, such a move seems unlikely after the MPC has spent much of the last two year's trying to engineer a soft landing in the housing market.

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	19.5	12.2	40.9
2001	6.8	30.8	16.4	54.0
2002	11.0	48.0	19.7	78.7
2003	18.8	47.3	34.8	101.0
2004	17.1	41.9	40.8	99.9
2005	*13.5*	*27.5*	*38.0*	*79.0*
2006	*13.0*	*27.0*	*34.0*	*74.0*

	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	106.8	429.0	535.8	1,967.9	27.2
2001	113.2	477.2	590.4	2,116.5	27.9
2002	123.6	550.5	674.1	2,568.1	26.3
2003	142.2	631.1	773.3	2,869.0	27.0
2004	159.4	715.8	875.2	3,324.1	26.3
2005	*172.9*	*781.3*	*954.2*	*3,370.5*	*28.3*
2006	*185.9*	*842.3*	*1,028.2*	*3,421.5*	*30.1*

Figures until 2004 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

The switch from equities to bonds seems to be continuing. Gilts may have had a good run, with 10-year yields down 100 basis points in the past year. But long-run total returns still favour equities. Institutions may also be raising weightings in commercial property.

Institutional asset allocation decisions continue to be driven by actuarial advice rather than prospective returns. ONS data and survey evidence from the Investment Management Association show the switch from equities into bonds is continuing. This is likely to be an attempt to more mechanically match liabilities rather than seeking the best returns for investors. To this extent, the switch makes sense. But the apparent lack of concern over relative prices and the impact of initial yield on returns needs to be addressed. 10-year gilt yields have fallen to a two-year low of 4.2%, as high liquidity – partly due to excess Asian savings – has forced up asset prices across a variety of asset classes and markets. Investors in gilts have certainly benefited from falling yields in recent months. Yet even if investors entered the market when yields were above 5% in mid-2004, returns are unlikely to match those on equities over the long term. The yield on the FT all-share index is currently close to its long-run average of 3.3%, indicating UK stocks are close to fair value. Add this to an estimated dividend growth of around 5% (approximate to the economy's trend rate of nominal GDP growth) and total returns are roughly double those delivered by gilts. Institutional investors may have also missed out on double-digit dividend growth. High levels of corporate sector liquidity have also buoyed share buy-backs in recent quarters, further boosting total returns. Aside from gilts, institutions may also be in danger of entering another over-valued market. Commercial property yields have reached 15-year lows, yet sentiment towards the asset class is decidedly upbeat. It seems possible that the bumper returns of recent years are tempting investors to purchase assets, even though prospects for rental growth remain meagre at best.

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	*821.8*	*221.2*	*254.2*	*95.2*	*214.9*
2005	*885.9*	*249.4*	*272.2*	*104.0*	*240.1*
2006	*928.7*	*279.0*	*290.1*	*110.3*	*266.6*

	Total holdings		Short-term assets		
	£b.	% increase on preceding period	£b.	% increase on preceding period	Liquidity ratio, %
2001	1,627.7	-4.1	70.7	-9.8	4.3
2002	1,464.8	-10.0	63.4	-10.3	4.3
2003	1,602.9	9.4	60.2	-5.0	3.8
2004	*1,666.9*	*4.0*	*59.7*	*-0.9*	*3.6*
2005	*1,811.6*	*8.7*	*66.8*	*12.0*	*3.7*
2006	*1,934.7*	*6.8*	*73.5*	*10.0*	*3.8*

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 remain healthy. Firms' ability to service their debt has improved further. Excluding any significant blow to confidence, firms are in a strong position to expand. Lending to the non-financial corporate sector is growing at its fastest pace in four years.

The non-financial private sector saw its debt rise fast in the five years between 1998 and mid-2003. Capital gearing, as measured by non-equity liabilities minus cash as a share of net worth, jumped to 58.2% in the second quarter of 2003 from 28% in the fourth quarter of 2000. Firms' net financial position moved from a balance in end-1997 to a deficit of 1.8% of gross national income by the start of 2000. But the corporate sector went into a stringent mode, improving its balance sheet and achieving a net financial surplus of 1.5% by the end of last year. Firms have lowered their capital gearing significantly since the middle of 2003 to 47.1% in the fourth quarter of 2004. But although their ability to service the debt, as measured by the non-equity liabilities minus cash as a share of earnings before interest, tax, depreciation and amortisation, has stopped deteriorating, this ratio remains relatively high by historical standards. Currently, the corporate sector is flush with cash. The corporate liquidity ratio (deposits divided by liabilities) remains above its long-term average at 62.5% in April compared with 58.6% over the past four decades. This is usually supportive of increased capital spending, merger and acquisition activity and strong distributions to shareholders, all of which in the end translate into higher domestic demand. However, should there be a significant blow to firms' confidence they could increase their preference to hold cash or could decide to pay down debt. But at present, lending to the private non-financial corporate sector is growing at its fastest pace since the start of 2001. Banks are well capitalised and are looking of ways to expand their balance sheets. The continued high growth rates of money, via their effects on company balance sheets, are likely to stimulate domestic demand and output late in 2005.

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	412.5	488.9	25.2	10.1
2004	1,534.2	471.7	518.3	14.4	6.0
2005	*1,552.3*	*518.9*	*573.3*	*10.0*	*10.6*
2006	*1,474.7*	*550.0*	*615.5*	*6.0*	*7.4*

	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	1,144.6	1,028.6	74.16	83.71	1.11
2003	1,288.8	1,097.6	84.36	77.30	1.17
2004	1,260.9	1,170.8	91.02	76.31	1.08
2005	*1,312.1*	*1,269.9*	*90.51*	*81.81*	*1.03*
2006	*1,308.1*	*1,346.4*	*89.36*	*91.30*	*0.97*

Figures until 2004 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 rose at a fast pace in 2004, but appear to have levelled off. Prospects for 2005 and 2006 remain relatively upbeat, with output growth likely to be sustained around trend. Wage costs have not put pressure on margins.

Private non-financial corporations continued to perform well last year. Their gross operating surplus rose by 7.4% in 2004, the same as in 2003 and above the twenty-year average annual rate of 5.7%. It fell by 1.5% in the year to the fourth quarter, after growing in each of the previous three quarters. However, these numbers are seasonal. Output growth seems set to stay around trend this and next year, suggesting that domestic conditions remain relatively supportive of profits. Corporate profitability improved in 2003 and levelled off at a high rate in 2004. The net rate of return on capital employed was 13.4% in the fourth quarter of last year, up from a low of 12.1% in the first quarter of 2003 and an average annual rate of 10.9% since 1965 and 11.7% since 1980. Interestingly, the improvement stemmed from higher profitability in the manufacturing sector, while service sector profitability stayed flat around its fifteen-year average. Companies have been using increased savings to boost investment, expand their businesses and raise distributions to shareholders. Investment rose by 4.2% in real terms in 2004, while the value of merger and acquisitions increased by 68%. Firms distributed 1% less dividends in 2004, but the value of share buy-backs almost doubled. In addition, firms have also built up their bank deposits. 2005 should see continued strong expansion of business investment. Current surveys on investment intentions are mixed, but British Telecom just announced a £10bn. programme of orders for a new network. This represents almost 1% of GDP, although phased over several years. Meanwhile, wage costs have not put pressure on margins. Unit wage costs grew at a slower pace in 2004, which was lower than the growth of consumer prices. But higher producer input price inflation has been squeezing profits margins in 2004 and continued to do so this year.

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	200.5	72.1	71.3	65.1	23.5
2004	215.3	76.5	70.6	71.9	26.1
2005	*229.3*	*79.6*	*77.7*	*78.5*	*28.8*
2006	*243.0*	*82.8*	*85.5*	*83.9*	*31.6*

	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	112.2	2.7	97.3	2.4	14.3
2004	122.7	2.0	104.5	1.0	18.2
2005	*123.0*	*2.0*	*114.1*	*2.1*	*7.7*
2006	*123.3*	*2.0*	*124.0*	*0.7*	*-0.4*

Figures until 2004 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 production of oil and gas fell in 2004. High oil and gas prices, however, have stimulated a recovery in drilling. Profits at Continental Shelf firms improved last year, but they no longer represent the large share of whole-economy profits they used to.

After peaking at the end of the last decade, UK's production of oil and gas has fallen continuously, down from all-time highs by 30% and 13% respectively. Last year saw oil output decline by 10%, while gas output was down by 7.2%, its largest annual fall so far. Oil and gas production is widely forecast to decline sharply from about 2004, with declines of up to 40% expected over the next five years. The days when the oil and gas sector provided a huge boost to the economy and to the balance of payments seem to be over. However, high oil and gas prices have buoyed firms' confidence and 2004 saw a 40% jump in exploration drilling from the meagre level in 2003. The number of wells being drilled has been on a downward trend over the past fifteen years, but success rates are much higher these days. In early 2004 the DTI conducted a survey of firms' intentions to drill offshore exploration and appraisal wells. Total intentions for the three years ahead were the highest compared with all the surveys since 1998, except the 2001 survey. But other investment was forecast to fall to about a third of what it was in 2003. The North Sea sector adds around 2.5% to output and around 10% of the total trading profit of private non-financial firms. Trading profits at Continental Shelf firms rose by 8.4% in 2004 after falling in the previous three years. Profitability has improved, with the net return on capital employed rising to 33.2% in 2004 compared with a thirty-year average of 29.8% and an average of 20.5% since 1990. Oil prices are likely to stay high on average in 2005 and in the medium term. But over the next eighteen months China's and later the expected US slowdown are likely to result in a cyclical weakening. Gas prices are no longer determined at home, with the UK becoming a net gas importer in 2004.

North Sea companies' income, costs and taxes

	Oil and gas output	Oil price		Gas price	Sterling/dollar
	m. of tonnes oil equivalent	$ per barrel	£ per tonne	$ MMBtu	exchange rate, $
2000	222.5	28.4	140.7	4.3	1.52
2001	209.5	24.5	127.4	4.0	1.44
2002	206.7	25.0	124.7	3.4	1.50
2003	196.6	28.9	132.6	5.5	1.63
2004	179.4	38.2	156.5	6.2	1.83
2005	*168.6*	*43.0*	*179.2*	*6.4*	*1.80*
2006	*158.4*	*38.0*	*158.3*	*5.5*	*1.80*

	Value of oil and gas, £b.	Gross operating surplus, £b.	Operating costs, £b.	Exploration costs, £b.	Fixed investment, £b.
2000	23.1	21.0	4.4	2.8	3.1
2001	19.9	19.8	4.3	3.5	4.0
2002	18.4	19.5	4.6	3.6	4.0
2003	19.9	19.1	4.5	3.4	3.7
2004	20.4	18.0	4.7	3.3	3.7
2005	*21.5*	*17.0*	*4.8*	*3.1*	*3.0*
2006	*17.9*	*16.1*	*5.0*	*2.9*	*1.7*

Figures until 2004 are taken from the Department of Trade and Industry, *Energy Trends, Petroleum Economist* and official sources; figures thereafter are forecast, but with heavy reliance on the DTI data, industry sources and newspaper cuttings. Oil output, profits and costs are totals for year; oil prices and exchange rate are average for the year.

4. Investment and stockbuilding

Inventories are the most volatile component of GDP. Stock level perceptions were low during most of 2004, but there was only a modest rebuilding of stocks in the second half of the year. Stocks subtracted from growth in Q1, but in 2005 as a whole they should provide a mild boost.

Inventories are the most volatile component of output. Moreover, the treatment of the stocks series in the *National Accounts* as a residual means it picks up all measurement errors. Even so, inventories are an important cyclical factor, affecting the growth of output. In 2004 as a whole de-stocking subtracted 0.2 percentage points from growth after being flat in the previous year. Strong domestic demand, resulting in real GDP growth of 3.1%, did not lead to a major rebuilding of inventories. Stock level perceptions in the manufacturing sector remained well below normal levels throughout most of last year. The CBI monthly business survey showed the reading for stock level perceptions come down to +5 in June 2004, the lowest number since 1988. Even so, the positive contribution from inventories in the second half of last year was only modest. This suggests that the stock cycle should boost growth in this year as a whole. 2005 started with stocks subtracting from output growth to the tune of 0.2 percentage points, despite stock level perceptions registering another +5 reading in January. The index for firms' assessment of their stock levels has since jumped to +17 in May, implying that firms' demand expectations must have worsened significantly. If demand turns out to be better than expected, de-stocking would continue for a quarter or so, but then the second half of 2005 should see a rebuilding of stocks. Our forecast is for stocks to add 0.1 percentage points to output growth in 2005 as a whole. Meanwhile, the CBI quarterly survey reveals that firms' capital expenditure intentions have also deteriorated in 2005. After being above their long-term average in the first three quarters of 2004, they fell to around 15 points below the long-term average in the three quarters to Q2.

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	4.6%	96.4
2001	105.1	100.0	-1.9%	98.0
2002	104.0	101.0	-2.1%	96.1
2003	101.0	103.3	-5.0%	94.2
2004	107.6	106.7	3.1%	97.9
2005	*117.9*	*109.9*	*6.3%*	*103.8*
2006	*128.7*	*113.7*	*5.5%*	*109.0*

	North Sea companies £2001b.	Financial corporations £2001b.	Total change in inventories, £2001b.	Stock/output ratio
2000	3.1	10.8	5.3	99
2001	4.0	7.2	6.2	101
2002	4.0	6.8	2.5	102
2003	3.7	3.6	2.5	102
2004	3.7	2.9	0.7	100
2005	*3.0*	*3.5*	*1.5*	*95*
2006	*1.7*	*4.1*	*0.5*	*90*

Figures until 2004 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 remains robust and the number of hours worked has lept in the last two quarters. Survey evidence on recruitment is more downbeat and the claimant count measure of unemployment has risen in each of the last three months.

Britain has successfully held its right to opt out of the EU working time directive that limits employees to working an average of 48 hours per week. Although official data show only one in eight of people work for more than the EU limit, the removal of the opt-out clause would still have had consequences for growth and inflation. By constraining a factor of production, output would suffer and pay growth would inevitably rise. The added administrative burden on business may have also harmed productivity. Output per hour worked rose by 1.6% in the year to Q1, down from a peak of 3.5% in Q2 2004. Some adjustment was expected. The Bank of England had previously attributed 2004's rise in productivity as a response to an unusually weak period in 2001 and 2002, as firms hoarded labour rather than lay off workers. Recent strong growth in employment and hours worked suggests this period of adjustment may be at an end. The increase in total hours worked over the last two quarters was the largest six-monthly rise since records began in 1971. Similarly, employment has risen strongly in recent months. Survey evidence is more downbeat, with both the manufacturing and service sector CIPS reports showing recruitment falling to below 2004 levels. Unemployment, as measured by the claimant count has edged up in each of the last three months. But rises may be limited as domestic demand recovers in H2 2005. The seemingly contradictory combination of rising employment and *un*employment is achieved by more of the economically inactive population joining the labour force and also by net immigration into the UK. These two factors have had a dampening impact on wages, with average earnings growth slipping to 4.1% from 4.5%. However, the recent rise in inflation should assist higher pay settlements.

The labour market

	Workforce, total, m.	Workforce jobs, m.	Unemployment, total, m.	Unemployment rate, %
2000	30.519	29.431	1.088	3.6
2001	30.707	29.737	0.970	3.2
2002	30.822	29.875	0.947	3.1
2003	31.146	30.213	0.933	3.0
2004	31.294	30.440	0.854	2.7
2005	*31.498*	*30.650*	*0.845*	*2.7*
2006	*31.656*	*30.810*	*0.840*	*2.7*
	Productivity, whole economy, %	**Productivity, manufacturing, %**	**Unit labour costs, whole economy, %**	**Real earnings, %**
2000	2.7	6.3	2.4	3.4
2001	1.2	3.4	4.2	2.1
2002	0.7	1.6	2.4	2.0
2003	1.2	5.5	2.2	1.5
2004	0.4	5.4	1.9	3.1
2005	*1.5*	*2.0*	*2.2*	*2.8*
2006	*1.8*	*2.0*	*2.5*	*2.9*

Figures until 2004 are taken from Tables 4.1, 4.2 and 4.7 of *Economic Trends*; figures thereafter are forecast. All figures are annual. 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

Output may have been a touch above trend in 2004. But beneath-trend growth so far in 2005 probably means that output is now at trend, i.e. the output gap is close to zero. Rising import prices and a possible fall in sterling could still see inflation above target later in the year.

Below trend economic growth in Q1 has helped to ease inflationary pressures. According to our calculations, the output gap turned positive midway through 2004, reaching approximately ¼% of GDP at the end of last year. However, weak household consumption growth and flat investment spending in Q1 has closed the output gap, suggesting inflation will rise only gently in coming quarters. Admittedly, the abstract nature of the output gap theory makes quantification difficult and other data must be considered before reaching a conclusion. Survey evidence from the CBI show an easing of skilled labour shortages and fewer firms are reporting capacity as a constraint on output. Both measures have a good record of tracking the amount of spare capacity in the economy and prospects for inflation. Despite the unemployment rate falling to its lowest level for thirty years, average earnings growth has edged down to 4.1% from 4.4%, indicating some slack remains in the labour market. Our forecast is for output to expand at around 2½% over the next two years, in line with the economy's trend growth rate. Consequently, the output gap is unlikely to widen significantly and inflation should remain close to – if slightly above – target. One possible threat to maintaining the inflation target could come from rising import prices. Since sterling's appreciation in 1996/97, the price of imported goods has fallen by a cumulative 20%. But global inflationary pressures have seen import prices rise by 2% in the last 12 months. This could be exacerbated further by a fall in the pound, as interest-rate differentials with the US continue to narrow. Part of the fall may be offset by a rise in sterling against the floundering euro, but the MPC could easily be faced with significantly-above target inflation by the end of 2005.

Measures of price pressure

	Underlying retail price index, %	Retail price index, %	Consumer price index, %	Consumption price deflator, %	Average earnings, %
2000	2.1	3.0	0.8	1.1	4.5
2001	2.1	1.8	1.2	2.4	4.4
2002	2.2	1.7	1.3	1.6	3.6
2003	2.8	2.9	1.4	1.9	3.4
2004	2.2	3.0	1.3	1.3	4.4
2005	*2.4*	*3.0*	*2.1*	*1.8*	*4.6*
2006	*2.4*	*2.5*	*2.1*	*2.0*	*4.9*

	House prices, £	House prices, %	Foreign producer prices, 1995 = 100	Sterling effective rate, 1990 = 100	Sterling import prices, 2001 = 100
2000	81,759	9.5	106.8	107.7	100.3
2001	92,580	13.2	105.2	106.1	100.0
2002	115,625	24.9	106.3	106.0	97.7
2003	131,796	15.7	107.6	100.3	98.1
2004	153,131	14.5	111.8	104.0	97.3
2005	*153,131*	*0.0*	*115.0*	*103.0*	*97.8*
2006	*153,131*	*0.0*	*118.4*	*102.0*	*98.5*

Data refer to final quarter of each year. Figures until 2004 are taken from NS, OECD and Nationwide publications; figures thereafter are forecast. Average earnings numbers do not refer to the underlying trend. Foreign producer prices refer to the OECD area excluding high inflation countries.

The balance of payments

1. Export and import trends

Net exports boosted GDP growth in Q1. However, European domestic demand is sluggish. The ECB may be tempted to cut interest rates, but this could add to sterling's recent gains against the euro, damaging prospects for UK exporters.

Net exports made their largest contribution to quarterly GDP growth in two years, adding 0.36 percentage points to overall growth of 0.5%. However, it was weak domestic demand rather than buoyant export growth that led to this outcome. Imports fell 1.9% on the previous quarter, compared to a 1.0% decline in exports. It is debatable whether this can be repeated. Relatively sluggish consumer spending (forecast to grow by 1.8% this year against an average of 3.4% over the previous decade) may add to imports' downward momentum, but investment spending is expected to be upbeat in 2005. Healthy corporate liquidity argues for strong increases in capital expenditure, which will inevitably require purchases of overseas capital goods. Export performance continues to depend largely on the euro-zone. Despite the ECB maintaining interest rates at 2% for more than two years, tangible signs of buoyant domestic demand remain rare. Annual export growth to the area has subsided to below 3% after peaking at 4.4% in Q3 last year. Sterling has strengthened by almost 6% against the euro since the start of the year and was above 1.49 at the time of writing, further damaging prospects for UK exporters. The rejection of the European Constitution by the French and Dutch has led to downward pressure on the euro that could take some time to reverse. Moreover, the prospect of a cut in interest rates by the ECB could add to sterling's strength. Currency developments outside the euro may prove more favourable for UK exporters, with further Fed tightening narrowing the interest rate differential with the UK. Near-term US prospects are upbeat, buoyed by high income growth. But the US' positive output gap – at 1½% of GDP – will eventually have to be eroded by a period of below trend growth.

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	5.2
2001	272.4	299.8	-27.4	11.7
2002	273.7	304.8	-31.1	22.0
2003	279.7	311.8	-32.1	23.2
2004	286.6	325.4	-38.8	24.0
2005	*299.9*	*336.8*	*-36.9*	*24.0*
2006	*312.6*	*345.3*	*-32.7*	*24.0*

	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	-2.5	9.4	9.1
2001	-6.6	-22.4	-2.3	2.9	4.9
2002	-8.5	-17.6	-1.7	0.1	4.1
2003	-9.9	-18.7	-1.7	0.9	1.9
2004	-10.9	-25.7	-2.2	3.0	5.2
2005	*-10.9*	*-23.8*	*-1.9*	*2.6*	*3.0*
2006	*-10.9*	*-19.5*	*-1.5*	*2.2*	*2.0*

Figures until 2004 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

Continuing large surpluses on services trade and investment income have helped the UK cope with a widening goods deficit. The subject of the UK's EU rebate has resurfaced. But unless France and Germany offer impressive compensation, the rebate will be maintained.

The UK's current account deficit increased to £25.7b. in 2004 from £18.7b. the previous year, as the trade deficit on goods rose to 5% of GDP, its highest share of national income since 1974. Slower household consumption and import growth should cause this ratio to become less negative over the forecast horizon. The UK's current account continues to be supported by healthy surpluses on services trade (+1.8% of GDP in 2004) and overseas investment income (+2.1%). The second of these two factors contributed more than £8b. to the current account in the final quarter of last year alone and is expected to continue to do so in the next couple of years. Another feature of the UK's balance of payments that has received much attention in recent days is the matter of the UK's EU rebate. Growing tensions in Europe have increased pressure on the UK to surrender the rebate, worth an average of around 0.3% of GDP per year. But this demand seems hopeful at best. The UK is still a net contributor to EU coffers to the tune of 0.4% of its annual national income. Furthermore, the possibility of negotiation on the rebate is doubtful unless other EU subsidies – most significantly the Common Agricultural Policy – are reformed. France is unlikely to be flexible on reducing its farming subsidies, but Germany (a significant financer of the CAP fund) may be willing to negotiate. Reduced government expenditure would alleviate pressure on German public finances at a time when European finance ministers expect the country's fiscal deficit to exceed the 3% of GDP limit for much of the next four years. After the rejection of the European Constitution, EU officials may be more inclined to punish member states who violate Stability and Growth Pact rules.

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

The slowdown in domestic demand during the first part of 2005 has reduced the immediate need for monetary tightening. However, base rates of 4¾% have proved insufficient to calm rapid rates of money and credit growth. Moreover, fast money growth has not been confined to one area of the economy. Financial and non-financial corporations have experienced double-digit increase in their money holdings, while household deposits continue to advance at more than 8% per year. Such trends are supportive of asset prices and a rebound in domestic demand in coming quarters. If this occurs, the MPC will be forced to raise interest rates to 5% to keep output at trend and inflation on target. The drag of net exports should subside over the forecast horizon, aided by a small fall in the exchange rate and weaker import growth, rather than especially buoyant export. Continued Fed tightening will narrow the UK-US interest rate differential, reducing support for sterling against the dollar. However, the possibility of an ECB cut may see sterling rise against the euro, limiting UK export growth to the region.

The main assumptions:

	Banks' base lending rate %	3 month interbank rate %	Mortgage interest rate %	Bank and building society deposit rate %	Government securities 10 year yield %
2004:4	4.75	4.85	6.6	3.1	4.7
2005:1	4.75	4.90	6.6	3.0	4.6
2005:2	4.75	4.75	6.6	3.0	4.4
2005:3	4.75	4.70	6.6	3.0	4.3
2005:4	5.00	4.90	6.8	3.1	4.7
2006:1	5.00	4.95	6.8	3.1	4.7
2006:2	4.75	4.80	6.6	3.0	4.6
2006:3	4.50	4.75	6.4	2.7	4.6
2006:4	4.50	4.70	6.4	2.7	4.6

	OECD real GDP growth %	Non-fuel dollar commodity prices %	Sterling effective rate 2005 = 100	Dollar/pound rate	3 month Eurodollar rate %
2004:4	2.9	10.9	100.3	1.86	2.2
2005:1	2.7	6.3	100.7	1.89	2.8
2005:2	2.5	6.8	101.5	1.80	2.8
2005:3	2.3	6.5	101.5	1.81	3.0
2005:4	2.1	5.7	100.4	1.79	3.3
2006:1	1.8	2.0	100.5	1.78	3.3
2006:2	1.3	-1.0	100.5	1.79	2.8
2006:3	1.1	-3.0	100.5	1.79	2.0
2006:4	1.5	-4.0	100.5	1.79	2.0

	General government consumption £b.	Labour force thousands	Oil price $/barrel	North Sea ICCs operating costs £m.	North Sea oil output m. tonnes
2004:4	63.1	31,300	48.3	1,180	23,100
2005:1	63.6	31,400	49.6	1,190	23,000
2005:2	65.5	31,500	51.4	1,200	22,400
2005:3	66.5	31,550	48.0	1,210	20,000
2005:4	67.9	31,580	46.0	1,210	22,600
2006:1	68.0	31,620	46.0	1,220	22,400
2006:2	69.8	31,650	42.0	1,250	22,000
2006:3	70.9	31,600	38.0	1,250	19,500
2006:4	72.2	31,550	38.0	1,270	22,000