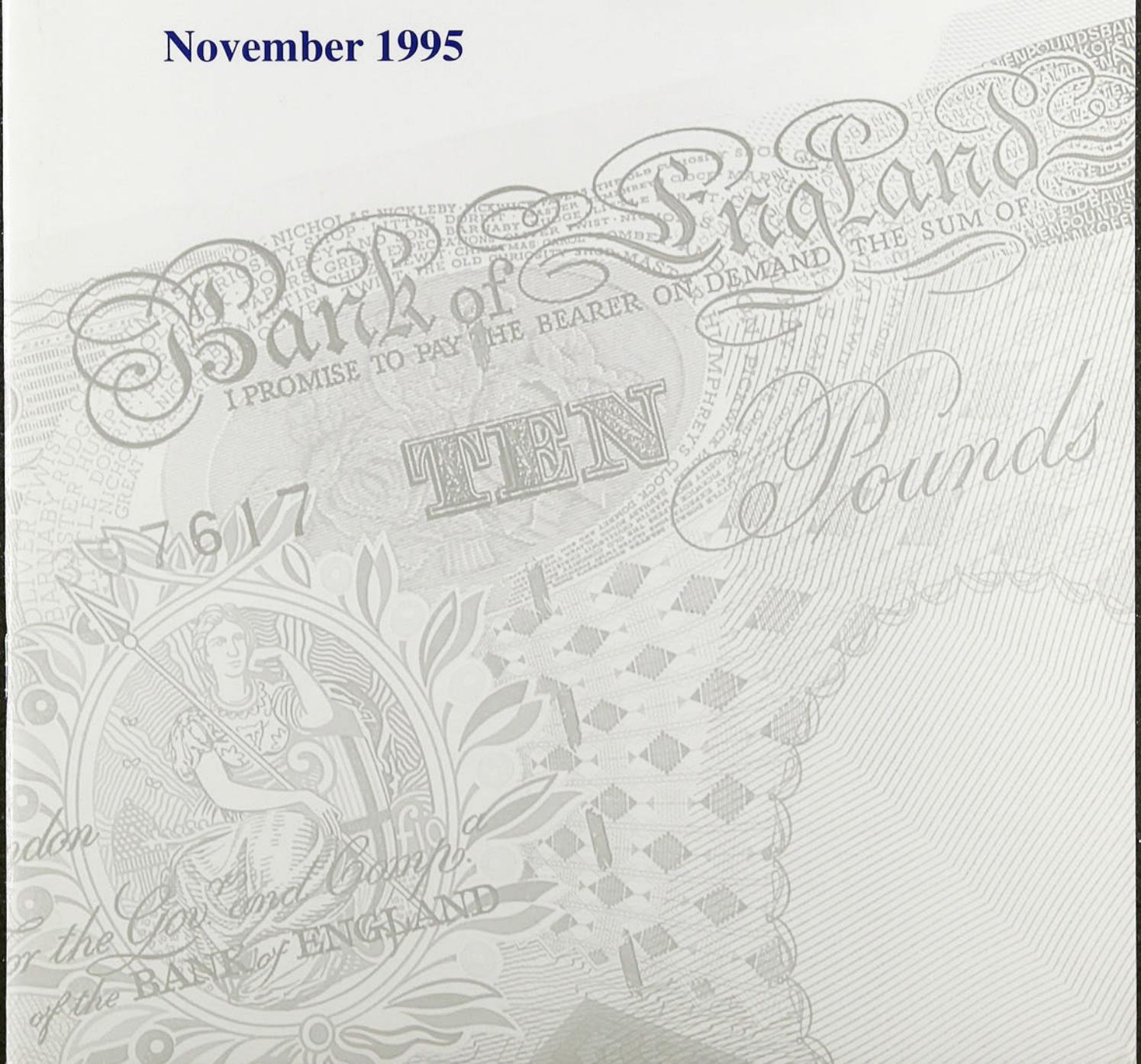


Bank of England

Inflation Report

November 1995



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Summary

Inflation has edged up from June. RPIX inflation rose above 3% in September. This was faster than projected in the August *Report*, primarily because of higher seasonal food prices.

Narrow and broad money growth stopped rising in September, but the monitoring range for M0 (0%–4%) was exceeded and the range for M4 (3%–9%) nearly so. The rapid expansion of credit, especially to the corporate sector, continued. Sterling's effective exchange rate rose by 1.1% in the three months to 3 November. Market interest rates tended to fall, as did expectations of rates in the near future.

Nominal GDP is rising more slowly than the rate implied by trend real growth and inflation at the target level. Real GDP grew at around its long-run average rate in the second and third quarters. Export growth slackened in the first half of this year. Domestic demand overseas has been a little weaker than expected.

Underlying average earnings growth fell slightly between May and August, although there were some signs of higher settlements in September. Wage drift in the services sector in particular has been exceptionally low or even negative. Employment increased in the summer, but the signs are that total labour demand did not. Unemployment has continued to fall.

Commodity prices fell in the third quarter, and producer input prices slowed down more than did domestic output prices. But manufacturing productivity also decelerated.

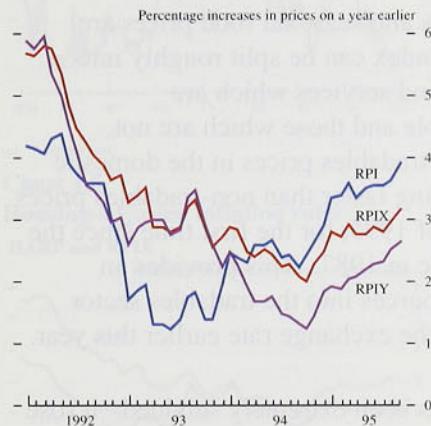
The central projection remains, as in the August *Report*, that there will be a temporary rise of RPIX inflation—as higher input prices feed through to domestic inflation, and the very low price rises of a year ago drop out of the twelve-month measure—followed by a fall towards, but remaining just above, 2½%.

The uncertainties surrounding the central projection have increased since the August *Report*, and the range of possible outcomes is wider. Achieving the inflation target in two years' time is by no means assured. It will depend on how the present uncertainties are resolved over the coming months.

Recent developments in inflation

1

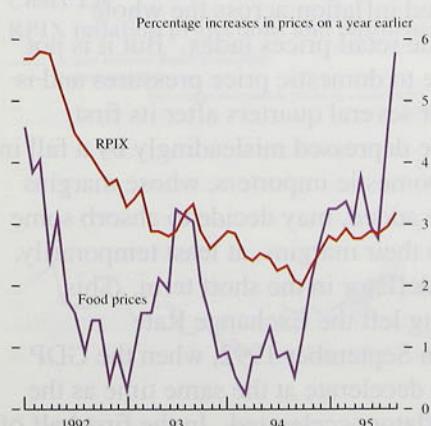
Chart 1.1(a)
Inflation



RPIX = Retail prices index excluding mortgage interest payments.
RPIY = RPIX excluding VAT, local authority taxes and excise duties.

(a) Adjusted by the Bank of England for CSO error in underrecording RPI and RPIX inflation between February and May 1995. Other charts and tables in this Report that include measures of inflation are similarly adjusted.

Chart 1.2
Food price and RPIX inflation



Sources: CSO and Bank of England.

1.1

Retail prices

Inflation has increased since the August *Inflation Report*. The Government's target measure of inflation, the twelve-month change in RPIX—the retail prices index excluding mortgage interest payments—was 3.1% in September, up from 2.9% in August and 2.8% in June and July. The headline rate of inflation rose from 3.5% in June to 3.9% in September.

Since the current monetary framework was introduced in October 1992, the RPIX inflation rate has averaged 2.8%, compared with 7.0% in the 1980s, 12.6% in the 1970s and 3.5% in the 1960s.⁽¹⁾ Although inflation has recently been low by historical standards, it has been higher than in the United Kingdom's major competitors. Between October 1992 and September 1995, consumer price inflation in the six largest economies excluding the United Kingdom averaged 2.4%. In September, UK inflation was the second highest among the Group of Seven largest industrialised economies.

RPIY inflation, which excludes indirect taxes as well as mortgage interest payments, has been lower than RPIX inflation over the past three years. It averaged 2.3% between October 1992 and September 1995. In the three months to September, twelve-month RPIY inflation increased from 2.3% to 2.6% (see Chart 1.1).

The rise in RPIX inflation between June and September was entirely accounted for by faster food price inflation. Excluding food prices, RPIX inflation fell from 2.8% to 2.7%. There were two main reasons for the acceleration of food prices. First, crop damage in the summer drought pushed up the price of seasonal foods: annual seasonal food price inflation was 13.4% in September. Second, meat prices rose strongly, reflecting a tightening of supply conditions in the European meat market. These reductions in supply are temporary and prices should fall back as new crops become available in the spring and as meat producers adjust their livestock herds, with no effect on the general price level—or the assessment of inflation—over the medium term. Chart 1.2 shows that the sharp increase in food price

(1) This comparison uses the RPI inflation rate before 1975.

Table 1.A
Short-run inflation

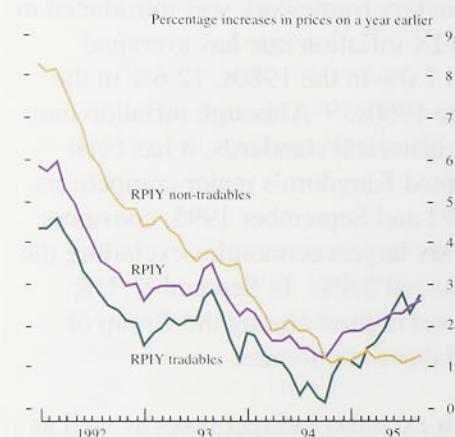
Percentage changes in three-month rates (a)

	1994 Sept.	Dec.	1995 Mar.	June	July	Aug.	Sept.
RPI	1.6	4.9	4.0	3.6	2.5	2.8	2.9
RPIX	1.6	3.8	3.5	2.5	2.0	2.8	2.7
RPIY	1.6	1.8	3.0	2.6	2.5	2.9	3.0
HARP	1.0	3.3	2.8	1.1	0.7	1.6	2.3
THARP	1.1	1.6	2.5	0.8	0.4	1.5	2.4

Sources: CSO and Bank calculations.

(a) The change between latest month and three months earlier (seasonally adjusted and annualised). The natural logarithms of the price series were seasonally adjusted using a Kalman filter to decompose the series into trend, cyclical, irregular and seasonal components. The seasonal adjustment of RPI and RPIX excludes taxes by multiplying the ratio of RPI and RPIY, and RPI and RPIX by seasonally adjusted RPIY.

Chart 1.3
RPIY inflation



Sources: CSO and Bank calculations.

Note: RPIY inflation can be greater than both non-tradables and tradables inflation since it includes seasonal food, rents and water charges, which are excluded from both the sub-indices.

inflation in 1993 had only a temporary effect on RPIX inflation.

Recent price developments are better captured by changes in the retail prices index over the latest three-month period. Table 1.A presents short-run inflation rates, seasonally adjusted and annualised. It shows that all three-month measures—apart from the headline inflation rate—rose between June and September.

If administered prices and seasonal food prices are excluded, the RPIY index can be split roughly into categories of goods and services which are internationally tradable and those which are not.

Chart 1.3 shows that tradables prices in the domestic market have been rising faster than non-tradables prices since the beginning of 1995, for the first time since the data became available in 1987. This provides an incentive to shift resources into the tradables sector following the fall in the exchange rate earlier this year.

The GDP deflator has been extremely subdued: it rose by 0.2% (at factor cost) in the second quarter, after increasing by 0.1% in the first (Table 1.B). Over the year to 1995 Q2, the GDP deflator was up 1.0%. This was only slightly higher than the 0.9% annual increase recorded in the year to 1995 Q1, which was the smallest four-quarter rise since the third quarter of 1962.

Chart 1.4 shows that the GDP deflator has been decelerating since the beginning of 1991.

In principle, the GDP deflator, which measures the price of domestically produced output, offers a better guide to domestically generated inflation across the whole economy than does the retail prices index. But it is not the most timely guide to domestic price pressures and is subject to revision for several quarters after its first release. It can also be depressed misleadingly by a fall in the exchange rate. Domestic importers, whose margins are part of total value added, may decide to absorb some of the depreciation in their margins, at least temporarily, depressing the GDP deflator in the short term. This happened after sterling left the Exchange Rate Mechanism (ERM) in September 1992, when the GDP deflator continued to decelerate at the same time as the domestic demand deflator accelerated. In the first half of 1995, non-oil import prices increased by 8.1%, a similar rise to that seen in the first half of 1993. While both the GDP deflator and the domestic demand deflator were subdued in the second quarter, the 0.4% increase in the

Table 1.B
Expenditure deflators (market prices)

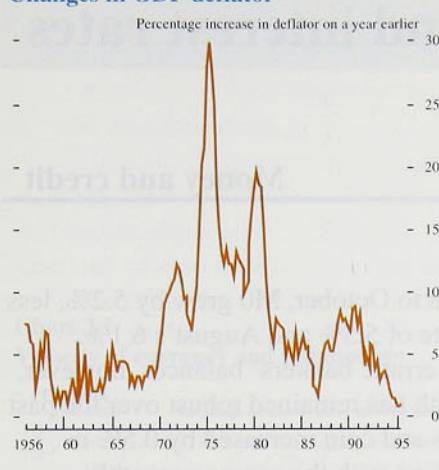
	Consum- ption	Invest- ment (a)	Govern- ment	Domestic demand (b)	Exports	Imports	GDP (c)
Percentage changes on a year earlier							
1993	3.5	0.5	4.3	3.3	8.8	8.4	3.5
1994	2.5	2.0	2.4	2.4	0.8	1.9	1.9
1994 Q1	2.9	1.2	2.7	2.5	0.1	-1.0	2.8
Q2	2.4	3.1	1.9	2.6	1.0	1.8	2.1
Q3	2.4	2.0	2.4	2.2	0.9	3.2	1.3
Q4	2.3	1.8	2.6	2.4	1.3	3.6	1.4
1995 Q1	2.7	2.1	2.8	2.8	5.2	9.7	0.9
Q2	2.7	-0.1	2.8	2.3	6.9	8.8	1.0
Seasonally adjusted quarterly percentage changes							
Q1 on Q4	0.9	-0.3	0.6	0.8	3.4	4.5	0.1
Q2 on Q1	0.5	0.2	0.7	0.4	2.1	2.5	0.2

(a) Private and public investment.

(b) Domestic demand also includes the value of the physical increase in stocks and work in progress, which is not included in this table.

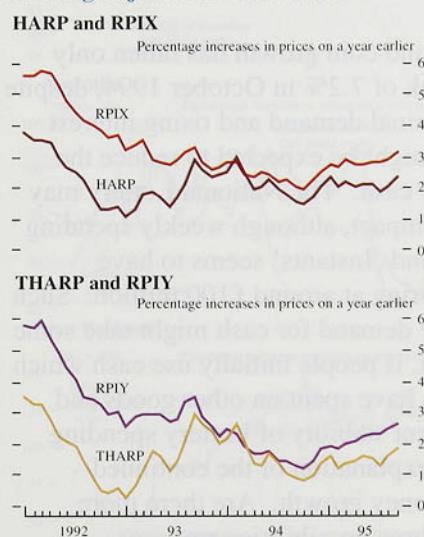
(c) At factor cost.

Chart 1.4
Changes in GDP deflator^(a)



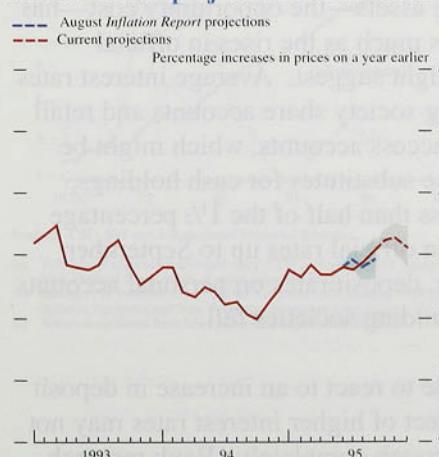
(a) At factor cost.

Chart 1.5
Housing-adjusted inflation rates



Sources: CSO and Bank of England.

Chart 1.6
RPIX inflation projections and outturns^(a)



Sources: CSO and Bank of England.

The range is defined as the central projection plus or minus the average absolute error on such projections in the past.

domestic demand deflator was greater than the 0.2% rise in the GDP deflator. The increase in the domestic demand deflator is likely to give a better indication of the pressure on domestically-set prices, so the GDP deflator may accelerate in the second half of this year.

House prices fell between March and July, but stabilised in the following three months (see Section 3). Measures of inflation which use house prices to adjust RPIX and RPIY for the cost of owner-occupied housing suggest that inflation is weaker than indicated by the unadjusted figures. But they also show that it is increasing. The housing-adjusted RPIX (HARP) measure replaces the Central Statistical Office's (CSO's) estimate of housing depreciation with the Bank's estimate of the user-cost of housing. The THARP measure adjusts RPIY in a similar way. Chart 1.5 shows that HARP and THARP inflation have been significantly lower than RPIX and RPIY inflation over the past year.

In October, twelve-month RPIX inflation is likely to increase slightly. This partly reflects the fact that sharp non-seasonal food price discounting in autumn 1994 and other special factors last year will not be repeated this year, but also continued increases in seasonal food prices. RPIX inflation is likely to remain higher in November, before dropping back in December (see Chart 1.6). In contrast, the headline rate of inflation is likely to fall back in October, because of the recent reduction in mortgage interest payments and as last year's interest rate increase drops out of the twelve-month comparison. It is likely to remain lower in November and December.

1.2

Summary

Twelve-month inflation increased between June and September, as a result of faster food price inflation. Most three-month measures of inflation have also risen. The faster increases in food prices are likely to be reversed over the coming year. The rate of increase in the GDP deflator remained at historic lows in the second quarter, but it may have been depressed by the depreciation of sterling between January and May.

2.1

Money and credit*Narrow money*

In the twelve months to October, M0 grew by 5.2%, less than September's rate of 5.5% and August's 6.1%. Excluding the often erratic bankers' balances, however, narrow money growth has remained robust over the past three months. Notes and coin increased by 0.5% in October, broadly in line with the average monthly growth this year, leaving the twelve-month rate of increase at 5.7%.

Twelve-month notes and coin growth has fallen only modestly from its peak of 7.2% in October 1994, despite slower growth of nominal demand and rising interest rates, both of which might be expected to reduce the growth in demand for cash. The National Lottery may still be having some impact, although weekly spending on the on-line game and 'Instants' seems to have stabilised since the spring at around £100 million. Such a one-off shock to the demand for cash might take some time to manifest itself, if people initially use cash which they would otherwise have spent on other goods and services. But the recent stability of Lottery spending makes it an unlikely explanation of the continued strength of narrow money growth. Are there more plausible reasons? Three possibilities are:

- (i) The cost of holding cash relative to other interest-bearing assets—the opportunity cost—has not increased as much as the rises in official interest rates might suggest. Average interest rates paid on building society share accounts and retail banks' instant access accounts, which might be considered close substitutes for cash holdings, increased by less than half of the 1½ percentage point increase in official rates up to September. And in October, deposit rates on personal accounts in banks and building societies fell.
- (ii) People take time to react to an increase in deposit rates, so the effect of higher interest rates may not yet have fed through completely. Bank research suggests that the maximum impact of interest rate changes on narrow money growth is felt at least a

Table 2.A
Growth rates of monetary aggregates^(a)

Per cent

	1 month	3 months (b)	6 months (b)	12 months
M0	July	0.5	6.9	6.2
	Aug.	0.5	5.2	5.9
	Sept.	0.4	5.7	5.7
	Oct.	0.5	5.8	5.7
	July	0.6	3.1	5.6
	Aug.	0.6	6.3	6.1
	Sept.	0.5	7.3	5.5
	Oct.	0.3	6.0	5.2
	June	0.6	7.7	6.8
M4	July	1.2	11.3	10.7
	Aug.	0.7	10.4	10.8
	Sept.	0.4	9.5	8.6
	June	0.2	6.5	8.4
	July	1.1	8.5	9.3
	Aug.	0.3	6.5	8.7
	Sept.	0.6	8.1	8.1
		1 quarter (b)	2 quarters (b)	4 quarters
		..	3.6	3.5
Divisia	1994 Q4	..	7.9	5.7
	1995 Q1	..	6.7	7.3
	Q2	..	7.5	5.4
	Q3	..	7.1	6.4

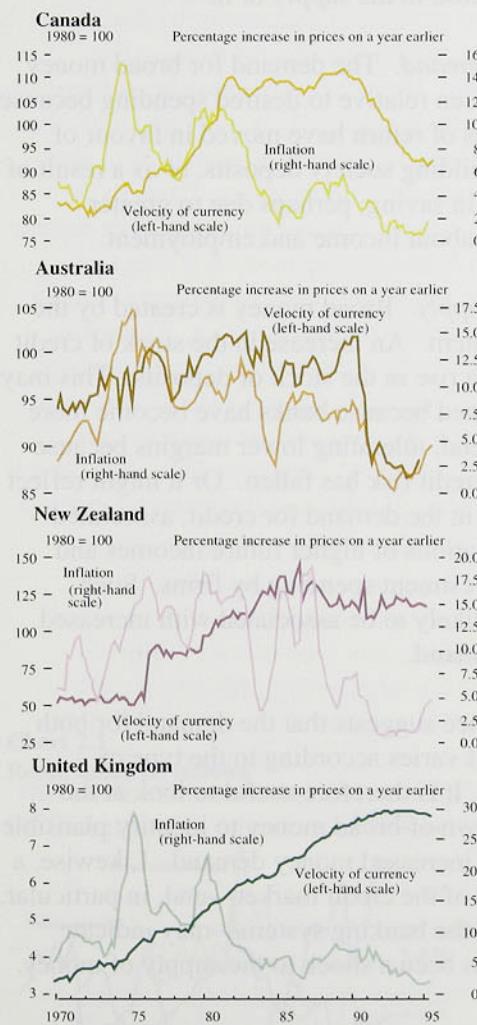
Source: Bank of England.

.. not available.

(a) Seasonally adjusted.
(b) Annualised.

inflation has been falling since 1991 and is now below the rate of growth in nominal GDP. This has been due to a number of factors, including a fall in the rate of growth of nominal GDP, which has been driven by a decline in the rate of growth of real output. The most significant decline in nominal GDP growth has occurred in the United Kingdom, where it fell from 4.5% in 1991 to 1.5% in 1995. In contrast, nominal GDP growth has remained relatively stable in Canada and Australia, both of which have experienced a slight increase in nominal GDP growth over the same period.

Chart 2.1
Velocity of currency and inflation^{(a)(b)}



Sources: CSO, BIS and International Financial Statistics.

- (a) Velocity of currency calculated using GDP at market prices, except for New Zealand where value of retail sales was used.
- (b) Measures of inflation used: United Kingdom and Canada—GDP price deflator; Australia and New Zealand—consumer price index.
- (c) Some components have been seasonally adjusted by the Bank.

year after the changes. Some international comparisons tend to confirm that the demand for narrow money adjusts slowly to higher interest rates. Currency in circulation in Canada and Australia has increased rapidly over the past two years, often at rates well in excess of UK notes and coin growth, even though interest rates were raised earlier than in the United Kingdom. But narrow money growth now seems to be falling in these countries. Moreover, their inflation rates have remained low despite the strong growth in narrow money.

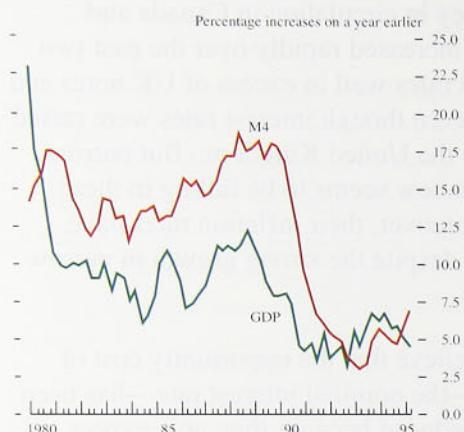
- (iii) People may believe that the opportunity cost of holding cash—the nominal interest rate—has been permanently reduced because they now expect inflation to remain low, and so want to hold a higher proportion of their wealth in notes and coin. This will affect the rate at which notes and coin change hands—its velocity. It is not clear, however, whether such a change would shift the *level* of narrow money velocity (generating a temporary effect on narrow money growth) or its *growth* (a permanent effect).

Evidence for the United Kingdom suggests that there may be a positive link between narrow money velocity growth and inflation. Low inflation in the 1950s and 1960s was accompanied by relatively low growth in velocity. In the 1970s and 1980s, high inflation coincided with a pick-up in velocity growth. Over the past few years, both velocity growth and inflation have fallen. In several other OECD countries, a fall-off or flattening in velocity has coincided with improved inflation performances. For example, in New Zealand this started towards the end of the 1980s, and in Canada and Australia it was most obvious after 1990 (Chart 2.1).

Broad money

Broad money has continued to grow strongly, although it is no longer accelerating. In the twelve months to September, M4 grew by 8.2%, slightly less than the rate in August (8.4%) but well above the 6.8% in June. Short-run measures fell in September, although both the three and six-month annualised rates remained above the twelve-month rate; in the three months to September, M4 grew by 9.5% at an annualised rate, compared with 10.4% in August. Moreover, because of the small increase in M4 last October, the twelve-month growth rate may move back up towards the top of its 3%–9% monitoring range.

Chart 2.2
Growth rates of M4 and nominal GDP^(a)



Sources: CSO and Bank of England.

(a) GDP at current market prices.

For most of the 1980s, broad money grew much faster than nominal GDP—largely reflecting financial liberalisation. Since the early 1990s, the relationship between M4 growth and nominal activity has been considerably closer. However, in the recent past they started to diverge again: in the year to the second quarter, M4 growth—at 6.8%—was much stronger than nominal GDP growth (Chart 2.2). The implications for nominal spending and inflation depend on why the stock of money has increased. It is useful to distinguish between increases resulting from shocks to the *demand* for money and those to the *supply* of it:

- (i) *Shocks to demand.* The demand for broad money may have risen relative to desired spending because relative rates of return have moved in favour of bank and building society deposits, or as a result of an increase in saving, perhaps due to greater uncertainty about income and employment.
- (ii) *Shocks to supply.* Broad money is created by the banking system. An increase in the stock of credit can lead to a rise in the stock of deposits. This may have happened because banks have become more willing to lend, tolerating lower margins because they think credit risk has fallen. Or it might reflect an increase in the demand for credit, associated with expectations of higher future incomes and planned investment spending by firms. Such shocks are likely to be associated with increased nominal demand.

Empirical evidence suggests that the demand for both money and credit varies according to the type of economic agent. It is therefore useful to look at the sectoral breakdown of broad money to identify plausible explanations for increased money demand. Likewise, a sectoral analysis of the credit market—and, in particular, the behaviour of the banking system—may indicate whether there has been a shock to the supply of money.

Table 2.B
Changes in M4^(a)

	£ billions				
	Personal sector	Unincorporated businesses	ICCs	OFIs	Total
1995 Q1	4.7	3.3	0.8	5.5	14.3
Q2	6.7	-0.8	-0.4	5.4	10.8
Q3	7.6	0.6	0.1	5.4	13.6

Source: Bank of England.

(a) Columns may not sum to totals because of rounding.

Sectoral M4

Table 2.B shows that nearly half of the £38.7 billion increase in M4 between December and September was in deposits of individuals, which account for around 60% of the stock of M4 and around 90% of the personal sector's M4.⁽¹⁾ The remainder of the increase was largely accounted for by the deposits of other financial institutions (OFIs)—which held around 20% of the stock

(1) The other 10% is accounted for by deposits of unincorporated businesses.

of M4. OFIs' deposits rose by £16.3 billion in the period, significantly more than their increases in the calendar years 1993 and 1994. The deposits of industrial and commercial companies (ICCs) have grown much more slowly and, in the second quarter, were run down—before being built up again in Q3.

Individuals' deposits have accelerated over the past year and rose by a further £7.6 billion in Q3, compared with £6.7 billion and £4.7 billion in 1995 Q2 and Q1 respectively. £1.8 billion of this rise probably reflected the payment of bonuses to deposit holders with the Cheltenham & Gloucester Building Society, following its joining the Lloyds Bank Group. It is not clear how far the increased deposits reflect a genuine increase in long-term desired money holdings, or how far they have resulted from a shock to the money supply. The sharp rise in personal income in the first quarter may have led to a temporary rise in personal sector deposits, which will be run down to finance higher nominal spending on goods and services and financial assets.

But individuals may want to continue to hold higher levels of bank and building society deposits over a longer period. Given the uncertainty over employment prospects, households may have increased their precautionary savings. And the recent fragility in the housing market may have discouraged them from tying up their wealth in illiquid assets. This process may have been reinforced by changed mortgage lending criteria requiring prospective owner-occupiers to save up larger deposits for house purchases.

Chart 2.3
Retail financial inflows



Source: Bank of England.

(a) Not seasonally adjusted.

The well-publicised take-overs in the building society sector may also have been a factor behind the rise in individual deposits. Some investors have increased their holdings in such accounts so as to qualify for bonus payments or shares in the event of future take-overs. Building society retail inflows, predominantly from household account holders, have risen significantly this year. The average monthly inflow up to September—excluding interest paid—was £0.7 billion, compared with £0.2 billion in 1994. This seems to have occurred at the expense of other types of financial assets: flows into unit trusts and national savings in the first nine months of the year were less than half of their level in the corresponding period last year (Chart 2.3). But individuals' bank deposits have also risen rapidly in 1995—in the first three quarters of this year they increased by £7.1 billion, compared with less than £1 billion for 1994 as a whole—so this speculative

motive can be, at best, only a partial explanation of the increase in personal sector deposits.

After growing strongly during 1994, ICCs' M4 deposits have been more subdued in 1995. In the year to Q3, they grew by 2.3% compared with over 10% in 1994. The fall in the second quarter was not repeated in the third, but the rise was only modest.

Most of the rise in non-personal sector deposits so far this year has been attributable to OFIs. As OFIs are the marginal source of funds for the banking system, this may simply reflect liability management by banks which finance increased lending initially by bidding for deposits from OFIs. However, OFIs may be holding more money in bank and building society accounts than they desire in the long run, perhaps because they are uncertain about returns on other assets. Even so, it seems unlikely that these excess deposits will be used to finance increased future expenditure on goods and services, since the financial sector's holdings of assets depend largely on relative rates of return. The main counterpart to the strong growth in OFIs' deposits this year has been their reduced take-up of gilts. Between April and September, the M4 private sector bought £6 billion of gilts, compared with over £13 billion in the same period last year. If OFIs use their deposits to buy gilts later in the year, the effect could be to reduce aggregate M4.

Credit demand

Bank and building society lending⁽¹⁾ is no longer accelerating, although its growth remains high. Taking the third quarter as a whole, lending grew by 2.0%, broadly comparable with the rate of increase in the first half of this year. In the twelve months to September, it grew by 8.1%.

OFIs' borrowing increased by a further £3.4 billion in the third quarter—a larger increase than Q2's £2.2 billion. The increase occurred despite repayment of £1.4 billion by securities dealers in Q3. As a result, OFIs' stock of borrowing grew by 13.4% in the year to Q3, accounting for around a quarter of the annual growth in bank and building society lending.

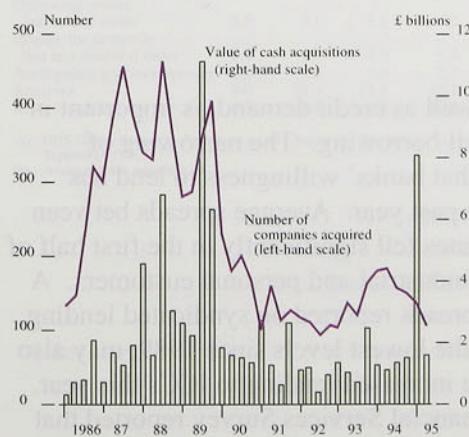
The increased demand for credit by ICCs has been maintained. In the third quarter, bank and building society sterling lending to ICCs increased by £3.5 billion, compared with £2.2 billion in the second

(1) Unless otherwise stated, references to bank and building society lending exclude the effect of securitisations and loan transfers.

quarter. And lending was depressed in Q2 (by around £2 billion) and Q3 (by around £1 billion) by the repayment of debt taken out in Q1 by Glaxo. Lending to ICCs stood at £138 billion in Q3, 10.5% higher than a year earlier. The increase may have reflected a greater desire to invest in fixed capital. Nominal investment spending by manufacturing firms in the second quarter was 16.8% higher than in the same period a year earlier. And the sectoral breakdown of lending shows that bank lending to manufacturers (excluding the chemical industry, lending to which was distorted by Glaxo's take-over of Wellcome) grew by around 5% in the year to the second quarter, the first rise since 1991 Q2. Data for the third quarter suggest that borrowing by non-chemical manufacturers strengthened further.

Some firms, however, may be borrowing to sustain cash flow and finance the involuntary build-up of stocks resulting from weaker-than-expected demand. Stocks increased by £4.4 billion (at current prices) between 1994 Q3 and 1995 Q2. In manufacturing, following a tightening of monetary policy, intermediate and small-scale producers of durable goods tend in the short run to borrow more from banks than do larger firms to sustain cash flow. But sectoral lending data show that lending to 'other manufacturers'—predominantly small firms—accounting for almost a quarter of total bank lending to manufacturing, increased by only 1.9% in the year to the third quarter. The largest increases were in lending to motor vehicle, mechanical engineering and food, drink and tobacco manufacturers, which are likely to be large firms. Moreover, lending to firms in the service sector, where output growth has remained robust in 1995, strengthened noticeably in the second and third quarters. So cash flow seems unlikely to be the explanation.

Chart 2.4
Acquisitions and mergers in the corporate sector^(a)



(a) By UK companies within the United Kingdom. Includes financial institutions from 1995 Q1.

Another possibility is that firms have been borrowing to finance more company acquisitions. Again, however, the evidence is not compelling. Apart from Glaxo's take-over of Wellcome, which occurred in the first quarter, the value of cash-financed acquisitions and mergers within the United Kingdom increased only modestly over the first half of this year. And the total number of take-over and merger transactions has fallen back (see Chart 2.4). But overseas acquisitions by UK companies have increased this year, with funds predominantly raised through the UK acquirers, which could account for some of the increase in bank borrowing.

ICC may be switching to bank finance from other sources of funds. Internal funds have continued to grow,

Table 2.C
ICCs' sources of funds^(a)

£ billions

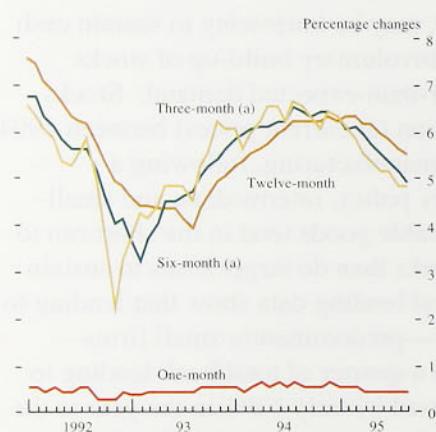
	Undistributed income	Bank/building society borrowing	Sterling capital issues
1994 Q3	17.6	0.4	2.3
Q4	17.7	1.3	3.5
1995 Q1	15.9	5.9	2.4
Q2	18.1	2.2	1.8
Q3	...	3.5	2.5

Sources: CSO and Bank of England.

(a) not available.

(a) Seasonally adjusted.

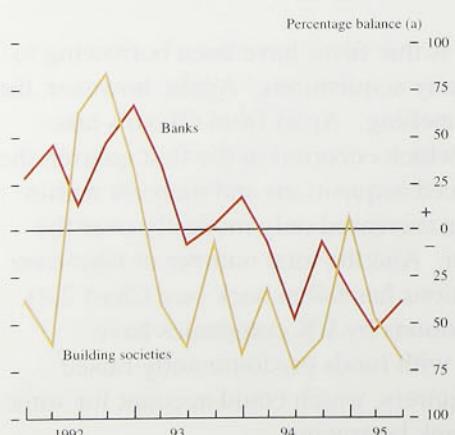
Chart 2.5
Growth rates of total personal borrowing



Source: Bank of England.

(a) Annualised.

Chart 2.6
Trends in bank and building society spreads



Source: CBI/Coopers & Lybrand Financial Services Survey.

(a) Balance of respondents reporting increases in average spreads over the previous three months minus those reporting a decrease.

but at a much slower pace: ICCs' retained earnings were 4.9% higher in Q2 than a year earlier, compared with average annual growth of over 25% in 1994. ICCs' net sterling capital issues have also fallen: they averaged £0.7 billion a month between January and September 1995, compared with £1.1 billion in 1994 and £1.3 billion in 1993 (Table 2.C). This decline occurred despite a significant increase in equity prices this year compared with last, which might have been expected to encourage greater recourse to the capital market.

Lending to the personal sector by banks and building societies decelerated a little in the third quarter, increasing by £5.4 billion in Q3 compared with a quarterly average increase of £6.3 billion in the first half of the year. The fall largely reflected borrowing for house purchase, which increased by £3.8 billion in Q3, compared with £4.3 billion in Q2. However, loan approvals stabilised in the third quarter—driven largely by banks, which recorded approvals of £4.4 billion in Q3 compared with £3.8 billion in Q2. Lending for consumption has remained robust; it increased by £1.3 billion in the third quarter, broadly in line with the quarterly increases earlier in the year.

The broader measure of borrowing by the personal sector—including that from specialist lenders, as well as from banks and building societies—was also subdued. Total net personal borrowing increased by £1.9 billion in September; the twelve-month growth rate has now declined for four consecutive months (Chart 2.5). Shorter-run growth measures have fallen for longer. Within this total, consumer credit (unsecured personal borrowing) continued to grow strongly, at year-on-year rates of over 10%, although it was no longer accelerating.

Credit supply

Credit supply, as well as credit demand, is important in determining overall borrowing. The narrowing of spreads suggests that banks' willingness to lend has increased over the past year. Average spreads between loan and deposit rates fell significantly in the first half of this year for both industrial and personal customers. A sharp fall in the spreads reported on syndicated lending, which are now at the lowest levels since 1989, may also help to explain the increased lending to ICCs this year. The latest CBI Financial Services Survey reported that average bank and building society spreads continued to narrow in the three months to September, as they have for well over a year (Chart 2.6).

Table 2.D
Large British banks^(a)

	£ billions				
	1990	1991	1992	1993	1994
Operating profits before bad debts	7.93	9.05	10.14	11.33	10.47
Charge for domestic bad and doubtful debts	3.50	5.90	6.70	4.70	2.10
Retained earnings	0.77	0.04	-0.42	1.41	3.31
Total net capital	36.96	38.83	40.88	44.98	48.95
Capital asset ratio (b)	9.30	9.90	9.90	10.80	11.40

Source: *Bank of England Banking Act Report* for 1994/95.

(a) Barclays, Lloyds, Midland, National Westminster, Abbey National, Bank of Scotland, The Royal Bank of Scotland, Standard Chartered and the TSB. Calendar-year information except for Bank of Scotland (1994 based on interim figures). The Royal Bank of Scotland (end-September) and the TSB (end-October).

(b) Assets are risk weighted.

The narrowing in bank spreads may be related to developments in banks' balance sheets. As the recovery has proceeded, the incidence of bad debts has fallen. Individual insolvencies fell from their peak of around 10,000 in the first quarter of 1993 to around 7,000 in 1995 Q2. Company insolvencies, too, have fallen sharply—to a level broadly comparable with the mid-1980s. This has led to a reduction in provisions and higher reported bank profits. To the extent that these have been retained, they have enabled bank reserves to be built up. In 1994, retained earnings for the largest nine UK banks increased by £3.3 billion, accounting for around 85% of the rise in their combined net capital. With the risk-weighted assets of these banks growing much more slowly, their combined risk-adjusted capital asset ratio rose to 11.4% at the end of 1994, well above levels at the beginning of the 1990s (Table 2.D).

Building societies, too, have enjoyed higher profits. The surplus of the top 20 building societies increased in 1994, rising as a proportion of reserves to 13.6%, from 12.9% in 1993 and 11.2% in 1992. With asset growth relatively modest, the ratio of reserves to assets has increased (Table 2.E).

The key question is how much this increase in capital has led banks and building societies to expand their balance sheets. If banks are willing to cut their margins further, stronger credit growth and in turn stronger demand growth may ensue. But there are signs that banks may choose to return some of their excess capital to their shareholders; one high street bank has already embarked on a share buy-back.

Table 2.E
Top 20 building societies^(a)

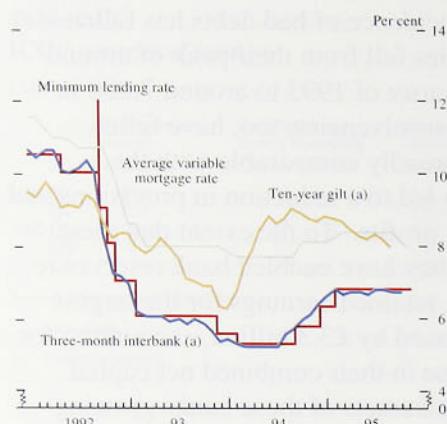
	£ billions				
	1990	1991	1992	1993	1994
Operating profits before bad debts	2.5	3.1	3.8	4.0	4.0
Charge for domestic bad and doubtful debts	0.4	1.1	1.9	1.4	0.7
Attributable profits/surpluses	1.4	1.4	1.3	1.7	2.1
Reserves	9.0	10.3	11.6	13.2	15.4
Reserves asset ratio (b)	9.3	9.9	9.9	10.8	11.4

(a) UBS Global Research, *Business Societies Research: The Major Players*, September 1995.

(b) Assets are risk weighted.

To sum up, there has probably been a one-off upward shift in the demand for broad money, although it is unclear how enduring this effect will be. But the recent strength in broad money growth also reflects an increase in the supply of money, as a result of both an increase in the demand for and a greater willingness by banks to supply credit. The rise in OFIs' deposits is likely to have fewer implications for inflation, since OFIs often switch assets within their portfolios with little effect on the real economy. The build-up of personal sector deposits may be less benign. If people decide to reduce liquidity partly by running down deposits to buy goods and services, nominal spending will accelerate, which could lead to higher prices. Even if this does not happen, nominal demand may still increase faster if the strong growth in credit persists. ICCs seem likely to continue to borrow to finance increased investment as the

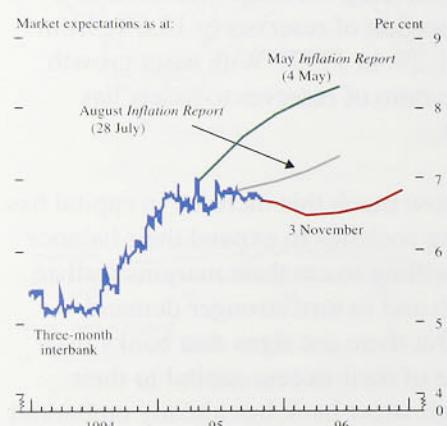
Chart 2.7
Interest rates



Source: Bank of England.

(a) Calendar-month average.

Chart 2.8
Sterling interest rate expectations^(a)



Sources: Bank of England and LIFFE.

(a) Based on a combination of sterling interest rate futures contracts.

economic recovery matures, despite the weakness of demand from the construction sector (see Section 3). This is particularly likely if banks continue to lend more willingly, trying to earn greater returns on their currently high levels of capital.

Divisia money

Divisia measures of money, which weight the various components of M4 according to their transaction characteristics, may provide some indication of whether the increased money growth is likely to be used to finance greater spending on goods and services. The Bank's Divisia measure rose by 6.4% in the year to Q3, compared with 5.4% in Q2. This is a notable pick-up in growth compared with 1994, when the annual rate averaged 4.6%.

The acceleration in Divisia money in 1995 is more marked in the personal sector. Personal sector Divisia rose by 1.7% in Q3, to bring its annual growth rate to 5.4%, its highest rate since 1990 Q4. This suggests that the build-up in personal sector deposits is likely to finance higher consumer spending, although the relationship is volatile. Corporate Divisia money rose by 9.7% in the year to Q3, compared with average annual growth of around 11% in 1994.

2.2 Interest rates and exchange rates

Since the August *Report*, official UK interest rates have remained unchanged at 6.75%. But market interest rates are now generally lower than in August. Chart 2.7 shows some of the interest rates paid by different borrowers or used as a basis for calculating their borrowing costs.

Futures markets have revised down their expectations of UK interest rates and now expect them to fall slightly over the next twelve months. Rates on LIFFE's December contract fell from 6.98% on 28 July to 6.64% on 3 November. They dropped from 7.11% to 6.49% on the March 1996 contract, and from 7.31% to 6.51% on the June 1996 contract over the same period (Chart 2.8). But interest rates are then expected to increase.

These interest rate changes have coincided with similar developments overseas (Table 2.F). Official interest rates were reduced by 50 basis points in Germany on 24 August and in Japan on 8 September, and these moves have led to widespread falls in both current and expected future market interest rates in those countries.

Table 2.F
Changes^(a) in official and key interest rates^(b)

In chronological order

Per cent per annum

Country	Interest rate	Date	Change (basis points)	Current level
France	5–10 day repo rate	3 Aug.	-50	6.50
Germany	Lombard rate	24 Aug.	-50	5.50
	Discount rate	24 Aug.	-50	3.50
	14-day repo rate	6 Sept.	-10	4.20
Japan	Official discount rate	8 Sept.	-50	0.50
France	5–10 day repo rate	9 Oct.	+110	7.25
	24-hour repo rate	16 Oct.	-25	7.00
Canada	Bank rate	1 Nov.	-147	6.18
France	24-hour repo rate	2 Nov.	-40	6.60

Sources: Datastream and Telerate.

(a) Changes since the August *Inflation Report*.

(b) In the G7 countries.

All major UK lenders cut their variable-rate mortgages by around 35 basis points in September. The weakness in the housing market was the reason most often quoted for the cuts, but the fall in the cost of attracting funds—both on retail and wholesale terms—also seems likely to have been a factor.

The inflation expectations implicit in gilt yields (abstracting from risk premia and other measurement problems) have fallen further at the three-year horizon—the shortest maturity at which they can sensibly be estimated—and are now around 4%, compared with 4.6% at the time of the previous *Report* (Chart 2.9).

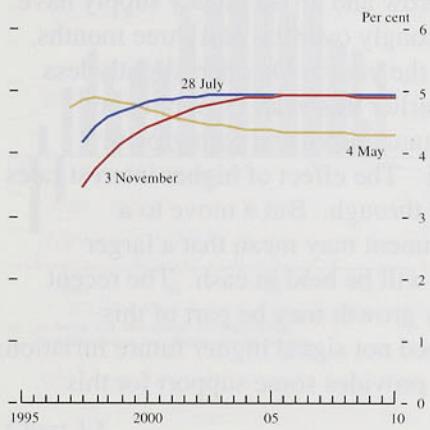
Longer-term yields have also fallen since the August *Report*, although much of the movement has been concentrated at shorter maturities. UK ten-year bond redemption yields were down 30 basis points between 28 July and 3 November, but overseas rates at longer maturities have generally fallen by more than in the United Kingdom. As a result, the tendency for interest rate differentials with the rest of the G7 countries to increase has continued.

The change in UK yields over any period can be decomposed into the changes in expected real interest rates and in expected inflation over the same period, although the division is affected by other factors, such as term or uncertainty premia. The average real interest rate expected over the following ten years fell sharply after 28 July, but this was reversed over the past month. Similarly, ten-year inflation expectations, after falling back in August and September, increased quite markedly in October. But on 3 November (assuming risk premia and other factors offset each other), expectations at the ten-year horizon stood at 4.9%—broadly consistent with levels at the end of July, but around 50 basis points higher than at the time of the May *Report* (Chart 2.9). This deterioration in expectations suggests some erosion of long-run UK monetary policy credibility.

Compared with its level at the time of the August *Report*, sterling has strengthened a little. But larger gains in August and September were partly reversed in October. On 3 November, sterling's effective index was 84.3 (Chart 2.10)—above the lowest points seen in the late spring and summer, but still around 6% lower than its average over the 18 months before it started to depreciate in January.

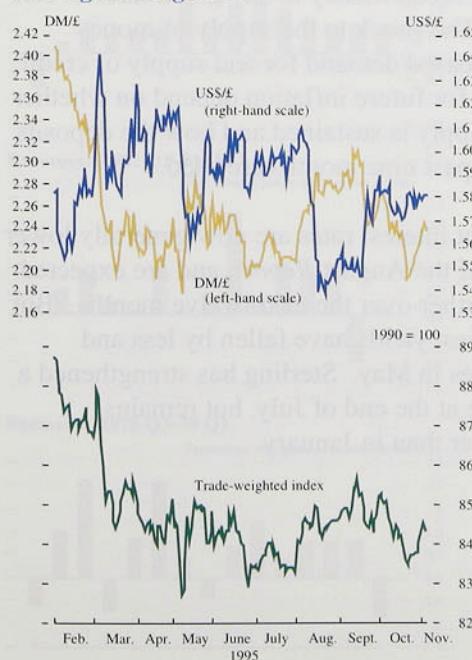
The May *Report* concluded that there was little reason to suppose that the decline in the exchange rate would be

Chart 2.9
Implied forward inflation rates



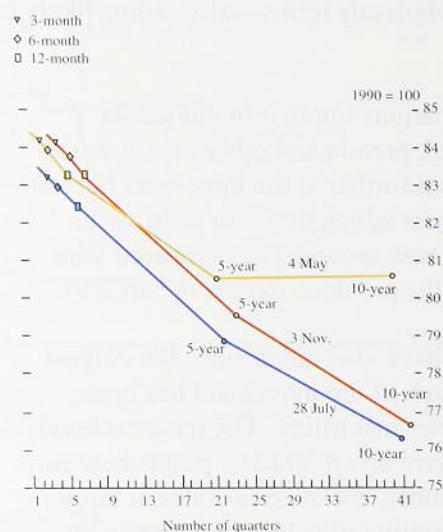
Source: Bank of England.

Chart 2.10
Sterling exchange rates



Source: Bank of England.

Chart 2.11
UK effective exchange rate profiles^(a)



Sources: BIS and Bank of England.

(a) Assuming uncovered interest rate parity.

reversed quickly. This view seems to have been borne out. Chart 2.11 shows the exchange rate paths implied over the following ten years on 4 May, 28 July and 3 November if interest rates adjusted for expected exchange rate changes are equalised ('uncovered interest parity'). Compared with the August *Report*, the future level of the UK rate is now expected to be slightly higher over a ten-year horizon, although still below the level expected in May.

2.3

Summary

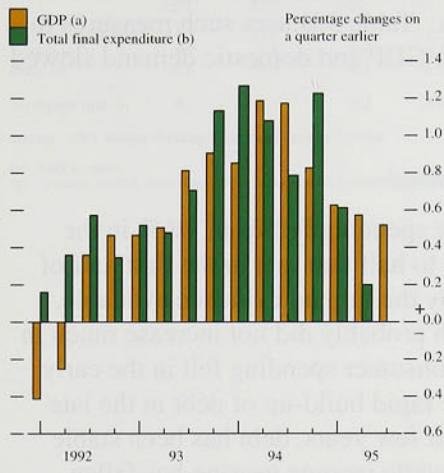
Measures of both narrow and broad money supply have continued to grow strongly over the past three months. M0 grew by 5.2% in the year to October, slightly less than rates recorded earlier this year. Stripping out bankers' balances, annual notes and coin growth remained close to 6%. The effect of higher interest rates may not yet have fed through. But a move to a low-inflation environment may mean that a larger proportion of wealth will be held in cash. The recent strong narrow money growth may be part of this adjustment and so need not signal higher future inflation. Experience overseas provides some support for this hypothesis.

M4 growth has increased in 1995—to an annual rate of 8.2% in September, close to the top of its 3%–9% monitoring range. It is probable that both the demand for and supply of broad money at any given interest rate have increased. The shock to the supply of money reflects both increased demand for and supply of credit. The implications for future inflation depend on whether the increase in supply is sustained and how the deposits built up over the past nine months are used.

Short-term market interest rates are now generally lower than at the time of the August *Report*, and are expected to fall slightly further over the next twelve months. But at longer maturities, yields have fallen by less and remain above rates in May. Sterling has strengthened a little from its rate at the end of July, but remains significantly lower than in January.

Demand and supply

Chart 3.1
Growth in GDP and total final expenditure



(a) At factor cost, two-quarter moving average.
(b) At market prices, two-quarter moving average.

Chart 3.2
GDP growth during three recoveries

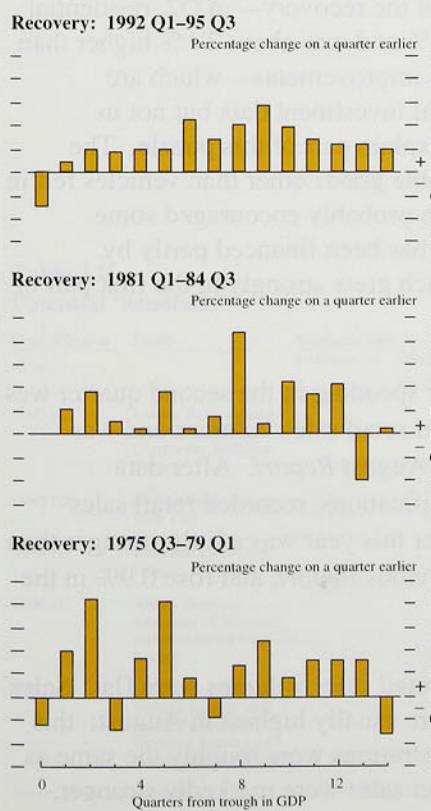
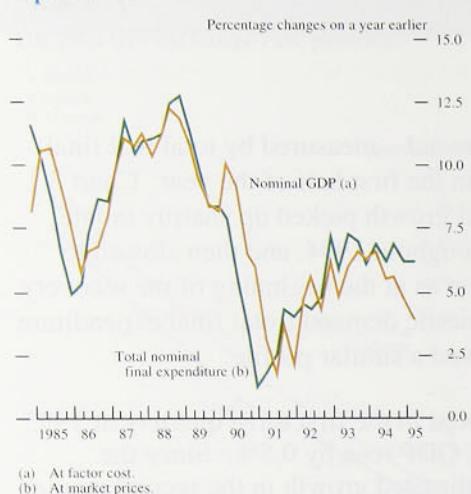


Chart 3.3
Growth in nominal GDP and total final expenditure



(a) At factor cost.
(b) At market prices.

Table 3.A
Contributions^(a) to GDP growth

Percentage points

	1993 Year	1994 Year	1995 Q1	Q2
Consumption	1.9	2.2	-0.1	0.6
Business investment	-0.1	0.3	-0.1	1.0
Private residential investment	0.1	0.2	0.1	—
Government	0.1	0.7	—	-0.6
Stockbuilding	0.4	0.5	-0.5	0.4
Domestic demand	2.5	3.9	-0.6	1.3
Net exports	0.1	0.5	1.2	-0.7
Factor cost adjustment	-0.4	-0.5	—	-0.1
GDP at factor cost	2.2	3.9	0.6	0.5

(a) Quarterly contributions are relative to the previous quarter. Components may not sum to total because of rounding.

consumption and investment rose, and stockbuilding also made a large contribution to growth. Excluding the alignment adjustment, stockbuilding was equivalent to about three quarters of one per cent of GDP in Q2.⁽¹⁾ Table 3.A shows recent contributions to GDP growth and illustrates the volatility of stockbuilding and net trade in the first half of this year. Because of this volatility, changes over six months provide a better illustration of trends: Table 3.B uses such measures to show how growth in GDP and domestic demand slowed down.

Personal sector demand

Growth in consumer spending fell from 1½% in the second half of 1994 to half that rate in the first half of this year. Judging by the limited evidence available, consumption growth probably did not increase much in the third quarter. Consumer spending fell in the early 1990s following the rapid build-up of debt in the late 1980s. Over the past few years, debt has been stable relative to income, while income gearing has fallen.

Growth in durable goods spending held up in the first half of 1995, despite low housing turnover. Private residential investment has risen more quickly than house sales since the start of the recovery—in Q2, residential investment rose by 1% and was about 2½% higher than a year earlier. Home improvements—which are included in residential investment data but not in housing turnover—explain part of this puzzle. The relative price of durable goods other than vehicles fell in the year to Q2, which probably encouraged some spending. Spending has been financed partly by consumer credit, which grew strongly in the first part of the year.

The rise in consumer spending in the second quarter was consistent with higher retail sales volumes and was foreshadowed in the August Report. After data revisions and reclassifications, recorded retail sales volume growth earlier this year was a little stronger than at the time of the previous Report, and rose 0.9% in the second quarter.

In the third quarter, retail sales volumes were flat. Sales of new private cars are usually highest in August; this year, private car registrations were roughly the same as in August 1994. Fleet sales were markedly stronger,

Table 3.B
GDP and domestic demand growth^(a)

Percentage changes (b); contributions to GDP growth in italics

	1994				1995		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
GDP	1.8	2.0	2.4	2.0	1.4	1.2	1.1
Non-oil GDP	1.4	1.8	2.2	2.0	1.4	1.2	1.2
Domestic demand	2.0	1.9	1.1	1.2	1.3	0.8	...
Domestic demand excluding stockbuilding	2.1	1.8	0.8	0.8	0.9	0.8	...
Net exports (c)	-0.4	0.1	1.4	0.8	0.1	0.5	...

... not available.

(a) GDP at factor cost, domestic demand at market prices.

(b) Latest two quarters on previous two quarters.

(c) Contributions over two quarters, two-quarter moving average.

(1) The box on page 24 of the May Report discussed the alignment adjustment.

Table 3.C
Housing market activity

Percentage changes on previous period, *levels in italics*

	1993	1994	1995		
	Year	Year	Q1	Q2	Q3
Private sector starts	11.7	13.1	-9.1	-1.7	-6.7
Turnover	5.7	7.8	-1.0	-6.1	-5.1
Price (a)	-2.6	0.6	0.1	-1.3	-1.0
Mortgage rate (b)	8.1	7.8	8.2	8.4	8.4

Sources: CSO, Halifax Building Society and Bank of England.

(a) Halifax index.

(b) Average variable percentage rate at major banks and building societies.

partly because of changes in VAT rules for leasing companies which took effect from 1 August. As in 1994, there were registrations by manufacturers and car dealers in August, though it is not clear whether they were more widespread than last year. And in Q3 as a whole, private car registrations were little changed compared with a year earlier.

House prices, measured by the Halifax index, fell between the second and third quarters, as did housing turnover (see Table 3.C). Nevertheless, some stability may have returned to the market more recently: house prices rose modestly in each of August, September and October. Cuts of about 0.35 percentage points in most variable mortgage rates were announced in September. But demand was still held back by many of the factors identified in the previous Report: uncertainty about employment; tax and income support changes which increased housing costs; and adjustment to a low-inflation environment in which houses are bought mainly for the service they provide—living space—rather than as an investment. All these factors mean that the housing market is probably adjusting to a new equilibrium and that it is going through a period of ‘price discovery’; lower turnover during such a period is not surprising.

The outlook for consumption depends on expectations about future disposable income. In the fiscal years 1994/95 and 1995/96, personal taxes increased by the equivalent of about 1½% and ¾% of personal disposable income respectively. The tax rises were part of a medium-term budget adjustment, so they are likely to have been perceived as permanent and thus to have reduced consumer spending. Some retailers did not pass on the indirect tax increases in full, which will have lessened their effect. Consumption has adjusted to the two Budgets of 1993 and is likely to return to growth at around its trend rate over the next year or so.

But greater job insecurity raises the perceived volatility of future disposable income, and may have increased desired levels of liquid assets for precautionary reasons—see Section 2. If so, consumption would be held back temporarily while savings were built up.

Other factors which will affect consumption include: real interest rates; payments following bank and building society mergers and conversions to plc status; rebates from electricity companies; and, perhaps, TESSA accounts maturing in 1996. Table 3.D shows the potential size of some of the bank and building society

Table 3.D
Potential ‘windfalls’

Date effective	Event	Estimated size £ billions (a)	Percentage of income (b)
1995 H2	Lloyds Bank joining with Cheltenham & Gloucester Building Society	1.8	0.4%
1995 H2	Lloyds Bank merger with TSB	1.0	0.2%
1996 H1	Regional electricity company rebates	1.1	0.2%
1996 H2	Abbey National take-over of National and Provincial Building Society	1.4	0.3%
1997 H1	Halifax Building Society merger with Leeds Permanent Building Society and conversion to plc status	9.0	1.9%

Source: Public announcements.

(a) At current prices.

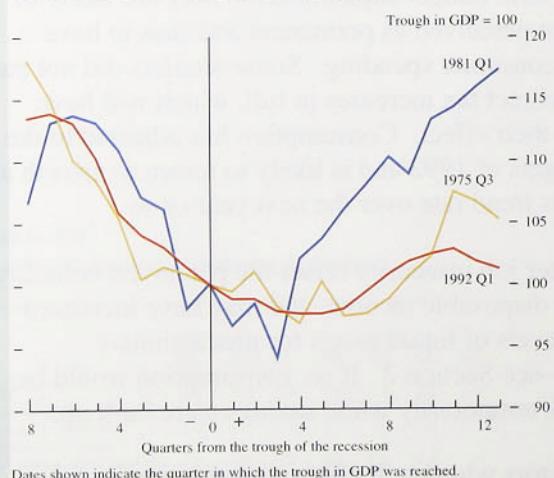
(b) Annual personal disposable income in 1994.

The UK construction industry

Construction output constitutes about 7% of GDP, and more than half of total investment is construction-related. As Chart 3.4 on page 23 shows, non-residential construction investment fell in the three years after the trough in GDP. The sector therefore accounts for much of the weakness of aggregate investment during this recovery. This box reports recent developments in the construction sector and assesses their implications for total investment.

The construction sector is not homogeneous; it encompasses the private housing market, the industrial, office and retail sectors, and public sector investment. Total construction output fell by about 15% from its peak to its trough in the most recent recession; Chart A shows that this was about the same fall as in the previous recession. But, in contrast to previous recoveries, output has not grown by much since the trough in overall GDP. One reason is that private sector construction output grew very strongly in the mid to late-1980s and, as a result, there is still much excess space in completed commercial buildings. According to Weatherall Green and Smith, for example, vacant office space in the City of London had fallen by the second quarter to below its peak in 1992, but was still much higher than in 1989.

Chart A
Construction output over the cycle

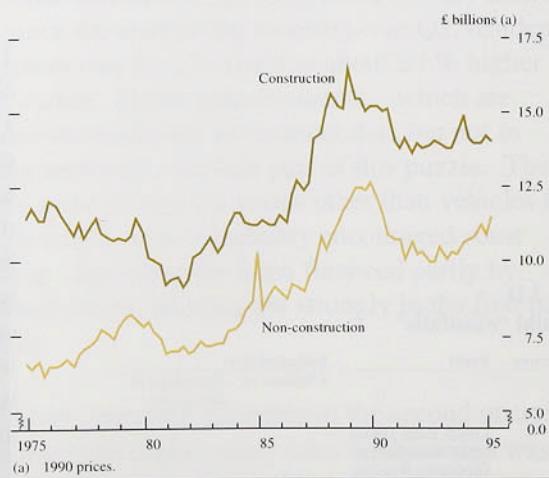


The Bank's Agents report that demand for commercial property—industrial, office and retail space—was low throughout the first three quarters

of this year. The Building Employers' Confederation reported that only 27% of firms were working at full capacity in Q3, compared with around 50% in the CBI's manufacturing survey. Low public sector activity, which accounts for about 40% of construction output, also helps to explain slow construction growth this year. Overall public sector investment fell by nearly 8% in the first half, and last November's Budget projected a fall in real public sector capital spending between 1995/96 and 1997/98.

Excess space, in the form of existing buildings, and low expected returns have affected private sector investment. Chart B shows how total construction investment boomed in the late 1980s but has been flat since 1992; and Chart 3.4 on page 23 shows how investment in building and works was the weakest component of total fixed investment during this recovery. By 1995 Q2, the rest of investment had increased by the same amount as in the two previous recoveries.

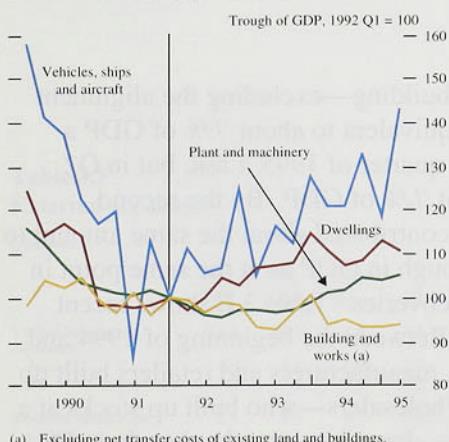
Chart B
Investment



The outlook for construction investment is depressed, so overall investment is likely to continue to grow more slowly in this recovery than in the previous one. Overall price pressures in the construction sector are still low: the deflator for building and works fell very sharply in the early 1990s, relative to both the total investment deflator and the GDP deflator. In the second quarter, it was still more than 10% lower than in 1990.

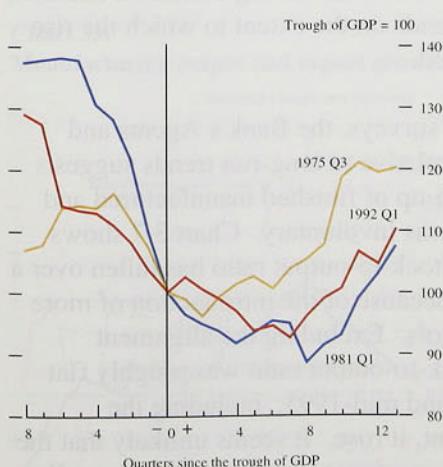
payments and of the electricity rebates. The maximum size of these payments will be in 1997; despite their size, their impact on spending will probably be small. Most of these announced 'windfalls' will be transfers of wealth within the personal sector. The deposits of building society members represent a claim on the assets of that society. A change to plc status or take-over which involves a payment to depositors merely converts some of this claim into a more liquid form. But even if the payments are treated as windfall gains to income, their direct effect on consumption will be lessened by three factors: they were pre-announced and therefore spending plans may have adjusted already; their effect on spending is likely to be spread over a number of years, precisely because they are one-off windfalls; and the consumers receiving payments may have high propensities to save—they are unlikely to be credit-constrained.

Chart 3.4
Investment by type of asset



(a) Excluding net transfer costs of existing land and buildings.

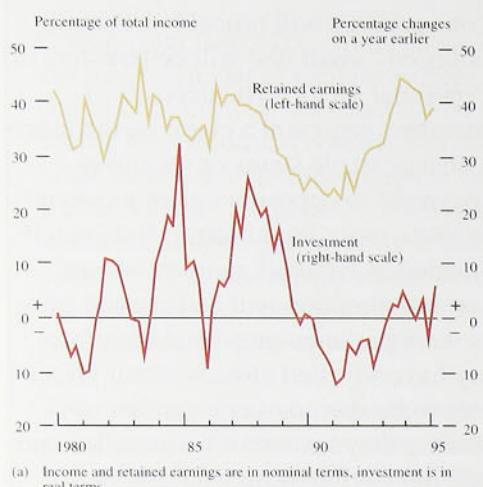
Chart 3.5
Manufacturing investment over the cycle



Dates shown indicate quarter in which the trough of GDP was reached.

As Chart 3.5 shows, manufacturing investment, which accounted for about a tenth of total investment last year, rose sharply over the past year or so. By the second quarter of 1995, manufacturing plant and machinery investment had risen by 10% since the trough in GDP; over the same period in the previous recovery, it was roughly unchanged. By contrast, growth in non-manufacturing business investment has been weaker. The strength of manufacturing investment is not surprising. Manufacturing output grew strongly last year, boosted by strong overseas demand, and capacity constraints—though uncommon—became more widespread. Because there are lags between changes in output and investment, manufacturers are probably still adjusting to their desired capital stock in the light of higher output. The CBI's October Survey reported a fall in manufacturing investment intentions in plant and machinery, though the balance was still positive. The

Chart 3.6 Business investment and retained earnings^(a)



(a) Income and retained earnings are in nominal terms, investment is in real terms.

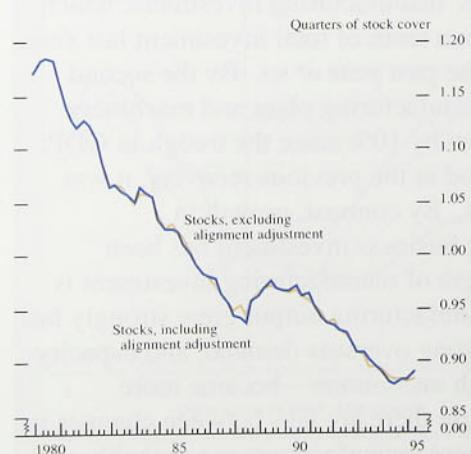
Table 3.E
Changes in stocks (1990 prices)

£ billions

	Total stocks	of which:				Alignment adjustment	
		Manufacturing	Retailing	Wholesaling	Other industries		
1994	Q1	0.2	0.3	0.1	0.2	—	-0.3
	Q2	0.6	0.1	0.3	0.2	0.3	-0.3
	Q3	0.6	0.3	0.2	—	—	0.6
	Q4	1.4	0.5	0.2	—	—	0.3
1995	Q1	0.8	0.7	0.1	-0.3	-0.2	0.5
	Q2	1.3	0.4	0.3	0.2	0.1	0.3

Note: Components may not sum to total because of rounding.

Chart 3.7
Stock-output ratio^(a)



Sources: CSO and Bank of England.

(a) Levels of stocks outstanding relative to quarterly GDP, in 1990 prices.

non-manufacturing sector faced fewer pressures to increase investment.

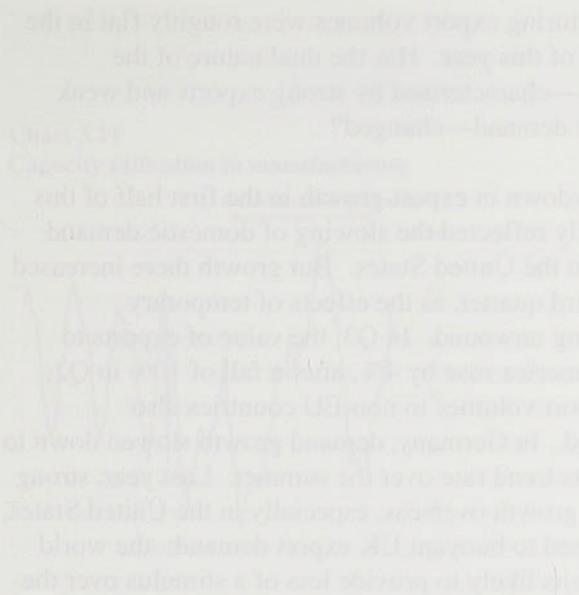
Company profits rose in the second quarter, but less quickly than last year. Between the second half of 1994 and the first half of 1995, they were roughly unchanged. Industrial and commercial companies' retained earnings, as a share of their total income, started rising in 1991, and in 1995 Q2 returned to 50%—around their average since 1960. Chart 3.6 shows for businesses that, over the past 15 years, changes in retained earnings often preceded changes in investment growth. In the past few years, businesses used increased profits to repair their balance sheets but, with that process more or less complete, they may now increase investment (and pursue mergers and acquisitions).

Stockbuilding

During 1994, stockbuilding—excluding the alignment adjustment—was equivalent to about $\frac{1}{2}\%$ of GDP a quarter. In the first quarter of 1995 it fell, but in Q2 stocks rose by about $\frac{3}{4}\%$ of GDP. By the second quarter, stocks had contributed about the same amount to growth since the trough in GDP as at the same point in the previous two recoveries. Table 3.E shows recent changes to stocks. Between the beginning of 1994 and the middle of 1995, manufacturers and retailers built up stocks the most. Wholesalers—who built up stocks at a slower rate in 1994—drew down stocks sharply in Q1, but then rebuilt them in Q2.

The August *Report* outlined the risk to output if firms satisfied demand in the second half of the year by drawing on stocks rather than producing more. The second quarter's rise in stockbuilding increased this risk, but the outlook depends on the extent to which the rise in stocks was planned.

Evidence from CBI surveys, the Bank's Agents and stock-output ratios relative to long-run trends suggests that part of the build-up of finished manufactured and retail goods stocks was involuntary. Chart 3.7 shows how the aggregate stock-to-output ratio has fallen over a long period, partly because of the introduction of more efficient stock controls. Excluding the alignment adjustment, the stock-to-output ratio was roughly flat between mid-1994 and mid-1995; including the alignment adjustment, it rose. It seems unlikely that the ratio has reached a permanent trough; stocks, overall, are higher relative to output than in the United States, and the Bank's Agents suggest that many firms are still



**Table 3.F
External accounts**

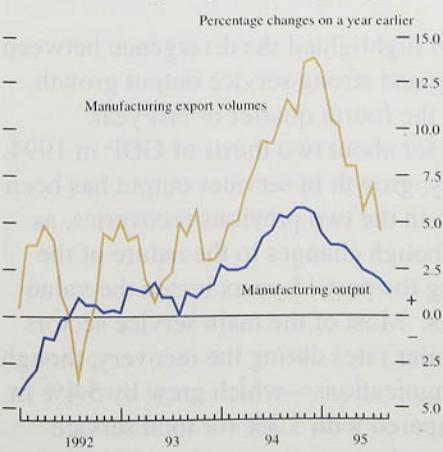
£ billions

	1993	1994	1995		
	Year	Year	Q1	Q2	Q3
Visible balance (a)	-13.4	-10.7	-1.9	-3.2	..
of which:					
Non-EU	-8.0	-5.1	-0.9	-2.0	-2.5
EU	-5.4	-5.6	-1.0	-1.2	..
Invisible balance (a)	2.3	8.9	0.7	0.9	..
of which:					
Services	5.7	3.8	1.1	1.1	..
Interest, profits and dividends	1.9	10.5	0.9	1.5	..
Transfers	-5.2	-5.4	-1.3	-1.7	..
Current account balance as a percentage of GDP	-11.0	-1.8	-1.2	-2.3	..
	-1.8	-0.3	-0.7	-1.3	..

.. not available.

(a) Components may not sum to total because of rounding.

**Chart 3.8
Manufacturing output and export growth(a)**



(a) Three-month moving average.

trying to economise further on stocks. Nevertheless, much of the rise in stocks of raw materials this year was planned, in anticipation of increases in raw material prices.

Output growth is sensitive to stock changes and there is a risk that changes to planned stocks will cut growth in the second half of the year, as happened in the second quarter in the United States. But the effects of such a 'stock cycle' are likely to be temporary, as they turned out to be in the United States. A rundown of UK stocks may explain part of the weakness of manufacturing output during the summer.

Public sector demand

In the second quarter, general government spending (consumption and investment) fell by 1.8%. General government spending is volatile; last year it rose by 2.8%. Last November's Budget projected that, over the three years 1995/96 to 1997/98, real government spending, as measured by the 'Control Total'—which comprises spending by central government, local authorities and the financing of nationalised industries—would rise by a total of 0.7%, after real cumulative growth of over 7% in the previous three years. Despite these tight spending plans, the public sector borrowing requirement (PSBR) was about 1½% higher in the first six months of the 1995/96 financial year than in the same period in the previous year. The Treasury's Summer Forecast revised up its PSBR projection for this financial year from £21.5 billion to £23.6 billion, largely because of lower projected tax receipts.

3.2

Net external demand

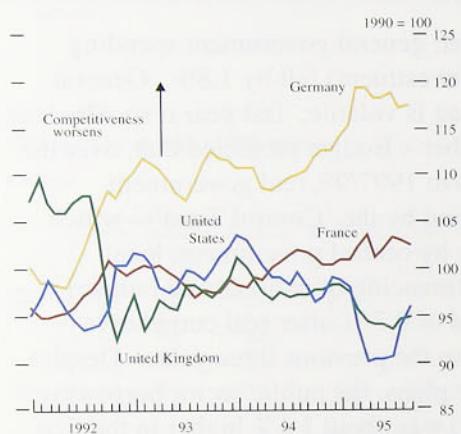
The current account deficit rose between the first and second quarters, to 1.3% of GDP (see Table 3.F). In the first quarter, the whole of the increase in GDP was accounted for by net exports, but in the second quarter net exports fell by the equivalent of about three quarters of a percentage point of GDP, as exports fell and imports rose. In the third quarter, the visible trade deficit with non-EU countries increased. Non-EU trade is just under half of total trade and normally provides a reasonable guide to the overall picture, if allowance is made for differential exchange rate movements. The CBI's October Survey recorded a fall in the balance of manufacturing firms reporting higher export orders over the previous four months. Last year, manufacturing exports grew more strongly than output—see Chart 3.8.

Manufacturing export volumes were roughly flat in the first half of this year. Has the dual nature of the recovery—characterised by strong exports and weak domestic demand—changed?

The slowdown in export growth in the first half of this year partly reflected the slowing of domestic demand growth in the United States. But growth there increased in the third quarter, as the effects of temporary destocking unwound. In Q3, the value of exports to North America rose by 4%, after a fall of 10% in Q2; total export volumes to non-EU countries also recovered. In Germany, demand growth slowed down to around its trend rate over the summer. Last year, strong demand growth overseas, especially in the United States, contributed to buoyant UK export demand; the world economy is likely to provide less of a stimulus over the next year.

The fall in the exchange rate in 1992, and subsequent improvements in price competitiveness, are still stimulating export growth. The fall in the real exchange rate this year (by about $3\frac{1}{2}\%$ to September, the latest month for which comprehensive data are available), was much smaller than in 1992 (see Chart 3.9). Overall, net external demand may add a little to growth over the next few quarters, but the dual nature of the recovery is likely to become less acute, as consumer spending and investment grow further.

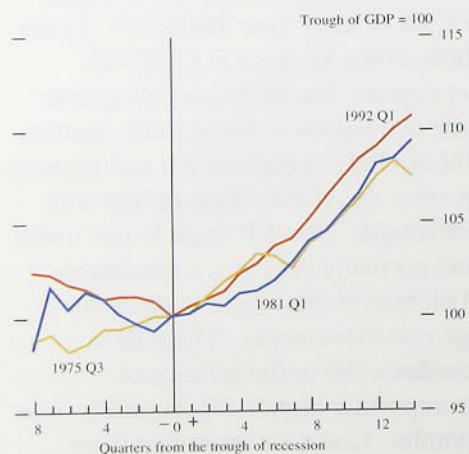
Chart 3.9
Real effective exchange rates^(a)



Source: International Financial Statistics, IMF.

(a) Nominal effective exchange rates adjusted for changes in relative consumer prices.

Chart 3.10
Services output over the cycle



Dates shown indicate the quarter in which the trough of GDP was reached.

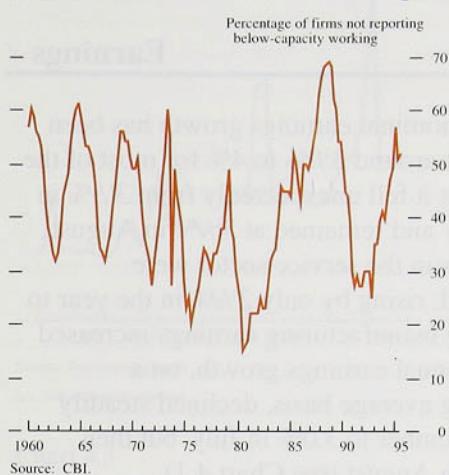
3.3

Output

Output growth fell in the first three quarters of this year. Whole-economy and non-oil output rose by 0.5% in the third quarter and services output rose by 0.7% (the same as in the first two quarters of the year). Manufacturing output rose by 0.2% in Q3.

The previous *Report* highlighted the divergence between weak manufacturing and strong service output growth, evident since about the fourth quarter of last year. Services accounted for about two thirds of GDP in 1994. During this recovery, growth in services output has been a little stronger than in the two previous recoveries, as Chart 3.10 shows, though changes to the nature of the service sector during the past 15 years lessen the value of such comparisons. Most of the main service sectors grew at broadly similar rates during the recovery, though transport and communications—which grew by 5.4% in the year to Q2, compared with 3.3% for total service sector output—was an important exception. Much of

Chart 3.11
Capacity utilisation in manufacturing



this growth was generated by innovation in the telecommunications sector. The strength of transport sector output last year was consistent with the strength of export growth.

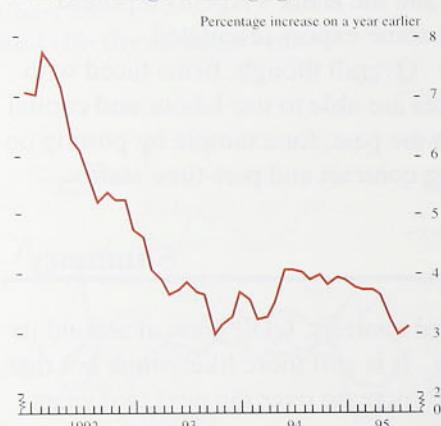
The slowdown in manufacturing output growth this year was also reflected in CBI and CIPS surveys, and reports from the Bank's Agents. As growth slowed down, manufacturing capacity utilisation stopped rising. The October CBI Survey reported that manufacturing capacity utilisation was virtually unchanged over the previous four months, after a fall in the previous survey. Chart 3.11 shows that utilisation was still high by historical standards, and the Bank's Agents reported capacity pressures at some export-orientated manufacturing firms. Overall though, firms faced with high demand pressures are able to use labour and capital more flexibly than in the past, for example by putting on extra shifts, and using contract and part-time staff.

3.4

Summary

In the second and third quarters, GDP grew at around its long-run average rate. It is still more likely than not that economic growth will increase over the next two years, narrowing the remaining output gap and reducing downward pressure on inflation. But the downside risks to output, especially in the short run, have increased since the previous *Report*: stocks were built up further in Q2, increasing the risk of a temporary destocking cycle; the housing market continued to be weak; and net exports fell.

Chart 4.1
Actual average earnings growth^(a)



(a) Three-month moving average.

Table 4.A
Earnings and settlements

	Percentage changes on a year earlier; previous Inflation Report in italics		
Wages and salaries per head	Q2	2.5	2.8
Whole-economy actual average earnings (Great Britain)	Aug.	3.1	2.8
Whole-economy underlying average earnings (Great Britain)	Aug.	3½	3½
<i>Settlements</i>			
IRS whole-economy (a)(b)	Sept.	3.0	<i>3.0</i>
IRS private sector (a)(b)	Sept.	3.0	<i>3.0</i>
IRS public sector (a)(b)	Sept.	3.0	<i>3.0</i>
CBI manufacturing (c)	Sept.	3.5	<i>3.4</i>
CBI services (c)	Sept.	3.5	<i>3.5</i>
IDS (d)	Sept.	3.0–3.9	<i>3.0–3.9</i>
LRD (e)	Sept.	3.4	<i>3.1</i>

(a) IRS = Industrial Relations Services.

(b) Median for latest twelve months.

(c) Mean for latest three months.

(d) IDS = Income Data Services. Range in which the median settlement falls.

(e) Labour Research Department: Bargaining Report, median for latest three months.

4.1

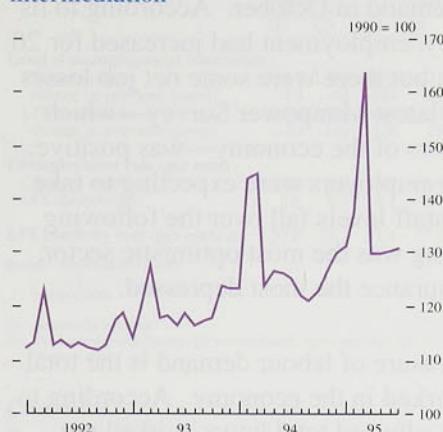
Earnings

Underlying annual nominal earnings growth has been remarkably stable at around 3½% to 4% for most of the past 18 months. But it fell unexpectedly from 3½% in May to 3¼% in July and remained at 3¼% in August. Underlying earnings in the service sector were particularly subdued, rising by only 2½% in the year to August; underlying manufacturing earnings increased by 4½%. Actual annual earnings growth, on a three-month moving average basis, declined steadily from 3.9% last December to 3.0% in July, but then increased to 3.1% in August (see Chart 4.1).

The recent decline in nominal earnings growth has not been driven by lower pay settlements (see Table 4.A). Industrial Relations Services (IRS), for example, reported that the median wage settlement across all industries was 3.0% in the twelve months to the end of September, unchanged from the twelve months to the end of June. And in the three months to September, settlements were slightly higher than in the three months to June. So earnings growth has fallen as a result of lower growth in the components of earnings other than basic pay. According to the New Earnings Survey, basic pay constitutes only 75% of gross pay; overtime pay accounts for 6% and bonuses 4%, with the rest accounted for by shift payments and grading increments. The gap between annual average earnings growth and settlements—called ‘wage drift’—is normally positive, and averaged 1.7 percentage points between May 1984 and August 1995. But it has virtually disappeared since the beginning of the year. In particular, the CBI Pay Databank—which splits settlements by sector—suggests that wage drift in the manufacturing sector has fallen over the past 18 months but remained positive, while wage drift in the service sector has fallen even more sharply and was negative in the second quarter.

The fact that the decline in average earnings growth in the service sector can be accounted for entirely by negative wage drift may mean the decline is temporary. Wage drift can be negative for three reasons. First, a shift towards part-time or lower-paid work would reduce average earnings per worker. Second, bonus payments

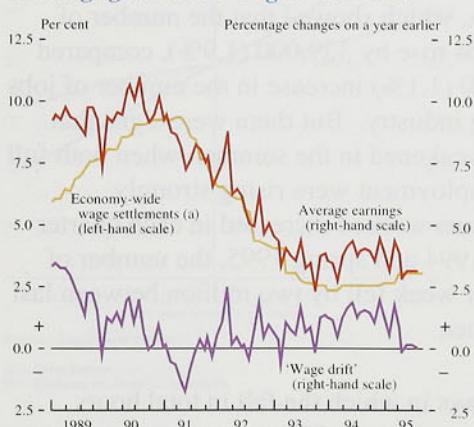
Chart 4.2
Average earnings in financial intermediation^(a)



Source: *Employment Gazette*.

(a) Not seasonally adjusted.

Chart 4.3
Earnings growth and wage settlements



Sources: IRS and CSO.

(a) IRS median settlements over the previous twelve months.

Table 4.B
Changes in numbers in employment
(Great Britain)

Thousands, seasonally adjusted

Estimate at the time of:	August Report	Current Report
Labour Force Survey		
Winter 1993/94 to spring 94	+49	+49
Spring 1994 to summer 94	+72	+72
Summer 1994 to autumn 94	+84	+84
Autumn 1994 to winter 94/95	+88	+88
Winter 1994/95 to spring 95	+25	+25
Spring 1995 to summer 95	+107	
Total from trough in employment		+564
Workforce in Employment Survey		
December 1993 to March 94	-47	+8
March 1994 to June 94	-26	+2
June 1994 to September 94	+113	+138
September 1994 to December 94	+78	+62
December 1994 to March 95	-12	+26
March 1995 to June 95	+14	
Total from trough in employment		+374

may increase more slowly than settlements. Chart 4.2 plots seasonally unadjusted earnings in financial intermediation industries—such as banking and insurance. It suggests that large bonuses were paid out in both February and March 1994, but in 1995 payments were made only in March. In total, bonus payments in financial intermediation industries were around 20% to 30% lower in 1995 than in 1994. Third, there may be a decline in the proportion of overtime payments. Whichever was the reason for the recent episode of negative wage drift, faster increases in bonuses, or a period of stability in part-time work or overtime, could increase wage drift significantly.

In the past, wage drift has not remained negative for long. Chart 4.3 shows when wage drift in the whole economy previously became negative in 1993 Q4, it quickly rebounded by over one and a half percentage points. At that time, settlements were on a downward trend, so there was little effect on average earnings. Other periods of negative wage drift have ended with an even sharper recovery. If a sharp rebound were to occur against a backdrop of flat settlements, average earnings growth would also rise.

4.2 Demand for labour

Employment has increased strongly this year, according to data released since the August *Report*. The Labour Force Survey recorded a 107,000 increase in employment between the spring and the summer, compared with an increase of 25,000 over the previous quarter. The CSO's employer-based survey showed a smaller 14,000 increase in the number of jobs between March and June.⁽¹⁾ In the past, the two series have diverged significantly, but substantial revisions to the estimate of the workforce in employment since December 1992 have reduced some of the discrepancies (see Table 4.B). The CSO estimates that the workforce in employment has risen by 374,000 since the trough in employment, compared with the LFS estimate of 564,000.

Job surveys indicate that the employment situation has been steadily improving. The October CBI Industrial Trends Survey found that, for the first time since July 1989, manufacturing firms had taken on staff over the previous four months. A balance of 3% reported that they had hired workers, compared with a balance of 4% in July expecting to shed staff. The Chartered Institute

(1) Data are for Great Britain.

Table 4.C
Average hours worked (Great Britain)

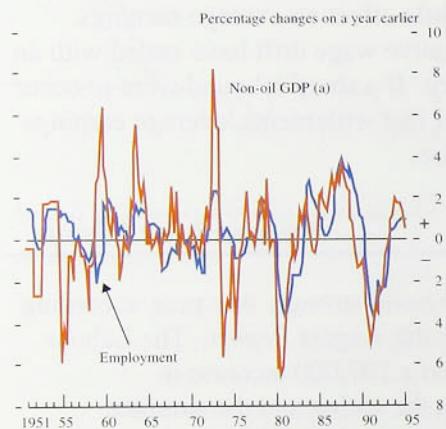
Hours per week (a)

	Spring	Summer	Autumn	Winter
1992	32.8	33.4	33.2	33.1
1993	33.1	33.0	33.0	33.2
1994	33.3	33.2	33.4	33.4
1995	33.5	33.3		

Source: Labour Force Survey.

(a) Seasonally adjusted; spring covers March, April and May, summer June, July and August, etc.

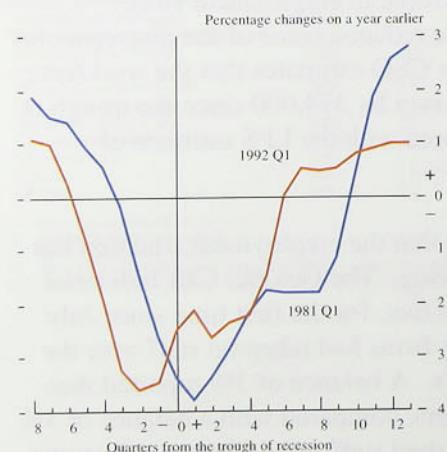
Chart 4.4
Employment and output growth



Sources: CSO and Bank of England.

(a) Detrended.

Chart 4.5
Workforce in employment



Source: Employment Gazette.

Dates shown indicate the quarter in which the trough in GDP was reached.

of Purchasing and Supply—which also covers manufacturing firms—suggested that there was no increase in labour demand in October. According to its latest monthly survey, employment had increased for 20 consecutive months, but there were some net job losses in October. But the latest Manpower Survey—which covers all main sectors of the economy—was positive. It showed that more employers were expecting to take on staff than to see staff levels fall over the following four months; retailing was the most optimistic sector, and banking and insurance the most depressed.

A more accurate measure of labour demand is the total number of hours worked in the economy. According to the LFS, seasonally adjusted total hours worked per week were 1.7% higher in the summer of 1995 than in the same period a year earlier: manufacturing hours were up 2.0% over the year, while service sector hours rose 1.5%. This sectoral breakdown contrasts with the employment data, which showed that the number of service sector jobs rose by 329,000 (1.9%), compared with just a 54,000 (1.1%) increase in the number of jobs in manufacturing industry. But there were signs that labour demand weakened in the summer, when both full and part-time employment were rising strongly. Whereas total hours worked increased in each quarter between spring 1994 and spring 1995, the number of hours worked per week fell by two million between last spring and summer.

There are two ways in which the fall in total hours worked over the summer could have accompanied a rise in both full and part-time employment. First, overtime working could have been cut back severely. Second, the average working week could have been shortened, by more people working fewer hours—resulting, for example, from a temporary surge in summer jobs. Indeed, seasonally adjusted average weekly hours fell from 33.5 hours a week to 33.3 between the spring and summer of 1995 (see Table 4.C).

There is some evidence that employment has become more sensitive to changes in demand during the most recent economic cycle. In particular, the size of the response of employment to output appears to have risen (Chart 4.4). This may be a result of the labour market reforms in the 1980s, which made it easier and cheaper for firms to hire and fire workers. Chart 4.5 shows that, although employment rose slightly earlier in the current cycle, it increased much less quickly over the past year than at a similar stage in the previous upturn.

Table 4.D
Unemployment and inactivity (Great Britain)^(a)

	1994			1995		
	Q2	Q3	Q4	Q1	Q2	Q3
Level of unemployment (thousands)						
Claimant count	2,567	2,498	2,374	2,278	2,231	2,203
change on previous quarter	-83	-68	-124	-96	-47	-28
LFS measure (b)	2,679	2,530	2,404	2,432	2,414	..
change on previous quarter	-39	-149	-126	28	-18	..
Unemployment rate (per cent)						
Claimant count	9.4	9.2	8.7	8.4	8.2	8.1
LFS measure (b)	9.6	9.1	8.7	8.7	8.6	..
LFS inactivity rate (per cent) (b)						
LFS inactivity rate (per cent) (b)	37.0	37.2	37.4	37.3	37.1	..

Source: *Employment Gazette*.

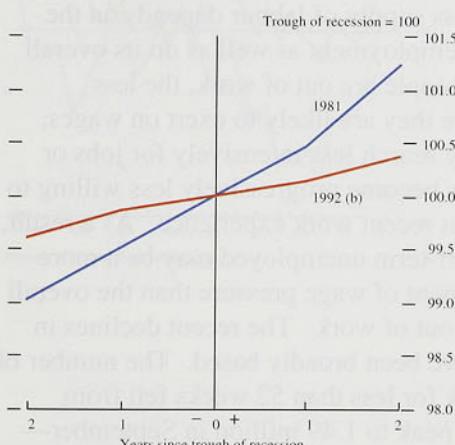
.. not available.

(a) Seasonally adjusted.

(b) For Labour Force Survey, Q1 covers March, April and May, Q2 June, July and August, etc.

Chart 4.6

Population of working age^(a)



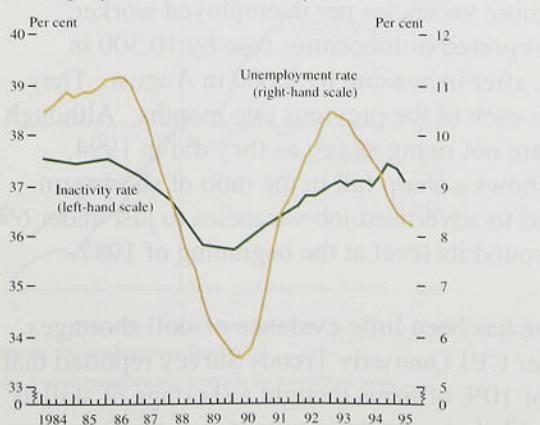
Source: *Employment Gazette*.

(a) Great Britain.

(b) Excludes residents in institutions.

Chart 4.7

Unemployment and inactivity^(a)



Source: *Employment Gazette*.

(a) Both seasonally adjusted.

4.3

Unemployment

According to the latest LFS, unemployment was down by 18,000 between June and August, after rising by 28,000 in the previous three months. Claimant unemployment started to fall faster, after slowing for the first six months of 1995 and stabilising in July. The claimant count fell by 21,100 in August and a further 27,200 in September (see Table 4.D for the quarterly changes).⁽¹⁾ The average three-monthly fall in the claimant count is still lower than at the end of 1994: it was 16,200 in the three months to September, compared with 47,900 in the three months to December.

Unemployment started to fall much earlier in the current recovery than in previous cycles. It has also fallen much further. Since the most recent trough in GDP, claimant unemployment has declined by a total of 390,000. This compares with a rise of 952,000 in the first three and a half years of the recovery in the early 1980s.

4.4

Supply of labour

The supply of labour increased between June and August. Indeed, the population of working age rose by around 25,000 in the quarter to spring 1995 and by a further 25,000 in the following quarter. Since the start of the recovery, it has grown by over 225,000, however, compared with a rise of approximately 700,000⁽²⁾ during the first three and a quarter years of the early 1980s recovery (see Chart 4.6). The change in the population of working age alone amounts to around a third of the difference in the level of unemployment between the two recoveries, although there is no reason to suppose that demographic factors should affect significantly the long-run equilibrium rate of unemployment.

Labour supply in the current recovery has also been reduced by a rise in the number of people not actively seeking work—partly as a result of young people entering higher education. Despite falling between last winter and this summer, the number of people of working age not actively seeking work rose by 326,000 in the first three years of the recovery (see Chart 4.7). In the early 1980s recovery, the LFS suggests that the number of people of working age not actively seeking work rose even more strongly.

(1) The introduction of incapacity benefit is estimated to have increased claimant unemployment by just over 2,000 in August, and by a further 3,500 in September; it had a negligible impact in the previous months.

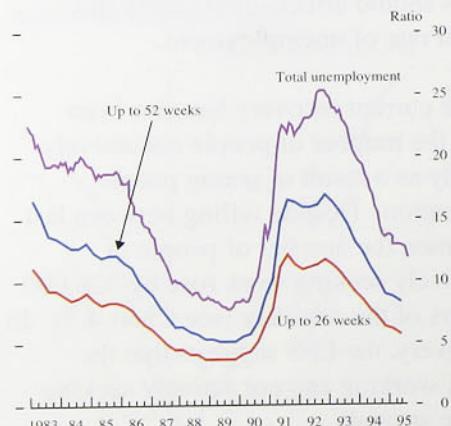
(2) Estimated from annual data.

The number of people who would *potentially* seek work as labour market conditions improve is important for future wage pressure. The Employment Department expects the population of working age to increase by 250,000 during 1996 and 1997. Although this is more than in 1994 and 1995, it is still much less than the 370,000 increase in the pool of labour between 1984 and 1986. However, the fact that inactivity has yet to fall significantly could mean that the labour force could expand quite rapidly with little pressure on wages—if, for example, people were easily tempted out of further education and into jobs.

4.5 Measures of labour market tightness

The effective excess supply of labour depends on the composition of unemployment as well as on its overall level. The longer people are out of work, the less downward pressure they are likely to exert on wages, either because they search less intensively for jobs or because employers become progressively less willing to hire people without recent work experience. As a result, the number of short-term unemployed may be a more important determinant of wage pressure than the overall number of people out of work. The recent declines in unemployment have been broadly based. The number of people out of work for less than 52 weeks fell from 1.95 million at its peak to 1.49 million in September—the same proportionate amount as the fall in total unemployment.

Chart 4.8
Ratio of unemployment by duration
to vacancies^(a)



Source: *Employment Gazette*.

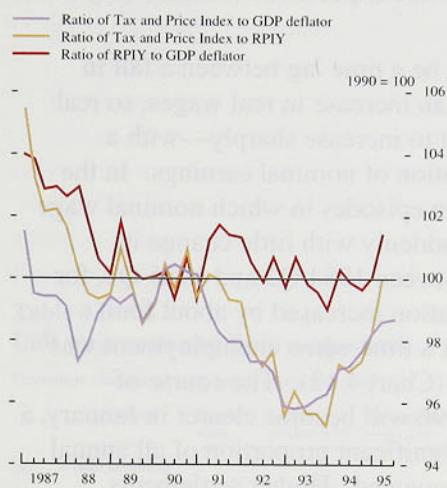
(a) Seasonally adjusted.

Vacancies are another useful measure of labour market tightness. As slack in the labour market lessens, there should be more vacancies per unemployed worker. Vacancies reported to Jobcentres rose by 10,300 in September, after increasing by 2,600 in August. They were flat in each of the previous two months. Although vacancies are not rising as fast as they did in 1994, Chart 4.8 shows a sharp fall in the ratio of short-term unemployed to advertised job vacancies to just under 6% in July—around its level at the beginning of 1987.

So far, there has been little evidence of skill shortages. The October CBI Quarterly Trends Survey reported that a balance of 10% of firms thought a shortage of skilled labour was likely to constrain output over the following four months—a figure which has been practically unchanged in each of the past five quarterly surveys. This is not surprising. During the 1980s recovery, skill shortages started to pick up rapidly only in 1987—six years into the upturn. It is possible therefore that skill

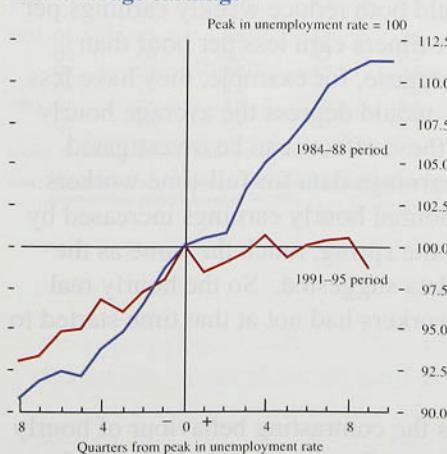
... than would be well to ensure galloping inflation. Leaving aside the question of how much inflation is acceptable, it is important to understand what factors have caused the recent fall in wages relative to money earnings. It is also important to know how this compares with previous falls.

Chart 4.9
The tax wedge



Sources: CSO and Bank of England.

Chart 4.10
Real average earnings^(a)



Sources: CSO and Employment Gazette.

(a) Nominal average earnings deflated by the Tax and Price Index.

shortages will soon become a much greater constraint on output.

4.6 Explaining the behaviour of wages

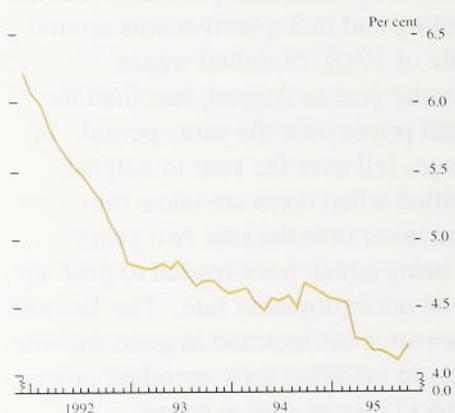
There are two main puzzles in recent wage behaviour. The first is that real wages have been much more subdued over the current cycle than expected, given that unemployment is falling and in September was around its level in the middle of 1988. Nominal wages increased by 3.1% in the year to August, less than the 3.6% increase in retail prices over the same period. In other words, real wages fell over the year to August. The puzzle is intensified when taxes are taken into account. Increases in taxes over the past two years would, other things being equal, have tended to push up earnings for any given unemployment rate. The Tax and Price Index (TPI) measures the increase in gross income required for taxpayers to maintain their spending power, taking account of direct taxes as well as prices.

Chart 4.9 shows that the TPI has been increasing faster than the GDP deflator since the beginning of 1994. This increase in the 'wedge' between the consumption wage and the product wage would have exerted upward pressure on wages if employees attempted to recoup some of their lost purchasing power in higher real wages. Chart 4.9 also decomposes the wedge into terms of trade effects and changes in the tax and price index relative to RPIY. Both have tended to reduce the consumption wage relative to the product wage since the beginning of 1994. Chart 4.10 compares the consumption wage in the current upturn with its path in the previous recovery.

The second puzzle is the continued divergence between the growth of nominal manufacturing and service sector earnings. Underlying service sector annual earnings have increased particularly slowly during the recovery, as a result of falling wage drift in the service sector, while underlying manufacturing annual earnings have risen more strongly. Yet service sector employment increased from 17.2 million to 18.0 million between spring 1992 and summer 1995—a period during which the number of jobs in manufacturing industry fell from 5.0 million to 4.9 million.

There are three possible explanations for the real wages puzzle. First, *expected* real wages may have started to increase, offset by a sharper fall in inflation expectations. This does not seem to have been the case. Because inflation expectations are volatile, Chart 4.11

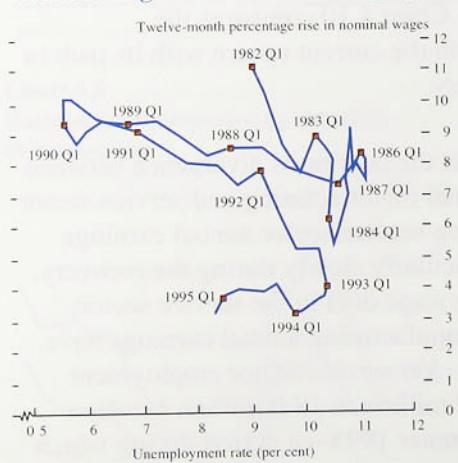
Chart 4.11
Employees' inflation expectations^(a)



Source: Gallup Survey of Employees.

(a) One-year forecast (six-month moving average).

Chart 4.12
Nominal wage inflation and unemployment



Source: Employment Gazette.

takes a six-month moving average of the inflation rate expected in twelve months' time by employees surveyed by Gallup. On this basis, expectations fell between January and September, but not sufficiently to account for the behaviour of nominal wages. The Gallup Survey also suggested that workers expected a *cut* in real wages over the coming year. Prices were expected to rise by 4.5%, while wages were expected to increase only 3.1%.

Second, there could be a time lag between a fall in unemployment and an increase in real wages, so real wages may be about to increase sharply—with a consequent acceleration of nominal earnings. In the past, there have been episodes in which nominal wage growth increased suddenly with little change in unemployment. Between 1984 Q2 and 1985 Q2, for example, wage inflation increased by about four percentage points at a time when unemployment was actually *increasing* (Chart 4.12). The course of settlements over 1996 will become clearer in January, a month in which a significant proportion of all annual settlements is implemented. Higher settlements, accompanied by a rebound in wage drift, would be consistent with this explanation.

Third, average *hourly* wages—more relevant when measuring inflationary pressure than total earnings—may be increasing more quickly than suggested by the average annual earnings figures. A shift towards part-time work would both reduce weekly earnings per worker and—if part-timers earn less per hour than full-time workers because, for example, they have less bargaining power—would depress the average hourly wage. The first of these effects can be investigated using LFS hourly earnings data for full-time workers. These show that nominal hourly earnings increased by 3.5% in the year to the spring, much the same as the headline earnings data suggested. So the hourly real wage of full-time workers had not at that time started to increase.

More remarkable is the contrasting behaviour of hourly earnings of full-time workers in manufacturing and services. Nominal hourly earnings for full-time service sector workers rose by 4.6% in the year to the spring. In manufacturing, however, nominal hourly earnings fell by 1.0% in the year to the spring. This is consistent, however, with data for total hours worked in the year to the spring—they increased by 2.4% in services, compared with 2.0% in manufacturing—and provides a partial resolution of the second puzzle.

None of the above possibilities is able to explain the subdued behaviour of real wages so far in the recovery. In particular, the decline in nominal hourly wages in manufacturing over the past year suggests sharp cuts in real wages. Service sector hourly nominal pay rose for full-time workers—but since services is the sector which saw the greatest shift towards part-time work, earnings in that sector are most likely to be exaggerated by the full-time hourly pay data. Either real wages are about to pick up, or unemployment remains significantly above its natural rate and traditional indicators of labour market tightness are underestimating the degree of slack in the economy.

4.7 Productivity and unit wage costs

Table 4.E
Unit wage costs and their components

Percentage changes on same period in previous year

	Output	Employ- ment	Labour productivity	Earnings per employee	Unit wage costs
(a) Whole economy					
1992	-0.5	-2.3	1.1	6.0	4.9
1993	2.3	-0.8	3.3	3.1	—
1994	3.9	0.7	3.3	2.9	-0.4
1994 Q1	3.4	0.6	2.8	3.3	0.4
Q2	4.2	0.5	3.8	2.9	-0.9
Q3	4.1	0.8	3.4	2.7	-0.5
Q4	4.1	1.0	3.1	2.7	-0.4
1995 Q1	3.6	1.1	2.7	2.9	0.3
Q2	2.8	1.2	1.8	2.4	0.7
(b) Manufacturing industry					
1992	-0.7	-4.2	5.7	6.6	0.8
1993	1.2	-3.2	4.7	4.6	-0.3
1994	4.2	-1.0	4.7	4.7	—
1994 Q1	2.3	-0.8	3.1	3.6	1.6
Q2	4.0	-0.5	4.5	5.2	-0.1
Q3	5.2	-0.2	5.7	4.6	-1.2
Q4	5.3	0.2	5.5	5.3	-0.3
1995 Q1	3.6	1.4	2.9	5.0	2.0
Q2	2.4	1.3	1.7	4.7	3.0

Source: *Employment Gazette*, Tables 1.8 and 5.8.

Note: Manufacturing employment and average earnings are based on SIC (80); manufacturing output is based on SIC (92).

The growth of productivity per head has been slowing since 1994 Q2—it increased by 1.8% in the year to 1995 Q2. Estimates of productivity growth in the manufacturing sector show an even more marked decline: productivity increased by 1.7% in the year to 1995 Q2, down from 5.5% in 1994 Q4. The fall in productivity growth is largely a cyclical phenomenon. Mirroring this fall, unit wage costs have picked up sharply. In the year to 1995 Q2, whole-economy unit wage costs increased by 0.7%. And manufacturing unit wage costs were up 3.0% in the year to 1995 Q2—after falling through most of 1994 (Table 4.E).

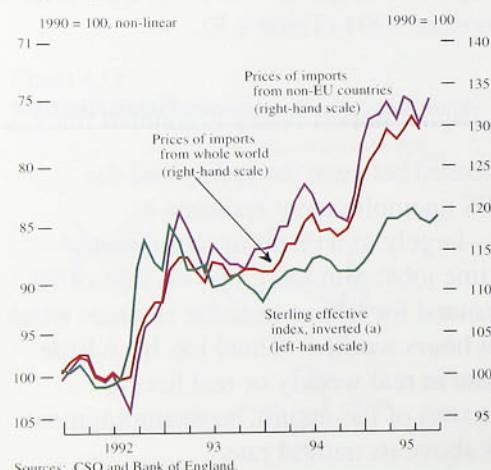
4.8 Summary

Employment increased between the spring and the summer—and LFS unemployment resumed its downward trend—largely as a result of more people working in part-time jobs. But there was no sign of an increase in the demand for labour over the summer when measured by total hours worked. There has been little sign of any increase in real weekly or real hourly earnings since the start of the upturn, so unemployment probably remains above its natural rate.

Since the August *Report*, producer input prices have continued to rise, though at a slower rate than earlier in the year. The twelve-month change in manufacturing unit wage costs rose in the summer. And producer output prices continued to rise much faster than retail prices, suggesting that retailers' profit margins have been squeezed. The exchange rate has risen a little since the previous *Report*, and its effective index is about the same as it was in May, when second-round effects from the depreciation in early 1995 were identified as a risk to achieving the inflation target. The cost and pricing developments assessed in this section should affect inflation only in the short run, unless they reflect monetary developments or affect expectations and become embedded in future wage and price setting.

5.1 The exchange rate and import prices

Chart 5.1
Import prices and the exchange rate

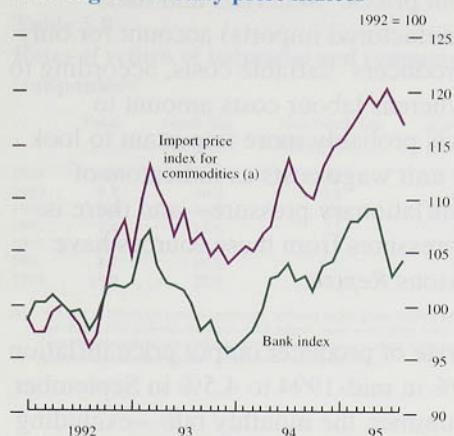


(a) The sterling ERI is inverted: a rise in the line reflects a depreciation.

Sterling's effective exchange rate index rose from 83.4 to 84.3 between the August and November *Reports*, but ended the period at about the same level as in May (see Chart 5.1). The direct (or first-round) effect of the depreciation in sterling over the past year has already affected import and input prices. Chart 5.1 shows that the recent depreciation coincided with a sharp rise in import prices and that, in contrast to 1992 (when sterling's membership of the ERM was suspended), import prices rose by more than the fall in the exchange rate. This was probably because the rise in import prices reflected not only the fall in sterling in the first quarter of this year but also the strength of imported commodity prices last year.

In the short run, the extent to which import price rises are passed through to final prices depends, among other things, on the extent to which prices are fixed in long-term contracts and whether the rises are expected to persist. Over the long term, the response of final prices will depend on the reasons for the rise in import prices and the stance of monetary policy. In the short run, however, price increases due solely to higher import and input prices might be misinterpreted as signs of higher domestically generated inflation. But, as yet, the potential second-round effects from the fall in the exchange rate, such as a rise in earnings growth, have not occurred.

Chart 5.2
Sterling commodity price indices



Sources: CSO and Bank of England.

(a) A sub-index of import price indices weighting together the indices for basic materials, fuels, and food, drink and tobacco.

Chart 5.3
Producer and retail price inflation

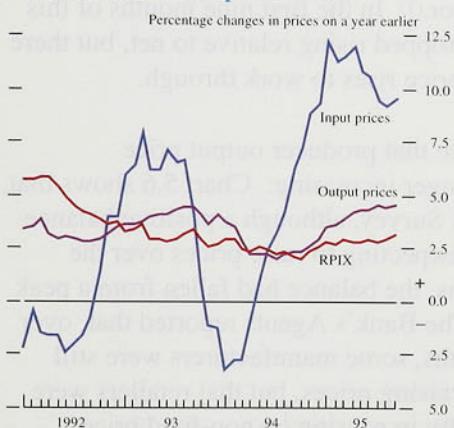
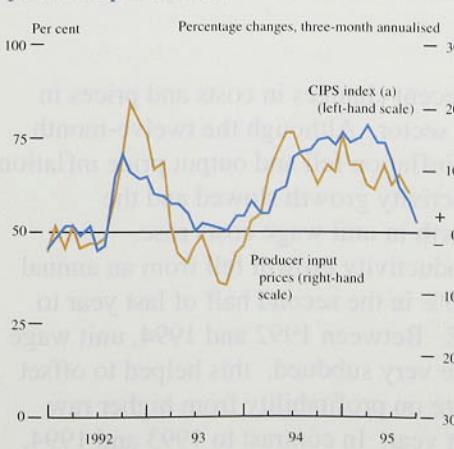


Chart 5.4
Producer input price inflation and CIPS purchase price index



Sources: CSO and Chartered Institute of Purchasing and Supply.

(a) The index compares the price of purchases in one month with that a month earlier. A figure above 50% indicates rising prices.

5.2 Raw material and commodity prices

Commodity prices, as measured by the Bank's index, fell in the third quarter and were no higher than in the middle of last year, as illustrated in Chart 5.2, which also shows that a crude proxy for imported commodity prices has risen over the past year. The divergence between these two indices reflects different coverage and weighting: the Bank's index is demand-weighted and covers domestic commodities too.⁽¹⁾ Growth in world demand has slowed by more than expected this year and this has reduced the demand pressure on industrial raw material prices. In October, the IMF's *World Economic Outlook* projected a rise of 2.5% in GDP in the industrial countries in 1995; six months earlier, it had projected 3%. Last year, in response to stronger-than-expected demand pressures, metal and non-food agricultural prices in the Bank's commodity index rose by 21% and 17% respectively. In the first nine months of this year, they fell, while food prices—which account for about a third of the Bank index—were roughly unchanged.

5.3 Input and output prices

Producer input prices, like commodity prices, decelerated in the three months to September; Chart 5.3 shows how the twelve-month rate fell from its rate in January. But, in ten out of the twelve months to August, the initially reported rise in input prices was later revised up. Higher import prices accounted for about three quarters of the rise in producer input prices in the year to September, reflecting the strength of some commodity and imported semi-manufactured goods' prices, such as chemicals, metals and other imported inputs.

What are the prospects for input prices? The effective exchange rate has increased a little since the previous *Report*, so import price pressures may ease. Commodity prices fell in Q3, suggesting that the annual rate of input price rises will probably fall further. This is supported by the CIPS Survey (which measures price pressures within the manufacturing sector and is therefore probably more closely related to input prices than output prices). Chart 5.4 confirms this weakening of input price pressures and shows that in October the CIPS index fell further.

(1) An article on pages 280–85 of the August *Quarterly Bulletin* described the construction of the Bank's index.

Chart 5.5
Ratio of gross to net output prices

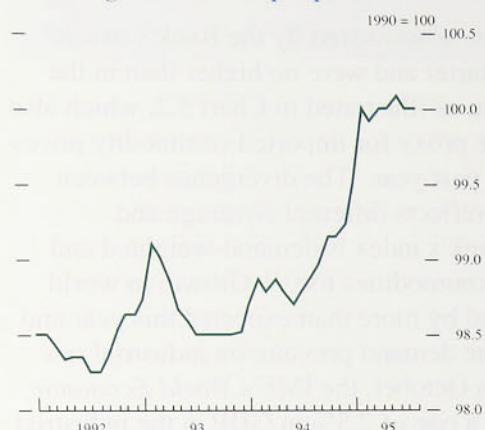
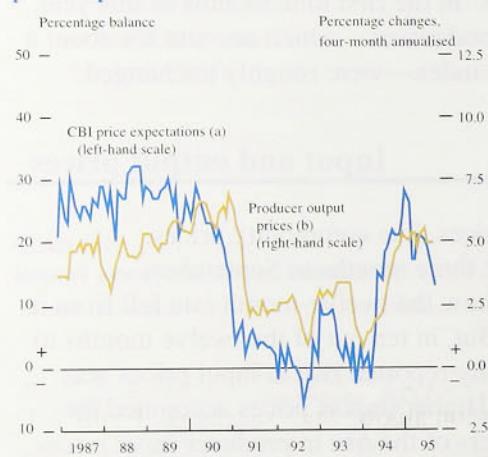


Chart 5.6
Producer output price inflation and CBI price expectations



Sources: CBI and CSO.

- (a) Balance of manufacturers expecting to increase prices over the following four months less those expecting a reduction, seasonally adjusted.
- (b) Excluding food, drink, tobacco and petroleum; four-month increase, seasonally adjusted and annualised.

Table 5.A
Rates of change of manufacturers' costs

Year-on-year percentage changes

	1993	1994	1995	Q1	Q2	Q3
Costs						
Unit wage costs	-0.3	—	2.0	3.0	3.9 (a)	
Materials and fuels (including semi-finished manufactured imports)	4.5	2.6	11.5	10.7	9.4	
Imports of finished manufactures	9.3	3.4	8.5	7.4	7.7 (a)	
Services	2.9	3.7	0.6	0.9	1.0	
Output prices (b)	3.9	2.5	3.6	4.2	4.5	

Sources: CSO and Bank of England.

- (a) Average of two months' data.
- (b) Domestic sales.

Over the long term, producer input prices are not well correlated with output prices. Materials and fuels (including semi-manufactured imports) account for only about a quarter of producers' variable costs, according to input-output data, whereas labour costs amount to around a half. So it is probably more important to look at output prices and unit wage costs as indicators of potential short-run inflationary pressure—and there is little evidence that pressures from these sources have eased since the previous Report.

The twelve-month rate of producer output price inflation rose from around 2% in mid-1994 to 4.5% in September 1995. During the summer, the monthly rate—excluding food, drink, tobacco and petroleum products—continued at around 0.4%. Chart 5.5 shows that gross output prices rose relative to net output prices in the second half of last year, as price pressures built up within the manufacturing sector.⁽¹⁾ In the first nine months of this year, gross prices stopped rising relative to net, but there may still be some price rises to work through.

Survey data indicate that producer output price pressures are no longer increasing: Chart 5.6 shows that, in the October CBI Survey, although a positive balance of firms were still expecting to raise prices over the coming four months, the balance had fallen from a peak earlier this year. The Bank's Agents reported that, over the past three months, some manufacturers were still having success in raising prices, but that retailers were still having difficulty in passing on non-food price increases to price-sensitive consumers. By contrast, food retailers were having more success in passing on price rises, consistent with the evidence reported in Section 1.

Table 5.A shows recent changes in costs and prices in the manufacturing sector. Although the twelve-month rate of input price inflation fell and output price inflation levelled off, productivity growth slowed and the twelve-month growth in unit wage costs rose. Manufacturing productivity growth fell from an annual rate of more than 6% in the second half of last year to less than 2% in Q2. Between 1992 and 1994, unit wage cost pressures were very subdued; this helped to offset some of the squeeze on profitability from higher raw material prices last year. In contrast to 1993 and 1994, all of the main elements of manufacturers' costs were increasing in the year to 1995 Q2.

(1) Gross output prices include the prices paid for goods exchanged within the manufacturing sector; net output prices do not.

5.4

Profitability

Table 5.B
Rates of return of industrial and commercial companies^(a)

Total	North Sea companies	Non North Sea companies	of which: manufacturing
1988 10.4	18.0	10.0	7.6
1989 9.9	16.2	9.6	8.2
1990 8.4	16.4	8.0	6.7
1991 7.4	12.6	7.1	4.3
1992 7.5	13.1	7.3	4.8
1993 8.7	16.6	8.3	6.0
1994 10.0	20.6	9.5	6.9

(a) Net rate of return on capital employed, defined as the gross trading profits from UK operations plus rent received less stock appreciation and capital consumption at current replacement cost, relative to the gross average capital stock employed less accrued capital consumption at current replacement cost.

As Table 5.B shows, the profitability of non North Sea ICCs rose last year—to its highest rate since 1989. In the first half of 1995, ICCs' profits were roughly unchanged, so profitability probably stopped rising.⁽¹⁾

Equity prices react to changes in expected future dividends and the interest rate at which they are discounted. Changes in the discount rate are likely to affect all equity prices similarly, so changes in sectoral share indices relative to the total market index reflect news about future profits of the sector. Last year, the engineering sector of the FT-SE All-Share index rose relative to the total—linked probably to the strength of engineering exports and expected future dividend payments. By contrast, the index for the consumer goods sector was roughly unchanged relative to the market. In the first nine months of this year, both sectors increased relative to the market. Profitability has also diverged within the retailing sector, with larger firms generally doing better than small retailers. Small retailers' sales values fell in the year to July, contrasting with a rise of 7% for large retailers.

Those sectors where profits are being squeezed most are likely to experience upward pressure on prices, as the weakest firms leave the sector, reducing the extent of competition. In some cases, remaining firms may be able to push down unit costs as well, depending on the degree of competition among their suppliers. Firms will be tempted to enter the most profitable sectors, putting downward pressure on their prices but also, in some cases, bidding up unit costs.

5.5

Administered prices

The previous *Report* outlined some of the announced changes in utility prices which will affect RPIX inflation over the next two years. Since the August *Report*, electricity companies have announced that they will offer customers a £50 payment each when the National Grid is sold. The payments will be made during the first half of 1996. If they are treated as a price cut by the CSO, the arithmetic effect on quarterly projections of annual RPIX inflation—assuming no second-round effects—will be to cut it by around three quarters of a percentage point on average in the first half of 1996, and

(1) The profits data quoted exclude the alignment adjustment, which is added to non North Sea ICCs' profits to reconcile the income and output measures in the national accounts.

to increase it by the same amount in the first half of 1997, as its effect drops out of the twelve-month comparison. No allowance has been made for this in the projections shown in Section 6.

5.6

Summary

Since the previous *Report*, the rate of increase of input prices has fallen, though over the past year initial rises in input prices have tended to be revised up. Output price rises have remained roughly constant, but unit wage costs have accelerated. Because wage costs have such a large weight in total variable costs, overall cost pressures have probably increased since the August *Report*. So domestic profit margins have probably been squeezed.

Prospects for inflation

6.1

The economic news

The following salient facts emerge from the previous sections:

- Inflation has edged up from June, whether measured on a three or a twelve-month basis. RPIX inflation rose above 3% in September. This was faster than projected in the August *Report*, primarily because of higher seasonal food prices (Section 1).
- Narrow and broad money growth stopped rising in September, but the monitoring range for M0 (0%–4%) was exceeded and the range for M4 (3%–9%) nearly so. The rapid expansion of credit, especially to the corporate sector, continued (Section 2).
- Sterling's effective exchange rate rose by 1.1% in the three months to 3 November. Market interest rates tended to fall, as did expectations of rates in the near future (Section 2).
- Nominal GDP is rising more slowly than the rate implied by trend real growth and inflation at the target level (Section 3).
- Real GDP grew at around its long-run average rate in the second and third quarters, although manufacturing and the retail sector were weak, and the markets for housing and construction showed few signs of recovery. New information about the composition of demand in the second quarter revealed that domestic demand rose sharply after a large fall in the first. Stockbuilding was equivalent to about three quarters of a percentage point of GDP, even more than in the first quarter (Section 3).
- Export growth slackened in the first half of this year, largely because of lower domestic demand growth in the United States. The visible trade deficit with non-EU countries increased in the third quarter. Domestic demand overseas has been a little weaker than expected this year (Section 3).

- Underlying average earnings growth fell slightly between May and August, although there were some signs of higher settlements in September. Wage drift in the services sector in particular has been exceptionally low or even negative (Section 4).
- Employment increased in the summer, but the signs are that total labour demand did not. Unemployment has continued to fall (Section 4).
- Commodity prices fell in the third quarter, and producer input prices slowed down more than did domestic output prices. But manufacturing productivity also decelerated, so the profitability of domestic markets probably did not increase (Section 5).

6.2 The Bank's medium-term projection

There has not been any major inflation surprise since the August *Report*. Between June and September, RPIX increased by just over 0.1 percentage points more than projected in August. If food prices are excluded, inflation fell.

Industrial production was unchanged between March and September, and manufacturing output fell by 0.3%. Total GDP in the third quarter is estimated to have been 2.4% higher than a year earlier, but services expanded by 3.2% while the rest of the economy (accounting for just over one third of output) grew by only 1.0%.

At first sight, this pattern of growth is inconsistent with the picture painted in past *Reports*, in which the sectors producing internationally tradable goods and services were expanding strongly and the non-tradables sectors were much weaker. But the distinction between tradables and non-tradables is not the same as the distinction between goods and services. The incentive for firms to produce both goods and services for export is still greater than it was last year. Manufacturers' export prices have risen faster than domestic prices. Net exports have probably not fully responded to the depreciation of sterling earlier in the year. Unless the growth of domestic demand in the rest of the world relative to the United Kingdom's falls, the tradables sectors—but not necessarily goods production—are likely to remain the more rapidly growing parts of the economy in the short run.

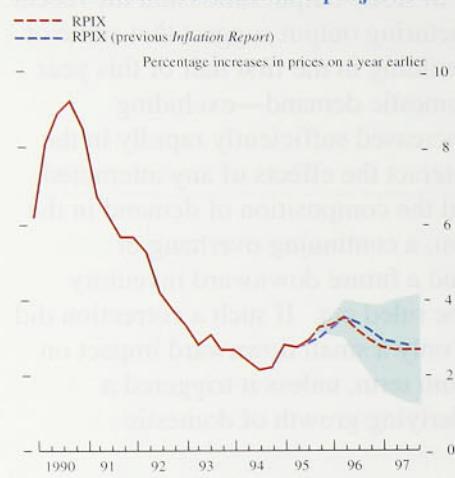
This short-run picture is complicated by the behaviour of stocks. An increase in stock-output ratios and the recent weakness of manufacturing output suggest that some of the extensive stockbuilding in the first half of this year was involuntary. Domestic demand—excluding stocks—may have increased sufficiently rapidly in the third quarter to counteract the effects of any attempted destocking. But until the composition of demand in the third quarter is known, a continuing overhang of unwanted stocks—and a future downward inventory correction—cannot be ruled out. If such a correction did occur, it would have only a small downward impact on inflation in the medium term, unless it triggered a slowdown in the underlying growth of domestic demand.

In the long run, inflation is determined by monetary growth, but in the short run the state of the business cycle is also important. When output is below its long-run potential path, and unemployment is above its natural rate, there is downward pressure on inflation relative to its expected rate. A rise in inflation expectations puts upward pressure on wage settlements and prices. If it were accommodated by monetary policy, actual inflation would also rise. So along a spectrum of shorter to longer-run influences on inflation, the key issues for the inflation outlook are:

- How will the components of demand evolve?
- Will earnings accelerate significantly?
- Is the rapid growth of money and credit a temporary phenomenon, reflecting changes in the relationship between desired holdings of money and nominal income, or is it a signal that nominal demand will accelerate?

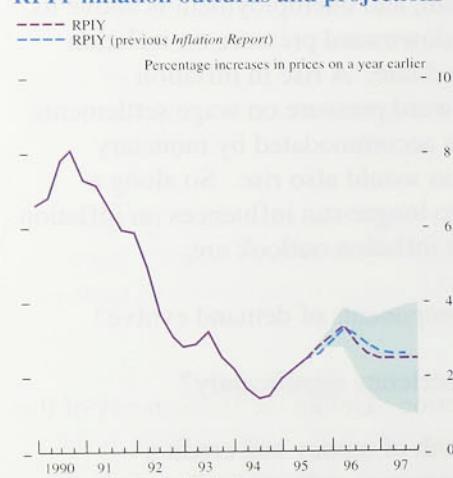
First, it seems likely that consumers have now largely adjusted their desired consumption to the fiscal consolidation of the past three years. So consumption is expected from now on to grow somewhat faster, at around its long-run trend rate. Investment may be held back relative to past recoveries by low demand for new commercial buildings and works, and business confidence and investment intentions are weaker than at the time of the previous *Report*. Public spending growth is expected to fall. On balance, growth in total domestic demand is likely to increase a little over the next couple of years. The depreciation of sterling since 1992, and subsequent improvements in price competitiveness, are still stimulating export growth. There are, however,

Chart 6.1 RPIX inflation outturns and projections



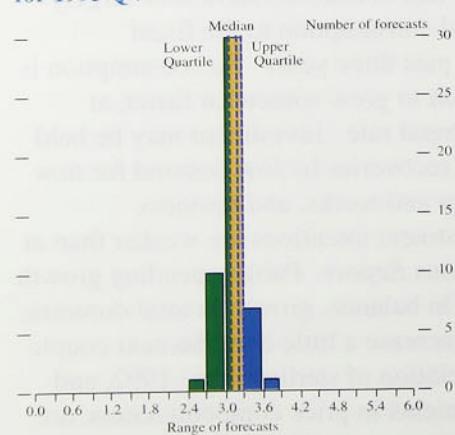
The range is defined as the central projection plus or minus the absolute average error on RPIX inflation projections since 1985. These projections have all been based on the assumption that short-term nominal interest rates are unchanged.

Chart 6.2 RPIY inflation outturns and projections



The range is defined as the central projection plus or minus the absolute average error on RPIY inflation projections since 1985. These projections have all been based on the assumption that short-term nominal interest rates are unchanged.

Chart 6.3 Distribution of RPIX inflation forecasts for 1995 Q4



Source: Forecasts of 49 private sector organisations as of October 1995.

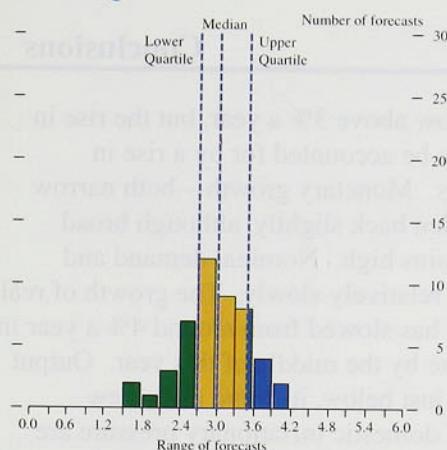
clear risks on both sides of this central view, especially in respect of investment and net exports.

The second issue for the inflation outlook is the behaviour of earnings. Some rise in earnings growth is expected, and is incorporated in the central projection. Will this exceed the rate compatible with target inflation and falling unemployment? There are three main reasons why this might happen. First, pay settlements might pick up in response to adverse supply shocks, such as the increase in seasonal food prices. The price rises that such supply shocks bring about might be misinterpreted as a sign that underlying inflation had increased, thus pushing up wage bargainers' inflation expectations. Second, wage drift might reappear in the service sector. The factors, such as an increase in part-time work, which have suppressed the usual drift cannot be relied upon to do so in future. Third, given the fall in unemployment, the growth of real earnings has been slower than expected. A return to the relationship seen in the past could be triggered by a few high-profile pay settlements. These risks have to be balanced against the possibility that the long-run natural rate of unemployment has fallen, increasing downward pressure on the growth of real wages.

The third issue—the rapid growth of money and credit—turns on whether there has been a change in the relationship between money and nominal demand. The central view—based on the discussion in Section 2—is that broad money growth will soon begin to fall back somewhat. If it does not, then nominal demand growth might accelerate leading to higher inflation in the future.

The Bank's central projections for twelve-month RPIX and RPIY inflation two years ahead are shown in Charts 6.1 and 6.2. It is assumed that official UK interest rates remain unchanged over the next two years and that the exchange rate evolves according to uncovered interest parity from its level of 84.3 on 3 November. No adjustment has been made for next year's electricity rebates, the treatment of which in the RPI has yet to be determined. The central projection is the Bank's judgment about the single most likely outcome for inflation. Of course, a wide range of other outcomes is possible, but the Bank's view is that the risks surrounding the central projection are now more evenly balanced than earlier in the year. The central projections are similar to those made in August—albeit slightly lower—with RPIX inflation in two years' time a fraction above 2½%, the figure specified in the Government's target.

Chart 6.4
Distribution of RPIX inflation forecasts
for 1996 Q4



Source: Forecasts of 48 private sector organisations as of October 1995.

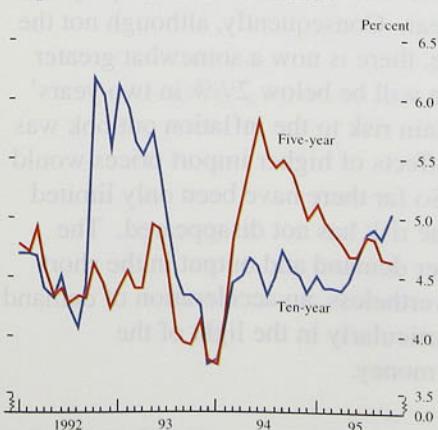
Chart 6.5
Average inflation expectations over the following three years^(a)



Source: Bank of England.

(a) Calendar-month average.

Chart 6.6
Implied forward inflation rates^(a)



Source: Bank of England.

(a) Calendar-month average.

The shape of the projected path for RPIX and RPIY inflation over the next two years is largely determined by the exchange rate depreciation seen earlier this year. This led to an increase in import prices and hence in the prices of domestic goods and services using imports in their production. Most of the first-round impact of the depreciation on the retail price level has probably come through by now, but this still has the effect of pushing up the twelve-month inflation rate for some months to come—leading to a peak in annual RPIX inflation around the middle of next year.

The central projection for inflation over the next two years starts out a little higher than in August, largely because of the slightly higher-than-expected outturn for inflation in the third quarter. But the seasonal food price increases responsible for this should unwind over the next year, so RPIX and RPIY inflation are both still projected to peak in the middle of 1996. Thereafter, the new central projection has slightly lower inflation, because of a downward revision to output prospects over the next year.

6.3 Other inflation projections

The distribution of forecasts of RPIX inflation for 1995 Q4 and 1996 Q4 collected by the Bank are shown in Charts 6.3 and 6.4. The median forecast for 1995 Q4 has increased from 3.1% to 3.2%, but that for 1996 Q4 has fallen from 3.2% to 3%; this is still above the Bank's central projection. Unlike the Bank, many of the other forecasters assume changes in interest rates in the next two years, the majority expecting some increase. Reflecting the greater uncertainty, the spread of forecasts for 1996 Q4, as measured by the interquartile range, has widened a little. Nevertheless, a higher proportion than in August forecast inflation to be at or below 2½% by 1996 Q4, and most of these also incorporate some fall in interest rates.

The reduction in medium-term inflation expectations can be seen in bond yields also. Chart 6.5 shows the average twelve-month RPI inflation expected over the following three years, as derived from a comparison of conventional and index-linked gilts and expressed as a calendar-month average. The average fell by around half a percentage point around May this year and then dropped further in September and October. Implied expectations over the longer term have behaved rather differently. Chart 6.6 shows how the twelve-month rate of RPI inflation expected in ten years' time has

increased since May. At the five-year horizon, the improvement evident up to around June has ceased.

6.4

Conclusions

RPIX inflation is now above 3% a year, but the rise in inflation can largely be accounted for by a rise in seasonal food prices. Monetary growth—both narrow and broad—has fallen back slightly, although broad money growth remains high. Nominal demand and output are growing relatively slowly. The growth of real demand and output has slowed from around 4% a year in 1994 to half that rate by the middle of this year. Output is now rising at, or just below, its trend rate. Few immediate signs of domestic inflationary pressure are apparent. The sharp rise in the price of imported goods in the first half of this year—which has now stopped—has not yet fully passed through to domestic prices. As yet, few second-round inflationary effects are visible.

Despite the slowdown in growth as a whole, the dual nature of the economic recovery continues, with net exports and manufacturing investment stronger than other components. The slowdown in output growth over the past year may persist through next year, or may prove only temporary, reflecting an unwinding of involuntary stockbuilding earlier in the year.

The central projection remains, as in the August Report, that there will be a temporary rise of RPIX inflation—as higher input prices feed through to domestic inflation, and the very low price rises of a year ago drop out of the twelve-month measure—followed by a fall towards, but remaining just above, 2½%. The uncertainties in this outlook—just as important to monetary policy as the central projection—are more evenly distributed around the central projection than earlier in the year. Consequently, although not the most likely outcome, there is now a somewhat greater chance that inflation will be below 2½% in two years' time. Earlier, the main risk to the inflation outlook was that second-round effects of higher import prices would push up inflation. So far there have been only limited signs of that. But the risk has not disappeared. The probability of weaker demand and output in the short term has risen. Nevertheless, an acceleration of demand is quite possible, particularly in the light of the behaviour of broad money.

The uncertainties surrounding the central projection have therefore increased since the August Report, and

the range of possible outcomes is wider. Achieving the inflation target in two years' time is by no means assured. It will depend on how the present uncertainties are resolved over the coming months.

Glossary and other information

Glossary of selected terms

RPI inflation: inflation measured by the retail prices index.

RPIX inflation: inflation measured by the RPI excluding mortgage interest payments.

RPIY inflation: inflation measured by the RPI excluding mortgage interest payments and the following indirect taxes: council tax, VAT, duties, car purchase tax and vehicle excise duty, insurance tax and airport tax.

HARP index: a price index which replaces the mortgage interest payments in the RPI with a Bank estimate of the user-cost of housing.

THARP index: the HARP index excluding indirect taxes.

M0: notes and coin in circulation outside the Bank of England and bankers' operational deposits at the Bank.

M4: UK non-bank non building society private sector's holdings of notes and coin, together with all sterling deposits (including certificates of deposit) held with UK banks and building societies by the non-bank non building society private sector.

Divisia money: a measure of the money stock in which each component is weighted according to an estimate of the transaction services it provides.

ICCs: industrial and commercial companies.

OFIs: other financial institutions.

Three-month annualised: the percentage change in a series between one period and that three months earlier, expressed as an annual rate.

Symbols and conventions

Except where otherwise stated, the source for the data used in charts and tables is the Central Statistical Office (CSO). The measures of inflation included in this *Report* have been adjusted by the Bank for a CSO error in underrecording RPI and RPIX inflation between February and May 1995.

... not available.

— nil or less than half the final digit shown.

Because of rounding, the sum of the separate items may sometimes differ from the total shown.

On the horizontal axes of graphs, larger ticks denote the first observation within the relevant period, eg data for the first quarter of the year.

Other information

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The Summary of this *Report* is available at:

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