Prospects for inflation 6

Output growth was above trend in the second half of 2003, and surveys point to a further strengthening in the near term. Thereafter the economy is projected to slow, but still maintain a fairly brisk pace. Annual CPI inflation should begin to rise during 2004. In the short term, that partly reflects a number of factors, such as planned utility price increases, that have a temporary impact on the overall inflation rate. But over the next two years inflation is likely to move up to the target as domestic supply constraints start to bite and import prices rise modestly. Compared with November, the more robust outlook for activity means that domestic inflationary pressures are stronger. But the higher value for the sterling exchange rate in this projection helps to offset their impact on prospective CPI inflation. Risks around the central projection are broadly balanced for both inflation and GDP growth.

6.1 World economy

The MPC expects the world economic recovery to continue in 2004 and 2005. The outlook for world economic activity has marginally improved since November.

Euro-area GDP grew by 0.4% in 2003 Q3, stronger than the flat profile for output projected for the November *Report*. Surveys suggest that there may have been a further slight pickup in growth during the final quarter of last year. But the appreciation of the euro, largely reflecting the dollar's fall, means that the recovery is unlikely to continue gathering momentum in early 2004, because net trade will probably act as a brake on growth. However, there are a number of factors that could support an improvement in domestic spending growth. Official interest rates remain low, and taxes were reduced in some countries at the beginning of 2004. Higher equity prices and lower market interest rates than in November should provide an additional impetus. So the MPC is projecting a somewhat firmer prospect for euro-area domestic demand. But that is likely to be balanced by the greater drag from net trade. Consequently, the outlook for GDP growth during the next two years remains broadly unchanged.

The near-term outlook in the United States is for very strong growth in output. This year, GDP is expected to increase at a rate well above its long-term average. High consumption growth should be sustained by expanding incomes, as labour demand revives and with tax rebates still in the pipeline. Rising profits, supported by strong productivity growth, and a low cost of finance are likely to foster the continuing recovery in investment. Domestic spending growth may also be buttressed by the rise in equity prices during the past three months. The further decline in the dollar should provide some support for net trade. The MPC's latest projections incorporate a somewhat more vigorous short-term prospect for the US economy than envisaged in November. GDP growth is expected to fall back towards trend in 2005, as monetary policy tightens, and the impetus to the economy from fiscal policy subsides.

Recent data releases for Japan have revised away some of the strength from the recovery that was apparent in the GDP data available at the time of the November *Report*. Even so, the Committee's projection is little changed as it had already placed weight on other evidence, which suggested a slower pickup was in train. The picture remains one of continuing growth during the next two years. GDP growth is likely to maintain a lively pace in other Asian economies—similar to November's projection.

The outlook for UK export markets is for further recovery. Much of this was anticipated in November. So compared with that forecast, the new projection for UK-weighted world trade is only marginally stronger.

6.2 UK output and expenditure

Consumption grew by 0.9% in 2003 Q3, stronger than expected at the time of the November *Inflation Report*. Revisions to the data, published by the ONS in December, also mean that the past few years look different, with the slowdown now less pronounced than was apparent three months ago. Indeed, these data together with the recent outturns for retail sales and surveys suggest that consumption may have a little more near-term momentum than the MPC believed in November.

But real post-tax labour income growth is projected to ease. In part, that reflects an assumption by the MPC that income tax receipts as a proportion of GDP will rise during the next two years, in line with the Treasury's estimates from its *Pre-Budget Report* forecast.(1) The expected pickup in consumer price inflation (see below) should also help to reduce households' real income growth. And the MPC continues to believe that annual house price inflation will slow markedly to around zero in 2005. Consequently, the Committee judges that consumers' expenditure growth will drop back during 2004 to around its long-run average and remain there for the rest of the forecast period. Except for the stronger near-term picture, the broad

(1) See HM Treasury (2003), *Pre-Budget Report*, December, page 220.

outline of the projection for the household sector is similar to that in November.

Business investment is estimated to have fallen by 1.2% in 2003 Q3, compared with the moderate rise projected in the MPC's November forecast. But, if anything, indicators of corporate sector financial health have improved somewhat since November. Profits have continued to recover, and equity markets appear increasingly confident about future growth in profitability. Corporate bond spreads have narrowed. And indicators of investment intentions have rallied sharply. As a result, the Committee judges that the conditions are in place for a stronger upswing in business investment than projected in November.

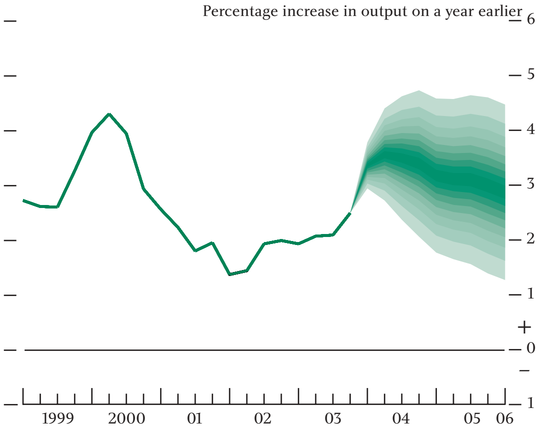
By convention, the MPC assumes that nominal government spending on goods and services will evolve in line with the Chancellor's latest projections. In the Chancellor's *Pre-Budget Report*, nominal government expenditure was projected to be higher than had been the case in his earlier Budget forecast.

The translation of that profile for nominal public spending into real public spending and output is not straightforward. As noted in Section 2, though nominal spending grew rapidly during the past few years, the ONS has reported much slower growth in the associated volume measure and a rapid rate of increase in the implied price deflator. That may reflect the inherent difficulty in measuring output in parts of the public sector. So although the nominal value of public expenditure can be projected forward with reasonable confidence, there is considerable uncertainty over how that will translate into the corresponding volume estimates. Fortunately, that uncertainty, though affecting the official estimates for GDP, has little bearing on the outlook for CPI inflation. In evaluating the impact of extra public spending on CPI inflationary pressures, what matters is the opportunity cost of the resources withdrawn from the private sector, not how effectively the resources are then used within the public sector.

Net trade made no contribution to GDP growth in Q3, in line with the projection in the November *Report*. Headline figures for trade continue to be affected by the closing down of VAT fraud.(1) Abstracting from that, export growth was probably quite strong in 2003 Q4, as the world economy improved further and as the effect of sterling's depreciation earlier in the year worked through. The continuing world recovery should help to ensure that exports grow at a healthy pace during the next two years. Imports should also regain some momentum, supported by strong domestic demand growth. The sterling ERI averaged 102.8 in the 15 working days to

(1) See the box on pages 18–19 of the August 2003 *Report* for a more detailed discussion of that fraud.

Chart 6.1
Current GDP projection based on constant nominal interest rates at 4.0%



The fan chart depicts the probability of various outcomes for GDP growth in the future. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

4 February, the starting point used for the MPC's central projection. Using the MPC's conventional approach(1) the level of sterling is assumed to depreciate to 99.9 by 2006 Q1—higher throughout than the level embodied in the November projection. The higher path for sterling means that the contribution to prospective GDP growth from net trade is a little weaker over the next two years than expected three months ago.

The Committee's latest projection for GDP growth at market prices is shown in Chart 6.1.(2) It is based on the assumption that official interest rates are maintained at 4.0%.(3) The four-quarter growth rate is projected to increase sharply at the beginning of 2004. Recent survey data are consistent with a pickup in quarterly growth. Revisions to 2003 Q3 and a higher expected outturn for 2003 Q4 also mean that the near-term profile for GDP growth in Chart 6.1 is somewhat stronger. Thereafter, the economy is likely to slow but still maintain a fairly brisk pace—broadly similar in the second year to November's projection.

6.3 The outlook for inflation

On 10 December 2003, the Chancellor announced a change in the MPC's target for the twelve-month inflation rate from 2.5% for RPIX to 2.0% for the consumer prices index (CPI). RPIX and CPI inflation are both affected by a combination of external and domestic pressures. Among the external influences, the price of oil was higher in dollar terms at the beginning of February than was implied by the November projection. But the profile of the futures curve, which is used to guide the MPC's projection, is slightly downward sloping during the next two years. In foreign-currency terms, the inflation rate of other goods and services that are sold to the United Kingdom should pick up as the world economy recovers. Overall, that represents a broadly similar outlook for world prices to that in November. However, these external influences are transmitted to the UK economy via the sterling exchange rate. During the past three months, sterling has appreciated by a little more than 2%, mainly against the dollar. And the higher value for the sterling ERI that is assumed throughout this forecast is one factor pushing down on the MPC's projection for UK inflation compared with three months ago.

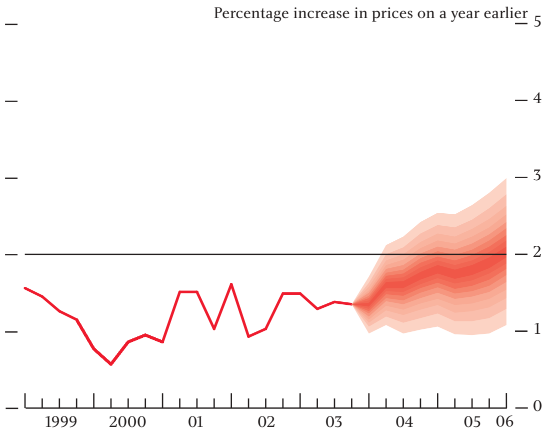
The future path for inflation also depends on the balance between demand and supply in the domestic economy. Growth in the UK economy has been relatively slow in the past

(1) See the box 'The exchange rate in forecasting and policy analysis', on page 48 of the November 1999 *Inflation Report*.
(2) Also shown as Chart 1 in the Overview.
(3) An alternative projection based on market interest rate expectations is shown in Chart 6.6 below.

few years. And as a result, output has probably fallen below its potential level. Indeed, since the November *Inflation Report*, the level of GDP at basic prices has been revised down. The Committee believes that, because it excludes indirect taxes, this is a better measure of the volume of goods and services produced in the economy than GDP at market prices. The MPC has not revised down its estimate of potential output as a result of the new data, so the lower level of GDP at basic prices estimated by the ONS would be consistent with output being further below its potential level than the Committee believed in November. The Committee has also revised up marginally its assumption about future growth of potential output over the forecast period to reflect changes in its judgment about the likely evolution of the labour market.

Scant pressure on supply is apparent in recent outturns for the labour market. However, the projected above-trend GDP growth should translate into demand for extra labour. The Committee expects nominal earnings growth to rise in response. Labour productivity per person employed is projected to grow above its long-term annual average rate of around 2% through the forecast period. That should offset the impact of rising earnings on unit wage costs to some extent. In spite of that, unit wage cost growth is projected to rise into the medium term.

Chart 6.2
Current CPI inflation projection based on constant nominal interest rates at 4.0%



The fan chart depicts the probability of various outcomes for CPI inflation in the future. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

Some indicators (see Section 4) have suggested that price pressures have been edging up recently, though they remain reasonably subdued. And annual CPI inflation fell slightly to 1.3% in 2003 Q4, from 1.4% in Q3. The Committee's projection for CPI inflation is presented in Chart 6.2,[(1)] conditioned on the assumption that the official interest rate is maintained at 4.0%.[(2)] Under the central projection, CPI inflation increases during 2004, as a number of factors, such as planned utility price increases, have a temporary impact on the overall inflation rate. Domestic inflationary pressures build throughout the next two years, accompanied in the latter part of the forecast period by the impact of increasing import prices as the world economy strengthens. So inflation continues to edge up towards the target through the second year of the projection.

Annual RPIX inflation fell in Q4 to 2.6%, from 2.8% in Q3. In order to facilitate a comparison with the outlook three months ago, Chart 6.3[(3)] shows a forecast for RPIX inflation consistent with the projection for CPI inflation in Chart 6.2. That RPIX inflation projection is shown alongside the one that the Committee agreed for the November *Report* (see Chart 6.4) conditional on the assumption that interest rates were

(1) Also shown as Chart 2 in the Overview.
(2) An alternative projection based on market interest rate expectations is shown in Chart 6.5 below.
(3) Also shown as Chart 3 in the Overview.

Chart 6.3
Current RPIX inflation projection based on constant nominal interest rates at 4.0%

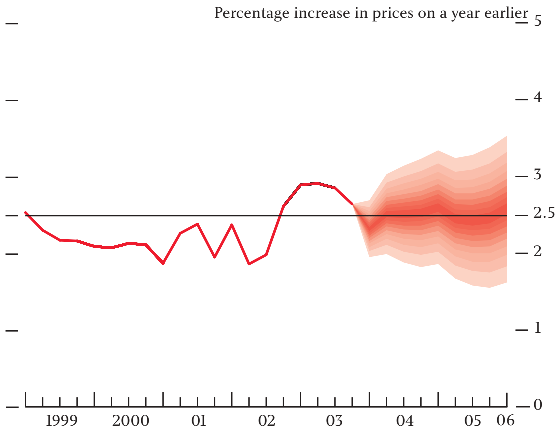
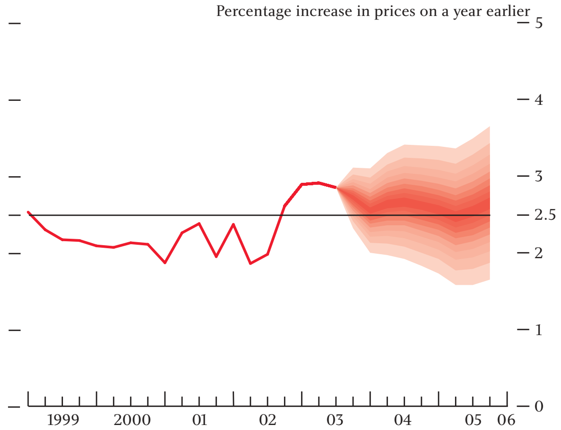


Chart 6.4
RPIX inflation projection in November based on constant nominal interest rates at 3.75%



The fan charts depict the probability of various outcomes for RPIX inflation in the future. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands is drawn to cover a further 10% of probability, until 90% of the probability distribution is covered. The bands widen as the time horizon is extended, indicating increasing uncertainty about outcomes. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

maintained at 3.75%. Unlike CPI, RPIX is directly influenced by changes in house prices through its housing depreciation component.(1) As in November, RPIX inflation is projected to fall initially as the impact of house price increases on the index diminishes. RPIX inflation remains around 2.5% for much of the next two years, a similar profile to November. The impact of the stronger demand pressures on inflation is broadly offset by the higher level of sterling. With the contribution to RPIX inflation from the housing depreciation component expected to decrease to zero over the forecast period, the gap between RPIX and CPI inflation on the respective central projections is likely to narrow in two years' time to around 0.5 percentage points—the numerical difference between the inflation targets on the old and new measures.

The Committee's projections for CPI inflation and GDP growth conditioned on an estimate of financial markets' expectations for official interest rates are shown in Charts 6.5 and 6.6 respectively. That estimate of interest rate expectations, shown in Table 6.A, has been constructed from the 15-day averages of interest rates on government securities of the appropriate maturity. According to these estimates, the market expects interest rates to climb less steeply than it did in early November. Even so, the latest profile for market rates still slopes upward. Hence, the central projection for growth in Chart 6.6 is below that in the constant-rate version. The profile for CPI inflation is also lower, and less steep, under market interest rates, with the central projection just below the new target at the two-year horizon.

(1) See the box on page 36.

Chart 6.5
Current CPI inflation projection based on market interest rate expectations

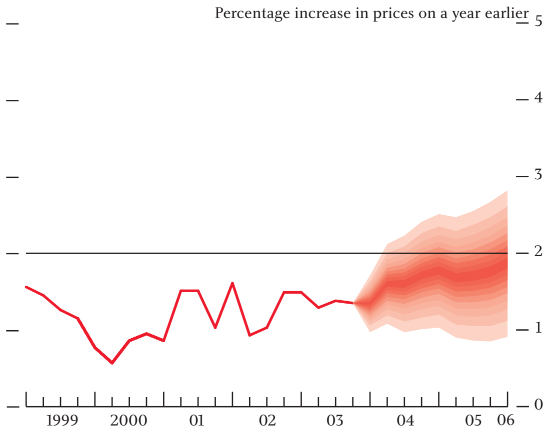


Chart 6.6
Current GDP projection based on market interest rate expectations

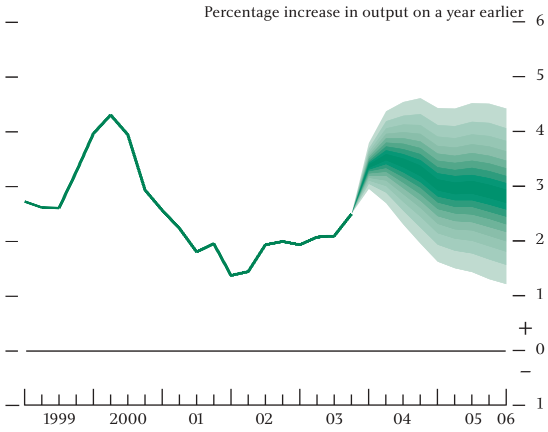


Table 6.A
Market expectations of the Bank's official interest rate[(a)]

Per cent

2004				2005				2006
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
3.9	4.2	4.3	4.5	4.5	4.6	4.7	4.8	4.8

(a) Based on the interest rate available on gilt-edged securities, including those used as collateral in short-term repo contracts, plus a small upward adjustment to allow for the average difference between this rate and the Bank's official interest rate. The data are 15-day averages to 4 February 2004.

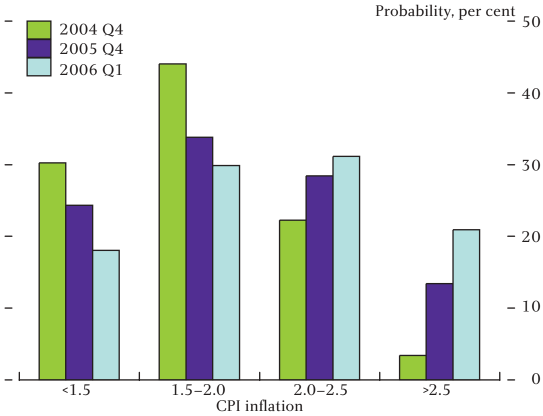
The prospects for output growth and inflation are, as always, uncertain. The fan charts illustrate the Committee's best collective assessment of the likelihood of possible outcomes, including judgments on the principal risks to the outlook. The width of the fan charts indicates how uncertain the Committee is about the prospects for the economy. It uses the experience of past forecast errors in making this judgment. As the Committee has agreed a forecast for CPI inflation for the first time to publish in this *Report*, there is no track record of forecast errors on which to base an estimate of uncertainty around the central projection. The MPC has provisionally decided that the errors made in forecasting RPIX inflation still provide a suitable yardstick by which to judge the likelihood of alternative future outcomes for CPI inflation. There has been little change to the level of the MPC's uncertainty about the outlook for GDP growth and inflation since November.

The Committee considers that there are a number of risks around the central projection. These chiefly concern the outlook for the world economy, the prospects for the UK household sector, earnings growth, and uncertainty about the degree of pressure on potential supply.

The continuing large current account deficit in the United States may prompt a further fall in the value of the dollar and a weaker outlook for world demand than is embodied in the central projection. Nevertheless, the Committee believes that there is less chance of the world recovery faltering than it did three months ago, as growth now seems more firmly based. So the downside risks from the world for UK activity prospects have diminished since November.

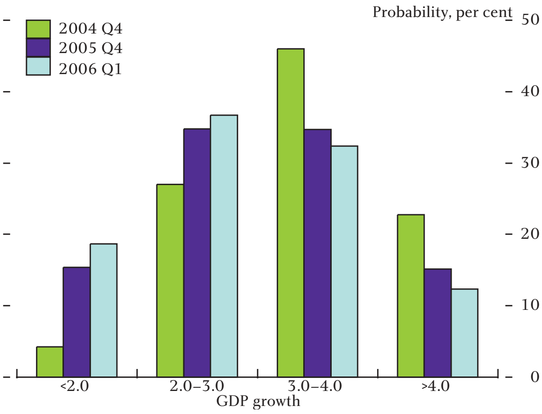
There are also risks to the outlook for UK household spending. The Committee may have underestimated the current momentum behind consumption growth and house price

Chart 6.7
The MPC's expectations for CPI inflation based on constant nominal interest rates at 4.0%(a)



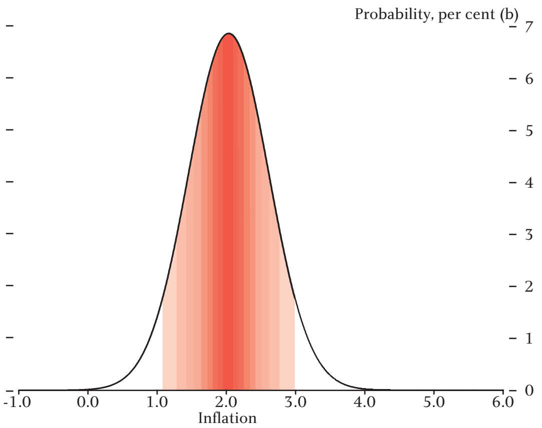
(a) These figures are derived from the same distribution as Chart 6.2. They represent the probabilities that the MPC assigns to CPI inflation lying within a particular range at a specified time in the future.

Chart 6.8
The MPC's expectations for GDP growth based on constant nominal interest rates at 4.0%(a)



(a) These figures are derived from the same distribution as Chart 6.1. They represent the probabilities that the MPC assigns to GDP growth lying within a particular range at a specified time in the future.

Chart 6.9
Current projection for the percentage increase in CPI in the year to 2006 Q1(a)



(a) This chart represents a cross-section of the fan in Chart 6.2 at the end of the forecast period. As with the fan charts themselves, the shaded areas represent 90% of the distribution of possible outcomes for CPI inflation in the future. The darkest band includes the central (single most likely) projection and covers 10% of the probability. Each successive pair of bands covers a further 10%. There is judged to be a 10% chance that the outturn will lie outside the shaded range. For further details on how the fan charts are constructed see the box on pages 48–49 in the May 2002 *Inflation Report*.
(b) Probability of inflation being within ±0.05 percentage points of any given inflation rate, specified to one decimal place. For example, the probability of inflation being 2.0% (between 1.95% and 2.05%) in the current projection is around 7%.

inflation, which could give rise to stronger activity in the near term and thus higher inflation. But that would increase the chance of a sharper correction to house price inflation and consumption growth at a later date.

The rise in National Insurance contributions in 2003 has already reduced employees' take-home income. They may take the opportunity of the coming pay round to try to claw back some of that reduction in the form of higher money wages. That would raise inflationary pressures.

There is considerable uncertainty about the level of potential supply in the economy and its likely future development. The factors contributing to that uncertainty include: whether the recent fall in hours worked is structural or cyclical; the degree of labour market tightness consistent with stable wage pressure; the difficulty of assessing the margin of spare capacity within firms; and the responsiveness of labour supply, particularly in view of the forthcoming EU enlargement.

The Committee judges that the downside risks to activity have receded since November. The best collective judgment of the Committee is that the risks to the central projection for both GDP growth and CPI inflation are broadly balanced. The probabilities of various outcomes for CPI inflation and GDP growth are set out in Charts 6.7 and 6.8. The overall balance of risks to the inflation outlook at the two-year horizon is shown in Chart 6.9. Given the many uncertainties in the outlook, Committee members hold slightly different views on the most likely path for inflation and on the overall balance of risks.

At its February meeting, the Committee noted that at the then official interest rate of 3.75%, CPI inflation, though currently below the 2% target, was set to move up to above the target at the forecast horizon and beyond. Given that outlook for inflation, the Committee judged that an increase of 0.25 percentage points in the official interest rate to 4.0% was necessary to keep inflation on track to meet the target.

Other forecasters' expectations of CPI inflation and GDP growth

In January, the Bank asked a sample of external forecasters for their latest projections of CPI inflation (which became the targeted measure in December 2003), output growth, interest rates and the sterling ERI (see Table 1). The average forecast for CPI inflation is around the 2.0% target at the two-year horizon. Nearly two thirds of the forecasters expect inflation of between 1.8% and 2.1% (see Chart A). And, on average, the external forecasters see a 56% probability of CPI inflation being at or below 2.0% in two years' time (see Table 2). In the past, forecasters were asked for their projections of RPIX inflation, so that comparisons with previous forecasts are not possible.

By end-2004 and end-2005, GDP is projected, on average, to grow at around 2½%. That is almost the same as last November's projections.

On average, official interest rates are forecast to rise to 4.7% by end-2005. That is little changed compared with last November's external projections. Nearly two thirds of forecasters expect interest rates of between 4.3% and 5.2% (see Chart B) at the two-year horizon. The sterling ERI is expected to fall to 98.5 by end-2005—somewhat higher than the respective average forecasts last November.

Table 1
Average external forecasts of CPI inflation, GDP growth, interest rates and the ERI(a)

	2003 Q4 (b)	2004 Q4	2005 Q4	2006 Q1
CPI inflation (c)	1.3	1.7	1.9	2.0
GDP growth (c)	2.5	2.6	2.5	2.4
Repo rate (per cent)	3.7	4.5	4.7	4.7
Sterling ERI (Index; 1990 = 100)	100.2	100.2	98.5	98.5

(a) For 2004 Q4 and 2005 Q4, 25 forecasters provided the Bank with forecasts for CPI inflation, GDP growth and interest rates; and 22 gave ERI forecasts. For 2006 Q1, 23 forecasters provided forecasts for CPI inflation and interest rates; 22 gave forecasts of GDP growth; and 19 of the ERI.
(b) Outturns. GDP growth is based on provisional ONS estimates for GDP at market prices. The repo rate and sterling ERI are daily averages.
(c) Percentage changes on a year earlier.

Table 2
Other forecasters' expectations of CPI inflation and GDP growth(a)

CPI inflation

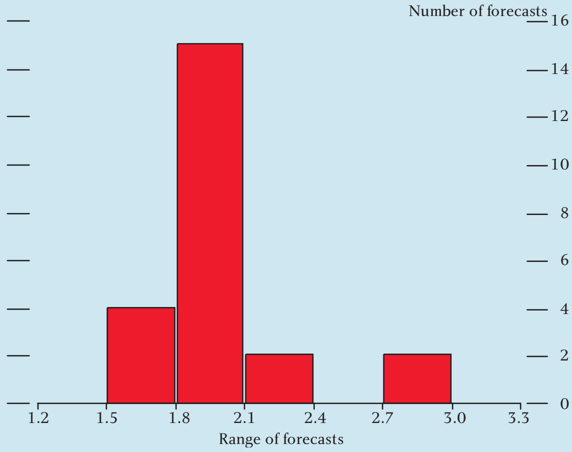
Probability, per cent	Range: Less than 1.0%	1.0% to 1.5%	1.5% to 2.0%	2.0% to 2.5%	2.5% to 3.0%	More than 3.0%
2004 Q4	8	25	39	19	7	2
2005 Q4	7	17	33	25	13	5
2006 Q1 (b)	7	17	32	24	14	6

GDP growth

Probability, per cent (c)	Range: Less than 1%	1% to 2%	2% to 3%	More than 3%
2004 Q4	5	20	47	29
2005 Q4	9	23	43	26
2006 Q1 (b)	10	25	41	24

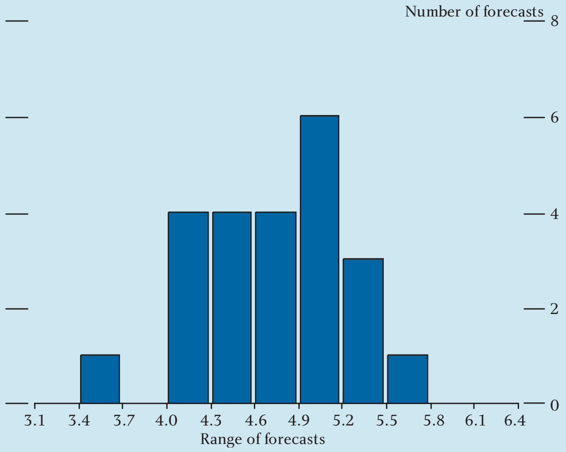
(a) 25 forecasters provided the Bank with their assessment of the likelihood, at three time horizons, of expected twelve-month CPI inflation and four-quarter output growth falling in the ranges shown above. For example, on average, forecasters assign a probability of 7% to CPI inflation turning out to be less than 1.0% in 2005 Q4.
(b) 23 forecasters.
(c) Figures may not sum to 100 due to rounding.

Chart A
Distribution of CPI inflation forecasts for 2006 Q1



Source: Central projections of 23 outside forecasters as of 30 January 2004.

Chart B
Distribution of repo rate forecasts for 2006 Q1



Source: Central projections of 23 outside forecasters as of 30 January 2004.